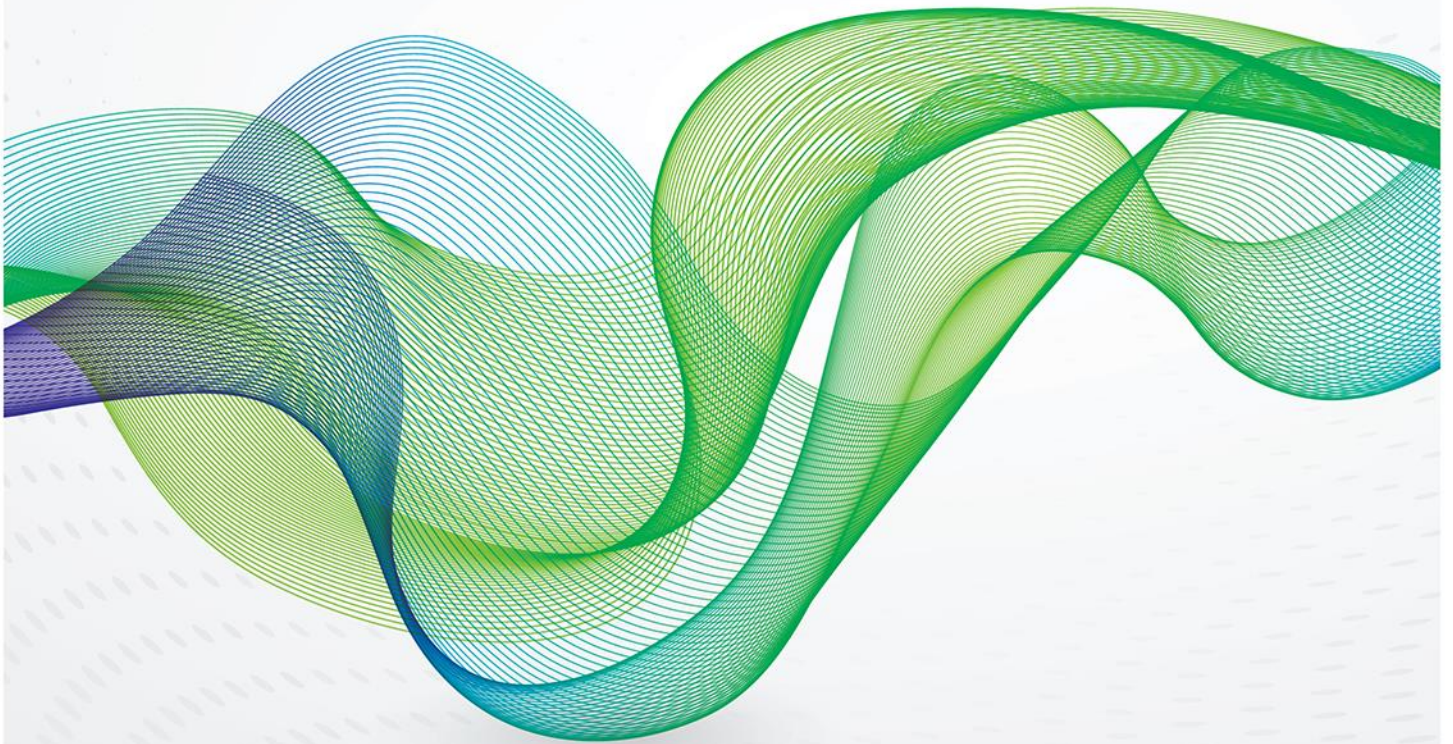


August 2019

Saudi Arabia's Next Oil Move



The sharp decline in the Brent price to below \$60/barrel and the weakening of oil demand outlook due to the US-China trade war has brought to the fore the issue of Saudi Arabia's next move. There have been multiple media reports indicating that Saudi Arabia would not tolerate the latest price slide and that the Kingdom has approached other OPEC members to discuss possible steps to arrest the decline in the oil price.¹ To most analysts and investors, this signals that Saudi Arabia is willing to cut its output further² to try to maintain a floor under the oil price regardless of the nature of the shocks hitting the market. When Saudi Arabia embarked on the long journey of rebalancing the market this is the situation it was hoping to avoid. In 2017, the Saudi oil minister, Mr Khalid Al-Falih declared that Saudi Arabia's balancing role in the market 'will not bear the burden of free rides' and should 'not tip investors into 'irrational exuberance' or 'wishful thinking that OPEC or the Kingdom will underwrite the investments of others at our own (the Kingdom's) expense'.³

