

Saudi Arabia Oil Policy: More than Meets the Eye? *Executive Summary*

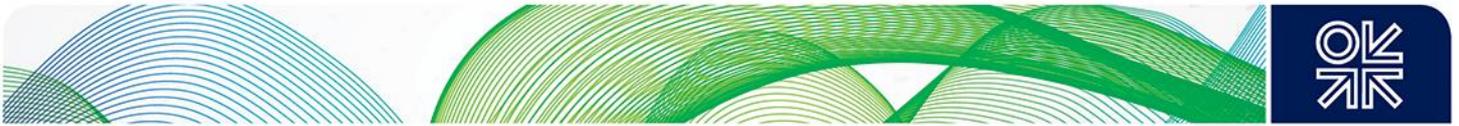
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The sharp drop in the oil price between June 2014 and January 2015 turned the world's attention to Saudi Arabia's role in the oil market and the determinants of its oil output policy. Initial hopes that Saudi Arabia would come to 'rescue' and 'balance' the market and put a floor under the oil price were replaced by stories of 'price wars' and 'conspiracy theories' aimed at pushing prices down to achieve some wider geopolitical objectives. This raised a set of fundamental questions: has there been a shift in Saudi Arabia's oil policy? And if the answer is yes, what are the implications of this shift in policy on the short and long run dynamics of the oil market? Has the role of 'swing producer' shifted from Saudi Arabia to the US shale producers? Is Saudi Arabia still relevant in the 'new oil order'? This paper argues Saudi Arabia's oil policy should not be analysed in isolation of the evolution of global oil market dynamics. It is also fundamentally rooted and shaped by some salient features of its political, economic, and social systems.

Given Saudi Arabia's multiple objectives, some of which are short term while others are long term, and also given the limited number of tools available to policy makers (essentially: adjusting output and signalling to the market in the short term, and determining the pace of investment in its energy sector in the long term), Saudi Arabia faces trade-offs with regards to its oil output decisions. One key trade-off is between the objective of revenue maximization vis-à-vis that of maintaining market share and production volumes above a certain level. Shaped by changing market conditions, lack of internal cohesion within OPEC, and the advent of US shale (which has introduced many uncertainties to the supply response), the trade-off for Saudi Arabia in the current market context has favoured market share over short-term oil revenue maximization. In 1985–1986, the relevant trade-off in the circumstances of the time favoured volume over price, after volumes went down to unacceptable levels. In 1998, the trade-off eventually favoured price over volume, given that the very negative impact of abysmally low prices on revenues induced an agreement on collective cuts from both OPEC and non-OPEC producers. From Saudi Arabia's perspective, keeping market share whatever the cost is not set in stone; its policy can change depending on market circumstances and the behaviour of other market players. The kingdom's oil policy is flexible and its preferred 'oil price' remains a moving target depending on oil market conditions. This explains why over the last few years the preferred price continued to drift upwards from \$20, to \$60, to \$75, and most recently to \$100.

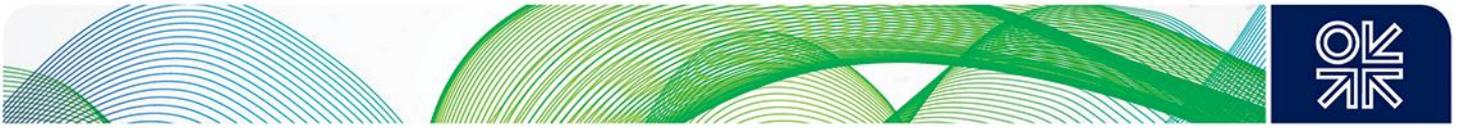
While Saudi Arabia's output policy has not been uniform over the years, it is possible to discern some general trends, which can help explain Saudi Arabia's behaviour during past cycles and, more importantly, help anticipate its output policy in future cycles.

