Uncle Sam's Energy Mess:

How the U.S. Government Empowers the OPEC Cartel and Takes Power from the People

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EXECUTIVE SUMMARY

After nearly two decades of relative calm, oil prices spiked in 2000 to their highest levels in 15 years, even after accounting for inflation. Unlike earlier episodes, present price increases have occurred during a time of comparative peace. Consumers of oil-based products have demanded an explanation for this sudden price increase. The outgoing Clinton-Gore administration, many other politicians, and some in the media blamed the oil companies.

First, critics assert that oil companies do not operate in a competitive market, which means oil companies can "gouge" customers at will. Second, critics say oil companies "manipulate" supplies of crude oil and oil products in order to force up profit margins. Government must then step in and correct these "market failures."

These arguments are false. OPEC is the immediate source of the price increases. However, the U.S. Government is also a major culprit. U.S. government intervention in energy markets has contributed to problems with oil since the 1970s. Government regulations on domestic energy exploration, production, and sales have enhanced OPEC's monopoly power.

Cartels are theoretically possible in a free market, but they usually break down because of cheating and entry. In fact, a cartel cannot exist very long without government enforcement of price fixing and barriers to entry to keep the cartel afloat.

By manipulating prices and restricting competition from American oil companies, the U.S. Government has been the OPEC cartel's greatest benefactor. Anti-energy policies include the locking up of more than a million acres of coal rich lands in Utah during the 1996 U.S. Presidential campaign, increased regulations on oil refining, and draconian restrictions on drilling for new oil.

Since coal is a substitute for oil, especially for producing electricity, restricting coal production puts pressure on oil and natural gas supplies and drives up their prices. The outgoing administration has severely curtailed offshore oil drilling, and restricted oil exploration on millions of acres of federal lands. The Arctic National Wildlife Reserve (AMWR) is possibly the largest oil reserve in the nation (with up to 16 billion barrels of oil). Although drilling there

would involve only about 2,000 of ANWR's 19 million acres, the outgoing administration blocked development.

Blocking oil exploration has also reduced supplies of natural gas, commonly found with oil. By making it more difficult for oil companies to produce and refine oil and to mine for coal in this country, these steps have restricted world energy supplies and contributed to high oil and natural gas prices. These policies have strengthened OPEC (the "True Big Oil" cartel) and given it renewed power to injure American consumers. U.S. energy policy has been OPEC's best friend.

Restricting U.S. energy development lowers our standard of living by forcing us to pay higher prices for fuel and to incur the costs and inconvenience of adapting to less energy use to power our automobiles, heat and cool our homes, and run our businesses. U.S. taxes and restrictions on energy production force artificial and uneconomical conservation of energy, and guarantee a stronger future for the OPEC oil cartel and a weaker future for the U.S. economy than would otherwise be the case.

Uncle Sam's Energy Mess: How the U.S. Government Empowers the OPEC Cartel and Takes Power from the People

By William L. Anderson, Jr., Ph.D.[*]

After nearly two decades of relative calm, oil prices rose in 2000 to their highest levels in 15 years, even after accounting for inflation. There has been a modest pull-back since, but OPEC curtailed output again in January, 2001, and seems determined to firm up the price. OPEC is the Organization of Oil Producing Countries, a group of 11 national governments that produce about 40 percent of the world oil supply and hold 77 percent of the globe's proven oil reserves.

The prior 20-year period of stability had one major interruption, in the fall of 1990, when war broke out in the oil-rich Persian Gulf in the wake of Iraq's invasion of Kuwait. But the present price turmoil is occurring during a time of comparative peace, something unprecedented in modern times.

Previously, it took major conflicts to jar the oil markets. The panic that gripped the oil and gasoline markets in the United States during the 1970s had at least part of its roots in wars or the threats of wars. The Arab-Israeli conflict of 1973, also known as the Yom Kippur War, led to the Arab oil embargo that temporarily decreased world oil supplies and forced up world energy prices, including U.S. domestic prices. Revolution in Iran in 1979, the Iran Hostage Crisis, and the Iraq-Iran conflict in 1980 also created temporary spikes in oil prices.

The impact of these world events was greatly exacerbated by ill-advised U.S. price controls on energy that converted the higher world prices into actual shortages of oil products in various parts of the United States. These events fostered the belief that Americans faced permanent economic hard times, and would always be at the mercy of OPEC.

Although OPEC and U.S. government energy policies were to blame for the oil price spikes, the public, the press, and the politicians preferred to blame the oil companies. In the 1970s, some politicians urged the government to seize oil companies outright.

Yet the energy crisis quickly faded when good policies replaced bad. In the 1980s, the Reagan administration removed price controls on oil (and natural gas), and the government did not seek to allocate supplies to end users. Inflation-adjusted prices for gasoline and other petroleum products fell sharply, and remained low for many years. In spite of rapidly growing

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world economies, energy supplies rose to meet the demand as exploration and oil production increased in many parts of the world. OPEC's dominance of the oil industry was diminished, and OPEC-induced shortages seemed an unpleasant memory.

