Preserve the Strategic Petroleum Reserve

Statement by
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before the
Committee on Commerce
US House of Representatives

May 8, 1996
Washington, DC

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Thank you for inviting me to testify on the important topic of the future of the Strategic Petroleum Reserve, the nation's insurance policy against the negative economic impacts of a severe oil supply emergency. As most of you know, I have been a proponent of the Strategic Petroleum Reserve (SPR) for decades, and the Foundation has testified many times on the subject. I hope that today I can convey the urgency of the need to keep the SPR filled, maintained and ready.

A Costly and Misguided Precedent

The recent decision to sell approximately 12 million barrels of oil, garnering revenue of $227 million for the FY1996 budget, was misguided when it was passed as a budget measure. We also believe the President should not have characterized the drawdown as a price dampening mechanism for the transient imbalance temporarily pushing up oil market prices. Meeting the short-term goal, the sale will compromise the tools available for the long-term benefit of the economy.

The President's reference to the current SPR drawdown as a price corrective -- when there is no shortage or disruption but a confluence of market factors temporarily raising prices to politically visible levels -- is likely to lead to the interpretation that this Administration now has put a low priority on the SPR's original purpose.

The question of selling SPR oil can now be expected to come up at every annual budget debate and the politics will usually be on the side of further reductions. Yet the damage to the economy during an oil disruption if the SPR is not available to mitigate the impact will be a high multiple of the revenue benefit from the sale, or any near-term price reduction in today's market.

Benefits Recognized Two Decades Ago . . .

The nation wisely decided in 1975 to create a Strategic Petroleum Reserve. Congress specified that it be used in severe energy supply interruptions of "significant scope and duration, and of an emergency nature" that "may cause major adverse impact on national safety or the national economy. . ." The current market does not come close to fitting the criteria.

The Congress recognized that in the wake of the Arab oil embargo of 1973-4, the nation had suffered significantly from the higher prices and product shortages. The National Petroleum Council's 1987 report *Factors Affecting US Oil and Gas Outlook* estimated that the economy in 1973-75, after the Arab oil embargo, and in 1980-82, after the oil market disruptions that followed the Iranian revolution, suffered the worst recessions of the post-World War II period to that time. According to economic models designed to isolate the impact of the oil price shocks from other factors, GNP shrunk by about 2.5% due to the earlier upheaval and by about 3.5% due to the later one. Furthermore, during the 1979 oil disruption, private companies engaged in rational and prudent inventory behavior—husband your stocks for a rainier day. The resultant inventory accumulation exacerbated the market shortage. (The SPR did not exist in 1973 and was not yet ready for use in 1979).

Thus, the benefits of government-owned and -controlled stocks were (and are) clear:

- They mitigate the impact of a supply disruption by increasing physical supplies of oil and hence lowering the market-clearing price and by putting that oil into markets at precisely the time that private companies would be most fearful of depleting their own stocks.
- They provide a window of time to look for diplomatic solutions to international conflicts.
- They meet the US treaty obligation to the International Energy Agency that each nation establish a mechanism to share an oil supply interruption, thus obviating the need for a cumbersome and unworkable demand-reduction program.

. . . And Proven During a War

Even these truths, however, were only theoretical until Iraq's invasion of Kuwait. The existence of the SPR provided foreign policy flexibility during Operation Desert Shield. The use of the SPR at the outset of Operation Desert Storm in January 1991 provided an instantaneous counter force to the expected market panic, even though the volumes finally sold were small. (Had it been used during the third quarter of 1990, the negative economic impact of the post-invasion price spike would have been significantly moderated.)

Therefore, the SPR has always been an insurance policy. In 1991, it proved itself as an insurance policy that will pay off on its claims. Like any insurance policy, it must be kept in force to be useful—not reduced, not sold off.

Only the SPR Will Do Its Unique Job

Some analysts have theorized that the SPR could be replaced by the diligent use of the now-mature futures market. The futures markets, vital as they are to the current oil market, would be no substitute for the SPR, because *physical volumes* are the only salve to an overheated market during a supply crisis. Futures transactions provide no incremental supply to the system. Thus, while futures transactions can effectively reduce a corporation's or consumer's exposure to price fluctuations (and provide ancillary benefits to the market, such as price discovery/transparency), they do not dampen the price move, *i.e.*, change the market-clearing price.

The futures market is by nature balanced—the "long" (buy) transactions match the "short" (sell) transactions. During a sharp price change, therefore, there are winners and losers, but the system by definition comes to a zero-sum game. This contrasts with the physical market. During normal times, markets are balanced, of course. A supply disruption, however, is like a game of musical chairs—the supply loss takes a consumer's chair away. The market will rebalance at a higher price because a consumer drops out of the game. In a supply crisis, some companies might try to take physical delivery of volumes purchased in futures transactions, yet those volumes would effectively not be available. Only the SPR would actually put a chair back on the floor in the form of physical supply.

Furthermore, prudence dictated that the New York Mercantile Exchange institute measures during the Persian Gulf crisis to suspend trading in the most frenzied periods, providing an orderly cool-down for futures. There is no similar hiatus in the need for physical barrels, however.

