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LOWER OIL PRICES AND THE CONTINUING IMPORTANCE OF THE SPR

Statement before the
Subcommittee on Fossil and Synthetic Fuels

of the

Committee on Energy and Commerce

U.S. House of Representatives

by

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President

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Once again oil prices have exhibited a discontinuity which will require a reexamination of all aspects of oil economics, politics and strategy. This time the discontinuity is downward which will of course be far better for the U.S. economy than the two upward price explosions of the last decade.

The price decline has come so quickly and under such circumstances that it is still too early to attempt serious price forecasts for the remainder of 1986 or beyond. We do know that the average crude acquisition cost of U.S. refiners which averaged near $27 in 1985 is now moving toward $17-18. One can make a case that it will go down toward the $10 level later in the year or that it will go back up toward the $20 level. Yet, even the upper end of this price range could be described as a discontinuity relative to last year's level which, incidentally, held until December.

The issue at this hearing is how the oil price collapse will affect the U.S. Strategic Petroleum Reserve. Let us start with some obvious general observations which require no calculations or debatable assumptions. (1) The cost of filling the reserve will be much cheaper this year than it was in any year since 1980. However, since filling of the SPR ceased just as the price collapse was occurring, the lower cost will not benefit the SPR unless the existing policy is reversed; (2) the lower prices will over time cause an increase in domestic oil demand and a decrease in domestic oil production, requiring a correspondingly higher level of oil imports; (3) if the new refiner acquisition cost

remains above the $10 level, the impact on supply and demand will be quite small this year but within 3-4 years imports can be expected to be substantially larger than had been assumed last autumn when the decision to limit the SPR to 500 million Bbls was made. The DOE's base price projection then was $25 for 1986 and slightly less for the first half of 1987; (4) since other industrial countries and some developing countries will be affected similarly to the U.S. by the current price decline, world oil exports in the late 1980's should be significantly higher than had generally been expected under last year's price projections.

Let us first look at the impact of the price decline on U.S. imports because of the obvious direct link between the SPR and our import level. Last year net U.S. oil imports amounted to 4.1 million B/D, a 12% reduction from the previous year. This year, the DOE in its latest Short Term Energy Outlook projects under its High Economic Growth Case (which assumes a $20 oil price which the paper's preface calls more realistic than its Base Case), that net imports will amount to 5.31 million B/D in 1986, or more than a million B/D more than in 1985. For the first half of 1987 the Outlook projects an import level of 5.46 million B/D or 0.5 million above the first-half 1986. On this basis one can readily project a net import level of about 6.0 million B/D for all of 1987, particularly if one assumes a somewhat lower price than the DOE's $20. This would mean a 1.9 million B/D, or 46%, increase in imports (exclusive of SPR purchases) between last year and next year.

The 1987 import level would require a 40 million Bbls increase in the SPR volume by 1988 to comply with the U.S.'s agreement with the International Energy Agency (IEA) to maintain emergency reserves equal to 90 days of the previous year's net oil imports. (At a fill rate of 100,000 B/D it would take 13 months to achieve this increase). By and large, the 500 million SPR volume could be considered adequate for an import level not in excess of 6 million B/D. It would permit a withdrawal rate of 3.3 million B/D for the first 90 days and 2.6 million for the next 30 days, followed by a much lower rate for a much longer period.

However, a 500 million Bbl SPR may very well prove quite inadequate in the post-1987 period if imports keep rising because of continued low prices. Such a scenario is far from certain but it is entirely possible. Since the SPR is primarily a national security measure, its administrators must make realistic worst-case, or at least bad case assumptions, rather than rely on a base case to determine its required size. A refiner acquisition cost in the $15 range over the next three years, followed by modest nominal increases in 1989-90 is by no means a worst-case scenario. In fact, for many oil companies and banks it represents their current base case. Yet, even under this scenario an import level of about 7.5 million B/D by 1990 is an entirely reasonable assumption for national security purposes. I would like to point out in this connection that the DOE's Annual Energy Outlook published in January 1985 assumed a 7.56 million B/D net oil import level for 1990 under a $24-25 real (1984) world oil price for the period 1984-90. The 90 day IEA

commitment would require an SPR volume of 675 million Bbls by 1990 under this import level.

