The Arab Gulf States Institute in Washington

Building bridges of understanding

Petro Diplomacy: Gulf Countries on the Front Line of Energy Security

Conference Report

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The Arab Gulf States Institute in Washington (AGSIW) is an independent, nonprofit institution dedicated to highlighting the importance of the relationship between the United States and the Gulf region through free and open exchange of multiple points of view on issues that concern the Gulf.

AGSIW strives to support this goal by:

- Providing expert analysis and thoughtful debate on the economic, energy, environmental, security, social, cultural, and political dimensions of the Gulf Arab states as well as their relations with the United States and other countries.
- Informing a global audience of policymakers, legislators, businesspeople, academics, media, youth, and others as the foundation for strategic decisions regarding this important region.
- Employing multiple avenues to inform public understanding of the importance of the relationship between the United States and the Gulf Arab states.
- Encouraging strong academic coverage by developing scholars who concentrate on the study of the region.

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About This Report

For the eighth consecutive year, the Arab Gulf States Institute in Washington convened its Petro Diplomacy conference, held in a hybrid format for the first time. The conference brought together private and public sector stakeholders from the United States, Europe, and the Gulf Arab countries, at a particularly critical time, to discuss the upheaval in the oil and gas markets following Russia's invasion of Ukraine and the role of Gulf Arab states in meeting the sudden demand surge, as international sanctions disrupted oil and gas flows from Russia. Petro Diplomacy offers a unique forum for industry experts to engage with policymakers and analysts to explore the momentous challenges facing Gulf Arab states, oil producing and consuming countries, and the international energy market. This report was compiled by Kate Dourian, a nonresident fellow at AGSIW, contributing editor at MEES, and fellow at the Energy Institute.

Videos of the conference's three sessions are available online at:

https://agsiw.org/programs/petro-diplomacy-2022-gulf-countries-on-the-front-line-of-energy-security/

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Foreword

Ambassador Douglas A. Silliman
President, AGSIW

On behalf of the Arab Gulf States Institute in Washington's board of directors and staff, it is my pleasure to share with you the report of our eighth annual energy conference, "Petro Diplomacy 2022: Gulf Countries on the Front Line of Energy Security."

The conference, held in a hybrid format October 20-21, brought together stakeholders in the energy sector of the Gulf Arab states, global supply competitors in North America, analysts, and policymakers to discuss how critical developments in the energy market and the energy transition continue to alter the relationship between politics and energy for both the region and the world.

This year's Petro Diplomacy conference was held at a particularly critical moment – against the backdrop of Russia's invasion of Ukraine, the subsequent economic and energy sanctions imposed on Russia, and an energy crisis resulting from disrupted oil and gas markets still recovering from the impact of the coronavirus pandemic. The conference's discussions were especially timely following an announcement in early October by OPEC+ producers of cuts in oil production quotas. Holding the bulk of global spare oil production capacity, the Gulf states are positioned on the front line of energy security and are exercising a newfound assertiveness. All eyes will continue to be on them as Russian oil and gas supplies may be stressed with the imposition of new sanctions, Europe faces a harsh winter, and China looks to an economic recovery and restored energy demand. With fears of a global recession looming large and OPEC+ seeking steady but higher prices, tensions over energy supplies are on the rise, especially between the United States and Saudi Arabia.

A signature annual event, AGSIW's Petro Diplomacy conference takes an in-depth look at these critical issues. It aims to advance the conversation on the future of the energy industry and assess the wider geopolitical, economic, trade, and investment climate. I am confident that the key findings from this report will better inform policymakers, industry leaders, and informed citizens as they consider the momentous challenges ahead for the Gulf Arab states, oil producing and consuming countries, and the international energy market.

Ambassador Douglas A. Silliman
President, Arab Gulf States Institute in Washington

Executive Summary

The Arab Gulf States Institute in Washington held its eighth annual Petro Diplomacy conference from October 20-21. The event examined the upheaval in the oil and gas markets following Russia's invasion of Ukraine and the role of Gulf Arab oil producing states in meeting the sudden demand surge, as a cascade of economic and energy sanctions disrupted oil and gas flows from Russia.

Held in hybrid format over two days, the conference was broken up into three sessions. In the first panel, speakers discussed the state of the oil market in light of the Ukraine crisis and sanctions against Russia and how these developments are affecting demand for Middle Eastern crude oil and whether the surge in demand for crude oil is a permanent trend. The second session explored how reduced flows of natural gas from Russia are impacting the market and the role that the Middle Eastern producers could play in filling the gap. The third session debated the implications of the decision by the OPEC+ alliance of OPEC and non-OPEC oil producers to make a steep cut to production quotas and its ramifications for U.S.-Saudi relations.

Introduction

The Gulf producers have been emboldened by their dominance of the oil and, to a lesser extent, gas markets, but this assertiveness has also become a point of friction between Riyadh and Washington.

