National Australia Bank

Oil Monthly – February 2007

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Summary – oil prices rebound from the lows, as the market tightens on OPEC cuts

- **Crude oil prices plunge in January:** oil prices fell sharply at the start of the new year, with fundamental and speculative factors weighing on markets. Prices briefly dipped below US$50 a barrel (in US trading) – the lowest level since May 2005.
- Speculative pressure on crude prices has waned in recent months – with net speculative positions switching to the short side. Uncertainty following speculative losses in natural gas markets may have discouraged investment.
- Crude prices fell too far, too fast and have subsequently consolidated in the mid-to-high US$50 range – possibly indicating the return of buyers into the market at relatively cheap prices.
- **OPEC cuts tighten the market balance…:** OPEC commenced the second part of its two stage production cut in February – reducing production under quota by 1.7 million barrels a day (see page 2).
- If OPEC can maintain production discipline, then the fundamentals of oil markets appear to be considerably tighter than in the period from 2004 to 2006.
- The International Energy Agency increased their forecast for oil consumption in February. Global consumption is forecast to increase by 1.8 per cent in 2007 to average 86.0 million barrels a day.
- **…but build spare production capacity:** Cuts to OPEC production has allowed spare production capacity to recover – to almost 3 million barrels a day. This increased coverage will weaken the risk premium embedded in prices – as there is greater cover in the event of a supply disruption (see page 3).
- **OPEC's enlargement could slow oil output growth:** In January, Angola – Africa's fastest growing oil producer – joined OPEC in what was the first enlargement of the cartel since 1975. The rapid growth in output in the west African nation since 2001 had raised hopes that Angola could be a key growth region for oil output. Membership of OPEC will instead impose restrictions on oil production and may limit opportunities for investment by major oil companies (see page 3).
- **Forecast oil prices revised down:** This month we are revising down our forecast for crude oil prices – reflecting the substantially weaker market conditions in the first quarter of the year. For the full year, WTI crude is forecast to average US$62 a barrel, a year on year decrease of 6.1 per cent (see page 2).
- **Product price forecasts lower in line with crude:** In line with our revised forecast for crude oil, refined product prices have also been revised lower. Australian capital city prices are forecast to average 117.3 cents a litre in 2007, while jet fuel is forecast to average US$609 a tonne (see pages 3 and 4).

Quarterly price summary

	Q4 06	Q1 07 f	Q2 07 f	Q3 07 f	Q4 07 f
Brent US$/bbl	60.06	55.91	58.99	63.50	61.74
WTI US$/bbl	60.07	57.26	61.50	65.50	63.75
Petrol Ac/L (a)	114.9	113.5	116.4	120.3	119.5
Jet fuel US$/t	602.3	566.9	599.4	641.8	630.8
US$/A$	0.77	0.78	0.76	0.75	0.75

Summary of revisions

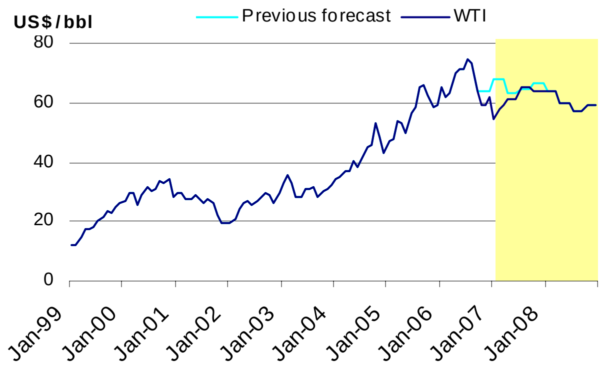
	2006	2007	Previous	2008	Previous
Brent US$/bbl	65.63	60.04	63.05	57.67	57.66
WTI US$/bbl	66.11	62.00	65.50	60.00	60.00
Petrol Ac/L (a)	124.7	117.4	122.1	117.3	118.8
Jet fuel US$/t	645.3	609.7	643.4	592.3	592.8

(a) – Weighted average capital cities, source: AAA, FuelTrac

Oil prices correct too far, too fast – consolidation now underway

In 2006, crude oil prices averaged US$66.11 a barrel (in West Texas Intermediate (WTI) terms), a year on year increase of 17 per cent. Oil market conditions echoed those of recent years, with supply disruptions, supply concerns and geopolitical tensions influencing price movements.

