

**Petrostocks 2007
New Perspectives**

The Use of Tickets for Security Stocks

A Blessing or a Curse ?

by

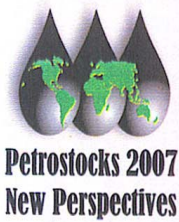
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Hamburg, Germany

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Tickets for Security Stocks – a blessing or a curse

What exactly are tickets – what is the deal ? (1)

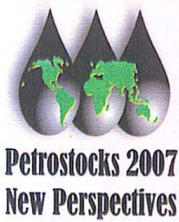
Promise to transfer title of a certain quantified parcel of oil from entity A to entity B

- in times of defined crisis,
- at a specified location,
- valid for a specified period of time and
- against a fixed fee.

Tickets for Security Stocks – a blessing or a curse

What exactly are tickets – what is the deal ? (2)

- To count against Compulsory Storage Obligations (CSOs) the specific transaction has to be approved by the concerned governments or fall into an approved governmental framework.
- Ticket transactions can be between public or private undertakings and they can be national or cross border.
- In the CSO context tickets are mainly used in Europe.



Tickets for Security Stocks – a blessing or a curse

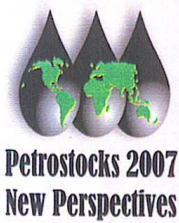
What exactly are tickets – what is the deal ? (3)

The key argument in support of tickets is the

- effective and
- cost efficient

allocation of stocks by making maximum use of market forces to cover compulsory stock obligations.

But the use of tickets is controversial and this presentation will attempt a valuation.



Tickets for Security Stocks – a blessing or a curse

What are security stock systems supposed to do ? (1)

- In the hydrocarbon age even small interruptions in oil (and gas) flows cause physical havoc.
- The cost of energy interruptions go far beyond the costs to direct market players.
- Strategic stocks provide protection against interruptions caused by
 - natural disaster,
 - political blackmail,
 - terrorism,
 - civil unrest, etc.

Tickets for Security Stocks – a blessing or a curse

What are security stock systems supposed to do ? (2)

- Strategic reserves serve to mitigate fundamental interruptions in the flow of oil.
- The presence of security stocks affords the economy and its governments
 - crucial additional time to ride out the crisis at hand and
 - additional time to take counteractive measures.

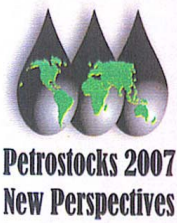
They also reduce the possibility of being taken hostage.

Tickets for Security Stocks – a blessing or a curse

Best practice in the security of supply equation (1)

CSO systems should be

- cost efficient,
- highly transparent,
- set up for the long term,
- market neutral,
- non-disruptive in times of crisis,
- providing additional oil to the market beset by the crisis at hand and
- market tested.



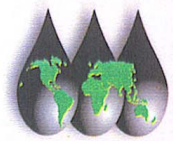
Tickets for Security Stocks – a blessing or a curse

Cost efficiency (1)

This is by far the biggest plus for tickets.

Tickets allow to reduce the costs of CSO below the normal carrying costs which comprise

- storage rental,
- the price of the oil stored and
- a risk premium.



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Tickets for Security Stocks – a blessing or a curse

Cost efficiency (2)

The feat is done by converting slack in the system into a tradable commodity thus reducing the overall cost in pre-crisis times.

Tickets also allow the CSO system to easily adjust to changes in the obligation to carry stocks – thus again minimizing costs.

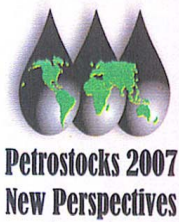
Tickets for Security Stocks – a blessing or a curse

Transparency (1)

Work done by the IEA has indicated, however, that

- tickets lack transparency and credibility.
- the location of the ticketed oil is opaque,
- accounting between receiving and providing countries tend to differ substantially –

in Europe there was a persistent gap of over 2 Mio cbm,
- the quality of tickets varies considerably.

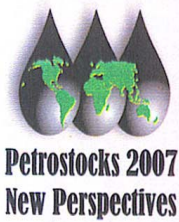


Tickets for Security Stocks – a blessing or a curse

Transparency (2)

Fraud by its nature cannot be quantified
but is a clear and persistent danger in ticketing regimes.

It is interesting to note in this context that the EU's fossil forum,
which advised the EU on its latest Green Book on Energy Policy,
stressed the importance of the visibility and credibility of the CSO regime
to fulfill its function to the maximum extent.



