

Center for Security Studies

# STRATEGIC TRENDS 2010

**Key Developments in Global Affairs**

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## CHAPTER 5

# Energy security: Oil price volatility and pervasive resource nationalism

When oil prices turned from highs of US\$147/b into lows of US\$33/b, the demise of producer regimes was expected to follow. But amid the crisis, producers proved to be politically resilient, with production cuts playing an important role. Their political survival is now being turned into sharpened resource nationalism into 2010. Prices have already lifted to over US\$80/b; consumers are feeling the brunt. Unless lessons are learnt to forge greater producer-consumer cooperation, all states will lose out.



Venezuela's President Chavez and his Bolivian counterpart Morales wave in Cochabamba, 16 October 2009, Reuters/Brendan McDermid



AT THE TURN OF 2009, THE POLITICAL OUTLOOK FOR OIL-PRODUCING STATES WAS BAD. The oil price had dropped to below US\$35/b, having stood at US\$147/b a mere six months earlier. It was widely expected that this decline would take a number of political casualties with it. After all, the logic that high oil prices are the route to political stability and economic growth of producer states at home and enable them to project power abroad applied not only to the Persian Gulf, but also to Venezuela, Russia, West Africa, and, to a lesser extent, Gulf Cooperation Council (GCC) states.

Contrary to expectations, however, regimes in producer states did not fall. When the oil bubble burst in mid-2008, they survived by resorting to two strategies that both worked. The first consisted of massive cuts in oil production, with Saudi Arabia providing a price floor for other producers to play on. The second was a political centralisation of power and a tightening grip on state control. President Mahmoud Ahmadinejad secured reelection in Iran with a blend of populism, potatoes, repression, and fraud. President Hugo Chavez took his opportunity to force through reforms that indefinitely extended his political tenure in Venezuela. GCC states continued to maintain a strong security apparatus to contain symptoms of po-

litical unrest rather than address the causes. Russia remained politically stable as the oligarchs were kept on a sufficient economic retainer.

It remains an open question how long some of the regimes in producer states could have survived had prices not lifted to over US\$80/b once more. But the key point for consumers is that with prices firming, producers are now busy turning their hard-fought political survival of 2009 into renewed political capital through the vehicle of resource nationalism in 2010. Delayed final investment decisions are back, greater shares of revenue streams are being demanded, and tighter control of production can be seen. If nothing else, producer states still need to make sure that the geological cost of extraction is linked to the realities associated with the political cost of survival. With Asian national oil companies (NOCs) also desperate to secure supplies on whatever terms possible, another sustained upward run on oil prices might well be in the offing, with politics as much as price dictating the market.

But whereas there has traditionally been tension between producer and consumer states, friction is now likely to be just as intense amongst a discrete set of producers on the one hand, namely 'price hawks' and



‘price moderates’ – and a discrete set of consumers (between East and West) on the other. Price will be the main source of contention amongst producer states, while accessing resources will be the primary concern for consumers. Carbon emissions will be an added complication all round. In the absence of effective hydrocarbon governance and investment strategies, the cycle of long-term boom and abrupt bust could repeat itself in the coming years, with detrimental effects on producers and consumers alike.

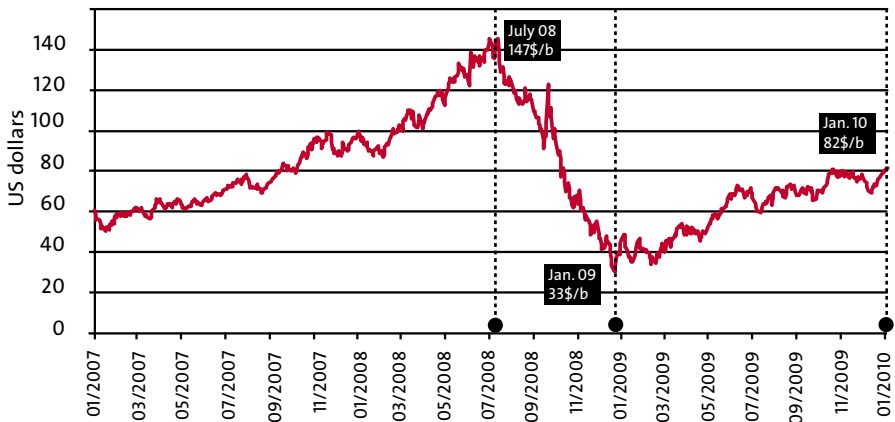
**Unprecedented market volatility**

As with previous price peaks in 1973, 1979/80, and 1990, the 2004–8 bull run was a result of the usual ingredients of tight supply-demand fundamentals and short-term price signals

driven by fear of physical outages. Strong Asian demand and sustained economic growth across OECD states over five years, against a backdrop of upstream ‘asset sweating’ from the 1990s, provided all the evidence traders required to build up net long positions on crude oil futures. Money was to be made.

