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THE WHITE HOUSE

WASHINGTON

Bill Sedlman

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[10/3/74]

United States Department of the Interior

OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

3 October 1974

Memorandum

To: Secretary William Simon
Chairman, Economic Policy Board

Subject: Oil Quota

A task force including Treasury, OMB, CEA (including the Troika staffs), FEA, and Interior, developed the attached analysis of the proposed quota. The message is clear: If a quota can be expected to cause the cartel price to drop from about $11 to $10 within one quarter, $11 to $9 within three quarters, $11 to $8 within twelve months, then the benefits of a quota can be greater than the loss to the economy. However, if the quota is not expected to cause the cartel price to fall during the year to at least $8, then the quota is more costly than it is worth. (See attached table.)

OPEC has already cut back about five million barrels per day to about 28 million barrels per day. The cutback of another one million barrels per day, or possibly two if other countries follow the U.S. and French lead, may not be enough to make a difference within the next twelve months.

Two alternative import and price control approaches are attached.

Jack

Jack W. Carlson
Energy Task Force

Attachment

Save Energy and You Serve America!

ECONOMIC COSTS AND BENEFITS FROM A QUOTA
(fixed import payment equivalent
to a decline of one million barrels per day)

(billions of dollars)

If the quota causes cartel price to drop to $8 by the end of 1/:	The present value import cost savings of the quota	Cumulative present value GNP loss of the quota 2/	Net benefit of the quota 3/
1975 I	$25.1	$ 5	$20.1
II	23.4	10	13.4
III	21.7	15	6.7
IV	20	20	0
1976	15	34	-19
1977	10	42	-32
1978	5	46	-41
1979	0	46	-46

1/ Assumptions: (1) expect imports of 2.3 billion barrels per year (6.3 million barrels per day) from 1975-1979; (2) OPEC will maintain an $11 price until 1979; (3) in 1979 the OPEC cartel will break of its own accord, and price will fall to $8.

2/ These figures were obtained from an estimate that the first year GNP loss would be $15 to $25 billion and the assumption that GNP would return to its trend growth at a constant rate within a five-year period. Discount rate is 10%.

3/ The loss in GNP probably understates the true cost of reducing oil consumption. For example, the total GNP loss estimated by FEA for last winter's oil embargo was as high as $20 billion. This loss is about $180per licensed driver in the U.S. If the inconvenience of gas lines, reduced speed limits, and curtailed driving and general uncertainties were considered, $180is too low a figure to reflect the real loss to automobile drivers.

DOLLAR LIMIT ON OIL IMPORTS

Beginning January 1, 1975, the President could establish a dollar limit on oil imports into the United States. Importers would be required to obtain licenses to import crude oil and refined products. Current imports are about $30 billion and at the rate of about 6 1/2 million barrels per day. Domestic price controls and allocation would be required if domestic prices are to be contained. Voluntary and involuntary conservation measures could facilitate the adjustment. Presidential authority exists under section 232 of the Trade Expansion Act of 1962 and the Mandatory Allocation Act of 1973 (expires February 1975). (A fixed dollar oil import limitation of about $25 billion or $4-5 billion less than current rates or equivalent to a reduction of one million barrels per day is used in the discussion of pros and cons.)

Pros

1. Improves the trade account by $4-5 billion.

2. Reduces dependence on foreign oil by one million barrels per day.

3. Creates some downward pressures on world prices by reducing worldwide demand by about 2 percent.

4. Provides leadership for other countries to follow the U.S. and French example.

Cons

1. Causes GNP to decline $15-25 billion annually: 1 to 2 percent in real growth for at least two years; unemployment increases by about 400,000; could trigger an even deeper recession with unemployment above 7 percent; automobile and related expenditures hit hardest (about one million decline in auto product); business fixed investment for electric utilities and manufacturing would decline. (See attached paper for greater detail.)

2. May not reduce oil prices by at least $3 a barrel within 12 months to be worth the economic cost. Already OPEC has reduced production by five million barrels per day and another one million may not make a difference either.

3. Could exacerbate energy situation at a time of natural gas curtailment and a threatened coal strike whether announced or implemented.

4. Requires allocation or rationing to contain an otherwise price increase of about 30 percent for oil products (for example, about 15¢ a gallon for gasoline). Substitute energy resources will likely experience price increases unless also controlled.

5. Requires congressional action between now and February 1975 (Energy Petroleum Allocation Act) to continue program.

Alternative Quota Systems

Bid System. The bid system would allocate import licenses to the importers of crude oil and petroleum products at the lowest price (given an allowed variance for differing crude qualities). Retail prices of imported products and products refined from imported crude would be based, for the purpose of cost pass-through, on import license bid prices.

