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# COMMENTS ON THE PRESIDENT'S PROGRAM TO DECONTROL DOMESTIC CRUDE OIL PRICES

Statement before the

Subcommittee on Energy and Power
U.S. House of Representatives

by

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The question before this subcommittee is, should domestic crude oil prices be decontrolled over the next 28 months, as the President has proposed? The President's authority to control prices under the Energy Policy and Conservation Act of 1975 (EPCA) terminates on October 1, 1981. Given this unequivocal provision in EPCA, the question is merely whether it is better to phase the controls out gradually over these 28 months, as the President wants to, or whether to maintain them until the last day and then let all domestic crude still under price control rise instantly to the full world price level. This could mean a $10-12/Bbl average price increase for at least 4.5 million B/D of domestic production, costing consumers more than $18 billion in the first 12 months after the end of the statutory price controls. Given these two options, I think everyone would have to agree that the President's is the better one, for it spreads the impact of the price increase over an extended period, thus averting a shock to the economic system.

However, the real issue under debate in Congress and indeed, throughout the nation, is of course a larger one, namely whether EPCA should be allowed to lapse at the end of September 1981 or whether new legislation should be passed now to extend controls beyond that date.

In our system of economics, direct and specific government price intervention in the private sector is the exception rather than the rule and is considered justifiable only in exceptional circumstances such as overriding national policy considerations

or the demonstrable inability of market factors to properly perform their function of price determination. The basis of our national oil policy is the need to reverse our growing dependency on foreign oil sources by increasing our domestic production of oil and other energy sources, and by decreasing our consumption of oil through conservation and substitution. I think there is general agreement among all discussants with this overall aim of our national energy policy. There must also be general agreement that keeping domestic oil prices lower through controls than they would otherwise be is bound to have a negative impact of some dimension on this policy aim. Hence, an extension of price controls beyond EPCA's expiration date is directionally at variance with our energy policy.

What about the other justification for controls--the dysfunction of market forces? As we know, under free market conditions, the price of a commodity tends to be determined at the "margin," i.e., by the cost of the last unit required to meet a given level of demand.

For the U.S., the marginal oil supply source is clearly foreign oil, which currently accounts for about 43% of our total supplies. The delivered cost of imported oil is substantially higher than that of most oil produced from previously discovered domestic deposits. If the foreign price level were the result of the normal interaction of competitive market forces (i.e., supply and demand), its role as the price setter for domestic oil would

perhaps never have been questioned and no gap may ever have developed since domestic prices would have moved right along with their foreign counterparts.

However, for the last eight years foreign oil prices have of course not been determined by competitive market forces but by the governments of a group of major oil exporting countries, acting in concert through OPEC. In addition, several of these OPEC producers have individually imposed production ceilings which, for economic or political reasons, are well below their current sustainable production capabilities as well as the potential capabilities from their recoverable resource bases.

Advocates for the extension of oil price controls have argued that since the foreign prices are government-administered instead of market-determined they do not represent the real marginal supply cost and, hence, should not be allowed to set U.S. domestic oil prices. No one could disagree with their premise that foreign prices are administered. But does that make them less real?

I submit that inasmuch as we and other oil importing countries have been unable (or unwilling) to persuade OPEC for the past six years to abandon their pricing policies and are quite unlikely to succeed in persuading them in the foreseeable future, we have no choice but to accept their prices as real and functional determinants of world oil price levels. The rest of the world has done so. No oil is available anywhere abroad at a lower price. Hence, it makes no difference whether the world price of oil is where it is because of a real physical resource constraint or because of a

government imposed production ceiling. The amount of oil available is the same in both cases.

It should also be pointed out that OPEC price administrators have not been totally indifferent to market conditions. During the 4 years from 1975 through 1978 when there was a sizeable world oil surplus, the cost of OPEC oil to the U.S. actually declined somewhat in real terms. The decline was more pronounced for importing countries whose currency strengthened vis-à-vis the dollar during this period. Furthermore, the original OPEC price increase scheduled for 1979 was by no means inordinately high. The inordinate price increases which have actually taken place in the first 5 months of this year reflect a real world shortage caused by a combination of circumstances: the 2 1/2 months total interruption of Iranian oil exports and subsequent resumption at a reduced rate, the refusal of several OPEC members to raise their production ceilings, except briefly, and the worldwide panic buying and hoarding at all levels of users which inevitably accompany a perceived or anticipated shortage of any commodity. If the effects of U.S. oil price decontrol contribute in a small way to restoring an equilibrium between world demand for OPEC oil and the supply made available by its members, this would also contribute to restraining future OPEC price increases.

This brings me to my next point--what impact price decontrol will have on domestic oil production and consumption and, hence, on the level of our imports. The DOE, which advocates price decontrol, estimates that by 1985 oil imports will be about 1 million

B/D less than if present controls were maintained, with at least 75% of the reduction resulting from higher domestic output. The Congressional Budget Office (CBO), which appears to be somewhat less sanguine about the benefits of oil price decontrol, estimates in its recent study that by 1985 oil imports will be reduced by 620,000 B/D as a result of decontrol, with 65% coming from incremental production. The lower estimate is by no means insignificant. It would be equal to a 6% reduction of the likely import level without decontrol and to a reduction of nearly 2% in free world oil import requirements. Furthermore, it would reduce our oil import bill by some $6-7 billion in 1985. Actually, both the DOE's and the CBO's estimates of import reductions are highly speculative because the amount of oil discovered over any specific period of time--particularly a relatively short period--is partly a matter of luck. In general, however, one can expect the positive impact of decontrol on production to grow over time. In the short run, decontrol should remove some of the impediments to higher production incorporated into the existing system.

