The New World of Oil

EGEE 497

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Part One Outline

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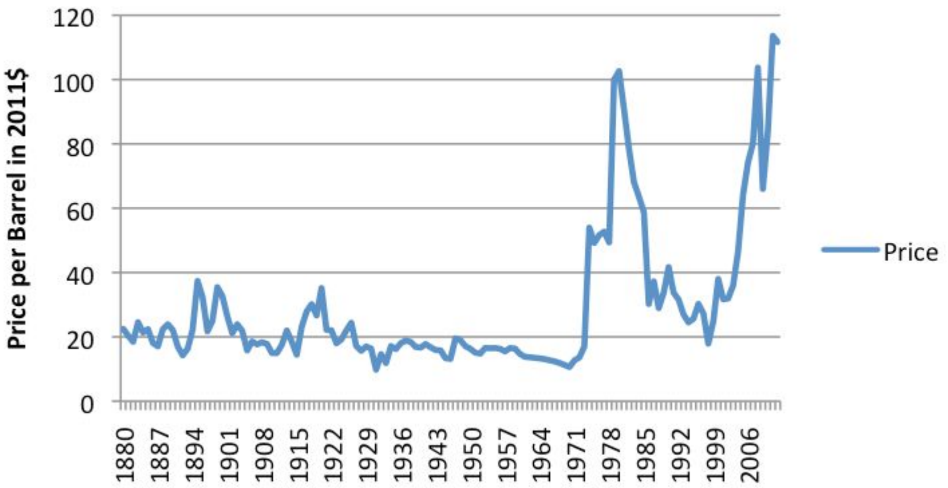
1. Russia Returns - Overview

The Soviet Union’s economy was centralized and reliant on oil and gas. After it’s collapse, the big question was how will it run and who will be in control of the oil and gas markets?

1. Russia Returns - Oil Reliance

In 1973 oil prices quadrupled due to the Arab oil embargo, giving the USSR a lot of money and delaying badly needed economic reform. Then, in 1986, a massive surplus in oil lead to a collapse in oil prices, putting the USSR's economy in danger.

They ended up begging the British Prime Minister, John Major to help.



1. Russia Returns - Change of Power

At the decline of the USSR there was a transition from a centralized socialist economy to a period with no established leaders. While the government was in reform, there were two immediate needs:

1. A short-term solution to stabilize the economy and provide basic necessities (mainly food) to the Russian people
2. Restructure government owned oil to be privately owned businesses

1. Russia Returns - Restructuring Oil Industry

Continuing into the 1990s, oil still accounted for nearly two thirds of the currency in Russia. To create a better market design, the oil economy was shifting from horizontally integrated and into a vertically integrated system to form a true market.

1. Russia Returns - Lukoil, Surgut, and Yukos

Lukoil: The leader of Lukoil, Vagit Alekperov, bought out small oil and gas businesses and convinced them to join his company. Alekperov put international standards into place and worked with international law firms, accountants, and banks to make Lukoil possible.

Surgut: Vladimir Bogdanov, the leader, lead a ‘decidedly Russian’ company. He was not interested in expanding internationally.

Yukos: Mikhail Khodorkovsky, the leader, was not in the oil industry as the others, but was considered a business man. He took part in the ‘loans for shares’ program, donating $309M to win control of Yuko’s shares.

1. Russia Returns - Opening Up

The USSR kept the oil industry largely closed off to western companies until the 80s when they wanted to integrate newer technologies. After the collapse of the USSR, many saw Russia as a competitor or a great opportunity. However, others saw logistical errors and risk in the changing government. They believed that Russia did not need help from outsiders.

John Browne and BP were the only western company to integrate into Russia and West Siberia through a partnership with Sidanco and TNK.

1. Russia Returns - A Great Economic Power

Vladimir Putin quickly escalated to power. Being a mining student and having published a paper on the importance of oil and gas, Putin believed oil and gas were the key to economic recovery and “entry of Russia into the world economy”.

Khodorkovsky, the leader of Yukos, and Putin did not see eye to eye. Khodorkovsky believed in a parliamentary government and sought to dismantle the presidency. He also bypassed Putin on important political decisions such as building and negotiating a pipeline with China. Putin had him arrested and Yukos dismantled due to political reasons.

