

Organization of Petroleum Exporting Countries (OPEC)

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INTRODUCTION

As a bloodline for the world as we know it, petroleum has become an integral part to virtually every aspect of our lives. From heating our homes and producing plastics to helping fuel the cars and planes we operate, it is clear that petroleum and its resulting products has helped shape the way modern society works. However over time, existing petroleum reserves have dwindled in volume and yield. Thus, the overall supply of petroleum and oil has often been able to keep up with overall demand. One of the most powerful entities that influences the supply and effective prices of petroleum and oil is the Organization of Petroleum Exporting Countries (OPEC).

This oil **cartel** is a trade bloc composed of twelve nations: Algeria, Angola, Ecuador, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the United Arab Emirates, and Venezuela. In 2008, Indonesia withdrew from OPEC when it became a net importer of petroleum. However, it expressed interest in returning should it become a net exporter again. OPEC's main objective is, "...to coordinate and unify petroleum policies among Member countries, in order to secure fair and stable prices for petroleum producers; an efficient, economic and regular supply of petroleum to consuming nations; and a fair return on capital to those investing in the industry" (OPEC). A keen interest of OPEC is the determination of the best methods for safeguarding and expanding the cartel's individual and collective interests.

With growth in nations across the globe such as China and India, the influence of OPEC on oil prices and production has become stronger. Since many nations depend on the energy input petroleum provides to operate socially and economically, increases or decreases in per barrel price of oil can have dramatic effects on economic growth. OPEC nations work together to collectively set production levels that effectively change the price people pay at the gas pump. Major disruptions in oil supply to other countries can have drastic effects. Nonetheless, despite overall increasing demand for petroleum and oil, OPEC members must strive not to abuse this power as taking actions that increase oil prices on markets might decrease consumer demand and lead to heightened tensions between producer and consumer nations. Conversely, as prices begin to fall, OPEC nations must act together in order to keep them from falling.

Cartel – a combination of independent business organizations formed to regulate production, pricing, and marketing of goods by the members



Clearly, as the world continues to grow in terms of population and energy consumption, OPEC will continue to play an influential role – so long as oil fields continue to pump smoothly without interruption. Additionally, with bigger pushes towards renewable energies and sustainable growth, it will be interesting to see how OPEC nations work together to maintain an economic stronghold and pursue their interests while supporting such progressive ideals. Nonetheless, in a holistic sense, OPEC will continue to be the gatekeeper to oil and petroleum for the foreseeable future to come.

EXPLANATION OF THE TRADE BLOC

Brief History of OPEC

During the 1960s, the concept of OPEC first came into development in the eyes of Venezuela. This nation, partnered with five other nations created a goal of, “...preventing its concessionaries – the world’s largest oil producers, refiners, and marketers – from lowering the price of oil” (Britannica). OPEC was officially founded in 1960 in Baghdad, Iraq after United States President Dwight Eisenhower instituted a law that forced **quotas** on Venezuelan and Persian Gulf oil imports. These quotas effectively favored Canadian and Mexican oil industries. The goal of OPEC was to unify and coordinate member nations’ petroleum policies. Similarly, OPEC prevented oil price reductions in the markets during the 1960s, but the success spurred increases in production. This resulted in gradual declines in the **nominal** price of oil.

As the 1970s came around, OPEC members focused on “...ensuring complete sovereignty over their petroleum resources” which led them to, “...nationalize their oil reserves and alter their contracts with major oil companies” (Britannica). With continuing persistence of the Arab-Israeli wars, OPEC raised its oil prices by 70% in October 1973. Two months later in December, prices were raised 130%. Later, OPEC’s Organization of Arab Petroleum Exporting Countries (OAPEC) – formed in 1968 – curtailed production and set an embargo on oil shipments to the United States and Netherlands. These countries did this for the purpose of centering their policies and placing pressure on the West over their support of Israel during the Arab-Israeli wars. In the west, people witnessed spiraling **inflation** and oil shortages that had never been seen before. As OPEC continued to raise prices over the rest of the 1970s, its political and economic power increased. Prices increased tenfold from 1973 to 1980 (Britannica). As money flowed to OPEC member countries, the nations began large-scale social and economic development programs and began heavily investing abroad – particularly in the United States and Europe.

Quota – a quantitative productive assignment

Nominal – of, relating to, or being the amount or face value of a sum of money or a stock certificate, for example, and not the purchasing power or market value

Inflation – a persistent, substantial rise in the general level of prices related to an increase in the volume of money and resulting in the loss of value of currency



In the early 1980s, oil-importing countries began to slowly react to high oil prices and began reducing overall energy consumption, finding other sources of oil, and developing alternative sources of energy like coal, natural gas, and nuclear power. In response, OPEC members reduced their production levels – an unsuccessful effort to protect their high prices. OPEC slowly began to lose some unity and their net export revenues fell in the 1980s when oil prices dropped close to 50% in 1986. The brunt of this decline was felt by Saudi Arabia whose oil revenues shrank by about 4/5 (Britannica). Oil prices as a whole dropped to less than \$10 per barrel.