Shocks and Constraints

While the recent signal from Saudi Arabia may give the market and investors some confidence that the oil market has a shock absorber, the reality is much more complex. If the recent decline in the oil price is solely driven by macro sentiment, then the impact will be temporary, and fundamentals will eventually reassert themselves, requiring no shift in current Saudi oil policy, as OPEC voluntary and involuntary output cuts will continue to tighten the market balances. Signaling that Saudi Arabia and OPEC will do 'whatever it takes' could backfire as it raises market expectations that deeper cuts are on the way. If the oil price decline is instead being driven by a shift in market fundamentals, then there might be room for an output response, but, the decision to respond and the type of response would depend on multiple factors including the nature of the shock and the constraints facing Saudi policymakers. What makes the current context particularly complex is that the recent decline in the oil price reflects both the deterioration in macro sentiment, as recessionary fears grow, and the deterioration in the outlook for fundamentals, as demand growth continues to be revised downwards. In short, the US-China trade war represents a shock to sentiment, fundamentals, and expectations about these fundamentals.

Regarding the nature of the current shocks, there are two main shocks pushing the oil market in opposite directions. On the one hand, the US-China trade war and a general deterioration in global macroeconomic indicators are causing a slowdown in oil demand and sharp downward revisions in global oil demand growth expectations. In its latest report, the IEA has noted that in the first five months of 2019, oil demand grew at its weakest rate since 2008.⁴ On the other hand, geopolitical outages are restricting available supplies from providing support to the oil price. Robust compliance and losses from Venezuela and Iran saw OPEC oil production fall by 2 mb/d versus July 2018.

It is possible to make a few observations regarding the current shocks hitting the oil market:

- First, both these shocks are beyond Saudi Arabia's control and are being driven by US policies on sanctions and trade and the Kingdom has no power to reverse these policies.⁵
- Second, the shocks hitting the oil market are not alike.⁶ There is plenty of evidence to suggest that the nature of the shock matters, and that demand shocks and supply shocks due to geopolitical outages do not have the same impact on oil prices, with demand shocks being more persistent and having a bigger impact on oil price movements. In a similar vein, not all supply shocks are alike and historically the impact of exogenous supply shocks due to

¹ Bloomberg, 'Saudis Are Discussing Options With Producers to Halt Oil's Slide', 7 August 2019.

² CNBC, 'Oil jumps 2.5% due to firm yuan, expectations of more OPEC cuts', 8 August 2019.

³ Reuters, 'UPDATE 1-FULL TEXT-CERAWEEK-Saudi Energy Minister Khalid Al-Falih's speech', 7 March 2017. <https://www.reuters.com/article/ceraweek-saudi-speech-idUSL2N1GK132>

⁴ Bloomberg, 'IEA says outlook for global oil demand is fragile', 9 August 2019.

⁵ There have been suggestions that Saudi Arabia could mediate between China and the US to moderate trade tensions and boost prices, but such suggestions are not realistic and unserious.

⁶ See Fattouh, B. and A. Economou (2019), 'Demand Shocks, Supply Shocks and Oil Prices: Implications for OPEC', OIES: Oxford. <https://www.oxfordenergy.org/publications/demand-shocks-supply-shocks-and-oil-prices-implications-for-opec/?v=79cba1185463>

geopolitical outages has been shown to be short-lived due to the availability of spare capacity. In contrast, positive demand shocks in the face of capacity constraints (as in the mid 2000s) can have a persistent impact on prices. In other words, the nature of the shock matters.

- Third, shocks can be temporary or structural in nature. For instance, the US could reverse its policy of maximum pressure on Iran, which could result in a quick return of Iranian barrels to the market. In contrast, if there is an escalation of the US-China trade war this could put the global economy and international trade on a lower growth trajectory. Moreover, US shale already represents a positive structural shock to supply with the bulk of non-OPEC supply growth originating from US shale. The sheer size of the US supply shock, the nature of its investment cycle, the improvement in productivity over the years, and its responsiveness to price signals is already complicating OPEC management of the market.⁷ As stated by Al-Falih, 'history has demonstrated that intervention in response to structural shifts is largely ineffective'... and 'that's why Saudi Arabia does not support OPEC intervening to alleviate the impacts of long-term structural imbalances'.⁸

But the nature of shocks is only part of the equation and there are various constraints that shape Saudi Arabia's oil policy regardless of the nature of the shock. One key constraint is that lower oil prices and lower oil revenues have a negative impact on Saudi government finances and its economy, including the private sector. Despite recent efforts to diversify the economy, establish new non-oil sectors, eliminate subsidies, and introduce new sources of government revenue, Saudi government income is still heavily reliant on oil revenue and spending has been on the rise. Looking ahead to the next few decades, Saudi Arabia will continue to leverage its oil sector and revenue from oil exports to diversify its economy.⁹

