 25X1C10b

Approved For Release 1999/09/02 : CIA-RDP79-01194A000100800001-7

February 1974

The Petroleum Economist

Volume XLI Number 2

Published monthly in English, French, Spanish, German, Arabic and Japanese.

Prices in Transition

In the circumstances of artificial scarcity created by the Arabs, crude oil is being traded at an extraordinarily wide range of prices; even those closely related to tax-paid cost are four or five times the level of a year ago. If host governments persist in their present attitudes, the demand for oil will be drastically curtailed.

Huge Increase in Oil Costs

The world is faced with an unprecedented increase in oil costs, with payments to producing countries in 1974 possibly totalling over seven times the amount paid in 1972 for the same quantity of oil.

Shock for the Third World

The developing Third World is now fully aware of the fact that the high cost of oil will strike a savage blow at its economic welfare. With no exemption from the unprecedented increase in prices, most countries in Asia and Africa will not be able to afford the quantities of oil needed for their [illegible] development.

Huge Increase in Oil Costs

ONE of the main reasons for the unilateral escalation of posted prices by the Organization of Petroleum Exporting Countries (OPEC), to the point where the international pricing system previously maintained by the major oil companies has virtually broken down, has been the high prices obtained by Middle East producers for the marginal amounts of oil sold on the open market. This oil has become available to the state companies largely as a result of various agreements made in 1973 – participation by Saudi Arabia, Abu Dhabi, Qatar and Oman, and nationalization in Iraq and Iran – and the still disputed 51 per cent nationalization by Libya.

But it should be stressed that these amounts of oil are still very small compared with the great bulk of supplies moved by the major companies – probably little more than 5 per cent of total production. It is the attempt to arrive at a so-called market price, based on marginal sales, that threatens the world with monetary chaos.

Under most of the original concession agreements, the producing countries were entitled to take up to 12.5 per cent of production in kind to sell themselves, in lieu of the cash royalty payment. This was usually less advantageous financially since, until the present situation arose, the government could not obtain full posted prices for the royalty oil, and received a higher revenue when it was sold by the companies. There were occasions, however, usually during a dispute of some kind, when this option was taken up. Thus in the mid-1960s, when the Shah of Iran was pressing the Consortium companies to increase production, Iran took sizeable amounts of royalty oil for long-term barter deals with Eastern European countries. When the new Iranian agreement was concluded in May last year, by which Iran had about 200 000 barrels daily, or 4 per cent of the Consortium's production, available for direct sale in 1973, some 60 000 b/d was earmarked for these deals.

Another country which in the late 1960s made similar barter deals with the Soviet Union and Eastern European countries, though for rather different reasons, was Iraq. In return for equipment, technical co-operation and cash loans, crude was to be supplied from the nationalized North Rumaila field. This came into production in 1972 at an initial rate of 100 000 b/d, scheduled to rise to some 360 000 b/d in 1974; most of this was earmarked for the Soviet bloc. But by March 1973, agreement had been reached with the IPC operating companies on the complete nationalization of the Iraqi oilfields, with the exception of the Basrah fields in the south, giving the Iraq state oil company over 1.5 million b/d out of a total production of some 2 million b/d.

Participation

In spite of these take-overs in Iran and Iraq and production-sharing agreements elsewhere, the main impact on prices in 1973 came as a result of participation agreements with four of the major Arab producers in the Persian Gulf; a fifth, Kuwait, has made, but not yet ratified, an agreement for a 60 per cent share, instead of the 25 per cent equity provided under the original agreement, rising to 51 per cent by 1982 (see also page 72).

Such is the present state of flux in the Middle East that agreements, however solemnly affirmed at the time, are scarcely worth the paper on which they are written. The recent unilateral actions of OPEC in setting posted prices without reference to the companies have negated the Teheran and Geneva pricing formulas, reached at various intervals between 1970 and 1973; even the countries which ratified the participation agreements have indicated that the terms are no longer acceptable; and Iran is thought to be seeking a revision of the 20-year pact with the Consortium to provide its state company with larger amounts of oil for direct sale. The situation is even more complicated by the actions of Libya and the lack of agreement with some of the companies whose rights have been expropriated; this has led to an extraordinary dual pricing system, by which the Libyans are charging $20 a barrel for undisputed and $16 a barrel for disputed oil.

