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Rising Oil Imports: Inevitable and Manageable

Statement before the Committee on Foreign Relations, U.S. Senate

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Table of Contents

- Import Dependency Inevitably Will Rise 1
 - The Role of the Middle East 2
- Living With Higher Imports 2
- SPR: The Only Surge Supply 2
- Diversified Supply Sources: The Best Defense 3
 - Allow Access to Promising Areas 4
 - Offshore Activity 4
 - ANWR 4
 - Remove Impediments in Existing Provinces 5
 - Provide Targeted Incentives for Production 6
- Fuel Mandates Are Undesirable 7

I would like to start my testimony with a brief comment on the Commerce Department's recent report on oil imports and national security. While we do not subscribe to the Department's findings that "petroleum imports threaten to impair the national security," we do agree with its conclusion that for the U.S. economy as a whole the positive impact of the low oil prices throughout the period under investigation outweighs the negative impact of these prices on the domestic oil producing industry and that therefore no governmental action should be taken to raise the price of imported oil.

The Commerce Department report recommends that the Administration continue its various existing policies designed to reduce at least the growth in U.S. oil imports. We believe additional measures not mentioned in the Commerce report, should also be enacted for this purpose. As we pointed out in our testimony for that inquiry, these measures should not be viewed as a response to a national security threat but as national domestic policy measures to provide support to a vital major regional industry. With one market price, a barrel of domestic oil is economically and commercially preferable to a barrel of imported oil.

Before discussing the additional measures that might be taken I would like to briefly reiterate our position on oil imports.

Import Dependency Inevitably Will Rise

The Commerce Department report accepts the Energy Information Administration (EIA) projection that the share of imports will rise from 45% in 1994 to 51% by 2000. Other forecasts show somewhat different growth rates but virtually all forecasts project a growth in U.S. oil imports to 2000 and well beyond. Thus, our growing reliance on foreign oil is an irreversible reality for the foreseeable future.

This puts us in the same category as most other industrial and industrializing nations. But most of them have a much higher dependency ratio than we do. Japan, France, Germany and Italy are all in the 95-100% dependency range. The European Union, even with its large North Sea production, has a 60% average import dependency. Thus, the only thing unique about our import dependency is that even by 2000 it will still be well below that of most other industrial or industrializing nations.

The Role of the Middle East

Since the Middle East, based on its historical record, is perceived as the world's least stable oil exporting region, the question of U.S. dependence on this region has played an important role in the "oil imports and national security" debate. In 1994 19%, or 1.7 million B/D, of our gross imports came from the Persian Gulf. This was a reduction from 21% in 1993 and 23% in 1992. Those concerned with the insecurity of this supply region may view this decline as progress. Actually it is irrelevant as a national security consideration. There is a single world oil export market with a single oil price (after allowing for quality differentials). Any disruption anywhere large enough to affect world oil supplies causes the oil price to rise globally, including U.S. domestic prices.

Given the fact that the Middle East contains 2/3 of the world's proven oil reserves and that its reserve/production ratio is nearly 100 years, compared to 21 years for the rest of the world, the Middle East's share of inter-regional oil exports (currently 47%) can be expected to grow for the foreseeable future. Will the Middle East countries provide these growing quantities of exports? There can be no doubt that they will want to. All of their economies are in a relatively poor state, they all need additional income to survive economically and politically and oil exports are practically their only source of hard currency earnings. Thus, there is true economic interdependence between the world's principal exporters and the importers of oil.

Living With Higher Imports

The risk of Middle East oil becoming a pawn in the East-West contest has of course ended with the Cold War. The Commerce Department report recognizes this in its findings. However, future disruptions of oil supplies from the Middle East or some other major oil exporter may still occur. They will probably be a by-product of domestic or regional conflicts. The disruptions will be limited in time but while they last could be quite large. One essential tool to alleviate the impact of such disruptions on the market is the ready availability of reserve supplies designated for this purpose.

SPR: The Only Surge Supply

Our Strategic Petroleum Reserve (SPR) has been created for precisely this purpose. It is the only source from which we can draw "surge" supplies in case of an import disruption for whatever reason, including a technical breakdown in

a country's transportation or export facilities. At its current level the SPR could supply an average of 2 million B/D for an 8-month period and a higher volume for a shorter time. If one considers that the largest disruption in recent history -- Iraq's invasions of Kuwait in 1990 -- caused an initial global loss of 5 million B/D which was fully offset by production increases in other OPEC members within 5 months, it is clear that a single emergency supply source of the magnitude of the SPR can play a major role in mitigating the impact of a supply disruption.

