



A Blueprint for Oil Price Stabilisation

Officially Presented at the



Energy Ministers Meeting
Rome 25th May, 2009

Contact Details: Eni Strategies & Development Department

Tel: +390659822793

A BLUEPRINT FOR OIL PRICE STABILISATION

Table of Contents

ENHANCING OIL PRICE STABILITY	1
1. The Vicious Circle of Oil Price Instability	2
2. The Optimal Price	3
3. Fostering the Dialogue: the Key to Prevent Future Crises	4
THE NEED FOR A GLOBAL ENERGY AGENCY: EXTENDING COOPERATION	5
MECHANISMS TO ENHANCE OIL PRICE STABILITY	7
4. The Global Stabilisation Fund	8
5. The Spare Capacity Market	9
6. Global Oil Stocks	11
7. A Framework Proposal	11
A POSSIBLE WAY AHEAD	13
CONCLUSION	16

ENHANCING OIL PRICE STABILITY

Is oil price instability inevitable? Or is there something which could be done to enhance oil price stability, to the benefit of producing governments, investors, and consumers?

This is an important question, and one which has sparked off lively debates.

Eni is pleased to offer its ideas on this matter, with the objective of stimulating an open and constructive dialogue amongst all industry players.

The challenges are significant, but “game-changing” developments rarely, if ever, materialize without major effort.

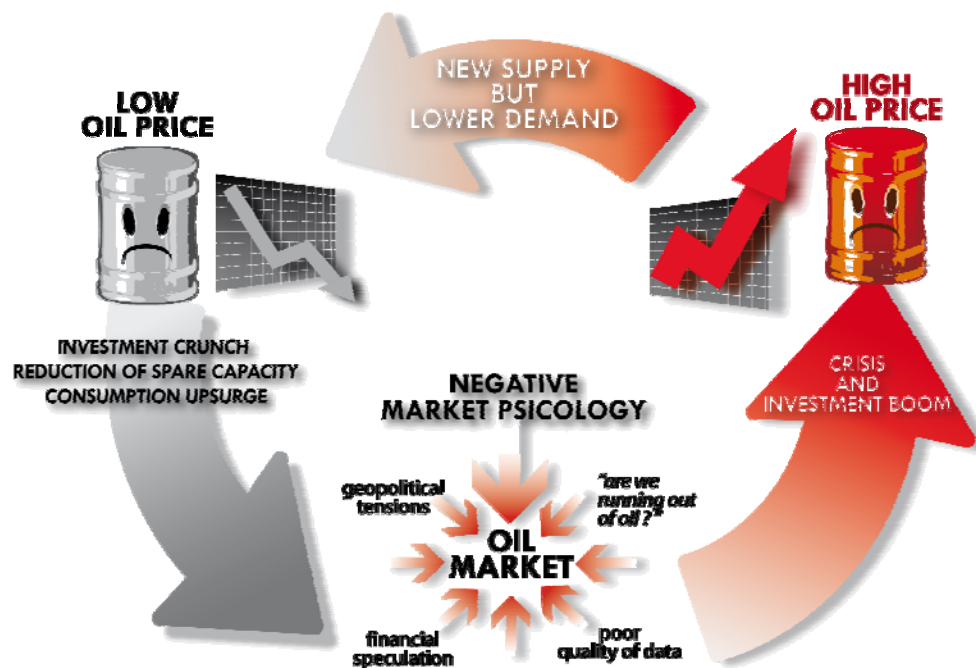
1. The Vicious Circle of Oil Price Instability

The oil industry is affected by recurrent boom & bust cycles. Indeed, in the last 15 years the volatility of the oil price has exceeded that of all other commodities.

Oil price fluctuations lead to volatile revenues for producers and unpredictable costs for consumers.

This unpredictability hinders investment in the oil industry, and affects investments in other energy sources.

Figure 1 - The Vicious Circle of Oil Price Instability



The single most important cause of oil price cyclicity is the level of spare capacity (the unused capacity ready to be put in production) available for the market.

