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THE OPEC PRICE INCREASE

A Statement

By

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Before the Joint Economic Committee of the Congress,

Subcommittee on Energy,

on the Topic:

"Energy Independence or Interdependence:

The Agenda With OPEC"

January 12, 1977

It is still too early to assess all the consequences of the decisions taken by the OPEC members at their Ministerial meeting in Doha last month. To some extent the decisions may be considered beneficial to the U.S. and other importing nations. Certainly, Saudi Arabia's removal of all production restrictions is welcome news, for the possibility that the country might not raise its imposed 8.5 million b/d ceiling in response to higher future demand for its crude had given rise to fears of a possible shortage of OPEC oil, perhaps as early as the middle of this year.

The other major decision, the establishment of a two-tier price system, is good for the consuming countries relative to the most likely alternative course of action, a 10% increase for all OPEC members. As it is, we estimate the new price system will mean a weighted average increase in the first half of 1977 for all of OPEC crude of nearly 8% on the basis of current output shares, and 7.5% if Saudi production rises to 10.5 million b/d. In the second half of the year, the price increase could go to 11.0-11.5% if the 11 other members go through with their announced additional 5% increase while Saudi Arabia and the United Arab Emirates (U.A.E.) remain at 5%. Since none of these price increases were the result of market forces but were all decreed by government edict, the question may be asked: are any of them reasonable, from OPEC's point of view as well as that of the consuming countries?

One answer frequently voiced in consuming countries is that after the 350-400% increase in OPEC oil prices in 1973/74 an extended pause before any further increase is eminently reasonable even if it means an erosion, in real terms, of the price levels achieved earlier. There is clearly much merit in this argument, particularly if one considers the significant impact which the earlier oil price increases had on the recession of 1974/75, the longest and deepest in the postwar period.

But I believe the argument lacks political realism. Between 1971 and 1974 OPEC had won a bloodless revolution of major historic proportions, taking control over the production of nearly 70% of one of the free world's most important resources and transferring hundreds of billions of dollars from the industrial nations to a group of developing nations. Having succeeded in this beyond expectations, OPEC is unlikely to stand by quietly now and watch its victory shrink away through a steady erosion of the purchasing power of its exported oil.

Thus, instead of the various pleadings and exhortations by the leaders of the consuming countries prior to the Doha meeting for a moderate price increase, no increase at all, or an increase no higher than a certain percentage, a possible alternate approach might have been for the consuming countries, perhaps working through the International Energy Agency or OECD, to calculate the real loss in the purchasing power of a barrel of oil in world trade since the last OPEC price increase and then attempt to negotiate an increase of approximately that magnitude with OPEC. This would of course be a form of indexation with all the problems inherent in such a system. But if the consuming countries have a direct influence in the construction of the index it might be worth experimenting with.

It certainly would have given us a better result at Doha than the combined OPEC increase. Even the lowest of the various increases, Saudi Arabia's and the U.A.E.'s 5%, was slightly higher than OPEC's real loss in purchasing power since the last oil price increase in October 1975. It is to Sheik Yamani's great credit that he publicly recognized this fact and thus was the first OPEC leader to break with the organization's party line which says increases of 15% to 25% would barely offset the inflation in OPEC's import prices.

Thus, an increase of about 5% for 1977 can be called reasonable by our definition. It would not present a major financial burden for most of the world's importers. If all OPEC producers had adopted it, its annual cost would have been about $6 billion. On a global scale this is a relatively negligible amount, equal to about 0.6% of this year's likely trillion dollar world import trade. Furthermore, it follows 15 months of virtual price stability in OPEC oil. By most standards of measurement a 5% price increase could therefore be considered quite tolerable for all but the Less Developed Countries who represent really a special problem requiring special measures.