There was a brief price scare in 1990 before the Gulf War, and the companies were criticized again for market prices that were beyond their control. Senator Joseph Lieberman introduced legislation that would have made raising gasoline prices during a "crisis" a crime punishable by up to five years in prison. Lieberman said, "There is no doubt that American consumers are getting ripped off on a massive scale. All of the price increase is unjustified."[1]

With the quick and successful outcome of that conflict, and with OPEC grateful for Western help in curbing Iraqi expansion, oil prices again subsided. Consumers came to believe that energy prices would remain low forever. The OPEC cartel, however, was not dead. It was still there, ready to respond, as cartels do, to changing conditions of supply and demand.

By 2000, OPEC again dominated world energy supplies and was able to muster the internal discipline needed to curtail production and boost world oil prices. Startled consumers of oil-based products demanded an explanation for the sudden peacetime oil price increase. Politicians and media commentators were all too eager to provide their own version of events. On a number of occasions, President Clinton, Vice-President Gore and other spokesmen for the outgoing administration, members of Congress, journalists, and members of consumer groups all took rhetorical potshots at "Big Oil."

During the 2000 presidential campaign, Vice President Gore accused Governor George Bush and vice presidential candidate Dick Cheney of being "in the pocket of Big Oil."[2] Mr. Gore declared, "We know that, according to the latest available statistics, oil company profits have increased by as much as nearly 500 percent in the first part of this year. These enormous and unreasonable profits suggest that big oil is gouging the American consumers."[3] These accusations are reminiscent of the attacks that politicians and the media made against oil companies during the 1970s and in 1990. Now, as then, the policy errors made by the governments of the consuming nations that contributed to the problem were ignored.

The critics of the oil industry make two accusations. First, they assert that oil companies do not operate in a competitive market, which means oil companies can "gouge" customers at will. Second, critics say oil companies "manipulate" supplies of crude oil and oil products in

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[1]Roy E. Cordato, "Gasoline Price Hikes: The Market Is Working Just Fine," Institute for Research on the Economics of Taxation, *IRET ByLine*, No. 93, August 22, 1990.

[2]Walter Williams, "Helping the OPEC Cartel," September 27, 2000, accessed at http://www.townhall.com/columnists/walterwilliams.

[3]William L. Anderson, "Gas Price Follies," *The DeWeese Report*, December 2000, p. 10.

order to force up profit margins. The accusers then conclude that government must step in and correct these "market failures."

These arguments are false. The U.S. Government itself has been a major culprit in the oil price increases in this and previous episodes. Government restrictions on U.S. energy exploration, production, and sales have enhanced OPEC's monopoly power in world oil markets. It will be argued that much of OPEC's power over American energy consumers, during the 1970s and again in this latest episode, is the result of U.S. regulations that have kept competition out of the market and reduced the ability of American consumers to diversify their sources of energy.

I. MYTHS ABOUT OIL COMPANIES

A number of charges have been made against oil companies each time a price spike has occurred. These charges include the following claims, none of which is true:

- Oil companies have conspired to raise their profit levels.
- Oil firms face competition periodically, but during crises they can quickly manipulate supplies in order to increase prices and profits.
- Oil companies operate in the arena of "imperfect competition" and are thus able to simply "pass on" all increased costs to consumers.
- Gasoline prices can be held down if government will set price controls on crude oil, since the cost of gasoline is derived from the cost of petroleum.

These myths need to be dispelled, as they shape how the public views the market for oil, gasoline, and the energy industry in general

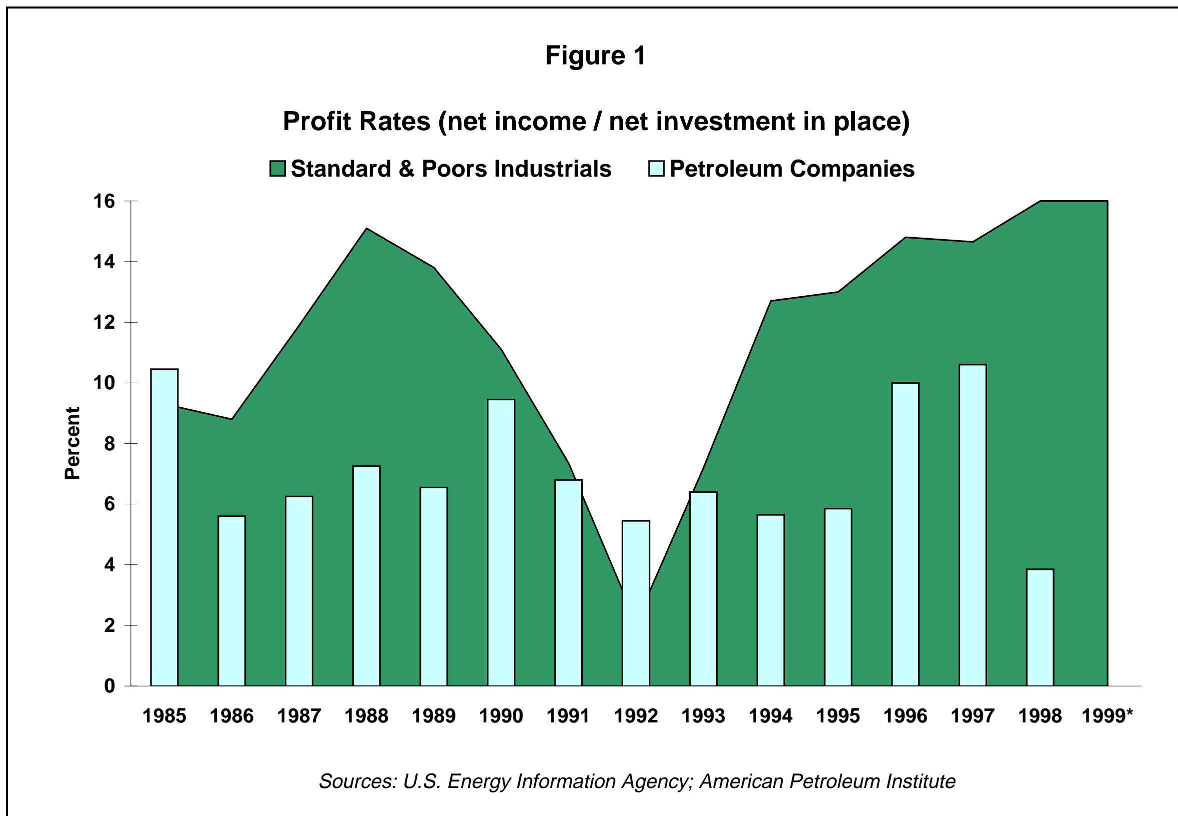
A. Oil Companies Can Increase Profits at Will

