Saudi Arabia and the Oil Bank

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This is a guest post by Chris Cook. Chris Cook is a former director of the International Petroleum Exchange. He is now a strategic market consultant, entrepreneur and commentator.

Max Keiser Interview: *Besides writing this post, Chris did a Max Keiser interview on this subject, which is linked here.*

Gail thought it would be a good idea if I put my article for 'Asia Times' - reprinted below – into context. Bearing in mind past discussion, I agree wholeheartedly, and will attempt to do so in this introduction in order to allow Oil Drum readers who wish to do so to engage on my chosen ground, which is the operation and architecture of the global market in energy generally, and oil in particular.

I see two secular trends in relation to the oil price. Firstly, I agree with the Peak Oil case, and consider that if we are not at the Peak level of global production we are close to it. I am not qualified to enter into discussion on that subject, but have learnt a great deal from those on this site who are. Secondly, I see the dollar continuing to devalue against 'real' assets generally and energy in particular, as a result of the fiscal incontinence of the US. Again, there are many better qualified to discuss that issue than me.

The combination of these two secular trends in the long term is that the oil price will, I believe, rise relative to the dollar. It's not Rocket Science. In my view, the oil price will rise over time between trending boundary lines: an upper bound ('seller's market'), at which demand destruction kicks in; and a lower bound ('buyer's market'), where marginal cost of production is the limiting factor.

The main thesis of my article is that there is a comprehensive misunderstanding - particularly in the US – as to what is actually going on in the oil market, and in particular, who is benefiting from the gyrations between these boundary trend lines.

Cui bono? Who gains from what's going on?

• Producers – gain from high prices, but lose from volatility and transaction costs;
• Consumers - gain from low prices and lose from volatility and transaction costs;
• Medium/Long Term Investors – e.g. Exchange Traded Funds (ETFs) gain from higher prices, but lose from volatility and transaction costs;
• Short -Term Investors /Speculators – e.g. hedge funds and investment bank proprietary desks, are transaction-oriented investors who are agnostic as to price, and may gain from volatility, but lose from transaction costs;
• Market-Makers/ Service Providers – are agnostic as to price, but gain from volatility and

transaction costs.

In a nutshell, my thesis is that commercial (initially) and sovereign (now) producers are using cheap money provided by medium/long term investors to keep the oil price at or near the 'upper bound' and thereby maximise their income. They achieve this through intervention in the Brent/BFOE (Brent Forties Oseberg Ekofisk) complex of contracts. The "Dated" BFOE oil price as assessed by Platts price reporters is used as a benchmark price to set - directly and indirectly via arbitrage - global physical oil market prices. The futures markets are the tail – not the dog – and investors are the fall guys for 'macro manipulation' by the real beneficiaries, who are the producers.

I find it fascinating to think that Saudi Arabia may – through the use of the new financial oil leasing techniques I refer to – now be acting to all intents and purposes like a Central Bank aiming to keep an oil currency pegged within a range against the dollar.

So, here goes. . .

“Saudi Arabia and the oil bank”

Reprinted from the Asia Times.

As crude oil prices climbed back over $80.00 per barrel during 2009 - after the dramatic spike to $147 and subsequent collapse to $35/bbl - US politicians and regulators are in no doubt who to blame. They accuse 'speculators' such as Exchange Traded Funds (ETFs) and hedge funds of manipulating oil prices through the use of futures and options contracts not only on the dominant exchanges - the New York Mercantile Exchange and the Intercontinental Exchange – but also off exchange, through bilateral 'over the counter' (OTC) contracts. But the truth lies elsewhere.

Introducing Oil Leasing

In 2005 Shell had a brainwave. They agreed with ETF Securities - a provider of Exchange Traded Funds – that a new oil fund could invest directly in Shell's oil production. Whereas most ETFs which are exposed to the oil price use the oil futures markets, this initiative cut out the middlemen, and all of the costs associated with maintaining a position in a futures market over time.

The outcome was that Shell borrowed dollars from the fund, while the fund borrowed, or leased, oil from Shell through forward sale agreements or otherwise. Everything was, and remains, above board and relatively transparent, but this innovative form of financial oil leasing appears to have been turned to other uses by other market participants.

Macro Manipulation

Simply stated, producers have an interest in high prices. Cartels of producers have therefore often been created to openly manipulate prices by artificially supporting them. A classic example was the International Tin Council which supported the tin price by buying tin – and stockpiling it – if and when the price fell to its 'floor' price. Unfortunately, the high prices stimulated new production; eventually the ITC ran out of money; and the tin price collapsed in 1985 – literally overnight – from $8000/ tonne to $4000/tonne.

In the late 80s and early 90s Yasuo Hamanaka, a Japanese copper trader acting for Sumitomo

Corporation, successfully manipulated the copper market not only for five years before someone blew the whistle, but even for another five years afterwards. The mechanism used was for investment banks to loan dollars to Sumitomo, who in return loaned copper through forward sales on the London Metal Exchange.

