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Oil Market at a Turning Point?

Crude oil prices have fallen markedly during recent months, so much so that the OPEC countries finally took action and resolved to curb production levels. Is the oil market becoming accustomed to ongoing geopolitical risks, and are oil price developments now being more strongly determined by fundamental market data once again?

World market prices for crude oil reached a new record high in early August when the price of Brent oil exceeded 78 dollars a barrel, but just two months later the barrel cost less than 60 dollars (see Figure 1). The extreme price fluctuations of recent months reflect often rapidly shifting assessments of the supply situation. Prices peaked during the summer in response to the Lebanon war and the partial suspension of production in the largest US oil field brought about by the detection of substantial pipeline corrosion. Yet even then the only possible conclusion to be drawn from fundamental market data was that the world‘s present oil supply is adequate. Furthermore, refinery inventories in the industrialised consumer countries have been relatively high for some months now. Nonetheless, the dwindling level of reserve oil production capacity caused in recent years by the sharp rise in oil demand, ongoing geopolitical tensions, and the ensuing concerns regarding possible supply shortages, have all made the oil market more sensitive to signs of crisis, while speculative buying strengthened oil price inflation. Since mid-August, however, good news from the point of view of the consumer – e.g. that diplomatic solutions to the Iranian nuclear issue are once again being sought, that oil production in Alaska returned to usual levels after a few weeks, and that oil and gas production in the USA has so far been unaffected by this year‘s hurricane season – has predominated to such an extent that the price of oil has fallen significantly.

Rising Demand for Oil in Asia

The growth rate of global oil demand, which last year slowed to 1.4%, will amount to 1.1% this year according to an International Energy Agency (IEA) estimate, raising world consumption to more than 84 million barrels per day (see Figure 2). In view of what continue to be high oil price levels compared to earlier years together with the prospect of a somewhat weaker world economy, the increase is unlikely to be much stronger next year, although the IEA recently expected the growth rate to accelerate to 1.7%.[1] A large proportion of the additional demand for oil came and continues to come from developing countries and emerging economies, particularly from China and the Middle East.

There have been no supply bottlenecks because world oil supplies also increased. The expansion of production facilities has continued, especially outside the OPEC countries. According to an OPEC estimate – which is little different from the IEA forecast – non-OPEC capacity will increase by around 1.8 million barrels per day (mbd) next year,[2] following a rise of just over 1 mbd this year. The increases are concentrated in Africa and the Caspian Sea. Yet in the OECD, too, where oil production will decline a little this year, we can expect an increase in output next year, particularly in the USA and Canada. In the case of Canada, this effect is partly due to the increasing output of oil products from oil sands. The latest discovery of apparently extensive oil reserves in great depths off the Atlantic

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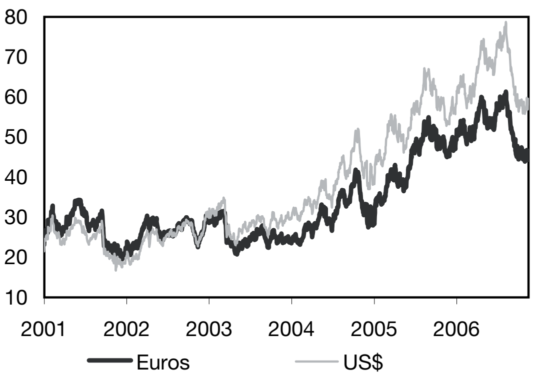
[1] Cf. IEA Oil Market Report, November 2006.

[2] Cf. OPEC Monthly Oil Market Report, October 2006.

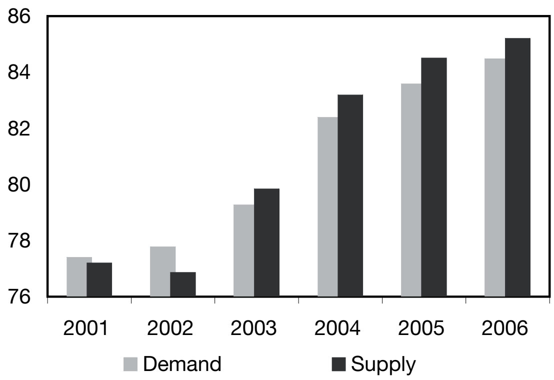
Figure 1
Crude Oil Price[1]



[1] Daily barrel price for dated Brent, fob.

