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Ten Years After the First Oil Crisis — OPEC's Past and Future

by Klaus Matthies, Hamburg*

In October 1973 OPEC sprang the first "oil shock" on the oil-importing countries. The member states took over the pricing of their petroleum and within three months prices had climbed to an unprecedented level. Only then did OPEC impress itself upon the public consciousness, although the organisation had been set up as long ago as 1960. Now, ten years later, the continuing oil glut has created the most difficult situation the organisation has faced since its inception. Is OPEC now slipping from the position it won in the seventies?

OPEC's posted price for oil was raised by small amounts on several occasions from February 1971 onwards by agreement between the oil-producing countries and the oil companies; these increases went largely unnoticed, however, even though they raised prices by two-thirds by September 1973. It was the scale of the first unilateral increase in prices by the producing countries in October 1973 — even though in retrospect it appears still relatively modest — and especially the circumstances surrounding it — the Arab-Israeli war, the temporary cut in production and the boycott on deliveries to the USA and the Netherlands — that focussed attention on the oil-exporting countries. Over-reaction by oil consumers and the consequent rise in prices on the spot markets gave OPEC an opportunity to make a second, more drastic increase as early as January 1974 and thus complete the picture of the first "oil crisis".

It was widely held at the time that by raising crude oil prices fourfold in only three months the oil-exporting countries had overstepped the mark and quite a few market observers predicted the imminent collapse of OPEC and a fall in prices, mainly on the basis of the obvious large discrepancy between production costs and selling prices. Subsequent events showed, however, that these expectations were premature. The export prices of oil did come under downward pressure in the next few years, but between 1979 and 1981 they tripled yet again. OPEC's reference price was reduced by 15 % in March 1983, but this occurred at a level many

times higher than had been assumed in earlier forecasts.

The break in the development of the world oil market in 1973 was not confined to prices alone. The increase in selling prices only became possible because the producing countries took control of production and pricing. Before 1973 by far the greater proportion of crude oil traded on world markets came from long-term concessions — valid until 1999 in Saudi Arabia and 1994 in Iran — that the foreign oil companies had been granted by the governments of producing countries and which gave them the right to develop and exploit the deposits independently. In return, the companies paid the governments royalties on the tonnage extracted and taxes on their production profits.

The alliance among the founder members of OPEC was a reaction to the oil companies' repeated unilateral reductions in duties. In the light of falling revenues, OPEC's main aim during its first decade was therefore to obtain improvements in the financial agreements with the oil companies in order to increase its members' income from concessions. As a result, the countries' tax revenue per barrel steadily increased from 1960 to 1970, although the oil price remained largely unchanged.¹ As the demand for oil in western Europe and the USA was increasing and as the Libyan Government had successfully demanded a 40 % increase in oil prices, the Gulf states finally approached concession holders at the beginning of the seventies

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¹ Cf. J. M. Griffin, D. J. Teece (eds.): *OPEC Behavior and World Oil Prices*, London 1982, Figure 1.2, p. 8.

with a view to obtaining a share in production and raising oil prices in accordance with an OPEC resolution of 1968.² In a series of agreements the companies accepted an increase in oil prices and declared themselves willing in principle to allow the states a share in concession rights, production volumes and production installations that would rise in stages from 25 to 55 %.³ However, subsequent events in other countries soon made nonsense of the agreement on ownership ratios. From 1971 onwards the oil companies operating in Algeria, Iraq and Libya were nationalised or taken under majority state control. After the October War and the oil embargo, first Kuwait and then the other Gulf states followed the example of these three countries in taking a majority shareholding.

Changed Trade Relations

During the seventies the international oil companies lost much of their control over world oil production as a result of the measures taken by the oil-exporting countries. Whereas at the beginning of the seventies the seven largest oil companies still owned 60 % of all crude oil outside the socialist bloc, ten years later their share was only half as large. Over the same period the producing countries increased their share from under 10 % to more than 40 %.⁴ The oil majors still carry more weight in world trade in oil, however, as they are still the main takers of the oil offered by the state enterprises of producing countries. In addition, an increasing number of other private firms and state corporations of oil-importing countries have become involved in trading since 1973.

At the end of the seventies direct bilateral supply contracts between the governments of importing and exporting countries temporarily gained greater prominence, as in the event of a shortage of oil they promised relatively secure supplies at prices below those other purchasers had to pay on the spot market. Whether such contractual supply commitments are or can be enforced when they are really relevant has become increasingly questionable, however, as the example of Iraq has shown. Moreover, during the present oil glut it has become clear that the supposedly greater security of supply at times of oil shortage is bought at the cost of an expensive undertaking to accept deliveries when oil is plentiful.

