PIRINC

You may be interested.

PIRINC has prepared the enclosed report, *The SPR, the Royalty in Kind Program, and Oil Prices.*

Since the beginning of August, oil prices have moved up to about $32/barrel, well above levels prevailing in the immediate aftermath of the toppling of the Iraqi regime in April. In searching for explanations for escalating prices, some have pointed to the oil deliveries being made to the SPR under the royalty in kind (RIK) program as a significant source of upward pressure on prices and have called on the government to suspend them. This note presents a brief discussion of the issue.

Last December, in response to the loss of Venezuelan supplies, scheduled deliveries of oil under the RIK program were deferred until September. In April of this year, with the end of major fighting in Iraq, contractors were advised that deferrals had ended and that normal deliveries would resume in May. Oil prices in the market at the time were down from their pre-war levels and the resumption of RIK deliveries had no apparent effect on the market. The markets since then have been responding to other far more important developments, in particular, the disappointing production levels in Iraq, slippage in Venezuelan production, uncertainties in Nigeria, and sharp reminders of ongoing terrorist threats in key oil producers. All in all, the impact of the SPR fill by itself on oil prices is measured in nickels and dimes per barrel, not dollars, and no more than about 1 cent a gallon to consumers.

If you have any questions or comments, please call John Lichtblau, Larry Goldstein or Ron Gold.

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The SPR, the Royalty in Kind Program, and Oil Prices

Summary

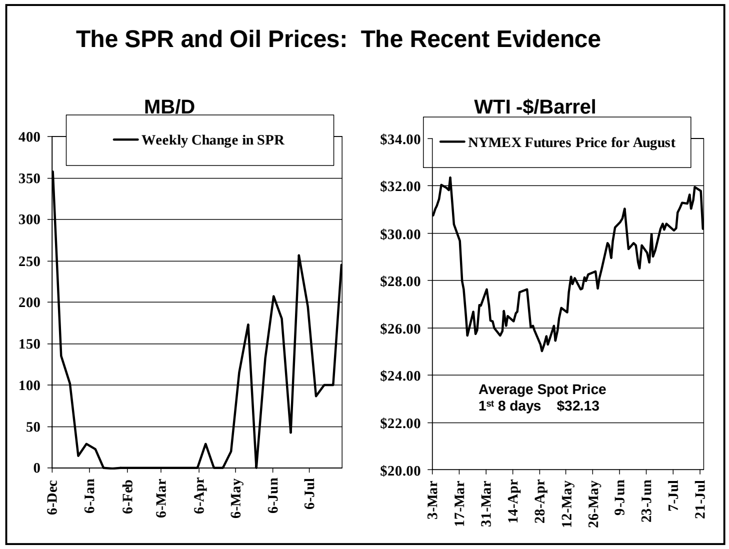
Since the beginning of August, oil prices have moved up to about $32/barrel, well above levels prevailing in the immediate aftermath of the toppling of the Iraqi regime in April. In searching for explanations for escalating prices, some have pointed to the oil deliveries being made to the SPR under the royalty in kind (RIK) program as a significant source of upward pressure on prices and have called on the government to suspend them. This note presents a brief discussion of the issue.

Deliveries of oil to the SPR have been averaging about 130 MB/D since May, which in turn amounts to less than 0.2% of world oil demand. Moreover, the deliveries come as no surprise to the market since there have been significant volumes delivered under the program for about two years. However, in December of last year, in response to the loss of Venezuelan supplies, scheduled deliveries of oil under the RIK program were deferred until September. In April of this year, with the end of major fighting in Iraq, contractors were advised that deferrals had ended and that normal deliveries would resume in May. Weekly inventory data released by the Department of Energy allowed markets to see the volumes involved and reflect them in prices. Oil prices in the market at the time were down from their pre-war levels and the resumption of RIK deliveries had no apparent effect on the market. The markets since then have been responding to other far more important developments, in particular, the disappointing production levels in Iraq, slippage in Venezuelan production, uncertainties in Nigeria, and sharp reminders of ongoing terrorist threats in key oil producers. All in all, the impact of the SPR fill by itself on oil prices is measured in nickels and dimes per barrel, not dollars, and no more than about 1 cent a gallon to consumers.

The SPR Fill and Oil Prices

The left panel of the chart below shows by week changes in the level of the SPR measured in thousand barrels a day (MB/D) since early December.[1] In that month, in response to the interruption in short haul Venezuelan supplies, the government announced a deferral of scheduled RIK deliveries until September. What had been a significant 350 MB/D build in the first week of December fell away quickly, dropping to zero in early January. There were no additions to the SPR for the next few months as the country moved toward military action in Iraq. In April, with the removal of the Iraqi regime and the substantial recovery in Venezuelan

[1] In early 1999, the Clinton Administration announced plans to use RIK oil as a means of adding to the SPR. The use of RIK oil for this purpose was endorsed in the Bush Administration's National Energy Plan released in May of 2001 and later that year, President Bush announced his intention to use this means to fill the SPR to a target level of 600 million barrels. Historically, the SPR had acquired oil through public tenders while royalties for oil produced in Federally leased offshore areas were generally paid in cash. For the oil industry, the switch to paying royalties in kind offered a means of avoiding disputes over valuations of oil at the well-head when comparative arms-length, publicly available prices were available only further downstream where they included implicit transportation costs.



production, the deferrals ended and deliveries of significant, contracted, volumes of RIK oil began in May. Since then, they have averaged about 130 MB/D.