In every oil crisis in history, a drop in available spare capacity led to skyrocketing prices. On the contrary, in periods with an adequate level of spare capacity, prices remained stable even when the market was faced with supply disruption risks.

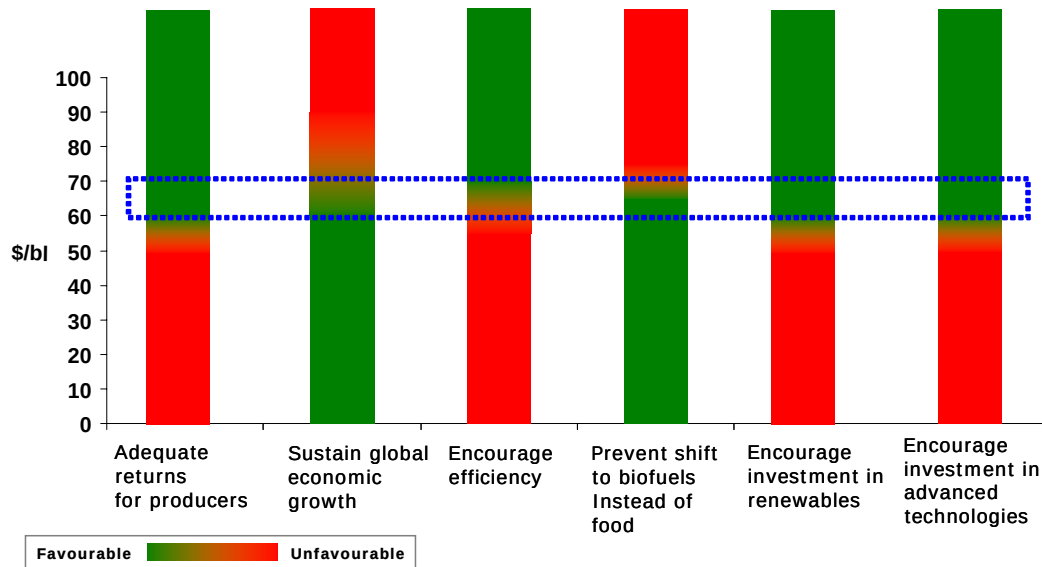
2. The Optimal Price

Oil market stability at a reasonable price is essential for sustainable development. But what is a “reasonable” price? In order to define the optimal price for oil, six key elements should be considered:

- ensuring adequate returns on investment for producers (which requires the oil price to fall no lower than 60 \$/bl);
- preserving economic growth (which requires the oil price to rise no higher than 75 \$/bl);
- encouraging a rational and efficient use of energy (which requires the oil price to fall no lower than 70 \$/bl);
- safeguarding food production (at oil prices above 70 \$/bl farmers have an incentive to switch to biofuels production instead).
- encouraging research and development of renewables (which requires an oil price no lower than 60 \$/bl);
- encouraging investment in new technologies so as to increase oil recovery and contain the environmental footprint (which requires the oil price to fall no lower than 60 \$/bl).

Taking all of these aspects into account, an oil price somewhere in the region of \$60-\$70 a barrel is – at the current time – a good compromise between the different interests involved.

Figure 2 - The Optimal Oil Price



3. Fostering the Dialogue: the Key to Prevent Future Crises

Given the negative repercussions of oil price instability, Eni has long highlighted the need for a new cooperation paradigm to achieve transparency and predictability, to reduce oil-price volatility, to ensure stable investment conditions, and consequently to promote sustainable development.

What shape might this cooperation take? Our proposal has two main pillars:

- the **establishment of a Global Energy Agency**, to improve and extend information on the oil market and on energy in general – which would contribute to the transparency and predictability of the oil market;
- the **identification and implementation of mechanisms to enhance oil price stability** – an effort which would be fostered and managed by the Global Energy Agency.

THE NEED FOR A GLOBAL ENERGY AGENCY: EXTENDING COOPERATION

We view the establishment of a broader global energy agency as having real potential to enhance international cooperation and oil price stability.

