

# HOW FEDERAL RESERVE POLICIES ADD TO HARD TIMES AT THE PUMP

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## HEARING

BEFORE THE  
SUBCOMMITTEE ON REGULATORY AFFAIRS,  
STIMULUS OVERSIGHT AND GOVERNMENT  
SPENDING

OF THE

COMMITTEE ON OVERSIGHT  
AND GOVERNMENT REFORM  
HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

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## HOW FEDERAL RESERVE POLICIES ADD TO HARD TIMES AT THE PUMP

WEDNESDAY, MAY 25, 2011

HOUSE OF REPRESENTATIVES,  
SUBCOMMITTEE ON REGULATORY AFFAIRS, STIMULUS  
OVERSIGHT AND GOVERNMENT SPENDING,  
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,  
*Washington, DC.*

The subcommittee met, pursuant to notice, at 3:11 p.m., in room 2247, Rayburn House Office Building, Hon. Jim Jordan (chairman of the subcommittee) presiding.

Present: Representatives Jordan and Kucinich.

Staff present: Ali Ahmad, deputy press secretary; Joseph A. Brazauskas, counsel; Benjamin Stroud Cole, policy advisor and investigative analyst; Gwen D'Luzansky, assistant clerk; Tyler Grimm, professional staff member; Peter Haller and Kristina M. Moore, senior counsels; Christopher Hixon, deputy chief counsel, oversight; Justin LoFranco, press assistant; Jaron Bourke, minority director of administration; Claire Coleman, minority counsel; Ashley Etienne, minority director of communications; Jennifer Hoffman, minority press secretary; and Carla Hultberg, minority chief clerk.

Mr. JORDAN. The subcommittee will come to order.

And let me first apologize to our witnesses. We just can't control the schedule, and we had, as you know, a number of votes on the floor. I particularly want to apologize to Mr. Wannemacher from the great Fourth District of Ohio for having to wait. Making constituents have to wait, that is even more of a problem.

So we will get organized and start. We will do our quick opening statements and get right to your testimony. And the schedule is, now that we are postponed, we may have many Members who are unable to be with us today. Hopefully some will be able to join us. But we want to thank you all for being here for this hearing on such an important topic.

Today's hearing of the Regulatory Affairs Subcommittee concerns two issues: how higher prices at the pump are hurting real people in their day-to-day lives and how a decline in the strength of the dollar, among many other factors, has had a significant role in adding to the price at the pump.

In Ohio, the unemployment rate is still at 8.4 percent, and the average gas price hit an all-time high of \$4.16 earlier this month. This has put unbelievable strain on families' budgets and forced painful sacrifices.

For the millions of Americans without jobs, rising gas prices has compounded their already-tight financial situations. Just this week, in a story in the Chicago Tribune, they reported that higher gas prices have restricted the unemployed from looking for work beyond their immediate communities, which has, of course, limited their options.

The trucking industry, which we have represented here today, has experienced the full blow of these price spikes. The average national cost of diesel fuel is \$3.99 per gallon, and trucking companies are now being forced to implement a surcharge and higher rates to offset their cost increases.

And while some industries have been hit harder than others, the effects ripple throughout our economy and are being felt by grocery stores, pharmacies, and in every other place that Americans spend their money.

We are familiar with some of the factors driving up the price of oil, including fear of supply disruptions because of the turmoil in the Middle East and increased demand from developing nations. But one major factor often overlooked in the policy discussions is how the weakening of the dollar has caused the price of oil to rise, and, I would argue, frankly, the price of many commodities.

Under Chairman Ben Bernanke, the Federal Reserve undertook an aggressive and unprecedented effort known as quantitative easing, while keeping interest rates at or below zero. Between December 2008 and March 2009, the Fed purchased \$1.7 trillion of Treasuries and mortgage-backed securities. The goal of this first round of quantitative easing was to reduce unemployment and ensure, "price stability." Yet, the results of QE1 proved lackluster.

Nevertheless, the Fed pursued the old definition of insanity: doing the same thing over and over but expecting different results. Late last year, the Fed began purchasing Treasuries at a rate of about \$75 billion a month and a second round of quantitative easing, known in the shorthand as QE2.

Now, at the most basic level, quantitative easing is about printing money. And the most basic result is that the value of the dollar falls, commodity prices increase, and American consumers are hit with higher costs of goods and services they purchase. Unsurprisingly, this is precisely what has occurred. The Joint Economic Committee recently released a study that looked at the strength of the dollar since quantitative easing began and found that 57 cents of the current per-gallon price of gasoline is directly attributable to the dollar's decline.

Today's hearing will attempt to lay bear the consequences of reckless monetary policy and highlight the need for corrective actions to foster a real and sustainable economy recovery.

Since November 2008, the value of the dollar has declined by 14 percent, and it continues to fall. In fact, by the most widely used index of the dollar strength, the dollar is now at its weakest point on record.

And while we may grant what the Federal Reserve vice chairman, Donald Kohn, noted earlier last year, that the Central Bank is in uncharted waters, experience with financial disruptions of the breadth, persistence, and consequences of the past several years, there is no denying that the Fed knew full well that such an under-

taking in the realm of monetary policy could have a weakening effect on the dollar, which would mean an increase in the price of commodities bought and sold internationally.

And, ironically, Chairman Bernanke testified a couple of months ago before the Senate Banking Committee that he knew that rising gas prices could negatively affect American consumers and hinder an economic recovery. He stated, "Sustained rises in the prices of oil or other commodities would represent a threat both to economic growth and to overall price stability."

It is the intent of this hearing to broaden the discussion about the causes and effects of higher gas prices so as to fully understand action the Federal Government can and should take to aid distressed American consumers and American small-business owners.

With that, I yield to the ranking member for an opening statement.

[The prepared statement of Hon. Jim Jordan follows:]

*Chairman Jim Jordan Opening Statement  
Subcommittee on Regulatory Affairs, Stimulus Oversight, and Government Spending  
"How Federal Reserve Policies Add to Hard Times at the Pump"  
May 25, 2011*

Today's hearing of the regulatory affairs subcommittee concerns two issues: how higher prices at the pump are hurting real people in their day to day lives and how a decline in the strength of the dollar, among other factors, has had a significant role in adding to that the price at the pump.

In Ohio, the unemployment is still at 8.4 percent and the average gas price hit an all-time high of \$4.16 earlier this month. This has put unbelievable strain on families' budgets and forced painful sacrifices.

For the millions of Americans without jobs, rising gas prices have compounded their already-tight financial situations. Just this week, the Chicago Tribune reported that higher gas prices have restricted the unemployed from looking for work beyond their immediate communities, which has, of course, limited their options.

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And while some industries have been hit harder than others, the effects ripple throughout our economy and are being felt at grocery stores, pharmacies, and every other place that Americans spend their money.

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factor often overlooked in policy discussions is how the weakening of the dollar has caused the price of oil to rise.

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Nevertheless, the Fed pursued the old definition of insanity: doing the same thing over and over, but expecting different results. Late last year, the Fed began purchasing Treasuries at a rate of about \$75 billion a month in a second round of quantitative easing, known in shorthand as QE2.

Now, at the most basic level quantitative easing is about printing money. And the most basic result is that the value of the dollar falls, commodity prices increase, and American consumers are hit with higher costs of the goods and services they purchase. Unsurprisingly, that is precisely what has occurred.

The Joint Economic Committee recently released a study that looked at the strength of the dollar since quantitative easing began and found that 57 cents of the current per-gallon price of gasoline is directly attributable to the dollar’s decline.

Today’s hearing will attempt to lay bare the consequences of reckless monetary policy and highlight the need for corrective actions to foster a real, sustainable economic recovery.

Since November 2008, the value of the dollar has declined by 14 percent, and it continues to fall. In fact, by the most widely used index of the dollar's strength – the Broad Dollar Index – the dollar is now at its weakest point on record.

And while we may grant what Federal Reserve Vice Chairman Donald Kohn noted early last year that -- the central bank is in "uncharted waters . . . [lacking] experience with financial disruptions of the breadth, persistence, and consequences of . . . the past several years" -- there is no denying that the Fed knew full well that such an undertaking in the realm of monetary policy could have a weakening effect on the dollar, which would mean an increase in the price of commodities bought and sold internationally.

Ironically, Chairman Bernanke testified a couple of months ago before the Senate Banking Committee that he knew that rising gas prices could negatively affect American consumers and hinder an economic recovery. He stated: "Sustained rises in the prices of oil or other commodities would represent a threat both to economic growth and to overall price stability."

It is the intent of this hearing to broaden the discussion about the causes and effects of higher gas prices so as to fully understand actions the federal government can and should take to aid distressed American consumers.

With that, I yield to the Ranking Member for an opening statement.

###

Mr. KUCINICH. Mr. Chairman, I want to thank you for holding this hearing. And when you and I talked, we were both sharing our concerns about the high price of gasoline that is really quite devastating to families in our respective districts. So I think that this hearing will help draw much-needed attention to the plight of American businesses and families as they struggle to deal with the effects of high oil prices.

And this hearing brings to us witnesses who are esteemed, and their presence here is quite appreciated. Thank you.

Congress cannot continue to allow American consumers to bear the brunt of our energy policies, which grant oil companies massive tax deductions in exchange for the privilege of reaping an unimaginable profit from extraction from the earth. Despite the worst economic crisis since the Great Depression, oil companies are charging record-high gasoline prices, and they have continued to make the highest profits of any industry in the world.

Low-income families across this country, including in my own district in Ohio, are especially harmed by high gas prices because they have a crippling effect on the price of food. While gas prices have recently come down a little, they are still too high for many Ohioans and Americans who have seen their incomes stagnate and decline. And I am very concerned that the burden gas prices place on American families and businesses could threaten any economic recovery.

With gas prices sky-high, this hearing can play an important role in helping us understand the cause of oil price volatility. As my friend, Mr. Jordan, notes, we share a, to put it mildly, antipathy toward the Fed. And, at the same time, I am concerned that, on this particular case, that we may risk missing the forest for the trees. Because, in my research, I am still trying to determine what kind of control the Fed has in terms of key drivers of high oil prices.

Now, the oil prices have soared recently, in part because of the rising demand in developing countries such as Brazil, China, and India. While consumption of oil in the United States may be slowing, global demand is at record levels, causing prices to soar. War, unrest in the Middle East countries, the oil-producing countries, has also driven up prices. The Fed doesn't have any control over these price-determinative factors. And it doesn't oversee the derivative market for oil that has really had a lot to do with fueling gas price spikes.

We know the Commodity Futures Trading Commission does have something to do with it. And what has been happening is that speculators have been betting on the future price of oil, and they have contributed to the sharp increases in oil prices. And what they are doing is they are encouraging oil producers to hoard their commodity in the hopes they will be able to sell it later at a higher future price. So it is speculation in the commodity futures, in the oil commodities, that I think is something that is very important to focus on.

The full committee released a report on Monday finding that excessive speculation could be inflating gas prices by as much as 30 percent. So, I mean, do the math. You know, we are paying over \$4 in some regions. That is what the price has been. Yesterday, the

CFTC charged five oil speculators with manipulating the price of crude oil in 2008 and making a \$50 million profit from the scheme.

Mr. Chairman, I would like unanimous consent to enter into the record a New York Times and CNNMoney.com article reporting on the Commodity Futures Trading Commission enforcement actions.

Mr. JORDAN. Yeah, without objection.

[The information referred to follows:]

*Kucinich UC***The New York Times**

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May 24, 2011

## U.S. Suit Sees Manipulation of Oil Trades

By GRAHAM BOWLEY

After oil prices surged past \$100 a barrel in 2008, suspicions that traders had manipulated the market led to Congressional hearings and regulatory investigations. But they produced no solid cases in the record run-up in gasoline prices.

But on Tuesday, federal commodities regulators filed a civil lawsuit against two obscure traders in Australia and California and three American and international firms.

The suit says that in early 2008 they tried to hoard nearly two-thirds of the available supply of a crucial American market for crude oil, then abruptly dumped it and improperly pocketed \$50 million.

The regulators from the Commodity Futures Trading Commission would not say whether the agency was conducting any other investigations into oil speculation. With oil prices climbing again this year, President Obama has asked Attorney General Eric H. Holder Jr. to set up a working group to look into fraud in oil and gas markets and "safeguard against unlawful consumer harm."

In the case filed Tuesday, the defendants — James T. Dyer of Australia, Nicholas J. Wildgoose of Rancho Santa Fe, Calif., and three related companies, Parnon Energy of California, Arcadia Petroleum of Britain and Arcadia Energy, a Swiss company — have told regulators they deny they manipulated the market.

If the United States proves the claims, the defendants may give up \$50 million in profits that were believed to be made as a result of the manipulation and also pay a penalty of up to \$150

million.

The commodities agency says the case involves a complex scheme that relied on the close relationship between physical oil prices and the prices of financial futures, which move in parallel.

In a matter of a few weeks in January 2008, the defendants built up large positions in the oil futures market on exchanges in New York and London, according to the suit, filed in the Federal Court in the Southern District of New York.

At the same time, they bought millions of barrels of physical crude oil at Cushing, Okla., one of the main delivery sites for West Texas Intermediate, the benchmark for American oil, the suit says. They bought the oil even though they had no commercial need for it, giving the market the impression of a shortage, the complaint says.

At one point they had such a dominant position that they owned about 4.6 million barrels of crude oil, estimating that this represented two-thirds of the seven million barrels of excess oil then available at Cushing, according to lawsuits.

This type of oil is also the main driver of prices of the futures contracts, and their actions caused futures prices to rise, the authorities say. "They wanted to lull market participants into believing that supply would remain tight," the agency said. "They knew that as long as the market believed that supply was tight and getting even tighter, there would be upward pressure on the prices of W.T.I. for February delivery relative to March delivery, which was their goal."

The traders in mid-January cashed out their futures position, and then a few days later began to bet on a decline in oil futures, with Mr. Wildgoose remarking in an e-mail about the "inevitable puking" of their position on an unsuspecting market, the federal lawsuit says.

In one day, Jan. 25, they then dumped most of their holdings of West Texas Intermediate oil, and profited by the drop in futures.

The traders repeated the buying and selling in March 2008, and were preparing to do it again in April but stopped when investigators contacted them for information, the suit says.

Between January and April, average gas prices rose roughly to \$3.50 a gallon, from \$3. It was

not until later in 2008, after the defendants had ceased their reported actions, that oil prices soared higher — reaching \$145 that July. By the end of the year, prices had fallen to about \$44. The Texas oil is now around \$100.

Many other factors were at work, including tight oil supplies in the Middle East and fears that a growing global economy would consume more oil. Yet the enforcement action by the commodities regulator was the first credible evidence that a small group of traders also played a role in manipulating prices.

“This will help to satisfy the desire to find a culprit and throw them under the wheels of justice,” said Michael Lynch, an oil market specialist at Strategic Energy and Economic Research, a consulting firm.

Calls to Arcadia Petroleum in London were not immediately returned. A person who answered the phone at Arcadia Energy in Switzerland said that he was unaware of the complaints and that Mr. Dyer and Mr. Wildgoose were on vacation and unavailable for comment.

In the last few years, the commission has settled a handful of cases of manipulation in the natural gas market.

In 2007, it settled charges for \$1 million against the Marathon Petroleum Company for trying to manipulate West Texas Intermediate crude oil in 2003.

The agency brought an action similar to its latest case in 2008, asserting that Optiver Holding, a proprietary trading fund based in the Netherlands with a Chicago affiliate, used a trading program in 2007 to issue orders to manipulate the crude oil market. The case is pending. It involved claims of manipulation of futures contracts for light sweet crude, New York Harbor heating oil and New York Harbor gasoline.

*Clifford Krauss contributed reporting.*

Mr. KUCINICH. Thank you, Mr. Chairman.

And stopping the manipulation of the market for the energy on which we are painfully dependent will have a significant impact on lowering gas prices. We have to ensure that the Commodity Futures Trading Commission has the resources and authority to implement the Dodd-Frank reforms passed last year to curb rampant oil speculation.

Most fundamentally, volatility in oil and gas prices will continue to threaten American prosperity until we change our Nation's energy policy. We have to free ourselves from oil dependence, which has enriched oil companies and left Americans struggling to pay for gas to go to work. It has also left us with an environment that has been spoiled. The path to a sustainable energy future demands that we focus on energy-efficient technologies and renewable energy resources for our energy supply.

