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TOPICAL STUDY #5

THE CASE FOR LOWER OIL PRICES

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Economics

I. Recent Events

The members of the Organization of Petroleum Exporting Countries are praying for a cold winter. They hope that demand for OPEC oil will rise sharply with the onset of the winter heating season. At the end of October, 11 of the 13 members agreed in Geneva to reduce their oil production ceilings from 17.5 million barrels a day to 16 million barrels a day. OPEC leaders believe that a combination of lower output and rising seasonal demand will stabilize their shaky $29 oil price structure. Nigeria and Iraq were exempted from lowering their production ceiling.

This is not the first time that OPEC's oil ministers have prayed for cold weather. In March 1982, the cartel members agreed in Vienna, for the first time in their history, to limit total crude oil output to 17.5 million barrels a day in an effort to defend the official $34 contract price of a barrel of Saudi Arabian Light crude oil, the "marker" for OPEC's price structure. The OPEC ministers attributed the sharp decline in oil prices to major oil companies unloading inventories. Kuwait's oil minister said that the new OPEC strategy should induce some of the more financially strapped producers to "sweat it out" until inventories are down in the summer and demand rises.

The Vienna agreement triggered a short-lived rebound in the spot price of crude. By early May, the spot price was back in line with the official contract price. But by early July, spot prices slipped to $32 per barrel. Iran was not abiding by the March quota agreement. The ceiling fixed for Iran was 1.2 million barrels per day. Iran reportedly was pumping twice that amount and selling it at a discount in the spot market.

OPEC met in emergency session on July 9. The meeting was called to revive the group's production limit of 17.5 million barrels per day set in March. It broke up without agreement on individual ceilings or on a date for further review. The organization's leaders pinned their hopes on a gamble that if they held firm for a few weeks, rising demand for OPEC oil by autumn would save the day.

The gamble worked through the summer of 1982 partly because of a revival of the Iran-Iraq War. Then, during the final three months of 1982, crude prices started to plummet. Part of the problem was a rebound in OPEC output. In April, the cartel produced 16.4 million barrels per day, well below the 17.5-million-barrel ceiling set in March. By October, output was up to 19.2 million barrels a day. Under the placid surface of stable official prices, Iran and Libya offered discounts through spot sales and barter deals. Kuwait and Venezuela undercut the official prices by processing their surplus crude output and selling refined product in the spot market. As a result, the spot market price of a barrel of Saudi Arabian Light crashed from $33.05 during September 1982 to $30.05 by January 1983.

To address the crisis, the oil ministers met in another emergency session in Geneva late in January 1983. The Saudis wanted OPEC's production cut to between 17 million and 17.5 million barrels daily. They also wanted Nigeria, Libya, and Algeria to increase the differentials they add to the benchmark price to reflect higher quality and closeness to markets. The Saudis wanted the Iranians and the Africans to stop discounting their oil. No agreements were reached. Instead, the Saudis talked of "teaching the others a lesson."

Although it appeared that Saudi Arabia was steering OPEC toward a price cut, the meeting ended inconclusively. Saudi Arabian Oil Minister Yamani, at a press conference on January 24 immediately following OPEC's consultative meeting in Geneva, predicted that "A few days from now we expect the North Sea price to come down. There is no way to keep it from coming down at least $2-$3."

Yamani was right. The marketplace was already accomplishing the oil production cutbacks and allocations that OPEC failed to formalize in Geneva. OPEC crude output was running barely above 16 million barrels per day during January 1983. In February, the British National Oil Corporation cut its North Sea oil price $3 a barrel to $30.50. OPEC-member Nigeria quickly followed suit by slashing its price $5.50 a barrel to $30. Then, in March, OPEC announced the first contract price cut in its 23-year history. Saudi Arabia's marker crude price was reduced to $29 a barrel from $34. The cartel's members pledged to abide by the March 1982 Vienna production ceiling of 17.5 million barrels a day.

