Are We Ready for the Next Oil Shock?

By Frederick W. Smith and P.X. Kelley
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Could a mere 4 percent shortfall in daily oil supply propel the price of a barrel to more than $120 in a matter of days? That's what some oil market experts are saying, and if they're correct, we face the very real possibility of an oil shock wave that could send our economy reeling. Such a rapid rise in fuel costs would have profound effects that could severely threaten the foundation of America's economic prosperity.

The global oil trends now at work -- rising consumption, reduced spare production capacity and high levels of instability in key oil-producing countries -- all increase the likelihood of a supply shock. But unfortunately energy debates in this country often suggest a profound misunderstanding of these international economic dynamics. Calls for "energy independence" notwithstanding, oil is a fungible global commodity, which means that events affecting supply or demand anywhere will affect oil consumers everywhere. A country's exposure to world price shocks is thus a function of the amount of oil it consumes and is not significantly affected by the ratio of domestic to imported petroleum.

The magnitude of our dependence on oil puts stress on our military, strengthens our strategic adversaries and undermines our efforts to support democratic allies.

Each year the United States expends enormous military resources protecting the chronically vulnerable oil production and distribution network while also preparing to guarantee international access to key oil-producing regions. This allocation of forces and dollars diminishes the military's capability for dealing with the war on terrorism and other defense priorities.

Considering the potentially devastating impact of an oil crisis, the time has come for new voices, especially those of business leaders and retired national security officials, to join the call for meaningful government action to reduce projected U.S. oil consumption. Our respective personal experiences -- running a global transportation and logistics company and spearheading the establishment of an independent U.S. Central Command in the Middle East -- convince us that America's extreme dependence on oil is an unacceptable threat to national security and prosperity.

During the coming months, we will be co-chairing the Energy Security Leadership Council, a new and intensive effort by business executives and retired military officers to advance a national energy strategy for reducing U.S. oil dependence. Although drawn from very different backgrounds, the members of the council are united in the belief that a fundamental shift in energy policy can prevent an unprecedented economic and national security calamity.

As President Bush and members of Congress construct a strategy for energy security, several central principles should guide them : The most substantial, rapid and cost-effective gains are almost certain to be achieved by making our transportation system more fuel-efficient. To be sure, the search for increased oil, natural gas and alternative energy supplies merits support, as do strategies for controlling industrial demand. But the transportation sector relies on oil for 97 percent of its energy needs and accounts for 68 percent of total U.S. oil consumption. With the right incentives, America's engineers and businesses could soon provide better vehicle technologies, a more efficient movement of goods and many other smart solutions. Substantially reducing demand in the transportation sector would help ensure availability of affordable supplies for critical industrial, commercial and consumer needs.

Pure market economics will never solve this problem. Markets do not account for the hidden and indirect costs of oil dependence. Businesses focused on the highest return on investment are not always in a position to implement new solutions, many of which depend on technologies and fuels that cannot currently compete with the marginal cost of producing a barrel of oil. Most important of all, the marketplace alone will not act preemptively to mitigate the enormous damage that would be inflicted by a sudden, serious and sustained price increase.

Government leadership is absolutely necessary. Many of the most promising solutions on both the demand and supply sides will require decades to mature. Government proposals should align the interests of businesses and individuals with society's goals; for example, tax credits and similar incentives must allow businesses to recover investments and engage in essential long-range planning, and they must account for the high implicit discount rates that consumers apply to future savings. While recent legislation has pointed us in the right direction, bolder action must be taken. Whatever the eventual shape of a credible energy security plan, significant public and private resources will be required to put policy into practice. The government needs to do more than just provide funds, though; it must sustain a strategic energy policy even if oil prices drop in the medium term. This is only fitting given the size and nature of the threat. Indeed, if it means condemning the country to another decade of energy dependence, the possible return of $50 oil should be no less frightening than the prospect of an oil shock wave. Frederick W. Smith is chairman, president and chief executive of FedEx Corp. P. X. Kelley, a retired general, was commandant of the Marine Corps and a member of the Joint Chiefs of Staff under President Ronald Reagan. They are co-chairmen of the Energy Security Leadership Council, a project of Securing America's Future Energy.