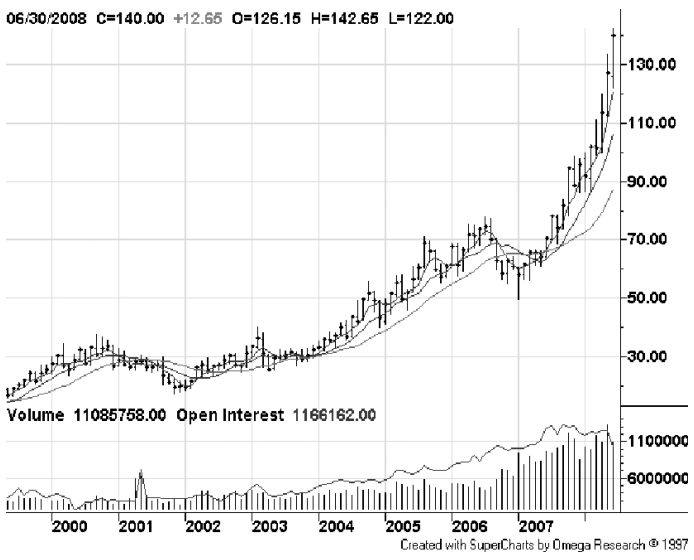


An Analysis Of The High Cost Of Oil And The Price of Deregulation
 By **John Dillard, JD, PHD**
 Vice President and Legal Counsel, Statewide Title, Inc.

The chart below shows how much the price of sweet light crude oil has increased in the commodities market since 1999. The upward trajectory in the price of oil is of great concern to everyone as the cost of oil is factored into almost everything we buy. Consider, for a moment, that transportation costs to bring raw materials to the manufacturing site are affected by rising costs of fuel as are transportation costs for the finished product to its retail location. Heating and cooling costs are factored in to the product's base as are any materials used in the product that are made from plastic, a petroleum derivative. Rising oil costs can be factored into a single product several times. Because the price of oil has such a diverse impact on so many sectors of the economy, it is worthwhile to examine some of the underlying causes for its rising costs. We'll begin by taking a look at some of the common myths being promoted today by the oil companies regarding the steady progression of petroleum prices.



Myth: Oil companies need to drill for more oil in the U.S. but can't because there is a ban on offshore drilling for oil.

Fact: There is no "ban" on offshore drilling, only a moratorium on new licenses that was enacted by President George H.W. Bush back in 1990. The oil companies are sitting on many viable leases for which they are not drilling. According to the Department of Energy's, Energy Information Administration, between 1997 and 2007 the number of permits for drilling new oil wells on public lands alone increased by 361 percent. Today there are over ten thousand drilling permits that the oil companies are simply sitting on. They cover approximately 66 million acres of land, of which 44 million acres are located offshore and which 10.5 million acres have actually been developed. That leaves 6,391 offshore leases on 33.5 million acres of land that can be drilled on for new oil.

In addition, there is a tremendous oil field in Alaska known as the National Petroleum Reserve of Alaska, in which 25 oil wells have been drilled but capped. The Department of Energy estimates that the total amount of oil that can be pumped from these wells vastly exceeds the amount of oil that is available in ANWR (Arctic Natural Wildlife Reserve), where oil companies are wanting to drill. The question we should be asking is why is oil not being pumped from these wells?

Moreover, last year the U.S. Geological Survey released information regarding the largest oil find on the North American continent in a remote area of North Dakota and parts of South Dakota, Montana and southeastern Saskatchewan. The site is known as the Bakken Oil Formation, and it is believed that between 200 and 500 billion barrels of oil are located in its 200,000 plus acres. This site has been known about since 1951. Why then haven't oil companies drilled here? Because the oil companies say it will cost them up to \$20 a barrel to recover the first 200 billion barrels and between \$30 to 40 a barrel to recover the remaining oil, and it isn't profitable enough. It doesn't take a rocket scientist to figure out how much profit can be made with oil going for \$145 a barrel as of the time of this writing. Source of information: U.S. Department of Energy, U.S. Geological Survey, and The Energy and Capital Report.

Myth: There is a shortage of oil because China is competing with us as a major consumer due to its citizens owning and driving cars now. If you listen to the ads the oil companies are running on television and in the newspapers they are saying that all of a sudden the people in China decided to go out and buy cars and that's where all the oil has gone.

Fact: This is another myth being circulated by the oil companies which would have you believe that everybody in China woke up and decided on the same day to go out and buy a car, and, for that reason, they are using up all the oil in the world. The fact is car ownership for all but a privileged few people in China remains an impossibility. The average annual income in China last year was \$1,058.00. Average income for rural families was a mere \$572.50, whereas their urban counterparts enjoyed an income of \$2,015.50 per year. Even on the income urban dwellers earn it is still very difficult to buy a car, especially since they lack the ability to buy on credit and must save and pay cash. (Source: The National Bureau of Statistics, Government of China).

