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Statement On

DECONTROL OF DISTILLATE FUEL OIL PRICES

Presented To The

SUBCOMMITTEE ON ENERGY AND POWER OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE , U.S. HOUSE OF REPRESENTATIVES

by

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Thank you for inviting us to participate in today's hearings of your Committee on the issue of decontrolling distillate fuel oil prices.

Price controls on crude oil and refined oil products were enacted in December 1973, at the height of the Arab oil embargo in the face of a real physical oil shortage and expectations of a further deterioration of supplies.

Clearly, the situation has completely reversed itself since then in regards to refined products and none of the justifications given in December 1973 for imposing price controls on products is any longer valid. To wit, imported crude oil is readily available from a variety of foreign sources at current market prices, with nearly all supply sources having substantial excess producing capacity. The same applies to foreign refineries, particularly export refineries, most of which are operating substantially below capacity utilization. Similarly, despite the sharp increase in petroleum demand experienced so far in 1976, U.S. refineries have had to operate at only 85% of crude oil capacity, compared to above 90% achieved in the first 10 months of 1973 (up to the time of the embargo).

It is extremely unlikely that a shortage in any oil product will arise in the foreseeable future in the absence of a new

international crisis or some other exceptional event. Thus, as the table attached to this memorandum shows (p. 10), if we assume an increase in U.S. oil demand in 1976 on the order of 5% to 17,355,000 barrels daily, with only marginal increases in product imports, U.S. refinery crude oil runs would still be at 85% of crude capacity. Even if the demand increase were on the order of 7%, which is not likely, refinery operations would not rise above 86.3% of crude capacity, because refining capacity in 1976 is expected to increase by more than 1 million b/d or 7% to 16.2 million b/d at the beginning of 1977. Most of the capacity increases are scheduled for the 2nd half of 1976, resulting in an average capacity for 1976 of nearly 15.7 million b/d.

Given these facts removal of price controls on refined products and relegation to a stand-by basis to cope with unforeseeable future emergencies would seem to be fully justified at this time. In fact, such action is overdue, since the surplus conditions we have just described have been in existence for at least the past 20 months. Price controls are cumbersome, expensive to administer and, by definition, cause market distortions and inefficiences, and on several occasions have come close to creating artificial shortages. The intent of Congress to keep domestic oil prices below world market levels is fully served by existing crude oil price controls. There is no need to control operating margins of refiners and wholesale and retail marketers as well.

The very brief experience with the first decontrolled product -- residual fuel oil -- shows that decontrol need not mean higher prices. Since decontrol went into effect on June 1, the New York Harbor contract prices of residual fuel oil have declined as a result of the imposition of a temporary discount by the largest supplier.

Turning to the specific issue of distillate fuel oil supplies, we project for the winter 1976/1977 (4th quarter/1st quarter) a Base Case increase in demand of 10% above a year ago to 3,722,000 b/d. The projection is based on an assumed normal winter. If it should turn out to be approximately 5% colder than normal, distillate demand could rise by another 75,000-100,000 b/d.

The calculation for our Base Case is shown in the table below.

OUTLOOK FOR DISTILLATE SUPPLIES/DEMAND
(000 b/d)

Winter 1976/1977

	1976		1977
	3rd Q	4th Q	1st Q
Crude Runs	13,600	13,600	13,800
Distillate Yield (%)	(20.25)	(22.50)	(22.25)
Distillate Output	2,755	3,060	3,065
Imports (Net)	110	235	275
Supplies	2,865	3,295	3,340
Demand	2,300	3,395	4,055

Stocks (Million BBls)

end 2nd Q 1976	160
end 3rd Q 1976	212
end 4th Q 1976	203
end 1st Q 1977	139

The required imports in our forecast are only about half the highest historical level (454,000 b/d in the 1st quarter of 1973 and 533,000 b/d in the 4th quarter of the same year). Given the excess refinery capacity overseas, these levels should be readily obtainable.

Our Base Case assumes that incremental interstate gas curtailments this winter will increase 26% above last winter. Data just released by the Federal Power Commission indicate that firm net natural gas curtailments will increase to 1,595,237,000 Mcf compared to 1,265,534,000 Mcf last winter. This would result in a gross incremental curtailment of about 375,000 b/d of oil equivalent. Not all of the gas curtailment will be replaced by distillate fuel oil. The exact allocation is difficult to project in the absence of actual data which do not currently exist. However, based on discussions with suppliers and staff members of the FPC and the FEA we have made the following allocations.

1. Approximately 25% of the gross incremental curtailment (95,000 b/d) is not met by distillate or residual fuel oil.*

2. Of the remaining 75% 150,000 b/d is met by distillate and 130,000 b/d is met by residual.

Thus, 43% of the projected increase in distillate demand in the coming winter is due to increased natural gas curtailments.

The second major factor responsible for our Base Case increase of 10% is that the winter of 1975/1976 was nearly 10% warmer than normal. Thus, the assumption of a normal winter adds

*Interstate pipeline companies and consumers will subsitute coal, electricity, propane and purchases of intrastate supplies. In addition a portion will probably not be met.

approximately 140,000 b/d.

The table clearly illustrates that under relatively conservative supply projections distillate supplies are ample throughout the winter and will leave us with end-of-March stocks well above minimum operating requirements of about 100 million barrels.

