

WebMemo



Published by The Heritage Foundation

No. 1951
June 10, 2008

What Is Driving the High Oil Prices?

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As oil and gasoline prices surpass \$134 per barrel and \$4 per gallon, respectively, it is clear that significant change is underway in global energy markets, portending major challenges for the global economy and energy security. A perfect storm of demand and supply factors is driving the high oil prices. Goldman Sachs predicts oil will reach \$200 per barrel by the end of the year—exactly where Osama bin Laden said it should be back in 2001. Absent significant changes, high prices are here to stay, and, a correction notwithstanding, may keep increasing in the long term.

Skyrocketing Demand. The supply and demand equation responsible for this situation is changing quickly. Demand for oil is no longer driven by developed economies like the United States. China, India, other developing countries, and energy producers themselves are transforming global energy markets through their sheer size and pace of growth. According to the Paris-based International Energy Agency's (IEA) "World Energy Outlook: China and India Insights," between now and 2030 China and India will account for 70 percent of the new global oil demand; their combined oil imports will skyrocket from 5.4 million barrels per day (mbd) in 2006 to 20 mbd in 2030—overtaking the current combined imports of Japan and the United States.¹

The energy needs of China and India will continue to grow as these countries transition from developing to developed nations. Rising incomes, strong growth in housing and construction, and the increased use of electrical appliances will substan-

tially increase demand. China is in the midst of an unprecedented construction boom in heavy industry that requires enormous amounts of oil. Massive infrastructure and construction projects generate a heightened demand for oil in China and India, as they did in the United States in the last century and Germany and Japan after World War II.² In terms of vehicles on the road, China will surpass the United States by 2015, becoming the largest automotive market in the world.³ Rising demand, however, is not isolated to East and South Asia.

The oil thirst is mounting in the Persian Gulf and within other major oil-exporting nations due to booming construction projects, growing populations, and government fuel subsidies, which are increasing demand for gasoline. According to Fatih Birol, Chief Economist at the IEA, the rising demand in the Gulf is the second only to that of India and China, and it will increase in the future.⁴ Edward Morse, Chief Energy Economist at Lehman Brothers, has stated that at least 1 mbd did not reach world markets last summer because of rising consumption among energy-producing nations, and the situation will repeat this summer.⁵

Additionally, as demand increases and aging oil fields produce less, some major oil-exporting coun-

This paper, in its entirety, can be found at:
www.heritage.org/Research/EnergyandEnvironment/wm1951.cfm

Produced by the Douglas and Sarah Allison
Center for Foreign Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002-4999
(202) 546-4400 • heritage.org

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tries are switching from being net exporters of oil to net importers. Two well-known examples are Indonesia and Great Britain. In fact, Indonesia just announced it is quitting the ranks of OPEC. Algeria, Malaysia, Mexico, and Iran appear to be on this path as well. This scenario may even offset planned Saudi increases in spare capacity, according to Amy Myers Jaffe, an oil expert at Rice University.⁶

Constricted Supply. Equally important, plans to increase supply through exploration and production between now and 2030 are being frustrated by heightened political risks and mismanagement, including anti-competitive national energy policies in the oil-producing countries. A third of Iraq's production capacity is off-line, while the country is capable of increasing production from the current 2.4 mbd to 5 mbd and beyond within five years or less—if the security situation is resolved. Iran is pumping 3 mbd, one half of what it did under the Shah due to the failure of the mullahs' regime to attract private capital and advanced technology, and to develop a predictable oil and gas investment environment based on transparency and the rule of law. The Islamic Republic's leadership also has made the Iranian energy sector the hostage of its dangerous and opaque nuclear program, which triggered international sanctions against Iran and stifled the development of its oil and gas resources.

One-quarter of Nigeria's productive capacity is permanently down due to social unrest in the Niger Delta. And Venezuela's Hugo Chavez is destroying his country's oil sector through nationalization, taking at least 1 mbd off the market.

Exporting countries' policies provide preferential treatment to national oil companies (NOCs) while denying equal access to international oil companies (IOCs). Oil-producing governments severely restrict foreign investment and access to resources. OPEC's 13 nations control 76 percent of global reserves; add Russia and the number grows to 83 percent. By contrast, the integrated oil companies, ExxonMobil, BP, Chevron, ConocoPhillips, and Shell, hold only 3.8 percent of known reserves.

Despite high oil prices and diminished spare capacity, OPEC is repeatedly refuses to increase production beyond current levels, alleging that the "oil market is balanced" and "there is no threat to or crisis in supply."⁷ The reality, of course, is quite different. OPEC and non-OPEC exporters insist on limiting the majority of new oil and gas projects to their NOCs, to the detriment of international oil companies and consumers world wide. They neglect or actively resist the development of modern natural resources legislation, court systems, transparency, and energy sector supervision by elected officials, as well as scrutiny by independent media. As a result, they prevent increases in production and disallow necessary investment by the international oil companies, which have the expertise to bring the needed supply online. This trend is set to increase: Over the next 20 years, 90 percent of new hydrocarbon supplies will come from countries that provide privileged access to national oil companies.⁸ Thus, oil prices can only go up.

