

## Oil Prices: \$200+ or \$20- ?

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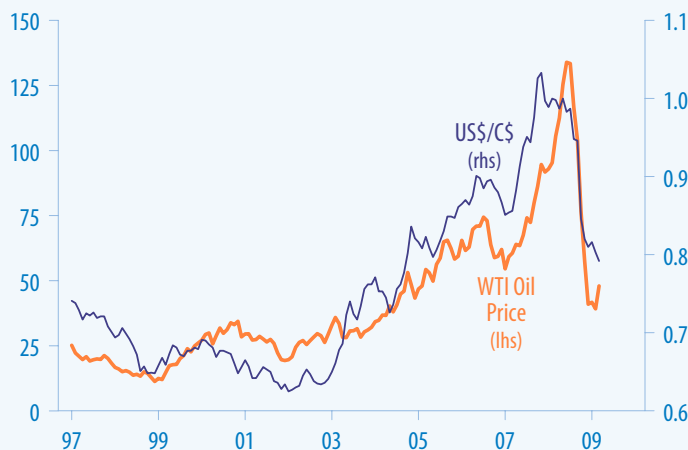
Whither oil prices? A critical question, given implications for the Canadian dollar (*Chart 1*), business capex, equities (energy accounts for almost 30% of the TSX), and the overall economy. Oil prices have resembled a roller-coaster during the past few years. Their sharp increase during the second half of 2007 and first half of 2008 popularized theories of *'peak oil' supply* and price predictions of \$200+, somewhat in a vacuum of what that might do to the global economy and, thus, the demand for oil. And now, symmetrically, the plunge in oil from its July 2008 peak of \$146 has surfaced comments about *'peak oil' demand* and talk that oil would decline to \$20 or below.

The deep, global recession has brought us a lot closer to the downside scenario, but neither of the extreme views would likely be sustained for long. The huge volatility in almost any tradable item in recent months could see prices break sharply lower from around \$50 currently. However, demand and supply fundamentals would not keep oil prices at barrel-bottom levels for very long. And, what counts is not where oil prices go for a few weeks, but their medium- to longer-term direction and level. On that score, it is instructive to look at market fundamentals such as inventories, demand, supply, and the cost of developing and producing new supply.

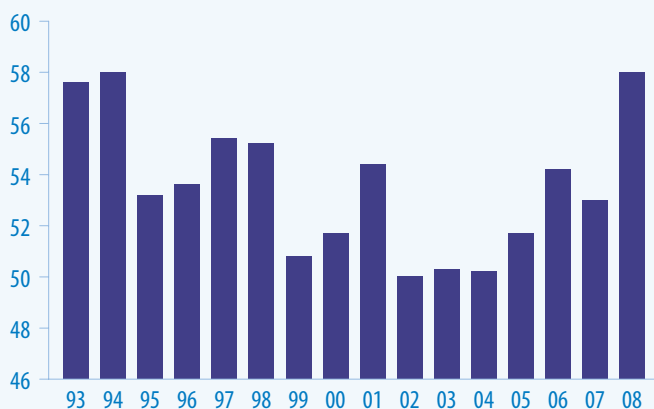
Global oil inventories are currently high (*Chart 2*), as demand fell faster than supply—initially, as consumers economized on fuel in the face of very high prices and subsequently as the recession took hold. Aside from the recession, the shift to a sharp contango—future prices exceeding current prices by much more than storage costs—has improved the economics of storing oil and selling forward. Non-government-owned OECD oil inventories stood at 2.7 billion barrels at the end of 2008, 5% higher than the average for the same period during the preceding five years. However, in terms of days of forward demand, OECD inventories reached 58 at the end of 2008, 12% higher than their five-year average. This partially reflects recession-reduced demand. The global excess of inventories may even be higher than these figures show, as exporters have hired tankers on which to load excess production, with no immediate destination.

Clearly, excess inventories and expectations of a deep, long recession have taken a toll on oil prices, currently running more than 50% below year-earlier levels. In 2008,

**CHART 1**  
**LOONIE TRACKS OIL PRICES**



**CHART 2**  
**OECD OIL INVENTORIES: YEAR-END**  
Days of Forward Coverage



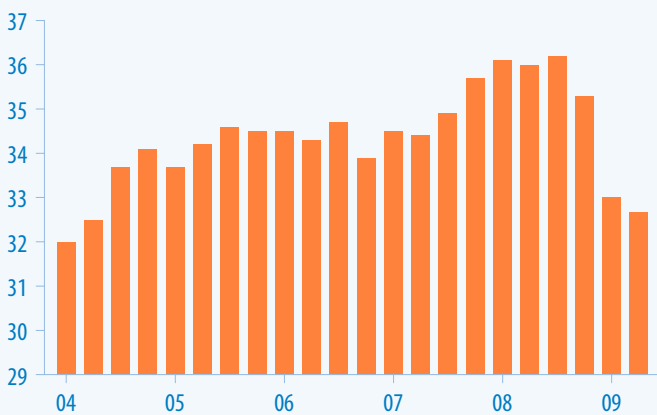
high oil prices during the first half of the year and slowing economic growth led to a 0.4% decline in global consumption of oil to an average of 85.7 million barrels per day (mmb/d). This followed strong growth averaging 2.1% during the 2003-2007 interval. In 2009, we expect demand to decline by a further 1.5 mmb/d (or 1.8%). If nothing else changed, then already-high inventories would become even more bloated and prices would crash.

