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U.S. OIL IMPORT POLICY -- WHAT HAS IT BEEN, WHAT SHOULD IT BE?

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by

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Our current official policy on U.S. oil imports and exports may be described as de minimis. It is simple, largely noninterventionist and has remained more or less unchanged for the past 4-5 years. Generally, a policy with these characteristics is blissfully ignored by the public in favor of more exciting issues. Last September when I was invited to give today's talk this was certainly the case. However, for the last several weeks U.S. oil import policy has suddenly been debated on the front pages of the nation's press, on prime time TV programs and in a series of Congressional hearings. The reason for the sudden interest is of course the dramatic fall in foreign and domestic crude oil prices since last January which, if maintained, is likely to change the structure, scope and size of the U.S. oil industry. Hence, the quest for a reevaluation at this time of the policy framework within which the industry operates.

Let me start with a brief overview of our current oil trade policy. There are of course no effective restrictions on the importation of crude oil and refined products into the U.S. from any source (with the exception of Libya). The existing tariffs on these imports were established long before the price increases of the 1970's and do not provide an effective protection to domestic producers or refiners nor are they intended to do so. On the export side, crude exports, except those going to Canada, are generally prohibited while all refined products exports have no restriction whatever. The restrictions on crude exports do not represent a serious market intervention (except in the case of Alaskan North Slope crude) because most domestic crude is more competitive with foreign crude at domestic refineries than at overseas refineries and therefore would not generally be exported even if there were no restrictions. (At times foreign product markets may offer a higher netback than domestic markets, as has recently been the case. Had crude exports been allowed, they would have taken place.) The situation is different for Alaskan North Slope crude. The approximately 40% share of ANS production which now is shipped to the U.S. Gulf Coast could be shipped at lower cost to foreign destinations in the Pacific region, if this were permitted. The infrastructure built by the domestic industry to deliver ANS crude to the Gulf Coast has greatly diminished the relative transportation advantage of exporting this crude. However, the ongoing price decline could make ANS crude unprofitable at the Gulf Coast before it does so in the Pacific, reviving the ANS export debate.

Oil imports under this system of regulations have shown significant changes in volumes, trends and shares of market in the last 5 years (1981-85). In 1985 crude imports were 27% and residual fuel oil 36% below their respective 1981 levels, while light products imports had risen by 65% and represented 26% of total gross oil imports last year against 13% in 1981. The reason for the decline in crude oil imports reflects of course the substantial drop in domestic demand together with the slight increase in domestic crude production. The decline in residual fuel oil imports is due primarily to the displacement of this fuel by gas in the industrial market and by coal and nuclear power in the electric power market. The main factor in the increase in light products imports was gasoline. Last year imported gasoline and blending components supplied nearly 7% of total U.S. gasoline demand, compared to 3% in 1981.

The increase in light products imports in the face of substantial domestic excess refining capacity has caused some domestic refiners to argue for a new import policy which would give them more protection against imports. However, the decline in total light products imports (but not gasoline) last year and the substantially improved refinery operating profit margins of the last half year or so have reduced the urgency of their plea and, hence, the need to respond to it.

The change in crude oil imports has been primarily geographic but it carries political-strategic implications. Last year nearly 50% of all crude imports came from Western Hemisphere sources and less than 8% from the Middle East. In 1981 the two areas accounted for 22% and 27% respectively. However the Middle East's share is on the rise again, largely due to sharp increases in shipments from Saudi Arabia following that country's move to a flexible market-related pricing policy last fall. In the fourth quarter of 1985 the Middle East accounted for 13% of all crude imports. In the first quarter of 1986 it was substantially higher.

So much for the past. But the question of the day is of course what kind of import policy is required for the oil market phase we have just entered. The question is certainly valid. For nearly 3 months now U.S. crude oil has been priced below the level required to replace depleting reserves. I recognize that this level is not easily calculable and varies greatly within the industry. But recent statistics provide some guidance. In the 5-year period 1975-79 when we drilled an annual average of 45,500 producing and dry wells, including 18,600 oil wells, our oil reserves fell by 6.5 billion barrels and our "Lower-48" production by more than 1 million B/D. During the following 5-year period (1980-84) we drilled 78,200 wells annually including 37,600 oil wells, and our reserves fell by only 2.1 billion barrels while Lower-48 production actually rose by 180,000 B/D. The production level held up in 1985 when we drilled over 80,000 wells.

However, the new prices are now causing reductions in exploration and production expenditures, likely to bring drilling rates sometime this year back to the 45,000 annual level of the earlier period. In fact, if not for the drilling commitments and contracts already entered into before the price decline, the drilling rate would probably drop even further this year. The inevitable result is of course a return to the decline in reserves and production that we experienced in the 1970's. Only this time the drop in the Lower-48 won't be more than offset by rising production on the Alaskan North Slope, as was the case from 1977 to 1980. In fact, we now expect North Slope production to start declining from the late 1980's on.

