 file 25X1

Central Intelligence Agency

Washington, D.C. 20505

DATE 4/7/86

DOC NO GI M 86-20084

OCR 3

P&PD 1

file & SOURCED

DIRECTORATE OF INTELLIGENCE

31 March 1986

The Saudi Oil Offensive

Summary

Saudi Arabia appears determined to maintain its aggressive oil marketing tactics despite the continued erosion in price. We believe the Saudi objectives are to increase their own oil revenues, regain Saudi Arabia's position as the world's largest oil exporter, ensure a growing long-term market for oil, and to squeeze Iran economically. In our judgment, a price of about $15 per barrel is most consistent with the combination of Saudi objectives, but Riyadh may not be able to prevent prices from falling further because of the complexity and size of the international oil market. Where ever prices stabilize, we expect Saudi Arabia to emerge with a much larger share of the market than it had last year. Over the longer-term the Saudi strategy of accepting sharply lower oil prices will lead to greater Western dependence on Gulf oil supplies and to increased vulnerability to future price shocks and supply disruptions. 25X1

[redacted] 25X1

This memorandum was prepared by [redacted] Energy Markets Branch, Office of Global Issues with a contribution from [redacted] OGI, and the Office of Near Eastern and South Asian Analysis. The information contained herein is updated to 31 March 1986. Comments may be directed to [redacted] Chief, Strategic Resources Division, [redacted] 25X1 25X1 25X1

25X1

GI M 86-20084

[redacted] 25X1

[redacted] 25X1

25X1

The Saudi Oil Offensive

Introduction

In late summer 1985 Riyadh abandoned its role as OPEC's swing producer because, in our opinion, it decided that lower prices were more palatable than the risk of growing domestic discontent with economic austerity (see Figure 1). Saudi Arabia was struggling to cope with sharply lower earnings after years of rapid development and high oil revenues. The Kingdom's oil income had fallen from a peak of $110 billion in 1981 to about $27 billion in 1985, but spending fell much slower. Because oil earnings account for more than 50 percent of GNP and 80 percent of government expenditures, Riyadh was forced to make a difficult choice: increase oil production or sharply cut spending. 25X1

Saudi Objectives

We believe a combination of economic, political, and security considerations is the catalyst for Riyadh's current oil offensive. The Saudis want to:

- Increase near-term oil revenues to avert further deep spending cuts and foreign reserve drawdowns.

- Capture a greater market share, preferably through producer cooperation.

- Ensure a growing long-term market for oil by making consuming countries more dependent on oil.

- Squeeze Tehran economically and hasten an end to the Iran-Iraq war.

The relative importance Riyadh attaches to these objectives will determine how far the Saudis are willing to see prices erode before they compromise. 25X1

