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US$147/B ONE YEAR ON: POLITICAL WINNERS AND STRATEGIC LOSERS

After a five year bull run from 2004-08 oil producers became used to high receipts cementing support at home while buying influence abroad. As highs of $147/b in 2008 turned to lows of $33/b in 2009, the political demise of producer regimes was expected to follow. But amid a sustained economic crisis, political resilience became the leitmotif of producer states. With prices and resource nationalism set to rise in tandem, the political impetus could shift back to producers once more, but unless lessons are learnt from 2008/9, all states will lose out.

President Chavez cements Chinese energy links with Venezuela, September 2008. *Reuters/Ho New*

At the turn of the year the political outlook for producer states looked grim. The oil price had dropped to below $40/b having stood at $147/b a mere six months earlier leaving a number of producers in bad financial shape. High oil prices were supposed to lead to political stability and economic growth at home, while projecting power abroad. This logic applied not only to the Persian Gulf, but in Venezuela, Russia, West Africa and to a lesser extent, Gulf Cooperation Council (GCC) states. But as the oil price tumbled, it was expected that it would take a number of political casualties with it. This has not been the case.

Governments from Caracas to Moscow have proven to be politically resilient in the eye of a sustained economic storm. Production cuts from OPEC played an important role in setting a price floor, but more importantly, producer states resorted to tried and tested centralization of powers rather than engage in any kind of genuine political reform to paper over the cracks. Iran provides the latest and most notable example of this trend, while Venezuela, Russia, Nigeria and to a lesser extent, GCC states have not been afraid to batten down the political hatches. How long political regimes in producer states could have survived without upward movements in the oil price remains an open ended question, but just as fiscal belts were being seriously tightened, prices firmed back to $65-75/b. All producer states will thus leave 2009 on a stronger footing than they entered it.

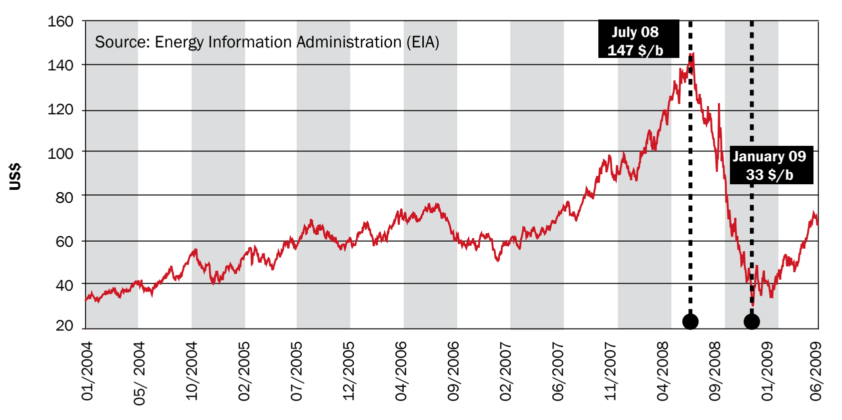
Admittedly, a 'one size fits all' analysis across producer states does not work. They all have radically different political and economic positions to defend on a domestic and regional basis and indeed, display different depths of foreign reserves and political *aplomb* to navigate crisis. But a number of lessons can still be drawn from this period of volatility. The first is that the impact of political risk on price will wax and wane with the tightness of the market just as readily as political points are scored between consumer and producer states. 'Who's up' and 'who's down' remains a function of how well resource wealth has been managed in the past of course, but having weathered the political storm of 2008/9, *most* producer states will now continue to press their perceived strategic edge through sharpened resource nationalism, a greater focus on National Oil Company (NOC) investment and political capping of reserves. This has not been lost on traders; short-term hedging is back in fashion, but the real question is whether the same structural factors leading up to the 2004-2008 spike will return once physical demand rebounds. Whether or not such fundamentals are in place for another bull run remains to be seen, but consumer states should be in little doubt: *politics* as much as *price* will continue to dictate the market.

'Irrational' political risk

As with previous price peaks in 1973, 1979/80, and 1990, the classic ingredients of tight supply-demand fundamentals and short term price signals driven by fears of physical outages came into play from 2004-2008. Strong Asian demand and sustained economic growth over the past five years against a backdrop of asset sweating in the 1980s and 1990s provided all the evidence traders required to build up net long positions on crude oil futures.

