31. Policy Implications

This chapter describes free-market public policies for the oil and gas market at the local, state, and federal levels, as well as prerequisites and strategies for achieving them. It begins with an examination of new trends in market-oriented political thought (as of 1984) and continues by describing the general framework of and central justification for relying on free markets. The chapter also identifies the major private and government constituencies that have the ability to lead the way toward noninterventionism. The chapter concludes with a look at a new era of laissez faire, especially the transfer of resources and power that will occur if the United States implements a thoroughgoing free market in oil and gas.

The Changing Face of Social Reform

Chief Justice John Marshall's description of government as "an investment of power for the general advantage" has influenced a long line of social reformers. Journalists and academics who specialize in oil and gas have been no exception. Among others, Ida Tarbell and Henry Demarest Lloyd in the last century and Eugene Rostow and Robert Engler in the present century have advocated activist government reform of the industry. Engler, while conceding "the failure of regulation," has gone so far as to advocate government ownership as the salvation for the status quo.[1]

Interventionist calls for a "new order," "the transformation of economic man," and "democratic planning" are empty slogans. When the voluminous record of intervention is studied and the inherent problems of central planning are recognized, governmental activism loses its appeal. Once the superiority of the market process to its political alternatives is appreciated, it becomes clear that enlightened reform is not continued or new economic coercion but *repeal* of existing interventions to promote consumer sovereignty, economic coordination and progress, political neutrality, and personal freedom.

The experience with regulation of natural gas after the Supreme Court's *Phillips* decision in 1954 and regulation of petroleum in the 1970s—both followed by falling prices and greater market coordination in the less regulated 1980s—has discouraged all but the most ardent interventionists. While earlier planning failures could be blamed on pro-industry intervention or the "capture" of regulators by the industry, more recent oil and gas regulation, purported to be

[1] Robert Engler, *The Brotherhood of Oil: Energy Policy and the Public Interest* (Chicago, IL: University of Chicago Press, 1977), p. 245. In this book, Engler breaks from his prior work (The Politics of Oil [Chicago, IL: University of Chicago Press, 1961]) to acknowledge that public planning and government ownership "may be no more efficient than its private counterpart" and even have no better "democratic accountability." While these concessions are made to dodge the utopian label, he leaves the reader uninformed as to why these government shortcomings might be the case. For a critique of Engler's conclusions, see chapter 1, p. 29.

"pro-consumer," brought shortages, rampant inefficiency, and politicization. The results were so disappointing that publications traditionally sympathetic to energy interventionism such as the *New York Times,* the *Washington Post,* and the *New Republic* were moved to extol the virtues of the market.

Energy-policy revisionism was also evident in a major study on post-World War II energy policy by the Brookings Institution, a think tank traditionally sympathetic to government intervention. In the final chapter, Craufurd Goodwin, the editor of the volume, concluded:

> The great virtue of free competitive markets is that they permit prices and allocation of resources to be determined by a complex of impersonal forces. When free markets are supplanted, there is simply no alternative to individual persons making these decisions. The questions become which persons and on what criteria. The story told in the chapters of this book is largely of rival parties jockeying for the authority to make those decisions about the production of energy goods and the distribution of income not left to the market.[2]

A second study of the period by Richard Vietor similarly concluded:

> The government's domestic policies for fossil fuels generally failed. They reduced economic efficiency in return for marginal gains in equity, temporary and misleading stabilization of markets, and little or no benefit to national security. For evidence of this, we only need to look to a few key areas of energy policy: synthetic fuels, oil imports, natural gas, and oil price controls.[3]

The Pandora's box of intervention, filled with distortions, unintended consequences, and a propensity to expand, has been documented in previous chapters. The insights of economics and public-choice theory, and more than a century of government interference in the market, argue eloquently against the alleged need for or ability of government to interfere with the oil and gas market for the good of society. Continued intervention and wholly new intervention must be rejected and a program based on private property and voluntary exchange adopted instead.

The Free-Market Framework

A policy program for the U.S. oil and gas market that emphasizes economic coordination and personal freedom is anchored in the rule of law—not legislation achieved by temporary majorities and commands from politically adept individuals and groups. With slight modification, the common law is the market's legal framework, permitting all conduct except that which damages persons or property or entails fraud. The enforcement of well-defined private- property rights, even when it requires novel interpretations in new situations, is entrusted to governmental and private institutions designed for that purpose.

---

[2] Craufurd Goodwin, "The Lessons of History," in *Energy Policy in Perspective*, ed. Craufurd Goodwin (Washington, DC: Brookings Institution, 1981), p. 671.

[3] Richard H. K. Vietor, Energy Policy in America since 1945 (Cambridge: Cambridge University Press, 1984), p. 345.

The framework of simple legal rules entirely eschews preconceived governmental plans and outcomes. This results from the inherent uncertainty and complexity of economic life. As F. A. Hayek explained:

> Since our whole life consists in facing ever new and unforeseeable circumstances, we cannot make it orderly by deciding in advance all the particular actions we shall take. The only manner in which we can in fact give our lives some order is to adopt certain abstract rules or principles for guidance, and then strictly adhere to the rules we have adopted in our dealing with the new situations as they arise. Our actions form a coherent and rational pattern, not because they have been decided upon as part of a single plan thought-out beforehand, but because in each successive decision we limit our range of choice by the same abstract rules.[4]

These abstract rules, Hayek adds, instruct individuals only on what not to do. They do not tell persons what they should do; that would interfere with the individual creativity that undergirds the market process.

Market forces, and basic common-law principles governing property rights, create a predictability that guides unpredictable human action into socially beneficial directions. Government efforts to duplicate this "spontaneous order" by conscious rules constrict the range of actions and result in less creative—less entrepreneurial— outcomes. On a personal level, free choice is also sacrificed.

Policy Proposals

The various policy prescriptions to be discussed share a defining characteristic. They would remove government intervention and rely on unfettered, self-regulating market processes grounded in private-property rights and voluntary exchange. Special government privileges and restrictions on the marketplace would be abolished. Associated regulatory distortions, many unintended, would thus disappear. In addition to public policy reform, the common-law legal framework of subsurface mineral ownership would be modified, where feasible, to improve the application of private property.

Pragmatists and the cautious will find the recommendations uncompromising. There is economic and political virtue, however, in this strategy. Government intervention in the oil and gas market has consistently failed, thereby justifying swift and complete reform. Partial (incremental) reform would be arbitrary, unfair, and tactically suspect, because some parties would be favored and others disadvantaged by the remaining intervention. Fundamental deregulation, without favoritism or exceptions, would be more politically acceptable.

Nevertheless, each policy recommendation is worthwhile on its own merits, even if other recommended changes are not implemented. No "second-best" case for intervention is developed

[4] F. A. Hayek, Studies in Philosophy, Politics, and Economics (London: Routledge and Kegan Paul, 1967; Chicago, IL: University of Chicago Press, Midway reprint, 1980), p. 90.

in this chapter. One intervention cannot cure another, not only because two wrongs do not make a right but also because the cumulative process adds more "wrongs." "Instead of having achieved greater mastery over our fate," Hayek explains, "we find ourselves in fact more frequently committed to a path which we have not deliberately chosen, and faced with 'inevitable necessities' of further action which, though never intended, are the result of what we have done."[5]

Similarly, this analysis does not choose between more and less desirable intervention. For example, the Windfall Profit Tax would not be supported even if it were less injurious than oil-price regulation. Neither would oil tariffs be accepted as less distortive than oil quotas. In fact, more disruptive interventions may have the virtue of being terminated sooner than less disruptive interventions. Relatively less distortive "market-conforming methods of intervention"[6] are ignored because of the primacy of market solutions over nonmarket ones.

State and Local Level

Below the federal level are thousands of governmental jurisdictions. In addition to the fifty state governments, county governments, municipal governments, school districts, and special districts are all taxing bodies. All states and many municipalities have enacted oil and gas regulation and taxation, and all have created agencies to administer them. Those measures should be repealed. Repealed federal laws should not be resurrected on the state level. "States' rights" can result in multiple standards that make state regulation worse than its federal counterpart. In the past, such situations have created political pressure resulting in federal regulation. It could happen again.

