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Klaus Matthies\*

# Commodity Prices Recede from Record Highs

*Several commodity prices appear to have peaked earlier this year and crude oil prices have even fallen by more than 10 dollars per barrel from their recent all-time high level. Is the worst over for buyers of raw materials or will prices rise again in the coming months?*

The HWWA index of world market prices, which had risen to its highest level on September 1, has since declined, mainly due to lower energy prices. The spot price for Brent oil fell to US \$54 per barrel in mid-November – \$13 less than the highest quotation – helped by warmer weather in parts of North America, which dampened demand for heating oil. Oil users in the euro area continue to benefit from their relatively strong currency, although the recent appreciation of the dollar reduced their advantage: \$54 for Brent oil in mid-November was the equivalent of €46. In real terms this year's high oil prices are still much lower than the peak levels seen in the early 1980s.

In the first eight months of this year, oil price increases had accelerated sharply despite a slowing world oil demand growth and rising crude stock levels in oil-consuming countries. Global oil consumption rose less than half as much in the first three quarters of 2005 compared to the same period in 2004, 1.4% against 3.2% according to recent IEA data. But concerns over the lack of spare production capacity, continued political turmoil in oil-producing regions, and the potential for weather-related demand and supply shocks have kept oil prices high and volatile. In early September, the crude oil quotations reached a new all-time high when oil production and refining in the Gulf of Mexico had to be shut down because of a hurricane approaching. The storm-related price rise was short-lived, though, as emergency oil reserves were released immediately to the market and Saudi Arabia promised to increase its output. There was considerable damage to energy facilities in the three states affected, but it proved less severe than feared.

Oil production in the Gulf of Mexico contributed almost 30% of the US total before the hurricanes struck in September, but in mid-November half of the Gulf oil production was still shut in. At the same time, refinery shutdowns in the region still amounted to 5% of total US capacity. As there already were shortages of refin-

ing capacity before the hurricanes struck, difficulties in starting up the refineries – the total recovery will take several more months – could keep oil product markets tight for some time. The situation is eased, however, by the fact that the high fuel prices slowed down demand for petroleum products. Also, higher refining outputs in other OECD countries helped offset the loss in the USA. The hurricanes also damaged a number of natural gas processing facilities on the Gulf Coast. The loss will delay the recovery of natural gas production in the area – almost half of the production was still shut down in mid-November – as the gas often cannot flow to customers without prior treatment.<sup>1</sup>

The release of strategic oil stocks by IEA member countries in response to the supply disruption left governments with less of a buffer to ease the supply situation if needed in the future. The OPEC countries tried to help calm the oil market by raising their joint production limit and finally suspending it for the rest of the year. But since the actual OPEC production capacities are almost fully used, the effect can only be limited. Any short-term increase in supply has to come from Saudi Arabia, which claims it can produce up to 1.5 million barrels per day (of mostly relatively heavy and sour qualities) more than its current output.

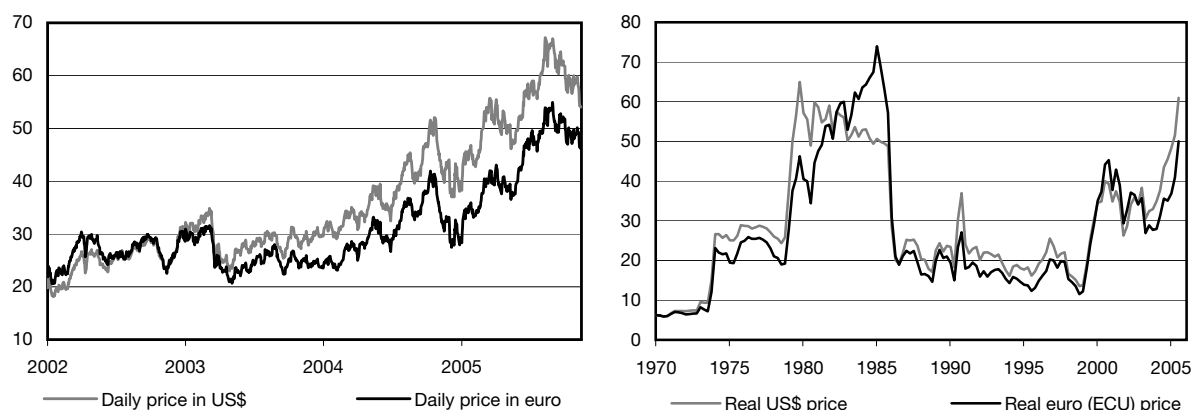
## Slower Rise in Oil Demand

The sharp rise in the oil price affects world oil demand. Global oil consumption will continue to increase, with additional demand concentrated, as in recent years, in the USA – still by far the largest single oil-consuming economy – and in Asian economies, China in particular. The non-OECD countries as a whole account for about three quarters of the global addition to oil demand. But the increase will be more moderate than last year as much higher oil prices together with a somewhat slower global economic growth will have a dampening effect on oil consumption. The IEA forecasts a rise in global oil demand of

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<sup>1</sup> Cf. EIA Report on Hurricane Impacts on U.S. Energy for the current situation [http://tonto.eia.doe.gov/oog/special/eia1\\_katrina.html](http://tonto.eia.doe.gov/oog/special/eia1_katrina.html).

