Oil Prices to Remain High Says IEA

The chief economist of the International Energy Agency (IEA) admitted this week that world oil prices are likely to remain high “for many years to come”. (Oil subsequently traded above $112 per barrel on April 9 before settling at $110.87/bbl, both record highs.)

As loyal readers know, I have been making similar forecasts as well. It’s gratifying that a bona fide practitioner of the dismal science agrees with me. Our logic is somewhat different, however.

As reported on Bloomberg.com, the economist, Dr. Faith Birol, opined that oil exporters are happy with the windfall they are getting from higher prices and see no need to increase production. This wouldn’t surprise me one bit.

However, I suspect that a more ominous factor is also at work. Exporters collectively are increasingly unable to boost oil production significantly.

Whatever the reason, the failure of oil supply to respond to price signals tells us that global oil markets are seriously dysfunctional.

As you learned in Economics 101, in well-functioning markets supplies increase as prices rise. Theoretically, higher prices spur competing suppliers to increase production to enhance market share and increase revenues, despite the expectation that increasing supplies will reduce prices somewhat.

The theory is founded on two basic assumptions, however. The first is that producers will always choose to increase supplies when it is in their economic interest to do so. The second is that they are always able to increase supplies whenever they choose.

Dr. Birol evidently believes OPEC claims that oil exports could increase, but the exporters have chosen not to. (He used to work for OPEC.) Perhaps.

My guess is that producing countries are producing nearly as much as they are able.

The chart below is one you have seen in this space before, updated with the latest data from the U.S. Energy Information Administration.
As you can see, global oil production has not increased since early in 2005. In fact, the trend was downward until an uptick was reported late last year. If Dr. Birol is correct, evidently producers have not been interested in increasing production for nearly three years.

In the meantime, production from Mexico and the North Sea has declined due to resource depletion. New production from deep water has been offset by declines elsewhere. Russia, the world’s largest oil producer, has recovered from the chaos associated with the demise of the Soviet Union, but indications are that further increases in production may not be forthcoming.

The only country believed to have substantial spare capacity is Saudi Arabia, but even that is in doubt. As Matt Simmons argued persuasively in *Twilight in the Desert*, there are good reasons to doubt Saudi claims. The bases for these claims are considered Saudi state secrets, so we have no way to verify them.

This week the Saudis announced that new fields will come on line later this year. Whether Saudi exports will increase remains to be seen.

OPEC kept production quotas unchanged at its last meeting in March but may reconsider before meeting again in September. In the meantime, even more demand will be chasing limited supplies if the global economy does not collapse.

If producers could increase production but choose not to, it is difficult to quarrel with the logic of the decision. Rather than pump more oil, further depleting their resources and lowering prices, they can keep production at current levels and watch the money roll in as prices continue to go up. Seems like a no-brainer to me.
Perhaps it doesn’t matter whether oil exporters are simply too busy spending their money to extract more oil, or they are running out of oil and cannot extract more.

Either way, we are witnessing market failure on a grand scale. Oil is by far the most widely traded commodity in the world, and the disappearance of market forces sufficient to increase supplies and limit prices is profoundly disturbing.

The collapse of the California electricity market was a mere blip on the economic radar screen by comparison.

As the chart shows, the US price of crude oil has doubled in the last three years, but in early 2005 few of us were predicting $100 oil by 2008.

Should we now expect $200 oil by 2010? $400? Is there any upper limit?

The mind boggles.

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Opinions expressed by DrF are not necessarily those of any organization with which he is affiliated.