Special Quick Report

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U.S. Declaration Of War Against Iraq And The Outlook For The World Oil Market

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Introduction

On March 17, 2003, 8:00 p.m. (U.S. east standard time), President Bush of the United States addressed the American people nationwide. In his speech, he demanded the Iraqi President Saddam Hussein and his sons to leave the country within 48 hours and gave the last warning that, otherwise, the U.S. would exercise its military force against Iraq. At present, a voluntary exile by President Hussein is unlikely and, therefore, the effective declaration of war will make a battle with Iraq unavoidable. Under such circumstances, this report will analyse the outlook for the world oil market and crude oil price after the outbreak of war, based on the latest developments of international oil supply and demand.

1. Recent crude oil price trends and background

- Since December 2002, the crude oil price on the international market has increased sharply. The futures price of WTI, the marker crude in the U.S., jumped by $10 from the $27 level early December to the $37 level early March 2003 (Fig. 1)[1].
- Major factors behind the WTI price spikes are: (1) Oil production in Venezuela, the main supplier to the U.S. Gulf region, has dropped due to the general strike in the country. The oil production fell sharply below one million B/D compared with the pre-strike production level (about 2.6 million B/D). (2) Because the whole of the northern hemisphere (particularly the northeastern part of the U.S.) had a more severe winter than in ordinary years, and among other factors, the U.S. oil stock level dropped to a "minimum operational level"[2] (Fig. 2), which intensified the sense of a tightening market balance.
- In addition, in order to make up the supply shortages from Venezuela, OPEC producers, notably Saudi Arabia, have increased production sharply since December. But, the output increase consequently narrowed the OPEC's spare capacity to offset the potential supply loss, which stirred a speculation among market players that supply losses resulting from a potential attack on Iraq (halted oil exports from Iraq, etc.) won't be covered fully.
- In this context, the price spikes on the brink of war can be attributed partly to actual tightening

[1] Meanwhile, since around the "declaration of war," on the assumption that the war should be over quickly, such moves as position clearing and profit taking sent the crude oil price plunging, and the price closed at $31.6 on March 18 (for April deliveries).

[2] Since early February 2003, the U.S. private crude oil stocks have been hovering at around 270 million barrels.

of oil supply and demand on the international market, in addition to a "war premium." This is a very important point in considering what will become of the supply-demand balance and crude oil price trends in the days ahead.

2. Crude oil price outlook

- Now that the commencement of hostilities is virtually unavoidable, future developments of the crude oil price, will again heavily depend on how the war with Iraq develops. As for possible developments of the war against Iraq, the three scenarios ("Iraq Stabilization Scenario," "Iraq Stalemate Scenario" and "Middle East Conflict Spillover Scenario")[3] published October 2002 by IEEJ seem well grounded even now. Therefore, in reference to the three scenarios, the crude oil price outlook will be analysed and summarized below.
- Listed below are the assumptions to be heeded when figuring out a future shape:

(1) The U.S. oil stocks remain at an extremely low level even now.

(2) Venezuelan crude oil production has improved from the level immediately after the strike and, according to the government, production is already back to above 2 million B/D.

(3) Spare production capacity of the OPEC shrank as a result of the output increases to make up supply shortages from Venezuela. Given actual production records in February 2003, the combined spare production capacity of OPEC 9, with Iraq and Venezuela excluded, is an estimated about 1.7 million B/D (Table 1). Meanwhile, the Saudi commitments to step-up output increases appears to be continuing throughout March up until the present. Therefore, there is a strong likelihood that the OPEC's spare production capacity has diminished further in recent days and could dwindle down to around one million B/D in the worst case[4]. However, because Saudi Arabia is reportedly able to gain an additional one-million-B/D production capacity within 90 days, it is quite possible that the Saudi capacity expansion efforts are already under way.

