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Blog/Online Placements (Full Articles Below)

- **The Problem With Oil Prices: Five Reasons It's Going to \$100 (And Five Reasons It's Not)**
– *24/7 Wall Street* – 10/28/10

BLOG/ONLINE COVERAGE

The Problem With Oil Prices: Five Reasons It's Going to \$100 (And Five Reasons It's Not)
– *24/7 Wall Street* – 10/28/10

By Paul Ausick

In March 2008, an analyst at Goldman Sachs predicted that the price of crude would see a “super spike” all the way to \$200 per barrel. At the time, a barrel of crude cost just under \$100, but had been rising for more than two years. The same analyst also predicted that oil prices would stick above \$100 per barrel into 2011.

Oilman T. Boone Pickens said that oil would rise to \$150 a barrel before the end of 2008, while, at the same time, others predicted crude prices would fall to as low as \$70 a barrel by the end of

the year. Pickens came close, when prices went above \$145 a barrel in July but stopped just short of his prediction. Similarly, the low-ball estimates were off by a factor of two. Oil closed 2008 just above \$30 a barrel.

Forecasting oil prices depends a lot on the angle from which the forecaster views the crude oil market. All forecasts consider supply and demand, of course, but how much weight is assigned to these and other factors can vary widely. The very bullish \$200 per barrel estimate was based heavily on the analyst's assumption that the world had a virtually unquenchable thirst for oil. He didn't consider the financial disaster that was just around the corner.

Are oil prices headed back to triple digits? In a recent note to investors, Goldman Sachs predicts that stronger-than-expected demand growth in 2010 will lead to more demand next year, resulting in a price of \$100 per barrel by the end of 2011. Other large banks, including Barclays are also forecasting higher prices. Societe Generale, Deutsche Bank and JP Morgan are not quite as bullish on oil prices, according to the Financial Times, forecasting a top of about \$90/b.

These estimates are not getting much support from the world's largest independent energy traders. Vitol, the world's largest, has said the price in 2011 will be between \$70 and \$85 a barrel. The FT says this view is shared "privately" by other large independent traders such as Glencore, Trafigura, Mercuria, and Gunvor.

We've put together two lists, one analyzing why oil prices won't rise to the \$100 per barrel level predicted by Goldman Sachs, and a second offering reasons why the triple digit price could be in our future.

Five Reasons Not to Worry

There are five major reasons that support the conclusion that oil will not reach \$100 a barrel by the end of 2011.

1) Demand Growth is Slowing

The International Energy Agency has forecast demand for 2010 at 86.6 million barrels per day (b/d), up 1.9% from 2009 demand of 84.7 million b/d. Demand for 2011 is forecast at 87.9 million b/d, up 1.3% from this year.

In the developed countries of the OECD, demand is well below the five-year average, even though US demand has ticked up slightly. Demand from Europe is at the bottom of its five-year range and is expected to decline further in 2011.

Chinese crude demand rose 3.3% in July according to IEA data. For 2010, China's demand for crude is expected to average 9.1 million b/d, a 9% rise year-over-year. For 2011, demand from China is expected to rise to 9.4 million b/d, up 4.3%. Demand for gasoline, though, is expected to double, as millions of new cars hit Chinese roads.

The other large increase among emerging nations comes from India, where crude demand in 2010 is expected to reach 3.34 million b/d and 3.45 million b/d in 2011, up year-over-year by 2.5% and 3.1%, respectively.

China and India combine to take about one-third of the projected demand growth in 2011.

2) Supply is Meeting Demand

World supply is a bit trickier to tease out of IEA reports, but the agency reports that OPEC, including Iraq, produced 29.15 million b/d in September. Iraq is not subject to the cartel's 24.845 million b/d production quota, but even subtracting Iraq's production, the cartel over-produced its quota by 1.58 million b/d.

Non-OPEC production is expected to total 52.6 million b/d in 2010 and increase to 52.9 million b/d by the end of 2011. Adding OPEC and non-OPEC totals yields a grand total 81.75 million b/d, far short of the demand forecast of 86.6 million b/d. The difference is made up in natural gas

liquids (NGLs) and biofuels, which are both now added to crude production to yield a total liquids production.

Also Read: [Is U.S. Solar Boom Over Just as it Gets Started?](#)

3) Commercial Stocks are Way Above Average

The other critical estimate that went into the forecast prices is commercial stocks, which include the oil in storage at refineries waiting to be processed. It does not include strategic reserves. The IEA reported global commercial stocks of crude rose in August to 2.79 billion barrels, their highest level since 1998.

Goldman Sachs believes these stocks will be drawn down rapidly in 2011 as the economy improves. Of course, that will lead to higher demand, which will be slow to met, and prices will rise.

The large trading houses and the IEA don't see it that way. Preliminary IEA data for August show a stock build of 8.7 million barrels, compared with the five-year average for the month of just 3.2 million barrels.

