

# The logic behind Saudi oil cuts

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*Saudi Arabia is transferring oil  
market cushions into its own  
hands*

*Saudi Arabia, Iran, Iraq  
insurgents may have good  
reason to doubt US resolve*

*As the US Senate contemplates a withdrawal of forces from Iraq and as oil prices approach record highs, Saudi Arabia's oil cuts continue to keep markets tight. Riyadh's defiance may be linked to internal politics and its post-US occupation Iraq strategy.*

Crude oil markets appear to be coming to a boiling point. In August, North Sea field maintenance reduces supply by 400k b/d while refinery runs are to increase another 1m b/d, causing substantial crude oil draws. Hurricane risk also peaks in early September. Reflecting an imminent tightening of crude fundamentals, the Brent futures curve flipped to full backwardation last week, while only the spot month remains in contango for WTI.

Despite this fundamental backdrop and near record prices, the Saudis, in our view, have refused to add oil to the market, with production levels about 600k b/d less than last summer. Saudi oil minister Ali Naimi, instead, sees “comfortable” global crude oil inventories, which today are still high because outages and maintenance have crippled the global refinery system. Even if Riyadh added oil to the market tomorrow, it wouldn't be delivered until late September, and inventories would still draw down in August to more normal levels. Saudi Arabia also argues that the supply-demand balance for crude reflects a tight market for products and that there is little it can do to lower the price of oil. We believe that if the Kingdom added oil back to the market tomorrow, crude oil prices would fall. Why has Riyadh seemingly decided to withhold oil from the market, against the advice of market analysts and international organizations?

Perhaps the answer lies in Saudi Arabian internal politics and its regional geopolitical strategy. By forcing commercial stock draws and driving crude markets into backwardation, Saudi Arabia is transferring oil market cushions into its own hands. Riyadh may desire to hold spare capacity at the expense of inventory draws to have the power to drop oil prices if necessary—say if the Kingdom feels Iran is encroaching beyond a certain red line in Iraq—and the Saudis would justify an output increase in oil market terms. As both popular and congressional opposition builds against President Bush, Iran and Iraqi insurgents will likely step up their efforts to influence events in Baghdad. By forcing oil markets into a higher-priced, more tenuous environment, Saudi spare capacity matters more. In a partial or phased US withdrawal scenario, that could become critical for the Saudi strategy to check increasing Iranian influence over Iraq.

## **The American debate over Iraq is shifting**

A formal change of mission in Iraq may no longer be about “if” but “when.” A July 8 *USA Today*/Gallup poll finds President Bush's approval rating reaching a new low: 29%. Over 70% of respondents favored removing nearly all US troops from Iraq by April 2008. In Washington this week, Senate majority leader Harry Reid ordered a rare all-night session to debate a measure for US troops to begin departing within 120 days. While the effort failed to gain the 60 votes needed to stop a Republican filibuster, three Republican senators supported it. Several others advocated alternate plans changing the US mission. However, most Republicans want to wait until General David Petraeus (the

top US commander in Iraq) delivers his September progress report on the troop surge strategy. While debate may stall until September, overwhelming popular opposition to the war could take its toll on Republicans in Congress, especially with 2008 presidential and congressional elections marching into full swing. Saudi Arabia, Iran and insurgents in Iraq may have good reason to be doubting US resolve.

### The Saudi calculus

As the US moves closer towards changing its mission in Iraq, Riyadh may worry about regional and Iraqi instability. What a change in mission actually means, however, introduces significant uncertainty into the Saudi decision cycle and may partly explain Riyadh's inaction since the late 2006 oil cuts. In reality, President Bush is likely doing his best to reassure the Saudis of the US commitment to staying in Iraq and preventing a regional power vacuum. There is still a significant probability (although declining) that US ground presence in Iraq will not change before the end of the Bush presidency. That does not mean "withdrawal" legislation will not be passed in Washington; the issue is that "withdrawal" is an incremental process that can mean many things to many people.

*With US mission change, Riyadh worries more about regional, Iraq instability*

*Elusive nature of US withdrawal causing Saudi indecision*

The elusive nature of any US withdrawal plan may be splitting the Saudi Royal family or at least causing indecision on how to proceed. Without clear direction from the top, oil technocrats may simply be following a wait-and-see strategy. No matter what politics ensue in Washington over withdrawal in the next 18 months, at least some in the Saudi government are likely worried about two potential outcomes: (1) Iran continues to move into Iraq by proxy to fill the power vacuum that expands with every failure of US strategy; and (2) Iraqi civil war and instability spreads to the Kingdom itself.

*Saudi worst fears may be of insurgents returning home to conduct terrorist acts*

With regard to containing Iraqi civil war, Riyadh looks to be in a bind: there is not much the Kingdom can do but accept higher security risks and redouble its defense efforts. One more certain effect of discussing withdrawal is that it emboldens insurgents in Iraq and potentially saps US troop morale. Both increase the risk of terrorism on Saudi energy facilities. News reports from last weekend cite US military and Iraqi government sources saying "45% of foreign militants in Iraq are Saudi" accounting for 50% of suicide bombers<sup>1</sup>. Perhaps the House of Saud's worst fear is that these war-hardened fighters experienced in bomb-making return to the Kingdom, joining with Al Qaeda or other groups already active in the country to achieve terrorist ends.

*Refusal to add oil to market may be part of Riyadh's post-US occupation strategy*

Saudi Arabia also has few options other than the US to counter Iran's regional power ambitions. Other than sending its own proxies into Iraq to fill some of the power vacuum, Saudi Arabia's current refusal to add crude oil to the market may be part of the Kingdom's broader post-US-occupation regional strategy.

