

Energy Monitor July

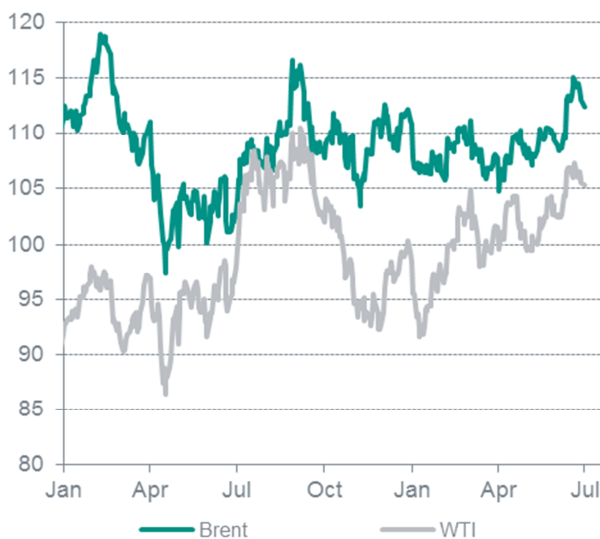
Oil: market development and risks

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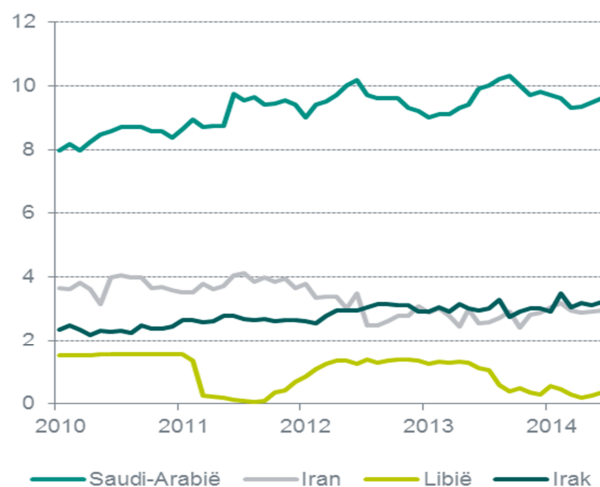
- Iraq crisis has limited impact on oil prices
- Stable to moderate decline in oil prices expected...
- ... but the risk of higher oil prices increased

Figure 1: Price of Brent crude versus WTI crude since Jan 2013 (in USD/bbl)



Source: ABN AMRO Group Economics, Thomson Reuters

Figure 2: Oil production of selected OPEC countries (x mb/d)



Source: Pira Energy Group, ABN AMRO Group Economics

Current situation surrounding oil from Iraq

In the space of just a few weeks the rebel group known as ISIS (The Islamic State in Iraq and Syria, also known as ISIL or The Islamic State in Iraq and the Levant) has occupied a large part of northwest Iraq. Iraq is OPEC's second largest oil producer, after Saudi Arabia, and produces about 10% of the daily quantity of OPEC oil. The abrupt, rapid and, above all, unexpected advance of the rebels has fuelled mounting fears that oil production and oil exports from Iraq will be affected. Nonetheless, the impact on oil prices will be limited for the time being to an increase of just a few dollars. There are various reasons for this. First, the region captured and currently controlled by ISIS lies in the northwest of Iraq. Oil production in this region had already come to a standstill a few months ago following an earlier attack. At present, oil exports are coming from Basra in the southeast of Iraq on the Persian Gulf. Since the unrest increased in mid-June, oil production and exports have continued unabated in the south of Iraq. Indeed, production in May and June was at its highest level in more than ten years.

Another reason is the general expectation that the predominantly Sunni rebel movement will encounter much more resistance once it tries to occupy areas controlled by either the Kurds or the Shias. So there is less chance of this. Nor is it clear whether ISIS is even out to occupy the oilfields in the south of the country. After all, ISIS is fighting to establish a caliphate¹ and not necessarily to conquer Iraq. It is at most the financial inducements of control of the oilfields that might prompt ISIS to press on into the south of Iraq.

The last reason is that neighbouring oil producers (other OPEC countries) and the international community (especially the United States) will not simply stand idly by and allow ISIS to gain control of the capital Baghdad and the large oilfields in the south. Although the capture of Baghdad by ISIS would not have an immediate impact on oil production, it might trigger increased market unrest.

