The Oil Market Through the Lense of the Latest Oil Price Cycle: Issues and Proposals

Bassam Fattouh

Senior Research Fellow
&
Academic Director of the Oil and Middle East Programme

Oxford Institute for Energy Studies

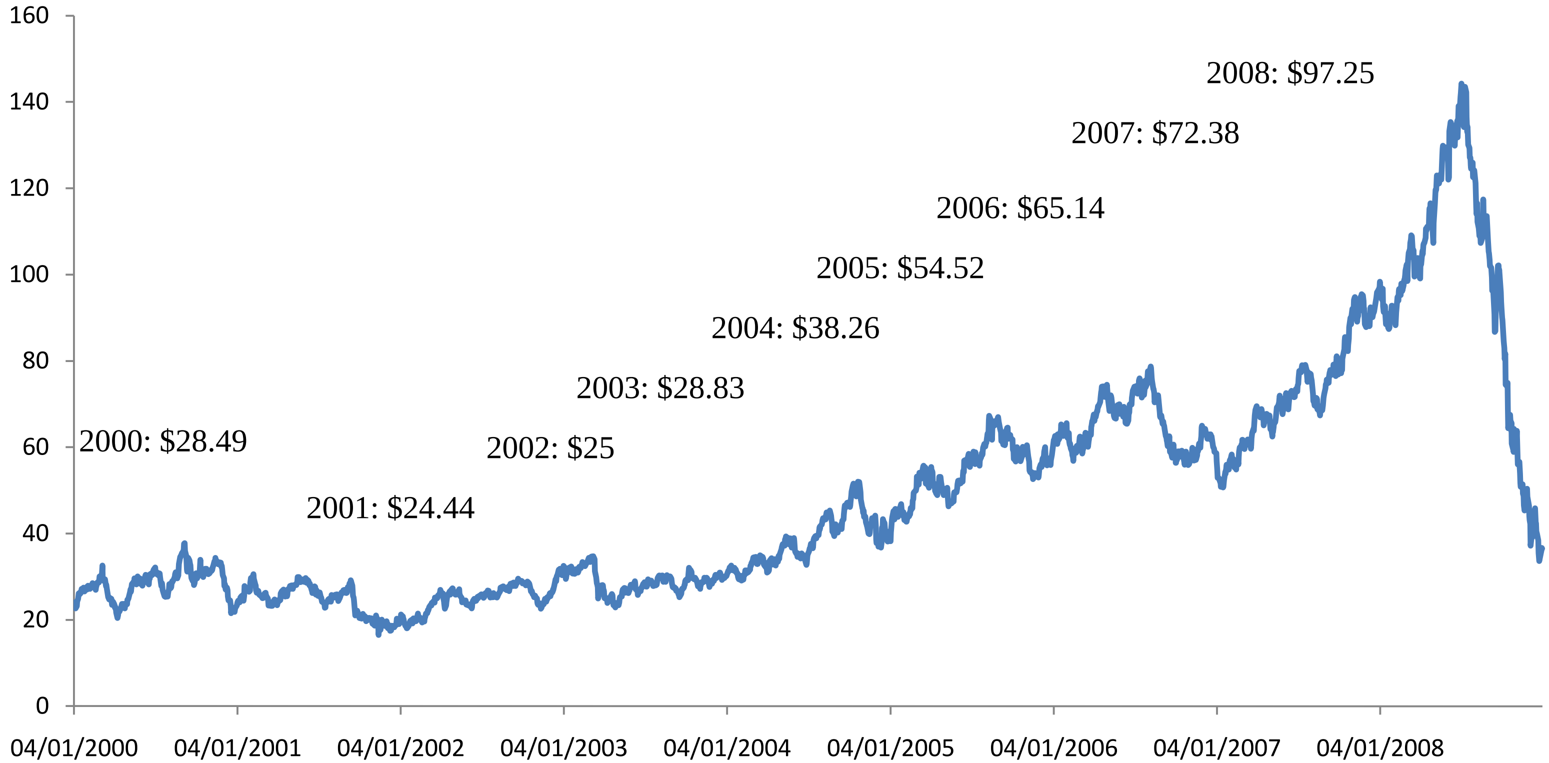
9 October 2009

Introduction

- Behaviour of oil prices
  - A sustained annual increase for seven years
  - Spectacular collapse of oil price
  - Increase in volatility
  - Dislocation of the long term oil prices
  - Dislocation of benchmarks
  - Volatile time spreads
- Polarised views about key drivers of oil prices
  - Fundamentals
  - Speculation
- A dichotomy dominates debate, but is it useful?
  - Simplistic and harmful in terms of formulating policy
- An Alternative view
  - Dual nature of crude oil as a physical commodity and as a financial asset
- Potential policy response

