

# Fostering upstream investment: The indispensable role of oil market stability

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Distinguished guests, ladies and gentlemen.

It is indeed a special honor to speak in this premier conference. My sincere thanks to the organizers for the opportunity they have accorded me to give this address. I would like to share with you today some thoughts on the role of OPEC in bringing stability to a very erratic oil market. Needless to say, volatility generates uncertainty, and uncertainty disturbs the steady flow of investment, which we think is vital for the long-term stability of the market. Thus, one of the main challenges confronting the Organization is to strike a balance between fostering upstream investment and preserving market share at reasonable prices

Allow me to start by pointing out that OPEC was not set up to dictate oil prices to the international business community. The creation of the Organization was, in many respects, a by-product of the US failure, in the early 1950s, to stabilize the market. Upon imposing import quotas on cheap foreign oil imports in 1959, foreign oil markets collapsed, threatening many oil producers of bankruptcy. The formation of OPEC, therefore, was an endeavor to bring order and stability to the international oil market, on a sustainable basis. This commitment to achieve equilibrium in the market is firmly anchored in OPEC's charter, and continually reinforced throughout the 41 years of existence of the Organization.

We, in OPEC, realize that stability is not a mere buzzword. It requires self-discipline from all producers of this exhaustible resource, not just our Member Countries. The major transformation, which the oil industry has gone through and the changes in world politics, economics, and energy have been instrumental in transforming relations between producers, investors, and consumers. All we need to do is to look at the many twists and turns the petroleum market has experienced in the past few years to know how crucial cooperation among all parties concerned is to avoid volatility. As the experience of the oil price slump of 1998-99 teaches us, failing to control the prices from dipping too low may shatter the fragile stability of the world oil, and ultimately the world economy. Thus, providing buyers and sellers with a stable market is one of OPEC's strengths. It is understood that when left to its own parameters and forces, the oil market will, undoubtedly, perform erratically.

As we cross the threshold of the 21<sup>st</sup> century, OPEC's commitments and vision are very clear. Despite all the odds staked against it, the Organization can surely live up to them. For many years now, political pundits, media experts, and

oil analysts are bewildered by our survival. However, despite the turbulent times, frictions and disagreements, OPEC's integrity remains intact. More united; better organized; and more transparent. Now, when it comes to dealing with oil market matters we have the benefit of wisdom and wide experience and knowledge, which, we can modestly say, is second to none.

OPEC principle objective today- as it has been since its inception- is to provide a reasonably priced, dependably available source of energy. Our efforts had been successful, and well received by the industry, especially in recent years. Together we were able to manage and to anticipate future trends in the energy sector. Nevertheless, prices are sometimes determined in a market at the mercy of inherently destabilizing forces beyond anyone's control. The events of September 11 are such an example. Within hours, the attacks led to a plunge in oil prices of around \$5/b below those of the period before these calamities.

Not even the Organization's tried and trusted formula of effective production agreements could be seen as a panacea for the economic hardships that have inflicted the global economy. Or even provide a timely solution to such a momentous catastrophe.

The international oil market has been mired in problems since the events of September 11, which deepened the recession trend affecting the US and other industrialized nations, particularly those of Western Europe and Japan. The tragedy has had adverse consequences of its own, such as the heavy drop in demand for jet fuel. At the same time, the fall in demand highlighted the fact that non-OPEC crude oil supply had been rising during the course of the year, by around 600,000b/d. This followed an increase of more than 1 mb/d in the year 2000.

It is against this backdrop that OPEC decided to make its production agreement, in Vienna on 14 November 2001, conditional upon contribution by non-OPEC producers. OPEC had already agreed to cut its output by 3.5 mb/d during the first ten months of 2001, only to see some non-OPEC producers diminish the impact of these cuts, by increasing production. The result was more pressure on prices, which in the period up to our midNovember meeting, had fallen by a further \$2 a barrel from the preSeptember 11 levels. We made the case that OPEC should not be expected to shoulder the responsibility of bringing about stability to the market on its own. We were adamant that if our Member Countries

were to cut output by five mb/d during the course of the year, other producers must commit, at least, ten percent of that figure, 500,000 b/d. After prolonged discussions, and when none-OPEC producers came to within a negligible margin of that figure, we made the decision in Cairo on 28 December 2001, to implement our cut, with effect from 1 January. In short, if we were to continue to carry the burden of market stability unilaterally, others would doubly benefit from the Organization sacrifices. The inescapable truth would be the neutralization of OPEC's efforts, thus obstructing stability, and causing our Members to lose market share and revenue.

That latest decision by the Organization has been taken solely to ease the pressure on the oil price, and to prevent another economic disaster reminiscent of the 1998 price collapse. So far this year, the price of OPEC's spot reference crude has averaged more than \$ 19/b. This is well above the averages for both November and December. The lowest daily price during that two-month period was 15.85/b on 19 November. That is to say, that OPEC's actions, supported by other producers, have been instrumental in halting the price slide and stabilizing the market. Nevertheless, we do not think that the oil industry is off the hook yet. Demand for oil is expected to be weak in the next few months, putting further pressure on prices, particularly in the second quarter. As producers, we have to keep a watchful eye on the market and be willing to manage any adverse situation when it arises. We believe that the future of the global market will hinge on whether we have the will and the power to relinquish the harsh rhetoric, and translate our convictions into realizing reciprocal interests among all parties concerned.

Allow me to turn your attention to oil demand projections. For the foreseeable future, oil is destined to maintain its position as the leading world's energy provider. According to our reference case, world oil demand will rise from around 76 mb/d in both 2000 and 2001 to 91 mb/d in 2010 and 106 mb/d in 2020. With non-OPEC oil production in the first two decades of the 21st century projected to remain relatively stable, OPEC Member Countries are expected to play a fundamental role in the world energy scene. Our projections show OPEC producing 39 mb/d of crude in 2010, representing 42 per cent of global supply, and 53 mb/d in 2020, when OPEC's share will break the 50 per cent barrier.