The only way to manipulate commodity prices is through the ability to secure supply. In the oil markets, funds, whether ETFs or hedge funds, are categorically unable to make or take delivery of the underlying commodity, and are therefore unable to manipulate the price. It is only 'end user' producers and distributors, or the few traders with the capability to make and take delivery, who are in a position to manipulate oil prices, and in order to do so they require funding, or leverage.

I believe that it is macro manipulation by oil producers, funded by cheap money from investors, which has been the principal reason for recent movements in the oil price. The advantage which producers have over oil traders is that producers are able to store their oil in the ground for free.

The Brent Complex

Over 60% of global oil production is priced against the price of UK's North Sea Brent, Forties, Oseberg, Ekofisk (BFOE) quality crude oil. Most of the rest is priced against the US West Texas Intermediate (WTI) price, but in the past 10 years the WTI price has increasingly become the tail on the BFOE dog through 'arbitrage' trading.

There are typically 70 or less cargoes, each of 600,000 barrels, which are produced by the BFOE fields each month, and in order to support the global oil price it is necessary to ensure that BFOE 'spot' cargo transactions take place at the or above the support level. This may be achieved by forward purchases or other contracts in the opaque BFOE complex of contracts where transactions take place off-exchange.

By the standards of the relatively few major market participants involved in the market, this is easily achievable if the funding is available. As the Credit Crunch unfolded from late 2007, fund money began to pour in to existing and new ETFs.

The Zero Bound

As short term dollar interest rates fell to zero - “the zero bound” - investors switched their dollars into other assets, and particularly commodities, which also carry zero income, but which at least have intrinsic value, unlike the dollar or indeed any other 'fiat' currency. We therefore saw simultaneous spikes in the oil markets, agricultural markets and metals markets which had nothing whatever to do with underlying supply and demand.

These rises in price continued until the destruction of demand created surpluses beyond global storage capacity, and prices thereupon collapsed as the bubble of leverage funded by investors deflated. The oil price collapsed to about $35 per barrel, and since short term interest rates remained at 0% the conditions were ripe for a repeat.

Banking on Oil

What follows is necessarily speculative in the absence of hard evidence, but in my opinion the 2008 'spike' was driven by one or more major commercial oil producers leasing and hence monetising oil stored in the ground to one or more investment banks. In return the banks

collected and deployed fund money through opaque structured finance products or otherwise. Liberal helpings of hype in relation to oil shortages helped to inflate and support the market price.

In the course of a 2 hour meeting in London in 2004 Mr Kazempour Ardebili -who had by then been the Iranian OPEC representative for some 18 years – explained that he had for almost all of that time been advocating an OPEC bank, and an OPEC investment institution, but that this had never found favour with the Saudis. Moreover, he looked back with nostalgia on the long periods of stability which pre-dated the development of the current market pricing structure. He pointed out that while high oil prices are in producers' interests, wild price swings destroyed Iran's ability to budget and invest.

The oil market in 2009 saw a rapid re-inflation from $35.00 to around $70/bbl and the price has for several months been relatively stable within a range of $75 to $85 per barrel. Commentators have suggested that perhaps $50.00 of that price is accounted for by supply and demand, while the balance is purely financially related.

It appears to me that Saudi Arabia – their participation is essential - could currently be playing the role of a Central Bank whose currency is crude oil, and backed by their reserves of crude oil in the ground. Through extremely opaque market interventions by investment banking intermediaries they could lend oil to the market – financial oil leasing - against dollar loans from investors in oil, and buy back their forward sales of crude oil in order to support the oil price within their chosen parameters.

The outcome – which has the effect of 'monetising' oil in the ground - is very similar to the way in which some governments maintain their currency more or less 'pegged' to the dollar and illustrates the reality that oil is not priced in dollars: dollars are priced in oil.

Whether or not it is in fact, as I suspect, macro manipulation by producers which accounts for movements in the prices of crude oil and oil products, and the flows and storage of crude oil and oil products, is a judgement I must leave to expert traders. But I am absolutely certain that the "speculator" investors blamed by US politicians and public for the movements in oil prices are ***not*** in fact responsible.

Unstable Equilibrium

The oil market has been swinging dramatically between a lower boundary price, where an excess of supply means that in a 'buyer's market' sellers compete for sales, and the upper boundary of a 'sellers market' price where demand destruction kicks in.

According to an OPEC spokesman, the current market price is 'perfect'. If it is the case that the price is being financially supported at the 'upper bound' within tighter pricing levels then this is a fundamentally unstable position, where increasing supply of crude oil, or falling demand for products, would lead to a collapse – due to de-leveraging - similar to that in the tin market in 1985, and indeed, of the 2008 'spike'.

Although the interests of consumers and producers diverge in terms of price levels – with many in the US still convinced it is ***their*** oil under the Saudi desert – both have an interest in price stability. That is not the case for trading intermediaries – the middlemen – and particularly not for the investment banks who thrive on volatility and opacity, and for whom the only bad news is no news at all.

So, like a RoRo ferry sailing in calm waters with water swilling about the car deck, I believe that

the oil market will continue in a state of unstable equilibrium until it hits the next wave – which could be at any time – and the ferry overturns.

The current market architecture is fundamentally dysfunctional, and in my view a new settlement is both possible, and long overdue.

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