Middle East turmoil: The impact on the energy sector

By Laura El-Katiri,
Independent Energy Analyst

The Middle East has in recent years been shaken by political and economic turmoil to an extent not seen in decades. Escalating conflict and violence in Iraq, Syria, Yemen, Libya and Nigeria have shut down, and increased uncertainty over, considerable volumes of OPEC and Middle East crude oil production. The lifting of international sanctions against Iran since January 2016 has lowered the potential for inter-state conflict, but added pressure on already oversupplied oil markets by planning to raise its production to pre-sanction levels, a contentious issue inside OPEC that adds to the already raw geopolitical tensions across the Middle East region – most principally between Saudi Arabia and Iran.

Yet, all is somewhat different and at the same time strangely familiar when we look at past instances of geopolitical conflict in the Middle East and oil market dynamics. Different in the sense that the oil price decline since mid-2014 has actually rendered much of our previously held perceptions redundant so that conflict and uncertainty in the Middle East translates into a higher risk premium, higher oil prices. While conflict in the Middle East has been intensifying, oil markets have actually been oversupplied and price dynamics reflect this reality on the fundamentals side.

But there is also familiarity. For instance where regional divisions have been evident in Middle East oil producers' position towards collective action on oil markets, where the collapse of global oil prices since 2014 has been accompanied by the decision by the OPEC not to intervene until their most recent meeting in September 2016. This left oil prices to decline as a policy to leave price formation to the market, a policy only now seemingly abandoned although we have yet to see how OPEC will implement its most recently agreed production ceiling.

This is one part of the story. On the other hand, the decline in global oil prices has left the region fundamentally challenged to find ways of coping with a low oil price environment that many expect to last far longer than originally thought. With regional oil producers' budgets remaining exceptionally dependent on oil export revenues – which account in many cases for over 90 per cent of central government revenues – the Middle East remains highly vulnerable to changes in global oil prices. The past two years have hence seen the proliferation of political reshuffles and economic reforms, including cuts to energy subsidies – once deemed an untouchable policy instrument across the Arab world. It is probably also this aspect which has provided the backdrop to the latest OPEC meeting's decision to limit output.

An inconvenient truth

Not everyone in the region felt the collapse in oil prices globally was inevitable. Indeed, the initial reaction of many energy ministers was that the fall in global oil prices would be a temporary event, and that prices would not fall below a certain threshold.

To a certain degree, the initial price drops of prices from a range of US$100-110 per barrel between 2010 to early 2014, down to a more moderate price range of US$80-90 in the later summer 2014 were not yet seen as alarming developments, at least in certain quarters of the Middle East. Nor was there clarity about the duration of the oil price slump. After all, the previous three to four years had been characterised by an unusual degree of price stability on global markets – with various supply-side shocks including supply disruptions in conflict-torn Libya, Nigeria, Iraq and Yemen offset by the decade's most notable supply-side development, the historic surge in US shale oil production from unconventional fields.

Time for economic reform

A further year into the oil price decline, the position of many Middle East oil producers began to tangibly change, with no market fundamentals in sight to come to producers' rescue. Demand for oil has been sluggish, including in growth markets such as China and India. Both Iraq and Iran have ambitions for the near future to maximise their production and revenue stream, the former's oil production having proven fairly resilient to internal political strife, while US shale has shown to be a much more permanent feature of oil markets than many might have originally thought.

With declining oil prices for more than one and a half years, dwindling oil revenues have become a factor in what may yet go down as the most unprecedented reform period in the region's economic history – particularly in the politically more stable countries of the Arab Gulf, such as Saudi Arabia, the United Arab Emirates (UAE) and Qatar.

