The Great Oil Price Fixes And How To Trade Them

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Key Players And Fixes In The Great Oil Game

Over the past few years, there have been a slew of accusations from media, regulators and participants of varying degrees of manipulation of markets, especially those relating to equities and FX. For the good trader, though, none of these supposed practices should have affected their ability either to maximise profits or minimise losses to any meaningful degree whatsoever, given that they should have been using intelligent risk management parameters (see *Risk Management And Hedging* section), dynamic cross-asset class investment techniques (see *Trading Oil And Gas Market Correlations* section), and the optimal mix of technical analysis (see *Technical Analysis* section) and macro-economic factors (see later) that have been vital to success for as long as markets have existed.

However, **the oil market –** a term used here as a synonym for the petroleum market (which covers both naturally occurring unprocessed crude oil and petroleum products that are constituted from refined crude oil) – **is different from all the rest, even other commodities markets. This is because it has been manipulated to an extremely high degree for decades, both overtly and covertly, and will likely continue to be so, given oil's enduring geopolitical importance to the world's supplier and consumer states alike.** It is, in short, simply too important to be left to chance in any significant way.

So, **if a trader knows the essential dynamics that drive the global oil market, it offers unparalleled opportunities to make returns over and above those of other markets, often in a virtually unidirectional manner over time. Understanding the global oil market is also an essential part of being able to trade FX, equities, bonds and other commodities, to their optimal profitability.**

This book is not a history book, but a bit of history is a necessary platform for establishing the broad architecture in which readers can trade this market, together with a solid knowledge of the market-specific trading nuances required in this particular field and the essential elements of the general trading methodology, strategies and tactics that underpin top professional traders.

The 'Seven Sisters'

Prior to the formation of OPEC (see below), the global oil market from the early 1940s had been dominated by a Western-centric group of seven major international oil companies (IOCs), known colloquially as the 'Seven Sisters':

- The Anglo-Persian Oil Company (now BP)
- Gulf Oil
- Standard Oil of California (SoCal)
- Texaco (now Chevron)
- Royal Dutch Shell
- Standard Oil of New Jersey (now Esso)
- Standard Oil Company of New York (Socony, and now ExxonMobil).

Until the onset of the 1973 Oil Crisis (see below) these firms controlled together around 85% of the world's petroleum reserves, having often paid the host countries a minimal percentage of the resulting sales profits in return, and sometimes – as in the case of the world's top oil producer, Saudi Arabia – having procured initial exploration rights for virtually nothing (the US's Standard Oil paid the Saudis just USD275,000 in April 1933 for the rights to drill across the entire country).

