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BI-WEEKLY OIL REPORT

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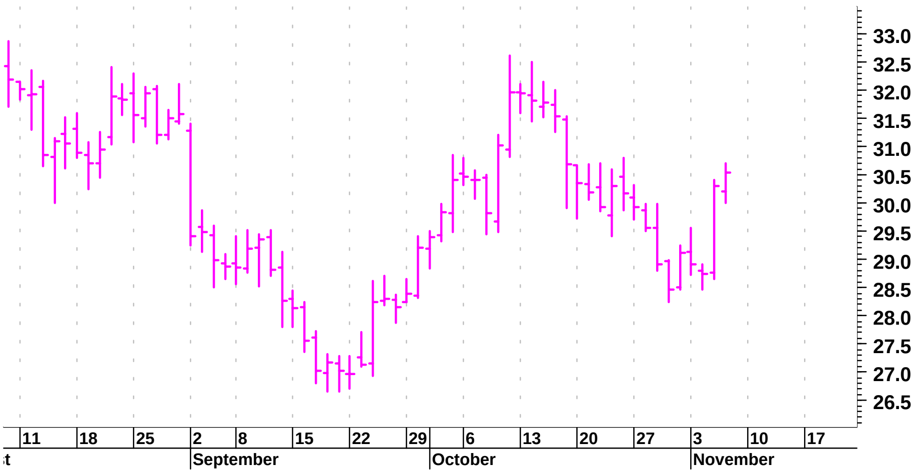
The Quest of Price Direction.

"OPEC will most likely wait until their Dec. 4th meeting before deciding what to do with output, but it seems that they will more than welcome a drop of $1-$2 until then. If no major supply shock takes place in the meantime it seems that oil markets will likely do them the favor." This is what we were writing in our previous report and this is what more or less happened soon afterwards, but as always markets also provided a strange twist to the development.

Markets did OPEC a favor dropping $1.5 since our last report and sending OPEC basket prices well below the $28 upper range limit. This, however, lasted only four days. In a spectacular demonstration of how volatile markets are, prices erased all previous days' losses in a single session and on the back of a slightly bullish US inventory report.

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



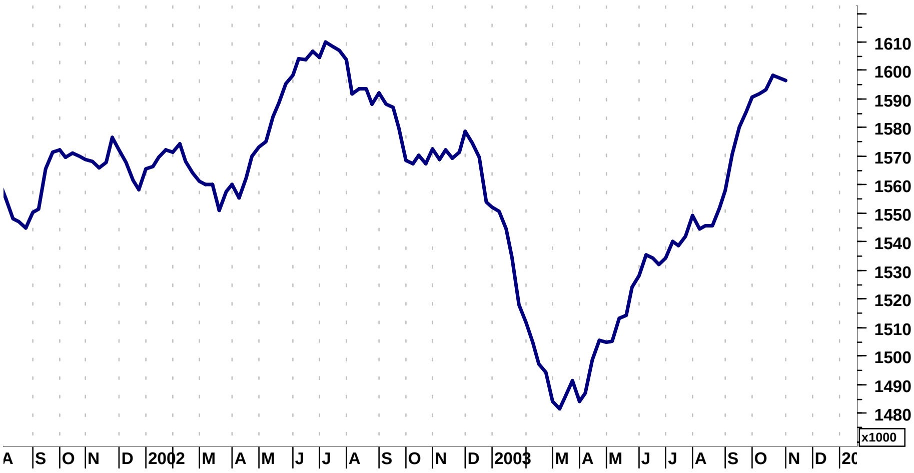
Source: NYMEX

The news did not justify such an intra-day move and its occurrence is more a result of price uncertainty, rather than a clear bullish sentiment.

The EIA report that sparked the rally was not extremely bullish and has only caused a very small dent to the steady rise of US petroleum inventories, which have added 44.6 million barrels since the beginning of September and 115.1 million barrels since March 14, 2003. Crude oil and product stocks are mostly within their recent average ranges and do not cause major concerns regarding product availability during the winter. The latest 1.7 million barrel drop cannot alter this picture, unless it is perceived as the beginning of a new trend.