The other aspect of the price decline is of course that it will raise demand. In its latest forecast, which was completed before the price fall of 1986 took place, the DOE assumes in its Base Case that demand would rise by almost 4% between 1985 and

1990. On that basis, an increase on the order of 7-8% as a result of the lower prices does not seem unreasonable. Altogether, the combined impacts of the price decline on supply and demand could well raise our net import level to 7.5 million B/D by 1990, equal to about 45% of total demand. By comparison, last year's 4.1 million B/D level was equal to 26% of demand.

This brings us right back to the import policy issue. For the last 12 years we have measured the success of our energy policy largely by the criterion of how much it has reduced our dependency on foreign energy sources. By this criterion our policy was a great success, since in 1977 our dependency on foreign oil was a record 47%. Now this is likely to be reversed if U.S. oil prices remain in their current $13-15 range for the next several years or even if they move up by $2-3 during this period. Should we accept this development as the superior wisdom of the market? Or should we actively intervene to maintain our current degree of energy independence? Or should we at least keep it from declining as fast as it would otherwise?

As we have already seen, there is no single or simple answer to the question, otherwise we would not have the kind of debate in which the President of the U.S. says "The market, now and forever" and the Vice President says, "Yes, but not now." One principal reason for the controversy is the dilemma created by the fact that two desirable trends have apparently become mutually exclusive: one is the reduction in oil import dependency, the other is the decline in oil prices. From 1981 through 1985 the two went hand in hand, as both prices and imports dropped. Now, as we have seen, the much accelerated price drop will cause imports to rise rapidly. So, which has a higher national priority, the tangible and widespread economic benefits of much lower oil prices or the potential political-strategic benefits of maintaining a low level of import dependency?

You may have guessed by now that I am not going to offer an answer to the question and I leave it up you to speculate whether this is due to my reluctance to discuss such a sensitive and controversial issue in public or whether I simply do not have an answer. But I would like to offer a few considerations which may be pertinent to the issue of free markets vs. market intervention in our oil import policy.

One such consideration is that the recent price fall is not an ordinary decline but a truly historic collapse which (in real, inflation-adjusted dollars) has wiped out not only all of the 1979/81 OPEC price explosion but also about half of the 1973/74 explosion. Since the growth rates in demand and the lack of spare capacity in the early 1970's absolutely required a substantial real price increase from the mid-1970's on even under the freest of market conditions, the current price of oil may actually be <u>lower</u> than if OPEC had never existed. Thus, someone wanting to intervene could argue that the recent price fall does not represent a normal economic adjustment but is an aberration or over-reaction which requires correction for the sake of price stability.

It should also be considered that, relative to the U.S., finding and production costs in the Middle East are so low, the excess producing capacity there so large and the potential for relatively low cost additional reserves so vast (no one has seriously searched for oil in the region during the current decade) that the U.S. oil industry could not compete with Middle East oil in a really free market but would remain relegated to the role of the marginal high-cost producer. For quite some time, probably well into the 1990's, this role would likely keep U.S. production drastically below its current level. Market interventionists may argue that this is not in the best interest of the U.S.

Opponents to market intervention may point out that one risk stemming from a return to excessive import dependency could be largely eliminated without any direct market intervention by building up our Strategic Petroleum Reserve (SPR). The SPR's current volume of 500 million Bbls is adequate for the existing level of imports. But if by 1990 we should import 7.5 million B/D we would need nearly 700 million barrels to meet our 90-day import obligation agreed with the International Energy Agency. Had we had anything near that level in 1973 or 1979 the recent history of the world oil industry might have been very different.

Another consideration is that other major industrial nations such as Japan and most Western European countries have long lived with an energy import dependency ratio higher than our record high of 1977. Yet, their economies, except for the brief periods of physical shortages, have not been handicapped by this dependency. Should the U.S. follow their path and become less concerned about energy dependence? One counter argument is that the U.S. is one of the world's two super powers. The other super power has a surplus of all fossil fuels. Could a growing dependency on endemically unstable overseas areas for our principal domestic fuel negatively affect our super power position?

As I said before, I won't try to provide answers to these questions. Those in this town who are paid to do so and then get their answers translated into action or non-action, as the case may be, are likely to lie low for the next few months because the issue is too new. I think they are right in this, for we don't really know yet whether OPEC has actually died or is just playing dead or whether it will revive if it gets a transfusion in the form of support from non-OPEC exporters. We also don't know how positive the effect of the price decline will actually be on the general economy.

I believe when the decision is finally made it will not be based on free market theology but on political pragmatism, economic interaction, budget considerations and longer-term national interests. It will include a respectful bow but no genuflection towards Adam Smith.