

IHS ENERGY

Reordered Stalemate in the Middle East

A Special Report on crisis and power in the region

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STRATEGIC REPORT

Crude Oil Markets

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Key implications

Power relationships in the Middle East are shifting. As a result, the stalemate in the region is being reordered. This will mean continued regional instability, which could by next year result in the return of a risk premium in the price of oil—a dramatic turnaround from today's depressed oil price.

- **Russia is reengaged and once again a regional player in the Middle East.** One can debate whether Moscow advanced any long-term strategic interests through its involvement in Syria. But Russia's partial withdrawal of troops from Syria, after forcing a cease-fire that cemented Russian-driven territorial gains for Syrian president Bashar al-Assad, left Russian president Vladimir Putin tactically triumphant—regionally, globally, and at home.
- **US credibility in the Middle East has diminished even if it has not been dismissed.** The United States looms as the region's "indispensable power." Yet US president Barack Obama's April visit to Saudi Arabia underscored the wide gap of credibility and trust between the United States and leaders across the Gulf, who criticize that the United States has been decisive only on its nuclear deal with Iran. Without US-Saudi cooperation, there is no base on which to build stability in the region.
- **By 2017, oil prices could recover more than supply and demand by themselves would suggest—with a new risk premium on oil that reflects regional tensions.** The global oil supply glut has been annulling the market impact of political risk. But as markets balance, and with demand growth projected to outstrip supply gains next year, IHS Energy expects concerns over political risk could add a price premium to oil. Higher prices could give the region's oil exporters a financial respite.

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Complexity piled on complexity

Power relationships in the Gulf and Levant are shifting. As a result, the stalemate in the Middle East is being reordered. This will mean continued instability in the region, which could by next year result in the return of a risk premium in the price of oil—a dramatic turnaround from today's depressed oil price.

President Vladimir Putin's announced withdrawal of Russian troops from Syria is one of the latest developments in this shifting set of relationships. Following on its dispatch of troops into Syria in September 2014, Russia has reestablished its place as a key actor that will shape power relations in the region.

Complexity is piled on complexity. Iran, which joined Russia in saving Syrian president Bashar al-Assad, will now hope that Russia does not precipitously participate in forcing Assad's transition from power, its key ally in supporting Hezbollah. Saudi Arabia, Assad's arch-opponent, may see strategic advantage in deepening ties with Putin after Russia proved its influence in Syria and demonstrated that no other player in the region has more leverage to remove Assad. Iraq will continue to stumble, hoping to avert the worst of crises that could spark its de facto dissolution.

The United States looms as the region's "indispensable power." Yet President Barack Obama's April visit to Saudi Arabia underscored the wide gap of credibility and trust between the United States and leaders across the Gulf, who criticize that the United States has been decisive only on its nuclear deal with Iran. The headlines from Obama's visit would ideally have underscored a new platform of cooperation against terrorism and to resolve the region's humanitarian crises. Instead, the public heard that leaders "cleared the air."

For oil markets, once oil supply and demand balance later in 2016 or early 2017, the region's instability could well mean a turnaround in pricing—the adding of a risk premium to a tighter market—and give the region's exporters a financial respite.

This Special Report explores the changing dynamics and seeks to identify the turmoil ahead.

Russia's tactical triumphs

One can debate whether Moscow advanced any long-term strategic interests through its involvement in Syria. But its partial withdrawal of Russian troops from Syria, after forcing a cease-fire that cemented Russian-driven territorial gains for Assad, left Putin tactically triumphant—regionally, globally, and at home. Within Syria, Russia maintains an air base in Hmeymim and a naval facility at Tartous. In February 2016 formal negotiations started under the auspices of the United Nations, with the participation of Russia, the United States, and most regional and international countries engaged in the Middle East, to seek a political agreement among Syrians that could lead to a peaceful political transition in Syria.

Getting Assad to negotiate

Russia surprised the world in September 2015 when it deployed in Syria advisors, aircraft, missiles, bombs, and (later) advanced air defense systems, followed soon by an intelligence-sharing arrangement with Syria, Iran, and Iraq. Almost as precipitously, Russia announced on 15 March 2016 that it would largely withdraw military forces from Syria, by most accounts to force Assad to participate seriously in the Geneva

negotiations. For Russia, it is a delicate balance. Russia sees no stability in a future Syria under Assad. Yet to remove him prior to finding a political path to transition simply repeats, in Russia's view, a pattern of "voids and chaos" in the region that it has warned against since before the invasion of Iraq in 2003.

