PIRINC

Telephone: (212) 867-0052
Fax: (212) 682-4498

Petroleum Industry Research Foundation, Inc.
122 East 42nd Street ▪ Suite 516
New York, NY 10168-0012

Oil and National Security

Presented By

John H. Lichtblau
Chairman

To

Fourteenth International Area Conference:
The United States and North America:
International Implications for Supply and Demand

The International Research Center
for Energy & Economic Development

University of Colorado
Boulder, CO

April 27, 1993

The Administration's proposed BTU Tax policy is focusing attention once again on the national security aspect of U.S. oil supplies. One of the reasons advanced by the Treasury for the tax is that it would "advance . . . security objectives" by "reducing dependence on foreign sources of energy." This applies of course only to oil and, hence, must be seen as a major reason for the substantial "Supplemental" BTU Tax on oil (59.9¢/MMBTU vs. a Base Tax of 25.7¢ for all other fuels). In fact, Secretary Bentsen at a hearing before the Senate Finance Committee last week specifically tied the Supplemental Tax on oil to "concerns about energy security" and potential vulnerability to an oil "embargo."

From the domestic economic as well as the balance of trade point of view, a barrel of oil produced in the U.S. is preferable to a barrel of imported oil, other things being equal. But this is just as true for many other imported items. However, does the national security aspect of oil imports remain a valid concern in today's world market conditions and geopolitical realities or has our oil policy in this regard become captive to an obsolete or irrelevant concept? Let us examine the issue.

The Market is Global

The national security angle of U.S. oil supplies has been greatly boosted in the media and in public debates by the Persian Gulf war which caused an instant dramatic rise in oil prices, driving home to every user at every level of consumption that oil is a global commodity whose price is inevitably affected by global events.

The price shock triggered by the invasion of Kuwait has been widely cited as evidence that we must reduce our dependence on foreign oil. Yet, the same price shock occurred in Canada and in the U.K., both net exporters of oil. The reason is that Canada and the U.K. are both plugged into the world oil market through their exports and imports, so their prices are just as determined by world market conditions as ours are. Hence, even a substantial reduction in our net import dependence would not insulate U.S. oil prices from the world market. True, in the U.K. and Canada, the price increases went to domestic producers, not foreign suppliers. But this is a balance-of-trade and not a national security consideration. (In the U.S., too, a significant share of any price increase accrues to the domestic oil industry. According to a recent GAO report, the cost of oil to U.S. consumers rose by $21 billion between August 1 and December 1, 1990 as a result of the war, but only $8 billion of this amount went to foreign suppliers.)[1]

Actually, the Gulf War does not provide an argument for future import curtailments but quite the contrary. It illustrates the ability of the world oil market to cope with an extended major disruption. The Iraqi invasion of Kuwait on August 2, 1990 did cause an

[1] U.S. General Accounting Office, Transition Series, *Energy Issues*, December 1992, p. 8

instant loss of about 4.5 million B/D of oil exports, equal to 14% of total world oil exports. U.S. oil import prices (c.i.f) rose dramatically but only for 3 months: from a monthly average of $17.65 in July to a high of $31.47 in October. Then they reversed themselves, even though Iraqi and Kuwaiti supplies remained completely unavailable. By December prices had dropped back to $24 and further reductions were clearly in store for January 1991 even had there not been the U.N. military action which caused the instant collapse of the price to the pre-war level.

It is interesting to look at 1991 under these circumstances. Iraqi exports remained completely out throughout the year and Kuwaiti exports only slightly less so; Russian oil exports were down by 1 million B/D from 1990 while world oil demand, excluding the former Soviet Bloc, was up by 1 million B/D or 1.8%. Yet, the average U.S. oil import price in 1991 (after January) was hardly higher than in 1989; inflation-adjusted it was actually lower. This despite the fact that OPEC capacity utilization -- which had been widely predicted to push prices up sharply if it ever exceeded 80% -- was at or above 90% most of the year, at times even at 95%. Thus, while the magnitude and duration of the Persian Gulf war disruption was substantial by any measurement, its impact on oil prices was quite limited. In fact, OPEC's biggest current problem is how to fit Kuwait's return to its pre-war production level into the organization's 2nd half 1993 quota, and the darkest cloud overhanging OPEC's longer-term outlook is the eventual resumption of Iraqi exports.

Consumers to Exporters: The Oil Weapon is a Two-Edged Sword

Another argument often advanced for reducing our oil import dependency is that as our dependency rises it will increase the foreign suppliers' power and/or temptation to withhold, or threaten to withhold, oil supplies for political reasons (the "embargo" scenario). Oil exporters did this once (in 1973). It did not work but prices rose sharply and stayed there even after the boycott had ended because the world oil market was then a seller's market.

Since the mid-1980's there has been a global buyer's market and all actions to use oil exports as a political instrument were taken by *buyers*, principally the U.S. which has a restriction on oil imports from Iran and a ban on imports from Libya, and by the U.N., which has a ban on Iraqi oil exports and had a ban on exports from Kuwait while it was occupied by Iraq. Given the urgent financial requirements of all major oil exporters and their need to have access to the U.S., the world's biggest import market, it is hard to imagine a situation in which a major oil exporter would deny supplies to the U.S. for political or other non-commercial reasons. Furthermore, unless the exporter reduces total exports by the volume of oil withheld from the U.S. the embargo would be ineffective. In this connection one should also consider the growing trend of the exporters' national oil companies' downstream investments in importing countries. Saudi Arabia, Venezuela and Mexico are examples of this trend in the U.S.

