

**GEOPOLITICS OF OIL:  
Experts Analyze OPEC Decisions**

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**Mark Schoeff:** Good afternoon. Thank you all for coming over to CSIS for this event. I'm Mark Schoeff, Director of External Relations here at CSIS. I want to introduce our panel to you. You have short biographical sketches of each analyst in the media advisory that's available at the door so I won't belabor each of their backgrounds. I'll just tell you that the people we have here are Robert Ebel at my far right. He's Chairman of the CSIS Energy Program. Next to Bob is Anthony Cordesman, CSIS Arleigh Burke Chair in Strategy. In the middle, and right next to me, Frank Verrastro, who is Director of the CSIS Energy Program.

Just as a housekeeping tip, you can get in touch directly with Bob, Tony and Frank. We've again out front at the media sign-in have this media information sheet, both sides, you'll find their numbers. So for follow-up questions either on the OPEC meeting or any other issue that comes up that you're covering, feel free to contact them directly.

With that we will start with an opening statement by Tony.

**Anthony Cordesman:** Let me make a very brief statement, and each of my colleagues is going to be talking in different ways about the oil market so let me talk a little about the issue of stability and security.

First, one of the realities is that from the viewpoint of somebody who looks at security analysis, some of what is happening is going to produce different conclusions than those of the people who are in the market.

The last thing on earth you want in a complex international system is stability, predictable prices, and reliable supply. What you want is a system that forces the market to adapt, where prices go through cycles, where people realize the system is vulnerable, and where what happens is limited enough to force people to become adaptable, flexible, to improve their tracking and response theory.

We do not face, at this point in time, any security crisis in supply. The problems, as my colleagues are going to outline, are different. I think it is very dangerous to go from today's situation to the conclusion that all that is happening is something which in the long run or even medium term is not something that's a necessary aspect of how the oil market and the security system functions.

That said, let me make a few comments about the patterns of security and terrorism. So far we have not seen attacks in Saudi Arabia directed at oil facilities. We have seen a very clear pattern of attacks directed at the foreign presence in Saudi Arabia; at secular influences from the outside; at the kind of forces which to the people in al Qaida; and much more to Salafi Islamists than to Wahabis, are seen as the enemies of the kind of puritanical state that people would like to see created.

Now the Saudis have claimed that this situation is a relatively minor threat, that there were six cells and only one is active. I think it is fairly clear that that is far too optimistic. Nobody knows how many true supporters there are that are willing to use violence. We do know that somewhere between 7,500 and 15,000 Saudi young men went through various indoctrination centers and training camps between 1979 and today, and we know there are significant numbers in the Kingdom.

We know that up until really May of 2003 while the Saudis had focused on this threat they had not given it the weight, the effort and the seriousness that they should have. And as a result of what happened in 9/11, much of the focus shifted to dealing with political problems with the United States, the flow of money to foreign groups and so on, rather than actually protecting Saudi facilities.

After May 2003 that changed. Significant improvements began. But security capabilities take time to develop. AS they develop the Saudis found that there were significant numbers of young men in Saudi Arabia that were allied at least loosely to al Qaida, that there had been significant smuggling of arms and munitions across things like the

Yemeni border, and that they were dealing with a very serious counterterrorism problem. Not a broad insurgency problem, but a counterterrorism problem.

It is a fact that their system is very large, very broadly dispersed, that some of the bottlenecks in there could produce temporary cuts in output if they were attacked successfully. Attacking the system in ways which produce significant lasting interruptions are probably very difficult. You can postulate the attack. In some cases it is technically possible. The reporting I have seen in the press so far has not done a particularly accurate job of identifying the targets, and if you'll forgive me, I'm not going to improve that today. But the fact is that in most of those targets that are real there has been a significant increase in the security presence. But I think we need to count on it taking at least several years before you actually can bring this particular terrorist threat under control and there are broad economic, social and other reforms that have to take place in the Kingdom to deal with the longer term problems of stability.

I'd make a couple of other points about the situation in the Middle East. One is that the situation in Iraq remains extremely unstable and at this point in time we will transfer power without any meaningful continuity by way of a plan for oil development and for oil recovery. Paper has been drafted, but paper does not consist of reality. So Iraq at least in the near term is not going to solve our problems, which is not to say that there will be major interruptions there. But certainly it is a fact of life that in many ways Iraq is still more vulnerable than Saudi Arabia and the other Gulf states.

Another point is there is no oil-exporting state in the Middle East that does not have Islamist cadres and cells in it. The fact these attacks have occurred so far in Saudi Arabia is not a measure of the future. The problem is regional. Therefore I think one question really for all of us is the extent to which you can refocus some aspects of the war on terrorism to look at energy security. Some of that has already occurred and I'll be happy to deal with that in the question period, but it is not a major objective, at least as yet, of U.S. policy, and it is one which may have to be in the future particularly because the Middle East is scarcely the only energy vulnerability issue. There are three others.

In the short term we have problems with Nigeria and Venezuela, which many of you are familiar with. In the longer run one real question of what is coming out of this is, if you do not really deal with the problem of short term terrorism, what impact does it have on mid and long term investment to increase oil production capabilities? And if we watch what's happening to date, the real impact in terms of terrorism might not be short term interruptions or the things that have caused reactions in the oil market, but a cumulative impact on the infrastructure, investment, development of facilities in the Middle East where even in the next few years we expect enough increase in production to help deal with some of the squeezes that my colleagues are going to describe.

