

Oil-Shock or Change Agent

In the early 1970s, a fourfold rise in the price of oil almost brought the world to a standstill. The oil-shock had then left a strong imprint on countries that got hit by it. America subjected its cars to fuel-efficiency standards, France embraced nuclear power. This naturally was the best anti-dote at that point in time and resulted in the softening of prices subsequently.

Now again after 35 years history seems to be repeating itself. Oil prices have quadrupled again. While the world should have realized the consequences of the growing demand from emerging economies, it chose to shrug it off. Only now when it is feeling the pain, the world perhaps regrets its “looking the other way” approach all this while.

Developed and emerging economies alike are bearing the brunt of the price hikes. All are reeling in pain and searching for a panacea through measures like cutting taxes on petrol, monetary policy tightening etc. In India these methods are proving insufficient to surmount the problem of spiralling prices. Hence unpopular steps like price hikes have been enforced unwillingly by the government.

It is clear that high oil prices are hurting many economies. Beset by inflation, increasing interest rates, falling asset prices, households are hardly well-equipped to foot the oil bill.

In America, the oil price inflation has nullified the largesse that was provided to help people cope with the credit crunch due to the sub-prime problem.

The problem and pain notwithstanding, the current situation could also come to represent an opportunity leading to solutions to defeat the price hikes as it had happened 35 years ago. While the shock seems irresistible today, in time it will give rise to an equally unstoppable and more positive reaction through reduced demand, alternate energy sources and smarter management of resources using available technologies.

Since the solution to the problem seems to be eluding most governments, the search for the scapegoats and blame games have started. There are several reasons being cited:

Reason No. 1: Speculators



Top of the list are speculators profiting from other people's hardship. Some \$260 billion is invested in commodity funds, 20 times the level of

2003. Surely all that hot money has supercharged the demand for oil? The high futures prices led by this increased investment in the futures market could lead to hoarding of oil so that more profits can be accrued at a later date. *(See box : 1 to know more about speculators role)*

Reason No. 2: Oil Companies.



If the speculators are not to blame, what about oil companies, which have failed to increase output in spite of record profits? Profiteering, say some.

However, that accusation is debatable. For Shell, Exxon et al to hoard oil underground would be to leave billions of dollars of investment languishing unused which would not be a profitable move on their part. The oil companies have directed the blame onto cost increases in refining. *(See box : 2 to understand more about the cost of refining)*

Reason No. 3: Increase in cost of discovery



Finding and developing new oil fields is an expensive and time-consuming business. The engineers, survey ships and seismic rigs that oil

firms need to find and produce new deposits are expensive right now. The costs of finding oil have, temporarily, doubled precisely because everybody wants to give them work. Thus the giant new fields in the deep water off Brazil are unlikely to produce oil for a decade or more. (See box : 2 to get a better understanding about the cost of oil discovery)

Reason No. 4: Imminent end of supply.

Others fear that oil is expensive because it is running out. But there is little evidence to support this theory.



The Middle East still seems to contain enough. While it is true that the new finds elsewhere have been rarer and less accessible

than in the past but what is worth noting is that vast quantities of oil could now be profitably extracted from tar sands and shale. Also, the potential in heavy crude is still to be exploited.

BOX : 1

Role of Speculation in Oil Futures

Generally it is presumed that the price of any commodity goes up when the demand for the same rises. However this is not the case at all times. If we glance at the prices of Crude Oil, it has more than doubled as compared to last year. But the aggregate demand has not shot up accordingly. Why is this so???. The blame to a large extent is on speculators using oil as a hedge against the declining dollar. (Dollar getting weak due to the sub-prime problem)

While the world may blame emerging economies for driving up consumption, statistics do not reveal so. During the period 1999-2003, average GDP growth in India was 5.32%, while oil consumption grew at an annual average of 4.37%. During the next four years from 2003 to 2007, India’s GDP galloped to 8.65% annual average while the annual average oil consumption growth remained lower at 3.79%. US strategic oil reserves which were at approximately 350 million barrels for a decade till 2006 have doubled to 700 million barrels over the past year and a half. Thus neither the

demand position nor the inventory position seems perilous.

