THE ISSUE OF PRICING POLICY IN OIL AND GAS SECTOR: WHY OIL PRICES ARE RISING

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The given article is dedicated to the current issues of pricing policy in the oil & gas sector. Particularly, it studies the factors, causes and consequences of oil prices rising. The research methodology of this paper is comparative analysis of the existing patterns of macroeconomic development, political differences and social issues within the global oil and gas industry providers. The given analysis is based on SWOT, PESTLE, cause-effect modeling, risk management techniques, as well as the five forces model by M. Porter detecting competitive advantages of the related countries. The authors also consider possible solutions and provide recommendations on how to improve the current global economic situation in the given field.

Keywords: oil & gas, price, pricing policy, Brent, WTI, Dubai

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THE ISSUE OF PRICING POLICY IN OIL AND GAS

Introduction

In this paper, we would like to considered the current issues of pricing policy in the oil and gas sector. We intend to study the factors which are driving up the crude oil prices and the related possible causes and consequences for the oil business worldwide. The oil price is reaching $80 per barrel (at the moment when this article was finalized) and it has risen almost double in the past year. The rise of crude oil prices caused diesel and petrol costs also go higher and this may become a serious challenge for many countries, which are already suffering from the above-target inflations. The Barclays Bank have earlier predicted that the average oil price might be from $62 to $73 per barrel while some other banks predicted that oil could knock out $100 per barrel in the coming year (The Guardian, 2018).

Below are the most frequently discussed reasons why crude oil prices are rising these days:

(1) Saudi Arabia has been negotiating with other OPEC countries and other main oil suppliers to raise the Brent crude price up into the $80 per barrel to fund its social state programs and also to get some other benefits for its state oil company Saudi Aramco. It was assuming that if the price between Brent and WTI stay consistent, the WTI price would be still around $75 per barrel (Forbes, 2018).

(2) On April 12, the International Energy Agency (IEA) declared that crude oil inventories will decrease, in the coming 2-3 months, below the average last 5 years’ production and this would have its effect on global supply and demand.

(3) One of the major reasons is that OPEC wishes the oil price be above $100 per barrel in the near future already. The Organization of Petroleum Exporting Countries, the largest world oil supplier with the share of 40%, is also one of the main instabilities influencer in the oil field. 14 countries are members of this organization: Saudi Arabia, the United Arab Emirates, Qatar, Iran, Iraq, Algeria, Angola, Ecuador, Equatorial Guinea, Gabon, Kuwait, Libya, Nigeria and Venezuela. This group has enough power to play with the global oil and gas prices by rearranging the production levels as per changes in global demand or according to some geopolitical changes as well. For example, in the middle of 2014 the OPEC produced quite a lot of oil to decrease the oil price from $100 to only $50 (Forbes, 2018).

(4) Although the Middle East controls the oil prices and keep it relatively cheap, oil production in Canada is more overpriced. The United States oil production also affects the rising oil prices as this country has the average output of 9 mln barrels per day. Hurricane Katrina which damaged the southern part of the USA really badly back in 2005 and the flooding of the Mississippi River in May 2011 affected the demands of the United States and fluctuate the oil price. Relatively unstable production in the United States thus pushes the rise in oil prices.

(5) Another serious reason for raised crude oil price is the US sanctions on Iran and Venezuela. Iran supplies around 4% of the total world's oil and once Donald Trump was elected the President of the United States, the USA declared they would leave the 2015 Iran nuclear arms agreement and reinstate sanctions on Iran. Venezuela is also facing the results of the widely disputed presidential elections, suffering from financial and logistics problems and also from the sanctions imposed by the United States. All these factors obviously decrease crude oil production in this country (NDTV, 2018).
Higher interest rates make the US dollar stronger and this, in turn, may affect currencies in other countries. At the same time, most of American oil companies buy more oil than during the times when the dollar was relatively low against foreign currencies.

Saudi Arabia is already arranging plans on how to substitute the dropping supplies from Iran, Libya, and Venezuela by extensively increasing oil production and storage while Russia is also speeding up its oil exports. However, there is still much uncertainty regarding how to satisfy the global oil demand and make the production rates of OPEC keep up with it. Riyadh, one of the most actively oil-producing city in Saudi Arabia, is currently aiming at 2 mln barrels per day for extra production capacity, but so far they can get only 1 mln barrel of daily output and there are no further barrels in production reality (The New York Times, 2018).

