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**PERSIAN GULF OIL DISRUPTIONS  
AND ITS IMPACT ON THE U.S.**

**Statement Before The Committee on  
Banking, Finance and Urban Affairs**

**U.S. House of Representatives**

**by**

**John H. Lichtblau  
President**

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I understand your hearing today deals primarily with the question of the strategic possibility and economic consequences of a major disruption of the oil flow from the Persian Gulf region.

As everyone knows, the world oil market is currently, and has been for the past seven years, in a state of substantial oversupply, with most of the excess production and producing capacity located in the Persian Gulf. Yet, given the region's endemic political and strategic instability, a concern over a sudden reversal of this situation for military or political reasons is legitimate, particularly following the recent events in the Gulf.

I understand that your committee is interested primarily in the current situation and in the near future. I'm therefore limiting my comments to the period through 1991. Let me start with my conclusions. I believe a sustained major disruption of Persian Gulf oil exports during this period is highly unlikely, though of course within the realm of possibility. I think our anxiety over its occurrence is based in large part on the traumas of the 1973 and 1979 oil disruptions which not only created temporary oil shortages but were also major factors in the U.S. recessions which followed these events with a lag.

I believe a recurrence of the circumstances causing these two disruptions is quite unlikely in the time frame under discussion. The two principal factors then were the almost

complete absence of spare producing capacity anywhere in the world and the non-existence of any non-commercial reserve stocks on which to draw in an emergency. Other special factors were an extremely sharp global demand increase in 1973 (8%) and a sharp drop in commercial inventory levels in the first half of 1979. Finally, buyers and users of crude oil and products, from major refiners to small-scale end users, believed, particularly in 1979/80, that OPEC had the power and ability to maintain whatever price level it had set. Hence, the market acted in that period as if a substantial drop in OPEC's official sales prices was not a commercial risk.

None of these factors apply even remotely in today's environment. Surplus capacity is super-abundant and while the bulk of it is located in the Persian Gulf, some 3.0-3.5 million B/D, equal to 13-15% of total world oil exports in 1987, are located outside the Persian Gulf. Similarly, the U.S. now has a Strategic Petroleum Reserve of 550 million bbls which can be drawn down at a daily rate of 3.5 million B/D for at least 4 months and at declining rates thereafter. The other OECD countries hold about 400 million barrels in "public" stocks for emergency purposes. Current commercial inventories are significantly higher than a year ago, with much of it concentrated in the U.S. Floating stocks are also higher. Finally, the myth of OPEC's irreversible price structure has been shattered for a long time to come by the events of 1986 which have been reinforced by the current price situation. Thus, a replay of 1973 or 1979, even in modified form, is highly unlikely even well beyond 1991.

Since the ultimate Persian Gulf oil disruption is generally equated with the closure of the Strait of Hormuz, I would like to address myself to this possibility in discussing the disruption potential and its impact. Before discussing the volumetric and market impact, I would like to briefly speculate on the likelihood of its occurrence. I believe it would be very difficult for any but a major military power to achieve and maintain the closure of the Strait for commercial shipping. The importance of the Strait to international shipping is such that Europe, the U.S., Canada and Japan would all, probably jointly, have to and want to take action to end or prevent any attempted full or partial closure of the Strait. Any country contemplating its closure knows this, of course. Furthermore, the closure of the Strait would immediately do much more harm to such Persian Gulf oil exporters as Iran, Kuwait, Qatar and the United Arab Emirates than to their customers, since all oil exports from these countries would cease. Saudi Arabia would be able to increase its pipeline exports by up to 2 million B/D, but would still see its total oil exports cut almost in half if the Strait were closed. Thus, both exporters and importers would want to do everything in their power to prevent or reverse such an event.

If it had occurred in 1987, about 8.3 million B/D of crude and product exports (of which 8% would be natural gas liquids) would have been shut in. Full utilization of Saudi Arabia's pipeline capacity to the Red Sea could have offset the loss by nearly 2 million B/D. Full capacity production in all countries outside the Persian Gulf would have added another 3.0-3.5 million

B/D. Thus, with the full cooperation of all oil exporters, the shortfall could have been reduced to approximately 3 million b/d. The U.S. alone, as pointed out, could meet the entire shortfall by drawing down its SPR at the maximum rate of 3.5 million B/D. Of course, under the International Energy Cooperation agreement other countries would also be expected to share in drawing down reserves to offset the shortage. There are, however, some differences between country views of when to tap these strategic reserves. The U.S. Administration is committed, correctly I believe, to tap the SPR at the beginning of a disruption. Other countries may have different time schedules.

There is no doubt that at the beginning of any such disruption world oil prices would rise sharply. But under reasonable assumptions of increases in non-OPEC production and government stock draw-down rates the price increases would level off and reverse themselves once the replacement system becomes visibly operative. Of course, if the closure lasts more than a couple of months with no immediate end in sight, the market might well be overtaken by fear and prices would soar. However, as I said earlier, I don't believe the Strait of Hormuz could or would be blocked for any extended period of time.

The dependency of the U.S. on Middle East oil at the time of a disruption is significant but not essential to our ability to cope with the crisis. For any major oil disruption anywhere in the world would affect all export prices, regardless of where the shortage occurs. In the first 4 months of 1988 we imported 1.3 million B/D of crude oil and products from the Middle East. This represented 19% of our total oil imports (for crude oil

alone the share was 25%). In 1987 the Middle East's share was 17% of total oil imports; in 1985 it was under 7% and in 1977 it peaked at 29%.

In closing, I would like to make one point which is not related to today's inquiry but which I think is potentially quite important for the U.S. energy sector, the U.S. economy and our national security. I'm talking about a development causing exactly the opposite effect of a disruption -- a collapse of OPEC and, with it, of the world oil price system. The risk of such an occurrence in the near future is far greater than that of a sustained major supply disruption. In a free fall the world market price could drop to \$10 or less and stay there for several years before market forces would begin to push it up. The drop would cause major financial crises in all OPEC countries, with those in the Middle East probably less severely damaged than the others. It would have equally negative effects on major non-OPEC exporters such as Mexico, Egypt, Colombia, Malaysia and Angola.

Above all, the relatively high-cost U.S. and Canadian oil and gas producing industry could not survive very long in a \$10 price environment. The price drop would of course have a significant anti-inflationary impact. But inflation is hardly a major problem for the U.S. economy just now. However, a severe recession in all U.S. oil and gas producing states might become a major national problem.

This is not the time or place to suggest public actions to offset or at least ease the impact on the U.S. economy of a sustained price collapse. Nor am I suggesting that such a

development is imminent. But if we prepare for energy emergencies, I believe we should treat the possibility of a price collapse at least as seriously as that of a foreign oil disruption, probably more so.