I want to thank the chairman and thank the witnesses. I look forward to your testimony. Thank you.

[The prepared statement of Hon. Dennis J. Kucinich follows:]

DARRELLE E. ISSA, CALIFORNIA  
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**Opening Statement**  
**Rep. Dennis J. Kucinich, Ranking Member**  
**Subcommittee on Regulatory Affairs, Stimulus Oversight and Government Spending**  
**Hearing on: "How Federal Reserve Policies Add to Hard Times at the Pump"**

May 25, 2011

Mr. Chairman, thank you for holding this hearing, which should help draw much-needed attention to the plight of American businesses and families as they struggle to deal with the effects of high oil prices. Congress cannot continue to allow American consumers to bare the brunt of our energy policies, which grant oil companies massive tax deductions in exchange for the privilege of reaping un-imaginable profit from the Earth.

Despite the worst economic crisis since the Great Depression, oil companies are charging record high gasoline prices and have continued to make the highest profits of any industry in the world. Low-income families across this country -- including in my district in Ohio -- are especially harmed by high gas prices because they have a crippling effect on the price of food. While gas prices have recently come down a little, they are still high for too many Ohioans and Americans who have seen their incomes stagnate and decline. I am very concerned that the burden gas prices place on American families and businesses could threaten the nascent economic recovery.

With gas prices sky-high, this hearing will play an important role in helping us understand the cause of oil price volatility. But by focusing on Fed policy today we risk missing the forest for the trees. The Fed has no control over the key drivers of high prices today.

Oil prices have soared recently in part because of the rising demand in developing countries such as Brazil, China and India. While consumption of oil in the U.S. may be slowing, global demand is at record levels, causing prices to soar. War and unrest in oil-producing Middle East countries has also driven up prices. The Fed has no control over these price-determinative factors.

The Fed also does not oversee the derivatives market for oil that has fueled gas price spikes: the Commodity Futures Trading Commission (CFTC) does. Speculators betting on the future price of oil have contributed to the spikes -- encouraging oil producers to hoard their commodity in the hopes they'll be able to sell it later on at a higher future price. The Full Committee released a report on Monday finding that excessive speculation could be inflating gas prices by as much as 30%. Stopping the manipulation of the market for the energy on which we

are painfully dependent will have a significant impact on lowering gas prices. We must ensure that the CFTC has the resources and authority to implement the Dodd-Frank reforms passed last year to curb rampant oil speculation.

Most fundamentally, volatility in oil and gas prices will continue to threaten American prosperity until we change our nation's energy policy. We must free ourselves from oil dependence which has enriched oil companies and left Americans struggling to pay for gas to go to work. The path to a sustainable energy future demands that we focus on energy efficient technologies and renewable energy resources for our energy supply.

Mr. JORDAN. I thank the ranking member.

Again, let me welcome our witnesses and apologize. With the change in schedule, we are going to have a lot of Members who are going to be unable to be here who would otherwise have been here at the 1 o'clock hour.

We have Mr. Vincent Reinhart, formerly the director of the Division of Monetary Affairs at the Board of Governors of the Federal Reserve System. He is currently a resident scholar with the American Enterprise Institute.

We have with us Dr. Robert Murphy. He is an economist with the Institute for Energy Research; Dr. Dean Baker is the co-director of the Center for Economic and Policy Research; Mr. Greg Wannemacher is president of Wannemacher Total Logistics; and Ms. Karen Kerrigan is president and CEO of the Small Business and Entrepreneurship Council.

It is the practice of this committee to swear witnesses in, so if you would just stand and raise hand and then just answer in the affirmative.

Do you solemnly swear or affirm that the testimony you are about to give will be the truth, the whole truth, and nothing but the truth? If you do, say, "I do."

All right, thank you.

Let the record show everyone answered in the affirmative.

And we will go right down the list, starting with Mr. Reinhart from AEI.

**STATEMENTS OF VINCENT R. REINHART, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH; ROBERT P. MURPHY, ECONOMIST, INSTITUTE FOR ENERGY RESEARCH; DEAN BAKER, CO-DIRECTOR, CENTER FOR ECONOMIC AND POLICY RESEARCH; GREG WANNEMACHER, PRESIDENT, WANNEMACHER TOTAL LOGISTICS; KAREN KERRIGAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, SMALL BUSINESS AND ENTREPRENEURSHIP COUNCIL**

**STATEMENT OF VINCENT R. REINHART**

Mr. REINHART. Thank you, Chairman Jordan and Ranking Member Kucinich, for the opportunity to discuss monetary policy and the price of oil.

I believe that this is an appropriate use of the subcommittee's time, as both the net rise and the volatility of oil prices over the past 9 months are partly a predictable byproduct of the Fed's expansion of its balance sheet in its policy known as quantitative easing.

QE was essentially designed to give a nudge to risk-taking. Fed officials announced they would purchase riskless Treasury securities on the hope that investors would reinvest the proceeds in riskier assets, such as corporate equities and bonds. But not all the effects of QE has played out in financial markets. Since the Fed firmly signaled in August its intent to launch the latest round of QE, oil prices have risen from \$76 a barrel to around \$100 per barrel.

Why does the Fed matter for oil prices? The producers of oil, as well as other commodities, typically sell their output in a worldwide market priced in U.S. dollars. Thus, they care about the current and expected future purchasing power of the dollar and how that will translate into goods and services back home. But QE has been associated with higher inflation and dollar depreciation, which combines to erode the purchasing power of the foreign producers of commodities. Thus, some of the rise in the nominal price of oil has been to catch up with that erosion.

More important in shaping near-term oil price dynamics has been the nudge to investors from QE to move from safe to riskier investments. The commodity market has been one outlet for that reinvigorated search for yield. This has been reinforced by the Fed's policy of keeping short-term nominal interest rates near zero, which keeps it cheap to trade on borrowed funds. Such speculation can fuel spasms of enthusiasm or angst that trigger wide swings in prices, although, on net and over the longer term, speculators neither consume nor produce oil.

This increase in the price of oil and its heightened volatility poses three distinct problems for the Fed and for the macro economy:

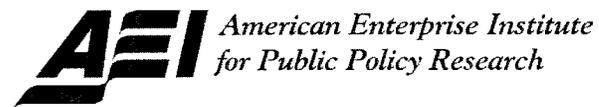
First, a rise in energy costs of one-third takes a distinct bite out of Americans' budgets, working to restrain spending in an economy already burdened by lingering balance-sheet problems from the financial crisis. As of yet, the oil price shock is not as large as those associated with severe macroeconomic dislocations of the past half-century, though.

Second, increases in the price of oil, as well as those of other commodities, have fueled an upsurge in inflation and a depreciation of the dollar on foreign exchange markets. Fed officials continue to believe that people are not likely to expect the prices of other goods and services to rise commensurately. If so, and if commodity prices do not continue to rise, then the level upshift in oil prices will ultimately pass out of inflation calculations.

Third, in recent months, the world seems to be a much less safe place. This makes the near-term balance between oil demand and supply volatile. This could, to the Fed's regret, also make global investors more skittish and undercut some of the benefits in financial markets attributable to QE.

On net, it is likely that the economy-wide effects of the energy shock are unpleasant but not derailing to economic expansion. But this is a gamble, and one that Fed officials must apparently have accepted when they decided to launch QE. We will live with the consequences of that judgment in coming quarters.

[The prepared statement of Mr. Reinhart follows:]



Statement before the United States House of Representatives

Committee on Oversight and Government Reform

Subcommittee on Regulatory Affairs

Hearing on How Federal Reserve Policies Add to Hard Times at  
the Pump

Vincent Reinhart

Resident Scholar

American Enterprise Institute

Thank you, Chairman Jordan and other members of the subcommittee, for the opportunity to discuss monetary policy and the price of oil. I believe that it is an appropriate use of the subcommittee's time to examine that connection. Indeed, both the net rise and the volatility of oil prices over the past nine months are partly a predictable byproduct of the Fed's expansion of its balance sheet in its policy known as quantitative easing (QE). The Fed gambled that the benefits of the stimulus of QE to financial markets would offset the adverse effects of oil price developments. Whether that gamble pays off is yet to be proven.

QE was essentially designed to give a nudge to risk taking. Late last year, Fed officials announced they would purchase \$600 billion of riskless Treasury securities over the period from November 2010 to June 2011. The hope was that investors would reinvest the proceeds in riskier assets. The resulting lift to equity prices and decline in corporate rates would, the theory runs, support economic expansion. The nudge to risk taking from QE seemed like mission accomplished for a time. Stock prices moved significantly higher and yield spreads narrowed once QE was seen as inevitable.

But not all the effects of QE have played out in financial markets. Since the Fed firmly signaled in August its intent to launch the latest round of QE, oil prices have risen from \$76 to around \$100 per barrel.

Why does the Fed's balance sheet matter for oil prices? The producers of oil as well as other commodities typically sell their output in a worldwide market priced in U.S. dollars. Thus, they care about the current and expected future purchasing power of the dollar and how that will translate into goods and services back home. But QE has been associated with higher inflation and dollar depreciation, which combines to erode the purchasing power of the foreign producers of commodities. Thus, some of the rise in the nominal price of oil has been to catch up with that erosion.

Much more important in shaping near-term oil-price dynamics has been the nudge to investors from QE to move from safe to riskier investments. The commodity market has been one outlet for that reinvigorated search for yield. Investment flows into commodity-related vehicles has stepped up noticeably. This has been reinforced by the Fed's policy of keeping short-term nominal interest rates near zero, which keeps it cheap to do some of that trading on borrowed funds. Such speculation neither produces nor consumes the commodity, so it should have no long lasting effect on prices. However, over short periods, it can fuel spasms of enthusiasm or angst that trigger wide swings in prices.

This increase in the price of oil and its heightened volatility poses three distinct problems for the Fed.

First, a rise in energy costs of one-third takes a distinct bite out of American households' budgets, working to restrain spending in an economy already burdened by lingering balance-sheet problems from the 2008-2009 financial crisis. This probably explains why the expansion of real GDP thus far this year has fallen short of most analysts' expectations. As of yet, however, the oil-price shock is not as large as those associated with severe economic dislocations of the past half century. For example, the recent rise in oil prices is small relative to the 150 percent hike from 2007 to 2008 that added to the headwinds creating recession.

Second, increases in the price of oil, as well as those of other commodities, has fueled an upsurge in inflation. Over the past six months, consumer price inflation has been running at a 5-3/4 percent annual pace and the dollar has depreciated on the foreign exchange market. But Fed officials had been worried for at least the past year that inflation might get too low relative to its mandate of price stability. Therefore, some lift from the prices of energy and other tradeables was probably not unwelcome to them. Further, they continue to believe that people are not likely to expect the prices of other goods or services to rise commensurately. If so, and if commodity prices do not continue to rise, then the level upshift in oil prices will pass out of inflation calculations in due course.

Third, in recent months, the world seems to be a much less safe place than usual, with unrest in the Middle East, uncertainties about Japanese energy supplies,

and changeable speculative flows in commodity markets. These combine to make the near-term balance between oil demand and supply volatile. They could, to the Fed's regret, also make global investors more skittish and undercut some of the benefit in financial markets attributable to QE.

On net, it is likely that the economy-wide effects of the energy shock are unpleasant but not derailing to expansion. But this is a gamble, and one Fed officials must apparently have accepted when they decided to launch QE. We will live with the consequences of that judgment in coming quarters.

Mr. JORDAN. Thank you, Mr. Reinhart.  
Dr. Murphy.

**STATEMENT OF ROBERT P. MURPHY**

Mr. MURPHY. Well, thank you for having me, and thank you for having this hearing. I think it is very important that the public realizes the possible role the Federal Reserve has been playing in high oil prices.

Unfortunately, a lot of my prepared remarks are going to overlap with what Mr. Reinhart said, so I wish I had gone first, and then he would be copying me. But I will go ahead, and maybe I will say his same points in somewhat different language.

So, of course, what everyone knows is that the Federal Reserve has expanded its balance sheet since the crisis set in by about \$1.6 trillion, in terms of what is called the monetary base. So that is how much physical currency is in circulation, plus banks' checking account deposits with the Fed, as it were. So, to put that number in perspective, from the time the Fed was founded in late 1913 up until the fall of 2008, they hadn't put that much in. So the Fed has added more in the last 2½ years than the entire history of the Fed up until that point.

Mr. JORDAN. And that number was \$1.6 trillion you said?

Mr. MURPHY. Right. About \$1.6 trillion, yeah, is how much they have added since September 2008 to the monetary base. And up until that point, it was \$932 billion, from 1913 to then.

So when we say it was an unprecedented intervention, I mean, that is not hyperbole; it really is. And, of course, we know, at the same time period, the price of oil, depending on when you start and stop it, has almost tripled. So the question is, do the two have anything to do with each other or is it coincidence?

So, in my written testimony, I gave the two main mechanisms by which Fed policy could be driving the increase in oil prices.

The first one is what the Joint Economic Committee focused on in their recent report, and what they looked at was just the fall in the dollar against other currencies. Because, as Mr. Reinhart said, oil is an international fungible commodity, so oil prices basically have to be the same for everybody once you adjust for currency exchange rates.

And so, if the dollars fall against other currencies, that means the oil price quoted in U.S. dollars is going to go up, everything else equal. So, in other words, Americans have seen oil prices go up more than the Japanese, for example.

Mr. JORDAN. Right.

Mr. MURPHY. All right. So if you look at—the JEC report looked at from, I guess, when QE1 was announced in November 2008 up until whenever this report came out, and they said the dollar fell about 14 percent, looking at the index they used. And so, on those calculations, that is how they are coming up with the figure that, if the dollar had stayed as strong as it was when QE1 was announced up until today, then right now gas prices at the pump would be about 57 cents lower. OK?

So that is the logic they are using to come up with that estimate, is they are saying the dollar has fallen since the announcement of QE1 and then QE2. And, hence, if the dollar stayed the same, then

gas would be 57 cents cheaper at the pump right now. That is what their argument is.

But there is a whole other possible mechanism that they didn't address, and that is, is it possible that the broad rise in commodities in general, regardless of the currency that you are using, could that also be influenced by Fed policy? And I would argue that it is, but it is hard to come up with a quantitative amount.

Just for qualitative arguments, commodities in general have gone up, so it is not just that oil went up. It is commodities across the board. And even, like, for example, gold and silver, since the crisis and fall of 2008 until now, gold has gone up about 80 percent and silver something like 210 percent. All right?

So I don't think that—I think it is very plausible to say at least some of that is due to people are afraid of the dollar being debased, and so they are rushing into the precious metals, you know, as an inflation hedge. It is not just that people in China are giving more jewelry as presents and that is why gold and silver are up so much. All right?

So if you buy the logic there when it comes to gold and silver, it is not a stretch to say, well, maybe some investors—you know, there is lots of liquidity floating around. What are they going to do with their money? They are not going to put it in real estate, obviously. Maybe they don't want to put it in the stock market because the economy is bad. Maybe they are going to go into commodities, thinking, you know, surely wheat and oil are always going to have a demand, and so that is a way to protect my wealth in case there is future inflation.

So that is the other possible mechanism by which Fed policy could be worked. So, you know, given whatever the world price of oil is if the dollar falls, that is one thing. But the other mechanism is maybe commodities, as part of that huge upswing, is people are trying to hedge themselves against inflation. So those would be the two—

Mr. JORDAN. And if I could interrupt you for a second. Would you say, so that is not—that is maybe just good, smart, practical investing versus any type of speculator driving the price up?

Mr. MURPHY. Well, yeah. I mean, it depends on your perspective. To me, that is like saying, you know, it is cold out because the thermometer is showing a low reading. I mean, if people think that something bad is going to happen, then they react. And that is the whole point, or one of the points, of having futures markets in the first place, is to anticipate future movements.

Mr. JORDAN. Right. We will give you 30 more seconds if you want, since I took some of your time.

Mr. MURPHY. That is fine.

[The prepared statement of Mr. Murphy follows:]

**Written Testimony of  
Robert P. Murphy, Institute for Energy Research  
Before the  
Subcommittee on Regulatory Affairs, Stimulus Oversight, and  
Government Spending  
On the Matter of  
“How Federal Reserve Policies Add to  
Hard Times at the Pump”  
May 25, 2011**

**1. About IER**

The Institute for Energy Research (IER) is a not-for-profit organization that conducts intensive research and analysis on the functions, operations, and government regulation of global energy markets. IER maintains that freely-functioning energy markets provide the most efficient and effective solutions to today’s energy and environmental challenges and, as such, are critical to the well-being of individuals and society.

