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Why Oil Prices Are Rising So Fast and What Will Make Them Stop

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“There is no justification for the current rise in prices” - Saudi Oil Minister Ali al-Naimi, June 9, 2008

With gasoline topping \$4 per gallon and crude oil prices approaching \$140 per barrel, most consumers are struggling to understand how energy prices could be rising so far and so fast. For the past few years, we have been told that rapid growth in China and India is causing energy demand to increase much faster than energy supply, and that this imbalance is causing oil prices to soar. However, the most recent run up in oil, from about \$80 per barrel to nearly \$140, is occurring despite data showing that global oil demand has been largely flat for the past year. While continued demand from China and India has largely offset declining demand in the U.S. and Europe, **even oil market professionals are struggling to understand how price increases are accelerating even as demand is decelerating.** Something is clearly having an impact on the oil market besides just normal supply and demand considerations.

Energy price subsidies in China, India, Indonesia and other emerging markets have prevented consumers in these countries from experiencing the full impact of rising oil prices. We believe that oil traders and speculators have noted that, thanks to these subsidies, demand for oil in the world’s fastest growing countries is largely divorced from the price of oil. **With subsidies placing a cushion between oil prices and consumer demand, traders have learned from past experience that they can push oil prices higher and higher without the collapse in global demand that would normally occur.** In essence, the subsidies have put energy speculators in the driver’s seat. We believe that global oil markets have come to resemble the subsidized California energy markets of 2000 and 2001. Based upon the California experience, rationality will likely return to the oil markets when, as in California, the subsidies become too expensive to continue.

