THE LEGITIMIZATION OF OPEC

by

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Next month's OPEC conference in Stockholm is probably the first in four years which is not awaited with trepidation by the world's oil importers. The reason is that the only remaining uncertainty about the pricing decisions to be taken at Stockholm is whether Saudi Arabia and the United Arab Emirates will maintain their present prices for the remainder of 1977, will raise them by somewhat less than 5% or by a full 5%. Probably, they will choose one of the two latter options. But the whole differential between no price increase and a 5% increase amounts only to $2.5 billion worldwide on an annual basis, equal to about 2% of total OPEC oil revenue. Compared to the price increases under consideration and imposed at previous OPEC conferences this is small stuff, indeed.

This might, therefore, be a good moment to take stock of OPEC's pricing policy and the U.S.'s and other importing countries' reaction to it since the price revolution of 1973.

The apparent decision of the 11 OPEC members other than Saudi Arabia and the UAE not to go up by another 5% on July 1st is further indication that OPEC prices since mid-1974 have increased only in line
with the approximate dollar inflation in world export prices and, thus have remained more or less unchanged in real terms for more than three years. Economically, this is hardly surprising, since throughout this period OPEC oil has been in continuous substantial surplus, a situation which would preclude a price rise under normal market conditions.

But, OPEC's price determination has hardly been based on normal market conditions. Yet, seen from today's perspective, neither was it irrational or arbitrary -- after 1973. OPEC has proclaimed that it wanted to maintain the fruits of its revolution and not see them eroded through a steady deterioration in its terms of trade with the nations to which it sells most of its oil and from which it buys most of its goods and services. Thus, despite widely publicized claims at every OPEC meeting for 15%-30% oil price adjustments to offset inflation, the increases actually decided upon at these conferences reflected no more than true dollar cost inflation of imports into OPEC. If armament sales are included, the increases were probably somewhat below the full inflationary adjustment. If this is OPEC's pricing rationale -- and the expected Stockholm decision would confirm that it is -- it will probably prevail at least into the mid-1980's, in the absence of politically or militarily conditioned supply interruptions, since no other forces, such as supply constraints, will be strong enough to move prices from this target before then.

How did the principal importing countries react to OPEC's policy? Their position has changed from one of indignant objection following the 1973 increases to more or less full acceptance not only of the prices
themselves but also of the need for them. One remembers the many schemes and meetings until less than a year ago designed to break up OPEC or at least force it to roll its prices back. This was the assumption underlying the original Project Independence; it played a major, if implicit, role in the formation of the International Energy Agency, it was the chief argument for vertical divestiture of the international oil companies, and it was the subject of innumerable articles, speeches and schemes, all designed to bring down OPEC prices.

The turn-around from this position has been in the making for some time. It was completed with the announcement of President Carter's new energy program which legitimized OPEC prices by officially identifying them as the true replacement cost of oil to the U.S. economy and proposing to raise all domestic oil prices to consumers to at least that level and also let newly produced domestic oil move up to it. The reason is not resignation to OPEC's strength but a conviction by the Administration that the world's oil resource base will soon be inadequate to satisfy all the increases in demand even at the high prices prevailing since 1974. Thus, the new reason that we and the other consuming countries are asked to practice energy conservation is not to weaken OPEC but to avoid a physical oil shortage in the next decade.

The Administration's assumption of an impending resource constraint is, by definition, speculative. But if one accepts it one must regard OPEC prices as much closer to the real long-term supply cost of oil than the much lower prices prevailing in the period when private companies were in charge. The latter might well have been prevented by competitive,
political and legal considerations from raising present prices on the basis of uncertain future shortages in the face of persistent current surpluses. The OPEC governments have, of course, no such constraints. They could, therefore, step in and correct the apparently excessive influence of short-term market factors over long-term considerations. Obviously, this was not why OPEC took over and set prices the way it did. But the Administration's current resource assessment makes not only OPEC's post-1973 pricing policy rational but, in retrospect, even the revolution of 1973, though it was telescoped into an unreasonably brief time span resulting in economic disruptions.

