The Iraq crisis and oil geopolitics

The UN’s unanimous approval of Resolution 1441 and, a few days later, Iraq’s unconditional acceptance of the return of the inspectors rekindled the debate over the short- and medium-term ramifications of the current crisis on the oil market. Today, given the organised information leaks concerning war preparations and statements from various US officials, few still doubt the imminence of military intervention.

As for oil, despite the Arab League’s rejection of any recourse to force at its 10th November meeting in Cairo, no one believes that Iraq’s demand for an oil boycott against any member of an armed coalition will in fact be implemented. As such, with reduced tensions and the main OPEC producers’ commitment to supply the market regardless of conditions, prices have begun to tumble. This trend is supported by forecasts of fundamentals for Q1 03 which suggest an oil surplus.

The general opinion is that, excluding slight upswings due to potential friction during the inspections, a military operation would probably cause prices to fall. The consensus forecast among analysts still favours lower prices in the medium-term. Over and above the outlook for fundamentals, these analyses are based on the idea that the Bush administration’s new international oil policy is turning Iraq into a catalyst for reshaping the oil market in the Middle East.

Military occupation of Iraq and the "conspiracy theory"

The most common post-crisis scenario predicts a change of regime in Iraq in favour of the United States, implying a redistribution of Iraq’s upstream oil infrastructure to US companies, a policy of a rapid production increase, even if this means going against OPEC and, perhaps eventually leaving the Organisation. The most daring scenarios predict the use of Iraq as a basis for developing a free oil market in the Middle East, thus encouraging the expansion of production, reductions in costs and prices and even the emergence of a new benchmark in the Gulf region, more credible than the Dubai benchmark, which would be an Iraqi crude covering larger volumes and produced by a multitude of non-OPEC producers. Basically, the scenario of the development of a free market (excluding OPEC), enlarged to the entire region, which would eventually erode profits, especially those of producers, and settle the problem of long-term supplies in a structural manner. Under this assumption, prices would remain at relatively low levels for several years, very probably below the USD 22-28/b range set by OPEC, because such developments would obviously destabilise the Organisation and destroy its effectiveness.
In order to support this sort of oil policy, some immediately suspect the US strategy of having secret objectives, such as wanting to occupy the country militarily. With the significant risks of seeing Iraq split up (and/or at least seeing its government weakened), more and more within a growing party of elites in the Arab world seem to think that the Americans will have no other choice but to set up a direct international administration (with a strong dose of US influence) for a rather long period, similar to the allied occupation of Germany and Japan after World War II or more recently in Kosovo. According to this theory, this phase would only be the first stage in a grander plan to break up all the major countries in the Middle East, including Saudi Arabia, reducing them into small, more easily controllable States, so as to ensure the expansion of the region’s oil reserves free of constraints.

However, although the credibility of this “conspiracy theory” is questionable, we cannot totally rule out the idea that the United States would like to enlarge its range of oil allies in this important region in order to meet future energy needs. The emergence of an allied Iraq, holding the second largest oil reserves in the world, would have the advantage of reducing the weight and influence of Saudi Arabia, whose future development has recently aroused fears in the United States. The determination of the Americans to proceed with a military strike, even without a serious default from Iraq on the terms outlined in Resolution 1441 and the fact that it is not encouraging other methods to destabilise the government in place, fuel this kind of speculation in the Arab world. The fears and reticence of leaders and other political forces in the region’s nations are therefore understandable. This interpretation of the United States’ motives may spark the mobilisation of forces hostile to its policy in the region and inspire opposition due to the risk of extending the instability to neighbouring countries, therefore creating a spiral of massive military presence which would require more and more resources without guaranteeing the flow of oil supplies.

Possible behaviour during the crisis

If we go a step further in our analysis, the oil scenario described above which would lead to the emergence of a free market is feasible. However, upon closer examination, it would require a number of conditions, some of which are not easily achievable. In fact, despite the emerging consensus, much uncertainty remains over deadlines, the behaviour of those involved and the consequences of military intervention. Some of the factors which may hinder this mechanism should be developed.

