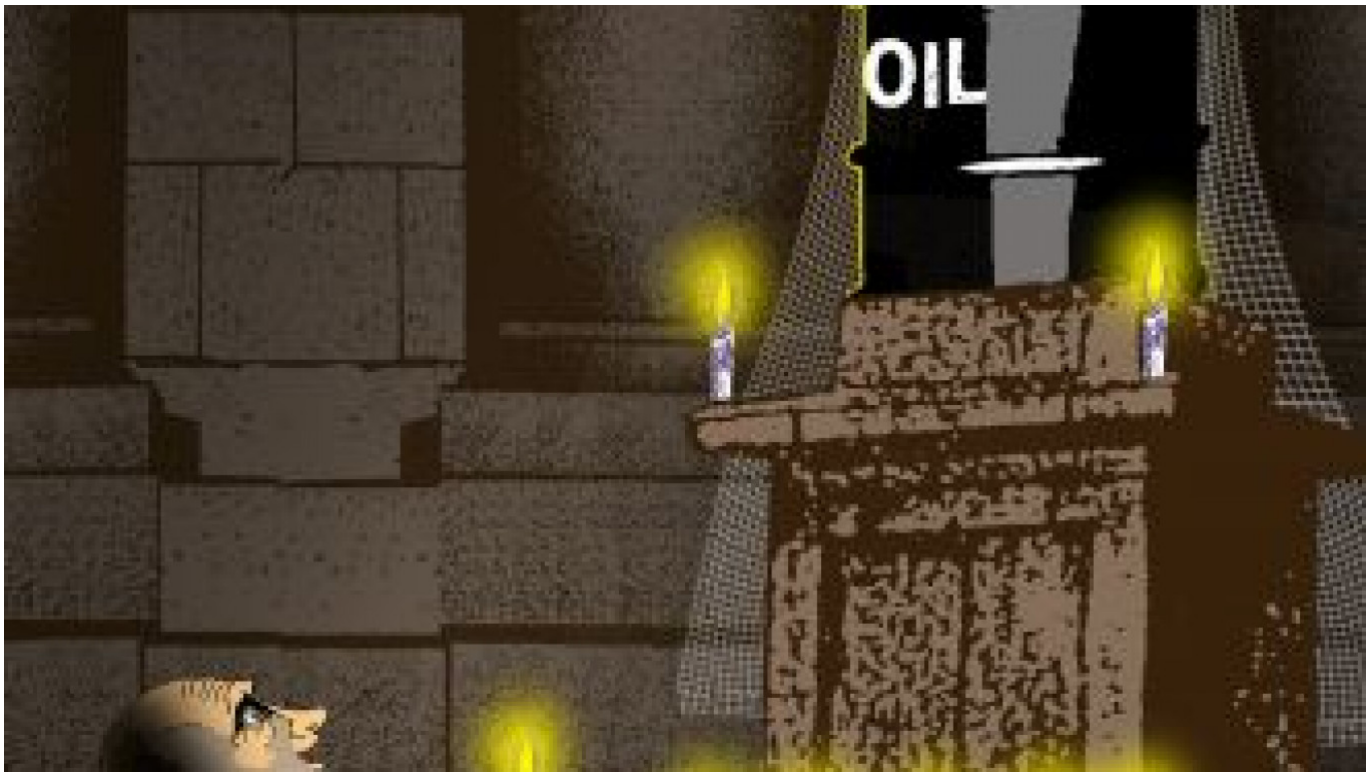
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# Still Betting on Oil Conflicts

By Chris Weafer

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Last week, the American Petroleum Institute called on the U.S. government to end the embargo preventing the export of domestically produced crude oil. The call comes against a backdrop of rapidly rising oil production, a trend that will make the U.S. the world's biggest oil producer within 12 months. Given how emotive this subject is and the fact that the embargo came into force as a direct response to the Arab oil embargo of 1973, it is unlikely that any such change is even possible for many years. Even after the rapid production increase in recent years, the U.S. still needs to import 9 million barrels every day to satisfy current demand. It is still a long way from energy independence.

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Much continues to be written about the threat to the price of crude from the rapidly rising production in North America as both U.S. and Canadian producers exploit unconventional hydrocarbon reserves. A steady customer switch to cheap shale gas will also soon create the potential to export crude according to the "end the embargo" advocates. The export call is also supported by the major oil companies who claim that U.S. oil will help lower global energy prices. Others argue that the cost of the new production is rising and, along with rising budget requirements across the Middle East and Africa, the current price is actually a sustainable new norm as producers would need to quickly act to correct any supply imbalances.

