Research Department
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Business & Financial Letter

Energy: Towards a Solution?

The House last week joined the Senate in voting to create a new Department of Energy, and in addition, committees in both houses began to analyze the Administration's plans for giving the new department something to administer. The Administration's plans involve the momentous decision to continue price controls indefinitely on domestic supplies of oil and natural gas—the two fuels which provide three-fourths of the nation's energy. Not surprisingly, domestic producers of those fuels are unhappy about the proposed legislation.

Administration policy makers recognize the need to permit domestic prices to rise to world levels as a means of curbing consumption of increasingly scarce fuels. They also recognize the need for such a step as a means of eliminating the complex entitlements program. That program in effect subsidizes foreign imports by requiring refiners with access to lower-cost domestic crude to pay refiners using higher-cost imported oil an amount sufficient to equalize the effective acquisition cost of oil available from all sources.

In the case of production from existing wells, the new program would equalize domestic and world oil prices not by removing controls, however, but by adding a tax at the wellhead. This approach would raise the effective cost of domestic oil to refiners and ultimate consumers, but would prevent producers from realizing any additional revenues from proven supplies. In the case of production from new wells, prices could rise to near-parity with world prices over a three-year period, but the volumes affected would probably be small, because new wells would have to meet strict geographical and depth requirements to qualify for the higher price.

Industry spokesmen claim that the Administration's plan fails to provide the financial incentives and regulatory climate necessary to stimulate increased domestic production. In addition to the complex oil-pricing formulas, the plan proposes the extension of price controls to intrastate natural-gas markets—interstate markets are already controlled—while another piece of legislation introduces stricter environmental controls on coal mining. More basically, producers claim that these steps would increase government intervention in the distribution and pricing of energy, rather than permit the more efficient allocation of resources through uncontrolled markets.

Limiting consumption

The Administration, in contrast, makes conservation the cornerstone of its energy program. The plan seeks to reduce the growth of U.S. energy consumption from the

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3½-percent annual growth rate of the 1950-73 period to less than 2 percent by the mid-1980's, primarily by lowering the demand for petroleum and natural gas. (Consumption increased 5 percent last year, but it actually declined over the recession-affected 1973-76 period as a whole.) The plan also seeks to reduce oil imports to 7 million barrels/day by 1985, in contrast to the current level of 9 million b/d and the projected 1985 figure of 11½ million b/d that would be achieved without restrictions.

Gasoline consumption is a prime target of these proposed conservation efforts. The combination of a tax on "gas guzzlers" and a rebate on high-mileage cars would discourage purchases of fuel-inefficient autos, and in addition, there would be a gasoline tax increasing by 5 cents/gallon for every year that the nation fails to meet annual consumption targets beginning with 1979. Through these measures, gasoline consumption presumably would be reduced 10 percent below current levels by 1985.

Further conservation efforts would include tax credits for homeowners and business firms that invest in insulation for their buildings, the termination of promotional electric-utility rates that decline with increased volume, and the imposition of mandatory efficiency standards for household appliances. To encourage a switchover to coal, the plan calls for a sliding-scale tax on large industrial users of oil and gas starting in 1979, and a similar tax on utilities starting in 1983.

Limiting production?

Production incentives get less emphasis in the Administration's plan, which calls for the indefinite continuation of price controls on domestic oil supplies. Price ceilings for oil from previously discovered properties would be permitted to rise by no more than the annual inflation rate, so that "real" prices would remain constant. (Given recent inflation trends, this provision would permit less of a rise over the next three years than under present controls.) By 1980, further adjustments would be made, through periodic equalization taxes, to bring the present multi-tiered prices into line with the average 1977 foreign oil price adjusted for U.S. inflation. The actual 1980 relationship of U.S. crude prices to foreign prices would depend on whether foreign prices had risen faster than the U.S. inflation rate.

The price of "new" oil—now redefined to include only oil discovered after April 20, 1977—would also be permitted to rise over the next three years to the 1977 world price level (adjusted for inflation). But to qualify for that higher price, oil from onshore wells would have to come from properties at least 2½ miles from existing wells (or from deep-drilled wells within that radius), and oil from offshore wells would have to come from tracts leased after April 20, 1977. The industry claims, however, that those restrictions would exclude the vast bulk of the properties either drilled or leased within recent months.