The Iran-Iraq War from 1980-1988 shook the unity of two OPEC countries. This also brought about a major policy shift from Saudi Arabia in which it stated that, "...it would no longer defend the price of oil but would defend its market share" (Brittanica). Following in suit, other OPEC members joined in protecting their respective production quotas.

As the 1990s began, OPEC members continued exercising their protection on oil production quotas. Before the 1990-1991 Persian Gulf War, Iraq advocated that OPEC increase world prices in order to help Iran and other member states repay debts. However, division and dissonance from the Iran-Iraq war and invasion of Kuwait lingered amongst OPEC members and did not allow for cohesion. Oil prices continued to slump to about \$15 per barrel by the late 1990s (Brittanica). And, as the 21st century commenced, the September 11,2001 attacks on the United States in conjunction with the 2003 invasion of Iraq elicited a sharp increase in oil prices to levels far above those that OPEC had targeted during the previous period. On a contrasting note, as international efforts to reduce burning of fossil fuels began to gather strength during the 21st century, the case has been made that the demand for oil will eventually decline. Clearly, "...the power of OPEC has waxed and waned since its creation in 1960 and is likely to continue to do so for as long as oil remains a viable energy source" (Brittanica).

Setting of Oil Prices

There is a common misconception that OPEC nations are price setters of crude oil. Although they did set crude oil prices from the 1970s through the 1980s, that is no longer the case. However, it is true that, "...OPEC's member countries do voluntarily restrain their crude oil production in order to stabilize the oil market and avoid harmful and unnecessary price fluctuations" (OPEC). One must not confuse this with price setting though.

In today's markets, movements along the three major interna-



tional petroleum exchanges set the price of crude oil. The first major exchange is the New York Mercantile Exchange (NYMEX, <http://www.nymex.com>). This is the world's largest **commodity futures exchange** located in New York City. Commodities traded on this exchange include crude oil, coal, natural gas, gasoline, propane, and more. In this exchange, with a weak U.S. dollar, the per barrel price of oil will often trade at higher prices. A weak U.S. dollar in comparison to other foreign currency in the foreign exchange market require more capital per barrel of crude oil in comparison to if the U.S. dollar is strong. Crude oil prices are also set in the International Petroleum Exchange in London (IPE, <http://www.ipe.uk.com>) and the Singapore International Monetary Exchange (SIMEX, <http://www.simex.com.sg>). These exchange markets work in a very similar sense to the NYMEX.

OPEC member nations have a significant effect on the prices at which crude oil is traded through rates of production in the face of heightened, diminished, or steady demand. It is imperative that any actions taken by OPEC member nations be analyzed thoroughly as shifts in production that increase or decrease production can have significant effects on consumer demand and trade revenue.

RECENT DEVELOPMENTS

Financial Crisis and Impact on Oil

In October 2008, the entire world delved headfirst into what would become one of the worst global recessions in decades. As a financial crisis hit the United States, housing markets slumped, credit froze, stocks plummeted, and jobs and investments fell through the floor. It seemed as if the economic society we had come to know came to a screeching halt. Alongside this deep recession, the OPEC community took a brutal hit as well. According to OPEC members, "Demand for OPEC crude has fallen so sharply because of the world recession that it will take another four years to recover to 2008 levels" (AP). Falling international industrial productions across nations worldwide severely dampened crude oil use. Furthermore, OPEC nations revealed that, "...the world would need 87.9 million barrels of crude a day by 2013 – nearly 6 million barrels less than previously expected" (AP). This essentially boils down to producing 31 million barrels of oil a day versus 31.2 million barrels a day in 2008. One might interpret this as an increase in the use of bio-fuels and renewable energies; however, much of this can be attributed to the economic downturn.

The volatility of the economic market rippled throughout OPEC's market prices of oil as the **OPEC Reference Basket** hit high prices of over \$140 per barrel in July 2008 and then falling by more than

Commodity Exchanges – an exchange for the buying and selling of futures contracts on commodities such as butter, coffee, grains, etc.

