



NAVIGATING THE STORM: "OPEC+" PRODUCERS FACING LOWER OIL PRICES

Marc-Antoine EYL-MAZZEGA (ed.)

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Executive Summary

Higher oil prices and sharp non-OPEC supply growth: a test for "Opec+"

On 22 June 2018, "OPEC+" oil Ministers (Organisation of Petroleum Exporting Countries members and an *ad hoc* alliance with several non-OPEC producers, notably with Russia, Kazakhstan and Azerbaijan) will gather in Vienna to discuss the status and future of their production limitation agreement which was initiated in November 2016 and runs until the end of December 2018. This landmark agreement has been a game changer for oil markets, as Saudi Arabia agreed to cut production (and implicitly exports) and Russia agreed to postpone the increase of its record high and steadily rising liquids output.

This analysis highlights the extent to which ten producers under scrutiny have been economically hit by lower prices and will want to cash in on present price rises, possibly seeking to ramp up production and exports where possible, especially since the fall in Venezuelan output is now larger than the Saudi production cut.

Another challenge is that continuing the current production cuts carries risks as market developments have surpassed these producers' expectations: oil prices have topped \$80 per barrel (bbl), way above what they hoped to achieve, and global stock levels have decreased, as they were planning. With the unforeseen and uncertain developments in Iran and Venezuela, prices may increase to \$90/bbl. Russia and Saudi Arabia will be tested as short and long term strategists, based on how they will transform their *ad hoc* alliance, to make it more operational and consistent with the recent market developments. Such higher prices risk slowing down the global economy and oil demand growth, but also accelerating the growth of non-OPEC supply: the United-States (US) already added 700 thousand (kilo) barrels per day (kb/d) to liquids production in 2017, *de facto* compensating for Saudi's supply cut, and is expected to add much more supply in 2018 and to ramp up its exports further. In 2018, the growth in non-OPEC supplies is expected to be higher than the growth in demand, but geopolitical tensions are strong and push prices up.

OPEC's total liquids output *de facto* only decreased by around 400 kb/d in 2017 versus 2016, due to the surge in output from Libya and Iraq. This also highlights the extent to which the production levels chosen as the baseline for the cut were high. With the return of US sanctions, Iran's 2.5 million barrels per day (mb/d) exports could slightly decline but it is expected that China, India, possibly also Russia and others, will find ways to access most of this oil, possibly at some discount, given that there will not be strong discipline to respect unilateral US sanctions. In Venezuela, production has fallen by 700 kb/d to below 1.5 mb/d in the past 18 months and could fall by another 300 kb/d, given the magnitude of its economic and political crisis and the risk of more US sanctions being introduced.

Keeping the current deal unchanged would put OPEC in a more-entrenched defensive position and potentially make it harder to agree and effectively influence oil markets in the future: this would require notably cutting production further (unless Venezuela's dip continues), losing revenues and market shares and risking lower compliance from several key members or allies. By contrast, raising OPEC + output in the second part of 2018 could help avoid accelerating the weakening of OPEC's market position, which should be a serious issue for consideration. It remains to be seen how Saudi Arabia will accommodate these realities with its planned Aramco Initial Public Offering (IPO) for which it needs a high oil price, and with the concerns expressed by President Trump as his voters will face higher gasoline prices this summer ahead of the mid-term elections.

The oil producers' economies have been shaken, and then saved by the rise in prices

With the exception of the dramatic social and economic crises in Venezuela, leading OPEC+ oil producers have managed to navigate through the storm of lower oil prices. This is because the real stress and strain period only lasted around 16 months, from January 2015 until August 2016, when the oil price slowly started moving upward. Kazakhstan and Algeria avoided sliding into economic recession but they experienced sluggish growth rates. Beyond the chaotic situation in Venezuela, Russia faced the longest and sharpest recession, while Angola, Azerbaijan, Saudi Arabia, Iraq, Iran and Nigeria also went through a year of economic recession and stagnation. Angola's economic situation worsened dramatically, yet was stabilized by the government. However, no

International Monetary Fund (IMF) country support programme was put in place for any of these oil producers.

Had Saudi Arabia pursued its high-output/low-price strategy during one additional year and had Venezuela's production not collapsed, several regimes would probably have been exposed to social tensions, falling production and unsustainable budget deficits, risking a destabilization. A sustained \$30/bbl oil period would probably have created very serious macroeconomic, social and financial challenges for Algeria and possibly also, Russia, Nigeria, Angola, Azerbaijan and Kazakhstan. Saudi Arabia itself would have struggled to finance its social and military spending. The OPEC+ agreement and Venezuela's output collapse have certainly set a floor to oil prices, making producers cautiously optimistic that the worst is behind them.

For most of these countries, the fall in oil prices and revenues led to currency depreciation or devaluations following costly attempts to defend the exchange rate (with the notable exception of Algeria), a move to floating currencies (Russia, Kazakhstan), rising inflation (due to imported inflation and monetary creation), spending cuts (primarily social or infrastructure spending, but also military outlays), growing State budget deficits, a fall in real incomes, a rise in poverty, lower upstream capital expenditures (with the exception of Russia), a weakened banking sector and weaker sovereign credit ratings.

Ultimately, producers did not drastically cut their public spending to avoid economic and social issues, yet decided to run budget deficits, covered by fiscal reserves and recourse to domestic or international bond markets. They also benefited from the currency depreciation which has softened the impact of falling oil prices, export values and tax revenues. Russia masterminded management of its budget deficit thanks to its Reserve Fund, from which it drew more than \$50 billion, as did Algeria, Kazakhstan and Azerbaijan. Yet all these countries also tapped into strategic welfare funds aimed at supporting infrastructure investments or pensions for example. Russia's Reserve Fund was emptied, as was Algeria's. Azerbaijan and Kazakhstan, by comparison, have managed to limit excessive withdrawals. Saudi Arabia managed to mobilize its large reserves, which are still far from depletion.

Regimes proved stable and unchallenged, with the exception of Angola and Venezuela

No producer has faced collapse, with the exception of Venezuela. It has been confronted with a perfect storm of falling investments, falling production, soaring inflation, insecurity, social uprising, institutional collapse and political turmoil. Despite strong backing from Russia, Cuba and China, the deepening Venezuelan crisis could not be contained. In the ten countries examined here, only one electoral change occurred which can be related to the fall in oil prices: in Angola, the former President Dos Santos finally left office after 38 years in power and the recent elections brought new persons in charge and reduced the direct influence of the Dos Santos family.

It is noteworthy that presidential elections took place in Kazakhstan in 2015 and then in Russia, Azerbaijan, Venezuela in 2018, without any serious challenge to the rulers seeking re-election, although none of these elections were free and fair. With the exception of Venezuela, the current turnaround has been strong. No policy shift has occurred in these countries. Social unrest has taken place here and there, locally in Russia, Kazakhstan, Nigeria, Algeria, and to a larger extent in Iran during the winter of 2017-2018, but under tight government control and with no political impact. Last but not least, in Saudi Arabia, a new leader has risen to power, Crown Prince Mohammed bin Salman. Legitimized by his father, he is young (born in 1985) in a country where 25% of the population is less than 15. He displays vision and ambition but he has also been taking big risks, both internally and externally, with still-uncertain consequences.

The resilience of regimes has many explanations. Yet, in Russia, Saudi Arabia, Iran and to some extent Azerbaijan, regimes have instrumentalized their geopolitical conflicts to strengthen loyalty and their legitimacy. Russia is involved in wars in Ukraine and Syria, and has engaged in a confrontation with the European Union (EU), the North Atlantic Treaty Organisation (NATO) and the US. Saudi Arabia is involved in a war in Yemen and has been playing up two enemies, Iran and Qatar. Azerbaijan engaged militarily in the Karabach conflict in spring 2016. And Iran was involved in the fight against the ISIS terrorist group in Iraq and is actively engaged in Syria and Lebanon in order to "stabilize the region" and fight terrorism. Regimes have played the geopolitical card in order to underplay, side-line or silence, political or social demands, and have resorted to repressive policies. This may backfire as the middle class, and the poorest can opt for the "voice" option. Yet in many cases, these countries lack a

political system, or opposition leaders, to channel political discontent, with opposition forces being marginalized or oppressed.

Iran, Iraq and China in focus

Iran is a special case because it was freed from sanctions when the storm of oil prices came, and benefited from a rapid increase of production and exports by 1 mb/d as of autumn 2015. A major political change had happened in 2013, when Iranians elected a reformer within the system as President, Hassan Rouhani, after years of conservative ruling and economic degradation. After successfully reaching the nuclear deal in 2015, he was re-elected by a stronger majority in the May 2017 presidential elections, in a clear signal that Iranians supported his economic reforms and want change: internal liberalization and external normalization. Supreme leader and all powerful cleric Ali Khamenei had given his blessing to these changes. Yet President Trump's repudiation of the 2015 nuclear deal and the re-imposition of sanctions – officially to negotiate a better nuclear deal that would go beyond 2025 and also address Iran's ballistic missile programme as well as its expanding military activities in the region, possibly with the ultimate goal of fostering internal divisions and tensions and provoking a regime change – is hazardous and dangerous. The country is deeply marked by a sentiment of injustice following the hyper-violent Iran-Iraq war. It is a proud, ancient nation that can be expected to reunite when facing other injustices. The economy is much less dependent on oil than usually assumed whereas financial sanctions, trade restrictions and lack of investments are more problematic. The regime has proven remarkably resilient since 1979 and against this backdrop, the hardliners may well become more aggressive, whereas the reformers may be increasingly weakened and marginalized, with average Iranians left hostage, and helpless, in a wider geopolitical conflict and internal power struggles. Iran could well leave the nuclear agreement altogether, opening the way for further confrontations, if not wars that will leave no winners.

Iraq has faced the triple storm of falling prices, the fight against ISIS and severe tensions with the Kurdish Regional Government (KRG), which culminated with the referendum for independence and the re-taking of key oil fields controlled by the Kurds by the central government's army. The country is on the path to overcoming these challenges and its stabilization, reconstruction and pacification will be helped by higher oil prices and production. Nonetheless, the country will have to address urgently critical challenges: diversifying its economy, developing its agricultural sector, reforming its institutions, combating corruption, and attracting investments. These challenges will be very hard to address and it will take

strong and credible leadership and responsible behaviour by foreign powers to succeed.

China in many aspects was a key backer of several weakened oil producers: it made inroads or provided investments or credit to Russia and Venezuela notably (to state or private stakeholders). Yet the crisis is expected to have a structural impact on China's overseas strategy: Angola and Venezuela turned into poisoned debtors so that China's generous credit lines in return for future oil supplies and infrastructural development may be reconsidered in future. However, China is expected to be the key winner from the new confrontation with Iran at the expense of Western interests and companies, leaving Iran no choice but to go East, towards India and China. The other unfolding geopolitical changes are Russia's engagement with Saudi Arabia, which is only an oil alliance so far but has the potential to widen, and a major question mark over China's role in the Middle East, given its significant imports of Saudi, Iraqi and Iranian oil.

Adaptive up & mid-stream strategies and corporate reconfigurations

National oil companies reduced their capital expenditures and drilling operations (with exceptions in Russia, due to the rouble's depreciation and flexible taxation), and moved to prepayments or managed to issue bonds. Traders such as Vitol, Trafigura or Glencore have certainly strengthened their positions in becoming creditors to several national oil companies. So did China or Russia, yet with unsatisfactory results. Nonetheless, major investments have been sanctioned, mainly in partnership with foreign companies: for example, in Azerbaijan (ACG-BP) or Kazakhstan (Tengiz-Chevron). Others were pushed back and oil exploration efforts delayed, as in Russia's Arctic, which is marked by high costs and technological constraints following sanctions. In Algeria, a February 2016 energy policy meeting laid out priorities for structural reforms, but was not implemented. Investment friendly amendments to the hydrocarbon law are being worked out, with no certainty over timing and content.

Privatization and asset divestment have taken place or are being planned in several producer nations, directly in the oil sector or in the overall economy. In Russia (19.5% of Rosneft), in Saudi Arabia (5% of Aramco now pushed back to 2019), in Angola, in Kazakhstan (KazMunaiGas). Iraq is planning to establish a state-owned oil company. Algeria's upstream sector requires large foreign investment and technology, yet no change is expected until the 2019 presidential election.

The fall in prices was an alarming wake up call, though many slept through it

The storm of lower oil prices left these oil producers weakened and their ability to navigate another similar storm will be largely diminished. If prices fall again, they will have lost their fiscal reserves and buffers to resist. Their ability to develop sufficient financial reserves again is uncertain. Their longer term development is at risk: Russia, Azerbaijan, Kazakhstan face a weak banking sector and have tapped into their strategic pension and infrastructure funds. Budgets were curtailed everywhere. Poverty has increased in Russia, Venezuela and Kazakhstan. In Algeria and in Russia, the middle class has been hit. Combined with high unemployment, especially in rural areas, and a very young and growing population, this could lead to tensions in Algeria unless structural reforms address these issues.

All these regimes have fossil fuel dominated energy and power generation mixes which limit their oil and gas exports, represent a subsidy burden and hamper their economic diversification. The ability of these regimes to diversify their economies and energy mix and invest in alternative, low carbon electricity supplies appears weakened.

On the one hand, they have a chance to benefit from the falling deployment costs of solar and wind power, and could reap the large benefits of energy efficiency investments. Energy subsidies have indeed been reduced in Iran and Saudi Arabia. Angola and Nigeria have introduced several important reforms, and Kazakhstan has been pursuing the attempt to increase the share of private investments in its economy.

On the other hand, the oil rent system itself is unlikely to be changed because many of these countries are involved in wars and larger geopolitical tensions (Russia, Iran and Saudi Arabia), face sanctions or the threat of sanctions (Russia, Iran and Venezuela) and are exposed to social instability, institutional weaknesses and insecurity (Nigeria, Angola, Venezuela and Iraq). Their energy sectors are dominated by state-owned companies (with the exception of Iraq) which can deliver large projects if they have access to finance. But they cannot change a country's energy governance and system marked by inefficiencies and corporate governance challenges (Russia, Iran, Venezuela, Nigeria, Angola and Algeria). With renewed sanctions, Iran's economy of resistance may well be perpetrated further. Priorities may be elsewhere: Saudi Arabia has just raised its military spending by 10%.

Yet among all these countries, Saudi Arabia's Vision 2030 plan unveiled in April 2016 clearly stands out as one of the boldest and most realistic programmes to diversify an economy. But, it can only succeed if the society becomes more inclusive and if the country reduces its geopolitical exposure. Algeria also has a large, untapped potential to diversify its energy and electricity mix and reform its economy, but this will depend on political will, a change in government and in the governance of state-owned enterprises, as well as the ability to attract more foreign and private investments.

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Introduction

Marc-Antoine Eyl-Mazzega

The sudden and sharp fall in oil prices as from end 2014 took leading analysts, companies and key oil producing countries by surprise. The continued fall from over the \$100/bbl mark that had held up since February 2011 until end of August 2014, to below \$30/bbl in early January 2016, brought several leading oil producers to near panic. If the trend was not reversed quickly, their financial, economic and social stability could be jeopardized. The storm of high commodity prices had already fuelled the Arab springs of 2011. This time, the low commodity circle was endangering the stability of several key oil-dependent economies.

The period of high oil prices had lasted 3½ years, following the 2009 price shock, and was marked by continued robust demand which gave the illusion that the steady growth in US liquids production and the high OPEC output would be absorbed by booming demand in emerging economies and that prices would remain high. Oil-dependent economies faced no need to diversify, improve governance or to reform. The very fact that Russia's economic growth slowly moved towards recession as from end 2012, amidst high oil prices and record high production and exports, did not trigger any particular policy reaction. It was not coincidental that the world's military spending reached an all-time high in 2011, and levelled off afterwards, mainly due to lower spending in OECD economies.¹

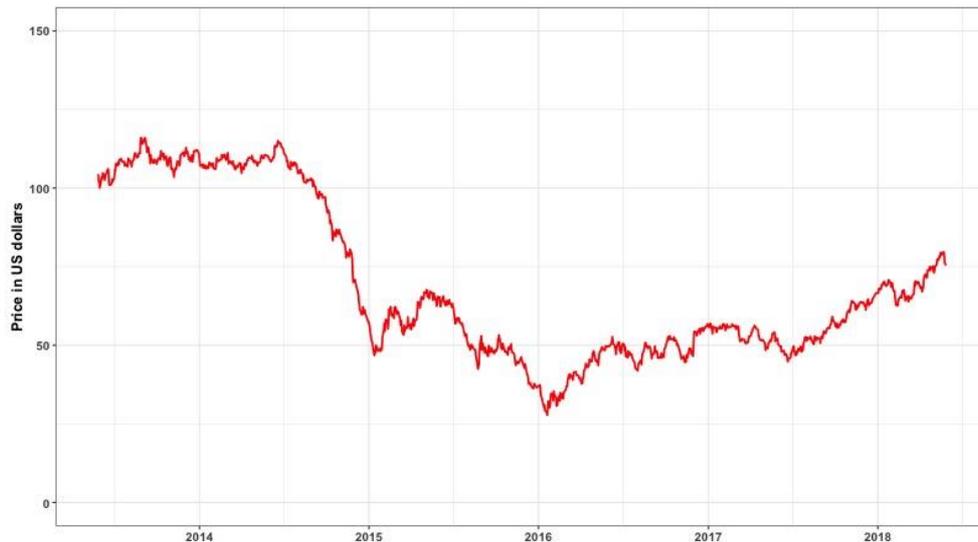
The sharp fall in oil prices as from fall 2014 onwards was a strategic surprise, especially since it was combined with restrictive western measures on Russia, following the annexation of Crimea and the war in Donbass. Russia was faced with a “perfect storm”, and respected institutions, such as the International Energy Agency (IEA), predicted a fall of its production.² It was also expected that US light tight oil production would stop climbing. Both predictions were proven wrong, as US tight oil

1. Stockholm International Peace Research Institute (SIPRI), “World Military Spending Levels out after 13 Years Of Increases, Says SIPRI”, 17 April 2012, available at: www.sipri.org; SIPRI, “World Military Spending: Increases In The USA And Europe, Decreases In Oil-Exporting Countries”, 24 April 2017, available at: www.sipri.org.

2. International Energy Agency, (IEA), *2015 Medium Term Oil Market Report*, Paris, February 2015.

output proved resilient and Russia's liquids output continued to beat records year after year.

Figure 1: Brent Price in US dollars, May 2013 to May 2018



Source: Thomson Reuters.

The next deceptions came soon: Saudi Arabia, the country with the largest spare production capacity, was in no hurry to cut its growing output, which actually rose from an average of 9.7 mb/d in 2014 to 10.2 mb/d in 2015, as the Kingdom was fighting with Russia over market shares in China and Europe. The Saudis were betting that US tight oil producers would be hit by the price storm and would run short of finance, that deep offshore projects would be abandoned or postponed, that demand would expand further and that Iran's output would find it harder to recover, in spite of the anticipated agreement on a Joint Comprehensive Plan for Action (JCPOA, hereafter, the 2015 nuclear deal). The latter was then still under negotiation, putting great strain on Saudi-US relations.

A series of further geopolitical and oil market deceptions also took place. Russia, which was absent for many years from the Middle East equation, not only jumped back with its military operations in Syria which proved cheap and effective compared to the Saudi military operations in Yemen. Russia and Saudi Arabia moreover started a historical *rapprochement* in spite of their deep opposing interests in Syria, driven by their respective oil ministers and their smart advisors, who step-by-step

engaged in a game of meetings and media statements aimed at stabilizing and then taking up the oil price.

All this laid the ground for the landmark "OPEC+" Vienna agreement, reached on 30 November 2016, whereby OPEC and several non-OPEC producers, chiefly Russia, sealed an alliance in order to cut supplies by a total of 1.7 mb/d from their very high end of the year 2016 production levels, including -300 kb/d for Russia and -486 kb/d for Saudi Arabia.³ This historical agreement was not easy though, and required skilful mediation, notably by Algeria's Energy minister and the intervention of President Putin in order to help accommodate Iran's demand to be able to continue raising output while formally being part of the agreement. Nigeria and Libya were exempted of production cuts because of their internal crises affecting their oil supplies.

The widely-shared assumption that OPEC had become irrelevant and that Russia would forever remain a free rider proved wrong. Saudi Arabia recognized that demand-price elasticity had delivered all its potential, and that US liquids output growth had not reversed severely.⁴ It also recognized that global stock inventories were at sky high levels with no prospect of decreasing. And ultimately, Saudi Arabia began to be concerned that its modernization ambitions, its social and high budget expenditures related to the Yemen war, and its Saudi Aramco IPO project, needed a higher oil price. So did President Putin, who was preparing for his re-election 18 months later and was well aware that Russia's rainy days' fiscal reserves would soon be partially emptied.

De facto, the OPEC+ agreement was a Russian-Saudi agreement whereby Russia would agree to postpone the increase in its liquids output and Saudi Arabia would make a deep cut in output, though less in exports. Rather symbolically, others were asked to follow, and felt privileged to do so at almost no cost. Surprisingly, Saudi Arabia accepted that its historic enemy, Iran, would be exempted. That seems to have been a tactical move to ensure the agreement stands. Iran was to be hit via other means: a coalition with Israel and the US to denounce the 2015 nuclear deal. And militarily, if not in Syria, then in Yemen. Iran has been steadily spreading its influence towards the Mediterranean, via Syria and Lebanon, while also strengthening its influence in Iraq, which the US 2003 invasion made

3 . *OPEC Agreement*, OPEC Press Release, available at: www.opec.org; "Declaration of Cooperation", Press Release No.52/2017, OPEC, Vienna, Austria, 30 November 2017, available at: www.opec.org.

4. S. Cornot-Gandolphe, "The Resurgence of Shale Oil", *Études de l'Ifri*, Ifri, September 2017, available at: www.ifri.org.

possible. And the war in Yemen is brutal but no victory is near, and Saudi territory has recently been targeted by Houthi armed groups' missiles.

From a historical perspective, Russia and Saudi Arabia resorting to joint oil market coordination to preserve their stability is ironic: it was Saudi Arabia's sudden rise in output, in the midst of the 1980s, that helped to crash the oil price, accelerating the economic collapse of the Soviet Union. The other irony is that to save its economy, Russia has helped masterminding this OPEC+ coordination which is *de facto* helping to boost US liquids production and exports, and so fuelling GDP growth and military spending by its strategic rival. Again, the irony is that this also benefits Iran, which has managed to add 1 mb/d of production and exports since 2016. One last irony is that now that midterm elections are due in the US in November 2018, some in Washington DC are concerned that with a possible reduction of exports by Iran and aggravating tensions, oil markets will tighten further ahead of the summer season, angering voters who will blame the White House for higher prices at the pump.

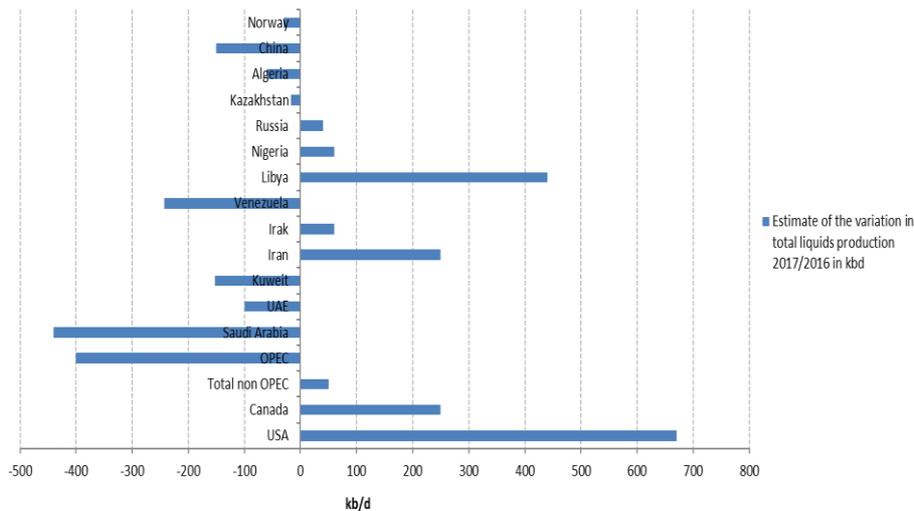
The OPEC+ Vienna agreement was then sequentially prolonged until end 2017, and later to the end of 2018. Helped by growing geopolitical tensions in the Middle East (especially missiles fired from Yemen on Saudi territory) and amplified by the collapse of output in Venezuela, the agreement has ultimately achieved more than what its backers were hoping for, much to the benefit and relief of oil producers, banks and the entire industry. Oil prices moved up above the \$70 mark in mid-April 2018, stock levels have been decreasing, and demand remains robust.

Yet uncertainties will lead to strong volatility. US liquids production is expected to add + 1.4 mb/d in 2018 and +3.7 mb/d by 2023 from the 2017 level, following a sharp upward revision by the IEA,⁵ to reach 17 mb/d. Total non-OPEC supply, driven by the US, Canada, Brazil is expected to add 5.2 b/d by 2023 while the IEA is already reducing its demand projection, due to higher oil prices. The prospect of a global trade war harms global growth and reduces additional demand for oil, although it is still expected to be reaching 100 mb/d in the coming 12 months. The Middle East is facing the risk of wars and key maritime straits are already exposed to the threat of military action. Venezuela, Iran, Iraq, Libya and Nigeria can quickly add or reduce production significantly, depending on quite unpredictable political and security factors. Key producers or transit countries from the region such as Russia, Azerbaijan, Turkey, Kazakhstan, Saudi Arabia, Iran, Iraq, Algeria (which has remarkably managed to stay

5. IEA, *Oil 2018*, Paris, available at: www.iea.org.

unharmful from the deteriorating situation in Libya and Mali) or Nigeria are all exposed to the threat of Islamic terrorism or regional tensions.

Figure 2: Evolution of liquids production from leading global producers, 2017 versus 2016



Source: IEA, Market Report Series: 2018 Oil – Analysis and Forecasts to 2023, March 2018.

OPEC has been reinvigorated, but remains in a defensive position, which largely boils down to Saudi Arabia accepting to take major output cuts. In the longer term, OPEC members like Iraq, Libya and Nigeria can see robust output growth and will refuse to curtail it, while Rosneft and Russia will be eager to increase output as new greenfield projects can be commissioned. In the absence of a geopolitical conflict, OPEC’s achievement may well be short lived and a downward price spiral is again possible, driven by market fundamentals. At least, OPEC may lose further market share.

Beyond this broad geopolitical and geo-economic picture, the OPEC+ producers should see no safety in the recent rebound in prices. Hence it is important to analyse and assess how they navigated the three years of lower oil prices. In none of these countries can the status quo of the past decade prevail. Yet will they change and how?

How did Algeria, Angola, Azerbaijan, Iraq, Iran, Kazakhstan, Nigeria, Russia, Saudi Arabia and Venezuela, all leading participants in the OPEC+ Vienna agreement, all oil-dependent economies representing almost 40% of global oil supply in 2017, with different political regimes, navigate the storm of lower oil prices? The analysis here has voluntarily left aside the United Arab Emirates and Kuwait, as the former (producing 2.93 mb/d in

2017) has been engaging in an effective strategy to diversify its economy, while the latter (producing 2.71 mb/d) is stable and has a small population. Libya, still divided and facing an internal clan conflict and war against Islamic terrorism, produced an average of 830 kb/d in 2017. It has also been left out, given the volatility of the situation in the country. So have Qatar and other smaller OPEC producers. Mexico and other non OPEC countries associated to the Vienna agreement are also not included in this study.

