Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer’s name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

Preparing for the Next Oil Shock

TO THE EDITOR:

Huzzahs for “The Next Oil Shock: Giving the Market a Chance” (Regulation, March/April 1984). While George Horwich and David Weimer perform a real service in confusion reduction, they unfortunately sow some confusion of their own on several smaller but important issues.

(1) The authors call for monetary ease to “offset the drag and facilitate the movement of resources” during an oil disruption. A disruption causes a real shift in relative prices that makes it socially efficient for resources to shift among sectors; some short-run unemployment of resources during this shift is a socially productive investment in the search process, yielding greater productivity later on. Monetary ease, which merely expands the nominal quantity of money, cannot undo this real relative price shift, and therefore cannot in any long-term sense offset the drag. Inflation will offset the drag in a short-run, illusory sense by creating an illusory increase in (nominal) demand in all sectors, thus delaying the inevitable reallocation process. And since inflation itself is a tax, affecting various sectors disproportionately, it will add its own “deadweight-loss drag” to the “oil price drag.” Government already has enough incentives to inflate; let us not provide it with an excuse.

(2) The authors are right to point out that the oil-sharing agreement of the International Energy Agency (IEA) cannot do much good directly. In fact, it is unlikely to have much direct effect of any sort, since international price controls could not be enforced. It is also conceivable that IEA sharing could serve as an excuse for import quotas, although few governments would be anxious to drive up domestic oil prices even further during a disruption.

But the silver lining of the IEA agreement is that it implicitly precludes export controls during disruptions. Governments would be much more tempted to proscribe oil exports than imports during a disruption. Thus its net effect might be unexpectedly beneficial, so long as market prices are charged for any transfers that take place.

(3) There is no need to counter embargoes directed against one country, because they have utterly no effectiveness under any conditions. Oil can be reallocated easily, as it was during the embargo against the United States and the Netherlands. It is dangerous to hold foreign and other policies hostage to an empty embargo threat, and it is high time that the public be told that it has one less thing to worry about.

(4) It is somewhat misleading to lump together the Carter and Reagan efforts to fill the Strategic Petroleum Reserve (SPR). The Reagan administration can take credit for about three-quarters of the more than 400 million barrels now in place. More to the point, there is nothing graven in stone about the many (poor) benefit-cost studies to which the authors refer for support of their SPR goal of 750 million to 1 billion barrels. It is far from obvious that we should rush to fill a large SPR at a time when oil prices are falling, real interest rates are high, Mideast oil is diminishing in importance, future disruptions are likely to affect prices less than past ones, and there is substantial excess production capacity.

(5) What exactly is the authors’ basis for asserting that the SPR has no natural political constituency? Plenty of special interests favor distribution of SPR oil at below-market prices as another way to get their hands on “cheap” oil during disruptions. After all, why is it that the same people arguing for controls argue also for a faster SPR fill rate? And part of the oil industry would prefer for the government to confiscate the taxpayers’ oil rather than its own. We have thus the makings of an interesting political coalition.

(6) The authors argue, incorrectly, that the social benefit of SPR crude oil exceeds its market price. That assertion is inconsistent with the later proposal that an import fee be used for SPR financing purposes. For if society at large is the main beneficiary, then society at large ought to bear the investment cost. More to the point, the industry does pay the SPR oil when it buys it at market prices during future disruptions. The import fee proposal amounts to an argument that the industry pay for the SPR twice. The taxpayers invest in an SPR because the market expects controls (i.e., confiscation) and so invests too little. Since SPR sales revenues would belong to the taxpayers, it is appropriate that the taxpayers make the initial investment, particularly since this (risks) investment is a penalty for the voters’ (implicit) past sins: the controls of the 1970s.

(7) Horwich and Weimer’s import fee is supposed to make up the purported difference between the market price and the social cost of imported oil. Since when does the government maximize social welfare instead of tax revenue? And what is the magnitude of the private sector inefficiencies caused by the tariff? Should we impose a tariff on bananas because increases in the demand for bananas drive up their price? If the answer is that the fee would transfer wealth to “the domestic economy,” the response is that the fee makes the government better off and the private sector worse off.

