

Changing the Modality of Saudi-Iranian Relations as a Factor in the Global Oil Market

Andrey N. Surkov¹ and Alexander G. Simonov¹

¹ RUDN University, Moscow, Russia

Author Note

Correspondence concerning this article should be addressed to

Andrey N. Surkov ORCID: 0009-0002-5732-6581

RUDN University, 6 Miklukho-Maklaya str., Moscow, 117198, Russia. e-mail: surkov_an@pfur.ru

Alexander G. Simonov ORCID: 0000-0002-8497-9564

RUDN University, 6 Miklukho-Maklaya str., Moscow, 117198, Russia. e-mail: Simonov_ag@pfur.ru

Abstract: The research aims to comprehend the impact of relations between Saudi Arabia and Iran on the global oil market. The research objectives are (1) to analyze the reasons for forming the current economic and political links between the two countries and (2) to identify the possible consequences of improving relations between these countries for the stability of global energy markets and ensuring reliable oil supplies. The current modality in bilateral relations has been formed as a result of many differences and discrepancies in the political and economic priorities of the countries. Since the studied countries are among the largest energy exporters, their economic relations greatly influence the oil market. There are also several emerging opportunities in the region. Among the prospects, the authors highlight an increase in China's economic presence in these countries and a potential opportunity for Russian companies to gain a foothold in the developing Iranian economy. The research contains an in-depth analysis of the economic and historical context of the bilateral relations between Saudi Arabia and Iran, the geopolitical and strategic importance of the countries for the oil market, and development scenarios in the context of the ongoing improvement of Saudi-Iranian relations.

Keywords: Saudi Arabia, Iran, energy market, energy policy, economic policy

JEL codes: Q3, Q4, N7

For over 40 years (since 1979), Saudi-Iranian relations have played an important role in regional stability in the Persian Gulf region. These countries have various political and economic peculiarities and seek to secure their status of religious centers in the Muslim world. Additionally, Saudi Arabia and Iran are major oil exporters, causing their political decisions to affect the global energy market significantly.

However, Saudi Arabia is seeking to reduce the number of infighting and discords in the region to enhance investment climate and economic activity. Therefore, to settle the conflict, it is necessary to reconsider the modality of bilateral relations and find compromises in the protracted confrontation.

Materials and Method

The specifics of the energy development of the Persian Gulf region are studied in the works of Ivanov and Matveev (2019). Lascaris (2017) studied the specifics of Saudi Arabia's activities against the Iranian economy.

In the context of changing opportunities for strengthening Russia in the Persian Gulf region and the world, the authors highlight the research of Lavrov and Dyakin (2018).

A wide range of energy data was analyzed, including data for 2022: Annual Statistical Bulletin (OPEC, 2022b), World exports of crude oil and petroleum products by country (OPEC, 2022a), BP Statistical Review of World Energy (BP, 2022), Monthly Energy Review (IEA, 2023), Annual report 2022 (Saudi Aramco, 2022), and World trade report 2022 (WTO, 2022). During the research, the authors applied various methods, including comparative analysis, synthesis, deduction, and induction.

Results

The Iranian factor has been one of the key factors in the energy policy and security of the Kingdom of Saudi Arabia (KSA) over the last 40 years. The Islamic Republic of Iran (IRI) is one of the largest oil suppliers in the Persian Gulf region. It is number two in terms of exports and number four in terms of daily oil production in the region (Figure 1). Therefore, in the regional arena, Iran claims the leading economic and political positions that Saudi Arabia holds for itself.

