

**Energy - Commodities**  
**Oil \$200 – Don't Bet Against It!**

DIPLOMATIC PLANET

**Goldman Sachs Predicts \$200 per barrel Oil! Can you bet on it?**

The headline definitely froze attention on the mind-numbing reality of \$200 per barrel oil. If oil is \$200 per barrel, isn't gasoline \$8 or \$10 per gallon?

The Goldman Sachs Group's [Global:Energy:Oil Report](#) issued on May 5, 2008 was an update to their "Super-Spike" Report from March 6, 2008. The real guts of the May 5th Report was the statement:

"The possibility of \$150 to \$200 per barrel seems increasingly likely over the next 6 - 24 months, though predicting the ultimate peak in oil prices as well as the remaining duration of the upcycle (in oil prices) remains a major uncertainty."

The Report re-pegged the upper range for the price of a barrel of oil between 2008 and 2011 at \$125 for 2008, **\$200 for 2009**, \$150 for 2010 and \$75 for 2011.

The gap between the current price at the time of the Report (just rising to \$100 per barrel) and the subsequent jump to the \$125 - \$135 per barrel price levels was startling. Although nothing within the overall markets had changed significantly (supply, demand or distribution disruptions), the estimate was immediately validated as the price jumped to then record levels.

Not so evident in the various re-hash of the Goldman Sachs Report were the facts that Goldman Sachs saw in the energy markets. The Report observed that the lack of supply growth from the OECD was finally capping the growth in demand in the US. The up-cycle in oil prices might actually be changing as the up-cycle in demand was slowing or being extinguished in response to supply capacity limits. Their conclusion: The industrial nations are effected by the limits on oil supplies.

The key insight from the Goldman Sachs Report however is their observation of "constrained supply driving demand rationing"... "One cannot demand that which does not exist."

In the face of economic growth in the emerging markets of the world, the world's oil producers are not increasing production. Users conserving and reducing demand are not having an impact on prices. Those actions may have an impact on economic production but the oil producers have entered an era where voluntary reductions in demand within the industrial nations does not slow the overall increase in demand and lower the escalation in pricing.

More directly - The long-term demand for oil is rising as the emerging economies grow, efforts by the industrial nations to conserve, cut-back or off-load demand to alternatives are much less than that tide of new demand, and the producers are not expanding supplies. The result, as stated in the Goldman Sachs Report, is that the producing nations can and are rationing the supply of oil.

The major oil producing countries obviously see the global demand for oil increasing dramatically as India, China and other emerging economies grow. That future demand is an incentive for them to hold oil production at current levels making the oil in the ground a reserve asset that grows in value. Flush with funds from the past decade, they can now ration production to prolong their economic power.

An additional tack in the oil producer's strategy is to build their own refinery capacity.

Rather than export the crude oil and then import the higher-value refined products - gasoline, jet-fuel and diesel - to meet their internal demand and growth priorities, the producing nations are building refineries to control their own energy destinies and capture the value spread between crude oil and its refined products. Owning production and refinery capacity also provides those nation's the options of selling their overall higher margin refined products as world demand increases and prices escalate.

The actual ability to forecast global oil production and demand is very limited. Accurate global data on oil production is not available. The majority of countries and state-controlled corporations manage their national oil production and do not collect and/or do not release data on production. Of the Industrialized G-8 nations only two, Canada and Russia, are particularly large oil producing states. The US, UK, Japan, Italy, France and Germany are not significant oil producers. Canada is open in reporting its production and its sales and it is the largest supplier of oil to the US.

The OPEC producers have some transparency and reporting of their oil production and sales into the US, UK, Japan, Italy, France and Germany. They also have production that is termed "off-market" and not part of the official trade data.

Russia is not transparent and is much less predictable in their oil production and sales even as it has great potential for increased oil production - particularly in its eastern regions.

The lack of data on the overall global oil markets forces most analysts, including Goldman Sachs, to focus on the US markets and the OECD production because reliable sales and consumption data are readily available for that trade relationship.

The US-OECD oil pricing relationship is also a data-source more relevant to their areas of interest - the US and Euro-centric companies and capital markets that they analyze, finance and trade.

The US-OECD oil pricing relationship is also used as the trend-setter - it is reliable, readily available and can be expanded as a best-fit proxy for the overall global market into which there is less transparency.

The oil price estimates are not just an academic exercise or an opinion to fill newsletters and advisories. The Goldman Sachs Report 's oil price estimates are used by their analysts and traders (and others) as critical data for their analytical models that rate industries and companies.

