Global Oil: Don’t Worry About Supply, Worry About Markets

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The G8’s recent statement on global oil markets reflects a concern as old as the oil age: ensuring affordable and sufficient supply for consumers. Recent events surrounding the Arab Spring have made consumers fear ever-higher oil prices. The tug-of-war over Iran’s nuclear program has added to this, as Tehran threatened shut down the Strait of Hormuz, the world’s prime ‘chokepoint’ in oil transit. Energy is the ‘lifeblood’ of modern societies, and short term oil supply disruptions call for action. In the short run, G8 leaders are therefore right in addressing shocks to the global oil market, to buffer price hikes and smoothen oil price volatility. Yet, in the long run, G8 leaders need to address the consequence of the energy world rapidly becoming more ‘Asian.’ In this context, it is not oil supply that’s in question. Rather, it is whether Beijing or Delhi will still rely on the market as a mechanism to deliver it.

Supply is not a problem

Global crude reserves are plentiful, and there is no indication that the world will run out of oil any time soon. The question is rather whether oil can find the money. To meet projected oil demand in the two upcoming decades the required global investment volume is in the neighbourhood of USD 9 trillion, according to estimates of the International Energy Agency (IEA 2011). That money might however not flow into exploration and production (E&P) unless there is a satisfying rate of return on capital. Obviously, that return is very much a function of the price. Throughout most of the 1990s, for instance, oil prices hovered around levels of 20 USD per barrel, which impacted negatively on capital spending in E&P as well as on energy technology development. So although coming with costs for consumers, oil prices at sufficiently high levels bear important benefits. They trigger investment; they foster technological progress; and they provide incentives to bring online alternative fuels. In fact, a recovering (and, in 2008, certainly overshooting) oil price seems to having yielded impressive results over the past decade. New oil finds abound globally; off Brazil’s coast, a giant deep-sea field now is being tabbed at economic costs; unconventional oil such as tight oil or Canadian tar sands have become competitive; and the U.S. oil industry currently experiences a stunning return on its homeland. As a result of the latter, the Energy Information Agency even projects U.S. oil imports to fall from 50 percent of overall consumption to only a good third by 2035 (EIA 2012). These developments are inextricably linked to technological progress. Comparably high oil price levels allowed embarking on technologically more demanding endeavors such as off-shore projects. They also provided for incentives to innovate. The deployment of ‘fracking’, a technology originating from shale gas extraction, to crude production is a key example in this regard. Finally, and importantly, they also trigger substitution effects. The rapid rise of the global biofuels industry is the result of alternative fuels becoming cost competitive against oil (in addition to being flanked by governmental policies in many Western countries).

Supply therefore is not the key problem in global oil. There is plenty of crude reserves left, even after 150 years of mankind being addicted to the ‘black gold.’ The challenge rather lies in turning reserves into available supplies. A sufficiently high oil price level will help in this regard. And there indeed is reason to assume that prices may remain around current levels. For one, global demand will continue to grow. New Asian consumers, notably China and India, will drive up total consumption which will have an effect on prices. Second, pricing policies of key producer countries are strongly driven by domestic fiscal imperatives, so probably aimed at keeping the oil price around the 100 USD level or above. This is possibly bad news for consumers in the short run. But in the long run it pays off as it will

continue to provide incentives to invest in the availability of future oil supplies – or substitutes.

New energy players will want it their way

Rather than focusing on security of supply, it would be crucial to pay attention to the bigger picture: the changing geopolitics of oil. Clearly, the global energy gravity center is heavily shifting eastwards. Oil consumption is projected to increase by 24 percent until 2013, with Asia accounting for most of the demand increment. China alone will be responsible for almost half of the global increase, and India for a third. Oil consumption in the West, in turn, will decline. By the middle of this decade, oil use in the non-OECD world surpasses oil use in the OECD (IEA 2011). As a corollary, incumbent consumers in the West will become less prominent forces in the global oil market. In short: the eastward shift therefore manifests itself as a change in rule setting power.

For most of the oil age, Western companies and governments dominated the global oil business and set the rules according to which the rest had to play. These rules were based, broadly speaking, on the Western liberal market model. Accordingly, it was mainly private market actors who were put in charge of delivering sufficient supply at affordable prices. Although markets did not always deliver smoothly (e.g. due to strikes in Venezuela, domestic turmoil in Nigeria or political conflict in the Middle East), occasionally overshot (e.g. oil prices hitting 150 USD a barrel in 2008) or were subject to incomplete competition (e.g. through OPEC cartelizing parts of global supply), this model has proven remarkably successful. Over the past decades it has ensured that oil, a high value commodity, has been effectively delivered over large geographical distances, involving a myriad of actors along the value chain. The market model has provided for the right price incentives, making sure that significant shifts in global demand got translated into an increase in global production, now standing at 87 millions of barrels a day, up from 65 just 30 years ago (IEA 2011). And despite ever-increasing global demand, still more oil keeps on being newly found than consumed.

The changing geopolitics of oil are about to tilt power towards countries less prone to embracing the liberal market paradigm. Latecomers on the market, China but also India have adopted a clearly mercantilist approach to energy supplies in order to satisfy their rapidly growing demand. While not outright rejecting free market exchange as an organizing principle, bilateral arrangements have become an essential part of Beijing's and Delhi's energy security strategy. China also uses its National Oil Companies to circumvent the global market in securing supplies and to put in place pricing arrangements that don't reflect competitive global price levels. India, a catch-up economy, also brings a strong development agenda into energy policy, in addition to classic energy security concerns. In this, it is supported by other nations in developing Asia, home to a large share of 1.3 billion people living without access to modern forms of energy worldwide (Birol 2012). Obviously, catering various overlapping energy policy goals comes with a much stronger dose of state intervention. This more statist Asian approach to energy policy blends well into a more general distrust into free markets as the incumbent global model, often viewed as a system ensuring Western domination. In other words, the market paradigm in global oil is no longer uncontested.

Implications for G8 policy

The eastward shift in global oil implies that policy priorities set in non-OECD countries will eventually determine policy pathways for the Western world – the new rule takers (Goldthau 2012). The G8, an organization initiated in the 1970s to address energy security concerns, needs to embrace this fundamental shift. While important, addressing short term fluctuations in the oil market are clearly not the prime policy challenge here. Emerging producer and consumer heavyweights China and India have already started to impact on the rules of the game in global oil. Strategies need to be developed on how to smoothly accommodate the newcomers in the global marketplace without compromising a successful organizational principle in resource allocation – the market itself. The G8, representing the seven largest (Western) economies plus Russia, a significant share of global oil consumption and the world's largest oil producer, has a role to play here. For this, however, it needs to re-focus its attention, away from short-term outlooks to long-term geopolitical shifts in global energy.

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Notes

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