

# # 53 VALDAI PAPERS

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## GLOBAL ENERGY AND THE POLITICAL DYNAMICS IN THE MIDDLE EAST

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*The views and opinions expressed in this Paper are those of the author and do not represent the views of the Valdai Discussion Club, unless explicitly stated otherwise.*

## 1. Introduction

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Crude oil returns as the key commodity on the global oil markets and, therefore, a closer look is needed to establish what the main challenges and opportunities are. This article reviews key dynamics in the Middle Eastern oil and gas to explain how they shape the global energy picture. The author makes sense of the Saudi-Iran relations and the role OPEC is set to play in the emerging energy landscape. Finally, political developments in the broader region, including Turkey, are discussed.

## 2. Global Energy

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The ‘war of attrition’ within the Organisation of Petroleum Exporting Countries (OPEC) over retention of market share has raised a question of the cartel’s future and, more broadly, change in political economy of the Middle Eastern oil. With the impact of US shale production being the ‘usual suspect’ in international oil market discussion the rivalry between the Islamic Republic of Iran and the Kingdom of Saudi Arabia opens yet another chapter of what seems to be a steady demise of the function the Organisation had been set to play at the time of its establishment. The Iran-Saudi rivalry, which reverberates in conflict-ridden Syria and Yemen, is the key development impacting the global oil order in a profound way. The petroleum cartel’s main function – oil price-setting by production-adjusting – was put into question at the OPEC’s 27th November 2014 meeting. Following the meeting commentators pointed out structural changes within the group involving OPEC’s cohesion and ability to manage the oil market.<sup>1</sup> The Organisation’s long-standing policy of defending the oil price by setting the group’s output ceiling to prevent reduction of revenues from international oil trade has been the key ‘weapon’ OPEC has had at its disposal to defend a ‘fair price’ of crude. Indeed, since its foundation and throughout the ‘oil shocks’ of the 1970s, OPEC was the key player in international political economy of petroleum trade exercising the production-quota leverage, a power which the group arguably no longer enjoys. Recurring oil price crises has been pushing the group to reach out to the non-OPEC producers to alleviate the impact of ups and downs of the global oil market’s supply and demand sides.

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<sup>1</sup> Lawler, A., Sheppard, D. and El Gamal, R., ‘Saudis block OPEC output cut, sending oil price plunging’, Reuters, 28 November 2014. <http://uk.reuters.com/article/us-opec-meeting-idUSKCN0JA00320141128>.

At the backdrop of the structural changes, the Group's consultations with non-OPEC producers such as Russia, the third largest oil producer<sup>2</sup>, provide for a new mechanism of oil governance. It is believed that Saudi Arabia's unquestionable leadership position and its ability to influence international oil dynamics is reaching its limits<sup>3</sup> and a more dynamic oil outlook may be emerging in the coming years. Bearing in mind volatile trends on international oil markets as well as possible changes on the global oil supply and demand sides the Saudi domination may be further undermined by the arrival of new market players. The 'usual suspect' in this respect is the US unconventional production which in a large part has been idle in response to the Saudi-Iran market share competition. The shale plays are there to stay due to robustness of scalability of smaller projects of scalable producers. Any loss of the Kingdom's oil output parity within OPEC is likely to strengthen Iran's position on the market, however, Asia is likely to remain Tehran's main export destination.

### 3. Iran's Reintegration into the International Oil Markets

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Lifting of the international sanctions against Tehran in January 2016 brought Iran away from economic isolation opening up the way for increased exports of crude to global oil market. With the energy sector in mind Iran has embraced the focus on oil export maximisation inevitably influencing the price of oil as it is becoming re-integrated into the world economy.<sup>4</sup> According to International Monetary Fund (IMF), the Iranian Economy Outlook is likely to be positive for both oil and non-oil economy. Yet, the ongoing transition to lower oil prices is putting pressure on exporters which can only be mitigated by higher oil export volumes in order to increase oil revenues.<sup>5</sup>

<sup>2</sup> Russian oil production stood at 10838 thousand barrels of oil daily (tbod) while the US's was 11644 tbod according to the BP Statistical Review of World Energy, June 2015. <https://www.bp.com/content/dam/bp/pdf/energy-economics/statistical-review-2015/bp-statistical-review-of-world-energy-2015-full-report.pdf>.

<sup>3</sup> Eaton, C., 'Saudi energy minister says oil glut has vanished', *Houston Chronicle*, 22 June 2016. <http://www.houstonchronicle.com/business/article/Saudi-energy-minister-says-oil-glut-has-vanished-8317909.php>.

