Five Myths About the Oil Industry

Particularly since September 11, global chatter keeps offering up supposedly accepted notions about oil. TIE *asked an expert to address some of the confusion.*

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888 16th Street, N.W., Suite 740
Washington, D.C. 20006
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

BY J. ROBINSON WEST

Since the energy crisis of the 1970s, a number of myths about the oil industry have developed in political and media circles. In the post-September 11 environment these have been raised to near gospel. At times, ideological opponents who cannot agree on most issues subscribe to these myths as if they inherently true. These myths underpin policy initiatives at the highest levels of government. Similarly, these myths fertilize the thinking of the global antiestablishment movement, whether they be anti-globalization activists or anti-war protesters seen recently around the world. The oil industry has done little to counter these legends in general although the industry spends heavily on public affairs editorials and lobbying efforts.

MYTH #1

THE OIL INDUSTRY OWNS WASHINGTON

THIS MYTH misses an important point about Washington: politicians are after votes from their constituents. Oil companies are capital intensive and are not large employers. Moreover, their investment dollars are increasingly going overseas where the real oil/gas assets are located. Yes, oil companies can help provide politicians with money to run their campaigns, but they have increasingly found that politicians will take their money and not always deliver the desired policy.

One reason is that other lobbies have far more political influence than what the oil companies can muster. Take for example the Bush Administration, supposedly the most pro-oil administration in U.S.

J. Robinson West is Chairman of PFC Energy in Washington, D.C.

history. The oil companies wanted three policy changes from the Administration: the right to drill offshore Florida, the removal of ethanol subsidies, and the lifting of the Iran Libya Sanctions Act (ILSA), which bans U.S. companies from investing in those nations.

On all three counts the oil companies lost. On the right to drill offshore Florida, the environmentalists and the Florida tourism industry pressured Governor Jeb Bush, the President's brother, and he appealed to the White House, which ruled against the oil companies. The farm lobby and other agro-business interests defeated the oil industry to maintain subsidies for ethanol (made from corn). And, on ILSA, the pro-Israel lobby prevailed over the oil industry.

As for investing in the Alaska tundra, the Administration has pushed for it while the oil industry has remained lukewarm. Alaskan politicians looking to create jobs and investments are pushing harder than the oil firms. The oil industry, seeking a greener image, is loath to incur more wrath from the environmentalists.

MYTH #2

THE IRAQ WAR WAS A GRAB FOR OIL BY U.S. COMPANIES

THIS MYTH, popular among anti-war demonstrators and Middle Easterners, particularly those from Iraq, follows on from the first one. For if you establish that oil companies are politically influential, then you can easily prove that they could manipulate politicians into invading countries to seize their oil assets. The argument goes that the only thing the United States planned for was to secure the oil fields and the oil ministry. The rest of the government and key sites—even nuclear weapons facilities—were left unsecured, leading to them being looted and burned.

In reality, oil companies were not the drivers behind the war. First, given their sensitivities to shareholders and the stock markets (the principal way CEOs make their fortunes), the last thing the oil companies want is instability in financial markets. Indeed, most oil firms were bracing for lower oil prices once Saddam was removed.

Second, oil companies favored a selected lifting of sanctions on Iraq rather than war. They saw war as too regionally destabilizing, and given the Middle East's importance to global oil the last thing they wanted was more instability in that region. Even with Saddam toppled, people such as ExxonMobil's CEO Lee Raymond warned that it would take some years to develop confidence in the stability of the political and commercial regime in Iraq before any large investments are made. Moreover, of the companies likely to benefit from an open Iraqi oil sector, only a handful are U.S. or British. There are several dozen others who would likely compete aggressively in any bids to develop new Iraqi oil, including French, Russian, Chinese, Italian, and Spanish oil firms. Some were already promised assets in Iraq (Russia's Lukoil and France's Total) and would hardly support the opening up of the sector.

Third, on why the United States went to war, it was about a new strategy that the Bush Administration is pursuing with a whole set of new tactics. Oil only had something to do with it in a vague sense because oil is important to the United States and the Middle East has some. But the specific reasons for the war were rooted in the new strategic ideas of the Administration which call for establishing the United States as the sole superpower with anti-proliferation and anti-terrorism as key means to get there.

MYTH #3

WE CAN REDUCE OUR DEPENDENCE ON SAUDI ARABIA

MANY BELIEVE that by encouraging diversity of supply, the United States will depend less on Saudi oil. Why reduce dependence on Saudi Arabia? Because some say it is politically unstable after September 11 and because beneath the surface of apparent friendship lies a fundamental animosity and hostility toward the United States and its value system.

Even if this were true, which it is not, this betrays a fundamental lack of understanding of how global oil markets work. The world oil markets are fully integrated. As a result, after accounting for quality and distance differentials, there exists a world price (a signal of supply demand conditions) for oil. Boycotting or reducing direct dependence on Saudi oil will not change this—the Saudis can influence the price by simply raising or reducing their production. It is true that the size of Saudi output and more importantly its willingness to hold excess capacity (which enhances it role as a swing producer) gives it stronger market power than other producers. But then the question is more of a political one of whether the Saudis are out to get the West or the United States.

