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West, John C. ② cfADRC
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EMBASSY OF THE
UNITED STATES OF AMERICA
Jidda, Saudi Arabia

February 27, 1978



The Honorable
Cyrus Vance
Secretary of State
Washington, D.C. 20521

Dear Cy:

The attached paper is one which we prepared recently in Jidda to look into the Saudi oil situation and is implications for the U.S. I think it gives a a good overview of the problems for us, and hope you will get a chance to read and digest it. I am also leaving a copy with the President, and with the Saudi Desk.

Best personal regards.

Sincerely,

John C. West
Ambassador

Enclosure:

Saudi Arabia and the World
Oil Market.





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# SAUDI ARABIA AND THE WORLD OIL MARKET

## I. INTRODUCTION

Saudi Arabia is the key to production and pricing of oil in the world markets, and will be until alternative sources of energy make oil less vital to our industrial economy.

If, for example, Saudi Arabia does not increase its production beyond the present ceiling of 8.5 million barrels/day (mmbd), there will be a shortage by 1980 which will probably cause a sharp increase in the price, irrespective of any OPEC action. On the other hand, if Saudi Arabia were to increase its productive capacity to the 16 to 18 mmbd which may be necessary to prevent oil shortages in the 1980's, while keeping price increases moderate, then the U.S. may be able to solve its energy problems without major change in economic patterns or life style.

There are many factors, internal and external, which will shape Saudi oil policy in the coming decade. Some of the policy decisions may in effect be made unconsciously or through lack of action; with lead times of three to five years required to implement oil production programs, funding or engineering approvals held up now can have severe repercussions later when demand tightens up.

These decisions--and there will be many which will bear directly on the basic issue--will be both economic and political.

The U.S. Mission in Saudi Arabia, as we view our mission here, has a responsibility to (1) collect, assimilate, and analyze all of the factual material bearing on every aspect of the oil issue; (2) attempt to recognize the forces and personalities that shape Saudi oil policy as it is formulated; and (3) determine how this policy can be influenced so as to best serve U.S. interests.

To that end, we have created a special task force within the Mission, including members from our posts at Riyadh and Dhanran. Its task is to assess on a monthly basis all of the relevant information on all of the issues having to do with Saudi oil. This is the first of these monthly reports. In addition to a continuing update on factual matters, the report will attempt to forecast (guesstimate!) on critical issues such as production and pricing.

## II. THE WORLD MARKET AND SAUDI OIL

The depression which has characterized the economies of the industrialized countries for the last several years seems likely to continue in to 1979, with a resultant slow growth in world oil consumption. Oil production from non-communist countries toward the end of 1977 was, approximately 50 mmbd, marginally higher than it had been in 1973, but increasing very slowly in response to stagnant demand. As much of this increase is being met by production from the North Sea, Alaska, and other new sources, a certain amount of shut-in capacity (estimated at 1.4 mmbd by the CIA, higher by others) is currently available in OPEC countries other than Saudi Arabia to meet near-term demand increases. The Saudi production ceiling of 8.5 mmbd is,therefore, unlikely to be challenged in the near run. In fact, the Saudis probably see their role in the coming year in terms of supporting the existing level of prices through production cutbacks, if necessary, much as they did in 1975 when Saudi production dropped as low as 6 mmbd on occasion. Production in January 1978 was 7.5 mmbd.

Over the middle term, however, world demand for oil is expected to absorb present shut-in capacity and then rapidly to require substantial increases in capacity. By 1980-81, with Alaska and the North Sea production on a plateau, any required increases in production will have to come to some degree from Mexico but, far more importantly, from the OAPEC countries and particularly Saudi Arabia. No other OPEC or OAPEC country has the reserve base to support production increases of the size needed to help meet projected world demand of approximately 66-69 mmbd by 1985.

The effect on oil prices of this looming oil shortage can only be estimated. Even if allowed to rise after 1978 at only a 6 percent rate to match the underlying rate of inflation in the U.S., the price of Arab Light would be over $19 per barrel in 1985. Any marginal shortage and bidding up could easily raise that price to $30 or more. If the Saudis decide to support OPEC moves to peg oil prices to a basket of currencies rather than the dollar, it could, in the short run, increase the price to the U.S. but would probably wash out over the long run as the dollar fluctuates.

