

OPEC and market stability after 2004

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Despite statistics which would imply that world oil supply exceeded demand by more than 1 Mb/d in the second and third quarters, oil prices have not stopped climbing this year. The price of the American reference crude WTI even nearly touched USD 50/b in August. Why such elevated levels when apparently there was no shortage; if stocks were not rising much, where had “missing barrels” gone? In 2004, geopolitical events and the supply fears they created have added tension, certainly, provoking strong market reactions – reactions sometimes considered disproportionate in comparison to concrete physical-market realities. In other respects, one saw that the behaviour of the various parties concerned had profoundly changed compared to that in 1973 and 1979. These days, OPEC is no longer accused of all evils; it was not also considered as responsible for this explosion of prices. To the contrary, its contribution to market stability (by assuring supply and prices) is often requested by other parties. Equally, how are we to interpret certain apparently-unusual declarations where on one side, OPEC officials openly worry that high oil prices will affect global economic growth, while current price levels do not seem, to any great extent, to disturb the economic or monetary authorities – or even the politicians - in industrialised countries. How can we explain such reversals, even if they sometimes are feigned? I said apparently unusual because, actually, they are still defending – on long term - their interests as producers or consumers. The most plausible explanation is that both sides have learnt from past experience. The former, which have pressing financial needs (and therefore want “good prices”): do they really fear that economic growth will brake too quickly, finishing in the end by substantially reducing oil demand? The latter, who have no interest in seeing a third oil shock: are they really insensitive to these elevated price levels, which alone are capable of slowing demand, encouraging energy efficiency and the development of other supply sources, including alternate energy?

But what is happening in the oil market?

What is happening in the oil market? two explanations are possible. Does the current situation result from geo-political risks in certain producing regions, or is it the forewarning of dramatic structural change? This is not the first time that the oil market is confronted with geo-political risk. In 1991, for example, around the time of the first Gulf Crisis, the market experienced price spikes - but quickly enough, once the danger was seen as past, the collapse was enormous and long-lasting; potentially-surplus global supply was the price determinant in that case. If this year’s increase in prices results from a temporary situation, artificially amplified by speculation, it will disappear with the return of calm to these regions. If, on the other hand, this is a matter of structural change, prices will soften only gradually as this latest oil-market cycle plays itself out. Or even – and this is what seems most likely to me – both explanations, which are not mutually exclusive, are true. If, moreover, prices reached the level of USD 50/b for WTI, it is precisely because the two explanations co-existed. In this case, we could enter, and remain for some time, in a fragile phase for supply/demand balance fundamentals.

Market participants who would like to ensure relative stability to the oil market need to be certain that their diagnosis [of the situation] is correct.

The reliability of oil statistics called into question

This year’s experience shows us what the market impact of statistics that do not reflect reality can be. Most oil market participants and analysts had become aware of the relative weakness of oil statistics, which - whether for demand, supply or stock levels - were revealed to be frequently contradictory. They increased market volatility in physical as well as paper markets by misleading market expectations, repeatedly throwing their trustworthiness and credibility into doubt.

Oil demand growth was not correctly evaluated

Several times this year, we have seen significant upward revisions in estimates of world oil demand and its growth. Finally, we have resolved the mystery of “missing barrels”; they were simply consumed or stockpiled, particularly in Asia, but the prevailing methodologies (and data gathering) do not permit precisely estimating

