Weak global oil demand, uncertainty affect activity

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LIKE ALL ELSE, FORECASTS of oil demand and its impact on energy firms, oil service companies and drilling contractors changed on 11 Sept. Even before the attack on the US, world economies were weakening. The **US Department of Energy's** Energy Information Administration sharply lowered its forecast of global oil demand. The **International Energy Agency** also significantly lowered its projection of world oil demand. Even though the extremes of international E&P spending and activity are less dramatic than in North America, the combination of economic slowdown and political uncertainty will likely prevent an increase in international drilling activity in the months ahead.

Because world oil demand during the past decade grew at least 1 million b/d each year except during periods of serious international crises, that was EIA's original baseline projection for 2001.

But a week after the release of its latest Outlook, "the world did indeed enter a serious political and economic crisis, and moved closer to a global recession," said EIA.

In the near term, the biggest impact was expected to come from the large drop in global demand for jet fuel. EIA said worldwide jet fuel demand probably fell by 10% outside the US and by as much as twice that within the US.

"In addition, revised economic estimates indicate that the United States, viewed as the engine for global economic growth, may be in the midst of a recession. These two factors have resulted in EIA's lowering its global demand projections for fourth quarter 2001 by 700,000 b/d."

For 2002, EIA projects that US commercial jet fuel use will recover somewhat, and that global jet fuel demand will be down by roughly 5%. "Weaknesses in the world's economies are projected to reduce growth further, leaving OPEC to supply a world oil market that is projected to be much smaller in 2002 than previously projected."

Growth in world oil demand in 2002 is now projected at 900,000 b/d, down from 1.4 million b/d in EIA's previous forecast.

GLOBAL OIL SUPPLY

Prior to the crisis, the EIA Outlook indicated that OPEC's planned production cutback in September was likely to be curbed because US demand continued to be stronger than expected and OECD and world commercial inventories were tightening. These trends were expected to continue in 2002, increasing the demand for OPEC oil.

"In fact," said EIA, "it is assumed that the OPEC 10 will further deviate from their September quota to reassure world oil markets that supplies will be available during the crisis and out of concern for the weakening outlook for world economic growth."

OPEC overproduction is expected to be about 1.3 million b/d in the fourth quarter 2001, said EIA. Non-OPEC production is expected to increase by 1.2 million b/d in 2002, greater than the projected growth in demand.

As a result, the call on OPEC oil will decline.

According to the EIA's Outlook, at the beginning of September, OECD commercial oil stocks (crude and product) were estimated to be at the bottom end of their normal range, only slightly higher than last year's extremely low levels.

With the increase in OPEC 10 production and the decline in world oil demand, OECD commercial stocks are projected to loosen and move into the middle of their range in 2002, said the EIA report.

OIL PRICES

World oil prices jumped immediately after the attack on the US, then fell sharply as OPEC reassured world markets that it would ensure plentiful supplies, leaving the market to focus on world oil demand, which was weakening even before the crisis.

The US average imported crude oil price in September was estimated at $22/bbl, said EIA, down almost $2/bbl from August levels. West Texas Intermediate averaged about $26/bbl in September. The OPEC basket price, which generally tracks closely with the average imported crude oil price, averaged about $24/bbl.

"World oil prices are expected to firm in the fourth quarter with the onset of seasonal increases in world oil demand," said EIA in its report. However, "As a barometer of developing world oil market tightness, expected inventory patterns over the next 15 months suggest weaker underlying support for oil prices than previously projected."

OPEC ACTION

Oil prices collapsed on 24 Sept in the largest single day price drop since January 1991.

The terrorist attack on the US and the world economic downturn appear to have precipitated new OPEC flexibility regarding its $25/bbl price target for its basket of crude oils, according to EIA.

Two days after the oil price collapse, OPEC held its already-scheduled meeting and did not change production quotas, despite the basket price hovering near 2-year lows.

Last year, OPEC adopted an informal price band mechanism whereby OPEC basket prices higher than $28/bbl or lower than $22/bbl would trigger automatic production adjustments.

