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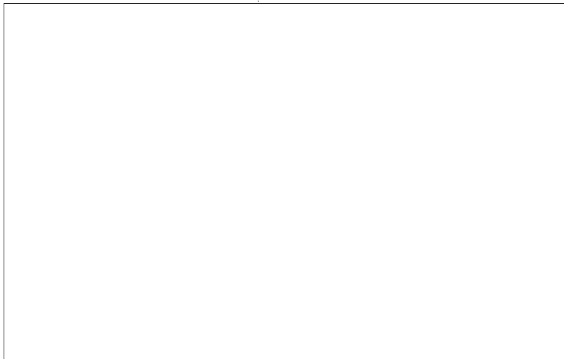

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OPEC: Narrowing Options in a Softening Oil Market

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An Intelligence Assessment

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This paper was prepared by [redacted] Office of Global Issues, with contributions from [redacted] OGI; [redacted] Office of Near Eastern and South Asian Analysis; and [redacted] Office of Imagery Analysis.

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Comments and queries are welcome and may be directed to the Chief, Strategic Resources Division, OGI, [redacted]

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OPEC: Narrowing Options in a Softening Oil Market

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Key Judgments

Information available as of 13 June 1985 was used in this report.

Overproduction and low demand continue to put intense downward pressure on oil prices. OPEC's lack of discipline to restrain production in the face of low demand could cause a price decline before OPEC's ministerial meeting on 5 July. Saudi Arabia's willingness to cut back production over the past two years to prop up OPEC's price structure has prevented a major price break, but with Saudi output at an 18-year low, Riyadh no longer appears able or willing to carry the burden alone.

This means that, with little or no prospect for a near-term increase in oil demand, market weakness will continue and downward price pressure is unlikely to abate. Strict adherence to production guidelines by OPEC could avert a price cut at this time, but the intense financial pressures on several members make voluntary restraint unlikely. Without production discipline, prices could fall—perhaps sharply—particularly if Saudi Arabia makes good on its recent threat to retaliate against quota violators by lowering prices and sharply increasing exports. A unilateral price break by the Saudis, which cannot be ruled out, could precipitate a dissolution of OPEC.

Recent market developments have created problems for Saudi Arabia. Riyadh will need OPEC's other members to share the burden of stabilizing the market. Financial and political constraints are narrowing Saudi options to cope with the weakening market. Saudi oil earnings this year will not match 1984 levels under any realistic price and production scenario. At the same time, the Saudis face further deep cuts in their ability to sustain wide-ranging domestic and foreign financial assistance programs—or a drawdown in foreign reserves—if they continue to absorb market slack.

OPEC's options to forestall a price break are extremely limited, particularly if members do not equally shoulder the burden of supporting prices. An oil price decline would have mixed effects on the world economy. Although lower oil prices would help efforts to keep inflation in consuming countries under control and give impetus to economic expansion, a precipitate drop would create severe financial problems for oil-producing nations with heavy debt burdens, and place serious strains on the international banking community.

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Scope Note

This assessment examines the events leading up to the current oil price crisis facing OPEC and sets the stage for the organization's semiannual ministerial meeting previously scheduled for 22 July. The meeting has been rescheduled for 5 July in Vienna and will deal with the risk of another price decline.

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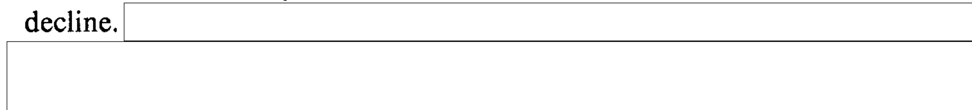

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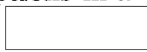

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Introduction

Pressures are mounting for another fall in oil prices. The oil market continues to weaken, and spot prices for major crudes are edging downward. High production levels by the Organization of Petroleum Exporting Countries (OPEC)[1] since the first of the year continue to reinforce industry skepticism that OPEC can and will hold prices by adjusting supply to meet lackluster demand. More ominous from OPEC's view, however, is the prospect that Saudi Arabia—faced with mounting financial and budgetary constraints—may decide not to cut back output further to support the organization's official price structure. Without renewed production restraint within OPEC, a new round of price cuts is likely, perhaps before OPEC's ministerial meeting, now scheduled for 5 July in Vienna.

