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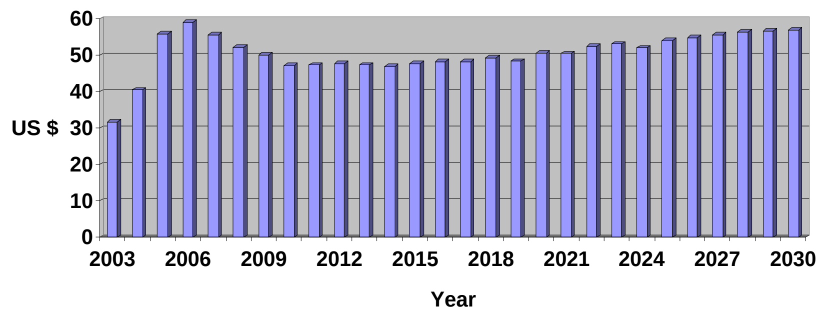
Waste Driven Demand Raises Petroleum Prices:

How Congressional SUV Subsidies Increase Prices at the Pump

The New Reality of Permanently High Petroleum Prices

On December 12, 2005, the US Energy Information Administration (EIA) released a revised oil price forecast through year 2030. On the supply side EIA sees increased use of coal and nuclear energy as OPEC output grows more slowly than previous estimates. Most jarring to American consumers is a $21 jump in per barrel prices. (See Exhibit #1) The revised forecast also predicts increasing reliance on foreign energy suppliers even as the US increases domestic production.

Exhibit 1: 2003-2030 Forecast Imported Light Crude Price per Barrel
(Source: EIA Annual Energy Outlook 2006)



Past EIA forecasts have underestimated future petroleum prices. Nevertheless, normally market savvy competitors such as GM and Exxon have not strategically realigned their operations or expectations to higher petroleum prices, producer country maturation and market demand issues. Their missteps have been heralded by the simplistic, yet erroneous, drumbeat of supply side mythologies promoted by mainstream American policy think tanks. Their misconceptions are echoed by politicians throughout the news media. The core mainstream think tank analysis is threefold. First, they would have Americans believe that energy prices are primarily a supply side phenomenon. Second, they propose that the price of Middle East petroleum is too high and could return to lower levels if only the demands of state owned national oil companies managing the majority of global production could be reigned in. Finally they postulate that US energy demand can and should shift away from Arab producers as an effective way to "fight terrorism". (See Exhibit #2) **These fundamentally flawed, and somewhat racist, arguments put basic economic principles on the defensive by ignoring demand side factors.**

Exhibit #2 A Mainstream Think Tank Obsession: Supply Side Energy Factors
(Source: AEI, Heritage, MEF, Brookings)

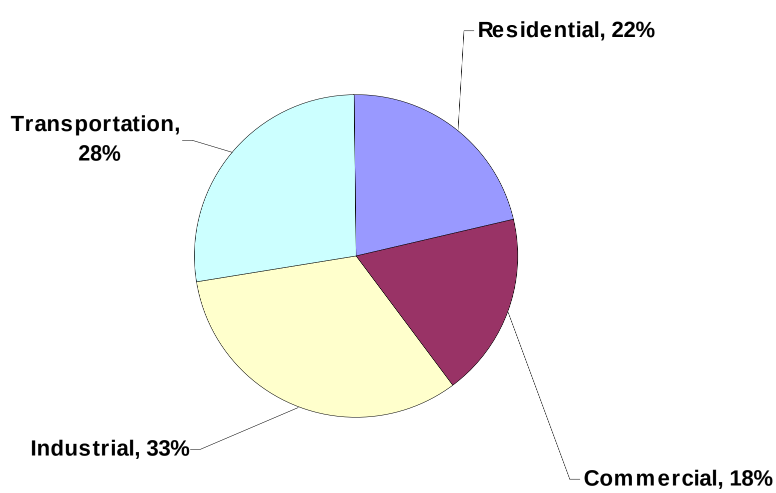
Think Tank	Study/Author/Date	Perspective
American Enterprise Institute	"Oil and Stagflation" John H. Makin 8/20/2004	"The rising oil price becomes a brake on demand growth by taxing consumers and producers. Higher oil prices have already reduced U.S. household incomes by about $40 billion this year, at about an annual rate of $80 billion or 0.8 percent of GDP."
Heritage Foundation	"Increasing the Global Fuel Supply"[i] Ariel Cohen 11/30/2005	"National oil companies control 58 percent of oil and natural gas reserves. In many of those countries, laws actually require that the government own or control significant shares of any oil-exploration ventures. But corruption in those very governments makes the multi billion-dollar investments required for oil exploration too risky."
Middle East Forum	Mission Statement Daniel Pipes 2005 http://www.meforum.org	"….reducing funds going to the Middle East for energy purchases."
Brookings Institute	"Vote Yes for the Energy Bill, Then Start Working on the Real Issues" Gregg Easterbrook 7/28/2005	"If all new cars, pickup trucks had roughly one-third higher fuel economy it would take less than 10 year's worth of new-vehicle sales to displace consumption equal to the among the US currently imports from Persian gulf dictatorships. This would be fabulous for US national security, while reducing total global greenhouse gas emissions and reducing the amount of dollars that flow to the oil sheiks who fund terrorism"

