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BI-WEEKLY OIL REPORT

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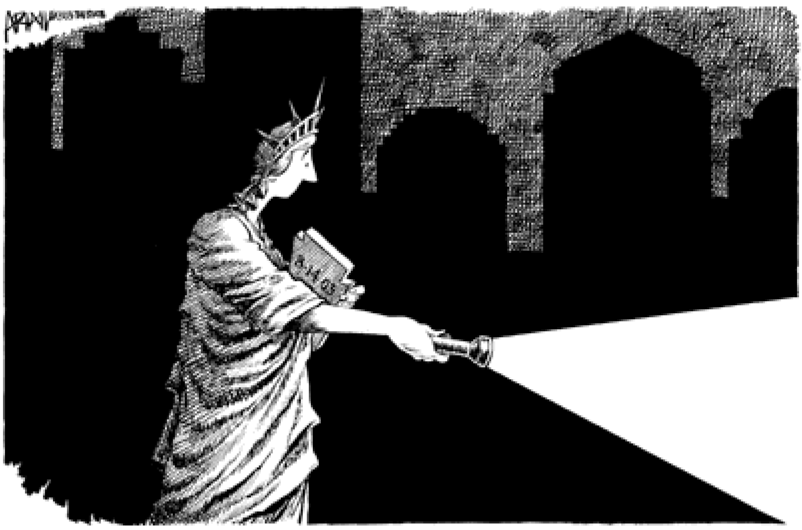
The exciting month of August.

When the famous Italian writer Umberto Echo said that there are no news during August he did not have in mind what happened this August in the US. The weaknesses of the US energy supply and distribution system were exposed on - by-one within a few days. Events ranging from huge car lines outside gas stations in Arizona to an electricity blackout that left most of the North East US in the dark, made the world's mightiest country feel like part of the so-called "Third World" for a while.



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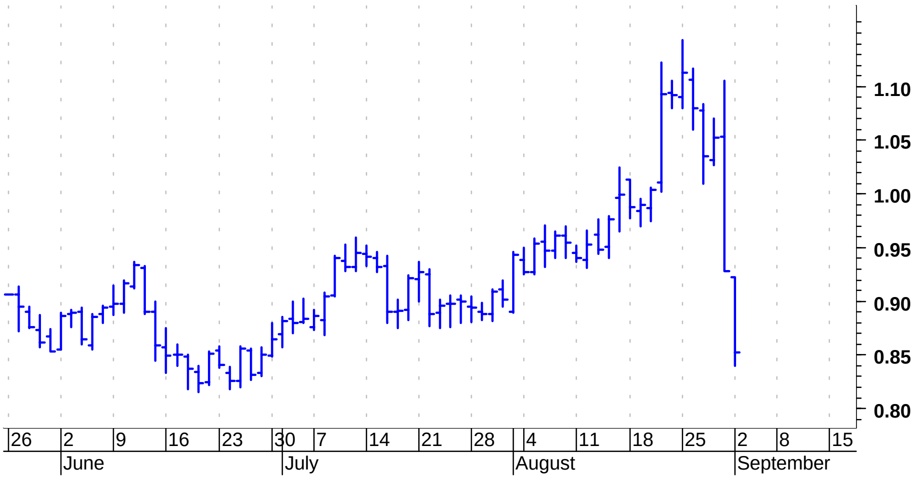
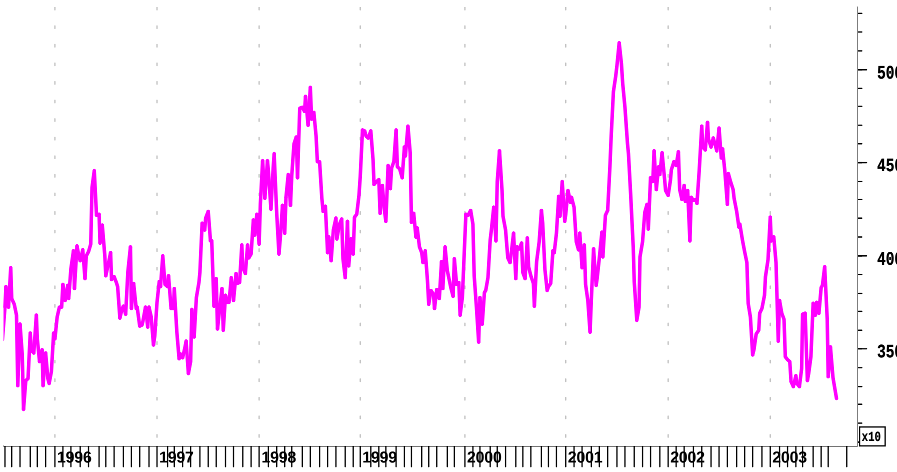
The excitement started as soon as the first day of the month. In a single day oil prices rose from $30.54 to $32.4 and averaged $31.60 throughout the month, only to collapse to $29.40 during the first trading day of September. What was more exciting however was the fluctuation of gasoline prices, which were standing at 90.16 c/gallon on July 31st and rose to 114.36 c/gallon by Aug 25th, before collapsing to 84 c/gallon on September 2nd. Gasoline was the main driving force behind the strong performance of the petroleum markets during August. Its strength came from a number of refinery snags and pipeline problems, which, coupled with the low RFG stocks, led to physical tightness in most major US markets. Physical RFG prices were trading 15 to 20 c/gallon higher than NYMEX futures prices at some point, as refiners and traders were bidding for the available supplies.

