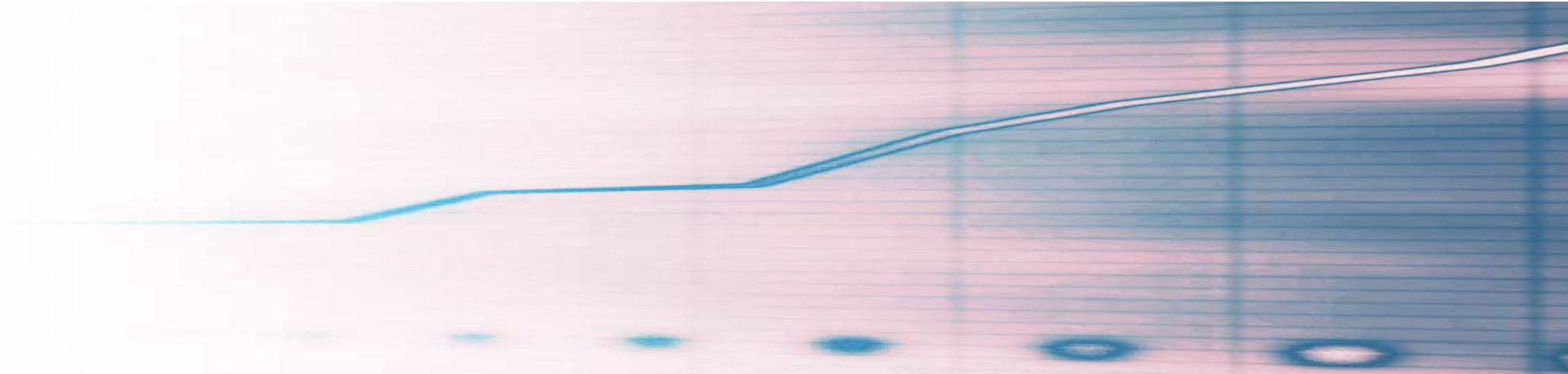


# The case for cheaper oil

Andrew McLaughlin

The 5<sup>th</sup> Annual RBS North Sea Conference



## Overview of Presentation

- Why does oil matter?
- Why do most economists argue the case for cheaper oil?
- Medium term price forecast
- The probabilities and the risks

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## The best oil price forecasts are directionally right and precisely wrong

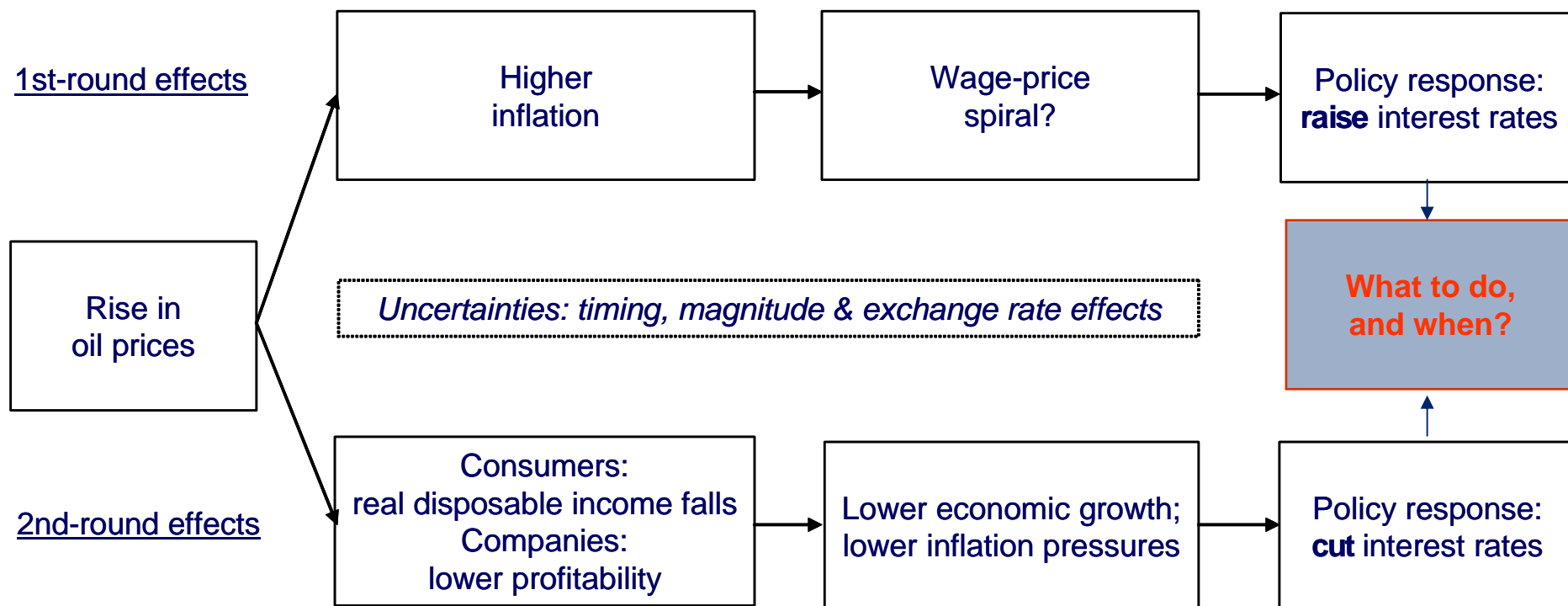
**“What do I detest about Moses? For 40 years he leads us through a desert, and where does he take us? The only place in the Middle East that does NOT have oil.” *Marleen Golda Meir (Israeli Prime Minister, 1970)***