As their analysts look at airlines - with fuel moving to almost 40% of an airlines cost structure (labor is the other major component) - a realistic upper limit on fuel costs is needed in order to project performance and compare airline cost structures and financing requirements. For those estimates, the Goldman Sachs Report sets a \$150 per barrel upper limit for 2008 and a \$200 per barrel upper limit for 2009.

Obviously, that estimated upper limit on fuel costs is also needed for comparing all other businesses where the cost of fuel has a direct impact on expenses. Agribusiness is sensitive to fuel costs for all activities - planting, irrigation, harvesting and processing.

Even in industries where the fuel cost is carried as a surcharge and passed along to the customer (such as in trucking) or where fixed contracts do not have adjustment provisions and rising fuel costs directly reduce profits - knowing those factors and having a basic assumption on the maximum impact of rising fuel costs is a critical part of the analysis process.

Even where the cost is passed along to the customer or other middle-men, the end-user will at some point look for other efficiencies in order to stay within their comfort zone on expenses or to balance their overall costs within their budgets. An example of this would be the two car family that now uses the more fuel efficient compact car rather than the SUV to run its local errands or for the longer commute.

Anticipating the break-point where the buyer's behavior changes or where alternatives become viable and compelling is also a critical variable for estimating the performance of any industry and its companies.

The Goldman Sachs Report's \$200 per barrel oil estimate is not, therefore, their absolute prediction of where that price will actually be within the next two years, it is the upper limit cost component that they believe has to be considered today in assessing and comparing business performance scenarios across all industries. That upper limit is one of the wild-cards that has to be considered - in Goldman's terms, it is one of the uncertainties.

Understanding the need for an estimate, however, doesn't mean it is just a hypothetical that gets plugged in. The likelihood of that estimate occurring also has to be computed. For substantive reasons, the likelihood of \$200 per barrel oil is almost guaranteed. The time line of 2009 is as good a bet as any.

The three components of the supply-demand relationship for oil pricing are the supply, the demand and the distribution.

Supply is not increasing. Those countries that have supply capacity are not going to be in the business of selling the oil to the US or anyone else. Their self interest in their own refineries and their own national needs will be paramount. Oil that will be on the market will be increasingly more costly.

Demand is increasing even with the US (25% of the global market) committed to conservation, fuel efficiencies and added attention to alternatives. China and India are the most obvious populations that will have more cars and more industry to feed.

Distribution is highly fragmented and dependent on oil fields, pipelines, terminals and shipping in the world's most geo-politically unstable areas. The most fragile chokepoint (uncertainty) for oil transport is the Strait of Hormuz - the shipping exit point from the Saudi, UAE, Iran and Oman oil fields around the Persian Gulf into the Indian Ocean.

The Strait of Hormuz is 30 miles wide but the shipping lanes are two narrow ribbons of water each a mile wide. Iran is on one shore and Oman is on the other shore. Two-fifths of the daily barrels produced in the world go through the Strait of Hormuz. Seventy-five percent of Japan's oil imports go through the Strait of Hormuz.

The alternative route for the Saudi, Iran and UAE oil that is shipped through the Strait of Hormuz would be a 745 mile pipeline through Saudi Arabia to the Red Sea - its capacity is 5 million barrels per day versus the daily tanker traffic of nearly 17 million barrels of oil through the Strait of Hormuz.

The Strait of Hormuz chokepoint uncertainty alone represents a risk that 12 million barrels per day (nearly one-third) of the world's global oil shipping could be disrupted at any moment.

The catastrophic disruption is not in the Goldman Sachs Report's oil price estimate. If an event such as that occurs, all bets as to prices will be cancelled.

Short-term, minor disruptions in supplies or in distribution do get reflected in the current prices for oil. Disruptions in Nigeria production and exports, hurricane season and transport delays into Gulf Coast refineries, as well as random pipeline, terminal and refinery shutdowns are all near term events that are in the current pricing levels.

Outside of catastrophe and short-term, minor disruptions, the long term price dynamics for oil will be determined by the X-factor that results from the decline in sales of oil from the producing countries even as some state's production increases.

You can't demand something that does not exist. The oil producing countries will not increase production as they extend the shelf-life of their oil reserves and leave the oil in the ground. They also will reduce the supply of oil on the world's market as they re-purpose their production for their own refineries and their own needs within their own borders. Those are the facts that will engender and maintain constant increases in oil prices.

**Goldman Sachs Predicts \$200 per barrel Oil!** A lot more exciting than "constrained supply driving demand rationing". It's a solid headline - either way.

Don't bet against it.

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