



THE LONG TERM HORIZON

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Globalisation, together with stronger trade and financial ties, means that each nation's prosperity has become closely intertwined with that of the rest of the world. This cannot be seen more clearly than in the area of energy. Rather than *independence*, the world of energy is one of *interdependence*, where the security of supply – and that of demand – are two sides of the same coin. In such an interdependent world, a constructive dialogue between consumers and producers is essential to promote trust, cooperation, information exchange, and a deeper understanding of each other's policies. The Asian Ministerial Energy Roundtable has become a key feature of this global energy dialogue.

The recent months have been, without doubt, very unusual, if not unique, for the oil market. After years of relative stability, the oil price started falling in the second half of 2014, losing more than 50 per cent of its value in a relatively short period of time. The sharpness and the speed at which the price fell has fuelled many analysts' imaginations, with some explaining the fall in the oil price in terms of conspiracy theories and geopolitical games. Others consider the current changes to be structural in nature – where we have entered a 'new oil order' with oil prices staying at this level, or falling even lower, for a long period of time; the cost curve for oil shifting downwards; the US shale producers assuming the role of the swing producer; and OPEC as an organisation playing no, or only a limited, role in market stabilisation, with some even going so far as declaring the death of OPEC. Virtually every oil price cycle in the past has generated its own narrative; this one is no different.

Despite their fundamental flaws, such narratives often dominate the energy discourse and tend to shape market expectations and beliefs. For a major reserve holder, oil producer, and exporter such as Saudi Arabia, our focus has always been on the long-term trends shaping the oil market. Rather than being a commodity in decline, as some would like to portray, supply and demand patterns indicate that the long-term fundamentals of the oil complex remain robust.

One fundamental flaw in the current narrative is the tendency to compare the current price fall with that of the mid 1980s. But this comparison is simply misguided. Market conditions now are fundamentally different from what they were then. In 1985, global oil consumption stood at just over 59 mb/d and the available spare capacity was at a historical level of over 10 mb/d, and the ratio of

spare capacity to global oil consumption was about 17 per cent per cent.

In 2015, oil consumption is estimated to reach 94 mb/d, while usable spare capacity, mainly held in Saudi Arabia, is estimated at 2 mb/d – in other words, a ratio of spare capacity to oil consumption of about 2 per cent. This is one of the few industries in the world that is operating at such a thin cushion. Spare capacity acts as an insurance policy against unanticipated changes in oil market conditions and is key to maintaining oil price and global economic stability.

There is another fundamental difference from the mid 1980s. Despite all the macroeconomic uncertainties engulfing the global economy, oil demand continues to grow at a robust pace and is set to increase by 1.5 mb/d in 2015, the strongest growth seen in the past few years. This is in contrast to the early 1980s where global oil consumption fell between 1980 and 1984 by more than 2.3 mb/d.

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There may be some bumps on the road, and the phenomenal growth seen in the last three decades in Asia may not be repeated, as growth in oil demand will be moderated by efficiency enhancement and oil substitution efforts. But the petroleum industry should not lose sight of the fact that scale matters. Globalisation, industrialisation, urbanisation, and rapid development – all fuelled by energy – will continue to lift hundreds of millions of people out of poverty and to expand the size of the middle class from the current level of 1.8 billion to 3.2 billion in 2020, and to 4.9 billion in 2030, with the bulk of this expansion occurring in Asia. The new emerging middle class will be made up of people who are younger, and eager to increase their consumption. Such young demographics amidst rising income levels will keep energy demand on an upward trend.

The current low levels of spare capacity, together with the robust growth in demand, indicate that the current market fundamentals are different from those of the early 1980s and that comparisons with that period are therefore misplaced.

To meet the expected increase in demand, the world

needs all sources of energy – including oil, gas, renewables, nuclear, and solar. The Kingdom has always been of the view that there are plenty of resources to meet the projected increase in demand. The peak oil theories that dominated the energy discourse a few years ago – insisting that global oil production had already reached a peak – have proved to be simply wrong.

The pendulum has now moved in the opposite direction, and expectations of ‘scarcity’ have been replaced with expectations of ‘abundance’. However, while the availability of resources has never been the constraint, it is also true that conditions must be put in place to provide the right incentives for the industry to explore and to develop these reserves in an efficient and timely manner. There is a sense of complacency and a misconceived perception that the challenges faced by the industry a few years ago – ranging from the small number of new oil discoveries, to the sharp rise in industry costs, to the difficulty in retaining talent, to the high decline rates in mature areas, and to the increasing complexity of developing new finds have all but disappeared.

