

Oil Monthly – February 2007

Minerals & Energy: Gerard Burg

Gerard.Burg@nab.com.au

(+613) 8641 3984

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

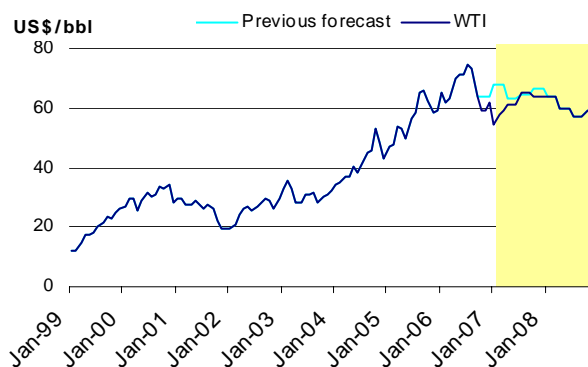
	2006	2007	Previous	2008	Previous
Brent US\$/bbl	65.63	60.04	63.05	57.67	57.66
WTI US\$/bbl	66.11	62.00	65.50	60.00	60.00
Petrol Ac/L (a)	124.7	117.4	122.1	117.3	118.8
Jet fuel US\$/t	645.3	609.7	643.4	592.3	592.8

(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



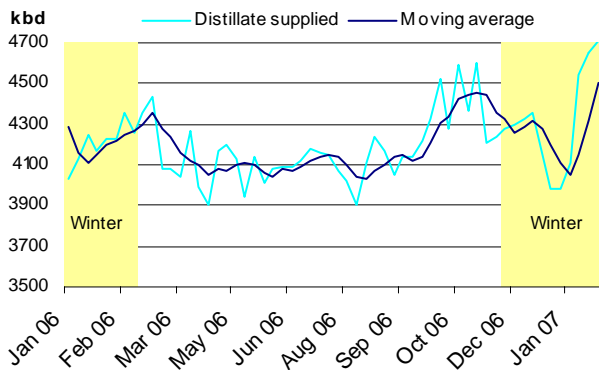
Source: Datastream, NAB Group Economics

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

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

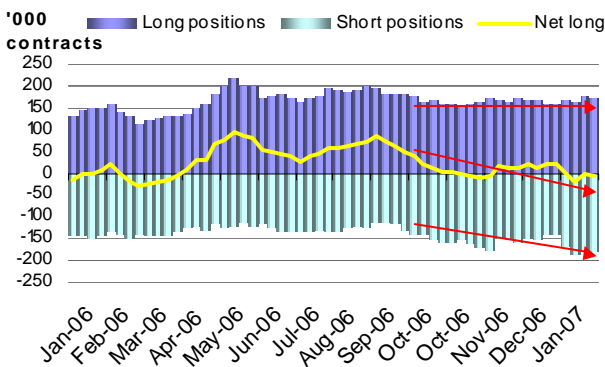


Source: EIA, NAB Group Economics

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

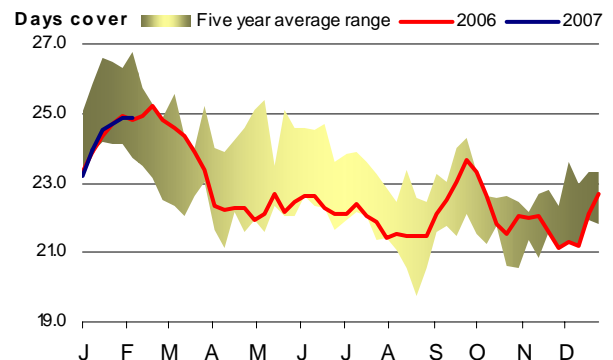
However, the failure of prices to sustain levels below US\$50 a barrel provided a significant psychological boost for global oil markets. Crude prices fell too far, too fast and have subsequently consolidated in the mid-to-high US\$50 range – possibly indicating the return of buyers into the market at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



