Drilling Rig Containment: Iraq's Postwar Oil Boom Helps Fuel U.S. Leverage Against Iran

CHINA'S OIL & GAS SECTOR FROM WELLHEAD TO CONSUMER

Operation Iraqi Freedom is often decried for having empowered Iran. For the first several years after the 2003 war, such dire assessments seemed justified. In the decade following U.S. intervention in Iraq, smoke from Iranian-made roadside bombs obscured the emerging reality that the removal of Saddam, the end of Iraq's pariah status, and the subsequent revival of the Iraqi oil sector has substantially undermined Iran's strategic position. Notwithstanding the forward deployment of the U.S. 5th Fleet, a new, effective, but underappreciated tool has emerged to help contain the dangerous ambitions of Ayatollah Khamenei and his hard line mullahs': the humble drilling rig.

For much of the past decade, Iran relied on the fear that tough sanctions would trigger a spike in oil prices, which would send shock waves through the global economy. This state of affairs bought Tehran time to continue supporting terror organizations – including supplying many of the IEDs that killed U.S. troops in Iraq – and almost certainly also gave it additional diplomatic space and time to pursue nuclear weapons since the U.S. was focused on the problems of the moment in Iraq.

Now, the tables have turned. Active drilling and workover rigs in Iraq have poured some 1.7 million barrels per day of new crude supplies onto the global market since 2003 (EIA and Bloomberg data). Iraqi oil deserves special attention because moving forward, Iraq will likely be the single largest source of new oil supplies outside the U.S. Even accounting for global demand growth, this flood of crude (bolstered by increased U.S. unconventional oil production and higher Saudi output) has effectively displaced Iranian oil exports and made harsh sanctions against Iran more palatable to the international community. These sanctions are crippling Iran's economy and may yet force Iran to make serious concessions on the nuclear issue.

The latest sanctions—an EU oil embargo against Iran coupled by additional EU and U.S. sanctions targeting Iran's financial sector and third parties that continue purchasing Iranian oil—crude cost Iran $40 billion in lost revenue in 2012 alone, despite the fact that sanctions didn't technically go into effect into the middle of the year. Even if Iran is able to sell black market oil cargoes in violation of the embargo, the volumes will be smaller and revenues will be lower than if Iran's oil could reach markets legally, as buyers will demand discounts in the price equal to the risks they are taking by running afoul of U.S. authorities. In fact, the price reduction on black market Iranian oil could exceed 20% relative to global benchmarks.

Against this backdrop, the rapid oil production growth in Iraq stands out. Despite the Iraq war's tragic human cost and murky outcome, major oil production increases are an underappreciated strategic benefit due to the additional leverage they confer to U.S.-led diplomatic measures against Iran. This undercuts critics who, noting that Chinese and Russian firms have signed the biggest deals in Iraq's post-Saddam oil patch, complain that the U.S. bore the war's cost but gained little.

Future Challenges and Opportunities of Drilling Rig Containment

Challenge 1—Rising oil production in Iraq is setting the stage for fractious oil diplomacy that will pose a complex challenge for U.S. policy interests in the Middle East. Most pointedly, Iraqi and Saudi oil ambitions are on a collision course. Iraq seeks to continue dramatically increasing production, which when taken in conjunction with substantial oil output increases from the North American shale boom, creates a rising probability that without a surprise spurt of new oil demand from emerging markets, oil prices will stagnate in 2013 and 2014 as U.S. demand for crude oil imports continues to decline. Iraq, however, would remain in a favorable position because it can make money on volume without needing the same prices Saudi Arabia does.

Saudi Arabia needs prices to stay above US $75 per barrel—and in reality, probably closer to US$100/barrel—in order to balance its national budget and fulfill a record 2013 spending plan aimed at preventing Arab Spring-style unrest in the Kingdom.

Saudi Arabia helped the world oil market absorb the loss of Iranian supplies in 2012, but moving forward, Iraqi and Saudi oil diplomacy interests and production aspirations are likely to increasingly diverge. The U.S. will need to play a lead role in managing Iraq-Saudi oil politics in order to minimize the distractions that such a divisive issue could cause when regional governments need unity in order to handle problems emanating from Iran and the bloody civil war in Syria.

Opportunity 1—Iraq has the geological capacity to continue significantly expanding oil production if the political system creates longer-term economic incentives to do so and oversees necessary expansions in water supply and oil transport, storage, and export infrastructure. The country's officially recognized oil reserves now stand at 143.5 billion barrels and the country's additional oil potential remains the most under-explored in the Middle East. Iraq's oil wells are also highly productive relative to those in other regions, in particular the emerging unconventional oil plays now garnering so much attention. The Rumaila Field, Iraq's workhorse oil producer, has an average production per well of between 4,000 and 5,000 barrels of oil per day. In contrast, oil wells in North Dakota's prolific Bakken Shale play average only about 140 barrels per day.

