

SPECIAL REPORT: OIL



February 7, 2006

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Recent Developments in World Oil Markets

World oil prices are spiraling upward in the past month. The West Texas Intermediate price of a barrel of crude has risen \$7 to \$67. Concerns about supplies from Iran, Nigeria and Iraq, all related to political issues, appear to be the explanation.

Oil Price Forecast

Our previous oil price forecasts anticipated an easing of world oil supply constraints as hurricane damaged oil facilities in the US came back on line. Oil prices did fall temporarily, but have since risen. If these supply concerns persist in 2006, oil prices are likely to be \$5 to \$10 higher than we previously expected. These forecasts still envisage a reversal in oil price trends from the now higher price level.

Display 1: Our Oil Price Forecast
\$/Barrel

	Current Forecast	Previous Forecast (supply concerns ease)
Q1/06	67	58
Q2/06	65.5	56
Q3/06	63	54
Q4/06	63	54
2006	65	55.5

Source: Alliance Capital Fixed Income 2/7/06

Demand for Oil

Demand growth in 2005 was very mild compared to previous years. The increase in world oil-consumption growth in 2005 was half that of 2004.

Display 2: Increase in World Oil Consumption
Barrels per day (Thousands)

	World	North America	China	Other Asia	Europe
2003	1,530	400	550	90	160
2004	2,360	810	860	500	190
2005	1,180	150	200	210	20
2006F	1,800	400	400	200	0

Source: International Energy Agency 2/7/06

This was the result of three major factors. First, world economic growth declined to 3.1% in 2005 from 3.9% in 2004. Second, demand from China slowed because of both policy changes that led to more efficient use of fuel and greater reliance on coal. Chinese imports of crude and products actually declined in 2005. Finally, there is evidence that demand fell in all regions of the world in reaction to higher prices.

The International Energy Agency (IEA) originally projected demand to grow by 1.8 million to 2 million barrels a day in 2005 but was obliged to continually revise this forecast downward. The IEA did, however, maintain this forecast level for 2006, although it did warn in their December report that their outlook “is conditional on continued strong economic growth and unchanged patterns of consumer behavior and/or energy policies...Thus, actual growth may well be lower.”

By contrast, our estimate for 2006 is for consumption to grow by 1.2 million to 1.5 million barrels a day.

World Supply

Several factors contributed to a slowdown in oil production growth in 2005 that offset the demand declines.

Display 3: World Supply of Oil
Barrels per day (Thousands)

	World	OPEC	FSU	Africa	OECD
2003	2,800	1,900	900	0	-300
2004	3,400	2,300	900	400	-300
2005	1,200	1,200	380	310	-900
2006F	1,800	500	500	550	0

Source: International Energy Agency 2/7/06

Hurricane damage shut down existing wells in the US and Mexico. For the most part, this capacity will be restored in 2006. This reversal could lead to a small increase in the supply from OECD sources, notwithstanding the long-term secular drop in these

supplies which has been taking place over many years.

Another factor, likely temporary, was the hostile political environment in Russia for oil producers. Investments in Russian oil production have now largely resumed.

A final factor in slower production growth were the large production increases by OPEC in 2003-04 which left OPEC with very little remaining spare capacity. Beginning in 2005 increases in OPEC output are largely dependent on new investment in productive capacity.

Supply increases this year could come from expansion of African production, restoration of US Gulf production, and resumption of trend increases in FSU oil production. Higher output by OPEC producers could also be expected, however, if oil demand growth continues at 2005 levels, very little additional supply will be needed from OPEC.

On the other hand, supply disruptions in Iran or further slowdown in production from Nigeria or Iraq could upset the global oil market and send prices soaring. OPEC has the capacity to offset some temporary supply disruption. OPEC currently claims spare capacity of 1.75 million barrels a day—possibly an exaggeration, although some OPEC producers are able to increase supply on relatively

short notice. But much of this extra capacity is probably heavy-sour crude which is harder to refine. World oil inventories have grown somewhat, covering about 50 days of world oil consumption. These could certainly help offset any temporary supply disruption.

The world supply situation could also improve. The IEA estimates productive capacity will grow over the next few years at a sustained rate of 1.5 million to 2 million barrels a day, based on world investment levels and oil reserves.

