INFERENTIAL FOCUS

BRIEFING

IF 3517 December 15, 2014

THE SAUDI TRIFECTA:

SUPPLY & DEMAND, MARKET RISKS AND A BIGGER "WHY?"

CONTEXT & DYNAMICS

***The recent downward plunge** of global oil prices has triggered an immense amount of speculation and fortune-telling. What we explained two years ago was that dynamics within the industry and geopolitical realities outside the industry were scrambling the energy market in such a way as to put longtime power brokers at risk and to make new sources of energy become significant players. That is what stands behind the recent actions of Saudi Arabia to increase production and send prices plummeting. The Saudi adventure looks very much like Riyadh might be hitting a trifecta of effects: (1) retain at-risk market share and extend it into new customers; (2) positively affect economies worldwide just when many countries face sliding growth; and (3) force countries whose recent actions have been harmful to the Saudis to deal with rapidly declining revenues and the domestic problems that such a change in economic conditions will likely cause. Geo-economics is changing geo-politics, as Saudi Arabia and China make headway, along with Europe and the U.S.*

OPPORTUNITIES

- *Processes and tools that lower the costs of development and production for alternative energy sources will find a market.*
- *Automobile sales in countries that benefit from declining gasoline prices could shift toward larger vehicles in the near term.*
- *Refineries, plastics and other such enterprises should benefit from the Saudi moves.*

RISKS

- *Countries economically challenged by the sudden loss of energy revenues could turn more aggressive abroad, hoping to exploit nationalism or sectarianism to deflect problems at home.*
- *For countries focusing on new energy sources, production costs for those new sources could become too expensive, and a developing industry could become weakened.*
- *Countries benefitting from lower energy costs could backtrack on efficiency efforts, making them economically vulnerable when oil prices start to rise.*

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A Simple Story, Often Told

"Supplies have flourished, triggering a marketshare battle that currently includes gas but, as new findings, including ultra-deep wells, are exploited in the U.S., Brazil, the Congo, Ghana and elsewhere, will likely affect oil markets, as well."

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Many people prefer their economic storylines to remain uncomplicated, and for them, the recent rapid decline in oil prices from triple digits to what seems to be approaching the middle double digits could be explained in a very uncomplicated way: supply and demand.

Supply–As of October, OPEC production had reached 31 million barrels per day, an eleven-month high, and the Saudis were increasing price discounts to its loyal customers in Asia and later the U.S. and Europe. Fracking (hydraulic fracturing) production in the U.S. and elsewhere has increased supply outside OPEC's control, with the U.S. alone adding four million barrels per day to the world's supply since 2008. (*Bloomberg BusinessWeek*, 10/27/14; *Economist*, 10/4/14)

Demand – Since 2010, global GDP growth has slipped from an average of five percent per year to slightly more than three percent (based on a purchasing-power-parity basis). In short, slowing economic growth requires less energy. New technologies, especially fracking, have enabled the United States to import 3.1 million fewer barrels of oil than it did in 2005. (*Guardian Weekly*, 10/24/14; *Economist*, 10/4/14)

That's clear enough: increased supply from OPEC and countries with fracking fields and decreased demand from slowing global economies have triggered basic market forces and lowered prices. But there's a glitch in the uncomplicated storyline: the threat of a slowdown in economic growth started a couple years ago, and fracking started years ago. Would the effects of such a slowdown not have surfaced prior to the third quarter of this year, and why, in the face of such a global slowdown, would the Saudis decide to increase production? Beyond those complications of the uncomplicated narrative, there are a few other curious twists to be reckoned with.

◆ In the first ten months of this year, China, which is one of the economies whose growth was slowing in the uncomplicated storyline, imported a record 253 million tons of crude oil. And then, in October, after prices started dropping, China increased its oil imports another 18 percent, adding another 24.1 tons of crude to its ledger. Also this year, China doubled its imports of crude from Colombia and upped its purchases of Russian oil by 57 percent. (*China Daily*, 10/27/14)

◆ For all of 2014, Asian economies will be responsible for roughly 80 percent of global growth in oil consumption, with China accounting for one-third of the increase. (*Bloomberg*, 10/27/14)

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Global GDP growth is slowing, yet demand does not seem to be sliding proportionately. Evidently, the uncomplicated story of simple supply and demand, while not irrelevant, cannot fully explain the recent dramatic change in oil pricing.