The cause seems to lie elsewhere and away from the simple economic laws of supply and demand. The sub-prime crisis followed by repeated softening of the interest rates in the US has

rendered the US dollar very weak. This has made the US financial sector turn its attention from currency and stock markets to commodity markets. According to “The Economist”, about USD 260 billion has been invested into the commodity market up nearly 20 times from what it was in 2003. Very clearly the fear of a weakening US



dollar is driving financial players to convert their dollar holdings into commodities. This sudden interest in commodities naturally has resulted in their prices to soar. Since the margin requirements (the fraction of payment that has to be made in order to buy futures contracts) for commodities is merely 5% to 7% as against 40% to 45% for stocks, the investment in commodities as of now seems lucrative. Thus

BOX : 1 (Contd....)

with an outlay of a mere USD 260 billion, these speculators would be able to take positions of approximately USD 5 trillion! Also it is estimated that more than half of these transactions are being held in oil.

In response to record oil and gasoline prices, the U.S. Lawmakers on Thursday June 26th, 2008 approved a legislation directing the Commodity Futures Trading Commission (CFTC) to use its authority, including the agency's emergency powers, to "curb immediately" the role of excessive speculation in the energy futures markets.

Hedge funds, pension funds and other speculators have been blamed by many lawmakers and some energy experts for doubling the price for crude oil in the last year.

The House legislation requires the CFTC to act against "sudden or unreasonable fluctuations" in energy futures prices and other trading activities that "prevent the market from accurately reflecting the forces of supply and demand for energy commodities."


It is important to note here that oil futures (oil prices) are no longer controlled by OPEC (Organization of Petroleum Exporting Countries). Generally it's done at US Wall Street. This mammoth shift in the determination

of international oil prices from the hands of producers to the hands of speculators is considered crucial for understanding the oil price rise.

At present Crude oil prices are determined at NYMEX by the major Anglo-American financial companies who are putting bets on Oil and thereby making their prices soar. Besides regulatory loopholes too are paving the way for speculation and price manipulation (read story below on *The finding of US Senate Committee in 2006*).

While oil demand and supply is evenly matched at about 85 million barrels every day, if supplies exceed demand by a substantial margin, downward pressure on oil prices would be created. In contrast, if someone with deep pockets, such as the financial companies, picks up even a small quantity of oil, it dramatically alters the delicate global demand-supply equation, creating enormous upward pressure on prices. By keeping the prices of oil artificially high, the speculators have also succeeded in keeping the value of US dollars intact. After all, a lot of US dollars are now required to purchase oil as against what was required a few months ago. Thus the demand for US dollars is also going up giving succor to the otherwise dwindling currency.

The finding of US Senate Committee in 2006



In June 2006, when the oil price in the futures markets was about \$60 a barrel, a Senate Committee in the US probed the role of market speculation in oil and gas prices. The report pointed out that large purchase of crude oil futures contracts by speculators had, in effect, created

additional demand for oil and in the process driven up the future prices of oil.

The report further stated that it was 'difficult to quantify the effect of speculation on prices,' but concluded that 'there is substantial evidence that the large amount of speculation in the current market had

(Contd...)

significantly increased prices.’

The report further estimated that speculative purchases of oil futures had added as much as \$20-25 per barrel to the then prevailing price of \$60 per barrel. In today’s prices of approximately \$130 per barrel, this means that approximately \$100 per barrel could be attributed to speculation!

But the report found a serious loophole in the US regulation of oil derivatives trading.

The report pointed out that US energy futures that were traded on regulated exchanges within the US were subjected to scrutiny by the Commodity Future Trading Commission (CFTC) — the US regulator for commodity futures market.

Interestingly, the report pointed out that the trading of energy commodities by large firms on unregulated OTC electronic exchanges was exempted from CFTC scrutiny by a provision inserted at the behest of Enron into

the Commodity Futures Modernization Act in 2000.

The report concludes that consequential impact on account of lack of supervision by CFTC has been ‘substantial.’