Founded in 1989 from a predecessor nonprofit organization, IER is a public foundation under Section 501(c)(3) of the Internal Revenue Code and is funded entirely by contributions from individuals, foundations and corporations. Headquartered in Washington, D.C., IER supports public policies that simultaneously promote the welfare of energy consumers, energy entrepreneurs, and taxpayers.

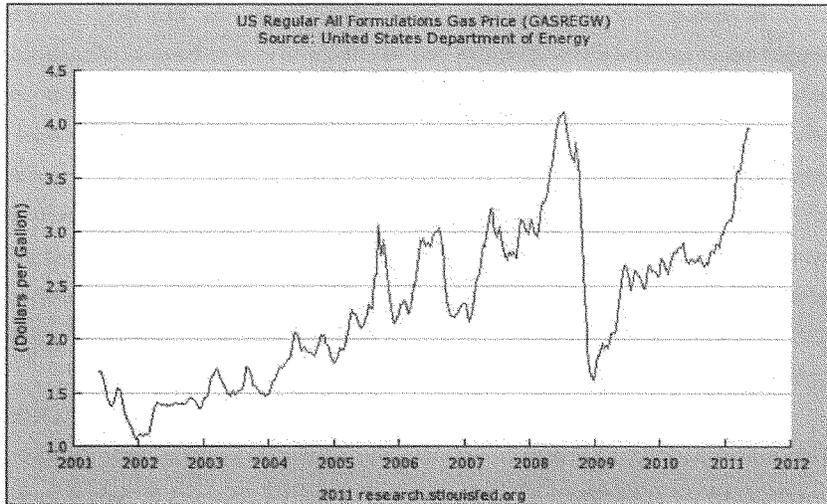
## **2. Robert P. Murphy Resumé**

Robert Murphy earned his Ph.D. in economics from New York University in 2003. From 2003 – 2006 he taught economics at Hillsdale College. After three years teaching, Murphy left academia for the private sector, taking a job with Laffer Investments, headed by Arthur Laffer of “Laffer Curve” fame. In this capacity, Murphy maintained and improved stock selection models, and also helped write research papers for clients. One of the Dr. Laffer’s main interests in this period was oil prices.

In the summer of 2007 Murphy joined IER as an economist. His academic research has focused on climate change economics, specifically the proper discount rate to use when evaluating mitigation policies. He has also given several public presentations on the oil industry, dealing with such issues as record oil prices, windfall profits taxes, and offshore drilling. In addition, Murphy has prepared studies for IER dealing with oil and food prices, the effects of ethanol on gasoline prices, and the role of institutional speculation in oil prices. Murphy previously testified (having been invited by Dr. Ron Paul [R-TX]) on the connection between the weakening dollar and oil prices on July 24, 2008.

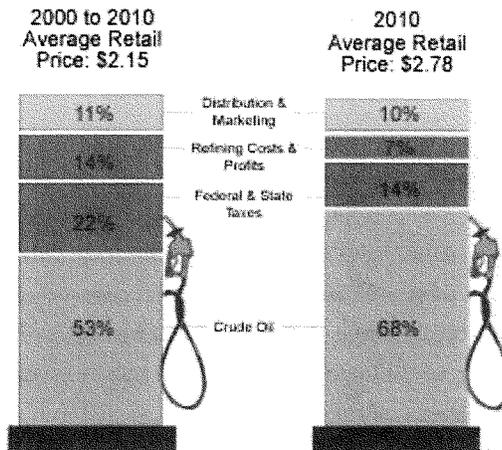
## **3. The Causes of High Gasoline Prices**

Although gasoline prices are still below the record levels (not adjusting for price inflation) set in the summer of 2008, they have been higher in the early months of 2011 than ever before:



Gasoline prices are driven by a few major factors, as the following chart from the Energy Information Administration (EIA) illustrates:

### What do we pay for in a gallon of Regular Grade gasoline?



Source: U.S. Energy Information Administration.

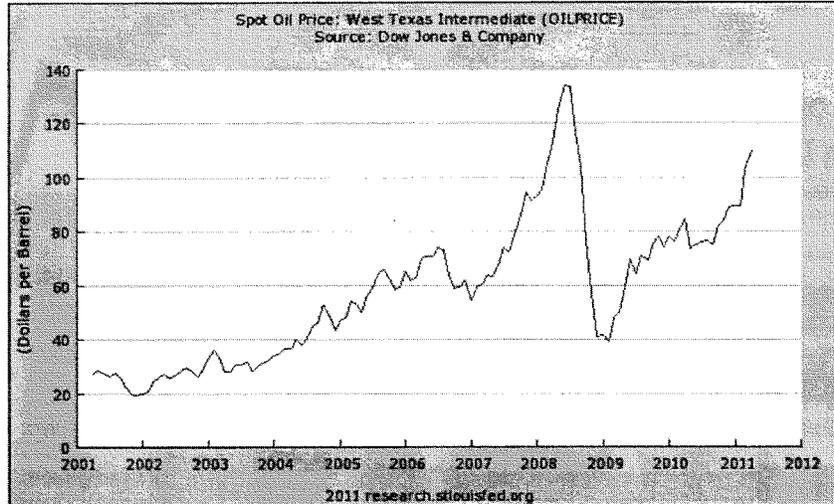
If policymakers want to reduce prices at the pump, the two most relevant components of gasoline prices are federal and state taxes, as well as the price of crude oil. Federal policymakers clearly have the ability to lower the federal tax of 18.4 cents per gallon, while state officials could lower the respective fuel taxes in their jurisdictions. This would provide immediate relief at the pump, though depending on (what economists call) the relative elasticities of supply and demand, not all of the tax reductions would be passed along to motorists. For a purely illustrative example, even if the 18.4 cents per gallon federal tax were completely eliminated, the price at the pump might only fall by (say) 10 cents per gallon, meaning that retailers would earn an extra 8.4 cents per gallon themselves.

Moving on to the price of crude oil, at first it might seem as if federal policymakers have little influence on a commodity traded in the world markets. However, by expediting the development of offshore and other mineral resources on federal lands, policymakers could signal an increased future output of crude oil which would actually reduce prices even in the present. For example, when President George W. Bush announced in the summer of 2008 that he was ending the executive branch's moratorium on offshore drilling, the price of oil dropped \$9 during the speech itself.<sup>1</sup>

In addition—and of more relevance to this hearing—the Federal Reserve has a tremendous influence on the value of the dollar and the financial markets, and as such may have played a significant role in the sharp run-up in crude oil prices over the last few years.

#### **4. The Federal Reserve's Role in Rising Crude Oil Prices**

After hitting record highs in the summer of 2008, the price of crude oil crashed amidst the financial crisis and slowdown in world economic growth. After hitting a low of \$33.87 per barrel on December 19, 2008, the benchmark price of a Cushing oil futures contract had risen to \$96.91 by May 17, 2011.<sup>2</sup> The following chart illustrates the wild swings in the oil market:

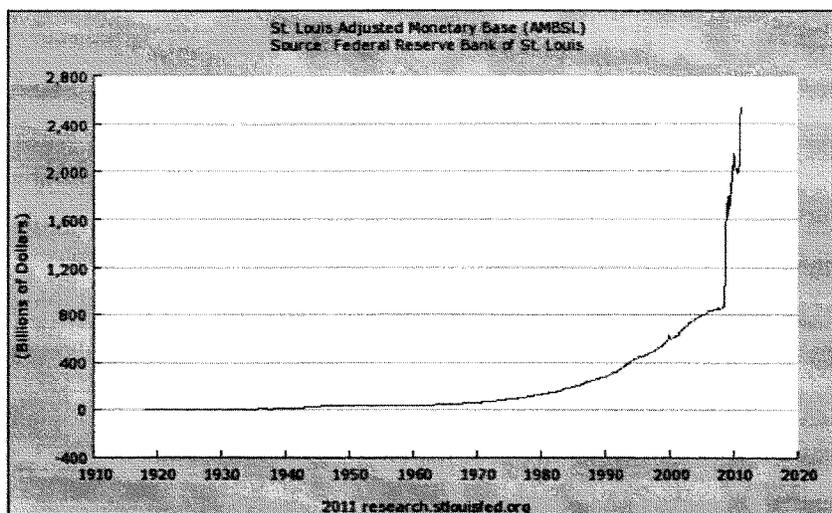


There are two main routes through which Fed policy could have influenced oil prices (quoted in dollars). First, the Fed could have caused the dollar to depreciate against other currencies. Second, the Fed could have raised the price of oil relative to most other goods and services. In the remainder of this written testimony, I will first lay out the extraordinary interventions of the Federal Reserve in the wake of the financial crisis, and then turn to each of the two possible connections to oil prices.

**a) The Extraordinary Interventions of the Federal Reserve**

The Federal Reserve has engaged in several extraordinary measures since 2007 to deal with the developing financial crisis. The Federal Reserve Bank of New York has compiled a timeline of these specific interventions.<sup>3</sup> In addition to cutting the federal funds target interest rate to virtually zero, the Fed has expanded its balance sheet by purchasing mortgage-related derivatives and Treasury debt. The following chart of the

“monetary base” (a measure of physical currency in circulation plus banks’ electronic deposits with the Fed) indicates the scope of the purchases:



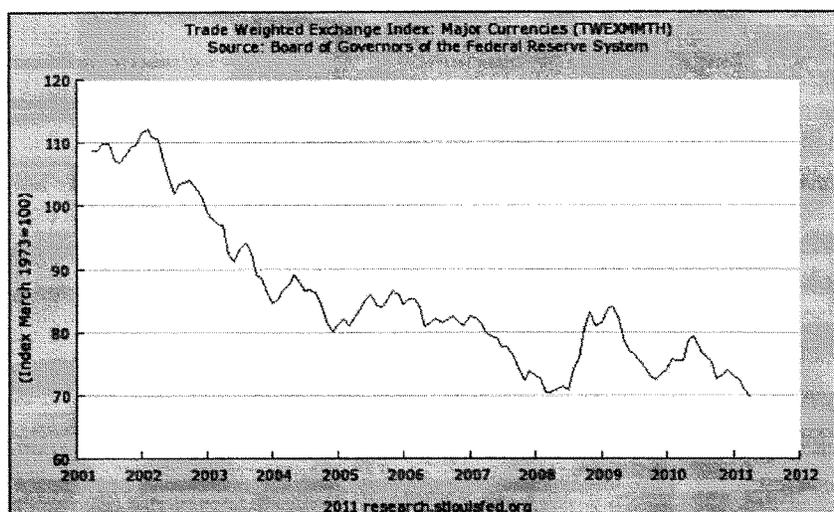
As the above chart indicates, from the creation of the Fed in late 1913 up until September 2008, the monetary base grew by a little more than \$932 billion. From September 2008 until the present, the monetary base has grown by an *additional* \$1,595 billion.<sup>4</sup> The Federal Reserve has clearly embarked on unprecedented injections of liquidity into the financial system during the last few years.

#### b) Dollar Depreciation and Oil Prices (Quoted in USD)

The U.S. dollar’s fortunes have varied during the financial crisis and its aftermath. In the midst of the global panic in the fall of 2008, the dollar strengthened sharply against other currencies, presumably because investors around the world began moving their wealth out of riskier assets and into conservative Treasury debt issued by the U.S. government. (If a foreign investor wants to sell assets denominated in other currencies

and buy dollar-denominated assets such as U.S. Treasuries, this will require the other currencies to be sold in order to buy dollars, which in turn will tend to cause the price of a dollar to rise in the other currencies.)

However, as the global financial panic subsided and (presumably) in light of the Fed's large injections of new dollars into the banking system, the dollar sank back to its pre-crisis levels. The following chart shows a (trade-weighted) index of dollar strength against other major currencies for the last ten years:



Crude oil is traded on a world market. If the dollar falls against another currency, such as the euro, then either the euro-price of oil has to fall, or the dollar-price of oil has to rise, to eliminate arbitrage profits. From its peak in March 2009, the dollar has fallen 17 percent against other major currencies.<sup>5</sup> Therefore, holding everything else constant, the dollar depreciation alone from early 2009 can explain a 20.5 percent increase in oil prices (quoted in dollars).<sup>6</sup> Put differently, the oil price quoted in (say) Japanese yen has not risen as much since early 2009 as it has in U.S. dollars.

It is on the basis of such calculations that a recent Joint Economic Committee report estimated that Federal Reserve policies have added almost 57 cents to the price of

a gallon of gasoline for American motorists.<sup>7</sup> However, this calculation assumes that the *entire* drop in the value of the dollar (relative to other currencies) since the announcement of the first round of “quantitative easing” (in late 2008) has been due to investor concern over U.S. inflation. One could plausibly argue that the retreat from the panic of that period has also led investors to shift some of their wealth away from U.S. Treasury debt and into riskier assets, thus reversing the sharp *increase* in the exchange value of the dollar that began earlier in September of 2008.

In a sense, both perspectives attribute the fall in the value of the dollar to the actions of the Federal Reserve, but the latter interpretation (that the Fed averted a financial meltdown) is of course less critical than the former (that the Fed debased the dollar). In either case, the JEC estimate of the Fed’s impact on gasoline prices only looks at the direct mechanism of monetary policy’s influence on the exchange value of the dollar relative to other currencies. The JEC analysis does not consider the possible role the Fed has played in pushing up oil and other commodity prices, regardless of the currency in which they are quoted.

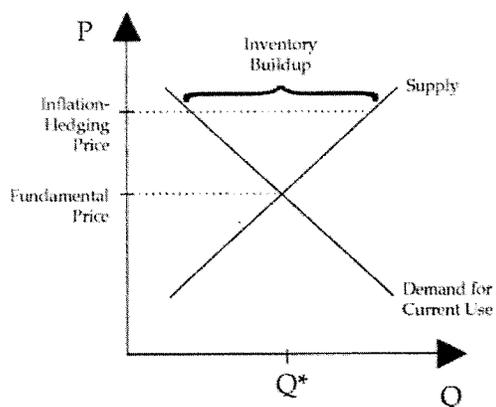
### c) **Commodity Price Surge as Inflation Hedge**

In addition to causing oil prices (quoted in dollars) to rise because of a weakening dollar, Federal Reserve policy may also affect oil prices more directly to the extent that it has caused investors to shift some of their wealth into commodities as an “inflation hedge.” For example, since September of 2008, gold and silver prices have increased some 80 percent and 210 percent, respectively.<sup>8</sup> A certain segment of investors and the general public are very concerned about the future purchasing power of the dollar, and have invested in the precious metals to protect themselves from potentially large future price inflation.

More generally, some investors may be turning to other commodities (including oil) thinking that they will provide a relatively safe store of value, in the event that the dollar and other paper currencies weaken in the future. However, although this theory has a surface plausibility, in practice it is difficult to distinguish it from an explanation that

oil's price rise is due to "the fundamentals," i.e. a genuine growth in end-user demand for oil relative to the increase in output.

If investors in the financial markets were in fact partially responsible for increasing the world price of oil (due to their efforts to protect themselves against currency depreciation), economists would expect to see a "speculative signature" in the form of inventory accumulation. The following diagram illustrates the logic:



As the above diagram indicates, if the actual spot market price were being held above the "fundamental" price, then producers ought to be increasing output while end users (such as oil refiners) would cut back on their purchases. The excess output over current consumption would then go into inventory accumulation.

Through mid-July 2009, there *was* evidence of a large-scale inventory buildup in crude oil. On July 8, 2009, Paul Krugman wrote that although he thought the run-up in oil in the summer of 2008 had been due to fundamentals, the price rise in the first half of 2009 was associated with bulging inventories in both tankers and conventional storage, suggesting that investor behavior in the futures markets could be partially responsible this time around.<sup>9</sup> However, the trend reversed in the second half of 2009. Looking at the entire period, official U.S. inventories of crude oil and petroleum products as tracked by

the EIA as of February 2011 were 36.7 million barrels higher than in December 2008, an increase of a little more than 2 percent.<sup>10</sup> Thus inventories in the United States have grown, but the growth alone is hardly enough to explain the huge increase in the price of oil over the period in question.