<sup>4</sup> 'Dawn of a new era as Iran sanctions lifted', *Al-Jazeera*, 17 January 2016. <http://www.aljazeera.com/news/af-rica/2016/01/iaea-iran-complied-nuclear-deal-160116205507774.html>.

<sup>5</sup> Lipton, D., 'Iran—Achieving its Potential in the Global Economy', *Speech by David Lipton First Deputy Managing Director, IMF Central Bank of Iran*, May 17, 2016. <https://www.imf.org/external/np/speeches/2016/051716.htm>.

Post nuclear sanctions environment forecasts assume the potential growth of oil production in Iran in a short to mid-term with the natural gas supply to continue. Iranian oil production rebound took many analysts by surprise and, contrary to what was believed to take years, the Islamic Republic's production has reportedly returned to the pre-sanctions levels at the time of writing this paper.<sup>6</sup> Iranian supply of oil rose to almost 3.6 million barrels per day (mb/d), a level last hit in November 2011, that is before tightening of the sanctions.<sup>7</sup> Increased production of Iranian crude is a trend that puts the country in a very interesting position on the markets as it is regaining its production levels to the pre-sanctions level and improving Iran's export standing. With a circa 2mb/d earmarked for exports Iran is currently right after Iraq (nearly 4.4 mb/d) and Saudi Arabia (nearly 10.20 mb/d), placing at the helm of OPEC's exporters. Taking a global oil perspective, Iran is the fourth-largest producer after Iraq, Saudi Arabia and the Russia Federation. Iran enjoys a fairly steady portfolio of consumers which is mainly outside of Europe. The key export destinations of the Iranian oil include China, Japan and India, countries which are witnessing substantial demand needs over the last couple of months.<sup>8</sup> Unrestricted production and exports of oil by the Iranian Government puts the National Iranian Oil Company (NIOC) in a unique position but, at the same time, raises the question of production ceilings. The statement by the Saudi Arabia's new Oil Minister, Khalid Al Falih suggests scepticism over Iran's ability to continue accelerating to further acceleration of Iranian oil production.<sup>9</sup> Externalities are still looming high on the Iranian economic re-integration agenda. What Tehran is still being held back by is the remaining international sanctions which keeps the main banking players away. With the ongoing 'war of attrition' with Saudi Arabia over the market share Iran is seeking options to fully resume business activities in the oil sector which according to commentators is still likely to take some time.<sup>10</sup>

<sup>6</sup> McDonald, M., 'Iran's Oil Production is Slowing Fast', *OilPrice*, 27 June 2016. <http://oilprice.com/Energy/Energy-General/Irans-Oil-Production-Is-Slowing-Fast.html>.

<sup>7</sup> International Energy Agency, 'Oil Market Report', 12 May 2016. <https://www.iea.org/media/omrreports/fullissues/2016-05-12.pdf>.

<sup>8</sup> International Energy Agency, 'Oil Market Report', 12 May 2016. <https://www.iea.org/media/omrreports/fullissues/2016-05-12.pdf>.

<sup>9</sup> Sheppard, D. and Hume, N., 'New Saudi oil minister signals end to glut', *Financial Times*, 22 June 2016. <http://www.ft.com/cms/s/0/29d0cef2-389c-11e6-a780-b48ed7b6126f.html#axzz4CvA1a0l2>.

<sup>10</sup> Raval, A., 'Iran fulfils pledge to raise oil production', *Financial Times*, 24 May 2016. <https://next.ft.com/content/64ec9f9a-218e-11e6-9d4d-c11776a5124d>.