The Kingdom's choices

Against this background, the choices facing the Kingdom are rather limited. The only variables under its control relate to its output policy: whether to increase, decrease, or maintain output at current levels, and the timing of implementing a particular policy. It is important to stress that any decision is taken in an environment of high uncertainty and generates its own trade-offs, which tend to change over time depending on market conditions.¹⁰

In the current context, one option is for Saudi Arabia to further deepen its output cut. Saudi Arabia is already doing this by producing below its quota and bearing a disproportionate share of the OPEC+ cuts. By signaling further cuts, Saudi Arabia would send a strong signal about its commitment to balancing the market and such a move would support oil prices, at least in the short-term. In fact, the recent announcement that Saudi Arabia will not tolerate a sharp fall in the oil price may have helped stop the price slide and did spark a limited price recovery. However, while this signal may have addressed the 'sentiment' dimension, it did not address the 'fundamentals' dimension and it remains unclear whether Saudi Arabia will actually follow through with deeper cuts. Given that demand shocks are more persistent and that the trade war could take a long time to resolve with resulting repercussions being felt for many years, the cuts may have to be deeper and maintained for longer. Saudi Arabia also faces the challenge of convincing other OPEC+ members to implement deeper cuts, especially given that the pool of countries that can cut is small, and limited to Kuwait, the UAE, Iraq and Russia. Also the longer and deeper the cuts are, the more difficult it is to maintain cohesion within the group. Cutting output unilaterally risks distorting other OPEC+ members' incentives, shifting the entire burden of rebalancing to Saudi Arabia. This is against the Kingdom's official policy that any action should be taken collectively and that there is no room for free rides. But even if Saudi Arabia

⁷ Fattouh, B., Poudineh, R. and Sen, A. (2016) 'The dynamics of the revenue maximization–market share trade-off: Saudi Arabia's oil policy in the 2014–15 price fall', *Oxford Review of Economic Policy*; 32 (2); 223-40.

⁸ Reuters, 'UPDATE 1-FULL TEXT-CERAWEEK-Saudi Energy Minister Khalid Al-Falih's speech', 7 March 2017. <https://www.reuters.com/article/ceraweeek-saudi-speech-idUSL2N1GK132>

⁹ Fattouh, B. and Shahabi, M. (2019), 'The Gulf Economies' Long Road towards better Diversification', *World Energy WE*, https://www.aboutenergy.com/en_IT/topics/spacial1-middle-east.shtml

¹⁰ Fattouh, B., & Sen, A. (2015). *Saudi Arabia Oil Policy: More than Meets the Eye?* MEP 13, OIES: Oxford. <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2015/06/MEP-13.pdf>

does cut output unilaterally, the oil price response may be muted (especially if some of the disrupted barrels return to the market, compliance within OPEC falls, and US shale surprises on the upside yet again) in which case the Kingdom may end up with lower revenues. In fact, the case for higher revenues is not clear in the current context, as Saudi Arabia is not responding to a large oil market imbalance but to deeper concerns that the trade war could compress global GDP and trade flows.

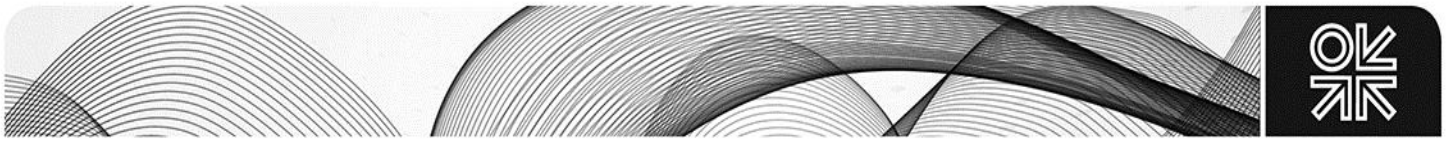
Rather than implementing deeper cuts, Saudi Arabia could increase its output to its agreed quota without exiting the OPEC+ deal. This is an option that most of the trading community and analysts (especially the bulls) conveniently rule out, as the immediate impact on oil prices and oil revenues would be severe. But if cutting output may not necessarily lead to higher revenues in the current context, could a policy of increasing output result in higher revenues in the medium term? In other words, could the revenue calculus facing the Kingdom change in the face of a negative demand shock such that the cost of attempting to raise the price/revenues in a falling market is higher than the respective cost of reversing the current policy?

