

Statement of David F. Johnson
Deputy Assistant Secretary for Petroleum Reserves
before the
Committee on Small Business & Entrepreneurship
U.S. Senate
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Mr. Chairman and members of the Committee, I am pleased to be here today to discuss the Northeast Home Heating Oil Reserve, which was established by the Department of Energy in 2000 as an emergency stockpile of heating oil to address weather-related supply problems in the Northeast.

NORTHEAST HEATING OIL MARKET

As you are aware, America's homes and businesses are heated predominantly by three fuels: heating oil, natural gas and electricity. Heating oil provides heat to only about 7 percent of residences on a national basis, but the demand is not uniformly distributed; the Northeast consumes about 73 percent of all the heating oil used in the country.

According to National Oilheat Research Alliance, the average heating oil consumption per household is three gallons per day, which for the Northeast amounts to about 428,000 barrels on an average winter day. However, when temperatures drop below normal, this figure could increase to as much as 700,000 barrels per day.

In terms of supply, heating oil supplying the Northeast comes from a number of sources:

- Shipments from Gulf Coast refineries via pipelines and, to smaller extent, tankers or barges;
- Shipments from Central Atlantic refineries distributed throughout the region by pipeline and barges;

- Imports from offshore and foreign areas – most notably, Canada, the Caribbean, and Europe.

In addition, private industry routinely builds up pre-seasonal heating oil stocks in terminals in New England and New York harbor; these reserves are required to augment the normal supplies of heating oil during the winter heating season and they are critical to satisfy normal surges in demand and to prevent heating oil shortages and spikes in heating oil prices.

The vulnerability of the Northeast to heating oil supply problems has always been a concern. The New England portion of the Northeast is most vulnerable to any form of heating oil supply constraints during the winter season. New England has no refineries, so that all heating oil must be brought in from outside the region. A high percentage of the movements both into and around the region are marine, thereby putting movements of heating oil at risk during very severe winters when rivers and, in some cases, harbors freeze or are closed by high winds during peak demand periods.

In the late winter of 1999-2000, for example, the Northeast suffered a severe cold spell. Just as demand was rising to record levels, domestic natural gas production slumped in the producing regions and harbors froze, North Atlantic storms kept ships at sea and barges could not move. Heating oil availability became spotty; dealers were rationing supplies and prices surged. This was not the only time in recent history that the Northeast has experienced exceptional heating oil price spikes. There were similar short run price spikes during severe cold periods in the winters of 1983-84, 1989-1990, 1993-94 and late 1996.

NORTHEAST HOME HEATING OIL RESERVE

In July of 2000, the President directed the Department of Energy to establish a regional distillate reserve in the Northeast, as an emergency stockpile of heating oil to address weather-related supply problems in the Northeast, as occurred in the winter of 1999-2000. The regional distillate reserve in the Northeast was later codified in the *Energy Policy and Conservation Act* as the Northeast Home Heating Oil Reserve (NEHHOR) at 42 USC 6250, et seq.

The authorized size of the Northeast Home Heating Oil Reserve is two million barrels. The intent was to create a stock buffer large enough to allow commercial companies to compensate for interruptions in supply during severe winter weather, but not so large as to dissuade suppliers from responding to increasing prices as a sign that more supply is needed.

The Northeast Home Heating Oil Reserve is comprised of Government-owned heating oil stored in commercial storage terminals in the Northeast, of which one million barrels is located in New England and one million barrels is located in New York harbor. The Department of Energy currently has established storage contracts for storing up to 1,000,000 barrels of heating oil at the Hess First Reserve terminal in New Jersey, 750,000 barrels of heating oil in New Haven, Connecticut, and 250,000 barrels of heating oil in Groton, Connecticut. Under the Government's storage contracts, the storage terminals have the responsibility to:

- provide inventory management and turnover of the Government's stocks;
- meet all Department of Homeland Security requirements for port security
- provide full availability of the Government's product in the event of a release;

- provide the capability to deliver all the Government's product within 10 days on a 24 hour notice; and
- provide the capability to distribute heating oil by tanker/barge, truck and pipeline where applicable.

The current storage contracts can also accommodate the storage of biodistillate as part of the Northeast Home Heating Oil Reserve, if desired.

The Heating Oil Reserve currently contains 1,965,000 barrels. The Department had to sell 35,000 barrels in June 2007, in order to have sufficient funding to award new storage contracts for the heating oil storage. Storage costs under the new contracts were significantly higher than the expiring contracts due to increased commercial demands for product storage. The current storage contracts, which were awarded in September 2007, have three one-year fixed-price options, and will provide for storage through September 30, 2011.

In 2008, Congress appropriated \$3 million of additional funds to repurchase the 35,000 barrels, and the Defense Energy Support Center, acting as our purchasing agent, has just this week issued a solicitation for the replenishment quantities.

RESPONSE PLAN AND CAPABILTIES

The Department of Energy's response plan for the Heating Oil Reserve provides for the release of heating oil by means of a competitive sale. The Department has implemented an on-line sales platform which allows for award of sales contracts within two days. The Department's Office of Fossil Energy website (www.fe.doe.gov) permanently posts standard sales provisions and also provides a means for companies or individuals to register for prompt notification of an imminent sale. Actual sales are limited to "entities

customarily engaged in the sale and distribution of petroleum distillate”. The Petroleum Reserves office conducts pre-season exercises of the sales system with industry every winter to assure industry’s familiarity with the sales system and to receive feedback for continual improvement.

