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OPEC before and after Iraq's Invasion of Kuwait

Presentation by

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What is OPEC?

In the public mind OPEC is viewed as the prototype of a producers' cartel which keeps the price of the commodity it controls substantially above the free-market level. Given OPEC's historic pricing record, this view is quite understandable. However, OPEC does not really fit the standard definition of a cartel whose ultimate purpose is to maximize the profits of its member firms. It was founded in 1960 for the purpose of collectively wresting control over resource policies, including pricing, from the foreign oil companies operating on their soil. This goal was largely achieved by the early 1970's. Since then OPEC has operated as an international association of sovereign countries whose governments see their national interest better served by a uniform pricing policy for their principal export commodity than by competing with one another.

OPEC has of course been a major factor -- at times *the* major factor -- in determining world oil prices since 1973. However, neither of the two historic price explosions -- 1973 and 1979 -- associated in the public mind with OPEC were actually brought on by OPEC. Both were caused by *market* forces reacting to extraneous events which had brought on a sudden supply disruption and major uncertainty on how and when it would end. What OPEC did was to put a floor under the disruption price and thereby prevent a return to the pre-disruption level once the supply crisis had ended.

Historical Pricing Posture

We know from examining OPEC's price proposals just prior to the two price explosions that the organization's own ideas of price increases were quite moderate. But once spot prices started to soar OPEC was quickly caught up in the high-price psychology and believed it could turn aberrations into fundamentals, thereby causing major economic dislocations throughout the world. In the 1974-78 period it was actually able to maintain the crisis price because all OPEC members as well as every other oil producer in the world were producing at or very near capacity. Thus, OPEC producers did not have to lower their prices because, at least temporarily, the world bought all their output at the high floor price fixed by the organization.

After the second (1979/80) price explosion, however, OPEC's hold on prices was quickly undermined by market forces. From 1981 to 1985 both prices and OPEC export volumes kept declining, causing an ever growing idle surplus producing capacity. By 1985 the surplus capacity amounted to over 10 million B/D. By early 1986 OPEC had temporarily lost control as oil prices underwent a historic free fall. Later in the year OPEC regained some control over prices. Nevertheless, from early 1986 until the invasion of Kuwait on August 2nd of this year world oil prices remained low by historical standards. In fact, they were much too low for most U.S. oil producers. Interestingly, just before the latest crisis, too, OPEC had announced its intended new price policy. The OPEC meeting which ended on July 27th raised the OPEC reference price from $18 to $21. If prices had actually moved up to that level, which was by no means certain, prices would have risen by about $4 or 20% by now. Instead, we have a $15-16, or 100%, price increase over July. This is of course due entirely to the U.S. - initiated worldwide boycott of Iraqi/Kuwaiti oil exports.

After a brief hesitation, OPEC at the beginning of September suspended all country quotas to enable its members to raise their production to offset the supply shortfall caused by the shut-in Iraqi/Kuwaiti production. By now this has been almost achieved. Had these countries stuck to their OPEC quotas, as Iran and Algeria advocated, prices would have risen much more, inevitably requiring massive market intervention in the consuming countries through drawdowns of strategic stocks and restrictions on consumption.

All producing OPEC members are of course substantially benefiting from the higher prices, as are all other oil producers. Those OPEC members with significant spare capacity at the beginning of the current crisis are benefiting additionally because their export volume also rose. The 11 OPEC members, other than Iraq and Kuwait, currently produce about 22.2 million B/D, a 20% increase over July, while their prices are up by about 100% (from $16 in July to $33 in October). Hence their current export earnings are more than twice what they were just before the crisis. The biggest revenue increase is going to Saudi Arabia since it is OPEC's largest oil exporter and had OPEC's largest spare producing capacity at the beginning of the crisis. However, Saudi Arabia is of course affected on both sides of the ledger by the Middle East crisis. It has substantial extraordinary military expenditures, including an $8 billion commitment to the U.S. to help defray the costs of Operation Desert Shield.

OPEC's Post-Crisis Role

OPEC's principal function is to calculate a collective production level which will approximately support an agreed-on reference price and assign each member a share of the total. Since the beginning of the Middle East crisis, this function has of course ceased and the organization is, in effect, irrelevant for the time being except as a research and information gathering agency.

However, if we assume that when the crisis ends Iraqi and Kuwaiti oil exports will be restored, OPEC could then play an important role again. If OPEC is to avoid a price collapse, perhaps to less than the immediate pre-crisis level, the return of Iraqi and Kuwaiti exports has to be synchronized with the reduction of exports from other OPEC members. Initially this may not be easily achievable. So, a brief sharp price reduction at the end of the crisis is quite possible. Beyond that period OPEC can be expected to reassert its function as a quota allocator. This would mean reimposition of the $21 price target adopted last July or perhaps a slightly higher price. As pointed out before, such a price would enable U.S. and other relatively high-cost producers to maintain their operations, whereas a price set by competition between OPEC producers with substantial spare capacity would hurt these operations. Furthermore, while a price in the low $20's would trigger moderate but not insignificant energy conservation and fuel switching away from oil, a price in the mid-teen dollar range would not.

