PIRINC

You may be interested.

PIRINC is proposing in the enclosed report entitled, *Shopping in a Distressed Market: A Role for the SPR,* that the SPR purchase over the next few months about 30 million barrels of oil.

The Strategic Petroleum Reserve is one of the cornerstones of U.S. energy policy. And it remains the most effective policy tool in minimizing the dislocations to the U.S. economy from a disruption in the international oil markets. However, over the past three years, the Congress and the Administration have seen fit to raid the SPR for budgetary purposes by selling off 29 million barrels. The time is uniquely right to at least buy these barrels back. Ironically, the world is again experiencing an oil price "shock," but this time the "shock," in the form of the lowest inflation-adjusted oil price in over 35 years, is hurting producers, not consumers. While prices can stay low for some time, they are unlikely to remain at these depressed levels indefinitely. Thus, this is the moment to buy.

If you have any questions or comments, please call John Lichtblau, Larry Goldstein or Ron Gold.

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Shopping in a Distressed Market: A Role for the SPR

The Strategic Petroleum Reserve is one of the cornerstones of U.S. energy policy. And it remains the most effective policy tool in minimizing the dislocations to the U.S. economy from a disruption in the international oil markets. However, over the past three years, the Congress and the Administration have seen fit to raid the SPR for budgetary purposes by selling off 29 million barrels. The time is uniquely right to at least buy these barrels back. Ironically, the world is again experiencing an oil price "shock," but this time the "shock," in the form of the lowest inflation-adjusted oil price in over 35 years, is hurting producers, not consumers. While prices can stay low for some time, they are unlikely to remain at these depressed levels indefinitely. Thus, this is the moment to buy.[1]

Right now, world oil prices are hovering around $11 a barrel, about $9 below its 1997 average price. While consumers are benefiting from the lower prices, it's not just foreign producers who are hurting. The U.S. is also a major oil producer. Indeed, with the OPEC production cuts in place, the U.S. is currently the world's largest single source of petroleum supply. Depressed oil prices adversely impact the finances of all oil producers, as well as drilling and service companies, and reduce their ability, as well as the incentive, to continue to find and produce oil.[2]

For the major foreign producers the most serious effects of depressed oil prices show up as reduced revenues and only to a much lesser extent, as impaired ability to produce. This is because actual costs of finding and producing oil can be very low. The Department of Energy estimated that average capital costs of developing reserves in the Persian Gulf ranged between about $0.50 and $2 per barrel (1998 dollars) while operating expenses ranged between about $1 and $1.75 per barrel. U.S. producers face a very different cost situation. In 1996, the major U.S. producers reported an exploration and development cost per barrel of reserve additions of $5.42. The same reports indicate an ex tax production cost per barrel of oil equivalent for oil and gas of about $4.25. . Of course greatly reduced revenues limit resources available for new development but some key, low-cost, producers have an option they are beginning to exercise, namely to invite in foreign capital. For U.S. producers, depressed oil prices are provoking cuts in employment and investment, as well as new rounds of industry consolidations. Warning signs for U.S. production are emerging. The number of rotary rigs in use for U.S. oil and gas exploration was down about 6% in the first 9 months of 1998 versus the comparable period in 1997. The decline is accelerating with no bottom in sight. The rig count for the third quarter of 1998 was 20% below the year earlier and for the most recent period, 32% below year-ago levels.

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[1] The Secretary of Energy has advocated the purchase of some additional oil, but not until fiscal year 2000, when the price may not be favorable.

[2] It will also negatively impact the production of natural gas since budgets for all aspects of oil and gas exploration and production are being cut across the board and some gas is produced in association with oil.

As a matter of long-standing policy, U.S. government interventions in markets have been rare and reluctant. Nonetheless, as the recent intervention by the Federal Reserve in the case of the LTCM hedge fund and the recent purchase of grain from domestic farmers for donation abroad remind us, the government does act when the threat to market stability, or to other key national interests require it. The oil industry is being impacted by some of the same exogenous factors that caused such distress for American agriculture, notably global weakness in demand and therefore prices, primarily as a result of the collapse of economic growth in Asia. The U.S. oil industry, and the financial stability of key, friendly, oil-producing countries---including those in our own hemisphere, Canada, Mexico, and Venezuela--- are under severe strain. An instrument is at hand, the SPR, which could be used to offer "temporary" relief at little if any cost, particularly when one factors in the added long-term benefits the U.S. buys by purchasing oil at today's excessively low prices.

A Buying Opportunity

For the world's largest inventory manager, the U.S. Strategic Petroleum Reserve, the combination of very low prices and domestic producer distress signals an exceptional opportunity to buy security insurance for the country and aid a key domestic industry at bargain prices, especially compared to historic prices paid for SPR oil. Most of the SPR oil was acquired in the first half of the 1980s when oil prices (as measured by refiner acquisition costs) were $25 to$30 a barrel, far above the current price. At a minimum, the SPR should replace the nearly 30 million barrels sold off when refiner acquisition costs averaged above $20 a barrel. The government would be buying back the barrels sold for budgetary purposes for about 60%of what it received for its sale in 1996---in effect buying low after selling high. Such a purchase, spread over say three months would have only marginal effects on the global oil balance since it would total less than 0.5% of world supply.

Since oil is an internationally traded commodity, an SPR purchase would impact not only domestic prices but world oil prices as well. No one is suggesting that U.S. consumers have any obligation to pay exporting countries higher prices for oil than the market justifies. But it should be kept in mind that today's conditions are unique and unlikely to last. The very high global oil inventories that helped depress prices are beginning to fall, aided by the reductions in production by oil-exporting countries. There is no guarantee that we will have yet another unusually warm winter to reduce demand or that the Asian economies will continue indefinitely in their depressed state. In this light, failure to buy now means passing up a time-limited opportunity for bargain-priced oil. There is a further reason to buy now. By stimulating higher demands and discouraging domestic supply, the current low oil prices will raise future import requirements. Higher imports mean the current level of the SPR will provide fewer days supply of coverage, in effect, less protection against supply disruption. Buying oil now keeps up to date a critical insurance policy for the country.

Buying oil now for the SPR raises a budget issue since there is no provision to pay for it in this fiscal year. But to wait until the next fiscal year means missing a buying opportunity. To move quickly, the Congress could approve legislation to provide emergency authority for the purchase upon a determination by the President that current market conditions are imperiling domestic oil production. The "emergency" designation means that spending for this purpose would be supplemental to current budgetary authority and would not require offsetting expenditure reductions. It should be kept in mind that such additional spending---about $375 million---would come at a time when the government is in its strongest fiscal position in decades, and can well afford to make the security investment. An alternative would be to pay for the oil through passage of a supplemental appropriation but this process would take considerably more time.

A Final Comment

No one can seriously complain about actions to provide limited, temporary support for the oil industry in an environment when retail gasoline prices adjusted for inflation are at their lowest level ever. Consumers would be trading somewhat less depressed prices now for future price moderation and enhanced security. There has never been a better time to make such a deal.