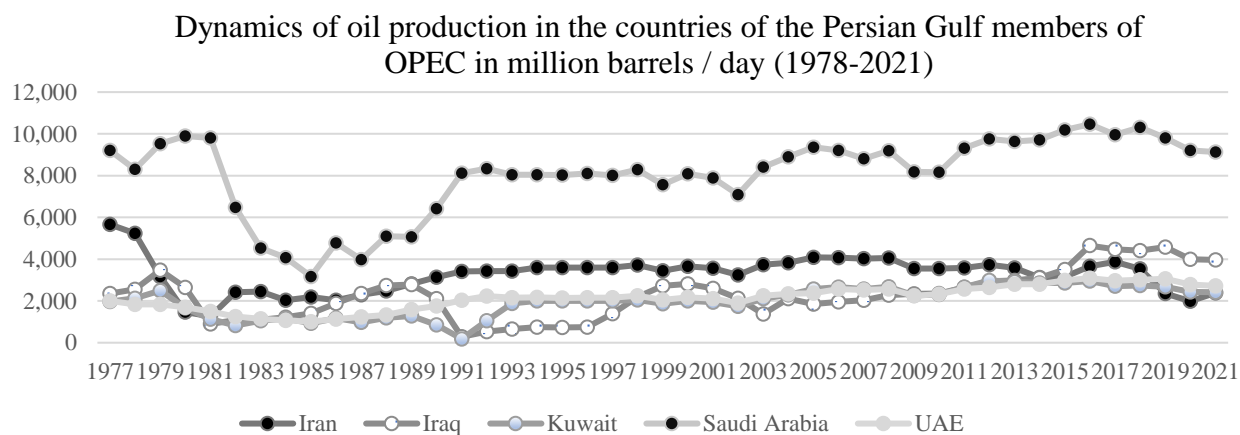


Figure 1

Dynamics of oil production in the countries of the Persian Gulf members of OPEC in million barrels/day, 1978–2021

Source: Compiled by the authors based on OPEC Annual Statistical Bulletin (2022)

After the Islamic Revolution in Iran in 1978–1979, during which the monarchy was overthrown, and Shiite politicians came to power, there was a noticeable surge in opposition sentiments in Shiite communities throughout the region. According to the Statistical Review of World Energy, after the Islamic Revolution, there was one of the largest spikes in crude oil prices due to the following reasons:

- After the revolution, many foreign companies left Iran, which led to a decrease in oil production in the country;
- Later, the Western countries imposed sanctions against Iran, which reduced the volume of oil supplies from this country.

During the first quarter of the 21st century, Iran has been substantially isolated from the global oil market.

The surging global demand after the COVID-19 pandemic and redirecting Russian energy exports from the West pose a new bunch of opportunities for Iranian energy suppliers.

The main importers of Iranian oil were the countries of Europe and the USA. However, after sanctions and a complete ban on almost any trade by the USA, the share of oil exports in Iran's GDP decreased from 28% to 10%. Before the Revolution in Iran, the Anglo-Iranian Oil Company controlled the mining and export industry under concession terms. After 1979, all extractive companies were declared national, and agreements with foreign companies were not signed until the 1990s.

Saudi Arabia's increased attention to Iran can be explained by the fact that it touches on the Shiite issue in the KSA. The official religion in Saudi Arabia is Sunni Islam, which is practiced by 85% of the country's citizens; according to various estimates, about 4%–15% are Shiites. In addition to religious differences among the population, they are also political and economic minority in the Sunni kingdom. This issue is complicated by the geographical location of Saudi Shiites, inhabiting oil-rich areas, mainly the eastern part of the country (Dammam, Al-Zahran, and Al-Hofuf). Therefore, any concerns and conflicts are a crucial factor in the country's energy policy, posing a significant threat to national security. Moreover, according to the Saudi government, such uprisings are allegedly sponsored and encouraged by Tehran, as it can be regarded as helping Shiites in other countries.

For Saudi Arabia, energy policy and relations with Iran have been closely linked and have affected the global oil industry for a long time. Iran controls the eastern part of the Strait of Hormuz, through which about 20% of all oil trade flow in the world passes. In 2019, the US Energy Information Administration named the Strait of Hormuz the most important oil transit hub due to the fact that oil from almost all Persian Gulf countries passes through it to such markets as India, Japan, Korea, China, and the USA.

The status of Hormuz is an important part of the Saudi-Iranian agenda. Since this route is strategically important for world oil supplies, the state and modality of relations between the two nations are a keystone of global energy security.

Turning to the international level of the influence of Saudi-Iranian relations on the oil market, it is worth considering that both countries are also members of the international intergovernmental Organization of the Petroleum Exporting Countries (OPEC). The tasks of OPEC include international energy security, maintaining the price balance to ensure constant access to energy resources at an affordable and satisfactory price for everyone.