A cold blast of Arctic weather across the U.S. during the winter of 1983/1984 and Iranian threats to cut off the Persian Gulf during the spring of 1984 propped up OPEC's shaky price structure until the summer of 1984. Fear over the fighting in the Gulf encouraged oil companies to build inventories. Ironically, this buildup helped to weaken prices during the summer, as many market participants anticipated that these oil inventories might be dumped back on the market. Also, most of the slack from the Iran-Iraq War zone was taken up by other Mideast suppliers. The Saudis increased the flow through a pipeline that had been operating at less than half capacity. Kuwait and Egypt also put out a little more.

The 1983/1984 winter chill stimulated heating oil usage. Gasoline and heating oil are made at the same time. Refiners stockpiled the gasoline by-product, expecting strong demand during the summer driving season. Demand did rise, but not enough to absorb the ample supply of gasoline. So petroleum product prices declined.

The events which led to the October 1984 agreement to cut output to 16 million barrels are very similar to those that precipitated the March 1983 official price cut. On October 17, the British National Oil Company cut official crude prices by $1.20 to $1.35 a barrel, following a similar move by Norway. Nigeria responded immediately by cutting its price by $1 to $2 a barrel. So another cut in OPEC's contract prices may be just around the corner.

Actually, there are already plenty of signs suggesting that the October plan is coming unglued. Early in November, Iran reportedly raised its production and exports rapidly by offering price discounts from $2 to $3 below the official price on its oil. Industry sources were surprised that Saudi Arabia commissioned at least four large tankers, capable of holding several million barrels of crude, to load oil from the kingdom. On November 7, the Nigerians announced that they will continue to exceed their output quota for the foreseeable future. Nigeria's oil minister declared that his country would remain a committed member of OPEC "as long as OPEC's policies don't interfere or conflict with our national interest."

Early in December, Norway temporarily suspended its official pricing system. Instead the price of its crude will be based on the spot market price. This action puts pressure on Britain to do the same. With the major non-OPEC producers moving toward free-market pricing, OPEC's members will have great difficulty adhering to a fixed-price structure.

II. OPEC's Dilemma

Clearly, OPEC is no longer a producers' cartel with the power to raise prices at will. Rather it is more like a consumer protection agency that is serving the interests of consuming countries by overseeing the *orderly* decline of crude oil prices. A sharp drop in prices is not in the best interest of oil consumers.

OPEC is now limited to choosing between only two unpleasant alternatives: 1) continue to lose market share, or 2) cut prices to revive worldwide oil consumption. The October 1984 production agreement suggests that, for the short-term, OPEC would rather lose market share than cut crude oil prices. Of course, OPEC's oil ministers are hoping that before long worldwide oil consumption will rise faster than non-OPEC production *without* a price cut.

The recent history of crude oil demand and supply suggests that market forces will continue to push prices lower. That's because OPEC's success in raising oil prices dramatically during the 1970s boosted non-OPEC production and induced conservation.

Total world consumption of crude oil equalled 69.5 million barrels per day during 1979. During the first nine months of 1984, consumption averaged 57.1 million barrels per day, 17.8% below 1979's oil use. Over the same period, free world non-OPEC production has risen steadily by 21.4% to 21.5 million barrels per day during the first nine months of 1984. In fact, non-OPEC output has exceeded OPEC production ever since March 1982.

With world consumption remaining fairly flat and non-OPEC production increasing steadily, OPEC has had to limit its output by imposing quotas on its members. So OPEC's market share has eroded dramatically in recent years. Its share of the total world oil market equalled 44.4% during 1979. By September 1984, it was down to 29.5%.

OPEC's 1983 official price cut has had no perceptible impact on reviving world oil consumption. To a large extent, that's because the foreign-exchange value of the dollar has increased more than oil prices decreased so, in most countries, the local currency price of oil actually rose in 1983 and 1984. Also, non-OPEC producers Britain and Norway have an incentive to initiate price cuts because, so far, such reductions haven't decreased oil income measured in terms of local currency.

It's unlikely that OPEC can maintain its production discipline for very long. During September, OPEC's output was 16.6 million barrels per day. That represents only 58.9% of the cartel's capacity of 28.2 million barrels per day. With so much excess capacity, members have an incentive to cheat by selling some of their production in the spot market.

The spot market once accounted for no more than about 5% of all world oil trading. Today, by some estimates, it represents as much as 40% of total trading. Long-term contracts to buy OPEC oil frequently include clauses that permit periodic changes in "fixed" prices to reflect spot-market conditions. In fact, both Norway and Britain claim that the recent cuts in their contract prices were forced by market conditions.

