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FILLING THE STRATEGIC PETROLEUM RESERVE

by

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Recently an unconfirmed report of a major Iraqi attack on Iran's Kharg Island oil terminal pushed oil prices in the spot market up by $1/barrel within hours because of the fear that if Iraq succeeded in blocking Iranian oil exports, Iran would retaliate by closing the Strait of Hormuz. Prices fell back the next day. But the brief episode was a reminder that without some form of early counterveiling market intervention in a real major oil interruption spot prices would probably soar again as they did in 1973 and 1979, to the detriment of the entire world economy. One important contemplated intervention is the release of oil from the government-controlled emergency stocks built up in the industrial countries.

In the United States these stocks are the Strategic Petroleum Reserve (SPR) which can only be drawn down if the President declares an emergency. The SPR was non-existent or too small to matter in our two previous oil interruptions Now, however, with 390 million barrels in place it is beginning to carry weight. It has become the Administration's principal instrument for dealing directly with an oil interruption. In fact, it is this Administration's only activist energy policy, reflecting its view that the energy market functions best with minimum governmental intervention, except when distorted by extraneous factors, such as major supply disruptions.
Yet, our SPR policy is surprisingly inconsistent. The more public recognition the Administration gives to the SPR, the slower it fills it, thus pushing the official inventory goal target of 750 million barrels further and further into the future.

The Energy Emergency Preparedness Act of 1982 established a minimum average annual fill rate of 300,000 B/D, or 220,000 B/D if the President notified Congress that the higher fill rate was not in the national interest. The President did so in December 1982 and reduced the fill rate accordingly. For the current fiscal year (1984) the rate was further reduced to 186,000 B/D under a budgetary escape clause in the law and for Fiscal 1985 the Administration is proposing a fill rate of only 145,000 B/D. None of the reductions were due to supply constraints, inability to acquire or develop storage capacity or increases in the price of oil.

If the 300,000 B/D rate had been maintained and were to continue, the 750 million barrel ultimate SPR goal could be reached nearly four years earlier than the Administration's currently projected date of late 1990. Given the demonstrated insecurity of Middle East oil supplies which still account for about half the world's oil exports, the difference could be vital. The 750 million barrel target is probably adequate for every realistic eventuality. But until we get a lot closer to it we will not be fully protected. Hence, the need for a higher fill rate. It is puzzling that an Administration which insists on increasing its military budget in the face of a record deficit
cites budget constraints as the sole reason for curtailing a program with such a major national security component. Yet, our SPR is far more likely to be activated in the foreseeable future than our high cost advanced weapons. In fact, there is a reverse connection. This Administration is committed to reopen the Strait of Hormuz should any country close them. Eventually we would have to do so because the world cannot do indefinitely without oil from the Persian Gulf. But the larger our SPR the more time and flexibility we would have to plan, schedule and execute an action of such enormous potential risk.

The SPR's present level and facilities permit a maximum drawdown rate of 2.1 million B/D for about 90 days or 1.7 million B/D for at least 150 days after which the rate would progressively decline. With a likely 6 million B/D of gross oil imports in 1984 this would equal 35% of our imports for the 90-day period or 28% for the 150-day period. Whether this would be sufficient to prevent a substantial price increase depends not only on the magnitude and duration of the interruption but also on the perception by the market of these two factors, particularly the latter. As we now know, the price increases of 1979/80 were caused far more by the relentless build-up of stocks than by the relatively brief cessation of Iranian oil production. The stock build-up was caused by a combination of uncertainty and confidence--uncertainty about future Iranian production and confidence that OPEC's power would protect all price increases, thus reducing the risk of inventory losses. The confidence in OPEC's pricing power has greatly diminished. But uncertainty over the duration of a major oil interruption could still cause
substantial panic buying unless it were counterbalanced by the perception of an adequate emergency reserve readily available to offset the shortage. The Secretary of Energy has recently explicitly declared his readiness to use the SPR early in an interruption. This was an important positive message to the market, providing assurance of some protection in an oil emergency. However, until the SPR is much bigger, uncertainty about its protective ability could still cause excessive price increases in case of a major interruption. The fact that U.S. oil imports are increasing again, following a 5-year drop, makes an acceleration of the fill rate all the more urgent.