Ferguson: Energy Matters

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Those Amazing Oil Prices

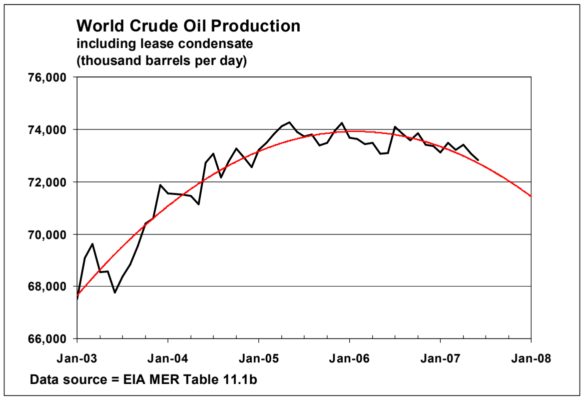
I confess that I am addicted to watching crude oil prices. I especially enjoy reading analysts' theories about the latest movements, none of which I find credible. As I write this on October 17, the NYMEX near month contract is flirting with $88 per barrel, moving down a bit as traders take their profit and moving back up as short traders decide to cover their positions. It's kind of like watching a good tennis match. (I have no bets on this game, by the way.)

One of the usual theories for price movements every Wednesday is based on the oil storage report issued by Energy Information Administration at 10:30 a.m. Eastern time. If U.S. commercial storage is higher than expected, prices tend to go down. When it appears that U.S. refiners are going to have to buy more oil, prices tend to go up. October 17 has been an exception so far. Crude oil in storage increased a bit over last week, but prices remained above October 16th's close almost all day before ending down 21 cents. But who knows—tomorrow prices could go up or down several dollars.

The short-term market movements constitute noise that tends to obscure the underlying trends. I fail to understand the interest in this noise. One day, pundits declare prices rose because Turkey is threatening to bomb the Kurds in Iraq. Why that possibility should increase the global price of oil escapes me. The next day, prices fall and the theory is that perhaps the Turks won't bomb the Kurds after all. Go figure.

Nowhere can I find a thoughtful explanation of why the price of oil is pushing $90 per barrel, an increase of nearly $20/bbl in the last two months. Unless we know why oil prices reached today's elevated levels, there is no way to know where they will go next.

Here's my theory in a nutshell: oil prices are rising because global crude oil production is falling and demand isn't. With more dollars chasing less oil, the price is bound to go up.



Alert readers may recall a chart I had in a previous column showing historical crude oil production estimates from the federal government. The most recent data for June 2007 show crude oil production dropped yet again, having fallen 2 percent since its peak in December 2005.

The trend in the data shown by the red parabola is ominous indeed. If this continues, prices can only continue upward. Data for July 2007 will be released soon, and a further decrease in production would delight the bulls on Wall Street if not consumers. But who knows?

The Organization for Petroleum Exporting Countries—especially Saudi Arabia—has promised time and again to increase production sufficiently to keep prices "moderate." So far we have seen neither more oil nor moderate prices. OPEC production in June 2007 was 3 percent lower than the 2006 average. It appears that all OPEC members are pumping as much oil as they can, but are unable to boost output. If not unable, they are surely unwilling, and with the money rolling in who could blame them?

The price of the OPEC "basket" of crude oil topped $80/bbl this week for the first time. In a recent report, OPEC found no evidence that current prices are cutting into consumption, however, implying perhaps that there is no cause for concern over prices today. The world is awash in dollars, and evidently there are plenty to spend on oil.

Many observers, including me, doubt that OPEC can increase production enough to offset increasing depletion elsewhere. In my opinion, the market is going to keep testing the upside of prices until more oil appears. The amount of money involved boggles the imagination, however.

Approximately 73 million barrels of crude oil are burned worldwide every day. At a price of $80/bbl, that's a value of nearly $6 billion today, another $6 billion tomorrow, and $6 billion the day after. Pretty soon you're talking real money.

In one rosy scenario, OPEC opens the valves, oil production begins to increase once more, and prices fall back to $50 in a few years. This happens to be the official scenario of the U.S. government as promulgated by the Energy Information Administration under President Bush.

In the less rosy scenario, OPEC cannot (or will not) increase production and prices continue to go nuts until …. what happens? Global recession? Riots in the streets? The U.S. invades Iran? And then what? What do we do if the world has to live with increasingly less oil?

Those fascinating oil prices are trying to tell us something. Now, if we can only figure out what they are saying.

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