PIRINC

Telephone: (212) 867-0052

Petroleum Industry Research Foundation, Inc.

122 EAST 42nd STREET

New York, N. Y. 10168

Statement before the

Committee on Energy and Natural Resources

of the

United States Senate

THE NEAR TERM WORLD OIL OUTLOOK

by

John H. Lichtblau
President

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Thank you for inviting me to appear before your Committee to discuss the world oil outlook. I would like to start by discussing briefly the question everyone in the industry and government is currently asking: How much will the world oil price decline? Obviously, the answer must be speculative. What is not speculative, however, is that the world oil price, as well as the U.S. domestic price, has already declined substantially since about mid-1981; any further decline is a continuation of a trend that has been under way for some time. We alluded to this last April when we testified before your Committee on the same subject and called attention to the "reverse oil shock".

The current cost of crude oil (foreign and domestic) to U.S. refiners averages probably around $30.50-31.00/Bbl. This is a $2.50-3.00 reduction from a year ago and a nearly $7 drop from the peak reached in February-March 1981. If we adjust this nominal price drop for inflation we find that the real crude oil cost to U.S. refiners has dropped by about 30% in the last two years. All indications are that the world oil price decline has not yet ended. The only question is whether the reductions will continue to be relatively moderate and controlled, as they have been up to now, or whether we are about to see a collapse of the entire OPEC price structure. Which of these price reductions will occur is of major importance to the U.S. and the world economy. Let us therefore briefly discuss each of them.

A moderate, controlled price reduction might be one in which the average world oil price level drops to $28-$30/Bbl and remains there for sometime. This would require OPEC to exercise its cartel power to retain some sort of effective control over the world oil price. Up to now the organization seems to have managed to do this in the face of sharply falling demand for its oil. The current market clearing price for oil is probably well below $20/Bbl, i.e. all production needed to meet the world's requirements would be available for some time at less than $20. OPEC's ability to sustain a price which, after all adjustments for official and hidden discounts, probably still averages at least $31/Bbl, could be taken as a sign that the cartel still controls the world oil price. One could also argue that since loss of this control would so obviously hurt all members severely and since the principal element of maintaining it would be a firm and effective agreement among the members, which had been achieved before, OPEC should be able to survive as an effective world oil price setter.

Maybe it will. But there are growing signs that it may be losing control and may not be able to stem the tide of market forces moving against it much longer. It was easy to be an effective cartel when all members were producing at 80-90% of their capacity, mostly at rising prices. But currently OPEC is collectively producing at less than 60% of its effective capacity, with some countries under 35%, and prices are falling.

As has been demonstrated, unity is much more difficult to achieve under those circumstances than when the going is better. Perhaps OPEC is not as effective a cartel as we all thought when we were mesmerized by its ability to raise oil prices at will. But the market was on OPEC's side during most of that time. Substantial real price increases, although less than those imposed by OPEC, were required in the early 1970's and, for somewhat different reasons in 1979/80 after Iranian production was indefinitely curtailed. But since 1980 market forces have been relentlessly pushing in the opposite direction. World oil demand (outside the Communist countries) has been declining in every year since 1979. Between then and 1982 it dropped by 6.5 million B/D or 12.5%. There has been nothing like it since the end of World War II. Nor has the decline come to an end. We expect another drop of at least 500,000 B/D in 1983 to a level of about 45 million B/D.

The reasons for these declines are both structural and temporary. The <u>structural</u> ones are the more important. Most are reactions to the excessive (both in magnitude and speed) OPEC price increases in 1973/74 and in 1979/81. Evidence of this is that oil demand and energy demand have moved in opposite directions since the mid-1970's. From 1976 to 1982 worldwide oil consumption dropped by nearly 1% annually while consumption for non-oil energy rose by about 3% annually. Other structural changes which are only partly related to the oil price increase are the shift in industrial production from energy intensive to high technology output. Thus, while steel and cement production has substantially dropped, the output of electronic equipment, computers, etc. has sharply increased.

The principal temporary reasons for the decline in oil consumption are the general economic recession and the unusually warm winter in North America, Japan and Europe. Further, requirements for new supply continue to be reduced by the exceptional worldwide inventory drawdown. Likely to be completed by mid-year, this drawdown has lasted much longer than anticipated a year-ago. Its end, together with the coming economic recovery should start raising world requirements for new oil in the second half of 1983. The recent and on-going price reductions should underpin this increase, for although the short run price elasticity of oil demand is low, it is not zero. If there is also a decline in the dollar exchange rate, as is expected, the price reduction abroad could be fairly significant in local currencies.

Thus, temporary factors could start working for OPEC from the second half of 1983 on. However, measured by any standard other than the dismal one of the last 18 months, the increases will be very modest. We expect 2nd half 1983 requirements for OPEC crude to be about 19.5 million B/D, or 3.5 million more than in the first half. The problem for some OPEC members will be to get from here to there without having to lower their price by more than the $3-4 reduction now under way, in order to maintain their perceived minimum export flow of oil.

In our view, the odds are that OPEC members can hold a new price floor at around $28-$30/Bbl for some time. However, the possibility of a price collapse is a very real one and will remain so for a number of years, given the likely demand for OPEC oil in the 1980's.

If a price collapse were to occur it would obviously have a positive impact on oil consumers and a negative one on oil producers. Since oil represents only one of many commodities used by most consumers but is usually the principal and often the only commodity sold by producers, the negative impact would be much more concentrated than the positive one.

The U.S. has an interest on both sides. It is the world's largest oil consumer and second largest oil producer. A moderate price decline would probably not create significant disincentives to domestic oil and gas exploration, nor would it increase demand substantially. A sudden sharp price reduction, on the other hand, would tend to do both. If that were to occur, the possibility of some action to maintain domestic exploration and conservation incentives may be considered, although one would first have to examine the inevitable market distorting effects of such measures. In the meantime the U.S. can do nothing to prevent a foreign oil price drop of whatever magnitude and should do nothing to accelerate it, particularly since the world is already on a downward price trend which is unlikely to be reversed for some time.

One final point; the risk of a major physical interruption of oil supplies from the Middle East due to unforeseen military or political events remains high. Hence, the current world oil surplus provides no legitimate argument for reducing the fill rate of our Strategic Petroleum Reserve. Perhaps, in view of our reduced import dependency--28% in 1982 compared to 47% in 1977--we may not need as big a reserve as had been earlier assumed. But until we reach the 500 million barrel level we should not even consider slowing down our effort in this area.