

Saudi Arabia's Oil Policy in Uncertain Times: A Shift in Paradigm?

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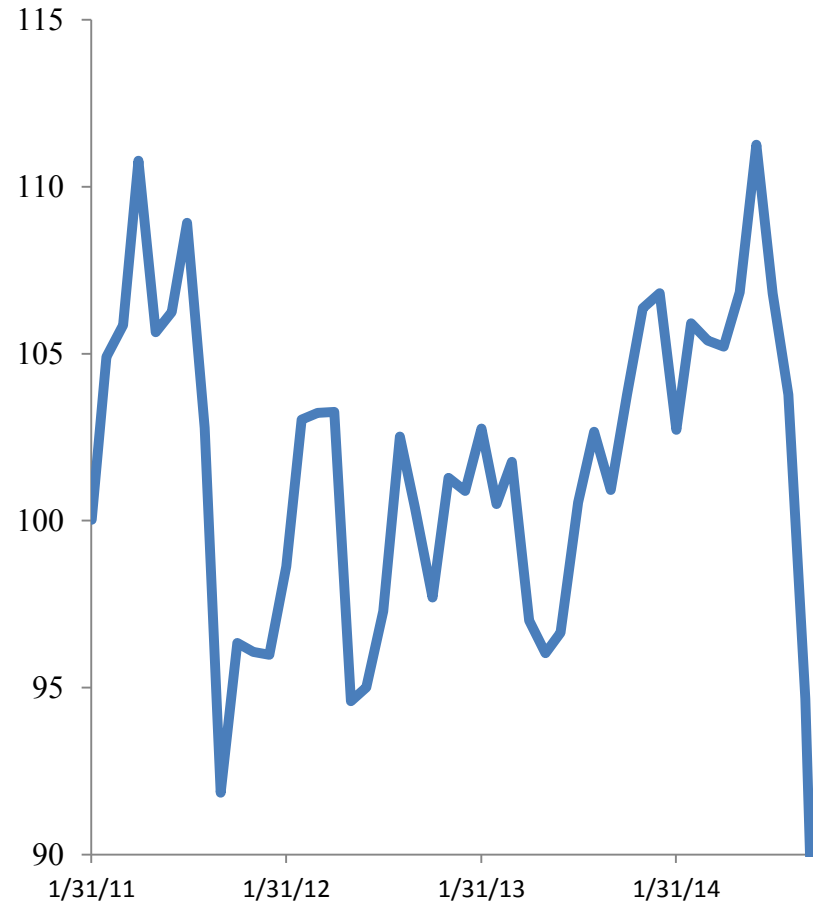
Oxford Institute for Energy Studies

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Attention Shifts Back to Saudi Arabia

- Sharp fall in oil prices turned world's attention to OPEC & Saudi Arabia's response
- Saudi Arabia communicated to market that it is comfortable with markedly lower oil prices even for an extended period which contributed to a further fall in price (though there remains doubts as to the credibility of the signal as it was communicated using unofficial and unorthodox channels)
- Hopes that Kingdom would come to rescue and 'balance' market and arrest decline in oil price replaced by stories of 'price wars', 'conspiracy theories' and 'grand design strategies and games' aimed at pushing prices down to achieve 'some wider economic and political objectives'

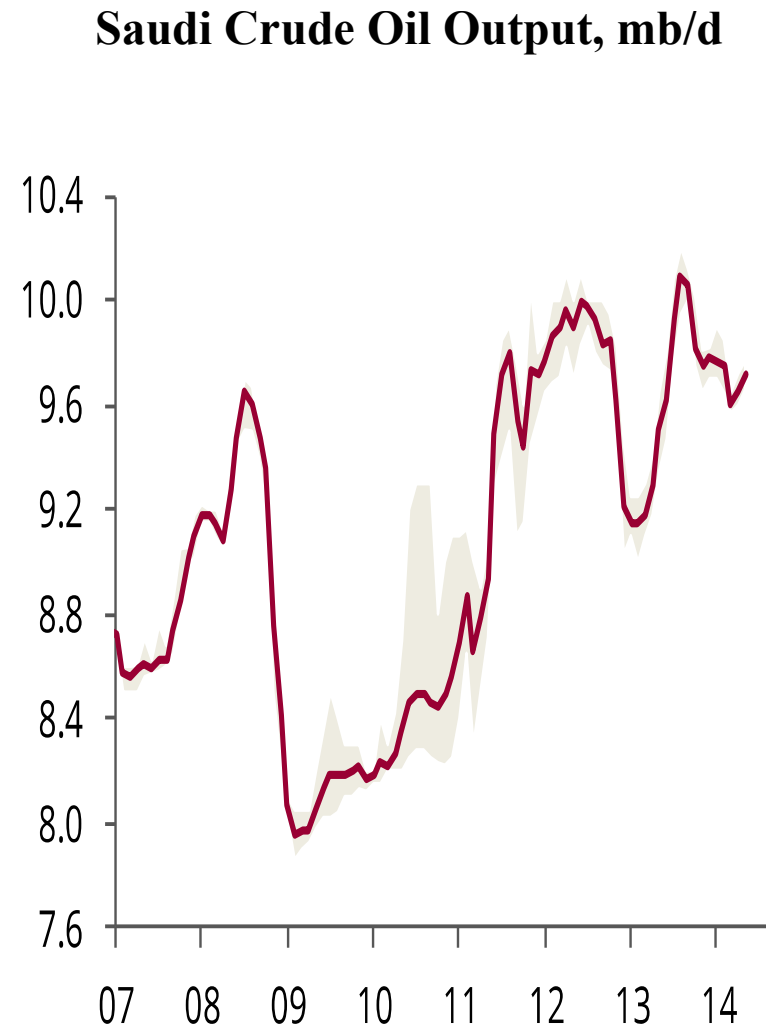
Brent Monthly Price, \$/Barrel



Source: Reuters

A Change in Saudi Arabia's Oil Output Policy?

