Saudi Arabia's Oil Policy and the U.S. Market

by

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The energy relationship between Saudi Arabia and the U.S. started with the discovery of Saudi oil by an American company in the 1930's, and while Aramco is now a wholly owned Saudi government company, the middle syllable in its corporate name is a permanent reminder of the "American" role played in developing the Kingdom's oil industry.

The Swings in Saudi Oil Supplies

Saudi oil exports to the U.S. began more than 40 years ago. Until 1973 they remained quite small relative to our total import needs. Venezuela and Canada were our principal foreign supply sources then. From 1973 on Saudi oil imports grew rapidly. In 1976 Saudi Arabia became our Number One foreign oil supply source, a position it maintained till 1981. From then until 1985 Saudi Arabia was playing the unenviable role of swing producer in a market in which demand was declining while supplies from other sources such as Venezuela, Canada, Mexico and the U.K. were rising. By 1985 imports of Saudi oil had dwindled to less than 200 MB/D, or just 4% of total U.S. crude imports. Then prices broke, the tide turned and Saudi Arabia took on the more desirable role of swing supplier in a rapidly rising market as U.S. production started to decline while consumption grew once again. Last year the 1.1 million B/D imports of Saudi crude, while still somewhat below the 1977 peak, supplied over 19% of total U.S. crude imports and accounted for 36% of total Saudi crude exports. This year both shares will be still higher.

Oil Imports and Star Enterprise

Underlying market forces had of course much to do with this turn-around. But Saudi investment policy also played a major role in it. In November 1988 Saudi Arabia made its first foreign downstream investment. It bought a 50% share in three U.S. refineries, with substantial ancillary distribution facilities, owned by Texaco and formed Star Enterprise in partnership with Texaco. Last year almost all of Star Enterprise's crude imports came from Saudi Arabia (539 MB/D). This made it by far the largest importer of Saudi crude in 1989, accounting for nearly 50% of total U.S. imports of Saudi crude. In 1988 Texaco's imports of Saudi crude had been about half of Star Enterprise's imports in 1989. Thus, clearly, the new joint venture has been instrumental in boosting Saudi oil exports to the U.S. Of course, Star Enterprise's other partner has also benefited from the new joint venture. The payment of more than one billion dollars from Saudi Aramco must have been quite welcome following the settlement of Texaco's dispute with Pennzoil. For the time being Star Enterprise may remain the only Saudi oil operation in the U.S. The Kingdom's next foreign downstream expansions will probably be in the Far East and/or Europe.
Future Import Levels and Future Prices

The interdependence between Saudi oil exports and U.S. oil imports will keep growing. Considering that the U.S. is the world's largest oil importer and Saudi Arabia the largest oil exporter, this is a natural development for both nations. As an aside it may worth pointing out that if we define markets by their economic rather than their national frontiers, the 12-nation European Community will be a much larger market for imported oil from 1992 on than the U.S. However, the expected continued decline in domestic production will keep U.S. import requirements growing at a faster rate than E.C. imports.

The key to future Saudi oil exports and revenues is of course the world price of oil. We know that this price is not determined by market forces but is administered by a producers' organization above the free market level but with considerable, often forced, attention to market conditions. In a free market the buyer-seller relationship is fundamentally antagonistic at any given moment. Buyers always want the lowest price and sellers try to obtain the highest. In an administered market other criteria apply and the buyer and seller roles can be reversed. Thus, the current advocacy by some OPEC producers that the OPEC basket price be maintained at an $18 nominal price for at least "several more years" in the face of a 4-5% annual world inflation rate is opposed by some importers as unduly low and hence leading to eventual price spikes. In the U.S., the world's second largest oil and gas producer, maintenance of the nominal $18 basket price would accelerate the decline in domestic oil production and bring about a decline in gas production, since oil prices affect gas prices. It would also increase fossil fuel consumption at a faster rate than is deemed environmentally desirable. Thus, speaking only for the U.S., the lowest oil price is not necessarily the best. Saudi price policy made $18 the official "minimum" price for OPEC at last November's meeting, implying that it be raised modestly but steadily (perhaps in line with inflation, as the OPEC Secretariat has suggested). For the U.S. this is probably a more desirable oil price trajectory than long-term maintenance of a nominal $18 price level.