So with that, let me turn it over to my colleagues.

**Frank Verrastro:** Thank you. I'm Frank Verrastro. I'm Director of the Energy program. We have a slight presentation. We had to go upstairs and burn a disk because we didn't make enough hard copies for you, and here's the disk right now.

So let me just make a few introductory comments.

What you heard this morning, most of the press reports that we've seen at least initially coming out of the OPEC meeting was an increase of two million barrels a day. We think that's slightly misinterpreted because what it really is is legitimizing what the current production rates already are, which are in excess of two million barrels a day over the April quota. So until you start seeing new oil come into the market, and there's a question of how much new oil you need to balance supply and demand, and take into account the fact that it will take a certain amount of time to get shipments to the United States especially, get them into refineries, if they can take that crude to make gasoline, what impact that will have on price.

So let me just kind of walk through. For those of you who have handouts, you can follow it through. We just thought that since there's a lot of numbers here it might be easier to go through if you have a visual.

Taking a step back, just to look how we got in this position, you need to go back to the beginning of the year. When OPEC went into their meeting in February, February 10th, what they were looking at was second quarter demand as demand typically does in the spring as we come out of the winter heating season, before we go into the gasoline driving season, demand goes down. The International Energy Agency had forecasted that we'd have a drop in demand of 2.5 million barrels a day from the first quarter, down to about 77.4. Now in the five months since that it's been revised five times. The current estimate for second quarter demand is closer to 79 million barrels a day, so you can see that there's been a bump.

But if you take that number as your target and you flip to the supply side, again if you look over at the second quarter 2004 column, the projection for non-OPEC supply, and Bob will talk a little bit about that, was in excess of 50 million barrels a day. There's about four million barrels a day of natural gas liquids available. So if you're still shooting at a target of 77 or 78, the call on OPEC was estimated to be around 23. That's presuming that Russia was going to increase production and people were concerned about Iraq wrapping up because at the beginning of the year the projections for Iraq getting back to 2.8 by April were pretty significant.

So what really happened? Well, second quarter demands were revised upward by about 1.3 million; and second quarter non-OPEC production has been revised downward by about 300,000 or 400,000 barrels a day. So you're getting a swing of between 1.5 million and 2 million barrels a day.

We've had continuing problems, and Tony alluded to this in Iraq, Venezuela and Nigeria, and they've moderated what we thought OPEC increases would be. High gasoline demand in the United States has increased demand for lighter crudes, and I'll talk about quality and quantity because it's really both. We've had low inventory levels and that's occasioned in part by the fact that we were under-producing at the beginning of the year and demand ramped up so quickly that a lot of the excess oil went right to the market, did not go into storage.

We've had in the United States on the gasoline side, changing product specifications which has meant that refineries are working harder. We've banned MTBE in some of the larger markets and now we have low sulfur requirements in gasoline that are coming on, so even our imports, the volume's been dropping a little bit because some of the import blends aren't able to meet U.S. specs.

We also have market islands, and I'll talk a little bit about that, so that even if you have an additional supply in Pennsylvania, you might not be able to use it in Illinois because the gasoline specs are different.

The threat of political instability and supply disruptions, this is kind of the fear factor. And as a result, even though Saudi Arabia, Kuwait and the UAE have pledged additional volumes to the market it doesn't change the dynamics of the speculation in terms of price. There's a lot of upside potential.

There's a second question and that's when you go back to the demand forecasts if you look ahead to the fourth quarter and demand continues to increase, especially in North America and China, the call on OPEC will be increased, and when you look at productive capacity you have to assume that nothing wrong will happen in the system to meet that demand, because that will be between '82 and '83 million barrels a day.

Here's a busy chart for you to look at. The two numbers you really have to focus on are the April quota number for the OPEC 10 which is 23.5; today's announcement was that OPEC production for this month or going forward will be 25.5. If you look at actual numbers in April, April production already exceeded the quota target and the estimate for May with additional Saudi oil and UAE oil coming on the market, is that they already exceeded the suspected quota or target price or target volume for August. So unless you're looking for incremental new volumes, what's in the marketplace is already there.

Now Saudi Arabia and UAE have pledged to increase production. We know that the Saudis in May had upped production to about nine million barrels a day, but on an average monthly basis it would probably bring the monthly volume, on a daily basis, on an average basis, down to about 8.4, 8.5. So this is where your change is taking place in the market.

The good news is that the incremental production that started in May is now working its way to U.S. markets. New production that's starting in June won't be here until the end of July in terms of factoring in for gasoline prices.

This just shows you how capacity -- because we're going to talk about capacity constraints. If you go back to 1979, OPEC's capacity was in excess of 38 million barrels a day. It's declined by over seven million barrels a day and the culprits are Iran, Iraq, and Libya by and large. They account for six of the seven million barrels a day drop which shows what sanctions and war can do and how long it takes for a country to come back.

I'll skip this one.

