Behind the Saudi Oil-Price Gambit

Exclusive: Saudi Arabia is wielding its oil weapon by keeping production high and prices low all the better to punish some rivals and consolidate market share but the gambit may come back to bite the House of Saud, as Andrés Cala explains.

By Andrés Cala

American motorists are enjoying the lowest gasoline prices since the depths of the Great Recession in 2008-09, but Saudi Arabia’s strategy of keeping its oil production high and prices low and thus punishing some of its geopolitical and economic rivals may have a number of unintended and unpleasant consequences.

While most attention has focused on how the Saudi success in pushing prices down now around $45 a barrel for benchmark crude is hurting its Mideast adversary Iran and Iran’s big-power backer Russia, the cheaper oil is also harming a number of other key oil-producers from Mexico to Nigeria, from Canada to Algeria, from Venezuela to the North Sea.

Other victims of the cheaper crude include shale-oil producers in the United States and developers of higher-cost alternative energy sources, such as biofuels, solar, wind, etc. All are likely to be hampered, though not destroyed, by the Saudi actions assuming prices stabilize at a higher level later this year.

Saudi Arabia’s moves also could be sounding the death knell for the Organization of Petroleum Exporting Countries, the 12-country cartel that has served as a key base for Saudi Arabia’s international power. Many OPEC partners are furious at what they consider Saudi self-interests, although some Sunni-led Persian Gulf states share Riyadh’s geopolitical goals, particularly combating the perceived rise of Shiite-ruled Iran.

But there is a measure of weakness, too, in Saudi Arabia’s flexing its oil-producing muscle, a sign that the kingdom is reeling from a series of setbacks and needs to remind the world of its powerful grip on the oil markets. But is this show of strength more ephemeral than imposing?

There’s no doubt that by lowering oil prices Saudi Arabia can both hurt its international foes and its economic rivals. It is squeezing its competitors in what amounts to a classic monopolistic gambit. If Saudi Arabia can succeed in reducing prices to a level that makes many of its competitors uncompetitive, it hopes that it can reorder oil markets to its benefit.

Otherwise, the trends are troubling for the Saudis, with U.S. shale-oil production reducing America’s dependence on imports and increased energy efficiency and alternative sources threatening the historic Saudi chokehold on the global economy. By striking now, Saudi could hope to put some competitors out of business or at least retard their progress.

Still, there is a limit to how long the Saudi strategy can work. Not only is there internal financial pressure on Riyadh to collect more money from Saudi Arabia’s only valuable resource but there is an economic logic that ultimately should negate the lower prices the burst of business activity (outside the energy sector) that cheaper oil will generate, thus raising demand for oil.

Citibank analysts, for example, more than doubled their demand growth forecasts for 2015 and 2016, although others, like HSBC, have been more cautious. As that demand rises, so should oil prices. At least that is what vulnerable oil producers hope.

Otherwise, there could be destabilization of some important U.S. allies, including Nigeria, Africa’s largest economy which is heavily dependent on oil exports, and Mexico on America’s southern border. Saudi Arabia is risking making enemies even among Washington’s friends.

Saudi Arabia’s Enemies

Of course, pain also is being inflicted on some recent American adversaries, such as Russia and Iran, amid Washington’s hopes that the oil-price cut might pressure them to be more accommodating, Russia on Ukraine and Iran in nuclear talks.

But that may be unrealistic given the internal political pressures associated with those issues, with Russia unwilling to acquiesce to NATO’s expansion into Ukraine and Iran resistant to complete capitulation on its rights to produce nuclear material for civilian purposes. So, any geopolitical pain from Saudi-induced oil price cuts will likely be weathered by Iran and Russia, believing that oil markets will stabilize soon enough at what they consider acceptable levels.

Iran’s President Hassan Rohani argued just that this week: “If Iran suffers from the drop in oil prices, know that other oil-producing countries such as Saudi Arabia and Kuwait will suffer more than Iran.” His math is straightforward. While a third of Iran’s budget income comes from oil sales, Saudi Arabia and Kuwait each depend on oil for more 90 percent. Granted, they have a huge financial cushion, but it makes no economic sense for them to deplete their capital reserves.

