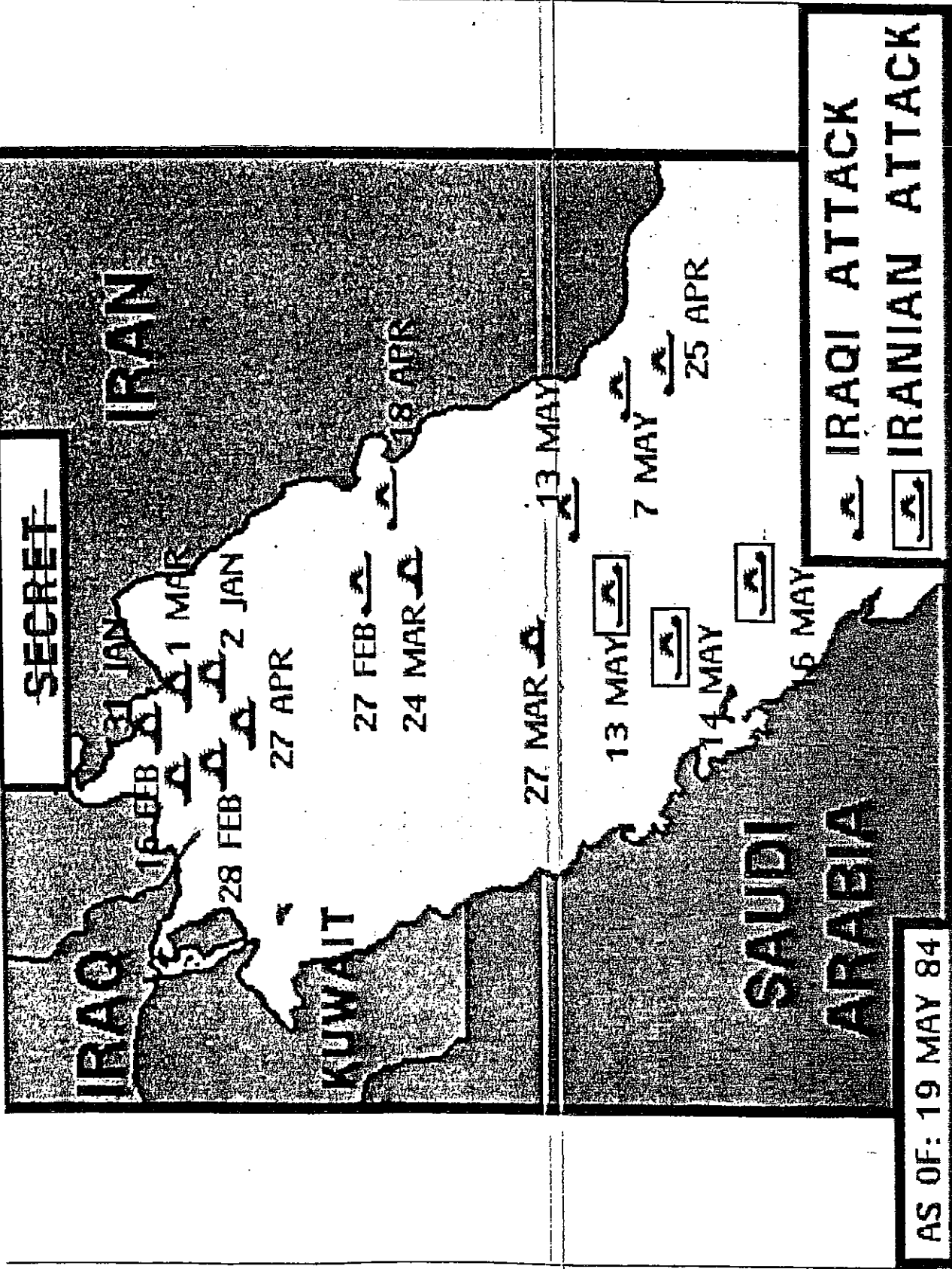


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BY ADT NARA, DATE 8/15/06



SUMMARY

- o Past oil disruptions in 1973-74 and again in 1979-80 had serious impacts on the world economy. In both cases the rapid increase in energy prices helped initiate new recessions and higher inflation.
- o The new round of Iranian and Iraqi attacks on oil tankers threatens to disrupt the flow of Persian Gulf oil. There is an increasing risk that the fighting could involve Saudi Arabia and Kuwait. Tehran continues to threaten oil facilities and the Strait of Hormuz.
- o Under the worst circumstances, oil prices could triple, triggering a new recession, increased unemployment, higher inflation, and a further deterioration of the debt crisis.
- o The energy policy of the United States is defined by NSDD-87 and NSDD-134.
 - oo Domestically, we will continue to rely on free market forces and the Strategic Petroleum Reserve.
