

Comments on Oil in FT, 11 Oct 2015

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Saudi Arabia oil: No gain without pain

Riyadh's decision to maintain output, even as prices fell, has hobbled rivals but exposed its economic weaknesses

Any idea that Saudi Arabia was about to abandon its effort to turn the oil market on its head was dashed earlier this month when the country's top energy official said it would do something few other industry players want to do right now: invest.

The oil price collapse over the past 16 months has forced the world's biggest energy companies to cut hundreds of billions of dollars in future spending to bolster their balance sheets. But Ali al-Naimi – oil minister and architect of the Saudi strategy to maintain output and keep prices low to hobble its rivals – voiced a commitment to press on with investments in exploration, production and refining.

It reinforced the idea that however much Riyadh's revenues have been shrunk – by an oil price that has more than halved – the kingdom has a higher pain threshold than everybody else. And it will press ahead with its long-term plan to undermine rivals and secure its market share

“No one in Saudi thinks lower oil prices are good,” says one Riyadh-based western diplomat. “But it is the reality. They have to weather through it and hope this strategy plays out. There is a great deal of uncertainty.”

Supplies from high-cost producers – ranging from US shale to Brazil's deepwater fields – swelled in a world of \$100 a

barrel oil and led to a shift in the market forcing a response from the kingdom which felt it had been pushed into a corner. The November 2014 Saudi-led decision by Opec ministers to maintain, rather than cut, output marked a significant departure from the cartel's traditional policy of reducing supply to stabilise price drops and upended an energy order in place for decades.

The push to focus on its own market share, rather than higher oil prices, is showing some signs of success. But it is also considered a perilous gambit that could last years, affecting the kingdom's economy far more than anticipated.

"It is working," says Bob McNally, a consultant at Rapidan Group which advises on the energy market. "But it is going to be longer and costlier than the Saudis expected. They're stuck in this seemingly endless trench warfare and have a bigger fight than expected."

Industry observers say they were acting too late but that in the absence of support from other major producers to cut output, Saudi Arabia had no choice. Leonardo Maugeri, a former executive at ENI, the Italian energy group, who this summer briefed Saudi officials on oil market dynamics says they do not consider what they have done to be a gamble.

"This was the only possible strategy they had," he says. "Saudi Arabia is hoping sooner or later that the strategy will work, but they are having to go through a lot of pain to find out."

Investment cuts and project deferrals will have a grave impact on high-cost production outside of Opec countries in the coming year, energy forecasters predict. That should translate into greater demand for crude from the cartel's producers.

Saudi Arabia has so-far shown itself to be resilient: retaining its share of imports to Asian markets amid increased competition from rivals such as Iran and Iraq. Lower crude prices have also boosted demand for refined products from the US and Europe.

But Saudi Arabia is only at the beginning of what could be a long-drawn out process. The effort to rid the world of 2m

barrels a day in excess supply could take several years. Even if prices bounce back to previous highs – as spending cuts reduce production too much – expensive oil output could surge again. Although Saudi officials hope flexible US shale production will prevent this, it is still uncertain.

As the experiment plays out, the kingdom is burning through its reserves to maintain social spending. The country has turned to the debt markets while renewed speculation against the Saudi riyal and a yo-yoing stock market have amplified anxieties about King Salman's economy. War in Yemen, China's economic slowdown and Iran's re-emergence have also raised the political and economic stakes.

"Ali al-Naimi said he was ready to see prices go down to \$20. They [The Saudis] don't care about others," says Ali Assaoui, a Riyadh based analyst. "The Saudis are the masters of the long game. Remember if they are suffering, others are suffering more"

The gain: Shelving of \$1tn in investment damages rivals

The impact of the Saudi Arabia-led decision to forgo high oil prices and short-term revenues for long-term market share has been felt all around the world: from Aberdeen and Alberta to Stavanger and Houston.

It was in the Texas oil town at the start of the year, as oil prices stood at levels last seen during the financial crisis, that Gallery Furniture owner Jim "Mattress Mack" McIngvale launched an offer to give away furniture should US benchmark crude top \$85 a barrel at the end of 2015. Those initially convinced by the offer to "give you back 100 per cent of your purchase amount" are now doubtful. "A lot of people immediately piled in believing that prices would inevitably rise. [But] who in their right mind is going to fall for that now?" says an oil analyst in Houston.