Source: IEA.

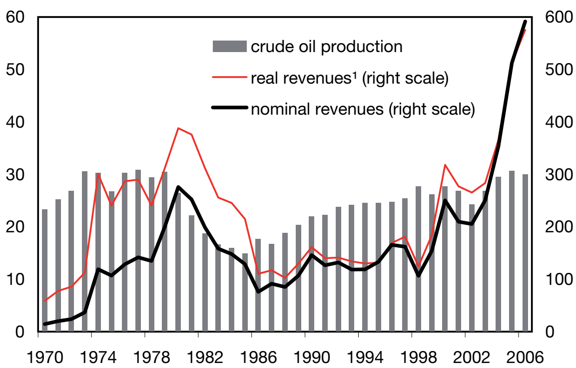
Figure 2
World Oil Supply and Demand[1]



[1] Annual averages in million barrels per day.

Source: HWWA index.

Figure 3
OPEC Oil Production and Oil Export Revenues
(in million barrels per day and US$ billion)



[1] Deflated with manufactures export prices, basis 2005.

Source: OPEC figures, author's calculations; 2006 estimated.

coast of the USA[3] – estimates put the figure as high as 50% of the country's current reserves – does not affect next year's output figures as the new fields will not be ready for production for a number of years.

In the OPEC countries, production facilities are also to be extended this year and next, although the organisation estimates that there will be no increase in requirements for OPEC oil next year. This would generate a more substantial supply buffer that could be tapped in case of unforeseen production shortfalls. In October, only Saudi Arabia had significant free capacity on hand, amounting to 1.8 mbd according to Saudi sources (see Table 1). The combined spare capacity of the "OPEC 10" (excluding Iraq) amounted to 2.8 mbd.[4] Uncertainty continues to surround the development of oil production in Iraq. Following a drop in supplies – partly due to a lack of export opportunities – to 1.5 mbd at times, output has now recovered to 1.9 - 2 mbd according to recent estimates. It is unlikely that the Iraqi government's production target of 2.5 or 3 million barrels per day can be achieved unless the security situation in the country improves. At present, there are still substantial obstacles for foreign companies to show more commitment in Iraq.

Continuing Pressure on Prices

Given the fundamental supply/demand situation, oil prices can be expected to remain under pressure in the near future. The good supply situation and the sharp decline in oil prices since August have raised OPEC memories of 1998, when a false estimate of global requirements – demand dwindled in the wake of the Asian crisis – caused the price of oil to fall to 10 dollars a barrel. In October, in an attempt to prevent a further drop in prices in the current situation, the member countries resolved to reduce their oil output by 1.2 mbd as from November. According to the Saudi oil minister, a further cutback could follow in December. The previous production target of 28 mbd for the 10 members had been valid since the middle of last year, but recently actual output had already been lower (27.5 mbd). The production cut had been generally expected and has so far had no perceptible effects on the oil market. This is partly because a cut had been anticipated, and partly because there is a degree of scepticism as to whether the resolution will be fully implemented, given that it initially means forfeiting crucial

[3] Cf. Chris Isidore: Major U.S. oil source is tapped, cnnmoney.com, 5.9.2006.

[4] Cf. EIA, op. cit., table, p. 16.

Table 1
OPEC Crude Oil Production 2006
(million barrels per day)

	Production target until October	Production in October	Production capacity in October	Spare capacity in October	Announced cuts from 1 November
Algeria	0.89	1.35	1.39	0.04	0.06
Indonesia	1.45	0.86	0.95	0.10	0.04
Iran	4.11	3.75	3.90	0.15	0.18
Kuwait	2.25	2.51	2.60	0.09	0.10
Libya	1.50	1.75	1.75	0.00	0.07
Nigeria	2.31	2.24	2.60	0.37	0.10
Qatar	0.73	0.82	0.87	0.05	0.04
Saudi Arabia	9.10	9.05	10.80	1.76	0.38
UAE	2.44	2.63	2.70	0.07	0.10
Venezuela	3.22	2.52	2.70	0.19	0.14
OPEC 10	**28.00**	**27.46**	**30.26**	**2.80**	**1.20**
Iraq[1]		1.92	2.50	0.59	
OPEC total		**29.38**	**32.76**	**3.38**	
(excluding Iraq, Nigeria, Venezuela, Indonesia:				*2.15)*	

[1] Iraq is not a party to the production agreements.

