BNP PARIBAS
Energy Commodities Export Project

OIL TRENDS

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Oil: When Will OPEC Cut Production?

- **Prices have fallen too fast in recent weeks given conditions in the US market.**
- **A production cut by OPEC would undermine the consolidation in oil prices longer term.**

Following a higher than expected increase in stocks of distillates fuel oil in the US at the end of November (a rise of 2.3mb), crude oil prices dropped sharply. In two days, the price of Dated Brent crude collapsed to USD 38.5pb, about 13% lower than its price at the end of November, while the price of West Texas Intermediate dropped to USD 43.3pb from just over USD 49 pb at the end of November.

Is this severe correction fully justified by market fundamentals? Is there a risk of a later rebound? How will OPEC's strategy be affected? There are numerous questions, which are difficult to answer given the high number of uncertainties facing the market. However, while an OPEC production cut will probably be unavoidable next year in order to stabilise an oversupplied market at a lower price level (USD 35.2pb, on average, in 2005 according to our forecast), a near-term production cut could rapidly refuel fears of shortages.

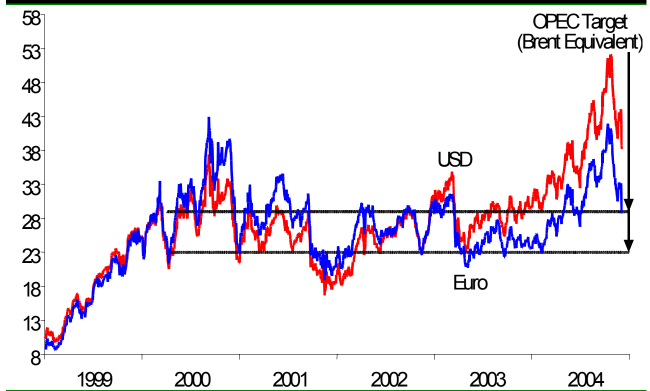
US market remains in a sensitive situation

A correction in oil prices following October's surge was easily predictable as operating conditions returned to normal in the Gulf of Mexico. The huge destocking of crude oil and distillates fuel oil observed at the end of September was entirely due to the exceptional weather conditions in the Gulf of Mexico. There was in fact no evidence that the market was undersupplied at the global level. Thus, increasing domestic production and a surge in imports helped to rebuild crude oil stocks quickly (a rise of 24.4 mb within eleven weeks) and, more recently, distillates stocks (a rise of 4.7mb within three weeks).

Crude oil stocks are now 4.6% above last year's level and US refineries are now running at a 94% utilisation rate (against 83.7% at the end of September) reaching a record high production of distillates of 4.2mbd. In addition, the beginning of winter has been 10% warmer than normal in contrast to earlier forecasts.

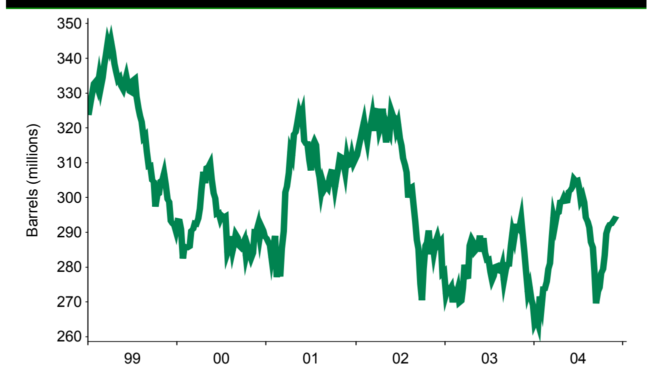
The US oil market is not fully representative of the world market, which could remain tighter than suggested by US data. Moreover, although US market supply has improved significantly since the end of September, the situation could change rapidly.

Chart 1: The Oil Price Collapsed (Dated Brent, pb)



Source: EcoWin

Chart 2: US Crude Oil Stocks Have Increased



Source: EcoWin

Chart 3: US Distillate Stocks Have Followed

Source: EcoWin

The rebuilding in distillates stocks could be a short-term phenomenon as crude imports could decline rapidly and consumption of distillates could increase soon.

