Analysis of OPEC/Non-OPEC Cooperation

By William R. Edwards*

The petroleum producers of the world are understand-
ably distressed with their inability to reverse the continuing
underlying trend of lower and lower crude prices. There has
been much said and written about the causes of the low prices
and the action needed to correct the situation. Most com-
mentators agree that if OPEC and non-OPEC producers could
agree on a joint production control agreement the problem
would be solved. Some officials, such as the Oil Minister of
Oman, have actively lobbied OPEC and non-OPEC partici-
pants in an effort to get agreement on cooperative measures
to rectify the situation. All participants and commentators
seem to be in agreement that the problem is overproduction
and the solution is a cooperative production cut.

While the imposition of a restriction on crude supply
would indeed provide temporary alleviation of the price
problems, this relief would be of very short duration (several
weeks to a few months) because it does not address the
problem in a fundamentally sound fashion. Thus it behooves
the industry leaders to look more realistically at the results of
an orchestrated supply restraint and alter their strategy to
produce a more lasting and desirable result.

To better understand the reasons why conventional
wisdom does not apply in the case of an OPEC/non-OPEC
production cut, let us think through the expected sequence of
events beginning with a coordinated agreement by OPEC and
non-OPEC producers to restrain production. For our think-
ing purposes, let us assume that the agreement is for each
group to reduce production by 5 percent, or a total worldwide
reduction of 1.5 to 2 million barrels per day of crude oil. This
would result in crude supplies being short of meeting demand
by more than 1 million barrels per day.

Sufficient crude inventories exist worldwide to compen-
sate for a million barrel per day drawdown for some months.
On a superficial basis, then, there would be little impact from
a 5 percent cut by half of the world’s producers. In actual
practice, however, the impact would not be so mild. Because
the world’s petroleum system is not one homogenous mix of
completely flexible entities, dislocations and problems would
appear almost immediately to some operators, resulting in
some panic driven actions.

Panic is contagious! Shortly after the curtailment had
begun, prices would respond and the response would not be
gradual and orderly. Because of the enhanced volatility
contributed by the futures markets, the price response would
be exaggerated. This exaggerated price response would
further feed the panic. Before long, commentators on the
reasons for the price move would convince the industry that
there was, in fact, a significant shortage of production. This
belief would be widely adopted, further feeding the panic and
causing further upward price moves.

The prevailing attitude would shift from one of supply
complacency to one of supply concern, and the industry
would begin increasing inventories out of fear of being caught
short. This action would create an added apparent demand on
the system, exacerbating the contrived shortage of supply.
The price increase hoped for by the OPEC and non-OPEC

*William R. Edwards is a Principal at Edwards Energy Consultants
in Houston, TX.
more revenue from an increased production level. Since all producers are inclined to respond in a like manner, it won’t be long before the market is again satisfied and prices will plummet to preagreement levels or lower.

The case described above is not merely speculative. It is based on historical fact. The description of events merely chronicles OPEC’s past actions when production restraint has been effectively applied for short periods during the last decade. The positive results have consistently been of limited duration.

Let us consider a best case alternative, the highly optimistic case in which, for whatever reason, OPEC and non-OPEC producers maintain their production restraint and magically achieve the target price level or a level only slightly higher than the target. At this level there should be almost no impact on demand, hence the shortfall in supply precipitated by the 5 percent production restraint will cause inventories to eventually reach tank bottoms. At this point someone must increase production to fill the gap. Who will decide who gets the production increase? Who will decide how much additional production each producer is allowed? Will OPEC merely fill the gap in supplies created by the 5 percent reduction implemented by non-OPEC? Would non-OPEC producers feel cheated if the ultimate result of a million barrel voluntary cut in their output merely becomes a corresponding million barrel increase by OPEC countries? Unless these questions are satisfactorily resolved prior to an agreement on production restraint, the agreement will disintegrate.

The main point being made here is that the entire process must be thought through – not just the first step. If a thorough analysis of the entire process does not result in a convincing answer to the potential problems, then an alternative strategy, other than production cuts, must be adopted.

While the description of expected events resulting from the implementation of production restraint portrays a bleak outlook, this should not imply that there is no means for achieving an attractive, stable price. In fact, if an enlightened application of fundamentally sound pricing principles is applied along with a practical, working knowledge of commercial marketing practices, then an attractive, stable price can result. The real challenge facing the producers is to acquire the assistance of a person or a group who can provide and apply the necessary pricing and marketing competence.

---

The INTERNATIONAL ASSOCIATION FOR ENERGY ECONOMICS Announces
The 20th International Conference

Energy and Economic Growth: Is Sustainable Growth Possible?
To Be Held At The
India Habitat Center
New Delhi, India
January 22-24, 1997

Conference Themes:
- Global energy economy and the developing countries.
- Minimum energy needs, social development and economic growth.
- Environmental concerns and the limits to energy and economic development.
- Role of technology in global sustainability.
- Issues in capital flows for energy development in Asia.

*** CALL FOR PAPERS ***

Deadline for Submission of Abstracts: August 1, 1996

Anyone interested in organizing a session should propose topics, objectives and possible speakers. Abstracts should be between 200-500 words giving an overview of the topic to be covered at the conference. At least one author from an accepted paper must pay the registration fees and attend the conference to present the paper. All Abstracts/Proposed Sessions and Inquiries should be submitted to:

Dr. Leena Srivastava
Dean, Policy Analysis Division
Tata Energy Research Institute
Habitat Place
Lodi Road, New Delhi - 110 003
INDIA

Phone: 91-11-4622246 or 4601550
Fax: 91-11-4621770 or 4632609

The 20th IAEE International Conference is being hosted by the Indian Association for Energy and Environmental Economics (IAEEE) and the Tata Energy Research Institute (TERI).

General Conference Chairman:
Dr. R.K. Pachauri

Technical Committee Chairperson:
Dr. Leena Srivastava

---

Advertise in the IAEE Newsletter

<table>
<thead>
<tr>
<th>Format</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/4 Page</td>
<td>$250</td>
</tr>
<tr>
<td>1/2 Page</td>
<td>450</td>
</tr>
<tr>
<td>Full Page</td>
<td>750</td>
</tr>
<tr>
<td>Inside Cover Page</td>
<td>900</td>
</tr>
</tbody>
</table>

For more details contact:
IAEE Headquarters
28790 Chagrin Blvd., Suite 210
Cleveland, OH 44122, USA
Phone: 216-464-5365
Fax: 216-464-2737