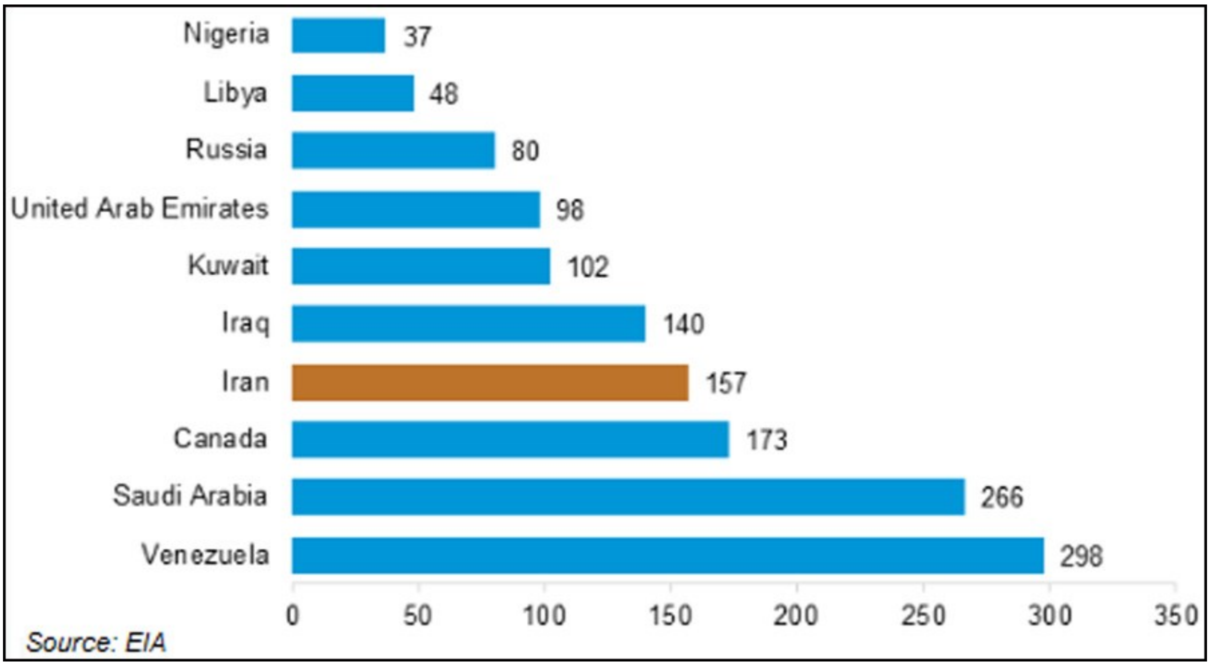
The Great Seven Sisters Fixes

The Seven Sisters' fixes were – unlike OPEC's have proven – often unilateral and designed to increase one company's market share at the expense of another's. Although in 1959, for example, the IOCs reduced the posted price for Venezuelan crude by USD0.05 per barrel (pb) and then by USD0.25 pb, and that for Middle Eastern crude by USD0.18 pb (without consulting the host countries), in August 1960 Standard Oil (again with no warning to its suppliers) announced a cut of up to 7% of the posted prices of Middle Eastern crude oils (see more on this fix in later chapters).

OPEC

In 1960, OPEC (the Organization of the Petroleum Exporting Countries) was **specifically founded to 'co-ordinate and unify the petroleum policies' of all of its member states; i.e. to align them and, consequently, to fix the oil price.** Membership of this cartel comprises virtually all of the world's major oil and gas suppliers – in alphabetical order, not that of global oil significance: Algeria, Angola, Ecuador, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the United Arab Emirates (UAE) and Venezuela – with the most notable exception, perhaps, being Russia.

World's Largest Proved Reserve Holders Of Crude Oil, Current (billion barrels)



Although there are members that flout OPEC guidance, **this club sets the oil production targets of its members. With a collective 40% or so of the world's crude oil output produced by these countries and around 60% of the total petroleum traded internationally coming from their oil exports, what OPEC says and does plays a huge part in determining the global price not just of oil but of natural gas and related oil and gas products.** Obviously, in the most basic terms, if OPEC cuts oil production – all other factors remaining equal – then the price of oil and related products will rise, and if it increases output then the price will fall, according to the usual laws of supply and demand.

The First Great OPEC (Saudi) Fix

Until 1973, the basis of the historical relationship between the US and OPEC (entirely driven at that point by Saudi Arabia) had been demarcated at a meeting on 14 February 1945 between then American President Franklin D Roosevelt and the Saudi King at the time, Abdulaziz. The first face-to-face contact between the two, it was held on board the US Navy cruiser Quincy in the Great Bitter Lake segment of the Suez Canal. The deal to which they agreed, which persisted unchallenged until 1973, was this: **the US would get all of the oil and gas supplies it needed for as long as Saudi had hydrocarbons reserves, in return for which the US would guarantee the security both of the country and of the ruling House of Saud.**

Having said all of this, **the key moment that would define the global oil market as it still stands today was the 1973 Oil Crisis.** This began in October of that year when OPEC members plus Egypt, Syria and Tunisia began an embargo on oil exports to the US, the UK, Japan, Canada and the Netherlands in response to the US's supplying of arms to Israel in the Yom Kippur War. By the end of the embargo in March 1974, the price of oil had risen from USD3 pb to nearly USD12 pb. As the Saudi Minister of Oil and Mineral Reserves at the time, Sheikh Ahmed Zaki Yamani unequivocally highlighted at that point, the extremely negative effects on the global economy marked a fundamental shift in the world balance of power between the developing nations that produced oil and the developed industrial nations that consumed it (see more on this fix in later chapters).

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