Oil and Gas Production. Wellhead production policy has been of particular interest to oil and gas scholars. John Ise, in an early study of U.S. oil policies, detailed the problems of oil conservation and called for "government regulation of the extraction of oil that is privately owned."[7] Many later economists and oil writers have found fault with tree-market extraction, and with the "cure" of market- demand proration, while industry executives—also critical of rule- of-capture competition—have been more partial to attempts by state governments to limit output through proration. The debate has been between unitization, supported primarily by academics, and proration, supported by the industry. Sometimes sparks have flown.[8]

The first decision to be made about oil and gas production policy is whether the rule of capture can be prospectively modified by a homestead rule, under which first title would accrue to the first finder of contiguous oil and gas deposits rather than the surface owners. The homestead rule would be a radical change from 125 years of leasing under the capture rule and would transfer

---

[5] F. A. Hayek, Law, Legislation and Liberty (Chicago. IL: University of Chicago 1973; London: Routledge & Kegan Paul, 1982), vol. 1, *Rules and Order,* p. 59.

[6] Richard Vietor, Energy Policy in America since 1945, p. 354.

[7] John Ise, The United States Oil Policy (New Haven, CT: Yale University Press, 1921), p. 496.

[8] See Stanley Learned, "Petroleum Conservation—The Myths and Realities," *Exploration and Economics of the Petroleum Industry* 6 (New York: Matthew Bender, 1968), pp. 167–95.

economic rent from owners of mineral rights to producer-discoverers. But given the logic behind the homestead theory, including the automatic transformation to unitized production, the change should be seriously contemplated.[9]

Currently known reservoirs would continue under their present royalty claim to subsurface wealth. It would be a legal nightmare to ascertain the first discoverer of each reservoir and reapportion property rights and the economic income therefrom. Undiscovered reservoirs, on the other hand, would revert to a state of nature, and drillers would rent or buy surface rights from property owners to explore for and produce hydrocarbons. Separate mineral rights would not exist. The government's vast holdings of oil- and gas-bearing lands would become a large part of this unowned inventory.[10]

Upon discovering a deposit, the driller would document his find and have reasonable opportunity to drill development wells to delineate the extent of the find. (The courts would develop rules to protect the discoverer against trespass by other drillers while he drilled those wells.) Separate reservoirs above, below, or to the side of the discovery would remain unowned.

With the lion's share of economic rent accruing to the driller-finder rather than to coincident royalty owners, unprecedented incentive would exist to locate new fields in the United States. This would instantaneously make the United States a “lower cost” oil producer and increase competition in the world oil market. That utilitarian result is an attractive feature of the homestead property-rights system, but the primary consideration is the proper reward for the first finder.

With homestead ownership, natural incentives would make traditional economic arguments for wellhead conservation regulation obsolete. Market-demand proration, maximum efficient rate allowables, well spacing, gas-oil ratios, natural-gas allowables, prohibitions against flaring and stripping natural gas, and mandatory pooling and unitization would all be ripe for repeal. Private contracts would govern extraction practices completely.

The repeal of state conservation regulation is recommended whether or not the rule of capture is reformed. As argued in chapters 3 and 4, wellhead regulation was not the solution to overproduction and waste but one of the causes. The rule of capture, despite the problems created by multiple ownership of common reservoirs, is still governed by market processes. Profit maximization discourages unnecessary drilling and encourages the preservation of the reservoir's capital value (the discounted income stream of future production). Buyouts, sellouts, and cooperative agreements after the fact, as well as block leasing and leasing covenants before the fact, are market solutions that call for the removal of government impediments, such as antitrust

[9] See chapter 2, pp. 64–74, for a review of the advantages of homestead rights over the rule of capture.
[10] See this chapter, pp. 1899–1901.

uncertainty, taxation, purchaser regulation, and conservation regulation itself.[11] Regulation imposes costs on taxpayers and industry and has a history of working for political majorities more than for hydrocarbon conservation. Politics aside, it is still difficult for authorities to know what optimal conservation policies should be.

De jure deregulation should replace de facto deregulation in several important areas. Market-demand proration, the centerpiece of state oil-conservation regulation, has been a dead letter since the early 1970s. The *Oil & Gas Journal* has favored its abolition, if only for symbolic reasons.[12] Maximum efficient rate allowables are what the company engineer submits to the state agency in most instances; ending the regulation would be of little consequence. Well-spacing exceptions that allow market-oriented decisions should become the rule rather than the exception. This is not to suggest that present regulation is without effect, only that it is less restrictive than in decades past and that complete deregulation is realistic. Such a step would remove the worrisome possibility of a return to effective market-demand proration (rates below 100 percent) and other restrictive measures if oil prices fall and wellhead protectionism gathers momentum.

Mandatory unitization, the compulsory consolidation of all interests in a commonly held reservoir, has drawn support from an honor roll of petroleum economists who otherwise would dispense with market-demand proration and other second-best regulation.[13] However, the unitization process should be deregulated as well to allow state conservation agencies to completely withdraw from petroleum regulation. Environmental matters would be transferred to special agencies.

Forced unitization creates a tyranny of the majority whereby the majority (a 75-80 percent minimum in most cases) dictates the fate of the remainder. The majority view is not necessarily the most economically efficient or equitable. Because of the imperfections of reservoir science and differences of opinion among reservoir co-owners (and petroleum engineers) about the "optimal" mix of present and future production, compulsion is no panacea for the problems of self-regulation; rather, it discourages self-regulation. The parties' power to abstain from bargaining, a source of discipline and efficiency in the market, is undermined by government-compelled agreement. Entrepreneurial error would surely be present in high- transaction-cost

[11] "Good industry practice," definable by trade associations and potentially enforced by membership agreements and ostracism, could also discourage and prevent worst-case situations of drainage competition by holdouts.

[12] "State regulators would do the industry a favor if they would publicly acknowledge the moribund state of market-demand proration, discontinue taking nominations and setting statewide allowables at public hearings.... The move would give oil critics one less cross on which to hang the industry." "Market-demand proration has outlived its purpose," editorial, *Oil & Gas Journal*, March 13, 1972, p. 19.

[13] Economists who have advocated unitization in books on oil regulation include Eugene Rostow, Stephen McDonald, Wallace Lovejoy and Paul Homan, Melvin de Chazeau and Alfred Kahn, and Erich Zimmermann.

situations, but error and waste, characteristic of other economic activity as well, do not justify forced agreement.

With major companies holding large ownership interests in many reservoirs, independents in Texas and elsewhere have been wary of forced agreement. Unitization also begets expanded regulation of drilling and production procedures to protect the rights of minority lessors.[14]

A market-driven wellhead policy would include a greater role for private resolution of environmental issues. Rather than opening the floodgates for contamination of surface land and the water table as a result of haphazard drilling practices, private resolution would substitute market constraints and incentives for governmental constraints. Owners of surface land and the water table (itself available for privatization under homestead principles) would be protected under the common law from property invasion and pollutive damage. If a plaintiff could show due cause, the defendant would be enjoined from polluting and required to provide full restitution for damage. In addition, land-rental agreements could specify drilling procedures to provide legal certainty about duties and liabilities; they could also require the posting of bonds in case liability was incurred.

Rules that require wells to be plugged within a set period of time after inactivation to prevent oil seepage into the water table are particularly distortive. Once a well is set with concrete, it is extremely costly if not impossible to reactivate. Rigid casing rules prevent entrepreneurs from withholding supply in distress periods to sell at higher prices when market conditions improve. Operators must continue to produce when prices are low or retire the well. The distortion of mandatory plugging in periods of low prices has led to calls for price floors and tariffs to keep stripper wells (wells producing less than 10 barrels per day) alive. Removing plugging requirements weakens the case for such "corrective" intervention.

Transportation and Distribution. States and municipalities regulate all forms of intrastate oil transportation—truck, rail, water carrier, and pipeline. Natural-gas pipelines are also regulated but not as comprehensively as natural-gas distribution. The same jurisdictions regulate gasoline service stations. All these regulations are candidates for reform. And in the cases of trucking and water carriage, where the travel lanes are public property, privatization opportunities exist to universalize right-of-way costs for neutral intermodal competition.[15]

Oil pipelines, gas distribution, and gasoline marketing are examined below; the case for railroad, truck, and water-carrier deregulation, discussed below on the federal side, can be applied to intrastate activity as well.

Oil-pipeline deregulation would complement wellhead deregulation at the state level. Absent common-carrier and common-purchaser law, greater discipline could be exerted by first

[14] See Elton Hyder, "An Analysis of Compulsory Unitization: What Is the Price to the Industry?" *Interstate Oil Compact Commission Quarterly Bulletin* 14 (1955): 51–53.