Under the most likely scenario, the competitive sales bidding will open the day after a specific notice of sale is posted. The secure internet sales platform will be open for 2-3 hours and close at approximately noon Eastern Time. Bids will be anonymous to other bidders and will specify the quantity, location, and price, expressed as a premium to the New York Mercantile Exchange (NYMEX) near month closing price for heating oil on the day of the bidding. This pricing methodology assures the Department receives fair market value.

A bidder must provide a financial guarantee of \$250,000 provided by wire transfer prior to submission of his bids. Companies may submit multiple bids, but no one company will be awarded more than 40 percent of the heating oil offered at any one geographical location (i.e. New York Harbor or New England). This limitation is intended to prevent any potential for a monopoly position in the resale of the oil. The Department reserves the right to limit the total volume awarded based on the reasonableness of the bids (including not awarding any sales contracts).

The premium values of the winning bids will be indicated on the sales platform, and contract awards will be confirmed following the close of bidding. Heating oil from the Reserve will be delivered on a prepaid basis only. The buyer will be required to wire payment to the Government within 48 hours following notification of award, or prior to taking delivery if less than 48 hours.

The distribution plan for the Northeast Home Heating Oil Reserve is based on maximum use of the commercial terminal infrastructure and industry procedures in place, since the greatest potential for efficient and expeditious distribution of the heating oil stocks rests with the industry performing these functions. The buyer must make arrangements to have delivery of their oil take place within ten days of award. However, distribution could be accomplished more quickly, if the buyers can arrange sufficient transportation. In recommending to the President that the Heating Oil Reserve should be released, the Secretary of Energy may include a further recommendation that the President direct the Secretary of the Department of Homeland Security to waive compliance with the coastwise laws affecting marine deliveries of heating oil from the Reserve, including the law referred to as the "Jones Act" that generally requires that coastwise trade be conducted via vessels that are owned by US citizens or US interests. See, 46 USC 12112. This may be vital to supply the areas in northern New England.

CONDITIONS FOR RELEASE

Congress, in the *Energy Policy and Conservation Act*, 42 USC 6250b, provided explicit conditions for the release of stocks from the Northeast Home Heating Oil Reserve. The Secretary may release the stocks from the Reserve only upon a finding by the President that there is a "severe energy supply interruption." Such a finding may be made only if it is determined that (1) a dislocation in the heating oil market has resulted from the interruption, or (2) a circumstance exists that constitutes a regional supply shortage of significant scope and duration that the Reserve's release would significantly reduce its adverse impact.

The law deems a “dislocation in the heating oil market” to occur when:

1. The price differential between crude oil and No. 2 heating oil increases by more than 60% over its five year rolling average for the months of mid-October through March (considered as a heating season average); and
2. The price differential continues to increase during the most recent week for which price information is available.

Since the Reserve was established in 2000, this calculation has only reached the defined level three times, all of which were in circumstances that were not characterized by a “severe energy supply interruption.” In December 2000, the disparity was caused by a significant decrease in crude oil prices due to increased OPEC production. In March 2003, there was a rise in heating oil prices at the end of the season, and in October 2005, the differential in crude and heating oil prices were a result of refinery outages due to Hurricane Katrina. Neither situation constituted a dislocation problem requiring a release of heating oil stocks.

The Administration has been steadfast in adhering to the law by not releasing heating oil to influence prices. However, the Department recognizes that price spikes are indicative of an underlying supply upset condition, and monitors prices, stocks, and temperature forecasts to discern when conditions may deviate significantly from normal. Likewise, continual collaboration with State energy offices, the Coast Guard, and industry associations provide information which may support a Presidential finding.

PRIOR USE

To date, the Northeast Home Heating Oil Reserve has not been needed to address an emergency winter shortage situation. The recent winter of 2007-08 saw an end-of-season potential supply situation develop in the Northeast, as commercial stocks fell to unprecedented lows due to the high market prices and strong demand for all distillates in Europe. That situation is not what the Reserve was established to address and would not be characterized as a “severe energy supply interruption” as the law stipulates. Last year’s situation gives us similar concerns for the coming winter of 2008-09. The normal off-season prices for heating oil stocks have remained high due to the current high crude oil prices, the continued strong demands for all distillates in Europe and Asia, and the year-round domestic demand for low and ultra low sulfur fuels in the on-road and off-road sectors. All this has made heating oil more costly and is currently impacting the rate at which needed commercial heating oil stocks levels will build in the Northeast.

CONCLUSION

I would like to conclude by saying that the Department’s Northeast Home Heating Oil Reserve stands ready to make heating oil available in a very rapid manner in the event of a Northeast supply shortage. We are currently adding heating oil to bring our supplies to 99 percent. During the winter seasons, the Department of Energy also participates in weekly energy call with the State Energy Offices, local governments, Northeast gas associations, the U.S. Coast Guard, and others to monitor the Northeast heating fuel supply situation. These calls have served in the past to help States to exchange information and coordinate responses to stock situations, transportation issues, price levels, and dealer and customer concerns. This concludes my prepared testimony and I will be happy to answer any questions you may have.

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