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The Next Oil Shock

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The price of oil soon will soar again. The present price of a barrel of oil, \$50 or so, is below the price needed to meet current demand for a sustained period of time, and it is well below the price needed to meet global demand as the world economy rebounds. In addition, with the U.S. Federal Reserve System greatly expanding the money supply - which will continue because of the explosion in government spending - the dollar is falling against other currencies; and given that global oil is priced in dollars, the price of oil will rise in dollar terms, just as it did two years ago.

About 65 percent of the demand for global oil can be supplied at a price of \$35 per barrel. Another 20 percent of demand can be supplied at a price of \$35 to \$60 per barrel, but the remaining 15 percent will only be supplied over the long run at prices of \$60 to perhaps \$130 per barrel. Oil, like all commodities, is priced at the margin, which means the price of all oil demanded by the market is equal to the price that producers can get for the last barrel of oil they sell.

It takes considerable time to greatly increase oil production, and it also takes time to reduce production. Despite the global recession, oil production capacity is only slightly above demand, so that any significant supply disruption - a war in an oil-producing area, pipelines being blown up or tankers sunk, etc. - will almost immediately create a supply shock, causing the oil price to soar again.

Because of the drop in oil prices during the last eight months, high-cost production facilities are being shut down, including low-output wells, some offshore production, Canadian oil sands, etc. When the oil price shoots back up, it will take time to get these production facilities back on line.

Oil prices will almost certainly be much higher in real terms (inflation adjusted) during the next 15 years because world energy demand is expected to increase at an average annual rate of 1.6 percent between now and 2030. More than 80 percent of the increase in energy demand during the next two decades is expected to come from China, India and the Middle East.

Low-cost oil production is declining sharply, as the old easy-to-produce fields are being rapidly depleted. There are still huge potential oil supplies, but most of it will be in very

expensive, deep-sea areas, or in oil sands (Canada) or oil shale (Colorado, Wyoming, Utah), all of which are much more costly to produce. Biofuels are also expensive and compete with food for land on which to produce them.

If suddenly it were announced that a miracle electric battery - one that could power a full-sized automobile at high speed for more than 300 miles and could be quickly recharged - had been developed, what impact do you think it would have on the price of gasoline next week? The answer is probably none because it would take several years for the manufacturers of automobiles to switch over completely to battery-powered ones, and then another decade or so before most of the existing stock of automobiles would be battery powered.

In the long run, improved battery technology will probably reduce the demand for liquid fossil fuels, but even under the most optimistic scenario, the dependence on oil will last a couple or more decades.

As vehicles eventually move from liquid fossil fuels to electricity, the demand for liquid petroleum will drop, but the demand for electricity will greatly increase. The environmentalists and many in the political class like to talk about “renewables” meeting the demand. A nice notion, but at best it is not going to happen for decades. As the chart shows, wind, solar and geothermal are less than 3 percent of total energy supply. They all still need to be heavily subsidized because they are not economical and probably will not be for many years.

Global Electricity by Type

Source of Electric Energy	Production Share
Coal	39%
Nuclear	24%
Hydro	19%
Gas	14%
Wind	less than 2%
Solar	less than 1%
Geothermal	less than 1%

Hence, even at high-growth rates, they will only supply a small percentage of total energy needs in the next two decades.

When oil prices soared a couple of years ago, the Bush administration moved to open up government lands and certain offshore areas for more oil exploration and production. Officials in the new Obama administration are now in the process of again locking up these areas to prevent oil production.

If the Obama administration is right in its forecast that the economy will be growing again by the end of this year - which is probably even more true for the world economy - the demand for oil will be rising rapidly again. Yet much production has been shut down because of the recession, and potential future supply inside the U.S. is being restricted by government action.

The result should be obvious - gasoline at the pump will be at least \$3, if not \$4 or more. Americans will still be hurting as a result of the recession, so many of them will be most unhappy to see the prices soar again.

Given that many in the political class seem to think the long run is the next five minutes, they do not see or want to see this tsunami coming. Many politicians will try to blame the high prices on “greedy oil companies” or laggard automobile executives rather than to look in the mirror and see the shortsighted demagogues whose policies led to the mess.

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