V. THE 2002 SPR FILL PROGRAM

"If you decide to have a simple rule for acquiring SPR oil, the worst one you could possibly pick would be filling at a constant rate of speed."
-- Internal DOE Analysis of SPR Program

"As to the questions that relate to the deferring of the filling of the Reserve because of issues that relate to price, we believe it's in our interest at this point to continue moving ahead at the pace we're moving to continue filling the Reserve, and not to defer that because of price fluctuations."
-- U.S. Secretary of Energy, April 9, 2002

In November 2001, the President directed the Secretary of Energy to fill the SPR to its 700 million barrel capacity "in a deliberate and cost-effective manner." Existing DOE market-based practices were to acquire crude oil for the SPR while oil prices were relatively low and less oil when prices were relatively high. Pursuant to this market-based policy, DOE had routinely allowed oil companies to defer scheduled shipments to the SPR when prices were high in return for additional barrels of crude oil deposited into the SPR at a later time. This approach had allowed DOE to avoid disrupting the crude oil markets and the economy while filling the SPR.

But in February 2002, a decision was made by DOE to stop allowing SPR deferrals. Under the new policy, as much oil as possible was to be put into the SPR, regardless of the price of oil. Documents provided to the Subcommittee by DOE indicate the decision to overturn the SPR program's market-based fill procedures was announced by the Secretary of Energy after consulting with other high-ranking Administration and White House officials.

DOE documents show SPR career officials opposed discarding the market-based procedures they had been using to fill the SPR and pushed for a return to those procedures. SPR officials accurately warned about the negative consequences of the no-deferral policy, including higher prices for crude oil, a dampening of economic growth, and foregone savings of hundreds of millions of taxpayer dollars. SPR career officials also accurately projected that filling the SPR without regard to global supplies or crude oil prices would reduce U.S. private sector inventories of crude oil, thereby undercutting the fundamental purpose of the SPR program – to ensure this nation has adequate supplies of crude oil in the event of a major disruption in oil supplies.

A. DOE Changed SPR Policy to Require SPR Fills Regardless of Oil Prices

In February 2002, BP, an oil company, asked DOE for permission to defer delivery of 9 million barrels of Brent crude oil that BP was contractually required to deliver to the SPR in May, June, and July 2002. At the time of BP's request, SPR Business Procedures allowed deferrals of scheduled deposits into the SPR provided the company seeking the deferral compensated the government for the delay by depositing additional amounts of oil into the SPR

at a later time.[187] SPR policies allowed the SPR Office to "let the markets determine [its] buying pattern" and to use its crude oil acquisition strategy "to stabilize markets."[188]

As explained in Section IV, in early 2002, Brent crude oil was in scarce supply due to large numbers of shipments of Brent to China and the SPR. As a result of the increased demand for Brent, Brent prices had increased in the spot and futures markets, and the difference in price between Brent and WTI had narrowed to about 75 cents, a level at which it generally is uneconomic to ship crude oil across the Atlantic. According to BP officials, BP was concerned that taking additional large quantities of Brent out of the marketplace at that time would further strain Brent supplies and increase prices, and requested DOE to defer delivery of the 9 million barrels of Brent it was required to deposit in the SPR. DOE denied the request.

On March 18, 2002, as the near-month price of Brent climbed to $25 a barrel and near-term prices on the Brent futures market exceeded future prices (shifting the market into backwardation), BP renewed its request for a deferral. In an e-mail to a DOE SPR official, Exhibit V-1, a BP official offered to deliver an additional 500,000 barrels if DOE would allow a one-year deferral. In the e-mail, the BP official stated the deferral would "eas[e] logistical issues," and wondered "whether the politicians might be keen given the rise in prices that we are currently seeing."

In reviewing the BP offer, another SPR official wrote in an internal e-mail dated March 20, Exhibit V-1, "See no change in the no deferral policy unless the price of oil increases. Recommend saying thank you, but not at the present time." On March 20, William C. ("Hoot") Gibson, the DOE Project Manager at the SPR site in Louisiana, responded to BP by e-mail, stating that DOE wanted to proceed with filling the SPR, and that BP should deliver according to the terms of the contract.[189]

The next day, March 21, 2002, a DOE official, in an internal e-mail sent to other SPR officials, Exhibit V-2, wrote that John Shages, Director of the Finance and Policy Office in the SPR program, planned to discuss the no-deferral policy with the staff of the National Security Council, so the issue should not be considered "totally closed." According to this e-mail:

> Deferrals in general were discussed in our PR [Petroleum Reserves] staff meeting this morning, with Hoot in attendance. John Shages said he wanted to discuss with the National Security Council to make sure he understood what the White House's reaction would be if prices were to go up to the politically sensitive level of $30/bbl or so. I think the issue is not totally closed and will be discussed further by management.

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[187] See Section II and Appendix 3, Exhibit II-1, for a copy of the published procedures.

[188] See Section II and Appendix 3, Exhibit II-2.

[189] This e-mail was described in a telephone conversation between DOE and Subcommittee staff on November 20, 2002, but DOE has not provided the Subcommittee with a copy.

On April 1, following an increase in the near-month Brent price to nearly $27 per barrel, BP again asked DOE to allow a deferral, and upped its offer by another 250,000 barrels. "I know that you said last week that the government would have no interest in deferring the exchange barrels," the BP official wrote in Exhibit V-3, "but the oil price does keep rising. As of this morning we calculate a years deferral would be worth an extra 750,000 [barrels] to you. I'm not trying to bug you on this, but just wanted to make sure you knew of the opportunity."

DOE officials told the Subcommittee staff that "issue papers" discussing BP's deferral request were provided to the Secretary of Energy as well as to National Security Council (NSC) and National Economic Council (NEC) officials at the White House. These DOE officials also told the Subcommittee staff it was their belief – although they did not have actual knowledge of the decision process – that the decision to adopt a no-deferral policy was then made by the Secretary of Energy in consultation with other high-ranking White House and Administration officials.[190]

The no-deferral policy was publicly announced by the Secretary of Energy at a press briefing on April 9, 2002. This press briefing took place a few hours after a meeting of several Cabinet members, including the Secretary of Energy, at the White House.[191] A reporter asked the Secretary, "In light of Venezuela and Iraq, how serious are you about using the Strategic Petroleum Reserve or, maybe to a lesser extent, deferring royalty oil?" The Secretary responded:

> Well, in terms of a decision to tap the Strategic Petroleum Reserve, I think the President has made it very clear that that happens if there's a belief that it's in the national security interests of this country. We're not at the point of making a – even looking at those options at this point. It's obviously, however, a tool available to the President should he conclude national security interests are involved.
>
> As to the questions that relate to the deferring of the filling of the Reserve because of issues that relate to price, we believe it's in our interest at this point to continue moving ahead at the pace we're moving to continue filling the Reserve, and not to defer that because of price fluctuations.[192]

After the Secretary's public statement on the deferral policy, a senior SPR career official prepared an internal SPR document entitled, "Options for Filling the SPR," Exhibit V-4, which describes the change in the SPR fill policy. This document notes that the no-deferral decision was made "after conferring with the White House" and that the "reasoning" was "not made

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[190] Telephone conversations with Subcommittee staff, November 7, 15, and 20, 2002. In a letter dated December 9, 2002, the Subcommittee asked DOE to provide all documents generated after November 2001, related to deferrals of SPR deliveries. On January 10, 2003, DOE provided several hundred pages of responsive documents to the Subcommittee, but also stated, "Certain additional documents still are under review." DOE staff subsequently told Subcommittee staff no responsive documents containing communications between DOE and the Executive Office of the President would be provided. DOE has yet to provide the Subcommittee with copies of documents indicating they were prepared for the Energy Secretary, NSC, or NEC officials related to the SPR deferral issue.