Experts are very much divided on whether or not we can continue at our current growth rate in world oil demand without creating shortages within a decade or two, accompanied by sharp further price increases independent of OPEC policies. But most agree that a continuation of the world oil growth rate at anything approaching the pre-1974 period of over 7% annually would be unsustainable through the 1980's. Their reason is not so much the potential physical supply constraint but, well before that, the production ceilings imposed by various OPEC members not for political purposes but to stretch the life span of their principal source of wealth and adjust their annual oil revenue to their perceived ability to absorb it. Thus, Kuwait whose current 2 million barrels daily production ceiling is equal to 85 years of proved reserves has recently suggested lowering its output to 1.5 million b/d. And the one real concern about the Stockholm conference is that Saudi Arabia which had removed its production ceiling at the last OPEC conference will now
reimpose it in some form.

What about the self-adjusting aspect of higher prices? In theory, significant price rises tend of course to reduce consumption and increase supply. In practice, this is what happened to world oil consumption in 1974-75 when it dropped by 3%, partly causing and partly reflecting the deepest economic recession of the post-war period. Last year and this year, however, the growth rate has moved back up to about 5% annually, which is not very much below the historic rate.

On the supply side, there has been very little evidence so far of the impact of higher prices on the rate of discovery. Some previously found oil that would have been marginal or submarginal under much lower prices can now be profitably produced. However, with OPEC accounting for 70% of the non-Communist world's oil production and the Middle East accounting for over 70% of OPEC production, a significant reduction in the importing nations' dependency on either is simply not in the cards in the foreseeable future. True, in the next 4-5 years, substantial non-OPEC production coming on in Alaska, the North Sea, Mexico and Egypt will temporarily slightly reduce both OPEC's and the Middle East's dominant role. But from the early 1980's on nearly all incremental world oil demand will once again come from the Persian Gulf.

Where does all this leave the importing nations? On the demand side it appears that if we really want to bring down the oil growth rate substantially -- say, to less than 3% annually worldwide -- which might avoid bumping against likely OPEC production ceilings until at least 1990 -- we must accept a lower level of general economic growth.
Not a decline, nor a stagnation, at least not in the industrial countries which consume 85% of the non-Communist world's oil. But a lower growth rate than we have become accustomed to in the postwar period. Thus, Presidential energy adviser James Schlesinger's prediction that by the mid-1980's the U.S. can achieve a GNP growth rate of 5% together with an energy growth rate of 2%, the first being higher and the second substantially lower than the historic rate, would seem quite unrealistic. The same can probably be said about the 4.2% GNP growth rate from 1974 right through 1990 assumed in the Organization for Economic Cooperation and Development's recent publication, World Energy Outlook.

On the supply side, if conventional petroleum resources produced by conventional methods will soon become constrained, we must maximize our efforts to develop unconventional resources as well as unconventional methods to increase production from existing resources. Unfortunately, in both areas President Carter's energy program is unimaginative and, apparently, uninterested. In effect, the Administration says that while it will not block unconventional resource development or production methods, it will do very little to encourage or support either. In the case of gas it has not even agreed to lift price controls on such production. Given its own basic premise of the energy program, this is a very serious flaw.

Finally, we must realize that the borderline between true physical resource constraint and shortages brought about by the imposition of production ceilings is blurry and the definitions subject to political interpretations. As we start consuming more oil than we find the ratios of reserves to production can be expected to decline. Up to a point -- and that
point could be far off -- this does not create a resource constraint. But it is likely to push producing countries into maintaining and lowering existing ceilings and imposing new ones. The danger is that the decisions will continue to be made unilaterally on the basis of the producing countries' perceived self-interest and judgement. Hopefully, the importing countries' recent legitimization of OPEC prices will cause OPEC to recognize the importing countries' legitimate interest in the determination of production levels. If not serious conflicts may be ahead in the 1980's.