Energy Intelligence

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EnergyCompass

Energy and Politics: The New Dynamics

Vol. XVIII, No. 26, June 29, 2007

Contents

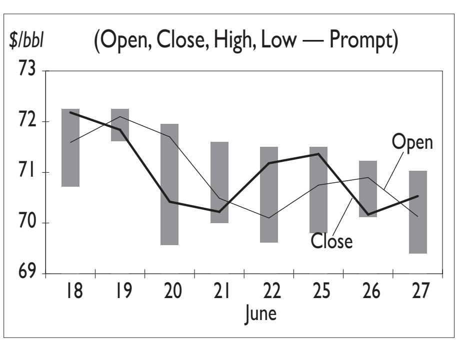
Pressure Points

Latest inventory reports from the US Department of Energy for the week ending Jun. 22 showed a 1.6 million bbl build in crude oil stocks to 350.9 million bbl. Gasoline stocks fell by 700,000 bbl to 202.6 million bbl, while distillate inventories — diesel and heating oil — were down 2.3 million bbl at 120.4 million bbl.

Refinery margins rose in the US, Europe and Asia. On Jun. 28, an incremental barrel of WTI made a $15.82 profit in a US Gulf cracker, up 18¢ from Jun. 21. In Rotterdam, an incremental barrel of Brent made a $1.41 profit in a simple topper, up 74¢, and a $5.38 profit in a neighboring cracker, up 12¢. Dubai made a $9.28/bbl profit in a Singapore cracker, up 75¢.

Opec's basket crude oil reference price was $67.43/bbl on Jun. 27, down 35¢ from Jun. 20.

Brent Futures



HEADLINE NEWS

Producers Take Control

- Resource nationalism was on the ascendant, striking first in Russia then in Venezuela. Caracas agreed stricter terms with four Western companies for ventures in the Orinoco Belt, but in a radical move, expropriated the holdings of two US majors — Exxon Mobil and ConocoPhilips — as talks remained deadlocked at the closing date (see p3).

- BP struck a deal with Russia's Gazprom, selling TNK-BP's 62.9% stake in the giant Kovykta gas field for between $600 million and $900 million — against the $500 million already invested (see p2). TNK-BP has an option to buy back in with 25%, but only if it first provides overseas openings for Gazprom. All in, a pretty poor deal — but BP faced losing Kovykta with no compensation, and needs to protect its core TNK-BP venture from a covetous Gazprom (EC Jun.1,p3).

- Italy's Eni agreed to build a new gas pipeline from Russia to Europe in partnership with Gazprom — a deal that helps meet future demand, but flies in the face of European concerns about overdependence on Russian energy supplies. Eni and Gazprom are fleshing out a strategic alliance, which earlier saw Eni buy a minority stake in oil affiliate Gazprom Neft, and Gazprom begin direct gas sales to Italian customers.

- Outgoing UK Prime Minister Tony Blair's appointment as international Mideast peace envoy was welcomed by Israel and the Palestinian Authority, but panned by the Islamist Hamas militants now controlling Gaza. A Hamas spokesman said Blair had not been honest or helpful as prime minister and "had constantly adopted the American and Israeli position." Washington hailed the appointment but played down expectations. "He is not superman, he doesn't have a cape," said White House spokesman Tony Snow.

- Turkey's top general, Yasar Buyukanit, reiterated his desire to carry out a cross-border operation targeting Kurdish rebels in northern Iraq and said some planning was under way. But, as in April, he stressed the need for a legal approval before going ahead. Tensions at the border spiked early this month amid a Turkish troop build-up and hot-pursuit operations. Parliament is in recess until elections on Jul. 22, but any early invasion could force a state of emergency, delaying a poll.

- A report by UK think tank Oxford Research fired a barrage of criticism against the growing international momentum for more nuclear-generated electricity to help fight climate change. The report said the world must start building four new nuclear power plants per month if nuclear energy is to play a significant part in combating global warming. This, the report stated, would have overwhelming implications for world security because of the danger of nuclear weapons proliferation — and, in any case, would prove logistically impossible.

- August ICE Brent crude oil futures settled Jun. 28 at $70.52, up 30¢ on the week. Nymex light, sweet crude (WTI) futures closed at $69.57, for a gain of 92¢. WTI's discount to Brent has narrowed to less than $1 because of improving US demand. ■

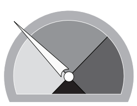
RUSSIA

The Game Gets Tougher

Moscow has extended its policy of resource nationalism beyond state control of its oil and gas sector, to aspirations for wider influence — including the international expansion of Russian companies, integration with the global economy through the World Trade Organization (WTO), and development of a leading position in the LNG market. That was one key lesson from the Kovykta saga, under which BP last Friday agreed to hand over the giant gas field in East Siberia to state Gazprom. The message: Foreign investors must render support in achieving those targets if they want to do business in Russia.

In rolling over at Kovykta, BP had its eye on protecting its $8 billion investment in its TNK-BP joint venture, which accounts for one-quarter of the supermajor's oil and gas production. It also salvaged some compensation, when Moscow was threatening to seize the field for license violations. TNK-BP agreed to sell its majority stake of 62.89% in the 70 trillion cubic foot Kovykta to Gazprom — for $600 million-$800 million, according to Gazprom, or slightly more, according to BP — as part of a strategic alliance facilitating access by the Russian goliath to assets around the world. TNK-BP had spent $500 million on Kovykta. The agreement fits perfectly with Russia's policy of allowing foreigners only a minority stake in domestic projects: TNK-BP has an option to buy back 25% plus one share of Kovykta within 12 months at a market price, but only if Gazprom has agreed to "suitable investment options across all geographies" by then.

Energy Riskometer



RUSSIA

The voluntary expropriation at Kovykta mirrors the experience of Royal Dutch Shell, which agreed to hand over control of the huge Sakhalin-2 offshore project to Gazprom late last year, following intense pressure from Russian environmental authorities (EC Jun.15,p5). Some analysts believe that, financially, TNK-BP managed to negotiate more favorable terms than Shell, as Kovykta has many future cost uncertainties, while Sakhalin-2 was already an oil producing project with its LNG phase nearly 90% complete. Gazprom paid $7.45 billion for 50% plus one share in the $20 billion Sakhalin-2 development.

On the other hand, Shell stayed in the project with its share reduced to 27.5% from 55%, and was not required to provide assets or investments for Gazprom overseas. Such an outcome could still pan out, however, with Shell Chief Executive Jeroen van der Veer stressing at the recent St. Petersburg Economic Forum that, "If foreign companies come to invest in Russia, Russian companies should come and invest in the West." BP's new chief executive, Tony Hayward, then dressed this up as the principle of reciprocity — although the gains seem more one-sided than reciprocal (EC Jun.22,p1). Shell and BP could support Gazprom's ambitions in the LNG market, while BP and Chevron have pledged to help Moscow's effort to join the WTO. Moscow would also like help developing and selling its technologies worldwide.

Exxon Next

For all the drama over Kovykta and Sakhalin-2, the story is not over. BP still faces uncertainty over the future of TNK-BP, including the prospect of a state company — Gazprom or Rosneft — replacing the existing Russian partners (EC Jun.1,p3). Exxon Mobil also faces pressure at its Sakhalin-1 project, as the chances dim that it will be able to export gas independently of Gazprom. The Russian company regards Exxon's preliminary supply agreement with China National Petroleum Corp. (CNPC) as an obstacle in its own talks with the Chinese, and also has different plans for the gas. Gazprom has already started a campaign to block Exxon pipeline supplies to China (EC Jun.22,p11).

The fate of Exxon's investment likely depends on whether it continues to insist that the Sakhalin-1 production sharing agreement allows exports bypassing the "single Russian export window" — aka Gazprom. Moscow could deploy various tools, such as claims of environmental or production target violations, or state representatives on the project's board could simply refuse to support the gas development phase.

