

Cold comfort in 2007

The oil market was volatile and uncertain in 2006, says Lawrence Eagles, head of the oil division at the International Energy Agency. And 2007 is unlikely to be any different.

ARGUABLY, THE BULL MARKET IN OIL BEGAN WITH THE RECOVERY FROM THE PRICE collapse in 1999, but there is no doubt that the rally truly kicked off in 2004, following an unexpected surge in global demand. A year of supply-side woes followed, due to slowing Russian production growth and the hurricane damage from Rita and Katrina.

The year 2006 was a year of dramatic inventory shifts. The 33mb rise in OECD total oil stocks in September was more than reversed by a 40mb stock draw in October, despite exceptionally mild weather in Europe at the start of the fourth quarter and relatively normal weather in the US. To this, we can add November's near 20mb draw on US stocks, a 3.7mb fall in Japanese inventories and a decline in independent storage in northwest Europe.

Heavy and protracted refinery maintenance in the US resulted in a sharp decline in product inventories, but the accompanying fall in global crude production appears to have dampened the usual offsetting rise in crude stocks. Admittedly, some of October's

primary inventory draw may have been exaggerated by consumer and wholesale restocking but the draws would appear to confirm recent trends in the primary balance.

Global uncertainty

There is considerable uncertainty over the levels of supply and demand over coming months. Global GDP, Iraqi and Nigerian output, and OPEC discipline are all unpredictable. But it is still a useful exercise to try to estimate the impact of recent changes in OPEC output on future stock levels. Figure 1 shows the cumulative stock change implied by three scenarios for OPEC production, based on:

- September OPEC production and the current 'call on OPEC and stock change' (call) (light blue)
- November OPEC production and the call (dark blue)
- November OPEC production and the call, plus an adjustment for statistical difference (green)

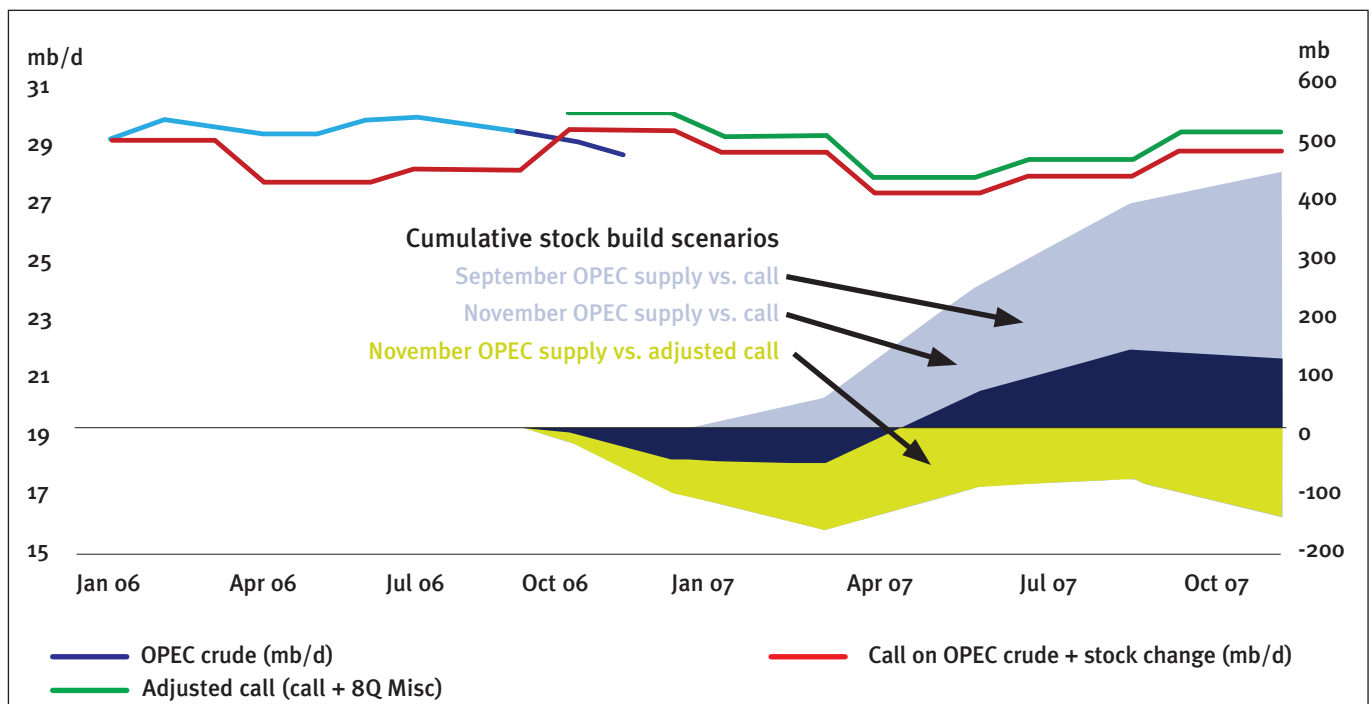
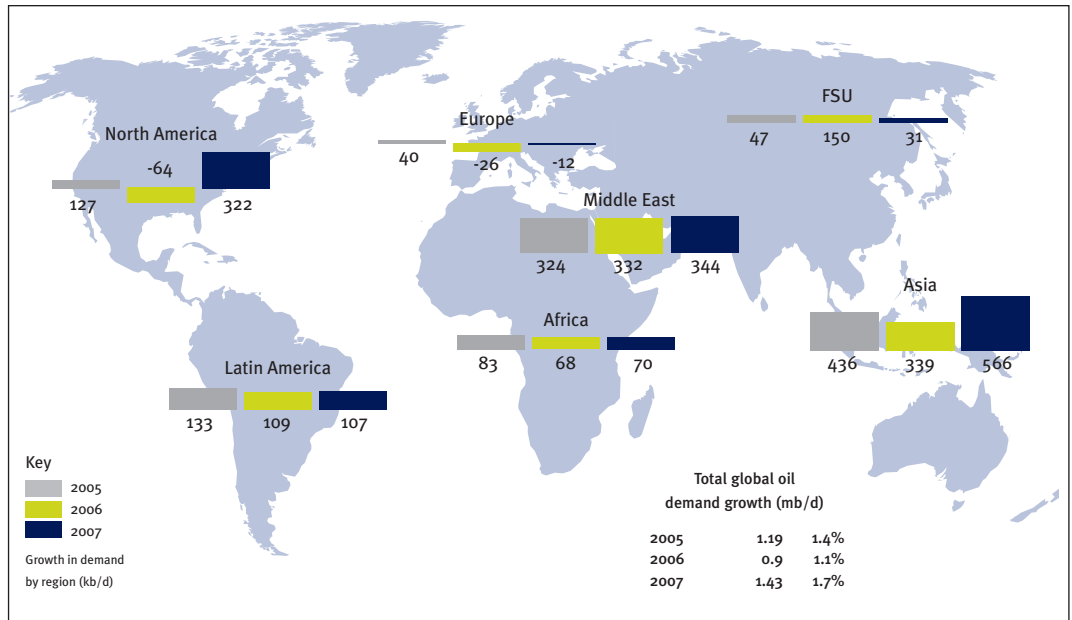