OPEC, led mainly by Saudi Arabia, is committed to ensuring energy security and stability by various means, such as quotas and voluntary restrictions on oil production for

member countries. Quotas in OPEC are distributed among member countries depending on their production capacities and reserves. The Organization uses a distribution system that is periodically reviewed to ensure that it is fair and reflects the changing circumstances of member countries. Each member country is assigned a quota that determines the amount of oil to be extracted and exported. Quotas are usually expressed as a percentage of OPEC's total output, with larger producers receiving a higher percentage. However, the allocation of quotas is subject to negotiation and is determined by consensus among OPEC members, while each country has the right to vote during the decision-making process.

Within OPEC, Saudi Arabia has the largest quota (11 million barrels per day) because it has the highest production capacity and reserves in the region. Iran has a 3.4 million quota, which is sometimes violated (e.g., Tehran produced over 4.5 million barrels per day in 2016, according to BP data). However, the problem of exceeding OPEC quotas also concerns other countries due to various political and economic factors that prevent the production volume from being controlled. Therefore, countries such as Iran, Libya, and Venezuela are temporarily exempted from quotas.

In the oil market, Saudi Arabia and Iran are competitors in terms of "heavy" (more viscous) oil, such as Iran Heavy and Saudi Arabian Heavy. Heavy oil is the main crude oil product for Iran. However, it is secondary for the KSA because the Saudi main export position is the brand of "light" oil Arabian Light. For this specific reason, Saudi Arabia currently perceives Iran not so much as an oil competitor but as a political opponent.

It was believed that Saudi Arabia did not want to allow the economic rise of Iran because this could become a threat to regional stability. According to the Saudi government, in the current political realities, Tehran exports resources to support various Shiite movements (e.g., Hezbollah in Lebanon) to expand its influence in the Persian Gulf region.

Nevertheless, on March 15, 2023, Saudi Finance Minister Mohammed al-Jadaan said that Saudi Arabia sees no obstacles to normalizing relations and attracting investment to Iran, provided that the sovereign rights of each country are respected. The purpose of this statement was to raise the issue of stability and attracting foreign investments by normalizing relations with Iran. According to the Minister, the region should become more attractive for foreign enterprises. Nevertheless, for this purpose, it is necessary to settle the issues that prevent this. The negotiations were trilateral, moderated by Chinese President Xi Jinping. It is worth noting that Saudi Arabia and Iran will restore diplomatic relations that were undermined in 2016 due to political differences and a direct threat to the lives of Saudi nationals in Iran.

China is interested in improving Saudi-Iranian relations because both countries are important partners for China in the Middle East region. In 2018, the main supplies through the Strait of Hormuz went to the Chinese market. Saudi Arabia accounts for 15% of all crude oil, and Iran for 10% in the composition of China's imports. In turn, China's market is one of the top priorities for Saudi and Iranian oil: 27.1% of all crude oil exports from the KSA and 28% from Iran are shipped to China. The share of Chinese imports (mainly manufactures) exceeds 20% for both countries. Improving relations between Saudi Arabia and Iran may lead

to increased trade flows and economic development in the region, which will be beneficial to the Chinese economy, as more developed and stable markets will appear in the rich Persian Gulf region, which is potentially one of the largest consumers of Chinese manufactures.

The improvement of Saudi-Iranian relations may have a positive impact on the global oil market. First, improved relations between Saudi Arabia and Iran can lead to greater stability in the region, allowing energy companies to conduct business safely, clearly plan long-term prospects, and increase investment flows in the region. Second, if the two countries are willing to cooperate on oil production and pricing, it could lead to a new mechanism for adjusting production and balancing prices that would benefit both exporters and importers.

Additionally, the resumption of the dialogue between the two countries has already yielded results of the Yemeni negotiations, in which Iran and Saudi Arabia participated. Thus, on April 9, 2023, Saudi Arabia informed the Presidential Council of Yemen about the completion of the military campaign of the Arab coalition “Storm of Determination,” which had lasted since March 30, 2015. It was carried out at the request of the legitimate Government of Yemen to help in the fight against the Houthi militants. The Houthis are a Shiite paramilitary group supported by Iran. This step is presented as a gesture of goodwill on the part of Riyadh after Iran refused to arm the militants further. On April 10, the delegations of Saudi Arabia and Oman held talks with the Houthis in Sanaa, where the Saudi side declared its desire to put an end to its military intervention in the protracted war. The result of the negotiations is expected by the end of April.

