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Why Saudi Arabia can no longer temper oil prices

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What's easy to lose sight of in the chaos sweeping through the Middle East is where oil prices were trading before it began. The Brent futures contract, the world's new benchmark oil price, had already broken $100 (U.S.) a barrel before protesters in Cairo started sweeping into Tahrir Square and demanding Hosni Mubarak's head. And the price of West Texas Intermediate CL-FT, laden as it is with record inventories of Bakken oil and Canadian oil sands crude piling up in Cushing, Okla., was trading just shy of $90 per barrel.

These are the kind of prices that one might expect to encounter at the end of an economic cycle, not at the beginning of one. But world oil demand once again grew at lot faster than the oil experts at the International Energy Agency were expecting – almost twice as fast, to be precise.

The global economy had no sooner put in its first year of solid growth when world oil demand, like a jack in the box, sprang to a new record high. China alone added almost a million barrels a day to global demand, which ended the year at more than 87 million barrels a day. And demand shows no sign of abating this year.

It was far from clear where the world was going to find another two million barrels a day of new supply to meet another year of demand growth. That would be in addition to the nearly four million barrels a day of new production that must be brought on simply to replace what is lost every year in depletion.

Then came the turmoil in North Africa and the Middle East. Now it's even less clear where that oil will be flowing from. The region of the world that was expected to pump that additional oil supply, utilizing its supposedly ample spare capacity, is now falling into anarchy.

In reality, that official spare capacity hasn't existed for years. Confidential cables from the U.S. embassy in Riyadh recently released by Wikileaks confirm what skeptics like the late Matt Simmons long suspected. Saudi Arabia, OPEC's biggest producer, and the country holding the world's largest oil reserves, has little more to give.

Transcripts of conversations between embassy personnel and Sadad al-Husseini, former executive vice-president in charge of exploration and production at Saudi Aramco, make it clear that neither the country's oil reserves nor its production capacity can be believed. Instead of the 12 million to 12.5 million barrels a day of official capacity, Saudi Arabia is barely able to pump out between eight million and nine million. Production is still below where it was in the 1970s, and Saudi Arabia has ceded ground to Russia as the world's largest oil producer. (Curiously, the IEA continues to forecast that the tapped-out Saudi oil sector will pump out 14.6 million barrels a day by 2035.)

Dr. Husseini's revealing assessment of the Saudi oil industry goes a long way in explaining why former president George W. Bush's desperate pilgrimage to the kingdom in 2008, during the height of the last oil crisis, was able to elicit only a token 300,000-barrel-a-day increase in production. Other than a limited amount of heavy oil, which many of the world's refineries aren't equipped to process, Saudi Aramco has little more to offer today's market.

While the country still has the capacity to raise oil prices should it withhold supply, it no longer has the capacity it once did to prevent prices from rising, because it can no longer boost its production to meet increases in world demand. Nor does it have spare capacity to make up for supply disruptions in neighbouring Arab countries such as Libya, Algeria or Egypt.

And Saudi Arabia, with rampant youth unemployment and a large, disenfranchised Shiite minority in its key oil-producing region, is not immune to upheaval. It's only a causeway away from an already embroiled Bahrain.

With no functional spare capacity left in OPEC, any significant supply disruption in the region could easily see prices spike and test the $147-a-barrel mark set in 2008, just before the crippling global recession. Once speculators start challenging the mythology of Saudi spare capacity, they will invariably squeeze the market.

But the real danger from the Middle East is not the risk of temporary supply disruptions, or the speculative betting that it will encourage. It is that we lose sight of the levels that oil prices had climbed to even before this latest crisis began, and the basic supply-and-demand forces that pushed them there.

We are now living in a world of triple-digit oil prices. The massive changes this will compel won't be limited to regime change in the Middle East.

Jeff Rubin is an economist and author of Why Your World Is About to Get a Whole Lot Smaller.

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