Saudi Arabia's position as the world's largest oil exporter, the holder of over 25 percent of the free world's oil reserves, and the most financially secure of the oil exporting countries, give it a unique leadership role in OPEC. The Saudis were until recently hesitant to play their hand blatantly in OPEC, but have in the last eighteen months taken a much more forceful role in the organization, particularly in holding down OPEC price increases. The Saudis do not share all of the concerns of their OPEC colleagues. They favor a moderate growth of oil prices which will prolong their earnings from their huge resource base; they want to maintain or strengthen their price leadership; and they share only in part some of their colleagues suspicions about the operations of the international oil companies. Even though they could gain most of their goals without OPEC, however, they have no interest in themselves weakening the organization.



## III. THE SAUDI SETTING

The unique nature of Saudi oil reserves has fortunately been matched by a unique relationship with the outside world and particularly the United States. A short look at Saudi oil history is therefore useful.

Since the discovery of oil at Dammam 7 -- "Lucky Seven" -- in March 1938, Aramco has in most years succeeded in proving more new oil reserves than it produced. Dammam and Abqaiq fields were discovered before WW II, but the major discoveries were made in the late 1940's and early 1950's -- Fadli, Safaniya, Berri, and particularly Ghawar, the world's largest oil field. By 1965, Aramco had proven reserves of over 78 billion barrels of oil but, because of low demand for Middle Eastern crude at the time, was producing only 2 mmbd. Demand for Middle Eastern crude grew in the late 1960's, but Saudi production increases were kept somewhat in check by the insistence of the Shah that oil production in Iran be kept even with Saudi production, and by the rapid growth of Libyan production nearer the major markets. The Saudi role in the relatively new OPEC organization was correspondingly muted. By the early 1970's, the situation had however changed. American and Iranian oil production began to level off or decline, and first Libya and then Kuwait, Venezuela and Canada began to restrict production to conserve their resources. Saudi Arabia had become the world's major potential supplier of new oil production by the time of the 1973 embargo. With current proven and probable reserves of 158 billion barrels of oil dwarfing those of Iran (60), Mexico (25), the U.S.S.R. (40), or Iraq (39), Saudi Arabia remains the single largest potential oil supplier of the world.

Almost all the reserves are in the Aramco concession area, which will soon come completely under 100 percent Saudi government control. (Reserves of the two companies operating in the Neutral Zone amount to only 3 billion barrels.) This preeminence of Aramco has strongly influenced Saudi history and attitudes. The company has played a positive and constructive role in the development of Saudi Arabia, much different from the role played (or seen to have been played) by the oil companies in other Middle Eastern countries. The Saudi economy, and many of the people who run it, are products of the Aramco system which--being virtually all American-- has created a pervasive pro-American feeling in the country. Aramco's foresight in helping establish local services, businesses, and treating generously with the government (e.g., the 50-50 profit split) have left a reservoir of good will which benefits U.S. interests in the country.

IV. SAUDI OIL POLICY

The key issue in Saudi oil policy is the amount and the timing of oil production increases. Price is an important element of the debate, as are a whole range of questions concerning the nation's development goals, its role in OPEC and Arab politics, and the Middle East peace negotiations. The key formal decision-making body is the Higher Petroleum Council, chaired by Crown Prince Fahd and including the key economic Ministers of Petroleum, Economy, Planning,and Industry. Behind the decisions of this body, however, generally lies an informal consensus procedure within the Royal family, and including other key Saudi figures. As the ministers on the Petroleum Council have views often strongly at variance on the issues, decisions are often put off until a wider consensus can be formed or, in cases in which urgent action is required, the Crown Prince exerts his leadership. Given the long lead times (3-5 years) required for many production decisions, this decision making procedure has tended to work against the taking of major decisions to upgrade capacity significantly.

Current policy calls for a limitation on actual production to an average rate of 8.5 mmbd for 1978. As noted above, this limitation probably will not be restrictive under actual market conditions, but could begin to bite by late 1979 or 1980. Whether or not it is lifted or eased at that time will depend on the value of price increases which will probably have been approved in the meantime, pressure from OPEC colleagues, and-- probably most importantly -- the Saudi perception of the Middle East settlement effort and whether the production limitation could serve as a useful pressure instrument to serve Saudi needs at that time.