The February 24 Russian invasion of Ukraine upended the oil and gas markets, pushing oil prices to near records and natural gas prices to an all-time high, inducing an unprecedented global energy and commodities crisis. European countries, heavily dependent on Russia for their crude oil and gas supplies, turned to the Middle Eastern and North African oil and gas producers for additional volumes of both crude oil and natural gas in what was already a tight market. The Gulf Arab states hold the bulk of global spare oil production capacity, and Qatar is one of the world's top three liquefied natural gas producers and exporters. That puts the Gulf countries on the front line of energy security, which has risen to the top of the political agenda since the Ukraine crisis disrupted oil and gas flows from Russia.

However, the decision in October by the OPEC+ alliance of OPEC and non-OPEC oil producers, led by Saudi Arabia and Russia, to cut production quotas for their 23 members by 2 million barrels per day starting in November was seen as a snub to Washington and its Western allies, whose leaders had been calling for more volumes as recession fears loomed large. Several OPEC+ producers are already struggling to meet higher quotas due to underinvestment in new capacity during previous oil price downturns. European Union sanctions on Russian seaborne crude imports due to come into effect December 5 may result in the shutdown of 1.5 mb/d of Russian crude oil production in the first quarter of 2023, and that might result in an imbalance between supply and demand should Chinese demand recover.

The quota reduction came as the OPEC+ producers were ramping up production to restore fully the 9.7 mb/d they had removed from the market at the start of the coronavirus pandemic

in 2020. This meant that spare production capacity held mainly by Saudi Arabia and the United Arab Emirates was running low as most producers were pumping flat out to meet rising quotas. Such a small spare capacity cushion means that any disruption, due to geopolitical upheavals in a producing country or weather-related shutdowns, would have an outsized impact on prices. Saudi Arabia and its OPEC allies argued that the decision to slash quotas was made purely on the basis of fundamentals, and its purpose was to restore stability to the market and encourage more investments. However, the argument failed to convince the West that politics did not play a part and gave rise to the perception that Saudi Arabia and the Arab producers were siding with Russia, which stands to benefit from higher oil prices.

The crisis has not led to a severe oil supply deficit yet, as Russia managed to divert its crude exports to China and India, which took advantage of the steep discounts offered by Moscow. But when it comes to gas, there is no immediate relief for gas importing countries because there is little surplus gas available today. The first large LNG increment from Qatar is due to come on line in 2025, so gas prices are likely to remain high until more supplies become available. By paying top dollar for LNG cargoes, European countries have secured supplies at the expense of importing countries in Asia, which had, until recently, been the main growth market for LNG. The demand surge for fossil fuels has boosted revenue for oil producers and international energy companies, which have been reporting record earnings and profits over the year. But the longer-term trajectory is for a gradual decline in demand as the transition to cleaner energy sources gathers momentum. After 2035, and out to 2050, the end date for attaining net-zero targets in much of the world, the share of oil in the energy mix is set to decline from around 100 mb/d to between 75 mb/d and 85 mb/d, so there is continued need to invest in new capacity. It also means that OPEC will have a smaller share of a shrinking market. Gas might have a slightly longer shelf life as a transition fuel and as feedstock for blue hydrogen, which some Middle Eastern countries see as a future growth market along with green hydrogen produced from renewable energy.

The Gulf producers have been emboldened by their dominance of the oil and, to a lesser extent, gas markets, but this assertiveness has also become a point of friction between Riyadh and Washington. What is clear in all these permutations is that the energy market is going through a period of uncertainty that is likely to linger for some time.

Middle East Crude Oil in High Demand but for How Long?

Based on known resources today, and using only today's technology, enough oil could be produced to meet the world's entire oil demand out to 2050 more than twice over.

The Middle East may be synonymous with oil and gas, but not all producers are equal. The OPEC+ producers, led by Saudi Arabia and Russia, have persistently fallen short of their official ceiling in 2022 as quotas were increased to restore barrels withdrawn at the start of the 2020 coronavirus pandemic. In October, the gap between quotas and actual production was around 3.5 mb/d, as the alliance of 23 producers struggled to maintain supply due to capacity constraints that date back to previous oil price downturns, the most recent of which was the coronavirus induced slump of 2020. The shortfall in 2022 started with some African

producers, including Angola and Nigeria. But, since the imposition of sanctions, Russia has seen the biggest slump in production, and a further decline is expected after an EU ban on seaborne Russian crude imports comes into effect December 5.

Given the shortfall by the OPEC+ producers, which account for roughly half of global oil supply, the OPEC+ decision to slash production quotas by 2 mb/d was viewed as a politically motivated move directed at Washington and its Western allies by an increasingly assertive group of Gulf Arab producers that was not justified as the world was on the verge of recession. Saudi Arabia and its OPEC allies argued that their decision was made purely on the basis of fundamentals and did not signify they were siding with Russia, which stands to benefit from higher oil prices as its output has declined. While the headline number of 2 mb/d jolted prices back above $90 per barrel after they had slumped below $85/bbl on signs of weaker demand, particularly from China, the reduction will be smaller given the underperformance by OPEC+ producers. Analysts see the actual reduction coming in between 800,000 b/d and 1 mb/d with Saudi Arabia, the UAE, Kuwait, and possibly Iraq bearing the burden of the cuts.

