

COLUMBIA GLOBAL ENERGY DIALOGUES

THE GCC AND THE NEW OIL WORLD

In January 2016, the Center on Global Energy Policy at Columbia University SIPA convened a roundtable of energy and regional experts from academia, industry, finance and government to discuss the wide sweeping changes underway in oil markets, especially the drop in oil prices, and their implications for the states that make up the Gulf Cooperation Council. Following is a summary of the event, which was held under Chatham House Rule.

Like the oil market itself, the oil producing countries of the Gulf Cooperation Council (GCC) are at a crossroads. These countries – which include both members of the Organization of Petroleum Exporting Countries (OPEC) like Saudi Arabia, the United Arab Emirates, Kuwait and Qatar, and non-members like Bahrain and Oman – collectively account for the lion’s share of world crude oil and LNG exports. Rightly or wrongly, Saudi Arabia had long been seen as the “central bank of oil” – a predictable “swing producer” committed to using its vast spare capacity to smooth out the market’s ups and downs. The decision by OPEC in November 2014 not to reduce production to buttress oil prices in the midst of a precipitous price collapse caught many in the energy community off guard. Broadly perceived as a break from the policies of OPEC leader Saudi Arabia for the last 30 years, it was followed up by an increase in output by the producer group of 1.4 million barrels per day that helped send prices to below \$30 a barrel, levels not seen for over a decade.

Whether the policy is actually new or a continuation of the stated but perhaps previously misunderstood policy of Riyadh is debatable. What has become more clear since the November 2014 decision was taken is that the oil market,

and energy markets more generally, are in the midst of an upheaval wrought by new technologies and policies, new market and economic forces, and changing geopolitical and environmental factors. Equally clear is that the emerging landscape is creating incredible challenges for Saudi Arabia and the other GCC nations. The economic pressures come as the region struggles with ISIS and conflicts in Syria and Iraq, civil war in Yemen and Libya, and generational change. In Saudi Arabia itself, a new generation of political leaders is coming of age whose ascent coincides with an apparent shift in the Kingdom’s international and military posture and signs of newfound willingness to embark on economic and social reform of a type that had previously seemed unfathomable.

In January 2016, the Center on Global Energy Policy at Columbia University SIPA convened a roundtable of energy and regional experts under Chatham House Rule from academia, industry, finance and government to discuss the changes underway in oil markets and their implications for the GCC states, as well as the other forces at work in their decision-making. Given its outsized importance within the GCC and to global energy markets, there was a special focus on Saudi Arabia, and given the nature of some of the factors, the discussion frequently came back to questions of whether the forces at work were new or another version of older problems. This document provides a summary of the discussions of the roundtable, without any attribution, as allowed by the Rule.

FOR FURTHER INFORMATION ABOUT THE CENTER ON GLOBAL ENERGY POLICY OR THE COLUMBIA GLOBAL ENERGY DIALOGUES SERIES, VISIT OUR WEBSITE AT: energypolicy.columbia.edu

NEW OIL MARKET ISSUES AND POLICIES?

In June 2014, oil markets tipped into the current down cycle that has sent prices from over \$115 a barrel to lows in the \$20s in early 2016. While signs of weakening Asian demand and higher production from some OPEC members were certainly factors in the downturn, the unprecedented boom in US oil and liquids output from shale—spurred by a five-year period of high prices—provided a new challenge for oil producing nations. Born of innovations in horizontal drilling and hydraulic fracturing, this new oil could be brought to production quickly and was driven by thousands of independent producers, in contrast to more traditional oil production.

Riyadh's decision to refrain from cutting production to support prices at OPEC's November 2014 meeting, and then to subsequently increase exports to build market share, provided a starting point for the roundtable discussion. Participants considered Riyadh's policy direction and the challenges facing it through a lens that was in turn technological, economic and socio-political. Much attention was given to the structural issues that informed Saudi oil policy, namely its towering oil and natural gas endowment, dominant position in oil production and trade, and high dependency on revenues from oil sales. All of these factors weigh heavily in calculations about whether to maximize short or long term revenues.

