

Crude Oil Prices on an Upward Trend?

By Mamdouh G. Salameh*

The consensus among oil market analysts in 1996 was that crude oil prices just had to fall, if not today, then tomorrow. There was much oil available and Iraqi crude oil was about to come to market. Yet, oil prices rose in 1996 by around \$8 a barrel, an increase of 44 percent. Even when a limited amount of Iraqi oil did return, there was barely a blip on the price charts.

However, failure to project correctly the oil price upward movement elicited a wide range of explanations. One popular explanation was a perception that oil inventories were at unusually low levels. A theory developed that the oil industry, copying the just-in-time delivery practices that made Japan's motor industry so competitive, had drastically reduced oil inventories and were relying on just-in-time deliveries of oil. So there had to be some buying pressure supporting prices.

Although there may be some truth in that conclusion, it does not provide an adequate explanation for the strong price showing in 1996. The oil industry has always kept oil stocks at the lowest level possible. Supply managers plan to have just enough petroleum in the system so their companies can always deliver a gallon of product on demand. But they fine tune supply plans so that there is the least number of barrels in the pipeline leading up to the nozzle. The reason is simple, holding more barrels than absolutely necessary costs money. One extra day of crude supply worldwide represents \$1.5 bn of working capital.¹

Inventory Management

This style of inventory management has resulted in oil companies keeping usable commercial stocks at levels equivalent to 11 to 13 days of petroleum consumption. Global oil inventories in November 1996 included 11.3 days of usable commercial stocks according to PIW's *Oil Market Intelligence*, down from 12.2 days in September. A decade ago the range was the same, namely 11 to 13 days. Industry performance has been logically consistent. This suggests that the inventory rationale is an inadequate explanation for the strong price rise in 1996. Rather, the cause can be found in the supply/demand balance, specifically underestimating the demand side of the equation.

While inventory management might be sound economically in reducing working capital needs and may not impact on prices in the short-term, the situation could suddenly change if there is a major supply disruption which could send oil companies scrambling for supplies to replenish their dwindling usable stocks. This would definitely push up the prices of crude oil and petroleum products reminiscent of the spot market prices in 1979-81.

The Missing Variable

The fundamental factor in determining oil prices is the

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¹ See footnotes at end of text.

supply/demand balance. Oil consumption has been rising robustly and is the factor that most explains the strong support for prices. Demand is on track to reach the 77.3 million barrels a day (mbd) projected for the year 2000, and could probably exceed it by up to 2 mbd.²

Nowhere today is oil considered a luxury item of consumption. Developing countries have no alternatives for petroleum to fuel rapid economic growth. Those that have achieved high growth rates now have prosperous societies wanting the good things of modern life, all of which consume energy. For example, the planned sale of 1,750,000 motor vehicles in South Korea this year could add about 10,000 barrels a day (b/d) to the country's oil demand. This trend is present, in varying degrees, in all the developing countries.³

The International Energy Agency (IEA), notoriously cautious in projecting global oil demand, sees demand in 1997 growing by at least 2.6 percent to 73.77 mbd, about 2.00 mbd higher than in 1996.⁴ With Iraq back in the market and a projected increase of 1.0-1.5 mbd of non-OPEC production, there should be no shortage of crude oil and prices should remain under \$25 a barrel (WTI). Only a major supply disruption could push prices up.

But growing demand also suggests that crude oil prices are not likely to fall below \$20 for a sustained period, and may not even fall that low. The bottom line is that demand for oil and consequently oil prices will be strong through the rest of this century.

U.S. Containment Policy & The Price of Oil

However, the price of crude oil could easily hit the \$40 mark if restrictions on the oil trade of some Middle Eastern countries are not lifted in the near future. With the production capacity of Iraq, Iran and Libya put out of reach by the blunt economic weapons of the United States, the \$40 barrel could be a reality by 2005.⁵

At the rate oil demand is growing these days and despite robust growth in non-OPEC output, it is highly likely that by 2005 - only eight years away - almost 10 mbd of additional oil will be needed from OPEC. On present plans, OPEC will be able to cope with this extra demand for its oil but it needs Iraq to be producing to its considerable potential by then (see Table 1).

Table 1
The Call On OPEC With Constant Nominal Oil Prices
(mbd)

	World Oil Demand	Non-Opec Oil Supplies	Call on OPEC	Planned OPEC Capacity	Needed OPEC Capacity
1992	67.0	40.5	24.4	26.6	26.1
1995	70.3	40.3	27.5	33.0	29.9
1996	71.9	40.1	28.2	33.0	30.2
2000	78.4	39.6	36.7	36.4	39.3
2005	83.6	38.8	38.7	39.0	41.4

Sources: IEA, Centre for Global Energy Studies (CGES).

Putting it differently, if the world is not able to call on 6.5 mbd of extra Iraqi, Iranian and Libyan capacity - that is extra planned capacity from the three countries bearing the brunt of the U.S. containment policy - there is bound to be strong upward pressure on oil prices. Iraq's oil potential is second only to Saudi Arabia, so that it comes as no surprise to find

that Iraq alone accounts for almost half of the additional 11.5 mbd of capacity OPEC is expected to install by 2005. What happens to Iraq is, therefore, of critical importance to the stability of oil prices.

