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Fluctuating Gas Prices Cause Business Concerns

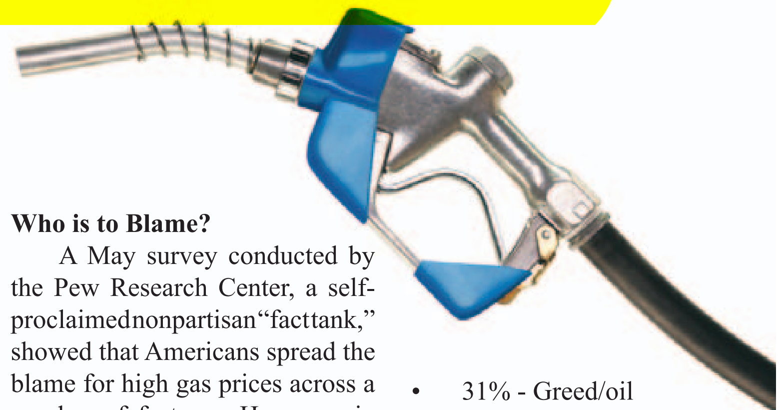
By David Baker
Margaret Baker

Gas prices are high. And they have fluctuated a good deal recently. In May, some of the Ann Arbor area gas stations saw the per-gallon price reach near $5. And the price of a barrel of crude oil was dancing around a $90 and $120 range. Experts expect prices to drop soon, but forecasts are uncertain.

The price of oil matters, of course, because it affects our Michigan economy in a number of ways beyond the pump: higher product shipping costs, price pressures on exports, downward pressure on consumer demand, and increased cost of oil derivatives such as plastics and polymers.

Prices are down for the moment, relative to the peaks in May, but what happens next? Can we expect gas prices to fall back to around $3 per gallon again soon? Will they go above $5 per gallon?

The short answer: We know the factors that impact gas prices, but we can't predict prices beyond the next 6 months. It turns out that, as with the factors that impact forecasting the weather for next weekend, the mechanics that determine oil prices in a dynamic global market are staggeringly complex.



Who is to Blame?

A May survey conducted by the Pew Research Center, a self-proclaimed nonpartisan "fact tank," showed that Americans spread the blame for high gas prices across a number of factors. However, in response to the question 'What is the main reason gas prices have gone up recently?', only 12% of those surveyed pointed to market forces as a driving factor. Here is how Americans' responses break down:

- 31% - Greed/oil companies/speculation
- 19% - Wars/Mideast unrest
- 14% - Politics/policy
- 12% - Economic forces
- 10% - Other reasons
- 14% - No opinion

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The lounge off the main lobby at Masco provides comfortable surroundings for guests and employees.

Masco Cabinetry Finds New Home In Ann Arbor

By Duane Ramsey

When it consolidated operations in Michigan and Ohio, Masco Cabinetry chose Ann Arbor Township as the location for the new home of its corporate headquarters.

Masco Cabinetry was created in 2010 by combining the previous Builder Cabinet Group in Adrian and the Retail Cabinet Group in Middlefield, Ohio.

"Combining the strengths and talents of the two organizations to generate significant value for our customers was a very exciting opportunity," said Karen Strauss, president of Masco Cabinetry.

The new company, a division of Masco Corporation based in Taylor, purchased the former Flint Ink facility on Arrowhead Drive off Dixboro Road for its new home.

"With the decision to integrate the Retail and Builder Cabinet Groups into the new Masco Cabinetry, our vision for the new headquarters facility was to build an environment that encouraged ownership of the company's bottom-line results

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Thomas P. Lyon, Director, Erb Institute for Global Sustainable Enterprise and Professor, Business Economics and Public Policy, Ross School of Business, U-M

To help untangle the question of oil prices, we spoke with Thomas P. Lyon, Professor of Business Economics and Public Policy and Directors of the Erb Institute for Global Sustainable Enterprise, a U-M institute supporting scholarship in support of a transition to sustainability. Lyon applies economic analysis to understand corporate environmental strategy and has co-authored *Corporate Environmentalism and Public Policy* (Cambridge University Press, 2004).

According to Lyon, while the factors that impact oil prices are generally understood, accurately predicting price changes for oil some distance out is virtually impossible. "It's hard to tease out the individual effects on oil prices," says Lyon. At the end of the day, "The only thing we know for sure is that oil prices went up or down."

"You can analyze some of the underlying factors, such as the total number of rigs, how much they are producing, overall demand, how much people are driving, etc. For all those kinds of factors you can have some subjectivity," Lyon explains. "[But] it's hard to account for uncertainties, such as conflict or instability in the Middle East."

With the recent fluctuations in oil prices, many want to blame speculators for driving up oil futures prices, oil companies for colluding to prop up artificially high prices, or just general greed of those involved in the markets. But this blame seems to be misplaced.

"It's hard to determine what is being driven by 'speculators' and what's driven by uncertainty in the market," explains Lyon. "I guess my personal bias is that most speculation is not the problem with the oil markets. Investors are just trying to make their best guess as to what's going to happen in the future."

Since oil companies are making terrific profits, some believe the firms are using current circumstances to prop up prices. That's difficult to argue, Lyon believes. "Oil companies, of course, would like to hold oil prices high. But there is competition in the oil market. If Shell, for example, tries to set high prices, somebody else can undercut them. I don't think that market is concentrated enough to successfully collude to make oil prices high."