Participants noted that Saudi oil policy makers had learned a harsh lesson from 1986 (which some said was really the last time the Kingdom tried to manage the market itself) when it slashed production to support oil prices, only to see its market share go to its competitors. In the current market, where Iraq has been ramping up supplies dramatically and Iran has been freed from the restrictions of sanctions, the prospect of restraining output and losing customers to its competition would not be logical, according to some at the roundtable. In addition, a higher price would stimulate more production from US shale—although the extent and timing of that increase was the subject of much discussion and uncertainty. Indeed, any deal to remove oil from the market would be troubled without

the participation of the larger non-OPEC producers, such as the United States (which cannot make policy decisions to lower output from its fragmented, private industry) and Russia (which has proved an unreliable partner in such deals in the past).

As such, some attendees argued that Saudi Arabia, and its close allies in the GCC, made the only rational economic choice, to increase output and allow prices to fall to a level that would force out competition from higher cost competition. For GCC countries, high levels of fiscal reserves would enable them to weather this period better than others—although most participants agreed the GCC countries did not anticipate oil prices falling this low or staying low for this long. However, it was generally agreed that US shale production adds new, untested supply dynamics to the market that has made and will continue to make it difficult for the producers and other oil market players to predict how and when the oil market will rebalance.

Production of oil from shale formations, roundtable participants noted, has changed the US oil industry. Small independent companies have taken the lead on exploiting shale. These companies, which fueled a production boom aided by easy access to capital markets, work on very different investment models than the traditional oil majors.

Attendees noted that OPEC may have miscalculated twice over. First, some participants observed that it was an error for GCC OPEC countries to “allow” prices to remain above \$100 a barrel from 2010 to 2014. These stable and high prices spurred massive investments in high-cost sources of supply from places like the ultra-deepwater, Arctic, and oil sands. Moreover, these high prices created the incentives for one of the largest oil booms in history in US shale. Secondly, with the November 2014 decision to maintain, and even increase, production to wean out high cost production from the market, GCC OPEC members had expected shale production to exhibit a much lower pain threshold. According to participants, policymakers from these nations were expecting shale production to begin to fold at levels between \$70 and \$80 a barrel. However, they noted that improving technologies, knowledge of the resource and overall efficiency gains, hedging strategies, as well as the specific financial and investment realities

of the large number of different producing companies, has made shale oil far more resilient to the lower oil price environment. Notwithstanding these miscalculations, most participants agreed that the decision to let the market come back into balance by allowing low prices to boost demand and curb supply was justified on economic grounds, particularly when other countries were unwilling to join Saudi and other GCC countries in a production cut.

Lower oil prices are also driving down costs for the industry as well, attendees noted, as companies cut back projects. The degree to which these lower costs will ultimately stimulate production when prices rebound was a critical question for participants. One participant raised the question of whether increased volatility in oil prices would impact the ability to finance projects, as they would not be able to guarantee the stability desired by investors. There was significant discussion as well about the impact reduced capital market access would have on the ability of shale producers, most of whom were heavily leveraged, to ramp up output as prices recover. Some thought access to capital would be a barrier that would preclude shale from returning to its prior growth rates even in the face of high prices, while others thought a herd mentality would lead financial markets to open back up quickly, despite claims to the contrary.

SAUDI PRODUCTION CONSTRAINTS

Another issue raised was how Saudi Arabia's ability to raise or lower oil production has changed. One attendee stressed that rising domestic demand for oil as well as its drive to increase its refining and petrochemical production capacity were creating new limits on Saudi Arabia's ability to reduce its oil production. The country may simply need to keep production at higher levels than in the past to meet these internal needs. At the same time, by pushing output higher in a bid to protect market share from competitors, Saudi Arabia's ability to adjust production to help regulate the market—to act as the global “swing producer”—had been compromised. Several participants questioned whether Saudi could really produce at the level of 12.5 million barrels per day, its stated production capacity, and thought their ability to ramp up production from current levels was more limited. As a result, oil markets were seen to

be running with the lowest spare capacity in decades, marking new territory and risk for the global economy.

