



# The “First Oil Shock” forty years after: Is a good memory still the best qualification for **a prophet?**

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# The subject of the title

- “The best qualification for a prophet is to have a good memory”

- George Savile, The Marquess of Halifax 1633-1695

- Wednesday 16th October 1973 the “First Oil Shock” was announced.

- From the events of forty years ago can we divine the future prospects for oil prices OR has the oil market changed significantly over the last forty years?

The subject of the title- From my CV

Predicting the 1986 oil price collapse

- "The Future of Oil Prices" Staff Seminar, PEMEX/IMP. March 1982. Mexico City.

- Oil Prices; The End of an Era? ODI Review 2 - 1982. Pp. 1-19

## The oil market before the 1970's

- The market was dominated by the “seven sisters”
  - Exxon, Chevron, Gulf, Mobil, Texaco, BP, Shell (+CFP = “Majors”)
- They were operationally vertically integrated which required “posted prices” as tax reference prices
- Price determination = Administered price
  - A “group of men” in a room –the producers - said a number
  - If the “those outside the room” – the refiners - believed it, that was the oil price!

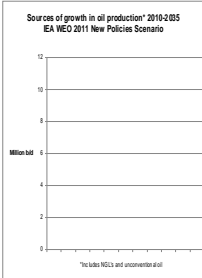
# The first oil shock

- **Pre-1970's** “The men in the room” were from the “majors” - “those outside the room” were from the “majors”.
- **Since 1950**, they had been saying a relatively low number
  - They feared competition from other fuels (mainly nuclear)
  - They feared a backlash from their own (OECD) governments
- **New developments after 1970**
  - In Libya in 1970, gov't forcibly enters the room to jointly negotiate prices
  - October 16th 1973 Arab producers + Iran in Kuwait “why do we need oil company men?”
  - Unilaterally increased price

The oil market today: very different from 1973

- The market is now dominated by the “six brothers”

# Meet the “six brothers”



The “six brothers” account for 91.2% of the growth<sup>7</sup>

## The oil market today: very different from 1973

- The market is dominated by the “Six Brothers”
- The oil price is now a market price largely based on spot prices
- BUT “the men in the room” are still relevant. however, now they are OPEC.
- AND the “number they say” now is a production level not a price



So now who are “those outside the room” who must believe in the price?

### **Wet barrel market refiners**

Trading real barrels

Spot and term contracts



### **Paper barrel markets**

“Money managers”



What are the main linkages?

“Those outside the room”?

Wet barrel market refiners



Paper barrel markets



**RESULT = Price determination doubly complicated**

**IN THE OLD DAYS** – They simply had to believe the (price) number and that was the price – made it predictable

**TODAY** – First they have to believe the production number **AND** then decide how it will affect price – makes it very unpredictable

