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Emerging Insight

Saudi Arabia: energy policy – It's not (only) the economy

07 February 2024

GEM Fixed Income Strategy & Economics
Global

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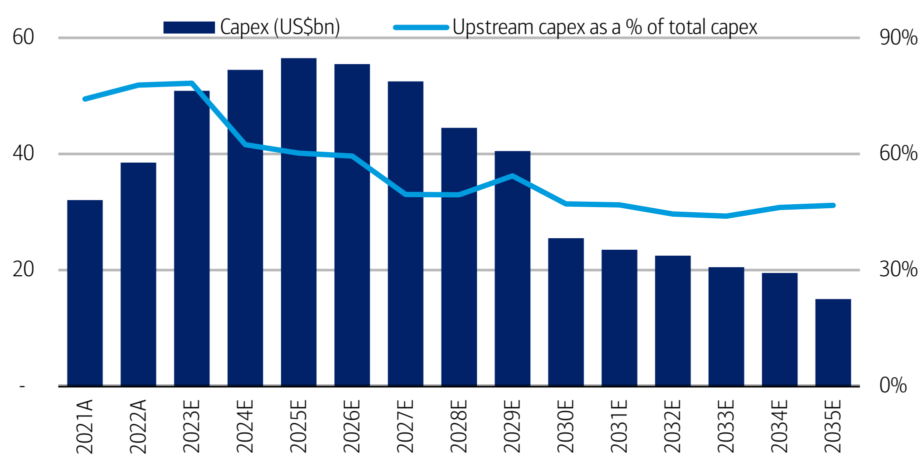
Key takeaways

- The revised Aramco production capacity target reflects oil market fundamentals, existing spare capacity and fiscal pressures.
- We estimate modest fiscal savings at 1.5% of GDP (cUS$17.5bn) over four years or 0.4% of GDP per annum.
- The additional funds could be put into use into priority domestic diversification projects instead, in our view.

By J. Saliba and S. Lanka

Exhibit 1: Saudi Aramco capital investment profile 2021-35E
Peaking capital investment could support dividend payments to the sovereign



Source: Company data, BofA Global Research estimates

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Saudi Arabia: energy policy – it's not (only) the economy

The revision to the targeted Aramco Saudi Maximum Sustainable Capacity (MSC) likely reflects a mix of medium-term oil market fundamentals, large existing spare capacity and ongoing fiscal funding needs. We estimate modest fiscal savings from the MSC target revision at 1.5% of GDP (cUS$17.5bn) over four years or 0.4% of GDP per annum, assuming unchanged payout ratio. The additional funds could be put into use into priority domestic diversification projects instead, in our view.

Saudi energy policy: it's not (only) the economy

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Saudi energy policy makes a U-turn

Main pillars of Saudi energy policy

We believe there are three aspects that are central to energy policy in Saudi Arabia: a) competition for global market share in upstream operations or swing oil producer role (affecting spot prices); b) future investment decisions and maintaining of spare capacity buffer (affecting long-term oil prices); and c) focus on integration and expansion of downstream ventures to create domestic jobs, secure captive demand for crude and make operations less volatile.

Saudi energy policy decisions are likely to finely balance OPEC (Organization of the Petroleum Exporting Countries) members' funding needs, the impact on oil demand, internal group cohesion considerations, reliability as a major oil supplier, and public perceptions (both domestically and internationally).

Strong near-term incentives to support high spot oil prices

The more assertive nationalistic 'Saudi First' policy and the ongoing mega-projects spearheaded by the Public Investment Fund (PIF) suggest large medium-term financing requirements and the need for elevated oil prices.

We think Saudi Arabia's interests remain centered around market stability, rather than spiking or too elevated oil prices that could lead to global oil demand destruction and more rapid decarbonization efforts. Indeed, the Saudi Minister of Energy self-describes energy policy as 'proactive, pre-emptive and precautionary'.

Press reports suggest authorities are considering a further secondary market listing for Saudi Aramco shares this year (current free-float is 1.8%). A potential sale may be aided by a supportive oil price backdrop, in our view.

