

BY IRWIN STELZER

There is a shortage of electricity in California. There is a shortage of natural gas in New England. There is a shortage of crude oil, worldwide. So, are environmentalists, who have been predicting that profligate use of energy will cause us to run out of fossil fuels, finally being proved correct? Should we now heed their pleas to substitute the long arm of government for Adam Smith's invisible hand as the determinant of who uses energy, and how much?

Hardly. What we are witnessing is not the failure of free markets to balance the supply and demand of energy, but the consequences of some quite natural, transitory economic forces and impediments to competition. In all energy markets – even those allowed to operate without artificial constraints on supply – there is an inevitable lag in adding to our usable resources. Gas fields can't be mapped out and tapped the moment economic growth produces an increase in the demand; neither can oil reserves. And power plants, even small ones, can't be sited and built the day that the thermometer leads everyone to turn the air conditioner knob to max.

If such lags entirely explained the current problem, the proper policy would be the one Ronald Reagan allegedly promoted with great success – “Don't just do something, stand there.” But unfortunately, they are not the only (or even the principal) reason energy policy is once again on the front burner. The

proximate cause for renewed interest is that energy prices are rising at a rate that consumers, and therefore the politicians who seek their favor, find unpleasant. Crude oil has gone from \$10 a barrel to approximately \$30, causing a hike in gasoline prices that adds 50 cents a gallon to increases recently generated by new regulations from the Environmental Protection Agency. Natural gas prices recently hit levels three times those prevailing last year, causing much pain as the winter heating season blows in. Electricity prices in California have soared to levels that prompted renewed calls for caps on what the power utilities may charge end-users for the pricey juice they are buying in the wholesale market.

But prices are a symptom, no more a cause than fever is the cause of the flu. The problem is that “powerful forces,” to borrow a term from Al Gore, are at work to prevent markets from working as competitive markets can and should. Those powerful forces are us – or the politicians we elected to make energy policy, domestic and foreign.

Start with electricity prices in California, a state that faces power shortages in the low-use

IRWIN STELZER is a senior fellow at the Hudson Institute in Washington and a columnist for *The Sunday Times* (London).



winter season and will possibly see rolling blackouts next summer. The problem is a lot less complex than meets the eye. The architects of the California electricity market that replaced the traditional regulatory regime designed a Rube Goldberg contraption that had not the slightest chance of functioning anything like a competitive market that relies on price to balance demand and supply.

The designers began by making certain that most consumers would remain ignorant of what they are paying for the electricity they are currently consuming. They also erected effective barriers to new entrants and prevented free dealing by sellers and buyers,

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requiring them instead to filter their offers through a central agency. They prevented wholesale electricity buyers and sellers from hedging or negotiating long-term contracts. They blocked the construction of new generating capacity. And their fellow policymakers demanded that one important supplier of hydropower put the welfare of young salmon in the north over the needs of aged humans in the south.

Having designed this wondrous machine, the policy gurus now profess surprise that a system thus constructed produces peculiar results. In fact, it is a textbook case of the consequences of keeping consumers ignorant of

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rising costs while simultaneously restricting supply artificially in the teeth of rising demand. And make no mistake: the constituency in California in favor of continuing to impede the construction of new power plants extends well beyond those who place environmental considerations above all other values. For example:

- Cisco Systems, an omnivorous consumer of electricity both directly and through the products it sells, is leading the opposition to new generating capacity located near its headquarters.
- To placate consumers, the governor would impose price ceilings that would lead several prospective entrants to cancel their plans to supply electricity to California.
- The state's citizens overwhelmingly voted for presidential candidates (Al Gore and Ralph Nader) who oppose the construction of new power plants.

He who sows the wind shall inherit the windmill, rather than more economic sources of much-needed generating capacity.

The electricity miasma can only be cleared if politicians are willing to add a liberal dose of laissez-faire to the policy mix. And thus far, they have shown no inclination to do so, preferring to move toward a state-organized cartel in which administrators fix prices.