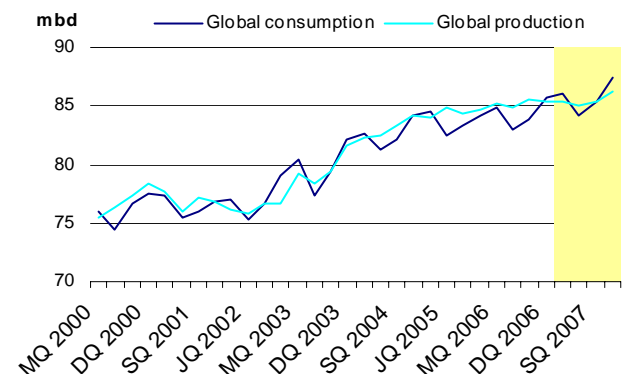
Source: EIA, NAB Group Economics

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

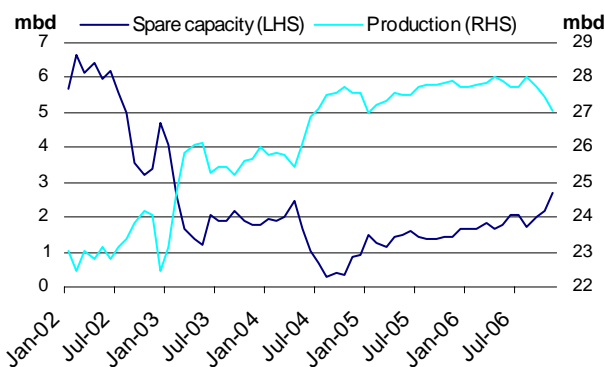


Source: IEA, NAB Group Economics

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

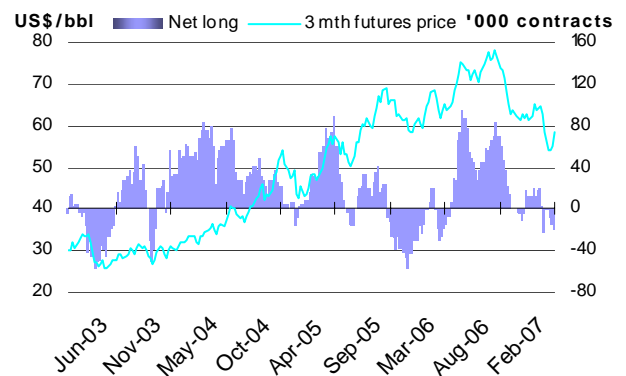
can operate in a cohesive fashion – and potentially increase oil revenues.

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



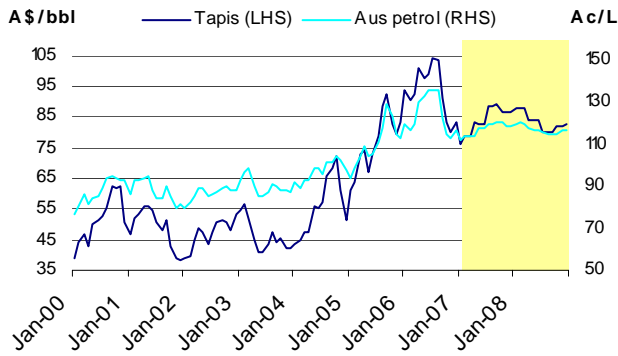
Source: CFTC, EIA

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.

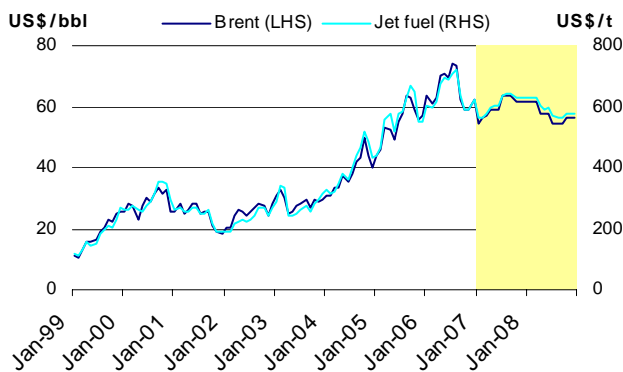
Petrol prices weaker in 2007 on lower crude prices

