



SPECIAL REPORT

Toward a global oil pricing and production pact

By Michael G Renner

"Consuming countries would be well advised to utilize this time of relaxed supplies to adopt policies for a long term stabilization of the global energy market."

Michael G Renner looks at ways of influencing the pricing and marketing of oil in moving toward "a more rational equitable energy future".

The dramatic collapse of oil prices that began some 20 months ago has highlighted the instability of the current world oil market and underscored — even for consumers who supposedly are the beneficiaries of this development — the need for a comprehensive approach to deal with the crisis. The prevailing Western assumption is that the net effect of the oil price slump is positive; that is, that the benefits will outweigh the social, economic, and political costs. It is further assumed that these costs, such as the aggravated debt crisis of oil exporting nations like Mexico, can be managed.

Yet these assumptions are questionable. Firstly, the benefits are probably overstated and may be more than offset by the losses. Secondly, in as far as gains are realized, it is unclear how lasting they will be. Plummeting oil prices have thrown oil exporters' into considerable disarray. The price slump has hit many countries especially hard because it came on the heels of an unprecedented boom characterized by unbalanced and often deceptive economic growth. The economic downturn in those countries is spreading to "labor-exporting" countries like Egypt and Pakistan as millions of migrant workers are laid off and the flow of remittances is sharply curtailed. In the Arab world, the non-oil countries also suffer from reduced economic aid by the exporters. The costs are neither limited to the Third World nor to the oil industry as such. Energy self-sufficiency in many countries around the globe will further be jeopardized as alternative sources of energy appear less viable. Energy and overall economic planning will be fraught with uncertainty. Reduced oil income shrinks the important export markets in oil producing countries (including the Soviet Union) that have given some impetus to the otherwise stagnant world trade of the 1970s. The current oil crisis reduces oil producers' ability to repay debts incurred during the boom years, and thus aggravates the debt crisis and puts addi-

tional strain on the world financial system.

The most dramatic liability, however, will arise in the long-run. Future oil production and reserve additions, particularly in high-cost areas, will be affected negatively as exploration expenditures are trimmed back considerably. The lower oil prices go now, the more likely a rapid rebound will occur later, especially as the case for conservation and increased energy-efficiency appears less compelling in a world "flush with surplus oil". Should the pendulum of power swing back in favor of the producers in a crisis-like manner, there may well be a revival of interventionist threats to safeguard Western access to oil supplies; nuclear power and other lifethreatening technologies may once more be presented as the only way to cope with a new "crisis".

Such a repeat of history can surely be avoided if more sensible policies are adopted. Because developing new sources of energy and implementing energy-saving technologies involve a considerable time-lag, consuming countries would be well advised to utilize this time of relaxed supplies to adopt policies for a long-term stabilization of the global energy market, e.g., to stabilize the price of oil, put a cap on consumption through conservation measures, and give priority to renewable sources of energy for long-term supplies.¹

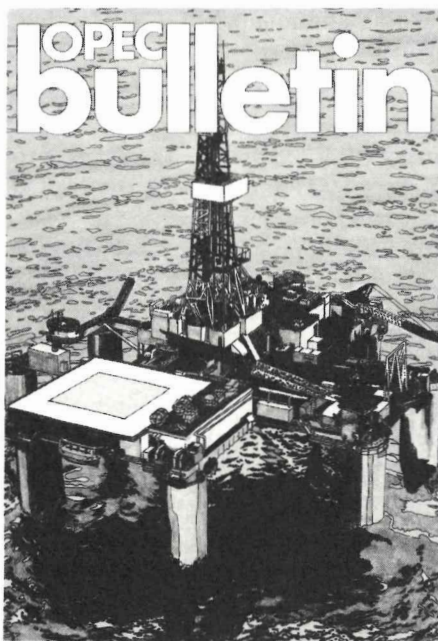
It is perhaps understandable that consumers would want to profit from low oil prices for as long as possible and not do anything that would contribute to raising price levels. Yet, a critical reading of the oil industry's recent history suggests that unilateral gains — whether by consumers or producers — are temporary at best, and counterproductive at worst in the sense that they tend to reinforce structural changes that will turn unilateral advantage into disadvantage. Today's turmoil is part of a larger boom and bust cycle that feeds on fundamental contradictions in the oil industry's structure and power bal-

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ance.³ Adjustment of structural imbalances has been and is delayed by both economic-technical factors (lead-times for developing new oil reservoirs or for higher prices to reduce demand) and political factors. Because of such delay, the eventual adjustment process has repeatedly been characterized by extreme suddenness and magnitude, essentially creating new imbalances and unleashing countervailing forces.