The bottom line is that oil prices aren't going up. And the odds increasingly favor further price declines. The downtrend in oil prices started late in 1980. It could continue for several more years. Rising oil prices were one of the major sources of inflation during the 1970s. *Now falling oil prices will help to keep inflation down in the 1980s.*

Recent events suggest that zero inflation is possible in 1985. Relative to such a rosy outlook, bonds are still very cheap. So interest rates should fall further. The improved prospects for price stability reduce the chances of a policy-engineered recession or a credit crunch. So an extended economic expansion through 1985 and 1986, possibly beyond, seems increasingly possible. Lower bond yields and a longer cycle are ideal for equity investments.

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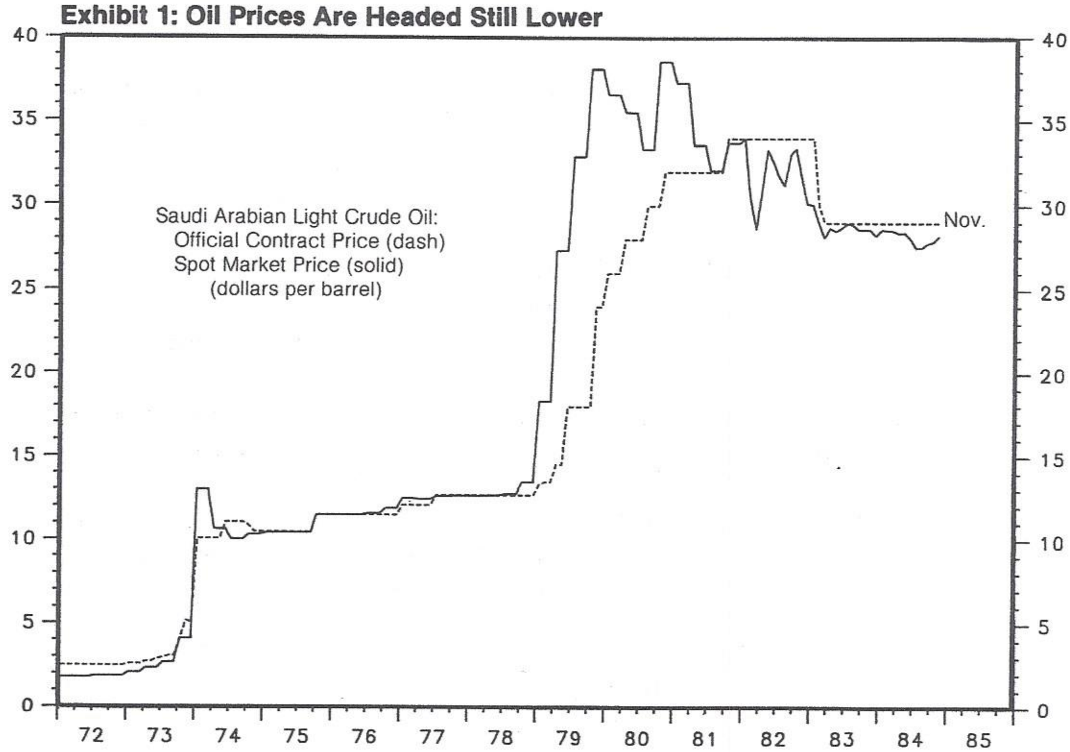
9/60	OPEC formed.
2/71	Teheran Agreement. Major oil firms accepted most of terms demanded by Gulf members of OPEC, including a 30-cent increase in posted prices (to about $1.68), a 55% minimum tax rate on the net income of oil companies operating in member countries, and the elimination of special discounts on sales of crude oil.
12/71	Libya nationalized British Petroleum's 50% interest in the Sarir field.
12/72	A General Participation Agreement was reached between the oil companies and Saudi Arabia, Abu Dhabi, and Qatar. It provided 25% participation interest by the producing governments, with additional shares each year thereafter, leading to 51% government participation by 1982.
9/73	Libya nationalized 51% of oil properties.
10/73	Yom Kippur War. Arab governments ordered production cutbacks and embargoed United States.
	Gulf members of OPEC, acting unilaterally, decreed an increase of about 70% in the posted prices of their crude oil. First instance that OPEC took the pricing function completely into its own hands.
