

## Understanding The World Petroleum Market

Crude oil. Black gold. Petroleum. It is the energy source that dominated the 20<sup>th</sup> Century and will continue to be pivotal for the foreseeable part of the 21<sup>st</sup> Century. It is the most versatile energy source available today. It is the most political of energy sources – the resource that makes countries go to war, the resource that countries must have to wage war. And yet, it is also a commodity – like sugar or pork bellies. It is the single largest commodity in international trade and has been one of the most volatile.

As the 20<sup>th</sup> Century began, petroleum was being found, produced, and wasted. In the US, states had to step into the production of petroleum to protect their resources. They created commissions to determine where wells could be developed and how much they could produce – forcing conservation and stabilizing the supply and price. After World War II petroleum's global nature changed the supply structure. As US demand increased and foreign supplies of petroleum became available, prices were largely defined by what refineries were willing to pay. This system worked fine for refineries but not for producers, particularly foreign producer nations that relied on petroleum sales to fund their national budgets. It led in part to the creation of the Organization of Petroleum Exporting Countries (OPEC).

By 1973 OPEC controlled enough petroleum production that if it acted collectively, it could determine whether the world had enough supply or too little; it could define the market price. Driven by political events of the time, a band of OPEC countries found the will to restrain exports and OPEC dominance of prices began. Like all cartels, OPEC's strength is in solidarity and trust. By 1986 this trust was lost and OPEC members began competing for market share, driving prices to their lowest levels since the early 1970's.

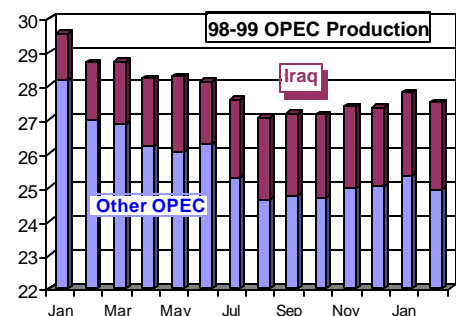
Ultimately, the OPEC infighting ended and new production quotas were devised. But, at the same time, a profound change in petroleum pricing was beginning. In 1983, the New York Mercantile Exchange began to trade oil futures on its commodity market. Over time, commodity market trading would become the price maker. Petroleum prices would not be set by regulators controlling supply, by refiners stating what they would pay, or by OPEC oil ministers setting production quotas. Instead, the oil market would be defined on the tumultuous and volatile trading floors of the NYMEX. We are seeing the consequences of this change.

### *1998-99: Low Oil Prices and the Crisis They Created*

In late 1997 several events combined to initiate a precipitous drop in world oil prices – events that continue to affect current energy issues. First, Asian economies, which had been generating the greatest increases in petroleum demand, suffered substantial contractions – lowering their growth in petroleum use. Second, OPEC – not perceiving this situation – agreed to increase production quotas. Third, the Northern Hemisphere benefited from a mild winter – reducing its petroleum demand. Fourth, weakness in the Russian economy resulted in higher exports of Russian petroleum. Fifth, Venezuela and Saudi Arabia engaged in a market share battle that led to higher volumes of petroleum exports.

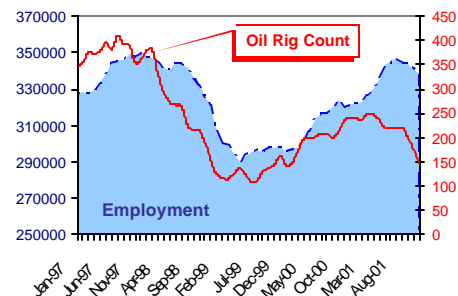
Taken together, these events triggered price drops on the commodity markets. OPEC then recognized the nature of the events and initiated production reductions, but a new factor was surreptitiously entering the arena. Iraq's petroleum production is defined by the UN sanctions program. With little notice, the UN allowed Iraq to increase the amount of production it could legally sell. At the beginning of 1998, Iraq exported roughly 500,000 barrels/day. By the beginning of 1999, Iraq was exporting 2.5 million barrels/day. This dramatic increase occurred while other OPEC countries were reducing production. Virtually every action to bring supply and demand back into balance was offset by Iraq increases. The commodity markets continued to drive prices down.

