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**The Impact of the Persian Gulf Crisis on the Oil Industry**

Statement by

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before the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

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Thank you for inviting me to testify before your Committee on the economic impact of U.S. involvement in the Persian Gulf.

You have asked me to comment on the question of "how the Gulf crisis affects the oil industry in the short and long term" and you have listed a number of specific questions on this subject. I would like to address myself principally to these questions in my testimony.

*How will the Gulf crisis affect worldwide oil production?*

The only major impact on production, so far, has occurred within OPEC. As two of its 13 members, Iraq and Kuwait, had virtually all of their oil exports -- about 4.3 million B/D -- effectively embargoed following the August 2nd invasion, the 11 other OPEC members started to increase their production. In November total OPEC production is about back to the 23 million B/D level of last July. In December it is likely to be slightly higher. The most important contributor to restore OPEC production has been Saudi Arabia which increased its output (excl. Neutral Zone) from 5.4 million B/D in July to 8.1 million B/D in November, accounting for over 60% of the 11 OPEC member's total production increase during this period. The next largest contribution has come from Venezuela which has increased its production by 400 M B/D, or 10% of the total increase. Saudi Arabia has indicated that it will raise its sustainable productive capacity progressively to 8.5 million B/D during the first quarter of 1991. The other OPEC members cannot increase their production much more in the short run than they have already done.

Since most non-OPEC oil producers are usually producing at or very near their sustainable capacity, additional production from these countries is relatively small. One somewhat significant increase has been registered in Mexico which raised its production by 120,000 B/D between July and September and its crude exports by 155,000 B/D. On the other hand, Soviet oil production has continued to decline, as have Soviet exports.

U.S. total crude production has also continued to decline but at a slower rate than before the crisis. The principal reason for the slower decline is the increase in Alaskan production much of which had been planned before the crisis started. However, there are signs that the higher prices brought on by the Gulf crisis have stimulated drilling, as indicated by industry rig counts. In the short term, this is slowing (but not reversing) the decline in "lower-48" production.

I would like to point out that even though world oil production is about back to where it was in July, despite the continued near total interdiction of Iraq-Kuwait exports, the world supply/demand balance is not back to normal. One reason is that, unlike before

the crisis, there is virtually no spare capacity left in world oil production. Thus, even a small further supply disruption, be it political, technical, or accidental, would have a disproportionate impact on prices.

### *How will the Gulf crisis affect the price of oil?*

The price of crude has already been raised by more than 75%. The average November price for WTI crude was \$32.50 compared to \$18.40 for the average July price. In view of my earlier comments that world oil production was about back to where it had been before the crisis, one may ask why are prices up by that much. There are two reasons, a structural one and a psychological one. Structurally, world oil demand would have been higher in the current 4th quarter had there been no price increase, while supplies would have been plentiful to meet the higher demand. Thus, the International Energy Agency (IEA) now projects an 0.8 million B/D demand decline for the OECD countries between the 4th quarter 1989 and the 4th quarter 1990. Prior to the crisis it had projected an 0.2 million B/D increase. The IEA ascribes the reversal to "the effects of higher crude oil prices" on products prices "with a downward impact on demand in many countries." The crude oil price used in the IEA projections is \$30. Some of the developing countries have also lowered their oil demand through government intervention because of their inability to pay the higher import costs. In other words, had prices not increased, demand would now be higher, requiring more supplies in the form of higher production and/or a larger stock draw-down. Since production cannot be raised and companies are not willing to reduce their stocks further under existing circumstances, and since the short-term price elasticity of crude oil demand is relatively low, a substantial price increase was required to balance the new supply and demand structure.

Additional upward pressure on prices came, and continues to come, from the fear that an outbreak of military activities in the Gulf would affect Saudi Arabian supplies. There is a very real chance that military action will break out in the region and there is a distinct possibility that when it does some of the region's oil production or shipments will be affected. Hence, current prices include a war premium which moves up and down with the probability of an outbreak of hostilities. I would like to point out that this premium could have been greatly reduced, probably even eliminated, if we, in cooperation with other countries, had drawn down our Strategic Petroleum Reserve(s) at a moderate but ongoing rate -- say 1 million B/D globally -- throughout the crisis. This would still be the case if we were to draw it down now.

### *What about future prices?*

If we assume that the end of the current Gulf crisis will bring an end to the U.N. embargo on Iraq and Kuwait, we can expect a substantial price reduction at that time. The

extent of the reduction will depend almost entirely on the individual decisions of the major OPEC producers whether, and by how much, to cut back their production to make room for the return of Kuwait and Iraq exports.

If we assume the crisis ends sometime in the 1st half of 1991 and all OPEC producers then return approximately to their pre-crisis quotas, prices for WTI crude would likely be in the \$21-25 range for the remainder of the year. The U.S. economy could of course easily cope with this price and domestic producers would consider it sufficient to expand their investments if they viewed it as a floor price for the foreseeable future.