12/73	President Nixon established Federal Energy Office and gave it authority to control oil prices.
1/74	Price for the Saudi Arabian Light marker crude raised to $8.32, over three times what it had been just three months earlier.
	Gulf states were successful in accelerating the General Participation Agreement and achieve 60% ownership.
10/75	OPEC increased price by 10%, compromising between 5% sought by Saudis and 15% by Iran.
12/75	Energy Policy and Conservation Act established fuel efficiency standards for automobiles and trucks, beginning with 1978 models.
5/76	OPEC met and voted to hold the marker crude price steady in the face of a temporary world oil glut.
1/77	Two-tiered pricing system emerged. The "moderates," Saudi Arabia and the UAE, raised their prices about 5% (to $12.09). The other 11 OPEC members led by price-hawk Iran raised theirs about 10% ($12.70), with an additional 5% increase scheduled to become effective July 1977. Saudi Arabia retaliated by suspending its production allowable of 8.5 million barrels per day and increased its crude production.
7/77	OPEC compromise reestablished unitary pricing system as Saudi Arabia and the UAE raised their prices 5% and the others agreed to forego their additional scheduled increase. Arabian Light marker crude price set at $12.70 per barrel. Saudi Arabia returns to 8.5 million barrels per day ceiling.
	U.S. Strategic Petroleum Reserve received its first oil shipments. Policy goal was for storage of 500 million barrels by end of 1980.
9/77	Opening of the Trans-Alaska Pipeline System.
9/78	Martial law declared in major Iranian cities. Strikes occurred in Iranian oil fields and refineries.
12/78	Most consortium employees and dependents left Iran. Iranian exports suspended. Spot market prices soared.
	OPEC at Abu Dhabi agreed on gradual price increases on quarterly basis through 1979, 10% increase for year as a whole.

