THE BIG PICTURE

Losing Iraq to the US’ Iran Agenda

• Washington’s determination to squeeze Iran, with a fresh round of sanctions targeting the country’s energy sector from November, is threatening instability elsewhere in the region.

• Iraq is a fragile state finally getting back on its feet after decades of conflict. US pressure on Baghdad to cut ties with Iran, which have strengthened on many different levels in recent years, risks backfiring on several levels.

By pulling out of the nuclear accord with Iran and vowing to apply unprecedented financial pressures on Tehran, the administration of US President Donald Trump made isolating the Islamic republic the focus of its Middle East policy. In doing so, it risks overlooking if not actively undermining other US policy aims — and its own reputation — in the region.

One of these aims, as Secretary of State Mike Pompeo told caretaker Prime Minister Haider al-Abadi by phone last weekend, was the formation a “moderate, nationalist, Iraqi government.” Negotiations on forming the new coalition government in Iraq are reaching a head, pitting pro-Iran factions against al-Abadi’s US-backed alliance. And with the tussle for regional influence hotting up, al-Abadi’s ability to balance the competing interests of the two strongest foreign actors in Iraq is being sorely tested. Many Iraqis may wish to see their country freed from the yoke of Iranian influence. But there is plenty of ill will toward the US too, which could escalate if the government’s inability to provide basic services like power and water, which has fueled major social unrest since July in Basrah, Iraq’s economic capital, is compounded by US sanctions.

Iraq imports a wide range of Iranian goods, which amounted to around 16% of its total imports in 2017 and include a substantial proportion of the country’s food supplies. When the first round of US sanctions came into force last month, al-Abadi reluctantly announced that Baghdad would comply with them, while warning that sanctions “destroy societies and weaken regimes” (EC Aug.10’18). Just days later the prime minister clarified his position, insisting Iraq would only refrain from conducting business with Iran in US dollars.

Sanctions mean imports of Iranian electricity will now be problematic, explains former State Department official Richard Nephew, as payments to any state-backed or other US-sanctioned entity are prohibited. Natural gas is actually exempt from sanctions. But again, the problem is how Iraq will pay for it. The nuclear-related US sanctions block payments to Iran unless it’s in the form of bilateral trade. So Iraq’s payments would be stuck in Baghdad until those

MARKET FORCES

LNG Pricing Takes Baby Steps

It’s been almost six decades since the world’s first LNG cargo was shipped, but pricing of the superchilled fuel remains fundamentally unaltered: It is still mostly pegged to crude oil, which is subject to disparate market fundamentals and signaling that can feed boom-bust cycles (EC Apr.27’18). But LNG has been taking baby steps away from oil indexation, the latest being the mid-June launch of a pricing window, similar to those in crude and oil product markets, by commodities reporting agency S&P Global Platts.

To give context, some 80% of the world’s LNG is locked into term contracts mainly priced off crude oil benchmarks like ICE Brent and the Japanese Crude Cocktail (JCC). Asia takes most of these oil-linked LNG volumes, while Europe-bound LNG is typically priced off established gas hub benchmarks like the UK’s NBP and the Netherlands’ TTF, which Asia lacks.

As more Asian term buyers eschew oil-linked pricing, other indexes are being sought to price LNG. The Japanese LNG Cocktail, the LNG equivalent of JCC, has emerged as a potential alternative. European gas hubs and the US Henry Hub are also probable, but are geographically distant from Asia. And globally,
sanctions are lifted, unless Iran wants to purchase non-sanctioned goods from Iraq, like food or medicine. But Iraq’s non-oil industries remain desperately underdeveloped after years of sanctions and conflict, effectively ruling out the barter option.

For all of al-Abadi’s rhetoric, and barring the US agreeing to make exceptions, which former Treasury official Brian O’Toole believes is highly unlikely, it is hard to see how Iraq can avoid complying with the new sanctions due to take effect on Nov. 4, without dangerous consequences. But by dealing a blow to Iraq’s power supplies, the sanctions threaten to seriously weaken the US government’s standing in Iraq, and to exacerbate unrest. Imports of Iranian gas only started last year, but Iraq is now the biggest buyer after Turkey, currently taking around 500 million cubic feet per day, according to a source at the ministry of electricity. It had also been importing around 1,000 megawatts of electricity before Tehran cut off supplies in July, partly because of Baghdad’s inability to pay its debts. This accentuated massive power shortages in Basra over the summer, helping to trigger the protests that have brought thousands onto the streets.

Sources tell Energy Compass that the Iraqi government is talking with non-Iranian suppliers about gas and electricity imports, although Sara Vakhshouri at Washington-based consultancy SVB Energy allows that there could also be commercial reasons for sourcing alternatives. But others say Iran’s supplies will be very difficult to replace, certainly in the short-term, and time to find alternatives is running out. “This will be the first challenge of the new government ... We saw the effect of electricity cuts in Basra during the summer,” says another Western diplomat.

