

Testimony to the U.S. Senate Committee on Energy and Natural Resources



May 15, 2007

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SUMMARY

The summer crude oil markets are expected to remain in the mid-\$60s per barrel, and gasoline prices will weaken slightly during the summer months. Crude oil and gasoline prices will continue to be vulnerable to real or perceived supply side events. Key factors driving the market today are:

- Political situation in Nigeria. Nigeria is a major supplier of gasoline and diesel fuel rich crude oils, an incremental source of supply for gasoline production. Supply is already reduced due to political unrest. Further reductions will have a direct impact on crude oil markets and U.S. gasoline prices.
- U.S. refinery operations. With low inventories and refineries just now ending scheduled seasonal maintenance—with some unexpected operating difficulties—a smooth transition to full production will be needed to attain the typical seasonal gasoline inventory builds over the next several weeks. If this happens, the current wide gasoline spread to crude oil will narrow and could put downward price pressure on retail gasoline prices, to around \$2.75 per gallon or slightly lower by the end of the summer. If there are significant additional operating issues over the next few weeks, gasoline prices could be under pressure to increase further.

SHORT-TERM GLOBAL OIL MARKETS OUTLOOK, SUMMER 2007

Global Oil Demand: Global oil demand growth is expected to increase 1.6 million barrels per day (b/d) this year. Slightly weaker demand by member countries of the Organization for Economic Cooperation and Development (OECD), resulting from very mild weather in the first quarter, is offset by slightly stronger apparent demand in China. Growth this year will once again be primarily in North America and China.

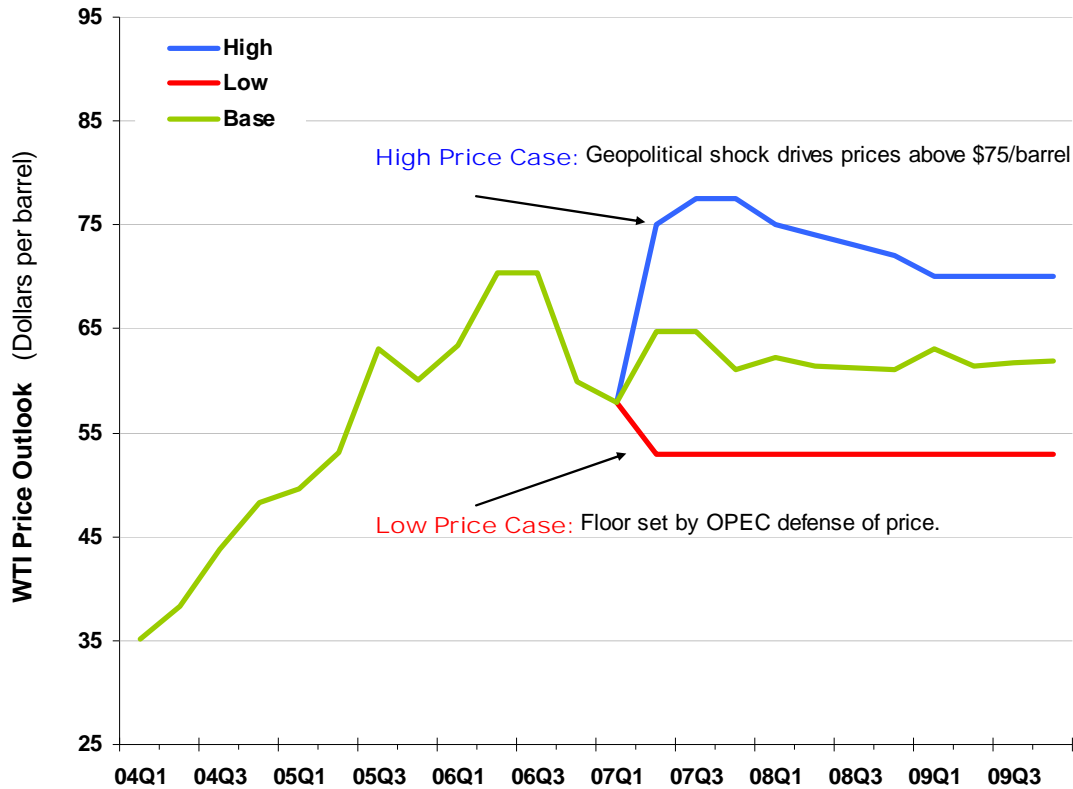
Non-OPEC Production: After making allowances for delays, disappointments, and accelerated decline, we expect non-OPEC production growth of around 0.7 million b/d this year. Higher growth is possible, but with delays to new production still arising, the summer maintenance and hurricane seasons still to come, and accelerated decline taking its toll, growth should be below announced additions.

