The Oil Market, the Middle East, and Saudi Policy

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Brief Analysis

Recently, Nawaf Obaid, author of The Washington Institute's recent book **The Oil Kingdom at 100: Petroleum Policy Making in Saudi Arabia, (templateC04.php?CID=32)** and Edward Morse, executive adviser at the Hess Energy Trading Company, addressed the Institute's Special Policy Forum. The following is a rapporteur's summary of their remarks.

EDWARD MORSE

The oil ministers from the Organization of Petroleum Exporting Countries (OPEC) reached an agreement last week to raise production quotas by 1.7 million barrels per day (bpd). The agreement reportedly came in response to intense pressure from Bill Richardson, the U.S. energy secretary, because a spike in crude oil prices last month led to a nine-year high of $34 a barrel. Saudi Arabia will account for the majority of the supply increase.

The U.S.-Saudi Relationship. A driving force in Saudi oil policy is maintaining Saudi Arabia's position as the leading oil supplier to the United States, as a cement for the political-strategic relationship. Because the security of the kingdom is dependent on its special relationship with the United States, Saudi Arabia wants to be seen as the most reliable and important supplier of oil to the United States.

In 1996, the Saudi share of the U.S. market fell sharply, with Saudi Arabia being only the third largest supplier of crude oil to the United States. This was an important factor in the Saudi decision to increase output and to concentrate even more on the U.S. market. Saudi Arabia reclaimed the top spot in 1999, when it provided the United States with 1.4 million bpd. But maintaining this position comes at a cost: To secure its large share of the U.S. market, Saudi Arabia has to sell its oil at a price that is about $0.75 per barrel less than market dictates. In other words, Saudi Arabia spends approximately $350 million per year to subsidize the U.S. consumer.

Another way that Saudi Arabia has guaranteed its position in the U.S. oil market is through the joint venture of Texaco, Shell, and Saudi Aramco formed in May 1998. This alliance, known as Motiva, has become the largest supplier of oil to the eastern United States. This political venture illustrates a fundamental rule of Saudi policy: First, analyze the oil needs of the United States, and then, based on those calculations, set other political and economic priorities accordingly.

Price Strategy and Prospects. The Saudis want an oil price that is high enough to achieve the revenue they need and low enough to keep the issue out of the American media. The Saudis understood that it was inappropriate for the oil price to go as low as it did in 1998-99 and that it is equally inappropriate for the price of oil to remain for a sustained period at a price higher than $25 per barrel. Indeed, if the price of oil stays above $20 for any length of time, then the oil industry would increase capital expenditures around the world: in the Caspian basin, the North Sea, and the deep waters off Latin America and West Africa. New oil would challenge the Middle Eastern suppliers, and the price would plummet again.

Recent diplomatic pressure by the United States did not facilitate reaching agreement within OPEC on a quota increase. Before the OPEC meeting, it was clear to the Saudis that the international market required more oil, and

the Saudis were sensitive to the criticism in the U.S. media about high oil prices. The Saudis were already prepared to deliver an extra 350,000 bpd as of April 1. The pressure applied by the United States only complicated the task facing the Saudis, namely, securing a consensus from other OPEC members to increase the quota.

It is not clear what effect the recent increase in OPEC quotas will have on U.S. gasoline prices. Washington estimates that U.S. refineries would have to operate at 98 percent capacity to meet demand for gasoline during the summer, the peak consumption period. But the refineries are not willing to run at more than 90 percent. What the Saudis, Mexicans and Venezuelans discovered after the OPEC meeting is that, when they offered more oil for delivery, no refinery wanted it. There may be a lot of demand for gasoline during the summer, but there are no incentives to create it now, because the price of oil delivered today is higher than the price of oil for future delivery, which can be bought on the futures markets). It makes no economic sense to stockpile oil when the futures markets are saying that the price of oil will fall. But because gasoline is not being refined and stockpiled for the summer heavy-use period, the United States may experience higher gasoline prices during the summer. The reason is not OPEC but the economic balance of incentives and disincentives within the oil industry.

NAWAF OBAID

Saudi Decision Making. The Saudi oil industry has recently undergone a major transformation with respect to how oil policy is carried out. Prince Saud al-Faysal, the foreign minister, is currently a key voice in setting Saudi oil policy. After him, the petroleum community breaks down into three main branches:

• The Supreme Council for Petroleum and Natural Gas Affairs: The Supreme Council was created this past January to "have the final word to consider actions of exploration, excavation, and production of gas and other hydrocarbonic materials, with the exception of petroleum," according to a royal decree. A subcommittee within the council negotiates with the international oil companies (IOCs). It is here that U.S. companies have the most at stake. The Supreme Council was created to provide a vehicle to create a consensus throughout the Saudi oil community. There had been some distinct differences in perspective that emerged after Crown Prince Abdullah's visit to the United States in September 1998, during which time he invited American (and later European) oil companies to reinvest in Saudi Arabia.

• The Ministry of Petroleum and Mineral Resources: The oil ministry is responsible for evaluating data, making recommendations, and implementing policy. Functionally and organizationally, the oil ministry lies above Saudi Aramco, but it no longer has any direct control over the company. The ministry's power, which has been substantial for the last twenty years, has been significantly reduced. Its role today is more of an advisory one.

• Saudi Aramco: Saudi Aramco remains responsible for actual production. It has always been managed and trained by Americans, and consequently, U.S. interests have permeated the company's negotiations. Saudi Aramco has never been run like a Saudi company with respect to its work ethic and the training of its employees. Meetings are conducted in English and middle managers are required to take an executive course at an American university if they wish to advance.

Investment in the Broader Petroleum Sector. A comprehensive debate has occurred regarding the extent to which the petrochemical and natural gas industries should be opened up. In fact, the Saudi elite understands that foreign firms can have an important role in sectors such as natural gas. Over the last ten years, Saudi Arabia could have been using natural gas to power electric and desalination plants which instead used approximately 300,000-400,000 bpd of potentially exportable oil. The failure to make appropriate use of natural gas came from a lack of the economic incentives to develop this industry. Now, the Supreme Council has proposed that the IOCs be able to enter existing oil fields and pump out the natural gas that is associated with the oil. This approach would allow for greater foreign investment, and would circumvent the expensive start-up costs. This is an example of how Saudi Arabia can benefit

from greater openness to foreign investment. Whereas U.S. companies have been most interested in direct involvement in oil production, that area is temporarily off-limits because of the extensive Saudi spare oil production capacity.

This Special Policy Forum Report was prepared by Marcus Oliver.

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