The other main project that doesn't fit with current policy is the Caspian Pipeline Consortium (CPC), which operates an oil pipeline from the Chevron-led Tengiz field in Kazakhstan to a terminal on the Russian Black Sea. This is the only private pipeline running through Russian territory, and was built at a time of national weakness in the early 1990s. Moscow, which has the largest shareholding of 24%, now wants to reform CPC's founding principles, tariff regulations and voting rights — giving Russia more sway (EC May4,p10).

Some Russian investors may also fall victim to the drive for strategic control. As well as the Russian shareholders in TNK-BP, likely targets include the biggest local independent, Russneft, which was set up by former Slavneft President Mikhail Gutseriev with support from trader Glencore. French Total's contract for the northern Kharyaga oil field also needs some issues ironing out, but there have been no signs of a state equity grab to date. ■

Nelli Sharushkina, Moscow

Compass Points

- SIGNIFICANCE: With Kovykta, Gazprom has strengthened its position in negotiations with China over Russian gas supplies. After blocking TNK-BP's plans to export the field's gas for years, Gazprom now says it could launch production earlier than the 2017 date stipulated by Moscow's new unified gas development plan for the region, on condition that China's price is competitive with sales to Europe.

- CONNECTION: Russia is playing a craftier game than Venezuela and others, using hard negotiation and leverage instead of outright nationalization, and now extracting overseas openings to boot.

- NEXT: Exxon Mobil played hardball in Venezuela, so its response to Russia's Sakahlin pressure will be closely watched. Regardless, the US major will likely limit its investments in Russia after this conflict. But other foreign companies will still compete for rights to develop Arctic and Pacific shelf projects with Russian companies, once relevant legislation is in place. How big a price will they pay — financial and strategic — for the privilege?

VENEZUELA

US Majors Walk Away

US majors Exxon Mobil and ConocoPhillips have seen their presence in Venezuela unravel with surprising speed. Rejecting Venezuela's terms for renegotiation, the two companies walked away from their Orinoco joint ventures this week, leaving only terms of compensation to be resolved, either by negotiation or arbitration.

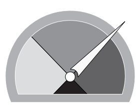
The Orinoco Revolution

Project	Capacity*	Previous	Now
Cerro Negro	120	Exxon 41.67%, PDV 41.67%, BP 16.67%,	PDV 83.37%, BP 16.67%
Sincor	200	Total 47%, PDV 38%, Statoil 15%	PDV 60%, Total 30.3%, Statoil 9.7%
Hamaca	190	Conoco 40%, Chevron 30%, PDV 30%	PDV 70%, Chevron 30%
Petrozuata	130	Conoco 50.1%, PDV 49.9%	PDV 100%

*'000 b/d.

Exxon's move was no great surprise: The major took a tough stance in earlier talks over its service contract for the Quiamare-La Ceiba oil field, and, in the latest round, also gave up its 50% stake in the separate La Ceiba production sharing agreement, rather than accept a lesser role (EC Mar.2,p5). Foreseeing the worst in the tough Orinoco negotiations, Exxon sold all its Venezuelan service stations last week and is now asset-free in the Opec member country. Exxon has a reputation as a hard negotiator, and some observers believe it wanted to send a message to other governments that might also be considering altering its contracts: Try it, and watch the money walk (EC Apr.13,p5). Exxon's interest in the Cerro Negro Orinoco venture was substantial, but accounted for only 2% of its total reserves, and just 1% — 48,000 barrels per day — of total company output.

Energy Riskometer



VENEZUELA

Conoco was more exposed, with large stakes in two Orinoco ventures, Hamaca and Petrozuata, and a smaller global portfolio to cushion the hit. The company plans to make a charge of $4.5 billion in its second-quarter accounts, and has lost 1.1 billion barrels of reserves, or 10% of its total oil and gas resources, and a curtailed 82,000 b/d of production, or 4% of the total — assets that may be hard to replace elsewhere in the current climate. In this week's seizures, Conoco also lost its 50% interest in the offshore Corocoro field, due to start production of 30,000 b/d this year, rising to 70,000 b/d. It retains a 40% stake in Block 2 of the offshore Deltana Platform natural gas project.

Other Western oil companies — French Total, Norwegian Statoil, the UK's BP and US Chevron — caved in to government pressure, switching large stakes and often operatorship to minority shareholdings in "mixed companies" with Petroleos de Venezuela (PDV). The state company will hold an average 78% stake, up from the previous 39%, in the four Orinoco projects — Cerro Negro, Sincor, Petrozuata and Hamaca — which have the combined capacity to produce and upgrade around 600,000 b/d of extra-heavy crude for export. Italian Eni also held on to its 26% stake in the Corocoro project, alongside PDV.

Staying Put

Total and Statoil said they had negotiated an unspecified compensation package with the government, in exchange for giving up part of their interest in the Sincor project, the largest of the Orinoco developments with an estimated value of some $14 billion. BP and Chevron came out as clear winners, keeping their shares in the Cerro Negro and Hamaca projects intact.

Talks on reforming the Orinoco ventures made little headway through last year, but were given a jumpstart by PDV's formal takeover of the projects on May 1. The private partners were given until Jun. 26 to agree terms, while the National Assembly must approve the new deals by Aug. 26. Between now and then, companies are expected to continue fine-tuning the new contracts (EC May4,p5).

What next? Discussions with Exxon and Conoco will continue, although a late deal allowing them to stay looks unlikely — the assets have been expropriated and relations have broken down. Conoco and Exxon will now try to negotiate compensation for the nationalization of their assets and, if that does not work, international arbitration would be the next step. In a statement, Conoco said: "Although the company is hopeful that the [compensation] negotiations will be successful, it has preserved all legal rights including international arbitration." The value of compensation and preservation of arbitration rights were reportedly sticking points in the contract talks. All this will be a long process — of the companies that lost assets in last year's reform of service contracts, only one, Eni, has so far initiated the arbitration process. ■

Patricia I. Vasquez

Compass Points

- SIGNIFICANCE: Venezuela's expropriation of US majors' assets represents one of the most dramatic steps in global resource nationalism, on par with — but more blatant than — Russia's move on Kovykta and Sakhalin-2 (see p2). Despite high oil prices and record profits, majors generally face tighter access to large new reserves and thus narrower options for organic growth.

- CONNECTION: Despite severe tensions between President Chavez and the US, Venezuela's oil exports mostly continued to flow north. The loss of Exxon and Conoco weakens the trade axis, although Exxon had already cut its imports. Asian sales are growing, but face logistical challenges.

- NEXT: Venezuela will be looking for new partners in the Orinoco Belt — certainly at new projects and perhaps also at Hamaca, Cerro Negro and Sincor Phase 2 — in a bid to fulfill expansion plans (EC Jun.22,p6). Chavez says he has a "lot of allies" to replace Western investors — mostly state oil companies — but none can match their experience or technology for extra-heavy oil. A more intriguing question: Will the Western companies that stayed behind now step up with new investments?

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IRAQ

Kurds Turn Eyes to Kirkuk

Iraq's parliament should start debating a series of oil-related laws in the coming weeks, as agreements between the central government of Iraq and the Kurdish region over a draft petroleum bill and an oil revenue sharing law are finalized by the cabinet and the state judicial council (EC Jun.22,p2). The Kurds will then turn their attention to the next — and arguably most contentious — issue in their pursuit of a quasi-independent state in northern Iraq: the dispute over Kirkuk and the extent of the Kurdistan Regional Government's (KRG) boundaries within Iraq. Yet with the stakes high for the various Iraqi ethnic and religious groups, as well as for neighboring states and the US, deciding the fate of the northern oil province might prove to be just too divisive for a deal to be struck.