**“Oil prices have fallen lately. We include this news for the benefit of petrol stations, which otherwise wouldn't learn of it for six months”. *William D. Tammeus***

**“The oil price is likely to stay at about \$10 to \$12 a barrel at least in the foreseeable future”. *The late Donald Dewar, First Minister, 1999.***

**"It's hard to identify any single commodity that has ever maintained a very high price over a very long period of time," *Lee R Raymond, Exxon Mobil Corporation, 2005***

## Why it matters. Threat of stagflation means a difficult judgement call for central bankers

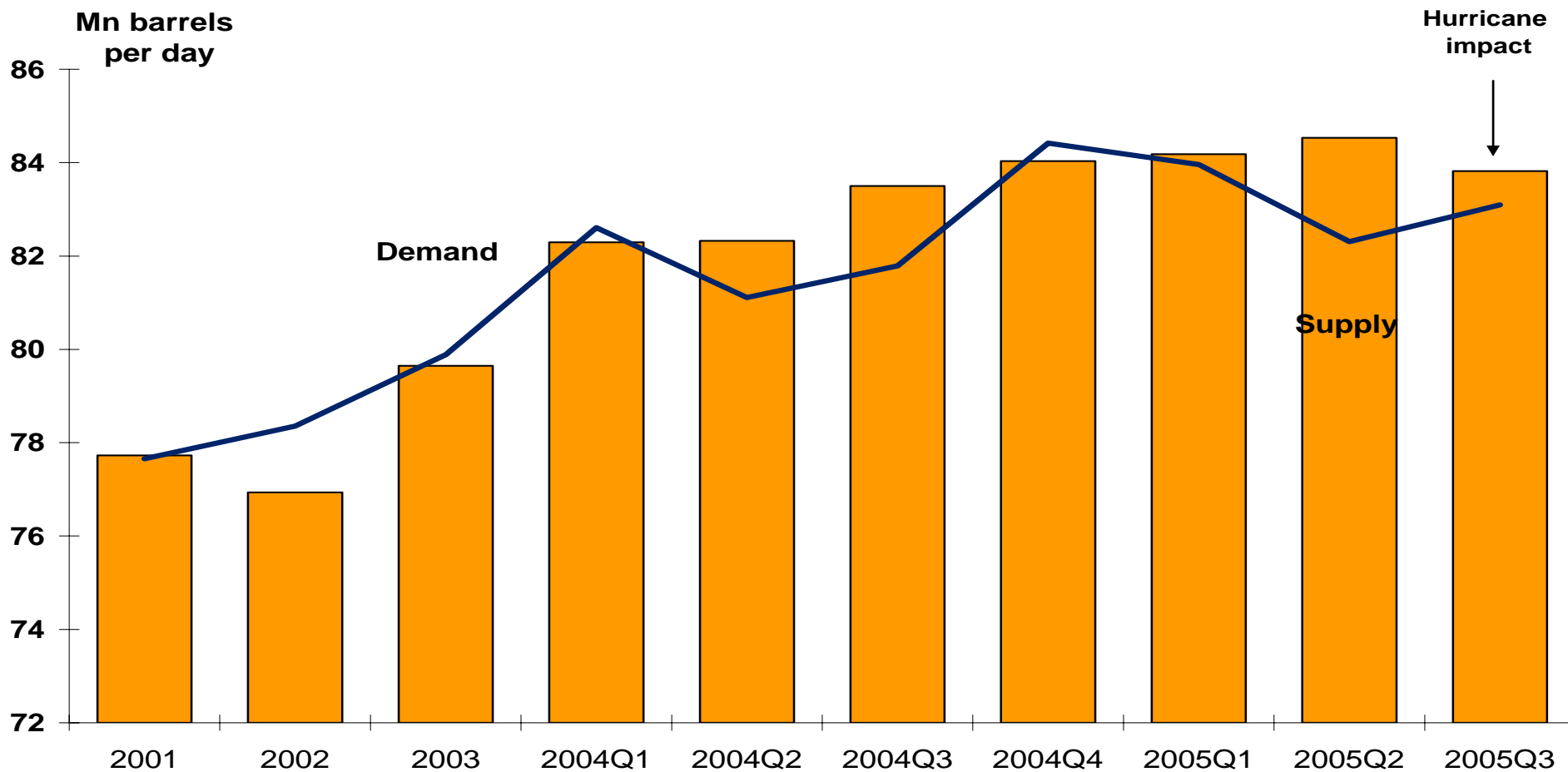


## Why it matters. High oil prices hit specific sectors and countries

### Companies' ability to mitigate exposure to oil-price hikes depends on:

- **Energy intensity in production processes** - cost implications will be greatest for sectors such as utilities, transport services and agriculture.