Crude Oil Prices: A Quick Look Back

Dated Brent: US$/Barrel



Source: BP

Notes: Annual Average

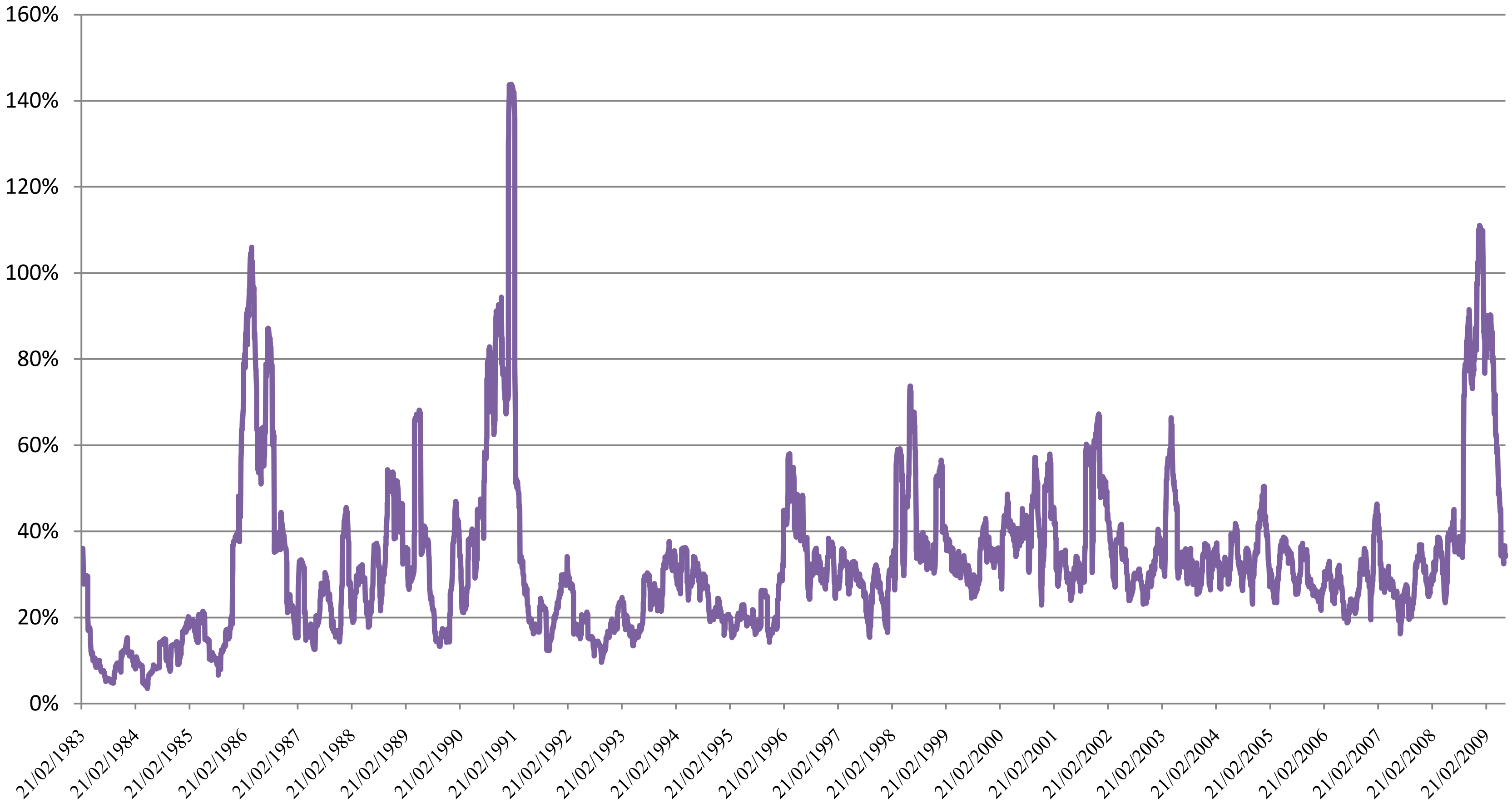
Sharp Cycles in Oil Prices

