

Background

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What To Do About High Oil Prices

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Abstract: *Rising oil and gas prices are a concern to consumers, Congress, and the Obama Administration. The impact of higher oil prices goes far beyond the gas pump and affects the U.S. economy, as a new Heritage Foundation analysis shows. In addition to unrest in oil-producing countries and increased demand around the world, U.S. policies are contributing to higher fuel costs and a smaller domestic supply. Heritage experts Nicolas Loris and John Ligon explain how the Administration's policies on domestic oil drilling and alternative energy are adding to the problem and what to do about it.*

The price of oil passing \$100 per barrel is triggering flashbacks for American consumers of summer 2008, when gasoline prices rose above \$4 per gallon. However, the adverse economic effects of high oil prices spread far beyond pain at the pump. Federal Reserve Chairman Ben Bernanke recently noted that high oil prices could curb economic growth and result in modest inflation.¹ A Heritage Foundation analysis found that an increase in the per-barrel price of imported crude oil by \$10 in the first quarter of 2011 and by \$20 in the second quarter would reduce gross domestic product (GDP) by \$20 billion, drop potential employment by nearly 100,000 jobs, and increase gasoline prices 18 cents per gallon in 2011 alone. Calls for increases in uncompetitive biofuel production and electric vehicle production will only drive up gas prices for consumers and waste taxpayer dollars. While rising demand for oil is pushing up prices, the political unrest in Egypt and Libya is cause for

Talking Points

- The recent political unrest in Egypt and Libya will likely have only a marginal impact on the price of oil going forward—since only approximately 4 percent to 5 percent of U.S. crude oil imports come from Libya and oil traveling through the Suez Canal (Egypt).
- Higher oil prices in 2011 will cost nearly 100,000 potential jobs and \$20 billion in economic growth just as the United States is recovering from its economic recession.
- The Obama Administration is continuing to advance energy policies that will raise world oil prices and increase the amount of oil imported into the U.S.
- Pushing for more renewable energy, such as wind and solar, in response to high gas prices is a non sequitur. Only about 1 percent of America's electricity was generated from petroleum in 2009.
- The U.S. should make a concerted move toward economically sensible energy solutions, which allow for greater access to onshore and offshore oil and gas exploration.

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concern and only reinforces the need to tap into domestic sources.

What's Causing High Oil Prices?

The political unrest in Egypt and Libya is in part responsible for the latest jump in oil prices, but the effect is marginal. Egypt is not a significant producer of oil, but 2 percent to 3 percent of the world's crude oil and refined petroleum travels through the Suez Canal. Libya produces about 2 percent of the world's oil (1.65 million barrels per day), with most of its oil going to Europe. Unlike 2008 when supply constraints existed, OPEC member nations have capacity to spare, and the International Energy Agency said it would increase supply from its 1.6-billion barrel stockpile. Political unrest driving higher oil prices becomes a much bigger concern if the turmoil spreads to the Persian Gulf or to Nigeria and Algeria. The U.S. used 18.8 million barrels of oil per day (MMbd) in 2009 and imported 51 percent (11.7 MMbd). Of those imports, 17 percent came from Bahrain, Iraq, Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates.² As of December 2010,³ the largest exporters of oil to the U.S. were:

- Canada (2.1 million barrels per day)
- Mexico (1.2 million barrels per day)
- Saudi Arabia (1.1 million barrels per day)
- Nigeria (1 million barrels per day)
- Venezuela (825,000 barrels per day)
- Iraq (336,000 barrels per day)
- Angola (307,000 barrels per day)
- Brazil (271,000 barrels per day)

- Algeria (262,000 barrels per day)
- Colombia (220,000 barrels per day)

The most significant driver of rising oil prices is increased demand. Industrialized countries climbing out of their respective recessions are using more oil, and China and India are also using more oil as they continue rapid economic growth. Rising demand will continue to put upward pressure on prices as the world economy attempts to recover.

Pain Hits Beyond the Pump

Since crude oil accounts for more than 70 percent of the price of a gallon of gasoline, higher oil prices will undoubtedly affect consumers at the pump, but the economic pain spreads well beyond the gas station. Higher energy prices also drive up production costs, which must be reflected in product prices, especially for goods reliant on transportation. Since higher prices reduce quantities sold, producers produce less. In turn, this drives wages down and incomes decline.