[191] Telephone conversations with Subcommittee staff, November 7, 15, and 20, 2002.

[192] Federal News Service, April 9, 2002.

public." The author observes, however, that "the most plausible explanation" is to fill the SPR as fast as possible "for national security or energy security reasons." One passage states:

> Prior to the events of September 11, 2001, the SPR Office routinely renegotiated delivery dates. The business model of trading more delivery time for increased volumes of oil was characterized by reduced costs, conformance with normal private sector practices, logistical flexibility to accommodate busy terminals or maintenance requirements at the sites, and acceptance by all of the companies with contracts. In February 2002, the SPR Office received a request to defer deliveries of 9 million barrels of oil for a year. The initial offer of extra oil in consideration of the deferral was valued at $18 million. In order to stay in conformance with the President's highest priorities, the SPR Office asked the Administration for guidance prior to negotiating for this deferral, and the Secretary after conferring with the White House announced we were planning to take oil deliveries on schedule without deferrals. The reasoning for turning away from a successful business model was not made public, however, the most plausible explanation is a desire to have as much oil in the SPR as fast as possible for national security or energy security reasons.

Two internal DOE e-mails, Exhibits V-5 and V-6, provide more evidence that SPR deferral issues were discussed by senior Administration officials to resolve conflicting views on whether to postpone SPR oil shipments when crude oil prices are high. These e-mails indicate that the Department of Interior (DOI), which oversees the exchange of royalty oil from federally-owned offshore leases for crude oil to be deposited into the SPR, wanted to stop transferring oil to the SPR program "when a certain trigger price for oil is reached" such as $30 per barrel. [193] According to these e-mails, the DOI and DOE positions differed on whether transfers of oil to the SPR should stop when the trigger price was reached, and the issue had to be resolved by the Deputy Secretary of Interior and the Deputy Secretary of Energy, "and then reviewed by the White House."

Exhibit V-5, an e-mail dated November 15, 2001, from John Shages, of the SPR Office, to Deputy Secretary of Energy Francis Blake, states:

> Frank: We held a meeting today with the Minerals Management Service hierarchy today. They allowed [Deputy Secretary of Interior] Steve Griles gave them clear instructions that if oil prices spike, and it becomes desirable to stop filling the SPR, the MMS should stop the transfer of royalty oil to DOE. We made the case for continuing the transfer and allowing DOE to manage the delivery schedule to eliminate the unwanted demand. They immediately said the issue would have to be resolved by you and Steve Griles, and then reviewed by the White House. They proposed writing an issue paper for you and Steve Griles, and then reviewed by the White House. They proposed writing an issue paper for you and Steve Griles, and we have agreed to do that jointly with them. While we believe the pros and cons of this issue are obvious, MMS feels they need some time to prepare

[193] See Section II.C.2 for a description of the role of the DOI in filling the SPR program. As explained in this section, the higher the price at which royalty oil is used for the SPR program, the greater the loss to the Treasury from royalty revenues, and hence the greater the total program cost to the taxpayer.

their position and asked for November 28 as a date to have the paper ready for delivery to you, and we also agreed to that.

Although both e-mails indicate a joint DOI-DOE issue paper was being prepared to help resolve this interagency dispute, DOE informed the Subcommittee staff that the dispute was resolved in DOE's favor after oral discussions and no such document was actually prepared.

These internal DOE documents indicate that DOE's decision to deny the BP deferral request was made after the Secretary of Energy consulted with other senior Administration and White House officials. DOE has declined to provide the Subcommittee, however, any documents prepared by SPR or other DOE staff for the Secretary of Energy, other top DOE officials, DOI, NSC, NEC, or other officials in the White House related to the deferral decision. DOE officials have also provided limited and, at times, inconsistent information on the process by which the Energy Secretary made the decision to deny the BP deferral requests and, more generally, to overturn the SPR Office's market-based deferral policy in favor of an inflexible rule against deferrals. The sequence of events presented here is the sequence most consistent with the documents and oral information provided to the Subcommittee to date.

B. SPR Career Officials Opposed Policy Change and Warned DOE the New Policy Would Increase Oil Prices, Consumer and Taxpayer Costs

In response to the Subcommittee's request for documents related to the change in SPR deferral policy, several issue papers were provided from the files of SPR officials. These documents provide candid assessments by SPR career officials of the new no-deferral policy and record their repeated attempts to return to a market-based deferral policy.

Exhibit V-7 is an internal SPR memorandum analyzing possible fill rates for the SPR. It notes that DOE has "the option of entertaining offers to delay [SPR] deliveries in return for bonus barrels of oil which could relieve the speculative oil market," as well as options to further accelerate the fill rate. The undated memorandum appears to have been written for higher-ranking Administration officials evaluating BP's April 1 request for a deferral, since it states, "DOE has received an offer to pay an additional 750,000 barrels of oil in exchange for rescheduling 9 million barrels to one year later," and discusses the pros and cons of accepting the offer.

The document summarizes the previous deferral policy of the SPR Office as follows: "During 2000 and 2001, whenever these conditions arose, the SPR Office agreed to later delivery dates in exchange for more oil. Renegotiation of delivery dates, if proposed by contractors, in exchange for more oil is the standard business practice for SPR oil acquisition." The document notes that deferrals during these years enabled DOE to acquiring additional SPR oil at no cost, thereby saving the Treasury $175 million.[194]

[194] See Section II.

