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Nick Butler

Oil prices – the Saudi dilemma

Nick Butler Author alerts Aug 17 05:30 6 comments

Deputy Crown Prince Mohammed bin Salman visiting Jordan this month © Getty Images

With the latest analysis from the International Energy Agency showing that oil production capacity continues to rise despite the sharp fall in prices, is Saudi Arabia ready to admit that its strategy of over-production designed to force other producers out of the market has failed?

Over the last year, Saudi Arabia has been pursuing what Frank Gardner, the BBC's security correspondent, described last week as a policy of flexing its muscles – both in the region and in the oil market. The policy is obviously failing. The question now is whether the kingdom will keep going, doubling down on its current approach, or will step back and change course. The second option would involve a significant loss of face for the new king and his favourite son. The costs of simply ploughing on, however, could be much worse. The outcome will shape the future of the region and of the international oil market.

This year is proving to be a bad one for Saudi.

- At the heart of the problem is Saudi's arch rival Iran. President Barack Obama pointedly overrode Saudi concerns over the nuclear negotiations with Iran and reached a deal that is already transforming the regional balance of power. Western politicians and investors – led, of course, by the oil majors – are flooding into Tehran even before the deal is completed. Iranian oil production and exports may not rise that much immediately but over a year or two a million barrels a day could be added, undermining an already weak market.
- The concern about Iran's rehabilitation and growing regional influence has led the Saudis to intervene in Yemen against the Iranian backed Houthi forces. The ill-conceived and badly

executed air campaign has achieved little beyond demonstrating the limitations of the Saudi military. After four months, the result is a humanitarian disaster that leaves Houthi forces in control of much of the north of Yemen on the edge of Saudi Arabia's southern border.

- Meanwhile, the Saudi's attempted assertion of power in the international oil market has backfired. The US shale industry has not followed the script by obediently cutting back in production as prices have fallen, as an excellent article from the Oil and Gas Journal confirms. On the contrary, producers have used the pressure of low prices to cut costs and US shale production this year will be higher than in 2014. Around the world other oil producers, including the Russians, have responded to the price fall by increasing output to raise revenue. The oil price is back to $50 a barrel. With stocks already high and demand flat because of the Chinese downturn, prices could fall further.

So what next? King Salman bin Abdulaziz al-Saud and his supremely ambitious son Prince Muhammad bin Salman – who at the age of 30 is now not just deputy crown prince, chief of the Royal Court and chairman of the Council for Economic and Development Affairs but also defence minister and chairman of the supreme council of the state oil company Aramco – could move in one of two ways. In the conflict with Iran they could seek to form a coalition of Sunni forces across the region to counter the power of Iran's network of alliances in Lebanon, Syria, Yemen and Iraq. That may be the thinking behind the unusual visits to Riyadh in recent weeks by representatives of Hamas and of the Moslem Brotherhood. Alliances of convenience that cut across past antipathies are not unknown in the complex world of the Middle East. This could lead to a decisive intervention against the Assad regime in Syria as well as an intensification of the conflict in Yemen. Both would be soaked in blood.

In the oil market, the kingdom could simply decide that it has not forced the price down enough to hurt the shale producers. If $50 is not low enough, it could aim for $40 and if a year is insufficient it could maintain the pain for two, three, four years or more. That could explain the enhanced financial borrowing which the Saudis have announced in the last two weeks. Why run down your own cash reserves – of which $62bn has already been spent this year – when the market remains very willing to lend? There would be a cost, of course, from a strategy that caused prices to fall lower for longer but the Saudi calculation may be that most of that cost would be paid by other countries that depend on oil exports – such as Venezuela or Russia or indeed Iran.

This hardline assertive approach, however, is not immutable. The alternative is a more pragmatic view of Saudi's true interests and a more realistic assessment of whether those interests are being well served by the current policies.

The risk of even more conflict in the region is obvious. The bomb attacks within Saudi Arabia show that the enemy is now within the gates. The risk of conflict spreading south from the Islamic State of Iraq and the Levant-controlled area of Iraq and north from Yemen is real, as the August 5 suicide bomb attack at the mosque in Abha, the provincial capital of Asir, near the south-western border with Yemen, confirmed. Equally real is the hostility to Saudi Arabia from other oil producers who lack deep pockets. Some Opec members have gone along with the Saudi strategy so far but there is no real confidence in the oil cartel in the judgment of King Salman and his son and a real concern that an even longer period of low prices could lead to instability spreading.

It is hard to see how those outcomes could match the interests of those in power in Riyadh. In common with many other regimes across the region, the Saudis' primary need is to ensure their own survival in power. That requires an extended period of calm and some evidence of an improving economy for ordinary citizens.

Internally, Saudi needs economic reform such as the removal of hugely inefficient subsidies – gasoline currently costs just 16 cents a litre and the kingdom loses an estimated $80bn a year in forgone export revenue because so much oil is burnt to keep air conditioning going. Long-promised but never delivered alternatives such as solar and wind could easily displace much of the wasted oil and save money in the process. If significant new volumes of natural gas cannot be found within the country – another issue on which the current government has not dared to admit failure because of the risk of losing face – then gas could and should be imported from elsewhere.

At the same time there is a need to stabilise the oil price. The painful truth that Saudi is not the power it would like to be is evident in what has happened in the oil market. The fact that the resilience of the shale industry is so strong seems to have come as a surprise, which just shows how out of touch the Saudi rulers have become. The king is 79, the oil minister Ali al-Naimi is 80. Both perhaps thought that the world oil market still operates as it did in the 1980s. It doesn't, and a pragmatic regime in Riyadh would accept that Saudis interests lie in a stable oil price perhaps at $70 to $80 a barrel for the next five years. To get to that will require a serious cut in production of perhaps 2mbd. A few others such as Kuwait and Abu Dhabi could make smaller contributions. Opec discipline is never perfect, and will certainly be challenged as Iran and Iraq raise production over the next few years but even partial discipline is better than the alternative.

A similar pragmatism is needed on other policies. Within the region, although the rivalry with Iran is real and long standing, there is scope for co-operation – on economic issues and on the common objective of defeating Isis. To be a cause of further instability by pushing prices down can only foster hostility and add to the dislocation on which Isis thrives.

Internationally as well as regionally Saudi Arabia needs friends. US patience with the Middle East has worn thin. That will not change much whoever succeeds Mr Obama as president. Raif Badawi, a blogger who wrote seriously about the value of separating religion and political power, is still under threat of receiving 1,000 lashes. Saudi Arabia's record on human rights – with 102 people beheaded so far this year, according to Amnesty International – is giving the country a pariah status. One senior European politician told me earlier this year that he had had to attend the funeral rites of the last Saudi ruler, King Abdullah, in January but that he had stayed for as few hours as possible and hoped he would never have to set foot in the country again. Only a radical reform and modernisation can change attitudes.

These are not easy choices. On balance, I think a change of policy is more likely than not. Over the years caution rather than assertion has served the kingdom pretty well. A change of policy would probably mean a change of leadership and almost certainly the departure of the deputy crown prince.

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