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The Evolution and Prospects of Saudi Arabia – Russia Oil Relations: A Saudi Perspective

Bassam Fattouh
Oxford Institute for Energy Studies

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Saudi Arabia's oil policy

Multiple factors shape Saudi oil policy

1. Domestic structural features:

- Massive oil and gas reserve base which will take many decades to exhaust;
- High dependency of the economy on oil revenues;
- Only oil-producing country with an official policy to hold spare capacity;
- Political leadership (high spending requirements, more assertive foreign policy, geostrategic relations with major superpowers).

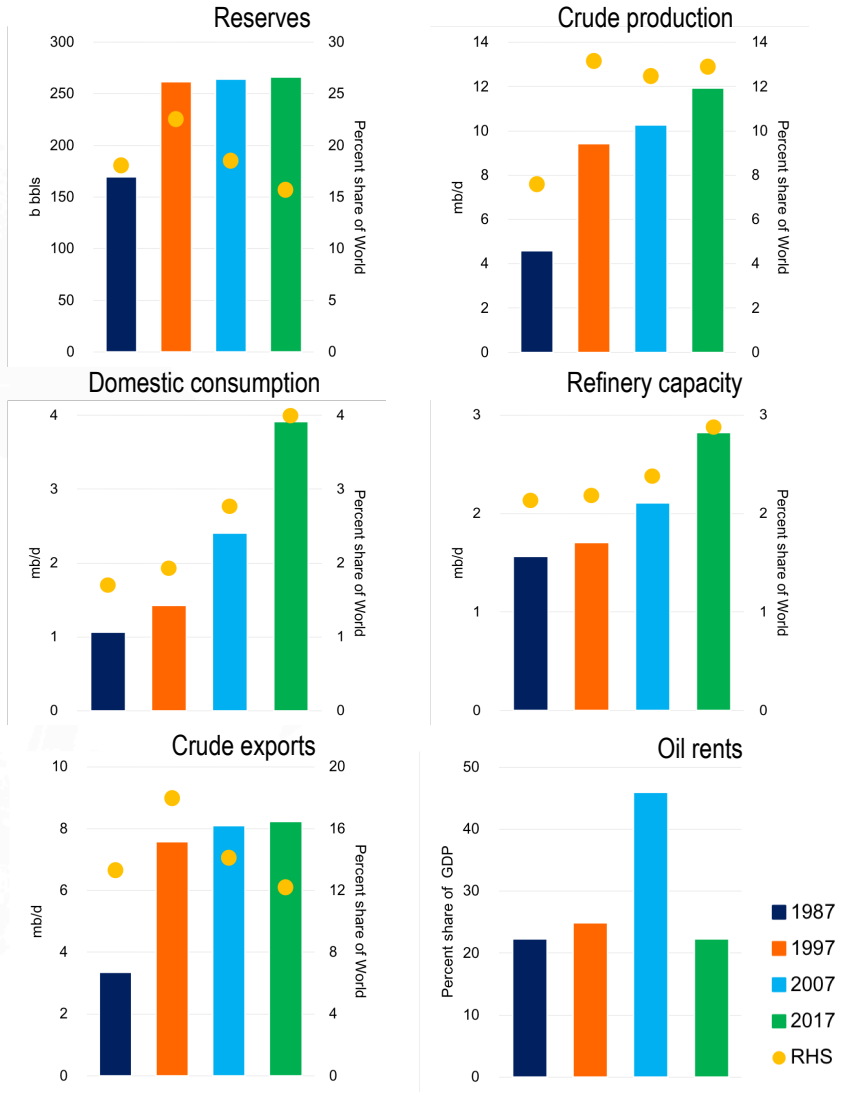
2. Cohesions within OPEC and relations with non-OPEC.

3. Nature of shocks hitting the oil market (temporary vs. structural) and the wide uncertainties associated with oil shocks.

Saudi oil policy should be analysed in the context of multiple objectives, trade-offs, internal constraints and few policy tools available.

Saudi Arabia oil policy is not constant, but it evolves in a dynamic context as trade-offs change over time, conduct of players change and uncertainties are resolved as new information arrives.

Saudi Arabia oil statistics



Data: BP, World Bank, OIES

What is this relationship about?

The Saudi – Russia oil ties

In 2017, King Salman became the first ever Saudi Monarch to visit Russia cementing the KSA-RUS ties

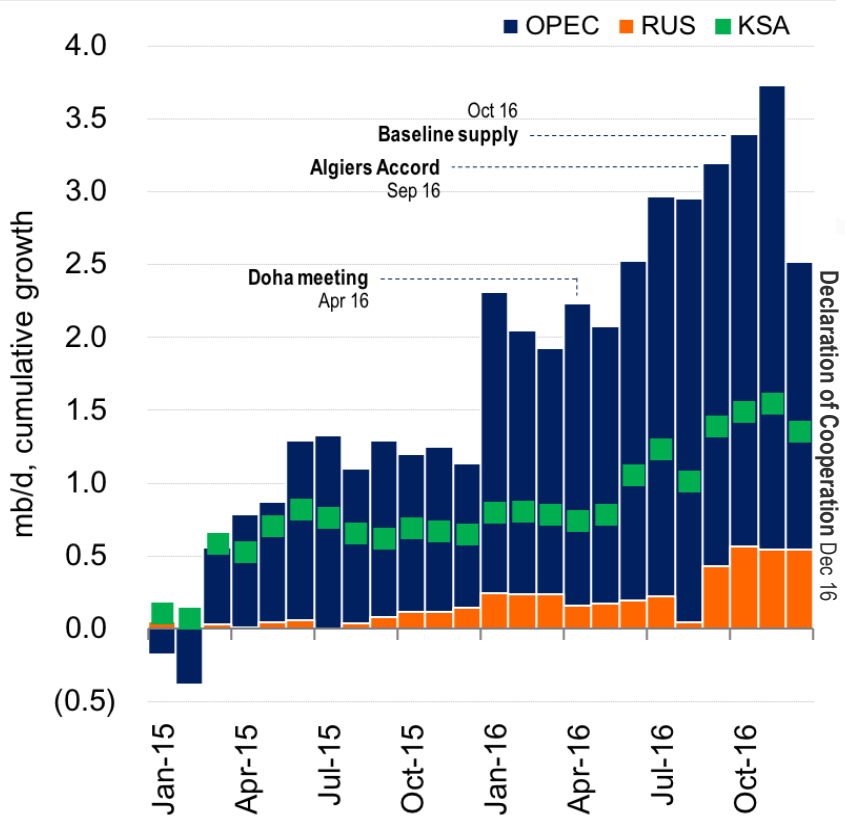
- The Saudi Arabia – Russia relationship has mainly centred on oil and energy relations.
- The expansion of this relationship to other non-energy related areas has been limited.
- There are major disagreements on multiple fronts including Iran, Syria, Qatar and Yemen.
- Improved oil relations will contribute little to nothing to bringing the parties closer on other regional issues.