(4) Along with high oil prices, non-OPEC oil production has been on the rise, while, on the demand side, the non-demand season sets to unroll with the winter winding up. According to IEA projections, world oil demand is likely to fall by 1.6 million B/D from 78.2 million B/D in the first quarter (1Q) of 2003 to 76.6 million B/D by 2Q.

(5) Once the attack on Iraq begins, oil exports from Iraq (about 1.7 million B/D) will halt. Also, if the operation of the Kuwaiti northern oilfields was partially suspended for security reasons, supplies to international market could shrink. Comparing these potential falls in supply to the international market with OPEC's present spare production capacity, the former outruns the

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[3] For details of the three scenarios, see "Middle East Crisis Scenarios Following a Potential U.S. Attack on Iraq" (appearing on IEEJ homepage, URL:http://eneken.ieej.or.jp, October 2002).

[4] IEA puts in its latest Oil Market Report that OPEC's surplus production capacity has declined to an estimated 910,000 B/D in the first half of March.

latter, and the calculation results in a supply shortage in theory.

(6) On this account, appropriate and timely implementation of market stabilization measures, typically releases of oil stocks by IEA members, will be a matter of vital importance. This conclusion is common to all three scenarios described below.

- Based on these assumptions, likely crude oil price trends are outlined in reference to each of the three scenarios.

<u>"Iraq Stabilization Scenario" (Probabilities: 60~70%)</u>[5]

a) The attack on Iraq commences but ends in a quick and overwhelming victory of the U.S. forces, thus achieving the removal of Hussein regime in a short time.
b) Though temporarily confused immediately after the war begins, a widely accepted view is that a new provisional government of Iraq can be established and stabilized under U.S. leadership.
c) Confusion of the oil market is minimized. Showing a very brief initial spike, the crude oil price bounces back to towards $40. But, the price sets to plunge sharply as a result of (expected) quick termination of war.
d) In addition to the war premium peeled off, the fundamentals, or the fears for potential oversupply in the non-demand season, could send the crude oil price falling. The WTI price, which is estimated to average around $25~30 in the second quarter (2Q) of 2003, declines to around $23 on average in the second half of 2003[6].

<u>"Iraq Stalemate Scenario" (Probabilities: around 30~40%)</u>

a) Due to resistance by the Iraqi forces, among others, military operations won't develop in such a pattern as a quick and overwhelming victory assumed in the Stabilization Scenario. During hostilities, the warring parties face increasing casualties and mounting damages.
b) The dominant superiority in military power ultimately leads to an U.S. victory. But, there is a spreading sense of uneasiness and insecurity over a possible failure in quick removing the Hussein regime and installing a new post-Hussein stable ruling regime.
c) With scant progress made in establishing a stable domestic regime, resultant instability has ripple effects on neighboring countries.
d) The crude oil price, up sharply at initial stage, unfolds a course to seek the ceiling in reflection to (expectation of) a time-consuming war before ending. The price of WTI outstrips $40 and, while centering on the mid-$40 level, proves highly volatile in reflection to changing war situations. Until the termination of war (or its definite prospect), the price

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5 With scenario-planning method, "probabilities" of a given scenario are never questioned as long as the scenario is well grounded on a thoroughly consistent logic. But, given recent international situations, we dare to put probabilities as a reference in this report.

6 Meanwhile, WTI crude oil prices averaged $34.5 from January to March 18, 2003.

remains high. Even after the war terminates, the crude oil price can hardly be stabilized due to uncertainties over stabilization of the political situation in and around the Iraqi regime.

e) After the termination of war, the fundamentals of supply and demand act as the principal driver, whereby the crude oil price sets to fall moderately during the second half of 2003. The average price of WTI remains at around $30~35 in 2Q, then slides to around $25 in Q4 at last. Meanwhile, the price proves very much volatile particularly the first half of the period.

f) By the way, President Hussein can try to destroy the Iraqi oilfields at the very beginning of the war. In that case, if damages occurred and produced a widespread speculation that resultant impacts should persist to some extent, the level of crude oil price volatility can be raised further by around $3~5.