- **Whether they are consumer-facing, particularly where spending is discretionary** - in the short run, as household spending slows in response to the drag on incomes from higher energy prices, the hardest-hit sectors would include retailing, electronics, automotive and travel services.
- **Whether competitive pressures are strong and/or demand is cyclically weak** - firms will be less able to pass on energy-cost increases in sectors such as manufacturing, where global competitive pressures are strong.
- **Whether tight labour market conditions exist** - companies may face additional cost pressure where employees try to 'catch up' real income losses via wage negotiations. Catch-up is most likely to take place when the workforce has specific, high-level skills, or when wider labour market conditions are tight.

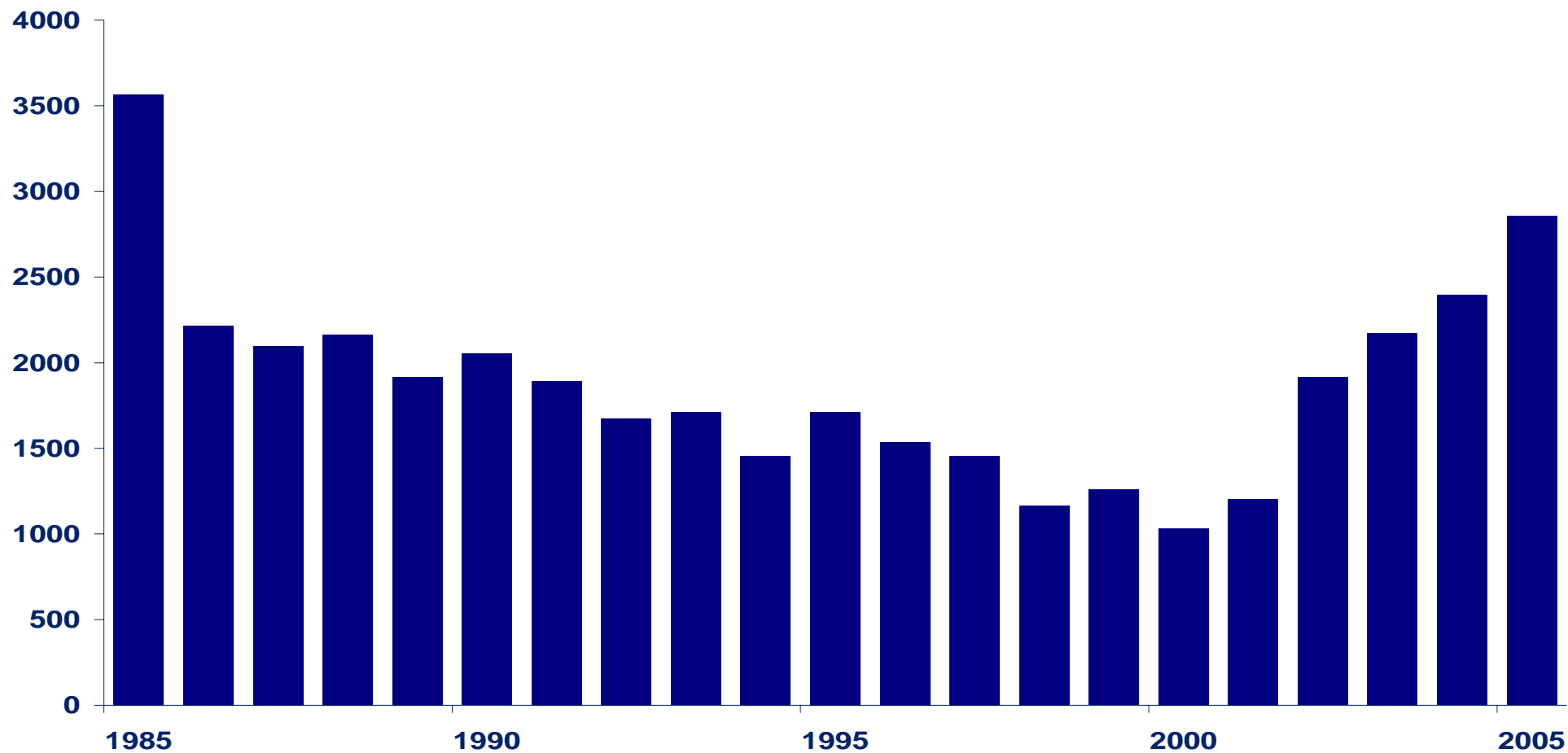
A demand/supply imbalance was the source of price pressure as world GDP recovery surprised on the upside thanks to activity in the dollar zone