Source: Getty Images

Has the relationship contributed to shaping market outcomes?

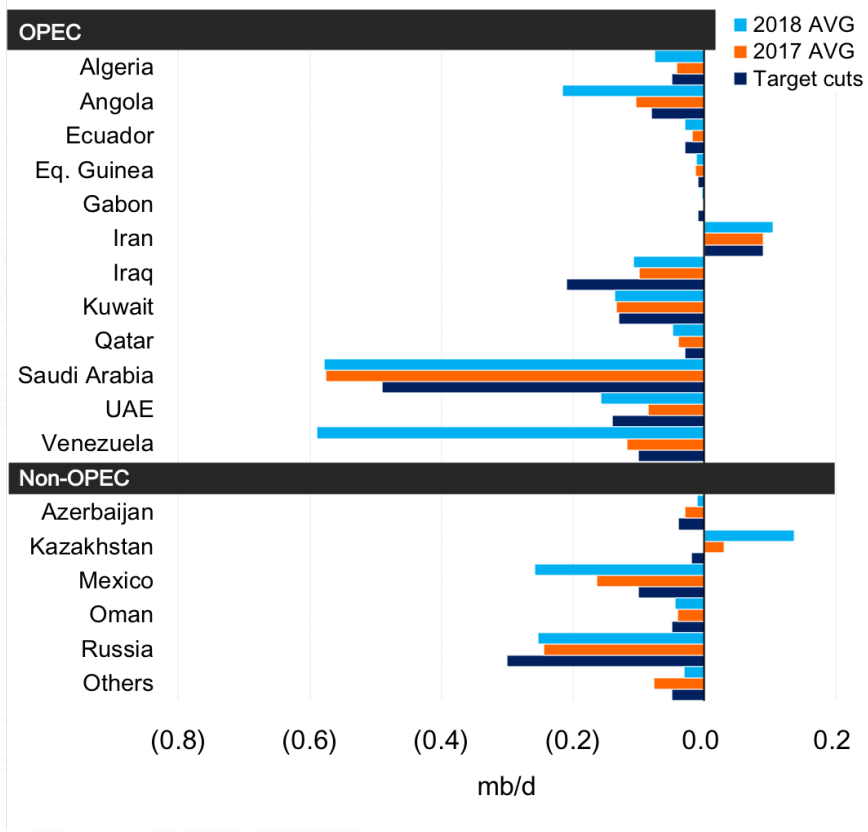
Several episodes illustrate the extent of the change

KSA and Russian output growth, Jan 15 – Dec 16



Cooperation between KSA and Russia cemented the foundation for reaching the Declaration of Cooperation in December 2016 that constituted an unprecedented milestone in the OPEC/NOPEC producers' relations.

OPEC+ target and actual output cutbacks

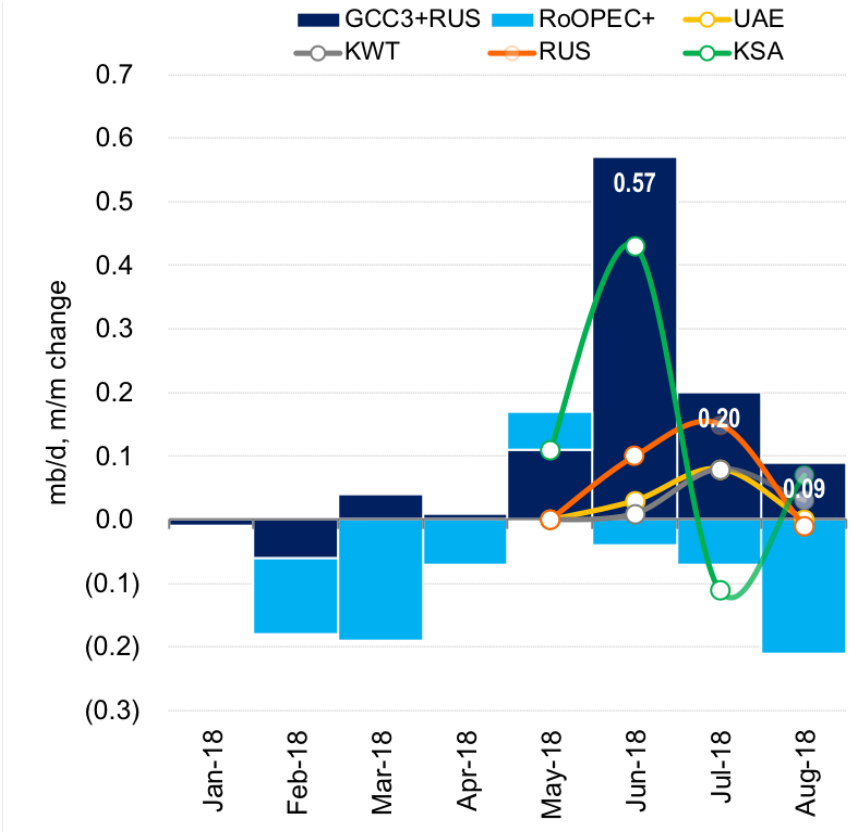


The unprecedented conformity levels achieved by the OPEC+ producers, led by KSA and Russia, surprised the market and proved that both producers were committed to bringing the market into balance.