A continued price shock to the crude oil markets would have adverse effects on the entire U.S. economy. Heritage analysts conducted a simulation modeling the economic impact of an increase in the per-barrel price of imported crude oil by \$10 in the first quarter of 2011 and by \$20 in the second quarter.⁴ As a consequence of such a price-shock scenario, the U.S. economy would shrink by \$20 billion and fall a total of 99,000 private-sector jobs below potential employment. In 2012, the number of lost potential jobs would increase to 117,000, and an additional \$13 billion in GDP would be lost.

1. Matthew Jaffe, "Bernanke Warns Rising Oil Prices Could Pose Threat to Economy," *The Note*, March 1, 2011, at <http://blogs.abcnews.com/thenote/2011/03/bernanke-warns-rising-oil-prices-could-pose-threat-to-economy.html> (March 1, 2011).
2. Energy Information Administration, *How Dependent Are We on Foreign Oil?* November 29, 2010, at http://www.eia.doe.gov/energy_in_brief/foreign_oil_dependence.cfm (March 2, 2011).
3. Energy Information Administration, *Crude Oil and Total Petroleum Imports Top 15 Countries*, February 15, 2011, at http://www.eia.doe.gov/pub/oil_gas/petroleum/data_publications/company_level_imports/current/import.html (March 2, 2011).
4. Heritage Analysts used the IHS/Global Insight July short-term macroeconomic model. IHS/Global Insight, Inc., is a leading economic forecasting firm in the United States. The Global Insight model is used by private-sector and government economists to estimate how changes in the economy and public policy are likely to affect major economic indicators. The methodologies, assumptions, conclusions, and opinions presented here are entirely the work of analysts in the Center for Data Analysis at The Heritage Foundation. They have not been endorsed by, and do not necessarily reflect the views of, the owners of the Global Insight model. Heritage analysts conducted a simulation where the weighted average price of imported crude oil was \$10 per barrel higher in 2011.Q1 and \$20 per barrel higher in 2011.Q2.

The Wrong Policies

Unfortunately for American consumers, the Obama Administration is advocating policies that will increase world oil prices and increase the amount of imported oil by restricting domestic supply. The Administration rescinded drilling permits already issued in the Chukchi Sea, and last December it announced that the eastern Gulf of Mexico and the Atlantic and Pacific coasts will not be part of the government's 2012–2017 Outer Continental Shelf Oil & Gas Leasing Program. Furthermore, federal leasing of oil and gas exploration in the western United States has dropped significantly in the past two years.⁵

To make matters worse, the Obama Administration has been pushing uneconomical and, at times, nonsensical solutions to reduce dependence on foreign oil, such as increased biofuel production, increased electric vehicle production, and increased renewable power production, all of which are bad policy.

- **Biofuels a failure.** The major source of biomass production, corn-based ethanol, is fraught with problems and has become an industry built on subsidies, tariffs, and federal protection. If ethanol were economically competitive, it would not need a federal mandate requiring production of 36 billion gallons by 2022 or a 54-cent tariff on imported ethanol. Ethanol produces less energy per unit volume than gasoline, contributes to food price increases,⁶ costs taxpayers \$4 billion to produce 2 percent of the total gasoline supply,⁷ and has dubious environmental effects.⁸

- **Electric cars are not economical.** Taxpayers have doled out billions for advanced battery vehicle development manufacturing, and they subsidize every electric vehicle purchase (from \$2,500 to \$7,500 depending on the battery capacity). Even so, the demand for electric vehicles is low because electric cars are prohibitively costly despite the lavish handouts.⁹
- **More wind and solar will not matter.** Pushing for more renewable energy, such as wind and solar in response to high gas prices, is a non sequitur because these sources of energy affect electricity generation. Since only about 1 percent of America's electricity was generated from petroleum in 2009,¹⁰ it is misleading to suggest that one would affect the other. Increasing wind and solar production will not affect the gasoline supply or the transportation sector.

The Right Policies

Increasing access to oil reserves in the U.S., both onshore and offshore, would help offset rising demand, increase jobs, and stimulate the economy. Moreover, this will help improve our strategic position, as much of the world's supply of oil is delivered in a restrictive market dominated by unstable or hostile nations. Some of these nations are using energy as a tool to frustrate U.S. national security and foreign policy objectives. The United States should allow access to easily recoverable domestic oil, remove unnecessary restrictions on oil shale development, and simplify the arduous permitting process.

