Oil Price Fundamentals: The Role of Spare Capacity 2003 - 2012

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Overview:

The oil producers' cooperation of Organization of Petroleum Exporting Countries (OPEC) has been a subject of numerous studies from the international political economists since the organization first arrived at the international stage in 1960. The major focus on those analyses has been twofold: 1) the struggle for supremacy at the organization level between two camps – the so-called "price doves", countries supporting the status quo of current oil prices, versus the "price hawks", countries vying for oil price increases (Amuzegar, 2001, Hartshorn 1993, Hines 1988, Bahgat 2011 etc.); 2) the organization's leadership based on the volume of the crude oil output (Claes 2001, Odell 1966 etc.). Still, while quite instrumental in presenting us with an overview picture of the relationships between oil producers, those works fail to provide us with an explanation of what role the ability to produce additional oil to enforce any country's political will has played in shaping the decision-making at OPEC level. This ability is called spare capacity and is inherently interlinked with industrial realities rather than political economy theories.

Spare capacity refers to an excess capacity which is being held idle at expense of the respective oil exporting country. It serves as a stabilizer of the oil market in case of sharp increase in the oil demand and sharp decrease in the oil supply. The role of spare capacity has gained significance since the end of 1980s where OPEC abonded net-back pricing system, and price-fixing as a whole, and let the international markets determine the price of oil. As a result of that, several factors have been used by market analysts to forecast the price movements: supply, demand, the reserves held by main consuming nations and the spare capacity among the OPEC members (Fattouh 2010). Therefore, the spare capacity is of significance to understand not only group dynamics of OPEC but the reaction of the market to that dynamics.

In this paper, I would like to analyze what the role of spare capacity played in shaping the decisions taken by OPEC since 2003and whether we could use it as an indicator for determining the decisions

Methods:

To analyze the role of the spare capacity, its volume and its role in shaping the behaviour of the oil producers I intend to use data from OPEC Annual Statistical Bulletin, BP Statistical Review of Energy, IEA World Energy Outlook and the decisions the OPEC has taken during its meetings since 2001.

I intend to test that data against the two major hypotheses of the political economy theory: 1) the decisions were taken as a result of internal infighting; 2) the production levels of Saudi Arabia help it achieve group decisions aligned with its strategic interests.

Then, I will analyze how the spare capacity levels interfered with those decisions.

I intend to use three cases: the price hike in wake of the Iraqi invasion, notably the period after 2005; the OPEC decision to lower production levels in 2008; and the production increases in the wake of the Libya production loss during the Civil War in 2011.

Results:

In the wake of the Iraq war and the increase of the world demand for oil, the oil production coming out of OPEC was squeezed and the spare capacity which the three major spare capacity holders – Kuwait, Saudi Arabia and UAE – used to compensate that loss. However, to restore the previous levels of that spare capacity, it took some time for those countries due to the lack of investments in the 1990s and the market reacted by pursuing higher price levels convinced of limited oil supply. Moreover, the peak oil theories gained momentum during this period stressing the depleting spare capacity. During this period despite their willingness many price hawks such as Iran and Venezuela could not enjoy the windfall profits the theory would lead us believe they would due to their inability to supply the markets with additional volumes of oil.

In the wake of the financial crisis in 2008-2009, the oil producers' organization took decision to implement production reduction which put simply aimed to reduce the production levels among members who could do it without seriously damaging their production capacities. In other words, shifting production to spare capacity enabled the organization to pursue higher price levels but that shift was once again exercised by those members being able to do so easily.

During the 2011 Libyan Civil War, Libyan oil production came to a halt. The loss of that oil was compensated by the production increases taken by countries with the spare capacity – Kuwait, UAE and Saudi Arabia. The lack of political decision at OPEC meeting in Vienna in June was compensated a bloc decision by Arab Gulf countries to increase production to compensate for the Libyan oil.

Conclusions:

The spare capacity has played a major role in understanding the group dynamics of OPEC since Iraqi war in 2003. Its possession enabled countries from the Gulf – Saudi Arabia, Kuwait and UAE – to stabilize markets and enforce political decisions at OPEC meetings. Still, its possession should not serve as the sole explanation for interaction between markets and producers. Other factors such as the level of reserves and demand should also be analyzed prudently.

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