Comment

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From an academic point of view, Professor Griffin's paper is excellent in its lucid analysis of what should be OPEC's ultimate behaviour as a maximizer of income. He also instructively points to the crucial role of what he calls the "cartel core" or the large oil reserve group, which is interested more in lower non-monolithic cartel price developments. The other two groups mentioned in the paper, which comprise the majority of OPEC members, are said to be interested in maximizing their income mainly through higher prices, but cannot in the final analysis exert any large influence on the price formation. Their small production capacity would not put them in a strong negotiating position vis-a-vis the first group which, according to Professor Griffin, comprises Kuwait, Saudi Arabia, the United Arab Emirates, and also post-Saddam Iraq.

While I agree with Professor Griffin in grouping the latter countries as being qualified to be in the core, it is not clear to me why he adds both Qatar and Libya to this group since their reserves are small. Furthermore, I concur with Professor Griffin's conclusion that no major price fluctuations would be expected in the medium term and that prices will oscillate around the present levels. But at the same time, I fail to understand his assertion that prices will be maintained in real terms rather than in current dollars, as an abun-

Energy Studies Review Vol. 4, No. 1, 1992 Printed in Canada

dant unused production capacity will be available until the end of the century. This point will be taken up later.

While the paper presents impressive analytical insights, there is a doubt in my mind about its perception of OPEC in general. The organization is not viewed as it was and as it is today — a political organization of economically heterogenous countries of clashing national interests. Instead, OPEC is reconstructed in the paper from this reality into a rational group of economic entities fully aware of their long term interests as a basis for their action on income maximization. Naturally, for someone like myself who lived with the OPEC process of decision making for more than 20 years, this reconstruction does not help much in understanding the real mechanics of OPEC and its pricing policies.

For example, the paper assumes that there must have been collusion among the high reserve countries not to expand production capacity in order to keep prices at high levels. This is simply not the case. The real reason why those countries did not invest in new capacities in the past was that they were, for many years in the 1980s, burdened with huge idle capacity as a result of the sharp decline in the call on OPEC oil which continued through 1985. When demand started to pick up in subsequent years, and investments in new capacity became necessary, those countries were overwhelmed with severe financial problems. With the need for oil income to support the public budgets the governments simply cannot afford to spend on these investments.[1]

Oil ministers are politicians and, by definition, politicians look always to the short term. Never in its history was OPEC successful in discussing seriously and meaningfully its income maximization in the long run and whether to achieve it through price or through volume, i.e., market share. The development of a long run OPEC strategy has been a total failure.

During OPEC meetings, a country like Saudi Arabia, with almost 250 billion barrels of oil reserves, will have to discuss prices with a country like Gabon, which has less than 2 billion barrels of oil reserves. Or a country like Kuwait, with a life span for its reserves reaching over 200 years (based on its pre-war production rates), will have to enter into heated negotiations with countries like, for example, Algeria and Ecuador, with life spans of reserves around 20 years.

Naturally, countries with low reserves/production ratios, like Gabon, Ecuador, Algeria, Indonesia, Nigeria, Qatar, and even Libya, seek higher prices in order to maximise their immediate income through higher revenue per barrel. Saudi Arabia and Kuwait, in contrast, look for greater market share and therefore have a lesser interest in high price levels. This divergence of interests makes it difficult to design a cohesive OPEC policy.

Production capacity is another important example of the clashing national interests of OPEC members. Algeria, with a current production capacity not exceeding 750,000 b/d, and hardly able to produce it, exerts pressure on large capacity producers to reduce output in order to increase prices. Any moderation in price would mean for Algeria a net loss in income.

Conflicting interests are also due to the vast differences between the national economies of OPEC nations. A country like the United Arab Emirates, which has more than $14,000 per capita income and a total population of not more than 1.5 million, a majority being expatriates, has to sit at the negotiating table with Nigeria, whose per capita income is only $165 with a population of 66 million! There are wide differences in the current accounts and levels of indebtedness among OPEC members. Venezuela with about $30 billion external debt obviously pursues other policy objectives than Kuwait, which has over $100 billion external investments.

All these incompatibilities of national interest prevent any common position on the optimization of resources and income flows, that could be the basis for rational decisions. This situation is the opposite of the theoretical cartel members, who are supposed to be clearly aware of their long term communality of interests. The sad reality of OPEC is that its member countries are generally interested in short term financial gains

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1/ See paper by M. Adelman, pp.7-22 above.

and, for this reason, they cannot agree on medium or long term policy objectives, because these are not of great relevance to them.[2]

The political factor appears most starkly when we see that even countries which do have similar national interests are not able to take joint positions. Iran of the Shah, and again of the mullahs, has been systematically taking a hawkish position on prices, and disagreeing with Saudi Arabia's desire for a moderated stance. This is not compatible with the theoretical insight that Iran, being a high reserve country, should presumably be closer to Saudi Arabia than to the group called the "price maximizers." Kuwait was equally short sighted, despite its massive reserves, as it followed the price hawks in adding up economically unjustifiable price increases during 1979-80. Retrospectively we know that these price policies backfired, mainly on the Gulf, which suffered most from the sharp demand decline between 1978 and 1985. Saudi Arabia and Kuwait suffered most, when the declining call on OPEC oil cut the cartel's production by half during the period. Kuwait's pricing policy proved clearly incompatible with its own long term interests.

