# Industry View of Economic Regulation of Oil and Gas Production

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## I. INTRODUCTION

When Kent Frizzell asked me a couple of months ago if I would come here and discuss the administration's energy policy, I gladly accepted and thought that this would be a great opportunity for me really to rip into everything I thought this administration was doing wrong in the energy area. However, on reflection of what happened in the past two administrations, I had second thoughts. I think I should level more of my criticism at what happened during these previous administrations, at least as far as it set the stage for a lot of what is happening now.

The obvious area of criticism of the Nixon and Ford administrations was the imposition of price controls and allocation regulations over an industry which had not seen any such regulation in the past through the creation of the Federal Energy Office which is now the backbone of the Department of Energy. I think these measures can be excused somewhat in that the Executive Branch was under a lot of pressure from Congress to impose price controls and to impose allocation regulations. The response of Secretary of the Treasury, George Schultz, to this was that the worst things the Nixon Administration did were excused since otherwise Congress would have done something worse. I do not know if that included Watergate, but it was certainly true as to wage and price controls and other actions in the economic area. The other major energy disaster of the Nixon Administration was the establishment of the Federal Energy Office. Perhaps this can be excused due to the emergency at the time, but I do not know if we

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needed to extend it and make a department of some twenty thousand people a permanent fixture of the Washington scene. Having noted these items, I think probably the worst thing that we did and the worst thing that we bequeathed to the current administration and to the oil industry was the two-tier crude oil pricing system.[1] I want to discuss further the pricing of oil, crude oil in particular. But first, I would like to comment on conservation measures discussed earlier.

## II. ALTERNATIVE ENERGY MEASURES

I can agree completely that the United States, and indeed the world, is in a serious energy situation. I think the differences in the approaches to energy problems lie in the ends that we would like to see achieved, and the means that we believe the country should use to go about achieving those ends.

The cornerstone of the administration's energy policy is conservation. This is something which is claimed we can have here and now. We used to talk about conservation a lot and implement programs with signs on the highway that said, "Don't be fuelish" and other silly slogans. Everybody believed it and agreed as long as they had a hard time getting gasoline. When they had to wait in line, they did not mind driving fifty-five miles an hour, but as soon as they were able to get all the gasoline they wanted, and as soon as they got used to another ten or fifteen cents per gallon at the pump, they put their CB's in and got back up to seventy-five miles an hour.

We hear that the West Germans and Swedes have as high a standard of living as we do and yet use a lot less energy per capita. Although their standards of living on an economic basis may be as good or better, I would submit that their lifestyles are considerably different. There are not many Germans who would drive a hundred miles from the airport in Tulsa in order to have a meeting. The distances most Germans are likely to travel are much shorter, and they probably would go by mass transportation, except for the few who can afford to get on the autobahns with their Mercedes. Thus, I think there are significant differences, and you cannot say that the West Germans or the

1. For a summary of the two-tier system from its beginning in August, 1973 to the present, *see Crude Oil Prices: Confusion Reigns Supreme*, 186 WORLD OIL 71 (1978). More complete coverage can be found in United States Senate Committee on Energy and Natural Resources, *Regulation of Domestic Crude Oil Prices*, Publication No. 95-8, March, 1977. *See also* Langdon, *FEA Price Controls for Crude Oil and Refined Petroleum Products*, 26 ANN. INST. ON OIL AND GAS LAW AND TAX. 55 (1975); Wakefield, *Allocation, Price Control and the FEA: Regulatory Policy and Practice in the Political Arena*, 1975 ROCKY MT. MIN. LAW INST. 257.

Swedes do a better job of conserving their energy than we do, because it is an irrelevant comparison between totally different worlds. We have one of the largest countries in the world and, particularly west of the Mississippi River, we have large distances to drive and frequently no other means of transportation than private automobiles.

We can turn our thermostats down, we can lower our speed limits, but we can only go to that well once. Turning down the thermostat a little more with every crisis or price rise will not continue to be a realistic solution.

I think we have to have conservation. I think it has to be important, but I do not think it is the only answer or even the primary answer to our problem. If the administration were really serious about conservation as the primary answer, it would let prices rise to market levels so that people would slow down their consumption. "Economics I" teaches that when commodity prices are permitted to rise, supply and demand become equal with supply increasing and demand decreasing. This administration will not allow this because it is afraid somebody might make a profit.