This analysis in particular aims at assessing the impacts of the fall in prices on these producers' oil sectors, on their economies, societies, governments, company strategies and wider strategic and geopolitical moves. What challenges did they face? How did they react? Did they reform? Did they simply tighten their belts? What policy and institutional shifts occurred? Who won, who lost and what are their economic and energy prospects? These are questions we will look at here.

Algeria

Carole Mathieu

Due to Algeria's overreliance on its hydrocarbon sector, the fall in oil prices has put huge strains on its domestic economy. Oil and gas account for 98% of total export earnings and hydrocarbon revenues provide around 60% of the State budget. Algeria (40.6 million inhabitants) is not only endowed with abundant natural resources, but is also gifted with a large, well-educated and growing labour force. Yet, the non-hydrocarbon private sector remains too weak to generate enough jobs for the youth bulge. While diversifying beyond oil is seen as a national priority to foster inclusive growth and preserve social stability, the need to step up economic reforms has become even more pressing with the collapse in oil prices four years ago. First triggering an active search for policy options, this low oil price environment is now leading to a political and institutional paralysis, and the postponement of any in-depth reform. The rebound in prices provides the regime with some breathing space and helps maintain the status quo, at least until the next presidential election scheduled for 2019.

Low oil prices weakening already-fragile economic and social structures

As extra public spending was deemed necessary to cope with the global financial crisis and then to ease social tensions in the context of Arab Spring revolutions, Algeria's State budget had been running deficits already since 2008. Still, the imbalance remained modest – below 2% of Gross Domestic Product (GDP) – until mid-2014. With hydrocarbon export earnings suddenly halved, following the drop in oil and gas prices, the budget deficit reached 15.8% of GDP in 2015.⁶ The government had no other choice but to engage gradual fiscal consolidation efforts as of 2016, which triggered protests in January 2017 after the adoption of a 14% cut in public spending (adding to a 9% cut implemented in 2016).⁷ Yet under social pressure, austerity measures were limited and the yearly deficit was

6. *Algeria Country Report*, International Monetary Fund, June 2017.

7. "Algerian Cabinet Okays 14-Pct 2017 Spending Cut, Sees 8-Pct Deficit", Reuters, 4 October 2016, available at: www.reuters.com.

still -8% in 2017.⁸ So far, the government has refused to engage in any comprehensive set of reforms, for fears of threatening social peace and generating popular discontent before the decisive 2019 presidential elections.

Algeria's budgetary savings, once gathered in a stabilization fund (*Fonds de Régulation des Recettes*, FRR), are now close to depletion. They can no longer be used to finance the State's budget deficit and the possibility of relying on domestic savings is equally limited, due to the low level of liquidity of the domestic banking sector and the extent of cash hoarding practices amongst Algerian households and private companies. In addition, and although Algeria's public debt is on a sustainable path and its external debt close to zero, the government rejects the idea of issuing sovereign bonds on international markets or requesting loans from the IMF, on grounds of preserving Algeria's economic independence. Thus, the only way to avoid further spending cuts or tax increases is to make use of "unconventional monetary measures", i.e. to allow the central bank, the Banque d'Algérie, to monetize the country's budget deficits. Algeria's newly appointed Prime Minister Ahmed Ouyahia opted for this money printing approach in September 2017, as part of a "crisis plan" to be implemented over five years. The crisis plan also includes measures to improve the business climate outside the oil industry. But it does not tackle the key obstacles to foreign investment, by not removing the requirement of 51% Algerian ownership in any public or private project for instance.

In parallel, a trade balance deficit has emerged, amounting to \$2.98 billion in 2017. The balance for payments also recorded a \$21.76 billion deficit in 2017, in spite of the recent increase in oil prices and export revenues. Since 2014, the country's exchange reserves have halved, even dropping below the symbolic \$100 billion threshold at the end of 2017. To address this vulnerability, the government has recently introduced a set of restrictive measures on the importation of certain goods and services, primarily to save exchange reserves but also shield domestic industry from foreign competition. After the introduction of quotas and the increase of taxes and customs duties as of 2016, the government issued a list of 877 products, including foodstuffs and raw materials, which are now banned from importation, as of the beginning of 2018.⁹ Although this ban is seen as a temporary measure to be removed as soon as a positive balance of payments is restored, it constrains consumers' choice and reduces

8. "Algeria Approves Measures To Cover Budget Deficit", Reuters, 7 September 2017, available at: www.reuters.com.

9. The list of products banned from imports features in the following governmental decree: "Décret exécutif n°18-139 du 21 mai 2018 modifiant et complétant le décret exécutif n° 18-02 du 7 janvier 2018", available at: www.commerce.gov.dz.

purchasing power over the short to medium term, because Algeria's industrial base is too weak to provide competitive substitutes for imports. Besides, this protectionist reaction risks upsetting Algeria's main trading partners.¹⁰ Likewise, the national central bank has progressively lowered the Dinar's exchange rate to facilitate oil exports and make imports less affordable, although this has contributed to a rise in inflation (+5.6% in 2017¹¹) and increases the burden on Algerian consumers, in particular those with the lower incomes.

Against this backdrop, economic growth slowed progressively from 3.8% in 2014, to 3.7% in 2015, 3.3% in 2016 to 2% in 2017.¹² In this state-dominated and commodity dependent economy, unemployment stood at 11.7% in September 2017¹³ and this rate reaches even higher levels amongst young individuals with a strong educational background. Unemployment in rural arrears can rise to 80%, which adds to the high risk social situation as the population is very young: 30% of the population is younger than 15 years old.¹⁴ In this explosive context, reducing subsidies for fossil fuel consumption is seen as a no go, which in turn, seriously erodes budget resources and prevents an efficient functioning of the power sector.

Algeria is struggling to reverse the decline of its oil and gas exports

Algeria holds considerable hydrocarbon reserves. The country ranks 16th in the world's proven oil reserves with 0.7% of the global total (12.2 billion barrels), and 11th for gas reserves with 2.4% of total (4.5 Tcf).¹⁵ Algeria is the third largest oil producer in Africa and is also a major gas producer and supplier, in particular to the EU for which Algerian LNG and pipeline exports represented 12.7% of total gas imports in 2017.¹⁶

After decades of steady growth, Algeria's oil production has been stagnating or even slightly decreasing, due to delays in developing new fields, insufficient gas re-injections, lack of efficiency measures and use of cutting-edge technologies to improve recovery in mature fields. Algeria's oil output was of 1.15 mb/d in 2016, much lower than the 1.37 mb/d peak that was reached in 2007.¹⁷ Algeria was a party to the Vienna OPEC+

10. "Algeria Draws Europe's Ire By Cutting Imports, Boosting Trade With China", *The Arab Weekly*, 22 April 2018, available at: theArabweekly.com.

11. "IMF DataMapper", International Monetary Fund, April 2018, available at: www.imf.org.

12. *Ibid.*

13. *Algeria's Economic Outlook*, Washington, The World Bank, April 2018.

14. *2017 World Population Datasheet*, Washington, The World Bank.

15. BP Statistical Review of World Energy, June 2017.

16. Eurostat Database, May 2018.

17. OPEC Statistical Bulletin.

agreement and pledged to reduce its production by -50 kb/d, from a supply baseline of 1.09 mb/d. Algeria has proved to be compliant, helped by the decline in production following maintenance operations in its main oilfields: the average compliance rate with Algeria's commitments was of 83% for 2017, and 97% for the entire commitment period through to March 2018.¹⁸

With most Algerian gas being produced from mature fields and delays in developing new ones, Sonatrach, the State-owned company, has been struggling to maintain stable output rates in recent years. Still, gas production rebounded by 5% in 2017, reaching 135 billion cubic metres (bcm), according to the latest data released by Sonatrach.¹⁹ Besides boosting production, the other challenge is to contain growth in domestic gas demand, which is primarily driven by gas-fired power generation. Increasing from 20 to 40 bcm over the 2000-2016 period,²⁰ internal consumption is reducing volumes available for exports.²¹ Half of Algeria's gas export capacity is unused today and pressure on Sonatrach is mounting as several key supply contracts with European buyers are set to expire soon. For these contracts to be renewed, Sonatrach needs to demonstrate shortly that it can foster production and maintain strong export levels.

The lack of foreign interest in Algeria's hydrocarbon sector partly accounts for Algeria's difficulties in raising production levels. Results of the latest licensing round held in 2014 proved highly disappointing, with only four out of the 31 oil and gas blocks on offer awarded to international consortiums. In addition to tough tax and contractual terms, the low oil price environment has led international companies to tighten their investment budgets and concentrate on projects seen as more profitable and easier to manage than the ones offered in Algeria. Besides, the 2013 attack on the In Amenas gas processing plant has raised security concerns in the oil & gas industry, potentially discouraging foreign investors from expanding activities. While social tensions remain preoccupying, especially in remote regions of Southern Algeria,²² the country has seemingly weathered the turmoil hitting Mali and Libya unscathed. With two-thirds of Algeria's territory considered unexplored or underexplored and high potential for shale and offshore gas, partnering with international

18. IEA, "Oil Market Report", January 2018; IEA, Oil Market Report, April 2018.

19. Reuters, "Sonatrach Boosted Gas Output By 5 Percent In 2017 – CEO", 30 April 2018, available at: www.reuters.com.

20. IEA, *Gas 2017*, Paris.

21. A. Assaoui, "Algerian Gas: Troubling Trends, Troubled Policies", OIES Paper, May 2016, available at: www.oxfordenergy.org.

22. L. Dufresne Aubertin, "Moral and Political Claims of a Revolt. The Riots of the Mzab in Algeria (2013-2015)", in: *L'année du Maghreb 16/2017*, available at: <https://journals.openedition.org>.

companies and engaging local communities are two imperatives for Sonatrach, if it wants to put more wells into production rapidly.

Developing electricity generation from renewable sources could actually help contain growth in domestic gas consumption, given that gas-fired power plants account for 98% of Algeria's total power generation.²³ However, and despite the country's high solar potential, progress on renewable capacity deployment has been slow to date. Algeria had only 400 Megawatt (MW) of solar photovoltaic (PV) capacity installed at the end of 2017,²⁴ whereas the national programme adopted in 2011 and amended in 2015 targeted 4,000 MW of renewable capacity by 2020, and 22,000 MW by 2030, with solar power accounting for 60% of these capacities. Slow progress may stem from a lack of institutional capability in the field of renewable energy policy and restrictions on investments from foreign competitors, including the 51/49 joint venture ownership model. Again, related to economic sovereignty considerations, Algeria might be reluctant to encourage massive renewables deployment before it has set up a robust domestic industry in PV component manufacturing. A new ministry dedicated to renewable energy was created in early 2017 and is now expected to re-start plans for large-scale solar PV tenders. Although the initial prospect was to launch a 4 Gigawatt (GW) tendering process, a more modest 170 MW request for wind and solar proposals should be launched in Q2 2018. It would still include local content requirements but with more reasonable targeted capacities for the near term. These should be easier to achieve by the nascent domestic renewable industry.

Initiating the transformation of Sonatrach while postponing reforms until after the 2019 Presidential elections

Following the series of corruption scandals which came to light in 2010, Sonatrach's top management has been highly unstable, with no less than six chief executives being dismissed in the past seven years.²⁵ Abdelmoumen Ould Kadour, appointed in March 2017, is now charged with the ambitious tasks of reviewing the strategy of the State-owned energy company and reforming its governance. A new planning document entitled "Project SH2030" is currently being drafted, and is the first of its

23. "Algeria: Electricity and Heat for 2015", IEA Statistics, available at: www.iea.org.

24. *Global Atlas for Renewable Energy*, 2017, IRENA, available at: resourceirena.irena.org.

25. B. Augé, "Les stratégies des compagnies pétrolières nationales africaines", *op. cit.*

kind. If given the green light by the Ministry of Energy, it should lay out the company's ambitions and new operational structure for the next decade.

In parallel, Sonatrach is taking steps to deepen cooperation with international partners. In December 2017, Sonatrach announced a close partnership with Total concerning offshore production, petrochemicals, solar energy and shale exploration now that former contractual disputes over profit sharing have finally been settled.²⁶ ENI and ENGIE are also engaging with Sonatrach for new projects in the field of energy efficiency and solar PV production.²⁷ Besides, ENI and ExxonMobil have started exploring Algeria's offshore areas, performing first drilling tests with Sonatrach in early 2017.²⁸

Efforts could be starting to pay off. After much delay, production started in four out of six Reggane Nord gas fields in December 2017, as well as in the Timimoun gas field in March 2018.²⁹ However, shale gas exploration is still on hold due to the need of conducting further studies and also to ease water pollution concerns.

The central question is whether sectoral reforms will extend to the tax and contractual framework applied to foreign investors. This may start with a revision of the hydrocarbon law, expected to begin in June 2018, although there is still little clarity on the depth of changes under consideration.

Meanwhile on the economic policy front, the government's efforts to reinvent the country's growth model are stalling. The most likely scenario is that the reform agenda will be postponed, affecting many pressing issues such as energy subsidy schemes and red tape. In a context of entrenched corruption and with President Abdelaziz Bouteflika likely to be running for a fifth consecutive term in less than a year from now, maintaining vested interests and delaying painful policy steps until after the elections becomes an attractive option. Helped with a higher oil price environment and the unconventional monetary policy, the government adopted an expansionary budget for 2018, reversing past trends and focusing on job creation and social policies. The national investment fund could also be reactivated to

26. "Algeria's Sonatrach Plans Closer Ties With Total on Energy Projects", Reuters, 13 December 2017, available at: www.reuters.com.

27. E. Bellini, "Engie, Sonatrach Officialize Partnership For Solar And Renewables", *PV Magazine*, 8 February 2018, available at: www.pv-magazine.com. E. Bellini, "Eni and Sonatrach to Develop More Solar Projects in Algeria", *PV Magazine*, 19 December 2017, available at: www.pv-magazine.com.

28. A. Henni, "Algeria Explores New E&P Frontiers", *EP Magazine*, 31 May 2017, available at: www.epmag.com.

29. "Algeria Boosts Gas Production from Conventional Fields", *EP Magazine*, 30 March 2018, available at: www.epmag.com.

finance major investment projects through cheap loans. Unsurprisingly, the sustainability of this new policy mix is questioned by many, including the IMF which has recently pointed to the risks of the accelerating loss of exchange reserves, pushing inflation up and further hampering private sector development.³⁰

30. "IMF Staff Completes 2018 Article IV Visit to Algeria", *IMF Press Release*, 12 March 2018, available at: www.imf.org.

Angola

Philippe Copinschi

Angola (28.8 million inhabitants) has been deeply affected by the oil price crisis. Not only has its economy suffered seriously as a direct consequence of the country's heavy dependence on oil revenues. But its strategic position, especially towards its closest ally, China, has been considerably weakened, forcing the government to go back to the negotiating table with the international financial institutions after having ostensibly ignored their recommendations for 15 years. Last but not least, the economic crisis caused by the low oil price environment unleashed a crucial political transformation with the election of a new President who seems to be willing to engage much needed reforms of the country's political and economic legacies. Yet it remains to be seen to what extent he will want and be able to change the system.

The brutal end of the “Angolan miracle”

Immediately after the end of the civil war in 2002, Angola experienced a fantastic economic boom. Its economy grew tenfold between 2002 and 2014, and the country became the third largest economy in Sub-Saharan Africa, after Nigeria and South Africa. The large majority of the population, however, did not benefit from the new prosperity, with approximately a third of Angolans still living below the poverty line.³¹

Several factors explain this “Angolan miracle”, including the end of the war. But above all it was made possible by the rapid increase of the oil production combined with the rise of the oil price, which skyrocketed from \$22/bbl when the war ended in 2002 to over \$100/bbl in 2014 (with a peak at nearly \$150/bbl in mid-2008). Thanks to amazing oil windfalls, the government embarked on one of the most ambitious programmes of national reconstruction in Africa. The state apparatus inflated its payroll by recruiting thousands of civil servants, while an infinite number of infrastructure projects (roads, hospitals, schools, airports, hydroelectric dams, a new city, etc.) sprouted up across the country, financed by the Angolan state as well as public investment banks from emerging powers,

31. World Bank Open Data, available at: data.worldbank.org.

especially China. This considerably transformed the face of the country and created the impression that Angola was entering a new era of prosperity. In 2005-2007, GDP growth averaged 21% per year. In the process, the regime created the conditions for an immense accumulation of wealth by the most influential members of the ruling party, and the individuals that sustained the country's security apparatus.³² In particular, the son and the daughter of President Dos Santos joined the richest persons of the continent.³³

However, this oil-fuelled national reconstruction programme soon proved to be unsustainable, as only a limited number of projects were actually able to function independently from oil. The majority of business investments focused on the distribution of financial resources among the elite, rather than the creation of employment opportunities for the population, especially out in the countryside where people continued to depend on public subsidies to survive.³⁴ The failure to diversify the economy away from the oil industry actually made Angola more and more dependent on oil revenues. Once a significant exporter of agricultural products such as coffee, but also diamonds and minerals, Angola now relies totally on this sole resource. The oil sector accounts for virtually all of the country's exports, three quarters of the government revenues and about a third of the GDP.³⁵ Quite logically, the sudden and abrupt collapse of oil prices in 2014 brutally stopped the miraculous economic growth, making Angola just another classic example of economies mismanaging their oil resources.

Angola was severely hit by the storm of falling oil prices. While Angola earned around \$71 billion in oil revenues in 2012, that figure dropped to as low as \$26 billion in 2016. As a consequence, the GDP growth rate collapsed, from nearly 7% in 2013 to 3% in 2015 and the country entered recession at -0.8% in 2016, before weakly recovering at 0.7% in 2017.³⁶ Even if the recovery is slow, economic growth is projected to accelerate to 2.2% in 2018, driven by higher oil prices. From 2012 to 2016, the country's GDP decreased from \$127 billion to \$95 billion (before recovering to \$124 billion in 2017). While Angola used to have a State budget surplus (up to 10% of GDP in 2011), fiscal policy was loosened from 2014 onwards, leading to a budget deficit of about 6% of GDP in 2017. Quite logically, the government's gross debt has increased at the same time from 30% of the

32. M. de Alencastro, "Angola under Lourenço: Towards a Negotiated Hegemony", *Notes de l'Ifri*, Ifri, February 2018, p. 9, available at: www.ifri.org.

33. "Isabel Dos Santos", *Forbes*, available at: www.forbes.com.

34. M. de Alencastro, "Angola under Lourenço: Towards a Negotiated Hegemony", *op. cit.*, p. 11.

35. *Angola Staff Report*, International Monetary Fund, February 2017.

36. "IMF Datamapper", International Monetary Fund, available at: www.imf.org.

GDP in 2012 to 80% in 2017. Inflation has surged (from 7.3% annually in 2014 to over 30% in 2016 and 2017), and the national currency, the kwanza, lost more than 60% of its value against the dollar between May 2014 and May 2018.³⁷ Moreover, as Angola depends almost exclusively on oil exports to access foreign currency, the severe lack of dollar liquidity, a consequence of the depressed oil price and the collapse of the local currency, has forced the government to take a series of drastic measures, including currency and capital controls. These have amplified the consequences of the oil price crisis, and have negatively impacted the capacities of the International Oil Companies (IOCs) to operate.³⁸

Declining oil production

Although the first commercial oil discovery was made in the 1950s when Angola was still a Portuguese colony, production really became significant in the 1980s, just after the country acquired independence in 1975 and despite the civil war that lasted from the independence until 2002. Thanks to a series of major, deep-water discoveries in the 1990s, Angola's oil production increased by about 15% per year on average between 2002 and 2008, allowing the country to become a member of OPEC in 2007. Oil production reached a peak of nearly 2 mb/d in 2008, briefly allowing the country to challenge Nigeria as the largest oil-producer in Sub-Saharan Africa. It has since then started to decline and stood just below 1.6 mb/d in the first quarter of 2018.³⁹

Angola has around 11 billion barrels of proven oil reserves, which represent 0.67% of global proven reserves.⁴⁰ However, Angola's pre-salt blocks hold very promising oil deposits, which means that the country's reserves could be much higher. Angola's challenge is that its main potential for new oil discoveries lies precisely in the ultra-deep offshore areas, where resources are very expensive to exploit. Given the time and the investment necessary to develop those resources, the IEA believes that the next fields to come on stream are more likely to sustain rather than boost production because of the fast decline in the country's more mature fields.⁴¹

Despite having been ruled by a Marxist-Leninist regime (led by the Popular Movement for the Liberation of Angola, MPLA) for more than

37. All figures are from the IMF World Economic Outlook (April 2018), except for those on the oil revenues (OPEC) and the kwanza-dollar exchange rate (Bloomberg).

38. L. Corkin, "After the Boom: Angola's Recurring Oil Challenges in a New Context", *OIES Paper: WPM 72*, Oxford Institute for Energy Studies (OIES), May 2017, p. 8.

39. *OPEC Monthly Oil Market Report*, April 2018.

40. *BP Statistical Review of World Energy*, June 2017.

41. "Africa Energy Outlook", *World Energy Outlook Special Report*, IEA, November 2014, p. 96.

15 years after the independence,⁴² Angola has always remained very open to foreign investors. In the context of the civil war, the government soon understood that a functioning oil industry would be necessary to finance its war effort and political survival, and made sure it kept normalised relations with the IOCs. Apart from Shell, all of them have been active in the country since the 1980s, with Chevron (the historical operator), Total, ExxonMobil, BP, and ENI operating most of the output facilities under production sharing agreements (PSAs) with Angola's National Oil Company (NOC) Sonangol, a "state within the state".⁴³

Since 2014, all the IOCs have drastically reduced their investments. A number of projects have been delayed or put on hold, even though final investment decisions (FIDs) had been made. The focus for the IOCs shifted from investing in discovering new fields and launching new projects, to cutting costs and preserving the cash flow of existing ones.⁴⁴ As a result, the number of operational rigs decreased from 18 in early 2014 to only 2 in April 2018.⁴⁵ Moreover, as the oil industry relies on dollar-denominated imports, the restrictive measures taken by the Angolan government on currency and capital control led to a complete halt in the routine maintenance required for oil installations, which directly impacted production capacities.⁴⁶ Due to financial stress, Sonangol also fell into arrears with its payments to its contractors and associates, including Chevron, Angola's oldest operator and strategic partner. This has severely impacted relations between the government and the country's most important investors. In response, IOCs have started putting pressure on the government to lighten their corporate tax burden, implying that subsequent new investments are conditional on substantial revisions to tax legislation for oil activities. Given its dependency on foreign expertise and capital, the government started in 2016 to revise key pieces of legislation and introduce a certain flexibility into the legal framework that governs the petroleum industry.⁴⁷ A positive factor is the recent ramp up of the Chevron-led Angolan LNG terminal.⁴⁸

42. The MPLA changed its ideology and embraced capitalism in the early 1990s, just after the end of the Cold War.

43. B. Augé, "Les stratégies des compagnies pétrolières nationales africaines", *op. cit.*

44. L. Corkin, "After the Boom: Angola's Recurring Oil Challenges in a New Context", *op. cit.*, p. 10.

45. B. Hughes, "Baker Hughes, a GE Company Announces May 2018 rig counts", *Press Release*, available at: www.bhge.com.

46. L. Corkin, "After the Boom: Angola's Recurring Oil Challenges in a New Context", *op. cit.*, p. 8.

47. *Ibid.*, p. 9 et B. Augé, "Les stratégies des compagnies pétrolières nationales africaines", *op. cit.*

48. "UPDATE 1-Angola LNG Steps Up Exports Ahead of Maintenance", Reuters, available at: af.reuters.com.

Towards a complete strategic and political overhaul

During the economic boom in the 2000s, as part of its reconstruction effort, Angola received huge amounts of foreign investment from Western and emerging powers. In this context, Angola has become the most important African partner for China in a balanced, mutually beneficial relationship. On the one hand, Angola has enthusiastically welcomed the arrival of Chinese investments, allowing it to develop completely autonomously from the tutelage of international financial institutions. On the other hand, China, being in the midst of its Africa offensive, was eagerly eyeing Angola's huge energy resources. Not only did Angola become China's second-largest supplier of crude oil from 2005 onwards, but the two countries also established a close partnership in which China provided billion-dollar loans with very low interest rates to Angola, that in turn used these monies to pay for infrastructure projects led by Chinese companies. This became known as the "Angola Model".⁴⁹

This model, though very successful for a decade, started collapsing after 2014 when China realized that Angola was struggling with a huge indebtedness. China started to limit drastically the allocation of funds to Angola, and Chinese companies started to leave the country as the Angolan government was not able to honour the contracts it had signed. As a consequence, Angola found itself in a position of unprecedented fragility since the end of the civil war, trapped in Chinese debt, with most of its oil revenues being used to repay the Chinese credit lines.⁵⁰

As the country needed emergency financial help and China was unwilling to renew its support, the government had no other choice but to call for assistance from the IMF. In April 2016, negotiations began with the IMF for a three-year loan facility of approximately \$1.5 billion per year. In exchange, the IMF proposed a package combining the adoption of immediate macroeconomic measures, including devaluation, the end of subsidies in most economic sectors, and a series of structural reforms.⁵¹ Yet no country support programme was finally put in place as the situation improved and the government managed to stabilize the economy and start reforms. An Article IV Consultation mission took place in March 2018,

49. R. Soares de Oliveira, "Magnificent and Beggar Land. Angola since the Civil War", London: Hurst, 2015.

50. M. de Alencastro, "Angola under Lourenço: Towards a Negotiated Hegemony", *op. cit.*, p. 24.

51. *Ibid.*, p. 22.

which was concluded in May 2018.⁵² That same month, the Angolan government announced its intention to privatize (fully or partially), about 74 of its public companies, yet without any mention of Sonangol.⁵³ In the accompanying Eurobond prospectus, the country's total debt was estimated at \$77.3 billion as at the end of 2018, i.e. 70.8% of GDP.⁵⁴

Last but not least, the new economic and geopolitical constraints created by the low oil price environment forced President Dos Santos to step down after 38 years in power. A new head of State, João Lourenço, was elected in August 2017.⁵⁵ Although Lourenço belongs to the same party as Dos Santos, he quickly showed his determination to reform profoundly the state and the economic system which are totally plagued by corruption.⁵⁶ The desperate situation of the economy combined with the discontent of the population, brought on by multiple corruption scandals involving the government's authorities, left Lourenço little choice but to be ruthless. Soon after he came into power, he started to dismantle the "state inside the state" that Dos Santos had put in place in view of his succession, with a speed and intensity that few believed possible. In November 2017, Lourenço dismissed Isabel Dos Santos, the daughter of the former president, as CEO of Sonangol. In January 2018, he removed José Filomeno Dos Santos, the son of the ex-president, from his position as chairman of the Angolan sovereign wealth fund. A couple of weeks later, José Filomeno Dos Santos was charged with fraud along with the former central bank governor.⁵⁷

The fall of the oil price was probably the trigger, rather than the cause of the current political and economic evolution. The country has faced an unprecedented economic crisis, and a growing number of voices have been calling for development, industrialisation and economic diversification away from the oil industry. Even though this discourse is not new, it sounds more real than ever before as, for the first time, there is clearly some political willingness to take reform forward. Although Lourenço has proven to be an agile operator in the first months of his presidency, it is still too early to tell whether he will be able to bring radical change to the

52. "IMF Staff Completes 2018 Article IV Consultation Mission to Angola", IMF, 16 March 2018, available at: www.imf.org; "IMF Executive Board Concludes 2018 Article IV Consultation with Angola", IMF, 21 May 2018, available at: www.imf.org.

53. "Angola Plans to Privatize More Than 70 Companies in Medium Term", Reuters, 11 May 2018.