The cornerstone of current U.S. policy towards the Middle East is the dual containment of Iraq and Iran – countries the United States considers a threat to the region. There is more than a suspicion, however, that as long as Saddam Hussein remains in power, there is no chance that Iraqi oil will flow freely again if the United States has anything to do with it.

This is worrying as far as the oil market is concerned, for it is known that the Iraqi oil industry needs time and billions of dollars in investment funds for rehabilitation. The longer Iraq is denied access to investment funds for maintenance and capacity expansion, the greater the pressure on other oil producers to fill the output gap in the years to come – and, failing this – the greater the possibility of higher oil prices. Therefore, what is needed is a novel, imaginative international community approach to the Iraqi question. Limited oil sales are fine for the time being but they do not help solve the world's longer-term need for oil. The world needs Iraq's oil and will be prepared to pay for it. The real problem, however, is how to satisfy this demand for Iraqi oil without Saddam Hussein using the revenues for rearming.

Iran is obviously not as significant as Iraq in terms of the geopolitics of oil. It remains, nevertheless, a populous Gulf state with abundant oil and gas resources that need to be exploited for the benefit of the country and the world at large. The additional 0.6 mbd of oil capacity that Iran plans to have available by 2005 would certainly help satisfy the world's growing demand. As in Iraq's case, investment is needed to bring this capacity on stream and the requisite funds are most likely to come from abroad. However, in Iran's case there are no UN sanctions to contend with, so in principle there is no reason why Iran should not fulfill its potential – except, that is, for the U.S. trade embargo against it.

U.S. Senator D'Amato's bill prohibits those foreign companies investing more than \$40 million in Iran from doing business in the United States as well. Companies are in effect obliged to choose between Iran and the United States. As it happens, many U.S. oil companies are also none too happy with a policy that restricts their freedom to invest where they see fit. The international oil industry is thus prevented from bringing low-cost supplies on stream for political reasons.

Libya too has fallen foul of the United States as another country suspected of promoting international terrorism and has, therefore, felt the long retributive arm of U.S. policy. Like Iraq, Libya is subject to a U.S.-inspired embargo that has restricted its ability to expand its oil production and thus its exports.

Libya's proven reserves are 30 billion barrels, seven times those of the UK, yet Libya only produces half as much oil as the UK. For some time now the United States has wanted to tighten the screws on Libya further, but Italy, France and Germany have been opposed to any policy that might deny them additional short-haul supplies in the future.

The Residual Supplier

This policy of containment has already had a big impact on the industry. The world's dependence on oil from just a few oil-producing countries has increased beyond what might

be considered reasonable. In 1996, Saudi Arabian oil exports amounted to 45 percent of the Middle East's oil exports and a staggering 20 percent of all the oil traded in the world and there is little reason to suspect that this dependency on one country will change in the foreseeable future. More significant than this is Saudi Arabia's 60 percent share of the world's current spare capacity. Its share could even exceed 65 percent if Iran's actual sustainable capacity is less than assumed.⁶

Last year, the world needed more oil from OPEC, its residual supplier, but this oil was not forthcoming, because Saudi Arabia with almost two-thirds of global spare capacity, decided not to increase production. As a result, oil prices rose in 1996 by around \$8 a barrel. This factor coupled with the growing global oil demand was behind the firming up of oil prices in 1996.⁷

What is more, the situation will hardly improve in the years to come if Iraq remains constrained for the foreseeable future and Iranian and Libyan oil industries are prevented from expanding as intended. Indeed, as a result of the containment of the three countries, oil demand may edge very near supply capacity, causing the price of oil to hit the \$40 barrel mark by 2005 and imposing additional costs on the global economy amounting to trillions of dollars over the period 1997-2005.

The cost of maintaining production capacity in Iraq, Iran and Libya for the period 1993-2000 was estimated at \$14.23 bn while the cost of adding capacity during the same period was estimated at \$13.4 bn giving a total of \$27.63 bn (see Table 2).

Table 2
The Cost of Maintaining and Expanding Capacity in Iraq, Iran & Libya, 1993-2000

	Cost of Maintaining Capacity		Cost of Adding Capacity			Total	
	\$/db	Total Cost \$bn	\$pdb	Total Cost \$bn	\$pdb	Total Cost \$bn	Total Spend \$bn
	1993-00		—1993-95—		—1996-00—		1993-00
Iraq	160	3.12	500	1.0	1000	1.0	5.12
Libya	300	4.09	8000	1.2	10000	2.0	7.29
Iran	200	7.02	6000	6.6	8000	1.6	15.22
Total		14.23		8.8		4.6	27.63

Source: CGES; Prof. Adelman, MIT.

So we are faced with the prospect of the world's only superpower pursuing policies that will surely increase considerably the world's dependence on a few countries for extra oil supplies and at the same time causing the price of oil to be higher than otherwise would have been the case.

In summary, growing global oil demand suggests that crude oil prices are not likely to fall below \$20 for a sustained period, and may not even fall that low. The bottom line is that demand for oil and consequently oil prices will be strong through the rest of this century. However, if the restrictions against the oil trade of Iraq, Iran and Libya are not lifted in the near future, the \$40 barrel could be a reality by 2005.

Footnotes

¹ A. W Jessup, "Price Pressures: Revisited," *The Geopolitics*

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