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Theme 200

OIL SHOCK AND ENERGY SECURITY

- PART - I

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**Theme No. 200 : OIL SHOCK AND ENERGY SECURITY – PART-I**

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With crude oil prices skyrocketing to new highs within a short span of time, it is hard to believe that fundamentals of demand-supply imbalances alone are spurring the oil prices. There are concerns about long-term supply constraints: estimates for North Sea and Russian crude production have been steadily declining, and global spare capacity has fallen to 2 percent of production from a historical average of 3 percent to 5 percent. But analysts express the view that this hardly justifies the doubling in oil prices over the past year. In 1970s, oil prices rose in similar meteoric pace owing to supply disruptions. But the present supply position does not vindicate such a crude price rally.

“The current oil price has no relation to market fundamentals,” explained Saudi oil chief Ali al-Naimi “It is linked to tremendous speculation in crude oil futures. There are even those who buy futures and speculate that oil prices will reach \$200 in 2013.”

The OPEC chief Chakib Khelil observed that crude oil prices were climbing, “even though supply is adequate, because the market is driven by the dollar’s slide. Each time the dollar falls 1%, the price of the barrel rises by \$4, and of course vice versa. If for instance, the US dollar would strengthen by 10 percent, it is probable that oil prices will fall by 40 percent.”

“A trend in motion, will stay in motion, until some outside force, knocks it off its course!” After watching the parabolic rise in crude oil prices, doubling from a year ago, to above \$130 a barrel in June 2008, there are analysts expecting this as a “bubble” that is destined to burst under its own weight, and at a moment’s notice.

Crude oil is one of the most basic global commodities and fluctuations in the crude oil prices have both direct and indirect impact on the global economy.

The price variation in crude oil impacts the sentiments and hence the volatility in stock markets all over the world. Price rise in crude oil virtually impacts industries and businesses across the board. Higher crude oil prices mean higher energy prices, which can cause a ripple effect on virtually all business aspects that are dependent on energy, directly or indirectly.

## **What are the basic factors that account for increase in fuel prices?**

According to analysts, the sources for the current price increase can be divided into two categories, the '*traditional fundamentals*' and '*new fundamentals*'

### *The 'traditional fundamentals'*

The traditional fundamentals start with the **supply-demand** mismatch. The growth of various developing countries like India and China is fueling the increasing demand for energy. But the supply side is not able to keep pace with the growth in demand. There are various reasons for this like uncertainty about investments, fiscal and regulatory regimes. The nationalization of oil and gas fields across the world from Russia to Bolivia is an example of this. This creates uncertainty in the minds of prospective investors like Oil exploration companies about the safety of their investments in oil fields, most of which are located in politically unstable regions. In Mexico, lack of investment due to restrictions on foreign investment is hampering the oil exploration in the prospective Gulf of Mexico.

A large part of the world's crude oil share is produced by OPEC (Organisation of Petroleum Exporting Countries) nations. Any decisions made by OPEC countries to raise the prices or reduce production, immediately impacts the prices of crude oil in the global commodity markets. But the recent phenomenon of sudden increase in prices is not directly caused by any of the OPEC actions.

The other major reason is **Geo-politics**. Disruption or mere fear or perception of risk regarding the reliability of supply is sufficient to increase crude prices. About 40 percent of Nigerian oil output was disrupted due to rebel attacks over the oil pipelines. The news of emerging crisis in the Middle East affected oil and gas production and increased crude prices drastically. In Iraq the production is far less than the pre-war days production capacity. Events like a hurricane hitting the oil producing areas in the US have driven the crude oil prices.

Oil producers and consumers build a storage capacity to store crude oil for immediate future needs. They also build some inventories to speculate on the price expectations and sale/arbitrage opportunities in case of any unexpected changes in supply and demand equations. Any change in these inventory levels triggers volatility in crude oil's prices which in turn creates ripples in the stock markets. The gradual depletion of inventory might be

one of the reasons for the sudden spurt in oil price.

### *New fundamentals*

**Doubling of costs** – Oil prices were very low during 1980s and 1990s and this had a dramatic impact on the oil industry. It meant investments were scaled down, drastic cost-cutting strategies were put in place, research and development spending was reduced. This short-fall led to doubling of costs, and postponement or in some cases abandonment of oil exploration.

**Speculators** – The role of speculators in crude price rally has been controversial. Speculators play an important role in price formulation in the market by responding to and by accentuating supply and demand, geopolitics and other trends. They are blamed for irrational exuberance and generating bubbles. Sentiment is also an important factor: if traders in the oil market believe there will be a shortage of oil supplies, they may raise prices before a shortage actually occurs.

Another element driving oil prices relates to the role of regulated oil futures and unregulated over-the-counter (OTC) exchanges. The trade in paper barrels has expanded dramatically in recent years. For example, the ratio of paper barrels traded on the NYMEX (New York Mercantile Exchange) to the physical barrels actually supplied has exponentially increased over the last four years. In 2003, for each physical barrel, six paper barrels were traded; today, that ratio has risen to more than 18. These ratios are even higher if London and Singapore futures exchanges, the unregulated OTC transactions, index trading and derivatives products are taken into account.

