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EXPECT NO RELIEF FROM OPEC

Pretending no more. For a long time OPEC officials have feigned lack of intent with respect to the high international oil price. That has changed. Mr. Chakib Khelil, Algeria's energy minister and the cartel's new president as of January 1, offered his view of the record oil price:

> "$100 per barrel for crude oil is not necessarily very high," and "if the (possible) recession in the American economy takes shape, OPEC is not going to increase its supply from the moment that is needed only to reduce it later."[1]

When questioned in an interview about influencing the oil market by cutting back or expanding production, the cartel's secretary general, Abdalla Salem el-Badri of Libya, said:

> "That's true, and we do this as we see fit. Beginning in 2004, we increased production by close to 5 million barrels per day by the end of 2006. Then we reduced production by 1.7 million barrels when we felt that the price was too low. It was a very good decision as far as OPEC is concerned."[2]

OPEC will exploit its position. As OPEC is convening on February 1, its leadership is not motivated to lower the oil price:

- The cartel's objective is to maximize the wealth transfer from oil consuming nations by manipulating the international oil market, not to help manage their economic stability.
- In theory, it may be to the cartel's benefit to increase supply if it can *preempt* an international recession and a large drop in demand for its oil. But as a practical matter, OPEC will not risk an increase that could *coincide* with a drop in world oil demand.
- OPEC's own growth prospects are generally good. Oil is abundant and fuel prices are low in its home markets.
- Despite an extremely high price umbrella on the international market, non-OPEC suppliers are not threatening the cartel's market share for now.
- The cartel is uncertain how two of the potentially very large producers in its ranks, Angola and Iraq, will manage their oil exports going forward. Keeping the cartel's output ceiling consistently low may discourage them from substantial export increases. (Angola joined OPEC in 2007, and its quota became effective this month. Iraq's remains suspended.)

World oil demand is likely to stay strong. In OPEC's estimation, a recession-induced drop in oil demand likely is not viewed as severe enough to warrant preemptive easing

[1] Dow Jones Newswires, January 5 and 6, 2008; http://online.wsj.com/article/BT_CO_20080105_700825.html and http://online.wsj.com/article/BT_CO_20080106_7002800.html.

[2] "International Oil Companies Are the Real Dinosaurs," German news magazine *Der Spiegel*, 1/20/2008. The price considered "too low" was about $55 per barrel. The secretary failed to mention that after 2000, OPEC *cut* oil output by as much as 2.6 million b/d before raising it again.

of the oil supply. In the first place, a recession and a decline in oil demand are by no means certain. The Congressional Budget Office, for one, projects that the U.S. will narrowly avoid a recession. World oil consumption forecasts by the Energy Information Administration (EIA), International Energy Agency (IEA), the Oil & Gas Journal (OGJ), and the one published by OPEC itself all project increases for 2008, not withstanding the economic slowdown in the U.S. These consumption increases are expected to occur despite *higher* average annual oil prices than last year. The EIA estimates that benchmark crude will rise from $72.30 per barrel in 2007 to $87.21 in 2008. With respect to the very near term, the seasonal springtime decline in world oil consumption would largely coincide with the onset of a recession, if one does occur, which means that OPEC is disinclined to increase supply at this time in particular. (There is some delay in implementing supply changes.)

Boston energy consulting firm Cambridge Research Associates (CERA) finds that the oil price would have to rise to about $110 per barrel and last six to twelve months to cause the economic harm that the oil price peak in 1980 brought about.[3] Beyond the fluctuations of the business cycle, the economy's underlying resilience to high oil prices thus may be even greater than manifested so far—further reason why OPEC won't relent from its restrictive supply stance.

The high oil price does not result from natural production declines. CERA has conducted a detailed study of 811 oil fields around the world.[4] A huge number of projects are under way in Brazil, Saudi Arabia, West Africa, the Caspian Sea, and the Gulf of Mexico that will more than make up for the natural declines from fields now in production. Pumping capacity could increase to 122 million barrels per day (b/d) by 2017 from about 91 million now (not all of which is in use; mostly OPEC keeps idle capacity.)

