Economic Research

- Economic Research Home
- About Economic Research
- **Publications**
- Economists
- Regional Economy
- Economic Data
- Events
- Globalization and Monetary Policy Institute
- Resources and Links

Tools

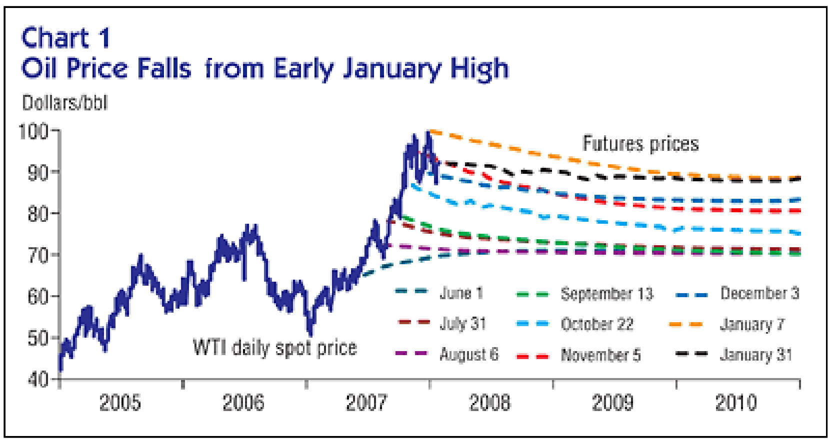
- E-mail Alerts
- E-mail This Page
- RSS Feeds
- Podcasts
- Videos
- View Printer-friendly Page

Quarterly Energy Update

First Quarter 2008

Oil Prices Rise to Near-Record Levels, Then Fall

Oil prices rose sharply in early January, with the benchmark West Texas Intermediate crude oil (WTI) almost reaching the $100 barrier (*Chart 1*). WTI peaked at $99.63 per barrel on January 2, barely $3 shy of the inflation-adjusted high of $102.81 set in April 1980. Escalating tension in the Middle East, fears of disruptions in Nigeria, a further slippage in the U.S. dollar (in early January) and a growing realization that oil resource development will likely not match the growth in oil demand accounted for the upward pressure on oil prices.



Oil's roller-coaster ride continued through January, as declines in stock markets worldwide and fears that a global economic slowdown could retard oil demand pushed prices to a low of $87.32 by the third week of the month. At the end of January, prices neared $90 per barrel, in part due to optimism about the impact of monetary easing and fiscal stimulus on economic activity and in part to OPEC's insistence that oil market fundamentals did not warrant a production increase.

While long-term oil price expectations strengthened by about 10 percent since November, these expectations remained little changed through the volatility seen in January. As of January 31, the long-term oil-price expectation—measured by the December 2010 price—stood at just above $88. Futures prices, consequently, showed far less backwardation at the end of January than they did at the beginning, suggesting that the market did not expect a strong decline in oil prices from their January-end levels.

Gasoline Prices Remain Around $3 per Gallon and to Climb Higher by Memorial Day

Nationwide, the pump price of regular gasoline has hovered around $3 per gallon during much of January (*Chart 2*). Gasoline prices are seeing normal seasonal weakness, and refiners' margins are being squeezed. After remaining well below trend for much of 2007, gasoline inventories were back in good health, with stockpiles above the five-year seasonal average for three straight weeks in January (*Chart 3*).

Current Analysis

- Dallas Beige Book
- Economic Updates
- **Quarterly Energy Update**
- Metro Business-Cycle Indexes
- Regional Economy Slide Show
- Texas Manufacturing Outlook Survey

Other Resources

- Fed in Print—an index of Federal Reserve economic research
- Catalog of Public Information Materials

