

OPEC's Manipulation of 1970's Oil Prices: Is It Justified?

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## OPEC's Manipulation of 1970's Oil Prices: Is It Justified?

For almost its entire existence, the Organization of Petroleum Exporting Countries, or OPEC, has been viewed as a bullying oil cartel concerned only with the economic and political welfare of its current members. Its actions and policies seem to benefit only the economies of its underdeveloped and oil-dependent countries. But OPEC's personal ideas are far different from the rest of the world. OPEC believes that their actions are not completely dependent on their economic welfare; but instead they hope to achieve stability which has been missing for numerous years from the volatile oil market. OPEC claims that the world is blinded by their greed for oil and is convinced that their actions are responsible for setting crude oil prices. Even in its autobiographical report released in 2003, OPEC openly accepts the reality that they set prices in the early 70's through the mid-80's<sup>1</sup>; although the actual length of their price setting is perhaps much longer. In its first couple of decades of operation, OPEC sought to control the continuously dropping oil prices and secure a profit for its members. In order to achieve this goal, OPEC, whose market share at the time of its creation was quite significant, altered its output in order to guarantee acceptable prices for the cartel. OPEC has continued this pattern of supply-price control over oil, with varying success over the years, and has made its member nations quite rich and powerful in the political and global economy. Its actions to set the price of oil bring some stability to the oil market but at a questionable price. Is it ethical for the oil cartel, OPEC, to control the price of global oil in the 1970's in order to secure a profit and economic vitality for only its member nations while either disregarding or paying little attention to the consequences of its actions?

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<sup>1</sup> Who Sets Crude Oil Prices? March 2003. OPEC. date accessed  
<[www.opec.org/NewsInfo/WhoSetsCrudePrices/Crude\\_Oil\\_Prices.htm](http://www.opec.org/NewsInfo/WhoSetsCrudePrices/Crude_Oil_Prices.htm)>.

## **THE CREATION OF OPEC**

### **Unrest in Future OPEC Companies**

The inspiration and drive to create the Organization of Petroleum Exporting Countries, OPEC, started with the political turmoil over the price of oil. Ever since the industrial revolution, oil has embodied wealth and power. Every developed nation is completely dependent on oil for its economy and its basic functioning. There are even underdeveloped countries, like those in the Middle East who now constitute OPEC, who are completely dependent on the sale of oil for their economy and basic functioning even though they do not consume nearly the same amount of oil as developed countries. Therefore, any change in oil prices and supply affects the entire world in different ways. Industrialized nations and capitalistic companies purchasing oil want a low price per barrel of oil; on the hand, underdeveloped nations and producers of oil desire high prices so as to maximize their profits. As a result, any oil policy or shift will negatively affect one group while benefiting another. On the global scale, this creates major political battles over such a simple concept as the price for a limited good.

In the early 1900's, the price and supply of oil was mainly controlled and regulated by the "seven sisters" cartel of the oil refining companies based mostly in the United States and in Britain. These independent and non-governmental companies created policies and set prices with their companies' welfare as their number one priority. These companies were major corporations with widespread power and consisted of Exxon, Chevron, Mobil, Shell, Texaco,

Gulf and BP. Many of their actions and oil prices undermined the future founding nations of OPEC, specifically Venezuela.

Of all the nations in OPEC, Venezuela is the most advanced and most developed and was the first country to realize and complain about the injustices it suffered from the oil companies. The oil workers were the first to voice their disgust with the current economic policy. They organized into the Union of Oil Workers, the first union in this industry, and held the first legal strike in Venezuela at the end of 1936. The strikers were so determined to receive better nationwide agreement and higher wages that they protested for 43 days. During that time, the oil production in Venezuela dropped 39% and caused such an economic disaster that the President was forced to get involved in the dispute.<sup>2</sup> He made the workers return to their jobs in return for a promise that some of their demands would be met. This initial strike, although not very successful in helping the workers, did demonstrate that the major oil producing companies were no longer content with their treatment. With the price of oil so low, there is obviously less money to allocate for the workers' salaries and benefits.