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The Market Backdrop

According to preliminary data, non-Communist oil consumption in the first quarter of 1985 was 1 percent below that for the same period last year, or more than 500,000 barrels per day (b/d) less than many oil companies had expected. Preliminary data also show sales in the United States in April were 3 percent lower than for the same period in 1984. Slower economic growth in the United States, the end to the British coal miners' strike, and continued gains in conservation and substitution—in part because of the strong dollar—contributed to the drop in oil use in the industrialized countries.

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Spot prices for most OPEC crudes are more than $1 per barrel below official levels (figure 1). Non-OPEC supply continues to rise and in the first quarter averaged 500,000 b/d above year-earlier levels. Non-OPEC producers such as Egypt and the USSR lowered official prices in recent weeks, and Mexico—under intense pressure from customers—reportedly is considering a $1-per-barrel price cut. British oil prices, now more closely linked to movements in spot oil prices, were reduced by $1.25 per barrel.

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[1] OPEC members are Saudi Arabia, Iran, Kuwait, Iraq, Venezuela, Qatar, Libya, Indonesia, the United Arab Emirates, Algeria, Nigeria, Ecuador, and Gabon.

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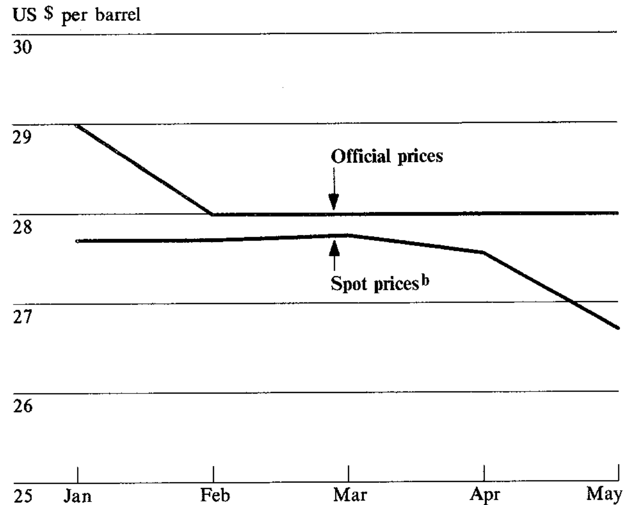
Figure 1
Spot Versus Official Prices for Arab Light[a] Crude Oil, 1985



[a] Formerly OPEC benchmark crude.
[b] Price at end of month.

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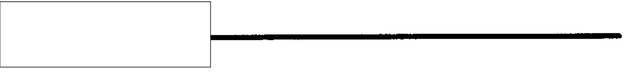

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Continued OPEC Overproduction

The market situation has been exacerbated by continued high levels of OPEC oil production. Through the first four months of 1985, OPEC's output was consistently above the 16 million b/d revised ceiling established last October (table). In recent months, 12 of the 13 members have produced at or above their individual quotas, with Nigeria at times exceeding its allocation by more than 300,000 b/d, according to US Embassy reporting

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Saudi cutbacks in April were quickly offset by increased Iranian production as Tehran pushed to increase oil sales. In May OPEC output finally fell

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OPEC: Crude Oil Production *Million b/d*

