JOINT ECONOMIC COMMITTEE

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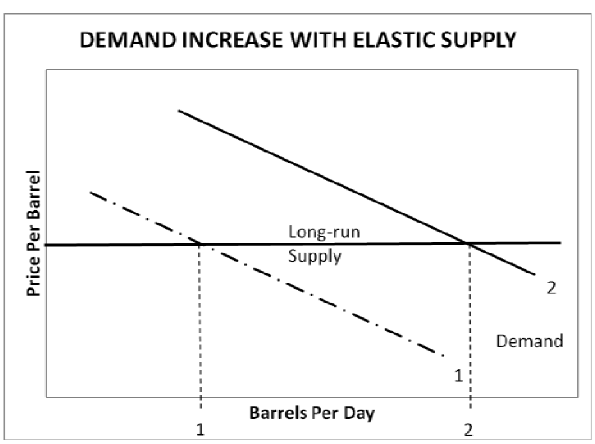
RESEARCH REPORT #110-28
November 2008

OPEC AND THE GYRATING OIL PRICE

The world has seen a $50 surge in the price of oil since January and a $90 drop since August. Perhaps even more surprising is that world crude oil consumption, which had been increasing rapidly, has *not* declined since August. In fact, the Energy Information Administration (EIA) and the International Energy Agency (IEA) continue to forecast increasing world oil consumption. Nevertheless, OPEC is cutting its production quotas. How is one to interpret these events?

OPEC could have stabilized the price. It is important to recognize that demand changes alone do not necessarily cause wild price swings. Figure 1 shows what would have happened if the oil supply were elastic: the additional demand would have been accommodated at the original price. Of course, if demand increases faster than supply can expand, the spot price will rise for a time (the supply curve would slope upward in the short run), but if buyers are confident that additional supply is forthcoming to accommodate the demand increase, then precautionary and speculative buying will not be stimulated and futures prices will not rise.

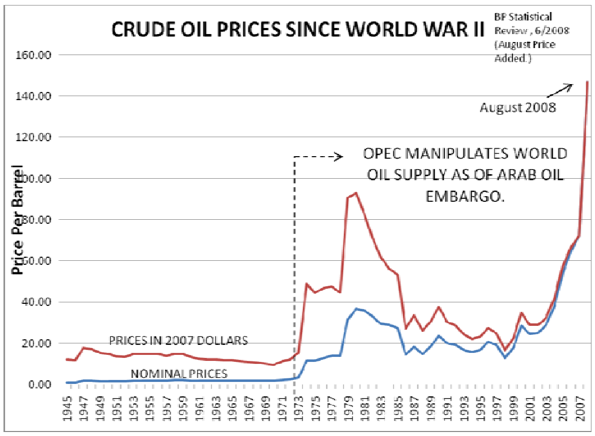
Figure 1



However, the OPEC countries that hold the world's largest and most easily accessible oil reserves (a) constrained supply collectively as consumption rose, and (b) gave no price guidance, i.e., failed to indicate at what price they would increase supply. Their refusal fueled the price surge because buyers extrapolated demand increases and expected that they would continue to run up against limited supply. Consequently, buyers accelerated their bidding for oil and investors, observing the opportunity for price appreciation, piled on. The economic slowdown has rendered extrapolations of oil consumption growth invalid and forecasts, while still increasing, now have been revised downward significantly. The upward shift in oil demand that was anticipatory therefore has reversed, relieving the price pressure for now.

The oil price used to be stable. The OPEC cartel has been compared to the Texas Railroad Commission, which regulates oil production in Texas. When Texas was the largest oil producing area in the world and a flood of new oil discoveries came on line, the Commission could influence the world price by limiting output in Texas. It would do so to maintain a price sufficient to cover the full production cost, including capital recovery, of the existing producers it regulated. But when oil demand rose sharply, it allowed more production. It practiced cost-oriented output regulation. Hence, the market did not come to fear that when demand rose the Commission would withhold output to drive the price ever higher. OPEC, on the other hand, has disconnected its production costs (less than $10 per barrel) from the price completely. In the absence of cost or any other reference point, price has no anchor. This is why the price was stable at less than $2 per barrel for the better part of three decades when Texas was able to increase oil production to meet additional demand but has gyrated wildly since U.S. oil production peaked and OPEC has manipulated incremental supply starting with the Arab oil embargo of 1973.

Figure 2



<u>OPEC seeks a higher long-term price</u>. The oil market could be the most stable of all the natural resource and commodity markets but for OPEC's greed. OPEC's large oil reserves are accessible with relative ease. The Persian Gulf members alone hold 737 billion barrels of proven oil reserves, 55 percent of the world total. Since the oil price first stayed above $30 per barrel in 2004, the cartel has had plenty of time to add pumping capacity, particularly in the Persian Gulf. Yet in all its Persian Gulf member countries combined there are far fewer oil producing wells than in Brazil, for example (7,618 vs. 11,995 in 2007). Had OPEC committed to meet increases in consumption demand at a specified price while working to bring new capacity on line, the enormous price swing would not have occurred. The reason that OPEC did not do so is that it wanted to probe how much more it could charge. What OPEC has found out is that the world economy is much less sensitive to high oil prices than it used to be. It took a global financial crisis to seriously dampen world economic growth. OPEC also has found that oil production outside the cartel has risen only slowly and is not likely to accelerate in the foreseeable future. The EIA and IEA have repeatedly scaled back their forecasts of non-OPEC production increases. Therefore, OPEC now is acting to keep the price vastly higher despite the global financial turmoil and economic slowdown than in 2004 when the world economy was not in crisis. With world oil consumption near 86 million barrels per day (b/d) and rising OPEC will be producing about as much oil after the 1.5 million b/d cut it has announced (excluding new members Angola and Ecuador) as it did in 2004 with oil consumption of 82.5 million b/d. The cartel is ceding some market share but obtains a favorable revenue tradeoff. It also sets the stage for further price volatility as the world economy recovers and oil consumption rises more swiftly again. The oil market already anticipates this: oil futures for delivery dates five years from now trade for $25 more per barrel than the spot price ($83 vs. $58).

<u>Conclusion</u>. It would be a mistake to think that OPEC had become irrelevant to the oil price on the way up or the way down. Effective cartels do not control demand, they control supply. If they want price stability, they have to take a proactive stance, set a price, and supply the market at that price. OPEC has not done so in response to the Asian oil demand surge, because it wants to see what the market will bear. That still has not been settled. OPEC's old price target range was $22 to $28 per barrel, yet even with the price near $60, the cartel is not committing to a forward price, because its choice could be less than the market can stand once the effects of the financial crisis wear off. One should be braced for further oil price volatility.