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Political Risk and the Energy Markets

It is a particularly interesting time to consider political risk and the energy markets due to the current record high for the price of a barrel of oil. The reason for this unique situation is largely a matter of political risk. The general belief on the markets is that the price of oil will continue to go up, and again the general reason behind that concern continues to be political risk.

The focus of this paper is on the extra ten to fifteen dollars per barrel of oil that is presently occurring in the market; the reasons behind this, how rational the situation is; and expectations for the future.

There are two parts to this presentation. First, an outline of political risk, what it is, especially in terms of the energy markets, and second, a brief overview of the countries where the largest portions of the political risk is presently perceived.

To start with, the definition of political risk, if you want to understand political risk in the global energy markets, has two components. The first is instability and the second is the likelihood of shock. One by itself does not create political risk--both components are necessary.

If you have a significant shock in a country which is stable, the effect will be relatively minor. For example, an election for a head of state that is considered illegitimate by half the population, which happened in the United States in 2000, did not impact the credit markets at all. This is because the US is stable. On the other hand however, a similar election result in Taiwan in the past year had a much different outcome. The markets crashed, there were demonstrations in the streets. This is the same shock but a far different result because Taiwan is much less stable. A situation may also exist where a country is quite unstable for a reasonably long period of time, but unless there is shock, you will not see an impact on political risk.

Stability is the capacity of a set of leaders to implement stated policy in the incidence of shock. In that regard, Saudi Arabia is quite stable, though shocks are hitting Saudi Arabia all the time. Iraq is an example of a country that is not stable. Russia was much more stable a year ago than it is now. Expectations are that Russia will become increasingly unstable over time. How that impacts on the energy markets will be explained later.

The next point is to clarify what an emerging market is. The definition of an emerging market is a country where politics is considered at least as important as economics to the market. For a developed state, domestic politics is not a significant concern as to whether or not to invest. If you are thinking of investing in Japan, analysis on the political situation with regards to the issue of contracts, the economic viability of partners, the economics of the deal or the vast majority of the consideration as to whether or not to invest, the issues of politics in Japan is a minor point to take into consideration.

A country where politics is considered at least as important as economics is an emerging market. The problem in the energy field is that energy exploitation in developed and stable countries are largely mature fields. The vast majority of the spare capacity available to the world today and expected to come onto the market in the coming decades is from countries where politics is considered more and more important.

Political risk in a developed state is basically negative. In the United States, Japan or South Korea for instance, looking at how political risk impacts the country, it is not internal, but external. This means factors such as terror, the current situation in Iraq, and North Korea. If the impact of these factors hit a developed state it is always negative.

In an emerging market however, the impact of political risk can be internal or external, negative or positive. In a pre-emerging market, no matter how good the political situation is, the only way political risk will impact the market is positively, because you need favorable international conditions from outside the country. Investing in Afghanistan is unadvisable, no matter how extraordinary the domestic policy-making is, unless favorable international support that is committed, sustained and long-term exists.

In terms of the international energy markets, viewed in a macro sense, in a developed state are exposed to the vicissitudes of political risk externally. This is a disadvantageous situation, the existence of political risk doesn't bring oil prices down, it only pushes oil prices up. The inevitable result of more political risk following September 11, President Bush's Axis of Evil speech in the State of the Union in January 2002, the announcement of the war on terror, and the instability in the Middle East, all have negative affects on the markets.

Now let us briefly consider oil prices. At nearly fifty dollars a barrel, the general presumption of the markets and Eurasia's internal assessments suggest that ten to fifteen dollars of the current price of oil is political risk. Where is that coming from?

There are many countries around the world that Eurasia focused on in the last year that caused significant concern with relation to the price of oil. These countries include Nigeria, Venezuela, Russia, Saudi Arabia, and generally all of the Middle East.

The level of concern is very much a matter of speculation, bearing in mind that US elections are coming up in two months. The current election is being dominated, unusually in the United States, by foreign policy. Not since 1980 in the United States has there been an election where foreign policy has played such a significant role. In 1980 a major focus of the election was on the Iranian hostage crisis, in 2004 it seems to be foreign policy in general, but Iraq and terror of course is dominating. Recent polls show thirty-eight percent of Americans believe that the US is heading in the right direction in terms of foreign policy. Yet this is not correlated to whether Americans feel that the economy in the United States is doing well, or new jobs are coming onto the market. Rather concerns are about the war on terror, the war in Iraq, and intriguingly, about high oil prices, which are directly influenced by the first two factors.

