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DOMESTIC REFINERY POLICY ISSUES

Statement before the

Subcommittee On Energy and Power
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by

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About nine months from now--or sooner if the incoming Administration so decides--the U.S. refining industry will undergo a series of major changes under existing legislation: 1) all protection against refined products imports based on lower U.S. crude oil costs will end as domestic crude oil prices rise to the world market level and the crude oil cost of U.S. refiners moves accordingly; 2) all regulatory advantages of small refineries and certain other companies through preferential access to the benefits of price controlled domestic crude oil will end; 3) small and independent refiners will no longer have assured access to controlled domestic crude oil from their historical suppliers, while crude oil suppliers will no longer have legal obligations towards their historical customers; 4) small and independent refiners unable to obtain sufficient foreign crude at "competitive prices" will no longer be able to look to the larger integrated oil companies as a designated supply source of last resort; and 5) all price controls and distribution allocations on gasoline and propane will end.

Since the legislative basis for all the regulations scheduled to end next September 30th are the Emergency Petroleum Allocation Act of 1973 or the Energy Policy and Conservation Act of 1975, the industry has lived long enough under the constraints and benefits of these regulations to have more or less adapted to them. Thus, their expiration will probably bring about structural changes in the U.S. refining industry. I would like to discuss some of these changes but first I

would like to comment briefly on the economic climate in which they are likely to occur.

The domestic petroleum refining industry has been a growth industry from before the end of the last century until 1978. There is now an assumption among a growing number of industry analysts that that year's consumption of 18.8 MM B/D represented the peak in U.S. oil consumption. This assumption is not based on the fact that consumption has dropped in 1979 and 1980 (such temporary declines have occurred before) but rather on evidence of a structural long term, perhaps irreversible, decline in U.S. oil consumption. The principal long term reason for this decline is consumer reaction to the price increases since 1973. They have resulted in less use, more efficient utilization and, in some cases, substitution of other energy sources for oil. Government policy since 1973 has accelerated this trend through appropriate legislation in all three of these areas. The decision to deregulate the prices of all domestic crude oil, old and new, is part of this policy.

There is now a national consensus that the more we can reduce our oil consumption (without constraining economic growth), the better the national interest will be served, since at present or higher rates of consumption we will have to rely to a substantial degree on insecure imported oil. While no one can argue with the validity of this concept, it does of course have potentially negative implications for the industry which manufactures, transports and markets the products whose demand

reduction is deemed in the national interest.

An additional problem is that the refining industry's capital investment requirements will not decline in line with its output. There are two reasons for this: a change in the quality of products requirements and a change in the quality of crude oil supplies.

In the 1980's we expect residual fuel oil demand to decline rapidly, middle distillate demand to grow and total gasoline demand to decline moderately but demand for unleaded gasoline to rise significantly. This means that U.S. refiners will have to install equipment to convert residual fuel oil into lighter products and to improve the octane number of gasoline.

At the same time, the average crude barrel will be more difficult to process into required products as U.S. crude oil supplies from foreign and domestic sources are becoming heavier and more sulfurous. Since U.S. refineries are designed to run only about 50% medium and high-sulfur crudes, substantial investments will be required to increase this share in line with expected future crude oil availability.

It is against this background of declining demand and continued high investment requirements that the decontrol effects enumerated earlier will take place. I will now briefly discuss the impact of some of these.

Import Competition

U.S. refiners have been protected from foreign competition since 1959. Until 1973 the instrument of protection was the Mandatory Oil Import Program which imposed volume restrictions first on all imported

products and since February 1967 on all products other than residual fuel oil. Since the fall of 1973 lower U.S. crude oil costs have made it largely impossible for foreign refiners to compete in the U.S. market for any product other than residual fuel oil at the East Coast (PAD I). Competition with the latter product was made easier by giving importers into PAD I (and later Michigan) a portion of an "entitlement," i.e., in essence a portion of the difference between the delivered cost of foreign and controlled domestic crude oil.