The degree of U.S. animosity toward Russia and Iran may be overestimated, too, since the Obama administration appears eager to enlist both countries on behalf of common interests, such as combating Islamic terrorism that primarily emerges from Sunni fundamentalism associated with Saudi Arabia and other Sunni oil sheikdoms.

Shiite-ruled Iran and Russia, which faces its own threat from Muslim radicals in Chechnya, are natural allies in the struggle recently highlighted by the terror attacks in Paris. The major terrorist groups from al-Qaeda to the Islamic State have long been associated with funding, albeit often indirect, from the Sunni oil states of the Persian Gulf.

Saudi Arabia also risks alienating some of its traditional allies in OPEC since some of them are among those suffering the most from the collapse in oil prices, including Venezuela, Angola, Nigeria, Algeria, Iraq and Iran.

This short-term pain is unlikely to translate into long-term gain for Saudi Arabia. That is because price correlation with oil supply is diluted over months and years, not days. In other words, oil producers with high marginal costs won’t reduce output because prices are low, but they will cut back on investments which will eventually translate into slower output growth.

The average marginal production cost of U.S. shale-oil producers is around $70 a barrel making production at $45 a barrel unprofitable but it can be as low as $40 a barrel. U.S. companies are also well hedged for months to come, so the damage should be manageable depending on how prices behave in 2015.

That said, there is early evidence, in the form of reduced drilling, that the oil plunge is affecting investment in U.S. incremental supply growth. It’s not surprising because much of the investment is directed to shale oil, which happens to be more capital intensive and with shorter life-spans than conventional oil production. It thus makes sense for the still maturing shale-oil industry to hold back for now to protect cash flow, while prices stabilize.

Marginal Costs

That is not necessarily the case though for other producers. Marginal costs of Canadian oil-sand producers is closer to $90 a barrel and that’s without including transportation costs, which are one of industry’s highest. The current unprofitability of this oil-sand production could influence, too, the U.S. political debate around the Keystone XL Pipeline, which would carry the product from central Canada to the Gulf of Mexico.

Europe’s biofuel industry will also struggle to adapt with its marginal costs above $100 a barrel. So will Brazil’s capital intensive, deepwater oil discoveries, with marginal costs of about $80 a barrel. African countries, with both nascent and mature oil industries, are also exposed in Angola, Algeria, and Nigeria.

Proportionally speaking though, some oil heavyweight countries heavily dependent on oil revenue will suffer more, such as Venezuela and Mexico. Their existing marginal costs are lower, around $30 a barrel, but it will be harder to attract investment or financing amid the oil slump to sustain or increase their falling production from mature wells.

The same can be said about European North Sea oil production. Marginal costs are around $50 a barrel, but the inevitable decline of its depleted reserves makes new and much costlier investment requirements a less attractive option.

Countries can postpone the damage in the form of sovereign debt, but only partially because they still depend on private investors for their cash and technology, which will be much harder to attract now with the unpredictable evolution of oil markets.

From an economic point of view, the Saudi oil industry can indeed weather sustained low prices much better than all its competitors because it produces the most oil at the lowest cost, giving it the short-term advantage. Most Saudi and other Persian Gulf oil has a marginal cost of $10 to $20 a barrel.

Some U.S. producers will be priced out, but even before them, many more will be in Canada, Latin America, Africa and the North Sea, which are arguably even more exposed.

But how the oil markets will stabilize is unpredictable. Take your pick from the many forecasts out there, but few expect prices to exceed $100 a barrel in the next two years. That is comfortable for Riyadh, but still manageable for many of its rivals and certainly for most U.S. shale producers, although many higher-priced projects globally will likely be postponed.

Riyadh also will make few friends along the way while inflicting what is likely to be short-term damage. And it has all but destroyed OPEC unity as well.

What’s worse from a Saudi perspective, both geopolitically and economically, is that the most unpredictable factors are still to come. If Iran reaches a nuclear deal and escapes from many international sanctions, Iran could unleash an incremental flood of oil exports to market. Iraq will surely be doing the same, although the timing remains uncertain because of security issues. And Libya, if it can stabilize politically, will eventually reenter the market in force.

