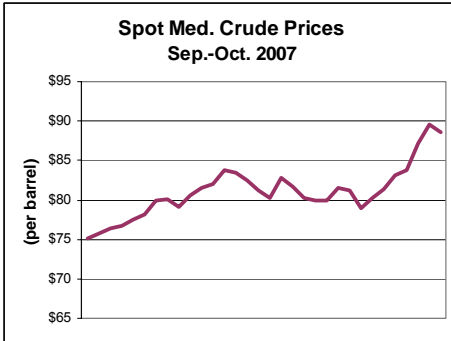


Oil Market Outlook — Late 2007

OCTOBER 30, 2007

\$100/barrel may be just down the road

\$100 Looks Much Likelier Than \$75 Within the Near Term



Because oil prices are denominated in dollars, the dollar's sharp depreciation tends to drive up crude oil prices further.

Iraq, Nigeria and Venezuela all show notable production shortfalls from historical output levels.

This October, spot and future oil prices continue to set new nominal highs, and verge very near an all-time inflation adjusted high. Prices have tested and intermittently breached the \$90/barrel threshold, and surged to \$93.50 for light sweet crude at the latest reading for this analysis, the close of trading on Monday afternoon, October 29. At this point, the per barrel price has jumped by nearly \$3 in a week, and by a full \$30 over the past year. This seemingly unstoppable run-up in oil prices is prompting anxiety — and for canny speculators, anticipation — that oil will be trading at \$100/barrel in the not-distant future. The all-time high crude price, on an inflation-adjusted, monthly average basis, was posted in December 1979, at the equivalent (in 2007 dollars) of \$100.30.

In an assessment of factors driving oil prices upward at the present time, no single one is decisive but several credibly contribute. Undoubtedly, speculative money is actively entering the oil market. Such inflows have been a recurrent phenomenon for several years, but with wide fluctuations in intensity. The oil bulls' latest gambit arises, for one thing, from geopolitical jitters, provoked in particular by increasingly bellicose U.S. rhetoric, especially by Vice President Cheney, directed at Iran. Simultaneously, the deleterious effect of the subprime meltdown on financial markets makes commodities a relatively more attractive spot to park funds. Moreover, the latest Fed easing, by a full half point, opened up some intriguing arbitrage opportunities. Finally, with this latest bout of financial turmoil taking a chunk out of the dollar's value, the circumstance of oil prices being denominated in a fast-fading dollar in itself serves to push up the crude quote.

The latest U.S. inventory report showed 21 days' stock of crude on hand, down by one day from the year-ago tally. Tight supply has become a norm, but a norm that naturally generates some background anxiety. Weather in summer 2007 was reasonably benign for production operations, with the exception of a temporary disruption to Mexican offshore rigs from Hurricane Dean in August.

Not an "oil shock," but a new normal

The previous record price for a barrel of crude petroleum, which seems likely to be matched either imminently or in the foreseeable future, came at the time of the "second oil shock" triggered by the Islamic revolution that overthrew the Shah of Iran. Today, a geopolitical storm, with the ironic possibility that Iran could be at the center of it, is a highly plausible scenario for how oil may soon hit the \$100/barrel mark. Yet, in a broad perspective, today's petroleum markets do not feature shocks and spikes so much as the onset of ordinary, inexorable scarcity.

Demand, especially from developing countries, continues to burgeon, while supply levels seem stuck on a plateau. In fact, world production is currently esti-

mated at 84.4 million barrels per day (mbd), actually some 1.5 mbd lower than in June. Oil “should” but isn’t coming from various sources, including war-torn Iraq, the Niger Delta during frequent outbreaks of civil unrest, and Venezuela, where current output of some 2.4 mbd falls nearly a million barrels short of that country’s consistent production in 1995-2000. President Chavez’ populist agenda and the U.S. interposition of an escalating war of words therewith have led to a significant exodus of expertise from the Venezuelan oil industry. This technical factor seems to be the main correlate with Venezuela’s depressed output numbers, which do not appear likely to recover in the near future.

*Grandiose yield projections for Al-
bertan tar sands seem question-
able.*

Both Mexico and Russia show stable but below-potential petroleum production at around 3.2 and 9.4 mbd, respectively. With infusions of investment, these countries’ reserves could come on stream in higher volumes. But nationalist proclivities — Putin’s post-Yukos statist reconfiguration of the Russian oil industry roughly paralleling the Cardenas expropriations in the 1930s — are keeping Mexico and Russia financially isolated. In a trend that would probably surprise most U.S. residents, Canadian oil has been one of the most reliable, modestly increasing elements in the U.S. import mix needed to bridge the large gap between domestic supply and demand. But for economic and environmental reasons, the oil from Albertan tar sands that ultimately reaches the market is unlikely to approach high-end estimates of the potential yield from this resource. Vast quantities of natural gas must be burned to liberate the oil trapped in the tar sands. Energy development in this region of the Far North will probably move toward direct gas sales.

*Cartel members’ response to
OPEC’s latest quota relaxation
has been soft — production has
barely risen.*

Inaccessible and perhaps distorted information impedes attempts to draw up a coherent worldwide inventory of remaining conventional oil resources. Yet hypotheses of “peak oil” are no longer just utterances ascribed to an alarmist fringe; such conjecture now crops up regularly in mainstream circles. Peak oil simply refers to a point at which half the reserves have been depleted, making extraction of the remaining half expensive and difficult and marking a transition to an era of unavoidable scarcity. Some major fields, including U.S. domestic reserves in the 1970s and the North Sea much more recently, have unquestionably peaked. The debate concerns whether or not planetary oil stocks are likewise half-exhausted.

One aspect of recent production data lending some support to the view that available reserves may have been overstated is a rather flaccid response by the OPEC countries to the cartel’s latest 0.5 mbd upward revision in its nominal production quota. Granted, actual OPEC output already exceeded the new ceiling when it was announced. The recent rise in OPEC production has been in the range of 250,000 barrels per day, when many industry observers anticipated at least 500,000 to match the authorized increment, especially with prices at record levels. The formal production quota for the so-called OPEC-11 (which excludes Iraq) now stands at 29.75 mbd, while these countries’ estimated actual current output is slightly over 30 mbd.