As a member of the International Energy Agency, the U.S. is obliged to have some form of stand-by mechanism to deal with a supply interruption. Some IEA member countries have pledged to impose rationing and demand controls, an avenue that would lead to an unenforceable web of regulation and bureaucracy in the huge U.S. oil market. Since our domestic crude oil production is almost always at capacity and oil companies normally carry no more than their operating inventories, the SPR is the most efficient and cost effective tool for managing the impact of a supply disruption.

Diversified Supply Sources: The Best Defense

Since the U.S. will remain vulnerable to supply interruptions, augmenting and diversifying our supply sources should be part of our energy policy.

Many countries are now encouraging exploration and production activity through more attractive contract terms, enhanced access to potential production regions, and new development projects for existing production areas. U.S. oil companies, contract drillers and service companies are the core of this global effort. The U.S., however, has recently followed a different course in the development of its own resources. We should take advantage of U.S. company expertise and technology for new upstream initiatives *domestically*:

- ◆ *Allow access* to promising exploration and production areas;
- ◆ *Remove impediments* to exploration and production in existing production provinces;
- ◆ *Implement targeted incentives* for certain high cost production.

In recent years, the star of the U.S. upstream segment has been the offshore arena. Production in the Lower-48 federal offshore has risen by 16% in the last five years while Lower-48 onshore production has fallen by 16%. New technology has facilitated deepwater projects, allowing development of

previously inaccessible resources. In addition, larger companies have sold offshore properties to independents, thus bringing new players to offshore activities. U.S. policy could have a positive effect on both of these trends.

Allow Access to Promising Areas

Historically, the larger oil companies have focussed their exploration and production efforts on the larger, potentially more rewarding plays such as those found in frontier areas. Deepwater drilling technology has now allowed these companies to explore and produce from the frontiers of the Gulf of Mexico.

The independent producers have traditionally dominated the densely explored mature production plays of the Lower-48 onshore. The risks and rewards are more predictable and therefore, lower. However, some of the new technology (and the computer power to analyze it) is the new levelizer: frontier exploration has now become feasible for a wider range of companies. (New technology may also allow additional recovery of the 2/3 of onshore reserves now left in the ground as fields play out.) Thus, increased access to promising exploration and production prospects will benefit both large and small companies and is in the interest of the nation and the region. It is therefore surprising that the Commerce Department report did not address this critical issue.

Offshore Activity

The U.S. offshore, the area with the most exciting new developments and an historical engine of industry and regional activity, is currently subject to limitations on access. Almost all of the Outer Continental Shelf is under leasing moratoria. Only the Western and Southern Gulf of Mexico remain active lease areas, while the North Atlantic, most of the Mid- and South Atlantic, the Straits of Florida, the Eastern Gulf of Mexico, the Pacific Coast off California, Oregon and Washington, and most of the Outer Continental Shelf off Alaska are all closed to leasing. The U.S. is thus precluded from the benefits of increased petroleum supplies from these potentially prolific areas.

ANWR

There is a high probability that ANWR contains North America's largest remaining oil structure. The American Association of Petroleum Geologists speaks of "Prudhoe Bay or Middle East caliber resources." Yet, oil drilling has been prohibited there since passage of federal legislation in 1960 establishing the Arctic National Wildlife Range (changed in 1980 to a much expanded Arctic

National Wildlife Refuge). The debate is entirely over Area 1002 in ANWR's coastal plain.

The regional public interest is tangible and calculable: Alaska's populace and leaders have judged that the environmental risks in Area 1002 are far less than the potential economic benefits if commercial quantities are found there.

The national economic interest in drilling for oil in the ANWR coastal plain is also tangible and calculable. Every barrel of oil produced domestically reduces our national trade deficit and increases domestic investment and employment. A concrete example: there is no question that world oil prices were significantly lower and the U.S. economy stronger throughout this period than if Prudhoe Bay had not been allowed to operate. In the 17 years since production started on the North Slope, nearly 11 billion barrels of oil have been produced, reducing U.S. oil imports by an equal amount. This year, Alaskan North Slope oil is still reducing our net import requirements by 17%, or almost \$10 billion, and it will continue to be a major oil supply source for another 10 years at least.