Speculators duly piled into oil as a hedge against the weak dollar and rising inflationary pressures and used every scrap of geopolitical friction to push prices higher. Intractable conflicts in Nigeria and Iraq alongside contractual instability for international oil companies (IOCs) in Central Asia and Russia entered the daily lexicon of oil price pressures, as did shorter-term flashpoints such as

**Oil price volatility 2007–10**



Source: Energy Information Administration

— WTI spot price \$/b



hijacked ships in the Gulf of Aden. Rumbblings in Latin America were billed as a potential 'Andean cataclysm' rather than a predictable *contratante* between Venezuela and Colombia. The death of Benazir Bhutto at the turn of 2008 also supposedly drew supply-demand fundamentals closer. As market positions amassed, investment banks started hinting toward US\$ 200/b forecasts. Many analysts began to present this figure as a self-fulfilling prophecy as the market approached US\$ 150/b in July 2008.

Even price moderates within OPEC who, unlike price hawks, maintained the ability to put more oil on the market, grew increasingly confident that demand would remain relatively inelastic. In the first half of 2008, OPEC earned as much as they did in the whole of 2007 – putting US\$ 645bn into state funds in six months, with the GCC earning over US\$ 1.7 trillion from 2002–7. Foreign reserves rapidly approached US\$ 2,500 bn in the Middle East, while sovereign wealth funds (although not exclusively oil-based) amassed a global total net value of US\$ 4 trillion in 2007.

### *Producer paradise*

Financial gains have a long history of being turned into political muscle across producer states of course. 2008 proved no exception. Iran, Venezuela,

Algeria, Ecuador, Bolivia, Nigeria, Libya, Angola, Kazakhstan, Russia, and, to a lesser extent, GCC players used high oil prices to maintain political stability and robust economic growth outlooks at home and to project power abroad. On average, OPEC states balanced their budgets in 2008 above US\$ 80/b. This was a bull market they thought was here to stay, and one in which they could gain the whip hand over consumer states and advance their regional interests.

Nigeria's budget was balanced at US\$ 60/b in 2008, with hydrocarbons forming the bedrock of the economy. High oil revenues meant that Abuja sought to recapture its lost West African energy crown from Angola by defeating, rather than seeking diplomatic accommodation with the Movement for the Emancipation of the Niger Delta. In Algeria, President Abdelaziz Bouteflika faced no such problems beyond sporadic attacks by al-Qaida in the Islamic Maghreb, but he still counted on oil for 41 per cent of national revenues.

Iran calibrated its spending to a US\$ 95/b benchmark price, having ably used its oil receipts to 'buy' influence in Iraq, Lebanon, and Palestine. Spending also had a domestic angle. With 80 per cent of government export revenues coming from the



energy sector, Ahmadinejad could let inflation hit 30 per cent and use 12 per cent of GDP on energy subsidies to garner support. Not to be outdone, Chavez balanced his budget at US\$95/b to maintain 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. Evo Morales in Bolivia, Daniel Ortega in Nicaragua, and the Farabundo Martí National Liberation Front in El Salvador were the key recipients.

President Dmitry Medvedev took up where Vladimir Putin left off in Russia by continuing to use hydrocarbons as a political tool to ‘recapture’ lost Russian influence. The budget was balanced at over US\$70/b, while Moscow became increasingly assertive in the Caucasus and bellicose towards the US and EU over anything ranging from missile defence to the formation of a nascent gas cartel. Central Asia was similarly flagged as a de facto sphere of Russian influence. The Kremlin was also happy to drag its heels on the Iranian nuclear question to gain leverage elsewhere, which helped to push prices higher in the process.

Even the GCC states started to balance budgets above a US\$50/b benchmark

price, both as a means of diversifying investments and more bluntly, to buy off political opposition and build strong security apparatus to deal with the symptoms of social unrest. Saudi Arabia, as the clear swing producer in OPEC, was able to court repeated requests from Washington, the EU, and Beijing to take the heat out of the market – a message Riyadh only partially acted upon. The Kingdom also doled out international aid to ‘favoured’ states, depending on the oil price.

If anything, producers became less concerned with prompting potential ‘demand destruction’ than with dealing with inflationary pressures inflicted by upward price movements. By May 2008 inflation had risen to 8.6 per cent in emerging markets. This was ‘dealt’ with through heavy subsidies, which, although fiscally painful, remained small beer compared to the drastic deterioration in external positions suffered by over two thirds of importing countries. Half of all developing states also ran current account deficits in excess of 5 per cent of GDP by 2007.

