

Falling Oil Prices and Saudi Decisionmaking

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Brief Analysis

As prices drop to around \$80 per barrel, more attention is being focused on the mindset of Saudi Arabia, the world's largest oil exporter.

The 20 percent decline in oil prices over the past three months has been attributed to a wide range of factors, including declining growth in China, poor growth in Europe, and the increase in U.S. production of "light tight" oil, often known as shale oil. As always, though, Saudi Arabia's policies are a key factor shaping prices. Apart from its huge oil wealth -- nearly a quarter of proven global reserves -- the kingdom is also the leader of OPEC, the cartel of mainly Middle Eastern oil producers who leverage their collective market influence to achieve the best price. Riyadh's reaction to the latest price shifts will therefore have numerous implications at home and abroad.

SWING PRODUCER

In addition to producing more than 10 percent of the world's oil and having very low production costs, Saudi Arabia is OPEC's "swing producer." The latest figures show it producing more than 10 million barrels per day, but it could pump around 12.5 million. At times of high demand, this excess capacity enables it to increase volume, thereby smoothing price increases. And during periods of declining demand, as now, its low costs and large financial reserves mean that it can weather lower export revenues -- it has the option of either sustaining production to preserve its market share (exporting more oil, but at a lower price) or cutting production to maintain prices (exporting less oil, but at a higher price).

Neither mechanism works perfectly. For now, the kingdom has evidently decided to maintain its production volumes and tolerate the fall in price. In effect, it is contributing to price weaknesses by discounting its own prices for contracted sales to clients in Asia, believed to be companies with refineries in China, Japan, and South Korea. The widely accepted economic explanation for this tactic is that by pushing down the price, the Saudis can drive out some global competitors who use higher-cost production methods, such as Canadian tar sand companies and U.S. shale oil firms. Maintaining markets is also important to Riyadh -- especially in the competitive Asian region, which

could quickly shift to non-Saudi sources such as Iraq if the kingdom cut back output in a bid to keep prices up. And despite high shipping costs, Riyadh wants to remain a top exporter to the United States as well because of the relationship's perceived geopolitical importance.

The notion that Saudi Arabia carefully calculates its political advantage when influencing oil prices had its heyday four decades ago, when Arab countries declared an oil embargo on the United States because of Washington's support for Israel during the 1973 October War. Yet that has rarely been Riyadh's practice, and the current perception is that Saudi behavior is reactive rather than controlling.

ROYAL FAMILY TENSIONS

One reason for this belief is the kingdom's geriatric leadership situation. King Abdullah, who turned ninety-one this year, is suffering from years of heavy smoking, is reliant on bottled oxygen, and can no longer walk without assistance. His notional successor and half-brother, Crown Prince Salman, is seventy-eight and has his own ailments. He recently spent a month abroad on what was officially dubbed a "special vacation," interpreted to mean medical treatment.

In theory, Saudi oil decisions are taken by a Supreme Petroleum Council made up of the king, senior princes, and relevant cabinet ministers, but there has been no recent public announcement of any council meeting. Instead, these decisions seem to have been left in the hands of long-serving oil minister Ali al-Naimi. Although he is in his late seventies and said to be looking forward to retirement, Naimi retains a firm grip and, until recently, calmed markets with the gnomish utterances for which he has become famous.

But Naimi's magic is apparently no longer working and, worse still, has prompted a rare public display of division in the royal family. On October 13, Prince Alwaleed bin Talal, a prominent business tycoon and nephew to the king, published an open letter expressing his consternation with the minister's apparent equanimity about the price decline. Alwaleed, who has no official position in the kingdom, cited several newspaper reports as evidence, including a September 11 story in the English-language *Saudi Gazette* headlined "No Cause for Alarm." Although the headline was not an actual quote from Naimi and appeared at a time when prices had only fallen to around \$95 per barrel, the article quoted the minister as stating, "Prices of oil always go up and down so I really don't know why the big fuss about it this time." Many in Riyadh will likely dismiss Alwaleed's audacity because his father -- Prince Talal, a half-brother to the king -- has an established reputation for eccentricity. Yet his gambit almost certainly grabbed the monarch's attention. In addition to criticizing Naimi, Alwaleed's letter implicitly asked the king to fire the minister, even citing the Prophet Muhammad for good measure: "Truly a leader is not to deceive his people."

If oil prices remain weak as expected, Riyadh may feel compelled to find a scapegoat, and the aging Naimi could indeed become a political casualty. Traditionally, Saudi oil ministers have been nonroyal technocrats like Naimi. His professional alma mater, the state-owned oil company Saudi Aramco, could provide several well-qualified replacement candidates, though King Abdullah may prefer someone from the Finance Ministry or Central Bank. Another possibility is Prince Abdulaziz bin Salman, the assistant oil minister and son of the crown prince. Although he is said to be ambitious for the top job, the king may hesitate to appoint him due to the wider politics of royal succession. Abdullah apparently prefers that another half-brother, Prince Muqrin, succeed him as king -- earlier this year, he gave Muqrin the title of deputy crown prince. He may therefore be reluctant to bolster the power base of Crown Prince Salman, whom he is trying to sideline.

CHALLENGES FOR THE KINGDOM

Although the current price decline will demonstrate anew Saudi Arabia's market influence, the situation will not be without some pain at home if it persists long term. The kingdom is believed to need a minimum of around \$80 per barrel to meet its budgetary spending requirements without running a deficit. Its huge cash reserves provide a

major -- though not limitless -- cushion against such deficits. For example, if oil income fell in half from its high 2013 levels, Riyadh would still have sufficient money to maintain its generous subsidies, salaries, and handouts for years. This largesse is perceived as essential to the kingdom's implied social contract: namely, that its people tolerate their lack of democratic freedoms because of the House of Saud's paternalistic generosity. But a significant price fall would be seen as a policy failure, invigorating opposition -- perhaps including those radical Saudi youths (and potential jihadist recruits) who despise the House of Saud.

In the short term, Riyadh wants to maintain its leadership of the Islamic and Arab worlds and, more immediately, its control of OPEC. The cartel's scheduled November 27 meeting in Vienna is already shaping up as a grudge match. Saudi Arabia is opposing any cuts in the current oil production ceiling, a stance supported by Gulf Arab allies Kuwait and the United Arab Emirates. Yet Venezuela, Iran, and other members whose budgets require high oil prices will probably urge cuts. Riyadh likely believes that it would have to shoulder the bulk of any such cuts, so it will resist them. The kingdom also has no desire to ease economic pain on Iran.

IMPLICATIONS FOR THE UNITED STATES

The falling oil prices have raised concerns in the United States about the commercial viability of shale oil production, some of which ceases to cover its costs at around \$75-80 per barrel. While this may indeed be a valid concern if prices continue to fall, improvements in fracking techniques are boosting margins. In the meantime, price drops should improve the impact of U.S. sanctions on Iran and Russia, while the broader decline in energy prices will eventually boost the American and global economy. But the speed at which oil prices are weakening poses a challenge to decisionmakers across the world, and how the Saudi leadership behaves will be crucial to a smooth outcome.

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