 - oo We cannot, however, insulate ourselves from the international economic impact as oil prices rise and available supplies are redistributed. If we are to win public support for our policies, we must not let it appear that the US is paying all the costs and making all the sacrifices. We are currently consulting with our allies to forge commitments to policies that will fairly share the burden of a major oil supply disruption, with particular emphasis on the adequacy and coordination of stock policy.

5/22/84

CURRENT OIL MARKET

- o Persian Gulf countries are producing about 12 million barrels per day (b/d) of oil, this accounts for about 25% of total Free World output.
- o Surplus capacity available to help offset a disruption totals about 8 million b/d in the second quarter of 1984.*
- oo Only 3 million b/d is outside the Persian Gulf, with 20% of the non-Persian Gulf total in Libya.
- o As a result of the recent series of attacks on tankers, insurance rates in the Persian Gulf have increased sharply.
- o After some initial nervousness, the spot oil market has adopted a "wait-and-see" attitude.

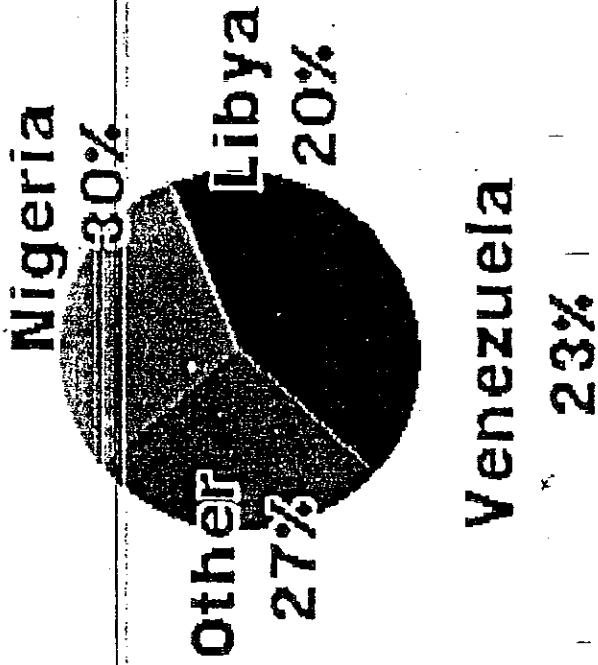
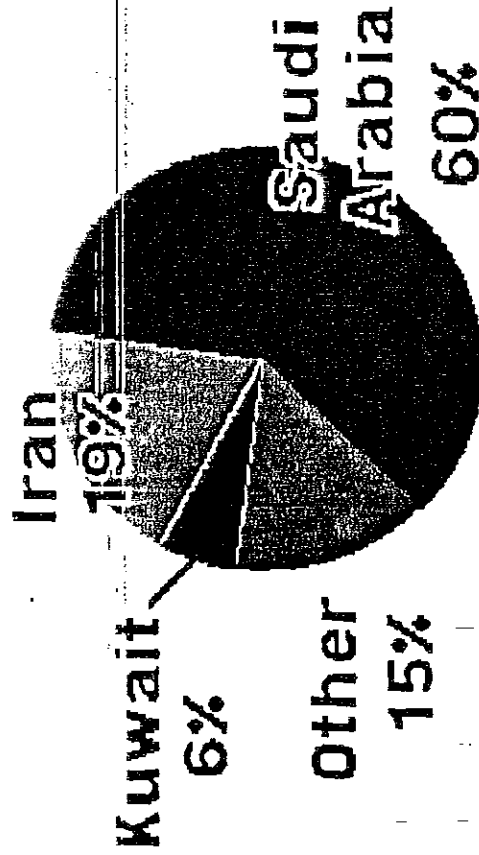
*NOTE: The unclassified estimate of surplus capacity is 9-10 million b/d.