1. Russia Returns

Russia returned as the largest producer of oil and the second largest exporter. The oil industry adapted and modernized and is a great source of wealth for the country, however the economy must still develop to be less reliant on the sale of oil and gas to prevent future downfalls.

2. The Caspian Derby

Caspian oil helped define how the world would operate after the Cold War. As the Soviet Union fell apart, many oil workers moved south towards the Caspian and Central Asia. This resulted in the discover of Caspian oil, the 3rd largest producing oil field.

2. The Caspian Derby - The New “Great Game”

The many competitors in this new region became known as the “great game”.

Competitors: Russia, Britain, US, Turkey, Iran, China and the newly independent countries in the region. Additionally, the oil and gas companies fought to maintain their supply and add new reserves.

2. The Caspian Derby - The Players

Russia and the newly independent countries were closely tied together even after the collapse of the Soviet Union. Russia wanted to absorb the smaller countries and restore itself as a great power. Some though that the US orchestrated the collapse to easily gain access to Caspian Oil via the new countries.

China had a growing interest in the oil industry because of its rapidly developing nation.

2. The Caspian Derby - “The Oil Kingdom”

The ‘oil kingdom’ refers to the Bakur region. This region dates back to the early years of oil and was initially neglected by the Soviets and lacked modern technology. The western countries wanted a share of the natural resources in this region.

2. The Caspian Derby - The Deal of the Century

Azerbaijan was seen as the entry point to the Caspian because of its geographic location. Heydar Aliyev was the pinnacle power in Azerbaijan, starting as a KGB general, and moving to the secretary of the Azeri Communist Party. After an internal exile, at the age of 70 he became president and brought stability back to the country through the deal of the century. THe deal allowed ten oil companies representing six foreign countries to drill for oil as part of the new Azerbaijan International Oil Company.

2. The Caspian Derby - Early Oil

The question was: where should the oil go?

The oil could be shipped in rail cars as in the 19th century, but this was not the most efficient option. The clear choice was a pipeline, but where should it go? There was an existing pipeline through Russia, but this would give Russia economic leverage over Azerbaijan. The alternative was through Georgia, an expensive option.

2. The Caspian Derby - Offen No One

In an effort to make a quick decision, it was suggested: why not do both pipelines? Starting with the existing Russian pipelines.

After early oil had a route, the question remained where the main pipeline should go. The cheapest option was to route the pipeline south to the oil refineries in Iran, to Tehran and the Persian gulf. Another option was to go west to Bakky, Tbilisi and Ceyhan, which was the most logical, most expensive, and most difficult route.

2. The Caspian Derby - The Final Pipeline

Everyone wanted the pipeline to benefit their needs. Russia was pushing for the pipeline to head north and through their central pipeline system to gain control and leverage over the Caspian. At the “Tale of Three Seas” conference, the CEO of BP, John Browne, stressed the importance of a new pipeline and finally gained support of the AIOC. After addressing potential concerns, the project was finally constructed.

Today the nation’s offshore oil field is the third largest in the world and still uses the BTC pipeline route.

3. Across the Caspian

In the summer of 1985, a massive oil and gas blow out occured in the newly opened oil field of Tengiz in the Soviet Republic of Kazakhstan. American and Canadian experts were recruited to help put out the fire which lasted for nearly 400 days.

Despite the fire, Tengiz continued and Kazakhstan brought in foreign investors due to lack of technology. Chevron, an American oil company, came and invested in infrastructure and pipelines to work the land.

3. Across the Caspian - Pipeline Battle

A contract developed between Nazarbayev of Kazakhstan and Chevron on a 50/50 split of ownership of a new pipeline where 80% of the economics go to Kazakhstan.

The pipeline was proposed to go through Russia, however Russia resented the growth of US interest within the newly independent states and even regarded Tengiz as ‘their oil’. After six years of negotiation including US VP Al Gore, Lukoil CEO Vagit Alekperov, the deal was eventually completed and oil finally passed through in 2001.

3. Across the Caspian - Kashagan

Kashagan was the largest oil field discovered since 1968. Even though there was potential here, manu challenges existed relating most to new technology.

China entered this space under the radar and built a pipeline in 1997.

3. Across the Caspian

More oil discovery in Turkmenistan proposed two pipelines from the area TAP which was for gas and COAP which was for oil in a partnership between Uncoal and Turkmenistan.

