TURMOIL AHEAD

Speculation in oil futures, crisis in the Mena region and limited global supply of oil in the face of rising demand have pushed oil to over $124 a barrel, pointing towards an impending oil shock for the global economy.

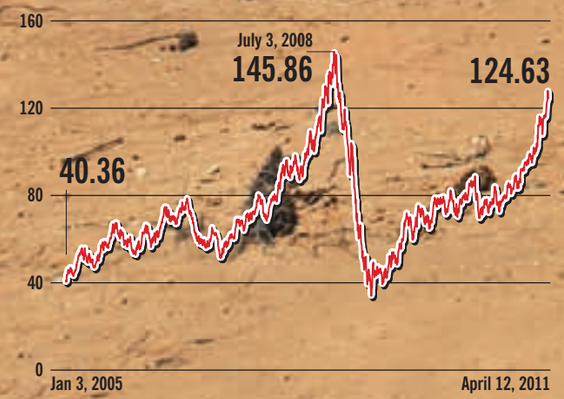
TANEESHA KULSHRESTHA

LAST YEAR, INDIA SPENT over $90 billion on importing crude oil—that's more than the GDP of 121 countries. On average, each 159-litre barrel set back India by $85.09. This year, Brent (the benchmark crude oil) has been soaring: earlier this week it was at a two-and-a-half year high of $127.02 and, at the time of going to print, was hovering around $124. And going by some of the estimates being tossed around, those numbers may well look like chickenfeed by the end of the year. $200 and even $300 for a barrel of crude? Has the world run so short of the black gold that it's giving the yellow metal a run for its money?

In a word, no. A record 90.65 million barrels of crude was pumped out the world over every day in March. The demand during the same period? An average of 88 million barrels a day (bpd). Oil inventories are also

RISING FAST

There's been no let up in crude oil prices.

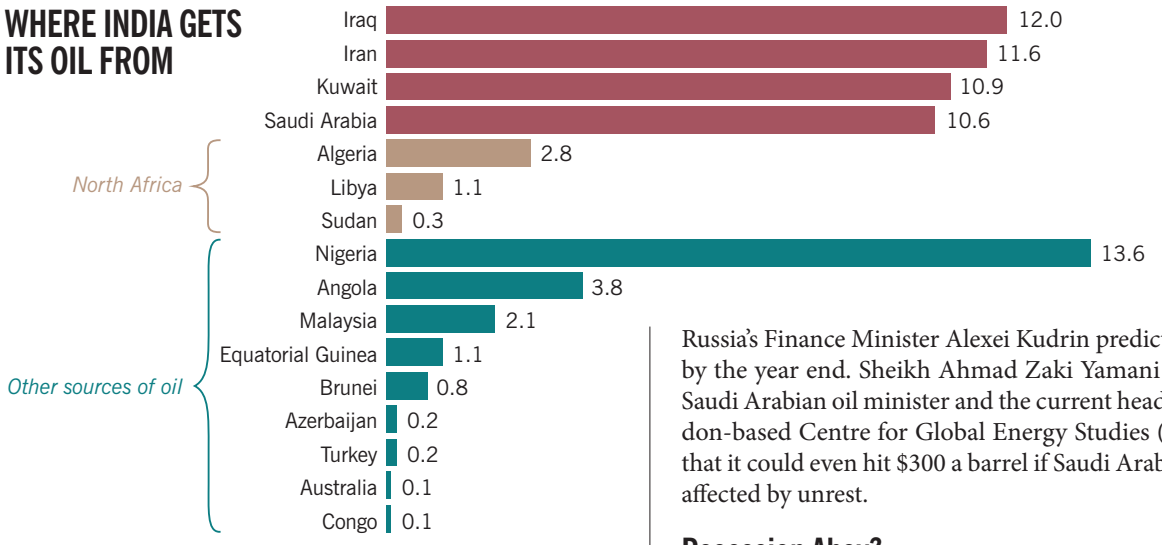


Figures in $/ barrel

Source: Bloomberg

PHOTOGRAPH BY AP

WHERE INDIA GETS ITS OIL FROM



Note: Figures in MMT; 2010-2011 April to February
Source: Ministry of Petroleum

piling up. For instance, in the US, which accounts for close to 25% of all crude oil consumption, there's an oil glut at Cushings, Oklahoma, the terminal where the physical delivery of the West Texas Intermediate (WTI) oil futures traded on Nymex takes place.