The consequences to petroleum production were devastating. Capital investment to develop new reserves and to maintain existing production was slashed throughout the world. Even the OPEC countries curtailed development projects to divert diminishing petroleum revenues to maintain their national budgetary commitments to their citizens. IPAA warned in early 1999 that this loss of capital could produce serious production capacity limitations as early as 2000 because the loss of an investment year in the petroleum production business creates a critical time lag.



## 1999-2000: OPEC Rebounds, But the Damage Is Done

In March 1999, OPEC countries agreed to substantial reductions in exports; Mexico, Norway and other producer countries joined in. Prices began to rebound, and so did demand. The US economy remained robust and Asian economies recovered. By year's end, prices had returned to 1997 levels, but by then the consequences of a year's lost investment began to tell. In the US, where 65,000 upstream jobs had been lost, only 7,000 had been recovered; where the oil rig count had fallen by 331, it had increased by only 67. Internationally, the results were similar. Strapped for revenues to meet national budgets, new production remained undeveloped and existing production was not maintained.

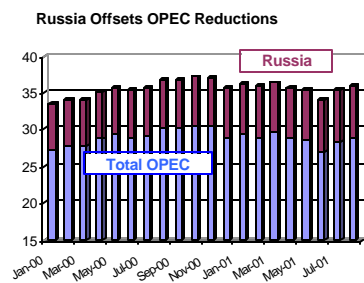


Continued demand growth and reducing inventories of petroleum were leading NYMEX commodity prices still higher. In March 2000, OPEC acted again – this time to increase production. It was not an easy task. When OPEC agreed to cut production, Saudi Arabia agreed to the biggest reduction – in part to offset the increased share that Iraq had acquired. Yet, when increases were at issue, no other OPEC country wanted to cede market share to the Saudis, but many countries had now lost their previous production capacity – the inevitable consequence of lost investment.

While Americans demanded that OPEC “open the spigots” and let the oil flow, the reality was that the capacity was not there except for Saudi Arabia, Kuwait, and the United Arab Emirates. Even after a year of high petroleum prices, new capacity was lagging because of the low prices in 1998-99.

## 2001: Price Bands, Recession, Russia, and Security

Reacting to the low price crisis, OPEC began to try to control production to keep its crude oil within a price band ranging from \$22 per barrel to \$28 per barrel. This range reflects a balance that OPEC believes provides their nations with the income necessary to meet their citizens' needs at the low end but maintains a price that does not hinder the world's consuming nations on the high end. However, as 2001 began, the strain on worldwide production capacity limited OPEC's plan; prices exceeded \$30 per barrel. However, prices drove conservation and the developing recession in the United States began to drive demand – and prices – down. OPEC initiated production cuts within its membership, but the commitment to meet quotas had waned and targets were not met. Following September 11, demand and prices began falling to levels not seen since 1999. OPEC currently seeks to further reduce production to bring supply into balance with demand. However, it also seeks commitments from other key exporting nations – Mexico, Norway, and Russia – to reduce production as well.



Russia's role has become a linchpin to the course of future crude oil supply politics. It is now the second largest oil producer in the world – trailing only Saudi Arabia. Its crude oil production has increased by more than 900,000 barrels per day since January 2000. This increase has essentially offset the reductions OPEC has made to stabilize crude oil supply. Without significant action by Russia to reduce its production, the world risks an oil price war that can result in adverse consequences to both global and national security.

In “Cheap Oil Comes at a Price”, *Washington Post* reporter William Drozdiak observes that low oil prices can help bring nations out of a slump. “But lower oil prices also raise the danger of economic turmoil in parts of the world where the United States is seeking help in its war on terrorism. If the Organization of Petroleum Exporting Countries fails to persuade key non-OPEC oil producers to cut production, a further plunge in oil prices could destabilize much of the Persian Gulf region.” It is a consequence that could impair future international efforts.

US production is equally in peril. About 20 percent of domestic production comes from marginal wells – wells that are the most vulnerable to low prices. Since the 1998-99 low price crisis, domestic production has dropped by over 10 percent – to 5.8 million barrels/day. Most of this loss comes from closing marginal wells. It has largely been replaced by imports from Iraq. National energy policy must reflect these evolving realities. *To meet future natural gas demand and provide the nation with its true strategic petroleum reserve of oil – domestic production – national policies must recognize the importance of a healthy and sustainable domestic exploration and production industry. Efforts must be undertaken to seek policies to assure a stable world crude oil market that protects US energy security.*