54. "L'Angola prépare une importante vague de privatisations", *La Tribune d'Afrique*, 12 May 2018, available at: afrique.latribune.fr.

55. M. de Alencastro, "Angola under Lourenço. Towards a Negotiated Hegemony", *op. cit.*

56. Angola ranks 167 out of 180 in the Transparency International's Corruption Perceptions Index 2017.

57. "Frozen \$500 Million in Angolan Fraud Probe Came From Central Bank Account with Standard Chartered", *Reuters*, 28 March 2018, available at: www.reuters.com.

economic system and implement new governance. What is certain, however, is that he clearly understands that the Angolan regime has no alternative other than deep reform if it intends to survive the new reality of the global oil market.

Azerbaijan

Marc-Antoine Eyl-Mazzega

Azerbaijan's economy has been severely impacted by lower oil prices, as the oil and gas sector represented 40% of GDP in 2014. The country (9.7 million inhabitants) entered recession and faces a weakened banking sector with high defence spending at the same time. The decline in oil production observed in recent years is expected to stabilize following investment decisions made in several fields or upcoming commissioning of major projects, such as Shah Deniz 2 and the opening of the Southern gas corridor.

Azerbaijan's economy has suffered from the oil price storm

Following the fall in oil prices but also weak economic growth by its main trading partners, export revenues collapsed in 2014. The transition to a floating exchange rate and the depreciation of the currencies of its neighbouring economic partners, such as the sharp depreciation of the Russian rouble, were all negative economic shocks that affected the country's foreign trade.

The decline in export-related revenues was largely driven by the oil sector, which accounts for the bulk of exports. In 2014 and 2016, they represented respectively 94% and 90% of total exports.⁵⁸ These revenues were almost halved between 2014 and 2015, decreasing from \$28.26 billion to \$15.59 billion and were estimated (e) to reach \$13.53 billion in 2016, a decrease over the entire period of more than 52%.⁵⁹

This contributed to a drastic drop in the trade balance. The trade surplus fell from \$18.92 billion in 2014 to around \$5.8 billion in 2015, and \$5.1 billion in 2016. According to the IMF, the trade balance could gradually rise to around \$7.7 billion in 2020, thanks to a decrease in

58. "2016 Article IV Consultation – Press Release; Staff Report, and Informational Annex on the Republic of Azerbaijan", International Monetary Fund, September 2016.

59. *Ibid.*

imports and a slight increase in non-oil sector exports supported by the currency depreciation.

Following the decline in oil prices, Azerbaijan tried to defend its currency indexed to the dollar. This led to a sharp drop in the country's foreign exchange reserves from \$13.76 billion in 2014 to \$4.02 billion in 2015 (e) and \$4.12 billion in 2016 (p).⁶⁰ Following these falling foreign exchange reserves, the Central bank of Azerbaijan proceeded with two devaluations in 2015 before moving to a managed floating system. In February 2015, the Central bank undertook a first devaluation of 25%. The value of the Azeri Manat decreased from 0.766 Manat per dollar to parity between the two currencies. Then a second devaluation took place in December 2015, before the move to a floating system. The value of the currency decreased from about 1 Manat per dollar to over 1.55 Manat per dollar. The Manat now trades at around 1.70 per dollar. This depreciation of the exchange rate has led to an increase in inflation, up from 4.1% in 2015⁶¹ to 15.6% in 2016 and to 7.9% in 2017.⁶² This has prompted the Central bank to gradually increase its refinancing rate, which reached 15% in September 2016. The rate was then lowered in 2018 to about 11% as inflation had slowed down.⁶³

The collapse in oil prices also led to lower growth in the non-oil sector. The IMF describes the transmission of the slowdown in the oil sector to the non-oil sector as passing via a decline in public investment: the decline in oil prices directly affects the revenues of oil companies operating in Azerbaijan and thus the rents of the State Oil Fund of the Republic of Azerbaijan (SOFAZ). In order to finance its public investments that partly fuel growth in the non-oil sector, the government relies on transfers from the fund. Yet repeated and substantial budget support by transfers from the SOFAZ fund to the government are contrary to the fund's primary purpose which is to create wealth for future generations.⁶⁴

The country's economic growth declined in 2014 to 2.8%, decreasing further to 1.1% in 2015, followed by a recession in 2016 as growth fell by -3.7%.⁶⁵ The economy GDP growth is expected to recover slowly to around 0.1% in 2017, and is projected at about 1.7% in 2018⁶⁶, highlighting once again the dependence of the economy on hydrocarbon revenues.

60. *Ibid.*

61. Central Bank of the Republic of Azerbaijan, available at: en.cbar.az.

62. Worldbank, available at: pubdocs.worldbank.org.

63. Central Bank of the Republic of Azerbaijan, available at: en.cbar.az.

64. For more details: K. Aslanli, "Fiscal Sustainability and the State Oil Fund in Azerbaijan", *Journal of Eurasian Studies*, 2015.

65. Central Bank of the Republic of Azerbaijan, available at: en.cbar.az.

66. "Azerbaijan: Economy", Asian Development Bank, available at: www.adb.org.

The fall of the national currency has put an already fragile Azeri banking sector under pressure. The government has merged or closed the smaller banks and restructured the larger ones. The state-owned International Bank of Azerbaijan (IBA), the country's biggest bank, defaulted on its debt payments in May 2017. It embarked on a process of restructuring and negotiating with its creditors.⁶⁷ The IBA proposed to swap debt for sovereign bonds, at higher interest rates and different maturities against a debt write down.⁶⁸ Following this restructuring, which was finally accepted by 93.9% of the creditors after negotiations,⁶⁹ the first bank of Azerbaijan is now preparing its privatization, which is scheduled to take place in 2018.⁷⁰

To stimulate growth and protect the most affected segments of the population, the government has put in place a counter-cyclical fiscal stimulus package while increasing public sector wages and social protection. This has contributed to the increase of government spending.⁷¹ The government budget has shifted into deficit: -0.5% of GDP in 2014, then -1.2% in 2015, -0.4% in 2016 and around -1.6% in 2017.⁷² Consequently, the state's debt has more than doubled in a year. With more than three quarters of the debt denominated in foreign currency, the depreciation of the Azeri currency has been a compounding factor.⁷³ The gross government debt rose from 11.2% of GDP in 2014 to 28.3% in 2015, and is projected to remain at between 36% and 38% from 2016 to 2018.⁷⁴ The rising indebtedness has also been related to the costs of the restructuring of the banking sector, notably the IBA bank.

To cover its budget deficit, Azerbaijan has also drawn on its fiscal reserve fund SOFAZ: the fund's assets decreased from \$37.1 billion in 2014 to \$33.1 billion in 2016.⁷⁵

67. H. Foy, "Azerbaijan's Biggest Bank Launches Debt Restructuring", *The Financial Times*, 23 May 2017, available at: www.ft.com.

68. H. Foy, "Bank of Azerbaijan Offers Debt Swap To Creditors", *The Financial Times*, 23 May 2017, available at: www.ft.com.

69. H. Foy, "Investors Back Restructuring of International Bank of Azerbaijan", *The Financial Times*, 18 July 2017, available at: www.ft.com.

70. "International Bank of Azerbaijan Assets Down to \$4.9 bln at end March", Reuters, 16 April 2018, available at: www.reuters.com.

71. "2016 Article IV Consultation – Press Release; Staff Report, and Informational Annex on the Republic of Azerbaijan", International Monetary Fund September 2016.

72. Central Bank of the Republic of Azerbaijan, available at: en.cbar.az.

73. "2016 Article IV Consultation – Press Release; Staff Report, and Informational Annex on the Republic of Azerbaijan", International Monetary Fund, September 2016.

74. *Ibid.*

75. *Annual Report 2016*, State Oil Fund of the Republic of Azerbaijan, available at: www.oilfund.az.

Declining oil production while new investments were sanctioned

Azerbaijan is endowed with significant oil reserves concentrated in its exclusive economic zone of the Caspian Sea. The country holds about 0.4% of the world's proven oil reserves – the equivalent of 7 billion barrels – and ranks 21st in the world.⁷⁶ Hydrocarbon production is mainly concentrated in three key fields: the Azeri, Chirag and Guneshli (ACG) fields, which account for more of 70% of the country's crude production, operated by BP in a consortium with the Azerbaijan International Operating Company (AIOC).

After a fall in production following its independence in December 1991, output was ramped up from around 183 kb/d in 1996 to reach its highest point of 1.023 mb/ in 2010.⁷⁷ This coincided with the peaking of the ACG complex. Oil production has declined in Azerbaijan since 2010, mainly due to the ongoing decline of the ACG fields. Between 2010 and 2014, oil production decreased by an average of -4.5% per year over the period, while in 2015 and 2016 the decline in production slowed down to respectively -2.4% and -1.6%.⁷⁸ Production reached 800 kb/d on average in 2017.⁷⁹

A milestone in ACG operation was achieved in September 2017 with the signature of an amended and restated ACG PSA, which was extended from 2024 until 2049. Under the agreement, the partners agreed to pay a bonus of \$3.6 billion to SOFAZ, and state-owned State Oil Company of Azerbaijan Republic (SOCAR) increased its equity share in the ACG PSA from 11.65% to 25%.⁸⁰ This agreement is paving the way for dozens of billions of dollars in new investments in the fields over the next decades.⁸¹ The production of the ACG oilfields fell from 620 kb/d on average in 2016⁸² to 588 kb/d for the year 2017, i.e., a reduction in the production of about 5%.⁸³ To halt the natural decline of the fields and irrespective of the decline in oil prices, the AIOC consortium has repeatedly realized injection

76. BP Statistical Review of World Energy, 2017.

77. BP Statistical Review of World Energy, 2002, 2009 & 2017.

78. BP Statistical Review of World Energy, 2017.

79. "Azeri Oil Production to Drop in 2018, Strong Compliance with Output Deal Seen", Platts, available at: www.platts.com.

80. The new ACG shareholder structure comprises: BP, 30.37%; AzACG (SOCAR), 25.00%; Chevron, 9.57%; INPEX, 9.31%; Statoil, 7.27%; ExxonMobil, 6.79%; TP, 5.73%; ITOCHU, 3.65%; and ONGC Videsh Limited (OVL), 2.31%.

81. "The Azerbaijan Government and Co-Venturers Sign Amended And Restated Azeri-Chirag-Deepwater Gunashli PSA", BP Press Release, available at: www.bp.com.

82. IEA, *Oil 2018*, Paris, March 2018.

83. *Ibid.*

wells to sustain output. In 2017, 17 new production wells were added as well as 3 water injection wells. At the end of 2017, there were a total of 115 production wells and 54 injection wells in the complex.⁸⁴

In parallel, the development of Shah Deniz 2 phase is almost complete⁸⁵ and is expected to produce around 100 kb/d of condensate, in addition to 16 bcm/y of natural gas. This is on top of the 50 kb/d of condensate and 10 bcm/y of gas that can already be produced from Shah Deniz 1.⁸⁶

Moreover, two new branches have been established by SOCAR to develop the oil and gas fields of Absheron (SOCAR Absheron with Total) and Karabakh (SOCAR Karabakh with Equinor, former Statoil). Drilling operations in the two fields should start by the end of 2018/beginning of 2019,⁸⁷ while production is expected in early 2020.⁸⁸

On 26 April 2018, BP and SOCAR signed an exploration and development agreement on the Block D230, in the Azeri Waters to the north of ACG fields.⁸⁹ About a month later, on 30 May 2018, Equinor and SOCAR agreed on the exploration, development and production sharing for the Ashrafi-Dan Ulduzu-Aypara area located in Azerbaijan's section of the Caspian Sea.⁹⁰

Azerbaijan was a party to the OPEC + Vienna agreement and symbolically pledged to reduce its production by -35 kb/d from a supply baseline of 815 kb/d.⁹¹ In general, Azerbaijan proved to be compliant with its commitment: Azerbaijan had an average compliance rate of 90% for 2017, and 77% for the entire period until April 2018.⁹²

In spite of the lower oil prices and related budget constraints, BP, SOCAR and their partners have also been active in completing the Southern gas corridor supply system, totalling about \$40 billion investments and 3,500 km in pipelines. The project is on schedule for first gas supplies to Turkey in the second half of 2018, and later on to the EU via

84. BP 2017 year-end results, available at: www.bp.com.

85. *Ibid.*

86. "Shah Deniz Stage 2, Azerbaijan", BP Press Release, available at: www.bp.com; "Shah Deniz Stage 1", BP Press Release, available at: www.bp.com.

87. "SOCAR to Start Drilling Appraisal Well at Karabakh Field by Year-End", *Azernews*, 2 March 2018, available at: www.azernews.az.

88. "Total Talks Gas Extraction at Azerbaijani Absheron Field", *Azernews*, 20 February 2018, available at: www.azernews.az.

89. "BP and SOCAR Sign New Production Sharing Agreement For Azerbaijan Exploration", BP Press Release, 26 April 2018, available at: www.bp.com.

90. "SOCAR and Statoil (Equinor) Agree To New Joint Upstream Projects in the Caspian Sea", SOCAR Press Release, 30 May 2018, available at: www.socar.az.

91. IEA, *Oil Market Report*, October 2017.

92. IEA, *Oil Market Report*, April 2018; IEA, *Oil Market Report*, January 2018.

the TANAP and TAP pipelines.⁹³ In autumn 2017, the European Bank for Reconstruction and Development (EBRD) provided \$500 million for the completion of the TANAP project, alongside other multilateral financial institutions. Azerbaijan's upstream sector is one of the most open to foreign investments in the entire region, and the country has the potential to increase its gas production further, beyond Shah Deniz 2, as gas fields such as Absheron (FID expected in 2018), Umid and Babek alongside Shafag-Asiman may well be developed or expanded in the coming five years. The ability of the country to ramp up gas exports in the longer term will depend on the increase of its internal gas demand (which has already prompted SOCAR to seek to import Russian gas again, with pricing levels reportedly a blocking factor), the pace of production increase and the available capacity in export infrastructure, which can be further expanded.

A regional hub

This year marks the celebration of the centenary of the Azerbaijan Democratic Republic. President Ilham Aliyev, in office since 2003, won the early Presidential election of 11 April 2018 with a strong majority and high turnover. Yet as in previous elections, the Organisation for Security and Cooperation in Europe (OSCE) has noted that the election took place in an "absence of pluralism (...) and genuine competition".⁹⁴

Located strategically between Russia, China, Iran, Turkey and the EU, while enjoying close relations with the US, Azerbaijan has always had a multidimensional foreign policy. It has aimed at ensuring secure and diversified oil and gas exports (notably the strategic Baku-Tbilissi-Ceyhan oil pipeline), secure oil and gas production in the Caspian, support for its regime and international support in the Nagorno-Karabach conflict against Armenia. With President Obama starting to reduce US involvement in the region and President Trump seemingly following the same strategy, the country has gone back to pursuing a regional balance-of-power policy, developing an East-West Baku-Kars and North South Russia-Iran rail transport corridor and showing new interest in a trans-Caspian pipeline which would turn it into a gas transit country. Relations with Iran have eased, as highlighted by discussions over the delimitation of the Caspian Sea and disputed fields alongside the transport corridor projects. But these relations remain clouded by Azerbaijan's very close ties with Israel. The country remains very active in terms of military spending (representing

93. "Shah Deniz Stage 2", BP Press Release, available at: www.bp.com.

94. "International Election Observation Mission: Republic of Azerbaijan, Early Presidential Election, 11 April 2018", OSCE, available at: www.osce.org.

3.9% of GDP in 2017, down from 5.5% in 2015),⁹⁵ and in terms of diplomatic and military attempts to regain the Nagorno-Karabach territories from Armenian forces. With foreign investments in its oil and gas sector having peaked yet still set to attract a total of around \$15-25 billion in the coming years, the country cannot afford a military conflict that would jeopardize these vital production assets. Yet military spending is high and its arms weapons race with Armenia is continuing, with Russia playing the role of a referee and, from time to time, when hostilities blow up, gathering leaders' summits, such as in Sochi. It remains to be seen how the sudden change of power in Armenia will impact this tragic, long standing conflict which OSCE involvement has not managed to end. While Georgia-Russia relations have somehow stabilized and the North Caucasus has become less violent, this conflict still has the potential to destabilize the entire region.

95. SIPRI, "Military Expenditure By Country As Percentage Of Gross Domestic Product, 1988-2002", available at: www.sipri.org.

Iraq

Saïd Nachet

Iraq has been shaken by many violent, destabilizing crises in the past 15 years, including the US invasion in March 2003, sectarian violence and civil war in 2006-2008, the partial occupation by ISIS and the fight against ISIS, as well as the dispute between the Iraqi central government and the Kurdistan Regional Government (KRG) over oil rights and associated revenues. Despite these upheavals, Iraq's current oil production today is three times higher than its level in 2003.⁹⁶ Iraq (37.2 million inhabitants) increased its oil production by 25% between 2014 and 2016, adding 1.5 mb/d,⁹⁷ thanks to past oil-sector investments, security improvements in key production areas and the completion of necessary infrastructure for oil exports. Keeping oil flowing to supply international buyers is crucial to Iraq as every single macroeconomic indicator of the Iraqi economy is dominated or determined by oil, which provides 51% of Iraqi GDP, 88% of State budget revenues and 99% of total exports.⁹⁸ Both the current account and the foreign exchange reserves seem to track crude prices closely. With the internal situation finally starting to stabilize, and a new government expected to take office following the May 2018 legislative elections, the country has the financial resources and international support to diversify and reform its economy, and ultimately turn the reconstruction into an opportunity for robust and inclusive growth and development. Yet, corruption and internal feuding are expected to be key obstacles.

Iraq was hit by the fall in oil prices while fighting ISIS and facing mounting tensions with the KRG

Iraq has been hit by three storms at the same time: the fight against ISIS and episodes of violence and destruction; and the fall in oil prices, which

96. Iraq registered an additional production of some 1.7-1.8 mb/d from 2011 to 2016.

97. Overall, Iraq registered the highest oil production growth between 2011 and 2016, with the exception of the US.

98. « La situation économique et financière de l'Irak », *Note du Trésor*, France, December 2017.

were not offset by higher production; and mounting tensions with the KRG, which culminated in September and October 2017.

Before being recently defeated at end of 2017, ISIS had controlled almost 30% of Iraq's territory with the country facing a deteriorating security environment and a devastating economic situation. According to the Iraq authorities' official reports, 10% of the Iraqi population was displaced during the war against ISIS, while the country was also receiving Syrian refugees. Access by a significant proportion of the Iraqi population to water, electricity and fuel remains very limited, with poverty gaining ground nationwide, and even more in the ISIS-affected governorates. The unemployment rate exceeds 16% and even more so among young people. More than 8 million people (a bit over 20% of total population) rely on revenues from public sources (wages or pensions), all connected in one way or another to the government as sole source of revenues. The conflict with ISIS has added to the fragility of the oil-dependent economy with some 11 million people, one third of the population, depending on humanitarian aid. The conflict has also damaged the country's infrastructure and assets. As the World Bank notes, "at the end of 2017, the cumulative real losses due to the conflict stood at 72% of the 2013 GDP and 142% of the 2013 non-oil GDP".⁹⁹

The devastation caused by ISIS and falling oil prices came when the country had finally started to rebound: mirroring oil production growth, the Iraqi economy made smooth and steady progress during the post-Saddam era, recording a GDP increase from \$12.3 billion in 2000 to \$222.9 billion in 2013. During the high oil price era, the country used to earn some \$8 billion per month from its oil exports, an amount that declined sharply to \$3 billion per month in autumn 2014, while wages of civil servants alone amounted to \$4 billion monthly in 2016,¹⁰⁰ including the army and security forces that are so important to the country's security. Iraq's federal budget has increased steadily during the past decade, the 2015 budget being five times higher than the 2004 budget. Illustrating the race to meet short term needs, a large part of the Iraqi budget is devoted to current expenditures, with less than 30% directed to investment and development.

The rapid growth of Iraq's oil production observed over the recent years did not offset the impact of lower oil prices (after 2014) on the Iraqi State budget. Like other producing countries, Iraq turned to its exchange reserves (\$40 billion in 2014) to compensate for lower revenues following

99. "The World Bank in Iraq, Overview", available at: www.worldbank.org.

100. "Iraq", IMF Country Report No.17/251.

the oil price decline starting from mid-2014. The drop in oil prices nevertheless battered Iraq's fiscal situation as the State budget deficit increased to 14% of GDP in 2016, mainly because of the fall in oil prices. The budget deficit was mostly financed by borrowings from the Central Bank of Iraq but also by the accumulation of arrears that represented 5.5% of GDP by the end of 2016. Public debt reached 66.7% of GDP in 2016 compared to 31% in 2013,¹⁰¹ reversing the healthy growth path registered in the past (Iraq's debt-to-GDP average value was 113% for the 10 years up to 2013).

With the defeat of ISIS and oil prices moving above \$70 a barrel, the economic outlook of Iraq looks brighter compared to the gloomy situation witnessed in the past. The improvement in the security situation and the rise in oil prices now allow the central bank to maintain the currency's dollar peg, thus reducing downward pressure on the Iraqi dinar.

Higher oil prices and improved financial stability boosted Iraq's economic growth in 2016: +11%, which was the best performance in the past decade, driven by rising oil prices. But challenges remain as the country's economy is still highly dependent on the oil sector. Reducing the level of public sector employment and the associated payroll, up substantially during the 100 \$/bbl era, improving tax revenue collection and management, combating corruption, engaging the private-sector while pursuing Iraq's long-term economic development and diversification are all necessary though challenging issues that government needs to address. Economic growth fell again in 2017, as the country entered recession (-0.8%) due to lower oil output and the impact of the war against ISIS.

Building on reforms announced by the Prime Minister in August 2015,¹⁰² the Iraqi government adopted a comprehensive plan focusing *inter alia* on security, stabilization and reconstruction; integrity and transparency; and activation of lending for housing, manufacturing, and agricultural projects. Unveiled on 1 April 2018, Iraq's five-year plan aims at pushing the oil-dependent economy towards more diversification. But many observers are sceptical that such plan could be enforced effectively, due to bureaucracy, poor governance and mismanagement.

101. "Études économiques : Irak", Coface, available at: www.coface.com.

102. "Letter of Intent to IMF", Memorandum of Economic Financial Policies, and Technical Memorandum of Understanding, 23 July 2017.

The Iraqi oil miracle can deliver more, if obstacles are removed

Iraq is the 2nd biggest oil producer in OPEC after Saudi Arabia and has the world's 5th largest proven oil reserves, with 143 billion barrels. On top of this, official Iraqi data indicate that there may be up to 215 billion barrels in undiscovered oil reserves (excluding Kurdistan), as a large part of the country remains unexplored.¹⁰³ Looking ahead, Iraq is expected to be one of the largest contributors to OPEC production growth through to 2020.¹⁰⁴

Iraq managed to increase production and output levels despite the ISIS security threats since as much as 95% of Iraq's total oil production is extracted and exported through southern oil facilities. The Iraqi authorities are pushing for a further increase of the country's crude-oil exports from its southern ports, and have recently completed a new pipeline with an export capacity of 1.5 mb/d, linking oil storage sites to export terminals located on the Gulf. Iraq announced early 2018 that its export capacity was almost at 5 mb/d, a target that the country would like to achieve by the end of this year.¹⁰⁵ OPEC's second largest oil producer has however to cap its oil production at 4,351 mb/d, under the OPEC+ agreement. The Iraqi government intends to increase the country's crude production capacity from 4.4 mb/d at present to 6.5 m/d by 2022,¹⁰⁶ and produce around 6 mb/d by 2020.¹⁰⁷ Reaching this goal will require fixing many hurdles facing investors and improving governance in the sector.

The oil and gas industry is structured around different regional and sectoral companies, and the oil sector operations are handled by the Ministry of Oil. Iraq, unlike its OPEC partner countries and many other producers, does not have a national oil company.¹⁰⁸ Iraq's parliament voted in early March 2018 to establish a new Iraqi National Oil Company, which will be in charge of managing Iraq's upstream operations, yet it remains unclear how and when this will take place.

103. See: IEA, *World Energy Outlook Special Report – Irak Energy Outlook*, 2012, available at: www.iea.org.

104. A. Mehdi, "Iraqi Oil: Industry Evolution, Production Dynamics and Future Competitiveness", OIES, 16 March 2018.

105. "Iraq to Comply with OPEC Deal Despite Oil Export Capacity Rise", Reuters, 29 January 2018.

106. "Irak : un oléoduc d'export de brut de 1.5Mb/j achevé", *Petro stratégies*, 30 April 2018.

107. "Iraq to Abide By OPEC Cut, Expects Output Growth In Future", Reuters, 12 December 2016, available at: www.reuters.com.

108. A national oil company was originally established in the 1960s, but merged into the Oil Ministry in 1987.

Kurdistan's oil fields produce some 15% of total Iraqi production. The creeping conflict opposing the central government of Iraq and KRG worsened further when Baghdad cut KRG's budget in 2014. This conflict has added to the complexity of the political situation in Iraq and the management of its oil resources. Baghdad then banned any export of oil produced in Kurdistan via the northern routes and US mediation managed to ease the tensions. Yet the KRG faced several successive setbacks: in spite of international condemnation, in September 2017, KRG staged an independence referendum with more than 90% of the Kurds supporting a break away from Iraq. But Kurdish President Barzani then resigned following massive international condemnation and strong opposition from Baghdad. And importantly, almost at the same time, the central government's forces in October 2017 regained control from the Kurdish forces over the strategic Kirkuk and Mosul oil fields,¹⁰⁹ weakening Erbil and the financial resources of the KRG, especially since Baghdad had increased exports from its southern terminals to offset a halt in shipments from the northern outlets. Tensions between KRG and the central government of Iraq worsened further in early March 2018, when the KRG's share of the national budget was lowered by the Iraqi parliament from 17% to 12.5%. Another contentious issue between KRG and Baghdad is the contractual framework governing the exploration and production of hydrocarbons in Kurdistan and elsewhere in Iraq. Companies operating in Iraq are acting as contractors under technical service contracts signed with the central government, and are paid a fixed fee for each barrel extracted,¹¹⁰ while oil production remains the property of the Iraqi state. By contrast, the KRG has pursued a different course and Production Sharing Contracts (PSC)¹¹¹ with partners operating in Kurdistan.

The technical contracts governing the partnership between foreign companies and the Iraqi government are not attractive for international players which are interested in accessing oil, booking associated reserves and having some control over the way fields are developed. To maintain its (high) level of production, Iraq will need to continue investing in upstream development, but the present contracts offered to international players are not seen by them as attractive enough.¹¹² The contractual framework

109. "Iraqi Forces Retake All Oil Fields in Disputed Areas as Kurds Retreat", *The New York Times*, 17 October 2017, available at: www.nytimes.com.

110. Around \$1.15 to \$2.00 per barrel.

111. PSCs are very common in most producing countries. The production is shared between host country and oil companies operating oil fields. Operating companies are allowed to deduct the equivalent cost of development from the turnover of their activities. They are also incentivized to reduce such cost as much as possible.

112. Shell's announcement made last year to withdraw from the giant field Majnoon is an illustration of this fact.

prevailing in Iraq has actually acted against the country's own objectives of raising production. Production growth requires granting more favourable terms to foreign partners,¹¹³ while lower oil prices reduced government's revenues, forcing the Iraqi authorities to cut planned investments for higher oil output, from \$21 billion in 2014 to \$13 billion in 2015. Planned projects in Iraq currently stand at \$37 billion, a figure weighed down heavily by political, economic and security risks.

