The Heritage Foundation Backgrounder

No. 103 | The Heritage Foundation 214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202) 546-4400

November 1, 1979

ENERGY UPDATE

INTRODUCTION

On April 20, 1977, President Carter first addressed the nation on the subject of energy. In his speech, he characterized the energy crisis as the "moral equivalent of war." The day following his talk, he sent to Congress a comprehensive package of legislation which he asserted would solve the problem. The first National Energy Plan (NEP I) was an amalgam of taxes, subsidies and regulations aimed at forcing a reduction in the domestic consumption of imported oil. The "centerpiece" of NEP I was the so-called Crude Oil Equalization Tax, a heavy tariff on domestically produced oil. The tax, abbreviated COET, was to finance a huge transfer payment program, intended to ease the impact of higher oil prices on the consumer.

After passing the House of Representatives in record time (and virtually intact), the Carter program ran into stiff opposition in the Senate. Having had more time to scrutinize the plan, senators raised doubts as to the wisdom of retaining price controls on domestic oil production, and imposing such a severe tax burden on a public already incensed at the level of taxation. As it became clear that the Senate would not pass the Crude Oil Equalization Tax, the Administration shifted its emphasis, proclaiming the Natural Gas Provisions of NEP I to be the plan's centerpiece. Again opposition surfaced.

As originally proposed, the natural gas-related elements of the Carter program would extend price controls to the intrastate market, which previously had not been subject to federal regulation, while providing few price incentives to spur additional production. As a result, while the House of Representatives had passed the Carter initiatives in their original form, the Senate enacted legislation which simply de-controlled the price of domestically produced natural gas. Following these actions, a

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

seemingly endless series of conference committee meetings between the two Houses of Congress began. Once again, the Administration found that its centerpiece was failing, and so once again the emphasis was shifted. With great fanfare it was announced that the centerpiece of NEP I was now coal conversion.

As might be expected, the coal conversion elements of the Carter program again experienced opposition from the upper chamber. As originally proposed, they would have forced a widespread conversion of industrial and utility boilers from burning oil and natural gas to burning coal, and would have required the addition of highly expensive pollution control devices when the conversions took place. As finally agreed upon by the conferees, the legislation enacted essentially required conversion for those industrial and utility boilers which would have converted to coal anyway.

Other elements of the first National Energy Plan were rejected out of hand, including a tax on fuel inefficient vehicles, which was coupled with a subsidy for fuel efficient ones, a sharp increase in the gasoline tax, indexed to domestic gasoline consumption, and a proposal to prohibit the granting of FHA or VA home financing to houses which had not had extensive retrofitting of energy conservation improvements.

Although there were some elements of the first National Energy Plan which were adopted, including the extension of federal controls to the intrastate natural gas market, what was finally enacted was a mere shadow of the President's original proposal. One of the key reasons for this was the lack of attention to the stimulation of domestic production of energy. While many Members of Congress might have been willing to go along with some of the demand-oriented parts of the program, they were disturbed by the total lack of consideration for the supply side. These congressional critics felt that no plan could make a reasonable claim to comprehensiveness and at the same time look only at half of the supply/demand equation.

As the debate in the Congress continued, the initial sense of urgency instilled by the President's April 20th address began to abate. Other more pressing and controversial questions surfaced and came to the forefront of the legislative arena. The energy crisis was, for the moment, relegated to the back burner. Events, however, were soon to change this situation.

During the latter part of 1978, the political situation in Iran became increasingly unstable. Militant workers protesting the regime of the Shah struck, interrupting the flow of oil from that nation. As the effects of the shutdown began to manifest themselves in lines at our nation's service stations, awareness of dangers inherent in our heavy dependence on imported oil once again permeated the public consciousness. While the lines were to a large degree the result of the misfunctioning of the price and allocation controls on motor gasoline, their message was clear: we could not continue to rely on constraining demand to solve our energy dilemma.

On the evening of July 15, 1979, President Carter again addressed the nation on the topic of energy, and again used his speech as a vehicle through which to introduce a comprehensive plan to deal with the energy crisis. As was the case more than two years earlier, the speech had its moments of high drama: this time when the President asserted that we would never again "import one drop more" of foreign oil than we do at present. This time, the "centerpiece" of the President's program (dubbed NEP 3½ by one wag) was a massive federal program aimed at creating a domestic capability to produce 2½ million barrels per day of synthetic fuels from coal and oil shale by 1990. The program was to be financed from the receipts of a "windfall profits" tax on recently decontrolled domestic crude oil, and administered by a quasi-governmental "Energy Security Corporation." Also included in the program were import quotas for foreign oil and a number of programs already working their way through the legislative process.

