

London, 28 October 2008

Speech of Eni CEO Paolo Scaroni at Oil & Money Conference

Good morning, ladies and gentlemen.

It is a great privilege and pleasure to be here today, and I wish to thank Tom Wallin and everyone at Energy Intelligence and the International Herald Tribune for giving me the opportunity to address such a distinguished audience at such a remarkable time for the world and for our industry.

In intergovernmental meetings, cabinets and boardrooms worldwide, the issue of the day is boom-and-bust cycles: their causes, how to cope with their consequences and how to avoid them in future. From Detroit to Beijing, the talk is about finding ways to smooth out the cycle or - in today's jargon - adopt counter-cyclical measures.

Boom and bust cycles are not entirely unknown in the oil industry, either.

Just three months ago, the big topic would have been high oil prices: whether they were sustainable, whether markets were functioning

properly, and whether something should be done to regulate speculation.

In the next two days, oil executives and energy ministers will presumably focus instead on the oil-price collapse: the pros and cons of further production cuts, the new outlook for oil and the impact this will have on the projects needed to secure supply in future.

Since July, the world has turned into a completely different place, with the oil price now 60% lower than its July peak.

Why did oil rise so fast, and collapse so quickly?

The reasons for the oil-price boom are well understood: 15 years of low prices, and the consequent underinvestment in exploration and production. From the mid-1980s to the end of the 1990s, 70% of global exploration was carried out in the US and Canada, mature areas which hold only 3% of global reserves. By contrast, only 3% of exploration was carried out in the Middle East, which accounts for 70% of global reserves. Add in growing demand, driven by the economic expansion of China and India, and what you get is declining spare capacity, vulnerable markets, global uncertainty and rising prices.

All this has been talked about at length, not least at the energy conferences held in the 7 years of rising prices. The reasons for the bust are perhaps less evident, if only because the phenomenon is relatively recent.

To my mind, the oil price has fallen for three main reasons.

The first is that, when oil prices rise beyond a certain level, demand for oil products in the developed world suddenly becomes elastic. And given that the OECD still accounts for 60% of consumption, this has a big impact on global demand.

Demand doesn't become elastic because consumers choose to use less oil. Not in the slightest. We would all love to keep driving our cars and live in tropical homes year-round. But when the barrel rises above \$110 - \$120 dollars, even the most obstinate consumer just can't make his or her dollar stretch.

For an example of how tight budgets became, look no further than the average American citizen. Between 2000 and 2008, per capita energy spending in the US almost tripled to \$7000 dollars a year, around a fifth of the average per capita annual income.

As a result, US demand fell by almost a million barrels a day.

This trend was already starting to emerge elsewhere. In the last two years, consumption in France, Germany, the UK and Italy has declined by more than half a million barrels of oil a day, and by a quarter of a million barrels in Japan. And all over the developed world, high oil prices have sparked increased interest in energy saving measures, whether it be energy efficient city lighting schemes or new eco-friendly skyscrapers.

Already, OPEC is predicting that in 2009 demand for its oil will be at least a million barrels a day lower than in 2008.

And all this in the context of a fairly healthy economy.

This brings us to the second driver of the oil price fall: uncertainty about global economic prospects. If, in the aftermath of the financial crisis, we should see the real economy suffering, oil demand will only head further south.

The third driver of the oil price fall has to do with the supply side. The rising oil prices stimulated investments in production capacity. Indeed, global investments in the upstream sector doubled between 2002 and 2007. As a result, production capacity has also started to increase, albeit at a slower rate than investments.

Add together falling demand, uncertainty about economic prospects and rising production capacity, and what you get is a rapid decline in prices.

The oil price cycle is not just driven by fundamentals, of course. The swings are exacerbated by financial speculation, the millions of paper barrels traded each day, which helps inflate the price on the way up and depress it on the way down.

But the net result of fundamentals and speculation is that the oil price, which was at \$70 in September 2007, more than doubled in 9 months and then promptly halved again. You don't get very much more cyclical than that!

These dramatic swings up and down are bad news for everyone.

For everyone in this room, for starters. Spiking and plunging oil prices certainly make life complicated for oil companies, whether they be international or national, as they try to plan something in the region of \$1 trillion of investments over the next 5 years and provide adequate returns to shareholders. Uncertainty about whether oil will rise to \$200 a barrel or crash to \$20 also impacts our human resource

management, our R&D efforts, and doesn't make it easy to draw up fair and sensible production sharing agreements.

But if the problems started and ended inside this room, we could just about cope. Oil companies have become adept at managing their business using forecast scenarios which are invariably wrong at least in the short term, and we all have sturdy business models to help us do so.

Unfortunately, the real consequences of oil-price uncertainty are felt outside this room.

First of all in oil-producing countries, which depend on oil revenues for infrastructure, economic and social policy, all of which profoundly affect their citizens' lives. These countries don't know whether from one year to the next their revenues will double or halve. And neither is a good thing!

When oil prices are lower than expected, planned investments need to be delayed. And when prices rise too high, the surplus cash tends to cause asset-price bubbles, which are then pricked when oil prices come down again.

Oil-consuming countries also suffer from this roller-coaster ride. In the west, low oil prices encourage waste, and detract attention from the development of alternative energy sources. Wasting energy is not only harmful to the environment, but also an irresponsible use of a finite resource which we still haven't found the way to replace effectively and efficiently. Meanwhile, high oil prices mean inflation and pinch consumer spending. Their impact is also regressive, hitting the poorest segments of the population disproportionately hard.

Last but not least, oil-price spikes and falls have important geopolitical impacts, periodically shifting power between countries which have oil and countries which use oil.

To sum up, the uncertainty about the price of oil has negative impacts on consumers, businesses and governments worldwide. Meanwhile, the cyclical nature of the industry means that benefits to producers and consumers are purely temporary, and bound to reverse sharply.

Armed with this knowledge, the time is ripe for the oil industry as a whole, producers and consumers, to move beyond short term power shifts and work together in the interest of mutually beneficial stability.

What shape might this collaboration take?

One idea would be to work towards a new contractual framework which ensures producers can count on stable demand for their oil and stable revenues, perhaps taking a leaf out of the take-or-pay structures which are common in the gas market.

This would give producers rational incentives to invest in exploration and production capacity, to the benefit of consumers, without the fear of being caught out by the downturn and seeing their returns on investment collapse.

On this note, it would also make sense to work out some sort of remuneration for spare capacity, along the lines of what happens in the electricity market. Spare capacity has enormous value for consumers, ensuring security of supply and limiting the uncertainty that feeds speculation. But for producers it currently constitutes an investment which doesn't provide a return.

The exact shape and nature of a new model for the oil industry would need to be carefully discussed. But it is in everyone's interest to forsake their short-term interests and work towards a compromise.

Just as consumers need supply stability, producers need demand stability. And the whole world needs to ensure oil is used rationally and efficiently. In order to safeguard the environment, but also to buy

scientists working on alternative energy the time they need to produce truly effective energy solutions.