QUARTERLY Energy Update
Federal Reserve Bank of Dallas

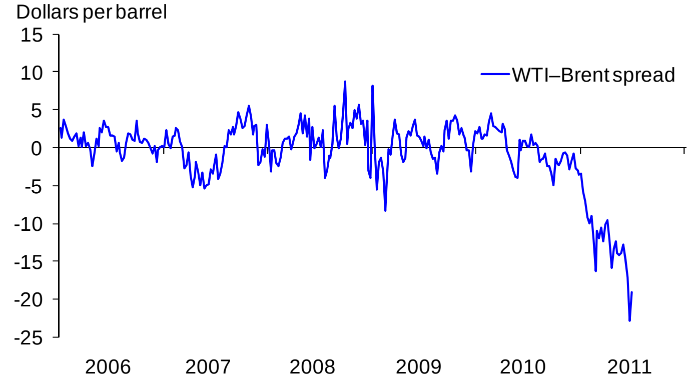
Oil Prices Retreat as Economic Growth Slows

July 7, 2011

Oil prices were affected by multiple factors during the second quarter. After Libyan supplies were disrupted near the end of the first quarter, second-quarter production was virtually nonexistent. Slowing world economic growth tempered expectations of oil consumption growth, taking some pressure off prices. OPEC members were unable to come to a consensus during their June meeting, which ended with the official quota unchanged. However, reports indicate Saudi Arabia will unilaterally increase its output. And on June 23, the International Energy Agency (IEA) announced it will release 60 million barrels of oil reserves to counter lost production from Libya.

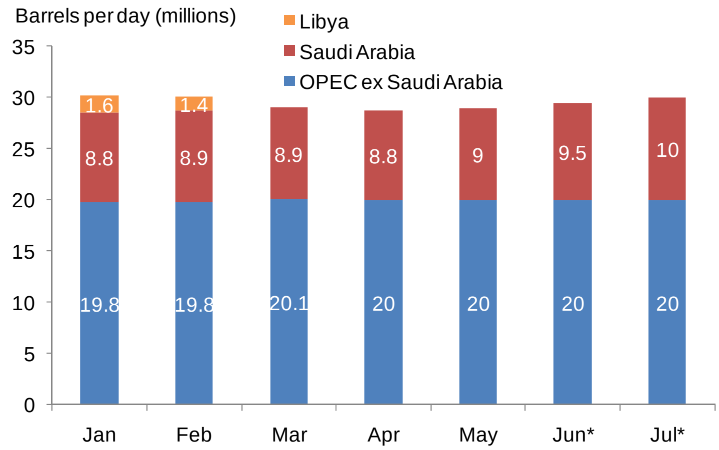
West Texas Intermediate (WTI) prices hit their highs for the year in late April at just over $113 per barrel and have since trended downward. Prices have been hovering in the mid-$90-per-barrel range recently, which is comparable to prices in mid-February, right before Libyan production was curtailed. The spread between Brent and WTI remains elevated because of high inventories at Cushing, Okla., and the significant amount of oil coming in relative to the ability to pipe it out to world markets (*Chart 1*).

Chart 1
Brent Trades at Significant Premiums to WTI



SOURCES: *Oil and Gas Journal*; Energy Information Administration; calculations by the Federal Reserve Bank of Dallas.

Chart 2
OPEC Crude Oil Production in 2011



*Estimated.
SOURCES: International Energy Agency; estimates by the Federal Reserve Bank of Dallas.

