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# OPEC AND THE OIL STRATEGY : TIME FOR PRODUCER-CONSUMER DIALOGUE

Number 13 is not always unlucky and definitely not for everyone. The OPEC, despite being a group of 13, did extremely well for over a decade since 1973 when oil price quadrupled[1]. The high prices of oil continued till late 1985 – a long period by any standard. This encouraged all oil producers to increase their production during this period. Some OPEC members because of their need for more foreign exchange either to boost their economies or to support some of their war efforts pumped oil beyond their quota limits set by OPEC. As non-OPEC producers were not bound by any quota restrictions their overall production also went up. Since 1981 British North Sea output jumped from 1.8 million barrels a day to 2.6 million barrels a day (mbd).[2]

As there was demand in the market, the extra oil, despite high prices were being absorbed. But this process could not continue for all time to come. The world consumption also started showing downward trend. In 1979 world consumption was over 52 mbd and OPEC's market share was 31 mbd and non-OPEC 21 mbd. For the first time in 1982 OPEC produced less than non-OPEC as its share was about 18 mbd against about 22 of non-OPEC.[3]

1. *The Economist*, November 14, 1987
2. *Newsweek*, February 3, 1986.
3. *Newsweek*, March 21, 1983, *Time*, February 7, 1983; and *International Herald Tribune*, May 10, 1983.

In 1985 world consumption actually came down to 43 mbd and OPEC and non-OPEC shares were 17 mbd and 26 mbd respectively. Thus a major oil supply group turned into a minor supplier in the world market — a situation quite unthinkable until it happened. Indeed there were structural changes in the world oil consumption and particularly so in the developed countries. Since 1973 the US reduced its energy consumption per unit of GNP by a quarter. Europe made 15% reduction and Japan cut its consumption per unit of GNP by a third. Thus since 1986 OPEC and non-OPEC countries have been fighting for a relatively shrunken market.

But the question arises why OPEC lost market while non-OPEC countries were able to increase their share. There is no doubt that non-OPEC production base was initially low whereas OPEC production base was high though some of them still then had unutilised capacities. Thus non-OPEC took the opportunity to pump more and capture the market when demand was still high. This was possible also for the reason that high prices made some non-OPEC producers including Alaska commercially profitable which facilitated increased production. OPEC was, however, in somewhat restricted situation as it was generally bound by production quotas and price limits though some cheating was reportedly going on. But non-OPEC countries were bound by nothing. They continued to pump more and sold at the price prevalent in the market. There were reports that when OPEC started asking for higher prices many buyers switched over to non-OPEC suppliers including Mexico, North Sea, etc. Thus non-OPEC countries secured some advantages and got higher market share.

OPEC members and particularly Saudi Arabia apparently woke up to realise that OPEC's loss of market share has been too much. Thus Saudi Arabia reportedly under its Oil Minister Sheikh Yamani's advice opted for regaining the "market share" irrespective of the price. But some quarters believe that Sheikh Yamani was not solely responsible for this strategy. Indeed, this was reportedly the official position of OPEC also as in the meeting in Vienna in December 1985, OPEC decided to recapture a "fair share" of the market no matter what the prices were. However, one notes the leading role reportedly played by Sheikh Yamani in pursuing the so-called "free for all" oil policy as he, according to reports, made statements[4] in March 1986 when oil price showed nose-dive movement making it clear that the "price-war" with North Sea producers — Britain and Norway has not been called off. The "only approach" to OPEC's problems was "the recovery of market share." He also reportedly said that "if prices stay low, you will definitely see fields shutting down".[5] But he also said that "the British people are the best judge of U.K. interests". The result was that OPEC temporarily abandoned its production ceiling and went for increased pumping of oil thus creating complete glut in the market. Though there was a price crash, OPEC could not force North Sea producers and particularly bigger producer like Britain to reduce production. Apparently North Sea production and particularly Britain's unabetted oil production and its refusal to cooperate with OPEC created real problems for OPEC.

