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WILL THE OIL PRICE HOLD?

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A conversation between two oil traders at the Houston Petroleum Club bar in early August.

Trader Horn: I'll bet you $100 that by the end of the year world oil prices will be down by $3 from where they are now, probably more.

Trader Vic: I'll take your bet, but let's define our terms. Are you talking about spot prices, term prices, posted prices or what?

H: Spot prices are already down by a couple of dollars. They will continue to fall and drag term prices along. So, to be specific, I say official OPEC sales prices, U.K. contract prices and U.S. postings for major crudes will all be down by $3 by year-end.

V: O.K. and I'll bet you that these prices will remain unchanged between now and year-end. So, I lose my bet even if prices drop less than $3.

H: I'm surprised you're taking the bet. Don't you see that OPEC is finished as a world oil price setter? They had their chance in the 1970's but they blew it by being too greedy, and by swallowing their own propaganda about the world's irreducible need for their oil. Now the market is reasserting itself and the cartel is progressively losing its power. If it were a well-disciplined cartel, maybe it could survive. But the whole world knows about its internal dissensions and its members' subterfuges to exceed their assigned production ceilings and sell below the official floor prices. Now even Saudi Arabia, supposedly OPEC's swing producer and the recognized guardian of its integrity, is joining the cheaters. That oil-for-planes barter deal is another nail in OPEC's coffin.

V: Well, I would say your facts are right but your conclusions are wrong. First of all, if OPEC were to lose control of the price structure, the price drop could not be stopped at $3. In a free market, as you may recall if you ever took an economics 1 course, the price of a commodity is determined at the margin, i.e. by the cost of the last unit required to meet effective demand. Well, there is no currently produced oil, not even the highest cost one, that could not continue to be profitably
produced at a price well below $20. So the full price reduction if OPEC really were to lose all control would be $12 or more, not $3, and prices would stay there a number of years under these conditions. The scary specter of such a development with its disastrous economic consequences for all members, will continue to serve as a last-minute rallying point for OPEC, as it has at least twice in the last three years. Even more important is the awareness of all non-OPEC oil producers that they too would be severely hurt by a price break. These producers are directly or indirectly supporting the OPEC price structure out of pure self interest. Mexico and the U.K. are prime examples of this. So is the fact that most U.S. posted prices have been maintained through July and early August in the face of heavy spot market discounts. So, what we're seeing now is not a reduction in OPEC's strength but a quasi institutionalization of its pricing structure in the form of a nearly global support system. It is precisely OPEC's weakness which has brought this about. The absence of this producer solidarity in 1982 and early 1983 contributed substantially to OPEC's only reduction in the price of its marker crude.

H: Oh, I think the most important reason for that reduction was Saudi Arabia's correct belief that the OPEC price increases above the $29 level were excessive, counter productive and had to be rolled back. Furthermore, I'm not at all sure that your argument about producer support applies to the integrated majors who are still a big factor in U.S. and North Sea pricing. These companies have seen how the price increases between 1973 and 1981 have turned oil from a long term growth product into one of long term stagnation at best, particularly in the industrial countries where most of their business lies. Why would these companies go on resisting a price decline required by the market when it's the one thing that would restore some growth to their industry? Furthermore, all majors are substantial buyers of crudes at official term prices. How much longer do you think they are willing to sustain a net loss on refining these crudes, just to maintain the OPEC price structure?

V: You got it wrong. Negative refining margins are not a function of the level of crude prices but of the existing excess refining capacity and its utilization. Lower crude prices would just lead to equally lower products prices. And, given the low short-term demand response to products price
changes, lower prices would not result in a corresponding increase in sales. On the other hand, a reduction in crude runs and an increase in spot market buying of products could improve refinery margins very quickly. The present situation is highly conducive to such action. That is why I believe refinery margins will soon start to improve and the downward pressure on crudes will ease up. I recognize the short-term risk of this strategy, i.e. before spot crude prices strengthen because of the better refinery margins they could fall further as refiners reduce their crude liftings. I think, however, that we have passed this critical point. Regarding your other comment, namely that the majors may fare better under lower, market-oriented crude prices than under OPEC's administered prices, let me remind you that if crude prices drop so would natural gas prices and, as you know of course, all oil producers are also gas producers and vice versa. So, it would take a long time before the overall negative impact of a price decline would be offset by an increase in sales. More likely, we would see an accelerated depletion of reserves in the U.S., Canada, the North Sea and other relatively high-cost producing areas as exploration activities there are reduced. Since this is where the Majors have most of their reserves, the result would be a progressive liquidation of their equity oil properties. Over time this would lead to a return to the low-cost OPEC supply sources, particularly in the Middle East, which have considerable existing spare capacity and a vast potential for additional low cost supplies. So, clearly, the private companies would not benefit from a lowering of crude prices, not even in the longer run. OPEC's problem is of course that they may not be able to get from here to there, that is, once the price has crashed their governments may not survive until revenues increase again because of higher exports.

H: What you're saying is that producers are hurt by price cuts. Everybody knows that. But I still maintain that in an oversupplied market an artificially high price can not be maintained indefinitely. That's why I think OPEC's time is up. Its power was based on its ability to set prices during an actual short-term and a perceived long-term supply shortage. Now that there is an actual surplus and a general perception that the surplus will last for quite some time, OPEC has lost its power base. The market is bound to reflect this before long.
V: I hope not before New Year's. I want to win my bet.

H: Actually, I think you'll see the first signs of OPEC's disintegration well before then.

V: You would have to, if you want to win your bet. But, if the world oil price structure has not started cracking by Labor Day I'm willing to triple my bet that it'll remain unchanged until next year.

H: Why is that?

V: Because by September at the latest refiners must increase their crude liftings to get ready for the peak demand season. That's bound to strengthen prices.

H: Unless OPEC responds by oversupplying the market.

V: Well, let's talk about that a month from now.

H: O.K. Meanwhile, who is going to pay for the drinks?