It's Getting Complicated

"Overall, energy producers are seeing their markets change rapidly and new competitors surface with abandon. As a result, old-line producers are scrambling to hold market position, secure contracts and nurture new markets."

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Alternative energy sources and changing governmental policies on efficiency and non-carbon-based energy supplies are further complicating the

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uncomplicated supply-and-demand storyline. Economic stresses and an expanding push for efficiency have given momentum to more efficient uses of energy, while popular discontent in places like China has put pressure on leaders to lessen the negative effects of large carbon-based operations.

Supply – The expanding use of alternative energy resources is starting to produce some eye-catching numbers. For instance, through October of this year, China installed 20 gigawatts of wind power, four times as much as Denmark, Europe's leading user of clean energy. In 2013, China installed 11.3 gigawatts of photovoltaic power, a yearly record for any country. In addition, China has 28 nuclear power plants under construction. Meanwhile, India will provide low-cost loans and grants for the construction of solar-power parks that will produce 20 gigawatts of capacity, thereby increasing the subcontinent's solar-power production tenfold. In the U.S., the price of solar panels, aided by state subsidies, has declined 80 percent since 2008, while solar-panel prices in Germany have declined 60 percent. Overall, solar power is now generating 100 gigawatts of energy worldwide. Germany's largest utility, E.ON SE, announced that it would spin off its fossil-fuel power plants and focus on its new "core" business: renewable energy. And in addition to the rapidly spreading deployment of alternative energy sources and new efficiency technologies, natural-gas availability from fracking is forcing more and more energy suppliers to back away from coal and is providing alternative power sources for cars and other machines that have, in the past, relied on oil-derived energy sources. To take just one example, China's focus on fracking natural gas has resulted in the country being ahead of its schedule to retrieve 2.6 billion cubic meters of gas by next year. It has already surpassed that goal. (*Bloomberg News,* 8/4/14, 9/4/14 and 12/1/14; *China Daily,* 10/30/14; *Nature Conservancy*, 10/14; *Scientific American*, 11/14; *Oil & Gas Journal*, 10/6/14)

Demand – California has mandated that 33 percent of its energy production must come from low-carbon, renewable sources by 2020. Forty-three states have net-metering laws that allow solar-powered households to sell excess production to local utilities. China, the U.S. and the European Union have all announced projects and agreements to increase the percent of carbon-free energy sources to 20 percent by 2030, 28 percent by 2025 and 40 percent by 2030, respectively. In addition, Japan announced that it has set a 2030 deadline for construction to produce only net-zero power-consuming buildings. While all of these countries might not reach those goals, their efforts in that direction will certainly negatively affect the use of carbon-based fuels. In addition, efficiency in energy usage across a wide spectrum of markets will continue to lessen energy demands, as new products, such as fuel cells, reach the market. (*Guardian Weekly,* 11/21/14; *Nature Conservancy*, 10/14; *Vox*, 9/29/14; *Nikkei Asian Review,* 11/17/14; *Bloomberg News,* 11/18/14)

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A Bigger Saudi "Why?"