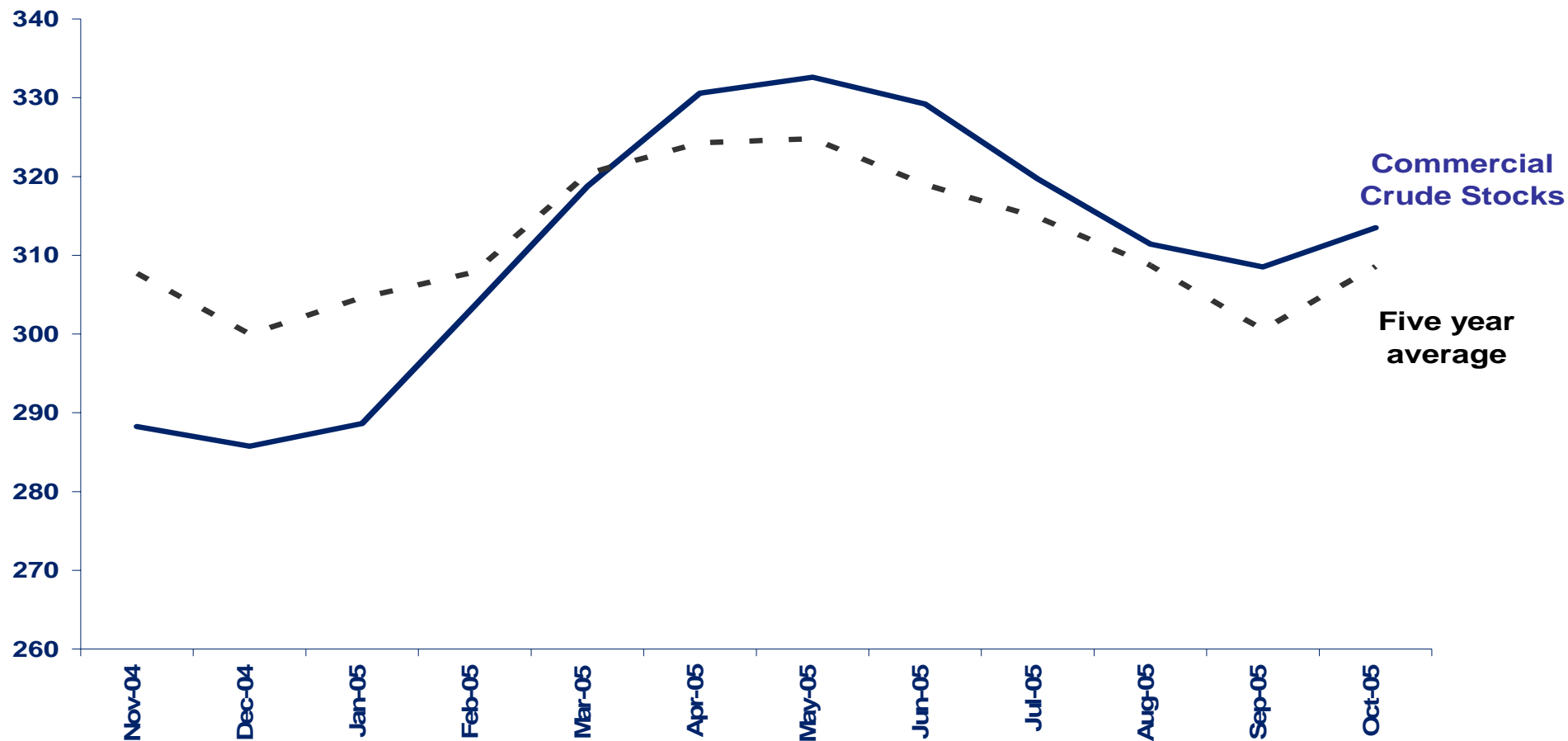
## Futures Market expects prices to stay above \$60 – but is this just a reaction of the spot price?