That would be bad news for higher priced oil production projects, but the surge in supply also could limit what appears to be one of the principal goals of the

Saudi price maneuver, strengthening its dominance over the oil markets. At that point, Riyadh might wish that it still had a collaborative OPEC to put a brake on supply.

Ultimately, Saudi Arabia might end up facing its greatest fear a world in which the Saudis no longer control the oil markets.

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Crime and CIA Embarrassments

Exclusive: Ex-CIA official Jeffrey Sterling is going on trial for espionage because he allegedly told a reporter about a botched covert op that sent flawed nuclear designs to Iran, but powerful people want to spare ex-CIA Director David Petraeus indictment for leaking secrets to a mistress, notes ex-CIA analyst Ray McGovern.

By Ray McGovern

I confess to being naive. From what I had read about "Operation Merlin," a harebrained scheme to sabotage Iran's nuclear program, I was convinced that the CIA would be determined to avoid calling more attention to it. Or, by extension, to author James Risen's continuing revelations in his new book *Pay Any Price*" of unconscionable incompetence by our intrepid spies. "Merlin" was exposed in an earlier Risen book, *State of War*.

How wrong I was! The decision by the CIA and hired hands at the Justice Department to prosecute former CIA official Jeffrey Sterling reflects, rather, a clear determination to give priority to deterring potential whistleblowers privy to information extremely embarrassing to the government. I repeat, embarrassing to the government, not detrimental to the national security.

As for risk of extreme embarrassment once U.S. citizens got additional insight into the dumb schemes of amateur intelligence operators, the government presumably thinks it can depend on mainstream media to treat bungling by our sophomore spies "with discretion."

In short, the prosecution of Jeffrey Sterling seems to have little to do with exposing secrets, but everything to do with hiding the kind of gross misfeasance that truth be told *does* constitute a real and present danger to our national security.

Similarly, one might think the government would be embarrassed when it became more widely known that Jeffrey Sterling did go to Senate Intelligence Committee staffers to tell them of this unconscionably stupid covert action (which involved delivering flawed nuclear weapons blueprints to Iran in 2000 with the goal of sabotaging any bomb-building plans, but the flaws were apparently detected and the real data inadvertently exposed genuine nuclear-weapons secrets).

Sterling's efforts to go through channels had zero results. One need not be a cynic to conclude that the government apparently sees an overweening, countervailing positive in demonstrating to potential whistleblowers (if further evidence were needed) that going to congressional "overseers" is a feckless exercise and only serves to get you in a peck of trouble. When Risen included a section about Operation Merlin in *State of War*, Sterling became the chief suspect and now faces 10 felony counts, including seven under the Espionage Act.

In this light, is there not supreme irony in former Senate Intelligence Committee chair Diane Feinstein's plea that former CIA Director David Petraeus not be prosecuted for sharing classified information with his biographer/mistress because he has "suffered enough?" Does one have to be an intelligence officer to appreciate the gravity of that crime, especially since Petraeus served as the agency's top official? Do the big shots with lots of important friends get one standard of justice and the lower ranks get another?

Apparently, there are some old-timers at the FBI and Justice who deem Petraeus's alleged indiscretions with classified material eminently worthy to pursue. And they presumably know the sensitivity of what Petraeus shared.

There is sad precedent here. After former CIA Director John Deutch stepped down in December 1996, CIA security discovered that several of his "unclassified" laptop computers at his home contained highly classified intelligence information, spurring a formal security investigation. Deutch got a pardon from President Bill Clinton on his last day in office.

With the arrogant Deutch it was above-the-law hubris, pure and simple; there was no sign of any effort to curry the favors of a paramour-cum-biographer. Sadly for Petraeus, L'Affaire Paula Broadwell seems to be over. Perhaps that is part of what Sen. Feinstein has in mind in suggesting he has already "suffered enough"? And he went through all that embarrassment! Poor boy!

A cruelly different standard applies to Jeffrey Sterling, who is alleged to have let the American people in on the secret of a reckless covert action.

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