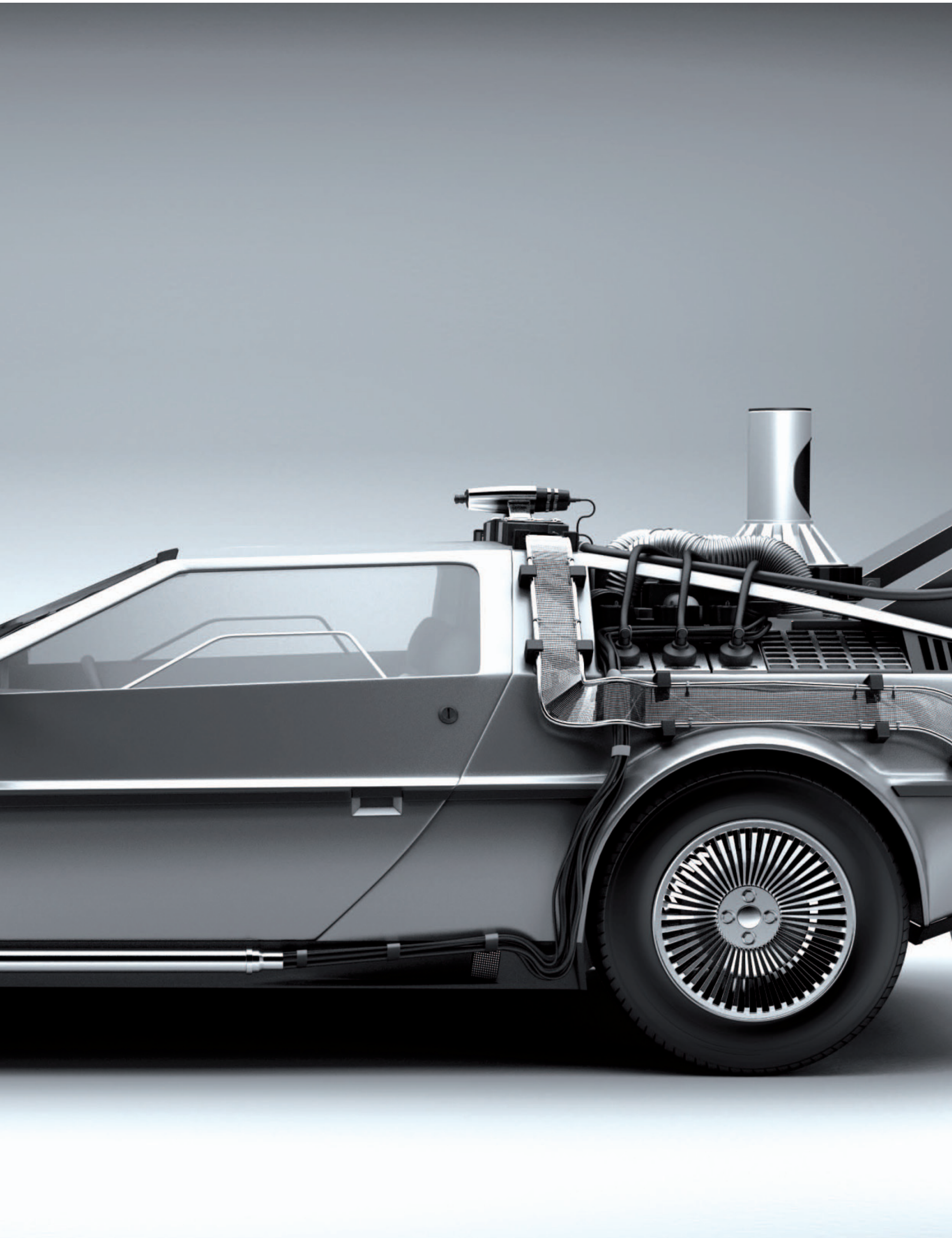

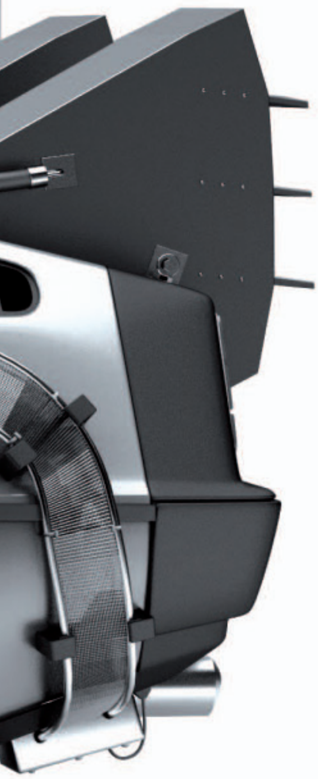

Back to the future

Where next for 100-Dollar oil?

