



**A WAR, A COUP AND AN EXPLOSION:  
CHANGES IN VALUE AND RELATIONSHIPS IN  
THE WORLD'S OIL MARKETS**

*Oil-producing countries are developing a new sense of value for their product, and it is generally higher than the market believes. Recent revelations about supply shortages matched with rapidly rising world demand have given producers this new perspective. Their own domestic economic troubles, have pushed them to act now. Meanwhile, consuming countries have launched numerous efforts to locate new oil resources and expand existing fields. The tenuous oil dynamic that has resulted has already contributed to the beginning of one war and one failed coup attempt. In addition, terrorists may have recently targeted downstream oil facilities.*

*All these phenomena hint that historic alliances between producer and consumer countries are giving way to new alliances of convenience among producers as well as between consuming countries and new producers. They also suggest increased volatility and conflict in world oil markets.*

**Signals of Change**

In January of this year, Shell Oil Company removed 3.9 billion barrels of oil from its list of “proven reserves” and added that amount to its “scope for recovery” (unproven) category. Immediately, the company’s stock price lost 7 percent on the London exchange. In February, members of the Organization of Petroleum Exporting Countries (OPEC) agreed to cut production by 4 percent, essentially promising to reduce output by one million barrels a day. By March,

the market price of May-delivered oil had declined 4 percent. (*African Business*, 4/04; *Reuters*, 3/26/04)

Together, these actions highlight an expanding gap between perception and reality in the current world oil market. Shell was admitting that its access to oil was less than it had announced, and OPEC was saying that the market price for oil did not match their new perception of the product’s emerging value. Both announcements hinted at changes in the oil market. Yet those participating in the market took actions reminiscent of past perceptions: Lower

reserves in one company? Then lower that company's stock price. Announced cutbacks in OPEC production? Members will cheat, supply will be plentiful and, so, lower the market price.

These habitual reactions to market announcements are from investors who seem oblivious to changes under way in the world oil market. First, some industry observers have recently suggested that the kind of announcement that Shell made may apply to producers worldwide, a supply reality that consuming countries have yet to recognize. Second, OPEC's seemingly anomalous decision to cut back supply when prices were already reaching historic highs could be signaling a change in the producers' perception of their product's value. Thus, while several recent oil-market moves indicate that on the surface the market's dynamic remains the same, more focused observations suggest that just below the surface real changes that could catch inattentive industry "players" off guard are taking place.

Asia. In the contemporary version, China, the U.S., Russia, Japan and Europe were (and are) maneuvering for influence in the Pacific Rim, Latin America, the Middle East and Africa (see "The Great Game Goes Global," Parts I and II, **IF 2304** and **2305**, 2/15/02).

In the third of these *Briefings*, we noted that oil was altering the new century's Great Game. Specifically, major oil-consuming countries (the U.S., Europe, Japan and China) were aggressively searching for reliable sources of oil other than those in the Middle East. They were competing for influence in areas where oil resources could be developed, especially Central Asia and Africa, and many were working to enhance relations with countries developing existing oil resources, especially Russia (see "The Great Game Plays for Oil: A Global Realignment of Oil Users and Producers," **IF 2331**, 11/17/02).

While competition for new oil resources has continued, a few recent book titles reveal a more urgent worry in the oil market dynamic between producing and

consuming countries, and they suggest why OPEC may have cut production when prices are already elevated. *Out of Gas: All You Need to Know About the End of the Age of Oil* (2004); *The Party's Over: Oil, War and the Fate of Industrial Societies* (2003); and *Hubbert's Peak: The Impending World Oil Shortage* (2001). The parameters of these arguments are simple. Global demand for oil has been increasing more than 2 percent per year, while production from the world's fields has been declining between 4 and 6 percent per year. More specifically, in 2002, the world consumed roughly 27 billion barrels of oil, while discovering only 7 billion barrels of new oil. Projecting these numbers, the authors of these books have identified a global economic "crisis" in the making.