There are some issues already mentioned that are of real concern and some that are not. The first issue that is not considered a real concern is Saudi Arabia. It is true that Saudi Arabia has significant problems, but it is also quite stable at least for the next two or three years. In fact the likelihood that a political risk will occur, significantly impacting the ability of the Saudi's to put oil on the market over the next two years is extremely low.

The first reason for this, despite the fact that expatriates are leaving Saudi Arabia, is that Saudi Armco has the internal technology and capacity to continue to produce oil at 9.7, 9.8, 9.9 million barrels a day. Expatriates leaving the country will decimate the Saudi economy in the long-term, and the petrochemicals industry and the ability of the Saudi's to diversify their economy. But it will not stop them from producing the existing amounts of oil in the short term.

Second, the oil infrastructure in Saudi Arabia is isolated from population centers making it secure. The ability of the Saudi government to maintain control of oil facilities is high. The infrastructure is developed, it is advanced and redundant. The ability of terrorist organizations to disrupt that network is extremely low.

Third, the amount of money available to the Saudi government in the short term is very high, because of repatriation of money into Saudi Arabia from external sources, and also due to the very high prices of oil.

Saudi Arabia is facing serious problems in the long-term. There are major issues with the lack of educational reform, major issues with flat economic growth and extraordinary population growth, which will create big problems in the next five to twenty years. But with regard to oil prices today, there is no rational reason why terrorist attacks, against either Saudis locally or against expatriates working in western companies in Saudi Arabia should impact current oil prices.

There is another country that should not be of concern - Russia, although it is becoming more unstable. A recent issue involving YUKOS regarding uncertainty about the company's ability to supply oil to China became big news. The issue occurred just before Mr. Wen from China was making a trip to see Mr. Putin. The timing was perfect from YUKOS's perspective, as the company was about to become bankrupt and the issue allowed them to bargain for more time. It made all the headlines and caused trouble with the China-Russia relationship. The Chinese and the press asked questions about Russia's ability to deliver.

But this issue does not prevent the Russians from pumping oil. First of all, if the YUKOS management gave the order, locals working in YUKOS in east and west side Siberia would not listen. If they did, President Putin would use the military or security forces to ensure that pumping stations were working, that oil was being produced. The dangers in terms of the international market are really not there.

Now let us consider the countries where there are risks. The first and the biggest risk is Iraq. The expectations from the US government and the Iraqi government for Iraqi oil production have not been met. Even the official numbers are higher than the Eurasia Group's estimates of what is actually been produced in Iraq over the past months and year. Estimates are that in July and August Iraq averaged at or a little below 1.5 million barrels a day.

Unlike Saudi Arabia, Algeria, and Nigeria, oil infrastructure in Iraq, particularly in the south, is concentrated in areas of high physical population. Security forces have yet to be established, the infrastructure is not redundant, the political instability and lack of authority is particularly significant. Predictions are that it is not going to get better in the future, it is only going to get worse. The ability of the Iraqis to develop expanded oil production and to create an environment that facilitates international investment is extremely negative and even more negative than the market was generally perceived when the United States initially went to war with Iraq last year.

Some of the reasons why there is particular concern relates to the seventeen billion dollars that has been allocated by the United States for reconstruction and infrastructure in the 2004 year in Iraq. So far only nine hundred million has been spent, or approximately five percent. If security is not there and the infrastructure is not there, the implementation cannot happen.

Concerns also relate to the estimated 3000 Iraqis killed over the course of the past month. Collin Powell, Secretary of State, said that his expectations are that violence will increase significantly as Iraqi elections draw nearer in the next two months. King Abdullah from Jordan, stated he does not believe that elections can take place in the current environment in Iraq in January. The expectation in a country where the Sunni have most of the weapons, but none of the oil, is an environment that is going to get more fractious, more violent with some of the biggest market hopes previously of oil production in the world.