Since the 2003 US invasion of Iraq and the toppling of the Baath regime, the Kurds have worked studiously to consolidate autonomy for their region — establishing an environment that, Iraqi and neighboring critics claim, would allow them finally to proclaim the first independent Kurdish state in centuries, including Kirkuk and its oil fields.

These efforts focused initially on transitional laws drafted by the postwar Coalition Provisional Authority, and later on the constitution adopted in 2005. The constitution laid the foundation for the claim to Kirkuk in Article 140, by setting out the procedure, starting with "normalization" of the population and a census, and concluding with "a referendum in Kirkuk and other disputed territories to determine the will of their citizens" by a deadline of Dec. 31, 2007.

The "normalization" process aims to reverse Saddam Hussein's policy in the 1970s and 1980s, which settled Iraqi Arabs in Kirkuk and expelled Kurdish and Turkoman residents. Today, the Kurds stand accused by other minorities of forcing an equivalent — if less violent — demographic change in the city, by bringing in Kurds who were never inhabitants of Kirkuk and forcing current residents to leave.

Another major problem is that the constitution did not state whether the census should cover the whole country, or just the Kirkuk city or region. Moreover, Saddam made administrative changes to the border of the governorate of Kirkuk — and that issue needs to be addressed and resolved before any referendum can take place. Again, the constitution did not specify whether the referendum on Kirkuk applies to the city or the whole governorate, which share the same name.

A modification of the borders of Kirkuk governorate would determine which oil and gas fields are to be included within the Kurdish region. From a list of 78 Iraqi oil and gas fields, the KRG claims that 15 fields and half a dozen exploration blocks lie in still-to-be-decided boundary areas. Attaching Kirkuk city to the Kurdish region would give the Kurds control over the giant Kirkuk oil field, as well as the neighboring Jambour and Bai Hassan fields.

Iraqi sources say there is no broad agreement among the country's political parties over how to tackle the Kirkuk problem. One idea on the table is to make Kirkuk an independent federal region of Iraq, which encompasses all its communities — a proposal opposed by the Kurds, who want to make the region specifically Kurdish. Another suggests splitting Kirkuk into two regions — one that includes the western and southwestern parts, where Arabs form a majority, and a Kurdish part that could be attached to the KRG's existing three governorates. That proposal is also opposed by some, as it does not address the fate of the Turkoman people based in Kirkuk city. For now, the Kurds seem to be alone in pushing for determination of Kirkuk's fate by the stipulated December deadline. The US administration, conscious of the internal and external implications, has been seeking a postponement of the vote till next year.

Turkish Threat

Turkish officials, wary of the galvanizing effect of a strong and prosperous Iraqi Kurdish region on its own Kurdish population, argue that Kirkuk's Turkoman character must not be eradicated. "Kirkuk has never been and cannot be Kurdish, even though Kurds are creating faits accomplis on the ground. They can change the demographics of Kirkuk, but cannot change its status," one Turkish diplomat told *Energy Compass*.

Turkey would like to see Iraq's Arab neighbors, especially those concerned about the fate of Iraqi Sunnis, take a stand on the Kurdish claims — Syria, for example, also has a large Kurdish population. Still, Turkish officials say that if the Kurds were to take over Kirkuk, this would not be tolerated by Ankara — creating another major problem in the Middle East. "Even without military intervention, all we have to do is close our borders with the Kurdish region and switch off the power," said the Turkish diplomat.

Sources in Baghdad say the Kurds themselves seem to be divided over how hard and how quickly to push for the end-year target, with KRG President Massoud Barzani and supporters sticking to the book, but the camp of Iraqi President Jalal Talabani taking a more flexible stance, fearing that the stakes are too high to rush a decision. ■

Ruba Husari, Istanbul

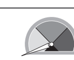
Compass Points

- SIGNIFICANCE: Detaching Kirkuk from Iraq and attaching it to the Kurdish region could unleash centrifugal forces — marking the first step toward the partitioning of Iraq, while encouraging secessionist movements in the Shiite south.

- CONNECTION: Neighboring Turkey, Syria and Iran all have restive Kurdish populations, will watch events closely and pose potential threats. A weak central government in Baghdad may not be able to help the Kurds in a crisis.

- NEXT: The insistence of some Kurds on a Kirkuk referendum by year-end could unleash hostile action, even from their — until now — Shiite allies. Limited violence against Kurdish targets in the city in recent months could develop into full-fledged, and possibly military, opposition.

ENERGY RISKOMETER



Energy Compass' Energy Riskometer provides a snapshot guide to the overall energy risk of a country, region or project covered, based on political, economic and commercial criteria. Settings are discussed and updated weekly by a steering group of senior *Energy Compass* editors and reporters.

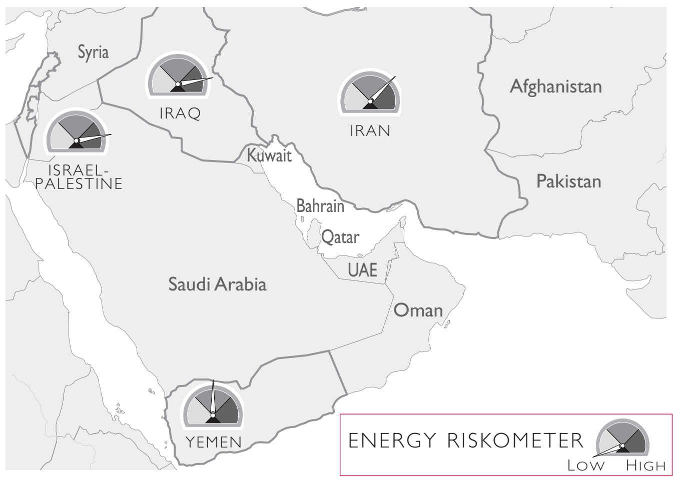
FLASH POINTS

Yemen's Tribal Mix

An attack last weekend by a lone gunman at an oil facility in southern Yemen, which killed a worker for US Occidental and injured several others, pushed Yemen back into the headlines, reminding the world of its potential for volatility. Occupying a strategic position as a bridge between the Arabian Peninsula and the Horn of Africa, Yemen is beset by tribal divisions and has been used as a safe haven by Islamic militants affiliated to Al-Qaeda. The instability is exacerbated by poverty and a rapidly increasing population of more than 22 million people.

Oil installations in Yemen are occasionally attacked — militants last year launched coordinated attacks on a crude export terminal and a small refinery — and over the past decades dozens of Westerners have been kidnapped and usually released unharmed. From time to time, something much more serious occurs, such as the bomb blast that killed 17 US Marines on board the *USS Cole* at the port of Aden in October 2000 — now seen as a precursor to the events of Sep. 11, 2001 — or the October 2002 attack on the French crude oil tanker *Limburg*.

This Week's Flash Points



Adding to the mix, the Yemeni government has been locked in a bloody three-year battle with Shiite rebels in the northern Saada province, who owe their allegiance to Zaidi tribal leader Abdel-Malek al-Hawthi, the death of whose brother in June 2004 was one of the catalysts for the fighting. The origins of the conflict are murky and are rooted partly in the refusal of Saada's tribes to take orders from the capital Sanaa, partly in their ability to access large amounts of weaponry. Shiites form a minority in Yemen but a majority in the north; the Zaidi imamate ruled in Sanaa until a 1962 republican coup.

Yemen's President Ali Abdullah Saleh — a moderate Zaidi who led the 1962 coup — has claimed repeatedly that the rebels are backed by Iran and Libya, but this remains unproven, and some local analysts believe he has exaggerated the threat to bolster military support from the US. There are signs that the conflict is drawing to a close, however, with tiny Qatar mediating a settlement under which the rebels would lay down their arms and some of their prisoners would be released.