Although the OPEC+ decision was unanimous, there are tensions within the alliance itself, and Asia is the demand battleground for both oil and gas. Since economic and energy sanctions were imposed on Russia after its invasion of Ukraine, Russia has been selling its oil at a steep discount to the official Brent benchmark with China and India the biggest buyers of cheap Russian crude shunned by European and other Western countries and is now competing with the more traditional suppliers from the Middle East who have had to look elsewhere to place their barrels. At one point the discount of key Russian grade Urals was as high as $40/bbl. The purpose of the sanctions is to deprive Moscow of funds to pursue its offensive against Ukraine, and the end result is that Russia is selling its oil at $25/bbl below its 2022 forecast of $80/bbl. Asia is the main area of competition because Asian refining capacity is rising, and its refineries are configured to run the type of heavier, sour crude grades exported by Middle Eastern producers and Russia. So, while refining capacity in Asia is rising, and with it demand for crude oil (an estimated 1 mb/d of crude distillation units that convert crude into refined products came on line in Asia between 2019 and 2022), refining capacity in Europe and North America is shrinking as a number of refineries have shut down or are being converted to run more environmentally friendly biofuels. Saudi Arabia has pointed to insufficient refining capacity as one reason for the current spike in the price of refined products, such as diesel and gasoline, which have contributed to inflationary pressure.

All this is happening in the context of tight upstream spare oil production capacity. As OPEC+ production quotas began to rise starting in mid-2021, the spare capacity cushion began to shrink, and that fed bullish sentiment. Only Saudi Arabia, the UAE, and, likely, Kuwait and Iraq have some additional capacity that can be tapped into should the need arise. However, as spare production capacity shrinks, any disruption would cause an outsized reaction in prices. So, cutting quotas could be seen as one way for OPEC+ to preserve and increase available spare capacity. For now, the risk of a supply shortage is minimal because demand for oil is slowing. The consensus forecasts by the International Energy Agency, the U.S. Energy Information Administration, and OPEC point to supply exceeding demand for the rest of the year with little chance of a rebound in Chinese demand. The obvious price trend for oil is downward but with a high degree of volatility because the system does not have enough buffers to cope with a sudden supply disruption.

Some may view OPEC+'s decision to act now on supply, when the global economy is so fragile, as an act of economic warfare, and it could be argued that it is naive to assume that in a situation in which there is a real war and economic warfare that the two are not related. On the one hand, President Joseph R. Biden Jr. went to Saudi Arabia, a country he had described as a "pariah state," to seek cooperation from the OPEC kingpin for an oil supply boost. On the other hand, Saudi Arabia and the other 22 OPEC+ members sat down in Vienna with Russian Deputy Prime Minister Alexander Novak to discuss cutting production. Historically, OPEC would not want to contribute to recessionary pressures because that would be detrimental to oil demand. In a situation in which the U.S. Federal Reserve is raising interest rates, and other central banks are forced to follow potentially at the risk of precipitating a recession to keep inflation under control, a price spike is not what the global economy needs. That makes the argument that OPEC+ wanted to stabilize the oil market and not increase prices hard to believe.

But there are mitigating factors that might explain the desire by the OPEC+ producers to make a point. As the world's largest oil producer since the surge in shale oil production in the last decade, the United States has also become a player in the global oil market. By continuing to release oil from its strategic oil reserve in an effort to bring down gasoline prices, it is competing with OPEC+ in market management. That explains why OPEC+ may want to keep Russia in the fold, which makes for a stronger, enlarged alliance of producers.

Yet Russia's dominance as a significant oil supplier and the world's biggest natural gas exporter is on the wane, and there is a risk that sanctions may result in supply losses down the line because of a risk of long-term damage to oil and gas fields if they are shut down. Russia may be forced to shut down 1.5 mb/d of oil production in the first quarter of 2023, as the EU sanctions are implemented. The sanctions by the United States, the EU, the United Kingdom, and some allied countries are meant to minimize Russia's revenue but also bring down volumes in the longer term, because of the theory that Russian oil fields are very different to the oil wells of the Middle East. There are tens of thousands of little wells; lowering production will damage these fields and diminish production capacity in Russia. When the Soviet Union collapsed, it took 20 years and a huge amount of Western technology and money to bring the fields back to previous levels because the wells were so damaged. Nobody knows when this damage will kick in and how much could be lost, whether it is 2 mb/d or 3 mb/d. The goal of the price cap on Russian crude oil exports proposed by the United States and backed by the EU is to keep some Russian oil exports flowing but at lower revenue to Moscow, an experiment that is unlikely to have a significant impact on the Russian budget.

