
Saudi Arabia's complex relationship to the oil market: 1985 and 2015

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In September 1985, during the Oxford Energy Seminar, the Final Panel assembled its usual set of luminaries (Ministers and CEOs of oil companies), but on this occasion it also included Sheikh Ahmed Zaki Yamani, the longstanding Minister of Petroleum and Mineral Resources of

Saudi Arabia. The fact that Yamani had shown up for the Final Panel was not necessarily remarkable, as Robert Mabro had an unusual capacity to draw the top names in the industry to the events he organized, especially the Seminar. This year, however, the fact that Yamani, easily the most

powerful and highest profile of all the OPEC Ministers, was attending had a special significance: after the price peaks of the post-1979/80 crisis, the oil market was softening and OPEC seemed powerless to arrest the slide. The presence of Yamani was a unique opportunity to hear what the Kingdom

had in mind at this critical juncture. Yamani did not disappoint.

Ministers and their style

Yamani is an imposing man, with a sharp intellect and impeccable manners, who clearly relished the high-profile role he played in the international petroleum industry. He had become minister in 1962, at the age of 32, at a time when OPEC was a low-profile club of oil-producing countries which rarely attracted media attention. A lawyer by training (King Fouad University, NYU, Harvard), Yamani was a perfect fit for the growing clout of Saudi Arabia among oil producers, oil companies, oil-consuming countries, and international markets at large.

Yamani had succeeded Abdullah Tariki, who had himself obtained a degree in chemistry and geology from Cairo University and a master’s degree in petroleum engineering and geology from the University of Texas. Tariki was the first Minister of Petroleum of Saudi Arabia, a ministry which had been founded in December 1960, right after the creation of OPEC in September 1960. Tariki had worked with Juan Pablo Perez Alfonso, the Venezuelan Minister of Mines, to create OPEC. He was especially critical of Aramco (the joint venture between Exxon, Chevron, Texaco, and Mobil – to give them their more contemporary names) and defended the right of Saudi Arabia to not only obtain a higher percentage of the economic rent accruing from oil production, but also to have a greater say in Saudi oil industry decision-making. Tariki was considered confrontational by the oil industry (especially by the large US oil companies that comprised Aramco) and probably by the US government as well. He also got involved in internal Saudi royal family politics, which eventually got him sacked as oil minister and as an Aramco board member.

The similarities and the differences between Tariki and Yamani reveal much about the changing role of the Saudi oil minister and the direction of Saudi oil policy itself. Both men were partly educated in Western universities and had done their share of legwork in the oil industry. One could say that they were both considered oil industry-knowledgeable when they were appointed. Tariki was 40 years old when he became minister, Yamani 32. But the differences between the two are particularly enlightening: while Tariki’s style was direct, outspoken, and confrontational, Yamani was a consummate diplomat, rarely losing his temper, and always trying to achieve his goals in ways that others would not find offensive (although that changed somewhat over time). Furthermore, Tariki took sides in one of the many Saudi Royal family feuds; one could question whether his mistake had been to back the losing Prince, or whether it was his involvement in Royal family politics itself which had been the mistake. The Saudi Royal family has always been careful to appoint non-family members as oil ministers (their only allegiance is to the head of state and they can more easily be sacked) and ministers normally steer clear of family politics (at least ostensibly).

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One can argue that Tariki was an essential component of Saudi Arabia’s early break from its oil childhood: founding and joining OPEC was a first step towards recognizing publicly that the interests of the nation and those of the companies were not necessarily aligned – or at least were not always aligned. But one can also argue that Yamani was the right man for the next step of Saudi Arabia’s oil policy

assertiveness: the more powerful the country and the stronger its oil policy, the more subtle the wielding of that power had to become. As Sylvan Robinson of Shell once put it: *‘The tougher the words, the sweeter the music has to be.’*

The current oil minister, Ali al-Naimi, was born in 1935. He was an Aramco ‘lifer’ – having studied geology in the USA (BS at Lehigh University, MS at Stanford) he became the first Saudi president of Aramco in 1983. After being in that position for 12 years, he became Minister of Petroleum and Mines in 1995 and has held the job ever since. Naimi is deeply knowledgeable about the oil industry, from the nuts and bolts of exploration and production to the subtleties of oil policy. He is a thoughtful and polite man, unassuming to a fault, the perfect sherpa to his King. Unlike Yamani, Naimi does not relish the limelight and only uses the high profile naturally accruing to a Saudi oil minister when it suits the policy purpose he is pursuing. If there have been policy debates and discrepancies within the Saudi political hierarchy during his tenure as minister – and there must have been a few – they have never come to light through his statements.