World supply-demand conditions would thus seem to warrant a decrease in oil prices from current levels. However, there is limited room for error. Politically-induced supply disruptions would leave world oil markets vulnerable to sustained price increases. Only oil conservation and sustained investment in production would alleviate this vulnerability.

In the interim—with supply reduction out of Iraq and Nigeria and possible future reductions looming out of Iran—we are raising our oil price forecast for 2006.

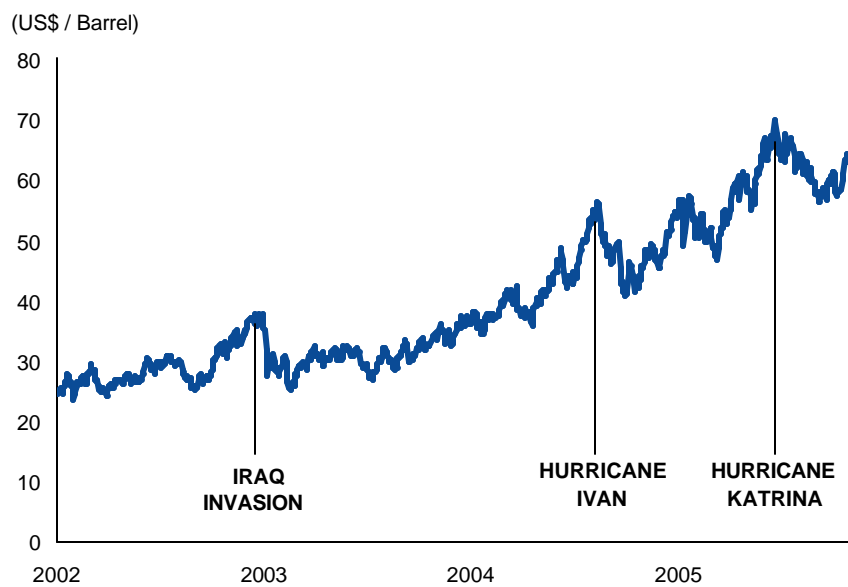
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Display 4: Oil Prices Return to Trend

West Texas Intermediate Oil Prices

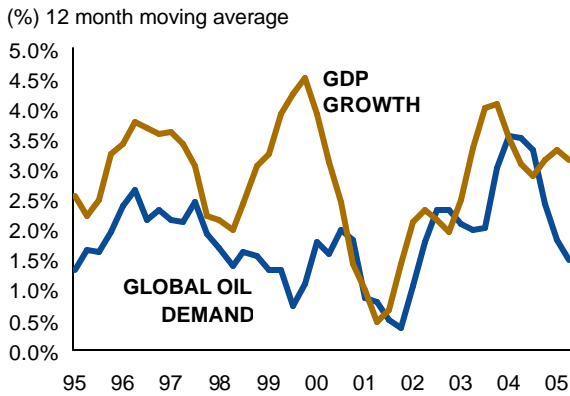


Source: Bloomberg 2/7/06

Oil prices have resumed their upward trend after dropping in Q4/05.

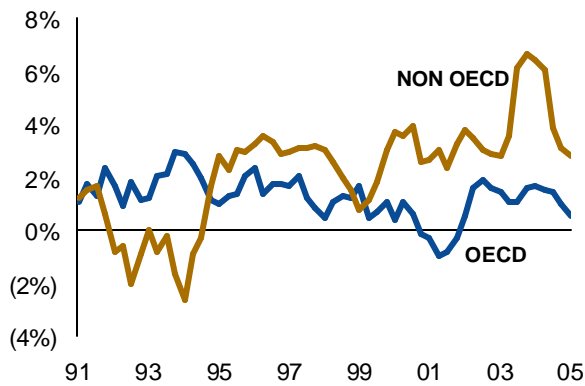
Display 5: World Demand for Oil
Oil Demand

Growth in Demand for Oil Has Slowed

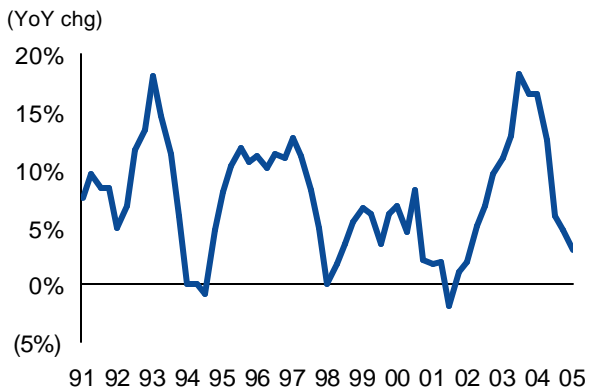


After unusually strong demand growth in 2004, demand for oil in 2005 was unusually weak.