The document provides an overview of the economic, energy security, budgetary, foreign relations, and market consequences of accelerating or deferring shipments to the SPR. The document summarizes the pros and cons of deferrals as follows:

Option 1: Do not entertain offers to renegotiate delivery dates

Pros

- Sends no signals to producing countries or allies
- Fills the SPR at an even rate between now and 2005
- Does not raise any speculation that the Administration is willing to meddle in the market

Cons

- Deviates from the normal SPR business practice
- SPR fill would continue even if markets become distressed or highly speculative

Option 2: Renegotiate delivery dates

Pros

- Reduces the program cost to Treasury, with a potential in the hundreds of millions of dollars
- Acts automatically to counteract market volatility by increasing demand when prices are relatively low and reducing demand when prices are relatively high
- Acts to mitigate an unwelcome price rise while the world's economies are only beginning to recover from recession
- Could be viewed favorably by consumers

Cons

- Delays the addition of oil to the SPR, with energy security implications
- May appear to be a market intervention or an attempt to challenge OPEC in controlling market inventories and prices
- Could be viewed as an accommodation to "big oil

The memorandum favors granting deferrals, identifying as potential benefits, among others, the saving of hundreds of millions of dollars for the federal government and lowering "unwelcome" crude oil price increases to benefit consumers and national economies.

A second document, Exhibit V-4, described earlier, was prepared after the Secretary of Energy's announcement on April 9, 2002, of the new no-deferral policy. This document describes how the policy to allow deferrals was overturned by the Secretary after conferring with

the White House, warns of the adverse consequences of a no-deferral policy, and proposes a return to the previous policy allowing market-based deferrals, which the paper calls "a successful business model."

According to this document, one of the prime reasons provided to the SPR Office for not granting deferrals was "the concern that the Government should not manipulate the market." Countering this assertion, the paper explains in detail how "its normal business practice does not manipulate the market, but instead conforms with the goal [that] the acquisition should minimize impact on market forces." Indeed, the paper notes, "The simple rule of taking SPR oil as it is contractually due exaggerates [price swings caused by OPEC production], since the SPR takes the same volume regardless of price. It is a business model different from all private market participants, and if followed by a significant number of market participants would lead to explosive prices swings."

The paper advocates a return to acting in "a rational business-like manner":

> The SPR Office proposes a return to the SPR oil acquisition business model, allowing deferrals which will always be counter-cyclical to OPEC induced price volatility. Since there would be consistency in our behavior, markets would not be surprised, and contractors would be comfortable knowing that the Government was acting in a rational business-like manner. Acquiring less oil in high price markets and more oil in low price markets is . . . ordinary behavior, [and] it would have much less impact on market forces than does the practice of ignoring price and acquiring just as much oil at high prices as at low prices.

The document also identifies a number of benefits from allowing deferrals when market prices are high. The document notes, "it would be good public policy if oil acquisition were to take [place] during robust growth and deferred when the economy is in a cyclical downturn." Identified benefits include reduced costs of oil imports, an improved balance of trade, and reduced costs for the SPR program.[195]

Another document, Exhibit V-8, is entitled "Renegotiation of Delivery Dates for Strategic Petroleum Reserve Oil" and contains a handwritten notation "5/2/2002" in the upper-right hand corner. It is a one-page document that, again, advocates "allow[ing] the [SPR] Office to resume negotiations of delivery dates for oil that is contracted for delivery on certain future dates." According to this document, the advantages to allowing renegotiation of delivery dates are that it is "very business like"; it "increases the inventory of the Reserve without fiscal expense"; the practice "testifies to serious management by bringing down the average cost of oil in the Reserve"; and it is "good public policy" because deliveries "can be successively renegotiated until [private sector] inventories are normal, near-term prices are low and the economy is growing strongly." The author observes, "Insisting on deliveries to the SPR during

[195] The final page of this document describing the benefits of the SPR's prior deferral policy ends in mid-sentence, one-third of the way down the page. Despite repeated requests, DOE has yet to explain the missing or redacted information.

[a] tight market would be heavily criticized as mismanagement and would be difficult to defend."

Exhibit V-9 is a June 5, 2002, memorandum from John Shages, a senior SPR official, to Paul Leiby of the Oak Ridge National Laboratory (ORNL),[196] in response to an earlier memorandum sent by Mr. Leiby in May 2002, Exhibit V-10, on designing a study of the economic impacts of filling the SPR. In his memorandum, Mr. Shages argues that a policy of allowing deferrals of deliveries into the SPR based on market conditions can provide a variety of significant benefits, including lower overall market prices for crude oil, an improvement in the balance of trade by $250 million per month, and greater amounts of crude oil available for private sector inventories.

In one passage, the document states the new no-deferral policy "appears irrational to the market place." The document observes that this new policy – which is termed the "status quo" – may have facilitated the squeeze in the Brent market in April 2002:

> For two years, any contractor could look at the backwardation in the futures market, and make us an offer for deferral. We ran our own valuation of the delay, set a negotiating target for ourselves for a share of the money on the table, and if we hit our target we agreed to the deferral. Every contractor deferred deliveries; they understood the process, it mimicked what they do in the private sector, and no surprises. The status quo is what appears irrational to the market place. It leaves the contractor vulnerable to things such as a short squeeze in the Brent market, and in fact there have been some attempts to blame a recent squeeze in the dated Brent market on us for demanding delivery regardless of market circumstances. Also, remember Howard Borgstrom's thesis. It can be boiled down to, "If you decide to have a simple rule for acquiring SPR oil, the worst one you could possibly pick would be filling at a constant rate of speed."

In another passage, the document describes the no-deferral policy as "a fill model that was discredited years ago."

Together, these DOE documents demonstrate that SPR career officials were aware of and warned against the negative consequences of a strict no-deferral policy, from encouraging "explosive price swings," to increasing taxpayer and consumer costs, to increasing the market's vulnerability to squeezes. The documents also demonstrate SPR officials advocated returning to a flexible deferral policy based on market conditions and overall national energy security.

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[196] Mr. Leiby is the principal author of a report prepared for the SPR Office in November 2000, on "The Value of Expanding the U.S. Strategic Petroleum Reserve," and has authored several other ORNL reports on the SPR.

C. SPR Career Officials Warned DOE the New Policy Would Reduce U.S. Crude Oil Commercial Inventories

Exhibit V-4, the internal SPR memorandum prepared by a career SPR official, also accurately warned DOE that filling the SPR during a tight market would reduce U.S. private sector crude oil inventories.

This prediction is based on fundamental market principles of supply and demand. In a tight market – when immediate demand is high relative to supply – every barrel of oil that goes into the government's inventory is at least one less barrel for private sector inventories. When near-term prices are high relative to future prices (i.e., when the market is in backwardation), refiners are more likely to take oil from their existing stocks than pay for expensive spot market purchases of crude oil.[197] When the U.S. government increases its own crude oil inventories during a tight market, it further tightens the market – reducing supplies and raising prices – making it even more uneconomic for the private sector to increase commercial inventories.[198]

Although the daily fill rate of the SPR is relatively small compared to daily global consumption and production rates for crude oil, it is sufficient to remove several millions of barrels of crude oil from the market over the course of a few weeks. In a tight market, this marginal reduction in market supplies can cause a corresponding reduction of several million barrels of crude oil from private sector inventories. SPR career officials were well aware of this causal relationship. Exhibit V-4 explains:

> Essentially, if the SPR inventory grows, and OPEC does not accommodate that growth by exporting more oil, the increase comes at the expense of commercial inventories. Most analysts agree that oil prices are directly correlated with inventories, and a drop of 20 million barrels over a 6-month period can substantially increase prices. . . . A variation of 3 or 4 million barrels from expected inventory can change prices more than a dollar per barrel during a day. Clearly, a change in private inventories equal to the SPR inventory change could have a substantial price impact.

