



New Cohesion in OPEC's Cartel? Pricing and Politics

By James Richard*

Political and economic considerations have led OPEC, under Saudi leadership, to make its most concerted effort in years to raise prices after a long period of declining income. This plan seems more likely to work than its predecessors to help oil-producers avoid a potentially dangerous economic crisis.

The Middle East's most direct effect on the international economy comes from the oil production and pricing policies of the region's major petroleum-exporting countries. In this context, the March 23, 1999 OPEC (Organization of Petroleum-Exporting Countries) agreement made a significant decision by cutting 2.1 million barrels per day from production.

After a long decline in oil prices, with an important impact on the economies and stabilities of Middle East states, the March 1999 agreement has attempted to raise prices by restricting production. This is by no means the first time OPEC has pursued such a strategy. More often than not in the past, these plans have been sabotaged by countries' cheating on the quotas in order to increase their own income.

This time, however, there is some reason to believe that the rally in oil prices will be sustained for some time. Political and economic circumstances--including the worrisome problems of lower income coupled with potential internal unrest--gives the OPEC states an incentive to cooperate more than before. At any rate, these developments provide a good opportunity to understand how, and how well, the oil-exporting countries have been managing this vitally important issue.

SAUDI ARABIAN POLICY

Because Saudi Arabia provides ten percent of the world's daily oil supply and almost one-quarter of exports, its oil policy is the linchpin in the dynamics of oil pricing. In recent years, Saudi policy has been based on three tenets:

- 1) Maintaining stability in oil markets;
- 2) Opposing high oil prices that might discourage demand growth or lead to a rapid rise in non-OPEC production;
- 3) Maintaining its own dominant market share, especially in the United States.

The OPEC agreement signed in Jakarta, Indonesia, in November 1997, which raised output by 10 percent, has been widely viewed as the source of the 1998 supply glut. Seen in the context of Saudi policy, however, the agreement met critical objectives. First, at the time there appeared to be a genuine threat that Brent prices of \$22 per barrel would encourage heavy investment in the Caspian and Central Asia. Second, as discussed below, the Saudis set the stage for a new political equilibrium within the OPEC cartel.

In any case, the effects of the output increase were unexpectedly great as the magnitude of the impending decline in

Asian demand was not fully appreciated at the time. And, of course, no one could have foreseen the historic warm winter that was about to occur in North America.

The consequences of oversupply were especially dire for Saudi Arabia, as its oil revenue fell by almost \$14 billion (30 percent), while population growth hovered near 4 percent and unemployment remained high. At the same time, it seemed impossible to cut the bloated public sector or the billions of dollars spent on royal stipends and other rents. The political instability that arises during any severe economic downturn was exacerbated in Saudi Arabia by an increased threat from Islamic extremists. The bombing of a U.S. military base at Khobar in 1997, and the activities of Osama Bin Laden outside the country, increased fears of a brewing indigenous revolt.

Nonetheless, even through the March 1998 OPEC cuts, the Saudis kept production at mid-1997 levels and preserved their dominance in the U.S. market. Saudi oil policy, despite damaging itself with low prices, was effective in deterring investment in exploration and production, particularly the rush into the Caspian and Central Asia, as well as destroying many independents.

Indeed, in the 18-month period after November 1997, marginal production was abandoned at a blazing pace. Canadian rig counts were down 69 percent and Latin American rig counts fell 26 percent. In comparison, Middle Eastern rig counts fell by only 12 percent). As of March 26, 1999, well into the oil price rally, the trend had not stopped, as rig counts in North America were down 10.7 percent from the week before (and 44 percent from the year before). The American Petroleum Institute's recent figures show U.S. oil production at a 49-year low.

While non-OPEC producers were shutting in wells from Oklahoma to West Africa, most oil majors were cutting capital expenditures on exploration and production

by 25-35 percent. Taken together, the above trends will likely eliminate as much as 500,000 barrels a day from non-OPEC production in 1999 alone. Such trends, once established, take time and economic incentive to change.

