You may be interested.

PIRINC has prepared the enclosed report, *What Happened To Heating Oil?*

Earlier this winter, heating oil customers in the Northeast faced an unprecedented surge in prices, which at their peak exceeded $2 a gallon. Prices have since moved substantially lower as market responses, plus warmer weather, improved the local supply/demand balance.

This report first analyzes the circumstances that led to the price surge. Some increase was coming in any case, but the price surge reflected certain very specific local factors. The episode revealed potential constraints in meeting peak demands for overall energy in the Northeast, not just heating oil. Indeed, oil is the region's safety valve at times of peak demand and served that role again, although at a high price. The report next focuses on proposals to ease the situation in the future. The government has already taken a critical step, namely expansion of the Low Income Home Energy Assistance Program. But proposals to deal with price surges directly raise more complicated issues, and in some cases could prove counterproductive.

Although the heating oil price surge is behind us, the world is currently experiencing a tightening of all product markets with the focus particularly on transportation fuels. If OPEC agrees to raise production significantly at its meeting scheduled for late-March, prospects for stabilizing prices would be greatly enhanced. Any delay, however, would lead to growing pressure for government action, especially pressure to use the Strategic Petroleum Reserve.

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

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What Happened To Heating Oil?

The monthly average price of WTI has moved up from its low point of $12/barrel in February 1999 to $29 in February of this year. The price has moved up further, averaging about $32 in early March. The difference of $17 between February 2000 and February 1999 translates into a 41 cent/gallon increase in the raw materials cost of making heating oil—plus a further 5 cents as of early March. In such circumstances, it would have been reasonable to expect an increase in heating oil prices over the same period of a more-or-less similar amount. However, as noted in the chart, the early February (2/7) residential price of heating oil this year in PADD 1 (the East Coast) was up by 107 cents/gallon over its February 1999 price, about 2½ times the increase in crude costs. By the end of February (2/28), residential prices in PADD 1 were 52 cents/gallon below prices earlier in the month and approaching the increase in crude oil costs over the period. Clearly other, temporary, factors besides crude costs were behind the recent spike in heating oil prices. These “temporary factors” are the focus of much this report.

Another critical global influence on prices is the exceptionally low level of commercial stocks of crude and products held in the major consuming regions of the world. Low inventories mean greater sensitivity of crude and product prices to adverse supply developments and unanticipated increases in demand. The next chart shows commercial inventories of crude and products in the three major OECD regions, the U.S., Europe and Japan, at the start of each year since 1991 in terms of days supply relative to first quarter demand. The major regions entered this year with commercial stocks at lower levels, 54 days supply, than at any time over the ten years shown in the chart. A secular downtrend in stocks over the period reflected industry efforts to reduce costs in the face of chronic, poor returns on downstream operations. But the decline in days supply between the beginning of 1999 and this year comes after a recovery in stocks from what had previously been considered an extraordinarily low level in 1996.¹

The current, low level of stocks, and the sharp increase in crude prices over the past year are of course related. Last March, OPEC and other key exporters agreed (for the third time within a year) to

¹ Stocks have continued to deteriorate well into the first quarter. With the approach of spring, concern has shifted to adequacy of supply of transportation fuels, gasoline and diesel.
reduce production in what has turned out to be a successful attempt to raise prices from levels that in real terms had not been seen since the 1950s. At the same time, economic recovery was strengthening in Asia, lending support to the attempt to prop up prices. Growing demand and restricted supply led to the drawdown in commercial stocks.

**Distillate Economics and Production in 1999**

To this point, the price discussion has focused on crude costs and overall inventories. But product prices depend also on consumer need for the product and willingness to pay. In the case of distillate, until mid-January of this year, support from these factors was very weak. As a result, gross margins for distillate produced by U.S. refiners were depressed through most of 1999.

The chart below illustrates trends in the economics of producing distillate and recent trends in U.S. distillate production. The panel on the left shows refiner gross margins, defined as the difference between refiner price of No. 2 Distillate to resellers and refiner acquisition cost of crude, annually for 1990-98 and monthly for 1999.

