

Oil Price Surge and Quest for Energy: Sri Lanka in Global Perspective

By Saman Kelegama

(Executive Director, Institute of Policy Studies of Sri Lanka)

During the last twelve months, world oil prices have remained stubbornly high around an average value of US \$ 55 per barrel. The oil prices have been on the upward trend since the beginning of 2005 (see Table 1). A Singapore based commentator stated that “As long as oil demand remains strong, in the short-term we cannot expect prices to drop significantly”. The world oil market has entered into a new phase where there is significant increase in the global energy demand which can be met by a few countries with a functional ability to increase supply. Current changes in the world oil industry and market are bound to have deep impact and implication for both oil producers and oil consumers.

Table I: US \$ Price of Crude Oil per Barrel : January-August 2005

Month	January	February	March	April	May	June	July	August
Price	50	52	56	49	52	58	61	68

Note: Rounded-off Price

Source: <http://buisness.updates.com>

Increasing Demand

The last few years have seen an unusually sustained strong demand. Table 2 shows that the global demand for oil has risen from 76.7 million barrels per day in 2000 to 84.3 million barrels per day in 2005. And this high rate of demand growth, although it might slow down as indicated in the Table (from 2 per cent in 2005 to 0.7 per cent in 2025), is unlikely to reverse its course in the near future. Demand for oil is on the increase due to the rapid growth in Asian countries, in particular, India and China. With the rapid growth of these two economies, the number of middle class vehicle owners has increased rapidly contributing to the additional demand. 35-40 per cent of additional oil demand during the last 5 years has come from China and India. But US still remains the largest oil consumer in the world accounting for 25 per cent of global consumption. India is the 6th largest energy consumer in the world and by 2010 it will be the fourth largest. Asia will account for one-third of world oil demand by 2025.

Supply Bottlenecks

There are indications of slow growing OPEC supply capacity and shrinking of the world refining capacity. Table 2 shows the supply of oil from OPEC and Non-OPEC countries and the energy demand scenario for the 2005-2025 period. OPEC stock changes will be slow and until about 2015 it will provide 37 per cent of the world supply. Non-OPEC supply is forecasted by many oil economists to continue growing at about 1 million barrels per day for the next few years and will not be adequate to cover the total global demand. Traditional OECD countries have peaked their oil production capacity. For example, US has not built a new oil refinery for the past 29 years and the US is running its old refineries at above 90 per cent of their capacity.

Table 2: Demand & Supply of Oil: 2005-2025

MILLION BARREL/DAY	Historical	Projection				
	2000	2005	2010	2015	2020	2025
WORLD OIL DEMAND	76.7	84.3	92.5	99.1	104.3	107.8
% Growth per annum	2.0%	2.0%	1.9%	1.4%	1.1%	0.7%
NON-OPEC SUPPLY (INCL. NGLs /OTHERS)	48.7	54.9	60.3	62.2	62.9	63.7
CALL ON OPEC CRUDE OIL	28.0	29.5	32.3	37.0	41.5	44.2
Stocks change	-	0.1	0.1	0.1	0.1	0.1
OPEC CAPACITY (INCL. IRAQ)	31.1	32.0	35.4	39.9	44.3	46.7
OPEC CAPACITY UTILIZATION	90%	92%	91%	93%	94%	95%
SHARE OF OPEC SUPPLY (Crude oil only)	37%	35%	35%	37%	40%	41%

Source: OPEC

The whole oil industry chain of supply from crude oil production to shipping and refining has become very tight. Why could not the oil suppliers anticipate the current demand? Let us examine the contemporary situation.

The first is that the world had taken it for granted that OPEC would always have enough spare capacity. The non-OPEC countries did little to explore alternative sources of energy during the last decade. In fact, growth in oil production in non-OPEC countries is going to show a decline from 2015. Oil is the only industry in which the best and largest assets are not in the hands of the most efficient and best capitalized firms (see Table 3). Two-thirds of the oil reserves are found in the Persian Gulf, where foreign firms are mostly unwelcome.