According to the Energy Information Administration (EIA), American crude oil stockpiles stood at a record 41.9 million barrels in the last week of March and the glut is expected to last well over two years. But, for now, oil prices are already near three-year highs. The WTI traded at $108.60 and Brent at $124.50 on April 12, 2011. Clearly, there is more to the fixing of crude prices than just fair market forces.

While geopolitical developments in the Middle East and North Africa (Mena) region are indeed a cause for alarm, the Organization of Petroleum Exporting Countries (Opec) members' refusal to hold a meeting for raising output and their voiced inability to control prices, despite holding the keys to the world's largest reserves, makes one question their intentions. "The nature of this lack of response and general drift of recent policy statements suggests that producers are a long way from seeking actively to bridle in the upside for prices, leaving the door to $130 Brent swinging open," says Barclays Capital's Paul Horsnell in a note commenting on the Middle East situation.

A poll of 32 major oil traders by Reuters in the first week of April found that oil prices are expected to go above $130 a barrel by late 2011; one in five traders said they expected oil to hit $150. While three in five also expected a short-term correction by June-end, most believe this decline will be temporary and oil prices will pick up soon after. Where it will go, though, is anybody's guess. New York-based hedge fund manager John Kilduff expects oil prices to cross $175 a barrel in the year's third quarter while Russia's Finance Minister Alexei Kudrin predicted $150-200 by the year end. Sheikh Ahmad Zaki Yamani , the former Saudi Arabian oil minister and the current head for the London-based Centre for Global Energy Studies (CGES), says that it could even hit $300 a barrel if Saudi Arabia were to be affected by unrest.

Recession Ahoy?

The consequences of such high prices will be, to say the least, dire. Every US recession since 1973 has been linked to rising oil prices. And when America sneezes, as the cliché goes, the rest of the world catches a cold. Many major financial firms believe the global economy could tip back into recession if crude prices cross $120 a barrel. "$120 per barrel is the level that oil as a share of global GDP starts to move above 5.5% of GDP, which has historically been an environment where global growth has come under pressure," says Deutsche Bank in a note. Standard Chartered in its report *Oil Price Scenarios and its Implications*, notes, "At $150/bbl, the world upswing would slow sharply; at $200/bbl, we would expect a new recession."

Credit rating agency Fitch also expects world growth to moderate to 3.2% in 2011 and 2012, having reached 3.8% in 2010 (it was 5.2% in 2008 and 3.1% in 2009). The rising fuel prices have already led to inflationary pressures in emerging markets. This has worsened "the policy dilemma faced by many monetary policy authorities," says Maria Malas-Mroueh, Director in Fitch's Sovereign team. As banks tighten rates and suck liquidity out of the system, growth may suffer.

"Crude prices could even go up to $300 a barrel if unrest hits Saudi Arabia.

