

## **The world needs to get into oil 'rehab', says RCM**

**Christopher Wheaton, a Director of RCM, the specialist global equity company of Allianz Global Investors, explains why he believes the mismatch between the growth in oil demand and the growth in oil production could lead to future spikes in oil prices.**

"Surprisingly, the price elasticity of demand\* for oil is actually lower than for products such as alcohol or nicotine. It is somewhere between zero and -0.1 in the short term, i.e. a 10% rise in oil price leads to less than a 1% fall in consumption<sup>1</sup>. Alcohol and nicotine on the other hand vary between -0.4 and -1, i.e. a 10% rise in their price will cut demand by between 4% and 10%<sup>1</sup>.

"What's more, oil is a depleting asset and the Organization of Petroleum Exporting Countries (OPEC) controls 40% of the world's output of oil and acts as a cartel. Perhaps it's time for the world to think about how it got addicted to oil, how much it is willing to pay for the oil it needs now, and the alternatives to oil it will need in the future. It's time to think about how the world can get into oil 'rehab'.

"In my opinion, the issue is urgent, and it's here now. If oil demand grows as expected next year, then the world needs to start investing in new oil projects - and quickly. While OPEC's spare oil production capacity does rise in 2009 - as OPEC, and particularly Saudi Arabia, has been investing through the credit crunch of 2008/2009 - spare oil production capacity should hold flat in 2010 versus this year. However, this assumes that oil demand in the developed world doesn't grow from here. If it does grow, then that spare production capacity starts to erode even more quickly than forecast, and will probably hit all-time lows as soon as 2013. Meanwhile, oil consumption across the developing world continues to rise; so spare oil production capacity is bound to fall in 2011, whether or not the developed world's consumption rises.

"The risk the world faces now is that the combination of volatile oil prices and an industry that has lead times of 3-4 years and investment horizons of 15 years, leads to further delays in the start of new oil projects. In my view, the world's problem with oil is not so much that it hasn't got enough oil in the ground; it's the risk of not having enough near-term oil production. This makes it imperative to restart the investment in oil production as soon as possible because if oil companies make the same mistakes in 2010 as in 2004/2005 and delay approval of new oil projects, then oil price spikes loom large. Oil companies will most likely end up approving new oil investment projects all at the same time late in 2010 or early 2011, creating an oil service capacity crunch, double-digit oil service industry inflation (perhaps 10%-15%), cost over-runs, 1-2 year project delays, and irate resource owners. We could be just 12 months away from this cycle of desperation starting all over again.

“There is an alternative: the world has to match its growth in demand for oil with the industry’s ability to grow production of oil. This is going to be painful, but the alternative would be a repeat of oil price inflation of the years 2006 to 2008 playing out into a much more fragile global economy across the years 2012 to 2014, and that would be even more painful. It’s time to get the world into oil rehab, before the oil price does it for us.

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**Notes to Editors:**

\* Price elasticity of demand is a measure of the sensitivity of quantity demanded of a product or service to changes in its price. So demand is inelastic if consumers continue to demand a product despite increases in its price.

1 – Source: Understanding Crude Oil Prices, University of California, May 2008, and RCM in-house research.

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**Awards**

- RCM named winner of Active North American Equity at Pensions & Investment Provider awards 2009. RCM US Large Cap Select Growth is managed by Scott Migliori, Co-CIO for US Equities, RCM.
- RCM named No.1 leading fund management firm for SRI Research by Thomson Reuters Extel 2009.
- Global CIO of RCM, Andreas Utermann, named CIO of the Year by Funds Europe magazine 2008.
- Winner of European Investment Trust of the Year by Investment Week magazine, 2008, for the RCM-managed Charter European Trust.

**About RCM (all data source: RCM as at 30/06/09)**

RCM is a global asset manager operating from six international offices - San Francisco, London, Frankfurt, Hong Kong, Tokyo and Sydney – with assets under management of over \$89 billion worldwide. The firm provides a range of investment management solutions to institutions and individual clients. At RCM we believe that by generating and exploiting an information advantage, we will be able to deliver superior and consistent investment results for the benefit of our clients - a philosophy we call RCM informed. RCM is a company of Allianz Global Investors, a pre-eminent global asset management group committed to helping clients achieve sustainable success. As a company of Allianz Global Investors, RCM offers a distinctive investment philosophy and culture, while benefiting from the scale and substantial

resources of our parent; including business support, industry best-practices and financial investment. This enhances our ability to attract and retain talent, and provide superior insight and investment performance.

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