![Graph showing trends in U.S. Distillate Economics and Refinery Production]

Gross refiner margins for distillate through much of 1999 were well below the average levels of the prior years. For the year as a whole, the distillate margin in 1999 was about 15% below its level in 1998 and about 20% below the average for the entire 1990-98 period.\(^3\)

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\(^2\) The weakness was due to the exceptionally warm winter of 1998-99 and the warm start to this winter. The weather influence is discussed later in the report.

\(^3\) Similar calculations for gasoline would produce a 1999 gross margin similar to 1998. However, the result is distorted by the gasoline supply problems in the unique California market that provoked temporary, sharp increases in prices in that region.
The right panel shows U.S. production of distillate by month for 1998, 1999, and estimates for January and February of this year. Until September, production of distillate was consistently below 1998 levels. In October and November, production was above year-earlier levels and in December, about the same. Production toward the end of the year was raised in anticipation of a Y2K build in consumer inventories. In January and especially February 2000, production was up significantly from year-earlier levels. Overall, production in 1999 was down only marginally on 1998--less than 1%--thanks to higher production levels in the last months of the year. However, U.S. distillate demand grew by an estimated 3% or about 100 thousand barrels/day in 1999 versus roughly stable production.

The difference showed up in a substantial decline in overall distillate inventories. As shown in the chart on the right, U.S. inventories of distillate at the end of 1998 were nearly 160 million barrels, an exceptionally high level. By the end of 1999, inventories were down to 124 million, at the low end of the range experienced since 1995, but still perceived as adequate. Contributing to this assessment was the view that some of the drawdown toward the end of 1999 reflected stocking up by customers concerned about Y2K problems, a process that would reverse itself in January. This assessment contributed to refiner decisions to go into early maintenance and turnaround. This situation delayed the refiner response to the sudden, unanticipated increase in demand beginning in mid-January.

**Influence of Weather**

The single most critical factor in demand for heating fuels, both gas and oil, is weather. In terms of monthly averages, this year to date has not been unusual, either for the nation as a whole, or in the Northeast region of the country. This next chart shows monthly average degree-days for the U.S. and for the Northeast for the last three winter heating seasons and so far this season. For the U.S. the monthly figures for this winter, particularly January, appear similar.

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4 The Department of Energy noted this view in its January 10 issue of its Petroleum Market Report. The publication reported, "API and EIA reported strong stockdraws for the week ending December 31 but most observers believe substantial Y2K pre-stocking has been a significant factor, and will result in reduced demand in January." This was consistent with the PIRINC view that consumers would build up their own stocks distillate by about 4 million barrels in anticipation of Y2K problems.
to the profiles in 1996-97 and last winter, although colder than the exceptionally warm winter of 1997-98. In the Northeast, this January was marginally colder, with about 2\% more degree-days, than January 1997 and last year. Adjusted for the extra day in February this year, degree-days in the Northeast were about 1\% above their February 1999 level (4\% unadjusted) and 8\% above February 1997 (11\% unadjusted).

Since neither January-February of 1997 nor January-February of last year produced a spike in Northeast heating oil prices, it is not obvious from the monthly data why such small difference in degree-days should produce one this year. As noted above, stocks at the beginning of this year were close to their levels at the beginning of 1997, although well below levels at the beginning of 1999.

However, monthly data do not adequately show the stresses on the energy supply system that can occur. The system must meet not only peak monthly demands but also peak weekly and even daily demands. These can be much sharper than indicated by monthly averages. As discussed more fully below, the problem can become particularly acute for gas—as it did this year. Residential heating oil customers (and their suppliers) have a buffer against very short-term peaks in the form of their own, on-site, inventories.

While on average the weather this January appeared to be in line with recent history, a more detailed examination offers a very different perspective. After very mild first few weeks, the Northeast experienced an unusually severe and prolonged period of cold weather that, along with related supply problems put severe stresses on supplies, particularly of natural gas, that in turn, produced a spike the price of heating oil.

To illustrate the particular nature of weather so far this year, the chart below shows weekly degree-days for January-February of 1997, 1998, 1999 and 2000 for the U.S. and the Northeast.

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5 In the case of electricity, the system has to manage intra-day peaks.
What Happened To Heating Oil?