Iran’s misfortunes are benefiting Iraq in other ways. Iraq’s oil production hit near-record highs last month, of 4.64 million barrels per day, at a time when sanctions have hammered competing Iranian supplies and supported oil prices. Some Iraqis also see new business opportunities arising from the sanctions, arguing that the economy would benefit from Iran rebalancing its trade relations and developing stronger links with its other neighbors. Increased commercial activity via the Arar border crossing with Saudi Arabia could, for example, help revive the economy of Sunni-majority Anbar province.

But the full impact of the new sanctions regime remains uncertain, in part because Iraq is still in the process of forming a government — with al-Abadi’s political alliance with the Sairoon grouping of nationalist Shiite cleric Moqtada al-Sadr now being challenged by the pro-Iran Shiite bloc led by former militia leader Hadi al-Amiri and ex-premier Nouri al-Maliki (EC May 18’18). The outcome is bound to have profound implications for Washington’s policy of containing Iran, which includes a demand that the Iran-backed Shiite militias that helped defeat Islamic State in Iraq “go home.”

What’s certain is that whoever is Iraq’s next leader will face strong headwinds either from complying with or defying US sanctions. But the US, too, could face trouble ahead. Turning the screws on Iraq’s ties with Iran — from forcing a gas cut-off to trying to oust Shiite militias that played key security roles — risks alienating a key ally in the region at a time when the US has already lost traction in Syria and Turkey (EC Jun.8’18). It also risks tilting Iraq toward greater instability, or even a rebirth of extremism (EC Aug.3’18). That combination could be toxic, including for Trump’s wider aim of keeping the US out of messy Mideast conflicts.

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**Connecting the Dots: Cast Aside**

- US Secretary of State Mike Pompeo’s brief visit to Pakistan this week didn’t exactly get off on the right foot. His arrival in Islamabad came just three days after the Department of Defense confirmed it was canceling $300 million in military aid to Pakistan, with that blow coming on top of the cancellation earlier this year of some $800 million in US aid. Pompeo on Wednesday promised a reset in relations. But with Washington reiterating its oft-repeated complaints about Pakistan’s support for the Taliban in Afghanistan, and Pompeo, along with Secretary of Defense James Mattis, heading swiftly on to rival India to sign a military communications agreement that will facilitate upgraded US arms sales, Islamabad may not have high hopes. Notably, it will host Chinese Foreign Minister Wang Yi shortly after Pompeo’s departure.

- It wasn’t all smooth sailing when Pompeo and Mattis met with their counterparts in New Delhi either. The US opposes India’s plan to buy Russia’s S-400 missile defense system, a purchase which could yet see India hit by US sanctions. Regarding upcoming US energy sanctions on Iran, Pompeo said the US would consider waivers for purchases of Iranian crude where appropriate and would work with the Indians, but still expected purchases of Iranian crude to go to zero. India has eased shipping rules to allow refiners to lift crude from Iran on vessels and insurance arranged by Tehran.

- Meanwhile, the leaders of key foreign players in Syria’s conflict — Russia, Iran and Turkey — are set to meet in Tehran on Sep. 7 ahead of an anticipated offensive by Syrian government forces, who are backed by Russia and Iran, to retake rebel-held Idlib in the countryside of the northwest. Turkish President Recep Tayyip Erdogan is hoping the Tehran summit will find a way to avert a major assault — the area is home to groups backed by Ankara, which also fears a refugee influx — but faces being outmaneuvered by Russian President Vladimir Putin and Iran’s leadership. Saber-rattling from the sidelines, the US has warned that it will respond “swiftly” to any use of chemical weapons in the offensive.

- Putin’s Tehran visit will be followed by preparations to host Chinese President Xi Jinping and Japanese Prime Minister Shinzo Abe in Vladivostok next week at the Eastern Economic Forum, where energy and trade cooperation top the agenda. Putin-Abe talks will also cover the disputed Kuril Islands (known in Japan as the Northern Territories), Kremlin aide Yuri Ushakov said this week.
Energy Issues Bubble Up in Midterm Elections

The looming 2018 US midterm elections have scores of eyes in the energy sector focused on the heated ballot battle playing out in the oil- and gas-rich state of Colorado. An anti-drilling voter initiative that threatens more than half of the energy powerhouse’s total real estate surface — Colorado is the nation’s fifth-largest natural gas producer — has the industry on edge. The chances of passage of the measure, which would mandate 2,500 feet setbacks from residences for new drilling, aren’t clear. But industry advocates are floating early estimates of a possible $31 billion economic blow to the state if the initiative succeeds, and delivering warnings of contagion effects in other US energy states like Texas. Others, however, have suggested limits to its possible spread — such as the unique characteristics of Colorado’s Denver-Julesburg Basin that make setbacks tantamount to bans, unlike in more ruralistically situated gas plays elsewhere in the country.

