Replay of 1986 price collapse looms

Chatham House warns that the price of oil is heading for a crash similar to that seen almost 30 years ago when world oil prices fell by over 50%, writes Damon Evans

THE oil price is heading for a crash reminiscent to the 1986 collapse, when world oil prices fell by over 50%, an energy economics expert from UK think tank Chatham House warned.

Professor Paul Stevens, who is also a specialist on the political economy of the Gulf States, told the Australian Petroleum and Exploration Association (APPEA) conference that the oil price is heading for a big fall over the next one to two years.

He had that while there are striking similarities to the price collapse in the period 1981-86, this time around, he believes the correction will happen in a much shorter space of time and it will rebound quicker too.

In the run up to the crash of 1986, Saudi Arabia was acting as a swing supplier to protect prices, new oil provinces lurked on the sidelines, notably the North Sea and Alaska, but required higher prices to develop, similar to the unconvetional story today, and similarly the collapse was preceded by a very bullish outlook on oil demand, which ignored price effects.

Stevens believes that the shale-technology revolution in North America, which is boosting world oil production, combined with the Arab uprisings over the past two years has resulted in what he calls "Opec's dilemma".

The legacy of the uprisings, which swept across the Middle East and North Africa from March 2011, resulted in the need for higher supply prices to help pacify nations and ensure their political survival. But "the big uncertainty is for how long the Saudis are willing and able to defend the price they need. It's not just Saudi Arabia, but it is the price maker, although they would publicly deny acting as a swing producer for the past six months," Stevens told reporters.

The resulting effect is a market reaction that will trigger demand destruction and boost supplies.

"This situation is simply unsustainable and reminds me of a re-run of events leading to 1986," said Stevens.

As in the early 1980s, world oil prices have been steadily rising and they will almost certainly feed into a reduction in demand, but there are some differences today, he added.

The rise of paper markets means prices are more volatile and will respond faster to change.

The cost structure of new supplies, namely the unconventional fields, has increased the price elasticity of supply, meaning the amount of barrels pumped will react much faster to a price fall as the marginal cost of production is much higher.

Another difference to 1981-86 is that demand is increasingly isolated from crude price changes as a result of sales taxes. Therefore falling prices do not necessarily equal higher demand.

The emerging market economies, which are projected to make up 68% of non-OECD oil demand growth by 2035, and have a long history of subsidising domestic fuel prices, are increasingly replacing those handouts with taxes to boost their coffers. In 2009, China not only started to introduce oil price reforms, but also taxes aimed at cutting oil consumption and improving efficiency.

India is increasingly cutting its oil subsidies too, while the Middle East nations are discussing reforms, but given the potential for civil unrest they are unlikely to push up prices just now. Another contrast to the early 1980s is that Opec is no longer as united as it was. "It's worth remembering the oil price collapse of 1986 was rescued because Saudi Arabia and Iran were able to sit down together and come to an agreement. The chances of that happening today are rather unlikely," noted Stevens.

Back to the future: Are 1980's market conditions set to return?

He concluded that the world is looking forward to much lower prices, but the timing depends upon how long Saudi Arabia can financially afford to play a swing role.

The oil price collapse of 1986 was rescued because Saudi Arabia and Iran were able to sit down and come to an agreement. The chances of that happening today are rather unlikely

But when the price falls, potential unrest in the Middle East and North Africa could lead to a rebound as "excitable 23-year-olds in the Nymex and ICE exchanges are quite likely to push prices up again" thereby further strengthening market feedback loops.

Meanwhile, the potential for geo-political outages sparking price spikes remain very real, particularly in Nigeria.

Overall there will be much greater oil price volatility, which will encourage consumers to diversify their energy sources away from oil, which in turn will aggravate Opec's dilemma said Stevens.

Oil producers will need to diversify their economies, much like Indonesia, Malaysia and Norway have.

At the same time, markets and policy makers' concerns will shift away from those of physical availability and import dependence to the macro-economic consequences of oil price volatility in an international market that is effectively "one big pool". ●