
Iranian-Saudi tensions: the energy dimension

David Ramin Jalilvand

In early January 2016, tensions between Iran and Saudi Arabia escalated. The execution of Saudi Shiite cleric Nimr Baqer al-Nimr sparked outrage among the Middle East's Shiite populations. In Iran, the Saudi embassy in Tehran and the consulate in Mashhad were stormed by protesters. Riyadh, in return, broke off diplomatic and trade relations with Iran. Several of Saudi Arabia's allies followed suit and also cut or downgraded their relations with Tehran.

These events mark a new episode in a deep rooted rivalry between Iran and Saudi Arabia. While its bottom line is a quest for regional hegemony, the Iranian-Saudi competition takes different forms and shapes. These include historic animosities between Arabs and Persians, religious differences between Shia and Sunni Islam, a host of political and violent proxy conflicts as well as economic strife. As both Iran and Saudi Arabia hold giant hydrocarbon reserves, it is barely surprising that their rivalry also unfolds in the field of energy.

European energy is likely to be affected by the Iranian-Saudi competition in several regards. Increased oil supplies will be available for the European market. The cycle of low oil prices will be prolonged, which comes as a mixed blessing. On the one hand, Europe's energy import bill is reduced. On the other hand, though, Europe's indigenous production is suffering and Russia's role in European natural gas is likely to be strengthened.

BACKGROUND

In terms of energy, competition between Iran and Saudi Arabia plays out against the backdrop of fundamental change in the international markets. This change includes a drastic decline in global oil prices, the expansion of unconventional oil and natural gas supply and rapidly increasing domestic consumption throughout the MENA region. Iran and Saudi Arabia are forced to respond to these challenges at a time when both countries' respective energy policies are facing substantial challenges at home. In some respects, parallels exist between the two countries, while differences persist in others. Both Iran and Saudi Arabia are facing a rapid expansion of their respective national energy markets. In both countries domestic oil and natural gas consumption has grown more than six-fold since the late 1970s. The increases in domestic consumption are the result of economic and population growth as well as over-consumption due to extremely poor levels of energy efficiency.

The two countries have chosen natural gas as the preferred energy carrier to meet the increasing domestic demand. In 2014, natural gas production was 172.6 billion cubic metres (bcm) in Iran and 108.2 bcm in Saudi Arabia, with consumption at 170.2 and 108.2 bcm, respectively. Both in absolute and relative terms, natural gas has increased its importance in the energy mix, accounting for 61% of Iran's 2014 primary energy consumption and 41% of Saudi Arabia's. As a consequence, Iran's natural gas exports are only marginal (less than 10 bcm/y or 6% of Iran's production) while Saudi Arabia does not export at all. While Iran is sitting on top of the world's largest reserves (34 trillion cubic metres/tcm), Saudi Arabia's natural gas deposits are smaller (8.2 tcm). Hence Iran has therefore the potential to increase its natural gas exports in the future.

Regarding the export of oil, the two countries differ markedly as Saudi Arabia's production and export levels are considerably higher than Iran's. In 2014, Saudi Arabia has produced 11.5 million barrels of oil per day (mbpd) of which it has exported 8.3 mbpd. Iran only produced 3.6 mbpd with exports at 1.4 mbpd. EU and US sanctions reduced Iran's production and exports from 4.4 and 2.6 mbpd in 2011, respectively. Reflecting the differences in

oil production and exports, the relative importance of hydrocarbon exports is larger in Saudi Arabia than in Iran. The export share in Saudi Arabia's combined oil and natural production amounted to 63% in 2014, while only 24% in Iran. Since the late 1970s, the relative importance of exports has declined in both countries from above 90%. But while Saudi Arabia is still exporting more than half of its combined oil and natural gas production, Iran's energy sector is mostly serving the domestic market today.

As a result of Saudi Arabia's higher export levels, the Kingdom is receiving substantially more oil export revenue than Iran. Therefore Saudi Arabia was able to amass vast financial reserves, allowing the kingdom to endure low oil prices much better than Iran – at least in the short-term. In the mid-to long-term, Riyadh's budget is more vulnerable to protracted periods of low oil prices. In contrast to about one-third in Iran, 80% of Saudi Arabia's government budget stems from oil exports.