such flows. If, in general, such revisions are normal practice, why have they had such a strong impact on prices this time? Why has the stronger-than-anticipated demand growth come as a big surprise? We know that it is due, first, to economic acceleration in OECD countries, most notably the United States, and second, to the increase in oil imports by emerging economics – particularly China, but also India and several others. What could be surprising about that, knowing that demand is more or less correlated to economic growth and that China's oil imports were called to increase sharply, given the limits of domestic production capacity? In fact, the only uncertainty was and remains the speed at which emerging countries build the strategic stocks they can no longer forego given their rising dependence on oil. Result: we already can declare that they risk importing even more oil than consumption alone would require. One can imagine higher energy efficiency in rich industrialised countries, and environmental reasons alone would justify achieving it quickly. But given their current economic conditions and technologies, I can scarcely see how one could ask an emerging economy in development not to rely on oil and petroleum products. It takes no great predictive powers to assert that - barring an economic crisis or structural change extending worldwide – the oil imports of such countries should continue to rise at sustained speeds. But despite several unexpected accelerations, the evolution of demand is not the principal cause of the magnitude of the price increases seen this summer. For middle term, the oil supply-demand balance cannot be prepared by adjusting the demand side; that role rests for supply.

...And oil supply capacity was over estimated

While a year ago, most analyses dealt with the risk of surpluses resulting from rising non-OPEC supply, today we fear that global supply will be insufficient to meet demand in the very near future. Geopolitics alone do not explain it. This year, in light of political problems in certain producing countries, one became aware – and, to my mind, this is the most important oil-market information of the year – of the limits of global production capacity. Spare capacity - and not in OPEC alone – was considerably lower than previous estimates would have had us believe. Contradictory information, and even polemics, on this subject (as well as that of reserves) only increased the confusion, particularly in the absence of a common market definition of “production capacity”. If one adds the tensions felt by physical-market participants during certain periods, we effectively can conclude that existing production capacity is being strongly bid into service, and deduce that the current supply/demand balance is fragile, after all, and could become a virtual “imbalance”. It is probably this reasoning which explains the disproportionate reactions of market participants to events or information that would not have had the same impact only a short time ago. That supply of some hundreds thousands barrels per day lower or US stock changes differing from market expectations could be the source of high volatility demonstrates precisely how fragile the market balance has become. This is why prices remain considerably higher than OPEC's target price band. OPEC's spare capacity has been reduced to the point that market participants fear that its margin of manoeuvre will not permit them to make up for possible problems in global supply. For the moment, given the most credible estimates, OPEC – which produced 29.5 Mb/d in July - still has spare capacity of 1-1.5 Mb/d. This is enough to avoid problems in the next few months and, a priori, pass the test of meeting this winter's demand when forecasts say that call on OPEC will be about 30 Mb/d. However, the new evaluation of global crude production capacity (about 85 Mb/d, including natural gas liquids) combined with forecasts of demand for demand in 2005 and beyond, effectively could become problematic if new enough production capacity is not added between now and then. **So, the virtual constraints will be more on the supply side than the demand one.** Therefore, one can expect an extended period of just-in-time supply - sufficient, certainly, to cover average demand, but inadequate to cover supply or demand unexpected fluctuations. May we presume accelerating price volatility and even closer attention paid to stock figures in the importing countries?

What can OPEC do?

Let s summarize the present situation: demand is growing more than expected, supply is virtually constrained, and prices are higher than 40 \$/b, world refinery is operating near the capacity, importing countries have to increase their stocks and IOC are asking for investment opportunities. So, for next winter, a dream context for OPEC but what about the longer term. If members countries no longer have sufficient spare capacity, it will be difficult for OPEC to prevent possible price spikes. One can, then, imagine that the Organisation might confine itself to defending prices against drop with the possibility of reducing its production. From this prospect, what questions could OPEC be posing itself?

Permit me, Mr. President, to give you a few of my thoughts on this subject.

