Quarterly Energy Update

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Oil Prices Reach and Retreat from New Highs; Gasoline Prices Fall

Oil Prices Rise Sharply

Oil prices have been volatile in recent weeks. They bounced to an all-time high of $78.22 per barrel for West Texas Intermediate crude oil (WTI) on July 31 and fell to a close of $72.07 on August 6 (Chart 1). A weaker U.S. dollar and overall tightness in the world oil market are keeping oil prices aloft. Resurgent refinery production in the United States also contributed an extra push to the price of WTI, which helped it close the gap with prices for other major international benchmark crudes, such as Brent and Bonny Light (Chart 2).

Much of the movement in oil prices has been confined to the short end of the market. Long-term oil price expectations have remained fairly steady. In early June the market was in contango, which means the market expected long-term oil prices would rise above the spot values that prevailed at the time (about $65 per barrel). The strong rise in crude oil prices that occurred at the end of July left the market in fairly sharp backwardation, which means that the market expected long-term prices would fall from the spot value that prevailed at the time (about $78 per barrel).

In early August, oil prices fell nearly overnight to about $72 per barrel, and the market expects oil prices to remain mostly flat over the coming months.
The short-term price fluctuations are the result of small changes in the perceived balance between supply and demand conditions in a market with little excess capacity in world oil supply. Because oil demand and supply are very inelastic in the short run, large price movements are necessary to bring production and consumption into balance. The lack of excess capacity means that any shortfalls are unlikely to be accommodated by changes in production. The long end of the market has seen much less movement because any short-term phenomena that tighten the market aren’t expected to last, and the consumption and production are better able to adjust over a longer period.

Gasoline Prices Slide Further from Highs
Gasoline prices continued a downward slide even as oil prices scaled new peaks. Since reaching an all-time inflation-adjusted high of $3.234 per gallon days before Memorial Day weekend, pump prices for regular unleaded have dropped about 33 cents per gallon (Chart 3). (The previous inflation-adjusted high of $3.223 per gallon was set in May 1981.) As of August 2, the futures market for gasoline suggested another 25-cent decline by December.

By most accounts, rising refinery production, increased imports and rising inventories have contributed to the slide in gasoline prices. In addition, the growth of seasonally adjusted U.S. gasoline consumption—which was particularly strong from late winter through spring—seems to have slowed during the summer.

In fact, the softening of gasoline prices since Memorial Day mostly reflects seasonality in the differential between crude oil and gasoline prices, which is caused by seasonal movements in gasoline consumption, refinery production, imports and storage. The seasonality of gasoline prices has increased in recent years, as refineries have been pushed closer to full capacity and refiners’ margins have risen.

Natural Gas Prices Slip Downward
Natural gas prices have slipped downward since the onset of summer (Chart 4). The slippage in natural gas prices is mostly a long-overdue market correction. According to the Brown-Yücel natural gas pricing model, current natural gas prices are now roughly consistent with crude oil prices, the inventory overhang and normal summer weakness. High inventories are the principal factor depressing natural gas prices relative to those for crude oil. Natural gas inventories are currently on a path to reach an all-time high of just over 3.6 trillion cubic feet.
The slippage in natural gas prices has brought natural gas futures prices into line with the conditional outlook generated with the Brown–Yücel natural gas pricing model (Chart 5). At mid-June, the futures market had shown a price of nearly $10 per million Btu for delivery in December 2007.

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