Moreover, Iraq faces an operational hurdle as rising oil output requires provision of significant quantities of natural gas for re-injection purposes. Iraq is still flaring large amounts of associated gas as oil supplies have increased, while only limited uses for natural gas have been developed. According to the World Bank, gas flaring in Iraq is around 2.5 billion cubic feet (bcf), equivalent to the country's domestic power needs,¹¹⁴ and to nearly \$2.5 billion of lost revenues for the government¹¹⁵. This is especially regrettable as the country started importing gas from Iran in 2017, and has been ramping up imports since then.¹¹⁶

In addition, Iraq will need substantial investment in water injection programs, to support its oil production plans. The government is prioritizing the power sector, especially following the loss of generation and transmission capacity during the war against ISIS. Power outages are frequent despite government support for the development of electricity sector projects to meet fast growing demand. The central government issues debt guarantees of service payments to independent power producers (IPPs) which represent the lion's share of the state guarantees in foreign currency denominated service payments (\$32,5 billion out of \$36 billion at the end of April 2017). Electricity prices remain very low, and payments represent not more than 11% of the generation and delivery cost. The government needs therefore to work on enhancing the electricity sector's performance by taking specific measures to increase prices and improve payment collection rates. It also needs to decrease the production cost of power generation by substituting imported gas and oil products with the associated gas that is currently flared.

The focus on oil Iraq's oil sector tends to highlight issues related to the upstream segment of the sector. However, and despite being a major crude oil producer, Iraqi spending on oil product imports for domestic use

113. Since the operating companies' revenues are based on the production of the fields they operate.

114. According to the Iraqi Minister of Oil, the country plans to reach zero gas flaring by 2021.

115. "Kuwait Energy Starts Producing Natural Gas from Field in Southern Iraq", Reuters, 25 April 2018.

116. "Iran's-Gas-Export-to-Iraq-to-Reach-50-mcm/d", *The Financial Tribune*, 3 June 2018, available at: financialtribune.com.

totalled some \$35 billion between 2004 and 2016.¹¹⁷ There is a dire need for foreign investment in this critical sector for Iraq, not only to fuel local needs but also to add value to its economy through manufacturing and the export of oil products. Iraq plans to boost domestic refining capacity to 1.8 mb/d, by expanding existing refineries and building new ones.

Looking ahead: political stabilization, reconstruction and economic diversification?

The reconstruction of Iraq following 15 years of armed conflict and violence remains the main challenge ahead. Gathered in Kuwait in February 2018, over 70 countries pledged to provide Iraq with \$30 billion in aid. While this amount is well below the \$88 billion requested by the Iraqi government, it provides an immediate assistance to Baghdad; most of this aid (\$17 billion) will be devoted to rebuilding homes.¹¹⁸

The strong dependence of the Iraqi economy on oil is a reality but oil also represents a valuable asset that the country can use for its post-war reconstruction and the modernization of its economy.

Iraq's development potential is real, thanks to its vast, and cheap-to-produce, domestic hydrocarbon reserves. But the country faces many challenges in converting such potential into real income flows, with many uncertainties on the horizon:

- The fast growing population of Iraq raises the urgency of economic reforms and makes job creation paramount for the government of Iraq. Approximately 290,000 people per year have been entering the labour market from 2016 onward,¹¹⁹ with two thirds of the Iraqi population below 24 years old. Jobs can no longer be created in the public sector,¹²⁰ as the government is struggling to reduce number and cost of civil servants (salaries paid to the public sector absorb some 40% of total government expenditures).¹²¹ Still, Iraqis consider a job in the public sector as their ultimate goal to enjoy abundant economic benefits (secure pensions, food ration cards, subsidized utilities, etc.). It is therefore urgent to accelerate structural reform of the economy in order to promote private sector growth and expansion, so this sector can participate fully in the job creation for the Iraqi population.

117. "Iraq's Oil Revenue Conundrum: Challenges and Opportunities of The Upstream Sector", APICORP Energy Research Vol. 3, No. 1, October 2017.

118. According to the United Nations, some 40,000 homes need to be rebuilt in one city (Mosul).

119. Booz and Company.

120. The State represents the largest employer in the country.

121. Coface, December 2017.

- The handling the KRG issue. The Iraqi government insists on having SOMO, the State Oil Marketing Organisation, manage the exports of the oil produced in Kurdistan, while the Central authorities of Iraq need the northern road to export IOCs production, thus securing revenues. On the other hand, the KRG owes a debt of some \$20 billion to many stakeholders (international oil traders, IOCs, Turkey, etc.) that could be better addressed if handled by Iraq as sovereign country. In addition, "Kurdish oil" will be sold at better prices through SOMO than by selling it to traders at discounted rates. It is worth noting that despite the ongoing acrimony between Baghdad and the KRG, Kurdish lawmakers voted with a parliamentary majority to establish the new Iraqi oil company.¹²² There are therefore mutually beneficial and converging interests between the central Iraqi authorities and KRG which are very positive for the country's future.
- Following the eight-year Iran-Iraq war, and the years of violence since March 2003, Iraq has not demonstrated an ability to achieve a high level of stability and to improve its business environment. Corruption remains a concern as it represents a major constraint on private sector development and on Iraq's attractiveness for foreign investors, according to the World Bank's Investment Climate Assessment.¹²³ Despite the local environment, foreign partners' interests and appetite are visible, including from "newcomers". Two Chinese companies (Power China and Nerco Chinese) were selected early this year by the Ministry of Oil to build a new 300 kb/d refinery in Al-Faw, and Baghdad awarded a development contract to Zhenhua Oil to develop an East Baghdad oilfield. The new Iraq-China partnership is supported by the development of oil trade between the two countries: China's imports of Iraqi oil amounted to an average of 740 kb/d in 2017 (up from zero in 2007) and represented almost 9% of total Chinese oil imports. China also provides bilateral loans aimed at rebuilding Iraq's economy and developing Iraq's infrastructure sector. Iraq also lies along a key route of the Chinese Belt and Road Initiative. Furthermore, there is an expression of interest from Arab partners to invest in Iraq; Algeria has expressed its willingness to invest in Iraq through its national company Sonatrach, while Qatar has announced similar intentions through Qatar Petroleum. The new Iraqi National Oil Company will have to be a model of transparent and efficient management and operations, yet this is not a given.¹²⁴

122. The law however excludes the Kurdistan region from the reach of new national oil company.

123. Iraq is the 10th most corrupt country in the world, according to Transparency International.

124. N. Butler, « The Dangers of Iraq's Oil Law », *The Financial Times*, 30 April 2018, available at: www.ft.com.

After the legislative elections held on 12 May 2018, the formation process of the new government has to reflect the parliamentary blocs that have resulted from different coalitions. The timing of such elections and the formation of the new government is not ideal as the country is studying the set-up of a new national oil company, the revision of the terms of the existing technical contracts, the signature of new exploration and production contracts with IOCs, and many other reforms which need to be pursued. Many challenges are awaiting action from the new government, and are already on the table of the new Prime Minister of Iraq. Implementing solutions could lead to quick and tangible results provided that all coalitions are working in the interest of Iraq and not in the interest of sectarian, political or foreign powers.

Iran

Elodie Bernard

Before the round of American and European sanctions related to Iran's nuclear activities in 2010 and mid-2012, Iran (80.2 million inhabitants) was OPEC's second largest oil producer. The intensification of American and European sanctions from 2010 onwards, and the reduction of oil exports from January 2012 (especially with the European decision to terminate all purchases of Iranian crude oil, refined petroleum and petrochemicals) had already undermined the Iranian oil and gas sector. Yet this round of sanctions was a key driver for economic reforms in Iran, especially introduced by the first Rouhani administration, beginning in 2013. The short-lived period of lifting sanctions following the Joint Comprehensive Plan of Action (JCPOA) of 2015 and the Implementation Day in early 2016 brought more leeway for the implementation of reforms, and enabled the re-election of President Rouhani in May 2017, supported by a large mobilization of Iran's middle class, eager for changes. However, the US withdrawal from the JCPOA in May 2018 is leading to huge uncertainties over the country's ability to pursue reforms, as oil exports will face renewed challenges and investments will not flow. The legitimacy of reformers and their ability to balance the strong influence of the clerics and the Revolutionary Guard are under pressure. There are open questions as to how the economy, which has successfully diversified away from oil, Iran's civil society and different power centres will adapt to another era of "resistance".

Iran's energy and financial sectors have faced decades of sanctions

Iran has a long history of facing Western sanctions. Its oil and gas sector were already targeted by sanctions with the Iran and Libya Sanctions Act of 1996 by the US Congress. But major oil companies maintained their activities in the country through to the 2000s.

On July 2010, the American Comprehensive Iran Sanctions, Accountability and Divestment Act targeted the development of petroleum resources in Iran, the production of refined petroleum products, and the

export of refined petroleum products to Iran. The National Defense Authorization Act of 2011 and the Iranian Financial Sanctions Regulations of 27 February 2012 have impacted Iran's financial transactions.¹²⁵ In 2012, the Iran Threat Reduction and Syria Human Rights Act strengthened sanctions against Iran's energy sector and imposed sanctions on foreign companies conducting business with Iran's energy sector and any company that insures, sells or leases tankers to Iran. This act was implemented as of February 2013: one of its effects has been that Iran has limited access to foreign oil revenues.

The 2010 round of sanctions targeted oil and gas exports and large-scale investment in the sector, by restricting them drastically, if not stopping them. Similarly, Iran's financial transactions were targeted, by cutting off its access to financial transaction services.

The EU also issued council decisions to impact Iran's oil and gas sector. The European Council decision 2010/413/CFSP of July 2010 banned EU exports of key equipment and technology for oil and natural gas production, exploitation and refining, financing in Iran's energy sector, and the Council decision 2012/365/CFSP of October 2012 established additional sanctions against Iran's banking system, oil and petrochemical industry as well as its shipping industry. In March 2012, the EU prohibited companies such as SWIFT from providing financial communication services to Iranian financial institutions that were subject to European sanctions.

In February 2013, the implementation of new restrictions on foreign banks receiving Iran's oil revenues significantly undermined the sector. Iran could still sell to six remaining customers,¹²⁶ but it was prohibited from repatriating its oil revenues other than by bilateral or humanitarian trade.

The imposition of successive waves of sanctions from 2010 had a similar effect as a drop in oil prices, namely reducing Iranian oil exports and cutting oil export revenues. Iran's oil exports fell by nearly 60% between 2010 and 2014, while oil export values only decreased by about 25%, thanks to high oil prices. The fact that Iran was hit by a fall in prices, while sanctions were maintained, did not have any major additional impact on its oil sector. Iran already had to cope with a reduction of oil export

125. The first Act banned foreign banks from opening accounts in the US if the banks processed payments of oil through the Central Bank of Iran. The second Act extended sanctions to foreign financial institutions that knowingly conduct or facilitate certain significant financial transactions with the CBI or a US-designated Iranian financial institution.

126. China, India, Japan, South Korea, Taiwan, Turkey. Sri Lanka, South Africa, Malaysia and Singapore are also qualified for waivers but they have not used them.

values as of 2012. Following the oil price fall in mid-2014, the value of Iran's oil exports decreased almost 50% between 2014 and 2015.

Iran's reforms and economic adjustment driven by sanctions and more recently by the JCPOA

At first, President Ahmadinejad's second administration (2009-2013) tried to compensate lower oil revenues by using an exchange rate policy, and implemented a strong devaluation of the rial in 2012.¹²⁷ This low exchange rate policy associated with a high oil price promoted Iranian exports and limited imports. Some sectors started exporting, like cement or bitumen – the bitumen then benefiting from a lack of legal clarity under the sanctions regime. However, this exchange rate policy did not have the expected effects on the country's economy because the Iranian economy is not flexible and does not adapt easily to the needs of exports. Moreover, the official exchange rate is not the market rate, so that most of people in Iran do not have access to the official exchange rate. China benefiting from waivers¹²⁸ took a growing place in Iran's oil sales¹²⁹ and intensified its trade with the country, which in turn led to massive Chinese exports into Iran, weakening Iranian domestic industries and handicrafts.

Previously, in December 2010 and early 2011, Ahmadinejad had already started to implement the controversial subsidy reform. This reform consisted of substituting a part of government subsidies on basic goods and services (gas, electricity, bread and milk) by a monthly allowance directly paid to the working classes in order to restore a certain validity of prices. However, even when implemented step-by-step, it has had a strong social impact stemming from higher goods prices and a rise in inflation. Besides, the reform did not have the expected effects on domestic consumption and in particular, on wasteful energy consumption.¹³⁰ Finally, the price of drugs, energy and food, which increased with the suppression of the government subsidies, could not be managed in any way by the exchange rate policy. This led to some minor riots around the price of chicken for example (in 2012).

127. The rial devaluation began in 2012 from 12,175 rials per dollar to 18,414 rials in 2013. See the *Annual Statistical Bulletin*, OPEC, 2012, 2013.

128. China benefited from waivers issued by the US, under the NDAA legislation, during sanctions from 2012 to early 2016, allowing it to continue importing Iranian oil at a reduced level.

129. EIA, "Iran country brief analysis", updated July 22, 2014, available at: www.eia.gov.

130. For more detail, see: Dr. E. Hassanzadeh, "Iran's Subsidies Reform. Mitigation Measures to protect the Poor", Oxford: Oxford Institute for Energy Studies.

Elected in the first round of the June 2013 ballot by a small absolute majority (just over 50%), President Rouhani, a reformer within the system, set up a more competent administration composed of technocrats whose experience goes back to the Khatami years. The first Rouhani administration inherited a tense economic situation with a population struggling with weak purchasing power, high inflation and a high unemployment rate (especially, among young people). Another challenge, which had intensified under the previous President, has been the large share of the economy controlled by the Revolutionary Guards, leading to excessive costs and inefficiencies.

Its short-term priorities were to reduce inflation (35.6% in 2013)¹³¹ and to improve the implementation of reforms of subsidies. The successful negotiations and agreement over the JCPOA¹³² in July 2015 opened the way for a lifting of sanctions and the removal of National Iranian Oil Company (NIOC) from sanctions lists in early 2016.¹³³

Iran's oil exports, and hence oil revenues have increased since 2015, which helped Rouhani's reform attempts. These higher revenues consolidated the surplus of current account (6.5% of GDP in 2016).¹³⁴ This stimulated economic growth, a rising employment rate and stabilized the inflation rate (1.6% in 2016).¹³⁵ Iran had \$100 billion in assets that were frozen overseas and that the nuclear deal was to release fully.¹³⁶

With Iran being vulnerable to the volatility of oil prices and sanctions, key points of Rouhani's strategy are to reduce dependency on oil revenues, to promote the agricultural self-sufficiency and the private sector, to stimulate foreign investment (especially, for the South Pars gas field), to develop downstream industries to deter commodity imports and to transform them in the country. In April 2018, in the context of a devaluation (\$1 was worth more than 60,000 rials in April 2018), Rouhani's administration implemented the reform of unifying the exchange rates on the official and unregulated markets (the official rate being 42,000 rials per dollar), to boost Iranian exports in different sectors.

The government has aimed at 8% economic growth for the next years, yet achieving this is highly uncertain. The country's economy rebounded to

131. "Data Bank", World Bank, available at: databank.worldbank.org.

132. European External Action Service (EEAS), *Joint Comprehensive Plan of Action*, 14 July 2015, available at: eeas.europa.eu.

133. "Mise en œuvre de l'accord nucléaire avec l'Iran", *France Diplomatie*, 16 janvier 2016, available at: www.diplomatie.gouv.fr.

134. "World Bank figures", World Bank, available at: www.worldbank.org.

135. "Data Bank", World Bank, available at: databank.worldbank.org.

136. "Here's What's in Iran \$100 Billion in Assets that Will Become Unfrozen by the Nuclear Deal", *Business Insider*, 14 July 2015, available at: www.businessinsider.fr.

robust growth levels: up 12.5% in 2016 and 4.3% in 2017. This followed a recession in 2015 (-1.6%), tepid growth in 2014 (3.2%), coming after previous contractions (-0.3% in 2013 and -7.7% in 2012). These fluctuations highlight the extent to which the country's economy reacts to external opportunities or pressures, and less to the oil price.¹³⁷ The country has also suffered budget deficits since 2014. Government subsidies are still weighing on GDP though less and less (3.4% of GDP in 2016, down from 4.2% in 2014), while Iran's current public expenditure remains around 10% of GDP.¹³⁸ Rouhani's administration has been continuing its reforms, primarily in the financial and banking sectors, and in favour of the better allocation and management of oil revenues. In December 2017, demonstrations took place in Mashhad and then around the country to voice frustrations and dissatisfaction over the lack of economic progress and poor results following the lifting of sanctions, but also over corruption.

With President Trump announcing on 8 May 2018 the withdrawal of the US from the JCPOA and the complete return to pre-JCPOA US sanctions on Iran, providing 90-day and 180-day wind-down periods for different categories of business involving Iran, the nuclear deal has almost collapsed. The other P-5 members have stated their intention of sticking to the nuclear deal.¹³⁹ Yet US pressure and exposure to US sanctions is expected to make this position largely ineffective. European banks and companies had been highly cautious and the withdrawal of the US from the JCPOA will block them from investing or trading with Iran. Iran will therefore have stopped its nuclear programme, without reaping the economic benefits. Against this backdrop, President Rouhani's strategy for economic recovery can hardly succeed. Yet, this does not mean the economy will collapse either.

Iran's oil and gas sector have proved resilient and rebounded after 2016

Iranian oil production declined from 3.74 mb/d in 2012 to 3.578 mb/d in 2013, bottoming out at 3.15 mb/d in 2015.¹⁴⁰ Production levels in 2016 (3.65 mb/d) and 2017 (3.8 mb/d) are higher than the volume of production in 2010 (3.54 mb/d).¹⁴¹ However, Iran's current production is still lower

137. "IMF DataMapper", available at: www.imf.org.

138. "World Bank figures", World Bank, available at: www.worldbank.org.

139. T. Gomart, "L'Amérique ne se résume pas à Trump. L'Europe doit défendre l'Accord sur l'Iran sans couper les ponts avec les États-Unis", *Éditoriaux de l'Ifri*, Ifri, mai 2018, available at: www.ifri.org.

140. Data on Iran's oil and gas production, exports and export values come from the Annual Statistical Bulletin, OPEC, from the year 2010 to the year 2017.

141. *Ibid.*

than before the 1979 Revolution when it averaged more than 5.5 mb/d in 1976 and 1977.¹⁴²

Iran's oil exports decreased significantly between 2010 and 2015, from 2.58 mb/d in 2010 to 1.08 mb/d in 2015: i.e. almost by 60%. Iran's oil exports started to decrease in 2012, as the sanctions regime had its first effects. In 2016, oil exports increased and reached 1.92 mb/d. Oil exports almost doubled between 2015 and 2016 and continued to grow by around 25% between 2016 and 2017, with over half of the production exported in 2016 and 2017. In 2016, 1.92 mb/d were exported out of 3.65 mb/d produced. In 2017, 2.5 mb/d were exported for 3.8 mb/d produced.¹⁴³

Oil export revenues accounted for about 85% of Iran's total exports in 2010 and 2011: respectively, \$71.570 billion in 2010 and \$114.750 billion in 2011. In 2014, they accounted for just over 50% of the country's total exports, which themselves had fallen by around 25% since 2012: in 2014, oil exports were worth \$53.652 billion, for a total export value of \$98.981 billion. The value of Iran's oil exports even reached \$27.308 billion in 2015. In 2016, the value of Iran's oil was still less than half of the value of Iran's total exports (42%). This drop in the share of Iran's oil exports in total exports dates back to 2013-2014¹⁴⁴.

In November 2016, Iran was *de facto* exempted from the OPEC+ cut, as the agreement included a reference level for Iran of 3.975 mb/d: a level that exceeded the effective Iranian production level in January 2017 (namely, 3.797 mb/d). That was to allow the Iranian economy to begin recovering from the oil embargo.

While Iran is the world's third largest producer of natural gas, behind the US and Russia, the country accounts for only 1% of global natural gas trade. Beyond re-injections, almost all domestic commercial production is for domestic use (32% in the electricity power sector, 29% in the residential and commercial sectors and 27% in the industries). The Iranian market consumes nearly 195.4 bcm of gas per year.¹⁴⁵ The rise in domestic consumption closely follows the rise in production, so much so that production is struggling to meet demand. Iran was until very recently a net importer of gas.

142. EIA, "Iran Country Brief Analysis", updated 9 April 2018, available at: www.eia.gov.

143. *Ibid.*

144. *Ibid.*

145. EIA, "Iran Country Brief Analysis", *op. cit.*

Gas production steadily increased between 2010 and 2016 (with the exception of 2013), by 5% to 7% per year. Marketed gas production was 187 bcm in 2010 and 227 bcm in 2016.¹⁴⁶ In 2017, total natural gas production averaged 269 bcm, including 207 bcm of dry natural gas, with 45 bcm re-injected into wells and 16 bcm flared or vented.¹⁴⁷

In 2017, Iran exported around 33 million cubic meters natural gas per day, of which about 73% went to Turkey, though a price dispute opposed the two countries.¹⁴⁸ Iran does not currently have a large capacity to export more natural gas, yet started limited supplies to Iraq in 2017 and has plans for gas exports to Pakistan and other neighbours. Consumption is such that it absorbs almost all domestic production. In addition, the country lacks infrastructure and therefore investment for large-scale export projects that may not be profitable.

NIOC's corporate strategy and the challenges facing the energy sector

Iran's oil Ministry is one of the most influential Iranian ministries. Constitutional restrictions ban private or foreign ownership of oil reserves. The National Iranian Oil Company (NIOC) directly depends on the Ministry but the relationship between the two bodies is not always obvious and easy. The growing presence and ownership of Islamic Revolutionary Guard Corps (IRGC)¹⁴⁹ in the oil sector during Ahmadinejad's mandate, combined with the designation of IRGC on sanctions lists have damaged the domestic energy policy strategy, leading to more and more obstacles for the development of the sector.¹⁵⁰

During Ahmadinejad's mandate and the sanctions related to Iranian oil sector, the energy policy priority was to increase oil exports and foreign currency revenues. New oil sector legislation from 2012 has given more autonomy to NIOC, and its subsidiaries, in signing contracts inside the country and abroad. NIOC subsidiaries have become more and more

146. *Ibid.*

147. *Ibid.*

148. In 2016, Turkey brought Iran to the International Court of Arbitration for overpricing on gas purchases during the four-year period from 2011 to 2015. The International Arbitration Court ruled in the favor of Turkey in February 2017, and for a reduction of 10-15 percent in the price of Iranian gas exports to Turkey during the mentioned period. In addition, Iran had to pay \$1.9 billion in compensation to Turkey, which was done by providing 8 bcm of free natural gas to Turkey in 2017.

149. A branch of Iran's Armed forces founded after the 1979 Revolution by Ayatollah Khomeini to counter the regular army, suspected of being loyal to the Shah of Iran.

150. See "Treasury Report on NIOC and NITC", United State Embassy, available at: ir.usembassy.gov.

independent, including on the international scene.¹⁵¹ Large privatizations were implemented (primarily in downstream activities) which also benefited the IRGC.

Following the election of Hassan Rouhani in June 2013, the close presidential advisor Akbar Torkan announced the reassessment of oil contracts signed with NIOC's subsidiaries under Ahmadinejad's mandate, as the new government's initial oil and gas policies. The value of these contracts was sometimes considered too high in comparison to the financial situation of the subsidiaries and their ability to honour them. After the Implementation Day in January 2016, the NIOC and its affiliates were removed from the sanctions lists. One of the Rouhani administration's key priorities in oil sector has been to attract more investors, primarily foreign investors, to find liquidity and Western technologies. During the oil embargo, the Iranian oilfields were maintained rather well for a certain level of production, and sufficiently to keep the fields in good condition, thanks to the development of a local services and equipment industry. However, rising output further requires foreign investment and equipment. A major achievement has been the creation of new Iranian petroleum contracts (IPCs), partially unveiled as of 2016. These replace the buybacks which were not attractive for foreigners. Leading IOCs (especially Total, ENI and Shell) have expressed interest in investing in Iran and cooperating with NIOC, in accordance with the international and Iranian legislation. Trump's recent decision has however jeopardized these prospects.

Iran facing another storm following Trump's decision on the JCPOA

In Spring 2018, Iran's oil minister Bijan Zanganeh said that "\$60 a barrel is a good price",¹⁵² and that if oil prices continue to increase to reach the \$70 barrel, "there will be no need to extend the OPEC/non-OPEC production deal" beyond the end of 2018.¹⁵³ Indeed, at \$60 or \$70 a barrel, the Rouhani administration will be able to implement its domestic reforms. However, on 8 May 2018, the situation changed with President Trump's statement announcing the withdrawal of the US from the JCPOA and the complete return to US sanctions on Iran. Even if the oil price reaches \$70

151. W. Yong, "NIOC and the State: Commercialization, Contestation and Consolidation in the Islamic Republic of Iran", The Oxford Institute for Energy Studies, May 2013.

152. "Iran's Oil Minister Says \$60 Is A Good Price For Crude Oil", Reuters, 11 April 2018, available at: www.reuters.com.

153. "Iran Says No Need to Extend OPEC, Non-OPEC Pact If Crude Oil Prices Rise", Reuters, 23 April 2018, available at: www.reuters.com.

or even more, US sanctions threaten to limit Iran's access to global oil markets and will challenge domestic economic and political reforms. Europeans and Iranians have been active in finding urgent and concrete solutions for their commercial trade in order to prevent Iran from coming out of the JCPOA. Iran's oil exports to the EU notably represented about €8.9 billion in 2017.¹⁵⁴ Iranian foreign Minister Mohammad Javad Zarif visited Beijing and then Brussels, on 15 May 2018, and met Boris Johnson, Heiko Maas, Jean-Yves Le Drian and Federica Mogherini. If Iran fails to rally the European countries to create a partnership that enables continued trade and investments as much as possible, the country could fall again into a situation similar to that between 2010 and 2013, under Ahmadinejad's mandate, without long-term investments, especially in the oil sector.

For President Rouhani, an economic and geopolitical failure could turn out to be a political disaster, primarily for Iranian pragmatic and moderate politicians who are facing rivals who oppose any opening. For the EU, the stakes are equally high, in terms of affirming and strengthening its economic sovereignty which is jeopardized by US unilateral action on Iran and trade. China, the country's first oil importer, is expected to seek to continue importing Iranian oil, yet could obtain discounts as it could set up commercial mechanisms preserving Iran from US sanctions. It certainly could benefit most from the current situation, with Iran reluctantly but without any other choice, possibly turning East. It also remains to be seen how the economy's structural constraints will impact the country's stability and how the government, and different interest groups, will address the new challenges coming ahead. What will be the role of oil? How will different interest groups cope with the situation and how will their interests and strategies unfold? Will the possible return to a "resistance economy" be sustainable? Who will benefit politically?

154. "Policies, Informations and Service: Iraq", European Commission, available at: ec.europa.eu.

Kazakhstan

Marc-Antoine Eyl-Mazzega

Kazakhstan's economy has been severely affected by the fall in oil prices. The country (17.7 million inhabitants) managed to avoid recession but has been confronted with a shaky banking sector, high inflation, a fall in budget expenditures and some social tensions. The country's oil sector is poised to recover, with production finally ramping up at Kashagan and new investments decided at Tengiz. Privatizations are due and the country is expected to continue seeking to attract large amounts of private and foreign investments.