The world is in an age of uncertainty that is likely to persist. That means that forecasters have to take this into account in their long-term scenarios so as to capture this range of uncertainty when looking at the role that OPEC, Middle Eastern oil and gas producers, and others will play in providing energy supply and how that plays out.

Middle Eastern crude is in high demand, but it is unclear for how long. BP's New Momentum scenario is meant to capture a range of developments over the most recent past, a scenario that is close to a business-as-usual trajectory but captures the recent more heightened ambition to get into a lower carbon pathway. The company's Accelerated and Net-Zero scenarios project carbon emissions falling between 75% and 90% respectively over the long term. In light of the

range of uncertainty over the long term for emissions, there is one thing in common in all the scenarios – the rise in renewable energy, more electric vehicle penetration, and an increasing role for biofuels. In all these scenarios that BP presented in 2022 looking out to 2050, oil demand falls. In the near term, there has been an upward revision to oil demand, but the broad trajectory is for a decline, particularly between 2035 and 2050.

Yet even in the deep decarbonization scenarios, whether in line with the Paris Climate Agreement of 1.5 degrees Celsius or a 2 degree Celsius rise in temperature, there will still be demand for 75 mb/d to 85 mb/d of oil, which means there is still a need for substantial investment in the oil and natural gas sectors to make ends meet. Looking at the commonalities across the scenarios and specifically at oil, it is clear that the emerging economies take on an increasing share of that oil demand – between 60% and 80% of the demand profile. What this means for oil supply is that OPEC's share of supply contracts over the medium term out to 2030, but on a net present value basis increases beyond that time frame even as volumes fall, allowing the OPEC producers to extract some rent and market power in the longer term.

There is plenty of oil to go around over the long term. Based on known resources today, and using only today's technology, enough oil could be produced to meet the world's entire oil demand out to 2050 more than twice over. Where Russian output stands, however, does change this over the short term though not necessarily over the long term. The broad range of expectations is a reduction in forecasts for Russian supply by between 800,000 b/d to up to 2 mb/d compared to where those forecasters were pre-war. The oil market does not turn on a dime, and there is a need to make investments now to make supply equal to demand even in the range of scenarios highlighted for 2030.

The key takeaway should be that between 2015 and 2019, there was roughly $600 billion to $700 billion of annual investment in the oil sector. In the New Momentum scenario, where oil demand is higher, around $500 billion in investments annually are required. In the Accelerated and Net-Zero scenarios, that amount of annual investment contracts to between $300 billion and $400 billion a year. Data from the past five to six years from consultants Wood Mackenzie indicates $108 billion a year was invested in new major projects between 2015 and 2019. This was followed by a contraction in 2020 to around $30 billion before a recovery in 2021, when investments exceeded the 2015-19 average by around 1.5 times; so far in 2022, investments are at 80% of the 2015-19 average.

But while there has been an increase in investments, Russia accounted for around one-quarter of that capital expenditure between 2019 and 2021. So, if Russia is stripped out of these numbers, it points to a severe decline in investments over the next two or three years. That means the call on other producers, including those in the Middle East, is going to be higher to meet the range of projected outcomes. Middle Eastern producers are going to play a larger role because of the shortfall and expected decline in Russian-related investment.

A Dash for Gas, but Will It Last?

When it comes to Europe, there is no certainty of continued demand for gas in the longer term because it may be replaced by renewables, hydrogen, or other sources of clean energy.

The natural gas market was shaken to its core by the Russian invasion of Ukraine. As Russia is the world's biggest exporter of natural gas, the disruption has had an impact on global trade in liquefied natural gas. With supplies not immediately available, the price of LNG has shot up, and there are no expectations for a respite before new supplies come on line, primarily from Qatar, which is due to complete the first phase of its LNG expansion project by 2025. The gas market was already tight before the crisis in Ukraine, and, as Russia has restricted pipeline gas flows to Europe, prices of both gas and electricity have risen to levels that are causing harm to consumers, forcing governments to intervene in an effort to secure supplies at any cost, often at the expense of Asian consumers. European leaders have been beating a path to Middle Eastern and African gas producers from Qatar to Egypt to Algeria seeking gas supplies as the EU scrambles to wean itself off Russian natural gas. A confluence of factors has contributed to this tightness and pushed prices to record levels for a fuel that until recently was being slammed as a polluting fossil fuel because of high methane emissions.

There are early signs of change as gas producers are revisiting plans to expand their production, which had been on hold before the crisis lifted demand, mainly in Europe, with new players entering the gas arena. The UAE, which previously shipped its LNG mainly to Asia, has shipped its first cargo to Europe in about a decade and is planning to expand its LNG export terminal to accommodate the surge in demand for gas. The east Mediterranean is coming into its own as an exporter of LNG as Israeli gas flows to Egypt, to be converted into LNG at Mediterranean export terminals for onward shipment to Europe and other destinations. Corporate and national leaders are looking around the globe for new supply and have turned attention to countries like Qatar and Algeria but also more complex operating environments like the east Mediterranean.