Another concern is political risk in Iran. To claim there is political risk in Iran because Iran is unstable is not necessarily correct. Indeed, since elections last year that brought the conservatives in Iran much greater control, physical control of the Iranian government, Iran has become more stable domestically. A belief that the Untied States could push the opposition to lead to regime change in Iran is misinformed. There is more unitary control of the government, commodity prices are high, Iran is having one of the best economic years in recent memory. Iran locally is not unstable.

But the political risk around Iran is still very high because of the perception of nuclear proliferation and because of the Bush Administration's reaction to Iran's desire to pursue a nuclear program. Political risk is also due to Israel, which is not necessarily directly coordinated with the United States.

At a recent IAEA board meeting a couple of weeks ago, the Europeans were unsatisfied with the level of compliance Iranians were showing in terms of uranium enrichment programs, and in terms of what they are doing as to their civilian nuclear energy program. The reaction of the Europeans was to give Iran two more months to comply satisfactorily.

The repercussions against Iran if they did not comply within the two months were not stated. The reason two months was given is evidently due to the US elections, and the hope of the Europeans that Bush loses and they don't have to worry about this issue as much.

But there is a very good chance, according to US polls, that that is not going to happen. The stance of the Bush Administration is to be very concerned with what they believe is the certainty of Iranian desires to proliferate, and the unacceptability of that as a status quo issue. Should the Bush Administration win, the likelihood that the United States will bring this issue to the United Nations, to try to pressure the Japanese and the Europeans to engage in comprehensive sanctions is high. The likelihood that the Japanese and Europeans will accept this is low. That means the United States, under a Bush Administration, will consider additional measures. The measures will cause more conflict with Iran, which will lead to more political risk in the markets and hence an increase in the price of oil.

Even if President Bush does not win, the Israelis will still represent a political risk, vis-à-vis Iran. The Israelis have also stated that the Iranians will not be allowed to develop a nuclear program, despite the fact that the Israelis have one themselves. The Iranians have responded by stating they would react very severely to an Israeli strike. The Israelis have suggested not 2007, as when the Iranians will be able to develop nuclear weapons, but three to six months as when the Iranians will be able to have nuclear capacity in the future without any further external support from outside countries.

The time horizon around the potential for Israeli intervention in Iran, either through covert or overt military means, is disconcertingly high for the markets. It is important to note that although the Israeli Prime Minister, Mr. Sharon, has lost domestic support from the right wing of his own Likud party, as well as the settler parties because of the unilateral withdrawal from Gaza, a sudden conflict with Iran to stop them developing nuclear weapons is something that would make Mr. Sharon more popular. The attitude of the markets is rightfully concerned about the likelihood of significant risk with Iran.

At the same time we have a Bush Administration which has shown itself unwilling to use the strategic petroleum reserve to try to balance out the speculation in the energy markets. Just yesterday the Bush Administration stated again that unless there is a specific shortage in supply, they are unwilling to dip into the SPR. This has been Vice-President Cheney's decision, it's something he feels strongly about ideologically, and they continue to be committed to.

In the context of US elections coming up and in the context of Iraq and Iran, there is ample reason to believe political risk will be high. There is one other reason - China. In this case however we are not talking about supply, but demand.

If you look at the world in terms of globalization and stability, globalization being the level of foreign direct investment, level of cross-border transit, level of political reform and openness, civil society, it does not necessarily mean that more globalization will result in more stability. North Korea is quite stable, but it is not at all globalized, being almost completely isolated. The best way to destabilize North Korea would be to globalize it. Open the borders to let investment in. This would cause significant problems. In fact one of the reasons Kim Jong Il will not allow nuclear inspectors in is because the process of exposing the country to inspectors is very destabilizing.

When a country is not globalized and the process of globalization starts and the reform process starts, instability rises very quickly. This is one of the dangers in Saudi Arabia and is one of the reasons why the Saudis continue to talk about the need to be very gradual in terms of political, educational and economic reform, because of the concerns that if they move too fast the people will reject it leading to a toppling of the Saudi regime.

When you talk about globalization, where is China? Does more globalization in China lead to more stability or less stability? Is it easier or harder to engage in more administrative or market based mechanisms to slow the over heating of the Chinese economy? It's unclear how much oil China is going to need in the next five years and how much they are burning and how much they are stockpiling today. How successful they will be at cooling down the over-heating that is presently one of the biggest economic drivers in the world is also unclear. This leads to uncertainty about where oil prices should be and is a very big political risk of its own.