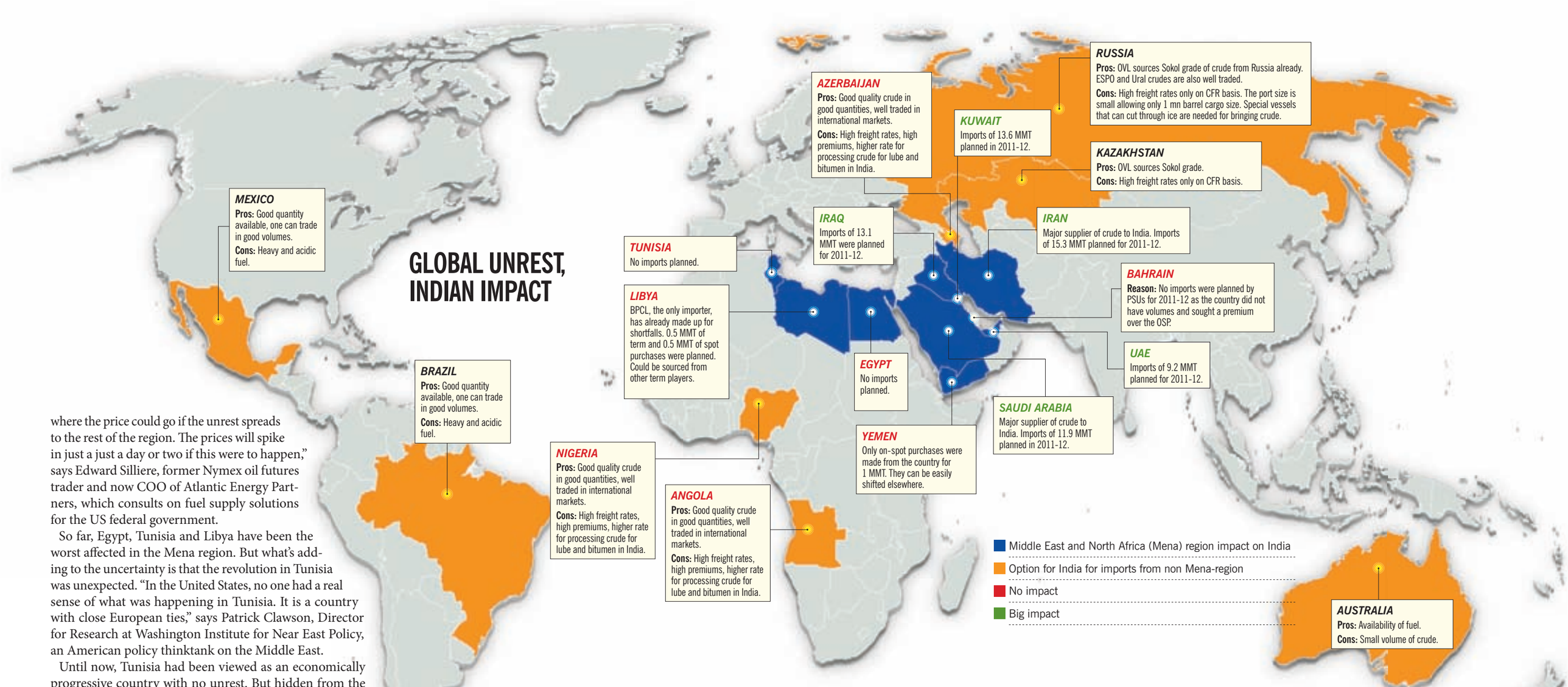
—SHEIKH AHMAD ZAKI YAMANI
Head, Centre for Global Energy Studies, London

The Trouble With Mena

The biggest risk to oil prices currently is the unrest in Middle East and North Africa, the domino effect of the so-called Jasmine Revolution. Between them, the 14 Mena countries control 65% of the world's known petroleum reserves and supply over a third of the global oil demand.

Any disruption of supply from this region could well cripple the world economy with an oil shock. "There is no telling

GLOBAL UNREST, INDIAN IMPACT



where the price could go if the unrest spreads to the rest of the region. The prices will spike in just a just a day or two if this were to happen," says Edward Silliere, former Nymex oil futures trader and now COO of Atlantic Energy Partners, which consults on fuel supply solutions for the US federal government.

So far, Egypt, Tunisia and Libya have been the worst affected in the Mena region. But what's adding to the uncertainty is that the revolution in Tunisia was unexpected. "In the United States, no one had a real sense of what was happening in Tunisia. It is a country with close European ties," says Patrick Clawson, Director for Research at Washington Institute for Near East Policy, an American policy thinktank on the Middle East.

Until now, Tunisia had been viewed as an economically progressive country with no unrest. But hidden from the vacationers on the pristine beaches was the simmering discontent against President Zine El Abidine Ben Ali's iron rule, the 14% unemployment rate and the usual charges of corruption and nepotism. "There was a strong sense in the US government and policy-making circles that things were not going well in Egypt and Yemen. But the timing of the revolt came as a surprise," says Clawson.

