

Crude Oil and Gasoline Prices: A Perfect Storm

By John Brodman

Fasten Your Seat Belts

The world oil market is a rollercoaster, and we're in for a wild ride. After falling slightly for two years in a row during the recession, world oil demand rose by more than 2.5 million barrels per day (mmbd) in 2010, to surpass the previous consumption peak of 86.5 mmbd reached in 2007. This represents the second largest annual demand increase in the last 30 years. At the same time, the political turmoil in the Middle East and North Africa is threatening the supply of oil. Oil production in OPEC member Libya is completely shut down, effectively removing 1.8 million barrels per day of oil supply from the global marketplace. Unrest in Egypt, Jordan, Oman, Iran, Iraq, Yemen, and Algeria is fanning expectations about what might happen if unrest spreads to disrupt more oil supplies. This expectation is driving the market higher.

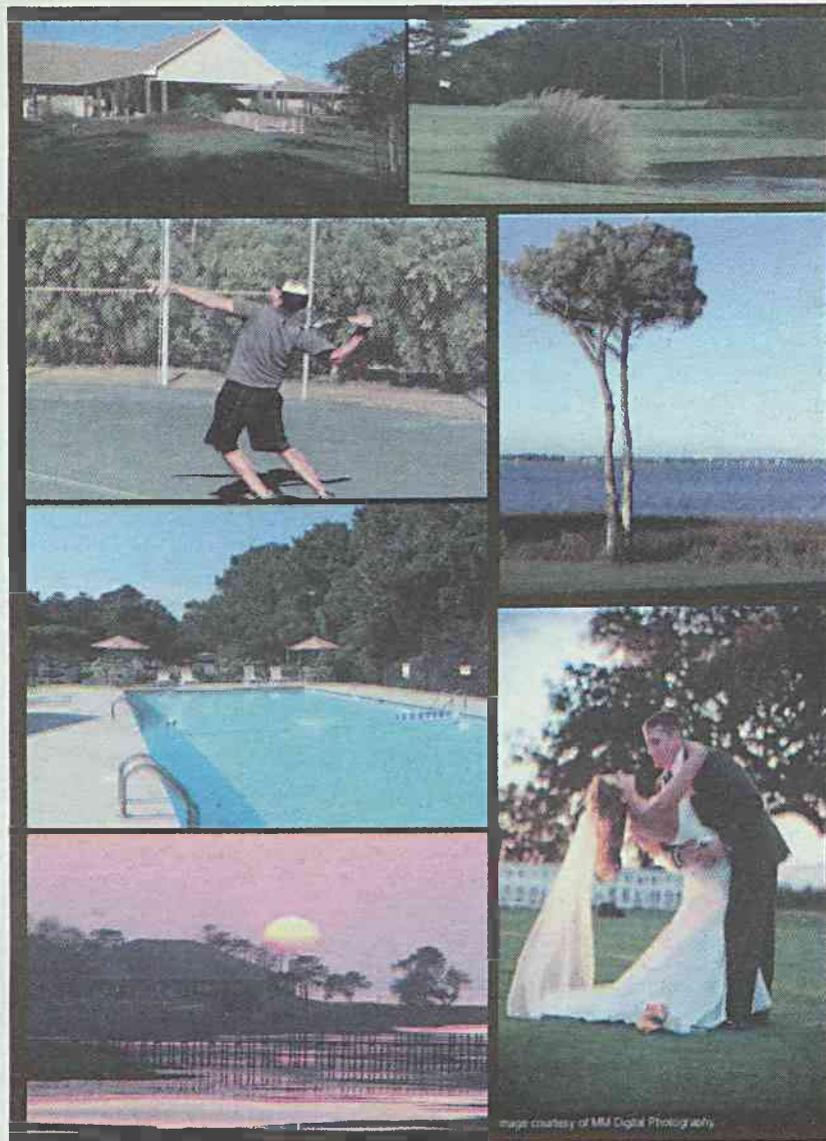
The loss of Libyan oil by itself is not enough to create an immediate shortage. Global inventories of crude oil and petroleum products are well above their normal levels for this time of year, and other oil producers (like Saudi Arabia) with spare oil production capacity are moving to produce replacement barrels. So why then are crude oil and petroleum product prices rising so rapidly? The answer is that oil is a widely-traded commodity, and like all commodities, its price is driven by both current market conditions and expectations about what might happen in the future. The current volatility in the oil market is really a variant of Economics 101, in this case, supply and demand on steroids.

Ten years ago, the average price of crude oil was \$26 per barrel. The average price rose in each of the next seven years to a level of \$99 in 2008, surging at one point to an intra-day trading high of \$147 per barrel. Prices then dropped with the global economic meltdown to a low point of \$34 per barrel in December 2008. Crude oil prices have since recovered, with the economic recovery and rising demand, from an average price of \$62 per barrel in 2009, to \$79 in 2010 and to \$87 per barrel at the beginning of this year. Prices rose further to just over \$100 per barrel in February and continued to strengthen to an average of just over \$110 per barrel by the middle

of March. The average regular retail price of gasoline at the pump in the U.S. followed crude oil, rising from a level of \$2.35 per gallon in 2009, to \$2.78 a gallon in 2010 and to a level of \$3.10 per gallon in January. Since then, gasoline prices have literally exploded, rising by \$0.38 per gallon in the last three weeks alone, to a national average of \$3.52 per gallon, with prices higher than \$4.00 in some parts of the country.

The increase isn't over yet. The U.S. Department of Energy's Energy Information Administration (EIA) expects motorists to see further increases now through spring and into the summer driving season (April through September). Increases will occur for seasonal reasons and because the recent rise in crude oil prices and gasoline prices at the wholesale level has not yet been fully passed through to the retail price of gasoline at the pump. Without any further increases in the price of crude oil, the EIA expects the national retail price of regular grade gasoline to average \$3.71 per gallon from April to September, which is \$0.98 higher than last summer, with the projected average price peaking at \$3.75 in June. Furthermore, the implied volatility of the futures market contract price for reformulated gasoline delivery in July suggests that there is a 25% chance

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