

## **War, Oil and the Danger of Knee-jerk Reactions**

War worry. Cold wave. Production pitfalls. Looks like a “perfect storm” is brewing in the oil prices market. Despite the outpouring of public outcry at the prospect of attack on Iraq, President Bush seems to be politically and strategically poised on the brink of war. This has created a ‘fear psychosis’ sending oil prices northbound. The cold weather is contributing to the price-spiral creating an unprecedented demand for heating oil in countries like US and Canada, sending inventories down and prices up. To add to the brimming woes, the Venezuela oil workers’ strike shows no sign of a let-up leading to a ‘scarcity phobia’. Result: worldwide oil panic. A panic that is sending governments, politicians, economists and analysts in a tizzy as they conjure up images of likely war scenarios and their impact on oil markets, global recession and macro-economic parameters.

What would be the impact of a Middle-East war on India? Can we withstand the shock? What is the prescription we have in hand? Will it insulate us from the storm or at least give enough cover till it blows over?

Prime Minister Atal Behari Vajpayee and Petroleum Minister Ram Naik, with the customary political bravado have made light of the situation saying that forex reserves were enough to import more oil should the situation demand, that oil production from other countries would make up for the shortfall from Iraq and measures like car-less days could help tide over the crisis in the short-term.

For the longer term, the government has gone ahead and announced the setting up of strategic oil reserves at a capital cost of Rs 4,300 crore. This would be besides an inventory cost of Rs 1,800 crore annually. This cost, announced the government, would be met through a special cess on petroleum products. Brave, new step. But it raises several questions and seems to be a knee-jerk reaction, borne more out of political necessity of action rather than economic viability. Here’s why:

First, the cost factor. Whereas the government claims that the inventory-cost of 45-day strategic oil reserves (approximately 90-100 million barrels) is Rs 1800 crore annually, data culled from various government sources reveals that taking into consideration the storage, transportation, insurance, safety and protection costs, evaporation losses etc, total carrying cost of the reserves will not be less than a whopping Rs 15,600 crore! Whether the government decides on a cess or one-time grant to finance this, the fact is that ultimately it will be the consumer who will directly or indirectly pay for this. The question, therefore, is that can a country like India afford this ‘solution’?

Second, storage logistics. The government says that to begin with it will create storage tanks at Rajkot, Mangalore and Vizag to stock 5 million tonnes of crude oil. These tankages will take three and a half years to build and pose several

issues that need to be addressed. For one, oil is a physical/liquid asset. It is vulnerable to evaporation, accident and spillage losses. It may even pose a security and defense threat. Remember the torching of oilfields and oil wells by Saddam Hussain in Kuwait in the 1991 Gulf war. In fact, Kuwait is still recovering from the devastation and today troops stand guarding its border areas with Iraq. Besides, there are environment issues involved in storing oil too.

Third, quality and specification issues. That we will build oil reserves is the simple part. More complex is what type of crude will we import? There are some seven grades of oil available like Arab light, Brent, Arab Middle Distillate, West Texas Crude, Dubai Fateh, Isthmus, Minas and the mix. What may be good for one refinery may not be good for another. Crude procurement and storage therefore has to be location specific. Besides, the procurement must be product-specific and dictated by the demand. This requires a detailed study of product demand so that reserves can be built accordingly. No such exercise has been conducted.

Fourth, the rationale for creation of oil reserves is insulation from international price volatility, especially the sudden swing in prices dictated by unforeseen circumstances, like the impending war. However, in reality when countries start building reserves in anticipation of price hike, it actually creates 'artificial scarcity,' akin to grain hoarding in times of famine. The net impact is price distortion. Besides, there are other mechanisms available today to minimize international oil price volatility. Hedging is one. Through financial instruments like futures and options, one can secure supplies and optimize costs. Long-term trade agreement can also help in insulating against periodic swing in prices. Besides, equity oil participation is a good route available to Indian oil companies to gain rights over oil production in other countries.

Creation of strategic oil reserves, at best, is a short-term supply-side security. Any long-term policy must take into account four factors- equity, security, efficiency and environment. Such a policy has to take into consideration development of alternative sources of energy especially bio-fuels, solar and wind energy in our country to arrive at a good energy-mix. It must accelerate indigenous hydrocarbon exploration and production and reward energy conservation and efficiency and above all it must be fair on the consumers. Like it is said, "The best way to face the future is to invent it now."