Transportation is essential part of logistics since all goods are being shipped from place to place which makes fuel the key to air transportation, motor transport, water transport etc. At the microlevel of economy, the rise in oil prices means more costs while doing business (Federal Reserve Bank of San Francisco, 2007).

Rising oil prices are commonly assumed to raise inflation and slow down the economic progress. Already raised oil prices tend to have both direct and/or indirect effects on the costs of goods sold, especially if petroleum is related to their transportation and production. “High oil prices can also reduce demand for other goods because they reduce wealth, as well as induce uncertainty about the future. “For the macroeconomy, costly productions also effect on a variety of products and services, thus, production costs affect the final consumers” (Federal Reserve Bank of San Francisco, 2007).

Analytical Part

Here we have used two analytical instruments -- PESTEL and Porter’s Five Forces. We aim to know the factors of the external environment at the oil market and to evaluate opportunities and threats for the oil and gas industry.

PESTEL Analysis

Saudi Arabia and Iran are now competing with each other in everything what concerns oil pricing policies and this competition is getting more and more intense with every new day. Both countries are trying to get a larger market share and overall be ahead in the ongoing price war, taking into account the changing intentions of the USA.

Political and Legal Factors.

Current price increases in the oil and gas sector affects many countries. The major concerns or common causes that influence the decisions within the oil and gas industry are geopolitical conflicts between the related countries and the (in)stability of these countries’ policies. The majority of governments of the oil producing countries, through their National Oil Companies, control more than 90% of the proven oil reserves and over 75% of the global oil and gas production (Greek Energy Forum, 2016).

As we have already mentioned above, OPEC consists of Iran, Iraq, Kuwait, Saudi Arabia, Venezuela, Qatar, Indonesia, Libya, United Arab Emirates, Algeria, Nigeria, Ecuador, Angola, and Gabon. As all these countries have their own intentions and visions
THE ISSUE OF PRICING POLICY IN OIL AND GAS

about political and economic issues, everything that happens within these countries will
definitely affect the oil and gas prices, not to mention the taxes policies of these countries.

Meanwhile, the USA have not been able, at least so far, to persuade China which is the
largest customer of Iran’s oil, to lower the oil purchase volumes, however, it is reported that
Beijing has already limited the imports of Iran’s oil. Moreover, other countries, such as South
Korea and Japan, are now thinking not to proceed to buy Iran’s oil and are thus trying to
looking for alternative options. All these factors make it very difficult for Iran to persuade
other countries of the world to continue buying its oil although it is already trying to provide
quite significant discounts for Asian customers (Paraskova, 2018).

Considering the intensity of the US efforts to cut off as much Iranian oil exports as
possible, it is unlikely that even Iran’s current significant discounts to Asian customers will
save this country’s oil exports. Analysts, and reportedly the US Administration itself,
currently expect the sanctions to remove around 1 mln bpd from the oil market (Lee, 2018).

Economic Factors.

Saudi Arabia’s economy is heavily relying on the oil sector. Income generated from oil
eventually goes to Government revenues. It is an obvious fact that the relationship between
the global economy and the consumption of the oil and gas can impact on the whole country
and its government. Furthermore, the oil and gas prices are the major factor, as it decides
whether country’s reserve is economically feasible or not. In this context we also need to
emphasize that unconventional and offshore oil and gas fields have the highest costs of
extraction among all the reserves (Greek Energy Forum, 2016).

“Higher oil prices will only help reduce the deficit and build reserves”, as Mohammed
bin Abdullah Al-Jadaan of Saudi Arabia told CNBC's Hadley Gamble relatively recently.
"We have had a very successful year… a lot has been achieved in terms of fiscal discipline,
the government has been really very efficient in its spending and, overall, non-oil revenue
has been as planned or even in certain parts (of the economy) better than planned," he said.
Later on in the course of the same conversation he also said that oil revenues are increasing
as prices rise, and this helps the country to reduce its deficit, which the government has
managed "to reduce by 40 percent in the last two years" (Ellyatt, 2018).

The recent trade war between the two biggest economy of the world - the USA and
China - has the effect on the sector in question. Trump has proposed 25% tariffs on steel and
same on aluminum. The reaction of China which is strongly interested in importing both, has
been obviously aggressive. “Oil prices fall each time the trade war escalates, with one key
consequence of this trade war being a fall in oil demand as the US exports to the world’s
largest oil consumer fall. While Iran may threaten to push oil prices up – a trade war between
China and the US would have the opposite effect” (Rizvi, 2018).

