THIRD WAY

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Energy Price Inflation at Our Doorstep

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Takeaways

Inflation is bad news for consumers, no matter how or where it strikes. But in the U.S., rising energy costs get bigger headlines than the wider consumer price index. The price of petroleum products like gasoline often becomes politically salient in the U.S. This year is no exception.

But despite the finger-pointing, partisan spin, and frantic headlines we're likely to see in the coming weeks and months, this year's oil story is mostly a rerun. Oil still has a boom-bust cycle that makes it vulnerable to exporter manipulations, and the COVID-19 pandemic put the cycle on steroids.

What happened?

When coronavirus initially spread throughout China, the economy came to a screeching halt and demand for energy in the country collapsed. As COVID-19 swiftly spread across the world, it resulted in a sharp contraction in global energy demand as national economies struggled with sudden lockdown measures. Oil prices, $57 per barrel in January 2020, plummeted to $16 by April. In the U.S., gasoline prices fell 26%, with prices at the pump falling from $2.64 to under $2 per gallon.

Oil and gas suppliers, faced with customer vapor and cash flow problems, began to shut down and reduce their exposure to a vastly oversupplied market. According to the U.S. Energy Information Administration, oil supply exceeded demand by 6 million barrels per day in the first quarter of 2020. By April, that surplus was enormous, forcing all the players to respond to market dynamics and cut supply dramatically.

As a result, US oil and natural gas producers drastically cut back rig operations. In January 2020, there were nearly 700 domestic operating rigs. By September, the oil rig count had collapsed by 75%, leaving just under 200 rigs in operation. Gas rigs also faltered, with rig counts falling by over 40%.

As Americans fume over energy costs, some pundits point blame at policies to fight climate change and support clean energy, claiming this is what’s holding back a rapid revival of domestic oil and natural gas production. To be fair, the global transition to clean energy does create risk for fossil fuel industries, especially if they fail to address their pollution. But in reality, that’s not the force behind the current disruption in oil and gas markets. Global climate policies have not substantially removed oil demand yet, nor are they likely to do so next year, and therefore transition risk still remains hypothetical.

The current underinvestment in oil and gas production comes down to pure economics. Investors and banks are worried about financing a full-on resumption of rig operations, given financial losses that have mounted since 2015. Uncertainty about the market dynamics is substantial and remains a barrier to pre-COVID levels of investment. In the September 2021 issue of the Federal Reserve Bank of Dallas Energy Survey, company respondents cited a host of issues preventing oil and gas sector growth, from lack of skilled labor to restricted access to credit.

With investment in new oil and gas not pouring in rapidly, OPEC (The Organization of the Petroleum Exporting Countries) and its partners saw an opening to keep production levels relatively tight, despite U.S. pressure, to garner geopolitical leverage and higher revenue, resulting in today’s $80 dollar price. Thankfully, prices have been range-bound above $75 per barrel in recent days on the prospects of more releases from government stockpiles, but looking ahead, the view may not be as rosy.

What can be done?

Energy markets are global, and that constrains US options to ease surging prices. Still, some near-term measures can alleviate some of the pressures as temperatures drop. In the face of market tightness, policymakers should consider taking the following potential steps to ease the burden of higher energy costs on American households.

1. **Discourage U.S. exports of gasoline and heating oil on an emergency basis.** The Biden Administration should consider using temporary (emergency) national security mechanisms to discourage US exports of gasoline and heating oil if major consuming regions are experiencing notable shortfalls. Exporting gasoline from California, for example, has increased local gasoline prices way above the national average in recent years. For context, the US currently exports about 10% of the motor gasoline supplied to the market (August data here).

2. **Waive the Jones Act temporarily.** The Jones Act requires that maritime deliveries between US locations must be carried on US vessels. It can be difficult and expensive to find Jones Act-compliant vessels that can move product from one part of the country to another, like the Gulf Coast to the Northeast or to California. The Biden Administration could consider waiving the Jones Act temporarily to facilitate efficient movements by sea to high demand regions suffering from high prices.

3. **Accelerate the release of oil from the Strategic Petroleum Reserve (SPR).** Currently the SPR holds over 600 million barrels of oil at four Department of Energy (DOE) sites. In August 2021, DOE announced intentions to sell 20 million barrels to comply with a 2015 law stipulating that 58 million barrels must be sold by 2025. **On Tuesday, November 23, 2021, the Biden Administration announced the release of 50 million barrels of oil from the SPR and is actively coordinating this release with other countries, including China, India, Japan, South Korea, and the United Kingdom.** This effort should be exploited to the fullest extent as Americans continue to be burdened by rising energy costs and increasing inflation. The Administration could accelerate these sales to sell a higher volume now and a lower volume in 2024 and 2025. This would have two benefits. First, it would provide additional relief to the market. The US treasury would then benefit from selling the oil now, while the price is high, instead of waiting several years when prices will most likely be lower (per the boom-bust cycle). China is already selling from its strategic storage and other countries might follow suit. That could be enough to scare speculators out of the futures markets and calm down any bubble effect.

4. **Expand funding for the Low-Income Household Energy Assistance Program (LIHEAP)**. The White House issued a statement on November 18, 2021 which urges widespread efforts to address home heating bills. This includes spending the $4.5 billion of funds in the American Rescue Plan. The Biden Administration is taking important steps to offer guidance and technical assistance to state and local governments to help them get money out the door. They are coordinating with utility companies to be proactive in identifying households in need. Looking ahead, more can be done. **Congress should consider allocating more money to LIHEAP in the year-end funding bills (or continuing resolutions). It is critical that no one is left without heat during what could be the one of the coldest winters on record.**

5. **Make quick use of the DOE's Weatherization Assistance Program.** Investments through this program, which just received an additional $3.5 billion in the bipartisan infrastructure bill, would alleviate some of the heating and cooling costs of low-income households, not just for this year but on a sustained basis. Energy efficiency remains one of the best ways to combat higher energy costs. Aside from creating more affordable housing options, this program grows local jobs as workers are hired to implement household improvements.

Americans have encountered a variety of challenges since the beginning of the COVID-19 pandemic. Moving quickly to alleviate soaring energy costs will make a meaningful difference to ease the economic burden on everyday Americans.

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