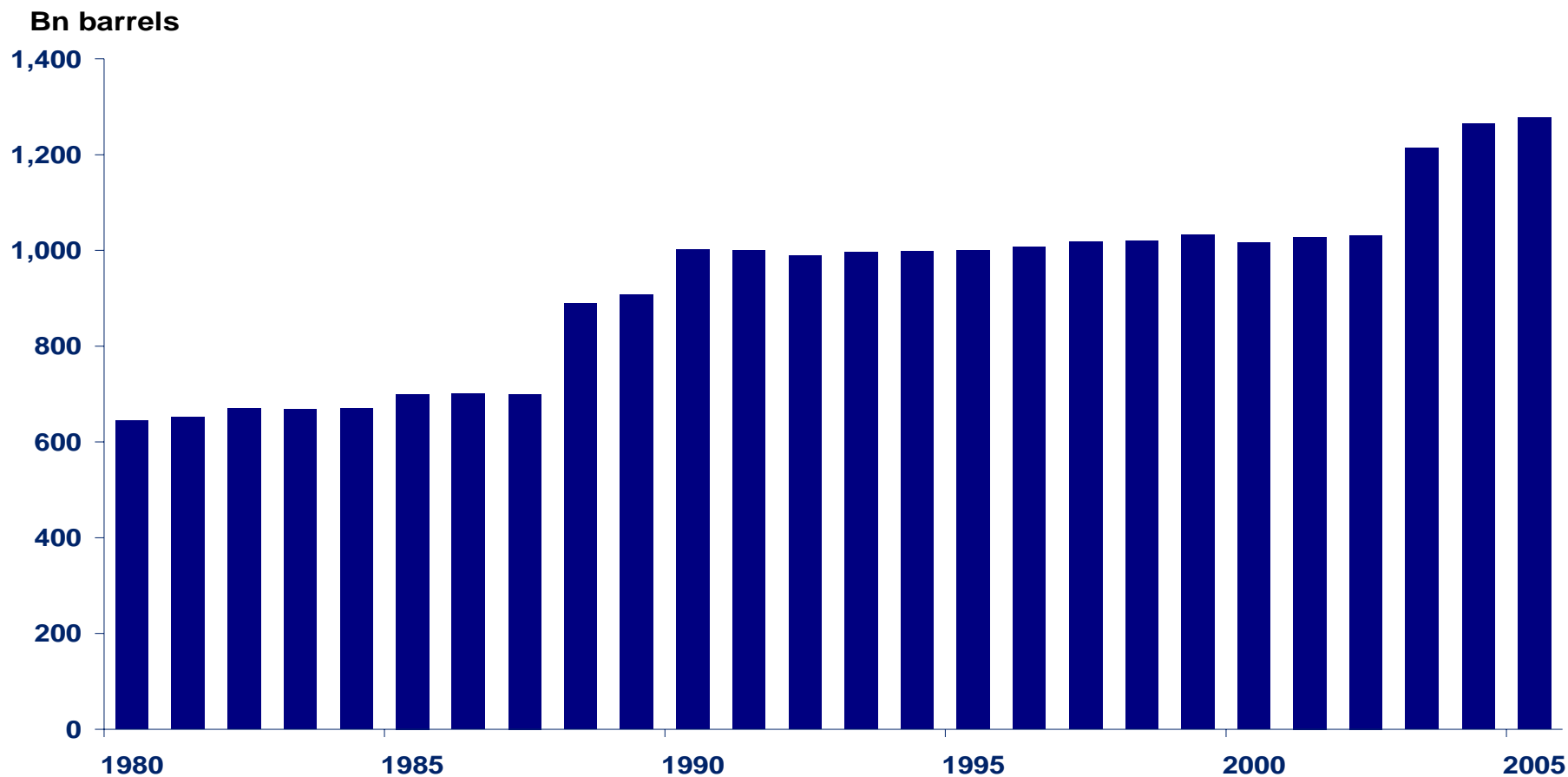
## Is the market responding to the price signal? Rig Count well above 20-year average