Present Saudi policy on production capacity is only moderately expansionist and may lead to production considerably below demand in the mid-1980's. The government has not accepted Aramco's proposals for increasing capacity to 16 mmbd in the mid-1980's, and has only agreed to a lower general target of 13.5 mmbd. of facilities capacity by 1983 (indicating a sustainable production rate of about 12 mmbd.). Moreover, it has left the company limited financial means to reach that goal, which the government has declared must be financed entirely out of the company's cash flow of approximately $1.5 billion per year. As a result, the date for reaching the 13.5 mmbd. facilities capacity will probably not be before 1985.

Moreover, if the government -- which is increasingly motivated by resource conservation goals -- demands that the company take additional precautions to protect the natural environment (aquifers, etc.), the cost of the project will rise and the date drift back still further.

The bulk of this production is expected to come from fields already in production or capable of production. Most of those fields are ones discovered in the 1950's and developed in the 1960's, and there is as a result need for major equipment overhaul and replacement, greatly improved pressure maintenance capacity, and large new dewatering and desalting facilities in order to increase production while maintaining acceptable reservoir pressures and reserve life. The attempt in early 1977 to increase production dramatically brought to light equipment and reservoir problems which had perhaps been inconspicuous under earlier and lower production rates, but which will now take much attention and money to correct.

The Saudi oil Ministry will be closely monitoring Aramco's efforts to redress these problems in the reservoirs, and the Ministry's increasingly conservationist-minded technical staff will not necessarily be inclined to accept the company's judgments. (There have already been allegations of mismanagement directed against the company.) While the reservoir problems should not, on a technical basis, preclude the possibility of installing and using a production capacity of 13.5 mmbd. or even beyond, the possibilities of delay caused by engineering arguments with Ministry officials, or required by additional costs incurred for resource conservation or security reasons, are very disturbing.

To reach beyond the 13.5 mmbd. target would require tying in the dozen or more discovered but not yet developed smaller oil fields. A maximum of two mmbd. of increased sustained production in 1985 could be achieved in this fashion by an investment of a minimum of $3 billion, but no money has been allocated and none seems likely at the present time.

Aramco's extensive exploration program may prove up new reserves between here and 1985, but if the above conditions continue, those new discoveries are unlikely to be developed for production. It should be noted in this respect that, although exploration will be at the expense of the Aramco parents, production investments would have to fall under the already strained Aramco budget. The joint Saudi-Kuwaiti concessionary companies operating in the Neutral Zone are unlikely to discover any new reserves or to be able to increase present production rates. The possibility exists that the Saudis could find new oil reservoirs or license new exploration efforts outside the Aramco areas, but it seems unlikely at this point that any such efforts could result in substantial oil production before 1985. There appears to be little interest from the Saudi side in increasing non-Aramco exploration dramatically. The one other foreign company still holding a concession, Tenneco, has apparently abandoned its small condensate find near Duba on the Red Sea as uneconomic.

Engineers from Aramco believe that major new reserves remain to be found in the Aramco area, but that they will lie largely in increasingly smaller fields, in outward delimitations of existing fields, or in deep and expensive to produce reservoirs. They foresee, however, not much more than another 30 billion barrels (still 3/4 as much as existing U.S. reserves) to be added to their present estimate of proven and probable reserves of 177 billion barrels, and they expect that they will begin to have a reduced discovery rate after five or so years. They believe that improved secondary, and eventually tertiary, recovery methods could ultimately wring another 50 billion barrels out of the Saudi reservoirs, and that the country could still be producing at the rate of several mmbd. in the middle of the next century. Petromin estimates proven reserves to be 144 billion barrels, giving a reserve life of only 26 years at 12 mmbd. However, Petromin's estimate of proven and probable reserves is well over 200 billion barrels.