Figure 1. Potential cumulative OECD stock impact of OPEC action.

Figure 2. Global oil demand growth for 2005–07.

The light blue area shows the outcome had September production been maintained. The dark blue and green areas represent the cumulative stock build/draw implied by the current OPEC cuts, based (respectively) on the call and the call together with an adjustment for the miscellaneous-to-balance. Although the miscellaneous-to-balance could represent either under-reported demand, over-reported supply or unreported stock builds, including it in the calculation shows a more realistic range of outcomes. It could be argued that a further adjustment should be made for known risks to non-OPEC supply, which can average 300–400kb/d, but for now we feel that there are offsetting downside risks to global GDP, and thus oil demand growth.



Without doubt, November’s output cuts could tighten the oil market this winter, and offer little prospect, allowing for demand growth, of a recovery in stock cover above the current 54 days – cold comfort for a risk-prone global economy already facing another winter with high oil prices.

Global demand

Global oil product demand growth remained unchanged at +1.1% in 2006 (84.5mb/d) and +1.7% in 2007 (85.9mb/d), as minor downward adjustments in OECD countries were offset by upward revisions in non-OECD countries. The 2007 forecast, though, faces downside risks, given uncertainties surrounding the US economy.

OECD oil product demand projections have been more or less maintained at 49.4mb/d in 2006 and 49.6mb/d in 2007. Support from strong US demand continues, even after accounting for last year’s hurricane-affected baseline. OECD Europe and the Pacific, meanwhile, will likely continue to see a gradual fall in demand.

Non-OECD oil product demand was also unchanged at 35.1mb/d in 2006 and 36.3mb/d in 2007, despite a slight downward adjustment in China’s oil product demand growth rate for 2006 (from 6.2% to 5.6% annually). This revision is related to the country’s relatively lower apparent demand growth over the past three months, possibly due to the drawdown of stocks. This could justify revising Chinese demand upwards in 2007, but the IEA is waiting for confirmation of the stock hypothesis.

Worldwide overview

The IEA has kept unchanged its global growth forecast for 2006 (+1.1% to 84.5mb/d) and 2007 (+1.7% to 85.9mb/d), as

	1Q05	2Q05	3Q05	4Q05	2005	1Q06	2Q06	3Q06	4Q06	2006	1Q07	2Q07	3Q07	4Q07	2007
Demand (mb/d)	84.5	82.4	83.3	84.1	83.6	84.8	83.0	83.9	86.2	84.5	86.3	84.5	85.5	87.5	85.9
Annual change (%)	2.7	1.6	1.6	0.1	1.4	0.3	0.7	0.8	2.5	1.1	1.7	1.7	1.9	1.5	1.7
Annual change (mb/d)	2.2	1.3	1.3	0.0	1.2	0.3	0.6	0.7	2.1	0.9	1.5	1.4	1.6	1.3	1.4
Changes from last month’s report (mb/d)	-	-	-	-	-	0.0	0.0	0.1	-0.1	-	-0.1	0.0	0.1	-0.1	0.0

Table 1. Global oil demand for 2005–07.

