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The SPR Financing Debate

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I. INTRODUCTION

For the first time since the Strategic Petroleum Reserve storage program (SPR) was begun in the 1970's, its importance has been *proven*. The SPR's existence provided foreign policy flexibility and its use on the outbreak of Operation Desert Storm provided a sharp counterforce to the expected market panic. Like an insurance policy which can appear to be only a cash drain while its benefits are abstract or potential, the SPR's benefits have now been made real. There is now little debate about the efficacy of a large SPR; the only debate now can be over how to achieve the goal. The Administration has endorsed the 1 billion barrel target for SPR fill, and in its National Energy Strategy points out the SPR has "demonstrated its capability to effectively address shortrun oil market disruptions." Even so, budget realities often make policy. Hence, the Administration has requested no new appropriations for purchasing oil, but is aggressively pursuing ways to reduce the cost of the fill. Leasing is one such mechanism. Congress is also entertaining alternative mechanisms to pay for the oil. This memorandum examines the history of the SPR and reviews some of the most important features of proposed alternatives for filling the Reserve.

The time may be ripe for consummating a leasing arrangement with one or more producing countries because the Persian Gulf conflict has underlined a commonality of interest between some producers in the region, especially Saudi Arabia of course, and consuming nations. The economic well-being of the two are undeniably interdependent, just as it would be intertwined with any important trading partner. The relatively modest step of cooperating on oil fill for the SPR benefits both parties.

The newly demonstrated commonality of interest, as noted, is likely strongest with Saudi Arabia. The nation has consistently taken a conservative pricing stance in OPEC debates, advocating slow price appreciation, and warning against aggressive price increases and sudden price run-ups. Further, there are a number of issues on which the U.S. and Saudi Arabia will be newly cooperating in the future. The SPR can be one of the issues on the negotiating table. Saudi Arabia has large crude oil stocks afloat and in foreign tankage, which it has obviously already produced and which require a cash outlay for continued storage. Could these stocks provide an SPR fill? While it has already incurred substantial costs in Operation Desert Storm, Saudi Arabia has a large war-related debt still to be paid to the U.S. Could any portion of the repayment be taken in kind? These are the kinds of possibilities that negotiators should take to the table.

Talks with other producers who have expressed an interest should also be pursued. With new enthusiasm for leasing and some new flexibility on both sides, an agreement on SPR fill should be more achievable now than ever before.

We would submit, however, that the direct purchase of oil for SPR fill from general revenues should not be abandoned, especially now that the SPR's usefulness and importance have been shifted from the theoretical to the proven category. The two financing methods can be used in tandem: direct purchase from general revenues could still provide the baseline fill rate; leasing or other reduced cost programs can provide the increment. It is important to retain the budget flexibility for direct purchase because 1) negotiating a leasing arrangement will take time under the best circumstances, and could involve false starts that waste time and 2) we may miss potential low-priced buying opportunities. Quality considerations, too, may be more easily balanced with direct purchase from disparate suppliers.

II. HISTORY AND PURPOSE OF THE STRATEGIC PETROLEUM RESERVE

A. *Energy Policy and Conservation Act of 1975*

In authorizing a one billion barrel SPR in the Energy Policy and Conservation Act of 1975 (EPCA), the Congress found that "the storage of substantial quantities of petroleum products will diminish the vulnerability of the United States to the effects of a severe energy supply interruption, and provide limited protection from the short-term consequences of interruptions in supplies of petroleum products." It defined a severe energy supply interruption as "a national energy supply shortage which the President determines--

"(A) is, or is likely to be, of significant scope and duration, and of an emergency nature;

"(B) may cause major adverse impact on national safety or the national economy; and

"(C) results, or is likely to result, from an interruption in the supply of imported petroleum products or from sabotage or an act of God."

The Strategic Petroleum Reserve underwent several significant legislative changes in 1990, including a *requirement* that it be filled to one billion barrels (DOE's previous plan was to develop and fill 750 million barrels of capacity; DOE must now submit a plan to accomplish the new expanded mandate within 24 months), the use of domestic supply disruptions for triggering an SPR drawdown, a move toward product storage, authorization to conduct a test drawdown and sale, and authorization of leasing mechanisms to fill the Reserve.

