

Oil Market at a Glance – July 2008

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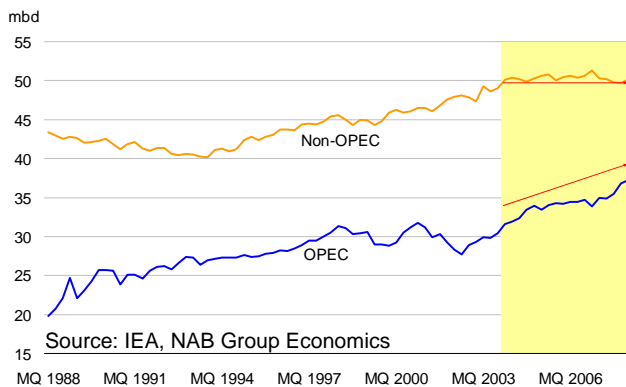
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Summary – supply side pressures help drive oil prices to all time highs – with little downside potential

- There are increasing concerns around the prospects for global oil supply – particularly longer term. Despite several years of historically high prices, global oil production has struggled to increase – with non-OPEC production plateauing and net oil exports declining. Future production prospects do not look particularly encouraging – with rising investment costs and a growing dependency on OPEC.
- That said, oil demand is responding to price signals. Consumption in OECD nations has been in decline since 2005, as consumers optimise their usage. Growth in oil consumption is only expected in subsidising regions. China – one of these subsidising countries – has recently increased product prices.
- While supply and demand have been key drivers of crude markets in recent times, there remains some uncertainty as to the impact of speculation on oil prices. The IMF is set to examine the influence of financial speculation in commodity markets. There is little doubt that the strong increase in speculative investment in commodities has increased the volatility in prices.
- Oil prices will be sustained at high levels in the longer term. Alternative fuels are unlikely to be able to undercut oil at these prices, but combined with the demand side management already underway, they may limit the upside risk. We expect prices to drift marginally lower in coming quarters, but remain within a range of at least US\$100-120 a barrel in coming years.

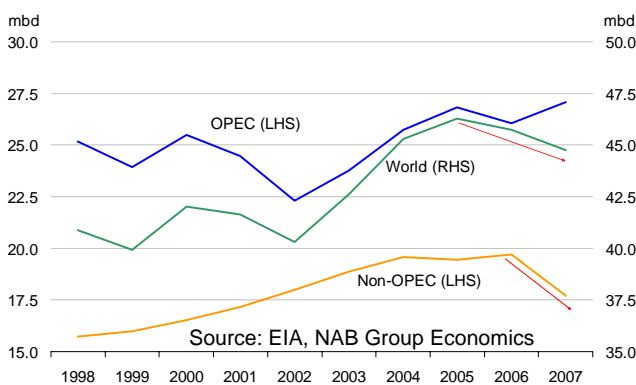
Issue 1: Non-OPEC oil production flat since late 2003 – leading to a greater dependency on OPEC



Crude oil production outside of OPEC has plateaued since late 2003. Three factors have contributed to this slowdown – Angola joining OPEC; the plateauing in Russian oil production; and the long term decline in OECD oil production.

We expect the latter two trends to continue. The strongest prospect for oil production outside of OPEC is Brazil's offshore Carioca field – reportedly the largest ever find outside the Middle East. That said, the field will take time to develop, and would prove to be an engineering challenge, given significant geological hurdles. At best, it would likely provide a partial offset to declining output elsewhere.

Issue 2: Declining net oil exports – China and the US increase competition over less oil



The fundamentals of the oil market have tightened considerably in the past five years, with a notable shift most recently. Net oil exports – effectively oil that is freely traded around the world – have fallen over the past two years. Major importers, such as China and the United States are competing for less freely traded oil – adding upward pressure to crude prices.

The key driver of this decline has been the rising consumption of crude oil in oil exporting nations – notably the Middle East OPEC nations. Flush with revenues from soaring crude prices, oil consumption in this region has leapt, supported by subsidised petrol and diesel prices. Conscious of the social implications of a cut to these subsidies, there seems little motive to change policy.

Longer term supply prospects don't appear rosy

The potential for longer term growth in oil production appears to rest with OPEC – given the existing plateau in non-OPEC production and natural field declines.

That said, a number of OPEC producers are already past the peak of production, and others are struggling to increase supply. OPEC's touted reserves – at almost 75 per cent of the world total – are vastly overstated, and do not represent an accurate picture of production potential.

The normally austere International Energy Agency shocked oil markets in May, when it was revealed to the Wall Street Journal that they would be drastically reducing their forecast for future oil production, to be released in November.

The IMF has noted that while nominal investment in oil exploration and development has soared, the real value of this investment has risen more moderately – with shortages of drilling equipment and skilled personnel as well as high energy prices increasing

the cost of projects. Oil producers are increasingly facing geological constraints – with new oil fields typically being smaller than older fields. Reflecting the greater financial risk of producing from these fields, the IMF argue that higher oil prices are needed to induce the additional investment required to balance the market over the medium term.

