OPEC Tri-Ministerial Conference: Focus on Strategy [redacted]

The oil, foreign, and finance ministers from the OPEC nations are scheduled to meet in Vienna on 15 and 16 September to review the wide-ranging oil, aid, and political recommendations of the OPEC Long-Term Strategy Committee (LTSC). Although broad agreement already has been reached on many issues, including the establishment of an automatic price adjustment mechanism, a discordant note may be injected into the proceedings by disputes over short-term price and production policies. Some OPEC officials expect that the meeting will turn into a confrontation between Saudi Arabia and the more militant OPEC nations, particularly Iran. Iran, Libya, Algeria, and Nigeria have scheduled a meeting just prior to the Tri-Ministerial Conference to coordinate their production and price positions. Confrontations over current policies could spill over into the discussions of the LTSC report, possibly even preventing agreement on aspects of the long-term pricing adjustment formula. [redacted]

Any unresolved issues among the LTSC recommendations will be dealt with by the committee over the next several months. Questions of implementation are unlikely to be settled quickly. A final review of the report is planned for a second Tri-Ministerial Conference scheduled for early November. The entire report will then be submitted to the summit meeting of sovereigns and heads of state of OPEC member countries in Baghdad on 4 and 5 November. [redacted]

Current Price and Production Issues

Contrary to press reports, Saudi Arabia has not yet decided to cut production from the current level of 9.5 million b/d. [redacted]

The Saudis recognize that maintaining production at 9.5 million b/d contributes to market pressures on other OPEC suppliers. On the other hand, the current market could absorb a 1 million b/d Saudi production cut without generating significant price pressures. Riyadh will have to raise prices by $4 per barrel if it is to realign its oil prices with those of other OPEC members. While the timing of Saudi actions remains uncertain, we believe Riyadh intends to use a production cut as an inducement to gain agreement on a reunified crude price structure sometime during the course of the series of OPEC meetings beginning in mid-September. [redacted]

Background on LTSC

The OPEC Long-Term Strategy Committee was established during the May 1978 OPEC consultative meeting in Taif, Saudi Arabia. It is a ministerial-level committee composed of the oil ministers from the five founding members of OPEC—Saudi Arabia, Iran, Iraq, Kuwait, and Venezuela—and Algeria, representing the African OPEC members. The committee was established at the urging of Yamani, who maintained that OPEC ministerial conferences spend an inordinate amount of time discussing current price issues and not enough time considering long-run issues. [redacted]

LTSC Recommendations

After working for two years on its report, the LTSC presented its recommendations at an extraordinary ministerial conference in Taif in early May 1980. [redacted]

Price. The committee's main recommendation was for the adoption of an automatic quarterly price adjustment mechanism. The system would establish a floor price for crude oil that, in the long term, would approach the approximate level of the cost of alternative fuels. To guarantee movement toward this goal, the price floor would be adjusted upward in line with a three-point formula incorporating:

- An index reflecting the impact of inflation on international trade. The index would be based on an OECD export price index to reflect commodity inflation and an OECD domestic consumer price index (CPI) to reflect inflation in the price of services. The export price index would have twice the weight of the CPI.
- An exchange rate adjustment mechanism. The currency basket being considered is the original 11 currency Geneva II basket [1] modified to include the US dollar and weighted according to OPEC imports from the countries whose currencies are included.
- A provision for increasing the floor price in real terms proportionately to the growth in real GNP of the OECD countries. [redacted]

The concept of automatic price increases was accepted by all of the OPEC members at the Taif conference. Iran, Libya, and Algeria, however, voiced reservations over the formula and insisted that price increases be based instead on:

- An index representing OPEC inflation rather than OECD inflation.
- GNP growth in the OPEC countries rather than the OECD countries.

[1] Australian dollar, Belgian franc, British pound sterling, Canadian dollar, French franc, Italian lira, Japanese yen, Netherlands guilder, Swedish krona, Swiss franc, and West German deutsche mark. [redacted]

The majority of OPEC members rejected this approach, reportedly on the grounds that OPEC inflation—historically higher than the OECD rate—often includes factors for which the consuming nations cannot be held responsible and that use of OPEC GNP growth could lead to a spiral of oil price rises generating GNP growth which in turn would push up oil prices. [redacted]

Although several compromises on price formulas were suggested at the Taif meeting, no agreement was reached and modifications were left to be developed by the LTSC. Over the last month or so, several reports have indicated that most of the differences among OPEC members were resolved. We have not been able to verify if or how the original formula may have been modified. [redacted]

The LTSC report stresses that the pricing formula only establishes a ***minimum*** floor price, and that as the market swings from surplus to shortage OPEC's pricing strategy must be flexible enough to allow prices to rise above the minimum. The LTSC presented alternative courses of action to be considered when prices rise above this level:

- Prices may be frozen in real terms until the floor catches up with the higher market determined price level.
- A new price floor could be established at the higher level.

Prevailing market conditions and the political climate would play a large part in determining which alternative is chosen. If OPEC were to be unable to reach agreement on which path to follow, the effectiveness of the price mechanism would be impaired. [redacted]

Although many details remain to be worked out, it seems clear that the Tri-Ministerial Conference will recommend to the OPEC Baghdad summit that an automatic quarterly price adjustment mechanism be adopted. Strong Saudi support for regular price increases is evidenced by a public statement made earlier this year by Yamani.

As a result of the freeze imposed by Saudi Arabia, oil prices have more than doubled since the end of 1978. If the Western countries had been realistic and had accepted regular annual increases in the price of oil, there w[illegible] [illegible]t have been such a sharp and sudden incre[illegible] in prices, with the ensuing impact on their economies. I wish we had not frozen the price of [illegible] in the past.

