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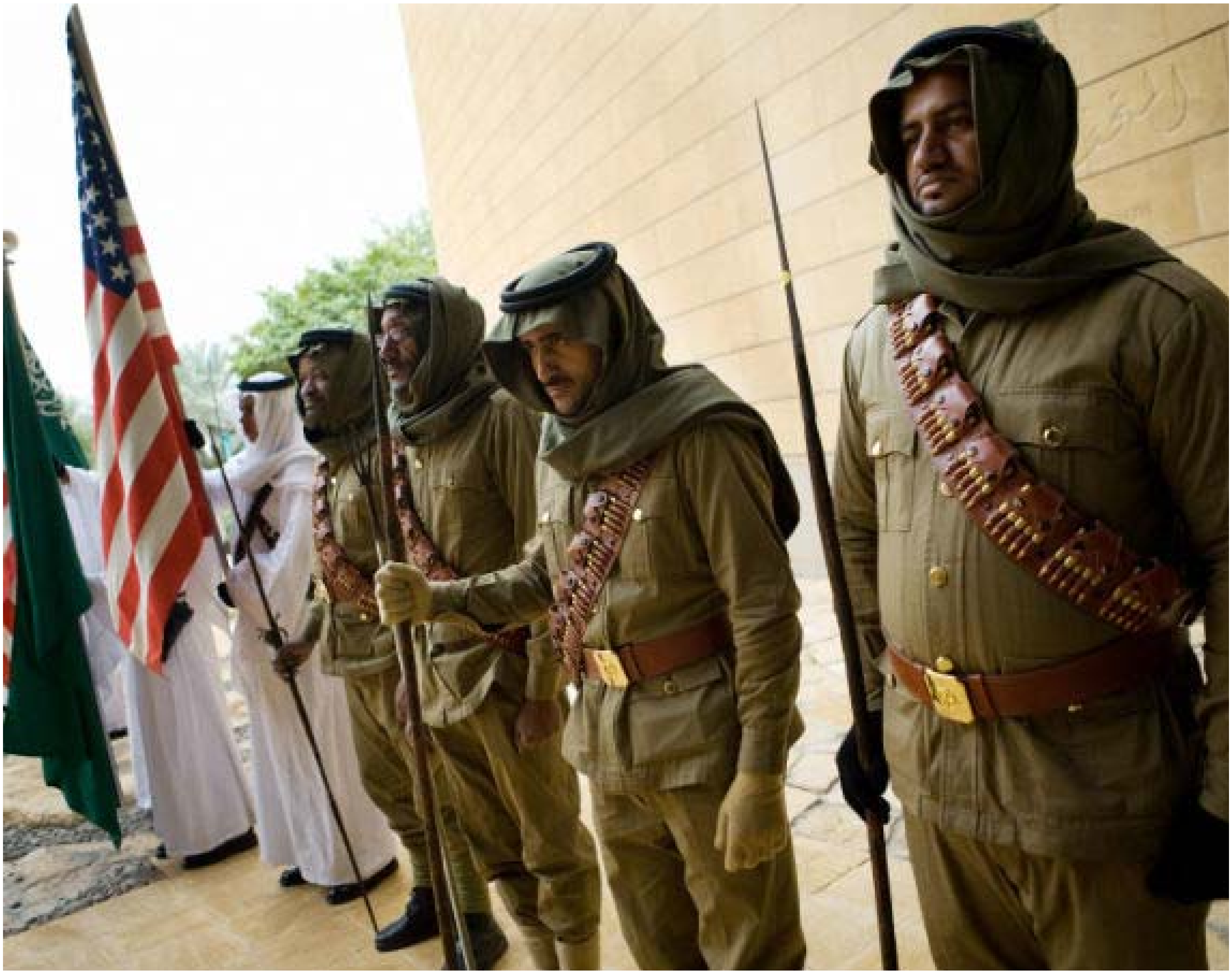
# America's Real Strategic Petroleum Reserve

Is relying on Saudi Arabia in times of war a smart tradition or future folly?