The ‘Turkmenbashi’, Saparmurat Niyazav, wanted to reach out and sell oil and gas to multiple consumers. He reached a deal eventually with Uncoal for help in exporting their resources.

3. Across the Caspian - Uncoal Pipeline

The proposed pipeline had to go through Afghanistan, Pakistan and through India to get to the ocean so the oil could be exported. There was much political turmoil in this area as the Taliban were taking control of these regions through violence under Islamic rule. Due to the chaos, Uncoal could not work in these regions.

Finally in 1996, the Taliban captured Kabul and Uncoal met opposition of working with such an oppressive group. Additionally, in 1998 an Al Qaeda attack on US embassies in Kenya and Tanzania and the pipelines TAP and COAP were finished before they were even started.

4. “Supermajors”

In July of 1997 Thailand was slammed with financial crisis threating the whole region and having an impact gobal finance and the word economy.

Jakarta: “OPEC’s Economic Stars”

OPEC’s petroleum ministers met and agreed to raise their production of quote by two million barrels per day which ended the fight over quotas and overproduction

“Essentially all Gone”: The Asian Financial Crisis

Asia had a flood of lending from the international banks and as a result the asian companies and property developers had taken on too much debt.

The Jakarta Syndrome

Since the Asian financial crisis had generated economic ruin and the Jakarta agreement was still in effect, the OPEC had been increasing the output when demand was low.

Price went from $10 a barrel to $6 a barrel

The Shock

From the price drop, the biggest reshaping of the structure of the petroleum industry happened

Negative effect was many employees being laid off

"Were He Alive Today"

John D. Rockefeller had a concept for transforming volatile new american oil industry into one highly ordered company

Result of this was one big company- Standard Oil Trust

The Merger That wasn't

Chief executive Of BP, John Browne, offered a merger since he believed BP was not big enough.

There was talks about about merging with Mobile but in the end both parties could not come to an agreement

"Easy Glum, Easy Glow": Exxon and Mobile

After BP and Amoco merged into the largest industrial merger, the CEO of Exxon, Lee Raymond, contacted the CEO of Mobile

The two merged to form what was called the "New Oil Behemoth"

The French Reconnection: Total and Elf

By June 1999, Total had worked out a plan to take over its main target, Elf

The two side privately exchanged plans and when the deal was done in 1999 TotalFina took over Elf. TotalFina would then be known as Total, one of the world’s supermajors.

Last One Standing: Conoco and Phillips

In November 2001, Conoco and Phillips announced that the two would meger forming ConocoPhillips

The reason for the merge was to compete against the biggest oil companies

5. The Petro-State

“ Petro-state” is a nation that export oil and natural gas regardless of political systems, social organization, economy, culture, religion and population

The “Reversed Midas Touch”

In the 1980s and 1990s, oil could generate more than 70 percent of Venezuela’s central government revenues

The competition for revenue and issues over distribution become the center of drama for the nation's economy

“We Couldn’t Lose Time”

The president of Venezuela, Andres Perez, embraced the petro-state since there was a big boom during his presidenancy.

In 1976 Perez, organized the government takeover of the oil industry

“It is a Trap”

When Perez left the office in 1979, money was still being generated but by the 1980s the oil price plummeted and so did the nation’s revenues. This caused inflation and unemployment and resulted in a population below the poverty line. Perez eventually got re-elected as president in the 1980s

The Coup

On February 4, 1992, a coup was in the process leaving many dead in the presidential palace.

The coup was lead by Hugo Chavez and it was unsuccessful landing him in prison

Hugo Chavez

In 1992, Perez was impeached for corruption. He had provided $17 million to the new president of Nicaragua

Chavez would later be released after the impeachment and his main goal was to gain control of Venezula while becoming good allies with Fidel Castro in Cuba

La Apertura

The “opening” was an inviting for international oil companies to return to Venezuela so they could produce more expensive and technologically challenging reserves

The Oil War

Venezuela would produce at its maximum rate, ignoring OPEC output quotas

Between 1992 and 1998, Venezuela increased its oil production by 40 percent

This made OPEC countries very upset which initiated the “oil war”

Chavez in power

In December 1998, 4 years after getting out of prison, the people of Venezuela elected Chavez to be their president.