A weakened economy

The decline in oil prices led to a collapse of Kazakhstan's export-related revenues. This was aggravated by declining demand for oil, metals and other commodities from two of its main export destinations, China (where economic growth fell below 7% in 2015) and Russia (which entered recession, posting a GDP drop of -3.7% in 2015).¹⁵⁵ Revenues associated with the sale of hydrocarbons accounted for nearly 67% of total exports in 2014, and amounted to \$53.6 billion. They were almost halved in 2015 where they reached \$26.8 billion and then \$19.4 billion in 2016, declining to 63% in January-August 2017.¹⁵⁶

At the same time, external debt went up from 35.2% of GDP in 2014 to more than 52.8% in 2016, the equivalent of \$163.8 billion. The fiscal balance shifted into deficit, from +1.5% of GDP in 2014, to an average of -5% over the period from 2015 to 2017(e).¹⁵⁷ The budget deficit is expected at around -3.3% in 2017. With an oil price set at \$45 for budget calculations, that deficit is still expected to narrow in 2018 as budget revenues will increase more than budget spending.¹⁵⁸

155. World Development Indicators, World Bank.

156. "Kazakhstan's Accelerating Economy Will Also Support Inflation", ACRA, December 2017.

157. "The Economy Is Rising: It is Still All About Oil. Country Economic Update", World Bank, Fall 2017.

158. "Kazakhstan's Accelerating Economy Will Also Support Inflation", *op. cit.*

To keep the State budget deficit below 3% of GDP, the government has largely cut public spending. The budget envelopes of the Ministry of National Economy and the Ministry of Investment and Development were revised downwards by -10% and -14% respectively for 2015, and by -18% and -32% for 2016. The Ministries of Interior and Defence have been more severely affected and saw their budgets cut by -69% for the former in 2015, and by -73% and -19% respectively in 2016. In addition, the government has also sought to save money by delaying pay rises for public workers and trying to improve efficiency on public policy programs like the *Employment Roadmap 2020*.¹⁵⁹

Despite falling oil prices, the country's central bank, the National Bank of Kazakhstan (NBK) initially defended its currency indexed to the dollar. Its foreign exchange interventions led to continued net sales throughout the period from June 2014 to August 2015, reaching as much as \$4 billion per month, as in December 2014 and August 2015.¹⁶⁰ Following the collapse of its bilateral trade with Russia due to the collapse of the Russian rouble, the NBK announced officially on 21 August 2015 that its monetary policy framework would move towards an inflation targeting regime and a floating exchange rate.¹⁶¹ This allowed the country to rebuild part of its reserves which amounted to a total of \$81.1 billion in 2016(e) (respectively \$19.9 billion in the NBK and \$61.2 billion in the Kazakhstan National Fund), though this was down from \$95.1 billion in 2014 (respectively \$21.8 billion with the NBK and \$73.2 billion in the Kazakhstan National Fund).¹⁶² In April 2018, total reserves again exceeded \$90 billion, with over \$30 billion international reserves held by the NBK and \$60 billion by the Fund.¹⁶³ The government is envisaging a merger of the pension fund and the Kazakhstan National Fund, in order to streamline efficiency and control, following a case of embezzlement.¹⁶⁴ A noteworthy development is the legal battle around the attempts to seize \$22.6 billion of the Fund, as part of an international investor dispute.¹⁶⁵

159. "Adjusting to Lower Oil Prices; Challenging Times Ahead. Economic Update No.2", World Bank, Fall 2015.

160. "The Economy Has Bottomed Out: What Is Next? Country Economic Update", World Bank, Spring 2017.

161. National Bank of Kazakhstan, Press Release No.38, 21 August 2015.

162. "The Economy Has Bottomed Out: What Is Next? Country Economic Update", World Bank Spring 2017; "Kazakhstan's Accelerating Economy Will Also Support Inflation", *op. cit.*

163. "International Reserves and Foreign Currency Liquidity", National Bank of Kazakhstan, available at: www.nationalbank.kz.

164. "Kazakhstan May Merge Oil, Pension Funds: President", Reuters, 25 December 2017, available at: www.reuters.com.

165. "Kazakhstan's Frozen Billions Sound Alarm for Sovereign Funds", Reuters, 20 February 2018, available at: www.reuters.com.

Following the move to a floating exchange rate regime, the overvalued Kazakh Tenge saw its exchange rate collapse at the end of 2015. It depreciated from 188 Tenge per dollar to 255 in one day,¹⁶⁶ and currently trades at around 327 Tenge per dollar. As a direct result of the collapse of the exchange rate, inflation has increased, largely driven by imported inflation, reaching 13.6% at the end of 2015 and 14.6% on average for 2016. Between 2015 and 2016, the price of clothing and medicinal goods increased by 27.9% and 24.2%, and prices of foodstuffs by 12.7%. The exchange rate and inflation situations have now been stabilized. Thanks to the tightening of monetary policy, inflation was reduced to 8.5% at the end of 2016 and is now projected to continue to fall until it reaches around 4-6% from 2018 onwards.¹⁶⁷

But to reduce inflation, the NBK had to increase the base rate drastically which went from 12% in September 2015 to 17% in February 2017. With the decline in inflation, it was then gradually reduced to 9.25%, where it is still today.¹⁶⁸

This increase in the base rate has constrained credit and investment in the country and contributed to the slowdown of a Kazakh economy, which was already weakened by the fall in oil prices. Kazakhstan's GDP growth fell from 4.2% in 2014 to 1.2% in 2015 and down to 1.1% in 2016.¹⁶⁹ The Kazakh government announced recently that it expected GDP growth to be around 4% in 2017,¹⁷⁰ while the World Bank estimated in December 2017 that it would be closer to 3.7% for the same year. The World Bank has also projected that GDP growth would stay under its pre-crisis level, at around 3% over the period 2018-2020.¹⁷¹

Unemployment has remained relatively stable, at around 5% throughout the period. Yet poverty has increased among workers because of wage cuts. The number of working poor increased by 1.1 and 1.3 million in 2014 and 2015, which correspond to 15.7% of the total number of working people in 2015.¹⁷²

166. "Republic of Kazakhstan", IMF Country Report No. 17/109, International Monetary Fund.

167. "The Economy Has Bottomed Out: What Is Next? Country Economic Update", *op. cit.*

168. National Bank of Kazakhstan.

169. "The Economy Is Rising: It Is Still All About Oil. Country Economic Update", World Bank, Fall 2017.

170. "In 2017, Kazakhstan's Economy Shifted to Higher Growth Rates", The Prime Minister of Kazakhstan Official website, available at: primeminister.kz.

171. "The Economy is Rising: It Is Still All About Oil. Country Economic Update", *op. cit.*

172. *Ibid.*

The 2009 financial crisis had put a strain on an already shaky banking sector, alongside several corruption and embezzlement scandals, which had notably affected the BTA bank.¹⁷³ The authorities have been active in recapitalizing the country's main banks, plagued by non-performing loans. The NBK bailed out the Kazkommertsbank (rebranded Qazkom), which was taken over by its Halyk Bank (the merger is about to be completed), turning Halyk into the dominant bank in the country, holding over 30% of market share.

Despite the government's plans, the banking sector continues to perform poorly. The injection of new liquidity into the financial system has scarcely increased lending in the economy. Small banks are still short of cash while the biggest banks are flooded with government securities. Non-performing loans also remain very high. In 2016, the NBK estimated them to be a little over 5%, but Moody's considers them to be around 35%.¹⁷⁴ The banking sector therefore remains highly vulnerable, a vulnerability that could pose a risk to the rest of the private sector.

The government also seems to be moving forward with its grand privatization plan, involving the sale of more than 800 state-controlled firms. Among these, 215 belong to the state holding company Samruk-Kazyna, including the seven largest firms which will sell shares by IPOs.¹⁷⁵ This program aims to help the diversification of the economy away from oil and to reduce the role of the state in the economy. In particular, the government is planning for a partial privatization of KazMunaiGas, the state-owned oil and gas producer, which it plans to float in 2019, and is reportedly looking to sell a minority stake to a leading IOC. Despite this, doubts remain about the timeline for this programme and its real impact on economic activities which will continue to be largely controlled by the state.¹⁷⁶

Oil production on a slow but steady rise, investment decisions sanctioned

Kazakhstan is endowed with vast coal, gas, uranium and oil reserves. The country holds about 1.8% of the world's proven oil reserves – the equivalent of 30 billion barrels – and ranks 12th in the world.¹⁷⁷

173. "How To Get Back A Lost \$10B: One Bank's Tale In Europe's Biggest Alleged Fraud", *Forbes*, 6 February 2017, available at: www.forbes.com.

174. "The Economy Is Rising: It Is Still All About Oil. Country Economic Update", *op. cit.*

175. The seven firms include: Air Astana (airline company), Kazatoprom (uranium producer), Kataztelecom, KazMunayGaz, Samruk-Energy, Kazpost (post company) and Kazakshtan Temir Zholy (national railway company). The first three companies are planned to be sold in 2018 while the IPO of the last four will probably take place in 2019-2020.

176. "The Economy Is Rising: It Is Still All About Oil. Country Economic Update", *op. cit.*

177. *BP Statistical Review of World Energy*, 2017.

The country's hydrocarbon production is mainly concentrated in three key fields: the Karachaganak oil and gas field in the north-west of the country operated by Shell/BG (Karachaganak Petroleum Operating Company (KPOC)); the Tengiz deposit on the Caspian coast operated by Chevron (Tengiz Chevroil LPP (TCO)); and the Kashagan offshore field operated by ENI (North Caspian Operating Company (NCOC)). State-owned KazMunaiGas (KMG) has stakes in all projects.

After a fall in production following its independence in December 1991, output has been growing steadily, from around 430 kb/d in 1994 to 1.72 mb/d in 2017.¹⁷⁸

Yet following the drop in oil prices in summer 2014, oil production declined slightly, which was unprecedented following almost twenty years of continuous increases: from 1.71 mb/d in 2014 to 1.67 mb/d in 2016.¹⁷⁹ This decline can be attributed to poorer maintenance at certain fields, lower capex for drilling activities and the decline at mature fields, not compensated by new developments. KMG investments in the upstream sector decreased from \$1.422 billion in 2014 to \$1.133 billion in 2015, and fell to \$431 million in 2016. Over the same period, KMG's total capex decreased by 62%, to reach a little more than \$1.6 billion in 2016, down from \$4.26 billion in 2014.¹⁸⁰

The decline in production nevertheless stabilized towards the end of 2015, thanks to the full resumption of production at the Tengiz deposit after several months of maintenance, so that production from that field increased by 145 kb/d to reach 595 kb/d in November 2015.¹⁸¹ On 5th July 2016, Chevron, which owns 50% of the TengizChevroil consortium, publicly announced that its subsidiary would finally move forward with its long-awaited expansion plan that will substantially increase the production capacity of the Tengiz oilfield. This \$37 billion investment plan is expected to raise the production capacity of the field by approximately 260 kb/d, to 850 kb/d¹⁸² by 2022.¹⁸³

Oil output began to increase steadily again only after output at Kashagan resumed in November 2016. Oil production started at the end of 2013, but soon had to stop due to gas leaks on the pipelines connecting the

178. "Kazakh Oil Output Growth To Remain Robust Despite Opec Deal", *Platts*, 12 January 2018, available at: www.platts.com.

179. *BP Statistical Review of World Energy*, 2017.

180. *NC KMG: Operational and financial results, 3Q and 9M 2017*, KMG, available at: www.kmg.kz.

181. IEA, *Oil Market Report*, January 2016.

182. IEA, *Oil Market Report*, July 2016.

183. "Tengizchevroil LLP Announces Approval of Final Investment Decision for Tengiz Expansion", Tengizchevroil, 5 July 2016, available at: www.tengizchevroil.com.

well to the processing units on the coast, adding to the huge cost overruns. In the meantime, the Caspian Pipeline Consortium (CPC) pipeline extension was completed in 2017,¹⁸⁴ doubling capacity to 67 million tonnes per year (mta), so as to accommodate these growing supplies.

Kashagan production was ramped up to reach an average of 250 kb/d by end 2017, and is expected to continue its increase towards plateau level of 370 kb/d in 2018.¹⁸⁵

As a consequence, in 2017, average oil production in Kazakhstan bounced back to 1.9 mb/d and is expected to continue increasing to reach 2.0 mb/d in 2024.¹⁸⁶

Kazakhstan was a party to the OPEP + Vienna agreement and symbolically pledged to reduce its production by -20 kb/d from the IEA October baseline of 1 723 kb/d.¹⁸⁷ Yet Kazakhstan has proven to be largely non-compliant, depending on field maintenance operations: Kazakhstan had an average compliance rate with its commitments of -176% for 2017,¹⁸⁸ and -277% for the entire period in March 2018.¹⁸⁹

The partial privatization of KazMunaiGas

KMG accounts for almost 30%¹⁹⁰ of the country's annual oil and gas output, and has been hit hard by the drop in oil prices. Following the fall, the Central bank was forced to inject \$4 billion¹⁹¹ into the company which is now owned 90% by the sovereign fund Samruk-Kazyna and 10% by the Central Bank. KMG revenues decreased by almost 32% between 2014 and 2015 and more than 14% between 2015 and 2016. Between 2014 and 2016, its EBITDA almost halved, from \$5.93 billion to 2.90 billion.¹⁹²

To cope with falling oil prices and meet its financing needs, KMG has made several agreements with Vitol, the global commodity trading company. At the end of 2015, KMG made a prepayment deal of \$3 billion dollars in exchange for crude from KMG's future shares from the Tengiz

184. "CPC Put into Operation All Expansion Project Facilities in Kazakhstan", CPC Press Release, 12 October 2017, available at: www.cpc.ru.

185. IEA, *Oil Market Report*, January 2018.

186. IEA, *Oil 2018, Market report series*, Paris.

187. IEA, *Oil 2017, Market report series*, Paris.

188. IEA, *Oil 2018, Market report series, op. cit.*

189. *Ibid.*

190. "Kazakh Oil Groups Buyback Paves Way for IPO", *The Financial Times*, available at: www.ft.com.

191. "KazMunaiGas Close to IPO Move as it Trims Debt Pile », *The Financial Times*, available at: www.ft.com.

192. KMG Factsheet 2016, available at : www.kmg.kz.

deposit. In August 2017, it added \$1 billion to an already existing \$1 billion deal for oil from the Kashagan oilfield.¹⁹³

In the context of KMG's planned floatation and IPO which could take place in 2019, KazMunaiGas has acquired its subsidiary already quoted on the London Stock Exchange (LSE): KazMunaiGas Exploration and Production (KMG EP). After two failed buyout attempts, an agreement seems to have been reached to buy shares at \$14 per GDR, which would value the total company at \$5.6 billion.¹⁹⁴ The takeover is the first step in a plan to remove the company from the LSE to incorporate it into the parent company and list the entire company through an IPO.

In preparation for the IPO, KMG is seeking to put its accounts in order. The company's debt was reduced from \$17 billion in 2014 to \$9.8 billion in 2016 before increasing again to reach \$12.943 billion in 2017, following a \$2.75 billion Eurobond issue in April 2017.¹⁹⁵ Between 2014 and 2016, the value of the company's assets dropped from \$5.938 to \$2.907 billion, a decrease of nearly 50%.¹⁹⁶ This was due to the loss of value of oil assets in a context of low oil prices, but also to the sale of many non-core assets.¹⁹⁷ In the same year, net debt (calculated taking into account assets on sale) totalled \$4.338 billion. This restructuring enabled the company to post a net debt / EBITDA ratio of 1.66 in 2017.¹⁹⁸

Renewable energy sector investments have been slow, but are expected to increase in the coming years, passing from around 330 MW installed to up to 1 GW by 2020, not least with key funding coming from the EBRD, for which Kazakhstan is a key country of operation.

Political stability and the continuation of Kazakhstan's pivotal regional role

Domestic politics are marked by the fundamental question over President Nazarbayev's succession in the coming years. He is 77 years old and has been in power since 1990. The next presidential elections are due in 2020 and his eventual departure raises questions of political stability. President Nazarbayev was successfully re-elected in April 2015 with 97.7% of votes cast, and a participation rate of 95%, in an early election that did not meet

193. "Vitol Extends Cash-for-Crude Deal with Kazakhstan to \$5bn », *The Financial Times*, available at: www.ft.com.

194. "Kazakh Oil Groups Buyback Paves Way for IPO", *op. cit.*

195. "The Economy Is Rising: It is Still All About Oil. Country Economic Update", *op.cit.*

196. KMG Factsheet 2016, available at: www.kmg.kz.

197. « KazMunaiGas Close to IPO Move as it Trims Debt Pile », *The Financial Times*, available at: www.ft.com.

198. *NC KMG: Operational and financial results, FY 2017*, KMG, available at: www.kmg.kz.

OSCE standards,¹⁹⁹ yet which showed the strong resilience of his regime. His succession has several scenarios including him stepping down as President at some point but heading an empowered Security Council. The risk of a vacuum as well as internal or external feuding is rather low, and leading stakeholders have a vested interest in a smooth transition. Key uncertainties are related to possible social tensions (frequent oil worker strikes for example), the ability to cope with the threat of Islamic terrorism with combatants returning from Syria or infiltrating from Afghanistan and other neighbouring countries. Tax pressure on foreign investors is also a key issue. However, the successful, smooth transition in Uzbekistan shows that political transition can be an opportunity, rather than a risk.

Kazakhstan's foreign policy stance has been strengthened by its successful mediation between Russia and Turkey following the downing of a Russian SU-24 plane in 2015 and its role in hosting the Astana political process driven by Russia and Iran over Syria, as well as by hosting the EXPO in summer 2017. Kazakhstan has taken up a new role in promoting regional cooperation between the Central Asian republics in a landmark regional summit held in March 2018 following the change of regime in Uzbekistan. It is also an important part of China's Belt and Road Initiative, with major rail infrastructure projects being developed. Moreover, the country is expected to benefit from the planned signing of free trade agreements between the Eurasian Union and respectively China and Iran. Kazakhstan is also expected to continue working in the future towards increasing the diversification of its oil export routes, which currently dominantly pass through Russia. Last but not least, as part of its multidimensional foreign policy, Kazakhstan also signed up to an enhanced cooperation agreement with the EU in January 2017.²⁰⁰

199. OSCE, OSCE/ODIHR Election Observation Mission Final Report, 29 July 2015, available at: www.osce.org.

200. Delegation of the EU to Kazakhstan, Enhanced Partnership and Cooperation Agreement between the European Union and the Republic of Kazakhstan, 12 January 2017, available at: <https://eeas.europa.eu>.

Nigeria

Philippe Copinschi

Nigeria is, without a doubt, a continental giant. It has by far the largest population in Africa (around 185 million), and is the continent's biggest economy, ahead of South Africa. A member of OPEC since 1971, Nigeria is also Africa's main oil and gas producer and it holds the continent's largest hydrocarbon reserves: 37 billion barrels of proven oil reserves (which represents 2.2% of the global oil reserves), as well as 5.5 trillion cubic meters of proven gas reserves (2.9% of the global gas reserves).²⁰¹ It is, however, a weak giant. Heavily dependent on oil and gas revenues, the country suffered a five-quarter long recession in 2016/17, mainly (but not solely) as the result of the collapse of the global oil prices since the autumn of 2014. The economic situation has improved slightly since then and oil production could pick up again, yet the country is not expected to undergo substantial reforms before the 2019 presidential election.

An economy deeply affected by the collapse of the oil price

Nigeria is a classic case of oil dependency. Despite the growing share of the non-petroleum sectors in the economy (due partly to the huge contraction of the oil sector over the last four years), Nigeria's dependence on oil and gas exports remains substantial. Petrodollars still accounted for about 40% of government revenues in 2016 and for about 85% of export earnings, although the share of oil in GDP had dropped to only 10% of the overall GDP.²⁰² The importance of oil is expected to strengthen from 2017 onwards, driven by prices and slight production increases. Because of this dependency, the Nigerian economy was hit relatively hard by the collapse of the oil price in 2014. Before the downturn of the oil market, the IMF projected continued robust economic growth of about 7% per year, in line with the rate experienced over the previous two decades. In fact, growth

201. Statistical Review of World Energy, BP, June 2017.

202. Nigeria, *Staff Report for the 2018 Article IV Consultation*, IMF, February 2018.

slowed sharply in 2015 (2.8%) and the economy even slipped into recession in 2016 (-1.5%) for the first time in 25 years.²⁰³

The impact appears to exceed disproportionately what would have been expected given the nominal role of oil in the economy. The non-oil sectors, which account for almost 90% of the total economy, also slowed sharply as a result of falling oil prices. Indeed, the negative impact of the drop of the oil prices was worsened by the government's inconsistent economic policies as well as the decline in oil production due partly to security problems in the Niger Delta region.²⁰⁴ The slump in crude prices seriously impacted the country's earnings, leading to a significant decline in foreign reserves (as oil receipts make up most of the country's foreign exchange). It also led to a free fall of the national currency, the Naira, which lost 60% of its value between May 2014 and May 2018, spawning chronic dollar shortages. As a consequence, non-oil activities that could have benefited from the weaker currency to increase their competitiveness were actually penalized by a lack of access to credit. Struggling to get dollars for imports, businesses were forced to lay off workers, leading to increased unemployment (up from 7% in 2014 to 18% in 2017). Moreover, inflation surged to 18.5% in 2016, the highest rate in more than a decade, causing enormous economic difficulties for the population and businesses. Services, food, manufactured goods and commodities that need to be massively imported became more expensive, energy prices and transportation costs increased steadily, income levels dropped and investment faded as banks stopped advancing loans.

The drop in oil revenues also seriously hit public finances. In 2016, Nigeria's oil and natural gas exports earned only \$28 billion, compared to \$90 billion in 2013. As the public sector is still the largest employer of formal labour, reduced government expenditure meant a cut in the number of new jobs created in the public sector. Moreover, the federal government struggled to pay salaries, and local authorities were unable to pay their workers for months (local authorities are totally dependent on the revenues distributed by the central government as these under-developed local economies cannot raise much tax on their own). This crisis happened against the background of unprecedented security risks stemming from the Boko Haram insurgency in the country's north and the need to devote significant expenditure to support military efforts and soldiers' morale.

203. *Ibid.*

204. *Ibid.*

One of the reasons that explains the severe impact of the shock on Nigeria in comparison to other, similar oil-producing countries, is the government's inability to redeploy resources across sectors and to carry out rigorous fiscal and monetary policies. No efficient countercyclical fiscal, monetary, or exchange rate policies were implemented to buffer the impact of the shock and to reduce its transmission to the non-oil sector. Along with everything else, the lack of flexibility in the currency regime with the decision not to allow the Naira to float clearly held the economy back.²⁰⁵

Systematic mismanagement also had an adverse impact. In 2004 Obasanjo's administration introduced the Excess Crude Account (ECA) in an attempt to mitigate the negative impact of the high exposure of the Nigerian economy to external shocks.²⁰⁶ Its aim was to protect planned budgets against shortfalls arising from changes in oil prices. When revenues dropped significantly in 2008 because of the falling oil prices, Nigeria was able to go through the period without the economy going into spin, thanks to the ECA. However, when prices rebounded after 2008, successive governments, instead of supplying the account with new revenues, continued to tap into the fund. In 2014, there was little left in the coffers to help reduce the shock from the oil price decline.

The case of the long-delayed Petroleum Industry Bill (PIB) is another astonishing illustration of Nigeria's difficulty to simply carry out sound economic policies.²⁰⁷ The aim of the bill is to overhaul the oil sector and redefine the organizational structure and tax terms governing the oil and gas industry. Although it has been under debate since 2008, it still has not been voted. The consequence of this regulatory uncertainty is that several planned deepwater projects, which have the potential to bring more than 1 mb/d of new production over the next couple of years, have been repeatedly pushed back. Although it is generally estimated that Nigeria could easily produce 2.5 mb/d of oil, the actual production rarely reaches 2 mb/d. The amount of money that Nigeria loses every year from not passing the PIB is estimated to be as high as \$15 billion.²⁰⁸

205. *Ibid.*

206. I. Ogboru, M. Terry Rivi and P. Idisi, "The Impact of Changes in Crude Oil Prices on Economic Growth in Nigeria: 1986 – 2015", *Journal of Economics and Sustainable Development*, Vol. 8, No. 12, 2017.

207. B. Augé, "Nigeria : les immenses défis pétroliers du nouveau président Muhammadu Buhari", *Actuelles de l'Ifri*, Ifri, September 2015.

208. EIA, *Country Analysis Brief: Nigeria*, US Energy Information Administration, May 2016.

An oil and gas sector dominated by the IOCs

Nigeria appeared on the oil and gas map in the 1960s after the first discoveries were made in 1956, when the country was just emerging from colonialism. This post-colonial context heavily shaped the Nigerian oil and gas industry that has long been dominated by the companies, such as Shell, which arrived during the colonial era. The oil industry in Nigeria, which gained independence in 1960, is an institution which is older than the State itself.

Nigeria's oil production became substantial in the 1970s, after the end of the Civil War (1967-1970) during which the oil-producing region of the Niger Delta (South-East), tried to secede. It rose from about 140 kb/d in 1968 to 2,25 mb/d in 1974, and has fluctuated around that level since then. After peaking at 2.4 mb/d in 2005, production has declined significantly as it has been regularly hampered by instability and sporadic supply disruptions, causing unplanned outages of up to 1 mb/d. As violence from militant groups regularly surged in the oil producing region, causing pipeline attacks and forcing many companies to withdraw staff and shut down their activities, production dropped to as low as 1.3 mb/d in March 2017, the lowest in almost 30 years, and far below the 2.2 mb/d that the government usually benchmarks in its budget. It has recovered a little since then, reaching 1.8 mb/d in the first quarter of 2018 but remains much below the level that the country can expect, given its potential. As a result of the fall in its oil output below normal production levels, the country was exempted from the OPEC+ Vienna agreement.

All major IOCs, as well as many independents are involved in oil and gas exploration and production in Nigeria, often in cross-partnerships. Currently, most of Nigeria's onshore and shallow water projects are funded through joint ventures (JV) between IOCs (Shell, Total, ExxonMobil, Chevron and ENI) and the Nigerian NOC (the NNPC), which is plagued by mismanagement and corruption.²⁰⁹ Although the NNPC is the majority shareholder, operations are always managed of by IOCs, which face tough local content rules which complicate operations.²¹⁰ Other projects (especially the deep-water ones) are managed through PSCs, with, again, the IOCs being the operators.

209. B. Augé, "Les stratégies des compagnies pétrolières nationales africaines", *op. cit.*

210. *Ibid.*

While Nigeria of key importance to these IOCs, given its reserves, the country also remains dependent on them for the development of its hydrocarbon resources, as it never managed (or even attempted) to play a central role in the local oil and gas industry, leaving the entire sector to foreign companies. As a consequence, the development of the oil and gas industry in Nigeria has always depended on the interests of the international oil business, which explains, for instance, why the gas sector has remained marginal for so long.

Until quite recently, IOCs operating in Nigeria showed no real interest in developing gas production. Although Nigeria holds the largest natural gas reserves on the continent, it was only in 1999 that the first Nigerian LNG plant came on stream, after gas had been flared for decades. Even if gas flaring in Nigeria has decreased in recent years, the quantity flared is still substantive (about 7.5 bcm in 2016).²¹¹ Given the size of the Nigerian population and the low rate of electrification (only 50% of the population has access to electricity according to the World Bank), gas could have been used for power generation. But the lack of creditworthiness among potential consumers has held back IOCs from investing in gas. Today, Nigeria produces about 24 million tons per year (Mtpa) of LNG and currently ranks as the world's fourth-largest LNG exporter behind Qatar, Australia and Malaysia.

A slow recovery and uncertain reforms

In 2017, the country's GDP recorded a small improvement (+0.8%) driven by the increase in oil production, the slight recovery of global oil prices and the good performance of the non-oil sector, especially the agricultural sector. Annual inflation has shown some improvement over the past year, dropping to 15% at the end of 2017.