With exciting new prospects for new oil supplies from the Gulf of Mexico and other domestic supply sources, some may believe the SPR could become less important. The many benefits of these new domestic volumes, however, do not include salving overheated markets during a crisis. Only *incremental* physical volumes can provide the necessary calming effect. Domestic production sources, in contrast, will be producing at capacity, supplying routine baseload volumes. Available surge capacity will be extremely limited, or as now, non-existent.

The Cost of Not Having the SPR is Huge

As noted earlier, the two oil market disruptions of the 1970's have been estimated to have penalized GNP by 2.5% and 3.5% in the years immediately following the upheaval. The negative impact of each of these shortages, and of the sharp run-up in global oil prices in the Autumn on 1990 after the UN embargoed Iraq's and Kuwait's oil, could have been countered by the early and prudent use of the Strategic Petroleum Reserve. Selling it all off for budget balancing would get a cash infusion of $8-12 billion dollars, a fraction of the cost of *any one* of the oil market dislocations of the last three decades. Since the 1970's, oil's role in the economy has declined, so the impact of a disruption is unlikely to be as severe. But in today's economy, *each* percentage point of GDP is worth nearly *$70 billion* of US goods and services, so even a more muted impact will impose a cost that is a high multiple of the short-term revenue gain from the sale of the SPR.

Allowing the oil market to function without the distortions introduced by government regulation was the best energy policy decision we have made as a nation. We can all remember that oil prices peaked with the end of controls in 1981 and have been largely on a downward trend ever since. The global oil market has brought on new supplies at price levels much lower than once thought possible. Oil has been plentiful and low priced. Efficiency improvements have kept prices low even while refiners have made extensive investments to supply products meeting ever- increasing environmental mandates. The market has served the American consumer well.

Establishing and maintaining the Strategic Petroleum Reserve is the perfect adjunct to our appropriate free market policy. We must all recognize that there may be times when unforeseen events will cause market disruptions of such severity that they will cause painful upheavals in the economy. These rare and temporary occurrences are exactly the target of our SPR insurance policy. Any alternative government policy carries a high multiple of the SPR's cost, and the diminution of the SPR will impose a high multiple cost on the economy in the event of a real, non-election year, disruption in the supply of oil.

Because our imports have been rising, the days' import cover of the SPR has been declining. In 1986, the SPR inventories were the equivalent of 95 days of net imports. By the end of 1995, days' cover had fallen to 75 days. Even if SPR volumes were to remain at present levels, they will be sufficient to cover less than 60 days of the Energy Information Administration's projected net imports in 2000. This declining trend could impair the effectiveness of the SPR if it makes policy-makers reluctant to use the Reserve early and decisively during a crisis. Raids on the SPR for budget revenue and/or for market manipulation cripple the program further.

A Note on the Current Market

The current market situation has gotten so much attention in the press and on Capitol Hill that I'd like to comment on it briefly. Not even the President has said that the imbalance that we now see in any way approaches the criteria for a drawdown of the SPR contemplated in the Energy Policy and Conservation Act, legislation that established the SPR. The market is in a temporary imbalance that will right itself, by itself, in the coming weeks.

How did we get here? Low stocks, brought about by some unpleasant supply and demand surprises in the fourth quarter of 1995 and the first quarter of 1996. Looking forward from September, for instance, the International Energy Agency forecast that non-OPEC supply in the fourth quarter 1995 would be about a million barrels per day higher than it turned out to be, and the same thing happened in its December projection: the Agency's forecast of non-OPEC supply for the first quarter was again million barrels per day higher than it turned out to be. (Examples of the unforeseen: the loss of 1 million barrels per day in Mexico's October production due to Hurricane Roxanne, slower-than-projected additions of North Sea production.) The demand surprises, of course were in the opposite direction. Last winter's cold added 1 million barrels per day to Europe's February gasoil consumption, for instance. Thus, we needed more oil and were producing less. This tight market then set the stage for other developments: crude oil prices started upward, wholesale gasoline prices followed and with a lag, pump prices.

The Department of Energy's recent deal with ARCO to lease up to 1 million barrels of SPR crude for line fill for six months deserves a positive mention in this context. PAD II crude oil stocks are at eye-catching lows, and any disruption in supply from the Gulf Coast will be deleterious for oil markets in the Midwest. With pipeline deliveries curtailed by a blockage in a nearby line, ARCO will use the leased oil for up to 40% of the line-fill necessary to commence operations in its larger Seaway line. ARCO will fully replace the volumes, pay a fee, and keep the SPR whole for any price decline in the interim. The arrangement is creative and useful to overcome this infrastructure snag. Such deals, however, should also remain rare.

Conclusion

Designed to reduce the impact of an oil supply disruption, the SPR helps the economy during an emergency. Like an insurance policy, the benefits appear only potential, even though the very existence of a strong SPR shapes policy options available to the US, its allies, and potential aggressors. When the SPR is needed, however, the benefits are incontrovertibly real and irreplaceable. Only the Strategic Petroleum Reserve can provide additional physical volumes during a disruption, and hence only the SPR can calm markets, provide time to explore solutions to international crises, and cushion the impact of hard decisions affecting the supply of oil, such as those made during the Persian Gulf conflict. Selling SPR volumes, while gaining a cash infusion, will impose a long-term cost.