Crude prices slump, but persistent risk offers upside



Source: Datastream, NAB Group Economics

Crude oil prices plunged in January, briefly falling below US$50 a barrel on 18 January (in US trading) – the lowest level since May 2005. For the full month, WTI crude averaged US$54.78 a barrel, a decrease of 12 per cent from December. A range of fundamental and speculative factors contributed to the fall.

On the fundamental side, a below average Atlantic hurricane season (in terms of severity – contrary to forecasts across the year for an above average season) followed by a mild northern winter (at least through

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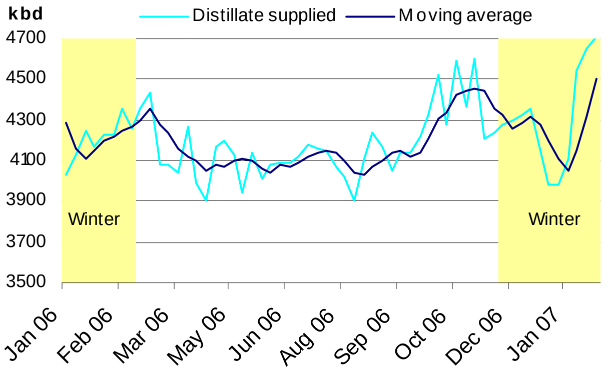
December) allowed both crude oil and refined product stocks to build well above expected levels. This reduced the risk of a physical shortfall in the event of a supply disruption – cutting into the risk premium embedded into prices.

Mild winter stalls US distillate demand – at least until January

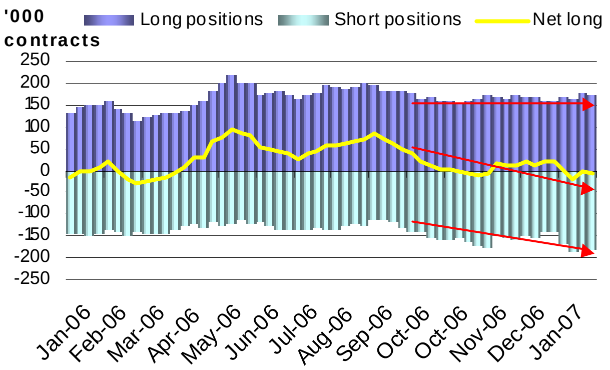


Source: EIA, NAB Group Economics

With the oil market under less pressure in early January, the flow of speculative money – as indicated by contracts on the New York Mercantile Exchange – changed direction. For the past five months, long non-commercial positions (commitments to buy oil) have remained relatively static, with growth on the short (selling) side of the market. As a result, the net position has decreased from around 94 000 contracts long to a modestly short position in late January.

The movement of fundamentals was exacerbated by the thin trading volume of the new year, hence crude prices plunged in the first three weeks of January as funds built short positions.

Speculative community builds short positions in the past six months



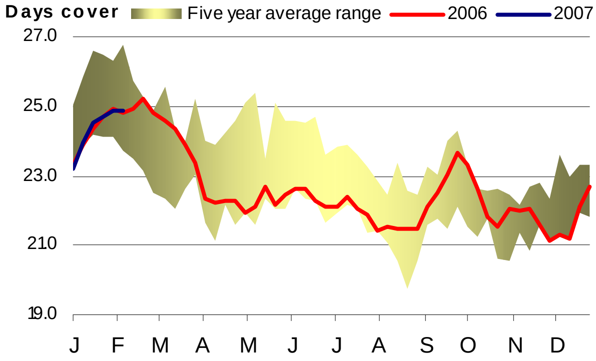
Source: CFTC, NAB Group Economics

However, the failure of prices to sustain levels below US$50 a barrel provided a significant psychological boost for global oil markets. Crude prices fell too far, too fast and have subsequently consolidated in the mid-to-high US$50 range – possibly indicating the return of buyers into the market at relatively cheap prices.