Another fact the oil companies fail to tell you is that although consumption for petroleum products has increased in China in the past decade, which is more due to the fact our factories have moved there and are consuming energy, China has been very aggressive at developing their own sources of oil. They are drilling off the coast of the China Sea as well as in Africa through a partnership with six Arabic oil producing states.

The question for us to consider is that if China is not gobbling up all the oil in the world what is causing the price of oil to escalate? Like most things, there are a number of causes contributing to the rising cost, and I will attempt to summarize them below:

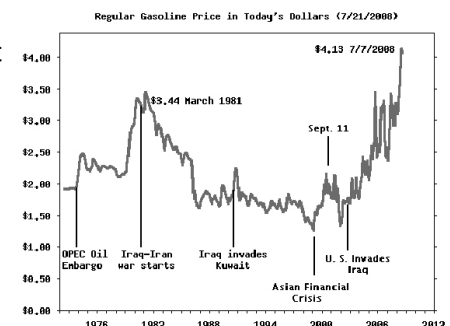
1) Weak Dollar. The chart below shows the decline in the value of the U.S. Dollar during the past decade. Why is it important that the value of the dollar be supported? It is because all commodities (corn, beans, wheat, pork bellies (bacon), cattle, oil, gas copper, etc), the things we use in our everyday lives, are traded in dollars on the commodities market. The dollar has an inverse relationship commodities such that if the dollar's value declines then the price of that commodity rises. And as the dollar has lost value in the commodities market the price of oil has risen conversely.



A number of factors have contributed to the dollar's decline including the Federal Reserve keeping interest rates artificially low and pumping excess cash by way of credit into the economy, the government's massive deficit spending, the tremendous increase in foreign debt and the Treasury Department's refusal to support the dollar and allow it to free fall against other currencies.

One other factor should be noted regarding why the dollar should be supported. Almost everything we consume is imported now. Therefore, the price of those goods must be filtered through the international currency exchange, and if the dollar loses value there will be a corresponding increase in the price of those goods, which the consumer will bear.

2) The War in Iraq. The next chart shows the relationship to the price of gasoline to international conflicts and crises, particularly in the Middle East. At the beginning of the chart prices began rising during the Israeli, Syrian, Egyptian War of 1973, also known as the Six Day War. This conflict, although short in duration, created a lot of instability in the Middle East and is considered one of the reasons for the OPEC Oil Embargo, which soon followed. There is another rise in prices during the Iraq-Iran War of the early 1980's, again with Iraq's invasion of Kuwait and with the U.S.-Iraq war currently ongoing.



3) Deregulation. Several changes over the past decade resulted in relaxed government oversight of the commodities markets. The Commodity Futures Modernization Act of 2000 (CFMA) allowed energy commodities for the first time to be traded on deregulated "exempt commercial markets," meaning exchanges exempt from the Commodity Futures Trading Commission (CFTC) or any other U.S. government oversight. This law was a departure from the Commodity Exchange Act of 1936, which had confined commodities trading to CFTC-regulated exchanges or publicly traded securities markets. The changes permit back

room trading that recall the bucket shops of the 1920's which led to over speculation in the stock market contributing to the 1929 crash. This type of back room trading is not only unregulated but it is off the books in terms of the commodities that are being bought and sold. The ugly side of this deregulation has meant that oil companies are now trading their own commodities in these Nouveau back room Bucket Shops and driving prices up in speculative trading.

Besides opening the door for unregulated, off-exchange trading, the CFMA has excluded what are known as "swaps" from regulation. As institutional investors like pension funds and university endowments have sought a hedge against inflation and alternatives to a shaky stock market, they have entered into swaps agreements with investment banks that allow the banks to trade in futures markets on their behalf. Under the 2000 law, the CFTC exempts these banks from position limits to which other speculators must adhere. As a result, investment in index funds tied to commodities, such as the Goldman Sachs Commodities Index (GSCI), rose from \$13 billion in 2002 to \$260 billion in 2007. These investors take long-term positions, which in turn generates upward pressure on commodities prices.

Source of Information: Gilbert E. Metcalf & George Norman, 2003. "Oligopoly Deregulation and the Taxation of Commodities," National Bureau of Economic Research, Inc. and Businessweek, June 2008.

4) Refineries. The oil industry has been spending quite a bit of their record profits trying to convince the public that there is a shortage of oil caused by increased consumption in China and this country and that the solution to the problem is to allow for more drilling. The issue of drilling permits has been discussed above and we'll now address briefly the issue of sufficient supply in the market.