Chart 2
Gasoline Prices

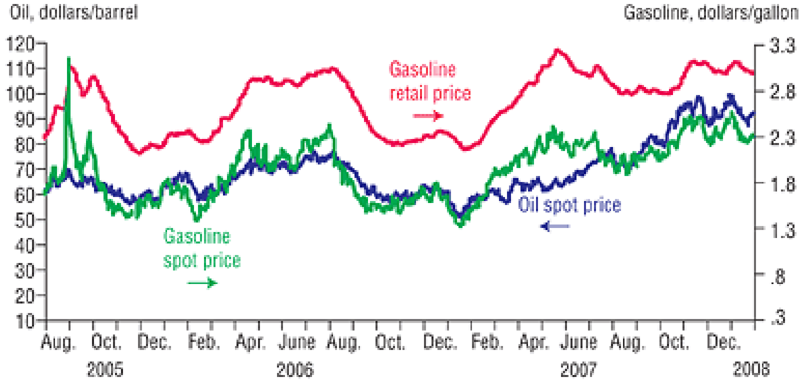
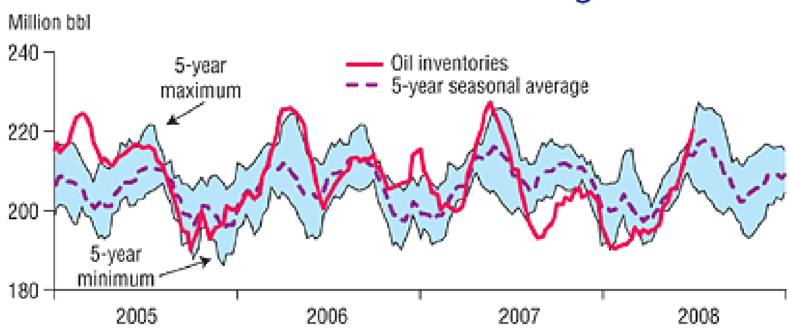
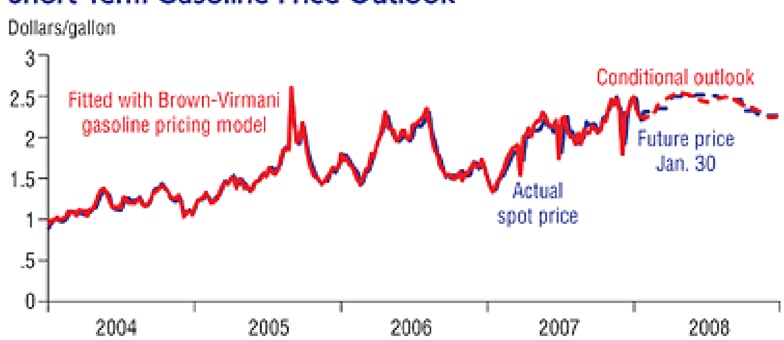


Chart 3
Gasoline Inventories Above Seasonal Average



If market conditions remain relatively unchanged, the [Brown–Virmani gasoline pricing model](), developed at the Dallas Fed, shows spot gasoline prices peaking at \$2.55 per gallon the week before Memorial Day (*Chart 4*), which would mean an all-time-high national average retail price of about \$3.30 per gallon, 7 cents higher than last year's all-time high of \$3.23 (also set the week before Memorial Day). The Brown–Virmani model looks for higher refiners' margins as the driving season gets under way—a view underscored by recent reports that refiners are cutting production runs because their current margins are unprofitable.

Chart 4
Short-Term Gasoline Price Outlook



Crack margins for ethanol are reported as depressed because corn crop prices are high and distillers now have more capacity to produce ethanol than the market seems capable of using in 2008.

Natural Gas Prices Strengthen

Seasonal gains in demand, several cold spells and expectations of increased natural gas use to generate electricity have pushed natural gas prices up to about \$8.20 per million Btu for delivery at Henry Hub (*Chart 5*). Extremely high natural gas inventories continue to depress the market and are keeping natural gas prices well below any normal parity with crude oil. Inventories hit a record high of 3.545 trillion cubic feet at the beginning of the heating season and were about 10 percent above normal levels in mid-January.

Chart 5
Natural Gas Prices

Natural gas exploration activity has been brisk, with current gas prices and futures market expectations sufficiently high to support strong gains in natural gas drilling.

The Brown–Yücel natural gas pricing model, developed at the Dallas Fed, shows current natural gas prices are now roughly consistent with crude oil prices—given the inventory overhang and normal seasonality. The futures market shows gains in natural gas prices throughout 2008 (*Chart 6*). High inventories and some concerns that spring weather may prove to be warmer than normal seem to be keeping natural gas futures from showing normal seasonal pricing.

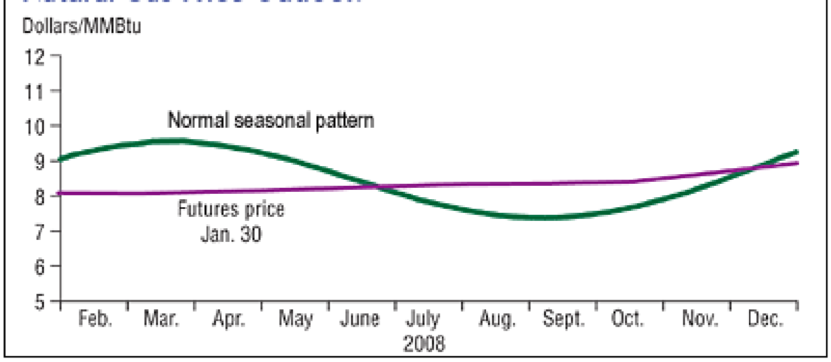


Chart 6
Natural Gas Price Outlook

—Stephen P. Brown and Raghav Virmani

About the Authors

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