If 1973 was Repeated –

*By Silvan Robinson**

Let nobody be under a misapprehension. It could happen again, indeed probably will happen again. When one considers the cocktail of stresses and resentments which characterizes the Middle East it is odds on that some accident will happen. The strident Arab/Israeli tensions, the rise of Fundamentalism, the youth unemployment, the likelihood that more than one Middle East power will soon have nuclear or biological weapons, or both, lead to this inevitable conclusion, so uncomfortable to liberal economists who like to think that the mutual self-interest of trade leads to peaceful relations. We had better be prepared, or at least know what we are in for. For the most part we are not.

The Commanding Heights

The 1973 crisis erupted on an oil world very different from the one we know today. Dan Yergin, in his recent book, has traced the evolution of the postwar industrial structure of control by governments of the "Commanding Heights" (apparently Lenin's phrase) to one where power has shifted to the market. Oil is only exceptional because its scope was international, and control was vested in the major oil companies, not governments. The battle was about who should control the Commanding Heights, not about whether they should be there.

To be sure, there were signs of decay of the control being exercised by the Eight Sisters (including CFP) by late 1973. Demand was escalating, Libya was taking advantage of pressure on prices. Texaco had broken the line. The Teheran Agreement was under threat. But the industry was still in a position to negotiate collectively under the watchful eye of John McCloy by special dispensation from the Justice Department. The Yom Kippur War changed things fundamentally and forever. The challenge came on three fronts – on price, on volume cutbacks and on destination control.

The Price Issue

I recall vividly stepping out of the Exxon plane one gray October day in Vienna with the industry team led by George Piercy and going straight into the meeting with the OPEC Ministers (I was allowed in as a sort of bag-carrying voyeur). The Yom Kippur War had just started. It was immediately apparent that the rules of oil engagement had also changed. OPEC was no longer talking about inching up the price gradient agreed under the Teheran formula by imperceptible stages, but about a massive hike – an extra three dollars, doubling the price. George Piercy responded that such a hike became a matter for governments not commercial companies. Amouzegar, the Iranian Oil Minister, started a long speech. Yamani in the chair yawned, having heard it all a dozen times before, got up and shuffled out of the room, Amouzegar still talking. That was the last occasion the industry confronted OPEC to negotiate prices as a body. Price management passed to the producers. As is well known, the second OPEC price hike took prices to $12 a barrel. This was still well below the price of $19 achieved at the notorious Teheran auction. But the producers, no more than the companies, believed that the emerging (and small) open market should actually control prices rather than influence them. The final decay of the controlled market happened much later, in the aftermath of the second oil crisis.

Cutbacks

What really scared the industry and consumers was OPEC's rolling program of production cutbacks. Whether the comparatively brief period in which these were in place led to an actual shortage or the appearance of one, two lessons emerged. The first was that when consumers panic, there is a run on stocks. If secondary distributors and consumers decide to build up stocks (keeping the car's gas tank full rather than half empty), there is a run on primary stocks and shortages happen. The second is the concept, much canvassed by energy economists at the time, of the backward sloping supply curve. It was observable that the more OPEC cut back volume the higher they could raise the price, to the huge short-term benefit of their budgets. Once they had got a taste for this, where would it end? This was the question which much exercised economists at the time. We now know where it ended: in failing demand and weakening prices. The process begun in 1973 is still with us. The 1973 price explosion saved the economics of North Sea development (and gas projects like Brunei LNG). Non-OPEC production has never looked back. The lower prices and loss of demand were the direct cause of the fall of the Shah of Persia.

The third oil weapon was boycott, named after a certain Captain Boycott of Irish revolutionary fame. There is no question that the concept of cutting off supplies to unfriendly states did carry a strong political message. The boycott was circumvented primarily by the ability of the central supply functions of the oil Majors to reallocate supplies around the globe on the principle of equal misery. Perhaps the most-remarkable example of the power of the Majors was Shell and BP's confrontation with the British Government under Ted Heath. Heath had sent Peter Walker to Saudi Arabia to negotiate a special supply of 300,000 b/d of oil for Britain. Unwisely, Walker handed this over to Shell and BP to administer, who promptly fed the oil into their general supply systems to make up, inter alia, for the boycott of Holland. A ranting Ted Heath could not budge them. The result was that UK power stations were short of oil when the miners' strike cut off supplies of coal. Ted Heath fell. Margaret Thatcher took over as Conservative leader and Thatcherism was born. Out of such unpremeditated consequences is history made.

This ability to shuffle oil around the system broke down when the supply systems of the Majors came to be replaced by commercial arms length dealing and the emergence of oil trading companies like Phibro, a process that had begun when the second oil crisis hit. The IEA's oil sharing mechanisms were based on the assumption that oil companies retained this power. They do not.

There would have been no way by the time of the second oil crisis in which the Majors could have reallocated oil by administrative means, far less today. The only way of securing oil is price. He who has the biggest purse will get the oil. That is the simple message.

The Changed Oil World

It requires a serious effort of imagination to recapture the business mind-set of 25 years ago. Fundamentally, four

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things have changed.