Data: IEA, OIES

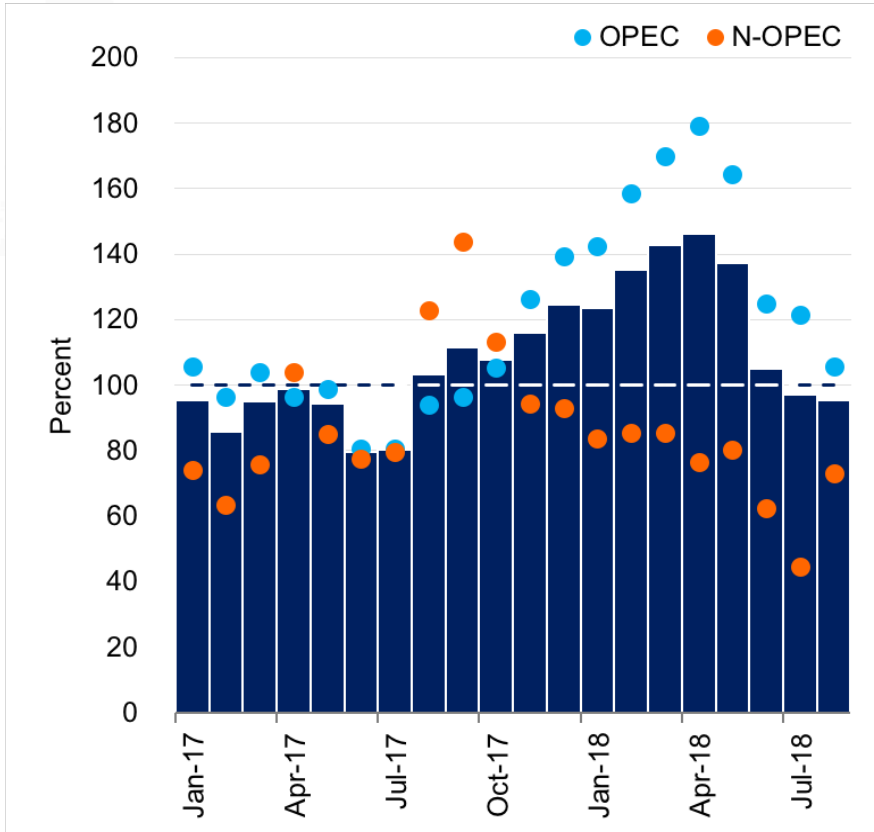
Another milestone has been the recent coordinated shift in output policy

GCC core and Russian production, Jan – Aug 18



Before the OPEC meeting in June 2018, KSA and Russia agreed to increase production outside the framework of producers' cooperation. Output hikes from the producers reached almost half the entire OPEC target cut (0.53 mb/d).

OPEC+ compliance, Jan 17 – Aug 18



KSA and Russia pushed for 100% compliance, allowing for those producers who could increase output to do so above their individual quotas. Notably, OPEC+ compliance from June to August 2018 averaged at 99%.

Data: IEA, OIES

Private deal in September?

KSA-RUS output deal to cool rising prices

- Reuters reported that Russia and Saudi Arabia struck a private deal in September 2018 to raise oil output and informed the US before a meeting in Algiers (JMMC Meeting) with other producers.

"The deal underlines how Russia and Saudi Arabia are increasingly deciding oil output policies bilaterally, before consulting with the rest of OPEC"

- Khalid al-Falih at a Moscow energy forum in October confirmed that the Kingdom increased its output in September and plans to raise its oil production further in November from an October level of 10.7 mb/d to meet rising crude demand.

- The Saudi Arabian Energy Minister added that the Kingdom was in weekly communication with Russia to stabilize the global oil market.

REUTERS

Olesya Astakhova, Rania El Gamal

BUSINESS NEWS OCTOBER 3, 2018 / 10:50 AM

Exclusive: Saudi Arabia, Russia agreed in September to lift oil output, told U.S.

Source: Reuters

Is the oil relationship symmetric?

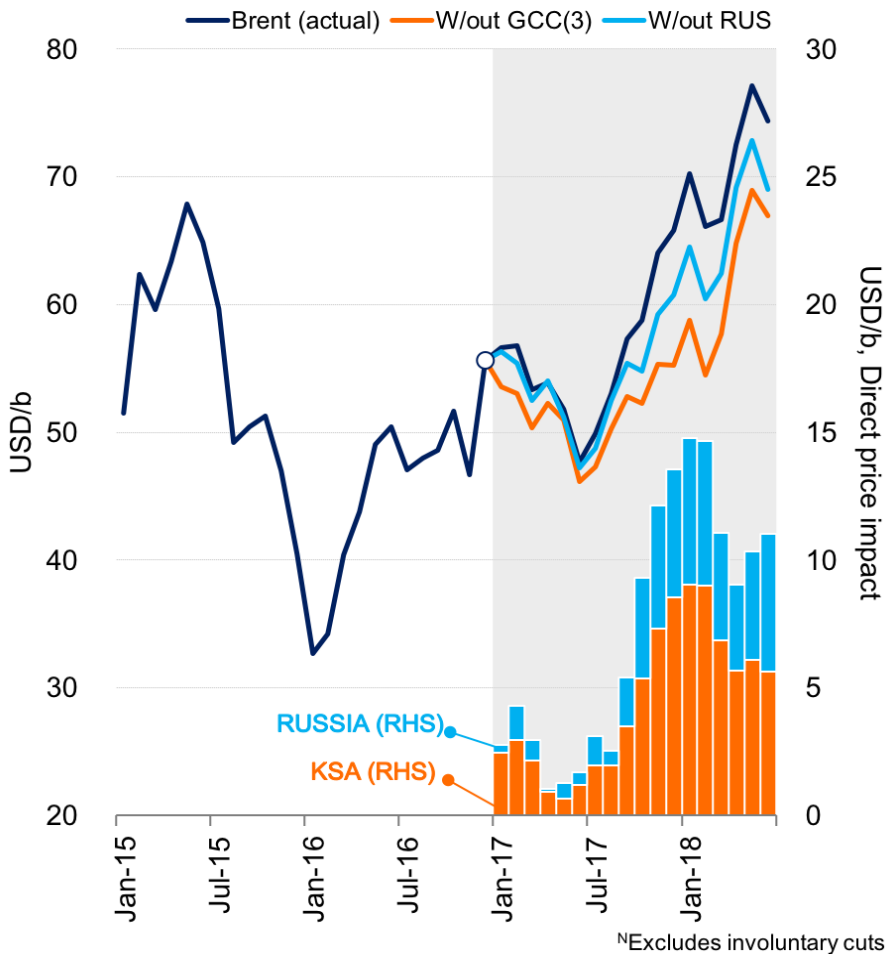
Despite a strong unified signal to the market, asymmetry exists

