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THE FUTURE OF OPEC -- THE PAST IS NOT PROLOGUE

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OPEC has been in the news again; not the banner headlines of the 1970's and early 1980's when the world economy seemed to depend on OPEC's price and production decisions. But the business and financial community and, of course, the oil industry itself, were quite interested in the outcome of OPEC's Ministerial Monitoring Committee meeting in Geneva 10 days ago (which I attended). Much of the attention paid to the minutiae of the deliberations, despite their relatively narrow scope, reflects the commodization of oil. The traders who deal in oil futures or derivatives must instantly respond, or better, react to all perceived changes in the market. Thus, whether a minister on his way to the elevator in the lobby of the Geneva Intercontinental smiles or frowns in response to an unanswered question about what OPEC will do is instantly interpreted and transmitted to a monitoring screen where it instantly affects prices. In the 1970's and early 1980's when the price fluctuations were often much larger it was still possible to contemplate any new development before reacting on it.

At the latest Geneva meeting the outcome, a roll-over of existing quotas, was widely anticipated. Yet, the persistent rumors and speculations of a different outcome kept the market fluctuating throughout the meeting.

The roll-over decision demonstrated once again the dominant role of Saudi Arabia within OPEC. We know that a majority of the 12 members wanted a 4-6% cut in OPEC production and that the OPEC Secretariat strongly recommended such action, thereby departing from its usual neutral position. Had a cut been agreed on, prices would undoubtedly have risen by much more than 4-6%, thus increasing the revenue flow of all members. However, Saudi Arabia was adamantly opposed to any reduction of its 8 million b/d production level at this time for a variety of political and economic reasons. Since it was clear even before the meeting that a quota reduction without participation of OPEC's largest member, which accounts for 1/3 of the group's total output, would be difficult to impose on others, the roll-over decision was hardly a surprise.

What prompted Saudi Arabia to adopt this position? (Only Kuwait supported it). There are four reasons and they give you an insight into how OPEC operates.

1) Saudi Arabia carries almost 2/3 of OPEC's total spare producing capacity. It did not want to increase this disproportionate ratio any further by reducing its output.
2) Saudi Arabia feared that not all members would adhere to a production cut, thus forcing a disproportionate share of the reduction on Saudi Arabia.
3) Saudi Arabia had not increased its 8 million b/d quota last September when all other members raised theirs as part of an overall OPEC quota increase. Hence, it saw no reason to share in any decline of the OPEC quota at this time.
4) If sanctions on Iraq's oil exports are lifted any time in the next 12 months, Saudi Arabia will have to participate in an overall OPEC production cut to make room for Iraq's re-entry into the market. Presumably, Saudi Arabia is ready to do this but does not want to make any production cuts before then.

These are all legitimate reasons and were reluctantly but realistically accepted by all members, with the important exception of Iran whose oil minister called a special press conference to denounce what he described as Saudi Arabia's single-handed blockage of pro-rata quota reduction. Iran is OPEC's second largest producer but its exports are only about 1/3 those of Saudi Arabia while its population is six times as large. Its economy is in deep trouble and in the short-term it can only improve it through a higher oil export revenue. According to many observers, Iran has virtually no spare producing capacity left and, hence, can only increase its oil export revenue through higher unit prices. Iran could of course have accepted Saudi Arabia's suggestion at the meeting that all members *other* than Saudi Arabia cut their production, particularly since some non-OPEC Persian Gulf producers, such as Oman and Yemen, had declared their willingness to join in any OPEC cut. This would clearly have raised prices at least moderately. But politically it would have been difficult, to say the least, for the Iranian oil minister to return to Teheran and explain that his country had agreed to a quota cut while Saudi Arabia was maintaining its level, thereby increasing Saudi Arabia's OPEC quota share still further.

The result of the Geneva decision is an average OPEC Basket crude price around $13 in the 10 days since the meeting. This is a $5 reduction from a year ago. The market is assuming that if OPEC approximately sticks to its quota throughout the remainder of the year, prices will improve by two dollars or so. But the average Basket price for 1994 is still likely to be only around $14.50, compared to $16.30 In 1993 and $18.60 In 1992. This, despite the fact that the demand for OPEC crude oil on average has increased in the last few years, and is likely to increase again this year to 25 million b/d.