In short, then, the Saudi-led emphasis on market control and avoiding new competition took priority over maintaining higher prices and short-term income. Arguably, the strategy worked very well. But this approach accorded less well with the political and economic needs of other OPEC members. And it was also necessary to deal with the dangers such a campaign posed for the involved Middle East states in terms of domestic problems.

RECENT DYNAMICS OF THE OPEC CARTEL

At the March 23, 1999, OPEC meeting in Vienna, the Saudis took the largest reduction and agreed on doing it a month earlier than the rest of the cartel. Counter to Saudi interests, these cuts will move Mexico or Venezuela ahead of Saudi Arabia as the main supplier to the U.S. market. This is a significant policy shift for Saudi Arabia, from which one can infer that Crown Prince Abdallah and the professionals in the Saudi oil industry have suffered enough pain, and are satisfied that the supply trend is turning downward.

To understand why they are so confident, we must consider dramatic changes within the cartel over the past two years. Most pundits, failing to observe the changes in market conditions, have analyzed OPEC's latest cuts under the standard theory of cartels. These economic arguments posit that under all circumstances, and all the time, the incentive of higher revenues for each cartel member causes the member to cheat on its quota, eventually driving down prices by flooding the market with supply.

This argument may be true in the long run, but it fails to account for the political dynamics of the cartel that is OPEC. Even a politically feeble OPEC had managed to remove more than 1.3 million barrels per day from the market since the March 1998 agreement, which resulted in oil prices bottoming at \$10/barrel, instead of \$5.

in the Saudi's own oilfield region, the Eastern province.

Since the Iranian revolution, however, Iran's oil policy had been dominated by conservatives. During 1997, the cash-strapped Iranians had one policy objective: produce every possible barrel of oil up to the country's capacity. They had

OPEC Crude Oil Production					
Estimated Mar. 1999					
(thousands bbl/day)					
	1998	1999	Change	Capacity	Utilization
Middle East:					
Algeria	890	800	-10%	930	86%
Iran	3,750	3,660	-2%	3,700	99%
Iraq	1,700	2,700	59%	2,600	104%
Kuwait	2,200	1,980	-10%	2,650	75%
Libya	1,470	1,350	-8%	1,560	87%
Qatar	690	650	-6%	740	88%
Saudi Arabia	8,700	8,120	-7%	10,800	75%
UAE	2,400	2,160	-10%	2,650	82%
Non-Middle East producers:					
Indonesia	1,430	1,310	-8%	1,420	92%
Nigeria	2,275	2,050	-10%	2,320	88%
Venezuela	3,400	2,860	-16%	3,600	79%
Total cuts	27,205	24,940	-8%	30,370	82%
Source: Bloomberg Financial Services & Firebird Management LLC					

Further, political changes within OPEC during 1998-1999 greatly improved the prospect for compliance with cuts in the short- to medium-term.

Most significant have been the altered positions of Iran and Venezuela. As for Iran, it is important to consider the Saudi position entering the 1997 Jakarta meetings. The Kingdom had what it perceived as a belligerent Shia regime for a neighbor. Since the Islamic revolution in Iran, a major strand of state security in Saudi Arabia has been to thwart any Iranian meddling in the domestic politics of the Arab Gulf states. This was especially acute since Shia are so numerous

also been overstating their production in hope of establishing a baseline for future cuts of 3.9 million barrels a day, instead of the 3.6 million barrels they had actually been producing. Teheran believed the higher baseline would leave room for potential cuts without real financial losses.

The Saudis, knowing the Iranians were operating at capacity in November 1997, steered OPEC to an agreement increasing production by 10 percent. Saudi Arabia and other cartel members were fully aware that the Iranians could not produce any more oil and that, because of increased supply in the market in the short-term, the "cheaters" from Teheran would receive

nothing for their maneuvering but lower prices and revenues.