Although there is no “smoking gun” in U.S. data, it is important to note that *worldwide* oil inventories are much harder to estimate. Only the OECD countries provide regular reporting on inventories to energy agencies. A potentially large source of error is China, which has been aggressively building strategic petroleum storage capacity while not being transparent as to exactly how much of its “oil demand” is actually being diverted into stockpiles, rather than being consumed.<sup>11</sup>

Besides storing oil above ground, another mechanism through which the actual market price could be held above the “fundamental” price would be a cutback in production. In effect, the owners of oil fields would be stockpiling inventory out of regular output underground.

The possibility of constrained output leading to the run-up in world price is consistent with the behavior of OPEC nations, as they have kept their official production quotas at the curtailed levels implemented after the global economic slowdown in late 2008, even as the world price recovered from its brief collapse. However, even though OPEC nations have constrained their production, output from other sources has more than compensated for the gap. Overall, estimated total world output of oil in the first quarter of 2011 was the highest ever.<sup>12</sup>

## 5. Conclusions

The Federal Reserve has engaged in unprecedented interventions in the financial system in the wake of the 2008 financial crisis. To the extent that the Fed’s actions have caused the U.S. dollar to fall against other currencies and led some investors to seek commodities as a hedge against price inflation, the U.S. central bank is partially responsible for the large run-up in oil prices since early 2009.

However, it is very difficult to isolate just how *much* of the price hike can be explained by Fed policy, versus “fundamental” factors such as the fall in Libyan production and the increasing oil demand from emerging markets. Absent very reliable worldwide data on inventory accumulation, the relative influence of monetary policy versus “real” factors specific to the oil market cannot be precisely quantified.

If policymakers want to lower the price of gasoline for American consumers, they have several options. Most obvious, they could reduce federal and state gasoline taxes. They could also expedite the regulatory and permitting process for the development of offshore and other domestic oil resources. Finally, with respect to the Federal Reserve, to the extent that a tighter monetary policy would strengthen the dollar and reduce investor concern about future price inflation, we would see lower crude oil prices and hence lower gasoline prices. It is notoriously difficult though to estimate the quantitative impacts of these policies, because market prices are influenced by so many different factors.

<sup>1</sup> See Robert Murphy, “Ending Permittorium Could Reduce Oil Prices More than Reducing SPR,” IER blog post, March 25, 2011, available at: <http://www.instituteforenergyresearch.org/2011/03/25/ending-permittorium-could-lower-oil-prices-more-than-reducing-spr/>.

<sup>2</sup> Oil history from EIA: <http://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=RCLC1&f=D>. Accessed May 20, 2011.

<sup>3</sup> See [http://www.newyorkfed.org/research/global\\_economy/policyresponses.html](http://www.newyorkfed.org/research/global_economy/policyresponses.html).

<sup>4</sup> Exact figures available at: <http://research.stlouisfed.org/fred2/data/AMBS1.txt>. Accessed May 20, 2011.

<sup>5</sup> Exact figures available at: <http://research.stlouisfed.org/fred2/data/TWEXMMTH.txt>. Accessed May 20, 2011.

<sup>6</sup> If the dollar had fallen by 50 percent against other currencies, then (all else equal) the oil price quoted in dollars would have doubled. A drop of 17 percent would thus yield a  $(1 / 0.83) \approx 1.205$  factor increase in the price of oil.

<sup>7</sup> “The Price of Oil and the Value of the Dollar,” May 16, 2011, Joint Economic Committee. Available at: [http://jec.senate.gov/republicans/public/index.cfm?p=PressReleases&ContentRecord\\_id=b0772383-bdb9-4ee8-af50-26c68f10aa8d](http://jec.senate.gov/republicans/public/index.cfm?p=PressReleases&ContentRecord_id=b0772383-bdb9-4ee8-af50-26c68f10aa8d). Accessed May 20, 2011.

<sup>8</sup> The (rough) estimates of gold and silver price appreciation were obtained by viewing the historical charts at <http://kiteo.com>.

<sup>9</sup> See Paul Krugman, “Oil speculation,” July 8, 2009, available at: <http://krugman.blogs.nytimes.com/2009/07/08/oil-speculation/>. Accessed May 20, 2011.

<sup>10</sup> Crude oil and petroleum products stock data available at: <http://www.eia.doc.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=MITSTUS1&f=M>. Accessed May 20, 2011.

<sup>11</sup> See Yan Pei, “China accelerates filling strategic oil reserves,” China.org.cn, July 21, 2010, at: [http://www.china.org.cn/business/2010-07/21/content\\_20545379.htm](http://www.china.org.cn/business/2010-07/21/content_20545379.htm). Accessed May 20, 2011.

<sup>12</sup> The EIA’s Short Term Energy Outlook interactive tables are available at: [http://www.eia.gov/emeu/steo/pub/cf\\_tables/steotables.cfm](http://www.eia.gov/emeu/steo/pub/cf_tables/steotables.cfm). Accessed May 20, 2011.

Mr. JORDAN. All right. Thanks, Doctor.  
Dr. Baker.

#### STATEMENT OF DEAN BAKER

Mr. BAKER. Thank you, Chairman Jordan and Ranking Member Kucinich. I appreciate the chance to talk on this set of issues.

I want to make three main points. First, what I am going to say is that the Fed's policies at most contribute a very small amount to the increase in the price of gas. Second, I am going to say that a decline in the dollar is both desirable and necessary. And then, very briefly, I will just say that most of the rise in the price of oil has been attributable to other factors, and the three obvious ones I think have all been mentioned here: one, the growth in the developing world; two, the instability in the Middle East; and the third, that there is certainly speculation in the oil market, which I would argue has had some effect on prices.

OK, the first point, the quantitative easing policy, I find it hard to quarrel—I have been a critic of the Fed quite often, and often quite harsh—but I find it hard to quarrel with their policy here. We have had the worst downturn the country has seen since the Great Depression. It was a situation that called for a very aggressive response. And the Fed gave, to my mind, a relatively timid one, with its policy of quantitative easing, given the current circumstances.

So the intention, of course, was, by buying large amounts of mortgage-backed securities and government bonds, that they would not just lower the short-term rate, which they had already pushed down to zero, but lower the long-term rate. And this would have three beneficial effects. On the one hand, it would give some boost to investment. Second, it would make it easier for people to refinance mortgages. We have 30-year mortgages at the lowest rate they have been in more than half a century. And, third, that it would actually lower the value of the dollar. That was quite deliberately one of the intentions, the idea being that would encourage net exports.

It did, I would say, have somewhat of that effect, but I think the impact has actually been very limited. I think there is a real distortion in this discussion in the sense that there was a big run-up in the dollar in the fall of 2008. So if you go back and look at the history, the dollar rose by around 14 percent between the summer of 2008 and the fall, which was a direct response to the financial crisis. There was a flight to safety. People have always gone to the dollar when there has been a flight to safety. That has led to a large increase in the value of the dollar.

You could perhaps blame QE1 and QE2 for helping to stabilize world financial markets and, that way, getting over that fear, but we should have expected that run-up in the dollar would be reversed once we saw the economy stabilize to some extent.

As it stands now, the dollar is just a little bit below where it was, I think about 2 percentage points below where it was before the run-up.

And I should point out—I can come back to this—I think there is a misunderstanding about the broad index, which is what I assume you referenced in saying that it is at the lowest level ever.

I think that, when you look at a measurement issue in there, it is really not. I can come back to that.

But the other point I wanted to make in that respect is that the dollar had been falling. This is not something that just happened. So the dollar had been falling from 2002 until the financial crisis in 2008. And if we just envision we had continued on that downward trend, the current value of the dollar is still about 16 percent higher than what it would have been on that trend. So there is nothing new in this story.

The second point, we need a lower-valued dollar. In a system of floating exchange rates, the dollar fluctuates to equalize trade. We have a very large trade deficit, currently about \$600 billion. The only mechanism I can think of to get that down is a lower-valued dollar.

As I said before, I take that was one of the main motivations of the quantitative easing policy because that is how you boost our net exports. You make our exports cheaper for people living in other countries. You make imports more expensive for people living in the United States. That is unpleasant, but there is no way around it.

In the context of the price of oil, the way I would see it is that if we deliberately try to have an artificially high dollar, we run a high dollar policy even though it is leading to very large trade deficits, in effect what that means is we are borrowing money from foreigners to subsidize our consumption of imports. In this case, we are talking about the price of oil. We would all like cheaper gasoline. I would like to pay less at the pump, too. But I am not really sure it is a good policy to tell our kids that we are going to be borrowing huge amounts of money from abroad so that we could have cheaper gas today. That is what a high dollar policy means.

The last point I was going to say is that, you know, it is easy to find the culprits, if we want to call them that, in terms of what is pushing up the price of oil. We have countries like China, which is now the second-largest consumer of oil, growing 10 percent a year; India coming up fast as well, also growing 10 percent a year. That is leading to rapid increases in demand for oil. There is no corresponding increase in the supply.

Uncertainty—we all know about the situation in the Middle East. And we could certainly fairly easily tie the most recent run-up in the price of oil—it went from roughly \$80 a barrel to over \$100 a barrel when the civil war in Libya broke out in earnest.

The last point, speculation. We know there is speculation in the market. Ranking Member Kucinich referred to the article in the New York Times today about SEC action against speculators that pushed the price of oil to \$150 a barrel before the downturn. Clearly, there is some speculation again today.

So, just to conclude, I would say that, you know, if we take a look at the Fed's actions, I'd say for the most part they have been, you know, largely on the right track. And insofar as they contribute to the higher price of oil, I really don't think there is anything we can or should think to do about that.

Thank you.

[The prepared statement of Mr. Baker follows:]

**“Federal Reserve Board Policy and the Price of Oil”**

**Statement by  
Dean Baker, Co-Director  
Center for Economic and Policy Research**

**Before the  
Subcommittee on Regulatory Affairs, Stimulus Oversight and Government Spending  
Committee on Oversight & Government Reform  
U.S. House of Representatives**

**May 25, 2011**

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Thank you, Chairman Jordan, Ranking Member Kucinich, and other members of the Subcommittee, for the opportunity to testify before you on the effect of the Federal Reserve’s quantitative easing policy on the price of gasoline. I will make three main points in my testimony:

- 1) The main channel through which the quantitative easing policy could affect the price of gas is by lowering the value of the dollar. The decline in the dollar has been modest since this policy began, and most of it just reversed the run up since bursting of the bubble. The decline in the value of the dollar can at most just explain a small share of the increase in the price of gas.
- 2) The dollar is over-valued at present. A decline in the value of the dollar is necessary to bring down our trade deficit. Such a decline is beneficial in the short-run because it means more net exports and therefore more jobs. It is also beneficial in the long-run since it will mean less borrowing from abroad.
- 3) The main factors behind the increase in the price of oil have nothing to do with Fed policy. Rapidly growing developing countries like China are causing the growth in demand to exceed the growth in supply. Instability in the Middle East has also created uncertainty in the market, thereby pushing prices upward. Finally, there is undoubtedly considerable speculation in this market that has likely exaggerated the upward movement in prices.

**Quantitative Easing and the Value of the Dollar**

The Federal Reserve first adopted an explicit policy of quantitative easing in November of 2008, when it committed itself to buying \$600 billion in mortgage backed securities. It subsequently expanded this target to over \$1 trillion in purchases in March of 2009.

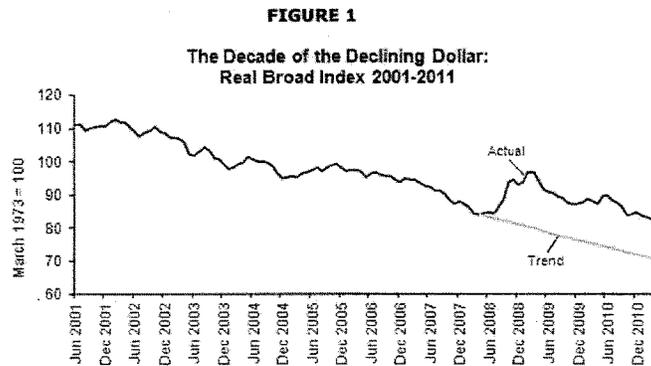
The reason the Fed adopted this path was that the economy was shedding jobs at the rate of several hundred thousand a month. The federal funds rate had already fallen to one percent, and the Fed was just

about to lower it all the way to zero the next month. Given the weakness of the economy, it would have liked to push real interest rates down further, but it cannot make the nominal interest rate negative.<sup>1</sup>

This background is important to realize the policy of quantitative easing has been in place for two and a half years. It did not begin with the Fed's announcement of its second round of quantitative easing in November of 2010. It began two years earlier in the last months of the Bush administration.

There are several channels through which quantitative easing could boost the economy. The first is that it would reduce long-term interest rates. This would make it easier for people to buy homes, having some positive impact on sales and prices. More importantly, lower mortgage rates would allow many homeowners to refinance at lower rates, reducing mortgage payments and thereby freeing up money for other consumption. Lower interest rates may also lead to some increase in investment, as it becomes cheaper for firms to borrow. And, lower interest rates could make dollar-denominated assets less attractive to investors, thereby pushing down the value of the dollar. A lower-valued dollar makes U.S.-made goods more competitive in world markets, increasing U.S. exports and reducing imports.

The actual impact of quantitative easing in these areas is hotly debated among economists in large part because it is not easy to determine what would have happened if the Fed had not gone this route. However, it is easy to show that its impact on the value of the dollar has been relatively limited, and therefore its impact on the price of gas paid by people in the United States must be limited. **Figure 1** shows the downward path of the dollar over the last decade.



Source: Federal Reserve Board.

<sup>1</sup> The real interest rate is equal to the nominal interest rate minus the inflation rate. In principle the Fed can lower the real interest by raising the inflation rate, but this could not be easily accomplished in a situation in which many prices were falling and the rate of inflation was declining.

As can be seen, the dollar has fallen from the levels reached in late 2008 and 2009, but it is just now returning to its pre-recession levels. The levels reached in that period were driven by a flight to safety. In the middle of the financial crisis, Treasury bonds were viewed as one of the few safe assets, leading investors from around the world to eagerly buy them up at extraordinarily high prices. This had the effect of raising the value of the dollar against the currencies of our trading partners.

Now that the panic in financial markets is largely over, we are seeing the dollar return to a more normal level. In fact, the dollar is still far above the level it would have been at if the rate of decline over the years 2002 to 2008 had continued. The real value of the dollar at the end of April 2011 was still 15.6 percent higher than the level it would have been at if the decline that began in March of 2002 had not been disrupted by the world financial crisis. In other words, the value of oil measured in dollars would be 15.6 percent higher than it is today if the dollar had continued to decline at the same rate as it did in the period from the beginning of 2002 to the spring of 2008.

It is not possible to assess the impact of the quantitative easing policy on the price of oil without a clear counterfactual for the value of the dollar. The fact that the dollar is just now hitting its pre-recession level suggests that the Fed's quantitative easing policy probably did not have too much impact in driving down the value of the dollar, except insofar as it helped stabilize worldwide financial markets, thereby making investors more comfortable holding assets other than Treasury bonds.

#### **The Benefits of a Lower Dollar**

The recent trend in the dollar suggests that the Fed's quantitative easing policy did not have much impact in pushing the dollar lower. However, a lower dollar would be desirable for many reasons, and is an important part of the necessary rebalancing whereby the U.S. economy can have healthy growth with low budget deficits.

As noted earlier, a lower valued dollar will increase demand in the economy by making U.S. exports cheaper for people living in other countries and making imports more expensive for people in the United States. This will increase the economy's net exports, which means more jobs and more growth. Given that Congress seems unwilling to support more stimulus, lowering the dollar to improve the trade balance is probably the economy's best hope for more rapid growth at the moment.

A lower dollar does have the negative effect that many have noted. Not only oil, but all imported goods will cost more to consumers. This translates into an increase in the cost of living. However, this increase in the cost of living is likely to be limited. Furthermore, there is no real way around it in the long-run.

To take an extreme case, suppose that the dollar fell by 20 percent against other currencies. Typically importers absorb some of the change in price in the form of lower profit margins. Based on research on pass-through ratios, it is likely that roughly 50 percent of this drop, or a 10 percent increase in import prices, would be passed along to U.S. consumers. With imports comprising 16 percent of GDP, this would translate into an increase in the cost of living of roughly 1.6 percentage points (16 percent multiplied by 10 percent).