**Figure 1**  
**Nominal and Real Brent Crude Oil Prices<sup>1</sup>**



<sup>1</sup> Price per barrel; real prices: quarterly prices (until 1981Q1 Arab Light), deflated with manufactures export price, basis 2005.

Source: HWWA.

1.5% this year and 2% next year, following 3.7% in 2004.<sup>2</sup> The OPEC estimate for next year is slightly lower at 1.8%.<sup>3</sup>

On the supply side a further addition to output capacity is to be expected. The oil production of non-OPEC countries is predicted by the IEA to rise by 1.3 million barrels per day in 2006, with major contributions by African countries and the Former Soviet Union. But in order to keep pace with worldwide demand the OPEC countries will have to raise their output as well. According to OPEC, the combined spare capacity of its member countries will rise by a total of 2 million barrels per day between December 2004 and December 2006. Almost half of the volume (0.9 million barrels per day) will be added in the course of 2006, above all in Algeria, Iran, Libya, Nigeria, Saudi Arabia and the UAE.<sup>4</sup> It is assumed that Iraq's production remains at its current level of about 2 million barrels per day. Expectations that oil production in Iraq could be raised significantly have not materialised. Ongoing acts of sabotage, frequent power failures and a general lack of security have resulted in a daily crude oil production that still runs at least one third below the pre-war level. The investment decisions of private oil companies are hampered by political stability concerns and will remain so unless the situation improves considerably.

#### **Oil Markets Remain Tight**

The storm-related production losses in the Gulf of Mexico and a moderate world supply growth in 2006,

combined with a slightly faster demand growth than this year, will keep oil markets tight. Although – assuming that there will be no major supply disruptions – no bottlenecks are to be expected in world oil supplies, the level of idle production reserves that can be mobilised at short notice will remain extremely limited in the short and medium term. Consequently, after the winter months, which could bring a cold weather related rebound in crude oil prices, no marked drop in prices can be expected next year, keeping the quotation for Brent above the 50-dollar mark, with large short-term fluctuations. A bigger fall in oil prices would result from a much lower than expected increase in oil demand in case of a marked slowdown in world economic growth.

Energy saving and increasing supply will eventually ease the situation in the oil market. For the medium and long term considerable investments in production and transportation facilities will have to be made to be able to satisfy the constantly growing demand to be expected in the emerging economies of the world. In its recent long-term projection,<sup>5</sup> the IEA sees world energy demand increasing by over 50% until 2030, if policies remain unchanged. Resources are adequate to meet this demand, but according to the study investments of \$17 trillion will be needed to bring them to energy users. In the case of oil, the countries in the Persian Gulf region have the largest and by far the most economically exploitable reserves at their disposal. But they show little interest in a rapid development of their resources with the help of private oil companies, so that for the time being these companies will have to focus more strongly on other, in general more costly,

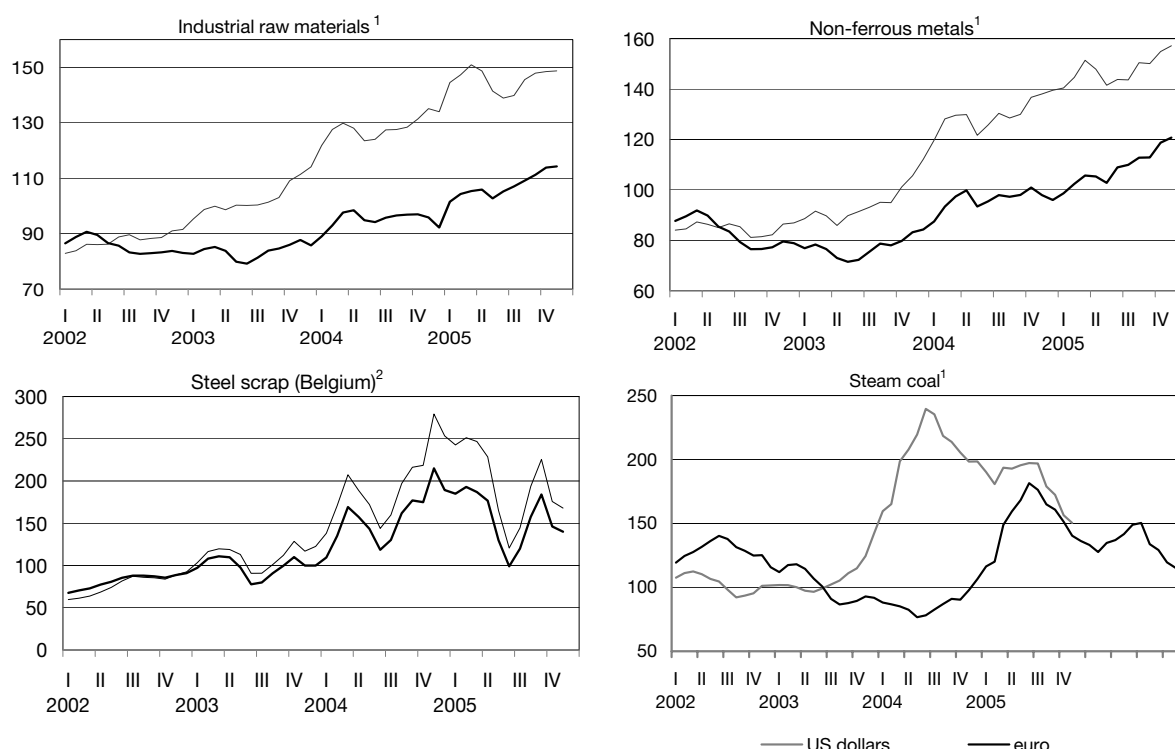
<sup>2</sup> Cf. IEA: Monthly Oil Market Report, 10 November 2005, Table 2.