Trouble is, the issues affecting Libya and Tunisia can be extrapolated to the rest of Mena as well—already, there's unrest in Syria, Yemen and Bahrain. Unemployment is rife in even wealthy Saudi Arabia. While the national rate is 10.5%, according to energy information provider Platts, it is much higher (30%) among 19- to 25-year-olds.

Saudi King Abdullah has already announced pre-emptive measures worth $100 billion to appease the population. "Increasingly, governments are finding it difficult to rule in the name of religion or tradition," says Rashid Khalidi, Professor of Arab studies at Columbia University in New York. "The rulers have never seen such unrest among the people; they are clearly scared."

When will the region return to stability? Nobody's really sure. A report by Dun and Bradstreet (D&B)'s Country Risk Service doesn't say when, but points out that the Mena region can be divided into three main categories at present.

The first group comprises states that have already gone through instability and are experiencing a long and difficult transition to democracy. "Tunisia and Egypt fall in this category as we have seen risk levels slowly subside in these two countries," says the report. The second group comprises states that are currently experiencing a crisis—Libya, Bahrain, Syria and Yemen—while the last group includes countries that have been affected modestly by the uprising, such as Algeria and Saudi Arabia. "The outlook for the region is extremely uncertain and could still deteriorate. In particular, the outcome of the Libyan and Syrian crises is likely to be decisive, as it could encourage people in countries so far spared from instability either to take to the streets against their governments or else to avoid engaging with the regimes," the report says.

But ousting authoritarian rulers is one thing, installing stable systems of representative government quite another. Success will depend partly on how well elected governments handle the social problems and economic hardships. Washington Institute's Clawson points to Iraq where people have a say in the government, but that has not resulted in good governance. "It has only led to more fighting and discontent," he says. He expects the region to undergo a long process of trial and error before hitting on the right sort of government model. "Monarchies seem to have done better than republics in the region. Perhaps a Singapore-like government that is not truly elected, but is worried about the people, may be a good idea. The more consultative a government is, the better it should do," he says.

For now, business activity is slowly returning to normal in Tunisia and Egypt. Companies have re-opened offices and authorities are stepping in to re-establish confidence in the local economy. But for the rest of the region, uncertainty about the political situation is likely to weaken business confidence for months.

"Risks to investors and exporters remain high. It is unlikely

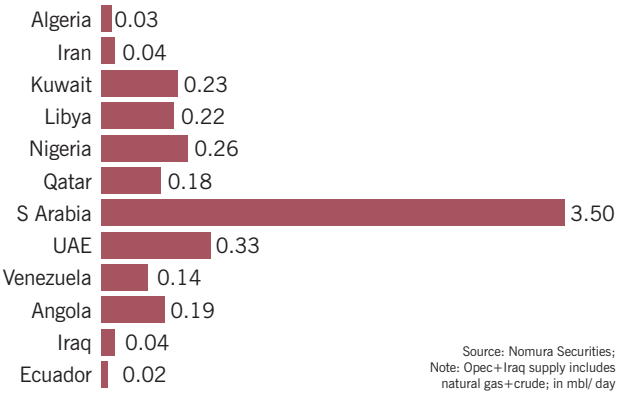
"When Morgan Stanley and others need insider knowledge, they purchase oil. We have to end these conflicts of interest.

—BERNARD SANDERS,
US Senator for Vermont

GRAPHIC BY SUMEET GUPTA

SPARING A THOUGHT

Saudi Arabia holds the key to the current situation since it is the only Opec nation with significant spare capacity.



that business activity will recover completely before 2012, at least," says Vandana Hari, Asia Editorial Director, Platts.

The Fear Premium

The Mena unrest has a direct impact on oil prices. But that's mostly because speculators are playing on the fear premium. Says CGES Senior Analyst Manouchehr Takin, "In terms of supply and demand, the price should probably be at around $100. But both the physical and the paper markets are being driven by fear of disruption spreading." Farouk al-Zanki, CEO of Kuwait Petroleum, agrees, saying the "fair price" for oil is between $90 and $100 per barrel.