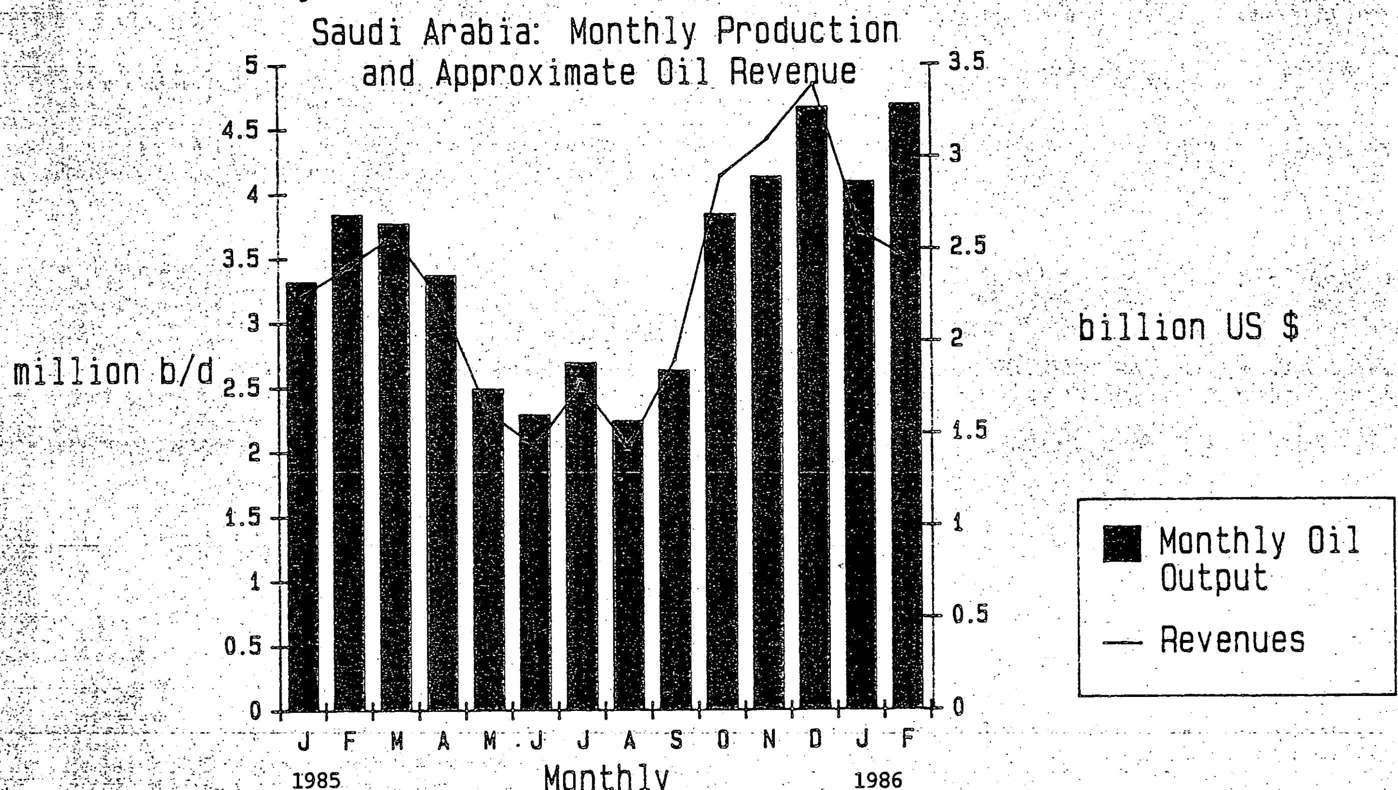
The Revenue Issue. By mid-1985 Saudi attempts to prop up prices caused oil production to fall to a 20-year low. On an annual basis, this level of output would have generated oil revenues of only $13 billion. Without further drastic cuts in spending Riyadh's liquid financial reserves would have been depleted in only two years. Spending cuts also were affecting Saudi citizens. Religious conservatives applauded the reduced rate of Westernization, but many Saudi businessmen were worried about bankruptcy. Furthermore, lower revenues lessened Saudi Arabia's ability to disburse foreign aid--a key source of Saudi influence--and eroded Riyadh's importance to consuming countries. 25X1

GI M 86-20084 25X1

25X1

25X1

Figure 1



25X1

[redacted] 25X1

From a financial viewpoint, increasing production was a no-lose situation since, at any price above $5 per barrel, Riyadh could produce enough oil to earn at least as much revenue as it was making in mid-1985 (see Figure 2). The institution of netback deals, aimed at keeping Saudi Arabia's oil exports competitive, allowed Riyadh to more than double production in just a few months. Aramco output averaged 4.7 million b/d in February 1986, compared to only 2.2 million b/d in August 1985. As production more than doubled during the period, exports more than tripled. If the Saudis sustain this level of output and prices this year average $15 per barrel, Riyadh would earn about $21 billion, a substantial improvement over what otherwise would have occurred in 1986. We believe that Riyadh can achieve adequate short-term revenues with prices in the $15-20 range. Although they would have to continue to draw down financial reserves, from the Saudi perspective, the trend of rapidly declining revenue would have been reversed. [redacted] 25X1

<u>Capturing a Greater Market Share</u>. [redacted] 25X1
[redacted], we believe that by mid-1985 Saudi leaders were also becoming concerned that the reduction in their oil market share was also eroding the West's perception--and perhaps their own perception-- of Saudi Arabia's strategic and economic importance. With exports under 2 million b/d and foreign exchange reserves declining rapidly, we suspect that this concern was a serious one in Riyadh. The failure of US officials to respond favorably to Saudi requests to get firms to buy more Saudi oil last summer may have reinforced this concern. During those meetings, Saudi officials were emphasizing the impact declining revenues would have on Saudi internal stability as well as their ability to fund special foreign aid programs. [redacted] 25X1

