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MONTHLY OIL REPORT

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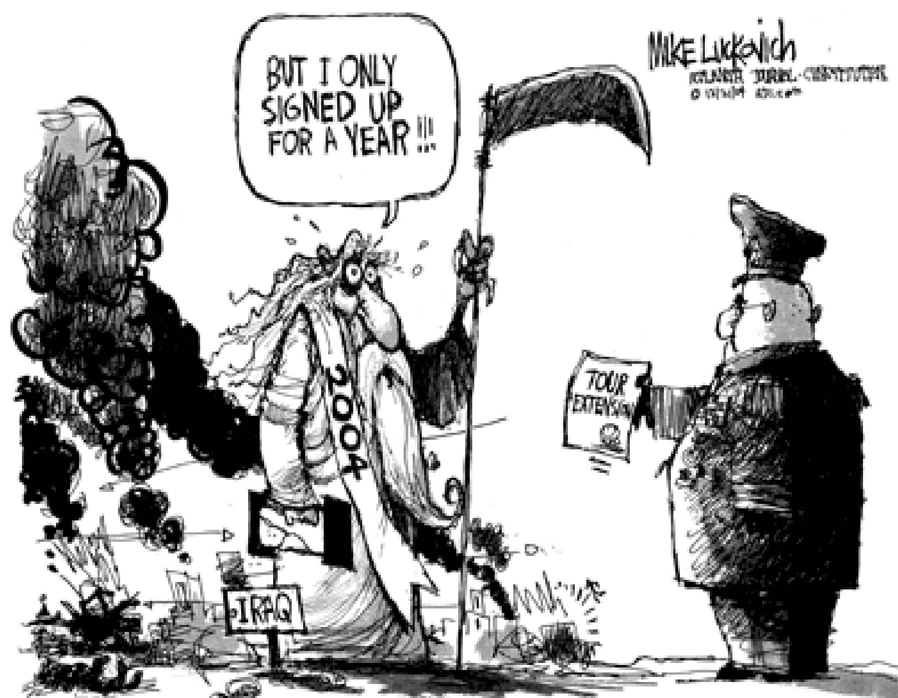
"Lessons to be learned."

Concluding this extremely volatile year in the petroleum markets one cannot help but try to assess what and why it happened. In a year during which bomb explosions, killings, political turmoil, hurricanes and unexpected crises appeared on a daily basis in hindsight it is hardly a surprise that prices rose. The strength of the move, however, and the fluctuations that followed it seem to be marking a new era for the petroleum markets that will probably leave its marks in the years to come. There are several "lessons to be learned" from 2004 and we will analyze them below. (As these words were written two bomb explosions shook the Saudi capital of Riyadh and led petroleum prices to rise by $2 in a symbolic ending for the year that passed.)



Prices, basis WTI, ended 2003 at $32.52, reached a year high for 2004 of $55.67 (71.19% higher) on October 15th and closed on December 29th at $43.64 (an annual rise of 34.19%). Throughout this spectacular ride we experienced a number of significant events, such as the establishment of China as one of the major and most rapidly growing consumers of energy, the continuous violence in Iraq and (for the first time in such an extend) in Saudi Arabia and, of course, the passing of Hurricane Ivan, one of the most catastrophic storms ever to hit the Mexican Gulf. We also experienced the covered re-nationalization of Russian oil giant Yukos, numerous strikes in Nigeria and a major one in Norway, the re-election of US President Bush and the victory of Venezuelan President Chavez at the recall referendum brought against him. During all this turmoil prices moved violently, making volatility one of the main characteristics of petroleum markets. Despite the volatility however one thing remained constant, the upward trending line starting from Sep 22nd 2003 with WTI hitting a low of $26.70 and which has now risen to $41.40 with a pace of 4.6 cents per day. Every time this support was tested the upward reaction was violent suggesting that the oil bulls were not willing to give up.

Chart 1. WTI futures price chart

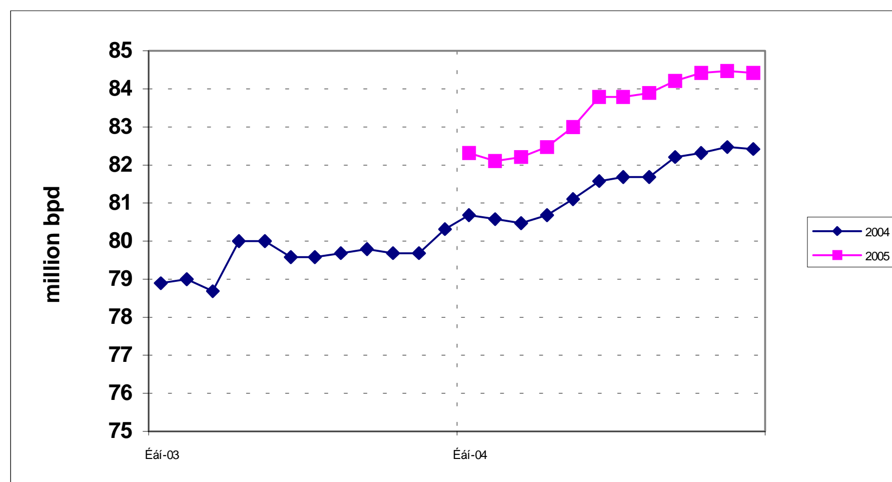
Source: NYMEX

What will happen in the year to come is something we will try to determine later, but first we would like to sum up the lessons learned from the situations faced this year.

