



NYMEX crude oil prices have continued to increase over the last month closing just above \$77, which is almost a 12% increase, since the end of June. NYMEX crude oil prices are now at the highest levels since July 14, 2006. The recent increase in NYMEX crude oil prices can be attributed to on-going geopolitical concerns, refinery problems both in the U.S. and in Europe, and strong gasoline and distillate demand.

Inventory Levels & Demand

In the latest weekly report from the Department of Energy, crude inventories are at 351 million barrels, which is 17.9 million barrels above last year's levels. Distillate inventories continued their seasonal builds but still remain 11.6 million barrels below last year. Gasoline inventories posted a counter-seasonal build based largely on record-high level of imports.

Total US products demanded over the last four-week period have averaged over 20.9 million barrels per day (mmbpd), or 1.2% above the same period last year. Total distillate demand over the last four weeks has averaged nearly 4.1 mmbpd, up 2.8% compared to the same time period last year.

Refinery Problems

Refinery problems in the U.S. improved slightly last week, as refineries operated at 91.7% of their operable capacity. US crude oil refinery inputs averaged over 15.8 mmbpd, up 172 thousand barrels per day (kbpd) and at the highest average since the week ending September 22, 2006. However, several refineries continue to have problems. The Coffeyville, KS, refinery was shut down due to flooding, and the refinery is not expected to restart for several more weeks. The Valero refinery at McKee, TX, continues to have problems, while the BP refinery in Whiting is not expected to reach full capacity until year-end at the earliest. Europe has also experienced refinery problems with the largest refinery in the UK being shut down on July 25. With strong gasoline and diesel demand, any reports of refinery disruptions will likely push prices higher.

U.S. Economic News

Despite the recent slow down in the housing market, U.S. GDP managed to post a 3.4% gain during the second quarter. This was above Wall Street expectations of 3.2% and was the fastest expansion since the first quarter of 2006. The greater-than-expected growth rate was attributed to rising exports, commercial construction, and government spending.



Tropical Weather

Despite the forecast for an above-average hurricane season, the tropics have been relatively quiet. Despite the fact that August is statistically the most active month for tropical storms and hurricanes, there is a growing perception amount market participants that oil prices may be ready to repeat the pattern established a year ago, when oil prices reached significant highs in mid-July and in early August for products. By the end of September, oil prices had fallen by more than 18% from the mid-July highs. One of the factors weighing on prices in 2006 was the same lack of tropical activity. Obviously, a hurricane like Katrina or Rita would changes things and push prices higher.

World Oil Supply and Demand

In June, the International Energy Agency (IEA) reported that the world supply fell by 500 kbpd to 84.3 mmbpd. The decrease was due to maintenance in North Sea production and seasonal factors that limited North American output. OPEC also had a decrease of 45 kbpd for June. For 2007, the IEA expects non-OPEC production to be 50.0 mmbpd and expects non-OPEC supply to increase to 51.0 mmbpd in 2008. Key drivers for 2008 non-OPEC growth are the FSU (430 kbpd), Latin America (290 kbpd), and Africa (130 kbpd). North America production is expected to see further decreases despite strong growth from the U.S. Gulf of Mexico and Canadian oil sands.

According to the IEA, global oil demand is expected to be 86.0 mmbpd in 2007, which is a 1.8% increase over 2006. In 2008, world oil demand is expected to increase a robust 2.5% to 88.2 mmbpd. U.S. oil demand is expected to increase from 20.7 mmbpd in 2006 to 21.2 mmbpd in 2007 and then to 21.3 mmbpd in 2008. China's strong oil demand is expected to continue as demand increases to 7.7 mmbpd in 2007 and to 8.0 mmbpd in 2008.

To meet the expected world oil demand of 86.0 mmbpd in 2007, OPEC crude and NGL production will have to reach 36.0 mmbpd to balance the market. Of course, this depends on Non-OPEC oil production reaching 50.0 mmbpd in 2007. The IEA estimates that OPEC's production for the first half 2007 was 35.1 mmbpd. This means that OPEC will need to increase its current production by almost 1.0 mmbpd to meet the expected 2007 oil demand. This would be possible as OPEC spare capacity is estimated to be 3.9 mmbpd, with Saudi Arabia having 2.2 mmbpd of the excess capacity. In addition, with prices well above \$70, OPEC will have incentive to increase its production at its next meeting in September.



World Refining Capacity Outlook

A recent IEA forecast shows that world refining capacity should increase in 2008. The IEA expects that there will be an increase of 1.5 mmbpd in new crude distillation capacity. China is expected to count for almost half of the increase, while North American capacity is expected to increase by 116 kbpd, driven by a number of small-scale expansions at refineries operated by Valero, Holly, Frontier, and others. The Middle East is expected to see 250 kbpd in growth, with the main growth occurring in Qatar, Saudi Arabia, and Iran.

Upgrading additions are expected to further add to the supply of light products in 2008. Coking capacity additions of over 400 kbpd are expected to occur in China, North America, and Latin America. An equally large tranche of hydrocracking capacity is expected to commence operations during 2008, adding to the supply of low-sulphur middle distillates. Additionally, the IEA expects 1.5 mmbpd of hydrotreating capacity additions in 2008, 60% of which are aimed at diesel desulphurization.

Geopolitical Issues

Iran: The stand-off with the West over Iran's nuclear program continues. Recently, Iranian President Mahmoud Ahmadinejad said that "Acceptance of Iran's legal rights to enrich uranium is an inevitable end" to the diplomatic impasse between the Islamic Republic and the UN. This situation should be monitored closely as any significant headline will likely lead to price swings.

Recommendations and Strategies

With oil prices over \$75 per barrel it is hard to recommend locking in prices long-term; however, your fuel management strategy should be focused on protecting against short-term price volatility. With the heart of hurricane season approaching, we recommend using our Flex-Term program to alleviate the potential price risk should a hurricane disrupt supply. This program allows you to fix your fuel price over a four-month window. You indicate the amount of gallons that you wish to commit and then have the flexibility to pull the gallons at any time during the four months. We also like this program should the lack of tropical activity continue and prices revert to the trend we saw at the end of 2006.

For a longer-term strategy, we suggest using our KnockOut program. This program allows you to buy price protection against increasing fuel prices. The cost for this program is well below what you would pay for an outright cap. This program offers a limited protection against upward price movements but allows for full participation with downward price movements.