ANOTHER OIL PRICE SPIKE?

In August 2002, crude oil prices surged, with West Texas Intermediate closing at over $30 per barrel for the first time since February 2001. According to the International Energy Agency's September *Oil Market Report*, lower Iraqi exports, North Sea maintenance and a reduction in Former Soviet Union crude exports constrained supply in August to 76.1 million barrels per day, down 580 thousand barrels per day from July. As the *Economist* reported, the reasons for the recent decline in Iraqi oil exports was not due to intentionally introduced volatility, but rather to a UN crack-down on a scheme under which Mr. Hussein was directly paid a surcharge by middlemen. Now buyers must commit to a shipment before knowing which price the UN has imposed. This stamps out the surcharge, but also discourages many buyers.

Not only lower supply, but primarily talk about war with Iraq has pushed up oil prices. According to Cambridge Energy Research Associates, the "fear premium" on each barrel of oil is now $3–5. As war becomes an ever greater risk, prices are bound to go still higher. During the Gulf war oil prices peaked at over $40/b in nominal terms. Rumours of war will also have been in the minds of the OPEC ministers' meeting in Osaka, Japan.

Yet, they decided to leave official supply limits unchanged at 21.7 mb/d, pointing to the existing OPEC formula under which prices staying above $28 for the basket, equivalent to about $30.50 for US crude, for 20 consecutive trading days would trigger more oil production.

They will decide on future OPEC output. Non-OPEC supply is projected to rise by 1.2 mb/d in 2002 and 700 kb/d in 2003. Global oil demand, which at 75.9 mb/d fell short of total oil supply of 76.9 mb/d in 2001, was forecast to rise to 76.1 mb/d in 2002 and 77.3 mb/d in 2003. These IEA forecasts have not factored in a war with Iraq and its economic consequences on oil consumers and producers. The short-term oil price may well go above $50/b.

The long-term outlook for oil prices is more modest, around $22-24 in today's prices, according to Boston Consulting. Proven oil reserves are believed to be sufficient to satisfy projected demand for the next two decades. By 2020, oil production, as projected in the IEA's *World Energy Outlook 2000*, will reach 115 mb/d or 40% of the world's total energy supply. Over the next two decades, most of the expected demand growth will come from the transport sector, where the potential for replacing oil with another fuel is still limited. Global oil production need not peak in the next two decades if necessary investments are made. Middle East oil producers have a challenge to exploit their low-cost oil resources, but their ability to mobilise capital is uncertain. Their production and investment will closely depend on their pricing policies. As the *World Energy Model* has shown, neither very high nor very low oil prices would improve cumulative revenues for the major producers over what they can earn under moderate-price conditions.

H.C.S.

LONDON BRENT CRUDE OIL PRICE - US$/BARREL

Source: Datastream and daily newspaper.