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OPEC and the U.S. Oil Market: Needs and Opportunities

by

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Rising U.S. Oil Imports

The single most important development in the world oil market since the price collapse of 1986 has surely been the trend reversal in U.S. oil imports from a steady decline in the first half of the 1980's to the steady increase in the second half. This year's net U.S. oil imports are likely to exceed 7 million B/D, compared to 4.3 million B/D in 1985. Directly or indirectly, all of the increase has to be supplied by OPEC, the world's reluctant but consistent swing producer. This means that over 2/3 of OPEC's production increase since 1985 (from 16 to 20 million B/D) is due to the rise in U.S. import requirements. As a share of the increase in OPEC's exports the percentage is even larger.

Not surprisingly, OPEC's benefit from this development is viewed with apprehension in the U.S. Most U.S. policy makers as well as the public at large prefer declining imports to rising imports and are as concerned about the new trend as they had been pleased by that in the first half of the decade. The rational explanation for their concern is that above a certain level oil imports "threaten to impair the national security" (the still applicable formulation used in 1957 when the first oil import restrictions were imposed). More recently, the impact of these imports on our trade deficit has also become a matter of concern.

Both concerns are valid. But underlying them are the lingering aftermaths of the shock of the price explosions and physical supply shortages of 1973/74 and 1979/80. The gasoline lines and the 50% and 100% price increases have become an American trauma which is continuously revived by the media and politicians, not as reminders of the past but as predictions of what will inevitably happen if our oil import dependence keeps rising. The validity of these predictions is certainly questionable but their emotional appeal is effective, particularly since virtually all forecasts agree that U.S. oil import dependence will grow throughout the 1990's. Thus, what would be a boon for OPEC is becoming a scare for the U.S.

U.S. Policies

The U.S. is of course not the only industrial nation with a high dependence on foreign oil. In fact, most industrial nations import a much higher proportion of their oil requirements than we do. Yet, while these nations are also concerned with excessive import dependency and have taken measures to reduce or prevent it, they are far less worried about its strategic and economic ramifications than the U.S. One reason may be our perceived super-power status. We are concerned that a growing foreign dependency for this essential commodity may somehow proscribe our freedom of action in world affairs. The other difference is of course that the U.S. is still the world's second largest oil producer and that the remaining resource in the ground is not only a function of immutable geology but also of technology and economics. Therefore, the U.S. has policy options to increase domestic oil supplies while most other oil importing industrial nations do not.

a) National Energy Policy

This brings me to my next point, a U.S. National Energy Policy. As you know there has been a widespread demand in the U.S. for a comprehensive National Energy Policy. The new Secretary of Energy has recently committed himself to submit one to Congress within the next 12 months. Of course, we already have a National Energy Policy, but a passive one. Since the early 1980's it has been U.S. policy to leave the determination of supply, demand and prices primarily to market forces. This policy is not borne out of neglect or disinterest in energy matters but reflects a conscious decision to let the market work, imperfect as it may be, rather than reimpose direct government intervention on the U.S. energy sector. Those who clamor for a National Energy Policy generally define it in terms of an overtly activist policy and therefore reject the existing one as a non-policy.

It is of course possible to stimulate domestic oil production and curtail demand by various forms of legislative or regulatory market intervention. The question is at what cost? For instance, a significant import fee would probably bring about a moderate increase in U.S. production. But if the cost of that increase is a higher price for all U.S. oil supplies as a result of the fee, the incremental barrels of domestic oil would probably cost a high multiple of the price of foreign oil. On the demand side there would be the domestic inflationary impact of higher energy prices and the international competitive impact of raising U.S. energy costs relative to those prevailing abroad. For these and other reasons I believe that unless world oil prices drop radically and for an extended period our National Energy Policy will continue to let market forces be the predominant factor in determining the level of U.S. oil imports.

b) National Environmental Policy

However, another national policy which will have to be activist is likely to affect our future level of imports. I'm talking about our emerging National Environmental Policy. This policy must be mandatory since the market on its own will not curb energy consumption, change the composition of energy products or switch to alternate fuels, all for the purpose of reducing air pollution. Up to now, environmental legislation and regulation has generally affected only the *quality* of oil products, primarily gasoline and residual fuel oil. In the future we are likely to see some mandated or subsidized fuel switching in the transportation sector from gasoline and diesel fuel to methanol, ethanol blends and compressed natural gas. The fuel switching will be small at first but by 1995 it will be statistically significant. We can also expect the fuel efficiency standards of new vehicles to be raised during this period and we may see an increase in the motor fuel excise tax for the purpose of lowering demand.

From the early 1990's on the combination of these factors could well end the uninterrupted growth in gasoline demand since 1983 which has raised demand by nearly 900,000 B/D. The growth in diesel fuel demand for transportation which has been quite

significant in recent years will probably also be dampened from the early 1990's by the effects of environmental regulations. Thus, environmental policies -- national, state and local -- are likely to have a bigger impact on future oil demand than any national energy policy.

