The Consumer-Producer Dialogue: Themes and Prospects

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Your excellencies, Ladies and Gentlemen

It gives me great pleasure to be with you here today. I would like to thank the organizers for their kind invitation, and for giving me the opportunity to address this distinguished audience. In the short time at my disposal, I will focus very briefly on five main themes that have been at the core of the consumer-producer dialogue.

The first theme concerns oil price stability and whether there are mechanisms that could help to stabilise the oil price within a preferred price range.

The second theme relates to physical disruptions and energy security. I will argue that the impact of producers' and consumers' reaction to the Libyan disruption has not been neutral on oil price behaviour and rather than reducing the cost of adjustment for market participants, may have contributed to increased price volatility.

The third theme concerns the role of spare capacity and how the dialogue has dealt with this key issue.

The fourth theme concerns the issue of investment in the oil sector.

The final theme concerns the role of signalling and whether the IEF could play a more important role in communicating some key messages to market participants.

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The price instability is linked to a fundamental feature of the oil market, namely the wide range within which the oil price can clear. The lower boundary of the range is set by the cost floor of oil production in key OPEC member countries, while the upper boundary is set by the entry of oil substitutes and, more recently, by the behaviour of market participants in the financial markets.

When the market is characterised by excess supplies, as it was in 1998, the oil price tends to move towards the lower boundary. At low oil prices, production capacity is not immediately shut down, and concerns about security of supplies don’t emerge in the short term.

However, in the medium- to long term, sustained periods of low oil prices undermine security of supplies in at least three ways.

First, a sustained period of low oil prices induces a cycle of underinvestment in the oil sector, affecting the availability of future oil supplies.

Second, since oil revenues still constitute the main source of producers' export revenues and government expenditure, a sustained decline in oil revenues caused by low oil prices represents a major threat to producers' political, economic and social stability and on their long-term capability to supply oil and undertake the necessary investment in the oil sector.

Finally, low oil prices can induce demand growth both in producing and consuming countries, undermining the conservation and climate change agenda. These effects can be counteracted by increases in domestic taxation of petroleum products and subsidies, but such actions raise serious issues concerning the distribution of oil rents between producers and consumers.

When the market is characterised by excess demand (ex-ante), substitutes and adjustments in demand patterns cannot place a cap on the oil price in the short term. Instead, in the absence of spare capacity, most of the market adjustment is likely to occur through sharp increases in oil prices. This increases the adjustment cost for firms and can induce a slowdown in the global economy.

And while this leads to an immediate rise in producers' revenues, sustained periods of high oil prices can undermine security of oil demand by encouraging substitutes and unconventional supply sources to enter the market and by inducing a permanent reduction in oil demand through price effects, anti-oil policies or structural changes in consumer behaviour.

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Therefore, both producers and consumers have an interest in keeping oil prices stable within a range whose lower boundary is not ‘too low’ or the upper bound is not ‘too high’. However, views differ on what ‘too high’ and ‘too low’ mean and whether this stabilisation should be left to the market or whether the market should be supplemented by mechanisms to stabilise the oil price within a preferred price range.

While producers have options in both falling and rising markets, consumers are much more constrained in their policies in the short term. In the long term, however, the balance of power tends to shift in favour consumers who can pursue oil substitution policies, implement efficiency measures, raise taxes on petroleum products, and encourage the development of alternatives energy sources which have the effect of reducing long-term oil demand and the share of oil in the energy mix. Thus, an important role for the consumer-producer dialogue is to bridge the gap between the long term and short term interests of consumers and producers in order to create a more stable oil market.

Although both producers and consumers' main concerns are about the level and volatility of the oil price, neither consumers nor producers have an interest in managing the price level. There is an agreement that the determination of the oil price should be left to market forces. This does not imply that prices are not discussed in Ministerial meetings. But the closing statements are very general. They often call to "reduce price volatility in the interests of producers and consumers" because volatility "complicates the interpretation of market signals and may adversely affect investment". Other statements call on "both producer and consumer countries...to take action to reach sustainable price levels" without describing what these actions might be. Similarly, in the 2004-2008 price cycle, concluding statements expressed concerns about the level of oil prices, noting that "oil prices should be at levels that are acceptable to producers and consumers to ensure global economic growth, particularly in developing countries" without any indication of what these levels should be.

Does the failure to manage the price level within bounds mean that the producer-consumer dialogue has failed? The answer is no. Since both sides agree that the oil price should be set by market forces, the producer-consumer dialogue has aimed at improving the functioning of the market. Recent events reveal that both sides have been advocating policies that enhance the price-determining role of the oil market. One of the major concerns has been the influence of financial markets on the level and volatility of the oil price and, in relation to this, whether the large-scale entry of financial players has had the effect of shifting the price away from underlying market fundamentals. Efforts are currently being made to understand the links between the financial and physical layers of the oil market and whether regulation is needed to improve market transparency. The IEF has also been showing a willingness to engage with the issue of stabilising short- and long-term expectations through better mutual understanding of oil market conditions, increasing transparency, better provision of data, and communicating to the market. Such communications or signals can play an important role in influencing oil price behaviour.

