

Market View - Oil

October 2007

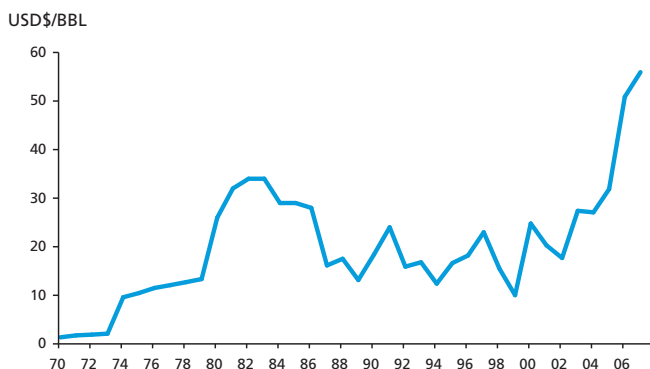
With stock markets sent reeling this year by fears of a worldwide credit squeeze, the role of cheap money in driving markets higher may be over. As investors reassess many market fundamentals, do we also need to rethink the prospects for oil? Our view is that ongoing growth in demand, a lag in developing new supplies and the absence of any clear substitute mean the oil price will remain strong, only edging down gradually over the next five years.

From deep lows to recent highs

The strengthening price of oil has been a central trend on markets during the last decade. Although the oil price is notoriously volatile, prices have risen to an average US\$63.24/bbl in the first half of 2007, US\$65.18/bbl in 2006 and US\$54.52/bbl in 2005, compared to US\$24.15/bbl for the 1980s and \$17.94/bbl in the 1990s. With supply and demand finely balanced, the oil price is likely to stay relatively high. Our forecast is for average prices of \$65 a barrel this year, \$60 next, \$55 next and \$50 longer term.

The recent trend for oil marks a turnaround from the '90s when it seemed unlikely oil would ever recover from the effects of a string of price collapses. The most recent collapse was in 1998 when the Asian economic crisis coincided with a spat between Saudi Arabia, the world's top oil producer, and Venezuela, the sixth largest producer. Venezuela was supplying additional barrels of oil to the US market in order to secure valuable market share. Saudi Arabia objected to this and decided to open the taps completely. Prices collapsed. Previously the West had triggered price crashes by curbing its consumption by over 5 million barrels per day, as it did between 1979 and 1983. This eventually resulted in a price collapse in 1986.

Oil Price since 1970*



Source: Energy Information Administration
*Saudi Arabian Light

Lack of incentive and rising demand

Current high prices are partly a result of these low prices in the past. The overall effect of these price collapses over a long period of time led to a lack

of confidence that oil prices would ever recover enough to justify additional investment. Investment fell dramatically in the oil industry as companies focused on increasing profitability at the expense of exploration and development in new fields. That lack of investment means there is simply not enough new oil coming onstream now, and it will take time for current rising investment to arrive. As a rule of thumb it takes between five to seven years between exploration, development and production, so investments made now will be realised in actual production by 2012/14.

The other main reason for higher oil prices is rising demand, particularly from China and India. While it is difficult to put a precise number on what their demand is adding to the current oil price, together they account for 12% of global consumption today compared to 7-8% ten years ago.

A very tight balance

The crucial factor is that this sharply increasing demand has taken away any slack in the market. Supply and demand are finely balanced. That balance

is likely to remain tight since the crucial oil producing group, OPEC, believes the market is well supplied. OPEC is central to managing the oil price since it controls 42% of global supplies. So the market remains nervous, marking oil prices higher at the slightest fear that the market may not be able to secure adequate supplies either from existing OPEC members, or non-OPEC producers. There is plenty risk on the upside. Nigeria remains a problem, the wars in Iraq, Afghanistan, the Palestine question, terrorist threats and delays to key Western projects have all served to ramp up prices.

No immediate change but solutions are coming

There is no reason to expect demand to decline suddenly. Hunger for commodities from China and India is unlikely to slow soon and is expected to continue with coal rather than oil being the fastest-growing fuel for the Chinese economy. The emerging middle classes who represent vast numbers in two of the world's biggest countries, who want cars and consumer goods, make any decline in demand for commodities even less likely.

On the supply side, those controlling oil are unlikely generally to cut supply, despite popular fears of politics driving the daily market. Mineral rights are not in the hands of publicly listed companies but government controlled national oil companies. Over 80% of current oil and gas reserves are controlled by state-owned oil companies such as Saudi Aramco, NIOC in Iran, IOC in India and PDV in Venezuela. These governments are eager to use oil revenues as a means to finance growing, and in many cases burgeoning domestic budgets. Saudi Arabia, for instance, faces a growing mass of younger people coming into the economy looking for jobs. So while there may be temporary anomalies, they are unlikely to last long.

Supply will eventually increase.

Investment in new and existing fields has increased. Nowhere has this been more true than in Saudi Arabia, where Western oil service companies have been brought in from the cold to provide a full range of drilling services.

The Saudis know that without access to this technology their position as lead global producer will wane and their economy with it. In refining too, where investment has also been scant, new super-sized refineries are being built in Asia and Saudi Arabia that will increase supply of refined products. So the prospect of higher production levels cooling off current high oil prices is therefore on the horizon, but it could be at least three years away.

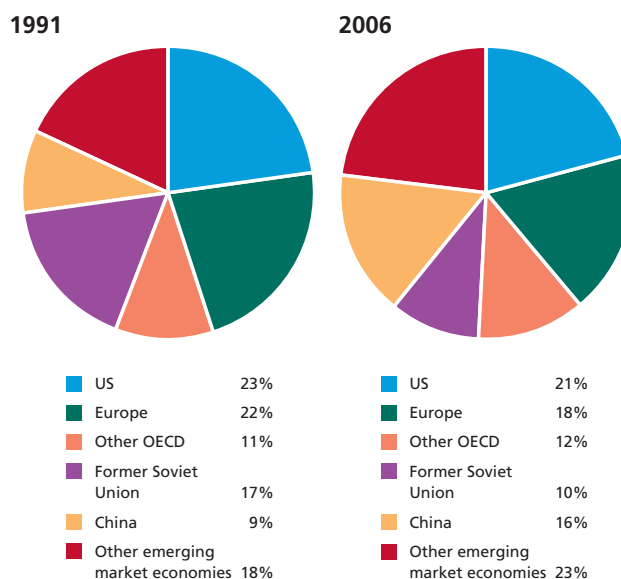
Real alternatives are further off

The Stone Age did not end with a lack of stone, and the Iron Age did not end with a lack of iron ore. The Oil Age will not end with a lack of oil but rather a switch towards a new energy source. However, oil's prominence will only decline when more is invested in making this change. It is in OPEC's and the national oil companies' interest to continue preserving the current status quo. There are several fuels in the wings including the alternative fuels like wind power, as well as nuclear energy and hydrogen that can power cars. However, a lot more global political will and investment than is currently evident will be needed to shift the balance away from oil and, ultimately, reduce the importance of its price.

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Shares of World Energy Consumption



Source: BP Statistical Review

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