In a June 5, 2002, memorandum, Exhibit V-9, John Shages, a senior SPR career official, predicts the SPR fills will significantly reduce private sector crude oil inventories:

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[197] See, for example, Section IV of this Report, showing how refiners in the Midwest drew upon their crude oil inventories during the spike in near-term WTI prices in April and May 2002.

[198] It has been suggested that each barrel placed into the SPR during a tight market in preparation for an imminent interruption in supply may displace more than one barrel in private sector inventories. Not only is each barrel placed into the SPR one less barrel for use in the private sector, either in a refinery or in storage, but to the extent that producers and refiners know the SPR will be available, they may be less likely to stockpile themselves. For example, one analyst recently commented, "Why were the oil companies holding such huge inventories prior to the Persian Gulf War? You saw a similar buildup prior to the Iran-Iraq war. And why aren't they building them now? . . . [I]t could be that they are relying on the U.S. Strategic Petroleum Reserve, and counting on the government to hold the extra supply for them." Melita Marie Garza, *Fuel Price Escalation Already Spills Into Cost of Other Goods*, Chicago Tribune, January 26, 2003, quoting Bill O'Grady, vice president, futures research, A.G. Edwards.

> Given OPEC behavior over the last 18 months, I believe OPEC is not accommodating economic growth, much less an inventory drop caused by SPR fill. . . . If you accept the assumption of an intransigent OPEC, then the impact of SPR fill on inventories is not a seemingly innocuous 100,000 barrels per day, but a powerful 30 million barrel reduction of private inventory over 10 months.

Later in the June 5 memo, Mr. Shages discusses the SPR's impact on U.S. inventories in these straightforward terms: "Think of the deferrals not as a daily flow, but as a change to projected inventory in the private sector. If, come December 2002, U.S. private inventories are down 30 million barrels of crude oil, we will have higher prices, nervous traders, a more confident OPEC and an [Iraq] that can cause price gyrations by deciding not to renew its export agreements for a month."

Mr. Shages accurately forecast the decline in U.S. private sector inventories that actually took place during the latter half of 2002. Figure V-1 shows that, from June to October 2002, U.S. commercial crude oil inventories fell by nearly 50 million barrels, including one-month drops of 20 million barrels in July and 30 million barrels in September. These large drops in inventories followed price spikes in the WTI market in which near-term crude oil prices exceeded longer-term futures prices (backwardation). By February 2003, U.S. private sector inventories had declined to their lowest levels since the EIA began keeping national inventory data records in 1979.

Not only have U.S. private sector inventories declined to unprecedented low levels, but these levels have become dangerously low – dipping under 270 million barrels which is considered the "Lower Operational Inventory" for the U.S. refining industry. According to the EIA, "While there is nothing to prevent inventories from falling below 270 million barrels, were that to occur, less flexibility would be expected, and according to the National Petroleum Council, localized disruptions in refinery operations could be expected."[199] U.S. commercial inventories have hovered around the Lower Operational Inventory Level from the latter part of 2002 to the present, risking refinery disruptions due to inadequate supplies.

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[199] EIA, *This Week in Petroleum*, January 15, 2003.

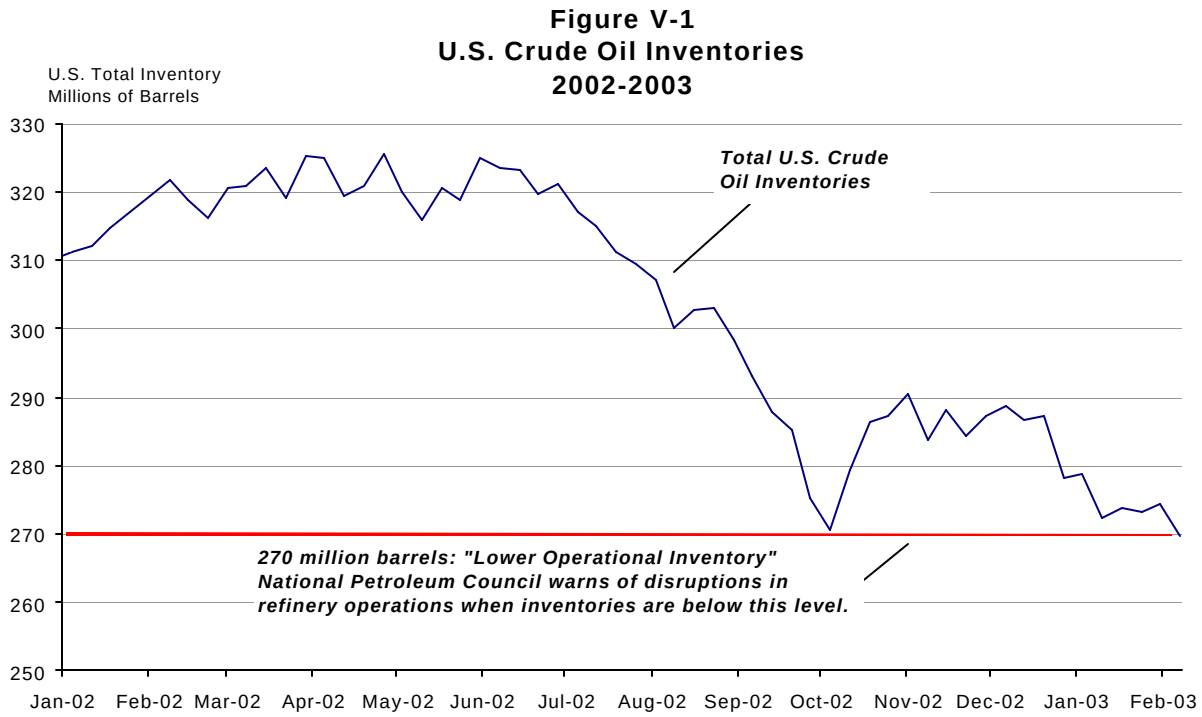

Fig.V-1. From June to October 2002, U.S. private sector crude oil inventories fell to the lowest level on record (since 1979). Source of data: EIA.

Over the same time period, DOE continued to fill the SPR at a steady rate of about 100,000 barrels per day, or about 3 million barrels per month, regardless of the tightening market conditions. The total amount of oil deposited into the SPR from June through November exceeded 20 million barrels.