Non-OPEC output is also slumping due to steep declines in key production areas like Mex-

1. "World Energy Outlook 2007: China and India Insights," International Energy Agency, 2007, p. 48.
2. Philip K. Verleger, Jr., "The Oil-Dollar Link," *The International Economy*, Spring 2008, pp. 46–50.
3. "World Energy Outlook 2007: China and India Insights," p. 298
4. Clifford Krauss, "Oil-Rich Nations Use More Energy, Cutting Exports," *The New York Times*, December 9, 2007, at <http://www.nytimes.com/2007/12/09/business/worldbusiness/09oil.html?ex=1354856400&en=850b0d0facc4d33&ei=5088&partner=rssnyt&emc=rss> (May 20, 2008).
5. Mathew Robinson, "Power-hungry Mideast may cut summer oil flow," Middle East Online, April 5, 2008, at <http://www.middle-east-online.com/english/?id=25234> (May 20, 2008).
6. Krauss, "Oil-Rich Nations Use More Energy, Cutting Exports."
7. Russell Hotten, "Iran and Qatar dampen hopes of lower oil prices," *The Telegraph* (UK), May 19, 2007, at <http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2008/05/19/cnoil119.xml> (May 20, 2008).
8. "The Changing Role of National Oil Companies in International Energy Markets," Baker Institute Policy Report, Number 35, April 2007.

ico's Cantarell Field and the North Sea. Russian oil production, which has accounted for over 80 percent of the net increase in non-OPEC oil production since 2003, is stagnant as the government insists on state ownership of the oil sector. Aging fields, high taxes, gasoline subsidization, a lack of private ownership, and other misguided policies are also decreasing output.

The global financial crisis is another key driver behind the high oil prices. After the Federal Reserve cut the prime lending rate last August in hopes of assisting major lending institutions, investors saw this as the Fed giving up on its battle with inflation.⁹ As a result, traders, hedge fund managers, and pension fund managers began to shift large amounts of cash away from the dollar into commodity futures markets, such as oil, in an effort to protect their investments from being devalued by inflation. As a result, increased demand in oil futures (no different than in any other commodity) has led to higher prices.

While the falling dollar has increased speculation and helped drive up oil prices, it is the awareness of the aforementioned trends and the exploding demand for oil that is driving investors to put their money into oil futures.

What to Do? There needs to be recognition that the depletion rates of oil fields world-wide are rising, and new oil fields are not coming online fast enough to replace the existing production capacity. Industry experts agree that the giant oil fields containing light sweet crude—the preferred form for gasoline refining—are not being discovered as often as in the past. Additionally, in order to meet growing demand, at least in the short and medium term, the world will need much more investment and production capacity—more than may be available. Even corrected for speculation, high oil prices adequately reflect current and future supply and demand of petroleum if access to oil remains restricted by governments. One result of high energy prices is that many new and exciting technologies—in oil and gas production and as substitutes—are becoming increasingly competitive in global markets.

With diminishing global spare capacity and the growing geopolitical potential for future supply disruptions, it is time to confront these anti-competitive policies head-on. To increase investment, open access to the remaining oil and gas reserves, and diversify the basket of transportation fuels, international oil companies and consumer countries should:

- **Increase** pressure on OPEC and non-OPEC countries to level the playing field and to open access for international oil companies to develop existing petroleum reserves. The rule of law and competitive market principles and institutions should be put in place to facilitate further development of energy resources. This includes cessation of cartel-like behavior by OPEC, which is illegal under U.S. law. Consumer nations should make energy investment a part of their bilateral agenda with all energy-producing countries. They should also keep in mind that the NOCs depend on imported oil services, information technology, banking and finance, food, and other external providers to function adequately—just as consumers depend on fuel producers. Consumer countries may begin conditioning supply of these vital services on equal access to energy resources.
- **Promote** market-based energy-saving technologies and unconventional sources of fuels world-wide. Japan and the U.S. are the world leaders in industrial and residential energy conservation, whereas the fast growers (China, India, the Middle East, etc) are energy inefficient. U.S., Japanese, and other Western companies can do well by doing good, marketing energy-saving technologies. Governments can prioritize energy saving through their export promotion activities. Technology is also key to oil production from unconventional sources, such as oil sands (Canada, Venezuela, Congo, etc.), oil shale, and deep water drilling, using the most environmentally friendly methods possible.
- **Prepare** for the likely transformation of automotive transportation when market forces will shift it to electric, hybrid, and plug-in hybrid cars. If

9. Verleger, "The Oil-Dollar Link."

oil-producing countries do not take measures to bring down oil prices, a number of market-driven solutions will likely replace internal combustion engine cars in the next couple of decades. The U.S. automotive industry should gear up today to be a market leader in these emerging transportation technologies. Otherwise Detroit will suffer even more from competition by Japanese and other companies and will lose more jobs and industrial base.

Conclusion. High oil prices are here to stay due to heightened political risks, irresponsible behavior by oil-producing governments and growing global demand outside U.S. control. Oil is a finite resource which is produced by a partially cartelized imperfect market. Consumer countries should expand cooperation in order to level the playing field and reduce prices by increasing investment and pro-

duction, promoting conservation, and diminishing geopolitical risks. Yet, in the long term, high demand, inadequate supply and severe geopolitical risks combine to make oil a problematic transportation fuel.

High oil prices are driving science and R&D to produce better and cheaper sources of transportation fuels and new engine designs, which may eventually offer alternatives to conventional oil and reduce its price.

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