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Petroleum Comment

Major SPR Oil Sales Likely Over Next Few Years

Philip K. Verleger Jr., a visiting fellow at the Peterson Institute for International Economics, President of PKVerleger LLC and former David Mitchell Professor of Strategy at the University of Calgary, examines here the prospects for and implications of substantial crude sales from the US Strategic Petroleum Reserve over the next few years as a consequence of the US' diminishing dependence on imported oil.

Energy analysts and reporters have spent the last weeks of summer debating whether the US and other countries would release stocks from strategic reserves. Reuters reported in late August that the Obama administration was considering such an action to moderate gasoline prices. The executive director of the International Energy Agency (IEA) responded pointedly that this was not warranted.

The debate has ignored the fact that the US will soon start selling oil from its Strategic Petroleum Reserve (SPR). The sales will occur not because prices are too high or too low, but rather because the US now holds more oil than required under IEA obligations. Rising US production combined with falling use will make roughly 100 million barrels per year superfluous every year until 2020. This means the US government will be putting 200,000 barrels per day or more on the market.

These sales will occur under a 60-year-old program. The US, unlike many other countries, has had a long history of building strategic stocks for national security reasons and then disposing of them when circumstances change. A study conducted under the auspices of the National Academy of Sciences recently noted that, over the last 10 years, our strategic stock managers have garnered $6.4 billion from sales of materials no longer deemed critical. These revenues were used to build inventories of other materials now thought to be in short supply.

Sales of oil from US strategic reserves could increase revenues for monthly sales of noncritical materials tenfold. At a time of extreme budget stringency, one can expect Republicans and Democrats to embrace such sales quickly. US strategic oil stocks will be liquidated as our IEA obligations diminish.

The current stockholding requirement was established by the members of the IEA agreement. Under the agreement, the US must hold strategic stocks equal to 90 days of its prior-year imports. The US obligation peaked in October 2005 at 1.2 billion bbl. Based on the most recent data, it has now declined to approximately 740 million bbl. In other words, the required amount is decreasing by 100 million bbl every year.

Today, the US holds 696 million bbl of crude in its reserve. Under the most rigorous interpretation of the program the US will need only 630 million bbl by this time in 2013 and 530 million bbl by this time in 2014 if imports continue to decline at current rates. The requirement falls to only 260 million bbl by this time next year and 160 million bbl the year after if imports from Canada and Mexico are excluded, as many would argue they should be. The US IEA requirement will fall a further 90 million bbl every year going forward if current trends continue.

Economic policymakers — particularly those at the Office of Management and Budget — will recognize the surplus. At a time when the government is looking for every possible penny of savings, the SPR overage will quickly become an inviting target for disposal. Furthermore, history shows that the more market-oriented Republican administrations have been quicker to seize the opportunity to sell unneeded strategic stocks. Under current circumstances, their embrace of stock sales will embolden Democrats to do the same if President Obama is re-elected.

Discussion of the sales opportunity will become a front-burner issue this December when Democrats and Republicans face the impending "fiscal cliff," mandating draconian cuts in defense spending and tax increases. Negotiators will recognize that up to 300 million bbl could be sold between January 2013 and the end of fiscal year 2014 on Sep. 30, 2014, a rate of almost 500,000 b/d, without violating the US obligation to the IEA. Such sales could add $30 billion to the US Treasury if prices remain at $100 per barrel. The prospects of such revenues will no doubt bring strong endorsements from the defense community in Washington, particularly firms such as Lockheed Martin and Boeing who will lay claim to the revenues. Sales could continue at a lower rate until 2020.

The world market, quite simply, must prepare for the US beginning such sales. At this time of budget stringency one can expect all politicians — even those most concerned with national security — to endorse sales whether at a rate of 200,000 b/d or 500,000 b/d.

The first oil sold will likely be the heavy, sour crudes purchased from Mexico almost 20 years ago during that country's first debt crisis. These crudes seem to be least coveted by buyers. For Canada, the timing of these sales could not be worse. The

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incremental volumes of SPR heavy crude will compete directly with the heavy bitumen the Canadians hope to push into the US refining sector. The addition of 200,000-300,000 b/d of heavy crudes into the US Gulf Coast market could have serious and possibly fatal economic implications for some Canadian producers.

History suggests that managers entrusted with disposing of US strategic stocks will show foreign producers little mercy. Their job is to achieve maximum revenue for the US government. Their actions are limited only by the requirement to avoid selling at a loss. This will not be a constraint because most of the barrels were acquired for less than $50/bbl. The economic pain of other producers, even those in Canada, will be of little concern.

Disposal of light, sweet crude stocks will create more difficulties for those charged with liquidating strategic stocks. Such sales would threaten prices paid to producers in Texas and other parts of the US. Sales may need to be spaced out over years to avoid distorting domestic markets.

For everyone concerned about global supply and demand, though, the message should be clear. First, the US has long experience with acquisitions and sales of strategic stocks. Second, over the next decade, the US will become a significant seller of oil from its SPR as holding requirements drop due to increased domestic supply and declining use. The nation with the most to lose is Canada.