As oil prices near $70, experts see danger

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WASHINGTON – Oil prices appear headed back toward $70 a barrel, a level not seen since Hurricane Katrina battered the Gulf Coast and sporadic shortages sent gasoline at the pump above $3 a gallon nationwide.

While last summer's price spike triggered outrage in Congress and hurt sport utility vehicle sales, it caused only a hiccup in motor–fuel consumption. And for now, with demand back on the rise, the economy seems capable of absorbing uncomfortably high prices.

Analysts warn, however, that consumers and businesses could be just one major supply disruption away from more serious financial consequences.

Sherry Cooper, chief economist at BMO Nesbitt Burns, said the ramifications of $70 oil and $3–a–gallon gasoline would be "more mild" the second time around "because we're getting kind of used to it."

But while the gas–price sticker shock may be wearing off, Nomura Securities chief economist David Resler fears a more subtle fuel–related angst settling in among consumers.

"There is the pessimistic notion that this is not going to go away and that's going to have a more lasting impact on driving habits and behavior, I suspect, than we've seen so far," Resler said.

In that context, a hypothetical supply disruption that jolts oil prices to $80 or higher and keeps them there for an extended period – say, three months – could result in "a substantial falloff in discretionary spending" that snowballs into a serious slowdown.

Overseas tensions
Perhaps the top threat for the oil market is the standoff between the United Nations and Iran, OPEC's No. 2 producer, over Tehran's nuclear energy ambitions. Iran's foreign minister said Friday his country would not use oil as an economic weapon, and that helped ease prices, but analysts say they remain concerned about supplies from Iraq, Russia, Venezuela and other places.

Unrest in Nigeria has taken more than 500,000 barrels per day of oil off the market, and more than 300,000 barrels per day of Gulf of Mexico output remains shut–in because of damage from last fall's hurricanes.

With global oil demand expected to average 85 million barrels per day in 2006, and excess production capacity limited to 2 million barrels per day, oil analyst Jamal Qureshi of PFC Energy in Washington said prices aren't likely to retreat anytime soon.

"The market is awakening to the scope of the risks," said Antoine Halff, director of global energy Fimat USA in New York.

Yet in spite of all the apprehension about oil supplies – or maybe because of it – U.S. inventories of crude are at a seven–year high of roughly 341 million barrels. That does not include the 685 million barrels in the country's strategic reserve, available in an emergency.

Some analysts point to this buildup of inventories as evidence the market is divorced from reality. IFR Energy Services' Tim Evans sees a "dangerous complacency about the downside potential for prices" – but many more say it is a reflection of unease about geopolitical uncertainties.

On Friday, light crude for May delivery settled at $66.63 a barrel, down 52 cents on the New York Mercantile Exchange. U.S. retail gasoline prices averaged $2.53 a gallon, or 37 cents higher than last year, according to Oil Price Information Service.

The potential exists for $3–a–gallon gasoline at some point this summer, analysts say, but that assumes out–of–the–ordinary disruptions to refining or distribution, or both. The Energy Department, meanwhile, is forecasting an average summertime price of $2.50.

Homeowners adapting?
Economists and oil–market experts say industry and homeowners may not like paying more for fuel but they are adapting, in large part because energy is a tiny piece of overall spending and, thanks to more efficient technology, an even smaller piece than it was during the energy crises of the 1970s.

The burden is most severe on low–income families and fuel–intensive businesses, though truckers, chemical manufacturers and, to a lesser extent, airlines have had success in passing along these costs.

Relatively low interest rates, which have made it easy to borrow money while helping to prop up the stock and housing markets, have reduced the impact of high oil prices on the economy.

Of course, the Federal Reserve has raised short–term rates 15 times since June 2004 to cool off the housing market and keep inflation in check, and this is likely to slow growth irrespective of energy prices.

BMO's Cooper said the Fed probably needs to raise interest rates again in

May to slow economic growth because there are signs – rising airfares among them – that inflationary pressures are creeping up.

Brian Hicks, co–manager of US Global Investors' Global Resources Fund, a mutual fund heavily invested in energy, said a recession in the U.S. would likely reverberate across emerging–market economies and could quickly depress daily oil demand by 2 million barrels per day.

That dire scenario is not what Hicks or most other financial professionals are anticipating. Hicks forsees oil prices trading in a range of $55 to $65 through the end of the year, with consumption tapering off anywhere above $70 and the Organization of Petroleum Exporting Countries curtailing production at around $50.

James Cordier, president of Liberty Trading in Tampa, Fla., believes oil prices will climb as long as the economies of the U.S., China and India continue to grow and that prices may need to hit $75 before there is any significant demand response.

"We are going to find out at what price level we start rationing demand," Cordier said. "That is what we have to do."

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