In 1975, Congress was acting on widespread advice to create such a reserve. Petroleum Industry Research Foundation was among the earliest groups that had

advocated government-owned strategic stocks, even before the 1973 Arab oil embargo. The National Petroleum Council had recommended an SPR in 1974 in analyzing the impact of the embargo and the preparedness of the nation's energy system to respond to another interruption in supplies. In 1975, the Council wrote a report detailing specific recommendations for development of a reserve, including several important aspects (such as the use of salt domes) later adopted. Furthermore, the International Energy Agreement was signed in 1974. By it, the consuming country signatories agreed to share their energy supplies in the event of another shortage, and its implementation included provisions on compulsory stock levels for each member country.

In the aftermath of the Arab oil embargo, it was clear that the U.S. economy had suffered badly from the higher prices and product shortages. According to estimates prepared for the National Petroleum Council's 1987 report *Factors Affecting U.S. Oil and Gas Outlook*, the economy in 1973-75 suffered the worst recession of the post-World War II period to that time; GNP had shrunk 2.5% by 1976, unemployment increased by 1.5 percentage points, inflation (measured by the Consumer Price Index) rose 3 percentage points. In addition, in the next disruption, in 1979, it was amply demonstrated that rational private inventory behavior (husband your stocks for a rainier day) exacerbated the market-wide impact of the supply disruption. Therefore, the presence of government-owned and -controlled stocks would mitigate the impact of a supply disruption in several ways: 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 running their own stocks down.

B. *SPR Drawdowns*

Volumes of SPR crude oil have been drawn out of storage, distributed and refined twice in the last six months. The skeptics, and there were some, have been proven wrong: the system worked, and worked well.

The trade and general press carried a number of stories in the early third quarter 1990, following on more muffled rumblings earlier, that the quality of the crude oil stored was unsuitable for U.S. refineries (there were even some totally unfounded allegations that the crude oil had been irretrievably contaminated), and that the logistics of the drawdown and delivery system, untested, would founder in scheduling delays, capacity constraints, and the DOE's inexperience in dealing with distribution and transportation operations.

These concerns were misplaced from the outset. The quality of crude oil in the SPR had been largely planned to substitute for imported oil. Although uninformed observers made claims to the contrary, the sulfur content and gravity closely matched import averages. Furthermore, the crude oils commingled in caverns were widely known and (largely) in the mainstream of world trade. The heavy Mexican crude oil, which

some of these uninformed observers charged was laced throughout the system, lowering the quality of all crude oil, constituted a very small (2%) share of total inventories. Most of it was segregated at the Bryan Mound site. Another concern was that a shortage of suitable U.S.-flag (Jones Act) tankers would constrict the system's distribution capability. DOE cooperated with the Maritime Administration in granting a blanket waiver from the Jones Act requirements when the SPR drawdown was announced. Operationally, the drawdowns were professionally and expertly coordinated. Hence, technical and operations issues were resolved and any nagging doubts about the accessibility of SPR volumes in an emergency were allayed.

The first drawdown was a "test" sale of 3.9 million barrels conducted over the late September to November 1990 period. Well before the Persian Gulf conflict began, DOE had scheduled an exercise to test the logistics of the bidding and delivery system, to take place in the fourth quarter 1990. The Strategic Petroleum Reserve Amendments of 1990, passed in September, made it possible to turn the scheduled dry run into a physical withdrawal of oil. The test was thus just a step beyond the original plan.

The second drawdown was "real," a declaration of a severe energy emergency brought about by the beginning of Operation Desert Storm. The International Energy Program participants announced prior to the war that they would collectively institute a combination of demand reductions and supply enhancements equal to 2.5 million B/D in the event of a declaration of war. In combination with the U.N. allies' highly successful sorties in the opening hours of the war, the announced drawdown of SPR stocks here and abroad contributed to the historic $12/barrel crude oil price decline on January 17, the first day of the war.

Like the test several months earlier, the SPR drawdown was carried out without a hitch. Bidders understood the system, the logistics worked, the crude oil quality was as expected, etc. The Department of Energy also showed flexibility in selling less crude oil than initially offered because, as reflected in the bidding pattern, markets wanted a lower amount but a higher quality than the DOE's offered mix. Having invited bids on 33.75 million barrels (2/3 high sulfur and 1/3 low sulfur), DOE awarded contracts for 17.3 million barrels (1/6 high sulfur and 5/6 low sulfur). The agency thus avoided pouring unnecessary supplies into the market, but responded to market needs. Deliveries were smoothly carried out.