During his reign, Venezuela became very close allies with Cuba by providing oil to them

The Recovery of Oil

Venezuela would no longer pursue a strategy of increasing revenues by increasing outputs due to a policy change by Chavez

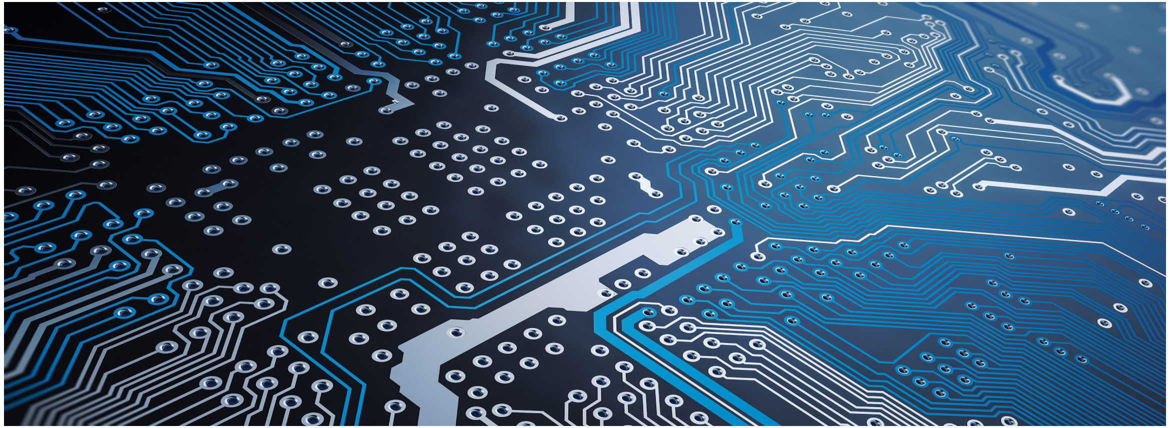
Prices started to recover as demand started to increase

The oil crisis of the producers was ending

6. Aggregate Disruption

Technological advancements were changing the world, making it easier to communicate with people

This made an open world, freely communicating, freely trading, and freely traveling



The Day That Changed Everything

On September 11, 2001, the U.S. was attacked by Al Qaeda. This was the first direct attack on the United States since Pearl Harbor in 1941

This transformed international relations making security the central priority

September 11 altered thinking about oil but it did not interrupt the supply

“Alo Presidente” - Venezuela

Hugo Chavez was re-elected president of Venezuela in 2000, and used the oil companies to gain his power

Chavez used his television show “Alo Presidente” to fire seven members of the board of PSVSA leading to an uproar.

“Call Fidel”

On April 12, 2002, Chavez was asked to resign and was taken into custody

Less than 3 days after his arrest, Chavez was once again in control of the country

The General Strike

In 2002 the union and business community joined together to call a strike in order to try and force Chavez out of his presidency

The country oil output dropped from 3.1 million barrels a day to around 200,000 barrels a day

Nigeria: Ethnic Conflict

Oil and Natural gas accounted for 40 percent of the GDP

Nigeria is a country of 250 ethnic groups, split between an Islamic north and a Christian south, with further division between the west and east.

The vast ethnic groups causes the country’s oil industry to struggle

Violence in the Delta

The Delta is where most of Nigeria’s oil is produced and where regional and local politician have the most wealth

This area was also known for its violent outbreaks

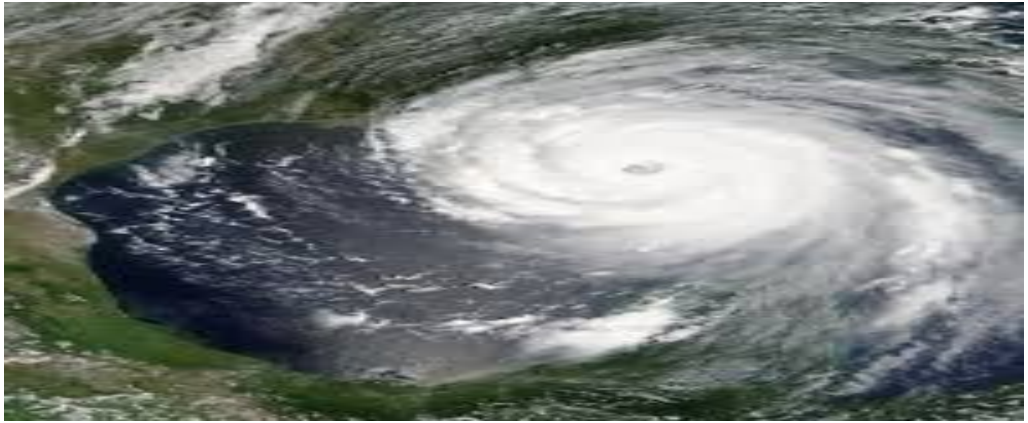
“Bunkering” was turning into a profitable business but also a dangerous one leading to an increase in violence