It seems that Yamani's alleged market inundation policy was being pursued apparently with a view to obtaining the following objectives:

The supply should be abandant so that the price falls to a level which would force North Sea producers and particularly Britain which refused to cooperate with OPEC to shut down their oil platforms. Indeed when price came down to $9.50 in July 1986, for North Sea brent, the situation was extremely difficult for Britain. With the fall in prices of oil, the pound sterling also fell. Reportedly one or two platforms were shut in the North Sea on the plea of maintenance. There were fears of more shut-downs as it was thought to be uneconomic for North Sea producers to produce oil at that price. According to some estimates North Sea producers' cost of production was around $7 to $11 with the average of $9 and that was probably the limit. If oil prices could be kept for sometime at $6 to $9, may

4. *Arab News*, March 26, 1986.
5. *Saudi Gazette*, March 26, 1986.

be some of the platforms would have gone for long maintenance shut-downs and in such a situation probably this policy would have worked. If North Sea platforms faced shut downs, probably some other non-OPEC producers would have gone for cut in production as their cost of production vis-a-vis Middle East oil producers and particularly Arab producers was higher, According to one estimate Middle East production costs are less than $1 a barrel and the cost of funding new oil is negligible.[6] Thus cost-wise they could possibly survive even at $5 or $6 but question was for how long. Apparently the idea was to return to production restraint as soon as some non-OPEC producers and particularly North Sea producers considerably reduced their production.

Some quarters believed that another idea probably was to teach a a lesson to Iran as it was insisting on higher prices which was not possible under the prevalent market situation. Moreover, higher prices meant more money to Iran, which would have enabled it to buy more arms to fight Iraq. This obviously no Arab wanted.

Another angle was to supply oil at a price for a period which would have upset the oil conservation policy of the importing countries and particularly the developed countries thus leading the world, albeit slowly, to increased oil consumptions. In his speech at Harvard in September 1986, Sheikh Yamani defended the long standing policy of his country on stability and predictibility in oil pricing, leading to slow but steady increase in world consumption, which in turn would allow a slow upward trend in prices by the end of the century.[7]

However, OPEC and particularly Saudi Arabia later realised that unlimited pumping of oil by OPEC did not produce the desired result in terms of market share and indeed depressed the prices to an intolerable level. In fact, in March 1986 the oil price came down to $13 from $27-30 of October-November 1985. The downward trend

6. *The New Nation*, 15-17 March 1987.

7. *International Herald Tribune*, October 31, 1986.

in prices continued as the production of OPEC also went up to over 20 mbd against its ceiling of 17.7 mbd. In July 1986 North Sea brent was being quoted at $9.50 a barrel. This created real panic among OPEC members. They clearly realised that unlimited pumping of oil for capturing "market share" for OPEC brought disaster for them. They, therefore, looked for a change in oil strategy. In fact, some of the OPEC members started speaking against the policy of unlimited pumping of oil and called for immediate OPEC meeting.

The meeting took place in Geneva, and OPEC members thoroughly debated the issue for days together. In view of oil glut and consequent price crash they decided to limit their pumping of oil. But as usual OPEC members found it extermely difficult to agree on a long term deal. They, therefore, decided on a temporary agreement for two months, i.e., September-October 1986. They agreed to reduce their present OPEC supply of 20.3 mbd to 16.8 mbd. OPEC members also felt that their production cut alone might not have the desired effect. They, therefore, called upon non-OPEC members to join the production cut. North Sea producers, namely, Britain failed to co-operate though according to some reports Norway's reaction was favourable. Soviet Union reportedly agreed to reduce their daily production by 100,000 mbd. Apparently China also indicated their intention to reduce exports. Indeed China's customs figures for the first half of 1986 showed export of 12.3 m tons from 13.8 m tons of earlier period. Iran itself announced reduction to 2.3 mbd from 3.2 mbd. All these pushed oil prices up from $10 to $14-17. This trend continued upto early October 1986 when OPEC again met in Geneva to strike a deal which was expected to be set for a longer period.

The Geneva meeting of OPEC in October 1986 was the 5th in the year and indeed after 17 days of haggling they only agreed to have the extension of earlier temporary agreement and that also again for only two months, November and December 1986, with the ceiling of 17 mbd, (15 for OPEC's 12 members + 2 for Iraq which refused to join the agreement). While negotiating this agreement Saudi Arabia and Kuwait pressed for bigger production quotas. Particularly Saudi Arabia wanted higher quota in view of drastic reductions in its production to only 4.35 mbd against 10 mbd it once produced. At a particular stage Saudi Arabia's production reportedly went down to as low as 2.3 mbd. However, with a view to striking a deal Saudi Arabia and Kuwait at long last agreed not to press for higher quotas.

While giving consent to this temporary agreement for November and December Saudi Arabia reportedly insisted on achieving a price level of average $18 for the Middle East benchmark — having a price range of $17-19. However, as the reports indicate the price target of $18 was not specifically mentioned in the agreement; it only remained as the aim of OPEC.