A more striking example of the predominance of political considerations in examining OPEC policies is that Saudi Arabia, although not convinced of the price increases of 1979/80, and being conscious of the importance of world demand for its oil, had to give in to the political pressures exerted by Algeria, Libya and the other small producers in OPEC. OPEC history shows that many of the major decisions are the result of political compromises, and not economic optimization.

OPEC members show heterogeneity in quite a number of ways, including the way they market their oil. This can have an impact on the distribution of market shares in times of market glut. Saudi Arabia, for example, has little access to downstream operations, so it has to market almost all its oil in the form of crude (the recent deal with Texaco is an exception), whereas Venezuela markets its oil almost entirely in the form of products. Eighty percent of Kuwait's oil is marketable through downstream operations in which Kuwait invested very heavily through the last 20 years.

In a glutted market it is very difficult for an OPEC member exporting mainly crude oil to sell its output at the so called fixed selling price as defined by OPEC. Saudi Arabia, for example, was unable to market its entire quota during the glutted years of 1981-85 because it had no way to escape from the OPEC price discipline. The Saudis therefore had to give up (until 1985) almost half their quota in the defence of the OPEC price. In contrast, countries like Venezuela and Kuwait are in a better situation because of the flexibility they enjoy in the marketing system through downstream operations which put them outside OPEC's price discipline; even in times of severe market depression, these two countries have always been able to market their full national quotas.

These disparities, together with the irrational price policies followed by OPEC in the 1970s and early 1980s, were behind the collapse of the price structure in 1986 and not a "tit-for-tat" policy of Saudi Arabia to contain cheating on quotas by the other members, as Griffin thinks. Between 1982 and 1985, the call on OPEC oil was itself below the total production ceilings agreed upon by OPEC so that the defence of price could either be shouldered by all countries (i.e., all should produce below their individual quotas), or this load could be carried by only one or two "swing" producers while the others supplied their own quotas in full. In 1984-85, and especially 1985, a substantial cut in OPEC production was necessary even without cheating on the part of any member.

As noted, the commitment by Saudi Arabia to sell at fixed prices forced her to reduce production because buyers shied away from its oil. In 1985, however, when its market share had experienced a severe fall, this country decided to shift to a market-oriented price formula (netback sales) in order to put itself on par with the other members who were selling at market-oriented prices in one form or another. The adoption of this system was a turning point in the history of

2/ See paper by M. Adelman, pp.7-22 above.

OPEC. It implied a de facto abandonment of the fixed price system and of the unequal sharing of the burden of price defence.

This type of intra-OPEC price diplomacy is often ignored in academic papers, which try to rationalize OPEC actions and reactions vis-a-vis events, even when such rationality is not there. OPEC's price behaviour was exogenous to the industry. It was prompted by nothing else than the political desires to attain short-term economic gains.

As Figure 1 shows, price movements were sharply fluctuating in response to major political events, and not to market fundamentals. This was the case of the first price explosion of autumn 1973, following the oil embargo imposed by the Arab oil countries in support of Egypt in its war with Israel. This chart also shows how the Iranian revolution and the Iran/Iraq war had influenced the price making. OPEC's reaction to these crises was to grab the market gains by increasing the price, without decreasing it when the crisis was over. Naturally the Gulf war had a similar price impact, with the difference however that OPEC dealt with this crisis more realistically than in previous cases, by allowing prices to fall after the war had ended.

Griffin's paper is incomplete by omitting the description of the situation after the Gulf War and the emerging role of Saudi Arabia as practically the only oil exporter with the power to determine prices. The other members of OPEC (the majority) are producing at their maximum capacity and are not capable of expansion in the near future. Because of the war and its aftermath, Iraq and Kuwait will not be able to assume any significant role in the process of price making in spite of their enormous oil potential. It will take a long time for Iraq just to regain its pre-war production position. The damage to the Kuwait oil industry has been less in the physical production capacity than in the managerial disruption of the whole country. As for the other two Gulf countries, namely Iran and the United Arab Emirates, their potential for expansion in production capacity in the medium term is limited.