"The geopolitics that has evolved around the global energy market is set to undergo a considerable restructuring, with new pressures, conflicts and alliances emerging as consumers and producers shift around."
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Based on the foregoing, the Saudi decision to expand production sufficiently to drive the price of crude oil down by roughly 40 percent could fit into a slightly more complicated storyline than what some people might prefer. The Saudis increased production into a slowdown in global economic growth out of a desire to push for market share in the face of shifting demand and to undercut the higher production costs associated with renewable energy sources (Saudi extraction costs are in the neighborhood of $10 per barrel). And the kind of positive results (for the Saudis) on oil demand of such a price drop are already starting to surface. For instance, in the U.S., the fuel economy of new cars sold in August was 25.8 miles per gallon, but in October, after oil prices started dropping – and gasoline prices followed, albeit slowly – the miles-per-gallon figure of new cars purchased declined to 25.3. (*NBC News*, 11/15/14)

"All things being held constant," as economists like to say, the Saudis' defensive market tactics would be the defining context for any oil-pricing discussion. But in the Middle East, hardly anything remains constant, and that inconstancy finally forced the Saudis to expand their tactics into a full-blown geo-economic strategy and to put oil pricing at the center of that strategy.

The Saudis have taken such extraordinary actions before. In the 1980s, as the so-called "swing" producer, Saudi Arabia increased production and lowered prices to teach OPEC's quota-cheaters a lesson about staying within some limits. Later, Riyadh used its oil-production power to successfully bring Iran to heel for its political mischief in the Middle East. That kind of reasoning seems to be have been critical in the Saudis' recent decision to lower the price of its crude oil.

The Middle Eastern disruptions that came to be known as the Arab Spring led to, as we noted at the time, "Seasons of Uncertainty," and the playing out of that uncertainty has been particularly worrisome to Riyadh. The royal family, feeling threatened all around, took actions to defend itself. For instance, the Saudis:

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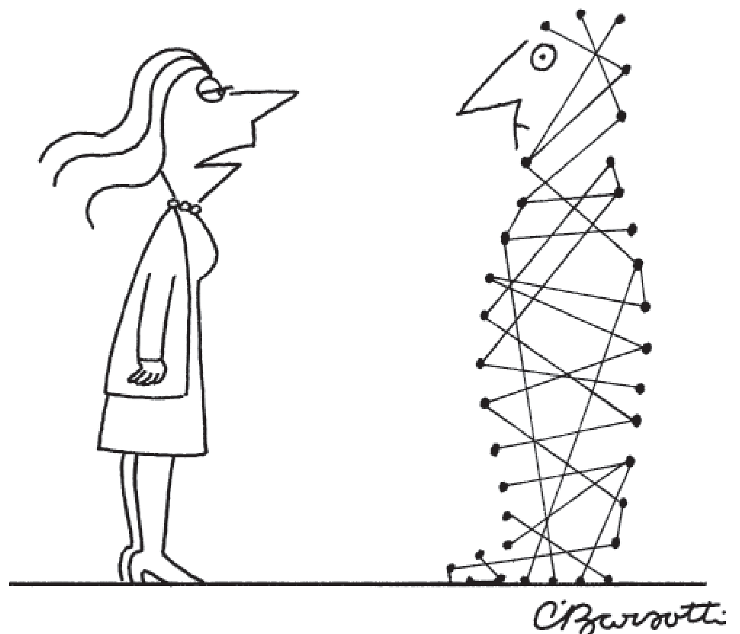
- built a monumental wall, with turrets, trenches, razor wire and towers, along the 900-kilometer border with Iraq, to seal off the jihadist threat that seemed alive in that embattled country;
- tried to convince members of the Gulf Cooperation Council (GCC) to put together a joint police and military force with a unified command center (to no avail);
- donated, along with the United Arab Emirates and Kuwait, $12 billion to Egypt's President Abdel Fattah el-Sisi, after he overthrew the Muslim Brotherhood's elected president, Mohamed Morsi;
- established a joint-military-operations room in Istanbul with Turkey and Qatar for the express purpose of coordinating plans to overthrow Syria's Assad regime, brokered arms shipments for Syrian rebels and channeled funds through intermediaries to the Future Movement in Lebanon. (*Current History,* 12/14)



"And don't come back until you've connected the dots properly."

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Perhaps the biggest signal to the world's leaders that the Saudis were getting frustrated with the global community for not dealing directly and effectively with the violence spreading across the Middle East came when Riyadh turned down a seat on the United Nations Security Council, an otherwise prestigious position. In a way, the royal family was sending a message that it would be getting more active on its own.