Thus it seems that Saudi Arabia decided to return to a fixed pricing system which went against Sheikh Yamani's alleged oil strategy of unlimited pumping to recapture the market share irrespective of price level. This reportedly created difference of opinion and Sheikh Yamani was relieved of his duties as Oil Minister of Saudi Arabia, which he had been performing 'magnificently' for long 24 years. The world saw the departure of an internationally reputed oil strategist from the world oil scene.

Why Saudi Arabia asked for a return to a fixed price of $18 which was much higher than the prevalent market prices of $12 to $14 was obvious. The Kingdom was losing heavily in terms of oil revenue from peak year's earning of $100 billion[8] to about $20 billion in 1986, which naturally caused great anxieties to the Kingdom authorities and consequently it looked for a system which could promise higher oil revenue. Though some quarters believe that the Kingdom had probably some political consideration too concerning Gulf-war while asking for higher oil prices, the bone of contention between Sheikh Yamani and Saudi central oil authorities however, seemed to be the

8. *International Herald Tribune* November 10, 1986.

strategy of return to a fixed pricing system with fixed production quota of OPEC. "He (Sheikh Yamani) thought it was contradictory. You either fixed prices or volumes and not both. That was his contention" — said a source close to Sheikh Yamani.[9] For a oil strategist of his stature and experience he probably believed in fixing volume and leave prices to the market or vice-versa. But obviously OPEC was no longer in that position. In the present oil market non-OPEC production is a major factor. Moreover, the present world consumption has turned to be less elastic to supply and pricing. Thus in order to achieve a particular price target it was necessary to tune the production keeping in view the total supply and market demand. But even there one would suspect non-OPEC pumping more taking the advantage of the supply gap at a particular time thus adversely affecting any desired price level.

However, it remains a fact that Yamani left the world oil scene, so also did his policy. But after so many months of Yamani's departure and abandonment of his alleged 'free for all' oil policy, one needs to assess the situation and see whether Yamani's oil policy could have brought some long term benefit to OPEC. One knows that OPEC as a producer and exporter group had been effective and played its role for over a decade and virtually dictated the oil price. Could OPEC do it again?

In those years OPEC's position with regard to its unity and members' financial positions were much different. With Iran-Iraq war the unity of OPEC suffered badly. The war drained out the economies of two warring members and also adversely affected many others. It is also a fact that many OPEC members which undertook huge developmental projects on receipt of oil money during those years of high prices could not keep up the tempo of development without the continuous supply of funds which could only come through oil revenue. Some OPEC members were under huge debt and they also needed oil money as they also had very little alternative source

9. *International Herald Tribune*, October 31, 1986.

of foreign exchange. All these obliged OPEC members to abandon Yamani's approach and return to OPEC production ceiling and fixed price. But did abandonment of Yamani's oil policy bring any substantial benefit to OPEC in the areas of market share and prices? One needs to look at the supply and price trends during post-Yamani period.

Yamani's departure in October 1986 did not create any upheaval in the oil market. The market reaction was only to the extent of a dollar-rise as the price became $15. Apparently the oil inventory was quite high in developed countries due to low price and abandant supply for over a number of months. However, oil traders expressed some apprehensions that aggresive oil policy would then be followed by OPEC. Immediately after the agreement the new Oil Minister of Saudi Arabia Hisam Nazer reportedly made an open call for a return to a fixed price i.e. $18 and asked for an urgent meeting of OPEC's Pricing Committee.

During the months of November and December 1986, oil price fluctuated between $14 to $17. Apparently the OPEC ceiling of 17 mbd was generally adhered to with some alleged cheating by some members. Some quarters believed that if there were no cheating, the price level of $18 could probably be achieved.

In December 1986 OPEC again met and this time went for a new agreement with a still lower ceiling of 15.8 mbd valid for a longer period i.e., the first half of 1987. In the ageement the fixed pricing system was reportedly introduced with average reference price at a $18 based on a basket of 7 crudes. Thus OPEC officially put an end to the "price war" which was allegedly launched by Sheikh Yamani.

After the December agreement prices jumped by $3.4 to $19.50 in the month of January. Apparently market reaction was that OPEC meant business this time as the agreement was valid for a longer period with a stated price and lower production ceiling. Thus, according to various reports, the oil prices during the first quarter varied from $18-20 and apparently the average production of OPEC remained around 15 mbd. As reports indicate some non-OPEC members namely, Egypt, Oman and Norway also gave some sort of support to OPEC either by raising prices or by cutting production. Egypt announced rise in price apparently with the arrival of Saudi Oil Minister in Cairo in January 1987. Egypt also decided to cut its production from 940,000 bd to 870,000 bd. Mascut and Oman cut their production by about 5%. Norway also made some cut reportedly 10% in their production level.

