OPINION

Will soaring oil and gas prices be the unmaking of high prices?

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An oil well service rig and storage tanks are seen surrounded by farm land near Cremona, Alta., on July 5.
JEFF MCINTOSH/THE CANADIAN PRESS

Despite some recent softness, gas and oil prices continue to be stubbornly high, panicking both politicians and consumers. At the other end of the spectrum, the Bank of Canada seems to be more optimistic, projecting that globally oil prices will gradually decrease.

In other words, central bankers are alluding that oil price behaviour is typical of commodity prices in every business cycle. But if they are wrong, and oil prices continue to be elevated for years to come, will we be at the threshold of a major economic disaster?

My view is that things are worse than what central bankers believe. Oil prices may decline in the short term on fears of a recession, but in the long term oil prices will remain elevated because of misguided government policies around the world.

In the 1930s, Cambridge economist Nicholas Kaldor analyzed commodity prices and their behaviour over the business cycle, developing what's known as the cobweb theorem, according to which producers' expectations about prices are assumed to be based on observations of previous prices. It applies to commodity markets, including oil and gas, since there's a time lag between exploration, mining, drilling and production decisions.

That is, low prices in one period lead to a fall in supply and a subsequent rise in prices. If producers plan their investment expecting high prices, then supply in the second period will be higher. Prices will fall when producers try to sell all of their output. This process repeats itself, going from periods of low supply and high prices to high supply and low prices. When prices rise a lot, higher production is encouraged. That normally will lead to overproduction and price decline as demand dips. As prices decline, many marginal producers go out of business. In turn, production declines, often so much that when demand starts to increase, prices rise sharply.

Does the current market look like the typical commodity price behaviour, or is this time different?

Legal threats, investor pressure and fear of regulations have caused investments in oil and gas to plummet in recent years, which has led to a sharp decline in oil production. Once the pandemic was kept in check and people started travelling again, the increase in demand mixed with reduced output led to the sharp increase in gas and oil prices. The restricted supply will continue to support increases in oil prices to a level that will encourage a lot of marginal production, at which time, in theory, prices will peak and start falling at the next phase of the business cycle.

But will the above scenario unfold this time around?

Global concerns over climate change and the drive to make environmental, social and governance factors part and parcel of investor risk may have permanently discouraged necessary investments in the industry. For example, pension giant Caisse de dépôt et placement du Québec recently decided to dump its oil and gas investments. The S&P 500 energy sector's capital expenditure as a percentage of operating cash flow fell by more than

30 per cent in 2021, according MacNicol & Associates Asset Management Inc. And despite the rise in oil prices, Moody's Investors Service reported that oil and gas companies expect continued restraint in spending in 2022. And it may not just be the long-term oil price dynamics that have shifted, but that of all commodities, too. For example, mining companies are returning capital to investors rather than investing it to increase production for fear of ESG regulations. This implies major shortages in metals down the road at a time when demand will be increasing to meet the needs of renewable energy and electric-vehicle production.

It seems this time there is no supply response to the price increase and this will further feed a rise in prices and inflation going forward – so it may indeed be different this time – oil prices will remain elevated for the foreseeable future.

Warren Buffett's Berkshire Hathaway has spent billions over the past few months acquiring more shares of oil and gas company Occidental Petroleum Corp. (OXY), raising Berkshire's stake in the company to 19.2 per cent.

Could Mr. Buffett's usual sixth sense be telling him the same thing?

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