Unlike the first National Energy Plan, which was strongly supported in the House of Representatives and did not meet with strong opposition until reaching the Senate, the latest Carter initiative met with opposition from both Houses of Congress virtually from the moment it was introduced. The price tag, an estimated $146 billion, was seen by many Members as totally unreasonable at a time during which the public was expressing increasing concern over excessive government spending. Environmentalists, led by House Interior Committee Chairman Morris Udall (D-Ariz.) opposed provisions aimed at expediting the construction of energy facilities, fearing that they would lead to a wholesale abandonment of environmental concerns. Others in the House, notably Rep. John Dingell (D-Mich.) feared that the same provisions did not go far enough, and would only result in an acceleration of negative decisions. By far the greatest concern, however, was not so much with the actual substance of the legislation as with the precedent it created.

In this latest set of proposals, the President was suggesting the most sweeping federal usurpation of the marketplace to occur in the history of the nation. Taken individually, many of the President's proposals appear to have surface merit. When a more detailed analysis is made, though, and all of the various elements of the program are viewed as a whole, a very different picture emerges. Through various means, the President's program would result in federal control of more than half of our nation's oil supplies by the year 1990. Moreover, were the price and allocation controls extended as well, as some Members of Congress are advocating, the federal takeover would be virtually total. Given the experience with quasi-governmental corporations such as Amtrak and the Postal Service, the wisdom of a federal takeover of energy production must certainly raise questions in some minds. To understand fully the pervasive government involvement which would necessarily accompany the latest White House energy program, it is necessary to take a close look at some of its key components, and how they would function, and at the issues which surround them.

THE ENERGY MOBILIZATION BOARD

Perhaps the single most serious question related to this element of the Carter package is whether or not the Board will have the power of substantive waiver. Substantive waiver is the power to exempt projects from state and local laws and ordinances if it is determined that such statutes would prevent the construction of a facility given a priority rating by the Board. These could range from local zoning ordinances to state environmental laws and regulations. As originally proposed, the Carter program was not clear as to whether or not such power would be granted to the Board. It was merely stated that the Emergency Mobilization Board would have the power to "cut through the red tape." Some interpreted this to mean that the Board could make a decision for a state or local agency if that agency did not meet a deadline, but would have to do so within the framework of the existing law, while others interpreted it to mean that the Board would have the power to exempt such projects from certain requirements under those laws. An example might be the ability to waive the requirement to perform a state environmental impact statement.

This issue was particularly thorny for conservatives, as there were significant states' rights questions involved. On the one hand, most conservative Members believed that there was altogether too much federal interference in the energy industry, and were therefore anxious to support any measure which would reduce this regulatory burden. On the other hand, many also saw the powers granted to the Board as yet another federal encroachment on the powers rightfully vested in the states. More importantly, though, to many conservatives, the very fact that such a Board would be thought necessary was merely an indication of the real problem, the extremely restrictive standards written into many environmental laws. To a significant degree, the creation of an Energy Mobilization Board was seen as a means of begging the real question: whether the standards currently in force under the provisions of such legislation as the Clean Air Act and Clean Water Act are realistic, or even attainable.

A second area of concern, especially in western states, was the premption of water rights. Synthetic fuel plants would require relatively large amounts of water, an increasingly precious commodity in the West. Westerners feared that the Energy Mobilization Board might seize water rights needed by farmers and ranchers for use by synthetic fuel plants.

The result of these varied concerns was that an unusual coalition of western governors, environmentalists, and some conservative Members developed to oppose the concept. At present, there remains a standoff within the House of Representatives over the question, with John Dingell sponsoring legislation which would create an Energy Mobilization Board with the power of substantive waiver, and Morris Udall sponsoring one which would not. The Senate passed a version of the measure which is thought to strike a middle ground between the two positions, but as both

sides are relatively adamant in their beliefs, little hope is seen for a compromise at this time.