<sup>3</sup> Cf. OPEC Monthly Oil Market Report, November 2005, p. 27.

<sup>4</sup> Cf. OPEC Monthly Oil Market Report, October 2005, p. 38.

<sup>5</sup> IEA: World Energy Outlook 2005, Paris 2005.

**Figure 2**  
**Selected Raw Materials Prices**



<sup>1</sup> HWWA Index, 2000=100. <sup>2</sup> Price per metric tonne.

Source: HWWA.

alternatives. For the oil-consuming countries the pressure to use energy more efficiently is rising.

### Lower Coal Prices

In the coal market,<sup>6</sup> prices for steam coal continued their descent from the record level reached in mid-2004. Demand pressure eased under the impact of slow economic growth in Japan and Europe, two major import areas, affecting coal consumption for electricity generation and industrial uses, e.g. in cement production, of a gradual shift from coal to other energy sources in power stations in both regions, and of short-term factors such as the resumption of hydro-power production in Europe following the replenishment of water reservoirs during a wet summer. Coal prices came back into the "normal" range of the 1990s, even if they are still high compared to the low levels of three years ago. On the supply side producers succeeded in overcoming infrastructure constraints, and capacity

expansions by major exporters are making progress. The ongoing shift in the market balance from under- to oversupply points to a further decrease in steam coal prices. Contract prices for coking coal, which are negotiated annually and more than doubled to an all-time high this year due to high demand from steel producers, may have reached their peak this year, as coking coal supplies seem to be catching up with demand. Rising supplies from additional capacities coming on stream as well as slowing demand following a lower growth rate in world steel supply will improve the position of buyers in the coming negotiation rounds.

### Industrial Materials Prices Near Their Peak

The slowdown in steel production affects other raw materials markets as well. It already put some downward pressure on ferrous scrap prices, and it will influence the imminent negotiations about next year's iron ore contract prices. Iron ore buyers aim at a price cut because falling steel prices have worsened the financial situation of many steel mills. But ore producers, having achieved an unprecedented 72% rise this year, are striving for a further strong rise next year

<sup>6</sup> Cf. Anthony de Carvalho, Paavo Suni: World Commodity Prices 2005 to mid-2007, AIECE Commodity Group Report, October 2005, pp.12-15.

pointing to the very tight market. Spot quotations for iron ore imports into China were markedly higher than contract prices in the April-October period.<sup>7</sup> Therefore, a price cut in 2006 is highly improbable, but a possible outcome is a rollover of this year's price. As large on-going iron ore projects will raise supplies in the coming years, the chances for price cuts will improve in future rounds.

The rate of increase in non-ferrous metals prices slowed down this year as stock levels rose in response to supply-led developments. But in November price rises accelerated and copper rose to its highest ever

official three-month price on speculation that demand for the metal from builders and manufacturers is outpacing production from mines. Copper inventories were low because world copper production has not kept pace with demand. Speculation over China's role in the market – traders bet that the government would have to buy large amounts of the metal to cover trading commitments – supported the upward movement.<sup>8</sup> Nevertheless, next year non-ferrous metals prices are expected to decline in line with slower growth in world industrial production. On average, industrial raw materials seem to be nearing their peak, as supply in many markets finally begins to keep pace with demand.

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<sup>7</sup> Cf. Iron ore fines price could rise 20% for 2006, *metalsbulletin.com*, 14 November 2005.

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<sup>8</sup> Cf. Maria Silander: Uncertainty lifts copper to all-time high, in: *Financial Times*, 15 November 2005.