OPEC's Mission And Power

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Preamble

The debate regarding the creation of the Organization of the Petroleum Exporting Countries (OPEC), its necessity, mission and power, since its establishment in September 1960, has been reviewed enormously and in its 50th anniversary year still persists. Some analysts are of the belief that Venezuela took a leading role in the constitution of OPEC; still others are debating the issue, arguing that the leading factors behind the constitution of OPEC were rooted in geopolitical developments in the Middle East. But both groups share the idea that a substantial reduction in the posted price of oil by the major oil companies was the main factor contributing to the pre-1960 situation.

However, the prominent historian Anthony Sampson argued still differently, when he emphasized the real powers of the giant oil companies Exxon and Shell: "Inside their corporate headquarters, which had seen so many wars and crises come and go, it was hard to believe that the new phenomenon of OPEC was anything more than another temporary setback in the long triumphant progress of the oil companies. For they represented much more than themselves: they were a central part of the whole economic system of the West." 1

Now energy economists are more perplexed than ever before about OPEC's mission and power. Oil, while representing a huge commercial share in world trade, is a strategic commodity and all efforts to convert it to a purely commercial one have failed so far. In order to shed light on the issue, a look at different aspects of the oil industry seems necessary.

Oil Management

Since the discovery of oil in Pennsylvania in 1859, its management has gone through different stages. From the very beginning of the Age of Oil, there was a distinct partition in its management of activities into upstream and downstream. Management of the different sections has changed at various times according to factors such as technological superiority, investment capital, concession rights (later on sovereignty rights), entrepreneurial costs, risk and geopolitics.The preliminary stage of management was shaped in the US. The downstream sector was targeted by Rockefeller and the upstream, with all its uncertainties, continued as a disorganized group of oil producers and private entrepreneurs. In the early US downstream, Rockefeller emerged with a monopoly called the Standard Oil Company. After several shocks from the unorganized oil producers and in order to overcome the difficulties arising from their supply gluts and shortages and consequent high oil price volatility, Standard concluded that full integration of the oil industry was the only solution for such inconveniences.

In the next stage, after the US became a net exporter of oil, Standard had encountered two powerful rivals - Shell from Britain, and Royal Dutch from the Netherlands. Although integration attempts failed for Standard at the globe, the two European companies joined forced to become Royal Dutch/Shell. The third stage came with anti-trust legislation against Standard's monopoly in US and its subsequent dissolution into five smaller companies: Exxon, Mobil, SOCAL, Gulf and Texaco. Exxon, with more than 40% of Standard's net value, practically replaced the parent firm and came to dominate the part of the Atlantic Basin while Shell came to lead the east, as shown by Sampson. Later on these five firms, along with Shell and British Petroleum - the former Anglo-Persian Oil Company - became known as the Seven Sisters. Through their cooperation the structure of the international oil system had been changed from a monopoly to an oligopolistic monopoly. Now production management and its geographical distribution was operated by these majors in the form of a prorationing system.The fourth stage was associated with the oil dependency experiences of European industrial countries during World War 1. The necessity for independent oil industries led to the creation of national oil companies (NOCs), initiated by France's CFP in 1924 and followed later by Italy's Agip and Eni and others European NOCs, and later still by Japan. Meanwhile, a number of powerful independent oil companies (IOCs) were founded in the US, and along with the European NOCs challenged the worldwide monopolistic status of the majors. This trend was intensified during and after World War II.

Policies Of The Oil Producing Nations

Two other prominent oil industry features after World War II were: the role of the USSR, which was highly consolidated and during the Cold War supplied cheap oil to the international oil market with intention of undermining the worldwide Anglo-American dominance; and the struggles of oil producing countries to raise their share of royalties and to take some shares through participation in productions. Of course, at the end the full participation was equivalent to the nationalization of their oil industries. Indeed, this conservative approach was adapted by Saudi Arabia and to some extent by Iraq. A more radical approach was the direct nationalization of the oil industries, as experienced by the Russians in 1920, much more successfully than Mexico in 1938 and Iran in 1951. 2The rivalries were not limited to IOC and NOC struggles against the existing monopoly. Interestingly, there was extensive internal competition among the dominant states themselves. Britain's predominance in the Middle East before World War II was later challenged by the US after its expert warned of supply shortcomings. The US adopted an aggressive attitude toward the potentially oil rich regions of the Middle East under an 'open door' policy that implied equal access to the oil regions for the winners of World War II. The US targeted Iraq, Bahrain, Saudi Arabia and Kuwait for oil, which led to the full monopoly of Aramco (Arabian-American Oil Company) in Saudi Arabia. This aggressive attitude, orchestrated by the US government, was not limited only to American majors; the US independents were also active in this rush.By the early 1950s, when Iranian oil production had been under the full control of Britain for 40 years, an aggressive move by US oil companies toward Iranian oil was triggered. By carrying out a coup d'état in favor of the Shah, the US finally ended the British oil monopoly in Iran. A new consortium with 40% owned by American oil companies was the result.

