

December 1, 2017

## Saudi Arabia's Transformation and U.S. Energy Security: Hope for the Best, Prepare for the Worst...

**Jonathan Chanis**, Senior Vice President for Policy

Since the elevation in June 2017 of Mohammed bin Salman (MBS) to Crown Prince, or next in line to the King, instability in Saudi Arabia and the wider region has grown to such an extent that many observers and analysts now say the oil geopolitical risk premium—the additional amount of money buyers will pay for a barrel of oil due to future supply uncertainty—has returned. After oil prices began declining in late 2014, many argued that the risk premium was zero. Now, new and old geopolitical concerns are bringing back this instability surcharge.

Potential regime instability in Saudi Arabia, rising Saudi-Iranian tensions, the ongoing war in Yemen, and extremely unstable situations in Iraq, Syria and now Lebanon are causing many to ask if the region is headed for a major catastrophe. It is unclear if this catastrophe might be a violent change in regime in Saudi Arabia or a regional military conflict, but the possibility for both has increased substantially over the last several months. If such events were to occur, they would have extremely negative consequences both for global energy markets and U.S. energy security. While the U.S. oil and natural gas revolution have reduced American vulnerability to a Persian Gulf supply disruption, we remain far from insulated from a major Middle East disruption, especially its price implications.

### Saudi Arabia

Changes both within the Kingdom of Saudi Arabia, and among other regional states, are central to the resurgent instability. In June 2017, MBS's father, King Salman, removed his nephew Mohammed bin Nayef as Crown Prince and replaced him with his son. In July and September, MBS arrested and imprisoned political dissidents and Wahhabi clerics. In early November, MBS detained nearly a dozen royals and scores of current and former government officials and prominent businessmen. The November "anti-corruption purge" heightens concerns over the stability of the Saudi regime.

On the surface, it seems that MBS has consolidated his position within the military, internal security, and intelligence services. This appeared to be particularly true after the removal of one of his last remaining security service rivals, Prince Miteb bin Abdullah, head of the National Guard. Yet MBS's position is still far from secure; he has to protect himself from other royals,

the Wahhabi clerics, and—should reform not yield quick benefits—the Saudi population as well.

MBS is undertaking these reforms with less money than was available to his predecessor. And historical precedents, including the recent Arab Spring experience, are not encouraging; Arab populations refused to accept the decline in living standards brought on by reform, and intra-elites conflict undermined the movement toward political change. As Alexis de Tocqueville once wrote: “...the most critical moment for bad governments is the one which witnesses their first steps toward reform... Evils which are patiently endured when they seem inevitable become intolerable when the idea of escape from them is suggested...”<sup>1</sup>

Here are just a few of the ways MBS’s reform effort could fail or otherwise lead to heightened energy insecurity:

- **Royal family dissent:** The possibility for a violent reaction by other royal family members after the loss of their privileges should not be minimized. Fratricide within the Royal family is not unknown; in 1975 King Salman’s half-brother, King Faisal, was assassinated by a nephew.<sup>2</sup> The November detentions may have bought MBS time, but it has not resolved issues of MBS’s political legitimacy, nor has it resolved the country’s desperate need for social liberalization and economic reform.
- **Opposition from the Wahhabi religious establishment:** The very foundation of Saudi Arabia is based upon the union (sealed by marriage in 1744) of the al-Saud family and the al-Wahhab family. In 1932, these two tribes emerged as the controlling groups of the Arabian Peninsula.<sup>3</sup> Now MBS wants to remove, or at least reduce, the influence of the single most important group giving legitimacy to his family’s rule. Despite the opinions of some commenters, building “moderate Islam” probably sounds a great deal more convincing in London than in Riyadh. Parts of the Saudi population are still extremely conservative. Wahhabism has been central to regime survival and reducing its power entails huge risks.
- **Popular resistance:** By framing the crackdown as a battle against corruption, MBS seems to have garnered support from the Saudi public. But the patience of the “street” is not infinite. Tangible and near-term signs of improvement, such as lower unemployment and good private sector jobs, especially for young men will be necessary. It is unclear if MBS has one year or several years, but a reaction from the public can never be completely ruled out, especially since the majority of the population is young, technologically connected, and increasingly able to see how other societies function.<sup>4</sup>

---

<sup>1</sup> Alexis de Tocqueville. *The Old Regime and the Revolution*. New York: Harper and Brothers, 1856. P. 214.

