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MONTHLY OIL REPORT

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April Fools Day!

April 1st is a day dedicated to jokes. One cannot help but wonder whether the OPEC decision to reduce quotas by 1 million bpd effective April 1st was another one of those jokes that people do that day. The leading actors of April 1st OPEC decision painted an almost surrealistic picture that was a pleasure to observe from a distance! Saudi Oil Minister Naimi was trying to persuade markets that he supported an OPEC basket price of $25 while at the same time lead OPEC to an output cut despite the fact that OPEC basket already stood at $31.49. On the other side, US President Bush tried to persuade OPEC to raise output, while himself refused to stop refilling the Strategic Petroleum Reserve that has added more than 50 million barrels the past 12 months on partial expense of the US commercial market.

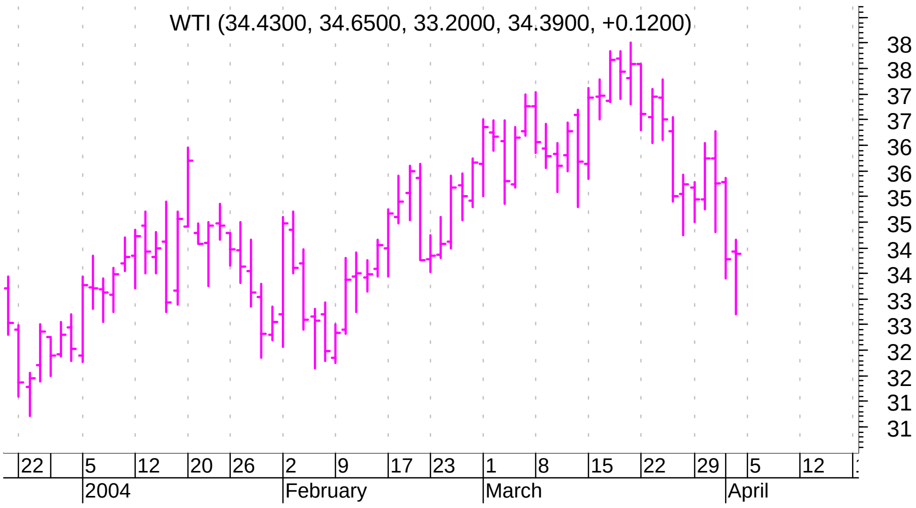
Supporting actors did a great job too as OPEC official reminded that the OPEC Price Band is the targeted price range for OPEC prices when prices have been above the maximum range of $28 of the Price Band since December 5th 2003!! The final scene of the act right after the announcement of the output cut deserved a special prize since while Saudi officials tried to convince the markets they were not the “bad guys” one of the OPEC delegates when asked if he was concerned by future US reaction, allegedly replied “…wah, wah, wah” implying the US administration was a cry-baby!

The days that followed helped sort out the situation a little, although not in full. Firstly US reaction did not go unnoticed. US Administration, faced with record high domestic gasoline prices, used very sharp words to express their disappointment to the organization’s decision. President Bush immediately stated his discontent, US Treasury Secretary Snow called the decision extremely unwelcome and unfortunate, while at the same time threatened WTO action against them. A number of senators demanded action against the “foreign cartel that wants to undermine US economy”. The reactions were directly targeting Saudi Arabia who was seen as the driving force behind OPEC’s decision. As a result Saudi Ambassador in the

US was quick to meet with US officials and assured them that the Kingdom will provide adequate supplies to the market. Saudi Oil Minister Naimi is currently touring Asia in order to assure China and Japan that he is committed to keeping petroleum prices fair.

The result of all this fuss can be seen on the chart below:

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



Source: NYMEX

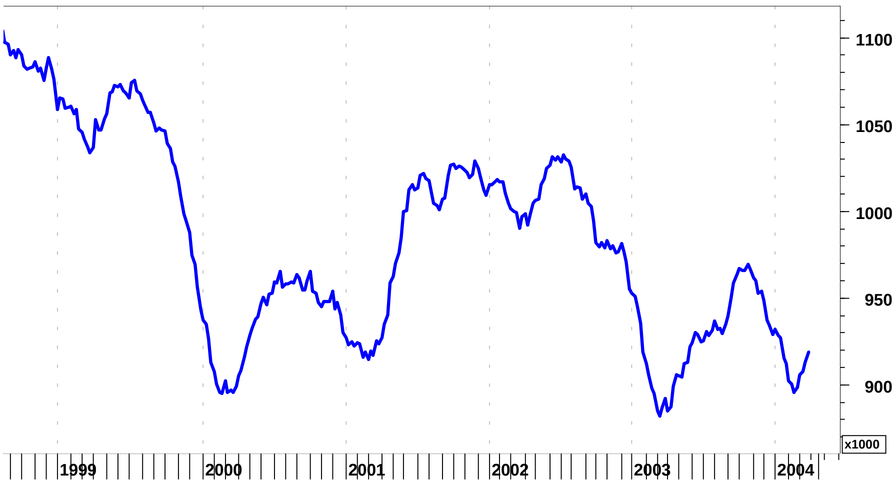
Prices had started retreating after reaching a high of $38.50 on March 19th. They rebounded on the day of the meeting, reaching a high of $36.77, only to retreat once again and reach a low of $33.20 on April 2nd. So…was Saudi Oil Minister Naimi right in his comments that despite cutting output further, prices would still drop?

