'The end of cheap oil' from Le Monde (25 October 1993)

Caption: On 25 October 1993, 20 years after the decision by the members of the Organisation of the petrolium exporting countries (OPEC) to drastically reduce their oil exports, the French daily newspaper Le Monde restates the economic and political reasons for this decision, which was at the origin of the first world oil crash.

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Twenty years ago

The end of cheap oil

by Philippe Simonnot

On Wednesday, 17 October 1973 a handful of men, half of them clad in jellabas, stayed closeted for several hours in the tiny conference room of an undistinguished building in Kuwait. It was Ramadan, and the dawn-to-dusk fast did not end until 5 p.m. 'Time for breakfast,' some of them said with a smile as they left the gathering. Others discreetly went off to pray. The overall atmosphere was good, particularly bearing in mind the bloody drama being played out at the same time in the Sinai and Golan Heights, where the Yom Kippur War between Israel and its Arab neighbours had been raging for several days.

The discussion resumed, still behind closed doors. At 8 p.m. came the news which startled the whole world: 'production of Arab crude oil will be cut by 5 %, month on month, until the Israeli withdrawal is completed from all the Arab territory occupied in June 1967 and the legal rights of the Palestinian people are restored.' This was something that even the most pessimistic experts had not dared to predict: here was oil being used as a weapon of war, while the tanks and the missiles were still firing.

Just as the Ministers announced their decision, Kuwaiti television was broadcasting the speech given by Anwar Sadat the night before to Egypt's People's Assembly. No doubt the Egyptian Premier already knew that he would not win the war. But he had won a battle, and that victory was enough to wipe out the decades of humiliation suffered by the 'Arab nation'. He knew, too, that he could count on oil as a weapon, because Nasser's successor, initially discounted by the West but now recognised as a formidable strategist, had planned in advance the blow which was now to fall upon the world economy, a blow which was all the more devastating in combination with the decision taken the night before in the same city of Kuwait virtually to double the price of petroleum set by the Organisation of Petroleum Exporting Countries (OPEC).

Was it predictable, this double blow which threw the international oil market into sudden chaos? With hindsight, it is easy to say: yes, it was, and to be appalled at the lack of foresight shown by the Western governments, who found themselves caught in a stranglehold overnight.

In fact, only a month earlier, on 13 September, no less a person than George Shultz, US Secretary of the Treasury, declared to America and the world that America had called the bluff of the Arab oil producers by making it clear to them that the US planned to push on with a major expansion of domestic energy resources. America's leading financial spokesman was replying, albeit not explicitly, to King Faisal himself, who had dared to say that America's total support for Zionism and its unfriendly stance towards the Arabs made it very difficult for them to go on supplying it with oil. Even though it came from a loyal friend of the US, Faisal's message was quite simply not believable until the moment when Egyptian tanks crossed the Suez Canal. But it had been passed on by the big American companies operating in Saudi Arabia. On 26 June 1973, Otto N. Miller, the President of Standard Oil of California, wrote as follows to his shareholders and his workforce — 300 000 or so strong — recommending that, in their dealings with those around them, they should 'foster the aspirations of the Arab people and their efforts toward peace in the Middle East.' But this move was interpreted as little more than lobbying.

The trauma of 17 October 1973 made people forget that the expression 'oil crisis' actually predates that dramatic day. Ever since the start of the decade, the oil market had been showing signs of nervousness. Between 1970 and October 1973, the price per barrel had risen by 50 %, prompting squawks of alarm from the most seasoned Western experts. Yet the reference price per barrel was still only US$ 2.60. What was going on?

Quite simply, a growing imbalance was developing between supply and demand. For decades, the oil price had been based on the cost of production in the Persian Gulf, i.e. 10 US cents a barrel. At that level, it stimulated consumption of fossil fuels and discouraged the development of oil production anywhere other than in the Gulf. From 1960 to 1972, the West's demand for oil had risen from 19 to 44 million barrels a day, the extra

consumption being largely met by Middle Eastern production. Thus the economy of the West was becoming increasingly dependent on this excitable region.