Speculators duly piled into oil using every scrap of geopolitical friction to push prices

Oil price volatility 2004-2009 (USD, WTI Spot)



higher. Intractable conflicts in Nigeria and Iraq alongside contractual instability in Central Asia and Russia entered the daily lexicon of oil price pressures, as did shorter term flashpoints such hijacked ships in Gulf of Aden and the supposed specter of war between Venezuela and Colombia. As market positions amassed, investment banks started hinting toward $200/b forecasts. This was a figure that that many analysts started to present as a self-fulfilling prophecy as the market approached the $150/b mark in July 2008, irrespective of conflicting price signals in play.

Even price moderates within OPEC ranks who, unlike price hawks, maintained the ability to put more oil on the market, grew increasingly confident that demand would remain inelastic. In the first half of 2008 OPEC earned as much as they did in the whole of 2007 – putting $645bn into state funds in six months, with the GCC earning over $1.7 trillion from 2002-2007. Foreign reserves rapidly approached $2,500bn in the Middle East, while Sovereign Wealth Funds (although not exclusively oil based) amassed a global total net value of $4 trillion in 2007.

Financial muscle politically flexed

The upshot was that many producer states became increasingly dependent on high oil receipts. Iran, Venezuela, Algeria, Bolivia, Russia, Nigeria, Libya, Angola, Kazakhstan and to a lesser extent GCC players all needed to maintain high oil prices for political stability at home and projection of power abroad, as well as maintaining robust economic growth outlooks.

Iran calibrated its spending to a $95/b benchmark price, having ably used its oil receipts to 'buy' influence abroad. This included offering free electricity to Shi'ites in Iraq, giving over $1bn to Lebanon (Hezbollah) after the 2006 war with Israel, and contributions to Hamas. Spending also had a domestic angle; with 80% of government revenues coming from the energy sector, Ahmadinejad could afford to let inflation hit 30% and use 12% of GDP on energy subsidies so long as receipts remained high. Sanctions against Iran's nuclear programme hardly touched the sides. Not to be outdone, Hugo Chavez balanced his budget at $95/b to maintain political momentum for the 'Bolivarian revolution' in Venezuela. Part of the revolutionary 'package' was to create an anti-US bloc in Latin America with more than a dozen countries in Central America and the Caribbean receiving 300,000 b/d of Venezuelan oil on easy terms in return for investment. This equated to roughly $1.7bn a year in oil alone, with around another $17bn in aid transfers made to support Morales in Bolivia, Ortega in Nicaragua and the FMLN in El Salvador. Meanwhile in Nigeria, political defeat, rather than diplomatic accommodation with MEND was the order of the day to try and regain Lagos's lost crown as the largest oil exporter in West Africa.

Medvedev took up where Putin left off in Russia by continuing to use hydrocarbons as a political tool to 'recapture' lost Russian influence. The budget was balanced more conservatively at $70/b but Moscow became increasingly assertive in the Caucuses and bellicose towards its relations with the West over anything ranging from missile defense to the formation of a nascent gas cartel. Even the GCC states started to balance budgets above a $50/b benchmark price, both as a means of investing in economic diversification and to buy political support. Riyadh, as the clear swing producer in OPEC was also able to court repeated requests from Washington, the EU and Beijing to take the heat out of the market. Iraq, although badly plagued by the politics of oil, was also starting to slowly rebuild its battered economy as receipts rolled in.

If anything, producer states became less concerned with prompting potential demand destruction, but with dealing with inflationary pressures inflicted by upward price movements. By May 2008 headline and core inflation had risen to 8.6% in emerging markets. This was invariably 'dealt' with through heavy subsidies or import-export control adjustments on energy and other key commodities. Although fiscally painful, it remained small beer compared to the drastic deterioration in external positions suffered by over two thirds of importing countries as commodity prices soared.