The record shows directly the opposite. True, the Saudis have become less willing to tolerate a lower price band than they used to be in the 1980s, but that has not stopped them, in the context of OPEC, from supplying sufficient oil to the market to ensure prices do not rise to dangerous levels (say above $40 per barrel for WTI crude). Take recent events as a guide: serious market supply disruptions in 2003 in Venezuela due to its oil workers strike, in Nigeria because of ethnic problems, and in Iraq following the U.S. invasion, were offset by Saudi Arabia's willingness to raise production to 9.5 million barrels per day—an unprecedented level and clear vindication of Riyadh's claim that it wants to remain a responsible oil producer. The ultimate point is that the Saudis are the only producer that provides liquidity and stability to the global oil mar-

kets, the Central Bank of oil, and are willing to do it given their long-term geopolitical interests.

MYTH #4

OPEC IS DEFUNCT AND IRRELEVANT, OR A DANGEROUS THREAT TO U.S. NATIONAL SECURITY

WHICHEVER SIDE OPEC detractors fall on, they miss a fundamental point about oil markets. The hostility toward Saudi Arabia often broadens into a distrust of OPEC in general given that many assume that most members of OPEC are Arab. This is partly due to residual anger from the 1973 Arab oil embargo. Here one can only point to Saudi Arabia's role and see that neither the Kingdom nor the rest of the members seek to destroy the market for the only real commodity that they sell. Maintaining consumer trust—damaged as it is—means national survival for many members.

On the other end of the spectrum, many argue the producer organization is defunct or can be made so if we encourage the Russians, West Africans, or the Caspian states to produce more and replace OPEC output. With the invasion of Iraq, many hope that a new administration in Baghdad will pull that country out of OPEC and increase output to undermine the organization, and even hope that this will lead to the demise of the Saudi and Iranian regimes.

Again, what both sides miss is that there has been an OPEC-type—i.e., an organization or group of companies that manage to set an acceptable price range—arrangement in the oil markets ever since the Spindle Top discoveries in Texas in the 1920s. Whether it was the Texas Railroad Commission or the Achnacarry Agreement or the Seven Sisters, prices have been managed by producers.

There is no reason whatsoever for this need to go away. Small U.S. independent producers need OPEC's price management more than ever and in fact sued OPEC for "dumping" a few years ago when prices fell below $15 per barrel. If the United States wants to maintain some level of domestic output given that it is a very mature oil province, it will also need higher prices. Also, the United States will become more supportive of moderate-to-higher oil prices as it restores oil output in Iraq and attempts to grow the Iraqi economy. OPEC will play a key role as Iraq seeks to maximize its government revenue. Therefore, Iraq will need to stay within OPEC and contribute to the organization's price management efforts. In the coming years, OPEC will have its problems, not the least of which is managing its current members' aspirations for higher output now that several have large amounts of excess capacity and Iraq will be back and demand a share of the pie as well. But it has been there before (1988 at the end of the Iran/Iraq war, 1992 when Kuwait returned to the market, and 1997 when Iraq's oil-for-food program started) and is likely to attempt similar efforts in the future. Plus, it will likely face an easier than expected task because of likely delays in Iraq's return as the United States flails around in its attempt to restore order in post-war Iraq.

MYTH #5

OIL COMPANIES MAKE OBSCENE PROFITS

THE LARGEST oil companies do make large profits when industry conditions are favorable, but there are three important points to keep in mind. First, the oil and gas industry is very capital-intensive—more capital is tied up in U.S. and European energy companies (oil, gas, power, and oil services) than any other industry in the developed countries—and this excludes the national oil companies around the world. Thus, the fair way to assess these profits is return on capital employed. By this measure, the oil and gas industry's results (14.5 percent) are in the middle range of other major industries over a five-year average. A number of other sectors have had far higher returns than the oil sector during this period, such as pharmaceuticals (25.5 percent), household products (23 percent) and beverages (21 percent).

Second, oil is a global commodity business that is extremely competitive, and the oil industry has become highly efficient. Being a commodity business, profitability swings widely from year to year, while companies must still invest at a steady pace for projects that have very long investment lead times. Further, U.S. oil companies face constant competition around the globe from established companies, new players, and emerging national oil companies. Most gains in profitability are quickly competed away.

Third, the petroleum industry deals with extreme risks and with billions of dollars on the line. People don't always realize that oil is produced in risky distant countries with enormous capital outlays, transported vast distances, refined in expensive refineries, distributed through a wide network of pipelines, trucks, and wholesale outlets, sold at stations in prime locations, all at a price that is less per gallon than designer bottled water in your supermarket from the next county. At the same time, oil products are heavily taxed, and the industry makes heavy outlays to protect the environment and to comply with strict and expensive regulation. This is unlike any other commodity. The oil and gas industry provides essential goods at the lowest possible cost, with great reliability and security of supply, while still ensuring a cleaner environment.

In conclusion, the oil industry has a colorful history. Some of its myths were once true, but now it's a mature, global, competitive, commodity-based, and capital-intensive industry. It's a tough but important business which doesn't deserve our sympathy, but does deserve realistic understanding. ◆