



Meeting the supply challenge

by

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Excellencies, ladies and gentlemen,

Let me begin by thanking the organisers for inviting me to deliver this keynote address to this year's Oil and Money Conference. The main theme of the Conference, the capacity challenge, is a very topical one at the present time and one to which OPEC is devoting much attention. I should, therefore, like to present OPEC's views on this important matter and to reassure the market that OPEC is committed to secure, stable supply with reasonable prices, at all times. Here let me emphasise that the recent high prices have been primarily product-driven, as the market has increasingly felt the pressure of refinery expansion lagging behind current oil demand growth estimates, with a particular lack of conversion capacity additions, of which I will speak more later.

OPEC's commitment to market stability was clear from our two-day Ministerial Conference, which ended in Vienna yesterday — coincidentally, just one week after the 45th anniversary of our Organization! We examined the current situation in the international oil market very carefully and reminded ourselves that there have been two distinct aspects in the prevailing volatility and high prices.

2003 began with strong oil demand growth, which then accelerated to exceptional levels in 2004. While growth has remained at healthy, although at more modest and sustainable levels this year, the challenge of providing adequate crude supply has been met successfully. This has been largely due to OPEC's actions, in raising its production ceiling on several occasions during this period, by a total of 4.5 million barrels a day. This has, in turn, led to a steady rise in OECD commercial oil stocks, which are exceeding their five-year average. OPEC output is now estimated at a satisfactory 30.2 mb/d.

OPEC has also been acting on a second front, with regard to its market-stabilisation measures. In the light of the surge in demand, an initial consequence of OPEC's increase in output was a reduction in its spare capacity, particularly in 2004. Therefore, given that the high levels of oil demand growth of the past two years, particularly in China and other emerging developing economies, appear likely to remain at least in the medium term — even if this is at more modest levels — OPEC's Member Countries have sought to accelerate their plans to bring on-stream new production capacity, currently at 2.0 mb/d. This is to re-establish a comfortable level of capacity, to help calm markets at a time when demand is expected to continue growing strongly.

This means that capacity will be more than adequate to cover oil demand growth throughout this winter and in 2006, with the call on OPEC only slightly higher than in 2005. It should be able to accommodate sudden, unexpected cutbacks in supply, just as it did when Hurricane Katrina caused an immediate loss of about 95 per cent of US Gulf Coast crude oil production. Furthermore, much of the new capacity from both OPEC and non-OPEC will in 2006 — luckily — consist of lighter crudes, which are in much demand in the market. More increases in capacity have been planned (and are being implemented) for the rest of the decade.

Let me say a few words here about the impact of Hurricane Katrina — from a market perspective and notwithstanding our deepest sympathy for all those people who suffered loss of family, friends, property and livelihoods. This tragic event demonstrated OPEC's readiness to respond to crises in a timely, considered and effective manner, with

our Member Countries pledging prompt provisions of oil and fuel supplies to help deal with the immediate severe impact on the region and its population.

However, although there has been considerable damage to the producing and refining facilities in the US Gulf Coast region, we think it is unlikely that this — on its own — could lead to a major energy crisis, given healthy levels of commercial oil stocks, especially crude, and taking into account also the International Energy Agency's (IEA's) announced release of member country government stocks; these, together with the efforts of the producers, have contributed positively, we believe, to calming the market. We understand that, already, more than half a million barrels a day of the region's crude output have been restored and that the situation will continue to improve, although the precise time-frame for this is somewhat uncertain — months at most, not years. Having said that, the chief problem remains that it is expected to be a long time before the region's refinery centres return to full operations, and this is adding to the already considerable strains in the global refinery system. More about the downstream in a minute.

I should like to make one more comment about the situation upstream. This relates to non-OPEC supply. For the third year in a row, the growth in non-OPEC supply has been falling behind that of world oil demand, reversing earlier trends of matching or exceeding demand growth, and this tendency is expected to continue for at least a while longer, although 2006 will see growth recover to 1.1 mb/d from the exceptionally low level of 0.6 mb/d witnessed this year on account of many factors (Russia, the North Sea, the USA). Nevertheless, while some non-OPEC producers have been experiencing absolute declines in production in recent years, others have been seeing their output grow. On balance, we expect annual average growth of around 1 mb/d in non-OPEC supply up to 2010, slowing thereafter. Combined with the planned increase in OPEC capacity from 32.5 mb/d to more than 38 mb/d by 2010 and an additional 1.5 mb/d increase in natural gas liquids over the same period, this means that cumulative world oil production capacity will rise by around 12 mb/d over the next five years, well above the expected cumulative rise in demand of 7–8 mb/d over the same period, and thus it will more than cover the forecast growth in demand.

