PORTLAND MARKET REPORT

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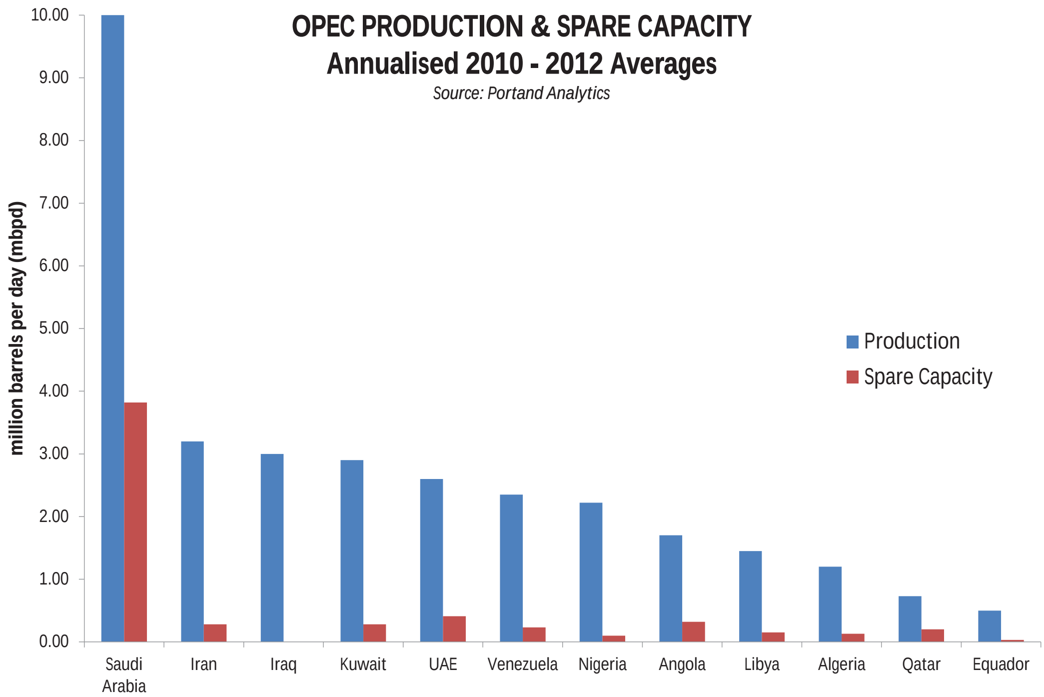
February update

World oil supply was on a knife edge in 2012

When the Libyan crisis hit, back in 2011, OPEC reluctantly released stocks to meet the supply shortfall. In reality, this was not an OPEC action, but a Saudi action, with the latter being the only OPEC member with sufficient spare capacity to actually meet production shortfalls (see attached graph). Releasing Saudi's spare capacity to address the Libyan crisis, drained the world's only significant crude reserve to empty. So in this light, it's fair to say that world supply was on a knife-edge throughout 2012, with no immediate spare crude capacity being available. Now even casual market observers will be aware that fear of shortages is one of the main drivers behind price rises - think endless petrol station chaos following the government's instruction to fill up our jerry cans. Factor that up many times and you have the situation in 2012, with the big strategic buyers (notably the Chinese National Reserve) pushing prices up, as they purchased excessive quantities of oil "just in case".



Does 2013 promise to be a more price friendly year?

The good news is that when it comes to reserves, 2013 actually looks likely to be a more price friendly year. As Libyan production came back on stream, so excess Saudi capacity was taken off the market and went back into building up their reserve to pre-2011 levels. And with ample capacity back in the system, the world should breathe a sigh of relief and pressure on prices can ease. An immediate consequence of any price falls however, will be a return to the historical OPEC divisions around production and price - last seen in June 2011, when OPEC was asked by the Western economies to release more crude to fill the Libyan production void.

In simple terms, "hawkish" members such as Venezuela will immediately want to start tightening supply in an effort to push prices back up – this of course to enable the continuation of their extensive and expensive social infrastructure programmes. On the other side, we will have the price "doves" (Kuwait, Saudi), who are far more sanguine about prices falling and will only really start making noises, when prices start to drop below the $85 per barrel mark. Such a relaxed attitude from Saudi Arabia is largely borne out of its huge production capacity compared to other OPEC members (revisit attached graph), which allows them to rely on large volume production rather than high prices, to generate required revenues. Such a position actually makes Saudi Arabia rather unpopular within OPEC, as the Arabian Kingdom is the only cartel member who can really directly affect oil prices. Plus, when Saudi responds to Western requests to increase production, other OPEC members suffer a "double-whammy"; not only do prices fall, but Saudi's dominant position within the group is further accentuated.

Returning to the issue of reserves and irrespective of OPEC's internal wrangling, the increased availability of spare capacity will clearly take the heat out of the market. But at the same time, Portland sees little chance of prices dropping. For one, the easing of Iranian sanctions (and consequent release of significant volume) seems highly unlikely at the present time and more importantly, there is no getting away from the fact that demand for oil in 2013 will again increase (by about 4%). So if anything, expect a repeat of 2012; prices will remain high, but there seem few clear reasons why they should become any higher.

For more pricing information, see page 26

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