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A recap of energy prices for 2008: The days of cheap oil are over

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Energy prices have increased considerably since the beginning of the year. West Texas Intermediate crude oil prices have risen from $95.98 per barrel to $142.50 per barrel in the last six months. That equates to a 48% increase in a very short period of time. To put it in relative terms, prices at the beginning of 2002 were $19.48 per barrel and in 2008 they began at $91.75 per barrel which equates to an average increase of 61% per year. 2008 had proven to be the year with the most rapid advance in the history of the oil market. Gradual increases over time limit the effect on consumer spending habits while shocks change their behavior. Predicting what will happen next winter is almost impossible as our economy has never experienced energy prices at these levels. Many factors have contributed to the price rises in both crude oil and products throughout the world.

Heating oil and diesel prices have increased by $1.50 per gallon since the beginning of the year. New specifications for heating oil and diesel fuel were introduced last year which complicated the manufacturing process. Refiners had to make many improvements to their refineries in order to meet these new cleaner burning requirements. This has increased the cost to make these new products. Not only has the United States changed the quality of these products, but Europe has also. This has put a strain on the global refining system at a time when demand is increasing as well. The winter of 2008 was mild compared to 2007, and thankfully so. If we had a real cold snap, this year prices may have skyrocketed in order to draw supply from other parts of the world.

Experts can not agree on the reasons why energy prices are so high. A weak dollar has been cited several times. The dollar has lost 17% of its value and oil prices have increased 54% this year. Demand has increased substantially in developing countries like China, India and Russia. Natural disasters in China and Japan, such as the earthquakes and infrastructure problems have caused them to switch the types of fuels they use, since other fuels are not available. This has caused demand for ultra low sulfur diesel fuel to increase dramatically in the last few months. China has increased their purchases with the summer Olympics right around the corner, making sure they have enough fuel on hand so everything goes smoothly. Europe has increased their demand for diesel fuel as more diesel cars are on the road. Chile, which uses mostly hydroelectric power had a draught and had to switch to buying diesel fuel on the open market to produce electricity causing more strain on the system. Iran has continued to defy international calls to halt their nuclear enrichment program, and Israel has threatened to attack them.

Finally there are several theories about financial speculation in the markets and their impact on the price of oil. Futures markets were introduced into commodity trading to be utilized as a hedging tool for the industry. Just a few years ago energy markets had approximately seventeen billion dollars in contract values and today have two hundred and forty billion dollars in contract values. Futures markets were not designed to be used as a financial investment vehicle but speculators add liquidity to the markets in order to help the hedgers obtain their goals. Yet with the introduction of hedge funds, inordinate amounts of money have been chasing. Speculators now control 71% of the oil market with 29% controlled by the physical market. Eight years ago 61% of oil was controlled by the physical players. Congress has begun to investigate why prices have increased so much in a short period of time and are trying to determine what action can be taken. OPEC ministers claim they are not to blame for high prices because there is plenty of physical supply. We have the same amount of inventory as the five year average in the United States. Yet critics claim the global supply and demand factors in combination with countries subsidizing prices internally to keep their economies strong are pushing prices higher.

So what is the "REAL" price? That is extremely difficult to answer, but with each additional barrel costing $60 to pull out of the ground, the days of cheap oil are over. It used to cost $7-11 per barrel to drill for oil. With inflation in materials, labor and the "easy" oil already found, prices have escalated substantially. With the international focus on oil, every possible shock to the system causes shockwaves in the price of oil. Israel's problems with Iran are first among these concerns. But demand is changing as people are changing their behavior - you can't give away an SUV today. It is estimated that world wide demand will drop 3 million barrels per day by 2012. There is also ample evidence that Olympic host countries' economies suffer after the games are finished; this will also help lower demand for diesel fuel. We might get an opportunity to lock in our supplies after the summer is over, but this will probably be at prices higher than last year.

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