

# OPEC: The importance of security of demand as well as supply



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In a world that is ever more inter-linked, with international trade, greater personal mobility and mass communication bringing us all closer together, it has become increasingly important to appreciate the scope and intricacies of the global energy system. It is a system that helps support the fabric of our everyday lives. Thus, it is essential to learn from the past, understand the present, and comprehend the possible energy futures the world may face. It is a path of perpetually evolving analysis, as the energy system faces both local- and global-impacting events.

This has been strongly evident over the past few years with the world economy undergoing a recession that turned out to be the deepest in more than six decades. No one was immune from the downturn, but the degrees to which industries, countries and regions were affected have differed. This has been apparent in the economic recovery.

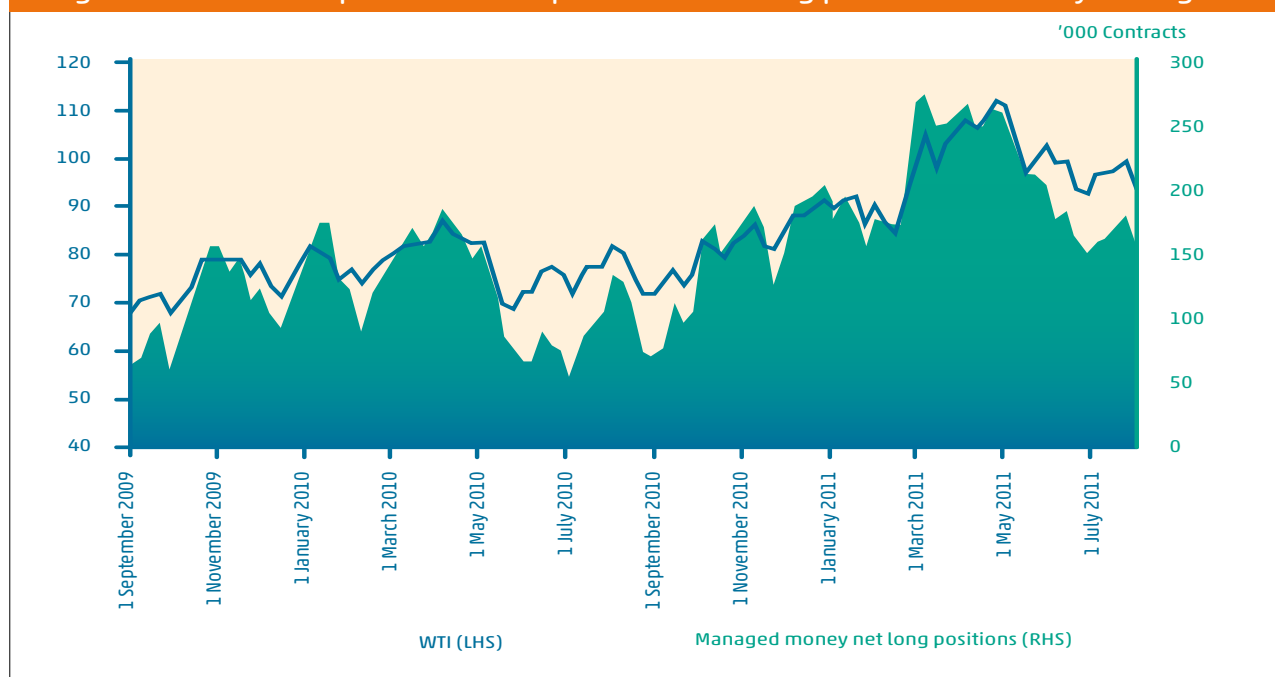
Emerging economies, with China and India to the fore, have returned to strong growth rates, and the challenge now comes from overheating and rising inflation. This is in contrast to many OECD countries that are juggling the need for additional monetary and fiscal policies to support fragile growth and the necessity for fiscal consolidation. In the US, growth has slowed this year, and in the eurozone,

despite efforts to avoid the contagion risks from the Greek sovereign debt crisis, serious concerns have emerged about a worsening situation in other countries.