	Oct 1984 Quota	1985			
		First Qtr	Mar	Apr	May
Total	**16.00**	**16.5**	**17.0**	**16.7**	**15.3**
Algeria	0.66	0.7	0.7	0.7	0.7
Ecuador	0.18	0.3	0.3	0.3	0.3
Gabon	0.14	0.2	0.2	0.2	0.2
Indonesia	1.19	1.3	1.2	1.3	1.2
Iran	2.30	2.2	2.5	2.7	2.6
Iraq	1.20	1.2	1.3	1.3	1.3
Kuwait	0.90	1.2	1.1	1.0	1.0
(Less share of Neutral Zone)	[a]	(0.9)	(0.9)	(0.8)	(0.8)
Libya	0.99	1.0	1.0	1.0	1.0
Nigeria	1.30	1.6	1.7	1.6	1.5
Qatar	0.28	0.3	0.3	0.3	0.3
Saudi Arabia	4.35	3.9	4.0	3.6	2.7
(Less share of Neutral Zone)	[a]	(3.6)	(3.8)	(3.4)	(2.5)
UAE	0.95	1.2	1.2	1.2	1.2
Venezuela	1.56	1.6	1.6	1.6	1.6

[a] Neutral Zone has no production quota; output is divided between Saudi Arabia and Kuwait and included in their country quotas.

Note: Due to rounding, columns may not add to totals shown.

below its ceiling, paced by an almost 1-million-b/d drop in Saudi oil production from April levels. The production decline was market induced, primarily because buyers delayed lifting crude in expectation that OPEC's prices will fall.

Iran Abandons Production Restraints

Until recently, Iran had been willing to restrain output to support high oil prices. The persistent weak oil market and Iraqi attacks on tankers, however, continue to play havoc with Iran's oil earnings. Monthly revenues from August 1984 through March 1985 averaged 30 percent less than during the previous year and a half. Economic retrenchment—the major result of declining oil revenues—led to growing public discontent. In April the Iranian Parliament reportedly ordered the national oil company to significantly boost oil sales. Iran's oil minister also authorized price discounts to market the oil, effectively abandoning Tehran's de facto support of OPEC's official price structure. 25X1

As part of its sales drive—and to reduce high insurance costs to its customers—Iran began to shuttle crude away from its vulnerable oil export facility at Jazireh-ye Khark to tankers anchored offshore at Jazireh-ye Sirri in the southern Persian Gulf for transshipment to customers' tankers (figure 2) 25X1 25X1 the shuttle operation began in early February. Initially besieged with technical and operational problems, Iran improved its efficiency, and by April oil exports through the shuttle operation surpassed direct exports from Khark. From a low production rate of 1.8 million b/d in January, Iran managed to increase output by about 500,000 b/d in February and another 200,000 b/d in both March and April, 25X1 25X1 25X1 we estimate that Iran's output reached an estimated 2.7 million b/d in April—its highest level in a year—before falling slightly in May. 25X1

Saudi Options Narrow

With Iran abandoning its position of production restraint and de facto partnership with the Saudis in supporting prices, Riyadh's options for coping with the weakening market are narrowing. Output in May, excluding Saudi Neutral Zone production, averaged an estimated 2.5 million b/d—down about 900,000 b/d from April levels—indicating that the Saudis for the moment are continuing their role as OPEC's swing producer. But a statement issued by King Fahd and delivered by Saudi Oil Minister Yamani at OPEC's Ministerial Executive Council meeting in Taif warned that Riyadh would stop supporting the current price if members continue to violate price and production guidelines. 25X1 25X1 25X1

Recent public statements by Yamani on the current low levels of Saudi output and the possibility of lowering prices of heavier crude oils appear designed