In the 19-month history of the price band, the mechanism has seldom been used. In 397 days of trading, OPEC's basket price has closed above OPEC's upper $28 band 121 times and below the lower $22 band 16 times (through October 2). OPEC has raised its quotas 3 times and reduced its quotas 3 times. Only one of these quota changes was the result of a price-band activation.

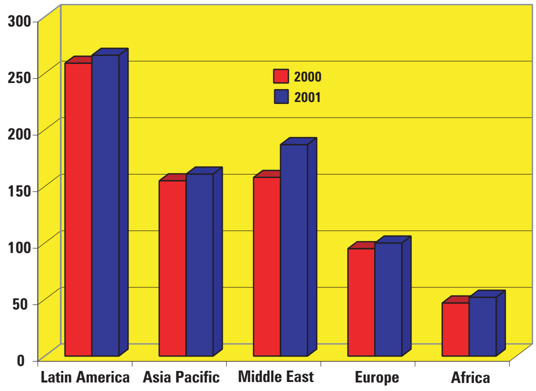
According to EIA, Kuwaiti Oil Minister **Adel Al-Subeih** has stated that the band is intended for use during "normal" periods, not times of volatile markets and economic uncertainties.

Hence, it would not be appropriate to use the mechanism now.

EIA expects oil prices in 2002 that will keep the basket price near the low end of it price band.

Before the attack, EIA had not anticipated OPEC fulfilling its 1 Sept 1-million-b/d quota reduction. Events since that date have made it increasingly likely that OPEC production will greatly exceed its quota levels in the fourth quarter of 2001. Over-production was expected to spike in October, with production approaching February 2001 quota levels.

International active rig count



Source: Baker Hughes

OPEC's unusually low quota compliance comes as members contemplate how to manage competing interests: OPEC's share of world oil markets and high oil prices, said EIA. In the last year and a half, OPEC appears to have been defending price at the expense of market share, a situation that might be changing.

IEA'S DOWNWARD REVISION

In its Oil Market Report, 12 Oct, the International Energy Agency said, "The September terrorist attacks on the US caused a sharp reduction in air travel and further lowered expectations of global economic growth for this year and next.

"The assessment of global oil demand growth, which was already falling before the attacks, has been cut to only 120,000 b/d for 2001." Jet fuel demand accounts for the bulk of he reduction.

"Demand growth for 2002 has been lowered to 600,000 b/d," said IEA.

World oil supply was unaffected by the attacks, averaging 76.8 million b/d for September, down 500,000 b/d from August.

OPEC 10 production fell by 450,000 b/d to 24.5 million b/d, but remained some 1.26 million b/d above the group's target, said IEA. OPEC said immediately after the attacks that it would ensure sufficient supplies, and at a scheduled meeting late last month it left its target unchanged at 23.2 million b/d.

DRILLING IMPACT

A significant decline in US drilling is forecast, due in large part to a drop in natural gas prices resulting from lower demand.

And the Canadian Association of Oilwell Drilling Contractors (CAODC) has revised its forecast of Canadian drilling activity in 2001.

In April, it projected an average of 488 rigs drilling. As a result of lower natural gas prices and on-going problems associated with access to drilling locations, the CAODC now projects the number of active rigs will be 405 this year.

Outside North America, drilling activity strengthened during the past year but the year ahead could, at best, see little change.

The international rig count is less volatile than that of North America because exploration and development outside the US and Canada typically involve longer-term projects by larger companies. Still, an economic slowdown will keep a lid on oil demand and US operations against terrorist networks will cause uncertainty that may result in projects being delayed. In mid October, it was far too early to tell how relationships among some key oil producing countries and energy companies would change.

Through September, the **Baker Hughes** international rig count stood at a total of 766 land and offshore rigs. That is a 7% gain over the same period in 2000 when the international count was 714.

Biggest gain in activity during the period was in the Middle East region where the count jumped 18% to 187 rigs in September. Increases in other regions—Asia Pacific, Latin America, Africa and Europe—ranged from 3-5%.

The number of land units operating outside North America increased 8% through September compared with the same period last year to 540 rigs; the 226 offshore units operating in September represented a 6% increase.