The four-to-five million b/d production level the Saudis have implied that they want would double Saudi Arabia's share of Free World oil consumption needs to 10 percent and enable it to resume its position as the world's largest oil exporter. Making room for this much Saudi oil, however, still requires producer cooperation or another sharp decline in oil prices (see Table 1). Last week's OPEC meeting allowed Riyadh to to reconfirm its adamant stand on the market share issue and provided a forum for the Saudis to determine whether other producers were ready to compromise. [redacted] 25X1

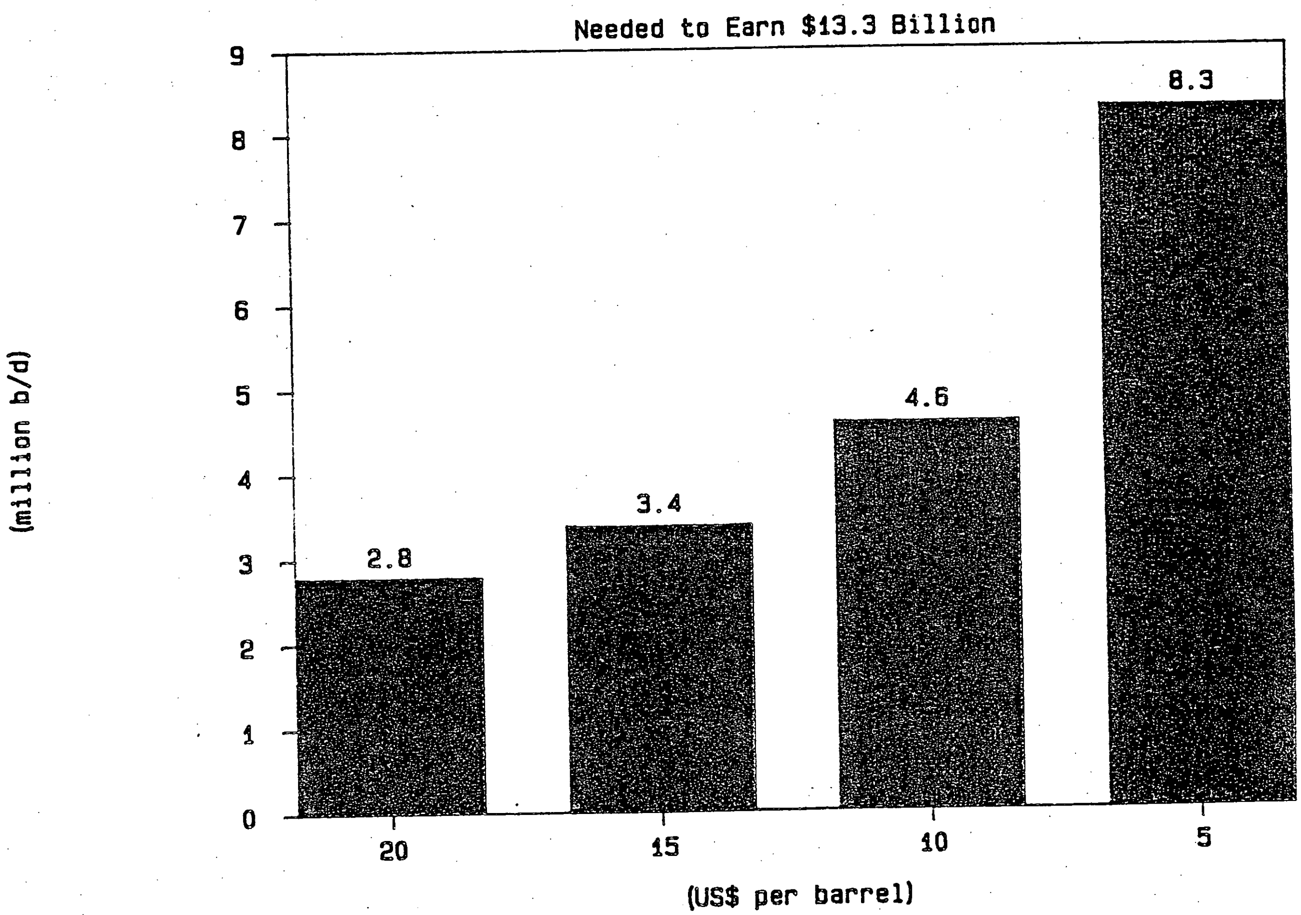
Saudi Arabia may believe that some progress has been made. Although OPEC ministers did not formally agree to reduce production last week in Geneva, they considered several proposals to cut their overall production ceiling to between 14 and 15 million b/d and may reach agreement when they meet again on 15 April. Five non-OPEC LDCs in attendance at the meeting, moreover, publicly urged production restraint to shore up prices, and appear ready to reduce output with the right signal from OPEC. [redacted] 25X1

