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NEAR-TERM OUTLOOK FOR THE WORLD OIL MARKET

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NEAR-TERM OUTLOOK FOR THE WORLD OIL MARKET

by

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The present world oil market situation can be summed up this way: demand is falling, supplies are rising, stocks are relatively high, and spot prices are dropping rapidly while official export prices are continuing to move up substantially. What are the factors underlying these current, partly contradictory movements? What can we expect beyond the first quarter of 1980?

On the demand side, the first quarter of 1980 is likely to register a 3% - 4% drop from last year's rather high level of about 56 million b/d for the Non-Communist World (NCW). The largest decline will take place in the U.S. where first quarter consumption is expected to be 1.0 - 1.3 million b/d below the 20.3 million b/d level of a year ago. The reason for the decline, both in the U.S. and elsewhere, obviously is the more than 120% foreign price increase over the last 14 months and the estimated 100% increase in the U.S. refiners' crude oil acquisition cost to about $25.70/bbl during the same period (Jan. 1979 - Feb. 1980). Had there been no significant increase in the real foreign price of oil during this period, current NCW oil demand would probably be some 2.5% above the first quarter of last year. Thus, so far, the full impact of the price increase may have reduced world oil demand by 6.0%, or by more than 3 million b/d.

NCW oil supplies are more than adequate to meet our estimate of the current level of demand. Current allowable (and available) OPEC production capacity (crude and NGL's) is around 31.0 - 31.5 million b/d, or at least 1 million above the first quarter 1979 level.

In part, this reflects the fact that most OPEC nations as of early February have not yet carried out their previously announced intentions of substantial reductions in their allowable production ceilings. Even Libya's announced reduction of 400,000 b/d by January 1 has not cut into required export demand, since the country would have lost a significant volume of exports for purely commercial reasons anyway, following its $8.50 per bbl official sales price rise during the last two months.

Meanwhile, non-OPEC production has increased more than 1 million b/d while net shipments from Communist countries to the NCW have probably declined by 300,000 b/d. Altogether, then, current NCW oil supplies are on the order of 2.0 million b/d or 3.5% - 4.0% above the first quarter of last year.

Meanwhile NCW crude oil and products stocks at the end of January, 1980 are undoubtedly higher than a year ago when the rapid inventory decline caused by the Iranian export cessation was already under way. In the U.S., for example, current crude oil stocks are 17% above a year ago and major products stocks are up by 8%.

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Taking all these factors together, it is clear that the world oil market has started to move into a surplus situation. Given the price increases and consumer government policies throughout the world of reducing oil imports, this development is hardly surprising. In fact, it has been widely predicted since last fall and it was approvingly described as the coming "mini-glut" by Sheikh Yamani and some other oil ministers at the OPEC meeting in Caracas last December.

Well, the "mini-glut" is here, but what has it done to prices? In the spot market, which made headlines throughout 1979, the reaction has been logical and predictable: prices dropped sharply. From a high of $15 -$20/bbl above the official contract price during the May-November period of last year, spot prices had fallen to less than a $10 differential by the time of the Caracas Conference in mid-December. Since then they have continued to decline. On the basis of current (mid-February) Rotterdam and U.S. Gulf Coast spot products prices, the f.o.b. value of Saudi Arabian or similar type Persian Gulf crude is probably no more than $29 -$30 and may still be going down.

Nevertheless, a premium market for some OPEC crude oil continues to exist, as is evidenced by the fact that Saudi Arabian Light is currently offered at about $34 f.o.b. on a spot basis. It is a very small market by comparison with last year but it is still larger than it was in the pre-1979 period. One reason for its persistence is the continued perception by buyers that the political security of oil supplies has deteriorated substantially since 1978, notwithstanding the present surplus. Some buyers are still willing to pay a security premium, if necessary, for incremental oil to increase their inventories. Another reason is the radical decline in traditional third-party sales by the major oil companies to other refiners since mid-1979. In Japan, where this trend was most visible, traditional third party sales to local companies dropped from about half of total crude imports in the pre-1979 period to less than 15% - 20% by the end of 1979 and are scheduled to drop further this year. In other markets the trend is similar but slower.

