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Mr Chairman, members of the committee, thank you for the opportunity to present my views on the current global oil market situation and the implications for US energy and economic policy.

My current position is senior advisor to the Energy and National Security program at the Center for Strategic and International Studies (CSIS). CSIS is a bipartisan, nonprofit organization headquartered in Washington, DC. CSIS does not take specific policy positions: accordingly all views expressed in this testimony are my own.

The Global Oil Market Situation and Outlook

The global oil market strengthened considerably in the latter part of 2010 as a result of the improving economic conditions in many developed countries such as the United States and among European Union members and strong economic growth in many emerging economies such as China and India.

As a result world oil demand increased by 2.8 million barrels per day in 2010 (mmb/d) bringing world oil demand to about 88 mmb/d. This was the second largest year on year increase in the last 30 years. Although the increase was from a recession induced lower demand in 2009 strong global demand placed upward pressure on crude oil and refined product prices. Crude oil prices (WTI and Brent) were mostly in the \$75-85 per barrel range for much of 2010 until late 2010 and early 2011 when prices moved into the \$90-100 per barrel range on the strength of demand for gasoline and diesel oil. Gasoline prices in the US averaged \$2.78/gallon in 2010 and had risen to \$3.10/gallon in January 2011. The current average is more than \$3.50/gallon.

Oil supplies have responded to higher prices. The Organization of Petroleum Exporting Countries (OPEC) members led by increases in Saudi Arabia ended 2010 at its highest output in two years. Non-OPEC countries such as, the US, Canada, Russia, China and Brazil, also increased production in 2010. It is important to note that other liquids from oil sands, biofuels and natural gas made important contributions to these supply increases.

Thus the political unrest in North Africa and the Middle East comes at a time when the global oil market is adequately supplied with the prospect of steady demand increases. Prior to the political turmoil in the region the consensus among organizations and institutions which project oil market supply, demand and price was for a moderate increase in price to the \$90-100 per barrel range for 2011. Increased uncertainty has raised the consensus projection by about \$10-20 per barrel. As the March EIA short-term energy outlook indicates there is a moderate risk that prices will rise well above the consensus.

With the notable exception of Libya, demonstrations and civil unrest have not significantly affected oil production or major transit routes such as the Suez Canal. Libyan oil exports are reported to have been substantially reduced from their pre-disruption rate of about 1.3 mmb/d. This represents about 2% of world oil production.

Global spare crude oil production capacity (as well as refining capacity) and healthy worldwide inventories are more than adequate to offset the loss of 1.3mmb/d. Saudi Arabia's spare capacity alone is sufficient to offset the volumetric loss of Libyan oil. However Libya's crude is of very high quality and replacement with Saudi crude would come at increased refinery and logistical costs. Nevertheless the combination of alternative crude oil supplies, product inventories and excess refining capacity can make this replacement possible at some loss of refinery efficiency.

The critical uncertainty for the global oil market is whether or not supply disruptions will spread. Demonstrations in moderately sized oil producing countries such as Algeria and Yemen seem to have subsided. Markets react to uncertainty by bidding up prices and that clearly has happened in the global oil market. The "risk premium" appears to be about \$5-15 per barrel compared with pre-disruptions expectations.

Oil is a truly fungible global commodity and electronic trading means instantaneous reaction to events effecting supply and demand. Therefore a disruption anywhere is a disruption everywhere transmitted through the price mechanism. The US imports very little Libyan oil but the economic damage from higher prices is the same as in Italy which imports a substantial amount of oil from Libya.

The most recent example of globalized energy markets are the tragic events unfolding in Japan as we meet today. The severe damage to Japan's nuclear capacity, oil refinery capacity and liquefied natural gas receiving capacity has boosted prices for refined oil products and natural gas. Market expectations are that Japan will require increased imports of fuel oil and LNG in the coming months. Preliminary estimates indicate potential increased demand of 100,000 to 200,000 b/d.

In the very short-term the challenge to US policymakers is to mitigate the possible economic damage of higher energy prices and to be prepared for the uncertainty of a potentially worse supply disruption. In the medium to longer term the challenges are broader and deeper as we face a global energy system in major transition. Energy demand is shifting away from the industrialized countries to emerging economies. Major

new supplies of oil will require massive investments increasingly dominated by national oil companies which have different objectives and ways of operating. Emerging new players are flexing their political and economic muscle. In short, the above the ground risks to adequate, affordable and timely oil supplies are increasing.

#### Implications for US Energy and Economic Policy

In the short term the main policy measure available to the US government is use of the Strategic Petroleum Reserve (SPR). The SPR contains more than 720 million barrels of crude oil. Within two weeks of a Presidential decision oil could be available to the market at a maximum rate of more than 4 mmb/d.

President Obama and his advisors have indicated that they are prepared to release oil from the SPR should that become necessary. The current assessment from the administration is that the market is adequately supplied and that they will be closely monitoring the situation along with our partners in the International Energy Agency and in key oil exporting countries.

I believe that is the correct course of action at this time.

The US is a member of the International Energy Agency (IEA) along with 28 other oil consuming countries. The IEA has a Coordinated Early Response Mechanism (CERM) which could be activated quickly. IEA countries, including the US, hold 1.6 billion barrels of government controlled inventories with a drawdown capability of 8-10mmb/d. The IEA system was used successfully after the Iraqi invasion of Kuwait and in the aftermath of Hurricane Katrina.

The IEA governing board met in late February to assess the developments in North Africa. The IEA Executive Director declared that the system is ready to be activated immediately should that be necessary.

Oil producers recognize that high and rising oil prices could damage the fragile global economy and limit demand for their oil exports in the medium and long term. Saudi Arabia has indicated a willingness to increase production to insure that markets are adequately supplied. Saudi Arabia is estimated to have 3 to 4 mmb/d of spare capacity and to have already increased output to about 9 mmb/d. In 2010 Saudi production was estimated at 8.1mmb/d.

In the medium and longer term US energy policy would benefit from a comprehensive approach in order to cushion our economy from disruptions and the longer term geopolitical risks in this precarious energy landscape. The comprehensive approach requires a policy that recognizes the long term nature of the transition from fossil fuels to alternatives. A transformation is already underway, however, due to financial and technology limitations, a large existing capital stock that runs on fossil fuels and the lack

of infrastructure to support a new system, that transition will take at least several decades. In sum there is no scalable alternative available today to replace our current system.

In the meantime our policies should be directed at promoting efficiency (reducing demand) and increasing supply of current fuel choices with effective environmental safeguards. Concurrently we need to promote technological development and innovation through research and development.

The following are some specific examples to facilitate reduced demand and increased supply in the medium and long term:

Demand side examples:

- Improved vehicle efficiency standards;
- Incentives for highly efficient vehicles such as hybrids (including plug-ins);
- Incentives for natural gas fleet vehicles;
- Market mechanisms which include externalities in the cost of energy such as a carbon tax.

Supply side examples:

- Facilitate development of domestic resources such as shale gas and tight oil (Bakken) through infrastructure expansion;
- Accelerate approval of drilling permits in the Gulf of Mexico with effective oversight;
- Facilitate secure sources of energy imports from Canada;

These are just a few of the many examples which can promote a more energy efficiency economy, enhance secure energy supplies and increase environmental sustainability for the long term.

Mr Chairman, members of the committee, this concludes my testimony. Thank you.

