The *impact* of Black Tuesday on *oil markets*

'War? What is it good for?' asks the soul lyric sung by Edwin Starr. Certainly not the stability of oil prices

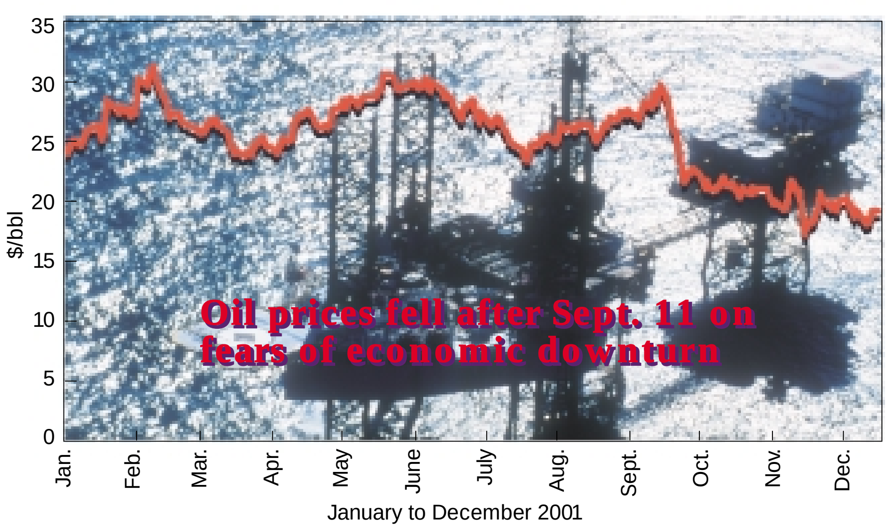
By Peter Stewart

World oil markets have always reacted predictably to the prospect of hostilities in the Middle East: Prices surge. Sept. 11, 2001, was no exception. But the gains that day were short-lived. Fears that the ongoing worldwide economic slowdown would further slash demand for oil, and the Organization of Petroleum Exporting Countries' (OPEC) insistence on keeping market share, subsequently drove oil prices down by more than a third.

Within minutes of the attacks on the World Trade Center and Pentagon, the price of oil surged around 10%, or $3/bbl. The leading world benchmark crude, Brent Blend from the North Sea, hit a high of $31.05/bbl in futures trading on London's International Petroleum Exchange in the panicky aftermath of the attacks.

But since then, oil prices have fallen to as low as 45% of their 2001 highs. The IPE Brent contract closed at $28.87 on Sept. 11, and within 24 hours of the reopening of the New York Mercantile Exchange on Sept. 17, Brent crude dropped nearly $4/bbl from the highs to $27.20. Losses accelerated in the following week as fears took hold that the terrorist attacks threatened to precipitate a global recession.

Two weeks after the attacks, IPE Brent was teetering at around $20/bbl. Oil futures markets virtually ignored the start of U.S.-led military action in Afghanistan, blipping higher by just 50¢/bbl before resuming their downward slide. By the time markets entered the fourth quarter, which is usually a time when prices are strong because oil companies build their stocks ahead of the winter, Brent prices had dropped briefly to below $17/bbl.



Platts dated Brent prices (price of physical cargoes of North Sea Brent Blend, a leading international benchmark grade of crude oil)

Fears of recession linger. A succession of inventory reports from the U.S. in the immediate aftermath of the terrorist attacks showed sharply higher gasoline stocks, which analysts believed could only be because citizens were simply too shocked to go about their business as usual. Many ordinary people were simply sitting in front of their TV sets watching the bad news roll in, and leaving their cars in the garage.

Once the immediate shock of the attacks wore off, however, markets did not go back to "business as usual." The trend towards higher stocks was confirmed by late-year International Energy Agency (IEA) reports that showed signs of strong stock building activity, particularly in the Asia-Pacific region. The IEA predicted that stocks would remain significantly above 2000 levels during the northern hemisphere winter, partly because of slack oil demand.

OPEC vs. non-OPEC

With oil demand growth shrinking, OPEC appeared to shift its priorities from keeping prices stable to keeping its market share. Evidence for the shift came from its meeting in Vienna on Nov. 14, when OPEC asked non-OPEC oil-producing countries to share in cutting production. OPEC promised to cut production by 1.5 million bbl/day, but said it would only implement the

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cut if key non-OPEC producers reciprocated with a combined reduction of 500,000 bbl/day. This reflected a desire to maintain market share relative to non-OPEC countries—in particular, Russia, whose production has been rising rapidly in recent months after years of stagnation.