After the expiry of the first half yearly agreement OPEC again worked out another half yearly ageement at the end of June with slight increase in their production ceiling from 15.8 mbd to 16.6 mbd. They also agreed to maintain the reference price level at $18. In the month of July prices went up and the North Sea brand was sold at $20 for the first time since January 1986. Experts, however, put this increase in price not on the results of the new agreement but on Gulf tension with both Iran and Iraq having attacks at that time on the oil tankers. At the end of the month of August prices started showing downward trend as OPEC production was reportedly high as much as 19.7 mbd against OPEC ceiling of 16.6 mbd. The increased supply led to fall in prices by $3. This created serious concern among some OPEC members. Key Oil Ministers then met in Vienna and decided to tour round the OPEC countries to urge them to stick to their producton quotas. Thus it seems that during the 3 month period July, August and September 1987 oil prices swung within $3 range apparently because of over-production and the fear of escalaltion of Gulf war.

It appears that the visits by key Oil Ministers to OPEC countries had some good effect and in early October 1987 prices started pushing up somewhat thus raising the OPEC's hope to maintain reference price at $18. According to some reports oil production by OPEC fell by 8% i.e.. about 1 mbd, but still OPEC was producing about 2 mbd above the agreed ceiling.

According to IEA's estimate during the 3rd quarter of 1987 the OPEC production was around 19 mbd and in the 4th quarter 18.9 mbd against production ceiling of 16.6 mbd. However, prices fluctuated between $19-21 in the 3rd quarter and between $15.50-19 in the 4th quarter. The 4th quarter fall in the prices was attributed to continued increase in production by OPEC members and alleged discounting. But one also notes the continued build up of world inventories due to abundant supply and low prices.

In December 1987 OPEC members met in Vienna[10] to strike a new oil deal for the first quarter of 1988. After six days of strenuous debate OPEC agreed to continue the earlier production ceiling of 15.06 mbd with no production quota for Iraq which remained out of the agreement. OPEC also agreed to stick to the earlier official price of $18.

During January-February 1988 OPEC production remained slightly lower than its production ceiling of 17 mbd (Iraq producing about 2.45) mbd against the average production of 18.4 mbd of last quarter of 1987. Thus during the first two months of 1988 there were apparent efforts by some OPEC members to remain within their production limits with reportedly same price discounting by some members. Indeed Saudi Arabia and Indonesia issued open threats to the effect that any violation by any OPEC member of the production ceiling agreed to in the new agreement would make the new agreement inoperative. Gulf producers also decided in their last Riyadh meeting to bring their productions within the quota limits. But despite all these efforts OPEC was unable to maintain the reference price of $18. Indeed, reports of third week of March indicate fall in prices by about $3-4 from the OPEC official price.[11] North Sea brent was quoted at $14.38 for April loading and Middle East brand–Dubai at $13.83 for May delivery. Apparently the fall in prices was due to discounts offered by some members and high oil inventory in the developed

10. *Bangladesh Observer*, March 4, 1988.

11. *Bangladesh Observer*, March 4, 1988.

countries. In fact, world oil stock at the beginning of 1988 was highest for five years.

It may be seen from above that in the post-Yamani period from October 1986 the prices fluctuated roughly between $14 and $21 depending on OPEC production levels and the world inventory and discounting practices. The first agreement after Yamani's departure limiting production of OPEC had good effect on prices. But as mentioned above the 3rd and the 4th quarters of 1987 saw widespread violations by OPEC members of its production ceilings, which depressed prices and led to high world stock. Taking advantage of the high world stock the buyers are presently showing reluctance to lift oil at OPEC's official price of $18. OPEC members and particularly Saudi Arabia and the Gulf producers are reportedly trying to stick to the official price of OPEC but that has led to building up of stocks[12] and reportedly some OPEC members are chartering ships[13] to stock the excess production. There is a feeling in the market that with already high world inventory the present over-production by OPEC would lead to price crash. Some experts believe price may even tumble down to $10-12 a barrel. It is also possible that OPEC would temporarily return to so-called 'Yamani strategy' to teach lessons to 'violators' of OPEC agreement so that they can have a meaningful meeting in June" for a new agreement for the second half of 1988.[14] One, therefore, does not see the immediate possibility of any increase in prices unless OPEC tries to adhere to official price and further lowers its overall production, thus forcing increased world stock drawings which may lead to some rise in prices. Thus it seems to be a war of nerves. OPEC must tune its production keeping in view the world demand, world oil inventory and non-OPEC production.