Mirroring earlier domestic energy price reforms in Iran in December 2010, other Middle East producers – Saudi Arabia, Oman, Bahrain and Qatar – have since engaged in partial or comprehensive reform efforts to tackle domestic energy subsidies, charging their own consumers more realistic prices for energy. This is no small development. Middle East governments have provided citizens with subsidised

energy, water and food as part of their unwritten social contracts – the provision of welfare services and cheap essential products in return for political consent. This basic equation has proven effective in protecting many Middle East oil producers from the kind of political turmoil seen in other parts of the region and in North Africa in 2011 and 2012, generally termed the Arab Spring. Reforming policies of supporting the public through subsidised energy could have proved a risky venture, but economic reform efforts in producers such as the UAE and Saudi Arabia have so far shown the opposite is true, and that economic reform can be achieved even in oil producing states.

Economic reform has since gone a long way in the region. Saudi Arabia, a country in the midst of a generational transition, announced far-reaching plans for what it calls its national economic transformation that is meant to "wean" the country's economy off its "addiction" to oil. The move which has been accompanied by the publication of the first ever comprehensive long-term plan for the country's economy, Saudi Arabia's Vision 2030, has also been marked by the parallel reshuffling of senior government positions, including the retirement of the long-serving oil minister, Ali Al-Naimi, and his replacement by former Aramco CEO Khalid Al Falih, in a new super-ministry of energy. In a parallel step almost overshadowing all other reform efforts, the Kingdom announced the listing of shares of national oil company Aramco on public stock markets in 2017/2018. If and when this plan materialises, this could indeed signify a significant and highly symbolic shift in Saudi policymaking, with wider consequences for the Middle East's regional economic transition and its efforts to move beyond oil.

Shifting role of OPEC

The parallel role of Middle East producers inside OPEC has since assumed a further marked shift from past positions. While there is visible disaccord within the producer organisation – nothing new for long-term observers – about the way in which OPEC should engage within the current low oil price environment, OPEC has in effect turned to an observer role for much of the past few years. This has led various outside observers to predict the "death of OPEC", unable or unwilling to use its collective weight to stabilise world oil prices. The decision by OPEC in September to agree on the first output ceiling in eight years presents a notable break with the past year's policy, although symbolic in nature more than anything else.

The irony is that where OPEC used to be viewed as a cartel interested in driving up oil prices, the group has in recent years been criticised for not acting to raise oil prices above a certain minimum level. This apparent shift in OPEC's role reflects the changing relations between Middle East oil producers and their traditional consumer markets on the one hand, and their security partners on the other hand. With much of the Middle East's incremental supply growth now going into Asia - the world's main growth market for energy demand - traditional markets in Europe and North America are re-defining their relationship to the region's oil producers. The US, formerly import-dependent for a large share of its energy needs, has in recent years evolved into a major centre of energy supply through the exploitation of unconventional oil and gas resources. This makes the US a major competitor on world markets to Middle East producers, in oil and, increasingly, in liquefied natural gas (LNG). US shale producers, and this is another paradox of today's oil markets, may be key winners of the September OPEC agreement if it succeeds in raising the price of oil sustainably.

What the future holds

Uncertainty surrounds the future for the region's oil producers. The duration of the current downward price cycle will affect government budgets throughout the Middle East. Some appear more resilient to longer periods of low revenues than others; Saudi Arabia along with Gulf Cooperation Council members Kuwait, Qatar and the UAE have been engaging in domestic economic reform as one way of responding to increasing fiscal pressures – albeit softened considerably by these countries' significant savings in foreign assets – and parallel popular expectations for the continuation of these states' longstanding socio-economic model. The Middle Eastern state, as central distributor of jobs, incomes and economic opportunities, remains a critical factor in the region's economic and political stability in the long-term. Other countries, particularly Iraq, Syria and Yemen face profound problems that are unconnected with the level of oil prices. High oil prices during the 2000s contributed nothing to these countries' stability. Nor does the political turmoil in the Middle East raise international oil prices as it would have done in the past. Even with war across the Arab Levant and Yemen, alongside global supply disruptions to the crude oil market, oil prices remain relatively low.