<sup>2</sup> Eric Pace. [King Faisal's Assassin Is Declared Sane](#). *The New York Times*. March 31, 1975

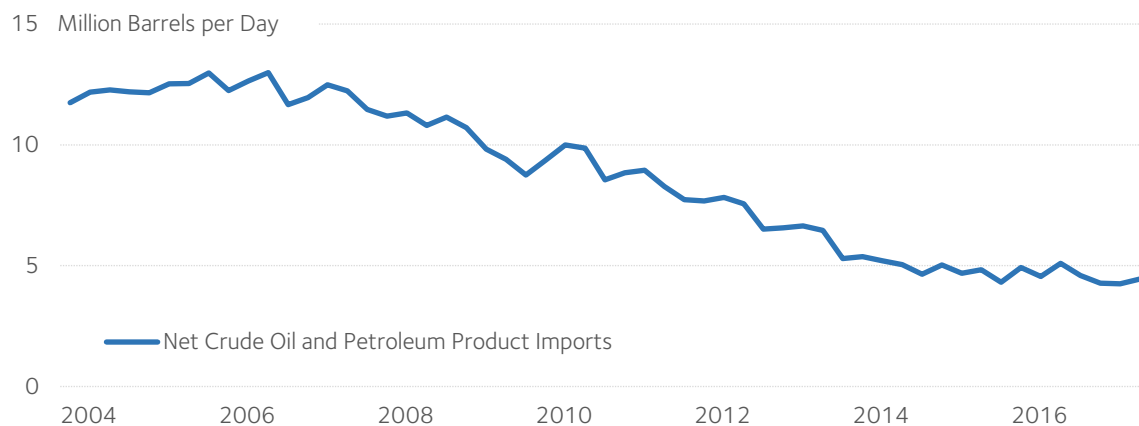
<sup>3</sup> Helen Chapin Metz, ed. [The Saud Family and Wahhabi Islam](#). *Saudi Arabia: A Country Study*. Washington: GPO The Library of Congress, 1992.

<sup>4</sup> Caryle Murphy. [A Kingdom's Future: Saudi Arabia Through the Eyes of its Twentysomethings](#). Wilson Center, 2012.

- **The Eastern Province:** The Eastern Province of Saudi Arabia produces 10 million barrels of oil per day (mbd) and it has a predominantly Shia population.<sup>5</sup> The relationship between the minority Shia's and the Wahhabi Saudis has been strained ever since the area was first incorporated into Saudi controlled territory right before World War I. And the region is prone to intermittent violence as occurred in 1979 and then again in 2016 after the execution of influential Shia cleric Nimr al-Nimr.<sup>6</sup> This conflict can deteriorate quickly, especially since it also involves Iraq, and since Iran sees itself as the local Shia population's protector.<sup>7</sup>

Managing these concerns was a great deal easier when oil prices were higher because the system was heavily biased toward the distribution of benefits through government patronage. This state generosity was undertaken to co-opt members of the public by bringing them into a beneficial relationship with the government. And the array of goods and services Saudi citizens receive was and remains extremely large. It includes among other things free health care, free schooling, and subsidized water, electricity, and gasoline.<sup>8</sup> From the perspective of regime stability, this expenditure of money might be a better use of revenue than supporting the Royal family. But it also drained funds from Aramco (the state oil company and generator of the funds), and led to massive over-consumption of the subsidized products because prices did not reflect real costs. In any event, with the decline in oil prices in late 2014, continuing this generosity became very burdensome. (See Figure 2 below). Initially, the state tried to reduce some of the subsidies and transfers, but many were reinstated several months later

**FIGURE 1: DECLINES IN U.S. NET CRUDE IMPORTS HAVE LEVELED OFF BUT REMAIN SUBSTANTIAL**



Source: SAFE analysis based on data from EIA

<sup>5</sup> Christopher M. Blanchard. [Saudi Arabia: Background and U.S. Relations](#). Congressional Research Service. Sep. 8, 2015.

<sup>6</sup> Mehruun Etebari, Jeff Gerlach and Paul Ruiz. *Rising Tensions Between Saudi Arabia and Iran Threaten Regional Oil Supplies*. Washington, D.C.: Securing America's Future Energy, 2016.

<sup>7</sup> Chris Zambelis. [The Kingdom's Perfect Storm: Sectarian Tension and Terrorism in Saudi Arabia's Eastern Province](#). Combating Terrorism Center, U.S. Military Academy. April 22, 2016.

<sup>8</sup> Adam Bouyamourn. [Saudi Arabia raises fuel price 66 per cent amid big subsidy shake-up](#). *The National*. Dec. 28, 2015.

due to the discontent it caused among the population.<sup>9</sup> If oil prices stay low, it will undermine MBS's ability both to buy off opposition and fund legitimate development objectives.