It turns out that Saudi Arabia was not bluffing about its pledge to see off the threat of US shale oil among other high-cost producers, she says.

For much of the past decade, the oil industry has been defined by robust demand growth and a consistent struggle for supplies. The growth of US shale turned the market on its head and forced Saudi Arabia and other oil-rich nations to change tack.

“What were they going to do, support the price for everyone else while they see their own production go down the tubes?” says Gary Ross, chairman of consultancy Pira Energy. “Momentum is moving towards where [the Opec nations] want it to go. So they are toeing the line with the strategy.”

While Saudi Arabia has produced more than 10m barrels a day for much of this year, and cranked up investment, exports and drilling, the financial screws are tightening on many US operators. Although Saudi officials say they “welcome” US shale production – it offers the production flexibility that Riyadh in some instances no longer wants to provide – they want to slow its growth. The US government expects production – which had risen by an annual 1m b/d average since 2012 – to decline from an average of 9.3m b/d in 2015 to 8.9m b/d next year.

Mark Papa, the former head of EOG Resources, which helped spur the US shale boom, said the sector needed at least \$80 a barrel to increase production growth – last week the price was bouncing around \$50 a barrel on the back of Middle East tensions. “We are about to see a pretty dramatic decline.”

The impact of Riyadh playing hard ball is starting to be felt: drilling, well completions and credit lines for US companies have taken a hit and bankruptcies loom. Although North America has taken the brunt of the pain, it is spreading internationally.

Bernard Duroc-Danner, chief executive of oil services group Weatherford International, last week likened the scale of cost-cutting in the industry to the late 1990s slump. “I

suspect by the year end it will be 250,000 to 300,000 people who have [lost their jobs since 2014]. The brutality of the costs side is exceptional.”

The International Energy Agency has said the move by Saudi Arabia to dent rival output “appears to be having the intended effect”. It expects oil production outside Opec countries to decline by nearly 500,000 b/d next year, the largest drop since the collapse of the Soviet Union. US shale will account for 80 per cent of that fall, but other countries – the UK, Russia and beyond – will also suffer.

Plunging oil prices have rendered more than \$1tn of future spending across the globe uneconomical, according to Wood Mackenzie, the consultancy. With production drops expected over the next year, the IEA says demand for crude from Opec nations is expected to rise to 32m b/d in the second half of 2016 – the highest in seven years.

“The Saudis will benefit,” says Nat Kern, president of Foreign Reports, a Washington-based consultancy. “They have a long wait in the meantime and of course \$60 oil would be a preferred reward to \$40 oil, but it will come.”

Facing growing competition in 2014, Saudi officials say they sought to send a message to the investment community.

Jeff Currie, global head of commodities research at Goldman Sachs, believes it has worked: “Expensive oil in the Arctic, Brazil . . . is not as economic as cheaper sources elsewhere. This strategy is enabling a shift of capital towards regions at the lower end of the cost curve, in essence, Opec producing countries with vast, easily accessible reserves.”

Meanwhile the kingdom is aggressively marketing crude to important Asian customers, from China to India. Its share of oil imports to the region held at about 23 per cent from January to June. This is similar to the same period in 2014, the US energy department says, even amid growing competition from Opec peers that will intensify as Iranian barrels re-enter the market after international sanctions are lifted.

Despite the price collapsing far more than Saudi oil officials and executives had expected, the country – with more than \$600bn in foreign exchange reserves – can withstand heavy losses.

“The Saudi economy has buffers to absorb some of the pain,” says Bassam Fattouh, director of the Oxford Institute for Energy Studies. “It has a big capacity to borrow, and banks have high liquidity and are willing to lend.”

The pain: subsidies under threat as budget deficit soars

When Saudi Arabia embarked on its oil strategy, officials assured worried citizens that the pain of the price crash would not last long.

