Oils

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The new geopolitical landscape for the oil sector

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No-one disputes the fact that oil will remain crucial to all modern economies for several decades to come. The fluidity of its supply affects the whole world. Oil prices not only determine everybody's energy bill, they also influence the price of other energies and are often used as a benchmark for determining investments, profits and business volume in other strategic sectors.

I am convinced that oil prices are determined by market fundamentals, namely supply and demand for oil on the various markets. I would, however, like to add two factors to this equation. First, oil demand and in particular its supply are affected by a number of random factors. Second, in a market that has imperfect competition, the behaviour and strategy of the leading players influence developments.

Oil supply is largely determined by a very limited number of large players. Over the past thirty years, we have seen that to analyse, interpret and anticipate market developments, economic analysis is necessary but not enough: oil is not like other products. The overlap between economic interests, politics, diplomacy and military concerns is clearly visible in the oil market and, in addition to fundamentals, oil industry players and analysts also factor geopolitical developments into their price forecasts.

In the short term, OPEC's market share is still being contested by other exporters. However, the growth in non-OPEC production will be limited over time and in volume, and all projections (IEA, DOE, etc.) agree that Middle Eastern oil will dominate future supply. In the years ahead, if we are to prevent supply-side shocks, OPEC members – and in particular the Gulf states – need to increase their production and reinforce its security. Some believe that the current conditions will not allow this, and that it will only be possible if international companies, with their technical and financial capabilities, are involved.

To facilitate this involvement, a number of changes are likely to be made. At a political level, internal stability needs to be assured within producing countries, meaning that economic and institutional reform needs to be completed. In legal terms, the conditions for accessing upstream oil activities in OPEC countries should be adapted to bring about the deregulation, or even privatisation of this sector. At a geopolitical level, the priorities are to resolve regional conflicts and establish the regional cooperation that will ensure the security of transport routes and guarantee supply to the global market.

Current trends in the oil market

- First, global oil demand growth is essentially being fuelled by emerging countries, mainly China, which accounts for a considerable portion of the total, but also India, whose oil demand is evolving rapidly. In the near future, other countries are likely to see their share of global imports increase. More notable still is the sharp growth in international trade in oil and refined products. On the one hand, the fastest-growing emerging countries have an energy deficit and the domestic production of the major industrial nations within the OECD is declining, which is boosting imports, while on the other hand, exporting countries are steadily increasing their exports. The result is that even though oil demand is growing by only 2%, international trade in oil is expanding more rapidly. This structural trend has an impact in terms of tension on freight, congestion on international transport routes, the risk of pollution, the security of transport routes, greater dependence, and so on.

- OPEC is no longer viewed as an aggressive "cartel". Its contribution to the oil market's stability is not only acknowledged but is even sometimes explicitly sought, even by the United States, which refuses any state intervention in other markets. In spite of the organisation of world trade, it is accepted that an "exception" exists in OPEC, which functions as a cartel. What explains this tolerance, notably on the part of the United States, which means accepting that a small group of countries can directly influence the price of a product? Is oil such a strategic commodity? For some time now, we have noted increased price sensitivity to problems at even minor production sources. For example, if production by an exporting country falls by 0.5 Mb/d, prices react sharply, while the opposite (a surplus of the same volume) does not have a similar impact. The market often overreacts to technical failure or tension on refined products such as gasoline or residual fuel – more often than in the past.

- The oil markets are becoming increasingly globalised: after the development and harmonisation of spot and futures markets, physical arbitrage between distant markets such as the Atlantic and Pacific basins is growing sharply. The increasing need for oil imports, the desire for direct access and the profits generated on upstream oil activities are intensifying competition between major countries for the main reserves around the world.

Impact of the strategies of important players

- In a global economy, equilibrium on the oil market stems from the actions of all players on all markets. Yet, the actions of some players can have a greater impact. Five countries seem particularly important in this respect. Their oil policies and the terms underlying their strategies are set to gain importance, and as such a number of questions arise.