Riyadh undoubtedly also recognizes that an automatic price adjustment mechanism would free them from some of the political pressures that they face on the price issue. [redacted]

If the proposed price adjustment mechanism had been in effect since 1973, the OPEC staff calculates that prices would have risen an average of more than 14 percent per year. By 1978—prior to the Iranian revolution—prices would have risen to $17.82 per barrel, compared with the actual average official sales price of $12.93. The formula would have called for a 1980 price level of $24.26 per barrel, but prices would have risen above this level because of the oil market disruptions associated with the Iranian revolution. [redacted]

Although we believe that the [illegible] proposals currently under discussion have a better chance of being realized than similar ones in the past—the LTSC under the direction of Yamani already has been charged with developing a plan of action—OPEC agreement in principle may not translate into speedy implementation. Many operational details need to be resolved before any of the committee's recommendations can be put into operation. For example, while the OPEC price structure over the last several years has been based on the price for a benchmark crude, Saudi Arab Light (34°), the LTSC report recommends that Arab Light be dropped as the benchmark on the questionable grounds that it is no longer the "swing crude" in the world market place, that is, that there is no longer sufficient excess capacity to produce Arab Light to cover short-term swings in demand. The LTSC also cited changing supply/demand patterns—with demand tending toward lighter prod[illegible]ts while supply is becoming increasingly heavier—as justification for abandoning Arab Light as the marker crude. Riyadh undoubtedly would also prefer to distance its price decisions from those of OPEC by getting agreement on an alternate benchmark crude. [redacted]

OPEC is considering several other options for a marker crude or crudes:
- Use of more than one benchmark—one for the Persian Gulf and one for the African region.
- A theoretical benchmark more representative of demand patterns.
- A theoretical benchmark reflecting the weighted average OPEC export barrel. [redacted]

The problem of determining price differentials[2] among the various OPEC crudes will continue to exist. OPEC has never been able to adequat[illegible]ly deal with this problem and the LTSC report sidesteps the issue by stating that, with a continuously moving price base, the problems should be less than experienced in the past. Other operational problems being worked on by OPEC include the periodicity and time lag in each of the components of the floor price and the associated question of changing price on the basis of projections or *ex post facto* adjustments. [redacted]

Production. The LTSC report recommends that during periods of surplus supply "appropriate measures must be taken by all member countries to restrict production." The report, however, does not advocate a formal production programing scheme. Iraq has long been the leading advocate of production programing. More recently, Iran has become vocal in its demands for the institution of some OPEC-wide mechanism to prorate production cuts. [redacted]

Saudi Arabia is adamantly opposed to any formal scheme for production programing, maintaining that each country should control its own production

[2] Differentials are the margins by which prices of various crudes differ from the price of the OPEC benchmark crude. Crude prices vary widely because of differences in crude quality and proximity to major markets. [redacted]

as a matter of national sovereignty. The Saudis, however, have made clear to their fellow OPEC members that after the current price structure is reunified, they will be more than willing to absorb their share of any necessary decline in output. Given the strength of Saudi opposition to programing, we believe it highly unlikely that a formal prorationing agreement would be included in the recommendations passed on to the Baghdad summit meeting. [redacted]

The LTSC report recommends that underutilized productive capacity be brought on line to hold prices down during periods of shortage. It also suggests compensatory financing be made available to revenue-short OPEC members during periods of falling demand. [redacted]

Relations With Developing Countries

The LTSC recommendations on future relations between OPEC and other developing countries were approved by all members attending the May 1980 Taif meeting. The OPEC finance ministers can be expected to pay particular attention to the specifics for implementing these proposals. According to the report, OPEC assistance to developing countries should include:

- Assurances about security of oil supplies, with the developing nations having priority over supplies to industrialized countries.
- A series of loans and grants to help developing countries meet the cost of their oil imports. Loans to the poorest LDCs would be on concessional terms graduated according to degree of need, whereas loans to developing nations with stronger economies would be on commercial terms.
- Development aid, including aid for development of their indigenous energy resources.
- Balance-of-payments aid. [redacted]

The report also recommends that OPEC "aid to developing countries not be given unilaterally without a commensurate commitment from the industrialized countries." It points to the Iraqi proposal for a joint fund for energy and development as an ideal vehicle for achieving these objectives. Aid from developed nations would be expected to increase in real terms to offset import inflation. [redacted]

Relations With Industrialized Countries

The LTSC report recommends that since recent developments in pricing and long-term supply seem to make some form of dialogue between OPEC and the industrialized countries inevitable, OPEC countries should be prepared to participate as a bloc. Most OPEC members see this as a way to prevent the developed countries from isolating the members from one another. [redacted]

In negotiations with the developed countries, the report suggests OPEC seek:

- Free access to the markets of developed countries for refined products and petrochemicals.
- Access to advanced technology needed by OPEC countries for development.
- Increased involvement of industrialized countries in exploration activities in OPEC countries.
- Participation in joint research activities.
- Location of energy-intensive industries in natural gas producing areas within OPEC countries.
- Removal of economic sanctions against OPEC countries and the lifting of trade barriers on non-oil-producing countries.
- Guaranteed access to financial and investment markets in industrialized countries for OPEC funds on "at least parity of terms and conditions" with those applied among industrialized countries. [redacted]

The report also recommends that because of the poor experience with previous producer-consumer meetings—specifically the Conference on International Economic Cooperation during 1975-77—participation should be limited to OPEC and OECD members. OPEC undoubtedly hopes that by excluding other developing countries from these meetings it will be able to limit criticism from these nations. The Tri-Ministerial Conference will consider how to proceed on these issues. [redacted]