Tickets for Security Stocks – a blessing or a curse

Playing for the Long Term (1)

To be credible a CSO system has to play for the long term.

However, CSO tickets traded in Europe range from 3 to 12 months.

In terms of security policy these are very short time spans indeed.

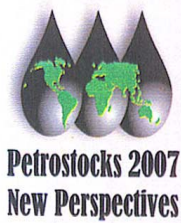
Tickets for Security Stocks – a blessing or a curse

Playing for the Long Term (2)

Changing market conditions can

- reduce the availability of tickets easily below the need of any given CSO system and
- drive the costs beyond normal carrying costs (This happens when the contango collapses and a strong backwardation emerges).

Thus in the long term there is no real guarantee that the argument of cost efficiency actually holds.



Tickets for Security Stocks – a blessing or a curse

Market Neutrality (1)

Strategic Stocks –
with their goal to decrease the high cost of externalities -
are in the interest of the public domain.

Therefore all market participants should carry the same burden
as a matter of equity.

Under CSO systems, where companies must provide the CSO cover,
a stock ticket system is a conveyor belt transferring funds from companies
short on stocks (traders) to those long on stocks (i.e. refiners).

Cost effective – on first glance in the public interest –
but not market neutral and in the end detrimental to competition.

Tickets for Security Stocks – a blessing or a curse

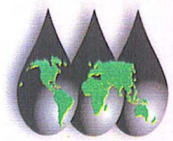
Market Neutrality (2)

Oil in CSO regimes relying on owned physical stocks
(be it by an agency or a company)

exit the market place for good during the duration of the obligation
once the stocks are built.

Under a ticketing regime the ticketed quantities reappear within 3 months to
a year in the market place pushing up the short term demand curve more than
it would otherwise be (and siphoning scarce oil further into contango plays).

Not exactly a happy coincidence in a time of burdensome high oil prices.

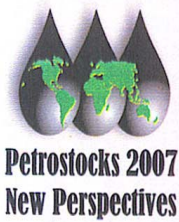


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Market Neutrality (3)

It would be interesting to get a meaningful study on the strengths of this correlation. If the argument holds the assumed cost efficiency would be “penny wise and pound foolish”.

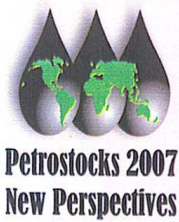


Tickets for Security Stocks – a blessing or a curse

Non Disruptive in Times of Crisis (1)

It seems self evident that in a crisis situation further market disruption is the least desired result of a stock release.

However, this result is the more probable the more a CSO regime relies on tickets.

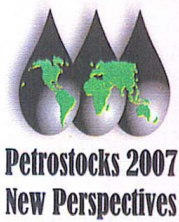


Tickets for Security Stocks – a blessing or a curse

Non Disruptive in Times of Crisis (2)

Oil stocks underlying tickets are working stocks
of market participants
held for various reasons
other than for a crisis release.

If in times of crisis the tickets are called
the market is additionally disturbed –
the least desirable outcome.



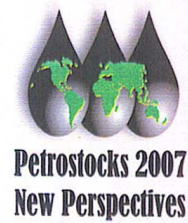
Tickets for Security Stocks – a blessing or a curse

Non Disruptive in Times of Crisis (3)

The market is disturbed because the original use for the stocks is being nixed.

What you need in times of crisis is fresh oil
and not closing holes by opening holes elsewhere.

As today's oil market is global
the above also holds true for countries
which enjoy a high product export rate
or buy tickets abroad.

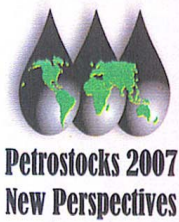


Tickets for Security Stocks – a blessing or a curse

Non Disruptive in Times of Crisis (4)

In today's volatile market place
nearly all stocks held by market entities are hedged.
Outright risks are the crass exception.

A call on ticketed oil in crisis times breaks the existing hedges
and confronts the market players with risks difficult to control
further disturbing the market (or worse).

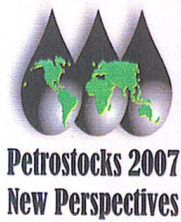


Tickets for Security Stocks – a blessing or a curse

Non Disruptive in Times of Crisis (5)

Not only are new risks opened
the need to buy back hedges introduces additional demand
and thus lifts up the demand curve at a decidedly inopportune time.

This risk is highly underestimated – if not neglected - by
policymakers, market participants and financial institutions alike.



