JOINT ECONOMIC COMMITTEE

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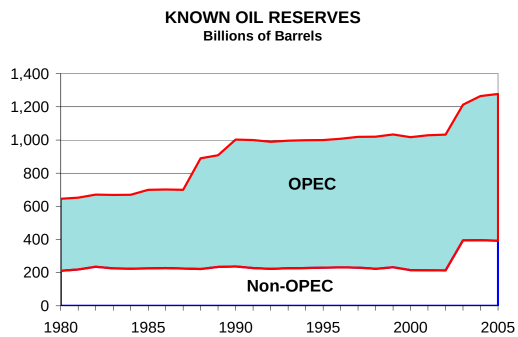
Explaining the High Price of Oil

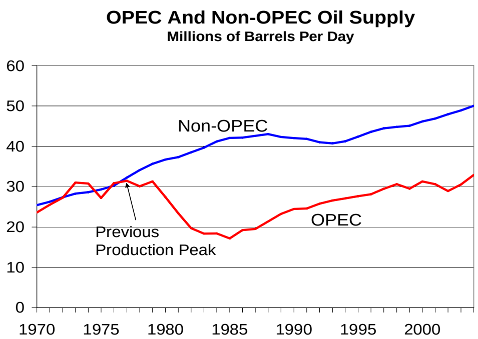
The OPEC Cartel. For three decades, OPEC has manipulated the oil market. The Persian Gulf countries sit on huge reserves of oil and are able to produce oil cheaply. The major ones, together with several non-Persian Gulf countries included in the cartel (Algeria, Libya, Nigeria, Indonesia, Venezuela), openly collude to restrict the output of oil and raise the price far above their cost. From the end of World War II until the oil embargo of 1973, Arabian Light crude oil sold for less than $2.50 per barrel; then the price shot up.[1]

Current known oil reserves are estimated at 885 billion barrels for OPEC versus 393 billion barrels for non-OPEC producers.[2] Yet



OPEC produces far less oil than non-OPEC countries, namely 32.9 million compared to 50 million barrels per day in 2004. While OPEC is able to push the market price of oil above cost, it is not able to consistently control the price level. It frequently is surprised by world events and the changing nature of the demand facing it. Moreover, it is not able to control the output of its members to the extent necessary to keep the price stable.[3] Prior to 1973, the market price of oil was stable. The graph on page 2 shows oil prices back to 1970, but the price line, in fact, is flat back to 1945.

Near term. The strong demand growth from Asia, and China in particular, is frequently cited as the reason for the rising price of oil. While this may be true in the short run, it is true only given the supply conditions that OPEC has created and given that it was surprised once again by a market development. OPEC only



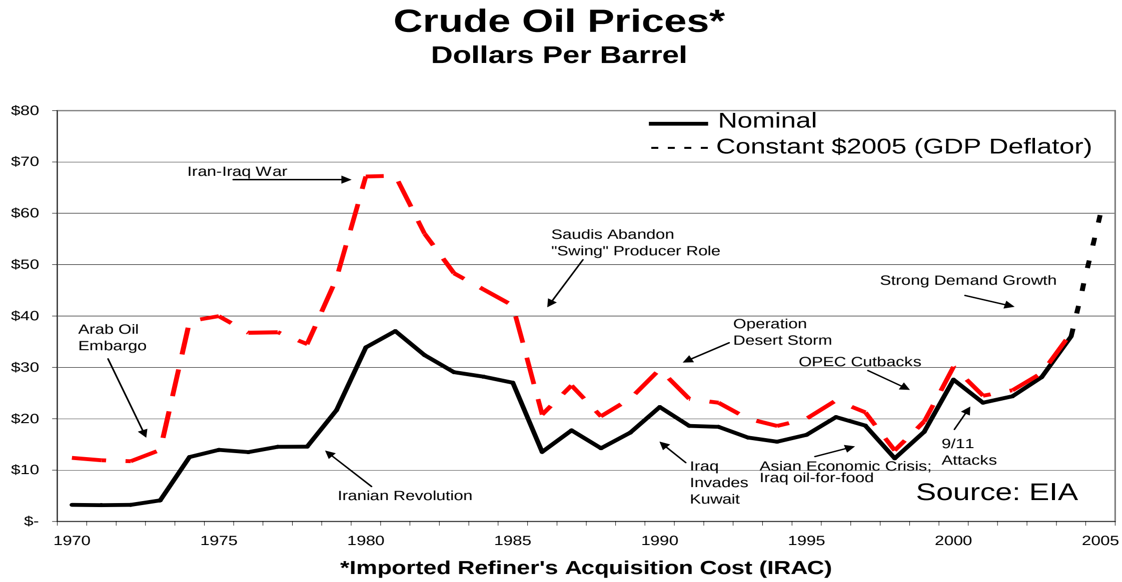
recently has edged its output past its historical production high of 31.4 million barrels per day set back in 1977. Having failed to anticipate the surge in market demand, OPEC likely must now drill more wells before it can increase production substantially.

Non-OPEC countries typically operated close to

[1] The Energy Information Administration (EIA) shows 2003 direct lifting cost of $3.99 and finding cost of $6.22 per barrel in the Middle East for major U.S. companies. The Mid-East national oil companies likely have lower costs.

[2] EIA is the data source for this report; it presents but does not certify foreign reserve estimates.

[3] For an extensive discussion of the OPEC cartel, its output manipulation and the effect on price, see M.A. Adelman, "World oil production and prices 1947-2000," *The Quarterly Review of Economics and Finance* 42 (2002): 169-191.



Oil prices fluctuate widely over past three decades.

capacity because they are price takers. Individually they do not account for enough supply to move the market price to their advantage, and to sell less than they are able to leaves profitable output in the ground. Therefore, with the notable exceptions of Iraq, Russia, and Saudi Arabia, the world's oil producers may be very close to their short-run output capacity. Continuing increases in demand and the possibility of even minor disruptions in supply thus help to explain the high spot market price for oil.

Longer term. At the same time, the incentive for producers to invest in substantial expansion of output is artificially weakened. The reason is this: OPEC's greatest concern is a price collapse. When demand recedes and discipline to hold back output breaks down among OPEC's members, the price can drop dramatically. For example, in December 1997 OPEC raised its production ceiling by 2.5 million barrels per day in anticipation of growing Asian demand, but the currency crisis of late 1997, instead, caused Asian demand to fall. The result was a market price in 1998 that dipped below $10 dollars, the lowest level since 1973, and a $51 billion year-over-year reduction in oil revenue. Asian demand accounted for about 23 million barrels per day in 2004 (6.6 million from China). Given continued uncertainty over the pace of China's economic development, OPEC may be cautious in expanding supply capabilities, its public pronouncements not withstanding. Meanwhile, the rest of the world is watching what OPEC does. The question is whether and how much to invest in additional production, if OPEC is going to substantially increase its supply of oil and brings the price back down. This uncertainty slows investment and contributes to high futures prices for oil delivery several years hence.

Conclusion. There is plenty of oil to satisfy demand, but for the manipulation of the OPEC cartel. At its current (2004) rate of production OPEC would not run out of oil for 75 years, and that assumes no additional reserves are found. The price of oil is high because (a) OPEC has held back output and not developed its vast oil fields enough; (b) strong demand growth, particularly from Asia, has encountered short-term production limits; and (c) uncertainty about OPEC's intentions slows output growth by the rest of the world's producers.