The United States: the world's main market, increasingly dependent on oil and gas imports, the only super-power, the only foreign army present in the Middle East (a region experiencing a difficult transition towards modernisation). The USA believes that oil forms part of its vital interests. Evidently, its intentions and behaviour in energy-related matters weigh directly on the oil market. This explains why participants in the world's financial markets keep a constant eye on developments on the US market and the NYMEX.

- Even if long-term oil interests were not the only reasons for the risks taken by the Bush administration in Iraq, they were crucial. What will the United States gain from its physical and military presence in the Middle East? Supply guarantees? Profits for its oil companies? A means of negotiation (and domination) vis-à-vis other importing countries? Clearly, in the current environment, the Americans do not seem to be worried that oil prices are between USD 22 and USD 28 per barrel. It was only when they remained above USD 28/b for some time that the US Secretary of State for Energy, Spencer Abraham, asked OPEC to act. Why? To favour other sources of production and boost diversification? Are oil prices not simply another way for the United States to regulate the global economy in its favour, like with the US dollar?

Saudi Arabia (and OPEC) - The world's main oil exporter and the only country with significant unused production capacity, its position determines that of OPEC. But the country is experiencing a difficult political transition and its relations with its main supporter and ally, the United States, have deteriorated, in particular since the terrorist attacks of 11th September 2001.

- What is Saudi Arabia's real production capacity? The most frequent estimate puts it between 10 and 10.5 Mb/d. Could it really produce at this level over the longer term if necessary? Does it have the means to stop prices from rising by producing substantial additional volumes? Probably, but some doubt that this would be sustainable without further investments. In any case, such a large unused production capacity is expensive to maintain, so why does it keep it? To influence prices or affirm its strategic position in order to bolster its defence or its incumbent regime?

- Is it in Saudi Arabia's interest for prices to remain above USD 28, with the risk that this may slow demand, reduce its market share and, in the longer term, bolster alternative energy sources? Given its internal problems and financial requirements, including its external commitments, can the country allow itself to lead a price war designed to discipline other sellers? Visibly, Saudi Arabia is facing a contradiction between its growing financial requirements and its policy of defending its market share. Can it implement the inevitable economic and political reforms without problems? The country's political and social situation is worrisome, in particular given the complex regional context, with the on-going problems in Iraq and the unresolved conflict between Israel and the Palestinians.

Iraq - Iraq's oil production will remain crucial to the market equilibrium. The country holds the world's second largest oil reserves and so potentially has a healthy financial situation if oil production could keep up. Its geographic and political situation could make Iraq a model for the region, but the opposite is also true – the unrest, terrorist attacks and divisions within the country could spread to its neighbours.

- Iraqi oil production will probably amount to 2.5-2.8 Mb/d by the end of 2004, and exports could resume, including to the North. However, the situation will depend on security at production and transport facilities. This security will only be assured by political stability (before democracy), which itself will require co-operation from the country's different communities on major issues, in particular on how to split oil revenues. Only this will bring about the political, economic and legal conditions needed to attract foreign investment and enable production to be stepped up in line with the country's reserves. The constitution and the political regime that will emerge from the current developments will provide a benchmark for the region. What form will Iraq's democracy take? What about the insecurity: risk of civil war, risk of contagion to other oil-producing Gulf states? The future status of the Iraqi oil industry could have a considerable impact on that of its neighbouring countries.

Russia put forward as a possible alternative to the Gulf states, a major producer, but the country's oil future is subject to speculation, notably about its capacity to increase its production in a sustainable manner.

- Russia has succeeded in increasing its production spectacularly in the past two years, but it has still not reached the volume it produced prior to the collapse of the USSR. Is this delay simply due to investment and modernisation problems? We cannot help noting the scepticism of some international experts and the comments of Russian officials on the limits to the policy of increasing production in the absence of renewed exploration.