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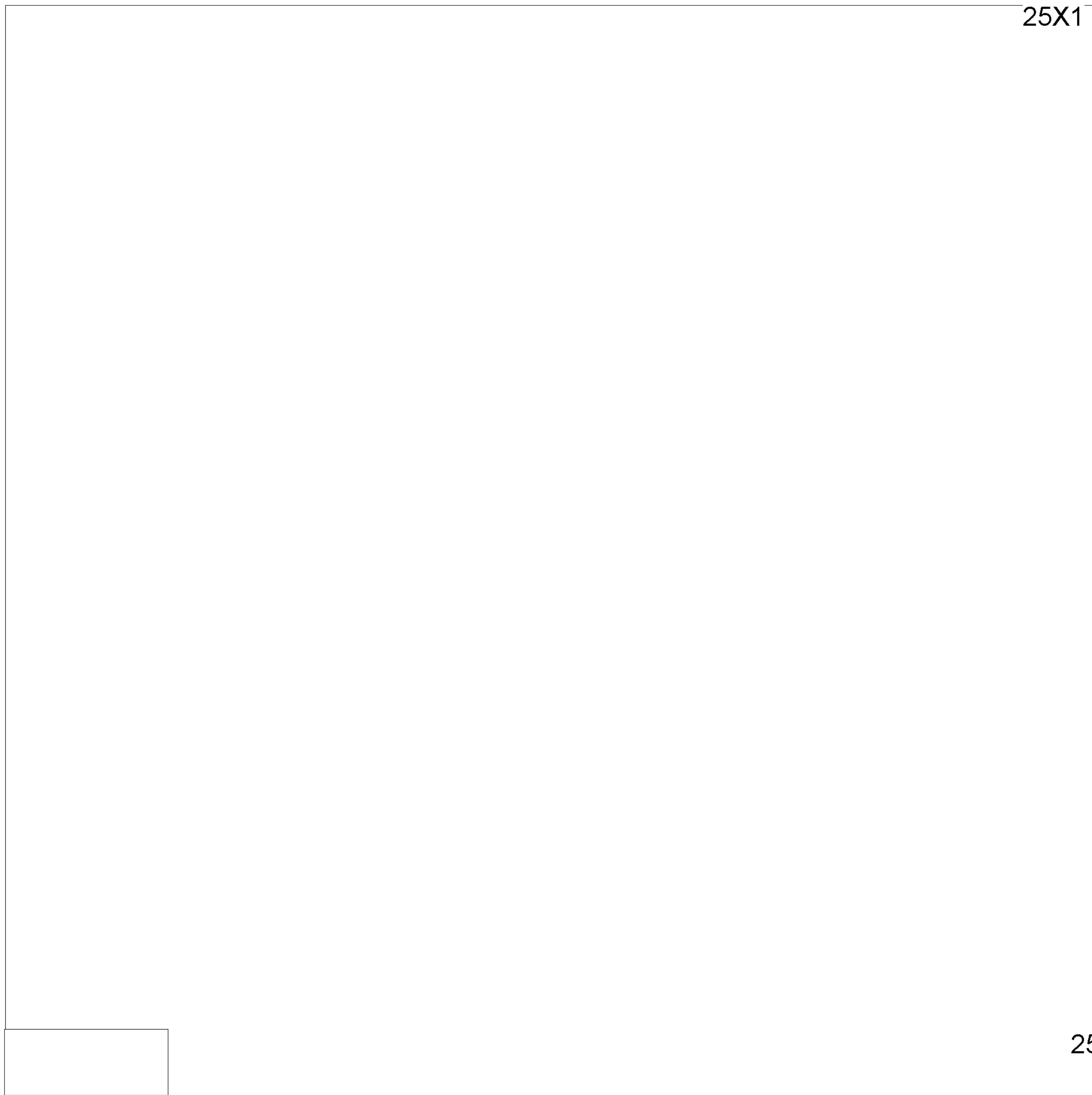

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to inform the market and OPEC's other ministers that Riyadh has begun to devote its full attention to the organization's upcoming semiannual ministerial meeting. Although Yamani did not quantify the potential price drop for heavy crudes, industry analysts suggest that a 50-cents-to-$1-per-barrel cut is possible. Riyadh realizes that, without production restraint by other OPEC members before the meeting, it is unlikely that continued Saudi output at the 2.5 million b/d level will be enough to narrow the widening gap between official and spot oil prices.