Which brings us to the oil market, where a more muscular version of the invisible hand would go a long way toward protecting consumers and the world economy from a government cartel that sets prices. It is difficult to overstate the importance of the problem created for America by the revival of OPEC.

The ability of the producers to subvert markets by constraining output threatens the ability of the consuming nations to sustain both economic growth and stable prices. Equally dismaying, the oil cartel undermines

America's ability to conduct an effective foreign policy. Even policymakers bolder than the Clintonauts cannot help feeling constrained by our economic dependence on volatile nations in the Middle East and, lately, in Latin America. In short, we are facing an economic and foreign policy challenge from a cartel that has found new cohesion and that is keeping the price of crude oil many times above the cost of finding, developing and producing new supplies. It is able to do this because of a coincidence of several events.

- The long-running American economic expansion came with a modest recovery in the economies of Europe and resumed economic growth in Asia, pushing up the demand for oil at unexpected rates.
- Embargoes on oil from Iran, Libya and Iraq have reduced world supplies.
- The pressures unleashed by \$10-a-barrel oil brought the Middle Eastern and other producing nations together as mere appeals to unity could never have done.
- Mexico decided that it could persuade Saudi Arabia and Venezuela to cut back production by promising not to fill the gap such cutbacks would create in the United States. Mexico, in effect, joined OPEC.
- Venezuela came under the control of an anti-American populist determined to change the distribution of the world's income in favor of developing nations.
- American policymakers, in pursuit of environmental objectives, decided not to develop the nation's own oil resources to their fullest, to make it somewhere between difficult and impossible to build new oil-processing facilities, and to make the use of coal increasingly difficult and expensive.

One plausible response would be to do nothing. After all, cartels have a history of tanking when members are tempted to cheat on their quotas or when high prices attract



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nonmembers into the industry. But the newfound cohesiveness of OPEC, and the rapacity it has recently exhibited, create two problems for such a passive strategy:

- While waiting for the cartel to collapse, American consumers would pay a very substantial toll in the form of slower growth and higher inflation.
- Although there remain substantial undiscovered reserves of oil in non-OPEC areas, it is not safe to rely on new entrants to drive down prices while incumbents sit on vast low-cost reserves. Potential newcomers to the oil game are well aware that, should

their exploration activities threaten the cartel, it can open its valves and make their projects uneconomic. That doesn't mean drillers are completely insensitive to higher prices, but it does suggest that they will respond more slowly to oil price run-ups than they would if the threat of OPEC retaliation did not loom over their spreadsheets.

So, too, with developers of alternatives to oil-using technologies. They have long complained that it is difficult to get financial backing because potential investors know that the cartel can always force down oil prices and transform promising alternative technologies

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into money losers. Which is one reason, when prices soared above \$30, that the Saudis began very publicly contemplating increasing output sufficiently to bring prices down to \$25.

The Saudis, with almost 100 years of proved reserves, will do what it takes to discourage investors in new technologies from seizing their markets. Although the development of alternatives to oil as an automotive fuel are likely to continue – ironically, California regulators remain determined to force drivers to shift from gasoline to scarcer electricity – these and other oil-conserving technologies face an uphill battle in the teeth of OPEC's ability to change the economics of these alternatives from attractive to dismal.

Passivity is thus not an appropriate policy. One alternative is to rely on the domestic Strategic Petroleum Reserve as a counter to OPEC. But history suggests two reasons why efforts to use the SPR to keep prices closer to competitive levels will not work.

First, the private sector is likely to reduce its own inventories in parallel with the government's additions to the SPR. Private companies hold inventories for a variety of reasons: to protect customers in the event of a supply interruption, to ensure the steady operation of refineries, and to profit from price spikes during periods of increased demand. But if the government stands ready to be the supplier of last resort, the incentive to incur the costs of excess inventory is reduced. Which seems to have been what happened in the 1980s, when the growth of strategic stockpiles in the major oil-consuming countries was fully offset by declines in private inventories.