Front Month WTI Price, US$/Barrel

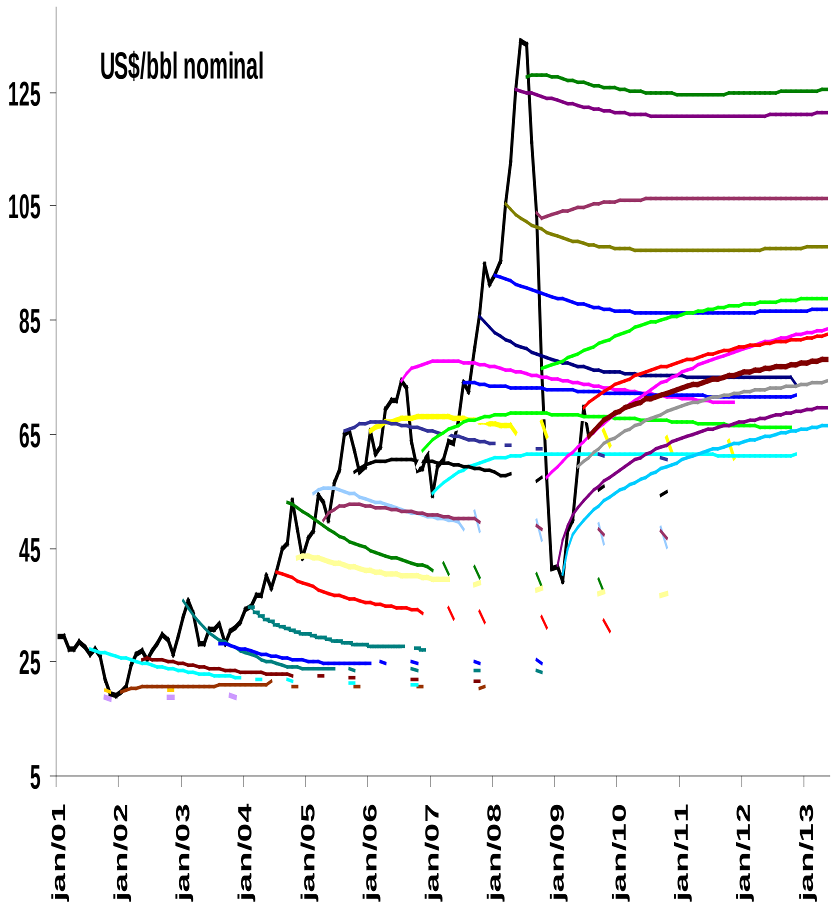
Source: EIA

Marked Increase in Volatility

Annualised Daily Volatility (1 month rolling Average)



