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

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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

2000: $28.49
2001: $24.44
2002: $25
2003: $28.83
2004: $38.26
2005: $54.52
2006: $65.14
2007: $72.38
2008: $97.25

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)
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 (in Thousands of Contracts)

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