Currently, there is no independent energy organisation which represents both producing and consuming countries. In fact, the most important watchdog, the International Energy Agency (IEA), is composed of only Organisation of Economic Cooperation and Development Countries, which account for 55% of global oil demand (down from 64% in 1980 and likely to shrink to about 40% in 2030). It is necessary to enhance completeness and timeliness of information from non-member countries in order to improve reliability of the aggregate data.

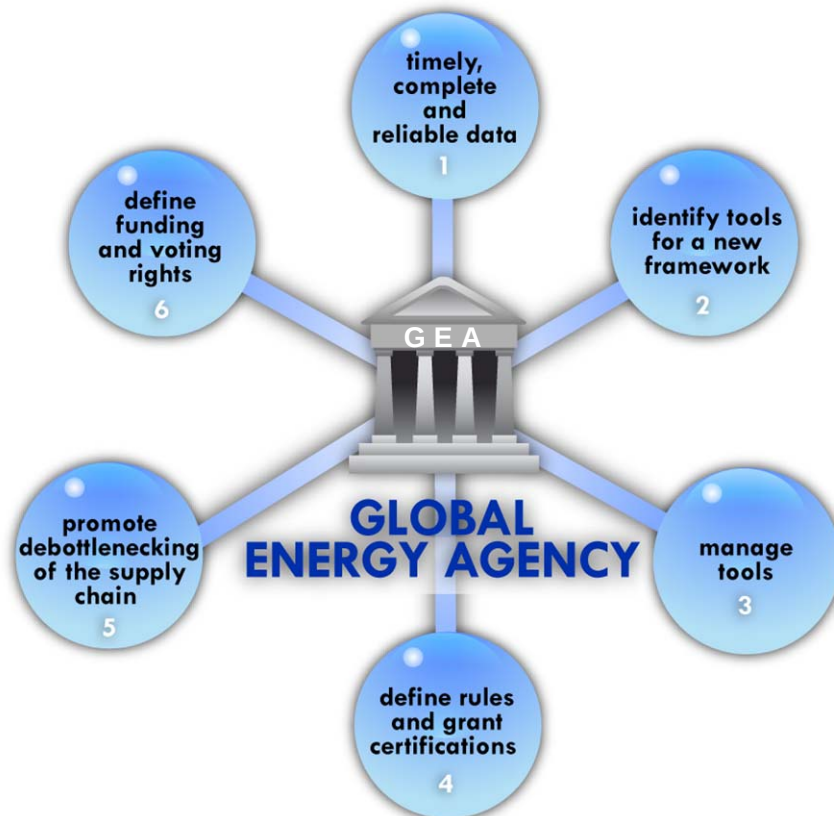
That is why a much more extensive umbrella organisation, a **Global Energy Agency (GEA)**, would contribute greatly to oil market stability, also through the promotion of long lasting cooperation between producers and consumers.

The starting point for the establishment of the GEA could be the International Energy Forum Secretariat (IEF), which is participated not only by the IEA and by the Organisation of Petroleum Exporting Countries, but also by Brazil, China, India, Mexico and Russia among others. The IEF accounts for more than 90% of global oil&gas demand and supply.

The GEA would have a broad mandate to gather information on world oil demand and supply, stocks, production capacity, and trading in oil derivatives on financial markets.

Gathering and sharing reliable, timely and globally extended data on energy is essential in order to increase transparency and data quality.

Figure 3 - The Mission of the Global Energy Agency



As well as promoting transparency and predictability in the oil market, the mission of GEA would also include:

- identifying and managing tools to enhance oil price stability;
- defining rules and granting certifications;
- promoting the debottlenecking of the supply chain (e.g. uniformity of product specifications in the final markets);
- defining the funding and voting rights of participants.

