Statement of David Cohen

Director, Office of Global Issues

Central Intelligence Agency

Before the Committee on Energy and Natural Resources

United States Senate

12 March 1986

[redacted]

Statement of David Cohen
Director, Office of Global Issues
Central Intelligence Agency
Before the Committee on Energy and Natural Resources
United States Senate
12 March 1986

Mr. Chairman and distinguished members of the Committee. I welcome this opportunity to present the Central Intelligence Agency's views on the world oil market situation and its implications. We believe weak market conditions will keep downward pressure on oil prices this year. The major factor propelling the market downward is OPEC's move, [redacted] to defend market share rather than prices. At this time, no other producer seems willing to cut production voluntarily [redacted] Furthermore, the impending seasonal decline in demand could intensify downward pressure on prices this summer, if [redacted] OPEC members try to maintain output at current levels. [redacted]

Current market weakness is due to a number of factors which came about as a result of higher oil prices in the 1970s. As the chart illustrates:

- From 1979 to 1985 non-Communist oil consumption fell by 7 million b/d in response to conservation and substitution away from oil. In spite of economic growth, consumption fell by 1 percent last year to 45 million b/d.
- At the same time, non-OPEC production rose 6 million b/d from 1979 to 1985.
- Ample supplies, falling demand and prospects of lower oil prices, in turn, caused non-Communist oil

[redacted]

inventories on land to fall by about 400 million barrels since 1980.

- As a result, OPEC oil production dropped by about 15 million b/d or 50 percent from 1979 to 1985 and
- Average OPEC prices fell from a peak of $34.50 per barrel in 1981 to $28 per barrel last year. [redacted]

Faced with an eroding market share, [redacted] OPEC countries decided late last year to defend market share even if it meant lower oil prices. [redacted] As the second chart illustrates, spot crude prices have plummented over the last three months. These lower spot prices are now pulling official prices downward. We estimate the average world oil price in late February fell to about $20 per barrel compared to $27 last year. [redacted]

OPEC producers have adopted flexible marketing arrangements in an attempt to recapture market share. OPEC February output, including natural gas liquids, climbed to about 19 million b/d, almost 2 million b/d above last year's average. [redacted] The increase has come at a time when commercial oil stocks in the West are probably already above planned levels and just as the seasonal decline in consumption is about to begin. OPEC has been able to increase production because its members have so far been more aggressive than some of their non-OPEC competitors in marketing their oil. How producers respond to lower seasonal demand this spring will determine near-term price movements. [redacted]

The market outlook for the remainder of 1986 offers little relief for producers. Given our estimates for consumption, inventory behavior, and non-OPEC supplies, demand for OPEC oil in 1986 will approximate 17 million b/d, or about the same as last year. Demand for OPEC oil will vary seasonally over the year, and will probably fall to a low of about 16 million b/d during the spring and summer months, 15 percent below current levels. [redacted]

This expected seasonal decline in oil demand will put severe downward pressure on prices during the next several months, unless producers are willing to cut output from current levels.

- The first bar of this chart shows estimated oil demand for the first quarter of 1986 and the breakdown between OPEC and non-OPEC supply. OPEC countries supply about 19 million b/d, and non-OPEC countries produce roughly 27 million b/d.

- The second bar shows how demand will fall in the spring and stay low over the summer months and illustrates the problem that producers are facing. Someone will have to cut production by as much as 2 to 3 million barrels per day in the spring. [redacted]

In our judgment, non-OPEC producing countries are unlikely to voluntarily cut output significantly, despite continuing pressure from OPEC countries, for several reasons:

- o Non-OPEC producers are a large group with disparate interests, a relatively small share of world oil trade, and no mechanism for communication or coordination. As the next chart shows, although these countries produce over 27 million b/d, they consume a large portion of their output. Net exports, represented by the smaller bar, approximate only about 6.5 million b/d, and would have to be slashed by more than one-third, an unacceptably large reduction, for OPEC to maintain current output without further price declines.
- o Voluntary cutbacks, moreover, are risky. Non-OPEC producers realize they might have to restrict output for an indeterminate period in order to prop up prices. In addition, they cannot be assured that other producers, including OPEC members, wouldn't immediately boost output to capture a higher share of the market. OPEC's inability to adhere to past quotas has undermined confidence that any kind of coordinated output-reduction agreement is possible. [redacted]