Saudi Arabia leads the producers' pack

- Saudi Arabia still does most of the heavy lifting when it comes to rebalancing the oil market.
- Notion that Russia calls the shots is misguided.
- Without Saudi Arabia there would be no producers' agreement and without GCC(3) output cuts the market would have taken much longer to rebalance.
- Though, without Russian participation it would have been more difficult for OPEC producers to reach an agreement in November 2016.
- Also, Russia did commit to its pledged output cutbacks this time round and contributed to the market rebalancing and the price recovery process.

An agreement to adjust output between two of the world's largest producers sends a strong signal to the market and currently any break in this alliance will affect market sentiment.

Direct impact of the KSA and Russia output cuts on the Brent price, Jan 15 – Jun 18



Data: OIES

How did this relationship evolve?

Oil market cycles and structural transformations within KSA

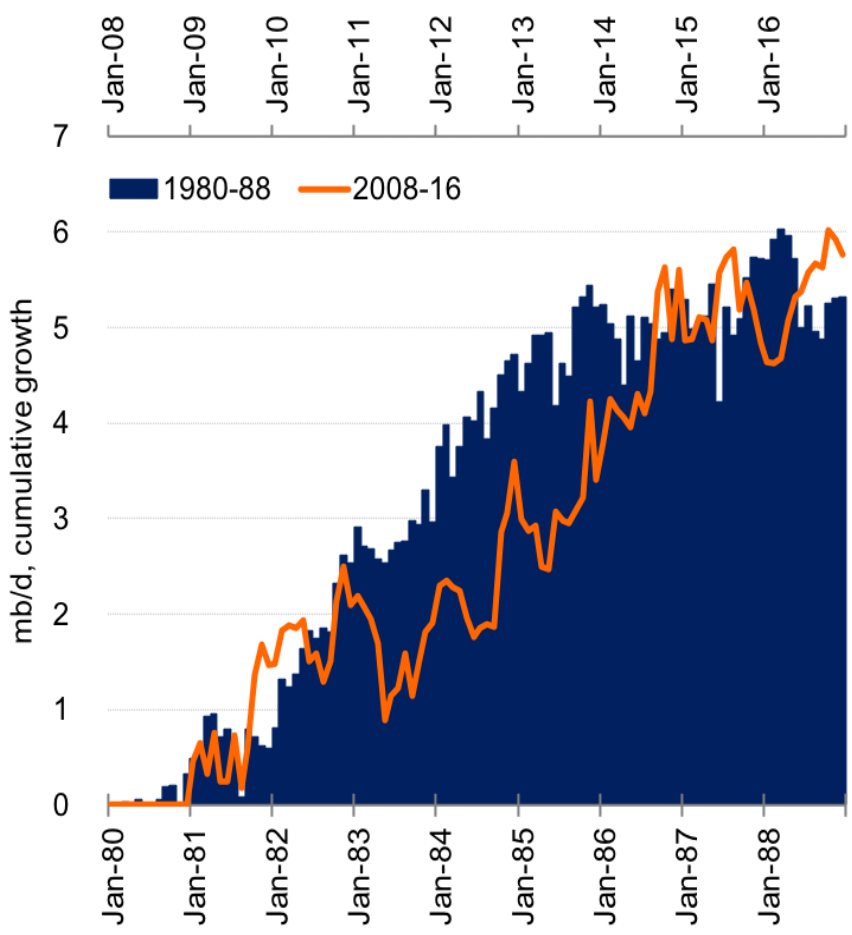
Current oil policy shaped by the 1980s experience

- In the early 1980s, OPEC was faced with multiple shocks on both the supply and demand sides.
- Saudi Arabia tried to defend the price but ended up cutting large volumes of production without succeeding in reversing the price declines and resulting in huge drop of oil revenues and market share.
- The failure of Saudi Arabia to reverse the price collapse at the time reflects the underlying nature of the shocks hitting the oil market: that is **structural rather than temporary.**

Since then, Saudi Arabia has taken a strategic decision not to balance the market on its own.

- Any output cut thereafter has to be done in agreement with other producers within and outside OPEC and as such in every episode that followed KSA insisted on collective cuts (e.g. 1998, 2001, 2008, 2016).