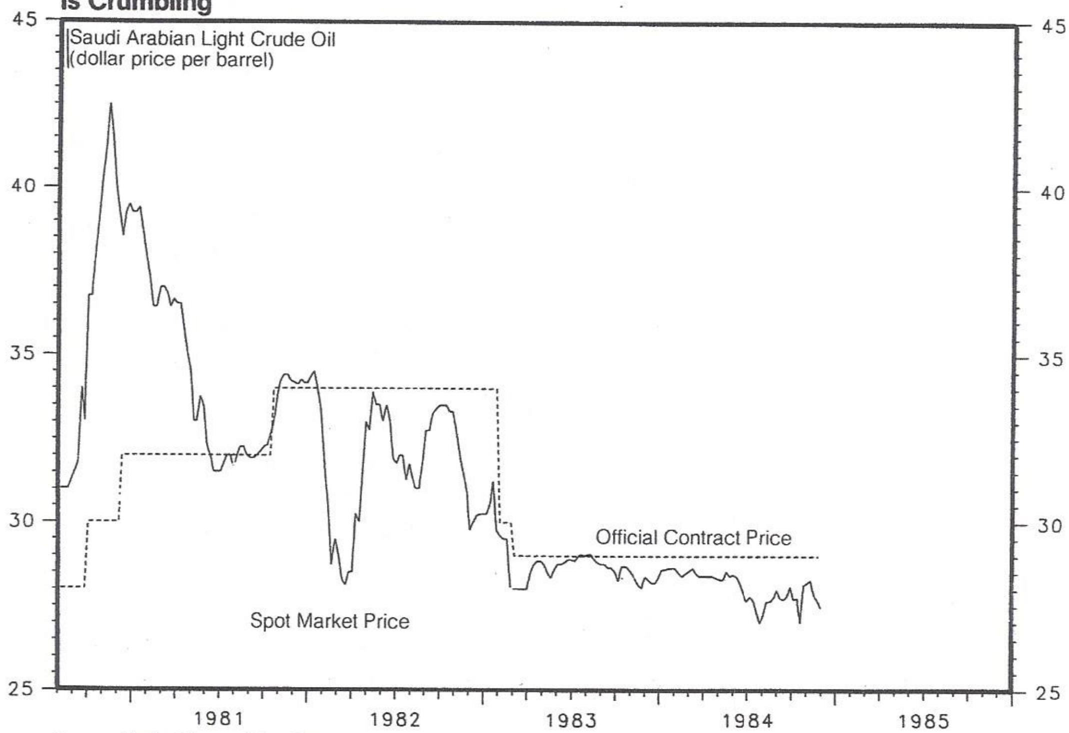
3/79	Iran established new revolutionary government and resumed exports at lower levels.
	Soaring spot prices caused OPEC to accelerate schedule of quarterly price increases, bringing barrel to $14.55 for second quarter.
5/79	Gasoline shortages developed in U.S.
7/79	Saudi Arabia raised the price of Arabian Light to $18.00 in an effort to unify OPEC. The unified pricing system broke down again during 1979 as some OPEC members chose to charge premiums of as much as $10 per barrel in line with spot crude transactions.
12/79	Marker price increased again to $24 per barrel as the Saudis continued to try to reunify OPEC prices.
1/80	Saudis again raised the price of Arabian Light, this time to $26 per barrel. This effort to close the price gap failed again as other major OPEC exporters raised their prices yet another time.
3/80	President Carter imposed an oil import fee of $4.62 per barrel designed to raise gasoline prices 10 cents a gallon by mid-May.
	Windfall profits tax imposed on U.S. oil company earnings.
5/80	Marker crude price raised $2 to $28 per barrel.
9/80	Iran-Iraq War began.
	Saudis increased price to $30.
12/80	Saudis increased their price to $32 per barrel.
1/81	U.S. crude oil prices were immediately decontrolled by President Reagan.
10/81	Marker crude price raised from $32 per barrel to $34 per barrel.
3/82	The cartel members agreed in Vienna to limit total crude oil output to 17.5 million barrels a day.
7/82	OPEC met in emergency session to revive the group's production limit of 17.5 million barrels per day in March. Iran reportedly was pumping twice the amount set by the March quota agreement. The meeting broke up without agreement.
1/83	Another emergency meeting of the oil ministers broke up with no agreement on price or production quotas.
2/83	The British National Oil Corporation cut its North Sea oil price $3 a barrel to $30.50. Nigeria slashed its price $5.50 a barrel to $30 without the agreement of OPEC.
3/83	OPEC announced the first price cut in its 23-year history. Marker crude price reduced from $34 to $30 as of February 1 and to $29 as of March 1. The cartel's members agreed to abide by the March 1982 Vienna production ceiling of 17.5 million barrels per day.
10/84	OPEC announced plan to reduce the cartel's production ceiling from 17.5 million barrels per day to 16 million barrels per day in an effort to hold the $29 pricing structure after Nigeria cut its official prices $1-$2 a barrel.
11/84	Canada deregulated export prices of natural gas.
1/85	U.S. scheduled to increase the proportion of natural gas output removed from price controls to half, from less than 10%, under its six-year old deregulation schedule set by the U.S. Natural Gas Policy Act of 1978.