Unrest about oil continued to grow as the National Union of Oil Workers in Mexico demanded increased wages and a nation-wide agreement for oil production. These workers problems also led to a strike but it was quickly dissolved by the Mexican Government. The production of oil was too important to the country to be resolved with an economic slowdown. Instead, Mexico called upon the Federal Council of Conciliation and then the Supreme Court for a just ruling against the oil companies. Both cases ruled in favor of the Mexican oil workers; they claimed that the oil companies were in an extremely prosperous time so they should be able to compensate the workers needs. But the companies constantly complained that they did not have the money or the ability to meet the workers so they simply refused to uphold the courts

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<sup>2</sup> Terzian, Pierre. OPEC: the Inside Story. London: Zed Books Ltd., 1985. p. 1

decisions.<sup>3</sup> The Mexican government was left with only two options: either force the companies to uphold the courts decisions or nationalize the oil industry. Since using force against American and British based companies was out of the question, the Mexican government nationalized the oil industry and shocked the rest of the world. For the first time, oil producers began to realize that they could unite, like the oil companies, and look after their own interests. This action shocked the world since the Mexican government nationalized subsidiaries of major American and British companies with one resolve. Mexico was determined to show the oil companies their limit of power and control. Unfortunately, these oil companies continually crossed this limit and drove the major oil producers to seek unified protection.

### **Middle East is Fooled**

The oil companies push their limits even more when they attempt to increase their profits once again. By 1948, the oil companies wanted more producers in competition with Venezuela's oil; especially since Venezuela was starting to resist their price setting tactics. So they dramatically increased Arab and Iranian oil imports by 7500%, from 1000 barrels per day to 75000 in only one year.<sup>4</sup> Once they secured a supply of oil from the Middle East, they began to drop the price of oil in order to make this new supply of oil competitive with Venezuela and compensate for shipping costs. So without regard for the Middle East's economic well-being, they increased the supply of oil and at the same time dropped the price of their oil so that by the time it reached the United States, it was equal in cost to Venezuelan oil. Unfortunately, the Middle East did not realize they were being cheated by the oil companies. Instead, they were under the impression that their profits were sky-rocketing and they were becoming extremely wealthy nations. At the time, the Middle East did not tax the oil companies; instead, it charged a

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<sup>3</sup> Terzian p. 2

<sup>4</sup> Terzian p. 4

flat rate per ton of oil that was produced. So as they price dropped, the oil companies raised the supply of oil so that the Middle East's revenue appeared to increase at a proportional rate. In reality, revenue should have increased exponentially when it only showed a slight increase. The Middle East was paid only \$1.75 per barrel of oil while Venezuela earned \$1.00 more per barrel of oil. The Middle East saw revenues increase from \$1.2 million in 1940 to \$10.4 million in 1946 as the production increased from 5.1 million barrels per day to 60 million. They never realized that their income actually fell from 23.6cents a barrel to 17.3 cents.<sup>5</sup> Even though the oil companies scored another victory against the oil producing countries, their dominance in the oil market would soon be overthrown with the same ruthless tactics.

As cheap Middle Eastern oil flooded American markets, Venezuela feared that it was losing its market share in oil exports. Venezuela had every right to worry because from 1945 to 1948, Middle Eastern production of oil rose 117% while Venezuelan production rose only 50%. Venezuela's government relied so heavily on oil exports that the looming prospect of being forced out of the oil market demanded immediate action. Almost 65% of the government's income was from oil taxes; therefore, any attack on oil prices and market share, meant an attack on the entire nation of Venezuela. The oil companies wanted to stir up competition amongst the oil producers in order to drop prices and maximize their profits. But they underestimated the resourcefulness of Venezuela and assumed it would fall into this price war with the Middle East. Venezuela was so dependent on oil that they knew this price war would have eventually destroyed them since their President believed that "oil was the thread we were hanging on by."<sup>6</sup> Therefore, they sought diplomacy and an agreement with the Middle East to keep prices from dropping to outrageous levels. But Venezuela was not entirely sure how to approach the Middle

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<sup>5</sup> Terzian p. 5

<sup>6</sup> Romulo Betancourt, *Venezuela's Oil*, George, Allen and Unwin, London, 1978.

