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Viewpoint

Politics—not OPEC interventions—explain oil's extraordinary price history ☆

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ABSTRACT

Oil prices in 2008–10, measured in constant money, were almost eight times the level of 1970–72. The prices of minerals and metals, another exhaustible resource group, increased by a mere 45% in the same period. The paper contends that the actions of OPEC, primarily production quotas, cannot account for this stark difference in price performance. Neither can the evolution of oil prices be rationalized by cost developments, for costs have remained far below the prices. The price evolution is better explained by capacity constraints caused by the inefficiency of state owned enterprises that dominate the oil industry since the 1970s, and that, additionally, have been deprived by their owners of financial resources to invest in capacity maintenance and growth. A capacity-destroying "resource curse" afflicting many oil producing nations, has been a further factor driving prices upwards.

1. Introduction

Oil price developments over the past 40 years have been truly spectacular. Fig. 1 compares oil prices in constant money with an index of metal and mineral prices, a group of materials which, like oil, are exhaustible. A detailed inspection of the numbers behind the graph reveals that oil prices in the most recent 3-year period (2008–10), averaging $79 per barrel, were almost eight times higher, in constant money, than the average of 1970–72. Metal and mineral quotations had risen by a mere 45% between the two periods. The graph reveals huge fluctuations in oil prices, caused by one-time events like the Arab–Israeli war of 1973–74, the Iranian revolution in 1978–79, and the global financial crisis of 2008. But ever since the first oil crisis of 1974, the price levels have remained far above those of 1970–72, an experience hugely different from that recorded by metals. The purpose of the present paper is to seek the causes to the long-run price performance in oil and to account for oil's contrasting experience with the metals group.

2. The oil cartel and its behavior

A widespread popular opinion, shared by a majority of market specialists, holds that OPEC's market interventions since the early 1970s have made all the difference in price performance between oil and other commodity groups. While there is no denial that OPEC policies, predominantly production quotas, have had some impact on oil prices in the shorter run, skepticism must be expressed about the sufficiency of the cartel's supply manipulations for explaining the huge difference in the development of the two price series contained in Fig. 1.

A number of careful analytical studies on OPEC has expressed serious doubts about the efficacy of the group's market management. Some even contend that referring to it as a cartel is a misnomer. Thirty years ago, MacAvoy (1982) argued that the observed trend of oil prices can be adequately explained by a competitive model. Somewhat later, Griffin (1985) tested the validity of alternative market models, and concluded, with several caveats, that a partial market sharing cartel model provides the best fit to the actual behavior of OPEC members. Alhajji and Huettner (2000) went even further, and contended that statistical tests fail to support a cartel model of OPEC behavior. Furthermore, their comparison of market characteristics for oil with those for diamonds, coffee, bauxite, tin and rubber, in which temporary price raising cartels occurred, points to the weak preconditions for establishing and running an oil cartel. For instance, they found that OPEC's share of global supply, a fundamental factor for successful market management, varied between a minimum of 31% and a maximum of 56% over the period of their study, compared to 73% and 81% for bauxite and even higher for the other products, while the price elasticity of oil demand was not exceptionally low. And yet, oil prices rose much more and OPEC persevered for far longer than in the products with cartel histories under their review. Alhajji and Huettner's surprise at this outcome is matched by Griffin's observation that economists typically view cartels as fragile entities with limited power to raise price appreciably and, if successful for a time, the cartels are unable to sustain the higher prices. Why, then, is his unanswered question, given the

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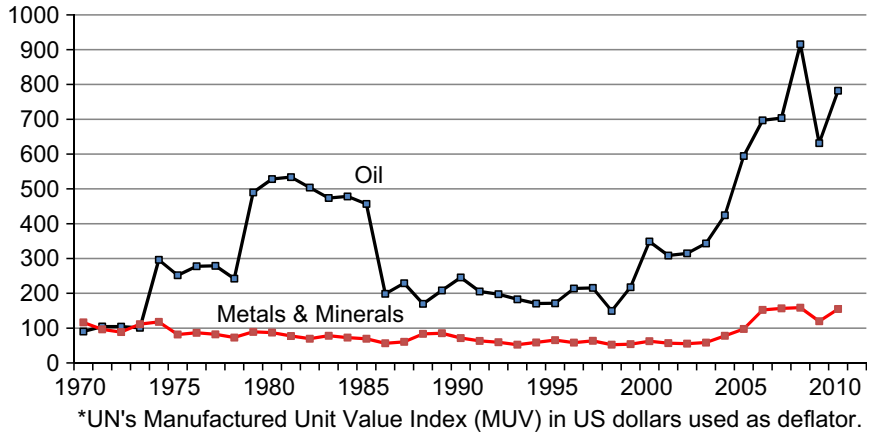

Fig. 1. Price indices in constant money*, 1970–72=100. *UN's Manufactured Unit Value Index (MUV) in US dollars used as deflator.
Sources: UNCTAD and UNSTAT on the internet.

oil group's weak cartel characteristics (Griffin, 1989), have (Milton) Friedman's predictions about OPEC's early demise proven so wide off the mark?