Nationally, and in the Northeast, the first weeks of this year started out similar to the exceptionally mild beginning of 1998. But then the weather turned much colder. At the national level, degree-days for the week ending January 22 were nearly 30% higher than the week before. The national degree-day count rose a further 15% in the following week before falling back, although to a level still above the prior years shown. In the Northeast, the change in temperatures was even sharper. In that region the week ending January 22 had over 40% more degree-days than the week before and was colder than any other week in the prior three years. In the two subsequent weeks, the degree-day count fell back somewhat but remained above levels seen the earlier years.\(^6\) Indeed degree-days in the last week of January this year were nearly 30% above their level in the last week of January 1999 and about 13% above their level for the comparable week in 1997. Moreover, while degree-days in the Northeast fell back in the week after January 22, they reached a peak on a national basis.

In early 1997, specifically the week ending January 18, degree-days also reached very high peak levels at the national level and in the Northeast. But thereafter, degree-days fell back to levels well below those prevailing after this year’s January peak.

**Developments in the Northeast Natural Gas Market**

In meeting winter customer requirements, natural gas suppliers face a particular challenge that oil dealers do not. Unlike oil customers, residential and commercial gas customers hold no on-site inventory and therefore must be supplied on a continuous, real-time basis. To meet the winter peak demands of such customers, suppliers rely on a network of pipeline and storage facilities and also on diversion of supply from other customers, primarily electric power generators and large industrial users. Without the flexibility to divert supply from others, costs of delivering gas to residential and commercial consumers would have to be much higher to cover costs of expanding pipeline and storage capacity to meet the most extreme peak demands. Costs would be especially high in the Northeast since the region is furthest from sources of supply to begin with. Supplies are diverted from those who can switch most easily to other fuels by invoking contract clauses permitting such diversions when winter temperatures drop below certain levels in exchange for lower prices (the basis of what are called “interruptible” contracts). Diversions are also accomplished by increases in the local spot price of gas that make it economic for users paying such prices to switch to other fuels. When winters are mild, diversions may be minimal. But a severe, prolonged cold wave can lead to extensive diversions and create a surge in demand for oil, the only readily available alternative. This is what happened in January.

While the volumes of gas diverted are not fully known, data are available regarding spot gas prices over the period.\(^7\) These are shown in the chart below. The left panel shows gas prices at Henry Hub (Louisiana) in dollars/MCF, while the right panel shows prices

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\(^6\) Wind-chill factors were also exceptionally high in the Northeast in late-January-early February, adding further to demand.

\(^7\) We believe these factors added over 100 MB/D to middle distillate demand in the second half of January through early February.
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at the New York City Gate. Prices are daily for December through February for the past three years and through March 1 for this year.

Henry Hub prices reflect the spot market at a major gathering point close to producing areas for gas to be shipped to virtually all sections of the country apart from the Far West. As shown in the gray area of the left panel, since early December 1999, Henry Hub prices have ranged between $2.20 and $2.80/MCF with the higher prices prevailing in late January. This is a much narrower range than prevailed over the same period of 1996-7 when prices reached peaks of about $4.70 in mid-December 1996 and again in mid-January 1997 before falling back to below $2 by mid February. As noted in the weekly degree-day chart shown earlier, mid-January 1997 was exceptionally cold nationally as well as in the Northeast. Henry Hub prices were generally lower and less volatile in the comparable 1997-98 and 1998-99 periods.

The panel on the right focuses on the New York City Gate price, the spot market for gas at entry into a major Northeast market with the gray area again showing prices since early December 1999. In December 1999, prices ranged between about $3.50 and $4.80/MCF. The average for the month, $3.30, was about 95 cents above the average December price at Henry Hub. January was very different. In the middle of the month, when the severe cold wave began, the City Gate price moved up sharply, reaching a peak of $15.50/MCF on January 20, equivalent to nearly $90/barrel of heating oil. From January 20 through the end of the month, the City Gate price averaged $9.63/MCF, nearly $7 above the Henry Hub average of $2.66 for the same period. The exceptionally large price differential between the New York and Henry Hub prices developed because, with major transmission pipelines already at full winter capacity, Northeast customers could not effectively bid for additional prompt supply from outside their region. In December-January of 1996-97, when Henry Hub prices moved up sharply, New York City Gate prices moved up as well, but the gap between the two prices never exceeded about $2/MCF and the peak price in New York, about $6.40, was well below what the region experienced this year. In December-January 1997-98 and 1998-99 the differential between the New York City Gate and Henry Hub prices averaged about 50 cents. Since
early February, the differential between the New York City Gate and Henry Hub price has narrowed considerably.