The energy market is facing an unprecedented and multifaceted crisis, a lot of which revolves around gas and electricity. Yet it is in essence a Eurocentric crisis in that Europe is imposing its needs on the rest of the world, particularly Asia and the developing world. That has spread the crisis further, as Europe has sucked in all available LNG supplies while others have had to go short because they cannot afford the elevated prices that European countries are willing to pay for the sake of energy security. This has caused physical shortages, putting LNG beyond the reach of poor countries, such as Bangladesh and Pakistan.

This is a dangerous trend that ultimately affects the global economy and stability. Some EU policies are shortsighted and may not necessarily reduce demand as intended. Increasing supply will take time; decreasing demand will be painful, but it needs to be done in a way that causes the least harm. There is no escaping the fact that eliminating Russian gas, either through sanctions or by Moscow's decision to withhold supplies to Europe, is disruptive, and the volumes are significant.

What is at stake is 140 billion cubic meters of annual Russian pipeline gas exports to Europe that cannot be replaced fully. LNG can meet only a fraction of the shortfall because of how much is actually available or can be diverted from other regions, and there is not enough infrastructure in Europe presently to accommodate greater imports, though some is being expanded. Whatever Europe has managed to secure in 2022 is not enough as volumes of Russian gas are down to 60 billion cubic meters, a gap of 80 billion cubic meters. Additional LNG, Norwegian gas, Azeri pipeline gas, and North African pipeline gas supplies (which are slightly down), come out to a combined 50 billion cubic meters, plus whatever is needed for storage. This is balanced by lower gas demand, which has fallen by 10% in 2022. The problem for 2023 is that Russian gas supplies will be below the 23 billion cubic meters that Moscow is supplying to Europe now, and there is no certainty that these will continue, in particular flows through Ukraine, which account for half of that volume. Supplies of Russian gas to Europe may come down to 15 billion cubic meters, so another 45 billion cubic meters will have to come from somewhere else. With LNG balances so tight, it is doubtful that more supplies can be diverted from Asia, where China has been locking in contracts from a number of suppliers. Between 2020 and 2025, there is no additional LNG supply that will be available in volumes large enough to meet global demand. There are also questions about the fate of Russia's Arctic Energy 2 project, which may be impacted by sanctions.

Record-high gas prices have pushed up electricity prices across Europe, and there is an urgent need to reduce demand. Surprisingly, gas demand for power generation has actually increased. One reason is that nuclear power generation has been declining. France has delayed maintenance of its nuclear power plants, which resulted in corrosion of pipes, while Germany is planning to decommission its nuclear power facilities by April 2023. Hydropower capacity is down 25% in Europe because of climate change. So, in order to replace these missing terawatt hours of hydropower and nuclear power, more wind and solar capacity is needed. But that is not enough, which is why coal has made a comeback; and yet, even with coal supplies, that is not enough. With more LNG destined for Asia being drawn into Europe, this is likely to impact the future of gas and LNG in Asia. This is critical because Europe was never meant to be a big LNG market and was a declining region in terms of gas demand before the current crisis. Given the revival of European gas demand and growth in Asian demand, gas prices are likely to remain high for at least three years until new supplies become available.

The Middle East is at the center of this demand revival, but European countries dashing around Arab capitals looking for new supplies will need stamina because there hasn't been much momentum on the supply side in the Middle East for some time, until quite recently. New export capacity is a multiyear project and cannot be done with the flick of a switch. Qatar brought its big wave of LNG on line around 2011 then imposed a moratorium on further developments until 2021, when it launched its expansion plans to take capacity from 77 million metric tons per year to 126 million mt/y in two phases due to be completed by 2026-27. The UAE was looking to import more LNG but is now building an export terminal at Fujairah, though that is likely five years away. The UAE could possibly squeeze out some additional LNG from existing facilities at Das Island, but if it is to supply Europe, it will likely be at the expense of traditional buyers in Asia.

Europe has had opportunities for at least the past decade or more to develop new suppliers in North Africa, the Caspian, and the Middle East, mostly for pipeline gas but also LNG. However,

it did not take up these opportunities and is now paying the price. So, there is a contradiction between the long-term gas outlook for Europe and its decarbonization agenda and the short-to-medium-term outlook, which requires a huge amount more of gas to replace Russia's. But LNG plants and major international pipelines can't be built on the back of a five- or 10-year commitment. Major producers like Qatar are looking for 20-year contracts, and Asian countries have traditionally been willing to sign up to that. When it comes to Europe, there is no certainty of continued demand for gas in the longer term because it may be replaced by renewables, hydrogen, or other sources of clean energy. With Russian supplies to Europe currently at 20% of the 2021 average and the Nord Stream 2 pipeline scrapped, Europe is faced with diminishing options, though it is clear that it will never again want to be as dependent on Russia as it was before the crisis.

OPEC+ and U.S.-Gulf Relations

The dispute between Saudi Arabia and the United States does not help to reduce market volatility at a time when there is a need for stability.

