

Relying on the Saudis: The Challenge for U.S. Oil Policy

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Brief Analysis

Over the past week, oil prices have exceeded \$40 per barrel for the first time since the 1990 Iraqi invasion of Kuwait, and gasoline prices in parts of the United States are now more \$2 per gallon. Contributing to this increase were heightened concerns about supply, particularly in the wake of a May 1 terrorist attack in Saudi Arabia, the world's largest oil exporter. Two Americans and three other Westerners were killed in the attack, and the body of one of the victims was dragged through the streets behind the terrorists' vehicle. Following the incident, the U.S. ambassador to Saudi Arabia urged Americans to leave the kingdom.

Even allowing for a trading differential of approximately \$4, \$40 per barrel is still well above the \$22-28 per barrel price band established by the Organization of Petroleum Exporting Countries (OPEC) in March 2000. Prior to the latest increase, the oil cartel's average monthly price had been \$26 per barrel dating back to the introduction of the price band. On May 10, prices dropped by more than a dollar after Saudi Arabia called on fellow OPEC producers to increase production by 1.5 million barrels per day. According to Saudi oil minister Ali al-Naimi, the kingdom issued its plea in order to prevent prices from rising "to the level that they negatively affect the growth of the international economy or the demand for oil." Stock markets ignored this gesture, however -- the Dow Jones industrial average closed below the 10,000 mark on the day of the Saudi announcement, and the London FTSE 100 index suffered its largest drop in a year.

Saudi Arabia's Crucial Role

Saudi Arabia's statements and actions regarding oil policy are crucial to global energy concerns. As the largest oil producer in OPEC and the only member with significant spare capacity, it dominates the cartel. In turn, OPEC's dominance of the international oil market gives Riyadh significant control over price. Historically, Saudi Arabia has claimed to take a responsible view of its role and has worked closely with the United States on oil policy. In recent years, however, the energy dialogue between the two countries has reportedly become more strained, especially in the aftermath of the September 11 attacks and disagreements over Iraq and the Palestinians.

Some have suggested that Washington's old relationship with Riyadh remains intact. According to Plan of Attack,

Bob Woodward's new account of the run-up to the war in Iraq, Saudi ambassador Prince Bandar supposedly promised that the kingdom would fine-tune oil prices in order to prime the U.S. economy for 2004, which would in turn help President George W. Bush win reelection. Prince Bandar has denied making this comment, however, telling Larry King in a recent interview that he had simply hoped market conditions would allow for a price decrease. In any case, evidence has emerged suggesting that U.S.-Saudi relations have become more difficult with regard to oil policy. According to some reports, the White House angrily summoned Prince Bandar after OPEC decided in February that it would cut production by one million barrels per day beginning in April, a move that contributed to the latest steep price increases. Other reports contend that Energy Secretary Spencer Abraham deliberately avoided meeting Saudi oil minister al-Naimi upon the latter's recent visit to Washington, specifically in order to reinforce the sense of U.S. annoyance.

According to Riyadh, the recent price increases were necessary in order to compensate for the depreciation of the dollar against the euro over the past year (in euros, oil prices have been stable) and for refining shortages in the United States (caused by new environmental standards for gasoline). During his visit to Washington, al-Naimi offered to build two new U.S. refineries. Yet, he insisted that any such projects not be hampered by regulatory restraints, knowing full well that environmental restrictions have prevented the approval of any new refinery in the United States for thirty years.

In reality, many factors are to blame for rising oil prices. In addition to increased U.S. demand, China has seen rapid demand growth in recent years. Political instability in oil producing countries such as Iraq, Venezuela, Nigeria, and Saudi Arabia itself is also a concern. Moreover, although OPEC quotas are theoretically responsible for restraining output, most OPEC members typically operate at their maximum production levels, leaving them with little individual control over prices. Currently, the only substantial spare oil production capacity in the world is Saudi Arabia's 2 million barrels per day. Yet, a distinguished oil analyst has suggested that the kingdom is mismanaging its oil fields and exaggerating its reserves. Although the state oil company Saudi Aramco has taken considerable pains to rebut such arguments, they may nevertheless be shaping expectations about how long the current oil situation will persist. OPEC has also blamed price increases on the involvement of noncommercial players in oil futures markets. This criticism likely holds some truth. While companies such as airlines play the market in order to determine the price of their fuel for the next six months, other players are attempting to balance against potential future depreciation of the dollar. Overall, then, oil markets have become very tight, with demand rising and supply constrained by political instability. In such an environment, Saudi Arabia effectively sets the price of oil by altering its production levels.

Although the kingdom's decisionmaking on this issue is generally opaque, Saudi bureaucrats are thought to consider factors such as the need for revenues, the desire to retain leadership over OPEC, and the need to maintain the kingdom's export share and market shares in Asia, Europe, and the United States. At the political level, Crown Prince Abdullah (the de facto leader because of King Fahd's ill health) is reportedly guided by the need to finance long-term growth while balancing the U.S.-Saudi relationship with competing domestic concerns. At the same time, it is quite easy to believe that Saudi Arabia has been encouraging higher oil prices in part to punish the United States for its policies in the Middle East, particularly with regard to the Palestinians. In 1979, Riyadh cut oil production by one million barrels per day to express its opposition to the U.S.-brokered peace accords between Israel and Egypt, and recent Saudi oil policy may have been guided by similar sentiments. Given Riyadh's May 10 call for a production increase, however, the kingdom may now be concerned that it has pushed prices too high, damaging long-term demand for its oil by making the development of energy alternatives more financially viable.

Limits of Acceptability

Just as OPEC oil rates have recently flouted the cartel's notional price band, it would seem that the U.S.-Saudi

relationship no longer operates within acceptable limits. Crown Prince Abdullah's publicly stated view that "Zionists" were probably behind the recent terrorist attacks in Yanbu shocked Washington, ruining the credibility of the prince's views on Middle East peace. His argument that only Zionists benefited from such acts was regarded as absurd, and his perceived need to invoke Zionism as a means of delegitimizing local Islamic militancy was contemptible. Moreover, reports suggest widespread sympathy in Saudi Arabia for those attacking U.S. forces in Iraq, with some Saudis lauding volunteer jihadists. Apart from policy differences, other irritants have emerged of late. On the Saudi side, travelers who had previously been frequent visitors to the United States now have difficulty with visas. For its part, Washington has grown increasingly annoyed by unexplained financial transactions passing through Saudi embassy accounts in the United States, which have made local banks reluctant to manage what was once a prestigious financial relationship.

The prospect of additional increases in oil prices, which could cause an abrupt slowdown in the global economy, underscores the urgency of pursuing vigorous new efforts in energy conservation and diversification. It is not yet clear whether concern over recent price increases will translate into political anger or a willingness to consider new policies in Washington. Barring a significant rapprochement, however, the U.S.-Saudi relationship no longer seems a safe foundation for energy policy.

Simon Henderson is a London-based associate of The Washington Institute and author of the Institute Policy Paper [The New Pillar: Conservative Arab Gulf States and U.S. Strategy \(templateC04.php?CID=33\)](#) (2003).

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