The market must learn to live with lower spare production capacity

First, I think that OPEC can no longer play the role of regulating the market alone, particularly if the members investments aiming to increase production capacity become delayed and the Organisation is not able to re-establish sufficient spare capacity. In fact, restoring its former margin of manoeuvre would require costly strategic decisions, because unused production capacity (which must also be maintained) represents heavy investments. There lies a question: can developing countries (such OPEC members) pay for such a strategy? Let us not lose sight of the fact that OPEC's spare production capacity resulted from an enormous loss of market share after demand's readjustments of the 1980's rather than deliberately-pursued policies, and that, for an extended period, spare capacity was a principal cause of OPEC's inability to enforce compliance with production quotas. Therefore, it seems doubtful to me that OPEC countries might invest heavily in capacity meant to be spare, although still risking lowering prices. Contrary to what some might think, this would not be a strategy designed to assure good prices in the future by restraining voluntarily the supply. In fact, considering their enormous financial needs, such an option (financing spare capacity) seems unrealistic to me for nearly all of them. For the others, I am convinced that they will proceed before making any global cost/benefit analyses of such projects. It will be already a valuable contribution from OPEC countries to invest for covering the projected demand with a small spare capacity for seasonal fluctuations. Therefore, I do not think that the global petroleum industry will have at its disposal, in the future, spare capacity equivalent to that of the 1990's. The market should adapt itself to this "new order" which implies, among other things, as I mentioned earlier, a far higher volatility in crude oil prices.

Update the mechanism regulating the market

Apart from the spare capacity issue, OPEC can regulate crude oil supply only if it possesses a clearly-defined policy, adapted to real market conditions and sustained by the unanimity of its members. This was the case over the past four years with the "price band" put in place, which became OPEC's "raison d'être", the reason for its existence. However, for more than a year, the Organisation has not needed to apply the price band mechanism, even those normally strictest in quota compliance. OPEC managed this phase pragmatically, not letting itself being trapped by automatic application of the mechanism, and reacting depending on events that were by no means under its control. Market conditions permitted member countries to produce practically at full capacity and therefore reporting internal debates but in the same time, this situation risks to throw doubts on the relevance on the current official distribution of quotas, the production ceiling and the price band to market prices. Nevertheless, the quota system and the price band remain indispensable, but like any other mechanisms, to be effective they must be used regularly, keeping pace with market developments. Ask yourself, therefore, whether redistributing quotas might not better be achieved in a comfortable position rather than in one of urgency. The current situation, when it seems that nearly all member countries are producing at full capacity, could serve as a reference point for a credible re-distribution of OPEC production quotas.

Pursue a target of an equilibrium price

More particularly, the price band should, if necessary, be regularly adjusted in order to take into account the constraints or the opportunities of the moment and to maintain its credibility. The economic principle that OPEC learned to its pain in the past is that the market for oil, although a strategic commodity, does not escape normal market rules and its cycles. Due to elasticity, relatively high prices cause demand to contract and vice versa. We have not yet reached the end of the "Oil Age", and I do not believe this reaction has ceased to exist. The experience of the past two years, however positive for (all) producers, should not make us forget this principle. In addition to their impact on economic growth, sustained high prices (for example, on the order of USD 50-60/b from now on) would re-invigorate energy-efficiency policies and brake the growth in global oil demand because they would make oil (economically) inaccessible to a great mass of humanity, particularly in developing countries. Such price levels would also attract (too quickly) other suppliers (and substitute fuels), strongly increasing competition and the speed with which prices fall back. OPEC officials rightly fear the operation of these economic rules; price cycles, as soon as they are amplified by high volatility, can return the market to extremely low levels (USD 18 or 20 \$/b?). Certainly, taking count of actual production capacity, such a scenario could appear nearly unpredictable on the short term, but - if (massive) investments were re-launched or/and the geopolitical situation calmed - what about the years to follow? OPEC should, therefore, pursue its goal to find the optimal price acceptable to the market: that is to say, a potential objective which implies a continued strategic watchfulness and regular changes which could, therefore, be easily understandable by both sides. In all cases, this relaunches the debate on an equilibrium price desirable for producers and consumers alike. The experience of the USD 22-28/b price band, which seemed to satisfy the principal parties until the end of 2003, was a good example. Market fundamentals would seem to push OPEC to revise this price band higher (inside a large band of USD 25-35/b?) without, for all that, preventing them from later revising the band lower if the market necessitates it.

