Oil Markets: why do people keep talking about when the market returns to balance?

by DIETER HELM

Oil prices have a habit of turning normally rational people into “believers”. Take the current discussion about OPEC and the market reaction to a few words from Saudi Arabia. The market moves up in response, as part of a process of “gradually returning to balance”. They “know” the long-term price is higher than the current price, and it is only a matter of time before demand catches up with supply, and the price goes back to at least a $60-70 range.

Why? Why should anyone believe that that current price is “wrong”? Does price not tend to equate demand and supply? Is the current price above the marginal costs of production? Isn’t the current market already in balance?

The convention argument is that at current prices, production will continue to fall and demand will keep going up. It is assumed that the marginal production is outside OPEC, and that the marginal cost of this new production is up there at $60-80. So that is where the price will balance the market.

Almost everything in this argument is open to challenge. First, the marginal cost of US shale oil has consistently fallen, and it is probably already at or below $50. That is what happens in markets when prices fall. Costs which were tolerated in a boom and high prices fall in a bust. Second, there is lots and lots of oil at a marginal cost of less than $10. Iraq is already at a record level of production following the US invasion over a decade ago. It is pushing towards 5mbd. Iran is boosting production too. And so is Saudi Arabia. All these countries need the money to meet their growing budget demands, built in a world in which they assumed they could spend up to $100 a barrel. If the price is now say $50, and their marginal cost is say $5-10, they have every incentive to pump as much as possible. And that is exactly what they are doing with lots of scope to push out the envelop further.

The third element is the real killer for the believers in high prices. Demand responds to the price of oil, but it also responds to the price of substitutes. Add in the digitalisation of the world’s economies, the expectation of a gradual electrification of transport and the abundance of cheap gas, and the writing is on the wall for longer-term demands for oil.

If most of your economy is based upon oil revenues, and you expect demand to fall over the longer term, you must expect the price to be gradually falling over this period. It means oil today is worth more than oil tomorrow.

My books - The Carbon Crunch along with The Burn Out: The end game for fossil fuels (due March 2017) cover this topic in more detail...

What do you do? Pump as much as you can now, and try to invest it elsewhere, including transitioning your own economy away from oil. That is a pretty good summary of the new Saudi economic strategy.

The conclusion is very different from those who believe in the gradual process of bringing the market back into balance at a significantly higher price. It is that the market may already be in balance. Prices may of course rise in the short run, but then there is always volatility around the trend. Prices can rise and fall, but it is the trend that matters.