

OPEC and the Price of Oil:

The Need to Reform
the Global Oil Market

By Giacomo Luciani



Gulf Research Center
Knowledge for All

OPEC heads of state will gather in Riyadh on November 17 for the third summit meeting of the organization, at a time when oil prices are close to the psychologically important threshold of \$100 per barrel. The summit is a political, not a technical meeting – and as such is unlikely to make specific decisions on prices or production – but a strategic statement on oil markets and prices seems a certainty.

OPEC heads of state are likely to disagree on the desirable level of prices. Saudi Arabia, Kuwait and the United Arab Emirates are of the opinion that the present level is too high, but other member countries with less abundant reserves might be quite happy with current circumstances. That said, all OPEC members should be wary of volatility, because the latter is a threat to rational policy making for all – producers, companies and importers alike. The price of oil was \$50 per barrel in January of this year and is now double that – a 100 percent increase in a span of just 10 months. This is a lot of volatility – and the likelihood that the trend might be reversed and prices could come crashing down to \$60 or \$70 per barrel is very real. On the other hand, the climb may continue well beyond \$100 – we just do not know. Yet, it is inconceivable that a continued price rise will prove to be harmless to the world economy, and, more importantly, be in the long term interest of major oil exporters.

This is hardly an ideal situation for anybody. So why have prices climbed so high?

Three main explanations of the phenomenon have been proposed, respectively based on geopoliti-



cal considerations, fundamentals and financial markets analysis.

Geopolitical Threats

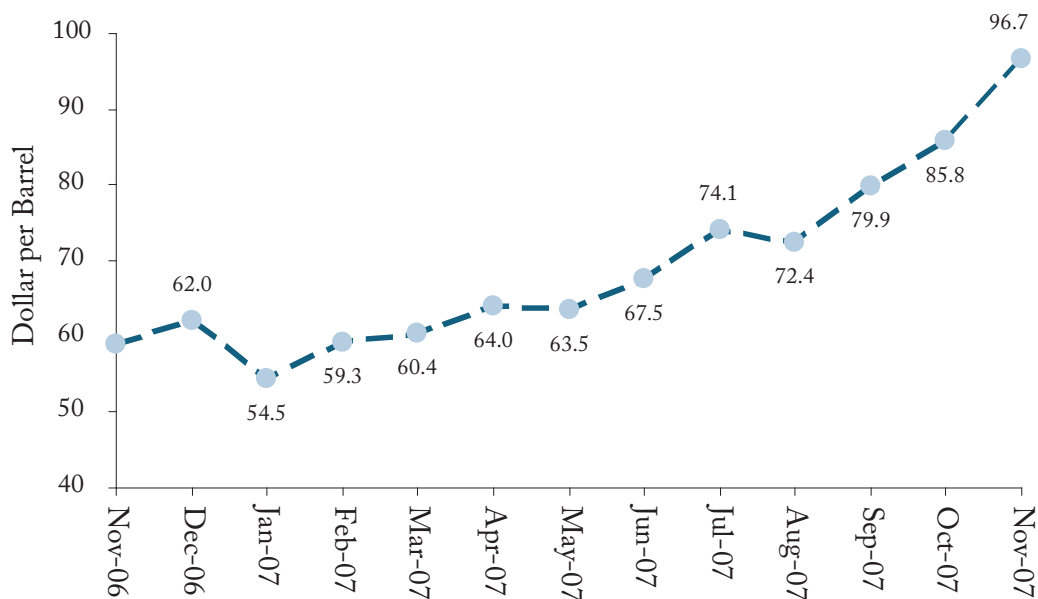
Geopolitical developments are frequently mentioned to explain high oil prices, and surely there is no dearth of news that may justify nervousness: one day it is Turkey threatening to send troops across the Iraqi border, another day the US President raises the spectre of World War III, on a third day martial law is imposed in Pakistan, and in Venezuela, students agitate against Hugo Chavez... However, the argument is not exactly convincing because potentially alarming geopolitical developments are frequent: they were as frequent one year ago as they are now, and prices then were much lower.