- A key question: Why Saudi Arabia has not reacted to the sharp fall in oil price 'in the expected manner'?
- No clear single answer but multiple potential explanations
- Explanations put forward suffer from some forms of internal inconsistency and need to be questioned



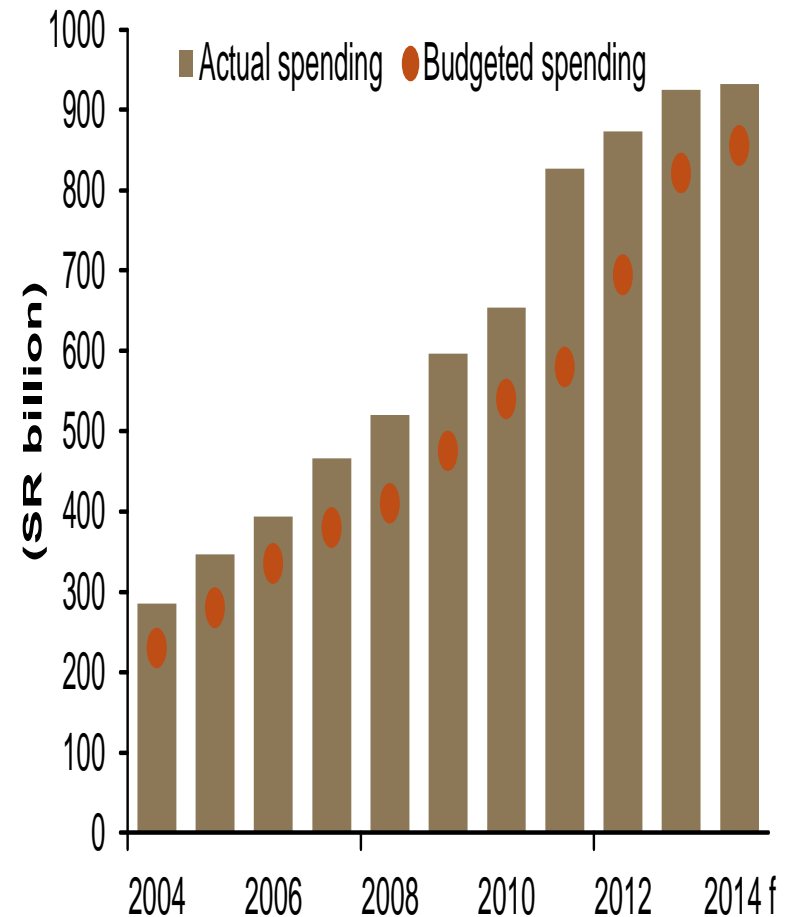
Source: MEEs, Energy Aspects

Does Saudi Arabia Desire a Lower Oil Price?

Does Saudi Arabia Desire a Lower Price?

- Existing explanations based on premise that Kingdom not concerned about lower price
 - Going so far as saying that ‘Saudi Arabia is in a sweet spot right now’ (FT, Oct 8, 2014)
- Far from established that Saudi Arabia actively ‘desires’ a lower price (their spending commitments both on domestic and regional fronts continue to rise)
- May 2014, Saudi oil minister Mr Ali Naimi: ‘One-hundred dollars is a fair price for everybody - consumers, producers, oil companies... it is a fair price. It is a good price’ (Reuters, May 12, 2014).

Budgeted versus actual spending



Source: Jadwa Investment

Saudi Arabia Can Withstand a Period of Lower Oil Price

- Kingdom able to tolerate lower prices in the near term
 - Accumulated large foreign assets
 - Does not need to balance its budget every year
 - Debt quite small in absolute value and relative to GDP and capacity to borrow large
 - Government expenditure an endogenous variable: Decline in revenues would result in adjustment of expenditure outlays

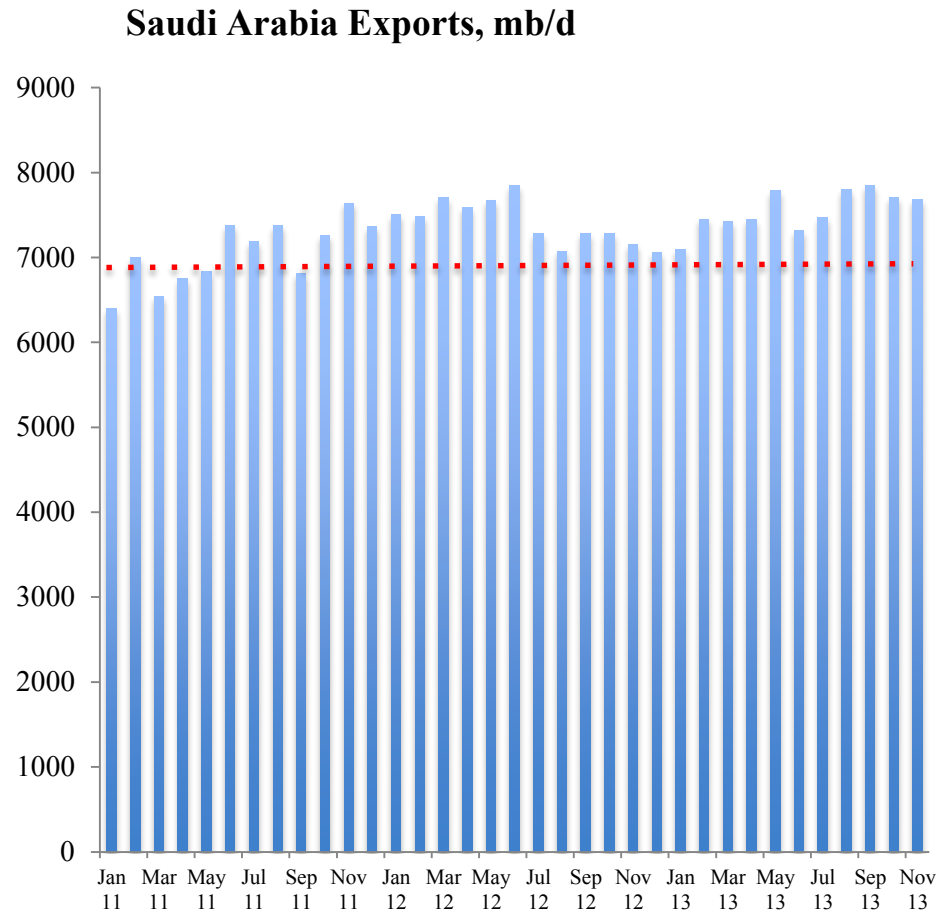
Government assets as a buffer against lower oil prices

	Government assets		Budget deficit at \$83bbl	
	USD bns	% GDP	USD bns	Years of assets
Nigeria	4.1	2.4	16.4	0.3
Russia	173.0	8.5	45.4	3.8
Saudi Arabia	446.9	58.1	56.8	7.9

Source: Deutsche Bank

Accept Lower Price to Maintain Market Share?

