

Oil price stays high in 2006

Continued strong global GDP growth will drive up global demand for oil this year. Together with geopolitical risk this will keep oil prices high, as Mike Wittner explains

The key oil market drivers for 2006 will be similar to those last year, and Calyon forecasts another year of high crude and product prices. The foundation for continued robust prices is strong global GDP growth, which drives oil product consumption growth – the single most important fundamental for the oil markets. Healthy oil demand growth will keep spare crude-refining capacity and spare crude-production capacity low, which will underpin the oil markets. Financial flows into the commodity space are also expected to continue, providing important non-fundamental support for the oil complex. Geopolitical risk in Iran, Nigeria, Iraq and elsewhere will also be a key non-fundamental price driver. The Iranian nuclear situation will develop gradually and will support prices all year long.

Global GDP growth of 4.3% is expected again this year. Following global oil demand growth of 3.2 million barrels per day (mmb/d) in 2004 (the fastest since 1978) and 1.1 mmb/d in 2005, the strong GDP environment should push oil demand up by another 1.2–1.3 mmb/d in 2006, led by China, the Middle East and the US (figure 1).

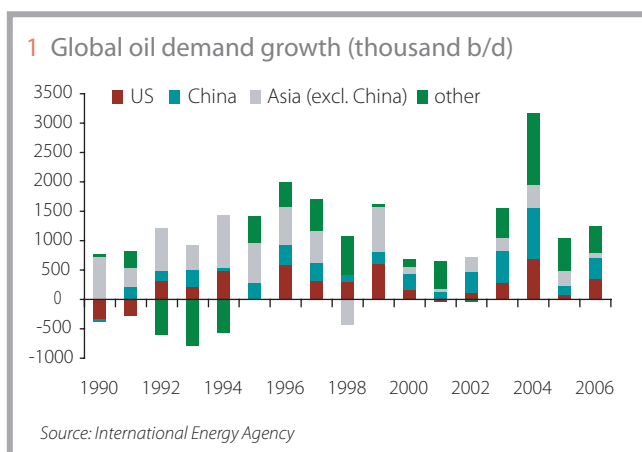
In the US, 2005 demand growth was constrained by the hurricanes, a warm start to the winter heating season and a

response to high end-user prices. However, recent preliminary statistics show that US core products demand (gasoline, jet/kerosene, distillate and residual fuel oil) is recovering and healthy, in line with the resilient and growing economy. US demand growth in 2006 will mainly be in transportation fuels: gasoline, diesel and jet/kerosene.

Chinese growth is also expected to recover this year. In 2005, artificially low retail prices set by the government caused Chinese refiners to undersupply the market, which constrained consumption. Refiners opted to export gasoline and some other products rather than sell them domestically at a loss. The resulting supply shortages have prompted occasional protests about availability, to which the government has begun to respond. After some tinkering with its export subsidy schemes to make exports less attractive to refiners, the government has taken the more important steps of increasing domestic retail prices twice this year – in March and May – with further increases possible. In addition, last December, the government paid \$1.2 billion compensation to Sinopec, the largest refiner, for financial losses. While this is not as efficient as market-based pricing, it is another form of incentive. This year, the combination of higher domestic retail prices and expectations of additional compensation should give refiners more incentive to provide enough domestic supply to fuel demand growth. Chinese oil demand growth will be broad based: industrial activity will drive middle distillate demand and gasoline demand will increase due to new car sales. Naphtha demand will also grow to meet the needs of the petrochemical sector.

For the past two to three years, demand has been generally strong, the markets have been led by products and refining margins have been stellar, especially complex margins. Complex refineries can process inexpensive medium/heavy sour crude and earn the highest margins; as a result, they have been running at full capacity. Refining investment has thus picked up. Since expansion of an existing refinery takes two to three years and construction of a new refinery five to six years, the additions should gradually ease the capacity constraint in complex refining. However, in 2006 and the first half of 2007, product demand growth will significantly exceed capacity growth, keeping upward pressure on the product markets.

By the second half of 2007, however, the large capacity additions expected in 2008 should start to weigh on product prices, narrowing product-crude price differentials, or 'cracks'. In particular, the upgrading capacity additions are expected to ease the complex refining constraint. From the refiners' perspective, 2006 may be the top of the cycle as far as margins are concerned. With downstream investment starting to catch up through 2007, the



persistent premium to spot levels offered by forward margin sales is expected to become increasingly attractive to refiners.

With long-term crude prices and refinery margins as strong as they are, times are tough for consumers hoping to manage energy costs over a longer tenor. This looks set to be another year in which consumers will need to remain nimble and gain value by increasing hedging ratios during periods of price weakness. These dips will occur, even in the expected supportive price environment of 2006. We are forecasting a fourth-quarter correction in the oil complex, perhaps during November and December. This time period is after hurricane season, after peak gasoline demand, before winter heating demand and during Atlantic Basin refinery-maintenance season.