Second, strategic reserves are difficult to manage. We have pumped some 570 million barrels into storage – a few months' worth of imports – but have never quite figured out

how to use it. Recently, Washington released a few barrels, only to find that it did not know how to conduct an auction, and that OPEC could credibly threaten to reduce its output barrel-for-barrel to match the drawdown.

Policy makers, from the President on down to officials at the Department of Energy, have held that the reserve is to be used only when storage tanks are empty, gasoline stations are closed, and residents of the Northeast are reduced to heating with wood-burning stoves. The reserve remained untouched even during the Gulf War because the wise men advising Bush the Elder decided that the doubling of oil prices did not constitute an emergency.

If doing nothing is too costly, if relying on the SPR would represent the triumph of hope over experience, and if past government interventions in energy markets have proved a colossal waste of resources, what can be done? We could design a policy aimed at making oil markets work better – a policy that does not rely on rationing on the demand side or subsidies on the supply side.

On the demand side, that means making the prices reflect all of the costs (private and social) associated with use. On the supply side, a market-oriented energy policy must seek to eliminate or, if that is impossible, counteract artificial constraints on the ability and willingness of suppliers to respond to price signals.

Consider the latter first.

We might begin by re-examining policies that make private oil storage expensive and restrict both domestic exploration and production. It might have made sense to ban offshore drilling and Arctic exploration when oil was selling for \$10 a barrel, and the value of the potential output was arguably below the environmental costs associated with the development of resources on the fragile tun-



dra. But the calculus may not hold when potential output is valued at \$30 a barrel. Although calculations showing that the environmental costs of opening now-restricted areas are exceeded by the benefits of increased domestic production are unlikely to persuade the greenest of our greens, a newly staffed Environmental Protection Agency might well find such arithmetic persuasive. It's worth noting, too, that the Department of Energy recently trebled its estimate of recoverable oil reserves along the coast of Alaska's National Wildlife refuge to 10.3 billion barrels, which would represent an addition of at least one-third to America's oil reserves.

The next step to enhance supply would be to mount a credible attack on OPEC's output constraints. This would begin by recognizing that Mexico is a key player in the recent trebling of oil prices, and taking steps to per-

suaire our southern neighbor that such behavior is not in its long-term interest. Although not a member of OPEC, Mexico proudly announced that it had brokered the deal between Venezuela and Saudi Arabia that limited output and triggered the price rise. This deal, in which Mexico agreed to rein in sales to the United States, cleared the way for OPEC's agreement to close its valves.

Why is the American government, which bailed out the Mexican economy when the peso collapsed and has bestowed the benefits of the North American Free Trade Agreement on Mexico, reluctant to read the riot act to President Vicente Fox? It is true that the benefits of Nafta are not Mexico's alone; American consumers gain from the international division of labor. But sometimes policy trade-offs must be made. And it would seem that the first step to bringing the price of oil closer to

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free-market levels might well be to explain to the Mexicans that they cannot hope to sell the output of their *maquiladoras* to us unless they also offer us oil at competitive prices.

A similar effort to induce an increase in supplies might be applied to Kuwait, a nation on which Saddam Hussein still has designs.

the world's oil reserves (with 3 percent, 10 percent and 10 percent, respectively). Reasons for pressing our balky allies to continue the embargo against Iraq remain as strong as ever. But relaxing the embargo against Iran just might prove justified if a deal could be struck with that increasingly hard-pressed country. After years of underfunding, Iran's

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Kuwait possesses about 10 percent of the world's proved reserves of oil, but accounts for just 3 percent of world output. It is one of the few OPEC members with large amounts of spare production capacity, giving it the ability to turn on the taps on short notice. Put another way, the country that we saved from destruction while its ruling family waited out the war at the Dorchester in London could produce oil at current levels for well over a century without discovering another barrel. We might even consider establishing a policy that relates our contribution to Kuwait's defense to the level of oil output set by the Kuwaiti royal family.

Again, we face a trade-off. If we threaten to abandon the Kuwaitis, we threaten ourselves with the loss of the country's oil. But the consequences to us would be some inconvenience; the consequences to the Kuwaitis would be annihilation. Guess who would blink first.