LOW SPARE-CAPACITY LEVELS

Consequently, the question of whether Saudi Arabia would invest to expand its spare capacity was raised frequently during the roundtable. It was estimated that production had reached a level where Saudi Arabia only has 1 to 2 million barrels per day (bpd) of cushion left, effectively all the spare capacity left to backstop a 95 million bpd global market. Some participants noted that the small amount of spare capacity is one of the main differences between the oil price collapse currently underway and the price collapse that occurred in the mid-1980s when there were more robust levels of spare capacity. The risk of upward spikes in the event of a supply disruption is consequently much greater now, unless US tight oil can respond to price changes very quickly and flexibly.

RIG-COUNT HIKE IN PERSPECTIVE

Some participants noted that rig counts in Saudi Arabia and other GCC countries had indeed been rising recently. However, others suggested that this increase was related to recalibrating the production system at a higher level, countering decline rates in some fields, as well as increasing output of natural gas to meet growing domestic demand. It was noted that at the moment there was certainly little incentive to increase spare capacity, but that in the long run if Saudi Arabia or the GCC countries want to have a role in bringing the market into balance, then there must be further investment here. Already, nearly \$500 billion in capex has been delayed or deferred globally in oil and gas projects in response to the low oil price. If demand growth remains reasonably robust, participants questioned whether the industry is setting itself up for another underinvestment cycle and, if so, whether Saudi Arabia might lack the ability to manage the market on the upside if a tight market leads prices to spike later this decade. Oil policymakers are discussing issues around the optimum spare capacity, but again the unknowns around the ability for shale oil to react to higher prices was a major issue that has yet to be made clear.

REACHING BEYOND OPEC FOR A SUPPLY DEAL?

Attendees noted that the oil price lows reached in early 2016 were much lower than the levels GCC states had initially expected prices to reach when OPEC decided not to cut output. Some participants asked if Saudi Arabia and the GCC would reconsider this position and strike a deal with OPEC and non-OPEC producers to remove oil supplies from the market in a bid to push prices up. It was noted that many of the producing countries that lacked the fiscal reserves of the GCC states were under considerable strain, notably countries like Venezuela and Nigeria, and that there had been signs in the press that even non-OPEC nation Russia might be willing to agree to such a deal. It was also suggested that the size of the market imbalance was much greater in 2014 than now, meaning a deal then would have required a cut by Saudi Arabia much larger than in the current environment. Nonetheless, there was general skepticism that major producers would be able to agree to cut output, at least in the near term.

THE CHALLENGE OF RISING IRANIAN AND IRAQI SUPPLY

Beyond the domestic factors facing Saudi Arabia discussed earlier, participants said that any deal would be complicated by the supply increases being brought on by both Iran and Iraq, and the need to bring that back within the OPEC quota system. With the lifting of sanctions, Iran is poised to sharply hike output, although how quickly is a source of major uncertainty. It was noted that the sanctions still in place, combined with uncertainty about the attractiveness of Iran's commercial terms, may pose barriers to the ability of Iran to draw fresh investment from foreign oil companies and increase production beyond a certain level very quickly. Iraq hiked output nearly 1 million barrels per day in 2015, and is reluctant to cut output as it has struggled recently to pay foreign companies in the face of the price collapse and is thus trying to boost revenue as much as possible.

SAUDI OIL POLICY AND MARKET DIRECTION

Some participants said that Saudi Arabia has traditionally tried to work with the market, rather than

against it, in developing its oil policy. Hence, it would not be likely to get behind any kind of deal to reduce global supplies to the market until there were signs that the market is tightening on its own. The GCC will be closely monitoring global stocks for signs that they are starting to decline, attendees stressed, adding that the issues surrounding Iranian production volumes and US shale response would become much clearer over the course of this year.

TOWARDS AN IRANIAN-SAUDI RAPPROCHEMENT OF NECESSITY?