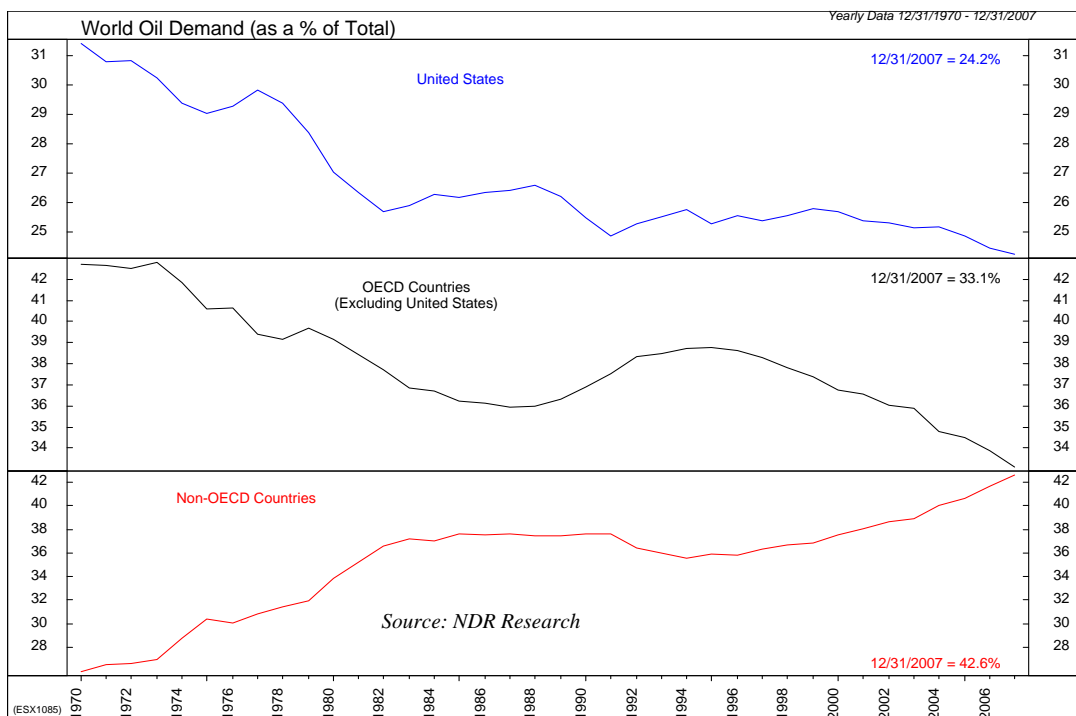
Subsidies and Emerging Market Demand

As shown in chart below, emerging market economies now account for more than 42% of global oil demand. Importantly, these economies account for more than 100% of the *increase* in oil demand. Declining demand in the U.S. and Europe is being offset by rising demand in China, India and other emerging economies. This shift in oil demand is partially a result of the much faster economic growth in these economies, but another big contributing factor to the continued rise in oil demand from these countries is the subsidies they apply to the price of fuel. The June 4 edition of the *International Herald Tribune* noted that, “China’s domestic fuel prices are among the lowest in the world, equal to about 61 percent of prices in the United States, 41 percent of Japan and 28 percent of England.” As oil prices have skyrocketed, subsidies have expanded to offset much of the price increases. According an analysis in the June 9 edition of *The National Journal*:

Gasoline prices in China have “risen 9 percent since early 2007, compared to 80 percent in the United States. Even more generous subsidy policies are pursued in India, Indonesia and other Pacific Rim nations.”

By sheltering consumers from rising oil prices, subsidies allow demand for oil in these rapidly expanding economies to grow despite extraordinary price increases. Perhaps more importantly, these subsidies remove the link between the world market price for oil and the demand for oil in some of the world’s fastest growing economies. As California discovered in 2000 and 2001, when governments sever the link between market prices and consumer demand, they surrender control of the market to speculators.

Chart 1 – World Oil Demand



A Lesson from History

In the late 1990s, California implemented an ambitious deregulation of its energy markets. Utility companies were required to buy electricity on the open market. These markets were structured in the hope that competition between electricity generation companies, such as Reliant, Mirant and Enron (yes, that Enron), would drive electricity prices down significantly. Not wanting to subject consumers to even short-term increases in their power bills, however, the prices that the major California electric utilities were able to charge their customers were capped at pre-deregulation levels. If prices in the power markets rose above these caps, utilities such as Pacific Gas and Southern California Edison had to subsidize the difference until prices dropped below the caps. In this way, the California government hoped to provide consumers with the benefits of deregulation (lower long-term prices) without the associated costs (occasional price spikes due to shortages). As students of market history will remember, things did not work out as planned.

A series of power shortages, some caused by nature and some caused by market manipulation, caused California power prices to spike on several occasions in early 2000. Energy traders at the major power generation and trading companies quickly noted that demand for power was relatively unchanged during these occasional price spikes. Consumers did not change their power consumption habits because their power bills were unaffected by these short-term price fluctuations. The subsidies forced on the utilities removed the link between market prices and consumer demand. Economists describe such markets in which rising prices do not cause a drop in demand as having “inelastic demand.” In such a market, economists note, a rational supplier will raise prices since they will be able to sell a similar amount of goods at the higher price. The traders at Enron had studied economics.

As shown in Chart 2 below, once traders understood that they were facing inelastic demand, they drove electricity prices in California higher and higher. We do not need to rehash the ugly market manipulations energy trading companies used to achieve these price spikes. The important point to take away from the California experience is that traders can achieve astonishing price increases when subsidies remove the link between market prices and consumer demand. The other important lesson from history is that the game comes to an end and prices return to “normal” when the provider of the subsidies runs out of money. After spending nearly \$20 billion maintaining the energy subsidies, Pac Gas filed for bankruptcy in April 2001 and Social Edison turned to the state for financial support.