Oil demand is responding to prices, with growth expected in oil subsidising regions

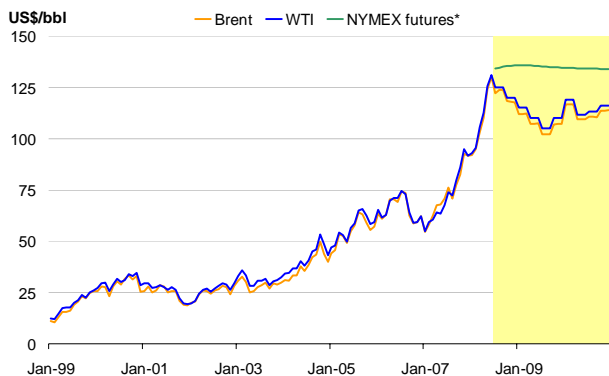
According to the latest forecasts by the International Energy Agency, global oil consumption is set to rise by just 800 000 barrels a day in 2008. The main contributors to this growth are China and Middle Eastern countries – economies that subsidise oil prices, leading to artificially high demand at current market prices. Consumption in OECD nations has been in decline since 2005 – down by just over a million barrels a day since the peak – as consumers in the region respond to price signals.

In June, China's government moved to increase domestic fuel prices – as the cost of the country's subsidies rose substantially. According to the World Bank, Chinese oil refiner SinoPec received a total subsidy of RMB 4.9 billion in 2007 as compensation for selling refined products at capped prices. In the first quarter of 2008, the subsidy has risen to RMB 7.4 billion. On June 20, China's National Development and Reform Commission increased petrol prices by 17 per cent and diesel by 18 per cent.

High prices are leading to changing patterns in demand. Usage rates of public transport in the developed world are rising, consumers are switching to smaller, more fuel efficient vehicles and individuals are optimising their vehicle usage. The introduction of plug-in hybrid vehicles – which will primarily operate on electric motors – in coming years may further limit demand growth in industrialised nations.

What does this mean for oil prices? Remaining high – limited upside on demand, limited downside on supply

In short, oil prices will be sustained at high levels in the longer term. Alternatives (such as biofuels, coal and gas-to-liquids) are unlikely to be able to undercut oil at these prices, but combined with the demand side management already underway, they may limit the upside risk. We expect prices to drift marginally lower in coming quarters, but remain within a range of at least US\$100-120 a barrel.



Source: Datastream, NYMEX, NAB Group Economics
* Futures curve as of 18 Jun 2008

While supply and demand have been key drivers of crude markets in recent times, there remains some uncertainty as to the impact of speculation on oil prices. At the behest of the G8 finance ministers, the International Monetary Fund is set to examine the influence of financial market speculation in commodity markets. There is little doubt that the strong increase in speculative investment in commodities has increased the volatility in prices.

Futures market prices seem to be in accord with our price outlook – with the forward curve flattening from early April 2008, before moving into contango in mid-May. At present, oil for delivery in December 2016 is trading at a premium to spot crude.

What is the impact of oil on the broader global economy?

Given this outlook, a deep global recession is very unlikely and activity will be sustained at a reasonable level abroad and in Australia. Moreover, there has been a marked shift away from oil/energy intensity relative to global output as well as improved fiscal and monetary reactions from policy-makers. This is unlike the oil shocks in the mid and late 1970s that were mainly driven by constrained OPEC supply as well as poor policy responses. Arguably, a sustained global shock to supply and sustained higher oil prices needs a geopolitical trigger involving conflict in the Middle East.

There are also likely to be some significant effects across industries – associated with the direct effects of higher oil prices and the indirect effects of lower demand and higher interest rates.

Quarterly price profile

	Q1 08	Q2 08 f	Q3 08 f	Q4 08 f	Q1 09 f	Q2 09 f	Q3 09 f	Q4 09 f	Q1 10 f	Q2 10 f	Q3 10 f	Q4 10 f
Brent US\$/bbl	96.66	121.31	123.04	117.97	112.04	107.23	102.20	107.10	116.60	109.40	110.55	113.60
WTI US\$/bbl	97.95	123.03	125.00	120.00	115.00	110.00	105.00	110.00	119.03	111.55	113.28	116.15
Petrol Ac/L (a)	138.3	147.3	151.0	151.0	149.7	148.2	145.8	148.5	153.7	151.2	151.5	153.1

Annual price profile

	2004	2005	2006	2007	2008 f	2009 f	2010 f
Brent US\$/bbl	38.22	54.80	65.63	72.65	114.75	107.14	112.54
WTI US\$/bbl	41.43	56.58	66.11	72.34	116.50	110.00	115.00
Petrol Ac/L (a)	97.5	110.6	124.7	124.6	146.9	148.1	152.4

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