The global oil market is hardly free of risk at the start of the new year. There remain a number of potential political flashpoints, especially in key oil producing regions. The Middle East remains tense – with Iraq on the verge of civil war, Iran continuing to pursue uranium enrichment and an uneasy ceasefire between Israel and Lebanon. Any escalation of tensions in this region will pressure oil markets. Elsewhere, unrest in Nigeria, nationalisation in South America and Russia and another (threatened) above average Atlantic hurricane season is likely to add oil price volatility.

Winter weather in Europe and North America may influence crude oil over the next month, however market participants will increasingly be looking towards gasoline stocks for direction. In absolute terms, US gasoline stocks are higher (year on year) than in early 2006, however due to increased consumption, are approximately equivalent in terms of days of cover. As major refiners head into a period of maintenance, falling gasoline stocks could add some upside pressure.

US gasoline starts 2007 with déjà vu



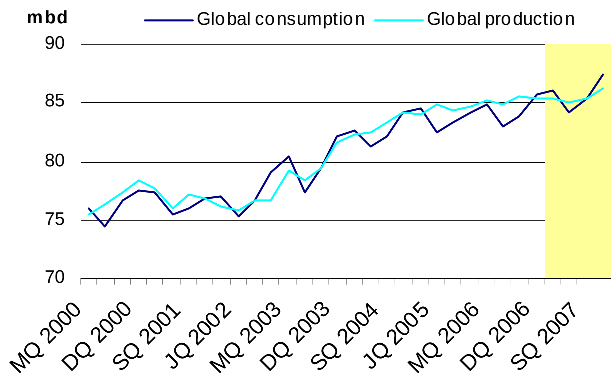
Source: EIA, NAB Group Economics

This month we are revising down our forecast for crude oil prices – reflecting the substantially weaker market conditions in the first quarter of the year. For the full year, WTI crude is forecast to average US$62 a barrel, a year on year decrease of 6.1 per cent.

The fundamentals – market balance tightens on OPEC cuts

In February, the International Energy Agency upgraded their forecast for global oil consumption in 2007 – with stronger growth tipped for China and nations bordering the Caspian Sea. In annual terms, global oil consumption is forecast to increase by 1.8 per cent to average 86.0 million barrels a day. In contrast, oil consumption increased by around 1.0 per cent in 2006 (IEA).

Crude market tightens – if OPEC maintains discipline



Source: IEA, NAB Group Economics

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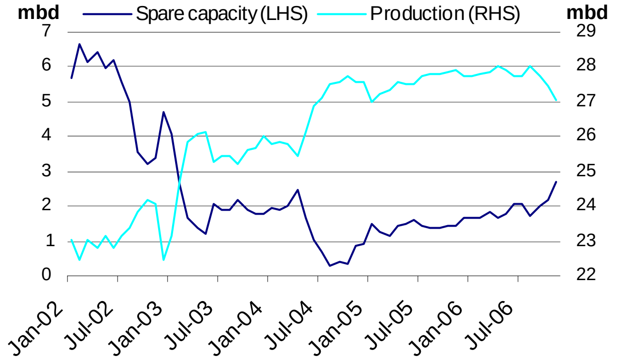
The IEA have also revised the growth in non-OPEC production lower – reflecting delays in development in North America. The recent move of Angola to join OPEC (discussed below) increases the degree of control over markets enjoyed by the cartel. If OPEC can maintain production discipline in 2007, we estimate that the global market could be firmly in deficit in the first and fourth quarters – in stark contrast to the trends of the past three years.

