



## Talk from a rock guy

Posted by [Heading Out](#) on July 13, 2005 - 8:05am

Normally I prefer to post on the events that are carrying us inexorably forward, but cannot resist the urge to respond to the recent article by [Econbrowser](#) that Prof G cited. Given that I am prone to the odd comment on economists, and, with your indulgence, let me try and respond to some comments in that post.

To begin with

Suppose you told me that you were certain that annual oil production was just about to plummet, and would be 30% below its current level in two years. I would say that the first thing we should do is curtail current oil consumption drastically. Oil is going to be an incredibly valuable commodity in two more years, and we've got to stop wasting it now. By leaving more of the oil in the ground now, we could stretch out the time available to us for developing alternative sources from oil sands and coal and to make radical changes in our transportation systems. And we would need to start immediately making huge investments in those alternatives.

Well the initial problem is not that oil will all drop that much, but we do know that oil production is dropping more than 10% a year in a number of fields, and by varying percentages in most countries that are now producing oil.

Secondly with an entire world economy running on oil, turning around and saying "excuse me chaps, I am going to cut your supply this year since we need to conserve" is a likely way for governments that need to spend that money now on current budgets to have a very short term in office. If not because of revenue problems then from the calamitous effect that this will have on their economies. Economies are currently built on a continuing income from oil, one cannot currently survive a dismount from this running tiger.

In regard to the need to invest in new technology, way back when there was an Energy Crisis in the past the United States Government was motivated to start a lot of programs that looked into alternative sources of oil and energy, including DoE. Just as some of those went into field production evaluation, the price of oil was dropped to a point that the short term benefit of those programs could no longer be justified. They died, and since a generation has passed most of that knowledge is gone.

This time around there is not going to be enough oil available to drop the price below that at which these new ideas might be competitive, but as we have discussed before you can't have a baby in a month by making 9 women pregnant, and there is a long lead time before they can have significant effect. In the meantime oil prices will continue to go up either steadily, or in bursts, depending on the relative perception of the different news stories that come out. Yes it is time to invest in alternate technologies, just don't expect that they will impact the oil market this decade.

Then we come to the bit that says

consider what would happen if the government doesn't make any policy response. Oil is going to become extremely valuable under this scenario in a very short period of time. Let's say for discussion we're talking about \$200 a barrel two years hence. Then I would like to make the observation that, if the facts were indeed as we just conjectured, oil surely could not continue to sell for \$60 a barrel today. Anybody who pumps a barrel out of a reservoir today to sell at \$60 could make three times as much money if they just left it in the ground another two years before pumping it out.

Ah! Well you know what? If someone has invested \$1.2 billion in putting in an oil complex that will generate 200,000 bd at \$60 a barrel, I can't see them waiting 2 years to start recouping their investment, even if they know that the price is going to go up to \$200 a barrel in a year. Why not? Well, in part, because the well will still be producing something like 200,000 bd next year and so they will reap that reward then, and still get an immediate return on their investment today. (And few folks think far enough ahead to the time that the well will start to run dry).

Oil wells are not, individually, resources that are expected to disappear within six months of being developed (although some do, and there are some being put into the North Sea now that have an expected life of about 3 years). Rather most wells are expected to last for a period of years, and thus the gain will continue to grow as the price goes up, but we still need the immediate return to pay for the increasingly expensive cost of the drilling system (look at the [cost and complexity](#) of Thunder Horse for example).

The bit that says

This particular understanding of the natural consequence of profit-seeking behavior is I think the heart of the issue that needs to be addressed in order for economists and noneconomists to understand each other on this issue.

Leads me to suggest that the scale of these numbers is perhaps misunderstood, in a way that is caused by the price of an individual barrel of oil. One needs to be more appreciative of the more realistic case. If you have an oilwell that is producing 6,000 bd at \$60 a barrel that is \$360,000 a day. Expecting anyone to wait around to make \$1 million a day a year or two from now seems to be rather unrealistic.

In the end I fear that we are still talking different languages and about different perceived situations. And, unfortunately, there are more economists out there who do not understand the true situation, but are willing to go on the talk shows and comment anyway than there are geologists or petroleum engineers that can be either found, or bothered to refute them. And as a result the general public will not be sufficiently warned in time, and will not appreciate the scale of the problem until after it has arrived.

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