The Mixed Geopolitical Implications of Low Oil Prices for Saudi Arabia, Russia & the United States

Author Peter E. Paraschos

By Peter E. Paraschos

Global oil prices crashed in 2014 for the first time since 2008, sliding from a multi-year peak of $115 per barrel in June 2014 to $45 in February 2015, due to rising supplies and declining consumption. This article analyzes the economic and geopolitical implications of low oil prices for the world's three leading oil producers: Saudi Arabia, Russia, and the United States. These countries accounted for a combined 37.5% of total global oil supply in 2013 and form the tripolar core of the global oil order.

Saudi Oil Power & Shifting the Burden of Oil Output Adjustment

Of the three core producers, Saudi Arabia is the most important due to its ample oil reserves, world-leading production capacity of 12.5 million barrels per day (mb/d), and low marginal production costs at $10 per barrel. Saudi Arabia is the world's largest exporter of oil and maintains reserve production capacity of 1.5 mb/d to 2.0 mb/d, which enables it to increase production at short notice to ease supply disruptions and limit oil price increases.

Saudi Arabia plays an outsize role in OPEC, which accounted for 36.46 mb/d of crude oil and other liquids in 2014, about 39.2% of global crude and liquid supply. In 2014, Saudi Arabia produced 9.7 mb/d, according to the US Energy Information Administration (EIA), or 32.2% of total OPEC crude supply. However, Saudi Arabia increased output to a near record level of 10.3 mb/d during the first quarter of 2015. Despite a notable increase in domestic oil consumption, Saudi crude oil exports actually increased from 6.3 mb/d in 2009 to 7.6 mb/d in 2013.

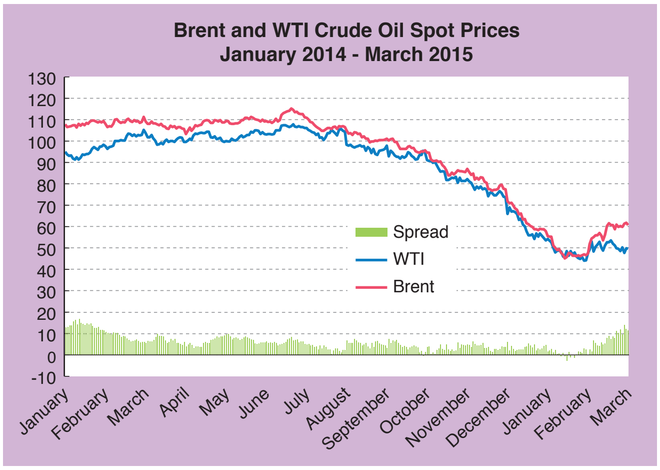
As the "global central bank of oil", Saudi Arabia has long proclaimed an interest in stable oil markets, but has at times tolerated and even engineered sustained periods of low oil prices to gain or maintain market share, enforce production discipline within OPEC, and ensure long-term demand for oil.

During late 2014, Saudi oil policy decisively shifted from supporting price stability to protecting market share. At the OPEC ministerial meeting in November 2014, Saudi Oil Minister Ali al-Naimi rebuffed considerable pressure from rival OPEC producers to cut production. Since then, Saudi oil officials have repeatedly made it clear that the kingdom will not curb output to support prices without cooperation from major non-OPEC suppliers. Saudi Arabia has abdicated its roles as global swing producer/market stabilizer, at least temporarily.

Photo 1: UNCTAD

Ali al-Naimi, Saudi Arabia's minister of petroleum and mineral resources

CHART 1
The decline of global oil prices
January 2014 - March 2015



Source: Developed by ITTA staff based on data from the US Energy Information Administration

This stands in contrast to the Saudi response to the oil price crash of 2008, when it rapidly organized coordinated supply cuts to support prices. This time, the response is more akin to the mid-1980s, when it tolerated low oil prices for an extended period.

The apparent commercial aim of current Saudi oil policy is two-fold: to shift the burden of adjustment (i.e. production cuts) onto higher cost producers, including Russia and the US, and to improve the kingdom's share of the global oil market, particularly in North America and Asia.

Saudi oil exports to the US market declined about 23% between 2008 and 2014, due to rising competition from US and Canadian producers. However, Saudi Aramco is well positioned through its

Motiva refinery joint venture with Shell, located on the US Gulf Coast, to anchor its position in the US market for the long term. Saudi oil sales to Asia have steadily increased in response to growing demand, increasing to 68% of total exports in 2013 from 60% in the late 1990s. However, Saudi Arabia must compete harder for market share in Asia due to the US displacement of imported oil from multiple regions, rising Iraqi production, and the entry of Russian oil into Asia-Pacific markets. In China, for example, imports of Saudi oil have declined for two consecutive years, subsiding to 997,000 b/d in 2014.