However, it must be kept in mind that during the same period room had to be made on the supply side for a return of Kuwait production from almost nothing in mid-1991 to 2 million b/d by mid-1993. Thus, the increase in available OPEC supply outstripped the increase in the demand for OPEC oil. Saudi Arabia was the principal factor in balancing supply and demand during this period by reducing its output from 8.4 to 8.0 million b/d, which is another reason why it did not want to cut its output further at this time.

Not surprisingly, OPEC members whose proposals are rejected or ignored in formulating the organization's production policy often impute non-economic motivations to those who overruled them. Thus, the Teheran press is now charging that the real reason Saudi Arabia blocked a quota reduction which would have raised prices was to help the U.S., the world's largest oil importer, which wants lower crude prices. Another charge is that the real purpose of the roll-over was to hurt the Iranian economy further, again at the behest of the U.S. Meanwhile Iraq, another OPEC member, is accusing the U.S. of wanting the U.N. sanctions on Iraqi exports to remain in place because they strengthen world oil prices which Iraq claims benefits primarily Saudi Arabia. But perhaps Iran and Iraq think that this self-contradictory U.S. stance is what U.S. dual containment policy is all about.

Now let us see where OPEC will be going after 1994. In part the answer is obvious. There is no question that world oil demand will rise for the foreseeable future. I have not seen any forecast which does not project a substantially higher level of world oil demand by, say, 2010 than in 1994. The trend is upwards throughout this period and there is every indication that it will continue after 2010. The average of six widely respected forecasts shows an increase of nearly 20 million b/d, or 28%, in world oil demand between 1992 and 2010. With

OPEC accounting for 77% of total proved reserves in the world but only 40% of total world production, obviously the bulk of the growth in world oil supplies will be provided by OPEC.

Most forecasts show an OPEC oil production level (crude and condensates) of 42 to 47 million b/d by 2010, an increase of 55% to 75% over current production. If this is a realistic scenario, OPEC's public concern about the potential negative impact of environmental legislation and policy on oil demand is at least premature and may even be unrealistic.

Of course, not all OPEC members are expected to share evenly in this growth. Indonesia and Algeria, for instance, are already at capacity and are likely to see their exports decline in coming years. Venezuela can fully participate in the projected growth only if it can turn its large volume of very heavy crude in the Orinoco Oil Belt into marketable products.

Thus, the growth in OPEC exports will come primarily from the Middle East and, within that region, from Saudi Arabia. Which means the bottom line is that for the foreseeable future, the world's dependency on Middle East oil will grow both in volume and share.

Eventually, this can be expected to end OPEC's principal function, to set production quotas for its members. If this occurs it will not be because of the organization's ineffectiveness in abiding by its set quotas but because of the phasing out of its members' surplus producing capacity and, hence, the need to control it through quotas.

It is often said that OPEC's great moments came in 1973 and 1979/80 when it tripled world oil prices either instantly or within a very short period. Yet, on both occasions the market was extremely tight because the world oil industry was literally producing at 100% of capacity while demand, either for consumption or for emergency inventory building, was rising. Thus, temporarily the market required the kind of price increases registered in both instances. In fact, as OPEC pointed out in its communiqué in December 1973, its tripling of prices to $11.65 was still some $5 below the actual spot market price at the time.

OPEC's true price setting role came only after demand started to decline and production surpluses developed. As the world's self-appointed marginal producer OPEC managed the world's oil surplus throughout this period to this day. It has generally been a far from perfect job by its own criteria. Nevertheless, from late-1981 on, world oil prices were nearly always substantially higher than they would have been absent OPEC's quota system. A major exception was the price collapse in the first half of 1986. (Market control was also beyond OPEC during the Gulf conflict in the second half of 1990, but the price pressure at that time was upward.)

Thus, despite its organizational shortcomings, OPEC was far from irrelevant for its members, or the world oil market, throughout the last 12 years. This is still the case. If one considers that OPEC's marginal production costs are the lowest in the world, the price in a free market could drop very steeply without affecting OPEC production. In other words, if OPEC eliminated its current quota restrictions and made its 2-2.5 million b/d spare producing capacity available at whatever price, which would be the case in a free market, the price could drop below $10/bbl without affecting production. It would of course affect the more expensive production outside OPEC. But even in the U.S., the most expensive major producing area, the actual operating cost of many flowing oil wells is closer to $5 than $10. Thus, many flowing

wells could operate for some time under such a free market price. Major exceptions are of course the Alaskan North Slope, where the cost of production is low but the necessary cost of transportation is high, and the uniquely American stripper well.

