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Prospects for the International Oil Market and Crude Oil Prices in 2006

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<Research Objectives>

On August 30, 2005, the near-month West Texas Intermediate (WTI) futures price – which serves as a benchmark for crude oil prices in the world oil market – hit a record high, temporarily rising above $70/barrel (closing price: $69.81). In addition, the average WTI futures price from January to November of 2005 marked $56.5/barrel, remarkably higher than the 2004 average ($41.5/barrel).

One of the factors behind this price hike was that the supply/demand balance in the overall world oil market remained tight, because while the world's oil demand continued to grow, though slower than in the previous year (2004), non-OPEC crude oil production remained at the previous year's level due to a slowdown in Russia's production increase and the United States' declined production caused by hurricane damages. In such a situation, the great hurricanes that hit the U.S. coast of the Gulf of Mexico from the end of August to September caused enormous damage to the region's refining capacity. As a result, the oil product supply/demand balance became stringent and prices soared in the U.S. oil market, which plays the central role in the price formation in the world oil market. This had an extremely significant impact on this year's price hike, including the above-mentioned rise to the new record high.

Since the trends in the international oil market and crude oil prices have a considerable impact on the future developments of the Japanese and global economies and of the world energy market, it is extremely important to gain an understanding of these trends and analyze their future outlook. This report prospects the international oil market and crude oil prices in 2006 by examining the supply/demand fundamentals and various risk factors based on the above recognition.

<Key Conclusions>

1. The important factors that will affect the trends in the international oil market and crude oil prices in 2006 include: (1) the global trend in oil demand growth; (2) the

non-OPEC production trend; (3) the trend in OPEC’s policy and production capacity expansion; (4) the situation of surplus supply capacity in the global oil market, including OPEC’s excess crude oil production; and (5) the possibilities for supply disruptions and market destabilizations. As future developments of these factors involve considerable uncertainties, it is significant to prospect the international oil market by assuming the most probable Reference Case as well as other cases (High-price Case and Low-price Case).

2. The Reference Case for prospecting the 2006 world oil market premises that: (1) the world’s oil demand will increase by about 1.7 million b/d over the previous year in 2006, supported by the robust world economy; (2) non-OPEC crude oil production will increase by about 1.4 million b/d over the previous year, backed by the United States’ recovery from hurricane damages and Russia’s moderate production increase; (3) OPEC’s crude oil production capacity will gradually expand, mainly in Nigeria and Saudi Arabia, and will increase to about 33 million b/d by the end of 2006; and (4) supply disruptions may occur sporadically in major oil-producing countries, but will not become serious. In this case, the annual “call on OPEC crude oil” stays almost the same as in 2005 at slightly less than 29 million b/d, which is lower than the current high production level (November 2005: slightly less than 30 million b/d). Since OPEC’s crude oil production capacity will also increase, its surplus production capacity will gradually expand. As a result, the supply/demand balance in the world oil market will slowly improve in principle.

3. However, the shortage of refining capacity and the lack of supply flexibility in the U.S. oil market, which were among the causes of the price hike in 2005, will remain present without being resolved in the short term. In addition, the impact of sporadic supply disruptions and OPEC’s policy to prevent a drastic price drop will support the crude oil prices and may cause a price hike, depending on how these factors develop.

4. Under these circumstances, the world oil market in 2006 will basically see improvement in the supply/demand balance. However, due to the above factors supporting the prices, crude oil prices will remain high at the present level, and the annual average WTI price will be around $55 to $60 per barrel.

5. The High-price Case mainly premises that: (1) the world’s oil demand will steadily increase, posting a demand increase of about 2 million b/d over the previous year; (2)

non-OPEC production will increase over the previous year, but the production increase will only be 1 million b/d or less; (3) as a result, the call on OPEC crude oil will steadily increase; and (4) supply disruptions and risks occur in major oil-producing countries, and will have an impact on the market. In this case, the world oil market will continue to be vulnerable to supply/demand fluctuations and external shocks, because the supply/demand balance will become tighter and OPEC's surplus production capacity will remain at the present low level. Therefore, the crude oil prices will further surge from the present level and continue to hit new highs depending on the occurrence of supply disruptions in major oil-producing countries. As a result, the crude oil price will reach an even higher level while fluctuating wildly, and the average WTI price for 2006 will be around $65 to $70 per barrel.

6. In contrast to the above case, the Low-price Case premises that: (1) the world's oil demand growth will quickly slow down due to factors including the stagnant world economy (an increase of about 1.2 million b/d over the previous year); (2) in non-OPEC countries, production will recover in the United States, and production will grow beyond expectation mainly in former Soviet Union and in West Africa; (3) the call on OPEC crude oil will dramatically decline, and OPEC's surplus production capacity will considerably expand; and (4) occurrence of supply disruptions in major oil-producing countries will be limited. As a result, the supply/demand balance will improve and OPEC will be pressed to cut its production dramatically, particularly from the second quarter onward. Under this situation, the crude oil prices will come under downward pressure in the low-price case, and the average WTI price for 2006 will be around $45 to $50 per barrel.

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