[15] Road and waterway privatization is discussed in this chapter, pp. 1896–97,1901–2.

purchasers to check wellhead overproduction and unnecessary drilling. Rate deregulation would give pipelines greater incentive to enter and expand as market conditions dictated—and in the process displace more expensive transportation modes.

Eminent-domain powers should be removed along with (or even without) the pipeline's "public-service" requirements. As Standard Oil did in the last century and some companies do today, firms would obtain rights-of-way by voluntary negotiation or not at all. In the event of ill-intentioned holdouts or obstruction, ingenuity would be called for, such as contract enticements or securing alternate routes. A blocked right-of-way could be bridged or tunnelled pursuant to a homestead definition of private property. The extra costs associated with these alternatives are the "price" of private- property rights in a free society where the peace of mind of surface owners is valued along with right-of-way cost minimization.

Deregulating natural-gas distribution would replace cost-plus pricing in legally protected markets with value-of-service pricing and open competition. With increased competition and the lure of pure profits, cost minimization would become paramount for local distribution companies. Regulatory expenses hitherto passed through to captive consumers would be removed. Political ratemaking to lower residential costs at the expense of less politically powerful end users would be replaced by market pricing aimed at increasing overall consumption.

Lower rates would be encouraged by reduced costs, increased competition, and higher load factors. Higher rates would result where largely depreciated rate bases were imparting windfall gains to consumers. "Consumerist" pricing and the "creeping expropriation" of company capital, due to depreciated rate bases, are bad not only for the involved firms but for efficient consumer service in the longer run.

The growth of fuel-switching capacity in industrial and electric markets has cast traditional arguments for public-utility regulation in a new light. If the fuel-oil market is competitive, which it is, and if fuel-oil prices constrain natural-gas prices, which they do in many markets, that sector of the natural-gas market is "workably competitive" from a neoclassical perspective and should be decontrolled. For captive residential and commercial consumers who cannot switch to fuel oil or other alternatives, a case can be made for self-help in place of paternalistic regulation. With the local distribution company no longer a monopoly, the field would be open to territorial invasion by upstart firms, as occurred a century ago before franchise protection arrested the process. But even if potential entry were deemed insufficient, consumers would be free to band together to counter "monopoly" with "monopsony." Well-organized consumer groups that are now active in the regulatory process could redirect their resources to private contracting. Their leverage to gain competitive rates for captive users could run the gamut from threatening to eliminate nonessential consumption to marshaling public opinion to their cause. Potential competition would also provide leverage where none existed before.

A vehicle for deregulating natural-gas distribution is the *exit contract,* whereby the economic agents of regulated transactions enter into a voluntary agreement to bypass the regulatory

process. Consumer groups could negotiate such contracts with their suppliers to substitute explicit rate and service terms for standard cost-based rates and obligation-to-serve "protection." Regulators should acquiesce to such agreements to remove the administrative costs of regulation.

An important result of burner-tip deregulation would be the creation of competitive pressure at the transmission level and the wellhead. The utility's long-term contract to supply gas at "X" price would require that it buy gas at the lowest "X-l" price, guaranteeing hard dealing at the wholesale level. Gas wholesalers, in turn, would be pressured to keep their costs down, which reverberates to the wellhead.

In the 1930s, a regulatory gap led to pipeline and then producer regulation. With distribution decontrol, a new regulatory gap invites not only state but federal pipeline and producer deregulation as discussed below.[16]

Natural-gas deregulation would extend to interstate (discussed below) and intrastate gas transmission lines. As the regulatory spiral of the last century attests, full deregulation of the industry is preferable to partial regulation. Along with rate deregulation, service requirements such as mandatory contract carriage and common- purchaser requirements would end. Forced purchases and obligatory transportation violate the basic business right to choose with whom to do business, discourage new investment, and weaken the market discipline exerted by pipelines on producers. The incentive for long-term contracting is replaced by increased reliance on the spot market. These distortions can and should be removed by deregulating intrastate carriage.

Regulation by the Texas Railroad Commission, which has jurisdiction over the largest natural-gas pipeline network in the country, is light-handed compared to that of its federal counterpart, the Federal Energy Regulatory Commission. Certification is not required, eminent-domain rights are absent, and rates for the majority of gas users are not regulated. There have been no performance failures of the intrastate industry, and prices and quantities are considered as competitive as those in the regulated interstate market—if not more so.

For decades, states and municipalities have succumbed to downstream special interests and passed laws to restrict low-cost forms of gasoline retailing, limit entry, impose higher costs, and inconvenience consumers. All of these anti-consumer interventions should be terminated, and new special-interest intervention must be resisted. This includes antitrust law, as discussed below.[17]

Barriers to universal self-service at gas stations are a flagrant denial of consumer choice and convenience. Statewide bans in Oregon and New Jersey, as well as numerous municipal prohibitions against open-latch dispensing on self-serve pumps, should be terminated. The safety

[16] See this chapter, pp. 1891–94.
[17] See this chapter, pp. 1890–91.

record of self-service is unassailable, and the consumer's interest in convenience and lower prices must be respected.

Zoning ordinances, which limit convenient locations and increase costs for existing stations, should be replaced by voluntary land-use controls. Station location and appearance should be "regulated" by contract and patronage, not politics. Deed restrictions or suasion by neighborhood or civic groups can accomplish this, while respecting the motorists' interest in convenient, competitively priced supply. As a last resort, extremely offensive stations can be boycotted or purchased for removal by neighborhood and other civic associations.

Some states have enacted dealer day-in-court laws to protect franchised independent operators by extra-contractual means. On the basis of an erroneous theory of exploitation and an alleged right of firms to stay in business, inefficient dealers vulnerable to competitive pressure have been protected from certain unilateral actions by their franchisors. Preserving inefficiency burdens franchisors and their stockholders and prevents the reallocation of resources to more profitable areas. Franchisees (lessees) are free to agree to whatever conditions they desire when they enter into a contract. The grounds for terminating and the conditions for renewing a contract should be left to the involved parties. But once they have agreed, contract breaking should not be legalized by intervention. State franchise protection laws, therefore, should be abolished.

As of 1984, Maryland, Delaware, Connecticut, Virginia, and the District of Columbia had passed divorcement laws to ban supplier- refiners from directly operating gasoline stations. Many more states have considered the same. These laws reduce competition, transfer market share from efficient to inefficient operators, and saddle consumers with higher prices, reduced service, and fewer choices. Such blatantly anti-consumer laws, and interventions such as moratoriums on both new outlets and conversions to salaried operation by integrated firms, should be repealed or rejected when they are proposed.

Taxation and Privatization. Part of the great wealth created by oil and gas has been siphoned from the private sector to allow state and local governments to fund projects that otherwise would have depended on more broadly based taxes with lower political ceilings. Motor-fuel taxes have raised revenue in all fifty states to construct streets, bridges, and highways. Oil and gas severance taxes and state-land oil and gas royalties have underwritten public school education, oil and gas regulatory activities, and the general treasury. Oil and gas taxation has played an important role in expanding state and local governments.

Since public roads are the major recipient of motor-fuel taxes, full deregulation of the petroleum industry would logically entail the privatization of roads. A triad of private-road ownership arrangements can be imagined. Residential roads could be transferred to property managers who would arrange with property owners for maintenance. Commercial roads adjoining businesses could be transferred to business associations that would provide for their upkeep (just as is done now with sidewalks and parking lots). As amenities, residential and commercial streets would

likely not be specifically priced for use. On the other hand, major roads such as freeways and highways could be the province of for-profit road companies.[18]

Electronic billing is central to for-hire roads. It has been a technologically proven option for decades. Wrote James Buchanan in 1970:

> Recent developments in electronic metering devices make direct pricing of street usage economically feasible. It is now possible to construct systems at reasonably low cost which will record the amount of road-street usage per automobile per time period.... Such a system seems eminently practicable as well as economically efficient in highly urbanized areas.[19]

Privatization of roads has several advantages. Scarcity pricing would replace gasoline taxes as the primary means of road finance. In urban areas plagued by congestion, peak pricing would ration driving demand to available road space and mitigate the present costs of underpricing: shortages (traffic jams) with attendant gasoline consumption, vehicle wear, and air pollution. With full pricing for automobile usage, entrepreneurs would promote (private) mass transit for commuters to economize on road fees.

