

Kangaroo Group Working Dinner in Strasbourg, April 5, 2006

Hellmuth Weisser on

**The Future of Fossil Fuels
in the European Union
Under the Special Aspect
of Security of Supply**

Thank you very much, Mr. Rübige, for your kind introduction.

I would like to talk about the future of fossil fuels in the European Union under the special aspect of security of supply.

Renewable energy – as you all know – is today's buzzword with policy makers, with agrarians, with economists and even managers of the old fossil type. But as Mr. Rübige already alluded to till 2030 the bulk of our energy needs will be covered by fuels such as coal, oil and gas. And this statement holds true whether we are on the vanguard of renewables or of the more sceptical persuasion.

Energy demand will grow from today till 2030 by a factor of 2.5. The growth of energy demand is increasingly generated by developing countries such as China and India. Our import dependence will by 2030 be larger than 80 per cent for gas and for oil. And both gas and oil come increasingly from areas which are either politically unstable, do not subscribe to free market organization and are state-owned, influenced or at least dependent on the states.

This scenario with a burgeoning energy demand still mainly served by fossil fuels, growing international competition for fuel, increasing import dependence and risk-afflicted areas of energy supply mandates in my opinion the attention to security of supply aspects.

Why bother about security of supply?

In the hydrocarbon age, even very small interruptions in energy flows cause physical havoc. We have seen that – the older ones of us – in the 1973 crisis during the oil embargo. We saw it more recently in the UK in 1999, when we had a blockage of fuel delivery systems. We had the Californian energy crisis in 2000 / 2001, the collapse of the electricity grid in Italy and – last but not least – the Ukrainian mini crisis at the beginning of this year.

The Ukrainian mini crisis was not really so much of a crisis, as I think it was a wake-up call for this topic to come back onto the agenda.

I think we should all know and realize that the costs of an energy interruption go far beyond the costs to the direct market players. These externalities are the costs paid by others and include inflation, trade and payment imbalances, high unemployment as well as weak business and consumer confidence.

Who then is responsible for security of supply?

In a liberalized environment freed from old monopoly structures, governments unfortunately have to take the responsibility to set the rules and obligations for the market in times of crisis.

Why is this so? Why can only government action set the rules for supply crises?

Market participants manage only their specific costs and there is an asymmetry of cost benefit calculation between market participants and the public at large. In a competitive environment with about 30 per cent of downstream capital employed in downstream operations – and that is an example from the oil industry – the trend to minimum operating and just-in-time stocks will prevail. Thus market operators set their stock levels optimizing the day-to-day business and not preparing for the eventual crisis – due to competitive pressure. And – mind you – in a market environment the pursuit of your own interest is the name of the game totally legitimate and a prerequisite for survival.

Now we come to the benefits of strategic stocks.

Strategic stocks provide protection against all kinds of interruptions: against natural disaster, political blackmail, terrorism, civil unrest or any combination thereof.

Strategic reserves serve to mitigate fundamental and severe interruptions in the flow of energy. The presence of security stocks affords the economy and its government crucial additional time to ride out the crisis at hand and additional time to take counteractive measures. They also reduce the possibility of being taken hostage.

What kind of strategic reserves do we have in oil, still our main energy source?

The dramatic effect of the 1973 oil embargo and the following oil crisis caught all players, policy makers and executives unprepared. However, the experience led to the creation of the emergency framework of the International Energy Agency, which today is a proven and tested instrument in times of crises.

All major security reserve systems in operation today fulfill the IEA requirements and our European regulations, that is they basically mandate 90 days security stocks based on either net imports as in the case of the IEA or consumption – as under European rules – and foresee certain release mechanisms in time of crisis.

Given today's market conditions it is worth noting that new big players such as China and India are not yet covered by the IEA system. Besides the pure physical havoc a supply crisis confronts us with, which can be mitigated by security stock arrangements, the economic benefit of a creditable security stock system cannot be rated highly enough. There is an undeniable correlation between low stocks and high price volatility and low stocks and high prices.

Out of the last US recessions the overwhelming majority was preceded by stiff price increases.

Now let us turn to gas security, the subject which was brought forcefully to us at the beginning of January.

Till the first day of January, 2006 gas security was a rather esoteric subject. Academia and some stakeholders discussed the issue. By the way, the article I wrote for the Energy Journal was written before January 1st. But there was no political momentum in this debate. A mini scare less than a week of somewhat reduced supply served as a political wake-up call.

