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Some Oil Policy Implications of the Middle East Crisis

Statement by

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before the

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The Middle East oil crisis is now nearly three months old. During this period we have seen crude oil prices rise by \$11, or more than 50%, during the first three weeks of the crisis, then by another \$10 by early October and in the last six days we have seen a record \$9 decline of which \$6 occurred in a single day. It is difficult, and of limited use, to analyze a market which swings so widely. We can generalize on at least one point, however: throughout most of the time the price of WTI has been \$30 or more, compared to an average July price of \$18.40. With OPEC production approximately restored to its pre-crisis quota level of 22.5 million B/D and total U.S. and foreign inventory levels at least as high as a year ago, i.e. with no visible shortage, why have prices risen so much? The answer is that absent a price increase there would be a shortage.

Of course, the principal reason, by far, why current supplies are adequate is the decision of all OPEC producers with spare capacity to maximize their output to offset the loss of Iraqi and Kuwaiti oil. Their action was based on policy, not price incentives. Their effort has returned total OPEC production to the 22.5 million B/D volume set by the organization just before the crisis started. However, if prices had remained at the pre-crisis level this would not have been enough. World oil consumption rose by about 2% (weather-adjusted) in the first half of 1990 and would have continued to rise in the second half. Thus, it had been expected that the required OPEC production would be 23.5-24.0 million B/D in the 4thQ 1990 and somewhat more in the 1stQ 1991. In fact, the OPEC Secretariat had recommended a quota increase to 23.5 million B/D for the 4thQ, under the assumption that this quota would have been somewhat exceeded, as has been the case historically. Thus, given the low price elasticity of oil demand in the short term, a substantial price increase was required to balance supply and demand at the maximum OPEC production level of 22.5 million B/D.

Most likely, the price increase would not have had to go all the way from pre-crisis \$20 to the mid-to-upper \$30 range to balance supply and demand at the current production level. However, other factors -- not quantifiable but by no means unreal -- pushed prices up further. The fear of war with its instant threat to Saudi production and exports was a very real concern of all crude oil buyers. Another real concern is the recognition that there is currently virtually no slack in the world oil supply system. Thus, any further disruption anywhere, be it military, political or accidental, would have an instant, disproportionately large impact on world oil prices. Before the crisis the world had a comfortable 5-6 million B/D readily available spare producing capacity.

The price increases brought about by the combination of these actual and potential factors have been large enough to affect the entire U.S. economy. Considering that each \$1 increase in the price of crude oil finally costs U.S. consumers \$6.5 billion annually and that nearly half of this amount goes to foreign suppliers, this is not surprising. We saw inflation in September rise at twice the pre-crisis rate and our foreign trade deficit deteriorate again despite the declining dollar which should have improved it.

Could the government have done anything to mitigate this impact? The answer brings us to the role of the Strategic Petroleum Reserve (SPR), which the Task Force has asked me to comment on. The SPR is the only governmental instrument specifically designed to deal with the economic repercussions of a foreign oil supply disruption. There is no doubt that the SPR could have been drawn down in sufficient volume to keep the crisis-

induced price increase significantly lower than it has actually been. After the market's loss of more than 4 million B/D throughout August, the difference between required world oil supplies under normal conditions and actually available supplies narrowed to one million B/D. Currently, it is less.

The U.S. alone could make up this volume for an entire year and still have nearly 40% of its SPR volume in place. However, a drawdown rate of, say, 600,000 B/D, which would have used up about one-third of current SPR inventories if sustained for one year, would have been sufficient to substantially mitigate the price increases we have experienced. A modest drawdown, 200-300,000 B/D, from Germany and Japan, the only other IEA member countries with government-owned SPR's, would have mitigated the price impact of the embargo still further.

The U.S. Administration and the other IEA members have so far decided against the use of the SPR in the present crisis. Their decision appears to have been based on the presumption that the actual and potential supply situation would get much worse in case of military action and that then would be the time to use the SPR, probably on a massive scale. If that is their approach, it is a judgment--one that may be arguable, but is nonetheless supportable. However, the Administration's publicized argument that so far there has been no shortage, only an increase in prices, does not stand up. Obviously, price changes reflect changes in the supply/demand balance. Thus, a sharp price increase following a very substantial supply disruption acknowledged to have been less than fully replaced from other sources indicates a continuing shortage relative to normal requirements.

It is entirely possible that we will not make use of the SPR during the current oil crisis. In that case the question may well be asked in the post-crisis period whether we need an SPR, or, at any rate, whether we need to spend additional funds to increase it to its new billion barrel target. One answer is that even if we do not use the SPR this time, its very existence and ready availability has greatly strengthened our flexibility in dealing with the Iraqi invasion of Kuwait. Had we not known that we alone could replace 2/3 of Iraq's and Kuwait's total export volume out of our SPR for about 4 months and at a declining rate thereafter we may never have opted for a total boycott of the two countries' exports. And had our SPR now been close to 750 million bbls instead of 590 million (which it would have been had we maintained the fill rate of the 1982-85 period), we would probably have been much less reluctant to use it to counteract the price increase caused by the U.N. embargo.