In a sense he was right, because he was implying that demand would weaken much more than the decided cut. OPEC, according to the latest surveys, has produced an average of 28.4 million barrels per day during March well above February levels despite pledges by OPEC that overproduction would be reduced. OPEC-10 output (excluding Iraq) stood at 26.04 million, 1.5 million barrels above the official quota of 24.5 million.

IEA puts Q2 call-on-OPEC (the quantity OPEC needs to produce in order to balance the markets) to 23.9 million. This is a staggering 4.5 million barrels per day below current production. Minister Naimi fears that unless OPEC reduces output significantly, this 4.5 million bpd surplus could lead to a major price collapse that will be very hard to reverse. Himself and other OPEC members believe that even a 1 million bpd cut will not be enough to control the size of the price fall, especially if it is combined with fund position unwinding.

To support his arguments came data from the Energy Information Agency (EIA) that showed a steady rise in US inventories during the past weeks. From February 20th to March 26th commercial US petroleum inventories rose by 23 million barrels to 918.9 million amid strong imports and a drop in demand. Extrapolating this situation in the second quarter would lead to the conclusion that inventories in the US could reach comfortable levels that would ease concerns regarding tight supplies.

Figure 2. US Commercial Inventories (million barrels)



Source: EIA

Against the above arguments come concerns that current demand forecasts estimate gravely underestimate Asian demand growth. It is very hard to gauge how strong Chinese petroleum use will be, as it is also hard to estimate how strong the economic recovery in the whole region will prove. Early signs are showing that the strong pace experienced last year will likely continue or even accelerate further.

In the US, demand is also setting a strong pace, with gasoline leading the pack. Record gasoline demand for the first months of the year coupled with the implementation of the new MTBE restrictions contributed to record high retail prices, which in turn created major reactions among US consumers and caused jitters to the Bush Administration. One should not ignore the fact that this is an election year and thus consumer reactions will not be taken lightly. Despite verbal reactions, however, it is very hard to gauge the effects neither of the new specifications, nor of the rising demand.

To make the situation even more complicated come signs of widespread insurgency in Iraq. The effort to arrest a leading Shiite cleric has led to fierce classes between US troops and Shiite militias that has led to many deaths both among Iraqis as well as US Forces. The fact that US troops have now two different open fronts, one against the Sunni loyalists to Saddam as well as Shiites, is a sign of the growing alienation of Americans in Iraq. The effort to be seen as liberators who freed the country from a tyrant, has hit a major obstacle of internal Iraqi politics, which the US cannot either fully comprehend or control. This leads to the conclusion that instability could persist more than initially expected and that the time needed for the transition of power to an Iraqi government could be prolonged.

On the other hand, as far as oil production from Iraq is concerned, the situation is improving steadily. The northern Kirkuk-Ceyhan pipeline is in operation, as is the second southern terminal of Khor Al-Amaya. This has led Iraqi output to 2.4 million bpd, reaching pre-war levels.

If US forces manage to insulate oil production and transport from political instability, oil prices might become indifferent to violent clashes in the region. The situation in Algeria is a good example of such conditions. If, however, this does not prove possible then the longer the unrest lasts the more serious the effects on oil supply may be. Insulating the oil industry could be a very difficult task, as it is not concentrated in one remote region and pipelines cover distances of hundreds of kilometers that cannot be fully guarded. While many uncertainties exist, at the current point in time, we believe that a couple of predictions could be made:

Firstly, we would expect that despite high demand and OPEC statements the expected supply/demand surplus for the second quarter will prove big enough to help overall inventory build-ups during the weeks to come.

Secondly, we would expect OPEC and specifically S.Arabia to refrain from aggressively implementing the announced cuts, unless prices drop significantly. The anger that current high prices have created within consumers cannot be taken lightly, especially as they are putting great pressure on the incumbent US government ahead of coming elections.

Price direction will hinge on the result of the tag-of-war between coming supply/demand surpluses and uncertainty risk premiums. If geopolitical conditions ease, fund unwinding could lead prices significantly lower, whereas if tensions increase dramatically further price spikes cannot be excluded. April 1st OPEC decision hides a well-played joke, what remains to be seen is who bluffed better…