First and most important is that **demand is hard to predict.** Just ask EIA and IEA whose demand forecasts at the beginning of the year were underestimating world demand by almost 2 million barrels per day (this is equal to the oil production of Iraq) without any major event affecting demand taking place. Major revisions usually take place as a result of dramatic changes (ie September 11th 2001). If one saw January 2003 estimates for 2004 demand then the divergence jumps to a whooping 3.5

million bpd. Usually both agencies tend to overestimate demand and then adjust their predictions downwards. This was also one of the few times oil markets had to face major upward revisions. The inability of these major agencies to predict the surge especially in Chinese demand caused great anxiety to traders who did not know whether they had seen the worst or not. We would still think that the major determinant for price direction next year is whether Chinese demand will overshoot or not EIA's estimates of 7.2 million bpd.

Chart 2. EIA world demand estimates for 2004 and 2005



Source: Energy Information Agency

The second lesson to be learned is that one should **never underestimate the forces of nature.** There is no clearer example than the disastrous tsunamis that wrecked havoc in 12 countries in Asia, but as far as petroleum is observed the lesson came from Hurricane Ivan which hit Gulf of Mexico on September 16th leading to the shut-in of 35 million barrels of crude production and whose effects continue to be felt. During a period hampered by the concerns regarding the upcoming winter, Yukos's problems with the government and continuing violence in the Middle East, Ivan knocked down more than 60% of oil production and operations in the Gulf of Mexico leading prices well above the once dreaded $50 level. We cannot predict that similar events will take place next year, but it seems that we are moving to more volatile meteorological conditions in the years to come and that we will have to learn to live with such events.

Third but not less significant than the above is that one **should not expect the major parties involved to do the right thing at the right time.** OPEC decided to restrict actual output by almost 2 million bpd on February 11th fearing a supply glut! Restricting output at a time when demand was surging prohibited the industry to replenish its inventories after a heavy winter and opened the way for the price surge that followed. They reacted with the same erroneous way, although towards the opposite direction, as they did in December 1997 when they decided to raise supplies when demand was collapsing leading prices then below $10. At the same time the

US Administration decided that there was no reason to stop refilling their Strategic Petroleum Reserve adding 37 million barrels of crude since the beginning of the year. The amount is not dramatic as it represents an outflow of 100,000 bpd, but in tight markets its significance is much higher than the actual number indicates. The US stance also indicated to market participants that the price levels observed did not particularly concern the world's largest consumer of energy. To make thing worse Russia, which was portraying itself as the more reliable supplier of oil decided to settle its accounts with the Yukos owners, putting at risk 1.7 million bpd of production thus raising the risk premiums in the price of oil and the nervousness of market participants.

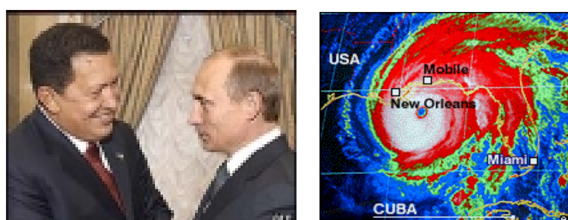
Another lesson learned (or one that should be learned) is that **stabilizing a foreign country is not an easy task.** Iraq is a clear example of the above lesson. US casualties have surpassed the 1,000 level and violence is an everyday phenomenon. All the overoptimistic assessments after the overthrowing of the Saddam regime have been proved wrong and while some steps have been taken especially in the oil sector, a lot needs to be done for the region to offer some basic stability. The return of the Khor-al-Amaya terminal in the South greatly enhanced Iraq's export capabilities, but the continuous attacks on the key Kirkuk-Ceyhan pipeline in the North are causing serious problems. The upcoming elections on January 30th cause more concerns than relief as violence is expected to escalate.

Last but not least is the lesson that **predicting where the next crisis will occur is extremely hard.** When prices were surging in June one would not have expected the Norwegian workers to put additional pressure on the markets with their strike, which affected 375,000 bpd of production for an 8-day period. Although it did not last long because of government intervention, it increased the risk premiums and the anxiety of traders. On the opposite side was the recall referendum of Venezuelan President Hugo Chavez. Most analysts expected turmoil that could even lead to civil war or another military coup, whichever the result. Chavez's clear victory, however, and the subsequent acceptance of the result by international monitors led to a peaceful resumption of his duties and some relative stability in this major oil producing country.

Looking into the year ahead and taking the above lessons into account we would note the following. The main reason for the price rise we observed this year was the inability to accurately gauge demand. If next year's Chinese demand is again underestimated and the world's most populous country continues to devour energy with no intention to slow down prices could continue their upward trend. On the other hand last Monday's tragic events with the Sumatra earthquake will also have adverse financial repercussions in the region and given the existing concerns regarding the overheating of the Chinese economy it is not unlikely to observe lower than expected demand at least for the first months of 2005. Such a development could put downward pressure to crude oil prices. We should not forget that it was the collapse of the Asian Tigers in 1997 that led to the collapse of prices the coming year.

On the flip side of the coin one should consider the unstable conditions in the Middle East and especially in Saudi Arabia. Any sign that Saudi supplies are seriously threatened will wreck havoc in the energy markets. Today's explosions in Riyadh are another sign that markets should pay close attention to the developments in the world's largest supplier of oil.

Attempting a rough estimate we would say that if things remain relatively calm during the next few weeks, prices will probably breach the previously mentioned trend line and attempt to reach another major trend line originating from November 2001 and standing today at $33.30. Whether they will reach it or reverse course will hinge mainly on the issues mentioned above or any unexpected development, which will most likely be bullish.



We would like to wish you all a Happy and Prosperous New Year.

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