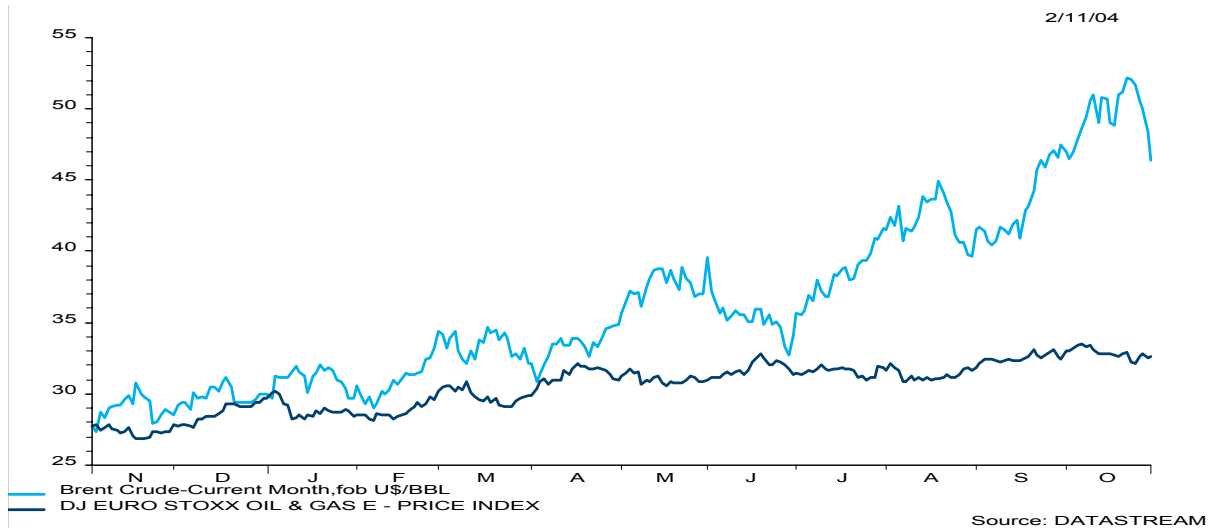


Oil sector

2 November 2004

Difficult winter ahead



Until one week ago, it seemed that nothing could stop the upward spiral of crude oil prices, which broke all previous records yet again last month. Refiners too, benefited from extremely high margins. Whether we're talking about crude oil or refined products, the problem remains the same: current production capacity is barely sufficient to cover booming demand, meaning that the slightest supply disruption can lead to extreme price volatility. Combined with the very low level of heating fuel inventories for the season as winter approaches, we have all the ingredients for a major crisis if winter proves colder than average. In spite of the fall in prices last week, conditions look set to remain extremely favourable for the oil companies, although 2005 and 2006 may prove more difficult. On the other hand, the significant increase in exploration spending is very good news for the oil services sector.

Average Brent prices and European refining margins

	2001	2002	2003	2Q03	3Q04	Sep-04	Oct-04
Brent (\$/barrel)	24.82	25.13	28.77	35.50	41.55	43.30	49.71
Brent (€/barrel)	22.16	26.56	25.42	29.31	33.97	35.50	39.79
European refining margins (\$/bl.)	2.54	1.67	3.89	6.60	5.79	5.57	6.39