The sliding fiscal regime allows authorities to capture the upside in oil prices. The royalty rate on crude oil and condensate production, amended effective 1 January 2020, is 15% for Brent prices up to US$70/bbl; rising to 45% for Brent prices between US$70/bbl and US$100/bbl, and to 80% for Brent prices above US$100/bbl).

Underwhelming November OPEC+ meeting does not help

The November 2023 OPEC+ meeting was underwhelming in terms of potential support to oil prices. We suspect it may lead to only resulting in a modest decline in production (possibly closer to a status quo outcome), and exhibiting little cohesion (with Angola subsequently leaving the group). The agreed production cuts are valid only for 1Q24, with some signs that further cuts may be difficult to agree upon, all else being equal.

We see the following key points from the meeting:

a) OPEC+ production is likely slated to decline only modestly in 1Q24, given the low credibility of the pledged cuts. We estimate the cuts announced could result in a decline of only 300k bpd in production for 1Q24 versus October 2023 levels. OPEC+ announced additional voluntary cuts of 2.2mn bpd, but this includes the Saudi 1mn bpd cut rollover and 0.2mn bpd in Russia refined oil product cuts (i.e. 1mn bpd of cuts pledged excluding Saudi Arabia rollover and Russia oil product cuts). Our estimates are smaller because a) the cuts are voluntary adjustments, and valid only for 1Q24; b) a number of countries may not fulfil pledges (United Arab Emirates (UAE), Iraq, Russia); and, importantly, c) the voluntary adjustments are calculated from the 2024 required production level as per the

35th OPEC Ministerial Meeting held on June 4 2023, in addition to the voluntary cuts previously announced in April 2023 and later extended until the end of 2024, and not from current production reference levels;

b) note that Iran, Venezuela, Libya still have no quotas. Production may increase from these countries, depending on US sanctions or security conditions;

c) cohesion of the group may have weakened. Angola rejected its output quota which was based on three external assessments, although its planned production level is not significantly different from the OPEC+ target, and subsequently exited the group. The unilateral Saudi 1mn bpd supply cut may have weakened its hand in negotiations; we had suggested it may distort compliance and future negotiation incentives within OPEC+;

d) Brazil could join OPEC+ from 1 January 2024, but this may be symbolic as it has suggested output cuts would not be binding on it;

e) further revision of quotas in June 2024 or November 2024 meetings may be complicated. Recall that OPEC+ is planning to start the process of negotiating quotas for 2025 based on independently-assessed production capacity, likely helping fulfil a key demand by the UAE to increase its quota over the medium-term. This could minimize frictions between the UAE and Saudi Arabia. OPEC+ had suggested that, by end-June 2024, all OPEC+ countries will undergo an assessment by three independent secondary sources to identify production capacities to be used for 2025 reference production levels. (Nigeria, Angola and Congo external assessments have already been completed); and,

f) a steep decline in oil prices may be needed to force the hand of OPEC+. The next (37th) OPEC and non-OPEC Ministerial Meeting will be held on 1 June 2024, and no official meeting has been announced in the interim period until then for now. The next Joint Ministerial Monitoring Committee (JMMC) is to take place on 3 April 2024.

Spare capacity decisions can affect long-term oil prices

Saudi Aramco future investment decisions and maintaining of spare capacity buffer are a critical policy parameter of Saudi energy policy. In addition to its influence on spot prices through its ability to adjust production, Saudi Arabia can decide on pace of its reserves development which would potentially affect future supply to the market, and hence long-term oil prices. There are distinct trade-offs in this decision. If Saudi Arabia is producing at close to its maximum capacity, it will have little control over sharp upside movements in oil prices. On the other hand, if excess capacity is large, oil prices are likely to be under downward pressure.

MSC revision unlikely to be solely justified by government fiscal needs

The Saudi Aramco announcement holds an important signal for markets, both for the government fiscal accounts and long-term oil prices. Saudi Aramco announced in late January that it has received a directive from the Ministry of Energy to maintain its Maximum Sustainable Capacity (MSC) at 12mn bpd, and not to continue increasing its MSC to 13mn bpd.