Many individual country governments have voiced their opposition to market intervention to bolster prices. In some cases, however, producers may be willing to offer token cutbacks or will attempt to score political points by portraying output reductions made as a result of marketing or other problems, as a sign of solidarity with OPEC. [redacted]

Norway, so far, is sticking by its long-standing policy of non-intervention. Projections of lower oil revenues, however, are sparking domestic political debate and the government appears to be searching for some flexibility to deal with future market developments--particularly if prices fall so low that capital costs of future projects are not covered. [redacted]

LDC's are also unlikely to bow to OPEC pressure to reduce output. Many countries are striving for energy self-sufficiency or need the foreign exchange earnings that oil exports generate. [redacted] **Oman** has said that it will reduce its output if all producers agree to cut production as part of a world producer accord. [redacted]

[redacted]

Both the **Soviet Union** and **China** have voiced support for worldwide production cuts. Any production cutback by the Soviet Union, however, would likely stem from domestic production difficulties. [redacted]

Despite an intensive campaign to push the blame for falling oil prices on non-OPEC producers, it appears that if OPEC countries want prices to stabilize near current levels, they will have to reduce production themselves. Financial considerations, however, will limit both their ability and their willingness to cut output. [redacted]

Some of the poorer OPEC countries, particularly those with little excess production capacity, have been surprised by both the pace and extent of the recent price decline, and are feeling the pinch of lower revenues. The blame for the deteriorating is that the meeting will end inconclusively, leaving the group deeply divided. [redacted]

In sum, producer intentions and market forces point to a continued decline in oil prices. [redacted]

A decline in oil prices is generally good news for the global economy. Lower oil prices will give impetus to economic growth and employment, help keep inflation under control and for many LDC energy importing debtors such as Brazil, reduce the financial drain on their economies. On the other hand, many LDC oil exporters, especially those already debt-troubled, will encounter financial problems with sharply lower oil prices. In some countries these problems could be severe, and may prompt political unrest or major policy shifts. As this next chart shows, at an oil price of about $20 per barrel, for example, further economic adjustment measures could prompt political unrest in Egypt, Iran, Libya, Nigeria, Peru, Ecuador and Tunisia. [redacted] In Iraq, we believe that the oil price decline will add to the military's dissatisfaction with the current leadership and increase regime vulnerability to coup plotting. [redacted] On the other hand, we believe that the governments of Algeria and Indonesia will be able to effectively manage any protests over economic conditions. [redacted]