The private sector of the oil industry, including firms engaged in exploration, production, refining and distribution, is highly competitive. There are many firms in each sector of the production chain that compete all the way from the acquisition of leases and drilling rights to the sale of refined products to industrial and retail customers. The companies compete with each other and with suppliers of alternative fuels such as coal, natural gas, and hydro-electricity. The oil markets, spot and future, are among the most efficient and liquid in the world (no pun intended). As with other commodity producers, the energy companies are price takers, not price setters.

If the oil price increases of 2000 indicated that oil companies can arbitrarily raise prices and profits, why did they not do so sooner? If oil companies had this unique ability, they would

certainly have used it years ago to generate above-normal incomes. Indeed, not to have done so would have made their managers guilty of dereliction of duty to their stockholders for not maximizing profits.

The facts on oil profits tell a different story. According to the Energy Information Administration, over the past 15 years, profits as measured by the ratio of net income to net investments *have been considerably lower for the oil industry than for the market as a whole.*[4] Profits remained above the stock market average (for the Standard and Poors 500 largest firms) in the late 1970s and early 1980s, but fell relative to the market after 1985. Even the brief price spikes during the Gulf Crisis of late 1990 and early 1991 did not change that pattern, because revenue gains were driven by cost increases. Figure 1 clearly demonstrates this point. Despite the critics' charges, oil companies have not been a particularly good investment over the last 15 years. If oil companies are indeed able to raise their profit margins at will, their stockholders should be rushing to the nearest trial lawyer to file multi-billion dollar class action lawsuits.



[4]American Petroleum Institute, "Oil Companies Have Experienced Lower Profits than Other Industries as a Whole for Most of the Past 20 Years," August 28, 2000, accessed at http://www.api.org/consumer/lowerprofits.htm.

B. <u>Oil Companies Periodically "Manipulate" Supplies to Raise Profits</u>

As stated earlier, believers in this myth claim that oil companies mostly face competitive conditions, but when potential supply problems occur, oil companies suddenly find the power to "manipulate supplies" and force up prices. Such bifurcated analysis is ridiculous. Either oil companies are subject to market competition or they are not. Assuming that there are no new barriers to entry into the market (a point that will be discussed below), a firm cannot choose on day one to be subject to market forces and then decide on day two to engage successfully in "predatory monopoly practices."

C. <u>Oil Firms Greedily "Pass on Cost Increases" to Consumers</u>

Critics charge that oil companies do not operate in the "imaginary" arena of "perfect competition," and that they are therefore able to "pass on cost increases" to consumers at will. This claim assumes that oil producers single-handedly set the price of oil, and that consumer demand for oil is completely inelastic (totally unresponsive to price changes).

When the late William Simon served as "Energy Czar" in the 1970s, he found, contrary to popular belief, that there were *thousands* of oil and gas producing firms operating in a very competitive market.[5] While politicians and the media accused oil companies of collusion to force up prices, Simon and his staff found no such behavior. Instead, they discovered a beleaguered industry that was struggling under the regulatory straightjackets and price controls imposed upon them by the U.S. Government.[6]

D. <u>Price Controls on Crude Oil Result in Lower Gasoline Prices</u>

Throughout history, governments have imposed price controls in a vain attempt to smother inflation, and the price ceilings have always resulted in shortages and market chaos. One of the least effective government practices has been to impose price controls upon factors of production in hopes that "cheaper" inputs will translate into lower prices of final products. Whenever past Congresses and presidents have indulged in such schemes, the results have been tragic.

During the 1970s, President Nixon and the Congress slammed price controls upon crude oil that came from U.S. wells. They could not, of course, control the price of oil from abroad; failure to pay the going world rate for imported crude or imported refined products would have meant that those supplies would have gone to other nations. As Armen Alchian and William Allen have pointed out, "Crude oil prices were held below market-clearing levels on the

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[5] William E. Simon, *A Time for Truth* (New York: Berkeley Publishing Co., 1979), pp. 76-77.