Table 3: Oil's Rich List -Top 20 Oil Companies, by Reserves, 2003

Company	Country	State Ownership %	Million Barrels
Saudi Aramco	Saudi Arabia	100	259,400
NIOC	Iran	100	125,800
INOC	Iraq	100	115,000
KPC	Kuwait	100	99,000
PDV	Venezuela	100	77,800
Adnoc	UAE	100	55,200
Libya NOC	Libya	100	22,700
NNPC	Nigeria	100	21,200
Pemex	Mexico	100	16,000
Lukoil	Russia	8	16,000
Gazprom	Russia	73	13,600
Exxon Mobil	US	-	12,900
Yukos*	Russia	-	11,800
Petrochina	China	90	11,000
Qatar Petroleum	Oatar	100	11,000
Sonatrach	Algeria	100	10,500
BP	Britain	-	10,100
Petrobras	Brazil	32	9,800
Chevron Texaco†	US	-	8,600
Total	France	-	7,300

Notes: * Now in effect controlled by government

† Does not include newly acquired Unocal

Source: *Petroleum Intelligence Weekly*

Second, is the low oil mentality of both oil producing countries and energy industrialists. Both were sceptical about the sustainability of a high oil price of over US \$ 20 per barrel in the past. Thus upstream, and downstream investment plans were based on very low crude oil price of between US \$ 20 and 25 per barrel. Consequently, for downstream investment, business environment was not encouraging enough for energy companies to consider any new investments.

Third, is the upstream policy which was misplaced after the price nosedive of November 1998 OPEC meeting in Indonesia. OPEC since then has been trying to prevent any big inventory increase in the world and has been coordinating very carefully with member countries the necessary level of her production (current official ceiling – 27.5 million barrels per day).

Speculation

There is price volatility in the oil market with prices fluctuating between US \$ 45-55 during April-May 2005. Speculative activities in the oil market have increased by the past erratic behaviour of prices and the key factors contributing to these speculations are: (a) the uncertainty of oil policy under the new President in Iran, (b) the uncertainty in the OPEC after the death the King of Saudi Arabia in July 2005; (c) the uncertainty over the recovery of some oil wells in Iraq after the US bombing in March 2003; (d) Hurricane Katrina in USA disrupting oil refineries in the Gulf of Mexico in late August 2005; and (e) whether there will be adequate supply of gasoline when winter arrives in the Northern hemisphere. The floor price of at least US \$ 40 - 45 per barrel compared to US \$ 20-25 per barrel is the likely scenario soon.

Emerging Trend

There are now signs of OPEC's supply responding to global demand. OPEC has revised its earlier stance and is attempting to increase inventories before an expected fourth-quarter peak in consumption. The organization is currently having discussions on raising output by an additional 500,000 barrels a day. The extra oil will mainly come from Saudi Arabia and Kuwait. The OPEC is quite confident that the speculative bubble will burst with such increase in production, but some others feel that it is not the increase in supply of crude oil that matters but the availability of refineries to produce the type of oil that is in demand by the global consumers. A prominent energy investor banker thinks that in view of rising input costs (for such things as oil rigs, steel pipes, tankers, and so on) the oil prices need to go further up (The Economist, April 30, 2005). But others say that working out a fair price for oil is "a moving target: it needs to be comfortable for both consumers and producers, and at a level where investors will put money in to the growth of the industry".

The international oil prices shot above US\$ 70 per barrel in the last week of August 2005 amid concerns about the damage to oil production facilities in the Gulf of Mexico caused by Hurricane Katrina. Petroleum importing countries around the world, both developing and developed are facing the challenge of handling the unexpected and unprecedented increase in oil prices. Economists fear that such levels could severely dent consumer demand and curb business activities. Some are referring to this situation as the "third oil

shock” after the first in 1973 and the second in 1979/1980. Asian leaders have been scaling back growth estimates for 2005 since August when crude oil started to climb above US \$ 60 per barrel. Many countries around the world are taking steps to curb the demand for oil and looking to alternative sources of energy. It is vital to ask at this juncture what is Sri Lanka doing to cope with the situation ?

Oil Pricing in Sri Lanka and Coping with the Oil Price Surge

When Sri Lanka signed the stand-by package with the IMF in March 2001, one of the conditions that the country had to fulfill was to introduce an automatic pricing for petroleum. In other words, petroleum prices should not be subsidized and should be adjusted according to the fluctuations in world market prices and passed-through to the consumers. Although this was a commitment undertaken by the government of Sri Lanka, this policy was not implemented in 2001 due to the political crisis that year. It was the newly elected government in late 2001 that implemented this policy in January 2002 and rescued the IMF package that was falling apart in 2001. Although automatic pricing for petroleum was put into operation, both diesel and kerosene were sold at the subsidized prices taking into consideration that kerosene is used more by the non-affluent and that an increase in the price of diesel can substantially increase public transport cost and thereby burden the less affluent masses.