III. FACILITIES AND TIMING OF SPR FILL

The DOE chose to use salt dome storage for SPR volumes, acquiring by purchase and condemnation six salt dome structures along the U.S. Gulf Coast. Caverns are leached out by water injection/brine removal. Each facility contains multiple discrete caverns. By the beginning of 1991, the DOE had developed 715 million barrels of storage capacity.

As shown below only the Bayou Choctaw and Big Hill sites have continuing cavern development. Volumes stored in Big Hill remain *de minimis* as of now, but the facility will accept fill when oil injection resumes. According to Department of Energy estimates, the remaining 180 million barrels of inventory necessary to reach the long-standing goal of 750 million barrels will take approximately 2 years to acquire and inject, a fill rate of approximately 250 thousand B/D. (After the recent drawdown, the SPR inventory is about 570 million barrels.) The estimate takes into account only logistics and facilities constraints; it excludes the most pressing constraint, funding.

Table 1

STRATEGIC PETROLEUM RESERVE STORAGE FACILITIES
(Millions of Barrels, as of 12/31/90)

Facility	Current Capacity	Planned Capacity	Oil in Storage
Bryan Mound	226.0	226.0	220.7
West Hackberry	219.0	219.0	209.2
Bayou Choctaw	56.0	72.0	53.2
Weeks Island	73.0	73.0	71.5
Sulphur Mines*	26.0	0.0	23.8
Big Hill	115.0	160.0	3.9
Total	715.0	750.0	582.3 **

*Sulphur Mines site is being decommissioned, and the inventory transferred to Big Hill.

**Excludes 3.1 million barrels of tank and pipeline fill.

Source: U.S. Department of Energy

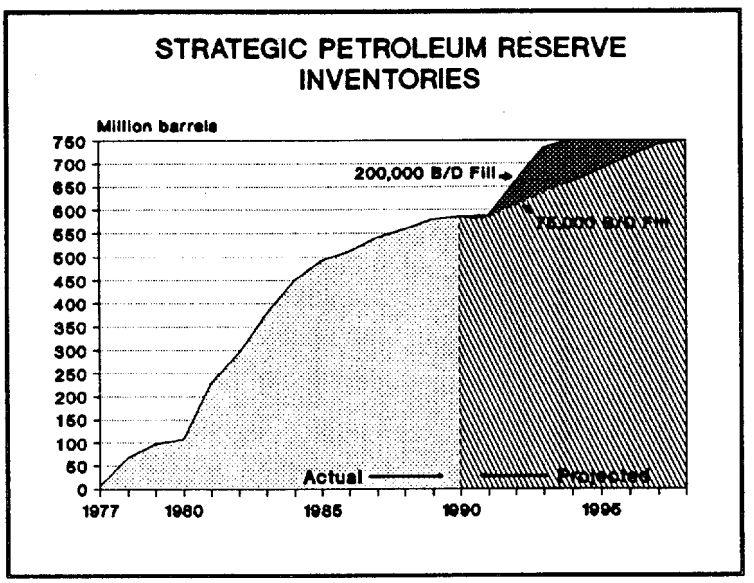
The Strategic Petroleum Reserve Amendments of 1990, as noted, require that the Department of Energy store one billion barrels of oil in the SPR, and the Administration's *National Energy Strategy* endorses the goal. Additional capacity will have to be developed, purchased or leased in order the meet the target, and DOE's plan for needed capacity expansion is not due to be sent to Congress until September 1992. It is therefore unclear whether the 250 thousand B/D fill rate mentioned above, which can be maintained for two years until the total inventories have reached 750 million barrels, could also be sustained for the next 250 million barrel increment to reach the one billion barrel target. One firm has put forward the idea to lease its salt dome to the DOE; it has been estimated that as much as 150 million barrels could be in place by late 1996 or

early 1997. Expanding the DOE's Big Hill facility would allow incremental fill at that site in approximately 1997. It seems likely, therefore, that the SPR could not hold as much as one billion barrels until the late 1990's at the earliest.