We don't know how and when the present oil crisis will end. But having now experienced the 4th major Middle East oil supply disruption in 35 years and having witnessed one more illustration of the region's endemic political instability, we must be prepared for further disruptions with attendant soaring price increases and macro-economic damage unless we can effectively counteract them. However, the suggestion, often heard these days, that we can reduce our import dependency over the next decade or so to a level where foreign supply disruptions will no longer matter for the U.S., is unrealistic.

This does not mean that we should not try to constrain our oil import requirements through conservation, fuel substitution and maximization of domestic production. World oil demand will rise throughout the 1990's and beyond. The incremental supply source will be the Middle East, whatever its political constellation. If the U.S., the world's largest oil

importer, can restrain its growth in oil import requirements, there will be less pressure on the Middle East to increase production and more spare producing capacity. However, under any realistic assumption our net import dependency will rise from this year's 43% of total requirements to above 50% in the late 1990's.

I would like to digress for a moment to call attention to the fact that an important contribution to curtailing the future rise in U.S. import dependency would be the opening up of East and West Coast coastal areas and the Alaskan National Wildlife Reserve (ANWR) to oil and gas drilling. The U.S. oil industry's record of many decades of offshore drilling is such that the risk of major environmental damage is minimal. Regarding ANWR, permission to drill was blocked under the emotional impact of the Valdez oil tanker spill in 1989. There is, however, no logical connection between a tanker accident and drilling in the ANWR. The oil industry's 25-years' record of drilling on Alaska's North Slope clearly justifies granting a permit for ANWR.

Let me now return to the SPR. As pointed out earlier, U.S. oil import dependency will not decline but increase during the decade of the 1990. This means that the SPR, the only governmental instrument specifically designed to cope with the eventuality of a disruption, should be expanded when the present crisis ends. I recognize that there are serious budgetary limitations to such an expansion under existing fiscal conditions. I believe therefore that we should revisit the concept of *leasing* oil for the SPR from select foreign producers. Under this concept which was widely discussed last year, certain foreign oil producers with substantial spare producing capacity would supply oil that would otherwise remain in the ground, and lease it to the DOE to fill the government's (non-commercial) SPR storage facilities. The leasing cost would presumably be much lower than the market price of the oil. If and when the oil is used for SPR purposes the lessor would get its value. The arrangements would have to be worked out in bilateral contracts between the DOE and the lessor. The DOE now has the authority to negotiate such contracts. When the current crisis has ended several OPEC countries such as Saudi Arabia, Venezuela and the U.A.E. will have more operative spare producing capacity than before and may be more interested in a leasing arrangement. This may offer a time-limited opportunity for such deals.

Dependence on the Persian Gulf reached about one-third of world oil supply in 1978, just before the last price explosion. The higher prices in the early 1980's brought forth supplies from around the world--from the North Sea, India, Malaysia, Egypt, Angola, among others in the Eastern Hemisphere, and from Brazil and Colombia, primarily, in the Western Hemisphere. Production in the U.S. also rose, because of Alaskan supplies and a massive development effort. The increased supplies from non-OPEC, and particularly non-Middle East, sources shaped the oil market in the 1980's.

Diversification of oil supply sources to reduce dependency on the Middle East for incremental supplies is an important policy to be considered. In general, diversification abroad is the traditional function of private international oil companies and as we have seen in recent years, exploration efforts of the U.S.-based multinational industry have moved abroad. Foreign countries have changed their tax and resource policies to make investment more attractive. But in countries where private foreign companies are excluded or where the political financial risks are too high, U.S. government policy should be sensi-

tive to any opportunities to enable foreign investment. This brings me to the Task Force's request for comments on Mexico and Venezuela.

Mexico's oil revenues have plummeted in recent years due to a combination of lower prices falling production and more rapidly declining exports. Mexico's budget constraints have impaired exploration and production activity in recent years, and a turn-around isn't possible without heavy investment of a scarce commodity--capital. As part of a trade agreement, Mexico might be encouraged to allow investment by U.S. oil and gas firms. Mexico's nationalist stewardship of its resources has been a critical determinant of its investment policy, a policy that has been fiercely adhered to, as is a nation's right. Incremental capital for petroleum investment would have important benefits, largely financial, for Mexico, however, and the current leadership may be more open than its predecessors to some easing in the restrictions; foreign capital has already been allowed into the parts of the petrochemical sector. Further movement toward additional foreign involvement can only come on Mexican initiative.

Venezuela, too, has opened the door to foreign investment in the petrochemical sector, and continues to prohibit foreign investments in exploration and production activity. There may be up to 1.2 trillion barrels of heavy oil-in-place in the Orinoco oil belt, of which 26 billion may be technically recoverable using steam injection. This could probably be done at likely post-crisis prices, but requires substantial capital investment which would likely have to come from abroad. In addition, Venezuela's plans to increase its productive capacity and develop its conventional reserves could be accelerated through foreign investment. A U.S.-Venezuelan governmental agreement might open the door for these investments.

As I look over my testimony, I feel a bit as though it has all been said before. The U.S. must recognize that oil import dependency is part of our energy landscape. We should maximize domestic production and improve conservation to reduce the rise in oil imports and we should encourage diverse sources of foreign supply both for ourselves and other consuming nations. And we must fine-tune our best tool for dealing with a supply disruption once it has happened, namely the SPR.