

Sheikh Yamani Lecture, 7/12/2004

A verbatim transcript of the Special Lecture given by Sheikh Zaki Yamani at the Royal Institution of Great Britain on 7th December 2005. Hosted by The Institute of Continuing Professional Development and the CPD Foundation. Introduced by Jonathan Harris CBE.

Thank you Mr Harris. Thank you for the invitation and for your kind words. But you raise the expectation of the audience, so I have to work very hard to live up to that level.

Ladies and Gentlemen, it is really a great honour and privilege to be able to address a highly distinguished audience like the one I have tonight. And the subject I was ordered to discuss tonight is oil. What else?! Of course, I need your help. Because, I have only half an hour to talk about a subject that needs to take at least an hour or two. So half an hour, and I need your help with your questions, so I can then fill the gaps. I'm going to mention a few headlines and thereafter you'll fill the gaps.

Of course we want to discuss the oil industry and prices in the short-term, mid-term and the long-term. But before we do that I think everybody has in mind a question: why do we have these sharp increases in the price of oil which took place in two years, 2003 and 2004, more than twice? There must be a reason. And it was not expected; there must be a reason. So, before we take our journey into the future I think we have to stay a little bit in the past and the present. When you talk about the price of oil, there is a divine rule; that is the rule of supply and demand. Everybody believes in this. But when you come to the oil business, it is not as simple as this. There are some other factors; political, financial, economic, and probably other factors. So we will deal with that, but very briefly.

So; supply and demand. Let me start with demand. Demand increased from the year 2003-04 unexpectedly, and I take it that probably everybody knows that in 2003 Japan had a problem with their nuclear reactors so they needed some additional oil, but that was not too much. But then we have this giant country, China, where demand flared up. Of course their economy is flaring up, so demand goes up with it.

However, in China there was another reason for this additional demand and people, usually, they don't look at it. The Chinese are building dams so they can have hydro-electric generators from those dams. And in order to construct these dams they need electricity and so they have generators and they started importing a very large amount of diesel, oil, and this is an additional demand on top of what comes with their really heated economy. However, you have to know that this is a temporary additional demand because once they complete the construction of the dams, they will no more need to import this additional amount of diesel. And not only this. They will generate electricity and this will replace some of what they import from the outside for oil. This is China, and China is a question mark, and probably we will come back to China now and then, here and there.

Then I come to another giant: the United States of America. They are really importing more and more oil. But I have to confess, though I understand what is happening in China, I find it difficult, really, to understand what is happening in America. Of course we know that they had a gas problem and electricity generated by gas had to be shifted to oil. I accept this. But what amazed me is something that we call in oil the coefficient factor. With every one percentage of economic growth there is an increase in energy consumption. In the past, during the Clinton period - and you all know that the economy was really very prosperous at that time, 4.9% or so - the energy coefficient was, for one percentage point growth in the economy, one third of a percentage increase in oil consumption. All of a sudden, with a

much lower rate of growth now, it is two thirds. That is my question. So, I hope that one of the audience can help me understand that. And of course America continues. Maybe you heard about some of the economists, they talk about the so called 'holding barrel'. There is a lot of oil going to America; it's not all reported, where does it go? And this reminds me of the old days, in the late '70s and early '80s. We had something called the 'missing barrel'. There were some barrels, we don't know where they did go, but finally, we discovered, it was hidden somewhere and it came back as a source of supply, and that's why we had a sharp decrease in the price of oil. Anyway that is another matter. So this is America, and this is demand. China; we know why. America; to some extent I know why, but I'm still amazed.