This is hardly trivial, but neither is it devastating. In an economy where productivity growth averages close to 2.5 percent annually, it would have roughly the same effect in lowering living standards as 8 months of productivity growth would in raising living standards. If this rise in import prices was associated with a sharp move toward balanced trade, and the millions of jobs that this would imply, most people would likely view this rise in import prices as being of little consequence.

It is also important to understand that a lower valued dollar is essential to reducing the trade deficit and raising national savings. This first point should be evident. The main factor determining our consumption of imported as opposed to domestically-produced goods is their relative price. An over-valued dollar makes imports cheaper. It makes our exports more expensive for people in other countries.

Even our best efforts at removing foreign trade barriers or promoting domestic industry will not have anywhere near the effect in reducing imports and increasing exports as even modest declines in the value of the dollar. Policymakers are just fooling themselves if they imagine otherwise.

Furthermore, a reduction in the trade deficit is a necessary part of increasing national saving. By definition, total national saving is equal to the trade surplus. When we have a trade deficit, that means that the country on the whole is on net a borrower.<sup>2</sup> This just logically follows from the notion that if we are buying more from abroad than we are selling, then we must borrow to cover the difference. This means that either the public sector must be borrowing, meaning that we have government budget deficits, or the private sector must be borrowing, which would correspond to a situation where we had very low household savings.

In the last decade we have seen both scenarios. We currently have very large government budget deficits. In this case, the government is doing the borrowing that corresponds to our trade deficit. However, before the collapse of the housing bubble, when budget deficits were relatively low, it was the private sector that was doing most of the borrowing. This was due to the consumption boom that resulted from the \$8 trillion in housing bubble-generated wealth. Consumers spent based on this illusory bubble wealth, sending the household saving rate to zero. There was a similar situation at the end of the 1990s, when the wealth created by the stock bubble led to another consumption boom that caused the saving rate to fall to what was at the time a record low.

There is no way to escape the simple accounting identity that national savings is equal to the trade deficit. This means that if we want the budget deficit to be brought down, and we don't want to see private savings collapse, as they did during the years of the stock market bubble and the housing bubble, then we must want to see the trade deficit fall. This in turn means that we must want to see the dollar decline since there is no other plausible mechanism for bringing about large reductions in the trade deficits.

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<sup>2</sup> The accounting identity is  $X - M = G_s + P_s$ , where X is exports, M is imports,  $G_s$  is the government budget surplus and  $P_s$  is the excess of private savings (household and corporate) over private investment. If X-M is negative, meaning that we have a trade deficit, then by definition we must either be running a budget deficit or have private sector savings that are less than investment, or both.

### The Causes of the Rise in the Price of Oil

The decline in the value of the dollar over the last two years was a relatively small factor in the rise of the price of oil for people in the United States. Even if we made a comparison to the value of the dollar at the peak of the crisis, the decline would only explain an increase in the price of oil of less than 20 percent. However, as noted above, this comparison would be hugely misleading since it refers to a temporary dollar peak that was driven by the crisis-driven flight to safety. Compared to pre-crisis levels, the recent fall in the dollar can essentially explain none of the increase in the price of oil.

There are three alternative factors that can explain the rise in the price of oil over the last two years:

- 1) the growth of the world economy, especially fast-growing developing countries;
- 2) instability in the Middle East; and
- 3) speculation in the oil market.

The first explanation should be straightforward; the developing world has been growing very rapidly over the last year and a half, and the demand for oil grows more or less in step with their economy. China, which is now the second largest user of oil after the United States, grew at 10.3 percent rate last year and is projected by the IMF to grow at a 9.6 percent rate this year. India grew by 10.4 percent in 2010 and is projected to grow by 8.2 percent in 2011. For Brazil, the numbers are 7.5 percent in 2010 and 4.5 percent in 2011. Many smaller developing countries have also experienced rapid growth over this period.

This means that the world demand for oil is growing rapidly, while world supply is stagnating. Many of the major oil producers are seeing their production dwindle, as most of their reserves have already been tapped, and the new sources of supply are not proving sufficient to add much to the output. The fundamentals of supply and demand suggest that oil prices are likely to continue to rise in the years ahead as demand growth will outstrip supply growth.

The second factor pushing up the price of oil is the uncertainty about supply resulting from the unrest in the Middle East. The biggest spike in the price of oil occurred in the two weeks during which protests turned into civil war in Libya, one of the world's leading oil producers. In the two weeks from February 18<sup>th</sup> to March 4<sup>th</sup>, the price of oil rose by more than 20 percent. There were actual disruptions to oil supplies during this period, but more importantly there is a real concern that continuing unrest could take much or all of Libya's daily production of 1.6 million barrels (about 2 percent of world production) off-line. With violence being used to suppress protests in Algeria and in Bahrain, which sits on Saudi Arabia's border (and is dependent on Saudi military assistance) there is an understandable fear of further disruptions to production in the future. This fear is likely to push up the price of oil as actors in the market will buy extra oil now in order to protect against the possibility it will be considerably more expensive at some point in the future.

This raises the last cause of the run-up in the price of oil: speculation. Inevitably, when there are sharp movements in price in either direction, there will be speculators entering the market who hope to profit from these trends. Speculation also certainly was an important factor in the run-up of the price of oil to \$150 a barrel in the summer of 2008. While the original increase in that year was driven by the fact that the growth of supply was outstripping the growth of demand, this increase was likely magnified by

speculators who anticipated further increases. The role of speculation can explain the speed with which prices fell later in the year as speculators were forced to unwind their positions.

Speculators are likely playing the same role today, amplifying price movements in both directions. The positive side of this story is that a price increase that is attributable solely to a speculative run-up will not be sustainable over the long-term. But the bad news is that for the period that prices are pushed higher by speculation, people will find it much harder to fill their gas tanks and heat their homes.

**Conclusion: The Fed's Quantitative Easing Is Not the Cause of the High Oil Prices**

As I have shown above, there really is not a plausible story that can tie the Fed's quantitative easing policy to the rise in the price of oil for people in the United States. While it may have had some impact in lowering the value of the dollar, this effect was likely very limited. The real value of the dollar is just now falling back to its pre-recession level. It is still more than 15 percent higher than it would have been if it had continued to decline at the same rate as over the years from 2002 to 2008. The real culprits behind the rise in the price of oil are rapid economic growth in the developing world, the uncertain political situation in the Middle East, and speculation in the oil market.

Mr. JORDAN. Thank you, Dr. Baker.  
Mr. Wannemacher.

#### STATEMENT OF GREG WANNEMACHER

Mr. WANNEMACHER. Chairman Jordan, Ranking Member Kucinich, I really appreciate this opportunity to testify today regarding the impact of higher oil prices on the trucking industry.

Oil prices have a dramatic effect on our business. Part of our business is a trucking operation. We operate 38 trucks; 33 trucks operate in the mid-Atlantic and Midwestern States, and 5 other trucks operate locally, shuttling loads to our various distribution centers and to our customers' plants, picking up customers' loads, and making local pickups and deliveries.

The cost of fuel has risen to be our single largest expense item. When I took over our company in 1991, fuel expenses were only 6 to 7 percent of revenue. During the last 4 years, our fuel expenses were the following as a percent of revenue: 32 percent in 2007; 41 in 2008; 29 in 2009, 31 in 2010. Now, in the first quarter of 2011, that expense was 36 percent of revenue.

Over the years, we have tried various techniques to better control our exposure to the fluctuation in fuel costs. We have had our own fuel tanks until the EPA regulations made it uneconomical for a fleet our size. We tried hedging a portion of our anticipated purchases to lock in the pricing. We contract with fuel service providers to buy at a fixed rate over their cost or off the listed pump price. We have set our trucks' top speed at 65 miles per hour, installed onboard auxiliary power units to eliminate idling, gone to wide base tires with a system to keep the tires properly inflated at all times. And, of course, we have contracts with our customers that include fuel surcharges to help offset the fluctuation of fuel costs.

For a fleet our size, hedging in contract fuel purchases are extremely challenging and very time-consuming. Small operations find themselves at a disadvantage, trying to find the time necessary to stay informed and educated on the constantly changing pricing structures and formulas the vendors try to institute.

Fuel surcharges are the least cumbersome for us to manage. The biggest challenge with this is that customers want you to lock your rates in for a minimum of 1 year. Depending on how their business is doing and whether they will take the time to renegotiate annually can also be an impediment. Because of our small size, in some instances we do not provide enough impact on their capacity to get their attention.

The fuel prices we are encountering today are having a huge impact. The best way to explain this is to illustrate how much profit we lose with fuel prices at the current levels. Let me explain how fuel surcharges are implemented.

Fuel surcharges only apply to loaded miles. Our fleets run about 15 percent empty miles. Our average truck runs 2,700 miles per week. The fleet average is 6.6 miles per gallon. Fifteen percent of the miles are equal to 405 miles per truck per week which we see no reimbursement for the increased cost of fuel.

The impact from the average cost at \$2.50 per gallon for fuel, last seen in the fall of 2009, to the recent average of \$4 per gallon

is \$1.50 per gallon on the 62 gallons it takes to run the 405 miles. Roughly speaking, that is \$92 in lost money per truck per week. Remember, I told you we run 38 trucks, so, therefore, that is almost \$3,500 per week. At the current rate, it will be a loss of \$180,000 for the year for our fleet.

Now, if it weren't for the higher fuel prices, we would recognize four potential areas for those extra funds: First, we could invest in more trucks; second, we would look to increase technology; third, to increase our drivers' pay; and, finally, to reduce the debt on our equipment.

Since 2008, many fleets have reduced the size of their operations, and significant amounts of others have simply gone out of business. Now we are starting to see a shortage of trucks. With the capacity shortage, we would utilize the extra money to increase the size of our truck fleet. This would create more jobs at our company. We could immediately grow our fleet 10 percent if the fuel prices were back down to \$2.50 a gallon.

A primary objective of our company is to look at and invest in new technologies and innovations that can help improve our fuel mileage. We do a cost-benefit analysis on any proposed improvements to justify any expenditure. It is imperative that the payback period is shorter than the useful life of the equipment and will not hinder the resale value at trade-in time.

During the downturn in the economy, most trucks, including ourselves, found it necessary to reduce drivers' wages to remain competitive. If fuel costs could get back in line, I believe you would see an increase in drivers' wages across the board.

Our final option would be to reduce the amount of debt we still have on our equipment. Solidifying the net worth of our company will enable us to secure better financing terms in the future. And it is certainly no secret that bankers today are taking a closer look at companies' debt-to-net-worth ratio.

During the fuel spikes in 2008, we elected to gradually reduce our fleet down from 64 trucks to the current level of 38 trucks. If pricing continues to vacillate, we will definitely reduce more to prevent losses. We certainly don't like to be put in this position, but we can't continue to put the remainder of our company at risk. Since it is our largest expense item, stabilization in the cost of fuel is extremely necessary and vitally important to provide the ability for trucking operations like ourselves across the country to remain in business.

We have absorbed the cost increases due to regulations of EPA on our truck engines and fuel-storage facilities, as well as the escalation of other government regulations and enlarged payroll taxes caused by high unemployment in all sectors of the work force. We cannot continue on this wild ride created by speculators and some in our government holding back on drilling opportunities that would reduce our dependency on foreign oil. Not just trucking companies, but the American people need stabilization in fuel prices.

Thank you for this opportunity to testify, Chairman Jordan.

[The prepared statement of Mr. Wannemacher follows:]

**What's Driving Oil Prices?**

**Greg Wannemacher  
President  
Wannemacher Total Logistics  
Lima, Ohio**

**How do oil prices affect how your business operates?**

**One segment of our business is transportation or a trucking operation. We operate an over the road fleet of 33 trucks and another group of 5 trucks operate locally shuttling loads to our various distribution centers either from our customer's plants or making local pickups and deliveries. Oil prices have a major impact on our business. It has risen to be our single largest expense item.**

**During the last 4 years our Fuel expenses were the following as a percent of revenue: 32.7% in 2007, 41.7% in 2008, 29.7% in 2009 and 31.6% in 2010. Now in the first quarter of 2011 that expense was 36.7% as a percentage of revenue.**

**Over the years we have tried various techniques to better control our exposure to the fluctuations in fuel costs. We had our own fuel tanks until the EPA regulations made it uneconomical for the size of our fleet. We hedged a portion of our anticipated purchases to lock in the pricing for several months. We contracted with certain fuel service providers to buy at a fixed rate over their costs or off the listed pump price. We have set our trucks top speed at 65 miles per hour, installed on board auxiliary power units to eliminate idling, gone to wide based tires with an Airgo system to keep tires properly inflated at all times, and installed on board scales to eliminate out of route miles to find scales to insure properly loaded trailers. And of course we have contracts with our customers that include fuel surcharges to help offset the fluctuations of fuel costs.**

**For a fleet our size hedging and contracting fuel purchases are extremely challenging and very time consuming. Small operations quite frankly find themselves at a disadvantage to try to find the time necessary to stay informed and educated on the constantly changing**

pricing structures and formulas the vendors try to institute. And at the same time address the many other factors to run your business.

The fuel surcharges that customers have agreed to, is the least cumbersome to manage. The bigger challenge is that accounts want you to lock your rates in for a minimum of one year. Depending on how their business is doing and whether they will take the time to renegotiate annually can also be an impediment. Because of our small size in some instances we don't provide enough impact on capacity to get their attention.

*Roughly speaking, how much money in profit does your business lose when gas prices rise to levels like we are seeing today?*

The best way to explain how much profit we lose to fuel prices at the current levels is to explain how Fuel Surcharges are implemented. Fuel Surcharges only apply to loaded miles. We run about 15% empty miles. Our average truck runs 2,700 miles per week. Our fleet average is 6.6 miles per gallon. 15% of the miles are equal to 405 miles per truck per week that we see no reimbursement for the increase cost of fuel. The impact from an average cost of \$2.50 per gallon for fuel, last seen in the fall of 2009, to the recent average of \$4.00 per gallon is \$1.50 per gallon on 62 gallons it takes to run those 405 miles. Roughly speaking that is \$92.00 in lost money per truck. Remember I told you we run a total of 38 trucks therefore that is almost \$3,500.00 per week. At the current rate it could be \$180,000.00 in a year.

*If it weren't for higher gas prices, what would your company do with that extra money?*

There are four potential uses that come to mind initially for extra funds. First we could invest in more trucks. Secondly look to increase technology. Third to increase our drivers pay and finally to reduce the debt on our equipment.

Since 2008 many fleets have reduced the size of their operations and a significant amount of others have simply gone out of business there is starting to become a shortage of trucks to deliver products on time. Some of our accounts are requesting more trucks from us daily. With the capacity shortages we would utilize the extra money to increase the size of our truck fleet. This would create more jobs at our company. We could immediately grow our fleet 10% if the prices were at the \$2.50 per gallon versus the current level of \$4.00 per gallon.

A primary objective for our company is to look at and invest in new technology or innovations that can help improve our fuel mileage of our fleet. It has been our practice to do a cost benefit analysis on proposed improvements to justify the expenditure. It is imperative that the payback period is shorter than the useful life of the equipment and will not hinder the resale value at trade in.

During the down turn in the economy most truck fleets, including ourselves, found it necessary to reduce driver's wages to remain competitive. Since there was a shortage of freight to be hauled we needed to alter the mindset of drivers to encourage them to take longer runs. Unfortunately that also impacts their home life and their family time. If fuel costs could back in line I believe you would see an increase in driver's pay across the board.

Our final option would be to reduce the amount of debt we still have on our equipment. Solidifying the net worth our company would enable us to secure better financing terms in the future. It's certainly no secret that bankers today are taking a closer look at company's debt to net worth ratio.

**Has your company had to lay off anyone as a result of higher gas prices?**

During the fuel spikes in 2008 we elected to gradually reduce our fleet down from 64 trucks to the current level of 38 trucks. If prices continue to vacillate we will definitely reduce more to prevent losses in the range of \$3,500.00 per truck per week.

**We certainly do not like to be put in this position, but we cannot continue to put the remainder of the company at risk. Since it is our largest expense item stabilization in the cost of fuel prices is extremely necessary to provide the ability for trucking operations like ourselves across the country to remain in business. We have absorbed the cost increases due to regulations of the EPA on our truck's engines and fuel storage facilities. As well as the escalation of other government regulations and enlarged payroll taxes caused by the high unemployment in all sectors of the workforce. We cannot continue on this wild ride created by speculators and some in our government holding back on drilling opportunities that would reduce our dependency on foreign oil.**

Mr. JORDAN. Thank you, Mr. Wannemacher. We appreciate getting the small-business owner's perspective.