Comparison of non-OPEC production growth between 1980-88 and 2008-16



Data: EIA, OIES

There were many attempts to involve Russia on collective cuts

Albeit, the history of Russia cooperation with OPEC is bleak

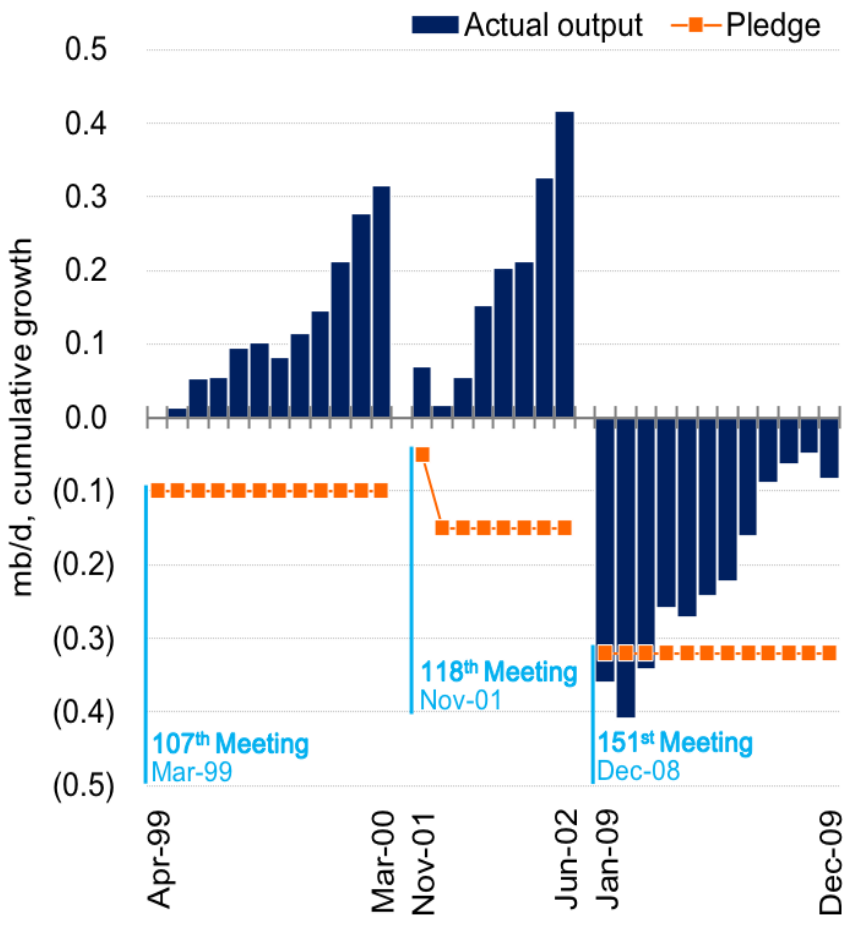
1999 In the aftermath of the 1998 oil price collapse, Russia agreed to cut its production by 0.1 mb/d as part of an agreement between OPEC and non-OPEC oil producers, but in reality output rose by 0.31 mb/d.

2001 In 2001, OPEC promised an output cut of 1.5 mb/d if non-OPEC producers could find a further 0.5 mb/d reduction. Initially, Russia responded by making an offer of a 0.05 mb/d cut. Russia later announced a cut of 0.15 mb/d in December 2001 but ultimately delivered no reduction at all.

2009 In 2008-09, Russia's Deputy Prime Minister Igor Sechin attended three consecutive OPEC meetings as an observer, setting off widespread rumours that the oil producer might consider joining OPEC.

He told OPEC delegates in December 2008 that Russia may restrict its supplies by 0.32 mb/d throughout 2009 to support prices. Despite this, during negotiations Russian output rose by 0.32 mb/d before declining by 0.14 mb/d year-end.

Historical episodes of Russia – OPEC cooperation



Data: IEA,OIES

In 2014 Saudi Arabia decides to pursue market share strategy

OPEC's fundamental dilemma in 2014

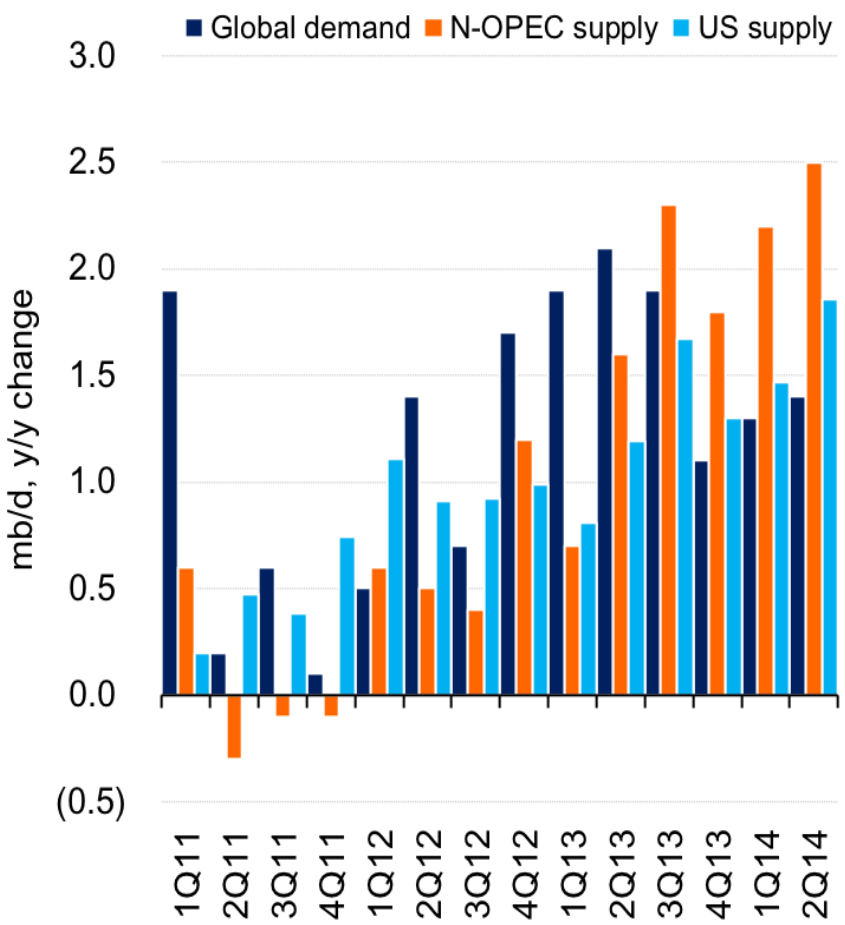
- In 2014, Saudi Arabia was reacting to an imbalance caused by fundamental forces unleashed by high oil prices.

