Gas Prices: Why So High?

Today, of course, who wouldn't *welcome* $3.19 per gallon for regular/unleaded gasoline?

United States oil lock: Brazil's Petrobas Oil tows an oil platform out to drill for offshore oil. Though other countries such as India, Canada, Spain, Malaysia, Norway, and now Brazil are reportedly doing exploratory drilling in waters little more than 60 miles from the Florida coast, the United States forbids drilling in about 85 percent of this area.

As this is being written (June 16, 2008), the national average price for regular/unleaded gasoline is $4.08, up from $4.04 on June 9 and up from $3.72 on May 12. A year ago, a gallon of regular/unleaded cost $3.00. Diesel fuel, used by large tractor-trailers, is considerably higher, at a national average of $4.69 per gallon, up from $2.80 one year ago. These record highs have been going up almost every week and will likely be higher by the time you read this.

Many people are frustrated, and those whose means of earning a living involve driving long distances (independent truck drivers, for example) are finding it harder and harder to make ends meet. The big question on everybody's mind is, *"Why?"* Why have these prices gotten so high? Are the oil companies gouging us with obscene profits? Are we running out of oil? How much higher will the price go? Will the day come when driving to another part of the country or even commuting a distance of several miles to work is no longer affordable? Can anything be done to reduce the price, or at least keep it from continuing to rise?

Value of the Dollar

Oil is not the only commodity that is becoming more and more expensive to buy. The cost of food is also going up. So is the cost of just about everything else. One major reason for this overall rise in prices is because the dollar does not buy as much as it used to. And the reason the dollar does not buy as much as it used to is because the Federal Reserve System (along with the U.S. Treasury Department) is

inundating our economy with newly created dollars. Their intent is to finance the federal government's massive expenditures as well as to prevent a deepening recession. The newly created dollars won't solve our economic problems, of course, since each new dollar added to the economy devalues the dollars already in circulation, causing prices to rise.

Inflation is usually, and erroneously, defined as rising prices. Rising prices are in reality an effect of inflation. Properly understood, inflation is expansion of the money supply: more dollars chasing the goods and services available in the market. Each dollar buys less. Since oil companies are not responsible for increasing the money supply, they are not responsible for the effect inflation has on prices. If the number of dollars in circulation is doubled, then all other things being equal, oil companies would eventually have to charge twice as much for their product.

How much of the rise in gas prices is attributable to the overall rise in prices caused by dollar inflation? One way of finding out is to measure the price of gasoline in terms of "constant" dollars instead of nominal dollars. For instance, in 1971 — the year is significant because that was when President Richard Nixon took us totally off the gold standard — a gallon of gasoline that cost 50 cents a gallon would cost $2.66 today in 1971 dollars, as calculated by the Consumer Price Index. In fact, this is a very *conservative* estimate of the devaluation of the dollar for the reason that the CPI increasingly underreports the actual overall increase in the cost of goods and services. (See "Dangers of an Underreported CPI" in our June 23 issue.) But even this conservative estimate shows that most of the increase in the price of gasoline from 50 cents in 1971 to $4.00 today is attributable to the dollar's overall loss of purchasing power, a devastating consequence of inflation.

Supply and Demand

But inflation, though hugely important, is not the only factor. To be sure, the price of gasoline is heavily dependent on the price of crude oil, which like any other commodity is affected by supply and demand. Either an increase in demand or a drop in supply (or both at once) will cause prices to rise. Rising prices also encourage more production and discourage wasteful usage.

Global energy consumption has been rising. According to the American Petroleum Institute (API), the demand for oil rose from 77 million barrels per day in 2001 to 85 million barrels per day in 2007. The API suggests, based on U.S. Energy Information Administration (EIA) projections, that world oil consumption will grow by 1.2 million barrels per day in 2008 and by 1.3 million barrels per day in 2009. Much of this projected increase will be due to the rapid growth of the economies of China, India, and other Asian countries, as well as the Middle East oil-producing nations.

Production of oil comes with a hefty price, and the price has been increasing. In 2005, the price of crude oil averaged $50.23 per barrel. It just recently surpassed $130 per barrel, topping out at a record $139.89 on June 16. The price of crude oil, which itself is affected by inflation, is the single biggest component driving the price of gasoline. According to the API, in the first quarter of 2008, crude oil alone made up 70 percent of the price at the pump.

The increase in demand is also an issue. Moreover, while demand is increasing, supply is tightening — OPEC's spare production capacity has declined from 6 million barrels per day a few years ago to around 2 million barrels per day as we move through 2008. Tightening supplies put upward pressure on the price of any commodity.

