

## OPEC Policy:

### A Correction Rather Than a Cure

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#### Brief Analysis

The Organization of Petroleum Exporting Countries (OPEC) is meeting this week in Beirut, where the cartel is expected to confirm a higher production ceiling that should lead to a decrease in international oil prices. Nevertheless, the sharp price hikes seen during the past few weeks have rekindled questions about OPEC's motivations and whether the world would be better off without the organization.

Since the beginning of December 2003, the OPEC basket price (i.e., the arithmetic mean of six different brands of OPEC crude plus one brand of crude from non-OPEC Mexico) has traded above OPEC's own stated price band of \$22-28 per barrel, declared in March 2000. This discrepancy has been a source of significant irritation. Moreover, although OPEC usually gives the oil market ample forewarning of its proposed decisions, many were both surprised and angered when OPEC decided in February 2004 that it would cut production by 1 million barrels beginning in April. At the time, the cartel apparently mistook a brief weakening in price as a sign of impending collapse.

#### Quotas and Competing Priorities

Upon its establishment in 1960, OPEC consisted of five member countries. The cartel reached a peak of thirteen members before settling at its current level of eleven (although member state Iraq's oil output has not been part of the cartel's quota agreements since March 1998). Formed "to unify and co-ordinate" its members' oil policies, OPEC achieved notoriety in 1973 by raising prices four-fold during the October War, a move accompanied by the freezing of Arab oil sales to the United States. Since 1982, the cartel's members have attempted to set crude oil prices by agreeing on production quotas. Although the existing quota total of 23.5 million barrels per day is less than one-third of daily global consumption (approximately 80 million barrels), OPEC crude dominates the internationally traded oil market and therefore effectively determines price.

OPEC members have a variety of policy objectives, many of them contradictory. Countries such as Iraq, Kuwait, and the United Arab Emirates are estimated to have more than 100 years worth of oil reserves at existing production levels. Therefore, they argue that pricing oil "reasonably," so that it continues to have a vital role in the world economy for as many years as possible, is important. At the same time, Iraq needs increased revenues now. In

addition to the recent overthrow of Saddam Husayn, the country has a much larger population than Kuwait or the emirates and therefore requires significantly more revenue for social spending. Similar factors apply to Saudi Arabia (with eighty-six years of reserves) and Iran (with seventy-four years).

The other members of OPEC -- Algeria, Indonesia, Libya, Nigeria, Qatar, and Venezuela -- have similarly competing priorities. These priorities are further complicated by other factors such as the varying costs of extraction, the need to maintain market share, and the parallel and sometimes competing desire to exploit large gas reserves. Politically, it is difficult to typecast OPEC members: the image of third-world radicals has never quite fit. For example, the 1973 price hikes were led by the pro-American Shah of Iran. And while the preponderance of Arab members means that Arab issues are seldom forgotten within the cartel, this fact did not stop Iran and Iraq from attending meetings together during their 1980-1988 war.

#### Doubts about Saudi Policymaking

Currently, OPEC decisionmaking is dominated by Saudi Arabia, the only member with significant, quickly available spare production capacity. This capacity gives Riyadh a potential disciplining measure if quotas are broken. Riyadh's recent verbal pledge to increase its production by 1.5 million barrels per day (a move that must be confirmed at the Beirut meeting) would be one of its largest-ever production changes within an OPEC context. (The kingdom had previously increased production at times of international political crisis, e.g., after the terrorist attacks of September 11, 2001, and the 2003 invasion of Iraq.) In effect, such an increase would constitute an admission of a previous policy error. This perception could exacerbate rather than diminish the sense in the world oil market that Saudi Arabia is politically unstable, especially after the latest terrorist attacks against expatriates working in the Saudi oil industry. Ahead of the Beirut meeting, Saudi oil minister Ali al-Naimi repeatedly blamed high oil prices on speculators who recently began trading in oil futures as a hedge against the declining value of the dollar.

#### Economic Logic

Like any cartel, OPEC must constantly ward off its own self-destruction. When prices are weak, national revenues are further constrained by subsequent production cutbacks, forcing smaller and poorer cartel members to question the value of production discipline. (Ecuador and Gabon both left the organization in the 1990s as prices declined.) When prices are strong, however, members often give in to the temptation to exceed production quotas in order to generate additional revenue. In April 2004, for example, OPEC exceeded its quota by 2.3 million barrels per day; in other words, the cartel was nearly 10 percent over quota (these figures do not include Iraq). Figures from the U.S. Department of Energy indicate that most member states were intentionally "cheating" by producing over quota. Indonesia and Venezuela were under quota, but only because of their limited production capacity rather than intentional adherence to OPEC agreements.

When prices are high -- particularly around the current level of \$40 per barrel for the U.S.-traded West Texas Intermediate brand, which enjoys a premium over most other brands of OPEC crude due to its refining qualities -- many marginal oil-producing areas around the world become economically viable. Theoretically, then, the next few months should see a surge in world oil production, which would cause a decrease or even a dramatic collapse in prices. Yet, any such increase in production would not match Saudi Arabia's current production level of 8 million barrels per day. Therefore, the world economy will likely remain reliant on Saudi oil for the foreseeable future -- meaning that concerns about the stability of the kingdom and its OPEC neighbors in the Persian Gulf will continue unabated.

#### Tough Questions for U.S. Policy

Americans might regard the current cost of gasoline as outrageous, but they still pay only a third of what European drivers do on average. Although the United States imports 60 percent of its oil needs, these imports are

predominately from non-OPEC countries such as Canada and Mexico, with comparatively little coming from the Middle East. If it were not for political uncertainties among oil producers, the future of oil prices would theoretically tend downward. As the experience of the past five years suggests, however, there would still be large price oscillations because of OPEC's policy failings. (In 1999, for example, prices fell to around \$10 per barrel.) Economic theory suggests that more spare capacity should be developed, but such a move would be anathema for commercial oil companies, although not for state-owned companies. As always, given the current environment of political insecurity, nations should pursue policies that encourage greater vehicle efficiency and alternative fuels.

Simon Henderson is a London-based associate of The Washington Institute and author of the Institute Policy Paper [The New Pillar: Conservative Arab Gulf States and U.S. Strategy \(templateC04.php?CID=33\)](#) (2003).

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