In order to answer this last question we should take a look at the latest developments that could affect demand/supply balances. One of the major issues under consideration is the return of Iraqi crude to the markets. The time that elapsed between this and our previous report was characterized by a rise in attacks against US and other foreign targets in Iraq. The highlight was the downing of a US helicopter which led to the death of 15 troops, but the list also includes the bombing of Red Cross headquarters, the attack with mortars on Al-Rashid Hotel threatening the life of the US Deputy Defense Secretary Wolfowitz and the continuous attacks on US patrols and oil facilities. While this is neither surprising nor implies the withdrawal of the US army, it indicates nevertheless that the full recovery of oil exports may take longer than expected, since it will face many snags before it is stabilized at substantially higher numbers.

Figure 2. Total US petroleum inventories incl. SPR (thousand bbls)



Source: EIA

Another bullish development is that the new reduced OPEC quotas are now in effect and the statements of top OPEC officials indicate that its members will adhere to them. The recent drop of OPEC basket price below the $28 threshold will make the implementation of the plan even easier. Had the prices not dropped, even for those four days, OPEC would by now have had to automatically reduce quotas as the upper band limit would have been violated for 20 consecutive days. Given current conditions the cuts can be implemented, at least until the next OPEC meeting.
This is only part of the story, however. Only a few days ago Russian Energy Minister Yusufov commented that current oil prices were unfairly

high! Signaling Russia's reluctance to proceed to any output restrictions. Mexico's Energy Minister followed suit the next day noting that current high prices could hinder global economic recovery.
These comments are setting the stage for another confrontation between OPEC and non-OPEC countries as the Dec. 4th OPEC meeting approaches. It is clear that OPEC is frustrated as it is reducing output in order to control prices, while at the same time the other producers are maximizing theirs, benefiting from the high price environment. It is clear that the market share issue will dominate all coming discussions and it is also likely that covered or open threats of price war will start hitting the screens as we are approaching December 4th.

It is very difficult to gauge the outcome of such a confrontation and the latest similar example provided mixed results. On its December 2001 meeting, OPEC, facing much lower prices due to the Sep. 11th events, hinged its output reduction decision on the participation of non-OPEC producers, openly threatening a price war. The initial reluctance of Russia to agree led to a further price drop, but its later agreement to a small output reduction marked the start of a significant price up-trend. The fact, however, was that Russia never followed its pledge and the initially observed output reduction was a result of seasonal factors. The fact that prices continued to remain high was a result from the gradual escalation of the Iraqi crisis, the military coup in Venezuela etc. and not coordinated oil producers' action. It is therefore likely that if a similar issue is raised again, a simple pledge will not be enough. It is not even clear whether the Russians are willing to give such a pledge unless prices drop substantially.

To add more complexity to the issue come the deliberations for the Venezuelan recall referendum. The drive for the gathering of signatures requesting the removal of President Chavez will take place between Nov 28th and Dec 1st, creating fears of turmoil in this oil-producing country right before the OPEC meeting.

Given the above mentioned conditions it seems that depending on OPEC member compliance, November will be a month during which the recent supply surpluses will be reduced. The extent of the reduction will also hinge on winter conditions, which up to now have been mild in the US and colder than normal in Europe. It is nevertheless clear that we will not observe a major shift in supply/demand balances during this period. It is December and the decisions of OPEC and non-OPEC members that could shift the balances substantially towards either direction.

Based on the above conclusion and the numerous uncertain factors that exist we believe that recent price action is more of a sign of increased volatility during the weeks ahead, rather than the beginning of a substantial up-trend. Market participants will be closely watching developments in order to get some sense of direction and their reaction to news could be very swift, leading to a rise in volatility and to significant price reversals like the ones observed recently.