The Market Oracle

Trump: Transform The U.S. Strategic Petroleum Reserve Into An Oil Bank

Steve H. Hanke

September 29, 2019

Following the attacks on key crude oil production facilities in Saudi Arabia, President Donald Trump announced the authorization of the release of oil from the U.S. Strategic Petroleum Reserve (SPR) to keep the market well supplied. This move changes nothing in the way the SPR is governed. The market, not the President, should determine the release of the massive SPR.

Government stockpiles are nothing new. The U.S. has had a long and fatal attraction to hoarding commodities for national emergencies. Indeed, the government has squirreled away everything from aluminum to zinc. But, the mother of all these commodity hoards is the SPR. Established in December 1975, it consists of five underground storage facilities hollowed out from salt domes in Texas and Louisiana. At present, they hold 645 million barrels of crude oil, over 1.5 times greater than the amount in private U.S. inventories. The massive SPR inventory would fully supply U.S. crude consumption for almost an entire month.

With an average price paid of $29.70 per barrel of oil, the current SPR inventory has cost the U.S. government $19.2 billion to fill. Even at today's market prices, the increased value of this crude inventory does not make up for the opportunity costs of carrying it for so long. This is all just a drop in the bucket when compared to the capital costs of constructing and maintaining what is probably the greatest white elephant in the United States.

The SPR—like the other government stockpile programs—has had a stormy history. One of the more outrageous episodes occurred in late 1978. The Saudis cut a deal with the Carter administration to stabilize oil prices by increasing their output. In return, the U.S. agreed to stop purchasing oil destined for its stockpile, giving the Saudis de facto control of the SPR. The Saudis knew the oil markets and the importance of seemingly small changes in the demand for inventories. They also knew that the Americans would keep their end of the bargain and that they would not.

In the 44 years following its creation, the SPR has only been tapped three times for emergency purposes: during the Persian Gulf War in 1991, following Hurricane Katrina in 2005, and in response to NATO's involvement in the Libyan Civil War in 2011. Even though the SPR has cost American taxpayers a fortune and has rarely been used, in the minds of the public and the politicians, the SPR remains an important strategic asset. Therefore, for the time being, we shall assume that the United States will be stuck with SPR, and the best that can be done is to improve its operation by transforming it into an oil bank.

Most oil is sold under fixed-priced contracts. In normal times, small excesses and deficits are absorbed by changes in private inventories. When the temporary supply-demand imbalances are too large for inventory absorption, they show up in the spot market for oil, where flexible prices clear the market.

When potential supply disruptions enter the picture—as they have done with increasing frequency since 1990—panic buying sets in. Nobody wants to be caught short, and the precautionary demand for more storage shoots up. Contrary to popular characterizations, the ensuing price increases are primarily driven by changes in the demand for storage, not supply problems.

For all intents and purposes, the oil being held in the SPR is not an realistic alternative to private inventories. This is because its eventual release is at the discretion of the President—in other words, tangled up in politics. In November 2001, George W. Bush ordered the U.S. government to purchase oil and fill its reserve to full capacity, which at the time was 700 million barrels and is presently 727 million barrels. By August 2005, the fill order was completed, with the reserve accounting for 69.6% of U.S. oil inventories. Today, the reserve, now at 645 million barrels, accounts for 60.7% of U.S. oil inventories. Even with the huge stock of oil being hoarded by the government, the private sector has seen the need to increase their oil inventories, with private stocks increasing by 42.1% since George W. Bush gave his fill order.

For the SPR to better serve the American economy, the release rules should be removed from politics and replaced by a market-based approach. Market-based release rules would transform the SPR into an oil bank. This bank would provide the country with a substantial precautionary inventory of oil, generate revenue to defray some of the government's stockpiling costs, smooth out crude oil price fluctuations and push down spot prices relative to prices for oil to be delivered in the future.

How would an oil bank work? The government would sell out-of-the-money call options on its stockpiles. It might, say, sell December 2020 oil options with a strike price of $60 a barrel. If the price surged above that level, the option buyer would exercise and take delivery of crude oil from the government's stockpile. If the price never reached $60, the option would expire worthless, and no crude oil would be released. Thus, the market would decide when the oil gets released to refineries.

The sale of call options on the SPR inventory would all but eliminate panic-driven buying and stockpiling. Indeed, the SPR options would liquify oil that is now, in effect, frozen solid. And with that, a giant pool of insurance would be created. Let the market, not politicians, determine the flow of oil from the SPR. Lower, more stable prices would ensue.

Steve H. Hanke is a Professor of Applied Economics and Co-Director of the Institute for Applied Economics, Global Health, and the Study of Business Enterprise at The Johns Hopkins University in Baltimore. Prof. Hanke is also a Senior Fellow at the Cato Institute in Washington, D.C.; a Distinguished Professor at the Universitas Pelita Harapan in Jakarta, Indonesia; a Senior Advisor at the Renmin University of China's International Monetary Research Institute in Beijing; a Special Counselor to the Center for Financial Stability in New York; a member of the National Bank of Kuwait's International Advisory Board (chaired by Sir John Major); a member of the Financial Advisory Council of the United Arab Emirates; and a contributing editor at Globe Asia Magazine.