

ARE HIGH OIL PRICES HERE TO STAY?

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Principal Objectives/Question: (Posed early this year)

- Is the unexpectedly high price of oil likely to be long-lasting? Structural or Cyclical?
- That is: Is the ‘Sellers’ Market’ –last seen in the 70s – likely to endure this time?
- IF so: What are some likely, major implications.

Appeared to be Structural

- Demand increase starting in mid-2004 *was* generally *unanticipated*: US/ China/India...
- Excess Supply cushion – mainly in S. Arabia – shrank rapidly;
- Refinery shortages (esp. of “right” kind”) pressured products &, in-turn, crude; &
- Concern grew about sufficiency of *longer-term crude capacity cushion/ refinery cap.*

A Result of D growth/ S Constraints

- Crude Oil Price Skyrocketed : (WTI, \$/bbl):

2003	\$31.1		
2004	\$41.4 (+\$10)		
2005 (to mid-Sep):	About \$54.5 (+\$13)		
- As did consensus, Oil Price Projections (Rtrs):

	2005	2006	2010
As of 3/17/05:	\$44.9	\$39.9	na
As of 8/24/05:	54.0	50.5	na
As of 9/14/05:	53.8	50.4	42.2

What About the M-Term Outlk?

Main Assumptions:

- Global Growth: About 3% (Like many other studies)
- With Continued relatively Strong Growth and Structural Chg. In China, India...
- Absence of Strong Energy Reform in the US/other OECD (w/r Cons., Alternatives) &
- Transport Sector = Major user of oil.

What About the M-Term Outlk?

Two Cases *:

- **Base Case:** Global Demand Growth = **2.5%**
- **Alternate Case:** Global Demand Growth = (“only”) **2.0% p.a.** due stronger price effect and/or weaker income effect

* (NOTE: Recent Demand Growth, 2000-05 = **2.3%**)

Oil Market Supply: Base Case, 2005-2015 (As of 4/'05)

	2000	2005	2010 (capac.)	2015 (capac.)
Opec Crude	27.8	30.0	38.3	47.2
(Saudi Arabia)	8.3	9.3	12.3	15.0
(Other Opec)	19.5	20.7	26.0	45.7
Non-O	45.3	50.8	52.2	53.9

Oil Market Balance: Base Case

(As of 4/'05)

(m b/d)	2005	2010	2015	05-15 (% /yr)
Glob D <i>(00-05)</i>	84.8	95.7	107.5	2.5% <i>(2.3%)</i>
N-OpS	50.9	52.1	53.7	0.6%
Opec Other	4.7	5.8	6.7	4.3%
Call on Opec	29.2	37.9	47.1	6.1%

Base Case, 2005-15, cont'd

(m b/d)	2005 e	2010	2015	05-15 (% /yr)
Opec Crude	30.0	37.9	47.1	5.7%
Opec Capac.	32.0	38.3	47.2	4.6%
<i>Excess Capac.</i>	2.0	0.4	0.1	-----
<i>% of Glob D</i>	<i>2.4</i>	<i>0.4%</i>	<i>0.1%</i>	-----

Base Case Implies?

- Sellers' Market *Will* Endure: Excess Capacity remains very uncomfortable & oil refinery shortfalls combine to underpin oil prices over the M-T.
- Does not imply the oil price will stick at \$60 + but : No Mean reversion to \$20s &
- Oil price could easily average \$40 + over M-T.

But: What If Demand/ Growth Is
Weaker?