Further complicating the above domestic problems are the region's many foreign policy conflicts. While some of these conflicts have been around for decades, what is new about the current period is the heightened role Saudi Arabia is assuming in them. Since the collapse of Iraqi power in 2003, Saudi Arabia has emerged as the primary counterbalance to Iran. Consequently, virtually every regional problem now has a Saudi-Iranian angle: Yemen, Iraq, Syria, Lebanon and the Eastern Province all involve Saudi Arabia on one side and Iran on the other. As a result, every regional encounter has the potential to escalate from a localized conflict into an outright Saudi-Iranian military confrontation.

Saudi relations with Iran are extremely hostile and domestic turmoil in Saudi Arabia only increase the prospect that some encounter between the two countries will spiral out of control. MBS is the architect of the intractable Saudi war in Yemen, and after the recent missile launch by Yemeni Houthis against Riyadh, the Saudi government issued a statement saying they considered the launch an act of war *by Iran*.

How MBS manages the Iran policy is a key risk for U.S. and global energy security. If Saudi Arabia and Iran were to engage in a military confrontation, it has the potential to destroy much of the region's energy infrastructure. And any conflict almost definitely would not be confined to just those two belligerents. Under almost any scenario, the risk to the region's energy infrastructure is extreme, and even if only part of Saudi Arabia's 12 mbd and Iran's 3.5 mbd production capacity were affected, the resulting impact on prices would be dire. It is not inconceivable that global oil prices could double or triple since it would be impossible for other oil-producing nations to compensate for the supply deficit.

Even if a full-scale conflict does not occur, there are many other situations short of full-scale war that could threaten global petroleum supplies, especially an Iranian provocation in the Eastern Province. This could entail Iran working through the Shia minority, or directly engaging in acts of terrorism, especially against Abqaiq—the world's largest oil processing facility and the center of Saudi Arabia's export complex.

## What Is at Stake?

Over the last few years, the United States has regained its position as a leading producer of petroleum. Together with Saudi Arabia and Russia, the three countries dominate global oil markets. But because Saudi Arabia has the largest reserves, the lowest cost of production, the controlling voice within OPEC, and often the globe's only spare production capacity, it remains at the center of the global petroleum system.<sup>10</sup> A significant disruption to Saudi Arabia's ability to produce and export petroleum would drastically increase oil prices and severely damage the global economy.

The precise degree of global disruption would depend on the magnitude of the price shock, the speed with which it arrived, and its persistence. However, it would not be unreasonable to assume that any Saudi-Iranian conflict would result in a large and immediate price increase and

---

<sup>9</sup> Onur Ant. [Saudi Arabia Weighs Slower Subsidy, Budget Cuts to Aid Economy](#). Bloomberg. Oct. 12, 2017.

<sup>10</sup> EIA. [Saudi Country Brief](#). Oct. 20, 2017.

that it would last weeks if not months, at the minimum. In any direct conflict, each side can be expected to target the another's oil infrastructure, increasing the likelihood of a lasting supply disruption. While the United States is involved in protecting the Saudi oil fields from Iran, especially through its anti-missile defense capabilities, the chances of a significant number of Iranian missiles reaching vulnerable Saudi targets has to be seen as high. Saudi ability to do major damage to Iran is less certain, but given the general fragility of oil assets, the risk of damage also is high.

Historically for every \$10 rise in the price of oil, U.S. GDP tended to decline by 0.21 percent during year one, and 0.52 percent in year two. Inflation tends to rise by about a half percent, real disposable income declines by 0.40 and 0.53% each year, and unemployment increases by 120,000 during year one and 410,000 in year two.<sup>11</sup> Consequently, a rapid \$30, \$40 or \$50 per barrel rise in prices would have a materially negative impact on U.S. and global GDP.

Recent advances in U.S. energy production, i.e., the shale boom, have altered these historic oil-macroeconomic relationships. But the inflationary impact would certainly endure, and while the other impacts would be less, they still would be significant. Moreover, the second order impact on the United States through trade linkages with Europe and Asia would be substantial. A global recession could not be ruled out, and in fact, would be likely.