MECHANISMS TO ENHANCE OIL PRICE STABILITY

We have taken into account a number of different options. These include:

- **Take-or-Pay OIL** – Clear commitment on volumes and prices within a predefined range on long term basis, as experienced in the gas business (*stabilise oil supply quantities at agreed prices*);
- **Joint Escrow Accounts** – Excess revenues paid in by partners of upstream contracts when oil price is above a ceiling, to be paid back when it falls below a floor (*stabilise revenues at asset level*);
- **Global Stabilisation Fund** – Fed by consumers when the oil price is below a floor to ensure fair revenues to producers, with the objective of sustaining investments (*store money at government level*);
- **Spare Capacity Market** – Trade spare capacity among operators, where consumers book the needed spare capacity volumes to reduce the risks of peaks in oil demand (*store oil underground*);
- **Global Oil Stocks** – Coordinated use of governmental inventories and demand-side management to shave peaks in periods of tight supply (*store oil above the ground*).

All of these alternatives present significant complexities. However, the establishment of a **Global Stabilisation Fund** and a **Spare Capacity Market** seem to be the most promising options. In addition, **Global Oil Stocks** may work as a complementary mechanism, especially as a shock absorber in short-term tight supply conditions.

Figure 4 - Most Promising Options



4. The Global Stabilisation Fund

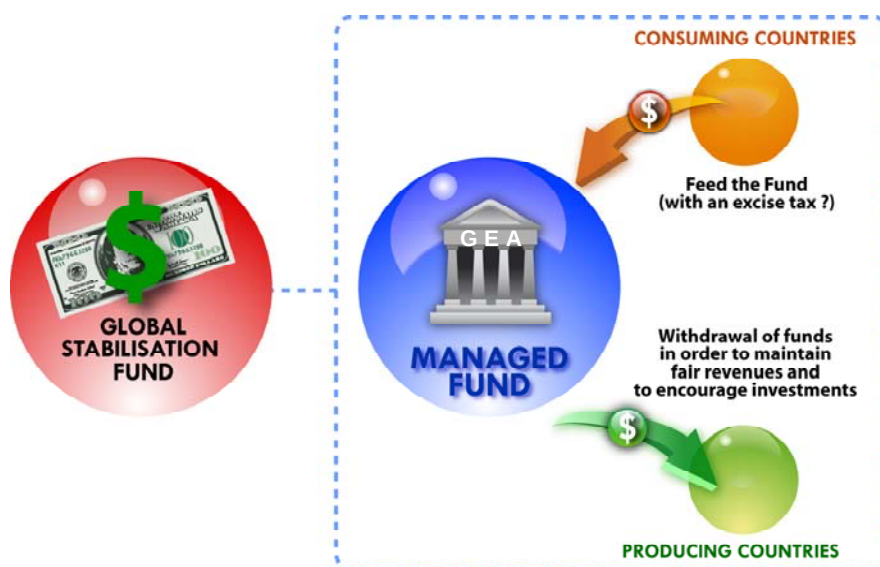
The Global Stabilisation Fund is a capital pool which aims to buffer the decreasing oil revenues of producing countries when oil prices fall under a certain floor.

Such a fund would be fed by consuming countries, which would contribute the equivalent of the “saved costs” (for example through an excise tax). In this manner, producers would be able to count on a minimum level of revenues to fuel their development.

Of course, defining the floor price and contribution levels would require a flexible and pragmatic approach which would need to be reviewed periodically.

The establishment of a Global Stabilization would contribute to a smoothing of fiscal budgets (and their social impact) for producer countries through price cycles. Meanwhile, it would cool down market expectations and speculation, avoiding excessive price lows.

Figure 5 - When the Oil Price falls below a Predetermined Price Floor ...



5. The Spare Capacity Market

Maintaining spare crude oil production capacity has become a key shock absorber for the world oil market and economy. But the development of spare capacity, as it exists today, was not intentional.

A steady and predictable level of spare capacity is needed to limit the possibility of another period of sustained rising prices – and wider distribution of spare capacity would also help calm the market during periods of high anxiety.