Conveniently for the Saudis, both Russia and Iran were already suffering economic stresses because of international sanctions.

All of the resulting actions sought to suppress the Muslim Brotherhood across the region, halt the spread of upstart and violence-prone Muslim extremists, offer critical support for rebels seeking to overthrow the Assad regime in Syria and finally draw the world's attention to the increasing danger of Middle Eastern disruptions. These actions all proved insufficient.

In September, Saudi officials held a private meeting with U.S. Secretary of State John Kerry, and afterward, the Saudis became more aggressive:

◆ Riyadh sent fighter jets to join forces with those of the U.S. and other Sunni Arab monarchies to launch airstrikes against ISIS. It also agreed to host on its soil the advanced training of Syrian rebels.

◆ The Kingdom increased oil production to drive down the price globally and force exporters who persist in taking actions that harm the Saudis and other royal monarchies to deal with the domestic pressures that would arise from rapidly declining revenues. It then unilaterally lowered the price of oil further by increasing discounts to specific (and friendly) countries, including those in Europe, because of their vulnerability to Russian intransigence, and China, because Riyadh and Beijing might well be opening up new levels of contact – and perhaps even coordinated this price shift.
(*Financial Times*, 11/4/14; *Current History*, 12/14; *Bloomberg BusinessWeek*, 10/27/14)

In terms of affecting conditions on the ground in the Middle East, the Saudis' pricing move was timely. Two of the targets were Russia and Iran – Russia because of its support of Syria's Assad, for blocking U.N. actions to restrain Iran and for offstage support of Iran and Syria; Iran because of its military support of Assad, its expanding support of Shi'ite jihadists and its military action inside Iraq.

Conveniently for the Saudis, both Russia and Iran were already suffering economic stresses because of international sanctions. By the time oil prices started to drop, Iranian oil production had already been cut in half, in part because sanctions made it difficult to publicly complete any kind of international financial transaction; revenues in most merchants' bazaars had fallen off by 50 to 75 percent; at least half the country's population had suffered significant salary losses (30 to 40 percent in the private sector and 50 percent in the public sector); automobile production had slumped by roughly 70 percent; and the country's currency value had plummeted (actually losing 40 percent in one week). So to configure a tactic that could significantly reduce revenues from the country's largest exported commodity was an effective way to further disrupt the Iranian economy in a hurry. (*Economist*, 11/1/14)

Russia faced better conditions, but not much better. Prior to the oil-price decline, the ruble had lost as much as 30 percent of its value (after the Crimea invasion); the cost of Russian imports, which had amounted to $341 billion in 2013, shot up as the ruble went down, triggering unanticipated inflationary pressures; after the Crimea crisis, investors and businesses took more than $200 billion out of the country, and Moscow started using its cash reserves to pay for governmental expenses; stores and small businesses, the ones that had survived recent stresses, were going up for sale; and sovereign debt at roughly $57 billion and Russian