More generally, despite the prolonged absence of President Buhari, who spent several months undergoing medical treatment in London in 2017, the government took a series of measures in order to put the economy on a much more sustainable path. It did this by diversifying the economy and strengthening the non-oil sectors, improving infrastructure and reducing wastage and corruption. Amongst other things, it initiated the Economic Recovery and Growth Plan. This 4-year development programme (2017-20) officially aims at restoring growth (targeting a 4.6% average real GDP growth rate over the Plan period, rising to 7% in 2020), improving ease of doing business to attract foreign investors, improving private sector participation in the economy, ensuring a market-driven

211. Global Gas Flaring Reduction Partnership (GGFR), World Bank.

economy with minimal government intervention, reducing the inflation rate (below 10% by 2020) and restoring the oil production (to reach an output plateau of 2.5 mb/d in 2020).²¹²

There still is a very long way to go before Nigeria achieves any of the objectives of this ambitious plan. Unfortunately, as the global oil price has started rising again (far over \$45 per barrel which is used as a benchmark in the 2018 budget), most of the incentives to launch the long overdue structural reforms could easily be set aside. To make matters worse, Nigeria has now also started preparing for the 2019 presidential elections, which means that no politically sensitive actions to improve the business environment, diversify the economy and boost non-oil exports will realistically be undertaken during the next few months.

212. "State of the Nigerian Economy: First Half of 2017", *Economic and Policy Review*, Vol. 16, No. 2, Nigerian Economic Group Research, 2017.

Russia

Marc-Antoine Eyl-Mazzega

Russia's economy and liquids production have proven to be resilient to the storm of lower oil prices and western sanctions, thanks to the sharp depreciation of the rouble, large fiscal reserves and cautious and effective macroeconomic and budgetary policies. Nonetheless, the country (144.3 million inhabitants, without Crimea) entered a long recession before entering positive territory again in 2017, and has been hit in many respects: real incomes have fallen, poverty has increased, foreign direct investments have diminished and the banking sector has suffered. The country's ability to withstand another oil price crisis is under question. Without deep institutional and economic reforms, a robust and inclusive economic recovery is unlikely.

Russia's economy: hit, but not sunk

Following seven successive quarters of economic recession, the Russian economy adjusted to lower oil prices and Western sanctions and came out of the recession in Q4 2016. GDP declined by -3.7% in 2015, the economy then bottomed out in early 2016. GDP still contracted in 2016 (-0.6%), but turned positive in 2017, posting a 1.5% rise, though this was less than official projections. The rouble has sharply depreciated as of December 2014, reaching a trough in 2016 before stabilizing and slightly rebounding in 2017, while the Russian Central Bank has successfully adopted a free floating policy.

The Russian budget has been established on the basis of a cautious oil price estimate of \$40/barrel and budget spending has been limited in several areas. The budget deficit for 2015 was -2.4% of GDP, -3.4% of GDP in 2016 and around -1.9% of GDP for 2017. The deficit was financed via bond issues and by resorting to fiscal reserves, mainly from the Reserve Fund, which was depleted by early January 2018, with over \$50 billion being spent. A few privatizations were also conducted, notably 19.5% in Rosneft. Overall, the crisis has artificially reduced the share of oil and gas revenues in the budget, moving from around 52% in 2013 to 42% in 2016, simply because the lower sectoral tax incomes were compensated with the

drawing down of the reserve funds. Liquid hydrocarbons export revenues fell from \$323.4 billion in 2013 to \$189 billion in 2017.²¹³

The present improving economic situation has been supported by several factors: a higher oil price and record high oil production, despite overall compliance (about 85%) with the OPEC+ cut; a strong agriculture and military sector; investments by the oil and gas sector, the building of new infrastructures for the football world cup and of the Kertch bridge to Crimea; a weak rouble boosting import substitution (thanks to countersanctions in the agro and food sectors notably) and reducing imports along with export competitiveness in a few sectors; an effective economic policy by the government and the Central Bank; and lately, a slight pickup in consumption and industrial production. During 2016, the rouble stabilized at an average of \$1/RR65 while inflation fell to 5.6%, and reached even lower levels in 2017, below 3%, which is a major achievement. The economic situation is expected to be further supported by the Central bank's rate cut to below 8% in 2018, and by its monetary policy aimed at keeping the rouble relatively weak, in spite of the increase in the oil price.²¹⁴

About 16 months before the presidential election scheduled for March 2018, Energy Minister Novak started preparations for a landmark agreement with Saudi Arabia and OPEC over managing supplies in order to stabilize and raise oil prices. This proved to be a strategic move which has worked remarkably well: the March 2018 Presidential election took place against an improved macroeconomic and budgetary environment and Russia has avoided the worst-case scenarios of having to make deep social and military budget cuts, further reducing personal incomes and raising the taxation of the oil and gas sector.

In 2018, with rising oil prices, the government is likely to have a much greater room for manoeuvre to narrow its budget deficit significantly (depending on the average oil price and on extra spending) and possibly, start refilling its depleted Reserve Fund, if it can avoid an appreciation of the rouble. GDP growth forecast for 2018 by the IMF is 1.7%.²¹⁵

213. "Statistical numbers", Russian Central Bank, available at: www.cbr.ru.

214 . See: "Russia Economic Report", World Bank, November 2017, available at: openknowledge.worldbank.org; "Russia Economic Monthly. Inching Forward in 2018", Sberbank Investment Research, Moscow, Russia, December 2017; "New Fiscal Rule to Lower Russia's Budget's Oil and Gas Dependence", ACRA Rating, 6 June 2017, available at: www.acra-ratings.com.

215. *World Economic Outlook Updated*, IMF, January 2018, available at: www.imf.org.

Yet the Russian economy has suffered: consumption, which was a key driver of GDP growth before 2015, has fallen sharply; due to the combination of sanctions and recession, bank liquidity and lending have fallen: with the exception of Sberbank, the banking sector is in a bad shape. Three major banks (Otkritie, B&N Bank and Promsvyazbank) were bailed out in 2017 and a further, costly bailout was being considered in spring 2018.²¹⁶ Real incomes have fallen, and a deep and painful pension reform is unavoidable. In many regions, public services are underperforming, while a number of regions have piled up massive debts they will find hard to honour. Private and foreign investments have fallen: *cumulative* foreign direct investments for the years 2014, 2015, 2016 and 2017 were below the record level of 2013 (\$70 billion).²¹⁷ In the longer term, the declining demography is a major concern which will be hard to address.

A widely shared view is that the Russian economy has bottomed out and is out of recession, yet that growth will remain modest and uneven. A robust recovery would require comprehensive economic reforms, reducing the share of state-owned enterprises in the economy and attracting large private investments and improved access to affordable credits and loans.²¹⁸ In turn, this would require an end of the Western sanctions regimes. The import substitution strategy, or the Eurasian economic union, or closer ties to China are no alternative or remedy for the underperforming economy.

Russia's oil sector is the unexpected winner with healthy profits and record high production

Russia has been producing an additional 400 kb/d since the summer of 2014, when Western sanctions were introduced and it posted a liquids production record in 2016 of 11.34 mb/d, marking a 2.5% increase (+250 kb/d), year over year (yoy). Russia's role in the November 2016 OPEC agreement came as a surprise, given that Russia had so far been a free rider, benefiting from OPEC's oil market management without bearing any cost. Russia pledged to a progressive cut of -300 kb/d, based on its record high production level of October 2016. While largely complying with its commitment, its output was *de facto* flat in 2017, year on year. Russia's pledge was thus to postpone the increase of its liquids production, which

216. "Exclusive: Russia Considers Extra \$17 Billion Bailout for Two Rescued Banks – Sources", Reuters, 16 March 2018, available at: www.reuters.com.

217. "Russia Economic Report", *op.cit.*; "Russia Economic Monthly. Inching Forward in 2018", *op.cit.*; "New Fiscal Rule to Lower Russia's Budget's Oil and Gas Dependence", *op.cit.*

218. "Russian Federation: Staff Concluding Statement of the 2018 Article IV Mission", IMF, 23 May 2018, available at: www.imf.org.

would have otherwise increased by over +150 kb/d in 2017, and by a further similar amount in 2018. Such an expansion of output would have been possible, notwithstanding the sanctions and the oil price fall, because of the opening of new fields in East Siberia and the Caspian offshore, which have benefited from key tax breaks and because of even higher drilling activity.²¹⁹

Russia's continued and steady liquids supply growth during the price storm came as a surprise, yet has relied on a combination of favourable factors.

The increase was largely driven by smaller producers such as Gazpromneft, Novatek, Tatneft, Russneft and Bashneft in 2016, with Novatek alone accounting for 30% of the net production increase that year. With a few exceptions, Russian companies, having the bulk of their costs in roubles, managed to maintain if not increase their capital expenditures. This resulted from the rouble depreciation (Russian companies export and collect dollars converted into depreciated roubles, while their costs are dominantly in roubles), foreign currency earnings from exports, as well as very flexible and favourable taxation when the \$ oil price falls. In 2017, the tax take on the sector was raised by \$3 billion, which was largely compensated by the increase in dollar oil prices and related revenues. The application a major tax reform has mainly hit the retail consumers through higher excise duties.

Rosneft effectively managed to pull out, or rather push itself out, of a very challenging financial situation by end 2014, when it was facing the pressure of falling revenues due to declining production and lower prices, Western sanctions, and very large short term debt repayments. The company signed up to large pre-payment schemes with traders and buyers, managed to issue bonds with the support of the Russian Central bank and state-owned banks, and stabilized oil production while internalizing drilling activity. It also refocused its capex and made some asset divestments. Last but not least, not only did Rosneft repay its debts, but it also made several acquisitions: Bashneft, Essar Oil and Zohr notably, consolidated its presence in the German refinery market, while it lent billions to debt-ridden PdVSA. Explanations for these successes include: a powerful and smart management team, with foreigners; direct and indirect support from the State; massive pre-payment schemes which were a risk if prices would remain low but ultimately proved a risk worth taking; and the power stemming from its huge reserves and production: the company produces over 40% of Russia's liquids, or around 4.8 mb/d.

219. IEA, *2017 Oil*, Paris and IEA, *2018 Oil*, Paris.

Russia's oil companies have sharply ramped up drilling activity, slowing down the decline in brownfields and have increasingly moved to complex drilling operations, with the share of horizontal wells increasing continuously to over 33% in 2016. At the same time, firms are resorting to deeper drilling, and have opted for multi-fracking alongside pad drilling. Major western service companies are still present and very active.

In the longer term, Russia's oil sector will face several challenges: if the government is not able to diversify the economy and intends to maintain budget spending, taxation levels on the sector are likely to increase and several tax breaks could be repealed, unless the government further increases retail taxation hitting the end consumer, as it has done in past years; stabilizing or slowing down the decline in brownfields at -1.5% per year level will require resorting to enhanced oil recovery techniques, a more supportive tax environment and a move to a profit-based tax system currently being tested; many of the ageing rig fleets will have to be replaced; Arctic deep offshore resources will probably stay in the ground forever due to technological and economic constraints; some shale oil deposits will be tapped, some by western joint-ventures still operating, others by Russian companies. But in a context of sanctions, these are operating at sub-optimal levels, with delays, and will again require a supportive tax regime. Russia has an opportunity to limit a negative impact on its oil exports if it accelerates the deployment of natural gas in the transport sector, or develops the use of electric vehicles.

Overall, the current oil price/exchange rate balance is very positive for the oil companies. This will support continued strong upstream capital expenditure, drilling activity, and liquids production. In the short term, risks appear to be a strengthening of sanctions, the appreciation of the rouble, higher transportation and labour costs, and the unpredictable taxation system.

Finally, the deployment of renewable energy sources (beyond hydro) remains in its embryo stage, with a target to develop 5.9 GW of solar, wind and bio-energy pushed back to 2024. This is despite the country's large potential not only in Russia itself, also for exports of cost-competitive equipment.²²⁰ Energy efficiency investments are also weak due to a lack of federal and regional funding, as well as high borrowing costs.

220. "Remap 2030 Renewable Energy Prospects For The Russian Federation", Researchgate, April 2017, available at: www.researchgate.net.

Politics, institutions, foreign policy: the status quo

Russia's domestic politics have proven to be strictly constant. President Putin was a candidate to his succession in the March 2018 elections. He ran no electoral campaign, and won by a large majority in a vote with no real competition (the main opponent was banned from running). He then nominated Dimitri Medvedev as Prime minister, in spite of the latter being widely unpopular. Vladimir Putin has been in power for 18 years and has started his new mandate in setting some ambitious economic and social development targets in his so called May decrees. The 2018-2024 presidential mandate will be dominated by two fundamental questions: who will succeed President Putin, and can his regime survive without his personal legitimacy? Will "Putinism" strengthen, adjust or ultimately be replaced, and if so, by what?

Social and political tensions exist, and pop up from time to time over specific issues (Moscow's housing restructuring, taxes on trucks and most recently, the urban waste policy around Moscow). They are also occasionally related to the country's political system (the Nemtsov murder and the Navalny demonstration). But so far protests have always remained constrained and controlled, being non-political and strictly issue focused. No anti-government mass demonstrations, such as those that erupted in the winter 2011-2012 following the Duma elections, have taken place in the past years. The local elections in 2017 proved a bit of a challenge for the Kremlin, given the low support for the ruling United Russia party. That challenge will need to be addressed by the Kremlin for the 2021 legislative elections, which might be more contested given that a new generation of candidates appeared during the March 2018 presidential elections and that opponent Alexey Navalny enjoys some support in the region, which he could build on.

The economic recession has been accompanied by a glorification of nationalism and conservatism, of the "us against the West" rhetoric and a militarization of society, not least because of the wars in Ukraine, Syria and the growing tensions with NATO and the US and how Russia's state-controlled media has obviously successfully distracted attention from challenging domestic issues. Russians have united and stood behind their President in what they see as a legitimate fight against the US-dominated "West", in favour of a multipolar world order and in defense of Russia's interests in its neighborhood.

Russia has navigated the storm of the economic and geopolitical crisis without making any concessions or any strategic adjustments or changing

its foreign policy behaviour towards the EU or the US: EU sanctions have been continuously prolonged by six months, US sanctions have been strengthened such as on April 6, 2018 following an August 2017 Congress vote in reaction to evidence of Russia interfering with the US presidential election in 2016. The Normandy format dialogue over Ukraine is in a stalemate, as are discussions about deploying UN troops. The only outcomes related to the Donbass are that no further territory has been grabbed, that prisoner exchanges have occurred, that an OSCE mission is on the ground, and that some direct or indirect commercial and human ties are preserved. Overall, the war is still going on, with several deaths every week, while Russia has built a bridge linking up Crimea with its mainland. In the Middle East, Russia has signed up to a strategic deal with Saudi Arabia on oil prices, and developed or strengthened relations with many countries in the region, such as Egypt, benefiting from the retreat and mistakes from the US, as well as Russia's ability to maintain relations with all stakeholders. That can also translate into business: Qatar Investment Authority owns 18.93% of Rosneft.

A strategic shift has come with China, but it is not without its challenges and limits. Russia has declared its own pivot to Asia, in energy as well as in economic and policy terms. While relations have been expanding at all levels, mutual trade topping \$84 billion in 2017 (with China becoming Russia's 1st trade partner), the relationship remains largely and increasingly asymmetrical. Russia faces the prospect of benefiting from deeper security cooperation yet being limited in its growing role as a supplier of oil, coal and gas to its neighbour. While Russia's exports remain largely dominated by hydrocarbons, agriculture, steel and weapons, China is already preparing to challenge the EU and the US for supremacy in high tech, big data and low carbon technologies, beyond its current domination in manufactured goods. Chinese companies and banks have provided funding or investments to Russian projects or companies (Yamal LNG, Sibur), but there have been also failed attempts, such as with the Rosneft privatization or some disagreement over upstream stakes valuations. These actions are nothing specific compared to Chinese investments in other hydrocarbon rich countries. It is significant, however, that in spite of the oil price storm, Gazprom has been investing to implement the first phase of its Power of Siberia gas supply system to China, and that oil exports to China have been growing, not least due to Rosneft's supply obligations under prepayment schemes agreed with CNPC. As for the Belt and Road Initiative, Russia is a part of the system, not least because Kazakhstan, Russia and Belarus are part of the Eurasian Customs Union, but China has been working on alternative, diversified routes as well.

Saudi Arabia

Saïd Nachet

Saudi Arabia's economy is highly dependent on oil which provided 45% of the government's budget revenues and represented 75% of the Kingdom's exports in value in 2016. The country (32.2 million inhabitants) has therefore been impacted by changes in oil production and exports, and is highly exposed to downward oil price trends. Following its recovery from the economic and financial crises that hit the world economy in 2009, Saudi Arabia – like other oil producing countries – enjoyed the dual benefits of three-digit oil prices, the highest registered ever, and increasing oil production, topping 10 mb/d. The fall in prices combined with strong military spending have had sharp economic consequences however. The country is the most important pillar of OPEC and is facing fundamental energy, economic and geopolitical challenges. Yet Saudi Arabia has a unique opportunity to diversify its economy, given its large financial resources and strong political will at the highest level: unprecedented changes are being implemented under the leadership of Crown Prince Mohammed bin Salman. But it remains to be seen how and at what pace they will be carried out, and if they will be sufficient. The Aramco transformation and its planned IPO are a first, major test.

The structural weaknesses of the oil-dependent economy exposed

The country's economy only entered recession in 2017 (-0.7%), following a progressive fall in GDP growth from 3.7% in 2013, a rally of 4.1% in 2015 and a renewed slowdown to 1.7% growth in 2016.²²¹ This is a paradox since oil prices had started to recover as of end 2016. The cut in Saudi Arabia's production as part of the OPEC agreement, for which the Kingdom made the largest contribution, has also limited the ability of the country to reap the full benefits of price increases. The recession also highlights the structural weaknesses of the economy, which is still expected to record renewed growth of 1.7% in 2018, as projected by the IMF.

221. "IMF DataMapper", available at: www.imf.org.

Despite the cautious approach adopted by the Saudi government for its 2015 fiscal budget while assessing its revenues for 2015, oil market developments took prices to lower levels than expected. Indeed, the 2015 Saudi budget was based on a price of \$60/bbl,²²² while Brent price averaged \$52/bbl in 2015: i.e., 53% lower level than the Brent price in 2014, and 49% below the average price over 2010-14.

In response to the oil price decline, which started in the summer of 2014 and its impact on Saudi Arabia's budget revenues, the Kingdom tapped its financial reserves and turned to borrowing in order to balance the 2015 budget. Saudi Arabia had \$724 billion of currency reserves at end 2014,²²³ and posted a \$97 billion budget deficit at the end of 2015, funded partially by digging into the foreign reserves of the Saudi Central Bank (Saudi Arabian Monetary Agency or SAMA). The Saudi government also used SAMA's reserves for the same purpose in 2016 and 2017. These reserves amounted to \$480 billion at the end of 2017 (equivalent to 28 months of imports of goods and services), thus standing at only some 66% of their peak, which was registered in August 2014 (equivalent to 35 months of imports of goods and services). The Saudi authorities also raised a US\$10 billion international loan in April 2016, and issued US\$17.5 billion in international bonds in October 2016 and US\$9 billion of Islamic bonds (Sukuk) in April 2017.

Liquidity in the banking sector tightened as pension funds, corporations, households and other government entities withdrew part of their deposits from banks, to acquire government bonds, as of late 2014. The drop in Saudi bank liquidity and the rising demand for loans pushed up interbank interest rates. However, the Saudi banking system proved to be resilient despite the severity of the macroeconomic shock during 2015-16. By end-2016, bank deposits had stabilized, liquidity conditions had normalized and interest rates had declined, as the government began to pay arrears to suppliers in October 2016.

Despite the economic and financial turbulence resulting from lower oil prices, the Saudi authorities' commitment to the exchange rate peg of the Saudi Riyal to the dollar remained unchanged.²²⁴ This meant anchoring the SAMA's key policy interest rate to US interest rates.

Public investment in Saudi Arabia tends to be used as the main variable to adjust to the economic environment. Among all public spending types, Saudi public investment had the biggest impact on non-oil GDP

222. Jadwa investment, available at: www.jadwa.com.

223. "Saudi Arabia 2017 Article IV Consultation—Press Release; And Staff Report", 28 October 2017.

224. 3.75 Saudi Riyals for a dollar.

growth over the period 2011-2016, with a strong multiplier effect. High oil prices from 2010 to mid-2014 enabled large public investment (the construction of new universities, new economic cities, etc.) and helped the Kingdom's leaders to respond to the Arab uprisings of early 2011, by increasing social expenditures to buy social peace. This involved some \$130 billion extra of social spending, as well as higher pay and bonuses for public-sector workers, leading to an increase of government spending by 25% compared to 2010.

With the decline in oil prices starting in 2014 and the extra budget spending related to the war in Yemen, the fiscal deficit rose from 3.4% in 2014 to almost 16% of GDP in 2015. In response, the Saudi government tried to raise non-oil revenue while cutting expenditures over the period 2015-2016; central government expenditures dropped by one third between 2014 and 2017, which severely hurt economic sectors relying on government spending. The latter suffered from the cancellation or postponement of publicly engaged/supported projects, with arrears accumulating to construction companies.

Cuts in government spending did not however affect strategic sectors. To cope with the surrounding geopolitical tensions (Syria, Iran, Yemen, etc.), the Kingdom maintained the growth of its military and security expenditures, which rose by 34% from 2008 to 2017, and which accounted for 10% of the Saudi GDP last year and 30% of budget revenues. This is the second highest budget share ratio in the world.²²⁵

The government pursues policies aimed at increasing non-oil revenues

In June 2017, the Saudi government introduced new excise duties on tobacco and carbonated/energy drinks, and introduced VAT starting from January 2018,²²⁶ expecting revenues from excise on tobacco/drinks and VAT to reach 0.4% and 1.6% of GDP respectively by 2020. The Saudi authorities also decided to introduce an expatriate levy, paid by companies whose foreign labour exceeds Saudi employees, and which is to be raised from SAR 200 to SAR 800 per month by 2020. There are also plans to introduce and/or increase fees and fines (e.g. visa fees, telecom license fees, tourism fees, etc.), and to improve tax collection through administrative reforms.

225. SIPRI, "Trends in World Military Expenditure 2017", May 2018.

226. In accordance with the Unified VAT Agreement for the Cooperation Council for Arab States of the Gulf.

For many years, provision of cheap domestic energy in the Kingdom had been one of the constant features of the Saudi energy policy. Low cost energy supplied to domestic energy-intensive industries such as petrochemicals, aluminium and steel, constituted a significant comparative advantage for Saudi-based investors.²²⁷ Low energy and water prices also pursue the objective of protecting low income citizens, an essential component of the "social contract" in Saudi Arabia. However, low water and energy prices (oil products, natural gas and electricity) have led to steady growth of the Kingdom's energy demand in recent years (4% to 5% a year), representing a huge drain on the government's budget in subsidies of some SAR300bn in 2015.

Raising domestic energy and water prices has been advocated by many as having a twofold benefit for the government of achieving not only a significant reduction of total subsidies but also allowing price signals to contain the surge in domestic consumption. The latter has pushed Saudi Arabia, the world's biggest oil exporter, to become the 7th largest consumer of fossil fuels in the world within a decade. But, successive Saudi rulers and governments have always been reluctant to amend the energy pricing system in place, fearing citizens' reactions to any decision to raise energy prices.

The government's decision to raise energy prices at the beginning of 2016, proved to be easier than expected, with almost no social resistance.²²⁸ With prices among some of the lowest levels in the world, the Saudi government could easily increase energy prices by up to 80% with domestic consumers still being able to enjoy very low prices by regional and global standards. In addition, the government implemented a compensation scheme intended to protect low income citizens from the additional burden of higher energy prices, which also facilitated public acceptance of the price reforms. The government intends to disburse \$8 billion under such a scheme,²²⁹ equivalent to 10% of total subsidies allocated in 2015.

The implemented rise of domestic energy prices in early 2016 has produced visible results as the energy consumption growth was much lower in 2016, compared to 2015 (1.7% against 3.5%). However, the energy

227. Such a feature was considered as unfair support to local industry when Saudi Arabia was negotiating its accession to the WTO, but the Kingdom argued that such (low) prices were applied to all companies operating in its borders, including foreign firms.

228. For oil products, the lowest increase was the price of kerosene (12% compared to 2015 price), while the highest increase concerned diesel fuel for transport (79%). Electricity prices were raised by 260% for residential consumption below 6,000kWh/month (from SAR0.05/kWh to SAR0.18/kWh).

229. Known as the Citizen's Account, the scheme is open to some 13 million Saudis.

price hike in early 2016 contributed to CPI inflation over the same year, and is expected to increase again in 2018 due to the recently introduced excises taxes, further energy price reforms and the introduction of the Value Added Tax in early 2018.

The Saudi authorities have also indicated that an automatic pricing formula will be introduced, once domestic prices are at international levels, sometime beyond 2020.

Preparing for changes of Aramco and the energy mix

At their biannual Conference in November 2014, and despite the oil supply surplus, Saudi Arabia and its OPEC partners decided not to reduce production, leaving market forces alone to adjust prices. The objective of this strategy was to drive US shale producers out of the market, but the resilience of such producers proved to be much greater than expected. This led to a reversal of strategy (based on a preference for higher oil prices against market share). Thus, on 30 November 2016, Saudi Arabia and other OPEC member countries finally decided, for the first time since 2008, to cut their oil production by 1.2 mb/d, starting from January 2017. Saudi Arabia's contribution to this effort, -500 kb/d, was the highest, from 10.54 mb/d to 10.06 mb/d.²³⁰ Despite the agreed cut, the country's crude oil exports increased slightly from 7.6 mb/d in October 2016 to 7.7 mb/d in January 2017, following a slight decline in its domestic consumption.²³¹ On average, the country exported 7 mb/d in 2017, around 700 kb/d less than in 2016.

Although desire to reduce oil and gas dominance in the Saudi energy mix has been announced in the past, the oil price slump starting mid-2014 has spurred Saudi Arabia to curb domestic consumption of fossil fuels and deploy investment in wind and solar power. Some 38% of the Kingdom's power generation (a capacity of 31 GW out of a total of 82 GW) is oil fired, absorbing as much as 700 kb/d oil to meet electricity demand during the summer period (for air conditioning notably). Cutting back on domestic energy demand has become an important component of the Saudi energy policy, as such demand is taking up a rising share of the Kingdom's hydrocarbon production. Following recent measures aimed at implementing the better conservation of Saudi energy resources, the Kingdom is now looking at the diversification of its energy consumption,

230. OPEC agreement, 30 November 2016. Agreed cuts are based on members' oil production in October 2016.

231. According to the Joint Organisations Data Initiative, available at: www.jodidata.org.

planning to supply 9,500MW from renewable sources by 2023, equivalent to 10% of its power consumption. Tenders have started to be announced, a first has been won by Saudi company ACWA Power. The Japanese Softbank has also pledged to develop a first phase of 7.2 GW of solar via its Vision Fund and is reportedly in talks with the PIF and other lenders for much larger investments.