<u>"Middle East Conflict Spillover Scenario" (Probabilities: Extremely low)</u>

a) Immediately after the war commences, Iraq launches a missile attack on Israel, then instant counterattacks by the Israelis make the war escalate. Massive casualties and damages touch off blazing anti-Israeli, anti-American sentiments across the Middle East, which makes the moderate producing countries in the Gulf politically unstable. Under such circumstances, the incumbent Middle East governments have few choices but to take an anti-U.S. stance as their strategy to survive. Then, as a symbolic action, they are forced to exercise the option of using oil as a "political weapon."

b) As a consequence, the international oil market gets extremely confused. The crude oil price skyrockets and stands above the $40 level even in 2Q average terms. The maximum instantaneous velocity can break the $50 line. To converge confusion of the oil market proves so time-consuming that the price should stay at around the mid-$30 level even in the second half of 2003.

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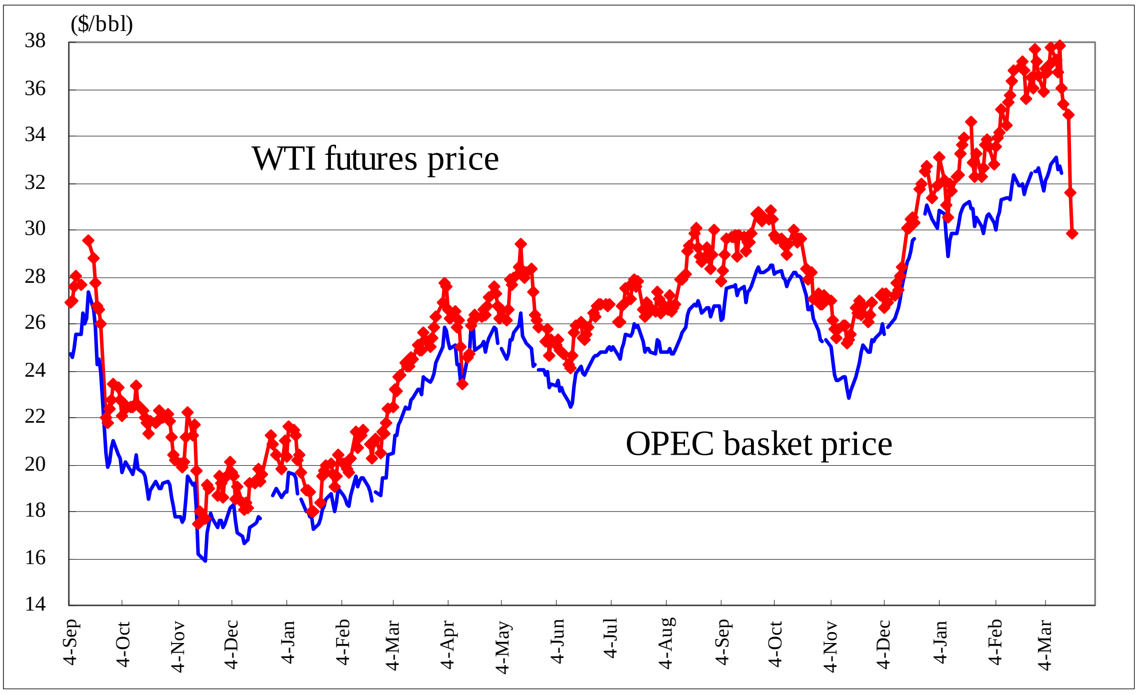
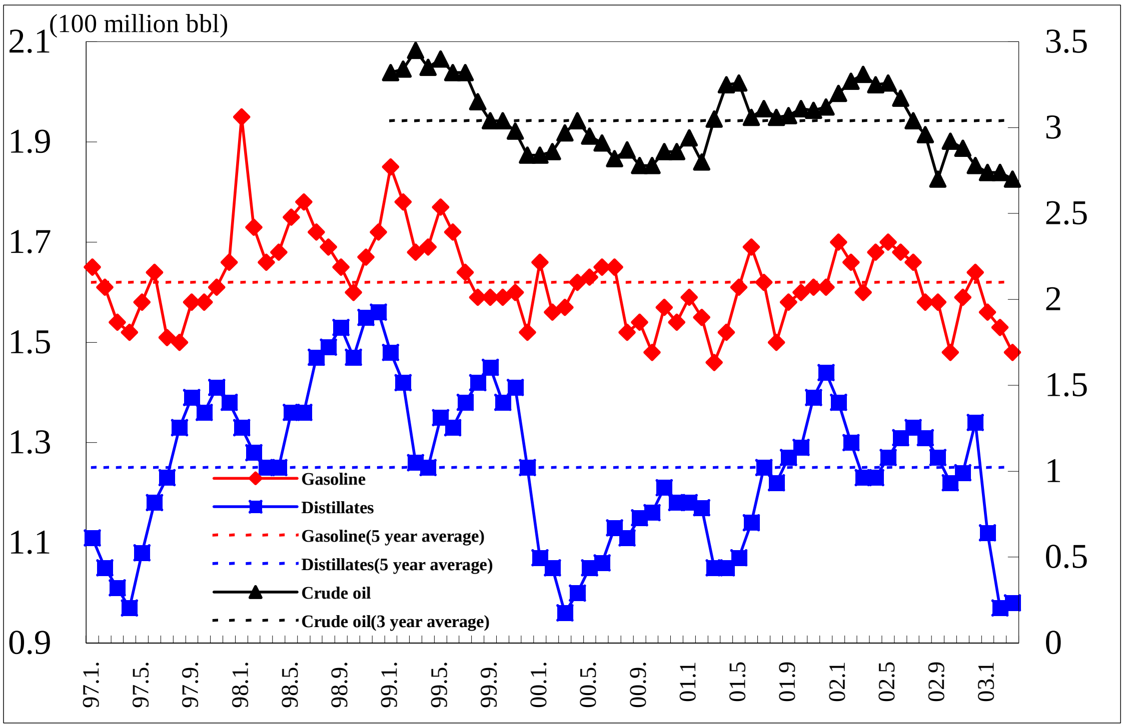
Fig. 1 WTI Futures Prices and OPEC Basket Prices