The surge in New York City Gate prices this year pushed the spot price of gas well above the cost of its closest alternative, distillate, creating a strong incentive for those who could do so to switch. At $10/MCF, close to the average for the latter part of January, the price is equivalent on a BTU basis to $1.42/gallon of heating oil. At the peak value of $15.50/MCF, the spot gas price exceeded the equivalent of $2/gallon of heating oil. As discussed in the next section, the spot price of heating oil never fully reached these heights although it was the surge in the spot gas price that was the magnet for Northeast heating oil prices.

**Movements in the Spot Price of Heating Oil**

The chart below summarizes daily movements in spot crude oil and heating oil prices since early December. For comparison purposes, prices are also shown for December-February 1996-97, when, as noted above, cold weather also produced significant surges in spot gas prices.

The left panel shows prices for WTI at Cushing. Since the beginning of the year, prices moved up from about $25/barrel to $30 by mid-January, and then fell back slightly, through the end of the month. Since then, they have climbed to an early-March average of about $32. Prices in December 1999 were similar to prices in December 1996. But prices since then show a widening gap versus 1997, with the end-February difference reaching $10/barrel. As shown on the right, after moving about in line with crude prices for the first half of January, the spot price of heating oil in New York Harbor shot up to a peak on January 21 of $1.24/gallon, or about $52/barrel, a price more than $20/barrel above the crude price. The New York Harbor price for heating oil again surged toward $50/barrel at the beginning of February before declining rapidly toward crude oil prices. The panel also shows another spot price for No. 2 oil, in this case, the price in the U.S. Gulf Coast, the nation's major refining center and source of product for other regions. The Gulf price showed far less of an upsurge relative to what happened in the Northeast. Between January 14 and January 21, the New York Harbor price rose from 76 cents to 124 cents/gallon, an increase of 48 cents. Over the same period, the Gulf price rose from 72 cents to 78 cents, an increase of only 6 cents and only slightly more than the 4.7-

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8 The prices shown here are the low end of the range of daily prices. New York Harbor prices at the high-end of their daily trading ranges reached peaks of $1.42/gallon twice during the January-February period.
cents/gallon increase in the price of WTI. In 1996-97, the New York spot price moved in line with crude oil throughout the December-February period.

The dramatic differences between New York Harbor and Gulf Coast prices from mid-January through the early part of February indicate that the Northeast was for the most part unable to draw on prompt supplies from elsewhere to meet the sharply increased demand for heating oil in that period. Part of the increase came from regular residential customers whose heating requirements went up with colder weather. But the local supply/demand balance was aggravated by the sudden, sustained entry into the local market by interrupted gas customers and gas customers seeking alternatives to skyrocketing spot gas prices.

**Relating Spot to Residential Heating Oil Prices in the Northeast**

The New York Harbor price is a good representation of current prices paid by large terminal operators for heating oil. They in turn sell to dealers (and other large, bulk customers) who in turn distribute the oil to their residential customers. To analyze relationships between the prices paid by terminal operators, dealers, and customers in the Northeast, the chart below focuses on specific price trends since early December in New York. The chart shows the daily New York Harbor price of No. 2 distillate, and for specific days sampled by the Department of Energy, the wholesale price of heating oil, where the wholesale price represents the dealer price, and the residential price prevailing in New York State.9

From early December through mid-January, New York Harbor prices and New York State wholesale prices (shown by the triangles) were within a few cents/gallon of each other. But thereafter, through early February, wholesale prices surged ahead of harbor prices, with the difference between the two reaching a peak of about 85 cents/gallon. Since then the gap has narrowed, falling to about 6 cents on February 28, the last common observation point available. When prices paid by dealers were rising sharply, their own prices to customers were rising as well, but at a slower pace. Between mid-January and early February, the wholesale price went up by 91 cents/gallon while the price to residential customers went up by 79. The apparent dealer margin, the difference between the wholesale and residential prices fell from 54 cents/gallon, about the level prevailing since the beginning of the heating season, to 42 cents. This margin shrinkage indicates that dealers were absorbing some of the cost increases rather than passing them on fully to their customers. Benefits went to

