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Saudis' price war could mean $5-$10 per barrel oil

by William Engdahl

A unilateral decision on the part of Saudi Arabia sparked the dramatic collapse in traded crude oil prices after Jan. 21, with quoted prices for the marker crude, North Sea Brent, collapsing almost $13 per barrel since its late November high of $31. As of this writing, Brent—currently the most liquid crude traded on forward markets—was quoted at $18.30 for March delivery.

By declaring a price war "to the finish" on the British-centered oil market, Saudi Arabia has become the loose cog in the world financial system. With their own production down to less than 2 million barrels per day at last year's low point, the Saudis were facing the prospect of burning off their entire financial reserves within two years. So instead, Saudi oil minister Sheikh Yamani decided to bring the British to their knees, while keeping his own war chest intact. The Saudis can produce oil for not much more than 50 cents a barrel, and there is no reason that the oil price should stand above $5 to $10 per barrel once the dust settles.

Oil prices on the spot market fell an additional $2 per barrel Jan. 29, while OPEC specialists in Vienna debated a new marketing agreement. North Sea Brent Oil closed at $17.90 for April delivery, the lowest since 1979. But British oil industry sources report that the Saudis are already selling oil in so-called "netback agreements" to major oil companies at $16.80 per barrel.

The Saudis have, in effect, made the spot market irrelevant. The netback agreements already in place in November had the effect of taking oil off the spot market, artificially supporting the price through mid-December. Once the increased Saudi oil output had worked its way through the system, the price fell like a rock.

The "seven sisters" oil cartel regard this development with powerfully mixed emotions. True, their own refining operations will benefit handsomely from lower-cost oil; but the enormous reserves they have accumulated by borrowing high-priced money will shrivel in value. Texaco has already had to postpone a $1 billion borrowing in order to post bond in its ongoing dispute with Pennzoil, since the collateral value of its oil reserves has collapsed. Financier interests associated with the oil cartel, such as the large American international banks, will be steamrolled by the effects of even a $15 per barrel price on their debtors' capacity to pay.

The fall below the $20 level, widely regarded in the industry as a kind of psychological barrier, has triggered near-panic in major centers of international banking and in major oil-exporting developing nations, especially Mexico and Nigeria.

The price collapse is also triggering regional bankruptcy crises in major oil regions of the domestic United States—Texas, Oklahoma, and parts of Colorado—and is feeding a precipitous decline of the British pound.

What is behind the sudden price collapse, and who potentially benefits from it? Below we detail the little understood but far-reaching structural changes which have taken place in world oil markets since the 1979 Iranian "oil shock," which drove official OPEC and world prices as high as $40 per barrel for select grades of crude.

How the panic began

The latest collapse—the first time in seven years that oil prices have fallen below $20.00—was triggered on Jan. 21 when an article in the Cyprus-based *Middle East Economic*

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Survey, a newsletter widely regarded as close to Saudi official circles, published a piece on a possible meeting between British Oil Minister Peter Walker and Saudi Oil Minister Sheikh Yamani. The article hinted at an "imminent threat of a disastrous collapse of the oil market," in the event that no production control agreement were reached between OPEC and such non-OPEC oil producers. The same day, Kuwaiti oil minister Sheikh Ali al-Khalifa repeated a call for non-OPEC producers to share the burden of reducing output in order to avert a price collapse.

Within hours of the two events, the rumor-hungry world oil trading markets of London, New York, Geneva, and Rotterdam unleashed a new wave of panic selling. Prices first dropped below $20 dollars in some European trading. Two days later, the situation reached what most traders termed a full-fledged panic, when Yamani publicly stated that prices could fall below $15 unless all producing countries, including those outside OPEC, agreed to limit production—in effect, unless they established a worldwide, if unofficial, cartel. Prices in London trading for Brent North Sea crude on Jan. 23 fell another catastrophic $1.50 per barrel. Brent is considered the most sensitive "barometer" of demand in the West European oil market.