#### *Producer panic*

OPEC and non-OPEC producers did not think a major price correction was on the cards, despite obvious signs such as slackening growth and weak US employment figures, which had



been on the horizon long before the bubble burst. 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 (see Chapter 2).

With banks scrambling to release liquidity following the collapse of Lehman Brothers, political risk now only mattered for oil in terms of how credibly OPEC could set the floor as demand slackened, not how highly prices would be propelled. 'Price signals' emanating from the Caucasus over the fraught existence of the BTC pipeline as Russo-Georgian hostilities broke out, Iranian threats to block the Strait of Hormuz, and even storms in the Gulf of Mexico were now irrelevant. This was a market desperately trying to stay above US\$40/b as demand fell, inventories swelled, and investors raced to unwind net long positions rather than wondering when the US\$200/b barrier would be broken.

While lower prices came as welcome respite for consumer states, this put the spotlight on engrained economic and political frailties in producer states. Financial muscle had shifted towards producer states to some degree,

but as the contrasting fates of 'price hawks' and 'price moderates' attest, this remained a function of economic (mis-)management rather than of ongoing structural shifts. Nowhere was this more evident than in Venezuela, Russia, and Iran, who six months prior 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. However, with inflation at over 30 per cent, foreign debt around US\$50bn, and a breakeven price of US\$97/b required to balance external accounts, Chavez was well aware that this would not be sufficient to save his political skin. Only successfully retabing constitutional reforms to extend his political tenure beyond 2012 could do that. Expropriation of assets, further plundering of foreign reserves, and the investment funds of *Petróleos de Venezuela, S.A. (PDVSA)* similarly remain on the cards to cover social spending shortfalls in Venezuela. Chavez was also aware that he would have to spend less money abroad to maintain cohesion at home.

In Russia, the Kremlin had to urgently draw on oil stabilisation funds to prop up the banking sector, which underlines the degree to which the world's largest oil producer (for now



at least) is dependent upon and exposed to hydrocarbon price swings. Russia could not escape the fact that oil and gas revenues now account for more than 60 per cent of its export revenues. Having whittled reserves down to under US\$ 200 bn, Moscow still had some way to go before the bank was completely broken, but it had to reduce its budget outlook radically to US\$ 41/b for fear of building up a major budget deficit. Russia did, however, manage to squeeze out a record 10 mb/d production for the first time in 2009. The main reason was the ruble's depreciation against the dollar and the euro, alongside lower oil export duties that made export increases possible, rather than getting investment policies right in Siberia. The Kremlin had been so sure that output would drop that Deputy Prime Minister Igor Sechin was dispatched to try and sign a memorandum of understanding on greater cooperation with OPEC. This was not a sign of strength, but one of fundamental weakness.

A word of caution is still needed, however: Even when prices dropped to US\$ 33/b and Medvedev was pondering how to pay off competing oligarchs, Russian membership in OPEC was simply not a realistic option. Russia would never play second fiddle to Saudi Arabia in the cartel.

This is probably just as well for the rest of OPEC, given that Saudi Arabia took the full brunt of production cuts. Since September 2008, OPEC has announced a total reduction of output by 4.2m b/d, which has roughly translated into 3.3m b/d of actual restrictions. Saudi Arabia was well aware that by OPEC standards, around 65 per cent adherence to cuts was impressive in 2009, but that it was also misleading. The majority of members still thought it preferable to keep oil flowing above quota, rather than face the graver short-term political risk of seeing the taps shut down. Far from playing the supply restraint game, Russia reverted to historical type by putting more oil on the market to capitalize on OPEC cuts. Thus, while a floor was set, it was predominantly the GCC states that had more fiscal room for manoeuvre to battle financial contagion and slackening prices, and in particular Saudi Arabia, that actually did it. Riyadh dropped its production by up to 35 per cent of its total capacity of around 11.5 m b/d, while regional revenues fell from a peak of around US\$ 3 bn a day in 2008 to less than US\$ 1 bn in March 2009.

The story could, however, have been very different. Saudi Arabia now holds 90 per cent of the world's spare oil capacity, and had much to gain





in allowing prices to plummet below US\$ 30/b by failing to rein in supply. This would have won Riyadh considerable political plaudits from consumer states, and would have been a useful means of cooling Iranian political ardour, not only in the nuclear realm, but also on more day-to-day geopolitical frictions in Lebanon, Iraq, and Palestine. Thankfully for Iran, whose economy remains in a parlous state, allowing prices to drop below US\$ 30b was a game that even the house of al-Saud could not afford to play for domestic political or economic purposes. The post-election chaos and the increasingly fractured political scene in Tehran also served as a good reminder for Riyadh that it can only take its oil weapon in the Middle East so far. Making Tehran sweat is one thing, raising the prospect of political implosion in Iran, Iraq, and Yemen by flooding oil markets is quite another. Even oil-rich Abu Dhabi had no choice but to step in and save the cash-poor Dubai towards the end of 2009.