**BY AMY JAFFE** | AUGUST 24, 2012



As oil prices ticked above $115 per barrel last week, a White House leak revealed that President Barack Obama may dip into the Strategic Petroleum Reserve (SPR), the United States' 695 million barrel stockpile of emergency fuel supplies. The leak might have been a signal that Washington wants Gulf countries to take action to lower oil prices. It might also have been an attempt to wring the risk premium out of current prices by reassuring the market that America won't let a potential war with Iran shut off the spigot. The one thing we can say for sure is that the announcement highlights two interrelated problems with U.S. energy policy: that every president since Ronald Reagan has used Saudi Arabia as his de facto SPR and that there exist no clear standards for when to dip onto the actual SPR. Both problems have the potential to bite us -- badly.

Over the years, the United States has been surprisingly reluctant to release SPR during times of crisis, preferring instead to let Saudi Arabia handle the problem by simply increasing its production. For decades, in fact, U.S. presidents have been able to count on the Middle Eastern petro giant to pre-release oil in anticipation of times of war. For example, Riyadh flooded the market ahead of the first Gulf War and, though many do not remember, it also put extra oil on the market ahead of the U.S. invasion of Iraq in 2003. Saudi Arabia even increased its oil production after the 9/11 attacks, which badly strained U.S.-Saudi relations. Likewise, this spring, when the Obama administration was debating whether or not to release the SPR ahead of the tightening of sanctions against Iran, Saudi Arabia helpfully boosted its production above 10 million barrels per day, causing oil prices to fall more than $10 a barrel and eliminating the need for the White House to make a firm decision.

But relying on Saudi Arabia, while politically convenient, is not without risks. The most obvious is that the Saudis have come under increased pressure -- both internal and external -- as a result of their longstanding oil-for-security alliance with Washington. Iran has warned its fellow Gulf producer not to make up the slack resulting from American and European sanctions, threatening direct retaliation if it does. Saudi Arabia isn't taking any chances. In recent months, it has arrested prominent Shiite dissidents -- always suspected of possible ties to Iran -- and doubled the number of Saudi National Guard forces in the Eastern Province, home to the vast majority its 2 million-plus Shiite citizens as well as the close to 90 percent of its oil production.

Oil markets might have taken solace in Saudi preparedness until rumors surfaced of an assassination attempt aimed at the kingdom's intelligence chief, a move purported to be a revenge killing by Iran for similar assassinations of senior military leaders in Syria. The rumors proved to be **false**, but like much of the region's murky political intrigue, it moved markets and served as a reminder that a tit-for-tat game of high level assassinations is not out of the realm of possibility. The oil implications of this unpredictability are clear: It will be hard to keep global oil markets calm in the coming weeks and months. Deaths of rulers can change dynamics overnight virtually anywhere in the region, and Israel's defense policy remains an ever-present black swan. Saudi Arabia's own **rumored** pursuit of new nuclear-style ballistic missiles from China adds an additional layer of uncertainty about a nuclear arms race in the region.

America's ability to fall back on the Saudis is further imperiled by the inherent instability of the kingdom's political and economic system.

Saudi Arabia is going to **need** more and more oil revenue just to keep its population from growing restive. Riyadh-based Jadwa Investment **predicts** that Saudi Arabia will be forced to run budget deficits from 2014 onwards, even at a break-even price forecast of $90.70 per barrel in 2015. Other **forecasts** are even bleaker in the medium term, estimating the breakeven price at $110 a barrel in 2015. Either way, the kingdom's thirst for cash is likely to mean that U.S. and Saudi interests diverge. The oil-for-security deal between the two countries has **destabilized** the kingdom in the past by igniting support for al Qaeda in the Arabian Peninsula and it could be used again by agents of internal opposition groups. Moreover, the recent pro-democracy upheavals in Egypt, Syria, and above all Bahrain are bound to influence U.S.-Saudi relations over time in ways that are hard to predict.

