

“Pricing mechanisms at the global oil market: defaults of Anglo-Saxon model & possible ways for improvements ”

Summary of presentation of Dr.A.Konoplyanik at International Oil Conference, Moscow, President-Hotel, 27 October 2009

The year 2008 – the year of global financial crisis – was the break-even year in the history of world oil market development. This market since late 1980s, after it has moved on to commodities pricing mechanisms on crude oil and petroleum products, has become factually just the integral part of the world financial market. In 2008 the collapse of Anglo-Saxon system of organization of market space has happened. This system developed a model of the liberal, competitive, liquid marketplaces (both in commodities and in financial and monetary instruments). Global financial and oil crises of 2008 has proved invalidity of this model for providing sustainable development within globalization stage of economic development of the mankind. 2008 events has demonstrated instability of this model and its unbalanced character for providing equilibrium interrelationship between stimuli for investments, on the one hand, and stimuli for increased competition, on the other hand.

Anglo-Saxon model is based on the hypothesis (and as the practice has shown – this hypothesis is not a universal one) that it is just all-round liberalization that leads to the full coverage of market demand and to the diminishment of energy prices for its final users. And under this model liberalization is generally understood as steady growth of competition and market liquidity through increasing number of the market players. 2008 events have finally dissolved this illusion and has proved invalidity of this major and as if universal hypothesis on which basis through many decades Western community has been constructing global architecture of international energy markets. The real life has placed on the agenda the issue of forming the new architecture of global market space, including in energy, taking account of historic tendencies in energy markets development, and also of forming optimal instruments and mechanisms of the energy markets, including such important as contractual forms and pricing mechanisms for major energy resources. These new instruments need to differ from those that proved their invalidity for sustainable development of global economy. These issues are especially actual within the “broader” Europe and within the whole Eurasian space (emerging Eurasian common energy space). In these areas technological basis for energy supplies is an objectively capital-intensive immobile (stationary) energy infrastructure with its length of many thousands kilometers. This infrastructure requests multi-billion investments and many years to recoup the CAPEX in its development and maintenance at the efficiently functioning level. This is why pricing mechanisms need create clear and sustainable price benchmarks for investors in real energy projects and to minimize price risks for their investments.

Development of oil pricing mechanisms took place within the framework of three major forms of organization of market space: vertical integration, long-term contracts, liquid marketplaces (exchanges). Key question is to find optimal proportions of all three above-mentioned forms within market-space of different states and regions. As time goes by, contractual structure of energy markets becomes more and more competitive: internal corporate (transfer) deals at the “physical” market have been succeeded by long-term contracts, which absolute market dominance has been step-by-step substituted by competitive structure of energy transactions. This structure is characterized by flexible internal structure consisting of long-, medium-, and short-term contracts and spot deals. Later on to this “physical” market structure the new segments of “paper” market has been added, the latter began to dominate in the price formation on energy resources through the instruments of commodities (exchange) pricing – futures, options, swaps, etc., i.e. financial oil instruments and their derivatives.

Pricing mechanisms have been evolving from “cost-plus” principle within vertical integration at the early stages of market formation, to the “replacement value (of competing fuels)” principle within term (especially within long-term) contracts, and further to commodities (exchange) pricing within liquid marketplaces. At that, consecutive pricing mechanisms (according to timing of their appearance) can both supersede preceding ones, as well as co-exist with them and create within competitive contractual market structure simultaneously acting multitude of competitive pricing instruments. Principle of single universal pricing mechanism within single universal contractual organization of market space is not a valid one. This is why organization of national energy market within this or that country can not serve as the reference for emulation and the model for its reproduction in other states. And, moreover, the model, that has proved its invalidity, that has not passed through test of time, that has been based on false (not proven) hypothesis (concept), can not serve as such reference.

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Following the above-said, the key issue for discussion at the session: which way further development of international pricing mechanisms on oil? Whether it will continue by inertia to move in the same direction as before, i.e. within being modified within the existing exchange pricing, or this system will also need its own “fresh start” as well as the whole organization system of financial and monetary markets, which have been agreed (at least verbally) by the leaders of the Top-20?

In case of correction of current oil pricing system within exchange pricing of liquid fuel, the following questions came to the top, like:

- (1) Whether oil prices will continue to be pegged to exchange quotations (futures) at two major oil marketplaces worldwide: WTI (New York) and Brent (London)?
- (2) Whether oil prices will continue to be pegged to US dollar as to universal currency of the transactions? To which currency(ies) departure from US dollar could take place?

If more radical “fresh-start” of global oil pricing system will take place, the question is whether return to such pricing systems as “cost-plus” and/or “replacement value” will take place? In such case key question is development of sustainable methodologies of marginal costs evaluation for traditional and new liquid fuels technologies. Lack of such methodologies and of consistent marginal costs estimates today deprives the industry of mutually acceptable and sustainable price and investment benchmarks and creates backgrounds for next price crises.

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