Everybody agrees that we have to use coal more, but many questions arise concerning coal as a substantial part of our energy base. One of those questions is how we would endure a lengthy coal strike if coal were still providing about fifty percent of energy in this country, as it had provided after World War II. It appears to me that this administration is having about as much success in dealing with the coal strike as we did in getting the Arabs to end their embargo in 1973 and 1974. The strike is causing a lot of those people who converted from coal to oil and gas twenty years ago to remember that they converted because they could not rely on the United Mine Workers to provide them with a steady coal supply.

## III. Present Energy Policy

When we talk about other new exciting energy forms which may or may not come to fruition, I think we have to recognize that implicit in the Carter Administration's National Energy Program is the concept that the government knows best; that the people in Washington are able to make better choices than we can as to the kinds of fuels we should use. The administration's philosophy is that regulators are better able to make decisions than the marketplace. I do not believe that government planners are better able to make decisions concerning fuel supplies than people in the business world who have a profit motive in putting together programs which will produce energy which consumers will buy.

I submit that regulations are what got us into our energy problem, and I do not believe that more government regulation will get us out of it. One of Dr. Schlesinger's main themes is that the oil industry does not like regulation now, but it did like it in the past when the price was low and going lower, and the industry wanted government regulation to support and stabilize the price. I would ask Dr. Schlesinger in that regard if he would have have preferred not to have had oil produced in unlimited quantities in Texas and Oklahoma in the 1930's and virtually poured on the ground when the price was ten cents a barrel, because that was the alternative. Along the same lines, he should consider if he would have preferred not to have had a mandatory oil import program which was approved by four Presidents, two Democrats and two Republicans from 1959 to 1973. As a result, we would have had even more of that cheap Arab oil at a dollar a barrel, and in return for that, we would have seen the domestic industry recede even further than it did. I submit that we would have had no development of the Outer Continental Shelf, and that none would have taken the risks on the north slope of Alaska that the oil industry did. Then what would have been the impact of the Arab embargo in 1973, when we probably would have had about half as much domestic production as we did. If that is what Dr. Schlesinger is saying when he implies that these former regulations were somehow evil or that they favored the oil industry and were not in the national interest, I disagree with him.

Oil pricing, and the two-tier system,[2] in particular, is the worst aspect of the entire program, and the worst thing that the Nixon Administration did in the whole price regulation area, except for price regulations themselves.

The two-tier system was not objectionable in the beginning when the difference between the regulated price and the then—unregulated upper tier price was about twenty-five cents. But when prices went up in late 1973, the price spread grew until the difference between the free world price and the regulated lower tier price was two or two and a half times that amount. This fostered the idea that since the old oil had already been discovered, those costs were sunk and government had to keep those prices down. This theory created a conflict between the producers, who wanted to see as much of their production as possible

2. Pub. L. No. 94-163, 89 Stat. 946 (to be codified in 15 U.S.C. §§ 753-55, 757-60h) [hereinafter cited as EPCA].

receive the higher tier price, and the regulators who wanted to achieve just the opposite result.

When you add on top of the two-tier policy the abomination of the Energy Policy and Conservation Act of 1976,[3] the situation that the oil industry finds itself in today was perfectly predictable. I think that position is characterized by a total lack of confidence in statements by federal government officials, an inability to make any long-range plans, and an uncertainty which pervades the industry and precludes the capital commitments that are necessary to develop supplies which are going to be needed to meet United States energy needs.

Let me give you just a couple of specific examples of this. In February, 1976, after Congress passed the EPCA, the FEA established a price schedule for both tiers. This included a rollback as far as the upper tier prices were concerned, which had not been regulated and were now brought under regulation. But at least the rules were laid out. However, those rules lasted for six months before we had another rollback and a price freeze. The Ford Administration could have gone to Congress and said they made a mistake in their calculations of these prices. They could have said that the overcharges were not the producers' fault—that the producers have not done anything wrong but have priced their crude oil as we told them to price it. The administration did not do that, but instead ordered a rollback and a price freeze which lasted until the end of 1977. The so-called "overcharges" (which is a word used to shift the blame to industry when it was the administration's fault) were finally repaid and a new schedule was put out by this administration for a three month period.[4] Three months is too short a time to try to do any serious planning in developing an oil field, but at least that is better than continued rollbacks and price freezes.