But Assad has no interest in negotiating away his future. A month after the announced withdrawal, Russia introduced Mi-28N and Ka-52 military helicopters in the battlefield, keeping Russia's leverage over Assad, yet provoking further the ire of the Sunni opposition. Moscow has made clear that it secured Assad's survival, and that Assad must cooperate to sustain Russian support. Russia's continued military campaign suggests that Assad has not outlived his utility.

Cornering Obama to cooperate

For President Putin, forcing President Obama to accept a role for Assad in Syria's political transition is a personal vindication that reinforces Russia's position against "regime change" globally and reasserts its relevance as a Middle East player. Since Obama stated that "Assad must go" as Syria's president, Russia has pursued the opposite, preserving Assad's tenure, first through its gambit to refocus US attention on removing chemical weapons. Having secured for Assad military gains against the opposition, Russia redirected its aerial bombing to support the Syrian army's recapture of Palmyra. Even if there are no other easy symbolic gains against ISIS, for now Palmyra is enough for Putin to underscore his point: aren't "we" better off allowing Assad a transitional role in Syria, and for international forces to combine efforts against ISIS? Putin may have acted directly against Saudi interests in Syria, but as became evident in Obama's meeting with Gulf leaders in April, the US president appeared to suffer the crippling fate of losing credibility.

Europe needs Russia

Russia's actions in Ukraine and Syria underscore to the European nations that they cannot solve regional or global crises without engaging Russia. As Russia's bombing campaign in Syria led to a new status quo regionally, it heightened the flow of refugees that underlies Europe's (and German chancellor Angela Merkel's) greatest social, political, and economic crisis. Russia may not be able to fix any of Europe's crises, but Putin has made clear that if Russia is left out of the solution, Russia's pursuit of its unilateral interests can make matters worse for Europe. Ukraine's 10 April government collapse and its failure to tackle corruption aid Russia indirectly. As Russia has underscored its relevance to Europe and the world, Ukraine has eroded Europe's patience, which could try the EU consensus to sustain sanctions against Russia when they come up for renewal in June.

Respect

At home, Putin demonstrated, again, that he has made Russia an international player and problem solver—and that he will not be lured into the trap of regime change, which he characterizes as mirroring the United States in Iraq and Afghanistan and creating chaos in Libya. "Securing respect" has become an antidote to domestic economic crisis. Yet victories abroad cannot forever mask the economic crisis in Russia, where GDP contracted 3.7% in 2015 and declined further this year, along with 15 continuous months of real wage declines. Still, for now, Putin continues to bask in restoring Russian's place in the world while averting "naïve American adventurism."

Iran entrenches further

Iran needs Assad in power, even if Russia supports his orderly transition. Iran will seek to establish an even stronger presence in Syria and Iraq and against ISIS. But in practice, neither Russia nor Iran is playing for a solution to the region's conflicts. Each seeks tactical advantage in a regional power play. As neither will really win or lose against the other, we don't expect a Russian-Iranian confrontation. Indeed, with the

lifting of sanctions, Russia has gained an Iranian client eager to expand purchases of arms, technology, and perhaps energy services, as well as investment.

Road to Hezbollah

Iran's core regional interest is to support Hezbollah in Lebanon and ensure that Hezbollah remains a force against Israel. Assad has been a critical ally, channeling weapons, forces, and resources to Hezbollah at Iran's behest. No other Alawite or Sunni leader could be expected to play this role. Conversely, Hezbollah's engagement in Syria has overstretched its capacity, and Russia's support for Assad gives Hezbollah space to regroup. Iran thus benefits from the murky status quo, with Russia sustaining Assad and intermittently battling ISIS, while Iran keeps its channel to Hezbollah refocused on Israel and Lebanon. It should be expected that Iran will reinforce Assad's instincts to preserve power and fuel local conflicts that undermine consensus for orderly political transition. Iran has little interest in the success of the Geneva process.

Better amok regionally than at home

For Iranian president Hassan Rouhani and the Iranian Revolutionary Guard Corps (IRGC), there is a perverse shared interest to give the IRGC a project of regional activity—and destabilization—rather than risk having the IRGC destabilize Iran's internal transition. Iran may not defeat ISIS, but better for it to take the battle to ISIS abroad—and to keep ISIS at a distance—than to let ISIS take its radical Islamist campaign to Iran. In Syria that means supporting Assad's campaign against ISIS—and supporting Assad against a sectarian power shift that makes Iran unwelcome in Syria. In Iraq, we expect Iran to strengthen support for Shia militias, demonstrating that the Kurds are not the only fighting force in Iraq and that Iran is critical to preserving Iraq's unity.