In order to meet these demands, a steady flow investment is the key if the world is keen in attaining oil price stability. The issue of investment is complex and, as with most problems concerning the energy world, is closely interweaved with international relations. Oil matters have a scope much broader than those of mere economic and market issues. The fact that oil is a vital commodity for both producers and consumers places it on top of the political and diplomatic agenda of nearly all countries.

This has led to the development of economic relationships cemented on diverging interests. On the one hand, the owners of oil reserves are interested in obtaining the greatest possible share of the income generated by the business. On the other,

investors are interested in maximizing profits, and this naturally involves transferring the lowest portion of such profits to host governments. This reality has remained unchanged over the years, and I would not expect it might change, after all. But in spite of the implicit contradiction in the interests of host countries and international investors, the two groups are bound by something much more powerful - their common goal of obtaining the largest benefit from an ever-expanding, highly profitable business. This is the case, at least, if upstream contracts are well designed.

Consumers constitute a third party which adds complexity to the relationship. Their main interest has always been in securing the lowest possible prices, sustainable in the long run. The best guarantee for this to happen is, precisely, a steady flow of investment.

Thus after several decades of confrontations and instability, the time has come to recognize the legitimate rights of each party, which must be taken into account any equitable agreements. If the oil owners are guaranteed a fair share of income sufficient to enable them to attend to the problems of their populations, to develop an adequate infrastructure and deal with other key problems, then for sure investors will see benefits in the form of the required levels of economic, political and social stability.

If additionally, technological progress allows for new ways of enhancing productivity and reducing costs, consumers will be bound to enjoy lower prices. By the same token, if consuming nations moderate their fiscal voracity, they will also be contributing to reducing pressure on the product prices paid by their own citizens and will be helping to stimulate the world energy market. In short, if we progress towards a type of relationship where the rights of each party are equally respected, and we abandon the use of pressure and force to impose our own interests, we shall all emerge victorious.

I would like to conclude this topic by pointing out that the issue of upstream investment is presenting itself in the form of a great new challenge for OPEC. The Organization has succeeded in achieving co-operation aimed at stabilizing international oil prices, avoiding unsound competition for market share among its Member Countries. This has culminated in benefits for everyone. Thus, we must now avoid the dangers inherent in allowing private investment back into many Member Countries to become a factor of instability.

The long-term danger is that every country may try to attract investment by giving greater and greater advantages to investors, in a way that misaligns the interested parties concerned. This, for example, has happened in the case of Venezuela under its so-called oil opening. What led to OPEC's creation and its great successes was the co-ordination of policies among its Member Countries pertaining to foreign investment, particularly in what referred to royalties and taxes. We must keep this positive experience in mind when drawing up strategies to face new challenges posed to us by the dynamics of an ever-changing energy world.

Investment is the key to the future of any business, and the oil industry is certainly no exception. To meet the increasing levels of crude oil demand in the world, sustained investment - running into tens of billions of dollars a year over the next few decades - is required in OPEC Member Countries, as well as in other oil producing nations. Without Sufficient investment, oil production declines. Fair and equitable oil prices, together with spare capacities, are two interlined parameters for bringing about petroleum security and stability.

Therefore, those countries need the availability of sufficient financial resources, not only to meet the needs of their populations, but also to reinvest in maintaining, developing and expanding their oil production. Moreover, since OPEC Member Countries possess three-fourths of the world's oil reserves, it is only logical that they will have the greatest need for upstream investment in the coming years. At the same time, care must be taken in the means by which we

access capital. The wrong sort of arrangement could result in oil producers losing out heavily in terms of the income they ultimately receive for the exploitation of their finite hydrocarbon reserves. Said another way, if there is cut-throat competition among oil producers for foreign capital, this could drastically disturb the equilibrium of shares awarded to the different parties involved, in a market where demand usually has a much greater influence on price than the cost of supply.

For the oil industry to fulfill its role as the engine of the world economy, all parties must contribute towards ensuring an adequate and steady flow of investment into exploration and technological development, and they all will do so, if properly rewarded. This is easier said than done. However, the well fare of the industry and the world at large depend upon our ability to attain this goal.

Thank you.

## Author

DR ALI RODRIGUEZ-ARAQUE was appointed Secretary General of the Organisation of Petroleum Exporting Countries (OPEC) in January 2001. His appointment came after a two-year period as Venezuela's energy minister under President Hugo Chavez. During this period he brought Venezuela's oil production into line with OPEC quotas and was also appointed president of OPEC.

He was educated in law at the Universidad Central de Venezuela and in economics at the Universidad de los Andes. He was a lawyer for civil, labour and commercial matters until 1983 when he was elected as a member of the Venezuelan Congress. He has held a number of energy posts in Venezuela including vice-president of the bicameral committee of energy and mines from 1994-1997. He regularly attended the Energy Council meetings of the US between 1994-97. Dr Rodriguez-Araque was a member of the transition committee of the energy and mines programme of President Hugo Chavez and was appointed energy minister in February 1999 until taking up his current position with OPEC.

Dr Rodriguez-Araque has a reputation as a builder of consensus within OPEC and a seeker of co-operation with non-OPEC oil producers such as Russia and Norway. At a meeting two months ago with the Belgian government he called for all the world's oil producers to demonstrate "cooperation and solidarity" to avoid a collapse in oil prices. Dr Rodriguez-Araque has given many addresses in different parts of the world, outside OPEC, as well as within.