- The recent problems at YUKOS and the refusal of EXXON MOBIL's takeover plans are delaying this strategy and they also emphasise the authorities' desire to control this strategic sector, which is the government's main source of currency. Russia is playing its oil and gas cards so it can have a strategic role on the world stage. It already has an important position as supplier to the European Union, but is attempting to capture transport routes for exports from the Caspian Sea and to become a key supplier in Asia via major gas and oil pipeline projects in China, Japan and South Korea.

- Is it in Russia's interests to support OPEC's price policy ? Given the importance of its oil and gas revenues and recent events in the oil industry, the possibility that it may join forces with other sellers if prices fall below USD 22/b cannot be ruled out, but many commentators consider that it will only really be forced to act if prices fall below USD 18/b.

China - In 2003, growth in oil demand reached nearly 10%. Transport requirements, in particular for vehicles, are growing sharply. Its enormous oil requirements mean China is increasingly concerned by the global oil issues that will determine its development, autonomy and international room for manoeuvre.

- It is interesting to note that for the first time recently a Chinese official explicitly expressed concern about the security of maritime oil supplies. Will China outsource its supply from the Gulf via the United States and international oil companies, or will it, like the United Kingdom, France and Russia, seek to be present in upstream activities in this region via its own oil companies? What can we imply from its relative discretion with respect to Iraq and the major political disputes in the Middle East? If it chooses the second option, we cannot rule out the possibility of greater competition in oil projects in the Middle East and the Caspian Sea region, with the rising access costs that this will imply.

What happened in the oil market in 2003 ?

- Preparations for and the aftermath of the war against Iraq produced a varying risk premium during the first half of 2003. Crude oil inventories were relatively low in relation to previous years. Fuels and gasoline came under pressure in line with seasonal fluctuations and/or accidents, including the closure of nuclear plants in Japan and the substitution for natural gas in the United States, and this had an impact on crude prices.

- The dollar fell sharply against other currencies, lowering the nominal value of oil prices in OPEC's point of view. Why did the slide in prices expected during 2003 not take place ? Admittedly, geopolitical events affected supply throughout the year, but OPEC offset the missing oil from Iraq, Venezuela and Nigeria. So is there another reason ?

- Clearly, the operational value of statistics released for the analysis and marketing of oil products is questionable. It is usual for demand estimates to be adjusted, and even though these adjustments have become increasingly frequent and sizeable recently, we know how difficult it is to measure this variable. What is more surprising are the errors in estimating inventories and supply figures, which have multiplied recently.

- Informed market participants (and speculators) know full well that reality is often more complex, and they use other tools to assess the situation, notably their feelings when negotiating their daily transactions. For these players, pressure on margins and differentials in either direction are the first signs of supply-side tension before prices adjust. We could attempt to revise our market analysis for 2003 from this angle, and conclude that supply was not as strong as suggested by the figures we had available.

- During the first quarter of 2004, it seems that all available production capacity around the world - apart from Saudi Arabia's – has been used, exceeding the official quota of 24.6 Mb/d for the OPEC-10 by 1.5 Mb/d. This suggests that more than 95% of capacity was used this winter, leaving little scope to deal with any malfunctions that may have arisen on as market that is more tense than we readily admit.

2004 outlook

- Excluding any major political event, which by nature is impossible to predict, opinions and forecasts differ for this year. The large majority, including SG, believe that on the basis of available statistics, a slide in prices is inevitable since the projections that we have at the moment point to a supply surplus that will emerge as of the second quarter. In this case, if OPEC wants to avoid a slide in prices, it will have to cut its effective production substantially (by 2.5-3 Mb/d), which will force it to lower its official production quota of 24.6 Mb/d. In contrast, some analysts, going by OPEC's practice over the past three years and the unexplained tensions on the markets, believe that the OPEC basket price will remain around USD 28/b. Some do not rule out the possibility that prices may peak at USD 40/b this year.