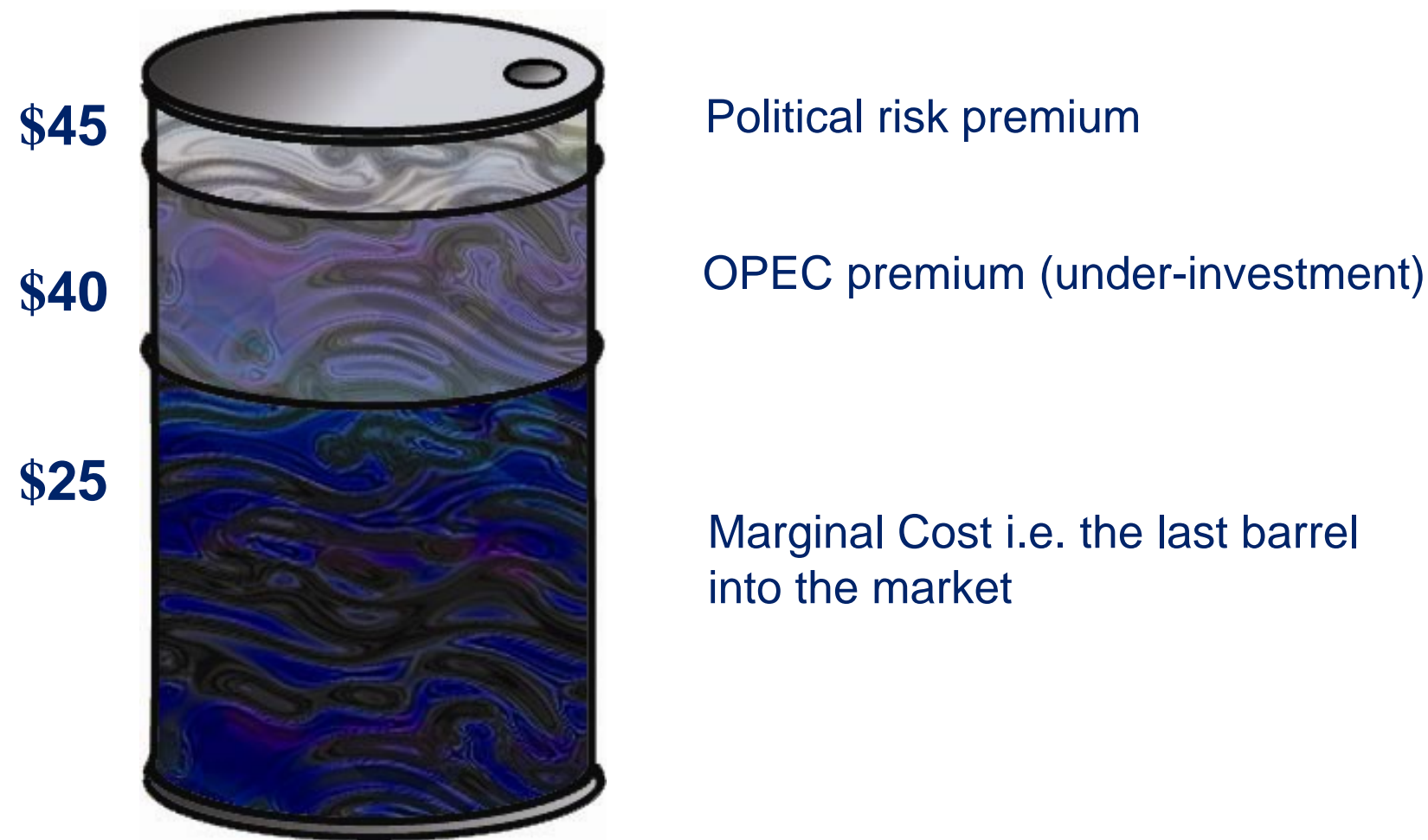
## Is the market responding to the price signal? Inventories



