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World Petroleum Outlook

by

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I have been asked to address you on the subject of the world petroleum outlook. I know of course that the key question on your mind regarding this subject is whether the new OPEC price structure will hold. It is certainly the most important question for anyone in the oil industry right now. Unfortunately, I don't know the answer. There are some very plausible current arguments that OPEC is finished as a world oil price administrator and some equally plausible ones that it isn't. The only indisputable facts are that OPEC has lost substantial power in the last 18 months but that it is still very much alive. Let us briefly discuss both these facts.

Prices are either administered or they are determined by the interplay of market forces. The OPEC price is clearly and officially an administered price. This is just as true at $29 as it was at $34 and would be at $25. No one knows exactly what the market clearing price of oil would be but the near-term range is probably between $12 and $16. At prices in that range enough oil would continue to flow from existing wells to meet all current demand. Since some 8-9 million B/D of the world's lowest cost producing capacity will probably remain shut-in in 1983 (mostly at the Persian Gulf), the flow could hypothetically continue for a number of years at that price range, absent any renewed market intervention. Actually, such intervention by producing and consuming country governments would be very likely if the price were to fall to this level. But the huge differential between the administered and the hypothetical market clearing price is a clear indication of OPEC's continued pricing power.

On the other hand, the recent $5 reduction in the group's contract prices and its near failure to agree on a common policy to protect its price structure are signs that the growing pressure of market forces is seriously weakening the cartel's cohesion and control. Since the market pressure is likely to continue, the possibility of a collapse of the cartel and a temporary return to price determination by market forces is a distinct possibility. Some analysts call it an inevitable development. Others argue that the alternative to an administered price is so scary for the OPEC members, as well as other exporters, that they will do whatever is necessary to maintain a degree of price control. Last week in London they certainly made a good showing of this determination to survive. Unfortunately for OPEC, the market is not convinced that it can succeed. This stand-off between the oil producers and their customers can only last for a limited period. By mid-summer the market will either have accepted the OPEC price structure through increased purchases and ending of destocking or the structure will start disintegrating under the strain of market pressures. If I had to bet, I would say the odds are modestly in favor of the price structure <u>holding</u>. This is not an analytical appraisal but the conclusion would probably be the same if it were.

If the price structure does hold, product prices must rise since, as you know better than I, the present price relationship between products prices and crude prices gives a negative refinery margin on most crude oils, particularly non-U.S. crudes. This is an unstable situation which must be resolved either by the feedstock price moving down or the products price moving up.

Let us now move from the immediate prospects to the likely market outlook for the next several years. If the current OPEC price holds approximately, there will be substantial excess crude producing capacity, though less than now, into the 1990's. On the other hand, if the price were to fall to the market clearing level and stay there, much of the excess capacity would probably be gone within 5 years. World demand could rise by 6-7 million B/D during this period while production from the U.S., Canada and the North Sea could start declining within 2-3 years.

In either case, the next few years are likely to be a buyer's market. That means spot prices will be mostly below posted and official sales prices, resulting in a shift in volume from the latter to the former. We have seen such a shift developing at an accelerated rate over the last 15 months when spot prices for non-U.S. crudes were almost consistently below official sales prices. Since early 1983 this has also been true for U.S. posted crude prices. Spot prices can of course not remain indefinitely below posted or contract prices, since the market will eventually bring them together. How long this will take if OPEC survives as a price administrator depends in part on how well it does its administering job. But as long as there is readily available excess producing capacity there will probably be an irresistible temptation to sell some extra oil below the official sales price.

Another feature of a buyer's market is that OPEC crude producers with surplus capacity will be tempted to go the same route many of the private crude oil producers went historically - integrate forward. They may do this by buying into existing refineries in importing countries, as the Kuwait National Petroleum Company has recently done in Europe and Petroleos de Venezuela is negotiating to do. Alternatively, they may build export refineries on their own territories, such as Saudi Arabia, Kuwait, and Libya are currently doing and Algeria has recently done. Or they make processing agreements with foreign refiners such as Libya's recent arrangements with several companies.

Such forward integration may be logical for surplus crude producers but it has obvious risks for the maintenance of administered crude prices. Since there are no OPEC administered products prices, nor are there likely to be any in the future, crude oil refined for export or abroad in integrated OPEC government refineries is not under OPEC price control. In a surplus market in which incremental products sales can only be made at discounted prices this tends to erode the administered crude price structure. The more the OPEC oil companies move into forward integration the more they weaken their cartel price in a surplus crude market. In a tight market, or even a balanced one, this would of course not be so. In fact, the original motivation of OPEC national oil companies to expand into refining was to benefit from upgrading their crude into higher-value refined products. But in a surplus market in which spot crude prices are below official sales prices, OPEC refiners may find that optimum plant utilization requires crude transfer prices at the spot level.

A surplus crude market means lower crude prices and lower crude prices mean higher demand. We don't know yet how much the latest price reductions will raise demand from what it would have been otherwise. But in the U.S. the refiner acquisition cost of crude oil has dropped substantially, from a peak of $35.24/bbl in 1981 to $31.85 in 1982 and a tentatively estimated $29.50 this year, if the current price level remains approximately unchanged. This would be a 16% reduction from 1981 in nominal dollars and about 25% in real (inflation adjusted) dollar.

Looking ahead at U.S. demand over the next four to five years, the crude price reduction is likely to slow down but not reverse the decline in gasoline demand because further improvements in fuel efficiency are likely to offset increased driving due to the lower prices. Middle distillate demand for residential/commercial heating should be relatively unaffected by the price reduction since the demand for this purpose is not very price elastic. Diesel oil demand should continue to grow but at a slower rate because the motivation to buy vehicles with diesel rather than gasoline engines will be lessened by the lower gasoline price, even though the price relationship between the two fuels is likely to remain unchanged. Distillate demand in the industrial sector, on the other hand, can be expected to rise at a faster rate because the liquid fuel will be more competitive with natural gas. Residual fuel oil may register the biggest impact from the price reduction because it competes in almost all markets with others fuels whose costs and prices are rising and because the widespread and still growing duel firing facilities of many actual and potential residual fuel oil users make the demand for this product extremely price sensitive. In the last five years (1977-82) U.S. demand for residual fuel oil has dropped by 46% percent or 1.4 million B/D. The decline has continued unabated through the first quarter of this year due to weather and economic factors. Yet, I think we may finally have seen the end of it. At present prices residual fuel oil should be able to compete with natural gas in an increasing number of industrial establishments and thus is likely to benefit from the general economic recovery now under way as well as the rising gas prices. Residual fuel oil demand may decline further in the electric power market because of new nuclear power and coal facilities. But since its share in that market has already dropped from 20% to 6% in the last four years the potential for further decline is rather limited, particularly if electric power demand starts rising again, as it is likely to for the next several years.

I have only touched very briefly on the likely consequences of the radical changes in the world oil industry now under way. All we know at the moment is that nothing is certain or even probable any more. We may see spot prices plunge later in the year if OPEC is unable to hold together against the onslaught of market power or we may see them rise sharply as the refiners of the world reverse their destocking in a market where end-use consumption has started to grow again. Either of these developments will profoundly but quite differently affect the oil market for the remainder of this decade.