But the fact that supporters for the petition turned in double the nearly 98,500 signatures needed should be enough to trigger alarms throughout the energy industry, one Denver-based energy attorney said. Industry, warning the setbacks spell economic ruin for a state that produces nearly 5 billion cubic feet per day of gas, has doubled down on its opposition since the measure cleared the state approval process Aug. 29. Defeating the measure is a major priority of the American Petroleum Institute, the US’ largest oil lobby.

However, Colorado, with its wide environmental community and burgeoning growth thanks to companies like Google setting up shop there, may not be a canary in the coal mine for voter backlash against oil and gas drilling. And for the most part, pollsters expect energy issues elsewhere to take a backseat to issues like tax reform and immigration. The ballot fight nevertheless showcases one of the various ways energy policies appear to be emerging as both a factor in and potential consequence of 2018 midterm elections.

Offshore drilling, emissions from drilling, and climate change policies are all in the mix, at a time when energy seems to be more of a partisan issue than ever — with US President Donald Trump’s high-level moves to ease burdens for fossil fuel development and improve access to energy production on public lands galvanizing at least some pushback. “It’s been bubbling up in different races in different ways,” said Jon Goldstein, director of legislative and regulatory affairs for the Environmental Defense Fund. Curbing emissions from the oil and gas sector, for example, is likely to crop up in the context of New Mexico’s gubernatorial race, given that Democratic candidate Michelle Luhan Grisham has long advocated for federal methane controls at a time when the Trump administration is rolling those back.

The Trump Factor

The energy industry also appears to be increasingly worried about wider opposition to Trump’s presidency fueling Democratic votes in swing districts of energy-producing states, particularly in urban areas. Some of those concerns prevail even in the fiercely red state of Texas, where a normally relatively energy-friendly state Democratic committee is taking a tougher stance on fossil fuels. To that effect, Republican Representative Will Hurd, considered a champion of defending oil and gas interests in the House of Representatives, could face a tough race in Texas’ 23rd congressional district, which covers a swath of the Permian Basin.

Greens are meanwhile hitting hard on the idea that winning key House, Senate, and gubernatorial races in certain energy states could help combat Trump’s energy agenda. Green group the League of Conservation Voters (LCV) is zeroing in on key races for the House, where a gain of 23 seats would give Democrats control of the lower chamber. “Flipping control of either chamber would halt a lot of attacks we’re seeing” and give Democrats some ability to conduct oversight when it comes to checking the White House on federal energy policy, LCV spokeswoman Alyssa Roberts said. Industry is all too aware of the possibility. “The House does cause us some concern because unfortunately, energy has become a partisan issue,” said Kathleen Sgamma, president of the producers’ trade group Western Energy Alliance. A flip in the lower chamber would mean industry is unlikely to see much in the way of “positive legislation,” she added.

Athan Manuel, director of the Sierra Club’s Lands Protection Program, described the group’s messaging ahead of key House and Senate races in Western states as centered on asking voters, “Are you going to stand up to Trump and up for public lands in your state?” (EC Dec.1’17). Montana, where incumbent Democratic Sen. Jon Tester will be defending his seat, could be a key battleground. Tester is a staunch advocate for protecting public lands from mining and energy extraction, and for federal climate change action.

And in Florida, where politicians tend to view offshore drilling in a more nonpartisan way, climate change and the Trump administration’s offshore leasing plans are spotlighted in a Senate race between Republican Gov. Rick Scott and Democratic Sen. Bill Nelson. Following a high-profile airport meeting in which US Interior Secretary Ryan Zinke appeared to pledge to Scott to leave Florida’s offshore territory off the table for federal leasing, greens are looking to distinguish between Scott’s opposition to drilling off the state’s Atlantic coast, and Nelson’s long-standing opposition to any new drilling (EC Mar.23’18). — Bridget DiCosmo, Washington

Compass Points

- **SIGNIFICANCE:** Although not likely to receive top billing in the minds of voters, energy policy fights will be front and center in states like Colorado and Florida in November and are emerging as possibly influential in key races in other energy-producing states.

- **CONTEXT:** The oil industry has devoted more attention in recent weeks to beating back Colorado’s ballot fight than its gubernatorial and other state-level races. That focus could backfire if Democrats win three state chambers of government, making it more difficult to narrow or eliminate the ballot measure by legislative means.