Ms. Kerrigan.

#### STATEMENT OF KAREN KERRIGAN

Ms. KERRIGAN. Well, thank you. Good afternoon, Chairman Jordan and Ranking Member Kucinich. Thank you for hosting today's hearing and for inviting the views and concerns of small-business owners to be considered on this important issue.

I have been asked to provide a general snapshot, if you will, regarding the impact of high gas prices on small-business owners and entrepreneurs. Needless to say, the high costs are making it very difficult for small businesses to compete, to grow, and even survive in what remains a very, very difficult economic environment.

For many small-business owners, sales and revenues remain weak while business costs continue to move higher. Business owners, for example, are very, very concerned and continue to stay burdened with high health insurance costs, with employee benefit costs. At the same time, raw material costs continue to go higher. Supplies, shipping, etc., all these costs continue to go higher. And with weak revenues, this is squeezing small-business owners.

So, obviously, costs are a major issue for small-business owners, how to control them, how to contain them, how to deal with them and remain competitive in a very, very competitive global economy. Tight cash-flows, combined with slim profit margins, limit the flexibility that many small-business owners have in responding to higher costs, particularly unexpected ones.

So, unquestionably, small-business owners are feeling the pinch of higher gas prices. The regular feedback that we receive from our members, as well as small-business owners across the country, point to significant effects that we believe are undermining the economic recovery.

This feedback has been backed up by our latest "Entrepreneurs and the Economy" survey that we released this week, which finds that the specific ways that business owners are dealing with higher gas prices could have profound consequences for our economy, and particularly if prices remain high. Seventy-four percent of business owners, according to that survey, report that higher gas prices are having an impact on their business. Forty-seven percent report that higher gas prices are affecting their plans to hire new employees. Forty-one percent have raised prices due to higher gas prices. Twenty-six percent have had to cut employees or their hours worked. And, staggeringly, 38 percent believe if gas prices remain high or increase further, their business will not survive.

Obviously, how business owners respond to higher gas prices not only impacts their own competitiveness and capacity to grow, but also impacts the overall health of the U.S. economy. If small-business owners are not hiring, if they are cutting hours or if they are cutting jobs, our entire economy suffers. Likewise, if small-business owners are putting fewer resources into investments and innovative projects, the vibrancy of the economy suffers along with the overall national competitiveness.

So high gas prices are hitting the two major pain points of small-business owners. Obviously, higher gas prices are raising business

costs, which is forcing many business owners to do things like raising prices that put them at a competitive disadvantage. Second, high gas prices are hurting sales, as customers have fewer disposable dollars to purchase the goods and services provided by small-business owners. And as I noted in my written testimony, a survey, DollarDays.com survey, found that 64 percent of business owners report lower sales due to higher gas prices.

Especially as our Nation is working to emerge from the recession, it is more important than ever that small businesses operate in a more predictable environment. I think they continue to tell us that uncertainty pretty much rules their everyday operations. Without certainty, without predictability, small-business growth will be stunted and these firms simply will not be able to create the large-scale number of jobs that are desperately needed by our economy.

Thank you again for hosting this hearing, and I look forward to your questions.

[The prepared statement of Ms. Kerrigan follows:]



**“How Federal Reserve Policies Add to Hard Times at the Pump”**

**Testimony of**

**Karen Kerrigan  
President & CEO**

**Small Business & Entrepreneurship Council**

**May 25, 2011**

**Before the**

**Committee on Oversight and Government Reform  
Subcommittee on Regulatory Affairs, Stimulus Oversight and Government  
Spending**

**United States House of Representatives**

**The Honorable Jim Jordan, Chairman  
The Honorable Dennis Kucinich, Ranking Member**

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*Protecting Small Business, Promoting Entrepreneurship*

Chairman Jordan, Ranking Member Kucinich and members of the subcommittee, thank you for holding this hearing today. High gas prices are causing pain for our nation's small business owners, and the issue remains a critical one for our country and the economy. Elevated gas prices are impacting small business operations and growth, which has the potential to more significantly undermine the economic recovery.

My name is Karen Kerrigan, President & CEO of SBE Council. SBE Council is a nonpartisan, nonprofit advocacy, research and training organization dedicated to protecting small business and promoting entrepreneurship. With nearly 100,000 members and 250,000 small business activists nationwide, SBE Council is engaged at the local, state, federal and international levels where we collaborate with elected officials, policy experts and business leaders on initiatives and policies that enhance competitiveness and improve the environment for business start-up and growth.

Small business owners are still struggling in their efforts to regain stable footing following the deep and historic recession. Revenue and sales growth remain weak in many sectors and regions of the country. Rising business costs continue to squeeze small-business cash flow. A recent *Business Journals* "SMB Insights" survey released in late April 2011 reveals the deep concerns small business owners have about the economy and rising costs. In the "SMB Insights" report, the same percentage of small business owners – 72 percent – are concerned about the state of the economy and rising health care and employee benefits costs. Fifty seven percent of small business owners express concern about higher business costs in general. Obviously, costs are a major issue for small business owners. Rapid increases in any number of cost areas are more challenging for small firms. Tight cash flow combined with slim profit margins limit the flexibility that small business owners have in responding to unexpected cost increases.

In general, small business confidence remains low given the slow recovery, policy uncertainty and the day-to-day reality of increasing business costs. Certainly, high gas prices erode confidence further, as well as the bottom line of many business owners.

Small business owners are in need of a period of stability and certainty in order to generate the type of positive momentum that will lead to robust job creation and sustained economic growth. Prior to the upward trajectory in gas prices, lingering uncertainty regarding the strength of the recovery and the direction of policies impacting business costs were already affecting business confidence and outlook, and thus plans for investment and expansion. The upward movement in gas prices is yet another hurdle preventing entrepreneurs from getting ahead and feeling secure enough to confidently build their businesses and create jobs.

A DollarDays.com survey released in mid-April found that 64 percent of business owners say their revenue is down as a result of rising gas prices. More than 25 percent fear they will have to lay off employees if prices continue at “current levels.” The results of the DollarDays.com survey align with recent SBE Council survey findings, along with information we are hearing from our members and small business owners across the country.

As SBE Council found in its latest “Entrepreneurs and the Economy Survey” (conducted by TechnoMetrica, April 21-27), small business owners are unquestionably feeling the pinch of higher gas prices. A substantial portion of small business owners (41 percent) have raised prices in response to higher gas costs. Of course, small business owners are loathe to raise prices because of competitive pressures. Especially in the current environment, they cannot afford to drive existing customers away. Still, many have no choice but to pass their cost increases onto customers and clients. Small businesses that have held back on increasing prices have employed other strategies; like cutting employee hours, forgoing investments, or scaling back marketing efforts. These strategies, however, affect their growth, their ability to compete and their ability to generate enterprise-wide momentum that enables a more stable and faster growth track.

As we see from the findings of the “Entrepreneurs and Economy Survey,” the specific ways that small business owners are responding to higher gas prices may have profound consequences for our economy, especially if these costs do not come down in the near future. According to the survey:

- 74 percent of small business owners report that higher gas prices are having an impact on their business.

- 47 percent report that higher gas prices are affecting their plans to hire new employees.
- 41 percent have already raised their prices due to high gas prices.
- 26 percent have had to cut employees or their hours worked.
- 38 percent believe if gas prices remain high or increase further their business will not survive.

The response of small business owners to higher gas prices not only impacts their own personal competitiveness and capacity to grow, but the overall health of the U.S. economy. If small business owners are not hiring, or if they are forced to cut back jobs or employee hours, our entire economy suffers. As committee members are well aware, our nation needs the job-creating prowess of small businesses in order to bring about full recovery and sustained growth. Likewise, if small business owners are putting fewer resources into investments and innovative projects, the vibrancy of the economy suffers along with our overall competitiveness.

A May 17, 2011 *Aol Small Business* article (“High Gas Prices: Who are the Biggest Winner and Losers”) reported on the various types of small businesses that are being hit the hardest from high gas prices. For example, retail stores, firms with sales staff, catering companies, trucking-related businesses, small oil companies, grocery/meal delivery businesses, IT/Tech consultants, florists, general contractors, and lawn care companies are some of the industries the article mentions. The story gives specific examples, including:

- **RETAIL:** According to the *Aol Small Business* story: “Sherri Comstock, who has three Grayslake, Ill.-based brick-and-mortar stores -- The Cheshire Cat, The Spotted Crocodile and the soon-to-open Foodie -- says gas prices ‘have caused the wholesale prices on many items to increase, and shipping costs like UPS surcharges have gone up due to the high cost of oil.’ But she adds the price goes beyond that: ‘There are the soft costs, like fuel costs driving from our warehouse to the stores.’ Comstock also says ‘the costs of employees’ airfare, meals and hotel to events like the gift show in Atlanta and other out-of-state vendor training events are eating away at my bottom line now.’”

SBE Council members report similar effects. They report less in-store traffic and lower sales volume, and they believe this is related to customers having less disposable income as a result of higher gas prices. As noted above, shipping charges have increased significantly, which means business owners are paying higher prices for goods and products being delivered to their shops. Many are being forced to absorb these costs, which mean fewer resources for adding workers, or increasing the pay of their existing workforce.

- **CATERING:** As noted by the *Aol Small Business* column: ““The fluctuating gas prices substantially impact our company,’ says Tom Walter, CEO of Chicago-based Tasty Catering. ‘Our business relies on being able to deliver affordable, quality food to Chicago area corporations.’” While the company recently purchased new fuel-efficient vehicles and “tinkered” with its delivery schedule to cut back on driving time “they’ve been forced to raise their prices, on average by 8 percent, for the first time in two years.”

Higher prices make smaller firms less competitive, and their services (or goods) less desirable. But raising prices is a reality for many business owners who simply cannot afford to absorb another penny of costs. Of course, artificially induced higher prices mean consumers pay more.

- **FLORISTS:** As reported in the *Aol Small Business* story: “Everyone involved in this industry -- from growers to wholesalers to independent flower shops -- relies heavily on shipping to ultimately get flowers to customers. And because shipping costs can vary significantly even on a daily basis depending on gas prices, the cost trickles down to the customer. Scott McBride, manager of Toledo, Ohio-based florist Myrtle Flowers & Gifts, increased delivery rates last month in anticipation of the high volume of orders for Mother’s Day. ‘If gas prices rise significantly, we might consider another hike,’ McBride says. ‘But we’re going to try and keep them as low as we can for as long as we can.’”

- **MANUFACTURING:** Keeping prices “as low as we can for as long as we can” is more easily said than done for small business owners. An SBE Council member/manufacturer has had no choice but to raise prices because of significant increases in shipping costs related to high gas prices. But this move to cover his

costs may result in future business opportunities going overseas to China. As the manufacturer reports:

“We purchase raw material (molding compound) from suppliers as far away as Ohio. Last year we started to make oven handles for a very large and well-known company. The material used to make the handles is made in Perrysburg, Ohio. On 5/11/11 we received 16,270 pounds of material via Con-Way freight. The normal shipping cost for this shipment is \$623.62; however, there is a fuel surcharge of 32.10 percent or \$200.18 which results in a total cost of \$823.80. We look at everything through the prism of ‘cost-per-pound.’ Normal shipping is \$0.038 per pound. The fuel surcharge adds another \$0.0123 per pound. That may not sound like much but that is not the whole picture. Our supplier in West Chicago has already raised their price to us by 6 percent effective 5/1/11 -- claiming high cost of fuel and materials, which I believe. When we started the program with the major vendor the price of the compound was \$1.06 per pound. It is now \$1.12 per pound. Our total cost increase for material is \$0.06 plus \$0.0123 or \$0.07123 per pound. Each handle weighs 2 pounds so our material cost increased \$0.152 per part. We have notified the vendor that their price for the handles will increase effective 6/1/11. I expect a fight. Near term we may be okay, but the large vendor has all sorts of options -- one of which is sourcing this product in China or replacing it with a cheap metal version (also sourced in China). Welcome to the world market. If we lose the business we will have to lay off 12 employees -- we currently have a total of 60.”

- *LAWN CARE COMPANIES*: Again, as noted in *Aol Small Business*: “Gas prices make up about 15 to 20 percent of lawn care companies' budgets. Ultimately, many companies may have to decrease their service areas or give up some of the higher-paying customers who have bigger lawns or more complicated landscaping needs. And because cutting grass and planting/landscaping gets highly competitive, most small companies have very little wiggle room when it comes to increasing their rates to make up for inflated gas prices.”

- *STAFFING SERVICES*: Companies in the employee staffing business are also having a difficult time operating in the high-cost environment. For example, an SBE Council member located in the Midwest reports that he is finding it difficult for workers who live in more remote locations to agree to work on projects or a

worksite because the cost of driving is too expensive. Potential employees are also declining work because of high gas costs. According to the owner, “We are getting hammered, both by current employees quitting because the cost of driving has become so onerous, and by potential employees declining work because the distance is ‘too far’ when factoring in the high cost of gas.” As an aside, he adds that unemployment allows workers to sit home (thus bearing no travel costs) and collect \$384 a week, which may be cutting into his pool of available workers.

SBE Council has long supported a national energy policy that leads to greater stability in energy prices. Especially as we work to emerge from the recession, it is more important than ever that small business owners operate in a more predictable environment. With sales revenues weak, and business costs still rising entrepreneurs cannot create the large-scale number of jobs that are needed in our economy.

The added burden of high gas prices is making a difficult environment much more challenging for small business owners. It is why SBE Council continues to support policies that encourage domestic exploration and development. It is also why our Chief Economist Raymond J. Keating believes mission creep at the Federal Reserve – that is, their foray into trying to manipulate economic growth – should be abandoned with efforts solely focused on maintaining price stability. As Keating recently wrote about this matter: “...being focused on maintaining price stability should be the only concern of any country’s monetary authority. Such focus will reduce inflation and inflation risks, strengthen the dollar, and have a positive effect on the price of oil and, therefore, gasoline.”

Thank you again for hosting this hearing, and I look forward to your questions.

Mr. JORDAN. Thank you, Ms. Kerrigan and all our witnesses.

Mr. Wannemacher, you mentioned fuel costs went from 6 percent, I think you said, 6 or 7 percent, to now somewhere in the last 3 years a range of 30 to 40 percent. Is that accurate?

Mr. WANNEMACHER. Yes, sir.

Mr. JORDAN. Yeah, I mean, that is huge. And, obviously, it has had an impact on your industry and, I assume, every other trucking industry out there. But have you noticed your customers, that it is impacting them? If we listen to Ms. Kerrigan's testimony, obviously it is. But have you seen that in a firsthand way with your customers that you deal with?

Mr. WANNEMACHER. Yes. The biggest impact is, you get the small companies that aren't—you know, the larger companies are familiar with fuel surcharges and are willing to absorb that. But it is the smaller companies that don't ship as many truckloads in a week that it really is alarming to them. And they try to absorb those things rather than try to pass them on to their customers.

Mr. JORDAN. Right. Right, right.

And you have seen that, as well, Ms. Kerrigan? Relative to the surcharge issue, have you had any specific examples with your folks on the surcharge issue?

Ms. KERRIGAN. On being impacted by surcharges?

Mr. JORDAN. Yeah.

Ms. KERRIGAN. Shipping I think is a huge one, you know, where, you know, anything that they are receiving—florists. I think the florist industry, in particular, are receiving a fair amount of surcharges on shipping.

Mr. JORDAN. Uh-huh. The other thing you mentioned in your testimony, Ms. Kerrigan, was the other regulatory concerns, other regulations that are a concern to business owners. One of the focuses of this subcommittee is, you know, regulation and how that impacts business.

Talk to me about some of the things—in addition to the gas price issue, we have other things that government is doing. Talk to me about some of the specific things that you think are negatively hurting job growth and economic growth right now.

Ms. KERRIGAN. Well, gosh, where do you start?

Mr. JORDAN. You or Mr. Wannemacher, either one.

Ms. KERRIGAN. Well, one big one, I think, is the health-care issue and, you know, the concerns about what the health-care reform bill, as it gets implemented, what it means for their health insurance costs. Because they don't see them going down; they continue to see them going up. You know, what the employer mandate is going to mean for their business, what the fines are going to mean.