Let me go then to supply. Supply. We take Iraq. Some people, they say that one of the objectives, if not the main objective, to go and invade and occupy Iraq is oil, so they say, but what happened is just the opposite. So much of the Iraqi exports were reduced. If we take 2003; one full month, no exports. Iraq, during the Saddam Hussein period, they say they used to produce 2.8 million barrels a day. Maybe a little bit more, we don't know, but this is the official figure published by the United Nations and others, but we heard about oil going to Syria, hidden in the pipeline, not reported. We heard about, what they called, the border traffic, whatever it is. But I stay with 2.8. Then one month a complete absence of Iraqi crude to the market, and after that it started to come down, and it never came to the same level. Sometimes it's 1 million barrels a day, 1.2 million barrels, something like this. You all read about the problems - security, sabotage, what's happening, so that is the situation in Iraq. There is a very sizeable amount of oil absent from the market from Iraq. Of course it was, to some extent, substituted by some OPEC countries.

Then I come to another question mark. As you know, in OPEC, they have what they call the price band. They wanted to protect the price of oil - 22 is the lower level, 28 is the higher. And they said, if the price comes to 22 then we have to cut production in order to raise the price and not let it fall below. But, if the price of oil goes above 28, for 20 days, then automatically OPEC will raise production, to calm down the price of oil. What happened in February is that the price of oil went way above 28 - over 30 - for more than a few months. Of course there was a complete silence. But when OPEC met in Algeria, instead of increasing their production, they decided to lower their production and of course this flared up the market. In the oil business, for the gentlemen who know, there is this stock, the commercial stock of the companies. And the commercial stock has to reach a comfortable level, and it is seasonal. During a season it has to go to a certain level in order to meet the requirements of the winter or the gasoline field, or whatever it is. So it goes up and down and the management of the stock is so important among the oil companies. What happened was that OPEC reduced their production at a time when the commercial stock was lower than comfortable. This created some sort of chaos and the oil companies were really not happy with that, and prices started to flare up. Of course, now the OPEC countries are very happy because they are generating a very sizeable revenue.

The oil companies are very happy as well, I don't know how many we have here, because they are making a lot, a lot of profit. I don't want to go recording how much they are making in billions of dollars in a few months or so. They take that money of course and some of it will be reinvested either in finding alternative sources of supply or going to alternative sources of energy and some oil companies, they buy some of their shares, but whatever it is, they are happy. And the value of the shares shows that happiness.

But the problem here is also this Futures market, the non-commercials as we call them. They go to NYMEX and they go long. They speculate and they make a really sizeable

amount of profit, from that speculation, at a time when they cannot do it elsewhere. So the oil price is no more a true reflection of this supply and demand. People they go and go long, push it long, and they make a few dollars on a contract, and they make millions, they have hundred of millions of dollars in the market. I'm talking about the non-commercials; we call them non-commercials, like the hedge funds, and so on, the insurance companies, and so on. The commercials, the oil companies, they do it for hedging, and that is understandable. That is one thing.

Another thing which is not normal. Now America is the most important country when it comes to the price of oil. We know that America rules the whole world, whether we accept it or we don't accept it, but this is the fact. The situation inside America dictates what is the movement of the price of oil. Every Wednesday you have these statistics coming from the API and from the Department of Energy and they tell you whether there is a draw down from the crude stock or a build up and the price goes up and down because of the American market. The whole world must pay the price of what is happening in the United States, either up or down. That is one thing which is new. But what leads to this is the wrong pricing system that we have now; I don't like to talk anything about it, but it's a pricing system. The bulk of the oil is coming from the Gulf, million of barrels and, for Europe, it is priced at a very small amount of Brent oil that is sold on the stock market. In the United States it is based on the WTI, it's oil produced inland oil, that has nothing to do with this. So instead of the price of oil you take the price. So that is also something which has to be corrected, I hope one day it will be done. This is the situation in the past and now OPEC is very happy that the price of oil is going up. And they will meet this coming Friday in Cairo.

Two years ago they were dreaming of \$22 or \$25, but that was history, now they are thinking of \$40. They want to protect \$40. Now they are talking about reducing their production. Of course a lot of noise we hear from President Chavez of Venezuela, from the Iranians, and the others who like it but, then see what to do. The question mark I have in mind, and which some OPEC member countries have the courage to do, something so harmful to the world economy though we hear every now and then, that this high price of oil is alright, that it does not affect the economy. I find it difficult to believe this. So we wait for this Friday and here let me leave this very quickly, we take a very quick journey to see what is the short-term, mid-term and long-term of this oil business.