Public statements from the Saudi spokesmen in recent months have singled out Britain as the prime target of the OPEC strategy. Yamani and others in OPEC argue that, while the Saudis have reduced their output to a low last summer of 2 million barrels per day, British North Sea production has continued to increase to record output in 1985 of between 2.6 and 2.8 million barrels per day. Saudi Arabia, the world's largest and cheapest producer of crude oil, had sunk below the level of Britain.

Behind the price collapse

World oil production has continued to plummet since the twin shock of the October 1979 U.S. Federal Reserve shift in monetary policy, which forced double-digit interest rates and industrial collapse throughout the industrial and developing sectors, and the negative impact on energy use of the 1979-80 Iran oil price shock, when major oil companies and OPEC producers shifted the traditional structure of world energy control and distribution.

But OPEC and member governments of the Western industrialized nations, despite overwhelming evidence to the contrary, continued to act on the basis of official reports from agencies such as the Kissinger-created International Energy Agency (IEA) at the Organization for Economic Cooperation and Development (OECD) headquarters in Paris. "The IEA, up until even last fall, continued to publish these optimistic reports of expected demand recovery and diminishing supply. OPEC, and in particular, Saudi Arabia, continued to believe these projections," according to Peter Odell of the Rotterdam Center for International Energy Studies. "The Western governments bought the myth that oil was scarce, while it isn't. We are finding three barrels for every two we consume. OPEC is a disaster. What do the Saudis and British have to negotiate about?"

According to studies made by the Rotterdam institute, since the first OPEC price "shock" in 1973, when OPEC countries supplied 37% of all non-communist world energy, today that share has collapsed to only 16%.

It is also noteworthy, that over the same period, the Comecon countries more than doubled their share of Western and non-Communist energy markets, from 2.5% of total energy consumption in 1973 to 6% in 1985. Though small in absolute size, "the East European export of natural gas, oil, and coal has definitely helped to weaken the market," Odell indicated.

But the real context for this increased influence, Odell emphasized, is the overall reality of collapsing oil consumption, combined with expanding non-OPEC production. Mexico, the United Kingdom, and Norway have all significantly increased production in the past few years. At present, OPEC produces less than 40% of world oil: In their peak year 1982, OPEC produced about 32 million barrels per day; today, this has dropped to an estimated 17-18.5 million.

The Saudi role

The present world crisis was actually triggered last September. This was the point at which, according to oil trading industry sources, Saudi Arabia abruptly reversed its policy of dropping production. At that point, the Saudi's began to sell to major international oil companies on a so-called "netback" basis. In such deals, a producer such as Saudi Arabia contracts, usually for a six-month term, renewable automatically, to deliver its crude to a major refiner at a price which guarantees the refiner a fixed profit. Exact estimates of the volume of netback deals are extremely difficult to pin down. However, discussions with major traders and industry analysts indicate that as much as 30% of major Saudi and other OPEC oil is being sold via netback deals today. Before last week's collapse in forward market prices, this oil was estimated by the authoritative London Petroleum Argus analysts to have sold at between $16.83 to $19.42 for delivery to northern European refineries. No estimate for latest netback prices is yet available, but it can be estimated to have fallen well below this level. Saudi production since the low last September of some 2 million barrels per day, has steadily climbed as high as 4.5-5.2 million barrels per day by the first week of January.

Saudi Arabia, in first week of 1986, reportedly compounded the crisis by contracting to sell an estimated additional 67.5 million barrels of crude which had been stockpiled on huge tankers in the Far East, according to a report in *Mideast Report*. About 48 million barrels were sold to Japanese customers, according to the report. The price was not disclosed, but was clearly attractive enough to soak up an additional 3 million barrels per day for the first three weeks

of January, the period of the most intense collapse in quoted traded prices of crude.

"If I were the OPEC, I would immediately turn on the spigot and increase the flow up to 22 million barrels per day. This would flood the market with cheap oil and force the marginal production and high-cost exploration out of the market. Then, maybe, OPEC would have a chance to rebuild its share of the world oil market. I doubt, however, they will do this." This was the view of one London trader for one of the two British oil multinationals. According to London industry analysts at a major brokerage house, the first to go out of business, were the price to fall to $15 or below, would be the considerably higher-cost United States domestic production, followed by the Alaska North Slope.