Political survival key

Despite this gathering storm, OPEC and non-OPEC producers did not think a major price correction was on the cards. But ultimately, market sentiment had to catch up with the financial crisis and weakening fundamentals. The paradox of booming commodity prices in the midst of collapsing credit markets could only last for so long, as could the myth of economic decoupling between emerging and developed market economies. With banks desperate to realize capital gains and release liquidity following the collapse of Lehman Brothers, political risk only affected oil in terms of how credibly OPEC could set the floor as demand slackened, not how highly prices would be propelled. Russo-Georgian hostilities, 'open war' in the Niger Delta and Iranian threats to block the Strait of Hormutz were now all irrelevant. This was a market now desperately trying to stay above $40/b, not reach $200/b.

While lower prices came as welcome respite for consumer states, the bigger impact of the correction was putting the spotlight on engrained economic and political frailties in a number of producer states. Nowhere was this more evident than in Venezuela, Iran and Russia who merely six months before had been pushing their case for regional domination. In Caracas fiscal positions were quickly revised, monetary policy loosened and bonds issued to meet funding shortfalls. Foreign expenditure was also clipped, but with inflation at over 30% and foreign debt around $50bn and a breakeven price of $97/b to balance external accounts, Chavez was well aware that this would not be sufficient to save his political skin. The passage of a long standing Constitutional proposal to indefinitely extend his political tenure beyond 2012 could only do that.

The Kremlin quickly drew on oil stabilization funds to prop up the banking sector and ruble, underlining the degree to which the world's second largest oil producer is *dependent upon* and *exposed to* hydrocarbon price swings. Oil and gas now accounts for more than 60% of its GDP; having whittled reserves down to $US380bn Medvedev still has considerable latitude to pay off the oligarchs before reserves are fully drained, but has had to radically reduce his budget outlook to $41/b for fear of building up a major budget deficit. The bigger problem for Moscow is that it can no longer perform its historical role of capitalizing on OPEC cuts to increase its market share due to a long term lack of upstream investment. The fact that Russia tried to sign a memorandum of understanding with OPEC to stem the tumbling oil price (full cartel membership is simply not in Russian or Saudi interests) was thus a sign of fundamental weakness, not one of strength.

Indeed, since September 2008 OPEC has announced a total of 4.2m b/d in trimmed output, which has roughly translated into 3.3m b/d of actual restrictions. By OPEC standards 78% adherence to cuts is impressive, but it's also misleading. The majority of members including Iran, Venezuela, Nigeria, Algeria and Ecuador still preferred to keep oil flowing above quota, rather than face the graver short term political risk of seeing the taps shut down creating further fiscal pressures. Thus, while a floor was set, it was predominantly the GCC states (which have considerably more fiscal room for maneuver) that did it. Riyadh dropped its production by up to 35% of its total capacity of around 11.5m b/d, while regional revenues fell from a peak of around $3bn a day in 2008 to less than $1bn in March 2009 causing considerable disquiet in Kuwait, Qatar and UAE.

The story could however have been very different. Riyadh had much to gain by allowing prices to plummet below $30/b by failing to reign in supply. This would have won considerable political plaudits from key consumer states, and would also have been a useful means of cooling Iranian political ardor, not only in the nuclear realm but in Lebanon, Iraq and the Gaza Strip to slowly wrestle back political influence from the Persian Gulf to the Levant. Fortunately for Iran, whose economy remains in a perilous state with inflation over 30% and a Central Bank devoid of cash following presidential elections, allowing prices to drop below $30/b was a game that even the al-Saud could not afford to play. However, as the post-election turmoil in Iran attests, with a new budget calculated on $37/b, social spending will need to far exceed this figure if domestic cohesion is to be restored beyond using blunt repression.

Resource nationalism sharpens

But the key point from the major price correction was not so much the short term economic pain and political panic it inflicted on producer states, but the fact that regimes in the Middle East, North and West Africa, Latin America and Eurasia all managed to weather the political storm. *Economic crises* did not translate into the *political abyss*.