IV. SPR FUNDING

SPR fill, initially targeted for 500 million barrels by the end of 1980, has been accumulated much more slowly, a victim of budgets and logistics. As shown in Figure 1, for instance, the Reserve held just over 100 million barrels at the end of 1980. It did not reach 500 million barrels until 1986. Congress in 1980 mandated an SPR fill rate of 100,000 B/D, and precluded the sale of oil from Naval Petroleum Reserve Number 1 (Elk Hills, CA) unless the SPR was being filled at the minimum rate or contained 500 million barrels. In 1986, Congress mandated a fill rate of 75,000 B/D until 750 million barrels are in storage. In recent years, appropriations have fallen short of the amounts necessary to meet the prescribed fill rates.

Figure 1



As of the beginning of 1991, SPR appropriations had totalled $20.1 billion, $16.4 billion of which went to oil acquisition and transportation and $3.4 billion to facilities development and operations. Beginning in Fiscal Year 1982, the SPR expenditures were transferred to the Strategic Petroleum Reserve Account, where they no longer counted toward Federal budget totals and deficit calculations. The deficit calculations required by Gramm-Rudman-Hollings put the SPR back into the budget in 1986, however. The outlay for oil fill is of course vastly variable, because of changing prices and fill rates. In its peak year (FY 1982), the appropriation for petroleum acquisition and transportation reached $3.7 billion. In FY 1990, the appropriation was $0.4 billion.

In spite of moving SPR expenditures "off-budget" in the early 1980's, Congress has consistently and appropriately funded the account out of general revenues. The reasoning behind the decision can be put forward as follows:

- *The economy is the beneficiary of the existence and use of the SPR, and thus all participants in the economy, not just oil importers and oil consumers, reap its rewards.* We saw after each of the market disruptions that the economy reacted with a negative ripple effect. Even people not directly consuming oil products are impacted by changes in the prices of goods and services. It is therefore not solely oil consumers who benefit from the SPR insurance policy.

- *The SPR is a national security measure, just like a weapons system.* It provides foreign policy flexibility, it provides a deterrent for the use of oil as a weapon, it bolsters the nation's strength during a crisis. These are each attributes of the defense systems as well. And just as the expenditure for defense would only come from general revenue, so should it be with the SPR.

- *General revenues fund the SPR at the lowest cost to the economy.* The general revenue route provides an efficient ratio between the desired funding level and the taxpayer outlay necessary to achieve it. An import fee, one alternative funding mechanism recently discussed, collects the desired monies on imports alone, while oil consumers pay equivalent higher prices on all petroleum products (and may raise the prices of competing fuels as well). So direct government revenues are less than half of the increased consumer payments initially. Government revenues are decreased further by the ripple effect of higher prices on the economy.

V. ALTERNATIVES FOR FUNDING AND FILLING THE RESERVE

While in our view the direct purchase of SPR oil from general revenues should not be abandoned, some alternatives to this method are decidedly more desirable than others. Leasing oil, for instance, has the advantage of minimizing costs and maximizing the oil fill, while maintaining the funding principles put forward in the previous section. In contrast, several current Congressional proposals for SPR funding use an import set-aside approach, effectively an import fee; the import fee imposes a markedly higher cost to the economy (though a lower *direct* cost to the federal budget) and targets just one of the groups benefiting from the SPR.

A. *1991 Johnston-Wallop Proposal*

The Senate bill, introduced by Senators J. Bennett Johnston and Malcolm Wallop, the ranking members of the Committee on Energy and Natural Resources, calls for an "Oil Security Premium." The provision requires that DOE, beginning in FY 1992, implement a program for filling the SPR at a rate of 220,000 B/D *and* meeting the steady-state peacetime petroleum product needs of the Department of Defense. Importers would be required to supply a proportion of their imports to meet these needs, with the exact percentage to be determined by the Secretary of Energy. Senator

Johnston has indicated that importers would likely have to supply crude oil and products equal to 9% of their import volume. Based on 1990 import levels, this would be equal to more than 700,000 B/D, thus accounting for the *worldwide* U.S. military consumption under normal conditions, only 3/4 of which is actually based within the U.S. The bill contains no sunset provision that would end the set-aside/fee when the desired SPR inventory level had been achieved.

