

Executive Briefing Book



What is the outlook for global oil in 2012?

Global/Oil Markets

An oil supply surplus is at risk from geopolitical shocks, especially in the Persian Gulf.

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Key Judgments

- Rising tensions in the Persian Gulf and Iran's threat to close the Strait of Hormuz cloud the outlook for 2012, raising the specter of a sharp spike in oil prices.
- Global demand growth may recover modestly this year, with China importing more oil, in part to replenish stocks, but EU demand will again contract tightly.
- On the supply side, Libya and Iraq have the potential to raise output, while strong growth in North America's unconventional oil will also contribute to a global market surplus.
- However, Iran is not the only geopolitical shock that could undermine these market fundamentals -- conflicts in Iraq and Nigeria are also potential threats to oil supply.
- With Libya's return to the market, Saudi Arabia will continue to ease back production -- especially now that the kingdom's budget requires an oil price of \$100 per barrel.
- The Brent futures market is signaling optimism about Iran and the eurozone, which is a key to oil demand and prices, but it may under-estimate the severity of both crises.

Analysis

Oil prices have had a relatively strong start to the year, largely reflecting saber-rattling in the Persian Gulf and an escalation of Islamist militancy in Nigeria. A high political risk premium is expected to keep prices at elevated levels at least in the first quarter of 2012. Later, however, if fears of major supply disruption retreat, fundamentals should reassert themselves and drive prices somewhat lower.



USS Lincoln enters the Persian Gulf, pressuring Iran

The market is expected to move into surplus this year owing to a sizeable contraction in EU consumption at a time of rising supply from Libya and Iraq, and also from North America, primarily in

the form of unconventional crude. However, some restocking, particularly in Asia, and loose global monetary conditions will support prices through the second and third quarters. By the end of the

year, prices may well start to move higher again — reaching a range of \$100-\$110 per barrel.

Key assumptions informing this forecast include the view that the eurozone averts a breakup and that prolonged disruption to global oil supplies as a result of geopolitical events will also be avoided.

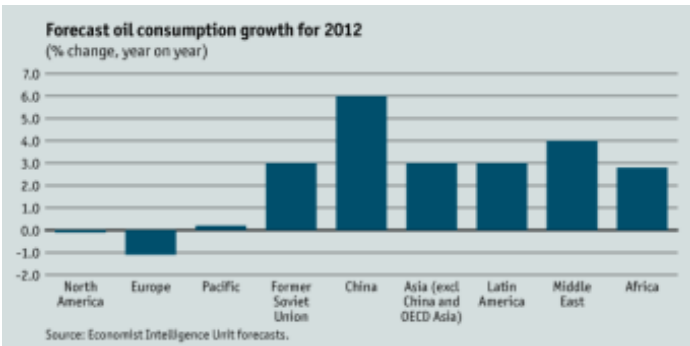
Will demand strengthen this year?

After a marked slowdown in global oil demand growth in 2011, perhaps to barely 1%, a modest improvement of 1.7% growth is likely in 2012. The global picture is, however, very mixed.

OECD. Developed-country consumption is expected to fall in 2012, but this will be almost entirely the result of another sharp contraction in **EU** demand, as the region enters recession and fiscal austerity hits disposable incomes. Ongoing efforts at conservation will also curb EU demand. In the **United States**, demand is expected to slip slightly, in part the result of efficiency gains but also subdued consumer sentiment. New domestic supplies of

natural gas, which are plentiful and relatively cheap, serve to further constrain US oil demand.

The long-term decline in **Japan's** oil demand has been arrested, temporarily, by the devastation caused by the March 2011 earthquake and the increased use of oil-powered generators to fill the gap left by nuclear output. In 2012 Japan's oil consumption is expected to grow modestly as the reconstruction effort will be energy-intensive, but by 2013 the decline in demand will resume.



China. Signs of weaker economic growth have prompted the government to start to relax monetary policy. Given that the transition to a 'fifth generation' of leaders begins this year, the authorities will be keen to support economic growth as well as ensure fuel and power availability. Furthermore, it appears that oil stocks were being drawn down in the second half of 2011, and some rebuilding is therefore expected in 2012, particularly if prices ease. As a result, China's oil demand should pick up, despite somewhat lower GDP growth.

Middle East oil consumption is set to accelerate, fueled by stronger regional growth (as economies that were hit by the Arab Spring start to recover), expansionary fiscal policies, and the persistence of retail fuel price subsidies. In Iran, sanctions will depress consumption by sharply reducing the import of refined products.

Demand growth in **Latin America** is expected to slip slightly, as economic expansion moderates in Brazil and Mexico.

How sufficient is supply?

Global crude oil output growth slowed in 2011, largely reflecting the loss of Libyan supply, but also production problems in the North Sea, Angola, Yemen and Azerbaijan. These losses were offset by increased

OPEC production, particularly from Saudi Arabia and Iraq. If Iraqi production continues to grow strongly in 2012, and if Libyan oil output is largely restored by the end of the year, OPEC output could expand by a brisk 6.5% this year, before slowing to a still-healthy 3.6% growth rate in 2013.



US shale oil adds to global surplus

Reports of strong growth in output of unconventional oil in North America — the tar sands in Canada and shale oil in the US — will give a lift to non-OPEC production. Furthermore, it appears that recent investment in North Sea fields could at least temper their long-term decline.

How great are the geopolitical risks?

