

The Oil Price Conundrum

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The governments of oil-importing countries are worried about the high oil prices of recent months. They worry about possible macro-economic effects: inflation, recession, balance-of-payments deficits. The consumers of energy in those countries where fuels are not subsidised are angry about the higher prices of oil, gas and electricity. Unfortunately these higher energy prices have coincided with increases in the cost of food and other items of vital expenditures. Those who use fuels in significant quantities, such as fishermen or truck drivers, are protesting through strikes or motorway blockades in some European countries.

Governments of importing countries could not remain indifferent to events too quickly labelled as the new oil price shock or the new oil crisis. Comparisons with the previous crises of the 1970s were hastily made but were more misleading than illuminating.

The focus in the 1970s was on OPEC. It is interesting to note that the response of OECD governments and their energy watchdog – the IEA – to the high oil prices of today followed the same line of thought: OPEC must be the guilty party in this new situation. The IEA asked OPEC to increase its production *illico subito*. President Bush asked Saudi Arabia, the only country with surplus productive capacity, to do exactly that. Prime Minister Gordon Brown made the same demands. President Sarkozy repeated the request. All that was backed up by a few unfortunate utterances such as ‘OPEC’s behaviour is scandalous’ (the UK PM) and ‘We should apply the blowtorch on OPEC’ (the Australian PM).

These governments did not seem to realise (or did not want to know) that OPEC’s role as the oil price administrator in international trade has ceased to be exercised since 1986. The ‘cartel’ label pinned on OPEC long time ago is still there. And the simplistic view that a rise in oil prices must mean that demand for physical oil *today* is greater than presently available supplies.

The reference prices for oil in international trade (WTI and Brent) are determined in futures oil markets in New York and London. OPEC adopts a production policy when oil prices are low and threatening to fall to even lower levels. This has happened in 1998 and early 1999; and even at that time the market response to OPEC’s policy involved a very long time lag of 12 to 15 months. Prices continued to fall as output was being cut.

Another attempt was made in late 2006 when the oil price fell from about \$75 per barrel (July 2006) to about \$50 per barrel (January 2007). This was more successful in stopping the decline. When oil prices are high producers do not restrict output. They sell the quantities demanded by their customers, subject to capacity constraints.

And those who requested OPEC, or more precisely Saudi Arabia, to produce immediately more did not seem to realise that the current oil market was not short of crude oil. There was evidence that Iran was unable to sell the whole volume of its planned production and stored the excess in big tankers with the aim of selling this oil on a spot basis in the Mediterranean and elsewhere. Saudi Arabia noted that many Western oil companies were nominating smaller volumes than specified in their long term evergreen contracts. Furthermore the term structure of futures oil prices displayed a contango, a phenomenon usually interpreted as a sign of excess supplies at the front end of the market.

To be sure, the supply/demand balances for different varieties of crude oil (for simplicity, say, heavy and light) is not uniform. There is excess supply for heavy varieties and excess demand for light/sweet crudes. But to ask OPEC to produce more oil is irrelevant when the output of the variety demanded by refiners cannot be increased.

Another approach favoured by some OECD governments was to advise developing countries to remove, or at least reduce, subsidies for petroleum products, gas and electricity in the domestic markets. Some countries have reduced, or indeed removed, all subsidies. Others are worried that such a move will have political implications for the stability of the regime. It is evident that the high oil prices are increasing the budgetary burden of subsidies. It is also evident that lower subsidies will reduce energy consumption after a time lag. Reducing subsidies may be achieved with a minimum of negative side effects if appropriate measures are introduced to alleviate energy poverty and distortions in the structure of the domestic fuel markets and industries are identified and at least partially removed. All that, however, may prove to be beyond the administrative capabilities of some developing countries. Furthermore, powerful vested interests may stand on the way to reforms.

The symmetrical policy to the reduction of subsidies in developing countries is increases in excise taxes on petroleum products in the US. In international meetings held in Asia on the subsidy issue nobody, to my knowledge (or perhaps this was not reported or publicised), has demanded that the quid pro quo was increased taxation in the US. The US would argue that this is politically difficult, nay impossible. Could we say that what is not good for the goose is not good for the gander.

No solution to a serious problem can be found by playing the blame game. To blame OPEC or the subsidisation of energy in developing countries will not address the oil price problem where it really lies. To be sure, co-operation with OPEC will be necessary in the search of a solution and for implementing some non-conflictual policies. Co-operation between developed and developing countries will also prove to be essential. Yet, the first stage is to identify correctly the problems, freeing oneself from prejudices, simplistic notions that are more in the nature of buzz words than analytical concepts, and from the tenets of a conventional wisdom rarely subjected to tough critical evaluation.

It stands to reason that an investigation of the causes of a given price movement must begin where prices are actually formed.

In the current oil price regime reference prices for crude oil exports in the Western Hemisphere (referred to in the past as the West of Suez oil trade) are generated in the futures markets of New York (NYMEX) and London (ICE Futures). The reference crudes are respectively labelled WTI and Brent. Oil exports to Asia (East of Suez) are priced according to formulas that take reference prices from a Platts assessment of Dubai and Oman prices. But the behaviour of these prices is influenced by movements in the Brent price.

