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BI-WEEKLY OIL REPORT

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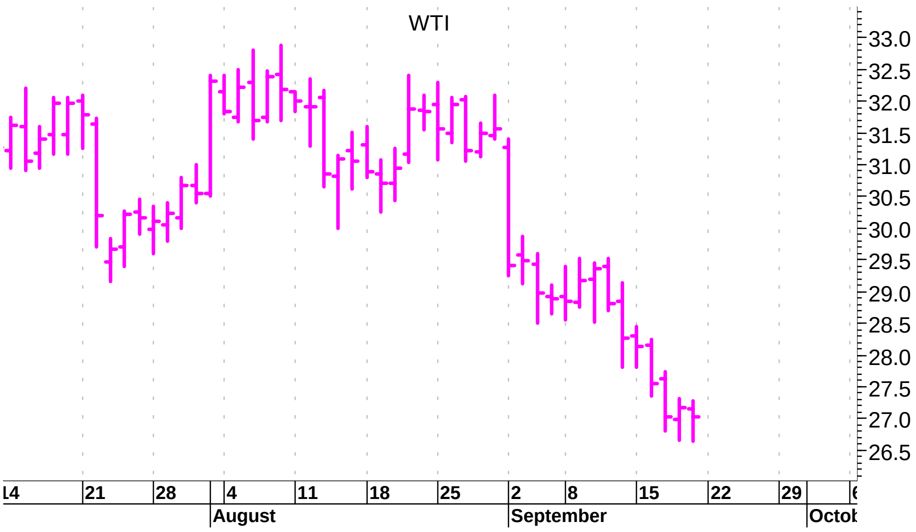
Drowning in oil?

Although no one had made such claims (quite the contrary), crude oil price action since the beginning of September seems to imply such a situation. It is not the price level that we are observing, but the speed with which prices fell, after remaining stubbornly high throughout the summer, that led to the above somewhat ironic, headline.

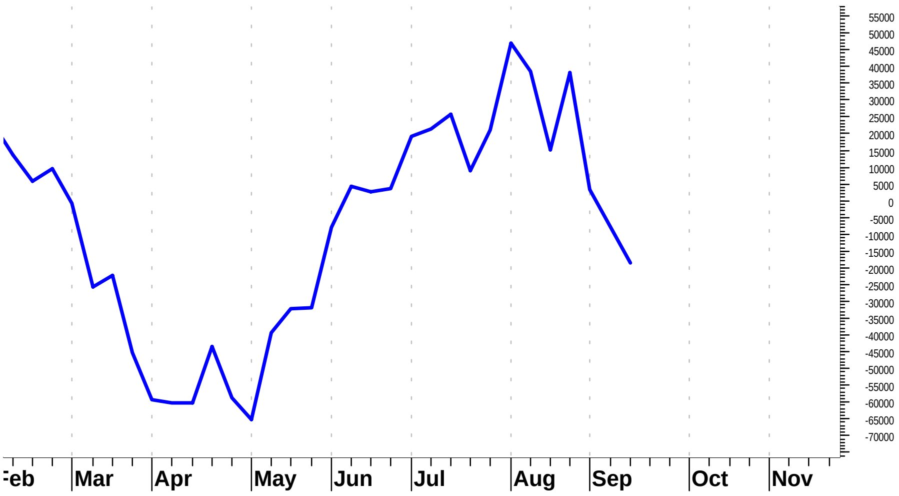
Figure 1. NYMEX crude oil futures ($/barrel)



Source: NYMEX

As figure 1 shows WTI futures prices have dropped from $31.57 on Aug. 29th to $26.88 on Sep. 19th. Product prices followed similar paths making September a distinctively weaker month than its previous ones. September average WTI price is now at $28.65 compared to $31.60 in August. The culprits of this major move were once again speculative funds, which had a net long position of 38,168 futures contract on Aug. 29th and had turned it to a net short position of 18,342 contracts by Sept. 9th,while prices were still at $29.18. It is therefore expected that the actual short fund position may be much higher at current price levels.

Figure 2. Non-commercial + non reportable crude oil futures position

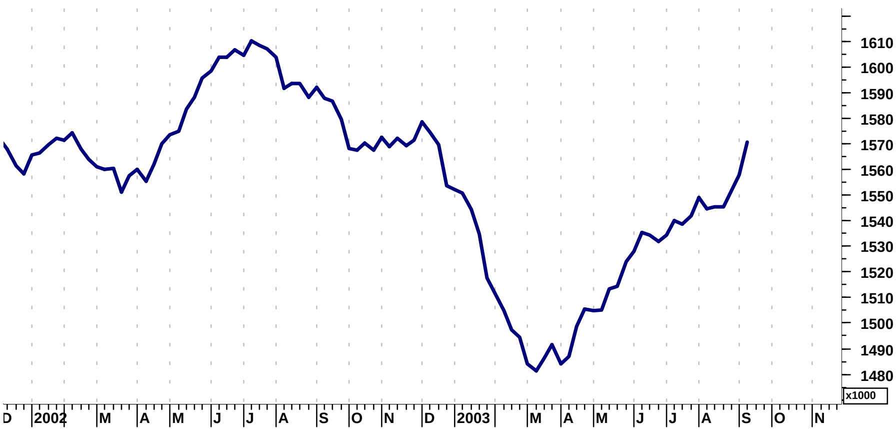


Source: CFTC

What has led, therefore, to this fund reversal? There were no major developments during September, apart from the fact that violence is continuing in the Middle East, hurricane Isabel forced even President Bush to evacuate the White House and the Venezuelan electoral panel rejected the votes collected by the opposition calling for a referendum to oust President Chavez.