To illustrate, the postwar international oil regime was geared to providing oil at artificially low prices, causing a rapid rise of consumption and rendering higher-cost energy sources uncompetitive. The 1973 Arab—Israeli war provided merely the trigger event translating this untenable situation into skyrocketing prices. That price surge was instrumental in eventually reducing global oil consumption (by 15 per cent in the OECD since 1973) and permitting the development of more expensive non-OPEC oil and non-oil energy, eventually resulting in a huge oversupply of oil and finally last year's price collapse. Extremely low prices in turn could set in motion a reverse process whose effects again would be felt only years down the road. Because neither consumers nor producers can unilaterally impose their designs on the oil market, a joint approach to stabilizing the world oil market is both needed and desirable.

Surely, political realities in the industrial countries, particularly in the United States, seem to prevent any cooperation with the "extortionist cartel". So entrenched is the villainous image of OPEC that a multilateral, equitable solution to the crisis is hard to imagine. But OPEC can prepare the ground and demonstrate to consumers the long-term benefits of a cooperative approach. The organization's interim accord on quotas could be the political and psychological underpinning for establishing a global production and pricing agreement. As a first step, consuming nations could be offered a guaranteed volume of oil supplies for a



specified period at a fixed contract price. This offer could be made on a "take it or leave it" basis.⁴

Non-OPEC exporters willing to cooperate loosely with OPEC — Mexico, Egypt, Malaysia, Oman, Angola, China, the Soviet Union, and Norway — could be asked to participate more formally in a production-sharing scheme. Allocating production quotas to such an enlarged group of exporters is a most delicate task, particularly as many Third World producers have grown increasingly dependent on oil revenues to finance their government budgets and service their foreign debts. Since the hardest-pressed exporters will not cooperate with any such effort unless they see some benefit in it, quota allocations should at least initially be based on the size of population, financial need, and indebtedness. However, in order not to sanction debt as a long-term parameter for allocating production quotas, it should be primarily of temporary significance. In addition, historic production levels and patterns are undoubtedly parameters of significance; maximum production capacities and the size of oil reserves, however, should be regarded only as a secondary set of

indicators.

Any production quota agreement, even if quite elaborate and sophisticated, may be futile unless accompanied by measures to shield the weaker and more vulnerable producing nations from the adverse effects of having to forego some of their potential output and income. To alleviate financial pressures on the poorer oil exporters, an economic adjustment fund should be established either by the oil producers or jointly with the consumers. Collaborating countries could "subscribe" to the pricing and production pact by sharing the financial cost of such an adjustment fund. There is a precedent for such action: after the first oil price explosion, the industrialized countries established an IMF "oil facility" designed to borrow funds directly from the oil exporters in order to lend to oil importers suffering balance of payments problems. Without such a pooling of resources, the pressure on many oil exporting nations to pay for their imports and to service crushing foreign debts will force them to continue their unilateral policies, i.e., slashing prices in the hope of gaining market share.

Assigning new production quotas is not nearly enough. In fact, to put a pricing and production pact on a secure footing, the structural causes of instability need to be addressed, particularly the sprawling spot and futures markets. These markets, which currently dominate the global pricing mechanism for oil, cannot safeguard the future availability of oil supplies. Spot and futures deals are now in vogue because they permit traders and speculators to reap handsome profits and — in times of plentiful supplies — allow consumers purchasing flexibility. Yet the very fact that these markets thrive on volatile conditions shows that their reign is detrimental to long-term energy security.

To increase price stability, it is imperative that long-term direct supply contracts between producers and buyers

be established. There are indications that a reintegrated world oil market is slowly emerging. Among producer governments, Kuwait and Venezuela are establishing refining and marketing networks in the industrial countries, thus creating a nascent vertical integration analogous to the majors' earlier operations. Within such integrated structures, spot and futures markets will gradually lose much of their current appeal.

Surely, this process of vertical reintegration will take a long time to take shape. In the meantime, a flexible, comprehensive, and global production and pricing pact is desirable for both producers and consumers. In mutual consultation, interested producer and consumer countries could project future oil needs and availabilities for consecutive five-year periods. Alternative energy paths for consuming countries could be established, from which the participating countries would choose a mutually acceptable scenario.

This demand/supply scenario, could then form the basis for a pricing and production reference system subject to regular reviews and adjustments. Lower and upper demand/supply limits would be established, with producers pledging to supply up to the maximum volume agreed and consumers to purchase at least the minimum volume agreed. To strengthen such a pricing and production pact, cooperating producers and consumers might pledge to accord each other preferred country status in terms of oil sales and purchases, respectively. Individual quotas (again with upper and lower limits) would be assigned for both producers and consumers.

What should the price for oil be? Prices have moved from as low as 1.80 USD per barrel to as high as 40 USD without reaching an equilibrium. To secure a lasting consumer—producer cooperation, both groups must be convinced that moderate and stable prices are preferable to short-term unilateral gain through price fluctuations. To give them long-term sustainability, oil prices

should take into account the following elements:

- The global average cost of producing oil from existing fields, ranging from as low as 2—3 USD in the Middle East to some 15 USD and more in the United States and other high-cost areas.

