

## BI-WEEKLY OIL REPORT

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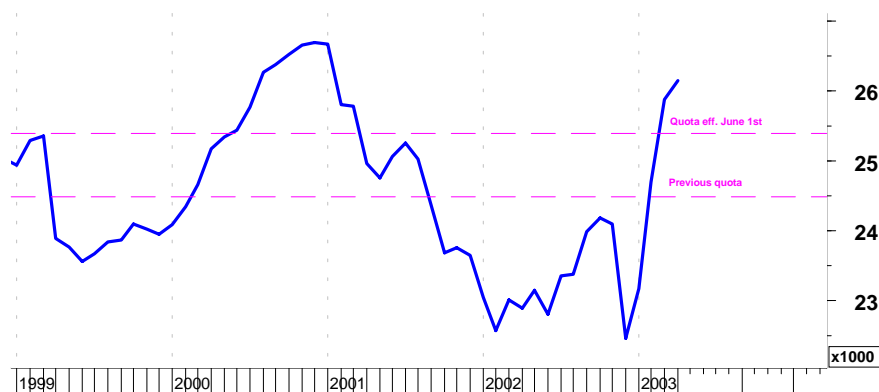
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### Doing the Math again.

In our previous report we tried to provide a qualitative picture of the world after the war against Iraq and the drop of Saddam Hussein. However, after watching the reactions of most major players we will try to calculate the demand-supply situation under the new setting. In a world without the Iraqi uncertainty, market share will start becoming a major issue, while other unexpected events (i.e. SARS) could become the center of attention in the days to come.

OPEC was the first to react to the changes in the petroleum world. In its April 24th meeting, only a few days after the collapse of Baghdad the organization came to decision that mostly confused the markets. OPEC decided to restrict output, by raising its quotas! This oxymoron can be understood if we add that its members agreed to restrict cheating, thus creating a net effect of supply reduction. They added however that the decision will take effect after June 1st, meaning that they will continue the high level of production during May. The main conclusion that can be drawn out of this decision is that OPEC wants to see worldwide inventories rise from their extremely low levels, but also wants to be in position to control future developments. We consider it very likely therefore that they could push for further supply restrictions after June.

**Figure 1. OPEC-10 (excluding Iraq) production and quota (million barrels per day)**

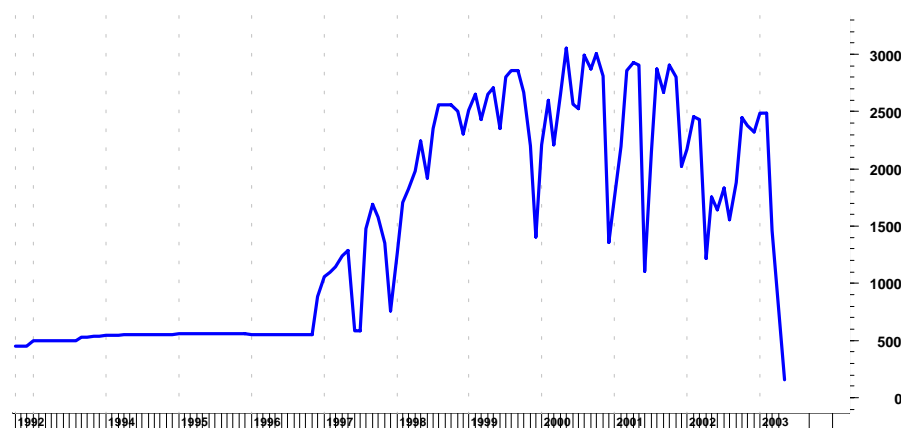


Source: International Energy Agency

The situation in Iraq after almost a month of the fall of Saddam is not clear enough, but it seems that scenarios of a swift resumption of production are not realistic. It is very likely that a limited production of 1.5 million barrels per day will be achieved very fast, but will be used to cover the country's own needs. Reaching the pre-war sustained production levels of 2.6-2.7 million bpd will be a gradual task that will have to overcome many technical and political obstacles. It seems that US officials are trying hard to overcome the political problems, connected to the UN oil-for-food program and the reluctance of other Security Council members to relinquish control of the Iraqi oil sector to a US appointed government. It is very likely that in the case of a deadlock, US will sidestep UN and unilaterally lift the sanctions against Iraq.

For Iraq, however, to reach production levels above 3 million bpd it may take more than 2 years. US Secretary of Defense Rumsfeld's statements that Iraq could be producing 3 million bpd by year's end seem now very optimistic.

**Figure 2. Iraqi oil output (thousands barrels per day)**



Source: International Energy Agency

Other major issues affecting supply are the uncertainties regarding the situations in Nigeria and Venezuela. The crisis in Nigeria seems to have been resolved and production is now returning to normal levels. Market participants are used to short-term problems in this African country and usually do not fear that the disruptions will last long. On the other hand the Venezuelan situation is more complicated. The oil industry has managed to recover from December's National Strike, but the political issues are not resolved. Although it is hard to predict future developments it seems likely that the more we are approaching Chavez's mid-term in August the more we will be hearing about developments in Caracas. For the time being however, both countries are supplying the world at normal levels.

The most unexpected change in the supply demand equation came from a very unlikely source. The SARS (Serious Acute Respiratory Syndrome) epidemic.

When it first made its appearance in Hong Kong the world was too occupied with the Iraqi issue to pay attention. Now that it is spreading worldwide, analysts are having grave problems trying to gauge its implications. It is very hard to estimate how long it will last and in what extend it will affect economic growth in Asia and the rest of the world. It is obvious however that it has caused negative effects in airline transportation and as a result in jet fuel demand. The effects are starting being felt in European as well as in American airports. IATA sees a 60% traffic decline in Hong Kong, 40% in Seoul and respective declines in other Asian cities. It is estimated that SARS has taken a heavier toll on the airline industry than the Iraqi war. The jet demand outlook will hinge on the speed of containing SARS, but it is expected that it will take 3-4 months after the lift of travel advisories before air traffic recovers. Preliminary estimates show a drop of more than 20% in jet fuel consumption in most major Asian airports. EIA data show that April jet fuel demand in the US is 11% down compared to the same month last year.

Following is a table with Energy Information Administration estimates for the worldwide supply and demand balance and the expected inventory build-ups or reductions.

**Figure 3. Supply-Demand balance (millions barrels per day)**

	Q1-03	Q2-03	Q3-03	Q4-03
Supply	77.9	78.4	79.4	79.8
Demand	79.3	76.9	78.3	80.0
Balance	-1.4	+1.5	+1.1	-0.2

Source : EIA

Although as we mentioned Q3 and Q4 balances incorporate a large degree of uncertainty, it is clear that Q2 will show builds close to the ones predicted. 1.5 million barrels per day increase in stocks means a total increase of 135 million barrels for the quarter. Such a development could bring stocks close to their averages reducing concerns and extreme price fluctuations.

Overall it seems that we are going through a period were supply surpasses demand and unless OPEC acts during the coming months, inventories will continue to build throughout the year. SARS could only act as another parameter suppressing demand and could become a significant obstacle in the worldwide effort for economic recovery. It is hard to gauge its effects yet, but if it persists traders will start pricing in a “SARS discount” as opposed to the previous “Iraqi war premium”.

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