The fighting, which has claimed an estimated 4,000 lives so far this year, has if anything bolstered the rule of Saleh, who likes to portray himself as the glue that holds the country together. Saleh — president since Yemen was reunified in 1990, having previously served 12 years as leader of the northern Yemen Arab Republic, and head of the ruling General People's Congress — is a consummate political operator who relies on fellow members of the Hashid tribal federation, the country's largest, to underpin his rule. One of Saleh's key backers is the speaker of parliament, Sheikh Abdullah al-Ahmar, the leader of the Hashids and long-serving head of the opposition Islah party. Sheikh Abdullah's son Hamid is one of the country's most successful businessmen.

Saleh, who became Yemen's first popularly elected president in 1999, is rare among Mideast leaders in that he has embraced democratic reform. But democracy has not always served his purposes, and Saleh faces criticism from parliament for allowing corruption to flourish and for failing to do enough to develop the economy. In 2005, parliament humiliated Saleh by rejecting a deal he had signed extending US Hunt Oil's rights to its Marib oil concession. Hunt, which had been operating in Yemen since the early 1980s, took the government to arbitration.

Saleh is a regular visitor to Washington and is comfortable with the alignment of national and US interests. But at home, Saleh has faced strong opposition from opponents, who claim he has sold out to the US and colluded in the arrest or even assassination of suspected militants.

Yemen's oil production is now hovering at around 350,000 barrels per day and falling steadily. In a bid to slow declines, the government has brought in midranking or small companies for exploration, while also pinning hopes on the $3.5 billion Yemen LNG project. ■

Paul Sampson, London

Compass Points

- SIGNIFICANCE: Yemen has a combustible mix of regional and tribal rivalries that can bubble to the surface and sometimes lead to major bloodshed. On the other hand, it is a budding democracy — at least by Mideast standards — and last year's presidential elections were possibly the most transparent in the Arab world for some time. President Saleh cannot bend parliament to his will.

- CONNECTION: Yemen's potential to spiral out of control is a concern for Saudi Arabia, Oman and other GCC members. The US, in turn, fears chaos in Yemen could turn it into a haven for Islamic militants loyal to Al-Qaeda among the Sunni majority.

- NEXT: Saleh will remain in power for the foreseeable future, playing opponents against each other and keeping tribal factions in check. But he faces mounting pressure to reform and develop the economy. The US will provide continued assistance to fight militants, while offering economic aid in return for more democratic reforms. For now, periodic attacks remain the main danger for oil companies.

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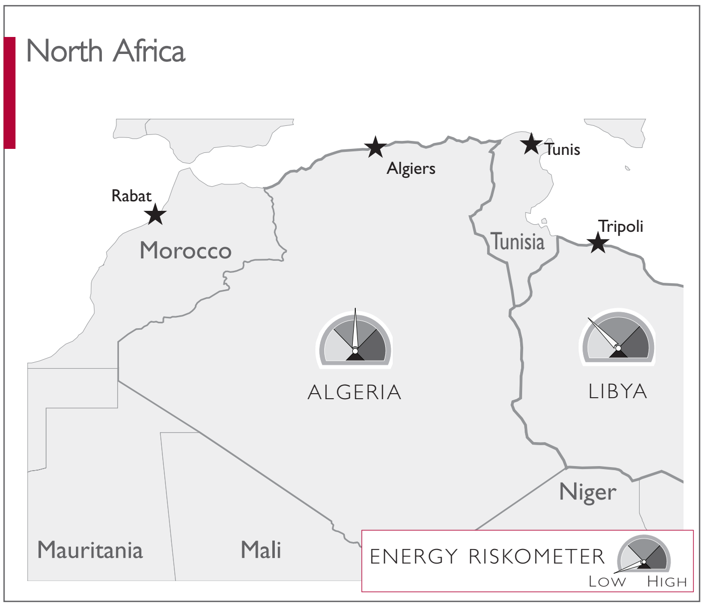
North Africa's Al-Qaeda Threat

Last September's announcement that Al-Qaeda was merging with Algeria's main militant Islamist group, the Salafist Group for Preaching and Combat (GSPC), contained the potential for a new threat to North African stability — but the jury is still out on the precise impact of the move.

Some argue that the increase of GSPC attacks since September — on the oil and gas sector, police and army posts, and government buildings, including the prime minister's office in April — shows that Al-Qaeda is succeeding in building a new regional force, and potentially setting up a new base from which to pursue its global jihadist goals. Connections have also been made between Al-Qaeda's presence in Algeria and a burst of militant activity in Tunisia and Morocco (EC Jan.26,p4).



But other Algeria-watchers are less aggressive, and say that GSPC links to Al-Qaeda — for now, anyway — may not extend much deeper than branding. Although the GSPC has changed its name to Al-Qaeda in the Islamic Maghreb (Aqim), there's not much evidence yet to suggest that, ideology aside, Al-Qaeda has made inroads into the operational or financial capacities of the old GSPC. According to James Howarth of London-based risk consultants Exclusive Analysis, Aqim is for now more of an aspiration than a reality.

What accounts, then, for the GSPC's dramatic increase in activity in Algeria? Attacks include suicide car bombings in central Algiers and three attacks targeting the oil and gas sector — namely, a December attack on workers with US Halliburton, a March attack on workers with Russia's Stroitransgas, and, last week, a reported attempt to target a regional gas pipeline west of Algiers (EC Apr.13,p9).

The group's resort to higher-profile car bombs may possibly reflect the weakness of the GSPC. Waning support may mean that the group, its numbers depleted in recent years by a government amnesty, is no longer able to operate in its usual way, carrying out ambushes and small-scale attacks over a wide range of territory. Adopting the new tactics may have been a practical step to raise its profile. Most attacks have also been localized, in an area east of Algiers, where the GSPC or Aqim is strongest.

The GSPC's alliance with Al-Qaeda created schisms, alienating some regional leaders, Howarth says. In future, two distinct strands of GSPC-Aqim could emerge — the old guard focusing on domestic targets, and the new Aqim targeting higher-profile, internationalist targets.

While oil and gas production facilities — heavily secured and usually located in the south of the country, away from population centers nearer the coast — are not likely to be targeted, pipelines and coastal export facilities are softer targets. The government will up security, but needs time to adapt to the new challenge.

Most analysts also argue that there's little sign of the newly dubbed Aqim coordinating like-minded groups or activities in neighboring states. There may be some communications and exchanges, but it's difficult to have strong organizational links in such a tight security environments, says Robert Parks of the American Institute for Maghrib Studies in Algeria. Tunisia is run as a police state, and things have been quiet there since government battles with a militant cell in December.

Morocco was plagued with a run of suicide bombings in March and April, but these caused few casualties and little damage. Small-scale attacks on US or European targets could continue, even though groups there now seem fragmented and amateurish. But the specter still looms of the Casablanca bombings in 2003, and the Madrid railway bombings of 2004 — indirectly linked to Moroccan group Salafia Jihadia and its offshoot, the Moroccan Islamic Combat Group. Those groups were weakened in a crackdown after the attacks.

In Libya, leader Muammar Qaddafi's control remains firm. The Libyan Islamic Fighting Group, made up of Libyan fighters returning from Afghanistan and based in Libya's Cyrenaica province, east of Tripoli, was severely weakened in 1995 after mass arrests in the wake of clashes with security forces. Now said to be allied to Al-Qaeda, its 2005 threat to attack government targets in the province unless its leaders were released gained no traction. ■

Jill Junnola, London

Compass Points

- SIGNIFICANCE: The resurgence of militant Islamist groups in North Africa is significant and potentially dangerous. Links with Al-Qaeda, if they develop, could magnify the threat posed by such groups, but should not endanger regime stability.

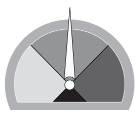
- CONNECTION: The focus of Algeria's main Islamist militant group for now remains local, despite some presence in Europe. But Algerians make up one of the largest groups of foreign fighters in Iraq, raising the prospect that battle-hardened returnees will significantly raise the stakes.

