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BI-WEEKLY OIL REPORT

Herodotus Antonopoulos &
Filimon Antonopoulos
Oil Market Analysts

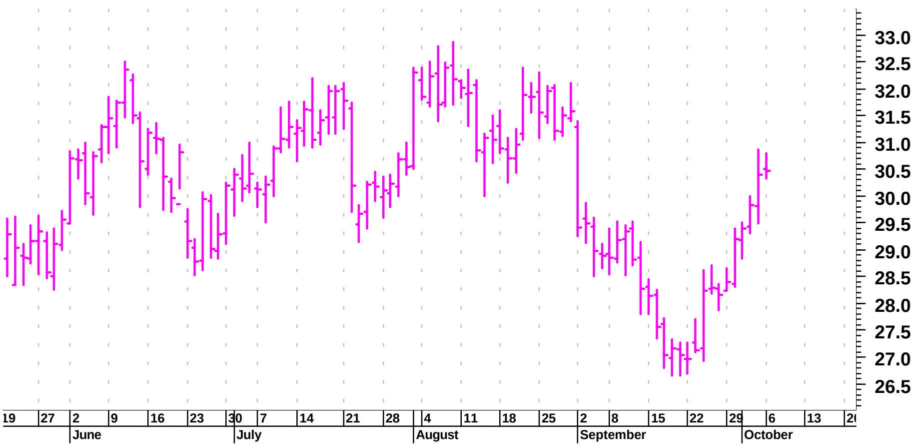
lnx@otenet.gr ; info@iraj.gr

OPEC saves the world from drowning!

"My reaction is that I would hope our friends in OPEC don't do things that would hurt our economy". The hope comes from US President Bush one day after OPEC's surprising decision to cut crude oil output by 900,000 barrels per day. The organization having read our previous report's headline ("Drowning in oil?" - Sep. 22, 2003) came to the rescue, against all expectations, causing Bush's comment and effectively reversing the recent price direction.

Markets, caught by surprise by this sudden move, were alarmed by the organization's effort to preempt price direction ahead of the winter amid relatively low inventories and low Iraqi production. The result was a ten-day rally that led WTI prices above $30, after gaining more than $4. The removal of 900,000 bpd starting November, although no sustainable recovery of Iraqi production has been achieved, caused concerns among traders, who see that prices will now become very vulnerable to any further supply disruption. The global conditions do not offer any relief, as the crisis in the Middle East is escalating fast, casualties in Iraq are an everyday phenomenon and Nigerian unions are ready to strike this Thursday if their demands for lower fuel prices are not met. Figure 1 clearly depicts the reaction of WTI futures to the above developments.

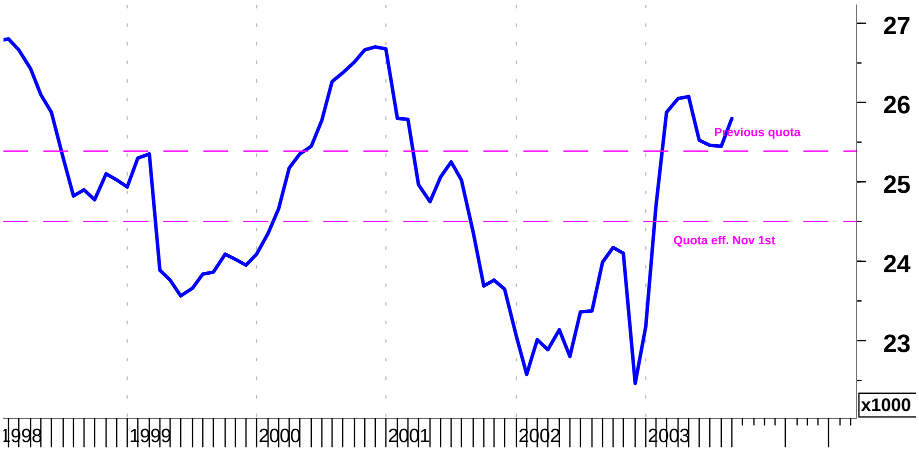
Figure 1. NYMEX WTI crude oil futures contract ($/barrel)



Source: NYMEX

OPEC's decision to cut output by 900,000 bpd will bring the OPEC-10 production to a total of 24.5 million barrels per day, effectively reversing their decision taken on April 24th, after the US offensive against Iraq seemed to have been concluded. The organization seems determined to aggressively control oil prices deciding to act preemptively and not waiting for the actual developments before taking measures. This policy has led to the more or less successful defense of their preferred $22-$28 OPEC basket price band, but has also led to the erosion of their market share. The effects were not felt as the suspension of Iraqi exports had allowed the remaining members to reap substantial gains by covering a market niche that did not belong to them. The fact remains however that non-OPEC members were the ones who benefited most, as they managed to both capture market share and sell their petroleum at higher prices. It is more than clear, that with the recovery of Iraqi exports the issue of market share between OPEC and non-OPEC will come to the forefront. Last time OPEC had risen the issue of market share and called non-OPEC members to participate prices dropped to as low as $17.12 on Dec 7th 2001. It is true that there were many bearish considerations at the time, the main being the Sept. 11th attacks, but the fact remains that OPEC members are gravely concerned about this situation.