Despite its large gas reserves, the Kingdom does not export natural gas and is considering imports of LNG as local consumption has risen steadily over the past decades, due to very low domestic prices for petrochemicals manufacturing and electricity generation. Saudi Arabia has tried to involve international companies in finding new gas reserves in Rub Al-Khali²³² but consortia's drilling programmes didn't lead to commercial discoveries and were stopped. As most of the Saudi gas supply is sourced from joint oil and gas production, the country has also to face the challenge of managing gas extraction and oil production, i.e. supplying more natural gas (current production is at 104 bcm/year) while limiting oil production to meet the Kingdom's extraction quota as an OPEC member..²³³

Against the backdrop of the oil price decline and Kingdom's evolving energy policy, Saudi Aramco is continuing its diversification, and pursuing both horizontal and vertical integration. The Saudi national oil company is expanding its investments locally in petrochemicals, to process directly the oil it produces. For many years, the Saudi domestic petrochemical industry has been the playing field of the Saudi Arabian Basic Industries Company (SABIC) conglomerate and its foreign partners, enjoying a very low and flat price of ethane (0.75 \$/ Mbtu) before the price was raised to 1.75 \$/Mbtu in 2016.²³⁴ The Saudi national oil company is now expanding its investments locally in petrochemicals, to process directly the oil it produces. At the same time, upstream oil is not neglected: Saudi Aramco announced in July 2017 an investment plan totalling \$300 billion, aimed at preserving its oil production capacity, and increasing its production of conventional and unconventional gas.

To capture more value added from the domestic oil production, Saudi Aramco is also investing in downstream industries, both at home or abroad. The Saudi company has recently concluded an agreement with Total to build a very large petrochemical plant producing up to 1.5 million tons of ethylene per annum, located next to the Saudi Aramco/Total refinery (Satorp). Saudi Aramco has also acquired a 50% stake in a new

232. Through the so-called "Saudi Gas Initiative" launched early 2000.

233. The "Saudi Gas Initiative" launched in Rub Al Khali did not lead to commercial discoveries, and almost all the selected consortia have stopped their drilling programmes.

234. The ethane price is still below international standards.

giant refinery project (1.2 mb/d) to be located in India, a country which has now become the world's third-largest oil consumer.

The Saudi national oil company is also developing its domestic and international refining capacity to become a global trading company, with its plan to trade up to 6 mb/d crude oil and oil products by 2020, compared to its current traded volume of between 3.3 mb/d and 3.6 mb/d.

The MBS factor

Diversification of the Saudi economy has been an economic policy priority since the 1970s, but the implementation of successive initiatives – from a series of five-year development plans first introduced in 1970 to a strategy to create six new 'economic cities' formulated in the 2000s – have usually fallen short of their targets. In April 2016, Saudi Arabia Crown Prince Mohammed bin Salman (also called MBS) unveiled a plan for a radical transformation of the Saudi economy, calling for an end the "addiction on oil" in four years. The privatization of government assets is expected to help finance investment in new sectors such as defence industries and/or mining.

Saudi Arabia has announced a plan to sell a stake (5%) of its national oil company and use the associated revenues to roll out the plan of the Crown Prince (Saudi Vision 2030), which aims at reducing the Kingdom's dependence on oil. Aramco is often said to be worth \$2 trillion, a figure mentioned especially by the Crown Prince and which is used as the basis for calculating the revenues from the 5% sale. However, given present levels of oil prices, these valuations may well be out of reach. Based on a few other assessments, the net present value of the company stands at only \$251 billion with a tax rate of 85%, and rises only to \$419 billion in the case of the 50% tax rate, recently adopted by the Kingdom to improve the valuation of the national company.²³⁵ It is argued that the Saudi authorities' activism to preserve the OPEC/non-OPEC agreement for a longer period is motivated by the Kingdom's desire to stabilize oil prices at higher levels, which in turn will value Saudi Aramco at the highest possible level.

The success of Saudi Aramco's partial IPO will create confidence in the success of the economic reforms that the Kingdom is trying to promote by making use of the resources generated by the IPO. In addition, Saudi Aramco would also gain from the planned IPO, as it would drive corporate governance changes, increase transparency, and give the company more room for manoeuvre.

235. B. Fattouh and L. Harris, "The IPO of Saudi Aramco: Some Fundamental Questions", *Energy Insight*, No.9, OIES, March 2017.

The \$230 billion Public Investment Fund (PIF), established in 1971 to support Saudi companies, is now the central financial vehicle in materializing the Vision 2030 of Prince Mohammed bin Salman, who is also its chairman. The PIF aims at raising its total assets to \$400 billion by 2020, and investing half of that amount abroad and channelling the other half to serve strategic projects in the Kingdom and support its economic diversification. PIF has already invested \$3.5 billion in Uber, \$45 billion in the Softbank Vision Fund (the world's largest technology investment fund), as well as \$40 billion in Blackstone's infrastructure investment fund. The Saudi Fund is expanding quickly and is looking at a variety of sectors as targets for investment (including tourism, health, artificial intelligences, hotels, media, etc.).

Saudi oil policy led the kingdom to look for new alliances

Saudi Arabia has strengthened its strategic partnership with the US since the arrival of President Trump and the rise of the Crown Prince to power. But recent developments, both domestically and internationally, have introduced new avenues for (strategic) partnership.

The developments of the global oil market and the Kingdom's evolving energy policy have led Saudi Arabia to initiate a new cooperation with Russia, despite Russia's ties with Iran, the Kingdom's top enemy. King Salman became the first Saudi monarch to visit Russia in October 2017, and signed several agreements covering the energy and defence sectors, as well as joint investments. According to the Memorandum of Understanding signed recently between the Russian company Novatek and Saudi Aramco, the parties agreed to initiate an international collaboration on natural gas projects, including LNG supplies, opening the doors for Saudi Aramco to possibly join Novatek and its other partners in the Artic-2 LNG project.

China has offered to buy up to 5% of Saudi Aramco directly through a state-run consortium that includes state-owned Chinese oil companies Sinopec and Petrochina, banks and China's sovereign wealth fund. Acquiring 5% of Saudi Aramco would help China, already the main importer of Middle Eastern oil, contribute to creating a strong link with the Kingdom which will remain an important oil supplier to China over the long term. Stronger economic relationships between Saudi Arabia and China could also serve as a Middle East anchor for the latter's Belt and

Road Initiative, and could expand into renewables, smart and sustainable cities or nuclear projects.²³⁶

Another shift in Saudi relations is the growing proximity with Israel as the two countries share the same concerns regarding Iran's nuclear and ballistic programmes and expansion in the region.

Huge potential: but will deeds match words?

Thanks to low production costs, Saudi Aramco can still turn a profit despite lower oil prices, i.e. as low as \$30 per barrel. However, the Kingdom needs much higher oil prices and the reforms engaged by the Saudi authorities are crucial in driving the Kingdom's towards a more sustainable development path: expanding higher education, creating jobs for a young and fast growing population, increasing the role of the private sector, enhancing the Kingdom's attractiveness as destination for foreign investment, diversifying its energy mix, increasing non-oil related revenues in the fiscal budget, etc.

The fact that the young Crown Prince is de facto the ruler of the country provides a sign that policy choices will be given enough time to produce outcomes, provided that no unforeseen internal or external negative developments arise in the short- and medium term. It is said that the "anti-corruption purge" led by the Crown Prince in November 2017, when 200 royal family members, government ministers and businessmen were detained in Riyadh, allowed some \$100 billion to be recovered²³⁷, and may have sent a signal to foreign investors that the Saudi authorities are working on creating a business environment free from corruption. Rapid implementation of economic reforms, even though some see the many targets set in the Vision 2030 as being too hard to achieve, are crucial if the Kingdom is to meet its long term economic, social and environmental challenges. Saudi Arabia needs to pursue much needed reforms, even if oil prices are recovering to higher levels. The present upward trend of oil will be a test to judge the Saudi rulers' ability to stick to their plans.

236. See: www.oilprice.com.

237. "Saudi Arabia: US\$100bn Recovered from Corruption Probe", Organized Crime and Corruption Reporting Project, 31 January 2017.

Venezuela

Isabelle Rousseau

Since the second half of 2014, the collapse in oil prices has amplified the multidimensional crisis which opened up after President Hugo Chávez Frías' death 1 ½ years before (5th March 2013). The systemic crisis in Venezuela (31.5 million inhabitants) is linked to the fall of oil prices in a country that was until 1998 a very important producer with 3.4 mb/d on average, and which has the largest proven oil reserves in the world (297 billion barrels), and widely relies upon oil export revenues (96% of the total exports). The recent rise in oil prices is not expected, however, to end Venezuela's oil, economic, political and social crises, as production is likely to decrease further and the political crisis continue deepening.

The unfolding of an economic, social and political disaster

Since 2015, oil revenues from sales and exports abroad have plummeted: even if they still reached \$54.716 billion, they fell to \$41.314 billion in 2016. In 2016, the fiscal deficit was almost 20% of Venezuela's GDP, so that Venezuela's external debt default became a real possibility. The fall in oil exports has been severely impacting budget revenues, which fell from \$20.209 billion in 2013 to \$1.794 billion in 2016.²³⁸

At the same time, since 2015, the investment budget allocated to Petróleos de Venezuela (PdVSA) decreased sharply (42% compared to the previous year), harming mostly the natural gas industry (-81%), more than the upstream (-34%) or the refining sector (-30%).²³⁹ Interestingly, however, the extra budget that the state company allocated to social development activities rose by 73%.²⁴⁰

238. The data included the income tax plus the contribution for social development. Unfortunately, there is no data for 2017.

239. *Energía en cifras, 2014-2015. Informe Anual de Gestión, 2014 and 2015.*

240. By law, from the income obtained annually, PdVSA must allocate part of its budget to a social development fund. This category increased strongly in 2015, illustrating the government's concern about the repercussions of the economic crisis on the population accustomed to receiving these funds (its political supporters).

Under these circumstances, the Venezuelan government requested the Central Bank of Venezuela to issue more money, unleashing inflation in large proportions and thus undermining the purchasing power of the population – especially its poorest segments. The inflation rate for 2014 was 68.3% reaching 2,400% in 2017 according to the IMF and projected to be 13,000% in 2018, with middle class people only able to buy food for a meal with their monthly salary.²⁴¹ The bolivar no longer has any market value. Gold and currency reserves have fallen to their lowest levels in more than a decade; together with the level of inflation, this situation has led to an impressive rise in the price of the \$ in the parallel market, which is the only reference for any business.

This deep economic and financial crisis had huge repercussions on the population. Social tensions were exacerbated by a dramatic increase in crime,²⁴² as well as social and labour conflicts – even among sectors that had supported Chávez in the past.²⁴³ At the same time, the shortage of goods and services (basic foods and medication) have provoked fierce rows in state stores and encouraged a gigantic black market.²⁴⁴ This is not to mention the lack of maintenance and investment in infrastructure, due to scarce resources, mismanagement and institutionalized corruption. Serious deficiencies have hit particularly the electricity system, the supply of drinking water, public transportation and the health sector. Migration abroad – increasingly relevant – is a good indicator of this malaise.

This spectacular economic deterioration has fuelled social discontent that, for the first time since the beginning of the Chavista Revolution, has favoured the opposition gathered in the MUD (the Unity Democratic Movement). The MUD won the legislative elections on 6 December 2015 by a considerable margin over the governing Venezuelan United Socialist Party (PSUV).²⁴⁵ Society wanted economic and political change, and stood against a regime without any real democratic guarantees.²⁴⁶

The opposition took advantage of its new position to block government decisions and organize demonstrations in order to destabilize the regime. In February 2017, it vetoed the signature of new oil contacts

241. According to the Central Bank of Venezuela inflation was 186.5% (much lower), www.imf.org.

242. According to the *Reporte Anual del Observatorio Venezolano de Violencia*, Venezuela is the most violent country in Latin America (28,000 murders in 2015).

243. According to *Observatorio Venezolano de Conflictividad Social (OVCS)*, in 2017 protests increased 41%.

244. R. Sánchez Urribarrí, "Venezuela (2015): un régimen híbrido en crisis", *Revista de ciencia política*, vol.36 no.1, April 2016, p. 369.

245. It obtained 112 seats in the National Assembly, out of 167, which represented more than two thirds of the seats.

246. Carlota García Encina, "Venezuela: ¿cambio político o ingobernabilidad?", *El Cano*, 2016, p. 1.

with Russia, arguing that it was just a way of selling national oil assets at knockdown prices. Opposition notwithstanding, the Higher Court of Justice allowed President Maduro to sign the contracts without the authorization of the National Assembly. Consequently, the MUD organized rallies against this illegal decision, and the government's response involved extremely violent repression, leaving 120 people dead. In order to bring down the opposition, Maduro (illegally) decided to dismiss the National Assembly on 1st May 2017, and convene new elections to create a Constitutive Assembly that would modify the Constitution. By then, the MUD was divided and lost the federal elections of 30th July 2017, and the regional elections in October 2017. In August 2017, the American government announced very drastic economic sanctions in order to strangle financially Maduro's "dictatorship". Some of sanctions include the prohibition of US citizens from negotiating new issues of debt (and other business transactions) with Maduro's government and PdVSA, as well as from purchasing *Petro* – the Venezuelan cryptocurrency. The reduction of oil purchases from PdVSA is another sanction.

The PdVSA disaster

Since 1999, following the Bolivarian Revolution, the state has put the hydrocarbon industry under its control.²⁴⁷ This has had many consequences for the PdVSA's operations, especially on levels of production and exports. There were massive lay-offs in 2000 which the company has hardly overcome since, and the company has taken over large social responsibilities and functions, outside the oil sector.

The collapse of the oil prices has an impact on the oil production, but only since 2016.²⁴⁸ Firstly, before the fall in prices, oil production had already been declining from 3.4 mb/d in 1998 to 2.899 mb/d in 2013. The decline in output first slowed to 2.785 mb/d in 2014 (the price was still \$88.42), and 2.764 mb/d in 2015. It then suddenly took a nose dive of 120 kb/d in 2016 (minus 69% in the inter-annual production with prices around \$24.15/bbl in February 2016). This trend became more pronounced in 2017 for reasons unrelated to the price of crude oil (which was rising): over the year, average production was 2,072 mb/d, but it fell below 2 mb/d in December 2017.²⁴⁹

247. PdVSA created Mixed Companies (compañías mixtas) with several Oil Companies (such as Total, BP, etc.). By law, PdVSA is the major partner (at least 60% of the share).

248. The Production indications emanate from the Annual Management Report of PdVSA (2013, 2014, 2015, 2016).

249. Such as mismanagement of the State Company, as well as the social and political situation in Venezuela.

Production of tight and medium crude oil production has been decreasing strongly (60% concerning tight oil, and 32% for medium crude oil). In contrast, heavy and extra heavy crude oil production has been increasing (up 52% in 2014, compared to 1998). Nowadays, 61% of all production of oil is coming from heavy and extra heavy crude oil from the Orinoco Basin. As a consequence, since February 2015, Venezuela has had to buy West Texas Intermediate (WTI) crude oil to dilute it, in order to export a mix. These developments took place before the fall in oil prices.

Total exports declined accordingly, from 2.425 mb/d in 2013 to 1.835 mb/d in 2016.²⁵⁰

Ironically, Venezuela signed the two OPEC agreements (2016 and 2017) and committed to reduce its production by 95,000 b/d, which it has largely surpassed. PdVSA is facing very challenging times. The state company's debts represent 40% of the whole national debt (\$150 billion): Standard and Poor's Global Ratings estimate that PdVSA is in partial *default* of payment: e.g., the government proposed the creditors to accept swaps for PDVSA bonds in 2016 and 2017 that were issued in 2010 (\$3 billion). More recently, it has been said that the bonds could be reimbursed in bolívares and not in US dollars.

Since 2015, PdVSA's poor cash flow has slowed down investments in the petroleum sector, affecting the maintenance of essential equipment across all of the industry's value chain. At present, for example, the volume of refined products is around 435,000 b/d *versus* 1.3 mb/d, a few years ago, and accidents have proliferated. At the same time, the state enterprise has dramatically reduced wages; workers faint from lack of food and many of them are abandoning their posts to emigrate or, worse, to sell stolen pipes and wires to make ends meet for their families. Additionally, the company has been accumulating huge debts with its suppliers and partners.

A large number of PdVSA's officials recently criticized the regime and were subsequently put in jail. Last October (2017), Maduro appointed a new team to manage the oil industry, led by Manuel Quevedo, the military commander who ordered repressive measures against the people demonstrating in April, 2014. Quevedo was given extraordinary powers and at the same time was nominated Oil Minister and President of PdVSA.²⁵¹ Quevedo, a former Housing Minister, knows nothing about the hydrocarbon sector, and yet he accepted Maduro's decision to increase the volume of oil production by 1 mb/d to bail out the company and the

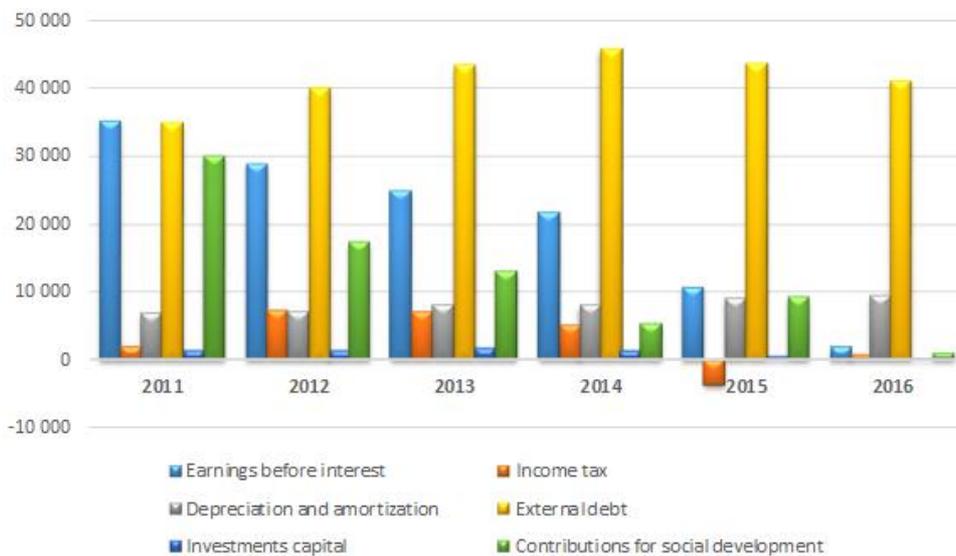
250. There is no information on total exports in 2017.

251. "Venezuela Empowers Oil Minister Quevedo To Reform Energy Sector », Reuters, 14 April 2018, available at: www.reuters.com.

country. Even if he tries his best, there is no doubt that he will fail, given the poorly maintained and ageing infrastructure. His involvement has so far triggered a lot of scepticism and calls for dismissal, especially from foreign partners.

In an attempt to obtain the necessary cash to pay the interest of its huge debt, PdVSA has divested many fields at very low prices. Recently, Rosneft took advantage of this in becoming the minor partner of PdVSA in five blocks, besides its participation (10%) in Petropiar, while Rosneft Trading SA resells 13% of Venezuelan oil output.²⁵² Russia and Rosneft have lent a lot of money to Venezuela and PdVSA, and facing risks if the opposition, which is opposed to these rock-bottom prices divestments, takes office in the near future. Specifically, in 2016, the debt with Russia was restructured, to stand at \$3.150 billion, and to be repaid within a period of 10 years. Also the debt that PdVSA has to Rosneft, initially of \$6 billion, is now down to \$3 billion, and Rosneft has expressed confidence that it will be repaid.²⁵³

Figure 3 : PdVSA: financial information, 2011-2016 (million \$)



Source: Author's own elaboration with data from consolidated financial statements of PDVSA (PdVSA, 2012-2016).

252. Since the 1980s, CITGO has been a subsidiary of PdVSA located in United States. On the other hand, Petropiar is a mixed enterprise in the Orenoco Basin created in 2007 (between Chevron Texaco and PdVSA). In 2007, Chevron held 20% of the shares while PdVSA retained 80%. Chevron increased its shares to 30%, and recently Rosneft has participated with 10%.

253. H. Foy, "Rosneft Seeks to Ease Fears over Venezuela Loans », *The Financial Times*, 19 March 2018, available at: www.ft.com

Foreign policy implications: Russian and Chinese bail outs

Motivated by political considerations, Hugo Chávez invited NOCs from friendly countries to produce heavy crude oil in the Orenocco Basin: an area of 55.314 km² with one of the most important concentrations of hydrocarbons in the world. Joint ventures with PdVSA were set up accordingly. At that point, this initiative represented a defensive move against the perceived threat of an American invasion.²⁵⁴ Without enough cash to meet the interests of multiple loans and to import gasoline (fuel) and basic food, Chávez relied on his two closest allies: China and Russia.

Since 2007, under the framework of the Financial Joint Fund, Venezuela has received more than \$62 billion from China. In return, PdVSA has continuously sent oil to China (around 1.2 mb/d in 2017).²⁵⁵ However, this system did not last long. Frustrated by Venezuela's delays in payments and high levels of corruption, China withdrew and was eventually replaced by Russia. But, no sooner had Venezuela received the money, that it was spent to reimburse expiring debts. And Russia cannot further ramp up its financial support of the regime, given its own financial difficulties and the fact that Venezuela's financial needs are tremendous.

Meanwhile, Venezuela was forced to reduce its crude oil deliveries to the Caribbean countries, particularly to its closest ally, Cuba (with Algeria replacing it).²⁵⁶

Is the worse still to come?

Financially, Venezuela is exhausted and the social situation is about to explode. On the political level, the government and opposition are facing very challenging issues. The opposition is divided after its electoral defeat; the incumbent governing group has recently split. A significant number of officials, claiming to represent the Chávez Bolivarian Revolution are critical of Maduro's incapacity to resolve what they see as an acute crisis. Maduro's response is to arrest his critics and send them to jail. In October 2017, 65 high-level officers of PdVSA and CITGO were accused of corruption. This was followed by accusations against three generals of the army, for

254. 24 oil companies among 19 countries created "mixed companies" with PdVSA.

255. Today China is the first destination of the Venezuelan crude oil (1.2 mb/d). 790 projects have been planned (reactivation of 800 wells in the Orenocco Basin and in the State of Monagas); as well as a refinery in China, the result of a partnership by CNPC-PdVSA.

256. Venezuela did not cancel its help to the Caribbean countries that are relevant political and diplomatic allies in the Organization of American States.

plotting against the President in March 2018. These events highlight both the extreme fragility of the regime, and the risk of a *coup d'état*.

With the 20 May 2018 presidential election, Nicolas Maduro scored 67.7% compared to his closest rival, Henri Falcón, who received 21.2% of the votes. However, Maduro's legitimacy is very weak: the participation rate was only 46.01% compared to 79% during the three last presidential elections,²⁵⁷ and Maduro's opponents refuse to accept the results while the international community has warned of irregularities and vote rigging.²⁵⁸ Far from giving Maduro more support, the last presidential (and legislative) elections have increased Venezuela's economic and social instability and will accentuate Maduro's lack of real political support (not to mention the possibility of an American oil embargo). This will hugely complicate his capacity to hold on to power. The US has just announced another round of sanctions targeting the financial sector and elites, yet leaving the oil sector untouched so far.²⁵⁹ But more companies are now seeking to seize overseas assets of PdVSA over unpaid bonds, debts and non-delivered supplies, and extremely difficult operations by foreign companies who decided to somehow stay.

Even if the OPEC+ agreement continues and the oil price keeps rising, many experts consider that it will not be sufficient for Venezuela to honour its external commitments. Production could well fall by another -300 kb/d by the end of the year.

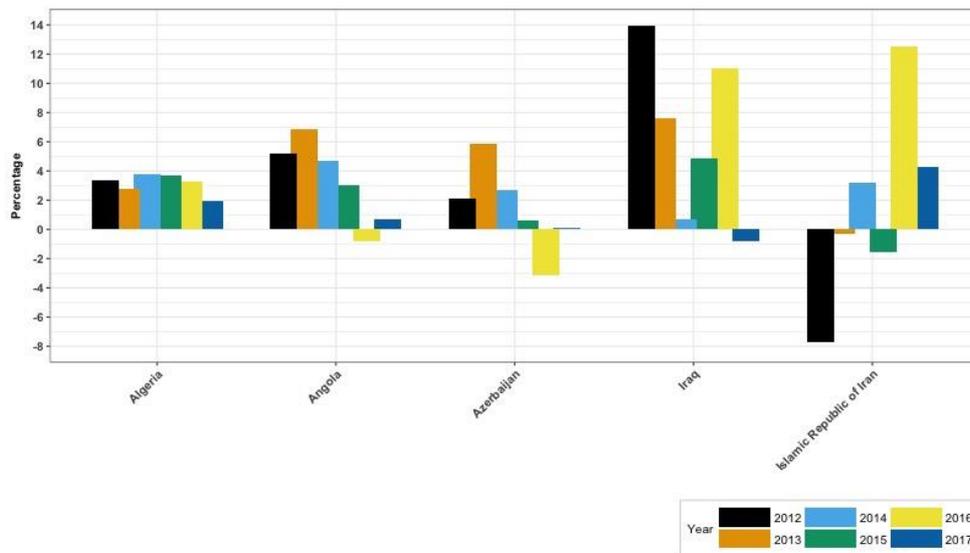
257. The MUD called for a boycott of the elections. Henri Falcón did not accept this call, and created a new party. However, all the incentives were put in favour of the regime (e.g. the purchase of votes in front of polling stations in many places), and Falcón did not succeed in winning.

258. Specific organizations included: the OAS, the European Parliament and the Lima Group (covering twelve Latin American countries). All had previously called for President Maduro to cancel these elections.

259. J. Hirschfeld Davis, "U.S. Places New Sanctions on Venezuela Day After Election", *The New York Times*, 21 May 2018, available at: www.nytimes.com.

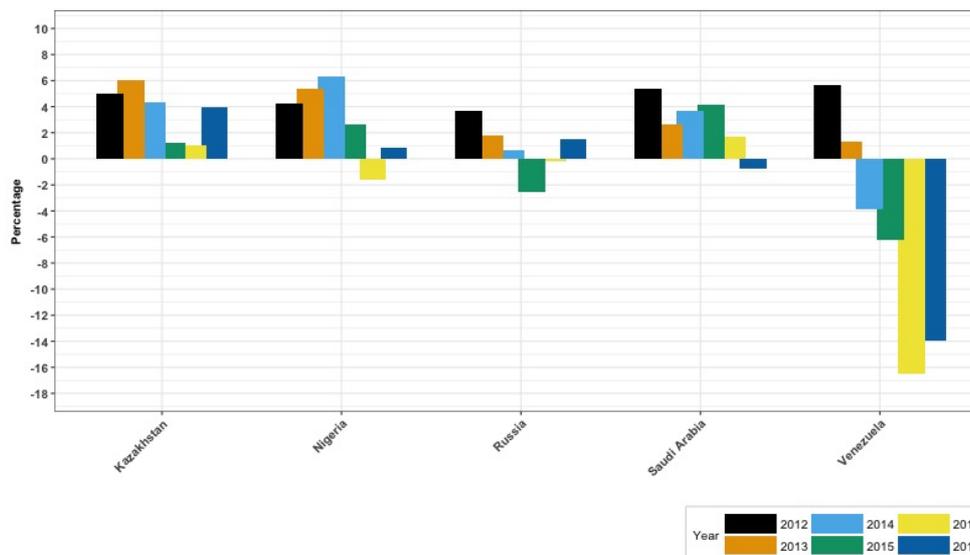
Annexes

Figure 4: GDP growth, selected OPEC+ producers, 2012-2017



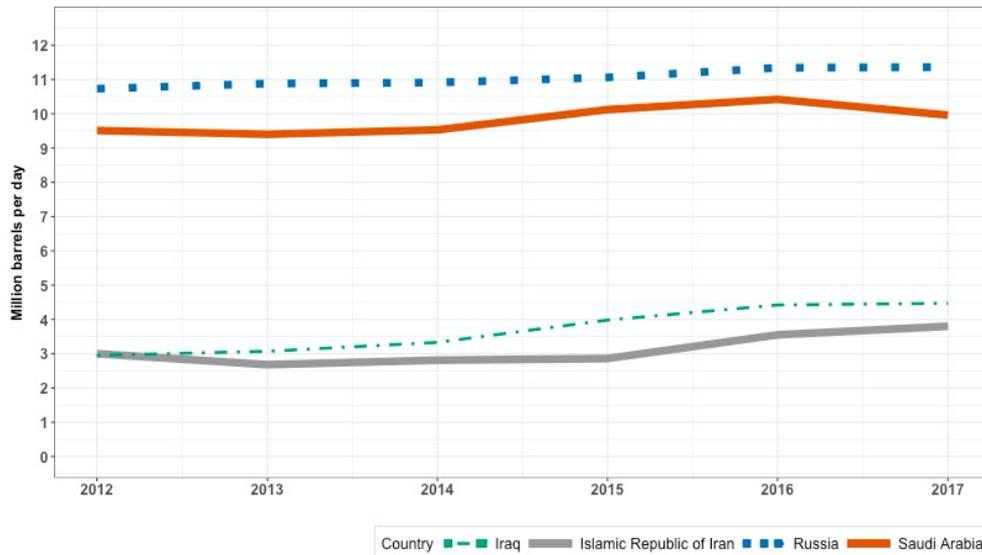
Source: International Monetary Fund, World Economic Outlook Database, April 2018.