In face of imbalance two options:
Cut output *or* leave it to the price mechanism to clear the market?

- Factors shaping Saudi Arabia's decision in favour of pursuing market share strategy (i.e. the second option):

1. Size of market imbalance in 2014 was relatively large.
2. Unwillingness to act unilaterally to balance the market; a fundamental principle shaped by 1980s experience.
3. Difficulty of reaching an agreement within OPEC and with non-OPEC producers as the pain of lower oil revenues was not widely felt and many countries had ambitious plans to increase productive capacity.
4. Saudi Arabia built strong fiscal buffers during the boom years and perhaps belief that it could withstand a lower-for-longer oil price.
5. US shale introduced a new set of structural uncertainties, unlike the 2008 temporary shock, which limited Saudi Arabia's ability to respond, at least in a sustainable way.

Global oil demand and non-OPEC supply, 1Q11 – 2Q14



Data: IEA, OIES

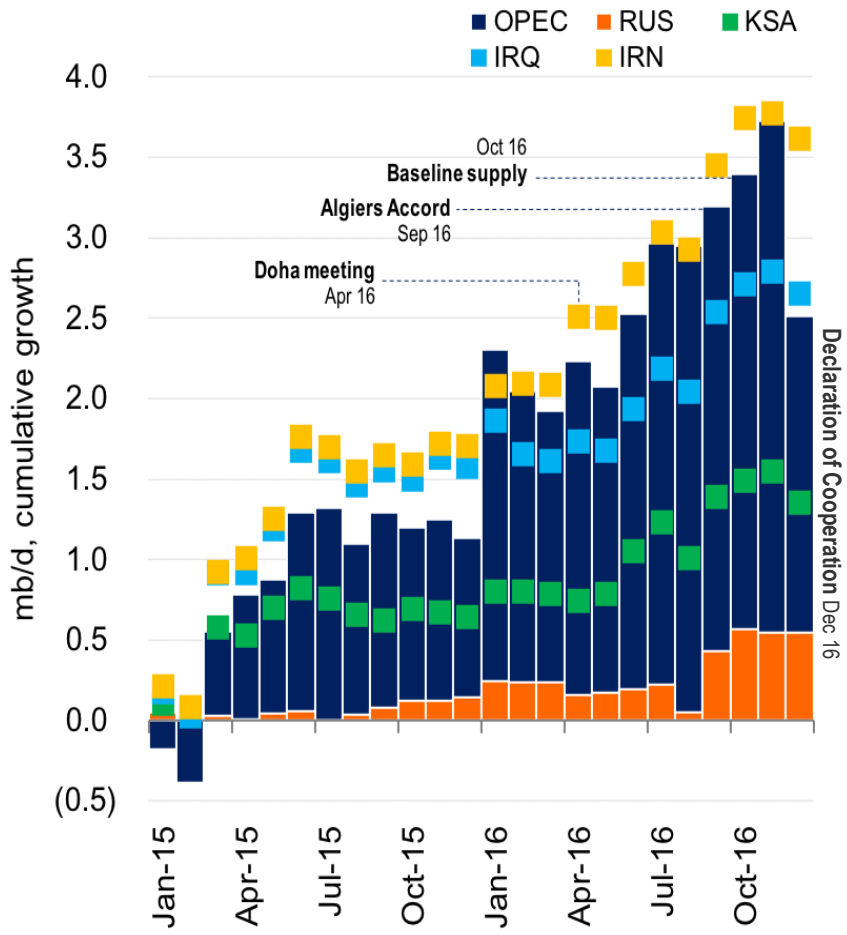
The long journey to reaching an output cut deal

No oil exporter is immune to sharp falls in oil revenues

- In 2016, Saudi Arabia showed willingness to freeze output and cooperate with other producers, but signal was not always clear and in 2H position shifted from *freezing* to *cutting* output.
- Failure of Dohan meeting to freeze output brought Saudi Arabia-Russia oil relations to a very low point.
- Russia and Saudi Arabia seemed a long way apart after the Doha meeting in April 2016.
- However, a series of inter-governmental meetings and agreements on lower level technical cooperation between Russia and Saudi Arabia provided a foundation for further talks.
- Key was the G-20 summit in China in September 2016, after a meeting between President Putin and Crown Prince Mohammed bin Salman in which they discussed avenues to cooperate on the oil front.

It took a long time to reach an agreement; output from the negotiating OPEC and n-OPEC producers surged before the implementation of the agreed cuts.

OPEC and Russia output growth, Jan 15 – Dec 16



Data: OIES

So, why now?

