JOINT ECONOMIC COMMITTEE

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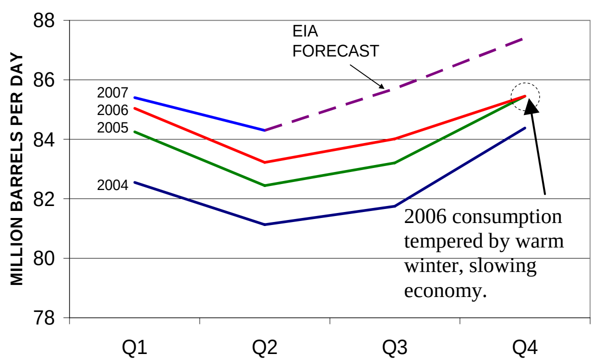
OPEC'S PURSUIT OF $70 TO $80 OIL

<u>Increasing world oil demand</u>. The world economy has continued to grow, and as a result, world oil consumption has kept rising while also following a seasonal pattern. There is a relative high in the winter and a relative low in the spring. Figure 1 shows oil consumption by quarter

Figure 1

WORLD OIL CONSUMPTION



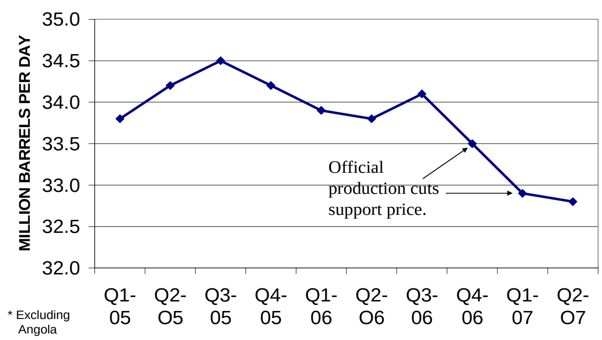
beginning with 2004. Based on the typical increase, the Energy Information Administration (EIA) projects oil consumption to reach 87.4 million barrels per day (b/d) in the fourth quarter of this year (see dotted line).

<u>OPEC cut its supply</u>. Countries outside OPEC can only increase oil output slowly. The cartel, on the other hand, can increase oil output relatively quickly; however, it has *cut back* its rate of oil production. Figure 2 shows EIA oil supply data for OPEC (excluding new member Angola) over the past 10 quarters. The price of crude oil has been above $70 per barrel this summer and presently exceeds $75. If OPEC does not reverse course soon and the demand pattern represented in Figure 1 holds, the price may increase still further. The cartel members will meet on September 11 and decide whether to increase oil production in time for the winter heating season.

<u>OPEC's price objective</u>. In past years, OPEC officials have indicated implicit price objectives in the $50 and then in the $60 per barrel range. Since last summer, they actually may have been aiming for $70. In August 2006, OPEC's president expressed satisfaction with $70 oil and

Figure 2

OPEC OIL SUPPLY*



* Excluding Angola

claimed that it was not damaging the world economy. Heightened supply risks—war in Lebanon and the possibility of another "Katrina" among others—had threatened the oil market and moved oil buyers to stock up precautionary inventories. OPEC did not accommodate the added demand, which consequently pushed the price up. When precautionary inventories were released again, the cartel withdrew supply from the market to support the price. The top portion of Figure 3 shows 2006 oil inventory levels in the summer rising far above the range of the previous five years. By autumn, the most severe supply risks had passed and oil from inventory was meeting consumption demand. Some OPEC members promptly reduced their output to offset the oil flow from inventories. But as the price continued to decline, the call went out to all cartel members to cut production by a total of 1.2 million b/d. The vertical bars in the bottom portion of Figure 3 represent resultant increases in the cartel's spare pumping capacity.