When Dick Cheney, the current U.S. Vice President, was chairman of Halliburton, he made just such an argument himself. The emerging production-use shortage, he told the International Petroleum Institute in 1999, "means by 2010 we will need an additional 50 million barrels per day, approximately the equivalent to [production] of more than 6 Saudi Arabias." (*Middle East*, 4/04)

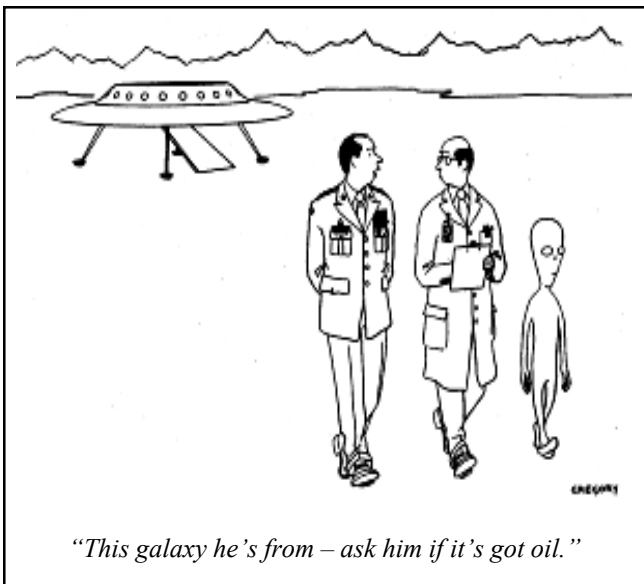


## **The Shortages Are Coming! The Shortages Are Coming!**

In three 2002 *Briefings*, we outlined the twenty-first century's version of the nineteenth-century "Great Game." In the earlier "Game," imperial powers Russia and Britain struggled for influence and control in Central

Whether these types of figures are correct is less important than the fact that some people, even those in positions of political power, think they are correct. Political rhetoric aside, this concern must have weighed on decision makers in Washington, D.C., when they decided to invade Iraq. From this perspective, U.S. military forces deposing Saddam Hussein may have staged the first war of the twenty-first century's Great Game for oil.

If so, it has not gone as planned. Prior to entering Iraq, U.S. authorities insisted that within 6 months, Iraqi oil would be able to foot the overall bill for the country's rebuilding. That such a desirable outcome has not happened reinforces the idea that, in the current Great Game for oil, executing a strategy—either as a producer or consumer—is fraught with difficulties and complexities often not anticipated at the outset.



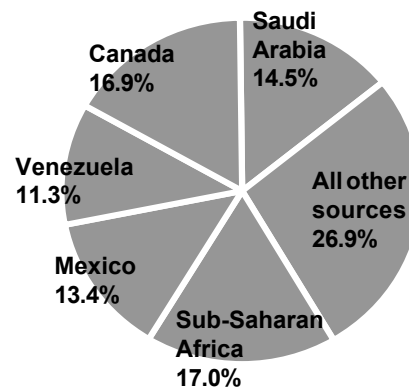
Military conflict to ensure oil supply has seemed less extraordinary as the world's demand for oil has risen, and may become even less extraordinary if existing supply is overstated and shrinking. In 2003, world demand for petroleum increased by 1.3 million barrels per day, to 78.6 million barrels per day. China accounted for nearly 35 percent of that increase and surpassed Japan as the second-largest consumer of oil. Beijing, where 21 provinces are already experiencing blackouts and energy rations, is increasing oil imports by roughly 10 percent per year. To put China's new oil-consumption status in perspective, the country was self-sufficient in oil

production as recently as 1993. (*Wall Street Journal*, 11/14/03; *Economist*, 3/20/04; *International Herald Tribune*, 1/5/04; *New York Times*, 1/3/04)

The largest consumer of oil, the United States, burns one-seventh of the world's production. The U.S. gets nearly 50 percent of its imported oil from Canada, Mexico, Venezuela and Nigeria and acquires less than 25 percent from Middle East producers, with Saudi Arabia supplying just under 15 percent of U.S. needs.

### Oil Suppliers to the United States

Of the 12,254,000 barrels of oil the United States imported daily in 2003, 56 percent was supplied by four countries.