The experiences during the last couple of months indicate that OPEC's total production level should generally remain much below

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12. *Bangladesh Observer*, March 8, 1988.
13. *Bangladesh Observer*, February 6, 1988.
14. *Bangladesh Observer*, March 24, 1988.

17 mbd for sometime to come and avoid discounting if it wants to achieve a price level of average of $18 and that also within a band of $15-21. However, this would also depend on the future behaviour of the non-OPEC producers. Presently some of them have the excess capacities to produce and also the need for more foreign exchange. They, therefore, may take the advantage of any demand gap and produce more which would frustrate OPEC's efforts to reach the targetted price level. Such a situation may lead to wide fluctuations in the prices and thus destabilise the oil market.

However, in order to consider the future oil strategy it is necessary to look at the following important issues :

Proven oil reserves world-wide are still increasing but equal to 15 years world demand, experts say.[15] Thus the world oil reserves are not unlimited. This is particularly so with non-OPEC countries. Some of the non-OPEC members' productions are likely to be reduced in a few years time. Even Britain's North-Sea oil supply would start tapering off in the near future and it is estimated that after 1990 Britain would only be self-sufficient[16] with regard to its oil supply. The costs of present explorarion and consequent commercial production outside Middle East and particularly in the US are high. Thus, if oil prices remain at depressed levels one does not see much possibility of emergence of many new sources of oil supplies in the coming years.

It is known that more than two-thirds of the oil reserves are in the OPEC countries. Thus OPEC stands in a better position even on the basis of the present oil reserves. Moreover. exploration cost in Middle East is negligible and as stated above the cost of commercial propuction is also less than $1 a barrel. Thus world should be aware of the production possibilities in the OPEC, in which Middle East members and particularly Saudi Arabia, Kuwait and United Arab Emirates, often called "mini-cartel", dominate.

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15. *New Nation*, May 4, 1987.
16. *International Herald Tribune*, October 24, 1986.

The most important issue is the price of oil on which future oil exploration and supply would depend. This is therefore, an extremely important and sensitive matter. It is known that the wide fluctuations in oil prices played havoc on the world economy during seventies and early eighties. OPEC's official price level is presently $18, but during the last couple of months oil prices have fluctuated between $15-21. However, for OPEC the task of monitoring of prices and productions has been rather painful. It seems that the market has got somewhat accustomed to this range of prices though there has been serious efforts on the part of the buyers to keep the prices at the lower part of the price-band taking advantage of the accumulated world stock. It is extremely difficult to say whether average price of $18 through a band of $ 15-21 is the right price for oil but one does see that while proposing this target price Saudi Arabia did take into account the qustion of survival of the world oil industry as well the suitability of the price for the world economy. One can well argue that if the oil price goes below $15 — say to $12, many non-OPEC countries would find it hardly profitable to produce oil, let alone go for further exploration. Moreover, low price would encourage increased consumption thus creating further gap in the supply which only OPEC would have the ultimate ability to meet. Such a situation may lead to the repetition of what the world witnessed in 1973 and 1979.

All these lead one to suggest that a commodity like oil on which the world economy is so dependent should not be left to the vagaries of such a manipulated market forces. One does see the importance and the necessity of having "talks for reaching an arrangement or at least an understanding on oil prices over a long period. Any reasonable arrangement on oil would ensure its steady supply at predictable prices which is more important for the managers of the world economy". In OPEC meeting in Geneva in October 1986, Nigeria's Oil Minister said, "Our view is that long term stability in the world energy market cannot be achieved in the context of conflict, something which can only lead to a supply crisis in a number of years' time."[17] Sheikh Yamani, who took control of the oil rope, tightly held and controlled by seven sisters for over four decades and passed it on to the OPEC also "fought for a producer - cosumer concept in early 1970s that would have tied small but steady increases in the price of oil for the rest of the century to economic advantages for the oil producers in Western economies".[18] It, therefore seems prudent to suggest that such a talk between producers including non-OPEC ones and consumers should be held as early as possible perhaps under the management of UNCTAD within the scope of the Integrated Programme for Commodities.

17. *International Herald Tribune*, October 13, 1986.
18. *ibid*, November 10, 1986.