Initial conditions have changed

Recall that the initial announcement of a 1mn bpd MSC boost was announced in mid-March 2020 in the midst of a price war with Russia. The initial conditions for such an announcement are likely to have dissipated.

Existing spare capacity is ample and could be costly to maintain

Furthermore, the current Saudi oil production profile suggests an ample capacity buffer of c3mn bpd, above the Saudi government stated policy of a capacity buffer of 2mn bpd. Maintaining a large spare capacity can be a costly endeavor for Saudi Aramco.

Long-term oil market fundamentals in the spotlight

Reducing MSC reduces headwinds to long-term oil prices and could suggest less confidence from Saudi energy policy-makers about the peak level of medium-term oil demand. A declining medium-term oil demand profile could likely eventually spur Saudi and other OPEC members to shift from defending prices to maximizing market share. Saudi Aramco may have calculated it is currently maintaining a sufficient buffer, as of now. Less oil may be demanded in the future from OPEC (call on OPEC), but more of it could likely by produced by Saudi Arabia, UAE and Kuwait in this scenario, in our view.

Increasing gas production could provide offset to crude oil export capacity

The MSC halt is partially offset by the ongoing plans of Saudi Aramco to free up to 1mn bpd for crude oil exports by 2030 as a result of an eventual halt to using crude oil for power generation. Saudi Aramco plans to increase gas production by 50% by 2030 versus 2021 levels. Half of the planned gas production growth is aimed to go into domestic gas sources. This includes c1mn bpd liquids (oil-fired power plants) that are likely to be displaced for power generation. Associated liquids are targeted to be c1mn bpd by 2030 and to be used as feedstock for the petrochemical and industrials sectors. The other half is aimed for exports, including through hydrogen if there is interest in offtake contracts.

Fiscal savings are likely to be relatively modest

Fiscal funding needs are unlikely to be the main driver to the MSC revision, in our view. We estimate Saudi Aramco capex savings could boost Saudi government fiscal revenues by 1.5% of GDP (cUS$17.5bn) over four years or 0.4% of GDP per annum, assuming unchanged payout ratio. This is because a number of projects with Final Investment Decisions (FID) are likely to proceed, as per Saudi Aramco guidance, and offset natural declines. The main change in Saudi Aramco capex is likely to come from the deferral of the Safiniyah project, scheduled to come online by 2027-28. This suggests little savings for Saudi Aramco near-term, at about US$5-6bn in capex savings over four years (cUS$25bn or 2.2% of GDP in total and 0.5%of GDP per annum).

How will the UAE respond?

It is unclear how UAE policy-makers will respond to the Saudi MSC revision. Abu Dhabi does not face similar funding pressures, and, with unchanged policies, the optics suggest that Saudi Arabia could be ceding market share to the UAE. Abu Dhabi National Oil Company (ADNOC) announced in November 2022 it will bring forward its 5mn bpd crude oil production capacity target from 2030 to 2027, and guided its crude oil production capacity already reached 4.5mn bpd in July 2023.

In the meantime, the potential redistribution of OPEC output quotas for 2025 is likely to benefit Saudi Arabia and the UAE. Recall that the 35th OPEC and non-OPEC Ministerial Meeting that took place in June 2023 opened the door for a revision to output quotas going forward. UAE and Saudi Arabia could be winners of possible quota redistribution as they have the largest gaps between actual production versus production capacity. The UAE was granted in June 2023 a 0.2mn bpd upward revision to its OPEC quota.

Expert call highlights limits to current energy policy

Our conference call with an oil & gas expert (Expert call on Saudi oil capacity increase halt and Red Sea tensions) highlights OPEC+ reluctance to cut production further unless there is a material demand shock, reducing potential support to oil prices. Our expert does not expect ADNOC to officially revise its oil production capacity target. Our expert suggested Saudi Aramco's focus on new field development helps it retain the optionality to return to an MSC target of 13mn bpd in the future.