Dislocation of Long Term Oil Prices



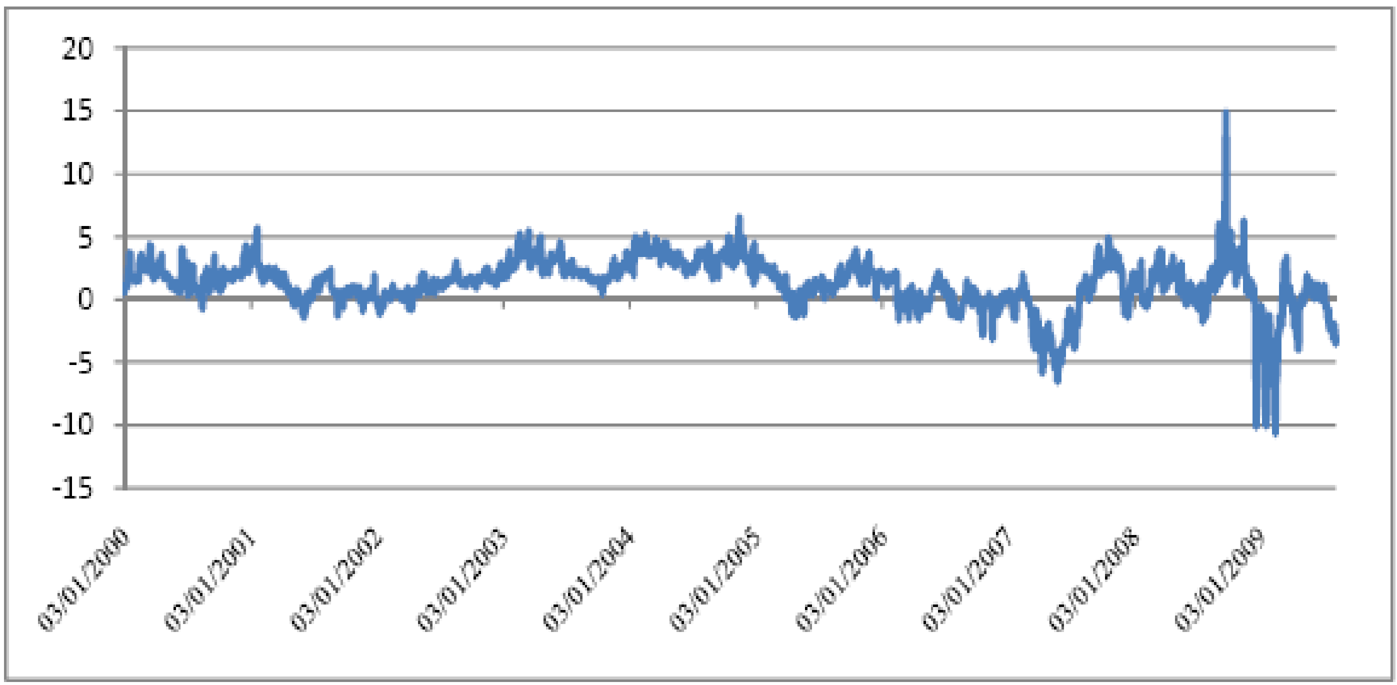
Nymex Light Sweet Crude Oil contract Front-Month Contract and 60th Contract ($/barrel)

Source: Bloomberg

Dislocation of Benchmarks

WTI-Brent Differential ($/barrel)

