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COMMITTEE ON THE BUDGET
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Mr. Chairman:

I am happy to be with you today to comment on President Carter's energy proposals. In response to requests from committees in both houses of Congress the Congressional Budget Office examined the Administration's proposals and issued a staff woking paper earlier this month. We have also appeared before several committees of the Congress to discuss our results and answer questions. In may remarks today I will not attempt to present a comprehensive review of our findings. Rather, I will highlight several points that I believe merit further discussion: 1) the need for an energy plan, 2) some economic and budgetary implications of the President's proposals, and 3) some recent issues on oil and natural gas pricing. However, I would be happy to answer any questions you may have concerning the full CBO report.

The Need for an Energy Plan

A major problem with which the President's proposals must contend is that many Americans simply do not believe that we have a serious energy problem. Just a few weeks ago the Gallup poll reported that only half the public knows that we import oil to satisfy our demands. The natural gas curtailments of this past winter -- along with the associated payoffs and production cutbacks -- have faded from memory. And the gasoline lines and the prohibitions against Sunday driving which we all found so nerve rattling just three years ago are now matters of ancient history. Yet, in our view, the case for some new energy initiatives at this time is compelling. Our energy problem is both immediate and long-term.

The long-run problem is simply that the growth in oil and gas consumption exceeds the growth in proven reserves -- both domestic and foreign. At some time in the not too distant future -- and no one knows exactly when -- we will have to shift to new energy sources or face drastic changes in our standard of living.

The more immediate problem, is that our imports of oil have increased substantially -- from 3.5 to 7.3 million barrels per day between 1970 and 1977. The fact that almost one-half of the oil consumed in the United States is now imported creates national security risks and makes our economy highly vulnerable to outside shocks, especially because the supply and price of oil is largely dictated by an international cartel.

A major reason for the substantial increase in our import dependence is the current system of price controls on oil and gas that have kept the domestic price of these fuels artificially below world levels. Over the past four years, this regulatory system has served to cushion Americans from the dramatic adjustments in consumption and lifestyles that might otherwise have taken place due to the abrupt quadrupling of world oil prices by the OPEC cartel in 1973-1974. However, this approach of "buying high" on world markets and "selling low" at home has also tended to encourage energy consumption and discourage the search for and production of new domestic resources -- thereby further increasing our dependence on potentially unreliable foreign suppliers.

Economic and Budgeting Issues

Having decided to move away from artificially low energy prices and to try to avoid the economic disruption that surely awaits us should we continue our present policies, the question is how to design an appropriate transition strategy. Unfortunately, it's a little like the fellow who responded to the out-of-towner's request for directions that "you can't get there from here." There are no simple answers. Most policy options involve gains for some and losses for others. However, most policy analysts do agree that the macroeconomic impacts of the President's proposals are, in fact, quite small.

The Administration has claimed that between now and 1980 its plan would have virtually no impact on the growth rate of real GNP and only a small impact -- about one half percent per year -- on the rate of inflation. The CBO estimates that growth in real GNP will be curtailed by about .2 percent per year -- but we are in virtual agreement with the Administration's estimate that the inflation rate will be boosted by about one-half of one percent per year between now and 1980 as a result of the President's energy propsoals.

To understand why these effects are so small, it is helpful to consider what is likely to happen to the nation's fuel bill with and without the energy proposals. In 1976, total U.S. expenditures on fossil fuels (including imports, but before domestic transportation, refining, or other process) amounted to about $90 billion or just over 5 percent of total GNP. A 10 percent increase in fuel prices

passed through almost entirely to final product prices would therefore cause roughly a 0.5 percent increase (5 percent of 10 percent) in the overall price level.

This direct pass through is not the end of the story, of course. On the one hand, reduced demands for fuel in response to higher prices could diminish the effect on the overall price level; but over a period of only a few years the demand reponse to fuel prices appears to be small enough so that this factor can safely be neglected in rough calculations. On the other hand, higher wage settlements in response to the higher prices and additional price increases based on these wage settlements could amplify the initial pass through; and past experience suggests that this amplification would be of some importance.

