

The Market System

Abridgment

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I will discuss some specifics of the Department of Energy (DOE) programs and provide some background on the free-market approach versus allocation and price controls and why the Department has taken such an approach.

Partly the free-market approach is a philosophical commitment, but it is also a practical choice. If I really believed that the markets would not work, I would be the first to consider other alternatives to meet the nation's petroleum supply needs. However, a careful examination of allocation controls reveals that at no time did federal allocation rules apply to retail purchasers of motor gasoline. They were always applied to wholesale allocations and their effect, particularly in the 1979 crisis, is questionable.

In effect a situation existed in 1979 where some of the major oil companies were fighting essentially a political and economic battle about allocations and the relationship of allocations to their own branded outlets--their own stations versus independent retail stations. Every year or so the allocation issue would be discussed and the Department of Energy would reject it. For reasons known only to DOE officials, the Department chose the moment of the Iranian revolution to dramatically change the whole framework of gasoline allocations. From about February 1979 through September 1979 the DOE essentially had a looseleaf regulatory program with additional guidelines and two or three changes per week in the rules. Not only did industry have difficulty understanding the program but in some instances the DOE regional offices did not even have copies of the regulations, which made implementing the allocation system extremely difficult.

The people who were affected by all of these changes in the allocation rules began to submit requests for special relief; several thousand requests were made in the first 2 or 3 weeks. The DOE Office of Hearings and Appeals granted all of the requests. Because matter is neither created nor destroyed, this resulted in the loss of gasoline allocations to numerous distributors and caused more petitions to be filed. The people who lost the gasoline filed another several thousand petitions and about 98 percent of these were denied. This led to a shortage of fuel for everyone.

One requirement of the allocation system was that a company declare an allocation fraction and then distribute its petroleum products at the beginning of the month based on these allocation fractions. The company accomplished this by computing the amount of petroleum products it had versus the amount it had to supply. Of course, because the petroleum system is never bone dry, it does not start out fresh every month. There is always some petroleum in storage. So there is an element of discretion about how the company is going to make those judgments. Some companies routinely held back approximately 10 percent (in some cases 25 percent) of their supply until later in the month, waiting to see if they were going to receive an order that would require them to distribute the product.

The result was that in the first two weeks of the month the amount of petroleum flowing in the system was dramatically lower. At the end of the month, if

a company did not get a DOE order to distribute, it was difficult to move the product because of logistics. Essentially at the beginning of the month the whole system slowed down. Further complicating the situation was the unwillingness of the oil industry, because of the overall regulatory framework, to do anything without approval from the DOE.

In the 1979 crisis because the allocation system was being used, people could not react. When American consumers were concerned and did not take vacations, oil companies still had to send gasoline to the resort communities because in the previous summer the resort communities were where people had the allocation rights and so they were awash in fuel and urban areas did not have any. This is one of the reasons the free-market approach was proposed.

Two other problems with the previous DOE programs should be mentioned: coupon rationing and lack of information. The Department of Energy printed 4.8 billion coupons which are stored in Colorado.

When the coupons were printed there was no effective coordination among any of the agencies that were responsible for printing banknotes. Consequently the coupons were printed on pieces of paper, black and white, without any serialization, identification, or documentation. They were printed with the same picture of George Washington that is printed on the one dollar bill, which means that they are entirely usable in change machines. Also, because they are black and white, usable reproductions can be made on ordinary xerox machines. The coupons cost approximately \$10 to \$12 million to print originally, and if it were possible to overprint them with a serial number, it would cost more than \$15 million. But because they have been sitting in Pueblo, Colorado, for about 9 years they can no longer go through the printing presses. Because of these problems, lack of serialization, easy reproducibility, and the public attitude toward gasoline rationing, the Department of Energy concluded that coupon rationing is not a viable option to use in an energy emergency.

Another problem with the way energy emergencies were handled in the past was the incredible lack of available information. One of the first priorities at DOE has been to create an information window that does not duplicate the modeling capability in the Department or the massive individual data collection efforts already in place, but its purpose is to provide enough readily available data to the Department so that it will have an idea of what is going on.

The mere existence of this 24-hour information system that has a wide range of information never before available to decision makers, not only at DOE but throughout the government, has dramatically improved the nation's energy emergency preparedness posture. We have also linked, for the first time, intelligence information with nonclassified information. So, the likelihood of a surprise in terms of energy disruptions and their impact on the United States is considerably less.

There are a couple of specific programs that I believe have some potential for assisting in energy emergency preparedness. I have mentioned the economic response measures, and I consider those a

vital part of any kind of emergency response procedures. There have been a number of comments concerning people on fixed incomes and people in lower economic groups. I am totally convinced as a political appointee that no democratically elected government will survive with high energy prices and large numbers of people unable to pay their fuel bills or their gasoline bills. There has to be a way of dealing with the severe social and welfare issues in an energy crisis, but fundamentally we do not want to interfere with the distribution of petroleum products. If an allocation or price control system is imposed there is too much danger that the mechanism for getting petroleum products where they are most needed will be fouled up.

The way to deal with the situation is to let the markets clear. Let the prices be charged. Let the marketplace make the allocation decisions and then deal with the social and economic problems through those agencies that have the expertise, for example, the U.S. Departments of Health and Human Services and Housing and Urban Development, the Social Security Administration, and the state and local agencies who have that expertise. One of the problems that occurred in the past was that DOE tried to deal with social and welfare-type issues through the energy system; it has no expertise in that area.