Although it clearly would be a stretch to pretend that the succession of Saudi heads of state had perfect foresight when they appointed their successive oil ministers, there is a certain pattern in the sequence of Tariki, Yamani, Nazer, and Naimi (Nazer may be the exception, up to a point). The degree of professionalization has deepened, as has the self-control of the ministers and the policy itself. Much as a central banker exerts influence over financial markets in subtle (using one word instead of another, like the US Federal Reserve currently agonizing over the word ‘patience’) and not so subtle (by changing the interest rate unexpectedly) ways, Saudi Arabia has



accumulated a wealth of experience about how to interface with the oil market. In the meantime, Aramco has become Saudi Aramco and the top echelons of the company (down to a pretty significant level) are occupied by competent and self-confident Saudis.

Policy continuities and discontinuities

Every student of macroeconomics 101 is taught how difficult economic policy is because the policy objectives (such as: employment, trade, income distribution, growth, industrialization, and regional development) are many, while the instruments (essentially monetary and fiscal policy, although nowadays regulation should also be counted) are few. In the case of Saudi Arabia, the number of policy objectives is very broad: foreign policy, defence, urbanization, employment, industrialization, agriculture, religious affairs, energy, social development, Royal family affairs, and more. These are all to be addressed through the lever of a single policy instrument: oil production.

The only way in which Saudi Arabia can use oil production as a policy instrument is by having the ability to ramp production up or down from a large base. This has led to Aramco keeping anywhere between 2.5 and 3.0 million b/d of unused oil production capacity (more at times, but generally unwillingly). The political importance of maintaining this available capacity is revealed by the significant cost entailed by investing and maintaining the capacity: one does not maintain idle oil production capacity unless there is a very compelling reason to do so. A complement to this unused capacity is the accumulation of monetary reserves: Saudi Arabia is said to currently possess about US\$750 billion in reserves, an essential element of their current oil policy (to which we will return).

But Saudi Arabia has a problem: it is

the single largest oil player in the international oil market. The scale of its production and its exports means that it can push the markets in one direction or another, but it also means that it has to be careful to avoid being actually seen doing so. The answer to this is OPEC. As Yamani once explained, OPEC is to Saudi Arabia what the UN, the IMF, and the World Bank were to the USA just after World War II: a screen behind which one could attempt to shade the raw power of the leading country. During meetings of the OPEC Conference, Saudi ministers are invariably polite and listen attentively to the utterances of their colleagues from countries which produce comparatively small volumes of oil, or which have no spare capacity, and thus no policy flexibility or influence. In the end, however, Saudi Arabia generally gets its way because the smaller players know that pushing the Saudis too hard (as in 1985–6) ends up damaging the weaker players more than the stronger ones, and none less than the strongest one, Saudi Arabia. The exceptions to this rule are the Iraqis (a special case since the Desert Storm campaign) and the Iranians (a damaged but powerful regional contender).

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Saudi Arabia also knows, rightly or not, that the oil price is also seen as a key factor in the general economic welfare of the entire world, especially of the OECD countries. It can impact GDP growth (through the equivalent of a tax hike or rebate, as the case may be, plus the recycling of petro-dollars) and inflation rates (through retail fuel prices, although these are influenced as much by local fuel taxes or subsidies as by the international oil price). The oil share of total energy consumption today stands at about 30 per cent (with

gas at 25 per cent in round numbers); OPEC's share of global oil demand is about 30 per cent and Saudi Arabia's share of OPEC production is about 30 per cent. Because of its size, Saudi Arabia knows that its economic welfare is tied to the growth of the world economy, to the share of oil in primary energy consumption, and to the OPEC share of global oil demand, as long as its own share of OPEC production remains more or less unchanged. While a smaller oil producer may believe that it can avoid the crush of macro trends, Saudi Arabia knows that it cannot. This means that in pursuing its national interest it must take into account the impact of its policies on the larger economic climate.