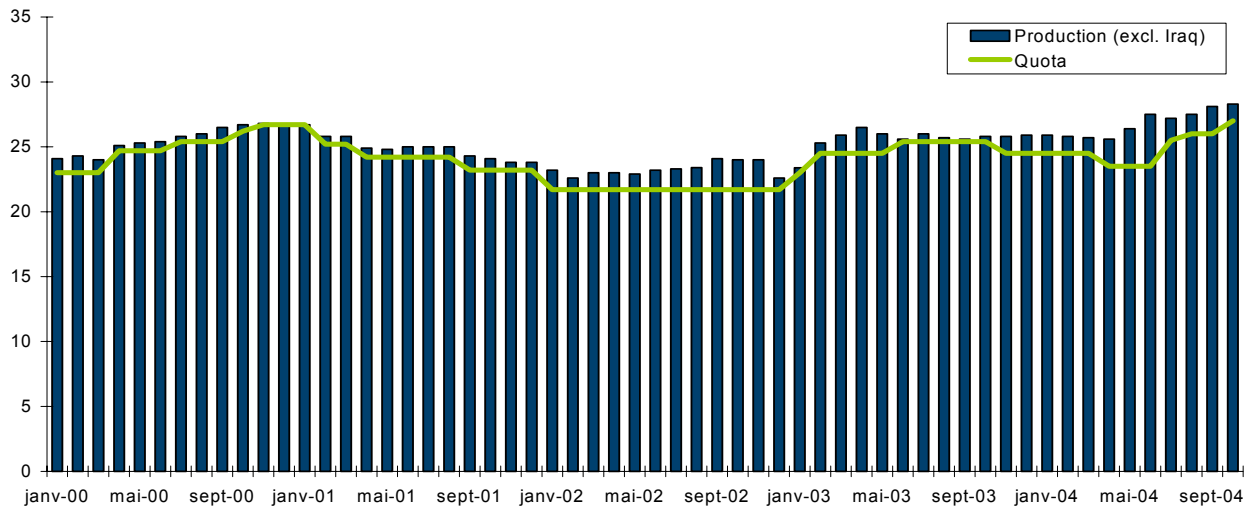
Source: KBC Securities

Insatiable demand and tight supply

At the end of last month, crude oil prices lost \$4/bl on the news of a 4 million barrels increase in US inventories and a rise in Chinese interest rates. We are not sure this is a real trend reversal as the latest price surge only had a limited impact on demand, which is being driven primarily by China, whose economy grew by 8.9% in Q3. The IEA estimates that Chinese demand for oil will increase by 15% this year, reaching 6.3 million barrels a day. In the meantime, supply is struggling to keep up, with the non-Opec producers at full stretch. Moreover, the damage caused by Hurricane Ivan in the Gulf of Mexico has reduced production by around 476,000 barrels/day and it will take several more weeks before output returns to normal.

The Opec reaction

Opec raised daily output to a record 30.7 million barrels in October, up from 30.4 in September. But surplus capacity is less than 1 million barrels/day, precious little considering world demand could top 84 million this winter. Saudi Arabia has announced its intention to boost capacity by a further 1.5 million barrels/day, making a total of 11.0 million. However, we suspect that this increase will do little more than offset the gradual decline in output from the major Saudi wells that are now several decades old.



World oil supply and demand

Million barrels/day	2002	2003	2004E	2005E	3Q04	4Q04E	1Q05E
World demand	77.9	79.7	82.4	83.9	85.0	84.0	84.0
(change)	+0.8%	+2.3%	+3.4%	+1.8%	+3.5%	+2.3%	+1.9%
Non-Opec supply	48.1	49.0	50.1	51.4	49.8	50.8	51.4
Opec condensates	3.7	3.9	4.4	4.8	4.4	4.5	4.7
Opec crude demand	25.1	26.8	27.6	27.6	29.4	28.7	27.9
Total supply	76.9	79.7	82.1	83.8	83.6	84.0	84.0

Source: International Energy Agency

Based on the IEA's latest monthly report, the above figures reveal a sharp increase in demand for Opec crude in 2004, although no increase is expected next year.

Diesel prices overtake gasoline and gas prices hit crisis levels

In a highly unusual development, diesel prices passed the \$500/tonne mark in Rotterdam last month, overtaking gasoline in the process. This reflects a deterioration in Europe's traditional deficit in distillates (diesel and fuel-oils) at a time when US inventories are declining.

The tension comes at the onset of winter just when refining capacity is barely sufficient to cover winter demand.

Note also that US natural gas prices climbed to \$ 8 to 9 per million btu, a level unseen since the two temporary shortages during the winters of 2000-2001 and 2002-2003.

Will conditions settle down after the winter?

In the short term, oil markets will probably stay very tight, particular if the northern winter is colder than average. Once winter is behind us, the increase in output capacity and the seasonal drop in demand should see a return to supply and demand equilibrium from the second quarter.

In the longer term, **we are maintaining our forecast for an equilibrium price of \$ 30 for a barrel of Brent since in our view, the underlying problem of reserve replacement will prevent prices from falling back down towards \$ 20-25.**

Note that on 26 October, BP announced that it too projects \$ 30/bl. for the medium term.

