**Essay Question 14**

**Crude oil can now be extracted out of the ground at a lower cost of production. In addition, global economic activity has been contracting as a result of the slowdown in China’s economy. This has resulted in crude oil prices falling by more than 50% in the second half of 2014.**

**(a) Explain the likely effects of cheaper crude oil on the market for natural gas and the market for refined oil. [10]**

i) look at the variables that affect the markets

ii) which are the markets that will be discussed (refined oil and natural gas)

Part A) – Analysis of the Question

For this question, students need to understand the following:

1. How to determine the price and output to explain the impact on consumers
2. How the cheaper price of crude oil as a resource will affect the market for refined oil
3. How the impact on the market price of crude oil will affect the market for natural gas
4. Analysis – significant factor – the extent of change in demand and supply and the price elasticity of demand and supply

Introduction ( economic principles / requirements of the question)

In order to derive the understanding of the impact of demand and supply, we need to apply the knowledge of demand and supply analysis and the knowledge of the types of demand to explain the likely effects of cheaper crude oil on the market for natural gas and the market for refined oil.

Main Body

1. Explain briefly on how the market for refined oil will be determined and how the cheaper price of crude oil will affect the market for refined oil

lower the cost of production – resource for refined oil – increase in supply of refined oil – decrease price and increase in quantity demanded – price falls and qty of output increases (draw diagram and description of diagram)

1. Explain how the impact on the market of natural gas will be affected by the cheaper price of oil (affected by the market of refined oil) – **subtitutes**

natural gases and refined oil are substitutes – increase in quantity demand for refined oil will lead to decrease in demand for natural gas (draw and describe diagram)

1. Analysis of the factor in this impact – state that the price elasticity of demand and supply will make the change in price of the good to be sharp while the change in output of the output to be little if both are price inelastic

Conclusion

In sum, the impact of the price of the refined oil will fall while the output for the refined oil will rise and the price of natural gas will fall while the output for natural gas will fall too. The extent of change in the price and output will depend on the price elasticity of demand and supply.

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**(b) Discuss the relative significance of demand and supply factors in determining whether a fall in price of crude oil will be persistent. [15]**

Part B – Analysis of the Question

For this question, students will need to understand the following:

1. The various demand and supply factors that will affect the market for crude oil
2. identify the significance of demand factors – decline of income – affect the demand for oil
3. identify the significance of supply factors – cost of oil
4. make a comparison of the influence – demand is the main source to determine whether production should increase – capacity of production will not increase the output if there is no economic activity – crude oil is a derived demand

Introduction

In explaining the persistent fall in the price and output level in the price of crude oil, there is a need to have a clear understanding of the factors that affect the demand and supply factors that affect the market for the crude oil market. In doing so, it is imperative to know more about the nature of the production and consumption nature of the market.

Main Body

1. Explain the various demand factors that will affect the demand for crude oil
   * income of the consumers – affected by sluggish growth in China
   * nature of consumers’ reliance on consumption of goods that depend on crude oil – usage of cars, consumer goods that are transported (crude is a derived demand)
2. Explain the various supply factors that will affect the supply of crude oil
   * technology like fracking will also lower cost of production
   * availability of resources
3. Analyse why the demand factors will be more significant in the influence than the supply factors in the crude oil market

consumers’ income – that will determine demand – if there is no need of demand – there is no need of supply

supply may be limited by the availability but fracking will increase the supply

* + use PED and PES to explain the significance
  + high degree of necessity of demand for crude oil – essential resource for production
  + fracking increase capacity of production supply is price elastic - easier to match demand

Conclusion

In sum, the price of crude oil is determined by the demand and supply factors and it is clear that the demand factors will be more significant in influencing the price and output level.