Oligopolistic market model and oil prices

Executive Summary

The report is prepared to explain how oligopolistic market model is the best model to relate to the current increase in the price of Oil. The Oil petroleum Organization is analyzed deeply which clearly depicts the oligopoly style of marketing by the members of OPEC. It has also examined by lot of research and based on recent reports that the OPEC tries to influence the oil prices by controlling the supply of oil production with the consent of all the members and tries to fix the oil prices in order to gain heavy profits. OPEC works on the same rule as followed by oligopoly market structure and hence clearly indicates its relation to each other and is best example of oligopoly market style.

1. 0 Introduction

The Oligopoly market structure is the market which has few producers and large number of buyers which gives these producers an advantage to control the market. According to (Scholasticus, 2010), the buyers have very less alternatives and do not have enough knowledge about the market. The producers inflate the prices of their goods to attract more customers by reducing prices leading to deflated price level.

Based on Scholastics writing in one of its articles, the producers have perfect knowledge of the consumers but consumers do not have any information about the producers or their act of influencing the prices has a negative effect on national economy.

2. 0 Discussion

2. 1 Features of Oligopoly Market

There are few producers and large number of buyers.

The producers deal in differentiated products. (Jayasuriya, 2011, p. 87)

One of the producer or firm become the leader of the group and makes others to agree or dominates them to fix the prices which results in price leadership.

The competition in an Oligopoly market is intense and both price and non-price methods are used to attract more customers. For example in lot of advertisements, producers mention ” We will not be beaten on price. The price will be matched with the competitor selling price” (Labs S. S.)

In Oligopoly market, firms or producers get together to share a market and decide on prices. Because of an uncompetitive market structure, they enjoy heavy profit by raising the prices or lowering the prices to attract more customers resulting in entry barriers to this market. (Labs S. S.)

According to recent study by Stanley St Labs., the competition is very different in oligopoly as compared to other markets forms. In other markets, it is violent because of the high competition to gain the market share but in oligopoly, the firms are interested to gain the market share by collaborating to earn heavy profits.

Firms are mutually interdependent which means if one firm changes its prices, it will affect the sales of other firms.

2. 2 Kinked Style Demand Curve

According to (Stewart & Rankin, 2008, p. 141), the oligopoly market structures have kinked demand curves and the demand curve for the product has two sections called inelastic and elastic section.

demand curve. png

Kinked Demand Curve

The elasticity of demand depends on the amendments of rival companies price or service output.

The assumption made here is that the all the companies would want a considerable market share along with heavy profits:

There is no increase of price by one particular firm. This is elastic demand. There would be an adverse impact on the total revenue of the company.

In a situation where the rival company reduces it prices in order to maintain its market share, it would be an inelastic demand curve. Due to reduction in prices again, this would impact the total revenue of the company.

The Price wars between the firms does not benefit anyone but it benefits the consumers in fact. (ecoteacher)

Based on the above graph, we state it faces kinked style demand curve because of these reasons:

It shows price rigidity.

It controls the market segment.

Leader decides the market Price and others agree to it.

It results in Mergers/cartels and collusion to control market.

Producers decide on prices with the consent of others.

It has Horizontal and Vertical Integration.

2. 3 Few Industry examples given by Economists teachers' society of South Australia are:

The grocery market in Australia is oligopoly which is dominated by Woolworths and Coles. They have lot of stores in Australia and have an extensive distribution system across Australia. It is difficult to compete with these firms as it requires huge investment to gain the kind of market share as they have.

The Automobile Industry is a form of oligopoly market.

The world Oil production market or Oil refining is also another oligopoly dominated by the " seven sisters" multinational oil companies like BP, Shell, and Exxon.

The telecommunications market in Australia was initially a monopoly but as new telecom service providers started operating, it resulted in a group of few giant telecom providers competing for a greater market share.

2. 4 INTRODUCTION OF OPEC

According to the OPEC Organization, OPEC is the intergovernmental organization (Organization of the Petroleum Exporting Countries) consisting of 12 oil producing and exporting countries across America, Asia and Africa continents. The members are Algeria, Angola, Ecuador, the Islamic Republic of Iran, Iraq, Kuwait, the Socialist People's Libyan Arab Jamahiriya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates & Venezuela. (About Opec, 2011)

A report (OPEC organization, 2011) states that it was formed on September 14, 1960 in Baghdad, Iraq, by five Founder Members: Iran, Iraq, Kuwait, Saudi Arabia and Venezuela. It was registered with the United Nations Secretariat on November 6, 1962 (UN Resolution No 6363).

OPEC organization (2011) indicates their principal objectives as:

To develop and maintain the petroleum policies for the Members Countries to safeguard their interests.

To ensure the stability of the prices in the international oil markets to eliminate the unnecessary price fluctuations

To provide a regular supply of petroleum to the nations while expecting a fair return on the petroleum industry investment.

2. 5 OPEC: Oligopolistic market model

The Organisation of Petroleum Exporting Countries or OPEC is an oligopoly market which is dominated by the Arab oil producers as they hold the maximum amount of oil refineries which gives them an opportunity to dominate others and decide on prices. Cartel is another name for an oligopoly of producers of a commodity. (About Opec, 2011)

The Members of OPEC tries to influence the world oil prices with the consent of all and they set the production quotas and become an effective cartel by restricting the sales. They deeply analyse the current market situation and anticipate future demand and supply to see various fluctuations of prices in the markets. After analysing the market scenario, they decide to raise or lower the oil production as agreed by all the members to maintain price stability and make the oil available for consumption. (corporation, 2003-2011)

According to (Oil : Crisis and Collusion, 2011), OPEC was organized with the purpose of manipulating the oil prices by controlling oil supplies to the market.

It controls approximately 80% of the world's oil reserves and 40% of the world's production among their 12 member states. As discussed earlier, it is dominated by Gulf States who can easily turn the taps on and off when required to influence the market prices. Even when the economy was facing an issue of recession, it did not have any effect on oil industry and were still making heavy profits.

Hence, we can say that OPEC does play an important role in making decision of oil supply to the market which may affect the oil prices in a greater extent. The members have larger number of oil reserves and can increase or decrease the production or supply whenever they want. As they very well know that all the developing and developed nations wants oil and has almost become the necessity of life like food in today's lifestyle, so they try to earn as much as they can by controlling the prices with the kind of power they hold in their hands.

However, we may say that OPEC has oil reserves and cannot produce more oil as they do not have any more oil reserves as overestimated by us. There can be lot of other reasons as well which may give rise to the oil prices like any commodity price fluctuation due to the demand and supply effect. (Savage, 2008)

2. 6 Advantages and Disadvantages of Oligopoly Market Structure

The cost of a service of product in under oligopolistic tend to be lower in comparison to that of a monopolistic firm, but more than a competitive market. There is stability in pricing; however the prices would lead to reduction if any other firm reduces. This will impact the profitability of the companies giving a benefit to the customer.

As there are barriers to join oligopolies, it gives the firms cost advantages. This is because they would cater to mass production. Consequently it encourages having highly competitive production processes which than improvises the service delivery.

(William Boyes, 2008)

3. 0 Conclusion

To conclude, we can say that OPEC is an oligopoly form of market structure where few nations who have oil reserves decide on the current production and supply of oil with each other consent which directly influences the price of oil. Hence, oligopolistic market structure model explains the behaviour of oil industry and its effects on the market prices. In a recent report (corporation, 2003-2011) states that United States, Canada, Mexico, Russia and China also produces oil and are expected to reduce the need for gasoline in future through its improved techniques and research and development in other forms of energy which will also reduce the affect of dominance of OPEC on the price of oil.