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

	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

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

Group Economics – Some Useful Contacts by Specialisation

Alan Oster Alan.Oster@nab.com.au	Group Chief Economist Economic, Financial & Business Conditions	(03) 8641 3464
Jeff Oughton Jeff.Oughton@nab.com.au	Head of Australia Economic, Financial & Business Conditions	(03) 8641 3469
Dean Pearson Dean.Pearson@nab.com.au	Senior Economist Telecommunications, Media, Recreation, Personal	(03) 8641 3474
Skye Dixon Skye.C.Dixon@nab.com.au	Economist Agribusiness	(03) 8641 3442
John Sharma John.Sharma@nab.com.au	Economist Property, Construction, Transport, Hospitality	(03) 8641 3473
Ian Gordon Ian.D.Gordon@nab.com.au	Economist Healthcare, Retailing, Business Services, Education	(03) 8641 3472
Gerard Burg Gerard.Burg@nab.com.au	Economist Minerals & Energy	(03) 8641 3984
Vacant	Economist Manufacturing, Wholesaling	(03) 8641 3762
James McKinlay James.McKinlay@nab.com.au	Economist (Australia) Economic & Financial Conditions	(03) 8641 3848
Tom Taylor Tom.Taylor@nab.com.au	Head of International Economic & Financial Conditions	(03) 8641 3475
Robert De lure Robert.De.lure@nab.com.au	Economist Country Risk & Asian Economies	(03) 8641 3445
Carolyn Fraser Carolyn.Fraser@nab.com.au	Economist (United Kingdom) Economic & Financial Conditions	(03) 8641 3694
Vacant	Economist (Europe) Economic & Financial Conditions	(03) 8641 4304

DISCLAIMER: “[While care has been taken in preparing this material,] National Australia Bank Limited (ABN 12 004 044 937) does not warrant or represent that the information, recommendations, opinions or conclusions contained in this document (“Information”) are accurate, reliable, complete or current. The Information has been prepared for dissemination to professional investors for information purposes only and any statements as to past performance do not represent future performance. The Information does not purport to contain all matters relevant to any particular investment or financial instrument and all statements as to future matters are not guaranteed to be accurate. In all cases, anyone proposing to rely on or use the Information should independently verify and check the accuracy, completeness, reliability and suitability of the Information and should obtain independent and specific advice from appropriate professionals or experts. To the extent permissible by law, the National shall not be liable for any errors, omissions, defects or misrepresentations in the Information or for any loss or damage suffered by persons who use or rely on such Information (including by reasons of negligence, negligent misstatement or otherwise). If any law prohibits the exclusion of such liability, the National limits its liability to the re-supply of the Information, provided that such limitation is permitted by law and is fair and reasonable. The National, its affiliates and employees may hold a position or act as a price maker in the financial instruments of any issuer discussed within this document or act as an underwriter, placement agent, adviser or lender to such issuer.”

UK Disclaimer: So far as the law and the FSA Rules allow, National Australia Bank Limited (“the Bank”) disclaims any warranty or representation as to the accuracy or reliability of the information and statements in this document. The Bank will not be liable (whether in negligence or otherwise) for any loss or damage suffered from relying on this document. This document does not purport to contain all relevant information. Recipients should not rely on its contents but should make their own assessment and seek professional advice relevant to their circumstances. The Bank may have proprietary positions in the products described in this document. This document is for information purposes only, is not intended as an offer or solicitation nor is it the intention of the Bank to create legal relations on the basis of the information contained in it. No part of this document may be reproduced without the prior permission of the Bank. This document is intended for Investment Professionals (as such term is defined in The Financial Services and Markets Act 2000 (Financial Promotion) Order 2001) and should not be passed to any other person who would be defined as a private customer by the rules of the Financial Services Authority (“FSA”) in the UK or to any person who may not have experience of such matters. Issued by National Australia Bank Limited A.C.N. 004 044 937, 88 Wood Street, London EC2V 7QQ. Registered in England BR1924. Head Office: 500 Bourke Street, Melbourne, Victoria. Incorporated with limited liability in the state of Victoria, Australia. Regulated by the FSA in the UK.

U.S DISCLAIMER: This information has been prepared by National Australia Bank or one of its affiliates or subsidiaries (collectively, “NAB”). If it is distributed in the United States, such distribution is by National Australia Capital Markets, LLC (NACM) which accepts responsibility for its contents. Any U.S. person receiving this information wishes further information or desires to effect transactions in the securities described herein should call or write to NACM, 245 Park Avenue, New York, NY 10167 (or call (877) 377-5480). The information contained herein has been obtained from, and any opinions herein are based upon sources believed to be reliable and no guarantees, representations or warranties are made as to its accuracy, completeness or suitability for any purpose. Any opinions or estimates expressed in this information is our current opinion as of the date of this report and is subject to change without notice. The principals of NACM or NAB and/or its affiliates may have a long or short position or may transact in the securities referred to herein or hold or transact derivative instruments, including options, warrants or rights with securities, or may act as a market maker in the securities discussed herein and may sell such securities to or buy from customers on a principal basis. This material is not intended as an offer or solicitation for the purchase or sale of the securities described herein or for any other action. It is intended for the information of clients only and is not for publication in the press or elsewhere.