Figure V-2 shows both the increasing deposits into the SPR and the decline in U.S. crude oil commercial inventories during 2002. Figure V-2 also shows the periods in which the WTI market was in backwardation during 2002. When the market is backwardated, the near-term price of crude oil is higher than the price of oil farther in the future. Under these market conditions, refiners will use oil in their existing inventories rather than purchase expensive oil on the spot market. Placing oil into the SPR when near-term prices are relatively high therefore exacerbates the tightness of the market, pushing near-term prices even higher, and providing incentives for refiners to take oil out of inventory. Thus, as can be seen from Figure V-2, depositing oil into the SPR during a tight market has the direct effect of depleting private sector inventories.

Figure V-2
SPR Program and U.S. Commerical Inventories
January - September 2002

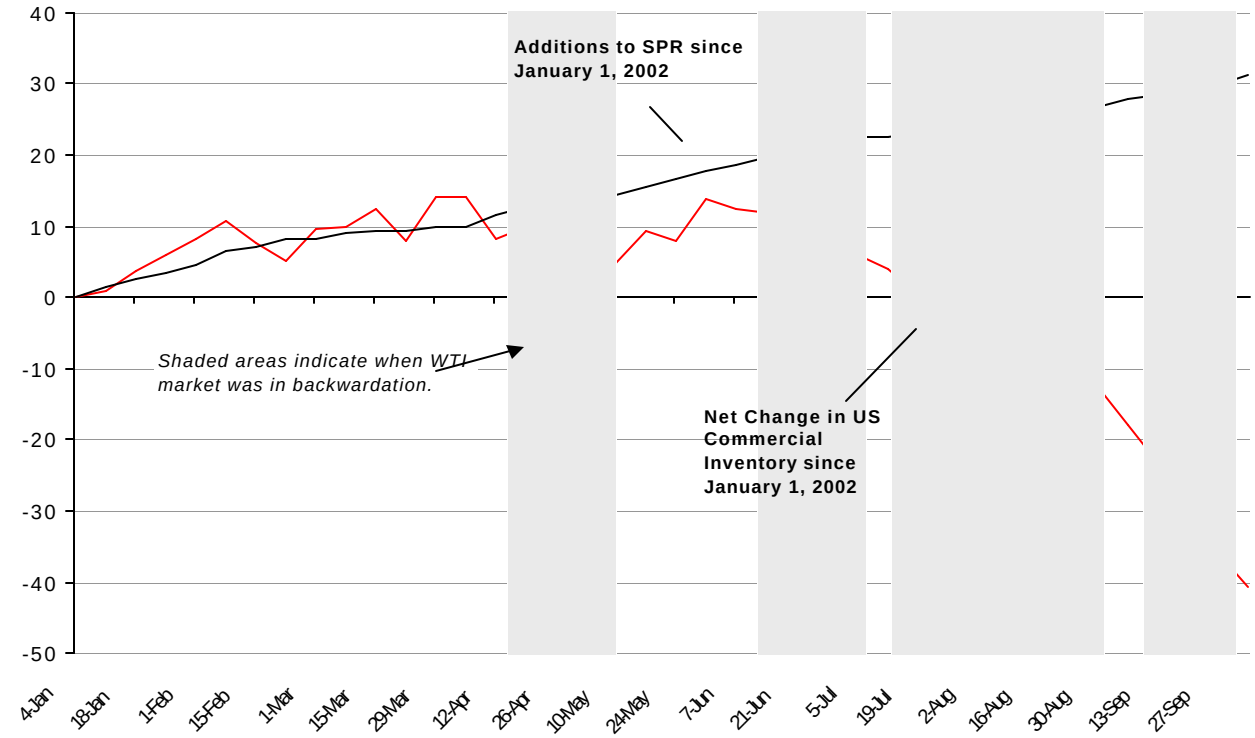

Fig. V-2. In 2002, the SPR program did not increase total reserves of crude oil in the United States. In effect, DOE's approach to filling the SPR in 2002 reduced commercial inventories by as much as it increased the amount of oil in the SPR. Source of data: EIA.

According to the fundamentals of supply and demand, reductions in crude oil inventories place upward pressure on crude oil prices. By comparing Figure V-1 and Figure V-3, it can be seen that at the same time total inventories dropped from over 320 million barrels at the end of May to just over 270 million barrels by the beginning of October, the spot price of WTI rose from just under $25 to nearly $31 per barrel. This relationship between inventory and price is a typical pattern in commodity markets, and was also predicted by SPR career officials in the spring of 2002, in Exhibits V-4, V-7, and V-9. As demonstrated in the case study in Section IV, placing oil into the SPR in a tight market can trigger a debilitating cycle of lower inventories and higher prices.