State land with potential or existing oil and gas production is another candidate for privatization. Under a homestead rule, a priori state claims are illegitimate since ownership cannot occur independent of discovery. Title would accrue to the discoverer of oil and gas reservoirs or subsequent owners, usually the operating company. Undiscovered reservoirs on state land, prominently including offshore tracts, would revert to non-ownership (a "state of nature") and would become owned property only on discovery, claim, and development.

As a second-best alternative to homestead rights, public authorities could sell the physical property to private parties rather than rent drilling and extraction rights. The proceeds could be refunded to taxpayers. In Alaska, for example, a trust fund has traditionally distributed 50 percent of the state's land royalties to taxpayers. Alternatively, debt could be retired.

Title to land with existing production could be privatized by turning over the property to the operating company free of charge or for a payment based on the discounted net present value of expected production. Given its history of mismanagement, removing government as the overseer of public lands would create efficiency gains in addition to taxpayer savings.

With mineral land privatized and oil and gas deregulated across the board, the need for state oil and gas bureaucracies disappears. Some thirty-nine state oil-conservation agencies and fifty

---

[18] Oil companies could participate in the ownership and operation functions since the demand for gasoline depends on roads. Members of the oil industry considered opening small private airports before municipalization set in. See *National Petroleum News,* "Oil Companies Leave Airport Chain Operations to Others in Field," April 3, 1946, p. 10; and Frank P. S. Glassey, "Airport Development," July 17, 1946, pp. 25–26.

[19] James Buchanan, *The Public Finances: An Introductory Textbook,* 3rd ed. (Homewood, IL: Richard D. Irwin, 1970), p. 469.

public- utility commissions could be abolished or at least severely cut back. The state-level energy offices created during the energy crises of the 1970s to allocate petroleum and enact conservation standards would also be unneeded. The Texas Energy and Natural Resources Advisory Council, for example, which was founded in 1979 and four years later had a $10-million budget for peripheral matters, is an obvious candidate for elimination. The budget savings would ease the fiscal crisis being experienced by many states, and freed resources could be used for useful private-sector purposes.

Privatization would also end the historic operation of the Interstate Oil Compact Commission. Since 1935, this institution, underwritten by member oil states, has served as a clearinghouse for state oil and gas conservation regulation. State funding should end, and Congress should remove the agency's antitrust immunity.[20] With private funding, the commission could continue in a purely voluntary industry advisory role, but its days as a quasi-governmental agency would be over.

Since the last century, a number of municipalities have established their own gas-distribution companies in place of investor-owned utilities. In 1981, an estimated 900 municipal gas companies were operating in the United States.[21] The case against central economic planning is fully applicable to local government ownership and operation of gas-distribution firms. Without the entrepreneurial incentive to minimize costs and a market test for innovation, these firms have been a burden to their ratepayers. Their saving grace has been to mimic the operations of nearby investor-owned utilities. Mergers with such (newly deregulated) investor-owned utilities and sales to new private firms are two ways to privatize municipal companies.

Federal Level

Although state and local governments have been the center of much oil and gas market intervention, especially in the production and retail (distribution) phases, federal activity has been extensive over important periods. This section deals with active federal intervention and several areas of potential intervention. Although the scope of federal intervention was significantly reduced on January 28,1981, with President Reagan's oil price and allocation decontrol order, much intervention still stands in the way of an entrepreneurially driven free market in oil and gas.

Antitrust Law. Antitrust law has been a barrier to efficient industry practices. In fact, it has distorted the petroleum industry more than any other major U.S. industry. Held out as public-interest law intended to prevent and correct underproduction and overpricing, antitrust instead has been a political weapon for less efficient firms to use against their more efficient rivals

[20] As explained in this chapter, p. 1891, antitrust law, if it continued, would apply only to government practices that restrained competition.

[21] Joseph Tomain and Donald Polden, "Rates and Service Obligations of Municipally Owned Gas Distributors," in American Gas Association, *Regulation of the Gas Industry,* 4 vols. (New York: Matthew Bender, 1981), vol. 2, p. 42–44.

during competitive stress.[22] Antitrust in a variety of settings, as described in chapter 26, has also prevented or hampered self-help remedies to pressing industry problems and challenges. Prominent examples of such forgone remedies include the aborted transformation from drainage competition to cooperative production in the 1920s and 1930s and the inability to substitute interfirm agreements for autonomous rivalry during wartime.

Federal antitrust law—the Sherman Act, the Clayton Act, the Federal Trade Commission Act, and the Robinson-Patman Act— should no longer apply to the oil and gas industry.[23] If the Antitrust Division of the Department of Justice and the Bureau of Competition of the Federal Trade Commission continue to have an antitrust agenda, it should focus on the true source of monopoly—*governmental* restrictions on competition.

Without the specter of antitrust law, the most efficient firms would more freely expand their market shares at the expense of less efficient (generally undersized) firms. Not only would certain competitive practices (such as so-called predatory pricing) be legalized, but cooperative strategies would be permitted. Wellhead interests, for example, could use a variety of cooperative strategies to reduce unnecessary drilling, deal with holdouts in pooling or unitization situations, and receive a better price in limited-buyer situations. Refiners would be allowed to pool technology to better compete against imported products. Cooperation in emergency situations would replace government planning. (Cooperative contingency agreements for emergency situations could be prepared as well.) Mergers to gain efficiencies would be free of Department of Justice and Federal Trade Commission guidelines. Rival firms could engage in cooperative pricing. These freedoms are based on the principles that (1) cooperation, not only rivalry, is a fundamental part of the market process contributing to economic coordination and growth and (2) the market naturally "regulates" itself against artificial attempts to monopolize it.[24] The same arguments apply to state antitrust laws.

Natural Gas. The deregulation of natural-gas transmission and distribution at the state level should be joined by federal decontrol of interstate gas transmission and wellhead pricing. To this end, the Natural Gas Act (NGA) should be repealed. Other laws affecting end-use, integration, and safety should also be abolished to create a totally free natural-gas market for the first time in a century. This transformation would virtually guarantee the end of the performance crises that have periodically plagued the industry.

---

[22] Independent gasoline marketers have been the most guilty party. A mild Reagan proposal in 1981 to curtail the antitrust activities of the Federal Trade Commission found those dealers opposed. "Reagan on FTC: Expendable," *National Petroleum News*, April 1981, p. 12.

[23] The case for abolishing antitrust laws entirely is presented in Dominick Armentano, *Antitrust and Monopoly: Anatomy of a Policy Failure* (New York: John Wiley & Sons, 1982).

[24] See chapter 29, p. 1799, for a summary of failed market monopolization attempts in the petroleum industry.

The deregulation of interstate natural-gas pipelines for the first time since 1938 is an idea whose time has come. A growing chorus of scholars is beginning to reconsider this area of public-utility regulation, and pipeline decontrol is a logical complement to deregulation at the local (city-gate) level.[25] The growth of spot-market transactions, the emergence of transportation services in place of traditional sales-for-resale by pipelines, widespread utility and industrial fuel-switching capability, bypass of local distribution companies by end users, and the impending introduction of natural-gas futures trading (as of 1984) have all increased interest in legalizing competition among interstate carriers.

The cost-plus oasis of interstate pipelines, threatened only by take- or-pay liabilities in recent years, has been costly and noncompetitive. Intractable debates over prudent costs, load factors, rate-base valuation, rates of return, rate design, and other regulatory issues—all creating malincentives for pipelines and deadweight losses for taxpayers and the economy—should be ended.[26] Burdensome certification requirements to meet the "public convenience and necessity" criteria for new entry and modified service must be repealed along with the "just and reasonable" price standard itself. It is not enough to liberalize certain sections of the NGA—such as expediting new entry by replacing pre-implementation approval with post-implementation review as proposed by one interstate carrier.[27] Thoroughgoing deregulation is necessary to substitute market entrepreneurship for the bad habits bred by traditional public-utility regulation. The Federal Energy Regulatory Commission's regulatory mission and reporting requirements for natural gas should be terminated.[28]

An unregulated market would substitute unprecedented entrepreneurship for commission directives. The innovative spot-gas marketing programs of recent years are an impressive beginning that should inspire more innovation. Business risk may increase without certification barriers to entry for pipelines and without franchise service territories for local distribution

---

[25] Prominent advocates of deregulation include Arlon R. Tussing and Connie C. Barlow, The Natural Gas Industry: Evolution, Structure, and Economics (Cambridge, MA: Ballinger Publishing, 1984), pp. 236–37; and Richard J. Pierce, "Reconsidering the Roles of Regulation and Competition in the Natural Gas Industry," *Harvard Law Review* 97, no. 2 (December 1983): 345-85. Sentiment against decontrol of gas pipelines remains entrenched, however. The Interstate Natural Gas Association of America testified before Congress that "INGAA has perceived no significant interest among its membership in 'deregulating' pipelines, at least up to the present time.... Congress should not expand the scope of its inquiry more than necessary." *Natural Gas Legislation, Hearing before the Senate Committee on Energy and Natural Resources,* 98th Cong., 1st sess., 3 vols. (Washington, DC: Government Printing Office, 1983), vol. 3, p. 1179 (INGAA responses to written questions).