Saudi Aramco is continuing to make major investments in its domestic and international refinery capacity. Indeed, Aramco plans to double its global refining capacity to 8.0 mb/d a day by 2020 to meet growing domestic demand for fuels as well as rising demand in East Asia, where Aramco has already established refinery joint ventures in China, Japan, and South Korea. However, there are indications that Aramco intends to reduce capital expenditures in response to low oil prices. Industry analysts are particularly interested in whether Aramco will delay or cancel plans to increase output from the giant Khurais field by 300,000 b/d to replace depleted production from mature fields.

Saudi Oil Policy & Looming Fiscal Constraints

Saudi Arabia depends on oil exports for the vast majority of its export earnings (perhaps as much as 90%) and government budget revenues.

Enabled by years of robust oil earnings, Saudi government budget expenditures increased by an average of $20.1 billion between 2003 and 2014, regardless of changes in oil prices. Saudi defense spending increased 17% to $80.8 billion in 2014, making the Saudi defense budget the world's fourth-largest budget.

Due in part to the impact of low oil prices, the kingdom returned to deficit spending in 2014. The Saudi government projected a deficit of $39 billion for 2015, about 5.4% of Saudi GDP, before King Salman announced $30 billion in additional spending in January 2015 and initiated an open-ended and undoubtedly expensive military intervention in neighboring Yemen in March 2015.

At the same time, Saudi Arabia currently enjoys a position of enviable financial strength. It has massive reserves, including $766 billion in highly liquid foreign assets (2014), and exceptionally low levels of public debt. Depending on the low oil price scenario, Saudi Arabia could maintain current spending trends for the next four to eight years. However, the persistence of anemic oil prices over time could seriously deplete Saudi financial resources and compel Saudi leaders to make difficult budget choices among the competing needs to maintain domestic socioeconomic stability, build up Saudi military defenses while simultaneously intervening in neighboring countries, and provide ample aid to poorer regional allies.

Russian Neo-Imperialism & Low Oil Prices

Post-Soviet Russia has rebuilt itself as an oil export power, second only to Saudi Arabia, increasing output from the post-Soviet low of 5.9 mb/d in 1996 to 10.6 mb/d in 2014. Today, Russian oil production accounts for 76% of total Eurasian oil output, and Russia's export pipeline infrastructure enables Russian oil to compete in both the trans-Atlantic and Asia-Pacific markets.

Post-Soviet Russia, like the Soviet Union, remains highly dependent on oil and gas exports to drive economic growth. Oil and natural gas comprised about 68% of Russia's exports in 2013, according to the EIA, and generated approximately 50% of Russia's federal budget revenues.

Russia remains determined to keep oil output and exports at elevated levels regardless of low prices, hoping to deflect any burden of production cuts onto other countries, especially on the US tight oil sector. This is reminiscent of Soviet Russia's response to the run of low prices from 1986 through 1989. During that era, Soviet oil production peaked at 12 mb/d in 1987 and remained elevated for years, but could not improve the Soviet Union's worsening fiscal condition.

Today, Russia remains under sustained, intense economic pressure due to the combination of low oil prices and US and European sanctions imposed in response to its annexation of Crimea in March 2014. As a result, the Russian Economy Ministry expects GDP to decline 3.0% in 2015.

The Russian ruble has sustained large losses against the US dollar, further stoking inflation, but the ruble stabilized in early 2015 due to significant increases in Russian interest rates, which should further dampen growth. Capital flight is expected to continue in 2015, averaging about $100 billion compared to $150 billion in 2014.

During the first quarter of 2015, Russia's budget deficit equaled 10.5% of GDP, and oil prices remained well below the $98 per barrel that the IMF says Russia needs to achieve a balanced budget. At the same time, Russian access to international debt markets is now seriously constrained due to sanctions.

The Russian government has already committed $56.8 billion to help highly-indebted "strategic" Russian companies meet short-term debt obligations. Major Russian energy companies, notably Gazprom and Rosneft, should continue to receive government support, at least over the short term.

The Limits of Russian Fiscal Resilience

Past episodes of low oil prices undermined the sclerotic Soviet economy during the 1980s and played a major role in post-Soviet

Photo 2: World Economic Forum

Russian President Vladimir Putin at the 2009 World Economic Forum meeting in Davos, Switzerland

Russia's default on its debt in 1998. This time, Russia has ample fiscal reserves to deal with the crisis, about $394 billion as of January 2015, down from $544 billion in 2011. Russia also has low levels of external debt, but its debt-to-GDP ratio is expected to increase to 16.5% in 2015 from 15.7% in 2014, according to the IMF.

