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Note to the Deputy Secretary-General

PLUNGING OIL PRICES: IMPACT ON AND RESPONSE BY THE GULF

1. The global oil prices have fallen by roughly 50% in the past six months. In mid-December, several important benchmarks, including Brent Blend and West Texas Intermediate, dropped below \$60 a barrel for the first time since July 2009. The most significant factor causing this sudden price plunge appears to be the oversupply of crude oil¹. Still, political considerations could also play a role.²

2. There are no signs that this downward trend may stabilize any time soon. If oil prices stand at a low level for a protracted period of time, the world economy in general is predicted to grow faster due to lower costs for manufacturers and greater disposable income with consumers. But for top oil exporting countries, this will result in substantial losses. Falling oil prices may become a threat to the entire Gulf region where countries are responding in drastically different ways.

Iran

3. Iran's energy sector has been under tightened international sanctions since early 2012. Its oil exports have since dropped by about 50%, averaging 1.2-1.3 million barrels a day in 2014. Oil exports currently make up about 30% of Iran's government revenue. The sharp fall in oil prices, taking place while Iran was attempting to increase its oil production, has impacted Iran's economy. On 7 December, President Rouhani submitted a budget for the next fiscal year that was based on an oil price of \$72 a barrel. Nevertheless, a former director general of the National Iranian Oil Co. cautioned that a base price of \$60 a barrel would be more "realizable."

4. A resultant reduction in government revenues is unlikely to cause sudden political instability in Iran. However, with smaller coffers, President Rouhani's government will find it extremely difficult to overcome problems such as unemployment and inflation. On 9 December, First Vice-President Jahangiri tried to reassure the population by saying that the government had prepared an economic plan that would go into effect if oil prices fell under 40 dollars a barrel - namely "to run the country with resistance economy policy", which Supreme Leader Khamenei has long advocated in reaction to sanctions. For their part, reformists have suggested that it was time for Iran to free itself from the shackles of oil and turn a "rentier" economy into one oriented towards real development.

¹ Worldwide demand for oil has recently been low because of weak economic activity in Europe, Japan and the major emerging markets that had been the engine for growth in the past years. America is importing much less oil as it is on track to be the world's largest oil producer. And OPEC has thus far refused to cut oil production, mainly due to objection by Saudi Arabia. (see *Why the oil price is falling?* <http://www.economist.com/blogs/economist-explains/2014/12/economist-explains-4>)

² There are allegations that, with a view to pressuring Russia on Ukraine, Iran on the nuclear issue and both on Syria, the US had increased its own shale oil production and persuaded the major Gulf oil exporters, particularly Saudi Arabia, not to reduce production as well. (see *Oil price drop threatens to hit Russia, Iran harder than sanctions* <http://www.latimes.com/world/europe/la-fg-oil-russia-iran-20141014-story.html>)

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DEC 31 2014

5. Tehran has blamed foreign conspiracy for the falling oil prices. President Rouhani told a Cabinet meeting on 10 December that "the fall of crude prices is not merely an economic issue; it is rather the result of certain states' political plot and planning." On 12 December, Deputy Foreign Minister Abdollahian singled out Saudi Arabia, warning that "Riyadh's lack of effort in preventing the price drop is at odds with the atmosphere of diplomatic negotiations between Iran and Saudi Arabia," and this "strategic mistake will be harmful to the entire Middle East and only benefit the foreigners." These accusations might make it more difficult for Iran and Saudi Arabia to reconcile.

6. The falling oil prices can also potentially affect the dynamics in Iran's talks with the P5+1. The West has long argued that Iran was forced to sit on the negotiating table because of the crippling sanctions over the years. The falling oil prices appear to be inflicting similar, if not greater, damage on Iran's economy. Undeniably, a nuclear deal will help create more favorable conditions for its economy to recover.