A major uncertainty overshadowing all of the above policy questions is the unresolved problem of who will control the Saudi state oil company after the 100 percent takeover of Aramco. This, in fact, is the major remaining stumbling block to the takeover agreement. A company responsible primarily to the Oil Minister, as in the present situation, would have a greater degree of day-to-day flexibility and presumably a greater responsiveness to the needs of the world's oil consumers. The tendency seems, however, to give the successor company a status dependent on the Higher Petroleum Council or Council of Ministers, thereby placing the ministers inimical to market-directed production increases in a position of yet greater control. The fact that the Royal family seems to be interested in having a direct voice in control of the company has further complicated the issue. If the faction which we could call "Saudi-firsters" (the more prominent members are the Ministers of Finance, Industry and Interior, the Governor of SAMA, and a number of the more conservative princes) succeeds in winning control of the company, it could have a seriously limiting effect on Saudi willingness to undertake the investments necessary to increase oil production.

The structure and functions of the follow-on company are also under debate at present. It will probably have at least two operating arms or affiliates -- for production operations, and for sales. How aggressive the new company will be in marketing the government's oil entitlement or following it downstream, however, remain to be seen. The government entitlement, in 1978, will be about 1.5 mmbd. which could grow to 5 mmbd. or more in 1985 if total production is 12 mmbd. If the Saudi company were to market that quantity, it would have the capacity to become the "eighth sister" of the world oil companies. There are indications that some Saudis (including, we understand, members of the Royal family) would like their company to play such a role, in which the potential for additional profits would be substantial. But the huge amounts of capital which would be required to compete successfully downstream with the existing majors might be an insurmountable obstacle to any hopes of building a major integrated oil company.

Finally, but not unimportantly, a group of non-directly related issues which will impact heavily on future Saudi policy must be mentioned. First of these is the search for a Middle East peace. It seems clear that the Saudi government is determined to follow an expansionary oil policy only if the consumers of that oil continue to help in the search for peace. Similarly, the Saudis have been at pains to point out that one of the prices they will exact for oil production increases is technology transfer to help them build an industrial base. In due course we should expect this demand to be supplemented by demands for preferential access to market for their manufactured or semi-manufactured goods. They will also continue to push Third-World demands of similar nature, though less forcefully than their own.

## V. IMPLICATIONS FOR THE U.S.

The U.S., as the traditional protector of Saudi Arabia, its biggest customer and supplier, and the principal intermediary in the Middle East peace negotiations, has a special role to play in helping develop constructive Saudi oil policies. The Saudis recognize this and, in fact, encourage it, wishing to see the U.S. fully engaged in their support. They are touchy, however, about U.S. efforts to influence directly the management of their most important resource -- the oil -- and are particularly sensitive to implications that we would react militarily or otherwise if they restricted production to the point of harm.

The Saudis have, unilaterally, put us on warning that they will expect "helpful" American policies in a number of areas as a prerequisite to themselves being helpful in increasing oil production beyond the current ceiling or expansion plans. These areas include the Middle East peace effort, U.S. readiness to transfer arms and technology, a serious U.S. energy policy designed to diminish our appetite for imported oil, and policies which facilitate rather than hinder U.S. private participation in the Saudi development effort (by this is meant boycott and personal taxation problems). We cannot evade responsibility in those fields, which stems from our predominant position in Saudi Arabia.

As long as the Saudis perceive our role as being helpful in the areas mentioned above, we have some ability to influence their oil policies in a favorable direction. We might, for example, be able to help convince them to go beyond the 8.5 mmbd. ceiling and 13.5 mmbd. capacity target, but not if they saw our effort as a substitute for a serious energy policy of our own. For the increased capacity, moreover, we might be asked to pay a price -- beyond the general level of OPEC oil prices which might make it attractive to the Saudis -- in terms of technology transfer or guaranteed market access for Saudi petro-chemicals. Similarly, the Saudis might be prepared to supply oil directly for our strategic reserve, though the terms would probably have to be particularly favorable to overcome their political reservations about our reserve policy, which they see as anti-OPEC.

The Saudis have, in the end, no desire to harm the U.S. or the western economies -- in which they themselves have a great deal at stake. They have taken a conservative attitude toward oil production increases partly because they hope it will push the consuming countries to cut back their consumption, and partly because they are concerned at possible depletion of their resources. But they have no intention of creating a world economic crisis -- even in a worst case scenario in the Middle East -- and are likely to remain open to reasonable economic arguments. A continuing dialogue will be necessary to convince them, to the extent the facts require, that a more expansionary oil policy will be in their interests as well as the consuming countries'.



February 18, 1978