The buyers who have lost access to these "secure" contractual supplies are unlikely to obtain firm contracts at official sales prices for all their requirements previously supplied by the majors. Thus, they will make use of the spot market to a larger extent than before. Finally, some of the exporting countries that entered the spot market last year and found it profitable beyond all imagination can be expected to stay there in the hope that the market will revive, particularly if they help it along with their sales and production policy. Of course, to the extent to which these countries are doing this by tying contract sales to specified volumes of sales at "spot" prices which they themselves set -- Iran is a case in point and so may be Kuwait and Indonesia -- they are not really selling in the spot market but have devised a two-tier price system in which the upper tier approximates their idea of current spot market values.

Taking these factors into account, it seems reasonable to expect in the near future a spot market which volumetrically is much smaller than last year's but much bigger than in the previous years, as well as a spot price which, absent new political upheavals in the world that might affect the supply side, will continue to move down toward the official contract prices throughout the first quarter and probably longer. Sporadically, the differential between the two types of prices might disappear or spot prices might even drop below contract levels.

Now let us look at recent official export price movements. This is the most curious aspect of the current market picture, with a series of substantial price increases having
been posted in the face of a growing supply surplus. Classical economics cannot fully explain this phenomenon. But neither can monopoly pricing nor cartel theory: of course, the various OPEC members and other major exporters not only failed to agree on a uniform price system but, quite the contrary, set up a series of qualitatively and geographically unrelated prices, blaming each other privately and semi-publicly for the lack of agreement. The result of their diverse action was that the composite OPEC f.o.b. price rose as follows since last December 1st:

- **December 1, 1979**: $21.53
- **January 1, 1980**: 26.96
- **February 10, 1980**: 28.80 (estimate)

Including Mexico, the North Sea and other non-OPEC exporters, the composite f.o.b. foreign oil price is currently in excess of $30/bbl. Since North Sea prices will soon be raised by $3-$4, the composite world price can be expected to move up further.

Several reasons can be advanced for these substantial price increases in the face of countervailing market trends. A major one is intra-OPEC power politics, i.e., who sets OPEC's pricing policy and by what criteria. It seems clear that, for the moment at least, Saudi Arabia's role in determining OPEC's oil policy has been significantly, not to say humiliatingly, reduced. At the same time, its image in the West as OPEC's principal price moderate has become somewhat tarnished, since the Saudis single-handedly triggered the latest round of price increases.

Another explanation for the price increases (other than Saudi Arabia's) may be that the OPEC members, like everyone else, saw the coming market deterioration and wanted to raise their official prices as much as possible toward the premiums which were still being paid in the spot market so as to protect their future revenue against any reduction resulting from declining sales. In other words, faced with the prospect of lower sales or lower prices, they seemed to have opted once again for the former. This applies particularly to African sweet crude oil producers whose prices are now about $6.50 above the supposed OPEC marker crude price of $28. Product prices in major markets might permit a differential of up to $4.00/bbl. At the current higher differential, these countries may have to bear the brunt of whatever reduction in OPEC exports takes place this year. The same can be said of Iran, whose $32.50 price is way out of line with all other Persian Gulf prices. Iranian exports have already experienced a significant drop this year.

Still another reason may have been OPEC's awareness sometime in January that at prevailing U.S. Gulf Coast contract and European inland prices for refined products, Arabian light-quality crude oil had a f.o.b. value of at least $28/bbl, including a reasonable refinery margin, rather than the then existing $24 - $26 price. Thus, the recent round of $2 increases of Persian Gulf crudes is more likely to reduce refinery margins than to increase consumer prices.

According to recent speculative but plausible reports, Saudi Arabia, having been stung by the uncooperativeness of its OPEC partners, intends to increase its output above 9.5 million b/d in the next quarter in order to create an even bigger surplus and thus bring about a general decline in the price level and reassert its economic domination over the organization. Assuming the Saudis' willingness to do this and their ability to raise their output for several months by as much as a million b/d to 10.5 million b/d, this would substantially increase the potential world oil surplus. Some OPEC members...
will respond by cutting their own production. But unless their cuts are quite drastic, they would only be doing what the market would force them to do under these circumstances anyway.