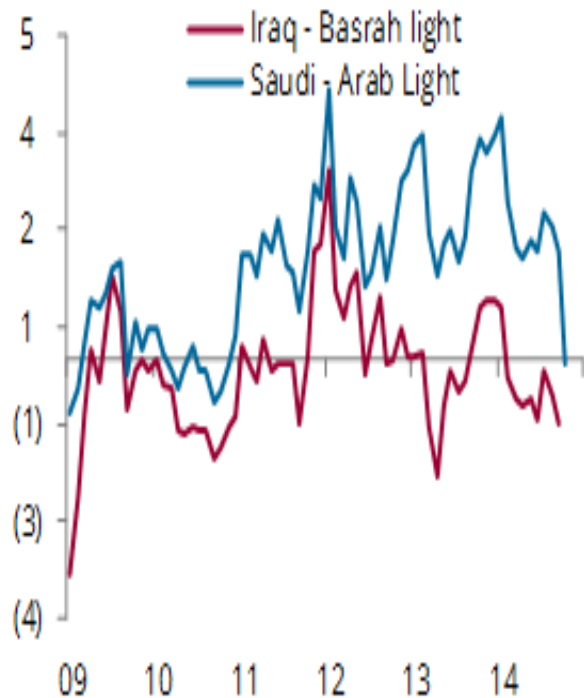
- Maintain exports stable at close to 7 million b/d
- Possible reasons
 - Market share matters
 - Presence in key markets important
 - Maintain relationship with customers in a much more competitive market
 - Get prepared for tougher OPEC negotiations ahead (better position to negotiate from level of production)



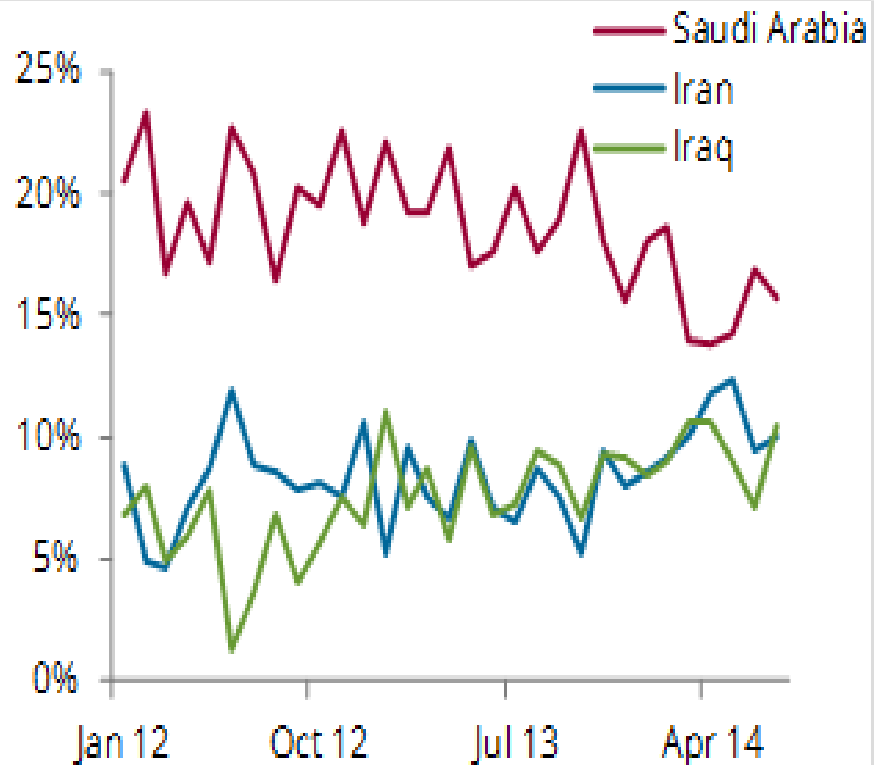
Source: JODI

Tough Competition in Asia Requires Adjustment in Differentials

**Iraq and Saudi OSPs to Asia
\$/barrel**



Chinese Imports by Country (%)



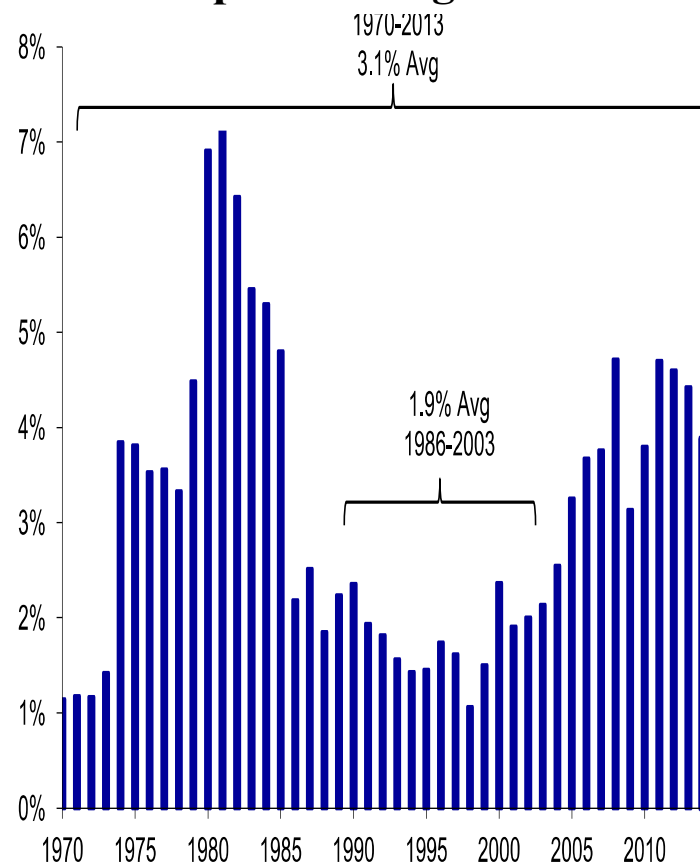
Source: Energy Aspects

Interpreted as ‘price war’ by market, though differentials are set well in advance based on past month’s data; Could Saudi Aramco have got the differentials ‘wrong’ assuming customers would pay for a ‘reliability’ premium?

