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Current Political Situation in the Middle East and Oil Supply

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I. Regional Politics in the Persian Gulf and the Backdrop to Oil Market Conditions

Long term Call on OPEC of 40 to 50 million barrels a day by 2025 cannot be met unless oil production investment programs in Iraq, Iran and Saudi Arabia are sharply expanded from current activity. Problems remain on the horizon, creating uncertainty in the international oil market.

Looming problem if solution not found to the possibility of more broadly based Iraqi civil war on many levels…

Fears that a Shia-Sunni civil war in Iraq could spread as a proxy war beyond Iraqi borders…

A. Saudi Concerns about the future of Iraq

"The real danger is in the division that is being projected between the Arabs of Iraq, dividing them into Shias and Sunnis, especially a separate entity for both…this is a recipe for bringing the countries around Iraq into conflict themselves. You have Iran on one side which will come in with the Shias. We have the Turks on the other side who will come in to fight with the Kurds, and the Arabs will definitely be dragged into the fight on the part of the Sunnis."
"Several years ago, we fought a war with the United States and Saudi Arabia in order to save Iraq from the occupation of Iran. Now it seems that Iran is being handed Iraq on a golden platter. So this is something that the U.S. must think about. Unless the Sunnis and Shias are brought together in a majority government to hold the country together, it will disintegrate into civil war. And then, the whole region will also disintegrate and conflicts that we have not dreamt of in the past will be facing the international community."

--HRH Prince Saud Al Faisal Bin Abdulaziz Al-Saud, Saudi Foreign Minister at the Baker Institute on September 21, 2005

B. Saudi concerns about Iranian actions and intentions --post Lebanon

Saudis were extremely concerned about the situation in Lebanon. Early in the crisis, Riyadh issued a strong rebuke against Hizbollah. Saudi Arabia even indicated a willingness to build an Arab coalition to push for the permanent disarmament of Hizbollah, were the US able to constructively engage Israel. Saudi officials have expressed concerns about Iran's activities in Lebanon, Iran's activities in Iraq and about Iran's nuclear program.

Tehran has already threatened to withdraw its oil from the market in the exchange of rhetoric regarding UN response to its nuclear weapons program. But this option may be constrained by the ability of other regional oil producers to increase production to make up for any Iranian shortfall.

Well-respected Saudi analyst Nawaf Al-Obaid, who is the Managing Director of the Saudi National Security Assessment Project, published an article "Saudi Arabia's Strategic Energy Initiative" asserts that Saudi Arabia will be able to replace all of Iran's exported oil, if necessary. Writes Al-Obaid, "…if Iran responds to UN-imposed sanctions by cutting its oil exports – which its foreign minister implicitly threatened to do this month when he said that the 'first consequences of these sanctions would be an increase in the price of oil to around $200 per barrel' –the impact won't be as severe as many think. In fact, the Kingdom has largely succeeded in achieving this goal (to be able to replace Iranian exports)."[1] He adds, "Saudi Arabia not only has a strategic interest in reigning in Iran, but it is well positioned to do so. With the price of oil at a high, the kingdom's influence as the world's central banker of energy is at its apex, making it the economic powerhouse of the Middle East."

However, Iran's geographic proximity to the Strait of Hormuz and its active intervention in internal conflicts inside Iraq could have serious consequences for its ability to assert itself in oil markets.

To circumvent other regional producers like Saudi Arabia from replacing lost Iranian oil supply under a conflict scenario, Iran could resort to military means to threaten flows of Arab oil. Such threats would not necessarily have to take the form of armed military

[1] http://www.saudi-us-relations.org

campaigns but rather could include terrorist attacks on Arab oil facilities or even fomenting of political unrest in oil producing regions inhabited by Shi'a populations.

Saudi Arabia is well aware of the threat of Tehran to Iraq and to the Gulf. One scenario is that Saudi Arabia may choose to keep oil markets more oversupplied than in the past to put Iranian regime under financial pressure.

Iran's economy remains its Aquilles heel. Rapid growth in government spending and liquidity would be hard to sustain at lower oil prices. Domestic inflation is expected to worsen while oil sector capacity constraints are expected to contribute to a slowing of GDP growth. Price controls on fuel continue to plague Tehran, which is running a budget deficit over $15 billion a quarter to support rising gasoline imports. Iran is using its Oil Stabilization Fund to supplement government spending and to lend to domestic firms in lieu of available international capital which is increasingly drying up because of political risk related to a possible conflict over the nuclear program. Capital inflows have slowed dramatically in 2006-2006, with many Iranians also moving funds out of the country. But foreign exchange reserves equal $47 billion or about 10 months of overall imports and are expected to keep rising, as long as oil prices remain high. GDP is also growing but so is inflation, and the Iranian economy is considered highly vulnerable to downward oil price trends, which gives Saudi Arabia –whose foreign reserves are flush-- some leverage over Tehran.

Iran's oil industry

Many of Iran's main existing oil fields are on the decline, including Gaqsaran and Ahwaz which are declining at the rate of 10% per annum (or about 300,000 b/d). To reverse this trend, Iran must bring on new fields, but bureaucratic infighting and uncertainty about possible international sanctions against Iran is slowing the signing of new deals for oil field investment.

