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Geopolitical Risks Expose Oil Market Stress Points

By Rachel Ziemba

- Political strains in many oil exporting nations are leading to supply concerns and threaten to raise production costs, posing upside risks for oil markets in the short, medium and long terms, which will partly offset the slowdown in demand and risk aversion. Absent an outright supply shock, macro issues, particularly global growth and eurozone (EZ) financing risks, should continue to drive markets, limiting the upside. A shock that removes significant supply from the market would be very costly to global growth. We summarize the risks to global oil supply in a Table of Risks to Watch.
- Iran's saber-rattling will loom large over the oil market in 2012, particularly as its upcoming election approaches, raising the risk of a policy mistake and a stumble into war. A planned European oil embargo, if implemented, could lead to an increase in oil prices, even if Iran's Asian buyers remain loyal. Even a temporary blockage of the Strait of Hormuz, which would hurt Iran in the medium term, could lead to a sharp oil price spike as supplies are rerouted.
- Elsewhere, political risks, could keep oil production growth weaker than otherwise, worsen the investment and regulatory climate and prompt the renegotiation of contracts and wages, undermining output growth. Upcoming elections in oil producers Angola and Venezuela and the political transition in Libya could likewise add contract-renegotiation risks and revive uncertainty.
- Across most emerging market oil producers, more extensive spending plans, exacerbated by these political risks, will boost the oil price required for marginal production increases, adding to pressure on oil consumers and the vulnerability of the oil market.

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Introduction: Despite Weaker Growth, Supply Risks Remain

The turn of the year was dominated by the deterioration of political conditions in many parts of the oil exporting world, posing risks to the short-, medium- and long-term production outlooks and the investment environment. These risks vary considerably, ranging from increased Iranian aggression, both rhetorical and actual (through arms protests) from Iran to peaceful protest against corruption in Russia, and strikes and protests in Nigeria and Kazakhstan. While some have yet to affect the oil market directly, all point to weaknesses within the political institutions of countries that supply much of global oil, and political changes, even if minor, may bring changes to regulatory regimes, which could lead to a delay in investment.

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In the short term, there is most at stake in Iran, both because of oil production and embargo deliberations, and also due to its strategic influence over the Strait of Hormuz (through which most GCC oil and Qatari LNG is transported). Other political risks could reduce production growth (Iraq), raise production costs and threaten contract renegotiation (Kazakhstan, Nigeria), adding to the medium-term risks.

The broader implications of these political strains are an increase in the oil price needed to encourage oil exporters to pump more oil, adding to the vulnerability of the oil market. Fiscal stimulus across Russia, the GCC and other oil exporters means that most key exporters now require an oil price of US$80-100 WTI to pay for 2012 spending, leaving little room for maneuver and suggesting producers will be quicker to cut production. Moreover, these risks will encourage more investment in alternative routings, particularly in the GCC, and support oil supply growth in North America and other areas that are more investable and subject primarily to policy and not political risk. These policies will have effect on supply and transportation only in the medium term.

Iran: The Boy Who Cried Strait Blockage

Rhetoric has heated up between Iran and just about all of its key competitors and trading partners in recent weeks, returning to center stage a perennial risk to the oil market. Most significantly, Iran has threatened to block the Strait of Hormuz, which separates it from Oman and through which 50% of seaborne oil and much of Qatari LNG is carried, should sanctions be stepped up. While blocking the strait might be economic suicide for Iran, particularly as it would result in a price spike that would damage global oil demand, given the escalation of the political climate ahead of the elections and the very tense neighborhood, the risk of a policy mistake is rising. As noted in our December 2011 Outlook, RGE continues to believe that an outright conflict involving Iran or even a short-term strait blockage remains a low (if rising) probability, but a high-risk event for the global economy, which would have a major adverse effect on global consumer confidence. As the tit-for-tat game of sanctions and military tests escalates, risks of outcomes that would reduce, divert or distort global oil supply are rising. Particular flashpoints will be the implementation of sanctions on Iran's oil industry by Europe and on the central bank by the U.S., as well as the response of other key allies.