Still my enemy's enemy

Iran and Russia shared an interest in saving Assad's regime when it appeared that it could fall without outside support. Russia still de facto supports Assad, but now in the context of fighting ISIS. That will suit Iran until some consensus emerges about finding a political transition for Syria. For now, there is no shared vision: Russia and Iran are at odds on Assad's future. The United States and its Western partners favor political transition but perhaps may diverge on Assad's role. Turkey and the region's Sunni states take different positions on the political players that can stabilize Syria. And the Kurds remain a wild card. There seems little chance for real momentum on a transition that could pit Iran and Russia against each other.

Might Russia court Iran?

In the 1990s, Russia's support for the Bushehr Nuclear Power Plant helped Iran start down its nuclear path, and Russia has supplied missile technology to Iran. Post sanctions, Iran may seek a major power alliance with a country that has significant oil, gas, and nuclear expertise; power in the region; and strong past ties. Russia and Iran deeply distrust each other, but they have found common ground to work together in Syria. Iran strategically would be a stronger asset to Russia than Assad. Russia has its best chance in a decade to restructure relations with Iran and Saudi Arabia (see below). It will be difficult for Russia or any country to forge deep ties with both but possible to take advantage of perceptions of eroding American power, influence, and interest in the Gulf—and that alone would reinforce Russia's play for power in the Middle East.

Iraq frays further

Iraq struggles to manage itself as a state. Many breathed a sigh of relief when cleric Muqtada al-Sadr ended his campaign on 31 March to unseat Prime Minister Haider al-Abadi, yet he still won almost a complete cabinet reshuffle. Other parliamentarians are calling for al-Abadi to resign for continuing to govern based

on sectarian interests. Low oil prices have put Iraq into an enormous fiscal crisis, which is forcing Baghdad to seek economic and governance reforms that reduce transfers to regional provinces. Reform has become synonymous with imposed austerity on Iraq's provinces. For now, the imperative to fight ISIS and the need for some central military authority may defer a faster descent to looser federalization. Eventually, Iraq will need to build a new consensus on governance or break.

Why share?

Basra province, home to Iraq's largest oil reserves and stronghold for Iraq's Shias, questions what it gets out of its contribution to the national budget. With fewer resources to share at low oil prices, the Basra authorities have agreed with the national Oil Ministry to earmark revenue from two fields in Basra for provincial projects. As resource-rich regions seek more budgetary control, they reinforce Sunni concerns that far poorer regions in western Iraq will never get what they regard as a fair share of Iraq's resources. The Baghdad government is mired in crisis management to keep itself in power first, and then to keep Iraq together as a state if it can manage to stay in power.

Kurds stare at autonomy

Baghdad needs the Peshmerga to stay engaged against ISIS. US military support for Kurdish forces has been the most effective formula for retaking territory from ISIS, although that too faces limits once it encroaches into traditional Sunni territory. For now the Kurds have used this leeway to export their oil independently. Still, at low oil prices, the Kurdistan region falls further into debt monthly under its export contracts, and Baghdad has stopped budget transfers to the Kurdistan region. Potentially Baghdad and Erbil could be better off with a consensus on revenue sharing, but that is too sensitive to tackle today, and the spirit of separatism may become too entrenched to keep the Kurdistan region linked to Iraq in anything but a loose federation in the future. We expect a cloud to linger over any sustainable solution for Kurdish oil exports.

Anarchy in the West

In western Iraq, territory has been reclaimed from ISIS, but no entity holds authority. US support for Iraqi Security Forces has displaced ISIS from control of several major cities. Yet ISIS is not defeated and roams across the region, now as an insurgent force. Patronage and weapons from Baghdad to Sunni militias may have secured their cooperation against ISIS but not a commitment to govern in concert with Baghdad. Take away US air support, and this tenuous balance collapses.

Regional vortex and new unknowns

As the dynamics around Russia, Syria, and ISIS change, regional relationships could shift as well. Some dynamics to watch are discussed below.

Saudi-Russian ties of convenience

The Saudis need an ally that can force Assad to follow a path out of Syria. Saudi Arabia depends regionally on a US security umbrella, but the United States has failed Saudi expectations in Syria. The Kingdom also worries that the rapid growth of shale oil in the United States diminishes US interests in the region. The nuclear deal with Iran and the purported "pivot" to Asia—and direct criticism from Obama—have further frayed Saudi confidence. Obama's visit to Riyadh in late April only underscored the differences. Saudi Arabia might test whether Russia has greater resolve. For its part, Russia needs an ally that will keep Syria's Sunni opposition in check just enough to achieve a transition strategy that includes Assad. Saudi Arabia has a power of purse with the opposition, and increasingly Saudi Arabia has shown a tendency to follow its own path, from oil policy to a potential IPO for Saudi Aramco. The breakup of the Doha "freeze" dialogue on 17 April is a very clear example. The potential relationships are fragile, and they will

fray further if Russia continues to act aggressively in Syria in support of Assad. Still, with Saudi Arabia committing in 2015 to investing up to \$10 billion in Russia, the courtship is more than theoretical.