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Riyadh may believe that the only way to spur demand for its crude in the longer term is to cut oil prices now. Yamani's recent public statements about lowering heavy oil prices and Fahd's admonition against over-production could be designed to facilitate a price cut while shifting the blame for not holding the line to other producers. several months ago Yamani foresaw Saudi production falling to a low of about 2 million b/d by this summer (figure 3). as early as February, Yamani predicted a price cut of several dollars this spring. If the Saudis intend to maintain their price management role, they may advocate a $2-to-$3-per-barrel price cut that would bring OPEC's price structure more in line with spot market levels.

Technically, Riyadh still can maneuver and reduce output to the "zero-export" level, which we estimate is around 1.5 million b/d. This production level provides enough oil to meet domestic consumption needs, while gas requirements can be met from a combination of the associated gas from 1.5 million b/d of oil production, nonassociated gas, and some switching to liquid fuels. Removal of the additional 1 million b/d of supply from the market—coupled with firm agreement by OPEC's other members to keep production at current rates—probably would be enough to buoy prices. It would, however, deprive Riyadh of all oil revenue for at least several months—an outcome we believe the Saudis would find unacceptable. Nor can the Saudis expect relief from a step-up in demand. Most industry analysts now call for little, if any, increase in demand for OPEC oil until winter needs spur seasonal demand.

For several economic and political reasons, however, we believe that the Saudis are no longer in a position to reduce oil production much below current levels. Relatively liquid international financial assets held by Riyadh are currently $95 billion—down roughly a third from the peak recorded three years ago—and will make the Saudis extremely reluctant to reduce oil production. We believe that the Saudis do not want to finance a government deficit much larger than $10 billion because they do not want to make a further sharp reduction in their international assets. A further decline in oil revenues would add to Riyadh's deficit. If, for example, oil production during the current fiscal year averaged 2 million b/d and nominal prices remain unchanged, government revenues would total roughly $30 billion. This would leave Riyadh with a deficit of about $20 billion, if no additional spending cuts were implemented. Saudi officials have already made cutbacks that, for the first time, are targeted towards Saudis, and they will be wary of making additional steep cuts. One Saudi official has told US Embassy officers that domestic benefits can be reduced only with great care and that Riyadh is aware of problems in Morocco, Tunisia, and Sudan resulting from reductions in consumer subsidies.

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Political imperatives also constrain Riyadh's ability to further cut back production. Not only are the Saudis directly subsidizing the Iraqi war effort by selling a large portion of their share of Neutral Zone oil production to Iraq's customers and giving Baghdad the revenue, but by lowering production to hold up prices Riyadh also indirectly provides Tehran the market share needed for increased sales and financing necessary to continue the fight. In our view, the Saudis are unlikely to allow the situation to persist much longer, particularly if they see Iran displace them as OPEC's largest producer. Moreover, although fiscal austerity does not yet seriously threaten the stability of the Al Saud regime, a further downturn in the economy probably would erode the monarchy's popular support and could fuel antiregime sentiment.

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Sharing the Burden

OPEC's options to forestall a price break at this time are extremely limited, particularly because the Saudis apparently have decided not to shoulder the burden of supporting OPEC's prices alone. Should the Saudis receive firm assurance from OPEC's other members of strict compliance with production quotas, Riyadh probably would be willing once again to do its part as OPEC's swing producer. In our judgment, the Saudis still do not want to keep production much under 3.5 million b/d—excluding output from the Neutral Zone—for more than a few months to restore stability to the market.