The Demand Side of the Petroleum Price Equation

Although mainstream American think tank energy price analysis focuses on the "supply curve", demand side issues are clearly a driving force in rising prices. The US and emerging Asia have the largest forecast increase in global petroleum demand, which required 84 million barrels per day in 2004, but will require 111 million barrels per day in 2025.[ii] **With major OPEC and other production lagging, simple economics dictate that in the face of spiraling demand, energy prices must rise.**

The highest US energy consumption sector is transportation followed by industry, residential and commercial sectors. Consumers looking for ways to cut their energy bill in 2006 have logically started in the garage: gasoline expenditures represent 61% of the transportation sector energy outlay. (See Exhibit #3)

Exhibit #3 2005 Delivered US Energy Consumption by Sector
(Source: EIA Annual Energy Outlook 2006)



Tragically, US consumers have had to suffer the efforts of think tanks, automakers, labor unions and the US Congress. All have worked to push through preferential subsidies promoting light trucks over fuel efficient passenger vehicles. Highly profitable SUV vehicle sales climbed 250 percent in the United States between 1995 and 2002.[iii] US automakers have been reticent to realign themselves with a future dominated by higher gasoline prices. As US automakers resisted increases in the Corporate Average Fuel Economy (CAFE) mileage standards, foreign competitors such as Honda and Toyota made major investments in hybrid technology. US passenger automobile standards, set at 27.5 MPG have not increased since the 1986 model year.[iv]

Even as gasoline prices steadily rose from late 2003 to mid 2004[v], US automakers and the United Auto Workers (UAW) eagerly lobbied for the passage of the "American Jobs Creation Act of 2004". This law introduced a massive US market distortion in the form of a tax preference for businesses purchasing SUVs and pickup trucks, rather than passenger cars. Although many small businesses needing hauling capacity benefited from the break, the tax benefit also put fuel inefficient SUVs into the hands of traveling sales people, accountants, realtors and other service providers who, absent the law's market distortion, would have responded to rising gas prices by purchasing fuel efficient vehicles. Those high mileage business people that purchased a SUV for the tax benefit over a typical hybrid passenger car would consume three times as much gasoline and pay considerably larger gas bills for accepting the Congressional subsidy. **Collectively, they shift the petroleum demand curve and raise gasoline prices.**

Exhibit 4: 2006 Toyota Prius vs Chevy Tahoe Fuel Consumption Costs
(Source: Cars.com, EIA and IRmep)

