THE WALL STREET JOURNAL
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VOL. [illegible] NO. 43 ★ ★ ★ MARCH 1988 • • • • 50 CENTS

U.S. Oil Industry: Search for Solutions

In the following pages, we present several views on the controversial issue of an oil import fee. We hope these articles stimulate debate and help bring the issue of a national energy policy to the attention of important political figures during this election year.

A Welfare Plan for U.S. Oil

Last week, while members of the Organization of Petroleum Exporting Countries were gathering in an effort to arrest the slide in oil's real price, Gov. Bill Clements of Texas sat on the lap of Santa Claus during a fund-raiser in Houston and asked for "$25-a-barrel oil."

Since oil is denominated in U.S. dollars, a further decline in the dollar could grant him his wish, current price movements notwithstanding. Disruption in the supply of imported oil also could yield this result. But that's not what the governor has in mind. He has proposed a federally mandated $20 floor and $25 ceiling on oil that would increase the government's role as a discriminatory-rather than discriminating-Santa.

For decades the U.S. was the world's largest producer of petroleum products. This happy occurrence came from our geological, technical, economic and political environment. But the geological and economic realities have changed-to the discomfort of many in the oil patch. We can expect those disadvantaged by that change to try to use the power of government to insulate them from the new realities, but that does not mean that granting their request is in the national interest or that change can be forestalled for long.

National Security Argument

Some industry representatives argue that national security dictates that domestic production be maintained at a higher level than the market would justify. They claim this is necessary to keep the domestic infrastructure in place. Over the long run, however, this is self-defeating, for any policy that constrains oil imports implies a decision to drain the U.S. first and thus directly, over the long term, increase U.S. dependency on foreign sources of oil. A far better strategy would be to find, develop and then shut in reserves for a rainy day, not pump them out.

Many of these representatives also claim that our imported oil from the Mideast carries an additional, extraordinarily high cost-the cost of defense. But this implies that if the U.S. itself weren't an oil importer, it could shed much of the military burden in the region that it now bears. Given the dependence other Western nations would still have, this is unlikely-the truth is we don't know what the marginal security costs of our import bill are.

America's comparative advantage no longer lies in oil production on its private lands. While these lands constitute only about 3% of the earth's surface, they hold more than 80% of the world's oil and gas wells. But the currently producing large fields' output is inevitably smaller and more costly as time goes on, and current technology and geological theories offer little chance of finding new oil fields with more than 100 million barrels on America's private lands. (By comparison, the Yates field of West Texas since 1926 has produced 1.1 billion barrels and has 900 million barrels left. Kuwait's Burgan field has reserves of 72 billion barrels; Saudi Arabia's Ghawar field, 83 billion barrels.) The remaining wells on private lands are likely to be small, high-cost producers. As a result, the U. S. increasingly will be dependent on foreign oil. (While there is greater potential on U.S. public lands, more than half are off limits for exploratory drilling.)

It is not that U.S. exploration and drilling costs have gone up or that the rate of success in finding oil has gone down. The problem is that our new fields now are much smaller, our wells have lower yields, and so our average production costs per barrel are higher.

When the huge East Texas field was found and developed during the early 1930s, the object was to hit the Woodbine sands at a shallow 3,600 feet. Our technology has become much more sophisticated - and cost-effective - since then. In the March 6, 1931 issue of *The Oil Weekly*, the costs of a typical well were reported: derrick $12,000; 1,500 barrels of fuel oil to power the drill at 75 cents a barrel, $1,125; casing $6,167; cementing $475. In constant dollars, domestic producers can drill a well of that size and depth less expensively today.

Early wells in the East Texas field often came in as gushers. Some were able to produce more than 20,000 barrels a day. Today the numbers are different. In 1986, the average daily production from a Texas well was an estimated 15 barrels; from a Montana well, about 20 barrels; from an Oklahoma well, about five barrels; and the U.S. average was about 15 barrels. By contrast, the average daily production from a well exceeds 1,500 barrels in Kuwait and 6,000 barrels in Saudi Arabia.