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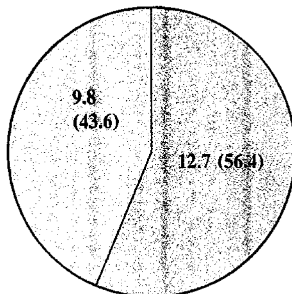
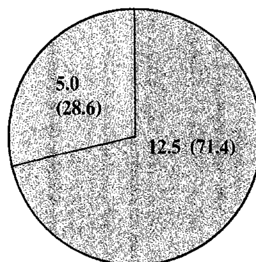
Figure 3
Saudi Arabia: Share of OPEC Crude Oil Production[a]

Million b/d (Percent) Other OPEC Saudi Arabia

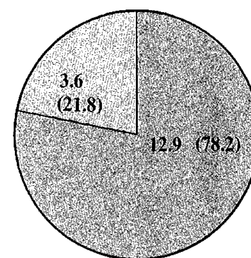
1981
Total OPEC: 22.5



1983
Total OPEC: 17.5



First Quarter 1985
Total OPEC: 16.5



[a] Excludes production from the Neutral Zone.

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Although this production level might be enough to hold prices near present levels if other OPEC producers cut back to the agreed quotas, there are several reasons why voluntary restraint from some of OPEC's other members is unlikely. Social, political, and economic pressures mounting in several member states are at the root of the problem as they work to encourage overproduction counter to Saudi Arabia's goal of stable output and prices. In particular, Nigeria, Indonesia, Venezuela, and Ecuador have stated the need to sell more oil to stave off social unrest. Iran and Iraq—locked into the fifth year of war—have vowed to maximize oil revenues to boost their faltering economies and to support the war effort. Nigeria, OPEC's most financially strapped member, has a large population and limited options outside of overproduction to reverse its declining economy. The Saudis probably are hoping that further progress by an independent auditor in monitoring production will lead to greater discipline and eliminate the need for Riyadh to adjust output lower than 3.5 million b/d. Any effort by the Saudis to ensure this level of output, however, could be quickly thwarted from within OPEC. Indeed, Ecuador, Nigeria, and Iraq probably will demand increases in individual quotas when OPEC meets early next month, according to US Embassy reporting, further aggravating the difficulty of getting Saudi output above its present depressed level without precipitating a price break. 25X1

The Coming Battle Within OPEC

With less willingness on its part to prop up the market by further decreasing output, we believe that Saudi Arabia appears ready to mobilize OPEC for a new round of talks on production restraint, lower output quotas, and smaller price differentials. The US Embassy in Riyadh reports that OPEC may reduce its output ceiling to 15.5 million b/d; 25X1 Saudi 25X1 Arabia would like a production quota of 3.5 million b/d, according to the US Embassy. Reaching agreement on a lower output ceiling would be difficult to

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achieve because it would require major sacrifices by OPEC to prorate quota cuts and, at the same time, allow the Saudis to produce at their preferred level. Nonetheless, OPEC consensus and compliance with any agreement will be critical if a price decline is to be avoided this year. The gap between spot and official prices is growing, and it now looks like prompt action to lower production is OPEC's best bet to hold the current pricing structure intact.

We believe that Riyadh also is well aware of the need to act quickly. At the same time the Saudis know the difficulty of soliciting support from all of OPEC's members. The recent Taif conference provided a forum for discussing OPEC's current problems and, more important for the Saudis, allowed members to review the latest auditor's report on exports and production levels that should lend credibility to Yamani's claim that Saudi Arabia alone has made sacrifices to hold prices. The conference also provided the ministers with a barometer of how to judge the Saudis' view of the current market situation and what actions Riyadh feels OPEC should take.

According to US Embassy reporting, Riyadh has decided that it is time for OPEC members to be held accountable for their collective decisions. Yamani understands that all members face revenue problems that are increasingly intractable and that few are willing to rein in production. He has, nonetheless, warned of retaliation against OPEC members who continue to violate the organization's guidelines, using the threat of a unilateral price cut and production increase. Yamani has used this tactic successfully in the past to get members to cooperate at the bargaining table.

We believe that the Saudis are hesitant to take any unilateral measures that could lead to a disintegration of OPEC and would probably do so only if declining revenues reach a point where the regime's domestic political support or revenue base is seriously threatened. Although financial pressures are now far short of this level, should Saudi oil production fall below current levels for more than a few months, mounting budget deficits could lead to more serious problems after a year or so.

