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ENERGY/OIL & GAS

Financial Regulation Could Lower Oil Prices

Enforcing Stricter Regulations Will Curb Speculation

SUMMARY

We believe the current high oil prices are caused by speculation, not market fundamentals, as oil supply is more than adequate to satisfy current and future demand, which is expected to remain weak. However, we expect crude oil prices to remain inflated until regulators curb trading in oil futures by financial speculators, mainly the large investment banks and their hedge and pension fund clients. We estimate that speculation may have cost American consumers more than $146 billion annually in the last five years, which helped fund obscene bonuses at large banks. We think market fundamentals do not support oil prices above $60/b, which is more than three times the industry average replacement cost.

KEY POINTS

- **Excessive Speculation.** While the rate of change in global oil supply and demand in the last five years remained in the single digits in any 12-month period, oil prices were extremely volatile, doubling within a year to a record $148/b in mid-2008, then crashing by over 75% by February 2009 before surging over 135% in the next eight months. This price volatility in our opinion was clearly caused by speculation.

- **Financial Regulations.** Unless stricter regulations are enforced, oil prices will remain inflated, and even manipulated by financial speculators. We believe financial players' trading of oil futures should be limited to under 10% of physical contracts by commercials, who are either actual producers, or consumers. Banks should provide services to, but not compete with, their clients and should not be allowed to own or operate energy businesses.

- **Fleecing The Public.** We believe excessive speculation and market manipulation have inflated oil prices in the last five years by more than $20/b. Based on US average crude oil consumption of 20 mmbd, or 7.3 bb annually, American consumers overpaid an estimated $146 billion annually, or $730 billion during the last five years, for oil under the watchful eye of regulators

- **Hedging Impact.** While major oil companies do not use hedges to protect their future cash flow from low oil and gas prices, most E&P companies do. They could not have survived low oil and gas prices, especially gas, which accounts for the bulk of their production, without hedges. We estimate that excluding hedging gains, the majority of E&P companies would have reported losses in the last six quarters.

- **Industry Consolidation.** Financial regulations could curb speculation, lower oil prices, keep gas prices low and force industry consolidation. Rising government take, limited access to resources and increased political risk made foreign investments less attractive, while technology advancements increased interest in non-conventional oil and gas plays in North America.