The Focus Should be on Revenues

- But a producer ultimately concerned first and foremost with total revenues (e.g. 7 mb/d of exports at \$75 would fetch Saudi Arabia \$525 million per day while 6.2 mb/d at \$100 would earn it \$620 million)
- Loss in revenues potentially large: 'Brent falls to \$80, OPEC countries would lose some \$200bn of their recent \$1tn in earnings, affecting not only their ability to earn enough to cover the post-Arab Spring expanded budgets, but also their capacity to service debt without triggering defaults' (Ed Morse, FT, October 15 2014).
- Is Saudi Arabia willing to protect its market share at whatever cost even if this means a sharp fall in revenues? If yes, for what wider objectives?

Oil as a percent of global GDP



Source: Deutsche Bank

A Helpless Saudi Arabia in a Falling Market?

Helpless in a falling market?

- Potential explanation: No point in defending oil price in face of weaker demand growth
 - ‘from an economics point of view, it’s much better to let prices go way down’, and that the emerging price war is ‘a war of necessity’ (Verleger, Reuters, October 14, 2014)
- But market conditions indicate current oversupply far from being out of control (for instance when compared to 2008/09)
- Call on OPEC crude close to OPEC supply
- Before loss of Libyan production, Saudi Arabian production was around 9.1 mb/d in early 2013 below 9 mb/d in 2011

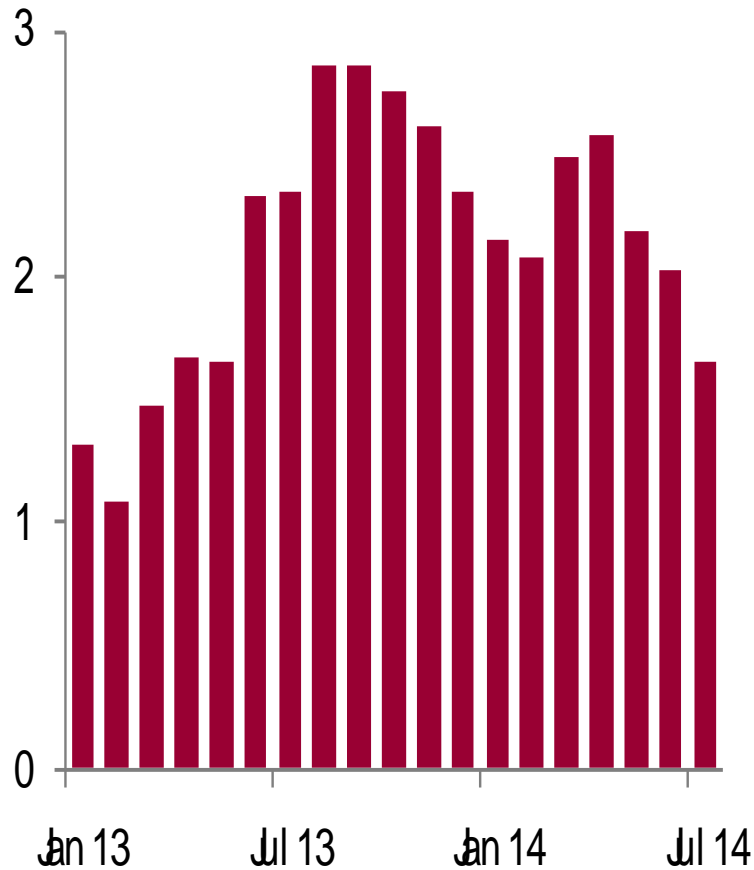
	2014 Quarters					2015 Quarters					y/y change		
	2013	Q1	Q2	Q3	Q4	2014	Q1	Q2	Q3	Q4	2015	2014	2015
Demand	91.7	91.6	91.6	93.3	93.9	92.6	92.8	93.0	94.6	95.0	93.8	0.9	1.2
OECD	46.1	45.7	44.7	46.1	46.6	45.8	45.7	44.9	45.9	46.2	45.7	(0.3)	(0.1)
Non-OECD	45.7	45.8	46.9	47.2	47.3	46.8	47.1	48.0	48.7	48.8	48.1	1.2	1.3
Non-OPEC supply	54.7	55.8	56.4	56.3	56.8	56.3	57.2	57.4	57.7	58.1	57.6	1.6	1.3
non-OPEC excl NA	37.5	37.6	37.7	37.7	37.8	37.7	37.7	38.0	38.1	38.1	38.0	0.2	0.3
North America	17.2	18.2	18.7	18.6	19.0	18.6	19.4	19.4	19.5	20.0	19.6	1.4	1.0
FSU	13.9	14.0	13.8	13.8	13.9	13.9	13.9	13.8	13.7	13.7	13.8	0.0	(0.1)
OPEC NGLs/Condensates	6.3	6.3	6.3	6.4	6.5	6.4	6.7	6.7	6.7	6.7	6.7	0.1	0.3
Call on OPEC crude	30.8	29.5	28.9	30.5	30.6	29.9	28.9	28.9	30.2	30.1	29.6	(0.9)	(0.3)
OPEC crude	30.5	30.0	30.1	-	-	-	-	-	-	-	-	-	-
Stockbuild	(0.3)	0.5	1.2	-	-	-	-	-	-	-	-	-	-