A delegate to the Taif conference claims that the ministers took King Fahd's warning to act collectively in upholding prices very seriously. Should Riyadh have to make good on its threat, the action could initiate a series of price cuts and possibly a sharp decline in oil prices before OPEC can devise new prices and production guidelines to protect its interests. In the absence of producer restraint, a much sharper price drop could ensue. Yamani recently confided that if a price break comes at this time, it could be as large as $10 per barrel, according to the US Embassy in Riyadh.

Outlook

... ***For the Oil Market.*** With little or no prospect for a near-term increase in demand for OPEC oil, downward pressure on prices is unlikely to abate. Low consumption and rising non-OPEC supplies will continue to put downward pressure on prices. As OPEC publicly struggles to deal with overproduction, expectations of additional official price cuts this year will persist and could further decrease demand for OPEC oil in the near term. Demand for OPEC oil is likely to remain at or below the organization's production ceiling in the coming months and, unless OPEC acts collectively and reduces output, a further erosion in prices is likely this year.

... ***For Saudi Arabia.*** Oil revenue in 1985 will not reach last year's level, under any reasonable price and production scenario. The February 1985 price cut cost the Saudis about 35 to 40 cents per barrel in revenue, and export volumes are unlikely to reach the level of 3.7-3.8 million b/d achieved in 1984. Additional price cuts without a boost in exports would worsen the revenue situation. Moreover, a unilateral price cut is unlikely to yield Riyadh any significant gain in market share, and the resulting drop in world oil prices probably would not stimulate demand enough to compensate for the lost revenue per barrel.

Saudi willingness to sacrifice production in the past enhanced Riyadh's power in OPEC and put the

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Saudis in a good position to impose their will on OPEC's other members. Nevertheless, Saudi leverage is weakening. We believe that the Saudis will continue to be the dominant force in OPEC, but their leadership role may well be challenged this year by Iran, particularly if Tehran's oil output begins to exceed Saudi Arabia's for a sustained period. Collapsing oil prices or sharply reduced oil revenues would aggravate economic, social, and political tensions in the kingdom and, over time, could threaten the stability of the Al Saud regime.

... ***For OPEC.*** If the organization can discipline itself and can cut production to reverse the decline in prices this spring, it will once again prove that OPEC's power stems from its ability to protect the organization's interests in a weak market. This would indicate that OPEC has learned from past crises and that the organization probably is still able to close ranks to avert a major price break. If, on the other hand, OPEC is unable to effectively grapple with its latest crisis and if its pricing structure severely weakens, OPEC will lose much of its credibility. Under these circumstances, if Saudi Arabia lowers prices unilaterally, both OPEC and non-OPEC producers would quickly follow suit. Unless OPEC members were able to devise new production and pricing guidelines, the often predicted demise of the organization would be likely to ensue.

Implications

... ***For Third World Debtors.*** A price decline would create financial problems for oil producing nations that are major debtors. Even a small price drop could reignite financial problems for Nigeria and Egypt because both heavily depend on oil export earnings. At the same time, a number of LDC debtors—notably Brazil, the Philippines, and South Korea—would save significantly on their oil import bills. The implications of a precipitate price drop—to perhaps $20 per barrel—would become serious for oil-producing nations like Mexico, Venezuela, and Indonesia that stand to lose billions in foreign exchange annually. Moreover, collapsing oil prices have the potential to undermine the political stability of several pro-Western governments in the Third World—oil-producing states and recipients of OPEC aid.

... ***For the United States and Other Industrialized Countries.*** The prospect of lower world oil prices will continue to be good news for the US economy, although a further strengthening of the dollar could lessen the beneficial impact of lower prices on other developed economies.[2] Whereas low oil prices keep inflation under control and give impetus to economic expansion, a price collapse would strain moderate regimes and threaten US strategic interests in several regions.