There are several interlinked risks:

1) **Blockage of the Strait of Hormuz (low to moderate probability, high impact).** While we believe that Iran would be unable to keep the strait blocked for long given the superior military force of the U.S. and its allies in the region, doing so even temporarily could lead to blockages, delays, an increase in shipping and insurance costs and a sharp increase in global oil prices. Moreover, it would wreak havoc on crude spreads, especially Brent/WTI and Arab blends, add volatility and send the curve into steep backwardation. To the extent that it blocks GCC oil even for a limited period of time, it could have an extensive effect on global oil supply, which might require the IEA and others to release emergency supplies, as they did symbolically in the case of Libya. Even a threatened closure could pose upside risks in the short term, depending on the underlying demand outlook. Responding militarily to an Iranian challenge would be very costly to oil producers and consumers, as supply could be reduced in the interim and questions would be raised about how alternative supplies could be transported. Moreover, any blockage of the strait would increase the chance of military conflict as the U.S., UK, GCC and others would be unable to look past the blockage, increasing the chance of military strikes, which could then escalate.

   Ultimately, neither Iran nor its neighbors have an interest in a massive spike in oil prices, given that such a spike would not be sustainable and would lead to demand destruction. As noted in our March 2011 "Crude Oil Price Scenario Analysis," a major output loss from a MENA oil producer could lead to prices spiking to US$150+ per barrel, but weakness in the global economy would not allow them to stay there, as

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seen in both 2008 and 2011. Given the weak state of the economy, consumers could not bear the hit and demand could fall off sharply.

2) **Oil embargo/sanctions from Europe (moderate to high probability, moderate impact).** At the time of writing, Europe has reportedly agreed in principle to implement sanctions on Iranian oil, but the details, implementation schedule and opt-outs are undisclosed, so this may be a tactic to bring Iran back to the negotiating table on its nuclear program. Europe has been considering direct sanctions on Iran's energy sector for some months, and these would add to the existing sanctions that have already led to an increase in Iran's production costs. The effect of implementing the restrictions will fall disproportionately on the EZ periphery, which absorbs most of the EU's 450,000 barrels per day (bpd) in imports. While the disruption would represent more damage to the periphery, the ensuing recession will also reduce demand, lessening the effect to some extent and adding to global supplies The true effect of restrictions would depend on the role of China, and other Asian oil importers, which absorb the bulk of Iranian oil and thus may able to bargain for cheaper prices. In fact, China has already trimmed imports from Iran in late 2011 and early 2012, in part to take advantage of cheaper supplies on the spot market, which may push Iran to offer even more discounts to buyers. We expect China would be unlikely to honor sanctions that stopped it from importing oil, but Chinese companies have been scaling back cooperation with Iran because of sluggish implementation and investment challenges and counter-sanctions, which have increased the cost of doing business. Turkey too, which is becoming Iran's largest trading partner, has already asked for an opt-out from U.S. sanctions. Others would do the same.

3) **Iranian oil weapon/withholding oil supplies (very low probability, moderate impact).** Iran's reliance on oil revenues makes it very unlikely it would cut production to add pressure on global competitors. Oil makes up the bulk of government revenue and Iran's external balance, meaning output losses would hit its economy further, when it is already suffering from rampant inflation and unemployment. Should this occur, Saudi Arabia and other OPEC members could take up some of the slack, assuming transit channels are still open. Replacing Iran's 3.5 million bpd of oil would absorb the bulk of OPEC's surplus capacity, and extensively test Saudi Arabia's claimed excess capacity. A partial replacement of Iranian oil would be easier for Saudi Arabia to stomach, particularly as its product mix is similar. This weapon would be more costly for Iran than anyone else, cutting off its revenues making its use unlikely.

4) **A unilateral military response from Israel or U.S. (low probability, very high risk)** remains unlikely, particularly given U.S. election concerns. In recent weeks, Israeli officials have remained publicly quiet, perhaps because the saber-rattling helps support their view of Iran's threat. Regardless, we think they will be unlikely to gain political cover. Israel continues to struggle to define a new policy after the Arab Spring, as it adjusts from dealing with dictators to politically elected and more Islamist rulers, who will be less likely to pass politically unsavory policies that support the military. The U.S. is focused domestically due to the election campaign, and will be reluctant to be drawn further into conflict, although it would be unable to fully ignore escalation. Such an outcome could have dire effects for the region and global economy given the potential for proxy wars, and regional spillovers.