But of course for the moment a 5% overall price increase for 1977 is just wishful thinking. As we know, unless something is done we will be saddled with a 15% price increase by next July for the 11 OPEC members accounting for 60-65% of total OPEC production. This increase may not be tolerable. What can we do about it? Perhaps nothing. But I would like to suggest two general approaches that may be helpful.

(1) We must stop planning and hoping for OPEC's downfall, since it is counter-productive to an atmosphere of cooperative co-existence with OPEC on whose oil we will have to depend significantly for the next 12-15 years, even with our efforts at conservation and new energy source development; and (2) we and the other consuming nations must use our collective leverage, which is considerable, to start a direct and specific dialogue with OPEC, and only with OPEC, on the one area of direct specific common concern -- the price and production of oil. As you know, the North-South dialogue in Paris was initially meant to do just that. It became a fiasco because it turned into a laundry list of problems and grievances between the industrial nations and the less developed ones, completely overshadowing the initial purpose.

I think we can make clear to OPEC that what is now happening in world oil price formation is the exact mirror image of their historic complaint prior to 1973, namely that prices were determined in and by the consumer nations without any regard for the interests of the producer nations. Now it is just the other way around and it is just as untenable. When OPEC meets to set prices no one speaks for the consumer and since free market signals have been banished by the cartel, the decisions are arbitrary from the consumers' point of view.

True, we have been fortunate so far in that Saudi Arabia, OPEC's most important member, has been a very effective moderating force at all OPEC price setting sessions since December 1973. This has saved the consuming countries many billions of dollars. But Saudi Arabia's economic and political interests and orientations are quite different from those of the major consuming countries. We should therefore not assume that Saudi Arabia will always use its influence on the side of the consumers. At the Doha meeting Saudi Arabia's official reason for not going along with the 10% increase contained the implication that if certain political expectations were not met its price posture might change. Sheik Yamani could have employed the same rationale to announce a high price increase now with a promise for a later reduction if the expectations are met.

The consuming countries must therefore try to find some forum where they can directly debate, discuss or negotiate the price of oil with OPEC. The new uncertainty over Saudi Arabia's future role in OPEC and the scheduled further price increase on July 1 make this a matter of real urgency.

Now, I would like to briefly examine how OPEC might fare under the new price system. The impact will be quite uneven. The additional revenue generated from the higher prices will accrue primarily to the two countries which least want or need it, Saudi Arabia and the U.A.E., because the increase in their combined production will more than offset their lesser price increases. It is not known yet how much Saudi production will actually be raised as a result of the removal of the 8.5 million b/d annual ceiling on Aramco production. But it appears that a sustained production level of about 10.5-11.0 million b/d is technically achievable in the first half of 1977. This would be 1.5-2.0 million b/d above actual production during the 4th quarter of 1976. In the U.A.E. production may be increased by about 250,000 b/d to 2.2 million b/d in the first half of 1977. Thus, under our assumptions the two countries will increase their combined output by about 15%-20% above the high levels realized in the fourth quarter of 1976.

Meanwhile, total OPEC production in the first half may decline by about 1.5-2.0 million b/d from the fourth quarter 1976 level. The decline will be largely concentrated in the first quarter and will be due primarily to the worldwide inventory accumulation of OPEC crude in the last quarter of 1976 which is now being reversed. Thus, under our assumed level of Saudi and U.A.E. production increases, which are by no means certain at this moment, the 11 other countries would have to absorb both the entire decline in the total demand for OPEC oil and the increase in the output of the two others. The result would be that the entire additional revenue generated by the OPEC price increases, about $5 billion in the first half, would go to the two countries with the lower increases.

Among the 11 others, those principally negatively affected would be Iran, Iraq and Kuwait since their oil is most similar in quality to Saudi Arabia's and, unlike some crudes of other OPEC countries, all of their crudes were increased by 10% or more.