5. Western Energy Alliance, "Western Oil and Natural Gas Dashboard," December 9, 2010, at <http://westernenergyalliance.org/resources/dashboard> (February 25, 2011).
6. Congressional Budget Office, *The Impact of Ethanol Use on Food Prices and Greenhouse-Gas Emissions*, April 2009, at <http://www.cbo.gov/ftpdocs/100xx/doc10057/04-08-Ethanol.pdf> (March 2, 2011).
7. James A. Baker III Institute for Public Policy, Rice University, "Fundamentals of a Sustainable U.S. Biofuels Policy," January 2010, at <http://www.bakerinstitute.org/publications/EF-pub-BioFuelsWhitePaper-010510.pdf> (March 2, 2011).
8. A report from Rice University notes that after accounting for land use conversion, the use of fertilizers, insecticides, and pesticides (which emit much more potent methane and nitrous oxide), as well as the fossil fuels used for production and distribution, biofuel production becomes quite carbon-intensive.
9. Nicolas D. Loris and David W. Kreutzer, "Economic Realities of the Electric Car," Heritage Foundation *WebMemo* No. 3116, January 24, 2011, at <http://www.heritage.org/research/reports/2011/01/economic-realities-of-the-electric-car>.
10. U.S. Energy Information Administration, *Annual Energy Review 2009*, August 2010, at <http://www.eia.doe.gov/aer/pdf/aer.pdf> (February 25, 2011).

- **Access onshore and offshore.** At least 19 billion barrels of easily recoverable oil lie off the currently restricted Pacific and Atlantic coasts and the eastern Gulf of Mexico. Another 19 billion barrels estimated to be in the Chukchi Sea off the Alaskan coast are inaccessible because of onerous regulations, such as acquiring air-quality permits. The U.S. Environmental Appeals Board invalidated the Environmental Protection Agency's permit approval for that area after appeals from environmental groups.¹¹ Another obvious and senseless restriction is in the Arctic National Wildlife Refuge, where an estimated 10 billion barrels of oil lie beneath a few thousand acres that can be accessed with minimal environmental impact. Those 10 billion barrels are equivalent to 16 years' worth of imports from Saudi Arabia at the current rate.
- **Access to oil shale.** According to the U.S. Department of the Interior and the Bureau of Land Management, there are 800 billion barrels (a moderate estimate) of recoverable oil from oil shale in the Green River Formation, which goes through Colorado, Utah, and Wyoming. This is three times greater than the proven oil reserves of Saudi Arabia.¹² While the technology is still developing and environmental considerations need to be taken into account, the Administration should not create onerous restrictions stifling commercial investment in research and technology that would make the process economically viable and safe for the environment.
- **Remove regulatory delays and limit litigation.** Environmental activists delay new energy projects by filing endless administrative appeals and lawsuits. Shell cited regulatory delays and legal challenges preventing it from moving forward with exploration programs in the Beaufort and Chukchi Seas. Creating a manageable time frame for permitting and for groups or individuals to contest energy plans would keep potentially cost-effective ventures from being tied up for years in litigation.
- **Require lease sales when ready.** Congress should require the Secretary of the Interior to conduct lease sales in the Outer Continental Shelf if a commercial interest exists. Interior should not drag its feet on lease offers for research, development, and demonstration projects involving oil shale. Further, Congress should require the Department of the Interior to provide the appropriate lease sales when the private sector deems oil shale commercialization possible.
- **Sensible review processes.** Placing a 270-day time limit on National Environmental Protection Act reviews would ensure a quick review process for energy projects on federal lands. Construction projects on federal lands take an average of 4.4 years.¹³ The 270 days would allow for a thorough environmental review process but would not prevent investments from moving forward.

What Congress and the Administration Should Do

Congress and the Administration should:

- **Get moving on permits.** As the only country in the world that places a majority of its terri-

11. Cassandra Sweet, "UPDATE: Shell Moves Alaska Drilling To 2012, Citing Regulatory Delays," *The Wall Street Journal*, February 3, 2011, at <http://online.wsj.com/article/BT-CO-20110203-720011.html> (March 1, 2011).

12. Oil Shale and Tar Sands Programmatic EIS Information Center, *About Oil Shale*, at <http://ostseis.anl.gov/guide/oilshale/index.cfm> (March 2, 2011).

13. U.S. Department of Transportation, *Evaluating the Performance of Environmental Streamlining: Development of a NEPA Baseline for Measuring Continuous Performance*, at <http://www.environment.fhwa.dot.gov/strmlng/baseline/section2.asp> (February 28, 2011).

Increase Supply, Not Dependence

If rising oil prices are a concern for the Administration and Congress, they should seek to increase access to oil and gas exploration in the United States rather than trying to force other sources of energy and technologies into the marketplace. A market-based energy policy that opens supply and pru-

dently balances economics with environmental benefit will lower prices, create jobs, and reduce the need for foreign imports.

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