In aggregate, the events of recent weeks have extended the low-level conflict and financial "war" that has been underway for some time, with attacks on computer infrastructure and a tighter financing grip (even the UAE, Iran's largest MENA trading partner, has implemented sanctions). The Arab Spring threat to the status quo has sparked new anti-Iran rhetoric and coordination from the GCC, which had been reluctant to criticize Iran publicly. As protests picked up across Kuwait, Bahrain and even in Saudi Arabia's Shiite-dominated Eastern Province, governments were quick to blame Iran, which has heightened the cold war between latter and the GCC.

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Upcoming elections, slated for the end of March, will accentuate the regional risks as different actors purport to speak for the regime (religious authorities, parliamentarians, military) and external threats may be pumped up to solidify domestic control. The ongoing battles within the regime over the past year (between those close to President Mahmoud Ahmadinejad and those aligned with Supreme Leader Ayatollah Khamenei and other power bases) are spilling out more into the public eye. Statements from the Ayatollah suggesting that Iran shift to a more parliamentary system (eliminating pesky presidents with popular support) indicate the internal jostling will continue for some time, increasing the volatility of Iranian policy. We do not expect a major shift in foreign policy after the election, but the tone of the leadership might shift, and Iran might be looking for more concessions.

More significantly, the continuing power struggles prefigure long-term succession issues. The Ayatollah, like many of his Arab counterparts, is old and has been in his position for decades. None of his likely successors have his charisma and influence, reducing Iran's room for maneuver. In the meantime, as RGE has noted, the slowdown in global growth, the tightening of sanctions and rising inflation will pressure Iran's economy, increasing the chance of leaders looking to deflect internal criticism via external attacks.

Short of these outcomes, the modest increase in oil prices is actually in Iran's interest as it provides more revenue, offsets the costs from higher sanctions, and the downside risk to oil from weaker global growth and EZ-led risk aversion, which would otherwise be driving oil prices lower. Iran's response, akin to lashing out, also reflects its economic vulnerabilities, which have built up over the past decade, exacerbated by sanctions. Iran's young population suffers from the country's high rate of unemployment, and the low interest rates to encourage growth have instead prompted a boom and bust cycle of property and other real assets. These low interest rates have also been accompanied by crony capitalism, with political allies of the government having more access to loans, as revealed in a banking crisis last year. Overall, growth remains too weak to support incomes, and Iran's black market has grown, with many prominent figures taking advantage of the distortions caused by sanctions. The sharp fall of the Iranian rial is but a case in point. The high rate of inflation and other vulnerabilities have prompted a rush to foreign currency and gold, as eligible Iranians have scrambled to take advantage of the access to FX and gold coins offered by the government as a redistributive mechanism.

Iraq: Political Stasis Splinters Deferring Oil Gains

Iraq's fragile political truce has ruptured following the withdrawal of U.S. troops, and the risks that the coalition could dissolve remain high. Given how fraught the process of forming the coalition was, its splintering should come as little surprise, but the political stalemate, along with systematic sectarian attacks and escalating tensions between the federal and Kurdish governments, may halt oil production increases. An outright collapse of the government, and the exit of minority groups from the coalition, would further undermine economic conditions in Iraq, undermining long-term stability.

Given the security investment by international oil companies, we envisage the political jousting both between federal parties and between the federal and parliamentary levels delaying future production increases rather than leading to output losses. A resumption of conflict and the sabotage of oil infrastructure are further risks, but do not seem likely at this juncture, given the financial interests at play in Iraq and among its foreign partners. Looking forward, regions like Basra are likely to seek more autonomy over production, which could delay output increases and also lead to changes to the royalty structure, but the dominance of servicing contracts rather than production-sharing agreements lessens this threat in the short term. Corruption too remains high, undermining infrastructure buildout, which is the key to achieving economic and political stability, and increases in hydrocarbon output.