OPEC Output and Capacity: Restricted OPEC output has provided a major support for crude oil prices. Publicly, OPEC ministers are describing the market as well supplied and are attributing high prices to geopolitical factors and a tight downstream. The OPEC Secretariat's very optimistic view of non-OPEC increases later this year explains OPEC's reluctance to consider increases in output. Spare capacity is around three million b/d, and additional capacity will come on-stream in the fourth quarter, so there should be no problem with raising output when members become convinced of the need to do so.

Crude Oil Prices: This winter has seen the steepest OECD inventory drawdown in several years, with product stocks in North America the largest contributor. Looking forward, the balance is getting tighter, but we assume price signals will indicate the need for increased supplies and that OPEC will respond. That response will be slow in coming, resulting in stocks levels being drawn down considerably in the second half of the year. Prices are expected to remain in the mid-\$60s per barrel in the second and third quarters, driven by tight crude markets and competition for available supplies;

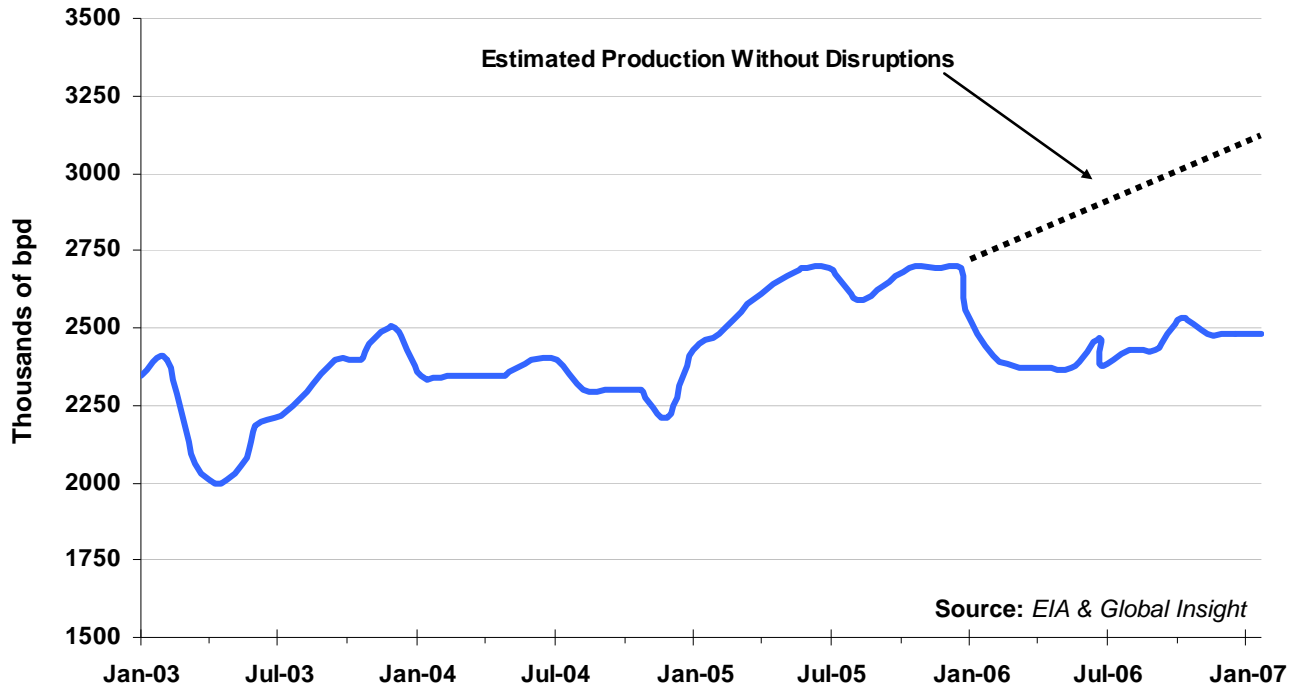
nevertheless, gasoline-driven pressures should ease with rising refinery output, but are expected to decrease in the fourth quarter as OPEC responds with increased output.