Futures markets deal with a financial instrument which is a contract to buy or sell 1000 barrels at a future date (the date at which the contract expires). The NYMEX contract is physically deliverable at the expiry date in Cushing Oklahoma; the Brent contract is cash settled. The relevant question is: to which extent are these futures markets fundamentally oil markets.

To be sure, oil news induce price responses. But much depends on how news are interpreted. Traders, and indeed nobody else, have exact information about the actual supply/demand situation at the moment of the bid. There are perceptions and expectations that move their 'animal spirits'. Some argue that spot markets, not the futures markets, are the locus of price determination. I believe, however, that spot and futures prices are co-determined for the simple reason that any entity wishing to bid in the spot market will look at the ruling futures price at that moment; and vice-versa anybody trading on a futures market will keep an eye on spot prices. And as there is a continual flow of futures prices data and on only intermittent spot transactions it stands to reason that futures lead. The claim made by the officers of the NYMEX that only the spot matters is not credible.

The futures markets where reference prices are determined are part of a wide set of other oil derivatives such as options of different types, contracts for differences etc. and commodity indices. All these are also financial instruments transacted over the counter (OTC) sometimes on the basis of contracts specifically negotiated for a particular deal. The difficult question refers to the inter-action between options, OTCs transactions, investments in commodity indices and the futures prices that emerge on the NYMEX or on the ICE Futures exchange. The objectives, behaviour of traders and the techniques used do differ depending on the nature of the transaction entered upon. And the question is whether all this can be neutral in their effect on the oil futures prices.

The oil futures markets are also part of a set of financial markets for other commodities, equities, bonds, foreign exchange, carbon, the weather etc. Some of those who trade on the oil futures markets hold portfolios of contracts from other markets. A rational objective is to try to optimise the performance of this portfolio. This is not inconsistent with the fact that some Chinese walls are erected around every specific trading activity. Strategic objectives can be still set, deciding for example to lower (or increase) the allocation for a given market in order to increase (or lower) the allocation to oil. What matters then is the expected relative profitability of different financial markets. A non-oil factor can therefore influence oil price formation.

The futures oil market is not cartelized but there is effective leadership. And because it is essentially a financial market the leadership resides with financial institutions. Their views and particularly forecasts expressed in newsletters, reports, interviews or conferences influence price behaviour particularly if the prediction track record turns out to be good. There is some feedback between a prediction that the market consider to be credible (on the grounds that it is uttered by an institution considered by a majority that it has superior knowledge or that it is a recognised leader) and the price outcome. If a bullish (or bearish) mood prevails after a prediction prices will undoubtedly rise (or fall) accordingly.

But what are the motivations of perceived leaders?

The most important fact is that futures markets have a tendency to overshoot. This point was brilliantly made by the late Professor Rudiger Dornbush in an article on exchange rates 'Expectations and Exchange Rates Dynamics' *Journal of Political Economics*, December 1976. There is overshooting because the futures market reacts very quickly to news (that may be true or false) while the real world takes much longer to adjust (or to dismiss the wrong expectations)

Those who have tried to attribute the price rise to the futures market have not yet pinpointed where the problem lies. They talk loosely of 'speculation@ a term that has different meanings and which is used without specifying its definition. Some use it as synonymous to manipulation. But why not simply use 'manipulation' if this is what is meant? Some seem to imply that speculation is an immoral activity; others that it is irrational. Speculation is also used as a shorthand for the motivation of those who trade in financial markets. And there is a technical meaning to speculation, not often mentioned. The speculator is somebody who takes the other side of a deal sought by a hedger. Without it there is no market.

And those who want to distract attention away from a necessary look at the current oil price regime will tell us *ad nauseam* that the fundamentals of supply and demand explain on their own the price behaviour. There is no speculation.

Of course, supply and demand are of fundamental importance. But they are not the only factor. The futures markets and its acolytes (options, OTCs, commodity indices) are not neutral mechanisms.

The issue is whether the current price regime for oil in international trade is an appropriate one. Nobody questions it because the vested interests in maintaining it are extremely powerful. Banks and hedge funds are wedded to it. Some of the major oil companies have trading arms that operate in these derivative markets like financial institutions. Their trading profits are substantial. OPEC accepted it because they thought that it will protect them from blame. It didn't.

And the question always asked is: What is the alternative?

I will simply say that no alternative will ever be found if nobody is looking for one.

Now the situation has changed. OECD governments have come to realise that oil price movements of the type recently witnessed have adverse macro- and micro-economic effects. Many oil exporting countries are receiving happily the manna that is falling on their treasuries from heaven. But some of them, particularly Saudi Arabia, worry about the international political pressures put on them.

A new price regime does not involve the abolition of futures markets. It would involve an agreement between large importers and exporters to establish a system of price administration that considers data about supplies, demand, futures prices, prices emerging in an enlarged spot market, the world economy, investment costs etc and then define a reference price at regular intervals. This has to be backed up by a physical capacity to intervene in the market with the use of stocks in the US and elsewhere and surplus capacity in Saudi Arabia and hopefully other exporting countries.

A political vision and much goodwill are required. If governments are unwilling to rise to the challenge we shall have to live with the side effects suffered by economies subjected to the shocks of an oil market always prone to over-shoot and under-shoot.