



How Would You Manage Saudi's Reserves?

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My impression is that we spend a lot of time trying to interpret comments or actions from Saudi Arabia, without attempting to understand the issues from their perspective. I think it is a useful exercise to ask whether their specific actions or comments make sense; 1). From the Saudi perspective, and 2). In the context of the market.

For example, when Saudi said that they were having trouble finding buyers for their crude in the spring of 2006, I won't simply look at the price and dismiss those comments as lies. I do a bit of digging. And when I uncovered that OECD crude inventories were high and rising at the time, that Iran said essentially the same thing at the same time, that any of Saudi's customers could pick up the phone and offer to purchase more crude, yet nobody came out and suggested that they had been unable to secure Saudi crude, then I concluded that those comments were consistent with the evidence available to us. (The final point is significant, because as soon as Saudi started putting Asian refiners on allocation later in the year, a number of Asian refiners leaked that news to the press. Certainly the same would have been true had Saudi falsely announced that they had crude but no buyers).

I have debated this issue multiple times, for example [here](#), and I don't intend to do so again. But the issue still comes up on a regular basis - and often in a derisive manner - and I wanted to share the thought process I went through. (Of course I would add that when they started increasing prices later in 2006, the argument that there were no buyers was obviously no longer true).

Along the same theme, I frequently consider how I would manage Saudi's reserves if I was in the position to do so. I think those who feel Saudi should be pumping all the oil they can at these prices haven't really thought it through from their perspective. So, let's go through that thought experiment, keeping in mind:

- 1). The primary allegiance is to Saudi Arabia.
- 2). This depleting resource must serve future generations.
- 3). OPEC must be on board with the decisions.

My primary objective would be to extract the most money I could from the rest of the world, but not so much as to cause a worldwide recession that would destroy demand. So, how would I achieve this? Very cautiously. Each time oil prices moved into new territory, I would seek to stabilize the price for a while so I could judge the impact on the world economy. As long as the world economy could cope with the price, I would continue to let it creep higher.

How would I push the price go higher? By restricting supply. How would I soothe the markets?

By adding incremental supply back a little at a time. What would I do if prices spiked high in a short span of time? Well, I would first wait a bit to make sure the price rise was sustained. After all, I can't react every week to price fluctuations. But if the price rise was sustained – and I had the oil available – I would go ahead and increase production to stop the rise. That would give me a chance to evaluate how the world economy had adjusted to the new price levels.

This is what I would do if I did have the oil. I would have no incentive for ramping production back up quickly and risking a price crash - regardless of the price of oil. My moves would be deliberate and conservative. After all, Saudi is reaping an incredible windfall at current oil prices. But greed is human nature. If I determined that the world can live with \$90 oil, I would want to see if the world could stand oil at \$120. Wash, rinse, repeat, until I saw the world economy dramatically slowing. That's where I would back off price by trickling in production.

On the other hand, if I was really out of capacity, and my reserves were truly overstated, my behavior would be somewhat different. First, I still don't want to panic the world and cause a super-price spike that quickly causes a recession. So, I would engage in a series of delaying tactics. I would want to maintain the *status quo* as long as possible, because when the truth comes out I will enjoy a brief windfall as prices spike much higher, likely followed by a worldwide recession and potentially the end of the world as we know it. To stall, I would point to other factors as the reason for the price rise (fear, speculation, the weather, etc.) I might make token increases in production in an attempt to placate the market, but I would mostly look for other scapegoats.

But the jig would be up when world oil inventories started getting pulled down into uncomfortably-low territory, prices were spiking, and I didn't respond with more supply. At that point, the cat is out of the bag. Well, I suppose I might have one more card to play, and that is OPEC. I could let news leak out that Saudi wanted a production increase, but the rest of OPEC outvoted us. After all, Venezuela, Nigeria, and Iran are all on record as saying \$100 oil is where they like it. So that could then be my final stalling tactic, but stalling tactics that don't involve putting more oil on the market won't stop the steady price climb.

So, how then do I read Saudi's actions? First, I recognize that they won't necessarily behave as I would. But that's all I have to go with. In that case, there are elements of both possibilities in their actions. Saudi was reportedly the driving force behind the recently announced 500,000 bpd increase. The increase wasn't huge, but this is exactly how I would play it even if I had the reserves and spare capacity, but was trying to avoid crashing prices. (Although if I didn't have spare capacity, I would not have offered to shoulder the bulk of the increase as they reportedly did).

But it also looks like they are engaging in a series of delaying tactics. They could act on prices at this weekend's meeting, but they have already announced that they won't discuss it until their December meeting. They blame speculators, and say there is nothing they can do about prices because the rise isn't being driven by fundamentals. First, speculators *are* a part of the reason for the price rise. They aren't the whole reason, but those who say they have nothing to do with it are also wrong. But Saudi can't be serious when they say they can't do anything about price spikes due to speculation. If they wanted to crush the speculation, it would be easy. If you have 2 million barrels of spare capacity, show the world. Push production up to 10 million bpd for a while. The price would come crashing down, which would be contrary in the short term to maximizing your revenues, but you would have eliminated the speculation. After all, there would be no more doubt: You can do what you say you can do.

We are certainly very close, IMO, to the truth. While IEA demand projections have been revised

downward due to the high prices, they still show a need for more crude than is currently being pumped. Looking forward, inventories are still projected to fall, albeit not as fast as previously projected. But I will note that projections all year long have been for OECD inventories to crash in the near future, and those projections have been mostly incorrect. Inventories have been pulled down recently, but the dire scenarios we heard about all year long were *projections* for where inventories *would be* in the future. (See the EIA's projection for OECD stocks on [Page 17 here](#), and then look at the [IEA's Oil Market Report](#) to see that what transpired was contrary to those EIA projections).

Those are my thoughts on Saudi production management, and I try to interpret their actions from that perspective. So, how would you manage Saudi production; 1). If you were sitting on top of a 100-year crude reserve; and 2). If you were truly tapped out?



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