More recently, Smith (2005) has asserted that the 'evidence' of OPEC behaving as a price raising cartel is inconclusive. The current availability and quality of data on demand and costs in the world oil market is inadequate for distinguishing competitive from collusive behavior. OPEC has indeed operated a formal production quota system since 1982, but given widespread cheating, the price impact of quotas is unclear and cannot be overly strong. In fact, data over the past decades (IEA, monthly) reveal that except Saudi Arabia, Kuwait and UAE, virtually full technical capacity utilization has been the rule among OPEC members. Formal constraints on capacity expansion have never been applied by the cartel.

The above analyses paint OPEC as a producer group able to extract prices somewhat above the competitive level for limited periods of time. However, this characterization is completely inadequate for explaining the spectacular achievements reflected in Fig. 1, if the difference between oil prices and the prices of metals is taken as an indicator of OPEC's market power. Also, the characterization runs counter to the perseverance of exceptional oil price levels over a period of almost 40 years, compared to an average longevity of 7.3 years in 54 commodity cartel cases studied by Griffin (1989). It is clear that perspectives other than efforts by colluding producers to manage supply are needed to satisfactorily explain the evolution of oil prices since the early 1970s. The sections which follow, attempt to provide such alternative vistas.

3. Rising cost of supply

It could be that costs have increased and reached levels that explain and justify the oil price developments, but then the differing performance of both prices and costs between metals and oil remains a mystery. Costs are hard to document and information from oil producers, the most common source, is often exaggerated, in efforts to ameliorate the industry's fiscal burden and as an excuse for the prices charged. When inspecting costs, one must be careful about what is included, since cost data are presented in many different formats. The costs of the marginal project, instrumental for price determination, are seldom available.

The price and cost data in this paragraph relate to the 2000s decade, and they are all expressed in 2010 dollars per barrel, using UN's MUV (US$) index as deflator. The numbers are purported to reflect *total* cost of supply, including capital costs, normal capital return and standard taxes, but they do not comprise special fiscal dues nor transport costs. Investigations by the IEA (2001), when the price of oil was $31 assess the costs of major Middle East producers at around $5.1, those of the international majors in a range between $7.7 and $14, and of Canada's unconventional resources at $6.4–20.4. An ambitious dissertation from 2006 (when oil prices hovered around $70) summarized in the *Energy Journal* (Aguillera et al., 2009) sets the cost of some 90% of world conventional oil resources at up to $16.5, the cost level of Canada's oil sands (Iraqi and Saudi costs are given in a range of $1.2–$3). With 2008 oil prices at $93, the Canadian Energy Board (2008) assessed the cost of oil sands between $29 and $33, but the IEA (2008) put the range at $32–62, and the cost of ultra-deep water reserves like Brazil's sub-salts, at below $60.

Two observations on these cost findings are warranted. *First*, it would appear that prices drive costs in considerable measure. Elevated prices relax cost control and encourage the mobilization of high cost units. The obverse is true when prices are low. After an extended period of exceptionally high prices, IEA (2011) notes that "Over the past ten years, worldwide costs of developing production capacity have doubled, largely due to increases in the cost of materials, personnel, equipment and services." In contrast, after the price excesses of 1980–85, the much lower prices of the 1990s led to impressive cost declines. According to IEA (2001), "Worldwide finding and development costs… declined from an average of $21 in 1979–81 to under $6 in 1997–9", while worldwide lifting costs fell by over half, to $3.9 in the same period (money of the day). Current costs likely represent a cyclical peak, and cost adjustments similar to those of the 1990s could well occur if and when the exceptional oil prices of 2006–10 moderate. Superimposed on the cost waves caused by prices, is a cost increasing tendency as the industry moves to higher cost resources, and a cost reducing tendency of technological progress. A persevering increase in costs, signifying economic depletion, has not been vindicated. *Second*, all the cost figures, including those for exploiting expensive unconventional resources, work out far below the simultaneous oil prices. Cost developments provide only limited support to the evolution of prices.

4. State ownership and government greed

In the 1970s, widespread nationalizations swept across the minerals and oil industries. Though the phenomenon was worldwide, much of it was a post-colonial reaction focused on the Third World. State enterprises emerged as a dominant phenomenon in consequence. In world copper mining, state ownership attained 51%