By February 1998, estimates showed a decrease in Asian demand of 600,000 barrels per day. Although expectations were that 2 million bpd (barrels per day) needed to be removed from the oil market, the OPEC agreement of March 1998 only managed commitments to cut 1.2 million barrels from production. After much wrangling within OPEC and between differing groups of the Iranian delegation, the Iranians insisted their cuts had to be based on the 3.9 million bpd baseline. In reality, Iran made no new reductions, a fact that immediately shaved 300,000 bpd from the cartel's agreement to cut 1.2 million bpd.

Clearly the deal was imperfect, especially for the Venezuelans, for whom oil constitutes 18.5 percent of GDP, 37.5 percent of government revenue, and 70 percent of hard-currency revenue. In recent years, Caracas' oil policy has been based on the objectives that any OPEC deal must be equitable and must include non-OPEC producers. In the March 1998 agreement, Venezuela was saddled with the largest percentage cuts and the Iranians walked away taking no pain. Further cuts were needed in June 1998, and the Saudis mustered most of them out of the Arab Gulf states.

Throughout this period of discord in OPEC, political change was stirring in Iran. In fact, over the past 18 months Saudi-Iranian relations have gone from horrible to almost cordial, which can be attributed to Iran's President, Muhammad Khatami. Although Khatami was elected in May 1997 with nearly 70 percent of the vote, he has only recently been able to exert authority over such conservative-dominated power portfolios as interior, foreign affairs, and oil and energy.

The increase in Khatami's power really began in late 1998 and early 1999, when several of Iran's leading intellectuals

were brutally murdered within weeks of each other. When officials within the Iranian intelligence apparatus were implicated, Khatami channeled public outrage and was able to increase his authority over the interior ministry and the intelligence service. The popular president's power was further enhanced in February 1999, as a result of the wide victory of pro-Khatami candidates in the first local elections in post-revolutionary Iran.

Conservative elements led by the Supreme Leader Ayatollah Ali Khamenei lost ground to Khatami. In early March, Khatami went to Italy, becoming the first post-revolutionary Iranian president to visit a Western country, to meet with the Pope, the Italian head of state, and top executives of the oil company ENI, displaying his new influence in both foreign affairs and Iran's oil industry.

As compared to Iran's schizophrenic policy at the March 1998 OPEC meetings--where moderates supported cuts on the 3.6 million bpd baseline, while conservatives argued for 3.9 million bpd--the recent cuts were negotiated under the authority of Khatami. With Khatami's support, Iranian Foreign Minister Kharazmi shuttled between Riyadh and Caracas, cementing the deal. Moreover, President Khatami was elected to promote the rule of law, and it is likely that he views this agreement within that context.

The new realities within domestic politics in Iran made it possible for leaders of Saudi Arabia, Iran, and Venezuela to attain a more open and transparent agreement. Succumbing to the reality of economic hardship caused by low oil prices, the Saudi Crown Prince agreed to take more cuts in volume terms and earlier than anyone else. On friendlier terms with Iran, the Crown Prince ceded to President Khatami new cuts from the 3.6 million bpd baseline. In reality, these will be the first cuts from Iran over the past year.

To appease Venezuela's new president, Hugo Chavez, the deal granted a smaller percentage reduction to Venezuela than the rest of the cartel. Finally, after being extremely critical about cheating throughout 1998, Norway, a non-OPEC producer that participated in March 1998 agreement, recognized OPEC's prospects for better compliance and added its stamp of credibility to the deal with a cut of 100,000 bpd.

As of May 7, 1999, it appeared that, indeed, OPEC compliance was on the rise. Bloomberg reported that April 1999 compliance for previous agreements was 83 percent versus 78 percent in March and 71

OIL SUPPLY: RISKS AND WILDCARDS

The wildcards in this equation remain the future of Iraqi production and record oil stocks. As to Iraq, OPEC fears that Iraqi production could soon be awakened from its deep slumber and easily drive prices lower. Iraq's reserves are second only to Saudi Arabia's, and its current production of 2.6 million bpd is less than half its 1990 pre-Gulf War levels. The Energy Intelligence Group estimates that, with proper investment, Iraq could double its production in less than two years and flood the market.