Figure 1: WTI Price Outlook Scenarios



Light sweet crude oil supplies, which are the incremental sources (represented by the benchmark crude oils Brent in the European Union and WTI in the United States) of gasoline production, are particularly tight. Declining production in the North Sea and production shut-ins in Nigeria—both of which are primarily light sweet crude oils—have tightened the market. In addition, ongoing concerns over future light sweet supplies in Nigeria are adding a risk premium to the price.

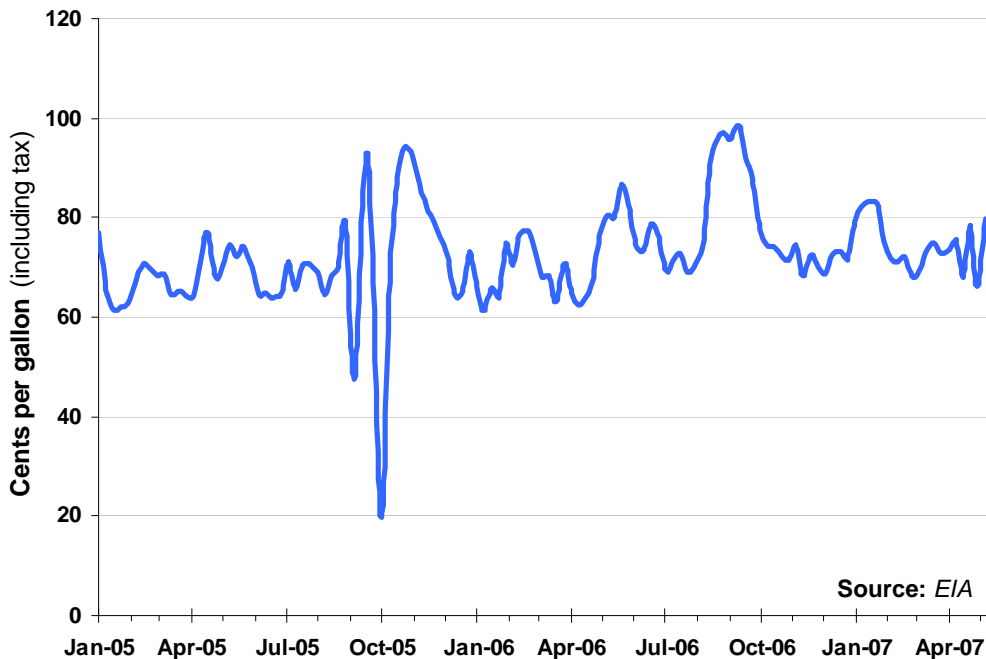
Figure 2: Nigeria Crude Oil Production



SHORT-TERM U.S. GASOLINE MARKETS OUTLOOK, SUMMER 2007

Refining Margins: U.S. gasoline refining margins, which directly impact the retail price of gasoline, will remain wide. However, May refining margins are