Royalties and 'posted price'

The imbalance was further exacerbated by the beginnings of the ecology movement, particularly in the USA (World Day in 1970 saw a hundred thousand people marching along New York's Fifth Avenue). This 'green' pressure would have two effects: on the one hand, it further pushed up demand for oil, which was preferred as far less 'dirty' than coal and, on the other hand, it created an additional barrier to the expansion of supply by forcing the Government to back down on developing Alaskan oil: the pipeline bringing oil from the Alaska's far north entailed risks to the natural environment which were deemed unacceptable.

The oil market really started to wobble when the USA, then the world's leading oil producer, was forced to rely increasingly on imports. In 1973, these reached a colossal 6 million barrels a day (equivalent to 300 million tonnes), at a time when domestic US production had plateaued at its 1970 level.

This massive entry of the USA into the oil market not only put a strain on prices; it also upset relations between the big oil companies and the countries in which they operated. In principle, under the system of concessions still in force, it was the oil companies which decided, in line with economic trends, on the oil price and the volume that they would pump. The host nation simply collected royalties, together with taxes on the companies' profits.

The Organisation of Petroleum Exporting Countries, set up in 1960, had made sure from the outset that the fiscal revenues of its members were protected against market fluctuations. The system of safeguards put in place by OPEC, in agreement with the oil companies, was simple: royalties and taxes were calculated on the basis of a (fixed) 'posted price'. The market risk was thus borne in its entirety by the companies.

The scenario changed completely once market prices started to reflect the pressure of the imbalance referred to above between supply and demand. When that happened, the oil companies were paying royalties and taxes which were lower than they would have been if posted prices had shadowed market prices. The producer companies saw their profits rise, whilst the revenues of the exporting countries remained stagnant. OPEC was trapped by safeguards of its own devising. And the higher oil prices rose, the more acutely aware the oil exporting countries became of the drawbacks of the safety net separating them from a share in the huge and unexpected profits which seemed to be coming their way.

The inflation rampant in the developed world was another cause for concern to the members of OPEC, who rightly feared that their revenues would be eroded by having to pay higher prices for the products that they imported from the West. On 15 February 1971, they secured an undertaking from the oil companies that the posted price would be increased by 2.5 % each year (the 'Teheran Agreement'). But here, too, they soon had the feeling of having been fleeced, since inflation in the West was two to three times higher than the annual rate of increase agreed. On 15 August 1971, Richard Nixon also decided to end dollar-gold convertibility and to allow the dollar to float. The result was a de facto devaluation of the US currency.

Turning off the Gulf oil tap

Accordingly, in the months leading up to the double blow of 16 and 17 October 1973, independently of what was brewing on either side of the Suez Canal, tough talks had begun between the oil companies and OPEC to renegotiate the 'Teheran Agreement'. A final round had taken place in Vienna, Austria, on 8 October, two days after the start of the Egyptian offensive. It ended in total failure. One week later, in Kuwait, the petroleum exporting countries decided unilaterally to increase the posted price of oil from US$ 3 to 5.12. As for the embargo, this was designed not just to hurt the friends of Israel. By exacerbating the imbalance between supply and demand a little bit more, it ensured that this new and brutal price hike would be endorsed by the market. OPEC had worked it out: with the world market in its present situation, all that it had to do was turn off the tap of Gulf oil. A piece of cake!

The oil revolution was complete, because the OPEC countries now controlled both the price of oil and the quantities pumped. The way was wide open for other increases, and they were not long in coming. At the end of December in Teheran, the Shah of Iran persuaded OPEC to double the posted price of oil again — to US$ 11.651 a barrel — thus prompting what came to be known as the ‘first oil crisis’. In 1980, the revolution in Iran would trigger the second crisis by pushing the price above US$ 30 a barrel.

The events of October 1973 had also unleashed other forces of which the OPEC Ministers were far less aware: market forces would operate when oil was expensive just as they had done when it was cheap, but the other way round. On the supply side, there would be a strong incentive to develop oil production outside OPEC as well as to find alternative energy sources — coal, nuclear, hydroelectric, solar, etc. On the demand side, consumption of oil would decline, but so would consumption of other energy sources, with the oil price serving as a reference for all energy prices. All in all, the world economy would not only grow more slowly; it would also become less energy-guzzling and, in particular, it would rely far less on oil.

These forces have worked so well over 20 years that, in 1993, the price of oil, in real terms, has returned to its 1973 level, to the point where we now fear a third oil crisis, because of insufficient supply and excessive demand. The story of oil keeps coming full circle!