No Room For OPEC

As far as the geopolitical set-up of the oil market was concerned, certainly the foregoing circumstances did not allow for an autonomous intergovernmental organization like OPEC to be shaped. For producers, though, two basic problems were urgent: first and most important was the producing countries' sovereignty rights over their oil reserves; and second was the required technologies for handling production, distillation, distribution and marketing of oil.

By 1960, most of the member countries lacked sovereignty rights on their oil; even the Iranian nationalization of oil industries was ruined by the subsequent coup d'état, and the Iraqi struggle to earn some participation the production after revolution in 1959 did not succeed in changing the existing concession. However, most of the future OPEC member countries had been pursuing a 50:50 basis for royalties, which was achieved firstly by Venezuela.On the technical front, there is no doubt that the majority of future member countries had become semi-expert in most parts of the business after many years experience in the industry, yet technically they did not have the initiative and were not self-sufficient, especially with the majors keeping the upper hand in global marketing. In contrast the comparative status of majors at the time, based on the available data in 1972, indicates that 77% of future OPEC and 70% of total world crude oil production was produced by them, which indicates that there was no room for OPEC. To legitimate its establishment, other factors should be taken into consideration.

Radicalism In The Middle East

One important factor worth mentioning was the political set-up of the Cold War, which intensified during the 1950s and created the danger of radicalism in Middle Eastern countries that were engaged in one way or another with the oil business. This political settlement and related fears over the expansion of communism, plus internal competition within the dominant states themselves, allowed for colonized countries to struggle for independence. National movements and liberation fronts were activated, resulting in the creation of many independent states and international bodies such as the Non-Aligned Movement, established in 1961.

There were three main 'experiments'. Iran's oil industry nationalization of 1951, which theoretically retained Iran control on oil production and reserves, in practice resulted in only a 5% share in production to cover the bilateral trades with the eastern European countries. The subsequent nationalization of the Suez Strait by Egypt in 1956 - with 50% of its transits being oil - ended the British control on the strait. Finally the revolution in Iraq in 1959 was followed by an aggressive bid to acquire 20% participation rate in production, with no success.The above-mentioned geopolitical settlements, Russia's supply of cheap oil and the NOC/IOC struggles were the factors that acted as necessary conditions for the formation of OPEC. The five OPEC founders' struggles for higher revenues and control over their oils, especially in the face of oil price reductions by the majors, also acted as a sufficient condition. Ultimately, all these forced the majors' monopoly to be broken and their control over supplies in the international oil system to be shared with a new intergovernmental organization of petroleum exporters - OPEC.

Suitable Prices

In the beginning, the mission of OPEC was the management of its crude oil production in order to attain a suitable price level. That is, it was given the role of residual player in the oil market with the responsibility to control the supply gluts and shortages to guarantee a suitable price level. The posted prices of the majors were designed to be low to satisfy the main consuming nations' interests, and especially those of the US, where they had faced an anti-trust ruling for setting prices at high monopolistic levels. This was the very charge that OPEC was now facing instead.However, from the very beginning, the tasks required by OPEC were distributed among its member countries according to their oil reserves wealth. The group with high per capita oil reserves and Saudi Arabian leadership took on the responsibility of production management, and those with relatively low per capita oil reserves and Iranian leadership took care of oil prices: this is in essence the hawkish and dovish strategy.The power of OPEC was also limited to bargaining for a few cents against the posted prices. Even in the face of the oil embargo initiated by the Arab states to support their war of 1967 against Israel, the result was quite desperate, since prices instead of escalating fell by one dollar. This was the exact opposite of what happened in a similar situation in 1973 conflict, when there was a quadruple price surge, revealing more of the strategic value of oil rather than OPEC's power,

even though this time OPEC countries were incidentally acting more cohesively than in 1967.

