On second thoughts . . .

Oil market second-guesses politicians as fundamentals look tighter

Not for the first time, the oil market has been overshadowed by Middle Eastern politics over the past few months. Hawkish sounds coming out of Washington - particularly about possible action against Iraq, but with a wider threat implicit - had the market jittery as far back as March. The seemingly intractable conflict between Israel and the Palestinian authority has also heightened tensions in the region, with the US afraid of losing the support of currently friendly Islamic states if it is not seen to be doing something about the situation.

We've been here before, of course - in fact, we've been here quite often. Those of us old enough to remember the days before OPEC may recall that the US (and the other major consumers) had it pretty easy then. Washington could promote official foreign policy in the region - which largely meant consoling Israel - while the oil majors effectively represented the country in the Arab world - as far as the oil industry was concerned, Persia was always a British fiefdom. The situation is a little more tricky now, with pesky dictators popping up here and there, wielding their state-owned oil industries like Excalibur and often undermining whatever success OPEC has had in controlling oil price fluctuations.

For, however much consumer countries dislike high oil prices, the major oil producers don't care too much for them either. Persistently high oil prices run the risk that non-OPEC producers will increase their production capacity, further eroding OPEC's power. It also gives the cartel a bad name in the business.

Events during April threatened OPEC's ability to manage the oil price within its target range - somewhere between $22/bbl and $28/bbl. Iraq announced it was suspending oil exports in protest at - well, in protest at all sorts of things, really. Political shenanigans in Venezuela didn't help, either. Some analysts suggest, however, that these events have themselves not had any great impact on the market. Prices had already risen by about $8/bbl since February with the market already taking into account the political risk in the Middle East. Indeed, during mid-April the price for marker crudes slipped back from the high point towards the end of March.

Rising prices were backed up by some promising signs in the market. In particular, refinery margins in the US started to pick up, encouraging a rise in imports to offset the beginning of a drawdown in the inventory overhang. Early signs of an economic recovery in the US prompted consumer optimism and a rise in gasoline demand. And the weather was unsettled, improving demand for distillates.

It also looks as though oil producers managed to hold their nerve in March, with preliminary figures suggesting no increase in output compared to February. This was not totally due to OPEC's discipline, however, as the 10 members other than Iraq actually increased output by about 450,000 b/d. Fortunately, Norway was true to its promise and held some production back.

The market's attention has, in fact, largely left the current political situation and is focusing on the second half of the year. Some predict problems ahead, not because of the difficulty in maintaining production restraint but quite the opposite. If the economic recovery in the US - and the rest of the OECD countries - does take hold from the summer onwards, then some see a shortage in the oil market. This could be made worse by any action in or near Iraq. London-based analyst CGES reckons that the market is currently in balance but its figures suggest that this is rather accidental, merely the mid-point between fears of surplus in the fourth quarter 2001 and equally dire warnings of a production shortfall in the second half of 2002.

CGES says that a price of $25/bbl is not sufficiently high to encourage OPEC members to raise output and warns that global oil demand could rise by as much as 1.3m b/d in the second half. With no action to increase production, crude oil prices

could hit $33/bbl by the end of 2002, CGES predicts, and even a 1m b/d production boost will still see prices at the top end of OPEC's target.
Fears of a supply shortfall might have been eased had the US come to a decision on drilling in Alaska but the disagreement between Congress and the House of Representatives suggests that no concrete action is likely to come on that subject in the near future. The next few months are going to be a ticklish time for the market, as traders wait to see signs of more oil being available, presumably from the Middle East. If it does, then tanker owners might get a little respite from the poor returns so far achieved this year.
But gambling on Middle Eastern politics is a sure way to lose money.

'Petros Petropolous'
uncle_petros@hotmail.com