There is some evidence that stock draws are speeding up though. Floating storage — crude carriers sailing around in circles waiting for a buyer — fell by 18 million barrels (about 9 tankers worth). The drawdowns occurred in the Middle East, in Iran where floating storage is common because the country has very little onshore storage, and the US Gulf of Mexico, where production was reduced due to the Macondo disaster.

4) Spare Capacity is Up

Virtually all the world's spare capacity of crude oil is held by OPEC members. In August, the IEA estimates total spare capacity for OPEC at 6.07 million b/d. Leaving out Iraq, Nigeria, and Venezuela, the total is 5.56 million b/d, with 3.92 million b/d available from Saudi Arabia alone.

During the price spike days of 2007, global spare capacity fell below 2 million b/d.

The availability of spare capacity does not mean, of course, that those countries that have it will pump it. But if prices remain around \$80/b, OPEC quotas could be ignored even more than they are now.

5) The Global Economy is Growing Slowly

In its October World Economic Outlook, the International Monetary Fund forecast global economic growth for 2010 at 4.8% and 4.2% for 2011. For comparison, the global economy shrank by -0.6% in 2009. Developed countries are expected to grow at a rate of 2.7% in 2010 and 2.2% in 2011. Developing economies are expected to post growth of 7.1% in 2010 and 6.4% in 2011.

The IMF also noted that the risk in these forecasts was to the downside, but that no sharp decline, or double dip, is anticipated.

The IMF used an average crude oil price of \$76.20 a barrel to compute its 2010 estimate and \$78.75 a barrel for the 2011 estimate. Those estimates are well within the range expected by the large oil trading companies — and well below \$100 a barrel.

Bottom Line on Good News

On fundamentals, there is not much reason to believe that oil prices will rise to \$100 a barrel by the end of 2011. But these estimates don't include non-fundamental factors like political instability which could play havoc with oil prices.

Five Reasons to Worry

The main reason to worry is that the reasons not to worry could disappear in a flash.

1) China Hikes Consumption

While China still consumes only about half as much crude as the US, the country's increased demand for oil far outstrips US demand growth. That's because of the fast-growing Chinese economy, even as the US and much of the rest of the world suffer anemic growth. If China's economic growth exceeds the current estimate of 8.9%, the country's demand for oil will inexorably increase.

A large contributor to that increase would be new car sales, currently forecast at around 17 million new vehicles in 2011. For the most part, those are not replacements for older cars, but additions to the country's motoring fleet. The new car owners will want to drive, and they'll need gasoline to do it. All the money China is spending on wind and solar power won't cut demand for gasoline.

2) Supply Gets a Shock

Current supply estimates indicate that supply will be able to meet demand in 2011, except for a few soft spots. Iraq, where production was pretty steady at 2.5 million b/d in 2009, has seen production fall off to about 2.3 million b/d in 2010. The country is predicting an increase of 600,000 b/d in 2011. If Iraq fails, global production will feel it.

UN sanctions are having a negative effect on Iranian crude sales. The IEA notes that traders are having difficulty getting letters of credit to purchase Iranian crude.

Russian production is estimated to be 10.45 million b/d in 2010, rising to 10.5 million b/d in 2011. Russia now exports more crude than any other country, although Saudi Arabia has the capacity to export more than 12 million b/d. But the Russian government has predicted a decline in oil production beginning in 2012 which may actually happen sooner. Investment in new fields has fallen since the country wrestled away assets from western oil companies, and the country's high taxes on crude have chilled investment even more.

Mexico's giant Cantarell field in the Gulf of Mexico has declined precipitously for the past few years. 2010 production is forecast at 2.9 million b/d, falling to 2.8 million b/d in 2011. This is a very hopeful forecast and could easily be missed on the short side.

Venezuela, like Mexico, is experiencing production declines. Unlike Mexico, however, the declines are the result of overproduction and sparse investment. The government has ransacked the oil fields after repatriating them, and spent almost all the money on social programs. The country produces about 2.23 million b/d this year and that is not forecast to change. But at some point, something has to give.

There are also external forces that could start a supply shock. No one expected BP's Gulf of Mexico well to explode. The chain of events that followed took as much as 600,000 b/d out of production although only for a relatively short time. A disaster like that in Alaska or in Russia could swing crude prices wildly higher.

Similarly, a hurricane or two roaring through the Gulf of Mexico sends spasms of fear through traders, who will essentially pay any price to guarantee their supply.

3) Politics Gets in the Way

Political instability in producer countries is always a risk, and it is a bigger risk the more oil a country produces. The poster child for this factor is Nigeria.

Nigerian production for 2010 is slated at around 2 million b/d with a small increase in 2011. The ending of attacks on the country's crude oil infrastructure could last only as long as the national

election in January 2011. No matter who wins the election, civil unrest is likely to follow, and the oil infrastructure is too tempting a target.