Russia-Turkey rapprochement?

While hard to imagine after Turkey's downing of a Russian jet in November 2015, Turkey has seen that it has little capacity to remove Assad as long as Russia supports him. Turkey could make a strategic choice to work with Russia to get Assad out eventually, rather than let the Syrian Kurds strengthen their position against Assad and encourage greater boldness within the Turkish Worker's Party (PKK). Turkey's reemergent conflict with the PKK since the summer of 2015 is clearly its most significant security concern. If Russia can get support from Turkey for a transition strategy that tolerates Assad, it then further isolates the United States. Conventional wisdom is that Turkey and the European Union will draw closer if Turkey takes pressure off the refugee crisis in Europe. Perhaps Turkey might care more about ousting Assad and controlling the Kurds on its borders.

The Syrian opposition's short-lived respite

Having suffered massive losses from Russian aerial support for Assad, and having seen little US or Turkish capacity to stop Assad and Russia working together, the Syrian opposition received a welcome respite during the March bombing pause. But the violence has resumed, and with no relief for Syria's humanitarian crisis. The European Union has called the situation in Syria "the world's largest humanitarian crisis since World War II." The numbers are huge. UN and humanitarian agencies estimate that 13.5 million people in Syria need humanitarian assistance, that 4.6 million Syrians are refugees, that 6.6 million are displaced within Syria, and that half of the refugees and displaced are children. In 2015, about 360,000 Syrian refugees applied for asylum in Europe.

Russia may argue that it needs to sustain military pressure to keep all parties at the bargaining table. For the opposition, such cycles of war and cease-fire may offer little more than a systematized process of suffering and surrendering territory. The Geneva process is founded on the prospect of political transition, but it will collapse if it cannot produce unity among the opposition and deliver a lasting cease-fire on the ground.

Whither the United States?

The United States achieved in July 2015, with the other permanent members of the UN Security Council and Germany (P5+1), a historic agreement to constrain Iran's nuclear weapons program. In order for the agreement to come into effect, Iran had to dispose of 98% of its highly enriched uranium, cut by two-thirds its installed centrifuges to enrich uranium, and remove the reactor core from its heavy water reactor and fill it with concrete. The Iran agreement required a singular US focus, but it may have distracted US attention both from Syria's further descent into conflict and chaos and from ISIS entrenching its foothold in the region.

In visiting Saudi Arabia in April, Obama faced an uphill struggle before he even got off the plane, owing to a number of factors: perceived indecisiveness in Syria, finding common ground on Iran, umbrage over his public comments that the Gulf states had not pulled their weight in the region—all against the backdrop of a US Congress seeking legislation to allow Saudi Arabia to be sued in US courts. It was important that Obama visited Saudi Arabia to stave off further damage in the relationship. As this US presidential administration ends, a bitter campaign portends, and a new president takes office, five issues stand out for US policy.

Transition needs stability. After the United States invested 150,000 troops in Iraq in 2008 and billions in developing new institutions, Iraq today remains a torn nation. At least a third of the country is entangled in war. A key lesson is that successful political transition needs local stability, including trust in those

who govern to share national resources. Neither trust nor stability characterized Prime Minister Nouri al-Maliki's tenure in Iraq.

Local actors are essential. Consider in the context of Iraq the Geneva process on Syria and the US aerial campaign against ISIS. Local actors in Syria do not trust each other and have no confidence in the international community to maintain stability and mediate disputes. Bombing ISIS has helped recapture territory, but who can hold that territory without a local foundation to build trust?

Filling a void of governance. To make the Geneva process work, and eventually to win against ISIS, regional and international partners have to fill a void of governance and security. No single actor can do it alone. No serious partners will consider joining without a US role. Until international and regional players can create a credible picture to sustain security, it will be difficult to solidify cooperation and compromises among local actors to accommodate their differences during a political transition.

