JOINT ECONOMIC COMMITTEE

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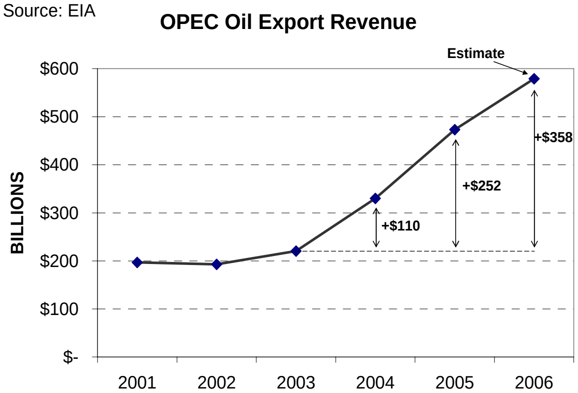
OPEC'S OPPORTUNISM

Exploiting Asian demand for oil. World oil demand has increased rapidly since 2003, driven mainly by Asian economic growth. China's consumption of crude oil alone has increased by 1.76 million barrels per day (b/d).[1] In response, OPEC abandoned its target price range of $22 to $28 per barrel and allowed the price to nearly triple relative to the midpoint of the range it had set in March 2000. The price increase has resulted in a cumulative increment to the cartel's oil revenues of an estimated $720 billion over three years. As the price for OPEC's crude oil receded from a peak of $72.68 per barrel on August 8 to $55.07 on October 20, the cartel announced an output cut of 1.2 million b/d, effective November 1 with possible additional cuts to follow.

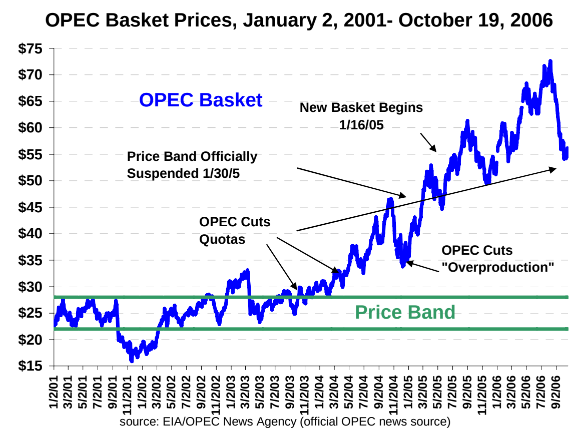
Figure 1

Source: EIA



Genesis of price rise. The market did not anticipate the large increase in crude oil demand, but OPEC's reaction to the increase clearly indicates its active support of higher prices. OPEC had held back about 2 million b/d of its oil pumping capacity as of December 2003 in order to support the $22 to $28 price band. In the face of rising demand, OPEC activated its idle capacity sparingly and even cut output intermittently when the price began to recede. Figure 2 shows average spot market prices for the different crude oil grades sold by OPEC.[2]

Figure 2



Eventually, OPEC ran into capacity constraints and suspended its output quotas. However, OPEC holds enormous oil reserves, which it keeps undeveloped. In the entire Persian Gulf region only about 2,000 exploration wells have been drilled since the inception of its oil activity compared to more than one *million* in the United States. Saudi Arabia has just over 1,500 producing oil wells compared to more than 560,000 in the United States.[3] OPEC's cost per barrel is approximately one-third to one-sixth of the price range it had set and one-ninth to 1/18

[1] Increase as of second quarter 2006 based on Table 2.4 "World Petroleum Demand, 2002-2006," International Petroleum Monthly, Energy Information Administration (EIA).

[2] On June 15, 2005, OPEC made changes to its crude oil "basket" price calculation that lowered the average at that time from $52.26 to $50.03; see EIA, "Country Analysis Briefs," November 8, 2005.

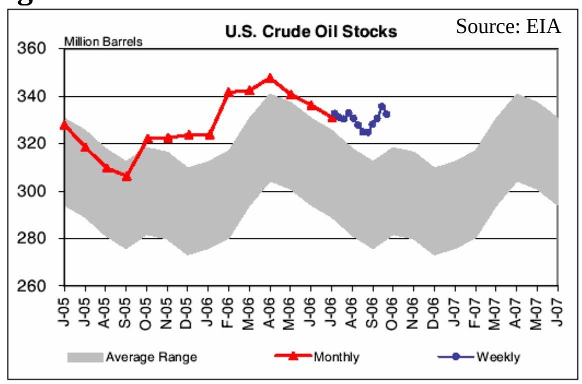
[3] Leonardo Maugeri, *The Age of Oil*, Praeger Publishers, 2006, pp. 204, 221.

of the recent price peak.[4] Thus, increased Asian oil demand had been met by OPEC's manipulation of its short-run pumping capacity and scores of inexpensive oil reserves kept locked away in the ground. While investment in capacity expansion is now underway, the cartel's renewed decision to cut production when the price had barely fallen below $60 per barrel demonstrates its intent to exploit the market further.

Refusal to stabilize price. OPEC did not announce a new price target and only communicated short-run production decisions to the market in an ad hoc fashion. If OPEC had announced continued support of the $22 to $28 price range in recent years and taken vigorous action to increase oil output and oil pumping capacity, then the unexpected shift in demand would not have raised the price by as much or for as long. Knowledge that the supplier with the largest crude oil reserves would raise its production rate to accommodate incremental demand would have reduced precautionary buying in the spot market and hedging activity in the futures market. Instead, both spot market trades and futures contracts for delivery dates out to 2012 increased dramatically in price. Had current market scarcity been viewed as temporary, long dated oil futures prices would not have risen. Today they remain above $60 per barrel and higher than the spot price. No one would offer to pay futures prices this high if OPEC were to give credible assurance to meet demand at $28 per barrel.

Precautionary oil demand. Pointing to buyers' high inventory levels, OPEC claims that the oil market is "well supplied." However, OPEC's opportunism contributes to precautionary stock builds. Oil inventories would be lower if the cartel refrained from cutbacks and threats of cutbacks. The Strategic Petroleum Reserve is a strictly precautionary, non-commercial inventory created in response to the oil embargo of 1973. Commercial oil inventories also have been stocked beyond the range of what is typically required to buffer seasonal demand changes, as shown in Figure 3.

Figure 3



High inventory levels together with high prices are indicative of a market that fears increased scarcity, not one assured of supply. A seasonal inventory drawdown reinforced by the diminishing need to compensate for hurricane damage (among other things) had contributed in late summer to lower market demand and crude oil spot prices that fell below $60 per barrel. The output cut announced by OPEC, however, has arrested the price decline.

Conclusion. OPEC is anything but blameless in the oil price surge of the last two years. The cartel is the single greatest cause of market instability, as it fans market fears with intermittent quota and output cuts to extend the price surge. Even assuming that OPEC was surprised by increased Asian oil demand and initially hesitant to view the increase as permanent, the cartel has had plenty of time to exercise market leadership. Instead, OPEC refuses to endorse a long-term price band and opportunistically seeks to extract as much revenue from the market as feasible. This year the cartel's oil revenue will approach $600 billion dollars, up from about $200 billion per year prior to 2003.

[4] Crude oil production cost is less than $5 per barrel in the Persian Gulf and less than $9 per barrel in the rest of OPEC; see "OPEC's 902 Billion Barrel Oil Reserve," Research Report #109-28, Joint Economic Committee.