- Maximizing revenues will always rank high in the formation of Saudi Arabia's output decision, but this objective should be balanced against another objective of maintaining output above a certain level and maintaining its share in key markets. The trade-off between these two objectives tends



to change over time depending on market conditions, the nature of the shock, and the behaviour of other producers; hence Saudi Arabia's output policy is not constant. With the advent of US shale, Saudi Arabia has entered uncharted territory where it is still learning about a new source of supply and its responsiveness to price signals. This has made the calculus of the trade-off more uncertain. As Saudi Arabia learns more about this new source of supply, its policy will adapt accordingly. This highlights the importance of relying on dynamic models that allow for changes in Saudi Arabia's behaviour. Attempts to fit Saudi Arabia into one category have failed in the past and would most likely fail in the future, as its output policy is constantly evolving.

- The fact that Saudi Arabia's oil policy could be subject to change will keep the market second-guessing and will continue to shape market expectations and influence prices. This, however, will reduce its signalling power. For instance, in the past, Saudi Arabia has sent market signals about its preferred price or price range, but these were moving targets and most of the time they tended to validate the prevailing market conditions. Over time, such pricing signals will become less effective as the market will consider these moving price targets as 'cheap talk'.
- Saudi Arabia's behaviour has been asymmetric during price cycles. In the case of a disruption, or in a rapidly rising market, it is willing to fill the gap without any coordination with other OPEC members, but in a weak market, it is not willing to cut output unilaterally. In the current cycle, Saudi Arabia is not opposed to cuts to balance the market and support the oil price, but these cuts have to be implemented collectively with other producers both from within and outside OPEC (though Saudi Arabia is very well aware of the difficulties involved in reaching and implementing an agreement to cut output in the current cycle). The market should not expect Saudi Arabia to play the balancing role by itself. Furthermore, while the kingdom can still adjust its output, this has become more costly and its output is likely to fluctuate within a narrower range than was seen in previous cycles.
- Saudi Arabia will continue on its drive towards downstream integration, which is likely to affect its position in both crude and products markets in the longer term. As it starts exporting more refined and petrochemical products and less crude, Saudi Arabia will have to adapt its output policy and marketing strategies, as the nature of the competition in the two markets is very different. The kingdom will also have to optimize the supply of its crude to its own refineries and export markets, adding an additional constraint on its output policy and hence its ability to shape market expectations as a 'refiner'. Traditional tools as such as quotas in production will become less effective as competition shifts to the products market.
- In the current cycle, there is a perception that OPEC (or Saudi) feedback has been lost (and for some observers it is a thing of the past). Perception of the loss of 'Saudi feedback' on the downside implies that oil prices are likely to become more prone to undershooting – sharp adjustments in oil prices may therefore become more frequent. Increased volatility, together with the perception that prices could fluctuate within a wide range, can cause investors to reassess the risks in new energy projects, discouraging overall investment and increasing the value of the option to wait.
- Faced with a high degree of uncertainty, Saudi Arabia will be reluctant to invest in new capacity. Given the rapid rise in its domestic demand and the increased risk of disruptions in many parts of the world, the availability of spare capacity should not be taken for granted. This poses a key challenge for Saudi Arabia. Given the size of its reserve base, securing long-term demand for its oil is key for the sustainability of its economy. Higher and more volatile prices do affect demand patterns and hence Saudi Arabia has the incentive to maintain enough spare capacity to keep a lid on the oil price. Low spare capacity will also limit the kingdom's ability to use production policy to enforce discipline among producers if needed. On the other hand, investing in idle capacity is costly and high spare capacity tends to be associated with weaker oil prices. Getting the balance right will prove very challenging in the current context. US shale producers will not be able to play the role of swing producer as effectively as Saudi Arabia, as their adjustment in falling and rising markets is far from smooth.
- While climate change policies aimed at substituting away from oil pose a threat to its long-term development strategy, there is a strong belief among Saudi policymakers that oil will continue to



play a role in the world's energy mix and that Saudi oil will be competitive in a 'carbon constrained' world. There is a clear recognition of the fact that in the face of climate change policies, diversification of the kingdom's economic base and income sources remains the only viable long-term response.