Figure V-3
WTI and Brent Spot Prices
January 2002 - February 10, 2003

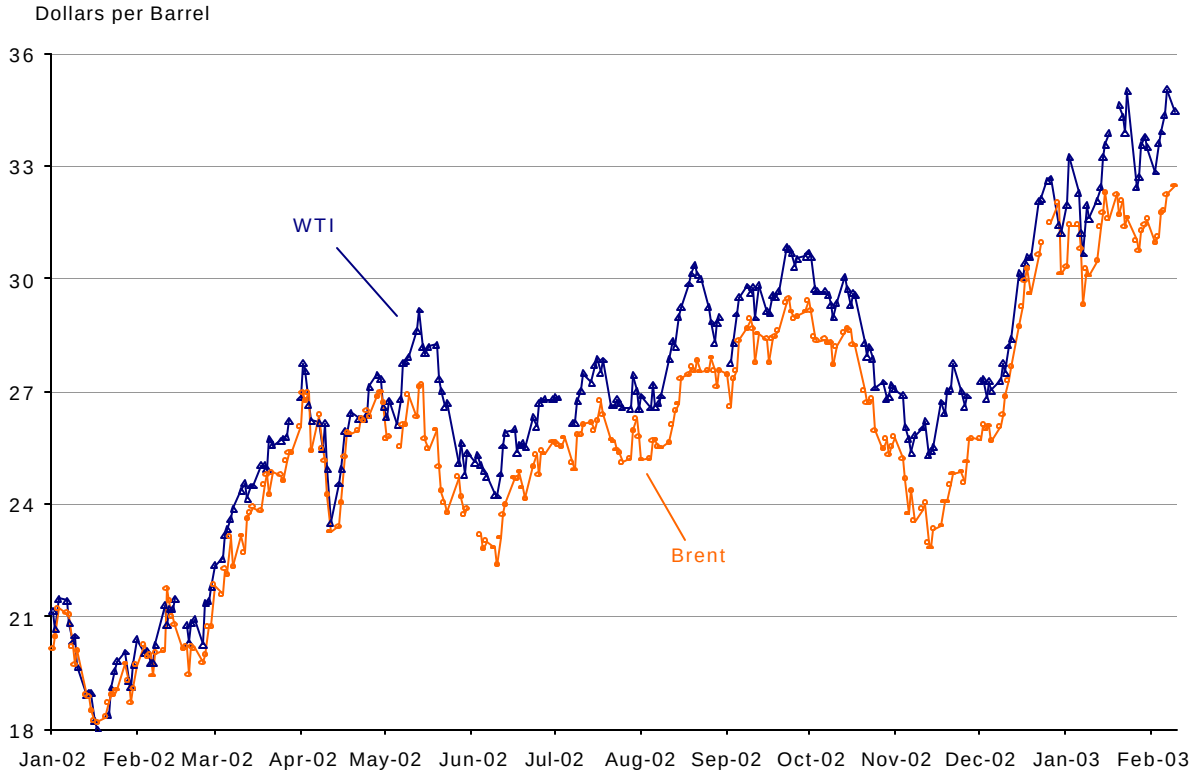

Figure V-3. WTI and Brent prices nearly doubled in 2002. Source of price data: EIA.

Despite rising oil prices, tight markets, and shrinking commercial inventories throughout the latter half of 2002, DOE kept the SPR no-deferral policy in place. Figure V-4 shows how the SPR continued to fill at a constant rate from October 2001, through the first nine months of 2002, the period for which the Subcommittee staff was able to obtain SPR program data on shipment dates.

Figure V-4
SPR Deposits
October 2001 - September 2002

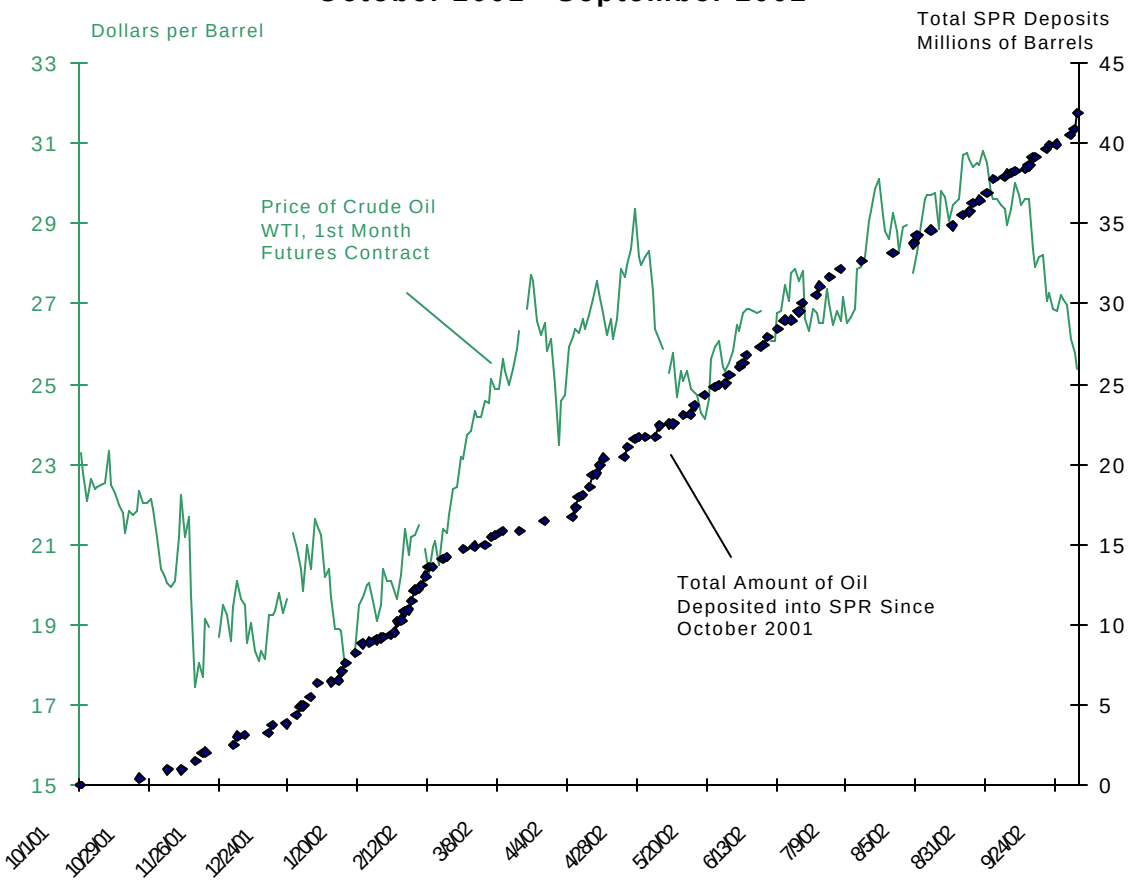

Fig. V-4. Crude oil was deposited into the SPR at a steady rate from October 2001 through September 2002, despite rising oil prices. Source of SPR and price data: DOE, EIA.

The inflexibility of the DOE's no-deferral policy was demonstrated when DOE insisted upon crude oil deliveries to the SPR even as Gulf Coast refineries were hit by supply disruptions and shut down due to tropical storms battering the Gulf Coast in late September and early October 2002.

In advance of Tropical Storm Isidore in late September, nearly 600 offshore oil and gas rigs in the Gulf of Mexico were evacuated, shutting down 95 percent of crude oil production in the Gulf. Most of the evacuated workers did not return or had to be re-evacuated the next week in advance of Hurricane Lili.[200] In just over one week Isidore and Lili together halted the production of about 10 million barrels of crude oil from offshore platforms.[201]

On October 2, 2002, with Hurricane Lili "bearing down" on its Louisiana refinery, its crude oil supplies depleted due to the disruption from Tropical Storm Isidore, its Ohio and Kentucky refineries running at reduced levels due depleted stocks and crude oil market shortages, and with near-term crude oil prices over $30 per barrel in the backwardated WTI futures market, Marathon Ashland Petroleum (MAP) requested DOE to defer its delivery of 250,000 barrels to the SPR scheduled for October "in hopes that we can prolong or at least expedite the recommencement of refining operations."[202]

DOE denied MAP's request. In an e-mail dated October 7, 2002, Hoot Gibson, the DOE SPR site manager, wrote to other DOE SPR staff: "The SPR policy per [the Deputy Assistant Secretary in the SPR Office at DOE headquarters] on deferrals of in bound crude oil is no deferrals at this time – deliveries should be made per current contract dates. Let me know by e-mail each deferral request received. Any media inquiries should be referred to Ms Rochon who will refer them to the proper contact in HQ. Thank you." On October 10, DOE informed MAP "the SPR is not considering deferrals at the time."

