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BI-WEEKLY OIL REPORT

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"All I know is that I know nothing" stated the Greek philosopher Socrates and nothing could better describe the situation we are facing in the oil markets today. While at a first glance many questions can easily be answered, a more thorough look makes it clear that getting the right answers is an impossible task. Almost everybody thinks that a war will take place in Iraq soon, but no one can easily predict the time, the duration and the effects of the attack. Everybody agrees that the general strike in Venezuela will eventually end and that oil operations will be restored, but it is not possible to predict neither the duration of the strike nor the events that will follow. It is very hard to estimate OPEC's output after their last decision, and it is as hard to gauge the effect of all the above to US and world inventories and if the governments will react by releasing oil from their strategic reserves.

If all the above sound confusing then one can only take a look at recent price fluctuations to get even more confused. Extreme volatility and continuous price reversals were observed on a daily basis, making it almost impossible to predict direction.

Figure 1. NYMEX WTI futures prices.

Source: NYMEX

Most of the forces that led to a price rally since the beginning of December are still in play and none of the outstanding issues are yet resolved. We had noted on the 26th of November that the events that were to take place at the beginning of December (Venezuelan General Strike, OPEC output decision, Iraqi weapons declaration) would define price direction for the coming months and we were proved right, to the dismay of all the oil consumers. The only change to the short-term bullish price environment came from the extraordinary OPEC meeting, held on January 12th. OPEC, watching prices reaching a 2-year high and the OPEC basket price stubbornly remaining above $28 for almost 20 days, decided to raise output quotas by 1.5 million. This decision follows last month's decision to raise production by another 1.3 million barrels per day.

Figure 2. OPEC capacity and latest quotas (million barrels per day).

	Capacity	Quota	Idle Capacity
S. Arabia	10.500	7.963	2.537
Iran	3.800	3.597	0.203
Venez.	3.000	2.820	0.180
UAE	2.650	2.138	0.512
Nigeria	2.300	2.017	0.283
Kuwait	2.000	1.965	0.035
Libya	1.580	1.312	0.268
Indon.	1.150	1.270	(0.120)
Algeria	1.050	0.783	0.267
Qatar	0.850	0.635	0.215
OPEC-10	**28.880**	**24.500**	**4.380**
Iraq	2.800	2.300	0.500
Total	**31.680**	**26.800**	**4.880**

However as nothing seems to be simple those days, this output hike needs some further analysis before its effects can become clear. OPEC decision to raise its output quotas did not come as a result of higher demand, but rather as an effort to replace Venezuela's reduced exports. As Saudi oil minister Naimi clearly stated, their aim was not to raise their output ceiling. In that sense it is absolutely incomprehensible why they raised the Venezuelan quota as well, by 170,000 bpd to 2.819 million, at a time when Venezuela produces well below 1 million. What this does in essence, apart from offering support to Chavez's regime, is that it brings the effective quota rise to 1.360 million barrels per day.

One however could go beyond the numbers announced and look at this latest decision as a return to the situation before December, when above quota production was tolerated. In other words it could be seen as a green light to its members to fill in the supply gaps as well as they can. Under this context many expect to see S. Arabia using part of its idle capacity, which now stands at around 2.5 million barrels per day, to make up for the lost Venezuelan barrels and reaching production levels close to 9 million bpd.

OPEC's additional barrels will be welcome in a market that is already facing some supply bottlenecks, and is also very weary about future disturbances. As a result prices are not expected to immediately fall after the cartel's decision. The situation will start getting more complicated if Venezuela restores its production capabilities soon. OPEC has scheduled another meeting on March 11th and it is likely that overproduction will not immediately stop. In such a case the possibility of a swift price retracement is very high and expectations could easily shift from those of supply deficits to a supply glut. OPEC President Al-Attiyah reacted to such notions by stating that if such a development becomes likely "… we will create a Noah's ship and we will come to Vienna and we will take the decision, the right one, to avoid the flood".

How close are we to a resolution in the Venezuelan crisis is still unclear. The opposition has declared a non-binding referendum for February 2nd and it is most likely that both sides will not give in until then. It is understandable that after 1 ½ month striking workers are under great pressure to return to their daily routines, but a high majority in the referendum will provide new fuel to their efforts. On the other hand, if President Chavez achieves to restore a significant part of oil production he could deal a major blow to the opposition. His efforts up to now however, had limited success and his policy of laying off PDVSA workers and refusing to enter negotiations with the opposition has infuriated them and did not allow the moderates to prevail. The general strike now poses a major threat to the country's economy, as the domestic currency came under heavy pressure and fears exist that the government will have difficulties servicing its foreign debt.

While it is clear that this is a situation that cannot go on indefinitely it is very hard to predict its outcome. We would note however that developments could accelerate extremely fast, as had happened during last April's coup d'etat.

In such an uncertain environment, where quantitative models offer little insight and where the speed of events can beat traditional analytical tools, even the most sophisticated analyst can find comfort in Socrates words and admit that (at least for the moment) …all he knows is he knows nothing.