For the time being, these risks have been at least temporarily mitigated. Recent leadership successions in the senior ranks of the Saudi security apparatus (defense, interior, and intelligence) and the common interest in containing Iran has brought Saudi oil policy closer in line with White House goals -- at least for now. Saudi oil shipments to the United States have been on the upswing this year -- a **reversal** of previous policy that favored sales to China -- and the kingdom, together with Kuwait and the United Arab Emirates, has stockpiled oil in ships off the coast of Al-Fujairah, outside the critical shipping chokepoint of the Strait of Hormuz, and added emergency crude oil stocks in China, Japan, South Korea, and Rotterdam. This coordination helped keep oil prices from spiking when Western countries tightened the sanctions regime against Iran's oil industry. The extra Gulf crude was aimed not only to wean Asian and European buyers off Iranian oil but also to give the United States (or even Israel) more economic leeway for a military strike against Iran's nuclear facilities in the event that diplomatic negotiations stalled out. But as more and more Iranian oil comes off the market and the specter of military action intensifies, the impact of these significant moves is wearing off.

But if Obama's trial balloon reveals the dangers of treating Saudi Arabia as a de facto emergency stockpile, the absence of concrete standards for releasing the real SPR will also make the president's job harder. There exists no defined mechanism to trigger a release, and each time it seems to make sense, the United States winds up initiating a cumbersome, time-consuming diplomatic process of negotiations with foreign allies and the International Energy Agency (IEA) that ofter over-politicizes the result. Moreover, the actual process of getting the oil from the reserves to the pump isn't instantaneous. It takes weeks after the announcement of an SPR sale for the U.S. Department of Energy to collect bids and award sales volumes. Then, the buyers have to schedule oil with nearby pipeline companies, so by the time the oil actually reaches the refineries and is processed into gasoline another several weeks will have passed. Thus, releasing stocks *after* a major crisis is a losing strategy -- better to plan ahead to shape the marketplace.

There is no question that the United States should get more oil onto the market, not only because prices have been rising but also because the war drums are beating again over Iran. But within the constraints posed by poorly designed energy policies, the president has made it harder for himself by adopting a non-committal approach. The optimum utilization of strategic oil stocks requires broad diplomatic coordination, a transparent policy, and well-articulated procedures. In 1991, that coordination was well advertised months in advance and markets knew what to expect. As a result, the oil-price impact of the Gulf war was small (by today's standards) and short-lived, and its impact on the U.S. and global economy was muted compared with other similar crises.

Where the oil markets are concerned, the president's coy, "see what you can get first" negotiating strategy with Western and Middle East allies might be less than useful. Transparency and planning are what takes volatility out of prices. In days gone by, a photo-op of senior U.S. and Saudi officials shaking hands was enough to convince the markets that oil would be there in a crisis. In the volatile post-Arab Spring world, however, this style of oil diplomacy can no longer be implemented without unexpected political consequences -- suggesting that the United States needs to **shift its thinking** about how it manages the SPR and oil crises in general. The time to revise the trigger mechanism for the SPR is now, before we hit a major crisis. Dithering only helps our enemies and puts the global recovery at risk.

That said, there is no wrong answer for when to time an SPR release. Given how long the process takes, an early release now means that markets would be physically well supplied by the time a possible war breaks out, potentially muting the impact on prices then. If the president waits, however, and announces perhaps an even larger release at the time of a crisis, it could have greater psychological power to move prices sharply lower all at once. The only wrong policy is to be indecisive. Having no policy means that market participants cannot plan whether to build commercial inventory or not. It gives speculators free rein and increases the chance American consumers will pay unnecessary fuel-risk premiums.

The geopolitics of the Middle East has likely changed forever as a result of the Arab Spring, and the United States has neither the resources nor the power to put Humpty Dumpty back together again. We must acknowledge this fact and forge an emergency oil stocks policy that fits 21st-century realities. Not only does Washington need to break its habit of falling back on the Saudis, it needs clearer definitions for the goals and mechanisms of an SPR release. It should also consider requiring U.S. refiners to hold a mandated minimum level of gasoline inventories (as is done in Europe and Japan) to ensure that Americans have immediate supplies of fuel in the event of a major oil disruption from the Middle East. Such domestic fuel stocks proved invaluable to Japan in the aftermath of the Fukushima nuclear crisis last spring. A more transparent and effective strategic stocks policy would not only better protect the U.S. economy in times of oil-market uncertainty, it would also give America more freedom of maneuver in the new Middle East.



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