- **NEXT:** Trump’s contentious presidency appears to galvanizing a broader opposition to his rollback of energy regulations and widening of access for drilling. The impact is likely to be felt in Nov. 6 midterm elections.
Saudis Look at the Bigger Picture

Could oil markets be without 1.5 million barrels per day of Iranian oil by November? Iranian officials think it is possible, which means Opec should be preparing a response. The group’s first test will be this month in Algeria, where ministers from Saudi Arabia and Russia will lead the Joint Ministerial Monitoring Committee that will discuss whether the market needs more oil, and if it does, how much.

There is no doubt that the Saudis are concerned about Iran. In August, Iran said its crude exports fell to 1.68 million b/d, excluding condensate, from 1.97 million b/d the previous month and 2.28 million b/d in June. By November, when US sanctions take full effect, Iranian industry sources told Energy Compass that Iran’s crude exports may drop to a stunning 700,000-800,000 b/d. That would be below levels under the crippling US sanctions in 2012, when UN sanctions and an EU embargo on Iranian oil were also in effect — neither of which will feature this time around.

But the Saudis are not rushing to put more oil on the market just yet, said a senior Gulf Opec source. They don’t want to take major action, or recommend changes to the existing Opec/non-Opec deal, unless they see sustained and quantifiable outages, the source says.

To formulate the right response, the Saudis are looking at the bigger picture. The source said they are carefully monitoring production and exports from five countries — Iran, yes, but also Iraq, Nigeria, Libya and Venezuela. By taking a holistic view they hope to gain a better understanding on how much oil the market will need in the fourth quarter. Their fear remains that hasty action could cause the Opec/non-Opec deal to collapse, or prices to spike or plummet.

Saudis policymakers are acutely aware of the oil market’s concern with thin global spare capacity — most of which lies in Saudi Arabia. State Saudi Aramco is deploying people and equipment to prepare its fields to pump record levels of 11 million b/d or even 12 million b/d, if required. Sources familiar with the matter even claim the kingdom can export 14 million b/d — drawing on storage and oversized export facilities to offset short, large outages. But the policymakers know that such unprecedented production levels would also cause panic — by signaling that the world is effectively out of spare capacity (EC Aug.10’18). Other Mideast Gulf countries may be able to add a few hundred thousand barrels per day. Iraq, if Baghdad resolved its political standoff with northern Iraq, could add some 200,000 b/d. But that’s effectively it. This explains part of the Saudi caution in putting oil on the market before it is truly needed.

The other part of the thinking is to defend prices in the $70-$75 per barrel range, which will help support the Saudi budget while avoiding damaging demand and annoying US President Donald Trump ahead of midterm elections in November.

The bigger picture for Opec and non-Opec is to secure a pact to allow shortages to be compensated by other states, but keep the participating countries united. This week, Omani Oil Minister Mohammed al-Rumhy told reporters that the group would shift focus to assessing the group’s overall compliance level — rather than monitor individual production targets. He added that by the producers’ Dec. 3 meeting, Opec and non-Opec officials will have transparent data on how much they can produce and export. This will determine what action should be taken.

Keeping Opec United

Stronger relations between Saudi Arabia and Russia have so far proven to be successful in keeping Opec and non-Opec aligned. Russia, which fully reversed its production cuts over the summer, is not interested in active market management, Energy Compass understands, but it does want to stay within the Opec/non-Opec framework (EC Jun.29’18). It has limited scope to boost production much higher than the current 11.2 million b/d, and, given its large number of operating companies, it is reluctant to restrain production again — barring another emergency.

But attempts to alter the current agreement, or any public suggestion that member states might lose their market share, could derail the December meeting. Iran’s oil minister Bijan Zanganeh has loudly rejected any arrangement that would allow member states to replace Iranian crude lost to sanctions. Zanganeh will be going to Algeria later this month to debate this issue, but Gulf Opec delegates expect that Iranian technocrats, including Zanganeh, will continue to be pragmatic and accept whatever terms the majority agree on. Al-Rumhy this week told reporters that he highly doubted that geopolitical tension between member states would come in the way of sound decision-making aimed at stabilizing supply levels and prices. There is a toxic geopolitical environment, but Opec does have a knack for putting aside its bitter differences for the sake of unity.

As with every Opec meeting in the recent times, Trump may pressure the Saudis by tweeting inflammatory statements aimed at bringing oil price levels down to appease his domestic audience (EC Jul.6’18). Saudi King Salman has already promised Trump that the kingdom is ready to tap its 2 million b/d spare capacity to supply the markets. However, for the time being, industry sources close to Aramco tell Energy Compass that the policy is to avoid placing barrels on the market without sufficient demand — a message that suggests Saudi oil policy, for now, is in the hands of the technocrats.
Nafta Guessing Game

For the second week in a row, Canadian and US negotiators were stuck in meeting rooms in Washington, DC, trying to thrash out trade terms to replace the 28-year-old North American Free Trade Agreement (Nafta) (EC Aug. 10’18). Publicly, both sides are giving little ground after US President Donald Trump late last week said the US and Mexico could move forward on their own without Canada. He threatened to go “back to pre-Nafta” if no agreement was struck and told Congress — where members have expressed support for a three-party deal — to “not interfere” or “I will simply terminate Nafta entirely.” Meanwhile, Canadian Prime Minister Justin Trudeau on Tuesday said that Ottawa would “hold firm” on inclusion of a mechanism to resolve antidumping and countervailing duty cases.