Price is volatility. Tony just talked about the merits of price volatility. If you look over the last 30 years it's been the rule, not the exception. I think one of the things that OPEC has been concerned about is if you look at the Asian recession in the mid 1990s is when they overshot the market. If prices get too high, like after the Iran/Iraq War and during the Asian recession when demand went down, if there's an over-supply in the market prices can drop precipitously, and the impact to these producer companies is considerable. These are OPEC net revenues between 1972 and 2005, projected for 2005, and the swing is ten-fold, from 30 billion to 300 billion in nominal dollars. So imagine if you're a producing country deriving 90 percent of your budget from export revenues what havoc that wreaks on your economy.

In terms of OPEC oil revenues, since 1993 for most of these countries it's doubled. For countries like Qatar it's tripled. So that's substantial. What do you do with the revenue? Even in the case of Saudi Arabia, last year with prices in excess of \$30 a barrel and producing a high volume, they ran a surplus for the first time in several years. Not a deficit.

The OPEC basket price. There's been a lot of discussion of the basket. For those of you who really believe that the basket price is still in the \$22 to \$28 range, we think it's closer to \$25 to \$34 instead of \$18 to \$28.

The challenges for OPEC, however, haven't really changed. Moderating prices in a high demand market because they are very concerned that if demand continues to grow and outpaces supply that when you get to \$40 and \$45 a barrel that you could have economic impacts and every price increase leads to a demand downturn, or it certainly has in the past.

There's a threat, however, of demand reduction. What if China craters? What if the demand numbers go back to being what we thought they would be on the low side? Then OPEC has over-supplied the market and prices could drop.

There's a concern about the near-term erosion of market share by non-OPEC producers if Russia comes storming back or we see increased production from Mexico or Angola or Canada. Managing the output from emerging members that have been constrained by quota. If there's new investment in Iraq, Libya, Nigeria, Iran, and they bump against their quota output but are used to increasing revenues for their internal consumption will they continue to stay as a member of OPEC?

Technological advances. Venezuela, Canada, in terms of heavy oil in tar sands are something you need to be concerned about in the long term. Environmental concerns. And the immediate concern is the fear factor of sabotage, terrorism and political instability.

Now we'll switch to gasoline. The U.S. gasoline market, it's a problem of both crude quantity and quality. We need a lot of light crude for our refineries to make high gasoline yields. Demand has increased year over year in this country, especially coming out of last spring when it might have been depressed because of the war in Iraq. Refining capacity while it's grown over the years, the number of refineries have gone down, but we may be reaching the limit on even expansion of existing refineries because of population incursion more than anything else, and also environmental regulation.

Low inventories, we talked about.

Regulation in fuel specs has been a considerable concern to refineries. If they're spent a lot of money changing equipment to meet fuel specs do they have additional billions to talk about expanding refinery capacity in this country?

We'll talk about federal, state and local taxes and the component part they make up in gasoline. And the security premium that's currently in the market ranges anywhere, depending on estimates, between \$5 and \$12 a barrel. So this is current gasoline and this is predicated on a gasoline price of between \$2.04 and \$2.13. I stopped changing this because it changes every day.

Roughly speaking for every dollar increase in the price of oil it's reflected in about a 2.5 cent increase in gasoline, so you can compute \$40, \$42, what that means. But almost a third goes to taxes -- federal, state and local taxes. California has the highest taxes in the nation, that's why they have the highest prices. But distribution, marketing and reprocessing costs have also gone up and profit margins have also increased during this period.

With that I'll turn it over to Bob and talk about other production.

**Robert Ebel:** Thank you, Frank. There are two countries that are thought to be standing in the wings ready and willing to take the place of Saudi Arabia and I'm going to talk in some detail about those two countries. The first is Russia and the second is Iraq. I'll expand a bit on the comments that Tony offered on Iraq.

Oil production in Russia today is matching that of Saudi Arabia. It's a little bit more than nine million barrels of oil a day, so it's pretty close to what Saudi Arabia is producing and I would guess that when the year comes to an end that the average for 2004 for Russia will be about 9.1 million barrels of oil a day.

Here's a country, though, where demand is relatively constant and has been for the last handful of years. That means that most of the incremental barrels coming out of Russia today become available for export. Here we have a country of 147, 143 million people, consume about 2.5 million barrels of oil every day.

This year production will go up by about 700,000 barrels per day so you can translate most of that becoming available for export. I don't see much growth in demand this year.

How does Russia feel about these high oil prices? It's a major exporter, probably will export about 6.5 million barrels of oil a day so its budget is very much dependent, as are OPEC member countries, on income from oil exports.

They're going to maintain production growth this year, not in support of OPEC, not out of concern for the consumer. Let me quote the Finance Minister who made this statement very very recently. It's in my handout. "Annually we increase production by five to ten percent. We are going to maintain this momentum. The growth in oil production is planned regardless of price. Our strategy does not specify a reduction in prices should influence production." In other words, prices come down, we're going to continue to export just as much as we would when prices are high. "We are going to increase production in accordance with our strategy."

So a substantial price drop on the world oil market would not bring about a drop in Russian oil exports. Similarly, an increase in price is not going to bring about any sudden increase in production. They don't have that spare producing capacity.

So they're going to continue to expand and to sell at whatever the price. That's really not any different than what the Soviet Union did. They sold whatever they had at whatever the price was because they needed the money.