[26] "Lovers of regulatory solutions to market problems should consider the case of Panhandle Eastern when it filed for a rate increase. It got a questionnaire from FERC that took 180,000 pages to answer. So-called consumerism often benefits lawyers and bureaucrats more than it does consumers." Toni Mack, "Natural Gas," *Forbes,* January 2, 1984, p. 82.

[27] Northern Natural Gas Company, "Proposal to Amend the Natural Gas Act," April 22, 1983.

[28] Over forty major mandatory federal reports in the oil and gas field are listed in Energy Information Administration, "Directory of Energy Data Collection Forms," February 1985.

companies. But, as elsewhere in a free market, consumer welfare must be placed above producer welfare. The results would be lower costs, better service, equitable competition between intrastate and interstate pipelines, increased incentives for new capacity and enhanced service, and taxpayer savings. In return for heightened competition and entrepreneurship, prices and profits should be limited only by what the market allows.

In the 1980s, a new controversy emerged concerning take-or-pay contracts between pipelines and producers. The problems were a discrepancy between the price or volumes that gas pipelines obligated themselves to purchase, or both, and what end-user markets would take or pay, or both. To break the "contracts problem," some pipelines invoked novel interpretations of the force majeure (unexpected events) clauses of their contracts to justify nonperformance.

Force majeure has traditionally covered compressor-station blowouts, interruptions due to weather, and other "acts of God" beyond the control of the buyer. Sometimes, acts of government that disrupt markets are also explicitly included in force majeure clauses.

Illegitimate force majeure events are changed market conditions or any species of entrepreneurial miscalculation not explicitly excused in the contract. A contract cannot be invalidated because it turns out to be "bad" for one party. Mutual consent is required to modify contracts. If a contract is unilaterally violated, timely restitution is required to fully compensate victims. Entrepreneurial error should not be excused.

Wellhead natural-gas price regulation, a controversial application of the "just and reasonable" pricing standard under the NGA and Natural Gas Policy Act (NGPA), should be repealed. Effective January 1,1985, newly deregulated wellhead vintages left regulated production in the minority. Total deregulation will end one of the most expensive regulatory failures, not only in the history of the energy market, but in the history of the U.S. economy.[29]

Incremental pricing, Title II of the NGPA, has mandated a rate design intended to benefit residential gas ratepayers at the expense of other less politically favored customer classes. The intention was to shift fixed costs to industrial users and power plants in order to lower gas prices for captive gas users. Yet by making gas less competitive in its most price-sensitive markets, the NGPA caused gas markets to be lost, leaving higher fixed costs for the intended beneficiaries to pay. Lost gas markets, in fact, disadvantaged the entire industry, from the wellhead to the burner tip, making repeal a "win-win" for everyone except fuel-oil and coal interests.[30]

Title IV of the NGPA authorizes federal allocation of gas supplies in an emergency. This title should also be repealed. The record of governmental allocation of oil and gas in periods of short

[29] Title I of the NGPA was repealed effective January 1,1993, to completely deregulate wellhead gas sales for the first time since 1940. Pub. L. 101-60, 103 Stat. 157 (1989).

[30] Title II of the NGPA was terminated in May 1987. Pub. L. 100-42, 101 Stat. 310 at 314.

supply points toward price deregulation, not mandatory allocation with continued price constraints, as the best social policy.

Other federal intervention stands between a regulated and an unregulated natural-gas industry. The Public Utility Holding Company Act of 1935 has achieved its intended effect of discouraging the integration of the transmission and distribution phases. Integration, however, is not only cost-effective, it introduces a coordinating element that has been sorely needed, as evidenced by take-or-pay disputes between producers and pipelines and minimum-bill controversies between pipelines and distribution companies. Timely enforcement of take-or-pay contracts and minimum-bill provisions, in fact, would encourage mergers and self-integration, partially removing the industry's "three-headed monster"—the antagonism among and inflexibility of the production, transmission, and distribution phases.

Improved capacity utilization benefits gas ratepayers by spreading fixed pipeline and distribution costs over greater units of sales. Yet a 1978 federal law, the Powerplant and Industrial Fuels Use Act, restricted the burning of natural gas in new boiler applications on the erroneous belief that natural gas as a depleting resource should be used only in higher uses (e.g., heating, cooking, and clothes drying). This law, like the incremental pricing section of the NGPA, hurts all phases of the gas industry, helps only the coal constituency, and should be repealed.[31]

A third sop to the coal industry, the Military Construction Codification Act of 1982, prohibits the Department of Defense from burning gas in any new large heating systems on military installations in the continental United States. It, too, should be repealed to allow the gas industry to achieve its rightful free-market level of demand.

Pipeline safety is vital to attracting and maintaining employees, winning the confidence of consumers, and staying out of courtrooms. The industry's performance record has been satisfactory. The Natural Gas Pipeline Safety Act of 1968 and the Hazardous Liquid Pipeline Safety Act of 1979, passed as alternatives to disparate state standards, should be repealed. Since at least the 1923 founding of the American Gas Association's Central Testing Laboratory, the industry has taken the lead in regulating itself for self-interested reasons.

Self-regulation would center around updated standards adopted by the American Society of Mechanical Engineers in the Code for Pressure Piping, Gas Transmission, and Distribution Pipeline Systems. State and federal regulation, in fact, has freely borrowed from these standards. The free-market alternative would also mean the end of liability limits such as those in the Comprehensive Environmental Response, Compensation, and Liability Act of 1979. Full market incentives for safety, without government regulation or subsidy, are merited.

[31] The Powerplant and Industrial Fuels Use Act was effectively repealed in May 1987. Pub. L. 100-42, 101 Stat. 310.

Oil Transportation. In the 1980s, the oil industry experienced competitive conditions not seen for over a decade. In such an environment, lowering business costs is essential. Lower cost transportation modes should freely compete against higher cost modes without regulatory impediment, which means that state and federal transportation regulations should be removed. Repeal of the Interstate Commerce Act, which regulates all four major modes of interstate oil transportation, is central.

Interstate crude-oil pipelines and oil-product pipelines have been subject to regulation under the Hepburn Amendment to the Interstate Commerce Act since 1906 and 1941, respectively. Public-utility regulation since that time has been light-handed in contrast to the regulation of natural-gas transmission under the jurisdiction of the NGA. But federal jurisdiction over ratemaking with the crude-oil Trans-Alaska Pipeline System and oil-product Williams Pipe Line Company has given downstream special interests a legal forum in which to argue for stringent original-cost regulation akin to interstate natural-gas pipeline regulation. Such controversy will remain as long as ratemaking is political instead of contractual. Pricing below market, which risks strained capacity and rationing, underinvestment, and even disinvestment, does not help but hurts consumers. Competitive distortions are also created for competing modes of oil transport. Repeal of the Hepburn Act would put to rest the political controversies over "light-handed" versus "heavy-handed" regulation and the economic distortions thereof.[32]

Oil pipelines, the major mode of petroleum transportation, compete against tank cars, tank trucks, oil barges, and oil tankers. Deregulation of the rates and services of these modes would benefit the entire industry. For the sake of competitive equity, travel lanes should be privatized and, in the case of water carriers, taxpayer subsidies should cease.

Repeal of the Interstate Commerce Act would deregulate interstate railroads (regulated in 1887), interstate for-hire trucking (regulated in 1935), and interstate for-hire water carriage (regulated in 1940), in addition to oil pipelines. Full decontrol is necessary for the same reasons that partial decontrol was necessary for railroads and trucks during the Ford and Carter years—to replace protection with competition, reduce shipping rates, restore pricing flexibility, legalize timely service modifications, and remove regulatory expenses for firms and administrative expenses for taxpayers.