Currently, domestic crude oil price controls still give refiners a crude cost advantage of about $3.50/Bbl on light products over foreign refiners and roughly half that much on residual fuel imports into PAD I (and Michigan). In addition there are U.S. import duties of 5.25¢/Bbl for heavy fuel, 10.5¢/Bbl for light fuel oil and 52.5¢ for motor fuels.

After complete domestic crude oil price decontrol the only mandatory protection for U.S. refiners will be the products import duties, whose real protection against foreign refiners is about 10¢/Bbl less than the actual duty because of a 10¢ import duty on most crude oil imports. Thus, the duty has no protective value whatever for products other than gasoline and not much value (1¢/gallon) for this product.

However, under existing legislation the President has the right to impose import fees, separate from the import duties, on oil imports. In fact, until suspended in April 1979, a fee of 63¢/Bbl was imposed

on all refined products and 21¢/Bbl on all crude oil. The import fees were not made additive to the import duties but were rolled into each other. The President may reimpose the fees at his discretion at the previous or any other level.

If he chooses not to reimpose a fee, an increase in U.S. products imports will certainly take place. But its impact will vary by product and region. The principally affected product will be residual fuel oil and the principally affected region PAD I. Export refiners in Venezuela and the non-U.S. Caribbean islands will be able to compete with residual fuel oil shipped from the U.S. Gulf Coast to PAD I, since they have somewhat lower operating costs and substantially lower freight costs. In 1980 the volume of oil affected by this competition would have amounted to about 230 M B/D. Refineries in PAD I producing residual fuel oil would also be affected by the foreign competition but much less so than the Gulf Coast plants.

The economic impact of increased imports would be to reduce the profit margins of refineries with significant residual fuel oil yields, to accelerate the trend towards more fuel oil conversion capacity in those U.S. refineries able to build such facilities and to weaken the economic viability of refineries not able to do so. The latter are most likely small plants located at the Gulf Coast.

From the balance-of-payments point of view a switch in imports from crude oil to residual fuel oil would be desirable, since the cost of the residual product is nearly always below that of the crude oil from which it is refined. From the security-of-supply point of view

it might also be desirable, since there is a world-wide surplus of residual fuel oil which is expected to remain, so that foreign residual fuel oil may actually be more easily obtainable than foreign crude oil. It would therefore appear that the principal valid objection to unrestricted imports of residual fuel oil is their likely negative impact on the profitability of Gulf Coast refineries which produce residual fuel oil, particularly those not in a position to install equipment to convert residual into lighter products.

Gasoline imports would probably not be significantly deterred by the existing 1¢/gallon net import duty. Again, the only potential region for such imports would be PAD I and the principal competition would be with gasoline tanker shipments from the Gulf Coast which are on the order of 415 M B/D this year. However, foreign gasoline supplies differ from foreign residual fuel oil supplies in two important characteristics: 1) most foreign gasoline is not of the right quality for the U.S. market; and 2) there is no foreign gasoline surplus and none is expected. Thus, the potential for U.S. gasoline imports is quite limited. Nevertheless, in a declining market even a small incremental quantity of foreign gasoline seeking to enter the U.S. could have a depressing effect on U.S. refinery margins.

The situation is different again for imports of distillate heating oils. Their quality is generally in line with U.S. requirement and foreign supplies of middle distillates are more readily available than gasoline. In fact PAD I regularly imports about 5% of its

distillate heating oil requirements during the heating season. About 305 M B/D of middle distillates is shipped to PAD I by tanker from the Gulf Coast. Since Caribbean products have a substantial transportation advantage in PAD I over the Gulf Coast, unrestricted access of foreign middle distillate would have a more significant negative impact than gasoline imports on Gulf Coast refinery margins and, hence, indirectly on refinery margins elsewhere in the country. Reimposition of the 63¢/Bbl import fee would of course reduce this impact, particularly if the 21¢/Bbl import fee on crude oil were to remain suspended. Given the existing level of foreign crude oil prices, there is no reason for this particular import fee.

An import fee or other effective restriction on the importation of middle distillate products would have a modest positive effect on the U.S. balance of payments, on U.S. refined products self-sufficiency and on the economic viability of U.S. refiners. By contrast, unrestricted middle distillate imports would benefit primarily the U.S. consumer, whose cost would be reduced.