There is a heightened probability of more marked disruption to supply in 2012 and, as a result, much higher oil prices, or at least a sharp spike in prices. Tensions between the West and Iran over its nuclear program have escalated and sanctions directed at oil in particular are set to intensify. Iran in turn has threatened to block the Strait of Hormuz, a key outlet for about one-fifth of global oil supplies and one-third of seaborne-traded oil, as well as large quantities of natural gas liquids (NGLs) and liquefied natural gas (LNG) from Qatar.



Spearhead of Iran's threat to close Hormuz

Iran can probably still find markets for its oil (especially in Asia) and attempting to close the strait would make little sense at this stage of the crisis. For Tehran, that logic would swiftly change if Israel were to attack its nuclear facilities.



Violence threatens Iraq's oil output targets

Elsewhere in the Middle East, security and political issues are once again becoming inflamed in Iraq, following the US military withdrawal. The oil-rich Kirkuk region, contested by Sunni Arabs and Kurds, is highly combustible.

Political stability is by no means assured in Libya, as a multiplicity of interest groups jostle for power, while the turmoil in Syria risks spreading a contagion of sectarianism across the region, with Lebanon especially vulnerable.

Two hotspots in Africa pose potential threats to oil supply:

- Mounting Islamist violence in Nigeria has exacerbated antagonism between the Muslim north and Christian south, and could even split the country asunder. However, the militants almost certainly lack the capability to extend their attacks as far south as the Delta oilfields. Nigerian oil output is therefore still likely to expand in 2012, primarily owing to growth in offshore production.
- The threat by South Sudan to shut down oil production, as part of an escalating quarrel with the North over transit dues, will hardly rattle global markets, but in the event of hostilities in the Persian Gulf, the loss of supply from any other quarter would serve to accentuate the price spike. Juba's announcement January 25 that it plans to build an export pipeline to Kenya will further inflame the dispute with Khartoum.

Will OPEC output rise this year?

According to officials at the Libyan National Oil Corporation (NOC), Libyan oil production was running at close to 1 million barrels per day (b/d) last month, with most of the large oilfields back on stream, though not producing at full capacity. The NOC expects output to reach 1.3 million b/d by end-2012, almost back to the pre-conflict level of 1.6 million b/d. However, setbacks are likely, as most Libyan fields are old and output had already been stagnating before the start of the conflict.

If Libya — critical to Europe in the event of a disruption

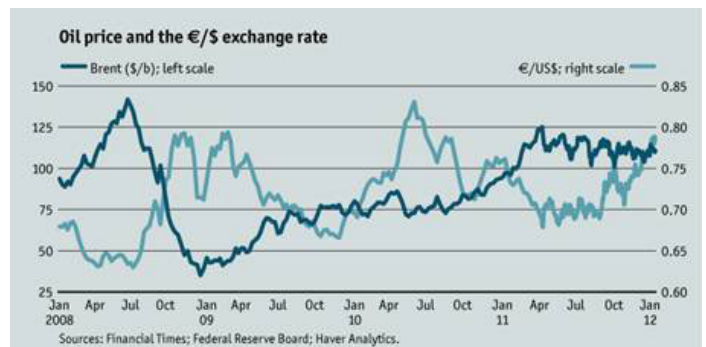
to supply from the Persian Gulf — is to counter a decline in output, it will need to ramp up the use of enhanced oil recovery techniques and begin developing new fields. In reality, Libya will probably produce an average 1.2 million b/d in 2012 and 1.5 million b/d in 2013 — still enough to significantly support this year's projected surplus in the global oil market.



Libya's oil revival still faces challenges

As Libyan oil returns to market, Saudi Arabia's production will continue to ease back from the highs recorded in mid-2011. Having spent lavishly on social programs in an effort to tranquilize a potentially restive population, the kingdom's rulers now have a vested interest in a \$100 per barrel price.

Iraq's oil output is poised to rise steadily in 2012, but progress will be more modest than official projections suggest, and much will depend on the security environment.



How healthy is non-OPEC production?

Non-OPEC production is expected to expand at an annual average rate of nearly 1.2% in 2012-13, boosted by the strong growth in unconventional oil output in North America. Russia's output surprised on the upside in 2011 as new capacity came on stream, particularly at the TNK-BP greenfields. However, this improvement will slow in 2012, reflecting financing and regulatory issues, as well as delays in bringing new fields into production.

Brazil will continue to boost output, but there are reports that its mature oilfields are declining more rapidly than envisaged, and this may curtail the overall growth in production in 2012. The rise in Colombia's output is steady. Bucking the Latin American trend is Mexico. Oil production there is expected to continue to fall in 2012 as a result of maturing fields and lack of new investment.

Outlook

Geopolitical crises — even and especially in the strategically vital Persian Gulf region — are nothing new to the global oil market. But this year, with acute tensions over Iran, fears of disruption to oil supplies are running unusually high. For oil producers, another major anxiety is that dissolution of the eurozone could trigger a sharp drop in demand, precipitating a plunge in oil prices and, hence, much-needed revenues.

The Brent futures market takes a sanguine position. Starting towards the end of last year, the market has moved to a near 'contango', meaning that future prices are progressively higher than current levels. What this signals is that traders and investors have discounted the geopolitical risks. They believe that any military hostilities in the Persian Gulf will be short and sharp, and that the eurozone will survive intact and embark on an economic recovery that will strengthen oil demand.

If the futures market is right, the longer-term risk to oil may once again become one of supply. The market may, though, be under-estimating this year's geopolitical threats. If so, Iran's retaliation against an attack could trigger an uncharted and lengthy spike in prices. Alternatively, though less plausibly, the breakup of the eurozone and the subsequent global impact could bring about a sustained collapse in oil prices.