



Politically Correct Energy Strategy: another policy disaster in the making?

In November, when the price of crude oil on the January futures market dipped below \$50/bbl, it occurred to me to advocate a change in our national energy policy once again. This time, more particularly, a tax policy as it applies to crude oil and petroleum products. My bottom line was to get the government to be after January 20, 2009 to use its rhetoric creatively and begin a national security tax on petroleum products. As Rogers and Hammerstein put it, I must be a “cockeyed optimist.”

I was not optimistic enough to think that esteemed journals of national opinion would want to hear common sense. That only works if you are already an elected politician, an evidently successful financial genius or a Nobel Laureate, or that you have a dear friend at the Editorial Desk of such Journals of Opinion. My well placed media friends tell me I am much too kind over the selection process applying to submitted opinions. Their view of what it takes to advance opinion in the public marketplace for ideas is more aptly termed, “paying for the privilege.” In any event, forgetting about what it takes to appear in print as an advocate of sensible energy policies, I will put down a few, seemingly obvious, comments about what the New Administration should do. I have few hopes that they will do this, because when it comes to Energy, political correctness trumps economic logic. I fear that the Government we get after January 20th will prove no exception.

Last week crude oil went down to the low 40's. There is every reason to believe we will see a 3 handle on crude prices sometime in the near, near future. The logic of a world wide recession that could cause a decline in world GDP growth of 1% or more threatens oil producers on two fronts. First, a *simplistic* analysis that postulates a 1% income elasticity of demand suggests a true decline in world oil demand. Second, as we know, short run reactions in the crude oil market are often counter-intuitive. Oil demand seems to surge even when prices surge because a boom or a bubble seems to dwarf common sense. And, it does so, largely because it triggers expectation shifts by the consuming public that suggest that economic Nirvana is just around the corner. We observe similar results on the down side, the more so when much talk of financial Armageddon abounds. With personal incomes eroding and financial wealth being obliterated, consumers suddenly stop driving and apparently use roller skates. Actual oil demand plummets, **in spite of the fact that prices are falling.**

Economists model comparative statics very well, but have grave difficulties with behavioral shifts of striking magnitude. One day we will have a testable model of the “madness of crowds,” but perhaps not in my lifetime. The facts, murky though they may be at this time, seem to show a whopping decline in the demand for crude and a resulting massive increase in **excess capacity**. There are lots of econometric tidbits that suggest **excess capacity to produce crude** is a nice variable to keep one's eye on. I think that is a bit of a fallacy, because excess capacity is not precisely a behavioral variable. It is an **outcome** of shifts in demand, and over the longer term, shifts in supply. As we know, however, supply shifts take a very long time to show up, maybe 10 or more years. Anyway, the result of an observed rise in excess capacity puts lots of pressure on oil producers, resulting in a kind of “backward bending supply curve for crude because of budgetary and/or rent-sharing reasons. If you have lots of royal princes supping at the crude oil cash register or corrupt generals running oil states whose loyalty to your regime is a bought and paid for commodity, falling oil prices and constant output mean lots of complaints. Instead of moving down a normal, upwardly slopped supply curve, as market prices fall, we are more likely to get increased output in the short run. The budgetary or pocket lining demands swamp the impact of producing marginal oil fields at a loss.

If you combine the expectation shifts on demand and the revenue-need driven supply effects, net available oil shrinks when prices are going up and rises (or at least does not fall) when prices fall, at least in the short run.. OPEC's dilemma as the manager of excess supply gets more formidable. Add some geopolitical assumptions