It’s not all bad: Canadian Foreign Minister Chrystia Freeland said late last week that US Trade Representative Robert Lighthizer and his team were “negotiating in good faith” and observers generally view it as positive that negotiators are still talking. But whatever happens — or doesn’t — in Washington this week, it won’t be the final word on trade in North America. Below, Energy Compass examines what’s at stake for the energy industry and possible next steps.

- **Dispute Resolution:** With the US and Canada locked in talks and no publicly available text of the US-Mexico agreement, key issues of concern for the energy industry remain in flux. Industry had been hoping for the extension of the investor-state dispute settlement (ISDS) mechanism, giving private companies recourse over changes in government policy affecting their investments (EC Feb. 9’18). This was important given the Mexican government’s recent upstream oil and gas opening. A senior US administration official told reporters that the ISDS protections remain “with respect to companies that have contracts with the government” in oil and gas, infrastructure, energy generation and telecommunications sectors. But the specifics won’t be clear until text is made public.

Still, even if certain caveats in the agreement don’t offer industry the same protection it’s had, investors can negotiate their own, says the Brookings Institution’s Geoffrey Gertz, although he allows that firms “won’t always get everything they want” in that process.

- **The “Energy Chapter”:** Likewise, an “energy chapter” in an updated Nafta that could have essentially codified the constitutional reforms that opened Mexico’s upstream sector to private investment appears to have been broken up in the US-Mexico agreement. At the time Nafta was originally signed, Mexico essentially banned private energy investment, with state producer Pemex having a monopoly in all stages of the hydrocarbon production chain. That changed in 2013, when Mexican President Enrique Pena Nieto successfully passed a constitutional energy reform that ended Pemex’s monopoly and paved the way for numerous upstream auctions, as well as the mushrooming of new retail service station brands and potentially billions of dollars in logistics and storage investment by third parties. Pena Nieto had hoped the updated treaty would provide greater security to foreign energy investors.

Mexican President-Elect Andres Manuel Lopez Obrador, whose team has been participating in talks, has said repeatedly that Mexico could not accept such a deal. Still suspicious of private energy investment, Lopez Obrador and his team have talked of halting bid rounds for at least a few years. However, the president-elect’s energy policy is still a work in progress. In an Aug. 27 press conference, Lopez Obrador said he was “satisfied” because the deal reached with Trump safeguards Mexico’s sovereignty. “Mexico reserves itself the right to reform its constitution, its laws, with regard to energy,” he said. “And it was settled that Mexico’s oil and natural resources belong to our nation.”

- **Congress’ Role:** If talks fail, Trump likely can withdraw the US from Nafta, but Congress has a say. That’s because Congress had to both approve the original three-party agreement and pass implementing legislation changing US laws to conform to it. “Trump obviously can’t unilaterally change the law,” says Terry Miller at the conservative Heritage Foundation. Even if Trump withdraws the US from the agreement, it’s possible that many of the laws will continue to apply. Some have also argued Trump was only authorized to renegotiate a three-party agreement under the congressional Trade Promotion Authority that underpins his ability to conduct trade talks.

- **Bilateral Route:** If Washington and Ottawa can’t come to an agreement, it’s not clear whether Congress will move forward on a bilateral agreement with Mexico. Republican lawmakers have traditionally supported free trade policies and several have said they believe Canada should be included.

Trump’s admonishment not to interfere appeared to be a threat to pull out of Nafta entirely if Congress insists on Canada’s inclusion in any new agreement. But after November’s midterm elections, he will likely face a House of Representatives led by Democrats, traditionally the party of trade skepticism. “I don’t think House Democrats will be too upset if the president withdraws from Nafta. Three years ago, they voted overwhelmingly against Trade Promotion Authority for a Democratic president,” says Derek Scissors at the American Enterprise Institute.

- **Grab Bag:** If Canada can’t be brought into the fold there are several possibilities for how trade relationships would be governed among the three countries. Nafta could remain in place for both the US-Canada and US-Mexico agreements so long as Trump doesn’t act on his withdrawal threat. “Nafta would continue to cover two sides of the triangle and not just one, and so I suspect Congress would see that as an OK outcome,” says Christopher Sands of the Johns Hopkins School of Advanced International Studies. If Trump withdraws the US from Nafta, then trade between the US and Canada would likely be governed by the Canada-US Free Trade Agreement.