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Even more puzzling is the argument that further benefits of the import fee include greater domestic oil production and revenue from the windfall profits tax. Benefits to the government are not necessarily benefits to society, and in a world of resource scarcity, more domestic oil production means less of something else.

(9) An SPR option system may substitute public for private stocks, resulting in little or even no increase in the total social stockpile. Moreover, I do not understand the authors’ distinction between a political drawdown decision and an “economic” drawdown decision coupled with a political decision on how fast to refill. As long as the marginal choices are those of the government, the drawdown decision is in effect political.

(10) The appropriate goal of policy is efficiency in resource allocation, not maximization of SPR sales revenue. And yet incentives would be for the latter if, as the authors suggest, revenues were earmarked for particular constituencies. Since these constituencies would receive SPR revenues but not bear the costs, the political system would be driven toward an ever bigger SPR, to be sold at revenue-maximizing rather than welfare-maximizing prices.

Benjamin Zycher, 
Jet Propulsion Laboratory, 
California Institute of Technology

TO THE EDITOR:

I applaud the authors’ view that “an essentially free-market response to an oil supply disruption is likely to prevail only if it is preceded by substantial government preparations.” The authors rightly note that once a disruption has begun, “the only steps the government can take to reduce the costs are those that have been planned ahead of time.”

The oil industry recognizes this fact, individual states recognize it, the International Energy Agency and its member countries recognize it, and Congress recognizes it. Unfortunately, the Reagan administration and the Department of Energy do not. I only wish Horwich could press his views more forcefully at the Department of Energy, where he now is a special assistant for contingency planning.

To date, the Department of Energy has failed to develop any specific plans to do any of the following in the event of an oil cut-off: (1) assist citizens unable to cope with oil price increases; (2) begin a public information program to help calm and inform a nervous and panic-prone public during a crisis; (3) begin a “fair sharing” program to require that oil companies who volunteer supplies to meet our international obligations will share the burden equitably (many, if not most, companies have very rightly said they will not participate in such a program without fair sharing); (4) meet our international oil-sharing obligations if voluntary U.S. oil company offers prove insufficient; and (5) allocate some portion of the Strategic Petroleum Reserve (through “directed sales”) to help meet special needs, including state and local needs for emergency services and so forth. Most of these issues can be addressed now administratively by the department, rather than through legislative action. To underscore the bipartisan nature of these concerns, I might add that when the House Committee on Government Operations recently issued a report highly critical of the administration’s failure to address these issues, not a single dissenting opinion was attached.

I am convinced that if the administration remains as ill-prepared as it is today, Congress will surely step in and act for it in the event of a crisis. As the authors predict, Congress would likely resort again to price and allocation controls, despite every effort by those of us who remember what disastrous results they produced during the 1979 oil disruption.

Horwich and Weimer suggest directing revenues from SPR sales to the states in a crisis. It was intended, of course, for these revenues to be used to replenish the reserve after an oil crisis has ended. But since the Energy Department has shown an unwarranted concern over depleting the Treasury in order to fund an emergency economic response program, the authors’ suggestion to use the incoming SPR revenues may well be one of the few avenues—if not the only one—by which the administration would agree to implement such a program. Accordingly, the suggestion deserves further consideration by both the administration and Congress.

On the authors’ call for an SPR options program, I should note that the Chicago Board of Trade expressed some reservations about SPR futures in response to a query from the Energy Department.

Among other things, the board suggested that it might not be possible to trade SPR futures contracts, since reserve oil for the most part consists of not one specific crude but rather a mix of several crudes. These concerns should be addressed. The House Energy and Commerce Committee, on which I serve, is about to take up a bill that would direct DOE to study an SPR options program and a “barter” program, as well as to conduct a limited test sale of SPR oil.

I agree with the authors’ call for a 1-billion barrel SPR: for one reason, the larger our reserve, the more flexibility we have as to when and how to use it. As the authors note, the SPR budget has been far too subject to political and budgetary whim (primarily because of its size). For three consecutive years it has gone under the knife of OMB Director Dave Stockman, although Congress fortunately restored most of the proposed cuts.

