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OPENING REMARKS

BY

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CONFERENCE ON

COPING WITH A PETROLEUM MARKET SURPLUS:

STRATEGIES IN THE 1980's

MAY 24, 1982

The theme of our Conference "Coping with a Petroleum Surplus-Strategies in the 1980's" actually represents a forecast. Hence, it is inherently speculative. I'm not even sure all speakers and panelists at this conference agree with this particular forecast. I've seen projections showing a progressively tightening world oil market from the mid-1980's on, as well as some showing a far bigger surplus than we assume. So, let me briefly explain to you the economic premise underlying the theme of this conference, as we see it.

First of all, what do we mean by surplus? Essentially, that substantially more crude oil will be physically, technically and logistically available than will be required throughout the remainder of this decade, and that the same will be true of crude oil refining capacity and, at least in the U.S., distribution facilities.

This definition, whatever its accuracy for the future, is of course a correct description of the present situation. Currently available world crude oil producing capacity (outside the Communist Bloc and China) is some 14 million B/D, or 35%, above current production of about 40 million B/D, while world refining capacity may be 55% in excess of current refined products demand of about 43 million B/D. These numbers have been on that order of magnitude since the beginning of the year.

It may seem strange that the producers and refiners of crude oil should have built this enormous, costly excess capacity. But it was planned and constructed when the industry still considered itself to be a growth industry. Actually, until quite recently it was. The oil industry's growth phase ended less than 3 years ago, following the second oil price shock, not the first one. From 1975 to 1979 world oil demand registered an annual growth rate of 3.4%. This rate was less than half that of the pre-1974 period. But if oil demand had continued to grow close to that rate, say 3% annually from 1979 on, which then was considered a very reasonable projection, demand this year would be 56 million B/D, or about 10-11 million B/D more than will actually be needed. Thus, had the price explosion of 1979/80, with its impact on demand, not occurred, world excess producing and refining capacity today would be just about adequate, perhaps slightly on the high side. Three years ago this was the best outlook for 1982. The historically unique decline in demand which occurred during these three years was neither foreseen nor forseeable. But it has changed everything. And it left us with an excess capacity that will still be substantial in 1990.

This is where we turn from facts to forecasts; and forecasts are based on assumptions. The most important assumption underlying any supply and demand forecast is of course the <u>price</u> of the commodity. As we have seen, the price explosion of 1979/80 has rendered all previous forecasts meaningless, no matter how reasonable they seemed at the time. The same thing may of course happen again. For instance, any extraneous political-military event interrupting Saudi export ability for a period of time is likely to send prices soaring once more, although we are now probably better prepared, psychologically, organisationally and physically (emergency stocks) to deal with an interruption than we were in 1979.

Perhaps, the next time prices will return approximately to their previous level once the interruption is over. If not, the economic hardship of the next price explosion, if there is one, is unlikely to be limited to the oil importing countries. The negative impact of the price increase on demand and the positive impact on new supplies would certainly increase whatever excess capacity exists at the time, thereby endangering the prevailing price structure. To a limited extent we have already seen this sequence of events at work following the 1979/80 price increase.

It would therefore be in the oil exporters' own longer term interest to let prices return toward the previous level, following a temporary supply interruption. Whether such longer term considerations would actually prevail over shorter term desires for revenue maximization under these circumstances is one of the uncertainties in price forecasting. We do know, however, that the governments of the principal exporting countries were surprised and concerned by the strength and length of consumer reaction to the last price surge. They may have learned from this experience.

In the absence of a major interruption we expect OPEC to continue to play an important role in determining the price of oil. This becomes clear from our conference theme of a surplus throughout the 1980's. If OPEC were to lose its price setting ability, the nominal price of oil would drop rapidly and substantially. Over a period of time this would significantly restimulate demand and deter the development of new supplies, both alternate energy sources and oil. We have already seen what a relatively minor price drop has done to the U.S. and Canadian synfuels industry. The inevitable eventual result would be an end to excess producing and refining capacity and a consequent market oriented price increase. If OPEC prices were to break this year or next, I believe the end of the surplus would come in the second half of the 1980's.