In recent months, the existing OPEC members have shown a degree of cohesion, by reducing output in the face of sliding prices – albeit not to the full 1.7 million barrels a day agreed. Perversely, lower OPEC output may have eased some of the concerns around the immediate security of global oil supply. In cutting output, spare capacity has increased – providing coverage in the event of unexpected production losses elsewhere.

OPEC cuts build crude coverage



Source: IEA

OPEC enlargement could sap investment opportunities

Until the start of this year, the membership of OPEC had not increased since 1975 – in fact it contracted in the 1990s with the withdrawal of Ecuador and Gabon. In late November 2006, Angola, one of the most rapidly growing oil producers, voted to join the cartel from 1 January 2007. In coming months, both Sudan and former member Ecuador may join an enlarged OPEC. Initially, none of these nations will face restrictions on oil output.

In the case of Sudan and Ecuador, OPEC membership is perceived to be purely a political move. Neither are major oil producers – combined output in 2005 was around 920 000 barrels a day (BP) – however OPEC membership will offer greater political influence. The conflict in the Darfur region – with allegations of genocide – have severely harmed Sudan's international reputation. In contrast, OPEC membership for Ecuador will allow the country closer align with near neighbour Venezuela.

Angola's membership sends different signals to global oil markets. The rapid growth in output in the west African nation since 2001 had raised hopes that Angola could be a key growth region for oil output. Membership of OPEC will instead impose restrictions on oil production and may limit opportunities for investment by major oil companies.

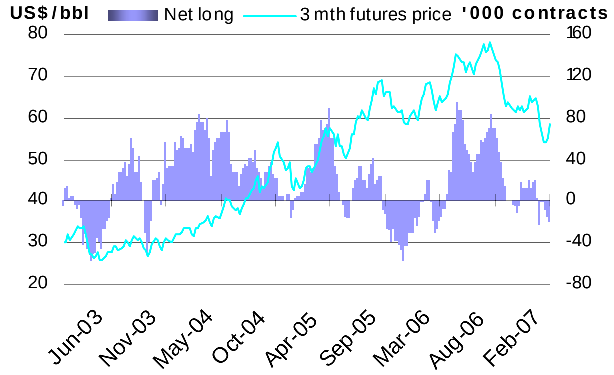
While this may act to slow investment inflows into Angola, OPEC membership will allow a greater influence on global crude markets – particularly price, provided a larger OPEC can operate in a cohesive fashion – and potentially increase oil revenues.

Futures market – "cheap" oil may lure funds

Futures prices on the New York Mercantile Exchange (NYMEX) fell sharply in January – in line with the correction in oil prices. The three month light sweet crude contract fell by around 12 per cent to average US$56.16 a barrel. Across 2006, the rolling three month contract averaged US$68.33 a barrel, a year on year increase of 18 per cent.

Speculative interest in the futures markets appears to have waned. While open interest – a measure of the total contracts active in the market – has continued to rise, the share of non-commercial positions has fallen, down from a peak of 21 per cent in May 2006 to just 12 per cent at the start of February 2007.

Speculative interest declines as prices plunge



Source: CFTC, EIA

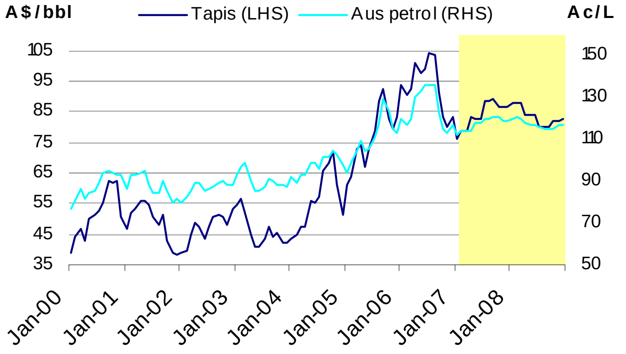
Speculative sentiment may have been impacted by the massive natural gas trading losses of Amaranth Advisors in late 2006, as well as similar losses by UK based hedge fund Red Kite in base metal markets. The slump in exchange traded resource commodities – including base metals and oil – in early 2007 may indicate some repositioning of risk in speculative portfolios in response to these high profile losses. As market fundamentals tighten in coming months, speculative inflows may return to global oil markets – albeit in a more modest fashion than witnessed between 2003 and 2006.

