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BI-WEEKLY OIL REPORT

Herodotus Antonopoulos &
Filimon Antonopoulos
Oil Market Analysts

lnx@otenet.gr ; info@iraj.gr

Operation Iraqi Liberation (O.I.L.), as US comedian Jay Leno put it, seems to be over. As we were writing these words almost all TV stations were showing the collapse of a Saddam statue in Central Baghdad. The end of an era for Iraq took place today, even if not much is known about the fate of many of its major actors. It took US-led forces almost twenty days to defeat the "mighty" Iraqi military machine and it may take several months to bring the Iraqi oil industry back to its pre-war status. One cannot help reflecting on the changes that are taking place in this sensitive part of the world.

What took so little time to contain, has been the major driving force behind major oil price movements for more than 20 years. Starting from the war between Iraq and Iran that lasted 8 years from 1980 until 1988 and led to a worldwide oil crisis, moving to the first Gulf War in 1991, that led crude oil prices above $40 and finally the 2nd Gulf War that led to a $39.99 high, Iraq had continuously played a crucial role in defining oil prices. In between the above-mentioned events we observed continuous aircraft bombings, halts of exports and threats regarding oil supplies. The swift reversals in sentiment due to the tag-of-war between Iraq and US caused nightmares to oil traders as well as several recessions to world economies.

Figure 1. Saddam statue falls

Source: CNN

There have been many thoughts and predictions regarding the petroleum prices in the after-Saddam era. Ranging from a price collapse and the break-up of OPEC to a spreading of military operations in other Arab Gulf countries (Syria, Iran) leading to extreme price spikes. Even though arguments for both scenarios can be found, we would take a more moderate view regarding the things to come.

While it is very hard to define the stability of the new Iraqi regime and while it is also hard to predict possible resistance by Iraqi groups against the new status quo, it is most likely that US officials will do all they can to secure the country's oil infrastructure. It is therefore fair to assume that regardless of the political conditions, Iraqi oil supply will be more stable than it has been during the last 12 years. The major projects that will take place in the coming years will greatly enhance the capabilities of the oil industry and create expectations of significantly higher output in the future. One could look at the example of Algeria, in which the fierce conflicts between the secular government, supported by the French, and fighting groups from the majority Muslim community, which led to many deaths and continuous turmoil, did not affect the well-guarded oil operations.

Such a development means that, while volatility in oil prices will continue, one should remove the Iraqi premium from prices, thus lowering the expected price curve. It is not easy to calculate what that premium was and it is very likely that one should not consider it a static factor, but at the same time it is clear that it was -in a way- a structural component of oil prices during at least the last 12 years.

The fact that the $40 level was approached during major events related to Iraq shows that oil prices will have a very tough time reaching such levels again in the near future.

Figure 2. NYMEX crude oil futures price in $/barrel

Source NYMEX

On the other hand the scenario that Iraqi supply will flood the world oil markets and that the new regime will lead the country away from OPEC leading to a price collapse does not seem likely. It will take significant time and major investments for Iraq to reach its full potential, which many estimate to be close to 6-7 million bpd. For the coming 1-2 years, Iraq could only aim at its pre-1991 levels of 3-3.5 million bpd. While this is a significant increase from an almost 2 million bpd production during the past years, it by no means translates to a world oil supply glut.

Regarding their OPEC membership, it is highly unlikely that any US controlled government will want to immediately severe ties with the Arab world, by trying to dissolve OPEC. The fact that the Organization was accommodative to the needs of the consumers and did not use oil as a weapon against the US, makes it a useful example that the US is willing to cooperate and not destroy international organizations. We should also take into account that S. Arabia is still the most prominent player in the world oil market and any attempt against the unity of OPEC will greatly jeopardize the Saudi-US relationships and the future of the current regime.

We would therefore not expect any significant changes in the way OPEC is now operating due to the changes in Iraq. We should also take into account that Iraq will continue to operate under the oil-for-food program for a little while longer and no one will be willing to rush into any decisions.

The scenarios that the US offensive could spread to other Arab countries, causing the outrage of the Arab world and putting at great risk the regions oil supplies and heightening the threat of terrorist actions cannot be dismissed. Especially as US officials, led by Secretary of Defense Donald Rumsfeld, were eager to threaten Syria and Iran while the war was still at its early stages. We believe however, that no US government would want to be seen as staging a generalized offensive against the Arab world. A war against any of the aforementioned countries will be an extremely hard thing to sell at this moment, even within the US.

If, however, such an event did take place, then an even higher premium could be justified, as it would obviously provoke reactions by most Arab countries and forgotten words such as “embargo” could be heard again.

In conclusion, it seems that the post-Saddam era will most likely lead to a near-term lull in oil prices, especially as all involved parts will focus their attention in sharing the pie of Iraqi oil infrastructure. The huge maintenance and development projects will take center stage in the months to come and will fulfill the true objective of O.I.L.

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