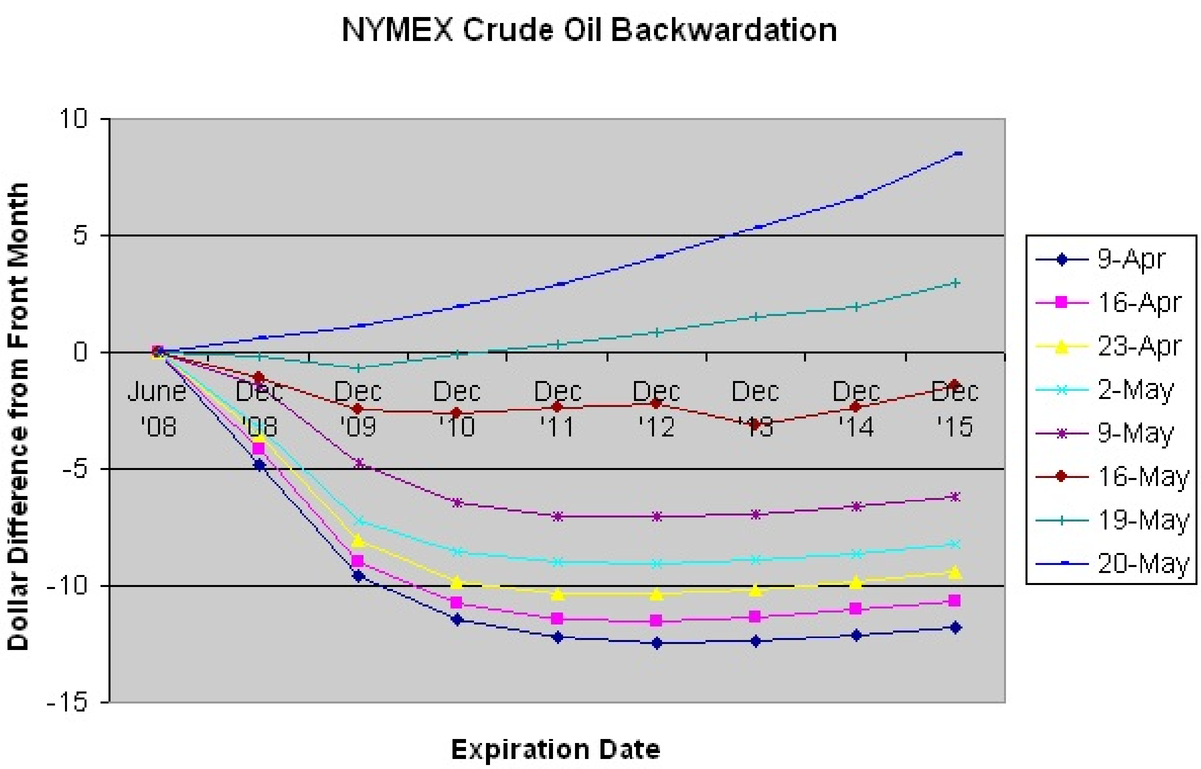
The Oil Drum
DISCUSSIONS ABOUT ENERGY AND OUR FUTURE

UPDATED: The Oil Market's Historic Swing to Continuous Contango--Has Peak Oil "Tipped"?