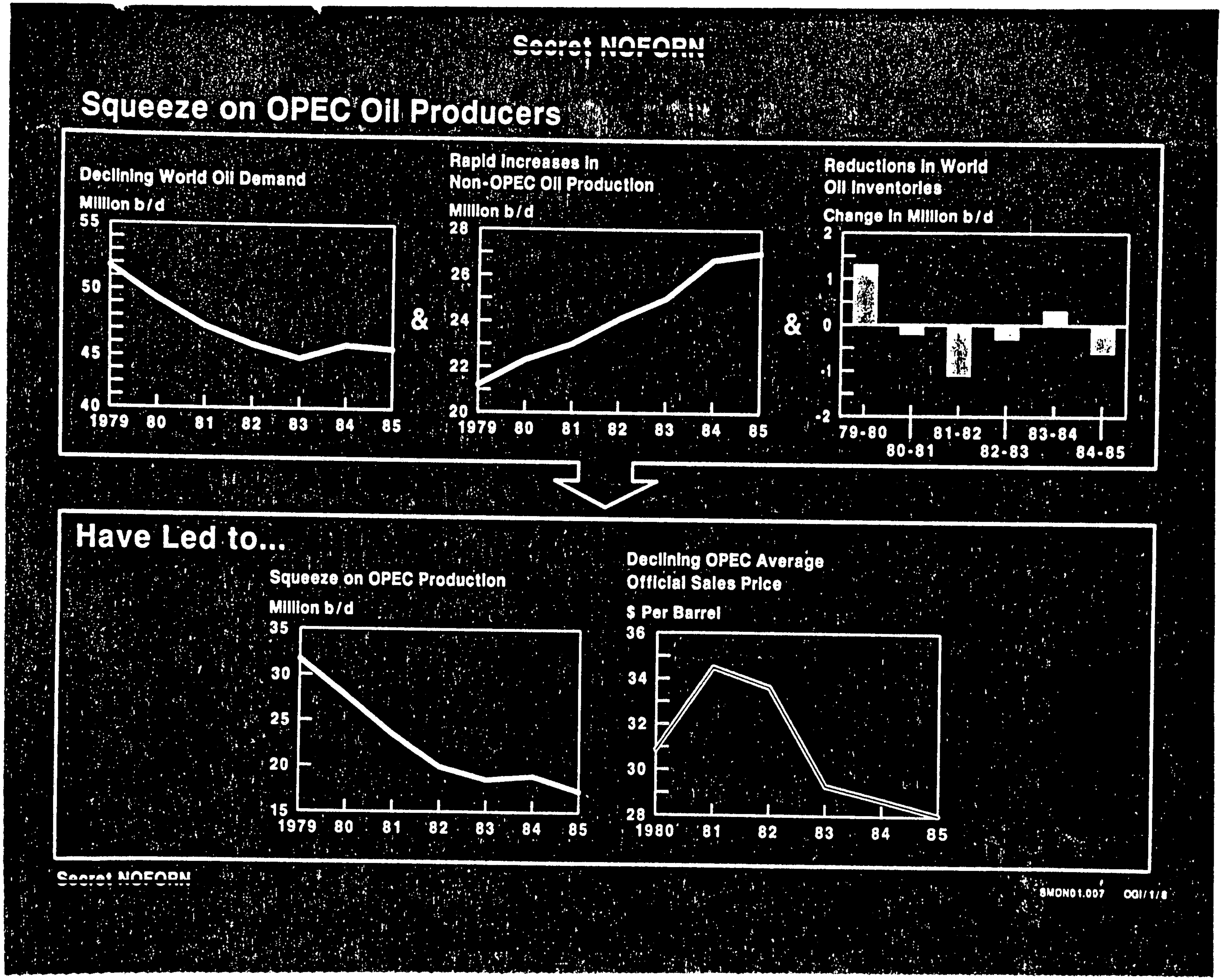
Finally, let me briefly address some implications for the long-term oil market. Lower oil prices will tend to raise demand, slow supply development and hasten a return to a tight market situation. No one knows precisely the magnitude of the consumption or supply response to lower oil prices. Some argue that oil consumption will rise fairly quickly, especially at extremely low prices because of faster economic growth and substitution back to oil. Others believe structural changes and prospects of higher oil prices in the future will moderate increases in oil consumption. Economic models based on historical trends will likely be poor predictors of the impact of lower prices. [redacted]

Despite the uncertainties, we believe lower oil prices will slow exploration and development. In addition, they will tend to dampen conservation and substitution, boost oil demand and hasten a return to tight market conditions. Under these circumstances, dependence on Middle East oil supplies will likely increase over time because most of the non-Communist oil reserves are in the region. As this chart shows, about two-thirds of known total non-Communist oil reserves are in the Middle East, and about one-fourth are located in Saudi Arabia. Given the long leadtimes necessary to develop new supplies and the current excess capacity in the Middle East, these producers would eventually recapture market share if lower prices persisted for several years. This would leave the market more vulnerable to supply disruptions and renewed upward price pressures. [redacted]

Although substantial surplus production capacity currently provides the oil market considerable flexibility, the unstable situation in the Middle East could cause a turnaround in the oil market. Surplus available production capacity averages about 10 million b/d, but only 3 million b/d of this lies outside the Gulf region. Persian Gulf countries still provide about one-fourth of total non-Communist oil supplies and most of the oil still flows through the Strait of Hormuz. Continued Iraqi attacks against the Khark Island oil export terminal increase the risk that Tehran may move to disrupt oil flows from the Persian Gulf. Recent Iraqi military setbacks could cause Baghdad to step up retaliatory strikes against Iran. [redacted]