Exhibit 1: Oil Prices Are Headed Still Lower



Source: *Petroleum Intelligence Weekly.*

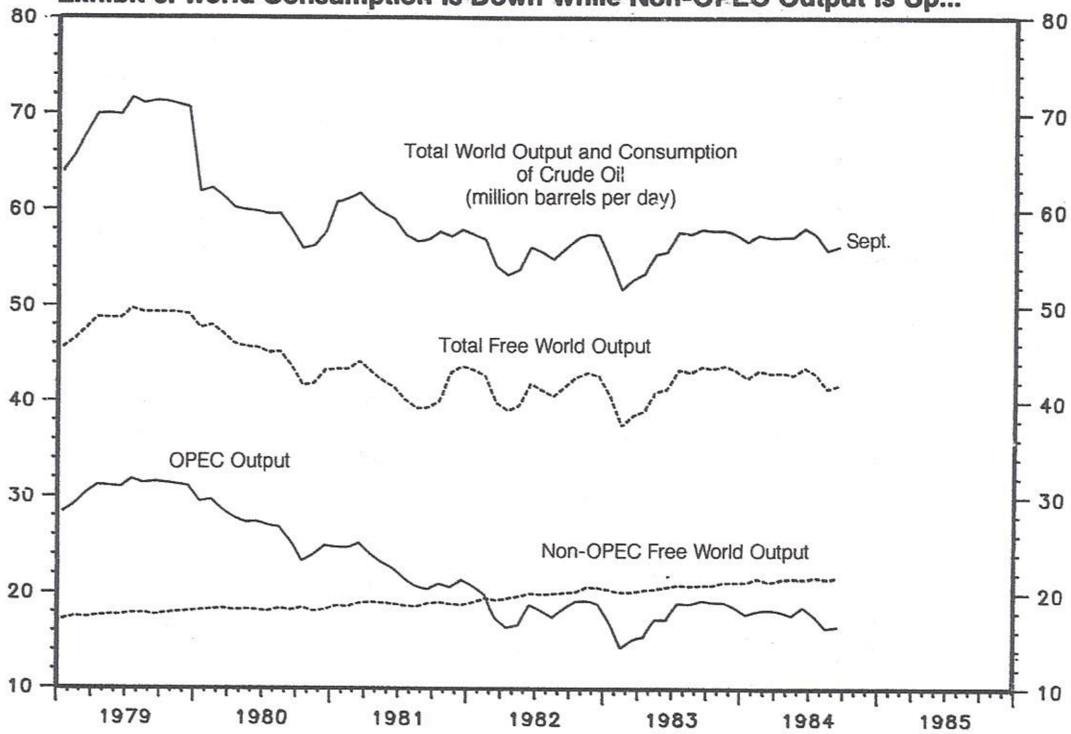
Exhibit 2: Weakening Spot Prices Suggest That OPEC's Latest Accord Is Crumbling



Source: *Platt's Oilgram Price Report.*

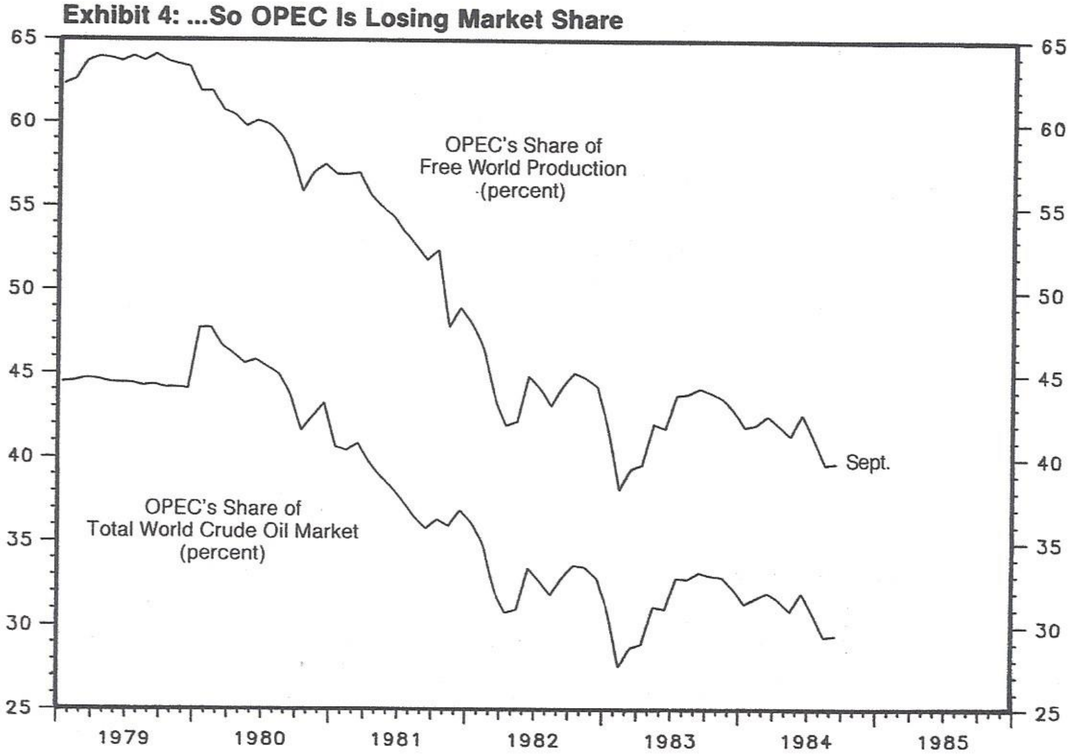
Latest data plotted 11/30/84.