Sources: OPEC; Bloomberg, 4/1/04

Japan draws more than 73 percent of its oil imports from the Middle East, while China buys 60 percent of its supply from the Middle East. Both are competing fiercely to win deals to construct a pipeline to bring Russian oil straight to their countries. Japan recently added its financial support to the Russian project, contributing \$2 billion for field development and \$5 billion for pipeline construction. Such competition among consuming countries is becoming commonplace. (*New York Times*, 1/3/04)

New and troubling oil-market realities—rising demand, shrinking supply and a wider concern that the world's oil reserves may be overstated—are making the Great Game for oil increasingly tense. OPEC's recent

effort to cut supply suggests that it has a new value for oil, a value derived from assessing rapidly rising demand against revelations of sliding supply. Such dawning realizations are prompting some realignments among oil-market players.



## Changing Partners

Changes in world oil markets are often subtle. Consuming-country economies weaken, and OPEC lets its price drift downward. Violence erupts in one supplier country, and another supplier country increases production to calm the market. These types of actions keep industry watchers busy. Lately, some unsubtle, indeed blatant, actions have taken place, and they hint at shifts in energy-market dynamics.

◆ On January 26, Lukoil, Russia's government oil company, signed a contract with Saudi Arabia to explore and produce natural gas in the Rub Al Khali region, the first Saudi-Russian deal. In the following two days, Riyadh signed similar deals with China's Sinopec Group and a European consortium headed by Italy's Eni and Spain's Repsol. Last year, Saudi Arabia granted similar contracts to Royal Dutch/Shell and Total of France. The Saudis did not extend an invitation to any American oil companies. (*Middle East*, 3/04)

Saudi Arabia is apparently shifting its market focus. It has taken a stake in China's Sinopec, and

according to Saudi Oil Minister Ali Al Naimi, "China is becoming quite a strategic ally for us in the energy business. They want to come upstream in Saudi Arabia. They are welcome, and we want to go downstream in China, where we are welcome."

With recent changes in Saudi law allowing foreigners to invest in domestic capital markets, European banks like Deutsche Bank and HSBC have moved into the country. In a signal of the shift in risk-and-opportunity perceptions, the U.S.-based Citigroup has lowered its exposure to Saudi Arabia, cutting its stake in the Saudi bank, Samba, from 48 percent to 20 percent. (*New York Times*, 3/18/04)

While the U.S. is being outmaneuvered in the Great Game's play for Saudi Arabia, it has had success elsewhere. In our 2002 *Briefing* on the Great Game for oil, we highlighted significant oil discoveries in Libya. At the time, oil companies declared Libya the "most attractive oil exploration location in the world." Moreover, that North African country's cost of producing one barrel of oil was around \$1, compared with \$2.50 for Saudi crude. We suggested then that this would have political ramifications. For those who missed these earlier observations, recent announcements about Libya-U.S. relations may have been surprising.

◆ On December 24, 2003, a little-noticed White House directive granted three American oil companies the right to negotiate with Libyan authorities to renew their Libyan oil leases, which were set to expire in early 2005. On January 25, 2004, an American-flagged plane landed in Tripoli, the first since 1969, and disgorged a delegation from the U.S. Congress. Soon thereafter, Libya's Colonel Muammar Gadhafi renounced a project to develop nuclear weapons, and Libya was officially "in play" in the Great Game for oil. Within a month of Gadhafi's announcement, several oil companies had signed Libyan deals, and U.S. company Occidental Petroleum had opened an office in the capital city. (*New York Times*, 3/26/04; *Tulsa World*, 3/16/04; *Middle East*, 3/04)

Adding to the momentum of Libya's rise in the eyes of American oil companies is the concomitant decline in these companies' confidence in their ability to pump oil from Iraq in quantities sufficient to defray risks and repay investments. Already, Kuwait is using

underground extraction technology to pull oil from fields inside Iraq, a provocative practice that, when done in the early 1990s, prompted Saddam Hussein to invade Kuwait. (*Middle East*, 3//04)

In addition, the U.S. political umbrella over Iraq may be closing. Paul Bremer, the U.S. official managing affairs in Iraq, announced his retirement, effective July 1, 2004. The oil industry took this announcement as significant. "If Bremer's statement isn't a signal that the Bush administration is ready to bail out of Iraq, then nothing is," said one industry analyst in Houston. "Under such a scenario, Libyan oil from Colonel Gadhaffi's more developed oil fields is a far more profitable proposition." (*Middle East*, 3/04)