As you know, there has been considerable controversy among forecasters about the continuation of OPEC's price setting ability. A number of forecasts have predicted the organization's demise in this regard for the current year. Our own view has been different, as those of you who have read our forecasts over the past year know. There is little doubt now that we'll continue to be right for the remainder of this year. We do acknowledge that OPEC could face a very difficult time once again by next spring if world oil demand should continue to fall while production from Iran and Iraq should no longer be constrained by military events.

Nevertheless, our analysis leads us to the conclusion that of the various possible pricing scenarios, approximate maintenance of the existing nominal contract price of the OPEC marker crude at $34 and of the average OPEC contract price at about $33 is the most likely next year, always absent a new major military-political interruption.

Beyond 1983, we have assumed an imprecise but modest nominal price increase, trying to approximate the world inflation rate, possibly rising a bit faster in the post-1985 period. This is the price assumption underlying our theme of an oil surplus for the remainder of the current decade.

The recent OPEC decisions in Vienna and Quito have done nothing to change our assumption. What OPEC has done at those meetings is reminiscent of the functions of the Texas Railroad Commission in the 1950's and 1960's, keeping in mind the limitation of historic comparisons. The Commission's production allocation scheme succeeded in keeping Texas' huge excess producing capacity off the market, thereby protecting the state's and the nation's oil price structure. OPEC is now doing the same and is likely to succeed, since nearly all the world's oil surplus producing capacity is located in OPEC countries.

However, the Texas Railroad Commission also had the support of the Federal government which controlled and restricted the flow of imported oil. OPEC has no way to control the impact of non-OPEC production on its markets. Between 1978 and 1982 the non-OPEC share of world production (outside the Communist Bloc and China) has grown from 47% to 60%. These countries price their oil at their own discretion which does not always coincide with OPEC's. Their impact is likely to curb or at least restrain attempts by OPEC to raise its price in the absence of an underlying real economic need.

As I said earlier, the surplus will be not only in producing but also in oil processing capacity. The excess processing capacity is, and will remain, concentrated in the industrial countries where virtually all of the decline in world oil demand since 1979 has taken place and where there is little expectation of a sustained future growth trend, although some upward adjustment from the exceptionally depressed current level of consumption is likely.

The industrial countries are reacting to this development by shutting down refining capacity. In the U.S. about 2.5 million B/D of distillation capacity, appears to have been closed during 1981. In Europe we estimate that by 1984 well over 3 million B/D will be closed down.

Meanwhile, new refineries are under construction in the developing countries, particularly the oil exporters. In part this reflects the expected growth in internal demand in these countries and in part it reflects export expectations into the industrial countries. Given the excess refining capacity and the flat-to-declining demand trend in these countries, it will be interesting to see how the oil producing countries will manage to export products into the industrial countries.

One might conclude that one positive by-product of this excess refining capacity in the industrial countries is a drop in capital expenditures in this sector of the industry. Such a conclusion would be quite wrong for the next few years. The latest McGraw-Hill survey of capital spending plans of the U.S. petroleum industry shows that refining sector expenditures will rise by 33% this year and another 26% next year, for a total planned increase of $3.3 billion between 1981 and 1984.

The reason for these increased expenditures is of course that the decline in demand is very unevenly distributed among products. Thus, unless the industry greatly increases its conversion capacity, it will produce more heavy fuel oil and less middle distillates and gasoline than the market will require. For the world market for residual fuel oil will continue to decline while that for middle distillates will grow and that for gasoline may remain about where it is, with a continuing decrease in the U.S. slightly more than offset by increases abroad.

Well, so much for the over-view of this conference. The specifics--which are really what counts--will be developed by the various speakers who are of course all renowned exports in their fields. May I close my comments on the theme of this conference with one final observation. An economic forecast is never neutral. Any perception of the future tends to influence the future, the more widely held the perception, the greater its influence. Our view of a surplus throughout the 1980's is by no means a solitary view. Thus, if the industry accepts this view and acts rationally on it, the surplus could well end earlier than we are assuming. This will not mean our forecast was wrong but rather that everybody agreed with it and acted accordingly. Perhaps it does mean that the only forecast likely to come true is one nobody believes!