Clearly, this national security program needs further insulation from the penny-wise but pound-foolish budget-cutters. I doubt, however, that an import fee is the answer, for both equitable and political reasons. Such a fee would hit one particular region of the country (the Northeast) unusually hard, and that area happens to have a sizable number of representatives in Congress, among them the Speaker of the House. And some of us true believers think that keeping oil prices artificially high, as an import fee would do, is a crime almost as heinous as holding prices artificially low.

Horwich and Weimer have presented a solid case for the absolute necessity of preparing now for a possible oil crisis. But I suspect they need to convince the Department of Energy more than your readers.

Mike Synar, 
2nd District, Oklahoma, 
U.S. House of Representatives

TO THE EDITOR:

Horwich and Weimer join the broad consensus of economists on oil supply disruptions. That this consensus extends across a wide political spectrum is evident from recent books produced by Resources for the Future and the Harvard Energy Security Program. As a subscriber to the consensus I applaud its promotion. As a pragmatist, however, I suspect that Horwich and Weimer
have merely added their voices to ours shouting into the wind.

Aside from academics and the Department of Energy, not many want to give the market a chance. A bill to reinstate the ill-conceived regulations of the 1970s passed the Senate 85-7 in 1982. It behooves those of us who advocate market policies to reflect on the reasons why they inspire so little faith even in the private sector. It is unfortunate that the authors have not done so.

A likely explanation is that the market does not in fact work very well in the short run. There is little quarrel that, given enough time, the market will adjust to balance supply and demand. But the very term "shock" suggests a short time horizon, in which it is far from obvious that the adjustment would be smooth or efficient. In their article and in the book on which it is based, the authors merely assume that the market works well: it is hardly surprising that their arguments fail to persuade those not already converted to the free-market faith.

The question of how well the market works is not easy to answer definitively, but some suggestive evidence is provided by contract prices. In the authors' frictionless market, any difference between the price of oil bought under contract and the price of oil bought in the spot market would be arbitrated away immediately. In fact, spot and contract prices diverged by large amounts, for an extended period of time, during the Iranian crisis. A single "market price" simply does not exist.

Further evidence comes from the buy-sell regulations, which forced sales from large to small refiners at average, rather than marginal, cost. Although the authors properly condemn this program as unfair and inefficient, closer examination shows that forced trades occurred even in periods when average and marginal cost were roughly equal, suggesting that small refiners did not have access to crude oil at the "market price."

Discussions with oil company executives leave me with the impression that existing contracts, whether explicit or implicit ("good business practice"), will prevent easy reallocation of large volumes of oil in a short time. Many think government intervention inevitable, and some even desire it on the grounds that emergency response is a public-sector responsibility.

Most of the authors' policy recommendations would be beneficial even if their premises proved to be wrong. Admitting that the market just might not work perfectly, however, raises the possibility of a more activist public policy. The trick is to design such policy so as to be helpful if the market does not work well, and do no harm if it does. One example is to improve the international oil-sharing mechanism, rather than scrap it as the authors suggest. Another is to restrict some of the auctions of Strategic Petroleum Reserve options to small refiners, who should bid the price up to market-clearing levels anyway.

The alternative to a little government intervention is not the pristine picture painted by the authors, but the ham-handed regulation of the 1970s. Let us not forget that the first energy czar, the man who set up the regulations and made them work, was that leading advocate of free enterprise, former Treasury Secretary William Simon.

Robert Weiner,
Harvard Energy and Environmental Policy Center

TO THE EDITOR:

The Strategic Petroleum Reserve has already been filled to a level of something close to a 100-day supply of current imports—without any help from oil import fees. And if an oil-import fee is enacted, it will be hard to remove once the SPR is filled. In fact, the authors openly propose having the revenues from the fee revert to the general fund at that point. Companies that de-
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for distributing SPR oil. The advantage of this system is that the drawdown of the SPR would begin slowly, in response to true market forces, rather than all at once after a political SPR drawdown decision was made. This approach might significantly dampen initial panic purchases of oil and hold down short-range oil price increases.