### **Resource nationalism: Survival and comeback**

Many analysts believed that the bruising across producer states would trigger the 'fall' of resource nationalism. The claim that correcting prices provide fertile ground for IOCs to reassert their position in global oil production amid cheaper assets, credit constraints

in producer states, and dwindling resource nationalism to help bring new reserves online certainly has historical validity in view of previous political risk cycles. Based on initial developments, it also looked like a reasonable bet to place. TNK-BP gained an extended stay of execution in Russia, Venezuela allowed IOCs to tender for new concessions, Mexico started to reconsider how it could best boost production, and Kuwait's parliament appeared more amenable to hydrocarbon investment, while African producers thought a little more critically about playing the Asia card against Western multinationals. Moreover, contractual relations in Central Asia seemed to be on firmer ground than they had been for some time.

But all these considerations were short-lived. The bet was lost, as resource nationalism has survived. For although the price correction inflicted major short-term economic and political pain on producers, most states – from the Middle East and North and West Africa to Latin America and Eurasia – had found some kind of coping mechanism to weather the storm. The Saudi price floor at the heart of the cartel helped in this regard, as it not only enabled other producers to keep their heads above water, but also played a role in the rapid rise of oil prices on the back of Asian demand



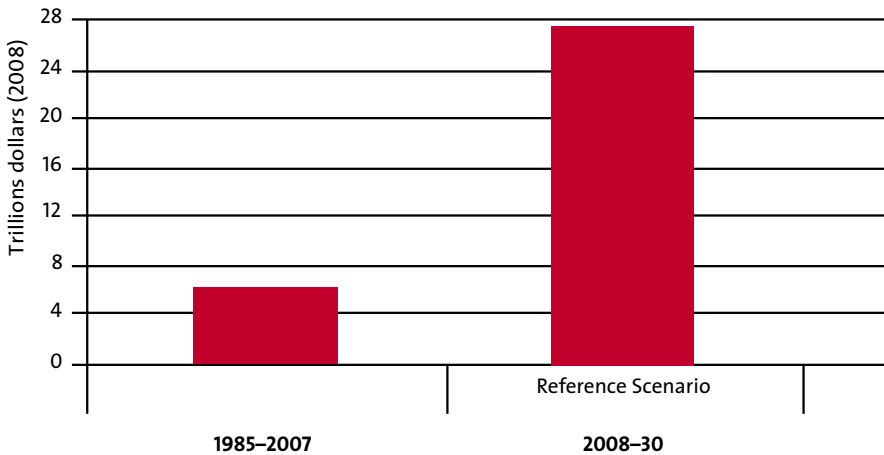
and market sentiment drawing states away from economic implosion.

Unlike in previous political risk cycles, where prices have typically remained subdued following a boom to bust scenario, prices now stand back above US\$80/b, with producer states eyeing another upward run in oil markets to recreate the conditions of 2004–8. This will not be built on an edifice on market liberalisation to diversify and restructure their economies away from oil and gas or to allow for greater upstream investment, but on renewed resource nationalism to refill state coffers.

It is important to note that another price spike is not *immediately* around the corner. Demand fell by around

2 mn b/d in 2009 (the sharpest since 1981), with around 5.5 mb/d of slack now in the OPEC system. Recent price increases are thus little more than speculative ‘froth’ linked to asset rotation and economic green shoots created by public demand rather than private sector fundamentals. But sitting beneath this ‘cappuccino’ is a set of concerning criteria for consumer states to consider, not least because well over US\$20tn of investment is needed in the energy sector over the next 20 years to meet demand. The problem is that the volatility of 2008/9 has drastically complicated the relationship between the price and politics of supply-side investment once more. Neither bodes well for bringing new oil online, but both

**Cumulative OPEC oil export revenues**



Source: International Energy Agency



indicate why resource nationalism has not only survived the crisis, but is now likely to flourish once more.

