JOINT ECONOMIC COMMITTEE

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TEN MYTHS ABOUT THE PRICE OF OIL

Many often repeated notions about the state of the world's crude oil supply and the reasons for the high price of crude oil are wrong or at best half-truths. The oil market is dominated and manipulated by the OPEC cartel, which controls the lion's share of the world's oil reserves and has the lowest production cost. Its collusive actions distort market outcomes and have led to erroneous conclusions about the true state of the oil supply. The world crude oil market is not competitive and the prices it generates can not be properly interpreted as though it were. Following are ten common myths.

1. <u>Myth</u>: The price of oil is high because the world is running out of oil.

<u>Fact</u>: Known oil reserves are being continuously replenished and enlarged through ongoing oil field development. Known oil reserves worldwide have nearly doubled since 1980 from 645 billion barrels to 1.278 trillion barrels today. The economic oil supply is not fixed. There exist vast additional oil resources on earth whose rate of development is determined by price, cost, and technology.

2. <u>Myth</u>: The price of crude oil is so high because it is so costly to find and produce oil.

<u>Fact</u>: According to the Organization for Economic Cooperation and Development (OECD) and other sources, the cost of developing and producing oil in the Middle East is less than $5 per barrel. The manipulation of the oil market by the OPEC cartel is the primary reason why the price of oil is many times its cost of production.

3. <u>Myth</u>: Increasing oil demand is the only cause of the high price of oil.

<u>Fact</u>: An inadequate supply side response to increasing demand caused the price to rise. At a cost of less than $5 per barrel the supply of oil could have expanded to meet the increasing demand without a prolonged and dramatic rise in price. But OPEC restrained increases in supply. From 1998 to the first quarter of 2005, the cartel's rate of oil production moved in a narrow range. At various times it lowered its output quotas even though world oil consumption increased each year. Core OPEC producers have failed to adequately develop existing oil fields.

4. <u>Myth</u>: It will be very difficult for OPEC to increase its oil production capacity.

<u>Fact</u>: In 2004, OPEC produced oil at a rate of about 33 million barrels per day with 70% of the world's oil reserves (885 billion barrels). The rest of the world produced 50 million barrels per day with 30% of the world's oil reserves (393 billion barrels) and faced higher production costs. It is implausible that the cartel could not match the rest of the world's rate of production and even substantially exceed it, if it wanted to. OPEC's bias to hold back output has led to inadequate development of its oil resources. The fact that some OPEC producers finally are investing in expanded production that is expected to come on line soon proves this.

5. <u>Myth</u>: Non-OPEC producers are to blame for the high price of oil because they have substantially underinvested in oil exploration and development.

<u>Fact</u>: OPEC is the dominant, low-cost producer and *it* has underinvested in oil production capacity. Non-OPEC producers have to guess how much of the market OPEC will leave for them because of its secretiveness. Their oil investments are largely unrecoverable, if they guess wrong.

6. **Myth**: The price of oil is kept high primarily because the oil supply is susceptible to a variety of disturbances: political instability in major oil producing countries, the threat of terrorist attacks, natural disasters, industrial accidents, labor strikes, etc.

Fact: While it is true that such events can have an effect on the price of oil, prior to OPEC's exertion of market power their effect was short-lived. Average annual oil prices were low and stable from the end of World War II to the oil embargo in 1973, as supply shocks were quickly absorbed by the world oil market. Since then, OPEC has persistently and systematically restrained the oil supply to keep the price above cost. A market that is disconnected from cost is more susceptible to disturbances and speculation, which can be fed by many factors.

7. **Myth**: OPEC stabilizes the price and offsets volatility in the oil market.

Fact: Gyrations in the price of oil are induced or exacerbated by OPEC, because the enormous price-cost gap it has created is inherently unstable. Changing market conditions and conflicting motivations among its membership give rise to delayed reactions, misjudgments, and course reversals by the cartel in setting its rate of output. And, the uncertainty over its next move keeps the rest of the market off-balance. As pointed out above, the price of oil used to be low and stable before OPEC started to manipulate it.

For more information, see "OPEC and the High Price of Oil," JEC study, November, 2005.

8. **Myth**: OPEC maintains excess production capacity for the benefit of oil buyers.

Fact: Nothing could be further from the truth. OPEC has held spare production capacity for years while the price of oil has soared. When the oil price was near its recent peak between storms Katrina and Rita, the Saudi oil minister explicitly declined to offer more oil at a lower price (*Wall Street Journal*, September 21, 2005). The fact is that OPEC's restrictive output policy has made the oil market more vulnerable to disruption and increased the price of oil in the first place. OPEC has indicated that it is considering raising its target prices and reducing its output next year.

9. **Myth**: Refinery "bottlenecks" are to blame for the high price of crude oil.

Fact: Refineries will not bid up the price and try to buy more crude oil than they are able to process. If a refinery has reached its processing capacity, its demand for crude oil has become limited. On the other hand, if producers bring more crude oil to market, that will lower the price.

10. **Myth**: The price of oil has risen so much recently due to increased oil consumption by wealthy nations.

Fact: OPEC has been able to raise the price of oil based on demand from relatively poor countries struggling for economic advancement. Most of the increase in oil demand since 1980 has come from developing countries, principally in Asia. Non-OECD countries now account for 40% of world crude oil consumption. Their economies are much less efficient in the use of oil than the more developed economies.