[6] *Ibid.*

assumption that thereby prices would be lower for gasoline, heating fuel, lubricating oil, and other products refined from crude oil."[7]

What Congress and the president did not care to comprehend, however, is that the value of gasoline does not come from the value of crude oil; rather, it is the other way around -- crude oil is valuable because consumers are willing to pay for the refined products. Alchian and Allen write, "The production costs that it pays to incur (costs of making the final good) are determined by the market value of the (final) good, not the other way around."[8] With this relationship in mind it should be clear that to put price controls on crude as a way of dampening the prices of gasoline or home heating oil is wrongheaded and ultimately futile. In the case of oil and gasoline during the energy embargo, incremental units were available only from abroad (imports), or by bidding them away from other domestic consumers (not producers). Thus the marginal cost to any consumer was the world price. Lowering the price paid to domestic oil producers merely transferred the savings to others in the domestic supply chain (insofar as it did not cause domestic producers to stop pumping), with no reduction in the price charged to the final consumer at the pump. This, in turn, led to price controls all the way up the production chain, and to the "windfall profits tax" that tried to capture for the government the money squeezed out of domestic oil producers by the cap on domestic crude prices, rather than letting it accrue to others in the production chain. The result was less domestic production of oil and refined products, and even more dependence on foreign crude, gasoline and heating oil.

E. Summary: Markets Work

Markets determine the prices for gasoline, heating oil, and other petroleum-based products. If that were not the case, the sellers of those products would never suffer decreases in profit margins, since those firms would be impervious to competitive market forces that constantly erode profit margins.

Oil prices over the last two decades back up this point. Following the decontrol of oil (and natural gas) in the Reagan Administration, real or inflation-adjusted prices for gasoline have *declined* over the last few decades, the current price spikes not withstanding. Table 1 demonstrates the price changes since 1973, when the first national oil emergencies related to the Middle East began. (Table 1 does not include the price spikes of early summer when *net of taxes* gasoline prices rose to about $1.60 and more per gallon before falling by later summer.)

Likewise, the price of crude oil has also taken a nosedive in real terms. In 1980, world oil prices hovered near $40 a barrel, and when measured in current dollars, that would translate

[7]Armen A. Alchian and William R. Allen, *Exchange & Production: Competition, Coordination, & Control* (Belmont, California: Wadsworth Publishing Company, 1983), p. 73.

[8]*Op. cit.* at 7, p. 75.

to about $80 a barrel. This places a better perspective on the recent prices of about $33 a barrel, which are high by current standards, but are low historically, especially when one looks at oil prices during the Carter years.

Given the decline in real gasoline and oil prices over the last 20 years, it is clear that the industry has been profitable only through massive cost cutting, innovation and capitalization. It should also be clear that oil companies are subject to competitive market forces. However, the way that profits are reported often misleads people on oil profitability. Quarterly reports show the increase in profits as compared not only to the previous three months, but also the same quarter a year before. For example, if the industry made two percent profit in the first quarter of 1999 and four percent the first quarter of 2000, it would be reported that profits "doubled" for the industry. The message then is garbled through the media that oil companies are making a "100 percent" profit because they capriciously increased gasoline prices. Such errors of analysis formed the basis for Vice President Gore's attacks on the oil industry during the recent presidential campaign.

II. COMPETITION, CARTELS, AND THE OIL INDUSTRY

For more than 200 years, economists have assumed that, as a first approximation, most of the economy functions in an imaginary state of "perfect competition." In "perfect competition," a market consists of a large number of near equally sized firms (atomized production), none of whom own "market power."

It is one thing to use this form as a basis of general theoretical analysis; it is quite another to insist that the conditions of "perfect competition" form the only basis of industrial organization in the real world. Alan Greenspan writes, "It was understood [by economists of the 19th Century Classical School] to mean that competition consists merely of producing and selling the maximum possible, like a robot, passively accepting the market price as a law of nature, never making any attempt to influence the conditions of the market."[9] Adds Dominick Armentano, "The economic problem lies in understanding how the competitive market process of discovery and adjustment works to coordinate anticipated demand with supply in a world of imperfect information."[10]

While economists during most of the 20th century believed that the level of competition depended upon the number of firms in an industry, competition today is correctly seen as a process of rivalry. Large-scale production often allows companies to produce much more cheaply

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[9]Alan Greenspan, "Antitrust," from *Capitalism: The Unknown Ideal*, Ayn Rand and Nathaniel Branden, editors (New York: Signet Books, 1967), p. 67.

[10]Dominick T. Armentano, *Antitrust: The Case for Repeal* (Auburn, Alabama: Ludwig von Mises Institute, 1999), p. 33.

and effectively than small firms. Even an industry with a few large efficient firms is competitive if they are rivals rather than partners, and if there is freedom for other firms to enter the market (including the freedom to import).

The oil and automobile industries provide two examples. Before the advent of large-scale manufacturing in these two industries, their products were often too expensive for most consumers. Only after John D. Rockefeller consolidated much of the oil industry and drastically cut costs did petroleum based fuel became priced low enough to allow America's poorest citizens to afford things like kerosene lighting. Likewise, Henry Ford's introduction of mass production techniques to building automobiles allowed even low income Americans to own cars, which until then had been a plaything for wealthy people.

