OIL & THE US ECONOMY

NOTES: MAY 17, 2004

The administration has had a long-standing commitment to markets. This philosophy has been clearly visible in their handling of the oil markets (short of asking OPEC and Saudi to produce more) where they've generally let price adjust to whatever level was necessary to balance S/D.

And despite legitimate differences we've had with the Administration on when, how or whether it was appropriate to look to the SPR[1] the Administration has been broadly successful in getting from markets nearly everything the markets have to give. For example, all non-OPEC countries are producing at capacity and non-OPEC production will rise by 1 MMB/D this year. Secondly, nine of the 11 OPEC countries are producing at capacity (OPEC is currently producing more than 2 MMB/D above its quota). The only country with "large" spare capacity is Saudi Arabia (40 days away and has the wrong quality crude).

The market wants Prompt low-sulfur, high-gravity crude and the Saudis are offering incremental high sulfur, low-gravity crude for July delivery. Not surprisingly they are getting a luke-warm response from their contract customers. In response to high prices, U.S. refiners are currently operating at 96% of capacity and have increased their output and yield of gasoline dramatically. The market has responded to the higher prices.

[1] In December 2002 for example, as a result of the strike in Venezuela, we suggested the need to lend 20 million barrels of SPR oil. We believed that while there was no global shortage, there was a logistical timing issue. Even if the Saudis made up the volume, they couldn't do it in a timely fashion. You couldn't replace the loss of 7-day-away supply with 40 plus day-away oil. We have a similar situation now. Even if the Saudi's increase June/July output by 0.6-1.0 MMB/D, they are 40 days away. SPR could be used as a timing bridge to this Saudi oil. The Saudi's need to also be willing to make Arab light available along with the heavy crudes if they want to achieve the higher-production volumes that they are speaking about.

While the growth in oil demand in general has surprised analysts[2], gasoline demand in the U.S. has been particularly strong. Despite "high" prices, demand has been running 3.0-3.5% above year-ago levels, easily – one full percent (90,000 b/d) above the most optimistic forecasts. We expect this growth rate to slow in the 2nd half since the 1st half growth was due in part to a relatively weak 1st half last year. This year consumers were insulated from the oil price "shock" in part due to the third round of tax cuts, which will largely play out over the first half of this year. [New environmental rules January 1, 2004 has probably resulted in the loss of perhaps one-half percent of supply.[3]]

Ironically, the oil price "shocks" have not had any visible impact on economic activity. GDP grew 4.2% in the 1stQ and virtually all projections look to 4 to 5% growth through the remainder of the year. Thus while oil price increases have been painful to the consumer, the economy has been relatively insulated from oil price "shocks" which historically has sent us into recessions. Thus, the Administration could still argue that it's best to let the markets work rather than interfere with it. However, if the administration doesn't want to tamper with markets, they might want to still consider tinkering with them.

For example, if the economy is relatively immune from high oil prices, certain consumers are not. These high prices are hitting low-income workers who typically use their cars to get to work. There are three things the Administration might consider in targeting a response to those most in need. A temporary increase in:

[2] Not us, in 2003 we forecasted that 2004 demand would grow 2 mmb/d. At the time, the consensus was for 1.25 MMB/D growth.

[3] New sulfur rules have restricted imports of finished gasoline from some high-sulfur gasoline exporting countries i.e., Brazil, Argentina.

a) The earned income tax credit and
b) the low income home energy assistance program (LIHEAP)
c) a modest additional adjustment to middle income tax payers who fall into the AMT trap since they didn't fully benefit from the tax cuts.

Having pushed markets (crude production and refining) to their practical limits, the appropriate question now is: Do markets need additional liquidity? While there is no right or wrong answer to the question, we believe that this is the uniquely appropriate time to revisit the issue. Our view is admittedly as much faith based as it is factually based, but we believe that a small amount of prompt good quality incremental crude would now be helpful and it would compliment and not compete with markets because markets are already giving what they have to give. Ironically, while OPEC can have a strong influence on price over time, they are (now) at any moment in time price takers.

If they (as we do) believe that $40 oil will do harm to economic activity, they should welcome the added liquidity.

With refiners operating at over 95% of capacity, there is not much room to run incremental crude. However, there is some, particularly in sweet crude refinery facilities. In addition, the SPR could be blended with higher sulfur, lower-gravity crudes held by refiners. This would reduce the sulfur content and raise the yield on gasoline.

Halting the deliveries to its SPR (R.I.K. Program) would have only a minimal impact on improving the current situation, although it could have a larger psychological impact. The oil under this program would be "freed" to the global market and as such its impact would be diluted. We need the oil now and we need it here.

Lending 15-25 MMBLS from the SPR would have a larger more immediate impact, since the volumes would not only be prompt but the full volumes would be refined in the U.S. The oil would be given over the June/August period, (meeting peak gasoline demand) and could be paid back later this year or early next year.

We need to develop a cushion now since we haven't even entered the peak-driving season. We are one refiner accident (or a production disruption; Venezuela, Nigeria, Iraq or Saudi Arabia to name a few) away from a major problem. Thus we need to maximize gasoline output now. Lending 20 million BBLs now to be paid back would hardly expose us to added risk should we face crude oil production surprises.

While we are not experiencing supply disruption in the traditional sense, the lack of refining capacity to meet peak seasonal quality requirements and tightness in low sulfur, high-gravity crudes should not be ignored.

$40 oil prices, which operate as a consumption tax, is infringing on economic growth and its impact will grow with time. The increase in oil prices are probably the equivalent of a 50-basis-point move in the Federal Fund Rates. What concerns us is that the Fed independently is likely to raise rates as early as this June and possibly again in August.

Thus, the economy could experience the equivalent of a doubling in the Fed Funds rate in a relatively short period of time. The last time we experienced rising oil prices and increases in Federal Fund rates was 2000 and the results "surprised" economists[4]. Economists have a poor track record when it comes to forecasting recessions. We, therefore, believe that the Administration should be proactive and not reactive and give the oil markets the oxygen and added liquidity it's asking for by lending limited volumes of oil from the SPR.

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[4] We don't believe that we're headed for a recession this time, but why risk a low probability event that might have large negative consequences if you don't have to.