## Prospects for a Solution

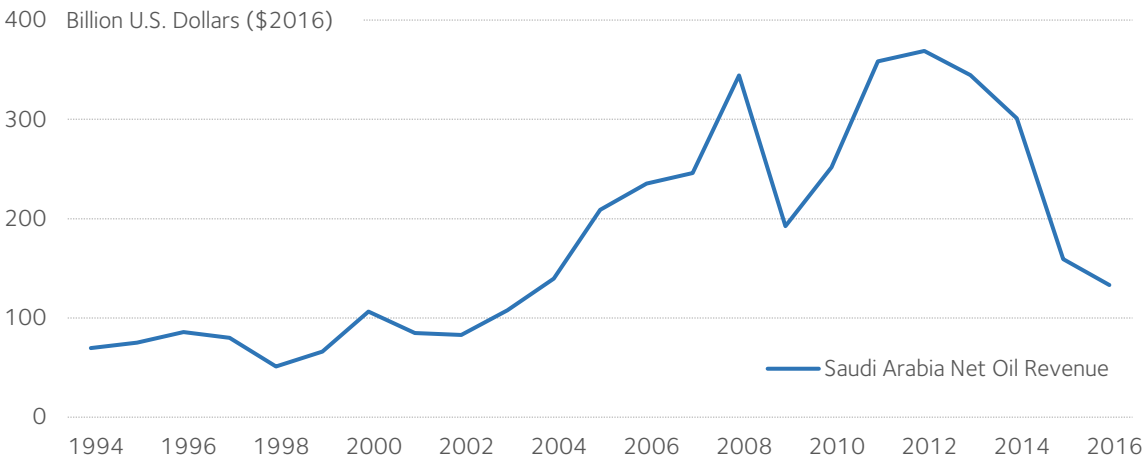
The United States relies on petroleum to power 92 percent of its transportation sector—a monopoly that remains a paramount security threat for the United States; instability in Saudi Arabia and the Persian Gulf remind us of this danger. SAFE has consistently argued for increasing domestic U.S. petroleum production, and indeed, the near doubling of domestic production over the last ten years has made the United States less vulnerable to supply disruptions from the Persian Gulf and elsewhere. The fact that the United States now only imports approximately 20 percent of its petroleum requirements (down from 65 percent) has vastly lessened vulnerability by cutting the number of barrels that need to be replaced during a disruption, and by keeping more of any offsetting benefits from higher prices in the United States. *But the decline in dependence still has not gone far enough to remove all U.S. vulnerability.* Unfortunately, the residual amount of petroleum imports the United States still needs is substantial, and the type of petroleum the United States produces is increasingly suboptimal for domestic refiners. And even though increased domestic production would reduce the severity of a prolonged global supply shortage, the nation remains vulnerable to sharply higher prices which are still set globally.

In spite of the impressive reduction in U.S. net import dependence and the prospect of further reducing imports by continuing to increase domestic supply, the United States now confronts the problem of having excess types of crude oil which are sub-optimal for its refinery system. As a result, it increasingly exports this light, sweet crude oil and imports heavier, sour crude oil. Given the quality mismatch, exporting the light, sweet barrels is best because domestic producers can realize a higher sales prices abroad, and domestic refiners can acquire less

---

<sup>11</sup> Nigel Gault. Oil Prices and the U.S. Economy: Some Rules of Thumb. IHS Perspectives. Feb 24, 2011.

**FIGURE 2: SAUDI NET OIL REVENUES DECLINE**



Source: SAFE analysis based on data from EIA

expensive foreign barrels which are better suited for their refineries. However, most, if not all of the quality mismatch could be reduced in the future if the United States moved decisively with opening acreage in Alaska, the Gulf of Mexico and other areas not concentrated in the traditional U.S. shale oil zones (e.g., Texas and North Dakota). Until this happens, however, Saudi Arabia and Iran will continue to matter to U.S. petroleum supply.

Additionally, the oil price connection between the United States and the rest of the world will continue even if we achieve total self-sufficiency in petroleum. Given the global integration of crude oil and refined product markets, U.S. supply and demand will be affected by events outside the country. A supply disruption anywhere affects prices to one degree or another everywhere. Therefore, as long as the transportation sector remains monopolized by petroleum, political and military disruptions emanating from the Persian Gulf will continue to severely and negatively threaten U.S. consumers and energy security.

To counter this threat, SAFE has long advanced a range of policy solutions that include transitioning automobiles and trucks toward the use of advanced fuels including electric, natural gas, and fuel cell vehicles. This promotes consumer choice, and creates mobility substitutes that lessen oil's monopoly over the transportation system. Diversity of fuel supplies creates options for consumers and businesses and remains a crucial component of U.S. energy security.

The potential for regime instability in Saudi Arabia and/or military conflict in the Persian Gulf is a reminder of how important it is to work against U.S. oil dependence. Any type of conflict in the Persian Gulf endangers global oil supplies. The impact of a supply disruption would damage the U.S. economy and business and consumer interests. Even absent a supply shock, U.S. oil dependence is undesirable because it constrains U.S. foreign policy options and empowers adversaries who rarely share U.S. geostrategic interests. We should hope for the best in Saudi Arabia, but it would be imprudent not to prepare for the worst by redoubling efforts to end America's petroleum dependency.

## Media Contact

For media inquiries please contact Bridget Bartol, [bbartol@secureenergy.org](mailto:bbartol@secureenergy.org) and (202) 461-2361.