Power Lunch

Obama Was Right About The SPR Release

Jerry Taylor and Peter Van Doren 06.27.11, 6:00 PM ET

Last week, President Barack Obama announced that, in response to the loss of Libyan crude to the global market, he was ordering the largest release of crude oil from the federally owned Strategic Petroleum Reserve (SPR) in U.S. history; 30 million barrels over the course of the next 30 days, to be supplemented by another 30 million barrels from various other reserves controlled by other oil consuming nations. Republican politicians and corporate oil executives cried foul. We certainly oppose the political management of oil inventories, which this is. But unlike Republicans, we oppose the existence of the SPR.

Although critics charged that the release was merely a political gesture that would not reduce oil prices given how small it is in relation to the global market (about two-thirds of one day's worth of global oil consumption), investors thought otherwise. The day the release was announced, the price of West Texas Intermediate crude oil for July delivery dropped $4.39 per barrel and the price of Brent Sea crude for July delivery fell even further on the London exchange. Goldman Sachs did some quick math and reported that the release could reduce oil prices by $10 to $12 per barrel over the next three months and by $5 to $7 per barrel in 2012.

If anything, the market may be underestimating the price drop that is to come. One of the nation's top oil economists-- Timothy Considine from the University of Wyoming--recently constructed a model of the global oil market and simulated the impact of a 30 million barrel release of crude from the SPR. He concluded that oil prices would likely drop about 3.5%, so a 60 million barrel release would suggest a 7% price drop, which in today's market translates into a $6.68 decrease in crude oil prices (off the pre-release announcement price of $95.41) which, in turn, translates into a 16 cent decline in the price of a gallon of gasoline.

But that assumes that the Saudis and a few other producers reduce output to offset the inventory release, something that they have done historically. If they hold production steady -- as President Obama says they have agreed to do via backchannel negotiations -- then a 60 million barrel release would translate into a 27.8% drop in world crude oil prices ($26.48 off the pre-release announcement price of $95.41) which, in turn, means a 63 cent drop in the price of a gallon of gasoline.

In short, a 16 cent to 63 cent drop in gasoline prices is nothing to sneeze at. What's the down side?

The complaint offered by both the GOP and the oil industry is that the release would harm national security by reducing the crude oil available to stave-off a real, honest-to-God "supply emergency" (as the American Petroleum Institute put it in a written statement decrying the president's decision). But that's hard to swallow on two counts.

First, the 30 million barrels of crude released by the president amounts to less than 5% of the volume of crude oil in the SPR. There is plenty more where that came from. Moreover, if the release is as functionally trivial as critics claim--less than a single day's worth of global crude oil consumption--then that 30 million barrels sure wouldn't do us a lot of good in the teeth of some hypothesized supply emergency.

Second, there will never be a "supply emergency" as long as markets are allowed to allocate crude oil via freely functioning prices. As long as you're willing to pay the market price for crude, you can have all you like. Hence, the underlying belief that the SPR is necessary to hedge against the sort of shortages that might shut-down refineries and cause gasoline to disappear at the pump is nonsense.

In short, a "supply emergency" does not manifest itself in the pumps running dry; it manifests itself in rising prices. And that's exactly what we've seen since the outbreak of political unrest and civil war in the Middle East.

This is hard for many to grasp given the hold that the 1973 Arab oil embargo has on the American psyche. Then, oil *did* disappear from the market and gasoline pumps did indeed run dry. But it was not the embargo that caused those things. It was a price control regime imposed by President Nixon that prevented oil companies from passing on the higher price of foreign crude oil on American consumers. Those companies responded by buying only what they needed for their franchised dealers and stopped selling to independent service stations which then, predictably, ran out of gasoline. The gasoline lines and subsequent dry pumps were the natural consequence.

We now know that the embargo did not reduce the inflow of crude oil from abroad. In fact, America imported more crude oil in 1973 than in 1972 and more in 1974 than in 1973.

The GOP is right to point out that the SPR was established in the aftermath of the 1973 embargo as a hedge against future embargoes that may result in physical shortages. But they are wrong to take that mission seriously.

So what should we do with this massive reserve of crude oil if its original mission is pointless? Well, we can mindlessly hoard crude oil at the taxpayer's expense or start selling it off while the selling is good.

We opt for the latter.

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