For example, the current price of lower tier oil of not quite $6/Bbl is just about the same as the price of controlled ("old") oil six years ago, after adjustment for inflation. If we consider that most oil producers have lost the tax benefit of the depletion allowance since then and that drilling costs have risen about 60% faster than U.S. inflation, it is clear that today's price for the 3 million B/D of lower tier oil is not nearly enough to maintain existing production levels through work-overs of fields and the

installation of more secondary recovery methods. Furthermore, the incentive to maximize oil sales at $6/Bbl cannot be very strong while there is a possibility that this same oil can be sold for 2 or 3 times that much in the not-too-distant future. Following the sharp rise in world oil prices in the last few months, the same can probably be said about upper tier oil. Also, the exemption of stripper well production from all price controls must have caused some switching into this category with a resulting net reduction in output.

It is sometimes claimed that price increases of the magnitude imposed by OPEC are not required to maximize U.S. conventional production. Yet, the most important oil discovery in the U.S. requires such a price level to be profitable for all its output. Last year the 400,000 B/D of oil from the North Slope of Alaska which had to be disposed of outside the West Coast carried a wellhead price of about $4.50/Bbl from which state royalties and severance taxes as well as lifting costs must be deducted to arrive at an operating profit. If the landed price of foreign oil with which North Slope crude must compete had been just moderately lower last year, this oil could not have been profitably produced and may therefore have remained in the ground. In the absence of any world price increase this year, North Slope producers may not have had the incentive to install the pumps in the pipeline and drill the development wells which will raise output by another 200,000 B/D by next January.

On the demand side, too, there is visible evidence of the impact of the higher oil prices on consumption. Last year's total domestic oil consumption was only 8% higher than in 1973. By contrast, in the five year period ending in 1973 the increase was 29%. During the same two periods the demand for gasoline rose by 11% and 27%, respectively. The recent sharp increase in the demand for small cars and the corresponding decline in that for large models is further evidence of the public's sensitivity to rising gasoline prices.

Now I would like to address myself briefly to the question of what the oil companies will do with the additional income received as a result of price decontrol. According to estimates by the U.S. Treasury, decontrol would give the oil industry additional annual gross income rising in current dollars from $5.8 billion in 1980 to $20.4 billion in 1985, assuming no real increase in OPEC prices. After adjusting for expected inflation, I estimate that the real additional gross income would rise from $5.4 billion to $13.5 billion, in constant (1979) dollars. Oil companies would have to pay out about 55 % of this amount in the form of royalties, severance taxes and state and federal income taxes. This would leave them $2.4 billion in 1980 and $6.1 billion in 1985 (both in constant 1979 dollars).

The Treasury estimates that in 1977 $16.9 billion were expended in the U.S. on oil and gas field explorations and development. In 1978 the figure was probably 15-20% higher. The magnitude of this amount, relative to the net after-tax income increase

due to decontrol, suggests that at least in the first 2-3 years the entire revenue increase could be readily spent in the industry's production sector. There would certainly be a strong incentive to do so, for domestic oil and gas production would be extremely attractive and this would have to be reflected in the industry's budget allocation.

The additional revenues resulting from decontrol will be substantially higher in the later part of the 1980-85 period, according to the Treasury estimate. They may still be absorbed in the production sector, since investment opportunities in this sector tend to increase over time. Also, exploration expenditures in the earlier part of the period may lead to relatively higher development expenditures in the later part.

However, to a large extent future investments in petroleum exploration and production will depend less on industry decisions than on government leasing policies. The reason is that the most promising remaining unexplored areas in the U.S. are on federal and state owned lands and waters. The government is deliberately leasing these areas slowly and cautiously, much to the frustration of petroleum producers and perhaps also some policy makers in the Department of Energy. We may have here another one of those conflicts between valid but conflicting national goals: environmental protection vs. incremental domestic energy production.

If as a result of this and other constraints the petroleum industry is unable to invest all its decontrol-related additional

revenue in the production sector, it may decide to invest elsewhere, increase its dividends, reduce its debts, or spend it on a combination of these options. This raises the question of whether some of the decontrol-related revenues should be subjected to a new tax on top of the statutory existing tax rate, since it may not be used for exploration or production purposes.

From a purely economic point of view there does not seem to be any justification for such a step. However, from a social justice point of view there may be. The public perceives OPEC's current pricing and production policy as a calamity to the U.S. and believes American businesses should not earn profits from this calamity in excess of what they can use to remedy it. The perception may be irrational but it is real and understandable. Furthermore, the taxes could perform specific social and research functions related to the problem, if properly earmarked. Thus, they could be used to help low-income families cope with the rapidly rising cost of household and transportation energy. They could also help finance research and development of new forms of energy with unproven economic viability, or underwrite particularly expensive and financially risky domestic energy projects. The President has of course proposed in this energy program that his requested "windfall" profits tax be used for both of these purposes.

However, two conditions are of the utmost importance in levying such a tax: (1) It must not create any new disincentives for domestic oil and gas production; and (2) it must be considered a transitional measure, to be phased out over a specified, limited time period. Thus, no special tax of any kind should be levied on production from genuinely new deposits, on very high-cost existing production such as North Slope, or on production achieved through enhanced (tertiary) recovery methods.

In conclusion I would like to say that while special taxation for a limited period may be an acceptable trade-off for the termination of domestic oil price control, we must take care that the tax will not prevent us from using OPEC prices to our own ultimate advantage by turning them into an instrument to reduce the effectiveness of OPEC's pricing power.