The automatic pricing policy for petroleum was abandoned in January 2004 to cushion the cost of living before the April 2004 general elections. The incoming new government continued with the policy it inherited due to fears of passing a higher price of oil on to consumers. Thus since 2004, petrol is sold below the automatic pricing formula and it continues today as a government policy. At present, petrol (general) is sold at Rs. 80 per litre compared to the market price of Rs. 90 per litre. Diesel is sold at Rs. 50 per litre compared to the market price of Rs. 65 while Kerosene is sold at Rs. 30 per litre compared to the market price of Rs. 70 (figures as at 01 September 2005). The Ceylon Petroleum Corporation (CPC) is selling these oils below the market price with a subsidy from the Treasury which amounted to Rs. 14.5 billion in 2004 and for the first half of 2005, the subsidy has amounted to Rs. 9.2 billion due to the escalating prices of oil in the world market. It is expected that the oil subsidy for 2005 will exceed Rs. 20 billion – a very large sum indeed.

The Lanka Indian Oil Corporation (LIOC) which bought 33 per cent of the CPC in 2002 was also requested to follow the subsidized pricing policy for oil from January 2004. Consequent to LIOC selling of oil below the market price it had to forego US \$ 60 million due to the company. The LIOC is making a claim for this sum from the Treasury; however, the Treasury is of the view that the government is not liable to pay the US \$ 60 million unless LIOC makes actual losses due to government determined pricing. This dispute remains far from settled at this juncture.

In this uneasy situation, the government is making attempts to minimize the hardship to the consumer by taking various measures. The 15 per cent VAT applicable on diesel was removed a month ago with the objective of giving some relief to the consumer. However, the National Chamber of Commerce of Sri Lanka has stated that there has not been any

reduction of diesel prices in the market. What appears to have happened is that both the CPC and LIOC may have been allowed to collect this sum from the VAT to maintain the subsidized pricing of diesel instead of the Treasury making a transfer to these companies for the diesel subsidy.

One can recall the President and the late Foreign Minister making a visit to Iran in November 2004 to negotiate a deferred payment for oil imports from Iran. Given Sri Lanka's foreign exchange situation, Iran which accounts for 36 per cent of oil imports to Sri Lanka granted a US \$ 180 million deferred payment. A few months ago, India, which accounts for 23 per cent of Sri Lanka's oil imports, granted a US \$ 150 million line of credit on an installment payment basis for purchase of oil. Both these schemes have now been fully utilized. It is reported that the government is contemplating on securing another line of credit from India for oil purchases. It is also reported that a high government official is scheduled to meet the G-7 group to make a request to extend the debt moratorium that was granted to Sri Lanka in the aftermath of the Tsunami. The extension for the US \$ 300- 500 million debt payments for one year more (2006) is based on Sri Lanka's inadequate foreign reserves to meet such debt obligations after paying heavy oil bills. These efforts clearly indicate the reluctance on the part of the political establishment to pass on the higher oil prices to the consumers and continue with the universal subsidized pricing policy.

The use of subsidies for the oil sector is not unique to Sri Lanka. Many countries provide subsidies for the oil sector to cushion the producers and consumers from fluctuations of the global oil prices. However, when oil prices are reaching unprecedented levels, governments seriously consider cutting down the subsidy at least for petrol and find various ways and means to conserve energy (combat demand) and find alternate sources of energy (increase supply).

Strategy to Face the Situation and Quest for New Energy

Investment must be made now to bring new energy resources within the next decade and about US \$ 16 trillion investment is required to meet energy needs by 2030. The message is that both supply enhancing and demand management policies vis-à-vis energy are considered as necessary to meet the current challenge by many countries. The new situation is causing the US, Europe and Asia, in particular, Singapore, China, India, and Japan to re-evaluate and to reconsider their energy policies according to their own strategic goals and objectives. Many countries are exploring alternative sources of energy and methods to curb demand for same. More energy diversification would help to ease demand for oil and other fuels and would make these countries less vulnerable to price hikes or sudden shortages of oil. Developed countries are looking for nuclear power as an alternative though it is costlier. Wind power is another cheap and clean source of energy. General Electrics claim that "one General Electric wind turbine can produce enough electricity for about 400 houses each year".