“It’s also possible we’ll have two bilateral deals,” he adds. Trump has repeatedly said he prefers bilateral agreements. The US and Mexico have been pushing to finalize an agreement before Lopez Obrador takes office on Dec. 1, but Canada doesn’t face the same deadline. If the two were similar enough, Congress could wait to put forward implementing legislation at the same time, effectively linking the two.

Not everyone is so optimistic. “Even in normal times, it’s typically an uphill battle to get congressional approval of new trade deals, and these aren’t normal times,” Gertz says. “There just aren’t that many Senators or members of Congress from either party who will see an incentive to vote for it.”
Resource nationalism continues to figure prominently on the political agenda of Indonesian President Joko Widodo’s administration as it moves to lock in votes ahead of presidential and parliamentary elections set for next April. On the energy front, Jakarta has urged state oil company Pertamina to boost oil and gas supplies for domestic consumers. It is also looking to solidify control over the country’s oil and gas assets, in part by cranking up the process of merging all state-owned enterprises in the sector into a single Pertamina-led holding company (EC Feb’16 ‘18). The nationalist slant has given some potential and existing foreign investors the jitters.

Analysts expect Widodo will keep up his administration’s populist stance until elections next year, particularly as campaigning gets under way. The incumbent is set to face a challenge from Prabowo Subianto of the right-wing Gerindra party. “Contract and investment risks in the energy sector will gradually grow from now heading into the elections, but should ease following a Jokowi win, which for now remains the more likely outcome,” said analyst Lina Gautama from consultancy Control Risks. Subianto, however unlikely, could turn the tables: “It will lead to a marked increase in regulatory, operational, contract and political risks for both upstream and downstream projects … [Subianto] is seen as more volatile and highly nationalist,“ Gautama added.

The Widodo administration has asked Pertamina to grow oil and gas supplies for local markets, which will have the dual effect of satisfying populist sentiment and narrowing Indonesia’s trade deficit. To that end, Jakarta has announced it will introduce regulations that oblige crude producers in Indonesia to sell a share of their supplies to Pertamina — or even all of it, in the case of crude — a move that Exxon Mobil, one of the country’s largest oil producers, said it would support. Exxon operates the 210,000 barrel per day Banyu Urip oil field on Indonesia’s Java island, which accounts for about a quarter of Indonesia’s total crude output.

The government has also pressured the state-run firm to raise domestic production through increased exploration activities and taking over more upstream oil and gas assets like the key Rokan oil and Mahakam gas blocks — even if it means the company takes on more fiscal risks. Pertamina assumed operatorship of the roughly 950 million cubic feet per day Mahakam field from France’s Total at the beginning of this year (EC May22’15). The 200,000-210,000 b/d Rokan field, meanwhile, remains wholly owned and operated by Chevron — another key crude producer in Indonesia — but the US major will cede ownership to Pertamina after its current concession expires in 2021. Rokan’s handover to Pertamina triggered concerns that the Indonesian state firm may lack experience in the enhanced oil recovery technology required to produce the oil. However, “there was just too much downside in the government being seen to favor a foreign investor and not the NOC [national oil company],” an industry observer told Energy Compass. Exxon’s Banyu Urip concession expires in 2035.

Challenges

But Pertamina faces challenges — it is generally seen as lagging oil majors in financial ability and technical expertise required to extract and commercialize resources. While taking over Rokan is “credit positive” for Pertamina and will better integrate its upstream and production, and downstream refining feedstock needs, “we do not believe Pertamina has the balance sheet strength to shoulder the substantial investment cost required to maintain production volumes at the Rokan Block,” ratings agency Moody’s said in a note last month. Pertamina also intends to accelerate refinery expansions and upgrades at projects in Balikpapan, Tuban and Cilacap, with an aim to double Indonesia’s total refining capacity to 2 million b/d by 2025.

Meanwhile, cutting the current account deficit is “very high on Jokowi’s priority list because if unchecked, it could lead to a downgrade of Indonesia’s sovereign debt ratings, which is undesirable to the investment climate and hence Widodo’s electoral prospects,” Gautama said (EC Aug.24’18).

The merging of Pertamina and state-run gas distributor PGN into a single oil and gas holding company is also seen as a nationalist move, but one that also promises benefits such as increased operational synergies and efficiencies. The plan was first mooted in 2014 but languished until gaining traction early this year, as the Widodo administration stepped up efforts to consolidate control over oil and gas assets ahead of elections. However, Gautama thinks the Pertamina-PGN merger will ultimately take a back seat for now, as officials prepare for the upcoming election cycle.