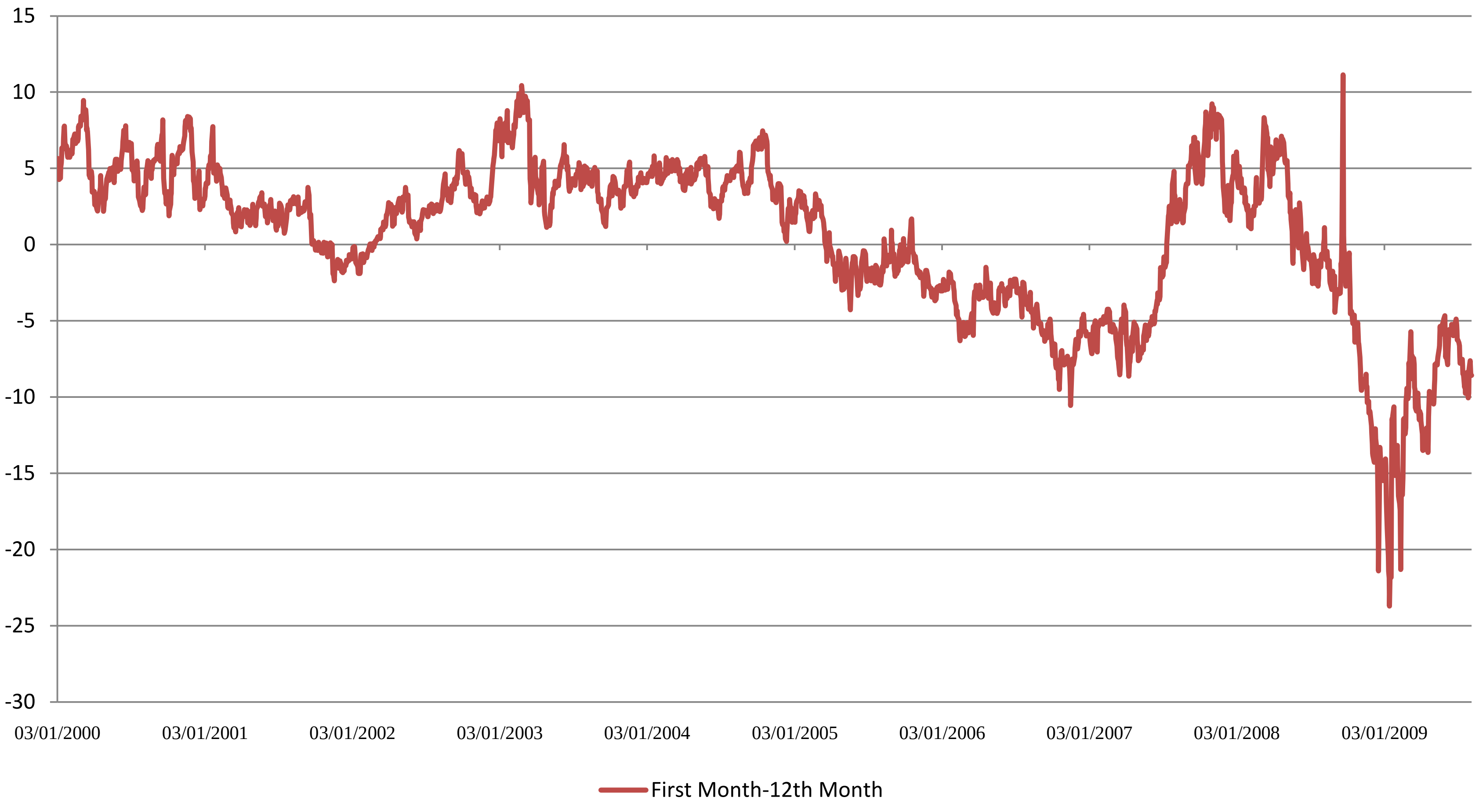
Figure 4: WTI-Brent Differential ($/barrel)



Notes: Light Crude Futures 1-month (Nymex, Closing price) minus Brent Crude Futures 1-month (ICE Closing price).

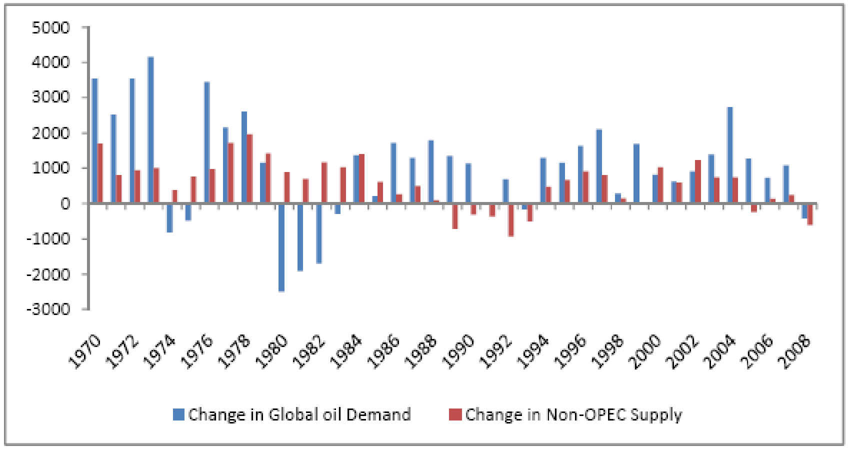
Volatile Time Spreads

Time Spreads for WTI ($/barrel)