Saudi-Iranian relations could potentially affect the Russian oil and gas sector in different ways. If we consider the countries as competitors, then the Iranian Iran Heavy may be considered a rival for the Russian Urals heavy oil brand. In this case, further competition will determine which way the negotiations on balancing Iranian oil production will go and how much future investments from Asian countries (especially China) will be invested in the Iranian oil industry.

Nevertheless, this improvement in relations may have a positive impact on the Russian mining industry because, for example, Russian Lukoil already has experience in the Persian Gulf region, and it can compete in the field of oil development in this region. In 2004, Lukoil and Saudi Aramco created a joint venture LUKOIL Saudi Arabia Energy Ltd (LUKSAR), where 80% of the shares belong to Lukoil and 20% directly to the Saudi government. Lukoil planned to fully transfer the project to the Saudi government; the project is currently frozen.

More positive aspects for the Russian oil industry may follow within the framework of OPEC+. OPEC+ includes 13 OPEC countries and ten other states (Russia, Kazakhstan, Azerbaijan, Bahrain, Brunei, Malaysia, Mexico, Sudan, and South Sudan). KSA heads this format as the largest regional oil producer; Russia participates in OPEC+. With the normalization of the negotiation process among the region’s countries, Russia will also be able to promote and, to some extent, moderate mutually beneficial terms of cooperation more effectively in the case of a more economically stable region.

Cooperation within OPEC+ has already yielded some mutually beneficial results. It has rationed oil production and stabilized prices, as well as supplies to some markets. On April 7,

Saudi Arabia and Russia reduced daily production by 500 thousand barrels per day until the end of 2023; 7 OPEC+ countries announced a reduction in total volume of about 1.7 million barrels per day. This agreement raised the price of Brent to \$87 per barrel and proved that the balancing mechanism of energy prices is still in the hands of OPEC and OPEC+.

Discussion

Tension management between Saudi Arabia and Iran gets a new round of development thanks to the influence of the People's Republic of China. These events largely changed the general vector in the region, and the scenarios for the isolation of Iran (Lascaris, 2017) did not come true in many ways. The new trends presented in the research show cooperation between Riyadh and Tehran. This new interaction model must be considered to build up the current foreign economic relations in the studied region.

Conclusion

Recent tensions between Saudi Arabia and Iran can be traced back to the 1979 Islamic Revolution in Iran. This event strongly influenced the formation of the system of economic and political relations between countries and was an obstacle to their normalization for a long time. However, new realities show that it can be more beneficial for the countries to reduce these tensions. Since instability in the Middle East region has often led to interruptions in oil supplies and sharp price spikes (with Saudi Arabia and Iran being the two largest oil suppliers in the region and the world), a new approach in mutual relations and reshaping the paradigm of rivalry and cooperation between two countries poses a significant factor of the global economy.

Any improvement in relations between Iran and Saudi Arabia can potentially lead to a more stable and predictable world oil market with low price volatility and a moderate risk of supply interruptions or artificial deficits. Nevertheless, further improvement of bilateral relations depends heavily on various factors, including the strategic influence of such global players as China, Russia, and the USA, each having specific economic and political interests in terms of the region, the energy market, and the investment in expanding Middle East economy.

The link between China and the Middle East region is being tightened. China is becoming a major market for Iran and Saudi Arabia to sell crude oil. In turn, Iran and Saudi Arabia increase their share of imports from China, which can also become a crucial investor in their economies. OPEC+ agreement and prospects of economic cooperation with Iran significantly increase the interest of normalizing tension in the region for Russia. For the USA, being one of the largest consumers of crude oil and the leading oil products producer in the world, the ability to influence Saudi-Iranian relations tuning up is a factor of global competitiveness.

Overall, it can be concluded that whether the relations between Iran and Saudi Arabia are improving in the long run or not, their modality will pose a significant factor in the world economy, with major states being the main stakeholders of this process.

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