Why Saudi Arabia’s best bet may be to increase output

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In their latest oil note, Goldman Sachs describe the oil market as having a “dominant firm/competitive fringe” structure, in contrast to say a monopolistic or perfect competition structure.

This is basically the description of an oligopoly, in which a dominant firm (for decades, Saudi Arabia) only differs from a monopolist in one key aspect...

... when deciding on production it must take into account not only the market demand curve (as a monopolist does) but also the reaction of the competitive fringe producers to its production decisions.

The structure results from the fact that no single entity is ever likely to be able to service the entire market by itself, meaning full monopoly is not desirable, since the consequences of failing to provide the market with the supply it needs may be even more undesirable than being able to control the market.

As a result, the strongest player never has an incentive to push prices to a level that may encourage new competition in, nor does it have an incentive to allow prices to drop below the break-even levels of competitors. It’s primary incentive instead is to protect as steady a revenue stream it can given its position as the provider of the marginal barrel. And that involves hedging.

Hence the need, as Goldman Sachs notes, to base prices on the strongest player’s marginal cost curve:

From this ‘residual’ demand curve we now calculate the marginal revenue curve and equate it to the dominant firm’s marginal cost (or supply) curve. Equating these two functions is exactly how the monopolist behaves, with the key exception that the monopolist did not have to first account for fringe producers. With the dominant firm’s supply decided, the competitive fringe firms will supply the remaining quantity demanded at the prevailing price level (Pdominant).
Importantly, this price level is lower than what would have been set by a monopolist (P\_monopoly) yet higher than the competitive price, and hence the total quantity supplied to the market is larger than under monopoly yet less than under perfect competition (Q\_dominant > Q\_monopoly).

There is only problem with the strategy, however. It assumes that the dominant firm wants to maximise profits today.

If the dominant firm is sneaky, however, it may wish to set production quantities higher today (reducing profits in the short-run) in order to drive the fringe firms out of the market, and later return to monopolist pricing.

And this really is what we’re facing now.

**Simply put, Saudi Arabia has more of an incentive to dump even more oil on the market by upping production, than by cutting production.**

The chances of such a production increase, however, are still grossly under-estimated by the market due to a misunderstanding about what Saudi Arabia’s situation really is.

As Goldman Sachs notes, the additional quantity has flown into the market because fringe firms that are now supplying additional quantity at a fixed price of $80 per barrel. But the dominant player’s supply never changed.

So the question is, why should Saudi Arabia — which still has spare capacity to hand — be inclined to preserve that additional output at this stage?

One argument, of course, is that Saudi’s spare capacity is not large enough to take prices below $80 per barrel for long enough to truly kill off the competition.

That may be true, but as we have already stressed, leaves Saudi Arabia with only one workable strategy: to grab what it can, while it can:

Applying this stylized theory to the oil market we see a number of effects: Saudi spare capacity is currently around 1.5 mil bbl/day vs. US shale production of around 5 mb/d. Accordingly, Saudi Arabia no longer has the ability to push prices lower than the production costs of US Shale.

Cutting production would accommodate the further expansion of US shale, as well as reduce Saudi profits.

**Hence the optimal response would be to increase production to maximum (removing spare capacity, similar to non-core OPEC producers) as Saudi Arabia’s dominant-firm pricing power wanes – the scenario outlined in Exhibit 22.**
Thus US shale, through its $80-$85 range of breakeven prices, takes over the function of the primary margin for balancing supply. **In summary, the key pricing dynamic in the oil market has moved away from the dominant firm (Saudi Arabia) and towards the pace of technological improvement (change in marginal costs) of the US shale fringe firms — remembering that these firms have no individual pricing power.**

The great thing about the “dump it on the market” strategy for Saudi Arabia is that at least this way — by eliminating spare capacity from its repertoire — it can stabilise revenue flows by locking in long-term supply agreements at maximum production levels.

And this way at least, the burden of managing marginal-barrel revenue risk — and the volatility that comes with it — meanwhile, is passed over to the US shale millionaires.

Unfortunately, while this may be the optimum strategy for Saudi Arabia right now, it’s anything but for the rest of the oil producing world given that what it really amounts to is the transfer of oil hegemony to the US government.

While it may be true that the “organised” marginal barrel is via the process replaced by a competitive marginal barrel — because, let’s face it, the US shale network will never organise the way Opec did — the pricing uncertainty, volatility and revenue risk associated with the transfer doesn’t necessarily have to be absorbed by the shale sector directly.

Indeed, the swing capacity factor transfers directly to US government SPR purchases and releases instead, providing in the process an oil backing for the US dollar-reserve system as well.

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