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Nigeria: Boko Haram, Corruption, Strikes Point to Political Uncertainty

Nigeria, which produces about 2 million bpd in oil, enters 2012 with a range of political disputes and security issues that will test the government and keep the focus away from progress on much-needed legislation to encourage oil-related investment. Over the past year, the government and local authorities have faced increasing threats from Boko Haram, an Islamist group or set of loosely connected groups that has taken credit for a number of violent attacks, whose escalation will focus the attention of the government. So far, there has not been a direct effect on oil production, but the threats are undermining the legitimacy of Nigeria's government, diverting its attention from economic and other policy issues, and could exacerbate some of the political stasis, delaying the passage of the oil law and increasing the demands for oil wealth to be redistributed. Coupled with a pre-Christmas offshore oil spill, these pressures could worsen the regulatory environment and raise the costs of doing business in Nigeria's oil sector. Moreover, to the extent that persistent if low-scale conflict undermines the confidence of consumers and investors outside the energy industry, it could increase the government's reliance on the hydrocarbon sector and thus up the need for rents and royalties.

So far, Boko Haram's targets have been primarily in Nigeria's northern Muslim-dominant areas around the capital Abuja, but the recent Christmas Day targeting of churches risks escalating the conflict, particularly as it has led to international condemnation of the militant group. Moreover, by broadening the religious conflict, it may be intended to spark retribution either through escalating violence or government condemnation at a time when other groups are already criticizing the government's management. Neither outcome is good for Nigeria's oil production, which has once again slipped below that of its African competitor, Angola.

More directly related to the oil market and potentially harmful for Nigeria's economy is the government's plan to remove oil subsidies, which absorbed about one-quarter of government spending. The bold move, pushed through by the government and unveiled January 1, removes a subsidy paid to fuel retailers, and government-set product prices have doubled, with transport costs rising more. Nigeria, like Iran and Venezuela, lacks sufficient refining capacity to meet domestic oil demand at home, forcing it to import much of its refined fuel, and undercutting its oil revenues. From an economic point of view, removing the subsidies makes sense, as they support corruption, add to distortions and disincentivize investment in new downstream capacity. However the uncertainty about the implementation of the new pricing scheme, and the high pass-through to other goods, will add to inflationary pressures, possibly prompting more capital outflows and weakening domestic demand. Moreover, with the government having pushed through the measure, despite parliamentary concerns, and not allowed a phase-in period, existing tensions between the authorities and the unions (already battling over the minimum wage) have been exacerbated. The surge in prices has prompted strikes, including a general strike slated for next week, adding to the long list of problems for the government. Having already faced pressure from unions to hike wages, Nigeria's government could find it more difficult to implement its new bold move. Reallocating the money to needed infrastructure could be even more difficult.

Kazakhstan: Protests Are a Smokescreen for Succession Issues

Protests in parts of western Kazakhstan, which flared in late December, continue, exposing splinters in the regime and reviving worries about succession. The protests, which intensified on the 20th anniversary of Kazakhstan's independence in December, have extended strikes by oil workers, who demand wage adjustments, despite the government's imposition of a curfew and state of emergency. Dealing with the underlying causes, which include demands for higher wages by Chinese and Kazakh workers, reduced working hours and better benefits, may raise production costs and/or prompt renegotiation of contracts. Although the details are murky, strike concerns remain.

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Combined with potential changes to the subsoil law, there is a risk that projects could be delayed, the investment climate will remain adverse and Kazakhstan's oil exports will not climb any time soon, restraining non-OPEC supply.

The policy environment remains uncertain and President Nursultan Nazarbayev's response to hold his son-in-law Timur Kulibayev—head of both Kazmunigas, the oil company, and Kazakhstan's sovereign wealth funds—accountable for failing to alleviate concerns, revives succession worries. Nazarbayev, in power for 20 years, is aging, and Kulibayev, whose political standing has been volatile, was on the purported shortlist for succession. While he could still be rehabilitated, it exposes the fact that power remains concentrated, and institutional strength is weak. We still expect the January parliamentary elections to return Nazarbayev's party with a strong margin, but turnout may be low and the poll will not be a paragon of fairness. The hard work will come after the elections, when the government will have to show clarity on its future path. The investment outlook is unlikely to brighten, while higher fiscal costs could prompt even more pressure for nationalization, boosting local wages and other costs.