In fact, the loose coherency in this movement was as a result of a few member countries struggling for higher prices with no interest in the conflict, such as Iran and Venezuela, while others still demanded a participation in production, such as Saudi Arabia, and with a group of more radical states using oil as a political weapon. If the price-driven revenue interests of the majors were deducted from this equation, then the result would be highly leaning towards a change in the strategic value of oil.

Demand Side Of The Equation

After the oil price quadrupled due to the 1973-74 oil embargo, the big consuming nations soon realized that the burden of oil market management could not be left to OPEC anymore, with its hand only on the supply side of the equation. This was especially the case as the interests of the majors, with a 75% share of oil production in the OPEC area, became generally aligned with those of the OPEC member countries. Therefore in early 1974, thirteen major consuming countries were called by US Secretary of State Henry Kissinger to Washington to consider a common energy policy to counter the situation, which resulted in the formation of the International Energy Agency. Indeed, the IEA is suited to industrial countries' energy issues, because it is designed to manage only the demand side of the equation. It is worth noting that the majors were thus forced to share control of demand in the international oil system with another new intergovernmental organization of oil consuming nations - the IEA.Commercial Vs Strategic Value Of Oil

Theoretically, it is necessary to distinguish between oil crisis and price crisis. Oil crisis is when a structural change in the oil market occurs and, as a result, prices never go back again to their original levels. This is the exact opposite of what happens in a price crisis. This is because, in the face of any structural changes in the oil market, the strategic value of oil will be undergoing a change.Such an incident took place in the 1973 oil embargo when, after oil prices quadrupled, all the market forces' efforts failed in bringing back prices to their pre-1973 levels. Since the oil embargo was imposed exactly at the time when the world political order had also undergone a change, the quadrupled oil prices were retained. The shift in the oil price equilibrium was as a result of the oil market structural change and the loose cohesive action of OPEC only facilitated it. Indeed, all OPEC power in the 1973 oil embargo was confined to supply curbs amounting to less than an accumulated 10% of total world supplies, for five months only. On the other hand, given the majors' control of the world oil distribution system, the effects of the embargo on the countries subject to sanction were simply limited to a temporary redistribution of production.In the price crisis of 1990-91 on the other hand, which occurred due to the Iraqi invasion of Kuwait, in spite of a price surge to $41/B, no changes took place in the pre-established price levels of $19/B, and after the crisis was over prices were returned to their original levels. Furthermore, as occurred on two different occasions in 1998 and 2009, OPEC cut its production by 4mn b/d and 4.2mn b/d respectively, acting cohesively and for long periods, but no price shifts were experienced again. This was because OPEC can only deal with the commercial value of oil and has no power to influence the strategic value of oil, which is a crucial element for shifting the established oil prices over time.

Price Determination

There are long debates among economists about how to tackle oil market clearing prices with a price inelastic demand function. The inefficiency in oil price discovery in an imperfect oil market, especially in the short run, has caused confusion among market participants between established, transitory and actual oil price equilibriums. This is because, in a market with a price inelastic demand function, there exists a wide range of prices that could temporarily clear the market given the political conditions and that can be confusingly treated as equilibrium prices.Established oil prices in an imperfect oil market are those clearing prices that have been dictated to the oil market by the international oil system, and have been usually kept to the minimum attainable level. The pre- 1973 and pre-1979 oil prices, and the entire price set-ups from the late 1980s through early 2000s, with their average range of $18-22 /B, have the quality of established oil prices.In contrast, sometimes the oil market clearing prices had been operating at maximum attainable levels, which was usually a short-lived phenomenon. Since in order for the attainable upper range clearing prices to be sustainable, it is necessary that the required political circumstances are sustainable and the world economy can digest them. Otherwise, any OPEC collective action intended solely alone to keep prices at the top of the range could not be endured for long. For instance, the highly cohesive OPEC move in the early 1980s to keep the oil prices at its high levels, which was implemented through the substantial supply curbs amounting to more than 10% of total world supplies, with an exclusive role played by Saudi Arabia, yielded no success when faced with IEA members' demand curbs. The struggle went on for nearly five years and ended with the price collapses in late 1985. 3This was a historic lesson for OPEC, showing that it cannot push for any desired price levels that is neither ratified by the international oil system nor allowed by the world political order. In fact, the entire effect of political developments due to the Iranian revolution in 1979 could only shift the oil price from its rough basis of $11/B pre-1979 to $18/B post-1979: the former was an established oil price and the latter a new oil price equilibrium.Transitory prices are those obtained at different points along a price trend. For any point on the price trend there exists a temporary market clearing price, which is sometimes hardly distinguishable from both established and actual equilibrium oil prices. For instance, in 2003-08 the established oil price was around $25/B, and the actual (revealed) oil price equilibrium was about $70/B. Surprisingly, any prices in between, which were mere temporary market clearing prices, at the times were treated by market participants as the actual price equilibriums. Unfortunately, based on these illusive transitory prices, there were suggestions for constructing price band references. To this end, it may be concluded that OPEC does not have the ability to detect the actual oil price equilibrium in the oil market, and as usual is only playing with prices around the established values on the basis of a few per cent.

