

Ferguson: Energy Matters

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\$100 Oil

World crude oil prices have been tantalizingly close to \$100 per barrel in the last few weeks. The consensus is that moving above \$100 is a matter of when, not if. The number 100 is, of course, just a number like 57 or 121. But a \$100 oil price is more than just a number—it's a milestone. Nearing this milestone should make us think about where we have been and where we are going.

To my dismay, there has been little serious discussion about the implications of \$100 oil. Instead, we hear that \$100 isn't what it used to be; some of the oil price increase is due to the fall in the value of the dollar; even at \$100 the cost of oil is not as large a fraction of the economy as it once was. All this is true, of course. But the implication that we should be sanguine about reaching the \$100 milestone is not.

Previous oil "crises," which drove prices temporarily to levels comparable to today's, were caused by war and revolution in the Middle East. The current turmoil in Iraq, however, is not the cause of \$100 oil. Much more fundamental forces are now pushing oil prices upward. The oil world has changed profoundly.

The official view is that there is plenty of crude oil available, primarily in Saudi Arabia, that can—and will—enter global oil markets at a price of \$50/bbl or so. However, officialdom has yet to reconcile this rosy view with the fact that crude oil production reached a peak three years ago. Since then, new production has failed to overcome the rate of depletion in the world's aging oil fields and prices have risen accordingly.

The world's oil exporters have either been unwilling or unable to increase production fast enough to keep prices at "moderate" levels. As the Algerian oil minister commented recently, OPEC has lost control of oil prices. Welcome to the new oil world.

Oil prices have doubled in the last three years and quadrupled in the last seven. Are we to see \$200 oil in 2010? \$400 oil in 2014? Is there any upper limit to the price of crude oil?

Higher prices will no doubt increase the rate at which we turn the world's food supply into ethanol. We can make liquid fuel from coal as well. Perhaps this will happen quickly enough to dampen oil price increases, perhaps not.

My guess is that oil prices will be limited by a reduction in fuel consumption rather than by an increase in supplies of alternative fuels. At some price, the world will be too poor to continue burning oil at prodigious rates.

This price may be high indeed. Even at \$100, consumption has not declined significantly. Due to the increase in the value of the Euro relative to the dollar, oil is much cheaper in Europe than in the US. The cost of oil is a smaller fraction of the world economy than it used to be. All of the factors given by the media to downplay concern over \$100 oil are also reasons why global oil consumption responds slowly to prices.

Oil prices may fall, of course. But reasonable people no longer doubt the *possibility* that prices could continue to increase. If so, what do we do?

In my worst nightmare, foolish politicians attempt to solve the oil “problem” by expanding warfare. At current prices, approximately \$5 billion *per day* is being transferred from consumers to oil producers. Such a massive transfer of wealth is unsustainable. Already there are sabers being rattled toward Iran and Venezuela, which not coincidentally, are major oil exporters. As oil prices continue to increase, so will the demagoguery and the propaganda. The temptation to blame others for our woes seems irresistible.

On the other hand, it doesn’t take a genius to understand that warfare doesn’t create more or cheaper oil. Quite the contrary. So, perhaps, cooler heads will prevail.

Even if warfare can be avoided, however, how long will people be content to rely on markets and prices to allocate remaining oil supplies? In a market system, the rich will always have plenty of oil and the poor less. That’s the problem with markets—the rich get what they can afford and so do the poor. As increasing numbers of people are forced by rising prices to use less fuel, the global allocation of dwindling supplies through markets is likely to become unsustainable as well.

In my opinion, deciding how the world will share Earth’s remaining crude oil peaceably and equitably is the most urgent task we have.

Reaching the \$100/bbl milestone should be adequate proof that we can no longer afford to be complacent about our oil future despite attempts by officialdom to downplay the dangers ahead. Crude oil is the lifeblood of the modern global economy. It’s time to stop dreaming about ever increasing supplies of liquid fuel and start to think seriously about how we could live peacefully with less.

The NYMEX January crude oil contract closed Friday after Thanksgiving at \$98.18, up 89 cents on the day.

—*Dr. Rich Ferguson, Research Director, CEERT, rich@ceert.org.*
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