As they take advantage of such opportunities, consumers will have to work hard to find ways to minimise hedging costs in this 'contango' (prompt discount) market environment, especially with the increased complexity of hedge-accounting regulations. The contango structure of forward prices is expected to continue this year; generally comfortable crude and product inventories will weigh on the front of the curve, while long-term financial investors will support the back of the curve.

In an environment of geopolitical risk, as well as constant oil-supply disruptions due to bad weather, guerrilla warfare, accidents and technical problems, the thin cushion of spare capacity has added an upward bias to oil prices.

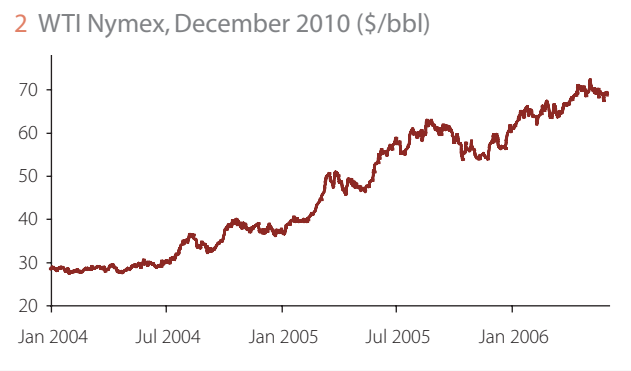
Almost all reliable spare capacity is in Saudi Arabia, and is for medium/heavy sour crude. The complex refiners that can use these crude grades cannot process any more because they are already running full-out, so spare capacity in medium/heavy sour crude is unused and unwanted. The marginal refining capacity in the world is in simple refineries seeking light sweet crude. Since there is no spare capacity to produce this light sweet crude, a premium is put on grades such as WTI and Brent.

New production capacity is now coming on stream in various members of the Organization of the Petroleum Exporting Countries (OPEC), including Saudi Arabia, Kuwait, the United Arab Emirates, Algeria and Nigeria. This will more than offset declines in mature old fields. In the case of Nigeria, growing supply from new fields is partly offsetting output lost due to attacks from militants. The majority of global demand growth this year is forecast to be met by growth in supply from non-OPEC, plus OPEC non-crude supply. This will leave OPEC crude output roughly flat this year at around 30 mmb/d. The combination of flat output with net capacity growth results in a forecast spare capacity increase of 0.5 mmb/d this year, to 1.7 mmb/d. Although this is a moderate improvement, it is still an extremely narrow cushion in an 85 mmb/d global market. As a result, we do not expect a lessening in the upward price pressure resulting from this factor.

Upstream activity has surged in response to the past four years' sustained oil price increases. According to Baker Hughes, the global rig count has increased from 1,917 in 2001 to 2,992 at the end of 2005. However, with a maturing oil resource base, the forward curve shows little signs of anticipating a significant change to the tightness in crude production capacity.

Currently, it is possible for oil producers to sell forward WTI swaps for the entire period 2007–2011 at price levels not far from the highest single month average price yet experienced (\$70.96 in May 2006). The reason is that long-term speculative buyers remain the dominant factor. This contrasts starkly with the historical situation, where producers have faced steep backwardation penalties for the privilege of forward selling in periods of 'high' spot prices.

Active investors, such as hedge funds and commodity trading



advisers (computer-driven trend followers), can take long or short positions. They are also active over the entire forward curve, in contrast to the index funds, which are invested only in the front months. Since the long-dated market (for example, WTI contracts in 2008–2011) continues to pull up, and anchor, the entire forward curve, the active investors pose more of a downside risk to prices: if they sell, the anchor is lost.

The investment thesis for the hedge funds is based on long-term economic growth in China and Asia, which will drive consumption of all commodities. The oil resource base available to meet this demand is maturing, especially in non-OPEC countries. Production costs are going up, and remaining resources are increasingly located in countries and regions with high geopolitical risk. The risk is that, if there is a recession or economic slow down, these long-term investors are likely to go short – even though the long-term thesis is still valid (figure 2).

Recession or economic slowdown presents the main downside risk to the oil price forecast for 2006. GDP growth drives oil demand growth, which maintains the squeeze on crude refining and production capacity and keeps upward pressure on prices. If GDP growth falters, the fundamentals weaken. In addition, the non-fundamental support could evaporate, and the financial flows could exert downward pressure on prices.

What could cause upside risk to the price forecast? There are geopolitical risks to crude supply. The 'usual suspects' include: Iran (nuclear programme); Nigeria (ongoing ethnic/community disturbances ahead of 2007 elections); Iraq (ongoing guerrilla war and sabotage); Saudi Arabia (radical Islamist/terrorist threat to oil facilities); Russia (Moscow reasserting control over oil and gas companies, as well as oil and gas policy); and Venezuela (unpredictable moves possible by President Hugo Chavez).

Another strong Atlantic/Caribbean hurricane season has been predicted for 2006, presenting further upside risk. Although a hurricane season as severe as that of 2005 is not likely, this year is forecast to be much more active than normal, in line with the heightened activity cycle seen since 1995. Severe hurricane-caused outages have not been explicitly factored into the price forecast; however, we do expect to see an upward bias to prices during the season. ■

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