A look back at the last decade reveals a tremendous level of oil price instability experienced by producers, consumers and global economies alike. In the last six months alone, the price of oil has had to weather a sputtering global economic recovery, geo-political upheaval (in the wake of the Arab Spring) and uncertainty within OPEC on production rates.

A retrospective on 100-Dollar oil reveals two things: that price volatility remains the only certainty; and that USD 100 is increasingly becoming the pivot point for measuring the condition of the global economy. Whereas in 2008, 100-Dollar oil was a way-marker on the way from rapid boom to the bursting of a speculative bubble, in 2011 it appears as an indicator of the shifting status of major producers and consumers and the complex impact of global macro-economic measures related to ongoing austerity and stimulus.

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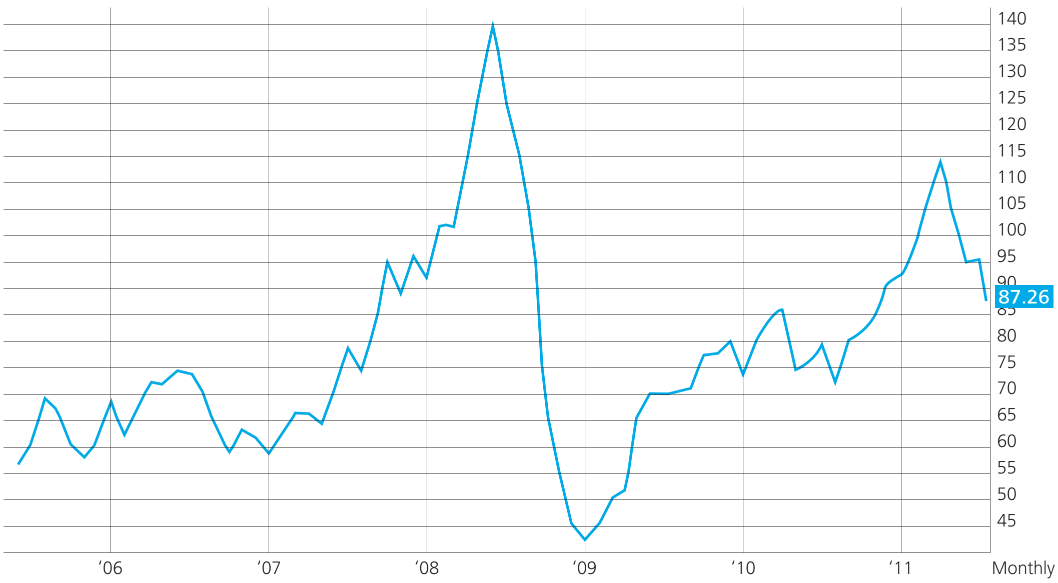
A rapid rise

In January 1999 the NYMEX West Texas Intermediate (WTI) price per barrel for 30-day deliveries (a benchmark oil futures contract) traded at USD 17. Prices proceeded to double in less than two years and after seesawing steadily upwards, reached USD 50, 60, 70 and eventually USD 90 between 2005 and 2007. In January 2008, a trade was recorded at USD 100. That threshold was sustained and eventually exceeded as WTI futures picked up about USD 10 per month before reaching an 'all time high' of USD 147 on July 11th, 2008. The rapid rise in demand in emerging economies, a declining U.S. Dollar, speculative futures trading run rampant, tight spare producer capacity, a deceptively buoyant climate in many sectors and recurring geo-political tensions all contributed to what seemed like an exponential increase in the price of oil. Indeed, the bullish spirit of the time is aptly evoked when recalling how, in March 2008, Goldman Sachs proffered the now infamous 'super-spike'[1] view that U.S. GDP growth or a major supply disruption would likely send prices as high as USD 200 per barrel.

%CL+1 [10] - Light crude oil-electronic - August 2011



Last: 87.26 Change: ▾ 0.32 High: 87.53 Low: 87.13

Source: CME Group

What goes up…

Summer 2008 not only marked the apex for crude oil prices but was also a historic watershed for the global economy as many countries began a rapid slide into recession. Wave after wave of crises in the currency, equity and debt markets broke with painful consequences for sovereign debtors. The decline in crude oil prices was even more spectacular than the preceding rise, as the NYMEX benchmark gave up over USD 100 in under six months. As the scale and impact of liquidity shortfalls, bank collapses and the global economic fallout started to show and crude consumption cutbacks and increased stockpiles took hold, traders sent the 30-day WTI contract to a 'crisis-low' of USD 32, a price level not seen since April 2004.