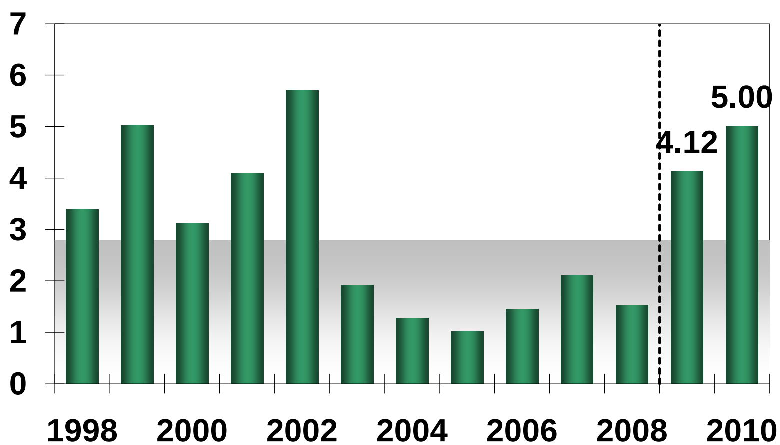
Fundamentals

Figure 9: Change in Global Oil Demand and Change in Non-OPEC Supply (Year-on Year)



Source: BP Statistical Review

OPEC Surplus Crude Oil Production Capacity



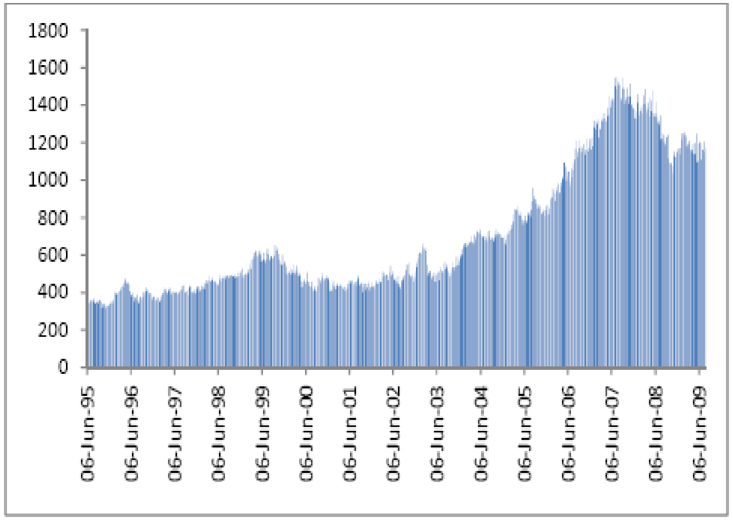
Elasticity Matters:

- Price elasticity of oil supply low
- Price elasticity of oil demand low
- Oil demand more responsive to income than prices
- Perfect recipe for oil price volatility

