SAND2006-4590P

Oil Floor Price:
Some Economic Considerations

Presented to:
Senator Pete Domenici

July 20, 2006

Dr. Arnold B. Baker, Chief Economist
Sandia National Laboratories
Phone: 505-284-4462 Fax: 505-844-1424
abbaker@sandia.gov

Dr. Al Romig, Senior Vice President
Deputy Laboratories Director
Integrated Technologies and Systems
Sandia National Laboratories,
Phone: 505-844-8358 Fax: 505-844-1424
adromig@sandia.gov

Oil Floor Price Objective

- Provide a "simple" way to encourage investment and reduce risk from falling oil prices for
  - Domestic oil, natural gas and coal production
  - Alternative energy, such as ethanol, coal to liquids, etc.
  - Energy efficiency

Positives

- Prevents "backsliding" of domestic energy investment and R&D when oil prices fall
- Could encourage domestic versus foreign energy investment
- Works through domestic market forces
- Doesn't pick energy winners and losers
- Simple in theory

Negatives

- Administrative complexities
- Constituency dependencies
- Global economic realities and competitiveness

Negatives (Continued)

- **Administrative complexity**
  - **Is the floor price (variable import fee) just on imported crude oil (for simplicity)? If so, what about**
    - » Imported petroleum products (e.g., heating oil, gasoline, jet, NGLs, etc.)
    - » Imported ethanol and other alcohols
    - » Imported petrochemical feedstocks
    - » Imported natural gas
    - » Imported coal? Imported electricity?
  - **How will pressure for exemptions be handled?**
  - **How to set and maintain imported energy variable import fee equivalents?**
  - **How often to adjust fees as oil prices move?**
  - **U.S. has been down this type of road before**
    - » Eisenhower voluntary oil import quota (1957) to keep out cheap foreign oil
    - » Limited oil import volumes to maintain domestic prices above world market level
    - » Grew into mandatory oil import quota program with small refiner bias and exemptions—became an administrative nightmare
    - » Fell apart in 1973-74

Negatives (Continued)

- Business dependency
  - Like agricultural price floors, open ended oil/energy price floors likely would build political business dependencies on above market energy prices that could be difficult to undo
    - » Could create dependencies for new energy technologies like ethanol, coal to liquids, etc., as well as for marginal oil (high cost) and gas producers

Negatives (Continued)

- Global Economic Realities and Competitiveness
  - If world oil prices remain close to U.S. oil prices, little or no economic issue other than program administrative cost
  - If world oil prices fall significantly below domestic U.S. oil/energy prices, the U.S. will be at a competitive disadvantage in energy intensive goods
    - » Will lose third country export market share to lower cost energy countries
    - » U.S. imports of energy intensive goods will be cheaper than domestic goods (e.g., increased pressure from Chinese, etc)
      - ¤ Adversely affect U.S. trade balance and U.S. jobs
      - ¤ Growing political pressure to keep out cheap foreign imports
      - ¤ Would oil floor price fees have to be extended to imported manufactured goods? How would this affect GATT? Would other countries retaliate?

Negatives (Continued)

- U.S. economy would lose the stimulus of lower oil prices that trading partners would gain

- Combination of relatively higher oil/energy prices and worsening trade balance would slow U.S. economic growth and cost jobs relative to trading partners. This could
  - Affect U.S. foreign capital inflows and payments balances
  - Affect relative value of U.S. dollar
  - Complicate U.S. monetary and fiscal policy

- U.S. business oil/energy price support dependency would make it difficult to undo program, especially in a weak economic environment