Free World: Surplus Oil

Productive Capacity

Persian Gulf
Total: 5.2 Million B/D

Non-Persian Gulf
Total: 2 Million B/D



DEPENDENCE ON PERSIAN GULF OIL

- o Despite the high percentage of Persian Gulf oil in world trade, the US relies on Persian Gulf oil for only about 3% of its consumption.
- o The rest of the OECD receives about 5 million b/d from the Gulf.
 - oo Japan depends on Persian Gulf oil for about 60% of its consumption.
 - oo Western Europe relies on the Gulf for almost 20% of its consumption.
- o The non-OPEC, less developed countries meet one-third of their consumption needs with Persian Gulf oil.

CASE

LOW MED HIGH

NET PRODUCTION
LOSS (MILLION B/D)

0 3 5

OIL PRICES
(\$ / BARREL)

30-40 35-75 50-95

MAXIMUM US GNP
GROWTH REDUCTION
(% POINTS)

0.8 2.5 3.2

INFLATION RATE
INCREASE (% POINTS)

0-1.2 .9-3.8 2-4.8

UNEMPLOYMENT RATE
INCREASE (% POINTS)

0-0.3 .2-1.0 .5-1.3

DISRUPTIONS SCENARIOS

- o Although the probability of a major disruption of extended duration is low, we need to recognize the potential economic consequences and be prepared to deal with the unlikely. The above table summarizes the potentially disastrous economic consequence that could result from oil shortfalls of various size and duration.*
- o LOW: Loss of Iraqi and Iranian oil exports. Although there would be no net production loss since surplus available capacity could easily replace the output reduction, oil prices could begin rising from their current level of about \$29 per barrel if it were feared the conflict might spread.
- o MEDIUM: Complete loss of Iraqi, Iranian and Kuwait oil exports, as well as a partial disruption of Saudi exports for 6 months. As a result of higher oil prices, the economic progress of the past three years would be threatened. Economic growth would stagnate and inflation would increase.
- o HIGH: Complete disruption of Persian Gulf oil flows for 6 months. It is unlikely that Iran could close the Strait of Hormuz for this length of time. A serious long-term problem could develop, however, if an expansion of the war resulted in the destruction of key oil facilities on the Arabian Peninsula and the creation of an environment which would not permit meaningful exports for several months. Oil prices might have to triple to balance supply and demand, triggering a new recession, increased unemployment and higher inflation.

*These scenarios are drawn from interagency projections and assume countries outside the Gulf produce at capacity.

TOP DEBTOR COUNTRIES

BRAZIL *

MEXICO

SOUTH KOREA *

ARGENTINA

VENEZUELA

INDONESIA

INDIA *

CHILE *

PHILIPPINES *

* SEVERELY AFFECTED BY
OIL PRICE INCREASE

\$420 BILLION
TOTAL DEBT

IMPACT ON LDC'S

- o As serious as the consequences would be for the U.S. and OECD countries, a sustained increase in oil prices would have an even more serious impact on LDC debtor countries and the stability of the international financial and banking systems.
- o Should we experience higher oil prices for any extended period, several heavily indebted LDCs:
 - oo Would be increasingly unable to finance oil imports and
 - oo Barring new rescheduling, could be forced to increasingly delay or declare moratoriums on repayments. This, in turn, could result in a breakdown in increasingly strained debtor-creditor cooperation.
- o To give you an idea of the dimensions of the debt crisis at year end 1983, 52 LDCs and East European nations were behind on their debt repayments, with arrearages in the neighborhood of \$35 billion.
 - oo That figure has undoubtedly increased in 1984
 - oo Bankers Trust Chief Economist Lawrence Brainard estimates that over 90 day arrearages on the books of U.S. banks at the end of the first quarter could be as high as \$10 billion.