[redacted] Although the risk is small, the loss of most Perisan Gulf oil supplies for a prolonged period could cause oil prices to rise sharply. [redacted]

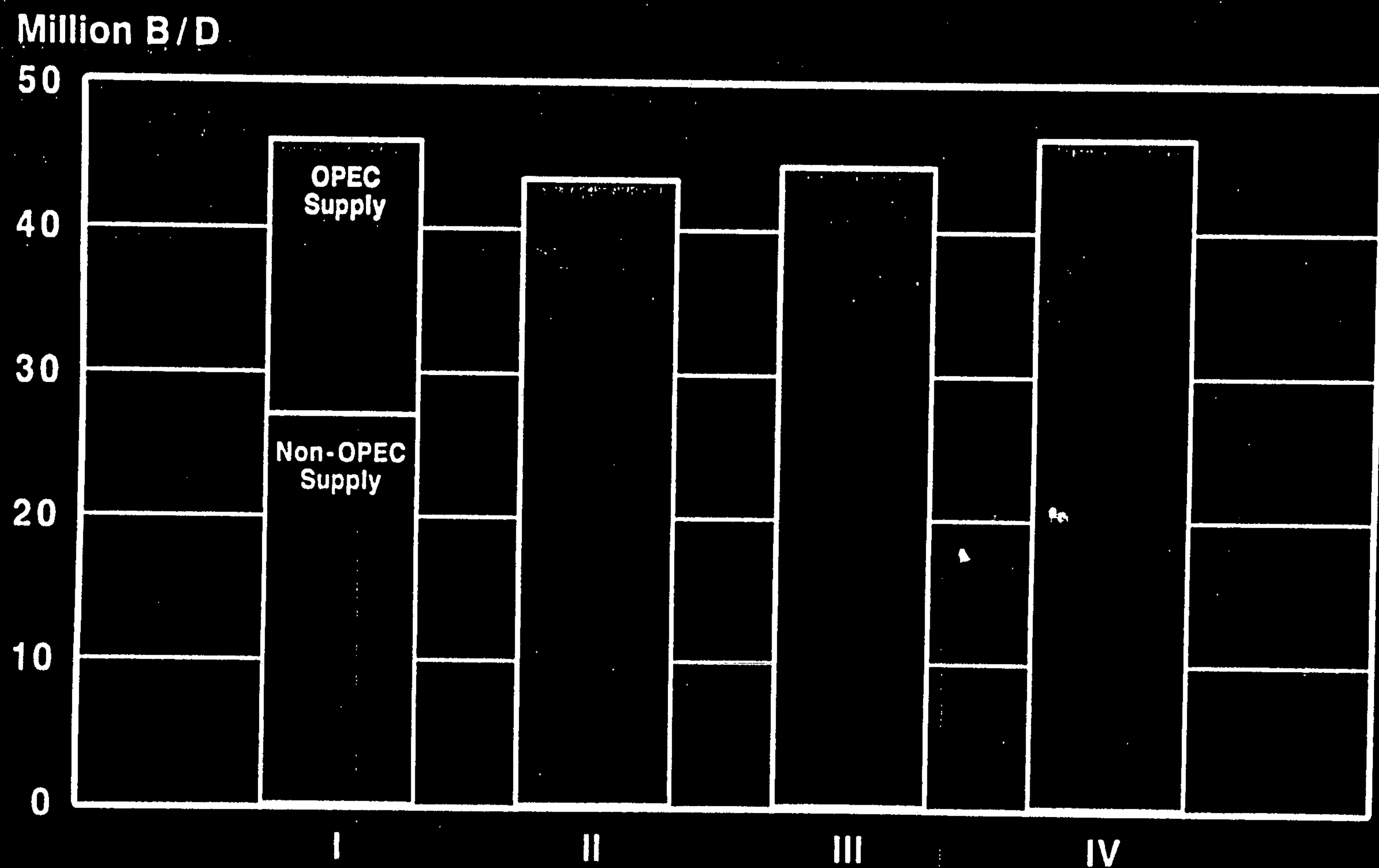
This concludes my statement, Mr. Chairman. I would be happy to answer any questions. [redacted]