According to Opec president, Chakib Khelil, worldwide supply and demand of oil is currently in equilibrium. He has also indicated OPEC is willing to pump as much oil as necessary to continue to meet demand and maintain market equilibrium. Is there in fact a balance between oil being supplied and that being demanded, and is enough oil reaching the American markets? Whether or not worldwide supply and demand are in balance is irrelevant to the U.S. market, because supply and demand for our market is not in balance, with demand exceeding the supply of refined gasoline. The problem is that our refineries are not refining enough oil into gasoline. In fact, refinery capacity over the past 25 years has decreased dramatically, and we are now importing over 10% of our refined gasoline. There is no single reason for the decline in refinery capacity. Some of the refineries were shut down due to age, others damaged during Hurricane Katrina. The mergers of Big Oil Companies also has resulted in the shutting down of many existing refineries. The current trend is for the small refinery operations to be shut down while large refinery operations expand their refinery capacity. Still, many refineries were shut down for simply no reason. In 1982 there were 301 refineries in operation in the U.S., whereas, currently there are only 145 according to the U.S. Energy Information Administration. Interestingly, as the number of refineries have been shut down, thereby decreasing supply, the refineries' margins have increased from \$.40 a gallon in 2006 to \$.80 in 2007.

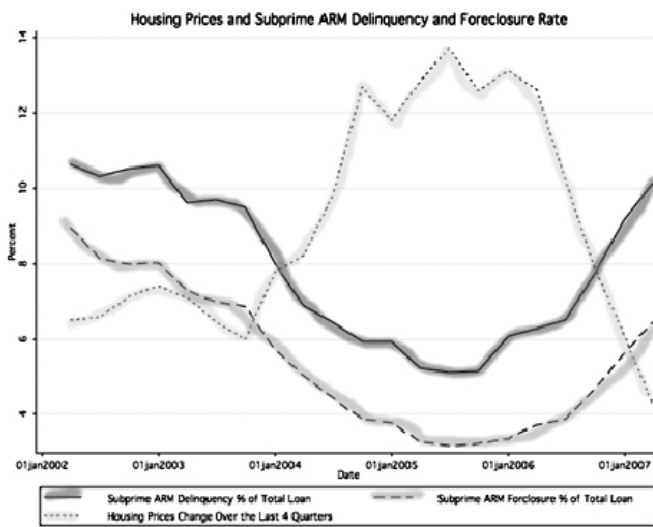
Oil companies like to tout in their ads on television how much of their record profits they are reinvesting in drilling for new oil and building new refineries, but the fact is there hasn't been a new oil refinery built in America since 1976. From 1975 to 2000, the U.S. Environmental Protection Agency (EPA) received only one permit request to build a new refinery. Our current supply problem is being caused by the inability to refine sufficient oil to meet demand.

Source: Committee on Government Reform Hearing, "Potential Energy Crisis in the Winter of 2000", 247wallstreet.com and BBC News June 24, 2008.

Conclusion. There is no smoking gun nor any one factor contributing to the high cost of gasoline and the seemingly ever-increasing price of oil. Rather it is a confluent number of factors contributing to upward price pressure. Oil prices can come down if the factors causing the increasing prices are effectively dealt with. This is not to say that we should continue to rely solely on fossil fuels to meet our energy needs. To the contrary, we should be mindful that oil is a finite commodity, and, to that end, we should be developing alternate sources of energy which would also bring much needed competition to the energy industry resulting in competitive price relief. But at present, we do have to be concerned with stabilizing and even lowering the cost of oil as it is factored into the price of almost everything consumed in this country and is a major contributor to inflation.

Economic Socialism In The Midst of A Free Market Economy

On July 30th, a bill was signed into law designed to bring relief to 400,000 struggling homeowners. The measure will allow homeowners facing foreclosure, and who are unable to refinance with conventional loans, to refinance into government backed FHA loans. The legislation also throws a lifeline to Fannie Mae and Freddie Mac while at the same time tightening control over these two entities. The Congressional Budget Office last week estimated the potential cost of this rescue could be \$25 billion. All of this is designed to ease the credit crunch currently existing in the housing industry and comforting the financial markets. The Treasury Department will have unlimited authority to loan money to Fannie Mae and Freddie Mac through the end of 2009. Other provisions of the bill provides \$180 million in pre-foreclosure counseling for struggling homeowners, \$15 billion in tax cuts, including a significant expansion in the low income housing tax credit for first time home buyers.



What has happened in the financial markets is not unlike the junk bond and Savings and Loan fiasco of the 1980's. Then as now, financial institutions who were reckless and made ill-advised investment and business decisions are being bailed out of the mess they created by the taxpayer. The architects of these financial disasters pushed for and were granted reform that deregulated their industries so that the "free market" could take control and make a more efficient allocation of the market's resources, leading to lower costs and better services for the consumer. But when these "free market" advocates ran their companies into the ground they quickly became advocates for economic socialism and government bailouts. In a free-market economy, shouldn't a company who is run poorly and makes poor business decisions be allowed to fail? Isn't that a part of a free market?

Unless the financial system is overhauled and new safety nets are put into place, there will no doubt be more failures and near failures in the upcoming months. Executives in our banks and financial institutions are among the best-paid executives in the world. Accountability needs to be introduced into the American financial marketplace so that these executives, whose decisions contributed to the failures, will be held responsible rather than simply being shown the door and given a golden parachute on the way out. In place of short-term, tax-subsidized bailouts, long-term solutions need to be put into place that will ensure sufficient oversight and accountability so that we will never see a crisis in our financial markets like this one again.