Iraq

7. Following decades of war and sanctions, Iraq's economy is now completely dependent on oil. The plunging oil prices will surely severely impact the country, which has already been facing a dire security and humanitarian crisis. Iraq is currently the world's fourth-largest oil exporter, selling 2.4 million barrels a day. The lower oil prices will likely cause a liquidity crisis for the government to effectively respond to increasing humanitarian and military costs (including fighting ISIL), as well as to fund reconstruction programmes, which are badly needed to win hearts and minds of the Iraqi people.

8. In this context, Iraq recently requested a one-year deferral of a \$4.6 billion reparations payment for production and sales losses as a result of damages to Kuwait's oil assets during its 1990-91 invasion and occupation of Kuwait. This would be the last and largest outstanding compensation claim by Kuwait. Following Kuwait's acceptance of the Iraqi request, the Governing Council of the UN Compensation Commission agreed on 18 December to postpone until January 2016 Iraq's obligation to deposit 5 per cent of its oil proceeds into the Compensation Fund.

9. It is not clear how the falling oil prices may affect the long-lasting disputes between the Government of Iraq and the Kurdistan Regional Government over oil management and revenue sharing, despite their recent agreement.

10. About three-quarters of Iraq's oil production is in the Basra province and most of its oil exports flow out from there. It remains to be seen how the oil prices plunge might affect the fledgling movement demanding that Basra governorate be declared an autonomous region - similar to Kurdistan in the north - in order to better control its oil fortune. It was recently reported that angry citizens in the city of Basra had designed their own flag, anchored by the image of a single drop of oil.

GCC

11. At an OPEC meeting last month, Saudi Arabia, supported by the UAE, Qatar and Kuwait, took the lead in maintaining current oil production despite the rapidly falling prices of crude oil. Recently, UAE ruled out the possibility of holding an emergency

OPEC meeting. These positions seem to indicate that the GCC oil producers prefer not to sacrifice their own market share to restore the price, despite the risks to their own oil-dependent economies.

12. In the short term, such a strategy could be costly for the GCC and might even backfire. According to one forecast, if oil prices average \$65 a barrel in 2015, GDP in the GCC region will shrink by at least 13 per cent. Despite the losses of billions of dollars in oil sales revenue each day, Saudi Arabia has made it clear that it is not going to cut oil production even if price falls to \$20 a barrel. Saudi Arabia cut its oil production time and again in the 1980s with a view to stabilizing the oil price, only to find later that it was hit hard by the cuts. It should also be noted that, GCC countries, with their abundant foreign currency reserves, are overall better positioned than many other oil-producing countries to deal with lower oil prices. They have the world's lowest marginal cost of producing oil. Since 2003, they have accumulated about \$2.3 trillion in current account surpluses, which gives them deep pockets to turn to when needed.

13. In the medium/long term, GCC countries could emerge victorious. Economically, low oil prices might curb Iraq's ambitions to significantly increase oil output and alleviate the burden on important GCC net-oil importing allies (e.g. Egypt, Morocco and Jordan). Politically, low oil prices could also tie the hands of Iran at a time of increasing suspicions vis-à-vis Iran's regional policies and mounting sectarian tensions. Under severe financial constraints, Iran might be forced to reduce its financial support to Shia allies in the region, including President Assad in Syria, Hizbullah in Lebanon and the Houthis in Yemen.



Jeffrey Feltman
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Note from Mr. Feltman on Plunging oil prices: impact on and response by the Gulf

Lourdes Selaya to: SGCentral

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DPA Middle East Desk, Andrew Gilmour, Ivan Lupis, Kaori Minami,
Cc: Katarina Mansson, Ugo Solinas, Dora Przybylek, Maria Zaroui, Silva
Armani

For the DSG's attention, please.

Best regards,



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Lourdes Selaya
Office of the Under-Secretary-General
for Political Affairs
United Nations
Tel: 1.212.963.3995
Email: selaya@un.org
Website: <http://www.un.org/depts/dpa>