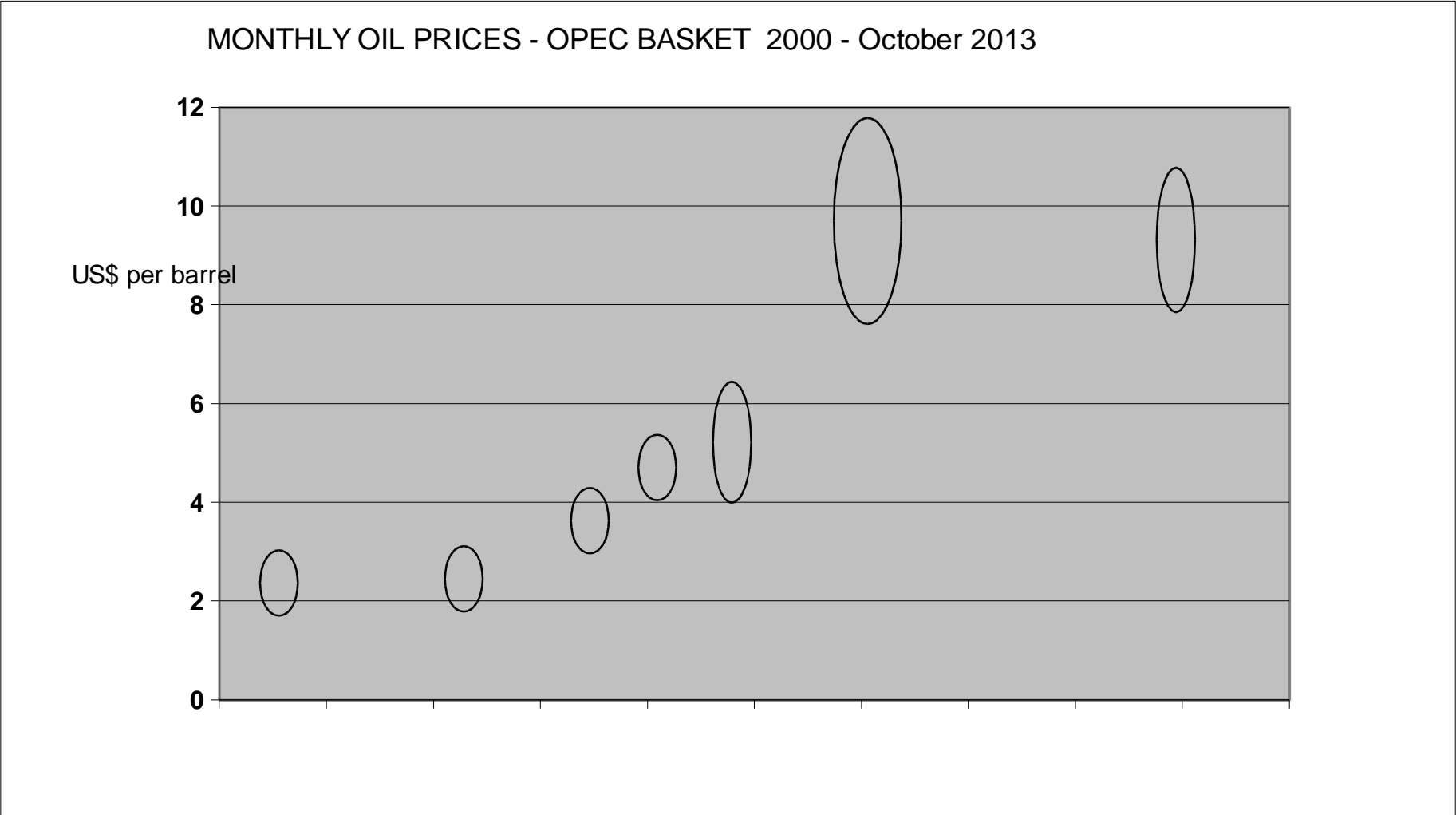
## New approach to setting price: Problems?

- Believing the production number
  - The market data on supply and demand are awful
  - Inventory data are even worse
  - OPEC members cheat
- Translating the production number into price...

Translating the production number into price  
Problems with the linkages = A disconnect



# When they misread, there is a dramatic adjustment



Use this analysis to consider a case study from history. Will it give guidance to future oil prices?

Compare 1980-86 with today's oil market given the current "OPEC's dilemma"

## “OPEC’s dilemma”

- Since the “Arab Uprisings” OPEC members need a high price to survive politically
- But this will lead to a market reaction
  - Demand destruction
  - Increased supply
- **This situation is unsustainable** and is very **similar to 1980-86**. Will it be a re-run of 1981-86 leading to a price collapse?



## Similarities to 1981-86 THEN ...

- Saudi Arabia was acting as “**swing supplier**” to protect prices – same again today
- **New oil provinces** lurked on the sidelines but requiring higher prices – same again today
- **Very bullish outlook on oil demand** which ignored price effects – same again today
- **BUT THERE ARE DIFFERENCES...**

# What are the differences from 1981-86?

- As explained **price determination far more complex**

- The rise of the **paper/futures markets** means prices are more volatile and price will change faster.

- Post the Arab Uprisings = **much greater threat of political unrest** which will spook markets and create a geo-political premium on prices

- **Greater divisions within OPEC post 2003.** 1986 rescued because of détente between Saudi Arabia and Iran. Today ...

