

Global Energy Demand Healthy

July 1 2010

Oil prices rebounded in the second half of June, rising above \$77 per barrel (*Chart 1*). In late May, prices had fallen below \$70 per barrel—more than \$15 per barrel lower than the year-to-date high hit in April.

The financial turmoil in Greece and fears of spreading contagion put downward pressure on oil prices in May. Moreover, stocks at Cushing, Okla., were 5 million barrels short of capacity in mid-May, pushing West Texas Intermediate (WTI) prices down and widening the gap between WTI and other crude grades such as Brent. The futures market expects prices to return to normal as the WTI–Brent spread returns to its longer-term average.

Global Demand Rising

In June, the International Energy Agency (IEA) upwardly revised global oil demand projections for 2010 due to better-than-expected growth in Organization for Economic Cooperation and Development (OECD) countries, driven mainly by North American nations and Japan. Chinese demand continues to increase at significant rates, jumping 12.7 percent year over year in April. Consumption in Europe was down 3.5 percent year over year in April due to weak economic growth and disruptions from the Icelandic volcano. Global demand is expected to increase 2 percent in 2010 following a decline of 1.5 percent in 2009.

The IEA, which bases its estimates on the International Monetary Fund global GDP forecast, expects demand to grow 1.4 percent per year, or 1.2 million barrels per day (mb/d), on average between 2009 and 2015. Non-OECD countries account for all of the demand growth; OECD consumption will decline slightly over the period.

U.S. Demand Strong

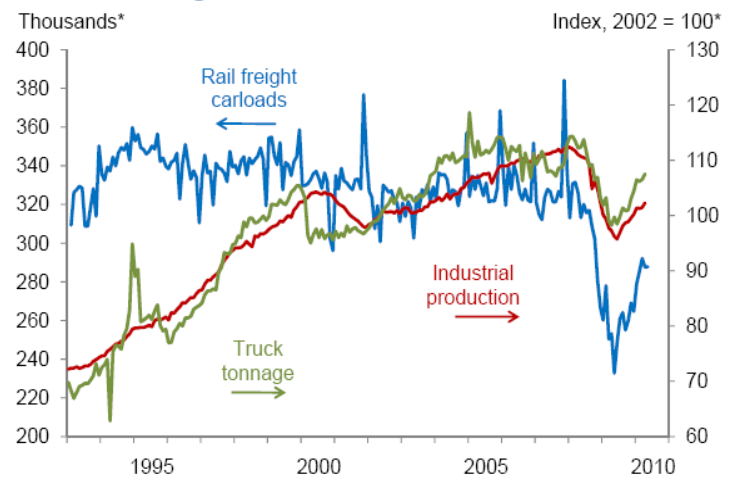
With the exception of gasoline, U.S. demand continues to be robust. Growth in industrial production has increased the demand for transportation services, which translates into demand for oil products (*Chart 2*). Simple statistical tests have shown that changes in industrial production lead changes in both rail carloads and truck tonnage. As seen in the chart, rail carloads and truck tonnage have been rising since industrial production touched a low in June 2009.

Chart 1
Oil Prices Recovering



SOURCE: Wall Street Journal.

Chart 2
Growth in Industrial Production Spurs Rail and Truck Freight



*Seasonally adjusted.

SOURCES: Association of American Railroads; Federal Reserve Board; ATA Business Solutions.

Demand for distillate and total oil products moved up in May after dropping in April (*Chart 3*). Gasoline consumption rose sharply in April but languished in May. Memorial Day is typically the start of the summer driving season, and the American Automobile Association expected auto travel to increase about 5.8 percent over last year. How-

ever, data show gasoline consumption increased only 1.7 percent year over year in the week leading up to Memorial Day and 0.6 percent in the week following (*Chart 4*). It remains to be seen if June shows the typical uptick in miles traveled.

Global Oil Supplies Down

Global oil supplies fell in May, mostly due to lower production among nonmembers of the Organization of the Petroleum Exporting Countries (OPEC). OPEC production also decreased slightly, and compliance with quotas stood at 58 percent in May. OPEC excess capacity was about 5.4 mb/d in May.

The British Petroleum (BP) disaster in the Gulf of Mexico hasn't significantly affected currently producing wells, which account for about 30 percent of U.S. oil output. If the deepwater drilling moratorium is reinstated in its previous form, the EIA estimates that production could be reduced by 26,000 barrels per day (b/d) in fourth quarter 2010 and about 70,000 b/d in 2011. Given the ban's recent repeal, considerable uncertainty remains over the outcome.

Another factor potentially impacting short-term supplies from the Gulf is the onset of hurricane season. The National Oceanic and Atmospheric Administration is expecting an "active" to "extremely active" hurricane season, with a 70 percent probability of 14 to 23 named storms. Three to seven of the named storms are expected to be Category 3 or higher.

Longer term, global production capacity is forecast to rise from 91 mb/d in 2009 to 96.5 mb/d in 2015. The bulk of this expansion comes from OPEC. Natural gas liquids production is also expected to expand strongly, rising more than 50 percent by 2015, with the majority of that growth coming from the Middle East.