The fast and sharp industry response to the current fall in the oil price, however, has shown clearly that the sustainability of investment and output growth cannot be achieved ‘at any price’. While it is true that underground resources are abundant, the technical and human resources, and the financial resources needed to develop these reserves, are not.

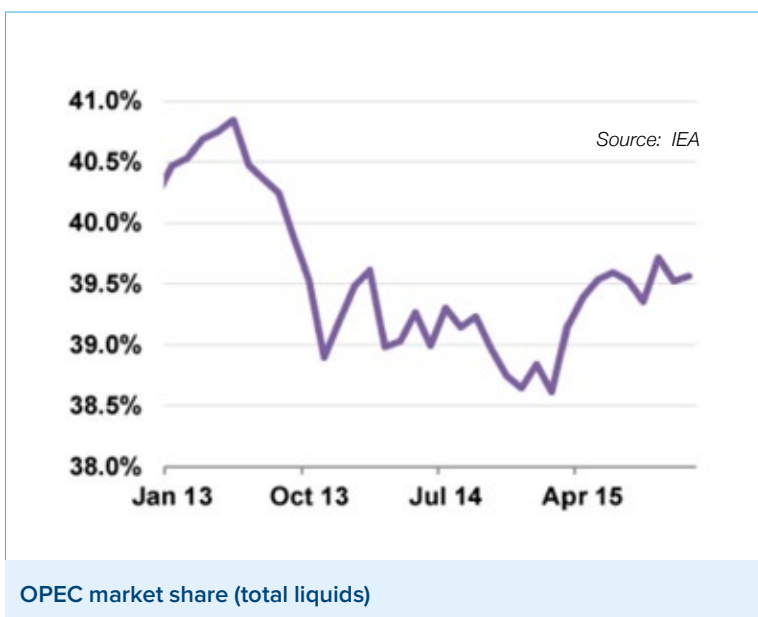
Both the industry and the supply chain remain highly vulnerable to sharp price movements. Around US\$200 billion of investments in energy have been cancelled in 2015, with energy companies planning to cut another three to eight per cent from their investments next year. This is the first time since the mid 1980s that the oil and gas industry will have cut investment in two consecutive years. The IEA describes the current decline as ‘the biggest in oil history’. Under increasing fiscal pressure, many governments in key oil producing countries are being forced to cut their investments in the energy sector and to revise downward their expansion targets. The impact of the recent cut in capital expenditure has not just been confined to oil exporters; it is also being felt in importing countries, where the decline in oil prices has increased the risks for firms in the Asian oil and gas sector, affecting their investment plans.

The potential impact of current cuts in expenditure on future oil supplies is both substantial and long-lasting. Nearly 5 mb/d of projects have already been deferred or cancelled. Also, the reduction in Capex at existing producing fields – including investment in enhanced oil recovery projects – will only accelerate the already high decline rates, especially in ageing offshore fields.

In fact, after three years of positive growth, non-OPEC supply is expected to fall in 2016; only one year after the deep cuts in investment. Beyond 2016, the fall in non-OPEC supply is likely to accelerate, as the cancellation and postponement of projects will start feeding into future supplies, and the impact of previous record investments on oil output starts to fade away.

An important part of the current narrative is that these cuts in investment and output can be quickly reversed when oil prices start rising again. This is attributed to the view that investment cycles are becoming shorter and the supply curve more elastic. But this is wishful thinking. Previous cycles have shown that the impact of low oil prices is long-lasting, and that the scars from a sustained period of low oil prices cannot be easily ‘erased’. During sharp downturns, the industry tends to lose talent, technical expertise, financial resilience, and the confidence to embark on new investments. Unfortunately, none of these adverse impacts on our industry can be quickly reversed.