This decision demonstrates DOE was so determined to increase the oil stored in the SRP that it was even willing to risk prolonging refinery slowdowns. Even after being warned by a major U.S. refiner that it lacked enough crude oil to keep its refineries running, DOE insisted that the refiner divert scarce crude oil to the SPR.

The crude oil market deteriorated even further in the last two months of the year. The prospect of war between the United States and Iraq, a major global supplier that provides 5-10 percent of U.S. oil imports, increased market uncertainty regarding future crude oil supplies and prices. In early December, Venezuela, a major exporter of crude oil to the United States, began

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[200] See John Sullivan, *Double Hit for Oil Industry*, Daily Advertiser (Lafayette, Louisiana), September 26, 2002; Marc Dupee, *Market Eyes Wrath of Hurricane Lili*, October 3, 2002.

[201] John Sullivan, *Double Hit for Oil Industry, infra*; Business Wire, *Lili Hits Offshore Hard; Platforms Register 150 mph Winds, 30-foot Swells*, October 4, 2002. Lili was a Category 2 hurricane over Louisiana, but a Category 4 hurricane when it passed over much of the oil and gas production area of the Gulf of Mexico. One company measured 150 mile per hour winds at its production platform; another company reported that its semisubmersible drilling unit had been ripped from its moorings and blown 45 miles away before grounding in 35-foot deep water off the Louisiana coast. *Id.*

[202] See e-mails exchanged between MAP and the SPR Office in Exhibit V-11.

reducing exports to the United States due to labor strikes and political unrest. The coldest U.S. winter in recent years also increased demand for home heating oil, further tightening the crude oil markets.

By mid-December 2002, several more refiners warned DOE that the shortage of crude oil imports from Venezuela would lead to refinery outages and requested a deferral of their upcoming shipments to the SPR. Initially, DOE denied these requests.[203] Instead, DOE declared the Venezuela strike a "force majeur" event under the SPR delivery contracts, which would allow a company to defer delivery if it could prove that the oil scheduled for delivery into the SPR had been Venezuelan crude and the company did not have adequate inventories to meet its SPR delivery requirements.[204]

Several days later, however, DOE agreed to allow any company to defer shipments scheduled for December 2002 or January 2003, even without such proof.[205] These were the first SPR deferrals granted in more than a year. According to a public statement by the Secretary of Energy, this change in policy was made to "help ensure that the deliveries will not negatively affect the oil market, while still providing for the energy security of the US."[206] The result of this decision was that 7.8 million barrels scheduled for delivery in December and January became eligible for deferral.[207] Nearly all of these scheduled deliveries were, in fact, deferred.

As the Venezuelan strike continued into 2003, and war tensions intensified, inventories remained near record lows, just above the "Lower Operational Inventory" level, and crude oil prices continued to mount. In early January 2003, DOE announced that deliveries then scheduled for February 2003 – approximately 3 million barrels – were also eligible for deferral.[208]

On January 24, 2003, Senator Levin called on the Administration to suspend further SPR deposits "until surging crude oil prices stabilize and consumers get relief from rising prices for gasoline, home heating oil, and other petroleum products."[209] Specifically, Senator Levin requested deferral of 4.4 million barrels scheduled to be delivered in March 2003, and of 3.7 million barrels scheduled to be delivered in April 2003.

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[203] Cathy Landry, Sheela Ponnusamy, *US DOE Rejects Requests to Defer SPR Deliveries on Venezuela Strike,* Platt's Oilgram News, December 13, 2002.

[204] *Id.*

[205] Cathy Landry, *US in Negotiations to Defer SPR Oil Deliveries, supra* note .

[206] *Id.* This article quoted a DOE spokesman as saying the Secretary made the decision "following consultation with advisors and oil company analysts." DOE has not provided the Subcommittee with any documentation related to this decision.

[207] Dow Jones Newswire, December 17, 2002.

[208] Oil Daily, *DOE Delays SPR Deliveries*, January 6, 2003.

[209] See Sen. Levin Press Release, Exhibit V-12.

On January 28, 2003, DOE approved requests from oil companies to delay the 4.4 million barrels scheduled for March delivery, but did not, at that time, delay the deliveries scheduled for April.[210]

One week after granting the deferrals of the March 2003 shipments -- presumably to calm crude oil markets -- DOE seemed to reverse course again, announcing a further acceleration of shipments into the SPR, beginning in April 2003. The new DOE schedule called for the deposit of an additional 24 million barrels over six months. In total, DOE now plans to deposit about 40 million barrels of crude oil into the SPR in 2003.[211] If carried out under current market conditions, these 2003 SPR deliveries will further reduce commercial supplies, further help drive up oil prices, and impose more costs upon U.S. consumers and businesses, again without ensuring any overall increase in U.S. oil supplies.

Since abandoning its market-based strategy for deferring SPR deliveries when crude oil prices are high and supplies are tight, the SPR program has failed to develop a consistent, coherent, or cost-effective deferral policy. The last-minute nature of the deferrals granted last December and January, the delay in making a decision on the April deliveries, and the further acceleration of shipments into the SPR in the face of record low inventories and high oil prices, demonstrate that DOE has yet to embrace a market-based policy.

D. SPR Documents State Filling the SPR Without Regard to Oil Prices Was Not Justified Even If A Major Supply Disruption Were Imminent

The SPR career official who wrote Exhibit V-4, on options for filling the SPR, states that the SPR Office believes it should not matter to the United States government whether the crude oil then scheduled for delivery to the SPR in 2002 is actually delivered in 2002 or postponed to 2003, even if an "energy supply emergency" were likely to occur within the next year. The reasoning underlying this advice is begun but interrupted in the version of this document provided to the Subcommittee. Exhibit V-4 states:

> The Issue of Urgency to Fill
>
> As noted above the strongest argument against renegotiating delivery schedules is that there is urgency to fill the Reserve to its capacity. However, given the current outlook for OPEC exports, and commercial inventories, it appears to the SPR Office the Government should be indifferent to deliveries of the outstanding oil accounts receivable in 2002 or 2003. If in fact, a major event is likely to occur within the next year that will cause an energy supply emergency, it is arguably superior to have the

At this point the document ends in mid-sentence, leaving the rest of the page blank.[212]

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[210] Oil Daily, *DOE Defers SPR Deliveries*, January 28, 2003.

[211] The current schedule of SPR deliveries appears in Section II.C.2.

[212] See footnote 195, *infra*.