As consuming countries have continued their quest for substantial sources of oil outside the Middle East, Great Game players have turned their attention to Africa. For example, in the past year, Algeria, a major source of gas and a growing resource for oil, has hosted (1) French President Jacques Chirac, who announced plans to commence Air France flights between Paris and Algiers; (2) U.S. Secretary of State Colin Powell, who praised Algeria's support for the "war on terrorism"; and (3) Chinese President Hu Jintao, who signed an agreement granting oil and gas exploration rights to Chinese companies. Also, British Airways announced plans to commence regularly scheduled flights between London and Algiers. (*New York Times*, 2/16/04)

As in Iraq, the U.S. has chosen to add a military component to its Great Game tactics in Africa. American Special Forces units are training troops and operating on the ground in Mali, Niger, Chad, Cameroon and Mauritania. The U.S. Army is also working alongside troops in Chad and Niger, surveillance flights from the U.S. European command routinely watch over Chad, U.S. planes have flown in air strikes inside Mali, and an increased U.S. Navy presence has developed off the West African coast. The U.S. has won increased military cooperation with Algeria, Morocco and Tunisia. (*Tulsa World*, 3/17/04; *Guardian Weekly*, 3/18/04)

Closer U.S. contact with Tunisia is interesting in light of the country's action at a recent Arab unity conference, which was seemingly contrary to its role as host. The Tunisian government unilaterally subverted and then abruptly canceled the conference, claiming that the 22 Arab countries assembled were not sufficiently dedicated to human rights to move toward any kind of

agreement. This came as a surprise to many delegates, who reported separately that agreements had been reached. They said the Tunisians had some "unspecified reason" of their own for wanting to cancel the meeting. As a result, efforts toward a new Arab unity collapsed. The Great Game has curious twists in story lines and surprising new partners, and Tunisia's emerging connection to the U.S. may be just such a twist. We anticipate the near-term arrival of American oil companies and/or the U.S. military. (*New York Times*, 3/28/04)



Increased military presence in North Africa parallels an increased economic interest in the region's oil resources. A consortium of U.S. companies headed by ExxonMobil is constructing a pipeline from the oil fields in Chad through Cameroon to the Atlantic Ocean. Unprecedented investments from Shell, TotalFinaElf, ChevronTexaco, BP and ExxonMobil are boosting the economies of Nigeria, Angola and Equatorial Guinea. Talk continues to surface about Nigeria leaving OPEC to escape the constraints of the organization's production quota, a new status that consuming countries would certainly support. Also, Mauritania and Sao Tome and Principe have new fields that could enhance their appeal to consuming countries. Even before this new focus on the region, the U.S. was getting 17 percent of its oil from sub-Saharan Africa. (*African Business*, 3/04 and 4/04)

Equatorial Guinea has attracted considerable attention, especially since recent discoveries could make that tiny country the top oil producer in West Africa. Since researchers discovered oil there, in 1999, the government's budget has gone from a deficit equal to 2 percent of gross domestic product (GDP) to a surplus

equal to 9 percent of GDP. The World Bank has reentered the country, and the International Monetary Fund (IMF) has reengaged there as well. The U.S. has reopened an embassy that was closed for decades, the African Development Bank has offered assistance to the government, and the European Union (EU) has resumed aid to the country. (*Rocky Mountain News*, 3/11/04; *African Business*, 3/04)



All these institutions and countries made their support for Equatorial Guinea conditional upon the government's actively advancing political and economic reforms. Given that the common perception of current leadership has been that it is corrupt and militaristic, such reforms are going to be difficult to realize. That created a problem for those countries hoping to exploit the country's oil supplies but needing political reforms before international organizations would extend substantial resources. Evidently, the reform process has not been fast enough, because the Great Game's oil tactics recently took another turn toward aggression.

◆ Zimbabwe's police arrested 64 men whose plane had landed in Harare for refueling. According to authorities, a rebel leader in Equatorial Guinea had promised the men \$1.8 million and future oil rights if they would surreptitiously enter the country, foment chaos and then support the overthrow of the current government. Details of the coup emerged from an alleged co-conspirator, Simon Mann, a British agent involved in buying weapons from dealers in Zimbabwe. (*Denver Post*, 3/12/04)

Where a rebel group acquired \$1.8 million to buy specially trained mercenaries and how a British agent became entwined in a covert coup attempt have yet to reach the public. Nonetheless, the event reveals that the Great Game for oil is becoming more aggressive and more contentious.