The second distinct aspect in the prevailing volatility and high prices occurs downstream. While the situation upstream has stabilized and is expected to improve, as explained above, there is a different picture downstream. The continued serious downstream bottlenecks in some major consuming countries — due mainly to a lack of timely investment and to increasingly stringent product specifications motivated by environmental concerns — have seen refineries operating at near capacity to keep pace with rising demand, putting pressure on not only product prices, but also crude prices. This has been particularly apparent in the post-Katrina market, with average OECD refinery utilisation above 90 per cent and some regions close to 95 per cent.

It is clear, therefore, that the industry at large — especially in consuming countries — must pay more attention to the downstream part of the supply-chain, in the interests of overall market stability. In particular, concrete measures should be taken to encourage rapid and sizeable investments in the refining sector, especially in conversion capacity, which has persistently lagged behind market requirements. This is a challenge that should be addressed urgently. It also includes conforming to the new product specifications.

Though their primary responsibility is in the upstream, OPEC Member Countries have taken the initiative — on their own and in partnership with others — to invest in downstream projects. However, without adequate and timely measures in the main consuming countries, today's high and volatile oil prices are likely to remain a feature of the market. As it stands now, it does not appear that the growth in refinery capacity will match demand growth before 2007.

On top of all this, there has been widespread concern about possible future supply disruptions that may result from increased geopolitical tensions. These factors have been reflected in increased speculation in futures markets, particularly through a rise in activity by non-commercials, notably pension and trust funds. Without any doubt, due largely to the perceived capacity constraints, the market has become very nervous and over-responsive to external impulses, and price levels cannot be justified by crude oil fundamentals alone. Indeed, a clear and strong correlation has existed between oil prices and both “open commitment” and trade volumes in NYMEX oil futures in recent years. Nevertheless, in real terms, crude oil prices, although high, are still well below levels reached in the early 1980s.

Clearly, there are no winners from such a situation. Excessive market volatility can have an adverse effect on activities at all levels within the industry and, ultimately, have negative repercussions for both producers and consumers. It can, in particular, be highly detrimental to investment in future production capacity, as indeed it can for domestic development in oil-producing countries. If prices are so high that they cannot be sustained, they may well be followed by very low prices and reduced revenues not long afterwards — just as occurred in the 1980s, with dramatic consequences for our Member Countries and their aspirations to sound, sustained economic and social development.

Turning to the world economy, it appears that the recent high oil prices have, so far, had little impact on global economic growth, which continues to be robust, a sign that the world economy has become less sensitive to oil price increases than it was three decades ago. However, we must not be complacent! There are signs that, if the current price levels persist, they will begin to affect some economies; indeed, they are already starting to affect some developing countries in Asia and Latin America.

Therefore, in the light of all this, our Ministerial Conference yesterday reiterated that OPEC would continue its proactive policy of supporting market stability by ensuring availability of adequate supply, at prices reasonable to both producers and consumers. This would be, notably, for the benefit of the world economy, including, in particular, the economies of the developing world. The Conference therefore agreed to make available to the market the spare capacity of around 2 mb/d in Member Countries, should it be called for, for a period of three months, starting 1 October. It further decided to review market developments at an Extraordinary Meeting, to be held in Kuwait on 12 December, and to take decisions deemed appropriate and necessary.

At the same time, our Conference called on all other parties in the industry to join its efforts to maintain market stability, with reasonable prices consistent with robust economic growth, as well as steady revenue streams, for producing countries and the industry, conducive to the expansion of upstream and downstream capacity to meet rising international demand for crude oil and products. It also welcomed recent actions taken by consuming countries to ease the burden of higher fuel prices on the final consumer.

So far, I have only spoken about the supply challenge for the near term. However, OPEC is equally committed to the achievement of market order and stability in the future.

