The Bet: Gulf Investment and the Future of Oil Demand

As fluctuating oil prices continue to affect both producers and consumers throughout the world, PFC Energy consultant Roger Diwan offered his insights into the particular role of oil investment within the Gulf States. He focused on the uncertainties of future oil demand, and how these factors in turn motivate the exploration and development of new fields in Saudi Arabia, Kuwait, and the United Arab Emirates. Kay offered his assessment at a Gulf Roundtable held at CSIS on June 16, 2009.

These so-called "bets" about future oil demand, based upon trends, insights, and guesses, ultimately provide the model of production that these countries will follow over the next 10-20 years. As Mr. Diwan stated, however, "Being able to have a clear view of the future, and how you position yourself, is very complex." Questions regarding the commercial risk, political constraint, and time frame of investment decisions all result in a sense of uncertainty within these oil-exporting states.

He identified several additional elements that heighten this uneasiness surrounding investment in new oil fields:

- The increasing attractiveness of alternative fuels
- The potential for legislation restricting carbon emissions
- The availability of technology to explore and develop oil fields
- The production and market share of non-OPEC countries
- The impact of global economic growth on world oil prices

In explaining this ever-present investment risk, Mr. Diwan shared three possible scenarios of future oil demand and supply. The first, the evolutionary scenario, assumes an eventual global economic recovery, driving oil prices up as demand grows and the refinement process becomes gradually more efficient. The second situation is termed the protectionist scenario, in which the global recession reduces international trade and capital flows, thereby depressing oil production. The final case, the transformative scenario, involves the greatest amount of international coordination and cooperation in fostering greener growth and cleaner energies such as solar power and biofuels.

Each of the three possible scenarios encompasses drastically different consequences for oil supply and investment in the Gulf. Under the evolutionary scenario, oil production reaches its highest levels, in turn spurring even greater investment in new technologies and new fields. If the world turns toward a protectionist or transformative era, however, oil production will eventually decline, resulting in potentially lost profits and even lower investment. These contrasting scenarios, in concert with their skewed outcomes, provide the foundation for so much uneasiness in the Gulf. The inability to predict the future trajectory of oil demand lies at the heart of the investment gamble.

Despite several unknown factors, Mr. Diwan did highlight the short-term actions and concerns of Saudi Arabia, Kuwait, and the United Arab Emirates in their struggle to maintain oil revenues. In terms of Saudi Arabia, the speaker described how the country's oil decisions strategically impact the broader economic and political conditions of the kingdom. Saudi Aramco provides a large base for employment in the state, in addition to stimulating large infrastructure projects and facilitating the distribution of profits. These and other considerations play a large part in answering the difficult investment questions within the country.

Furthermore, as the world's largest oil producer, Mr. Diwan noted that Saudi officials are often bombarded with requests from Western governments to increase investments in order to lower gas prices. As a result, Mr. Diwan stated that millions of dollars in research with only potentially meager gains have partially stinted the exploration of new fields. Saudi officials currently appear to be treading softly, being careful that domestic oil investments are cost-effective and advantageous before they are initiated. Current estimates maintain that production in Saudi Arabia will reach 12.5 million barrels per day by the end of this year.

Investments by the Kuwaiti government appear to be inhibited by a lack of political cooperation. Officials continue to report that funding toward Project Kuwait will allow production to reach 4 million barrels per day in 10 years, but Mr. Diwan and his colleagues at PFC Energy are doubtful. Investment and production have been stagnant for the past 11 years, and Mr. Diwan points to the fact that this situation has occurred not because of financial or technological issues, but as a result of a political stalemate between the king and parliament. Several small fields are under development but are unlikely to produce substantial amounts of oil before 2015.

Regarding the United Arab Emirates, Mr. Diwan stressed the commercial nature of the country, reinforcing that oil fields in the UAE are managed by national and international consortiums. As a result, investment decisions must satisfy a wide range of state and non-state actors. Agreements subsequently often take decades to conclude and last for approximately 20-25 years. This fact adds yet another layer to difficult investment decisions, as companies struggle for their share of oil revenues and claims to new fields.

Notwithstanding the aforementioned challenges to investment in the Gulf, Mr. Diwan was also quick to mention the scope of spare capacity in the region and its impact on future investment. Mr. Diwan identified spare capacity as the difference between OPEC's current production and its potential production, or the "buffer" between supply and demand. He revealed that OPEC's spare capacity as a whole remains at healthy levels and will be maintained through 2030. He also emphasized the importance of Saudi Arabia for OPEC, articulating that the country is "the central bank of the oil market, able to add liquidity and remove liquidity, depending on the goals and the environment [of the market]." Saudi Arabia alone produces six million barrels per day in spare capacity, an influencing factor in its short-term decisions.

Due to these large overages, new OPEC expansions are mostly complete, with no large expansions planned until 2020. The Gulf States in particular have seen large increases in production due to burgeoning oil demand over the past several years, but these countries have maintained so much spare capacity that government officials are hesitant to undertake sizeable investment projects without knowing the future demand for oil. With so many unknown factors

still in place, all bets are off as to what option Gulf States will choose in their next phase of oil investment and production.