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Statement before the

Committee On Energy and Natural Resources

of the

United States Senate

The World Petroleum Outlook

by

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President

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Thank you for inviting me to address your Committee on the near term world petroleum outlook. It is certainly appropriate for the Committee to inquire into this subject at the present time. The world oil market is currently in the process of unprecedented drastic changes. We are actually witnessing another oil shock. Only this time it is the producers, not the consumers, who are experiencing the pain of the impact. World oil production (excluding the Soviet Bloc and China) peaked in 1979 at 51.4 million B/D and has declined in every year since then. In 1982 it is likely to be down to about 43 million B/D, a drop of 16.5% over a three year period. There has been nothing like it in the post war period. The only other extended world production drop occurred after the first OPEC oil price explosion. It lasted for two years (1974-75), during which production dropped by 9% before resuming its upward climb.

The shock of the decline has fallen primarily on OPEC which has borne all of it while non-OPEC production collectively has increased steadily since 1979. This year we estimate total OPEC crude and NGL production to average about 21 million B/D, a drop of over 10 million B/D from the 1979 level. Meanwhile, non-OPEC production is estimated to amount to 21.5-22.0 million B/D, an increase of about 2 million B/D over 1979.

The reasons for the world production drop are known. They consist of three factors: structural decline in demand due to price-induced oil conservation and substitution; cyclical decline in demand due to the general worldwide economic

recession; and global petroleum inventory unloading on an unprecedented scale, due to the high cost of money, declining oil prices and the perception among buyers of readily available new supplies.

The reason for the sharper decline in OPEC oil production than in world production is twofold: 1) the physical availability of non-OPEC oil supplies increased throughout this period, and 2) OPEC and non-OPEC producers pursued different policies, particularly in the last six months. OPEC's policy was price-oriented, while that of most other producers was volume-oriented. Thus, OPEC currently maintains a substantially higher price structure than its non-OPEC competitors, but has lost substantial volume to the latter, most of whom are producing at or near capacity.

The bottom line of all this is that the average f.o.b. world oil price has dropped from a peak of $35.60*/Bbl in March 1981 to an estimated $33.00 today. Similarly, the crude oil acquisition cost of U.S. refiners has dropped from its March 1981 peak of $37.48 to an estimated $33 in March 82, a decline of 12%. The sharper decline in the U.S. refiner cost than in the world price reflects the fact that domestic crude prices dropped more than foreign prices in the last 12 months. In the previous 12 months U.S. refiner crude cost had increased by about 39%.

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*EIA, Weekly Petroleum Status Report, April 3, 1981.

The price decline, like the demand drop, is unique in the recent history of oil price movements. Certainly since the late 1960's,nominal oil prices, both in the U.S. and abroad, have only moved upwards.

Will the trends that I have just described continue in the near future? I do not think so. I believe the production, demand and price declines have all about reached bottom. They are likely to stay there for a while after which production and demand will start rising again and prices will strengthen somewhat. Underlying this prediction is our assumption that two of the factors causing the recent production drop -- recession and inventory reduction -- have about run their course. A recession is by definition the downward phase of a business cycle. A turn-around is part of the same cycle. A growing number of economists are now predicting the turn-around in the current cycle for the second half of this year, both in the U.S. and Europe. I am aware, or course, that majority views of economists are a rather weak forecasting tool but some of the signs they claim to see are quite real. Foremost among these is the impressive decline in the inflation rate, brought about in part by the drop in oil prices.

The end of the inventory reduction can be expected sometime in the third quarter. There are indications that during the first quarter of this year world oil inventories were reduced by about 4 million B/D, or 1.5-2.0 million B/D more than is

normal. If this is correct, inventories at the beginning of the second quarter were some 600 million Bbls below the year-ago level. Given the declining demand and the new, much lower perception of the desired level of oil stocks, we are likely to see a further inventory reduction in the second quarter. But if we are right in our assumption that the demand decline will turn around in fall, the same will be true of inventory movements. Hence, in the third quarter stocks are likely to be built up again for the seasonal winter drawdown.