The first pace-setting sale of participation crude was by Saudi Arabia in May last year. The amount involved in 1973 was only 69 million barrels, or about 2.5 per cent of Aramco's total anticipated production of 2 760 million barrels (the 25 per cent equity share minus 90 per cent for "bridging" and "phase-in" volumes which the state was committed to sell back to the companies). Similar amounts were sold for delivery in 1974 and 1975, when the percentage available to the state would rise to 5 per cent and 6.25 per cent. The price set was 93 per cent of the posted price, which at that time was $2.742 a barrel for Arabian Light (now the benchmark for Gulf prices), thus realizing $2.550 a barrel. At that time the government take from Aramco's production was $1.607 and the bridging price which Aramco had to pay for most of the remaining equity share was $2.39. Aramco's tax paid cost was $1.707 a barrel. Thus, already a small amount of oil was beginning to enter the world market at about 84 cents/barrel more than Aramco's tax-paid costs and 16 cents/barrel more than the bridging price.

Further participation sales by Abu Dhabi and an increase in the buy-back price for Libyan crude to $4.90 a barrel, following Libya's acts of nationalization which are still in dispute, accelerated this trend. Apart from the agreed increases in posted prices to offset the decline in the dollar under the Geneva formula, they encouraged OPEC to make a 70 per cent rise in posted prices on 16th October, lifting the posting for Arabian Light for instance from $3.011 to $5.119 a barrel. Finally, after even higher prices were obtained for sales in Nigeria, Venezuela, Libya, Algeria and Indonesia, a record-breaking $17.34 was offered for some of the direct-deal and joint-venture crude auctioned by the National Iranian Oil Company in mid-December. It was that price and others of the same order which stimulated OPEC to make the most massive increase of all in posted prices as from 1st January, raising the government take by some 130 per cent to around $7 a barrel, based on a posted price of $11.651 for Arabian Light compared with £5.036 the previous month.

Price Increases

It was largely the fear of shortages last year – when supplies were tight because of a high world demand, especially in the USA, to meet industrial expansion – that spurred many independents and consumer governments to bid up the price of participation and nationalized crude. The shortage has, of course, been made immeasurably worse by the cutbacks in Arab production for political reasons. With "consuming" governments attempting to put a ceiling on product prices to control inflation, and in any case limited by a lack of foreign currency in their ability to pay for the oil, it is probable that some of the independent buyers, including a number of speculators who had never been involved in the oil business before, may have burned their fingers. Even some governments such as the Indian, which sought to by-pass the oil companies which were their regular suppliers by purchasing supplies direct, may now have cause to regret their decision. For example, although the tax-paid cost to Aramco for most of its production is now just over $7 barrel, for the original purchasers of Saudi participation oil the cost has escalated to over $10 (93 per cent of the posted price).

Oil is now entering the world market at such a host of different prices that it is impossible to predict accurately the cost of imports to the consuming countries in 1974. A major uncertainty is the level of government participation that may be reached this year as a result of re-negotiation of previous agreements. Whether a 60 per cent or a 100 per cent equity share is achieved by the Arab governments, a major determinant of prices will be the proportion sold back to the companies and at what price.

At the current OPEC price level (which has been frozen until 1st April) the following is an example of the cost of a representative 1 million barrels Saudi Arabian Light crude under the terms of the original participation agreement.

	barrels	
Aramco share		
75% at tax-paid cost of $7.108 a barrel	– 750 000	– $5 331 000
State share		
12.5% bridging crude at $8.436 a barrel	– 125 000	– $1 054 500
7.5% phase-in crude at $7.458 a barrel	– 75 000	– $559 350
5% direct sale at $10.835 a barrel	– 50 000	– $541 750
	Total	– $7 486 600

