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Oil Markets and the Geopolitics of the Middle East

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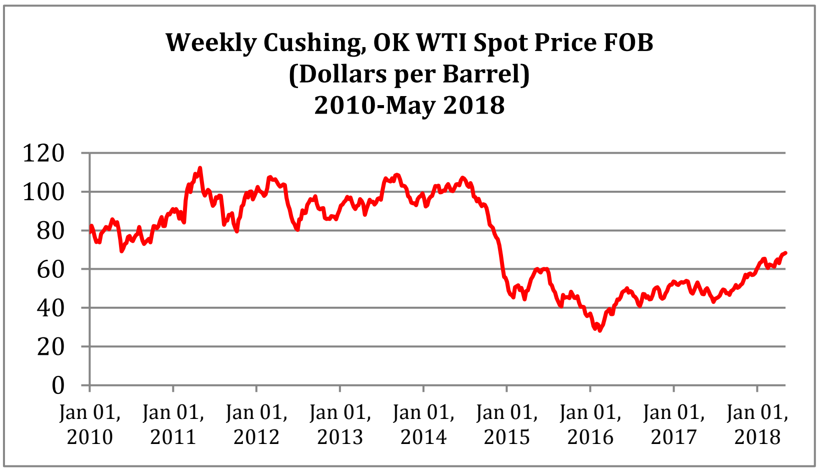
Introduction

Since 2014, geopolitics almost disappeared from oil pricing in the international market. However, in 2017 they began to return. This brief paper tries to understand why. Explanation however, and especially the implications of its return, are clouded by uncertainty driven by a number of factors. First, there is "Trumpian Uncertainty" as an increasingly erratic Administration in Washington gropes its way around policies towards the Middle East. Second, there is uncertainty over Israel's policies as Prime Minister Netanyahu seeks to divert attention from his domestic problems. Third, there is uncertainty over the direction of policies in both Iran and Saudi Arabia and its allies. Finally, there is the uncertainty over whether oil markets have forgotten how to price political risk in this very uncertain context.

The Historical Background

The context to the analysis begins with the collapse in oil prices experienced after the summer of 2014, illustrated in Fig. 1.

Fig. 1



Source: EIA Website

This collapse arose because of "OPEC's Dilemma". Following the Arab Uprisings that began in Tunisia at the start of 2011 governments in the Middle East and North Africa (MENA)

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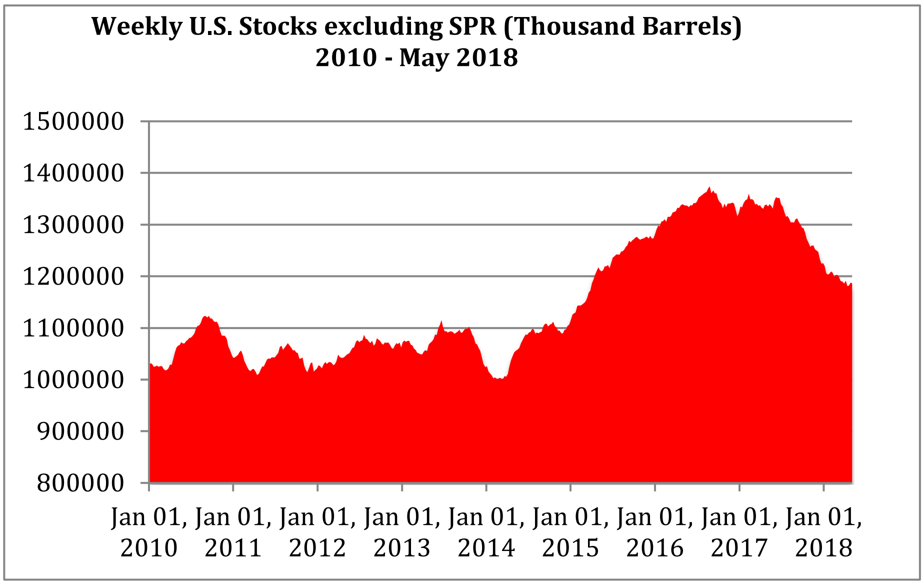
needed higher oil prices to increase their revenue to buy-off and pacify domestic political unrest. However, these higher prices would mean reduced oil demand and increased supply, especially in a world where the shale technology revolution was dramatically increasing U.S. production. The dilemma was that the need for revenue would undermine the level of oil prices. In the end, they went for higher prices and the market became grossly over-supplied leading to a dramatic collapse in oil prices. However, as 2017 developed, the stock overhang accumulated since 2014 began to reduce as can be seen from Fig. 2[1].