*Riyadh eliminating storage cushions, concentrating relief valves on Saudi soil*

On the face of it, Saudi Arabia's oil cuts of approximately 600k b/d deprive the Kingdom of about \$45m per day (\$16 billion per year). Moreover, the cuts appear to strengthen Iran's hand by keeping oil prices high, more essential to Iran than Saudi Arabia given the former's lower export revenue per capita, more extensive government expenditure commitments and smaller budget and current account surpluses. On top of this, if oil prices do breach \$80 per barrel, Saudi Arabia risks threatening the global economy and its political relationship with the United States if it does not add oil to the market. Whether the Saudi calculus is driven by regional political strategy or indecision at the top of the Royal hierarchy, the result is that the Saudis are eliminating storage cushions in the oil markets, concentrating relief valves on Saudi soil in the event of a disruption.

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<sup>1</sup> "Saudis' Role in Iraq Insurgency Outlined," Los Angeles Times, July 15, 2007.

**Market impacts**

*Saudi oil cuts have caused Brent to flip from contango to backwardation*

Saudi Arabia's oil cuts have caused the Brent oil futures curve to flip from contango, the dominant curve structure of the last two years, to full backwardation. Assuming only precautionary hurricane outages and that Saudi Arabia reverses its cuts at the September 11 OPEC meeting, we believe Brent should flip back to contango in September. Additional OPEC oil, fall seasonal refinery maintenance, and 400k b/d less North Sea maintenance in September m-o-m should reinforce a contango structure until at least the winter. Note that Saudi Arabia can reverse its cuts without reducing its spare capacity because it is bringing on the 500k b/d Khursaniyah field by end-2007.

*Saudi objective: maintain spare capacity to replace Iran and Iraq's exports*

While the scenario we have painted is one of many, the stated objective of the Saudi government is to maintain the spare capacity to replace the combined exports of the two largest OPEC members. We believe Saudi Arabia's current spare capacity of some 2.5m b/d is just enough to replace Iranian exports. Interfering in global oil markets can have serious consequences, but perhaps Riyadh now views them as less serious than counting on the success of the US in Iraq.

**Light sweet crude quarterly oil price forecast (\$, period averages)<sup>1</sup>**

	3Q06	4Q06	1Q07	2Q07E	3Q07E	4Q07E	1Q08E	2Q08E	2006	2007E	2008E
Price (\$ per barrel)	70.70	60.61	58.62	68.66	76.00	75.00	76.00	77.00	66.15	70.00	75.00

(1) Forecast for Brent prices. Actuals for Brent. Forecast WTI likely to trade \$2 below Brent in 2007-08. Source: Actuals – Bloomberg; Estimates - Lehman Brothers.

**Supply-demand balance 2006-08 (m b/d)**

	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	2006	2007	2008
<b>Demand</b>											
USA	20.8	20.7	20.8	20.7	20.9	21.1	21.3	21.0	20.6	20.9	21.1
Rest of OECD	28.4	29.3	29.0	27.6	28.6	29.9	30.3	28.1	28.8	28.8	29.3
China	6.9	7.0	7.4	7.4	7.4	7.7	7.8	7.8	7.0	7.4	7.9
Rest of World	28.0	28.1	29.0	29.1	29.2	29.3	30.0	30.1	28.0	29.2	30.2
<b>Total Demand</b>	<b>84.1</b>	<b>85.1</b>	<b>86.2</b>	<b>84.7</b>	<b>86.0</b>	<b>87.8</b>	<b>89.4</b>	<b>87.0</b>	<b>84.4</b>	<b>86.3</b>	<b>88.5</b>
<b>Supply</b>											
OECD	19.9	20.0	20.0	19.9	19.6	20.0	20.1	19.9	19.9	19.9	20.0
OECD North America	14.3	14.3	14.3	14.3	14.2	14.3	14.4	14.5	14.1	14.3	14.6
OECD Europe	5.0	5.1	5.1	4.9	4.8	5.0	5.0	4.7	5.2	5.0	4.7
Rest of Non-OPEC	27.4	27.8	28.0	27.9	27.9	28.0	28.2	28.4	27.3	27.9	28.5
FSU	12.2	12.4	12.6	12.6	12.6	12.7	12.7	12.8	12.1	12.6	13.0
Other (1)	2.1	2.1	2.1	2.2	2.2	2.2	2.3	2.3	2.1	2.2	2.3
Total Non-OPEC	49.4	49.9	50.1	50.0	49.7	50.2	50.5	50.6	49.3	50.0	50.8
OPEC Crude	31.3	30.3	29.7	29.9	30.4	31.4	32.0	32.2	31.0	30.4	32.4
OPEC NGLs	4.2	4.1	4.3	4.3	4.4	4.4	4.4	4.4	4.3	4.4	4.5
<b>Total Supply</b>	<b>84.9</b>	<b>84.3</b>	<b>84.1</b>	<b>84.2</b>	<b>84.5</b>	<b>86.0</b>	<b>86.9</b>	<b>87.2</b>	<b>84.7</b>	<b>84.7</b>	<b>87.7</b>
<b>Inventory Change</b>	0.9	-0.8	-2.0	-0.5	-1.5	-1.8	-2.5	0.2	0.2	-1.6	-0.8

Note: Supply balances carry Angola with OPEC; (1) Other includes global processing gains and biofuels outside US and Brazil. Source: Lehman Brothers estimates (including historical numbers).

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