Regarding the impact of the President's proposals on the federal budget, the CBO analysis indicates that the net impact of the proposals on the deficit or surplus would be relatively small. The principal reason for this is that while there are more than 100 specific legislative initiatives in the proposal, many of them directly affect activities of the private sector and do not even enter the federal budget, e.g. mandatory appliance standards. And many of the proposals that do affect federal expenditures or tax collections are designed to have only a small fiscal impact, e.g., the crude equalization tax. By 1985, CBO estimates that revenues from new taxes are expected to exceed direct expenditures associated

with the President's program by about one and one-half billion dollars. In 1980 outlays are expected to exceed revenues by about $2.5 billion.

While I will not detail further parts of the CBO analysis at this time, I should note that the conclusion of our study is that the strategies proposed by the Administration are generally effective in reducing America's energy use and dependence on oil imports. We have estimated that the Administration's estimates of the energy savings are slightly optimistic -- but enactment of the plan is likely to result in energy savings of at least 3.5 million barrels per day by 1985.

A critical element in the President's proposal is the effort to raise the price of petroleum and natural gas by predictable increments so that consumers and businesses can begin to make decisions on the basis of higher future energy prices. The theme of the plan is that the transition to a less energy-intensive economy is a long and complex process. Incentives established now to alter consumption and investment decisions regarding energy will only begin to yield significant savings within the next few years. Truly large-scale energy savings will not show up until the middle of the next decade or later.

Issues in Oil and Natrual Gas Pricing

One issue which is highly controversial -- and on which the subcommittee's initial vote differed dramatically from the Presi-

dent's propsoal -- concerns the pricing and possible deregulation of new natural gas.

The Administration has proposed to merge interstate and intrastate markets and to place a ceiling on new gas of approximately $1.75 per thousand cubic feet (MCF), adjusted thereafter for increases in other fuel prices. Compared to this approach, deregulation will increase both the level of domestic production and the price paid for natural gas.

Since pipelines typically average new gas prices with those of already flowing gas -- some of which were purchased at prices as low as 20-30 cents per MCF -- competition from other fuels is not expected to serve as a check on higher prices for new natural gas. Thus, under deregulation the price of new gas is expected to rise well above the BTU equivalent, at least for the next few years.

Our analyses indicate that if deregulation were to become effective this year the average price of new gas would increase immediately from its curent level of about $1.85 per MCF to approximately $4.00 per MCF. However, as a result of new gas production, and the possibility of reductions in demand and switches to lower priced fuels, this $4.00 price is unlikely to be maintained for a long period. New gas prices would be expected to drop back to about $2.80 per MCF by 1985. New production resulting from deregulation is expected to be about .9 trillion cubic feet per year by 1985.

On the basis of these estimates we calculate that if natural gas were deregulated, as opposed to being priced in accordance with the schema proposed by the Administration, consumer costs for natural gas would rise by about $80-$85 billion (in 1977 prices) over the period 1977-1985 for the same volume of gas. Since producer costs are not expected to vary significantly as a result of deregulation, it is anticipated that industry profits would also rise by about $80-$85 billion. Similarly, there would be a small additional increase in the overall inflation rate above that indicated earlier. The incremental .9 TCF of annual production by 1985 resulting from deregulation, which is equivalent to about 450,000 barrels per day of crude oil, would most likely reduce oil imports.

A final issue I should like to address concerns the revenues to be received by producers for oil and gas already flowing. in the case of oil, the Administration has proposed that the controlled price of already flowing domestic oil (average about $8.00 per barrel) be raised to the world price (about $13.50) by taxing the domestic oil, and then returning the revenues to the public in the form of per-capita tax rebates. In the case of natural gas, the Administration has proposed, as noted, a ceiling on new gas prices which prevents them from rising above the BTU equivalent of oil. In effect, this cap prevents producers of new natural gas from capturing the benefits of averaging-in low prices on already flowing gas and preserves these benefits for residential and commercial customers.

In both cases the producers have argued that the additional cash flow that could be generated for the industry from those already flowing resources is essential to the development of new fields. Many observers hold this view that cash flow determines investment, but recent econometric evidence generally indicate that cash flow has only a small effect.

The alternative view is that expected profit is the key determinant of new investment. As long as the price of new resources is sufficiently high to promise a high profit as incentive, the argument goes, producers will find a way to finance it. It may require breaking the long standing internal financing tradition of the oil industry, for example, but the financing will be found.

Thank you.