Insight

Talladega, Hedging and Oil Production

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In our national debate over domestic oil production, too much time is spent discussing whether more production can lead to oil independence and too little time on the potential impact on liquidity in global oil markets. Lost in the back and forth is the fact that increasing domestic production by any amount increases spare capacity globally and lowers the risk premium.

In the world of commodities, hedging oil is the market equivalent of racing at Talladega. As one race car driver observed, “It's Talladega, short for 'We're going to crash, we just don't know when.' “

Instead of car wrecks, however, oil markets constantly face the threat of supply disruptions among the multiple producers, shippers and refiners. Instead of cars being driven around a superspeedway by highly skilled men and women at high speeds with little margin for error, international oil suppliers are trying to choreograph the movement of 90 million barrels a day with an added challenge — the equivalent of a nearsighted Mr. Magoo cartoon character driving against traffic.

At any given moment, hedgers, who include refiners, utilities and airlines, are trying to protect themselves against the likelihood of a collision with a Magoo by purchasing a blend of long and short positions in an attempt to balance risk. This blend, and the level of price premium on various contracts, reflects the hedgers' sense as to how many Magoos are on the road and the likelihood of hitting one in a given time period. The higher the perceived risk of a supply disruption, the larger the cost of the premium.

In the oil world, a Magoo can come in the form of Nigerian pirates, civil wars, sabotage, major accidents and random political acts such as industry nationalizations (this happened most recently in Argentina). The consumer ultimately pays extra at the pump to insure against such events.

Of course, one of the differences between Talladega and the oil markets is that when you crash at Talladega, you are out of the race (but hopefully alive) and can go home. In the oil markets, you try to grab supply from another oil producer, if it's available.

Availability of an alternative supply, or reserve capacity, is causing a lot of concern in today's market, and it is raising the risk premium. Analysts are concerned that today's relatively small global reserve capacity of approximately three million barrels, which is held almost exclusively by Saudi Arabia, is too small to absorb a significant disruption.

Equally concerning, but less common, is the possibility of what the racing world refers to as “The Big One”, an accident involving more than seven cars.

During the Arab Spring last year, many in the oil industry feared the oil equivalent of the Big One as Libya stopped producing and unrest escalated in Algeria, Bahrain, Oman and Egypt, which is a major transportation hub. As a result, the price of oil shot up.

Since policymakers have marginal ability to calm the internal politics of oil producing nations, the challenge for oil consuming nations is to create adequate spare capacity in order to minimize market stress and lower the risk premium that drives up the price of oil.

The traditional method has been to lobby Saudi Arabia to create more capacity and thus lower risk. While the Saudis have been accommodating, there are limits as to how much they are willing to invest in unused capacity.

A second option is to develop additional supply from other producers — including the United States. As the world's third largest oil producer and its largest natural gas producer, America has the resource endowment to produce more oil and help relieve energy price pressures.

In the debate over how, when and where to produce energy, it is critical that policymakers ask the right questions. Rather than debate whether America can become an energy island, they should be asking whether we can raise domestic production in order to minimize the inevitable Talladega moments and to ensure a relatively stable global supply and price for oil.

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