THE EFFECT OF THE JUNE 26 OPEC PRICE INCREASE ON THE DECONTROL OF DOMESTIC CRUDE OIL

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The Effect of the June 26 OPEC Price Increase on the Decontrol of Domestic Crude Oil

On May 23, 1979, the Congressional Budget Office (CBO) released a study on domestic oil decontrol and windfall profits taxes, entitled The Decontrol of Domestic Crude Oil: An Overview. This paper updates the estimates made in that original report, so that they reflect higher OPEC oil prices. The original report, however, should be read for a complete explanation of assumptions and methodologies. The higher OPEC prices will substantially increase the various impacts of decontrol. Decontrol under higher OPEC prices will further decrease consumption in the United States and stimulate additional domestic production. In addition, the OPEC price increases will add to inflation and result in larger producer revenues and, if a tax is enacted, higher windfall tax revenues.

Great uncertainty does exist, however, about the oil price that will prevail on world markets in the coming months. Consequently, CBO has made several alternative price assumptions. One, the base case, represents CBO's current estimate of the price of oil that appears likely in the near future. The others represent higher and lower possibilities favored by individual OPEC members at the June meeting.

Price Assumptions

In December 1978, members of OPEC decided on four quarterly price increases that would raise the price of the Saudi "marker barrel" from $12.70 to $14.54. 1/ In the first quarter of 1979, however, the supply of Iranian oil was halted, and the world oil supply tightened considerably. On March 26, OPEC announced its decision to implement all of the remaining three quarterly increases in the second quarter, and to allow individual producers to add surcharges to their prices on an individual basis.

During the week of June 26, a meeting of OPEC ministers agreed to a new set of oil prices. After failing to establish a single price, it was agreed

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1/ The marker barrel is the barrel that provides a reference price for all other types of oil. The marker barrel has a specific gravity of 33.4° API, and a sulphur content of 1.8 percent. The prices of oil with different weights or sulphur contents will be determined in relation to the marker barrel.

that OPEC members would sell oil at a price between $18.00 and $23.50 in the Persian Gulf, allowing the market to determine the final price. Saudi Arabia, the largest source of U.S. imports, has expressed its intentions to sell at the floor price of $18.00. Other important suppliers to the United States, such as Nigeria and Libya, will attempt to sell at the ceiling price. In addition, between 5 and 20 percent of our current imports are purchased on the spot market at prices which are considerably higher than the OPEC ceiling. Thus, the average price of oil imports to the United States will depend on the actual behavior of producers and market conditions.

In assessing the economic impact of crude oil decontrol, CBO has based its analysis on the following three price assumptions which fall within the range defined by the latest OPEC price meeting.

- Base Case: In this case, a marker barrel price of $20.12 in the Persian Gulf is assumed. This was the level that the price of high-quality oils was based on before the June 26 meeting. Unless new supplies come from Saudi Arabia or, conversely, new limitations are placed on supplies, a price around $20.12 is likely. This price is assumed to increase by 1.5 percent in real terms each year.

- Low Case: In this case, a marker barrel price of $18.47 in the Persian Gulf is assumed. This was the de facto marker barrel price until the June 26 meeting. This price could result if Saudi output were to be expanded substantially and world economic growth slowed considerably. 2/ This price is held constant in real terms.

- High Case: In this case, a marker barrel price of $23.50 in the Persian Gulf is assumed. This case would result if a new disruption in supply were to occur in the near future, or if the demand for oil continues to be strong despite rising prices and slow economic growth. This price is assumed to rise by 3 percent in real terms annually.

The various impacts of domestic oil decontrol and a windfall profits tax are summarized below. All the estimates are relative to an indefinite continuation of the present controls under the Energy Policy and Conservation Act of 1975. This is consistent with the assumption in CBO's original

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2/ In 1977, the Saudis refused to go along with a 10 percent OPEC price increase and increased production to enforce a lower market price. Thus, there is a precedent for this scenario.

report on the decontrol of domestic oil prices. All estimates are in current dollars, and the tax estimates are based on the President's initial proposal. 3/

The Base Case

Should the oil price of $20.12 prevail on world markets, decontrol of prices would have the following effects in the United States.

Import Reductions. Under this case, decontrol would lead to a reduction in oil imports of about 1,230,000 barrels per day in 1985. Of this total, about 600,000 barrels per day would be realized through reductions in demand, and about 630,000 barrels per day through increased domestic supplies. Of these 630,000 barrels, 340,000 result directly from the decontrol of lower- and upper-tier oil. The remainder result from new incentives given to tertiary recovery and new discoveries.

Producer Revenues. Under this case, producer revenues (not including revenues on new production) would rise from $7.6 billion in 1980 to $28.3 billion in 1985, for a total of $135.4 billion between 1979 and 1985. Estimates of the additional producer revenues by year are shown in Table 1.

Windfall Taxes. Under the windfall tax proposals made by the President, $71.8 billion in liabilities would be incurred on this $135.4 billion producer revenue. Of this total liability, $20.6 billion would be a new tax liability on stripper oil and new discoveries; this is attributable to that part of the proposal which would tax future real OPEC price increases. Total revenues would rise from $4.6 billion in 1980 to $15.3 billion in 1985. Estimates of annual windfall tax liability for all price cases are found in Table 2. These totals do not include tax liabilities that would be generated from the corporate income tax, which would add about $15 billion between now and 1985.

