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Session 2 –Energy Markets: Mitigating Volatility

Keynote Speech by

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Thank you Mr Chairman,

Excellencies, ladies and gentlemen,

Let me begin by thanking the Kuwaiti Government for hosting this meeting and the co-hosts Algeria and the Netherlands for their contribution and support.

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The theme of this session is: 'Energy Markets: Mitigating Volatility'. What I would like to stress upfront is that concerns surrounding volatility in commodity markets, in general, and energy markets, in particular, are not new.

The issue remains an obstacle for the world economy; for those producing countries whose economies are still highly dependent on oil export revenues; and for consumers whose energy needs continues to be primarily satisfied by fossil fuels. In truth, it matters for each and every one of us.

We all remember that, back in the late 1990s, prices plunged below 10 dollars a barrel in the wake of the Asian financial crisis. At the time, on the occasion of the 6th IEF meeting in South Africa, OPEC stressed that these price levels were not suitable for producers, and in the long-term, they were not beneficial to consumers.

This proved to be true. Investment stalled and human resources shrunk, when the industry undertook deep cost-cutting strategies. This, in turn, meant the market tightened quickly as the global economy and oil demand rebounded a few years later. Without the availability of OPEC's spare capacity, such tightening would have been even sharper.

More recently, price swings were even larger and faster. For oil, in mid-2008, crude prices reached a peak of 147 dollars a barrel. They then sank to the low 30 dollars in December of the same year.

In addition, daily price changes have been greater since 2007.

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However, many believe that price fluctuations are today amplified by a new phenomenon: the financialization of commodity markets, in general, and oil markets, in particular.

Since 2004, the participation of financial players has grown significantly.

For example, the number of outstanding exchange-traded commodity contracts has expanded from a level of around 15 million contracts in 2004 to more than 60 million contracts today. Over-the-counter commodity derivatives also sharply increased between 2004 and 2008, with notional amounts outstanding increasing from one trillion dollars to more than 12 trillion.

New players have also entered the market, such as index funds and exchange trade fund sponsors.

And the strategies of the participants have become more varied and more complex. This includes hedging against inflation or currency fluctuations, portfolio return risk management, arbitrage opportunities, index tracking, herd behavior and speculation. Recently, a new feature is the development of high frequency trading.

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This phenomenon has been visible in oil markets.

In addition to oil being a physical commodity, it has increasingly been treated by financial investors as an individual asset class.

Oil-related derivatives markets have expanded sharply in terms of size, participants, types of contracts and complexity. For example, since 2005, the total open interest of the NYMEX crude oil futures and options has increased sharply. In the middle of 2008, it surpassed three million contracts per day. This was 35 times the size of physical world oil demand. Today, the level of open interest is equivalent to 29 times the size of physical demand.

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This leads to the question: do futures prices still reflect the physical supply and demand fundamentals, or are they mainly driven by financial motivations?

It is a question that has attracted attention in recent years. The Jeddah Energy Meeting held in June 2008 was a landmark meeting in this regard. It helped in the convergence between producers and consumers on the issue of excessive energy market volatility and the need to mitigate it.

Areas of cooperation were agreed by the IEA, the IEF and OPEC on the occasion of the 12th IEF in Cancun. And over the past two years we have seen the successful implementation of this programme of cooperation,

This has included two workshops and forums on the inter-linkages between physical and financial energy markets and on regulation, where discussions have reflected a wide diversity of views.

Some participants attributed the recent price movements to oil physical fundamentals, while acknowledging the impact of financial markets on short term price changes.

Others participants saw speculative activity and the financialization of commodities as amplifying price movements and leading to excessive market volatility.

And there are others who regard crude oil price formation as consisting of a complex interaction of physical and financial factors, including speculation in financial markets.

At OPEC, we believe that massive and rapid in- and out-flows of financial investments into oil markets can alter price dynamics away from fundamentals. This can exaggerate price swings, both up and down, in the short-term, and, if persistent, in the medium- to long-term.

Regulatory reforms are already being proposed, for financial markets, in general, and commodity markets, in particular. And efforts to increase transparency and oversight in the commodity derivative markets are underway, on both the futures exchanges, as well as the over-the-counter derivatives markets.

However, it is still too early to judge the overall impacts of these reforms and it is important to monitor such developments and their potential impacts on the functioning of markets.

In recent years, we have also witnessed the further strengthening of the Joint Organisations Data Initiative. The value of timely, more accurate and transparent data is essential to our industry. Last year JODI celebrated its 10th Anniversary. We applaud its efforts. OPEC is proud to have played a role in JODI's establishment and we continue to fully support the Initiative.

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While it is short-term price volatility that usually makes the headlines, the long-term price of oil matters too. Our industry is capital intensive, with long lead times and payback periods. And we need to remember that security of demand is as important as security of supply.

This leads me to look to the future of oil. It offers some very difficult questions, relating to such things as foreseeing future economic growth; the possible impacts of the financial crisis; the effect of technology on the demand and supply side; policies; consumer preferences; and, of course, geopolitics.

Given the complexity of these drivers, and the wide spectrum of feasible future energy scenes, the OPEC Secretariat has developed a scenario-based approach for the long-term.

Under OPEC's World Oil Outlook Reference Case, which assumes a continuation of past trends, over the period 2010–2035, energy demand increases by 51 per cent. Fossil fuels will still satisfy the lion's share of world energy needs, contributing up to 82 per cent of the global energy mix by 2035. Resources are sufficient in this regard.

Demand for oil is expected to increase by close to 23 million barrels a day over the period 2010–2035, reaching almost 110 million barrels a day by 2035, driven mainly by developing Asia and by the transportation sector in non-OECD countries. But the share of oil in the energy mix is expected to decline from 34 per cent today to around 28 per cent in 2035.

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However, the future is rarely a simple continuation of the past.

Many uncertainties are associated with oil demand projections, which can be viewed in scenarios from our World Oil Outlook.

For instance, OPEC's Accelerated Transportation Technology and Policy scenario indicates that global oil use could be more than 7 million barrels a day lower by 2035, compared to the Reference Case.

And between higher and lower economic growth scenarios, there is an almost 20 million barrels a day difference.

This leads me to ask a number of questions about these scenarios. What would be the impact on prices? What would be the effect on investments? And what might it mean for more expensive sources of oil, such as non-conventionals? The two common words that arise with to each of these questions are 'uncertainty' and 'instability'.

Let me stress that 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.

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Excellencies, ladies and gentlemen,

I am sure everyone here can appreciate that we cannot avoid speculation and volatility altogether. It is a part of the market.

However, it is essential to mitigate extreme volatility and excessive speculation, which are detrimental.

Thus, it is important we look to well-designed regulatory reforms, continually improve the quality and timeliness of data and strengthen JODI, advance academic research, and further enhance the producer-consumer dialogue.

In recent years, the producer-consumer dialogue has taken significant steps in this regard. It is important we continue to follow up on these actions.

I think we all recognize the value of this. Oil will continue to play a major role in the world economy, and in the socio-economic development of billions of people, while ensuring the world moves along the path toward a sustainable energy future. It matters to us all.

That is why our constructive dialogue needs to be pursued.

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Thank you for your attention