Social Factors.

Oil and energy sector’s impacts on social and economic development of the countries
are basically connected as the economic situation in a country always has the major impact
on the society of the same country. Some of the most obvious social impacts could be as
follows:

(1) Countries’ consumption may reduce due to increasing oil prices.
(2) Transportation costs, affected by the increase in oil prices, may cause the rise in traded goods prices. Thus, trade volumes will decrease and for the society, this would mean losing the sources of income. In simple terms, this means that some people might not be able to buy even essential food products.

(3) Therefore, extra expenditures on food supplies (due to increased food import costs) or social spending (due to increasing unemployment rate) would compete with potential investments in oil substitutes and green technologies (Clarke, 2011).

Technological Factors.

The role of oil and gas companies such as Saudi Aramco is very important as these companies are large and rich enough to invest in innovations. Today, most of advanced technologies are being created/sponsored by powerful market leaders from this industry. Many additional factors such as cost of funding, available skills, uncertainty over prices, policies, rules and regulations, have impact on the players at the oil and gas market. Despite the increase of oil prices at the global level, many related businesses are still trying to produce and/or develop machines and vehicles that consume less fuel and oil as well as alternatives or substitutions. This is actually one of the solutions on how to reduce the negative impacts from oil price increases.

Environmental Factors.

The global environmental issues can also affect the oil and gas industry. The recent global environmental trend of decreasing carbon dioxide emissions assumes that the use of fossil fuels in the global energy mix should go very much down while renewable sources of energy in the global energy mix are supposed to be on the rise. This trend alone can restructure the whole global oil and gas industry, thus directly affecting the oil prices. Many players at the related markets are planning to invest in the renewable energy sector at the moment.

Finally, natural disasters can also affect the prices for oil and gas resources. When there was a hurricane in South Texas with heavy rains in the previous year, this turned into a big trouble for the whole US oil market since crude oil prices rose by nearly 3% (Dilallo, 2018).

Porter’s Five Forces

In the oil industry, competition is an everyday job since oil prices are rising. Despite the fact that Saudi Arabia has promised to boost its production volumes, it may not be enough to offset the declines in Iran, Libya, and Venezuela. In this situation, every oil company needs insights about the industry overall and the current market situation. For example, we can analyze the industry using the method known globally as Porter’s Five Forces. This is an effective strategic tool which can help with analyzing potential profits, risks and threats. The five forces, under this method, are:

1. New Entrants
2. Power Of Buyers
3. Power Of Suppliers
4. Industry Rivalry
5. The Threat Of Substitutes
THE ISSUE OF PRICING POLICY IN OIL AND GAS

Below we present our Five Forces’ analysis for the oil and gas industry.

*The threat of New Entrants – Weak*

Becoming a new entrant in the oil industry required huge amounts of capital to establish a petroleum company. First of all, it costs billions of dollars to develop oil fields so that to make them easily accessible. Offshore oil reserves require even more, as their method assumes very advanced (and thus expensive) technologies. The equipment costs are also very high, same applies to skilled manpower which is always in high demand. Secondly, it is not that easy to get a distribution channel in the petroleum industry because oil companies usually operate at national or international levels where distribution channels are already well established. Thirdly, special government policies and legal acts would be needed for new entrants. All governments that can boast successful oil production and export, favor their own national oil companies, stemming from the generally accepted idea that oil and gas are the resources owned by nations. Therefore, we can, with great deal of confidence, state that the threat of new entrants in this business is very weak for all these and some other reasons (Zaidi, 2018).

*Power of Buyers – Strong*

There no industries that can survive without potential buyers, as the latter always have strong influence on industry’s profitability. In our specific case, buyer actually is not an end users because buyers can be refiners, traders, distribution companies, national oil companies, and even countries such as China, Japan, USA etc. (Zaidi, 2018). As buyers set up tenders and the government buy a large fleet with the global oil price, this leads buyers to seek the best contract terms. In addition, buyers can choose the suitable firm for a long-term business relationship and then evaluate negotiations in detail with more than one party. Most of the buyers are from developing countries with their increasing demand in oil. The oil industry is going to grow in the future despite the oil prices rising at present.