The Communist Party in China has urged citizens to conserve electricity by turning air-conditioners in government buildings to no lower than 26 degrees Celsius and wear thinner clothing rather than Western suits. Meanwhile, China is going all out to ensure

energy security to sustain its rapid economic growth. With rise in oil nationalism particularly after 9/11, big consumers such as China are locking in “equity oil” to have peace in mind (The Economist, 30 April-6 May 2005). Two months ago, China’s National Off-Shore Oil Corporation (CNOOC) offered the highest bid (above that of Chevron) to purchase the US oil company Unocal in order to gain assets, particularly gas, in Southeast Asia which is the hub of CNOOC’s overseas activities. The Chinese government has taken a deliberate decision to secure Chinese oil and gas assets overseas in order to address its long term concerns relating to security of energy supply. This purchase attempt has sent alarm bells throughout the USA.

Other countries/regions too have taken various measures to face the current energy crisis. For instance, in Thailand, Prime Minister, Thaksin Sinawatra has already announced strategies to restrict usage of energy and he stated “A compulsory requirement may be needed if people fail to cooperate with the government’s current campaign”. In Western Europe tax incentives are offered to people to switch to diesel based motor vehicles and 42 per cent of new car buyers go for diesel vehicles. In Indonesia, President, Susilo Bambang is contemplating on scrapping the fuel subsidy amounting to US \$ 6.4 billion despite mass protests. The Malaysian government has raised petrol and diesel prices four times since last October in a bid to cut the soaring cost of fuel subsidies.

These measures are taken to conserve foreign exchange, particularly by targeting the more affluent people who use the highest amount of petrol and who are the major beneficiaries of the petroleum subsidy. It is the general view that the non-affluent should not pay for a subsidy that is mostly used by the affluent.

Sri Lanka does not seem have a long term strategy to deal with the oil price hike. Time and again, respective governments have been advised to take measures to cut down the use of oil. The government was advised on the need to improve public transport (both the bus and railway services) to reduce motor vehicles on the road and thereby reduce traffic congestions. In fact, the 2004 Annual Report of the Central Bank (CBSLAR) stated: “Developing an efficient mass transport system will not only reduce the use of private vehicles thereby saving energy, but will also help to protect the environment” (p.15). It is reported that currently there are 2.2 million vehicles on the roads and road congestions lead to large wastage of fuel and the country loses Rs. 20 billion annually in traffic congestions (Commissioner of Motor Traffic).

Successive governments were also advised to move fast on coal power projects and the remaining hydro power projects to reduce the 65 per cent dependence on thermal power for electricity supply. Sri Lanka’s hydro energy sources are reaching saturation level (only three new large projects remain). Thus, biomass, wind power, dendro, etc., should be fully explored to produce new energy from non-oil sources while accelerating coal power plants (Norachchalai and other new sites). It is reported that a Chinese company was given the contract for Norachchalai and work will begin in October 2005. This is good news but what steps has Sri Lanka taken to restrict demand for energy ? Will there be restrictions on electric power use ? A 10 per cent reduction in oil consumption would have saved US \$ 150 million a year (CBSLAR, 2004, p. 15).

In a recent interview, the Finance Minister has stated that "...we should take every step to restrict the use of fuel. Fuel is being used in a wasteful and in an anti-social manner. I am going to set up a ceiling on the funds, which the country will have to spend on fuel. Once we set up the ceiling, we will have to impose restrictions up to that ceiling. There is no other option" (Daily Mirror, 29 August). He went on to say that transport will not be restricted but the affluent will have to pay the market price of petrol very soon.

It is good to note that the government will take some steps to curb fuel demand but this would not be adequate and a lot more needs to be done on both to control demand for oil and increase supply of less oil dependent energy. The problem is that it is election time in Sri Lanka and whatever citizens resist and is unpopular will be avoided and postponed. This means that in the medium to longer term there will be more burdens on the economy.

(Lecture delivered at the "Cutting through Crises", Certified Management Accountants Business Management Conference, Taj Samudra Hotel, Colombo, 02 September 2005)