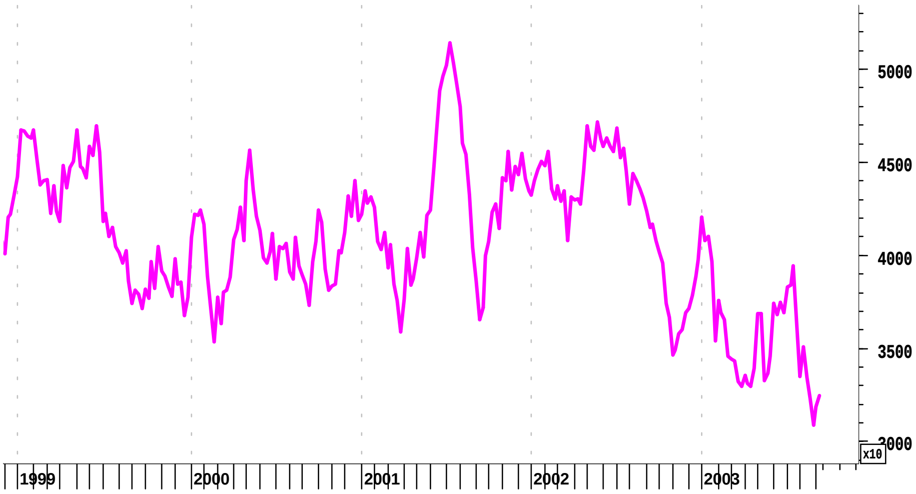
It seems however that none of the above led to a decisive move in oil prices. Traders' positioning seems to be reflecting their views that demand in September will be substantially lower and that the end of the driving season will render the complex's most volatile component (gasoline) as irrelevant. At the same time crude's recent price movement seems to be reflecting the rise in US inventories, which had risen by 15.4 million barrel during the first half of September and if one adds the SPR stocks, the rise reached 18.7 million barrels. The rise was most spectacular in distillates and heating oil, which have now reached comfortable levels, while on the contrary RFG stock levels remain close to their historical lows.

Figure 3. Total US petroleum stocks incl. SPR (x1000 barrels)



Source: EIA

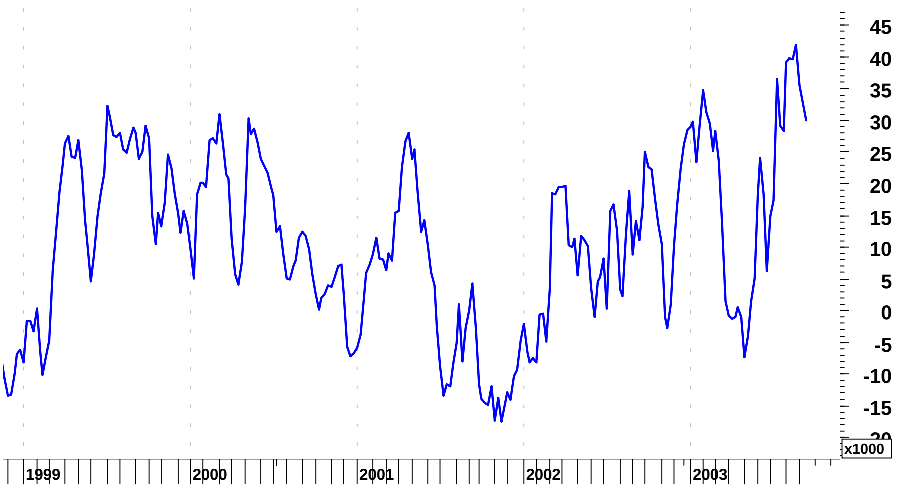
Figure 4. Reformulated Gasoline (RFG) inventories (x10000 barrels)



Source: EIA

The fact that gasoline prices have retreated substantially despite the continuous tightness in RFG stocks, and despite the fact that refineries in the East Coast were threatened by Hurricane Isabel, is a clear sign that again funds which as we discussed in our previous report held a significantly high long position, are now unwinding their length expecting the seasonal drop in demand with the arrival of winter.

Figure 5. Non-commercial + non reportable gasoline futures position (x1000 contracts)



Source: CFTC

The weakness in the energy markets during September now puts the spotlight on OPEC. The organization is going to meet on Sept. 24th to discuss output quotas. Most of the member countries have expressed the opinion that output should remain stable, until a clearer picture is drawn regarding Iraqi production. The fact, however, that prices have dropped so fast could cause calls for even tighter production. It is unlikely that a decision to restrict output will be taken, but the beginning of such discussions ahead of the winter could support the market.

No significant developments have come out of Iraq, other that the violence and sabotage actions continue undeterred and that production from the north fields of Kirkuk will not reach the markets soon. What is the most likely scenario is that Iraqi production will continue to rise slowly and at a much slower pace than initially expected.

Other than that, oil supplies seem to be quite stable for the time being, especially as the procedures regarding the Venezuelan referendum have been postponed and Nigeria is facing no disruptions in oil operations. This could mean that, whereas supply/demand fundamentals will define price directions, no significant premiums are expected to be added into prices. We would think, nevertheless, that no further significant price drop is justified. Pushing prices towards $25 basis WTI could trigger a fierce response by OPEC as well as bargain hunting buying. Given current conditions crude oil's recent sell-off may be nearing its end, since historically low inventories and sensitive supply/demand balances show that … we are not drowning in oil.

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