Other ongoing uncertainties include how Indonesia’s gross-split production-sharing contract (PSC) will function in practice. The gross-split scheme aims to incentivize production through tax waivers and by offering contractors a larger share of output, although they would have to shoulder more of upstream costs. Wood Mackenzie analyst Johan Utama said many aspects of the PSC remain unclear, such as how much freedom an operator would have in procuring goods and services and how the government determines the discretionary split between state and producer. He noted, however, that some new PSCs have been signed under gross-split terms.

Jakarta also replaced the chief executive and other key appointments in Pertamina, in what is seen by some as a power move to install loyalists within the national oil company. Energy Compass understands that former CEO Elias Massa Manik, who was sacked in April, had a relatively adversarial relationship with the government and regularly clashed with Jakarta over issues like fuel subsidies.

Irwin Yeo and Shani Alexander, Singapore

Compass Points

• SIGNIFICANCE: Indonesia holds huge oil and gas reserves that upstream investors are keen to tap into. But resource nationalism is expected to crank up heading into elections, possibly dampening investor sentiment.

• CONTEXT: Investors have long had issues with Indonesia’s energy policies — from the lack of clear policy direction to the need to engage with a huge number of national and local stakeholders — even without the specter of polls.

• NEXT: A Widodo win in April should ensure policy continuity. “What we see as resource nationalism now should water down as he is generally more business-friendly,” Gautama said.
MARKET FORCES
LNG Pricing Takes Baby Steps (cont. from p1)

there is also some 20% of LNG sold on spot basis — tiny but growing — that requires credible pricing (EC Dec.22’17).

Price-reporting agencies and regional exchanges have been racing to offer such a price benchmark, with Platts’ Japan Korea Market (JKM) now seen as pulling ahead of the competition. But the JKM has been assessed largely via market surveys of bids, offers and deals — a process some say is opaque, time-consuming and less methodical than that used for crude and products. This is where Platts’ markets-on-close (MOC) process — which it already uses to price several crude and oil product benchmarks — purports to help. By extending the pricing window to LNG, the firm aims to enhance transparency, accuracy and efficiency in its JKM assessments. But the market participants Energy Compass spoke to had mixed views on the LNG MOC — some hailed it as a step in the right direction toward eventual LNG commoditization, but others say lack of bid-offer liquidity in the window makes the JKM prone to being skewed.

Close to 20 companies have signed up for the LNG MOC, Platts said, including oil major BP and state China National Offshore Oil Corp. The rest are mostly European and Japanese trading firms. This is a significant jump from just three participants when the window was first launched. And more companies are set to sign up, with a Platts spokesperson saying interest “remains high and consistent.”

The window also saw its second and most recent trade carried out last Friday — with Russia’s state-run Gazprom selling a cargo with a mid-October delivery window to Japan to trading firm Vitol. Notably, Gazprom is not yet registered on the LNG MOC but was able to ink a deal as Platts allows any market participant to respond to window bids or offers, provided they have an “established trading relationship” with the counterparty.

But to be sure, a structural shift in the way LNG is priced is still distant. The LNG MOC faces some hurdles, most notably a lack of liquidity. Just two trades have been done in close to three months since the window was extended to LNG. And bids and offers have come mostly from just a handful of firms — BP, Vitol, Trafigura and Diamond Gas International, a trading subsidiary of Japan’s Mitsubishi, Energy Compass understands.

Some market participants are nervous — a buyer said if Platts gives extra weight to confirmed window deals in its JKM assessment, the index risks being skewed if “it’s just one deal that is not representative of the market.” The recent Gazprom-Vitol window deal was done at $11.80 per million Btu. Meanwhile, a tender by Angola LNG to sell a cargo for delivery to Northeast Asia in late October was awarded just a day earlier at around mid-$11/MMBtu, possibly to a Chinese buyer.

And as one market participant explained, the LNG MOC is “good for trading firms that regularly take both buy and sell positions easily. If I am nearly always in a buy position, I can’t see how window pricing would be useful to me” — adding that joining the LNG MOC is not a straightforward process as it involves reviews and assessment of regulatory risks, among others.

But a Japanese trader said while illiquidity affecting the JKM might be an issue for now, it is likely “inevitable” that the LNG market will shift toward window pricing eventually. “It is more a matter of time. In one to two years, I believe activity will grow in the [LNG MOC] window,” he said.

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CLOSING ARGUMENTS: CHINA’S SYRIA MOVE, ISLAMIC STATE’S RETURN

China: On the Move in Syria

China is taking a larger role in the ongoing Syrian crisis, positioning itself as a leading player in post-conflict reconstruction and reconciliation efforts, and — for the first time — signaling that it is prepared to dispatch combat troops to assist Syrian government forces in the upcoming battle for the province of Idlib, the last bastion of organized resistance in Syria. The possibility of China deploying troops to Syria represents a major transition away from traditional Chinese military doctrine, which eschews military involvement in the affairs of other nations.