Source: IEA September Oil Market Report Source: Energy Aspects

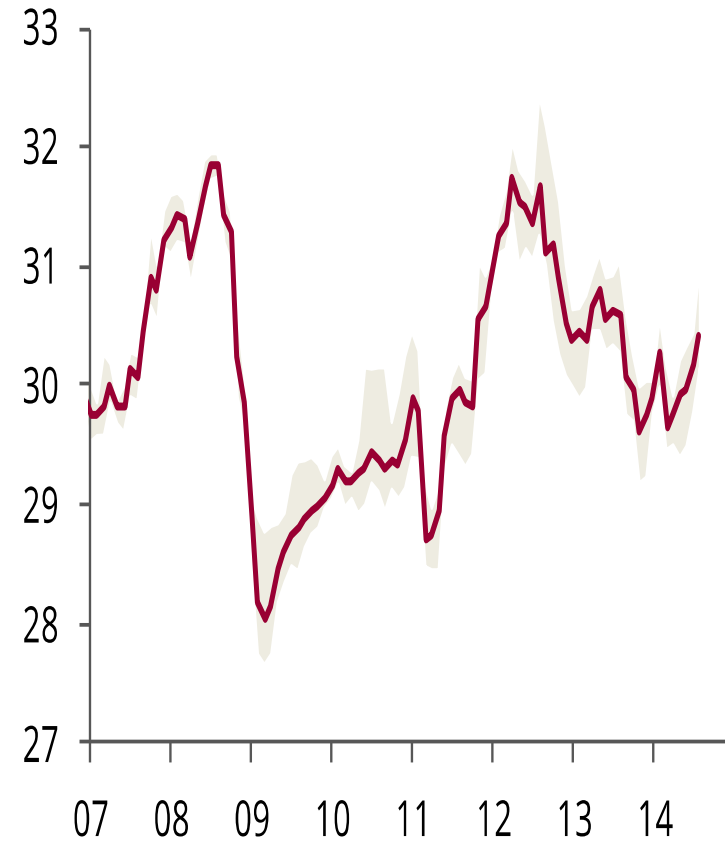
Rebalancing supply side market would not require a journey into uncharted territory though the size of crude stocks make it more challenging

OPEC Output at Relatively High Level As Disruptions have Eased

OPEC output disruptions, mb/d



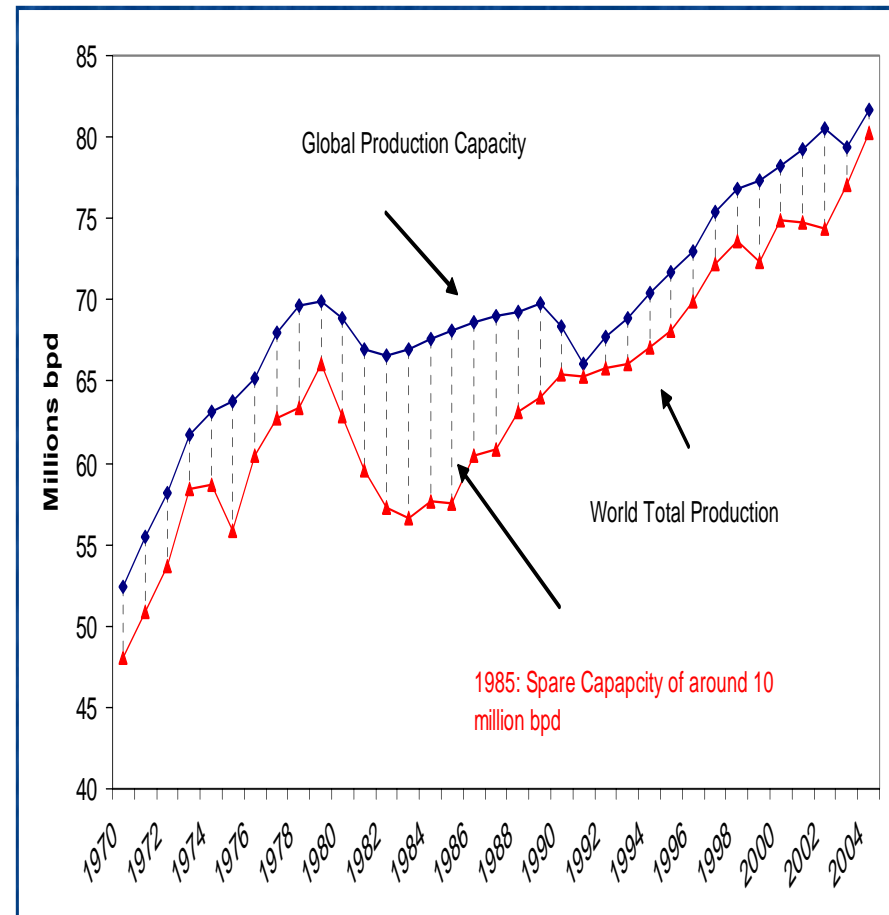
Total OPEC Output, mb/d



This is not 1986: Spare Capacity Now and Then

- Challenge ahead for OPEC unlikely to be a repeat of the 1980s
- In 1980s, spare capacity peaked at over 10 mb/d and group's share of global supply dropped well below 30%
- Oil system much bigger now: spare capacity as share of crude production much smaller when compared to the 1980s
- Another key difference: oil demand collapsed after price shock of 1970s; in current context global oil demand is still rising though at a slow pace

Evolution of Spare Capacity in 1980s



Light Versus Heavy?