OPEC in particular enjoys an abundant oil supply. The OPEC member countries themselves have been consuming substantially increasing amounts of oil at very low prices and many are experiencing significant economic growth. For example, in Algeria and Libya, the home countries of the cartel's president and secretary general, the price of diesel fuel is less than $1 per gallon. The cartel's ability to increase the oil supply at low cost is not in question. OPEC's oil reserves have increased from 902 billion barrels in 2006 to 918 billion barrels in 2007 for its eleven long-time members (932 billion barrels including new members Angola and Ecuador).[5]

It is important to distinguish between the market for internationally traded oil and national oil markets. The cartel members' oil *exports* matter for the international price and those have been curtailed by coordinated action to drive the price level up to unprecedented heights. Non-OPEC countries are on track to increase oil output in the coming years but not sufficiently to match incremental demand in 2008 and at best, they will hold pace

[3] "$100 Oil: Moving Deeper into Uncharted Territory," Cambridge Research Associates, January 3, 2008; www.cera.com/aspx/cda/public1/news/PrintPage.aspx?CID=9190&Page=NDR.

[4] January 17, 2008 press release on CERA/HIS Study; www.cera.com/aspx/cda/public1/news/PrintPage.aspx?CID=9203&Page=PDR. Also, see "New Fields May Offset Oil Drop," *Wall Street Journal*, 1/24/2008.

[5] "Worldwide Look at Reserves and Production," *Oil & Gas Journal*, December 24, 2007.

with the expected demand increase in 2009. EIA estimates the non-OPEC supply increase at 2.41 million b/d compared with an increase in world consumption of 3.16 million b/d through 2009. Therefore, OPEC is under no immediate pressure to defend its global market share.

Matters internal to the cartel. OPEC now counts 13 members. Among the considerations that motivate them individually are, on the one hand, the desire to increase earnings from the sale of more oil and, on the other, the knowledge that increased oil sales will tend to lower the market price. In an environment where demand and price are increasing and there is little competitive pressure, earnings rise and it is relatively easy to maintain sales discipline. EIA's "OPEC Revenues Fact Sheet (January 2008)" shows that OPEC's net oil export revenues reached $675 billion in 2007, a 10 percent increase over 2006, and could reach $850 billion in 2008. However, Angola and Iraq could weaken the cartel's discipline in the future.

Angola has been a fast-growing oil producer that joined the cartel in January of 2007. No doubt pleased to have a competitor become a member, the cartel leadership did not assign a production quota immediately, but waited a full year. The ceiling is 1.9 million b/d effective this January, which is lower than expected and very close to the rate at which Angola now is producing oil. Iraq has enormous oil reserves. Together with Saudi Arabia, Iran, and Kuwait, it is among the so-called "Big Four" Persian Gulf oil nations. As other factors constrained its ability to produce and export oil, the cartel had suspended its quota. If Iraq continues to stabilize politically, oil exports could become the vehicle for its people to escape poverty and strife. Neither Angola's nor Iraq's willingness to submit to a quota going forward is clear yet, which presents added reason for the cartel not to liberally raise the other members' ceiling.

Conclusion. OPEC feels in control of the oil market right now. It sees no compelling reason to increase supply and lower the oil price at this time to address the economic slowdown, because (1) a recession neither is certain nor believed to impair world oil demand very much, and (2) it wants to avoid increasing supply just as demand declines, and a seasonal decline is approaching in the second quarter. Price may fall from extraordinary highs reached briefly but on average still is likely to move higher this year and next than in 2007. Non-OPEC production will not seriously challenge OPEC in the next two years. The cartel also sees risk factors ahead. CERA shows oil supply capacity increasing by a third in ten years, including OPEC and non-OPEC countries. Angola and Iraq have the potential to increase supply substantially and may feel inclined to exceed cartel-imposed production limits. OPEC's reaction for now likely is to grip the oil spigots tighter. This may explain why its officials are hedging less and intend to project more power over the market in their commentary.

OPEC's oil price strategy makes dealing with the near term economic challenges much more difficult, whether its assessments and the forecasts cited are correct or not. And, whatever market signals OPEC officials intend to send with their commentary, it is striking how the cartel president can proclaim that $100 oil is "not necessarily very high" while OPEC's oil reserves increase, its oil export revenue reaches record highs, and fuel prices in its domestic markets remain low.