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The SPR: Consumer 'Insurance' or Producer Cronyism? (time to privatize)

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March 25, 2020

Expanding the Strategic Petroleum Reserve would be throwing good money after bad. Instead of remaining a valuable asset mired in the political swamp, the SPR can be turned into an entrepreneurial asset. The reserve can be privatized by selling off either the entire operation or its individual parts. – RLB (1991)

Good analysis passes the test of time. And since policy activism has a long history, the past is prologue. MasterResource has documented the false claims of energy Malthusianism in this regard.

The excerpt below, nearing a quarter-century of age, concerns the Strategic Petroleum Reserve (SPR), a forgotten, obsolete oil stockpile that could disappear tomorrow and hardly be noticed by the market. Created by the Energy Policy and Conservation Act of 1975 (one of many energy-crises laws), the SPR began operations in 1977.

With a design capacity of 714 million barrels, today's crude-oil inventory is 635 million barrels (89 percent of capacity). One-million-gallon product inventories are held for fuel oil and for gasoline in the Northeast.

President Trump announced a 77 million barrel purchase to top off the SPR at full capacity, and a $3 billion budget authorization request. This would equate to nearly $40 per barrel. Compared to current spot prices of $25 per barrel, that's two-third's above market.

"DOE is moving quickly to support U.S. oil producers facing potentially catastrophic losses from the impacts of COVID-19 and the intentional disruption to world oil markets by foreign actors," stated DOE Secretary Dan Brouillette in a press release. Under Secretary Mark Menezes added:

The small to midsize oil producers, which are the focus of the initial crude oil purchase, employ thousands of Americans…. [We] are taking swift action to assist hard hit producers and deliver strong returns to the taxpayer.

UPDATE: Less than two weeks later, the fill plan is in trouble–as it should be. The happy middle is no government subsidies for crude oil and for wind, solar, electric vehicles, and ethanol. Let the market decide–as in consumer choice and taxpayer neutrality. Subsidizing every energy versus every other energy is a fool's errand, anyway. Planned withdrawals from the reserve, meanwhile, have been suspended.

SPR Fail

It is difficult to call the whole SPR exercise, now in its fifth decade, anything but a government mal-investment–and one in the tens-of-billions-of-dollars. It's creation was an overreaction to an energy crisis created by 1970s federal price and allocation controls. (For a five-part history of the Strategic Petroleum Reserve, see here.)

The third major oil interruption never came. Emergency drawdowns have been small. So it became a money jar for government spending in the last decade or more and, most recently, at least in a Presidential proposal, a bit of welfare for small oil producers.

Scholars such as Robert Murphy have called for SPR privatization as an alternative to increasing the federal debt ceiling. Back in 2016, Presidential candidates on the Republican side (Ted Cruz; Donald Trump) were open to privatizing the SPR as a means for federal deficit reduction and federal debt retirement.

1991 Thoughts

So here are/were my SPR analysis from back in 1991, excerpted from a longer article, **What Now For U.S. Energy Policy? A Free-Market Perspective** (Cato Institute, January 29, 1991). Despite unprecedented criticism that the Strategic Petroleum Reserve has been poorly utilized in the current crisis, there have been calls to enlarge the stockpile from its present target of 750 million barrels to 1 billion barrels. The proposed 10-year, $6 billion expansion is unwarranted. **(1)** Private entrepreneurship should be the first and last line of defense in an energy "emergency," given the real and theoretical problems of the reserve.

The SPR, hitherto unused when the opportunity seemed to beckon, has attracted media scrutiny that has uncovered a series of problems with the stockpile. A front-page Wall Street Journal evaluation pointed out the following problems: a distribution system untested in a true emergency, high-sulfur crude that cannot be distilled by many U.S. refineries, corrosion problems, the loss of a $90 million facility when its oil is withdrawn, a requirement that only U.S.-flag tankers carry released oil between domestic ports, and a 10 percent DOE set-aside for political distribution. **(2)**

Are critics of the SPR just complaining after the fact about the costs of an insurance policy that has not been used? Or are there fundamental problems–retrospective and prospective–that suggest that the reserve has been and will continue to be a mistake?

Looking back, it is clear that the SPR has not been a success. It was authorized in 1975, but it was nowhere to be seen when the energy crisis hit in the summer of 1979. There were some 80 million barrels in the ground but no drawdown plan or drawdown capability. The SPR was solely an injection, not a withdrawal, program. All President Carter could do was to suspend purchases because of higher prices.

With President Reagan's reserve build-up in 1981 and 1982, which reversed Carter's fiscal prudence, the average cost of a barrel of SPR oil shot up. Today some 590 million barrels of oil that have cost approximately $20 billion are held in five caverns in Texas and Louisiana. Simple division gives an average cost of over $30 per barrel. In 1990 dollars, the per barrel cost is more than $40. The SPR has not only been expensive insurance, it has been prohibitively expensive insurance.
Its 'insurance' is growing more expensive each day. Each year adds another dollar per barrel to the cost of the reserve. **(3)** In any case, the SPR will not "pay back its cost many times over" as one of its early government architects recently stated. **(4)**

How long will it take to effect an SPR drawdown, and will it be too late when the crude leaves the caverns? The procedure is for the Department of Energy to recommend a drawdown to the president. Then the serious politicking will start. For example, military interests will argue against a drawdown to preserve their stake vis-a-vis civilian supply. Assuming the president agrees to a drawdown, the DOE is to publish a notice of bidding, solicit bids, pick the winners, and physically draw down the oil.

How long would it all take? The DOE estimates that it could all be done in 20 days, but that is just a "best guess." **(5)** Indecision could add weeks or longer. In the recent test sale of 5 million barrels, the time between Bush's withdrawal announcement (September 27) and the physical flow (late October/early November) was four weeks or more. More than 20 percent of the oil (1.1 million of 5 million barrels) attracted no bids because of quality problems. In addition to its prohibitive cost, the reserve has uncertain redemption value.

Even the belief that the reserve would "work" by damping a market panic and lowering prices has been deservedly criticized. For the petroleum industry, the prospect of a drawdown discourages precautionary ("speculative") stockpiling since government oil would be available and prices would fall when the SPR "flooded" the market. The National Petroleum Council has complained that "excessive reliance on early drawdown of SPR stocks in a disruption could . . . undermine efforts to encourage producer stockpiling and consumer conservation." **(6)** President Bush's reluctance to begin a major drawdown has reflected those disincentives as well as concern about indirect federal price manipulation.

Recent pronouncements about when the SPR would be activated demonstrate that the incentives created by the reserve are a double-edged sword. The American Petroleum Institute has deviated from its free-market position to support the reserve as an alternative to price and allocation regulation. But the official line from the DOE and the International Energy Agency is that strategic stockpiles should not be activated until "physical shortages" appear. **(7)** What would trigger physical shortages? Federal price and allocation controls. The API should reconsider its pragmatic support; the Strategic Petroleum Reserve does not pass muster even as "second best."

Privatize the SPR

Expanding the Strategic Petroleum Reserve would be throwing good money after bad. Instead of remaining a valuable asset mired in the political swamp, the SPR can be turned into an entrepreneurial asset. The reserve can be privatized by selling off either the entire operation or its individual parts.

The new owner or owners should have full rein to buy and sell SPR crude as they desire. Foreign ownership (by Saudi Arabia, for example) should not be prohibited. Even a decision by the new owners to liquidate the crude and mothball the reserve must be respected. After all, the private market would not have constructed the reserve in the first place.