HOW HIGH CAN OIL GO?

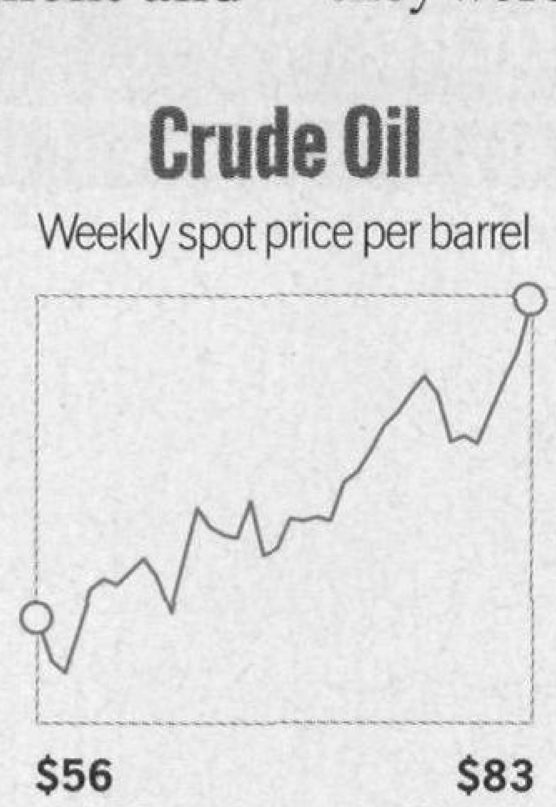
Goldman Sachs commodities analyst Jeffrey Currie sees crude prices moving above recent record levels.

LOGJAM Problems at refineries helped boost gas prices earlier this year.

GUSTAVO GRAF—BLOOMBERG

CRUDE OIL PRICES HIT a series of record highs in the past month, topping $83 a barrel—and that was after OPEC announced it would increase production by 500,000 barrels a day. The sharp spike went against post–Labor Day tradition, when the end of a gas-guzzling summer usually brings lower prices, and refineries head into their fall maintenance schedule. After Goldman Sachs raised its year-end price forecast by $13, to $85 a barrel, Jeffrey Currie, global head of commodities research in London, spoke to FORTUNE's Eugenia Levenson about where oil is headed from here.

What's behind the recent surge in crude oil prices?
The OPEC supply increase was too little, too late. The market is in a significant deficit, the first deficit we've seen since 2003. Inventory started to drop in October of last year for two reasons. Non-OPEC supply has been extraordinarily disappointing, because those producers are hitting technical difficulties with new equipment and their existing fields are getting less productive. OPEC has the supply but hasn't brought it online. The second factor is that we're in the part of the energy cycle where extraction costs are rising and have been since 2001.



So how high will prices climb?
Our high-risk scenario is in the $90 to $95 a barrel range. I think there's high probability we'll get there, rapidly approaching 50%. The later OPEC is in responding to the higher prices, the sharper the deficit and the more critical the drawdown on inventory this winter—and the more volatile the price spikes. They'll have to respond by first quarter of next year, barring a global collapse in demand.

Why hasn't OPEC increased supply?
First and foremost, domestic demand is strong in the entire Gulf region. Exports from the Middle East are lower today than they were in 2000, but production is up two million barrels a day. There are serious bottlenecks preventing non-OPEC from growing supply even at $70 per barrel, so if I'm OPEC, I know I don't have significant competition for market share. The last reason, which is very important, is that if OPEC did ramp up production, they'd go to capacity, which would reduce their political negotiating position.

What does an $80 barrel mean for gas prices?
This is a crude story. Retail prices are lower today on $80 a barrel than they were in May. At Memorial Day, the average price at the pump was $3.25 a gallon, and at Labor Day it was $2.86 a gallon.

What's keeping retail prices low?
Refining margins [profits earned by the refiner] dropped from 74 cents a gallon in May to 19 cents. The main reason for the high margins in the summer was an unprecedented number of refinery outages. In part, that's because of continuing problems from hurricanes Katrina and Rita. It's also true that significant increases in environmental regulations on fuel create a higher probability of these types of mishaps. There were also distribution problems during that time period, which led to higher marketing margins [profits earned at the retail level]. But now the gas stations' take has dropped from 47 cents a gallon to 32 cents.

Refining margins have come down, but will they start rising again?
We're modestly bullish on refining margins. They will probably get bigger, though not as big as in May. That's why I don't think that even if crude goes to $90 a barrel, retail prices will be as high as they were. Stocks in the refining sector were pulled down by concerns over the credit crisis as well as declining refining margins. Investors are not pricing in the potential rebound in margins.

Higher gas prices this summer didn't seem to dent demand. Why?
It's the price change that matters. In September 2005, retail gasoline prices reached an all-time high of $3.11 a gallon. That was a 70% year-over-year increase, and it killed off U.S. gasoline demand and significantly impacted economic growth. This May prices reached a new all-time high of $3.25, a 12% increase year-over-year, and it didn't even make the headlines. The consumer had already adjusted to the $3 level. F

Goldman's Oil Plays

The bank has buy ratings on these 12 energy stocks. (Prices are rounded, and as of Sept. 24.)

APACHE
APA $88

BAKER HUGHES
BHI $91

BERRY PETROLEUM
BRY $38

DIAMOND OFFSHORE
DO $114

HESS
HES $68

MURPHY OIL
MUR $70

NATIONAL OILWELL VARCO
NOV $143

SUNCOR ENERGY
SU $95

SUNOCO
SUN $77

ULTRA PETROLEUM
UPL $58

VALERO ENERGY
VLO $71

WEATHERFORD INTERNATIONAL
WFT $67