Prices of automobiles and oil were declining even before the government intervened to break up the Standard Oil Trust. Today, there are many private sector automobile and energy companies, with no single firm or small group of firms controlling a dominant market share.

Of course, firms can attempt to form cartels by agreeing to hold back output and raise prices. They may succeed, however, only as long as two vital conditions are met. The first is the prevention of "cheating" by firms, in which some companies break their agreements by charging lower prices and increasing their output. The second condition is prevention of entry into the market of firms that are not going to abide by the cartel's agreement.

Table 1

Year	Retail Price Net of Taxes of Gasoline in current dollars
1973	1.036
1974	1.419
1975	1.409
1976	1.440
1977	1.457
1978	1.378
1979	1.768
1980	2.249
1981	2.274
1982	2.007
1983	1.773
1984	1.620
1985	1.552
1986	1.099
1987	1.087
1988	1.044
1989	1.116
1990	1.241
1991	1.090
1992	1.041
1993	0.970
1994	0.903
1995	0.899
1996	0.961
1997	0.941
1998	0.740
1999	0.828
April 2000	1.056

Sources: American Petroleum Institute, *Basic Petroleum Data Book*, Volume XVIII, Washington, D.C., January 1998; U.S. Department of Labor, Bureau of Labor Statistics, "Gasoline Average Price Per Gallon, U.S. City Average and Selected Areas"; And U.S. Energy Information and Administration.

While cartels are theoretically possible in a free market, they usually break down because of cheating and entry. Indeed, the structure of the private sector of the energy industry -- many efficient firms supplying the products and few import barriers -- is not conducive to cartelization.

In fact, cartels are generally possible under two scenarios. One is when a government acts as an enforcer to support the policies set by a private sector cartel. The other is when a government (or group of governments) imposes a monopoly or cartel arrangement on an industry, either by taking over production directly or by dictating production targets to the firms. William Shughart writes, "Government will respond to the demand for protection against the pressure of competition."[11] By creating and enforcing the cartel agreements, the government is able to keep a cartel in business through coercion – to the detriment of consumers and other firms that would like to enter the industry. One cannot emphasize enough that cartels *could not exist very long* without the monopolistic enforcement mechanism of government. Government is an entity that has a legal monopoly on coercion, and it is through that power that it imposes the legal price fixing and denial of entry necessary to keep cartels afloat.

While Americans are taught that government tries to "promote competition" through various policies, in reality government usually is the engine of movements to prevent competition. Writes Shughart, "Government-managed cartels have a long history in the United States."[12] As we shall see, by manipulating prices and restricting competition from American oil companies, the U.S. Government has been the OPEC cartel's greatest benefactor for the past three decades. This is a remarkable case of a government (ours) supporting a cartel of foreign governments against private businesses and consumers in its own country.

III. EMPOWERING OPEC: FROM THE 1970s TO THE 1990s

In the 1970s, at the height of the Cold War, Washington was favorably disposed toward the fledgling OPEC. It was felt that a more prosperous Middle East would be a stronger bulwark against Soviet expansion, and that such prosperity would be bolstered by a shift in power from the international energy companies to the governments of the region. Partly as a result of that view, the U.S. government did not object as foreign governments began forcing less favorable contracts on the energy exploration and production companies.

In October 1973, war broke out between Israel and an alliance of Egypt and Syria. Unlike the Six Day War in 1967, the Israelis were suffering numerous setbacks and faced the prospect of running out of supplies. The United States, however, airlifted tons of military supplies to Israel, turning possible defeat into a smashing victory. The angry Arab governments retaliated by announcing an oil embargo against the United States and the Netherlands, and

[11] William F. Shughart II, *The Organization of Industry* (Boston: Richard D. Irwin, Inc., 1990), p. 238.

[12] *Ibid.*, p. 239.

curtailed oil output to Western nations, exercising OPEC's recently acquired economic and political clout.

The embargo caused almost immediate chaos in the United States, and politicians milked the crisis for its full worth, excoriating oil companies for their alleged "economic crimes." Contrary to popular belief, however, the problems did not originate with OPEC or even with President Richard Nixon's imposition of price controls on oil on August 15, 1971. Political interference with oil had begun almost two decades earlier.[13]

Beginning with crude oil, the number of oil wells drilled in the United States dropped by nearly two-thirds from 1955 to 1972.[14] In order to "help" domestic drillers, the government instituted import controls on crude oil "but encouraged the importation of refined products."[15] These actions discouraged the building of new refineries, a problem that still haunts us today.

By the late 1960s, environmentalism was making a large political impact. The infamous 1969 Santa Barbara oil spill brought severe restrictions on offshore drilling. Two years later, President Nixon slapped price controls on everything, but when he lifted his order, he kept controls on domestically produced crude oil and gasoline. As with similar experiments in price controls throughout the world over the last 4,000 years, the Nixon price controls created massive shortages and chaos for producers and consumers alike.[16]

Not only did the government restrict the prices of petroleum and gasoline, it also determined the "proper allocation" of oil products. This obviously meant allocation that would provide the greatest political benefits for members of Congress, as the National Energy Act of 1975 clearly demonstrated. That law required refiners to produce less gasoline and diesel than they otherwise would have in favor of heating oil that would go to the highly populated northern cities.[17]

Even before 1975, the government controlled allocation of oil products. Domestic crude oil price controls had already forced U.S. producers to buy more and more oil abroad, which turned into a crisis when OPEC began its embargo in 1973. At the same time, when world crude oil prices rose, the government refused to allow price increases at the gasoline pumps until the

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[13]Simon, *op. cit.*, p 71.