25X1

[redacted] 25X1

Figure 2

Saudi Arabia: Minimum Production Level



25X1

Table 1

OPEC: Winners and Losers In A Price War

For each price level, this table depicts which OPEC countries have more than enough capacity to offset lower prices (●), just enough capacity (O), or insufficent capacity (⊙).

Country	Oil Revenue Requirement[a] (Billion US $)	Available Capacity[b] (million b/d)	$20/bbl	$15/bbl	$10/bbl
OPEC Middle East					
Saudi Arabia[de]	36.0	8.8	●	●	⊙
Kuwait[d]	6.0	1.6	●	●	⊙
Qatar	2.0	0.6	●	●	⊙
UAE	10.0	1.7	●	●	⊙
Iran[c]	20.0	3.2	⊙	⊙	⊙
Iraq	10.0	1.8	O	⊙	⊙
OPEC Africa					
Libya	11.0	1.8	●	⊙	⊙
Nigeria[e]	11.2	2.2	●	O	⊙
Algeria	10.0	1.2	⊙	⊙	⊙
Gabon	1.5	0.2	O	⊙	⊙
OPEC Latin America					
Venezuela	12.0	2.4	●	⊙	⊙
Ecuador	2.0	0.3	⊙	⊙	⊙
OPEC Far East					
Indonesia[e]	8.0	1.6	O	⊙	⊙
TOTAL OPEC REVENUE	$139.0				
TOTAL OPEC PRODUCTION REQUIRED FOR REVENUE		27.4	22.9	29.4	41.3

[a]Unless stated otherwise, CIA estimate of oil revenue requirement assumes foreign currency expenditures on imports of goods and services and foreign debt remain at 1985 levels.
[b]Available or allowable capcity is defined as the production rate of oil and natural gas liquids attainable between 30-90 days of a government decision to raise output.
[c]Government-stated revenue target.
[d]Includes oil revenue from share of Neutral Zone production and aid to Iraq.
[e]CIA estimate of 1985 oil revenue.

25X1

25X1

[redacted] 25X1

[redacted] 25X1

Securing Long-Term Markets. We believe that ensuring a long-term market for its oil is also playing a role in current Saudi oil policy. With an estimated 170 billion barrels of petroleum reserves, assuring a worldwide need for this resource is critical to Riyadh's long-term interests.

- o Despite a major effort to diversify its economy, Saudi Arabia will remain dependent on its vast oil resources. At last year's production rate the Saudis have a 150-year supply of oil.

- o After waiting almost six years for the long predicted recovery in demand for OPEC oil, Riyadh seems to have accepted the fact that its support of the $28 OPEC benchmark price was undermining the value of its chief resource by slowing growth in oil consumption and encouraging the development of non-OPEC oil supplies.