The OPEC+ decision to cut production quotas by 2 mb/d further strained relations between Saudi Arabia and the United States. Such a steep cut, even if the actual reduction will be lower than the headline figure, exposed tensions between the two allies that were aired in public through the media. The U.S. administration was outraged that Saudi Arabia was not cooperating with it in the effort to bring down the price of oil, a particularly sore point as the cut was to come into effect in November, just as U.S. congressional elections were due to take place, while Saudi Arabia did not appreciate the U.S. stance on a decision that is fundamental to its economy and national security. Beyond energy, the dispute should be viewed through the lens of the Ukraine war and the perception that the decision was made in coordination with Russia, which stands to benefit. By holding the OPEC+ meeting in Vienna in person on October 5 with Russian Deputy Prime Minister Alexander Novak attending, the perception was that Saudi Arabia was effectively siding with Russia and providing President Vladimir Putin with a platform. The dispute also comes in the context of a growing breach of trust between the two countries going back 15 or 20 years and throughout the second term of President Barack Obama, though they improved at the start of the Donald J. Trump presidency. However, the lack of a U.S. response to Iranian missile attacks on Saudi Aramco facilities in 2019 was a turning point for the Saudis with the Trump administration in that it fed the perception that Washington was no longer a reliable guarantor of Saudi security.

The way in which the decision was presented to the world may have also been a contributing factor. The OPEC+ meeting was scheduled for October 5 but originally not as an in-person meeting. The group hadn't met in person in Vienna in two years and sprung the desire to convene in person on participants a week before. It wasn't so much the decision to cut production quotas but the messaging. OPEC+ producers wanted to make a splash and shock the market and show that they were in charge and would not be dictated to by Washington or anyone else. Because a number of producers are not meeting their higher quotas, the actual reduction will likely be half or less than half the headline figure, but this was not explained. It took a question to Prince Abdulaziz bin Salman, the Saudi energy minister, for him to explain that the cut may actually be no more than 1.1 mb/d. Analysts at the Petro Diplomacy

conference suggested it may even be 800,000 b/d, which isn't huge considering that Chinese demand is weak, and demand growth in general is decelerating.

The oil market was tight even before the Ukraine war but not so tight as to warrant near-record high oil prices, which soared in March because of fears of a much bigger loss in Russian oil exports. Russian oil production has held relatively stable, declining by around 400,000 b/d, though exports have held up as large volumes of discounted Russian crude oil are being diverted to China and India. EU sanctions are due to come into effect December 5, and that might lead to the shutdown of 1.5 mb/d of Russian oil production in the first quarter of 2023. One of the main concerns of the IEA and the United States is that by cutting production, OPEC+ is preventing stocks from being replenished. Many countries in the industrialized world, the OECD countries, have been drawing down their inventories because of the release from strategic stocks that was ordered by the IEA and the United States. So, stocks are at the moment below the five-year average, which is the benchmark that OPEC uses to determine how much the market needs.

It was the way in which the message was delivered that appeared to be political rather than the message itself, although the decision to cut production – and not just the messaging – angered the Biden administration and Congress. Market fundamentals may well justify a production cut because demand is weaker, but if producers were worried about a recession that might reduce demand further, the last thing the global economy needs is less oil. What Saudi Arabia and OPEC+ appeared to be saying was that they are in charge and their mandate is to serve the interests of their members and keep prices at a certain level to meet their budgetary requirements. Consumers have also been sending mixed signals to the oil producers: declaring a desire to ease their reliance on foreign imports and switch away from fossil fuels then calling for more oil when crisis hits. With OPEC members Venezuela and Iran still under sanctions and political instability in countries like Libya, there is little likelihood of substantial volumes of oil being made available in the immediate future, more so since the prospects of a nuclear deal with Iran are all but dead. Furthermore, Saudi Arabia worked hard to secure an alliance with Russia, and it wants to preserve it.

All this is taking place amid an energy transition and a move toward a more decarbonized future, which has a direct impact on the oil producing states. The 2022 United Nations Climate Change Conference, COP27, in Egypt underlined this trend.

The transition hits the Saudis and other Gulf states in a much more fundamental way than it does even the countries more concerned with energy security. For the oil producing states, how they manage their resources has to do with their very ability to survive and secure their future. Saudi Arabia, in particular, has taken steps to link its energy policy to domestic social reforms and the Vision 2030 economic diversification program on the institutional level. The chairman of Saudi Aramco is also the chairman of the Public Investment Fund, which is managing Saudi Arabia's investments to achieve this energy diversification. The need for high revenue to drive the transition is at the forefront in Saudi decision making. In addition to the social transformation, Saudi Arabia is going through a tremendous political transition to a more centralized system, all of which is being captured in a nationalist mood. Saudi Arabia has a lot more ambition to assert itself on the global stage, to be relevant and promote its interests. It's not surprising that the area of oil, where the Saudis have the most leverage, is

where they are applying their power.