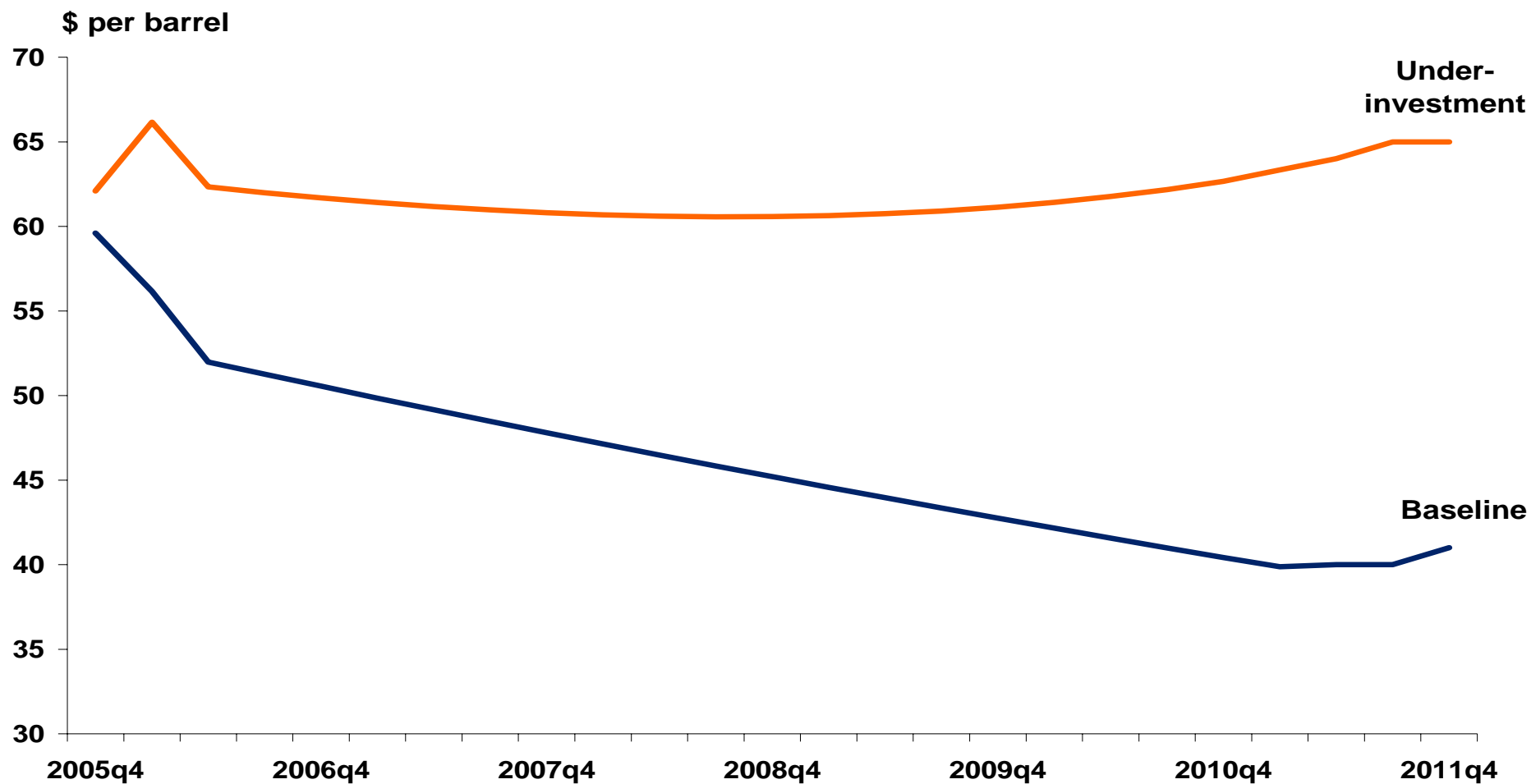
## Is the market responding to the price signal? Proven reserves still rising