There hardly is a day that does not provide us with some news which we may conveniently use to explain oil price increases – but the causal link remains unproven. Some events – for example, a US or Israeli attack on Iranian nuclear installations – may indeed have a major impact on global oil supplies; but others – such as Turkish cross-border action against the PKK – may not touch oil production and logistics at all.

Fundamentals

Fundamentals have seemingly evolved in the direction of supporting, or at least validating higher prices. We have no hard evidence that oil is in tight supply – certainly there has not been any physical shortage so far (OPEC frequently stresses this point,

*Monthly WTI Spot Oil Price November-06 to November-07
(Dollar per barrel)*



Source: EIA



and uses it to justify its reluctance to increase quotas) – but surely demand has continued to increase while non-OPEC supply growth has been disappointing, and spare capacity worldwide has decreased from more than 6 mbpd in 2002 to around 2mbpd today.

The continuing strength of demand is the most surprising aspect here: that non-OPEC supply is slowly reaching a plateau (or peak, depending on your preferences) has been known for quite a while. But demand, no: for the past four years at least we have been waiting for high prices to have consequences such as increased inflation, or a slowdown of the economies of the major importing countries. But this has not happened: oil demand appears to be insensitive to price, and income growth too has not been seriously affected so far. Rather, demand has simply validated ex post any level of prices that was reached on the markets: we constantly expect that a major reaction is just around the corner – but we turn one corner after the other and find demand growth as usual.

Since 2005, demand growth has taken place mostly in non-OECD countries (China, Middle East, and to a lesser extent India and other developing countries). There is some preliminary evidence that in OECD countries the price effect is visible; however, no such evidence has been observed in the developing countries.

Gross domestic product (GDP) has continued to grow at historically high rates especially in China and India – in contrast to all long term scenarios, which are uniformly based on the assumption that Chi-

nese and Indian growth will slow down. The latest *World Energy Outlook*, published by the International Energy Agency (IEA) on November 7, focuses on the impact of China and India on global energy equilibria. “*The staggering pace of Chinese and Indian economic growth in the past few years, outstripping that of all other major countries, has pushed up sharply their energy needs, a growing share of which has to be imported.*” Yet, the IEA simply cannot accept that this growth might continue at unchanged speed: “*Both the Reference and Alternative Policy Scenario projections are based on what some might consider conservative assumptions about economic growth in the two giants. They envisage a progressive and marked slow-down in the rate of growth of output over the projection period. In a High Growth Scenario, which assumes that China’s and India’s economies grow on average 1.5 percentage points per year faster than in the Reference Scenario (though more slowly than of late), energy demand is 21% higher in 2030 in China and India combined.*” A scenario in which growth simply continues at current rates is not even considered.

Needless to say, neither country is interested in seeing a slowdown of its growth, and will do its best to avoid it. Their abundant reservoir of surplus labor ensures that growth can continue for a while before serious tensions in wages arise. The complementarity of their economies with the economies of the Gulf ensures that higher incomes in the Gulf will mean higher demand for imports from India and China, and increased Gulf investment in both, offsetting at least in part the deflationary effect of higher energy prices on aggregate demand. Their trade balances are in any case quite healthy



(perhaps too much so in the case of China!) and higher oil prices will not force them to curb growth for the purpose of maintaining their external balance.