1. The war is not inevitable: First, military intervention. Even though it is highly likely, there is no indication today that it is inevitable. Two other possibilities should not be entirely ruled out. The first is that Saddam Hussein, knowing that he is gambling with his survival and having demonstrated his deftness in emerging from sticky situations in the past, would decide to destroy all weapons of massive destruction prohibited by the United Nations if he still has any. He would then attempt to apply the terms of Resolution 1441 as scrupulously as possible in order to avoid risking the sanctions announced. The Americans would then have to proceed with a military strike using any excuse possible to overthrow Saddam Hussein’s regime, if that is truly their war objective. The second possibility is that the conclusions from the UN inspectors are not unfavourable for Iraq, and the Americans, finally measuring the risk of an unilateral or feebly supported strike, unite with Arab countries and other important parties in the international community to deal with the Iraqi crisis diplomatically. As Saddam Hussein would be on reprieve, the oil market mechanism outlined above would not be triggered, and Iraqi production would remain restricted for an indeterminate period.
2. **Future Iraqi government and oil policy**: Many believe that the US strategy’s real objective in this crisis is to overthrow the current regime, which can only happen rapidly through military force. Therefore, the most likely assumption remains that of a war against Iraq, perhaps a relatively easy one, without destroying too many oil facilities and rapidly overthrowing Saddam Hussein once US troops hit Iraqi soil. In any case, even without military intervention, the United States has decided to deploy other pressure and action in order to replace the regime in the next few months. The authority of a new Iraqi government will depend to a great extent on the conditions of the military victory, notably the number of civilian victims and material damage from bombardments. Its task will be facilitated if the military operation does not encounter too much resistance. Given the divisions still prevailing among the various political forces of the opposition, a few difficulties and negotiation deadlines can already be expected in implementing this new government. However, despite the statements, we should not expect a major upheaval in the oil industry.

3. **The issue of OPEC quotas**: We should not forget that Iraq was an active founding member of OPEC and this membership owes nothing to Saddam Hussein. On the contrary, since he took power, he has not revealed any particular eagerness to maintain a united front within Organisation, sometimes having his country taking marginal stances. The idea of a new Iraq becoming a United States ally does not automatically imply aggressive policy towards OPEC. A number of examples among the other OPEC members attest to this. In my opinion, Iraqi executives have a sentimental and political attachment which cannot be wiped out in one fell swoop. The new leaders must certainly account for the real constraints involved, the stance of other parties and the need for the recognition of their legitimacy from neighbouring countries, the most influential of which are OPEC members. Why then would they be against OPEC? We can clearly expect strong demands from them to return to the production quota before the Gulf crisis in 1991, in other words, Iran’s production level. In any case, several of the Organisation’s resolutions have already provided for that. We can also expect difficulty from other members which will be reluctant to cut their production. With regard to this issue, we already know that one of the major questions will be the attitude of Saudi Arabia, the main beneficiary of the 1990 embargo. Furthermore, some observers have not ruled out the possibility that some OPEC member states’ overproduction in recent weeks could (also) be regarded as preparing for future negotiations over the redistribution of quotas.