In Vienna, OPEC's leading members were said to be frustrated because non-OPEC countries, while paying lip service to the need for production restraint, were doing nothing to rein in oversupply. In particular, Saudi Arabia was thought to be angry at Russia's offer to cut daily production by just 30,000 barrels, which many in the market saw as derisory. Norway, Mexico, Oman, and Angola also promised production cuts.

Because oil markets had anticipated that OPEC would cut unilaterally, oil prices dropped sharply when it became evident that the cuts were conditional. Mutterings that a price war was brewing were officially denied by OPEC, but reflected the fractious mood of the Vienna meeting. Although Russia raised its offered reduction—first to 50,000 bbl/day, and then in December to 150,000 bbl/day—the damage was done: OPEC and Saudi Arabia in particular received the news of the proposed deeper production cuts by Russia with skepticism. A Saudi oil source said it was "a step in the right direction" but noted that the Kingdom had expected more from Russia.

'Bear' market?

Underlying OPEC's sensitivity about non-OPEC supply is the fact that Russia's oil production had risen rapidly in 2001, at a time when ties between Russia and the U.S. have warmed. Russian production dropped to 5.89 million bbl/day in 1998, but as oil prices have improved, daily output has recovered to more than seven million barrels in 2001. The IEA forecast at the end of 2001 that, of total world oil supply growth of around 920,000 bbl/day in 2002, Russia would contribute 430,000 bbl/day—more than 46% of the total growth forecast.

OPEC's leading member, Saudi Arabia—the world's biggest oil exporter—has in recent years been a key ally of the U.S. in the smoke-and-mirrors world of Middle Eastern politics. But the Saudis are acutely aware of their position in the Muslim world, and in the past have had close links with the Taliban. Their position in the wake of the Sept. 11 attacks was ambiguous. Although the Saudis on Sept. 25 severed diplomatic ties with the Taliban, for instance, they also refused to allow the U.S. to launch attacks on Afghanistan from Saudi soil. The perception has grown that Saudi Arabia's support for American action against the Taliban was lukewarm.

Oil market observers now see Russia as a possible alternative supply source, given the political instabilities in the Middle East. Whereas Saudi Arabia at times appeared tentative in its support for the American-led anti-terrorism campaign in Afghanistan, Russia welcomed it, and relations between Presidents Putin and Bush warmed several degrees in 2001.

In the light of that rapprochement, OPEC has a delicate task at the moment. Since March 2000, it has staunchly defended a $22-28/bbl price band for what is known as the OPEC basket—six crude oils produced by OPEC's 11 members, and one non-OPEC grade, Mexico's Isthmus crude.

In theory, the producers have in place an automatic mechanism that works as follows. If the OPEC basket slips below $22 for 10 consecutive trading days, the cartel cuts production by 500,000 bbl/day. If the price breaks above $28/bbl for 20 consecutive days, it increases production by the same amount. However, that mechanism was not activated after Sept. 11, because of OPEC's concern that it would lose market share to non-OPEC countries.

Balancing act

OPEC's decision to target $25/bbl in 2000 came in the wake of a devastating drop in oil prices, which was triggered in turn by the dampening of oil demand growth caused by the 1997 Asian economic crisis. In December 1998, Brent crude dropped below $10/bbl, its lowest level in 12 years.

But with the world teetering on the edge of recession, any attempt to boost oil prices would risk dampening demand for OPEC oil further. OPEC's own economists predicted in the aftermath of the terrorist attacks that the economic downturn after Sept. 11 could reduce world oil demand by 500,000 to 800,000 bbl/day.

OPEC has faced the price/market share dilemma for years. On the one hand, if it constrains supply, oil prices rise—but that encourages non-OPEC producers to invest and, in the long run, builds non-OPEC market share. But on the other, if it opens the taps, oil prices tend to crash to below $10/bbl, as they did in 1986 and 1998, and at that price level most OPEC producers—even those Gulf states with the lowest production costs and the deepest pockets—struggle with their budgets.

The delicate act of balancing price and market share is likely to continue. Analysts believe that OPEC's share of world oil demand is likely to rise over the next decade or two because OPEC's Gulf members have the largest oil reserves. But they also say that in the short term, OPEC will struggle to maintain its share of the demand pie. The IEA, for instance, estimated in late 2001 that the call on OPEC crude for 2002 would average 25.9 million bbl/day—compared to a projected 26.5 million barrels in 2001, 27.1 million in 2000, and 27.7 million in 1999. ■