

## STEP ONE – CHOOSE AN ARTICLE

I like this article as I can use diagrams I have learned to try to explain what is going on (S/D diagrams) and it shows a change. As usually you want to draw two diagrams in the analysis part of your commentary, it is good to have an article that features an initial situation/problem and then a change or response to this problem. This change can then be evaluated. Articles that feature a problem and a government response to the problem similarly give you the chance to draw two diagrams and write an evaluation.

### Inaction on \$100 oil is likely to backfire

Consumers may go for alternative energy

Gulf News, Nov 9<sup>th</sup>, 2007

New York (Reuters) OPEC's reluctance to open the spigots as oil nears \$100 a barrel could backfire on the group as alternative energy sources and consumer conservation dig into demand.

Output curbs by the group, which controls more than a third of the world's oil, have contributed to a 90 percent rally in crude prices from last winter's lows and have helped spur investment in renewable fuels while denting demand growth.

The trend mirrors the effects of the oil boom of the 1970s, when Americans traded in gas-guzzlers for compact cars and took other conservation measures that cut into oil demand.

"Over time, the danger for the group is accelerating a decline in primary consumption of oil products, as is now happening in the US, which has been its largest growth market for the last 17 years," said Edward Morse, chief energy economist for Lehman Brothers. "It accelerates both the market incentives for investments in alternatives and energy saving technologies as well as for political incentives to foster the same ends."

OPEC agreed to roll back 500 000 barrels per day of a 1.7 million barrel per day output cut starting this month to sooth consumer fears high oil prices would damage economic growth.

But the group has dismissed calls from the US and other consumer nations to further increase output, saying speculation and geopolitics are to blame for oil's surge – not a lack of supply.

## STEP TWO – PLANNING

Use the commentary planning sheet and lay out what it is you are going to write. If you have the ideas clear in your head before you put pen to paper (or digits to keyboard) the writing will be much easier.

- A) Two terms: Demand and Price Elasticity of Demand

Note that you have some choices here – I have chosen these terms but, in a discussion about alternative, renewable fuels, substitutes might be a useful term to define as well.

- B) The change discussed in the article is the rapid rise in the oil price which could result in, over time, people moving away from petroleum towards alternative energy sources and practicing more energy conservation.

- C) The diagrams I could draw could be, first, the initial situation of rising oil prices due to output curbs enacted by OPEC. I would show a shift in the supply curve to the left and a rise in oil prices.

The second diagram would show the possible response by consumers in the medium to longer term. If they were to embrace conservation and alternative energy sources, then demand would move to the left as well, moderating the price increase.

Note that you have some choices here as well. For the second diagram I could also draw OPEC's decision to scale back their production cuts. However, in my opinion, this would not give me as much to work with in my evaluation. Most articles can be approached from a few different angles, so try and choose the angles that will give you the best chance of writing an interesting commentary.

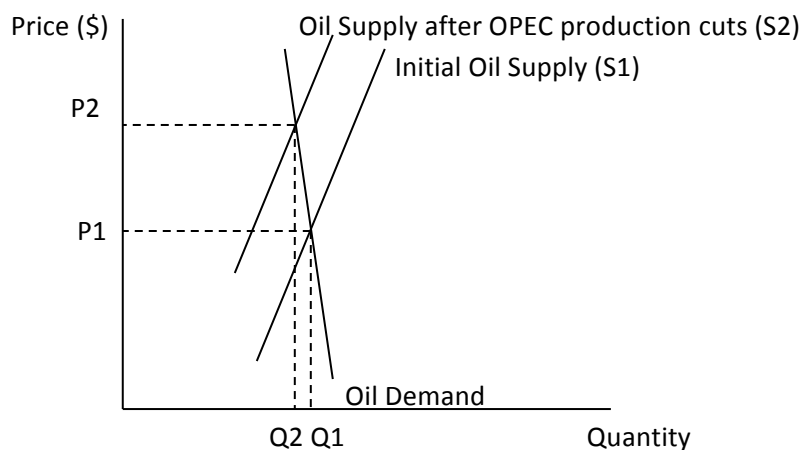
- D) I will evaluate the impact of such changes on the oil producers, the oil consumers (firms and households, in developed and in developing nations) in the long and short term to try to judge whether continued oil prices in the \$100/barrel region are on balance good or bad. It is clear that the move away from oil in the medium to longer term in response to a price change accords with theory. Overall, I think perhaps that continued oil prices at \$100/barrel might be more positive than negative.