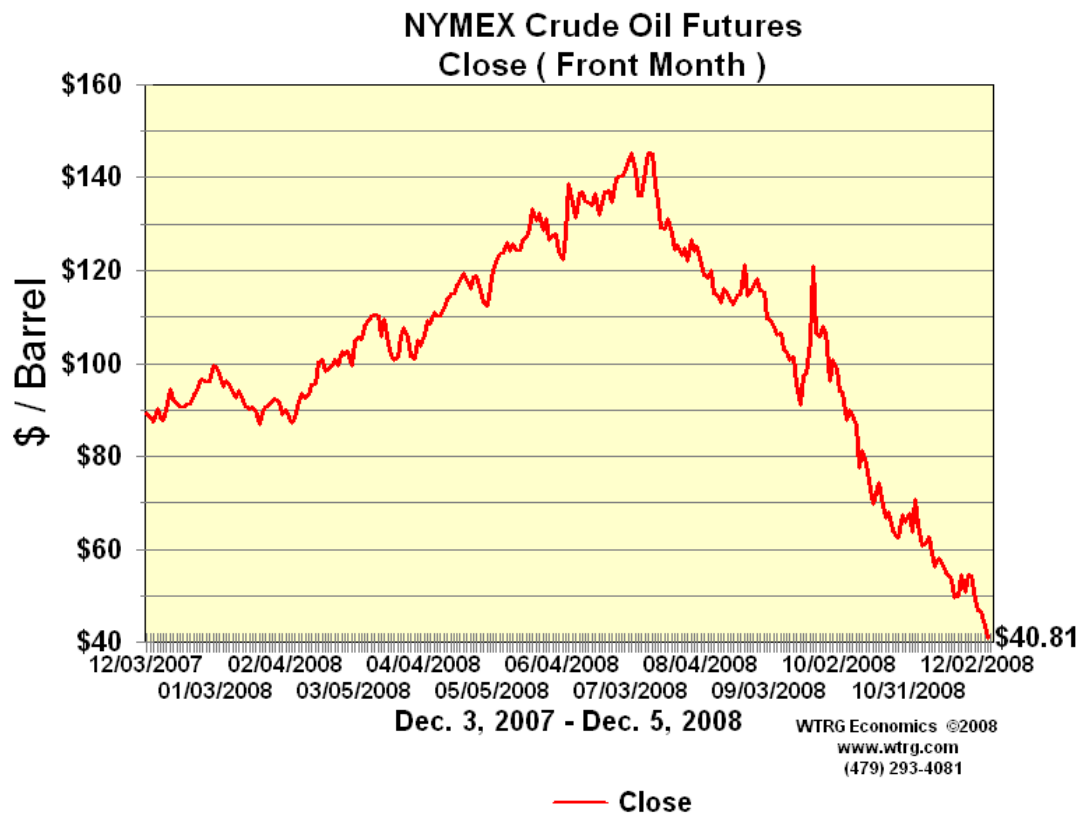


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and you might just see a rupture in OPEC's seemingly stolid management of the oil cartel. Indeed, we may be seeing that now.

All of this is surely known in upper policy circles in both the *ancien régime* and the hopeful forces of the **politicians of change** soon to take office. The former used to put oil into the SPR even when the price of oil soared near \$100 a barrel (as if the budgetary impulses of crude suppliers were inverse to our own). The latter have their eyes on **2030** and the 'predicted' CO₂ that will confront our children and grandchildren. They are driven to reward many efforts to promote non-carbon based energy, seemingly, to hear them pontificate, without much concern for the unit costs of the energy produced to this standard. Carbon based energy in the New Administration is a strictly non-kosher diet.

Common sense, however, would suggest that if the future threat of a crude oil interrupt is even slightly probable, maybe this is the time to be **filling up our SPR** with much cheaper stuff. All on the assumption that electric cars don't clutter the highway in 2010 after the Congress straightens out Detroit. Sadly, this is not an age where the economics of the public's tax payers is revered.¹



Buying oil for the SPR when it is cheap, cheap because of a world wide recession, is a policy that is likely to be thrown under the bus. Better off to waste money on producing gas guzzlers from effectively bankrupt

¹ Courtesy of James Williams, WTRG Energy Economics, <http://www.wtrg.com/daily/crudeoilprice.html>



American motor companies or setting up a selective bureau for the enhancement of non-carbon energy production twenty years out.

Is it skepticism to think that selecting the right technologies will be difficult? It may be the case that by paying lower compensation than is paid by energy companies in their search for new technologies will attract really capable diviners of technology and materials science. I guess it is possible that ideals can combine with talent in the new Washington and the Energy Department will be populated with bureaucrats of uncommon wisdom and prophetic abilities. If so, they will be able to use public's money's to reward all those wonderful ideas for non-carbon energy production that can't get to market because of the narrow-mindedness of capitalist financiers (if any such are left).

For those of us who might be skeptical of such a turn around in the ability of Washington to pick winners, there is at least a short run possibility to improve our energy security. At today's market price, a billion dollars would buy the SPR close to 24 million barrels of oil. Since no one in Washington takes a billion dollars seriously anymore, let's multiply up to get into contemporary budget space. If we could spend 10 Billion dollars on oil, maybe we wind up with 240 million barrels of oil. (I am ignoring the impact of such a bountiful addition to world demand on the crude oil price and the joy it will create in a nuclear bent Iran or a Venezuela trying to tweak our nose with new Russian weaponry). Perhaps a more realistic goal would be to latch on to 250 million barrels of oil at the tidy, but no overly large, sum of 12.5 billion dollars. That is considerably less than what is now proposed to prop up the Detroit Dinosaurs.

Of course, it would also be helpful to continue to constrain U.S. demand for petroleum products which is likely to expand if the price of crude stays below \$50/barrel. The shock effect of \$100 plus crude oil will wear off over the months, the more so if we are able to get out of our current economic malaise. In the meantime, with premium gasoline under \$2.30 per gallon, driving Junior to school in the 300 plus horsepower SUV or a jaunt to the sales at the electronic discounters will become more prevalent and the demand for gasoline will rise. It might be as Keynes once said, "In the long run, you're dead." But, it also just might be true that in the short run we forget basic truths very quickly. To jog our memories, the imposition of a new National Security tax at the pump that is scheduled to rise without relief over the next decade or two, would be more than helpful. If I am allowed to fantasize about cheap crude getting into our SPR, why not let me go all the way and hope that the New Government can use market based economics to restrain oil demand going forward. A cockeyed optimist indeed!

Of course, all of this is a political fantasy. No one in the New Washington of political correctness and change is likely to think that an extra 250 million barrels in the SPR could help in a security emergency, and even less likely is the thought that bringing the SPR up to a trillion barrels of oil could work as an inventory overhang to restrain rising oil prices in the future. Fear not! Our current consumption of petroleum is under 20 million barrels per day with imports of petroleum in various forms around 12 million barrels per day (I am ignoring the issue of converting crude to products for simplicity sake). Adding 250 million barrels of crude for 12 billion bucks seems to me like a cheap way to buy some short run energy security while the clever new bureaucrats of change figure out just which bright new energy innovation to massively subsidize. If I believed in Santa Claus, I could make this the top item on my wish list.

While Santa Claus might still be politically correct, buying crude oil in a down market isn't. And adding an intelligent, well thought out plan to reduce our dependency on crude oil, particularly from geopolitically unsafe regions is not either. Sadly, Santa is not likely to shimmy down my chimney decorated with hopes for real



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energy policy change.²

² See MAS112908, "A Time to Change Our Oil Policy," www.ecomentary.com