

GEOPOLITICS OF MIDDLE EAST OIL

Comment by Luis E. Giusti

June 3, 2004

During the past 26 months OPEC has enjoyed a free and safe ride, with high prices and no real concerns about volumes.

A major shift took place in early 2002, a time when OPEC was preparing to tighten hard its belt, with a ceiling of 21.7 MMBD, or 33% market share. It would have been the lowest market share since 1980.

But, psychological factors began to affect prices, with a premium that during those times was estimated between 2 and 5 \$/B. Since then, the market entered into a predominant backwardation that substantively affected stock movements. With time, it turned into a vortex (the term backwardation vortex was coined by Energy Security Analysis Inc).

In the occasions when the vortex was about to be broken, by an overhang of prompt crude or a slowdown in demand, something has happened:

- The strike in Venezuela in December 2002 (production never returned to the previous level)
- The war in Iraq in early 2003
- A slower than expected Iraq's production recovery
- Several episodes of civil unrest in Nigeria, affecting oil production
- And now, focused terrorism in Saudi Arabia (Iraq's problems have already been discounted by the market). The current premium could be as high as 8 \$/B.

All along, OPEC has been able to play "smoke and mirrors" with quotas and volumes, which they have managed to do with great efficacy. In fact, one could say that there is a certain degree of disconnection between statements and facts. Take today's situation. In the OPEC meeting currently being held

in Beirut, the most likely outcome will be an increase of the ceiling by 2.5 MMBD from its current level of 23.5 MMBD, i.e. 26 MMBD. But in fact, OPEC is probably already producing close to 27 MMBD. The only significant new addition will come from the promise of Saudi Arabia of increasing their level by 2 MMBD (plus small increases in Kuwait and the UAE)

In reality, the recent terrorism episodes in Saudi Arabia have not affected oil flow at all. They have been targeted against oil industry employees. But they have significantly affected supply perceptions.

What will happen?

If a combination of effective security indications in the oil flow chain, plus indications of higher output by OPEC settle in, prices will ease-off. In that case the average WTI price for the year could end up around 33-34 \$/BBL.

If the backwardation vortex is broken in the 1st quarter of 2005, prices will fall. How much? In that moment it will really depend on OPEC's volumetric moves. If they act to defend prices, average WTI for the year could be around 27-28 \$/BBL. If by then the "new habits" are more deeply embedded in the members of the organization, prices could fall significantly.