While the 1.8 million bpd from Libya is only partially available, the quantum isn't large enough to have a major impact on price. Besides, others are making up the deficit. In recent weeks, Saudi Arabia has raised production by 1 million bpd, while keeping another 2.5 million bpd-worth of spare capacity. Other countries like Kuwait, too, say that they have between 600,000 and 700,000 bpd in spare production capacity (*see: Sparing A Thought*). The world demand for crude oil in 2010 was about 86 million bpd and International Energy Agency (IEA) forecasts only a marginal increase in demand this year.

But there's really little correlation between oil demand and supply and its price. That fact was conclusively proven in an August 2008 report by brokerage First Global. An analysis of demand and supply data between 1965 and 2008 found hardly any correlation between annual changes in demand of oil and the price of oil.

> **"Risks to investors and exporters [in Mena] remain high. It is unlikely that business will recover fully before 2012.**
>
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> **Asia Editorial Director, Platts**

The long-term annual growth in demand for oil has been in a tight cluster through booms and busts. The world pretty much consumed at the same/ similar rate of growth over the five-year period ending 2008 (1.83%) as for the trailing 20-year period (1.56%). That meagre growth could hardly justify the giant leap in oil prices in 2008. In the report, First Global Chairman and Managing Director Devina Mehra concluded that "the oil had been in a pretty long bear market, had not adjusted for inflation, and the rally in oil was nothing but a huge catch-up rally to adjust for years of non-performance. It is a typical market phenomenon across all asset classes. The short point is: currency and commodity movements are largely technical in nature. They have no value. Only price. And price on its own moves only on technical factors. But once the move happens, fundamental nonsense is drummed up to support the price." Today, the real danger of supply disruption is adding fuel to the already charged-up oil market.

And high oil prices have even Opec worried. Consider the statement by UAE Energy Minister Mohammed bin Dha'en Al Hameli, as reported by UAE's official news agency Wam: "There is little we can do in terms of price control, which is set by international markets. International oil markets should pay more attention to real supply rather than imagined shortages."

Speculative interest is only on the rise as the instability in the Mena region shows little signs of abating. In a March 21 research note, Goldman Sachs estimated that for every million barrels of oil held by speculators, there is a rise of 8-10 cents in oil prices. It also said that investors accumulated nearly 100 million barrels of oil between mid-February and late March, over and above their existing positions.

The bank estimated $10 as the 'risk premium' at the time: it could be even higher now. Similarly, on April 5, the US Commodity Futures Trading Commission (CFTC) said traders held total net-long positions equivalent to a record $267.5 million in US crude contracts. Going by Goldman Sach's estimate, the total speculative premium for US crude comes to between $21.40 and $26.75 a barrel. This is almost a fifth of the current price.

At the time of going to print, Goldman Sachs had advised investors to lock in trading profits for the "CCCP basket" trade it recommended in December, which has returned clients 25% in four months. The basket has a 40% weight for oil. The bank saw oil slipping in the near term with nascent signs of oil demand destruction in the US, "but also record speculative length in the oil market, elections in Nigeria and a potential ceasefire in Libya that has begun to offset some of the upside risk owing to contagion", according to a commodity team research note. As per Reuters, there was a 3% slide in crude oil prices because of Goldman's call.

Past Revisited?

If speculative interest is building up in oil, it's certainly not

Many major financial firms believe the global economy could tip back into recession if crude prices cross $120 a barrel. Rising fuel prices have already added to inflationary pressures.

a new occurrence. On June 23, 2008, the US Oversight and Investigations Subcommittee held the second of two hearings on the effect speculators have on energy prices. Oil had, by that time, crossed a peak of $135 and was on its way to the historical high of $147 (July 11, 2008). In his testimony, Fadel Gheit, Managing Director and Senior Oil Analyst at Oppenheimer, said: "I firmly believe that the record oil price in excess of $135 a barrel is inflated. I believe, based on supply and demand fundamentals, crude oil prices should not be above $60 per barrel."

