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OVERVIEW OF TRENDS IN U.S. GOVERNMENT POLICY TOWARD REFINERY EXPANSION INCENTIVES AND RESIDUAL FUEL OIL ENTITLEMENT TREATMENT

In this memorandum, we review recent developments in U.S. Government policy toward refinery expansion incentives and residual fuel oil entitlement treatment. Both of these issues are of course interrelated, together with U.S. oil import policy. The deliberations in Congress on the Administration's National Energy Act have generally ignored these issues, concentrating largely on legislative proposals directly affecting U.S. oil and energy demand. The Federal Energy Administration (FEA) has been the focal point of activity in the refinery incentive/entitlement program policy areas.

On August 8 and 9, 1977 the FEA held public hearings on the impact of Government allocation and price regulations on refinery investment. The purpose of these hearings was to discuss the issues involved in refinery investment and to solicit information from industry and others upon which to base a thorough analysis of FEA's regulations considering what amendments to its regulations, if any, may be necessary to insure that regulatory disincentives to investment in domestic refineries are minimized. At about the same time as these hearings, an FEA task force completed an initial draft report on U.S. Government policy towards residual fuel oil entitlement treatment and the general issue of U.S. refinery expansion incentives. The information gathered from the hearings and the initial task force report lay the groundwork for possible regulatory and/or legislative changes which may be made either by the end of

this year or early next year.

The major features of the initial draft of the FEA task force report are outlined below:

(1) Removal of the reverse entitlement which currently penalizes refiners one-half their entitlement on all sales of residual fuel oil on the U.S. East Coast in excess of 5,000 barrels per day. This proposal if adopted would increase the value of an entitlement to U.S. refiners marketing residual oil on the East Coast by $1.20 to $1.25 per barrel.

(2) Importers of residual fuel oil would be granted 100% product entitlement compared to 30% product entitlement currently in existence. This increased product entitlement to residual fuel oil importers would currently be worth an additional $1.70 to $1.75 per barrel.

(3) The current import fees on crude of 21¢/Bbl. would be eliminated while product import fees would be reduced from 63¢/Bbl. to 42¢/Bbl. The 42¢/Bbl. product import fee would be waived for any importer bringing in products in domestic tankers.

(4) Immediate elimination of all fee-free import licenses.

(5) Also, to encourage additional refinery capacity in the U.S. the fourth major provision of this proposal recommends that a direct Government subsidy of 42¢/Bbl. be given to U.S. refiners who add new capacity.

Tables I and II illustrate the relative competitive position of major residual oil supply sources on the U.S. East Coast under current FEA regulations and the proposal incorporated in the FEA task force report. The current 49¢ per barrel advantage of Virgin Island residual sales on the East Coast over Caribbean suppliers would be eliminated under the task force proposal. Residual fuel oil marketers dependent

on Caribbean supplies together with Caribbean refiners would clearly benefit from the task force proposal.

The task force proposal would also tend to lower residual oil costs on the East Coast since effective product costs would be lowered by additional entitlement benefits. The extent to which these lower costs would be passed on to consumers would obviously depend on market supply/demand forces.

East Coast refiners supplying the area's residual oil market would continue to have the greatest cost advantage under the task force proposal. They would be followed by Caribbean refiners and Amerada Hess and then by Gulf Coast refiners. It is unlikely that residual oil imports from the Virgin Islands and the Caribbean would utilize domestic flag tankers in order to forgo payment of the product import fee as would be permitted under the task force proposal, since currently the difference between tankers rates for foreign and domestic flag vessels is well above 42¢ per barrel. However, if adopted, this provision would have some importance in the future if Congress enacts new cargo preference legislation since the import fee exemption would to some extent offset the added cost to importers who would be required to import a portion of their residual oil in domestic flag vessels.

The task force proposal by calling for immediate elimination of fee free licenses would increase the competitiveness of certain importers who are currently short of fee free tickets relative to their import requirements. The cost savings would be significant since the product import fee is currently 63¢ per barrel. Moreover, large consumers of residual oil, such as electric utilities and industrial consumers, all of which do not have fee free tickets would be able to arrange direct

import agreements with offshore refiners without facing the competitive cost disadvantage of not having fee free tickets. It should be noted that the FEA task force is also considering as an alternative policy the phasing out of fee free licenses as currently scheduled* and the imposition of a 42¢ per barrel entitlement penalty for all imports which do not pay the license fee. This would have the same relative impact as the immediate elimination of the fee free tickets.