It is important to keep in mind what was underpinning market expectations at the time. In particular, in late April-early May, Iraqi production was expected to rebound quickly with the newly appointed head of Iraq's oil sector anticipating 1.5 MMB/D of production "within weeks." The key issue for markets was the ability of other OPEC members to make room for rising volumes of Iraqi and Venezuelan oil and thereby contain a threatened, price-depressing surplus of oil. To illustrate market sentiments at that time and how it has changed, the panel on the right shows the trend in the NYMEX August futures price for WTI daily from early March through July 22nd, the last trading date for the August contract. At the beginning of March, the August contract price stood at $32/barrel, reflecting a premium for potential risk to oil supplies extending beyond the immediate war time frame. By late-April through early May, even with the resumption of RIK deliveries to the SPR, the August contract price was down to $26. In the face of such bearish market signals, key OPEC members began taking back the production increases that had been made to offset losses from Venezuela and to calm markets in the run-up to military action in Iraq. In particular, Saudi Arabia raised production by more than 1 MMB/D between January and April, but by June, had reduced production by approximately 0.75 MMB/D.

It soon became clear these early anticipations were not going to be met. The International Energy Agency reports Iraqi production in June averaged only 440 MB/D and July production averaged 665 MB/D. Slippage in Venezuelan production in recent months, ongoing terrorist acts and threats in key oil producing countries have added to supply concerns. Since early May, these changes helped propel the August contract price in almost a straight line to the $30 level and beyond by the time of the July 22nd contract expiration date. The actual spot price of oil in early August is averaging just about $32.

Low levels of commercial inventories have magnified the translation by the oil market of supply disappointments into higher prices. In the US, the latest statistics show commercial crude and product inventories running about 9% below year-earlier levels.

RIK Oil in Perspective

World oil demand this year is estimated at about 78 MMB/D. At 130 MB/D so far this year, RIK deliveries to the SPR amount to less than 0.2% of this total. The deliveries are also small relative to a major influence on world oil markets, rising US oil imports. In the 4 weeks ending August 1st, US net oil imports averaged 11.6 MMB/D, up 1.3 MMB/D from the same period last year. The rise in imports reflects the combination of slightly higher final demands, ongoing declines in US production, and the need to rebuild stocks from exceptionally low levels reached earlier this year. Deliveries to the SPR in the 4 weeks ending August 1st had a minimal role in the increased level of imports. Deliveries were up about 60 MB/D versus the same period a year ago. Since the beginning of May when significant deliveries began, they have been running at about the same rate as over the same period last year.

In principle, any addition to demand, however modest, other things equal adds upward pressure to prices, and therefore, any reduction in demand, would have a similar negative impact on prices. But in considering the price impact of even the modest level of current SPR fill rates, it should be kept in mind that these amounts were known well in advance by market players, including the OPEC countries, and entered into their supply planning. In effect, the known requirement almost certainly had a positive impact, however small, on overall supply, mitigating what in any case would be a modest impact on prices.

The SPR is the nation's insurance policy against international supply disruptions and the economic dislocations that could follow. Currently, the days of import protection provided by the SPR are far lower than in the early 1990s when they stood at over 80 days. There has been some improvement since coverage reached its 50-day low point in 2001, thanks to the RIK program. This year, import coverage should exceed 55 days, still well below its early-90s level. In October 2001, PIRINC issued a report strongly supporting filling the SPR to its 700 million barrel capacity.[2] At current import levels, filling the SPR would raise days import coverage to about 65 days, still well below the early 1990s levels. Moreover, virtually all forecasts project rising imports.

Undoubtedly, a sudden, unanticipated deferral or suspension of RIK deliveries would have a temporary downward impact on prices since immediate global supply availability is unchanged. But just as the resumption of deliveries in the spring would have entered into the supply planning of key producers, so too would a suspension, limiting the impact of the modest reduction in global oil requirements beyond the very near term.

- [2] **Buy Insurance When It's Cheap: Add to the SPR Now,** October 2001.

Nothing comes free and the use of the SPR in other than emergency situations could have long term costs. If market participants come to believe that the SPR will be used in non-emergency situations to dampen prices, the result will be greater reluctance to take the actions that themselves prevent or alleviate tight markets such as building inventories and shopping the market for additional supplies.

The SPR by statute is meant to deal with a “severe energy supply disruption” or conditions that could lead to “a domestic or international energy supply shortages of significant scope or duration.” The deferral of deliveries in December in response to the loss of Venezuelan supplies clearly fit within these stated purposes. Bringing the world price down by 1 to 2 cents/gallon clearly does not. Given the recent demonstrations of supply risk over the past several months, there is compelling reason to continue to build up the SPR using the relatively modest, predictable volumes of the RIK program.