Oil Over-Priced

In June, a couple of Dutch energy researchers released a fascinating, long-gestating report on high oil prices. At the time, oil was selling for about $130 a barrel, and the authors, neatly dissecting the market, argued that prices were only going to get worse. Just the next month, they did rise — to $147 a barrel.

But, as O and G readers know, there was good reason to argue the other way at least in the short term – Ed Morse, now shifted from defunct Lehman over to LCM Commodities, asserted correctly that we were in for a considerable price correction.

So, with prices having gone strongly down, as Morse forecast, I made a phone call to the report’s lead author – Jan-Hein Jesse, whom I met last year at an OPEC meeting in Vienna – and asked whether he thinks his thesis still holds. I.E., is another price spike coming down the road?

The answer, Jesse replied, is probably yes. The ‘probably’ covers the event that we are headed into a long, deep depression, in which case all such previously composed economic analyses are off the table, and one must reassess the facts afresh.

But if in the next two or three years we come out of recession in fair economic shape, look for another steep rise in oil and gasoline prices.

Fatih Birol, chief economist at the International Energy Agency, has been arguing the same point while making the rounds last week and this week in Washington and elsewhere. He’s been explaining the IEA’s latest World Energy Outlook, which is just as bleak as Jesse’s paper. Jesse wrote the paper with Coby van der Linde.

In short, demand in China, India and elsewhere in the developing world is probably going to roar back and outstrip supply in 2011 or beyond.

That alone will push prices back up. But oil companies also are now responding to $50 oil by shelving oilfield development projects. So, as Jesse told me, “In 2010 or 2011, we will be in the same situation as [the high prices of] last year. Then we will start all over again [in an energy crisis], but it will be much more difficult.”
One interesting observation of Jesse’s is that price no longer works as a stimulant in the other direction – high prices don’t necessarily motivate oil producers to flood the market with supply, and thus tamp down the upward motion of prices. That’s because almost all the available new oilfields are controlled by national oil companies like Saudi Aramco, Russia’s Gazprom and Venezuela’s PDVSA. Unlike oil companies such as Exxon and BP, which if they can are driven to maximize profit by producing more oil when prices are high, these national companies earn what they need from the higher prices, and let the rest of the oil sit in the ground.

In order to meet rising demand starting in 2011 and beyond, Jesse wrote, these producers – the companies and countries – will have to bring twice as much newly found oil onto the market in the next 22 years than what they did in the last 22 years. Meaning they will have to find and deliver 70 million barrels a day of new supply to the market. Almost no one thinks that is possible.

Jesse’s ultimate forecast is that the West – the U.S. and Europe – are going to have to use a lot less oil in order to make way for rising demand in China, India and elsewhere. If they don’t, he says, look for geopolitical tension, and another possible deep and prolonged recession. The coming energy shortages are bound to produce “sometimes confrontational relationships” between the world’s main oil consumers and the petro-states, the authors write.

Jesse and the IEA come to the same conclusion – the current global energy model isn’t sustainable. In order to avoid “the nasty side of oil scarcity,” Jesse and his co-author write, OPEC and other petro-states need to produce more oil, and the West needs to purse efficiency and the development of alternative energy