THE PRICE OF OIL - PART 1:
A BRIEF HISTORY OF OIL PRICING

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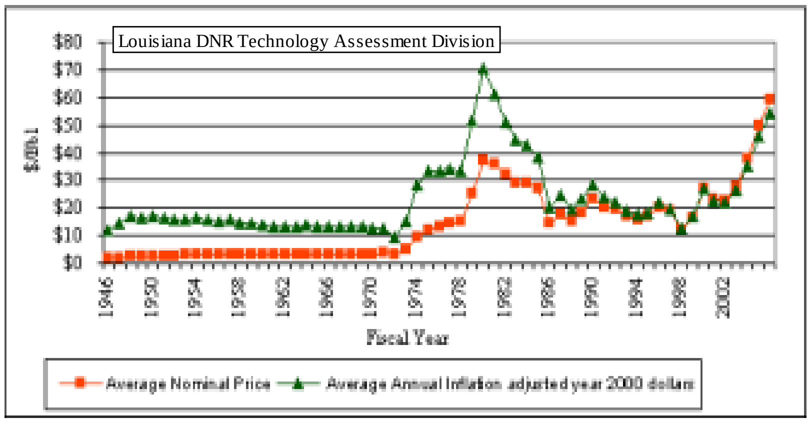
For much of the 20th Century the Texas Railroad Commission (TRC), through its production proration orders, was a primary determinant of the wellhead price of crude oil in the U. S. (Figure 1). But, in 1973, the oil exporting countries exercised their growing market power by withholding supply in a geopolitical dispute that drove U. S. prices higher. Market control over prices subsequently shifted to the Organization of Petroleum Exporting Countries (OPEC).

The U. S. then began a long period of transition to market deregulation of oil and natural gas prices in an effort to stimulate additional domestic supply. By 1986, prices had stabilized in the $20 per barrel ($/bbl) range. Following the collapse of the Berlin Wall in 1989 (the symbol of the opening of the global economy), the 1990s began a prolonged period of stable, and slightly declining, oil prices.

Figure 1. Nominal and Real (Inflation Adjusted Year 2000 Dollars) Average Annual Crude Oil Prices (1946-2005)

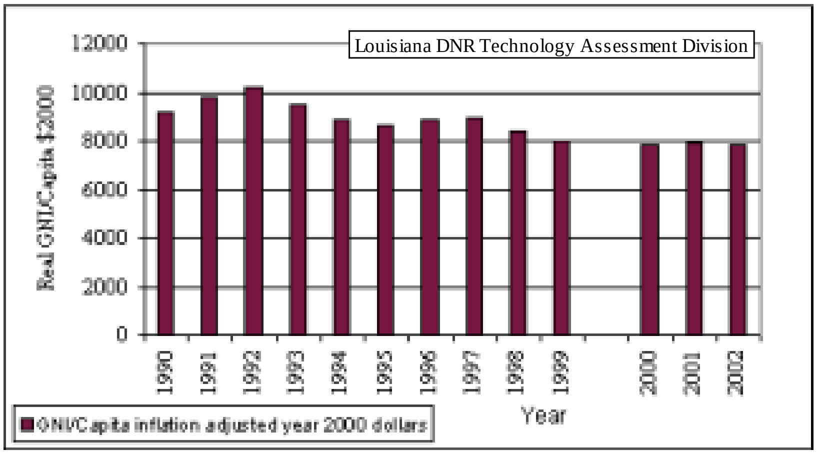


But Saudi Arabia began to experience internal political unrest over declining gross national income (GNI) per capita. During the second quarter of 1999, the OPEC countries agreed to a price range for crude oil of $22.00 - $28.00/bbl, again asserting their market power.

Between the second quarter of 1999 and the fourth quarter of 2002, and just prior to the invasion of Iraq in the first quarter of 2003, the average price of oil was very near the mid-point of the price range, about $25.00/bbl, an increase of nearly $5.00/bbl over the average price for the period of the 1990s. This price range accomplished its purpose of stabilizing Saudi GNI/capita and easing internal unrest temporarily (Figure 2).

OPEC has not publicly made any reference to a new price range over the succeeding seven years. Were the price range to be updated by OPEC for (1) inflation, and (2) a decline in the value of the U. S. dollar, the new price range would likely be $37 - $47/bbl. This new and hypothetical range is arrived at by adjusting for commodity price inflation—which is what OPEC is paying for in their current reinvestment in internal nation building activities, and an adjustment for the decline in the value of the dollar against the euro. In view of the sustained growth in crude oil demand, even in the face of prices exceeding the new hypothetical range, it would not be unreasonable to again hypothesize an OPEC floor price at the top of this newly calculated price range, i.e., $45.00 - $50.00/bbl, as the new OPEC consensus should OPEC again achieve market control.

Figure 2. In Saudi Arabia, the GNI/Capita (in Real Inflation Adjusted Year 2000 Dollars)



Market control of oil pricing has shifted to the likes of hedge funds and large banking institutions with proprietary trading operations whose raw financial power and electronic speed move futures markets on every rumor or fact of unrest in an oil exporting nation, or to the development of a hurricane threatening to disrupt production in the Gulf of Mexico. The role of these financial behemoths in controlling the crude oil futures market pricing can be discerned from Commitment of Traders (COT) reports filed with the Commodity Futures Trading Corporation (CFTC).

For example, open interest is the total of all futures and/or options contracts entered into and not yet offset by a transaction, by delivery, or by exercise. Open interest has nearly tripled as of June 27, 2006 from June 24, 2003. Clearly, the volume of transactions without offset indicates the anticipation that prices will go higher in the future than they were on June 27, 2006.

COT reports are filed by both commercial traders, those who are "…commercially engaged in business activities hedged by the use of the futures or options markets…," and non-commercial traders, those who are speculators. The net long positions of both sets of traders have nearly doubled since June 24, 2003, reflecting how potential geopolitical events are expected to drive oil prices higher.

By December 2004, the futures markets had begun to show a condition known as "contango," i.e., the condition in which distant delivery prices for futures exceed spot prices.

In Memoriam

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