Critics cite the volatility in oil prices to prove the point. Oil reached a peak price of $147.36 per barrel in July 2008, almost double its price a year earlier. Over the following two weeks, prices dropped by $20 and by October 16, 2008, were at under half the peak price (under $70). By December 24, just five months down, oil was trading at $33.87 a barrel, one-fourth the July 2008 price.

In August 2009, Michael W Masters, Portfolio Manager, Masters Capital Management, in his testimony to the CFTC on introducing limits for future positions in oil squarely blamed the index traders for this volatility. He told the CFTC that the money invested in the commodities derivatives market rose from around $10 billion in 2002 to $250 billion by March 2008, an unbelievable 2,400% rise. This was besides the unregulated, over-the-counter market.

Congressman Bart Stupak, too, agreed with Masters in his testimony. He argued that in 2009, oil supplies were at a 20-year high while oil demand in the US was at a 20-year low. And yet, oil was trading at a rate of more than $70 a barrel in August 2009, up from $35 in January. This represented a price rise of over 100% in six months in the middle of the worst global growth and demand declines.

The problem of speculation is compounded by the presence of a few players that are present on both sides of the oil market supply and demand spectrum, causing a major conflict of interests. For instance, the research arm of Goldman Sachs also predicts oil prices and at the same time it also buys and sells oil for clients. So when it says that the price of oil will go up, so does its profit in the oil futures market.

Says Bernard Sanders, Senator for Vermont, in his testimony to the CFTC, "When Exxon-Mobil wants to sell or buy oil in the futures market, they go to Goldman Sachs or other large financial institutions. When sovereign wealth funds, pension funds, or smaller dealers want to invest in energy derivatives, Goldman Sachs and other investment banks facilitate those trades. When Morgan Stanley and other investment banks need insider knowledge of the heating oil market that benefit their traders, they physically purchase large quantities of heating oil for storage and delivery. We have to end these conflicts of interest."

Present Situation

For now, money seems to be flowing into oil again, and in even larger sums than before. According to Barclays Capital, funds invested a record $360 billion in commodities in 2010, a $90 billion increase over the previous year. The total funds invested in commodities could top $420 billion in 2011, it estimates. And Merrill Lynch Bank of America Analyst Sabine Schels predicts that the drivers of this funds flow will be energy and base metals.

As the money flows in, rumours of speculation have started making the rounds. While the current rally in oil prices is said to have started with the unrest in Tunisia, there is evidence that oil prices have not really been following demand.

For instance, in July 2010, JP Morgan revised its price forecast for the rest of the year for WTI crude on Nymex to $77.25 a barrel. Its month-earlier position stood at $81.75 a barrel. In a report, JP Morgan's Lawrence Eagles said, "Weaker economic growth, energy efficiency and Opec intransigence provide downside risks." He added that there was a risk of prices falling even further if Opec was not able to cut back on production and suggested prices could fall to as low as $50 a barrel.

In the meanwhile, oil supplies, too, increased to record highs. In August, the EIA announced that supplies in the US had risen to 1.13 billion barrels, the highest level since the introduction of weekly reports in 1990. A month later, oil demand continued to be low, the result of the American, Chinese and Japanese economies maintaining their slow pace of growth in the post-recession period. In October 2010, American government gasoline inventories, too, rose by 4.4 million barrels against estimates of an increase of 900,000 barrels. Despite all this, by December 2010, the price of oil had risen to $90. And in January 2011, the falling demand notwithstanding, it crossed $100 a barrel.

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—PATRICK CLAWSON, Research Director, Washington Instt for Near East Policy

Speculators are becoming even more bullish on fuel prices rising. As per the CFTC, money managers, the key specula-

tor group, increased their net long crude oil futures position on the Nymex by 13,231 to 305,297 in the week to April 5, 2011. Last year, for the week through March 9, 2010, the number stood at 159,400. The rest of the market, too, seems to be party to this frenzied trading. On January 28, WTI futures reached a record of 1,472,088 contracts (the earlier record of 1,423,536 contracts was set on April 13, 2010). The WTI daily options volume also reached a record of 290,365 contracts, overtaking the previous record of 282,860 contracts (September 16, 2008). The open interest in WTI Crude Oil futures, the global crude oil benchmark, too, rose 16.9% over March 2010 to touch 1,516,018 contracts on March 28, 2011. The average weekly volume over the past four weeks stood at a whopping 3.6 million contracts.