The crucial issue is how the Saudis will play their oil cards within OPEC. As the only remaining "price maker" in OPEC, the Saudis' role has to be seen through the strategic relationship which emerged between the Gulf countries and the United States of America as a result of the war. This point is related to the US dependence on Gulf oil, mainly from Saudi Arabia, and the increasing dependence of the Gulf, especially Saudi Arabia, on the security shield provided by the US.

As a result of the low price regime administered by OPEC since 1986, the US dependence on oil imports has kept increasing, so that these imports in 1990 accounted for about half of the US oil consumption compared to 35% in 1985. Virtually all the additional imports came from the Gulf, so that by 1990 Gulf oil accounted for 25% of total US oil imports. In 1985, the share had been only 8%. Lower OPEC prices led to an increase in the US demand for oil and a decrease in US production. The gap between domestic consumption and production in the US was therefore widened. The gap had to be filled in by the Gulf exporters, since the production capacities in other exporting areas are either declining or stagnating. According to a study by the Centre for Global Energy Studies, the dependence of the US on Gulf oil could increase to 43% of total imports by the end of the century if US production levels remain unchanged. However, if US oil production continues to decline at the rates witnessed in the last five years (5% annual reduction), the dependence on Gulf oil could reach as high as 57% of total imports, corresponding to the staggering figure of 7 million barrels per day. These results are based on the assumption that prices are kept constant in nominal terms and that US demand for oil continues to expand at the high rates recorded between 1985-89 (9.4% in total over the four year period). Naturally, only the Gulf can secure an expansion of this size.

For the US such a dependence raises a series of strategic and economic problems. The US would have to mount a political effort, a workable system to secure this enormous volume of oil. Also, the price of oil imports poses difficult issues, whichever way the prices move. A rising price can create problems for the US economy and the balance of payments. Conversely, lower oil

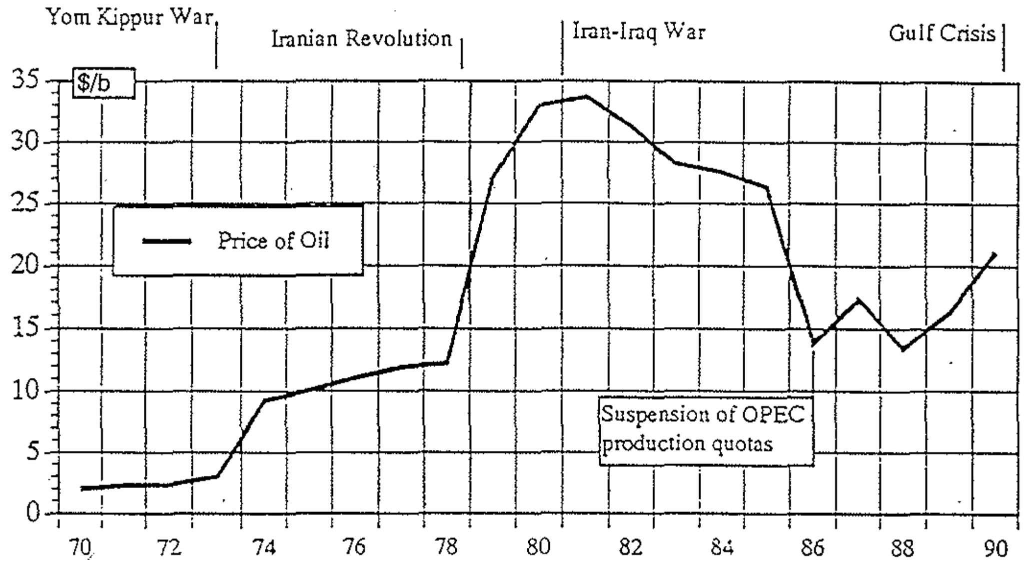

Figure 1: Oil Price since 1970

prices can help the US economy to revive and regain competitiveness in international trade. On the other hand, lower oil prices would harm the oil industry inside the United States and hence increase dependence on imported oil. This is widely considered to be strategically undesirable.

Against this increasing US dependence on Gulf oil, the war has created a totally new regional geo-politics, which would make the Gulf countries increasingly dependent on the US for their security. Prior to the war, the Gulf Cooperation Council used to take the position that the defence of the Gulf belongs to the Gulf itself, and not to foreign powers. This might have been feasible during the cold war when the nuclear deterrent of both the United States and the Soviet Union created a strategic balance in the Gulf. The war created a new situation in which the US is the only super-power in the world. The Gulf attitude now is to depend on the US and, to a lesser extent, the UK for maintaining security. This shift is especially important when we consider another change in the geo-politics of the Gulf. As a result of the destruction of Iraq's military power and industrial infrastructure, Iran has became the only regional power of note. The need for protection from the US, felt by the other Gulf countries has increased even more in consequence.