Natural Disaster

On August 25, 2005, Hurricane Katrina hit leaving heavy devastation as it passed through the Gulf of Mexico

30 percent of U.S. domestic oil and 20 percent of natural gas production came from the Gulf of Mexico

This caused oil prices to surge upwards since almost 1.5 million barrels per day were being lost



7. War in Iraq

- The country of Iraq’s whole identity in the modern world revolves around their large reserves and production of oil

- Contrary to popular beliefs the war in iraq was not due to the oil
It was due tension being high after the attack on US soil on 9/11 and country’s links to terrorist organization Al Qaeda

- It was also believed that the country also possessed weapon of mass destruction

Oil

- A policy introduced by Truman prevents Persian Gulf oil from falling into the wrong hands

- US wanted to have its influence on decision Iraq makes for oils on government level regarding production and distribution

- The war regarding this issue started on MArch 20, 2003 and ended on the April 9th with the US capturing Baghdad.

The Aftermath

- With the conclusion of the war, the country was in chaotic state with no trustworthy leader

- The country’s main source of income, which were the oil fields, were in terrible condition and further worsening the country’s economic and state

- The army was dissolved after the war as while as the De-Baath Iraq society, which was the party of Saddam Hussein
- Coalition Provisional AUthority was introduced to fully dissolve/ dismantle the army

Insurgency and Civil War

- After the war country faced a serious problem of looting and riots
- Turmoil between the Shia and the Sunnis led to a civil war, which eventually turned into a war against the US occupation
- The Baath party was put on a high priority under the assumptions that they were responsible for sabotaging the oil industry
- The oil industry was hit hard and never fully recovered, it somewhat recovered towards 2009, but only operating at $\frac{2}{3}$ of its orginal capacity

8. The Demand Shock

- Light, sweet crude oil also known as WTI began to accumulate in Cushing, Oklahoma

- After the boom of WTI, their pipelines were utilized for transportation of petroleum, but WTI still remained the benchmark fo other oil prices

- There was a surge for the oil price, which began in 2004 as a result of supply and demand further magnified by the expectations and financial market
- The demand for oil almost quadrople globally, increasing by 4.9 million barrels, between 2003-2006

The Tightest Market

- Due to high demand surge, some countries were taking supplies off the market, resulting in a “historically tight market”

- Companies’ reserves went down significantly, the reserves went down for around 4 million barrels per day to less than 1 million

- Due to such discrepancy on the oil industry, the enrollment for petroleum engineering decreased significantly in the 1900s and people were leaving the oil industry due to fear for the worst
- Even after the turnaround in 2004, there was still shortage of petroleum professionals

Financialization

- The price of crude oil was inversely related to the value of the dollar

- Oil was a great financial asset as well as a physical commodity

- Due to global rise in the trading of oil, the US decided that the federal gov. Needs to have control control over the price of the oil, which led to Britain followed the similar policy

Investment Opportunity of a Gen.

- Countries such as Russia, IDia, Brazil, and China had exponentially growing population , which meant they would grow faster than the main industrial economies
- This became a widely used framework for evaluating the world’s economy

- “New Era Thinking” the new mindset justifies the rapid rise and fall in the asset pricing

- This is a consistent feature for “bubbles”.

Does Price Actually Matter?