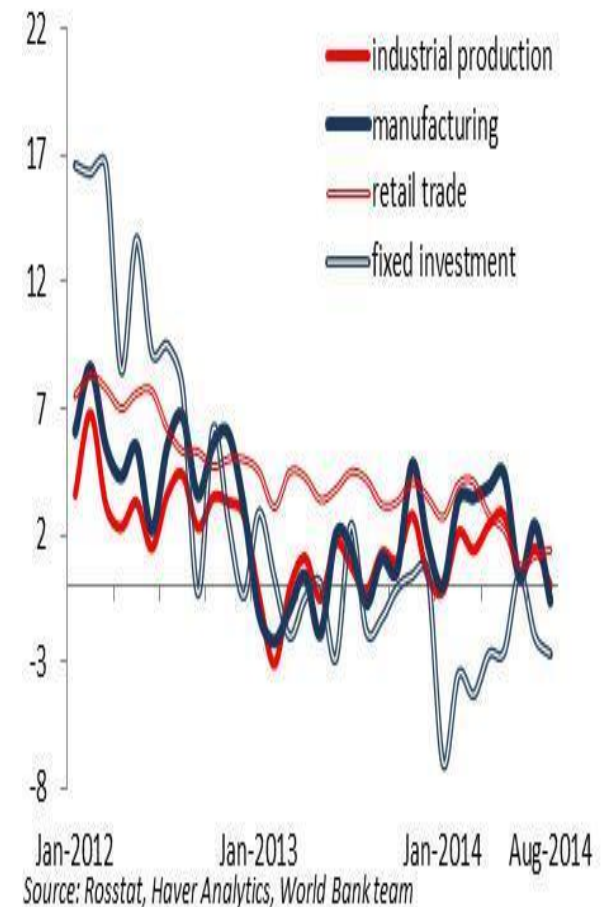
- Surplus in global oil supplies largely in light, sweet grades rather than medium to heavy crudes that dominate Saudi and other Middle East production slates
- Argument: Saudi Arabia cut will simply add to light-heavy imbalance
- Saudi Arabia cuts unlikely to be solely in heavy grades (their new refineries process heavy crudes, freeing up their light and medium grades for exports)
- Refineries globally prefer a heavy feedstock but can still process from light grades, especially if prices fall sufficiently
 - Gasoline and middle distillate cuts of these crudes may well be a constraining factor as refineries try and manage structural oversupply in refined products
- But a cut in output would tighten global balances

Willingness to accept lower revenues to achieve some wider objectives?

Political Objective?

- Drive down price in order to batter petroleum export-dependent Russian & Iranian economies
 - ‘by pushing oil prices lower, Saudi Arabia is helping to orchestrate some geopolitical outcomes that will be very welcome in Washington. The plunging price will create further problems for the Russian economy, which is already suffering under the weight of US and European sanctions in response to its intervention in Ukraine. Iran’s economy will also be affected by lower oil prices...which could encourage Tehran to make concessions to the US’ (FT, October 16, 2014)

Russian Economic activity is trending down (% change, year-on-year)

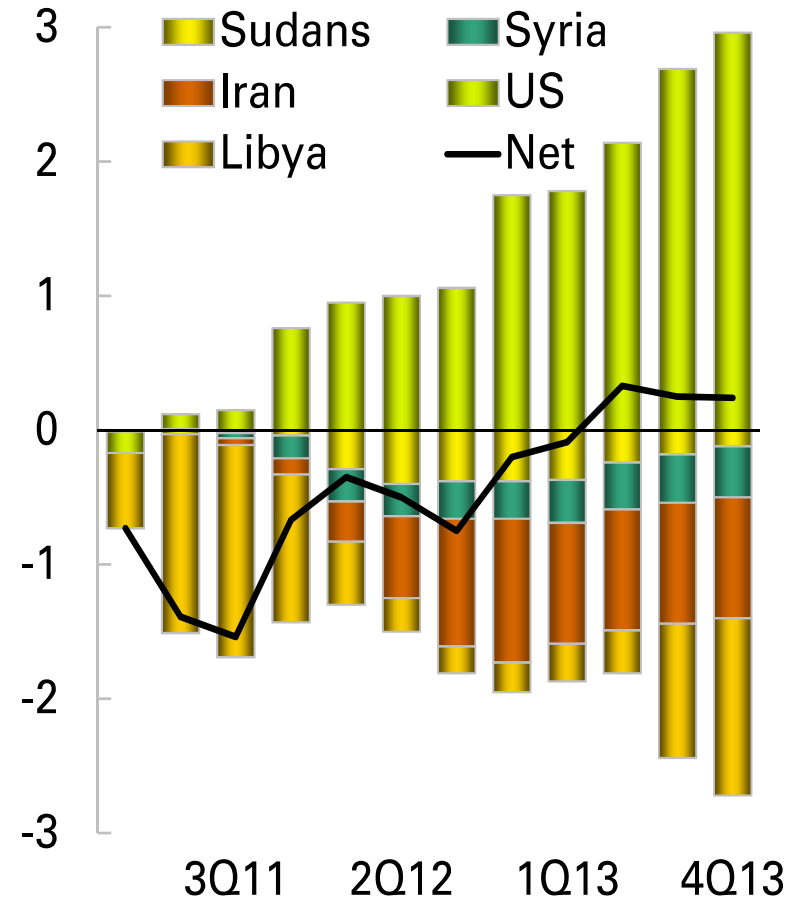


Use of Oil as a Political Tool?

- Since oil embargo in 1973, Saudi Arabia has not used oil as a political tool
- Has always prided itself that decisions related to output policy and energy sector based solely on commercial considerations
- Using oil market as ‘political weapon’ would represent a radical shift in oil policy
- One should question the effectiveness of such a policy and whether it can induce a radical shift in Iran’s or Russia’ foreign policies
 - Highly unlikely

Harm US Producers?

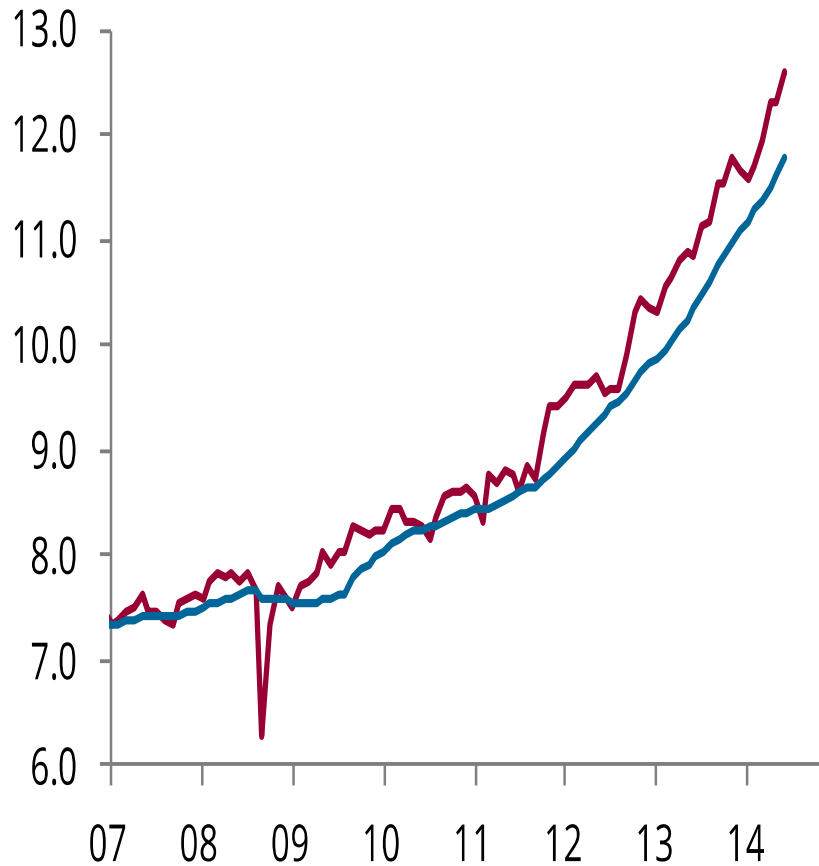
- Objective: harm US producers ‘subtly squeezing the finances of some of America’s fledgling shale companies’ (FT, October 16, 2014)
- SA not shown any signs of panic in past in accommodating a high cost producer
- Past position: Kingdom welcomes all sources of supplies to the market to meet the expected growth in future oil demand
- Had it not been for US supply growth, given plethora of supply outages elsewhere burden would have fallen almost solely on it to increase output and balance market
- Would have created significant volatility and potential price spikes something that SA wishes to avoid