As if a war in Iraq and an attempted coup in Africa were merely harbingers, a recent event in the U.S. points toward more brazen actions in the future.

◆ Just one week after the U.S. Federal Bureau of Investigation (FBI) warned of a possible terrorist attack on Texas oil facilities, explosions and fires ripped through a BP refinery in Texas City. (*Reuters*, 3/30/04)

◆ Less than two weeks after the Texas incident, a round of explosions rocked a gasoline refinery in Gallup (NM). Officials said the cause was unknown and that an investigation to identify it **could take a year**. (*Associated Press*, 4/10/04)

Given that U.S. refineries were already operating at near capacity, these two incidents will eventually have an economic impact. Who would want that to happen?



### In Context

For economic and political reasons, many oil-exporting countries have decided that their product has been undervalued, even though it was reaching record prices in world markets. Russia needs economic growth to keep the country stable, and oil is its principal cash resource. Thus, Russian production has just reached all-

time highs, and President Vladimir Putin has undertaken some extreme political maneuvers (including arresting and sequestering the country's wealthiest oligarch who operated the country's largest private oil company) to assure Moscow's control over the country's oil supply. Putin plans to extract higher taxes from the oil companies to support needed social services. Saudi Arabia faces growing social discontent, as its economy has stagnated. Thus, Riyadh has, for the first time in recent history, opened its fields to foreign oil and gas companies, even as it was turning away from U.S. companies whose presence in Saudi Arabia could become a political liability. Iran has a huge youth population bulge that requires an expanding economy to keep these frustrated youths employed. Thus, it is connecting with Russia to expand its nuclear power plants so that it can free more oil for export. Iraq has been suffering constant sabotage of its oil pipeline as well as spreading rebellion, both of which have limited the financial return available to rebuild and stabilize the country. Thus, the U.S. has decided to pull back. Venezuela's street demonstrations and impeachment movement have reached such proportions that the government needs money fast to spread wealth into the country's poorer regions to stanch the protests' spread. Thus, Caracas is shifting oil revenues straight to social programs, foregoing needed maintenance on the fields themselves. As noted, countries offering new sources of supplies, such as Libya, Algeria, Tunisia, Equatorial Guinea and the like, have willingly opened their doors to international companies to develop their fields, often because domestic economic pressures have been mounting.

Meanwhile, consuming countries face their own difficulties. Revelations that available supply may not be what it was thought to be have given political leaders reason to rethink relationships with traditional suppliers. Rapidly rising global demand, as more countries become expanding industrial economies, has made the situation worrisome to some leaders. Since most consuming countries have let their alternative fuel research atrophy, they find themselves exposed to risks in supply they once thought impossible. Thus, U.S. President George W. Bush, who when first entering the White House insisted that Africa "doesn't fit into the national strategic interests as far as I can see them," now oversees an aggressive military and economic push into the continent. The U.S.

is also involved in a war in Iraq that is connected to the Great Game for oil, and American automobile companies have revived and accelerated their projects to put "hybrid" (battery/gas-powered) cars and sport utility vehicles (SUVs) on the market. China, which had seemingly been focusing only on marketing goods around the world, has now turned its strategic attention to Saudi Arabia, Russia and North Africa for the energy necessary to sustain a rapidly growing economy.

The problems facing both producing and consuming countries have created a shifting, potentially volatile situation in the oil markets. Producers are becoming more demanding, raising prices, cutting production to make supplies last longer and demanding more money from customers to develop fields. Moreover, with Russia and Saudi Arabia – the world's two largest oil exporters – sharing common economic and domestic problems, they are coordinating their efforts to manage world oil prices. In the past, elevated oil prices would merely encourage exploration elsewhere, but for geopolitical reasons (*i.e.*, the Great Game) exploration is already under way. This time, Russia and Saudi Arabia have been developing their own connections in Central Asia in order to become involved in some of those new-field explorations.

Consuming countries have become more aggressive in their efforts to secure supply, even launching a war, attempting a coup and spreading military forces around vital locations. In this process, producers and users are changing partners, developing new relationships and revising best possible scenarios. As a result, higher prices, greater volatility and even spreading conflicts (mostly covert) could haunt oil markets in the near future.

