

Energy shock comes as no surprise

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In *The Australian Financial Review* of January 6, 2011, ResourcesLaw predicted an energy shock.

This was before the recent upheavals in the Middle East. How could we be sure?

The answer lies in the continuing increase in global energy demand – principally in the rapidly developing economies of Asia – without adequate counterbalancing on the supply side. This trend started over 10 years ago.

Because oil supply is exposed to uncontrollable geopolitical risks and the possibility of arbitrary production constraints, importing countries are always vulnerable to an energy crisis. The recent events in the Middle East have served to highlight the risk.

The International Energy Agency's emergency oil stocks can cope with supply shortages for a month or two. After that, rationing will occur as a natural result of higher prices, which are bound to persist unless there is a major reduction in demand.

Airlines, shipping companies, trucking firms and chemicals, rubber and plastics manufacturers may feel a lot of pain.

All mining operations that depend on a continuous supply of liquid fuels, such as iron ore and coal mining, may also feel pain.

For far too long, short-term thinking has tended to prevail over longer-term strategic responses.

With the oil market, we are concerned with not just a commodity but also the most strategically important commodity in the world. There are limits to which consumers of strategically important commodities should expose themselves to the risk of market disruption.

Governments were distracted in 2009 and 2010 by the global financial crisis and a slackening of energy demand. They were also distracted by climate change negotiations in Bali, Copenhagen and Cancun.

They have allowed themselves to be lulled into a false sense of security about the future supply of oil.

Each oil-importing country, including Australia, now has an excessive oil-dependency problem. Each must now develop its own country-specific response tailored to its own needs.

At the very least, this requires further diversification of all fuel types. It also requires greater investment in more efficient, low-carbon technologies. We may need to start driving electric vehicles sooner than we expected.

The oil and gas industry has been lobbying governments to accelerate investment in upstream development and refining capacity by guaranteeing competitive investment conditions for investors. As a rule, governments have not followed this advice.

Resources nationalism remains alive and well. Countries with national oil companies have preferred to keep their resources under state ownership. Some countries have wanted to retain as much as possible of the value of the resources for the host nation itself.

Oil exporting countries keep telling everyone that they should have no fear of an oil crisis because the exporting countries need stable revenues just as much as importers need the oil.

With many producer governments not allowing foreign investment in the oil sector, and with 10 and sometimes 20 year lead times for new project development, these unilateral policies are no longer enough.

There is a need to re-assess the systemic risks inherent in the current arrangements.

Bold and innovative ways of market restructuring should be explored but restructuring costs will be high and “free riders” will be everywhere.

Governments need to adopt policies that promote, not impede, the restructuring process.

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