KEY OIL-IMPORTING LDC DEBTORS: IMPACT OF \$5/BARREL INCREASE

NATION	\$ BILLION (US)
BRAZIL	1.2
CHILE	0.1
KENYA	0.1
MOROCCO	0.2
PAKISTAN	0.2
PANAMA	0.1
PHILIPPINES	0.3
S. KOREA	0.9
SUDAN	0.1
THAILAND	0.5
TOTAL	3.7

LDC FINANCING REQUIREMENTS

- o For every \$1 increase in the price of a barrel of oil, the total annual oil import bill of the 10 countries listed above would increase by an estimated \$750 million.
- oo A \$5 increase would mean an estimated \$3.7 billion in additional costs to maintain current oil imports.
- o It is important to note that this is the first time we have had the prospect of a major new round of oil price increases running parallel with an international debt crisis. As a result, we could be faced with a new and more perilous wave of international economic dislocations, with substantial national security implications.
- o Increasing oil prices, combined with rising interest rates, could lend impetus to calls for a politicized debtor cartel.

1979 -- Iranian Revolution

- **Oil Production Shortfall:
1-2 million b/d**
- **Low Stocks**
- **Agreement to:**
 - **Reduce Demand 5% (IEA)**
 - **Oil Import Targets (Tokyo Summit)**
- **Highly Competitive Market**
- **Prices Double**
- **Principal Cause of Last Recession**