This situation is made worse by the fact that the United States has become dangerously dependent on foreign oil. Put simply, we now consume far more oil than we produce. According to EIA statistics, the

United States produces 10 percent of the world's oil and consumes 24 percent. The difference is made up in imports. Over 65 percent of the oil we consumed during 2007 was imported. Some 18 percent of our net petroleum imports (imports minus exports) came from the relatively politically unstable Middle East: Persian Gulf nations including Bahrain, Iraq, Kuwait, Qatar, Saudi Arabia, and United Arab Emirates. A sufficiently large enough percentage of our oil imports comes from the Middle East to mean that political uncertainty and instability there is bound to affect prices here.

Obviously, political instability in the Middle East — including the quagmire in Iraq as well as the looming threat of war with Iran — greatly affects the price of oil from the region as well as the price Americans pay at the gasoline pump.

Political strife and uncertainty are not limited to the Middle East. Nigeria, another major oil exporter, is embroiled in civil strife. Venezuela, a major source of South American crude, faces some uncertainty because of an ongoing war of words with the Bush administration over actual and proposed hemispheric trade agreements (e.g., a Free Trade Area of the Americas, strongly supported by President Bush and North American internationalists). Venezuelan leader Hugo Chavez sees these as threats to the economic independence of the region. None of these nations share the American vision of a free society based on the ideals of constitutionally limited government; none of them are particularly friendly to the United States. Political reasons could cause any of them to restrict or curtail the oil they now sell us.

Many American consumers doubtless realize what our political class seemingly does not, that we place ourselves at risk by becoming dependent on foreign and potentially hostile regimes for a basic need of our civilization.

America's Energy Resources

Tragically, our dependence on foreign oil is not only dangerous but unnecessary. America has abundant energy resources, including oil reserves that remain largely untapped. For example, significant untapped reserves exist in the Gulf of Mexico, off both our Pacific and Atlantic coasts, and both on land and offshore in and around Alaska. According to API, "The U.S. government estimates that deepwater regions of the Gulf of Mexico may contain 71 billion barrels of oil." API estimates that there are 10.5 billion barrels off the shores of California and the Pacific Northwest, 3.8 billion barrels off the Atlantic coastline, and 18 billion barrels onshore and 26.6 billion barrels off the Alaska coast and in the Alaska National Wildlife Refuge (ANWR). This adds up to 138.1 billion barrels of oil, enough to power over 60 million automobiles for 60 years according to government estimates. (These same reservoirs could supply 656 trillion cubic feet of natural gas, sufficient to heat 60 million homes for the next 160 years.)

The domestic political climate, however, hasn't been conducive to developing these reserves. The above oil reserves have been largely off limits. While the Prudhoe Bay area in Alaska's North Slope currently supplies 17 percent of domestic oil production, ANWR remains closed despite geological studies done in 1987 and again in 1998 indicating significant amounts of untapped oil there. Well-funded environmental groups have thus far successfully fought the development of ANWR. Meanwhile, the same kinds of groups have steadfastly opposed drilling off the California coast despite major technological advances that have rendered offshore drilling environmentally safe.

What domestic oil we are able legally to remove from the ground must of course be refined, and here, too, environmentalist groups and environmental regulations have hamstrung the oil industry — to the extent that not a single major new refinery has been built on U.S. soil since 1976. How limited is our

refinery capacity? Hurricane Rita answered that question when she stormed through the Gulf of Mexico in late summer 2005. Although Katrina received more press coverage, having devastated New Orleans a few weeks earlier, Rita actually did more to disrupt the process that supplies gasoline to millions of American consumers. Rita damaged a number of major refineries along the Texas coastline, temporarily affecting supply and causing a spike in prices. For the first time, we saw gas prices increase to over $3 per gallon; this happened in less than 24 hours. As the refineries were repaired and supplies were restored, however, prices retreated.

Some states, moreover, have passed restrictive laws resulting in higher prices for consumers. California is an example. The State of California operates its own reformulated gasoline program, calling for special oxygenated, reformulated, and low-volatility gasolines to reduce toxic emissions. These cost more to produce than conventional gasoline. In other words, California state law is stricter than what the federal government requires. In addition to the added costs of the additional refinement, California imposes a combined state and local sales and use tax of 7.25 percent on top of an 18.4 cent-per-gallon federal excise tax and an 18 cent-per-gallon state excise tax. California's refineries must run at or near full capacity at all times to meet the state's fuel requirements. If more than one refinery experiences operating difficulties, the result will be supply problems and a spike in gas prices in the state. There are relatively few suppliers of the unique blend of gasoline required by California state law.

Taxes added by federal, state, and even local governments do contribute to higher gas prices elsewhere. We just noted how federal excise taxes account for 18.4 cents per gallon of gas. State excise taxes account, on the average, for another 21 cents per gallon. Eleven other states add additional state sales and other taxes. This does not account for local city and county taxes which can also impact significantly on the cost of a gallon of gasoline, varying from location to location.