But the question that comes forward today with regard to Russia is can the growth in Russian oil production exports be maintained? Unfortunately, there are conflicting signals coming out of Moscow and we can, if we look hard enough, we can find official statements to support whatever answer we choose for that question. Can the production and exports be maintained?

In effect the Russian oil sector has been living off its inheritance, that is what it inherited from the former Soviet Union in terms of producing fields, pipelines, refineries, what have you. Has it been careful with this inheritance? Has it been spending it wisely? Or is it being depleted very quickly to take advantage of current high prices?

Once again we have some official statements that we can turn to. The country's energy regulator, that is the guy who monitors energy producers, had this to say. "Growth in oil output is to stop in the year 2005 as some fields are being depleted."

Lukoil, which is now the leading oil producer in Russia, had this to say. They noted that the annual production in Russia is to peak at between 9.6 and 10.3 million barrels a day as early as 2007 and then stabilize.

So the question comes down to this. Where will the new oil come from? East Siberia? Off-shore? The Russian sector of the Caspian Sea? The potential is there. All it takes is time and money. A good portion of the money, though, is going to have to come from the pockets of the major international oil companies and as time passes and as the older fields in Russia decline in terms of output, much of the new oil is going to have to go to offset that decline.

On Iraq, here's a country with promises largely unfulfilled. Before the war I had an opportunity to work with the Iraqi Opposition in developing an assessment of its oil sector. In the minds of the Iraqi Opposition only Iraq had the potential to challenge Saudi Arabia as a producer and exporter. They said well look, Iraq is second only to Saudi Arabia in terms of reserves. We have a great number of oil fields that have been discovered but not yet developed. Much of the country remains untouched by the drill bit. So we think that maybe a production goal of around six million barrels of oil a day by the year 2000 is quite reasonable. We have a longer-range potential of 12 million barrels of oil a day.

But there were others in the opposition that weren't so optimistic. They were thinking in terms of four to 4.5 million barrels a day by the end of this decade. So we should keep in mind that Iraq has never in its history produced more than 3.5 million barrels of oil a day, and that level was reached some 25 years ago. Moreover, any industry which has been neglected and underfunded for more than 20 years, bearing the impact of wars and 12 years of UN sanctions, any industry's going to suffer greatly and the Iraqi oil sector is no exception. But it

continues to struggle in its effort to return to at least pre-war levels of exports and production. It's getting close, then it falls back as pipelines are taken out of operation because of sabotage or because of a breakdown in equipment.

They hit their post-war peak in April at around 2.3 million barrels of oil a day, with exports about 1.9 million barrels of oil a day. Then they fell back because of sabotage.

I would not think we can see much expansion in Iraq this year in terms of production and exports, and even into the year 2005. Time and money again come to the fore. Foreign investment's going to be essential if the oil sector is to move ahead. Iraqi oil is good quality. Production costs are low. There's easy access to ports of export. All of these conditions are attractive to the foreign investor, but Iraq is well aware of this attraction and the investment terms are not going to be so easy.

When will a popularly elected, internationally recognized government be in place ready to negotiate long-term investment contracts? And will contract terms, as well as the general conditions in the country be acceptable to the potential investor? Only then will the investor be prepared to come to the negotiating table.

Iraq today, as I said in the beginning, is one of promises unfulfilled, and the optimism which was held early before the war has now been replaced by a strong dose of reality.

Let me make a final comment on what we've been talking about this morning. Saudi Arabia has something that no other country has. Russia doesn't have it -- not today, not tomorrow. Iraq of the future is not going to have it. That is substantial spare producing capacity to be used in support of its national interests.

We as a country have searched long and far, seeking a substitute for Persian Gulf oil. The continuing centerpiece of our energy policy has been to encourage U.S. oil companies to explore for oil outside the United States but away from the Persian Gulf. This effort in some ways has been somewhat encouraging. Caspian oil, West African oil, Russian oil, all helpful to the importer as he seeks security of supply through diversity of supply. But production follows reserves and where is the bulk of oil reserves in the Gulf? So at least I can conclude there's no substitute for Saudi oil. Not yesterday, not today, not tomorrow.

Thank you.

**Mark Schoeff:** We're happy to entertain questions now.

Just two quick housekeeping things. For those of you who didn't get a copy of Frank's presentation, we now have more copies available outside when you leave. We also have

outside a statement from Luis Justi who's a Senior Advisor in the CSIS Energy Program. He is the former head of the Venezuelan state oil company and is now with us here at CSIS.

So we'll start the Q&A and I apologize that you over here don't have a full-on view of Frank, but anyway, that's about as far back as I can go with the podium.

**Question:** Warren Beath, LA Times. Does \$40 oil endanger the U.S. economy?

**Frank Verrastro:** We haven't seen a decrease in demand yet, at least on the consumption side. In the past every time we've had prices that have been sustained over \$35 a barrel for four months, five months, it's led to an economic recession. Our GDP has been unconnected from oil prices. We're more efficient than we were in the '70s, but sustained prices in excess of \$40 or \$45 a barrel certainly has a dampening effect, whether it's in gasoline consumption or it translates through the economy to things that you buy that are moved by truck or by rail or by airline. So yeah, it's a concern.