Of course when you talk about short-term, which is this coming year, what are the factors that can raise the price of the oil? Number one: the weather. If, especially America, they have a severe winter, which will of course mean that consumption will go up. If it so not so severe, if it is mild, then we will have a soft price of oil, of course considering the other factors. And then of course we have OPEC; what will be their decision? As a matter of fact, if you take things logically, right now we know that Norway lost more than 200,000 barrels a day of export from some of their fields. So there is a reduction of oil, sweet light crude coming from Norway. And something also from Nigeria. Nigeria always have some tribal problems and so on, and a smaller amount is absent from Nigeria.

We understand that one of the reasons that the Brent price came down is that a huge amount of oil from the Gulf started to land in America, so they are not calling on Brent, and there was no demand on Brent so the price came down \$2 or \$3 or something like this. Anyway right now most of the oil that comes from the Gulf is heavy and sour, most of it, and it isn't needed in America, they rely on sweet crude. So we don't know now what will happen, and OPEC, they are in the habit of something very strange. They have a quota and they are supposed to abide by that quota. In the old days if someone had exceeded

the quota by a few hundred thousand barrels, then they raise hell. But now openly they increase by 1,000,000 or 1,500,000, depending on their ability and the surplus capacity. So we have a quota which is about 27,000,000 barrels a day, but now they are producing over 30,000,000 barrels a day.

Now I know that demand for the oil coming from the Gulf is starting to shrink; that producers in the Gulf are offering the oil, but buyers are not knocking on their door. That is one thing we have to bear in mind; we don't what will happen then.

Then I take China, we know that a few years ago they just adopted the five year plan. They said they would slow down the economy and reduce the heat, which means lower demand in China. We will see what will be the demand for Chinese oil. Most probably, already, we see a drop in their demand; already. I mean a drop in their increased demand. Then there is something very important, and that is Iran. This is a political factor. If you follow the news you know there is something cooking about Iraq. Every day there is something new. Now, if the Americans attack Iran - I don't think they will occupy Iran, too big for them, and they already have problems with Iraq, if they attack Iran, President Jacques Chirac said the occupation of Iraq will open the doors of hell. But the real doors of hell is if they attack Iran, so we will have to wait and see and if that happens, God help us. It is going to be a very serious situation. This is Iran, and this is on the horizon in the coming 2005. It's not far, its next door. It is the same thing with Iraq. The Iraqi situation; there is a big question mark. I don't believe what I hear sometimes from Washington; that things will be under control, all from this temporary government of Iraq. The Iraqi situation is a very serious situation. I can sometimes feel horrified. I see a disintegration of the country. And if this happens, and if the production of Iraq comes much lower then this will affect also the supply this coming year. So forgive me, I cannot give you anything solid, because when you deal with politics and you deal with politicians, you are dealing with the unknown.

When you come to the mid-term, and I'll deal with this very quickly, of course the world economy is very important. Are we going, really to have a continuous growth? Or will this high price of oil have its impact on demand and on the rate of growth? Of course we cannot compare 1973, with the high increases in the price of oil at that time and what happened to the world economy, with now, because the cost component in the energy for industry right now is much less than what it was and, if you say that, in real terms the increase now in the price of oil is not really an increase. That is what they say. But the economists here they understand that there will be a delayed impact on the economy.

When there is inflation, and inflation will come, with inflation the Federal Reserve and central banks have definitely to raise interest rates and this will have an impact on the economy as a whole.