Saudi Arabia's key role. Saudi Arabia has been one of the longest-standing US allies in the Middle East. Its resources and wealth have a large effect on global stability. Since 2014, Saudi oil policy has inverted the logic of global oil markets, from control under OPEC's oligopoly to deferring to markets to recognize the lowest marginal cost producer. With the prospective IPO for Saudi Aramco and a huge sovereign wealth fund as key parts of a new "Vision 2030" national economic strategy, Saudi Arabia would establish a wealth base to invest globally and diversify revenue from petroleum.

Modernizing Saudi Arabia will not be simple. Issues of demography, tradition, religion, and social pressures will be part of every step of change. Still, it is clear that both the United States and Saudi Arabia benefit—from security to energy—when they work as partners. Both countries need stable relationships with Iran and Russia. That should not cloud over the primacy of US-Saudi relations. But those relations must show concrete payoffs. Sharing insights on energy, on efficiency and renewables and not just oil and gas, tangibly addresses Saudi electric power stability. Working together on regional security, starting with a potential local ground coalition to secure Syria and western Iraq, will signal to each other and across the region their shared ambitions. Those should be the kind of headlines that emerge from a presidential visit. Without US-Saudi cooperation, there is no base on which to build stability in the region.

Engage and contain Iran. President Rouhani must show domestically that the nuclear deal will help Iran reenter the international economic community and boost the economy in order to sustain internal support to implement the agreement. That creates a dilemma regionally and domestically, as neighboring states and Israel see a stronger Iran as a direct threat. Yet globally, all nations have a stake in avoiding either nuclear weapons capability in Iran or having to go to war to preclude that capacity. Iran is too closed and too strong internally for any external party to think it can influence domestic politics. Iran's internal balance of power will depend on the support that Iranian actors can win for the future they offer the country. Externally, the international community can work to deter disruptive Iranian actions, and that has to start regionally. How the United States manages these two challenges—engagement and containment in parallel—will shape the success of a complex US relationship with Iran.

A redrawn stalemate

The current Gulf and Levant dynamics reshuffle power relationships to create a new stalemate of persisting conflict, but they do not create new prospects for stability. For now, Russia is reengaged and once again a regional player; US credibility has diminished even if it has not been dismissed; Iran will seek to entrench further in Syria to protect Assad; the Sunni states might welcome new allies with firmer resolve against Assad; and the Syrian opposition is in disarray. Little in this mix creates a foundation for stability that can underpin a political transition in Syria and the military capacity to enforce any agreement reached. The region will grind forward in this reordered stalemate.

All those dynamics will likely encourage Russia to expand its influence in the region. Even if it cannot guarantee stable outcomes, it can use others' fear of instability to make Russia seem a credible and reliable

player. The United States now must work with Russia on peace in Syria, despite their deep differences over Ukraine. Until the United States gets through the presidential election, other actors will not trust in the depth or longevity of US commitments and policy, in effect reducing US leverage and influence. Domestically, the United States will be preoccupied with a campaign that projects America turning inward, even if that will not be the outcome. We expect Russia to use this space to establish a position of strength with a new US president, and possibly to play for Europe to end sanctions, especially if Europe loses patience with corruption and erratic governance in Ukraine.

The United States will need to take a serious look at whether the Geneva process for Syria and the aerial campaign against ISIS, without other tools, can lead to stability. Some may conclude that a coalition of regional and international partners committing resources and troops under a coordinated form of engagement may be essential, both to persuade opposition groups in Syria and Iraq that it is worth the risk to stabilize Syria and fight ISIS and to signal to would-be spoilers that there are limits to gaining power and influence through disruption. It would be a massive diplomatic undertaking to make it possible, and it would need to be coordinated with the United Nations to make it politically palatable for many of the players.

Finally, by 2017, oil prices could recover more than supply and demand by themselves would suggest—with a new risk premium on oil that reflects the realities of regional tensions. A global oversupply of 1–1.5 MMb/d through the first part of 2016 annulled the market impact of political risk. ISIS attacks in Paris, Egypt, Turkey, the United States, and Belgium did not raise oil prices. Nor did the break in Saudi-Iranian diplomatic relations. Competition between Iran and the Sunni states drove more oil onto the market as the Iran nuclear agreement took effect.

Now, most major producers are close to peak capacity. Contraction of non-OPEC production will likely bring the market into balance by the end of the year or early next year, although there will still be an overhang of inventories. As oil markets balance, and with demand growth projected to outstrip supply gains in 2017, we expect concerns over political risk to add a price premium to oil. If Iraq can hold itself together, given its deplorable budgetary problem, it will win the most immediate existential benefit. A key risk, of course, is whether higher oil prices and more cash injected into in a Middle East stalemate of crisis will embolden some actors to entrench further in the region's conflict.