May 25, 2022
Labor Market Reports
research@employamerica.org

Employ America Research Report

The Relevance of the SPR's Acquisition Authority to Furthering Climate Goals

Arnab Datta
Senior Counsel,
Employ America

Skanda Amarnath
Executive Director,
Employ America

Executive Summary

As the Department of Energy ("DOE") considers rulemaking pertinent to the SPR's acquisition of crude petroleum through forward contracts, it should consider requiring that producers engaged in contracts with the SPR adhere to the most stringent environmental standards for oil production. **It is a worthwhile opportunity to ensure that the Administration's efforts to increase oil production minimize environmental harm. Furthermore, creative production contracts involving the sale of put options (as we previously advocated for), could help set a soft "floor" on oil prices, preventing a large-scale return to consumer purchases of gas-guzzling cars**. *As the Administration considers how to relieve oil price pressure in the broader context of decarbonization and transitioning to a clean energy future—these actions would help ensure that necessary oil production aligns better with our long-term climate goals.*

Policy Objectives

With crude prices rising again following the historic SPR release, the Administration is considering a slate of options to increase oil production and release price pressure on American consumers. But as we try to ramp up domestic production, justifiable concerns have been raised about how the promotion of oil production fits into environmental concerns about emissions and the broader goal of decarbonization and transitioning to a clean-energy future.

We've previously written about how increasing oil production, and the subsequent reduction in oil price volatility, could actually support the transition to a clean energy future. Aside from that, avoiding further oil price spikes in the short-term is necessary to ensure that American consumers are not subject to sustained inflationary pressure, especially if the political viability of policies to address climate change are to sustain. But the Biden Administration could also take actions to ensure that its power to acquire crude oil directly mitigates potential emissions while raising the environmental standards associated with domestic oil extraction. Furthermore, it could support the long-term transition away from oil use by ensuring that put options contracts function as a soft price floor for crude oil. Such a price floor, albeit a porous one, would promote both the financial sustainability of the industry and the environmental sustainability of consumption patterns.

Discussion

Possibly the most impactful action from the Administration to boost future production is its decision to use the SPR's purchasing authority to engage in forward contracts – a welcome signal of future demand for producers. The Administration can use this rulemaking opportunity to undertake two useful policy goals: (1) requiring higher environmental standards in its acquisition contracts; and (2) setting a soft floor on oil prices through the sale of physical put option contracts.

1. Encouraging Competition Along Environmental Dimensions of Production

The SPR's acquisition statute offers justification for stronger environmental standards during acquisition. 42 U.S.C. 6240(b) requires that the SPR acquire petroleum products in a manner consonant with several objectives, including "(5) encouragement of competition in the petroleum industry."

"Encouragement of competition" is not defined in the statute or clarified through regulation. A narrow interpretation limiting "competition" to "cost competition" (and attendant lower prices for the reserve) would run afoul of well-established principles of textual analysis—namely that courts must "lean in favor of a construction which will render each word operative, rather than one which may make some idle and nugatory." The first stated objective in the paragraph is "(1) minimization of the cost of the Reserve." The acquisition statute also requires the SPR to develop procedures consistent with the objectives in paragraph (b), and includes that those procedures minimize the costs of acquisition for the DOE. Defining cost narrowly to focus on cost competition would render those provisions meaningless.

An expansive reading that considers competitive factors beyond mere price or cost competition would be more appropriate. This argument is buttressed by the considerable discretion afforded the Secretary of Energy to determine acquisition procedures. Paragraph (c) determines the factors that the Secretary shall consider when crafting procedures to acquire crude oil for the reserve, and explicitly requires the Secretary to "take into account the need to— …(6) address other factors that the Secretary determines to be appropriate." Accordingly, the Secretary can develop procedures that he or she determines appropriate and consistent with the objective of encouraging competition (so long as they don't contradict other objectives or procedures defined in the statute).

Acquisition procedures could favor producers that are more competitive on environmental dimensions. This could include the producers with superior capacity to minimize methane emissions, or those that limit the use of internal combustion engines to power drilling and meaningfully reduce flaring intensity. Such a policy could also fill a noticeable policy gap in oil production regulations, since the relevant EPA regulations are not necessarily consistent with the highest standards and practices, and the degree of control over methane emissions varies substantially across producers within the industry.

These would not be market-adverse regulations (which would run afoul of other objectives in the statute)—they would simply reward already germinating competitive practices in the oil industry. In a globalized economy, as end-consumers grow more sensitive about the sourcing of fossil fuels, as nations seek actions marginal and major to meet their Paris Accord commitments, and as investors look to align their investments with ESG goals, many producers are already seeking competitive advantage through stronger environmental practices. One need only look at the marketing materials and sustainability reports for firms like Pioneer Natural Resources or Occidental Petroleum to see this shift in action, with attention placed not just on carbon footprint but on the minimization of freshwater usage. Using the SPR's competition objective would simply capitalize on this by rewarding extraction methods that make producers more competitive in the domestic and global marketplace for fossil fuels.

2. Using Put Options to Set a Soft Floor on Crude Prices

In a previous piece, we advocated for rulemaking that would allow the use of options contracts for SPR acquisition, with the primary purpose of replenishing the reserve more efficiently and helping remove excess uncertainty from the market. But these put options could also have an important secondary benefit: creating a soft floor (albeit a porous one) under the price of crude oil.

While the power of the price mechanism can be overstated in the context of major shifts in consumption patterns, there is a truth to the fact that a higher gasoline price can facilitate demand for environmentally superior transportation substitutes, like hybrid or electric vehicles, and reduce demand for gas-guzzling vehicles. Yet until EV production is high enough to support mass adoption at competitive price points and without long lead times, a strategy relying on high gas prices to push decarbonization has disproportionate financial impact on lower-income populations. A more sensible (and ethically defensible) position would be reducing extreme price pressure through increased production, but with mechanisms to prevent the price of crude oil from bottoming out to a point where consumers return to the gas-guzzling behemoths that are only economical when gas prices are low.

Absent significant institutional reform to guide investment on the upside and downside (and related capacity enhancements like additional SPR storage), the SPR is unlikely to be able to implement a hard floor on the price of crude oil. However, the use of put options could help set a more sustainable zone of prices.

By allowing the SPR to write put options, the agency could ensure acquisition occurred as prices fell below a certain level—essentially pulling excess supply from the market and stabilizing a price fall. How? By selling a put option to a producer, the producer would retain the option to sell at a future date at a given strike price. If prices fell below that strike price—the producer would gain a financial advantage from selling to the SPR rather than in the spot market. Because the SPR would then put that crude into storage—the net effect would be a reduction in supply available in the market. Of course, in a global marketplace, the effect could be minimized by other factors. But it would be a worthy tool—and even marginal effects can play an important role in determining the price of oil.

And as with setting higher environmental standards for general acquisition we described in the previous section, the SPR could set procedures for evaluating the “environmental strength” of the bids received for put options, and reward more environmentally-sound producers with cheaper or deeper options.

Therefore, while supporting efforts to boost oil production long-term to reduce inflation and the extremely high gas prices we're currently experiencing, we can still work to support a price level that continues the demand shift towards a greener, more sustainable future.