(Source)Prepared by IEEJ from NYMEX data etc.

Fig. 2 U.S. Private Oil Stocks



(Source) Prepared by IEEJ from US DOE/EIA data

Table 1 Spare Production Capacity of OPEC (Surplus Capacity)

	Crude production capacity (1,000 B/D) (A)	2003 February prodction (1,000 B/D) (B)	Spare capacity (1,000 B/D) (A) - (B)	Production Quota(Feb. 2003) (1,000 B/D)
Algeria	**1,100**	**1,050**	**50**	**780**
Indonesia	**1,180**	**1,050**	**130**	**1,270**
Iran	**3,900**	**3,690**	**210**	**3,600**
Iraq	**2,800**	**2,490**	**310**	
Kuwait	**2,150**	**1,980**	**170**	**1,970**
Lybia	**1,450**	**1,390**	**60**	**1,310**
Nigeria	**2,440**	**2,190**	**250**	**2,020**
Qatar	**750**	**740**	**10**	**640**
Saudi Arabia	**9,500**	**8,850**	**650**	**7,960**
UAE	**2,500**	**2,320**	**180**	**2,140**
Venezuera	**2,750**	**1,430**	**1,320**	**2,820**
Total	**30,520**	**27,180**	**3,340**	**24,500**
OPEC10(excl. Iraq)	27,720	24,690	3,030	
OPEC9(excl. Iraq & Venezuer	24,970	23,260	1,710	

(Source) Prepared by IEEJ from IEA Oil Market Report 2003 March