In addition, this year has also seen a number of other unforeseen events, such as the multiple disasters that hit Japan – earthquake, tsunami and nuclear accident – and the unrest that has been witnessed in a number of countries in North Africa and the Middle East.

The knock-on impacts of these developments to oil and energy markets have been varied. For example, the initial impact of the global recession was a demand drop off in both 2008 and 2009, although demand has grown appreciably in the period since. A number of energy investments were initially put on hold, although many of these are now being implemented; and of course, jobs were lost. In terms of Japan, the disaster led to a sudden decline in the country's oil use. However, this was broadly offset by the need to substitute some of its shut-in nuclear capacity – whose future is now being questioned, as it is elsewhere – with oil- and gas-based generation. Moreover, reconstruction efforts are expected to lead to higher energy use. And in North Africa and the Middle East, there has been interruption in supplies from Libya, as well as

Figure 1: Relationship between WTI prices and net long positions of money managers





market fears that disruptions might spread.

These developments underscore some of the multiple challenges facing the market, but it should be noted that oil markets have rapidly adjusted to these events. Over the period highlighted here, there has been no shortage of oil anywhere in the world. It is essential that all stakeholders look to maintain oil market stability in the months and years ahead.

That is not to say that the market has been free from volatility. This is clearly underscored in the price swings witnessed over the past few years. In mid-2008, crude prices reached a peak of US\$147/b, with crude prices earlier that year fluctuating by as much as US\$16/b on a single day. The magnitude of the price volatility was not at all consistent with market fundamentals. Then, driven by the global economic downturn, they plummeted to the low US\$30s in December of the same year. In 2009, prices rose steadily, to end at close to US\$80/b at the end of the year, and it remained around this level throughout 2010. However, the early part of the year saw a surge in oil prices to above US\$120/b, although prices in the second and third quarters saw some movement in the opposite direction on the back of bearish economic concerns.

As in 2008, the volatility in the first half of this year has in part been driven by speculation. This can be observed in speculator activity on the Nymex, which surged to record highs in the first part of the year. For example, by mid-March, the volume of open interest contracts for Nymex WTI was 18 times higher than the volume of daily traded physical crude. Such an increase was the result of concerns of a further deterioration in supply. The build-up of large speculative positions on the crude futures markets was a key factor behind the increased crude oil price volatility. Figure 1 highlights the relationship between WTI prices and the speculative activity of the net long positions of money managers. A curb in speculative activities is needed.

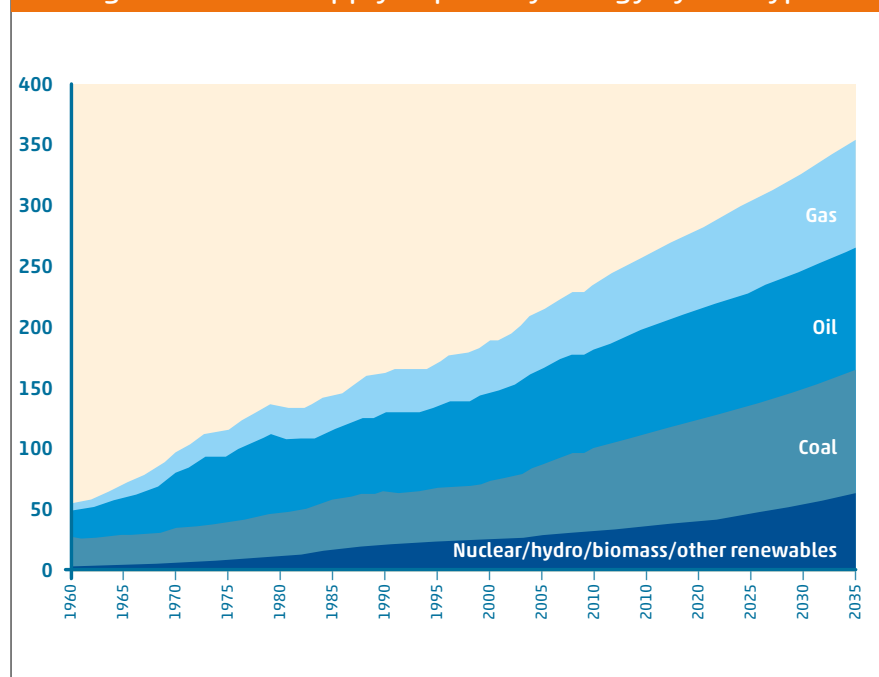
It should also be noted that the price rises in the first half of this year were even more pronounced at the consumer end, where the effect of consuming country taxation is greatly felt. While OPEC has played its role by ensuring the market remains well supplied in crude, it is of course helpful if consuming countries that have a high level of taxation on oil products consider revising down these levels, at least when prices reach certain levels, to alleviate the impact on consumers.

