Helima L. Croft and Amrita Sen discuss oil and geopolitics: blood and steel

2011 was always going to be a year in which it would be risky to get heavily involved in the oil market without maintaining a fairly strong focus on the key geopolitical developments, rendered more acute in a world of phenomenal demand strength, reduced inventory overhang and less spare capacity. Indeed, even before the up-surge in geopolitical risks, we expected global oil spare capacity to decline steadily out to 2015. With demand having shown no signs of slowing and Saudi output having already risen in response to the demand-led increase in prices, spare capacity in the oil market was down to just over 3 mb/d before the Libyan supply shock hit the market. The large inventory overhang that kept a comfortable cushion at the margin of the market has disappeared, too, with OECD inventories now below the five-year average. Not surprisingly, against this fundamental backdrop, the current plethora of geopolitical events is adding a further layer of instability and volatility to the oil market. However, with some of these issues likely to be a source of long-lasting uncertainty, the rapidly thinning buffer in the oil market is creating an environment for prolonged and heightened volatility.

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The broad sweep of global geopolitical issues appear to be negative in terms of their immediate implications for external investment, while also introducing a wider range of medium-term possibilities given the potential unfreezing of some deeply entrenched elements of the economic and political status quo in some key regions. While the immediate focus of the oil market remains Libya, which has clearly entered a protracted period of civil war that is set to reduce its energy export capacities significantly, there are a series of geopolitical events across this region that have either gone relatively unnoticed or are likely to have a greater longevity than Libya itself. Perhaps amongst all of this, the escalation of tension in Bahrain, which has reopened and emphasised some deep sectarian tensions, is likely to have the greatest effect. While not necessarily headline-grabbing on a daily basis, Bahrain's importance cascades through its relationship with Saudi Arabia and Iran, and in turn with the USA, thereby having the potential to redefine some key and fundamental relationships both politically and in relation to the oil market. The reshaping of the regional political balance already appears to be as profound as that which surrounded the first oil shock of 1973 and may yet prove as sweeping as the background to the second oil shock of 1978–79. In our view, the regional status quo as it stood at the start of the year has now been disturbed so severely that a swift return to anything approximating it is now impossible.

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Libya: The Immediate Risk

By any credible historical standard, the international system's actions to date on Libya have been swift and encompassing. On 26 February, the Security Council adopted Resolution 1970 imposing an arms embargo and wide-ranging sanctions and referring Libya to the International Criminal Court. This happened with unprecedented speed. More impressive was the fact that the UN Security Council invoked the principle of the responsibility to protect. Clearly, the current situation in Libya involves a protracted period of the country staying away from the oil market, not just due to the oil sector being inwardly constrained because of potential damage and other dislocations, but also due to the complete breakdown of Libya's external relationships. Whether or not external intervention changes the nature of the military disposition of forces on the ground, it seems unlikely to us that it would ease or speed the reincorporation of Libyan oil into the world market. Libyan exports will remain out of the market for this year and possibly for a significant part of next year as well. The loss of Libyan crude is more than just about the loss of 1.3 mb/d of supply; it is the loss of 1.3 mb/d of short haul light sweet crude that now needs to be replaced with the long haul heavy side of medium and sour crude and is thus far from a perfect fit.

Indeed, even before the military action, Libya was moving on a path, dangerously mirroring Iraq post-1991 and its history of degrading oil sector and causing instability for the oil market, and the military action has simply served to intensify that situation. While direct damage to oil infrastructure from bombings and sabotage remains a possibility, underlying damage to oil fields from the lack of protective measures taken (eg, properly conducted well shut-ins) is the greater risk. The longer the civil war lasts, the more likely it is that reservoir damage accumulates due to lack of maintenance and oil well shut-ins that might at best have been emergency, rather than best-practice, shut-ins, and the greater the threat to energy infrastructure. Indeed, the damage done to Iranian oil fields during its war with Iraq in 1978–79 was far more due to reservoir damage caused by the way that the oil wells were shut down, as well as by the dislocations of people and equipment that followed. Since then, the country has not been able to surpass its 1970s' production peak of 6 mb/d, struggling to top 4 mb/d.

Bahrain–Saudi–Iran–Iraq: The long-lasting risk

While events in Libya have largely dominated the news cycle, the unrest in Bahrain is of far greater importance to strategic balance of power in the Middle East, in our view. The tiny Gulf nation is home to the US Fifth fleet and is connected to Saudi Arabia by the 15-mile King Fahd causeway. Although Bahrain is more liberal socially and more open politically than its Gulf neighbours, it has deep sectarian divisions. The Saudi leadership is particularly anxious given the country's border with Bahrain and the fact that its local Shiite community, while comprising less than 15 percent of the total Saudi population, constitutes a majority in the oil-rich eastern region. The deployment of troops from Saudi Arabia and other Gulf Cooperation Council (GCC) nations to Bahrain has served to deepen the ongoing political crisis in the country and intensify the regional power struggle between Saudi Arabia and the Iranians. The Saudi leadership has become increasingly alarmed by the unrest in the region and is concerned that the Iranians are the principal beneficiary of the tumult.