Figure 3: U.S. Retail Gasoline minus USGC Spot Gasoline Prices

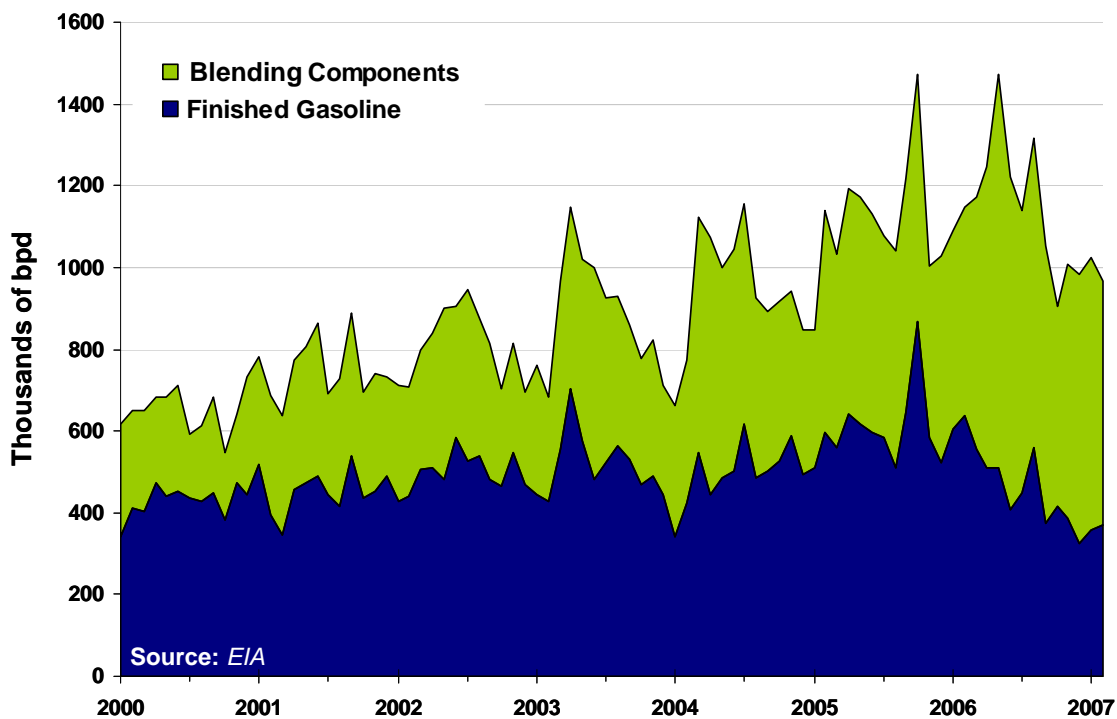


expected to be at or near the peak. Refineries are returning from scheduled maintenance and will be increasing production late May through June. It will still take until at least June before stocks have grown to comfortable levels that support lower prices.

Risks to refining margins are two-fold:

- Continued, unexpected refinery operating difficulties that keep production from rising as expected.
- Availability of imported supply. Import levels have fallen from last year's high levels. The decline was the result of falling seasonal demand and rising refinery output. If import levels do not match last year, margins could stay high.

Figure 4: U.S. Gasoline Imports



Retail Gasoline Prices: Current average U.S. retail gasoline prices are over \$3.00 per gallon. If refiners continue to come on stream as expected over the next few weeks and import availability remains adequate, retail prices are not expected to increase further, and may decline to \$2.75 per gallon or slightly lower by the end of the summer. However, the system remains extremely vulnerable to

disruptions and events. The risk of higher prices at the retail level comes from refining operations and the global crude oil market. Further events that increase supply concerns materially could drive average gasoline prices to around \$3.25 by the end of summer.

U.S. Gasoline Production: U.S. refinery gasoline production is expected to be high this summer as refiners return from maintenance. Refiners have set record-high levels of gasoline production in 10 of the last 12 months, although gasoline inventories are lower than typical for this time of year. Production levels are expected to be at least as high as last year—possibly higher—after returning to full operations.