[14]*Ibid.*, p. 69.

[15]*Ibid.*, p. 71.

[16]See Robert Schuettinger and Eamonn Butler, *Forty Centuries of Wage and Price Controls: How Not to Fight Inflation* (Washington, D.C.: The Heritage Foundation, 1979).

[17]Alchian and Allen, *op. cit.*, p. 75.

higher priced crude oil "had passed through the system." Consumers, realizing that future gasoline prices would be higher, decided to "buy now." Their actions, by quickly stripping gasoline stations of supplies, soon deteriorated into full-scale panic buying, causing the gasoline lines remembered so sorely by consumers during that time.

Although journalists and even some oil "experts" said that the gas lines were the natural extension of the Arab boycott, they actually resulted from U.S. price controls and allocation rules. While Americans sat in lines and cursed the oil companies, Europeans experienced no such problems, as their governments had not imposed American-style price controls. Whereas some economists, such as Milton Friedman, pointed out this important fact, American journalists and politicians found it preferable to bash the oil companies.[18]

In fact, Friedman and others explained that the price controls not only hurt U.S. consumers, but they also *helped* OPEC by discouraging oil and gas production in this country.[19] Were it not for the price controls that reduced U.S. output of oil, OPEC's embargo would have driven prices higher and encouraged new exploration and an expansion of output in the United States, eventually weakening OPEC and depressing prices. Instead, primarily as a response to price controls, exploration and new drilling in the United States came to a halt during the mid-1970s, enhancing OPEC's power for years afterwards.

When the government got out of the price and allocation business with full oil price decontrol in 1981, oil markets worked relatively smoothly to diminish OPEC's power, and energy prices began to fall rapidly. The end to product allocation by the government was also key. Gasoline lines *did not appear* in 1990 and 1991, despite the obvious crisis in the Persian Gulf region. That is because gasoline prices *rose immediately* upon new surges of consumer demand, dampening consumption, and because the energy companies were free to allocate their product to where the prices were the highest and the demand the greatest. Despite the predictions of journalists and some "oil experts" that gasoline lines were just around the corner, they never materialized.

In fact, even during the latest round of gasoline disruptions in 2000, American motorists did not have to wait in line as they did during the 1970s, because the government did not misallocate available supplies. However, the government has not ceased its meddling with energy markets, it has merely changed its methods. Instead of regulating prices and product allocation, the government has turned to taxes and environmental regulations to curtail domestic energy production. Consequently, OPEC has regained some of its strength. Consumers have found themselves unnecessarily hurt at the gas pump by a modest squeeze by OPEC, and political demagoguery against oil companies is again popular.

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[18]Milton and Rose Friedman, *Free to Choose* (New York: Avon Books, 1980), p. 9.

[19]*Ibid.*

In the 1980s under President Reagan, many bad energy policies of the Nixon, Ford, and Carter administrations either were repealed or simply became irrelevant.[20] However, as the environmental movement continued to grow, politicians again turned against the energy industries. Energy regulation intensified with scares about global warming and acid rain. Numerous new laws and regulations greatly hindered the production of oil and other energy sources and once again empowered and emboldened the OPEC oil cartel.

The oil industry was hammered following the Alaska oil spill of 1989. As the media focused upon oil-slicked beaches and dead animals, Congress and the Bush administration strengthened prohibitions on offshore drilling and made it even more difficult to drill for oil in Alaska. One of former President George Bush Senior's campaign promises was to be the "environmental president." His administration was the driving force behind the Clean Air Act Amendments of 1990. The Amendments had a major role in restricting oil exploration. Other provisions, although aimed primarily at coal-fired plants that produced electricity, also attempted to force plants that burned oil and natural gas to adopt new but questionable clean air technologies.

Consequently, when Mr. Clinton and Mr. Gore took office in 1993, they did not have to change the *direction* of U.S. policies in order to meet their environmental goals. What they did, however, was to raise the *level* of environmental and anti-fossil fuels activism by an order of magnitude. Mr. Gore's best selling book, *Earth in the Balance*, became a guide for the Clinton-Gore energy and environmental policies. In the book, Mr. Gore advocated the "phasing out" of the internal combustion engine in 25 years and the imposition of stiff new taxes on gasoline. He also wrote that government-mandated mileage standards for automobiles, sport utility vehicles, and small trucks should be increased. His book blames fossil fuels for creating environmental crises, and he believes that government must act to eliminate them.[21]

The Clinton-Gore administration took many steps to restrict energy production. These include a five cent increase in the federal gasoline tax, verbal attacks on the automobile industry for producing popular SUVs, the locking up of more than a million acres of coal rich lands in Utah during the 1996 U.S. Presidential campaign, increased regulations on oil refining, draconian restrictions on drilling for new oil offshore and on millions of acres of federal lands, and a ban

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[20]For example, the Natural Gas Policy Act of 1978 operated on the assumption that the United States would run out of natural gas supplies by 2000. The act directed natural gas for home heating and away from industrial use. Today, that same government is forcing manufacturing firms and electric utilities to use natural gas instead of other fuels, often in furnaces that do not have dual fuel capability. Such industries cannot switch to oil or coal when shortages of natural gas loom. These government policies have contributed to the current price spike in natural gas for business and home use.