**Anthony Cordesman:** I would just add, one answer to your question is when. In the short term, certainly, but if the U.S. economy assumes that oil prices are predictable within the basket and structurally adapts to stable oil prices, then in any mid or long term sense having stable prices creates, again, this climate of illusion which simply is not going to occur in the future. Again, the problem here is that these cycles of instability at low levels have a productive impact as well as a negative one.

**Question:** -- with [inaudible] News. Two questions for Mr. Cordesman.

Is it your view that the Saudis have honestly faced up to the internal threats that exist and have taken effective measures to deal with that over this past year? And I'd also like to ask what should the U.S. do to, as you say, refocus the war on terrorism to deal with energy security issues?

**Anthony Cordesman:** First I think the Saudis have since May 2003 faced up to the scale of the internal threat. There are no instant solutions to counterterrorism. You don't create real world capability simply by recruiting more people, buying more equipment, and putting more guards in the field. It's hard to get long lead-time items, by redundancy, think about ways or reducing vulnerability. Then the question is where? Do you do it domestically in the oil industry?

So I think the honest answer to your question is have they faced up to the threat and the problems they face, yes. Can they adapt to it? Probably. But it's going to take some time. Do they tend to understate the threat? Well virtually everybody who has a threat does. But you need to look back at this.

First, Israel is probably the most experienced country in the world in dealing with counterterrorism. Is it perfect? No. Have the British, who probably rank second, ever been able to secure Northern Ireland? No, they haven't. When Europe was facing tiny threats from Baader Meinhoff and the Red Brigades, it took three to five years to counter them when we were talking cells that couldn't replete or strengthen themselves over time. A lot of the judgments that people are making about how quickly you can do this defy historical reality.

How do you deal with this? Well precisely because of this the Saudis and others in the Gulf need as much U.S. and other help in counterterrorism, training, equipment, intelligence, outside support teams, as they can absorb and are willing to take. They need the kind of pressure they have had from the United States to improve things, and they've had it from Britain, France, and other countries as well.

One of the broader issues is that we have never designed energy facilities in the Gulf to deal in broad terms with the threat of terrorism. There are many areas where people went for economies of scale or created bottlenecks which should probably be removed so you do not have easy targets and you have a more stable system. And since we project massive increases in the flow of exports over the next five, ten, and fifteen years, and we are going to watch problems in terms of demographics, internal instability, economics and so on play out over at least the next 20, one key issue is how do we work with exporters in this region to create a more stable growth and redesign of the systems over time to make them less vulnerable and more reliable?

**Question:** Barry McGillim, from [inaudible] Globe Mail.

Mr. Cordesman, you mentioned it would take several years to deal with the terrorist threat in Saudi Arabia. Does that mean that the fear factor that's on oil now will remain for several years?

**Anthony Cordesman:** I'd leave part of this to my colleagues, but it is a reality in economics and particularly in commodity markets, whenever anything goes wrong people tend to have a higher fear premium than is really sustainable over time.

We just can't make that prediction. If they continue only to attack foreign workers then I think the premium will go down significantly. If the Saudis roll up more of the cells it will go down. The first time anybody hits an energy facility anywhere in the Gulf the fear premium will probably be very high. And as Frank pointed out, these are very unstable, volatile prices.

But one other aspect of this, as the market learns that you don't get the worst case, the

Cassandra Model, and that there aren't the Saudi equivalents of Dr. No out there capable of destroying the whole system with a hand grenade, then people become less and less sensitive to each attack and the fear premium tends to go down.

But is this a volatile situation? Of course it is.

**Question:** Dick Farmer, [inaudible].

On that last point, if U.S. oil workers in particular heed the State Department warnings can the Saudis increase production as they're planning, or [inaudible]?

**Anthony Cordesman:** I don't think the problem is oil workers. Out of the current Aramco structure if you get rid of Americans you're probably going to find there are plenty of people outside who can be recruited to handle a lot of the technical chores that are left and may actually be cheaper for Saudi Arabia. A lot of this is to some extent a political heritage of Aramco's origins.

It will, I think, have much more impact on Saudi Arabia's ability to develop its gas industry which of course affects how much oil it can export. It will affect Saudi Arabia's ability to bring in advanced technology, to go into downstream operations, and certainly to attract foreign investment. All of those things will impact, sooner or later, on what the Kingdom can do in terms of investing in crude oil as well as in other areas of its development, and so certainly if you watch this situation dealt with as it's been to date, and I have to say I think the U.S. embassy dealt with it more in terms of panic than anything else, although frankly having worked in the State Department the tendency to use a kind of "cover your ass" warning notice every time anything goes wrong in any country is so ubiquitous I can't blame the embassy in Saudi Arabia.

But yes, if people really react to this kind of warning and panic along with the embassy the results could be quite serious.

**Frank Verrastro:** Let me just add to that, having been to Saudi Arabia two months ago, Saudi Aramco personnel are much better served than they were say ten years ago in terms of indigenous people running the facilities and the operations. There are still a number of ex-pats but a lot them are there because they want to be there. I don't know that it affects the technical capability of Saudi Aramco in any way.

**Question:** This is for Bob.

Could you comment, or anyone else, what you think today's OPEC [inaudible] by two million barrels I think July 1st, and then 500,000 and another 500,000 August 1st, is going to

have? Maybe not just for the summer but also the upcoming winter.