4. **The attitude towards oil pricing policy**: The financial needs of an Iraq undergoing reconstruction and seeking social and political stability will be difficult to meet with low prices and production which, whatever the degree of voluntarism, will remain significantly limited by the state of affairs. Why would the new Iraq totally ignore OPEC’s current formula which, while accounting for market share, also aims to optimise income through prices? If prices are maintained around USD 18-20/b, chances are the new Iraqi authorities will be very aggressive towards OPEC, including in the form and manner of tackling the situation. This will probably drive market to gamble on a drop in prices. However, lower prices, even at less than USD 15/b, would be a restriction that would feed Iraqis’ interest in OPEC’s pricing policy.
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5. The opening of the upstream oil infrastructure: Considering Iraq’s economic history in the past three decades and the nationalist culture prevailing in the country, as well as for much of the opposition, we may doubt the immediate emergence of an ultra-liberal government. We must not be deluded by promises from a few members of the opposition currently in exile. Realistically, this opposition does not have the competent personnel to take power immediately. To maintain, or even increase, oil production will prove vital for the country’s stability and reconstruction. We should therefore expect to see a large number of executives currently in place, at least those who are not too involved in the current system. They will continue to make up the majority of the teams negotiating over oil issues on behalf of Iraq. Moreover, why would the authority (at least if it is central) of a new Iraq deprive itself of a tool like the national oil company, which is used to control oil profits, thus a genuine lever of political command? Lastly, opening up oil exploration and production in Iraq would not necessarily imply full privatisation, at least not in the immediate future, given problems linked to any redistribution of production. Any new government – especially if it is set up by the US administration – is likely to be very firm in order avoid suspicions of selling off national interests. It may be tempted to spark competition, relying on those who have already obtained promises of production contracts, such as Russian, French and Chinese companies, which would not easily agree to any of their negotiated projects being questioned. Negotiations are expected to be difficult. Why should the fiscal and legal conditions be so different from those in other countries in the region?

How will OPEC react?

- In the event of war, rapidly followed by a new government and recovery in Iraqi exports, OPEC will have to deal with three particularly difficult problems before next summer: production compliance, the redistribution of quotas and the stance vis-à-vis non-OPEC producers.

- In the event of war leading to the suspension of Iraqi exports for a certain period, OPEC’s current overproduction level – between 2.5 and 3 million b/d – would be easily absorbed by the market. If the war persists, tensions linked to the safety of supplies would maintain a risk premium in oil prices.

- In the event of pursuit of the diplomatic path to resolve the crisis, therefore postponing any major political change in Iraq, we can suppose that the United States will nevertheless look to maintain pressure to limit Iraq’s oil exports. The current conditions would be extended under this assumption. We could then expect OPEC to attempt to negotiate production cuts at the end of the winter by simply returning to a stricter compliance with quotas.

Therefore, whatever the outcome of the crisis, with or without war, it seems that Iraq’s production level will be one of the major variables in global oil trading in coming months. Iraq’s behaviour will certainly be the focus of debates within OPEC as well as for other exporters. If oil demand remains hesitant at the beginning of next year, crude prices may fall below the USD 22/b floor due to both the disappearance of the war risk premium and excess supplies (current production from the OPEC 10 and Iraq plus non-OPEC producers has increased by over 1.7 million b/d in 2002). Therefore, can producers agree on a sufficient production cut in order to avoid this plunge in prices or, if prices do fall, to bring them up quickly?
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Some observers doubt it. In light of their past behaviour and experience over the last two years, I am not so pessimistic. First, because OPEC’s decision not to raise the official production level in 2002, despite pressure, was a wise one. Using this artificial mechanism, which was only possible thanks to price levels, OPEC reduced the difficulties to be faced when production will have to be reduced next spring: it will not be forced to formally yield market share to non-OPEC producers, nor apply the pro rata rule which implies an official reduction in the production limit, difficult to accept for some member countries. The alternative therefore consists in reducing current overproduction with greater production compliance. The decision would not require formalising and could be carried out on a pragmatic and voluntary basis in which major producers would play a predominant role. OPEC could even continue to require the participation of other exporters.

Admittedly, this scenario is not easy, but the threat of a lasting return to low prices and the proven determination of the Saudis to safeguard their market share (they overstep their quota by 12%) can push the others towards greater compliance and solidarity. Additional market share could not justify a drop in current prices. It is more advisable to show patience and wait for demand to recover before upping production. Even Russia, where the debate between the companies and authorities over cooperation with OPEC is still alive and kicking, cannot ignore the issue forever if it wants to reach the levels forecast in its 2003 budget based on a price of USD 21.50/b. From this point of view, we can understand OPEC’s interest in maintaining an official limit of 21.7 million b/d at the meeting on 12th December: it will leave some leeway for future developments.