

MINISTER'S SPEECH

Fourth Asian Round Table in Kuwait City

ENERGY PRICE VOLATILITY

18th April 2011.

His Excellency, Minister of Oil and Minister of Information, State of Kuwait, Honorable Chair, Honorable Panelists, distinguished guests, ladies and gentlemen:

Assalam – o – Alaikum and a very good after-noon

This indeed is great pleasure for me to address the fourth Asian Ministerial Roundtable, 2011.

I understand that this forum offers wonderful opportunity to the members for stocktaking of what we were expected to do and what have been done so far. Additionally, it provides a platform to the members to have meaningful dialogue on major energy issues confronting us and to learn from each others experiences.

Ladies and Gentlemen:

Coming to my topic of speech that is “Energy Price Volatility” I start my speech by mentioning that, over the last five years, energy price volatility has become the most significant issue facing the oil industry and energy companies. Natural gas, electricity, crude oil and oil product markets have all exhibited price volatility for some portion of the period. Price volatility has contributed to a climate of uncertainty for energy companies and investors and a climate of distrust among consumers, regulators, and legislators.

Energy price volatility creates uncertainty and concern in the minds of consumers and producers, who may delay decisions to make investments in new supply. Such delay

may result in lost market opportunities and inefficient long-run resource allocations. In addition, volatility may create pressures for regulatory intervention that can bias the market and penalize regulated entities and market participants by generating wide and unpredictable revenue swings. Finally, volatility can hurt the image of energy providers with the customers and policymakers and create doubt about the industry's integrity and competency to reliably provide a vital economic product.

Ladies and Gentlemen:

In developing countries, Energy price volatility is taken more seriously as the price increase burden is taken by the Government in shape of providing huge subsidies to consumers.

However, price volatility in energy markets is a complex issue that affects the various stakeholders in different ways. In addition, price volatility is poorly defined, and there is not a consistent frame of reference for talking about and evaluating price volatility, let alone developing strategies designed to mitigate the impacts of price volatility.

I would also say that there is widespread concern that large fluctuations in the real price of oil are harmful to the economies of oil importers in particular. In addition, the volatility of the real price of oil also poses challenges for policy makers in oil-exporting economies.

I would like to mention that one of the most common indicator of price volatility is to measure dispersion of daily price changes over a certain period. The analysis of dispersion of daily price changes indicates that oil prices have been more volatile during the last several years. This change in oil price movement can be attributed to a change in OPEC's production policy. However, a number of other factors such as the decline in spare

crude oil production capacity in the oil producing countries, and lower level of desired inventories and rapid decline in surplus capacity in the global refining industry also enhanced this transformation to a period of more volatility. The resulting tightly balanced market has become more sensitive to actual or threatened supply disruptions, and swings in demand are increasingly met by price changes rather than delivery from storage. Liberalization of trading markets and development of transaction tools such as derivatives and information technology seem to intensify volatility.

Historical analysis implies that an increase in oil price volatility is associated with a decline in investments by the oil industry, and that there is a positive correlation between investment and price changes, confirming the intuitive hypothesis that investment rises with price levels. Similarly, in the current competitive electricity markets, price volatility can hinder decisions of market participants to build, buy, sell, or retire power plants and transmission facilities.

Whatever the adverse effects of oil price volatility, it seems that oil prices will remain highly volatile in the foreseeable future. Unless significant amount of surplus capacity in crude oil production and refining emerges, markets will remain sensitive to actual or feared disruptions. Similarly, electricity and gas prices will remain volatile, unless market reforms under progress are more carefully redesigned.

What are the main reasons behind energy price volatility and how to limit it:

Ladies and Gentlemen:

One strand of the literature views oil as an asset, the price of which is determined by desired stocks. In this interpretation, shifts in the expectations of forward-looking traders are reflected in changes in the real price of oil and changes in oil inventories. The other strand of the literature views the price of oil as being determined by shocks to the flow supply of oil and flow demand for oil with little attention to the role of inventories in smoothing oil consumption. Recent research shows that shocks to the flow supply of crude oil overall have had little impact on the real price of oil since 1973. In contrast, shocks to

the flow demand for oil associated with the global business cycle have been responsible for long swings in the real price of oil, notably in 1973/74, 1979/80 and 2003-2008. In addition, speculative demand shocks defined as any demand shock that reflects forward looking behavior by traders played an important role in 1979 (following the Iranian Revolution), in 1986 (following the collapse of OPEC), in 1990/91 (following the invasion of Kuwait), in 1997-2000 (following the Asian crisis) and in late 2008 (during the global financial crisis). Unlike shocks to the flow demand or flow supply, speculative demand shocks can cause large immediate effects on the real price of oil, for example in response to geopolitical events.

To my understanding price stability does not mean fixed prices. A certain price variation is inevitable. However, increasingly volatile energy markets can distort the mid- and long-term development path of the industry and even countries' economy as a whole. The "mutually reinforcing volatility effects," where reduced investment is partly responsible for the current volatile price regime and at the same time, is partly the result of volatility, highlight the energy security in today's context.

