FUTURES $ OPTIONS

"Don't Blame OPEC"

*by Philip J. Baratz, C.T.A.**

It's the beginning of January, and the New York City area has just gone through 15 consecutive days of warmer-than-normal temperatures. The current forecasts call for a week-long Artic cold snap that anticipates spot natural gas prices hitting the equivalent of >$3.00/gallon. When all is said and done, it will likely put us in a position that has HDD's season-to-date through the middle of January somewhere around "normal". Cold weather in January is by no means unheard of, nor was the warm weather at the end of December. In all, we seem to be (weather-wise) experiencing nothing out of the ordinary—except for the price!

Ever since the run-up in prices leading up to the (2nd) war in Iraq last year, prices have been overly volatile, with a tendency to exaggerate every move, and to err to the side of bullishness. As the summer progressed, and prices moderated in the aftermath of the war, the push and pull (I don't want to use the "tug-of-war" analogy) between the bulls and bears kept prices somewhat stable. The rallies were generally met with sell-offs as the fundamental supply situation remained intact. When prices did start to slip in the middle of September, OPEC members (with some support from other non-cartel members) surprised the markets by announcing a prophylactic production cut. The announced premise (other than the "unannounced" obvious desire to sell oil for as much as they could) was two-fold. First, there was the fear of a price collapse as Iraqi oil would start to hit the world markets. Iraq sits on some of the world's largest oil reserves, and the likelihood of increased production to jump-start their economy made (makes) perfect sense. In addition, the 2nd quarter of the year is generally the lowest period of the year, from the demand side of the equation. In anticipation of the severe drop-off in demand (not that it doesn't happen each year), the lower production numbers were announced. The OPEC proposition was that they needed to support the prices in anticipation of lower demand down the road. Logical premise (to some), and their "right" as independent producers.

Then, as we moved through the fall, and into the winter, things started making less sense. As the weather lacked the power to support prices, Merc traders and several analysts pointed to the POTENTIAL for cold weather as a reason for prices to remain high, and even gain from those levels. When the time finally hit—with no extremely cold weather—at the end of December, the "Pricing Formula" restrictions were to kick into place—OPEC has a self-mandated formula that decreases production if prices fall and remain below a certain level for more than 20 consecutive days. The formula is also structured to kick in, and INCREASE production if prices remain above a certain level for 20 consecutive days. This formula SHOULD HAVE automatically called for production increases to go into effect for the 1st of the year. However, as the date of the automatic production increases approached, OPEC came out and said that there were not "normal" times, and that the production increase would not be implemented. The rationale was that, according to OPEC, the high prices that should have generated the increase were not being caused by supply shortages, but by fears in the marketplace (this comment, interestingly, was made with crude oil supplies in the U.S. well below year-ago levels, and sitting on "minimum operating levels", according to some).

As outrageous a claim as that would seem—bear in mind that production cuts would certainly be forthcoming in the event that prices were LOW for an extended period of time—there might be something to be said for the OPEC claim that it's "the other guys". If you look at the typical supply/demand factors that (or so we've been taught to believe) move both "spot" and "future" prices, it is hard to argue with OPEC's premise that it's not them, and their production quotas. Demand is steady, but not overwhelming. Inventories are (with the exception of crude) ahead of last years' pace. The weather, albeit not warm, in nowhere near the frigid experience of last winter, and the notion of our improved economy as a catalyst to higher prices is quite counterintuitive (every petroleum economist will gladly point to the correlation between high energy prices, and a WEAKENING economy). Personally, I'm not a big fan of OPEC, and the way they play their games, but finding fault with them (in this instance) seems to be a bit of a stretch.

Consider that oil is bought and sold around the globe using US Dollars. Now consider that the Dollar has fallen about 45% versus the Euro "dollar" in the past two years, and over 25% in the past year alone. While this may be good news for US exporters, it is great news for those who convert their own currencies into U.S. Dollars to buy crude oil. However, as egocentric as Americans are, we are not the only currency of value in the world, and as the Dollar has weakened, the need to charge more dollars to sell the same barrel of oil has made more and more sense. Oil prices sitting in the $35.00/bbl. range, are really only the equivalent (in our terms) of about $24.00/bbl. for a European purchaser using their own currency. The fact is that the weak dollar is just one of the factors that explain the seemingly illogical reason behind the strength in energy prices, but one that cannot be ignored. Nor can the weak dollar be (directly) blamed on OPEC and other oil producers.

So, now that we know what the problem is, what can we do about it? In all likelihood, the weight of the high energy prices will have some negative (perhaps only dampening) effect on the economy. If that does not happen, it will be a true testament to the policies of the Federal Reserve, and their conscious efforts of keeping interest rates low despite the weak effects on the Dollar. Regardless of where prices go, the volatility that we have begrudgingly grown accustomed to over the past few years is not going to go away. The costs of hedging and protecting prices have become, and will continue to be, an integral part of your business.

If you offer a cap, you need to fine-tune it to make sure that it achieves its goals. If you don't offer a cap, you are going to have to stop wondering why customers are leaving. If you lock in wet-barrels, you need to remember that what goes up (usually) must come down. There are so many variables that sometimes you have to accept that you cannot predict everything, and you cannot plan for every contingency. Sometimes, you have to make the best calculated moves, and seek logical counsel. Answers are out there, but they don't necessarily answer the questions that you have been asking. Try to concentrate on asking the right ones.

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