Refined markets – Australian petrol prices dive in line with crude oil…

Petrol prices fell in January, in line with declining crude oil prices. Weighted average capital city prices slumped by around 4.0 per cent to average 112 cents a litre (NAB estimate). In contrast, petrol prices averaged 124.7 cents a litre in 2006, an increase of 13 per cent year on year (FuelTrac, AAA).

Petrol prices are forecast to increase marginally in the short term, as crude prices have pushed higher. The price of regional benchmark crude, Tapis, did not fall as sharply as WTI, and has therefore built a sizeable premium in recent months. It remains to be seen whether this premium can be maintained, or whether arbitrage opportunities will bring prices more closely to alignment.

Petrol prices weaker in 2007 on lower crude prices



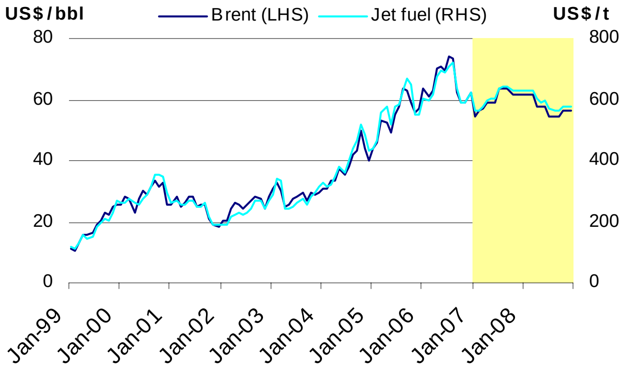
Source: Datastream, FuelTrac, AAA, NAB Group Economics

Reflecting the changes in NAB's exchange rate assumptions, weighted average capital city prices are forecast to average 117.3 cents a litre in 2007 (previously 118.5), a decrease of almost 5.8 per cent.

…and jet fuel follows the trend

Jet fuel also fell in January – following the trend in oil product prices – declining by 10 per cent to average US$562 a tonne. In 2006, benchmark European jet fuel prices averaged US$645 a tonne, a year on year increase of 15 per cent.

Jet fuel dives, but set to track crude outlook



Source: Bloomberg, NAB Group Economics

Reflecting the weaker condition of global oil markets at the start of 2007, forecast jet fuel prices have been revised downward. In 2007, benchmark European prices are forecast to average US$609 a tonne (previously US$643), a year on year decline of 5.7 per cent.

Monthly price summary

	Oct-06	Nov-06	Dec-06	Jan-07
Brent US$/bbl	58.70	59.22	62.26	54.50
WTI US$/bbl	58.88	59.29	62.03	54.78
Petrol Ac/L (a)	115.2	113.1	116.6	112.0*
Jet fuel US$/t	592.3	591.2	623.3	561.7

*NAB estimate

Quarterly price summary

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WTI US$/bbl	60.07	57.26	61.50	65.50	63.75
Petrol Ac/L (a)	114.9	113.5	116.4	120.3	119.5
Jet fuel US$/t	602.3	566.9	599.4	641.8	630.8

Annual price summary

	2004	2005	2006	2007 f	2008 f
Brent US$/bbl	38.22	54.80	65.63	60.04	57.67
WTI US$/bbl	41.43	56.58	66.11	62.00	60.00
Petrol Ac/L (a)	97.5	110.6	124.7	117.4	117.3
Jet fuel US$/t	398.7	563.2	645.3	609.7	592.3

(a) – Weighted average capital cities

Source: Datastream, AAA, FuelTrac, Bloomberg, NAB Group Economics

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