Singling out oil consumers to bear the cost of both the SPR and the Defense Department needs, the bill is based on an inappropriate premise, as noted above. The benefits of both items accrue economy-wide, not just to oil users. In particular, asking petroleum consumers to pay for Defense Department supplies cannot be justified on any logical grounds. Military oil consumption and oil consumption in other sectors are unrelated. This is a "user fee" where the universe of users has been badly mis-identified.

Furthermore, the 9% volume surcharge on importers means a 9% price increase. In fact, this is the sponsors' stated intent, in order to discourage imports. U.S. supplies, competing with higher priced imports, will also enjoy a price increase. Some firms, such as U.S. independent producers, will receive higher prices with no offsetting obligation. Firms which produce in the U.S. as well as import crude oil and products will incur a partial offset to the higher prices, as they fulfill their SPR supply obligations. Firms which have no production, but only import crude oil to refine or products to sell, will have only a higher cost. Therefore, the measure creates competitive advantages and disadvantages.

The fee-induced price increase will cause a negative ripple effect across the economy. Numerous studies on import fees have demonstrated that there are considerable economic costs: lower disposable income, lower employment, lower GNP, and reduced government tax revenue, for instance. Work done by the Department of Energy in 1987 indicated that net government revenue would in fact be lower under an import fee than without one.[1] DOE's analysis, based on $5 and $10/bbl import fees, showed that increased employment in the oil producing regions was more than offset (3:1) by reduced employment elsewhere. Under DOE's $5 import fee case, the Consumer Price Index rose almost 2 percentage points in the near-term and about 1 percentage point in the longer term. Annual GNP losses ranged from $15 to $25 billion. Modelling the five-year impact of a $5 import fee, DRI/McGraw-Hill also showed significant costs: industrial prices would rise 3.1% faster on an annual basis, consumer prices 1.5% faster, capital spending would decline by 1.4% per year, real disposable income would be reduced an average of 1.1% annually, employment would be lower by almost 1 million jobs at the end of the five years.[2]

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[1]U.S. Department of Energy, "Energy Security: A Report to the President of the United States," DOE/S-0057, March 1987.

[2]J. Yanchar and C. Caton, "Energy Taxes: Still Not a Good Idea," *Data Resources U.S. Review*, March 1987.

Generally the economic costs of import fees are considered directly proportional to the fee level. Hence, at the relatively low level anticipated in the Senate bill, it will be argued, the pernicious effects are not catastrophic. But benefits also pale at low fee levels. Increased domestic production due to the higher price will not be material.

Figure 2

Macroeconomic Impacts of an Oil Import Fee

Real GNP	Falls; lower personal incomes, reduced domestic consumption spending, and less efficient use of capital lead to lower GNP.
Inflation, Interest Rates	Rise; higher energy costs increase inflation directly, the energy cost component of other goods and services rise secondarily.
Consumption	Falls; oil consumption falls because of higher prices, consumption of other goods and services fall because the additional payments for oil reduce the possible payments for other items.
Business Fixed Investment	Falls; increases in the energy sector do not offset cutbacks elsewhere.
International Competitiveness	Falls; higher prices impair exports and encourage imports of non-oil items. Oil imports are somewhat reduced by falling oil consumption.
Employment	Falls; more jobs in producing areas are more than offset by job losses in consuming areas.

In fact, the Department of Energy in its 1990 analysis of SPR financing mechanisms reported negatively on the use of an import fee for SPR financing.[3] Among the problems: an import fee designed for SPR financing does not "seem to fit [the Office of Management and Budget's] definition of 'user fees';" exporter nations would likely raise objections under the General Agreement on Tariffs and Trade; the U.S.-Canada Free Trade Agreement exempts Canadian oil from import fees; an import fee would have negative macroeconomic impacts.

[3]U.S. Department of Energy, "Report to the Congress on Alternative Financing Methods for the Strategic Petroleum Reserve," DOE/FE-0155, February 1, 1990.