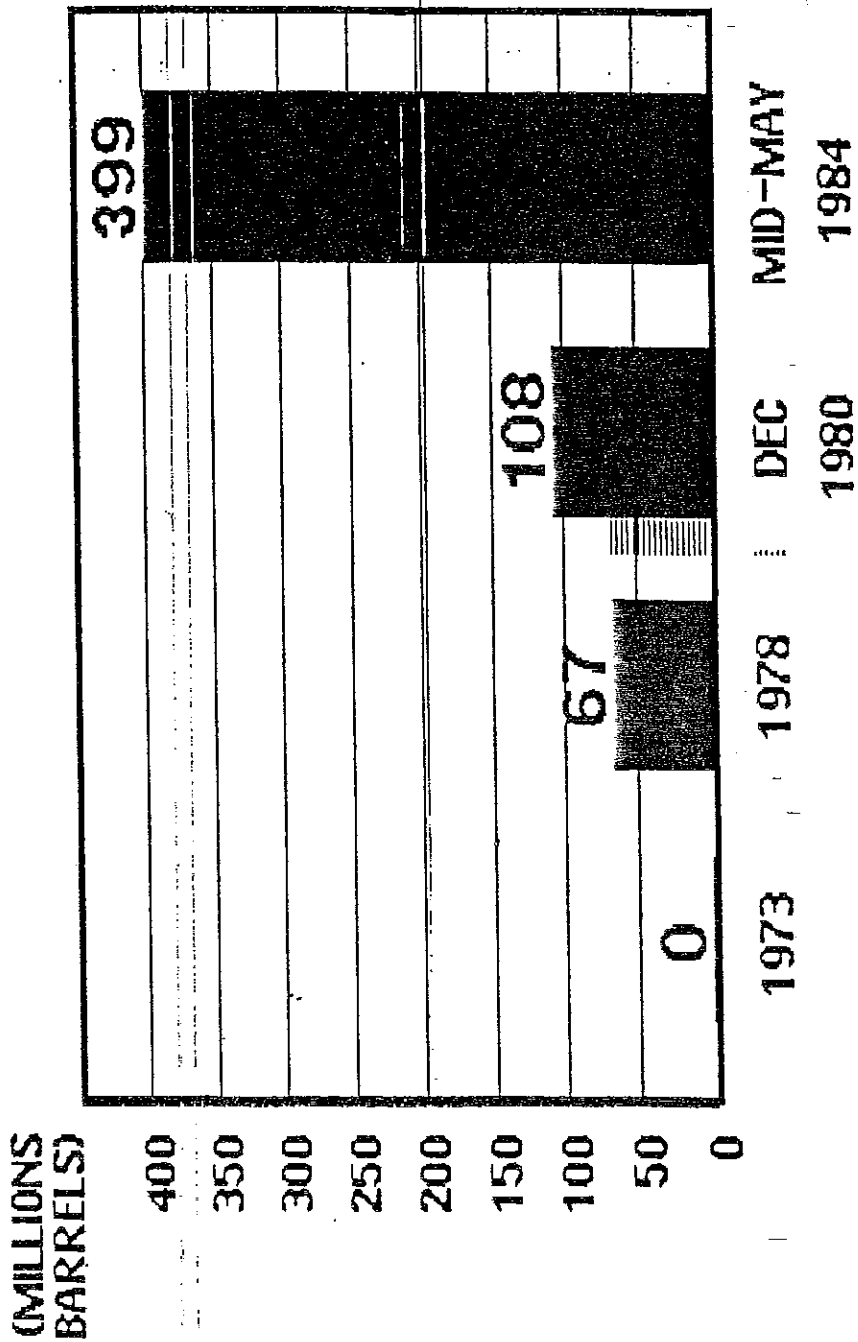
PAST EXPERIENCE -- 1979

- o The Iranian Revolution resulted in a complete halt of Iranian crude oil exports for three months. Uncertainty over future supplies and fear of a spreading Islamic revival subsequently caused a massive stock build.
- o Weak or vague international agreements calling for oil import ceilings (Tokyo Summit) and demand restraint (IEA) did not prevent a scramble for oil. Foreign companies, with the support and at the initiative of their governments, greatly contributed to this bidding war.
- o As a result, oil prices rose from less than \$13 per barrel in 1978 to over \$32 by the end of 1980. This triggered a major, worldwide recession.
 - oo Real GNP in the US, which had been growing at about 5%, stagnated.
 - oo Unemployment increased from less than 6% to nearly 9%.
 - oo The inflation rate rose from 9% to over 13%.

1980 -- Iran-Iraq War

- **Oil Production Shortfall:**
 - 1-2 million b/s/d**
- **High Stocks**
- **IEA Agreement to:**
 - **Reduce Stocks**
 - **Price Restraint**
 - **Share Burden**
- **Japan and Europe Jawbone Companies**
- **Prices Increase 10%**

US STRATEGIC PETROLEUM RESERVE



PAST EXPERIENCE -- 1980

- o The Iran-Iraq war disrupted oil production from both countries. The size of the net production disruption was similar to the one after the Iranian Revolution.
- o Declining consumption and the large increase in oil inventories accumulated after the Iranian Revolution, however, provided us with a cushion.
- o The response in the international community was also different because the experience of 1979 was still fresh in everyone's mind. The IEA reached a firm agreement to lower stocks and avoid abnormal spot market purchases. These agreements encouraged Japanese and European restraint.
- o As a result, price increases were all but avoided.

CURRENT SITUATION

- o The current situation is very similar to 1979. Oil stocks are low, except in the US which has built up the SPR to 400 million barrels -- almost 6 times the level on hand in 1978 prior to the Iranian Revolution.
- o The current slack market, combined with excess productive capacity, has encouraged complacency. As a result, the stage is set for a bidding war which will significantly drive the price of oil upward.

