Prospect of $100 oil turning into reality

NEWS ANALYSIS

Not so long ago the $80 level was seen as damaging to the world economy. **Javier Blas** looks at the changing views

As oil approached $100 a barrel yesterday, the key question was whether fundamentals or financial flows were driving the price higher.

If the main force is financial flows, the price could be inflated artificially and it could fall sharply once hedge fund take profits. In other words, the current price rally would be unlikely to inflict lasting damage on the world economy.

On the other hand, if fundamentals are driving the rally, oil prices are unlikely to stop their meteoric rise at $100 a barrel. The world economy may face high prices longer than previously expected, triggering an inflation spike just as central banks are considering interest rates cuts to help ease problems in the banking system.

The International Energy Agency, the energy watchdog, along with the US Department of Energy and some private analysts argue that fundamentals are the main force, suggesting that oil prices are not artificially inflated.

Indeed, analysts agree that between the start of 2007 and the end of the summer, market fundamentals played the dominant role, boosting the oil price for a year-low of about $50 a barrel in January to about $75 in September. Strong economic growth, particularly in China and India, has led to an annual increase of 1.2m barrels a day in crude oil demand. Meanwhile, production outside the Organisation of the Petroleum Exporting Countries has disappointed, growing just 700,000 b/d from 2006.

Eric Kreil, a petroleum market analyst at the Energy Information Administration, the statistical arm of the US Energy Department, said that when non-Opec supply growth is below growth in global consumption, the gap needs to be filled by Opec members' production increases or draw-downs from inventories.

So far this year, Opec, the oil cartel which controls about 40 per cent of the world's oil production, has restrained its output in an effort to keep prices high, pumping in September about 700,000 b/d less than last year. Opec agreed to boost production by 500,000 b/d starting in November, but it is too soon to say whether this will be enough to closet the gap.

As a result, inventories have had to take the strain. In the third quarter, rich countries' crude oil stocks suffered a counter-seasonal draw of 360,000 b/d, instead of the traditional increase of about 300,000 b/d.

Nobuo Tanaka, IEA executive director, yesterday blamed current record prices on "tightening crude oil fundamentals," such as the fall in inventories. In the US, the world's largest oil consumer, inventories fell last week to 311.9m barrels, the lowest since October 2005.

Worldwide refining bottlenecks, ongoing geopolitical risks and concerns about supply availability have also helped drive prices higher, analysts say.

If fundamentals are behind the problem, prices must rise to a point where consumption is brought in line with production. Paul Horsnell, head of commodities at Barclays Capital in London, said that so far the latest increase from $80 in mid-September to almost $100 had not effected supply and demand balances.

"There is nothing magical about $100-a-barrel level to resolve the disequilibrium of the market," Mr Horsnell said, suggesting that prices will need to rise further to damp oil demand through slower economic growth.

Not everyone agrees that fundamentals are the cause of high oil prices. Opec, for one, disagrees, arguing that speculators betting on dollar weakness are the main force behind the increase hefty $20 a barrel increase.

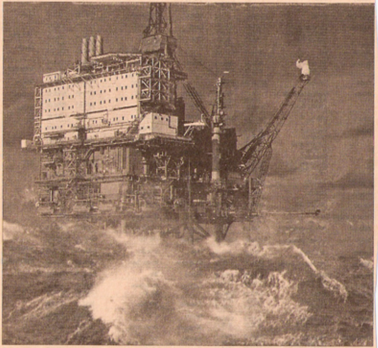
Other analysts, such as Edward Morse, chief energy economist at Lehman Brothers in New York, say that financial flows trading in options – contracts that give the right to buy at a predetermined price and date – are boosting short-term oil prices as the banks that sold them have to hedge some of their positions by buying crude oil in the spot market.

Disagreements over what is driving oil prices and the probability of a correction, however, overshadows a fundamental fact. Even if financial flows are responsible for the latest leg of the oil price rally, oil could still trade at around $80 a barrel based on tight supply and demand fundamentals, That is a level that not so long ago was considered damaging for the world economy.

Oil

Dec 2007 call option for $100 per barrel
Number of contracts outstanding ('000)

Source: Bloomberg



Storm warnings: worldwide refining bottlenecks have created supply fears

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