# Conclusions

- A much lower price is likely although the timing is uncertain.
- The timing uncertainty depends upon how long Saudi Arabia will play the “swing role” ... How much “wriggle room”?
- When price falls, possible political unrest in MENA may lead to a price rebound driven by the “money managers”
- Meanwhile the potential for more geo-political outages and consequent price spikes remain very real

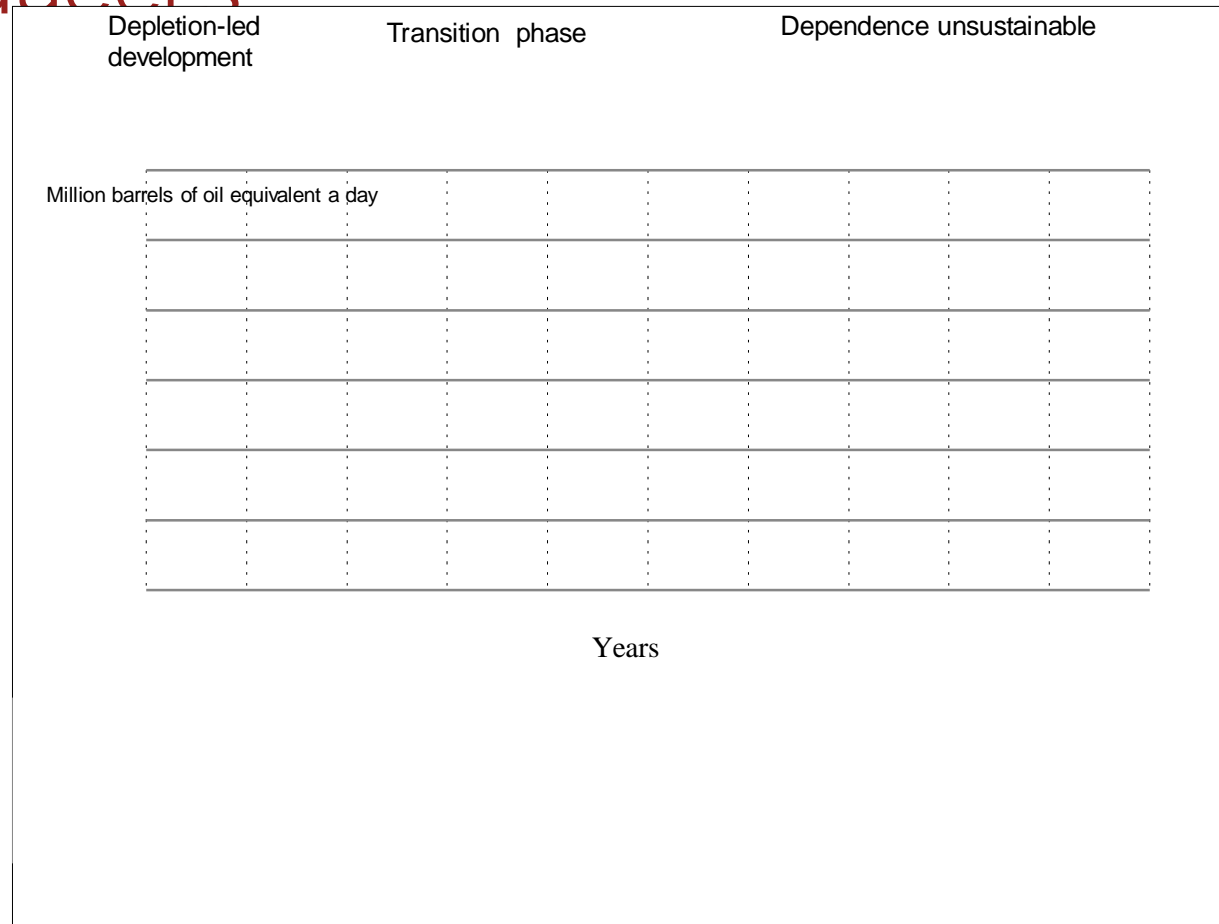
# Policy implications of greater price volatility? Consumers

- Emphasizes the **need to diversify their energy sources** away from oil although this will aggravate “OPEC’s dilemma”.
- “Supply security” will **increasingly relate to the macro-economic consequences of oil price volatility** in an international oil market which is “one big pool”.
  - Especially true in a USA with growing “Energy Independence”

# Policy implications of greater price volatility? Producers

- Emphasizes the **need to diversify their economies** away from oil BUT this is easier said than done!

- In the GCC in 1990, 61% GDP from non-oil. In 2010 51% (IMF, 2011)





## The future of the Arab Uprisings?

“When the people contend for their liberty, they seldom get anything by their victory but new masters” G Savile

# Thank you for your attention