W. J. Montgomery, Standard Oil Company (Indiana)

TO THE EDITOR:

Although it is desirable to add to the Strategic Petroleum Reserve, a tax on oil imports is not a good way to raise money for this purpose. Such a tax would make all oil products more expensive, and the higher cost of heating fuel would be particularly burdensome to the poor and to residents of the New England and other northern states. Furthermore, by depressing crude oil prices abroad, it would aggravate the foreign debt problems of many oil-producing countries, and probably stir up resentment abroad and strengthen the influence of the militant members of OPEC.

The excise tax on gasoline was recently raised from four to nine cents per gallon. If only two cents of this increase were designated to finance the SPR, it would support a fill rate of about 200,000 barrels per day. That is not only higher than the current rate, but higher than the 186,000 barrels-per-day rate that Congress would appear to be advocating.

The authors note, it is important to establish in advance definite procedures that would make the SPR promptly available during any future disruption. They propose selling options to purchase SPR oil in advance. Before an emergency develops, however, it is most unlikely that enough options or future contracts on SPR oil could be sold to make any difference in the market. The purchase of such contracts would entail significant costs that could hardly be justified in today's highly competitive crude oil markets. After an energy emergency has begun, of course, there is obviously no longer any need for sales of SPR options or futures. A better solution would be to sell SPR oil to U.S. refiners by public auction for current delivery only.

The authors also propose a system of emergency subsidies for those who suffer hardships during an oil disruption. This scheme attempts to solve an energy and a welfare problem simultaneously and winds up with second-best solutions for each. The revenues from the sale of SPR oil should be used to replenish it in the future. If persons on welfare need additional support to cover the increased costs of heating oil, food, or clothing, those funds should be provided from the traditional sources.

W. D. Hermann, Chevron Corporation

George Horwich and David Leo Weimer respond:

We welcome Rep. Synar's views, most of which are consonant with our own desire to rely on market forces. We have serious reservations, however, as to the IEA sharing agreement, which we believe would substitute mandatory allocation of oil for market distribution on the international level. We would also counsel against directed sales of SPR oil, other than to meet our IEA sharing obligations. In general, individuals or groups that are deemed worthy of assistance should receive cash grants, not oil. Directed sales do not promise greater efficiency and could initiate a general slide into allocations of oil at below-market prices throughout the economy.

We do not understand the basis for W. D. Hermann's claim that companies will find it prohibitively expensive to buy options on SPR oil. We would expect a well-designed options market to handle the trivial transactions costs. The stringent product specifications of a futures contract, referred to by Rep. Synar, are not relevant to the sale of options. Given the flexibility of U.S. refineries, allowing a wide universe of primary and secondary buyers would assure that SPR oil of any grade, obtained through options, would eventually find its way to an optimum use.

There is merit in W. J. Montgomery's suggestion that SPR sales be conducted continuously at a price fifty cents to a dollar per barrel above the current market price. We do not believe the actual details of an automatic drawdown device are as important as the principle that it be in place.

The primary case for an import fee to fund the SPR is that there is a national security premium not reflected in the market price of unstable imported oil. Others have explored this subject at length; our proposed $2 fee is at the bottom of the range of premium estimates. The fee will not, as Montgomery fears, lead to a differential between the prices of domestic and imported oil and thus to lobbying for entitlements to the lower-priced oil. There will be one common price for the entire oil market.

If, as is likely (especially in the present soft market), the fee reduces the world price, there will be losers as well as gainers, as Hermann points out. Previous analyses, however, have invariably found a net gain to consuming countries from any price decrease. Montgomery's suggestion that exporting countries will somehow retaliate against a U.S. tariff is not supported by conventional economic theory or the history of oil markets.

Our prediction of higher revenues from the windfall profits tax following imposition of a tariff was not meant to imply, as Ben Zycher infers, that the former tax is in any way desirable. In fact, we believe the misnamed windfall tax is highly inefficient and should be phased out as soon as possible.