Indeed, at our Ministerial Conference this week, OPEC adopted a comprehensive long-term strategy, to provide a coherent and consistent vision and framework for the Organization's future. The strategy defines specific objectives for the Organization, identifies the key challenges it faces now and in the future, and explores scenarios for the energy scene. It is designed to be robust and adaptive throughout the various possible futures.

According to the reference case scenario from OPEC's World Energy Model, world oil demand will continue to rise in the early decades of the 21st century, at an average annual growth rate of 1.5 per cent up to 2025, reaching 113 mb/d. With non-OPEC output expected to reach a plateau of 55–57 mb/d in the post-2010 period, OPEC will be meeting nearly half the world's oil demand in 20 years' time, according to this scenario.

This is an awesome challenge, but OPEC has the resources to meet the growing oil requirement, to ensure that the market remains well-supplied with crude at all times, at reasonable prices that are compatible with robust growth in the world economy. The Organization is, indeed, committed to maintaining and developing sound investment strategies, and will see that these are put into effect, in a timely and sufficient manner, to provide the required production capacity for oil that is cleaner, safer and more efficient than ever before. Moreover, OPEC's long-term strategy envisages an enhanced role for its Member Countries' national oil companies in this, as well as developing close cooperation among themselves in such areas as technology, industrial networks and knowledge- and experience-sharing.

But there are many uncertainties which make sound investment planning a hazardous business, in an industry where the lead times can be very long and the capital requirements enormous. Future economic growth rates, consumer government energy and environmental policies, technological advances and the oil price path lie at the heart of these uncertainties. Over-investment implies heavy costs to be borne by producers, while under-investment will lead to severe price movements. Thus every effort must be made to reduce uncertainties and to share the risks involved.

Increasingly, attention is being turned to long-term investment in the downstream, an issue that has been brought into focus by the short-term bottlenecks. The move towards demand for ever lighter and cleaner products represents a significant challenge for the downstream sector, and substantial investment will be required to meet this in the years ahead. If the required investment does not take place in a timely manner, this sector will remain a source of tightness and volatility.

All this reinforces the case for the continued enhancement of the process of dialogue and cooperation within the oil industry, involving producers, consumers and the international oil companies. As the OPEC President, HE Sheikh Ahmad Fahad Al-Ahmad Al-Sabah, said in Vienna yesterday, dialogue is "no longer with just producer and consumer; (it is) with everybody." OPEC has and will continue to play its role in ensuring a sufficiency of crude. It is up to the international oil companies to shoulder their responsibility by investing their current large profits in upstream and, in particular, downstream projects. Consumer governments' responsibilities lie in encouraging more

rapid investment in downstream projects, harmonizing their economic, energy and environmental policies, and examining their fiscal policies — noting that taxes today represent more than 60 per cent of the cost of products to consumers in most OECD countries.

Our Organization welcomes the continuation of consultations between OPEC and the IEA, as well as noting the increasing effectiveness of the International Energy Forum as a platform for global dialogue. We are also very satisfied with the recently established OPEC/European Union dialogue, and we are ready to enter into similar dialogues with other regional and international bodies.

However, although much welcome progress has been made in this area in recent years, OPEC's long-term strategy recommends that dialogue should be widened and deepened to cover more substantive issues of mutual concern, such as security of demand and supply, market stability, investment, technology and the downstream.

The strategy calls for OPEC Member Countries to strengthen cooperation in upstream and downstream scientific research and technological development among themselves and with institutions. It advocates supporting research in the production and use of cleaner petroleum-based fuels and taking an active role in the development of technologies that address climate change concerns, while improving and expanding the role of oil in meeting future world energy demand, such as carbon dioxide sequestration.

Let me close by saying that we must accept the fact that natural or man-made events, that can interfere with production capacity across the supply chain, can happen at any time, as was vividly illustrated by Hurricane Katrina. This underlines the importance of building into the system safety valves, including adequate spare capacity across the supply chain.

There is, therefore, a powerful new incentive for the responsible members of the industry to continue working together to help stabilise the market and ensure its steady, orderly evolution in the opening decades of the 21st century, to the benefit of the world community at large. OPEC has long been striving for a constructive, mutually beneficial dialogue and will continue to play its part to the full. We hope others — notably, oil consuming nations and the international oil companies — will also do their share.

For it is only if we work together that we can be sure of meeting the supply and capacity challenges successfully.

Thank you.