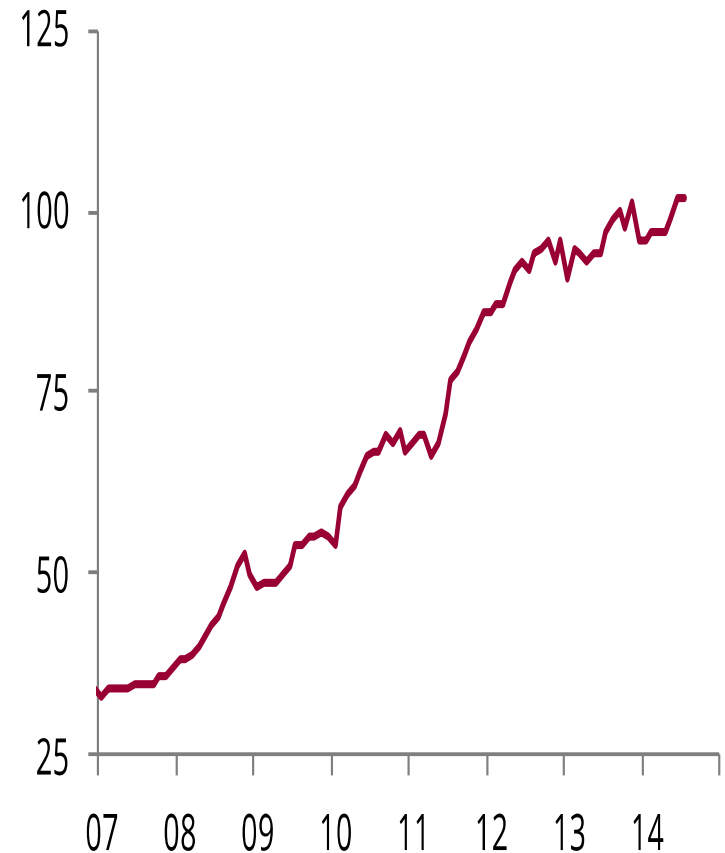
Source: BP

The US Oil Supply Shock

Total output and 12m avg., mb/d



Oil output per well, b/d



Supply Responses far from Clear

- Producing close to 12 mb/d would have stretched and put SA under greater pressure to invest in additional capacity
- A belief that oil companies and non-OPEC producers have shifted to developing reserves in more difficult areas (including shale) would put a floor on long-term oil price
 - CEO of Saudi Aramco Mr Khalid Al-Falih ‘to tap these increasingly expensive oil resources, oil prices will need to be healthy enough to attract needed investments. The other side of the same coin is that long-term prices will be underpinned by more expensive marginal barrels’.
- Question whether lowering oil price could have effect of reducing growth in US tight oil growth given wide variation in breakeven price and uncertainty on how fast would shale production growth respond to a lower price environment

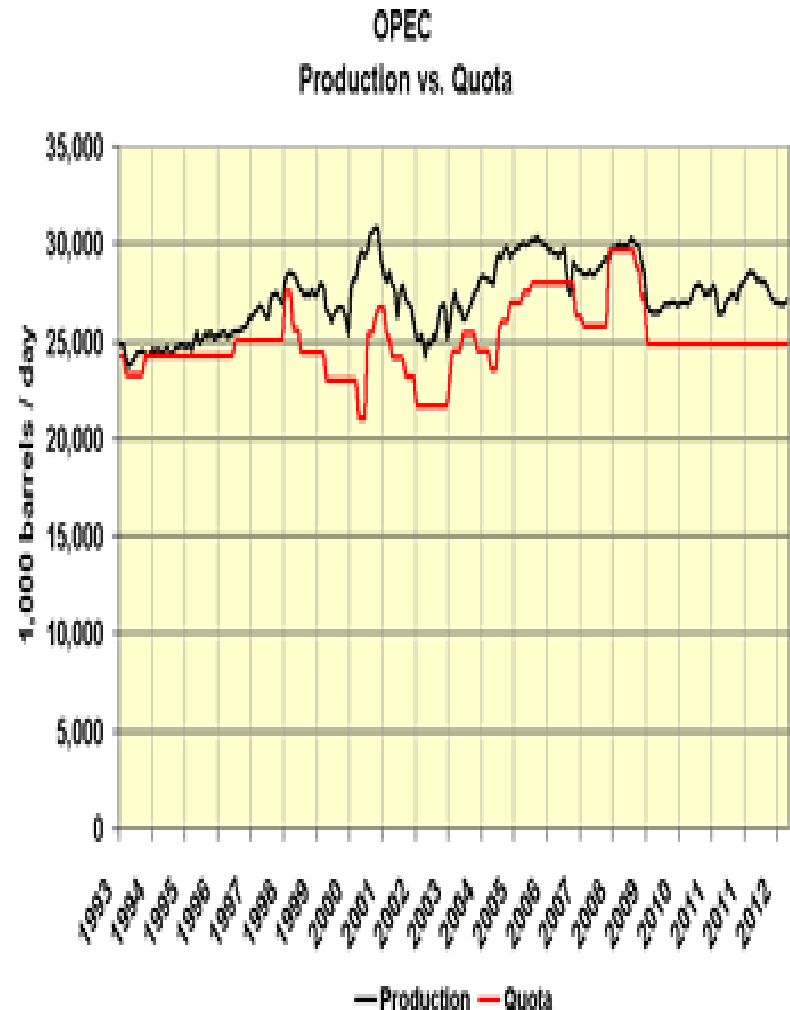
North Dakota Break-Even Oil Prices		
	Price (\$/bbl)	Rigs
McKenzie	\$28	66
Dunn	\$29	28
Stark	\$36	2
Williams	\$37	43
Mountrail	\$42	31
Bottineau-		
Renville	\$51	4
Billings	\$53	4
McClean	\$73	1
Bowman-		
Slope	\$75	0
Golden Valley	\$77	0
Burke	\$81	3
Divide	\$85	8
Average/Total	\$56	190

