

## Keeping the lights on

For Professional Investors Only

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### **Newton's oil and gas analyst, *Charles Whall*, explains what is driving oil prices, considers the role of market speculators, and looks at the likely future direction of prices and their impact on the global economy.**

You may have noticed recently that, if an investment fund buys equities or debt, it is an investment; but buy a commodity and you enter the realm of speculation! If you believe much of the press, and recent pronouncements from politicians, the move in the oil price to \$135 per barrel can be explained entirely by the actions of 'speculators'.

#### **Back to basics**

At the most basic level, oil prices have risen from \$10 per barrel in 1998 to \$130 per barrel today. This decade has seen a change in fundamentals where, as the oil price has risen, it has failed to stimulate material incremental supply. Much has been written about the factors behind the tightening supply picture, including depletion of the world's major oil fields, concentration of remaining oil, and limited access for oil companies.

Demand has also surprised, with limited price elasticity. The main driver of this has been globalisation, outsourcing manufacturing to developing nations, increasing transportation for raw materials, components and the end-product – as well as transferring wealth to aspiring, populous nations with growing ambitions for an increasing, fuel intensive standard of living. The facts therefore suggest that fundamentals are the main driver behind the escalation in oil prices.

Whereas physical market fundamentals are the primary driver of price escalation, closer scrutiny of recent price rises will demonstrate that the actions of non commercial buyers, or paper market participants, have also had an impact on the pace and scale of price development.

In fact, participation by investment funds has been growing over the last two years, as some managers and consultants have recommended that portfolios contain a significant proportion (often as much as 5%) of their asset allocation in commodities, generally as a tool to hedge indirectly against inflation. It is difficult to argue that increased competition for futures contracts has not exaggerated price escalation. However, whether long-term investment in commodities is any more speculative than investment in real estate is very debatable.

Nevertheless, the rise of hedge funds has led to an escalation in a second form of commodity investment, where funds take long and short positions in certain term contracts in commodities, essentially betting on the mis-pricing of contracts either on an absolute or relative basis. These investments are more speculative in nature, but can be important for price development.

The move to \$135 per barrel was not driven by 'speculators' as the political rhetoric would have us believe. This was a capitulation move triggered by commercial buyers, such as airlines and other large users, who had been waiting for the pull-back in prices as forecast by most of the commodity specialists with an eye to the growing global economic slowdown; even the Goldman Sachs commodity team, which had been consistently bullish, was forecasting a near-term correction.

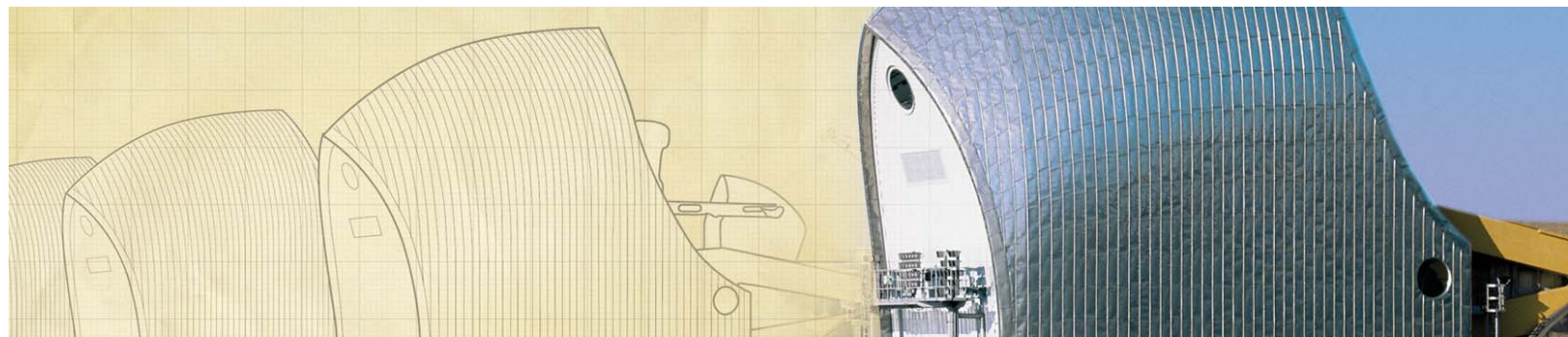
Then, research published in early May by Arjun Murti of the Goldman Sachs equity team, indicated that prices could move to \$150 per barrel, and potentially to \$200 per barrel, without cratering demand. This was followed by an about-turn by the widely-followed Goldman commodities team, with a more bullish short-term outlook, and a ramping up of its forecast for the end of 2008 by 30%, from \$115 to \$149 per barrel. Commercial buyers, who were very short, jumped in and bought the curve.

The move was exaggerated by the actions of hedge funds, who, as the true speculative buyers, were playing time spreads, essentially betting the front-end against the back-end of the curve, where they were short. Covering the back-end gave an extreme move down the curve, with the curve jumping from backwardation into contango (increasing forward prices).