We propose one option to achieve this goal: the auction of spare oil production capacity licenses (Spare Capacity Market).

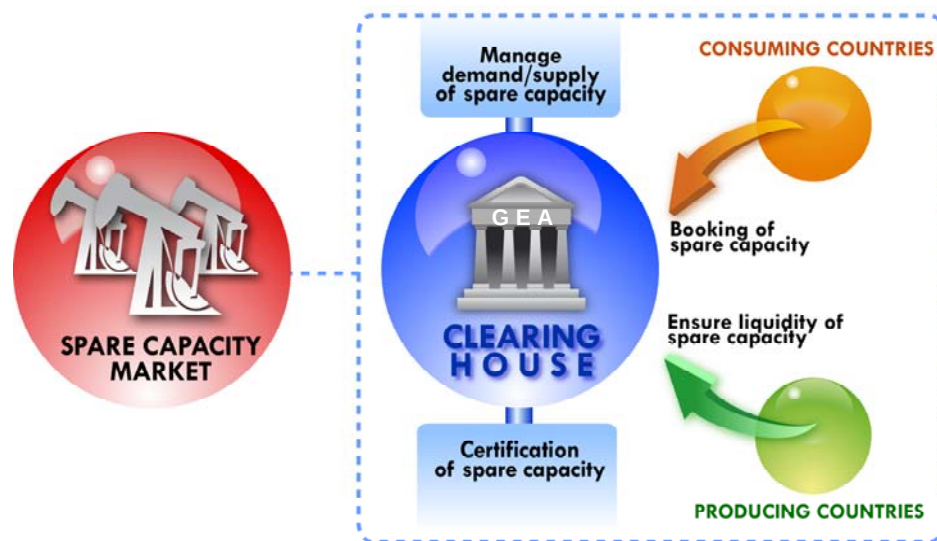
This option requires government action and the management of a Global Energy Agency.

A Spare Capacity Market would allow consumers to book spare capacity in order to protect themselves against the risk of oil demand peaks, also for extended periods.

The spare production capacity ensures system reliability, is managed by an independent body (GEA) and paid by the market (like in the electricity sector).

Creating a spare capacity market in oil would require operators to develop and maintain an adequate level of spare capacity certified by Global Energy Agency as a “clearing house”. Spare capacity volumes would be traded among private operators through a sort of bidding process of “supply rights”. In this way, the market would assign a specific value to spare capacity.

Figure 6 - An Adequate Spare Capacity Level Prevents High Oil Prices



For a Spare Capacity Market to prove robust and effective, especially during crisis periods, the following conditions would need to be met:

- maintaining an adequate level of spare capacity (to be defined, but could be at some point between 5-10% of global consumption);
- ensuring an even geographic distribution and crude quality diversification;
- guaranteeing the availability of reliable, timely, complete and globally extended data on energy.

A fully functioning Spare Capacity Market would cool down market expectations and speculation.

6. Global Oil Stocks

This is a complementary mechanism, acting as a short term shock absorber. An agreement to cooperatively share the supply of oil during times of crisis – and to hold emergency, government-controlled oil stocks – would prove successful in diminishing some of the natural panic that occurs in the oil market following a supply disruption. History demonstrates the effectiveness of cooperation and emergency stocks.

At the moment, the International Energy Agency is an important institution in mitigating the fallout of oil supply disruptions/crisis, holding emergency, government-controlled oil stocks. However, it is an exclusive club since the IEA is composed only of OECD member states.

The argument to expand the number of countries that work cooperatively during extraordinary conditions in the oil market is clear. It would foster the development of a larger volume of government-controlled oil stocks. Meanwhile, having a much larger share of the world oil market working cooperatively to manage supply during a crisis would contribute to reducing friction in international relations.