The last part of the FEA task force proposal deals with refinery expansion incentives. Current incentives to U.S. refinery expansion are the 42¢ per barrel differential between crude oil and product import fees and the partial exemption of the crude oil fee payment for five years**. The task force proposal calls for a 42¢ per barrel product import fee, elimination of the current crude oil import fee and a direct subsidy of 42¢ per barrel. The total incentive to new refinery expansion would therefore be 84¢ per barrel. The direct Government subsidy would possibly be financed by the crude oil equalization tax, additional tax credits or perhaps revenues from the product import fee. The subsidy route to provide refinery expansion incentive would require Federal

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*The current schedule calls for base period fee free allocations of residual oil to be reduced according to the following timetable:

Beginning	Percent of Base Period Allocations	Total U.S. Volume of Fee Free Licenses (000 B/D)
May 1, 1977	50	1,450
1978	35	1,015
1979	20	580
1980	0	0

**New, reactivated or expanded refinery capacity is allocated fee-free quotas for 75 percent of the capacity expansion for a period of five years.

Government legislation, while adjustments to import fees can be made by Presidential Proclamation. (Changes in the entitlements program can be made by FEA regulatory changes.)

Even though the President could bypass Congress via Presidential Proclamation, there are a number of important members of Congress who consider the refinery incentive issue of vital importance and therefore Congressional views are likely to be sought by the Administration before proposing any new refinery incentive program. Congress is likely to be more receptive to a subsidy program than higher product import fees, where both render the same level of refinery protection. A refinery subsidy would only benefit those refiners who actually expand capacity, while all refiners, whether they expanded or not, would benefit from higher product fees. Moreover, as refinery capacity utilization approaches maximum feasible levels over the next few years, refined product imports are expected to increase to meet a major portion of incremental petroleum product demand. Consequently, higher product import fees are likely to be passed on to consumers, putting upward pressures on prices of domestic refinery output. This will be especially the case for residual oil, but possibly also for distillate fuel oil. The Northeast would be particularly vulnerable to this situation, because of its much larger dependence on imported product than any other region of the country. In contrast, product prices would be largely unaffacted by a direct subsidy to new refinery expansion.

It should be emphasized that the FEA task force proposal is in initial draft form. Changes from its current structure could possibly be made since opposition from domestic refiners, particularly those located in PAD Districts II-V and the Virgin Islands, is likely to develop.

TABLE I

RELATIVE COMPETITIVE POSITION OF MAJOR RESIDUAL OIL SUPPLY SOURCES ON THE U.S. EAST COAST BASED ON CURRENT FEA REGULATIONS

MAJOR RESIDUAL OIL SUPPLY SOURCE	CRUDE OIL ENTITLEMENT BENEFIT	PRODUCT ENTITLEMENT BENEFIT	LESS: TRANSPORT COSTS TO U.S. EAST COAST***	NET REDUCTION IN COSTS AT U.S. EAST COAST****
Caribbean	-	0.74**	0.30	0.44
Virgin Islands	1.23*	-	0.30	0.93
East Coast	1.23*	-	-	1.23
Gulf Coast	1.23*	-	1.06	0.17

*Represents 50 percent of the current entitlement value per barrel of crude run. Applies to sales of residual oil on the U.S. East Coast in excess of 5,000 barrels per day wtih the reverse entitlement in operation.

** Represents 30 percent of the current entitlement value per barrel of crude run.

*** Assumes that no product import fees are paid due to the availability of fee free tickets.

**** Due to entitlement benefit.

TABLE II

RELATIVE COMPETITIVE POSITION OF MAJOR RESIDUAL OIL SUPPLY SOURCES ON THE U.S. EAST COAST BASED ON PROPOSALS IN FEA TASK FORCE REPORT

(dollars per barrel)

MAJOR RESIDUAL OIL SUPPLY SOURCE	CRUDE OIL ENTITLEMENT BENEFIT	PRODUCT ENTITLEMENT BENEFIT	LESS: PRODUCT IMPORT FEE	LESS: TRANSPORT COSTS TO U.S. EAST COAST	NET REDUCTION IN COSTS AT U.S. EAST COAS
Caribbean	-	2.46*	0.42**	0.30	1.74
Virgin Islands	2.46*	-	0.42**	0.30	1.74
East Coast	2.46*	-	-	-	2.46
Gulf Coast	2.46*	-	-	1.06	1.40

*100 percent entitlement value per barrel of crude run.

** Assumes residual oil shipments to the U.S. East Coast are in Foreign Flag vessels.