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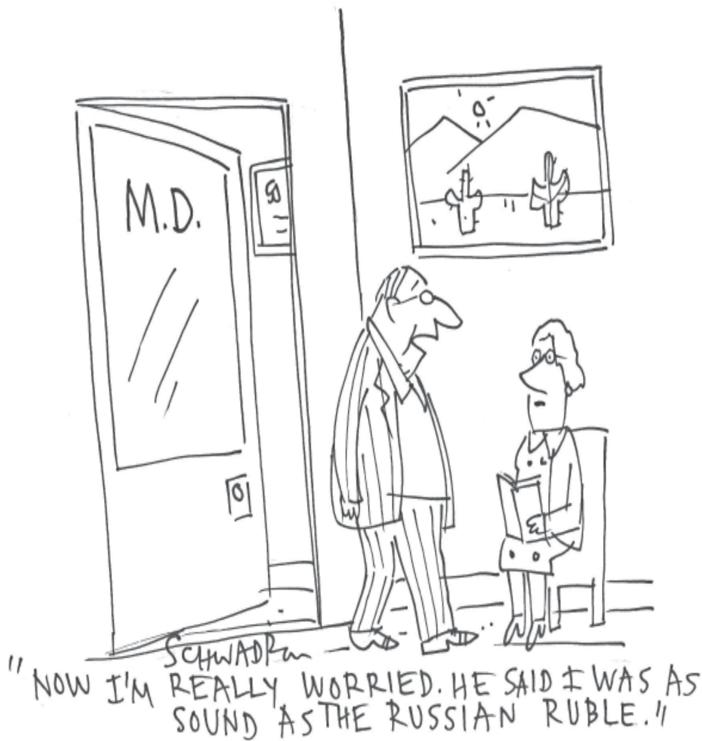
corporate debt, which surpassed 10 times the government's, had also become more costly with the ruble's loss of value. Rosneft, the Russian oil company, implored the government to give it money to help repay a $30 billion loan it had taken to buy TNK-BP. Putin's "retaliation" against the West for imposing sanctions was to make the import of many foreign goods illegal, which seemed more like an effort to cut the inflationary effect of purchasing imported goods with a deflated currency. So again, if Riyadh was seeking to cause economic stresses for the Russian leader to address back home, then the oil-production increase could not have been more timely. (*Economist*, 11/22/14)



The Saudi Trifecta

"Countries losing market share in global energy markets will likely endure economic slowdowns at home, with unclear consequences for political and economic stability."

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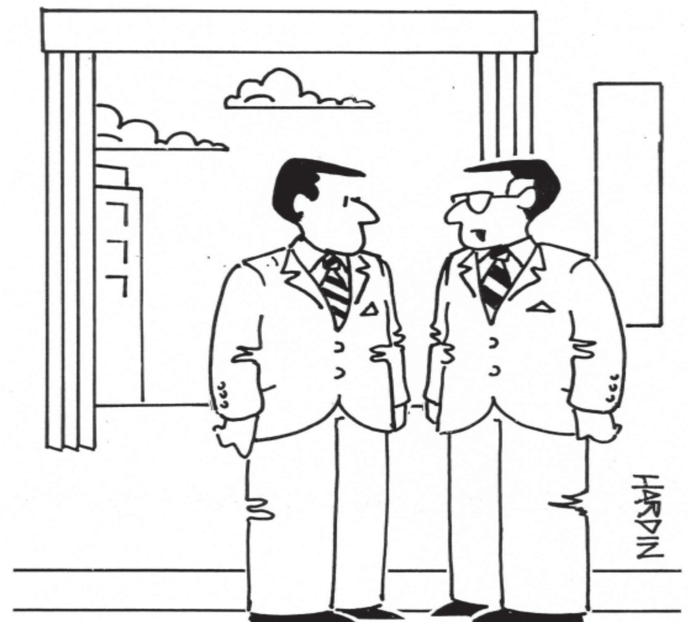
By increasing production suddenly and lowering oil prices substantially, the Saudis hit the trifecta of geo-economic effects:

1. By lowering the price of oil, the Saudis are seeking to shore up their global market share, especially in Asia, and slow the pace of growth in alternative energy sources.

2. According to the IMF, a 10 percent change in the price of oil is associated with an inverse change of 0.2 percent in global GDP. And so, the lower price is providing a *de facto* stimulus to much of the global economy, which could help revive the Saudis' and OPEC's global market opportunities.

3. Falling oil prices are causing economic troubles in countries whose actions in the Middle East represent a challenge to the Saudis' identity as a regional leader in political, economic and religious affairs.

The Saudis' actions seek to lessen and even eliminate the risks that they see deriving from the Arab Spring and the resulting Seasons of Uncertainty. Riyadh has hinted that, given the resources the country has on hand, it can live with low oil prices for a couple years. Such a time frame might be needed to turn around the world's economies, revive the Saudis' regional power and disrupt the recently deepening enthusiasm for some alternative sources of energy. And as to the Bigger Saudi "Why?" Riyadh believes its economy and its leadership can endure revenue losses longer than can either Iran or Russia.



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