The decision to actually go to this level can be postponed for some time. In fact, if the Administration were to resume filling the SPR at a steady rate of 100,000 B/D it would take 3 years to reach just the 610 million Bbls level for which storage facilities and draw-down equipment are already largely in place. Thus, this intermediate SPR target would require very little expenditure outside of the oil itself which currently sells at about 35% less than last year. In fact, on a real (inflation-adjusted) basis it sells at less than in 1974, the first full year of the OPEC price explosion.

It has been suggested that if the U.S. resumes filling the SPR it should buy all its requirements from Mexico since that country's economy may be entering an economic crisis stage, largely because of the sharp drop in its oil export prices. The idea of course has merit. At a 100,000 B/D fill rate and a price of, say, $15/Bbl, Mexico would receive $550 million annually for the 3-year period it would take to raise our SPR to 610 million Bbls. However, since it is Mexico's stated policy to maximize its production at all times, the question has to be asked whether the Mexican oil going into the SPR would otherwise stay in the ground or be sold at about the same price to other customers.

I would now like to turn briefly to the international scene to examine the likely impact of the lower prices on the volume and source of world oil exports.

We have assumed under the $15 case that U.S. oil imports

could be as much as 3.5 million B/D higher in 1990 than in 1985. The rest of the world will of course also consume more oil than it would have under the previously assumed price scenario. Last year the rest of the non-communist world* (NCW) consumed about 30.6 million B/D of oil. An increase to 33 million B/D by 1990, which would mean a 1.6% annual growth rate, may not be unreasonable. Based on this price scenario a free-world (NCW) demand of 50-51 million B/D in 1990 is a plausible assumption for public policy planning purposes.

NCW production outside the OPEC countries may well remain flat under this scenario, with declines in the U.S., Canada and perhaps the U.K. North Sea offsetting increases elsewhere, and with Mexico financially unable to raise its productive capacity above the current level. Thus, the entire increase in free world consumption of 3.5-4.0 million B/D would have to be supplied from OPEC, as would be the offset to any decline in net exports from Communist countries.

The non-Middle East members of OPEC have current excess producing capacity of about 2.3 million B/D but under current price conditions it is steadily declining. Thus, by 1990 Middle East exports may well have to supply about 2.5 million B/D of the incremental world export requirements. There would be no problem in achieving this, since Middle East producers

*Excludes internal consumption in the Soviet Union, Eastern Europe and the Peoples Republic of China.

have 8-9 million B/D of excess producing capacity at present, even considering war time constraints on Iranian and Iraqi production. But it would raise total Middle East oil exports from last year's level of about 8.5 million B/D to above 11 million B/D by 1990.

The importance of this increase lies in the fact that the Middle East is, and is likely to remain, one of the most insecure areas in the world, politically and strategically. Thus, as the industrial world becomes once again more dependent on this region for its oil, the need for protection against potential large scale interruption grows of course. The planners of an adequate strategic petroleum reserve for the U.S. must look at these entirely possible developments over the next 3-5 years in deciding the required level.

It is easy, and probably correct, to argue that an oil interruption that requires the U.S. to draw down more than 3.3 million B/D for the first 90 days and more than 2.6 million B/D for the next 30 days is unlikely under the scenario just outlined. But defense measures, and the SPR is clearly a defense measure, are not based on likely scenarios but on unlikely but realistically possible deviations from these scenarios. Otherwise, there would be little justification for our enormous military expenditures.

Oil supply interruptions are not just a hypothetical possibility. They have actually happened several times, with severe impact on the economies of importing countries. If we have a sufficient cushion of protection, we can avoid a repetition of these events, or avoid having to take far more

drastic actions if and when they do occur. This may be the least expensive way to purchase the most security in this particular area.

In closing, I would like to point out that if the suggested higher SPR level, or even the present level, should at some future time be found to be excessive, the necessary corrections can of course be made simply by selling the excess volumes at prevailing market prices which may well be higher by then than they are now.