March 1999 OPEC Targets, New Change Estimated (thousands bbl/day)					
	Production	Quota	Change	Capacity	Utilization
Algeria	800	731	-9%	930	79%
Saudi Arabia	8,120	7,438	-8%	10,800	69%
Iran	3,660	3,359	-8%	3,700	91%
Iraq	2,700	n/a	n/a	2,600	100%
Kuwait	1,980	1,836	-7%	2,650	69%
Libya	1,350	1,227	-9%	1,560	79%
Qatar	650	593	-9%	740	80%
UAE	2,160	2,000	-7%	2,650	75%
Non-Middle East producers					
Indonesia	1,310	1,187	-9%	1,420	84%
Nigeria	2,050	1,885	-8%	2,320	81%

Source: Bloomberg Financial Services & Firebird Management LLC

percent in February. With futures contracts and agreements with shipping companies to fulfill, near full compliance is difficult in the oil industry on a moments notice, but certainly the trend is moving in that direction. This unity greatly contributed to the fact that in the second week of April 1999 demand for crude outstripped supply for the first time in almost two years.

Perversely, the best news for oil would be Saddam Hussein's continued hold on power. As long as Saddam is in Baghdad, the United Nations will be regulating Iraq's production and investment in the oil industry, thus keeping overall production levels lower and meaning that prices would stay higher. Saddam may be removed and/or sanctions are lifted in the future. However, because the U.S. policy follows that of the

Arab Gulf states on Iraq, it may follow that the timing of such a move would happen at a time of high oil prices, when the Gulf economies could better absorb the damage from marginal Iraqi production.

The other wildcards for supply are the current high inventories and the mysterious "missing" inventories. Standing at 350-400 million barrels, world oil stocks have reached record levels. OPEC behavior must remain unified for at least all of 1999 to get over this hump, but even at 50 percent compliance this would be achieved.

The "missing" stocks refers to oil that was accounted for in OPEC production in late 1997, but unaccounted for in consumption or inventory statistics. These are assumed by analysts to be floating around in non-OECD stocks. However, this oil probably was never produced in the first place, but was merely the result of false claims of higher output made by countries at the 1997 OPEC meetings in order to avoid real cuts.

Finally, there is cash-strapped Russia, which some observers argue will flood the market with oil. This should not happen, however, because most Russian companies have not had enough financing or cash-flow for capital expenditure even to maintain existing production. Indeed, overall Russian production fell a few percentage points from 1997 to 1998. I assume that Indonesian oil companies are having the same problem.

The Russians also cannot flood the market with crude because of transport constraints. Russian transport capacity utilization is 100 percent and so, as in 1998, Russia will export 2.5 million barrels a day

in 1999. There are talks about a new 50-million ton- a-year pipeline from Timan Pechora to the Baltic Sea, but this project is at least two years off. In the March 1999 OPEC accord Russia pledged to cut 100,000 bpd, which was a nice gesture, although no one really expects compliance.

Interestingly, throughout this downturn in oil, a few Russian oil companies have been fairly successful at maintaining production and exports. Because they continue to be unable to rationalize their wells for efficiency during periods of low prices, most producers with any cash flow never took wells out of production. In fact, large Russian producers such as Surgutneftegas' 1998 production rose 4 percent over 1997, and LUKOil's also rose slightly. Because Surgut has remained current on its taxes, its export quota has increased significantly within the constraints of the transport system.

Both because of decreased supply from non-OPEC producers and a better political environment for compliance within the cartel, it is likely that the 1999 OPEC agreement will succeed where its predecessor failed. Clearly, some leakage will occur and market conditions will shift over the long-term, but new realities within OPEC give it the capability easily to remove one million barrels-a-day from production. If so, this means an upturn in the income of Middle East producers.

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