STATE OF PLAY

Two factors provide the framework for Iranian-Saudi competition in the energy field. First, the July 2015 nuclear deal. Since 2010, EU and US sanctions have reduced Iranian oil production and exports, slowed the expansion of natural gas production, prevented Iranian liquid natural gas (LNG) exports, and forced Western companies to leave the country. Although significant other obstacles will continue to remain in place, the nuclear deal – if fully implemented – will lead to the lifting of several energy and financial sanctions and thereby allow Iran to assume a greater role in international energy.

Second, Iran and Saudi Arabia are competing in international energy markets that have increasingly become buyer's markets. Since mid-2014, oil prices have radically declined: in the case of Brent, from above 110 to around 30 USD per barrel in late January 2016. Oil producers are forced to compete for market shares. Saudi Arabia played a key role in bringing down international oil prices and – though certainly not intended by Riyadh – turning energy into a buyer's market. During the past two years, Saudi Arabia did not cut its oil production, thereby allowing global oil supply to exceed demand. In the past, as the cartel's leading power, Saudi Arabia has repeatedly enforced OPEC production cuts in order to maintain certain price levels. In 2014, however, the situation was different. The high oil prices of the early 2010s made the exploration and development of alternative reserves economically viable. In North America, the production of unconventional oil and natural gas became commercial, leading to a surge in global production.

The apparent rationale behind Riyadh's decision not to cut its oil production was to force competition from North American shale out of the market by bringing down the price of oil. The production of unconventionals comes with extremely high operational costs while Saudi Arabia is enjoying the world's lowest production costs. Had Saudi Arabia cut its production, the Kingdom would have lost in two ways: by losing market shares (reducing the Kingdom's strategic role in global energy) as well as by keeping oil prices high (benefitting the competition from unconventional producers).

Harming Iran was, from the Saudi perspective, a positive side-effect. In contrast to Saudi Arabia, Iran does not hold large financial reserves and assets abroad were frozen due to sanctions. Although generally more dependent on oil revenue than Iran, Saudi Arabia seemingly believed to have a position of strength, being able to endure a period of lower oil prices better than its rival. By early 2016, however, when tensions between Riyadh and Tehran escalated, it became clear that Saudi Arabia's calculus did neither succeed in the international energy markets nor *vis-à-vis* Iran. Saudi Arabia was successful to the extent that oil prices were brought down to levels at which it was believed North American shale oil would not be able to compete. Indeed, many unconventional rigs were forced out of production. On the whole, though, North American shale oil was much more resilient than expected. At the same time, global oil demand has weakened, first and foremost due to slower economic growth in East Asia, especially China. Thus, despite the dramatic oil price decline, the production of unconventional oil did not collapse – mainly due to increased productivity. Meanwhile, global demand turned out weaker than expected. As a result, oil markets are currently over-supplied. At least under these particular circumstances, Saudi Arabia appears to have lost its ability to act as the world's swing producer, effectively regulating the supply-demand balance in global oil.

Iran was less affected by the oil price decline than expected. Tehran experienced the major fiscal shock already earlier, in 2011/12, when tough EU and US energy and financial sanctions came into play. Since then, Tehran has introduced a series of adaptation measures, labelled the "resistance economy". These included the increase of non-oil taxation and the promotion of non-oil economic growth, partly on the basis of the domestic use of Iran's energy production. Thus, when oil prices declined in 2014/15, Iran was more or less prepared. Despite

experiencing severe budgetary pressure, Tehran proved able to cope with the reduction in oil revenue, expanding its resistance economy-policies.