Mohammed al-Mady, the former chief executive of Saudi petrochemical giant Sabic, talked of lower oil prices lasting a year or so. Government officials assured markets that the precipitous price drop was “temporary.” But amid concerns over China’s economy, the driver of oil import growth for the past decade, confidence in the short-term nature of the price slide has mutated into worries about the impact of lower spending trickling through the economy.

Oil revenue accounts for 80 per cent of government income and 45 per cent of gross domestic product. The prospect of a more parsimonious 2016 – after small scale spending cuts this year – is deepening the gloom.

Most agree that the Gulf monarchy had little choice but to defend its market share amid weakening demand. But the resulting cap on prices is severely affecting spending – which has been used to paper over social unrest and buy loyalty – during the past 13 years of almost continuous oil market strength.

Columnist Abdulhamid al-Omari recently wrote that an extended period of low oil prices would exacerbate the kingdom’s

crises, including unemployment, the housing shortage, income inequality and private debt.

“Without a doubt the national economy is facing heavy challenges, the like of which may not have been seen in our modern history,” he wrote.

HSBC, for example, says Saudi Arabia faces the biggest trade shock in a generation. With oil prices forecast between \$50-\$60 a barrel through to 2017, hydrocarbon revenues – \$246bn in 2014 – will be 45 per cent lower than the previous three years. ***In response the government has delayed some infrastructure projects, such as the \$22bn Riyadh metro, but it has yet to make the deep adjustments necessary, says economist Nasser Saidi.***

The monarchy’s financial buffers have allowed the government to maintain spending and push back difficult reform choices – at least for now.

This year’s \$130bn budget deficit – compared with last year’s deficit of \$17bn and 2013’s surplus of \$48bn – can be sustained for almost three years with the \$370bn of government savings at the central bank, while foreign reserves, down \$82.5bn from \$737bn last August, can defend the riyal peg to the dollar from overseas speculation.

Farouk Soussa, chief regional economist for Citi, says debt levels could within four years reach 100 per cent of GDP, as they did in 2000.

“In one sense, it’s not so bad – Saudi has six or seven years until it goes back to 2001,” says Mr Soussa. “But that would not be a good idea – they have to protect intergenerational wealth.”

For the first time in eight years, Saudi Arabia has issued local bonds that are expected to raise \$27bn by year’s end. The money will soften the funding blow but Standard & Poor’s says the domestic banking system will only be able to lend the government up to \$100bn. Riyadh may then have to turn to international debt markets in 2016 or 2017.

“If you start tapping the banks, you crowd out the private sector, and . . . you need the private sector to diversify

the economy," says Mr Saidi.

The son of the king, Deputy Crown Prince Mohammed bin Salman, is now the most powerful economic figure in the country. His allies say he will transform the private sector by breaking up monopolies and ushering through privatisation programmes.

He pitched to top business leaders in Washington last month, calling for US investment into health and infrastructure. But observers query whether his vision can be transformed into reality.

Inevitably spending on subsidies and wages will also need to be cut as Riyadh rebalances the books. Energy subsidies, which the International Monetary Fund is calling on Riyadh to review, cost the kingdom \$106bn in 2015, or \$3,400 per capita, according to the fund. But it is a difficult balancing act. Sensitivity to a reform backlash haunts Riyadh.

The late King Abdullah cruised through the popular unrest of the Arab spring by raising salaries and pledging \$130bn in infrastructure investment. But his successor now faces the much tougher challenge of introducing structural reform while tightening the country's fiscal belt. Prince Mohammed was only a teenager when the government last considered cutting electricity tariffs in 2000. A backlash from wealthy industrialists and the population forced the government to shelve these plans.

The fiscal situation was saved when the oil price rose after 2002, allowing a period of rising government spending as the authorities battled an al-Qaeda campaign in 2003-06. Now, with rapidly depleting coffers, the kingdom faces the threat of a new insurgency from domestic sympathisers of militant group Isis.

At the same time, it is spending billions of dollars on the campaign to reinstall the Yemen government overthrown by Iran-allied Shia rebels.

The Saudi business community is still hopeful that an oil price revival could offer some fiscal leeway, but hopes of a quick turnaround are fading.

"Yes the stakes are high," says Mr Saidi. "And the economics

are biting.”