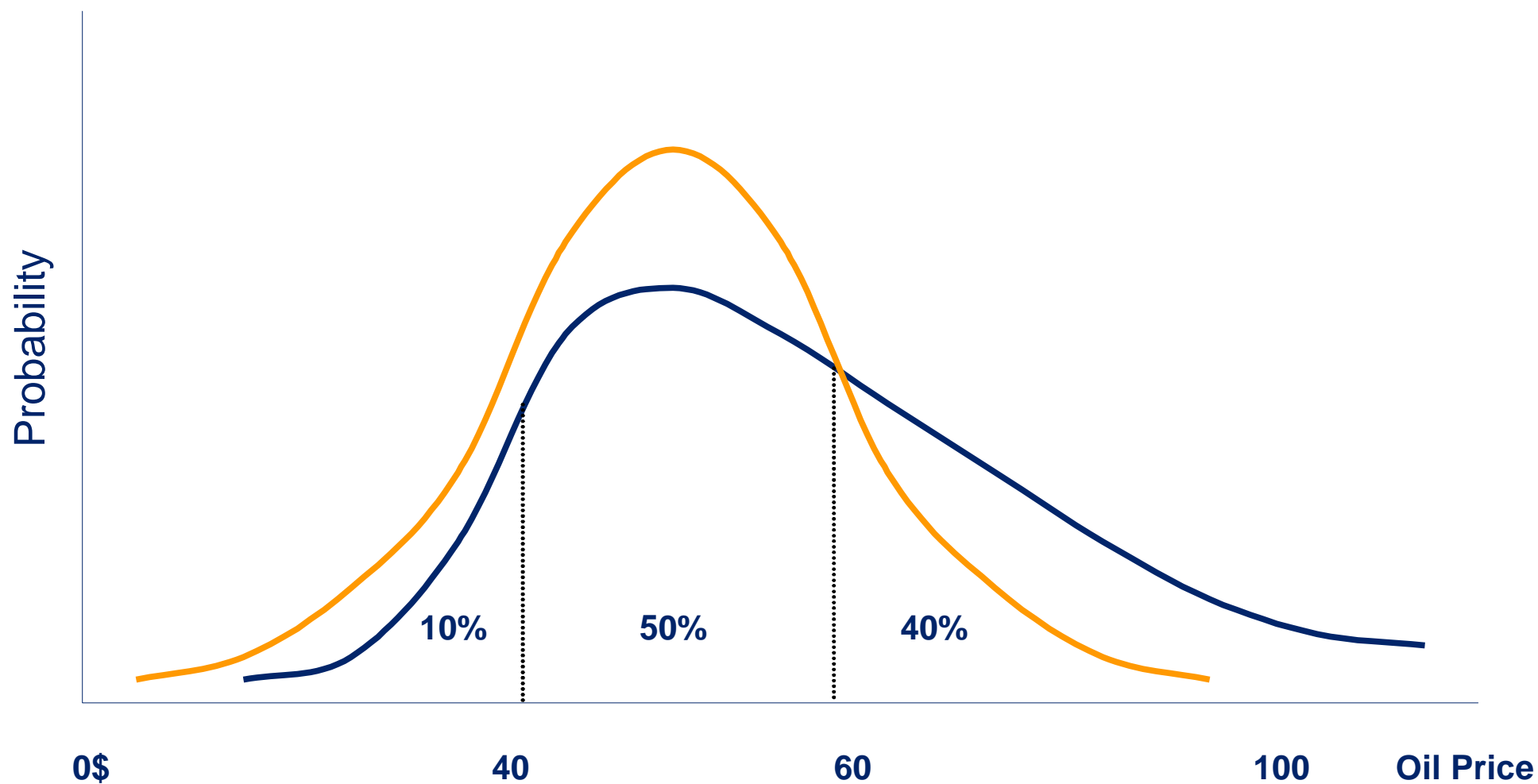
## Basic building blocks of a medium term price



## Baseline Forecast and an under-investment scenario



## A probability distribution reveals substantial upside risks to the forecast



## The case for cheaper oil

- We prefer to stress a lower medium term price target with upside risk rather than a high price with more downside risk
- Prices are stuck in a channel between \$56-66 per barrel with no imminent sign of a break
- Two issues matter for the medium term:
  - The fundamental economics of the price signal still work but this could be an elongated commodity cycle
  - The big call relates to investment made now for the next decade. Globalization has shifted the demand curve. Is that a one-time move upwards or have the emerging economies increased the sustainable growth rate of the global economy at the same time? That would require a substantially higher investment response between now and 2010

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