Saudis declare oil war—British are the target

by William Engdahl

"The Saudis are willing to play this thing through and are willing to scare the daylights out of everybody." This was the comment of a leading analyst with the *Middle East Economic Survey* to the writer on the news that the Feb. 3 Vienna OPEC mini-talks ended with no agreement. *MEES,* which is widely believed to be very close to Saudi official thinking on oil strategy, added that Kuwait privately has stated that it expects "a three- to six-month bloodbath, and they are well prepared to live through it."

Coming out of the Vienna talks, prices of as low as $10/barrel were floated in rumors for the first time since the Saudis triggered the present price collapse last December. Within minutes of the news from Vienna that the OPEC countries will continue to flood the world market with cheap oil until the non-OPEC countries, most especially Britain, agree to cooperate on limiting production, traded market prices for North Sea Brent oil collapsed another $1/barrel, bringing it to below $17 dollars for the first time since 1979. As of the close of trading in London on Feb. 4, Brent had dropped to $15.75/barrel for forward contracts, making almost a $3 drop since the Vienna meeting of the day before. London traders see no bottom in sight.

One leading London source close to the financial community in that leading money center, told this news service on Feb. 4, "The oil price situation is very serious, indeed. Mexico is only the tip of the iceberg. With talk of possible $10/barrel oil, it will be difficult to avoid severe financial disruption this year. The Bank of America, to cite one obvious case, with its large Mexico loan exposure as well as major domestic energy loans, could become the next Continental Illinois." This is a reference to the largest postwar U.S. bank crisis in summer of 1984, which sent shockwaves through the world banking system.

Since the oil price collapsed below the $20 level, widely regarded in the industry as a kind of psychological barrier, a near panic has been triggered in major centers of international banking and among major oil-exporting nations, especially Mexico, the world's fourth-largest oil producer. Mexico late in the week before the OPEC meeting announced a $4/barrel cut in its oil price in response to the falling prices, in coordination with neighboring OPEC producer Venezuela, who also lowered prices to maintain markets. Nigeria, on Feb. 3, announced through its state oil company an increase of production to average 2 million barrels/day for the January-March quarter. Because Nigerian oil is directly comparable with British North Sea crude, the addition of some 700,000 barrels onto the present market will put enormous additional pressure on British production.

Mexico's Finance Minister, Jèsús Silva Herzog, told a conference of the Interamerican Development Bank in London on Jan. 29 that the new oil price collapse had created impossible conditions for the repayment plans to major New York and London banks of interest on their $97 billion foreign debt. The impact of sharply falling oil prices has triggered devastating bankruptcies in areas where the oil industry is concentrated, especially in Texas. One of the world's largest offshore oil drilling companies, Global Marine, recently filed for bankruptcy reorganization on with $1.1 billion of debts.

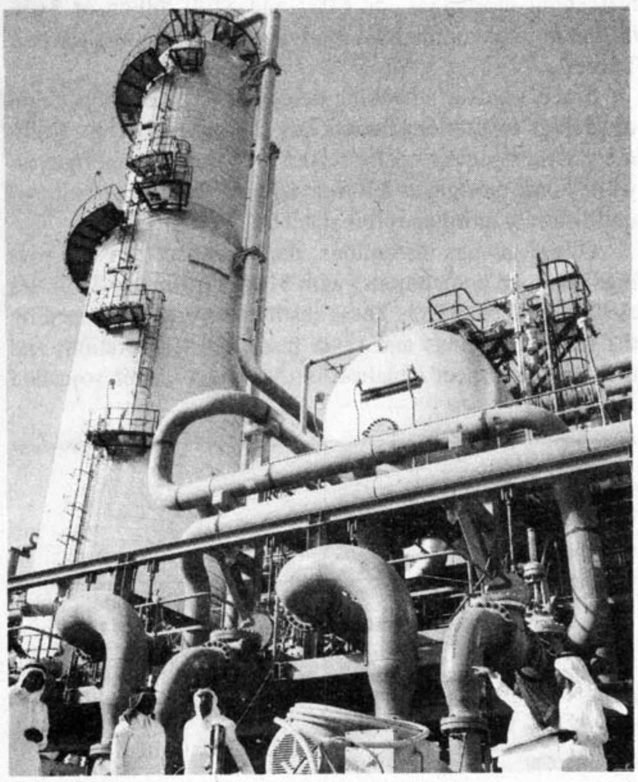
The British pound has also fallen dramatically, to record lows against the German deutschemark, because of the importance of oil to the revenues of the British government. Oil is supposed to bring approximately £11 billion to the United Kingdom's Treasury, until the latest collapse in price.