Buyers are interested not only in prices but also in quality of a product. It is known that global oil benchmarks play an important role in prices for crude oil. The main oil benchmarks are:

1. Brent Blend;
2. West Texas Intermediate (WTI);
3. Dubai/Oman (Fig. 1).

Today’s oil price rising is not affected by buyers directly because they have very little bargaining power in deciding how much oil will be consumed in the EU, China, USA, Japan, and India in comparison with other countries (Pitatzis, 2016).

*Power of Suppliers – Strong*

There is large number of suppliers in this sector and stronger suppliers have more power. There is also complex networks of suppliers which include the suppliers of equipment, materials, technicians, skilled manpower, and pipeline installation suppliers. All of them have sufficient powers for increasing the price or decreasing the quality. When the demand for oil is high, the supplier power is strong both in a country and in the industry. The oil-supplying industry has more profitability than the buying industry (UK Essays, 2015).

Some bigger suppliers are fully integrated into the oil and gas industry such as Chevron, Shell and national oil companies like Saudi Aramco, Gazprom, and Petrobras. On
the other hand, some suppliers are oil-rich countries. As their more of business segments get involved in the global oil and gas industry, their bargaining power is getting higher than that of buyers (Pitatzis, 2016).

All OPEC members have nationalized oil productions in their countries. OPEC nations also have very high bargaining power because they hold 2/3 (70%) of the whole world’s oil reserves. Their bargaining powers are so strong that they can actually make other firms leave the industry as such. At present, President Trump has been pressuring Saudi Arabia to increase oil production by 2 mln barrels per day if possible (Stanley Reed and Mihir Zaveri, 2018). Hence, the OPEC and Russia consider increasing oil production by around 1% of the global oil supply. On the other hand, Nigeria’s suppliers are cooperating to work around the strikes of their workers and also in finding alternative solutions from the crude export dependency on the United States (Reed et al., 2018).

Figure 1 - Benchmark Oils: Brent Blend, WTI and Dubai
(Source: energyroutes.eu)

Industry Rivalry – Very Strong
Since the oil industry is very large and already matured, a firm stays in it for the lifetime and takes a strong position. A strong firm will always have a bigger market share and more power, and lower firm will have a smaller market share and less power (Zaidi, 2018). There are high exit barriers in this sector due to huge capital assets involved. Bidding gets very competitive and in an attempt to get new contracts/agreements, the one who can offer lowest cost will win the bid.

Threat of Substitutes – Weak
There are many alternatives to oil such as coal, solar, wind power, natural gas, and nuclear energy. These alternative resources could replace high amounts of hydrocarbons used in the global energy mix. For this strategy, truly huge investments in R&D and production process restructuring would be needed. So, the real possibilities for substitution of so powerful oil in the global energy mix until 2040 are very small (Pitatzis, 2016). Moreover,
The issue of pricing policy in oil and gas

color is already too well developed globally while natural gas will soon be on high growth compared to oil, at least according to some analysts’ forecasts. Gas market shares in residential, industrial and commercial use are stably on the rise. Thus, as a substitute it makes a big threat to oil production companies (Zaidi, 2018).

In addition, despite the fact that oil and gas are commonly known as one and the same industry, it is also commonly known that getting them from under the ground to consumers requires very different and highly specific technologies and even very different business models. And this overall huge industry might be broken down to three lines, each with its own set of challenges and opportunities. Upstream, Midstream, and Downstream sectors within the oil and gas industry are presented in Fig. 2.

![Figure 2 - Sectors within the Oil and Gas Industry](Source: avata.com)

**Solutions & Recommendations**

Crude oil prices have been getting higher since 2014 and now are reaching their highest. The oil price reached over $80 per barrel, which is the highest rate in four years while the lowest price was $29 per barrel in early 2016. One of the additional reasons for this rise is that European energy companies will be no longer getting the benefits from special preferences in doing business with the companies from Iran (Constable, 2018).

Oil prices in the US have been on the rise mostly due to supply shortages from Libya and Venezuela. As the US is the huge importer of oil, it could impact on oil prices for both companies and consumers through its political and business decisions. In the context of sanctions against Iran, the US government today has big hopes on the OPEC countries (Organization of the Petroleum Exporting Countries) and Russia could fill up this oil gap substituting for Iran, Libya and Venezuela. On the other hand, Japan, India, and South Korea are also about to stop importing Iranian oil since the US sanctions are confirmed (Resnick-Ault, 2018).