A clue as to the SPR Office's reasoning, however, is provided in Exhibit V-9, Mr. Shages's June 2002 memorandum to Mr. Leiby. In Exhibit V-9, Mr. Shages discusses the costs and benefits of postponing SPR deliveries scheduled for 2002 until 2003. In this memo, Mr. Shages states there is almost no incremental benefit to the SPR from placing an additional 42 million barrels, on top of the 570 million barrels already in the SPR, in 2002 rather than 2003, even if it were known there would be a massive supply disruption in January 2003. The document states:

> The volume subject to deferrals at this moment is 42 million barrels, and the period of deferral might be a year. If you ran the [model] and postponed the incremental fill by one year (made 2002 fill equal to zero but increased 2003 fill by the same volume) how would the value of the Reserve change? I venture to say almost not at all, because the chances of drawing all the oil in the Reserve during the year delay are minute. Furthermore, if I **knew** we were going to have a massive disruption starting in January 2003, given my assumption that OPEC does not accommodate SPR fill with more production, I would doubly insist on deferral because I would rather see a build in private inventories than in SPR inventories.

Thus, in the opinion of this SPR expert, if the United States were facing the prospect of a massive and imminent disruption of oil supplies, U.S. energy security would be better served by building up oil supplies in private sector inventories rather than shifting that oil from the private sector to the SPR.

E. 2002 SPR Fills Increased Consumer Costs But Not U.S. Oil Supplies

As predicted by DOE SPR officials, filling the SPR without regard to oil prices and tight market supplies helped push up oil prices and deplete U.S. private sector inventories. The case study in Section IV traces how SPR deposits in the spring of 2002 raised the prices of crude oil and related petroleum products like home heating oil, jet fuel, and diesel fuel. Since then, prices for crude oil have continued to climb, recently reaching a peak of nearly $40 per barrel. Home heating oil, jet fuel, and diesel fuel prices have also continued to climb, and were recently joined by gasoline. Figure V-5 shows that gasoline prices are now over $2 per gallon in many markets, record highs for late winter. The continuing record low levels of crude oil in U.S. commercial inventories portend additional gasoline price spikes as refiners begin to build gasoline supplies for the spring and early summer driving seasons. The SPR program's record in 2002 demonstrates that, under these market conditions, more deposits of crude oil into the SPR will only exacerbate supply shortfalls and high prices.

Figure V-5
U.S. Gasoline Prices
January 2002 - February 17, 2003

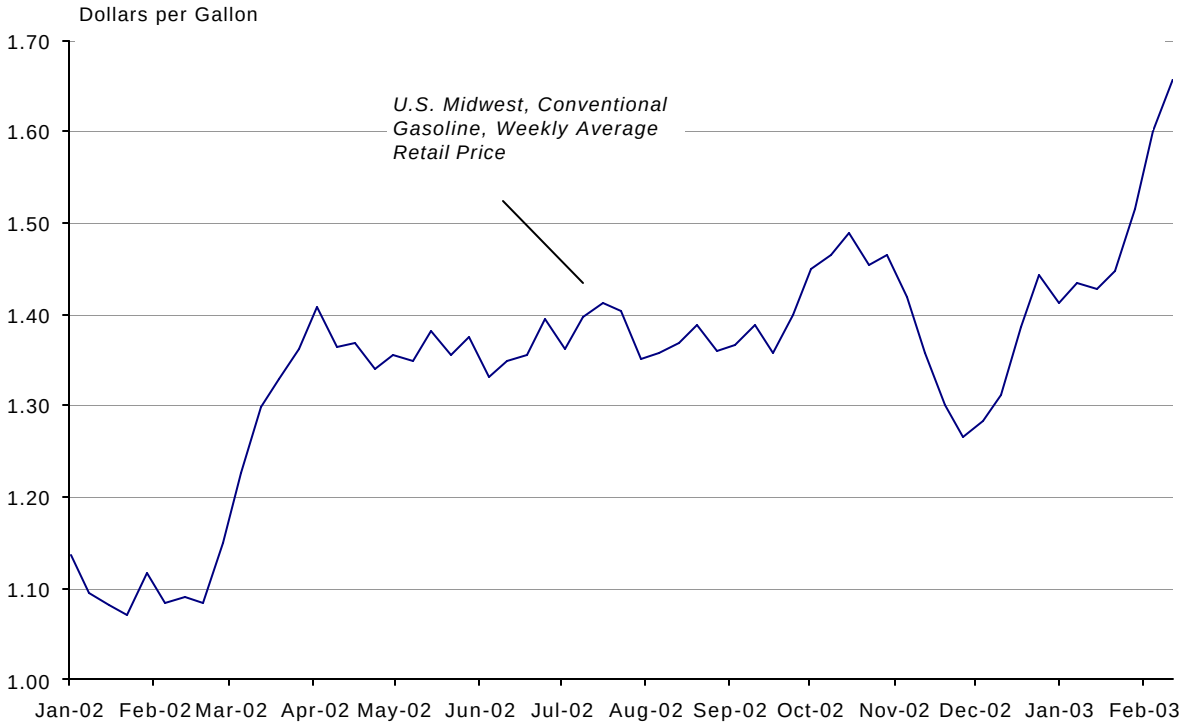

Figure V-5. By early 2003, gasoline prices had risen about 50 percent from levels in early 2002. Source: EIA.

Despite its high cost to U.S. consumers and taxpayers, inventory data indicates that the new SPR fill policy did not increase overall U.S. oil supplies. In 2002, the SPR program put about 40 million barrels of crude oil into the SPR, increasing the total 7%, from about 560 million to 600 million barrels.[213] Most of this oil was removed from the marketplace, however, when crude oil markets were tight, which increased oil prices and caused U.S. oil refiners to take oil from inventory instead of buying expensive new oil. In 2002, U.S. commercial inventories dropped 10%, from about 310 to 280 million barrels. In 2003, commercial inventories dropped again to less than 270 million barrels, dipping below the recognized level at which refinery operations risk disruptions due to inadequate oil supplies.[214] Today, overall oil supplies in the United States, which consist of the oil in the SPR and commercial inventories, total about 870

[213] See Figure II-2.

[214] See Figure V-1.

million, the same amount as at the end of 2001, before the recent SPR fills. Although the SPR program has placed more oil under government control, lower private sector oil inventories mean there has been no net increase in overall national oil supplies.

The benefit to U.S. energy security of shifting oil from private sector control to government control in the SPR, without a net increase in overall oil supplies, is unclear at best, since in the event of a major supply disruption, the SPR would act to release oil on the market, shifting supplies back to the private sector.

Filling the SPR to capacity is intended to strengthen U.S. protections against the "adverse economic impact" of a major oil shortage. But the facts show that the abandonment of the SPR program's "deliberate" and "cost-effective" market-based approach to filling the SPR, in favor of a market-blind policy of filling the SPR regardless of oil prices, resulted in the depletion of private sector crude oil inventories by at least as much as it has increased governmental reserves, costing U.S. consumers billions of dollars while contributing marginally, if at all, to overall U.S. energy security.

With crude oil prices at a 12-year high, and U.S. commercial crude oil inventories at record lows, it is time for DOE to reassess and revise its decision to stop allowing deferrals of crude oil shipments to the SPR.