

Industry Comment

New York, USA, 11th May 2009

Peak Oil, Not Speculation

By Steven R. Kopits, Managing Director, New York Office

In seeking to explain the run up in oil prices from 2004 to 2008, commentators often turn to 'speculation' as the primary cause. While speculation — or at least a kind of piling-on — may have explained the very late stages of the oil price rally, the willingness to attribute oil prices primarily to financial investors — as the CBS news show '60 Minutes' did a few months back — risks drawing the wrong lesson from the period. Let's re-wind the clock and recall the events of the time.

After many years of solid growth, oil production plateaued in October 2004. Regardless of the price level, the oil supply simply stopped responding, and from then on, the world had to make do with broadly flat supplies. Ordinarily, the expansion of the world's economy would be accompanied by increased energy consumption and an inelastic oil supply might have been expected to hinder economic development. It didn't. In the four years to mid-2008, the world economy expanded by 18%. The global economy boomed, even without new oil.

However, this came at a price. In the absence of oil supply growth, demand accommodation was required. This was achieved by secular price rises averaging 25% per annum from 2003 to the end of 2007. In other words, the price of oil went up, and this constrained consumption by causing the marginal consumer to drop out of the market. This proved a workable solution for a time, but the global economy could not sustain 25% annual price increases indefinitely, and by the second half 2007, the situation was becoming critical. Consumption was being maintained by continuing draws on inventories averaging 1.4 mbpd, and virtually every producer, with the possible exception of the Saudis, was running flat out. By early 2008, even the Saudis were throwing the kitchen sink at the market — all to no avail. On paper, it looked like a peak oil nightmare.

Of course, consumers were responding. From 2005, the EU and Japan began to shed consumption and, from late 2007, US consumption also began to decline as the US consumer sought to escape high oil prices. Notwithstanding, developed economy consumers were not abandoning the market as fast as Chinese consumers were entering it, and prices continued to rise. In early 2008, prices took off and some argue that speculation took over. Still, as inventories continued to fall until May 2008 and all the oil producers were running at full output, the case for market manipulation at that time is hard to make. Indeed, the market was in backwardation most of this time. In backwardation, futures prices are lower than spot prices, the equivalent of the market saying, "Well, prices are high now, but they'll be lower later." The market — those very speculators — believed that oil was over-priced but was continually surprised as demand kept pushing up prices.

Prices did ultimately fall, but not because the supply situation eased, nor because speculators fled the market, and not because inventories were released. Prices fell because the global economy collapsed.

This period then shows us two of the possible adjustment mechanisms in the era of peak oil: oilless growth characterized by increasing prices and continuous, incremental adjustment; and recession accompanied by a dramatic step drop in consumption and a collapse of oil prices. The lesson to be drawn is that conservation can work within limits, but at some point, there is a straw that breaks the camel's back and the whole system collapses. Ultimately, the inability of the oil supply to keep pace with global demand proved to be a key contributing factor to the current recession. I would note, however, that the proximate cause of the recession is China, not peak oil. China ultimately provided both the financial liquidity and the commodities demand which brought down the global economy. Were China not so large and not at its current stage of development, peak oil could pass without anyone noticing for some time. As it was, China hit its stride just as the oil supply was stumbling. The issue was not, therefore, peak oil in and of itself, but rather the supply/demand imbalance caused by the inability of the global oil supply to adjust to China's incremental demand.

As for market manipulation, it has recently been running at full tilt. You can read about it daily in any newspaper or news website. OPEC, acting as a cartel, has reduced production by millions of barrels a day in order to drive prices up. Investment banks have chartered supertankers and hoarded perhaps 100 million barrels of crude to profit from current market conditions. Both of these remove supply from the market and drive up spot prices. Indeed, were OPEC to pump at full capacity and oil move out of those storage tankers at reasonable speed, the oil supply could

be 5 mbpd higher than its current levels. That would depress prices by quite a bit, perhaps by half or more. So there is plenty of market manipulation at present.

Why no outrage? Surely the economy could use the implicit stimulus now more than ever. Why are commentators failing to take OPEC or the investment banks to task? Is it not a question of principle? Is 'market manipulation' not a bad thing?

Or is the real issue a matter of interests? Does really come down just to price? So it would appear. And this, then, is the greater lesson. When oil prices are high, even ordinarily reserved and thoughtful people will abandon their principles and demand action, demand that someone be held accountable, insist that someone pay. For some, it will be the bankers; for others, the oil companies or the Saudis. Some may come to blame the Chinese, or perhaps the Russians, Iranians or Venezuelans. But someone will have to pay and guilt may be difficult to assign precisely. When this happens, those suffering high oil prices may seek redress by using their national might and influence to ease the burden or exact retribution, even in contravention of obligation, prudence or proportionality.

So as we consider policy in the next cycle, the central issue is not whether to curb speculation by insuring that margin requirements on commodity futures are high enough or by hiring more regulators. The central issue is the containment of oil prices within bands that prevent a second peak oil recession. In doing that, we will prevent the irrational and reactionary from dominating policy and undermining the system of global trade and international relations upon which all our prosperity rests.

ENDS

For further information please contact:

energy business analysts

douglas-westwood.com

New York Office
40 Wall Street
28th Floor
New York, New York
10005
USA

t: +1 (212) 400 7195
f: +1 (646) 512 5675
e: steven.kopits@dw-1.com