We expect the government to step up its investment and social transfer program, as global conditions continue to tighten and Kazakhstan's growth cools. Compared with other oil exporters, and especially its neighbor Russia, Kazakhstan has much more fiscal space and has been saving, not spending, money in its sovereign fund over the past year, giving it some space to stimulate and continue to circumvent weak bank balance sheets. Since a property boom went bust in 2007, credit has been nonexistent and the tightening of global markets has prevented Kazakhstan from attracting many capital inflows. News that Kazakh bank BTA might again seek to renegotiate its debt after restructuring in 2009 is one sign that the banking sector is suffering from the European deleveraging.

Russia: A More Interesting Election

Russia, the world's largest oil exporter, has faced unprecedented protests, threatening the support of United Russia (the party of government) and its claims of stability. While we don't expect policy changes in the near term, the government will need to respond, particularly after the lengthy New Year holiday, as it hopes to cool tensions ahead of the March presidential election. Doing so may be difficult, particularly as Russia's economy slows, and the political pressures and need for more revenue could prompt changes in the oil tax regime.

These protests come despite extensive government stimulus and social transfers, with the latter mostly benefiting government workers and the elderly, i.e. not for the most part the protestors. There has been no effect on the oil market, but the low chance of reform risks a further deterioration of the investment climate. Moreover, higher spending means more revenue is required, suggesting the government will not be able to make meaningful adjustments to royalty regimes to support investment.

A certain portion of the Russian elite seem to have had enough. Following the contested parliamentary election, protests have continued, on weekends, as the urban population show their disgust with the lack of reforms and opportunity. Thus far, the government has barely reacted, and we expect any significant response will be delayed until after the New Year holiday, when there could be more of a political shuffle. The protests have prompted some prominent Russian politicians to run to oppose former president and current Prime Minister Vladimir Putin, which will paradoxically please the regime by satisfying its desire for a semblance of more choice. We expect, though, that Putin will win the election, returning to his previous office. Moreover, we fear that calls for reforms will remain unanswered, with security, not economic modernization, remaining the primary goal.

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Table of Risks to Watch

Note: "Likelihood" denotes the probability of output loss. "Impact" is a judgment call based on the amount of supply that could be affected and the severity of the risk to global supply. This list is not comprehensive and will be updated as needed.

Risk		Likelihood/ Impact
Iranian military conflict	While blocking the Strait of Hormuz might be economic suicide for Iran, particularly as it would result in a price spike that would damage global oil demand, the risk of a policy mistake is rising. An outright conflict involving Iran or even a short-term strait blockage remains a low (if rising) probability, but a high-risk event for the global economy, which would have a severe effect on global consumer confidence. As the tit-for-tat game of sanctions and military tests escalates, risks of outcomes that reduce or distort global oil supply are rising.	Low, but rising/high
Libyan political transition	Libyan oil production continues to come back on stream slowly, but will take more than a year to return to pre-unrest levels of 1.6 million bpd. The new leadership has rejected calls to renegotiate contracts, which would undermine cooperation with international oil companies and the funds needed for reconstruction, but a more permanent regime could put policies up for review. The increase in production has eased some of the strains on Brent and Middle Eastern crude spreads, and helped the, mostly European, buyers of Libyan oil, who happen to also be the primary buyers of Iranian crude.	Low/high
Russian election	Despite the unprecedented protests, calls for reform will likely remain unanswered, with security, not economic modernization, remaining the primary goal. However, the pressure for more spending may preclude changes in the oil tax regime, which would support more investment and production.	Low/high
Saudi Arabia's Eastern Province	Protests continue in Saudi Arabia's lightly populated but Shiite-dominated Eastern Province—though reports are murky. We do not expect this to effect oil production, given the heavy investment in security. Across the country, the government will maintain its dual policy of, on the one hand crackdown and increased security, and on the other increased stimulus, overspending on its planned budget again in 2012, which will increase its reliance on high oil prices. Its domestic concerns will make it hypersensitive to what it sees as intervention from Iran in GCC domestic affairs, and King Abdullah may push forward with plans for a more united GCC front versus Iran. Unless transit channels are blocked, Saudi Arabia would increase production to offset Iranian declines and European demand, reversing any production cuts to stabilize prices.	Low/high
EU embargo	The EU restrictions on Iranian oil output seem more likely, though the timing and scope of implementation will determine the effect. As EU consumers, particularly the already weakened periphery, consume less, China, Turkey and Asian customers may be able to drive a harder bargain,	High/moderate