Figure 3 OECD TOTAL COMMERCIAL OIL STOCKS

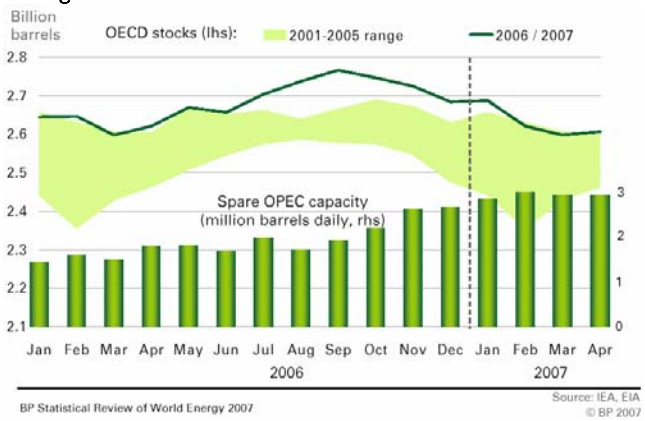
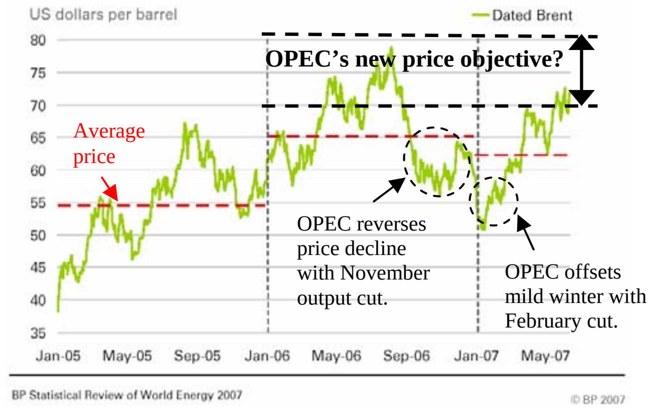


Figure 4 THE PRICE OF CRUDE OIL



OPEC idled more and more pumping capacity as oil from inventory entered the market (note the decline in the inventory level as of September 2006 and its return to the five-year average range by February 2007). OPEC managed to reverse the price decline. Warm weather during early winter and a slowing U.S. economy tempered the seasonal rise in 2006 fourth quarter oil consumption (see circled data point in Figure 1) and price fell, whereupon OPEC cut output by another 500 thousand b/d in February. Figure 4 depicts the crude oil price movements since 2005. Starting at $50 this year, the price has climbed back above $70 per barrel. Throughout, the cartel has held to its reduced oil output quotas. OPEC officials often proclaim that they offer as much oil to the market as is "needed" and blame a host of factors outside their control for high prices. Unofficially, however, they appear to have been working toward a crude oil price of $70 per barrel all along.[1] The cartel's September meeting may reveal whether they now are aiming still higher.

OPEC is behind the rising trend in oil prices. It bears emphasis that increases in oil demand do not necessitate higher prices in this market. The cost of oil production, less than $10 per barrel for OPEC as a whole and $5 or less for its Persian Gulf members, is so far below price that supply could expand very profitably to meet incremental demand without further price increases. OPEC's concerted effort to constrict oil production in the face of rising demand is driving the price up. Having abandoned its previous *official* price band of $22 to $28 per barrel, OPEC refuses to announce a new one and counteract precautionary or speculative demand surges, because it wants the price to keep rising as world oil consumption increases. To facilitate the price rise, it cut its oil production unabashedly and is adding new members to it ranks. Angola, one of the fastest growing oil producers and China's largest supplier of crude in 2006, joined the cartel as of January 1st. Reportedly, Angola will be assigned a quota soon to cap its oil output growth.

Conclusion. OPEC's public statements should not always be taken at face value, but they can provide clues about its intentions, particularly in retrospect when one can match observable actions to them. OPEC takes any new oil price peak that the world economy has absorbed, even for a short time, as the rightful price for its oil. To speed the return to a price peak, it will reduce its oil supply even as demand is trending upward. Oil demand has been increasing mainly in Asia, and the cartel leaders appear to believe that Asia's rapid economic growth not only will be sustained, but together with Middle East growth, can offset a slowdown elsewhere.[2] Therefore, the cartel has become less concerned with the economic stress ever-higher oil prices cause and more assured in its pursuit of aggressive price objectives. At its September 11 meeting, it is likely to remain intransigent with respect to oil supply expansion.

[1] International Energy Agency's (IEA) director general, Claude Mandil, stated: "The market has become aware [that OPEC] has set an implicit new objective of keeping prices at or around $70 per barrel and that the organization is trying to defend this level." Thomson Financial, 8/28/2007.

[2] See Bhushan Bahree, "Why Fears of a U.S. Slowdown Aren't Weakening Oil Prices," *The Wall Street Journal*, 8/27/2007.