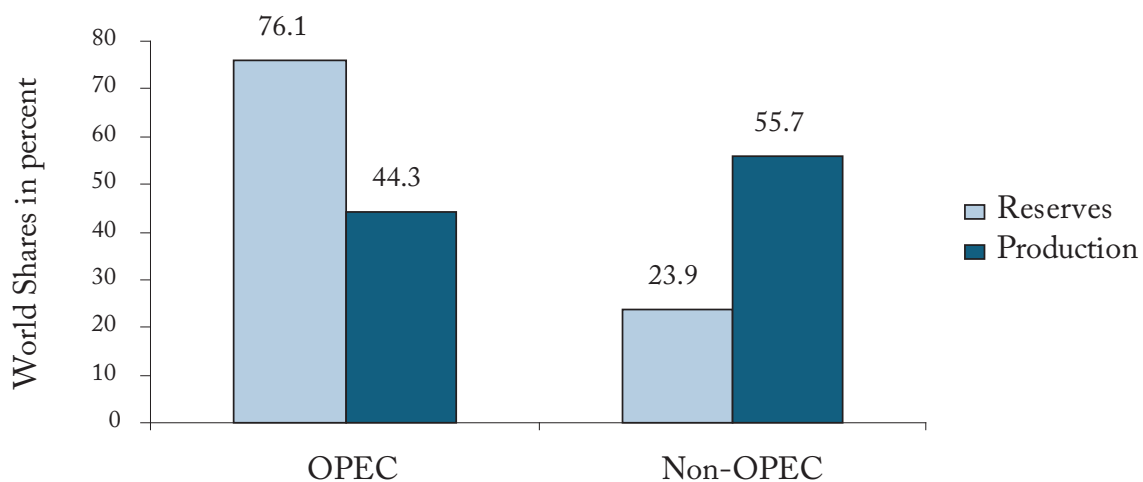
Elsewhere in the world too, growth engines are at work. In the European Union, sclerotic and inefficient as people may like to depict her, the integration of new member countries will exert an increasingly beneficial effect on growth. Europe is also well positioned to improve its exports to the Gulf and North African oil producers, as well as to Russia, again offsetting the immediate deflationary impact of higher oil prices on aggregate demand. Other emerging countries, such as Turkey or Brazil, are also well positioned to continue their growth, and Russia is, of course, a major beneficiary of higher oil and gas prices.

The most important question mark is over the future of the US economy – and

this is certainly not just a minor detail. The excessive debt of families, the corporate sector and the state will require a long and painful readjustment process – of which the subprime mortgage crisis is but one early manifestation. This has been known for a long time, and a weakening of the dollar had been expected. It is now taking place, more abruptly than many expected or desired: but will this necessarily lead to a “collapse” of the US economy? Surely not: progressive adjustment is possible, although a downsizing of US share in global demand and consumption is inevitable – and specifically, American energy consumption habits must change.

Therefore, we fail to see a convincing case for increased oil prices leading to global recession, unless major policy mistakes are made by key monetary authorities. The other side of this coin is that oil demand may well continue to be strong notwith-

OPEC and non-OPEC Share in World Oil Reserves and Production



Source: BP Statistical Review



standing higher prices, and “validate” ex post the new price levels, although logically we would have to assume that the rate of increase moderates. We cannot expect doubling of prices every year – or even one additional year – to pass harmlessly.

Can we, then, on the back of this argument, conclude that the current level of prices is justified by fundamentals? I believe not: just as geopolitical tensions are a constant and cannot justify prices climbing 100 percent in 10 months, so the demand/supply balance does not appear to have deteriorated to an extent sufficient to justify the price shift.

We hear frequently about stocks being very low, but it is well known that our understanding of stocks is partial to say the least. Excessive importance is attributed to information concerning US stocks (and in one specific location: Cushing, Oklahoma – as if this were the center of the world) primarily because of lack of information about the rest. US refinery stocks have decreased since the summer, but it is not at all clear whether this is due to scarcity of oil (i.e. refiners would have liked to hold more, but they could not find supplies and were forced to draw down their stocks) or to financial calculus. In fact, over the summer, the market shifted from contango (which is when future prices for subsequent months are higher than for the front month) to backwardation (which is when future prices for subsequent months are lower than for the front month). In a contango, it pays for refiners to accumulate physical stocks, while in a backwardation it pays to reduce them: therefore the decline we are witnessing may be the result of a deliberate shift in policy on the part of refiners.