There could be several ways to maintain stable crude oil prices: increased production of shale oil and alternative fuels in the US so that others regions could share the imported volumes to the US. OPEC countries and Russia could increase the output, thus keeping the
foreign exchange currency rate stable. Another potentially changing factor is that there can be decline in global demand although this factor is unsure and unpredictable (Amadeo, 2018).

The US Energy Information Administration (EIA) forecasts that fuel production in the USA could reach the level of 10.8 mln b/d at the end of this year and this would be the highest yearly production in the history of the US. In 2017, the industry produced 9.4 mln b/d already. The EIA estimates were that oil production in 2019 could jump up to 12 mln b/d by the end of the year. The International Energy Administration expects that in 2023, the United States will become the world’s largest oil producer and they would meet the domestic demand of 30 mln b/d per year consumption. The US government is expected to encourage the development of these sectors so that they could reduce their reliance on OPEC countries, especially Saudi Arabia which has been the main supplier of crude oil so far (Amadeo, 2018).

The US shale industry is growing quite actively and is getting more efficient, and the ey investors are not losing their focus on investing in this sector. The IEA believes that 53% of such investments will come exclusively to shale industry. With the increased capacity of this subsector, the OPEC countries are already starting to worry they could lose the US market, which is quite huge and seemingly has place for all, however, the shale industry is doing really well, so such fears actually have reasonable grounds (Consultants, 2017).

The OPEC had a new member joining in the second quarter of 2018 - the Congo Republic. Thus, the organization overall managed to increase its output by 320,000 bpd in one month only from June to July when the rate became 32.64 mln bpd per month, and this became the highest production output for 2018.

At the same time, Iran has a tremendous drop in production by 100,000 bpd, which was the impact of the US sanction, obviously. Saudi Arabia, Kuwait, and UAE took the chance to boost their production volumes. In such a way they managed to compensate for the drop from
other OPEC member countries that also have issues with sanctions such as Venezuela, Angola, and Libya (Paraskova, 2018).

Maintaining the inflation rate and currency exchange rate is one of the options how to control oil price be stable within a country since all oil transactions are always paid in US dollar. For petroleum-exporting countries, the dollar exchange rate is one the main factors to be considered as it could impact all current and future benefits. Some even go as far as stating that having a strong currency that is aligned with the US dollar guarantees up to 70% of petroleum price (Amadeo, 2018).

Myanmar is a curious case in this regard: one of the key reasons why fuel price is getting higher in this country is coming from exchange rates, as stated by MPTA (Myanmar Petroleum Trade Association). During August 2017, the currency exchange rate of Myanmar Kyats against US dollar was 1,361 MMK for 1 USD and the fuel prices per liter were (92 Ron) 680 MMK, gasoline (95 Ron) 715 MMK, diesel (10 ppm) 690 MMK and diesel (500 ppm) 670 MMK (Aung, 2017).

According to the (Central Bank of Myanmar, 2018), the exchange rate as of 18th of August was already 1,498 MMK for 1 US dollar and the petroleum price was 970 MMK (Diesel 500 ppm), 985 MMK (Premium Diesel), 950 MMK (Octane 92) and 1,010 MMK for Octane 95 (Max Energy, 2018). As the Myanmar currency is not strong enough as compared with the USD dollar, there is a huge impact on this country in terms of fuel price increase which becomes almost automatic. Moreover, Myanmar has the policy of petroleum storage which means that local petroleum stations have the prescribed limit and they are not allowed to store too much of it.

For further distribution at the local market, the Thilawa Port stores some 12,000 tons of fuel oil and it is getting quite difficult sometimes to handle both oil prices and storage due to the overall number of stations because of this policy (Wai, 2018).

Another interesting side is that China’s oil consumption is going somewhat down and is reaching the minimum level since December 2017 (Alternative Fuel, 2018). The global demand for oil consumption used to be increased mostly due to demand coming from China but the economic reforms is China took a rather unexpected turn, thus making the global oil demand going down.

Finally, when discussing the potential development in the oil and gas sector, we always need to keep in mind that there are other possible solutions that we could rely more on, such as natural gas and also ethanol, biodiesel, solar power, electricity and some of other, so far barely touched options.

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THE ISSUE OF PRICING POLICY IN OIL AND GAS


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