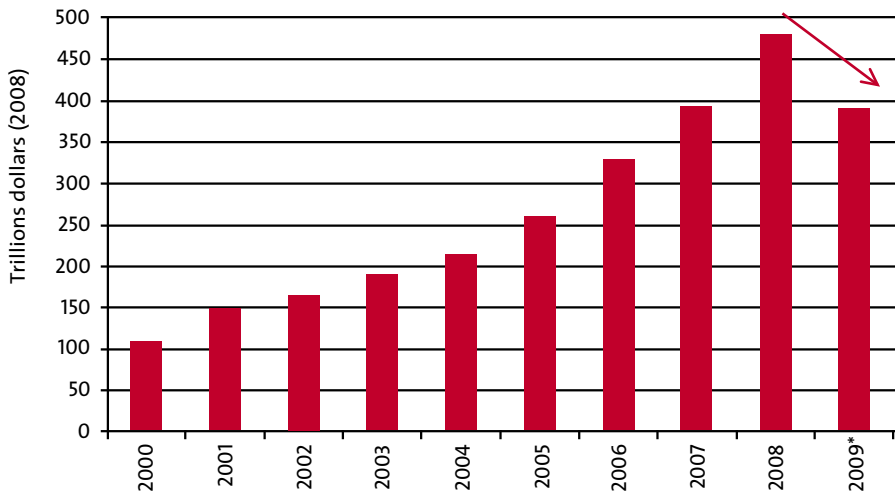
### *Price and politics a problem*

Turning to price first, IOCs have become increasingly cautious when committing to long-term projects. In light of price volatility and credit constraints, the International Energy Agency (IEA) thinks investment will decline by around 15-20 per cent in 2009, which could knock out over half of the expected growth in oil production capacity over the next five years through deferment or cancellation. More expensive non-conventional production, such as tar sands and deep-water projects, are likely to

be the most obvious casualties, while weak investment in maintenance of existing sites could also see depletion rates speed up. In effect, crucial investment has been and will be lost.

As for politics, it influences capital flows either through deliberate policy changes within producer countries or through unrealised supplies due to political uncertainty in producer states. It is contestable whether producer states are actively looking to orchestrate depletion policies (whereby reserves are carefully managed over time to maximise long-term revenue), but in most states, political capping and control of resources has been far stronger of late. IOCs can still only

## IOC upstream capital expenditure



Source: International Energy Agency

\* IEA initial forecast



contest around 10-15 per cent of global reserves because producer states are as determined as ever to strengthen their grip on natural resource wealth and ownership.

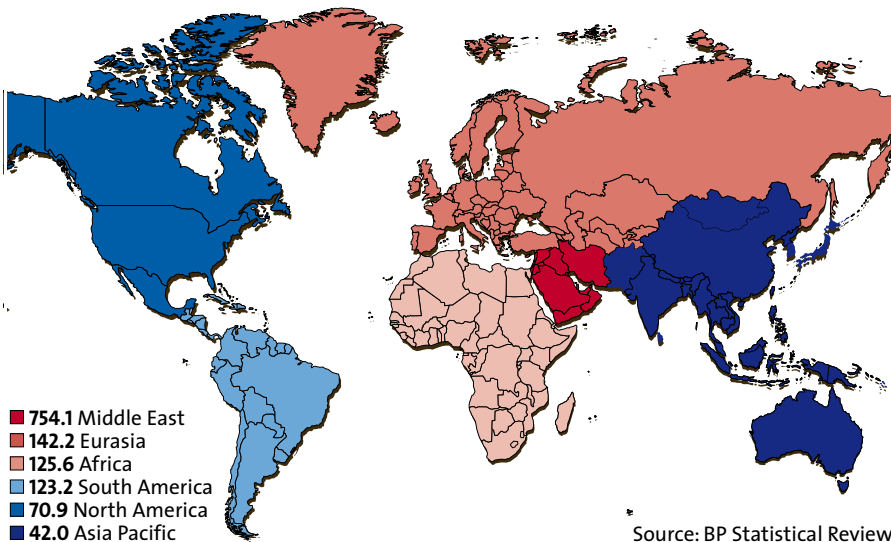
In the Middle East, NOCs control 95 per cent of reserves. Kuwait and Saudi Arabia have effectively factored out upstream investment from IOCs, while the UAE and Qatar are only marginally less cautious. Despite recent interest from international firms, Iraq remains particularly challenging when it comes to making major commitments. Baghdad wants to retain tight control of its oil, and it wants to do so without any credible legal or security guarantees in place. Iraqi infighting as to how

oil receipts and ownership should be divvied up remains a core stumbling block to political reconciliation in Baghdad beyond the ballot box (see Chapter 3). Worries about how Iraq will fit into OPEC quotas are likely to be premature, particularly when considering that old fields will be costly to bring online and require new infrastructure.

The crisis over Iran's nuclear programme has caused an exodus of international oil firms. Iran remains a net importer of gas, and its oil production is now forecast to fall from 3.97 mb/d in 2008 to 3.48 mb/d by 2014. Depending on how the nuclear issue or Tehran's internal political

**Global proven oil reserves**

Thousand million barrels



Source: BP Statistical Review



schisms play out, this decline could even be more precipitous.