[32]Administrative and judicial reform of interstate oil-pipeline rate regulation, which began in the early 1970s, as described in chapter 14, would be joined by section 1801 of the Energy Policy Act of 1992 (Pub. L. 102-486, 106 Stat. 2776 at 3010) that mandated a "simplified and generally applicable" methodology for just and reasonable rate reform. In response, Federal Energy Regulatory Commission order 561 (58 Fed. Reg. 58753) of October 22, 1993, allowed rates to be set by index, settlement, traditional cost of service, or market competition. The last alternative, market-based rates, required a Herfindahl-Hirschman Index determination of an absence of market power, a methodology also used by the commission in the 1990s to allow market- based rates for interstate natural-gas pipelines and storage facilities.

Other government involvement with water carriers should cease. Under the guise of national security, construction and operating expenses for U.S. ships have been subsidized since the early 1970s to allow them to compete against lower cost foreign vessels. New construction subsidies have been stopped, but construction and particularly operating subsidies have continued in existing contracts. This is corporate and labor-union welfare at the expense of taxpayers; the program should be eliminated by repealing the Merchant Marine Act of 1936. U.S. costs would fall, and the share of the market going to foreign shipyards and foreign crews would free domestic resources for more urgent uses.

Private-property rights should be established for water lanes. The homestead principle could be used to determine first title from which a resale market or rental market could emerge. Along with road privatization, which would introduce market values for commercial road use, water-lane pricing would create competitive equity with pipelines and railroads that already pay right-of-way costs. Water ownership would also internalize pollution costs and reduce government involvement with water port decisions.

Foreign Trade. Amorphous reasoning based on claims of national security and the national interest has sanctified oil-import regulation, export restrictions on oil technology and equipment, and loan subsidies from the Export-Import Bank and the World Bank. “Just and reasonable” price regulation has governed natural-gas imports. Foreigners, such as a group of Kuwait investors in 1983, have been prevented from acquiring oil leases on federal land. All these interventions have disadvantaged U.S. consumers or fostered nationalism in world energy markets, or both.

Table 31.1
PETROLEUM TARIFFS AS OF 1984
(dollars per barrel)

Hydrocarbon Type	Most Favored Nations	Communist Nations
Gasoline & jet fuel	0.525	1.05
Kerosene 7 naphtha	0.105	0.21
Lubricating oil	0.80	1.60
Crude oil (above 25° API)[a]	0.105	0.21
Crude oil (below 25° API)[a]	0.0525	0.105
Fuel oil (above 25° API)[a]	0.105	0.21
Fuel oil (below 25° API)[a]	0.0525	0.105
Natural gas & natural gas liquids	Free	Free

SOURCE: General Agreement on Tariffs and Trade.

[a] API gravity, expressed in degrees, is the standard industry measure of density of petroleum liquids. The higher the value of API gravity, the less dense, and more valuable, the petroleum.

Open trade in oil and gas requires the repeal of the pertinent sections of the Tariff Act of 1930, the Trade Expansion Act, the Defense Production Act, the Export Administration Act, the Trans-Alaska Pipeline Authorization Act, the NGA, and the Mineral Leasing Act. Repeal of the oil section of the General Agreement on Tariffs and Trade, authorized by the Tariff Act of 1930, would remove the tariffs administered by the Bureau of Customs within the Department of the Treasury (table 31.1).

Full participation in the world oil market by the U.S. oil and gas industry would assure domestic consumers of maximum supply at the world price. Political distortions at home and energy nationalism abroad would be minimized. World competition would promote competitive prices across the energy spectrum, since residual fuel oil and natural gas compete with hydroelectric, geothermal, coal, and nuclear power.

An infamous foreign trade restriction is the ban on crude-oil exports from the United States that effectively prohibits the flow of Alaskan North Slope crude oil to the Pacific Rim. The ban benefits West Coast (and even Gulf Coast) refiners by giving them a monopoly on Alaskan oil. The victims of the ban are not only the sellers and would-be (foreign) buyers of Alaskan oil but also California crude-oil producers who have experienced artificially low prices because of the supply glut caused by Alaskan oil. The only winners have been two narrow but politically adept constituencies—domestic-flag carriers, who under the Jones Act of 1917 have exclusive shipping rights between U.S. destinations, and independent Petroleum Administration for Defense District V refiners.

The export ban should be removed, not only for improved international relations but as good domestic energy policy. Free trade will improve the economics of California and Alaskan oil production and improve transportation efficiencies in the world oil market.

Open international trade also requires the United States to cease imposing periodic sanctions to protest other nations' policies. The petroleum equipment ban against the Soviet Union, begun by President Carter in 1978 for human-rights violations and expanded by him to protest the Afghanistan invasion and by President Reagan to protest martial law in Poland, has hurt the domestic oil service industry as much as or more than the targeted countries. West European suppliers have been the major beneficiaries. Petroleum export and import bans against isolated countries have been easily circumvented by redirecting oil flows in the world market. While individual firms, aware of public opinion, should be free to boycott foreign countries, U.S. government policy should not force them to do so.

Privatization and Dissolution. The federal government holds valuable crude-oil and natural-gas assets: the Strategic Petroleum Reserve, the naval petroleum reserves, the naval oil shale reserves, and millions of acres of commercial or potential oil- and gas-bearing lands. In addition, the Department of Energy (DOE) owns civilian energy research-and-development assets. Those assets have value in the private sector, where they can be more efficiently utilized. They should be either transferred to the highest private bidder, as was done with the federal pipelines after World War II, or granted outright to private parties under a homestead property-rights system.

Leased onshore and offshore properties, including the naval petroleum reserves, with proven reserves should become the sole property of the lessee-operators. Properties with mineral potential, but not presently oil or gas bearing, would become free and open for drillers to create ownership by the acts of discovery, claim, and development. The surface property required for exploration and production in the case of public land would also be homesteaded property. The Department of the Interior would no longer lease land, regulate activity, or collect proceeds. The Mineral Leasing Act and the Federal Oil and Gas Royalty Management Act would no longer apply. Exploration and production would be entirely private matters, and provable damage (invasion) would be subject to tort remedies outside the bureaucratic process.

The Strategic Petroleum Reserve, the contents of which fall somewhere between proven reserves and surface inventory, should be sold to the highest cash bidder and the proceeds used to retire associated debt. Given the political barriers to timely utilization, the Strategic Petroleum Reserve is far more valuable to consumers as an entrepreneurial asset than as a political one. Related expenses for maintenance and crude-oil additions (if any) would be privately borne rather than imposed on taxpayers. Privatization would also deter the government from imposing major oil regulation or intervening abroad since policy mistakes could not be covered by drawing down the reserve. The reserve's purported "insurance policy" is as much for the benefit of government policymakers as for the private sector.

The four naval petroleum reserves should be privatized. The Elk Hills, California, field (NPR-1), the seventh largest oil field in the country, is the plum of the four, but significant production is also present at the Buena Vista, California, field (NPR-2). The other producing reserve is Teapot Dome, Wyoming, (NPR-3). Southern Alaska (NPR-4) is not active. Although not active, the three naval oil-shale reserves—two in Colorado and one in Utah—are also candidates for privatization.

Synthetic-fuel research and development assets that have accumulated within the DOE are a final candidate for privatization. In conjunction with the agency's abolition and the elimination of synthetic-fuel subsidies, discussed below, these assets should be auctioned off to private parties.

Thoroughgoing conversion to a noninterventionist oil and gas market requires the abolition of the DOE. As a Heritage Foundation study concluded, the agency's problem is not administrative but "the fact of its existence."[33] The assumption behind the creation of a cabinet-level energy bureaucracy in 1977 was that federal intervention was necessary in energy markets; the assumption behind its demise is that regulation and subsidization are counterproductive and should not have a central command post.

The national-defense functions of the DOE, including the nuclear programs, should be transferred to the Defense Department and other appropriate agencies. The remaining programs associated with civilian energy should be terminated. These include

- research and development;
- conservation grants;
- direct energy production (including the Naval Petroleum Reserves);
- the Strategic Petroleum Reserve; and
- other energy functions (the Federal Energy Regulatory Commission, the Energy Information Administration, the Economic Regulatory Administration, the Office of Hearings and Appeals, and Emergency Preparedness).