Secret NOFORN
Squeeze on OPEC Oil Producers
Declining World Oil Demand
Million b/d
55
50
45
40
1979 80 81 82 83 84 85
&
Rapid Increases in Non-OPEC Oil Production
Million b/d
28
26
24
22
20
1979 80 81 82 83 84 85
&
Reductions in World Oil Inventories
Change in Million b/d
2
1
0
-1
-2
79-80 80-81 81-82 82-83 83-84 84-85
Have Led to...
Squeeze on OPEC Production
Million b/d
35
30
25
20
15
1979 80 81 82 83 84 85
Declining OPEC Average Official Sales Price
$ Per Barrel
36
34
32
30
28
1980 81 82 83 84 85
Secret NOFORN
SMON01.007 OGI/1/8

[redacted]

Confidential NOFORN

1986 Oil Demand Outlook*



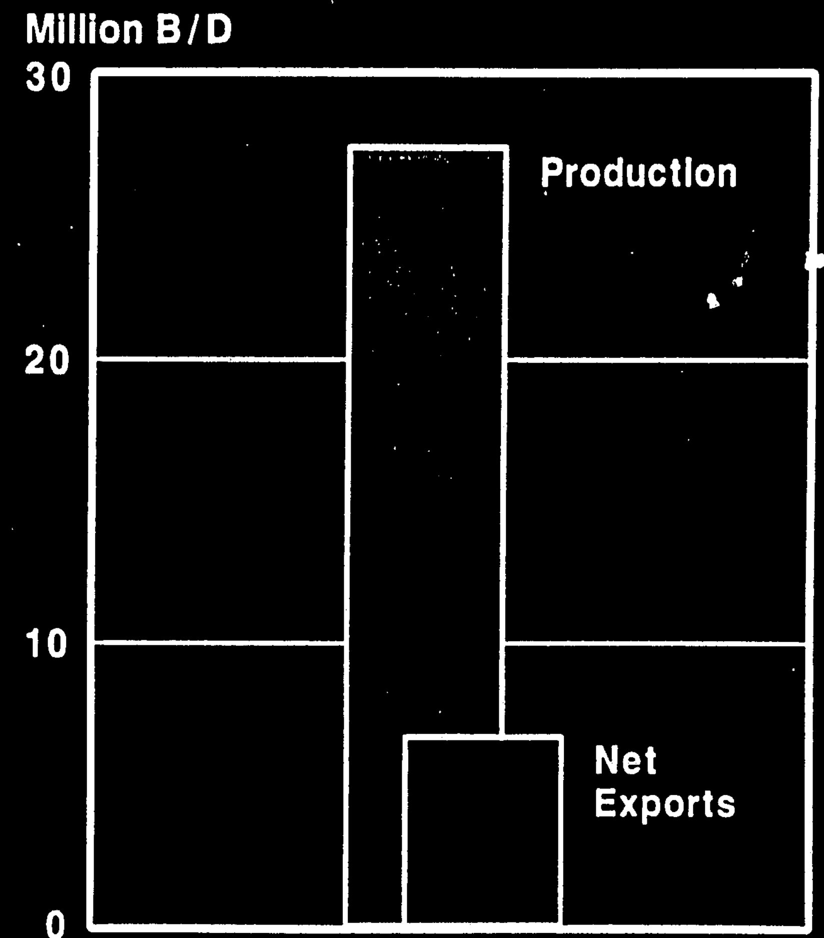
* Excludes refinery gain.

Confidential NOFORN

BONK03.001 OGI 1/8.