**Robert Ebel:** That's a good question because with demand much higher in the fourth quarter than what it is today will there be sufficient oil to meet that demand?

High oil prices today in large part are demand driven. Can we look forward to a time when high oil prices will be supply driven? That's a rather short answer to your question but I think there is concern about the fourth quarter. But in the interim, between now and then, Saudi Arabia will be concerned about will supply overwhelm demand during the summer time and early fall? But as we get into the fourth quarter I think the concern shifts around. Will we have enough oil to meet the growing demand? At least in my judgment.

**Question:** [inaudible].

What do you think is the impact, either direct or indirect, of the resignation today of George Tenet on oil markets and counterterrorism?

**Anthony Cordesman:** Let me say that I think it is inevitable in the next day George Tenet is going to be tried in the media and tried by rumor -- he already is if you read the wire services. But I think first, he has been seen within the agency as an outstanding director. The problems he faced I think would have been faced by any director. They are not related to the current war on terrorism. They are not related to petroleum. They are not related to oil supplies. His resignation is not going to affect any function of the U.S. intelligence community or any function of the U.S. counterterrorist efforts or any other aspect of U.S. security efforts, and it certainly isn't going to affect energy planning.

Now again, as I said, my experience is that anything like this tends to produce some reaction in the stock market and in the commodity market. So my advice would frankly be to go out and speculate that there will be a temporary rise in prices and try to make your million while you can. [Laughter] But I do not see that this is any reason to over-react in any way, and I think that while all of us make mistakes and I'm sure that Director Tenet did, I would at least take into account as you see the speculation in the media that's going to occur, how respected he became within the CIA and within the intelligence community.

**Question:** [inaudible].

A two-part question. To what effect [inaudible] price of oil is a fact [inaudible] are trying to stockpile oil reserves? And secondly, what effect on the price of oil is market speculation playing in all of this? Could we see the price go up [inaudible]?

**Robert Ebel:** We're adding a little over 100,000 barrels of oil a day to our strategic

petroleum reserve. If you put that oil on at the marketplace and you refine it, that will give you about 45,000 barrels of oil and of gasoline against a daily demand in excess of nine million barrels. What kind of impact would that have on the price? Not much.

We're watching China very closely because this is where the real push in demand is coming from, world oil demand. If you go back to the year 1990 and take it up to the present time, almost 70 percent of the growth in world oil demand has taken place in the Asia Pacific region. That is largely China, Japan, Korea, and India. So we watch those countries very closely.

Suppose something happens to demand in China caused by not necessarily a soft landing of the [inaudible] but maybe a hard landing where demand collapses. And if demand collapses in China, world oil demand growth goes down.

OPEC's been through that back in the 1990s and they don't want to make the mistake again of having too much oil out on the marketplace when something happens to demand.

China's, of course, trying to develop its own strategic petroleum reserve, has selected four sites. But I think they're toying with the question, do we go ahead and build the sites but not fill them until the price comes down? Or do we try to fill them at a time when price is so high? So it's a real question that they face. They have to have the strategic petroleum reserve. We have long encouraged them to do just that, but it's been slow in coming. Expensive oil for China could have a way of slowing things down. They're worried very much now about security of supply just as most all the importing countries are. Here's a country that until 1993 was not a net importer, it was a net exporter. Now things are different. They're out exposed in the world oil market just like everybody else.

**Frank Verrastro:** There's a psychological piece to the SPR as well, and there's two separate questions. One is suspending the fill rate and the other is actually drawing down. And I agree with Bob, in terms of the actual price effect from additional gasoline or additional oil to be put on the market, it just strikes me on the building up the reserve at this point, it's not only high-priced oil, but at a time when we're asking other producers around the world to ante up and produce another 150,000 barrels a day because that's significant in the cumulation part of it, to be taking that much off the market and putting it in reserve doesn't make a lot of sense, and at 100,000 barrels a day it will take over six months -- If you suspended the fill rate for six months you would have gained less than a day's worth of additional security. So in the short term if you're concerned about getting through the driving season, continuing to fill the reserve at this point doesn't make a lot of economic sense.

**Anthony Cordesman:** There's another aspect of that question as well. Instead of filling, why don't we start withdrawing? When we do at least a test withdrawal of five million

barrels and see what happens, what psychological impact would this have on the marketplace? Would this lead people to think that we're getting ready to make major continuous withdrawals from the strategic petroleum reserve? Possibly. But if I were an oil exporter I would say oh, they're getting ready to withdraw from the SPR. I don't need to expand production because they're taking care of it themselves. So you could end up with no change in the world oil balance.

**Question:** I'm Jack [inaudible] from [inaudible].

Just a follow-up. I just came back from China [inaudible] and just last week there are new discoveries in the north [inaudible] of about eight billion barrels [inaudible] initial discoveries. You can anticipate that there will be much more reserves.

Secondly, it seems like [inaudible] subsidized [inaudible] 40 cents a liter. So at the medium term what would be the impact of this discovery [inaudible] and possibly larger discoveries [inaudible]? I'm speaking about China.

And future changes in pricing, realistic of what [inaudible]?

