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BI-WEEKLY OIL REPORT

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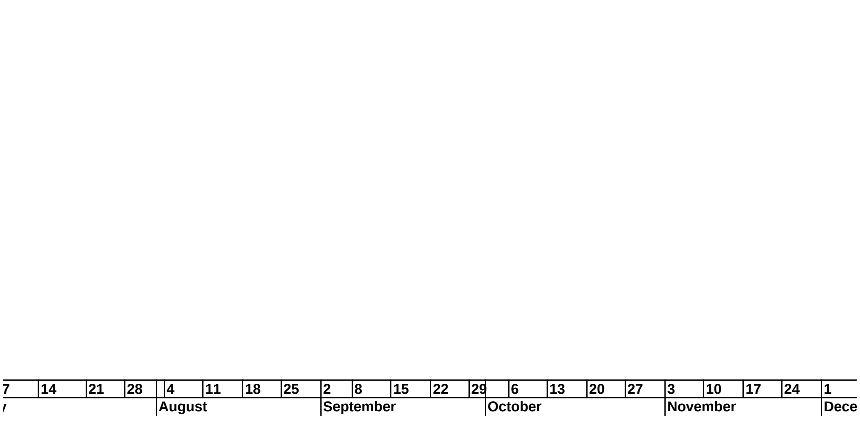
TNT+MTBE= Price explosion

As this report was being written news hit the screens about three bomb explosions in Istanbul that led to the deaths of at least 25 people and the injuring of several hundreds. This was not the first such incident taking place in Istanbul lately and it highlighted an extremely violent fortnight that led to a large number of deaths, linking in a deadly cycle cities such as Riyadh, Nasiryia and Istanbul (twice).

The first major bombing attack took place in Riyadh killing more than 20 people. The fact that the majority of the victims were Arabs, added a new element to previous attacks. Up until now targets outside Iraq were linked to US and other western interests. The Riyadh attack as well as the following attacks in Istanbul added a new element in our efforts to analyze the situation. Targets now include not only foreigners and foreign interests, but also locals who cooperate with them or even simply tolerate them. This new effort to "discipline" fellow Muslims and their governments poses new challenges to an already fragile world.

Crude oil prices have risen $5.3 since October 30 to as high as $33.55. The significant premiums incorporated into current prices, at a time when supply / demand fundamentals are more or less balanced and inventories remain healthy are a direct result of geopolitical uncertainty.

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



Source: NYMEX

Terrorist actions in major European and US cities do not justify higher prices, as their effects are detrimental to petroleum demand. Reduced traveling and tourism, slower economic growth, restrictions to trade are the main characteristics of such events, as experienced after Sept. 11th,2003. The equation however changes dramatically when attacks affect oil-producing countries and mainly S. Arabia, the cornerstone of OPEC and one of the most stable suppliers to the US. The situation becomes even more complicated when terrorist attacks kill “friends” and “foes” alike, as was experienced in Istanbul. This makes it extremely difficult to gauge both the size of the threat posed, as well as any possible pattern of action.

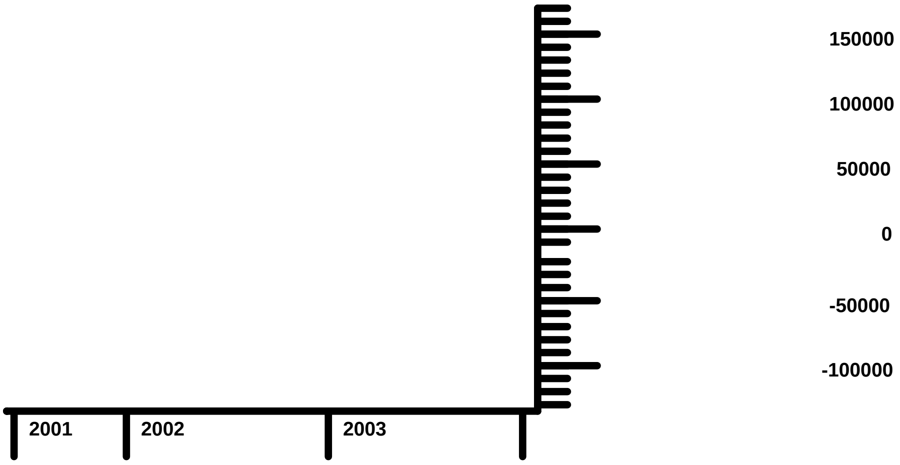
Is therefore the recent $5 premium justified and sustainable? We would argue that based on current fundamentals the recent premium is rather high. On the other hand, if one concludes that there is a serious threat to the S. Arabian regime then the recent premium may be very small. Markets have never in the recent years tried to discount Saudi supply disruptions in their price estimates. This is an issue that could definitely send oil prices to a much higher range than we have recently experienced.