The last few years have been an unpredictable time and the industry continues to face many hurdles and challenges. Yet, there is still good reason to look ahead with optimism.

As economies expand, the global population grows and living conditions improve, energy demand will continue to increase. By 2035, world energy demand is expected to be more than 50 per cent higher than it was in 2010. With this expansion in mind, it is clear there is room for a variety of energies, but it is important to appreciate what each can actually offer. Which energies will form the core of our future? And which energies will play a more complementary role?

Renewable energy, mainly wind, solar, small hydro and →

Figure 2: World supply of primary energy by fuel type





→ geothermal, is expected to grow fast, as a result of massive government support and incentives. Globally, however, its share in the energy mix will remain modest, given its low initial base. Hydropower should also expand, but given the limited scope for further expansion in many developed countries, it is expected that much of this will be in developing countries.

Biofuels are also expected to play a greater role, supported by direct and indirect government subsidies, but not at levels once assumed. For first-generation biofuels, much concern has recently been expressed over the competition between food and fuel. There have also been reports on their possible negative impact on biodiversity, their potential to make scarce water resources, even scarcer, and, in most cases, their relatively high greenhouse gas emissions, when land use change effects are fully taken into account. Second generation biofuels can overcome some of these concerns, but they are still far from being available for commercial use.

Nuclear power had witnessed something of a revival in recent years, with a number of countries looking to build nuclear plants. Events earlier this year at the Fukushima nuclear complex in Japan, however, have led to many questions being asked about nuclear power, particularly in terms of safety, waste and decommissioning.

It means that fossil fuels will maintain their prominent role, continuing to supply over 80 per cent of the world's energy needs by 2035 (Figure 2). Even with a number of energy policies that to a considerable extent seek to reduce oil use, it is clear from OPEC's World Oil Outlook (WOO) 2011 that oil's leading role in the energy mix will continue for most of the period to 2035. Towards the end of this timeframe, however, it will be surpassed by coal, with oil's overall share falling to around 28 per cent in 2035.

Fossil fuels also have challenges, such as their environmental footprint, in particular in terms of CO<sub>2</sub> emissions. It should be recalled, however, that the petroleum industry has a long history of successfully reducing its environmental footprint, for example, in drilling, gas flaring and plant emissions. And the automotive industry, as well as the refining industry, has a good track record in continuously reducing the pollutant emissions of vehicles. It is essential that we continually look to advance the environmental credentials of oil, both in production and use; improve operational efficiencies and recovery rates, and push for the development and use of cleaner fossil fuel technologies, such as carbon capture and storage.

