
Déjà vu all over again: another oil price fiasco

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OPEC: market share versus target price

It appears to us that the current oil market situation has a familiar and disheartening ring. In September 1986, we presented an analysis to the Oxford Energy Seminar in which we estimated the high cost of a decision taken by OPEC to pursue market share rather than defend a target price. This analysis later appeared in a book, *The Oil Price Crisis*,¹ edited by Robert Mabro. (Quotations in this article are taken from this book.) In November 2014, OPEC oil ministers again faced a similar choice: defend the oil price, which had been declining since June, or defend the OPEC market share, which had been threatened by soaring non-OPEC oil production for several

years. No one believed the ministers could do both simultaneously.

Many outside observers and analysts (including ourselves) expected OPEC to pursue a price defence strategy by reducing its ceiling of 30 million b/d (in place since 2011). A cut to something nearer to 28.4 million b/d, OPEC's own projected global requirement for OPEC crude oil in 1Q15, was a reasonable expectation

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By the week of the November meeting, the average price of the OPEC Basket

of crude oils had already declined to about US\$75/bbl, from US\$108/bbl in June. A temporary cut in the ceiling to 28.4 million b/d should have been sufficient to reverse the price slide. Many were surprised that OPEC chose to leave its ceiling unchanged.

Long-run cost to OPEC of market share defence

Why the meeting made the costly choice to defend market share rather than price is an important question to which we will return later. Meanwhile, we have estimated that the long-run cost to OPEC of its decision ranges from US\$343 bn to as high as US\$746 bn over the period to 2020,

Table 1 High

		The 2015–20 overall balance											
		Price defence strategy						Market share strategy					
		2015	2016	2017	2018	2019	2020	2015	2016	2017	2018	2019	2020
Net demand on OPEC crude	mb/d	29.5	28.5	28.2	28.5	28.7	29.0	29.4	29.9	30.5	31.0	31.6	32.1
OPEC local consumption	mb/d	9.7	9.8	9.9	10.1	10.2	10.3	9.7	9.8	9.9	10.1	10.2	10.3
OPEC exports	mm/d	19.8	18.7	18.3	18.4	18.5	18.7	19.7	20.1	20.6	20.9	21.4	21.8
Average price	US\$/bbl	100	100	100	100	100	100	55	62	67	70	71	73
OPEC revenue	US\$ bn	723	683	668	672	675	683	395	455	504	534	555	581
Cumulative export revenue													
Price defence strategy	US\$bn	3420											
Market share strategy	US\$bn	2443											
Cost of market share strategy													
Undiscounted	US\$bn	977											
Discounted at 12%	US\$bn	746											

depending upon one's assumptions about how a price defence strategy, had it been adopted, would have been implemented. Our higher long-run cost estimate (Table 1) assumes that a price defence strategy would have cut the OPEC ceiling sufficiently to push the OPEC Basket (reference) price back to US\$100/bbl on average (in nominal terms) for each year 2015–20. OPEC would, in this scenario, have had to adjust its ceiling to equal the projected call on OPEC crude for the next few years.

Our lower estimate (Table 2) assumes that the same cut in the OPEC ceiling would face greater headwinds and would have been able only to stabilize the price slide at US\$75/bbl on average for 2015, and to bring the price gradually back to US\$100/bbl by 2020. There are many reasons why this slower price recovery is plausible, such as weak OPEC credibility due to past failure to enforce ceilings, unanticipated adjustments of supply and demand data, drawdowns of already high global inventories accumulated over recent

years, or unresolved disagreements among member countries on the new price target.

In both our high and low estimates:

- We assumed the call on OPEC crude oil over the remainder of the decade under the price defence strategy would follow the trajectory foreseen in the OPEC Secretariat's World Oil Outlook Reference Case, which assumed an OPEC Basket price of US\$110/bbl in nominal terms throughout the 2015–20 period.²

Table 2 Low

		The 2015–20 overall balance											
		Price defence strategy						Market share strategy					
		2015	2016	2017	2018	2019	2020	2015	2016	2017	2018	2019	2020
Net demand on OPEC crude	mb/d	29.5	28.5	28.2	28.5	28.7	29.0	29.4	29.9	30.5	31.0	31.6	32.1
OPEC local consumption	mb/d	9.7	9.8	9.9	10.1	10.2	10.3	9.7	9.8	9.9	10.1	10.2	10.3
OPEC exports	mm/d	19.8	18.7	18.3	18.4	18.5	18.7	19.7	20.1	20.6	20.9	21.4	21.8
Average price	US\$/bbl	75	80	85	90	95	100	55	62	67	70	71	73
OPEC revenue	US\$ bn	542	546	568	604	641	683	395	455	504	534	555	581
Cumulative export revenue													
Price defence strategy	US\$bn	2902											
Market share strategy	US\$bn	2443											
Cost of market share strategy													
Undiscounted	US\$bn	459											
Discounted at 12%	US\$bn	343											

- We compared OPEC’s projected revenue under the price defence strategy with its projected revenue under the ongoing market share strategy. The impact of the market share strategy on OPEC’s revenue is reflected in a recent IEA report,³ which assumes a much lower trajectory of oil prices. This report confirmed our own views on the very limited impact of lower prices on global oil demand and a delayed impact on non-OPEC supply growth.
- We adopted OPEC’s own projection of domestic oil consumption in member countries⁴ (the IEA report referred to above makes no equivalent projection).
- We then calculated the difference in OPEC’s projected revenue from petroleum exports under the price defence strategy compared with its projected revenue under the market share strategy, and discounted the difference at 12 per cent. Our estimates ignore revenue losses attributable to natural gas and NGL exports.