Fall in oil revenues was the key factor

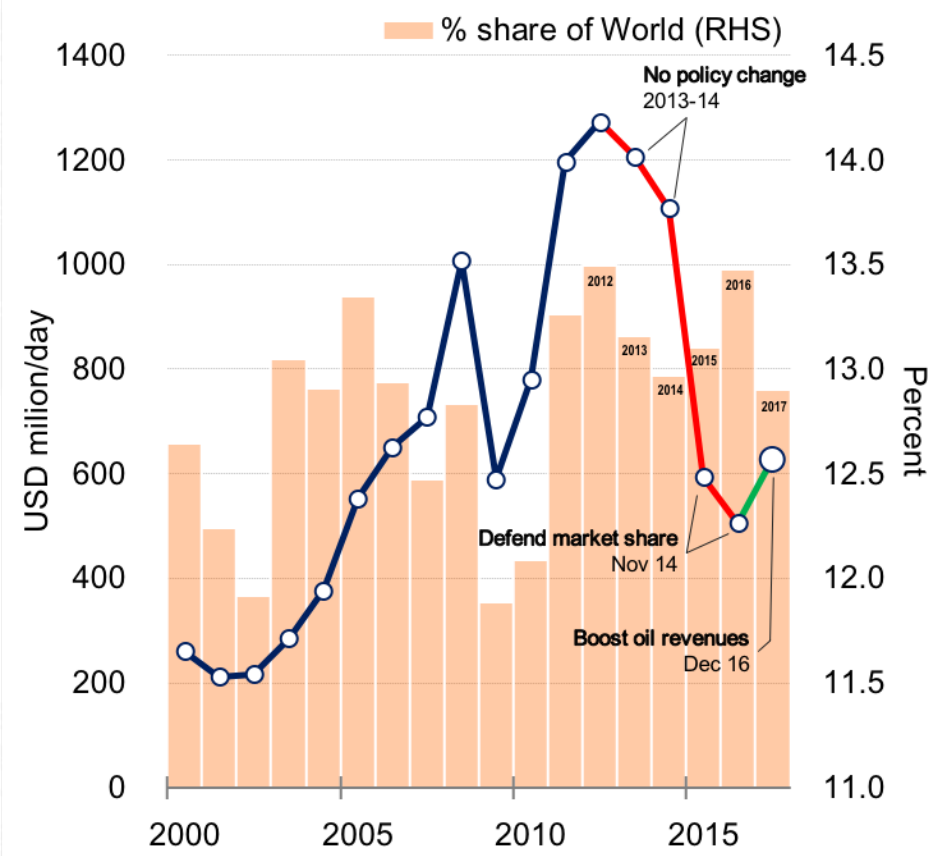
Despite adjustment measures, fiscal challenges persisted

- Confronted by a sharp price fall in 2016 and the fall in oil revenues, Saudi Arabia had to reverse its course and seek cooperation with other producers.
- The Kingdom soon realised that despite the adjustment measures to a low oil price environment, these had not been enough to address its fiscal challenges:

1. Draw down on foreign reserves;
2. Increase domestic lending;
3. Tap international debt markets;
4. Increase domestic energy prices;
5. Reduce capital spending;
6. Boost non-oil revenues;
7. Devaluation (albeit, it was never really on the table).

Saudi Arabia is constrained by the fact that its economy is highly reliant on oil revenues at a time when its spending keeps increasing.

KSA gross oil revenues v market share, 2000-17



Data: OPEC, OIES

Change in Saudi power structure

Consolidation of power in the hands of MBS

- The change in Saudi power structure and the unprecedented consolidation of power within the hands of Crown Prince Mohammed bin Salman (MBS) who controls the Kingdom's main pillars:
  1. Economy;
  2. Defence;
  3. National guard;
  4. Intelligence;
  5. Foreign policy.
- MBS pursued a more assertive foreign policy emboldened by closer alliance with the US and heightened threats from Iran.
- At the same time diversifying its foreign relations.
- The politics of 'strong men'.

MBS pushed for the agreement with Russia at the highest level.

G20 Summit in Hangzhou China, 4 Sep 2016

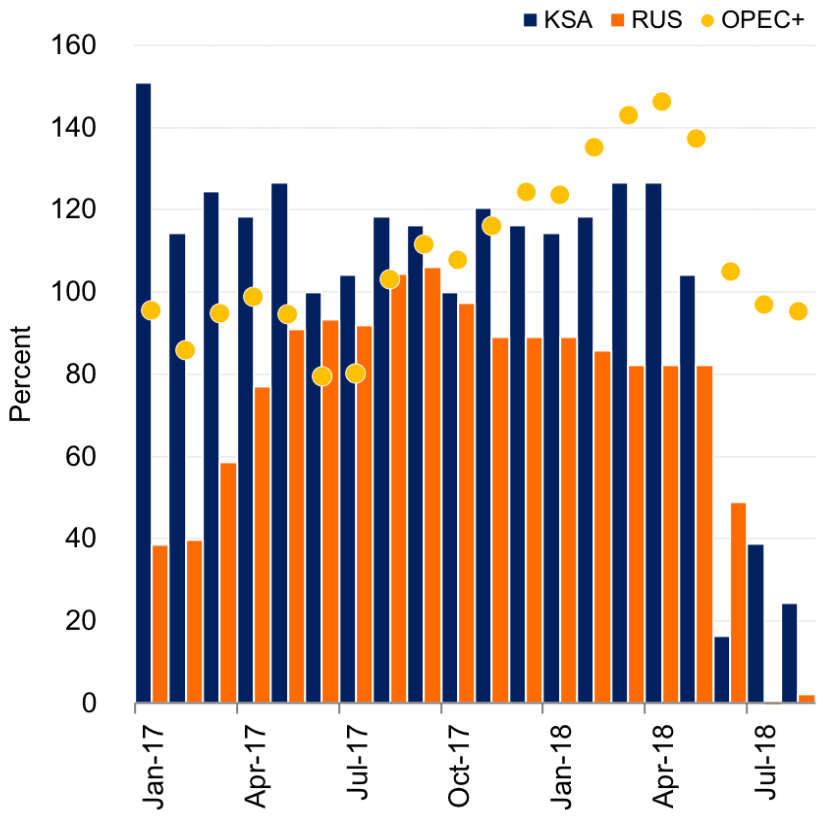
Featuring Russia's President Vladimir Putin during a meeting with Saudi Arabian Crown Prince Mohammed bin Salman

Source: Alamy

Has the relationship been successful?