But the potential deployment, hinted at in early August by China’s ambassador to Syria and its military attaché to the country, would serve two key aims: First, it would allow Beijing to directly address the threat posed by Muslim Uighur separatists from its Xinjiang province who are fighting alongside anti-government rebels in Syria and are now largely confined to Idlib; second, it would enable China to get a foothold in the economic reconstruction of the war-torn country, and so advance its ambitious Belt and Road Initiative.

A potential Chinese role in rebuilding Syria would fill a gap left by the US and Europe, which have so far refused to support in Russian-led reconstruction efforts absent progress on a political transition in the country. But a Chinese military presence in Syria threatens to put Beijing directly in the US’ firing line — with US President Donald Trump and senior US officials repeatedly warning the Syrian, Russian and Iranian governments against any “reckless” assault to retake Idlib, and of a “swift” US response if chemical weapons are used.

At present, China provides a few thousand troops for UN peacekeeping operations, while China’s one major overseas base, in Djibouti, operates primarily in support of Chinese peacekeepers deployed to Africa, and of anti-piracy naval patrols in the Gulf of Aden. Since the outbreak of the Syrian civil war in 2012, however, an estimated 5,000 Uighur fighters have joined ranks with various rebel factions inside Syria. Many are drawn from the estimated 45,000 Uighurs who have settled in Turkey over the past decade. Others have made their way to Syria via Southeast Asia, primarily with Turkish help — with Ankara keen to attract Uighurs to bolster the ranks of the indigenous Syrian Turkmen minority fighting against the Syrian government.

As Syria’s civil war nears its endgame, China is pushing the Turks to assimilate the Uighurs operating inside Syria into the existing Uighur immigrant population in Turkey, while also making plans to work with the Syrian government to capture or kill those Uighurs who insist on fighting. The last thing China wants is for battle-hardened Uighur veterans to escape the Syrian battlefield and return to China, where they can use their combat skills to sow unrest in a region already contending with ethnic tensions.

One risk for China is attracting more negative attention from Washington. Congress has already asked the White House to consider economic sanctions against China over its treatment of the Uighurs. China, however, views Uighur radicalization as an existential threat and is unlikely to alter course regardless of any US reaction. More broadly, any sizable Chinese civil and military footprint inside Syria will add to the already complex brew of foreign players there — a development that will further complicate any US military operations in the country, while further eroding US influence in the region.

Islamic State: The Risks of Return

At the height of its power and influence, Islamic State controlled an area in Iraq and Syria with a combined population of nearly 8 million people, with an annual operating budget of over $1 billion and more than 30,000 fighters under arms, many of whom were foreigners drawn from the Muslim populations in the Middle East, North Africa and Central Asia. Fast forward and the defeat of the jihadist group in its Iraqi and Syrian heartlands is raising new problems. Hundreds of militants are returning to their homes. These fighters possess a wealth of practical experience in waging guerrilla conflict and are seen as representing a genuine threat to their respective homelands.

Russia and China are both at risk from Islamic State veterans hail- ing from the northern Caucasus and western China. Indeed, analysts in both countries blame the US for facilitating the return of these fighters for the express purpose of generating this kind of destabilization activity. Russia fought two bloody wars against Islamist separatists in Chechnya, from 1994-96 and 2000-09, and one of its stated goals in entering the Syria conflict was to prevent Islamist extremism from springing up closer to home.

Islamic State has already taken root in the northern Caucasus, with more than a dozen deadly attacks against Russian military and police units having taken place under its banner. Any infusion of battle-hardened fighters from Syria onto Russian soil would be seen by Moscow as a serious threat. Meanwhile, the Ferghana valley, where the three former Soviet republics of Uzbekistan, Tajikistan and Kyrgyzstan come together, has provided an estimated 4,000 fighters to Syria since 2012.

Like Moscow, Beijing hopes to head off the possible return of radicalized nationals from Syria — namely, fighters from its Uighur population. Beijing’s concerns also extend to its neighbor Afghanistan, where the US military has targeted militant camps set up by Taliban fighters and Uighur members of the East Turkistan Islamic Movement, and where some 3,000 fighters as a whole have pledged their allegiance to Islamic State — challenging the Taliban as the symbol of anti-American resistance in the region. China’s ambassador to Afghanistan told Reuters this week that China will train Afghan troops as part of an effort to combat returning fighters who aim to launch attacks in their countries of origin — namely Central Asia and China.

The primary danger to Russia and China is that any widespread Islamic State rebirth in Central Asia would provide a new training ground for the next wave of Islamist militants, allowing for the continued radicalization of Russian and Chinese Muslims. This risks perpetuating the kind of social and economic disruption that has paralyzed Afghanistan, and threatens the wider region as a whole.