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	with Iranian oil trading at a discount, as it did following the 2007-08 round of tighter sanctions and the weakening of global demand. The uncertainty of supply may add to distortions and raise price risks.	
Iraqi politics	The political stalemate, along with escalating tensions between the federal and Kurdish governments, will halt oil production increases, but are unlikely to lead to output losses. An outright collapse of the government, and the exit of minority groups from the coalition, would weaken economic conditions in Iraq and delay needed infrastructure for the power and oil sector, undermining long-term stability.	Moderate/ moderate
Kazakh protests	Protests, and strikes by oil workers, mean the policy environment is very uncertain. Meeting the demands may increase production costs, but avoiding addressing the economic reasons behind the protests may delay projects and deter investment.	Moderate/moderate
Nigerian security issues and removal of oil subsidies	The attacks by Islamist militants Boko Haram have not had a direct effect on oil production, but the threats are undermining the legitimacy of Nigeria's government, diverting its attention from economic and other policy issues, and could exacerbate some of the political stasis, delaying the passage of the oil law and raising the cost of doing business in Nigeria's oil sector. Meanwhile, having already faced pressure from unions to hike wages, Nigeria's government could find it more difficult to implement its bold decision to remove oil subsidies. Given the primary production of light sweet crude, oil output losses from Nigeria tend to have a higher impact than the amount of outage might imply.	Moderate/moderate
Algerian policy	The Algerian government quashed protests in early 2011 with a combination of force and stimulus, a policy mix it will likely use again if needed. Algeria faces some of the same economic demands as its North African neighbors and weaker oil production, but the government is most likely to spend more of its savings to remain in power.	Low/moderate
Angolan elections	Ahead of the October 2012 elections, long-time ruler Jose Eduardo dos Santos is sending mixed signals about retirement, first selecting the head of Angolan oil company Sonangol and then reversing his decision. Angola vies with Nigeria as Sub-Saharan Africa's largest oil producer, and any political uncertainties could increase royalties. As an OPEC member, Angola's oil output is constrained.	Low/moderate
Venezuela	Economic woes have mounted ahead of the election, with the country hemorrhaging FX reserves. President Hugo Chavez's desire to bolster his support will prompt more redistributive policies, which could further undermine the investment climate. Venezuela needs foreign investment and expertise to exploit its heavy oil reserves and boost production, meaning production increases are unlikely in the near term.	Low/moderate
Syrian conflict	EU sanctions on Syria have had more effect on the regime than the global oil market as Syria is a small producer and already a net importer of oil, especially oil products. The sanctions have increased pressure on the regime, which is now seeking to safeguard its interests and cling to power. Deepening conflict or a power vacuum in a post-Assad world	Syrian output loss: High/low Regional loss: Low/High

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	could undermine already unstable neighbors like Iraq, which would have a more extensive effect on regional sentiment and oil supply.	
North/South Sudan rivalries	South Sudan separated from the North without a deal on transport fees for its oil, which must go to the North for refining and exports. The North is losing a large share of its revenue and is insisting on high tariffs for transport, which could cripple its neighbor. Northern demands will accelerate the move to alternative trade routes, including the already planned construction of a pipeline to Ethiopia and new refineries, but these will take at least a year to complete.	High/low
Eastern Med. gas fields	The battle for offshore gas (and possibly oil) has heated up, with the Israelis first to begin production and other countries (Lebanon, Turkey, Cyprus) racing to find supplies or to make claims on resources that might cross their borders. The search for fuel among this group of fuel importers could exacerbate territorial disputes, particularly as ties between these neighbors have deteriorated severely in recent years.	Low/low

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