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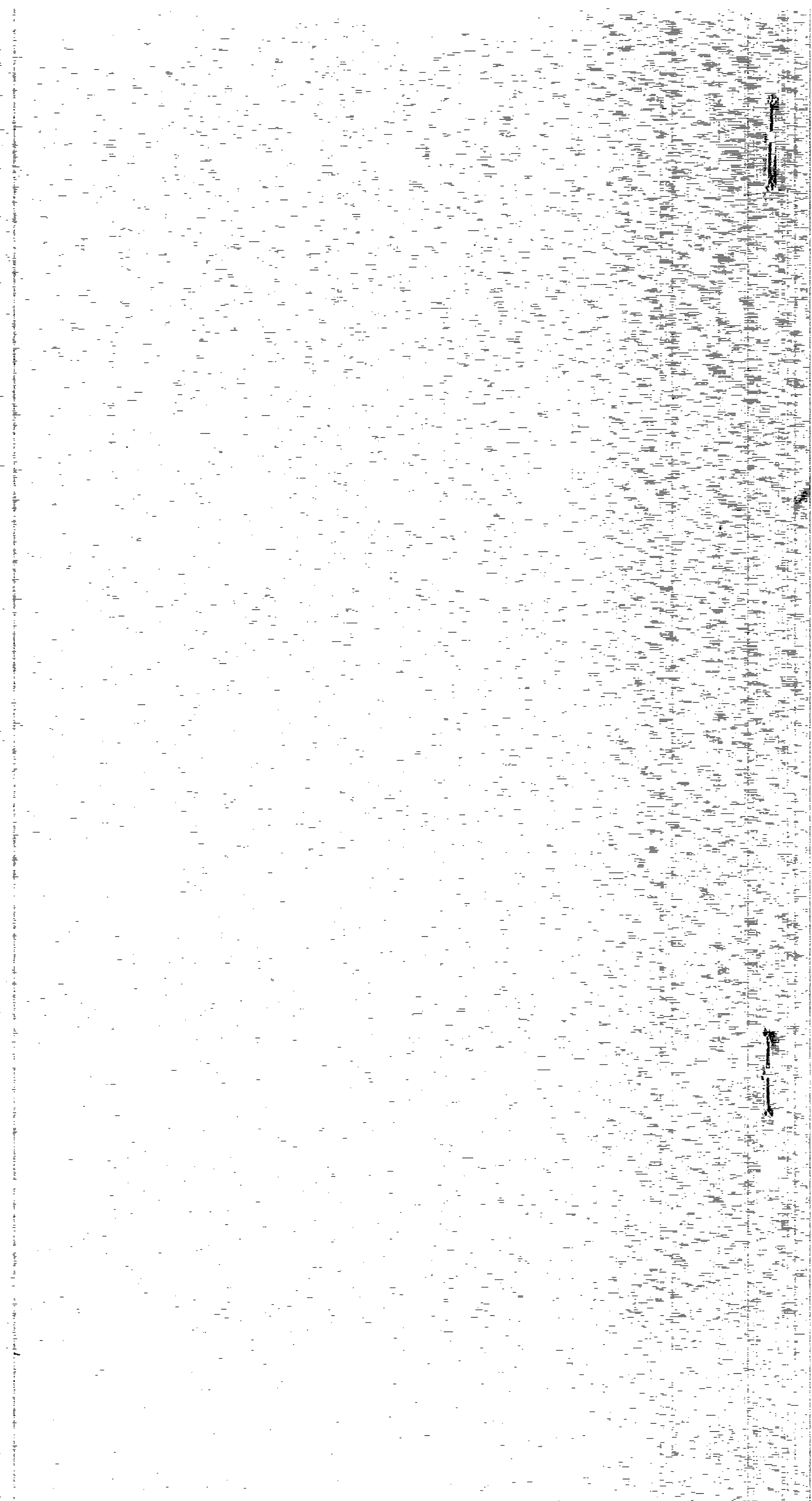

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