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ASPECTS OF THE U.S. CRUDE OIL ENTITLEMENT PROGRAM

Statement before the

Subcommittee on Energy and Power
U.S. House of Representatives

by

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Thank you for inviting me to testify before your committee on the subject of crude oil entitlements -- their original purpose, their current uses and the question of their continued need.

In essence, crude oil entitlements represent a form of direct government intervention in the market. Like all such interventions, it has created vested interests on both sides -- those who benefit from it and those who are hurt by it. Given the fact that the annual value of entitlement exchanges amounts to several billion dollars, the stakes on both sides are quite awesome.

Yet, recognition of the fact that entitlements distort market forces is not necessarily an indictment of them, at least not of their original purpose. We must remember that with the tripling of world oil prices by the OPEC cartel, which was at that time unrelated to underlying market conditions, it became virtually obligatory for the government to intervene in the market. It was deemed necessary to prevent the initial inflationary impact of the OPEC price increase from spreading to domestic oil and it was deemed equally necessary to prevent domestic oil producers from receiving a sudden major "windfall" profit by raising their oil prices to the foreign cartel level. The result was the imposition of price controls, first on old oil only and since February 1976 on all domestic oil, with certain specified exemptions.

The crude oil entitlement program was a logical outgrowth of the price controls. Its purpose was to give equal access to all U.S.

refiners to price controlled domestic crude oils through compulsory transfers of rights to such crudes. The system has accomplished its purpose of approximately equalizing crude costs among U.S. refiners. But its complexities are mind boggling and its administration has been expensive, both for the administrators and the administrated. And, predictably, it has increasingly given rise to requests for differential treatment by various groups for various reasons.

The price controls and entitlements package makes sense only as a temporary measure -- as part of an adjustment process to the new oil era. It would not be in the national interest to attempt to protect U.S. consumers permanently from the real world price of oil as long as their incremental requirements come mostly from foreign sources. Neither would it be in the national interest to force U.S. producers to liquidate their entire inventory of previously discovered reserves at prices significantly below replacement costs. Finally, it would make little sense to keep U.S. refiners permanently indifferent to the true cost of their respective feedstock, which is what the entitlement system is in effect doing through its crude oil cost equalization formula.

Both the existing legislation (EPCA) and the legislation proposed by the Administration have in principle recognized the need to end the price controls. Under EPCA all controls would end by May 1979, with Presidential discretion to extend the deadline to October 1981.

Under the Administration proposal, the price of all domestic oil to refiners would be raised to the world price level over a two year period by establishing a crude oil equalization tax (COET), thereby automatically ending the needfor entitlements. However, upper and lower tier crude price ceilings would be more or less permanently frozen at existing levels, adjusted for inflation.

Both the proposed legislation and the expiration of the existing one would have an inflationary impact on the economy, since they would raise consumer prices of most oil products by the approximate differential between current average crude prices to U.S. refiners and world crude prices. This is not a criticism of either measure but there should be no false expectation that somehow domestic refiners could be made to absorb much of the crude price increase or the tax so that ultimate consumers would not be significantly affected by crude price decontrol or by COET.

Neither EPCA nor COET offers an adequate solution to the problem of what to do about the existing price controls. Under EPCA the "windfall" profit question would undoubtedly come up once again when full decontrol is required. In 1981 lower tier oil production will still amount to more than 2.5 million b/d, and its price is likely to be some $10/bbl below the landed cost of imports. Regardless of economic justifications, what is the political likelihood that Congress, or the Administration, will permit a sudden, one-time price increase of this magnitude, with all of the money going to producers? Former FEA Administrator Frank Zarb predicted the recurrence of this problem

in 1975 when the present legislation was before Congress.

Under COET, the problem would be on the other side of the fence. Permanent control of wellhead prices below replacement cost for most domestic oil discovered prior to April 1977 is obviously unacceptable to the oil industry. Nor would it make economic sense. Just consider the fact that after adjustment for inflation and the loss of the depletion allowance the real value to a producer of a barrel of lower tier oil is less today than it was in 1973. Under COET this would continue to be the case but consumers would no longer benefit from the low prices.

Thus, if the Administration is determined to use COET as the instrument to raise domestic oil prices to world market levels, it should combine it with a phase-out schedule of all wellhead price controls. For upper tier oil this presents hardly a problem, since its price is already only about $2.00-2.50/bbl below the market level. Upper tier price control could therefore be phased out over the next 2-2½ years without creating any significant profit bulge in the industry's earnings.

For lower tier oil the phase-out period may have to be somewhat longer, perhaps 4-5 years. The technique to accomplish it could be quite simple: establish a fixed decline curve for lower tier oil production, designed to reduce it to zero by the set date.

The phasing out of price controls under this system would of course automatically bring about a parallel phasing out of the

COET so that by the end of the period both price controls and crude oil taxes would cease to exist.

This still leaves the question of what to do with the money collected under COET while it exists -- how much of it to rebate to consumers, how much to use for the development of new energy sources and whether any part should be rebated to refiners to protect them from foreign competition during the transition period. These are important questions but I believe they are secondary to the establishment of the principle that price controls, entitlements and taxes on crude oil are all temporary provisions which should not be incorporated into our long term energy policy.

Next, I would like to discuss briefly another point you raised in your letter to me, Mr. Chairman, namely the existing and proposed system of entitlements for residual fuel imports into PAD I.