Back to the future

By March 2011, the price of oil had crossed the USD 100 threshold for the second time, a remarkable three-fold increase in just over two years. After factoring the impact of the situation in Libya and the ability of Saudi Arabia to cover most of the production shortfall, oil has traded close to USD 100 after briefly peaking at USD 114. Trading continued below the USD 90 range following a decline on the heels of the US credit rating downgrade in August 2011. As speculation mounts that WTI will (again) be trading at USD 100 or above, it is worth examining the factors that may impact this increase and what measures governments, producers and consumers, either individually or collectively, can take.

While oil prices are largely set by the views that traders (predominately speculators) take with respect to where oil markets will be heading – and this in itself is an area of significant debate – decisions taken by governments in the U.S., Europe, China and elsewhere in response to the economic crisis, which are themselves important market sentiment markers, will play an important role. Traditional, fundamental supply and demand indicators such as stock levels, refining demand, producer spare capacity and the GDP growth forecasts of net importer nations also help in understanding the marketplace. Looking at the last six months a number of important trends emerge:

> Global average demand for crude reached 86.6 million barrels a day in 2010, the highest level since 2007 and is set to increase by almost 2 million barrels a day each year over the next two years according to most estimates

Changing demand patterns

Global average demand for crude reached 86.6 million barrels a day in 2010[3], the highest level since 2007 and is set to increase by almost 2 million barrels a day each year over the next two years according to most estimates[4]. So whatever opinions abound about the pace of economic recovery, the demand for oil continues unabated.

Importantly, demand in China and Asia remains robust. Chinese demand, which quadrupled between 1980 and 2009, and is currently estimated at almost 9.6 million barrels per day, is expected to increase by 6% within the next year. Non-OECD[5] countries demand growth has offset OECD declines and is expected to grow from 48% of current global demand to as much as 60% by 2035[6].

At the 158th OPEC meeting held in Ecuador in December 2010, ministers indicated that production targets would remain stable at 24.8 million barrels per day and that the increasing price of oil was not worrying

Upstream capital expenditures

The cyclical nature of capacity investment means that demand growth, price and supply reaction are not synchronous and under-investment during the lean years may only recover after demand fundamentals have been re-established. Global upstream capital expenditure (production spending), which had declined about 15% during 2009 as oil prices plummeted and the economic crisis set in, increased during 2010 by approximately USD 470 billion[7], or about 9%.

U.S. and Chinese macro measures

While indicators of U.S. economic growth remain tenuous, the Federal Reserve has kept markets guessing in terms of a clear direction with a range of monetary supply measures being employed over the last year. This 'quantitative easing' coincided with an increase in oil prices as the USD-denominated commodity was impacted by an increase in the money supply. Bank of America's Merrill Lynch unit has estimated that an additional round of quantitative easing in 2011 in the U.S. may increase oil prices by 6%, whilst similar measures on a global level may impact the price of oil by as much as 26%[8].

Chinese inflation recently reached a two-year high at just over 6%. The reaction of the Chinese government to an increase in oil prices is an important indicator for oil traders who view industrial demand by the world's second largest consumer as a key barometer for the price of oil. Notably, China is expected to register economic growth of 9.6% in 2011, or approximately 30% of global growth.

OPEC production

At the 158th OPEC meeting held in Ecuador in December 2010, ministers indicated that production targets would remain stable at 24.8 million barrels per day and that the increasing price of oil was not worrying.

In his opening remarks at the 159th OPEC meeting in Vienna in July 2011, HE Mohammad Aliabadi, Acting Minister of Petroleum of the Islamic Republic of Iran and President of the conference, announced that speculative activity on the Nymex had reached record highs, that "excessive speculation in the futures markets increases volatility unrelated to fundamentals" and that "efforts by governing and regulatory bodies in the consuming countries to minimize such speculation remain imperative."

While speculation and volatility have remained high throughout the economic crisis and recovery, it was the lack of consensus among OPEC members on production levels in that meeting that led to a sharp rise in oil prices and the subsequently announced release of strategic oil reserves by the International Energy Agency (IEA) designed to calm markets.

Whilst the specter of a deeper, prolonged recession on the back of unfolding Euro-zone and U.S. default and debt crises continues – and this has kept prices at below USD 100 – it will continue to be all hands on the global deck to counter this, with a priority on measures to induce economic growth.

Ultimately, analysts appreciate that rising oil demand in the fastest-growing parts of the world requires the development of increasingly more expensive sources of harder-to-find oil and while an incremental increase in future production is likely, this may come as spare capacity is squeezed and prices are steadily pushed upwards beyond USD 100. Again.

by **Mutasem Dajani**, partner, Oil and Gas, Deloitte in the Middle East

Endnotes

1 New York Times.
2 Nymex price data from CME Group.
3 US Energy Information Administration.
4 JP Morgan.
5 Organization for Economic Cooperation and Development.
6 International Energy Agency.
7 International Energy Agency.
8 Reuters/ Bank of America Merrill Lynch.

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