In Africa, Libya and Algeria only court investment on their own terms, and although the Nigerian government has made some progress in the Delta through a blend of 'diplomacy and dollars', the looming Petroleum Industry Bill will hardly help to increase IOC investment in the region. Output will struggle to reach much more than 2.5 mb/d by 2014 due to delays in expanding ultra-deepwater developments. Angolan output is running considerably higher, but even here, Luanda remains pre-occupied with outpacing Abuja through whatever contractual terms necessary rather than fostering longer-term hydrocarbon stability.

In Latin America, Mexico's reforms to allow for international investors to bolster PEMEX's output have been decidedly tepid in lifting constitutional restrictions on resource ownership. IOCs might be able to tender for concessions in Venezuela's Orinoco belt, but only provided that they renounce all arbitration rights. Given that Chavez has expropriated a number of oil service companies for refusing to fulfil contracts without payment, it is hard to imagine the Bolivarian revolution mustering more than 2.5 m b/d in output any time soon. A similar logic applies to Ecuador, which is likely to

see production fall by over 100,000 b/d over the next few years. Even Brazil has made clear its intent to maintain close control of the Santos Basin amid a tightening political grip on natural resources as a potential counterbalance to Venezuela resource dominance in Latin America. As far as the big oil prizes are concerned, this leaves Russia. Unless there is a major change in the political and legislative environment, Moscow will struggle to exceed 10 mb/d output, not least as the Kremlin wants to tighten its control of the Arctic Shelf and Eastern Siberia.

#### *Emerging market NOCs make a mark*

The upshot of this is that the economic downturn has played out badly for IOCs to regain access to resources. Even in states where the door to reserves has been left ajar, the risk and reputational profile attached to them is invariably simply too high for IOCs to take on, compared to national counterparts, as seen in Somalia and Sudan.

This chimes with the fact that NOCs are now firmly engaged in internationalisation strategies, whereby political linkages take priority over price and indeed risk for predominantly political rather than commercial stakeholders. The fact that China has been leading this charge is hardly



surprising. The IEA forecasts that China will overtake the US as the largest consumer of energy in the world from 2010–14 (previous forecasts had not expected this to happen until 2026–30). This has helped to stoke resource nationalism across producer states. The idea is to build greater linkages across the energy value chain in terms of upstream development in producer states and downstream refining capacities in China. This has not only been obvious in the cases of Russia, Iran, and Venezuela on the ‘critical list’ of resource mismanagement, but also in West and North Africa, in key emerging countries such as Brazil, and in 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 US\$2 tn in foreign reserves to turn financial capital into strategic presence as a major commodities hedge. Since 2008, it has spent over US\$ 50 bn a year on such investments. An additional US\$ 10 bn of loans and credit lines to Africa at the close of 2009 will certainly increase this balance sheet further.

Production Sharing Agreements and long-term supply contracts are still very much in vogue for Beijing, but China is also determined to buy direct stakes, if not outright ownership of upstream players where possible. Sinopec duly

purchased Addax, a Swiss upstream player, for US\$7.2 bn, with CNPC and CNOOC chasing Repsol’s Argentine assets YPF, tabling bids around the US\$17 bn mark. Other emerging market players, most notably ONGC of India, have followed suit by increasing their stakes in producer countries through a blend of political non-interference, soft loans, aid packages, and inflated signature bonuses. What Asia may have lost as a producer region it is now trying to recover through expansionist NOC policies to ensure that oil flows its way.

The snag, as far as the energy balance is concerned, is that the rise of emerging market NOCs comes with three costs: The first is that while national champions may be willing to put more oil onto international markets at times of their choosing and continue to invest where international counterparts cannot, the cardinal rules of the game favour security of supply and political control of resources, not enhancing international oil markets.

The second is that this also assumes that emerging market oil majors will actually be able to get more oil to market in the first place. The record so far is circumspect. Their technological edge is still decidedly blunt compared to Western counterparts. More worryingly, many of the investments so far



have been made with scant regard for the political risk pervading producer states. China stands most accused in this regard.

To be fair, China does not really have much of an option but to play this game at a time when the global oil balance is slowly shifting from West to East. If nothing else, a strategic presence across multiple producer states provides China with useful bargaining chips down the line should it need to cash some assets in order to retain others. But if Beijing assumes it will be able to find a 'magic button' capable of turning bastions of instability to oceans of calm just at the critical point of when it needs the oil to flow thick and fast, it could be disappointed. This is precisely when serious questions will be asked as to whether China has put the energy cart in front of the stability horse to secure long-term reliable supplies. Clever use of joint ventures to put local energy players on the political front-line in Africa might appear to be a canny option to hedge political and reputational risks for Beijing, but 'pushing proxies' in this way could actually complicate regional politics even further, particularly as it has placed Angolan-Chinese relations on a pedestal. Aligning state-based energy policies to a stable regional balance

of power is clearly not a strategy that China has managed to perfect yet.