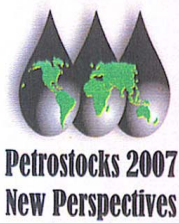
Tickets for Security Stocks – a blessing or a curse

Non Disruptive in Times of Crisis (6)

All ticketed stocks are financed and very often pledged as security (if held by private institutions).

In times of crisis these arrangements can certainly be unwound.

But whether this can happen in a timely and non disturbing manner remains an open question.



Tickets for Security Stocks – a blessing or a curse

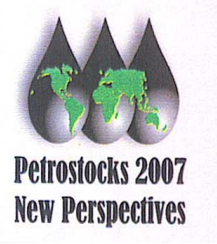
Non Disruptive in Times of Crisis (7)

The last 2 issues - pledging and hedging - warrant the special attention of the EU.

Under the EU's CSO directive (2006/67/EC Art 3,1) it is clearly mandated that countries must have free and unhindered access to the CSO quantities.

For me the reality of the market place does not quite match this requirement.

Further studies seem warranted.



Tickets for Security Stocks – a blessing or a curse

Providing additional oil to the market effected by the crisis at hand

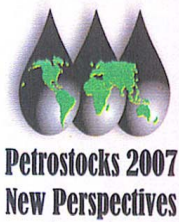
We touched on this item before.

Ticketed oil is already in the market place.

Ticketed oil represent inter alia minimum operating stocks (MORs) and slack in the system.

In times of crisis cutting slack and digging MORs is the least you want to achieve if indeed the aim is to add liquidity to the market.

Ticketed oil when based on contango stocks does add liquidity but at the same time reappear in the market place as demand to cover broken hedges - again a not perfect solution.



Tickets for Security Stocks – a blessing or a curse

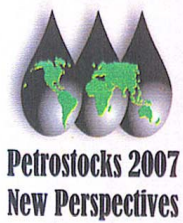
Market tested

I am not aware of any sizeable ticket release tests.

Therefore my answer to the question of “market tested” must be answered with “No” – and if only out of ignorance.

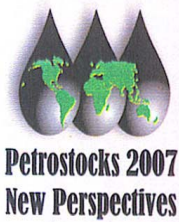
On a cynical note the answer could be that a ticketing system has been tested successfully once you car is able to run on tickets.

But returning to serious debate it might be interesting to have ticket release scenarios as a part of an IEA’s crisis exercises.



Tickets for Security Stocks – a blessing or a curse

| Tickets for Security Stocks – a blessing or a curse | | | |
|--|--|-----------------|--------------|
| | | | |
| | | | |
| <u>Requirement</u> | | <u>Blessing</u> | <u>Curse</u> |
| | | | |
| cost efficient | | ✓ | |
| transparent | | | ✓ |
| playing for the longterm | | | ✓ |
| market neutrality | | | ✓ |
| non disruptive | | | ✓ |
| providing additional oil | | | ✓ |
| market tested | | | ✓ |



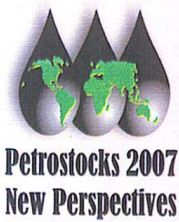
Tickets for Security Stocks – a blessing or a curse

Conclusion (1)

In a non crisis world
tickets do afford an interesting tool to minimize costs.

They are also an interesting tool to make money for traders and refiners

- to commercialize slack in the system and
- to maximize contango play.

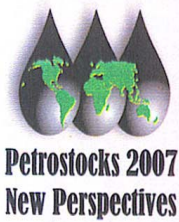


Tickets for Security Stocks – a blessing or a curse

Conclusion (2)

But in a crisis
this accounting exercise comes to naught.

- it adds to the confusion,
- begets no additional oil and
- pushes the demand curve at an extremely inopportune time.



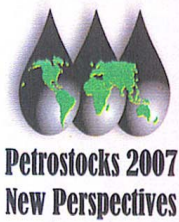
Tickets for Security Stocks – a blessing or a curse

Conclusion (3)

Mechanisms to fight crises must be judged

- by their efficiency,
- by their effectiveness and
- their cost in times of crisis.

To look at the costs in a non crisis scenario only appears to be counterproductive or rather disingenuous.



Tickets for Security Stocks – a blessing or a curse

Conclusion (4)

Some degree of tickets in a CSO system might be acceptable – or even advisable – to have operating flexibility within the system.

But the more a CSO regime relies on tickets the less appropriate it becomes as a crisis fighting tool.