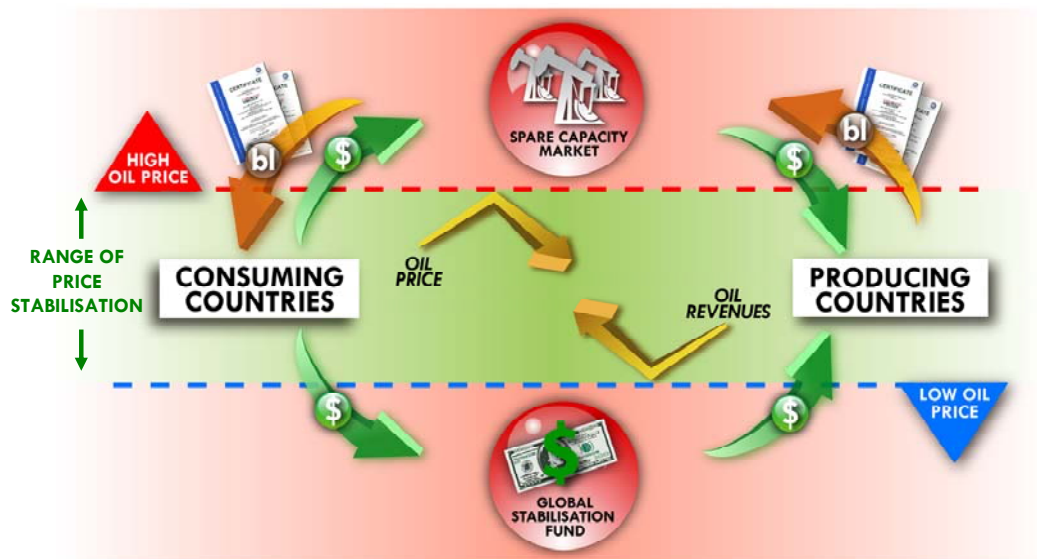
The GEA would manage global government-owned inventories (crude oil and main petroleum products), releasing them in a harmonized way in order to shave demand peaks in periods of tight supply. Moreover, it could be used to coordinate purchases of oil stocks from producers during periods of low prices.

7. A Framework Proposal

Proposed mechanisms are to be strictly connected and interrelated. In fact, their collective functioning – under the control of the GEA – would stabilise price fluctuations in a reasonable range.

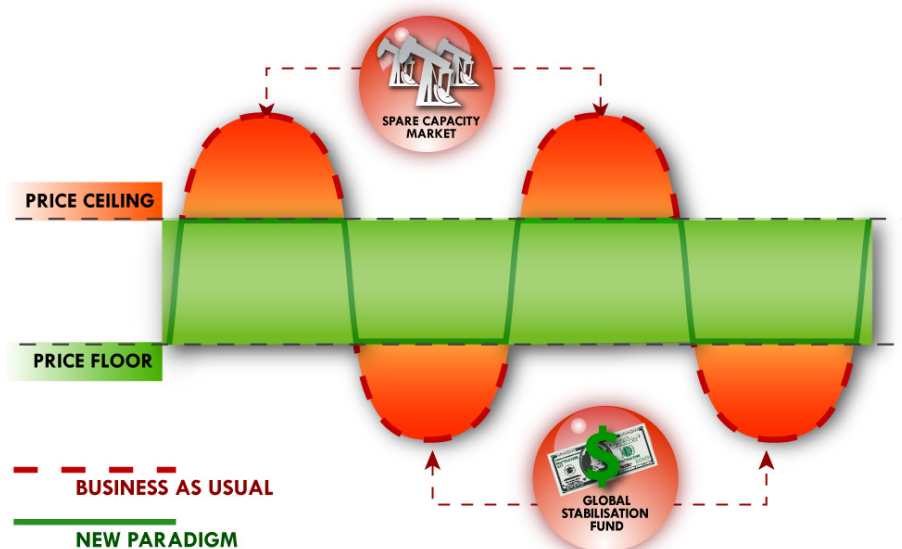
A Spare Capacity Market and Global Oil Stocks would guarantee adequate quantities of extra barrels under and above the ground in tight market conditions, thus preventing negative market expectations: and the rise of oil prices out of control.