## 4. Saudi Arabia's Over-Production and Over-Supply

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The OPEC's Doha talks on 17 April 2016 aimed at achieving the first global oil deal in 15 years among the world's major oil producing nations. Nevertheless, the objective of the meeting proved to be beyond producing conclusive results.<sup>11</sup> Fiasco of the Doha talks coincided with the rise of Prince Mohammed bin Salman Al Saud, the deputy crown prince of Saudi Arabia and Minister of Defence, as the key oil decision maker of Saudi Arabia.<sup>12</sup> Prince Mohammed's stance on the low price of oil and insistence on a collective freeze of oil production that includes Iran indicated the Kingdom's readiness to continue increasing the crude output. Saudi Arabia's decision resulted in upholding the 'oil glut' by continued over-production with the primary reason behind Saudi's actions to turn its crude into 'oil weapon' that could wipe out Iran from the global oil competition. As a result, Saudi Arabia's crude oil production reached nearly 10.2 mb/d in April 2016 making the Kingdom the largest oil producer globally.<sup>13</sup> Yet, the face of Saudi petroleum is changing and driven by new ideas and Prince Mohammed's conviction on inevitable need to shift away from dependence on oil revenue stream in a long-term perspective. A blueprint of broader economic and social changes in Saudi Arabia includes creation of world's largest sovereign wealth fund with more than \$2 trillion in assets, restructuring Saudi Aramco, the Kingdom's energy champion, and diversifying away from petroleum assets and, thus, ending the Saudis' nearly total dependence on oil for revenues.<sup>14</sup> Saudi Arabia's plan to pursue a large-scale modernisation of its economy to reduce its dependence on crude sales includes expanding on the manufacturing industry partly by using oil-based chemicals to produce materials such as plastics that can be used in manufacturing of other consumer products.<sup>15</sup> This political shift is likely to receive substantial support among energy consuming regions. The country has been criticised for its excessive use of energy in the past and need for reform of its energy market (in particular the problem of energy subsidies) are yet to be tackled. Having said this, Saudi Arabia's internal energy consumption levels have been discussed in the context of energy efficiency and progressive liberalisation of what is a system relying heavily

<sup>11</sup> Raval, A. and Sheppard, D., 'Oil price tumbles on Doha deal stalemate', *Financial Times*, 18 April 2016. <https://next.ft.com/content/7584b5e4-045c-11e6-a70d-4e39ac32c284>.

<sup>12</sup> Khalaf, R., 'Collapse of Doha talks highlights the rise of Mohammed bin Salman', *Financial Times*, 18 April 2016.

<sup>13</sup> International Energy Agency, 'Oil Market Report', 12 May 2016, p. 16. <https://www.iea.org/media/omrreports/fullissues/2016-05-12.pdf>.

<sup>14</sup> Waldman, P., 'The \$2 Trillion Project to Get Saudi Arabia's Economy Off Oil', *Bloomberg*, 21 April 2016. <http://www.bloomberg.com/news/features/2016-04-21/the-2-trillion-project-to-get-saudi-arabia-s-economy-off-oil>.

<sup>15</sup> Mahdi, W. and Dipaola, A. 'Aramco, Sabic One Step Closer to Turning Oil Into Chemicals', *Bloomberg*, 28 June 2016. <http://www.bloomberg.com/news/articles/2016-06-28/saudi-aramco-sabic-one-step-closer-to-turn-oil-into-chemicals>.

on state subsidies. The move towards economic diversification as discussed above is a step to address both the internal as well as external energy challenges by a degree of diversification and, perhaps, in the future liberalisation of the Kingdom's energy sector to meet the ambitious assumptions as set out by the Kingdom's leaders.

## 5. Saudi Arabia and Yemen

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While a lot focus has been devoted to the Syrian Civil War and the impact it has regionally and internationally, less spotlight has been on the tip of the Arab peninsula. Conflict-thorn Yemen has been the key bone of contention between Saudi Arabia and Iran. Following the end of the Yemeni Civil War a coalition of Arab countries led by Saudi Arabia have supported the domestically contested Yemeni government while conducting airstrikes of what it considers as armed rebels, the Houthis. Saudi Arabia-Yemeni relations have a long history of political animosity, a trend that continues until the present day.<sup>16</sup> Yet, the latest conflict comes in very complex time. Post-sanction Iran has been voicing opposition to the Saudi Arabia's military intervention in Yemen seeing it as leveraging the balance of power in the region. The Saudi Arabia-led coalition in Yemen which started in 2015 has been backed by nine Arab states. Since the start of the intervention United Arab Emirates (UAE) has been the main backer of Saudi Arabia until June 2016 when it has decided termination of combat operations to exert pressure on the Saudi. Ending combat operation on part of the UAE is likely to change dynamics on the ground in Yemen and may limit Saudi Arabia's ability to fight the proxy war. Any change in the balance of power in the conflict holds a promise of benefiting interests of the Islamic Republic, Saudi Arabia's main regional rival.

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<sup>16</sup> Nasser, A., 'How long can Saudi Arabia afford Yemen war?', *Al-Monitor*, 21 January 2016. <http://www.al-monitor.com/pulse/originals/2016/01/yemen-war-saudi-arabia-economic-repercussions.html#ixzz4ACQkzzf8>.



