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COMMENTARY

The Oil Market: It's All About Demand…For Now

Frank Verrastro
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Less than six months ago, as oil price futures approached the $150 per barrel mark, many analysts (including the energy team at CSIS) publicly commented that the then-current trends were unsustainable and that eventually the persistence of high prices would lead to demand destruction, mandates for improved fuel efficiency, and the development of additional supplies—both conventional and alternatives. We also predicted that 2009 was likely to see an increase in surplus productive capacity around the world and ultimately lower oil prices.

What we did not foresee was the extent to which, in a matter of a few short months, the U.S. mortgage problem would become a full blown economic crisis and how rapidly the recessionary clouds would move east to span across the globe. As a consequence, rather than seeing slower economic growth and reduced energy demand limited to the United States and Europe, we instead are witnessing significant demand destruction in all corners of the globe.

The most recent decision by the Organization of the Petroleum Exporting Countries (OPEC) to curtail production (their third such reduction since September) is, in fact, a calculated yet panicked attempt to chase down demand in order to "rebalance" an oversupplied market and restore some level of price stability that allows both consumers and producers to survive without being whipsawed when demand and economic growth returns.

On Wednesday, December 17, the 11 quota-compliant members of OPEC (Iraq has no quota) agreed to reduce production by an additional 2.4 million barrels per day (mmb/d) from their actual September output to an "adjusted" level of 24.85 mmb/d. Although this 2.4 mmb/d reduction represents the single-largest cut to which the organization has ever agreed, in net terms, it actually requires the removal of more than 3.0 mmb/d from estimated production levels seen only last month.

In addition, as a consequence of both OPEC overproduction and reduced demand this fall, global oil stocks have increased—now representing 57 days of forward cover—so reductions also need to take into account the price impact of inflated inventories as well as prospects for further economic and energy demand declines. These factors will only serve to exert further downward pressure on prices.

In short, despite OPEC's desperate but necessary action, it remains unclear if even cuts of this magnitude will be sufficient to stem the free fall in prices anytime soon. Working off the "surplus" will take time—likely the better part of 2009. The most dangerous time for OPEC will come in the first half of the year when Organisation for Economic Co-operation and Development (OECD) demand typically declines as developed nations transition between the heating and driving seasons and refinery needs are low due to service and maintenance turnarounds.

That being said, hard economic times affect the supply side of the ledger as well as demand. Unless there is commercial justification to warrant the timing of new investments, new supply projects are likely to be delayed or cancelled, especially in the case of the more expensive nonconventional fuels and some renewables. The same is true for the timing of efficiency projects (which in a lower price environment lose some of their luster). And while it is the case that as prices decline, drilling, labor, and equipment costs will also decrease, the real question is one of timing and lags.

Implications for Energy and Environmental Policy

In a lower price environment, things change. Actors, including nations, behave differently during periods of surplus than in times of shortage. Lower economic growth generally means lower energy demand, and in the case of fossil fuels (which compose 85 percent of global energy use), lower greenhouse gas emissions. In a sense, we have been given a reprieve of sorts, a break from escalating demand, rising prices, and emissions growth. But this respite is likely to be all too brief. Just as high energy prices lead to economic downturns, persistently low prices stimulate economic recovery and ultimately lead to increased energy demand.

The incoming Obama administration, while admittedly faced with an array of daunting challenges, nonetheless has a unique opportunity to reset the energy system and pave the way for a more reliable and sustainable energy future. But it must be one that balances our economic, energy security, and environmental goals. Achieving this balance will require some difficult trade-offs and the recognition that transformation takes time, likely decades, rather than a single term of office. Having the "vision" of the future is only part of the puzzle. Resetting the system and managing the transition will require the maintenance of conventional fuels delivery (in environmentally acceptable ways), even as we develop and deploy the next generation of low emission fuels.

Frank Verrastro directs the Energy and National Security Program at the Center for Strategic and International Studies in Washington, D.C.