Sector mismanagement and delays are endemic in Iran and it remains unclear how quickly Petro Iran will be able to get a development plan in place for key fields such as the Agadezan field. Observers believe that new production from the field, initially slated for 2008, could be pushed back at least two years. The development of Agadezan is considered particularly sensitive given its proximity to the Iraqi border and the important Iraqi Majnoun field. Plans for development of the Ahwaz-Bangestan field are experiencing similar delays while the South Pars project –involving Shell, Total, and Repsol YPF, appears to be on track.

Iraq's Oil Industry Outlook

Iraq's Constitution has created ambiguities about the future control of new oil and gas development in Iraq.

Article 111:

> "Oil and gas are owned by all of the people of Iraq in all regions and governorates."

Article 112:

> "(a): The federal government, with the producing governorates and regional governments, shall undertake the management of oil and gas extracted from present fields, provided that it distributes its revenues in a fair manner in proportion to the population distribution in all parts of the country, specifying an allotment for a specified period for the damaged regions which were unjustly deprived of them by the former regime, and the regions that were damaged afterwards in a way that ensures balanced development in different areas of the country, and this shall be regulated by a law."
>
> "(b): The federal government, with the producing regional and governorate governments, shall together formulate the necessary strategic policies to develop the oil and gas wealth in a way that achieves the highest benefit to the Iraqi people using the most advanced techniques of the market principles and encouraging investment."

Article 115:

> "All powers not stipulated in the exclusive powers of the federal government belong to the authorities of the regions and governorates that are not organized in a region. With regard to other powers shared between the federal government and the regional government, priority shall be given to the law of the regions and governorates not organized in a region in case of dispute."

Oil production

Iraqi Oil production fell in late 2005 / early 2006; and is averaging only 2 million barrels per day (mbd), well short of the government's projected target of 2.5 mbd for 2006. Fortunately for the government, prices have been higher than projected, making it possible for Iraq to meet its budget revenue targets.

U.S. grant aid of $1.72 billion was allocated for reconstruction of the oil sector under the Iraq Reconstruction and Relief Fund II, but the effort lacked proper coordination and oversight, failed to establish a strategic vision for prioritization, and has not resulted in the expected improvement in oil production.

Exports

Lack of storage facilities has hindered exports from the Gulf, while a successful insurgency attack on a crude processing unit at Baiji in the north has thwarted an increase in crude exports via Turkey.

Outlook

There has been little or no investment in the oil sector to date organized by the central government. The main reason for this lack of investment has been the politicization of the oil ministry, the absence and/or exodus of trained personnel, and poor/corrupt management.

Water Injection operations at the large southern field of Rumaila have not been fully successful due to lack of technical expertise among workers implementing reservoir management and water recovery operations, and there are fears that reservoir damage might be sustained to this field which is the backbone of current Iraqi production. The lack of adequate security poses a major challenge for the government in the oil sector. Projects are stymied, investment is deferred, and productivity is compromised. It is possible that Iraq's production could wind up going down, before the country is able to restore its industry and generate new investment in existing and new fields to get production back on an upward trajectory.

Senior members of Iraq's oil industry argue that a national oil company could reduce political tensions by centralizing revenues and reducing regional or local claims to a percentage of revenue from local production. However, regional leaders are suspicious and resist this proposal, asserting the rights of local communities to have direct access to the inflow of oil revenue.

Devolution in the oil sector

Kurdish leaders have been particularly aggressive in asserting independent control of their oil assets, signing and implementing investment deals with foreign oil companies in northern Iraq. Shi'a politicians are also reported to be negotiating oil investment contracts with foreign companies for development activity in the south.

SCIRI –best organized, led by Abdel Aziz Al-Hakim, seeking Majnoun field development, known for strong links to Iran; Badr Organization of Reconstruction and Development includes militia of 25,000; considered largest Shi ite militia in Iraq

Risaliyoun –Led by Muqtada al-Sadr, Mahdi army with main support base among poor areas of Baghdad and Basra; includes estimated militia of 10,000

Grand Ayatollah Sayyed Ali Al-Sistani --grassroots network organization believed to include thousands of students, activists and members; considered best organized religious organization

Foreign groups pursuing MOU for Kifl field in south

Kurdish Regional Government (KRG) passed draft oil law and signing new deals

Norway's DNO drilled well Tawke-1, under PSA agreement with KRG

Heritage Oil has MOU for several fields in Irbil-Mosul area, studying areas near Taq Taq oil field

Canada's Western Oil Sands subsidiary, WesternZagros, enters into PSA with KRG for a block in the Zagros Fold belt

Bina Bawi field includes stakes for Prime Natural Resources, Petoil of Turkey and Oil Search of Papua New Guinea

Iraq Ministry of Oil tells companies that companies with deals without its approval will be blocked from working in new areas but so far, its purview seems to be getting eroded.

Need for US Support To Realign Iraqi Oil Sector

The U.S. government should urgently support the Iraqi government's current efforts to negotiate a political consensus on the dispensation of oil revenues and investment in new assets.

The U.S. should also provide technical assistance to the Iraqi government in preparing urgently a transparent and clearer draft oil law that defines the rights of regional and local governments and creates a fiscal regime for both State and privately owned companies in the sector.

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