Against this background, as the Iranian-Saudi crisis has now reached a new high and both sides can be expected to intensify their competition (also) in the international energy markets, it appears as if Iran's position *vis-à-vis* Saudi Arabia has somewhat strengthened. Iran's government budget, due to its lesser dependence on oil, is better prepared to endure a longer period of low oil prices, with Saudi Arabia experiencing much greater pressure from low oil prices than Iran. Tehran was able to bring down the oil revenue share in its government budget for the upcoming Iranian year, starting 20 March, to 35%. The remainder will stem from non-oil sources, including increased taxation. Saudi Arabia, however, does not appear ready to drastically reduce its 80% government budget dependence on oil. According to the International Monetary Fund (IMF), Saudi Arabia's financial reserves will be depleted within five years, should oil prices and government spending remain at current levels.

The countries' oil export policies are likely to be affected by their different fiscal situations. Iran has recently stepped back from previous statements to reclaim its pre-sanctions market share as quickly as possible, regardless of price considerations. However, the country can still be expected to raise its exports of oil, thereby possibly delaying the recovery of oil prices. Saudi Arabia, however, finds itself in a quagmire. Cutting oil exports would benefit the competition from higher-cost producers, both conventional and unconventional, as much as Iran's comeback to international energy, while losing market shares at the same time. Increasing oil production and exports levels would enhance the global oversupply and thus risks further bringing down oil prices. Therefore, a continuation of current oil export policies, i.e. neither supply cuts nor increases, seems likely.

In the case of natural gas, Iran is still several years if not decades away from markedly increasing exports. However, time is on Iran's side. Because of rapidly growing consumption, most countries in the Middle East and South Asia will need to increase imports in the upcoming years. In this context Iran, with the world's largest reserves, is hard to ignore. This is also the case for gas-short countries in the Persian Gulf, which should have little interest in becoming overly reliant on Qatar as their sole source of supply. For Tehran's regional position, potential future gas exports are already a strategic asset today, increasing the country's relevance and attractiveness as a partner. Saudi Arabia, challenged to meet its own demand, will not be able to export any natural gas.

PROSPECTS

Energy competition between Iran and Saudi Arabia is likely to unfold in different arenas. In several regards, this will also affect Europe. At the very general level, *the EU is involved in the Iranian-Saudi energy competition* through its key role in the 2015 nuclear deal. The nuclear deal has led to the lifting of several EU (and US) energy and financial sanctions against Iran. However, sanctions might be re-imposed ("snapback") should a permanent member of the UN Security Council accuse Iran of violating the deal. As investments made possible by the nuclear deal would not be protected, this constitutes a significant risk for potential investors in Iran's energy sector. In Iranian-Saudi rivalry, the snapback provision benefits Saudi Arabia as the prospect of sanctions being re-imposed could impede investments and thus slow down the pace of Iran's return to international energy. In the event of a dispute on whether or not Iran is violating its commitments under the nuclear deal, the EU could potentially be asked to mediate – very much like during the nuclear negotiations, which made frequent bilateral talks between Iran and the US possible.

Iran's energy sector is affected negatively by the tensions between the two countries. While other factors such as the details of Iran's new petroleum contract are relevant (and uncertain), the crisis between Riyadh and Tehran is increasing political risks for investments in Iranian energy. This comes at a time when, due to low oil prices, international energy companies are already reducing their spending on new projects. Many European and other companies have already announced – at least informally – a more cautious stance towards investments in Iran's energy sector. Riyadh is to benefit from this in its competition with Tehran.

In oil, Iran can be expected to increase both its production and exports. Additional exports of up to 1 mbpd within a year after the lifting of sanctions appear feasible. Saudi Arabia is likely to maintain current production levels. *OPEC is a victim of the Iranian-Saudi standoff.* Effective decision-making and co-ordination on production quotas will be impossible without a minimum level of co-operation between Riyadh and Tehran. Consequently, any agreement on production cuts by the cartel, which accounts for 41% of global oil production, seems highly unlikely. This will possibly translate into a prolonged cycle of low oil prices. As a result, investments into Iran's energy sector might be delayed. Europe, while benefitting from a reduced import bill, is also facing negative consequences. Weaker global growth – many emerging economies are resource-rich – is reducing opportunities

for trade. Adverse effects for Europe are also likely in the field of energy as low oil prices are harming Europe's indigenous production and possibly increasing the EU's dependence on Russia (see below).

