



Two signals came out of the IEF meeting this week. One, oil prices between \$70 and \$80 are equally acceptable to OPEC and the IEA. Two, the Producer-Consumer dialogue will focus more on price volatility. Both signals hinted at a desire for more control over the market. It's important to keep in mind, however, that it is governments who make policy, and within the rules set by governments, markets should be left alone. In the meantime, the market will function more efficiently if the producer-consumer dialogue can indeed yield more transparent market information.

Is \$75 the Fairest Price?

Like the magic mirror in Snow White, the delegates at this week's International Energy Forum have answered the question, "Mirror, mirror on the wall, what's the fairest price of all?" Representatives from both the IEA and OPEC have agreed that an oil price in the \$70-\$80 range is the fairest price for producers and consumers. This view is compelling because, at a \$75 price, unconventional crude oil production from Canadian oil sands or from deep water off shore fields is economical, although for many conventional crude producers, \$75 still represents a substantial windfall. It is harder to see the fairness of \$75 crude from the perspective of the consumer. Crude oil at \$75 means gasoline in the U.S. at \$2.75 to \$3.00 per gallon. On what basis is this price "fair" for consumers and especially consumers in other countries who pay a hefty tax on top of that, and what about consumers in developing countries?

Some might say it is fair because \$75 crude oil has begun to internalize the economic externalities of energy security and environmental degradation from burning oil. This view suggests that the \$25 oil price of the 1980s and 1990s was anomalous. Oil was under priced. It did not correctly reflect the cost of maintaining a naval force in the Persian Gulf to ensure the free flow of oil through the Straits of Hormuz, or maintaining strategic reserves or remediating environmental damage.

Others might say that the apparent inelasticity of demand to price in the mid 2000s is a sign that, by and large, consumers have the wealth and appetite for more expensive petroleum products. Putting this view in context, consumers paid high prices for everything in the 2000s and that turned out to be unsustainable, leading to the recession and financial collapse.

Still others would say \$75 is a fair price for consumers because it is the price needed to make alternative fuels and engine technologies competitive with oil. If these alternatives are competitive then they can replace oil use and reduce our collective carbon footprint. Even at \$75, however, bio-fuels need mandates, ethanol needs subsidies, cellulosic ethanol needs tax breaks, and PHEV and EVs need lots of tax

credits and will eventually need preferential electricity tariffs and more battery development subsidies.

Finally, some would say, \$75 dollars is fair because it's a number on which producers and consumers can agree in their effort to combat price volatility. Indeed, the Secretary General of the IEF believes the producer-consumer dialogue must be strengthened in a manner to "better limit excessive oil price volatility."

Anointing \$75 crude as fair for everyone and discouraging price volatility, however, are two very different things. The price volatility of 2008-2009 was painful for producers and consumers, but it was short lived and will be difficult to repeat. The 2003-2007 increase in oil prices had a lot to do with the elimination of spare capacity in the supply chain. The final run up in oil prices in 2008, however, had more to do with the highly leveraged financial institutions' interpretation of the fundamentals than with either speculation or the fundamentals themselves. When the financial markets buckled, so did the price of oil. Oil demand was clearly falling in the US and China by early 2008. As the decline in demand accelerated and prices (helped along by the financial mess) collapsed, the marginal producer (OPEC) made a heroic production cut, which gradually pulled prices back up.

The oil market may have failed in 2008, but only briefly and for reasons beyond the reach of the global oil market. As the last few months have shown, price volatility is not as urgent a problem as some would have you believe and the identification of a fair price is academic. Governments make policy. They need to press on with policies to promote investment, transparency and security, while addressing the pressing issues of climate change and financial sector regulation. Clear policies will send signals to the market and the market will adapt in the most efficient manner possible. In the meantime, if the producer-consumer dialogue can promote greater transparency in the flow of information, then the market may find its own solution to volatility.