One participant suggested that low oil prices could help moderate the tensions in the Middle East, by drawing together Saudi Arabia and Iran. If Iran is disappointed with the extra revenues that they generate this year by adding new supplies into the market, Tehran may be interested in reaching a deal with the Saudis to take oil supplies off the market. Riyadh could be open to such a discussion, the participant said, if it involved Russia and other key non-OPEC producers. However, it was stressed that any cooperation would be over oil, and that there was little chance that Iran and Saudi Arabia could cooperate to solve the wider issues of the collapse of state authority due to ISIS or the war in Yemen, both for a lack of money due to low oil prices as well as for a lack of the necessary military power.

SHIFTING OIL TRADE FLOWS

Attendees probed in some depth the cyclical and structural issues at work in the global oil market and their impact on the current price environment. It was noted that the growth in oil production in the United States had changed the dynamics of the Atlantic Basin market, turning it from an import market into an exporting market. While US production is seeing declines currently, it was stressed that for all practical purposes, Asia is the only region that has growing demand and as such is the front in the battle for oil producers to place barrels.

IMPACT OF CHINA'S ECONOMIC SLOWDOWN

As China has been the biggest driver of oil demand for the 2000s, questions arose about whether the downturn in consumption seen in recent years is structural or cyclical in nature. While there were certainly cyclical

problems impacting the economy, it was noted that Chinese diesel demand may well have peaked in 2011. One participant noted that the explosion in China's oil demand was a once in a lifetime event, similar to what was seen during the period of the reconstruction of Japan and Europe after World War II. What they share is a huge build up of fixed asset investment that supported oil demand due to the accompanying requirement for diesel fuel. For China, this occurred over a 20-year period that is likely now over, and is unlikely to be replicated in the foreseeable future. While demand will certainly grow in some emerging economies, it is unlikely to be able to match what was seen in China, according to some participants.

A CHINESE TRANSPORT REVOLUTION IN THE MAKING?

In addition, the top-down nature of China's economy provides challenges to its oil demand growth, a factor compounded by the nation's efforts to implement its COP 21 objectives. As such, electric vehicles, hybrid vehicles and natural-gas-powered vehicles could cause a real dent in demand for oil as a transportation fuel. The results have large implications for Saudi Arabia and other producers that depend on petrodollars and are competing furiously for a market that looks like it may be smaller than previously expected.

CLIMATE POLICY AND THE FUTURE OF OIL DEMAND

Globally, questions about the impact of efforts to address climate change on fossil fuel demand remained a topic of importance for participants. It was pointed out that Saudi Oil Minister Ali al-Naimi has on several occasions invoked the possibility of a "black swan" event that could seriously lower oil demand and hurt the economies reliant on oil sales. Participants pointed to the auto fuel efficiency standards for automobiles in the United States and their impact on gasoline demand, and questioned whether similar measures would be adopted elsewhere. Several participants noted that a combination of policy drivers, technology advancements, and structural economic shifts could lead to much lower, even possibly declining, oil demand in the future, which would threaten the financial model of GCC countries and other petrostates.

PRODUCTION-COST DECLINES

From the supply side, in addition to the questions around shale resilience, some participants noted that the cost of traditionally more expensive oil developments in areas like the deep-water offshore were likely to come down as well, thanks to simplification of development structures and the standardization of equipment the cost deflation occurring in the oil sector could eventually make higher-cost endeavors such as the offshore more reasonable investments for larger oil companies. Other attendees noted that the price of deep-water drilling vessels had come down around a third of the price it was in the middle of 2014, and the price of steel needed to build equipment is a fraction of what it was two years ago.

WEATHERING THE STORM

A critical factor for the future of OPEC policy and oil markets is the ability of the GCC countries to withstand the low price environment. It was noted that oil prices in most of these nations were supporting vast public sector employment schemes that are critical to the social contract and that private sector employment levels for citizens was generally low, making many austerity measures difficult or off-limits.