The fact that the SPR benefits society at large, not just consumers of imported oil, does not, as Zycher argues, justify funding it through a general tax. Applying the tax to imported oil internalizes the costs of future disruptions, the mitigation of which constitutes the social benefit in question. Zycher's argument is analogous to calling for non-poluters to share in the costs of antipollution measures on the grounds that they benefit from the resulting clean-up.

Zycher confounds oil price drag with the resource reallocation dictated by higher relative prices of energy. The drag is a temporary but potentially damaging siphoning of funds into the coffers of the petroleum industry or financial institutions from other markets and industries. The empirical evidence indicates that oil price drag is at most a moderate deflationary force. But it is deflationary, and a moderate easing of monetary policy would serve to offset the fall in prices, not to raise them. At the same time, the massive permanent reallocation of resources that the higher relative price of energy induces would almost certainly be facilitated by a slight inflationary bulge. We believe there is a limited tradeoff between inflation and unemployment in transitional periods.

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Robert Weiner cites, as evidence of market failure, the tendency of spot market prices to rise above contract prices during disruptions. An alternative interpretation is that the usual excess of contract prices over spot prices during stable periods reflects in effect an insurance premium, assuring buyers of some future supply, and that this insurance is effectively cashed in during disruptions. That would be a symptom not of market failure, but of the market at work. One should not, however, take at face value the full difference between contract and spot prices during disruptions. Recent studies indicate that there are many non-price features of modern contracts that make the effective contract price higher than the nominal contract price during shock periods.

Weiner also sees market failure in the lack of “access” to crude oil supply experienced by small refiners and others during disruptions. His implicit assumption is that in a functioning market all buyers would undergo equal proportionate supply reductions. Again the market reality is more complex. Demand elasticities vary widely among petroleum products. The heavier output in which smaller refiners tend to specialize (boiler fuel, heating oil) has a higher demand elasticity and thus tends to undergo a greater reduction of demand when prices rise than does the lighter output (such as gasoline) that is more typical of larger refiners. The result is that disruptions reduce the relative economic power of small refineries to bid successfully for crude oil.

Familiar as these relationships, as Weiner does, lead to corrective policies (of which Weiner has a whole bagful) that destroy efficiency and exacerbate the costs of oil shocks—exactly as in the 1970s.

Video Copying

TO THE EDITOR:

Your “Perspectives” piece entitled “Betamax Goes Free” (Regulation, January/February 1984) was wide of the mark; the majority opinion in Betamax was correct on the merits. As patent law has evolved, contributory infringement can only be predicated on the sale of an article which has no other use than to infringe. In contrast, a “staple” item cannot be forced off the market in this way, for then purchasers would be deprived of a product that has some admittedly legitimate functions. Holding Sony liable on this basis is equivalent to finding Seagrams liable because some of its customers drive after drinking.

There is, however, a theory that could have suited the purposes of those who regard “time shifting” or “librarying” as a threat to the economic well-being of movie studios and the like. Section 271(b) of the patent statute states that “whoever actively induces infringement . . . shall be liable as an infringer.” Like the doctrine of contributory infringement, this doctrine could have been extended from the patent to the copyright context. As the district court opinion pointed out, Sony’s ads urged users to “record favorite TV shows” and “build a library.” Even so, the plaintiffs could not have prevailed unless they had established that such uses were unlawful.

More important is a point that was neglected by both minority and majority, the ninth circuit, and your article, namely that no user of video recorders was represented in the Betamax litigation. I fail to see how a court could, consistent with our notions of fair play, hold any user of a video recorder to be exceeding the bounds of “fair use” when no such user was more than nominally present in the litigation. The only individual user named as a defendant, William Griffiths, was (1) recruited by the plaintiff’s law firm and (2) unrepresented in the litigation! I shudder to think of the long-term implications if this procedural device were to become common in resolving our rights and liabilities.

Thomas G. Field, Jr.
Franklin Pierce Law Center

THE EDITORS respond:

Field apparently believes that we have accepted the view of the Betamax minority that the manufacturers of recorders can be guilty of contributory infringement when their customers employ the equipment to infringe a copyright. Instead we simply reported the disagreement between the majority and minority opinions on this issue. Moreover, the theory that Field argues could have been used to find Sony guilty—that it induced infringement by others—was in fact advanced by the court’s minority.