POLICIES TO MEET THE CHALLENGE -- DOMESTIC

- o Reliance on market forces and opposition to price and allocation controls remains the cornerstone of our domestic policy response to an oil supply interruption.
- o The Strategic Petroleum Reserve is our most effective tool for reducing the economic dislocations of an oil disruption. In order to maintain flexibility, we continue to oppose any legislation that would require specific triggers, detailed criteria, or specific scenarios for SPR use. We are, however, on record supporting, under most circumstances, the early sale of SPR oil in the event of a major disruption. Early use of the SPR could reduce price increases by \$5-40 per barrel depending on the size of the disruption and demand response.
- o We also realize that federal, state and/or local economic response programs are necessary for those least able to cope with adverse economic consequences of major oil supply disruptions, such as low and fixed income groups.
- o DOE and State have developed and implemented mechanisms for coordination of the information which is disseminated to Congress and to the media concerning Persian Gulf developments and the ability of free world nations, including the U.S., to cope with such developments, thereby avoiding panic behavior.
- o DOE has instituted a dialogue with various groups concerned about energy emergency preparedness (including States, producers and various industrial and agricultural consumers) so they will have better understanding of Administration policies and efforts.
- o The Administration has also actively supported a legislative effort to facilitate use of energy emergency manpower reserve from the private sector.

International Response

- Stock Drawdown
- Demand Restraint
- Use of Spare Capacity
- Assistance to Strategic Countries
- Consultations
- IEA Trigger

POLICIES TO MEET THE CHALLENGE -- INTERNATIONAL

- o United States international energy policy is based on the guidelines established in NSDD-87 and NSDD-134 which called for strong and continued cooperation with other consuming countries, equitable burden sharing and reliance on market forces.
- o If our policy of reliance on free market forces is to be successful in the domestic arena, we must ensure that the international market functions well enough to prevent the US from having additional problems at home. The Congress and the public will be very concerned if Europe and Japan are not carrying their fair share of the burden.
- o In order to develop a firm basis for international cooperation, we have conducted an extensive series of consultations with our allies.
 - oo We have engaged the International Energy Agency (IEA) in a major review of international energy emergency preparedness, primarily focusing on the adequacy and coordination of stock policy.
 - oo We have conducted bilateral consultations with the British, Germans, French, Italians, Japanese and Canadians.
- o In all these consultations our representatives highlighted the need for appropriate international policies in order to fairly share the burden of an oil supply disruption among the allies. Special emphasis was placed on the need for increased strategic stocks, coordinated stock policies and the usefulness of an effective public information strategy. It was recognized that each country would have to respond through measures appropriate to its own situation, including means to reduce demand on the world oil market in an emergency. Our allies all responded favorably and, in principle, indicated that they would be supportive of the U.S. approach.
- o In addition, we must be prepared to provide allied assistance to strategic countries in meeting their oil or financial needs, especially those countries where basing rights would be vital to military efforts in the Persian Gulf.
- o As a last resort we must be prepared to meet our commitments to the IEA emergency sharing program.

PUBLIC DIPLOMACY

- o An effective public information strategy will be essential to our efforts. If we can calm the market, we can better contain the economic impact and buy ourselves some time to assess the situation.
- o The following talking points may be used when discussing this issue:
 - oo We support UN Security Council resolution 540 which calls for freedom of navigation and an end to hostilities in the Gulf.
 - oo We and our allies will not stand by an permit an interruption in the oil flows necessary for maintaining the world's economic well being.
 - oo Due to this Administration's early efforts to decontrol oil prices, we have spurred domestic production and cut our imports. At the 1977 peak we imported 8.6 million barrels per day. Today our imports are only 5 million barrels per day and oil from the Persian Gulf accounts for only 3 percent of our consumption.
 - oo As long as we are dependent on any imported oil, we need to have sufficient reserves for use in times of disruption. Our Strategic Petroleum Reserve (SPR) has been increased to 400 million barrels, nearly 4 times the amount on hand when this Administration took office in January 1981. This represents the equivalent of 80 days of our net oil imports and is in addition to commercial stocks which can also be used to cushion the effects of a disruption.
 - oo We are willing and intend to use the SPR to optimum advantage early in a major supply disruption.
 - oo Surplus capacity available to offset a disruption is greater than ever before, totaling about 9 million barrels per day worldwide.
 - oo Because the oil market is international, we could not isolate ourselves from the effects of a temporary interruption of Persian Gulf oil flows.
 - oo Our allies remain very dependent on Persian Gulf oil. Europe depends on imports to meet nearly two-thirds of its consumption needs, while Japan imports nearly all of its oil.
 - oo We are engaged in an extensive new round of consultations with our allies on ways to prevent or deal with a disruption.