In fact if for some reason demand should turn out to be much higher, supplies could readily increase by an additional 350,000 b/d without straining the system or even reducing stock levels. Below is an illustration of how this could be accomplished.

Winter 1976/77 Distillate Supplies
(000 b/d)

	High Case	Base Case*	Increase
Average Refining Capacity	16,000		
Refinery Crude Runs (91.5%)	14,640	13,700	940
Distillate Yield (23%)			
Distillate Output	3,367	3,062	305
Imports	300	255	45
	3,667	3,317	350

*See Table page 3.

Price Outlook

Now I would like to turn to the issue of prices which is the key question concerning this Committee today. In principle it is of course true that if available supplies are adequate to meet projected demand there can be no substantial price increase.

Two recent reports, one by the FEA ("Preliminary Findings and Views Concerning the Exemption of Middle Distilaltes from the Mandatory Allocation and Price Regulations") and the other by the

Library of Congress ("Middle Distillate Fuel Oil Pricing and the Decontrol Issue"),come to approximately the same conclusion, namely that decontrol of distillates could result in no more than a very small price increase. The FEA report sees the possibility of an increase of a little over 1¢/gallon in retail margins while the Library of Congress report concludes an overall 2¢ increase is possible.

We believe the 2¢ increase is likely to be on the high side. But even if prices were to increase by that amount following decontrol it would mean a rise of less than 5% over existing retail prices of about 41¢/gallon. This is less than the current inflationary trend in the U.S. economy. It is difficult to see justification for maintaining the whole cumbersome and costly system of price control solely fo r the purpose of preventing a hypothetical price increase whose maximum would still be less than the average increase in the U.S. consumer price level. It must also be considered that the artificial control of any price below its market level entails the risk of creating a shortage. Clearly, everything being equal, refiners or any other producer will in principle be less ready to increase supplies in response to a demand increase if prices are frozen than if they are not. Furthermore, price changes signal supply changes to the public and since heating oil is by no means totally demand inelastic even in the short run, the absence of price signals could bring about a sudden shortage which could then only be met through additional imports at substantially higher prices. Thus, the

possibility of a modest non-inflationary price increase as a result of decontrol is by itself not enough reason to maintain controls. In fact, it could well turn out that the price increase is less than the cost of a shortage brought about by continuation of the controls.

While it is admittedly difficult to project actual levels of increases there are reasons to believe that prices of distillates will rise by less than 2¢/gallon.

One reason is that most increases in distillate demand this winter are projected to occur in the industrial sector which is very sensitive to the costs of various fuels and is in a position to switch between them.

In the following table we have compared current New York Harbor contract prices for No. 2 oil with various sulfur grades of No. 6 fuel. As the table indicates, based on a cost per million Btu, distillate fuel oil is currently more expensive than all grades of residual fuel oil. For example 1% sulfur residual is currently 39¢/million Btu below the price of No. 2 oil. An increase in distillate prices of 2¢/gal would be equivalent to an additional 14¢/million Btu's. Since many inustrial customers are sensitive to the price differentials between these fuels and have the flexibility to opt for one fuel over the other, the relatively lower current price levels of residual could act as a constraint on the upward movement in distillate prices.

CONTRACT CARGO PRICES - RESIDUAL FUEL OIL AND DISTILLATE FUEL OIL

Current

		$/bbl	¢/MMBtu
I.	Residual Fuel Oil		
	0.3% S	11.95	196
	0.5% S	11.53	189
	1.0% S	11.03	179
	2.8% S	9.50	153
II.	Distillate	12.68	218

Source: Developed from Oil Buyers' Guide

Another likely price constraint would be the excess refining capacity previously referred to. Even a small price increase (less than 2¢) relative to other products would cause refiners to raise their yield of distillate fuel oil. The resulting increase in output could be expected to prevent any further price increase.

For similar reasons it is also very unlikely that domestic prices will rise to the level of import prices following decontrol. The current differential between landed foreign spot prices and domestic contract prices in New York Harbor is 4.3¢/gallon, including importfee, or about 3¢, excluding the fee. Given the lower cost of crude oil to domestic refiners and the existing excess refining capacity, it does not appear likely that even under our maximum demand projections domestic distillate prices will approach import prices.

Another consideration in evaluating the outlook for decontrolled vs. controlled prices is that even under control, price increases can be expected in response to significant demand increases, in view of "banked" costs which have not been recovered because of adverse competitive conditions . Some of these consist of refiner banks -- mostly in the form of accumulated "non-product" costs -- but there are indications that banked costs held by independent distributors may be more significant.

Altogether, then, we would say that the need to single out distillate fuel oil for continued price control while the prices of virtually all other products in our economy are determined by market forces has ceased to exist and that decontrol at this time will have no adverse effect on the economy or on consumers.

U. S. Domestic Petroleum
Operations - 1976

	Base Case	Case A
	(000 b/d)	
Crude Oil Production	8,125	8,125
NGL's	1,630	1,630
TOTAL	9,755	9,755
Imports - Crude	5,100	5,425
- Products	2,025	2,025
	7,125	7,450
Processing Gains	475	475
Total Supply	17,355	17,680
Demand - Domestic	17,155	17,480
- Export	200	200
	17,355	17,680
Crude Runs	13,225	13,550
Avg. Refin. Capacity	15,700	15,700
% Utilization	84.2%	86.3%

Base Case assumes a 5.3% increase in domestic demand.

Case A assumes a 7.4% increase in domestic demand.