- NEXT: Algeria will try to secure oil and gas facilities, including pipelines, but the situation will remain complicated by civil-military dynamics. A complete end to the violence would weaken the military arm of the regime, threatening levers of control that have been reinforced by a state of emergency since 1992.

Nigeria: Security for Hire

The explosion in Niger Delta violence since 2006 has cost the Nigerian state and international oil companies billions of dollars, whether on losses from deferred production or on outlays to beef up security. But for others it represents an attractive money-making opportunity, not least the security companies now piling into southern Nigeria. Some, exiting mature security markets in Iraq, see Nigeria as a major growth area. Other, more established players report that turnover from Nigerian operations is up more than 100%.

Energy Riskometer



NIGERIA

Attacks on oil pipelines and flow stations, and repeated kidnappings — 120 or so this year alone — are forcing the oil sector to spend big money to protect staff and installations. An executive from one major told *Energy Compass* that security outlays doubled in 2006 and will increase again in 2007. Much of the money goes to Nigeria's security forces. Both state Nigerian National Petroleum Corp. (NNPC) and the international oil companies decline to disclose how much they spend on security, or how they share the burden among themselves and with service companies. But NNPC is said to have requested an oil and gas security supplement of more than $300 million from Congress last year just to fund services provided by Nigeria's army, navy and mobile police, a vast increase on levels of $10 million reportedly sought in the mid-1990s.

Established players in Nigeria include UK-based Group4Securicor with its Nigerian partner Outsourcing Services Ltd. (OSL), Control Risks Group, and UK-listed Armor Group. OSL, jointly owned by Chevron and NNPC, has an extensive contract with Chevron to provide guards, marine security, satellite tracking and escort protection for supply vessels rigs and barges. Control Risks was originally set up by underwriter Hogg Robinson in 1975 to add value to its insurance services and mitigate risk through security services and kidnap negotiations. The company, which does not provide armed guards, focuses on risk analysis, security design and coordination, and works with several oil companies in Nigeria.

Armor Group — which listed in London in 2003, after a management buyout split the services arm from US security equipment manufacturer Armor Holdings — arrived more recently, in part diversifying from mining security in Congo (Kinshasa). Its Nigeria business drove a 29% increase in African revenues last year and is expected to grow substantially in 2007. The firm expects this to help offset declining profit margins from the increasingly competitive Iraqi security business, which forms a large part of its business.

Newer still to Nigeria is Erinys, a British company that set up a Nigeria operation last year after exiting Iraq. It has teamed up with the Ibru Group, owned by Alex Ibru, the former governor of Delta state who heads one of the area's most influential families.

The security firms' Nigeria business differs from operations in other risky countries like Iraq, where expatriates are assassinated or blown up in roadside bombs. Despite all the violence and attacks on oil installations, Niger Delta militants and criminals have, for now at least, shown little inclination to kill their hostages. Most focus on kidnaps and hostage-taking to raise money or score political points (EC Jun.15,p3).

In addition, Nigeria's military has a monopoly on legal force: The Private Guards Act of 1986 prohibits private security companies from carrying firearms. While the industry is forced to rely on the military for coercive support, it uses private security companies for risk analysis, planning and security coordination. Mindful that the Nigerian military's lack of discipline often exacerbates tensions — soldiers killed 12 people while rescuing hostages taken from the Ogbainbiri flow station last week — oil companies often hire security companies for their professionalism and discipline, and also to provide a "buffer" between themselves and state security forces, according to a rare study on private security in Nigeria by Aberystwyth University.

The international security companies are just as reluctant as the majors or government to discuss their finances or operations in Nigeria, citing both security and commercial sensitivity. The costs vary according to the size and reputation of the service provider and how the security services are packaged. However, sources say that security companies can charge around $18,000 per month for a security coordinator. Some will charge oil companies $12,000/month for an experienced expatriate to guard a senior executive — and the guard gets 40%-60% of that fee. Rates for security consultants typically range from $800 to $1,200 per day, according to one analyst, but can exceed $2,000/day at the top end — or up to $60,000/month.

While the major oil companies provide regular business, the service companies are the security providers' main growth area, particularly smaller companies, which, previously ignored because of their low profile, are increasingly caught in the net of expanding militant and criminal activity. ■

Christina Katsouris, London

Compass Points

- SIGNIFICANCE: Nigeria's sharp increase in security costs works through to operating costs. Service companies, but not producers, can pass on the costs through higher fees.

- CONNECTION: With upstream access tight and oil demand growing, companies can't ignore such risky environments. Security is a growth business, but the Iraq war resulted in many new players — resulting in a more competitive business globally and, some sources say, tighter margins. Nigeria remains a niche market, with competition limited.

- NEXT: Some say the solution to security should involve local communities in the Niger Delta, and one proposal calls for programs to train local youths to guard pipelines and flow stations, at an estimated cost of $500 million per year. Others focus on decent community programs. The bottom line: Any solution will come from President Umaru Yar'Adua, not the oil majors.

MARKET FORCES

New Strategic Reserves

India has joined China in pushing ahead with development of a strategic oil reserve, as the fast-growing Asian consumers seek to limit their vulnerability from rising imports. But key differences in their plans — particularly over funding and timing — underscore differences in domestic needs and political approaches to energy security.

After much internal discussion, India is set to move ahead with construction of 5 million tons (36 million barrels) of strategic underground storage, with the start of work on a first site on the east coast scheduled for later this year. Engineers India should issue an international tender next month for the facility in Visakhapatnam, Andhra Pradesh state (EC Jan.12,p12). The project is being overseen by Indian Strategic Petroleum Reserves, a new government agency that was established last year with an initial $2.7 billion.

The 7 million bbl Visag facility is expected to cost $170 million and take four years to build, with capacity to store 70% high-sulfur crude and 30% low sulfur. Two other locations have been identified for future storage caverns: Mangalore (11 million bbl) and the nearby Podur (18 million bbl), both on the west coast. The initial plans will provide 15 days of import cover, adding to around three weeks of cover already maintained by refiners as commercial stocks. The government is considering ways to double the stockpile to 10 million tons, but these plans are not likely to materialize until the first phase is completed.

Getting Going

India started discussing the idea of a stockpile in the mid-1990s, but funding and operational issues prevented any concrete steps until now. As debates raged, oil prices soared — so the government now plans to start construction while it decides how to fill and manage the reserves.

While India appreciates the importance of supply security, it has much less financial clout than China. New Delhi estimates the cost of creating the first phase over nine years at around $2.5 billion, with an annual operating cost of $20 million. Beijing, by contrast, plans to invest over $13 billion in its strategic crude reserves by 2010, with the plans moving ahead quickly since official approval in 2001.

The first phase in China's plan involves four sites totaling 100 million bbl, or 30 days of import cover, which are expected to be filled primarily with imported crude. Imports are handled by the different state oil firms tasked with construction of the facilities: Sinopec is overseeing the 33 million bbl Zhenhai facility and the 19 million bbl Huangdao site in Qingdao, while PetroChina is managing a 19 million bbl facility at Dalian and trader Sinochem is constructing storage for 31 million bbl in Aoshan.

The largest base, in Zhenhai, was finished in August 2006. Despite high oil prices, stockpiling started soon after completion, using crude from Russia and the Middle East (EC Jun.9'06,p7). Huangdao is expected to be completed ahead of an end-2008 target and should start being filled soon, while the Aoshan site took in its first crude cargo in May. Construction at Dalian is still under way.

The second phase of stockpiling should add a further 200 million bbl of storage capacity by 2010, although actual sites are pending approval, while a third phase would add another 200 million bbl. According to consultancy Facts, China will need about 625 million bbl of oil in its strategic reserve by 2015 in order to have 90 days of forward import cover — the requirement for industrialized nations set by the International Energy Agency, which is advising Beijing. China and India may eventually set their own guidelines for cover rather than follow the industrial world's rules.

