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The world might be drifting into an oil price shock

By Paul Stevens

Arab unrest and the shale boom present Opec with a dilemma, writes Paul Stevens


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There are two new dimensions to international oil markets that are creating a dilemma for Opec and may be sowing the seeds of an oil price shock. The first is the fallout from the Arab uprising, which began in 2011. The second is the development and application of shale technology – horizontal drilling and hydraulic fracturing or "fracking" – to oil production.

A significant consequence of the upheaval in the Middle East and north Africa is that oil-producing governments need more revenue to pay for social policies that will assuage popular unrest. This requires higher prices. For example, in 2008 it was estimated that Saudi Arabia needed about $50 a barrel to balance the books. Last year estimates put the figure closer to $95.

Such high prices will produce market responses and this is where shale technology comes in. This relatively high-cost technology has led to a dramatic increase in oil production, most obviously in the US. The new *Review of World Energy Statistics* from BP shows that 2012 recorded the highest single-year increase in US oil production ever.

At the same time, high prices will also lead to oil demand destruction. In particular the impact will be felt in the Middle East, India and China. The MICs, according to the International Energy Agency, are expected to account for 68 per cent of the increase in non-OECD oil demand between 2011 and 2035. However, all three have historically had heavily subsidised oil that encouraged oil demand growth. This has been changing. With price reform in the MICs, the higher prices needed by Opec will be paid directly by consumers. That will cut demand growth. The result is unsustainable. Higher supply and lower demand will put the high prices needed by Opec under pressure.

Markets do work and the situation is very reminiscent of the period 1981-86 which culminated in the dramatic 1986 oil price collapse. Saudi Arabia then was acting as the so-called swing producer in order to defend high prices. Its eventual rejection of that role in 1985 triggered the 1986 price collapse. In the past nine months, Saudi Arabia has quietly resumed that role.

Before the 1981-86 period, new oil sources – the North Sea, Alaska and other non-Opec resources – were waiting to be tapped if prices rose high enough. Today it is the resources potentially unlocked by shale technology that lurk.

Finally, the industry consensus then expected ever-rising oil demand – ignoring the impact of the oil price shocks of the 1970s. Today there is a similar consensus that again ignores the fact that oil prices have steadily been increasing, albeit around a volatile trend since 2002, rising from $20 a barrel to more than $100.

Thus market responses will affect prices as in 1986, possibly leading to a significant collapse. The key will be how long Saudi Arabia continues to act as swing producer before the pain becomes too great, as it did in 1985. While in recent years the Saudis have been able to accumulate a financial cushion – although exactly how much is uncertain – cushions eventually disappear. If they are no longer willing or able to protect prices then these must fall. Opec, now facing extra sectarian divisions following the 2003 invasion of Iraq, would struggle to respond.

But there are differences between today and the 1981-86 period that complicate the story. Then there were no "paper" markets trading future barrels of oil. Today futures markets play a big role in price determination and lead to prices changing at a much faster rate than before. The new supplies today have a different cost structure: supplies will respond faster to lower prices than was the case in the early 1980s.

If prices do drop, it could lead to further unrest in oil-producing nations, spooking the markets. The result would be much greater oil price volatility. In that case, security of supply concerns – based on fears of physical disruption – would be overtaken by concerns about the macroeconomic impact of oil price volatility. At the very least, this would increase pressure to further regulate the paper markets.

For producers it would bring to the very top of the agenda the need to diversify their economies away from oil dependence. This has long been an aim but for the most part with very disappointing results which will, in turn, feed the consequent political upheavals. Overall, oil markets are in for a rough ride.

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