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22 June 2012
Economic Update

A rapidly changing energy world, or perhaps not.

Slow growth here and in China, and recession in Europe are reducing demand for oil. Inventories in the U.S. are at a 22-year high. The Federal Reserve Board's QEs that pumped paper money into the economy and drove up the nominal price of oil have come to an end. And the twelve OPEC oil cartelists, who between them supply 40% of the world's oil, are producing 1.6 million barrels in excess of the agreed daily quota of 30 million barrels. As a result, U.S. benchmark crude oil prices are now closer to $80 per barrel than to the $110 they reached only four months ago.

OPEC's hawks -- Venezuela, Iran and Nigeria among them -- want Saudi Arabia to rein in output. They need much more than $80 to cover their budgets, while non-member, fellow-traveler Russia needs closer to $90 to avoid a problem for its rouble. The Saudis feel they can finance their welfare state, their prince's live styles and their clerics' call for funds to spread their misogynistic anti-Semitic version of Islam around the world with $80 oil. So that's the new floor -- unless the Saudis decide U.S. production is becoming so great a threat that they cut prices to levels higher-cost American producers cannot meet, a real threat of which operators in the U.S. are well aware. Bill Maloney, who heads the vigorous North American development

operation of Statoil, the Norwegian state oil company, told the Financial Times, “If it’s [a price drop] a flash event, the industry could withstand that. If it’s for an extended time, that is when you begin to think: ‘my gosh, what are we going to do here?’”

For now, the Saudis have several reasons for feeling that $80 oil suits their purposes -- no lower, no higher. For one thing, they do not want a severe global recession that higher prices might trigger, lest oil demand collapse and the value of their enormous investments in Western assets be impaired. For another, they want to keep producing at the high current rate to prepare to make up for any output loss should the European embargo on Iranian oil take effect on July 1, as scheduled. That ban would remove about 500,000-700,000 barrels from world markets, and the Saudis are determined to prevent a price spike that might weaken the resolve of the consuming countries to continue the ban on oil from their regional rival.

All of this makes for exciting geopolitical maneuvering, and provides oil traders with food for thought. But it is far less important than some very fundamental changes that are going on in our energy markets. Thanks to a new technology, hydraulic fracturing (known as fracking), and horizontal drilling, production of oil and gas from shale is increasing despite the Obama administration’s reluctance to grant permits for drilling on federal lands and offshore.

America, which in 2008 imported almost 60% of the oil needed to run its cars, trucks and factories, now imports only 45% of its requirements. And that is likely to decline when the vast quantities of oil under the surface of American lands and coastal waters, including two trillion barrels trapped in shale and sand -- 100 times our currently reported reserves -- are finally tapped.

That is only one of the threats to OPEC’s continued dominance of oil markets. The second is Canada, with its vast reserves of oil shale, waiting construction of pipeline connections to the US -- so far refused by President Obama. The third is natural gas, now available in such huge quantities as a result of new drilling technologies that prices are depressed, as seen by producers, or attractive, as seen by consumers and developers of gas-powered

vehicles. Finally, there is electricity, available more cheaply from generators fueled by cheap, abundant natural gas and, possibly, by a renascent nuclear power industry that some utilities are betting their shareholders' money has overcome its history of cost over-runs and operating problems, and will be able to compete with cheap natural gas.

At the moment, the use of natural gas to power vehicles in America is confined largely to buses and garbage trucks: only Honda is offering a natural gas vehicle (NGV) for ordinary consumers. These vehicles do have limitations: the tank for natural gas consumes almost all of the space in the trunk of an ordinary passenger car, and infrastructure for refills has yet to be developed. But enthusiasts for this fuel, among them Robert Hefner III ("The Grand Energy Transition"), expect wider use in the transport sector to result from the current level of natural gas prices.

The electric car and its hybrid variants have become the véhicule de jour of the wealthy, trendy green, Hollywood set, but no one outside of the White House believes President Obama prediction that one million such vehicles will be on the road by 2015, in part because a battery-driven car costs about $15,000 or almost 40% more than an identical gasoline-driven car, according to Alan Mulally, CEO of Ford, the maker of the all-electric Focus.

So far, growth in the use of these vehicles depends heavily on several subsidies from the federal government for these so called plug-in electric vehicles (PEVs). Buyers get a tax credit of $7,500, and makers of batteries for PEVs receive subsidies from a $2 billion fund used by the administration to pick winners in the race to develop batteries that can reduce "range anxiety" by increasing the range of PEVs from their current at-best 80 miles, clocked by the new Ford Focus Electric. Hybrid electric/gasoline vehicles do better.

One beneficiary of taxpayer largesse, A123 Systems, the poster-boy for President Barack Obama's drive to replace gasoline with batteries, recently laid off some of its workers after one of its products proved a dud, and is now seeking private financing to supplement the $249 million promised by the government so that it can continue down a

new, allegedly more promising path. The company's first-quarter loss of $125 million and 40% drop in revenues were due to soft demand for PEVs, even though sales of conventional vehicles are booming and consumers can remember $4 gasoline. If A123 does go under, its fall will add to the President's embarrassment at the failure of his other chosen "winner", Solyndra, a bankrupt solar panel manufacturer that cost taxpayers half-a-billion dollars. Politicians make poor venture capitalists; Mitt Romney's supporters argue the reverse is not true.

Not all the news is bad for the PEV industry: Federal Express is slowly converting parts of its truck fleet from gasoline to battery-driven, and the military is attempting to do the same to reduce problems of supplying gasoline to its far-flung forces. But the gasoline-driven car will be with us for a long while, eliminating any pressure on the Saudis to open the valves enough to lower prices to the $50-$70 range on which they thrived a mere three years ago.

Which brings us back to the subsidies to battery manufacturers. Because the use of oil imposes on society security and other costs not borne by consumers -- what economists call externalities -- it is not unreasonable for society, aka taxpayers, to set aside some modest sums for research into ways of reducing that security risk. So score one for the President, and ignore the never-subsidize-anything crowd. But when it comes to allocating the funds, the President has it wrong and his critics have it right: politicians can't pick winners, and in many cases don't even try -- with all those campaign contributors at the trough, we get crony capitalism rather than efficient use of resources. Indeed, the lending process itself becomes distorted. In the case of batteries, recipients of grants had to agree to staffing targets unrelated to market demand for their batteries -- a job creation scheme, timed with the election in mind.

There is a solution. The funds set aside for this sort of product research and development can be put in a pool, and handed out to the bidders who agree to put their own funds at risk. Those offering the most skin in the game, get the subsidies. In effect, that leaves the allocations to expert venture capitalists and entrepreneurs

who have a real incentive to pick the most likely winners.

If America's environmentalists lose their fight to prevent the spread of new drilling technologies, to curtail development of oil-rich areas in the United States, and to prevent the construction of pipelines to Canada, and if some of the new alternatives to gasoline develop, OPEC's power over prices might be weakened. Not eliminated, just weakened. That's progress of sorts.