1. "Supply" has everywhere given place to trading.
2. The OECD no longer dominates international trade.
3. Oil is now almost exclusively a transportation fuel. The potential for substitution between oil and other under boiler fuels is minimal.
4. Non-OPEC supplies have grown enormously in importance.

It is worth examining the consequences of these changes.

The Impact of Trading

At the start of the second oil crisis the market was still dominated by long term contracts and prices based on OPEC official selling prices. Although in retrospect there never was an oil shortage in 1979-81 the perception was there. Traditional supply patterns were disrupted, price premia were introduced to the market by some producers, oil was withdrawn from the contract market and offered out spot. The actual size of the spot market was not enormous, but rather like a volcano, pressure exerted on a narrow front exaggerated the impact. Saudi Arabia in particular made efforts to restrain official prices, without, however, understanding the dynamics of supply disruption and the need to keep a balance between crude long and crude short companies.

The period of crisis was the prelude. It loosened the system up and taught the market new tricks. "They have taught me language, and the profit of it is I have learned how to curse" said Caliban. When oil demand began to collapse in the early 80s, product prices also collapsed. Refiners put pressure on their suppliers to supply crude at bargain prices, with the very real threat that they could always look elsewhere. Increasingly trading companies had to subordinate supply security to the best short-term buy, however much this upset Managing Directors in their ivory towers, who did not like the threat to their authority any more than OPEC did.

The era of the spot market had begun. Term contracts had to be accommodated to the going market price and post-1985 all OPEC crudes abandoned the idea of setting prices in favor of mimicking the price structures of the markets into which their oil was sold. OPEC has never learned one of the primary lessons from the Seven Sisters, that integration is useless unless the oligopoly is lateral as well as horizontal with rules carefully constructed to prevent overproduction at the margin and excess capacity development. As Robert Mabro has recently elegantly put it, you have to mind both your p's and your q's – your prices and your quotas – if either is to be effective.

The period of price hedging had begun. I recall the gasps of astonishment at an Oxford Energy Seminar when I held up a diagram of one of the first "daisy chains" – 30 transactions long. A forward market developed, and alongside it a futures market. The Wall Street traders began to show off their pyrotechnics. It was all quite exciting. Trading organizations in the Majors had to adapt very fast to survive.

The growth of demand outside the OECD has transformed the pattern of international trade. In a crisis the OECD could no longer act unilaterally to control the market, even if it had that capacity (which it does not). This means that in an open market oil will flow to the highest bidder, whatever officials may think. Non-OECD is not going to show any discipline.

The effect of oil becoming a transport fuel is that there is much less price elasticity and substitutability. There is relatively little scope for switching power stations over to coal or gas. This means that there is no self-correcting mechanism adjusting demand to rising prices and lower supply.

Non-OPEC capacity adds little to flexibility. The growth of non-OPEC supply may create a small buffer because it is always possible to squeeze a bit of extra oil out of a production system in the short term. But non-OPEC runs flat out. Flexibility is limited.

In a Crisis, What Would Happen Now?

The Gulf War never really produced an oil crisis. Volumetrically oil lost from Iraq and Kuwait was replaced by Saudi Arabia and Abu Dhabi. There was a sensation of unease and the market responded. But the reality was that there was no shortage. A sensible release of some U.S. reserves calmed nerves at a critical point and things rapidly returned to normal. This was not, as is sometimes suggested, a triumph of the futures markets, giving the opportunity to buy forward and so reducing pressure on the physical market. It was simply a consequence of the crisis never having existed in the first place.

But supposing a real crisis did develop with serious disruptions to supply, perhaps boycotts? The defenses are perilously weak.

There are no government selling prices to act as a lagging mechanism in an exploding market. There are no sharing mechanisms that can be put in place. Efforts by one consuming country to put a cap on consumer prices would simply lead to the oil going elsewhere to the highest bidder. OECD on its own would be ineffective without the growing markets elsewhere joining the club. The futures markets are paper markets without any real impact on the supply/demand equation. Demand for automotive fuels, cushioned by high consumption taxes is seriously inelastic. It does not look good. And yet the chances are that another crisis will happen.

There is only one solution: to impact on the supply/demand equation through the emergency use of strategic stocks. The fact is that stocks everywhere have been run down by commercially correct "Just-in-Time" policies. Governments, including the United States, find the sale of Strategic Stocks a budgetarily convenient thing to do. Strategic Stocks are available very unevenly around the world and are far too small. Their use in a crisis does not necessarily add to the oil flow to the country releasing them, but it does help to calm markets.

An urgent rethink of the Strategic Stock issue ought to be a major international preoccupation. But governments prefer to play with aircraft carriers, altogether more dangerous toys and probably less effective. An oversupplied market is just the time to reopen the debate on stocks. This is not something that producer governments should feel sensitive about. It is in their interest, quite as much as that of consumer governments, that unease over the risk of crisis should be reduced. It will always be there, but the knowledge that there were sufficient stocks to calm markets and provide a breathing space would make the consuming world a lot less anxious about a renewed reliance on Middle East supplies. The economic cost of putting oil into storage is simply the cost of production. Why should not Saudi Arabia ship some of its oil out of the ground in Saudi Arabia and into the ground in caverns elsewhere? The economic benefit is unquantifiable.

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