Market stability requires co-operation with the other market participants

In many respects, the future of the oil market remains uncertain. Nothing can guarantee OPEC how prices will evolve. Could the Organisation, then, finance on its own the construction of production capacity greater than that necessary to satisfy the seasonal peak of demand, a necessary condition for market stability? It seems to me that OPEC should, first, equip itself with a tool to track, with a minimum of coordination, the timing with which new production capacity comes into service, both for its member countries and at a world level. This would avoid (or at least to soften) the impact of sudden and big supply surpluses on the market. Incidentally, why would OPEC countries remain alone in wanting better prices, differentiating themselves from other exporters, other producers that are oil companies or even importing countries that wish to rationalise their oil use. Why shouldn't they be assisted in this responsibility? OPEC already asks the cooperation of other exporters as soon as it needs to check collapsing prices. The experience of the past few months indicates that it also needs to recourse to the cooperation of other parties in order to stabilise the market. In fact, to stabilise the market, the latter can no longer permit themselves to rest passive. For example, the authorities of large consuming countries could contribute (to stability) because they possess tools to regulate supply and demand in their markets: the policies governing stocks, taxes and regulation. In this manner, in order to prevent otherwise-uncontrollable price spikes (when production alone was insufficient), they might partially utilise strategic stocks. The same is true for the oil majors, whose discretion cannot make us forget that they are also non-OPEC producers. An exchange of information on when they planned to add new production capacity [and appropriate modifications to their plans thereafter] could reduce the tensions or surpluses on the markets. Laws strictly forbid competing multi-nationals from directly exchanging such information, mutually agreeing investments and production and generally co-operating as OPEC producers could do. But even within these constraints, they could meticulously publish their plans (to add, expand or close capacity) in the trade or general press for anyone to read, and to trust that their competitors will do the same.

The necessity to re-launch oil investments

Global oil reserves should be sufficient, broadly speaking, to meet oil demand for several decades to come. Without under-estimating the interest on the debate over "peak oil", the real worry concerns much nearer horizons: the future of production capacity and the risk that it will be insufficient. We must not forget that today's relatively limited production capacity is the consequence of the low prices of 1986-2000 and that of the longer process (since 1973) which systematically favoured non-OPEC production. What is problematic is the geographic distribution [of oil reserves] and the rapidity with which investments [in exploration and production, in refining and/or GTL] will be made. From there, the challenge is first, to create good conditions for these investments. For example, the forecasts indicating that it will be indispensable for OPEC production (particularly in the Middle East) to double within the next fifteen years. **Is it feasible?**

Permit me to remind you of what I was considering to be the principal conditions of such a perspective:

The first is, of course, the price levels which need to attract and then satisfy investors. Prices sustained between USD 30 and 35/b certainly would be the best of arguments to encourage producing countries to increase their production capacity once again. No body can guaranty that level **and I don't believe that market forces alone can solve the problem.**

The second consists of creating the conditions for profitable investments because, once again, how can one hope that exporting countries would repeat past errors in taking sole responsibility for the financing of all these [oil-production] installations, with the risks that capacity would be excessive, that they would compete and that prices would drop. Seeking the [investment] participation of the oil majors on a larger scale, for which one must also ensure good legal and financial conditions, is already the beginnings of a response, but to be at the level of the challenge, this action should be done at a higher scale and imply new kind of relations between IOC and NOC.

The third consists of creating investment policies, knowing that the stability, security and the peace of exporting countries are no longer in the same conditions as thirty years ago; their populations have new needs. The problem poses itself not only in terms of external revenues required, but also the conditions under which they are used. Oil exporting countries should absolutely avoid the mistakes of the past in the use of the incremental oil revenues and allocate them for reforms and sustainable development. Because this risks constraining supply, future oil supply/demand balances and market stability also depend on this variable. What happens in Iraq is instructive on more than one level; it is a matter of regulating not only its problems of peace but also those of

development, democracy and the participation of the populations concerned. Under complex and varied forms, the requirements of democracy and justice pose themselves in many exporting countries, not uniquely those of OPEC. Better sharing of the riches, control of revenues and their use, that is the future of these countries, even if the path is difficult and cannot be externally-imposed.