Figure 2. OPEC-10 output until September and quotas (in million barrels/day)

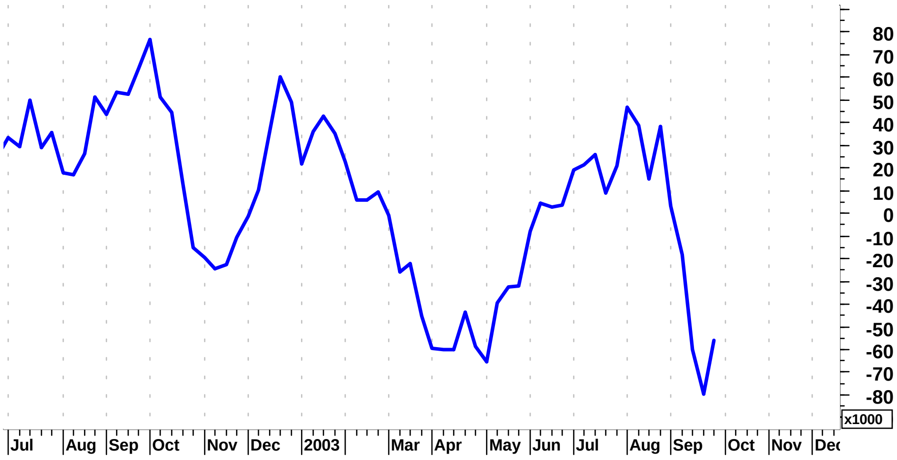


Source : IEA

Once again funds played the most active role in this price recovery. As we had noted in our previous report the speed of the early September drop in prices had led to the conclusion that funds had accumulated a large net short position. This opinion was proved accurate when the data was released. On September 23rd with prices close to $27 the net short position of non-commercial and non-reportable participants had reached 79,350 contracts. This is the largest short position established by funds since 1998 when crude was well below $20 and is slightly higher than the position funds held on Dec. 2001. This position was established in the early weeks of September and it seems that it was almost reversed during the last 10 days.

The continuous reversal of positions in such volumes is the main characteristic of a market that is struggling to find direction.

Figure 3. CFTC non-commercial and non-reportable net position (thousand contracts)

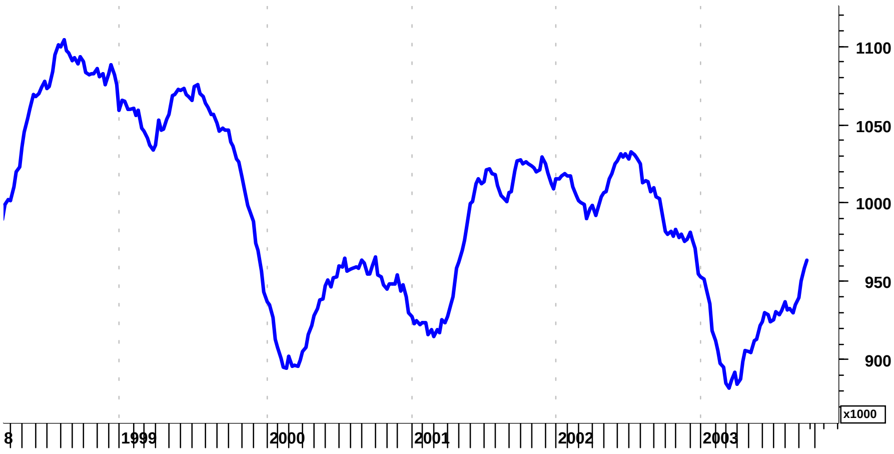


Source: CFTC

It should be noted that the chart covers only positions held until Sept. 30th when crude prices stood at $29.20. It is therefore expected that the $1.5 move that followed has substantially shrunk the funds net short position.

Market fundamentals, a very fragile geopolitical environment and active intervention by OPEC have created a very complicated situation. It is characteristic that the recent rally occurred against a very strong rebound in US as well as world inventories. Oil producers were alarmed by this development, but five weeks of continuous inventory builds failed to dampen the bullish sentiment and prices rose despite them.

Figure 4. Commercial US petroleum inventories (millions of barrels)



Source: EIA

The US inventory situation looks even more improved if one adds the fact that the Strategic Petroleum Reserve is now 35.6 million barrels higher than during the same period last year.

It is clear that the situation we are faced with is one in which supply temporarily surpasses demand, while at the same time no serious obstacles to supplies is in play. OPEC's action, which will become effective by November 1st, as well as uncertainty in Nigeria and Venezuela, whilst Iraqi exports are well below pre-war levels leads to a relative premium in prices. Since arguments supporting both directions in prices are all valid and uncertainty regarding most major geopolitical issues is on the rise it is very likely to continue experiencing violent price fluctuation within the wider $25-$32 range. The range may seem rather wide for day-trading purposes, but it nevertheless marks the levels at which powerful forces are ready to act. OPEC's output reduction and Bush's quick response make our point a rather obvious one.

In the meantime one could try to predict how severe the winter is going to be. For those who think the Weather Service is not accurate enough let us suggest the Farmer's Almanac.