FUTURES $ OPTIONS

When the top is not the top

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

Over the past few months, oil prices have continued to do what they have done for the past few years: ***behave unpredictably and irrationally, while analysts spend their time trying to come up with logical explanations for the illogical***.

Since June, when crude oil prices started their latest string of "new, all-time record highs", we have seen a whole bunch of "reasons". We hit $40 per barrel on concern over strong demand, and an ever-growing Chinese economy. Then, $42 per barrel was eclipsed in the aftermath of terror attacks in Saudi Arabia. Jumping again, $45 per barrel followed closely behind as the insurgency in Iraq continued, and on the tug-of-war between the Russian government and the Russian oil giant, Yukos.

As a South Florida resident, I can attest first-hand that the Hurricane trifecta (Frances, Ivan and Jeanne) were clearly enough to take prices above $48 per barrel. The simmering and boiling-over of unrest in Nigeria took prices up to that magical level of $50 per barrel. Not to be undone, supply concerns, cold-weather forecasts, talk of strikes in Norway, and the Red Sox sweeping the Angels all seemed to have a hand in taking prices towards the $54 per barrel level as of this morning [mid-October]. Each time we approach a previously "untouchable" level, the magnet-effect of trading seems to hoist prices up to that level. Hopefully, by the time this article is read, all of this nonsense will have stopped; but based upon the market's unwillingness to behave logically, a move to $63 per barrel (unfortunately) is as likely as a drop back to $43 per barrel.

Is oil worth it? And how much is it really worth? When you look at some of the short-term issues that we are facing—continued production shut-ins (both crude oil and natural gas) in the aftermath of Hurricane Ivan, and strike threats in Norway and Nigeria (both producers of the lighter grades of crude oil that we need)—there is logic for prices to be "moving higher". The real question is whether the "base" from which prices are moving makes any sense at all.

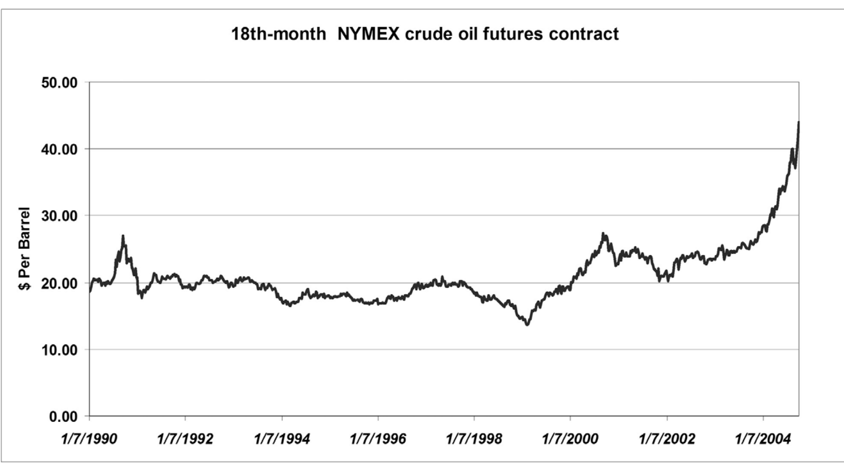
As will be discussed in subsequent articles, "this ain't your Father's oil market". We spent the better part of the 1990s with a great deal of steadiness in the long-term oil economics. In plain English, the consensus throughout the decade was that the marginal cost to produce crude oil was about $20 per barrel. This steadiness was reflected in the fact that the long-dated (i.e. the average price over the next few years, per long-term supply deals) didn't vary all that much from the $20 per barrel level, regardless of whether crude oil prices were rallying in the face of war (1991), or collapsing in the face of perceived over-supply (1998). Spot oil prices could move by $10-20 per barrel, and the long-term prices would move by only a few dollars per barrel (the attached chart shows where oil futures were since 1990 for the 18th-month-out futures contract—predictions for 1½ years later). The theory behind the steady-as-she-goes longer term prices was that just because (for example) there was a pipeline problem today that caused prices to jump up, it didn't really bear any impact on supply a few years down the road. Conversely, when prices fell, producers held a firm line on how cheaply they would sell oil well into the future, not willing to sell at levels below their marginal costs to produce. ***To repeat, it is hard to argue that short-term issues will have a real impact on prices well into the future***. Therefore, while the swings will remain in place, the long-term price of oil should rely on anticipated production costs, and a long-term view of supply and demand.

The importance of the long-term prices of crude oil seems to be the major change that we are witnessing in our markets. Even though, in the '90s, we did see prices at both $40 per barrel and $10 per barrel, the extent that the prices were able to move seemed to be that they were still tethered to the long-term price of oil. Short-term issues (pipelines, politics, weather, economics, etc.) will all swing prices from the marginal cost to produce—and, as seen in the '90s it can move prices by as much as $20 per barrel away from that number. So, how could prices get to over $50 per barrel—ignoring the "Hedge Funds Conspiracy Theories" —if the long-term costs are only $20 per barrel? Good question, but the answer is not one that will make you happy. From 2000 to 2003, the costs (estimated long-term marginal costs to produce) rose from the steady '90s-based $20 per barrel to about $25 per barrel. Not too bad. Unfortunately, since late '03, as a myriad of things kicked in, such as increased development and operating costs, higher producer taxes, and increased commodity—i.e. steel for production—costs, we have seen a dramatic jump in the long-term cost of crude oil—all the way up to around $35 per barrel. ***So, prices are no more out of whack now than they were on several occasions in the past***. With all these new costs in the market, the only way to shift the long-term curve back down would be for a low-cost producer, such as Saudi Arabia, to bring a lot of new product to the market—which would lower the marginal cost of production.

So, given this shift in the long-term cost of oil production from $20 per barrel in the '90s to today's "reality" of $35 per barrel, are prices in the $50s per barrel really out of line? Unfortunately, the answer seems to be "no". If (this is a BIG 'if') long-term prices are to stay in the mid-$30s per barrel for the foreseeable future, we can look forward to seeing crude oil prices range (in bullish short-term times, such as the current environment) up to the upper $50s per barrel, and down (in bearish—wouldn't that be nice?) times down to the mid-$20s per barrel.

Is there a silver lining? Well, firstly, we don't live in Europe, where oil prices (to the consumer) are dollars per gallon higher than prices in the US. Admittedly, we don't have the luxury that citizens in some oil producing nations have, that government subsidies take prices to lower-than-cost; but that is the reality in a democracy that imports about 10 million barrels of oil per day.

We can't change reality, and today's reality is that oil prices are very high—and even a mild start to the winter won't change that. Fully hedged dealers are in the cat-bird seat, but only for this season. Planning for next season is only a few months away. Using the dart-board approach to hedging usually doesn't work. We have a plan, so get in touch with us, or just stay tuned. Stay warm, and keep your customers warmer. □



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