#### **A volatile outlook**

Prices moderated slightly at the end of May, but the direction of short-term prices remains very difficult to call as the negative demand impact of higher prices in the OECD continues to be cancelled out by disappointing supply additions. The oil market is data watching, and very news flow sensitive, so volatility is likely to remain high.





With the absence of decisive moves to limit demand, we find calling the longer-term oil price a little easier.

Although exploration performance is improving, we are still failing to replace production, and the data shows that new projects are taking longer to approve and then longer to implement – as the material new projects are in deeper and deeper waters, higher pressure reservoirs, or needing extensive infrastructure. For example, the giant Kashagan project in Kazakhstan, now looks like it will come on 2012, six years after originally intended, and the transportation solutions remain to be solved. Oil prices are likely to continue to increase in real terms – and this will cause inflation to increase, a considerable headwind to global economic performance.

#### **Modern complexities for a modern world**

Unlike previous oil spikes, there are limited options for 'getting out of jail free' or even with your shirt. This is not an 'oil' problem; what the world is experiencing is the first stages of what could become a global energy crisis. The problem now is a shortage of cheap, available energy sources to reduce oil demand through fuel switching.

Natural gas has taken up the slack in recent crises. Recently however, liquefied natural gas prices have risen faster than crude prices. Indeed a recent trip to the Middle East confirmed just how tight the global gas market is becoming. There, a shortage of natural gas is having a direct impact on oil supply: firstly, oil products are being burned instead of natural gas, and secondly, reduced gas injection into oil reservoirs is limiting crude production.

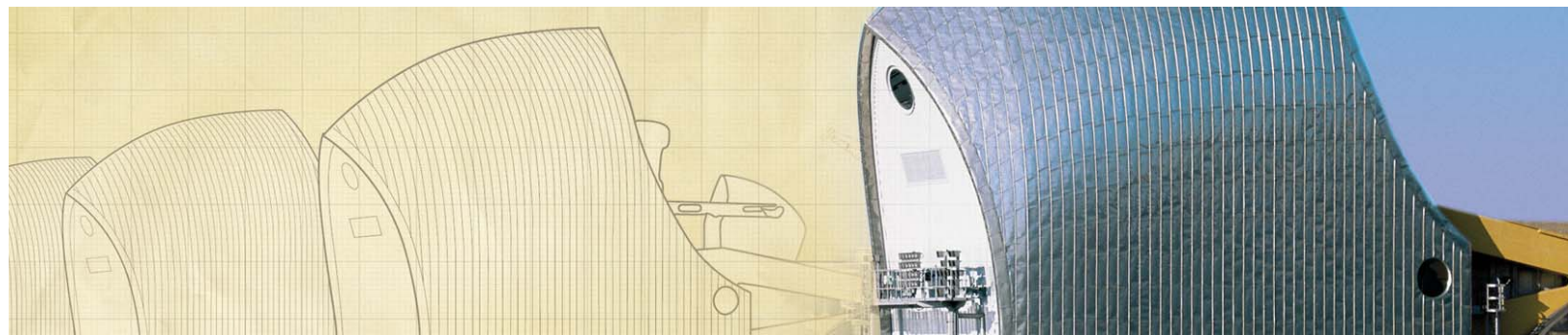
Elsewhere, environmental concerns and tight supply lines limit coal substitution, while nuclear capacity is fighting the age of existing capacity, and the immediate elements of renewable energy that produce transportation fuels compete with the food chain, further increasing inflation.

Oil prices need to rise to the point where demand is limited. Unfortunately the majority of world oil demand comes from growth countries (approximately 85% from China, India and the Middle East) with significant subsidisation of oil product prices. These subsidies are significant, suppressing the price signals and encouraging incremental demand, which further boosts prices.

Unfortunately, politicians globally are too worried about short-term inflation to take the correct steps. Calls for reduced taxation of transportation fuels by Nicholas Sarkozy, the incoming President of the European Union, and the former US presidential candidate Hillary Clinton, demonstrate a lack of understanding of the long-term issues.

Furthermore, the recent political focus on limiting investors' exposure to commodities futures markets fails to tackle the root problem. Like subsidies, such intervention with the intention of controlling markets for the benefit of consumers is counter-productive. Failing to take tough decisions will lead to an extended period of energy inflation; this will prevent OECD economies from stimulating growth through interest rate policy, while developing economies, burdened with subsidies, will be forced into trade controls and commodity hoarding.

There are no easy answers; price signals are needed to limit demand and stimulate investment. Positive intervention is needed to remove barriers for new energy technologies, and incentivise fuel efficiency, rather than super profits taxes for oil companies, in addition to mandatory investment in hydrogen networks, carbon sequestration, and second generation biofuels (that do not compete with the food chain). Revaluation of currencies will give the global economy some local stimulus. The age of globalisation may not be over, but the real cost and impact on energy prices must be captured, or the lights really will start to go out.



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