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The supply disruption caused by the Gulf War in 1990-1991 proved to be decisive for the consumer-producer dialogue, as it increased the awareness of common interests among parties and revealed the usefulness of coordinating actions in key areas such as the use of stocks and spare capacity. Disruptions however did not feature prominently in the dialogue during most of the 1990s. The availability of large spare capacity and the willingness of OPEC to fill the gap in the case of physical disruptions meant that concerns about disruptions received little priority in the policy agendas of consuming countries. The rapid rise in demand in the mid-2000s and the various supply shocks in producing countries such as Iraq, Venezuela, Nigeria and recently Libya brought back to the fore the issue of spare capacity and its role in dampening price volatility.

The Libyan disruption in 2011 put serious strains on consumer-producer and producer-producer relations. OPEC members were not able to reach a consensus on increasing output in response to the Libya's output loss while the IEA's release of strategic stocks was not part of a coordinated effort between key producers and consumers. Consequently, the signals sent to the market were weak and confusing and created the perception that producer–consumer relations cannot be relied upon to smooth the oil market's adjustment to disruptions. This is unlike the supply disruption of the first Gulf War which proved to be the turning point for producer-consumer cooperation.

Thus, the impact of producers' and consumers' actions has not been neutral on oil price dynamics. Their actions revealed a rift in producer–producer and producer–consumer relations. At a deeper level, the June events revealed a market in which its key players have failed to coordinate their efforts in the face of a serious disruption.

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Despite the role it plays in filling supply gaps especially in periods of disruption, producers and consumers shied away from the issue of spare capacity for a long time. It was not until the Jeddah meeting in 2008 that specific calls were made for the expansion of spare capacity, with the acknowledgement that maintaining spare capacity is the responsibility of consumers as well as producers and consumers and extending to the entire supply chain, not just upstream players.

However, there are complex issues surrounding spare capacity: Does spare capacity constitute a global public good? If it does, should all parties share the cost of maintaining spare capacity? If spare capacity is to be held in producing countries, can consuming countries find acceptable mechanisms to compensate producing countries? In such a system, who makes the decision to release the supply from existing capacity? These issues have not been addressed by the dialogue.

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The investment issue has been a recurring theme in most IEF Ministerial meetings. One of the important achievements of the dialogue in this area has been the increasing awareness that investment in the entire oil and gas chain is a shared responsibility between producers and consumers. Nevertheless, the fact remains that the decision to develop reserves in producing countries is mainly in the hand of their governments and the NOCs, and none of the producers wish to relinquish this sovereign decision either through discussion or agreements between producing countries or between producing and consuming countries. As a result of the wave of mergers in the 1990s, many investments in upstream and in refining are now in the hands of privately owned oil companies in various consuming countries where governments' influence is mainly in the area of regulation. Recognizing this asymmetry, the consumer-producer dialogue has never attempted to coordinate investment plans. Instead, it has explored ways to remove impediments to investment in the oil sector.

The basic message of the dialogue has been the importance of adequate investment, aided by “favourable energy, fiscal, investment and environmental relations” which “are needed for freer and expanded trade in oil and gas and for sustainable world economic growth”. The IEF agenda has broadened to discuss specific measures that can induce investment in the energy sector, such as reducing long-term uncertainty through public information on investment plans energy security and climate change policies and their potential impact on demand; enhancing the corporation between NOCs, IOCs and Service Companies; and broadening cooperation and exchanges in the fields of human capital and technology advancement and many other measures.

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Given the role expectations play in the process of oil price formation, one of the main objectives of both oil-importing and -exporting governments should be to stabilise market participants' longer-term expectations about a range of oil prices which both parties consider acceptable. Furthermore, if anticipated government responses are slow, or are perceived to be absent on either the demand or supply side, the market is likely to drift away from the preferred price range. This creates a reason for cooperation and dialogue between consumers and producers. For example, if the market believes that spare capacity is thin, while in reality supplies are abundant and key governments are willing to bring these supplies to the market, then the IEF could play an important role in stabilising expectations by increasing the visibility of these policy responses as in the case of the 2008 Jeddah Meeting. During the Jeddah Energy Meeting, Saudi Arabia sent a strong signal to the market that it was deeply concerned about sharp rises in oil prices and the impacts these oil price may have on growth and demand. Saudi Arabia's declaration that it would increase output followed later by market confirmation of that increase, played a key role in convincing the market to price in a more elastic supply curve.

The dialogue has already reached many milestones. Consumers and producers have overcome some of their past myths, fears and suspicions and have become more aware of a number of common challenges facing energy markets. The institutional structure supporting the dialogue continues to strengthen; the structure and quality of the dialogue have also improved over the years. A visible and concrete example of success in the consumer-producer dialogue is the establishment of the Joint Oil Data Initiative (JODI).

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To conclude, in the last decade both sides in the dialogue have tended to avoid such confrontational topics as taxation, climate change, and the financing of spare capacity, and have focused more on themes that can bring them closer together. However, there is a long-run risk that the key issues that lie at the heart of consumers' and producers' concerns becoming marginalised, leading to a loss of interest in the dialogue. Furthermore, while the dialogue in the 2000s has resulted in greater understanding of the nature of the investment problem and appreciation of the individual sides' point of view, concrete initiatives and proposals to alleviate the investment problem have remained limited. The Libyan disruption in 2011 put serious strains on consumer-producer and producer-producer relations.

Therefore, many challenges remain. The way in which producers and consumers express their interests, to what extent they are willing to engage in issues that lie at the heart of their energy concerns, and whether they succeed in relating these energy issues to the wider context of political, economic and social security and the climate change challenge will define the future path of the dialogue.

Thank you for your attention.