Price Gaps And Oil Subsidies

Any price gaps between the established and the actual oil price equilibriums are economic rents, which are taken by the dominant parties in the international oil system. These economic rents will either be taken for granted by the consuming nations, as free oil subsidies, or will be expropriated by their governments in the form of energy taxes. It is clear that each country's share of these economic rents (oil subsidies) depends on their share of total world oil consumption. These economic rents should be used as capital investments to guarantee the future streams of oil.In 2003-08 the difference between the two set of prices was roughly $45/B. A rough estimation of the aforementioned economic rents, based on this price differential and on average global oil consumptions of 84mn b/d, amounts to $8,000 trillion. If the calculation runs from 2000 through 2008, the amount of the economic rents will reach to $12,500 trillion. Further, by taking into account the respective subsidies granted for gas consumption, which are priced with reference to the international oil prices, the total fossil fuels subsidies will reach the sky.Needless to say, the roles of speculative investment funds or OPEC in actual equilibrium price discovery in the oil market are complementary, since in the absence of geopolitical changes, no market-oriented forces have the power to shift the oil prices from established values to their actual equilibrium levels. Nonetheless, the magnitude and sustainability of the actual equilibrium oil prices should be consistent with the status of the world economy. In the current depolarized world, with its respective political consequences, this sometimes allows for the strategic value of oil to be changed and its actual equilibriums to be revealed.

Oil Reserves And Production

One of the interesting features of OPEC is its members' reserves and productions inter-relationships. Here, it is not intended to go through the full details of OPEC member states oil reserves and productions; rather it is to understand the mechanism due to which these factors have been set. The issue has been confined to the relationship of the two main players' oil reserves and production, namely Saudi Arabia and Iran. In the 1970s, the former's figures were 130mn barrels and 7mn b/d and the latter's respective figures were 65mn barrels and 6mn b/d. These figures by 2010 were for Saudi Arabia 264mn barrels and 9mb/d and for Iran 137mn barrels and 4mn b/d. 4 That is their reserves had been doubled and their production added up to 13mn b/d in either period. 5 Apart from redistribution in the two countries' production in favor of Saudi Arabia, in general and over the last 40 years no substantial change had been taken place. At these levels of production the two countries' production/reserves ratios became closer. This indicates that the both OPEC giants adhere to the 'zero sum game' principle, which has made any strategic cooperation within the organization if not impossible, practically difficult.At this juncture it seems inevitable to have a look at Iraq's newly announced strategy for 12mn b/d of production capacity to be obtained by 2015, and its possible implications. According to BP's Statistical Review of World Energy, Iraq, with oil reserves of 110mn barrels and based on the above production/reserves ratios, could produce about 3.8mn b/d. Compare to its current production of nearly 2.4mn b/d, a surge in productions equal to 1.4mn b/d is required, which is of course necessary for the country's reconstruction. Iraqi production of 3.8mn b/d will be consistent with the hitherto adapted 'zero sum game' principle by OPEC in order to keep the oil market in balanced, based on current prevailing oil prices.Now, any substantial Iraqi production beyond this level will have immediate political implications for its neighbors Saudi Arabia and Iran, and price dives for all oil producers. Unless it has been scheduled to compensate for the non-OPEC productions falls, which have been pronounced recently, and yet should be fulfilled according to the above principle, any substantial surge in the country's oil production will be interpreted either to be designed for undermining the Saudi Arabia's relative position, or to create an excess capacity to facilitate potential attacks on Iran, or both! 6It seems there is consensus among Iraqi oil analysts that the more feasible and attainable production level for the newly announced Iraq government's production plans is somewhere around 6mn b/d. 7 It is worth mentioning that historically this illusive model of a temporary surge in oil production had been applied for Mexico to cover the oil requirements of World War I, for Venezuela to cover the oil requirements of World War II, for Libya to cover the oil requirements of the 1967 Arab-Israeli war, and/or for Iran to cover the oil requirements of the 1973-74 Arab-Israeli war. Yet on several occasions Saudi Arabia partially fulfilled the job; for instance in the Iraq-Iran war of 1980-88, the Iraq-Kuwait conflict in 1990-91, and subsequent political developments until recently.