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9 Wholesale and residential prices are as published in the **Winter Fuels Report** by the U.S. Department of Energy, Energy Information Service.
customers with contractual arrangements with their dealers, especially customers with dealers offering price protection plans. Heating oil users without such relationships would have been most exposed to wholesale price increases (just as in other winters, they would have been most advantaged by the lowest wholesale prices).\(^{10}\)

The latest observations show significant declines in both wholesale and residential prices, with wholesale prices approaching their former relation to New York Harbor prices. Residential prices initially fell at a somewhat slower pace than wholesale prices. But after widening substantially in the week following the residential and wholesale price peaks, dealer margins began to decline later in February.

**Oil and Gas: Spot versus Residential Prices in the Northeast**

Although the Northeast experienced a spike in the spot price of gas that was even larger than the increase in spot heating oil, the impact on residential customers was very different. While the increase in spot oil prices had immediate effects on residential customers, the increase in spot gas prices had no apparent effects on residential gas customers. Clearly, the dynamics of pricing to residential customers in the Northeast is very different for the two fuels. To consider differences, the next chart shows certain average January oil and gas spot prices and Northeast residential prices for 1995 through 2000, all expressed in $/MBTU for comparison purposes.

The bars of left panel divide the Northeast residential heating oil price into two components, crude price, in terms of WTI, and the difference between the residential and crude price. The dotted line shows the New York Harbor price. By and large, the residential price of heating oil in the Northeast moves primarily with the crude price, although this year, local supply/demand problems contributed, as indicated by the wider gap between the New York Harbor distillate price and WTI than prevailed in earlier years.

Residential gas prices in the Northeast, shown on the right, have a very different profile. In particular, they have been virtually stable since 1997, despite movements in January Henry Hub prices over the period and this January’s surge in New York City Gate prices.

One reason for the difference is that crude oil costs are a much greater component in the Northeast residential price of heating oil than wellhead gas prices are for the residential gas price. Over the five years shown, the January crude price averaged 45% of the

\(^{10}\) About half of heating oil customers have budget and/or price protection plans and would therefore have been insulated to a certain extent from the initial price shocks.
residential heating oil price while the wellhead gas price (as represented by Henry Hub) averaged 27% of the residential gas price. Transportation, storage and local distribution costs of bringing supplies to Northeast customers are far more important for gas than for oil. A more fundamental reason, however, is the insulation of residential gas customers from the spot market. Utilities generally have firm contracts for supply and transport to meet most of the needs of their residential customers. The remaining, short-term cold-weather peak requirements, as discussed earlier, are met by contractual diversions of supply from interruptible customers and to a lesser extent from those paying spot market prices that suddenly find it cheaper to switch to oil. In effect, the recent spike in the local spot gas price reflected the severity of problems facing interruptible customers as they attempted to line up alternative supplies (of gas or oil) but did not involve an immediate direct cost to residential gas customers. However, while residential gas customers were spared, the pressure from interruptible gas customers, as they scrambled for alternative supplies, contributed to the price spike felt by residential heating oil customers.

While residential gas customers in the Northeast have had a more stable price environment than oil customers, they have paid for it with higher average prices on a BTU basis for every period shown on the chart. Surprisingly, even in January of this year, the residential heating oil price was lower, although only by 8 cents/MBTU (equivalent to about 1 cent/gallon of heating oil) as opposed to a January average for 1995-2000 of $1.32 (about 18 cents/gallon).11

**Prices to New York State Customers**

Data collected by the New York State Energy Research and Development Authority also indicate that on a BTU basis, heating oil has generally been cheaper than natural gas for residential customers.12 The table on the right shows New York State residential prices for heating oil and natural gas for 1990 through 1998 both in prices per physical unit and prices per MBTU. In 1990 and 1991, years impacted by the Iraq crisis, gas was cheaper than oil. In 1992, prices on a BTU basis were about the same. But beginning in 1993, heating oil has been cheaper in every year through 1998.