Saudi Aramco to maintain MSC at 12mn bpd

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Saudi Aramco has announced receiving a directive from the Saudi Ministry of Energy (MoE) to maintain its Maximum Sustainable Capacity (MSC) at 12mn bpd and not increase it to 13mn bpd, which was expected to be complete in 2027. The decision to cancel the capacity increase could be driven, in our view, by: 1) Saudi Aramco's current spare capacity of c3mn bpd and uncertainty around when production will increase; 2) longer-term oil demand outlook; and, 3) the importance of Saudi Aramco to Saudi's fiscal position with potential capex reduction being directed towards an increase in dividends. Aramco is expected to provide updated capex guidance during its FY23 results in March.

Development of fields passed FID to continue

The development of the Dammam (2024 and 2027), Berri (2025), Marjan (2025), Zuluf (2026) fields, which have passed Final Investment Decision (FID), will continue. Through infill drilling, the company will control production capacity in each of these fields, which will help offset natural declines across other fields and eventually help the company maintain its MSC of 12mn bpd.

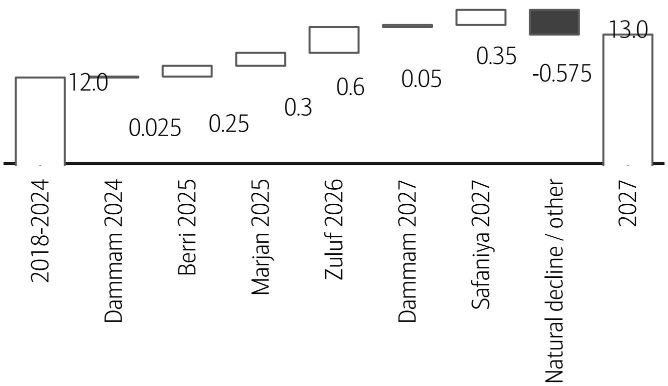
Since Saudi Aramco will continue to spend for development of these fields, it is difficult to forecast at this stage the impact of capex reduction due to cancellation of the MSC increase. Safaniya (700kbpd capacity, the world's largest offshore oil field) is the only large field of Aramco's MSC expansion plan awaiting FID, which is now likely to be deferred because of the announcement. The project was expected to generate US$10bn of Engineering, Procurement, Construction and Installation contract awards this year, according to Upstream. In total, Wood Mackenzie has estimated total project capex at over US$25bn. As a result of this, capex on average could drop by US$5-6bn per annum over the next four years.

Capital investment to still peak mid of decade

On the back of the announcement, while we expect lower capex over the medium-term versus our current estimates (average 2024E-27E capex: cUS$55bn), we still expect capex peaking next year given the continued development of the projects that have passed FID. Saudi Aramco has guided that, in the short-term, 60% of the capital investment is to be spent toward upstream, 30% downstream and 10% toward low-carbon initiatives, while over the medium- to long-term, 50% is likely to be spent toward upstream, 35% downstream and 15% toward low-carbon initiatives.

Aramco's proposed route to 13mb/d MSC

Exhibit 2: Aramco old MSC delivery plan decomposed (mn bpd)
Zuluf was expected to add 0.6 mn bpd with the remaining from other fields



Source: Company report. BofA Global Research. Note: Safaniya currently pending Final Investment Decision; c350mbpd planned delivery in 2027, with remainder after 2027.
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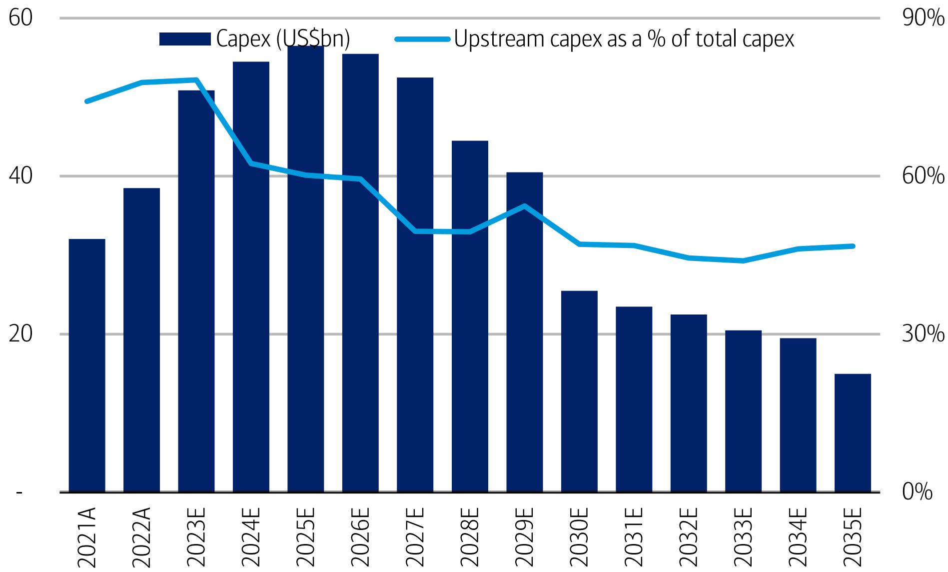
Exhibit 3: Saudi Aramco capital investment profile 2021-35E
We assume capital investment peaks mid of this decade around US$56bn