## 6. Other Players and the Regional Energy Politics

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### 6.1. Iraq and KRG

The oil glut has an impact on other existing and prospecting producers in the Middle East. Iraq, the second-largest OPEC producer after Saudi Arabia, has been seeking to increase its oil output up to 6 mb/d by 2020, a strategy which has been viewed with scepticism by major oil companies operating in the country. In 2015 the Iraqi Federal Government's ability to pay the oil companies involved in production of the crude in the country has been affected by financial matters which worsened due to low prices of oil and the war in the north of the country. Internal Iraqi politics – the Federal Government's conflict with the Kurdistan Regional Government (KRG) and political infighting in Baghdad – puts a strain on the country's oil production increase strategy.<sup>17</sup>

Fragmentation of the Iraqi energy governance structure remains a key challenge. The long-running dispute over the oil revenue sharing between the Central Government in Baghdad and the KRG has been exacerbated by the low price of crude hitting the oil-based revenue stream and prolonging the hiatus between Baghdad and Erbil.

Political and security challenges in Iraq are high on the agenda having increased volatility of the bargaining power between Erbil and Baghdad in particular as much as the status of oil-rich Kirkuk region is concerned.<sup>18</sup> KRG capital Erbil has witnessed oil revenue sharing has falling significantly which in turn has coincided with political upheaval and uncertainty in Baghdad. The KRG's geopolitical locus – interconnection to Turkey and ability to export crude directly to the consumer countries via Turkey – has benefited Erbil's external trade options while disentangling from the Central Government in Baghdad. Exports of the KRG oil has continued through pipeline to Turkey generating significantly lower revenues due to low oil price. KRG exported circa 0.5 mb/d in May 2016 using the oil pipeline.<sup>19</sup> New transportation and transit options have been looked by both Iran and KRG to strengthen the latter's position on the oil trade market. At the backdrop of the disagreement between Baghdad and Erbil, an idea of connecting KRG with Western Iran through a dedicated oil

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<sup>17</sup> Raval, A., 'Iraq struggles to match January's record oil production', *Financial Times*, 24 May 2016. <http://www.ft.com/cms/s/0/d97a876e-21ca-11e6-9d4d-c11776a5124d.html#axzz4D5CM8rL7>.

<sup>18</sup> 'Kirkuk must join Kurdistan Region, no independent entity, says PUK leadership', *Rudaw*, 28 June 2016. <http://rudaw.net/english/kurdistan/280620166>.

<sup>19</sup> Chmaytelli, M. and Coles, I., 'Kurds ready for new oil deal with Baghdad if they get \$1 billion a month', *Reuters*, 15 June 2016. <http://uk.reuters.com/article/uk-iraq-oil-kurdistan-idUKKCNOZ10D0>.



pipeline was conceived in 2014.<sup>20</sup> If completed the pipeline will increase and diversify KRG's security of oil demand and may well introduce a degree of competition vis-à-vis the existing Turkey-bound outlet. The oil pipeline brings in a new dimension to the contestation over the way revenues should be managed and governed between the Kurdish regional authority and the central government in Baghdad. The ongoing discussion in which KRG says it is ready to strike a deal with the central government subject to a share of US\$1 billion a month. While such a deal is rather unlikely in the current political context, advancing the Iran-championed oil pipeline would enhance the KRG's economy.

## 6.2. *Turkey, Israel and Russia*

Outside of the OPEC countries of the region, Turkey is likely to be re-entering a new phase in its relations with Israel and Russia. Turkey and Israel had witnessed steady deterioration of relations since arrival of the Justice and Development party to power in Ankara. Their relations abruptly deteriorated following the 2008 Davos developments<sup>21</sup> and, two years after that, the Gaza flotilla raid by Israeli defence forces. The Turkish – Russian political spat is a recent foreign policy dilemma of Ankara. Shooting down of the Russian military aircraft by Turkish forces in the vicinity of the Syrian-Turkish border in November 2015 brought the Ankara-Moscow cordial policy dialogue – including in the energy domain – to a standstill.<sup>22</sup> While the mechanics of Ankara's policy of reconciliation with Israel and Russia are yet to be established, it already opening a number of energy opportunities. Cancellation of the US\$ 11 billion-worth Turkish Stream natural gas pipeline designed to diversify Russia's gas export routes was a serious blow to Ankara's hopes for securing additional sources of supply to meet the country's growing energy demand. Warming up of Russia-Turkey relations facilitates reversal of the policy and, as emphasised by the head of Russia's Gazprom, the natural gas company is ready for dialogue.<sup>23</sup>

<sup>20</sup> Khajepour, B. 'Iran's pipeline politics reaches Iraqi Kurdistan', *Al-Monitor*, 29 June 2016. <http://www.al-monitor.com/pulse/originals/2016/06/iran-kurdistan-regional-government-pipeline-energy-deal.html>.