The Alternative M-T Case:

Alternate Case: Slower Demand

(As of 4/'05)

(m b/d)	2005	2010	2015	05-15 (% /yr)
Glob D <i>(00-05)</i>	84.8	93.4	102.1	2.0% <i>(2.3%)</i>
N-OpS	50.9	52.1	53.7	0.6%
Opec Other	4.7	5.5	6.5	1.8%
Call on Opec	29.2	35.8	41.9	4.3%

Alternate Case, cont'd

(m b/d)	2005	2010	2015	05-15 (% /yr)
Opec Crude	30.0	35.8	41.9	4.0%
Opec Capac.	32.3	38.3	47.2	4.6%
<i>Excess Capac.</i>	2.0	2.5	5.2	-----
<i>% of Glob D</i>	2.4%	2.7%	5.1%	-----

Alternative Case Suggests:

- Excess Capacity Still Constrained Thru 2010 but eases between 2010 & 2015;
- Implying that the Oil Price Could Remain Strong thru 2010 ; but
- Be subject to downward pressure between 2010 and 2015:
- True: But ONLY if Opec (Saudi) Behavior remains unchanged = NOT likely!

Continued M-T Oil Price Pressure Likely

- The Base Case points unequivocally to a cont'd, relatively high oil price *trend*:
- Strong demand growth (barring deep recession) ;
- Persistent supply restraints: Non-Opec production growth slowing; and
- Refinery capacity constraints

Pressure Likely Even Under Alternate Case

- Main Reason: If Demand Weakens more sharply or Non-Opec Supply increases more rapidly:
- Opec – especially S. Arabia – will be closely monitoring developments and would likely slow capacity expansion to limit oil price erosion:
- ‘Ideal’ oil price lifted sharply (since 9/11)

Ideal Opec (Saudi) Price Objective:

- *Much Higher* “now” due Revenue Needs:
 - Rising For: Economic, Socio/political & Military/defense needs, esp. post ‘9/11’.
- Plus:*
- Arguably: Less Concern about L-T Demand “*Destruction*” and/or
 - Non-Opec Supply *Competition!*

Implications of Higher Oil Prices

If becomes dominant view among IOCs, NOCs, and oil service companies & if

- “Hurdle”/Mid-cycle/Planning Price assumptions are also raised :

Likely to see:

- Increased E + D/P (already evident);
- More M&A Activity?
- More Intense Competition /More Jt. Ventures; *But*
- Less Share Buy Backs? D. Paym'ts ?

E & D/P Budgets Increasing?

- Based on surveys, development budgets have been revised upward in 2004 and 2005 by (a) Opec (sharp rise in drilling activity); (b) majors and independents; (c) in the North Sea; and by (d) NOCs in consuming countries BUT not V. Sharp:
- Global E&P Spending, 2005 (\$ bn.):
- Lehman Bros (6/05): \$192, up 13.4% vs. 5.7%, 6-months earlier & Citigroup: + 13.2%. *

* Source: EI, IPF, July 2005.

Will E & D/P Budget Increase Accelerate?

- Further acceleration this year and beyond depends on:
 - (a) Price expectations: Are producers and companies increasingly convinced higher oil prices are ‘here to stay’?
 - (b) Will hurdle/planning prices be raised accordingly? Signs = *some* are being lifted;
 - (c) Will “all-in” costs continue their sharp upward trend esp. since 2004: Drilling rig, manpower shortages & skyrocketing costs.

What About M & A Activity?

Yes: Since 2003 (*PIW*, 9/12/05):

WW Total (\$ bn.)	Value of Reserves	Implied \$/boe
2004	\$ 57.52	\$ 2.80
2003	\$ 42.86	\$ 4.81
2002	\$ 37.30	\$ 3.18
2001	\$ 63.3	\$ 4.09

What About Share B.Bs / Dividend P.Os.?

- Spending by Majors on Buying Back shares still in the \$ billions despite (a) record prices and (b) criticism for not raising E + D more rapidly.
- Will buy backs slow *relatively* over M-Term?
- Depends: On expected oil price path; E+D opportunities/costs: Will it continue to be cheaper/easier to BUY assets rather than explore for them ??

Conclusion

- Higher Oil Prices Are Very Likely Here To Stay!
- Hard to be Precise About How High for How Long: \$40-50 (ave.) to 2015+ likely
- There will be no “Mean Reversion” to the \$20/bbl of the 1990s, even IF Global Growth slows substantially for a time.
- The Effect Higher Prices = Time Will Tell!

It Has Been A Pleasure!

Thank You For Your Attention

S. Ghalib (9/20/05)