East so they appointed Juan Pablo Perez Alfonzo as the National Democratic Party representative for the Venezuelan Congress. Alfonzo thus became the father of OPEC since he took control of the nation's oil portfolio and began his plans for an oil agreement which would later become OPEC.<sup>7</sup>

### **Oil Companies' Dominance**

Around the same time, the Middle East started to realize the dominance and unfair control by the major oil companies. The British company AIOC had overstepped its boundaries too many times. Even its workers were mistreated and in 1951 they held a strike for better social and economic demands. At the time, the Iranian prime minister was unsupportive of the severity of the workers and nation's demands and wanted to reach a simple compromise with AIOC. Unfortunately, the opposition to AIOC demanded immediate nationalization and would not budge from their stance. Therefore, since a compromise could not be reached with AIOC, the prime minister was forced to resign on April 26, 1951. The new leader, Dr. Mossadegh, authorized the immediate nationalization of AIOC into the new company NIOC. With the nationalization of AIOC, Iran now had complete control over their oil and would no longer have to deal with the oil companies' price setting and unfair business practices. Of course, Britain would never allow its major source of taxable income and power slip from its grasp that easily. By 1951, oil had become a diplomatic wildcard and insured power and prosperity to its holders. Britain would not let Iran, just an infant country, overpower the great British Empire. Britain immediately protested Iran's actions and international tension increased dramatically. The Security Council of the United Nations attempted to swell this controversy, but with such a powerful topic as oil, neither side was willing to budge an inch. So Britain sought the help of the International Court of Justice which ruled in favor of Britain. Iran was expected, by the

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<sup>7</sup> Terzian p. 2

international community, to return AIOC to British control and its nationalization; but, of course, even with the court's ruling they refused to lose their oil. Britain began a global boycott of Iranian oil and intercepted any shipment of NIOC oil claiming that it was legally property of AIOC and Iran had no right to sell this oil. The boycott proved to be extremely successful. Iranian oil exports plummeted from 665,000 barrels a day to 27,000 from 1950 to 1953.<sup>8</sup> Iran was forced to produce only the oil that its country consumed. But this global boycott was only possible with the support of the other major oil producing companies in the Middle East. With the loss of nearly 650,000 barrels a day of oil from Iran, the global market need these countries to compensate for the drop in the supply of oil. The Middle East was more than willing to see their profits and supply increase so they overlooked the treatment of Iran and simply produced more oil. But they would soon learn that if Iran could be treated like this, so could any other oil producing country in the Middle East. The only way to end this control by the major oil companies would be to join forces and control the supply of oil. But most Middle Eastern countries were not treated so poorly yet that they were not yet ready to revolt against the oil companies.

### **Oil Companies' Price Gouging**

Venezuela, on the other hand, knew they were being mistreated by the major oil companies, but they were still unsure of their course of action and did not yet realize the seriousness of the situation. The major oil companies had not yet driven Venezuela to seek immediate action so they attempted to push their limits even farther. On February 2, 1959, Shell announced that the price of Venezuelan oil was to drop 5-15 cents a barrel.<sup>9</sup> The announcement shocked Venezuela; especially since the price drop was announced without first notifying or

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<sup>8</sup> Terzian p. 14

<sup>9</sup> Terzian p. 23

even discussing this action with Venezuela. Only six days later, BP followed and dropped the price per barrel of oil 18 cents for Kuwait, Qatar and Iran. BP claimed that the price drop was necessary since there was an extremely large excess of oil supplies in those region. Ironically, the excess of oil was attributed to BP's increase in production to overtake the Venezuelan markets. The oil companies had just started the price war between Venezuela and the Middle East but neither country wanted to participate. When Venezuela protested this price drop, Shell only responded with another 5-15 cent per barrel drop in prices in April. Shell claimed they were bringing the price of oil to "more realistic levels" when they were actually returning prices to levels of 1953.<sup>10</sup>

By this time, the Middle East and Venezuela refused to accept this treatment. The Middle East finally realized they were being treated unfairly and issued a warning to the major oil companies to stop their actions: "The Middle East, great center of world petroleum reserves and of production for international commerce, is conscious of what is convenient for its fundamental interests and of the responsibility which it has in the world market."<sup>11</sup> No longer would the Middle East allow their profits to be wasted away and their actions manipulated. But the oil companies simply took their statement as a bluff and attempted to push the Middle East one more time. The major oil companies were still under the impression that the Middle East was naïve and did not understand the extent of their losses in oil revenues. So on August 9, 1960, Exxon cut prices 5-14 cents for the Middle East. Within two weeks, Shell, BP, Gulf, Texaco, CFP, Mobil and Chevron quickly followed and also dropped their prices 5-15 cents. The major oil companies had succeeded in dropping the price of oil back to the 1950 level in only two weeks. They thought they were now unstoppable and retained complete control over

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<sup>10</sup> *Platt's Oligram News*, New York, April 8 1959.