If prices remained in the mid-$20 range much longer, we believe the long-term market for Saudi oil would have been permanently damaged. Riyadh has probably reached a similar conclusion given the rapid growth in oil supplies and alternative energy sources outside the OPEC area. To correct this situation, the Saudis would have to force prices down to a level that would encourage oil consumption, reduce the economic benefits of greater energy efficiency and conservation, and restrict development of alternative sources of supply. If this is the primary objective then pushing prices to $15 per barrel may not be enough in their eyes. [redacted] 25X1

Denying Iran Oil Revenue. Riyadh almost certainly is pleased that lower prices are creating difficulties for Iran. Lower oil revenues make financing the war effort more difficult and lower prices partially offset the potential benefit of Iran's increased export capability. At present Iran has the capacity to market 2.5 million b/d; moreover, plans are on the books to expand export potential. Since Iran has little borrowing capacity and limited foreign exchange, oil revenue shortfalls can have a direct bearing on the level of Tehran's purchases of arms and equipment for use in the war. Riyadh may also want to undermine Tehran's potential clout within OPEC. Saudi Arabia's past willingness to lower output allowed Iranian production to surpass the Saudi production level last August. The position, however, quickly changed once Riyadh initiated netback contracts, and the Saudis appear determined to retain their dominant position in OPEC. [redacted] 25X1

Iran has publicly [redacted] warned Saudi Arabia that 25X1
intransigence on oil policy would risk Iranian military retaliation. As a result, Riyadh has increased security at key

[redacted] 25X1

[redacted] 25X1

installations in the Shi'a-dominated Qatif Oasis, [redacted] 25X1
[redacted] So far the Iranian threats have not 25X1
shaken Riyadh's resolve to keep pressure on prices. We believe the Saudis will maintain their high output levels despite Iranian threats as long as Riyadh feels that it is politically and militarily secure. Large-scale sabotage of oil installations, terrorism or a successful Iranian military strike, however, might lead the Saudis to cut production. [redacted] 25X1

Market Implications and Future Saudi Oil Policy Directions

Each of Saudi Arabia's objectives entails different implications for the market:

- If maintaining current oil revenues in the short-run is Riyadh's prime objective, we would expect the Saudis to begin soon to take steps to stop the price decline. Average oil prices in the $15-20 per barrel range probably would provide Riyadh with adequate short-term revenues.

- If ensuring a growing long-term market for its oil is the predominant objective, Riyadh probably would attempt to keep prices in the $10-15 per barrel range for several years.

- If Riyadh wants to force other producers to make room for 4 to 5 million b/d of Saudi oil, it is probably prepared to see prices fall to $10 per barrel or less for several months. This would also serve the objective of imposing a financial squeeze on Iran. [redacted] 25X1

In our judgment, a price of about $15 per barrel is most consistent with the combination of Saudi objectives. At this level Riyadh would probably be able to obtain adequate revenue, would improve its long-term market outlook, and might even obtain limited producer cooperation--especially if prices drop sharply for a brief period. With spot prices approaching the $10 per barrel level and the average world price already below $17, however, the Saudis would have to act quickly to reverse the downward price path. OPEC meets again on 15 April and could help the Saudis achieve this price level with an agreement to cut output. Without a strong Saudi role in forging a consensus, OPEC probably will be unable to formulate an approach to stabilize prices. [redacted] 25X1

Risks for the United States

US vulnerability to a future price shock or oil supply disruption will be heightened considerably by the Saudi strategy promoting sharply lower oil prices, regardless of the motive. Lower prices will discourage investment in new exploration and development. As one of the world's high-cost producers, the US oil industry will suffer from Saudi actions even though Riyadh is

[redacted] 25X1

 25X1

not specifically targeting it, in our opinion. At $10-15 per barrel as much as 500,000 b/d to one million b/d of world oil output could become uneconomic, with at least half of this amount in the United States. Over the longer term, the US needs a very active exploration and development program to stabilize production. 25X1

The decline in US proved oil reserves is likely to accelerate, eventually causing a further reduction in US oil output. Drilling in the United States has declined 15 percent since 1981; the active drilling rig count is down 80 percent. Drilling activity was forecast to fall another 5 percent this year, even before the latest price cuts which forced some oil companies to cut exploration and production expenditures by as much as 40 percent. 25X1

Although the degree to which lower prices will stimulate greater consumption and substitution of oil for other energy sources is uncertain, the trend toward a convergence of demand and worldwide oil production capacity will be hastened. Because of the high concentration of commercially exploitable reserves in the volatile Middle East, current low oil prices will accelerate a return to dependence on this region. By the early 1990s, even a relatively minor disruption could produce another price shock. 25X1

