The Oil Tide and the Gathering Gloom

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Stock markets are aflame. Not only have the main indices for oil prices – Brent Crude and West Texas Intermediate – leapt closer and closer to the $100/barrel price, but the long-term indices have also made this journey. Normally, it is the current oil price that zips up and down, pushed by wars in the oil lands and pulled by speculators in their pin-striped suits. But now, even the five-year 'forward price' and the call options have needled upwards. They anticipate that oil prices – now at $80 per barrel – will linger at around $130 per barrel by 2020. There is money to be made. But not by the people who live on the ground above the oil.

War Premium.

Oil analysts use the antiseptic term 'war premium' to talk about how military and economic wars against oil producing countries lifts the price of oil. At present, three major energy producers face the wrath of the West: Iran, Venezuela and Russia. Russia, with Saudi Arabia, is one of the largest oil producers in the world. Iran and Venezuela would be high on the list, but they are not. Venezuela has the world's largest proven oil reserves, while Iran has the fourth largest such reserves. Nonetheless, the wars against Iran and Venezuela have battered their ability to bring the oil to market. This has certainly impacted not only on their domestic economies, but also on oil prices.

1.Iran.

Sanctions against Iran have been harsh. They have – since 2006 – hurt Iran's ability to bring its oil to the market. The nuclear deal with the international community in 2015 began to loosen the rope around Iran's economy. Iran saw investments return to its faltering oil infrastructure and Iran hoped to begin to bolster its public finances by robust oil exports.

US President Trump's new drive against Iran has put this buoyancy on hold. On May 21, US Secretary of State Mike Pompeo said that the United States is now preparing the 'strongest sanctions in history' against Iran. The ultimatum given to Iran will be impossible for the country to meet. The demands include that Iran withdraw from Syria and that it allows 'unqualified access to all nuclear sites throughout the country'. No country gives the International Atomic Energy Agency such authority. It is an impossible standard. These ultimatums are designed to fail.

Both BP and Total have – in anticipation – suspended work on their projects in Iran. BP (based in Britain) was working on the Rhum gas field in the North Sea. This project is a joint venture between BP and the Iranian Oil Company. Total (based in France) has declined to continue to finance the construction in Iran's South Pars 11 project. Investments of this kind will gradually dry up. This will have a long-term impact on Iran's energy infrastructure, much of it in need of investment and modernisation.

2. Venezuela.

Venezuela's oil industry has seen a precipitous collapse in the past few years. Crude oil production fell from 2.3 million barrels per day in January 2016 to 1.5 million barrels per day last month. In 1997, Venezuela produced 3.2 million barrels a day. The number of active oil rigs have fallen from seventy (2016) to forty-three (2017). There is no expectation that this situation will improve. It has pushed Venezuela's economy into the shadows.

The core reason why Venezuela's economy is in such poor shape is the sanctions regime put in place by the United States a decade ago. It is important to note that the initial reasons for the sanctions regime was that the US accused Venezuela with lack of cooperation on counter-narcotics and anti-terrorism programmes pushed by the US. In recent years, the United States and its allies in the Lima Group have made the point that Venezuela must be sanctioned because it is a 'dictatorship'. Public reasons for the sanctions have shifted, but the core reason remains the same: Venezuela is not to be allowed to chart an independent economic and political policy, and certainly not allowed to chart such a policy for Latin America.

Tough US and Canadian sanctions have prevented Venezuelan companies from basic business practices, including selling their debt and raising funds from capital markets. Venezuelan assets – such as a refinery in Curacao – have been seized through the intervention of American courts. This has hurt the ability of Venezuela's state-run oil company from selling its oil and making key investments.

The problem of a lack of investment in the oil sector is not one that has hit Iran and Venezuela alone. It is a broad problem in the industry. The International Energy Agency's 2018 reportpoints to a drop-off in investments by twenty-five per cent in both 2015 and 2016. 'Investment was flat in 2017', says the Agency, 'and early data suggests only a modest rise in 2018. This is potentially storing up trouble for the future'. Oil companies have been taking their profits and failing to reinvest them into declining infrastructure. In countries under sanction – such as Iran and Venezuela – the problem is even more acute.

Contradictions.

Europe is in a bind. It had relied on a slate of countries of its energy, including Russia, Iran and Libya. The sanctions against Russia and Iran have been detrimental to Europe's need for natural gas and NATO's war in 2011 has ruined Libya's ability to meet European demand for oil. Political pressure inside Europe to move out of the nuclear energy sector and to 'go green' has meant increased demand for natural gas. US policy against Russia and Iran has hurt Europe's ability to import natural gas from these countries. This is why Europe is keen to maintain the nuclear deal with Iran.

On Friday, Germany's Angela Merkel and Russia's Vladimir Putin will meet in Sochi (Russia). Merkel has made it clear that Germany will back the Russian-Norwegian Nord Stream 2 pipeline. The United States has tried its best to scuttle this project, but both the Russians and the Germans want it to continue. Many European firms – Royal Dutch Shell, BASF, Engie and so on – have helped finance this Gazprom project. It will bypass Ukraine, a political problem for this US ally which will now lose fees from a pipeline that goes through its territory.

Chinese investments in Iran and Venezuela are on the cards. Beijing sees these new sanctions policies as beneficial to its own attempts to secure energy resources from these oil and gas rich countries. The United States will have a hard time pressuring China to back off from these states.

Meanwhile, tensions are on display in numerous US allies – Argentina, Poland, Turkey and Ukraine. These countries now find that their foreign exchange reserves have slipped into dangerous territory.

High oil prices and political instability – including the war premium – will put these countries into deep trouble. Already, Turkey's central bank has had to hike its key rate to protect the collapse of Turkey's currency, the Lira. An election is on the horizon in Turkey. This is bad timing for President Erdogan. Ukraine's economy is in danger of default.

It is one thing to brashly produce sanctions against countries like Iran and Venezuela. It is another thing to see these sanctions being the cause of chaos around the world – not just in Iran and Venezuela, but also in Turkey and Ukraine. The oil tide will not only drown Iran and Venezuela. It will likely drown a great many other countries.

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P.S.

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