Macroeconomic Impact. When compared with an indefinite continuation of controls, decontrol will add about 1.0 to 1.2 percent to the price level by 1985 with most of the impact occurring by the end of 1981. Decontrol will add about 0.1 percentage point in 1979, 0.4 percentage point

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3/ At the Tokyo economic summit, President Carter committed the United States to holding oil imports to 8.5 million barrels per day through 1985. That commitment was not incorporated into this analysis. Rather, 1985 imports were derived from the projected rate of growth in the demand for oil and domestic supply projections.

TABLE 1. ADDITIONAL PRODUCER REVENUES RESULTING FROM THE DECONTROL OF LOWER- AND UPPER-TIER OIL UNDER ALTERNATIVE PRICE CASES: IN MILLIONS OF CURRENT DOLLARS

Calendar Year	Base Case	Low Case	High Case
1979	883	883	883
1980	7,641	5,890	11,072
1981	19,286	14,289	28,784
1982	25,235	18,257	37,854
1983	26,360	18,186	40,735
1984	27,640	18,203	43,934
1985	28,328	17,712	46,425
TOTAL	135,373	93,420	209,687

TABLE 2. PRODUCER TAX LIABILITIES RESULTING FROM THE PRESIDENT'S WINDFALL TAX PROPOSALS, UNDER ALTERNATIVE PRICE CASES: IN MILLIONS OF CURRENT DOLLARS

Calendar Year	Base Case	Low Case	High Case
1980	4,649	3,369	7,072
1981	10,330	7,568	15,419
1982	13,406	9,516	20,410
1983	13,584	9,083	21,498
1984	14,483	9,297	23,440
1985	15,298	9,426	25,309
TOTAL	71,750	48,259	113,148

in 1980, and 0.5 percentage point in 1981. Additions to the price level in the years after 1981 should add no more than 0.1 or 0.2 percentage point. The price of refined petroleum products in 1985 should be about 10 cents per gallon higher than without decontrol. Annual growth in real GNP may be slowed from 0.0 to 0.2 percentage point by 1981, and from 0.2 to 0.4 percentage point from 1982 to 1984. The unemployment rate would be higher by 0.1 percentage point by 1981 and by 0.1 to 0.3 percentage point by 1984. 4/

The Low Case

Should the price of $18.47 per barrel prevail on world markets, price decontrol would result in the following additional producer revenues and windfall tax revenues.

Producer Revenues. Under this "low" case, producer revenues, excluding revenues from new supply, would rise from $5.9 billion in 1980, to $17.7 billion in 1985, for a total of $93.4 billion for the 1979-1985 period.

Windfall Taxes. Under the windfall tax proposals made by the President, $48.3 billion in liabilities would be incurred on this $93.4 billion transfer between 1979 and 1985. Of this total liability, $12.2 billion represents a new tax liability on stripper oil and new discoveries; this is attributable to the President's proposal to tax future real oil price increases. The total tax revenues would rise from $3.4 billion in 1980 to $9.4 billion in 1985. These totals do not include tax liabilities that would be generated from the corporate income tax, which would add about $10 billion over this period.

The High Case

Should the price of $23.50 per barrel prevail on world oil markets, decontrol would result in the following additional producer revenues and windfall tax revenues.

4/ These estimates assume that there is no significant lag in the recycling of most of these funds. Given the size of the pretax revenues ($135.4 billion), the task of recycling these funds without considerable lag will be difficult, and this larger size increases the possibility of underestimating the dampening effect of decontrol on economic activity.

Producer Revenues. Under this "high" case, producer revenues, excluding revenues from new supply, would rise from $11.1 billion in 1980 to $46.4 billion in 1985, for a total of $209.7 billion between 1979 and 1985.

Windfall Taxes. Under the windfall tax proposals made by the President, $113.1 billion in liabilities would be incurred on this $209.7 billion revenue over the 1979-1985 period. Of this total liability, $35.3 billion represents a new tax liability on stripper oil and new discoveries; this is attributable to the President's proposal to tax future real oil price increases. Total tax revenues would rise from $7.1 billion in 1980 to $25.3 billion in 1985. This does not include any tax liability from the corporate income tax, which would add about $27 billion over this period.

A Modified Extension of the Energy Policy and Conservation Act (EPCA)

An alternative to the President's decontrol plan is a modified continuation of the EPCA price controls. Under this option, lower- and upper-tier oil continue to be controlled at the present prices, but marginal lower-tier oil is allowed the upper-tier price. New discoveries and all tertiary oil would be decontrolled.

Relative to full decontrol, this alternative creates very little additional inflation and transfers little income from consumers to producers. On the other hand, however, the demand reductions and supply responses are less than those estimated for decontrol. Relative to a full continuation of EPCA controls, this option would stimulate an additional 225,000 barrels per day of new supply, but reduce demand by less than 50,000 barrels per day. Thus, total imports would be reduced by about 275,000 barrels per day in 1985. The producer windfall over the 1979-1985 period would be approximately $11.2 billion.