Figure 5: U.S. Finished Gasoline Production

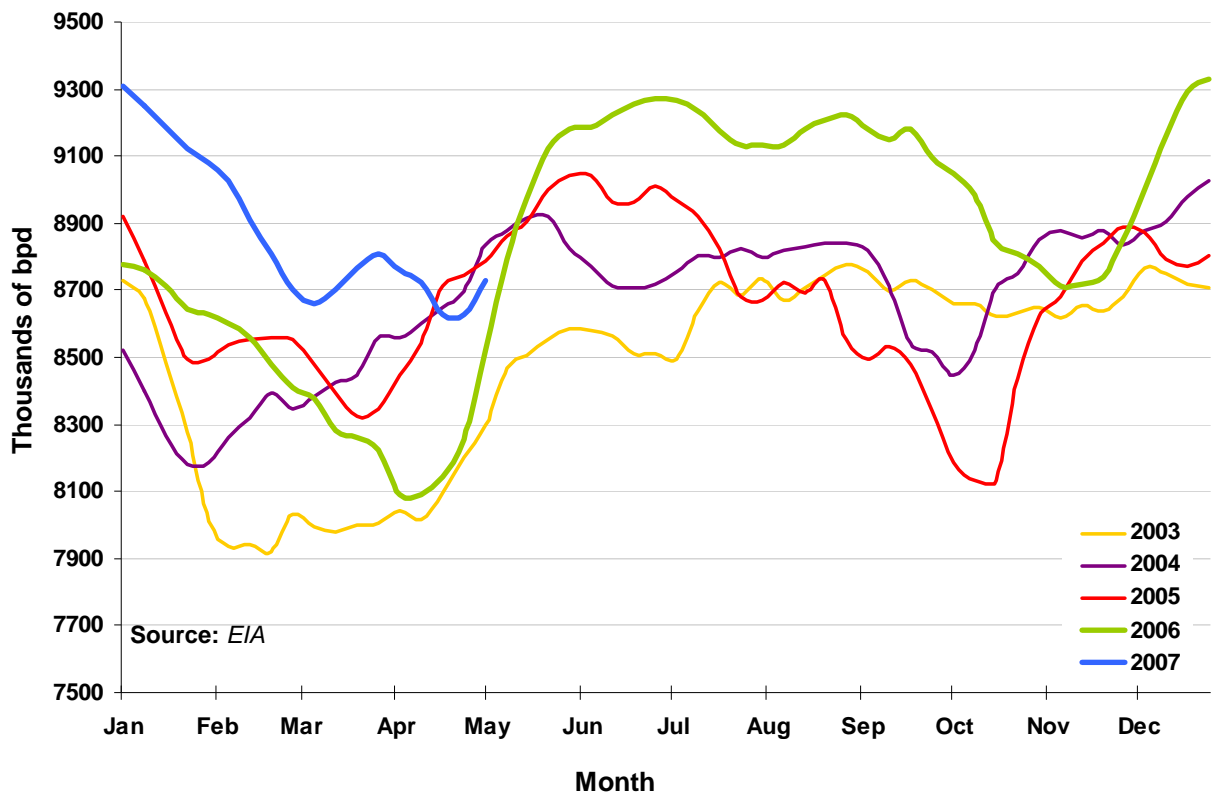
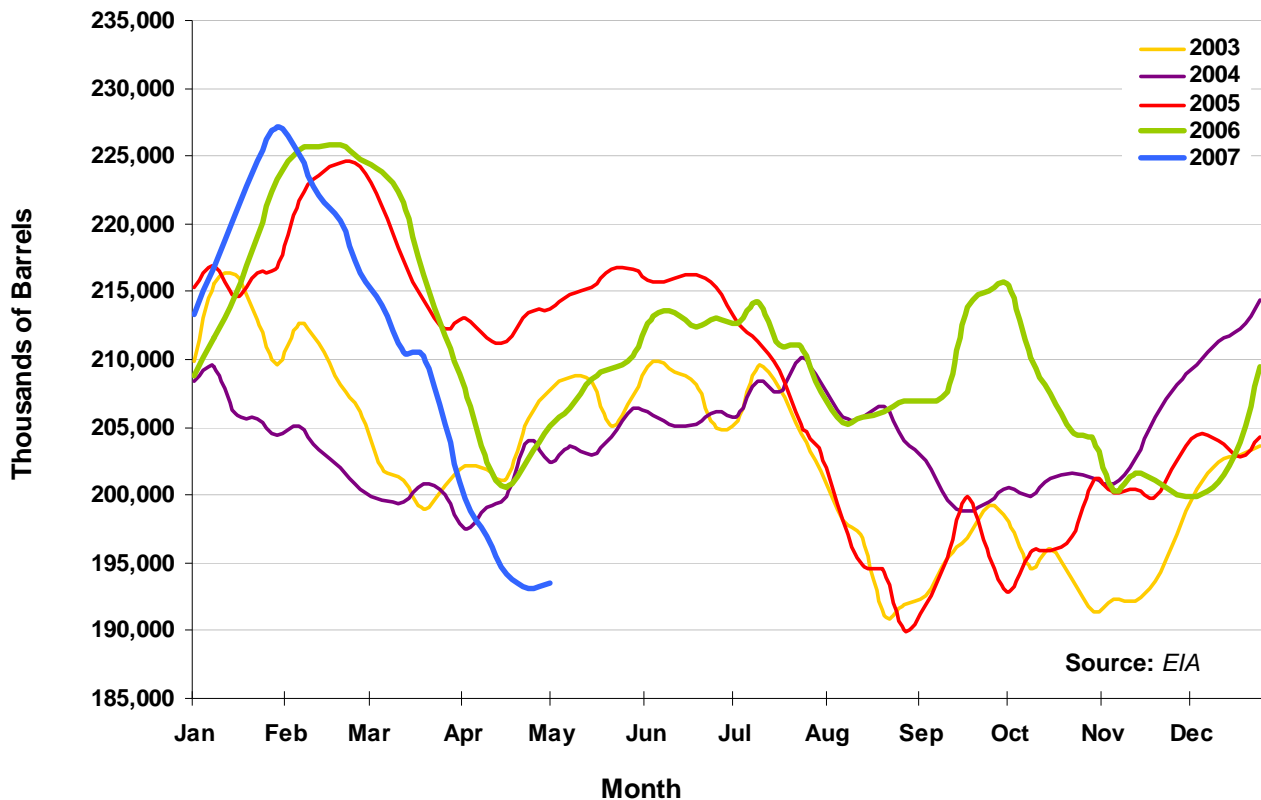