But then also there is a question mark about the American economy with this huge deficit in the budget. We don't know; it's growing, it's like cancer spreading. We have heard lately that they are going to stop it and reduce it but I find it difficult to swallow that. And it's a very strange situation. When Great Britain was, in the past, the major power in the world, you used to export capital outside to be invested. Now the major power in the world is America and the largest massive aid in history is coming from the outside to help America, to finance their deficit. About 93% of the treasury bonds are coming from China and Japan and the others. So we don't know until when this will happen. We know that China will find it very difficult to stop, they have a trade surplus with America, but with the depreciation in the value of the dollar the Chinese are not happy and they continue to do that, but for how long? One day, they say, they will bite the bullet and reduce that. If they do, it is very

difficult for the American economy because they have to go to the inside to get the financing from within, or a good part of it. And that is very bad for the American economy, already we hear about a movement from the dollar to the euro, and all these things you know about - I don't have to talk so much about it. So the American economy is an important factor when you go to the mid-term; very important.

And also Iraq. Are we going to have a stable democratic country in Iraq? That's beautiful wishful thinking; so the supply of oil from Iraq can jump, from what it is, 5 million barrels, 6 million barrels, and so on. Iraq is the second country next to Saudi Arabia, if not equal to Saudi Arabia, when it comes to the reserve and the ability to raise their production. So Iraq is very important; the policy of America is to reduce, we know, their dependence on the Gulf oil and mainly on Saudi oil and we know about what's been done. If they can really get it from Iraq, because most of the Iraqi oil can come to the east Mediterranean and it is a beautiful thing for America, they get all that they want and they forget about Saudis and others. But this is Iraq, and really nothing can come so quickly. But if Iraq is to be disintegrated, and we already hear about people in the South who want to have their identity and their autonomy, they want separation.

And the Kurds we can see in the north, it is the same, already they are practicing that, and in the centre we have the Sunni groups and we don't know what they are going to do, they will fight, and if there is a Civil War there, then forget about Iraq. So Iraq is an important factor.

I will move very quickly to the long-term. Now. Long-term I find it very difficult to see that this question of a high price of oil will continue. If it continues for a bit longer - two or three years - the drop, and the sharp drop in the price of oil, will be heavy; very heavy. Long term, technology is against the oil producers. Both, when it comes to upstream or production, because it reduces the cost of production and finding oil, and also in consumption. Technology is against that. Then with this huge amount of money in the hands of the oil companies, there will be good investment in alternative sources of supply, whether it's in the Caspian Sea or in West Africa or the Gulf of Mexico - everywhere - so there is really something coming. Today I heard that the people in the Caspian Sea, they want to export their oil to Japan and to China. How? They want to come to this pipeline in Egypt, instead of bringing the oil from south to north, they want to reverse that, they want to send their oil there. They're really hoping that a huge amount of oil will go, not to Europe which is next door, or to America, but to go to China and Japan. So there is something cooking, and this is history repeating itself. What happened after 1979 when prices jumped, and then in 1980, and people were intoxicated and prices went to \$40 they were very happy. When I said that the price would drop and production would drop they didn't like what I said, it was recorded, I was very unpopular for that. But this is what happened, and there was a sharp drop in the price of oil. Do you remember; 1986, and what happened, and so on? And this will be repeated. I mean, there are things you cannot play with it. And of course there are some alternative sources of energy. We are studying what they call the nuclear energy comeback. There are so many countries which are now starting to build reactors to generate electricity. You have Russia; of course France, which is the pioneer; China; Japan; South Korea and so on, and they are really embarking on a very ambitious programme and this is why it is called the nuclear energy comeback. And we cannot forget the hydrogen. Hydrogen is a very clean source of energy and already existing. In this country you have buses already in the streets working on hydrogen; it's very clean.

And then there are so many other things (I don't want to take more time, because I want the questions). The Kyoto Protocol and how it is going to be implemented, and so many other things, that oil is not really to stay for ever as it is, and one day you will remember me for this.

Well I thank you very much for listening, and now I need your help, because I said a few things without elaborating, and with your questions you will help me to elaborate.

[Applause]

[Question about bio fuels - a curse or as a way forward?]

Well biomass is one of the alternative sources of energy but it will not really occupy a large percentage in the energy mix, but it is coming. It is coming and it's in our studies, it is there and we know the countries which have started, but it will not really be a great competitor to oil.

[Question about the consequences of wealth creation from oil around the globe, creating a large amount of cross border capital flows, but a shortage of good quality real estate for the capital to buy. What impact will oil have on future of global real estate.]