Afterwards, all those oil production surges had been eliminated in favor of the initially established production scheduled in the international oil system. This is the very lesson that all the involved member states have learnt from history, and no one is willing to repeat, and which forms the political backbone for today's better cooperation. Of course, the recent statement by the Iraqi prime minister that Iraq will join the OPEC production quota system only when the country's production reaches about 4mn b/d proves that they are moving in the right direction.

Majors Adjusting

The monopoly powers of the majors diminished after the 1970s and are still challenging by newcomers from other parts of the world. The early structures of the dominant oil companies changed, and in the period 1998-2002 several merges took place, resulting in a new crop of 'super majors'. ExxonMobil, Royal Dutch/Shell and BP still lead this group, now known as international oil companies (IOCs). Major international oil assets still belong to them, and in the case of Iraq's ambitious production strategy the leading oil companies involved are ExxonMobil, Royal Dutch/Shell and BP.Technology and the availability of capital are among the factors making the majors' dominance still possible. There is also a group of powerful rivals: Petrochina, Gazprom, Sinopec and Petrobras, national oil companies (NOCs) with majority shares owned by the governments of China, Russia and Brazil. It is likely that the history of oil will repeat again, but with new players and combinations of IOCs and NOCs.

Now OPEC is faced with these new global rivals, which present both opportunities and threats. Opportunities because these newcomers are thirsty for new sources of oil and can afford higher prices. The first factor will facilitate investment inflows and the latter will lead to oil market efficiency, allowing the actual oil price equilibrium to be detected. However, this requires a more delicate and balanced strategy to be adapted by OPEC in future, for historical experience has shown that rivalries of this extent, for a strategic commodity like oil, could always be sources of disaster and political unrest, especially when non-OPEC supplies have been said to be theoretically approaching their peak.

A New Diplomatic Body

The International Energy Forum (IEF) is a loosely organized diplomatic body for the peace-time settlement of energy issues, but in face of a real oil crisis its deficiencies may be revealed. For instance, in the aftermath of the price surges to $147/B in mid-2008, the British prime minister called an urgent meeting with OPEC, IEA, IEF and Saudi Arabia to coordinate oil market stabilization and price control - that is, to undertake the very role devoted to IEF. The US government intervened by regulating the financial market to prevent any further oil price surges of that size; but this action against the free market competitiveness also limited the IEF's ability to handle the issue in a more systematic manner.

However, establishment of the IEF proved that the previous dominant parties did not have the upper hand in the oil market any more, and that they need immediate transparency in oil market data in order to retain market stability. This shows that a place has been opened up for OPEC to play a new role, of course through a joint initiative with the other oil producing nations, instead of limiting themselves to sub-groups of countries within OPEC.

The Way Forward

After half a century of existence, OPEC now has a great deal of experience, which forms the backbone for any successful strategy in future. Currently it is acting in a much more orchestrated way than before, and there is no room for any hawkish-dovish diplomacy. For further success, some preliminaries are essential:

* First is solidarity. OPEC members should reach the level of solidarity that the majors had at the beginning of the 20th century. To start, they should give priority in their marketing, operational and expertise requirements.

* Second is know-how. Vast theoretical and practical oil-related skill and experience within the member states could easily be exchanged. OPEC could run an international technical university to supplement its members' technical requirements. This could be similar to Standard Oil's link with Chicago University or Shell's with Cambridge University.

* Third is financial strength. To create investment capital and opportunities for member states, it is highly recommended that a commonly-owned investment bank could fulfill the role.Unity based on rationality is the core of any success in future. OPEC should have the ability to substitute the principle of 'zero sum game' with 'non-zero sum game' and gain from the available capacities within member states. Like the super-majors' revival through merging, members should utilize all existing economies of scale to strength their competitiveness at the globe. To the degree that the above steps are fulfilled, then OPEC can expect to attain a determinist power and operate more efficiently, based on actual oil equilibrium prices, and move firmly in future.