Source: EIA

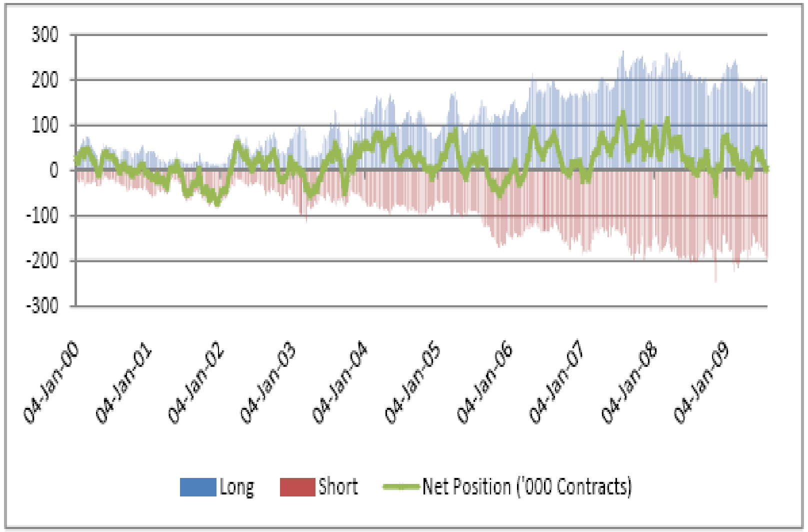
Speculation

Figure 14: Total Open Interest (Thousands of Contracts)



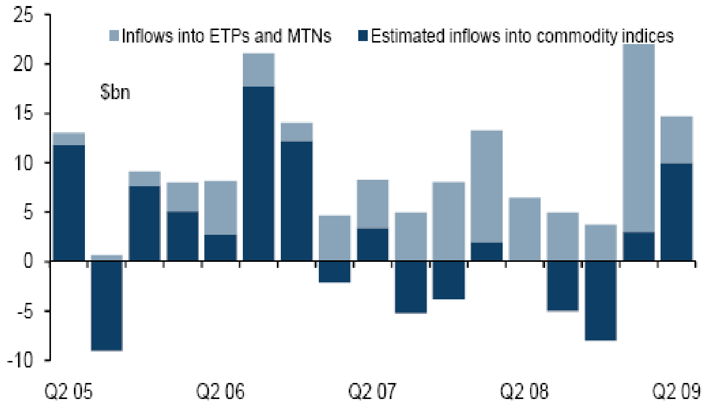
Source: CFTC

Figure 15: Short, Long, and Net Positions of Non-Commercials (000 of Contracts, Futures Only)



Source: CFTC

Figure 20: Inflows into ETPs and MTNs (in Billion of US$)