This gives an average price of $7.487 a barrel which, if multiplied by a possible 1974 production of 3 000 million barrels and taking into account the fractionally lower prices for other Saudi Arabian crudes, would give Saudi Arabia a revenue of some $21 billion, compared with just over $3 billion in 1972. But in fact, the producing countries have been demanding higher buy-back prices which will raise revenues even further. There are obvious uncertainties depending on the exact levels of bridging, phase-in and direct sale crudes, and at the prices being obtained Saudi Arabia and others might wish to take some of the 12.5 per cent royalty oil to increase their direct sales. Another imponderable is any revision in the level of participation. Should Saudi Arabia achieve a 60 per cent equity, for instance, and with corresponding increases in the three types of crude available, the average price (at present levels) would increase to about $8.550 a barrel, giving an income of $25 billion on a similar production. This difference alone is more than Saudi Arabia's total revenues in 1972.

On a world basis, including all the non-communist oil exporting countries and assuming similar price levels, host government revenues under the present participation agreements would total around $116 billion at 1973 production levels, compared with about $15 billion in 1972 and probably around $35 billion in 1973. Should participation be increased to the 60 per cent level with higher buy-back prices, revenues on the same output could rise to around $125 billion. And when freight charges and a minimum level of company profits are added, the consuming countries could be faced with a staggering bill of over $160 billion. But at such costs demand must, in fact, fall since many of the importing countries simply do not have the foreign exchange to buy the same amount of oil.

Such price levels are unprecedented, not only for oil but for any commodity, considering that the actual cost of production averages only from 10 to 30 cents a barrel in most of the countries concerned. It has been estimated by the World Bank that by 1980 the five main Gulf producers alone, after allowing for maximum internal development programmes, could accumulate some $280 billion, well over half of the total world monetary reserves. That figure compares with net foreign assets of $5 billion in 1970 and $20 billion last year. Some of the producers, and Saudi Arabia in particular, see the need for a lowering of prices. Iran, on the other hand, has taken the lead in pressing for even higher prices, although it was only in June last year that the Shah of Iran expressed his opposition to increasing prices on the grounds that it would force Western exporters to raise their prices for the heavy industrial equipment which Iran needed to import.

Shock for the Third World

THE developing Third World is now fully aware of the fact that the high cost of oil will strike a savage blow at its economic welfare. With no exemption from the unprecedented increase in prices, most countries in Asia and Africa will not be able to afford the quantities of oil needed for continued development. Worse still, agricultural output can be expected to stagnate or decline – at a time when expansion is urgently needed – because less petroleum-based fertilizers will be available. This raises the spectre of widespread famine.

The tenor of radio and press commentaries in Asia and Africa has become one of growing concern about the explosive rise in crude oil prices, which will affect national trade and payments so adversely. It is increasingly realized that declining industrial activity and deterioration in the balances of payments will cause the advanced countries to import less from the Third World and export their manufactured goods at higher prices. There is also the clear danger that industrialized nations might have to cut down on their aid programmes for developing countries. International tourism, an increasingly important foreign exchange earner in the Third World, is facing a slump.

Several of the worst hit Asian countries have appealed directly to Arab producers for supplies at concessionary prices on a direct government-to-government basis, thus bypassing the American and British oil companies that are their traditional suppliers. The special committee of the Organization of African Unity, formed to study the effects of the oil crisis on the economies of African countries, has also appealed for preferential prices or, alternatively, for a system of long-term credits to pay for oil.

Although OPEC is studying special schemes to help the "friendly" developing nations out of the financial difficulties it has created for them, no immediate steps have been taken to supply oil at the old prices – a move which could have firmly nailed African and Asian colours to the Arab mast. Instead, there is now talk in Asia and Africa about economic *realpolitik* by the oil-producing countries; and the £50 million loan to be placed in the new Arab Bank for industrial and agricultural development in Africa was seen as "coming back in part as a tip for services rendered" by Kenya's "Daily Nation".