British analysts claim that the North Sea "breakeven" price for 80% to 90% of today's British production will permit companies to continue at a profit until they hit a $3-$5 per barrel cost of production. The British may well be able to continue to pump oil out of their wells, which will be exhausted by the early 1990s; but at below $20 per barrel, Britain will not be able to invest in any new production, so that Britain would be pushed out of an important role in world oil markets for the foreseeable future.

By comparison, estimates of Saudi cost of production vary, but are very likely to be below $1 per barrel.

Hopes for some stabilizing sign center on the Feb. 3 special OPEC meeting, which will discuss details of the Dec. 9, 1985 OPEC ministers' decision. That Geneva meeting triggered the recent dramatic collapse, when leading OPEC ministers announced that the oil producers' cartel would abandon its three-year policy of controlling supply to maintain prices in world markets. Within hours, the pound sterling (whose value is widely regarded as heavily dependent on North Sea oil revenues) plummeted, and world oil "spot" traders launched panic selling for several days, until OPEC made public statements indicating a retreat from their new confrontation course.

But these hopes were dashed by British Prime Minister Thatcher, as by the chairman of government- and Bank of England-owned British Petroleum (BP). Both declared that the United Kingdom would not cut production to help stabilize the oil situation. Thatcher, herself under major political attack inside Britain, told Parliament that she would not intervene in the rights of oil companies to full production from the North Sea. Sir Peter Walters of BP said that no major world production-sharing agreement were possible without the consent of the world's two major oil producers in the world: the United States and the Soviet Union. (Russian daily production is estimated in excess of 12 million barrels.) The BP chairman declared that, lacking such agreement, OPEC is the only one which can stabilize prices by cutting production again. A spokesman for Royal Dutch Shell, who asked not to be named, said the "only thing realistically which can even stabilize the situation, is a Saudi cutback to 1.5 million barrels."

Price drop triggers new debt crisis

In the wake of the latest collapse of world traded oil prices in U.S. and European futures and forward markets, Mexico's Treasury Secretary Jesús Silva Herzog told a London debt conference on Jan. 28 that Mexico, the second largest Third World debtor nation with $97 billion in foreign debts, was "going through an emergency—a very real one—which, if not acted upon with speed and wisdom, could make the summer of 1982 [when Mexico was forced to abandon normal servicing of its debt] look like a relatively calm and quiet period." Mexico relies on oil export, mainly to the United States, for 70% of its foreign export earnings. Because of the oil price collapse, Mexico will need to borrow several billion dollars more just to meet interest payments to international banks.

Silva Herzog referred to three years of savage domestic austerity and indicated to the assembled, which included Chase Manhattan's David Rockefeller, that more sacrifice was not possible. Mexico City's influential daily, *Excelsior*, headlined on Jan. 24, "We must suspend debt service" if oil prices continue to collapse. Silva Herzog the same day cancelled scheduled talks with New York creditor banks on the debt.

Nigeria, where collapsing oil revenues have dealt disastrous blows to the repayment of that country's estimated $12 billion foreign debt, announced several weeks before the latest price drop that it was limiting debt repayment to 30% of its export income. Nigeria is directly competing with North Sea oil for markets, as both produce crude oil of comparable quality.

Indonesia, another major developing-sector oil producer, announced an austerity budget which will reportedly cut industrial development projects. This was before the latest round of price cuts as well.

In the United States, the world's largest offshore drilling contractor, Global Marine, announced on Jan. 28 it was filing for bankruptcy leaving $1.1 billion in debts, while the Dallas, Texas, Diamond Shamrock oil company, a major regional company, reported a net loss for 1985 of $605 million, largely related to write-downs on the group's Indonesian oil and gas properties.

Texas Commerce Bank, one of the largest Texas banks, just reported $29 million in loan losses from real estate and energy lending defaults. And the giant Bank of America, which has large energy loans in its portfolio, continues to report record losses.