"There are a number of political forces," Lyon continues, "that lead politicians to point the finger and try to blame somebody when oil prices go up. And they'll often launch an investigation into some kind of collusion among oil companies. I think it's usually pretty hard to find collusion, except among members of OPEC. I don't really think that it's Wall Street that's creating the problem."

This doesn't leave oil companies off the hook completely, however. "The oil companies are making a ton of money. I'm just outraged that Congress just voted to keep subsidies in place for oil companies. These companies do not need subsidies to go and find more oil. That just keeps us more dependent on oil and keep us locked into that fuel for longer and they throw public money at oil companies. It's embarrassing that our Congress votes for that kind of stuff."

Supply, Demand, and Risk

Subsidies aside, however, it is economic factors that are contributing to volatility in the oil prices. And these factors can be grouped into three classic categories: supply, demand, and risk.

As Lyon explains, "There are a couple of long-term trends that are the big drivers, both on the demand side and the supply side. On the supply side we have peak oil. We don't exactly know when it's going to hit, but basically we're starting to run out of oil. And no matter how hard we try, the total amount of oil production is going to start declining. That happened in the United States back sometime around 1978 when we hit our maximum production, and it's been declining ever since."

"It's not because oil companies have stopped trying to get oil out of the U.S.," Lyon clarifies. "It's that we're running out. And the same thing is going to happen at the planetary level. There are some people that predict that [reaching peak levels has] already happened. I think that's incorrect, but if you look at total oil production over the last few years it hasn't gone up much.

"So, on the supply side, we're definitely decreasing marginal return. It's harder and harder to find new sources of oil, it's more and more costly, and it's more and more dirty. The [Athabasca] tar sands in Canada, for example, are terribly dirty and expensive."

"[On the demand side]," Lyon continues, "India and China just keep growing. China is building automobiles and selling them much faster than the United States. That's where all the demand is."

According to Reuters, for example, China's crude oil consumption grew 13.1% in 2010. And while the growth projects for China's oil use in 2011 is only 6.6%, that growth is higher than

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the projected global crude output growth of 4%.

The third category, risk, is difficult to quantify. However, as shown in the Pew research, people intuitively understand that unrest in the Mideast can impact oil prices. And the crisis with Deepwater Horizon highlights the broad company and societal risks associated with oil exploration.

Lyon sees recent events as opportunities to make changes. As Lyon describes, "The Deepwater Horizon incident is a reminder that oil extraction is costly and risky; it imposes environmental risk. I feel that we have been missing a couple of, what you would call, teachable moments, now, with the Deepwater Horizon and with the high oil prices that we're facing now. And I'm shocked that no politician is saying, 'Hey, everyone, this is why we have to get off of oil.'"

Long Term – Just Assume No Change

Knowing the factors that impact oil prices is one thing; but it's an entirely different matter to forecast or predict oil prices in the future. In fact, nobody seems to have even a good academic model for doing so.

When economists evaluate a forecast model, they often compare forecasts generated from that model with the "no-change forecast." The no-change forecast simply assumes that prices will remain the same. So if gas is $3.90 per gallon at the pump today, the no-change forecast one year from today is $3.90 per gallon.

It turns out that the most sophisticated models for predicting oil prices in the future (beyond 6 months) is, surprisingly, no better than the no-change forecast.

Lutz Kilian is a professor of economics at the University of Michigan. The majority of Kilian's recent research has focused on fluctuations in oil prices.

In a paper Kilian and others submitted in May to the Center for Economic Policy Research (CEPR), their data showed that, for time horizons beyond 6 months, "The no-change forecast of the real price of oil typically is the predictor with the lowest MSPE [i.e. mean-squared prediction error.]"

What about the idea that speculators are driving up the price of gas. Certainly one would expect a relationship between the oil futures prices and actual prices. Not so, says Kilian et al. "At the long horizons of interest to policymakers," they noted, "oil futures prices are clearly inferior to the no-change forecast."

This is a very important finding for business owners. Basically, if you want to plan your business expenses for gas and oil in 2012, the best prediction is, believe it or not, today's prices. Today's price is a better predictor than economic forecasts or the futures market. Unfortunately, since today's prices are relatively high, that means businesses should plan for relatively high prices in 2012.

Short Term – There's an App for That

The short term, however, is a different matter. Economic models and, therefore, experts and analysts can be a good source for anticipating gas and oil prices over the summer. Most analysts predict a 50-cent price drop is gas at the pump, so businesses should probably use these forecasts as a baseline assumption.

As for managing your business, you might turn to new tools and resources available to help you make smarter purchasing decisions. For finding the best prices at the pump, for example, the internet is contributing to the very competitive market that Lyon describes.

Gasbuddy.com is a crowdsourcing website that provides semi-real-time information on prices at the pump. It is also available as a downloadable app for iPhone or Android phones, with over 135,000 Android downloads to date. The application identifies your location and provides gas stations near you with the lowest posted prices.

For the Ann Arbor area, Speedway consistently showed up among the lowest-priced providers. On the other hand, the CITGO on Packard and Stadium did not have a recent pump price listed in gasbuddy.com, but by visiting CITGO we noticed that it had prices 2-cents lower than the neighboring Circle K.

In the end, there just seems no returning to days of inexpensive fuel. As Lyon concludes, "We've got supply side that is decreasing with demand growing quickly. That means high oil prices for the foreseeable future. . . I just don't think we're going to see a return to the happy old days when oil was so cheap." ■