

## CRITICAL QUESTIONS

**Global Oil Prices**

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**Q1: What is driving the surge in crude oil prices—market fundamentals, dollar weakness, geopolitical tensions, or speculators?**

**A1:** The short answer is all of the above, but to varying degrees. With respect to supply and demand fundamentals, despite recent evidence suggesting a decided tempering of demand growth in the United States and Europe, production outside of the Organization of the Petroleum Exporting Countries (OPEC) has been unable to keep pace with seemingly unrelenting demand growth, especially in Asia and the Middle East, thereby resulting in increased reliance on OPEC countries. With the notable exception of Saudi Arabia, even OPEC producers are producing at close to capacity. Consequently, when supply disruptions occur—be they acts of sabotage, weather related, or policy induced—there is little in the way of spare capacity to make up for the shortfall. For example, the sustained loss of Nigerian production earlier this year resulted in Saudi Arabia increasing its output last month, but at the expense of its own spare capacity.

When a global imbalance occurs between production and demand, inventories either swell or shrink to make up the difference. And OPEC's decision in 2006 to cut back output in order to stem the price decline largely resulted in tighter inventories worldwide heading into 2008. Problems in Nigeria, the production decline in Mexico, Russia's plateau, strong Asian demand, and refinery problems all contributed to tighter fundamentals this spring.

The declining dollar and weak real estate markets have also left many investors looking for a place to “park” their investments—and commodities have proven to be such a magnet. Tight fundamentals have spurred investment momentum and volume in energy-related funds and exaggerated price movements. In the space of the past week, crude oil prices declined from \$135 a barrel to \$122, only to rise again to \$139. Part of the increase has been attributed to a comment by the Israeli transportation minister threatening action against Iran; even Saudi Arabia would be unable to fully replace lost barrels resulting from a disruption of Iranian oil supplies.

**Q2: Are current oil prices indicative of “peak oil” or a bubble?**

**A2:** The world is not running out of energy or oil anytime soon. Energy resources, when measured as “molecules” in the ground—including conventional and unconventional fuels and the ability to convert them to liquid fuels—are indeed enormous. But heightened and sustained “above ground” risks—such as access and security to transport, investment, and environmental concerns—may restrict their production. Rising demand will continue to place extraordinary burdens on producers. Conventional approaches to calculating oil prices cannot explain current prices or the rapid increases seen over the past few years. Some analysts see similarities between current oil markets and previous investment bubbles, but there is no clear indication of when or how far prices will recede.

**Q3: What about retail gasoline prices?**

**A3:** Crude oil costs are the largest single component of gasoline prices. At full pass through, every dollar increase in crude translates into 2.4 cents per gallon at the pump. In addition to crude oil costs, product refining, marketing and distribution, advertising, station lease costs, profit, and taxes (federal, state, and local) all contribute to the final pump price. Competition and adequate gasoline supplies are currently holding retail prices below what they could be (estimate of \$4.31 per gallon) if the full cost of \$139 per barrel for crude was reflected in the retail price.

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