ASSESSING GCC FINANCIAL BUFFERS

Many GCC states had built up sizeable foreign reserve buffers during the period of high oil prices preceding the crash. Kuwait, Qatar and the UAE were seen as being in relatively strong positions, while Bahrain, Oman and Saudi Arabia were seen as under “acute pressure,” according to one attendee. It was noted that Bahrain would likely be able to find protection from Saudi Arabia in case of extreme economic difficulty, while Oman was more of an open question. Much of the discussion was focused on Saudi Arabia, specifically around its overseas reserves and austerity measures.

In contrast to previous periods of low oil prices in the late 1990s, the Kingdom has large foreign reserves to draw upon, although there has been some drawdown, from \$730 billion at the peak to around \$600 billion now, participants noted. That said, attendees said that Riyadh would look to issue debt to cover their deficit in 2016 by issuing bonds in order to preserve their foreign reserves as much as possible. By one estimate, Saudi Arabia’s debt-to-GDP ratio was expected to rise from just over 5 percent in 2015 to 17.6 percent in 2016, before growing to 47.1 percent in 2020. At the same time, growth in the labor sector was expected to be strong, putting further strain on coffers due to the high reliance on the public sector for employment. (Wages and salaries, for example, were estimated to constitute 53 percent of total projected spending in 2016.) The total labor force is expected to grow from nearly 5.6 million in 2014 to nearly 7.3 million in 2020, of which an additional 780,000 would be employed by the public sector, according to one attendee.

ECONOMIC REFORMS AND AUSTERITY MEASURES

In terms of austerity measures, Saudi Arabia has reacted to the price collapse more quickly and systematically than during the crash in the 1980s, according to one attendee. Saudi Arabia, as well as other GCC countries, has used the opportunity created by lower oil prices to raise the prices of fuel, water and electricity. However, there was a lack of administrative capacity to provide targeted cash to lower income households to offset the increase in fuel costs. It was noted that there has also been a fairly drastic reduction in capital expenditures, which is hitting the contracting sector hard.

Further efforts at austerity measures and broader economic reforms may run into political headwinds, participants said. In Saudi Arabia, participants pointed to the problems associated with a youthful, underemployed and better-educated population with limited job opportunities. Highly reliant on public sector jobs paid for with oil wealth, the option of reforms that would lower the public sector salaries were seen as potentially running risks of a public backlash. Concerns were also raised about the ability to grow the limited private sector. Some attendees were skeptical that recent talk of a VAT would be implemented, for reasons that included limited administrative capacity, and that even if imposed, such a tax would do little to fill the budget gap.

Participants also discussed the possibility of raising money by holding an IPO for part of Saudi Aramco, a prospect raised earlier this year by Deputy Crown Prince Mohammad bin Salman. Some participants speculated that it might not have been a ‘serious’ proposal as much as an off-the-cuff comment made in the heat of a press interview. Others suggested that while such a plan might be popular with some Saudis supportive of Western economic models, any such move would fall short of giving investors access to Saudi Arabia’s oil production. More likely, it would be confined to Aramco’s downstream operations. Moreover, participants noted that Aramco had a history of delaying or shaping projects that its leaders did not fully agree with, and stressed that this is why there has been some distance between the oil company and the royal family. But it was also suggested that while there had been a traditional firewall between

politics and oil policy, the core business of Aramco remained inherently political. Indeed, Aramco is often called upon to take on state imperatives beyond its core oil business, such as managing parts of the health care system and undertaking large construction projects. As such, some thought Aramco could find itself under pressure to pursue a limited IPO option if that was truly the direction that the government wanted to push toward.

PASSING OF THE TORCH

The generational change in Saudi leadership and its potential implications were also discussed, especially as the levers of political power are passed on from the sons of King Abdulaziz to their children. Participants discussed the views of Mohammad bin Nayef (MbN) and whether the designation of Mohammad bin Salman (MbS) as the deputy crown prince by King Salman had the potential to mark a break from the practices and policies seen in the Kingdom over the past 40 years. It was noted that with the exception of the oil embargo of the 1970s, Saudi Arabia had proved to be a reliable actor in the global economic system, and had provided a pillar of stability in the region. Indeed, against this backdrop, some participants noted that the war in Yemen could be viewed as a departure from previous Saudi policy, and that it was destabilizing for the region.