The appropriated budget savings for fiscal year 1985 would have been approximately $8.2 billion.[34]

The oil and gas programs of the Department of the Interior should be dissolved as well. The Bureau of Land Management and the Minerals Management Service would no longer be needed

[33] Milton R. Copulos, "The Department of Energy," in *Mandate for Leadership: Policy Management in a Conservative Administration,* ed. Charles L. Heatherly (Washington, DC: Heritage Foundation, 1981), p. 217.

[34] U.S. Department of Energy, "History Table," internal document, May 5, 1994. The DOE's fiscal 1995 nondefense budget appropriation would be $7.8 billion. U.S. Department of Energy, "FY1996 Control Table by Appropriation," internal document, July 20, 1994. Conversation with Rusty Perrin, budget analyst, DOE, July 21, 1994.

if mineral leasing on government land were privatized. Indian-owned land would come under tribal jurisdiction, not the jurisdiction of the Bureau of Indian Affairs.

Taxation. With multi-billion-dollar spending cuts on federal energy programs, major industry tax reductions become not only possible but fiscally justifiable. For example, the motor-fuels tax should be eliminated. Road privatization removes the basis for the $0,091 per gallon (as of 1984) federal gasoline and diesel-fuel tax.[35] Motorists' payments to road companies are vastly superior to "user- fee" taxes, which include a premium for government inefficiency and discriminate against less fuel-efficient vehicles. With the end of local, state, and federal fuel taxes, motor-fuel prices for the first time in decades would reflect underlying market scarcities.

The controversial Windfall Profit Tax on crude oil, a revenue grab at the expense of a politically outmaneuvered industry, raised much less money than anticipated because of falling oil prices, declining domestic production, and royalty owner deductions. It should be terminated ahead of its scheduled expiration date, not only to make the domestic industry more competitive against international competition (oil imports), but to end tax discrimination.[36]

Synthetic Fuels. The government-industry partnership to advance synthetic oil and gas from the drawing board to commercial production ended in 1985.[37] The experience with synfuels was similar to earlier episodes, the initial optimism and promises of which were unmatched by the results. The fact that the various projects could not secure private financing but required major taxpayer support demonstrated the fallibility of government forecasting and the collective wisdom of private capital markets.

Approximately $7.5 billion in price supports and loan guarantees in various stages of commitment as of 1984 are summarized in table 31.2.

Unilateral termination of outstanding liabilities has the attraction of discouraging similar private-public partnerships in the future. This is one bridge that should be burned. Repudiation, on the other hand, should not apply to government-industry contracting for the fuel needs of the military and other public-sector agencies. Such contracts put the government on a private-sector basis and preclude the need for emergency or wartime planning. Short of unilateral termination, existing synfuel contracts should not be extended past their original term, and new commitments should not be made.

Government disengagement does not spell the end of research on synthetic fuels. It ends only uneconomic research at the taxpayers' expense,

---

[35] This levy was increased to $0,141 per gallon effective in 1990 (Pub. L. 101-508, 104 Stat. 1388-423 [1990]) and to $0,191 per gallon effective in 1993 (Pub. L. 103-66, 107 Stat. 312 at 510 [1993]).

[36] The Windfall Profit Tax was repealed effective August 23, 1988 (Pub. L. 100-418, 102 Stat. 1322).

[37] Pub. L. 99-190, 100 Stat. 1185 at 1249 (1985).

Table 31.2

GOVERNMENT-SUBSIDIZED SYNFUEL PROJECTS

(as of December 1984)

Project	Type	Location	Value of Aid	Guarantee
Cool Water	Coal gasification	California	$120 million	Price
Dow Syngas	Coal gasification	Louisiana	$620 million	Price
Union Phase II	Oil shale	Colorado	$2.7 billion	Price
Cathedral Bluffs	Oil shale	Colorado	$2.19 billion	Loan & price
Great Plains	Coal gasification	N. Dakota	$790 million	Price
Northern Peat	Peat	Maine	$365 million	Loan & price
Seep Ridge	Shallow oil shale	Utah	$45 million	Loan & price
Kentucky Tar Sand	Tar sand	Kentucky	$543 million	Price
HOP Kern River	Heavy oil	California	$100 million	Loan & price
Forest Hill	Heavy oil	Texas	$60 million	Loan & price

SOURCE: Synthetic Fuels Corporation.

which misallocates resources from higher priorities. Market-oriented research, albeit less than the subsidized effort, is the responsibility of individual companies and cooperative private research associations such as the American Petroleum Institute, the Gas Research Institute, and the Electric Power Research Institute.

Mandatory Conservation. Mandatory conservation, another legacy of the Carter era, should be abolished in its many forms. This purported antidote to the supply problems created by price and allocation controls is uneconomic. As a rule, forward-looking suppliers and consumers make rational energy choices—leaving less desirable conservation choices for mandates. The abolition of the DOE would end the following conservation-related programs: the Industrial Energy Conservation Program, the Energy Conservation and Utilization Research Program, the Federal Energy Management Program, and the Energy Analysis and Diagnostic Center. DOE-directed state conservation programs, such as the Schools and Hospitals Grant Program and the Low-Income Weatherization Assistance Program, would also cease. The DOE should not be in the welfare or end-use conservation business.

The demand for motor fuel should be free to reach its natural market level. The Corporate Average Fuel Economy mandates, which have set fuel-efficiency standards for cars since model-year 1978, should be terminated, not just relaxed as the National Traffic Safety Administration did for light trucks in 1984. The Energy Tax Act of 1978, which placed a "gas-guzzler" tax on cars not meeting strict mileage standards, should be removed. The demand for larger (and safer) cars reflects the fact that fuel is plentiful and affordable. Automakers should be able to offer the mileage consumers are willing to accept without penalty.

The Energy Efficiency Improvement Program, which sets mandatory conservation standards for businesses that consume 1 trillion British thermal units or more per year, should be repealed. The assumptions behind mandatory conservation have been discredited. There is no reason why taxpayers and corporations should spend more money on energy conservation than they save with lower fuel costs.

Two other federal laws should be stricken from the statute books: the Residential Conservation Service Act of 1978 and the Commercial and Apartment Conservation Service Act of 1980. Taxpayer-subsidized energy audits have not only proven uneconomic, they have attracted mostly an affluent clientele. Thus, despite legislative intent, gas and electric ratepayers have subsidized the comfortable, not the poor.[38]

Freed from government-orchestrated conservation, petroleum conservation would remain—but not at the expense of taxpayers and consumer preferences. Firms and individuals would determine their energy conservation by measuring benefits against costs. For- profit energy

[38] Milton Copulos, "Reconsidering Energy Audits," Heritage Foundation Issue Bulletin, April 6, 1984. Also see Michael Frankel and John Duberg, "Energy Audits as an Investment: The Residential Service Program Analyzed," *Public Utility Fortnightly,* April 12, 1984, pp. 20–25.

conservation firms and nonprofit groups such as the Alliance to Save Energy (founded in 1977) would have to work through market incentives rather than maneuver the heavy hand of government—or perish. Taxpayer monies should not be used in those efforts.

A final legislative initiative to reward the oil and gas industry with a market level of demand is the elimination of subsidies for competing fuels. Nuclear power is subsidized by the Price-Anderson Act, which limits liability in major nuclear accidents. Nuclear power has also been generously subsidized by government research and development. The vast hydroelectric power systems of the Tennessee Valley Authority, the Bonneville Power Administration, the Southwestern Power Administration, the Western Area Power Administration, the Southeastern Power Administration, and the Alaska Power Administration have been subsidized since their creation in the 1930s by below-market interest rates and a lax principal- repayment schedule. Those agencies are all inconsistent with a fuel- neutral energy policy and should be reorganized as market institutions.

Other Intervention. Various other federal interventions inhibit expanded entrepreneurship and industry coordination and growth.[39]

Service-station deregulation at the state and local level should be joined by the repeal of the federal Petroleum Marketing Practices Act of 1978. Repeal would permit unbiased service-station contracts between lessors and lessees. To the same end, explicit contract covenants should be respected by removing the "unconscionability" and "unfair surprise" defenses from the Uniform Commercial Code. Protecting independent lessees from lessors by extralegal means violates and weakens the franchise arrangement to the detriment of not only lessors but consumers who depend on the consistent quality of brand-name stations.

