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Black Gold

The record profits earned by major U.S. oil companies in the wake of the Arab oil embargo have triggered a public outcry against the industry by a number of consumer groups. Coming at a time of shortages and sharply rising consumer prices, the spectacular upsurge in oil profits has aroused suspicions that producers may have taken advantage of the embargo to reap excessive profits. Some of the industry's critics have even suggested that the large companies deliberately contrived the energy shortage to push up prices and profits, to drive out independent refiners and marketers and to force a relaxation of stringent environmental standards.

The oil companies categorically deny these charges. They contend that the nation's energy problems are the outgrowth of inadequate investment incentives, that the industry's profit gain in 1973 stemmed largely from foreign sales, and that domestic prices for refined products have been raised only enough to compensate for the rising cost of imported and domestic crude oil.

Size and performance

Some of the criticism levelled against the industry undoubtedly can be traced to its enormous size and economic influence. In terms of sales, the petroleum industry is the third largest business group in the United States, outranked only by the agribusiness and construction sectors. The 18 largest U.S. petroleum companies rank among the top 100 manufacturing firms in the nation in terms of sales, and they account for about one-half of total U.S. crude oil production.

Even so, the uniqueness of the industry's structure lies not in the size of its corporations nor in its high degree of concentration, which actually is somewhat less than in other basic industries, but rather in its high degree of vertical integration. The 18 largest producers are fully integrated and are important forces in all four of the industry's major activities—crude-oil exploration and production, transportation, refining and marketing. These same companies also account for the bulk of the crude oil produced overseas —in Canada, South America, the Middle East, Africa and the Far East. But in addition to those fully integrated companies—the so-called majors—the industry embraces other large firms that are partially integrated as well as several thousand smaller "independents."

In view of the industry's multilayered structure and international involvements, the task of monitoring its financial performance is quite difficult. Nonetheless, by any measure of profitability, 1973 was a banner year for the American petroleum industry. The 97 largest U.S. oil companies boosted their total earnings 53 percent in 1973 to a record $9.9 billion, and thereby far surpassed the 31-percent annual gain recorded by all of manufacturing (First National City Bank data). The industry's profit performance also was outstanding measured by a 15.6-percent return on net worth.

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But the bright results achieved in 1973 and early 1974 followed a four-year period which was perhaps the flattest in the industry's postwar history. During that 1968-72 period, earnings rose at an annual rate of only 1.5 percent, compared with a 5.2-percent rate for all of manufacturing. Moreover, the industry's return on net worth not only moved steadily lower over the period, but averaged only 11.6 percent.

The Arab take

The oil-profits drama has been played against a background of changing relationships between the major international oil companies and the eleven members of the Organization of Petroleum Exporting Countries (OPEC), who account for about four-fifths of world crude-oil exports. In 1970, Libya took the lead by securing higher taxes and royalties through means of a production cutback. In early 1971 the Persian Gulf countries, through the Tehran agreement, achieved a pattern of higher "posted" prices—reference prices for calculating taxes and royalties—as well as a higher tax rate on profits. In early 1973, Saudi Arabia and two other Gulf states moved into direct ownership, with a 25-percent shareholding scheduled to reach 51 percent by 1982. From the host countries' new share of output, specified portions of oil were to be sold back to the companies, with the price of this "buy back" oil to be higher than the cost of their own "equity" crude. Iran and Iraq fully nationalized their operations.

These agreements served to cloud the 1973 supply outlook—even before the imposition of the embargo. For that matter, the supply situation already was uncomfortably tight, in part because U.S. production of crude oil had been declining ever since 1970. With demand meanwhile soaring because of the worldwide economic boom, market prices for foreign crude oil began to rise even faster than posted prices, boosting the companies' profit per barrel.

The denouement of course came last fall, with the embargo, production cutbacks, and unprecedented price increases, following the decision by the Persian Gulf countries to repudiate the 1971 Tehran agreement and to become themselves the sole arbiters of crude prices. By year-end, their actions had raised their revenue to $7.12 per barrel, compared with $1.51 at the start of the year. The Arabs also indicated that the price of "buy back" oil would have to be raised to reflect the sizeable increase in market prices, although the "buy back" price remained undecided throughout 1973, forcing the companies to estimate this cost in their earnings reports. Yet, despite these actions, the companies' profits continued to benefit from soaring worldwide demand.

Firming product prices also gave a large lift to profit margins in European "downstream" operations of refining and marketing—while overseas earnings also benefited from

the devaluation of the dollar (which raised the conversion value of foreign profits) plus the rising value of inventories and the strong demand for petrochemical products. As a consequence, almost two-thirds of major oil company profits last year came from overseas operations.

The U.S. return

In the United States, the industry benefited from the increased consumption of refined products, the end of gasoline price wars, and a sharp increase in domestic crude-oil prices. However, price controls prevented domestic prices from soaring to foreign levels. Refiners were allowed to pass on the higher costs of imported crude, so that refined-product prices jumped 39 percent at wholesale, but eventually increases were allowed only once a month, thereby slowing the rise in profits. More importantly, price controls held domestic prices for crude below foreign levels.

Recognizing that the differential between foreign and domestic prices was encouraging exporting and hoarding, the Cost of Living Council last August freed at least one-quarter of U.S. production from controls —"new" oil, or output in excess of 1972 levels—and also raised the ceiling price on "old" oil. As foreign prices continued to soar, however, the weighted average of U.S. crude prices under this "two-tier" system lagged behind, and the COLC finally raised the price of "old" oil again. In late December, foreign prices averaged $9.50 per barrel, while the weighted average of U.S. prices stood at $6.50 per barrel. Nonetheless, the doubling of U.S. crude-oil prices during 1973 transformed the prospects for domestic producers and encouraged an upsurge in drilling activity.

Sharp increases in worldwide prices for crude and refined products had a significant impact on profits during the first quarter of 1974. Profits for thirty large U.S.-based companies jumped 78 percent above the year-ago level, partly because of the huge inventory profits earned on foreign oil—one-shot gains made by revaluing earlier purchases of inventory at today's higher prices. Profits would have been even larger had not the companies established a contingency fund to cover anticipated but unknown costs of foreign "buy back" oil.

Even so, the companies contend that they might not be able to maintain this strong profits performance, because of the need to acquire new inventory at higher prices and because of nationalization moves abroad. Indeed, the recent "interim agreement" between American firms and the Saudi Arabian government left the latter with a 60-percent (up from 25-percent) participation in Saudi Arabian operations. Agreements such as this could signal an end to American access to low-cost foreign crude, and over the long-run might even result in the complete elimination of U.S. ownership rights overseas.

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