Regulations governing the pricing of natural gas would be even more complex, involving the concept of oil-equivalent pricing. The plan would eliminate the interstate-intrastate distinction for "new" gas, making both subject to a price limitation—determined as the equivalent, on a BTU basis, of the average refiner acquisition cost of all domestic oil. That price ceiling would be approximately $1.75/thousand cubic feet at the beginning of 1978. Under current policy, new gas for sale to intrastate pipelines is free from controls and now sells for about $2.25/thousand cubic feet. Gas from existing wells would remain at current prices until the expiration of existing contracts, at which time gas for sale to intrastate pipelines would be subject to the same $1.75 ceiling as for new gas, while interstate gas would qualify for a price no higher than the current ceiling price of $1.45/thousand cubic feet (adjusted for inflation).

Pricing and production

This pricing approach seems to assume that oil and gas supplies would be unresponsive to higher prices—a somewhat doubtful assumption over the long run. For example, Federal Energy Administration projections suggest that U.S. crude oil production could rise from 10.0 million b/d in 1975 to 14.9 million b/d in 1985 at an average domestic price of $13 a barrel (constant 1975 dollars), in contrast to the constant level of production which would be maintained at the present average price of $8 per barrel. Similarly, in the case of natural gas, production would rise from 19.5 to 22.3 trillion cubic feet over the 1975-85 period, if prices were deregulated and permitted to rise to $2.03/thousand cubic feet (constant 1975 prices), while production would drop to 17.9 trillion cubic feet by 1985 if current price controls were to continue.

Other problems would rise from the need to stimulate the production of coal and other energy sources, especially in view of the fact that consumption would continue to grow even under the Administration's conservationist program. The plan calls for domestic coal production practically to double over the 1976-85 period, thereby rising from 21 percent to 31 percent of an expanding national energy market—and for nuclear energy to increase its share from 3 percent to 8 percent of total consumption. The obstacles to this approach include the strict environmental limitations on coal production in both Eastern and Western mining states, as well as the increased safety requirements for the construction of light-water nuclear reactors and the indefinite postponement of the fast-breeder reactor project. In this situation, new Congressional pressures might arise to stimulate domestic energy production rather than simply curtail consumption, perhaps through increased reliance on the price mechanism.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 5/25/77	Change from 5/18/77	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	95,960	- 267	+ 8,738	+ 10.02
Loans (gross, adjusted)—total	74,323	- 19	+ 8,329	+ 12.62
Security loans	2,174	+ 212	+ 1,004	+ 85.81
Commercial and industrial	23,802	- 79	+ 1,606	+ 7.24
Real estate	22,986	+ 51	+ 2,933	+ 14.63
Consumer instalment	12,998	+ 61	+ 1,928	+ 17.42
U.S. Treasury securities	8,388	- 134	- 818	- 8.89
Other securities	13,249	- 114	+ 1,227	+ 10.21
Deposits (less cash items)—total*	94,626	+ 383	+ 7,502	+ 8.61
Demand deposits (adjusted)	26,606	+ 337	+ 2,894	+ 12.20
U.S. Government deposits	334	- 88	- 125	- 27.23
Time deposits—total*	66,079	+ 298	+ 4,502	+ 7.31
States and political subdivisions	5,887	+ 31	- 768	- 11.54
Savings deposits	31,851	- 85	+ 5,730	+ 21.94
Other time deposits‡	26,573	+ 387	- 99	- 0.37
Large negotiable CD's	9,648	+ 326	- 1,754	- 15.38

Weekly Averages of Daily Figures	Week ended 5/25/77	Week ended 5/18/77	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (-)	+ 41	- 27	+ 55
Borrowings	18	4	1
Net free(+)/Net borrowed (-)	+ 23	- 31	+ 54
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales (-)	- 197	+ 117	- 271
Transactions with U.S. security dealers			
Net loans (+)/Net borrowings (-)	- 143	+ 216	+ 42

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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