Thus, OPEC is far from irrelevant. In fact, following the international companies' loss of concessions in the major oil exporting countries and the global commoditization of oil through the international futures exchanges, OPEC has become the only institution able to perform the function of keeping prices above the hypothetical free market level and it is of vital self-interest for it to do so. For the OPEC countries, the price of oil must include the externalities -- or perhaps they should be called 'internalities' -- of the revenue required to support their countries' infrastructure, including social services, military expenditures, etc. In a free market these very substantial supplements to the production cost could not be incorporated in the price. Yet, for the governments of countries whose principal source of income is oil exports, these supplements are literally vital for their political survival.

Will there be enough capital to finance the required expansion in oil producing capacity? The question becomes more pertinent after 2000. Ongoing or planned expansion projects should provide the required supply to 2000. For countries with a reserve/production ratio of 50-100 years these represent very attractive investments under any realistic price assumption.

After 2000 some OPEC members may not be able to self-finance their capacity expansion fully, for there will be simultaneous claims on oil revenues for other purposes. One such claim is the need to upgrade the industry's infrastructure which has been neglected in several major OPEC countries. Another is the need for more downstream investment to meet the rapidly growing (subsidized) domestic oil demand; finally, and perhaps most importantly, there is what has been called "the revolution of rising expectations" which requires a greater share of the developing countries' oil wealth to be spent on social programs and other national interest expenditures outside the oil sector.

All this means that internal self-financing may be insufficient to meet the upstream expansion foreseen in the next decade. However, capital availability is not limited to domestic sources. In all OPEC member countries the oil industry was started, developed and operated by foreign capital until nationalization took place. The same companies, as well as many others, are quite interested in investing again in these countries' oil production. Thus, from an economic point of view there should be no capital constraint on the investment needed to raise OPEC's capacity level if foreign companies can participate in this development.

However, as is so often the case, politics interfere with economics. Some countries, including OPEC's super-giant Saudi Arabia, still do not permit any foreign investment in their upstream oil sector; others have offered initially unattractive terms. In some countries, there are also political constraints on investment imposed by the companies' home country. Nevertheless, the trend is clearly in the direction of more joint ventures in OPEC's upstream sector because of the attraction to invest in a commodity whose demand will grow well into the next century and whose resource cost (in the major OPEC countries) is only a fraction of its sales price.

In closing, I would like to turn back briefly to the origins of OPEC to illustrate the metamorphosis it has undergone since its foundation.

At its first meeting in September 1960 in Baghdad, OPEC's primary goal was to get the oil companies to reverse the 25¢-30¢ price decline which had taken place in the aftermath of the Suez Canal crisis of 1957. It also wanted companies to maintain steady prices "free of unnecessary fluctuation," a modest request even then. By 1968 it had not yet succeeded in raising prices and was still largely ignored by the oil companies, but it had gotten stronger and more self-assured as shown in its press release about the "inalienable right of all countries to exercise permanent sovereignty over their natural resources... As a universally recognized principle." Its position had been greatly strengthened by the much-disputed U.N. Resolution on the subject passed in 1966. By 1981 when OPEC was at its historic power peak with prices averaging near $35 for the year and most forecasters in OPEC as well as the consuming countries expecting them to at least stay there but probably rise, OPEC issued a remarkable public statement which said, "One of OPEC's greatest services to the world community has been its constant efforts to arouse global public awareness of the rapid depletion of crude oil reserves. Indeed, while it may appear somewhat paradoxical for oil exporting nations to do this, OPEC was the first to promote, in word and action, the urgent need for large-scale development of alternative forms of energy." It also said the purpose of what it euphemistically called "price adjustments" "has been only to correct a long-standing dangerous under-evaluation of this vital resource."

Such language was never again heard and from 1983 on OPEC's public and internal concern was primarily to maintain a degree of functional unity among its members. It has been able to do this on a limited but operative scale and can be expected to continue doing so. Its next major test may come when the sanctions on Iraqi oil exports are removed.