Under these circumstances, the lowest world oil price is not necessarily the best, not only for producers but also for consumers. This becomes clearer when we look at oil supply and demand in the more distant future, say, 1995. By then OPEC's pre-crisis spare capacity of about 5.5 million B/D will all have been absorbed into production. Absent an increase in this spare capacity over the next five years OPEC would then have to operate at as high a utilization rate as it did in the 1970's.

Several OPEC countries, however, the most important being Saudi Arabia, have recently begun to increase their production capacities to reverse the decline in their spare capacity since 1986. OPEC's existing spare capacity, in contrast, was not deliberately built to be idle. It evolved involuntarily out of the decline in OPEC production from a peak of 31.5 million B/D in 1979 to a low of 17.3 million B/D in 1985. No non-OPEC oil producer has now or is likely to have significant spare producing capacity since these producers always set their prices so as to produce at capacity, making OPEC the world's swing producer. Thus, the recent moves to increase capacity above anticipated requirements have been concentrated in the areas with vast reserves and high reserve-to-production ratios. The spare capacity will continue to give these producers a measure of control over world oil prices. They are likely to strive for a modest increase from the current $21 reference price over the next few years. However, if world oil prices remain low (say, in the mid-teen dollar range in real terms) over the next 5 years, rising demand for OPEC crude may absorb all existing excess capacity while the funds available for capacity expansion are likely to be insufficient for most countries. One important exception would be Saudi Arabia which is likely to continue to increase its spare capacity even under a low price scenario. On the other hand, Iraq and Kuwait may not be able to increase their capacity in the next few years even under a high-price scenario.

Geography or Organization?

By the mid-1990's OPEC's role as a price setter via the quota mechanism may well diminish or even end. By then only 4 or 5 OPEC members -- all but Venezuela located in the Middle East -- will have significant spare producing capacity. These countries may prefer to negotiate price targets and the underlying production levels with each other rather than submit them to the scrutiny of all 13 OPEC members, particularly since those members which produce at capacity can predictably be expected to have a strong bias towards higher prices in almost any scenario.

The question has been asked whether the U.S. could or should do anything to reduce "OPEC's hold" on the American oil market. I submit that the issue is not OPEC but the Middle East. The two are not synonymous even though the pre-crisis production quota of OPEC's Middle East members accounted for 2/3 of the organization's total quota. (The Middle East members' actual share was still higher since OPEC's 6 Middle East members were the largest violators of the OPEC quota ceilings). As has been shown time and again, the Middle East is an endemically insecure region, politically and strategically. Yet it contains 2/3 of the world's proven crude oil reserves, holds most of the world's spare producing capacity and last year accounted for 42% of total world oil exports. If the U.S. can keep its oil imports from rising in the 1990's, which would be quite a feat since domestic production is declining, this would take some pressure off the growth in Middle East oil exports. However, since world oil demand will doubtless rise throughout the 1990's, probably at 1-2% annually, depending on prices and economic conditions, a growing share of the increase will have to be supplied from the Middle East. Thus, global dependence on Middle East oil can be expected to rise throughout the decade if prices return to more normal levels in the near future. We will have to live with this reality, as will most European countries, Japan and the newly industrializing countries of the developing world. But dependence should not be confused with disruption.

Commercial dependence in this case is a two-way relationship between buyers and sellers. The Middle East oil producers have no other industry but oil and they have enough oil in the ground to sell it in growing quantities well into the 21st century. One of their concerns is that their kind of crude oil may become commercially obsolete long before their resource begins to decline. Having seen in the 1980's what excessive prices can do to their exports in just a few years, most OPEC oil ministers as well as the OPEC Secretariat have expressed concern over the potential longer-term impact of the current crisis-price level. Thus, their interests and those of their customers are not necessarily mutually antagonistic. It is interesting in this connection that the U.N Department of International Economic and Social Affairs has invited a "Group of Experts on International Cooperation in Energy" to meet next week in Geneva to lay the groundwork for an unofficial producer-consumer dialogue in oil and other energy sources under U.N. auspices.

I would like to close my remarks with the comment that while we can live with growing dependence on OPEC oil supplies, we must protect ourselves against the potentially disastrous impact of foreign oil disruption. Our first and foremost weapon in this regard is the Strategic Petroleum Reserve whose importance has become clear during the present crisis, even though we have so far not made use of it. In the post-crisis period we should continue to fill it, test it and view it as our principal weapon in case of another disruption. The OPEC Secretariat, which was once believed to be critical of the concept of a Strategic Petroleum Reserve in the hands of consumer countries, is now advocating its use to mitigate the crisis-induced price increase, a further indication that OPEC is concerned about the longer-term impact of the current high price.