One difficulty with that schedule was that it was not high enough to permit industry to charge the prices that the law permits. We had a law, passed by Congress under serious protest from the industry that it was a disincentive that provided very nominal increases in prices, only slightly higher than the ten percent annual inflation. Then this administration comes out with a new schedule which allows the producers the rate of inflation, but denies them everything that Congress has allowed. The resulting dollar amount has been, as of the end of January, 1978, over one billion dollars that producers could have been permitted to

3. *Id.*
4. *Crude Oil Price Schedule No. 9*, 42 Fed. Reg. 62125 (1977).

charge for their oil if the administration had permitted them the increases provided by law.

Why has not the Carter Administration allowed prices to rise? There are several theories on this. Depending on who you talk to in the administration, you get different pictures, but a part of the answer may be their legislative strategy, that this somehow is going to be held out as a carrot to Senator Russell Long[5] and others to get the kind of legislative program the Administration wants. The administration denies that. Then there is the feeling, as expressed in Mr. Bardin's interview with the *Oil and Gas Journal* last year,[6] that producers are getting too much money already. Under this theory, producers of old wells do not have any costs any more, so it is really a gift to permit them to charge $5.25 a barrel for that oil. The producers probably ought to donate that production to the public. This theory fails to take into account the increases in costs that have occurred over the last decade. We have set up a situation in which the producers have put that money in the ground under one set of assumptions, and now the government says those assumptions have changed, but does not take into account that producers need the capital that this production should generate in order to put that money back in the ground and look for new oil and new gas, at today's prices. There is one other possible theory for the reduced price ceilings—the stated position of the administration. The argument has been put forth by some officials that this margin, this billion dollars or more, is necessary to permit higher prices for new and unconventional supplies, such as enhanced recovery and new frontier areas. This position does not cost the administration very much because, in the time frame we are talking about, there is not going to be any significant amount of oil produced from these unconventional sources. The country faces long lead times on all of these projects, and the capital is just not going to flow into them when the Department of Energy sets up programs like they are proposing to do now on the enhanced recovery program.

Basically the administration proposes to let producers receive free market prices for that increment which would not have been produced if there had not had been an enhanced recovery project. That is not much to begin with, because producers already get the upper-tier price,

5. Russell Long is U. S. Senator from Louisiana, and Chairman of the Senate Finance Committee.

6. David Bardin is Administrator of the Economic Regulatory Administration (ERA) of the Department of Energy. For an interview with Bardin in which he expresses the aims of ERA, *see* Bachman, *Price Seen Key to U. S. Regulatory Trend*, 75 Oil and Gas J. 74 (1977).

so all the administration is saying is that the price will be increased from the upper-tier price to the free world price, but that is just for that increment. Unfortunately, it may be several years before a producer knows whether there is even going to be any incremental production in an enhanced recovery program. It must first be piloted to determine whether it is going to work. For the risks the producer is taking, and for the capital he is pouring into the ground, the administration is going to let him try to get a little bit more on this increment. But then the administration is going to put a few strings on this that it can pull at any time if it does not like what the producer is doing or the results that he is getting. Under this kind of program, it is highly unlikely that many producers are going to put much money into one of these projects. So it is relatively inexpensive for the Administration to say that it is going to let the prices of these unconventional supplies rise in return for prohibiting the producer from receiving all that Congress said he could get for his conventional oil and gas supplies.

## IV. Conclusion

The bottom line in all of this is a situation in which there are not many clear rules, but when there are rules they have not always been articulated clearly. Now we see the Department of Energy interpreting those ambiguous regulations, never giving the benefit of the doubt to the industry, and applying those interpretations retroactively to the first day of price regulations. I would submit to you that the only way we are going to solve our energy problems in this country is for the government to get out of the way as quickly as possible. Until that can be done, I think we have got to have rules that encourage capital formation and encourage capital expenditure, and we have to have rules that are clearly articulated and are applied fairly and prospectively only.