The entitlements policy for residual fuel oil dates back to the beginning of 1976. At that time it had become amply apparent that the crude oil entitlements were causing some structural changes in the East Coast residual fuel oil market. Thus, while in 1973 about 79% of East Coast residual supplies came from foreign sources, by the second half of 1975 the share had dropped to 57%. The principal reason, by far, for this change was of course, the differential in crude oil costs between U.S. and foreign refiners. It enabled the domestic companies to undersell the importers in the East Coast market which had traditionally been supplied almost entirely from

foreign--mainly Caribbean--sources. The principal beneficiary of the system, according to offical FEA analysis, was the refinery in the U.S. Virgin Islands, since it was the only major U.S. plant at the time designed to maximize the yield of residual fuel oil per barrel of crude throughput. Its share of the East Coast market rose from 11% to nearly 17% between 1973 and the second half of 1975.

In order to halt this shift in market share and its negative impact on traditional U.S. residual importers and their Caribbean suppliers, the FEA issued a 30% crude oil entitlement for each barrel of residual fuel oil imported into PAD I and reduced U.S. (including Virgin Islands) refiner crude entitlements by half a barrel for each barrel of residual oil sold in PAD I above the first 5,000 b/d. This reduced, but did not eliminate, the advantage of the Virgin Islands over foreign Caribbean refiners. At the same time it created a disincentive for Gulf Coast refiners to ship their residual fuel oil surplus to PAD I.

The DOE is about to propose several changes in the existing system, such as granting full crude oil entitlements for residual fuel oil imported into PAD I and removing all entitlement restrictions for domestic refiners selling in or to PAD I. The proposed action would in essence put the Virgin Islands refinery competitively on a par with non-U.S. Caribbean refiners by eliminating its remaining advantage over these plants; it would also eliminate the existing disadvantage of Gulf Coast refiners in the PAD I market.

As for the consumer, the move to 100% residual entitlements can be expected to reduce the cost of the product from what it would otherwise be. From the point of view of regional equity, this may be justifiable. Residual fuel oil is the only oil product in the U.S. whose price has not been significantly affected by the crude oil entitlements program because of its high ratio of imports. Since 95% of U.S. residual imports go into PAD I, which also accounts for 60% of total U.S. consumption of this product, the economic impact of the entitlement treatment of this product has been concentrated on the East Coast. Thus, as long as the entitlement program remains in existence, it would seem appropriate that PAD I should share in its full benefit. On the other hand, it would be wrong to extend this treatment to areas supplied adequately from domestic sources, since this would probably result in the displacement of domestic residual fuel oil by imports which would be contrary to the Administration's policy.

A problematic aspect of giving full entitlements for residual fuel oil imports is its potential disincentive for new domestic refining capacity. With new capacity cost nearly twice that of plants built only a few years ago and with substantial excess capacity in both the Caribbean and Western Europe, the phasing out of the entitlements program will create a major deterrent to the construction of additional full-scale refining capacity in the U.S., unless some substitute protective measure is devised by the government. Since

future U.S. refineries are likely to be more fuel oil and less gasoline oriented, inasmuch as U.S. gasoline demand is expected to start declining after next year while fuel oil demand will probably grow for another 5-6 years, full cost equalization of imported and domestic residual fuel oil at this time could advance and strengthen the impact of this deterrent on new capacity.

This raises the question of whether the U.S. really needs new refining capacity. Certainly, we will not need much. We expect U.S. oil demand to rise by 2.2-2.4 million b/d between 1977 and 1985, which represents an annual growth rate of 1.5%. Since U.S. refineries still have some spare capacity, to meet all of this increase from domestic plants might require a little under two million b/d in capacity additions. If we build less than this capacity, products imports will have to grow. Given the substantial spare capacity in existing Caribbean and other foreign export refineries, some additional products are readily obtainable from abroad at lower costs than from newly built domestic plants. However, if we do not expand our refining capacity by at least 1.0-1.2 million b/d over the next seven years, we will encourage the construction of new foreign capacity to meet our incremental needs. This does not seem to be in the national interest from an employment, investment or balance-of-payments point of view.

As I have indicated, the required domestic capacity addition to prevent such a development would be relatively small. Yet, much of it is unlikely to take place without some form of long term government

incentive or protection, in excess of the existing 58¢/bbl protection given new capacity for the first five years of operation. Failure to develop such a policy soon would be tantamount to deciding in favor of the import option, considering the lead time required to build new facilities.

Ironically, the Administration has a very generous incentive policy for one type of domestic refinery by virtue of its "Small Refiner Bias" which is particularly favorable to plants in the 35,000 b/d or less category. In 1976 and 1977 some 25 grass roots plants in this category were built and additional ones are continuing to come on stream. Many of these plants would never have been built without this particular subsidy because economies of scale would not have enabled them to compete with larger, more efficient domestic plants. Those that would have been built anyway are receiving substantial "windfall" gains.

Thus, a program whose initial purpose was merely to continue the relatively modest preferential treatment to small plants which has been in existence since about 1960, has through its excessive generosity created a new inefficient small-scale industry. Responsible DOE officials are fully aware of the excessiveness of the program but have done nothing about it, despite a recent Justice Department finding that the existing Small Refiner Bias program is "unnecessary and wasteful and in excess of those sums necessary to equalize costs".

Another problematic aspect of these plants is that most are designed to run on sweet crude oil only. Since this type of crude is expected to be less readily available over the long term, both in the U.S. and abroad, than sour crude, it would seem to be in the national interest to encourage more sour crude, rather than sweet crude, refining capacity in this country.

The Administration cannot and should not go back on its commitment in principle to small refiners. But it could at least stop encouraging the proliferation of these mini-plants. If we need additional refining capacity in this country, it should be of the most efficient, rather than the least efficient, size and type.