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BI-WEEKLY OIL REPORT

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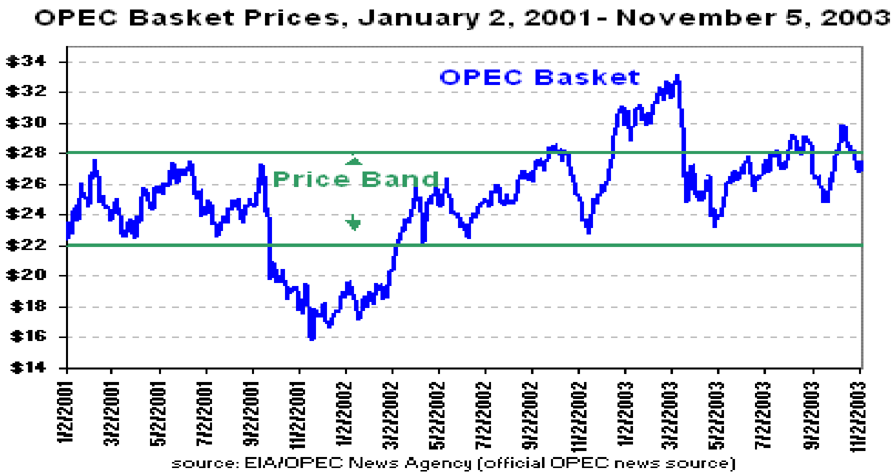
"A hard rain a gonna fall"

Bob Dylan's song could provide some idea of the future of oil prices. OPEC members coming out of their informal meeting today announced their decision on output. It is to be kept unchanged until the organization's next meeting on early February. This in essence implies steady supplies until the beginning of March and just ahead of the dreaded second quarter of 2004.

Almost all members have agreed that it will be necessary for them to cut output during their next meeting, but they were unable to decide so yesterday, as current high prices, quota-busting and differing views would have undermined any decision and damage the organization's credibility. Saudi Arabian Minister Naimi tried to downplay the effects of higher prices, noting that it was the weakening of the dollar that led oil prices to current levels and not tight supplies. He noted that oil is fairly priced for most of the consumers and that OPEC should definitely reduce output ahead of Q2. We have analyzed the effects of the US$ drop well before the issue was brought up, but we would note that what Minister Naimi meant was not that the price at $31 is fair, but rather expressed his concerns that OPEC revenue needs to be protected.

The question therefore lies on if and how can OPEC achieve this objective. It is a fact that since 1998 OPEC has been quite successful in keeping prices within its $22-$28 preferred range (basis OPEC basket prices).



Trying, however, to achieve this, OPEC has managed to relinquish market share to non-OPEC producers, who are much more reluctant to reduce output and will do so only under extreme circumstances. Non-OPEC countries have taken advantage of the higher price environment and made the necessary investments to increase their output capabilities. In addition price levels of the past few years have made the operation of many idle oil fields commercially viable. It should therefore be of no surprise that no non-OPEC country showed any desire to cooperate with OPEC on setting up an output strategy during this latest meeting. The cancellation of a well-advertised meeting last month between S. Arabia Venezuela and Mexico clearly illustrates our point.

If, therefore, OPEC's target is to keep oil revenues high by unilaterally cutting output, they may be able to do so only for a limited time, while at the same time relinquishing market share and allowing non-OPEC countries to reap the most profits out of this effort.

It is already obvious that such a strategy is not widely accepted even among its members. Countries like Nigeria, Algeria and Libya, who have increased capacity through investment during the recent years, now seem to envy Russia who can export maximum quantities at favorable prices. Venezuela on the other hand, which has problems raising production, is one of the main proponents of output restriction. OPEC will then soon have to agree on whether they are willing to act alone or whether they will try to force non-OPEC producers to participate.