One could write volumes about the pros and cons of that argument. Suffice it to say that the relative price stability seen over the past three years is unusual. The price of Brent crude has averaged $108 per barrel, almost consistently, since late 2010. The outlook for the first half of 2014 is not much different, although we have cut our forecast for the second half to under $100 per barrel as some of the current production outages are partially restored. At that price average, the federal budget is expected to run a deficit equal to 1 percent of gross domestic product for this year, and the ruble would come under more pressure.

But as much as strategists and economists would like to be emphatic in oil-price forecasting, there is still a lot of guesstimation involved. That is because, unlike with most globally traded commodities where one can build scenarios based primarily on supply and demand, the oil industry has an additional element that trumps economics: politics.

The demand side is the easiest of the four forecast model elements to forecast — that is, with the caveat being the assumption of growth forecasts issued by the World Bank and the International Monetary Fund are correct. In its October 2013 review, the IMF forecast global growth to reach 3.6 percent this year, up from 2.9 percent last year. On the back of that forecast, the International Energy Agency expects average daily oil consumption to rise by 1.2 million barrels to 92.4 million barrels. That is a similar increase to the one recorded last year.

In theory, the supply side should also be relatively predictable. The pace of supply growth in the U.S. and Canada is reasonably clear, and the 1 million extra barrels expected in the former plus the 250,000 barrels expected in the latter should cover the expected global demand increase.

Kazakhstan's Kashagan field, located in the north Caspian, was expected to be producing an average of 200,000 barrels per day later this year and double that in 2015, but it has had to suspend operations again because of technical difficulties. The project has so far cost $50 billion, the same as the cost of building the facilities for the Sochi Olympics, and is a good example of just how difficult and expensive it is to bring major new oil sources on-line. The easy oil plays are ending. The next wave of oil will have to come from shale, the Caspian, the Arctic and from offshore Brazil. All of these projects will be technically challenging and carry an unpredictably high cost. But for 2014, the majority of new oil flows will come from North America.

Then there is the politics. The reason why the 1.3 million extra barrels produced in the U.S. and Canada last year did not depress oil prices is because they only compensated for production disruptions in Libya, Sudan, Iraq and the losses from the continuing Iranian sanctions. If there had been no internal conflicts in the Middle East or Africa and if Iranian sanctions had been lifted, then the price of Brent would more likely have plunged to $80 per barrel by the end of last year. Will the conflicts in Libya, Sudan and Iraq be resolved and oil exports restored? Given the news from those countries at present, any answer is no more than a guess.

And then there are potentially new conflicts. Kurdistan is planning to export 300,000 barrels of new oil per day via the newly built pipeline to Turkey's Ceyhan terminal. If that oil reaches the market, then it would be a price negative. But don't bank on it. Kurdistan is behaving as if it were a sovereign country instead of a province of Iraq, so this also has potential conflict written all over it. The news flow from Nigeria is also disconcerting, and many commentators see a risk to oil production if the Islamic militants currently active in the country's northern regions extend their campaign to the oil region.

Iran is also another big question mark. The country is capable of restoring at least 1 million barrels to daily production and exports once the sanctions are lifted. It can do so relatively quickly because the oil-production wells were placed in suspension rather than damaged. The timetable to possibly allow Iran to resume bigger export volumes in six months has now started as part of a deal reached last year. But at the same time, a bill to impose new sanctions is currently being debated by the U.S. Congress. The situation is far from clear, and while oil traders expect to see more Iranian oil exported in the fall or from early 2015 at latest, the return will more likely be a slow build up rather than a sudden deluge.

The value of the U.S. dollar is also a factor because this is the traded currency for oil. Historically, there has been a close correlation between the trade value, or purchasing power, of the dollar and the price of oil. Since the U.S. Federal Reserve started its quantitative easing programs in mid-2009, the weakened dollar has provided support for crude oil. As the Federal Reserve is now starting to cut quantitative easing support, the value of the dollar may well start to rally from mid-year and into next year and act as a depressant for the price of oil.

All things considered, rapidly rising U.S. and Canadian oil production certainly poses a threat to the price of oil in the long-term, albeit with the caveat that cost requirements are also expected to rise. But how quickly and to what extent that threat actually starts to influence the global market will depend largely on politics in the Middle East and Africa. In any event, it is safe to say that from the oil market's viewpoint, an agreeable level of disruption and uncertainty will continue for some time. The oil-revenue assumptions in Russia's federal budget look safe for 2014.

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*The views expressed in opinion pieces do not necessarily reflect the position of The Moscow Times.*

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