Capacity Constraints and Expansions

While no one in OPEC is advocating a sharp price increase, quite a number of analysts and forecasters in the consuming countries are currently predicting an OPEC basket price of about $30 by 1995. This would be an increase of more than twice the rate of the expected inflation, starting from the 1989 average basket price of $17.30. The prediction could only come true if OPEC's sustainable producing capacity keeps shrinking. Currently OPEC's spare capacity is about 5 million B/D, equal to about 20% of current production. As production increases, this excess margin must be approximately maintained to give the delivery system the required flexibility. Everybody agrees on that but not everybody may be doing something about it. OPEC Secretary General Subroto has recently made a world speaking tour to publicize his fear that the cost of maintaining a 5-6 million
B/D excess capacity by 1995 may be more than the OPEC nations can collectively afford to spend out of their own oil export earnings. However, if there is one country which is publicly committed to a policy of maintaining its existing spare producing capacity margin in the face of rising production, it is Saudi Arabia. We also know that the Kingdom is not only planning to increase its capacity ceiling but is actively engaged in doing so. If the 3-4 other major OPEC producers do the same for their spare capacity, the 1995 price projections I just quoted will not be realized.

**Saudi Arabia and the SPR**

Even if the upward trend in world oil prices remains relatively modest as a result of OPEC capacity additions, there is a perennial risk of a price spike because of unforeseen temporary disruptions caused by political or military events or technical problems. The way to cope with such eventualities is by having ready access to sufficient non-commercial strategic petroleum reserves set aside for this purpose. All member countries of the IEA carry such inventories. The largest is the U.S. government’s Strategic Petroleum Reserve. It currently contains 580 million barrels and is supposed to reach 750 million barrels by 1995. However, at the presently contemplated fill rate it won’t reach that level until the end of 1999. The reason for delay are U.S. budgetary constraints. To overcome this obstacle the DOE is considering leasing, instead of buying, some of the oil going into the SPR from certain OPEC countries with spare producing capacity. The prime candidate appears to be Saudi Arabia, which has indicated a definite interest in the concept. Preliminary discussions between the two governments have been held. It is too early to say whether anything will come of it. However the Saudi willingness to participate in a scheme to raise the fill rate of the SPR so the U.S. is better prepared to cope with the consequences of foreign disruption is significant as an indication of Saudi Arabia’s interest in avoiding a reoccurrence of the historic price spikes of 1973/4 and 1979/80. Such an indication may be useful. For the memory of the physical oil shortages on those two occasions are still quite vivid here and public thinking on the issue of oil import dependency continues to be affected by the fear that in the latter 1990’s, when most incremental oil supplies will come from the Middle East, the region’s oil will again carry a political price.

**Crude Oil Quality**

I have alluded earlier to the continuing symbiotic relationship between the U.S. and Saudi Arabia, with the former not only remaining the largest single market for imported oil but also growing throughout the 1990’s, while the latter is becoming the world’s principal producer of incremental crude supplies. However, the quality of the oil needed vs. that of the oil produced also matters. The decline in lower-48 U.S. production is primarily in light, sweet crudes as is the decline in pipeline imports from Canada to the U.S. Midcontinent. Most Saudi crudes are heavier and more sour, by comparison. Over time this could create
problems for Gulf Coast and Midcontinent refineries, requiring them to build additional conversion units at considerable capital costs. However, two recent developments, one here, the other in Saudi Arabia, may alleviate this potential problem. One is the decline in Alaskan North Slope production which is of heavy, sour quality. About 500 MB/D of this oil goes to the Gulf Coast and other Eastern markets which will be the first to be affected by the decline. These volumes must be replaced by similar quality crude from abroad. Saudi oil qualifies for this purpose.

The other, probably more important, development is the recent discovery in Saudi Arabia of substantial quantities of very light sweet crude. The press has talked about recoverable reserves on the order of 30 billion barrels. In future years they could play an important role in replacing the declining North American supplies of light/sweet crude oils.

We may also see an increase in refined products imports, both unfinished and finished, from Saudi Arabia. Last year's 111,000 B/D products imports accounted for only 5% of total U.S. products imports and 16% of total Saudi products exports. As our refineries move closer to capacity utilization and no new refineries are built, products imports are likely to grow. Saudi Arabia can be expected to play a role in this growth, particularly once its new Rabigh refinery is fully operative.

To sum up, the interdependence between the world's largest exporter and the world's largest importer of oil will continue throughout this decade. But it may be different from that of the last decade. The 1980's were mostly a buyer's market; the 1990's will be primarily a seller's market.