

Washington Concerns about Saudi Oil

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Articles & Testimony

Saudi decision-makers would be well advised to examine what lies behind the deep U.S. concern about oil prices. America is more worried about a politically-motivated crisis than about the usual market manipulation, writes Patrick Clawson, director for research at the Washington Institute for Near East Policy.

The smaller part of Washington's energy worries is the usual politicians' panic. Politicians hate to see consumers unhappy, especially before an election. President Bill Clinton is concerned that protests over high oil prices could develop just as quickly and unexpectedly in the U.S. as those that so badly damaged the popularity of his good friend, British prime minister Tony Blair.

This is something Saudi leaders understand well. They have learned that the interests of Saudi Arabia, as well as those of oil consumers, are best served by policies that reassure consumers that they can count on oil as an energy source. Given that its proven reserves could sustain production for at least a century, Saudi Arabia has every reason to make sure that consumers do not go hunting for another energy source to replace oil. Sensitive to Western political pressures to raise production, Saudi leaders will almost certainly work to keep prices close to, if not actually within, the declared OPEC target range of U.S.\$22-\$28 per barrel. It would be quite surprising if in fact Saudi Arabia limited its output to its new 8.512 million barrel per day (mbd) OPEC quota; 9.2mbd seems more likely for the final quarter of 2000.

Rather than how much oil OPEC pumps in the last months of 2000, what looms larger in U.S. concern about the oil market is the shortage of spare capacity. Washington is afraid that past inaction means Saudi Arabia would not be able to guarantee world energy security in a crisis.

Margin of Safety

For most of the last twenty years, there was sufficient excess capacity — much of it in Saudi Arabia — for the world to have a large margin of safety. Numerous U.S. energy emergency simulations showed that the excess capacity provided shock absorbers strong enough to absorb any blow other than a disruption of Saudi production. In other words, Washington policy-makers could rest assured that so long as Saudi Arabia's security was guaranteed, world energy security was safe. This has been an important element in the special U.S.-Saudi relationship, but it is now at risk, because that spare-capacity shock absorber is gone.

OPEC's unused oil production capacity is estimated at 0.95mbd by Petroleum Intelligence Weekly. That is an extraordinarily narrow margin. It could entirely disappear in the face of a colder than forecast winter, a few unexpected oil well repair shutdowns or a burst of extra demand from higher economic growth. As a result, what worries Washington is the potential for political disruption by secondary producers. With market conditions this tight, there are a number of oil exporters who have the power to throw oil markets into turmoil if they are so minded for political reasons. Were Venezuela's mercurial President Hugo Chavez to decide to drastically curtail his country's 3.0mbd output, there is not sufficient excess capacity worldwide to make up the difference. Iran's hard-line radicals hold a similar power to cause market turmoil if they were to scale back Iran's 2.7mbd production.

Testing U.S. Will

Realistically, the most likely suspect for creating another energy crisis is Iraqi leader Saddam Hussein. The United States is worried that he might lash out at the West by shutting down his current oil production of about 3.0mbd. Saddam Hussein would have several reasons to act. First of all, he benefits domestically when he can demonstrate that he is still a force that global powers have to reckon with. Secondly, he badly wants economic sanctions removed, and this is a good time to put on maximum pressure for a new deal from the United Nations (UN), combining Iraqi pressure on oil prices with complaints about the sanctions-related suffering of ordinary Iraqis. Thirdly, he has a history of testing U.S. will during presidential transitions, as he did in January 1993 with a crisis over Iraqi military flights and again in September 1996 with his reoccupation of Kurdish-opposition-controlled northern Iraq.

Add to this a host of less important factors, all of which push Saddam Hussein in the same direction.

Iraq has billions set aside in a UN controlled bank account from which humanitarian imports for Iraq are funded, so that even if Iraq stopped exporting oil, it could still import goods for months and months to come.

Saddam Hussein intensely dislikes the UN requirement that 25 percent of Iraqi oil earnings go to pay compensation for war damages, especially now that the main claims remaining are those of Kuwaitis, including most notably the U.S.\$15.9 billion owed to the Kuwait Petroleum Corporation (KPC). Stopping production would mean less money to the Kuwaitis.

Saddam Hussein has a record of causing turmoil in world oil markets for the purpose of personally profiting from speculation in oil futures. He is rumored to have pocketed several hundred million dollars from past episodes during which he threatened to shut off Iraqi spigots, driving the price up temporarily.

Western Reserves

Were Iraq to create an oil crisis, the Western governments would spring to react through releasing their strategic petroleum reserves. Those reserves are ample to make up temporarily for any shortfall from Iraq, even though Iraq is now the world's fourth largest oil exporter after Saudi Arabia, Russia, and Norway. Yet the problem is that the Western reserves could only make up for the shortfall for about six months, and Saddam Hussein is stubborn enough that he could keep Iraqi oil wells shut down for much longer. After all, he has shown that he can out-wait the West on weapons inspections and sanctions. So the strategic petroleum reserves are but a temporary fix.

The world's vulnerability to a political oil shock from a secondary producer like Iraq is not going to diminish soon. The key to ending that vulnerability is ensuring sufficient excess production capacity such that no secondary producer can credibly threaten a crisis. Unfortunately, the world is not going to have that kind of excess production capacity soon, on present investment plans. For instance, in 2001, world oil demand may well rise by 1.5mbd, which would absorb every drop of extra OPEC capacity that year -and half of that increase will be from Saudi Arabia.

Emergency Investment Programme

So there could be an oil crisis any time during the next year. While Western strategic reserves would meet the

immediate need, the only way to insure against this would be rushed investment programs that could increase capacity by the time the Western strategic reserves were emptied. Only Saudi Arabia is in a position to implement an emergency investment program that would quickly raise output by anything close to the necessary 2.5 million barrels a day; all the other OPEC states combined would have difficulty raising their output by even half this amount in a year. So the future of world oil stability lies in Saudi hands.

The problem is that Saudi Arabia may be hard pressed to meet the need. Confident that world oil production capacity was going to be ample – which it has proven not to be – the Kingdom's national oil company Saudi Aramco let its own production capacity slip. Some observers think that Saudi capacity fell as low as 9.5mbd earlier this year, and it is still below 10.0mbd; indeed, on present plans, production capacity will only be 10.5mbd at the end of 2001.

Saudi oil minister Ali Al-Naimi has argued that Saudi Arabia has lots of production capacity and has therefore resisted suggestions by some senior Saudi political leaders that Western oil companies be allowed to invest in new production facilities.

Political Pressure

If Saudi Arabia is not able to fill the gap in face of a crisis, there will be political pressure to open up Saudi oil fields to western upstream investments. Plus consumers may reconsider how reliable oil is as an energy source, which could feed interest in alternative energy sources and energy-conserving technologies, already popular among the environmentally minded. That, however, will only be a minor part of the story. More important will be the damage to the special U.S.-Saudi relationship. The foundation of that relationship has been Saudi Arabia's central role in preserving global energy security – an energy security that America prizes highly, both because it is the world's largest oil importer and because it is aware that energy was a major factor in the last two world economic recessions. Saudi Arabia's ability to deliver energy stability in 1990 in the face of Iraq's last major challenge to the West did much to cement the U.S. security commitment to the Kingdom. Inability to respond to another such challenge could weaken the value of the U.S.-Saudi security tie.

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