Attendees also discussed the degree to which new leadership would threaten to break the traditional wall built up between oil policy and the royal family, put in place to prevent rivals from taking control of the nation's economic driver for political gain. It was noted, however, that thus far MbS appeared to be siding with the technocrats right now on oil policy and recognized that any policy that reduced oil production would only lead to a loss of market share for Saudi Arabia, which might be taken by Iran. However, one participant suggested that if there was a convincing argument that there was a windfall profit to be made by reducing production at a time when extra oil profits were viewed as critical, then the Saudi leadership could support such a decision. There was also a discussion around whether there was a rivalry between MbS and MbN and whether such a rivalry could potentially pose a threat to stability. However, it was stressed by some participants that there was little evidence from the outside of such a rivalry, and much remains unknown about their relationship.

In discussing internal threats to the Kingdom, one participant discussed three pillars of stability: 1) the cohesion of the royal family, 2) robust oil prices, and 3) peace among the Saudi population. It was then suggested that while there may be signs of competition in the royal family, at this point it was not representative of the kind of infighting that would threaten the regime. Likewise, although oil prices are low, they would have to remain at low levels for a significant period of time—potentially five years—to create destabilizing economic repercussions. Finally, in terms of a threat from the streets, participants noted that Saudi Arabia was being careful in its austerity measures, and that moreover, there may be a feeling within the population that the violence seen in Yemen, Syrian and Iraq was a warning signal for the dangers of an unstable government.

LOOKING FORWARD

The decision by Saudi Arabia and its GCC allies to pursue a course of increasing oil production in the face of declining oil prices may be viewed as a logical and rational extension of its stated policies in the past. However, participants generally agreed that oil markets are entering a period of uncertainty that will be defined in part by new factors around shale oil elasticity, potentially weaker demand, and limited spare capacity. Further complicating the price collapse have been ISIS and various regional conflicts that are potentially destabilizing factors that add further burdens on budgets.

Oil producing countries in the GCC have built up considerable foreign reserve buffers and taken steps to raise subsidized fuel energy prices. Yet more aggressive austerity measures, if required, may remain difficult to undertake, due to the strong reliance on public employment and the desire to avoid wide scale public discontent. Importantly, while Saudi Arabia is currently holding the line in attempting oil policy largely in the hands of the technocrats, as a new generation assumes power, there is a great deal of interest in whether pressures emerge that could change that dynamic.

Understanding the impact of the oil price collapse and the dramatic changes underway in the oil market on GCC countries, and more broadly, will require deeper analysis of numerous overlapping dynamics. Several forthcoming research streams from the Center on Global Energy Policy will focus on these to facilitate a

broader understanding of the historic shifts underway. These include a careful study of the potential for technology, policy, and structural economic shifts to lead to peak oil demand, and what the economic, geopolitical and environmental implications might be; analysis of the outlook for tight oil production, both in the US and overseas, in the face of lower oil prices; and the potential geopolitical ramifications of structurally lower, and perhaps more volatile, oil prices without a “market manager.”



ABOUT THE CENTER ON GLOBAL ENERGY POLICY

The Center on Global Energy Policy provides independent, balanced, data-driven analysis to help policymakers navigate the complex world of energy. We approach energy as an economic, security, and environmental concern. And we draw on the resources of a world-class institution, faculty with real-world experience, and a location in the world's finance and media capital. Visit us at energypolicy.columbia.edu

 facebook.com/ColumbiaUEnergy

 twitter.com/ColumbiaUEnergy

ABOUT THE SCHOOL OF INTERNATIONAL AND PUBLIC AFFAIRS

SIPA's mission is to empower people to serve the global public interest. Our goal is to foster economic growth, sustainable development, social progress, and democratic governance by educating public policy professionals, producing policy-related research, and conveying the results to the world. Based in New York City, with a student body that is 50 percent international and educational partners in cities around the world, SIPA is the most global of public policy schools. For more information, please visit www.sipa.columbia.edu