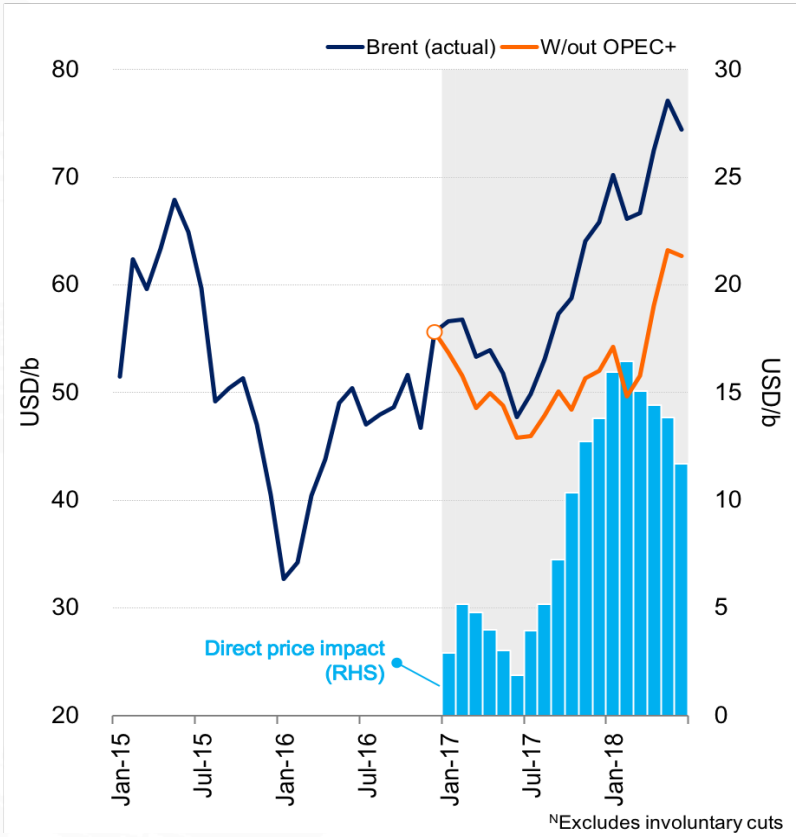
The KSA - Russia cooperative framework worked remarkably well

OPEC+ output compliance, Jan 17 – Aug 18



Both OPEC and non-OPEC producers in the DOC exhibited higher than expected output compliance to their pledged targets, with KSA leading the pack. Since June 2018 compliance remains near 100%.

Direct impact of the DOC on Brent price, Jan 15 – Jun 18



The producers' cooperative framework under DOC accelerated the price recovery, adding more than $10/b to the Brent price, despite strong US shale growth and supported by favourable demand conditions.

Data: OIES

Can this relationship continue?

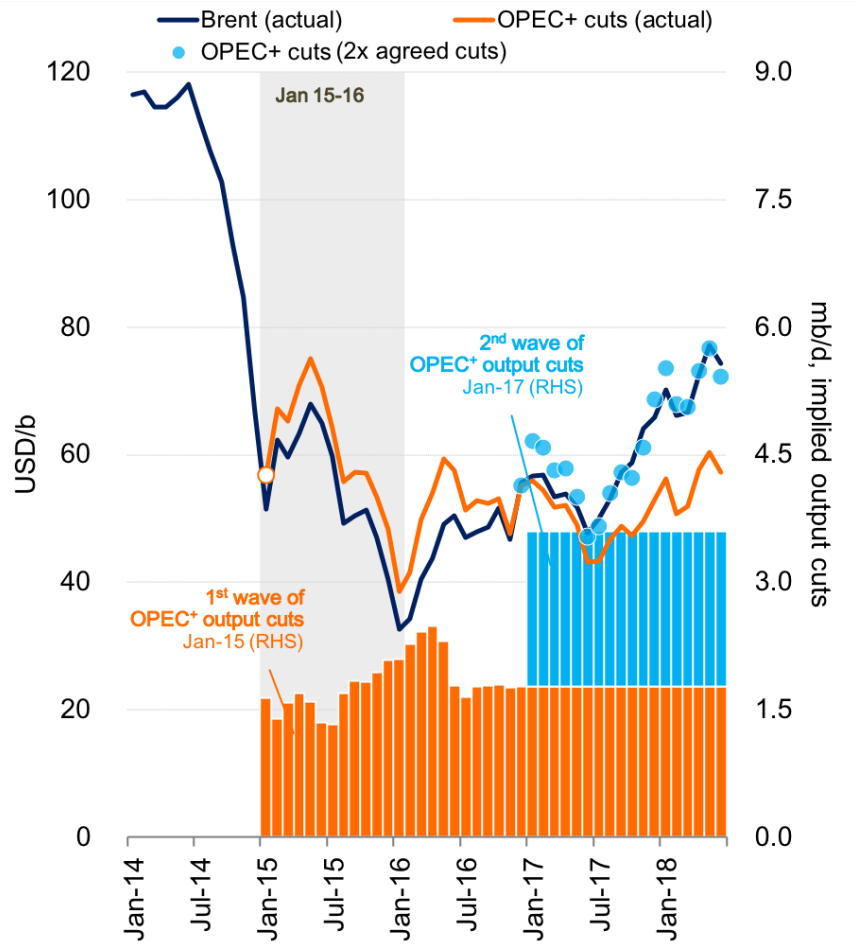
Plans to extend the framework of cooperation beyond 2018

But the relationship is yet to be seriously tested

- It is highly likely that Saudi Arabia and Russia will maintain a close level of cooperation even after the expiration of the current output cutback deal.
- According to media reports, both OPEC and non-OPEC producers are aiming to formalise their long-term cooperation later this year by approving a charter that will make further joint coordination of oil policies, aimed at stabilising the oil market, possible.
- However, despite its short-run success, a long-term cooperation is faced with multiple challenges of a different nature compared to the current short-run cooperative framework.
- Relationship yet to be tested: What if there is a negative demand shock and US shale continues to increase and the cuts needed to balance the market are large?

But the alternative of non-cooperation also comes with a high cost.

Brent price outcomes under the scenario that DOC is enforced in January 2015, Jan 14 – Jun 18



Data: OIES

Will this renewed relationship reduce the importance of OPEC for Saudi Arabia?

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Bassam Fattouh, Director OIES

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