As I mentioned before, economic response measures are a vital part of any kind of emergency response. I do not call these recycling or rebate mechanisms for a very important reason. In referring to them as recycling measures at a conference at MIT or Harvard, someone commented that there would not be any money to recycle because even though additional money is received for taxes on energy, the overall economy would decline and there would not be as much money coming into the treasury as anticipated.

My point is that, if an energy crisis of a major magnitude occurs, and people are being hurt, it does not matter if the deficit is increased. Fundamentally the money has to be found to alleviate the hardships, whether additional tax revenues are coming in or not. So I have changed the frame of reference from one of recycling and rebate to an economic response to reflect the fact that this is a program designed to mitigate economic hardships. It will not be contingent on funding from other sources, so that if there is no funding there is no program. There must be a program to deal with the economic problems that result from high energy prices during an energy emergency, if not, the administration will be out with the next election.

Another measure under consideration that may have some interesting implications, particularly for state and local government, and perhaps for the transit systems, is a hybrid of the futures and cooperative program. This is an outgrowth of a discussion I had about one year ago with jobbers who were concerned that they could no longer afford to store as much fuel in their tanks because of the holding costs and the weak demand.

We are investigating whether it is possible to set up a futures-cooperative approach where the stocks are actually prepositioned, as in a mutual fund, and the jobber or a middleman arranges to sell small shares in petroleum so that people actually own something. Theoretically it appeals to two of the most important human virtues, greed and self-interest: greed because there is a possibility of getting additional money if a shortage occurs, but also self-interest because those people who need the fuel actually have something.

One of the concerns about straight futures is that it is fine now as a hedge or as an investment, but in a crisis it is only paper, and of course, the people who sell futures say, "Well, don't worry

about it, it is all backed up by volumes." But in any event if the oil is actually there, not only can the tanks be filled up, but also there is a mechanism for people to participate. There is a substantial difference of opinion about whether an energy crisis is likely, but the problem ordinary citizens have is that they do not have the opportunity to decide how much fuel their dealer maintains in storage. Shell decides for them, or Arco, or their jobber decides, and to some extent they can decide if they want to fill up their tanks, but that is a fairly final decision, particularly in the case of a heating tank, because, the fuel cannot be disposed of after the tank is filled. If the fuel is at a local jobber, and he is a middleman, an individual who wants to dispose of the fuel can sell it at a profit.

Another important mechanism that I have mentioned before is the National Defense Executive Reserves. The word defense might be misleading. I do not see this group as being solely limited to a defense situation. It is called National Defense Executive Reserves because it is authorized by the Defense Production Act which was extended for 6 months, not the 5 years the Administration had asked for. One of the concerns that has been expressed by a number of people in state and local governments has been that funding has been cut. Grants from the federal government have been reduced. States no longer have the expertise to deal with problems, and yet they see the federal government turning over more responsibility to them. We are trying to create a group (we have three reserve groups already: petroleum and gas, solid fuels, and electricity) that will be a nationwide network of experts who are available to assist not only the federal government, but also state and local governments in dealing with real world problems.

I will now review several other points. A number of people are concerned that stockpiles are down. Relative to demand this is not a problem, but still there is concern. We are considering incentives for stockpiling. Soon a notice will appear in the Federal Register requesting comments on a study that has been conducted for DOE on stockpiling. There are many questions about how the Strategic Petroleum Reserve (SPR) is going to be used, the timing, how the fuel is going to be sold, and to whom. It is important to recognize that the SPR has been opened up to the universe of buyers. In the past only a domestic oil company or a domestic refiner could bid on SPR oil. Now anyone with money can bid, which does provide opportunities for cities or groups of consumers to join together, purchase the oil, and arrange through processing agreements to have it refined. Also under consideration are futures and options, that is, forward sales for SPR oil. A test of the SPR will be conducted in July 1983; it will be a simulation of sales not an actual sale. (The DOE does not have the authority for actual sales.)

Before I discuss the International Energy Agency Program test, I will give an example of how the marketplace works. Last fall, because of concern about stock levels, we solicited voluntary standby stock availability from the electric utility industry and they responded. At the time of our discussions, the primary stocks of distillates in the New England region was approximately 10 to 14 million barrels, and through the work of the North American Electric Reliability Council approximately 2 million additional barrels of distillates were identified that the electric utility industry volunteered to make available (subject to appropriate regulatory approval) in the event of a severe energy

crisis. We are working to establish this on a nationwide basis.

We have contacted the National Association of Manufacturers and the National Chamber of Commerce because we plan to set up the mechanisms so that the private sector can arrange a voluntary network before the heating season. Using this network a state or local government or a city or county can contact local organizations or utility companies that have agreed to offer assistance. In conclusion I will mention the AST-4 allocation system test, the fourth test of the International Energy Agency Program. It is designed to test the mechanisms of international sharing and the ability of national emergency sharing organizations (NESO) to deal with the disrupt-

tions that are postulated by the International Energy Agency.

This year we have expanded participation in AST-4 to involve not only participants in the past, which included the International Energy Agency, the federal government, and some major oil companies, but we are also expanding it to include states (which may have been included in the past), counties, trade associations, industrial consumers, some consumer groups, as well as citizens. We are trying to provide information about the international agency system, but we also want to get reactions to the approaches proposed. We believe expanding participation is vital to all of the activities in the energy area. This concludes the summary of DOE programs.