If it had done so, China would probably avoid the effects of the third impact: providing producer states with all the ammunition they need to enhance their bargaining positions from competing Western and Asian interests. The most obvious play is in Central Asia, where China, the US, Russia, Europe, and even some Middle Eastern consumers are competing for reserves. Kazakhstan and Turkmenistan are certainly well placed in this regard, while Azerbaijan has downgraded any possibilities for further investment into the giant ACG field from production-sharing agreements to more limited service contracts. Similar trends can be seen in West and North Africa, while Latin America is certainly not above enhancing its perceived economic and political standing from a contractual perspective, nor indeed, is Russia. Key Middle Eastern producers are also more than able to play this game. Even Australia and Canada have been luring multiple consumers to enhance their respective positions. Without a seismic shift in capping of reserves and a rolling back of resource nationalism globally, supply will struggle to keep pace with demand.

**Supply will struggle to keep pace with demand**

hancing its perceived economic and political standing from a



### Limited scope for cooperation

The problem for consumers is that ‘reining in resource nationalism’ is about the last move that producer states are about to make. Having weathered the political storms of 2008/9, they are now far more likely to capture more of the revenue stream through contract revisions while tightening control of reserves and supply – both for economic and political priorities that reach beyond further investment in the oil and gas sector at this stage.

With 4.5 mb/d sitting idle, the Saudis are unlikely to invest much further to ramp up production towards 15 mb/d until they can be sure they would not be left with the worst of both worlds (falling demand and increased supply). Other GCC states, notably Kuwait and the UAE, will follow this lead. Meanwhile, Iran, Venezuela, and Russia will be more than happy to see the oil price go back up, particularly as Tehran will not want slackening prices to allow international sanctions to create complications for its nuclear programme. The desperate need to paper over political cracks will see the National Iranian Oil Company (NIOC) economically plundered to new heights in order to finance social spending rather than investment in upstream capacity. Anything left over will probably go towards advancing Iran’s region-

al interests in Iraq, Lebanon, and Palestine once more.

Caracas will push to maintain its ‘revolution’ by whatever means Chavez sees fit to stay in power. Venezuela has already resumed sabre-rattling with Colombia (see Chapter 1); further bids for regional domination will likely follow, despite the irony that PDVSA production will continue to falter. The Bolivar has also been devalued for political purposes. Russia will be similarly keen on high oil prices without any supply constraint on its part. This might preserve Moscow’s seat at the BRIC table for the time being, but it is unlikely to provide the political consistency required to bring new oil fields online in future. Bilateral deals with oil producers, blustering talk of gas cartels, and selective supply cuts to European gas markets will be the all-too-obvious response. The fiscal health of other major producers such as Algeria, Iraq, Angola, Ecuador, Bolivia, and Kazakhstan also remains deeply intertwined with a high benchmark price.

Even in the Gulf States, where production will remain steady over the coming years, the name of the game is still to leave oil in the ground today in order to make more money tomorrow. Such a trend will be magnified if higher-risk non-OPEC production in





Sudan, Chad, Cameroon, Equatorial Guinea, and Central Asia drops, either through domestic unrest or contractual instability, which would enhance reliance on OPEC supplies. Likewise, although major finds have been made in Sierra Leone and Ghana, turning seismic surveys into output remains a long and arduous task to alter the supply-demand balance.

Producers should, however, be wary of upward price movements from rebounding demand and reduced supply, which will inevitably come at a political cost. Inflationary pressures are the most obvious financial concern, but with discrepancies in production levels between price hawks and price moderates set to widen (both within and between OPEC and non-OPEC ranks), the potential for geopolitical friction between these sets of producers will grow. Depending on what benchmark price the Saudis want to achieve as the overwhelming swing producer in OPEC, they could soon be on a direct collision course with a growing body of price hawks populating the cartel. Algeria, Iran, Venezuela, Angola, Nigeria, and Ecuador all want higher prices at Saudi expense, a position that Iraq is likely to follow as politics continues to afflict output.

How Saudi Arabia responds to all this will ultimately depend on how it

balances long-term demand security against short-term geopolitical gains that could be made either with producers or consumers, depending on the prevailing benchmark price. Its role as a price moderate is thus contingent to some degree. But there is little doubt that, should prices slacken in the coming months, Riyadh will act to put a floor under prices for the same reasons it did in 2008/9: assuring regime stability of the house of al-Saud, and preventing further regional instability in the Middle East.