Mr. JORDAN. Right. And it is this cumulative effect that concerns me and I think concerns many Members of Congress and obviously concerns—so it is not just—well, you can point to one, but it is one on top of the other. Now you throw in the gas price issue.

Ms. KERRIGAN. It is one on top of the other. I mean, there is the tax issue and uncertainty—

Mr. JORDAN. Right.

Ms. KERRIGAN [continuing]. Of what their taxes are going to be. I mean, there is the implementation of Dodd-Frank. What is it

going to be in terms of their cost availability of capital and loans? It is all that.

It is very difficult to get traction. And a business owners needs momentum, they need traction in order to grow and have the confidence—

Mr. JORDAN. Right.

Ms. KERRIGAN [continuing]. To do the things that they need in order to invest and to create jobs.

Mr. JORDAN. Mr. Wannemacher, can you comment on the cumulative effect that concerns so many of us?

Mr. WANNEMACHER. You know, it is. It is just a compounding. When you have the EPA issues—for example, when the EPA changed the regulation on the truck engines, we ended up paying about—the first round, it was about \$6,500 for just the EPA regulations. The second round was an additional \$8,000. And so it is just a compounding thing of those type of things.

When we went to low-sulfur fuel, which gave us lower fuel mileage, higher-cost trucks, lower fuel mileage, and, you know, we can only pass on the fuel surcharge based on the price of fuel. So that was also a loss.

And then what Ms. Kerrigan said, also, about the health care. I mean, that just creates such an instability in your mindset as far as going forward, those added-on costs of government regulations that really have no—really don't belong there, in a lot of instances.

Mr. JORDAN. Uh-huh. Great.

Let me turn to our other guests, and we will do a second round here.

I am just curious—and let me start with maybe Mr. Reinhart—in the last couple years—and I genuinely don't know the answer to this one—has the Fed been the largest purchaser of Treasuries? Are they the single largest purchaser and/or holder of Treasuries in the last, say, 2 years?

Mr. REINHART. No, actually. Here is a good comparison—

Mr. JORDAN. That surprises me. Because I think it is, like, \$75 billion—

Mr. REINHART. So when the Fed—

Mr. JORDAN. So who is their largest holder? Is it—

Mr. REINHART [continuing]. Put QE2 on the table in August, since then it has expanded its balance sheet by \$500 billion of extra Treasury securities.

Mr. JORDAN. OK.

Mr. REINHART. Over that same period, foreign official entities have increased their holdings of government securities held in custody at the New York Fed by \$1 trillion.

Mr. JORDAN. OK.

Mr. REINHART. So, in some sense, as Dr. Baker noted, the net depreciation of the dollar has been pretty modest, so you can't say it contributes a lot to the rise in oil prices. But that actually masks two effects. The Fed has been buying Treasury securities with \$500 billion of extra dollars, which would tend to move the dollar lower.

Mr. JORDAN. Sure.

Mr. REINHART. But, at the same time, foreign official entities have been buying a trillion dollars of Treasury securities with their own currencies, tending to offset what the Fed is doing.

Mr. JORDAN. OK, but you said foreign. So, total foreign holdings of Treasuries is bigger than the Fed—

Mr. REINHART. Oh, most certainly.

Mr. JORDAN [continuing]. Single biggest holder? Are they bigger than—so the single biggest entity holding Treasuries today, in the last few years, would be the Fed?

Mr. REINHART. The single biggest entity in terms of the stock holdings of government securities right now would be foreign official entities.

Mr. JORDAN. Combined?

Mr. REINHART. Yes. That is, the reserve managers, China, India, Russia, Brazil, and the like.

Mr. JORDAN. OK. Got it. And then would the Fed be second?

Mr. REINHART. The Fed would be second.

Mr. JORDAN. Ahead of other funds and individuals and etc.?

Mr. REINHART. Yes.

Mr. JORDAN. OK. OK.

I will get back to that, but I want to get to our ranking member, and then we will do another round.

The gentleman from Cleveland is recognized.

Mr. KUCINICH. Let me ask Mr. Reinhart just a quick followup. I was distracted for a second. I want to make sure I got your answer.

Of the trillion dollars that is being purchased, did you say who is buying those from abroad? China, you said?

Mr. REINHART. So, all we know is that the Federal Reserve Bank of New York holds Treasuries—government securities in custody for foreign official accounts.

Mr. KUCINICH. Right. But—

Mr. REINHART. That went up a trillion dollars.

Mr. KUCINICH. OK. Got it.

Mr. REINHART. We don't know the composition of it.

Mr. KUCINICH. OK.

Dr. Baker, in a March 2, 2011, Congressional Research Service report entitled, "The U.S. Trade Deficit, the Dollar, and the Price of Oil," which I am going to ask unanimous consent be entered into the record—

Mr. JORDAN. Without objection.

Mr. KUCINICH. Thank you, Mr. Chairman.

In this, CRS agrees with your assessment that the Fed's monetary policy actions have not been the main driver of higher oil and gas prices.

Now, can a case, however, be made here that there is a tangential effect that the Fed has on these prices? I mean, some of our witnesses have made that. Would you comment on their analysis?

Mr. BAKER. Well, again, I would say—and the CRS report, of course, agrees that there was some impact in lowering the dollar. But, again, I think that was relatively modest, you know, and I think most of the evidence suggests that.

The other issue is, I had said and the other witnesses I think suggested this, maybe put in a different way, but that the low-interest-rate environment does create a situation in which you are likely to see some speculative run-up in the price of oil and other commodities. And I think that has certainly been true. That was

certainly true in the period in 2007–08, when oil hit \$150 a barrel. And it would be surprising to me that there is not some speculation there today. It just stands to reason that when there are sharp movements, almost invariably at least some of that is driven by speculation.

Mr. KUCINICH. OK. Is speculation driven by being able to trade with borrowed money?

Mr. BAKER. Of course. You know, speculators tend to—the way you make money as a speculator is you become heavily leveraged. And if you could do so cheaply, then it makes it easier to speculate.

Mr. KUCINICH. Let me ask you—well, first of all, just to preface, we can debate the causes of high oil and gas prices, but I think that, you know, just in my own opinion, we have to keep in mind that the U.S. ranks second in the world in fossil fuel consumption. And energy-producing companies have used our dependence on oil to enrich themselves and pollute the air and the land.

It is clear to me what we are seeing is the result of a monopoly. And by that, I mean, when it comes to individual transportation, there is only one source—major source of fuel, and that is oil. Americans depend on it every day to get to work, get their kids to school, get groceries, conduct their daily lives. Businesses are dependent on it, as has been pointed out. So the demand for oil is fairly inelastic.

When demand is inelastic, if there is a monopoly in supply, conditions are ripe for the kind of price manipulation that was documented in the minority report issued on Monday. And that led the Commodity Futures Trading Commission to charge five oil speculators with illegal price manipulation yesterday.

Dr. Baker, can you talk a little bit about the effects of monopoly of oil on our economy and about the possibility that breaking that monopoly with alternative energy sources, what that would mean for our economy?

Mr. BAKER. Sure. I just realized, earlier I had made a reference to the Securities and Exchange Commission. In fact, it was the Commodity Futures Trading Commission that brought those charges. So, just to correct my earlier statement.

Mr. KUCINICH. Thank you.

Mr. BAKER. Yeah, I see it as a situation as, in effect, we are subsidizing oil consumption, part of that story being an overvalued dollar. So, in a situation where we are running a very large trade deficit, in effect what we are doing is borrowing money to get oil and other imports cheaper than would otherwise be the case if we had a dollar that was consistent with more balanced trade.

And, obviously, when you have a situation where there is a number of relatively small number of oil companies, they are in a position to take advantage of shortages, temporary shortages. It makes it a more volatile environment because, as you say quite correctly, at least in the short term, demand is very inelastic. When you have a relatively small number of suppliers, supply can be very inelastic as well.

Mr. KUCINICH. Let me ask you something. I have about a half-minute. How would you explain to my constituents simply—I mean, we are talking about some, you know, fairly high-level extractions there, in terms of money supply, the role of the Fed. How

would you explain this, in layman's terms, to the average motorist who is paying \$4 to \$5 a gallon about why is this happening? Put it in layman's terms.

Mr. BAKER. Well, I guess I would say there are two parts to that story. One is, you know, certainly the short-term story, where I think the price has gone up more than would be justified by the fundamentals due to the fact that you have speculators that are pushing up the price. So you have speculators who are thinking prices will be higher in the future or at least for a short period of time. They are hoping to get in—

Mr. KUCINICH. So speculators are driving up the price. That is one factor.

Mr. BAKER. That is one factor.

Mr. KUCINICH. OK. And the other factor?

Mr. BAKER. The other is simply the long-term story, that oil is a commodity in relatively limited supply. Demand is increasing very rapidly in the developing world, and it is almost certainly going to outstrip the rate of growth of supply. And the only way you can reconcile more demand and relatively limited increase in supply is with a much higher price.

Mr. KUCINICH. So, even without speculation—thank you, Mr. Chairman—even without speculation, based on the supply demands that you are talking about, you are saying that the price of oil—if nothing else changes in terms of alternative sources, the price of oil is going to go up. Is that what you are saying?

Mr. BAKER. Exactly. I don't see any story where, if we look out 5 years from now and let's say there are no speculators, you know, we are just looking at what the world economy looks like, possible projections of growth, I don't see any story in which the price of oil is not considerably higher than it is today.

Mr. KUCINICH. OK.

Mr. Chairman, thank you for your indulgence on that.

Mr. JORDAN. No problem.

Mr. Baker, you said earlier about subsidizing oil consumption. What was the statement you made earlier, that we were—when we were doing that and what—

Mr. BAKER. That, in effect, by having a large trade deficit, which is associated with an overvalued dollar, we are subsidizing our consumption of oil and all imports and paying for that with money that we have borrowed from foreigners. That corresponds to a trade deficit.

Mr. JORDAN. Which, I think, raises the question. So do you think rising fuel costs are a good thing?

Mr. BAKER. I think that they are an inevitable thing. That is part of the—

Mr. JORDAN. I didn't ask you that. Do you think they are a good thing, do you think they are a positive thing?

Mr. BAKER. I think there are positive—I mean, I am not trying to be evasive—there are positive aspects to it. I mean, it will—

Mr. JORDAN. In light of what we just heard from a small-business owner?

Mr. BAKER. There are negative aspects as well, of course. None of us want to pay more for gas. Businesses are going to be very harmed. Some businesses will go out of business.

On the other hand, exporters are going to do very well because the dollar will fall. So we are going to get a lot of jobs created in export industries. Also, in import competing industries, because imports are now more expensive, there are going to be more jobs there.

Mr. JORDAN. Let me get back to Dr. Murphy.

You made a point earlier. You said, I believe, added to the monetary base \$1.6 trillion since September 2008 to today; from 1913 to 2008, \$932 billion. So, in 3 short years, or less than 3 years, more than we did in—I didn't do the math, but what is that? Almost 80-some years, or 90—80-some years.

And Mr. Baker, I think, called that "timid" in his opening statement, that the Federal Reserve's approach to this was timid. I assume you disagree with that.

Mr. MURPHY. Right, I disagree strongly. And, I mean, it probably is the difference in our perspective as to what the appropriate policy response is. I believe that the problem was that Chairman Alan Greenspan had interest rates too low after the dot-com crash, and that fueled the housing bubble—

Mr. JORDAN. Uh-huh.

Mr. MURPHY [continuing]. And so that was the wrong thing to do. That caused mal-investments. And so, to me, what Chairman Bernanke has done is just doubled down on the wrong policies that Chairman Greenspan put into place.

Mr. JORDAN. Yeah.

Mr. MURPHY. But I think Dr. Baker is coming from a different perspective, obviously. And so, right, so they would say it is timid because, look, it didn't work fully, so we need to put more medicine in; whereas I am saying, no, that is poison, just pumping in extra money that you are creating out of thin air—

Mr. JORDAN. Yeah.

Mr. MURPHY [continuing]. To use a colloquialism.

Mr. JORDAN. Do me this. Maybe you and Mr. Reinhart then second. Rank order—I mean, look, because we got supply and demand concerns, we got turmoil in the Middle East, we got those who say speculators, and then we got the Fed and quantitative easing and devaluing of the dollar.

So, rank order—and let's just, as a starter, say all have some influence on the price of fuel and, ultimately, the price of gasoline. But rank order them, which one has the biggest, which is second, which is third, and which is fourth.

And I would also—well, I will get to that article in a second. But do that first, and then we will go to Mr. Reinhart.

Mr. MURPHY. Sure. I mean, I think we should just be humble and say nobody knows for sure. We would have to turn back time and do the alternate universe to see what actually happens. So this is all speculative, no pun intended.

I personally think that the Fed has not fixed the problem. OK? So it is true, as Dr. Baker was saying, you could argue, well, no, the Fed averted a catastrophe, and so, therefore, even though—we are, in a sense, both agreeing the Fed caused oil prices to go up. And he is saying that is, you know, arguably a good thing in one perspective. But I don't think we are out of the woods yet. I think, you know, years from now we are still going to look back and say,

when is the economy going to get better? So, in that sense, I think the Fed is—I personally would say it is the Fed.

Now, in terms of speculators, again, that is sort of a loaded term, but, I mean, if people are worried that the dollar is going to depreciate strongly—

Mr. JORDAN. Right, my first question to you.

Mr. MURPHY. Yeah. That is partly what they are supposed to do.

Mr. JORDAN. Normal behavior, yes.

Mr. MURPHY. A futures market is supposed to allow that.

Mr. JORDAN. But you would say the Fed's actions are the number-one reason that the price of gasoline for families and business owners went up, more so than turmoil in the Middle East, more so than rising demand from countries and rising demand, period, you know, more so than supply and demand concerns?

Mr. MURPHY. From the fall of 2008 until now, yes. I think, if you are saying—like, the last 6 months, the Middle East, I think, is a far bigger influence of what is going on.

Mr. JORDAN. But over the last 3 years.

Mr. MURPHY. Right, if I had to pick one.

Mr. JORDAN. Mr. Reinhart, could you comment, the rank order in question?

Mr. REINHART. So, one thing I do want to make clear is the distinction between the relative price of oil and the nominal price of oil and, similarly, the real exchange rate and the nominal exchange rate.

We need real exchange rate depreciation to adjust the trade accounts. Maybe we should think about a way of getting that without as much domestic inflation. Global supply and demand is such that the real price of oil is going to be going up over time, but Fed policy will determine how much of that real price increase turns into nominal price increases.

And I think, over the longer history of the Fed—that is, over the last couple decades—the very high nominal price of oil relates to the Federal Reserve's failure to achieve price stability. And so, if you are looking for the big picture, why are oil prices so high over the last two decades, it has to be about Fed policy, because the Fed is responsible for the nominal prices everywhere.

Mr. JORDAN. Right.

Mr. REINHART. OK. Now, if you are asking in the last year or so, or over the whole profile of quantitative easing, I would say that it is mostly something about the balance of real supply and demand; the Fed comes second. And I would put third speculation. There has been a bit of discussion about the CFTC's—

Mr. JORDAN. Right.

Mr. REINHART [continuing]. Ongoing case. And it is not appropriate to opine on an open case, but I think you would have to remember three important points. And the first is, in the futures market, almost nothing settles in a cash transaction. That is, the futures market is very large relative to the cash market. So trying to manipulate cash to affect the futures market is the tail wagging the dog.

But second, in a very short period, the tail can wag the dog. Even in the CFTC's press release of yesterday, they say it was a strategy designed to first raise, then lower oil prices. So, in the short run,

speculation can matter. But the short run, it can be, you know, relatively short.

But, third, we do have to worry about speculation in the market because it raises volatility of prices, and that is just a deadweight loss for everybody. It is just more expensive to use those markets efficiently for hedging.

Mr. JORDAN. OK. Thank you.

The gentleman from Cleveland.

Mr. KUCINICH. I have heard the witnesses talk about the role of the Fed here, and that is what has made this hearing very instructive. Because all of—you know, including Dr. Baker, all talk about the Fed has some role here. You know, there might be some debate about what kind of role, about where it falls in the hierarchy of economic effects on the price of oil. You know, you talked about supply and demand, then the Fed, and then speculation.

Mr. Reinhart, am I right in that? OK.

And we are talking about the Fed's policy since 2008, you know, the role that has had on the price.