NYMEX (New York Mercantile Exchange) traders are required to keep records of all trades and report large trades to the CFTC enabling it to gauge the extent of speculation in the markets and to detect, prevent, and prosecute price manipulation. In contrast, however, traders on unregulated OTC electronic exchanges are not required to keep records or file any information with the CFTC as these trades are exempt from its scrutiny.

Consequently, as there is no monitoring of such trading by the regulator, the committee believes that it allows speculators to indulge in price manipulation.

BOX : 2

Increasing cost of refining and discovery

There are some who believe that oil price is still a function of supply and demand. For the past few years, the world's production capacity has grown only sluggishly. Meanwhile, demand, especially from the developing world, has been growing faster. So there is hardly any slack in the system. Only Saudi Arabia and the United Arab Emirates are thought to be able to increase their output from today's levels, and even then, there are doubts, since Saudi Arabia, in particular, is secretive about the state of its oil industry.

That leaves the oil market at the mercy of even small disruptions to supply. Prices tend to jump

each time militants sabotage an oil pipeline in Nigeria, bad weather threatens production in the Gulf of Mexico, or political clouds gather over the Persian Gulf.

The problem is exacerbated by a growing mismatch between the type of oil being produced and the refineries that must process it. The most common benchmark prices, including the one used in this article, refer to “light” crude, the least viscous sort, which produces the most petrol and diesel when refined. “Heavy” oil, by contrast, yields more fuel oil, which is used mainly for heating.

BOX : 2 (Contd....)

At the moment, diesel is in short supply and there is a glut of fuel oil. That makes processing heavy oil unprofitable for some refineries, since the gains from diesel are outweighed by losses on fuel oil. As refineries turn instead to lighter grades, it pushes their prices yet higher. The discount on heavier crudes has risen to record levels. But even then, Iran is having trouble selling the stuff. It is storing huge quantities of unsold oil on tankers moored off its coast.

Presumably, Iran and other heavy-oil producers will eventually be obliged to drop prices far enough to make processing the stuff profitable for refiners. In the longer run, more refineries will invest in the equipment needed to crack more diesel out of heavy oil. Both steps will, in effect, increase the world's oil supply, and ease prices.

But improving an existing refinery or building a new one is a slow and capital-intensive business. Firms tend to be very conservative in their investments, since refineries have decades-long life-spans, during which prices and profits can fluctuate wildly. It can also be difficult to find a site and obtain the right permits. This is one of the reasons why no new refineries have been built in America for over 30 years. Worse, the equipment for refining is becoming ever more expensive. Cambridge Energy Research Associates (CERA), a consultancy, calculates that capital costs for refineries and petrochemical plants have risen by 76% since 2000.

Much of the same applies to the development of new oilfields. CERA reckons that the cost of developing them has risen even faster by 110%. At the same time, oilmen remain scarred by the

rapid expansion of output in the late 1970s, in response to previous spikes in prices, that led to a glut and so to a prolonged slump. Exxon Mobil claims that it still assesses the profitability of potential investments using the same assumptions about the long-term oil price as it did at the beginning of the decade, for fear that prices might tumble again. Environmental concerns are also an obstacle: America, for one, has banned oil production off most of its coastline.

Increasing nationalism on the part of oil-rich countries is adding to the difficulties. Geologists are convinced that there is still a lot of oil to be discovered in the Middle East and the former Soviet Union, but governments in both regions are reluctant to give outsiders access. Elsewhere, the most promising areas for exploration are also the most technically challenging: in deep water, or in the Arctic, or both. Although there have been big recent discoveries in such places, they will take longer to develop, and costs will be higher. The most expensive projects of all involve the extraction of oil from bitumen, shale and even coal, through elaborate processing. The potential though is more or less unlimited, although analysts put the costs as high as \$70 a barrel, more than the oil price this time last year.

Nonetheless, based on the projects that are already under way, global oil production will grow by over 3m barrels a day (b/d) over the course of this year and next. In particular, it expects production outside OPEC to grow by about 500,000 b/d which is a marked increase from the near stagnation of recent years.