<sup>21</sup> Katrin Bennhold, 'Leaders of Turkey and Israel Clash at Davos Panel', *The New York Times*, 29 January 2009. [http://www.nytimes.com/2009/01/30/world/europe/30clash.html?\\_r=0](http://www.nytimes.com/2009/01/30/world/europe/30clash.html?_r=0).

<sup>22</sup> Katz, M., 'Russian-Iranian Relations after the Iranian Nuclear Accord', *Harvard's BelferCenter*, 29 June 2016. <http://iranmatters.belfercenter.org/blog/russian-iranian-relations-after-iranian-nuclear-accord>.

<sup>23</sup> 'Turkish Stream project to resume after Erdogan apology', *RT*, 29 June 2016. <https://www.rt.com/business/348872-turkish-stream-project-financing/>.

After more than six years of the split between Israel and Turkey in the 27 June 2016 both parties announced a reconciliation deal.<sup>24</sup> Normalisation of Israeli – Turkish relations are expected to flourish in energy security and energy diversification or, more broadly, economic cooperation in the energy.<sup>25</sup> Israel's offshore production is in its large part destined for exports and requires long-distance gas pipelines to deliver the resource to the demand centres. If realised, both the Turkish Stream connection to Russia via the Black Sea and the offshore interconnection to Israeli gas infrastructure enhances Ankara's long-standing aspiration to become a regional energy trading hub.

## 7. Iran–Saudi Relations – the Litmus Test for Global Oil Supply

Current political-economic developments in the Middle East have reverberated around arch-rivalry between Teheran and Riyadh. In a petroleum domain the conflict between the two regional powers is quintessentially economic. Iran's reintegration into global economy and the country being poised to gain from the post-sanctions trade in oil puts pressure on the Saudis as well as other OPEC and non-OPEC states. Within OPEC, Saudi's insistence on cutting production to an agreeable level backfires due to difficulty with ensuring full compliance and enforcement of the rule among the group members. Going beyond OPEC, the Saudis' focus on Iran alone is unlikely to provide measured response to the global oil supply. Indeed, the freeze in production makes little or no effect even if complied with by Teheran in presence of non-OPEC Russian production. For the Saudis to make any significant impact is to freeze output in concert with Russia and Iran.<sup>26</sup> Following the meeting between Saudi Prince Mohammed and Russia's President Putin it was announced by the Energy Minister Alexander Novak on 27th January 2016 that Russia was prepared to discuss supply cut at the level of 3–5 percent or 300,000 – 500,000 barrels

<sup>24</sup> Opall-Rome, B., 'Israel, Turkey announce reconciliation deal', *Defence News*, 27 June 2016. <http://www.defense-news.com/story/defense/international/2016/06/27/israel-turkey-reconciliation-relations/86433120/>.

<sup>25</sup> 'Turkish – Israeli economic, trade ties expected to soar after deal', *Hürriyet Daily News*, 27 June 2016. <http://www.hurriyetdailynews.com/turkish-israeli-economic-trade-ties-expected-to-soar-after-deal.aspx?PageID=238&NID=100945&NewsCatID=510>.

<sup>26</sup> Raval, A. and Sheppard, D., 'Oil price tumbles on Doha deal stalemate', *Financial Times*, 18 April 2016. <https://next.ft.com/content/7584b5e4-045c-11e6-a70d-4e39ac32c284>.

per day (b/d). There is, however, little evidence the deal could be moved forward and, as suggested by the market leading analyst, such a deal is unlikely to materialise.<sup>27</sup>

## 8. Conclusion

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The global energy continues to be driven by political economy of oil production and trade. The Middle East continues to play enormous role on the global supply of crude less so the OPEC structure. Production outside of the group has been ramped up in recent years by new supply from the unconventional production in the US, a trend which is likely to continue impacting the conventional production. The evidence of that has been the Saudi-Iran rivalry over the market share following Iran's re-introduction to international oil trade at pre-sanctions levels. Energy markets have made a full circle returning to the fundamentals: oil is there to stay and play important role in the era of slow melting of the oil surplus.

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<sup>27</sup> Henderson, J. and Fattouh, B., 'Russia and OPEC: Uneasy Partners', Oxford Institute for Energy Studies Energy Comment, February 2016. <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2016/02/Russia-and-OPEC-Uneasy-Partners.pdf>.

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