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A Regional Heating Oil Reserve: A "Solution" With its Own Problems

On March 18, the President proposed the establishment of a Heating Oil Reserve for the Northeast region. He proposed that it be incorporated as part of the reauthorization by Congress of the Strategic Petroleum Reserve, although he reserved the right to act under his existing authority. Current authority for the SPR expires at the end of March. Although the President gave no details, he appears to be calling for the establishment of a 2 million barrel distillate reserve to be located at leased terminals in the Northeast. The 2 million barrel figure was estimated by the Department of Energy in a June, 1998 "Report to Congress On the Feasibility of Establishing a Heating Oil Component to the Strategic Petroleum Reserve,"as the amount needed to cover the 7 to 10 day period required to move additional supplies of products from the Gulf Coast to the Northeast.
Clearly, the recent spike in the price of heating oil triggered demands that the government take action to prevent a repeat and the President's proposal is an attempt to respond. But there are strong reasons not to rush into it, especially given the potential for perverse effects on overall supply.

Legal authority for the Strategic Petroleum Reserve is provided for under the Energy Policy Conservation Act (EPCA) which expires at the end of March. EPCA also provides the authority for the President to establish product reserves, including in this case a heating oil reserve. However, the current law restricts the use of the crude oil reserve, and any product reserve as well, only to instances of supply disruption, as determined by a Presidential finding. Under EPCA, the President must find that a drawdown is required by a, "severe energy supply interruption," or by obligations of the U.S. under the I.E.A. The three-week weather triggered event in the Northeast would not have met this condition. The temporarily high prices insured supply/demand balance while, as described below, setting in motion, industry responses that quickly brought prices back down. Until the President made his proposal, the most likely prospect was that Congress would simply extend the current provisions of EPCA, as it did once before in October. Now the prospects for amendments have grown, especially amendments that broaden the conditions under which a Heating Oil Reserve, or any strategic reserve, can be used. The broader the conditions for use of the proposed Heating Oil Reserve, the greater the risk of perverse effects.

At the beginning of this year, distillate stocks in the Northeast amounted to about 35 million barrels (28 in the Mid-Atlantic region and 9 in New England), an amount toward the lower end of the normal range but still viewed as adequate. The total of these commercial stocks in place was about 18 times the proposed level of the 2 million barrel

Northeast Heating Oil Reserve. The government reserve would become a factor in calculating winter price risks for holders of these inventories. The more aggressive the potential use of the government reserve, which political pressures are likely to intensify, the greater the skewing of risk toward the downside and the greater the disincentive for the private sector to hold inventories. After all, while the government would be capping the upside risks, the downside risks, which have materialized all too frequently, would remain. Thus, a government reserve, especially if perceived as easily triggered, could potentially lead to no net gain in inventories, perhaps even a reduction.

The price spike this winter, while painful for consumers without price protection plans, did plant the seeds of its own demise. At the onset of the price spike (the week ending January 21) distillate imports averaged about 150 thousand barrels/day. Three weeks later, imports surged to over 500 thousand, and two weeks after that, to over 700. This was a significantly faster industry response than the 4 to 7 weeks estimated as the response time to a price spike by the Department of Energy in their 1998 Report. An aggressive use of a government reserve to hold down prices would hold down the supply response as well, potentially prolonging the problem. Any trigger mechanism for the reserve would involve the setting in advance of a specific price (and/or price differential versus crude) at which reserves would be released. This price, known to all participants in the market in advance, sets a cap on how much would be paid for additional commercial supplies from foreign and domestic sources. This would negatively impact the incentive to obtain new supplies during periods of greatest need. It should also be kept in mind that this winter's surge in imports, and the subsequent downturn in heating oil prices, was accomplished despite growing concerns about world-wide crude supplies and low levels of inventories in all major consuming regions.

As PIRINC pointed out in its recent report, "What Happened to Heating Oil?" the episode revealed potential constraints in meeting peak demands for overall energy in the Northeast, particularly peak demand for natural gas, and 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 President alluded to this issue when he noted in his statement of March 18 that the Department of Energy is studying "...the effects of interruptible natural gas contracts on the home heating oil market in the region."

By looking to Congress and not using his existing authority to establish such a reserve, the President is allowing more time for careful assessment of the proposal. This is certainly needed in view of the risks and complexities involved. As the President said in response to a related question about use of the SPR, he wanted to avoid "taking shortsighted and risky steps now we might regret later." The same caveat applies to the Heating Oil Reserve.

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March 22, 2000