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**Enclosed is a summary of comments
made on the Proposal to Exchange SPR
Barrels for Heating Oil**

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President - PIRINC**

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**PROPOSAL TO EXCHANGE CRUDE
THE SPR FOR HEATING OIL
OR
JUST SAY NO**

I HAVE BEEN ASKED TO ANALYZE A PROPOSAL FOR THE EXCHANGE (SALE) OF CRUDE OIL FROM THE STRATEGIC PETROLEUM RESERVE FOR HEATING OIL. THE GOVERNMENT IS PROPERLY CONCERNED ABOUT THE ISSUE OF SUPPLIES (AND PRICE) FOR THE UPCOMING WINTER.

WHILE THE CONCERN IS LEGITIMATE, THE PROPOSED SOLUTION WOULD BE COUNTER PRODUCTIVE. SOME HAVE SUGGESTED THAT THIS PROPOSAL POLITICALLY HAD STRONG "ARMS AND LEGS" WHILE IT MIGHT HAVE STRONG ARMS AND LEGS, IT UNFORTUNATELY HAS NO BRAIN.

IN ORDER TO PROPERLY WEIGH THE MERITS OF ANY "SOLUTION" ITS IMPORTANT TO UNDERSTAND HOW WE GOT TO WHERE WE ARE. NOT SURPRISINGLY THERE ARE A NUMBER OF FACTORS PLAYING THEMSELVES THROUGH THE MARKET TODAY. SOME ARE STRUCTURAL AND SOME ARE TRANSITIONAL ALL, HOWEVER, ARE PULLING THE MARKET TODAY IN THE SAME DIRECTION - TO MINIMIZE INVENTORY.

FIRST DEMAND THROUGHOUT THE YEAR GLOBALLY AND PARTICULARLY IN THE U.S. HAS BEEN VERY STRONG. AND THE STRENGTH HAS BEEN FOCUSED IN DISTILLATES. IN JULY FOR EXAMPLE - DISTILLATE STOCKS IN THE U.S. GREW BY ONLY 4 MILLION BARRELS. MORE TYPICALLY STOCKS RISE BY 12 MILLION. SINCE DISTILLATE PRODUCTION AND IMPORTS WERE ABOVE YEAR AGO LEVELS THE EXCEPTIONAL LOW SEASONAL BUILD WAS DUE TO A VERY STRONG GROWTH IN DEMAND OF MORE THAN 11%.

THIS JULY EXPERIENCE HAS HAD AN IMPORTANT IMPACT ON THE INCENTIVE (DISINCENTIVE) TO BUILD INVENTORIES.

THERE TYPICALLY IS A SMALL POSITIVE CARRY IN THE FUTURES MARKET FOR DISTILLATES DURING THE FALL TO EARLY WINTER. THAT IS, THE PRICE TODAY IS USUALLY LOWER THAN THE PRICE NEXT MONTH OR THE MONTH AFTER. THE MARKET TODAY IS HOWEVER BACKWARDATED. THE PROMPT TIGHTNESS HAS THE MARKET WILLING TO PAY A PREMIUM FOR TODAY'S BARRELS. THIS BACKWARDATION STRONGLY DISCOURAGES THE BUILDING OF INVENTORIES. MOST MARKETERS WANT TO HEDGE THEIR INVENTORIES. HOWEVER, TODAY YOU CAN ONLY HEDGE AT A LOSS.

FOR EXAMPLE, THE PRICE FOR HEATING OIL IN THE NEW YORK HARBOR TODAY IS 71.5¢/GAL, THE FUTURES PRICE FOR DECEMBER IS 69.5¢. THUS, ANYONE (GOVERNMENT INCLUDED) WHO PURCHASES HEATING OIL TODAY FOR USE IN DECEMBER WOULD BE LOCKING IN A 2¢/GAL LOSS NOT INCLUDING A 1/2¢ /GAL MONTHLY COST FOR MONEY AND ASSUMING NO STORAGE COSTS]

THIS BY ITSELF WOULD EXPLAIN MOST OF WHAT IS CURRENTLY DRIVING THE MARKETS. HOWEVER, ITS IMPORTANT TO ALSO KNOW THAT THE DISTILLATE STOCK SITUATION IN EUROPE IS ALSO TIGHT AND IN FACT DURING THE PAST MONTH, EUROPEAN BUYERS HAVE BEEN WILLING TO OUT BID OTHERS FOR DISTILLATE SUPPLIES. THUS NOT ONLY IS EUROPE CURRENTLY IN COMPETITION WITH THE U.S. EAST COAST FOR IMPORTS IT CAN'T BE LOOKED TO TO SUPPLY SPOT CARGOES AS IT HAS IN THE PAST.

ALL OF THIS IS OCCURRING AT THE SAME TIME THAT COMPANIES HAVE COME TO THE REALIZATION THAT HOLDING INVENTORIES HAS BEEN A POOR INVESTMENT SINCE PRICES BOTH IN NOMINAL AND REAL TERMS HAVE BEEN DECLINING OVER THE LONG TERM (AND ARE EXPECTED TO CONTINUE TO DECLINE.)