	Demand		Annual change			Annual change (%)		
	2006	2007	2005	2006	2007	2005	2006	2007
North America	25.44	25.76	0.13	-0.06	0.32	0.5	-0.3	1.3
Europe	16.20	16.19	0.04	-0.03	-0.01	0.2	-0.2	-0.1
OECD Pacific	8.47	8.44	0.10	-0.12	-0.03	1.2	-1.4	-0.3
China	6.98	7.35	0.18	0.37	0.38	2.8	5.6	5.4
Other Asia	8.87	9.08	0.16	0.09	0.22	1.8	1.0	2.4
Subtotal Asia	24.32	24.87	0.44	0.34	0.57	1.9	1.4	2.3
FSU	3.95	3.99	0.05	0.15	0.03	1.3	4.0	0.8
Middle East	6.45	6.80	0.32	0.33	0.35	5.6	5.4	5.4
Africa	2.94	3.01	0.08	0.07	0.07	3.0	2.4	2.4
Latin America	5.20	5.31	0.13	0.11	0.11	2.7	2.1	2.1
World	84.89	85.93	1.19	0.91	1.43	1.4	1.1	1.7

Table 2. Global oil demand (mb/d) by region for 2005–07.

and OPEC crude availability. A yearly comparison shows 3Q06 global output 1.3mb/d above disrupted year-ago levels.

Non-OPEC supply estimates have been revised down by 40kb/d for 2006 and by 115kb/d for 2007. Next year's adjustments are focused in the 1Q–3Q period, when Australia, Russia, Brazil, Sudan, Egypt and Mauritania now appear headed for lower than previously expected output. A partial offset comes from higher expectations for North America and China. All told, non-OPEC supply rose by 650kb/d in 2006 (constrained by weak 2Q performance) and could rise by 1.7mb/d

downward adjustments in OECD countries were largely offset by upward revisions in the rest of the world.

There is, however, a big question mark over US economic growth prospects in 2007, which could have a powerful influence on the oil market. Although most observers concur that economic activity is slowing, the jury is still out regarding the magnitude and timing of the slowdown, amid a host of contradictory signals.

As a result, the IEA has decided to continue to base its forecast on the IMF's US GDP projection for 2007 (+2.9%, compared with an emerging current consensus of 2.5%), but it will review this figure. Moreover, it can be argued that slower US economic expansion will not translate into much lower domestic oil demand next year. US citizens are likely to maintain their driving and flying habits in the short term.

The oil price fall after last summer's highs encouraged the marginal substitution of hitherto cheaper natural gas with naphtha and fuel oil in the US. However, this effect has diminished following the rebound in oil prices over the past month. As a result, demand for the heavy end of the barrel has resumed its long-term downward trend.

Supply picture

World oil supply slipped by 50kb/d in November to 85.4mb/d, with lower OPEC crude supply outstripping an OECD-inspired rise from non-OPEC. August and September production estimates have been revised down by close to 90kb/d, based on a lower baseline for non-OPEC Africa and the North Sea. October supply has been revised up by 120kb/d, on the strength of higher FSU

d in 2007, reaching 52.6mb/d. OPEC NGL supply growth is expected to remain unchanged at 0.2mb/d both years, averaging 4.7mb/d and 4.9mb/d respectively for 2006 and 2007.

Total OPEC crude supply fell by 555kb/d in November, after a 225kb/d reduction in October. November supply averaged 28.9mb/d, after substantial reductions from Saudi Arabia, the UAE, Venezuela and Iran. There were ongoing disruptions to supply from Iraq and Nigeria.

OPEC-10 (excluding Iraq) output fell 500kb/d in November to 27.1mb/d. In all, OPEC-10 production is running 610kb/d below September, compared with a cut of 1.2mb/d pledged at the October OPEC meeting. Notional spare capacity reached 3.8mb/d, but effective spare capacity (excluding Iraq, Nigeria, Venezuela and Indonesia) rose only modestly to 2.4mb/d.

The call on OPEC is revised up by 0.1mb/d to 28.4mb/d for 2007, based on lower expectations for non-OPEC supply in the first three quarters of the year. The current quarter's call stands at 29.8mb/d, nearly 1mb/d above prevailing OPEC supply, suggesting the potential for a substantial 4Q stock draw unless winter weather proves markedly milder than normal. Similarly, the 1Q07 call stands marginally above recent OPEC output, at 29.0mb/d. ●

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