Source: IEA.

income from oil exports. Assuming that the geopolitical situation does not deteriorate, and in particular that no military „solution" is sought to the nuclear conflict with Iran, the price of oil will probably fluctuate around the 60 dollars a barrel mark during the coming months and next year, although short-term price hikes of considerable magnitude can still be expected.

Some market observers expect even greater price cuts, arguing *inter alia* that as the markets become generally accustomed to the ongoing geopolitical tensions the crisis premium included in the price of oil will shrink.[5] Lower oil prices could certainly be expected if global economic growth were to suffer a marked slowdown. China's oil requirements play an increasingly important role here. As the Chinese economy continues its strong expansion unabated, the country's energy requirements are also increasing apace, so that there would appear to be relatively little scope for oil price cuts in the foreseeable future. Substantial price increases could be expected – at least temporarily – in the case of larger supply failures, for instance if conflicts in important oil-producing countries were to escalate, or if there were a very cold winter in the North.

The most likely way to achieve more than just temporary calm in the oil market would be a relaxation of political tensions in the Middle East. Since, in view of the current deadlock, no rapid progress can be expected on this front, hope rests upon the reaction of supply and demand to higher oil prices. Although investment in the expansion of production capacity and the development of new sources of oil has increased considerably in recent years, the pace of expansion – at least in those oil-producing countries whose state-run oil companies control the lion's share of the respective oil reserves – is relatively restrained bearing in mind the expected development of oil consumption. The strong increase in revenues from oil exports dampens the propensity to expand output. Until the beginning of the decade, the OPEC countries were usually forced to stifle their production volumes in order to keep oil prices up and so to avoid too great a loss of income. In the meantime, almost all the oil-producing countries are operating at or near full capacity – with oil prices at a substantially higher level. At present, OPEC's total production volume is approximately equal to when the first oil price crisis began in 1973, but revenues from oil exports have mushroomed since then. This year they are likely to climb to US$ 600 billion, which would be more than twice as high as their long-term high of 1980. „Real" oil income, deflated with export prices for manufactured goods from industrialised countries, now exceeds the 1980 level by far (see Figure 3).

Advances in Oil Saving

On the demand side there are signs that higher prices for oil products are influencing consumer behaviour in the way one would expect. Thus, for instance, sales of SUVs with high petrol consumption in the USA dwindled when petrol prices climbed to a record level in the summer months, while in contrast there were supply bottlenecks for hybrid vehicles. In the short term, however, opportunities to save oil without any loss of comfort are limited, and they will only become effective in the medium term as older, less energy efficient vehicles, machines and equipment are replaced.

In the past, energy policy measures helped accelerate the shift away from oil. The most effective of these was without doubt the raising of consumption taxes. This is clearly demonstrated by the difference in per capita oil consumption between North America with its very low taxes and Western Europe with its relatively high rates: Europeans consume about half as much as the North Americans. What also becomes clear is that there are great regional differences in the possibilities

[5] Ann Davis, Bhushan Bahree: Oil's price drop reignites debate on turning point, in: Wall Street Journal, 21.8.2006.

to save oil and/or in the political resolve to implement measures to do so. In the USA in the 1990s, even a plan to increase petrol taxation by no more than a very modest amount was scuppered by a disapproving electorate. Besides increasing energy taxes there are a number of less intrusive measures to consider. These include tightening the norms regarding specific petrol consumption and/or CO_2 emissions from motor vehicles, a measure that is currently under discussion in the EU. In some regions there is a backlog as far as dismantling subsidies is concerned. These still exist above all in developing countries and emerging economies, where they are designed to cushion the inflationary effects of world market prices on domestic fuel prices.

Despite higher prices and additional policy measures, dependency on oil can only be reduced gradually. This is true above all for the transport sector, although alternative fuels have gained importance recently as substitutes for, or supplements to, fossil fuels. Substitution, hitherto encouraged by way of tax exemptions or reduced tax rates, is now to be accelerated by the obligation to add (more expensive) alternative fuels, which will lead to a slight increase in fuel prices at European filling stations.