The Saudis' increased market share also would give them considerable economic leverage, which they might at some point use to advance political objectives. Although such actions would appear unlikely in the current economic and political circumstances, a change in regime or another outbreak of Arab-Israeli hostilities might increase Riyadh's willingness to use oil as a political weapon. An effort to gain policy objectives through such means as an oil embargo would have severe economic repercussions. 25X1

Finally, since the Saudi strategy of flooding the oil market has increased tensions between conservative Arab states and more radical oil producers like Iran and Libya, Riyadh's oil policy could contribute unintentionally to the spread of hostilities in the Persian Gulf. Although the probability of a major disruption of oil production now appears low, such an event could cause a dramatic turnaround in the international oil market. This, in turn, would increase pressure on the US to intervene directly in the region to ensure the flow of oil. 25X1

25X1

25X1

Some Key Indicators of the Objective Driving Saudi Oil Policy

Revenue Maximization

- Reassess strategy and cutback output as prices fall.
- Show willingness to compromise on production restraint without concessions from other producers.
- Help OPEC formulate new strategy to stabilize prices.

Producer Cooperation

- Continue sharp rhetoric, against non-members.
- Insist on OPEC compliance with lower production quotas.
- Refuse accommodation without production restraint.
- Encourage non-members to communicate more with each other.
- Embark on diplomatic missions to major producing countries.

Ensuring a Long-Term Market

- Keep a low profile in OPEC decision-making process making it difficult for the group to formulate strategy.
- Ignore attempts by OPEC to stabilize prices.
- Increase production to lower prices.
- Maintain technical ability to raise output within a wide range.
- Keep exports competitively priced to keep output high for prolonged period.

Deny Iran Revenue

- Lure Iranian customers.
- Give Iraq financial support to continue war effort against Iran.
- Try to deflect criticism for strategy by blaming other for market conditions.
- Elicit support from other Gulf states to counter Iranian measures.
- Step up security at key oil installations.

25X1

25X1

Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

MEMORANDUM FOR: Charles Boykin
Deputy Assistant Secretary for Intelligence
Department of Energy

FROM: [redacted] 25X1
Director of Global Issues

SUBJECT: Saudi Oil Offensive [redacted] 25X1

Attached is our assessment of Saudi oil policy and the implications for the oil market. The paper outlines the factors driving Riyadh's aggressive new oil strategy, and assesses Saudi determination to hold firm despite rapidly falling prices and lower revenues. Implications and risks for the United States are highlighted in the paper's conclusion. If you or members of your staff have questions concerning the report, please call [redacted] 25X1
[redacted] Chief, Strategic Resources Division, OGI, [redacted] 25X1
[redacted] 25X1

25X1

[redacted] 25X1

Attachment:
The Saudi Oil Offensive [redacted] 25X1
GI M 86-20084, March 1986, [redacted] 25X1

25X1

[redacted] [redacted] 25X1

[redacted] 25X1

[redacted] 25X1

SUBJECT: Saudi Oil Offensive [redacted] 25X1

OGI/SRD/EMB/[redacted] (31 Mar 86) 25X1

Distribution:
1 - Charles Boykin, DOE
1 - John Brodman, DOE
1 - Guy Caruso, DOE
1 - Dave Tarbell, DOD
1 - Joseph Hatfield, Interior
1 - Bill Martin, NSC
1 - Lou Pugliaresi, NSC
1 - E. Allan Wendt, State
1 - Daniel Serwer, State
1 - Charles Higginson, State
1 - Robert Knickmeyer, State
1 - Marion Creekmore, State
1 - Doug Mulholland, Treasury
1 - Charles Schotta, Treasury
1 - Kenneth Glozer, OMB
1 - SA/DDCI
1 - EXDIR
1 - DDI/PES
1 - NIO/ECON
1 - CPAS/ISS
1 - DD/OGI, D/OGI
1 - OGI/PG/CH
3 - OGI/EXS/PG
5 - CPAS/ICB
1 - C/SRD
1 - [redacted] 25X1
1 - [redacted]
1 - SRD/EMB (Chrono)

[redacted] 25X1

Sanitized Copy Approved for Release 2011/02/23 : CIA-RDP86T01017R000100650001-8