- Some people felt that the price didn’t matter
- They assumed prices would continue to go up with impact on consumers and producers
- While other felt price mattered - the price would impact on supply, investments, and dampen demand

- The oil industry was in bubble as gasoline price rose above $3 gallon in 2008
- Airline industry was hit the hardest with these price changes, they felt that oil industry was just looking for an oppurtunity to rise the prices

More Buyers

- GEorge W. Bush, tried to negotiate with Saudi Arabia to increase the oil output to combat the rising costs, which SA suggested to find more buyers

- Cars sales were impacted directly due to new high price, which caused car sales to plummet

- Americans wanted congress to find a solution to lower the prices of the oil, while the oil company executives were proud that their earning were being invested in the future supplies

Break Point/Adapting car industry

- At this point realization hit that prices actually mattered both economically and politically
- With this realization, companies started to be more energy efficient, and demand started to slow down

- Since US has the largest car fleet in the world, and most of them run on oil
- The price growth meant the the cars/other vehicles had to be built for efficiency

The Great Recession

- Occurred due to US being too much in debt, leverage, too many derivatives, and surge in oil price

- Due to drastic rise in oil prices, the car companies were put into extremely difficult scenarios, due to their lack of planning for the surge

- The high prices caused lot of money being transferred from producing nation to consuming nation, PEC oil revenue grew from $243 billion in 2004 to $693 billion in 2007

The Peak/ The Financial System

- The price reached it’s peak in 11 july 2008, went from being $25 to $147.27 per barrel in just a year
- Then price suddenly dropped on 16th july, putting an end to the rapid price rise

- After Lehman brothers, the world's financial system stopped flowing

- People were trying to fix the failing bank system, while the oil price returned to what it was year prior to the rapid rise.

9. China's Rise

- China emerged from being a relatively small player in the global oil economy to a heavy hitter towards to turn of the century

- There were lot of risk the country had to face such as uncertain political stability and unstable economic growth

- By the 2010s, China had overcome various obstacle to establish itself as the second largest economy in the world

China Oil Import/Imports

- China's surge in economy could be traced due to two factors exporting and importing oil

- To combat economic depression, China opened its door and started to export oil to outside world in 1978

- While exporting lasted about 15 years, and when the realization hit that rising demand will not be able to met, China turned from exporters to importers

Explore and Invest Strategy

- Such strategy involved for the country to invest/control foreign oil and natural gas sources
- China made partnerships throughout the world including Russia as well
- China also faced some competition from chevron in 2005 about acquiring UNOCOL, which was in Thailand and Indonesia
- While that rivalry did not last for long as both parties formed partnership five years later

Growth and Anxiety

- China’s economy was growing at the rate of 10% each year after the emergence
- Such growth resulted in concerns regarding not being able to keep up with energy demand of the ever growing economy
- Oil shortage fears was growing which led to 2004 demand shock due to consumption rate grew by as much as it would in 2 and half years
- Then the entire world noticed the impact of China’s economy in the oil market

INOC

- Chinese oil companies rebranded into International National Oil Company
- These company were majority owned by the gov. But not run the by the gov. And chances are these companies will be much bigger even in the global market
- China has balance between the explore/invest strategy and producing oil domestically, while remaining as one of an important/largest consumer

10. China in the Fast Lane

- China’s increasing dependency on the global oil market had becoming an issue of security
- Tension grew between the US and China due to China’s exploration towards new energy security strategies
- Meanwhile China feared that the US would cut off china from the overseas oil markets

Coexistence

- The global energy security proposed a way to keep the both US and China happy with new energy security for the countries

- Responsible Stakeholders was the term used for the shared international responsibility to shape and benefit the international trade system

- China started to purchases large number of automobile from the US, which meant business was booming for the american dealers

Success has a Price

- This unparalleled growth in a country economy and opportunity meant a price had to be paid
- The price came in the form of environmental deterioration, water supplies were contaminated, overpopulation was also a concern.
- Another major concern was the quality of the air due to pollutions and a major health concern,

Power Generation

- Towards the 2010s china faced a challenge in the form of generating and providing enough electricity for the growing economy while working with environmental restriction

- Suffice to say they solved such a problem and overlapped the US on electricity generation by utilizing coal, which contributed to 65% of electricity generated by the country

- China is also addressing its' environmental concern by implementing hydropower as well as solar farms etc.

Similar Interests?

- The relationship between China and the US will not deteriorate due to competition but rather by geopolitical, foreign policy, and human rights issues

- The relationship between the two country can still get better given how they are two of the largest consumers of energy
  They can work together on the environmental concerns on a global scale as well as work together to meet their energy demands