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Falling Oil Prices: Useful Lessons from the Slump at the Pump

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Last summer's record-breaking oil and gasoline prices—exceeding \$140 per barrel and \$4 per gallon—received plenty of attention in Washington and sparked a host of proposed responses from Congress. However, the real lessons are to be learned by studying the dramatic drop in prices since then. These lessons, if incorporated into the nation's energy policy, could help prevent prices from going back up to record levels in the future.

Lesson 1: Blaming Big Oil, Wall Street Speculators, or Other Scapegoats Is a Waste of Time

Anger at high prices last summer led to the usual push for politically convenient scapegoats. The public was told that major oil companies and Wall Street speculators were responsible by manipulating prices to their benefit, and in response Congress proposed all manner of punitive taxes and regulatory crack-downs. However, the current drop in prices should throw at least some cold water on these claims.

Such allegations are made every time energy prices go up. They have been investigated numerous times by the Federal Trade Commission and others and found to be without merit, but few critics are ever convinced. But what better proof that sinister capitalists are not jacking up energy prices than the bottom falling out on those prices? Oil, at \$147 per barrel on July 11, has recently traded for half that. And gasoline, which reached \$4.11 per gallon around the same time, is now averaging \$3.04 and is falling by several cents per day.

If large oil companies really were responsible for creating last summer's high prices, why would they

give them up so quickly? And if speculators were capable of profiting by driving prices ever higher, why would they allow themselves to be caught holding the bag in a free fall?

Clearly, the drop in prices is strong evidence that the market is not so easily manipulated. And it suggests that efforts to punish oil companies and investors—either through price controls, windfall profits taxes, or trading restrictions—are not really solutions. Instead, they are noisy diversions from what really needs to be done, such as expanding domestic oil supplies.

Lesson 2: Markets Work—If We Let Them

As summer turned to fall, sky-high pump prices in the face of a weakening economy led to lower demand and a drop in those prices. In other words, market forces do work, and they tend to counter big price moves in one direction or the other. The financial meltdown may have weakened faith in markets over the last few weeks, but the precipitous decline in oil and gasoline prices should help strengthen that faith.

Of course, markets can work only if they are allowed to. The biggest threat to the functioning of energy markets right now is costly cap-and-trade

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legislation in the name of fighting global warming. These measures would set a limit on the emissions of greenhouse gases, mainly carbon dioxide from the combustion of coal, oil, and natural gas. This cap-and-trade legislation, and the energy use restrictions that would result from it, would create an unprecedented level of interference by the federal government in the energy sector and the overall economy. Bottom line: Such legislation would lead to gasoline rationing and higher prices.

The America's Climate Security Act, the only cap-and-trade bill to be voted on in 2008, was easily defeated in the Senate last June, largely due to concerns about costs. The bill was estimated by the Environmental Protection Agency (EPA) to add 0.53 cents to the price of gasoline by 2030,¹ while analyses by The Heritage Foundation and others estimated considerably larger impacts.²

Reps. John Dingell (D-MI) and Rick Boucher (D-VA) have recently introduced a new cap-and-trade proposal that could serve as a starting point for global warming discussions in 2009. At the same time, the EPA is pursuing a regulatory crackdown on carbon dioxide emissions.

Costly restrictions imposed by a cap-and-trade bill or EPA regulations would act as a one-way ratchet on oil and gasoline prices, precluding the kind of market-driven declines like the one we have experienced since the summer.

Lesson 3: What Comes Down Can Go Back Up

We have seen that prices can fall dramatically, but we should not forget that they can rise just as

dramatically. It is good that gasoline has become more affordable, but the main reason—an economic downturn that has dampened demand—is one nobody expects (or wants) to last forever. Now is not the time to get complacent, lest we see prices take off again once the economy turns around.

One thing America can do is expand domestic oil supplies. America remains the only oil-producing nation on earth that has placed a significant amount of its reserves out of reach. To its credit, Congress recently allowed the longstanding restrictions on offshore drilling in 85 percent of our territorial waters to lapse. This happened because of public anger over high prices. However, now that the anger has subsided a bit, some Members of Congress are talking about reinstating the offshore restrictions after the elections.

This is not the time for complacency about energy supplies and prices, especially given the expected increases in demand in the years ahead. If a temporary drop from \$4 toward \$3 a gallon prevents the new offshore drilling from actually moving forward, it could end up costing us in the long run.

Much to Learn. The drop in oil and gasoline prices has not gotten nearly as much attention as the preceding rise. This is unfortunate, as the decline contains at least as many useful lessons as the increase that, if heeded, could lead to better news for prices in the years ahead.

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1. Environmental Protection Agency, "EPA Analysis of the Lieberman-Warner Climate Security Act of 2008," March 14, 2008, p. 2, at http://www.epa.gov/climatechange/downloads/s2191_EPA_Analysis.pdf (October 17, 2008).
2. Ben Lieberman, "The Lieberman-Warner Climate Change Act: A Solution Worse Than the Problem," Heritage Foundation *Backgrounder* No. 2140, June 2, 2008, p. 5, at <http://www.heritage.org/Research/EnergyandEnvironment/bg2140.cfm>; American Council for Capital Formation and National Association of Manufacturers, "Analysis of the Lieberman-Warner Climate Security Act (S. 2191) Using the National Energy Modeling System (NEMS/ACCF/NAM)," p. 12, at <http://www.accf.org/pdf/NAM/fullstudy031208.pdf> (October 17, 2008).