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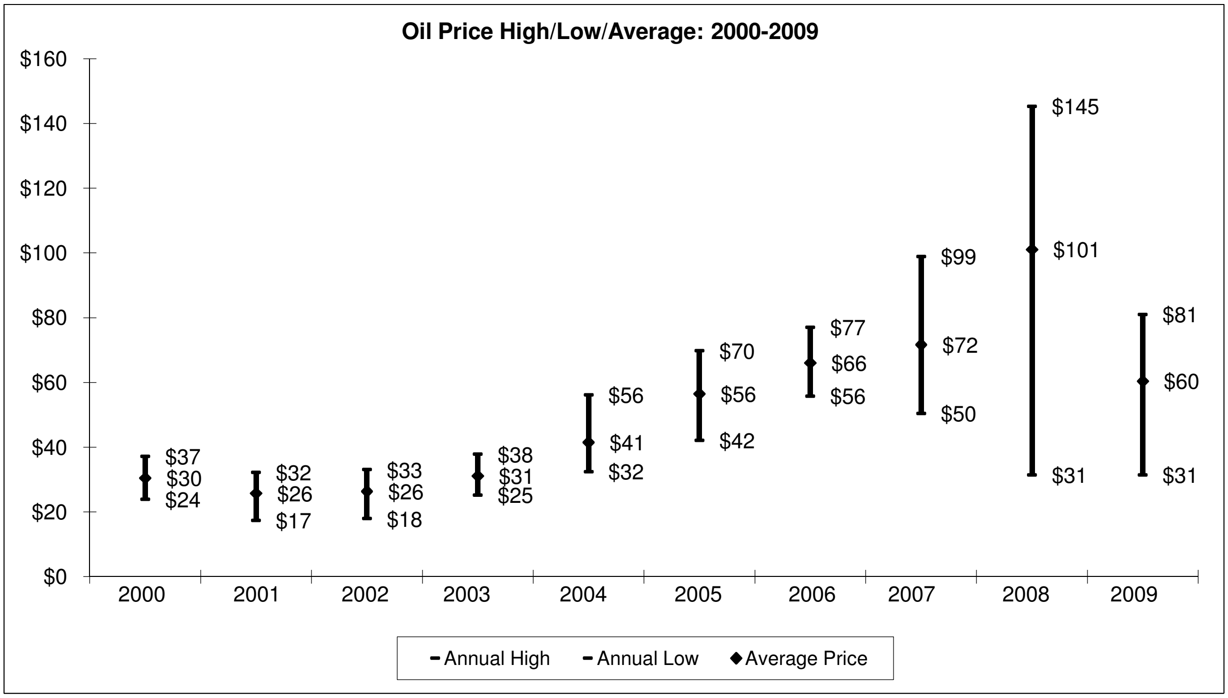
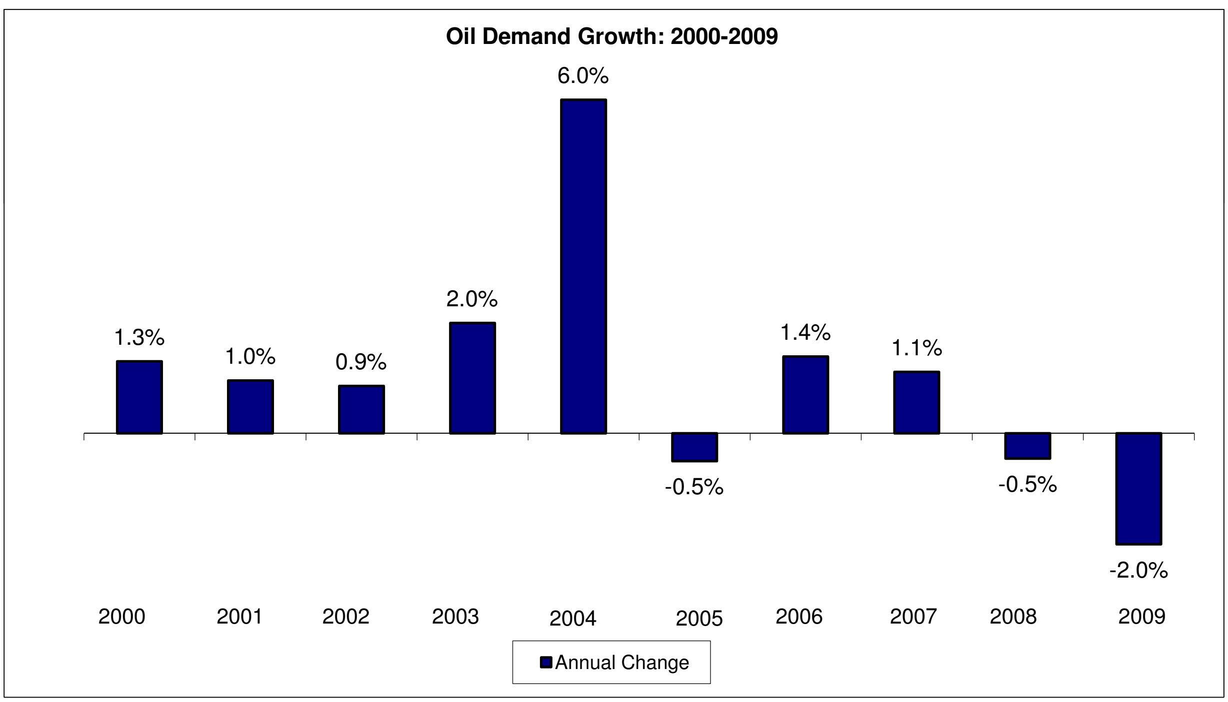


Source: Bloomberg



Source: EIA

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