<sup>11</sup> Terzian p. 32

the major oil producers. The oil companies justified their actions, once again, with the stance that they were simply bringing prices back to reasonable levels instead of cheating the oil producers out of their profits. Even the Financial Times tried to downplay the incident and reported that the price drop was only a minor change: “the cut in prices will probably not have any disastrous consequences for the main oil-producing countries.”<sup>12</sup> The oil companies now thought they had won the price war but they had in fact just ended their control over oil prices.

### **Formation of OPEC**

Within hours of the first price drop, Venezuela and Kuwait immediately began discussing plans for a meeting to end the prices cuts the oil companies’ domination. The oil companies had walked over them one too many times and they were now prepared to end this control. On September 10, 1960, only one month after the most recent price drops, Venezuela, Kuwait, Iraq, Iran and Saudi Arabia met to discuss the recent drops in prices and the actions of the major oil companies. The rest of the world was shocked by this urgent meeting; especially the oil companies. Once Shell learned of this meeting, it realized it had overstepped its limits and quickly dropped its oil prices 2-4 cents<sup>13</sup>; this was only twenty days after it had dropped prices. But the major oil companies were too late and on September 14, 1960, the creation of OPEC was announced to the world.

### **Analysis of Oil Companies’ Actions**

The oil companies treated the founding members of OPEC poorly and assumed they were ignorant and simply accept their actions. The companies used numerous tactics to lower the price of crude oil and maximize their profits. At the same time, they carefully manipulated OPEC countries and allowed only a slight increase in their profits to give the illusion of

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<sup>12</sup> Terzian 32

<sup>13</sup> Terzian 35

prosperous times. When these countries began to revolt against the oil companies, they were met with even lower prices and oil embargos. These countries were so dependent on oil that they could not afford to lose this profit or oil exports. As a result, the oil companies manipulated the weak and underdeveloped countries in order to make enormous profits and become national powers. But the oil companies forced these countries to unite and create OPEC. The oil companies' actions undermined OPEC's member nations and forced them to seek retributions for their mistreatment.

## **OPEC'S CONTROL OF WORLD OIL**

### **Change in Power of Oil**

In the early 1970's, oil was still an extremely influential product. So many countries and companies were completely dependent on the price of oil. Any major change in the price of crude oil could devastate a nation's economy destroy major corporations. But there was still not just one price for the sale of crude oil; instead, there existed two different prices: market price and posted price. The market price was a combination of the supply and demand of oil. It changed quite frequently from week to week and was dependent on the physical and chemical properties of oil as well as the location and gravity of the oil. Prior to 1973, the posted price was the suggested price of oil posted by the major oil companies; it reflected their willingness to supply oil. The market and posted price of oil were both interdependent; therefore, if someone controlled one price, they controlled the price of oil in the open market. Since the oil companies had always set the posted price, they were actually setting the price of oil for the rest of the world.

OPEC sought to change this unbalance of power by taking over the oil companies' ability to set prices. In 1970, the posted price of oil was set at \$1.80 per barrel by the oil companies. In Teheran, OPEC met with the oil companies in an effort to raise prices and return wealth and power to OPEC nations; after the meeting prices rose to \$2.10. Throughout 1971 and 1972, prices would be continuously raised 4 more times through the efforts of OPEC.<sup>14</sup> OPEC had finally realized that they could influence the price of oil. The major oil companies feared OPEC's power so they slowly allowed prices to rise. But once again, the oil companies underestimated OPEC's true power and only allowed slight increases in the price of oil.