Calculations by Energy Intelligence's *Oil Market Intelligence* indicate that the Chinese strategic reserve currently holds about 42 million bbl, and that up to 200,000 b/d has been funneled into the reserve this year. Analysts concur, with estimates of 100,000-200,000 b/d.

Beijing's policy-making National Development and Reform Commission (NDRC) has indicated that China's stockpile model will incorporate both government and commercial oil reserves, although the exact relationship is not clearly defined. Part of the strategic reserve in Zhenhai has been leased to Sinopec, for example, while cumulative monthly volumes delivered there since the start of the year have surpassed total capacity — suggesting some drawdown from the stockpile. More clarity on the rules governing use of strategic stocks is expected when Beijing unveils a new energy law, due in the second half of the year.

Although China's state oil companies construct the sites and procure the crude, the strategic reserve will be directly managed and operated by the National Oil Stockpile Center, an independent agency under the oversight of the NDRC. ■

Song Yen Ling, Singapore, and Ammar Zaidi, New Delhi

Compass Points

- SIGNIFICANCE: Strategic inventories in fast-growing China and India — the world's second- and fifth-largest oil consumers, respectively — are important to the wider oil market, as if those countries are caught short, the upward pressure on prices would reverberate around the world. Strategic reserves will allow them to smooth out supply disruptions, whether specific or more widespread. Both previously used a hand-to-mouth approach to oil imports.

- CONNECTION: China's rapid pursuit of strategic reserves is symbolic of its ascent as a global economic force. While China is firmly in the fuel-intensive phase of development, India's service economy has taken a somewhat different path, but may now follow suit.

- NEXT: Beijing should issue clearer guidelines on its reserve strategy. The West would like to see more transparency in the relationship between government and commercial use, but China may prefer to keep these lines blurred, allowing use of strategic reserves for short-term commercial purposes. China will continue to press ahead with filling its first phase, while the less-decisive India will start construction and deal with details later.

Rethinking North Sea Trade

Cash trade in the Platts window of the 21-day Brent-Forties-Oseberg-Ekofisk (BFOE) contract, which underpins dated Brent assessments, has dried up since the pricing service decided to impose a minimum standard of 37° API gravity and 0.6% sulfur for Forties crude oil cargoes deliverable into the contract (EC Jun.15,p9).

Platts' move was rooted in concern that Forties maintenance shutdowns in late July and the first half of August would increase the contribution by medium, sour Buzzard to the Forties blend — resulting in a quality deterioration that would threaten the grade's status as a light, sweet crude. Jorge Montepeque, Platts' global director of market reporting, said that in order to protect the integrity of the assessment process, the agency would exclude Forties deals unless sellers could guarantee to deliver Forties of the stipulated quality.

At a seminar hosted by Platts on Jun. 19 in a bid to calm the ensuing outrage, traders were practically unanimous in declaring that no seller could reasonably guarantee the standard required by Platts, with some declaring that the "cure" was "worse than the disease." Montepeque announced a consultation period through Friday, Jun. 29, during which the industry could submit suggestions for improvements to the methodology, but said the restrictions would remain in place in the meantime. Liquidity has dried up as a result, with dated Brent assessments varying sharply among the three principal pricing services, Platts, Argus and ICIS-LOR.

In an effort to inject at least some flexibility, BP has suggested including in the Forties contract a price de-escalator of 30¢ per barrel for each 0.1% sulfur above 0.6% sulfur, to compensate for all quality reductions associated with the increased levels of Buzzard, not just the sulfur level. While this might be an improvement, some traders maintained the proposal was still too rigid.

Then, on Jun. 27, consultants Consilience Energy Advisory Group (CEAG) published proposals titled "Brent Contract — A Suggestion for the Consideration of Industry Players." CEAG — led by Liz Bossley, former head trader with Enterprise Oil — said building quality guarantees into sales agreements is operationally unworkable and fraught with contractual difficulties. CEAG instead proposed that the industry agree a standard Brent reference quality with a starting point for further discussion, somewhere around 38° API, 0.4% sulfur, plus a simple, transparent escalation/de-escalation formula based on API and sulfur that applies to all grades delivered into the 21-day contract — not just Forties. The inclusion of a medium, sour grade like Flotta in the 21-day contract — creating BFFOE — subject to the same formula might improve liquidity and bring more players to the table, added the report.

CEAG argued that the contractual price for a 21-day BFOE contract could then be agreed at the standard Brent reference quality, with the final invoice adjusted for the bill-of-lading quality of each cargo. The pricing services could then assess and report the standard reference quality price — and the actual quality delivered would cease to matter.

It would probably take three to six months before such a formula could be applied, for existing open interest to work through the delivery system and for the details of new arrangement to be worked out. It would, of course, not solve the existing July-August problem. But BP's simpler de-escalator could help bridge that period.

One refiner welcomed CEAG's suggestion to include other grades, describing it as "logical and probably workable," but doubted the need for the change — except to get Platts off its self-impaled hook. Another said the proposal has the merit of retrieving the common sense that Platts threw out of the window: "A benchmark doesn't need to be perfect — that's an illusion anyway — but it must inspire confidence and be adaptable and this proposal seems to do that," he said.

However, others said the proposal was a case of "too much, too late," as it would take too long to implement, and suggested a modified form of the BP proposal might be adopted. ■

Crude Oil Markets

	Jun. 27	Jun. 20	Chg.
Futures			
Brent 1st	70.53	70.42	+0.11
Brent 2nd	71.30	71.31	-0.01
WTI 1st	68.97	68.86	+0.11
WTI 2nd	69.28	69.51	-0.23
Oman 1st	66.87	65.74	+1.13
Oman 2nd	66.17	66.27	-0.10
WTI-Brent	-1.56	-1.56	0.00
Brent-Oman	+3.66	+4.68	-1.02
Benchmarks			
Dated Brent	73.00	72.01	+0.99
B-Wave	70.33	70.60	-0.27
Mars	66.12	64.80	+1.32
Dubai	65.41	67.08	-1.67
Oman (spot)	65.46	66.98	-1.52
Tapis	73.95	76.20	-2.25
Minas	67.85	69.70	-1.85
Differentials			
Dtd Brent/BFO:			
Urals Med	-3.95	-4.05	+0.10
Bonny Light	+1.55	+1.05	+0.50
Cabinda	-3.10	-3.20	+0.10
WTI:			
LLS	+5.30	+6.45	-1.15
Mars	-2.85	-3.60	+0.75
Cusiana	+6.29	+6.00	+0.29

$/bbl.
Source: London Oil Reports, exchanges

Refining Margins

	Jun. 27	Jun. 20	Chg.
Rotterdam (Brent)	-4.80	-4.00	-0.80
US Gulf (WTI)	+11.06	+12.00	-0.94
Singapore (Dubai)	+0.04	-1.66	+1.70

$/bbl.
Source: EIG

Product Markets

	Jun. 27	Jun. 20	Chg.
Rotterdam			
Regular Gasoline*	712.50	721.50	-9.00
Diesel (0.005%)*	655.75	663.50	-7.75
Fuel Oil (1%)*	316.50	307.00	+9.50
Fuel Oil (3.5%)*	328.50	319.00	+9.50
US Gulf Coast			
RBOB†	233.45	219.20	+14.25
Distillate Fuel (0.2%)†	199.50	200.40	-0.90
Fuel Oil (0.7%)‡	57.75	58.25	-0.50
Fuel Oil (3%)‡	51.53	53.17	-1.64
Singapore			
Naphtha‡	72.86	73.83	-0.97
Premium Gasoline‡	85.27	83.91	+1.36
Gas Oil (0.5%)‡	81.20	83.50	-2.30
Fuel Oil (3.5%)*	367.10	362.45	+4.65

* $/ton. † ¢/gallon. ‡ $/bbl.
Source: Reuters

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BOLIVIA

President Evo Morales led a ceremony to take possession of the country's two main oil refineries from Brazilian Petrobras, marking the end of a year-long dispute under his nationalization program. In a deal struck in May, Petrobras agreed to sell the refineries, with a combined capacity of 60,000 b/d, for $112 million to Bolivia's state YPFB. Bolivia has now set its sights on joint ventures controlled by Repsol YPF, BP and US Ashmore (EC Jun.1,p7).