Although the risk of a possible effect on oil production and exports has increased slightly, the market does not as yet think (for the reasons set out above) that there is much chance of oil exports coming to a complete standstill. Moreover, the market is aware that if oil production in Iraq is reduced, the shortfall can, in principle, be offset by additional oil production in other OPEC countries, in particular Saudi Arabia. Although it would be difficult to immediately make up for Iraq's complete oil production (around 2.6 mb/d), OPEC has itself indicated that it is capable of doing this. However, this would absorb almost all the spare capacity (i.e. the oil production capacity that can be brought on line within 30 days). Lower production from Libya, Nigeria and

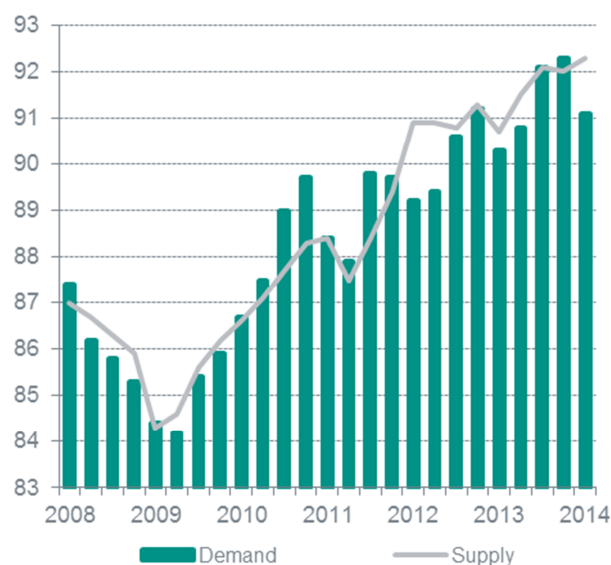
¹ A caliphate is a state governed by a supreme religious and political leader, known as a caliph, i.e. a successor to the prophet Mohammed. This caliphate should extend from eastern Syria into western Iraq and should be known as The Islamic State. The ISIS leader has been proclaimed caliph.

Iran has already been largely made good at the expense of OPEC's spare capacity. The rest of the shortfall has been offset by higher oil production in the United States and Canada. A further reduction in the spare capacity would expose the market more quickly to fresh disasters. This could push up the risk premium, and result in higher oil prices.

Iraq as a major factor in the future

Iraq accounts for 'only' 3% of global oil production, which is over 90 million barrels a day (mb/d). Nonetheless, its role in oil production in the future will be crucial. In the years ahead global demand for oil will continue to increase, driven mainly by higher demand from Asia. In principle, it should be possible to meet this increased demand for oil relatively easily. A contribution could and should be made by higher production in the US, Canada and Iran and restored production in countries such as Nigeria, Libya and Syria. Much of the higher demand for oil should, however, be met by higher production in Iraq, which previously announced its aim of almost tripling oil production. The present crisis may impact the investment needed to raise or even maintain oil production and can therefore pose a threat to the required level of production in the future.

Figure 3: Global oil demand and supply (x mb/d)



Source: International Energy Agency (IEA), ABN AMRO Group Economics

Basic scenario: oil prices to remain stable or fall slightly

Despite the increased risks, our basic scenario (which focuses on the next two years) envisages a situation in which oil prices remain stable or fall slightly. This scenario assumes that the supply of oil will remain sufficient in the years ahead. Although global demand for oil is increasing, this is at a very moderate pace and is driven mainly by demand from Asia. This moderate increase in demand for oil can be satisfied from the rapidly increasing level of oil production in non-OPEC countries such as the United States and Canada. Moreover, the present (almost structural) decline in oil production (in Libya, Nigeria, Syria and Iran) of some 3 mb/d is being offset without difficulty and is causing scarcely any unrest, volatility or oil shortages. What's more, according to the International Energy Agency (IEA) there has been overcapacity since early 2012 (figure 3). This overcapacity and our expectation that the US dollar will stage a recovery are the main factors underlying our basic scenario, namely that oil prices will fall slightly and move towards the lower end of the USD 100-120/bbl trading range. Even within our basic scenario, however, it is not inconceivable that Brent crude could reach USD 120/bbl, including possible temporary upward outliers, for example if tensions continue to mount in Iraq. History shows that at a level above USD 120/bbl, intervention is likely by either the IEA (strategic reserves) and/or Saudi Arabia (OPEC).

In view of the low rate of inflation (whether or not helped by subsidies and grants) and improvements in global growth, the economy is evidently able to cope with a high oil price, provided that it is not unduly volatile. And that is the case. Since mid-2012 the price of Brent crude has moved within the relatively narrow trading range of approximately USD 100-120/bbl. Oil price volatility recently reached its lowest level ever, before rising slightly as a consequence of the crisis in Iraq. Clearly, oil prices now face greater upward than downward risks.