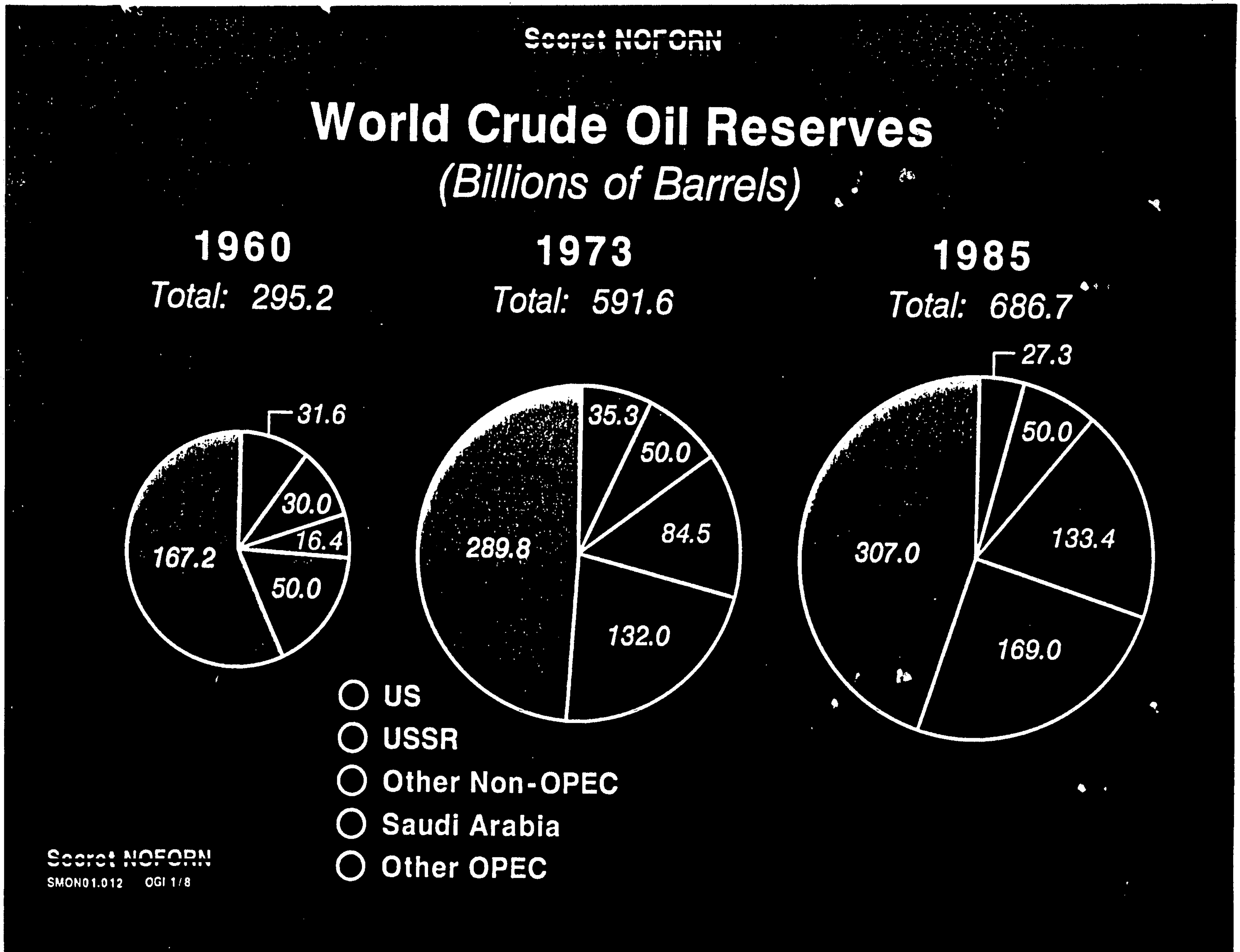
Confidential NOFORN

Non-OPEC Production and Exports 1986



Confidential NOFORN

BONK03.002 OGI 1/8


Secret NOFORN
World Crude Oil Reserves
(Billions of Barrels)
1960
Total: 295.2
1973
Total: 591.6
1985
Total: 686.7
31.6
30.0
16.4
167.2
50.0
35.3
50.0
84.5
289.8
132.0
27.3
50.0
133.4
307.0
169.0
US
USSR
Other Non-OPEC
Saudi Arabia
Other OPEC
Secret NOFORN
SMON01.012 OGI 1/8