B. *1991 House Proposal*

Congressman Philip R. Sharp of Indiana and several co-sponsors have also introduced SPR financing legislation, the "Strategic Petroleum Reserve Enhancement Act of 1991." Representative Sharp's bill would increase the SPR fill rate to 200,000 B/D, expand the SPR's ultimate size to 1.5 billion barrels, and require importers to contribute a share of their imports to fill the Reserve (3% at current import rates). The measure differs materially from the Senate proposal in that the importer would retain title to the oil, and receive the revenue from its sale when it was drawn out of storage (on a first-in, first-out basis) during an SPR withdrawal. Importers would have no control over the oil. DOE would dictate the necessary quality and storage location of the oil. While the drafters intended that product imports be added to a new refined product reserve, the Secretary of Energy has the authority to require that all stored volumes be crude oil.

Although the import surcharge required under the Sharp bill is lower than under the Senate proposal, the measure still has the effect of raising the cost of imports, and hence, the cost of domestic supplies competing with imports. Like its counterpart in the Senate, the bill would also require one segment of the population to pay for a program which benefits all.

C. *Leasing Oil for the SPR*

While the concept of leasing oil (and facilities) is not new, it has recently gained new supporters. The Congress passed new authorization to undertake leasing arrangements in 1990; the Administration has endorsed the concept. The time is opportune to negotiate and implement leasing deals. As world oil markets emerge from the Persian Gulf conflict, the world once again finds itself with a surfeit of oil. OPEC is likely to trim at least one million B/D from its output in the coming months, leaving a small margin for production in excess of market needs, and as Kuwait's and Iraq's facilities return to production, excess productive capacity will grow. Some of that oil could go into the U.S. SPR. Remaining outside commercial channels, it would have a negligible effect on supply/demand balances. As noted above, the SPR facilities are estimated to be ready to accept 250 thousand B/D for the necessary two years while filling the remainder of the 750 million barrel goal.

In 1990 the DOE completed a Congressionally-mandated study on alternative financing mechanisms for the SPR, concluding in general that "there is a clear potential for the Federal Government to acquire oil directly from producing nations or state-owned oil companies if a policy decision is made to pursue this approach and the issues

identified . . . can be addressed."[4] Based on conversations with numerous producing countries, DOE noted that "there were indications that . . . cooperation [with the U.S. Government in filling the SPR] might be viewed as a "value-added" feature of oil leasing." Whatever value-added was formerly perceived, it is now greater for at least some of the candidate producing nations.

i. The Lease's Cost Structure

Under a given budget outlay, a leasing arrangement has the advantage of putting significantly higher volumes of oil in SPR storage and under the Government's control. Lease terms of course, would have to be carefully constructed. Among the most important:

a) What to do with the oil at the end of the lease term (renew, purchase, return);
b) What to do in the event of a disruption during the lease term (sell and pay the lessor, purchase at a pre-determined price); and
c) How to treat the lessor's revenues for U.S. tax purposes.

DOE's consultations with producing countries identified several other issues which would have to be resolved in the negotiating process, such as the cargo preference requirements which currently apply to SPR deliveries.

The cost structure for the leasing agreement is of course the critical question. The ceiling for Government payments for leased oil is generally perceived as its alternative cost: borrowing money at the Treasury rate for the outright purchase of SPR supplies. The floor for producing country revenues from a leasing arrangement is the rate of return on the cost of production. One could argue, therefore, that the negotiating room is thus the cost of money on, say, $18 per barrel (purchase) versus the cost of money on, say, $2 per barrel production cost (lease). (Some additional one-time costs incurred in shipping oil to the SPR--transportation and handling--would also have to be covered. DOE estimated these costs at roughly $1.25/barrel, rising to $2.50/barrel over the next decade, in nominal dollars.) Thus, while the DOE's lengthy analysis points out that *private firms'* costs of oil acquisition and desired rate of return are unlikely to produce lease terms more favorable to the Government than outright purchase, the same is not true for *producing countries*, where the low production cost provides additional negotiating flexibility. The producing country's comparative advantage is the central factor which makes a lease economically viable for both sides, and that provides negotiating possibilities for a host of bilateral arrangements.

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[4]U.S. Department of Energy, "Report to the Congress on Alternative Financing Methods for the Strategic Petroleum Reserve," DOE/FE-0155, February 1, 1990.

