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International Oil Market Turns into Competitive Market without Managers

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

I visited France and the United Kingdom from January 17 to 21 to implement presentations mainly on our institute's "Asia/World Energy Outlook 2015" and Japan's latest energy policy trend and exchange views on them at various locations. In discussions in the exchange of views, I heard various views about the future of renewable energy and nuclear power generation, the possibility of enhanced energy conservation, and the potential of carbon dioxide capture storage technology as discussed in our outlook. These views will be very helpful for analyzing long-term world energy supply and demand outlooks. It was significant for me that deep discussions came on an approach for the "Lower Price Scenario," on which our outlook focused.

The reason the Lower Price Scenario attracted great interest in the discussions is that oil prices are very low now and one of the greatest matters of concern to people interested in energy. In fact, the discussions led me to reaffirm an interesting viewpoint for analyzing the present international oil market and the crude oil price problem. The viewpoint is that the crude oil price problem in the international oil market can be viewed from the perspective of the history of surplus supply capacity control in a sense.

In the history of the international oil market since the second half of the 19th century, the market has almost constantly had certain degree of surplus supply capacity except for some exceptional periods. As a mismatch emerges between resulting supply capacity and changing demand, prices may shot up or slump remarkably and wildly fluctuate, as seen frequently in the past. Since wild price fluctuations are a big problem for suppliers (and consumers), large-scale initiatives to manage such fluctuations and stabilize the market have been pursued throughout the history.

The history of the international oil market includes various market stabilization mechanisms including market management by Standard Oil, market adjustments under the Achnacarry Agreement, production adjustments by the Texas Railroad Commission, the Seven Sisters' joint control of Middle Eastern oil, production quotas among oil producing countries within the framework of the Organization of Petroleum Exporting Countries and production adjustments by Saudi Arabia as a swing producer. When these initiatives worked effectively, crude oil prices in the international oil market entered stabilization periods.

However, these mechanisms did not necessarily continue to work permanently or stably. Market changes and problems contained in these mechanisms led the mechanisms to fail, repeatedly bringing about the absence of a management mechanism or managers in the international oil market. In this way, a competitive market where crude oil prices weakened and went up and wildly fluctuated and a relatively stable market where some managers make adjustments to stabilize the market emerged alternately. In this sense, the presence and working of some managers in the market have not necessarily been natural or guaranteed. Rather, periods when the market is stable with managers working well have been limited.

The present international oil market lacks managers. In the period from 2011 to the first half of 2014 when crude oil prices remained above $100 per barrel, market players had expected OPEC members including Saudi Arabia to adjust production to defend prices. In fact, however, the expectations have failed to be realized. Saudi Arabia and other major oil producing countries have raced to expand their market shares, demonstrating that the abovementioned market expectations had been wrong. As a result, crude oil prices have lost supporters and tumbled in a free fall. Throughout 2015, no moves to end the market share-expanding race were seen. Recently, factors that could enhance the competitive environment has increased, including Iran's planned comeback to the market, a growing rivalry between Saudi Arabia and Iran, and an expected global demand slump. As a result, crude oil prices slipped below $30/bbl and are testing even lower ground.

In a competitive market, prices wildly fluctuate. Once a price decline accelerates, it is difficult to predict how far prices would decline. Based on economic logics, high-cost oil producers' short-term marginal production cost may be viewed as one of the floor for oil prices. Nevertheless, crude oil prices could slip below the marginal cost level temporarily. In the latest discussions in France and the United Kingdom, some experts said that the abovementioned short-term marginal production cost level is very low and that it is uncertain whether crude oil prices could stop their downslide after falling to around $25/bbl. No one is certain about how far crude oil prices would decline. Low oil prices, while bringing about benefits for consumers, have substantially reduced oil sector investment, dealt a severe blow to oil producing economies and exerted deflationary pressure on the world economy, resulting in a combination of crude oil price plunges, global economic deceleration and stock market declines. As crude oil prices have plunged so much, fears about negative effects of the plunge are growing despite the plunge's positive effects.

At present, we see no sign of any change in the competitive oil market. As explained above, however, the international oil market has historically explored mechanisms to stabilize the market following every absence of market managers. In this sense, it may be problematic to fully accept any idea that simply reflects the current international oil market situation. We have to watch whether the history of the international oil market could repeat itself.

Contact: report@tky.ieej.or.jp

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