Figure 5: GDP growth, selected OPEC+ producers, 2012-2017



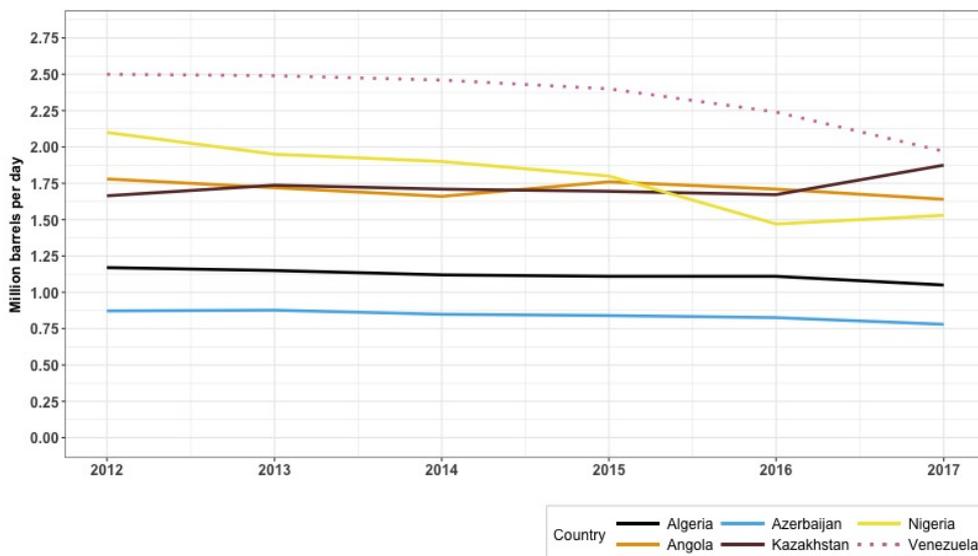
Source: International Monetary Fund, World Economic Outlook Database, April 2018.

Figure 6: Oil production by Iraq, Iran, Russian and Saudi Arabia, 2012-2017



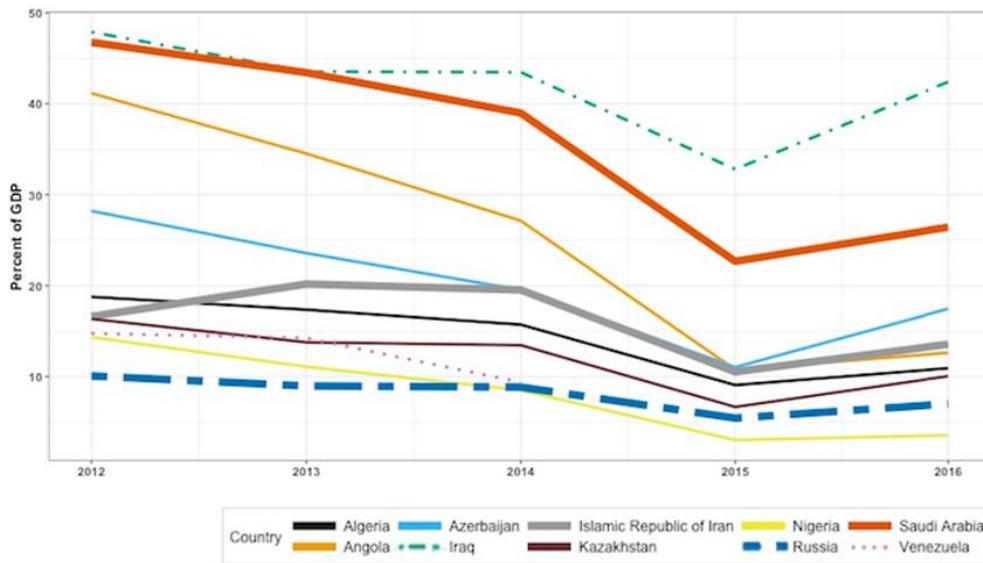
Source: BP Statistical, Review of World Energy, June 2017; IEA, Oil Market Report, January 2014, January 2016 and January 2018; IEA, Market Report Series: 2018 Oil – Analysis and Forecasts to 2023, March 2018.

Figure 7: Oil production by Algeria, Angola, Azerbaijan, Nigeria, Venezuela and Kazakhstan, 2012-2017



Source: BP Statistical, Review of World Energy, June 2017; IEA, Oil Market Report, January 2014, January 2016 and January 2018; IEA, Market Report Series: 2018 Oil – Analysis and Forecasts to 2023, March 2018.

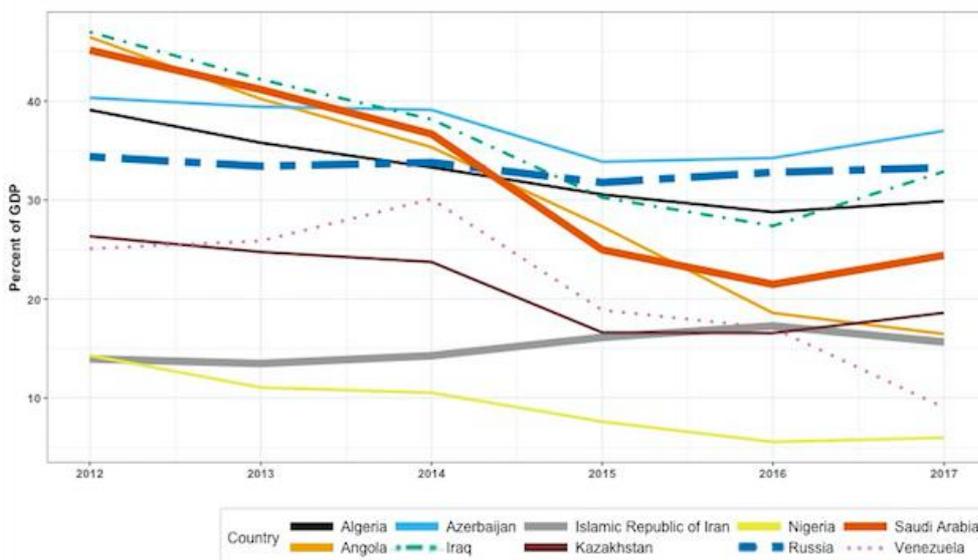
Figure 8: Oil rents* (Percent of GDP)



*World Bank definition: Oil rents are the difference between the value of crude oil production at regional prices and total costs of production.

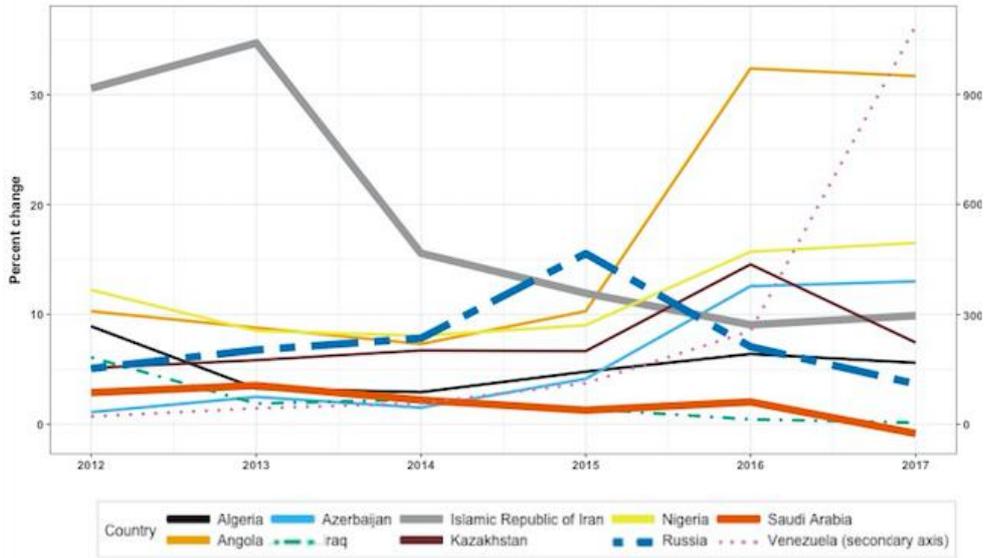
Source: World Bank, World Development Indicators.

Figure 9: General government revenues



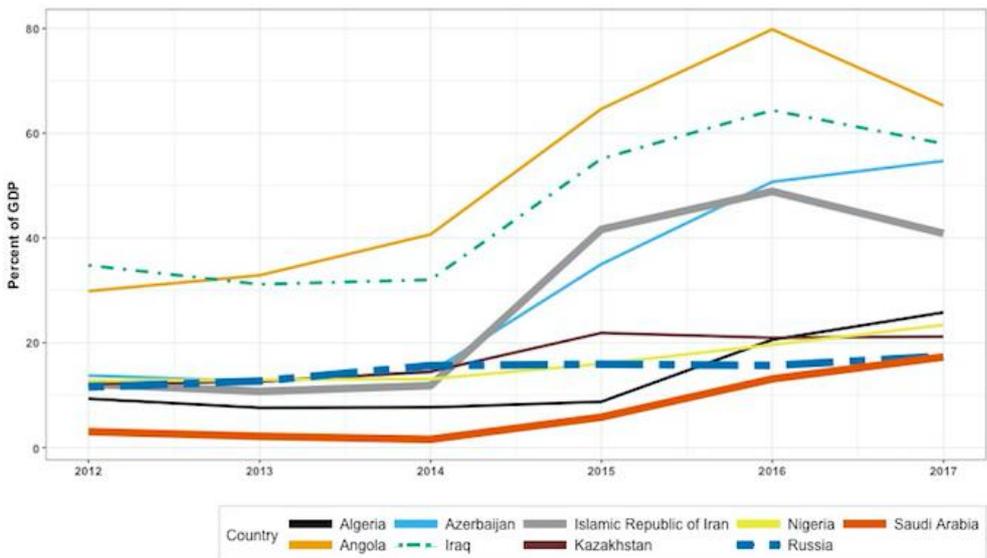
Source: International Monetary Fund, World Economic Outlook Database, April 2018.

Figure 10: Inflation, average consumer prices



Source: International Monetary Fund, World Economic Outlook Database, April 2018.

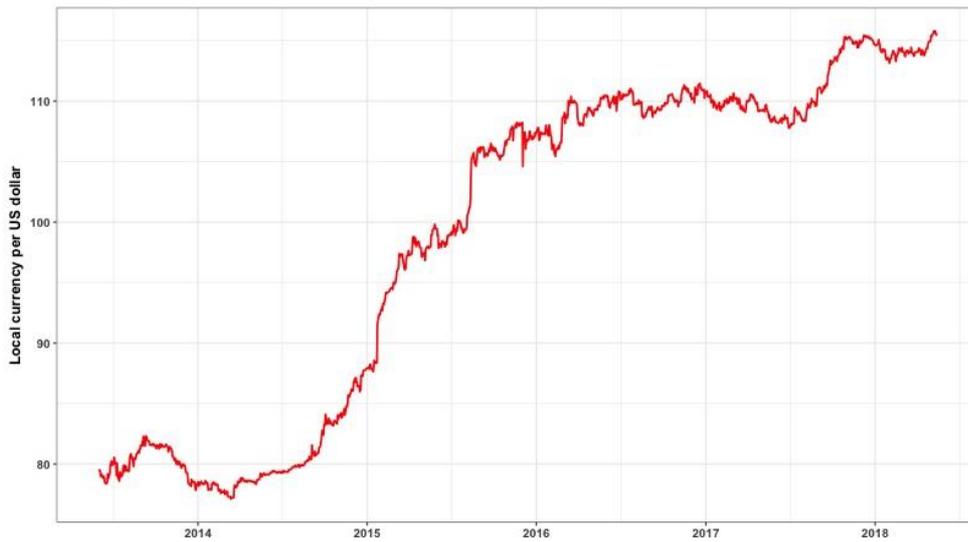
Figure 11: General government gross debt



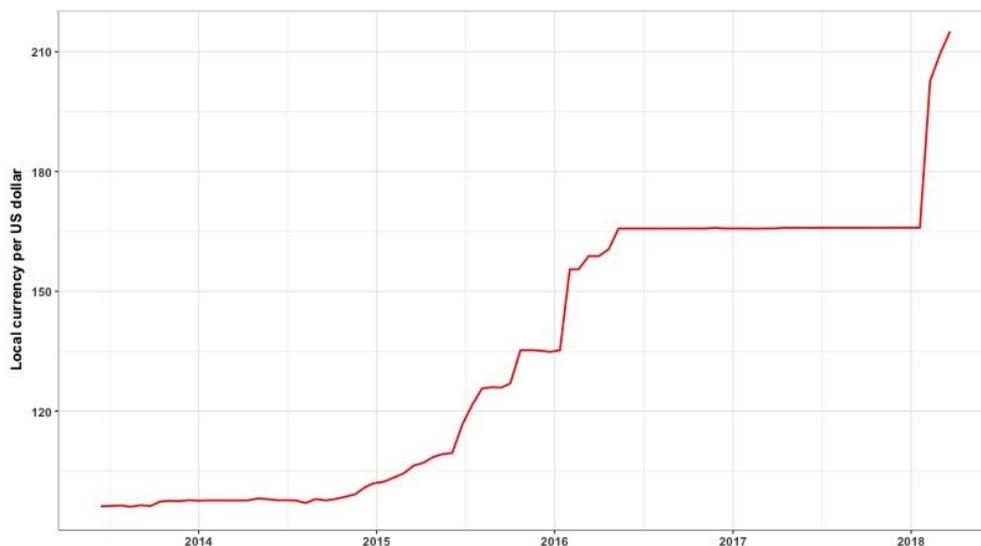
Source: International Monetary Fund, World Economic Outlook Database, April 2018.

Figure 12: Evolution of local currency exchange rates with the US dollar, Q3 2013-Q1 2018

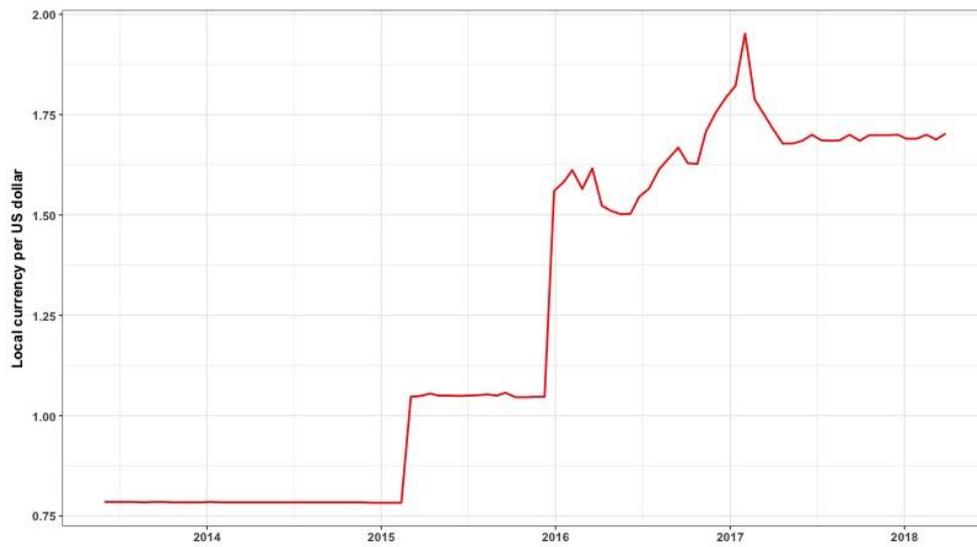
12.a. US dollar to Algerian dinar (May 2013-May 2018)



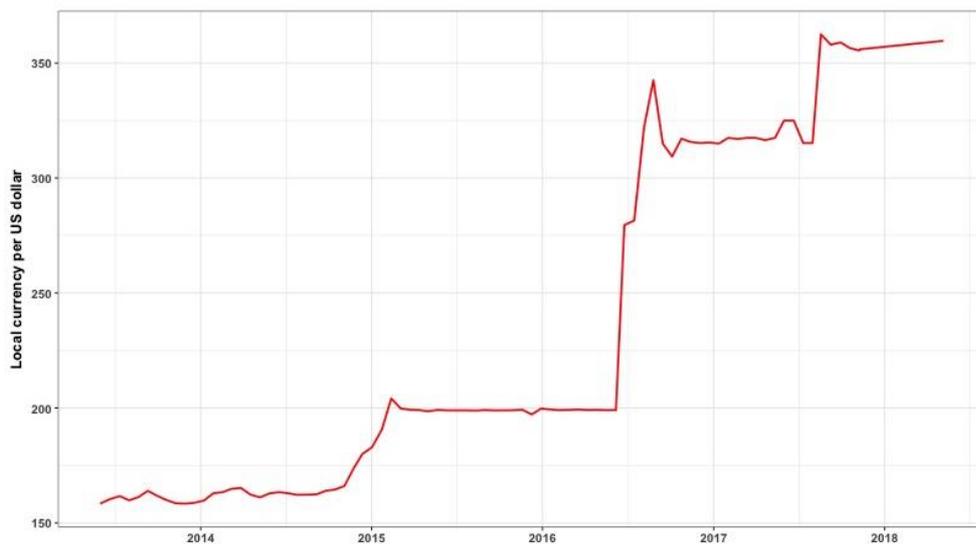
12.b. US dollar to Angolan kwanza (June 2013 to March 2018)



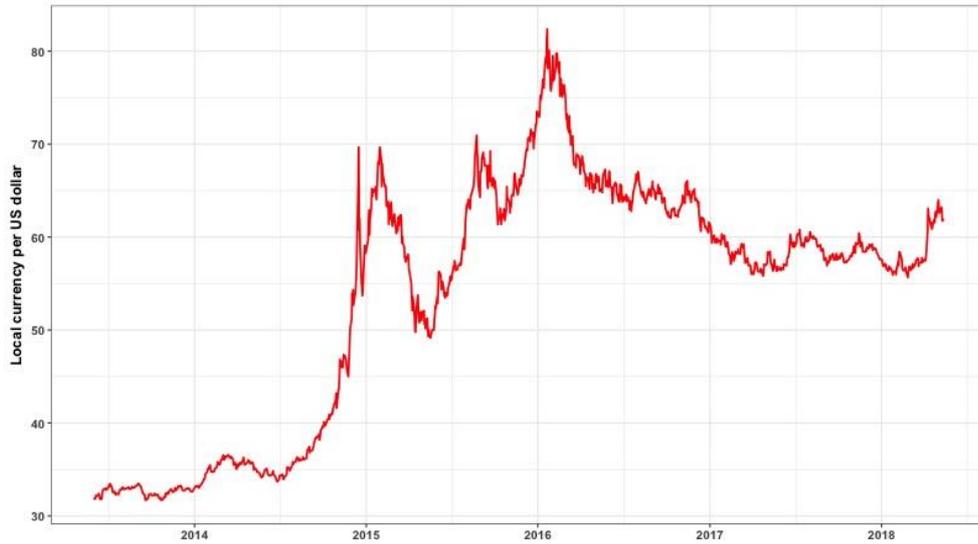
12.c. US dollar to Azerbaijani manat (May 2013 to March 2018)



12.d. US dollar to Nigerian naira (May 2013 to May 2018)



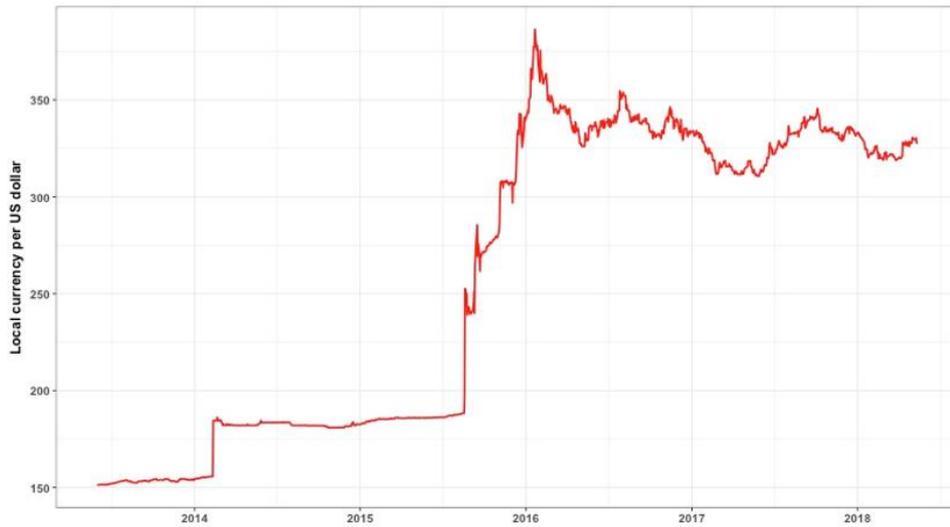
12.e. US dollar to Russian ruble (May 2013 to May 2018)



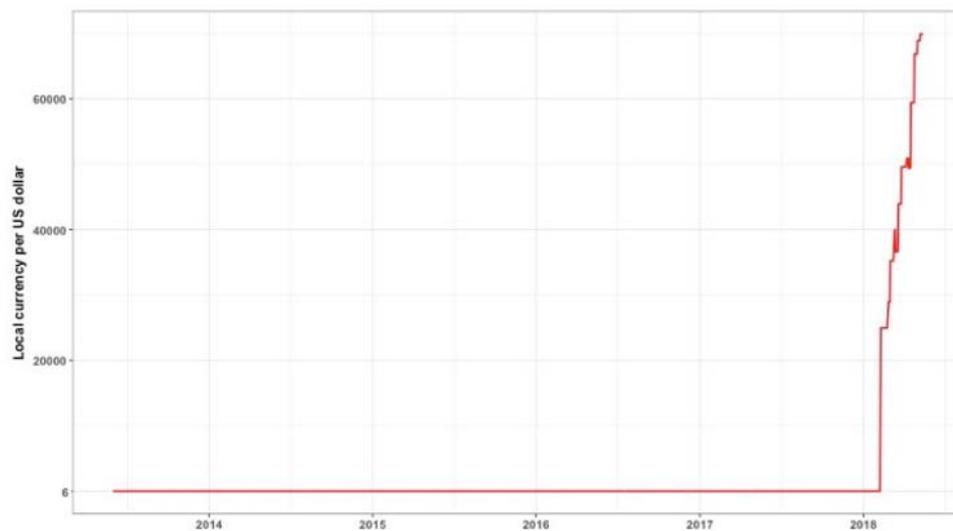
12.f. US dollar to Saudi riyal (May 2013 to May 2018)



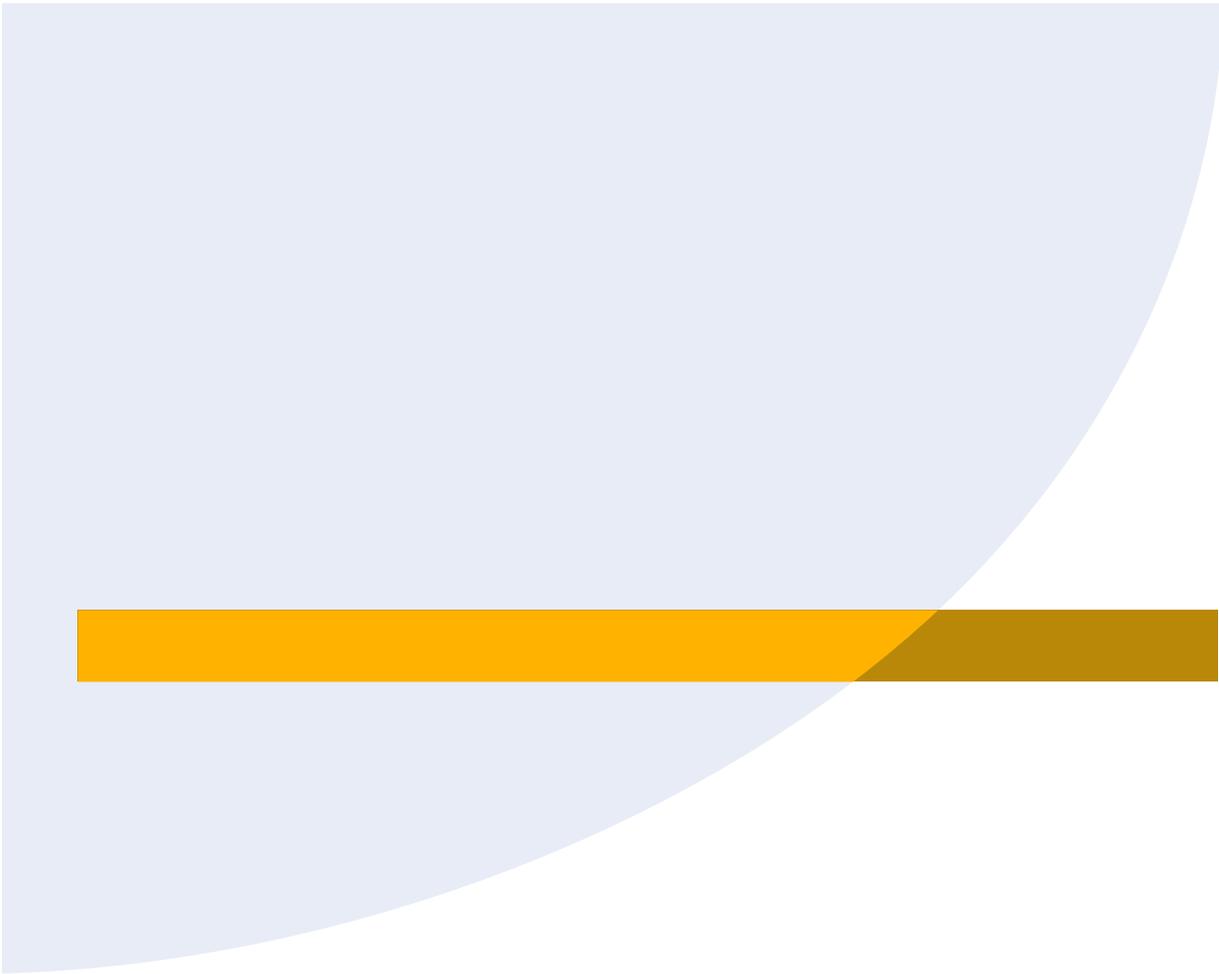
12.g. US dollar to Kazakh tenge (May 2013 to May 2018)



12.h. US dollar to Venezuelan bolivar (May 2013 to May 2018)



Source: Boursorama.



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