- In addition, a flexible price element could serve as an incentive for future exploration and production in higher-cost areas; new North Sea oil, for example, will cost 20 USD per barrel and possibly more to develop. That price element could be made payable into a global fund for future resource development.

- Recognizing that exploitation of oil deposits depletes many oil exporting countries' sole or primary source of national wealth, an allowance for the depletion of oil resources — possibly indexed to the global reserves-to-production ratio — should be incorporated into the price of oil. A further compensatory element might index oil prices to world inflation.

- A flexible element that adjusts the price of oil to the price of alternative energy sources and recognizes the versatility (and thus attractiveness) of oil. For example, it costs 15—30 USD per barrel of oil equivalent to produce coal in Western Europe. Synthetic energy from coal has been estimated to cost between 35—65 USD. Alternative sources of energy, such as solar energy and biomass, which have received little serious attention are generally estimated to be even more costly. While it would be impractical to raise the price of oil to the cost of the currently most expensive alternative, a flexible price element could contribute to the timely development of renewable sources of energy. That price element could be made payable into a globally-administered fund for research and development of sustainable sources of energy.

The relative weight of these price elements in a price formula would vary according to their relevance to the energy market. Consumers and produ-

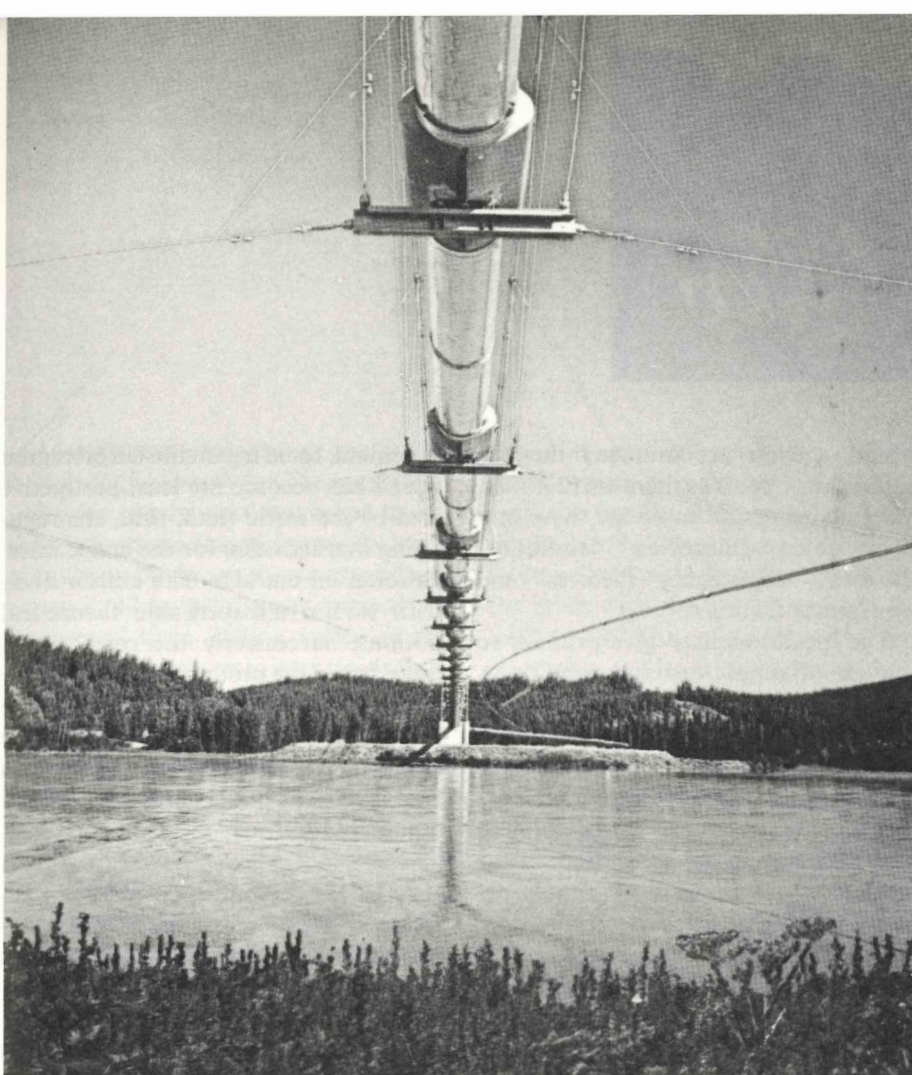
cers might agree to establish upper and lower price limits within which prices would be freely determined. If prices crossed certain thresholds (say, came within 5 per cent of either price limit), a bufferstock mechanism would come into play. Even so, periodic reviews of the price formula and production limits would probably be necessary to keep the system flexible enough.

