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COMMENTS ON S. 2177:

**The Distillate Market's Not Broken
So Why Fix It**

Testimony by

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before the Subcommittee on
Energy Regulation and Conservation
of the Committee on
Energy and Natural Resources
United States Senate

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In his letter inviting us to testify at today's hearing, Senator Wirth asked us to comment on S. 2177 and any policy changes that should be considered in light of the Energy Information Administration's recent report, *An Analysis of Heating Fuel Market Behavior, 1989-1990*. Our own report on the subject, *A Season of Extremes*, published about a month prior to the EIA report, is appended to my statement for the record.

■ *In a season of extremes, the market worked: a summary of our May report*

- The heating oil market in December 1989 was put under extreme stress by the historically cold weather, a stress made worse by supply factors, but functioned properly to get oil where it was needed, when it was needed.
- The market at all levels reacted to the extreme demand with soaring prices which rapidly came down when degree days, and hence the supply/demand situation, eased.
- On the demand side, the weather caused dislocations throughout energy markets. Demand for heating fuels--oil, gas, electricity, propane--rose in line with degree days, and then rippled throughout the market, notably, back to oil. Increased gas use in the residential sector, for instance, had to draw on gas supplies from other sectors; those other sectors had to turn to alternatives, primarily oil. Increased electricity use put an additional strain on all generating fuels.
- On the supply side, inventories at the beginning of the season were lower than the previous year, but in line with earlier years. Imports in the early part of the season were lower than in previous years because of competition for supplies in world markets. Refiners rapidly responded to the developing supply/demand situation in December with sharply increased output, but were stopped in their tracks by the bad weather of Christmas week, which was so severe at the Gulf Coast that refineries were damaged.
- The January thaw, like December's cold, was extreme. The supply/demand balance quickly righted itself. Prices at the wholesale levels responded instantly, giving back half of their increase in one week. Retail prices also quickly retreated from the peak, but did not return to the November level.

■ *Comments on S. 2177: No major policy initiatives or interventions are necessary*

My first comment is that our findings summarized above agree with the EIA report: the market worked as well as could be expected under extremely unusual and difficult circumstances and actually succeeded in supplying all the oil to all customers in the Northeast throughout the critical period from mid-December to early January. There was no evidence of collusion or withholding of supplies in order to raise prices. Hence, our study and the EIA study come to the same conclusions on the broad issues and the important factors behind them.

The very steep price increases which occurred in December can be traced to the highly exceptional weather. In a month where the weather was "one-in-ten" colder than normal or even "one-in-twenty" colder, prices would not have risen enough to call public attention to them. With the coldest December in sixty years, however, they did explode for about one-third of the prime heating season (roughly a 4-week period), causing, understandably, grief, anger and financial hardship to many consumers. By the turn of the year, prices were up to 50% higher than the year before, and December consumption for a typical Northeast consumer was probably about one-third higher. However, over the entire heating season, a typical heating oil consumer in the Northeast likely used somewhat less oil in 1989-90 than in the year before and his outlay for heating was 10-15% higher.

Understandably, the political representatives of these consumers want to be "sure" that last winter's price spikes are not repeated next winter. No such assurance is possible in a free and competitive market. However, the price spikes occurred entirely because of extremely unusual, extraneous factors. Under less extreme circumstances--like those that occur in most heating seasons--the market could be assumed to work efficiently and require no direct or indirect governmental intervention or bureaucratic guidance. It is important that last season's experience, painful as it may have been in December, not be used as a reason to initiate policies and programs which may be counterproductive.

■ *Price monitoring programs already underway and under development are likely to be adequate*

Detailed monitoring of wholesale and retail heating fuels prices and inventory levels, state-by-state and company-by-company, as proposed in S. 2177, is unnecessary. Last winter, the Northeastern states (all the states from Pennsylvania to Maine) collected and published residential heating oil prices on an ongoing basis during the heating season. Perhaps some of these states may require encouragement to continue. The Energy Information Administration already has an extensive collection and publication effort for state prices on a monthly basis, and is currently increasing its efforts to provide timely and comprehensive data for the oil consuming states. S. 2177's additional prescribed detail is unlikely to be needed.

Some states already provide considerable detail. New York, for instance, publishes regional prices for nine regions within the state. It should be pointed out that price differentials between states or between local markets and the state average are not necessarily a sign of greater or lesser competitiveness. The differences could be due entirely to variations in distribution and other costs. For instance, in New York, upstate prices of heating oil are always lower than downstate prices. A primary reason is different distribution and property costs, although different market profiles also play a part.

■ *Recommended inventory levels will be counterproductive*

The provisions in S. 2177 which call for recommended national, regional and state inventory levels and a system of public notification when these levels are not met is not only an unnecessary measure in a competitive market but also potentially a damaging one. The levels recommended by the Federal government would probably be biased on the up side under the criteria stated in the bill. Thus, there would be an ongoing conflict between actual and recommended stock levels. In this conflict state legislatures may be under pressure to make the DOE's recommended state levels mandatory. Thus, the proposed

recommendation could well be the first step towards mandatory inventory control. In fact, such a development would be quite likely since in a competitive market individual companies cannot increase their inventories to comply with the state-wide or regional recommendations. Thus, any gap between the real and the hypothetical inventories could only be closed by enforcement. Inevitably, any mandated inventory increase would raise the cost of doing business and, hence, the consumer price of the heating fuel in question.

Furthermore, setting recommended stock levels is unrealistic for the nation and impossible for subregions. The market balances stock levels among regions--product moves from the Gulf Coast to consuming regions, marketers in the consuming regions are willing to pay a premium or not depending on the supply/demand situation in the region. These movements are a central part of the ongoing balancing act of the market, safety valves. A temporary imbalance is not cause for government intervention. And the industry's distribution centers, such as New York Harbor, may not respect state boundaries.

■ *Further study will help us understand the impact of interruptible gas contracts*

Senator Wirth has asked us to address the issue of interruptible gas sales. Indeed, the *ripple effect* of surging demand for heating fuels was critical in December, and some study of seasonal swings in fuel use would be useful to understanding how markets will react in times of difficulty.

Gas use in December rose substantially above year-ago and month-ago levels. Virtually all firm customers got their supply. Withdrawals from storage hit a new monthly high. But the need to fuel the weather-related demand pulled supplies away from others, who turned to oil, exacerbating the stress in oil markets. Although some argue that the volumes are not large relative to total oil demand, they come at the margin, and in December 1989, the price impact, at the margin, may have been considerable. We, like the EIA, estimate that about 130,000 B/D of incremental distillate was supplied to electric utilities and industrial plants last December during the colder weather, equal to about 3.3% of total

U.S. distillate consumption. Most of the additional consumption went to substitute for natural gas.

Interruptible service has traditionally helped the gas industry balance the seasonal demands of its heating customers. In the coming years, the role of the interruptible market segment will become even more important, since the need for increased electric generation will require the installation of more turbines that can run on gas or distillate. This means more seasonal fuel switching in the future.

Data on the interruptible segment of the gas market, and how it reacted in December, is not readily available. A study to determine the current impact of interruptible gas contracts on energy markets, as mandated in S. 2177, will be useful to policy makers and the industry. Furthermore, a forecast of the role of interruptible contracts would help assess whether the price volatility of this season may become a more commonplace feature of the heating season.