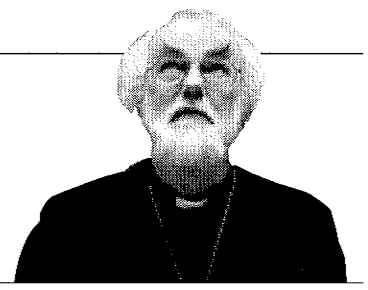
Opinion

If the Archbishop can't stand up for his beliefs, he must quit
George Walden, page 26



The world must kick its addiction to oil

Markets won't correct the soaring prices that threaten our economic wellbeing. So governments must

Anatole Kaletsky

At the time of the last energy shock in the 1970s, Sheikh Yamani, the shrewd Saudi Oil Minister, famously told his greedier Opec colleagues that they would encourage replacement of oil by other energy sources and kill the golden goose that had made them wealthy if they kept pushing the oil price too high. "Remember," he said, "the Stone Age didn't end because the cavemen ran out of stone."

The last three global recessions — in 1974, 1980 and 1991 — were all triggered by an oil shock and it looks as if Opec is now determined to repeat this experience. How many such shocks will it take before we control our addiction to oil? Cynics will say that all the world's oil will have to run dry before we see any decisive action in the US or China to reduce and ultimately eliminate their oil demand. But a confluence of economics, politics, diplomacy, environmentalism and finance has suddenly been created which may unexpectedly prove the cynics wrong. An oil price of $140, never mind $200 or $300, is simply too economically damaging to be tolerated much longer.

The question is no longer whether oil prices will be left to the market, but whether political interventions that override market forces will improve or worsen the situation.

The usual answer to this question is the latter, which is why Western policymakers have been reluctant to do very much so far to curb the oil price. Such, in fact, is the faith in "oil market fundamentals" expressed, for example, by Gordon Brown and the recent Treasury paper he commissioned on the oil shock that one is drawn to a surprising conclusion: the main reason for inaction in the face of the oil shock may not be the lack of political will to implement difficult decisions, such as higher petrol taxes or government guarantees for nuclear construction, but simply the ideology of market fundamentalism, expressed in such slogans as "the market is always right".

But the market is not always right. It is usually right, but sometimes it is spectacularly wrong — as in the recent sub-prime saga. To acknowledge that governments must sometimes correct market failures is not to reject the economic lessons of the 1980s but rather to apply a proper understanding of economics.

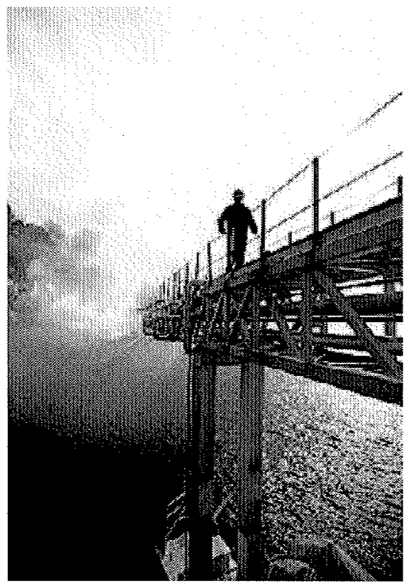
There are three main reasons why the market cannot be trusted in the case of oil. First, there is the enormous gap between the cost of producing oil in areas where it is abundant and the cost of producing any close substitutes for this oil. Easily accessible oil in places such as Saudi Arabia, Venezuela and Nigeria costs only a few dollars a barrel to pump once an oilfield is producing. Even including exploration expenses, the total cost of production of Opec oil is well below $10 a barrel.

However, the cost of any substitute runs to $50 or $60 a barrel, whether the Opec oil is replaced by oil from more hostile environments, such as deep-sea drilling in the Arctic, or by some other energy source such as nuclear or wind power. The gap between cheap Opec oil and any other energy source creates an enormous "rent", beyond any normal return on capital and costs of production, which either accrues to Opec as profits or to consumers as the benefit they enjoy from an energy source cheaper than any alternative in their own economies.

This rent, currently running at around $2 trillion annually, is at the heart of the perennial struggle between oil-producing and consuming governments. Either Western governments claim most of the rent for themselves by levying high taxes on domestic oil consumers, or Opec governments pocket most of the rent, as they are doing today.

But why shouldn't this rent be distributed "fairly" or "rationally" by market forces? The answer lies in the second "market failure" inherent in the oil business — monopoly power. Because almost all of the world's readily accessible oil is concentrated in a handful of nations, they have been able to achieve almost total monopoly power through Opec. With the supply of oil controlled by a monopoly, there is nothing "efficient" about the level of prices set in the market; and the competition between producers and consumers inevitably becomes an issue of politics, rather than economics.

The rational response of Western governments to this monopoly power is to lower the cost of energy substitutes by accelerating technological advances and increasing economies of scale. This can be done by imposing very high



Oil exploration is inefficient; better to invest in new technologies

taxes on oil consumption to guarantee high profits for producers of non-oil fuels. At the same time, such taxes can ensure that most of the rent earned from the difference between consumer prices and Opec production costs stays in Western treasuries instead of going to producer governments.

The use of tax policy to capture rents for Western governments would be particularly effective if combined with regulations designed to prevent money being poured into speculative markets for "paper oil" — which brings us to the third reason why price signals are misleading in the market for oil.

The gap between physical trading in oil and the paper markets in oil futures and oil-company shares raises all sorts of financial anomalies. One is the ramping-up of oil prices by institutional investors. Another is the strong incentive for Western oil companies to invest in oil exploration, which is inherently inefficient, when competing with low-cost state-owned producers, instead of investing in new technologies to replace oil, where Western economies have a comparative advantage over Opec.

As a result of these perverse incentives, Western energy executives invariably insist that there is no plausible alternative to oil. For example, Rex Tillerson, chairman of Exxon, remarked last year that he wasn't interested in biofuel research because "I don't have a lot of technology to add to moonshine". Tony Hayward, chief executive of BP, wrote a few weeks ago that "humankind remains dependent on fossil fuels" because renewable sources now account for only 2 per cent of global energy use. This is hardly surprising, since companies such as BP and Exxon have no special skills in nuclear power, wind turbines or photovoltaics, and they have strong vested interests in political and fiscal support to explore for oil in ever more difficult and hostile regions of the world. But such support cannot be economically justified since Opec will always have an unbeatable comparative advantage in producing oil.

If Western governments play their cards correctly, people such as Mr Tillerson and Mr Hayward will be proved wrong — and ironically Sheikh Yamani will eventually be proved right. The world will wean itself off oil long before the sands of Saudi Arabia run dry.