

# The New World Oil Pricing System—Year 2000

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## WHY OIL PRICES SOARED TO THE \$30+ RANGE THIS YEAR FROM \$10 TWO YEARS AGO

Why? Just a couple of years ago, the WTI oil price was around \$10 per barrel. Much of the annual world statistical data looks fairly normal, but the crude oil price tripled.

Our answer is that the petroleum industry has invited in the financial community to help set the future energy price. In the late eighties and early nineties, many “points” were established where a trader could conveniently make paper (financial) energy trades. The Industry has created futures markets, WTI at Cushing, Oklahoma, Brent at Rotterdam, Natural Gas at the Henry Hub in Louisiana. Fuel Oil and Gasoline in New York harbor. Even Electricity is traded at select points in the U.S.

These crude oil futures pricing signals are mostly based on the industrialized nation’s current oil inventories, and on market psychology—but **certainly not long-term supply and demand trends**. Today’s paper energy traders have zero vested interests in the long-term energy future.

**As a matter of fact, their vested interest is in having the energy markets remain volatile.**

In the fall of 1997, OPEC, meeting in Indonesia, increased their production 2 million barrels per day. This was a 2.5% increase in world volume. With the economic slowdown in Asia, the United States oil inventories reached 50 million barrels above the normal operating range. The N.Y. Merc oil traders looked at this surplus inventory and set the marker oil price in the \$10 per barrel range.

In late 1998 and early 1999, OPEC, with several other countries,

decreased their oil exports 4.5 million barrels per day. This was a 6% decrease in volume. This shrunk the U.S. oil inventories to 100 million barrels below the normal operating range. The N.Y. Merc oil traders then bid up the oil marker to the \$30+ range.

Evidently, the WTI futures price has a close relationship with the oil inventory numbers.

The world oil exporting countries now believe that they can manipulate world oil inventories via controlling production. This effort to raise the oil price was led by Mexican Oil Minister, Luis Tellez. Several non-OPEC oil-producing countries are cooperating with OPEC. Mexico is participating as a de facto OPEC member and even provided most of the leadership to cut world oil production to increase prices.

Now, OPEC supposedly is trying to increase their oil exports, to lower the world oil price to their target \$22 to \$28 range. Even the United States is in the process of taking oil out of the Strategic Petroleum Reserve in order to drive down oil prices.

Ironically, the International Energy Agency (IEA), the organization of consuming nations, provides the energy reporting system, which allows the traders to monitor the industrial world's oil inventories. However, recently there has been an argument within the industry on the accuracy of the oil inventory data. (The missing barrels argument).

Our observation is that the world petroleum data is very suspect. We have said for many years that the data does not reconcile. Most of our peers do not fully understand that the industry operates without good data.

## **THE FUTURE OIL PRICE SETTING MECHANISM**

The question is: Do the world's oil producing countries have the wherewithal to correctly set their oil production and consequently prices **for the good of the energy industry in the long term**? I question they do. My analysis:

The world operates with an inadequate energy model for the long term. The world must operate with suspect energy data. The present oil pricing system, mostly controlled by N.Y. Merc future energy traders, is operating on a short-term oil inventory model. This means that in the future, the oil price cycles will continue to be very volatile. More importantly, the petroleum industry and the energy consumers will have to

learn to live with this constant change.

The world oil producing nations do not have a formal, mandatory process to control world oil production, like the Texas Railroad Commission did for the middle third of the 20th century.

**We have publicly offered a World Oil Stability Policy that would bring stability to both the producers and the consumers. Our formal proposal is documented in the Int'l Association of Energy Economics and the Int'l Energy Agency meeting proceedings.**

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## **ABOUT THE AUTHOR**

**Dale W. Steffes, P.E.**, founder of Planning and Forecasting Consultants, Houston, Texas, is a gifted observer of the international energy scene. He specializes in independent analyses of market opportunities for major energy producers and users. Mr. Steffes' freedom from the strictures which often cause corporate and industry errors in judgment have made his evaluations especially valuable to those executives who understand the merits of a professional outside viewpoint.

Mr. Steffes is a member of *SPEE's* Editorial Review Board.

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