THUS MANAGEMENT'S HAVE ENCOURAGED THEIR SUPPLY DEPARTMENT NOT TO TIE UP WORKING CAPITAL IN INVENTORIES. WHILE THE LEVEL OF INVENTORIES WILL CHANGE FROM TIME TO TIME THIS PHILOSOPHY OF NOT TYING UP WORKING CAPITAL IN INVENTORY WILL NOT SOON CHANGE.

IF ANY LARGE INCREMENTAL BUYER, THE U.S. GOVERNMENT FOR EXAMPLE, WERE TO STEP INTO THE MARKET TODAY, A BIDDING CONTEST WOULD DEVELOP, DRIVING UP THE PROMPT PRICE OF HEATING OIL. THIS WOULD PROBABLY THROW THE MARKET INTO FURTHER BACKWARDATION AND FURTHER DISCOURAGE PRIVATE COMPANIES FROM BUILDING INVENTORIES.

JUST AS IMPORTANT THE MARKET WOULDN'T KNOW WHEN THE GOVERNMENT WOULD RELEASE THESE SUPPLIES. THUS THEY WOULD WANT TO HOLD AS LITTLE INVENTORY AS POSSIBLE BECAUSE THE GOVERNMENT'S DUMPING OF THIS OIL WOULD RESULT IN INVENTORY LOSSES.

THE GOVERNMENT WOULD BE BUILDING UP OTHER COSTS AS WELL. DISTILLATE STORAGE IS NOT GENERALLY AVAILABLE IN THE WINTER THE GOVERNMENT WOULD HAVE TO ENCOURAGE THE MARKET TO LEASE IT TO THEM. THIS COULD PROVE TO BE EXPENSIVE.

CLEARLY THIS PROPOSAL IS A HEAVY HANDED SHOTGUN APPROACH. FORTUNATELY, THERE IS A SIMPLE ECONOMIC AND POLITICAL SOLUTION ONE THAT IS TARGETED IN ITS APPROACH AND KEEPS THE GOVERNMENT OUT OF THE PRIVATE SECTOR.

THERE IS LEGITIMATE CONCERN THAT SUBSTANTIAL ECONOMIC PAIN COULD BE FELT BY THOSE LEAST ABLE TO AFFORD IT. LUCKILY, WE HAVE AN EXISTING PROGRAM ALREADY IN PLACE TO HELP THOSE IN NEED. THE LOW INCOME HEAT ENERGY ASSISTANCE PROGRAM -- LIHEAP-. A SMALL CONTINGENT SUPPLEMENTAL APPROPRIATION TO LIHEAP TO BE USED IF NECESSARY WOULD DEAL EFFECTIVELY AND EFFICIENTLY WITH THIS CONCERN. FURTHER ITS AN INSURANCE POLICY THAT MAY NOT HAVE TO BE CASHED. NOVEMBER AND DECEMBER COULD TURN OUT TO BE WARM & U.S. REFINERS ARE SHARPLY INCREASING DOMESTIC PRODUCTION, THUS, WHILE LIHEAP AFFORDS THE SAFETY NET PROTECTING THOSE IN NEED, ITS POSSIBLE THAT THE PREMIUM ON THIS INSURANCE MAY NOT HAVE TO BE PAID. IT'S POSSIBLE THAT SEASONAL RECORD U.S. LEVELS OF U.S. DISTILLATE REFINERY PRODUCTION WILL BE PROVIDED IN RESPONSE TO MARKET SIGNALS DURING THE NEXT COUPLE OF MONTHS THE GOVERNMENT OUGHT NOT BE INTERFERING WITH THESE SIGNALS.

SUMMARY

LETTING THE GOVERNMENT INTO THE OIL BUSINESS WOULD BE COUNTERPRODUCTIVE. IT WOULD INITIALLY DRIVE UP COSTS AND DISCOURAGE PRIVATE INVENTORY ACCUMULATION. IT IS AN IMPROPER USE OF THE SPR WHICH SHOULD ONLY BE USED DURING IMPORTANT SUPPLY DISRUPTIONS AND NOT BECAUSE OF THE THREAT OF A POSSIBLE PRICE INCREASE. IF THE GOVERNMENT WERE TO IMPLEMENT THE IDEAS TODAY FOR HEATING OIL WHY NOT FOR GASOLINE NEXT SPRING. THERE IS ONLY ONE SENSIBLE ANSWER TO GOVERNMENT ---- JUST SAY NO.

LARRY



OIL PRICES DISTILLATE

	cents/gal			
	<u>N.Y. Harbor</u>	<u>N.W. Europe</u>	<u>Singapore</u>	
July	55.3	57.1	57.9	
Aug	60.2	59.1	60.1	
Sept (18)	67.8	71.5	66.7	
				Diff.
				<u>cents/gal</u>
				8.0

	WTI \$/BBL		
	<u>July</u>	<u>Aug</u>	<u>Sept</u>
	21.31	21.90	23.80