Natural Gas Price Climbs

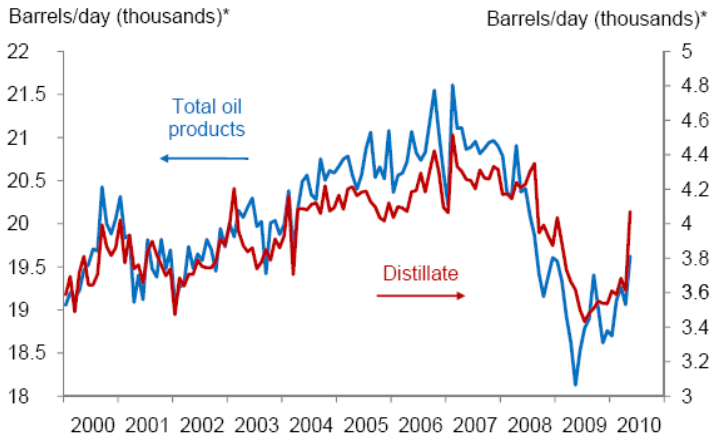
The price of natural gas rose to \$4.90 per million cubic feet in the fourth week of June, up from the year low of \$3.80 in the first week of April (*Chart 5*). The futures curve now has natural gas rising to \$5.25 by year-end.

Increased production from shale plays continues to be a damper on prices. Total shale gas output was 8.5 billion cubic feet per day (bcf/d) in 2009 and is expected to average more than 10 bcf/d in 2010, accounting for about 15 percent of U.S. gas production. Shale gas is expected to account for over 40 percent of gas production by 2030.

BP's Gulf Spill

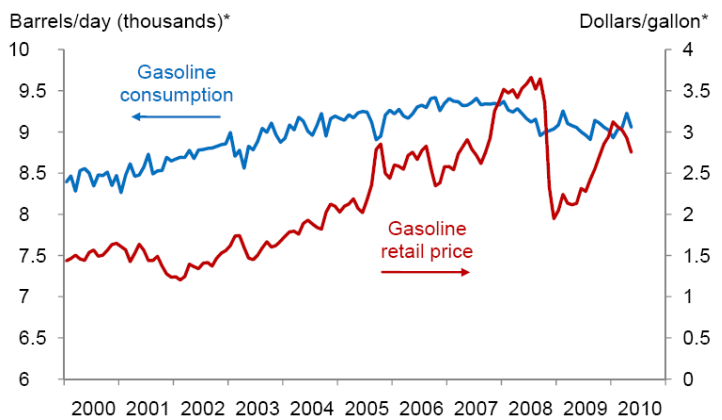
On April 20, BP's Deepwater Horizon rig exploded, killing 11 people and releasing thousands of barrels of oil into the Gulf of Mexico. Initial flow rate estimates of 5,000 b/d have risen to between 35,000 and 60,000. Using initial estimates of 5,000 b/d, the BP rig spill has already re-

Chart 3
Demand for Distillate and Total Oil Products Recovers



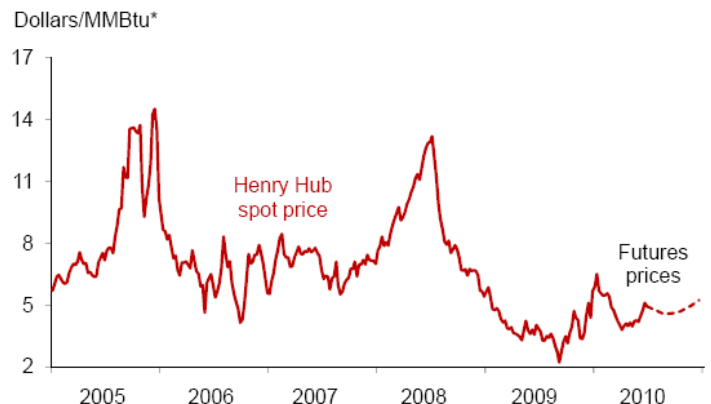
*Seasonally adjusted.
SOURCE: Energy Information Administration.

Chart 4
Gasoline Consumption Weakens in May



*Seasonally adjusted.
SOURCE: Energy Information Administration.

Chart 5
Natural Gas Prices Expected to Rise Modestly by Year-End



*Millions of British thermal units.
SOURCE: Wall Street Journal.

leased more oil than the 1989 Exxon Valdez tanker spill, which dumped 257,000 barrels along Alaska's coast. If higher flow rate estimates are used, more than 3 million barrels may have already spilled into the Gulf.

As of June 27, BP was siphoning approximately 23,000 b/d, with plans to almost double the amount captured; however, storm activity in the Gulf may derail those efforts. BP is also drilling two relief wells to permanently stop the flow of oil into the Gulf, but they won't be completed until early August.

If evidence of negligence emerges, the fines for BP could be as high as \$4,300 per barrel under the Clean Water Act. As of June 28, this would exceed \$17 billion in liabilities, assuming a constant 60,000 spill rate from the time of incidence. In June, BP agreed to set up a \$20 billion claims fund and noted that costs related to the spill had already exceeded \$2.65 billion.

—Jackson Thies and Mine Yücel

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