The claimed environmental negatives, neither tangible nor calculable, do not offset these indisputable economic positives. There is no agricultural or marine industry and no tourism, camping or other forms of recreation in Area 1002. The area is very sparsely populated, has a harsh climate and is not considered scenically attractive. It is fortunate for the U.S. that its largest remaining unexplored oil deposit is located in such a remote area. According to a principal North Slope operator, only 2,000 acres would actually be required in Area 1002, or a little more than one-tenth of one percent of ANWR's coastal plain or one-hundredth of one percent of all ANWR. If no oil is found--still a distinct possibility--the "footprints" left by the exploring companies will be quite small since no pipelines, storage tanks, pumps or permanent housing will be built. Thus, in the case of failure, most traces of exploration activities can be erased as the companies leave. It appears that the environmental activists have decided to draw a line in the tundra and oppose ANWR drilling as a symbolic statement, an assertion of environmental ideology which does not lend itself to cost/benefit analysis.

Remove Impediments in Existing Provinces

A variety of measures impede exploration and production activities in existing provinces. Some of these rules and/or limitations are vestiges of earlier debates and concerns, such as the prohibition on exports of Alaskan North Slope oil. Some started out to protect the environment and went awry. An example of

the latter are the onerous financial responsibility provisions under the Oil Pollution Act of 1990 (OPA).

OPA has had some salutary effects, including driving home its primary lesson: "Don't spill." In contrast, the financial responsibility requirements it imposes on offshore operators are likely to create a spate of negative consequences -- barriers to small companies' participation in offshore projects, premature lease abandonment, reduced royalty payments, regional economic stagnation to name but a few -- while providing no positive benefits. The mismatch of costs and benefits comes from a misunderstanding about the environmental danger of offshore operations in the U.S. Gulf of Mexico.

The framers of the Oil Pollution Act (OPA) applied its "polluter pays" principle by imposing a requirement on potential polluters that they show evidence of their financial capability to pay for a spill. Under OPA the required amount has been raised from the prevailing \$35 million to \$150 million. This is a real disincentive for the smaller independents and over time would affect the level of OCS production.

Provide Targeted Incentives for Production

Targeted incentives for certain high-cost production are good national policy. Properly designed, they will increase exploration activity and production volumes. Tax revenues and royalties will increase for the federal government. Support activities will boost regional economic activity including jobs, investments, and tax collections at all levels of government.

Several members of Congress have recently put forward proposals to provide relief for producers. One such bill would provide royalty relief for production from deepwater on the Outer Continental Shelf, a program which is also part of the Administration's plan for producer relief. The bill is aimed at projects that would be uneconomic without abatement, an all-important qualification. The appropriate incentives will not be designed to pay producers for production they would have undertaken without aid, as any tax or royalty relief on such volumes will be a net drain on the Treasury.

Fuel Mandates Are Undesirable

The Energy Policy Act of 1992 assigns a relatively small designated segment of the U.S. market for new automotive vehicles to alternative fuel vehicles (primarily natural gas and electric). The California state legislation mandates a much larger share of its vehicle sales particularly after 2002, for alternative fuels vehicles. The intent of both mandates is to reduce *air pollution*.

The question has been raised whether it would be in the national interest to expand these alternative fuels mandates in order to reduce oil imports since oil is the base for almost all road transportation fuels. Yet, any significant reduction in oil imports by this means would take many years and would require a long-term massive mandate of alternative fuels vehicles. There is currently virtually no market demand for such vehicles: the EIA estimates that by the year 2000 the purchases of alternative fuels vehicles by *preference*, rather than mandate, will be less than 1% of total new vehicle sales; by 2005 their share will be about 1.5% and *all* alternative fuels vehicles in operation by then, including those mandated by federal or state legislation, are estimated to consume the equivalent of not quite 2% U.S. oil imports. Any attempt to significantly increase this percentage would require a major government intervention in the U.S. automotive market.

Since the first energy crisis in the early 1970's there have been many "solutions" proposed to reduce oil imports through government market intervention, from President Nixon's "Project Independence" to the Synfuels Corporation, to President Carter's National Energy Act which included provisions to dictate fuel choice in electric power and industrial plants. None of them worked and all were abandoned in favor of free markets. An expanded mandate to move to alternative fuels vehicles would probably share the same fate for the same reason. That does not mean alternative fuels vehicles have no future in the U.S. As their technology improves and the infrastructure builds up they could well over time become a significant component in the U.S. transportation sector. The government is justified to give research and test market support to this infant industry. But reduction of oil imports should not be a consideration in the government's policy on alternative fuels.

In conclusion, I would like to reiterate my two principal points. The government should not engage in largely futile but commercially harmful market intervention in an attempt to control the level of oil imports. But it should take additional steps to encourage more U.S. oil and gas production, particularly in its frontier areas.