“ Reducing dependence on the Middle East may help India in controlling the price of fuel.

—AMOL KOTWAL,
Deputy Director, Energy and Power Systems Practice, South Asia and Middle East, Frost and Sullivan

India And The Middle East

As for the rest of the world, instability in Mena is not good news for India either. According to the Petroleum Ministry figures, 67% of India's total crude imports of 79.6 MMT came from the Mena region till February 2010-11. Of this, 53.4 MMT of crude came from West Asia and 4.2 MMT from North Africa. If major supply disruption were to occur, India could be left high and dry. It has only about 10 days' worth of reserves in refineries across India. Crude in transit could provide another eight to 10 days of cover.

Over two-thirds of India's total crude imports of 79.6 MMT came from the Mena region till February 2010-11. If major supply disruption were to occur, India could be left high and dry.

In the event of a price rise, the effect on an already-high inflation will be crippling. “Consistently high inflation related to food and crude oil prices and poor industrial growth threatens to derail the government's plan of achieving about 9% growth in the next fiscal,” says the Deloitte's *Asia Pacific Economic Outlook* report on India. For the week ended March 26, fuel inflation had risen to 13.13%, compared to 12.79% for the week ended March 12. Fuel has a weight of 14.2% on the Wholesale Price Index (WPI), the key measure for inflation in India. The government had decontrolled the prices for petrol in June last year while diesel, the main fuel used by transporters and the industry, still continues to be regulated.

Public sector oil marketing companies lose ₹16.76 per litre on diesel sales at the moment. They also lose ₹28.33 per litre on kerosene and ₹315.86 for every 14.2-kg LPG cylinder sale. At the 2009-10 price levels, they lost around ₹78,000 crore in revenue. If high fuel prices continue, they stand to lose an even higher amount this fiscal, translating into a higher subsidy burden. This may very well make it impossible for India to reach its 4.6% fiscal deficit target. Morgan Stanley suggests that a crude price of $85 a barrel can shave off 0.9% from gross domestic product and at $100, the effect can be as high as 1.3%. A high fiscal deficit threatens to not only put India under even more inflationary pressure, as the government borrows more from the market, but will also leave it less money to spend on developing core and social sectors.

This means India has to hedge the oil price risk. “Reducing dependence on the Middle Eastern region may help India in controlling price of fuel in India,” says Amol Kotwal, Deputy Director, Energy and Power Systems Practice, South Asia and Middle East, Frost and Sullivan.

Little progress has been made on that front, though. The best figures are of Bharat Petroleum, which brought down its dependency on Middle Eastern crude from 73% in 2007-08 to 56% in 2010-11. Others haven't been as effective. Mangalore Refinery & Petrochemicals' dependence is down only marginally, from 94% to 92%, while the numbers for India's biggest oil retailer, Indian Oil, are 61% in 2010-11, down from 66% in 2007-08. In the same period, other oil retailers like Hindustan Petroleum saw their dependency on the Middle East for crude actually rise, from 84% to 87%. A background paper by the Ministry of Petroleum suggests that India has only limited options in case of a prolonged crude supply disruption. These include stepping up of heavy crude imports, something the country has not tried earlier. India has only limited pipeline facilities for transporting this grade of crude; as such, only coastal refineries would be able to process it.

Another option could be to relocate locally manufactured crude to inland refineries. For import security, the paper suggests setting up of long-term contracts with major international oil companies; persuading public sector undertakings to set up crude storage facilities in India; hiring Very Large Crude Carriers for storage; hiring tank capacities in South Korea and South Africa; and supply of crude sources.

For now, India, like the rest of the world, waits with baited breath for the situation in the Middle East to resolve itself.

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