Figure 1. NYMEX gasoline futures price ($/gallon)



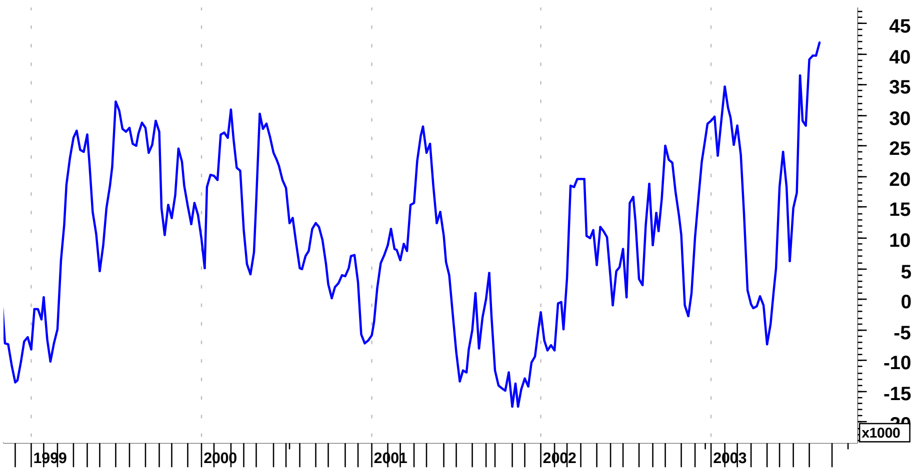
A rupture at Kinder Morgan's Phoenix Arizona pipeline led to severe shortages in the region for about four weeks, while refinery snags in the Midwest led to market tightness there. The final blow came with the electricity blackout, which hit an area covering New York, Detroit and Toronto and, led among other things, to shutting 600,000 bpd of refining capacity for several days. If one adds a record high gasoline demand it is not too difficult to see why a price squeeze took place and prices averaged 99.43 c/gallon during August. RFG stocks are now at their lowest level since September 1995, while demand continues to remain high.

Figure 2. Reformulated Gasoline (RFG) inventories (thousand barrels)



What cannot be easily explained by the above mentioned developments is the sudden drop of prices yesterday when crude dropped almost $2 and gasoline shed more than 7 c/gallon. One has to consider, however, that Labor Day marks the end of the driving season and therefore the peak for gasoline demand. Historically September gasoline demand drops by more than 300,000 bpd compared to August, while after September 15th standards for the RFG grades used in major US cities are lowered. Both developments point to an easing of market tightness. Exacerbating the downward move was the fact that funds had accumulated a record high long position in gasoline futures, which at some point reached a long to short ratio of 27! The unwinding of such length led to the sudden collapse in prices and although figures are not yet available it seems that the coming CFTC reports will show this major shift in funds' positions.

Figure 3. Non-commercial + non reportable gasoline futures position (thousand contracts)



Meanwhile, in the other major issues facing energy markets, developments were not as breathtaking. Iraq continues to be an extremely unstable region and while production is slowly picking up, the rise is mainly due to developments in the South. Oil from the northern Kirkuk fields has not reached the markets in significant quantities yet. The strategic Kirkuk-Ceyhan pipeline is facing continuous sabotage actions and even if it successfully returns to operation this week, no-one can guarantee that it will not be attacked again soon. The death toll among US soldiers continues to mount, while overall security in Iraq's major cities is at least problematic. The US administration realizing that it needs more troops to control the country is now making an effort to persuade other countries to participate. Its reluctance however to hand over at least some control to the UN makes their task difficult. Preliminary estimates for August show that Iraqi production stands now at 1.1 to 1.3 million bpd. This is close to the target for this period of time, but the promised 2 million bpd by year-end target cannot be achieved without sustained production from the northern fields of Kirkuk.

Nigeria faces continuous turmoil, but the situation there only partially affects oil operations and not for long time periods. The escalation of violence could however lead to more serious disruptions, especially as most major issues remain unresolved. At the time this report was written Shell's white-collar workers were continuing a 6-day strike and no agreement had been reached with management. Exports were not yet affected and analysts believe that the issue will be resolved. Such events, however, are now occurring more often, forcing market participants to keep a wary eye on this African country.

Venezuela seems to be experiencing a lull before the storm. The country's High Court eventually appointed a long awaited Electoral Council. Both the government and the opposition expressed their satisfaction with the members of the council and are now standing on the sides to see how it performs. The opposition has submitted the more than 2 million signatures needed for a recall referendum and the electoral council needs to check their validity, update the ballots and decide if and when a referendum will be held. Depending on the speed of their work and their final decision they will face reactions from both parties. President Chavez's government believes that the work undertaken by the council is so grave that it will take month before it is concluded. This is something that the opposition will not accept setting the background for the confrontation that will take place during the months to come. For the time being, however, oil operations remain stable, with the Venezuelan government going as far as to pledge more gasoline to the US after the blackout occurred. The gesture received warm reviews by the US government.

Given therefore that for the time being Nigeria and Venezuela supply the markets as they normally do, price direction will hinge on the success of the restoration of Iraqi exports and OPEC's reaction to such a development. The organization's meeting on September 24th could therefore be crucial as we are entering the winter season. It seems, nevertheless, that there remains a high level of uncertainty in the energy markets and if this August serves as an example, we are heading for very exciting months ahead.

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