**Robert Ebel:** That new discovery has been touted as the largest oil discovery in China in the past decade. It's probably the only major discovery that they've made in the last decade. The major oil field in China, Da Ching [ph], what you're doing now is calculating its decline on an annual basis. So by the time this new discovery comes into play, whenever that might be, seven or eight years from now, where will Da Ching [ph] be? Well, on balance probably the new oil will no more than offset what Da Ching had lost. So it's helpful.

If you are subsidizing gasoline, maybe the Chinese become so accustomed to cheap gasoline that is it politically doable to raise prices in a way of causing the consumer to conserve? What impact would that have on the market? What impact would it have on the individual consumer?

You might be able to get away with slight increases every year, but maybe China's like the United States. You can't even get an increase in the tax of a nickel a gallon without causing all sorts of political fallout. I'm sure they've looked at it and they're talking about conservation in China. Give the people an incentive to conserve, and incentive comes in price.

**Anthony Cordesman:** When you asked that question, I was in Western China about two year ago talking to people about the aftermath of their last massive discovery of oil reserves which of course turned out not to be a discovery at all. I hope this one is, shall we say, a great deal better grounded in reality than some previous Chinese discovery of reserves

have been.

But you hit on something that this price subsidy issue which reminded me of the situation in Iraq. We not only, as Bob said, do not have any clear development plan, and it is compounded by all of the debates between Shiite and Sunni and Kurd and Turkamen and Arab, but one of the heritages of the CPA is we sustained oil prices at four to five cents a gallon in Iraq as the street price of gasoline, for which we are paying somewhere between \$1.70 to \$2.00 a gallon in the U.S.

The end result is that we have created an incredible increase in domestic consumption in Iraq for in the near term refined product and obviously for crude as well.

So if you want to look at really bad oil subsidy policies, the one that the CPA adopted in Iraq has to set the record and it is I think truly ironic that having gone in there to try to create a market system we managed to distort the market just about as badly in energy as anybody could conceivably do it.

**Frank Verrastro:** Let me just add one other point. Going back to the time it takes to develop a field, if you look at the Caspian and the AIOC project was similar in size, three to four billion barrels, we're ten years out from the signing of the contract and production is 150,000 barrels a day or less, so it takes a good long time to ramp up.

**Question:** [inaudible], Washington Post.

I'd like to come back to [inaudible] take a crack at this question, what [inaudible] portend for prices over the next, in the short to medium term? You said that the increase only validates what's already being produced. Is that [inaudible]?

**Frank Verrastro:** I think there are two separate things. In terms of extra oil being put on the market, when it's delivered to the United States, so we'll start seeing this in the next four to six weeks. Stuff that's already been produced and has been on the market in May should start showing up. To the extent that it meets demand and it can be made into products that are useable, prices can be moderated. What it doesn't do is deal with the fear factor that both Bob and Tony talked about. Nothing has changed since the events over the weekend or the events two weeks ago. We could have more volume on the market but if the market is tight any disruption, whether it's Venezuela, Nigeria, Iraq or Saudi Arabia, is going to give speculators an advantage in that the potential is on the up-side. So far they haven't been wrong. There's a greater likelihood of prices increasing than decreasing in the short term.

**Question:** So in the short term while markets are tight, which is basically the summer, we assume I guess that markets will not be quite so tight in the fall, right? After the --

**Frank Verrastro:** Gasoline demand should go down a bit after Labor Day. Right.

**Question:** So at that point [inaudible] will begin to reassert themselves.

**Frank Verrastro:** Assuming that increased production adds to the supply, and even if it's in excess of demand, we're going to put some oil in storage because the fourth quarter issue that Bob brought up I think is very real.

At current production limits today, if nothing else goes wrong and non-OPEC stays at 50 and OPEC can produce, including Iraq, at about 28, we ought to have enough oil in the fall and in the fourth quarter. But if anything else changes that dynamic, if Iraq can't produce because they're sabotaging the pipelines, if Nigeria or Venezuela go down, if there's a disruption in Saudi Arabia, then you're going to still, even in the fall, have a price impact and the security premium is still going to be there because nothing has changed in that regard.

**Anthony Cordesman:** There's one other impact historically. We don't know whether it will occur again. That's that elasticity is not the same in all countries. At a given point, if prices rise to it developing countries simply can no longer afford to compete and they tend to drop out of the market disproportionately quickly rather than having some smooth elasticity curve.

We don't know how much that price rise, which has not produced reductions in Asian growth or Western growth, has already affected the poorer developing countries. There's simply no way to track it. But the last few times this has happened, it does have a disproportionate impact on poorer countries.

**Question:** You said [inaudible] price band is now [inaudible].

**Frank Verrastro:** Twenty-four to 34. It's just not the 22 to 28 any more I don't think.

**Question:** Do you think even if there are not disruptions, no major terrorist [inaudible], no major attack on the pipelines in Iraq, then what's the -- Even then you're saying the best scenario is -- I don't understand if I'm interpreting it correctly.

**Frank Verrastro:** I think you are.

**Question:** If you think [inaudible], I understand that, but did I understand you correctly to say that your sort of best case is still in the --

**Frank Verrastro:** I'm saying if you go back and look not just in the immediate past,

but you go back five years. We've had I think kind of bracket creep so that prices have gone - This idea that we had a bracket price, I think it's higher than the expectation of what it was and market fundamentals show that it should probably be in the high 20s, low 30s, and that anything above that is probably a security premium, and I've seen numbers from \$5 to \$12, depending on near term, short term, what do you think's going to happen?

