OVERVIEW

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Road to recovery

***Matthew Culver*, Partner, CMS Cameron McKenna LLP takes a closer look at some of the latest oil and gas developments in the Middle East.**

The decision by OPEC in December 2016 to cut oil production by 1.2mn b/d from the start of this year is not only significant as it reverses OPEC's policy from 2014 – to let free market economics determine the price of oil whilst increasing production in the face of falling global demand – but also for the agreement by non-OPEC producers, led by Russia, to follow suit.

The 11 non-OPEC producers agreed to cut production by 558,000 b/d. Although less than the targeted 600,000 b/d, this is the largest ever contribution to production cuts by non-OPEC members. It shows a level of cooperation by OPEC and non-OPEC producers not seen in over 15 years, in a mutual desire to end the three-year crude oversupply to the global market and reduce the huge inventories that have depressed global oil prices for so long.

Much depends on how strictly members of both groups stick to the agreement – which they have not always done in the past. However, after a month's worth of data since the cuts came into effect, initial signs are that the producers are sticking to the levels of cuts agreed, with Saudi cutting its production quicker than expected. In the same period the oil price has reached a 17-month high.

The next six months will be important for OPEC and non-OPEC members alike in creating what Saudi Arabia's Minister of Energy, Industry & Minerals Resources Khalid al-Falih described at a press conference after the announcement as '... a range [in oil price] that attracts enough investment to bring long-term supplies and balance the expectations of demand'. Most commentators see that range as between \$50–60/b for the foreseeable future.

Whilst signs are positive that the oil market looks set to rebalance from the oversupply of the last few years, Khalid Al-Falih further commented at the World Economic Forum in Davos, that it may not be necessary to extend the deal reached in December beyond the initial six months. It is difficult to see how such a short-term fix can redress the global backlog of inventory. All eyes will be on OPEC's next meeting on 25 May to see whether the sentiment of continued cuts and cooperation with the non-OPEC producers remains.

The re-emergence of Iran

Meanwhile, in Iran, the National Iranian Oil Company (NIOC) has taken a number of important steps in preparing the ground for attracting foreign investment to the country's oil and gas sector, including the eagerly awaited Iran Petroleum Contract (IPC), a revision of the much criticised buy-back contract. In December 2016, NIOC announced that 29 international oil companies (IOCs) had been pre-qualified by NIOC to submit tenders to develop upstream projects in Iran. With US IOCs caught by the continued US sanctions against Iran (see p20), the pre-qualified companies comprise mostly European, Russian, Chinese and other Asian IOCs and national oil companies.

A key theme coming out of Tehran is of 'technology transfer'. Iran is not only seeking to rehabilitate its vast oil fields and increase production, it is determined to develop its own expertise in new technologies after years of underinvestment. A pre-requisite of the forthcoming tenders will be the involvement of a local partner ensuring that Iranian companies will have access to the new technologies, know-how and training that the IOCs will bring to such projects.

Iraqi challenges

If Iran needed guidance on developing the IPC model in a low oil price environment, they need look no further than Iraq as to how not to do it. The fall in oil revenues in Iraq over the last two years has led to the struggle by the Iraqi government to reimburse the fees owed to the IOCs under their respective service contracts with the Iraqi State, putting considerable strain on the IOCs in managing the huge capital investment for these projects.

Under the service contracts, the IOCs charge the Iraqi State a fixed price for the work in rehabilitating the fields and increasing production. That fixed price has remained the same despite the fall in the oil price and has led to the Iraqi Oil Ministry to commence talks with the IOCs in an attempt to make adjustments to the service contracts – to reflect the decline in the oil price and subsequent decline of Iraqi State's oil revenues.