Figure 7 - The Integration of Mechanisms Works Better



These volumes would be made available by producers. They would be able to invest in long term projects in the knowledge that should oil fall below a certain price level the Global Stabilisation Fund would step in to ensure a minimum level of revenues.

Figure 8 - Possible Effects on Oil Prices of the new Paradigm



A POSSIBLE WAY AHEAD

The establishment of a Global Energy Agency represents a major milestone in global cooperation, but it requires aligning the interests of many key players.

It would have to be clear that the benefits of joining outweighed the costs or the appearance of surrendering some element of sovereign control, at least over market data, to a global agency. In other words, the value of contributing as a member would have to be greater than not contributing.

Also, the development of the GEA would likely be characterized by an evolution in its powers and responsibilities, as opposed to strong powers from day one, over release of oil reserves to combat high prices.

A multi-step process could lead to the establishment of the GEA and its eventual role as force for stability in the world oil market in the interest of oil consumers and oil exporting countries.

The vision of the GEA would be to enhance global oil security – and consequently improve global economic security – by broadening international cooperation on oil matters.

Critical to the success of the GEA is attracting pivotal actors of the world oil market to join. It is important that major producing and consuming nations join as founding members to strengthen the breadth and effectiveness of the GEA.

A crucial first step to illustrate the practical value of the vision is to articulate the information void that the GEA could fill. The GEA would be to have a broad mandate to gather information on world oil demand and supply, stocks, production capacity, and trading in oil derivatives on financial markets.

A vision with mutual and relatively uncontroversial benefits – such as good, timely information – would be a useful first step to gain the interest and commitment of major players.

Indeed, upon establishment, the GEA would need to quickly develop channels to gather, process, and distribute information so as to illustrate its value and establish trust among its members.

Figure 9 - A Proposal for a Gradual and Progressive Path

	Actions	Complexity rate
1	Establishing the Global Energy Agency including producers and consumers	
2	Improving quality and extension of energy statistics (physical and paper barrel)	
3	Enlarging and improving stock management	
4	Identifying and selecting tools for oil price stabilisation	
5	Tools management	
6	Gathering and managing funds necessary for implementation of tools	

 relatively easy
 relatively difficult

Once trust and effectiveness are established, GEA would expand its responsibilities to include coordinating the release of oil stocks in the event of a supply disruption, but also during periods of high and rising prices. Also, to appeal to the interests of exporting countries, the GEA might need to commit to filling government-controlled oil inventories during periods of very low prices, so as to help bring the market back into balance.

Expansion of GEA responsibilities would include a role as identifying and selecting tools for oil price stabilisation. This is essential in order to have a common view on the definition of a new contractual paradigm and on the effectiveness of different options.

Moreover, the GEA would coordinate or manage the operational development and maintenance of these tools (e.g. Spare Capacity Market and Global Stabilisation Fund).

Last but not least, GEA would gather and manage funds necessary for the implementation of selected tools. This is a really hard task and will be successful only if it is clear and self-evident that the benefits of joining the GEA (avoiding the negative economic impact of boom and bust cycles and oil price peaks & lows) outweigh the costs of membership and of financially supporting selected tools.

CONCLUSION

The oil price remains at the centre-stage of any possible energy scenario, because what affects oil has repercussions for all other energy sources.

The recent boom and bust cycle highlights the need for a new cooperation model in the oil market to enhance stability.

The starting point would be the establishment of the Global Energy Agency, representing both producing and consuming countries. This organisation would foster dialogue to identify the most effective mechanisms – such as the proposed Global Oil Stocks, Global Stabilisation Fund and Spare Capacity Market – and would eventually manage them efficiently.

Greater stability would benefit consumers and producers. It would also contribute to sustainable development, as oil-price fluctuations also affect investment in other energy sources.

The challenges are significant, but the long-term benefits for all players outweigh the costs. Broad consensus and support on this vision is the necessary first step to build a new paradigm of cooperation for the oil industry.