Though the aforementioned cost factors may seem to contradict the reasons given in mainstream media behind rising gas prices — i.e., that malicious unregulated oil speculation (buying oil futures, betting prices will rise) is driving up gas prices — they are not contradictory. Speculators purchase futures contracts, hoping to sell the contracts in the future for a higher price, thereby making a profit. But even in unregulated markets, commodities prices can only continue higher as long as commodity supplies remain low. When high prices cause a commodity glut, prices drop or stay stable. In the case of oil, high oil demand, along with tight oil supplies and huge government infusions of new cash into the markets (which prompt increased speculation), are driving oil prices up. The speculators are not evil; they are responding to market forces.

Alternatives to Oil?

In addition to pumping crude oil out of the ground, the technology has existed for decades to convert our vast supplies of coal reserves — a whopping 27 percent of the world's total — into liquid hydrocarbon fuels. Coal-to-liquid technologies have gotten a bad rap over time because they were expensive and polluting, but now they can be made economical and clean. If nuclear power were used to transform coal into diesel fuel and gasoline, our country could replace the majority of our country's oil imports with a fuel so clean that even many of those most fearful of human-caused global warming could agree with its use. (See "Coal in Your Car's Tank," in our June 9 issue.) Additionally, modern nuclear plants can be built so that meltdown becomes an impossibility, and 97 percent of nuclear "waste" can be recycled.

Nuclear power could also be used to reduce our dependence on crude oil from either domestic or foreign sources — directly by replacing oil now being used to produce electricity (though that particular

form of electrical generation is not all that significant), and indirectly by replacing coal-fired plants and therefore allowing that coal to be converted into liquid fuel for your gas tank.

Oil Company Profits

But what about the profits that large oil companies make? Are they not gouging the public?

The API *Primer* on oil and natural gas (available for free on the API's website) contains an analysis suggesting otherwise. Oil and natural-gas revenues are large; there is no question about that. But so are the industries themselves, and so are the costs involved in providing fuel to consumers. Oil company profits allow for reinvestment in facilities, technology, and infrastructure. Reports on oil company profits can be misleading because they focus exclusively on earnings and don't take into account the size of the operations. Earnings alone, therefore, do not tell the whole story. Relative to other major industries, oil company profits are about average, at 8.3 cents for every dollar of sales, compared to the chemical industry's 12.7 cents for every dollar of sales, the computer industry's 13.7 cents and the pharmaceutical industry's 18.4 cents for every dollar of sales.

Some politicians would like to see a new era of "windfall profits" taxes on oil companies. Their contention, based on the illusion of earnings figures alone, would clearly do more harm than good to an industry they do not understand. By and large, America's oil companies aren't owned by the small groups of insiders that control political parties. The percentage of industry shares owned by oil executives is only around 1.5. The rest is owned, indirectly, by tens of millions of American shareholders, often through their mutual funds, IRAs, or other personal retirement accounts, most of which invest in oil and natural gas stocks. If politicians were to institute a "windfall profits" tax or — worse yet — attempt to nationalize the oil and natural gas industries under the belief that this would get prices under control, who would really be hurt? The answer: these millions of ordinary investors with mutual funds, IRAs, or other personal retirement accounts.

Like any other enterprise operating in the marketplace, oil companies need to make a profit if they are to stay in business. But the fact of the matter is that the more competition there is, not just among oil companies but among energy producers in general, the harder they will work to innovate, economize, and hold down prices to consumers. If the now-existing roadblocks to the development of energy resources in this country were removed, there would be much more domestic oil exploration, drilling, and refining. There would also be more effort put into developing our energy resources and technologies. We could begin to end our long stretch of dependence on foreign oil and work toward the energy independence a sovereign nation requires.

What Can Be Done?

At present, the reality is that our economy is dependent on oil and will remain so for at least another generation. Thus our short-term goal should be to do what we can to ensure that the cost of both producing oil and refining it into gasoline is contained, so that gasoline remains affordable to American consumers. Congressman Ron Paul (R-Texas) has introduced new legislation, H.R. 2415, the Affordable Gas Price Act. The bill states its own purpose: "To reduce the price of gasoline by allowing for offshore drilling, eliminating Federal obstacles to constructing refineries and providing incentives for investment in refineries, suspending Federal fuel taxes when gasoline prices reach a benchmark amount, and promoting free trade."

With this last, Dr. Paul means real free trade, not the managed, pseudo-free trade of NAFTA, CAFTA, and the like. The point is, the federal government has proven to be the biggest obstacle to our achieving

energy independence and thus containing the alarming escalation of gas prices. Environmental groups may run a close second, but their influence is felt through legislation passed by Congress. What Congress has done in the past, it must now undo. H.R. 2415 would go at least part of the distance if it can obtain cosponsorship and support so that it will receive committee action and eventually come to the floor for a House vote.

Were such a bill to become law, it would mean developing oil fields that have been off-limits for political reasons.

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