Chart 2 – California Power Prices: 2000 - 2001

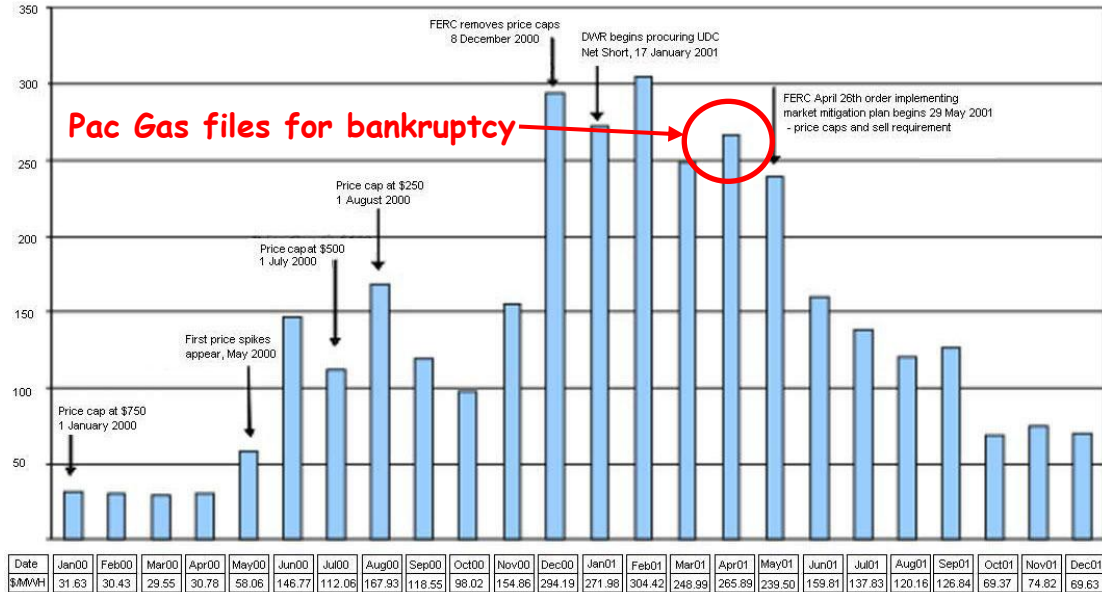


Chart prepared by California Public Utility Commission, Energy Division.

Implications for Oil Prices and Portfolio Strategy

As with every market bubble, a powerful fundamental economic truth underlies the current oil price frenzy. The increasing importance of emerging markets, especially China and India, as energy consumers has radically altered the balance of supply and demand in the oil markets. This new source of demand, coupled with the difficulty in providing new sources of supply, explains much of the rally in oil prices witnessed in recent years. However, the hyperbolic rise in oil prices witnessed thus far in 2008 suggests to us that speculators now dominate the oil markets. As with the California power crisis, the power of these traders to influence oil prices will only be broken when subsidies are substantially reduced.

Unlike the utility companies in California, the governments providing fuel subsidies are not facing imminent financial collapse. However, as soaring oil prices rapidly escalate the costs of subsidy payments, several governments are examining their subsidy policies. Over the past two weeks, Indonesia, Taiwan, Sri Lanka, Bangladesh, India and Malaysia have attempted to raise fuel prices or have pledged that they will. Even these modest proposals have sparked protests, and even riots, illustrating the difficulties faces by governments in reducing these subsidy payments. These governments will not want to face the political pain of lowering these payments unless they are reasonably certain of a gain in the form of falling oil prices. Since China is by far the largest consumer of oil in the emerging markets, any significant effort to reduce subsidies must have China's participation.

Unlike some of the other emerging market governments, China has ample resources to continue its fuel subsidies even if oil prices continue to escalate. We believe that China will eventually have to pass on additional fuel costs to consumers, because until they do, speculators will continue to control the oil market and the costs of these subsidies will continue to increase. Given the potential for social unrest in the wake of reduced fuel subsidies, China is extremely unlikely to alter its subsidy policies until after the Olympics are over and all of the Western tourists and journalists have gone home. However, whether China addresses this issue immediately after the Olympics or waits until the oil markets inflict additional financial pain is impossible to predict.

While we cannot predict when the Chinese government will alter its current energy policy, the California experience suggests what could potentially happen once they do. Speculators know that these subsidies are the key to their trading

strategies. As price increases are passed on to the final consumer, demand falls as prices increase and speculative excesses are quickly washed out of the market. Supply and demand relationships return to normal, and so do prices. In determining which level reflects “normal” conditions in the oil market, the May 12th edition of *The Weekly View* noted that the trend line for the 10-year bull market in oil suggests a level of about \$88 per barrel. From a fundamental perspective, Shell Oil President John Hofmeister recently suggested that the “proper” price for oil should be somewhere below US\$90 a barrel. Accordingly, we believe that investment strategies premised on oil continuing its meteoric rise are likely to disappoint. We are focusing our portfolios on those energy companies in that can provide attractive earnings growth even if oil drops back to the \$80 to \$90 range.

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