Fig. 2



Source: EIA Website

At the same time, as inventories began to return to normal levels historically, there was growing concern that the levels of spare capacity in the system would be insufficient in the event of any supply outage. This allowed the re-entry of geopolitics into oil market deliberations at the same time as a number of geopolitical issues began to arise in MENA.

The Return of Geopolitics to the Oil Market

The geopolitical events in the MENA region from 2014 are listed in Table 1[2]. Normally such events would have produced a price response. However, as can be seen from Fig. 1, they did little to affect price.

[1] Statistics for oil inventories are notoriously unreliable. Thus the US stock levels, that can be regarded as reasonably accurate and relatively up-to-date, are used as a proxy to reflect global inventory levels.

[2] There were other geopolitical events outside MENA that should also have impacted oil prices, notably developments in Venezuela, that did not effect prices.

Table 1 Political Events in MENA Post 2014

•**2014**	Iraqi civil war
•**2014**	Libyan civil war
•**2014**	Israel attacks Gaza
•**2015**	Yemen civil war
•**2016**	Attempted coup in Turkey
•**2016**	Saudi Embassy in Tehran attacked
•**2017**	Saudi/UAE boycott Qatar

Thus the plentiful physical supply of oil as reflected in the record level of inventories muted the normal concerns for geopolitical outages that would normally characterize the oil market. However, as 2017 progressed, a series of geopolitical event in MENA began to make the market nervous. In June, there was an outbreak of ‘hostilities’ between Qatar and Saudi Arabia and the UAE that only just stopped short of military action. In October, northern Iraq caused concern as the Kurds were ejected following the removal by the Iraqi Government of ISIS around Kirkuk in July. Over summer, there was a deterioration of relations between Saudi Arabia and Iran reflected in an attack on the Saudi Embassy in Tehran. Early in November, the stability of Saudi Arabia was thrown into doubt, as a large number of wealthy Saudis, including members of the royal family were effectively imprisoned in the Ritz Carlton Hotel in Riyadh and held hostage until ‘ransoms’ were paid. In December, street protests broke out in a number of Iranian cities. Finally at the end of 2017, President Trump announced that the U.S. would recognize Jerusalem as the capital of Israel and would move its embassy there. This was expected to lead to very large-scale unrest among Palestinians[3].

Looking at the MENA region since the Arab Uprisings of 2011, it has looked extremely volatile and unstable. Indeed it is necessary to go back to 1918 – the end of World War 1 and the collapse of the Ottoman Empire - to see the region in such turmoil.

These geopolitical upheavals of 2017 were further compounded this year with the U.S. unilaterally ripping up the JCPOA nuclear agreement with Iran and re-imposing stringent sanctions against Iran. It has now become fairly clear that the Trump Administration’s plan is to make the lives of ordinary Iranians so desperately miserable that they will rise up and overthrow the government in Tehran. It is effectively regime change on the cheap. At the same time, the U.S. is making warlike noises threatening Iran supported by Israel, Saudi Arabia and the UAE. To date, Iran has not responded apart from a great deal of rhetoric but its economic state is deteriorating

[3] In the event, to the surprise of many observers, including this author, such large-scale demonstrations have failed so far to materialize.

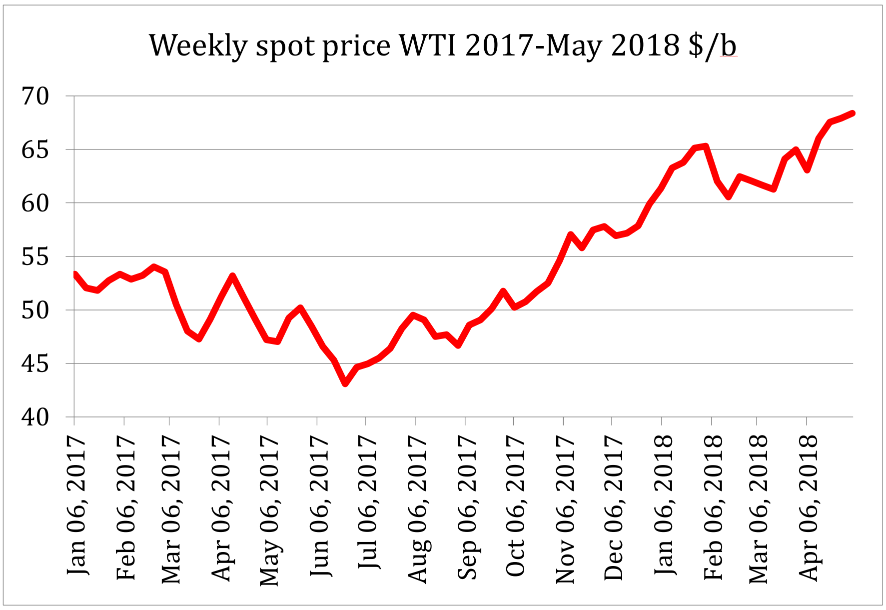
rapidly with a collapse in the value of the Riyal. At some point, Iranian retaliation will come that is likely to seriously destabilize the MENA region.

