

January 10, 2006

COMMENTARY

The Upside of the Oil Curse

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Of all the long-term challenges facing the country, none touches as many areas of our national life as energy, particularly our dependence on a variety of unstable oil-exporting nations. It impacts our global competitiveness, our environmental policy and our foreign policy, both in the Middle East and in our own hemisphere. Moreover, our nation's major strategic competitor, China, is responding to a similar challenge by acquiring global energy assets and targeting its foreign policy on befriending a variety of oil exporters.

In echoes of the 1970s, many politicians complain that the price of energy is too high and that oil companies are making "windfall profits." But history shows us that the price mechanism is not the problem. Though it has downsides, particularly in the short run, it beats every alternative. And in the long run the price mechanism is a major part of the solution to our energy challenge.

The history of the '70s and early '80s also explains the advantages of the price mechanism to both energy efficiency and the environment. The most rapid gains in energy efficiency in the U.S. took place when prices were very high. In fact, a sharp break in the energy intensity of the American economy appears to have occurred in 1973, the year of the first price spike. Prior to that date, the energy intensity of the economy was fairly stable, declining at just 0.4% per year. Since that date, the amount of energy needed to produce each real dollar of GDP has fallen by 50%, a decline of 2% per year. Unfortunately, the pace of progress slowed after prices dropped markedly in 1986.

Today, we are again seeing the positive incentive effects of high oil prices. The recent run-up has encouraged a new class of entrepreneurs and scientists to search for technological solutions. Nanotechnology is improving battery life, which will make hybrids cars and solar electricity more realistic. Historically costly alternative fuels like ethanol are suddenly looking practical, especially with advances in biotechnology and new processing technologies. A look to Latin America shows that rapid change can happen faster than commonly thought. Over the last three years in Brazil, the share of new car sales that can run on high-content ethanol fuel has risen from 4% to 67%. Its sugarcane-based ethanol is priced competitively with gasoline.

There is little doubt that technology and innovation, along with steps toward conservation, will ultimately solve the oil supply problem. But given the instability in the countries northwest of the Strait of Hormuz (where 20% of the world's daily oil supply passes), it's less certain that this will come before an economy-crippling crisis.

Capital flows into new technologies and domestic production would be stronger if investors had more certainty about their potential return. Until recently the futures market converged on a long-term oil price of \$20 per barrel, and memories persist of the collapse of the oil price in 1998 to just \$10 a barrel. Domestic oil producers, venture capitalists and entrepreneurs don't know whether the price of oil in the next decade will justify the costs of investments they must make today in new technologies and new production techniques.

The market for long-dated oil futures contracts is not sufficiently large or liquid enough to fully and inexpensively hedge the vast quantity of investment that is needed for the U.S. to substantively reduce its dependency. Hedging is also too expensive for many small- to medium-size entrepreneurs. Even bigger domestic oil producers, who have endured extended periods of low prices in the past, aren't yet investing in line with their current profits. Some oil producers argue that they need prices consistently above \$35 a barrel to justify unconventional projects. Coincidentally, potential investors in new ethanol technologies also say that oil needs to stay above \$35 a barrel for their plans to be cost-effective over time. With oil now trading over \$60 per barrel, many would think that \$35 oil is only a fantasy. No doubt in the early 1980s few thought that oil would ever be at \$10.

Ironically, the best way to cap the upside to the oil price is to encourage new energy producing technologies by limiting the potential downside to the price. If we could somehow guarantee that the price of oil would never be low again, so many new technologies would develop over time that the price would certainly fall from today's high levels. In fact, this is OPEC's worst fear and is the reason it becomes cooperative when prices start to climb rapidly.

The U.S. government could approximate a guarantee by taxing oil imports (and other petroleum products) dollar for dollar when the world oil price falls below \$35. In effect, the government would be picking up the hedging costs by guaranteeing a long-term "put option" on oil 40% below the current market price. This policy has several advantages to our policies after the last energy price shock. It provides more certainty to private sector investors, which can provide a powerful multiplier to investment. It is likely to be used infrequently given the rapid development of Asia -- yet the plan still provides an incentive effect.

The tax is neutral on how we move toward independence -- everything from domestic tar sand production to hydrogen to solar power would have an equal chance to succeed. New alternative technologies would lower carbon emissions without the drawbacks associated with hyper-complex worldwide regulatory schemes. Politically, the tax would be spread more evenly than the gas tax, since home heating oil used in the Northeast would be included as well as the gasoline used in the West. Finally, this policy would allow a reduction in inefficient regulations and subsidies that try to pick winners among competing technologies.

Some might say that this is a "bailout for big oil." But domestic producers import a large share of their production from foreign fields and these imports would be subject to the tax. Moreover, the policy would increase the number of competitors oil companies face. Others would argue this is government interference with the market. True, but oil consumption comes with many externalities, from pollution to geopolitical concessions to the military expenditures needed to protect global supplies. Incorporating externalities into the price

can increase efficiency. Others would object that this is a potential tax increase. If the tax were to kick in though, much of the burden would fall on foreign producers, especially if OPEC has pricing power. Even if the U.S. were in a period of economic weakness, the Congress could assure that consumers were held harmless by reducing another federal tax.

Allies abroad might cry that this would be an unjust and potentially illegal tariff. But they would benefit substantially from lower U.S. oil consumption when world prices fell and also from lower global pollution. At a minimum, there is strategic value in making the proposal to show the world we are serious about reducing our own oil consumption. Of course, the loudest cries would come from foreign oil producers, some of which are also important allies. But economic history teaches us that dependency on oil is harmful to the producers as well. The so-called "oil curse" has fostered corruption and made it hard for non-energy businesses to develop in these nations. Not only must the U.S. wean itself from foreign oil, but oil producers need to wean themselves from the American consumer.

All Americans would be better off if our nation's economic, foreign and environmental policies are freed from dependence on unstable sources of oil. Our competitors abroad, and our enemies, doubt that we have the will to make such a break. Naysayers at home doubt that it is possible to measurably reduce our energy dependency anytime soon. Great leaders, however, have the ability to imagine a different world and take us there. President Kennedy put it best: "Our problems are man-made, therefore they may be solved by man. No problem of human destiny is beyond human beings."

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