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Away with jerry cans! Oil bubble is bursting

By Nick Butler

One of the great pleasures in life for economists is watching bubbles burst. First the speculative air is pumped in just beyond the point of reason. There is always a trader willing to say that a tulip bulb will soon be worth a million guilders; an investment bank ready to predict $200 oil prices by the end of the year. There is always a looming war or a potential harvest failure to add spurious justification. But the end is inevitably the same. The bubble bursts.

That is what is happening now in the energy market. Sometimes the bubble deflates rapidly, as with the US natural gas price – now at a 10-year low of less than $2 per mmbtu. In other cases the air escapes slowly. That is what has been happening to the oil price since the announcement of a modest fall in Chinese imports.

Once the fall begins it tends to continue. European gas prices are also declining and utilities tied into long-term contracts are struggling to renegotiate terms. If the Japanese succeed in restoring some nuclear power capacity the Asia gas market will follow the downward trend. Simultaneously the important report from the UK’s energy department has reopened the door to shale gas development in Britain and perhaps across Europe.

The oil market is also set for a serious adjustment. Iran has backed off from its threats to close the Strait of Hormuz, and another complex negotiating process has begun in Istanbul to find a way in which Israel and Iran can step back from a confrontation neither could win. The sanctions on Iranian oil exports are an important bargaining chip in these negotiations. If there is any progress, Iranian production will come back on to the market.

In any circumstances short of a long war, the decline in prices could be substantial and only the action of Opec swing producers, led by Saudi Arabia, could set a floor. The Saudis’ position is that prices should average $100 a barrel, but with output from Iran and Libya restored, that would require a cut of up to 3m barrels a day in Saudi exports – with troubling results for the kingdom’s budget.

Nor is the fall likely to be temporary. Years of high prices have encouraged investment and technical advances have started to transform the energy market. The focus of attention has been on shale gas, with US production up 14-fold since 2000 and now meeting almost a quarter of US demand. In China, shale gas exploration is just beginning and if successful could dramatically reduce import requirements over the next decade. In Europe, the environmental debate is unresolved but following the UK government's supportive report, a forthcoming paper from the Royal Society could help set new standards, opening the way for production across the continent.

Significant shale gas reserves exist in Poland and France. With new and clear guidelines, development could be rapid and sharply reduce Europe's import needs. At the same time, the US is beginning to plan for exports of gas. This is the context behind last week's remarkable comment by Vladimir Putin, who warned Gazprom it would have to rise to the challenge of a transformed market.

But shale gas is not the full story. US production of tight oil, which is produced from shale and other rocks, has tripled in the past three years to almost 900,000 b/d. Predictions that the US could become self-sufficient in hydrocarbons in the next two decades no longer look absurd.

For consumers the news is good. The jerry cans in the garage will decline in value but the price at the pumps should decline steadily. In the US, the low gas price is seen as rebasing industrial costs and opening the door to a renaissance of manufacturing. The losers will be those who have invested in the highest-cost oil and gas developments and those who have planned their corporate or national finances on the basis of a one-way bet on rising prices and revenues. One of the most telling features of the current market is that despite the high prices of recent months the shares of oil majors have suffered serious falls. Shell and BP are both down against the market by more than 10 per cent since the start of the year. A persistent fall in prices will reopen the question of industrial restructuring, which has been postponed by the largesse of the past few years. Several Opec states will also be in serious trouble, with any added production from Iraq putting yet more pressure on the quota system, which sustains the cartel.

Within the energy market, attention has shifted to electricity production. The attraction of gas as a feedstock for generating power is well known. If that is reinforced by plentiful supply and falling prices, the drift from nuclear will continue and more questions will be asked about the scale of subsidies needed to back renewables. With climate change off the political agenda the risk of slippage on pledges to reduce emissions is high.

Bubbles tend to distract attention from such long-term trends. As the bubble bursts, we will see more clearly how much the landscape of the energy market is changing.

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