The international oil prices are of those traded and quoted in the Intercontinental Exchanges. Traditionally, prices were based on market fundamentals, where demand was highly dependant on global macroeconomic conditions. However, in recent times, non-fundamental factors have been mainly responsible for the price increase. The heightened levels of speculation have become a principal driving force behind price volatility with oil becoming a financial asset. The falling US dollar has encouraged additional inflows of money into the crude oil futures market. Resultantly, it is widely believed that crude oil prices have become detached from the dynamism of supply and demand.

The recent events in MENA (Middle East and North Africa) region have pushed oil prices to the highest level since 2008. This might further be exacerbated as there is speculation around the aftermath of Japan, as Japan will eventually need to increase its demand for energy to rebuild the country followed by the tsunami and earthquake damage.

I strongly believe that the energy prices volatility can be limited through ensuring energy security. Security of demand to producers is an important as security of supply to consumers. Countries should focus on entire supply chain, i.e. upstream and downstream. Rich and poor countries should focus on increasing their production capacity and also plan to bring on-stream new projects, so as to respond to the further demand both home and abroad. Moreover, emphasis should be placed on how to develop, produce, transport, refine and deliver oil to end-users in an efficient, timely, sustainable, economic, reliable and environmentally sound manner.

To what extent and improved data transparency can contribute price volatility reduction?

Ladies and Gentlemen:

There is a clear need to increase security of oil demand. One important area where consumers can act is in policy-making – through the introduction of greater predictability, consistency, stability and transparency. The joint Oil Data Initiative (JODI) is a good starting point in this respect. The JODI partner organizations produce monthly data on production, refining, trade, demand and stocks of seven product categories: crude oil, LPG, gasoline, kerosene, diesel oil, fuel oil and total oil. The initiative has played an important role in raising political awareness of the difficulties encountered in improving data reliability and timelines.

How can government and companies ensure a more stable market environment?

Ladies and Gentlemen:

The greatest challenge which a developing country faces is whether to invest in their oil and gas, and produce now or postpone investment to a later date. Not only do they have to address ongoing economic and social development aspiration but they also have to consider how to meet the future demand challenges for oil and gas.

I must mention here that one scenario can be to focus on the downstream project along with supply chain infrastructure to achieve efficiency and effectiveness. This can be done through investment in refinery project and also development of a major storage and bunker port at Gwadar which is at the gate of Strait of Hormus.

The other scenario is to focus strongly on upstream investments – with the goal of expanding capacity and relying less on imports of deficit products. But if the upstream investments are pursued without careful consideration of global market conditions, the result could be higher risk of idle spare capacity and unnecessary costs to maintain this.

Ladies and Gentlemen: Strategies designed to address volatility fall into two categories:

- 1) Strategies and policies that are designed to reduce volatility, and
- 2) Strategies that are designed to manage volatility and allocate the risks associated with volatility.

There is no “silver bullet” to address market volatility that is guaranteed to reduce oil, gas and electricity prices in the long-term. Rather, there are real, and in some cases, significant costs associated with all of the analyzed strategies that would increase prices over time, but result in more stable prices in return.

What is a fair and acceptable price range and why?

Ladies and Gentlemen:

One of the striking findings of the recent literature is that speculative demand shocks, unlike shocks to the flow demand for and flow supply of oil, may have large immediate effects on the real price of oil. In many ways, these speculative demand shocks resemble the types of shocks that the earlier literature associated with exogenous political events in the Middle East. There is evidence that these geopolitical events indeed matter, but not so much through their effect on crude oil production, but through their effect on expectations of future crude oil production disruptions.

The fair and acceptable crude price is in the band of US \$ 60 - 70 per barrel. Anything above this rate would have to be subsidized by the government as it would drive up the food and commodity prices in the country which would subsequently increase the inflation rate.

Does energy price development favor the spread of efficient and sustainable energy technologies?

Ladies and Gentlemen:

In view of the current international oil price scenario where prices are at their highest level since 2008, diversity in the overall energy mix is essential. This is the time to push and develop alternate fuels and stress on renewable sources of energy. Biofuels (Jatropha Curcas Diesel and Ethanol blended Motor Gasoline) and wind energy generation have recently been introduced in Pakistan and are planned to be given fiscal and policy incentives, but the sustainability of large-scale supply is becoming the subject of serious discussion, in terms of competition for land and scarcity of resources, biodiversity and impacts on food prices.

What are the recommendations for an enhance cooperation?

Ladies and Gentlemen:

To my understanding and knowledge based on my experience I would like to suggest that all member countries can jointly work together to resolve the issue of Energy Price Volatility and this can be done by increasing the supply to match the many-fold increased demand. As far as Pakistan is concerned, I recommend that any investment consortium can explore opportunities for setting up 250,000 barrels per day complex refinery at Hub Coastal area in Pakistan. A number of investor friendly incentives are offered by the

Government under the current Petroleum Policy. The proposed refinery would significantly reduce Pakistan's dependence on refined products imports thus resulting in significant savings to the national exchequer.

Prospects for setup of a major storage and bunkering facility can also be explored at Gwadar which is just outside the Strait of Hormus. This can serve as a major gateway for product movement to the rest of the world.

Ladies and Gentlemen:

I would end my speech with a positive note that with joint efforts we would Insha-ALLAH make our markets more transparent and responsive and will definitely provide "Energy to All" at an affordable rate.

Thank You very Much.