- While OPEC's production capacity affords the organisation scope to influence prices during the spring and summer (it could even prove problematic by creating competition between members), it seems to be insufficient during the winter when demand is stronger, in particular during demand peaks. OPEC ministers have repeatedly said that the market has sufficient oil, so it was not necessary to increase production as provided for under OPEC's automatic mechanism to bring prices back within the USD 22-28 trading range. Yet I think that in reality, OPEC cannot produce the substantial additional volumes needed to bring current prices back below USD 28.

- As for the official production limit, i.e. the theoretical quotas, with the prospect of the seasonal drop in demand in Q2/04, OPEC ministers believe that it would be too risky to raise the quota as it will probably need to lower it again at the start of the spring, with the problems that this could entail. At best, and this is what seems to be on the agenda for the next conference in Algiers, OPEC will not apply the production cut it should carry out as of 1/03/04.

- Similarly, despite expressing its concern about the slide in the dollar, I do not expect any decision in this area from OPEC. There is still no alternative to the US dollar, and OPEC will not readjust its USD 22-28 trading range for this reason. Statements in this respect can be attributed to political justification for not increasing production while prices are above USD 28. In any case, it will probably not be easy – while prices remain above USD 22 – to impose a considerable cut in exports on some country members which have recently increased their production capacity, in particular since non-OPEC countries are increasing their exports and that they will probably refuse to ally themselves with OPEC while prices remain above USD 18-20/b.

In conclusion, it seems that OPEC has the means to defend its pricing policy in 2004. I do not think it will try to raise the upper level of its target price range as some have suggested. Saudi Arabia, and implicitly OPEC, does not seem willing to encourage alternative sources of oil. OPEC needs to consolidate its revenues based on an average price (I emphasise the word "average") of USD 25/b. This would already be a major victory for the organisation. Let's not underestimate ministers' concern that prices may fall below USD 22 – they are still unsettled by what happened in 1998 after they raised the production limit in Bali (Indonesia).

SG FORECAST SUMMARY TABLE – FEBRUARY 2004

Million bpd	2002	1Q 03	2Q 03	3Q 03	4Q 03	2003	1Q 04	2Q 04	3Q 04	4Q 04	2004
OECD	47.7	49.4	47.2	48.0	49.5	48.5	49.7	47.4	48.5	50.1	48.9
Non-OECD	29.3	29.7	28.9	30.0	31.3	30.0	30.8	30.5	30.9	32.1	31.1
Total Demand	77.0	79.0	76.1	78.0	80.8	78.5	80.5	77.9	79.4	82.2	80.0
OECD	22.0	22.1	21.3	21.4	21.9	21.7	22.0	21.8	21.7	21.9	21.9
Non-OECD	24.3	24.8	25.1	25.5	25.9	25.3	26.2	26.4	26.6	27.0	26.6
Processing Gains	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Non-OPEC Supply	48.0	48.8	48.1	48.7	49.6	48.8	50.0	50.0	50.1	50.7	50.2
OPEC NGLs	3.5	3.3	3.7	3.8	4.0	3.7	4.0	4.1	4.1	4.2	4.1
OPEC Supply	25.1	26.7	26.2	26.6	27.7	26.8	27.9	26.2	26.1	26.4	26.7
Total Supply	76.7	78.7	78.0	79.1	81.3	79.3	81.9	80.3	80.3	81.3	80.9
Stocks (+/-)	-0.3	-0.3	1.9	1.1	0.5	0.8	1.4	2.4	0.9	-0.9	0.9
WTI NYMEX USD/b	26.14	33.80	28.96	30.24	31.19	31.05	31.00	27.30	25.80	27.50	27.90
Brent IPE USD/b	25.06	30.63	25.83	28.19	29.13	28.44	28.60	24.80	24.00	25.00	25.60