CHINA

The chairman of listed Sinopec Corp., Chen Tonghai, resigned two years early for "personal reasons." Reports suggested he was under investigation for "economic irregularities" and "serious breaches of discipline" following a corruption probe. Chen was also removed as president at state parent Sinopec Group. Former PetroChina executive Su Shuklin replaced him at the parent company, and is widely tipped for the listed unit, too.

CHINA

Chinese crude imports in May totaled 3.07 million b/d, up 4.6% on a year previously. Angola and Iran were the top two suppliers at 430,000 b/d and 400,000 b/d, respectively, pushing Saudi Arabia into the third spot with 382,000 b/d. Significant volume increases came from Sudan, the UAE and Kazakhstan. Mideast supplies made up 40% of total imports, while Africa accounted for over 38% (EC Jun.1,p10). Latin America nudged 6%, while Asia-Pacific made up 8%.

HUNGARY

Austria's OMV appears to be gearing up for a bid to take over Mol, after spending €1 billion ($1.3 billion) to nearly double its stake in the Hungarian firm to 18.6% and announcing that it was pursuing a "friendly" merger. Mol announced its opposition, while the Hungarian government said it would use all means possible to block a takeover. Mol's options appear limited, however, as the alternative is likely a takeover from Russia's state Gazprom or Rosneft (EC Jan.5,p9).

INDIA

State ONGC assigned $11 billion for overseas spending in 2007-12, almost double the $6.1 billion spent in 2002-07. ONGC will spend $15.6 billion on domestic exploration and production in 2007-12, taking total investment to $26.6 billion, up from $18.4 billion in the previous five years. ONGC also said it is in talks with Chevron, Total and Royal Dutch Shell on asset swaps, including 15%-30% stakes in deepwater blocks off India's eastern coast. Separately, the government approved steel baron Lakshmi Mittal's plan to take a 49% stake in state Hindustan Petroleum's 180,000 b/d Bhatinda refinery project in Punjab, an investment of $785 million.

IRAN

The Iranian government bit the bullet and, with little notice, launched gasoline rationing for private vehicles — provoking unrest in Tehran as motorists queued to fuel up. The plan, which allows motorists 100 liters of subsidized fuel per month, drew fierce criticism of Iranian President Mahmoud Ahmadinejad. Iran imports large volumes of gasoline, making it potentially vulnerable to sanctions, while subsidies create a heavy financial cost.

IRAQ

June loading schedules show Asia taking just 340,000 b/d of Iraqi crude, down around 250,000 b/d on May and April, and the Americas taking an extra 120,000 b/d, for 63% of the total 1.48 million b/d. Europe is down slightly at 205,000 b/d. Somo plans a tender to sell 3 million bbl of Kirkuk oil from tanks at Ceyhan.

Iraqi Oil Exports

('000 b/d)	Apr.	May	Jun.
Americas	633	811	931
Asia	592	595	340
Europe	300	226	205
Total	1,525	1,632	1,476

Source: Energy Intelligence

LIBYA

A Scottish judicial commission recommended that an appeal be granted to the Libyan convicted of the 1988 Lockerbie bombing, questioning the reliability of evidence used to sentence Abdel Basset al-Megrahi in 2001. Iranian and Syrian links to the bombing have long been suspected. Separately, Libya is expected to release six Bulgarian medics sentenced to death for deliberately infecting children with HIV. Libya's top court is expected to find them guilty, after which a judicial panel could annul the sentence.

MEXICO

President Felipe Calderon presented a fiscal reform plan to Congress that could eventually allow the state energy company to set aside more revenue for badly needed upstream investments. The reform would raise government revenues, mainly by introducing new taxes on private companies and closing loopholes allowing tax evasion. Although it doesn't directly address Pemex, the proposal would offer an additional income source, paving the way for reducing the oil company's tax burden. Pemex turns 55% of its revenue over to the state and funds 40% of government spending.

NIGERIA

Shell started producing 38,000 b/d in the western Niger Delta, and hopes to beef up exports in July, mainly from storage. From February 2006, Shell

South Stream Rains on Nabucco, Turkey

Russia's Gazprom and Italy's Eni agreed to set up a 50-50 venture to study a 900 km (560 mile) gas pipeline from Russia to Bulgaria under the Black Sea — a move that could undercut Turkish hopes of becoming a key east-west gas transit hub, increase Europe's reliance on Russian gas, and cast further doubt on the Azerbaijan-Europe Nabucco pipeline project.

The South Stream pipeline project would cost €10 billion ($13.5 billion) and take three to four years to build. It would run from Beregovaya on Russia's Black Sea coast to an unspecified Bulgarian landfall and handle 30 Bcm/yr (2.9 Bcf/d) of gas. The feasibility study could begin next year and take 18 months to complete.

Once it reaches Bulgaria, Gazprom and Eni will look at extending the pipeline 1,000 km southwest — from Bulgaria through Greece, Albania and the Adriatic Sea to southern Italy — or with a 1,300 km spur north to Central Europe. Gazprom said both overland routes might even be built.

South Stream creates a further problem for the beleaguered European Union-backed Nabucco plan to pipe gas 3,400 km west from Azerbaijan and maybe Iran, to help reduce Europe's reliance on Russian gas (EC Jun.8,p5). In May, Hungary's Mol, one of the main backers of the OMV-led Nabucco consortium, signaled it was veering toward the South Stream proposal. Playing down the challenge to its preferred route, the European Commission insisted both pipeline projects could coexist, but added it would "soon nominate a coordinator for the Nabucco project" to continue efforts to secure new Caspian gas sources for that line.

Beregovaya is also the main pumping station for Eni-Gazprom's Blue Stream pipeline, currently carrying 8 Bcm/yr of Russian gas under the Black Sea to Turkey. An expansion of that line from Turkey into Europe was previously seen as Gazprom's most likely new southern export route. South Stream eliminates Turkey as a transit country.

shut in about 500,000 b/d of crude production after militant attacks. Separately, Eni confirmed resumption of output from the Okono and Okpoho fields, shut in since May 3 after similar attacks on its production ship. Also, four kidnapped foreign nationals working for Schlumberger were released unharmed in Port Harcourt. Nigerian labor unions suspended a nationwide strike Saturday after the government made a number of concessions.

NORTH KOREA

A team of UN nuclear inspectors will be allowed access to North Korea's Yongbyon nuclear reactor for the first time since 2002, after $25 million in frozen funds was released from a Macau bank. The planned inspection has bolstered optimism that North Korea is finally serious about rapprochement with the West and intends to shut down the reactor in return for fuel oil aid (EC Jun.22,p11). But determined to underline its bargaining power, it tested more ballistic missiles this week.

RUSSIA

PricewaterhouseCoopers (PwC) withdrew a decade of audit reports for bankrupt firm Yukos, whose battle with the Kremlin had brought the international financial auditor under increasing pressure from Russian authorities. PwC withdrew audits for 1995-2004, saying it had discovered information that could have affected the reports if known earlier. PwC admitted that the Yukos shareholders' use of the audits in charges against Russia in international courts prompted the move, but denied that Kremlin pressure influenced its move. Russian officials raided PwC's Moscow offices earlier this year (EC May11,p10).

QATAR

A tender should soon be issued for construction of a new 250,000 b/d oil refinery. Technical and economic studies have been finalized for the Al-Shaheen refinery at Ras Laffan, which will be Qatar's third, with start-up due in 2011. Qatar is already building the 140,000 b/d Ras Laffan condensate refinery, for completion next year. The country's existing refinery is at Umm Said.