Increased risks

A risk scenario that has become more prominent following the recent events in Iraq is structurally higher oil prices. Such a scenario would become reality if the price of Brent crude were to rise above USD 130/bbl and remain there over a prolonged period. Such a situation might have a significant impact on the economy. After all, higher oil prices result in

Table 1: Upward and downward potential of oil prices

Upward potential	Unrest in the Middle East continues or even increases. This can be in the major oil producing countries or the spill-over risk from nearby countries
	New calamity increases worries about production and spare capacity (driven by weather conditions, terrorism, market sentiment, etc.)
	Economic recovery sets in at a faster pace than forecast, triggering high demand
Downward potential	Economic data disappoint, hurting global economic growth and prompting a downward revision in the oil demand outlook in some regions
	Production is higher than forecast, resulting in ample supply to meet the expected rise in demand
	A rising USD and higher yields create a less interesting investment case for commodities

Source: ABN AMRO Group Economics

transfers of capital from oil consumers to oil producers. In our view, one or more of the following factors could result in structurally higher oil prices:

- Disruptions to oil production in Iraq over a longer period cause the IEA to release strategic reserves and/or OPEC (Saudi Arabia) to increase production at the expense of spare capacity.
- The investment needed to ensure that Iraqi oil production is increased in the longer term fails to materialise as a consequence of the crisis.
- Oil production in / exports from other OPEC countries (in particular Libya, Iran and Nigeria) remains blocked for a longer period, in combination with fresh disruptions to production.
- Extreme weather unexpectedly reduces oil production over a longer period.
- Oil production in the United States and Canada peaks much earlier than expected and/or expectations concerning oil production growth are not achieved in the years ahead.
- Economic growth increases much faster than expected, not only in Asia, but also in the United States and Europe.
- Another disaster disrupts supply of or demand for oil over a longer period.

Nonetheless, the downward risks should not be ignored either, particularly if geopolitical tensions unexpectedly decrease rapidly and demand for oil lags behind the forecasts owing to low economic growth.

Oil price forecast and outturn for H1 2014

The first week of July is the right time for reviewing the first six months of 2014. In the January edition of the Energy Monitor we indicated that OPEC oil production was under pressure, particularly as a result of declines in production in Libya, Iraq and Saudi Arabia. The relevant passage reads: "There is still ample supply, even despite production disruptions in the most important oil-producing region. This is one of the reasons that oil prices did not balloon, in combination with increased output in non-OPEC regions. On the other hand, tensions in oil-producing countries – or in countries that are in the vicinity of major oil producing countries and therefore pose the risk of a spill-over – kept risk premiums high and prevent Brent prices from dropping significantly below USD 100/bbl. Hopes are building that additional production will come back to the market in the course of 2014. Negotiations with Iran look promising and may eventually result in an easing of the sanctions. Also the possibility of a return of Iraqi and Libyan oil paves the way for lower oil prices this year, even if Saudi Arabia were to cut back its production. After all, a cut in Saudi output increases its spare capacity, which may be called upon again in case of (renewed) escalation of tensions or new production disruptions. Overall, there currently is no reason to expect significant oil price rallies based on production disruptions in the Middle East." On the basis of this assumption and our expectations that demand for oil would rise only moderately (due to the economic recovery in the US and Europe) and that the US dollar would appreciate, we expected oil prices to fall to the lower end of the USD 100-120/bbl trading range mentioned previously.

Today, six months on, it appears that the average price of Brent crude was USD 107.87/bbl and USD 108.82/bbl in the first and second quarters respectively. Our forecast of the oil price was therefore too low. There are two main reasons for this, both of which are connected with production disruptions. First, oil production in Libya has still not resumed, despite the earlier promising signs. Libyan oil production fell from over 1.5 mb/d in January 2011 (during the Arab Spring) to almost zero, before recovering to 1.4 mb/d in the course of 2012. The return of the unrest after the summer of 2013 resulted in a corresponding fall in oil production (figure 2). Oil

Table 2: ABN AMRO oil and gas price forecast (oil prices in USD/barrel, gas prices in USD/mmBtu)

Price	Q3 2014	Q4 2014	Q1 2015	2014*	2015*
Brent	100	100	100	100	95
WTI	95	95	95	95	90
NG **	4.50	4.75	5.00	4.50	4.75

Source: ABN AMRO Group Economics

* year average ** Natural Gas Henry Hub

(Please see our Quarterly Commodity Outlook for details of our long-term forecast)

Figure 4: Prices in EUR/USD since 2010

Source: ABN AMRO Group Economics, Thomson Reuters

production in Libya is at present fluctuating at around 0.2 mb/d, leaving a structural shortfall of 1.3 mb/d compared with the original oil production capacity.

The second reason is the recent events in Iraq, as already described in this report. As these events may impact the spare capacity of Saudi Arabia / OPEC, this is pushing up the risk premium and has prevented the expected decline in oil prices.

A third reason is the US dollar, which, contrary to our previous expectations, has not appreciated (figure 4). [Click here](#) to view our most recent economic projections, including our forecast of the EUR/USD exchange rate. This will tend to support commodities, including oil. In our new *Quarterly Commodity Outlook Q3*, which will be released at the end of July, we will take a fresh look at our oil price forecasts and, if necessary, adjust them in line with the new expectations concerning macroeconomic drivers and estimates of geopolitical developments.