Philequity Corner (October 29, 2007)
By Valentino Sy

Oil on the way to US$100

Last Friday, crude oil prices set an all-time nominal record high of US$92.22 per barrel. What many had feared is now becoming a distinct reality. Any untoward incident in Iran or Turkey now will likely propel oil prices toward US$100 per barrel.

Nymex Crude Oil ($/bbl)

Source: Technistock

While crude oil prices fall at this time of the year (note last year's trend) following the end of the peak driving season, the combination of several recent developments has contributed to sustain the crude price rally to record nominal highs.

Rising crude oil demand, especially from China and India, has driven oil's recent rally. Tight supply conditions, against this backdrop of growing demand, have heightened global inventories over the past 12 months, making markets even more anxious. Meanwhile, political tensions in the Middle East have increase investors' worries that some output could be disrupted.

On Wednesday, a US report showed a larger-than-expected decrease of 5.3 million barrels in US crude oil inventories. And on Friday, the US announced new sanctions on Iran as it accused the latter anew of supporting terrorism. Iran is the world's second largest holder of oil reserves.

Another reason for the rise in oil prices is the weakening of the US dollar. The easing monetary policy of the US has weakened the US dollar, which in turn has diverted investment flows into commodities and oil (see "*Oil and Commodities Surge as Fed Eases*" on Oct. 1, 2007 issue of *The Philippine Star*).

Lastly, the prevalence of financial products & other derivatives is pushing oil and other commodity prices higher. Oil & other commodities, such as gold and copper, are now becoming

an investment choice among funds with the introduction of exchange traded funds like United States Oil Fund (symbol: USO) and Street Track's Gold Shares ETF (symbol: GLD). According to the Bank of International Settlements, the claims on real barrels of oil rose nearly six-fold from December 2004 to June 2006 largely because of the rise in the notional value of oil derivatives held by financial institutions.

Peso appreciation is a blessing

There's no question that rising oil prices will have a great impact on an oil-importing country like the Philippines, especially when the country is striving to achieve higher levels of growth. Higher oil prices make it more expensive for companies to operate as electricity and transport costs go up. The cost of living will also be higher as transport fares, as well as food items and other necessities, become more expensive.

In short, higher oil prices will eat into the country's income growth. By how much will depend on a number of factors, including the exchange rate and the oil & energy intensity of the country.

It's a good thing that the peso appreciated. While exporters are getting hurt by the peso appreciation, it has proven to be a blessing to the general populace. A peso appreciation increases the purchasing power of domestic income over oil imports. If not, it would have been disastrous for the Philippines.

Looking at the table below, local pump prices (as of Oct 23, 2007) have increased by only 11 percent year-on-year for unleaded gas and 9.5 percent for diesel. In the U.S, gas prices have surged 61.5 percent and diesel by 57 percent during the past year. This is because the peso has appreciated 11.6 percent versus the US dollar during the same period as crude oil prices increased 56.4 percent.

Local & US fuel prices

	Oct-06	Oct-07	% Chg
P/$ Rate	49.84	44.06	11.6%
Local Pump Prices (P/liter)			
Unleaded Gas	38.24	42.45	11.0%
Diesel	33.74	36.95	9.5%
US Pump Prices ($/gallon)			
Gas	1.748	2.823	61.5%
Diesel	1.971	3.094	57.0%
NY Light Crude	58.73	91.86	56.4%

Source: Department of Energy, Wealth Securities Research

Meanwhile, it is also a good thing that the Philippines is not as dependent to oil as before. Oil, as a major source of power generation has now been replaced by natural gas, which is indigenous to the Philippines. From supplying over 50% of the country's power needs in the 1990s, oil-based power generation is down to 8% as of end-2006. While coal (our second biggest energy source) is mostly imported, it is still much cheaper (i.e., around US$44/MT for 1H07) than oil.

Power Generation by Source (Percentage Share)	1986-90	1991-95	1996-2000	2001-05	2006
Oil-Based	42.75%	53.91%	37.39%	14.55%	8.22%
Oil-Thermal	42.75%	30.11%	15.58%	2.83%	0.48%
Diesel	0.00%	10.99%	14.70%	10.16%	7.32%
Gas Turbines	0.00%	12.81%	7.10%	1.56%	0.42%
Hydro	24.88%	18.79%	16.51%	14.94%	17.52%
Geothermal	20.46%	20.81%	21.93%	19.42%	18.45%
Coal	9.78%	6.48%	24.15%	31.16%	26.96%
Nonconventional	2.13%	N/A	N/A	0.01%	0.10%
Natural Gas	N/A	N/A	0.03%	19.93%	28.85%
Total	**100.00%**	**100.00%**	**100.00%**	**100.00%**	**100.00%**

Source: Department of Energy, Wealth Securities Research

Lastly, with external positions more secure (i.e., current accounts and balance of payments in surplus), monetary policy more credible (with inflation at low levels) and fiscal strength greater, we believe that the Philippines is now better positioned to absorb large shocks than it was at the time of previous oil shocks.

For comments and inquiries, you can email us at info@philequity.net. You can also view our archived articles at www.philequity.net or www.yehey.com/finance.