THE ENERGY SECURITY CORPORATION

Perhaps the most controversial of all of the elements of the latest National Energy Plan is the creation of a quasi-governmental Energy Security Corporation. One of the key concerns lies in the fact that the Chairman of the Board of the ESC, as it is called, would have the power to construct synthetic fuel plants owned and operated exclusively by the federal government. The language of the proposal as submitted to the Congress indicated that the number of these facilities to be built would be determined at the sole discretion of the Chairman. The only requirement was that he determine that private capital would not be forthcoming to accomplish the task. The effect of this would be to put the government in direct competition with private industry. Since the government has no responsibilty to stockholders, nor need to make a profit, the potential for bureaucratic abuse inherent in such a situation is considerable.

A second criticism of the Energy Security Corporation was that by determining which projects to fund, or grant subsidized loans, the corporation would be giving a preferred market position to some technologies at the expense of others. Since there would be an absolute limit on the number of plants the corporation could build, given the funds available, it would, in effect, be directing energy capital markets towards a limited number of options. Since there are considerable lead times involved in even the most expedited construction of facilities on the scale contemplated under the President's program, the net effect of such subsidies might be to encourage less efficient technologies at the expense of more efficient ones.

A final criticism lies in the fact that the corporation would be funded by the "windfall profits" tax on domestic crude oil. Using this source of revenue to fund projects of this nature has a certain irony, as the synthetic fuels produced would be in direct competition with the petroleum which was the source of the revenue which built the plants producing it. In effect, the oil industry would be taxed in order to finance its competition. Many critics feel that there is a basic inequity in a situation such as this. More importantly, such a tax would serve to divert finds for domestic exploration and development of oil to other uses, thereby limiting the ability to maximize domestic production.

THE WINDFALL PROFITS TAX

This windfall profits tax would apply to the incremental increase in revenues resulting from the decontrol of domestic crude. At present, there is considerable disagreement between

the House and Senate as to the exact tax rate to apply, what tax credits if any should be allowed, and exactly which categories of oil should be subject to the tax.

Over and above the argument that to impose such a tax would reduce the amount of capital available for exploration and development of domestic oil is the basic question of the potential which exists for diversion of these revenues to non energy-related areas. Proposals have already surfaced suggesting that the revenues accruing from the windfall profits tax be used to reduce the Social Security Tax, reduce the federal debt, and simply be added to the general fund of the Treasury. Obviously, such diversion would seriously hamper the ability to attain necessary national energy goals.

To many observers, the concept behind the windfall profits tax is illogical. By eliminating the added profit resulting from higher prices for domestic oil, the incentive to increase domestic production simply disappears. Further, once a tax is imposed, it is rarely repealed, and frequently extended. This could mean that the categories of oil which are not at present subject to such a tax could be subjected to it at some later date. Finally, the imposition of this tax would impose an incredible drain on capital markets, already thin, further hampering the process of capital formation.

As is the case with the Energy Mobilization Board, there is sharp division between various elements in the Congress as to the exact form this tax should take. The House of Representatives has passed a version of the measure which is essentially the same as the one originally proposed, although with an even higher tax rate. The Senate, on the other hand, has not completed its deliberations, but is inclined to enact a far less punitive tax, with a relatively large number of exemptions, and tax incentives for enhanced or tertiary oil recovery techniques. In fact, at one point, the total tax incentives provided under the Senate version of the measure were said to include tax incentives totalling more than the revenues the tax would produce. At this time, there is considerable agreement that some sort of tax will eventually be enacted by the Congress, although its form and actual impact are quite uncertain.

OIL IMPORT QUOTAS

The most dramatic point in the President's July 15th speech came when he indicated that he would impose quotas on the amount of foreign oil imported into the United States, so that we would never "import one drop more" of this oil than we do today. In actuality, the quotas set by the White House were not as drastic as the President's talk indicated. The year selected as the base year, 1977, was the one in which American imports reached the highest level they had ever attained, and the consensus of opinion among energy experts was that the U.S. would not again need to

import such large amounts for at least two years. It was therefore assured that the President's import quota goals would be met during that period. After that period, it was anticipated that no rational leader would allow an oil shortage to be artificially created by unrealistic quotas.

What is of far greater concern with regard to import quotas is the way in which they would be administered. Their nature would insure that some sort of rationing of foreign oil would have to take place, thereby creating yet another level of bureaucracy to run the program, and making the rights to purchase such oil a valuable commodity. A plan currently favored by the Administration would involve the sale of "tickets" entitling the purchaser to a specific amount of the imports. In essence, the government would then become the purchasing agent for all such petroleum. In this role, they would also have total control over its allocation.

