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The Middle East Oil Crisis: Implications for the U.S. Oil Industry

Presentation by
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Last April when I was invited to address your organization's September meeting I had intended to present a broad forecast based on the assumption that crude oil was gradually moving back into a sellers' market and, accordingly, prices could be expected to rise somewhat faster than the expected rate of inflation throughout the 1990s. Under that scenario the nominal price of crude by the mid-1990s would have been about where it had been in 1985, the year before the Great Price Crash. Now that the new Middle East crisis is entering its 8th week, with no end in sight, forecasts made last spring obviously require some modifications -- short-term and longer-term. Let me start with the very short-term prediction that if the Middle East crisis eases up somewhat, or even if it freezes into a solid stalemate for some time, crude prices will fall from their current $33 level (for WTI). For the present price level reflects considerable war scare. Of course if war actually broke out -- a real possibility, according to many Middle East and military experts -- prices would go much higher. But if the immediate war scare subsides, prices are likely to drop back to around $30. If the U.S. and other members of the International Energy Agency were to draw down their Strategic Petroleum Reserves prices would drop further.

The reason for the expected price decline if war fear abates is that the combination of an unexpectedly large increase in OPEC production, a small increase in non-OPEC production and a likely reduction in 4th Q world oil demand due to the 50-60% crude price increase (the IEA projects a 0.7 million B/D decline in OECD demand relative to its latest pre-crisis forecast) is reestablishing a 4th Q supply and demand balance. However, it is a very precarious balance, with no slack, no flexibility and with even small surprises likely to have an immediate disproportionate impact on prices. If the crisis continues unabated into the 1st Q 1991, prices might move back up above the $30 level, given the required inventory drawdown.

If and when the crisis ends altogether and Iraq and Kuwait, jointly or separately, resume their exports, prices may temporarily fall substantially, partly in standard overreaction to the political turn-around and partly because of temporary excess production, since OPEC's "over-producers" are unlikely to synchronize their output reductions with the return of Iraqi and Kuwaiti exports. However, after this adjustment period crude prices will still be higher than if there had been no Middle East crisis. This higher price level will be one of several longer-term effects on oil prices of the current crisis. There are both short-term and long-term reasons for the higher post-crisis prices. The short-term reason is that Iraq, which was already in deep financial trouble when it invaded Kuwait, will be in far worse shape after several months of zero oil revenues. Whatever government is in charge then will therefore use all its power and leverage to keep oil prices high. Whatever Kuwait's status will be at the end of the crisis, it can be expected to support higher price aspirations, both for security reasons and because it will also have sustained substantial financial losses.

The long-term reason for the price rise is that neither Iraq nor Kuwait can be expected to increase their producing capacity over the next five years along the lines expected prior to the crisis. Iraq clearly will not have the capital for such a project and cannot count on the foreign investment it was seeking for this purpose prior to the invasion. Kuwait is also likely to have other investment priorities than to expand its spare producing capacity when its oil industry becomes operative again. Furthermore, it may be prevented from doing so by Iraq.

All other OPEC members will have more money than before to spend on capacity expansion. Still, the organization's total producing capacity is likely to rise somewhat less

between now and 1995 than if there had been no Middle East crisis. Of course, given our revised price assumption, the demand for OPEC oil will also rise somewhat less during this period. All of which gets us back to our proposition that to balance world oil supply and demand in the post-crisis period (assuming no war-related physical destruction) requires a higher medium-term price level than if the crisis had never occurred. The direct beneficiaries will be all oil producers -- from domestic stripper well operators to international majors and foreign national oil companies. However, to put the benefit in its proper perspective it should be pointed out that the oil price from 1986 through mid-1990 was clearly insufficient for the U.S. since it caused domestic oil drilling to fall to a postwar low in1989.

Now let us look briefly at some other longer-term implications of the current Middle East crisis. Refiners may be negatively affected. Their crude oil costs will rise while the demand for their light products, particularly gasoline, will be reduced from what it would have been otherwise, not only by the crude oil-related increases in the price of these products but also by direct or indirect government intervention in the motor fuel market to reduce consumption in order to lower import dependency. Prior to the crisis the import dependency problem had been assigned a relatively low priority in the government's energy policy. Now it is near the top of both the Administration's and Congress' agenda. The contemplated measures, such as raising motor fuel taxes, increasing mandated automotive fuel efficiency standards or requiring alternate fuels are likely to cause a modest reduction in gasoline demand over time instead of the previously projected modest growth. All of these measures had been previously proposed for environmental purposes. Their new dual purpose makes their enactment much more likely.

The oil import dependency issue brings me to my next point. Since the outbreak of the crisis there has been much talk in the media and in Congress about our "wasteful," "profligate" use of energy, particularly oil and particularly gasoline which the public is widely accused of "guzzling." The clear implication of all this, according to these critics of our oil consumption habits, is that if we had continued to conserve energy as we did in the 1970's and early 1980's, we would not have been affected by the latest Middle East crisis and would not have had to send soldiers to Saudi Arabia to protect the region's oil. There is no doubt that we could, and should, have conserved oil better than we did, particularly in the 5 years since the big price break. However, our record is not bad. Our oil consumption this year will be no higher than in 1980 while our G.N.P. during this period has grown by one-third and our automotive stock by 28%. Suppose we had been much more energy efficient and had realized a maximum reduction in consumption by 1990 of 2 million B/D below our actual consumption. This would have been an impressive gain. It would have given us a net import dependence this year of 39% instead of the actual 45%. If the same Middle East crisis had occurred under this lower import dependence ratio, oil prices would have risen about as much and our rationale for sending troops to Saudi Arabia would have been the same!

As the world's largest oil importer we must try to curb our import growth so as not to push Middle East and other OPEC members to their physical capacity limit. When that happens prices rise on their own, irrespective of OPEC's or anyone else's pricing policy and goal. But we should not delude ourselves that by the year 2000 our import dependence can be much lower than today and that the Middle East will by then no longer be the principal price determinator for world oil.

In evaluating our continuing oil import dependency, we should also bear in mind that normally, i.e. most of the time, it is an interdependent relationship. In fact, the single - commodity economies of most oil exporters are much more dependent on their oil exports than their customers are on oil imports from individual suppliers. Our oil policy must recognize this difference between normal commercial interdependence and the occasional supply disruptions brought on by extraneous events. It should also be kept in mind that in this instance the disruption was brought on by the importing countries' decision to impose an embargo.

Finally, I would like to comment briefly on the impact of the Middle East crisis on the oil industry's public image. Obviously it has deteriorated. There is a widespread perception that oil refiners and marketers raised consumer prices of gasoline prematurely and excessively in order to profit from the crisis. Much has been written and talked about the subject from all sides. I would just like to cite one fact: Since the beginning of the Crisis the increase in the average U.S. gasoline price has been less than the increase in the price of crude oil. This is still the case today. Thus, the gasoline price increase has essentially been only a lagging transmission of the crude oil price increase to the ultimate users of the commodity. It was a market message to consumers that a shortage of the raw material from which their product is made had occurred or was impending. As happens often, the messenger was blamed for the message.

Some legislators, frustrated with the Administration's inability to solve the oil crisis at its root (the Persian Gulf) and sensitive to the public's resentment over the products price increase may decide to punish the messenger since it cannot reach the perpetrator.