As an incentive for increased conservation, it may be envisioned that oil demand beyond a jointly agreed level would be met only at a progressively increasing price. Such a price escalator should be used for retail purposes within the consuming countries as well. This is based on the realization that basic energy needs are virtually independent of price, whereas more luxury forms of consumption could be restrained by price escalation.

Furthermore, a two-tier international oil price could be established whereby poorer importing nations would be charged a lower price than wealthier countries. Mexico and Venezuela have set a modest precedent through the so-called San Jose Accord, an oil-loan venture that supplies oil to ten Latin American countries at 80 per cent of the international market price.⁵

Finally, to dampen the impact of currency fluctuations on both consumers' oil import bills and exporters' purchasing power, the US dollar should be gradually phased out as the currency in which world oil prices are expressed. That function could better be fulfilled by international currency units (such as Special Drawing Rights) or by weighted, regional baskets of importing and exporting nations' currencies.⁶ Such a measure would particularly relieve Third World countries of the need to expend foreign exchange on oil imports and eliminate national (i.e., US) currency policies as a major disturbance factor in international oil pricing.

A bufferstock could help safeguard agreed-to price and production levels



“Flexible price element could serve as an incentive for future exploration and production in higher-cost areas.” Photo from Alaska’s pipeline crossing the Tanana River at mile 288.

and balance out short-term fluctuations. To limit the financing costs of such a stock, it may be desirable to keep at least part of its reserves in the ground rather than in storage. A producing country would “subscribe” to the production and pricing pact by pledging a share of its annual production quota to the bufferstock. A to be determined percentage of the pledged volume would actually be pumped and stored by an international bufferstock authority. The remainder would be left in the ground at the bufferstock authority’s disposition, to be made available whenever the latter determined a need to do so. Consumers for their part would subscribe by sharing the storage costs and acquisition costs for additional oil volumes according to their assigned consumption quota.

In times of oversupply, the bufferstock would get title to the oil that a producing country is unable to sell; i.e., the difference between the actual sales volume and the nominal quota. Compensation for lost revenue would come from the adjustment fund. In times of shortage, the bufferstock would release oil from its stocks and call on the additional oil it has title to. Producing and

consuming countries that renege on their commitments would lose access to the compensatory facility and, respectively, the oil they originally had made available to the bufferstock and the capital paid into the adjustment fund.

This essay has mainly been concerned with the pricing and marketing of oil. There are additional tasks, however, in moving toward a more rational, equitable energy future. For example, to safeguard future supplies of oil, promote the development of alternative sources of energy, and encourage energy conservation, globally-administered databases, funds, and advisory bodies might be established to map hydrocarbon and other sources of energy worldwide; to assist particularly Third World nations in exploration and production operations; to formulate model investment contracts; to conduct environmental impact studies to determine potential hazards of oil exploration, production, and use; to research, develop, and apply energy-efficient technologies to production processes, transportation, and heating and cooling. Some of these activities, on a rather limited scale, are already being undertaken by various UN departments as well as by private

consulting firms. Funding for enlarged operations could come from the price elements set aside for this purpose as well as from perhaps voluntary contributions by states and non-governmental organizations.

In light of current political, institutional, and market realities, these suggestions may sound far-fetched. Yet, dramatic, unanticipated change has almost been the norm in the oil industry. As indicated in this essay, there are emerging structures and fledgling developments which in the future may make a concrete contribution to more cooperative, globally-oriented policies. Wider recognition in Western societies of the costs and dangers of continued extreme oil market instability and of the infeasibility of unilateral solutions may, over time, create the necessary environment for multilateral action.

Notes:

¹ I have made the case for such an approach in the US context in “Shaping America’s Energy Future”, *World Policy Journal*, Vol 4 No 3 (Summer 1987).

² See Michael Renner, “Restructuring the World Energy Industry”, *MERIP Reports*, January 1984, pp 12—17.

³ Such a proposal was first spelled out by Humberto Penaloza, “The Decline of OPEC: A Way Out”, *OPEC Bulletin*, December 1985/January 1986, pp 17—18.

⁴ Consumers and producers may find it desirable to revive Iraq’s 1979 suggestion to set up a joint fund to compensate developing countries for imported inflation and any increases in crude oil prices.

⁵ The European Community has shown interest to use the ECU (European Currency Unit) as a reference currency for crude oil and oil product transactions. Meetings have been held with representatives of the Gulf Cooperation Council since early 1985. See “Oil Currency Shift Weighed”, *The New York Times*, 1985-03-18. For policy proposals to reform the international financial system, see Arjun Makhijani and Robert S Browne, “The World’s Monetary Arrangements, A Proposal for a New System”, *World Policy Journal*, Vol 3, No 1 (Winter 1985—86), pp 59—82. ■