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OPEC Deliberates: A Saudi Opportunity

By [Simon Henderson]
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Today, oil ministers from the Organization of the Petroleum Exporting Countries (OPEC) meet in Vienna to discuss a possible production cut. Originally planned for November, the meeting was brought forward because of falling oil prices. With the perilous state of world financial markets, seldom has an OPEC meeting been so critical for both itself and the world. Although hard hit by falling revenues, oil market conditions give Saudi Arabia the opportunity to show strong leadership, most likely by limiting any production cut. But the oil-consuming nations would prefer no cut at all, so any reduction would discomfit relations between Washington and Riyadh. The kingdom was unhelpful as prices rose above $100 per barrel months ago, and both presidential candidates have called for independence from foreign -- implying Saudi -- oil.

Saudi Arabia as Swing Producer

Saudi Arabia effectively heads OPEC because it is the largest oil producer and has the greatest volume of exports, the biggest reserves, and, most crucially, extra, unused capacity to produce and export. At the same time, Saudi Arabia can afford a substantial drop in production because it maintains a cautious government-spending program, which can be sustained at a much lower level of oil revenues than those earned in 2008. This enables the kingdom to become a swing producer that can either ramp up or scale down output to affect world oil prices.

But in recent years, as demand has increased and prices have climbed, Saudi Arabia has hesitated to expand production and ease the pressure on prices. In part, Riyadh's policy was predicated on fear that the country's spare capacity was probably insufficient to have a large market impact, especially since most of Saudi Arabia's extra capacity consists of heavy crude, which many world refineries cannot process. Politically, observers think the kingdom wanted to punish the Bush administration for the messiness of the invasion and subsequent occupation of Iraq, as well as the lack of progress on the Middle East peace process.

Now, as world demand for oil has eased -- in the United States alone, consumption has declined by 10 percent -- the kingdom's spare capacity has increased. In these new circumstances, Riyadh's ability to pump more oil if necessary, and drive down prices, enables it to discipline OPEC members, forcing them to accept Saudi Arabia's view of appropriate production and price levels. In the past, this capability has usefully stabilized the world oil market; for instance, Saudi increases were essential during the 1979 Iranian revolution, when exports from Iran stopped, and during the 1980-88 Iran-Iraq war, when both sides targeted the other's oil export facilities. The existence of a swing producer like Saudi Arabia also makes oil markets less jittery to periodic reports of supply disruptions.

Economic Calculations

In economic terms, dilemmas exist for both oil producers and consumers. For OPEC hawks Iran and Venezuela, the recent $70 per barrel price exposes their economic vulnerabilities, so these countries will aim for large production cuts to force prices back above $100 per barrel. Such a move would require some OPEC states to accept lower production levels, but a reduction would not necessarily benefit the states taking the largest production cuts -- usually Saudi Arabia -- since they would earn less revenue even though the oil price goes up. Furthermore, a price boost might exacerbate the recession that much of the world is facing, a situation that may cause OPEC to cut quotas even further in the future.

On the other hand, lower oil prices -- some forecasts suggest prices could fall to around $50 per barrel by the end of the year -- would stimulate the world economy and raise demand, particularly benefiting those OPEC producers with extra capacity, such as Saudi Arabia. In addition, lower oil prices make alternative fuels less attractive economically, increasing the likelihood that the world will continue to depend on OPEC products. Lower prices would enhance oil's reputation as the largest and most convenient source of energy compared with natural gas, coal, nuclear, hydro, solar, wind, and ethanol.

Impact on the United States

While Saudi Arabia's position is strong within the cartel, it is not so with the international community. Saudi support for even moderate cuts could cause a public and political backlash, particularly in the United States, where higher gasoline prices directly affect domestic politics. Both presidential candidates are vying for extra votes by reminding the electorate of the Bush family's friendliness with the Saudi royal family. The threat implied by al-Qaeda's Saudi origins -- Osama bin Laden and fifteen of the nineteen hijackers in the September 11 plot were born there -- is also deeply implanted in the American psyche, despite official Saudi efforts to counter this association. The U.S. presidential candidates will likely continue to urge America away from imported oil and toward alternative fuels.

The global economic crisis, however, has already revised the priorities surrounding alternative energy sources. In addition to lower oil prices threatening the viability of such projects, the huge sums being used to save the financial system will mean less money available for government-supported research and subsidies. Lower oil prices also translate into less enthusiasm for new and expensive exploration in, for example, deepwater fields or the remote areas of Alaska.

For the United States, one positive impact of falling oil prices has been the resultant budget crises for the "axis of diesel" -- Russia, Venezuela, and Iran -- the countries that have used their burgeoning oil revenues to challenge U.S. power and influence. The single most important impact of the decline could be the financial pressure on Iran, which may force Tehran to reconsider its expansion of nuclear research and apparent determination to develop nuclear weapons. But other possible consequences across the Middle East may be less welcome, especially if the rapid growth of prosperity among U.S. allies suddenly reverses direction, causing social and political unrest.

This week's announcement that Russia, Iran, and Qatar are seeking to form a natural gas cartel is a worrisome indication of the prevalence of resource nationalism and the difficulties Washington faces in isolating Iran. This cartel, however, would need more members to be effective, since despite controlling 55 percent of the world's gas reserves, their share of world production is only around 25 percent.

Prospects

The scale of the recent international economic and financial turmoil has strained both official and public understanding, and there is little confidence that the crisis has stabilized. Despite occasional rhetoric to the contrary, OPEC is perceived as being inward looking, with little sense of responsibility to the world at large. Today's meetings, and the informal discussions beforehand, are unlikely to reverse this impression.

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