Financial Investors

This gets us directly into the third possible explanation, which is related to the functioning of financial markets. The core of the problem is that the price of oil is fixed not on the spot market, where so-called “wet” barrels are traded, but on the futures market, where only paper barrels are traded. Spot markets lack liquidity and transparency: furthermore, and possibly more importantly, the major oil streams are not available for trading, because major oil exporters do not allow their oil to be traded. In contrast, huge liquidity is available on the futures markets, which are exchange-based and much more transparent – but: they only trade paper barrels. The peculiarity of the international oil market is that the price of a physical commodity, oil, is fixed on the market for a class of financial assets, oil futures. This paradox and the negative consequences of it have been denounced since many years by Robert Mabro (whom the OPEC summit will honor with a special prize) but not much has been done to remedy it.

Oil futures are a specific asset class that is tied to the broader galaxy of financial markets, because money can readily flow from one to the other. The subprime crisis, fear of resurgent inflation and higher interest rates are discouraging investment in bonds and other fixed income assets; uncertainty about future growth, especially in the United States, is discouraging investment in equity; investors therefore have apparently focussed on commodities, pushing higher the prices of a broad range of commodities, not just oil. In addition, the futures market – as all



financial markets – is influenced by technical trading and other forms of speculation, which tend to profit out of volatility, and at the same time further increase it. It is therefore possible for the futures market to push prices well beyond their “equilibrium” level.

Normally, when financial markets become seriously misaligned with underlying economic realities, a reversal of expectations eventually sets in and brings valuations back to a more sustainable level. In the case of oil, however, demand rigidity in the short term tends to validate any level of prices that we have seen so far. Ex post, demand and supply would look like they are in equilibrium at \$50 per barrel as well as \$100 per barrel. Possibly, some stream of heavy and sour Middle East crude will find fewer buyers at

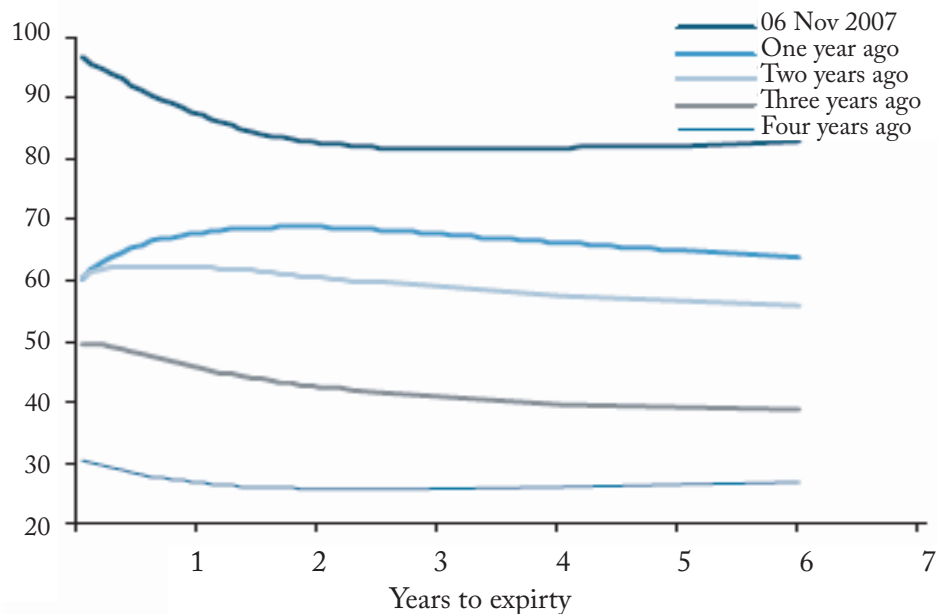
the higher price – but any amount of “unsold” oil would not be clearly visible, and no downward price signal is generated.