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Unlike many other oil producing countries (including several OPEC members) Saudi Arabia has very large reserves of oil, probably significantly upwards of 300 billion barrels. Its economy is also inexorably tied to oil, which represents 45 per cent of its GDP, 80 per cent of its budget, and 90 per cent of its exports. Saudi Arabia thus wishes to extend the global economic use of oil for as long as possible, while maintaining an oil price that can satisfy the economic requirements of the nation (a nation that collects practically no taxes from private citizens or companies). These two imperatives can sometimes (like today) be very hard to harmonize.

Finally, Saudi Arabia is a close ally of the USA. This arrangement has been in place since the famous meeting between King Saud and President Roosevelt. Notwithstanding the natural ebbs and flows of such a relationship, the mutual security interest is riddled with complexities, but it still remains the bedrock of Saudi foreign policy.

1985 and 2015: what 30 years of experience can do to a policy

In September 1985, Mabro introduced his guests on the Final Panel as he usually does: respectfully, but with a dose of humour and a degree of lightness. Final Panel guests are all big movers and shakers, with sizeable egos and big claws to match. Mabro needed their continuing support for the Institute and the Seminar, but he would also generally do as much as he could to prevent his exalted guests from lapsing into making banal statements, country or company advertisements (or, even worse, self-advertisements, of which there were very few, to tell the truth).

Yamani stood up and quickly made the point that Saudi Arabia had tried to balance the market and hold prices steady by proposing that OPEC cut back its production, but it had had no success (Saudi Arabia had maintained its official selling prices while its OPEC colleagues did not and Saudi exports and production had collapsed – Saudi produced 10 million b/d in 1980 and 3.4 million b/d in 1985). He explained that Saudi Arabia was being forced to abandon its official price policy and essentially join the netback bandwagon: pricing crude oil relative to its refined products realization, thus guaranteeing refiners' margins and ensuring that Saudi exports volumes would remain competitive. Yamani was telling (OPEC and non-OPEC) producers: since we can't convince you to manage the market by cutting production back, we are going to join you. The rest is history: prices proceeded to crash into single digits as the natural arbitrage that governs the crude-to-products relationship disappeared, due to the guaranteed refining margin. The refiners' normal incentive to run their facilities up to the point where the refining margin equalled zero gave way to an alternative incentive to maximize volume. Yamani's simple, straightforward explanation was so clear, direct, and unvarnished that it

was not immediately understood by all, or at least its consequences were not. Mabro himself, on the other hand, was entirely clear: the Saudis had reached the end of the road and could not hold the fort any longer by themselves, which meant that the price softening would quickly become a rout. And it did.

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Fast forward 30 years and one finds coincidences and differences between the two situations: just when the market was getting used to prices of US\$100/bbl or higher, the inexorable global rise in oil consumption led by China slowed, while the cost curve of oil production changed (as a result of the shale oil phenomenon in North America). Between the low-cost reserves of the Middle East and the high-cost reserves in ultra-deepwater or the Arctic, billions of barrels of shale oil suddenly became economic, aided by high oil prices and technical progress. Furthermore, US\$100 oil depresses consumption of oil versus other sources of energy and incentivizes the substitution of capital for energy, thus accelerating energy productivity growth, while generally diminishing the share of oil in the energy matrix, the share of OPEC oil, and inevitably – sooner or later – the share of Saudi Arabia in OPEC's production. Saudi Arabia clearly has conflicting interests; one can only imagine that these have led to internal policy debates:

- maximize the price and trim production (some argue that this optimizes the cash gain over time, since the volume sacrifice is lower than the price sacrifice),
- or maintain market share and let the price of oil adjust downwards?