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Despite the growing tensions in Bahrain, our base case remains that Saudi Arabia will weather the current wave of regional unrest relatively unscathed. However, the deteriorating situation in Bahrain still has tremendous implications for the oil market. While not a major oil producer, Bahrain's effect on the oil market reverberates through its relationship with and proximity to Saudi Arabia and, in turn, its relationship with the USA. For much of the twentieth century, the USA was the undisputed economic heavyweight. As a result, key relationships in the world market were defined on this basis. Oil became critical for the pragmatic and strategically significant US–Saudi ties, the world's largest consumer and producer, with for an extended period Saudi Arabia subsidising its oil exports to the US refiners by about $1/bbl compared with Asia. Within its ups and downs, the Saudi–US relationship underlined the principal dynamic in the oil market and close Saudi–US ties anchored much of the stability in the oil-rich Gulf. The Wahhabi-led monarchy provides about 13 percent of US crude imports and serves as a powerful regional counterweight to Iran, a defiant US foe. Indeed, the US–Saudi relationship is based on common interests that are fundamental and critical to both countries and for the oil market as a result.

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For the most part, Saudi–US relations have been built on a longstanding mutual interest in developing the kingdom's immense oil resources. Unlike other countries in the Middle East, Saudi oil was developed entirely by American companies. In 1933, Standard Oil of California obtained a concession from the founder of modern-day Saudi Arabia, King Abd Al-Aziz Ibn Saud. Commercial production began in 1938, but large-scale production was delayed until the end of the Second World War. In 1944, the California Standard-Texaco operation in Saudi Arabia became known as the Arabian-American Oil Company (ARAMCO). Prior to the Saudi takeover in the mid-1970s, ARAMCO was the largest single American investment in any foreign country. For most of the last half century, Riyadh has advocated the use of oil as an important policy tool to safeguard their interests and build up the military and economic strength of Arab states. However, the first chink in that armour appeared shortly after the outbreak of the Arab–Israeli war in October 1973, when Saudi Arabia announced an embargo on oil shipments to the United States for its support to Israel. The embargo was officially lifted a few months later. Another period of disagreement between the two countries also resurfaced during the US confrontation with Iraq. In spite of these tensions, the overall relationship between Riyadh and Washington has been one of continuous cooperation.

However, with the growth of China and India, Saudi Arabia has already started to become more diversified in its interactions with other economies. Saudi exports to China overtook those to Europe in 2008 and briefly surpassed that of the USA in late 2009. While the scale of the recession that hit the western world might have exaggerated the pace of this shift somewhat, even following the economic recovery, the lost barrels from the Middle East have not entirely made their way back into the US system. Compounding that effect, the recent unrest in the Middle East and the lack of US support for its staunch ally in Egyptian President Hosni Mubarak has created a concern in Saudi Arabia about the United States' commitment to protecting their interests. Should the Bahrain situation worsen, the already strained Saudi–US relationship could deteriorate even further, with oil markets likely to feel the ripple effects. Despite eroding spare capacity, Saudi Arabia remains the world's only swing producer, possessing the bulk of global spare production capacity (2.6 mb/d of the remaining 3.3 mb/d) and, thus, the last word on any attempt to drive down prices through production increases. That intent to calm global oil markets may well take a backseat under these circumstances, as has been clear in the market over the past month. Before the breakout of the conflicts in the Middle East limited producer control over the upside generating a \$100 average was not tenable, given the level of spare capacity available in key producing nations. However, the deterioration in the Saudi–US relationship has re-shuffled those cards, with higher oil prices negatively affecting the US economy not necessarily a key concern for the Saudi kingdom. Indeed, key producers can remain somewhat on the slow side in terms of reining in the upside, with ultimate control re-established at higher price levels than \$120 for the OPEC basket, in our view. The present crisis may well worsen, perhaps even to the dimensions of 1973–74 when contradictions of the Saudi–American relationship reached a breaking point as officials in Washington openly threatened the possibility of seizing Gulf oil fields, or even beyond, given the absence of the Cold War framework. If such a scenario arises, the pressure on oil prices will be tremendous. But while the bonds of over half a century were never those of fondness or common outlook, neither side seems able to locate a meaningful alternative to the other. Over the long term, the relationship appears to be guided, as ever, by the relentless logic of energy and security in the hydrocarbon age.

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Developments in Bahrain are also of particular significance as they can open lines of political stress that may find their echo in developments in Iraq and elsewhere. Indeed, the spill-over effect from the situation in Bahrain could well lead to an intensification of the existing fault lines in Iraq, which could make matters an order of magnitude more dangerous. It could once again represent a watershed between what had been a slow but uncertain improvement towards one in which matters might take a sustained turn for the worse. Indeed, the implications for regional stability of some of the extreme possible cases are beginning to represent a non-trivial concern. Some of those cases could involve a failure by the political actors to bridge the sectarian divide or address serious economic grievances, with the potential for some serious long-term regional consequences. In terms of the oil market, the situation remains fluid, but we would not rule out further damage to Iraqi oil output and exports in the coming months, especially given that there has already been an escalation in violence with attacks at the Daura (110 thousand b/d) and the Baiji (310 thousand b/d) refineries and the Kirkuk-Ceyhan export pipeline.

Conclusion

The political unrest in the Arab world, fuelled by autocratic governments and failing economic, social and political systems, has thus created a series of significant inflexion points in these countries. The demographic and economic challenges faced by many of these governments are substantial. The foundation that has held the region together for the past 30 years has been shaken, and the first cracks that appeared with the uprising in Tunisia and Egypt is now causing widespread ruptures in the region. Of course, a destabilisation or potential discrete change of policy course in the most populous nation in the Arab world is of key significance. Clearly, the contagion has been spreading and the instability in this region is likely to be a major source of lasting unease in the oil market. The repercussions from these revolutions will force new actions and policies globally, from the United States to al Qaeda to every single MENA country. It is a new day in the Arab world as the fight for dignity and self-determination continues to spread. Change is coming: in some places, it will happen quickly; in others, it will evolve over time. Only some of these are immediately quantifiable effects, but most others may not be instantly visible, creating further pressure in an already resource constrained oil market.