Another plank of a sensible supply-enhancing energy policy would involve a review of our economic sanctions. Libya, Iran and Iraq account for almost one-quarter of

oil industry is badly in need of investment simply to maintain its production capacity. It is in our interest as well as Iran's to increase the country's reserves and its capacity to pump them – but only if Iran agrees to lift of the ban on American oil company investment and to step up output sufficiently to bring world oil prices closer to the marginal cost of development.

Then there are our antitrust laws, statutes from which the Arab and other oil producers have been uniquely exempt for political reasons. There is little doubt the laws could be used to prosecute the cartel members. After all, the Department of Justice has successfully brought actions against German, Japanese and French cartels in products as diverse as citric acid, vitamins, fax paper and the amino acid lysine. In most of these cases the cartelists had no offices in America; they merely sold products here. Indeed, in the case of fax paper, the United States Court of Appeals for the First Circuit has upheld the Antitrust Division's suit against Nippon Paper, a company that did not sell directly to the United States but fixed the prices of those who did.

American law grants foreign sovereigns immunity from antitrust prosecution, and grants similar immunity to companies acting under the compulsion of foreign sovereigns. But that law is no real barrier to prosecution if there is a will to move against OPEC. For one thing, the so-called commercial-activity exemption allows the Justice Department to proceed if it decides that the sovereign governments are engaged merely in commercial activity, like selling oil, which OPEC euphemistically contends is a matter of the preservation of national patrimony, not just commerce. For another, the exemption could be repealed.

Such a move would permit the trust-busters to take action against the Saudis and other producing countries, all of which have substantial assets in America that could be attached to satisfy legitimate claims. But a variety of political considerations has prompted the State Department to stay the Antitrust Division's hand – though what we have gotten in return from countries that persist in conspiring to elevate the level of world oil prices is difficult to discern.

Finally, consider the demand side of the oil equation. The first step would be to make certain that the prices consumers pay for oil reflect the marginal cost they are imposing on society by virtue of their consumption. If market prices do not reflect the full cost of use, measures might include increased taxes on oil, with the proceeds used to reduce marginal income tax rates and other initiative-stifling taxes. If it is indeed the case that oil embargoes or cartel-induced price run-ups threaten dire macroeconomic consequences, the risk and cost of such events should be reflected in the price of gasoline and other petroleum products.

Richard Berner, chief United States economist at Morgan Stanley Dean Witter, esti-

mates that every \$5 increase in the price of a barrel of oil knocks 0.3 percentage points off the GDP. That suggests that the recent run-up will cost us something like \$80 billion, and, according to Mark Zandi of Economy.Com, will add one percentage point to the inflation rate. This may not be a problem when the economy is booming, but in the less-pleasant economic circumstances that many predict await us this year, the loss of \$80 billion would have quite noticeable consequences.

Besides, if we chose higher oil prices as the means of slowing an overheating economy, it would be far wiser to raise taxes on oil (and, I repeat, keep those funds from spendthrift politicians by reducing other taxes in parallel) rather than to allow OPEC to do the equivalent by raising prices. Better the money flow to our Treasury for recycling than to have it finance terrorist groups or the construction of more Middle Eastern palaces, or be spent on efforts to keep Saudi Arabia's fragile commonweal in one piece. We could also determine whether demand-side measures that were uneconomic when oil was at \$10 a barrel are worth pursuing when prices are two or three times that level. Keep in mind, though, that if we get the price of oil right – including all costs associated with its use – there is little rationale for further government action.

It should be emphasized that none of the components of the market-oriented energy policy I have described involve price controls or subsidies to producers of oil or alternative technologies. Such policies have failed in the past, and would be virtually certain to fail in the future. But a program to introduce more competition by weakening the cartel, to enhance supply by insisting on reciprocal decency by our allies and trade partners, and to adjust environmental and tax policies to the new reality of the increased cohesiveness of OPEC, could make a big difference. **M**