Heightened Geopolitical Risks in the Middle East and Potential Impacts on Oil Markets

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Changing Nature of Geopolitical Risks

• The nature of geopolitical risks in MENA region have changed and are becoming more complex
  – Reconfiguration of borders
  – Fragmentation of some states and rise of non-state actors and local power centers
  – Consolidation of power with domestic and regional repercussions
  – Heightened regional confrontation and proxy wars
  – Changing roles of international and regional actors

• Overall, there has been a general deterioration in the geopolitical backdrop, but the short-term impacts on oil and gas markets have been limited
  – Output losses from the region have been limited in the last few years
  – Libya output has recovered from low levels (but below its pre-2011 levels)
  – Did not preclude OPEC/NOPEC reaching an agreement on oil output cut
  – When stocks were high, the market barely reacted to geopolitical flashpoints

• However, geopolitical backdrop is having some more subtle longer-term impact
  – Higher spending requirements which require higher oil prices
  – Affecting the long-term productive capacity of many oil producers
    • Will the lowest cost producers be able to develop their reserves?

• As the overhang has been eroded and spare capacity is thin, geopolitical events will have bigger impact on markets, but the impact will remain small in the absence of large supply disruption
Divergent Dynamics: Fragmentation versus Consolidation
Fragmentation and Rise of Non-State Actors

- The eclipse of the central state and its formal institutions in many parts of MENA
  - Weakening of states’ formal institutions (army, security, judiciary)
  - Legitimacy crisis (Libya, Yemen, Syria)
- This has encouraged the proliferation of armed non-state actors and rise of local power centers
  - Hizbollah (Lebanon), Houthis (Yemen), Libya Dawn (Libya), Hashd al-Shaabi (Iraq), YPG (Syria) just to mention few
  - Rise of local power centers who act strategically and can enter in alliances with or against central authority
  - Have control over large areas in a country and can target infrastructure to improve their bargaining position
- Changed the nature of risk facing oil and service companies: can no longer just negotiate with the central government; but also with local power centers and non-state actors for issues such as access and security
Consolidation of Power in Saudi Arabia

- Unprecedented consolidation of power within the hands of Crown Prince Mohammed Bin Salman (MBS)
  - Positioned himself as a reformer with a vision to transform the economy in very challenging times (Vision 2030: Means and an end)
- A decades-old system of consensus rule dismantled
- Absolute power with little checks and balances
- More assertive foreign policy
- Loss of traditional alliances
  - Key branches of royal family sidelined
  - Crack down on the religious establishment
  - Private sector in recession and corruption probe increased uncertainty
- New alliance: Young Saudis
- Is social opening enough on its own?
- MBS will be judged mainly on the performance of domestic economy (success to create jobs for his ‘new’ constituency)
- But then successful delivery on the reforms is key
But Output Disruptions have been Limited
The defeat of ISIS reopened an old dispute between Baghdad and KRG

Baghdad retaking Kirkuk in October meant that KRG lost almost half its oil output

Baghdad limiting flows through the Kurdish pipeline until new deal reached on export volumes and revenue sharing

- Flows on Kurdish pipeline dropped by few hundred thousand barrels
- Partially offset by increase in exports from the South and limited exports to Iran from North

Source: MEES
Libya’s Volatile Output

- After reaching very low levels, Libyan oil output recovered reaching around 1 mb/d in recent months.
- However, output has been highly volatile and the recovery remains fragile as the underlying political problems remain highly unresolved.
- Output volatility affected by closure of pipelines, fields, and terminals and often by local power centers demanding jobs, better pay conditions and demanding higher share of the oil revenues.

Source: Energy Aspects
Outages from MENA have receded as Libya increased its production and Iran resumed its production after the lifting of sanctions.
No Impact on the OPEC/NOPEC Deal

OPEC compliance has been very high defying all expectations

Source: Energy Aspects

Iran less complicating factor in the OPEC/NOPEC deal as country reached its maximum potential with limited upside from here without attracting foreign investment/technology

Note: Shows OPEC average and compliance of five members

OPEC Compliance Rate, %

Iran oil output, mb/d
Impact on Long-Term Productive Potential
The Iran Nuclear Deal: On Life Support?

- Trump refused to certify Iran is complying with the JCPOA but extended nuclear sanctions waiver in January 2018
- But warned that ‘This is the last chance’ putting pressure on Europeans/US Congress to ‘fix the deal’ + announced new targeted sanctions against Iranian entities and individuals
- In public, Iran refusing to renegotiate and it will consider any new conditions as a breach of agreement
- In case US decides to withdraw from the deal, US secondary sanctions that impact non-US companies would snap back into place
- Massive uncertainty affecting investment in Iran’s energy sector

### Table 1: Upstream Contracts Awarded, MOUs for Study, and Heads of Agreement (2016)

<table>
<thead>
<tr>
<th>Operator</th>
<th>Partners</th>
<th>Field</th>
<th>Date</th>
<th>Type</th>
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- Total (50%), CNPC (30%), Petropars (19.5%) South Pars Phase 11 08-Nov Heads of Agreement
- DNO None Changuleh 16-Nov MoU for study
- Pergas consortium None Shadegan / Rag-e Sefid 23-Nov MoU for study
- Schlumberger None Shadegan / Rag-e Sefid / Parsi 27-Nov MoU for study
- PTTEP None Changuleh / Balal / Dalamperi 06-Dec MoU for study
- Shell None South Azadegan/Yadavar/Kish Gas 07-Dec MoU for study
- Gazprom Neft None Changuleh / Cheshmeh Khosh 13-Dec MoU for study
- Petronas None South Azadegan / Cheshmeh Khosh 22-Dec Mou for study

Citing U.S. assets, Total chief says would have to review Iran gas deal if new sanctions arose
Potential Output Growth Constrained in Other Regions

Prior projections that Libya will increase its productive capacity to 3 mb/d will not materialize due to lack of investment in an unstable environment.

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<table>
<thead>
<tr>
<th>Block (field)</th>
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<th>Current output</th>
<th>End-2015 target</th>
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**Gas condensate fields**

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<th>End-2015 target</th>
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<tr>
<td>Miran</td>
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<td>Khor Mor</td>
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**Total:**

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<tr>
<td></td>
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<td>199</td>
<td>446</td>
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KRG’s ambitious plans to increase productive capacity unlikely to be met in the foreseeable future given the constraints on finance and unstable relationship between KRG and Baghdad.

Source: Energy Aspects, IEA
Geopolitical Risk in Tighter Markets
Geopolitical Risks More Important in Tighter Markets

OECD stocks relative to the five-year average Mb

OPEC surplus capacity, mb/d

The crude overhang has been largely eroded as a result of stronger demand and OPEC/NOPEC cuts.

OPEC spare capacity thinner especially when measured as a percentage of global oil consumption.

Source: Energy Aspects, EIA
But Impact Limited in Absence of Large Disruption

Libyan and Nigerian geopolitical supply disruption scenarios, in USD/b

Venezuelan crisis scenarios, in USD/b

Losses from Libya and Nigeria to the January 2017 levels will result in marginal increases in the oil price relative to the baseline forecast

Source: OIES, Oil Price Paths 2018

An unanticipated collapse of the Venezuelan output in 2018 constitutes the biggest geopolitical risk that could, ceteris paribus, push prices well above the $70/b mark