The New World Order

The end of the Cold War and the attendant political dismemberment of the Soviet Union is another development which invites rethinking of the national security aspect of U.S. oil imports. Prior to this development the proximity of the Soviet Union to the Persian Gulf was, perhaps incorrectly but not unreasonably, viewed as a potential threat to Persian Gulf oil exports in case of a Cold War confrontation. This threat, real or imaginary, no longer exists. Instead, the Western capitalist countries and their private enterprises are now attempting to return Russia and its newly independent neighbors to its status of a major oil exporter. If they succeed, the former Soviet region may eventually reduce world dependence on Middle East oil from what it would be otherwise.

"Externalities" -- Another Buzz Word

Now let me briefly comment on what is often considered the weightiest national security argument for reducing oil imports, i.e. the supposed "externalities," the external costs of protecting access to certain foreign supply sources. These sources are of course, primarily, the Middle East. According to one recent estimate in *Foreign Affairs*, "even before Iraq invaded Kuwait, U.S. forces earmarked for gulf deployment were costing tax payers $50 billion yearly -- nearly $100 per barrel of oil imported from the Persian Gulf."[2] This is a surprisingly simplistic statement. Suppose commercial conditions caused half of these imports to be shifted to other areas. Would that double the military cost per barrel of Persian Gulf oil? Or would our military forces in the region be cut in half? Or would they be doubled if our Middle East imports doubled? Of course not.

There is no direct relationship between the deployment of U.S. forces in the Middle East and our importation of Middle East oil. These forces were deployed there as part of our Cold War global strategy, just as they were deployed in Europe and the Far East. Commercial trade patterns clearly did not determine these deployment patterns. No doubt, the fact that the Middle East is the *world's* principal oil supply source played a role in locating some of our forces there. But this would have been so regardless of our own oil imports from the region. Thus, the argument that we must spend billions of dollars annually in military expenditures specifically to protect our foreign oil supplies is spurious. The one time we did have substantial military expenditures in the region, during operations Desert Shield and Desert Storm in 1990/91, we were fully reimbursed by our allies. This, incidentally, is a clear indication that these operations were international in scope and not related to our level of Middle East oil imports. In fact, our current role in the Middle East is primarily a function of our super-power status, not our oil import dependency.

---

[2] Amory B. Lovins and Joseph J. Romm, "Fueling a Competitive Economy," *Foreign Affairs*, Winter 1992/93, p. 47

The Market Will Work

None of my comments are intended to give the impression that foreign oil supplies, particularly those in the Middle East, are as inherently safe as domestic supplies and will be always available. Temporary disruptions for political, military or even technical reasons must be expected. All importing countries are vulnerable to such disruptions. As pointed out earlier, the resulting temporary price increases will affect all countries whose prices are market determined, regardless of their respective level of self-sufficiency and regardless of their level of dependence on a particular region.

For the rest of this decade any less-than-catastrophic disruption can be met from OPEC's spare producing capacity, which should still amount to several million barrels per day by the year 2000, based on ongoing and announced expansion plans and realistic world supply and demand projections. Most of the spare capacity will be located in the Middle East.

Beyond that period the situation is of course less clear. However, if there should be a gradual return to a seller's market sometime in the next decade and prices rise accordingly, the market could be expected to react in a normal fashion: the growth in world oil demand would slow down due to increased conservation and fuel switching, non-OPEC drilling activities would increase bringing forth more supplies, and the introduction of new upstream technologies, some of which are not attractive at current prices, would be accelerated. Such a development, which is a normal phase in any market, could not be viewed as a threat to our national security.

The SPR's Role Continues

There remains the possibility of short-term disruptions which a tighter market may not be able to correct. However, this can be remedied by expanding our Strategic Petroleum Reserve which was designed for exactly this purpose. There is a debate over how large this reserve should eventually be. But there should be no debate about the need to fill the reserve rapidly from its current level of 576 million bbls to at least the 750 million bbls for which the capacity and infrastructure are already in place. At the present fill-rate of 13,000 B/D this would take 36 years! A fill rate three or four times that large would give us an adequate emergency reserve cushion at the beginning of the next decade at a relatively low cost and without market distortions.

It should be pointed out in this connection that in the view of a number of industry and government experts the crisis-induced price increase in the fall of 1990 would have been considerably smaller if the SPR had been made available then. The fact that it was made available in January 1991 when Operation Desert Storm started was undoubtedly a factor in the price collapse. At present prices the cost of filling the SPR to 750 million bbls would equate to 7-8¢ per barrel of total U.S. oil consumption over the fill period. By comparison, the Supplemental BTU Tax would raise prices permanently by an inflation-adjusted $2/Bbl.

The Middle East is routinely perceived as an "endemically insecure" region. Given its perennial political, military, religious and ethnic conflicts and the fact that its predominant position as an oil exporter will keep growing over the next 10-15 years, there is a potential security risk to Middle East oil exports. As pointed out, the risk is global since a disruption in Middle East supplies would affect all market-determined oil prices in all countries. However, the risk is manageable and at a much lower cost than any attempt to achieve a substantial permanent reduction in imports through a government mandated policy.