Well, if I take my country, Saudi Arabia, there is a huge drop in this wealth coming. Real estate is affected, but inside Saudi Arabia. There is an increase in the price of land - up to 50% - because people there are not really clever enough, they don't know what to do with their money. They won't really take it abroad, unless this phenomena, this very high price of oil, will last for a bit longer. Then they might come to Great Britain, and especially those from the Gulf, they love this country, and they might start buying some real estate, for developments, but I don't think this will last for so long. The money they have, they are reluctant to go now to America, they are afraid of the American behaviour vis-a-vis Arab money, and so on. So this country, so far so good. It can accommodate some of this surplus and enjoy it but it doesn't have to be only in real estate, there are some other things.

I know that prices in real estate have come down a little bit, in certain categories of real estate in this country. But I don't see the wealth, I don't see so much wealth, because don't forget some of these countries in the Gulf, they are heavily indebted. Until recently Saudi Arabia was in trouble with how to finance the debt they had, and if they start paying back some of it, that would be nice. And now we have some terrorist activity in the country and this needs a lot of money to buy arms and to pay for soldiers and sometimes we get them from outside and we need to pay them so we are not really heading for a very comfortable future. So I find it too optimistic to talk about real estate, I'm sorry to say that.

[Question about the relationship between oil and the currency markets; the huge deficit currently in the US; the volatility of the dollar - how long can oil continue to be priced in dollars? And how far can a country like Saudi Arabia diversify its official reserves away from the dollar without jeopardising the quality of its relationship with the United States?]

You know, we have to distinguish between two things: how to price your oil, and how to get paid for your oil? Two completely different things. How to price oil, this is not a big problem. You know, in the past, OPEC did not price their oil only in dollars. We used to have something called the Geneva One. We took a basket and we took few currencies, and we put it in that basket, took a mathematic average and that's how we priced the oil at that time. Then we came to Geneva Two, we took currencies and we looked at how much

we import from the Americans, from UK and so on, so in that basket a weighted average, and that was how we priced our oil. But you know people are greedy by nature. When the interest rate on the dollar jumped, the value on the dollar jumped and everyone said, no, we don't want the basket and they went to the dollar. They came back to the dollar. But then as usual, the dollar was up and down, it came down, and they wanted to come back to anything else. They thought of the SDR, it didn't work, because some countries within the organisation, they don't want to hurt and disturb the feelings of the Americans, so they stayed with the dollar. But now there are so many noises about this. No problem, you can move from the dollar to price your oil, not necessarily in Euro - it's no good for you, in this part of the world - but you can price it in a basket or whatever. But the serious problem is how to get paid.

Here, if they move from the dollar to another currency, the value of the dollar will come down to less than half of what it is, because the volume of trade of oil is too big and in order to buy one barrel of crude you go and buy dollars to pay for it. So there is a heavy demand on the dollar. So, I want you to distinguish between these two things. Pricing the oil - not a big problem, it can be done, though some OPEC countries say, no, they don't want to hurt the feelings of the US. So it's not bad for you. Aren't you happy? Because you are getting a cheaper barrel; every time the dollar comes down, the price of oil comes down with it.

[Question about the view that the point where depletion of reserves will balance the rate of increased demand will occur in the next few years. What investment is being made in alternative sources of energy, and what are they?]

Sir, these noises we hear about the depletion of oil reserves. that we won't have enough, we heard it sometime in the past and we are hearing this again. I assure you that we have too much oil; that is not the problem. This is not a problem. Iraq alone, they have one hundred, maybe ten or twenty billion barrels of oil and they are thinking of three hundred. There are areas they can increase in Saudi Arabia, we have plenty of oil, and if they open the country to foreign investors, we can flood the whole world with oil. But these noises always come. Do you remember the Club of Rome, and they used to say that the whole world is running short of raw materials and of oil? Exactly the same is being said now. Sometimes they are politically motivated and I'm not worried about this. I know this for sure.