If market fundamentals change, if China's demand goes down and OPEC is over-supplying the market, it takes a while. You've seen the charts even going back 30 years, that we've had volatility in the oil market place. It doesn't take a lot in terms of over-production or under-production because it's the marginal barrel that drives the train here.

So I think going forward you still have volatility unless you bring a lot more production on or we get more stable demand.

**Mark Schoeff:** We have time for about two more questions. Tom?

**Question:** What happens if this latest effort by OPEC or the Saudis [inaudible] particular, to increase production does not work? The fear factor remains there, prices remain high. Because while they are supplying more oil, the market is worried that it might not get here because of some kind of attack. Are we then therefore at a point where the U.S., or the only other big reliable supply of oil that is secure is the SPR and maybe the government should do a five million barrel test sale to prove the [RBE's] if we have to? Because right now the Administration doesn't say they're considering it. Unless there's an oil embargo we're not going to touch it. At what point does it make sense to do a test sale maybe or consider suspensions of the SPR, deliveries to the SPR?

**Frank Verrastro:** I think there are two separate issues here. One is the issue of speculators and price and what's driving the market. The other is using the SPR to offset an actual shortfall. If something were to happen, if there was sabotage or a pipeline is blown up or a loading facility is blown up, that's the point that you would actually need the SPR because there's no other substitute. If it's Saudi Arabia, for example, the rest of the world can't fill that gap so that's what you'd use the SPR for.

If you're talking about price, I think people are waiting to see, and it hasn't really changed in terms of gasoline consumption, but they're waiting to see what the next couple of months mean. Will high prices, as Tony suggested, start reducing demand in some of the poorer countries? Will China continue to keep growing? Will U.S. gasoline demand be offset a bit because people at the pump are not willing to pay \$2.25 any more?

So OPEC is doing I think what you would expect OPEC to do as prudent business decision. You kind of look at the market, you put out what you think is needed, you don't

want to oversupply and you reevaluate in 60 days or 30 days. In the mean time as long as prices stay high my gut reaction is the same as what they've been doing for the last couple of months. Those that have additional production will cheat on their quota. If you can sell your oil for \$35 or \$37 a barrel and you have another barrel to sell, with the exception of Saudi Arabia that probably won't go all the way to the limit, almost everyone else is at capacity or will be at capacity.

**Anthony Cordesman:** One important point about the SPR, it is designed to deal with interruptions, not structural changes in the oil market. It does not make sense to draw down on the SPR if you anticipate years of say low-level terrorism or risk from al Qaida in the Middle East. It simply is not what it is designed to do and you would simply be wasting oil which could be extremely valuable in a critical situation.

If you have a long-term risk premium what you do is you adapt to it. You live with it. If that affects economic growth or conservation or supply in other areas, that's a fact of life, but it's not something the SPR should be used to deal with.

**Question:** So the economy would have to suffer [inaudible] secure emergency supply  
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**Anthony Cordesman:** What I'm saying is you will not solve any problem by taking a limited amount of oil out of the SPR and trying to change the structural nature of the world oil market. As Bob pointed out, all that does basically is waste the SPR in a contingency for which it was never designed.

There are people politically who might want to see oil prices capped before the election. That is not in the national interest.

**Question:** Cathy Landry, [inaudible].

You mentioned early on in your presentation that it isn't just the quantity of oil that's going to [inaudible] the market but also the quality. With Saudi Arabia being the only country able to make production increases and most of their crude being sour, what effect does that have on the U.S. market, particularly for gasoline?

**Frank Verrastro:** Two points again. I think the Saudis believe that the market is already adequately supplied, but they're willing to produce more to make sure that there's a cushion.

You're starting to see refinery spreads, and you can look in the first quarter and see profit margins of refiners. Those that have the capability of buying lower quality crude and

still selling gasoline at the market price are making good-sized profits. What's happening is there's somewhat of a shift and it's really dependent on the capability of the refinery and the crude oil that's available, but the light, sweet stuff is the easiest to make a high gasoline yield out of. But also you pay a premium for it. If you can run something less expensive and run your equipment harder, you're probably doing that and making a bigger profit margin.

So the addition of additional barrels on the market has some effect, not a large effect. I think EIA put out a report the other day that suggested that if refineries, for example, were able to increase utilization rates from 96 to 98 percent, which they've done in the past, that that's an extra 350,000 barrels a day of through-put which translates into an additional 160,000 barrels a day of gasoline if you assume about 50 percent gasoline yield. And if you add that up over time, that's five million barrels a month.

So there are other ways of approaching this. But again, if you're a refiner you kind of look at these blips and anomalies and when do they become a trend? The tendency in this country is to meet certain requirements, like sulfur specs and fuel additives, to be able to deliver product, you're probably not going to make an investment in new capacity unless you think that demand is sustainable, so what we've done in the past is increased our imports, but we may be getting to a limit there.

**Mark Schoeff:** We have to wrap up there. Thank you all for coming over this afternoon.

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