Oil Prices Still in the Headlines, by Carla L. Romita
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Oil prices have recently been extraordinarily volatile and reached unprecedented levels. This is news to just about nobody. Why do prices continue to remain so high in the face of reports that inventories are strong and supplies are sufficient?

Many factors influence the world oil markets. Oil prices are basically driven by the laws of supply and demand—"fundamentals". Since 2002, growth in worldwide oil demand has unexpectedly accelerated to nearly 85 million barrels a day. Along with traditional players in this marketplace, developing countries need increased supplies of oil to fuel their economies. Demand volume is approximately 98% of total worldwide daily delivery capability (or supply). This narrow margin of excess production makes the market vulnerable to even small supply disruptions. When a refinery is incapacitated or a pipeline is disrupted, and the excess capacity is eclipsed, the markets compete for the oil that remains available. Excess capacity worldwide is so tight that even fears of supply disruptions have the effect of increasing prices.

Why is excess capacity so tight? Despite increasing demand for petroleum products over the decades, no new refining capacity has been constructed in the U.S. since the 1970's. Although existing refineries have been updated the amount of construction needed to create reliable excess capacity has not kept pace with the growing demand for fuel.

Fundamentals alone are not driving the volatility in today's energy markets. Inventories of no. 2 heating oil are high and the market is well supplied for the upcoming season. Based on fundamentals, the price of no. 2 heating oil should have weakened by now, but this has not happened. Speculation has become a powerful force behind today's global energy markets. Speculators who purchase and sell large numbers of heating oil contracts on the New York Mercantile Exchange (NYMEX) take positions that can create significant market fluctuation. It is important to understand that speculators make money off of market volatility. Based on the how speculators position themselves, they can make profits whether the market moves up or down. If a speculator "shorts" the market, or has fewer contracts than necessary to cover his market obligations, and prices move down, the speculator can purchase contracts to satisfy his obligations at a lower price and profit from the downturn in prices. If a speculator is "long" in the market, he has more contracts than he needs to meet his obligations. He would hope that the market moves up so he can sell his excess supply back to the market at a profit. Speculators thrive on market moves, and it is not necessary that it moves in a particular direction. That is why any news may create increased volatility and can drive prices higher.

The mere fact that there may be news can create price movement in the market that day. Political instability and/or violence reported in any country which is a major U.S. supplier of crude oil contribute to an environment of fear and concern, and may promote ever higher oil prices and serve to increase volatility in an already volatile market.

Some consumers imagine that their local fuel oil dealers are participating in windfall profits during these times of rising prices. Fuel oil dealers buy their product competitively in the marketplace. They grapple on a daily basis with the market's volatility. When prices are high, fuel oil dealers must, in turn, pay these higher prices to buy the product required by their customers. The dealers are forced to deal with higher working capital requirements. This represents increased risk to lenders and they may require the fuel oil dealers to pay higher costs to borrow money in order to finance their product purchases. Fierce competition in the New York metropolitan area and customer resistance to movement past certain price points limit the dealers' ability to pass these increased costs into the market. Compounding the problem is that high prices make it more difficult for customers, especially those working within the confines of a budget, to pay their bills according to terms. This saddles the dealers with higher credit balances over a longer time. The lost time value of money chips away at the dealers' already shrinking profits. You can well understand that no one hates high prices more than your fuel oil dealer.

There are a multitude of ways which the Government, private industry, and consumers can all help to moderate energy prices. Government should continue to implement higher efficiency standards for automobiles and should streamline the permitting process for new energy development as well as open more areas for responsible, environmentally sensitive exploration and development. Businesses should improve fuel efficiencies at facilities by keeping equipment in proper working condition or installing new more energy efficient equipment when feasible. Businesses can also explore ways to enhance the energy efficiency of their buildings as early as in the design phase, or later through insulation, and material upgrades such as weatherproofing or installing new windows and doors, or sealing cracks to prevent heat loss. As fuel prices increase, return on investment (ROI) time frames shrink rapidly for these types of projects which in turn increase a buildings value. Consumers can conserve energy by installing computerized heating plant management systems in multi-family buildings, and installing insulation and new thermal pane windows and doors. Eventually all of these measures will reduce demand, increase supply, and dampen prices.