Thus, if Saudi Arabia's contemplated action were actually to take place (still a very speculative assumption), its most likely result would be the disappearance for the time being of all spot premiums and perhaps a reduction in some of the current official price premiums, such as Iran's $3 for 50% of its contract sales. Basic official sales prices would probably not be reduced under these conditions, but neither would they be raised further. Therefore, in the next quarter and probably the one thereafter, foreign oil would once again register some price declines in real terms as premiums are reduced and general inflation continues to erode the base price.

In the absence of a Saudi production increase, prices can be expected to be higher but probably not by very much. A significant surplus would exist throughout most of 1980 even if the Saudis just maintain their current output. Thus, for the remainder of 1980, barring major extraneous political events, world export contract prices will range from a low of a slight decline in government imposed surcharges to a high of an increase in composite official-cum-surcharge prices about in line with world inflation. In short, effective real contract prices will probably not rise further this year and could decline slightly.

In the U.S., the oil price situation will be much less stable than abroad, even if we assume no further increase in the price of foreign oil in real terms after February. The reason is the phased-in decontrol of domestic oil, which we estimate will raise average refiner acquisition cost of all crude oil from about $23/bbl in December, 1979 to an estimated $29 - $30 by year-end. This would be a jump of about three times the projected general inflation rate for the U.S. economy in 1980. Since the crude price increases are expected to coincide with a 2.2% decline in U.S. oil demand from last year to about 18 million b/d (following a 1.8% decline in 1979) and with a domestic refinery capacity increase of about 2%, refiner margins will be under some pressure this year if crude oil supplies remain adequate. Even unleaded gasoline, the product in shortest supply last year, is likely to be adequate for this year's demand in view of the sharp decline in the purchases of domestic new cars, all of which require unleaded gasoline.

A final word about the impact of the increase in oil prices on world economic activity is in order. The 120% rise between December, 1978 and February, 1980 has not yet worked its way through the economic systems of the industrial countries. But oil prices had already risen by over 60% in July, 1979. The impact of this sharp increase can be assumed to have started to affect the economies of the oil importing industrial countries by the fourth quarter of 1979. Yet, preliminary data indicates that in most European countries, the GNP growth rate at year-end was only slightly lower than had been expected prior to the oil price increase. In Japan, where dependence on foreign oil is particularly high, it was actually better than expected. Oddly, the only major OECD country with a fourth-quarter decline in its economic growth was the U.K., a major beneficiary of the oil price increases.

A recent OECD study forecast that, excluding the U.K. and the U.S., the composite 1980 GNP growth rate of its member countries would be about 3%. The latest oil price increases may reduce this rate to 2.5% or slightly less. As of now, however, no economic
recession or even stagnation is imminent in Europe or Japan as a result of the cumulative oil price increases since the end of 1978.

Of course, inflation will accelerate throughout the OECD area as a result of the oil price increases. But other factors will also contribute to this year's expected 2.0 - 2.5% increase over the 1976 - 78 average in the OECD's composite GNP price deflator, excluding the U.S.

In the U.S., an officially termed 'mild' cyclical downturn lasting about nine months is likely, but not certain, this year. However, predictions of this sort have been offered repeatedly since before oil prices started to rise. The impact of the oil price increase on general inflation will be stronger here in 1980 than in most other industrial nations, but this will be due partly to our current policy of decontrolling domestic crude oil prices.

All explanations for this unexpectedly soft economic impact of the unexpectedly high oil price increase are very speculative at this point. Perhaps it is simply a case of delayed reaction -- i.e., the full damage of the price increases on the industrial economies will not show up until somewhat later. In that case, instead of the generally predicted economic recovery in 1981, we may face several years of stagnation or at least subnormal economic growth throughout the industrial world. OPEC's $65 billion Current Account surplus in 1979 and about $100 billion surplus expected in 1980 could well contribute to such a development by skimming off purchasing power in the industrial nations.

On the other hand, it is also quite possible that the Western economic system simply has more resiliency, flexibility and adaptability than was realized and that it takes more than an increase in the price of oil, even of the magnitude we have experienced, to inflict serious structural damage to the system. However, at some point an oil price increase obviously would inflict such damage. The question is how close we are to that point.