## STEP THREE – GET IT WRITTEN

### Inaction on \$100 oil is likely to backfire

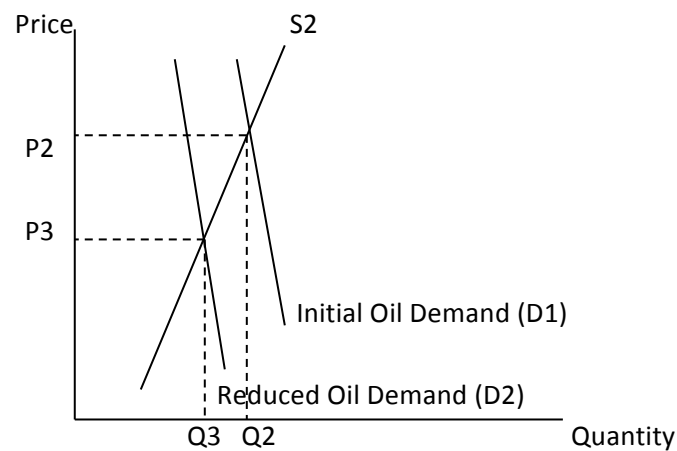
The recent increases in oil prices are now causing pain to oil consumers, but continued high prices could hurt producers as well. Two terms that will help to understand why are **demand**, which is the quantity of a good or service that consumers are willing and able to purchase at a given price over a given period of time, and **price elasticity of demand**, which is a measure of the responsiveness to the quantity demanded to changes in price, often expressed as the percent change in quantity demanded divided by the percent change in price.

The initial situation is clear. The OPEC group of oil exporters cut their output and as a consequence of this decrease in the supply of oil on world markets the price of oil has increased by 90%. We can show this using a diagram:



We can see that the shift in the supply curve to the left (from S1 to S2) has caused the price of oil to rise significantly, from P1 to P2, while leading to only a slight fall in the equilibrium quantity of oil, from Q1 to Q2. You may observe that this is due to the fact that both the oil demand and supply curves have been drawn quite steeply. This is because, at least in the short run, both oil demand and oil supply are relatively price inelastic. On the demand side, it is hard to change energy consumption habits very quickly. While higher gasoline prices may lead you to want to cut down on your consumption of gas, it takes time to organize car pools, move closer to your workplace, or replace your car with a more fuel efficient model. For producers, as it takes years to find and develop new oil reserves, supply is similarly inelastic in the short term.

As time passes, though, consumers facing sharply higher prices will find ways to use less petroleum, and this will, everything else being equal, shift demand to the left, as shown in the diagram below:



Observe that due to the price inelasticity of both supply and demand, the shift in demand from D1 to D2 has a large impact on the price of oil, moving it down significantly from P2 to P3 even while the equilibrium quantity of oil is reduced only slightly from Q2 to Q3.

In the short term, higher oil prices will undoubtedly cause a great deal of economic pain. As energy and in particular petroleum are used in the production of many products (fertilizers for food, plastics etc.) as well as in transporting them, higher oil prices will lead to higher prices for most goods and services. This price inflation will hurt the poorest the most, both in developed and, most severely, in developing countries. Middle class consumers will be hurt as well, but likely not catastrophically as generally they spend a smaller portion of their incomes on food and fuel.

Oil producers, meanwhile, will enjoy a windfall in the short term. With oil prices at \$100 per barrel, the royalties flowing to the governments of oil producing and exporting nations will rise significantly. This will in turn allow these governments to increase spending on infrastructure, education and health care which will improve the living standards of citizens. However, alternatively, these extra revenues may stay in the hands of well-connected officials and fuel corruption, which would be a sad waste. Lastly, the increase in oil revenues may also retard the growth of non-oil businesses in oil producing countries and discourage the development of manufacturing and services, which would also be a blow to their economic and social development.

In the long term, though, if consumers respond to the higher oil prices as we have indicated above by investing in and switching to alternative energy sources like wind and solar energy the benefits could be significant for the environment, threatened as it is by anthropomorphic global warming. However, for oil producers such a move could be disastrous, but even if oil were no longer used as a fuel, it would still be needed as an industrial feedstock to make plastics and chemicals. Perhaps, without the means to earn 'easy' money from extracting and selling oil these nations would be able to develop other industries and diversify their economies.

Thus, overall, a move to higher oil prices would likely have more positive consequences than negative ones.

## STEP 4 – EDIT AND GET THE WORDCOUNT RIGHT

Total word count (not including title or diagrams) – 729

Note – When I finished my first draft, I had 776 words! Be sure to go through your writing after you finish and take out unnecessary words. As you can see, I removed almost fifty words from my commentary after I had written it. The challenge when writing commentaries is never to get enough words – the challenge is always to say what you need within the word limit. That is why you should never summarize the article and why the analysis needs to be so crisp. In the commentary above, the evaluation is almost half of the total word length (341 words). If I hadn't spent some words explaining the elasticity of demand and supply for oil, it would have been longer!