UK Government Oil Price Forecast

Posted by Chris Vernon on July 16, 2006 - 11:16am in The Oil Drum: Europe
Topic: Policy/Politics
Tags: government, oil prices, united kingdom [list all tags]

John Hemming MP has recently tabled a written question asking the Chancellor of the Exchequer what oil price his Department predicts for each of the next 10 years.

As is usual the straight forward question didn't result in a column of ten numbers plus the appropriate uncertainties or caveats for use. The get-out seems to be based on semantics since the treasury doesn't actually make its own predictions but works with an average of independent forecasts. It was clear that the information Hemming was actually after was what prices they use internally... However the response did provide an interesting document on the assumptions used by the treasury.

I have often wondered what assumptions are fed into the Government's forecasts. In the past I have been critical of the forecast growth in aviation. The 2003 aviation white paper predicted that from 2002 levels, passenger numbers would double by 2020 and freight tonnage double by 2010. This was based on the following assumptions:

- UK GDP growth over the next 25 years will average 2.25%
- Air fares will decrease at 1% in real terms for the next 25 years
- Aviation fuel prices will stabilise at $25 a barrel in 2000 prices

Anyway, the document provided is titled ***Audit of Assumptions for the 2005 Pre-Budget Report*** and is available here (pdf). On oil price forecasting it seems to suggest that there is a systemic failing in the way five year oil price assumptions are generated. I say systemic failing since it appears the system could not have allowed the rapid ramp up in prices we've seen over the last few years to be used internally by the treasury, even if every independent forecaster in the land had predicted it a few years ago.

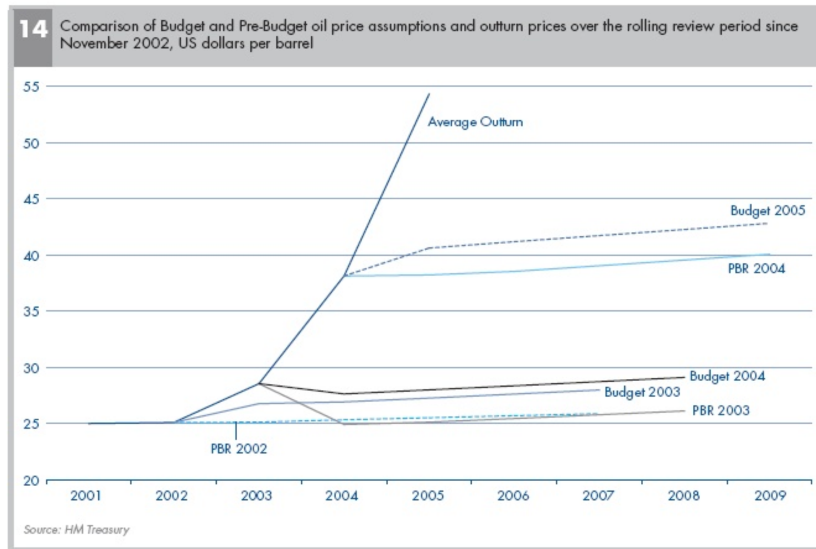
The method is:

> The oil price will be based on the average of independent forecasts for one year ahead. If the average of independent forecasts shows a fall in the oil price, that price in real terms will be used for the remainder of the five year forecast period. If the average of independent forecasts for one year ahead shows a rise, then the previous convention that oil prices would be close to their current levels in nominal dollar terms over the coming year, and remain flat in real terms thereafter, will be adopted.

If I understand it correctly even if the best information available suggested oil prices were going to double over the next five years, all that the treasury would assume over those five years would be one year's price increase then the price would remain flat in real terms for the following four years. In this hypothetical situation it would mean planning decisions for five years time could be based on an oil price some 40% lower than the oil actually costs in five years time.

It would appear the treasury is systemically blinkered to any forecast price rises the global

peaking of oil will inevitably bring. It would be nice if the adopted system at least had the capability of describing past behaviour, I don't think this system can claim that. This graph shows how things have evolved through 2002 to 2005:



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