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International Oil Prices

The sharp rise in the cost of imported oil that has occurred this year caught the Administration unprepared. Escalating prices for products on the Rotterdam spot market* flashed early warning signals of the trouble ahead, but they went unheeded. Movement upward began in mid-1978, but in the budget for 1980 submitted to Congress last January, the Office of Management and Budget proposed a cut in energy research and development for synthetic fuels.

The Rotterdam spot market is only a small component of a complex distribution system. But this component is a sensitive fever thermometer—an indicator of trends of future prices. Currently, this market signals further substantial increases in the cost of oil.

For many years prior to the late 1960's, the major international oil companies were in firm control of the production, distribution, and pricing of oil. The seven sisters—Exxon, Texaco, Mobil, Standard of California, Gulf, British Petroleum, and Royal Dutch—held concessions covering the major sources of non-U.S. oil, including the Middle East. Most of the oil was sold on the basis of long-term contracts. For years, the posted price of Saudi crude remained fixed at \$1.73 a barrel.

But all that has changed. As a result of expropriations, the major international oil companies no longer control the supply or price of crude oil, and long-term contracts are a thing of the past. Most oil and its products are still handled on the basis of contracts, but prices are subject to arbitrary surcharges by the Organization of Petroleum Exporting Countries (OPEC).

A small fraction (5 to 10 percent) of the total oil and its products are traded on a spot basis. When a surplus of oil is present, prices may fall below those typical of contracts. But when supplies are short, eager buyers may cause spot prices to move up sharply. This spring, they rose to more than double contract prices. This performance assured OPEC that it could easily obtain much higher prices for all of its oil.

The Rotterdam spot market is not like the New York Stock Exchange or the London Metal Exchange. It has no formal structure or headquarters. It is unregulated. It is the summation of private deals—some made in Rotterdam, but many made around the world. However, Rotterdam is a key center of the oil trade. It is the busiest port in the world. With its superb port facilities and huge storage and refinery capacities, it serves as a major distribution center for much of Western Europe, including West Germany.

Left to their own inclinations, participants in the spot market would reveal little of their activities. But reporting services have arisen. The leader among them is Platt's Oilgram service, an affiliate of McGraw-Hill. A network of employees gather data that are published 5 days a week.

The embargo of 1973-74 brought a quadrupling of oil prices and a subsequent recession that diminished demand for oil. For nearly 4 years, spot prices were depressed. But by 1978, free-world oil consumption had increased, chiefly because of increased U.S. imports. In mid-1978, well before the Iranian revolution, supplies were tight and prices on the spot market were moving up. Subsequently, a drop of 4 percent in world crude oil production led to a doubling of spot prices and the later OPEC increases of this June. Spot prices are currently about 50 percent above contract prices. In this volatile market, rapid movement down or up could occur. A persistent drop brought on by a worldwide recession would signal a period of stable contract prices, but if the present disparity continues, perhaps exacerbated by turmoils in the Middle East, contract prices would be likely to rise toward the level the spot market has revealed that buyers are willing to pay.

—PHILIP H. ABELSON

*A useful series about the Rotterdam spot market by Joe Roeber appeared in the *Petroleum Economist*, February, March, and April 1979. The Energy Information Administration Clearing House of the U.S. Department of Energy now issues a *Weekly Petroleum Status Report* that includes data about the Rotterdam spot market.