One of the major distortions in the gasoline market has been the disintegration of the refining and retailing phases. State and federal tax policies began the disintegration in the 1930s; the process has continued with laws and proposals aimed at divorcement and divestiture. Although chain-store taxes no longer apply, and Social Security and unemployment taxes now apply equally to all dealers, the political clout of lessee-dealers has discouraged the refiner-sup- pliers from resuming salaried operations. With an end to political interference, market incentives would be allowed to determine the extent to which refining and marketing were integrated.

Government-to-government entanglements with energy supply should be ended from the U.S. side, and such agreements should be avoided in the future. The United States should withdraw from the Organization for Economic Cooperation and Development's International Energy

[39] Previous chapters developed free-market arguments against government intervention that applied not only to oil and gas but other business sectors as well. These areas included labor and safety regulation (chapter 10); accounting, securities, and futures-market regulation (chapter 17); and environmental regulation (chapter 21). These arguments are not repeated here.

Agency. The flawed idea behind the formation of the agency in 1974, as discussed in chapter 17, was to combat the OPEC cartel with a consumer cartel.

The centerpiece of the twenty-one-country plan is the Emergency Sharing System, whereby oil is stockpiled to distribute in an emergency according to each country's historic supply and demand configuration. This is a naive egalitarian plan. Not only would it break down from the self-interested actions of sovereign governments, it has the great potential of turning into a U.S. foreign aid program. If antitrust barriers were removed to facilitate interfirm coordination, multinational U.S. firms could make their own contingency plans free of the directives of an international energy czar.

Prosecution of U.S. firms for alleged oil-price overcharges during the 1974-81 period of price and allocation regulation, primarily of crude oil, has continued at a snail's pace in the 1980s. How to distribute several billion dollars in collected overcharges has been as controversial as the decisions themselves. Jobber and retailer groups, in particular, have circled the loot in hopes of a windfall.

Proposals for distribution to industry groups are based on the tenuous assumptions that the "overcharges" actually occurred, that oil prices would not have been bid up anyway by downstream parties (resellers in particular), and that individual "victims" can be identified. Another "overcharge" distribution plan—underwriting state conservation programs in the midst of a conservation boom and falling prices—adds insult to injury for the industry and dubiously assumes that today's consumers are the same as yesterday's. Given the ambiguity of maximum-price regulation in the period and the problematic alternatives for distribution, another plan should be considered: returning the collected overcharges to the companies that paid them. All pending audits, litigation, and settlements should be dropped to end taxpayer involvement. This would close an infamous period of federal oil regulation—and set a precedent to discourage future attempts by government to salvage misguided intervention by post hoc penalties on private-sector parties "responsible" for its failure.

One of the last vestiges of 1970s' oil regulation is mandatory financial reporting by the major oil companies. Some twenty-six firms periodically submit information on costs, cash flow, revenues, and investments to the DOE's Energy Information Administration. A lawsuit blocked a DOE attempt to end the requirement in early 1984. Repeal of the DOE Organization Act would solve this problem. Another DOE proposal to drop mandatory allocation reporting for 200,000 firms, also a vestige of oil price and allocation controls, should be enacted to slash a business cost at an opportune time.

Potential Intervention

Judging by history, there is little intervention that government is not able or willing to implement. What political majorities—and in some cases well-organized political minorities—want is what they get, and this can be expected to continue. There are several potential interventions that are a constant threat to a free market in oil and gas.

Standby Controls. A courageous veto by President Reagan in 1982 prevented Congress from enacting standby price and allocation controls. Such standby authority could again be considered by Congress when a perceived emergency looms.

The moral of "emergency" regulation is that intervention has been the cause, not the cure, of past energy crises, and new regulation will make things worse. Without standby controls to trigger actual controls, the government will have difficulty creating another crisis. The experience of the 1970s should have made it clear that price and allocation regulation should never again be proposed or implemented.

Refiner Protectionism. "National security" has been a recurring rallying cry for intervention that has left a trail of distortion and broken promises. Yet national-security rationalizations still have political life. In 1984, a group of independent refiners, threatened by increased gasoline imports, organized the Independent Refiners Coalition and lobbied Congress for increased gasoline tariffs for reasons of "national security." Their desperation signaled that the U.S. refining industry's adjustment to changed market conditions is not complete.

Downstream protectionism must be resisted to induce excess refining capacity to exit rather than remain to the detriment of consumers and the stronger firms. A stronger, leaner refining industry congruent with underlying demand is preferable to a larger, weaker sector less able to weather the industry's storms.

Producer Protectionism. Independent producers can be expected to lobby for crude-oil tariffs if oil prices decline sufficiently. The "national-security problem" of rising oil imports will again be the rationalization. Fears will be expressed about low prices' shutting in domestic production and unstable imports' replacing domestic output. Once the "peril point" of import dependence is reached, the argument concludes, foreign oil powers will be able to raise prices at will to replay the 1970s energy crisis.

This argument for upstream protectionism is not persuasive. The fungibility of oil makes nation-to-nation embargoes virtually impossible, which changes the threat to that of a *net reduction* in world output. With excess capacity in the world petroleum market in the millions of barrels per day, supply cuts by some countries create profitable substitution opportunities for other countries. To the extent that slack capacity is exhausted and prices increase, new incentives are created to increase production and reduce usage (conserve). This longer run market "punishment" for price spikes is a disincentive for short-run reductions in supply.

Market-oriented energy policies allow entrepreneurs to anticipate and thus mitigate supply cutoffs. Upgraded refineries allow a greater variety of crudes to be processed today than in the 1970s to facilitate substitutions for lost feedstock. In the electric-generation market, many consumers responded to the energy crises by installing dual fuel capability and now can protect themselves by switching to alternate fuels. High oil prices encourage gas burning, and high gas prices encourage oil burning, in most markets.

Relief for domestic oil production can be found in a variety of market-driven policies that reduce costs and increase markets. Transient oil tariffs or quotas only delay the needed restructuring and

create a political climate for the oil industry in which a “favor” here is joined by a “penalty” there. Industry relief through protectionism is a mirage, as chapter 13 has documented.

Toward a Laissez-Faire Era for Oil and Gas

Free-market policies would result in noticeable changes in the industry, the professions that serve it, and the general economy. As state and federal energy bureaucracies contracted, entrepreneurship would expand. Reduced costs would free resources for other uses in the industry and elsewhere in the economy. Lower taxes would result in higher retained earnings, allowing more projects to be undertaken domestically and abroad. Many lawyers, accountants, economists, lobbyists, and other specialists involved with intervention would leave the industry or focus their talents on core industry functions. Energy-belt law firms would no longer need a “Washington presence.” The number of industry lobbyists and trade association personnel would greatly diminish. Within oil and gas companies, the government (regulatory) affairs and public affairs departments would contract. Regulatory compliance and analysis jobs would become expendable. On the other hand, skills in geology, engineering, market analysis, marketing, accounting, and finance, which comprise the core functions of market-oriented energy firms, would enjoy enhanced demand.

Under laissez faire, a variety of regulatory terms would recede into the past. Hot-oil, allowable oil, stripper oil, NGPA gas categories, intrastate verses interstate, domestic versus foreign, exempt (non-jurisdictional) versus nonexempt (jurisdictional), Hinshaw pipelines, and other artificial distinctions would become artifacts of a bygone era. Oil and gas activities would be described by their physical and economic characteristics, not their regulatory characteristics.

With less government power over the industry, there would be increased social power embedded in the entrepreneurial, managerial, ownership, and consumer functions. More than ever before, policies, priorities, and guidelines would be set privately. Consumers, in particular, with their decisions to buy or not to buy controlling the fate of firms, would occupy a central position of market power.

Company directors, stockholders, and management would be very sensitive to consumers' desires. Policies governing insider trading, company transactions with controversial groups, financial disclosure, and philanthropy would be decided with an eye to the preferences of the consuming public and stockholders. Journalists and academics would have an important role in the free society, complimenting or criticizing business strategies and decisions by the standards of justice and the common good. The legislature and judiciary, however, would no longer be able to effect social change through government policies.

Economic progress and social benevolence are byproducts of private property rights and voluntary choices in the marketplace. The distinguished performance of the U.S. oil and gas market—despite government intervention—is a case study of this first principle of political economy. In a new era of laissez faire, an even greater contribution to a free and prosperous society can be expected from the oil and gas industry.