² "Declaratory Statement of Petroleum Policy in Member Countries", adopted at OPEC's 16th Conference, June 24-25, 1968. Cf. OPEC Chronology, Vienna 1980, p. 19.

³ Cf. OPEC Chronology, op. cit.; P. Roggen: Die Internationale Energie Agentur, Bonn 1979, p. 40.

⁴ Cf. Weltenergie – Daten und Fakten, Shell Briefing Service, January 1983, p. 7.

OPEC Chronology 1973-1983

1973	October	OAPEC embargo of USA and Netherlands, production cutbacks
	October-	
1974	January	OPEC quadruples crude oil price
	March	End of embargo
	March-	Several governments gain
	June	majority interest in oil production
1975	March	Nationalization of Kuwait Oil Company
	October	10 % rise of OPEC price
1976	December	Saudi Arabia and UAE refuse to raise their prices to the new \$ 12.70 level in January 1977; two-tier price system in effect
1977	July	OPEC prices reunified at \$ 12.70
1978	September	Begin of Iran revolution
	December	OPEC agrees on price rise in four steps by a total of 14.5 % from October 1979; Iranian oil exports end
1979	February	Breakdown of price unity when several OPEC members raise prices above agreed level
	March	Iran resumes exports
	June-	Arabian Light price raised
1980	May	in four instalments to \$ 28
	June	OPEC aligns crude price on a fictitious "marker" of \$ 32 after Saudi Arabia refused price rise
	September	Arabian Light, marker crude again, raised to \$ 30; outbreak of Iran-Iraq war
	December	Arabian Light raised to \$ 32; other official prices aligned on a "marker" up to \$ 36, with an absolute maximum price of \$ 41
1981	October	Saudi Arabia sets price for Arabian Light at \$ 34; OPEC agrees on a system of differentials
1982	March	OPEC agrees to limit production to 17.5 mbd
	May-	At several meetings OPEC fails
1983	January	to coordinate pricing and production policies; some countries offer discounts
	February	Nigeria cuts crude price by \$ 5.50
	March	Saudi Arabia cuts price for Arabian Light to \$ 29; OPEC sets production limit at 17.5 mbd; actual production down to 14.7 mbd

Exploration outside the traditional producing countries increased considerably after the enormous rise in the price of oil, and deposits were developed that it had not previously been economical to exploit. The position of the OPEC countries as oil suppliers on the world market weakened accordingly after 1973. This development was strengthened by the unexpectedly strong reaction of oil consumers to the price rises, for in recent years the decline in oil requirements was due more to energy saving and oil substitution than to the cyclical slowdown in oil demand. The curtailment of demand since the second oil price rise affected primarily oil from OPEC countries; the exports of most other countries showed a steady development largely unaffected by fluctuations in demand, and in some cases – such as Mexico, the United Kingdom and the USSR – even increased despite falling world demand. As a result, OPEC's share of world exports of petroleum fell from 87 % in 1973 to less than two-thirds in 1982 and will be even lower in 1983. Whereas OPEC's exports changed little in volume terms up to 1979, the

particularly marked fall in percentage share in later years was primarily due to a dramatic reduction in export volumes. This also had a severe effect on the oil revenues of the OPEC countries; after more than doubling from US \$ 116 to 279 billion between 1978 and 1980, they had already fallen back to \$ 202 billion by 1982.

Has OPEC Passed its Zenith?

Declining OPEC oil exports and falling oil prices suggest that OPEC has passed its peak and that oil prices will revert to a falling long-term trend after having risen in real terms for a decade. The view that oil prices will decline in real terms also in the long run, a view that has been gaining ground of late, is based on the expectation that the oil-importing countries will make further substantial progress in their structural adjustment to higher oil prices. It is realised that the demand for oil is being depressed partly by the weakness of growth in the oil-importing countries, but much greater significance for the development of oil consumption is attached to the increase in the efficiency of energy use that has been achieved so far and, more importantly, that is expected to materialise in future. Many of the measures for adjusting to the changes in relative prices take a considerable time to produce effects; as they involve high capital investment, the changeover will be spread over many years. It might therefore be concluded that world oil demand is unlikely to pick up even after the resumption of faster economic growth. If in addition the supply of oil from non-OPEC countries continues to increase, the demand for OPEC oil might be permanently restricted to a volume that does not permit the organisation to raise selling prices.

