AFTER ALGIERS: AN OVERVIEW
OF THE WORLD OIL MARKET.................JOHN H. LICHTBLAU
PETROLEUM INDUSTRY RESEARCH ASSOCIATES, INC.

INVESTMENT PERSPECTIVE AND STRATEGY........PETROLEUM DEPARTMENT

NOTE: This is an abbreviated version of our traditional publication Oiltrends and is designed for those who are interested mainly in an overview of the oil industry and a perspective on oil securities. The complete version of Oiltrends will be distributed shortly to all oil analysts and other interested parties.

COPYRIGHT 1980, L.F. ROTHSCHILD, UNTERBERG, TOWBIN

This memorandum is prepared for your personal use and for information purposes only and it does not constitute a solicitation, or an offer, to buy or sell any security. Offerings of securities subject to registration requirements of the Federal Securities Act of 1933 are made only by the Prospectus, copies of which will be supplied upon request. We may from time to time have a long or short position in and buy and sell some of the securities referred to herein. The information and statistics in this memorandum are based upon sources which we believe to be reliable, but have not been independently verified by us. The information, comments, and opinions, if any, are not intended to be, and should not be, relied upon as complete.
Interpreting world oil price fluctuation is no easier when available supplies are in excess of demand than when the reverse is true. Last November - December, when OPEC's crude output was almost 31 million b/d, including 3 million from Iran, the spot price of Arab-Light type crude was at its all-time high of about $40/bbl. Now that OPEC production is some 4 million b/d lower, including a 1.5 -1.8 million b/d reduction in Iran, the spot price is down to just over $35/bbl (f.o.b.) a decline of $5. Yet, during the same period OPEC's composite of official sales prices (OSP) has risen by $6 to about $31.50 and non-OPEC oil prices have moved up correspondingly.

Meanwhile, refiner margins on spot crude have tumbled even faster than spot crude prices since the end of 1979. Of course, margins were exceptionally high then. But the current spot price for Arabian Light crude results in a negative margin for most refiners in Rotterdam, the Mediterranean or the U.S. Gulf Coast. Consequently, spot sales of crude oil have nearly dried up in recent weeks. Yet, incremental volumes of crude from OPEC and other suppliers who have such volumes for sale are generally available only at substantial premiums above the OSP. Such incremental crude is even less attractive than spot crude for most refiners, and little of it is actually purchased just now.

What all this means is that international crude oil trading at the moment is largely limited to the companies' contractual base load volumes plus any oil that may become available to them under newly concluded government-to-government deals between exporters and importers.

In attempting to prognosticate how long the present situation is likely to continue and what market developments could affect it during the remainder of this year, it may be useful to start with a brief analysis of the reasons for the seemingly contradictory spot and contract price movements of the last six months.

On the surface, the increases in the OPEC OSPs came in erratic and unexpected jumps, reflecting largely political infighting within OPEC over the determination of the organization's "marker" crude price. Underlying these movements, however, was OPEC's established practice of viewing the spot prices of its crudes as the real indicators of their market values for the purpose of setting OSPs. The entire $30/bbl OSP increase over the last seven years was based on this approach. Whenever, for whatever reason, spot prices exceeded contract prices, OSPs were raised to narrow the differential. In the absence of any differential or when the differential was negative (spot prices below contract prices), OSPs have generally remained relatively stable. This is how OPEC has converted temporary upward fluctuations in spot prices into permanently higher floor prices which, in turn, prevent the spot prices from dropping back to their previous levels when the cause for their increase ceases to exist.

* John H. Lichtblau is President of Petroleum Industry Research Associates, Inc.
Except for two countries, Saudi Arabia and Iran, the process of eliminating the
spot/OSP price differential existing at the end of last year is completed. True,
the most recent spot price for OPEC "marker" crude is still a full $3.50 above
OPEC's official theoretical OSP for this crude, established at the Algiers
meeting in June. But, as we pointed out, relatively little oil is now sold at this price.
The current value of "marker" crude quality oil to a refiner is probably slightly
below the official OPEC price of $32.

The Saudi Arabian OSP for its Light crude remains $4 below the OPEC market crude
OSP. The Saudis have publicly acknowledged that at this price their oil is under-
valued and there are strong indications that the Saudi OSP will be raised, perhaps
retroactively, in the third quarter. There are also persistent reports that recent
Saudi government sales contracts have carried a $3 - $4 premium above the OSP.

Iran is at the other end of the price scale. Its OSP for marker crude quality oil
is $3.40/bbl above the OSP for the OPEC marker crude set in Algiers. This is one
reason why Iran's current export volume is only about a quarter to a third of what
it was last November - December. Other reasons are the formal boycott of Iranian
oil by the U.S. and the apparently informal boycott by some other western countries,
increasing technical production problems and, possibly, sabotage in the oil fields.
The diversity of these reasons makes it difficult to determine whether Iran currently
does not want to sell more oil or is unable to do so. Iran will probably not lower
its OSP, but if it can and wants to sell more oil, it may give hidden discounts.
Otherwise it will have to wait until market forces catch up with its price structure.