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11 The BLS data showing January 2000 heating oil still slightly cheaper than gas for Northeast urban consumers reflects the nature of the sample data. No doubt heating oil was significantly cheaper than gas in the first half of the month and with the late-January price spike, became temporarily more expensive.  
12 Data are from Table 3-1a and 3.1b of Patterns and Trends, New York State Energy Profiles: 1984-1998, New York State Energy Research and Development Authority, December 1999.
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The residential price of natural gas moved up by about 30% over the 1990-98 period. While the 1998 price of heating oil was exceptionally low, the price over the period remained below the 1990 level for all the years shown.

The data from the Bureau of Labor Statistics and New York State should give pause to heating oil customers who, after this winter’s experience, might be considering converting to gas as a cheaper alternative. Conversion of course involves capital costs, typically $2,000 to $3,000. There is also a policy issue to consider; namely the implications of adding further to peak gas demands in the Northeast. Adding to peak gas demands raises the amounts required to divert from interruptible customers to maintain supply/demand balance, which in turn pushes up peak demands for heating oil.

The Industry Supply Response

The surge in Northeast heating oil prices set in motion an industry supply response that, along with the end of the exceptional cold-wave, is pushing prices down both absolutely and back toward its normal relationship with crude feedstock costs. The table below illustrates trends in distillate production, imports, and stocks starting with the week preceding the beginning of the price surge.

As discussed earlier, the weather in the first half of January was exceptionally mild, a key factor in refinery decisions to undertake early maintenance. As a result, refineries, especially local refineries could not respond immediately to the dramatic upsurge in demand when the weather turned sharply colder in the week ending January 21. Nor could there be an immediate response from imports. Stocks were the only immediate source of additional supply and the last two weeks of January saw substantial drawdowns to exceptionally low levels—and even further drawdowns into early February. The bidding for these increasingly scarce stocks, magnified by interrupted gas customers who were pushed into the market, produced the spike in heating oil prices.

At the national level, the 99.6 million barrels reported for February 4th was about one-third less than stocks at end-January 1999 (when stocks were exceptionally high) and about 25% less than at end-January 1998. The PADD 1 stock level of 27.9 million barrels was down by far more in relative terms, than stocks at the national level—by about 60% versus end-January 1999 and 50% versus end-January 1998. The 3.6 million-barrel level for New England represents an even steeper decline than the average for PADD 1—down 75% from end-January 1999 and down 65% from end-January 1998.
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The Mid-Atlantic region level of 15.1 million barrels was down versus 1998-99 by about the same percentages as PADD 1 overall.

Although with a brief delay, the industry responded to the price surge with additional supplies sufficient to push prices back down. In the week ending February 25th, U.S. distillate production reached 3,445 MBD, up nearly 250 MBD from the week ending January 21st, the coldest week of the season. Production in PADD 1 (the East Coast), the region incorporating the distressed Northeast market, was up by nearly 120 MBD. Even greater relief for the market came from imports. U.S. distillate imports rose from the 150-160 MBD range in the last two weeks of January to a peak of 718 MBD in the week ending February 25th.13 Nearly all of the distillate imports would have come to PADD 1.14

Higher production and higher imports, combined with an easing of the cold wave, has allowed inventories at all levels shown first to stabilize and then increase, reducing vulnerability somewhat to a new, weather-induced, price surge. However, it should be kept in mind that stocks, and therefore the margin of safety, are still very low.

Proposals and Problems

The spike in heating oil prices has inspired a number of proposals for remedies, most of which raise serious problems of their own. The Administration has properly recognized that while the economy has become less vulnerable to oil price shocks, certain individuals have not. Thus, while not a “remedy” per se, the best approach is to expand the publicly funded low-income assistance programs already in place. The President immediately released to the states funds available under the LIHEAP program and has proposed to expand it. The objective in this case is not to prevent price increases from occurring, but to protect the most vulnerable groups from their worst effects. Of course, no such program can protect everyone and certainly many people would still experience hardship in meeting an extraordinarily high oil bill. The problem of high price has now spread to the transportation sector.15

Other proposals attempt to minimize price spikes in the first place. In assessing such proposals, it’s important to remember that painful as the recent spike was, it did trigger market responses, higher supply—and price-induced moderation of demand—that prevented immediate, outright shortages and, later, brought prices down. Proposals that interfere with market responses risk prolonging the initial problems.