Since the first oil price explosion in 1973-74 there have been repeated attempts to predict the future course of oil prices – generally with disappointing results, as it has proved. This is hardly surprising, since both jumps in price were triggered, if not actually caused, by political events. However, the inaccuracy of most forecasts also reflects the uncertainty of market observers about OPEC's role in determining world market prices of oil. An example of this is the continuing discussion whether OPEC is or is not a cartel. While some hold the view that the OPEC countries determine the price of oil by means of coordinated cartel or cartel-like behaviour,⁵ other analysts believe that, all things considered, OPEC as an organisation has no significance for price formation. They acknowledge that oil prices have been raised above "competitive" levels,

Peter Flora

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⁵ Cf. M. Adelman: OPEC as a Cartel, in: J. M. Griffin, D. J. Teece, op. cit., p. 37-63.

but attribute this more to "good luck and special circumstances".⁶ According to this interpretation, the high level of oil prices brought about by political events and panic on the part of consumers could be maintained for as long as it was because the substantial rise in revenues caused by the price increases induced many countries with a low absorptive capacity to refrain from expanding production in order to earn additional revenue, without there being need of any coordination among them.

This debate has produced a rash of interesting theories to explain the behaviour of the OPEC countries. In the final analysis, however, a satisfactory answer has still not been given to the question of what determines the market price of oil. As far as the past is concerned, it is of course immaterial whether the increase in OPEC countries' revenue was achieved by means of coordinated action or as a result of the chance coincidence of views of individual member states, each of which was motivated by its own foreign exchange "requirement". Nevertheless, this distinction may be important for future developments.

Problems of Coordination

In view of the continuing oil glut, OPEC is now in the most difficult situation it has faced since its inception. If a further price collapse is to be avoided, a coordinated production policy must be pursued over a fairly long period. To the surprise of many observers, it appears that since reaching agreement on production limits in March 1983 the member countries have so far resisted the temptation to exceed their quotas, even though oil revenues in many countries fall short of their minimum "requirements". It remains to be seen whether this self-discipline can be maintained for long. One of the reasons why the agreement has held so far is probably the comparatively large sacrifice made by Saudi Arabia, which has reduced production to a level well below the minimum that can be sustained in the long run without cutting back on the country's extensive industrialisation projects. The scope for a further reduction if production is increased in other member countries is therefore limited. A second reason lies in the slight revival in the demand for oil, which appears to be due to a slowdown in destocking in oil-importing countries.

The price trend that has favoured oil consumers since 1981 will not necessarily last, despite OPEC's present sales difficulties. It is true that the long-term rise averaging about 3 % a year in real oil prices on which most forecasts have been based in recent years has not come about, at least not yet. Apart from the fact that

such annual averages are difficult to calculate as oil prices tend to rise in large jumps, an increase of this magnitude is unlikely to occur during the remainder of the eighties if there are no political upsets. However, this does not necessarily mean that real oil prices will not rise again in future. The present supply situation is marked not only by weak demand but also by a continuing pronounced rundown of stocks in the oil-importing countries. It is impossible to say precisely when this "oil well" will run dry, but it will probably happen in the not too distant future.⁷ This will again stimulate oil exports and bolster OPEC's prices. With oil demand expanding once again and the world economy recovering, it is quite conceivable that the real price of oil will begin to rise again in the second half of the eighties.

Danger of Further Price Rises

Due weight should therefore be given to the warning sounded by the IEA in its World Energy Outlook of 1982⁸ against any slackening in efforts to raise the efficiency of energy use and increase oil substitution in the light of falling oil prices, for the long-term trend of oil supply and demand show the present situation of oversupply to be "deceptive". It is highly probable that the downward trend in oil prices since 1981 is also depressing consumers' and producers' longer-term price expectations and at least delaying efforts to reduce consumption or to exploit deposits with high production costs. The search for new oil deposits is already slowing down and projects for the exploitation of tar sands and oil shales and for the gasification and liquefaction of coal have been shelved or discontinued on grounds of profitability.

This tends to increase the scope for future price increases by the OPEC countries, which will remain by far the most important suppliers on the world market for many years to come. Above all, this will once again give Saudi Arabia the latitude it needs to play the role of "swing producer". The price concepts contained in the draft OPEC long-term strategy of 1980, which was strongly influenced by Saudi Arabia and foresaw real prices rising more or less in line with the rate of growth in the industrial countries, could then well become relevant once again after the present reprieve. Prophecies of the demise of OPEC, which have been made regularly since 1974, still seem premature.

⁶ D. J. Teece: OPEC Behavior: An Alternative View, in: *ibid.*, p. 86.

⁷ Nevertheless, should the expectation of a further decline in oil prices take hold, there is probably still scope for a continued sustained drawdown of inventories. Cf. E. Krapels: Growing influence of oil stocks, in: *Petroleum Economist*, June 1983, p. 213.

⁸ IEA: World Energy Outlook, Paris 1982.