Now let us look for the reason behind the decline in spot crude prices and values
since last November - December. This can be explained largely by the surprisingly
sharp drop in global oil demand in the first quarter of 1980 and the probability
that the drop continued in the second quarter. For the non-Communist world as a
whole, demand in the first quarter is estimated to have dropped by about 2.5 million
b/d from the level of the comparable period in 1979. U.S. demand dropped by 2.2
million b/d, the other industrial countries by about 1 million b/d while the rest of
the world appears to have had a demand increase of 0.5 - 1.0 million b/d.

In the U.S., the decline continued into the second quarter, with demand for the first
five months 1.8 million b/d, or 9.5%, lower than in the same period of 1979. In
Europe and Japan, too, demand seems to have remained below last year's level. The
decline in demand has of course put downward pressure on product prices which was
transmitted to open (spot) market prices for crude oil.

Another factor exerting pressure in the same direction is the relatively high oil
inventory level in the non-Communist world. Currently, it is roughly 500 million bbls
higher than a year ago, or some ten days of world consumption. Finally, while OPEC
production declined, non-OPEC output increased in the first four months of 1980 by
one million b/d from the same period of a year ago. The combined result of all these
factors is that more oil is currently available in the world than is actually required
by consumers, despite the very low level of Iranian exports.

What is the outlook for the remainder of the year? On the demand side we are likely
to see a continuation of the global decline. In the U.S., the recession, which will
certainly run through the remainder of the year, plus the continued oil products price
increase, reflecting the phasing-out of domestic crude oil price controls, will keep
demand for all of 1980 6 - 7%, or 1.2 million b/d below last year. Considering that
last year's demand was already half a million b/d below the previous year's, this is a substantial reduction.

The reduction will affect all major products but particularly residual fuel oil because demand for it is tied most closely to the level of general industrial activity and also because of the current availability of additional domestic natural gas supplies for the industrial and electric utility market. The principal impact will be on importers of this product. The impact on domestic refiners will depend on their relative yields of residual, which generally are higher for small refiners than for large ones.

In Europe too, oil demand can be expected to stay in a downtrend for the remainder of the year, in view of the rapidly growing signs of an impending economic recession. The European petrochemical industry is apparently already in recession and this is depressing the price of naphtha, Europe's principal petrochemical feedstock. For all of 1980, European oil demand could well be down 3 - 4% from last year. Oil demand in Japan is likely to remain flat while the rest of the world should register some increase. Altogether, non-Communist world oil demand in 1980 may be down by about 1.5 million b/d from last year's level which, in turn, was up only fractionally from the previous year's. Thus, demand in the remainder of the year will certainly not contribute to any tightening of market conditions or renewed upward price pressure.

On the supply side, the outlook for the next six months is less clear because of the many non-economic factors which affect it. The critical period is the fourth quarter, when world oil demand normally increases seasonally by about 4 million b/d above the third quarter. To meet this demand without undue stock reduction may require an OPEC crude oil production level of somewhat less than 28 million b/d, compared with the group's current production of just above 27 million b/d. If Saudi production remains at 9.5 million b/d, this total volume can probably be obtained without any OPEC member having to raise its official production ceiling, even if Iran continues to produce at its current very low rate.

However, if any OPEC member, for any reason, should reduce output from its present level, the required production may not be available and inventory reductions would have to be correspondingly larger. With demand declining, this reduction should be feasible but there may be resistance, or at least reluctance, on the part of refiners and marketers, given the renewed market insecurity which would prevail under these supply conditions.

How might all of this affect world oil prices? As was said earlier, the Saudi OSP for Light crude will probably move close to or reach the designated OPEC marker crude OSP before year-end. For countries other than Saudi Arabia, OSPs may remain unchanged for the rest of the year, in view of the declining market demand and perhaps also because of the strongly worded appeal made at the Venice summit meeting for a pause in OPEC price increases. However, individual OPEC members may still try to continue their present practice of charging premium prices on incremental sales volumes. This would mean higher prices for the additional volume of OPEC crude required in the fourth quarter and, possibly, a resulting rise in refined product prices. However, if the premium prices encourage an increase in inventory drawdown as an alternative to purchasing the incremental crude, OPEC members may not be able to sustain the premiums.
From the desk of JOHN H. LICHTBLAU

Dillard Hariggs
Retirement Analysis
20553

PLINE
Board Members

Ed Casey

Segler
Gene Johnson

Pay
Send Friday

Tony Harris
Jim James
Added journal