The cost structure of a lease also becomes subject to a Federal budget technician's debate: from the perspective of the Federal budget, an obligation to make lease payments over a period of time requires that the full amount be authorized at the outset, even though a small amount is actually paid out each year. Hence, the budget *outlay* (the annual payment) for a lease is substantially smaller than for a conventional direct purchase, but the budget *authority* (the stream of payments) may appear much closer to parity for the two mechanisms. The authority is particularly high for a lease which amortizes the purchase price over the lease term; that is, one where the U.S. will take title without further payment at the lease's expiration. This type of a lease would be conceptually similar to directly purchasing the oil, as historically, with borrowed funds.

Thus, although the Office of Management and Budget's guidelines on the evaluation of leases, because of their methodology, may make a lease appear less economic, the Gramm-Rudman-Hollings law and other standard calculations of the budget deficit use outlays, not authorizations. DOE, formally bound by OMB guidelines, has focused on the advantage of lower outlays provided by leasing in its budget request and its public statements. Finally, Congress, in its legislation authorizing leasing, has required that any lease contract explicitly state that the obligation of the United States is subject to the availability of appropriations.

ii. Other Considerations

The producing country lessor's conceptual floor--being kept whole for the cost of production--is not necessarily its practical or its political floor. The acceptable lease revenue will depend on the mix of its expectations of future prices, the terms for payment in the event of SPR drawdown, the terms for return of the oil in the event of the expiration (and non-renewal) of the lease, and its motivations for storing oil. Saudi Arabia, for instance, already stores significant volumes, which it produces, pays transportation, storage and carrying charges for. If the Saudis decided to reduce their stocks held abroad in tankers and in the Caribbean and elsewhere, using some of these supplies for SPR fill could benefit both nations. The oil would provide a quick increment for SPR fill, a help to the U.S. For the Saudis, they would not longer incur the carrying charges for having it available. Moving from storage to the SPR, it would remain outside commercial channels and the OPEC quota, thus minimizing the market impact of de-stocking. Furthermore, Saudi production could remain higher, since market needs would be met only from new supplies, not from stocks.

The lease term dealing with the return of capital--under what terms can the lessor take back the oil or its purchase value--is another example of differing concerns for a lessor which is a producing country versus a lessor which is a commercial entity. In its analysis of leasing and alternative financing methods, the DOE pointed out that if the lease requires the return of wet barrels to a lessor on a date certain, for example, the lessor will reasonably be concerned about the price risk exposure, a soft market at the

time of the planned return. And logistically and administratively, a return of wet barrels poses problems for the SPR. A commercial lessor, however, might be reticent to agree to a perpetual renewal of the lease, since such an arrangement is analogous to a loan where the principal is never repaid. But as noted, a producing country brings to the negotiating table more favorable economics and, perhaps, a different agenda from the private firm. Thus, the idea of creating a perpetuity, without any return of capital, may be significantly more palatable for the producing country than for the solely commercial entity.

Additional considerations enhance the advantages of a leasing arrangement consummated now:

- ***Reduced Vulnerability***: The budget constraints are currently blocking SPR fill, even in the face of widespread agreement that the SPR worked in 1990 and 1991, and that its replenishment and continued fill is a necessary part of our energy policy. Leasing oil for the SPR would reduce U.S. vulnerability to disruptions in petroleum supplies by putting more barrels in storage for the same annual outlay.

- ***Demonstrated Interdependence***: There has never been a period of more vividly demonstrated interdependence between oil producing nations, especially the majority of those in the Persian Gulf, and oil consuming nations than the last five months of 1990 and the first two months of 1991. This is a worldwide phenomenon, leading to new calls for producer-consumer dialogues, among other cooperative measures. But it is also more pronounced for the U.S. and Saudi Arabia, because of their unique roles in the Persian Gulf.

- ***Mutuality of Interest***: The need for SPR oil coincides with the growing excess capacity in producing countries. Some of these countries have stated their policy of maintaining a capacity margin, but their investments, with their planned idleness, do not earn a return. The leasing option thus may provide a benefit to both sides: the U.S. get the oil and the producing country utilizes an idle asset.

In summary, we need to continue a strong SPR program, filling facilities as rapidly as possible to the 750 million barrel level, and moving forward expeditiously with plans to store 1 billion barrels. In our view, general revenues should continue to provide the funding, and direct purchase should continue to be an important method of acquisition. Since budget constraints have limited direct purchase, however, analysis of the financing alternatives ranks the options: leasing is best, and an import fee the worst.