Putting it simply, geopolitics has returned to the oil market with a vengeance. And this is reflected in the gradual rise in oil prices seen since July 2017 illustrated in fig 3. This rise in prices is accelerating as November 1st 2018 approaches when full sanctions will be restored. At the time of writing this article in early October 2018 the price of WTI is exceeding $76.

The Impact of the Return of Geopolitics to the Oil Market

The problem with assessing the impact of all this political uncertainty over oil prices is that there are two markets that are affected. There is the wet barrel market where real barrels of crude oil are exchanged and the paper barrel markets such as NYMEX in New York and the ICE in London where promises to deliver or take delivery of paper barrels are exchanged.

Fig. 3



Source: EIA Website

Relations between the two markets are complex and controversial. Players in the wet barrel market when negotiating contract prices will look to prices in the paper barrel market for guidance as to what prices might be in the future. This is despite the fact that ‘ futures prices’ are statistically shown to be a poor guide to future prices! Similarly, players in the paper barrel market will look to the wet barrel market to see if there are likely to be shortages or surpluses in the future. Geopolitical events in MENA will clearly impact both markets.

Obviously, the loss of Iranian supplies as sanctions are re-imposed will curtail physical supply.

There has been much speculation over how much Iranian oil will be lost. When the EU imposed sanctions on Iranian oil in 2012 exports fell to I million b/d recovering to 2.5 million b/d after the nuclear deal. There are a number of uncertainties this time. It is not clear how many waivers Washington might grant to crude buyers wanting to avoid sanctions. This is because there will be no votes in helping Iran in the forthcoming U.S. mid-term elections. But, at the same time, voters will be affected if crude price increases feed rapidly into domestic gasoline prices in the U.S. before those elections. At the same time, the European signatories to the JCPOA, trying to keep the deal alive, are trying to create a financial loophole to allow European companies to still trade with Iran. This loss of supply from Iran is likely to be aggravated as international oil company investment in the Iranian upstream is also inhibited by sanctions. All the signs are that this is already happening on a very large scale. Another uncertainty is whether Saudi Arabia is willing and able to increase its production to replace lost Iranian supplies. Mohammad bin Salman appears to have promised to do so but at the same time, Oil Minister Falih has been clearly stating that there is no physical shortage of crude oil. This is very reminiscent of the arguments in 2008 over whether higher prices came from real physical shortage or simply speculation in the paper markets.

Geopolitical upheavals in MENA will also obviously frighten the paper barrel market. As fig 3 illustrates, there have already been clear signs that the geopolitical premium on oil prices has returned in 2017. This raises an interesting question as to how far, since 2014, the paper markets have forgotten how to price geopolitical risk? If so, this suggests the market faces a period of increasing price volatility as the various players try to come to terms with new information entering the process of price discovery that characterizes paper markets.

There can be little doubt that a serious geopolitical event in MENA leading to significant outages of crude supplies could lead to another oil price shock. This will obviously have important short run macro-economic implications. The crude oil price remains an important economic variable. However, of even greater importance is that is will speed up the current energy transition. This current transition is a move away from hydrocarbon molecules to electrons in response to environmental concerns over climate change and poor urban air quality. Any significant oil price shock would persuade governments of oil importing countries to take further policy steps to speed up this transition.

Writer’s Profile

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Educated as an economist and as a specialist on the Middle East at Cambridge and SOAS; 1973-1979 teaching at the American University of Beirut in Lebanon; 1979-93 at the University of Surrey. Between 1993 and 2008, he was Professor of Petroleum Policy and Economics at the University of Dundee, Scotland, a chair created by BP. He is an expert in the international petroleum industry, economic development in the Gulf and energy economics.