At roughly the same time, the government of President Vladimir Putin intends to increase Russia's sizable defense budget from $68.9 billion in 2013 to $98 billion in 2016. In December 2014, Russian Finance Minister Anton Siluanov warned that at the current rate of expenditure, Russia could rapidly deplete its financial reserves, saying "If no decisions are made, we'll burn through all the reserves in 2016-2017."

The Russian annexation of Crimea in March 2014 marked the first forcible territorial change in Europe since 1945, and Russia now finds itself enmeshed in a prolonged, costly conflict in eastern Ukraine. As a result, Russia is experiencing its worst era of relations with the West in decades.

Russian military interventions in Georgia in August 2008 and in Ukraine in February 2014 coincided with strong oil prices, which suggest that Putin's willingness to use military force may be greater during such times. Whether prolonged low oil prices will dampen Russia's newfound appetite for military adventure is unclear. There are concerns that the prospect of acute economic distress could make Russia behave even more dangerously, perhaps provoking new conflicts with Baltic members of NATO, like Estonia, that have large Russian populations.

To lessen Russia's dependence on Western energy markets, Putin is seeking to further reorient the bulk of Russia's energy trade toward Asia, and especially China, to reduce Russian dependence on European markets. This effort, however, will require the development of expensive energy transportation infrastructure and access to substantial capital. Putin's turn toward Asia also revives memories of Moscow's interest in improving relations with China, Japan, and South Korea during the 1980s, an effort that ultimately foundered due to the Soviet Union's economic and political collapse during the early 1990s.

Russia also has outsize influence over other major oil and gas producers in the former Soviet space — Azerbaijan in the South Caucasus and Kazakhstan, Turkmenistan, and Uzbekistan in Central Asia. However, Russia's transportation monopoly based on the old Soviet pipeline network, which routed outlying oil and gas production through Russia proper, has significantly eroded. Kazakhstan and Turkmenistan are now exporting petroleum to China, while Azerbaijan has long had access to Western markets through the Baku-Tbilisi-Ceyhan pipeline.

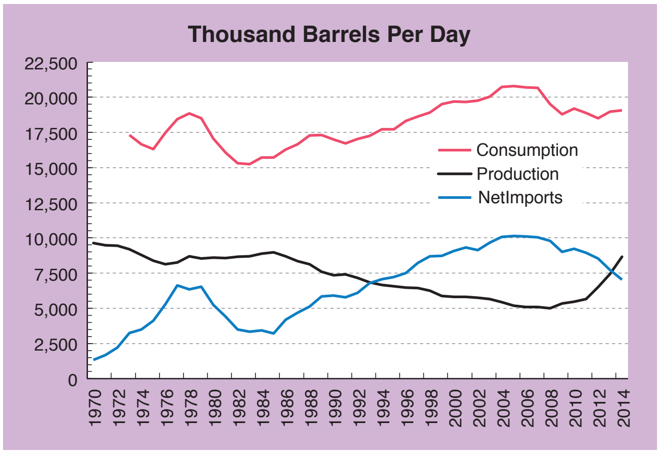
The United States & Low Oil Prices

The revival of US oil production is a "game changing development" that is significantly altering the global trade in crude oil. US output of crude oil and lease condensate peaked at 9.6 mb/d in 1970 and continued to decline, hitting a post-1945 low of 5.0 mb/d in 2008. US oil production was expected to remain in decline, leaving the US market increasingly dependent on imports of foreign oil.

Due to the impressive growth of tight oil production from shale formations, however, the US oil sector has increased output every year since 2008, reaching average annual production of 8.7 mb/d in 2014. In February 2014, US oil output totaled 9.4 mb/d, but the EIA later forecast that US oil output would end 2015 at 9.2 mb/d and 2016 at 9.3 mb/d. As a result of the US "tight oil boom", the US has strengthened itself as the thriving heart of the integrated North American energy complex involving Canada and Mexico, which accounts for 23.4% of global oil supply.

CHART 2

US crude oil production, consumption & imports: 1970-2014



Source: Developed by ITTA staff based on data from the US Energy Information Administration

The consequent decline in US imports of crude oil has been dramatic, falling from 67% of total consumption to 47% in 2014, the lowest level since 1992. To date, 2.4 mb/d of imported oil have been displaced between 2008 and 2014, freeing up these supplies for other global markets. In the Asia-Pacific region, Middle Eastern producers must now compete with African, Latin American, and Russian crudes formerly bound for the US market.

The US remains the world's largest consumer of oil, yet US consumption of crude oil and petroleum products peaked in 2005 at 20.8 mb/d before declining. US consumption has rebounded somewhat since 2012, rising to 18.96 mb/d in 2013 and 19.03 mb/d in 2014. The EIA anticipates that US consumption of crude oil and petroleum products will continue to increase, but only marginally over the short term.