[21]For important criticisms of Gore's book, see John A. Baden, ed., *Environmental Gore: A Constructive Response to Earth in the Balance* (San Francisco, CA: Pacific Research Institute for Public Policy, 1994).

on recovering oil from even a tiny portion of the remote Arctic National Wildlife Reserve (ANWR). All are important reasons why current oil prices are as high as they are.[22]

Since coal is a substitute for oil, especially for producing electricity, curtailing coal production puts more pressure on existing oil and natural gas supplies, thus driving up their prices. The ANWR restrictions are especially disturbing. ANWR is possibly the largest oil reserve in the nation (holding as much as 16 billion barrels of oil). Despite the fact that drilling there would involve only about 2,000 of ANWR's 19 million acres, the Clinton-Gore administration opposed opening the area to exploration.[23]

The administration's oil policies have also stopped much of the search for clean burning natural gas, since natural gas is typically found in conjunction with oil. Consequently, these same policies have contributed to the current sharp run-up in the price of natural gas.

IV. OTHER ENVIRONMENTAL OBSTACLES

Not all of the energy problems in 2000 were due to OPEC and restricitons on U.S. exploration and production. Environmental regulations of a different kind gave us last summer's particularly sharp, brief spike in the price of gasoline. That spike, on top of the higher gasoline prices already in place due to the rise in oil prices, was the last straw for many irate consumers.

One result of the Clean Air Act Amendments of 1990 is an Environmental Protection Agency (EPA) regulation requiring oil refiners to include additives like Methyl Tertiary-Butyl (MTBE) to help gasoline burn more efficiently. Although there is ample evidence that these additives are ineffective at cleaning the air (but are *very effective* in polluting ground water), the government still insists on their inclusion.[24]

EPA's requirement for new additives to be mixed into gasoline last summer in certain high pollution areas disrupted the gasoline refining and distribution process far more seriously than EPA expected, and set off chaos. Unfortunately, the government and especially the EPA chose to engage in obfuscation rather than admit what really had happened.

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[22]John K. Carlisle, "Government Restrictions on Domestic Energy Development Contribute to U.S. Dependence on Foreign Oil," from The National Center for Public Policy Research, Publication #305, August, 2000, accessed at http://www.nationalcenter.org/NPA305.html.

[23]*Ibid.*

[24]Syd Gernstein, "Gasoline Additives Fuel High Prices and Environmental Problems," from The National Center for Public Policy Research, Publication #302, July, 2000, accessed at http://www.nationalcenter.org/NPA302.html.

The EPA, using average cost analysis, assumed that the new additives would cost between five and eight cents a gallon.[25] These costs were calculated under the naive assumption that there would be no disruption to the refining and transportation process when the new additives came on line. However, the new regulations, which required numerous mixes of gasoline and "clean air" additives for different areas of the country, slowed and reduced production, and imposed significant extra refining and distribution costs on the industry. The EPA cost calculations were in substantial error. In fact, the new regulations forced the price of gasoline to shoot up by 25 cents or more. Midwestern cities like Chicago and Milwaukee were hit the hardest.[26] The timing of the resulting additional gasoline price surge could not have been worse, coming on top of the rising prices imposed by the OPEC production restraints.

V. CONCLUSION: WHAT TO DO – AND WHAT *NOT* TO DO

The anti-energy policies of the federal government have strengthened OPEC and given the cartel the power to once again strike fear into the hearts of American consumers.[27] By locking up coal, oil, and natural gas fields, the out-going administration has succeeded in forcing U.S. energy producers to look outside this nation's borders for fuel. Unless the incoming administration has a change in policy, we can expect more price spikes as OPEC producers once again assert control over world oil markets.

These policies amount to protection for the "True Big Oil" cartel, that being OPEC. By making it more difficult for oil companies to produce and refine oil and to mine for coal in this country, the outgoing Clinton-Gore administration was OPEC's best friend.

Energy exploration can and should be done in a careful, clean and responsible manner. However, overly restrictive energy policies that ban all development or impose unnecessary costs are not acceptable. They ensure that future generations of Americans will suffer a lower standard of living. Consumers will be forced to pay higher prices for fuel and to incur expenses to adapt to less energy use in powering their automobiles, heating their homes and running their businesses. Government's use of taxes and other restrictions to force conservation of oil and other products imperils our economic future.[28] Restrictive energy policies in the United States

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[25]U.S. Environmental Protection Agency, *Phase II Reformulated Gasoline: The Next Major Step Toward Cleaner Air*, EPA420-F-99-042, November 1999.

[26]Lawrence Kumins, "Midwest Gasoline Price Increases," Congressional Research Service Memorandum, June 16, 2000, p. CRS-5.

[27]Wilson and Antonelli, *op. cit.*, p. 11.

[28]Roy Cordato, "Corporate Average Fuel Economy Standards: The Case for Repeal," Institute for Research on the Economics of Taxation, Washington, D.C., *Studies in Social Cost, Regulation and the Environment*, No. 3, May 2000.

reduce the world supply of energy, raise the world price, and exacerbate our dependence on OPEC oil. Such policies guarantee a stronger OPEC oil cartel and a weaker U.S. and world economy than would otherwise be the case. They leave the world vulnerable to future supply and price disruptions.