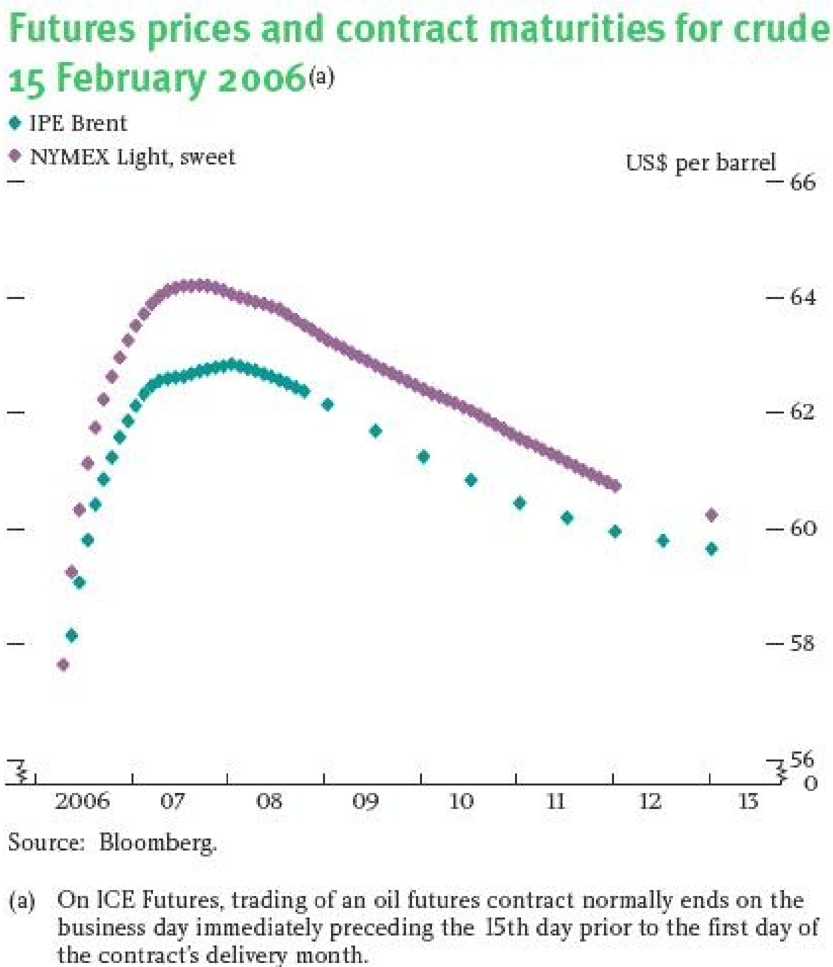
Posted by jeffvail on May 20, 2008 - 7:30pm
Topic: Economics/Finance
Tags: backwardation, contango, oil futures, peak oil, peak oil meme [list all tags]

To the greatest extent in the history of oil futures trading, oil prices are now in continuous contango--that is, oil futures get progressively more expensive each year into the future. Does this mean that Peak Oil, as a meme, has "tipped"? Our latest oil price poll suggests that well over 70% of the sample (N>3000 now) thinks that oil will at least stay above $114 a barrel for the next two months--and almost half think it will hit $140 a barrel in that timeframe. Search volume on Google for the term is up dramatically in the past month, as is traffic at The Oil Drum. The following graph shows the dramatic swing from backwardation to contango over the last 6 weeks:



A few quick definitions: Backwardation is when prices in the future are lower than in the present. Contango is the reverse, where future prices are higher than in the present.

Backwardation is the historical norm in oil futures markets, and it is conventional wisdom that there are fundamental reasons for this "normal backwardation." While contango has occurred in the past in oil futures markets (most recently in 2005 - 2006), past occurrences have always been "partial" contango--where prices increase for some years, but decrease beyond that. This type of contango is explained by expectations of near-term shortages, and can be seen in this chart of the backwardation curve in crude oil from February, 2006:



The rapid swing to contango between May 16, 2008 and May 20, 2008 is unprecedented for both the degree of continuous contango and the rate of price movement (today's $9+ advance in December 2016 futures is the largest single advance in history). What was the cause of this shift? Has market awareness and acceptance of Peak Oil "tipped"? This morning both [Boone Pickens and Robert Hirsch appeared on CNBC discussing oil markets], with Hirsch laying out an explicit and forceful case for Peak Oil. While the appearance of this historic contango in the oil markets is not dispositive of a sudden market awareness of Peak Oil, I think it is the most likely explanation. Either way, the situation certainly bears scrutiny and discussion...

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