Our scenario for Brent (quarterly data)				
\$/barrel	Q1	Q2	Q3	Q4
2003	31.3	25.9	28.4	29.4
2004E	31.9	35.5	41.6	42.4
2005E	44.0	30.0	30.0	32.0

Source: KBC Securities calculations and estimates

Brent prices and refining margins (annual data)							
\$/barrel	2000	2001	2002	2003	2004E	2005E	2006E
Average price of Brent crude	29.1	24.8	25.1	28.8	37.8	34.0	30.0
European refining margins	3.8	2.5	1.7	3.9	5.0	3.8	3.0

Source: KBC Securities calculations and estimates

Investment set to increase

Following on the heels of Total and Royal Dutch, BP has just announced that it plans a significant increase in its exploration-production budget. These increases highlight a number of visible trends:

- A recovery in genuine exploration spending after five years in which the development of existing wells took priority over new discoveries.
- A volume increase in development costs exacerbated by a rise in the price of steel and other industrial materials.
- Oil services companies are at full capacity, which has augmented their pricing power vis à vis their clients.

It hardly needs to be said that these conditions are extremely beneficial for groups like Géophysique, Schlumberger and Technip.

Key ratios

At 29 October 2004	Current price	Currency	P/E			P/CF		Performance
			2003	2004E	2005E	2003	2004E	2004*
BP	527.75	Pence	17.5	12.6	14.1	9.9	8.4	+16.4%
Chevron Texaco	53.06	\$	15.2	9.7	12.2	8.8	6.8	+18.6%
ConocoPhillips	84.31	\$	12.8	8.3	9.9	6.7	5.2	+28.5%
ENI	17.8	€	11.9	8.7	9.3	6.3	5.3	+18.8%
Exxon-Mobil	49.22	\$	19.8	14.3	15.8	12.9	10.2	+19.9%
Petro-Canada	66.48	CAD	10.5	9.5	10.9	4.3	3.6	+3.7%
Repsol-YPF	16.99	€	8.9	7.2	8.5	4.3	3.8	+9.9%
Royal Dutch	42.59	€	15.5	12.1	13.1	7.9	7.3	+1.8%
Statoil	92.25	NOK	12.3	9.9	10.0	6.2	5.2	+23.3%
Total	163.0	€	13.8	9.8	10.6	8.3	6.2	+10.7%
General average			13.8	10.2	11.4	7.6	6.3	+15.2%
Supermajors			16.4	11.7	13.2	9.6	7.8	+13.5%
Others			11.3	8.7	9.7	5.7	4.9	+16.9%

Source: IBES and KBC Securities estimates

* change in share price (in local currencies since end-2003)

Share news: the end of outperformance?

Over the first three quarters of this year, oil shares rose by 9.1% on average, compared to a 1.2% fall for the Euro Stoxx50. This outperformance appeared to come to an end in October, when the integrated companies were broadly unchanged and the Euro Stoxx50 gained 3%.

In our sector universe, BP and Royal Dutch posted Q3 results showing strong growth, albeit weaker than expected for BP given the favourable business conditions.

It would appear that the decline in technical costs has come to a halt and is now beginning to increase (cf. previous page).

BP also probably took advantage of the current climate to set aside provisions for future charges and obligations.

On 12 October, we upgraded our rating for Royal Dutch from Underperformance to Neutral.

In effect, despite the group's disappointing performance in exploration-production, it is benefiting from the prevailing business climate and its very strong positions in refining and natural gas.

On 28 October the group announced a drastic simplification of its structure: The two holding companies Royal Dutch and Shell Transport & Trading are to merge. The resulting company "Royal Dutch Shell" will have one CEO and one single board of directors.

Unfortunately, the group also announced a fifth downgrade of its proven reserves, now down to less than 10 years of production at current levels.

We have made no other changes to our October ratings and target prices:

Performances and rating					
	Share price	October	Rating	Price target	November events
	31/10/2004	change			
BP	527.75 p	-0.1 %	Neutral	500 p	
ENI	€17.8	-1.3 %	Outperformance	€ 21	Q3 (10-Nov-04)
Repsol-YPF	€16.99	-3.9 %	Outperformance	€ 19	Q3 (11-Nov-04)
Royal Dutch	€42.59	+2.7 %	Neutral	€ 41	
Total	€163.0	-0.6 %	Outperformance	€ 182	Q3 (11-Nov-04)
EUROSTOXX Energy index	311.89	+0.3 %			

Source: KBC Securities calculations

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