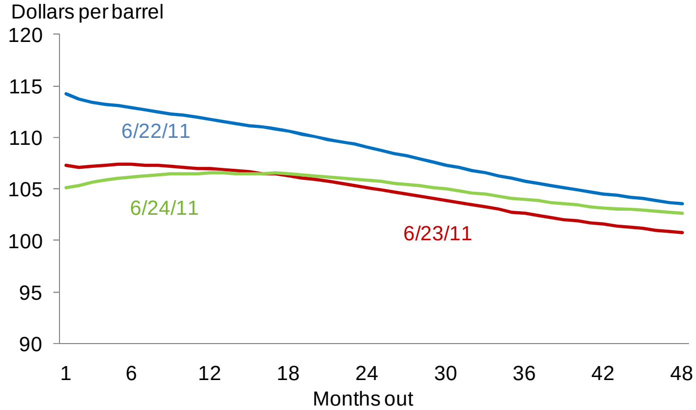
After Disruptions, Supplies Uncertain

OPEC left production quotas unchanged at its June meeting after disagreement between countries that wanted to increase production, including Saudi Arabia, and those that did not, such as Iran and Venezuela. However, reports indicate Saudi Arabia will increase production to 9.5 million barrels per day (mb/d) in June and 10 mb/d in July. Given that Saudi Arabia accounts for about 65 percent of OPEC's spare capacity, the country has the production capability to easily accomplish this. Assuming this occurs, OPEC production at the end of July would almost be back to pre-Libya levels (*Chart 2*).

Libyan production remains at very low levels, and the country is currently unable to export any significant amount of oil. The worry that contagion would spread to other Middle East and North Africa (MENA) countries has subsided. With the exception of Yemen, there has been little effect on production in other MENA countries.

On June 23, the IEA announced it would release 60 million barrels of reserves to counter the effect of lost Libyan production. On its announcement, the spot oil price dropped sharply due to the additional supply; however, in the long term, the reserve release should have little impact on prices because the length of the release was short term. The markets accounted for this by flattening the futures curve (*Chart 3*). In early July, more details emerged, and the amount of oil coming from government inventories will be about 40 million barrels, 30 million of which will come from the U.S. Strategic Petroleum Reserve. Since the announcement, oil prices have rebounded somewhat. Given that the lost Libyan production was a high-quality light, sweet crude, there has been

Chart 3
Brent Futures Curve Flattens After June 23 IEA Announcement



SOURCE: Bloomberg.

speculation that the release will target light, sweet crude as well.

Global Oil Demand Continues to Rise

U.S. oil demand eased in the second quarter as gasoline prices rose and economic growth slowed (*Chart 4*). Nationwide gasoline prices peaked in early May at just over $4 per gallon but have declined about 10 percent since, recently registering $3.63 per gallon. The decline provided much-needed relief to travelers during the critical summer driving season.

Diesel consumption also declined throughout the second quarter, likely due to slowing economic growth. Both the Ceridian Index—which tracks diesel purchases across the country—and truck tonnage declined in May (*Chart 5*). Because diesel consumption usually leads industrial production, a further slowing in the industrial production growth rate could possibly follow.

Foreign oil demand continues to grow, but the IEA trimmed estimates of demand growth due to higher oil prices and weaker gross domestic product growth projections from the International Monetary Fund. According to the IEA, global demand will grow 1.4 percent this year, rising to 89.3 mb/d. However, a discrepancy emerges between developed and developing countries. Developed countries, represented by the Organization for Economic Cooperation and Development (OECD), will likely see oil demand growth contract by 0.5 percent, whereas non-OECD countries should see growth rise 3.6 percent. Much of this growth continues to be driven by the Middle East and emerging economies, particularly China. The IEA expects Chinese oil demand to rise 6.9 percent in 2011 and the country to increase its share of world oil consumption to 10.9 percent, second behind the U.S.'s 21.5 percent. One way to gauge China's oil demand growth is by looking at its oil imports, which have risen steadily over the past decade (*Chart 6*).

Inventories Elevated but Below Highs

U.S. inventories remain elevated but are off recent seasonal highs. Compared with a year ago, U.S. inventories have declined about 1 percent, aided by the start of the summer driving season. OECD days of cover, defined as commercial inventories divided by consumption, are above trailing five-year-average levels but tracking slightly below 2010 levels (Chart 7).

Natural Gas Production Continues to Rise

The natural gas rig count has declined roughly 2 percent since the end of March and now accounts for 46.4 percent of all rigs, the lowest level since 1994. Despite the decline, natural gas production has held up well (Chart 8). This is largely due to the significant role shale gas is playing and the proliferation of hydraulic fracturing around the country.

Natural gas prices have been suppressed by the ample supply available. This year's high was hit in early June at just under $5 per million British thermal units (MMBtu), although prices are now marginally higher than at the end of March at $4.33. The Energy Information Administration (EIA) estimates that prices will average $4.25 per MMBtu in 2011.

—Jackson Thies and Michael Plante

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About the Authors

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