The Feb. 3 Vienna meeting was of a subcommittee of five OPEC producers—Kuwait, UAE, Iraq, Venezuela, Indonesia—called to discuss details of the decision announced on Dec. 9 of last year at OPEC's ministerial meeting. On Dec. 9, OPEC officially announced it was abandoning its strategy of the past three years—reducing production hoping for future oil demand sparked by the economic "recovery" in the industrial nations to increase future demand for their oil. The chief OPEC victim of that strategy had been the world's largest oil producer, Saudi Arabia. By August 1985, Saudi Arabia had dropped its output down to as low as 2 million barrels/day in a desperate losing battle to stabilize the price. During the same period, Britain—not an OPEC member—steadily increased its production to record levels. In 1985, British North Sea production reached some 2.7 million barrels/day, exceeding Saudi Arabia!

Saudi Arabia has singled out Britain's role in its declarations, insisting that OPEC will continue to produce more oil so long as Britain refuses to discuss reducing its production. On Jan. 28, British Prime Minister Thatcher told the press, as expected, that the U.K. government will not intervene in the rights of oil companies to extract their full production from the North Sea.

Change in the oil market is target

The real target of the Saudi war, according to industry and trading sources we spoke with, is the British role in the past several years to destroy the traditional manner in which countries like Saudi Arabia sold oil to major customers. Before the 1979-80 Iranian oil price shock, falsely driving the price of world oil to the level of $36 to $40 per barrel on the lie that the world was short of the plentiful energy resource, most oil was sold in long-term contract, usually five-year, to



A near panic has gripped the markets, as the Saudis drive down the price of oil. Shown here is a processing facility at Yanbu, Saudi Arabia.

a specific buyer such as France. This method ensured stability and orderly markets. Only 3-5% of total oil was sold to usually small trading companies, odd-lot cargos which could not be delivered. This was called in the industry, the "Rotterdam spot market," because most companies were in the huge Dutch oil port city.

Since 1982 or so, New York and London trading houses, including the major oil companies such as Royal Dutch Shell and British Petroleum, began to destroy the traditional long-term contract market by introducing speculative "paper" markets, called futures—the New York Mercantile Exchange, or the London 15-day "forward" market for North Sea Brent oil. In the spring of 1985, the Thatcher government gave this speculative market a major boost when it announced that the government's British National Oil Company was turning its oil purchases of North Sea oil to "free market" price control rather than contract buying. Some 600,000 barrels of Brent oil is daily available in the forward speculative markets today as a result of this decision. This British action had placed impossible pressure on OPEC long term agreements in recent months.

Beginning September, after repeated pleas to Britain to change, Saudi Arabia began a reverse which, by the third week of January precipitated the current world price collapse. Steadily increasing its production, Saudi Arabia began offering its oil at flexible contracts, six months long, at prices which guaranteed the purchasers a $1.50 *profit* at the refinery of destination. These contracts, known as "net-back" deals because of the novel profit incentive, were snapped up by BP, Shell, Exxon, and the other major oil companies. By the December OPEC meeting, Saudi production reached 4.5 to 5 million barrels/day. Then, beginning about Jan. 2, the Saudis *added* some 3 million barrels/day for three weeks from some 67 million barrels it had stocked in super-tankers off the Japanese coast. These were reportedly bought by the huge Japanese trading houses. With the oil majors and the large Japanese buyers locked in, Saudi Arabia for the moment has created a major problem for British financial speculation strategy.

According to expert industry engineering sources, the Saudis have a long range to wage this remarkable price war. They are able, according to sources, to produce up to 14 million barrels/day at a cost of production of some $1.50 to $1.75/barrel. "If I were the Saudis," the head of futures trading for one major British oil company related, "I would flood the world with about 22 million barrels/day of cheap OPEC oil, force all the non-OPEC players like Britain to collapse operations significantly, then restabilize the market."

Whether they even can at this point is by no means clear, but it is clear that the Saudis are acting as a "loose cannon" on the deck of the world financial system. No wonder reports are that Prime Minister Thatcher is personally traveling to the oil kingdom this month. The question is, what can she offer?