OPEC Reference Basket – weighted average price for petroleum blends produced by OPEC countries. It is used as a benchmark for crude oil prices



\$100 to below \$40 in January 2009 (OPEC). However, OPEC nations, "...clearly stated that high oil prices in the middle of 2008 were not justifiable by physical supply and demand fundamentals"; but rather, these shifts in prices were, "...exacerbated by massive direct and indirect investment flows by non-commercial players looking to gain exposure to commodity markets" (OPEC). An absence of caps on oil speculating activities could have facilitated these actions. In contrast, OPEC states that the low oil price levels for the first half of 2009 are not sustainable. The trade bloc believes fair and stable prices, "...should take into account energy supply, demand, and investments, including core issues as costs and human resources, over all timeframes" (OPEC). In this sense, OPEC has begun stressing a need for improved regulation and better transparency in these markets so that both producers and consumers may be helped.

In relation to oil demand from developed and developing nations in the wake of this recession, OPEC has begun to believe that developing nations would account for any future increase in oil demand. Since industrialized nations – like the United States and Western Europe – were more harshly affected by the economic downturn, such nations will be slower to return to normal levels of consumption. For developed nations, peak in oil demand was reached in 2005. Demand from these countries is expected to fall from 47.5 million barrels a day to 45.5 million barrels a day by 2010 and will likely remain at that level through 2013 (AP). On the contrary, demand from developing nations was expected to rise by 23 million barrels a day between 2008 and 2030 to reach an approximate daily consumption of 56 million barrels a day – approximately 80% of this growth will be in developing Asia (AP).

It is obvious that the changing global economic climate can have dramatic effects on the abilities and clout of OPEC. Similarly, as the recession begins its recovery process, OPEC is beginning a focus on more developing nations. These nations will be key players in increased energy consumption over the future years. Nonetheless, developed nations will also play key role players as it is often the stability of these markets that can affect effective demand for petroleum and oil across the entire globe.

FOCUS OF THE DEBATE

Cartel Enforcement Problems

Since OPEC is a cartel of oil producing nations, all member nations must collude together in order to determine the best policies for oil production and prices in the market. The major decision making of OPEC occurs during its conference that meets twice a year in order to



decide overall oil output and to assign output quotas for individual nations. These quotas are upper limits on the amount of oil an OPEC member is allowed to produce and trade. Special sessions are held when downward pressures on oil prices become very severe. Nonetheless, since OPEC functions as a cartel, the trade bloc occasionally experiences a major cartel enforcement issue: overproduction and price cheating by its members.

As natural economics goes, higher prices lower consumer demand. With higher cartel prices, less oil is demanded from OPEC countries. Moreover, "...the output quotas are necessary in that each member of OPEC has an incentive to sell more than its quota by 'shaving' (cutting) its price because the cost of producing an additional barrel of oil is well below the cartel price" (Zycher). To cheat this way, OPEC cartel members can resort to a number of methods. Oil producers can, "...extend credit to buyers for periods longer than the standard thirty days, sell higher grades (or blends) of oil for prices applicable to lower grades, give transportation credits, offer buyer side payments or rebates, etc" (Zycher).

Individual OPEC members have frequently deviated from their production quotas and produced more. This tendency to cheat has become a long lasting characteristic of OPEC operating behavior. However, in comparison to a normal cartel, OPEC is slightly different in that Saudi Arabia is a much larger producer than other countries. This has frequently caused Saudi Arabia to be more of a swing producer – that is, "...the producer that adjusts its output in order to preserve the official price in the world market" (Zycher). Saudi Arabia – like virtually all other OPEC members – acts out of self-interest. The downward pressure on oil market prices creates larger total losses on them than their OPEC counterparts in the short run. In effect, Saudi efforts to protect the official OPEC market oil price has resulted in reduced sales and reduced revenues.

A New Face: Alternative Energy

In a new era where the push for **sustainability** has gained steam, a new competitor has entered the previously exclusive realm of OPEC dominance: alternative energy. As nations across the globe take heed of current climate changes – directly caused by the burning of fossil fuels and release of carbon emissions into the atmosphere – the world has begun to research and invest in more sustainable forms of energy which will also protect the environment. This push for alternative and sustainable energy sources is stressed even more by **Hubbert's peak theory**. This theory asserts that for any geographical area, the rate of overall petroleum production will move in a bell-shaped curve. In addition, it states that the world will eventually reach, "... a point at which half of the global oil reserves have been

Sustainability – *the ability to supply with the necessities of life*

Hubbert's Peak Theory – *for any region in the world, the yield of oil supply will form an upward bell curve with a maximum peak and then terminal decline until oil depletion*



used, at which point scarcity will gradually increase and prices rise” (CSA). After this point as been reached, the rate of oil production will enter a terminal decline until all oil has been depleted.