Much as domestic political imperatives require increased spending by the Saudi state, and thus a high price of oil, the requirements of such a policy are clear: Saudi Aramco would need to cut production back by 1.5 to 2.0 million b/d for a period. This might maintain the price level around US\$100, but it would entail the possibility of Saudi Arabia finding itself in a quasi-repeat of the 1985 situation: cutting back its own production in order to (unwittingly, but surely) protect expensive oil production, oil substitution, and energy saving. Yamani had tried this policy, only to find that it depleted Saudi foreign currency reserves and shrank its oil production, to the point where the only way out was a policy that led to the destruction of the oil price. In the summer of 1986, the situation was resolved by Iran reaching out to the Saudi government in search of an orchestrated production cut. It is not a stretch to imagine that Saudi thinking in 2014/15 is running along similar lines: if OPEC (together with some non-OPEC countries) cannot be mobilized to trim production back, then Saudi Arabia by itself cannot and will not do it by cutting its own production. On the contrary, biting the bullet and accepting the consequence of OPEC's inability to coalesce around a new volume and price policy may be the best course of action for Saudi Arabia, especially at a time when its foreign currency reserves are high and a period of relatively low prices can be withstood by the Kingdom. The complexity in this case is that no one – including the Saudis – really knows where the new equilibrium will be.

Will the new price equilibrium gravitate around US\$50/bbl, US\$70/bbl, US\$80/bbl? And just as importantly, how long will this equilibrium last before prices naturally climb back towards the US\$100/bbl level again? On the other hand, will oil prices ever reach that level again? If it is Saudi



policy to ensure that its reserves get produced at a reasonable rate (around 9 to 10 million b/d, let's say), can that happen without accepting a permanent ceiling on the oil price? And where should that ceiling be set? What has changed in the 30 years since 1985? Is Saudi policy essentially responding – just as it did then – to a potential loss of OPEC production quota, or is the problem apparently similar but fundamentally different?

The differences are not hard to detect: shale oil is one, followed by cheap gas in North America and a growing share of gas in the energy matrix, a higher degree of attention paid to environmental issues, and a disappearance of oil uses other than those associated with transportation fuels, gasoline and diesel. Technology and a high oil price have also made energy productivity a more attractive proposition. It shouldn't stretch the imagination to believe that the Saudis would consider every one of these issues as a threat to the long-term productive use of their extensive reserves. The US\$100/bbl (and higher) oil price also gave rise to an overheated market in oil services and capital goods: semi-submersible rigs reached US\$650,000 per day and are now

quoted below US\$300,000 per day. Saudi production discipline essentially resulted in cost inflation and a transfer of rent from the oil producers to the service and engineering companies.

But all these differences between the situation 30 years ago and now cannot obscure the fact that current Saudi oil policy, more sophisticated and better articulated as it may have become, shares its DNA with the Saudi oil policy of the 1980s: it is based on a deep understanding of the need to preserve the role of oil and the corresponding Saudi production volumes. To that continuity the Saudis have added the weight of experience, which dictates that if bullets are going to be bitten, they should be bitten early rather than late.

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In addition to straightening out the oil production cost curve (goodbye Arctic, ultra-deepwater gas, marginal tar sands, and marginal shale), the Saudi policy (or the absence of one, in consonance with OPEC's refusal to cut

production) will also eventually result in OPEC members' acceptance of a new normal – producing a smaller volume at a lower price point. Indeed, what would have been unacceptable to most OPEC members a few months ago (namely the recognition that an oil price in the neighbourhood of US\$70/bbl, let's say, is essential to the preservation of oil's share of primary energy) will now be seen by most, if not all, members as a pretty good deal in comparison with the current level of prices.

Future Ministers

There is a new King in Saudi Arabia, and a new generation of Princes is getting closer to exercising power. Ali Naimi will probably be replaced at some point relatively soon. One can only hope that the experience the Saudi government has accumulated regarding oil policy will result in his replacement being yet another experienced civil servant with deep experience and self control. The challenges facing the oil commodity over the next few years (gas, renewables, energy productivity) will be matched by the challenges facing Saudi Arabia's oil policy. A very steady pair of hands will be needed to steer the main player in the global oil market.

