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Report Summary

Prospects for the World Oil Market and Crude Oil Prices for 2005

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<Purpose of Study>

Crude oil prices on the world petroleum market in 2004 reached a record high on October 22, 2004 at $55.17/barrel for futures prices (front month, settlement price) for West Texas Intermediate (WTI) crude, which is used as an indicator of world oil prices. In addition, the average price of WTI crude from January - November 2004 reached $41.30/barrel, a significant leap over the $31.10/barrel average for 2003.

Factors that combined to contribute to the price jump included the exceptionally high growth in petroleum demand centering on China; the tight supply/demand situation in the US petroleum product market; a marked drop in surplus supply capacity in the international petroleum market; terrorism, conflicts, oil company financial/operational problems, and other problems in major petroleum producing countries such as Iraq, Saudi Arabia, Nigeria, and Russia that resulted in concerns about supply interruptions; as well as very active speculation in the futures market.

Trends in the international petroleum situation and in crude oil prices have a large impact on the world and Japanese economies, and on the future of the energy market and supply/demand. So it is extremely important to examine those trends and analyze future prospects. Keeping that in mind, in this report we will discuss supply and demand fundamentals and various risk factors, and present an overview of the international petroleum situation and crude oil prices for 2005.

<Conclusion>

1. Main factors influencing the trends in the international petroleum situation and in crude oil prices for 2005 include...
   - A. World petroleum demand increase trends
   - B. Non-OPEC countries' production trends
   - C. OPEC production and surplus production capacity trends
   - D. Possibility of supply interruption and instability in major petroleum producing countries.
   - E. Influx of speculative funds into the futures market
   - F. OPEC's actions on the above factors

It is important to note that, there is great uncertainty in regard to the future for those factors. Thus, in studying the prospects of the international oil situation, it is meaningful to assume cases for sensitivity analysis (high- prices and low-prices cases) in addition to the reference case.

2. In the reference case for the international petroleum market in 2005...
   A. World oil demand growth (compared to previous year) slowing from more than 2.6 million barrels/day in 2004 to 1.4 - 1.5 million barrels/day in 2005
   B. Non-OPEC production, centering on the former Soviet Union (especially Russia), increasing by around 1.2 - 1.3 million barrels/day
   C. OPEC crude oil production capacity, centering on countries such as Saudi Arabia, gradually expanding to 32 to 33 million barrels/day by the end of 2005
   D. Supply instability in major oil producing countries, while occurring sporadically, not becoming serious

   are given as assumptions for supply and demand fundamentals. In that case, **demand for OPEC crude (annual average) will be around 28 million barrels/day, just about the same as for 2004. However, that will be below the current high production level of around 30 million barrels/day registered in November 2004.** Thus OPEC will face **a need to reduce production in the future, especially in the second quarter when demand is low.** At the same time, OPEC's crude oil production capacity will increase, resulting in an increase in OPEC's surplus production capacity. That will create a gradual easing of the supply/demand balance in the international petroleum market.

3. Furthermore, **surplus production capacity will expand while no serious supply interruptions occur, so the vulnerability of the international petroleum market, which became apparent in 2004, will tend to be improved, and under the circumstance, speculative investment in the petroleum futures market will decrease**. OPEC will continue to supply sufficient petroleum necessary to stabilize the international petroleum market to prevent excessively high or low prices. And it will adhere to a policy of making supply adjustments (including cutting production) in accordance with demand trends for OPEC crude.

4. In light of this situation, **with the easing of the supply-demand balance as the basis, a gradual downward pressure will be exerted on crude oil prices in the international petroleum market in 2005.** Crude prices will fall mainly in the second quarter, with the **price for WTI crude over the year averaging around $37 to $39/barrel**.

5. **Basic premises for a high-price case include...**
   A. **World petroleum demand continuing to rise steadily in 2005, with an increase in demand of about two million barrels/day over 2004.**
   B. **Non-OPEC production growth being unexpectedly low**

C. That resulting in a steady increase in demand for OPEC crude

D. **Instability in the Iraqi situation and other frequent supply interruptions by major petroleum producing countries**.

In that situation, **the supply/demand balance will not be eased and OPEC surplus production capacity will remain at current low levels.** Thus, the international petroleum market will remain vulnerable to supply and demand fluctuations and "external shocks." With the assumption of the supply interruption for this case, **a high level of "risk premium" will continue to be attached to crude oil prices**. The results of all that will be continued crude price volatility and high crude oil price levels just as recorded in September through November 2004. In this case, **the average price of WTI crude in 2005 will be around $48 to $50/barrel**.

6. The premise for a low-price case is the opposite of that in the case above. It includes...

A. A rapid slowdown in world petroleum demand growth

B. Production by non-OPEC countries, mainly the former Soviet Union, increasing more than expected

C. Demand for OPEC crude taking a big drop, greatly increasing surplus production capacity in OPEC countries

D. Limited incidence of supply instability in major petroleum producing countries

That will result in the further easing of the supply and demand imbalance, forcing OPEC to make major production cuts. In such a situation, crude prices will drop substantially. Thus, **the average price of WTI crude in 2005 will fall to around $30 to $32/barrel**.

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