

Fifty Years to OPEC: Time to Break the Oil Cartel

Written by Gal Luft

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Fifty years ago, five of the world's top oil producing countries convened in Baghdad to form the Organization of Petroleum Exporting Countries (OPEC), the most powerful cartel in modern history. Contrary to popular belief, OPEC was not the brainchild of an Arab but of Venezuela's Energy and Mines minister Juan Pablo Pérez Alfonzo who got fed up with the domination of the petroleum industry by the Seven Sisters, the seven Anglo-American oil companies, and particularly with the Eisenhower Administration's law that forced quotas on Venezuelan and Persian Gulf oil imports in favor of Canadian and Mexican oil firms. Pérez Alfonzo, who is otherwise known for titling oil "the Devil's excrement," convinced his Saudi and Iranian counterparts to join a consortium of major oil producers whose goal would be to "assert its member countries legitimate rights" and to gain "a major say in the pricing of crude oil on world markets."

OPEC did just that. In the decades that followed, the cartel nationalized international oil companies' oil fields and infrastructure assets, and gained the upper hand in price negotiations, turning the Seven Sisters into seven dwarfs whose ability to influence oil prices is virtually nil.

As their collective power grew, OPEC members discovered the use of oil as an instrument of national power. During the 1967 Six-Day War, Arab oil producers refused to sell oil to western countries that supported Israel, but the war ended so quickly that the world paid little attention. Six years later, when the same exporters imposed a six-month oil embargo and "No Gasoline" signs spread throughout America's service stations, the economically ruinous oil weapon, exacerbated by counterproductive domestic policies, was felt by all.

Since then, OPEC has earned a reputation of a club of greedy, non-democratic governments whose oil ministers gather in Vienna every few months to fix the price of crude and, in more than one way, determine our security and economic well being.

This reputation is well deserved.

With 12 members, the cartel produces today one third of the world's oil supply, and it prides itself for controlling almost all of the market's spare production capacity, the main shock absorbers for the world economy against supply disruptions. But the cartel's level of production is unimpressive when one considers its control of 78% of global reserves. Compare this to non-OPEC producers, who own only 22% of world reserves, yet supply two thirds of a world demand, twice as much as OPEC.

OPEC clearly produces far less than its reserves allow

In absolute number of barrels OPEC's production level is even less remarkable. In 1973, just before the Arab Oil Embargo, OPEC produced 30 million barrels per day. Thirty-seven years later, with global oil demand and non-OPEC production nearly doubling in the interim, and despite the fact that in 2007 the cartel inducted two new members, Angola and Ecuador, with combined daily production capacity equivalent to that of Norway, OPEC's crude production has not increased. In 2010 it is expected to average 29 million barrels a day – one million barrels per day less than in 1973.

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The cartel's performance as buffer against oil shocks is also worthy of examination. While OPEC owns the swing production capacity necessary to stabilize the market in time of disruption, it seldom uses this capacity. Time and again when disruptions occur OPEC drags its feet and ignores consumers' pleas to open the spigot and provide some relief. Instead, it insists that the market is well supplied and that high oil prices are the doing of speculators as well as SUV-driving soccer moms. When in 2008 oil prices neared \$150 a barrel and then President George W. Bush visited Saudi Arabia, which yields the most influence within OPEC, he was swiftly rebuffed by the Kingdom's oil minister Ali Naimi upon requesting more oil. A few months later the world slid into a painful recession, largely driven by high energy prices, from which it hasn't yet recovered.

Further, OPEC members are in most cases responsible for the very same supply disruptions they are expected to counter. The Arab Oil Embargo, Saddam Hussein's 1980 attack on Iran, his subsequent attack on Kuwait, Nigeria's endless war in the Niger Delta, and the 2003 long oil strike in Venezuela have all been originated by OPEC members. OPEC is no less of an arsonist than a fireman.

The cartel's manipulation of oil prices by yo-yo-ing supply is designed for one end: to maintain the virtual monopoly of oil over transportation fuel—almost all of the world's cars, trucks, ships and planes can run on nothing but petroleum—by blocking competition from alternative energy sources. True to form, in response to President Obama's call in 2009 to steer America's energy policy away from oil, Ali Naimi, the man who effectively runs OPEC, resorted to the old scare tactics to dissuade oil importing nations from promoting alternatives. He warned that “a nightmare scenario would be created if alternative energy supplies fail to meet overly optimistic expectations, while traditional energy suppliers scale back investment.” Translation: if you keep investing in alternative fuels, we are going to cut back on investment to make sure oil prices stay high.