Crushing Burdens

One nation which will have to bear a particularly crushing burden arising from the higher crude oil prices is India, which has just drafted its Fifth Five-Year Plan envisaging an annual growth rate of 5.5 per cent. On our reckoning, India would have to pay some US $1 240 million to cover her imported crude oil needs during 1974, which is around 40 per cent of her potential export earnings and twice her existing foreign exchange reserves (see table). This assumes a landed cost of $10 a barrel (based on an average tax-paid cost of $7.5 a barrel in the Gulf) – over four times the average paid a year before.

India's oil imports come chiefly from Iran, Iraq and Saudi Arabia. Clearly, without concessionary crude oil prices, special barter deals involving steel and jute for oil, or cash aid from these exporting countries, India would have to halve crude oil imports and face a harsh economic depression because it does not have the foreign exchange to pay for so much oil at today's prices. However, it is highly unlikely that any OPEC scheme could rescue India's Fifth Plan, which will also be affected by the international economic repercussions arising from the higher crude prices.

SELECTED DEVELOPING COUNTRIES: IMPACT OF HIGH CRUDE OIL COSTS

Million US dollars

		Oil a) Estimated Cost	Foreign Trade b) Exports	Imports	Balance	Foreign Exchange Reserves c)
India	1972	—	2 372	2 598	(−226)	661
	1973	—	2 934	2 771	163	629
	1974	1 241	—	—	—	—
Pakistan	1972	—	784	644	140	101
	1973	—	983	928	55	254
	1974	266	—	—	—	—
Philippines	1972	—	1 009	1 354	(−345)	309
	1973	—	1 494	1 243	251	606
	1974	693	—	—	—	—
Thailand	1972	—	1 194	1 411	(−317)	838
	1973	—	1 382	1 662	(−280)	1 107
	1974	657	—	—	—	—
Tanzania	1972	—	307	390	(−83)	n a
	1973	—	399	363	36	n a
	1974	62	—	—	—	—
Sierra Leone	1972	—	152	125	27	35
	1973	—	145	125	20	36
	1974	29	—	—	—	—
Sudan	1972	—	355	356	(−1)	38
	1973	—	401	376	25	28
	1974	127	—	—	—	—
Ethiopia	1972	—	183	203	(−20)	53
	1973	—	285	180	105	114
	1974	51	—	—	—	—

a) Assuming normal requirements and an average landed cost of $10 a barrel.
b) Annual rates based on first quarter statistics.
c) End of first quarter 1973.

Source: International Monetary Fund, except oil estimates.

Pakistan will find the bill for imported oil this year, estimated at $266 million, only slightly less crushing. For it would be drained of its current foreign exchange reserves in the year, rather than within six months. The oil import bill would be 27 per cent of Pakistan's potential export earnings, using first quarter 1973 figures which reflect a booming world economy not yet shaken by OPEC.

The impact of high crude oil prices on Southeast Asian nations is similarly disturbing. Here, only two countries – Indonesia and Malaysia – can escape the consequences of reduced supplies and higher prices by virtue of having their own oil production, respectively 1.4 million b/d and 97 000 b/d. This they export at premium prices to Japan and the USA, as internal demand is no more than 170 000 b/d and 84 000 b/d respectively. Appeals from fellow Southeast Asian nations to Indonesia and Malaysia for emergency supplies to plug supply cuts ranging from 20-30 per cent have met with limited response from Indonesia which will supply 5 000 b/d of gasoline to ASEAN countries, 5 000 b/d of fuel oil to Thailand and 8 000 b/d of crude to Burma. China was also able to offer Thailand supplies – 50 000 tons of diesel oil with first deliveries starting in January. An acute shortage of this product since late November has seriously disrupted nationwide road transport and caused a major drop in tin mining, Thailand's third biggest export earner.

Hopes Dashed

Faced with an estimated bill of $657 million for oil imports during 1974, the Thai government has raised the excise duty on gasoline and diesel oil by about 12 per cent in a move to curb demand. The prospect of a permanently adverse trade balance and a total drain of its foreign exchange reserves, have also led the government to announce that it is rushing through plans to invite international bidding from oil companies for rights to develop an oil-shale deposit in Tak Province. These were estimated by a recent UN survey to contain about 670 million tons of low-sulphur oil, which compares with a current internal demand of around 9 million tons of oil a year.