Thus, for the next 2 or 3 months the oil revenues of these three countries will decline substantially if their price relationship to the new Saudi Arabian prices remains unchanged. Venezuela will also be somewhat hurt because more Saudi Arabian crude and products made from it will come to the Caribbean and the U.S. East Coast. In the second quarter the situation is likely to improve somewhat for these countries because of an expected increase in world demand for OPEC oil. However, they could still earn less than if they had not raised their prices at all and Saudi Arabia had maintained its output ceiling.

If the 11 countries go through with the announced additional 5% increase on July 1, their situation will improve, since they will not lo se much more business to Saudi Arabia and the U.A.E. at the higher price differential than at the lower one. This considera-tion might in fact strengthen their determination to move to the higher level if the two other countries maintain their current prices.

Such a scenario is of course only speculative as of now. It is equally possible that by next July the two sides will have come together again and will have established a uniform base price for all members. There are pressures on both sides to move towards a compromise. Iran, Iraq and Kuwait know that a price reduction towards the Saudi level in return for reinstatement of a lower Saudi Arabian production level will net them significantly more revenue than the present system. On the Saudi Arabian side there have been the repeated public and private complaints that the 8.5 million b/d ceiling was much too high in terms of the domestically investable revenue it generated, and that the country's interests would be better served if any oil volume which had to be converted into foreign investments, over which the country has no ultimate control, stayed in the ground. The removal of the output ceiling will of course greatly exacerbate this problem.

But even if the split continues I do not think it will mean the end of OPEC's effectiveness, if we mean by that its power to set and enforce prices. For one thing, Saudi Arabia continues to provide a floor for all OPEC prices which is 4-5% higher than last year's floor. Secondly, Saudi Arabia's productive capacity is limited in the short run. Theoretically it is 12 million b/d, but a sustained production level above 11-11.5 million b/d is unlikely to be achieved this year. Thus, the two countries together cannot supply more than about 13.5-14 million b/d maximum. Since world demand for OPEC oil (including internal demand) for the last 9 months of 1977 will be 31-32 million b/d, the 11 other members, if they can absorb the shock of the first quarter reduction, will have an assured outlet of about 18 million b/d for the rest of the year, 9% less than in 1976 but at 10-15% higher prices.

In the short term, the most the consuming countries can therefore hope to gain from the OPEC price split is an eventual official or unofficial reduction of the prices of the 11 countries towards the new Saudi level. This would be significant. But it would hardly herald the end of OPEC's price setting power.

I would like to end my statement with a brief comment about the international oil companies and OPEC prices. The decisions at Doha have made it clear, if further evidence was needed, that the companies' influence on OPEC prices is non-existent. They would hardly have come up with the price structure adopted there.

While the two-tier system lasts, those companies with access to Saudi and U.A.E. oil -- that includes not only the companies with concessions in those countries but also those which buy from them or from the two countries' government companies -- may derive some relative downstream advantage (but no increase in crude oil profit margins) from the lower cost oil. Those without access to this oil will of course be at a corresponding disadvantage. Inventory profits are likely to be quite limited, particularly for those who stored additional volumes of Saudi Arabian crude, since the inventory appreciation is largely offset by the cost of storage. More importantly, in many major consuming countries, including of course the U.S., some form of price controls or price supervision exists which would prevent the accrual of such profits. In fact, past experience has shown that in many of these countries permission to pass on higher crude oil costs is usually delayed well beyond the time of the arrival of the higher priced crude so that the companies often incur initial losses on OPEC price increases.

But how a foreign company fares under a given OPEC price change is really quite irrelevant to the reason for the price change. None of the considerations that went into the two price decisions at Doha had anything to do with oil company profitability. In fact, the only comment made on that subject was Sheik Yamani's warning that he would not let the companies with access to Saudi crude make a profit on the price differential.

Thus, if we are frustrated by OPEC's pricing policy we must discuss it with OPEC and stop inventing convoluted theories of how OPEC's survival depends on the oil companies' support. The reality is much simpler but admittedly much more difficult to deal with.