But, other things are changing. For one, during the final few months of 2008, OPEC announced output cuts amounting to a little over 4 mmb/d. Although a supply cut of that magnitude would more than balance oil markets by the end of this year, the market was sceptical that OPEC would follow through with large reductions. However, the International Energy Agency estimates that, by February, OPEC had slashed its oil output by 3.5 mmb/d (*Chart 3*)—showing high compliance with intended cuts. Further, while Saudi Arabia naturally has accounted for the lion’s share of the cuts,

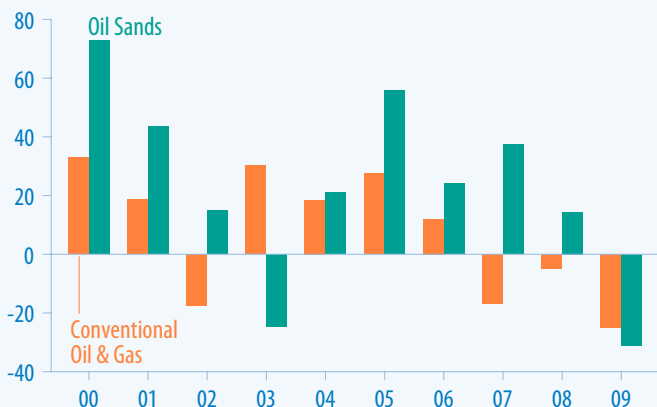
given its production dominance, almost all other members of OPEC have contributed. If OPEC were to maintain production at current levels, we estimate that there would be a global stock-draw of 0.9 mmb/d, or close to 330 million barrels for the year. That would tighten the oil markets considerably, potentially leading to a supply squeeze by 2010 as the global economy and oil demand begin to strengthen.

We also expect that low prices will impact the non-OPEC side of the global supply ledger, possibly with even longer-lasting implications to oil markets. Outside of OPEC, oil production has remained essentially flat during the past five years as existing fields deplete rapidly and new resources become harder to find and more costly to develop. Today’s lower prices will make it even harder to maintain non-OPEC production at current levels and could lead to declining production. *First*, exploitation of marginal conventional fields—i.e., squeezing every last drop out—was profitable with high prices, but clearly much less so now. *Second*, reduced investment will accelerate productivity declines in major basins. *Third*, and even more important, while most ongoing operations are not likely to be curtailed by prices above \$30/barrel, they are not high enough to spur the development and production of new high-cost resources in oil sands and deepwater fields. And, they are postponing or slowing projects already well into the planning and development stage. For instance, oil and gas producers in Canada intend to slash investment by 27.5% this year (*Chart 4*), following explosive growth during the past decade and a half (averaging 12.5% per

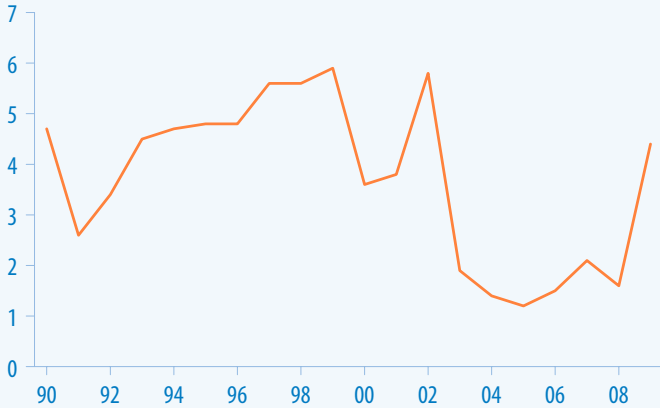
**CHART 3**  
**OPEC PRODUCTION**  
(million barrels per day)



**CHART 4**  
**OIL & GAS INVESTMENT**  
Canada (y/y % chng)



**CHART 5**  
**OPEC SPARE CAPACITY**  
(million barrels per day)



year). In Canada's oil sands, where the all-in cost, including a normal rate of return, exceeds \$70/barrel to develop and produce new resources, investment is slated to drop 31% this year after almost quadrupling since 2003. Consequently, expected production growth from the oil sands during the next several years is being reduced.

Thus, while most of the market's focus so far has been on demand, supply-side responses point to higher prices over the medium term. One factor that could mitigate the extent of price increases is rising excess productive capacity in OPEC (*Chart 5*), stemming from capacity expansion in Saudi Arabia during the past couple of years and the cartel's recent production cuts. This fattening supply cushion would allow OPEC to raise production should prices rise too quickly or if any major supply risks actually materialized.

**Bottom line:** While oil prices have fallen victim to their own previous heights and to the deep global recession, forces are in place which could lead to a supply squeeze and higher prices in 2010 and beyond. We currently expect WTI to average \$50 in 2009 and \$65 in 2010. Once the global economy moves onto a stronger footing in 2011, a return of \$100+ oil wouldn't be out of the question.

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