Our feeling, nevertheless, is that it is still too early to consider adding a Saudi premium in oil prices. There are no signs that the regime is losing control, neither have supplies in the country been threatened. Unless spectacular events take place soon, the Riyadh bombing incident will stop adding a premium to prices.

This assumption brings us therefore in a situation where a number of bearish parameters could affect prices during the days to come. If the terrorism threat eases, then current premiums will be reduced. If terrorism rises and starts affecting economic growth then instead of a premium prices will move to discounts, as demand will start to wane. It is a lose-lose situation for prices. Current price environment also makes it extremely hard for OPEC to reduce output further, in order to avoid a supply glut when Q2 arrives and also raises the incentive for quota busting among its members. Continuing supply surpluses, amid high prices, raise the risks for a sudden and significant price correction.

The possibility of such a move becomes even higher if one observes recent speculative funds positioning. We have noted in recent reports that their activity has risen substantially leading to frequent price reversals and adding substantially to volatility. Today’s CFTC report, released after the close of the markets, will most likely show a significant rise in total long positions as of November 18th. A total long speculative position of almost 100,000 contracts is expected, which will demonstrate how powerful a long liquidation could be.

Figure 2. Total NYMEX futures net positions of non-commercial and non-reportable traders (in thousand contracts)



Source: CFTC

The above chart shows spec positions as of 11/11. Prices between then and 18/11 have risen by $2.20 and total open interest in crude oil, heating oil and gasoline futures rose by 82,862 contracts. Since speculative funds usually lead such price movements it would be safe to assume that most of the 82,862 long positions established were theirs. Estimates therefore that the CFTC report will show a total spec position of around 100,000 contracts should not be far from true.

A parameter, which also added to the recent volatility and we had not had a chance to discuss thoroughly, is the ban of the gasoline additive methyl tertiary butyl ether (MTBE) in certain states of the US by Jan. 1st. MTBE, an additive used, to improve US reformulated gasoline (RFG) air emissions and engine performance, has been blamed by recent studies for underground water contamination. As a result the states of New York and Connecticut have decided to ban the additive and replace it with ethanol as of January 1st. US gasoline specifications have frequently been the reason for supply bottlenecks that have led to significant price spikes.

The replacement of MTBE with ethanol, poses some technical challenges that will need to be addressed, especially in regards to the summer grade RFG and will also reduce refinery flexibility to move from one blend to another, as it requires a completely separate blending process. The shift also creates concerns regarding foreign refineries' willingness to invest funds in order to transform their processes in accordance with the new specifications. This could lead to reduced foreign available capacity to cover any potential US domestic supply shortfalls.

The uncertainty created by this shift in gasoline standards has been one of the latent factors supporting petroleum prices recently. It is not clear how smooth the transition will be as we enter the new-year, but it will probably add a premium in gasoline prices until summer. The extend of the possible supply bottlenecks will define whether this premium will spillover to the rest of the petroleum complex during the months to come.

For the time being, however, gasoline additives and TNT have created a very explosive global cocktail. The coming weeks with the Venezuelan petition drive and the OPEC meeting looming will offer more clear signs regarding price direction in a market where explosions do not always have the same effects.