A Market-Oriented Mechanism For Managing Oil Prices: IAEE October 20, 2003

Sharif Ghalib
Energy Intelligence Research

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The 2004 Outlook: A Problem?

- Absenting disruptions, most — not all — pundits expect fundamentals to soften & oil prices to begin to weaken.
- If so, how will Opec react? And…
- How will non-Opec respond?
Energy Intelligence’s 2004 Oil Market Outlook

- Similar to several others (Preliminary):
  - **A.** Global Demand: Up by about 1 m b/d (with faster global economic growth).
  - **B.** Non-Opec Supply: Up by about 1.5 m b/d (with two-thirds from the FSU, led by Russia). So:
The 2004 Call on Opec Crude

- IF S and D behave as projected, the ‘call’ on Opec falls to about 25 million b/d (with no change in inventories).
- That figure assumes Iraq’s oil production is (still) about 2 million b/d.
- That figure is 1 million b/d less than estimated for Opec crude in 2003.
- Also, it assumes Saudi crude output of about 7.2 m b/d (vs. about 8.5 m b/d in September, including the NZ).
## That 2004 Outlook is Typical

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<th>(millions of b/d)</th>
<th>IEA: Oct.’03</th>
<th>Energy Intelligence: Aug.’03</th>
<th>Deutsche Bank: Sep.’03</th>
<th>Prudential: Oct.’03</th>
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**Memo:**

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Oil Prices in 2004?

- The fundamentals suggest downward pressure on oil prices, absenting disruptions or further quota reductions:
- Recent Poll Results (July 2003):
  - Brent: Q4’03: $24.23f  2003: $26.53f
  - Actual (as of Sep.’03: $ 28.27)
  - Brent: 2004: $ 21.69f
  - 2004 Range: $17.50 (DK) - $24.60 (JPM)
More Recent Price Forecasts

- **EIA (Oct.’03):**
  - WTI = $30 thru Q1’04; $27 by late-2004.
  - (Implied Brent: $28 & $25)

- **Deutsche Bank (Sep. 26, 2003)**
  - WTI = $29.68 in 2003; $24.50 in 2004
  - Brent = $ 27.13 ; $23.00

- **Prudential Financial:**
  - WTI = $27 in Q4’03; $24 in 2004
  - (Brent = $25 in Q4 ; $22 in 2004)
Brent Prices: 1979-2003 (September)

- The Average Price has tended to rise recently:
  - 1979-85: $32.33
  - 1986-89: $16.52
  - 1990-99: $18.30
  - 2000-02: $25.90
  - 2003 (to Sep.): $28.27
Oil Prices Have Risen Because:

- There have been disruptions.
- Opec has been more cohesive since 2000.
- Opec has also had some help from non-Opec, though limited.
- With the ‘September Surprise’, it has begun to preemptively target still low oil inventories.
- No evidence — YET — of ‘mean reversion’.
What If Oil Prices Threaten to Crash in 2004/2005?

- What is Opec likely to do?
- The likely Non-Opec reaction?
Opec’s Attitude:

- The cartel surprised the market in Sept.:
  - It unexpectedly & preemptively cut quotas to 24.5 million b/d from Nov. 1.
- But its President said later:
  - Non-Opec will need to support Opec if the market softens in 2004 (especially Q2), or ‘we will switch from stabilizing prices to protecting our market share!’
Non-Opec’s Verbal Reply

- Norway: No way now! Not at current prices that are ‘too high’.
- Russia: Want ‘fair prices;’ ready to help if prices fall (sharply); favor price band of $20-25 for Urals:
  - Equal to about $21-26 for the Opec Basket & lower than ‘$22-28’.
- But Both Norway & Russia have recently referred to $20 as a ‘threshold!’
If Push Comes to Shove…

- Is an oil price-war inevitable?
- That depends on:
  - How far prices threaten to fall
  - Opec and non-Opec capacities to withstand low prices for a lengthy period of time.
- In other words: That depends on ‘Pain Thresholds’.
What is a ‘Fair’ Price of Oil?

- Both consumers and producers have given lip service to the desirability of achieving ‘fair, reasonable, stable’ oil prices. But:
  - Given marked differences in resource endowments, economic structures, and market philosophies… it remains an elusive and probably unattainable target.
A Market Oriented Mechanism

- Can a market-oriented market mechanism be devised to:
  - ‘Manage’ oil price fluctuations
  - Reduce the potential for a debilitating Price War?
- A suggestion is the creation of a global ‘oil-for-cash’ swap. Its elements are as follows…
Existing Price Thresholds: A
Existing Price Thresholds: B
The Global Swap: Elements

- Agree on a *range* of prices acceptable to both sides.
  - Agreement on that range could be facilitated by providing financial incentives in the form of ‘compensatory payment arrangements’.
- The financial mechanism could be effected via the IMF: SDR allocations or a new compensatory facility.
The ‘Global Swap’ Price Band

[Diagram showing Global Oil Swap with price bands and labels for Dated Brent Price in Slbl, Global Oil Output in millions of b/d (annual average), OPEC Pain Threshold, Oil Company Hurdle Prices, OPEC Price Band, and Global Swap Band.]
Movements Within the Swap Band

Global Oil Swap

- OPEC Price Band
- Global Swap Band
- OPEC Pain Threshold
- Oil Company Hurdle Prices
- Global Oil Output in millions of b/d (annual average)

Dated Brent Price in Sibbl

$27
$25
$23
$20
$18
$15
$12
$10

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Within the Swap Band

- As long as the oil price stays within the band, ‘nothing’ happens
- Therefore, the price of oil would be determined by market forces
Payments From Oil Producers
If Prices Exceed the Top End:

- Producers become obliged to make payments to consumers = to the price difference (shaded area).
- If prices stay above the upper band level, the financial penalty *could* be large.
- But it *could* provide producers with the incentive to raise oil output and put downward pressure on prices.
Payments From Oil Consumers
If Prices Fall Below the Low End

- The opposite happens: consumers become obliged to make payments to producers.
- If they remain there for an extended period of time, the obligations to pay could become sizeable.
- Thus producers could provide consumers with an incentive to lift D
  - For example, add to SPRs even though the lower prices will stimulate demand anyway.
Benefits of the Global Swap

- Market Oriented:
  - Constrains oil price volatility with clearly defined rules of the game.
  - Could reduce possibility of a Price War.
- If both Oil Consumers & Producers commit, the ‘Global Swap’ could work!
Thank you for your attention.