The extreme price movements that we have



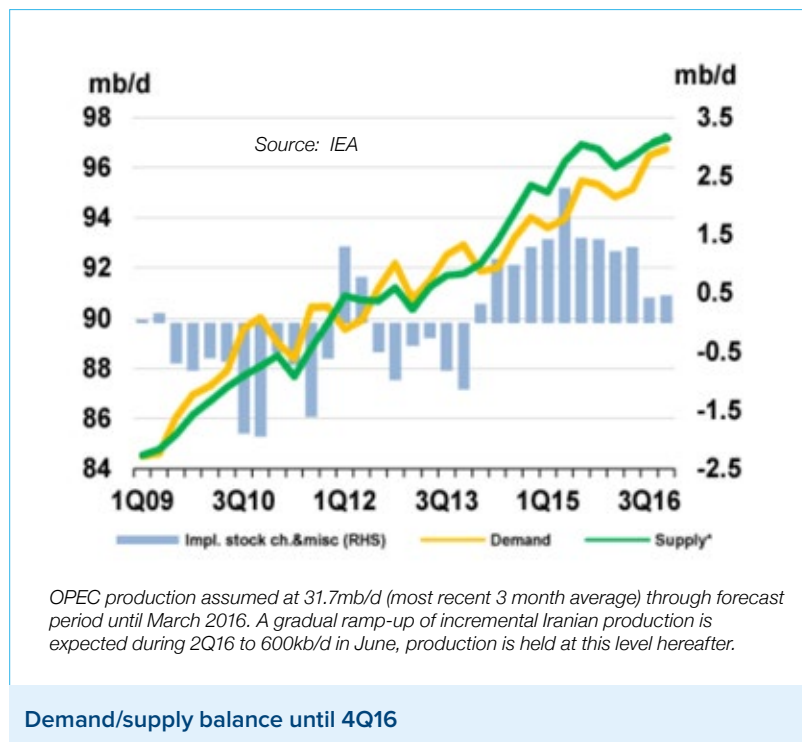
witnessed recently are very harmful for producers, consumers, and industry players. For producers whose economies are highly reliant on oil revenues, they undermine their development plans and complicate their macroeconomic management. For consumers, oil price volatility induces uncertainty in the general macroeconomic environment, reducing investment and capital formation, and undermining the viability of their energy policies. For the oil industry, sharp price swings make future planning extremely difficult, delaying much-needed investment in the oil sector.

The impact of such price instability is not just confined to the oil sector; the spillovers are being strongly felt in other parts of the energy complex – such as renewables and natural gas. This is because price instability undermines the viability of energy policies – of both producers and consumers – that are aimed at increasing the share of renewables in the energy mix, and enhancing energy efficiency.

As we saw back in 2008, high oil prices proved to be unsustainable, and the price fell sharply following the great financial crisis. But this works in the opposite direction. A prolonged period of low oil prices is also unsustainable, as it will induce large investment cuts and reduce the resilience of the oil industry, undermining the future security of supply and setting the scene for another sharp price rise. Just as the assertions, heard a few years ago – that the oil price would reach US\$200 a barrel – were proved wrong, so the recent assertion that the oil price has shifted to a new low structural equilibrium – will also turn out to have been wrong.

As a responsible and reliable producer with a long-term horizon, the Kingdom is committed to continue to invest in its oil and gas sector, despite the drop in the oil price. Concrete steps are also under way to reduce the energy intensity of the Kingdom's economic activity, through the implementation of energy efficiency schemes. Saudi Arabia has also taken steps to diversify its use of energy resources. These measures validate our belief in the strength of the long-term fundamentals of energy markets, and demonstrate the importance that Saudi Arabia attaches to maintaining its oil export capability and spare capacity.

Saudi Arabia plays, and will continue to play, a proactive



role in stabilising oil market conditions by building on its close relationship and ongoing cooperation with both producers and consumers, and through its effective and constructive engagement in OPEC and the IEF. However, in an increasingly interdependent world, achieving this objective is a shared responsibility. Both consumers and producers have a common interest in working collectively to achieve a more stable market; this is essential for sustaining much-needed investment and for ensuring a stable, secure, and sustainable energy system to the benefit of all. The International Energy Forum remains the only international energy body under whose umbrella both producers and consumers can cooperate on energy issues, exchange information, and gain deeper understanding of each other's energy concerns to enhance their common interests. The IEF should continue to organise Roundtable events and extend their reach to other regions.

Back in 2010 in Cancun, Mexico, I stated that the IEF 'is an embodiment of the shared views of producers and consumers and a recognition of the need for stronger, broader and more effective cooperation.' This cannot be more true than it is now, during these times of challenge and uncertainty. ■