	Chevy Tahoe	Toyota Prius
Base 2006 Model Sticker Price	$35,915	$21,725
City MPG	16	60
Highway MPG	20	51
Total 2005-2009 fuel cost at 25,000 miles per year, split between city and highway.	$15,753	$5,078
Curb Weight	4,978 lbs	2,921 lbs
Tax Preferences	Preferential "equipment" tax deduction allowing accelerated depreciation for business vehicles. Ability to deduct full vehicle cost in 2003, $25,000 thereafter.	Standard business depreciation schedule, eligible for a "clean fuel" deduction of $2,000 if placed in service by the end of 2005. Starting Jan. 1, 2006, buyers of some hybrid vehicles get a tax credit, subject to the first 60,000 vehicles per manufacturer and buyer's AMT status.[vi]

Some US auto makers, led by Ford, are now retooling a bloated and stagnating product line. In the year 2000, while many American manufacturers saw innovation as a 10 cylinder gasoline engine for the consumer light truck market, Toyota was quietly launching hybrid vehicles worldwide. Even now, when the fuel inefficiency of the US vehicle fleet is considered to be appalling by many consumer groups and some members of Congress, GM is still attempting to defy gravity.

Exhibit 5 2004 Pickup Truck Fuel Efficiency (8-Cylinder)
(Source: Cars.com)

Make	Model	City Miles per Gallon	Highway Miles per Gallon
Dodge	Ram	9	11
Chevrolet	2500 HD Silverado	10	12
GMC	C1500 Sierra	11	14
Ford	F-150	11	15

Amid plummeting SUV sales General Motors launched a marketing blitz on December 27, 2005 seeking to change the perception of GM SUVs from gas guzzler to "fuel efficient". GM will tout the Chevy Tahoe's 16 mpg city/18 highway against the Toyota Sequoia's 15/18 performance as well as harvest public misperceptions that SUVs offer more safety to child passengers (they do not).[vii] Toyota is choosing not to compete in this type of marketing hair splitting, but rather continues to focus on fuel efficient mini SUV's and hybrid product lines as it sprints to first place in the world market.

Further behind the scenes, a larger battle is raging that determines the profitability of major American oil companies.

National Oil Companies and Rates of Return

State owned national oil companies are under the supply side spotlight of mainstream think tanks. The world's greatest reserves of petroleum belong to national oil company Saudi Aramco, while the leader in natural gas is Russia's Gazprom. Even in Western Europe the largest producer is Norway's national oil company, Statoil. Many are portrayed by think tanks as "inefficient" or "socialistic" through a hostile ideological lens that masks the real rate of return issues at the heart of their dealings with private oil companies.

Venezuela's national company Petroleros de Venezuela, S.A. (PDVSA) and wholly owned subsidiary CITGO distribution company has received the most negative press. PDVSA's social programs such as distributing below market rate heating oil allotments to low income Massachusetts and New York residents seek to reverse negative sentiments in the US. The Bush administration's push for the free market over socialism questions Chavez's use of PDVSA funds going toward welfare programs. Like many national oil companies, PDVSA's relations with major western petroleum companies have become increasingly confrontational as the era of global oil exploration has been increasingly supplanted by production of known reserves. Venezuela passed a law in 2001 requiring the reevaluation of all production contracts with foreign companies to determine whether they are "proper". This lead to a direct confrontation with Exxon-Mobil, which transferred its stake in Venezuela's Quiamare-La Ceiba oil field just before January 1, 2006 rather than renegotiate rate of return.

Think tanks frame the Iraq oil debate around the need for "shaping" the future of any national oil company in Iraq away from a "socialist" outcome similar to Venezuela. US oil companies and the Bush Administration are pushing for a highly privatized petroleum production model dominated by long term Production Sharing

Agreements (PSAs) signed between Iraq and American petroleum companies. This raises the question whether PSA's are appropriate for operating Iraq's large existing fields of proven reserves. Production sharing agreements for oil extraction are usually signed only when the probability of oil discovery is low and production costs are high.[viii] From the standpoint of the Iraqi treasury and petroleum funded reconstruction, if Western companies are able to sign recently drafted PSA's at $40 per barrel, Iraq could forgo an estimated $74-$194 billion in revenues over the lifetime of the contracts. [ix]