But it would be a mistake only to look at the bottom end of the market, both for consumers and producers. If price moderates are wise, they will cool the market to prevent another bubble from bursting as prices rise, but also continue to invest in economic diversification at home and allow for international upstream investment. In such a scenario, the real divide would be between producers that have used oil windfalls wisely and those who have frittered away their revenues.

Competition for resources will also sharpen between consumers, especially between East and West. Once Western appetite for oil picks up and credit constraints ease, IOCs might well find they are starting to play catch up against their Asian counterparts in the Middle East, Central Asia, Latin

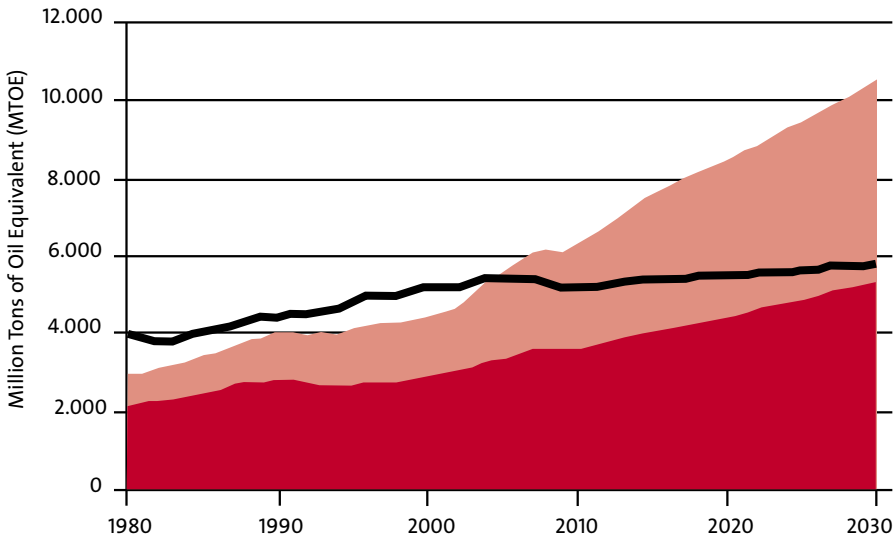


America, and Africa at the same time as domestic producer demand increases. The prospects for cooperation amid this quagmire of producer vs. consumer, producer vs. producer, and consumer vs. consumer competition are thus remarkably limited without concerted political engagement all round. Domestic politics will make such engagement difficult to achieve, not least because one party's energy gains are still perceived as another party's loss.

The politics of climate change make things even more complex. Reducing carbon emissions and providing demand security to producer states

remains difficult to reconcile. The meagre outcome of the Copenhagen climate summit in December 2009 indicates that even with rising oil prices, consumer states, both in the West and in the East, still lack the political determination needed to shift towards a low-carbon economy when 'business as usual' remains the easier option. Yet, as Western states continue to pursue the goal of cutting emissions while failing to make real progress, the OECD's position to provide demand security to producer states is undermined. Even the EU's stringent emissions targets remain more an aspiration rather than

**Energy demand shifts East**



Source: International Energy Agency (IEA) ■ China and India ■ Rest of non-OECD — OECD



operational reality. This, in turn, offers non-OECD consumers a 'comparative advantage' to build relations with exporter states. Brazil, China, India, and South Africa made it clear to developed nations that if they are to sign up to any serious climate change commitments, the West will need to carry the bulk of the costs.

#### *A coming crunch?*

Ultimately, consumers have missed a valuable, if short-lived, opportunity in 2008/9 to realise their shared interests in stable production and to set a credible price band with weakened producer states, or to fix a highly dysfunctional market in terms of reducing speculative flows. With more players on both sides of the oil producer and consumer ledgers, consumers need to find a common rule book on resource investment and market principles. Very little political or institutional progress has been made on this level. Western consumers will probably pay the highest price in failing to get their house in order as it allows producer states to fall back on what they know best: putting faith in resource nationalism over open markets, having survived extreme oil price volatility. What

is more, producers will draw on 'new' consumers to do so where demand growth will be strong and price signals weak due to subsidies.

The upshot is that there may well be another price crunch in the coming years as investment lags, demand rises, and supply tightens, even if such a trend will not become immediately apparent. Some states will no doubt see this as a strategic victory, but unless the 'right' lesson of 2008/9 to diversify economic bases beyond narrow resource wealth has been learnt, once the next bubble bursts, the economic and political fallout could be considerable for all. This is true not only in terms of continued price volatility for consumers, but also the difficulties producer states may face in maintaining domestic political cohesion should prices slacken for a sustained period of time. 2008/9 will no doubt be seen as the year when everything should have changed for oil, but in fact, producers got lucky and consumers failed to act. The result is that the world is back on an unsustainable path of hydrocarbon dependence and ever-increasing emissions. ●

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