[Question about the stability of the Gulf, in respect of the rate of diversification of the Gulf economies.]

I think the stability in the region will come with democracy. There is no other way to have stability. And then you can do the investments, and diversify, and there are different ways and means to do it. But first is democracy. Dignity for individuals. It's like a mirage. And now, even for those countries that claim to be applying a democratic regime, the president will be elected by 99.9% of the people, and you have to believe that and you applaud them. President Saddam Hussein, that famous dictator, was elected 100% because he refused to be inferior, or equal to, the others. So I think it is democracy; once you have democracy there will be a lot of stability and diversification and everything will come.

[Question about security in the Middle East, the war on terror, Iran etc; could this lead to more destruction of the infrastructure and disruption to the distribution and supply, and eventually lead to an increase rather than a decrease in the price of oil?]

Sir, this slogan, 'war on terror', I cannot buy it. Those people who are really ready to commit suicide and want to go to heaven so quickly - this is ideology. You cannot fight ideology with a gun. There are other ways and means to do it. What America is doing now, they are planting more terrorist activities in the world. We have to understand this. You must come to the root of the problem. This funny Islamic ideology, which we all know about, we have to stop it. We don't spend money to let it flourish. The way to fight terrorists is to give the others - the bulk, the billions of Muslims who don't belong to that school of thought - to speak up, give them the right to tell people what Islam is. This is the way you fight terrorism. There are no other ways to do it; you cannot fight it by force. When you have ideology, when you have a crazy person, who wants to go to heaven - look what happened in Jeddah yesterday, some crazy people, they came and they killed innocent people, not even Americans, if they hate Americans, not even Americans, but one Yemeni, and so on. But they think they are going to heaven. What to do with those people? But they are planted in the soil, you have to stop that and you have to give the others power to speak up. Now if they speak up they go to jail. So that is the problem. I am not a man who can buy this phrase - war against terrorists - this is a slogan, a political means to achieve something else. We all know about it.

[Question about the political and commercial imperative to find alternative sources of oil. Followed by a question about the lack of stability in some oil producing democracies, e.g. Nigeria]

Taking your first question, I come from an area where oil is there in huge quantities and we know we can double the reserve. We'd be working against our own interests by developing alternative sources of energy.

Usually, you don't compete with yourself. But there are some countries in the area are looking at gas, and I really ignore talking about gas as a new or alternative source of energy, though it is clean. The state of Qatar, they are developing their gas resources, as an alternative to oil, though it is hydro-carbon anyway. But usually if you have a commodity and it is demanded, you don't come and compete with that commodity and attract people to buy something else. When I come to Nigeria, Nigeria is a special case. These are tribal disputes. I visited that lovely country and I know the tribes. Any country when you have tribes you have to deal with them. Look at Afghanistan. They think now they've elected a president, by the people, but just wait and see. When you have tribes, you have to deal with them with tribal law. It's not a question of democracy, and it's not against the concept of democracy. It is tribal problems.

[Question about unlikely scenario of oil producing countries competing with themselves by producing alternative sources of energy. Did His Excellency believe Iran's own claim that it's nuclear activity was for domestic use, to allow them to export their oil outside the country for income?]

Sir, if you know the Persians, you will know that you cannot get through and understand what they have in mind. I have dealt with them for decades and I really don't know now. I don't have a crystal ball, to tell you what they have in mind. According to their own religious philosophy, it's a virtue to hide your intention. A virtue. I really don't know, but the concept of having an alternative source of energy in order to free oil is there. Take Saudi Arabia; they opened the upstream for gas so that they can use gas instead of burning crude oil to generate electricity so they can sell that crude oil. And this is exactly what the Saudi's are doing. It's not nuclear energy but it is gas. So this is done. I really don't know whether the Iranian's are looking for a source of energy - a nuclear source of energy - or they have another intention but they tell you, no, and the parliament and the grand, grand

Iman, the man who gets his contacts from the high authority, said that its against religion. I don't know. So you ask someone who cannot see, I am blind when it comes to this.

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[Thanks from Jonathan Harris.]