Pros

- Controls dollar value of imports
- Eliminates highest priced import increments
- Tends to bring downward pressure on foreign prices

Cons

- Unsuccessful bidders have choice of operating at a loss or closing
- Existing long-term commitments for foreign oil may be abrogated
- Uncertainties of supplies may eliminate dealers or refiners from market
- Interjects government approval in negotiations which have traditionally been left to business
- Increases or expands bureaucratic system

Licenses based on the percentage of historical imports. This system would issue licenses on the basis of historical trends; percentage of 1973 imports.

Pros

- Controls dollar value of imports
- Permits importer widest latitude and least government interference of the three options

Cons

- May not result in obtaining lowest unit price
- May result in insufficient supplies

Tickets based on the percentage of historical imports, with varying cost pass-through. This system would provide importers, on the basis of 1973 imports, licenses to import limited quantities at ceiling prices as indicated:

- A maximum of 80% of the licenses would allow a cost pass-through corresponding to present prices, allowing for variance in crude qualities.

- 10% of the licenses would allow a cost pass-through of $2 per barrel less than present prices.

- 10% of the licenses would allow a cost pass-through of $4 per barrel less than present prices.

- An unlimited number of supplemental licenses would allow cost pass-throughs of $6 per barrel less than present prices.

Pros

- Controls dollar value of imports
- Places ceiling on highest priced import increment
- Tends to bring downward pressure on foreign prices
- Provides incentives to obtain more imports by harder bargaining
- Provides basis to take advantage of soft markets

Cons

- May not obtain adequate imports within the unit price limits
- May require continuation of allocation system
- Will expand the bureaucratic system

Analysis of the Economic Impact of Reducing Crude Petroleum Imports by One Million Barrels Per Day

This paper presents an analysis of the impact of reducing crude petroleum imports by one million barrels per day for an indefinite length of time. A reduction in the imports of crude petroleum of one million barrels per day represents a decrease in imports of approximately 26 percent in crude petroleum imports. At current crude oil prices, this would reduce the dollar outflow by a little over $4 billion.

Two possible ways of transferring this reduction in imports to the economy are discussed: (1) the Federal Energy Administration would allocate scarce petroleum supplies in an equitable fashion, maintaining control of the prices; or (2) prices would be allowed to fluctuate freely in order to achieve a balance between demand and the reduced supply.

The paper summarizes briefly the current petroleum demand and production situation and provides an indication of the U.S. economy's expected performance through 1975 in the absence of any restriction in imports as a base case. The impact on the economy of a restriction in imports is then compared to this base case using the experience of the recent oil embargo as a framework.

Current Petroleum Situation

Total demand for petroleum products for the four week period ending on September 13 averaged 16.5 million barrels per day. Imports of crude oil averaged 3.8 million barrels per day. Total imports of petroleum

products averaged 6.1 million barrels per day (excluding Puerto Rico). Domestic production of crude oil averaged 8.9 million barrels per day. The U.S. imported 13.2 percent of this production. OPEC production of crude oil has decreased steadily from 32.9 barrels per day in May to 28.8 million barrels per day in August, a decrease of 10.4 percent.

The Economic Background

From 1974 to 1975 the economy is expected to show little or no growth in real GNP. The economy will remain very sluggish over the next two or three quarters with a good possibility of declining real output. The near term outlook could even be much worse if the economy suffers a significant interruption in coal production this fall. However, some improvement is expected after the spring although there is some difference of opinion as to how strong this recovery will be. Unemployment is expected to rise throughout 1975 averaging 6.75 percent for the year as a whole as compared to an average of 5.4 percent for 1974. The GNP deflator is expected to average 10 percent higher in 1975 than in 1974. The inflation rate will be lower at the end of next year than at the beginning, but the improvement is likely to be small.

The Impact of Crude Oil Import Restrictions

The imposition of a reduction in the imports of crude petroleum will most likely decrease current dollar GNP by $15-25 billion and real GNP by $8-14 billion in 1958 dollars. Growth in real GNP would be reduced by 1 to 2 percent for at least two years.

Under both options, civilian unemployment would be increased by approximately 400,000. This would raise the unemployment rate over 7 percent for all of 1975. Under option (1) the CPI will tend to increase to the extent that the prices of other substitute energy sources are bid up. However, by allowing prices to increase to allocate scarce petroleum under option (2), the CPI would increase initially by 1.2 percent and an additional .5 percent for the remainder of the year. Lower income groups would be affected more adversely because of the greater budget share attributed to the purchase of energy.

Even without this import limitation program, weakness in the U.S. economy has been a cause of concern on the part of other countries. A weaker U.S. economy would hurt foreign economies. This, in turn, could reduce U.S. exports, offsetting some of the balance of payments improvement expected from reduced oil imports.