Source: Barclay's Capital

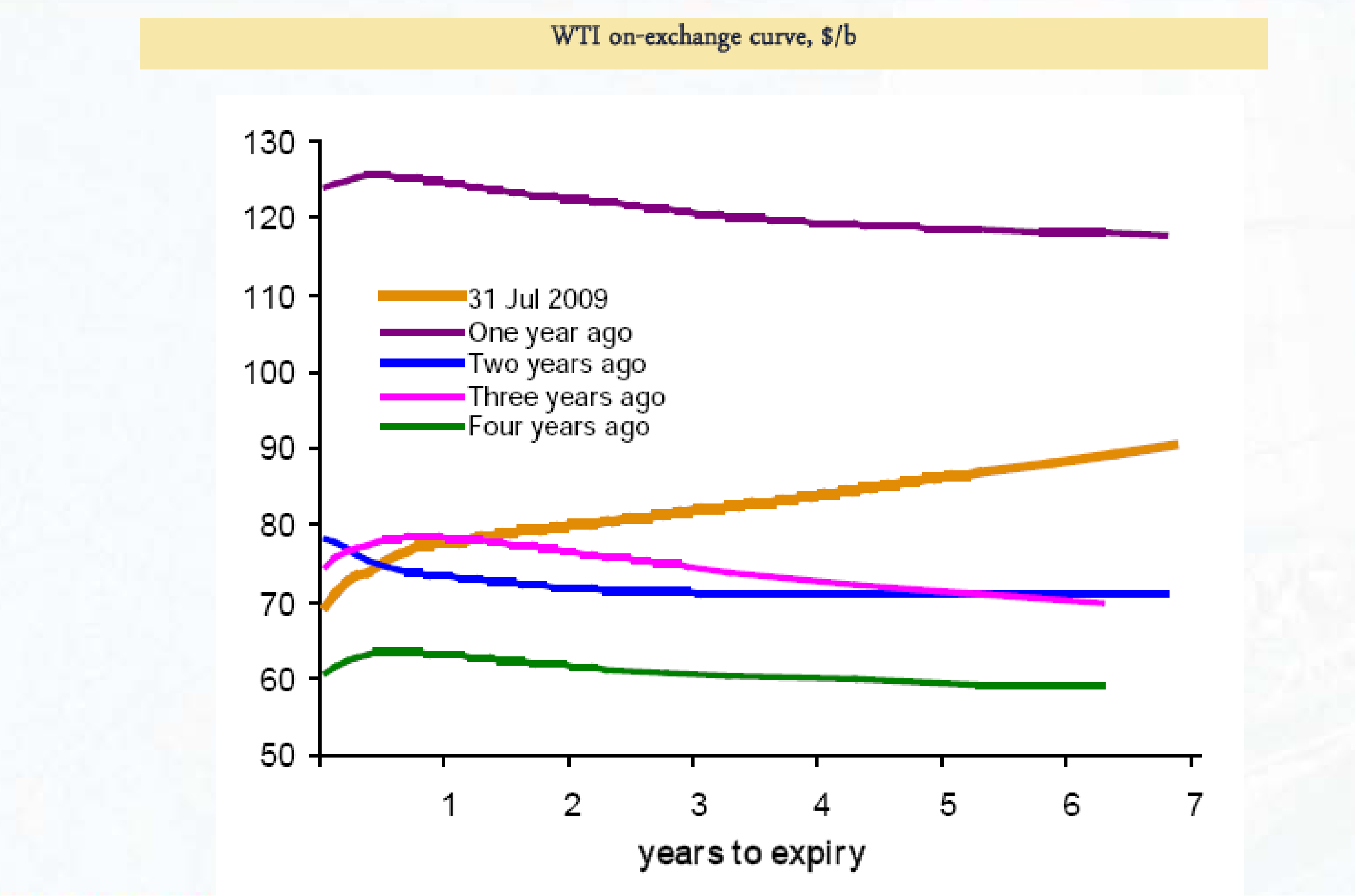
Risks to the Dichotomy

- Assumes a clear dividing line between speculators and hedgers
  - " the line between minimizing risks – which is what the term "hedge" connotes – and maximizing profits – which is what the term "speculation" connotes – can be exceedingly difficult to draw"
  - In need to define speculation
- Idea that the oil price can be sliced into various components reflecting fundamental and non-fundamental factors is theoretically weak
  - Interrelated determinants
  - By no means suggests that market always generate the 'correct' or efficient price
- Financial players don't operate in isolation of the physical parameters of the oil market
  - Choice to enter and leave market is partly endogenous to oil market dynamics
- Two layers of price discovery: paper and physical
  - What are the links between the two?

Dual Nature of Crude Oil

- Changing nature of crude oil result of structural transformations over last two decades but accelerated recently
  - Change in oil pricing regime, rapid growth of paper market entry of diverse players with different investment strategies
- Brings to forefront role of expectations in formation of price
  - Expectations of future fundamentals and news and information about future fundamentals play an important role in its pricing
    - Not only current fundamentals
  - Current market fundamentals should affect market's view about future fundamentals and the two set of expectations should be linked
  - Dislocation between short-term and long-term expectations
- Expectations the key missing link, but raises key issues
  - What affects market expectations?
  - Do financial players amplify expectations? For how long? What about governments and international organisations?

Forward Curve Out of Balance



Source: Barclay's Capital

Policy Responses

- A key question: How to stabilise market expectations? Is there a role for government policy and international coordination?
  - Distinguish between price cycles and short term (inter-day and intra-day) volatility
  - Causes are different
- Various proposals under discussion
  - Change the international pricing regime (Mabro, Luciani)
  - Spare capacity
    - It is now there, but issues of when, who, and how it would be used?
  - Regulation of derivatives (US)
    - Is it the magic bullet?
    - Very unlikely
  - Price band (UK government)
    - Heavy handed approach
  - A global oil agency (ENI)
  - Focal point (OIES)
    - Stronger when exporters and importers send a common signal as to preferable range of oil price