Medical ethics begins with the dictate "First, do no harm." That rule might well apply to government energy policy. If we are to diminish the power OPEC has over our economy, and avoid self-imposed economic distortions and inefficiencies in the energy area, then the government must first follow sensible policies. It must repeal bad laws and regulations already in place, and must refrain from placing new controls on domestic oil production. The following sets of guidelines would be a good start:

- Do away with policies aimed at forcing individuals and businesses to "conserve" energy beyond what they would naturally do given market prices. In a free market, people will price every resource to reflect both its value at present and its expected value in the future. They will make sensible decisions as to how much energy to use and how much to spend instead on conservation techniques and other alternatives to energy consumption. They will "conserve" that resource in a way that is consistent with the conservation of other resources and does not distort resource markets.

- Do not enact new taxes aimed at forcing up gasoline prices and depressing current demand. In a recent *New York Times* column, Economist Hal Varian of the University of California at Berkeley advocated a new tax on gasoline to promote less use.[29] Other economists, including Paul Krugman of the Massachusetts Institute of Technology, call for measures that will "encourage production and discourage consumption.."[30] Such measures would artificially and uneconomically depress current demand but would do nothing to encourage oil companies to produce more oil and gas.

- Do not increase Corporate Average Fuel Economy (CAFE) standards. As Dr. Roy Cordato has demonstrated, these "feel-good" measures again distort production markets by overvaluing fuel and undervaluing other resources, while doing little to reduce gasoline consumption.[31] Forced conservation methods like fleet mileage standards for automobiles also distort the total development of resources and cost the economy more whatever "savings" these regulations bring about in fuel economy. It is best to simply abolish these standards immediately.

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[29]Hal R. Varian, "Economic Scene: Tax Cuts May Be Fashionable, but Now's a Good Time to Raise Gas Taxes," *New York Times*, Op-Ed, October 19, 2000.

[30]Paul Krugman, "A Drop in the Barrel?" *New York Times*, Op-Ed, September 27, 2000.

[31]*Op. cit*. at note 33.

If the government *were* serious about ending the economic power held by OPEC, it would further take the following positive steps:

- Deregulate oil and gas markets in order that consumers and producers may enjoy the benefits of free markets.

- Enact common sense environmental regulation, including the opening of oil fields offshore and in Alaska. Make sure that any laws and regulations do not incur costs that outweigh the benefits to producers and consumers alike. Gasoline additives that do little to decrease air pollution but are proven to foul drinking water supplies should *never* be mandated into our nation's fuel supply.

- Cut gasoline taxes. A "true" free market price would more accurately reflect conditions of supply and demand and provide markets that are much better suited to meet the nation's energy needs.

Each of these measures would permit oil markets in this country not only to work properly, but would also make the U.S. economy less vulnerable to periodic oil shocks due to overseas events. Such actions, of course, would take political courage. The environmental lobby is rich, powerful and is well connected with the mainstream news media. However, if these measures are not taken, the United States will remain hostage to OPEC as it has been these last three decades.

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.

ABOUT IRET

IRET was founded in 1977 as a 501(c)(3) public policy research organization dedicated to the belief that constructive, free-market economic policies are essential for the nation's economic progress. To this end, IRET conducts research and analysis of the economic effects of tax, budget, and regulatory public policy initiatives. IRET is a leader in offering guidance to policy makers regarding fundamental tax reform that would eliminate the bias against saving and investment in the current tax system, including elimination of the estate tax, taxation of capital gains, and the double taxation of corporate income. IRET is also researching ways to replace Social Security with personal saving for retirement.

IRET has a reputation as a no nonsense resource for policy makers and opinion leaders. IRET relies on contributions from individuals, foundations, and corporations to perform its work. It accepts no government funding. IRET is the leading public policy institute in Washington focusing realistically on the growth aspects and economic consequences of federal policy changes.

IRET's founder, Norman B. Ture, was a distinguished tax advisor to Congress and served as Under Secretary of the Treasury for Economic Affairs in the Reagan Administration. Dr. Ture played a central role in the development of the Economic Recovery Tax Act of 1981. IRET's current President and Executive Director is Stephen J. Entin. Mr. Entin was Deputy Assistant Secretary for Economic Policy at the Treasury Department in the Reagan Administration. He prepared economic forecasts for the President's budgets, and the development of the 1981 tax cuts, including the "tax indexing" provision that keeps tax rates from rising due to inflation. Mr. Entin represented the Treasury Department in the preparation of the Annual Reports of the Board of Trustees of the Social Security System, and conducted research into the long run outlook for the system. He advised the National Commission on Economic Growth and Tax Reform (the Kemp Commission), assisted in the drafting of the Commission's report, and was the author of several of its support documents.

Prior to joining Treasury, Mr. Entin was a staff economist with the Joint Economic Committee of the Congress, where he developed legislation for tax rate reduction (the Kemp-Roth bill) and incentives to encourage saving. Mr. Entin is a graduate of Dartmouth College and received his graduate training in economics at the University of Chicago, majoring in macroeconomics, monetary policy, and international economics.