Cycles and the international oil industry: where are we today?

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The international oil industry has always been characterised by cyclical behaviour. In particular, there are clear political and contractual cycles. These arise because of the nature of the relationship between the owner of the oil under the ground and the operator whose role is to get the oil above ground and to market. The owner of the oil in virtually all legal systems outside of the United States is the government. In the United States it is the property of the landowner who in any case is often the federal or state government. The operators, for much of the history of the industry, have been the international oil companies (IOCs).

The basis of this relationship between government and IOC is the contract negotiated and signed before the process of exploration begins. There are a great variety of such contracts ranging from concessions where the government gives the IOC operational control and taxes the profits to various production-sharing agreements where the government and its national oil company (NOC) participates in the operations and takes a share of the output. However, whatever the nature of this contract, its prime function is to divide the economic rent from producing and selling crude oil. This is the difference between the full cost of production including an acceptable rate of return on investment and the market price at which the oil sells. This is large and not surprisingly, the subject of considerable haggling between the two parties. For example, in Saudi Arabia the full cost of producing a barrel is currently less than US$5 while market prices are over US$70 and in 2008 reached over US$147.

This agreement gives rise to the contractual cycle which comes out of something known as the "obsolescing bargain". This concept, first identified by Ray Vernon at MIT in the 1960s although grand sounding is very simple. The terms of the contract are the outcome of the relative bargaining power of the two parties at the time of negotiations. This will be affected by many issues such as the competence of the negotiators, the attractiveness of the exploration acreage and the extent of competition among the IOCs to name but a few. However, once oil has been discovered and the investment sunk in developing the field, the bargaining power switches dramatically in favour of the government. This invariably results in demands by government to renegotiate the agreement to secure a greater share of the rent. Incidentally, this phenomenon is not something which is only associated with "dodgy governments" in "dark continents". Among some of its most belligerent adherents have been the governments of UK, Norway and Canada.

Related to this contractual cycle is the political cycle of "resource nationalism". There are many definitions of "resource nationalism", especially given its recent resurgence in countries as diverse as Venezuela and Russia. The simplest version has two components – limiting the operations of IOCs and asserting greater national control over natural resource development. When the government lacks capacity to find and develop its own oil, it depends upon the IOCs. However, the country over time increases its own capacity to manage its oil resources. The government therefore begins to demand greater control; a process that is reinforced by the operation of the "obsolescing bargain". It then pushes out the IOC and often reduces production levels. If a number of producers follow suit, oil supplies are constrained and prices rise. Higher prices with correspondingly higher government revenues means governments are better able to do without the IOCs or indeed greater production. In effect "resource nationalism" becomes a self feeding cycle. However, at some point the rising price produces a reduction in demand and an increase in supply from other sources. Prices fall and governments find themselves strapped for cash. Greater production is required and the IOCs are encouraged to re-enter. The higher production forces prices even lower increasing the imperative for governments to raise oil exports.

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The political and contractual cycles together go a long way to explain the history of the oil industry. When the large fields of the Middle East were first discovered in the middle of the Twentieth Century, the contract terms were extremely favourable to the IOCs. This reflected both the power of their home governments in terms of colonial control over the countries and the lack of negotiating capacity on the part of the producer governments. During the 1950s and 1960s, these governments, especially in the Middle East and North Africa, became more aggressive over changing the contract terms and developing the capacity to manage their own oil. This culminated in the nationalisations of the early 1970s when in most producing countries the governments took over the operating companies owned by the IOCs. This process was strongly reinforced by a more general nationalistic drive which emerged from the post-colonial period and the advent of the "Third World". It was also encouraged by the two oil price shocks of the 1970s which reduced the need for governments to increase output.

After the oil price collapse of 1986 which was triggered by lower oil demand and the rise of non-OPEC supplies, producer governments started to look again at getting the IOCs to come ▶

◀ and develop their oil resources. Contracts were negotiated and signed and fields developed and produced. However, after the oil price collapse of 1998, as OPEC began to get its act together, oil prices began to rise. At the start of 2002 oil was US$20 a barrel which rose inexorably to over US$140 by mid 2008. In such a world, the "obsolescing bargain" re-emerged. Many governments demanded a revision of the fiscal terms which determined the split of the oil rents. At the same time, there was a growing view among producer governments who believed prices would rise forever, that since "oil in the ground was worth more than money in the bank" the IOCs were no longer needed. At the same time, populist politics encouraged the exclusion of the IOCs. In Latin America it was perceived that the IOCs had produced "our oil and our minerals" and there had been no tangible benefit to the "wretched of the earth" despite the fact that IOCs had been paying large tax revenues to their governments which meant because many were kleptocracies, the fault lay there rather than with the IOCs. Thus "resource nationalism" was alive and flourishing and the IOCs were being pushed away from prospective acreage.

The key is to remember the cyclical nature of these phenomena. While oil prices were rising as they had been since 2002 reaching a peak in July 2008, "resource nationalism was a luxury which producers can afford. However, the collapse in prices at the end of 2008 caused a number of producer governments to reconsider. Many began to think again about encouraging the IOCs to become involved in their upstream. This was true even when prices began to recover in 2009 and entered 2010 in the US$70 to US$80 per barrel range. However, there were several problems with these approaches. First, the obsolescing bargain experience during the ramp up of prices between 2002 and mid 2008 made many of the IOCs very suspicious of the terms of the contracts being offered. The IOCs perceived that any agreement on terms would not survive very long, especially if the oil market showed signs of further recovery. Second, because of the global economic recession and its impact on oil demand, the amount of excess capacity to produce crude oil was high with the International Energy Agency estimating it at over 6 million barrels per day in May of this year. Thus, IOCs are concerned that if they were to develop even greater crude producing capacity they would not be allowed to use it as OPEC sought to defend prices. Finally, in many cases, the terms on offer failed to provide a rate of return that would be attractive to the IOCs. In the absence of such attractive returns, the financial strategy adopted by the IOCs (value based management) meant they preferred to return the funds to their shareholders.

All of this carries important implications for future oil markets. Oil demand growth will return as the global economy recovers from the recent global economic recession. Although it is now generally accepted that OECD oil demand has probably peaked, there is still appetite for more growth in Asia, the Middle East and Latin America. Oil supply also faces constraints. The recent oil spill in the Gulf of Mexico may restrict access to more deep-water acreage and production, and not just in the United States. In addition, many producer governments are reluctant to allow their NOCs to invest more partly because of existing over-capacity and partly because they are seen within the governments themselves as being high-cost and inefficient rent seekers. Together, all this points over the next five to ten years to an erosion of the spare capacity to produce crude. As the spare capacity falls the oil market becomes vulnerable to outages of oil supply triggered by geopolitical events. When an outage occurs in a tight oil market, the resulting supply crunch leads to price shocks. If this were to happen there is a danger that the oil importing governments will resort to the type of ill thought out energy policy responses that characterised so much of the 1970s. Before that happens, there needs to be a grown-up discussion of possible joined-up energy policy options. At the very least this should try and mute any tendency to knee-jerk policy responses which have been so ineffective but also so costly in the past. ❑

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Upgrading work at Suncor's oil sands refinery, Alberta, Canada