If the numerous reports that US shale is on its last legs and ‘the time for US shale is up’¹¹ are correct, and given that most of the growth in non-OPEC supply originates from the US, then it is straightforward to construct a scenario in which higher Saudi output would accelerate the slowdown in US shale and Saudi Arabia’s medium term revenues would rise as the Kingdom could increase its market share without negatively impacting the price. Also by not ruling this option out, Saudi Arabia would stop underwriting investors in US shale, though this would contradict the ‘whatever it takes’ signal. The current financial pressures facing shale producers are immense and finance would dry up even quicker if prices fall and Saudi Arabia sends signals that it could change policy. Under these conditions, the market share strategy would be much more effective as compared to 2014: the decline in US shale output would be faster and deeper. There is some inconsistency in the arguments of those that say OPEC should cut output to support prices while at the same time prophesying the death of US shale, unless there is an underlying belief that US shale is in terminal decline regardless of the price level.

The reality however is that the US shale response is not yet understood and as recent history has shown, its performance can’t be predicted with any accuracy, and it could be that many of the reports highlighting the extent of the current weaknesses and the decline in productivity of US shale are exaggerated. As such, the costs of undertaking such a strategy could be high while the benefits are highly uncertain. Saudi decision makers will be extremely cautious not to adopt a strategy that could be seen as responsible for oil prices falling. Also the domestic context has fundamentally changed. When Saudi Arabia decided to pursue a market share strategy in 2014, its financial position was much more solid. Following several years of oil prices above \$100/barrel, Saudi financial buffers were stronger: Foreign reserves were at very high levels, domestic and foreign debt were negligible, and the IPO of Saudi Aramco was not on the cards. There was a feeling, at that time, that Saudi Arabia could tolerate a few years of low oil prices. Things have changed and now Saudi Arabia’s financial position is weaker: Foreign reserves have been depleted, foreign and domestic debt has risen substantially, government spending keeps increasing, and the government has plans to IPO Saudi Aramco.

Given the risks associated with each of the options above, and the wide uncertainty regarding the size of the shocks and their persistence, the most likely scenario is that Saudi Arabia will not deepen its cut further nor push for a new OPEC+ agreement for deeper cuts, in the hope that slower US shale growth and geopolitical outages will outweigh demand weakness and that stocks will fall in the second half of the year. Looking at current market fundamentals alone, there is no urgent need to shift gears for now: the overall compliance within OPEC+ is robust, supply outages remain high, and US shale production growth has been showing signs of deceleration. On the supply side, almost everything is

¹¹ Cunningham, N. (2019), ‘Time Is Almost Up For U.S. Shale’, 8 August 2019 <https://oilprice.com/Energy/Energy-General/Time-Is-Almost-Up-For-US-Shale.html>; Cunningham, N. (2019), Oil Prices To Skyrocket If U.S. Shale Stalls, 13 March, 2019 <https://oilprice.com/Energy/Oil-Prices/Oil-Prices-To-Skyrocket-If-US-Shale-Stalls.html>; Wall Street Journal, ‘Frackers Face Harsh Reality as Wall Street Backs Away’, February 24, 2019.



going in the Kingdom's favour. The problem lies elsewhere and supply measures alone can't counter the broad macro factors. Sometimes the best course of action is to do nothing.

However, looking ahead into next year, the challenge of balancing the market gets more difficult if demand weakens further and Saudi Arabia may have to reconsider its policy. If expectations of a sharp fall in demand growth do materialise, it should consider all options as the trade-offs and the revenue calculus could change. The Kingdom should not instill the idea that it will act as the absorber of all types of shocks and that it will react to every downward price movement by signaling that it will do 'whatever it takes'. As argued by Liam Denning, 'using language any central banker would recognise these days, Riyadh is trying to hold back a literal tide. And like the bankers, it may find a trade war exceeds its capabilities'.¹²

Bumpy Road Ahead

We have argued previously that 'the extent of dislocations in expectations and the challenge of navigating in the current foggy conditions indicate that the oil market is set for a very bumpy ride'.¹³ These dislocations have only intensified in recent months, with physical oil market balances still showing some strength due to geopolitical outages, rising geopolitical tensions, deep OPEC cuts, and the slowdown in US shale growth, while expectations of a sharp fall in demand are worsening the oil market outlook by the day with some predicting a perfect storm in which lower demand and rising US shale supply will throw the market out of balance. Until the divergence in expectations narrows and the macro sentiment stabilises, OPEC may find that it has little choice but to 'stay on the sidelines'¹⁴ but prepare for the increasing possibility of harder times ahead.

¹² Denning, L., 'Saudi Whatever it Takes Runs into Oil Market's Whatever', Bloomberg, 8 August 2019

¹³ Fattouh, B. and A. Economou (2019), 'Has Saudi Arabia's Balancing Act Gotten Any Easier? Oxford Energy Comment, Oxford: OIES.

¹⁴ Ashford, A. and P. Horsnell (2019), 'Washington and Beijing in control of oil prices', Standard Chartered Commodity Alert, 8 August 2019.