A key factor in all this is of course OPEC's willingness and/or ability not to exceed the 17.5 million B/D collective production ceiling agreed to at its recent meeting in Vienna. In the 5 weeks since the meeting it appears that OPEC production has actually been below it. We know that Nigeria has been producing less than its assigned ceiling in April. The same is apparently true of Iraq since its pipelines through Syria have been closed by the Syrian government a few weeks ago. Iraq's under-production may be offset by Iran's ability and announced decision to exceed its ceiling. But for a variety of reasons the Iranians are unlikely to exceed it by very much. Meanwhile, Saudi Arabia may possibly be producing some 500,000 B/D less than its 7 million B/D ceiling.

Whatever the exact level, OPEC's current production is less than the world would require if it were not for the inventory

reduction. Thus, once this reduction is completed, the demand for OPEC oil is bound to rise by several million B/D. We expect this to occur in the fourth quarter of this year at the latest.

Beyond 1982 we see world oil demand recovering at a modest but steady rate from the decline of the last three years, partly as a result of general economic growth and partly because of the absence of real oil price increases (of which more later). By 1985 demand may amount to 49.5-50.0 million B/D which would be equal to the level reached in 1977. OPEC would share to some extent in this increase. It may be required to produce 24 million B/D of crude in 1985. This would be a substantial increase from the current year but would still be way below its annual production level during the period 1972-80 which fluctuated between 31 and 27 million B/D. Thus, throughout this period OPEC will have substantial collective excess producing capacity. Prior to 1981 this was generally not the case.

What will this do to OPEC's ability to set world oil prices? Or more broadly, can OPEC survive as an effective cartel in the market atmosphere of the next several years? Within the time frame of the first half of the 1980's, the period under discussion here, our answer would be _yes_, with some qualifications. During this period OPEC will of course be very different from what it was during the 1970's. The aforementioned shock effect of the impact of the price increases on oil demand, together with the increasing role of non-OPEC suppliers and OPEC's own substantial excess producing capacity have clearly reduced

OPEC's ability to determine prices and this will continue to be the case. Most OPEC oil ministers have recognized this. In fact, several have acknowledged that OPEC's pricing policy of the period 1979-80 was largely responsible for the dramatic decline in the organization's oil exports during the last 12 months.

Thus, for the time being, OPEC appears to have lost its ability to raise prices at will, as it could in the previous period, but it has probably retained its ability to protect its existing floor price level. We therefore expect OPEC contract prices to remain approximately at their present nominal level this year and next and increase somewhat (but no more, and perhaps less, than inflation) in 1984 and 1985.

In our view, this price path would be an indication of OPEC's continued strength as a price setting cartel. For the present world oil price is substantially above the level which would prevail under real free market conditions. The often quoted figure of $20/Bbl under this latter scenario seems reasonable, at least in the short run. OPEC has been able to keep the price some 60-70% above this level, in the face of a unique combination of market forces trying to depress it.

Under our price and volume assumption, OPEC's collective Current Account surplus would probably disappear by next year. However, the group's oil export earnings in 1983, with no change in prices, are likely to amount to about $250 billion. This would be a 28% increase over the $195 billion the group earned in 1979 when most members registered a significant Current Account surplus. Thus, after adjustment for inflation, OPEC's

foreign exchange earnings may not be less than their requirements in 1979, a year of substantial economic growth for all OPEC members.

Of course, if there is no growth in real oil export earnings, most OPEC countries will have to scale back their economic expectations and development plans. But the predictions by some analysts that OPEC will "fall apart" because some of its members will undermine its collective price policy under the pressure of short term foreign exchange requirements, does not seem to be borne out by our calculations.

The country currently most vulnerable to this type of pressure is Nigeria. Nigeria's willingness or unwillingness to abide by its OPEC assigned quota under current conditions may be a test case of OPEC solidarity under extreme conditions. Clearly, Saudi Arabia, whose power and influence in matters of oil policy is awesome, is taking some unusual steps to strengthen Nigeria's determination to stay with OPEC.

In concluding I would like to say that all my comments assume of course no major military or political disruption of the oil flow from the Persian Gulf. This standard disclaimer could become more important than all my other comments if Saudi Arabia should become directly involved in, or affected by, some of the ominous military-political-religious developments in the region.

Thus, we are by no means home free in regards to our dependency on foreign oil, whatever OPEC's official price policy may be.