There has already been a demonstration of the inefficiencies and inequities attendant upon price and allocation controls with the motor gasoline situation earlier this year. It is probable that similar problems would occur should oil imports be allocated by the Department of Energy as well. Moreover, by creating a premium which would otherwise not exist, such a program would only serve to further increase the cost of imports, and ultimately the cost of petroleum products.

Just as with the "white market" proposed for gasoline rationing coupons, a similar market would evolve for the sale of rights to foreign oil. As the amount of domestic petroleum, or of other alternative fuels available, became increasingly scarce, these rights could take on considerable value in and of themselves. In most instances, the costs imposed would be borne directly by the consumer.

At present, the U.S. is importing slightly under half of its domestic petroleum requirement. For the four weeks ending September 14, 1979, total imports came to an average of slightly over 8.5 million barrels per day, of which nearly 6.8 million barrels were crude oil, and close to 1.8 million barrels were refined products. This amounted to 49.9 percent of total petroleum demand. This compares with a 38 percent share of total petroleum demand accounted for by imports in 1973, or a 31.6 percent increase in the overall level of imports since 1973.

Should domestic production of oil continue to decline, as a result of the effects of price and allocation controls, environmental restraints, and excessive taxation, the consequences of federal control of imports will become increasingly profound. A simple extrapolation of current trends would indicate that between control of imports and control of even a modest portion of domestic petroleum products through synthetic fuels plants, as much as 60 percent of U.S. oil requirements could be under direct federal control by the end of the next decade. Should imports account

for more than the anticipated share, and some form of federal allocation remain in place as a result of the quotas, this proportion could be even greater. This federal stranglehold on supply would amount to a back door nationalization of the oil industry, an event which would be fraught with pitfalls for the overall health of our nation's economy.

THE CONCEPT OF SYNERGY

When prescribing drugs, physicians often have to consider what is termed the "synergistic" effect, the possible magnification of the effects of one drug by another. This synergism is sometimes used intentionally to enhance a beneficial effect of a drug for a patient, and in other instances carefully avoided so as not to cause harm. A parallel can be drawn between this sort of synergy and the synergy which exists between each of the elements of the President's latest proposal. In this instance, the synergy could end up being fatal to the patient.

Through the windfall profits tax, the federal government proposes to finance a massive synthetic fuels program, administered by a federally chartered corporation, the Energy Security Corporation, and expedited by another federal entity, the Energy Mobilization Board. At the same time, the federal government intends to take control of oil imports through the mechanism of quotas and entitlements to portions of the oil represented by those quotas.

The windfall profits tax inhibits the ability to explore for and develop domestic oil. This creates a market for synthetic fuels. At the same time, the tax also drains capital from conventional capital markets which might be the sources of financing for competing energy resources which would also be domestically based. Additionally, the Energy Mobilization Board, through its powers to expedite selected energy projects can give special considerations to government-financed plants, which might not be made available to plants being constructed by the private sector. Similarly, the system of "tickets" envisioned to regulate the flow of imports concentrates the allocation function for imported petroleum, further weakening the overall position of the domestic oil industry.

CONCLUSION

An understanding of the interaction between the key elements of the most recent Carter energy initiative is critical to an understanding of the underlying difference between it and the first National Energy Plan. While the first plan would have created considerable federal interference in the energy market, it did not entail the extensive control over physical supplies of oil which the latest one would, and did not put the federal government in direct competition with the private sector in

producing energy. The first version of the National Energy Plan was basically regulatory in its emphasis. The latest one is pre-emptive.

There are certain similarities, as noted: the reliance on a price increase for petroleum caused by a heavy tax to discourage consumption, the overall emphasis on conservation, and the general reluctance to fully endorse nuclear power as a necessary part of our national energy mix, for example. These similarities, however, are insignificant in comparison with the areas of difference.

In the final analysis, there is a certain irony to be found in the fact that the solution to an energy crisis largely created by federal red tape, and by federal departments, should be thought to be found in the creation of even more red tape and federal agencies. This irony is further enhanced by the fact that this proposal is coming at a time when there is a growing public antipathy towards the increasing growth of the federal government. It is perhaps an unconscious recognition of this irony which has led to the stiff opposition these programs have encountered in the Congress this year, and at a minimum will be food for thought to the motorists lining up for gasoline when the current price and allocation system causes shortages next spring.

Milton R. Copulos
Policy Analyst