Figure 6: Total Gasoline Stocks

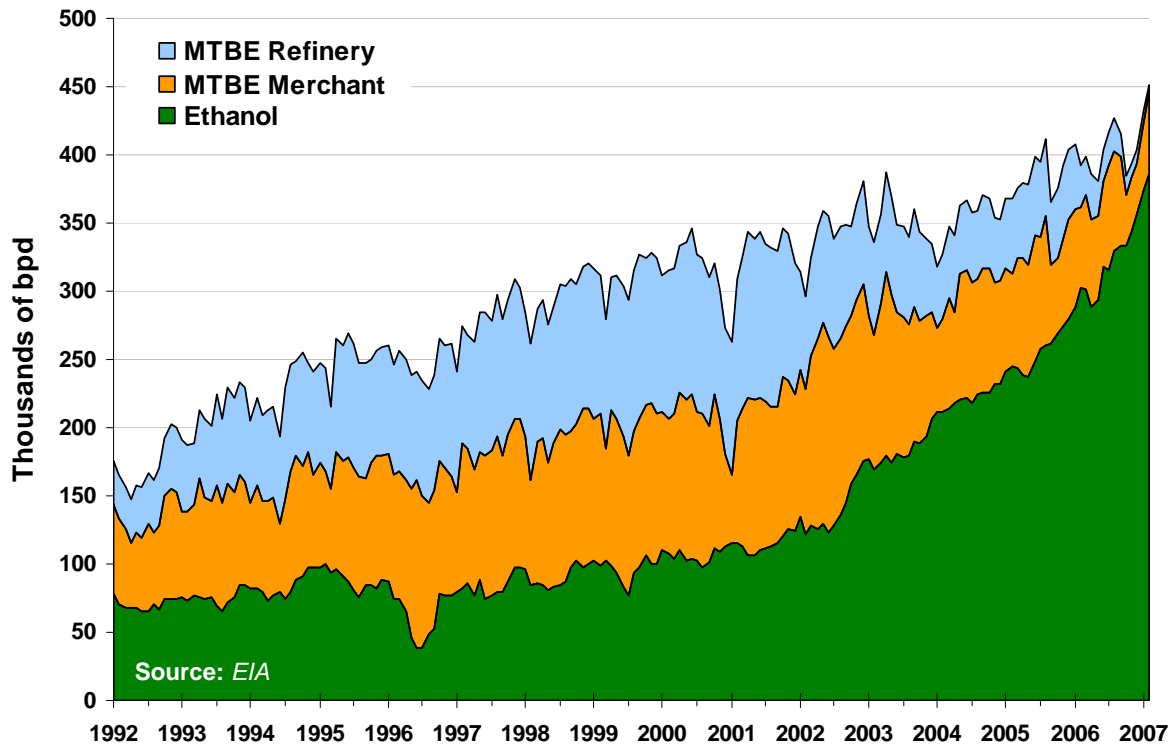


U.S. Gasoline Imports: U.S. gasoline imports have declined over the past several months due to seasonal demand trends. Most major foreign U.S. gasoline suppliers have made the shift to accommodate the change from MTBE to ethanol. Finished gasoline imports have declined since the MTBE ban, and blending component imports have increased correspondingly. Current and recent very high refinery margins are expected to attract higher volumes of imported gasoline supplies, which will put downward pressure on margins and, thus, gasoline prices.

Ethanol and Oxygenates: Ethanol production has been increasing dramatically since 2002, currently up 250,000 b/d from late 2002 to February 2007. Corresponding higher gasoline production from ethanol did not occur due to simultaneous declining MTBE production. Recently, MTBE production has fallen to very low levels, and ethanol production continues to climb. Higher net gasoline production from rising ethanol has begun to emerge since January 2007. This rising net supply from ethanol will continue as ethanol production continues to

rise. Ethanol additions in 2007 are expected to meet a significant share of the expected gasoline demand growth in 2007.

Figure 7: U.S. Oxygenate Production



KEY CONCLUSIONS

Global Insight expects crude oil prices to remain in the mid-\$60s per barrel for the summer, with some weakness toward the end of the year. Retail gasoline prices are at or near the peak and should weaken slightly through the summer. However, increased geopolitical tensions or disruptions in major crude oil producing areas could cause oil prices to increase further. Crude oil markets will drive gasoline prices. Also, additional refining operational issues, such as hurricanes or unexpected outages, will add to upward pressure on gasoline prices.