Consumption

The import limitation program will probably have impacts like those that occurred last winter. With gas prices not rising under option (1), there would be long lines at gasoline service stations. Uncertainty on the part of consumers about the availability of gasoline would probably cause a reduction in demand, especially for large cars. The common expectation for new car demand next year is a sales rate of 10 million domestic and foreign units. Reduced petroleum imports under either option might lower this by 3/4 million units and perhaps as much as 1 million. The industry is in a better position to produce small cars then it was last winter, but it has not been expecting the large car to disappear.

Gasoline consumption, auto accessories, outlays for hotels and motels, vacations, and recreational vehicles will also be adversely affected, as they were last winter. Some substitution of other types of consumer goods will occur especially in the longer run but because we cannot be sure about the extent of the substitution, we are expressing our estimate of the impact in terms of a range. Greater certainty of gasoline availability (under option (2)) would reduce the disruptions experienced by sellers of gasoline and auto manufacturers.

Fixed Investment

As last winter the crude oil import restriction would be felt in the form of reduced purchases of trucks and automobiles by business. The uncertainty caused by the embargo and its consequences seemed to have had a very pronounced impact on business planning, since capital appropriations of manufacturers fell sharply in the winter months and recovered in the spring. The import limitation program would probably have similar adverse effects on appropriations, especially for the electric utilities, who are already hard pressed. Some offset would occur in investment by domestic energy industries but this might be somewhat delayed. This disruption would probably be greater under the allocation scheme (option (1)).

IMPORT DISINCENTIVES PROGRAM

Discussion:

This program is designed to reduce imports with the least disruptive impact on the domestic petroleum distribution system and provides for direct pressure to be placed upon the OPEC cartel.

The program would set a ceiling price on oil imported from OPEC.

A ceiling would also be placed on domestic crude prices at below current free market levels but near the landed cost of imported OPEC oil prices and thus eliminate many of the present competitive disparities among domestic refiners caused by the present two-tier system.

The program will reduce the dollar out flow by: (1) restricting revenues paid for OPEC imports, and (2) decreasing domestic consumption through price responsiveness. It will also remove domestic old oil supply disincentives caused by the present two-tier crude oil pricing system.

Pros:

- Allows U. S. to avoid complicated price equalization schemes such as entitlement systems.
- Places pressure on retailer margins.
- Will tend to equalize nationwide product prices ending two-tier price system.
- Might make it possible to eliminate product allocations.
- Forces price pressure on imported crude oil prices from OPEC producers.
- Rewards domestic producers, penalizes OPEC producers.
- Stimulates domestic supply.
- Forces conservation.
- Removes disincentives to new refinery construction.
- Limits major oil company profits on OPEC production.
- Decreases dollar out-flows.
- Spurs exploration and production in non-OPEC countries.

-Encourages domestic recovery procedures.

-Can be phased into existing allocation and price control program.

-Can be established and dismantled quickly.

-Will have immediate effects.

-Consistent with Project Independence goals.

-Will visibly demonstrate U. S. intentions to break OPEC cartel.

Cons: -May create shortages of oil and exacerbate problems with the economy.

-Escalates brinksmanship with OPEC.

-If plan fails, may institutionalize high crude prices.

-Establishes higher prices from non-cartel countries.

TREASURY

Tariff Increases

An import fee increase (tariff) could be instituted on all crude and products, including residual fuel oil. (Monetary and fiscal policy is utilized as needed to prevent this removal of funds from putting the economy into a recession.)

Pros

1. Can be instituted by modification of the current import proclamation without the delay of going to Congress.

2. By raising prices the cut in consumption is achieved without allocations, rationing, or gas lines. (e.g. tariff of $5 reduces consumption by 400,000 barrels per day in the first year and 800,000 by the third year; however, purchasing power would decline by $10 billion. Federal receipts would increase by the same amount.)

3. Deflationary because of the purchasing power removed from the economy.

4. Does not concentrate all cutbacks in consumption on the gasoline sector.

Cons

1. Raises fuel prices, which in the short run is perceived as inflationary (in the long run is counterbalanced by the tax increase aspect).

2. If residual oil is included, has an adverse effect on the Northeast and Florida (residual could be excluded at the cost of inefficiency in refining).

3. Would be subject to pressures for exemptions.

4. Would raise domestic crude prices unless such increases are prevented by price controls (controls on stripper crude would require legislation).

5. With price controls, some type of entitlement scheme is needed to distribute the cheap price controlled crude.

Office of Management and Budget

THE WHITE HOUSE

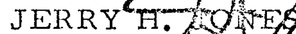
WASHINGTON

October 5, 1974

ADMINISTRATIVELY CONFIDENTIAL

MEMORANDUM FOR: L. WILLIAM SEIDMAN

FROM: JERRY H. JONES



The attached was returned in the President's outbox and is forwarded for your information.

cc: Don Rumsfeld