Beneath the mainstream think tank disdain of foreign national oil companies lays the real disagreement: destination of oil profits. Many national oil companies are demanding lower foreign rates of return from partner oil companies that are more in line with real costs and historical production experience. Saudi Arabia's 2003 negotiations with American oil companies drove many to look for higher returns from less savvy producing states. In 2003 US bidders lost the Kingdom's $25 billion integrated tender of gas and infrastructure development projects because of their demands for excessive returns.[x] Even as western surrogates cried “corruption” the market proved otherwise: foreign companies eagerly snapped up the abandoned Saudi tenders. Kuwait has also recently rejected high rate of return PSA's with American oil companies. **Rates of return and destination of profits are the central issue between western oil companies and national oil companies, not the smoke screen allegations of "corruption" or "mismanagement".**

In Iraq's case, in exchange for American petroleum company investment in “a sure thing”, demanded rates of return would far exceed an industry norm of 12% return on investment, instead reaching 42% to 162%. [xi] Whether or not Iraq ultimately forms a national oil company is beside the point: disadvantageous production sharing agreements could be signed even with a national oil company in place. Technically, all reserves and producing fields remain in the state's hands. In practice, most benefits and rights transfer to the corporate holder of the PSA contract. From the perspective of foreign oil companies, if Iraq continues to be a highly unstable security environment, verging on civil war, higher rates of return might be warranted to cover the costs of extra security. **From the standpoint of US consumers at the gas pump, little of the global "rate of return" squabble really matters. Whether American or national oil companies capture the lion's share of per barrel margin, given the efficiencies of the global energy market, American consumers will continue pay the same price at the pump.**

Xenophobia Poisons the Global Energy Debate

Many American think tanks inject an added dollop of bigotry into their energy analysis. Most involve unfounded accusations of terror financing against Arab oil producers. Although the rest of their attention is focused on supply side issues, when they do finally analyze demand issues, such as stricter fuel efficiency standards in the United States, as in the case of Brookings Institution, it is couched as a strategy for fighting "terror" and “reducing the amount of dollars that flow to the oil sheiks that fund terrorism.” [xii]

While there is no hard evidence linking petroleum revenues to 9/11 or other horrific attacks on the US, mainstream think tankers feel comfortable hurling accusations and declaring oil producers "guilty until proven innocent." For many neoconservative think tankers, “terrorism funding” goes far beyond illicit funding of terrorist groups on the US State Department list: they chafe at all regional largesse and most particularly funding for reconstructing Palestinian society and aid to refugees. **Unfortunately for Brookings, no amount of smear or defamation is likely to reduce legitimate Arab donor commitment to funding Palestinians and other refugees of natural and man-made disasters.**

Recommendations

1. **US consumers need to be more demanding about their vehicle purchases:** Lumbering gas guzzling behemoths produced by American auto makers are “inefficient at any speed”. Toyota's rise to global market dominance[xiii] is a signal that market sensitive innovation and fuel efficiency are now the winning combination, not government subsidy and wasteful consumption. Purchasing a fuel efficient car or light truck will shift the demand curve and lower prices, in the most important energy consumption category: transportation.
2. **US Oil companies need to reevaluate rates of return:** High project rates of return better suited to the exploration period of the early 20th century are not appropriate in many areas with proven reserves and fewer engineering challenges. American petroleum companies would do well to reign in their expectations and accept lower, but profitable rates of return in mature energy supplier markets.
3. **Mainstream think tanks should turn down the xenophobia machine:** The slander and constant denigration and delegitimation of oil producers by vocal neoconservative minorities and their echo chambers in the media obscures real energy supply and demand issues while thwarting productive communications flow. There is no payoff for injecting racism, bigotry and xenophobia into any debate, including global energy.
4. **Congress needs to stop subsidies that increase petroleum prices through unnecessary demand:** The “American Jobs Creation Act of 2004” legislation distorted the market by creating more demand for gas guzzlers than the market would have otherwise dictated. The resulting shift in the demand curve punishes all energy consumers. Congress can do auto makers and consumers a favor by letting energy supply and market factors, rather than subsidies and ill-considered legislation, send clear signals to the market.

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