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13 In February 1998, distillate imports averaged 213 MBD, and in February 1999, 265. For the four weeks ending February 25th of this year, imports are averaging 451 MBD.
14 In February 1999, nearly 95% of total U.S. distillate imports came into PADD 1.
15 State taxes on gasoline and diesel currently average 20¢/gallon. States might want to temporarily (perhaps 6 months) reduce or suspend these taxes. However, we do not believe that it is appropriate at this time for the federal government to suspend these taxes since this would undermine the credibility of the U.S. in its negotiations with our trading partners on important issues involving trade and the environment. However, the Federal Government could help by expediting the flow of trust funds to those states to make sure that current plans to maintain our highway system remain on schedule.
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During the worst of the price increases some proposed using the SPR to bring prices down. While use of the SPR was also promoted for broader geopolitical purposes, (as a means of confronting the major oil exporting countries and bringing down world oil prices) it was also proposed specifically to bring down heating oil prices. However, the surge in distillate prices in the Northeast reflected an extraordinary demand for prompt, in-place, product, a demand that could not possibly be met in time by crude oil in salt caverns over a thousand miles away.\textsuperscript{16}

Another proposal, which has been made before, is to establish a publicly held distillate inventory in the Northeast that could be used to head off future price surges, in effect an in-place SPR for heating oil. However, there are several issues involved that raise questions about its role. In particular, just when would it be used and for what purpose? The wrong answers could undermine incentives for both suppliers and customers to take action on their own to maintain adequate commercial inventories, adjust demands and/or bring in new supplies. The SPR itself was never intended as a price-dampening mechanism. It was designed to be used to minimize economic dislocations that would otherwise occur as a result of supply interruptions.

Another approach would focus on the source of the aggravated rise in local demand, the shift of gas customers to oil as a result of contractual interruptions or spot price differentials. It has been suggested that they should be required to hold certain minimum stocks of alternatives (including perhaps propane, and heavy fuel oil as well as distillate, depending upon their use) as a condition of getting the low initial gas prices in the first place. Such a proposal would put some of the costs of avoiding heating oil price spikes on those whose entry into the local market at peak periods help provoke them. This approach as well comes with its own set of questions and problems. Just who would have to hold inventory and how much? Must they hold it physically on site? Do they have to own it or could they contract with others to hold it elsewhere? When could or should they be drawn down? What about those who switch for economic reasons as opposed to being interrupted? Of course interruptible customers generally hold some inventory in any case given the risks they face if they don’t. This year’s experience may encourage them to hold more rather than less in any case.

Any proposal to raise inventory levels, whether held by government or privately involves costs. The extent of the costs depends mainly on the amount of additional inventory required, which in turn depends on just how severe---and how rare---a contingency to provide for. In making such judgements, it should be kept in mind that this winter’s spike in heating oil prices was due to an extremely rare confluence of events, and even so was over within a few weeks.

The worst possible approach would be any attempt to regulate inventories and prices directly. Any such move would risk transforming a problem of high prices into a problem of outright shortage. The country has been there before during the first and second oil crisis and fortunately seems to have learned from the experience. As for

\textsuperscript{16} Nor is it clear that the national interest would be served by using the SPR in an attempt to lower world oil prices at a time when oil-exporters are looking at the price and commercial inventory levels in attempting to judge whether to raise production levels.
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inventories, it should be kept in mind that inventories at the beginning of the heating oil season were well above recent experience. Even at the beginning of January, inventories were still within a normal range. Thus any likely minimum inventory requirement would have had no impact on the Northeast heating problems this winter.

Even if the weather had not been exceptional this winter, the rise in crude prices since last winter would have produced a substantial increase in the cost of heating oil, and indeed all refined products. As of early March, crude prices are still moving up and concerns are rising regarding implications for costs of transportation fuels. Inventories of diesel and gasoline are exceptionally low as we head toward the beginning of the driving season. If, as seems likely, OPEC agrees to raise production significantly at its meeting scheduled for late-March, prospects for stabilizing crude prices—and avoiding price spikes in transportation fuels would be greatly enhanced. If there are delays in either reaching such an agreement or in implementing it, political pressure for Government action to head off sharp price increases would grow substantially. However, remembering that oil markets are global it would be best to coordinate responses with the International Energy Agency.