Life was made easier of course as prices lifted to $73/b, but political coping mechanisms had clearly been found, even at $33/b. Thus the key question is where will producer states go from here? Any hopes they will diversify and restructure their economies away from oil and gas and allow for greater international upstream investment are likely to be disappointed. Unlike previous political risk cycles, most producer states (inflationary pressures aside) are now viewing another potential sustained bull-run in oil markets. This will not be built on an edifice on market liberalization requiring $6.5trillion of upstream investment over the next 20 years to meet demand, but on renewed resource nationalism to refill state coffers. Clearly, with 6m b/d of slack now in the system, and demand forecast to drop by over 2m b/d in 2009 (the steepest since 1981), upward price movements of late are little more than speculative froth that could still rapidly lose steam. But sitting beneath the 'cappuccino' are a set of concerning criteria for consumer states to consider, not least because volatility has drastically complicated the relationship between the *price* and *politics* of supply side investment.

«Economic crises did not translate into the political abyss.»

Turning to price first; Intenational Oil Company (IOC) investment is expected to drop by around 15-20% in 2009 due to volatility and credit constraints. This could halve the expected growth in oil production capacity over the next five years; weak investment in maintenance of existing sites could also see depletion rates speed up. From a political perspective, IOCs are now only currently able to vie for around 10-15% of global reserves, largely due to a heavy concentration of proven reserves (over 50%) residing in a small number of countries restricting international capital flows. In the Middle East, NOCs now control around 95% of reserves. Kuwait and Saudi Arabia have effectively factored out upstream investment from IOCs while concrete commitment in Iraq remains challenging. Iran's nuclear programme and associated sanctions has seen an exodus of international firms. Russia has consistently failed to develop new upstream sites due to political priorities falling further downstream and capricious attitudes towards IOC upstream presence. The investment environment in Nigeria, Libya, Ecuador, Algeria, Bolivia, Canada and Kazakhstan has similarly worsened as producers look to leverage their positions amid competing international interest. Venezuela has taken this several steps further by way of nationalizations, but even Brazil has now made clear its intent to maintain close control of the Santos Basin, underlining the limited degree to which IOCs can now secure reserves.

This chimes with the fact that NOCs are now firmly engaged in internationalization strategies whereby *political linkages* take priority over *price* and indeed *risk*. The fact that China has been leading this charge is hardly surprising. The Energy Information Administration (EIA) forecasts that China will overtake the US as the largest energy consumer in the world from 2010-14; Beijing has thus been building greater linkages across the energy value chain through upstream development in producer states and downstream refining capacities at home. This has not only been in the obvious cases of Russia, Iran and Venezuela, but also in key reforming countries such as Brazil and energy giants, most notably Saudi Arabia. China has thus used the economic downturn as a perfect opportunity to invest in major resource acquisition by drawing on its $2 trillion in foreign reserves to turn *financial capital* into *strategic presence* – a trend other emerging players such as India have tried to emulate. This is not to say that NOCs will be adverse to making profits or putting more oil on international markets at times of their choosing, but security of supply and political control of resources will be the cardinal rules of the game. Whether or not NOCs become as adept as IOCs at getting oil out of the ground is thus beside the point; without a seismic shift of political risk all round, upstream supply will inevitably struggle to keep pace with demand.

But the blunt reality is that having weathered the political storm of 2008-09, this remains a highly unlikely move for producer states to make. They may not have been political winners in 2008, but they have proven to be survivors. With 4.5m b/d sitting idle, the Saudis are unlikely to invest much further until it can be sure of strong demand, and will no doubt enjoy the political windfalls associated with excess capacity. Meanwhile, Iran and Venezuela will be more than happy to see the oil price go back up, particularly as Tehran will not want international sanctions to start creating complications for its nuclear program, while Caracas will push to maintain its 'revolution'. Russia will need high oil prices to retain its seat at the BRIC table, while the fiscal health of all other major producer's remains deeply intertwined with a high benchmark price, most notably Nigeria, Libya, Iraq, Algeria, Bolivia, Angola and Kazakhstan. Upstream investment will hardly be the number one priority for producer states still grappling with tight budgets; rather the name of the game is to leave oil in the ground *today* in order to make more *tomorrow* while continuing to reign in supply to maintain high prices - albeit at GCC expense. The upshot is that consumers could well face another price crunch in the coming years as investment lags and demand rises. Some producers will no doubt see this as a 'strategic victory': but unless they have learned the lessons of 2008/9 to diversify their economic bases beyond narrow resource wealth, once the next bubble bursts, they will no doubt need to batten down the political hatches once more.

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