While less dramatic than attacks on oil facilities, government policy could also play a role in driving up demand or reducing supply. The usual suspect here is OPEC, which theoretically can turn the spigot on or off. In reality, the cartel is unlikely to do anything drastic, but the Middle East is not famous for its political stability. And even a whisper that OPEC may cut supply can cause markets to turn north.

In politics, too, China plays a role. The country has recently instituted measures to cool off its economy, raising interest rates a bit and letting the currency appreciate a little. But the government has a history of alternating between stimulating and cooling its domestic economy. The decisions are based largely on how the government views the domestic mood. If the recent cooling results in job losses and domestic unrest, the government will allow the economy to heat up again, driving demand for oil, pushing up its price.

Also Read: [Another Walmart Digital Disaster?](#)

4) Commercial Stocks Nosedive

While not very likely, any unexpected hit to supply may result in a sharp drawdown of stocks. Importing countries will attempt to maintain what economic growth they have by keeping petroleum products flowing. But, as the drawdowns lower inventories, importers will be forced to try to replenish their stocks if inventory gets too low. That will drive up the cost of crude.

5) The Oily Speculators

A lot of misplaced blame for the oil price runup of 2007-2008 settled on futures traders bidding up prices for paper barrels of oil. While it's true that fear of supply declines among speculators can trigger rising prices, it's less clear that speculation can keep prices high for an extended period. All things being equal, the futures price for paper barrels in 12 months cannot outrun the

spot price for physical barrels this month. Absent one of the other shocks mentioned, the price for physical barrels simply should not support a run on futures.

A related concern is currency speculation. The weakening dollar contributes to higher prices for oil because oil is priced in dollars almost everywhere. The dollar would have to drop a lot, though, to have a big enough impact on its own to move oil prices to \$100 a barrel. If that drop should happen, we'd all have bigger problems than expensive oil.

Bottom Line on Bad News

The only real way to prepare for any of these systemic shocks to the crude oil market is to reduce global dependence on oil. That's not likely to happen in any meaningful amount for decades.

Until world demand plummets, we all live under a Damoclean sword, which hangs not by a thread but enclosed in a barrel of oil.

BROADCAST COVERAGE

1. CTN Schedule

CT-N, Hartford/New Haven | DMA: 30

10/28/2010, 08:00 PM - 10:00 PM

[CC] 01:40:19 (speaker is Rep Larson)...We see growth centers coming in energy, transportation around energy, health care, health care-related activity, health I.T. , Whether in is further expansive, the genome project's going on. Also utilizing existing resources we've got. This is all hands on deck. We brought T. **Boone Pickens** up to Connecticut a couple of times, what we agree on is when you have 200-years-worth of **natural gas**, a clean **fuel**, and we're trying to go to a hydrogen economy and let's get it. To the extent with federal health that you talk about is Speaker Boehner going to see the world as you do? I don't think Speaker Boehner will see this world the same way we do . What has us concerned is the road map they are publishing which calls for the privatization of Social Security also, medicare vouchers, they want to end medicare as a guarantee. We do not think these are wise decisions...01:42:53

Audience: N/A Spot Cost: N/A

2. CTN Schedule

CT-N, Hartford/New Haven | DMA: 30

10/28/2010, 04:00 PM - 06:00 PM

[CC] 01:27:42 (speaker is Rep Larson) What an outstanding loss it will be to not have Chris Dodd who has been there for our state and country for 30 years in the U.S. Senate. His relationships, his incredible work deserve merit. That is a big gap to fill. It will require that we work even closer together and that we man the key committees so important to Connecticut's future. A couple of announcements: tomorrow we're heading back --We are we are having back T. **Boone Pickens**, all 3 of us are on the Natural Gas Act... I think, with more than 200-years-worth of gas, we to wean ourselves off foreign **oil**, we need to make certain we, in this country, have our energy source of our own that will, over time, lower costs and we will later have to export dollars abroad that end up funding the very terrorist organizations going against our troops. We've done good work in the U.S. Congress especially in the House. ...01:31:27

[CC] 01:32:48 Last month, we announced \$93 million in broadband coming into the state, in keeping community colleges open weekends and nights so people can seek retraining that they will need to compete globally. Another additional five buses powered by **fuel** cell technologies. The state of Connecticut in tandem with a new governor will have its opportunity to align itself

with this **energy** chris was speaking of, this will be a job-creator, bar none. I am a big fan of thomas friedman. I think a number of you are as well. Will we need to do to compete if we are getting it from the **energy** side, not only a standpoint o **natural gas**, you will hear from **T.BoonePickens**, he will talk plainly and directly about why we need to do this, what investments we need, what it means. Weather is **fuel** cells, **wind**, solar, photovoltaic, geothermal etc. This is where we have to make an investment. ...01:35:04

Audience: N/A **Spot Cost:** N/A