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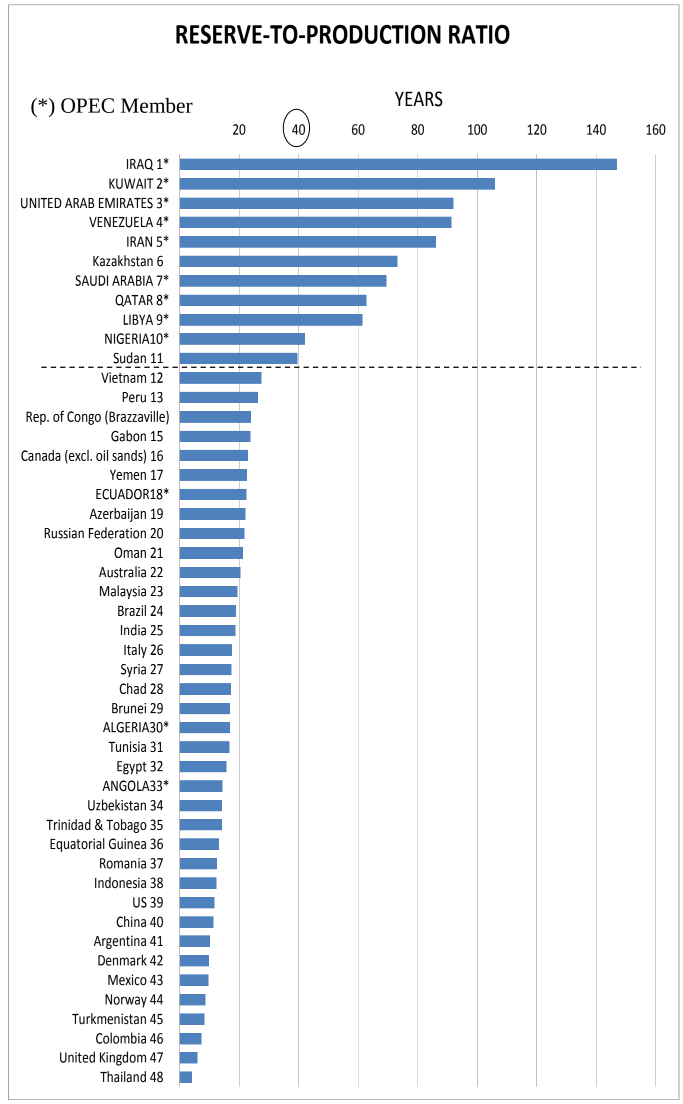
THE OPEC CARTEL IS COUNTERPRODUCTIVE

<u>OPEC holds back massive quantities of oil</u>. To the OPEC member countries clustered around the Persian Gulf holding 55 percent of the world's known oil reserves and exporting their oil through the Strait of Hormuz, it is obvious that jointly restricting supply will boost the international oil price. They have no control over new entry into the world oil market or over world oil demand, but they have in their favor the lowest production cost (less than $5 per barrel), ease of physical access to world markets (via supertankers), and hence a high degree of output flexibility.

It is equally clear that substantial alternative sources of oil supply exist outside the Gulf (45 percent) and that production costs among many of them are not much higher. To the extent that the cartel can persuade other large oil reserve holders to restrain their output growth, the price can be pushed up beyond their costs as well. Making the case for restraint in oil production easier is the fact that in most countries the central government controls production. The cartel has attracted enough members to raise its share of world reserves to 70 percent, 927 billion barrels, and has convinced the members to throttle their output. Figure 1 ranks the world's significant oil producers by how long their reserves[1] would last at present production rates and reveals a large difference between the top 11 countries and all others. Of the 11 countries with the slowest release rates relative to reserve size (reserves divided by production), nine are OPEC members. The reserves of

Figure 1



BP Statistical Review 2008, p.6; www.bp.com/statisticalreview.

eight members would last more than half a century and in the case of two, more than a century. Kazakhstan (5) and Sudan (11) are the only non-OPEC countries whose known reserves would last 40 years or more, and both have difficulty accessing their reserves and/or bringing their oil to market. Among

[1] The full resource potential exceeds "known" reserve estimates. As ongoing oil production reduces known reserves, additional reserves are developed, meaning that the oil would last well past the time periods shown.

the countries with lower rankings, only Algeria, Angola, and Ecuador are OPEC members, whereby Angola and Ecuador joined OPEC only last year. At present, the cartel accounts for only about 40 percent of the world oil supply.

The OPEC member countries vary in population size, contend with various internal political problems, and face varying technical production issues—much as oil producing countries outside the cartel. But member countries have markedly lower release rates relative to reserve size. This demonstrates the cartel's effectiveness in retarding oil production beyond the impact of common hindrances to oil field development and maintenance experienced in many countries inside as well as outside the cartel and beyond the restrictive effect that state control of oil operations tends to have in isolation.

The cartel acts in unison when it has to. When major market events, such as declining demand or new market entry, lower the oil price and oil export revenue, OPEC has shown a remarkable ability to cut production. From 1979 to 1985, while non-OPEC output was increasing, OPEC cut its oil output by 45 percent to support the price and managed to hold it between \$15 and \$21 per barrel for the most part from 1986 to 1999. In the face of a dramatic oil price drop this year, OPEC members again are implementing large output reductions: the cartel just announced its single largest cut ever of 2.2 million barrels per day (b/d) on top of 2.0 million b/d in cuts already under way. In total, 4.2 million b/d are being cut from the actual September rate of 29.05.[2]

OPEC achieves huge operating profits. The Energy Information Administration estimates that OPEC's cost of onshore oil production is a mere \$3 to \$9 per barrel even for projects coming online during the most recent three years. In the past 35 years the oil price has been well above \$10 for all but a few weeks and most of that time at least 50 to 100 percent higher. The period from 1986 to 1999 is often invoked as evidence that the cartel had become ineffective because the price of oil fell steeply, but in truth, it shows that (a) the OPEC members behaved differently from nonmembers, who increased output, and (b) the cartel was able to maintain the international oil price substantially above cost. The parochial interest of producers is to increase oil sales as long as the price exceeds their cost of production, and especially when a price decline lowers the oil export revenue they have come to expect. Holding back a flood of cheap oil from huge reserves over decades not only in the Persian Gulf but also in other countries with large reserves, such as Libya, Nigeria, and Venezuela, has allowed the cartel to push the price well above their cost also. The current output reductions are helping to keep the oil price far higher than OPEC's old price target range of \$22 to \$28, not to mention its cost.

Conclusion. Too often OPEC is cast as just another factor "influencing" the oil market, in view of noncompliance with quotas (generally minor) by some members, technical or political factors that weaken control over output volume, demand changes, and extraordinary price volatility. In fact, the cartel has fundamentally altered the oil market. The OPEC members with the largest oil reserves and the greatest output flexibility implement most of the output adjustments (primarily Saudi Arabia), while the other members desist from undermining them. As Figure 1 clearly shows, the cartel members set their oil release rates proportionately lower than nonmembers. The true measures of OPEC's success are the collective restraint of oil output achieved, the discipline to make drastic production cuts when the price falls, and maintaining the price far in excess of cost through all phases of its gyrations.

[2] For OPEC's 11 members subject to output quotas; this excludes Iraq whose quota is suspended.