An artificially inflated domestic oil price mandated by the government would be a welfare plan for domestic producers. It would buffer them from the consequences of their investing based on erroneous energy shortage-era projections of $30-plus oil, while increasing the costs for everyone else. The oil producers spent a lot on wells that are now producing expensive oil. The Clements plan would force everyone to pay for these mistakes.

The market works so well precisely because prices convey distilled information and incentives to act on that information responsibly. Gov. Clements' plan would censor data regarding the rela-

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A Welfare Plan ...continued

tive value of oil in the international markets when the world price moves outside his narrow range. The spread between the world price and the governor's proposed $20 minimum is a drag on the U.S. economy. Oil's price should provide a signal of how much we have to sacrifice to obtain a barrel of oil, but a $20 price is not a true indicator if oil can be obtained for less. If, on the other hand, the market value of oil exceeds $25, Mr. Clements' plan would rob producers and owners of what is rightfully theirs. (Thus the plan is even more pernicious on the upside than is the still-in-force Windfall Profits Tax, which expropriates up to 70% of the value above its trigger price.)

For the national economy, the cheaper the oil the better, once security costs are factored in. It is really that fundamental. And whether by accident of geology or the will of Allah, the Mideast sits on an ocean of low-cost oil. In September, Kuwait could find, develop, produce, and deliver oil to Rotterdam for less than $2 a barrel-and make a profit. By contrast, America's finding and developing costs alone are at least $10 a barrel. In the past five years, Kuwait has added 25 billion barrels to its reserves-without an active exploration program. Even if the world price dropped to $12 a barrel from its current $16 range, it would take time for increased demand to sop up the world glut.

This situation is historically normal. Misguided government policies and international politics can temporarily cause shortages, but the fundamental problem has been how to control excess production. For example, the average U.S. price in 1930 was $1.19, but with the development of the East Texas fields in 1931 it dropped to 65 cents. To deal with buyer or seller unhappiness, regulators periodically have fiddled with the market relationship.

In so doing, governments have grossly distorted oil prices and incentives and thereby censored information about relative values and opportunity costs. Should we further distort the data required for intelligent decisions? Even for those whose interests lie solely in the industry, the superior move would be toward a national energy policy based on market allocations with strong environmental safeguards but minimal governmental interference.

Consumer Makes Final Choice

Those in the oil and gas business are quite capable of responding responsibly to market signals. Their experience with price controls, the Windfall Profits Tax, pipeline regulations, and misguided environmental constraints on exploration on the public lands and Outer Continental Shelf should have made them wary of government intervention in the oil market. Specifically, the oil industry's comparative advantage lies in exploring and engineering offshore, abroad and on untapped public lands and waters.

The temptation for the oil-producing regions and industry to look toward the government for succor in the form of artificially higher prices is understandable. It's comforting to believe in Santa Claus. Still, the consumer at the gasoline pump makes the final choice. When he tired of paying $1.45 a gallon in the late '70s and early '80s, he bought a more energy-efficient car, demand dropped, and the price came down. Above $20 a barrel of oil, substitutes emerge. Brains and creativity become substitutes for BTUs

What should we do? Clearly the national interest is linked to a healthy energy industry-and good health is most likely to come about if the industry learns to deal with the uncertainties of the marketplace, rather than the illusory comfort of the public trough.

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December 18, 1987

Private Views on an Oil Import Fee...

"I think it would be a terrible mistake. It would end up being a program that wouldn't work, and you would have a large, governmental bureaucracy developed to oversee it."

Ray L. Hunt, Chairman and Chief Executive Officer, Hunt Oil Company, Dallas, Texas.

"For years, a lot of independents kept complaining about the government being in the oil business. Now that the price of oil has dropped, those very people are calling for an import fee on foreign oil. ...I'm still unalterably opposed to it. It's a false deal. The oil and gas industry in the United States should be run as a business subject to the law of supply and demand and competition."

W.A. Moncrief, Jr., Proposal for Solving Problems Now Plaguing the U.S. Oil Industry Without Resorting to an Import Fee on Foreign Oil.