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Blow-Out?

Predictions are always risky in the petroleum business; back in 1891, for example, the U.S. Geological Survey confidently asserted that there was no oil in Texas. What then can we make of the wildly varying claims about the consequences of the price-decontrol measures that will take effect on September 1, in the absence of a Congressional override of the President's legislative veto? Many Congressmen claim that the consequent price upsurge will rival the awesome destructive power of an oilfield blow-out. But *Wall Street Journal* editorialists and like-minded thinkers argue that little if anything will happen—and that whatever happens will be for the best anyway.

These skeptics argue that the only results of the present controls system are market distortions and a fast-growing bureaucracy, with the Federal Energy Administration alone hiring 3,000 employees and generating 3,200 pages of regulations in its first year of operation. On the other hand, defenders of the system point out that consumer motor-fuel prices have risen only 2½ percent since mid-1974, after a 39-percent jump over the preceding twelve-month period, and they thus claim that continued ceilings are necessary to keep prices under wraps.

At stake is the continued existence of the jerry-built structure of controls that was hastily thrown together at the time of the Arab

oil embargo, in an attempt to reconcile the apparently unrecconcilable goals of plentiful, cheap and secure oil supplies. The basic question concerns what will happen to the average price of oil when price ceilings are lifted on the 40 percent of the market represented by "old" oil, which is essentially the 1972 level of domestic production.

The impact

U.S. refiners process about 12.2 million barrels of crude a day at an estimated average cost of \$10.50 a barrel. That figure comprises 3.8 million b/d of imported crude at a landed cost of up to \$14.50 a barrel; 3.4 million b/d of uncontrolled domestic crude costing up to \$13 a barrel; and 5.0 million b/d of domestic (old) oil held under price controls at \$5.25 a barrel. Under the arithmetic of decontrol, all domestic oil ultimately would sell near the level of the landed cost of imported crude—minus \$2 after the removal of import fees. All crude oil might level out eventually at a refinery cost of roughly \$12 a barrel, or about \$1.50 higher than the refiners' present average cost. As refiners attempt to pass on their higher costs, the result could be an increase of perhaps 2 to 4 cents a gallon for oil products.

Most economists are now cranking into their forecasting models the impact not only of the \$1.50 (or greater) post-decontrol increase in refinery costs, but also the \$1.50 increase expected to be imposed

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by the OPEC cartel this fall. (Whether the cartel can make that price boost stick is problematical, considering that the recession has forced a greater reduction in Arab oil production than even the embargo caused.) The gloomiest forecast comes from Charles Schultze, former Director of the Budget, who argues that the price hikes will siphon \$38 billion out of consumer purchasing-power by late 1977—roughly equivalent to the “tax” imposed by the cartel’s 1973 actions.

A recent analysis by the Library of Congress concludes that, in the absence of offsetting fiscal and monetary policies, the price increases will reduce the rate of growth of real GNP by 4 percentage points by late 1977, and hold the unemployment rate near today’s high levels. Under the same assumptions, the consumer price index would rise initially at a rapid rate—at an 8-percent rate in the fourth quarter of this year, compared with a 5½-percent rate otherwise expected—and then begin to taper off. In all cases, the impact would be somewhat smaller with a prolonged period of decontrol, which helps explain the strong pressure in Congress for this type of solution.

The crucial point in all these analyses is the size of the increase in the average level of prices that

will follow decontrol and the next OPEC price action. Some iconoclasts argue that the average price will rise little if at all, and that the impact thus will be minimal. In this view, retail prices of refined products are restrained by the market, not by price controls. Because basic supply and demand conditions would remain unchanged between August 31 and September 1, consumer prices would thus be unaffected by the shift from control to decontrol.

The causes

While waiting for the numbers to fall into place, we should pay some heed to the underlying causes of the present crisis, to help determine if there is a way to obtain cheap, abundant and secure oil supplies. Between 1970 and 1974, U.S. production declined from 9.6 to 8.7 million b/d, while consumption rose from about 14 to 17 million b/d. Consequently, we are now dependent on foreign sources for 40 percent of our daily needs, and the cost of this oil has skyrocketed from \$2.3 billion in 1970 to \$23.6 billion in 1974.

The crisis has been characterized by a very abrupt change in energy prices in the world market. As late as mid-1973, the American consumer was paying about 25 percent less for energy than in 1950, in real terms, as a result of a prolonged—and accelerating—downward trend in prices. Prices fell in the 1950’s and ’60s primari-

ly because competition in the world oil market drove crude prices down toward the cost of production. Prices then shot up in 1973 largely because the OPEC cartel was able to offset the forces of competition.

The mistakes

Herbert Stein, former chairman of the Council of Economic Advisers, argues that the situation was aggravated by public-policy mistakes, in giving the wrong signals to the private energy system. In testimony to the Senate Interior Committee, he noted that public policy in the late 1960s and early 1970s gave more emphasis to cheap energy than to secure energy. By reducing restraints on imports, and later by putting ceilings on domestic energy prices, the Government gave the signal that more foreign oil was desired—and the private sector delivered. But the OPEC cartel then forced a change in signals, with greater emphasis on secure domestic sources. But “public policy, notably price controls, muffled that signal and so deterred the response.”

Basically, Stein argues, a price ceiling on domestically produced oil is contradictory to the new policy emphasis on secure energy, with price controls actually subsidizing imported oil. Since all crude oil sells at the average of higher-priced uncontrolled and lower-priced controlled oil, the imported oil sells at a price which

is lower than what the importer paid for it—the difference being made up by the relatively low price of controlled “old” oil. This makes the American consumer willing to buy more imported oil than he would if he had to pay the full price. It also enables the OPEC cartel to sell more at its established price than if the U.S. domestic price were uncontrolled, and thus helps to support the high OPEC price level. Thus, Stein says, “In our zeal to insure that domestic sellers do not get ‘too much’ for their oil, we are assisting foreign sellers in getting even more.”

The national dilemma—cheap oil or secure oil—is bound to continue. Several recent studies suggest that U.S. imports would decline to about half their current level if the present high price structure is maintained throughout the next decade. However, many experts believe that current world prices cannot be maintained. If prices fall, domestic energy costs will be lower, but imports will rise and the goal of secure supplies will be threatened. This would seem to call for a policy of stockpiling oil—a goal which Congress and the Administration apparently agree upon—and perhaps also a policy of tariffs or other import curbs. Meanwhile, the pressure grows for domestic decontrol—if not on September 1, at least within a definite time limit.

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