The US tight oil boom commenced during an unusual multi-year era of sustained high oil prices. Breakeven prices for most tight oil producers range from $50 to $69 per barrel, according to energy consulting company IHS. In response to low prices, US oil companies have slashed planned capital expenditures, causing a 50% decline in onshore drilling activity as of April 2015.

At this juncture, the US oil sector is likely headed for a period of consolidation in which financially weaker producers are either acquired by stronger companies or are forced to declare bankruptcy. At the same time, lower prices are generating intense pressure on oil companies to reduce costs and improve operating efficiency. However, it remains unclear at this time if the US oil sector will assume the role of market-based swing producer, especially when higher prices return. The strength of any recovery will likely be constrained, at least initially, Photo 3: AP/AFLO

Saudi Arabia's King Salman pictured with US Vice President Joe Biden

Photo 4: Official U.S. Navy Page

The USS George H.W. Bush patrolling regional waters

by a shortage of skilled workers in the oil sector, particularly among oil services companies, which have sharply reduced employment.

The Tight Oil Boom & Regional Challenges to US Power

After US oil production peaked in 1970 and the US became increasingly dependent on imported oil, Washington prioritized diversification of overseas oil supplies as a vital interest. Washington conspicuously promoted US access to petroleum resources in West Africa, North Africa, Central Asia, and later in post-Soviet Russia to guard against the possibility of supply disruption.

The US shift from net exporter to net importer of oil, combined with the rapid rise of OPEC oil power, came with profound geopolitical implications. The US entered into highly unstable regions and even into conflicts the origin of which had little or nothing to do with the US. The US-Iran Gulf "tanker war" in 1987–1988, the 1991 Persian Gulf War, and the US-led military intervention in Iraq from 2003 to 2011 stand out as prime examples.

The US now faces substantial regional challenges that are affected to different extents by the decline in oil prices: in Europe, the US is engaged in an uncertain effort to reverse Russian military intervention in Ukraine and shield NATO allies from Russian intimidation. While low oil prices have clearly intensified the negative impact of Western sanctions on Russia's economy, a comparable deflating impact on Russia's aggressive neo-imperial ambitions has yet to materialize.

In the Middle East, the US is once again leading a coalition of regional allies, including Saudi Arabia, Gulf Arab states, and Jordan to defeat the so-called Islamic State in Syria and Iraq, while simultaneously backstopping the Saudi military intervention in Yemen. At the same time, the administration of President Barack Obama is attempting to resolve the longstanding nuclear dispute with Iran, which is under sustained pressure due to sanctions and low oil prices.

Declining US dependence on imported oil, combined with "war fatigue" among the general population, has caused significant concern among Washington's Gulf Arab allies about the strength and durability of the US security commitment. However, the renewed application of US military power in the region has largely eased Gulf Arab concerns about US "staying power".

In East Asia, the US must now deal with an increasingly assertive, confident China that is systematically expanding its reach into maritime areas claimed by US allies, including Japan and the Philippines. At the same time, China has overtaken the US to become the world's largest net importer of crude oil and petroleum products, causing Beijing to pursue greater diversification of overseas oil supplies to diminish its vulnerability to supply disruptions in the Middle East. Due to its own naval limitations, China still relies on the US Navy to ensure security of maritime energy transportation. To the extent that low prices cause China to increase domestic oil consumption, China could become even more dependent on Middle Eastern oil and US naval protection.

Conclusions

The implications of low oil prices, both economically and geopolitically, vary considerably for Saudi Arabia, Russia, and the US. Saudi oil policy remains focused on securing market share at the expense of higher cost producers. While low oil prices are testing Saudi public finances, Riyadh insists that non-OPEC producers must share the burden of any production cuts to stabilize oil prices. The kingdom has increased production to near record levels in a soft market to buttress this demand.

Russia remains under sustained economic pressure, and the apparent drain on Russian financial reserves is significant. Russian officials have highlighted the recent strengthening of the ruble and the consequent diminution of inflationary pressures to assert that Russia's economic position is stabilizing. However, the persistence of low oil prices will further undermine the Russian economy and magnify the price of Russia's military intervention in Ukraine.

The rapid growth of US oil production has significantly reduced the role of traditional energy security concerns as a driving force in US foreign policy. However, the implications of low oil prices are generally mixed and still emerging in the US case. The key uncertainty is how low oil prices will affect US oil production over the medium term and whether the US dependence on imported oil will increase to any significant extent. JS

Peter Paraschos is director of energy and geopolitical risk at International Technology and Trade Associates, Inc. (ITTA), a consulting company in Washington, D.C. His primary areas of expertise include Middle East, North American, and Caspian Sea oil and gas producers.