These hypothetical price defence scenarios illustrate that a relatively small, credible cut in OPEC output (averaging less than 5 per cent below the current 30 million b/d ceiling on average over the 2015–20 period) would have been sufficient to avoid the much larger (16–29 per cent) loss of revenue now foreseen under the market share strategy.

All of our calculations of OPEC’s comparative loss due to the adoption of the defence of market share strategy treat OPEC as a unit. The loss calculated here is collective, and all member countries bear part of this burden.

How did OPEC make this choice, and what could OPEC do now?

The decision last November to defend market share was practically imposed

by Saudi Arabia who:

- doubted the willingness of other OPEC members to abide by any agreed production cut, and
- despaired of persuading non-OPEC producers, such as Russia and Mexico, to collaborate on a price defence strategy.

Saudi Arabia feared that they alone would bear the entire burden of a price defence strategy, while the benefits would accrue to others.

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The November 2014 decision has yielded a market situation that is far from stable. If OPEC continues producing at present levels, exceeding the global call on OPEC crude oil, further price drops are likely. Some OPEC members such as Iraq (and Iran if sanctions are lifted) will expand output, while global inventories will swell, enhancing price weakness and volatility. OPEC has abandoned its primary *raison d’être*, namely price stabilization, thus damaging the organization’s long-term credibility.

Today’s challenge compared with 1986

The challenge facing OPEC is even greater today than it was in 1986, when petroleum derivatives markets were still in their infancy. Today, the volumes of ‘paper’ oil traded on the principal futures exchanges vastly outweigh volumes traded physically. Financial investors now play an enormous role in oil price formation and their expectations (which govern the magnitude of their holdings of futures contracts and other derivatives) can fluctuate rapidly; this happened last summer, contributing to the price decline. In the absence of a credible OPEC price signal, price volatility will only be exacerbated.

Another way in which the challenge facing OPEC today is greater than that in 1986 is that the mantle of ‘pioneer in asserting sovereignty over natural resources by developing countries’, which OPEC wore proudly during its first three decades, has worn thin. The opportunity to achieve a higher standard of living thanks to enhanced export revenues has clearly been squandered by some OPEC members, while numerous oil-importing developing countries have outdistanced some OPEC members in many measures of citizens’ welfare. Some global observers who once viewed OPEC sympathetically as a champion of the rights of former colonies now see the organization as being composed of super-rich ‘winners’ and left-behind ‘losers’. The present strategy split within OPEC does nothing to dispel this perception.

Potential fiscal response by governments of oil importing countries

Compounding the challenge to OPEC is the likelihood that the governments of oil-importing countries will seize the opportunity afforded by lower oil prices to increase excise taxes or diminish subsidies. Many governments need to expand revenue to balance budgets, while some will also employ taxes on petroleum products to discourage consumption and reach emissions targets. Other governments, urged by the IEA and IMF, will reduce or eliminate subsidies to end users of petroleum products. Such modifications of end-user price regimes are most easily implemented when consumers perceive prices to be relatively low.

In *The 1986 Oil Price Crisis* Mabro correctly anticipated such developments following the 1986 oil price collapse. OPEC members will end up with an even smaller percentage of the end-user value of their principal export than they received prior to



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adopting the market share strategy – and this will be a permanent shift.

Possible future courses of action

For all of these reasons, it would appear urgent that OPEC reconsider its current strategy and adopt a plan that would reverse the foreseeable revenue loss. How could this come about?

- The initiative for such a change must come from OPEC members other than Saudi Arabia. Saudi Arabia has shown no inclination so far to review the strategy adopted last November, and indeed is expressing an unrealistic confidence that oil prices have stabilized and global oil demand growth is accelerating.
- The initiative must convince Saudi Arabia (and the rest of the world, including financial investors) that other OPEC members are willing to abide by agreed production cuts.

This will be difficult given that non-GCC OPEC members have, in the past, tended to produce at their respective capacities, regardless of OPEC agreements. Temporary self-restraint will be required, particularly from Iran and Iraq, both of whom view themselves as having special historical rights to expand output.

- The initiative should be open to participation by non-OPEC oil exporting countries, but should not be contingent on, or even be hopeful of, such cooperation. Non-OPEC countries have never contributed significantly to OPEC price or revenue stabilization efforts in the past.
- The initiative will lack credibility unless the non-GCC OPEC members have already agreed, before approaching their GCC partners, on how to allocate their share of potential production cuts among themselves.
- Saudi Arabia may welcome the initiative more than recent Saudi statements would suggest. The Kingdom continues to find OPEC useful; otherwise it could have left the organization long ago. The Kingdom

has not flooded the market with its own exports, driving prices even lower in a competitive effort to expand market share. The Kingdom clearly understands and appreciates the potential benefits of cooperation.

While circumstances today are in many ways different from those surrounding the 1986 oil price war, what Mabro wrote then remains applicable today: *‘The conclusions of this analysis are that a low oil price strategy is likely to prove costly for OPEC in the medium term, and that such a strategy is totally irrational for non-OPEC exporting countries, particularly for those belonging to the Third World.’*

Our own 1986 conclusion was similar, and deserves to be reemphasized: *‘We believe that [OPEC] should have never expressed its objective in terms of market share only but rather in terms of overall revenues. As we have seen, the losses already incurred, and those to follow in the future, exceed any imaginable production sacrifice that OPEC would have had to make to defend the price prevailing on the eve of the war.’*

Notes

¹ *The 1986 Oil Price Crisis: Economic Effects and Policy Responses, Proceedings of the Eighth Oxford Energy Seminar September 1986*, Robert Mabro (ed.), Oxford: OUP/OIES, 1988.

² *World Oil Outlook*, OPEC, 6 November 2014, page 32.

³ *Medium-Term Oil Market Report 2015*, International Energy Agency, February 2015, page 12.

⁴ *World Oil Outlook*, op. cit., page 71.