**Turbulence in Currency Markets:** - The fall in the value of the dollar in relation to other currencies especially Euro and GBP might have accelerated increase in the international price of oil. If crude oil speculators on the NYMEX were buying “black gold” as a hedge against the US dollar’s slide against the Euro, traders in London were buying North Sea Brent crude as a hedge against the British pound’s devaluation against the Euro. The recent credit crisis in the US and **weakening of US Dollar** have added to the woes as weakening US Dollar means increasing oil prices in terms of US Dollar.

### **Are cost-push factors decisive in surge in fuel prices?**

An important factor that today hampers the economics of upstream projects is the cost of engineering, procurement and construction and petroleum services, as well as the cost and availability of skilled labour. In recent

years, the oil industry has witnessed huge increases in the cost of raw materials, as well as in all segments of petroleum services. Rapidly rising upstream costs point to higher breakeven prices for some capital intensive oil investment projects. Some estimates point to upstream costs having more than doubled since 2000.

### **What is meant by the term ‘Peak Oil’ and is it something a cause of concern?**


‘Peak oil’ is just the point of maximum global oil output at any particular time. The term indicates the historical point at which the annual volume of oil production is the highest it has ever been or ever will be.

Once the peak is hit, the demand for oil will always be greater than the supply. This will cause prices to skyrocket. Once the peak is reached, global oil production begins to decline, continuing a downward trend until the oil that remains in the ground is unrecoverable at any price because it takes more energy to pump the oil than that can be recovered by drilling.

“Peak Oil” is a worldwide concern among oil experts and geologists. After the peak of production is reached, the amount of oil which can be drilled and recovered falls at a dramatic rate. In another words, beyond peak level of production, the world will produce less and less oil with each successive year.

### **Do we know for sure that the worldwide production levels have reached peak levels?**

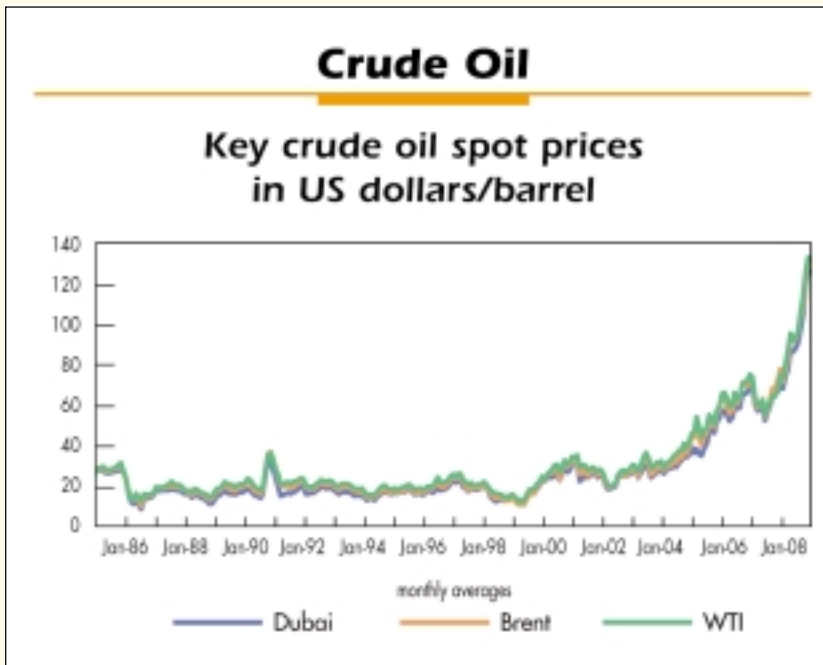
No, but there are great warning signs. It is made known that major oil fields have had huge amounts of seawater injected into it for several years. The purpose is to float the remaining oil in the field to the surface to aid in extraction. Injecting water into an oil field is one of the last stages of the petroleum life of the wells. Signs such as these lead some scientists to conclude that oil production capability may be on the downward side.

A consensus is forming among true oil experts and geologists that petroleum production has recently peaked, or will peak within the next few years. Peak Oil has serious ramifications. The output from many of the “giant” and “super-giant” oil fields is now declining, and recently new discoveries of such fields have come to a naught. It is unlikely that new super-rich oil fields will be discovered to replace the aging oil fields. These trends all point to a near-term peak in petroleum production. International Energy Agency (IEA), which had previously held that “peak is decades away”, has recently revised their future-production estimates substantially downward. 

## World Supply of Energy by Sources Projections for years 2006-2030

	Fuel shares (%)			
	2006	2010	2020	2030
Oil	37.3	36.3	34.6	32.7
Coal	27.6	28.1	28.6	28.4
Gas	22.2	22.5	23.2	24.4
Nuclear	6.8	6.5	6.2	6.2
Hydro	2.3	2.4	2.5	2.6
Biomass	3.2	3.5	3.8	4.1
Other renewable	0.6	0.7	1.1	1.6
Total	100.0	100.0	100.0	100.0

Source: OPEC World Energy Outlook, 2007



Source: International Energy Agency - World Energy Statistics, 2008



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