The Philippines sees its hopes for a continued economic recovery, begun in early 1973, dashed now that she would have to pay an estimated $693 million for normal oil imports this year. This estimate, also based on $10 a barrel landed cost, is conservative compared with $10.80 fob for crudes produced in neighbouring Indonesia, reflecting probably more precisely the cost of alternative Middle East crudes in the Southeast Asia area. Again, the estimated oil import bill is more than the country can expect to earn net from its trade and more than its foreign exchange reserves. The government has already introduced gasoline and diesel rationing. It is seeking to barter Iranian oil for cement and sugar, while it has also started negotiations for petroleum products supplies from China.

The cost of Black Africa's oil imports – despite its solidarity with the Arab cause – will also be high. The total is estimated by OAU's oil crisis committee at $1 000 million during 1974, $600 million more than the 1973 oil imports bill. The new-found solidarity between Black Africa and the Arabs, which for historical reasons must be considered fragile at best, is showing strains now that the Arab oil weapon hangs over the delicate national economies (see table). Diplomatic pressures on the Arabs for concessionary oil prices and special loan or barter deals to safeguard economic viability have been intense, without significant results so far.

In our calculation of the impact on selected African countries, $10 a barrel has again been used, although the landed cost will tend to be lower in Northeast and East Africa which are closer to the Gulf. It shows that the cost of oil to the Sudan, closely allied to the Arab world, would be particularly severe to its trading and foreign exchange positions.

Fertilizers and Chemicals Affected

Apart from the crushing burden on the export earnings and currency reserves of developing nations, high-priced oil in short supply threatens to dislocate agricultural production – in developing and advanced countries alike – because petroleum (oil or gas) is used not only for the manufacture of fertilizers, but also for powering irrigation pumps, tractors and drying equipment.

The Japanese Fertilizer Association has indicated that the country's output of urea and ammonium sulphate would have to be reduced by 24 and 18 per cent respectively, resulting in delivery cuts of fertilizers to India and other developing countries in Asia. Even in the American Midwest, farmers are clamouring for fertilizers now that a worldwide supply shortage has become severer because of the oil crisis, with prices skyrocketing beyond the purses of the poor. (New York fob price of ammonia last year rose from 1.30 US cents per lb to 3.95 cents.)

India is expected to have to make do with 2.5 million tons of chemical fertilizers this year, compared with 3.5 million tons in 1973 – a shortfall which will cause an estimated reduction of some 10 million tons in India's potential grain harvest. The fertilizer shortage in America is expected to be more than 1 million tons this year, resulting in a reduced output from land which increasingly needs chemical fertilizers to provide food for peoples whose continued expansion presses relentlessly on the limits of arable land and agricultural technology. The supply and pricing of oil have now aggravated an already difficult worldwide food problem. And experts see no end to the worldwide shortage of chemical fertilizers because of the huge capital requirements for new plant and the large amount of energy needed to make fertilizers. (One ton of oil makes one ton of ammonia which converts to 2-3 tons of fertilizers, depending on the type.)

Reports from Asia also indicate that Japanese supplies of chemical raw materials for the manufacture of plastics and synthetic textiles have dropped severely, leading to a reduction of manufacturing operations in many Asian countries. Insufficient supply of bunker fuels is expected to result in a sharp decrease in the volume of trade between Japan and the rest of Asia, which will also affect iron and steel deliveries. Increasing shortages and rising prices of Japanese exports will force many Asian countries into changing their economic development directions.

The recent Tidewater Conference of aid-giving nations found that the developing countries which do not possess oil will be affected to a greater extent than the industrialized nations by the oil crisis. The Shah of Iran in announcing the extortionate prices fixed for 1st January spoke of a "new equilibrium" between rich and poor. But the quadrupling in twelve months of the price of so vital a commodity to rich and poor nations alike is hardly the way to close the poverty gap.