This accepted theory has continued to worry nations of both developing and developed status since fossil fuels continue to act as the bloodline for everything we do. In the case of OPEC nations, the point of oil peak may be in the foreseeable future. Moreover on this subject,

“...while some of the more pessimistic oil specialists are declaring that peak oil has already passed, or at best is here now, others believe it is not going to arrive before 2010. Some optimists give the world a little more breathing space – that is to say up to 2020, and perhaps even up to 2030. However, all in all, most would appear to agree that peak oil output is not very far for all of us. It could take place within the next decade or so, which in fact means that there is not much time left for a world economy to be driven largely by oil” (OPEC).

So, with the peak in oil on the horizon, OPEC nations will naturally face difficulties in deciding how to proceed with oil production and develop a unilateral plan for sustainability. Alongside peak oil, OPEC must also be **cognizant** of ways to supply a demand for oil that will increase in the long term.

Cognizant – to be aware of

As ideas of solar, wind, hydroelectric, geothermal, and biomass energy sources become more appealing with the general public, OPEC is beginning to think that its power may be in jeopardy in the years to come. They have begun to see alternative energy as a strong threat to their dominance. According to Abdullah Salatt, Qatar’s representative to OPEC, “Our competitors, the alternative energy providers are intensively pursuing research programs aimed at reducing the domination of oil and gas in the global energy market. Likewise, we should have our own independent programs”. In this respect, OPEC has already begun plans to establish a research and development institute which will allow it to build new ways of improving oil production technology. Nonetheless, with a growing movement in favor of sustainable and potentially cheaper forms of energy, OPEC will soon face tough decisions on how to ensure its status of power and longevity for the years to come.



NGO PERSPECTIVES

Greenpeace

As one of the environmental frontrunner NGOs, Greenpeace has staunchly advocated implementations of more sustainable technologies and energies to protect the earth. Nonetheless, Greenpeace acknowledges the world may not ever enjoy the cheap energy generation through alternative fuels that oil has afforded us throughout the years. Since OPEC is one of the main entities that contribute the very fossil fuels that power the world yet continue to drive climate change, Greenpeace is naturally at odds with the economic and environmental ideals of the cartel. Despite the fact that OPEC is attempting to make strides towards more sustainable oil production, Greenpeace says this is not enough. Greenpeace advocates that OPEC put the interests of the environment and humanity at the front while not becoming consumed in drives for extremely high profit.

POSSIBLE SOLUTIONS

Questions for Policymakers

With the passing of time, OPEC members must continue to face a number of questions that will determine the ultimate course of action for the trade bloc in the future. Some of these questions may be more **multifaceted** and complex in nature than others; nonetheless, OPEC must strive to address them in the most rational manners possible. How might OPEC continue to ensure reasonable prices for consumers on the market while yielding profits? Additionally, how might OPEC be able to keep its other members from cheating and pursuing individual interests to make more profits off increased production under quotas? Keep in mind that too high of prices for importing nations may yield high returns; however, this can ultimately decrease demand for oil from consumers and lead to net losses of profit.

How will OPEC retain its economic influence throughout the world with the point of peak oil production on the horizon? Similarly, as demand continues to increase in the long run, how can OPEC be sure it will be able to maintain supply with this enlarging demand? This will be a major issue to deal with as the world continues to grow in population and as energy consumption continues to rise as developing nations continue to modernize.

Environmentally, OPEC must also deal with growing popularity of sustainable technology and energy. How big of a threat will these

Multifaceted – to have many aspects or phases



sustainable resources be to OPEC in the short term and long term? Are there ways in which OPEC nations can work with the development of sustainable resources as it develops more sustainable oil production methods? OPEC cannot completely oppose alternative energy and sustainable growth as the cartel already faces international criticism on its self-focused goals. Doing so would only further damage the entity in the eyes of the international community.

These questions are but a few issues that policymakers of OPEC must seek to address. Nonetheless, there are numerous others out there that must also be thoroughly addressed as well. It is quite important that policymakers of OPEC nations represent the viewpoints of their respective nations in order to please their constituents. However, all OPEC members must cooperatively work together in order to create proactive solutions that will solve these urgent issues at hand.

CONCLUSION

Although OPEC has experienced ups and downs throughout the years, the trade bloc continues to play a significant role in supplying the oil and petroleum to which the world has become addicted. Members of this cartel must be aware of the power that is invested in the natural resources of oil and petroleum; however, such nations must not let power overwhelm them. OPEC nations must strive to achieve goals of equality and fairness in the market and amongst each other when working to deliver such highly sought after resources. OPEC nations must create comprehensive and effective solutions that will solve some of the world's toughest problems yet ensure their long-term longevity and prosperity. These will be difficult challenges to address; however, OPEC nations can successfully work together to produce plans that will revolutionize the way in which the world sees oil supply, pricing, and consumption.

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