The Inevitability of Rising Imports

U.S. oil consumption will still continue to rise under these conditions but at a very modest and probably declining rate. By 1995 it may be 3-5% above this year's. Since domestic oil production will continue to decline during this period (with Alaska joining the Lower - 48 after 1990) the growth in U.S. oil imports will continue, all rhetoric about the need and determination to reverse it notwithstanding. Of course, some action, such as tax incentives, should and probably will be taken to slow down the current decline rate in Lower - 48 production. But even if all this reduces the 1995 net import level somewhat below the 9.5 million B/D projected in the Department of Energy's latest Base Case, the U.S. will still remain the world's biggest growth market for oil imports during this period. Barring a serious recession, OPEC can count on this.

Oil import dependency is not risk free. But if a growing dependency is inevitable the U.S. must try to cope with the risks. The biggest ones are not explosive price increases maintained by OPEC cartel action nor political oil embargoes by foreign suppliers. Both were tried and failed and eventually backfired on those who had initiated or supported them. I think the private and public comments by most OPEC oil ministers over the last several years that the events of 1973/4 and the price strategy of 1979-82 were major mistakes which must not be repeated can be taken seriously. And of course their appraisal of the consequences of a repetition of these events is essentially correct.

However, this still leaves one major risk: an oil disruption not by design but as a by-product of an extraneous event such as war, revolution, sabotage or even a major accident. All of these have affected oil supplies in the past and could of course do so again. The disproportionately large and steadily growing reliance of all major oil importers on the Middle East raises the risk of the occurrence of such an event.

Managing the Risk: The Strategic Petroleum Reserve

a) A Necessary Cost

The U.S., along with most other industrial oil importing countries, is protecting itself against this risk by building up a Strategic Petroleum Reserve (SPR). In the U.S. this reserve is built, owned and administered by the government. The SPR contains currently 571 million bbls. These can be drawn down and distributed at a rate of 3.25-3.50 million B/D for about 4 months and at declining rates thereafter. Since 1985 the growth rate of oil

imports has been faster than that of the SPR so that the number of days of net imports covered by the SPR has dropped from 96 in 1985 to 81 days in the first half of 1989. If the import cover is to return to the Administration's desired 90-day target, the SPR would have to attain 850 million bbls by 1995 and probably 1 billion bbls by 2000. The Senate recently voted to expand the SPR's ceiling from 750 million bbls to 1 billion bbls.

The problem is how to finance this growth. At the current annual fill rate of about 60,000 B/D the days of imports covered will be well below 80 by 1995, given our rising import level. Yet, the federal funds for even just maintaining the current fill rate are in jeopardy, particularly if oil prices should rise from 1990-91 on. Congress is therefore looking into alternative means of financing the desired growth in the SPR. One of these alternatives has international implications since it would involve foreign suppliers.

b) An OPEC Opportunity

Most major producing countries in the OPEC group have substantial readily available excess producing capacity which is not utilized under the OPEC production quota agreement. However, if any of these countries were to supply oil for the SPR out of their unutilized excess capacity, it would arguably not be a violation of the intent of the OPEC quota agreement, since the oil would not go into the market but would remain in controlled non-commercial storage until a supply crisis of some visible magnitude develops and the oil is needed to ease the shortage. Since several OPEC countries have sufficient proved and probable oil reserves to maintain any economically and technically realistic production level for 50-150 years, the present-day cash value of their marginal barrel of oil reserve is very low. It might therefore be in these countries' economic interest to sell or lease this oil to the SPR at prices or fees which have no apparent relation to the current market values for their crude oil. If they *sell* the oil they will earn a current positive cash flow from the transaction as long as the price is perceptibly above their actual production and other direct costs.

If the U.S. government were to *lease* incremental SPR oil from these OPEC suppliers, for storage in our facilities, the annual cash cost might be even lower, since the leasing fee paid to the supplier would likely be less than the purchase price of the oil under the above described conditions. A primary contract clause would specify that the oil is under U.S. custody and control, although title would formally remain with the supplier. This would facilitate its exemption from OPEC quota controls. The terms of the lease would have to be negotiated as would the ownership of the oil after expiration of the leasing contract. Aspects such as the price on drawdown also require consideration and clarification. It should be pointed out, however, that while leasing SPR oil instead of buying it at market prices reduces the annual cash expenditure, the cumulative cost over time is likely to be the same (or perhaps even more) for the U.S. Thus, the advantage is primarily the reduction in annual budget outlays.

The communality of interest between buyer and seller in a transaction of this nature is based on the assumption that the U.S. government wishes to procure incremental volumes of crude oil for non-commercial purposes and cannot pay the commercial market price for these incremental volumes. The supplier, on the other hand, should be interested in providing oil at a profit from his unused surplus which would otherwise remain in the ground and earn no money at all for a very long time.

Conclusion

In conclusion, I would like to say that U.S. policy on oil imports to the mid-1990's is likely to be a mixture of public emphasis on the need to restrict the growth in imports and tacit acceptance of the inevitability of continuing growth. However, the *rate* of growth could be constrained by new government policies such as tax incentives for drilling, higher fuel efficiency standards for motor vehicles, giving gas preference over oil in electric power generation, etc. Any indication that "OPEC is back in the driver's seat," as the widely used editorial and speaker's phrase goes, and can push up oil prices at will, would of course strengthen the government's resolve and public support for a more activist policy.