The instruments being used to influence energy prices have political and economic dimensions, but the urgency of the strategic objectives behind the recent moves seems to be more political in nature for the White House and economic in nature for the Saudis, particularly in this period of transformation for the Saudi economy. This might in part explain why Saudi Arabia and OPEC+ made the decision to cut production quotas, but that does not mean that there were no other considerations. The first has to do with the role of energy markets for the fiscal health of Saudi Arabia, the second with the benefits of maintaining an oil surplus, and the third, how these factors support the Vision 2030 program. The fiscal health of Saudi Arabia is still directly dependent on energy markets. The latest Ministry of Finance budget documents show that between 60% and 70% of government revenue came from the oil and gas sector in 2021, according to a conference participant. That doesn't account for government wages and other policies and injections of capital into the economy that is then recycled through the economy and comes back in the form of taxes. So, with a budget so dependent on oil revenue, high oil prices are necessary for the government to continue to enjoy budget surpluses. Estimates of the break-even price of oil for Saudi Arabia have been around $70/bbl. Some new estimates for 2023 suggest that the figure may be around $76/bbl. As things stand now, the Saudis can manage prices in the $80/bbl range, and they do not want prices to fall below that. Oil prices had sunk from a near-record close to $130/bbl in March to below $85/bbl when the OPEC+ ministers met in October. Prices have since recovered to trade above $90/bbl, which would meet the higher spending planned by Riyadh in 2023. There is significant interest in Saudi Arabia in maintaining economic momentum because a number of megaprojects, such as the futuristic city of Neom, are moving from the conceptual stage to implementation.

OPEC+ is due to meet again December 4, just one day before the EU embargo on Russian seaborne crude imports comes into effect. Any decision made at that time would likely depend on where prices are. Saudi Arabia invested heavily in new production capacity and holds the bulk of global spare capacity that can be brought on line in the event of a supply disruption. Saudi Arabia and other Gulf states with excess capacity are at the forefront of energy security, but they do not want to be dictated to and are insisting on acting in their own interests. The bulk of spare production capacity is with Saudi Arabia and the UAE, and Kuwait and Iraq may hold a little bit of spare capacity.

But it's not just about oil. Qatar is the gas supremo in the Middle East and one of the biggest exporters of LNG in the world. The UAE has the most diversified energy system in the Middle East, including oil and gas, as well as nuclear and solar resources. The UAE is investing in blue hydrogen as is Saudi Arabia, which is also building the world's biggest green hydrogen plant in the world at Neom at a cost of $5 billion. So, Saudi Arabia might need even higher break-even prices to balance its budget, given plans for building ski resorts in the desert and futuristic cities like Neom with The Line and investing in unconventional gas at a cost of $100 billion.

There is a process of decarbonization going on, but it is impossible to get to 100% renewable energy overnight from around 20% of global power generation capacity now. Even in a deep decarbonization scenario, the world will need around 75 mb/d to 85 mb/d of oil. So Middle Eastern oil will remain necessary, so long as these oil producers can reduce the carbon content of their products. Oil producers argue that the race to switch to renewables before the global

energy system is mature enough to accommodate intermittent supply has contributed to the current tightness in the oil and gas market. So, LNG prices went through the roof because there's more demand, crude oil is being burned for power generation because gas is too expensive, and coal has come back. Persistent high oil and gas prices will likely accelerate the switch away from fossil fuels, but it will take time to scale up.

The dispute between Saudi Arabia and the United States does not help to reduce market volatility at a time when there is a need for stability. Meanwhile, OPEC+ has also contributed to the mixed signals that have influenced price direction. After Biden visited Saudi Arabia, a country he had called a "pariah state," in July, OPEC+ made what appeared to be a small gesture by increasing production by 100,000 b/d in September, which is a small volume in a close to 100 mb/d market. A month later, OPEC+ reduced production by the same volume. At the same time, there isn't much new capacity coming on line. Saudi Aramco is only increasing its production capacity by 1 mb/d, and that's not going to happen until 2027. The UAE is speeding up its production capacity expansion plan to 5 mb/d. But other OPEC members are not doing much to bring on new upstream capacity. Iraq has ambitions to do it, but it is limited by infrastructure bottlenecks. As the energy transition advances, there will be fewer investments in new oil and gas infrastructure projects because of the risk of stranded assets when demand peaks, so capacity is likely to be constrained for some time unless energy efficiency measures succeed in reducing demand significantly. Then there is Africa, which needs more energy to grow. African countries need access to investments that are becoming more difficult to obtain for fossil fuel projects, and green funding has fallen short of pledges by the wealthy countries.

Saudi Arabia has often been referred to as the producer of last resort – the central bank of the energy system. So, when the big OECD countries start to release from strategic reserves, it rankles the Saudis because they see it as market intervention that encroaches on their efforts to manage the market. Strategic reserves are meant to be used in the event of a supply shortage and not to influence price. If reserves are drawn from, they have to be filled up again. The proposed introduction of a price cap on Russian crude oil exports is also an example of market intervention that may not have the desired effect if Putin refuses to sell at a price determined by Washington as he has threatened to do. The sanctions have so far not resulted in a big drop in Russian oil exports. Iran has been under sanctions on and off for decades but still manages to export more than 1 mb/d of crude oil. Price sensitive importers like India will not turn away discounted barrels from Russia or Iran.