OECD and Developing Countries Demand

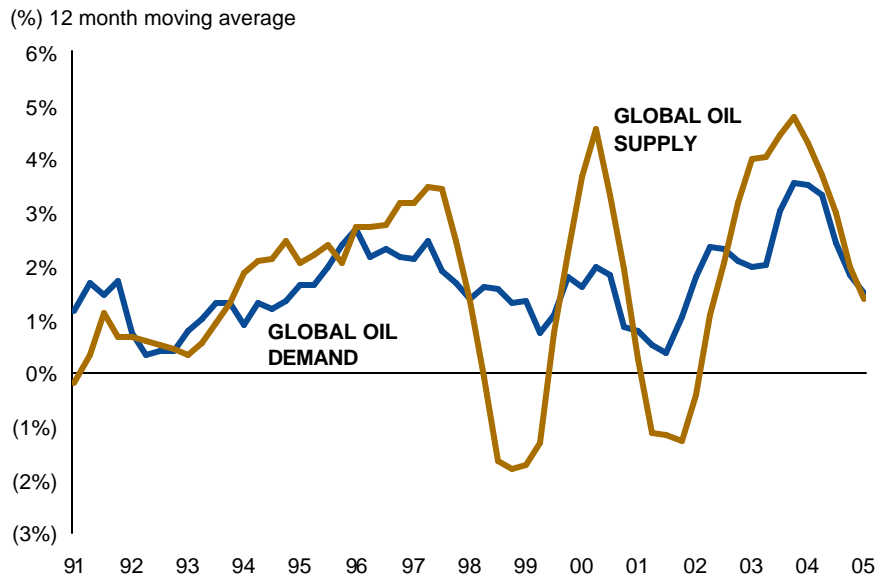


China Demand for Oil



Source: IEA 2/7/06

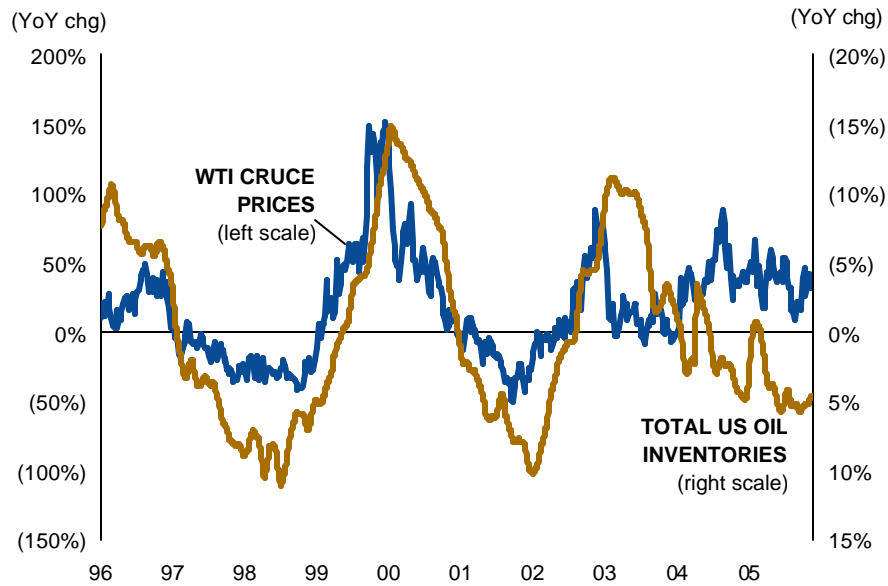
Display 6: Supply Growth Also Moderated in 2005 Global Oil Demand and Supply



Source: Bloomberg 2/7/06

Oil supply growth was unusually slow in 2005 due to oil-supply limitations from Hurricane Katrina and Russian politics.

Display 7: Higher Oil Inventories No Longer Limit Price Increases US Total Oil Inventories and West Texas Intermediate Prices



Source: Bloomberg 2/7/06

The inverse relationship between oil inventories and oil price appears to have been broken.