Challenge 2—Iraqi production may not grow as quickly as the optimists believe. In its base case forecast, the International Energy Agency (IEA) sees production rising to 4.2 million bpd in 2015 and 6.1 million bpd in 2020, suggesting that over the next eight years Iraqi oil output will increase by an average of nearly 363,000 bpd each year.

While the country appears to have the geological constitution to support this level of production growth, the Iraqi political fabric may be too fragile to support the long-ranging decisions necessary to create the infrastructure needed. For instance, demand for water to inject into oilfields to support production—much of which will need to be piped more than 100km from the Persian Gulf—would likely increase more than seven-fold by 2020 in order to support oil production in the 6 million bpd range, according to the IEA. Similarly, Iraq would also need to bolster its export pipeline network and increase the capacity of onshore oil storage tanks so that oilfield production would not be impacted if bad weather disrupts tanker loadings in the Persian Gulf.

Each of these, and other, investment decisions will require substantial government input and political consensus, which may be hard to reach. The recent spate of bombings across Iraq suggests that the country's violent ethnic political cleavages could continue to deter long-term investment for the foreseeable future. And investors and policymakers should certainly rely on Iran to stir up unrest and violence in Iraq to help drive up global oil prices and maximize Tehran's revenue on its own declining output and exports.

Opportunity 2—Continued growth in Iraqi oil production, backstopped by North American unconventional oil output increases, can solidify the fence holding Iran's oil out of the global market. Iran will seek to market sanction-busting cargoes at cut rate prices, but this gambit will not salvage Tehran's budget. As Iraqi crude oil production increases (even if at a slower pace than projected by the IEA and others) and rising U.S. domestic production continues displacing imports of oil from West Africa, Iran's Asian and European buyers will have much less incentive to deal with Iran, and are instead likely to get an increasing proportion of their oil imports from other sources.

Chinese buyers are already doing so. A key development in global crude oil markets during the last five years has been the emergence of China as the star customer for Iraqi crude oil. Chinese oil traders and refiners have been purchasing cargoes of Iraqi crude at a steadily rising rate, and in 2012 Chinese purchased nearly one-quarter of Iraq's oil exports. The volumes of Iraqi oil China imports is already in the ballpark of its former import levels from Iran, and are likely to rise to as much as 2 million bpd by 2020 if production keeps rising.

China has powerful incentives to seek steady longer-term supplies of Iraqi oil. Iraq now appears to be the only large-scale source of net new oil production growth outside of North America. As an oil consumer with stagnant domestic production and rising import needs, China is therefore deeply interested in securing new Iraqi barrels as they come onto the market.

The rising appetite among Chinese refiners for Iraqi crude oil raises the possibility that Iraq's state oil company could follow the example of Saudi Aramco and Kuwait Petroleum Corporation and invest in constructing refineries in China that help ensure downstream markets for Iraqi oil as output increases in coming years. To boot, as China's reliance on Iraqi crude oil increases and the U.S. considers taking a less active role in the Gulf region, Beijing will face increasing pressure to become involved in the area's treacherous political and security situation.

Bottom Line:

Iraq's growing oil output now forms part of an oil supply anvil upon which the U.S. can, through economic means, smash Iran's financial capacity to simultaneously pursue nuclear weapons, sponsor terrorist proxies such as Hamas and Hezbollah, and maintain military forces capable of credibly threatening its neighbors. Squeezing Iranian crude out of global markets by encouraging buyers such as China to favor Iraqi oil can undercut the mullahs' position, increase the opportunities for internal change, and reduce the probability that military action will be needed against Iran. Iran will likely attempt to foment sectarian violence in Iraq, but so long as the oilfields and export infrastructure can be secured, production can continue expanding. To avoid armed conflict over Iran's nuclear weapons program, now is the time to exploit the window of leverage conferred by rising Iraqi output

About Us

China Oil Trader™ strives to provide a holistic, globally-oriented analysis of oil and gas issues in China and those which intimately affect Chinese economic and security interests. In doing so, we often view multiple classes of commodities simultaneously and assess how they interact with each other. Our ultimate goal is to provide a focused source of fresh, creative, and anticipatory research for policymakers, investors, and others interested in China's development as an energy and commodity superpower.

China Oil Trader™ founder Gabe Collins grew up in the Permian Basin and has experience dealing with energy issues for both the U.S. government and as a private sector commodity analyst. He speaks and reads Mandarin, Russian, and Spanish. Gabe has published numerous oil and gas analyses in outlets including Oil & Gas Journal, The Naval War College Review, Orbis, Geopolitics of Energy, Hart's Oil and Gas Investor, The National Interest, and The Wall Street Journal China Real Time Report. Gabe also co-founded the www.chinasignpost.com analytical portal. He can be reached at gabe@chinaoiltrader.com.