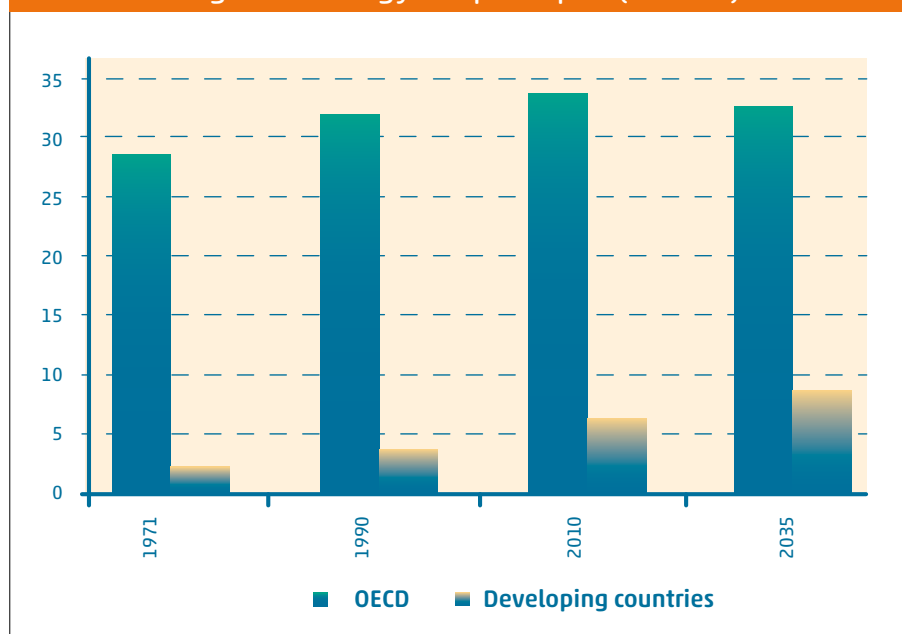
Looking ahead, developing countries are set to account for most of the long-term oil demand increase, with consumption rising 26 million barrels a day (mb/d) over

the period 2010-to-2035 to reach almost 62mb/d. Around 80 per cent of the net growth in oil demand in this period is in developing Asian economies. Transportation is the main source of this growth, and developing countries' percentage of passenger cars globally will increase from around 23 per cent to 49 per cent in 2035.

In fact, the hub for oil demand has been progressively shifting towards Asia in recent years. For example, since 2005, OECD oil demand has contracted by around 3.7 mb/d, while developing Asia actually saw an increase of almost 4.8 mb/d over the same period.

Nonetheless, energy poverty

Figure 3: Energy use per capita (mboed)





will remain. Energy use per capita in developing countries has always been well below that of the OECD and this remains the case in the future: in 2035 the OECD will be using on average three and a half times as much energy per capita as developing countries (Figure 3).

From an oil perspective, the world also has plenty of resources to meet the expected increase in demand. The end of oil has been talked about since the very beginning of the oil age, more than 100 years ago. However, it has never come to pass, and since the early 1980s, ultimately recoverable reserves of conventional oil worldwide have doubled and the figure continues to rise. Technology has resulted in new discoveries, increased recovery rates and improved efficiency. Today, we are also seeing the vast potential for the expansion of non-conventional sources of oil.

While suppliers continue to face significant challenges, such as the impact of the global financial and economic crisis, market volatility and the role of speculation, and an often unclear demand picture as a result of a number of consuming country policies, investments to turn resources into capacity are being made. In the medium-term to 2015, OPEC Member Countries are expected to invest an estimated US\$310 billion in upstream projects. OPEC remains committed to future investment plans to boost its capacity.

It is important to stress, however, that the pace of future energy demand growth, and in turn investments, is affected by many uncertainties. This includes the possibilities of varied economic growth paths, consuming countries' energy and environmental policies, technology and consumer choices.

For example, OPEC's WOO 2011 shows that demand for OPEC crude by 2025 could be as low as 31 mb/d or as high as 38 mb/d. These scenarios point to an uncertainty range in the billions of dollars. Such fears constitute a great challenge for all stakeholders.

If there is no confidence in there being additional demand

for oil, there is no incentive to invest. Why waste precious financial resources on unneeded capacity? On the other hand, if investments are not made in a timely and adequate manner, then future consumer needs might not be met. The supply and demand balance is essential to the overall health of the industry. Oversupply or a supply shortfall is detrimental to both producers and consumers. It is important to appreciate and better understand the two sides of energy security: security of supply and security of demand.

The oil market has been — and will continue to be — an ever-changing arena. This is because oil is so vital to the world economy, it is present in everyone's daily lives and its market is truly global. This underscores the importance of dialogue and cooperation, on both a bilateral and multilateral basis, to meet both the challenges and opportunities facing the industry. While differences of opinion will obviously occur, it is important to try and reach an underlying consensus on, at least, the major issues that concern all parties — such as pricing, stability, security of demand and supply, investment, environmental issues and sustainable development. This will hopefully ensure that the world oil market continues to operate efficiently and effectively in the future, for the enhancement of everyone across the globe. ■