UAE

Abu Dhabi Future Energy initiated the world's largest carbon capture and storage (CCS) project, to be used for enhanced oil recovery in the emirate. Canadian SNC-Lavalin will lead a six-month feasibility study and complete conceptual engineering to capture, process, compress and transport carbon dioxide to Abu Dhabi's oil fields. The UAE, one of the world's biggest per capita CO_2 polluters, said it was the first step toward a countrywide CCS network (EC Jun.22,p8).

CLIMATE

As global temperatures rise, so too will potential drivers of conflict, posing a major threat to security as climate change increases competition for energy, water, food and other resources, a Chatham House conference heard this week. African countries already wracked by instability and weak governance are probably most vulnerable, but mass migrations and the fight for resources could also foster greater instability in the Middle East.

CORPORATE

The UAE's Rak Petroleum said it is scouting for another upstream acquisition in the Mideast after the collapse of its takeover of UK-listed Gulf Keystone. Rak reached an impasse with the government of Algeria, where Gulf Keystone's assets are concentrated, and withdrew its $410 million offer late last week. Algeria wanted a $10 million fee to approve the takeover, while Rak offered a smaller amount.

OPEC

Governments pushing for biofuels and policies to increase fuel efficiencies add to the insecurity of future oil demand, which could force refiners and oil producers to postpone investments in new capacity, said Opec in its *World Oil Outlook*, covering the period through 2030. Opec still sees demand for oil growing by 35 million b/d to 118 million b/d in 2005-30, in line with last year's projection from the International Energy Agency.

10 YEARS AGO

Meeting in Vienna, Opec said it was committed to its 25.03 million b/d production ceiling, but few expect wayward members to stop the chronic abuse that has left the producer group's output nearer 27 million b/d (EC Jun.27'97,p1). The flagrant violations have continued despite a $7/bbl drop in oil prices since January that has pushed down Brent to $17.50/bbl, with Venezuela alone reckoned to be producing 800,000 b/d over quota. Opec lynchpin Saudi Arabia has issued a thinly veiled threat to flood the market unless Venezuela toes the line, with a major test of wills apparently shaping up that could lead to serious market instability later this year. Saudi Arabia faces a two-fold problem — losing influence in global markets and market share in the US, where its only tactical weapon may be a price war. The November meeting in Jakarta should be interesting.

Energy
Compass

Energy Compass® charts the impact of geopolitics on the global energy industry through the prism of supply, security and prices.

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PERSPECTIVE

China and India: An Economist's View

Ever since the explosion in Chinese and Indian petroleum consumption in 2004 spurred the sharp rise in global oil prices, apparent oil demand in these two countries has been on the rise, but volatile. Economists have struggled to agree on oil demand forecasts for both countries, partly because of the distorting effects of domestic oil subsidies.

Between 2003 and 2006, apparent — or estimated — oil demand in China accounted for 32% of the rise in global consumption, while India made up 8% — for a combined total of some 40%. But in both countries, the rate of growth in this period was uneven. Chinese oil demand ranged between 16.1% in 2004 and 4.8% in 2005, while Indian demand varied from just 0.4% in 2003 to 19.5% the following year.

This year, Chinese demand — strengthened by strategic stockpiling — is projected by Energy Intelligence's *Oil Market Intelligence* to grow by 4.5% to 7.4 million barrels per day, while Indian demand is seen rising by 3.9% to 2.7 million b/d. Those rates compare with projected 1.2% growth in global oil demand, to 85.4 million b/d.

The exercise of gauging demand is hindered by the paucity of comprehensive and transparent oil statistics and by significant smuggling in China. But there are other complications, too: China and India seem to defy the standard economic theory of demand, whereby consumption of oil is inversely related to its price — consumption falls as prices rise, and vice versa — assuming that all other factors influencing consumption are unchanged.

One problem is that these other factors rarely stay the same — such as the pace of economic expansion, consistently underestimated in recent years, particularly in China; the rate of population and labor force growth; changes in wealth, particularly with the surge in Chinese equity markets; structural changes, such as accelerating shifts from bicycles to cars, or from rural to urban areas; sudden shortages of electric power due to drought; decisions to build strategic oil stocks; or exchange rate fluctuations. Even if the price of oil remains constant, changes in these factors translate into fluctuations in demand.

Another significant — but less reported — complication concerns the fact that in both countries, but particularly China, desired demand is often higher than measured consumption. Why? Because when product prices are artificially reduced through subsidies, domestic refiners withhold supplies from the domestic market and instead either scale back runs, stockpile products or export some of the surplus. This creates product shortages, with the result that demand is not fully satisfied — and an "unmet demand gap" emerges. Paradoxically, this situation is a result of government-imposed domestic subsidies on petroleum products, especially gasoline and diesel.

More Balance

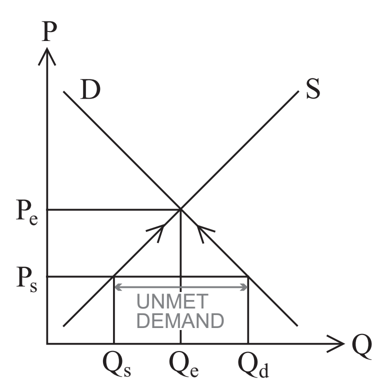
In China, as subsidies are relaxed and domestic prices are allowed to move up toward the equilibrium price — as occurred last year and is likely to continue gradually — consumption rises closer to desired demand, as domestic refiners gain the incentive to supply more products. The rise in the domestic price stimulates consumption, and so appears to contradict the law of supply and demand. In fact, all that's happening is a narrowing of the artificial gap between apparent demand and desired demand.

India's price controls have had a different impact. The imposition of domestic prices below equilibrium levels opens up a gap between desired and apparent consumption, just as in China. But in India's case the primary reaction of domestic refiners — particularly private-sector players like Reliance — has been to shift supplies to the external market. This helps explain a 38% jump in Indian product exports during the fiscal year to March 2007, to 650,000 b/d.

Put simply, product price subsidies in both China and India create an artificial gap between desired demand and apparent consumption, as refiners withhold supply by cutting runs or stockpiling, or exporting more to take advantage of higher international prices. As subsidies are cut and prices rise, domestic consumption gets a fillip — not the reverse.

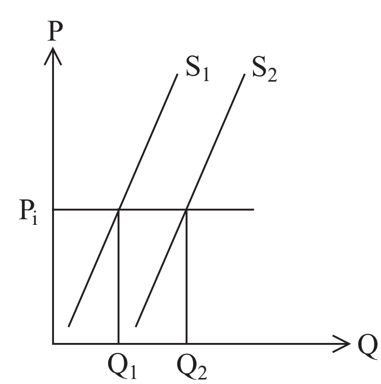
Sharif Ghalib, New York

China's Demand Gap



This chart uses supply and demand curves to show how subsidies crimp supplies as refiners limit runs. Without subsidies, the price (Pe) and quantity of demand (Qe) are in equilibrium, at the point where they meet on the demand (D) and supply (S) lines — so that supply satisfies demand. Where the price is subsidized (Ps), the quantity demanded (Qd) increases along the volume line (Q), but the quantity supplied gets smaller (Qs). This creates a gap of unmet demand — the difference between Qs and Qd on the quantity (Q) axis.

Indian Export Supply



In this chart, supply to the domestic market again falls short of what the domestic market wants to consume, but this time because refiners are switching more supplies to exports. S1 represents export supply without domestic price subsidies: Q1 represents the "natural" export quantity, which allows sufficient domestic supplies. S2 represents the situation with price subsidies: As refiners take greater advantage of the higher international price (Pi), the export volume moves along the quantity line (Q), increasing exports and squeezing domestic supply.