Iran and Saudi Arabia are also likely to *compete for downstream opportunities in importing countries*, especially in East Asia but also in Europe. When sanctions reduced Iranian production and exports, Saudi Arabia strove to fill the void. However, the Kingdom is trying to go beyond mere crude oil exports and seeks to cement its (new) ties through investments in the refining sector, including in China or South Korea. Iran has declared its ambition to recapture lost market shares and might try to replicate the Saudi example. Tehran has already been in talks with refiners, including in Spain. For the EU, this does not carry risks as long as neither of the two countries gains a dominant position in the European downstream sector, which is not on the agenda anytime soon. However, in this context, European-Iranian co-operation is complicated by the prospect of a sanctions snapback.

In European oil, Iran's main competitor will not be Saudi Arabia, but Russia. As both countries' crude oil is of similar grades, it was Russia that replaced the bulk of previously Iranian supplies. Relations between Moscow and Tehran have deepened recently. President Putin's visit to Iran in November 2015 underlined common interests in areas such as bilateral trade and the Syrian conflict. In light of this, it remains to be seen which kind of policy Iran will adopt *vis-à-vis* the European oil market, although it seems unlikely that Iran might totally abandon the European market. Iranian oil would help diversify EU oil imports.

In natural gas, Iran is likely to expand its output as more South Pars-phases come into production. While Tehran has given priority to domestic natural gas consumption, it might be able to substantially increase exports in the future. Saudi Arabia's first and foremost challenge in natural gas is to meet its growing domestic demand. Both for commercial and political reasons, Iran's neighbourhood would assume priority in Tehran's natural gas export plans, should Iran possess spare capacities at some point. Many countries in the region will need to increase their natural gas imports and commercially, pipeline exports – over comparably short distances – are more competitive *vis-à-vis* long distance trade by pipeline or ship. Politically, regional natural gas exports would advance Iran's strategic standing, particularly towards Saudi Arabia. Riyadh cannot compete with Iranian natural gas directly due to the absence of sufficient reserves. The Kingdom might therefore try to subvert Tehran's export projects with a combination of financial incentives and political pressure on potential Iranian partners – as seen in the case of Pakistan, for example. Iran's prioritisation of the Middle East makes *European imports of Iranian natural gas highly unlikely* anytime soon. All further political and commercial questions aside, Iran will simply not possess enough volumes to allow for exports to Europe over the next couple of years. Hence, for the time being, the potential game changer for the Southern Gas Corridor will remain only a theoretical option.

Russia's relative position in the European gas market will be strengthened. With Iranian natural gas presently out of the game, Russia's main competition in the Europe will remain LNG (and, to a lesser extent, natural gas substitutes). In the European market, low oil prices – partly a result of OPEC's ineffectiveness due to the standoff between Iran and Saudi Arabia among with the prospect of increased Iranian oil production – is good news for Moscow, despite the fact that Russia is suffering from low oil prices domestically. This is because higher-cost production is affected negatively by low energy prices. European investments in non-Russian energy production and infrastructure might be reduced and/or delayed as a result. This includes European LNG infrastructure as well as domestic European production, especially offshore oil and gas but also coal, nuclear, and renewables. Hence, although under severe pressure domestically, it appears as if Russia is set to benefit from Iran's continuing absence from the European gas market and the low price environment in global energy. Therefore in European natural gas, Russia may increase its clout and could emerge as a beneficiary of the Iranian-Saudi rivalry.

David Ramin Jalilvand is a Researcher in the Middle East and North Africa Department of the Friedrich Ebert Foundation, in Berlin.

European Policy Centre ■ 14-16 rue du Trône, 1000 Brussels, Belgium

Tel: +32 (0)2 231 03 40 ■ Fax: +32 (0)2 231 07 04 ■ Email: info@epc.eu ■ Twitter: [@epc_eu](https://twitter.com/epc_eu) ■ Website: www.epc.eu



Europe for Citizens
Programme

With the support of the Europe for Citizens
Programme of the European Union.