A rebound in prices remains possible

In the short term, demand for distillates should increase for seasonal reasons even if the winter remains warmer than is typical. On the supply side, US refiners could now rapidly reduce their purchases of crude as stocks are replenished (and also as a result of US tax incentives). Thus, higher demand and lower imports could have a rapid impact on the level of crude and distillates stocks. For instance, a 0.5mbd increase on the demand side and a 0.5mbd decrease on the supply side would provoke a sharp destocking before the end of January refuelling fears of oil shortages. Moreover, it should be highlighted that the rebuilding in distillates stocks during the past two weeks was also partly the result of declining demand at the end of November.

Thus, even though there are the first signs of an oil market rebalancing due to a slowdown in oil demand growth, the situation in the US oil market could change very rapidly. In fact, US refiners' strategy and speculative positions will influence oil prices more than the fundamental market situation in the short term. A rapid decline in crude and distillates stocks would certainly increase hedge funds interest and oil prices could thus regain some ground before the end of December and in January.

OPEC could rapidly reverse any further downside trend

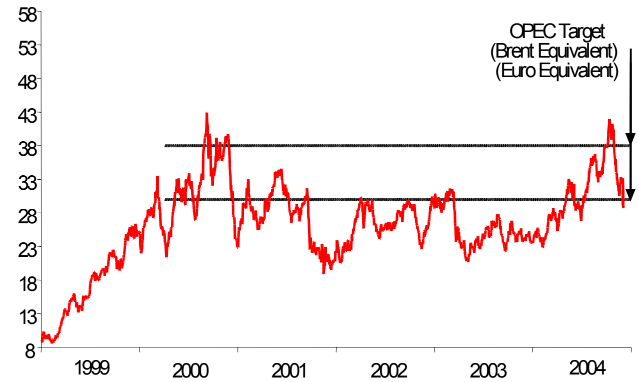
Against this background, the outcome of today's OPEC meeting will be critical. Until now, OPEC has indicated its willingness to maintain its quotas and its production at the current level but this could change if oil prices collapse further. In fact, a formal revision to quotas would not even be necessary as actual production is well above official quotas. In any case, Saudi Arabia could reduce its production in a discretionary manner before the end of December if required. Under a similar market configuration in 2000, OPEC cut its production rapidly in January (down 1.5mbd from February). In response, oil prices rebounded quickly.

In the short term, a pre-emptive OPEC production cut, combined with a decline in distillate stocks in the US in January, would provoke a strong rebound in oil prices. This could have a big impact on the market during 2005. A 1.0 to 1.5 mbd production cut from the beginning of January would make a decline in oil stocks unavoidable and a large increase in stocks during the spring difficult to achieve. Under this scenario, oil prices would certainly remain higher than previously forecast on average for 2005.

Short-term benefit versus longer-term consolidation

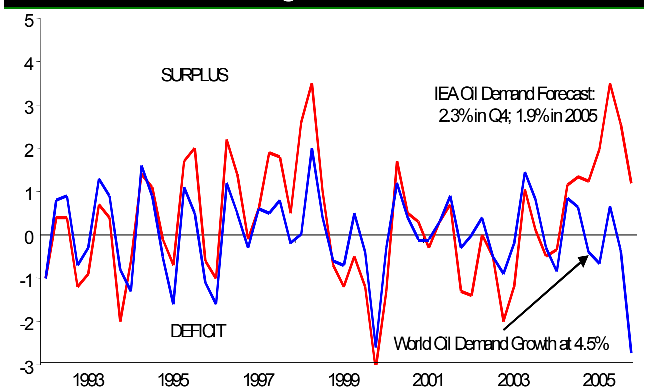
In our view, the market is now sufficiently supplied

Chart 4: OPEC Could Decide to React Quickly (Brent dated, EUR pb)



Source: Thomson Datastream

Chart 5: Supply Can Match until 4.5% demand growth



Source: International Energy Agency

with no risk of a significant shortage given the current level of OPEC production. The slowdown of growth in world oil demand seems sufficient to prevent a significant decrease in oil stocks during the winter and to allow a large rebuilding of stocks during the spring. A cut in OPEC production would certainly be necessary before the end of the spring but a durable consolidation at a lower oil price level requires at least another two to three months of limited oversupply. Any pre-emptive cut would be dangerous given the level of uncertainties in the oil market. Thus, to the extent that it may defer OPEC action, a short-term rebound in oil prices should be welcomed as it would favour a weaker outlook for oil prices longer term.

Will market participants prove wise and OPEC patient enough? Probably not, and we can be at least sure that the oil market will remain extraordinary volatile in the coming months.