Energy Insider by William Engdahl

New oil shock could be severe

The production wars have begun, and the effect on world politics and finance could be immense.

On Sept. 30, OPEC Secretary General Subroto, ex-energy minister of Indonesia, dropped a new oil bomb on world markets when he told AP-Dow Jones press that world oil prices could collapse to $5/barrel were Saudi Arabia to continue its new policy of abandoning its agreed OPEC production ceiling of 4.3 million barrels per day (bpd). On Oct. 3, in a statement signed by King Fahd, Saudi Arabia announced, "The Kingdom will not accept an OPEC member adding to its quota at the Kingdom's expense and will not freeze its production while others increase."

Those who remember events of 1985-86, know that oil price policy is no minor affair in world politics.

On July 5, 1986, reports hit jittery world petroleum markets that Saudi Arabia, OPEC's most formidable producer, had contracted to sell its oil for $8.50/barrel on a "netback basis." Within minutes, the world oil futures markets responded with prices for the "black gold" dropping precipitously. OPEC at that time was producing 19.5 million bpd, flooding world markets with "cheap" oil when the market "demand" for OPEC crude oil was estimated to be 17 million bpd. Vice President George Bush made a rush diplomatic visit to Riyadh that summer, following his earlier calls for an end to the price war, and by September, OPEC had sharply curtailed output.

By October 1986, the Saudi King had fired Oil Minister Sheikh Zaki Yamani, scapegoating him and reversing policy. By early 1987, prices were inching back to an agreed $18/barrel level. But the results of the 12-month Saudi production war had been of cosmic proportions: In the wake of an August 1985 Saudi decision to abandon its role of cutting back (so-called "swing producer" role) to maintain a stable price when other OPEC partners exceeded production quotas, world oil prices plunged some 70% from approximately $28/barrel to lows not seen since the early 1970s. The oil-based economy of the U.S. Southwest plunged into a depression from which it has yet to recover. The largest U.S. banks reeled on the edge of collapse as Mexico's debt repayment crisis exploded. The Soviet Union's hard currency export revenue from oil and gas plummeted. And the wildest speculative run-up in Wall Street stock prices since the late 1920s was kicked into high gear, culminating months later in Black Monday, Oct. 19, 1987.

According to latest reports from Mideast and London oil trading sources, Saudi production is now as high as 5.7 million bpd, almost 1.5 million over quota, and they can go to 11 million. Overall OPEC production is above 20.5 million, against a quota of 17.5 million, and climbing daily, as all-out price war has erupted among the oil cartel producers. Overall for September, according to a new monthly report by the Paris-based International Energy Agency of the OECD, world oil production reached the highest level since the boom-year 1980, some 50.8 million bpd. Now Norway and Indonesia have threatened to join the production war. On Oct. 5 the traded price of West Texas Intermediate crude dropped to $12.48/barrel, its lowest price since August 1986. North Sea Brent fell to $11.25/barrel.

"The price of crude will continue to drop by some 50-60¢/day until the time OPEC ministers agree to an emergency meeting to stabilize production," noted a spokesman for Shell Trading Co. in London. OPEC's next semi-annual meeting is set for Nov. 21, and informed Middle East observers report that the Subroto warnings and the recent Saudi moves are part of a coordinated strategy to "scare the hell" out of the other producing countries, most especially Iran and Iraq, which have been exceeding any demands for production restraint.

It will be a very bitter and, possibly, protracted fight with the stakes far beyond Saudi Arabia's clear desire to reestablish predominance over broad OPEC and Gulf policy. Saudi Arabia is uniquely placed to wage a long oil war. It has the world's largest known petroleum reserves and the cheapest cost of production, estimated to run $1.25-1.50 per barrel. By contrast North Sea or Alaska oil "breakeven" cost is $14-15/barrel.

Whatever the short-term windfall profit to Wall Street stock and bond markets in the run-up to U.S. November elections, the medium- and long-term consequence of the oil policy shift are staggering. Moscow can ill afford further loss of hard currency revenues at this time. The U.S. banking system, with the financial hemorrhage in Texas and Mexico, is equally near the brink. Informed London financial sources report that the Saudi strategy portends an imminent "free fall" in which prices could easily drop to Subroto's $5 level if not halted. The second time around, the outcome could detonate a global financial and political shock far beyond Oct. 19, 1987.