Half a century of a transportation sector dominated by OPEC has led us to accept the cartel's shenanigans as a fait accompli. We shouldn't. In a modern world economy where free trade, open markets and strict anti-trust laws are bedrock principles, there is no room for a cartel dominating any commodity, not the least, the most strategic one of all.

So far the US Congress has mainly attempted to fight OPEC the American way: in court. In 2000 the Senate Judiciary Committee unanimously approved the “NOPEC” (No Oil Producing and Exporting Cartels) bill, enabling the Justice Department to sue in federal court “any nation [...] that is engaging in cartel or conspiracy to limit the production of oil.” Responding to the public's rage over high gas prices, Congress passed NOPEC again in 2008. Luckily the Bush White House announced that it would veto NOPEC, sparing us the media circus that would have followed had our government attempted to sue Hugo Chavez, Mahmoud Ahmadinejad or other colorful oil sheikhs. While focusing on populist solutions, the US surrendered the only leverage it ever had on the country that effectively runs OPEC: In 2005, in an act that is most antithetical to free trade, it approved Saudi Arabia's admission to the World Trade Organization.

Equally futile have been the efforts by Congress and successive administrations to address America's oil dependence through policies that increase either the availability of petroleum (like

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domestic drilling) or the efficiency of its use (like increasing mandatory fuel efficiency standards). Experience of the past three decades reveals that neither drilling nor efficiency would do much to defang OPEC because they do not address oil's virtual monopoly in the transportation sector, now 95 percent dominated by oil, from where the cartel derives its power. Whenever non-OPEC producers like the US increase their production, OPEC decreases supply accordingly, keeping the overall amount of oil in the market the same. OPEC's response to conservation is similar. When in 2007-2008 gasoline prices soared, American motorists reduced their consumption by as much as 10 percent, which amounts to a saving of nearly 1 mbd. In response, OPEC throttled supply down by 4mbd. In other words, when we drill more, OPEC drills less, and when we use less, OPEC, again, drills less.

To break OPEC we must change the playing field altogether

Every year more than 10 million new cars roll onto America's roads, almost all of which can run on nothing but oil fuels. Each of those cars has an average street life of 15 years. This means that the number of cars that don't enable fuel competition is growing by leaps and bounds and with it the power of OPEC. So if the US is to seriously address its vulnerability to the oil cartel, the first thing it should attempt to do is ensure that new vehicles enable fuel competition.

In the coming years a shift from cars powered by petroleum fuels to ones powered by electricity (whether plug-in hybrid electric vehicles or pure electric vehicles) would have tremendous impact on the oil market. Electricity is cheap, clean, scalable, and readily available. Most importantly, 98% of US electricity is generated from non-petroleum energy sources like coal, natural gas, nuclear power and renewable energy. But studies project that pluggable vehicles will not reach the deep enough market penetration necessary to threaten OPEC before 2030, which means that complementary near term solutions are needed in parallel to progress toward vehicle electrification.

To enable near term competition to OPEC, a simple technical fix, which according to GM costs \$70 per car, should be added to every new vehicle sold in the US. Flex fuel vehicles ensure that cars powered by internal combustion engines can run on any combination of gasoline and a variety of alcohol fuels such as methanol (made from coal, natural gas and biomass) or ethanol. An Open Fuel Standard ensuring new cars are flex fuel vehicles would open the transportation fuel market to fuels made from energy sources beyond oil. (The spot price for methanol from natural gas, currently under a dollar a gallon, is competitive on a per-mile basis with gasoline.) Such a standard would put a virtual cap on the price of oil. Consumers would opt for the most economic fuel on a per mile cost basis, and thus shift to substitute fuels the next time OPEC allows oil price to exceed a certain threshold. Since no automaker can give up on the US market, the Open Fuel Standard would become a de-facto global standard. Cars sold anywhere in the world would be Flex Fuel, allowing small and developing countries to develop competitive fuel markets and domestic alternative fuel industries, and to protect themselves against economically devastating oil shocks.

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An Open Fuel Standard would add an extra cost to a new car equivalent to the cost of one barrel of oil. Such minimal investment would enable America for the first time to challenge OPEC using the weapon the cartel fears most—competition at the pump. Neglecting to adopt such a standard, thus maintaining oil's virtual monopoly over transportation fuel, the strategic importance of the commodity, and the power of the oil cartel, is the best birthday gift the US could give OPEC.

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