### **Vienna Conference**

In September of 1973, OPEC held its 35<sup>th</sup> Conference to discuss oil prices. OPEC was still unsatisfied with the price of oil, regardless of the recent increases in the price of oil. OPEC demanded a substantial increase in oil prices since they believed it was due to their member nations. The oil companies complained that a major increase in the price of oil would make the market unstable so they suggested a smaller increase in prices. The oil companies' interests were represented by their chief negotiator, George T. Piercy. He was the senior executive vice-president of Exxon, at the time the world's largest oil company. Piercy wanted only a 15-20% increase in prices in order to maintain the stability of the world oil market. OPEC's demands were voiced by Sheikh Yamani, an oil minister of Saudi Arabia since 1962. Yamani, although representing conservative views from his country, sought to at least double the price of oil. When negotiations began and each side stated their desired price of oil, Piercy wanted \$3.50 while Yamani wanted \$6.00, the oil companies were shocked to hear OPEC's demands for such a major increase in prices. They did not anticipate OPEC to take such a strong stance on the price of oil and were unprepared to negotiate at such a high price. Piercy managed to bring the

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<sup>14</sup> Allen, Loring. OPEC Oil. Cambridge, Massachusetts. Oelgeschlager, Gunn & Hain, Publishers, Inc.: 1979. p. 3

negotiated prices down to \$3.75 to \$5.00, but Piercy was at his absolute maximum. He was informed by his government not to allow any increase in oil prices beyond 25%.<sup>15</sup> If prices were to jump that high he was supposed to inform his government and then they would make a decision. Piercy then told OPEC that they needed to end the meeting so he could discuss the price of oil with his government. Piercy complained that the market could not handle such a dramatic increase in prices and it was absolutely necessary to discuss this matter with outside people. But OPEC did not believe Piercy and thought his actions were just another stalling tactic of the oil companies. OPEC was not worried about the oil market and believed that it could handle the increase in prices. Besides, OPEC never expected the oil companies to pass the full increase in prices on to the consumers; OPEC expected the oil companies to personally absorb a large portion of the increase. This expectation was based on the oil companies past actions against OPEC countries. OPEC wanted to regain their profits that the oil companies slowly stripped them of in the past couple of decades. But the oil companies made their last and final mistake by assuming OPEC was bluffing and would not raise the price of oil. After the oil companies left the conference without reaching an agreement, OPEC told them to listen to their radios for the price of oil. OPEC never negotiated the price of oil with the companies ever again.

### **OPEC's Demonstration of Power**

After the meeting ended, OPEC set the price of oil at \$5.12 per barrel. The OPEC countries had finally agreed on a 70% increase in the price of oil without the consultation or advice of the major oil companies; OPEC was now in control of the posted price of oil. In order to ensure that their posted price was followed, OPEC sought to also control the supply of oil. The member countries of OPEC immediately nationalized their oil industries so they could

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<sup>15</sup> Allen p. 8

restrict supply to control world markets.<sup>16</sup> By October 1973, OPEC had completed nationalization of their oil industries and not only controlled the price of oil, but also the supply of oil. OPEC thus retained complete control of oil and dominated the world oil markets.

To demonstrate its new power, OPEC began its first successful embargo in 1973 of the United States. OPEC had attempted a few embargos in the 1960's but with little success. In the previous embargos, the member countries did not completely hold their supplies and many shipments slipped through to the wrong destinations. But OPEC was now determined to demonstrate its control over the world market. In 1973, war broke out between Israel and Egypt and Syria, the Yom Kippur War. Since OPEC was composed mostly of Arab nations, they sought action to support Egypt and Syria and attack the Israelis. OPEC started an embargo of Israel in order to cut off their supplies for the war and cripple their army. But the United States quickly interfered and shipped supplies and oil to Israel. In order for OPEC to cripple Israel, they needed to not only start an embargo on Israel, but also on its supporters. So OPEC cut all oil shipments to the United States to demonstrate its political control with its oil. Saudi Arabia immediately cut production 10% while Yamani ordered Aramco to cut 25%. Between September and November of 1973, OPEC dropped production by 12% while its Arab member countries reduced shipments by 26%. OPEC's embargo effectively reduced oil supplies all over the world and forced countries to enact policies of oil conservation. The world oil market was so disrupted that oil prices increased out of control. In December, OPEC held auctions to determine the market price of oil in the world and received bids from \$15 to \$23 per barrel of oil. OPEC showed its power and set the price of oil to \$11.65 per barrel on Dec. 23, 1973. In only three years, OPEC raised the price of oil 6.5 times the level of 1970.<sup>17</sup> OPEC was no longer a group