Exhibit 3: World Consumption Is Down While Non-OPEC Output Is Up...



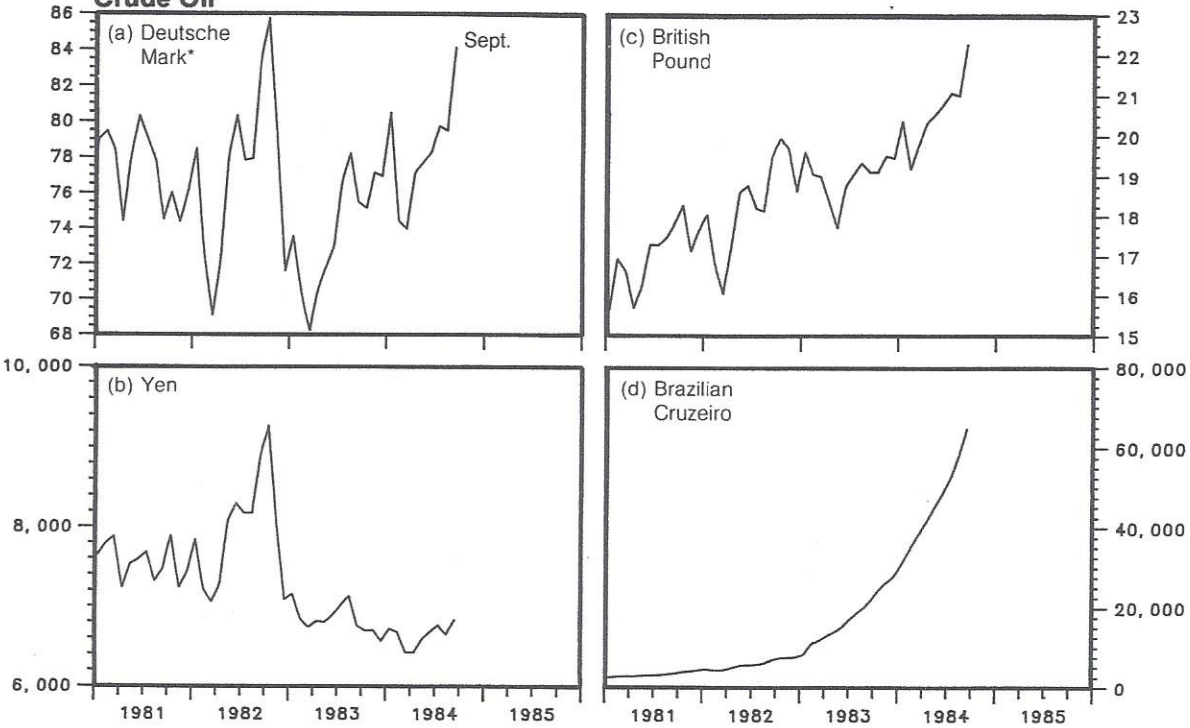
Source: *Petroleum Intelligence Weekly.*

Exhibit 4: ...So OPEC Is Losing Market Share



Source: *Petroleum Intelligence Weekly.*

Exhibit 5: The Strong Dollar Has Boosted The Foreign Currency Price Of Crude Oil



*Foreign currency price of a barrel of Saudi Arabian Light crude bought in the spot market.

Topical Study	#1	Dr. Edward Yardeni, *"Exports Should Weaken U.S. Recovery,"* March 22, 1983
	#2	Dr. Edward Yardeni, *"The Ten Pillars of Faith,"* April 6, 1984
	#3	Deborah Johnson, *"Behind the Corporate Borrowing Binge,"* June 13, 1984
	#4	Dr. Edward Yardeni, *"Why Has the Leading Index of Inflation Failed So Badly?,"* October 24, 1984
	#5	Dr. Edward Yardeni, *"The Case For Lower Oil Prices,"* December 12, 1984