It remains to be seen whether the Iraqi Oil Ministry can push through such changes to the service contracts, including those contracts governing the supergiant fields such as the BP-operated Rumaila field or the Shell-operated Majnoon field without dis-incentivising the IOCs to the point where they look to withdraw and redeploy their capital elsewhere, such as Iran. There was speculation at the end of last year that Shell was considering selling its Iraqi assets in a drive to slim down its vast oil and gas portfolio following its acquisition of BG Group. It is difficult to see how, in the present climate, any IOC would look to take on such a huge project – especially given the well-documented challenges and difficulties faced by IOCs operating in Iraq. In late 2016, Occidental Petroleum pulled out of the joint venture in the Zubair oil field in southern Iraq, its interest taken over not by an IOC but instead by the state-owned South Oil Company.

Petrochemical developments

Despite the low oil price, the Middle East region has seen several major developments in the petrochemicals sector. The Sadara Chemical joint venture (with Dow Chemical), inaugurated in November 2016, has been hailed as a 'game-changer' in the Middle East chemical industry. It is one of the world's largest integrated chemical facilities and the mixed feed cracker, which came online last year, is used to produce ethylene and propylene – components used in plastics and specialty chemical products.

This demonstrates an important trend in the Middle East region over the last few years to focus on the petrochemicals and refinery industry. As part of the Kingdom's 'Vision 2030', Saudi Aramco is aiming to triple its chemical production to 34mn t/y in 2030 from a present level of 12mn t/y. It is also seeking to increase its refining capacity over the same period to 8–10mn b/d from around 5mn b/d today. Such projects show the focus by leading Gulf producers to develop the downstream business of refined products and diversify their operations away from purely oil extraction.

State revenues

As a consequence of the decline in oil revenues for Gulf States, their governments have carried out not only cost cutting in government expenditure but also policy reform. Policymakers have even uttered the three-lettered 'T-word' (tax) in considering alternatives to a reliance on oil receipts. With the exception of Dubai which has successfully diversified into tourism and services, oil receipts typically account for more than 80% of government revenues and over 90% of Saudi Arabia's government take. The low oil price has meant Gulf States have had to make massive cuts into their generous public spending.

Whilst the drawdown on sovereign wealth funds is widely reported, many Gulf States have made significant policy reform to curb the excesses of the public sector. Qatar's Emir Sheik Tamim bin Hamad al-Thani stated back in 2015 that the government can no longer 'provide for everything'. It has also been reported that Oman has removed perks such as cars for all state-owned enterprises, while redundancies have been noted in Abu Dhabi and Qatar state-owned companies. The UAE cut fuel subsidies in 2015 and a value-added-tax of 5% is set to be introduced across the GCC region by 2018.

It was, however, not until September 2016 – two months before OPEC's announcement – that Saudi Arabia cut public sector bonuses and benefits for the first time since the collapse of the oil price. The lavish salaries and generous perks of public sector workers were cut through a series of public decrees, and included a reduction in ministerial salaries of 20%. The cuts apply to all public sector workers (including expats) except for soldiers on active duty in Yemen who are exempt. Given that the state sector employs around two-thirds of working nationals, such cuts will have a major impact on government spending.

Such austerity measures will always be politically-sensitive. However, it is without doubt that the low oil price environment created the conditions to allow policymakers in Saudi to make such dramatic reforms. Whilst drawing criticism for those affected, reform of public spending as a consequence of the low oil price will, in the long-term, be good for the Gulf States.

In July last year, the International Energy Agency (IEA) reported that the oil price environment has had a negative impact on oil investments and hurt efficiency. Although, significantly, the IEA also noted that it had boosted the share of oil produced in the Middle East. The cut in output from higher-cost producers such as the US, Canada and Brazil, has led to the increased dominance of Middle East producers and Middle East supplies now account for 35% of global oil supplies – the highest level since 1975.

The end justifies the means

There is no doubt that the period of low oil price has been economically painful for the Middle East States and many of their sovereign wealth funds have been used to cover the shortfall from oil receipts. However, during the same period policymakers have been able to make significant cuts to public spending and remove subsidies. Ultimately, the Middle East States have ended up with a greater share of global oil supplies than they did several years ago – which, one may argue, that the end does justify the means. ●