If, however, some major OPEC producers decided to maintain their production at or near their current levels while Iraq and Kuwait sought to reenter the market, the price structure would collapse, i.e. it would go below \$15 for WTI. The U.S. economy would actually be worse off under this price structure than under the higher one described before. The lower price would discourage domestic production and encourage consumption, thereby raising import dependency. Since the low price would have a similar impact on supply and demand abroad, it could not be maintained for more than a few years and would then be followed by sharp price increases. Thus, of the two scenarios described the higher priced one is clearly preferable in the longer run for producers and consumers. It is also the more likely one. However, in several major OPEC countries there are now proponents for a go-it-alone policy in the post-crisis period. One prominent advocate is the chief of Venezuela's national oil company. However, his view is not shared by his country's oil minister.

In the longer run, i.e. from the mid-1990's on, the role of OPEC as a quota allocator will be greatly diminished or might even end. The reasons are (1) the expected upward trend in world oil demand throughout the 1990's at a rate of 1.0 - 1.5%; (2) the near leveling off of total non-OPEC production in the early 1990's; and (3) the consequent growing role of OPEC members individually as the world's marginal producers, supplying most of the incremental oil demand. OPEC's annual production growth rate during the 1990's may therefore be on the order of 2.5 - 3.0%. For the group's Middle East members the growth rate will be still faster. Quota allocations to restrict their production should therefore become obsolete over time. It should be pointed out that the trends I have described will not be very different from those that would have prevailed had there not been a Middle East crisis.

### *What are the consequences of Iraqi dominance of Middle East oil production?*

Throughout the 1980's Kuwait and Iraq had different oil policies. Kuwait wanted low prices and gradually rising export volumes while Iraq's policy was determined by the fact that the Iran-Iraq war (1980-1988) prevented the country from expanding its export volume so that it could only increase its oil export revenue through higher prices. The end

of the war did not immediately remedy this situation, given the time, capital and foreign technical assistance required to expand productive capacity. The fact that Kuwait had large profitable investments abroad and a very small population while Iraq had large foreign debts and a relatively large population also made for different approaches towards long term and short-term oil revenue optimization. As we know, Iraq was very critical of Kuwait's oil policy of consistently exceeding its assigned OPEC quota in order to keep prices low. In fact, it was one of the reasons given by Saddam Hussein for invading the country. Whatever Kuwait's future, it is very unlikely to return to its previous policy in the post-crisis period. Even if it regains its formal independence, its future oil policy can be expected to conform with that of Iraq rather than oppose it. Thus, whatever the outcome of the current crisis, Iraq will have a strong influence over Kuwait oil policy while it had none before.

However, as the current situation has illustrated, if necessary the world market can do without any oil from Iraq and Kuwait for an indefinite period. True, the current embargo has a cost for oil consumers but it has a far bigger cost for the two producers.

The principal reason the embargo on Iraq and Kuwait oil exports is tolerable for those who have imposed it is of course Saudi Arabia's willingness and ability to expand its production to make up for the bulk of the loss. This means that if Saudi oil policy were also to come under the direct or indirect control of Iraq the situation would be very different. Iraq could then effectively dictate world oil policy and all our Middle East policy planning would have to take this into account. Thus, there would be a quantum jump, politically, economically and strategically, from Iraq's control over Kuwait's oil policy to its control over Saudi Arabia's oil policy.

### *What impact will the Persian Gulf crisis have on oil industry profitability?*

When crude oil prices rise, producers automatically receive additional revenue. Refiners and distributors do not. For refiners and distributors, revenues are determined by their margins--the difference between the purchase price of their raw material or supply and the selling price for their products.

Current gross unit revenue is about 75% higher for producers--whether in Texas or Africa or Europe--than it was before the Persian Gulf conflict. In some periods since early August, prices have been twice their pre-crisis levels. There are few immediate increases in costs which must be offset against these revenues. Over time, however, the revenue begins to be plowed back into upstream operations. We have seen the cycle before: drilling activity increases; drilling costs rise; land prices rise; higher cost prospects become profitable. Thus, while the first flush of increased revenue gives rise to an inflated producer cash flow, higher prices, *should they prevail*, enhance the long-term profitability of producing operations through additional investment. However, companies are not making long-term in-

vestment decisions based on the current crisis prices. Most likely, this is a correct judgment.

None of this holds for refiners or distributors. Short-term, refiners have experienced sharply lower earnings. And long-term, a price-induced demand decline will squeeze refiner/marketer margins from what they would have been. By now, it is clear that refiner earnings in the third quarter 1990 were low in comparison to historical standards. Exercising the restraint requested by the President, and constrained by the market, oil companies tempered the pass-through of increased costs to retail gasoline prices. Penny-for-penny, refiners under-recovered their increased crude costs until late October, when falling crude oil prices finally brought the August-to-October crude price rise into line with the rise in gasoline prices.

A recent analysis by Salomon Brothers points out that some integrated companies' earnings are more dependent at the margin on shifts in refinery profitability than on shifts in production profitability. The large integrated companies have widely disparate self-sufficiency ratios (the ratio of owned-crude to crude requirements). The operators on the North Slope, for instance, have more than enough crude oil to meet their needs. Others, even among the largest companies, purchase a significant portion of their crude oil needs. The firms most dependent on purchased crude oil are thus most affected by the volatility of refining margins, and are in fact better off with lower crude oil prices than with higher ones.