U.S. Products Exports

I would now like to make a few comments on products exports. These have been prohibited, except under special license, since the beginning of domestic crude oil price controls. The reasons are obvious. The crude oil price controls were made for the benefit of U.S. consumers, not foreign ones. Furthermore, with their relatively low crude costs, U.S. refiners could have probably sold a significant

portion of their output abroad in the absence of restrictions, potentially leaving the U.S. short of products.

However, next October when U.S. and foreign refiners will pay about the same prices for their crude oil, these reasons will no longer be valid.

In the absence of any export restrictions the U.S. would not become a substantial exporter of refined products, since U.S. refiners have no cost or freight advantage over their foreign competitors. But small amounts of products may be exported under those conditions. Such exports would increase the opportunities of U.S. refiners for the disposal of their products and, hence, their ability to balance their products output. Export permission might become particularly important for West Coast refineries which will likely produce substantially more residual fuel oil than is required in their market region but would find it more difficult, both from a marketing and a transportation cost point of view, to dispose of the excess in other U.S. regions than in the Far East.

Access to Crude Oil

Let me turn to the question of access to crude oil after decontrol. There is considerable concern among those U.S. refiners who have access to the domestic crude oil supplies of other companies under existing supplier/purchaser regulations that as they lose this access, they would likely have to go into foreign markets to replace much of it. This concern is understandable. If the supplier/purchaser regulations

ended right now the purchasers would certainly encounter considerable difficulties in replacing their lost crude at competitive prices in the world market. One may hope that by next October the world oil supply situation will have improved.

However, the problem is perceived to be deeper than this. The question has been posed: can independent refiners obtain adequate volumes of foreign oil under economic terms similar to those of the major international oil companies with whom they must compete?

There is no simple answer to this question. For one thing, in the world oil market upheaval which has occurred over the past two years, the majors, as a group, have lost a considerable part of their previous contractual access to OPEC crude oil. Their loss has benefitted primarily OPEC's national oil companies which have become the rising stars in the world oil market. Furthermore, not all majors are equal in access to OPEC oil. In fact, the independent refiners' often expressed concern about inability to compete with the majors refers almost entirely to the four Aramco shareholders.

There is no doubt that in the last 20 months or so, the Aramco companies have had a significant economic advantage over most other oil companies in the form of lower prices for their share of Saudi Arabian oil. Even with the periodic retroactive upward corrections imposed by Saudi Arabia, these companies had access to substantial volumes of oil at a significantly lower price than was generally paid by their competitors for the same quality. However, the price differential between Saudi and other OPEC crude is a short-term policy measure

by Saudi Arabia, designed to obtain price moderation from other OPEC members, and is unlikely to be maintained, since it makes no economic or political sense for Saudi Arabia to underprice other OPEC members on a long term basis. Thus, the Aramco companies' price advantage is unlikely to last much longer.

Aramco's security of access to Saudi Arabian oil supplies is much more likely to endure. But this gives its shareholders a real competitive advantage only during periods of sustained market tightness. It is for such exceptional periods (which, however, have been more frequent than normal market conditions in the last two years) that a system may have to be devised to assure all U.S. refiners approximately equal access to available foreign and domestic oil supplies. This would not only be a matter of equity but also a means to prevent the occurrence of local shortages brought about by uneven distribution of supplies rather than an overall insufficiency.

In other words, there appears to be a need for some form of stand-by system of crude oil supply allocations to be triggered only by a real or clearly impending supply shortage and to be of defined limited duration. It will not be easy to devise such a trigger. An established mechanism is necessary, however, to avoid ad hoc policies implemented under the market strain of a disruption.

There are several other important aspects of U.S. refining policy such as what, if anything, to do about the small refiners whose preferential entitlement treatment will end with crude oil decontrol and whether to give tax or other incentives to U.S. refiners for upgrading their plants to produce less fuel oil and to process more heavy, sour crude oil I am not commenting on these matters so as to stay within my alloted time But I would be glad to answer any questions regarding them.

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