As we reported, Universal named a token individual as a defendant. But it is not entirely clear how Universal could have done otherwise. Would it have had to sue all individual users of videocassette recorders, or would some users have been assumed to represent their class? If the latter, how would the representatives be chosen? And who would have to pay the legal fees?

If the Supreme Court majority had held simply that Universal had brought the wrong defendant to the bar, the case could have stood for the proposition that Field is apparently advancing. If the court had held only that time-shifting was fair use, or that manufacturers of recording equipment would not be liable for their customers’ infringements, the decision would similarly have had limited impact. But the majority’s extended limining of the rights of “noncommercial” users, its requirement that copyright holders demonstrate that they have been harmed by such use, and its narrow view of what constitutes such harm, all suggest that the creators of intellectual property will have some tough times ahead no matter whom they pick as a defendant.

Coal Leasing Scandals

TO THE EDITOR:

Your discussion of the Commission on Fair Market Value Policy for Federal Coal Leasing (“The Coal Leasing Scandals,” Perspectives, March/April 1984) is the best I have seen. It notes the key problem—that the commission was a short-term educational venture in which four of the five commissioners themselves needed tutoring. How-
ever, you do not fully succeed in describing the convoluted process in which we on the commission were engaged.

One major issue was whether the Interior Department received fair market value on the Powder River Basin lease sales. The prior estimates of the fair market value of the tracts had been padded outrageously, and I felt any estimates of lost revenue ought to take into account all sources of errors, not just those attributable to the Watt managers. Others wanted to include a stronger condemnation of the conduct of the program. Moreover, I felt then and feel more strongly now that the question of how much revenue the department lost on the Powder River sales was the wrong one to stress; the more important question was how to make leasing procedures sounder in the future. The resulting discussion of the Powder River sale in the commission report reflects a compromise among diverse positions, hammered out in exceedingly unfavorable circumstances.

At the last minute, previously confidential Inspector General reports suggesting wrongdoing were suddenly released. The commission staff had to draft and redraft its final report, without time to digest the new material thrown at it, under great pressure from an unreasonable deadline. (The chairman of the commission pushed with what I and others considered undue haste to complete the report.) The enemies of coal leasing made much of the report’s failure to stress a few allegedly damaging data. Given the stresses, however, the surprise is that the report achieved the coherence and moderation it did.

It is hardly surprising that your article did not sort this all out. I was more startled to find you making some statements that seem unduly favorable to existing leasing policy.

First, you say that the process of estimating fair market value “involves two symmetric dangers: the price may be too low, giving the bidder an undeserved windfall, and the price may be too high, preventing the sale from taking place.” In fact, these dangers are not symmetric. Overvaluing imposes real costs on the economy by preventing more efficient production. Undervaluing causes only a (probably modest) transfer of income to the bidder.

Second, you complain about the limited competition for coal leases. I am not sure that this problem would be a serious one if not for the current diligence requirements (which require companies to forfeit their leases unless they develop them within ten years). If companies in particularly advantageous positions really place unduly low bids, speculators can step in to bid up prices—except that the diligence requirement makes such speculation dangerous. The commission’s reform program includes a loosening of this anticompetitive restraint; the next logical steps should be to remove the mass of limits on the permissible coal holdings of individual companies and replace the current royalty-per-ton system with an exclusive reliance on the initial bidding for leases themselves.

Richard L. Gordon, Pennsylvania State University

THE EDITORS respond:

Gordon is reading us too literally if he interprets our use of “symmetric” to mean that the dangers of undervaluing and overvaluing are precisely the same. Our point was simply that there are dangers on both sides; it meant as a corrective to the too-common view that undervaluation is the only real hazard.

The hazards of undervaluation, however, may go beyond the distributional concerns Gordon describes. Under a variety of plausible assumptions, undervaluation could lead to economic inefficiencies in the bidding process, the production process, or both.