Source: Company data, BofA Global Research estimates
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News and Views

Brazil: January trade balance with a US$6.5bn surplus

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The trade balance posted a US$6.5bn surplus in January, from a US$9.4bn surplus in December. Despite below market expectations of US$7.5bn, the result was an increase of 185.6% yoy. Exports totaled US$27 bn, increasing 18.5% yoy, while imports were stable in yearly terms, at US$20.5bn. The 12-month accumulated balance was US$103.1bn, with exports totaling US$343.9bn and imports US$240.8bn. On the exports side, agriculture (+21% yoy) and extractive sector (+53% yoy) remain supporting the Brazilian trade balance. On the imports side, the slump in extractive sector (-28% yoy) acted offsetting the increases in agriculture (1.5% yoy) and manufacturing goods (2.4% yoy) imports. With this print, 2024 trade balance started the year at a high level – as expected.

- **To follow:** Trade balance should continue strong in 2024, though at a lower level than recorded in 2023.

Brazil: Core Retail Sales increased 1.7% in 2023

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In December, Core Retail Sales declined by 1.3%momsa (from 0.1% momsa in November), below market expectations of -0.1%. There was a widespread contraction in retail sales, after seasonal adjustment. It was the worst monthly reading of the year, but in 2023 retail sales accumulated growth of 1.7%, from 1.0% in 2022. November has been concentrating over time the revenue of October and December, because of Black Friday. Consumption that would otherwise happen in October is delayed while December's purchases are brought forward. Meanwhile, broad sales, which includes Building Materials, Vehicles and wholesale food items, were down by 1.1% momsa (from 0.7% in November). In 2023, Broad sales increased 2.4% (from -0.6%), driven especially by the positive performance from Vehicles (8.1% in the year).

- **To follow:** 2023 continued the trend of 6 consecutive years of growth in the sector. Regarding 2024, we foresee a more positive year for the sector – as private consumption should accelerate.

Brazil: Public Sector ended 2023 with a deficit of 2.3% of GDP

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According to the Brazilian Central Bank (BCB), the public sector posted a deficit of R$129.6bn in December, above market expectations of a R$125.5bn primary deficit. In 2023, the Central Government contributed with a R$264.5bn deficit (vs surplus of R$54.9bn in 2022), with regional governments registering a surplus of R$17.7bn (vs +R$64.9bn) and state-owned companies a deficit of R$2.3bn (vs +R$6.1bn). With this, the public sector primary balance moved down to -R$249.1bn in 2023 (vs +R$126.0bn in 2022), while the nominal deficit went to R$967.4bn (8.9% of GDP), from R$460.4bn (4.6%) in previous year. Gross debt/GDP moved up to 74.3% of GDP (from 71.7% in 2022); as well as net debt, which went to 60.8% of GDP (from 56.1%).

- **To follow:** 2023 ended on a sour note, especially due to the large central government primary deficit. For 2024, we believe that the public sector will post a primary deficit of -0.4% of GDP (from a 0.8% deficit in 2023), due to approval of the revenue boosting measures, as well as a more positive activity growth breakdown.

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