The decision to cut production quotas at a time when oil prices were not far below $90/bbl was seen as a signal that OPEC+ wants a floor at that level, though this was never announced. OPEC in the past tried to set a price band but never managed to stay within it. But the actions of these oil producers speak for themselves: They didn't like oil prices below $85, and now that they're above $90, everyone seems to be happy. The optics of the OPEC+ meeting are also interesting. Russian Deputy Prime Minister Alexander Novak was present in Vienna, but he did not appear at the closing press conference alongside Prince Abdulaziz bin Salman of Saudi Arabia as he would have done previously.

From a political standpoint, there has been growing mistrust between Riyadh and Washington on a number of issues. They haven't always seen eye to eye on Yemen, which has been a thorn in relations. Attacks by Houthi rebels in Yemen against energy infrastructure in Saudi Arabia

and a deadly missile attack on Abu Dhabi was another sign for the Gulf countries that the United States is unable or unwilling to meet their security needs. But on the issue of energy security, Washington seems to keep the security arrangement with the Gulf states and Saudi Arabia separate from other issues, like energy and human rights. But it is unlikely that there will be a total breach between two countries that have been allies for more than 80 years.

The UAE, while retaining close ties with the United States, now has the implied security umbrella provided by the Abraham Accords with Israel, and that recent geopolitical development is highly significant. So, while the Gulf states still consider themselves traditional U.S. partners, there has been a growing sense in the last 15 years that it is simply unwise to rely on Washington in a way that is fundamental to national security, and that has given way to strategic diversification and new alliances.

Conclusion

The Russian invasion of Ukraine has created an unprecedented energy and commodities crisis and ushered in an era of instability that is likely to linger for some time. International sanctions against Russia have reduced oil and gas flows from one of the world's biggest energy exporters and altered the geography of the energy world. With energy security becoming central to policymakers in the major energy consuming countries, all eyes have turned to the Middle Eastern oil and gas producers, which, by virtue of their vast reserves and spare production capacity, are on the front lines of energy security.

The empowered OPEC+ countries have made clear that they are in the driver's seat and will not be dictated to when it comes to their own national interests. The decision to cut oil production quotas by 2 mb/d by the 23 members of the OPEC+ alliance led by Saudi Arabia and Russia was one example of this assertiveness that has caused friction between traditional allies Riyadh and Washington. With oil prices reaching near-record levels and the world teetering on the verge of recession due to inflationary pressures caused by high food and energy prices, the decision was seen as a snub to the United States and its Western allies. Europe, which had until recently relied heavily on Russian crude oil and gas for its energy needs, has had to scramble for alternative supplies to replace Russian oil and gas, some of which has been diverted from Asian countries that cannot compete as prices of LNG rose to a record high, pushing up electricity prices. Whether the decision by the OPEC+ ministers was political or purely economic is debatable, but it would be naive to think that there was no element of political posturing in the way that the decision was presented to the world. The implication drawn by Washington and the Western countries that had been urging for more, not less, oil was that Saudi Arabia and its Gulf allies were siding with Russia, which stands to benefit from higher oil prices. Regardless of motive, the decision has further strained already shaky relations between Saudi Arabia and Washington, though quiet efforts seem to have been made on both sides to limit any long-term damage to the relationship.

Agenda

October 20-21, 2022

Session 1: Middle East Crude Oil in High Demand but for How Long?

Speakers:

Michael Cohen, Chief U.S. Economist and Head of Oil and Refining, BP

Christof Rühl, Adjunct Senior Research Scholar, Center on Global Energy Policy, Columbia University

Herman Wang, Managing Editor, OPEC and Middle East News, S&P Global Commodity Insights

Moderator:

Kate Dourian, Non-Resident Fellow, AGSIW; Contributing Editor, MEES; Fellow, Energy Institute

Session 2: A Dash for Gas, but Will It Last?

Speakers:

Anne-Sophie Corbeau, Global Research Scholar, Center on Global Energy Policy, School of International and Public Affairs, Columbia University

Jamie Ingram, Senior Editor, MEES

Robin Mills, Non-Resident Fellow, AGSIW; CEO, Qamar Energy

Moderator:

Colby Connelly, Senior Research Analyst, Energy Intelligence

Session 3: OPEC+ and U.S.-Gulf Relations

Speakers:

Kristin Smith Diwan, Senior Resident Scholar, AGSIW

Kate Dourian, Non-Resident Fellow, AGSIW; Contributing Editor, MEES; Fellow, Energy Institute

Robert Mogielnicki, Senior Resident Scholar, AGSIW

Moderator:

Hussein Ibish, Senior Resident Scholar, AGSIW

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