Let us look at the gas supply situation today.

Strong dependence – as I said, 80 per cent imports by 2030. 33 per cent to come ex Russia, 27 per cent from North Africa and about 17 per cent from the Middle East. A high dependency on only three suppliers might be bad enough. But you should realize that at least 12 EU member countries rely on

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one supplier only. And the situation is exacerbated by political uncertainty in the supply regions, monopolistic, that is non-market structures on the part of the suppliers and increased evidence of preparedness to use energy policy for political gains.

Gas to Europe is mainly pipeline-fed. We basically rely on four trunk line systems for our needs in the total union. The pipe system is also nearly fully booked and not reversible, i. e. there is no flexibility or optionality. The EU internal gas market is at its infancy – and again – offers little optionality. Our gas supply system is static, provides little flexibility and affords no optionality in terms of transit dependence.

There exists a high facility dependence out of old monopoly times. Systems were built to serve a market supplied by one supplier only. Investments in flexibility or redundancy was deemed unnecessary. And unfortunately in new LNG facilities this pattern is repeated.

In the face of high dependency and vulnerability at the source, in transit and in terms of general hardware, we have no security system at hand. A situation which we responsibly cannot tolerate to continue. And I think that is the basic message of my speech.

Why is it so that we not responsibly can tolerate this to continue?

Not if you realize that gas takes on the same responsibility of the electricity generation as oil does for transport today. What needs to be done to mitigate the perilous gas security equation?

First: The IEA and the EU must revise their mistake in policy that gas security matters are best left to national decisions. The emerging of a worldwide market for gas and LNG mandates this conclusion to be scrapped. World's trade from today's 22 per cent in gas will be assumed to be 40 per cent in 2030 and 50 per cent for LNG.

What has to be done?

Governments need to encourage optionality. As to source and to hardware. As to countries of origin,

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transport optionality, dual fuel plans and encourage free LPG markets without monopolistic structures as we see in today's gas market.

Thirdly they need to address the issue of security systems which are international. Create transparency as to the availability of stocks – which is presently unknown – and which this winter were depleted by 70 per cent even without a crisis.

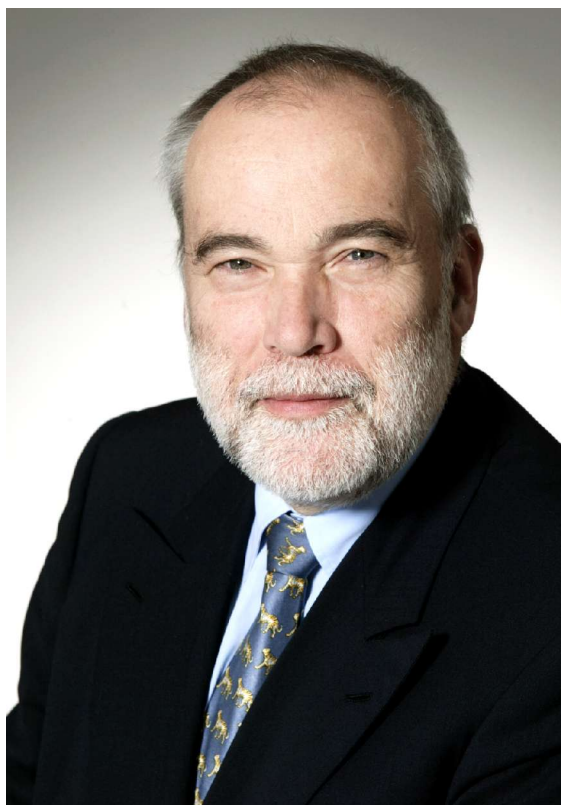
And policy makers should create a minimum stock policy. We have in many countries interruptable gas contracts, where the gas industry can say in times of crisis: "Sorry, guys, switch to oil."

These contracts have to be taken into the regime of national or international oil security systems, because there gas has a free ride.

Conclusion:

Fossil fuels will remain the backbone of our energy supply till 2030 and beyond. The EU will be import dependent for oil and gas for up to 80 per cent. And energy interruption causes havoc in today's modern economies with disparities in costs of suppliers and consumers. Governments therefore must set the rule for security of supply issues. While there exists an international crisis tool for oil, gas is lacking this comfort – an unbearable situation, which needs urgent action and attention.

Thank you very much.



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