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Lessons learnt from the History of Market Adjustment in the World Oil Market

Ken Koyama, PhD
Chief Economist, Senior Managing Director
The Institute of Energy Economics, Japan

Oil prices have strangely remained stable. When the Gaza Crisis began with Israel's counterattack in response to Hamas's surprise invasion in October last year, oil prices rose, including Brent, which topped $90 per barrel. Amid a widespread recognition that there would be no major disruption to oil supply in the Middle East despite the escalation of the Gaza crisis and the spread of the Israel-Hamas conflict and others, however, the Brent has stayed in the $80-85 range since November, with the West Texas Intermediate hovering around $80/bbl. Occasionally, crude oil prices deviated from these central levels. For the past four months or so, however, crude oil prices have basically remained stable, at around $80/bbl. In particular, crude oil prices have remained extremely narrow fluctuations since early February. The Brent has stayed within a small range of $80-84/bbl.

What are the factors behind the stability? The first conceivable factor is that the supply-demand balance is stable in the absence of major destabilizing factors. The second is that a kind of equilibrium situation exists as destabilizing factors offset each other. Since early 2024, global oil demand has continued to increase steadily. Although outlooks for oil demand growth in 2024 differ greatly by respective outlook sources, their average comes to around 1.5 million barrels per day. At the same time, however, U.S. and other non-OPEC oil production is smoothly expanding. Non-OPEC oil production growth is expected to be comparable to the average demand increase. Against this backdrop, market participants are aware that downside risks for oil demand include sluggish demand amid a global economic slowdown and a Chinese economic slump, while upside risks include the potential impact of deterioration in the Middle East situation. A conceivable reason for the oil price stability is that there is a kind of equilibrium between demand and supply factors or between upside and downside risks. This means that there are no major eminent market-moving factors.

Another important factor behind the oil price stability is the role played by the presence of the OPEC-plus group of oil-producing countries and their oil supply and demand adjustments. The group, which consists of the Organization of the Petroleum Exporting Countries led by Saudi Arabia and some major non-OPEC oil-producing countries such as Russia, has increased its presence as a supply-demand adjuster in the international oil market since late 2016. The group of oil-producing countries dependent on oil export income adjusts supply and demand in order to protect or support crude oil prices. The OPEC-plus group's representative oil supply and demand adjustments include the largest coordinated production cuts in history from May 2020, which came in response to a crude oil price crash caused by the COVID-19 pandemic. The group has been expected to adjust supply and demand not only to protect prices, but also to suppress price hikes or lower prices. It is still fresh in our memories that amid crude oil hikes since the second half of 2021 and their acceleration under the Ukraine crisis, there were calls around the world for Saudi Arabia and other countries with huge surplus production capacity to increase production in order to lower crude oil prices. Even when crude oil prices rise significantly, the presence of supply-demand adjusters such as the OPEC-plus group increases significantly worldwide.

The OPEC-plus group, which is now making headlines as a supply-demand adjuster in the international oil market, was launched with the "Declaration of Cooperation" between oil-producing countries in late 2016, as noted above. It is a young group that was created less than 10 years ago. In a sense, however, the long history of the international oil market is a history of fighting against price fluctuations, or a history of how to devise mechanisms and initiatives to avoid the negative effects of extreme price fluctuations. It can be said that the impact of fluctuations in crude oil prices on the economy and industry is so significant that there is a sense of urgency and seriousness that something must be done about such fluctuations.

There is also a question of why crude oil prices fluctuate so much. A traditional analysis of the oil market has pointed out that the short-term price elasticity of both oil supply and demand is small. Demand for oil (such as gasoline) as an essential commodity does not immediately decline even if oil prices rise by 10% or so. Even if oil is expensive, we have no choice but to buy and use it. Rising prices may not immediately boost oil production (apart from the exploitation of surplus production capacity). Investment may be made in response to price hikes, leading to a supply increase later. Under these circumstances, prices are prone to large fluctuations. Conversely, high prices maintained over a certain period of time may stimulate supply (conversely, low prices may discourage investment). Over the medium term, high prices may structurally lead the supply-demand balance to loosen (and vice versa). It also happens that price fluctuations go too far cyclically. Another important issue is who and how to manage the surplus production capacity that has always existed in the market. The oil market has always had the potential to see an excessive oil supply and an oil price crash if the management fails to work.

That is why there has been a recognition that surplus production capacity should be managed to adjust supply and demand in the international oil market. Historically, some market participants have played roles in managing surplus capacity. Since the inception of the international oil market in the second half of the 19th century, its history has been marked by volatile crude oil prices. In response to early crude oil price fluctuations, Standard Oil Co. dominated and controlled the market. After the dismantling of Standard Oil, oil majors concluded the Achnacarry Agreement to divide the market and adjust supply and demand. As crude oil production in Texas expanded rapidly, the Texas Railroad Commission was launched to allocate oil production quotas and adjust supply and demand to avoid any oil price crash. Reportedly, OPEC later referred to the commission’s approach. As oil supply expanded rapidly due to the development of huge oilfields in the Middle East after World War II, the "Joint Control" of Middle Eastern oil by the giant oil majors known as the "Seven Sisters" played an extremely important role in stabilizing the market through supply and demand adjustments. The majors mutually held equity stakes in major Middle Eastern oil production operating companies for mutual surveillance and joint control, contributing much to stabilizing the international oil market in the 1950s and 1960s.

OPEC, which was created to counter the Seven Sisters, regained sovereignty over oil resources and became the prime mover of the international oil market in the 1970s. However, this forced OPEC to replace the oil majors as a supply-demand adjuster. It has continued to serve as an adjuster until today. OPEC's production coordination has continued to have difficulties over the establishment of member countries’ production quotas. In order to increase the effectiveness of supply-demand adjustment under such circumstances, Saudi Arabia has sometimes taken on the role of a swing producer to adjust supply and demand (reduce production) on its own. However, this role was too much of a burden for Saudi Arabia, leading the oil kingdom to restore its market share in a manner that invited a crude oil price crash in 1986. The history of OPEC production adjustments has continued

beyond the 1990s. The inauguration of the OPEC-plus group added a new page to history. In the face of an unprecedented increase in U.S. shale oil production since the mid-2000s, OPEC alone became unable to effectively serve as an oil supply-demand adjuster and chose to cooperate with Russia, another major oil-producing country.

Interestingly, we can see that an existing production adjustment system either fails or requires a new one when its burden becomes too great. It is not clear at this point how long the current OPEC-plus framework will continue and function, but history seems to provide some implications for the future of the framework.

Contact: report@tky.ieej.or.jp
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