**The Oil Bubble**

Seventy dollars a barrel? Relax, it'll come down.   
  
*Saturday, October 8, 2005 12:01 a.m. EDT*

We keep hearing the word "bubble" to describe industries with rapid and unsustainable rising prices. Hence, the Internet bubble, the telecom bubble, stock market bubble, and now, some analysts believe, a housing bubble. Yet for some mysterious reason no one speaks of the oil bubble--though prices have tripled in two years to as high as $70 a barrel.

Reviewing the history of oil-market boom and bust confirms that we are in the midst of a classic oil bubble and that prices will eventually fall, perhaps dramatically. Despite apocalyptic warnings, the world is not running out of oil and the pumps are not going to run dry in our lifetimes--or ever. What's more, the mechanism that will surely prevent any long-term catastrophic shortages in energy is precisely the free-market incentive to make profits that many politicians in Washington seem to regard as an evil pursuit and wish to short circuit.



The best evidence for an oil bubble comes from the lessons of America's last six energy crises, dating back to the late 19th century, when there was a great scare about the industrial age grinding to a halt because of impending shortages of coal. (Today coal is superabundant, with about 500 years of supply.) Each one of these crises has run almost an identical course.

First, the crisis begins with a spike in energy prices as a result of a short-term supply shock. Next, higher prices bring doomsday claims of energy shortages, which in turn prompts government to intervene ineffectually into the marketplace. In the end, the advent of new technologies and new energy discoveries--all inspired by the profit motive--brings the crisis to an abrupt end, enabling oil and electricity markets to resume their virtuous long-term downward price trend.

The limits-to-growth crowd has predicted the end of oil since the days when this black gold was first discovered as an energy source in the mid-19th century. In the 1860s the U.S. Geological Survey forecast that there was "little or no chance" that oil would be found in Texas or California. In 1914 the Interior Department forecast that there was only a 10-year supply of oil left; in 1939 it calculated there was only a 13-year supply left, and in 1951 Interior warned that by the mid-1960s the oil wells would certainly run dry. In the 1970s, Jimmy Carter somberly told the nation that "we could use up all of the proven reserves of oil in the entire world by the end of the next decade."

We can ridicule these doom-and-gloom predictions today, but at the time they were taken seriously by scholars and politicians, just as the energy alarmists are gaining intellectual traction today. But as the late economist Julian Simon taught, by any meaningful measure oil (and all natural resources) has gotten steadily cheaper and far more bountiful in supply over time, despite periodic and even wild fluctuations in the market.



If gasoline cost today what it cost a family in 1900 (relative to income), we would be paying not $3 but $10 a gallon at the pump. Or consider that in 1860 oil sold for $4 a barrel, or the equivalent of about $400 a barrel in today's wage-adjusted prices. The first of a continuous series of innovations, in this case the invention of modern drilling techniques in 1869, cut the price by more than 90%--to 35 cents a barrel.

Fifty years ago people would have laughed out loud at the idea of drilling for oil at the bottom of the ocean or getting fuel from sand, both of which were technologically infeasible. The first deep-sea oil rig went on line in 1965 and drilled 500 feet down. Now these rigs drill two miles into the ground--and miraculously, the price of extracting oil from 10,000 feet deep in the sea bed today is approaching the cost of drilling 100 feet down from the richest fields in Texas or Saudi Arabia 40 years ago.

This spectacular pace of technological progress explains why over time the amount of recoverable reserves of oil has increased, not fallen. Between 1980 and 2002 the amount of known global oil reserves *increased* by 300 billion barrels, according to a survey by British Petroleum. Rather than the oil fields running dry, just the opposite has been happening. In 1970 Saudi Arabia had 88 billion barrels of known oil. Thirty-five years later, nearly 100 billion barrels have been extracted and yet the latest forecast is that there are still 264 billion barrels left--although the Saudis have never allowed independent auditors to verify these numbers.



In this industry, alas, bad news tends to crowd out the good. When Shell announced earlier this year that its oil and gas reserves were down by 30%, there was a global outcry. But when Canada announced in 2004 that it has more recoverable oil from tar sands than there is oil in Saudi Arabia, the world yawned. There is estimated to be about as much oil recoverable from the shale rocks in Colorado and other western states as in all the oil fields of OPEC nations. Yes, the cost of getting that oil is still prohibitively expensive, but the combination of today's high fuel prices and improved extraction techniques means that the break-even point for exploiting it is getting ever closer.

The energy Malthusians counter that China, India and other nations will satisfy their growing appetite for oil by driving demand and prices ever higher. In the short term, yes. But over the longer term, as the Chinese become more prosperous through free markets, China will become vastly more fuel efficient and also help discover new sources of energy.

America produces twice as much output per unit of energy consumed as it did 50 years ago. Liberals who say we need government to intervene in the energy markets, to patch the alleged failings of the free market, fail to comprehend that the command-and-control economies of the last 50 years have been far and away the biggest wasters of energy (and the biggest polluters). South Korea produces about three times as much output per kilowatt of electricity as North Korea does.

This is no call for complacency or inaction in the face of very high energy prices; it's a call for realism. Higher prices for gas and fuel for home heating have cost the average U.S. family about $1,500 to $2,000 a year. (Thankfully the Bush tax cuts have given back about precisely that amount in lower tax payments to the IRS.) The tax on the American economy from higher oil prices has reached $300 million a day and has chopped nearly a percentage point off GDP growth.



Our point is that the constraints on our ability to find and extract new oil are not geologic or scientific. The real constraints on oil production are barriers created by government. Myron Ebell, an environmental analyst at the Competitive Enterprise Institute, notes that roughly 90% of the oil on the planet rests under government-owned land and these resources are abysmally managed.

In the U.S., environmentalists have erected myriad barriers to drilling for new sources of oil. The American Petroleum Institute estimates that there are at least 100 billion barrels that are fairly easily recoverable in Alaska and offshore that oil companies are not permitted to exploit. Once, we could afford the luxury of not drilling there. Now, thanks to a witch's brew of unforeseen circumstances--political turmoil in the oil producing countries, China's surge in demand, and hurricanes that have knocked out Gulf refineries--it's an economic and national security imperative that we do.

Here's one simple idea to increase the domestic supply of oil: Have Uncle Sam share its oil-drilling royalties with the California government. If Californians realized they could go a long way to solving their deficit and over taxation problems by raising billions of these Petro-dollars, the aversion on the left coast toward offshore drilling might well begin to subside.

We will assess at another time the many dreadful ideas--price controls and "windfall profit" taxes--that Congress is considering to deal with the energy crisis. But for today it is sufficient to note that the free market will deliver oil, electricity and other forms of energy at declining prices in the future, if only the government will let the market's benign and productive forces work their magic.