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<sup>16</sup> Allen p. 10

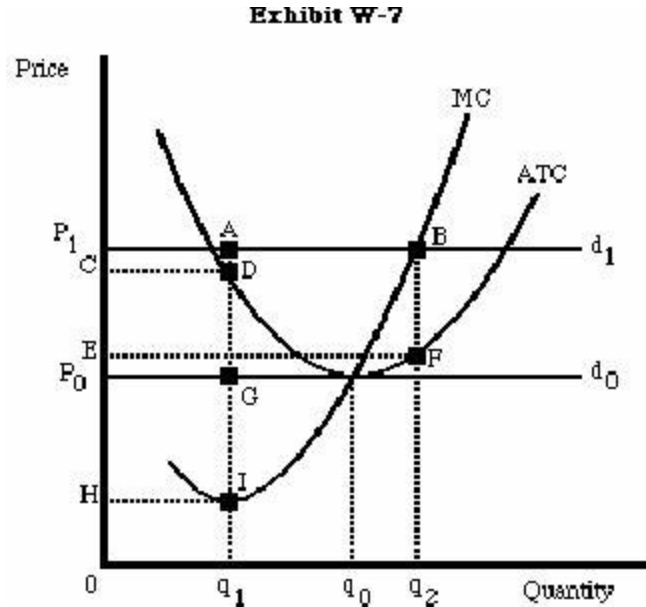
<sup>17</sup> Allen p. 18

of nations that could be ignored as the Shah of Iran explained to oil consumers: “the industrial world will have to realize that the end of the era of their terrific progress and even more terrific income and wealth based on cheap oil is finished. All those children of well-to-do families who have plenty to eat at every meal, who have their own cars, and who act almost as terrorists and throw bombs here and there, will have to rethink all the privileges of the advanced industrial world. And they will have to work harder.” OPEC had thus demonstrated that they can control the price of oil and influence the world; the oil consumers could only accept the price of oil OPEC determined.

### **ARE OPEC’S ACTIONS JUSTIFIED?**

OPEC’s actions of price setting were not a new concept to the world oil Market. The “seven sisters” cartel of oil refining companies set prices of oil for the first half of the 20<sup>th</sup> Century. Therefore, even companies controlled by democratic nations were engaging in the same activities as OPEC’s actions. But the oil companies actions in the first half of this century severely undermined OPEC’s member nations. By setting oil prices well below the fair market price, the oil companies were actually robbing OPEC countries of oil profits and wealth. Therefore, a major motivation for OPEC’s actions in the early 1970’s was to regain their money that they lost to the oil companies. But regardless of the oil companies previous actions against OPEC, is it ethical for OPEC, when dealing with a global oil market, to set the price of oil?

To completely understand whether or not these actions are acceptable, it is important to understand the basic economics behind price setting for oil. The diagram at the right shows a sample supply and demand curve for the global oil market. If oil was controlled by purely competitive companies and not cartels, then supply and demand would determine the price of oil. The supply



of oil would be set at  $q_0$  and the price of oil would be  $P_0$ .<sup>18</sup> This is the fair level for prices and supply for both the consumers and producers. But when a cartel controls the market, it wants to set prices and supply at a more favorable point. When the seven sisters cartel controlled oil, they wanted the supply to be beyond  $q_0$ , at  $q_2$ , and the price to drop below the equilibrium, at  $H$ . At this price and supply, the seven sisters cartel would be guaranteed high profits but this point would undermine the oil producers since they would receive a lot less money for what their product is worth. On the other hand, in the early 1970's when OPEC controlled oil prices, OPEC wanted to set the price of oil at  $P_1$  while restricting supply to  $q_1$ . This point would inflate the value of OPEC's oil and ensure a generous profit for its member nations. Unfortunately, if the market operated at this point, the consumers of oil would be over paying for oil. Therefore, it is unethical for OPEC, or any other cartel, like the seven sisters cartel, to set prices of oil without regard for the market. OPEC's actions, as a cartel, ignore the needs of the market and are concerned only with the financial well-being of its member nations. Even if the oil companies

<sup>18</sup> Monopolist Competition and Oligarchy. March 2003. Sam Houston State University. date accessed <coba.shsu.edu/micprin/arnold/chap23/chap23.htm>.

drained OPEC nations of profits in the first half of the century, this does not justify OPEC creating instability in the world oil market and setting oil prices to their desired levels. Therefore it was unjustified for OPEC to set prices in the early 1970's.

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