Source: North Dakota Department of Mineral Resources

Source: Oil Daily, October 17 2014

Enforce OPEC Discipline?

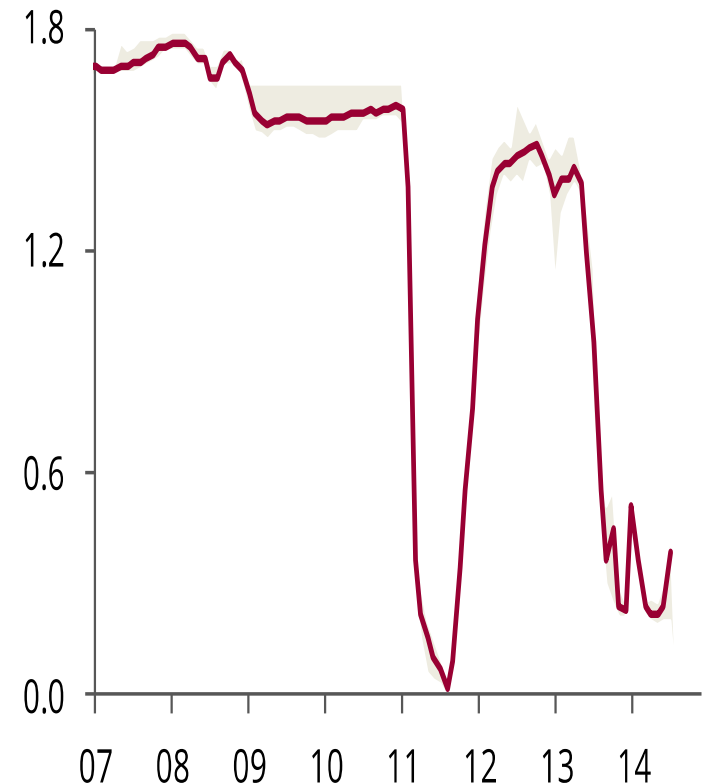
- Potential explanation: Low price need to enforce more discipline within OPEC (only low prices can bring OPEC members to the table)
- Saudi Arabia sent clear signals that it is unlikely to reduce output unilaterally and is happy about the quota system
 - ‘we (Saudis) have learned our lesson. Every time we go to quotas, who bears the brunt? Us. We have learned the lesson. We are no longer the swing producer. Who needs quotas?’ (MEES, Dec 6, 2013)



A Difficult Task which is Becoming More Difficult

- Achieving OPEC discipline never been easy
- More challenging: Many OPEC producers unable to reduce their production due to their heavy reliance on oil prices for basic functioning (e.g. paying wages in Libya, buying basic amenities in Venezuela)
- Even if a cut to OPEC quota agreed in November enforcing cuts across OPEC nations beyond very short term at best, will be difficult
- Is there a price at which SA can bring others to the table?
- Coercing OPEC discipline through pushing prices lower may not work, especially that many are producing below their maximum capacity due to various sorts of problems

Libyan oil production Mb/d



More than Meets the Eye?

Shift in Paradigm....

- Is this a paradigm shift in Saudi Arabia's oil policy towards maintaining market share at any cost and leaving it to the market to find the price floor
 - 'The best quota is satisfy your customer' ((MEES, Dec 6, 2013)
 - *Mr Falih (CEO, Saudi Aramco) been reported to have said 'that he does not believe producers, whether OPEC or other industry players, should try to influence oil prices, which should be market driven. Nor would Saudi Arabia consider cutting production in response to rising output from fellow OPEC producers Libya and Angola' (MEES)*

....Or Constraints in Policy Making in Face of High Uncertainty?

- Possibility that extent of price slide caught policymakers in Saudi Arabia (like many others) by surprise
- A decision to unilaterally cut exports represents a U-turn in policy which needs time to take shape within the Kingdom and could meet resistance especially as markets becoming more competitive
- Or lack of urgency: No clear signal from the top to push things
 - In 2009: King Abdullah Bin AbdulAziz: ‘We still believe that a fair price is \$75 and perhaps \$80 a barrel’
- No high strategy: Just wait and see till there is more clarity about the status of demand (passive behavior)
- Passive behavior could have been reinforced by an expectation that demand will pick up in fourth quarter
- The market ‘over-reading’ Saudi Arabia’s steps?

Perception of a Loss of a Market Feedback

- A passive behavior in a falling market poses a big risk as it may send a signal to the market that OPEC approves and validates fall in oil prices regardless of how fast and how low the oil price goes (unintended consequence)
- A perception of fundamental change in policy would indicate that an important feedback mechanism on the downside has been lost or can longer be taken for granted
- Even if SA wishes to arrest decline in price, it may take larger actions and longer time to reassert itself in market (signals have to be credible to have an effect)
- Market perception of an absence of a key feedback mechanisms (either due to passive behaviour or change in policy) mean that markets would have a higher tendency to undershoot and therefore sharp swings in oil prices due to shocks may well become more frequent (the US supply response feedback on the upside versus the OPEC supply response feedback on the downside)