Volatility, therefore, is especially damaging because there is no effective mechanism to dampen swings and encourage a reversal of expectations. In the long run, demand will slow down, expectations will reverse, prices will decline; but a lot of economic damage may be done in the meantime.

The Role of Major Producers in Oil Market Reform

If then the root cause of the current situation is to be found in the fact that the price of oil is fixed by trading of a financial, not a real

WTI Forward Curve (\$/b)



Source: Barclays Capital



asset, the step which is required of OPEC is that it should again take upon itself the role of price maker, which belongs to the major producers in any market. Currently OPEC tries to play the role of price maker indirectly, through control of supply to the market. This policy has worked in the past and may continue to work in the future but less effectively. The mere suggestion of Saudi intent to discuss another increase of OPEC supply by 0.5 million arrested the price climb and caused a drop of ~ 2\$. Of course, this may be just a pause in the tug of war between OPEC and the financial market speculators. Had OPEC excess supply been more plentiful, the organization's influence over the market would have been more effective, but, in the final analysis, the major producers will need to shift to a more active role. This should not be interpreted as meaning a return to posted prices: OPEC countries, as we have noted already, would not easily agree on a level of prices and we have seen the consequence of this already in the early 1980s.

Prices should continue to be set by market forces, but it should be a market for wet, not paper barrels. Or, to say the least, a market in which the demand and supply of wet barrels are more important than the demand and supply of paper barrels. To achieve this result, it is necessary to allow major oil streams to be traded, and organize the trading in an efficient and transparent fashion.

It is frequently said that major crude oil streams cannot be traded because there is but one seller. This, however, is certainly not true: there are several markets in which there is only one seller of a specific good – the way in which a price signal is generated

in this case is by conducting an auction. We can, for example, point to the market for government bonds, which is in many ways similar to oil.

There are many ways in which an auction can be conducted, and the details are far from irrelevant. But this is not something that should concern the OPEC heads of state – they should simply signal the will to make more of their oil available for trading so that the excessive influence of financial investors may be dampened. This is a better solution than simply announcing an increase of quotas, which may or may not be necessary, and may or may not be effective as a tool to dampen speculation.

The definition of new modalities for crude oil trading should be the object of wide technical consultations and is an area of potential cooperation between oil-exporting and oil-importing countries. Both sides have an interest in reducing volatility and in contributing to designing a better global oil market, even if, in the final analysis, they have opposing interests with respect to the level of prices. The International Energy Forum, based in Riyadh, should be entrusted with the task of coordinating an international effort aimed at establishing oil trading on stronger and more reliable foundations.

Although details may differ, the direction in which we need to move is well understood. It is the direction that the recently launched DME Oman contract points to: establishing exchange-based futures trading with physical delivery. In other words, create paper barrels that turn into wet barrels



at maturity, and can be laden unto a ship and fed to a refinery.

The DME Oman contract has started well, and its potentially revolutionary impact has been widely recognized by independent observers, but it is not enough to reform the global oil market. What is needed is an array of such contracts for several qualities of crude oil from several producers, including from outside the Gulf (especially some of the Mediterranean and Caspian producers). As with equities, longer term futures trading could then develop on the basis of indexes of several crude oils, in order to attract the liquidity that each stream is unlikely to attract in isolation.

It is obvious that in a market structure based on DME Oman-like contracts

or other forms of auction, the producers would retain very substantial influence on both settlement prices and quantities sold. If they used their market power to stabilize prices at a fixed level, this scenario would boil down to a system of posted prices under a different name. But this is not necessary and would be not wise.

The producers are better off if they allow price signals to emerge from the trading floors, and simply avoid excessive fluctuations in one direction or another. This would not necessarily require frequent active intervention, because the mere knowledge that producers might influence the market will discourage excessive speculation. The trick is to devise a market structure that will be more stable even in the absence of intervention: this is possible, and it is urgent.