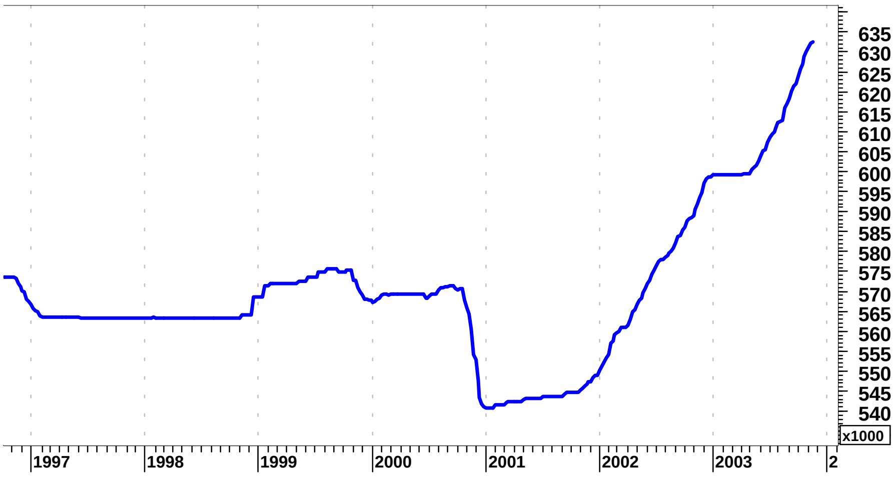
Current quota busting shows that its own members will most likely undermine the former, while the latter will take substantially lower prices before other producers are convinced, as such was the case on December 2001.

Summarizing, if no decision is taken the 2 million bpd drop in demand during Q2 will lead to a price collapse; a unilateral move will most likely have limited effects; while combined producer action will not take place unless prices drop from current levels.

All the above clearly point to lower prices and make Naimi's dollar weakness analysis look more like wishful thinking than anything else.

Naimi could have used another reasoning for higher prices, but neither he nor most analysts are willing to discuss openly. Since November 2001 when US President Bush announced his plan to fill the Strategic Petroleum Reserve 87.8 million barrels have been added. In 2003 alone, 33.8 million barrels were added to the SPR. Removing more than 100,000 bpd out of the US market has created underlying support for prices, as the government was crowding out commercial US players in their quest for supplies. The Strategic Petroleum Reserve can store 700 million barrels of oil meaning that another 67.4 million will need to be added.

SPR inventories in million barrels



Source EIA

The effects of this inventory re-inflation effort have not been adequately gauged by analysts up to now and, as mentioned before, drew very few reactions by producers. The tag-of-war between oil producers and consumers, or to make it more specific between OPEC and IEA (which controls OECD strategic reserves) is very rarely discussed, as it is extremely politically sensitive. IEA has more or less held a hands-off approach towards the market, threatening intervention only when serious supply problems exist, while OPEC tries hard to show its willingness to secure steady supply at "fair" prices. It is, nevertheless, obvious that one of OPEC's most important reasons for willing to keep prices high is to avoid the rise in global petroleum stocks. Such a development could significantly limit the organization's power to control prices through reduction of output. It is very hard for OPEC to react to US's efforts, but they will certainly become more active if a more widespread effort to raise strategic inventories starts taking place worldwide.

OPEC is therefore caught in a very serious dilemma. Allowing prices to fall could mean loss of power over consumers, whereas unilaterally keeping prices high would cause loss of power over other producers.

The only possible way out of this deadlock, other than concentrated OPEC and non-OPEC effort, would be a significant supply shock. This is exactly what happened during the last years when Iraqi output was substantially reduced. The fact that OPEC made up for the missing Iraqi barrels allowed the postponement of making decisions on the above mentioned issues. While possible supply shocks cannot be excluded (Venezuela and Nigeria being the first places to look at) it is very unlikely that they will be as large and as long lasting as the Iraqi one. This means that the issues will have to be resolved, one way or the other, during the months to come and it seems that the low Q2 demand will provide the catalyst, setting the tune along Bob Dylan's lyrics.

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