But what hasn't been discussed here and what I would like to ask you to consider and maybe just give me some quick response on is the fact that, in 1913, when the Federal Reserve was created, it actually created the transition away from the Article I, Section 8 responsibilities that were constitutionally vested in Article I to Congress for the purpose of coining money or controlling the money supply. That was taken away. You know, the Fed ends up with the responsibility.

So my question to you is, if we see that the variable effect and sometimes the adverse effect which the Fed has in the management of these things, the question becomes, what about having the Fed being put back in the control of the government, as the Founders intended? For example, being put under Treasury.

Would you comment on that? You know, if we are really talking about the Fed as something that we really have very limited control over, what do you think of that?

Mr. REINHART. So, I see the Federal Reserve Act as a delegation of congressional authority given to it in the Constitution to an independent agency, the Federal Reserve. Fundamental to that was the implicit belief that independence would lead to better monetary policy over the long run. Because there are short-run and long-run considerations, something decided in the Congress lends itself to a short-term gain and not enough assessment of the long-term benefit. The idea was giving the Fed independence so it can take account of the longer-run benefits of price stability.

I think the record is not good for the Federal Reserve in taking account of that longer-run responsibility.

Mr. KUCINICH. Dr. Murphy, would you say the record is not good over the long haul here, or what would you say?

Mr. MURPHY. Well, right, I mean, the Fed was created to get rid of the ups and downs, and then after they formed it there was a Great Depression. So, I mean, the Fed has not had a great track record over its history.

As far as your broader question—and I am speaking on my own; this isn't an IER position on monetary policy, obviously—but I don't think the issue is, well, should it be Ben Bernanke right now

making Fed policy or Treasury Secretary Geithner? I don't—you know, I think if you are going to—

Mr. KUCINICH. Well, I mean, there is some question about the structures here of whether or not there is public accountability, responsibility. If you can print, you can use quantitative easing to print an unlimited amount of money and basically, until recently, in a nontransparent way, give it to banks who are too big to fail, they can park their money, gain interest on it, and at the same time you got businesses starving for cash in my area, there are some public policy questions.

Go ahead.

Mr. MURPHY. Well, right. My point was, a lot of people—and I would subscribe to this view—would say that there should be no such entity that can just create a trillion dollars out of thin air and hand it to rich people. That, you don't need to say, well, who should run this organization? There wasn't always a Fed. So, you know, if you are going to start questioning it, just go the full way.

Mr. KUCINICH. Dr. Baker, do you have any comment on that?

Mr. BAKER. Yeah, I mean, the Fed was set up almost a hundred years ago, and I think its structure reflects both the power of the financial sector and also the politics of 1913. I mean, it is sort of striking, we have 12 regional Fed banks and two of them are in Missouri. I don't think anyone would set it up that way today.

The idea that you would give the financial industry, the banking industry, a major, direct say in monetary policy—which the structure of the Fed does. It is not just that they have advice; they basically appoint 12 of the 19 people who sit on the Fed's Open Market Committee, 5 of the voting members—I think that is really hard to justify.

So I think having the entity that controls monetary policy, whether it is the Fed or we give a different name to it, I think having that directly answerable to Congress certainly makes sense. And, you know, again, one could think of how best to structure that.

I, for one, wouldn't say I necessarily want, as much respect as I have for the members of the committee, I don't want the Members of Congress directly setting interest rate policy. But the analogy I would make is to the Food and Drug Administration, that, you know, we expect that they are answerable to Congress.

Mr. KUCINICH. But I would tell you, back home, people have skepticism and businesses have skepticism about letting the Fed pass out, you know, free money to certain interest groups while businesses on Main Street are starving. I mean, you know, that—thanks. My time has run out. Thanks.

Mr. JORDAN. I just have one more question, but then I will give the ranking member another round if he would like.

But in yesterday's Wall Street Journal, Mr. Ronald McKinnon from Stanford University, the Stanford Institute for Economic Policy Research—are you guys familiar with Mr. McKinnon? Yeah. He wrote what I thought was an interesting piece. I actually read it last night. He thinks stagflation is coming, maybe here. And he makes the comment, which I think strongly reinforces what Dr. Murphy and Mr. Reinhart said, "The Federal Reserve is the prime contributor to the current bout with stagflation."

So I would just like your—we will go down the line here, too—your thoughts on the piece Mr. McKinnon had in the Journal yesterday. And do you think that is where we are—this stagflation concept, do you think we are headed back there?

Mr. REINHART. My wife Carmen and I wrote a paper in August for the Fed Reserve-Kansas City's Jackson Hole Symposium called, "After the Fall." And what we documented was, after a severe financial crisis, economies grow more slowly than before for the entire decade—a point and a half slower in the decade after a crisis than before the crisis.

So the real macroeconomy is going to probably be growing only around the rate of growth of its potential. It is going to take a long time for the unemployment rate to come down. In that environment, we are probably in for a spell of subpar economic performance.

Mr. JORDAN. Uh-huh.

Mr. REINHART. To the extent that we also lose the anchor of price stability, then that would be a double dose of problems.

I don't think right now the Fed will—that will necessarily happen. The Fed can be responsible for price stability. I think it could have been more effective in its program of quantitative easing, but I am not quite as pessimistic as Professor McKinnon.

Mr. JORDAN. Well, in Mr. McKinnon's article, he points to the same thing Dr. Murphy mentioned in his testimony, the tripling of the money base. And I don't see it offhand, but he makes some of the same arguments.

Dr. Murphy, your comments on Mr. McKinnon's piece?

Mr. MURPHY. I actually haven't read that particular piece yet. But, yeah, I mean, I have been for a while very concerned about stagflation, that the policies, both the Federal Reserve and Federal Government policies, the last few years would slow real economic growth and also add inflationary fuel.

One thing I should have said before about speculators, if I could just say one thing very briefly, is, I just want to remind people that it can go both ways. For example, when President Bush, back in I think it was July 2008, announced that he was going to end the executive branch's moratorium on offshore drilling, apparently oil prices dropped \$9 during the speech itself. OK?

Mr. JORDAN. Yeah.

Mr. MURPHY. So that is what I mean, that when people think that there are future events that are going to affect the supply of oil, that can drive prices.

Mr. JORDAN. And if the Congress of the United States would pass legislation saying we are going to expand dramatically drilling and exploration and get the resources out there, most likely that would have an impact on the price of oil, not in the 8 to 10 years that people say it takes to get the product to market, but when it is actually done, when the bill is passed.

Mr. MURPHY. Right. And the way that happens, it is not that there is a time machine, it is that—if U.S. policymakers expedite and give the green light so people think that U.S. production is going to be higher in the future—

Mr. JORDAN. It sends a message.

Mr. MURPHY [continuing]. Right, then current producers with access capacity, like Saudi Arabia, they increase current output.

Mr. JORDAN. Just like if we would actually cut spending and cap spending and send a message to the market, that might actually help maybe PIMCO get back in the Treasury market and Standard & Poor's change their outlook, right?

Mr. MURPHY. Right. So, yeah.

Mr. JORDAN. It sends a message. I mean, it is of critical importance. Thank you, Dr. Murphy.

Mr. Baker, we have to get back to my first question, Mr. McKinnon's analysis.

Mr. BAKER. Yeah, I have to say, I haven't read the piece. But I have to say, I am not very concerned about the prospect of the inflation side of the stagflation. I mean, if you look at the inflation data, it almost all shows very low inflation. And in terms of market expectations, we actually know that because we have futures, we have inflation-indexed Treasury bonds. And those suggest that the markets are anticipating 1½ to 2 percent inflation well into the future.

So I am not concerned on the inflation part. I am very concerned about bad policy giving us slow growth. And in the short term, I don't see any alternative to the deficits boosting the economy, because the private sector is not about—I certainly don't see any evidence—

Mr. JORDAN. Mr. Baker, let me ask you a question. If big government spending were going to get us out of this mess, don't you think we would have been out of it a while ago? In light of the fact that, for the last 3 years, that is all the Congress, all the administration has done—more spending, more spending, almost 25 percent of GDP, record levels, haven't been there since World War II, quantitative easing policy, the tripling of the Fed's balance sheet—don't you think it would have done a little better job than it has, if that was the answer?

Mr. BAKER. Well, I think it has done a job. I think that, if you look at the size of the—

Mr. JORDAN. Yeah, the job it has done is that we still have 8 percent unemployment in Ohio.

Mr. BAKER. And I think it would probably be 10 or 11 without those actions.

Mr. JORDAN. It was.

Mr. BAKER. Well, it would still be, absent those actions.

We lost on the order of \$1.2 trillion in annual demand with the collapse of the housing bubble, between construction and the lost consumption due to the disappearance of equity, home equity. So that is what we are trying to counter with that.

The other part of the story, of course, when you look at trying to rebalance the economy, the only way I see to do that in the long term is with net exports, which involves a falling dollar. I don't know any other way to do that.

Mr. JORDAN. I ran over my time three times in a row.

Mr. Ranking Member, this will be the last round, but you can take as long as you need.

Mr. KUCINICH. I want to—

Mr. JORDAN. Can I interject?

Mr. KUCINICH. No, go ahead.

Mr. JORDAN. I need to enter the Committee on Oversight and Government Reform report, the majority report, for the record. Thank you.

[The information referred to follows:]

**U.S. House of Representatives**  
**Committee on Oversight and Government Reform**  
Darrell Issa (CA-49), Chairman



**RISING ENERGY COSTS:  
AN INTENTIONAL RESULT OF GOVERNMENT ACTION**

STAFF REPORT  
U.S. HOUSE OF REPRESENTATIVES  
112<sup>TH</sup> CONGRESS  
MAY 23, 2011

**Findings**

1. Key Obama Administration figures have expressed a belief that Americans should pay more for energy – a pattern of actions shows the Administration is, in fact, pursuing an agenda to raise the price Americans pay for energy.

*President Obama, Energy Secretary Chu and others have stated that American consumers should pay more for energy, including electricity and gasoline. From a political perspective, increasing the price of energy (by whatever means) helps them make the case for “green” energy. Even beyond the effort to raise energy prices through “cap and trade” legislation that Congress rejected, a pattern of increased enforcement, regulatory delay and new hurdles can be seen across numerous agencies and approval processes. The result of this government action is less production, higher costs for producers, and more expensive energy.*

2. While the Administration touts nascent “green” energy technologies, U.S. domestic energy resources are currently the largest on earth—greater than Saudi Arabia, China and Canada combined.

*New developments in drilling and extraction technology have dramatically expanded the amount of total recoverable reserves of oil and natural gas. Much of this, however, may be put off-limits by the government.*

3. Still trying to capitalize on domestic energy resources, U.S. firms are nevertheless investing billions of dollars to tap newly recoverable resources in California, Texas, Colorado and North Dakota, among others.

*By 2015, fields in these areas could yield more daily oil than the Gulf of Mexico produces today, boosting domestic production by 20-40 percent and increasing our energy independence if government action does not severely restrict development and yields.*

4. Recent Administration action has already led to significant cost and regulatory barriers that have limited domestic production of oil.

*Even before the Gulf oil spill, the Department of the Interior had undertaken significant steps to restrict access to much of the energy resources located in the outer continental shelf: Alaska, the Gulf of Mexico, and along the Atlantic and Pacific coasts.*

5. Other agencies have stepped up their efforts to indirectly curtail energy production through environmental regulations.

*The U.S. Fish and Wildlife Service has proposed placing the dunes sagebrush lizard that lives in New Mexico and Texas on the Endangered Species list—designation that would severely restrict production activity in a resource-rich part of Texas.*

6. EPA has collaborated with environmental groups to target independent energy producers for environmental concerns not related to their operations.

*In an email message reviewed by the Committee, environmental advocates and EPA's Texas-based regional director exchanged celebratory accolades for efforts that create barriers to energy production. One exchange concluded: "Yee haw! Hats off to the new Sheriff and his deputies!"*

7. President Obama's proposal to increase taxes on the energy industry will cost American jobs and hamper economic recovery.

*Independent operators are responsible for 95 percent of domestic oil and gas wells and they currently invest 150% of their domestic cash flow back into future projects development. Tax increases proposed by President Obama, some of which would be transferred to "green" energy producers, would cost energy producing firms a combined \$12 billion in the first year.*

8. Some green energy sources the Administration is promoting at the expense of expanded domestic oil, gas, and coal supplies create unintended environmental, security and economic consequences.

*Green energy technology like batteries, turbines, hybrid power systems and similar technologies require "rare earth" commodities. China has a "near monopoly" on this market controlling between 95-100 percent of the market. Further, China derives 71 percent of its own energy needs from coal. Ethanol, for example, also requires large amounts of corn to deliver fuel. "[T]he entire U.S. corn crop would supply only 3.7 percent of our auto and truck transport needs while using 300 million acres of U.S. cropland."*

## INTRODUCTION

In his 2010 State of the Union address, President Obama declared, “the nation that leads the clean energy economy will be the nation that leads the global economy... America must be that nation.”<sup>1</sup> Yet today, more than 80% of the United States’ primary energy comes from carbon-based resources that cannot easily, cheaply, or quickly be replaced.<sup>2</sup> Even so, the Administration is aggressively suppressing the use of carbon-based energy sources in the United States. To do so, it is pursuing a broad array of measures to block carbon-based energy extraction, to tax, and to otherwise increase the costs of its use, and to subsidize wherever possible the development and use of so-called “clean energy.” The economic and geopolitical implications of such a policy, if it is successful, are not good for the United States. It will make the United States poorer and more susceptible to the pressures of countries that now control a large share of the world’s oil—countries, which for the most part, do not share America’s goals or ideals.

The Obama Administration has advanced an agenda that discourages development of domestic carbon-based energy resources. Administration actions include the threat of new federal regulation of hydraulic fracturing, withdrawal of federal lands, both on and offshore, from energy production, increasingly burdensome requirements for oil shale research and development leases, and a de facto moratorium on drilling permits. This strategy has added to permitting delays, created additional layers of review, and prolonged study periods. In addition, other laws such as the Endangered Species Act and the Clean Air Act have been used to further suppress domestic oil and gas production, leading to higher gasoline prices and growing dependence on foreign oil. The Administration has also proposed a series of discriminatory tax increases targeting oil and gas producers in order to subsidize its favorite industry: so-called “clean energy” (primarily wind and solar).

The Administration’s bias against carbon-based fuels should come as no surprise. The President ran on an agenda that anticipated higher energy costs:

Under my plan of a cap-and-trade system, electricity rates would necessarily skyrocket. ... Coal-powered plants, you know, natural gas, you name it, whatever the plants were, whatever the industry was, they would have to retrofit their operations. That will cost money.<sup>3</sup>

Some of his key cabinet officials have expressed similar views. Prior to his confirmation as Secretary of Energy, Steven Chu, then director of the Department of Energy’s Lawrence Berkeley National Lab, advocated raising gas taxes--and therefore prices--to encourage the sale

<sup>1</sup> President Barack Obama, Remarks by the President in the State of the Union Address (Jan. 27, 2010) *available at* <http://www.whitehouse.gov/the-press-office/remarks-president-state-union-address>.

<sup>2</sup> Energy Information Administration, *Energy in Brief*, “What are the major sources and users of energy in the United States?” (Updated: Oct. 28, 2010) *available at* [http://www.eia.doe.gov/energy\\_in\\_brief/major\\_energy\\_sources\\_and\\_users.cfm](http://www.eia.doe.gov/energy_in_brief/major_energy_sources_and_users.cfm)

<sup>3</sup> Deroy Murdock, *Obama Declares War on Coal*, NAT’L REVIEW (Nov. 3, 2008) Original source: audio/video of Obama’s appearance before the San Francisco Chronicle’s editorial board in Jan. 2008.

of more-efficient cars: “[s]omehow we have to figure out how to boost the price of gasoline to the levels in Europe.”<sup>4</sup>

This report will examine specific Obama Administration policies targeting oil and gas production from both a regional and national perspective. Additionally, it will take a close look at the regional and local impacts of the growing web of laws, regulations, policies and tactics aimed at suppressing the development and production of domestic, carbon-based energy reserves that the President has labeled “yesterday’s energy.”<sup>5</sup>

#### **President Obama’s policy bias against fossil fuels**

The Obama Administration is promoting a clean energy agenda at the expense of domestic oil and gas production. Administration officials, including the President, have publicly stated that increasing domestic oil and gas production is important to stabilize gasoline prices. However, a review of their actions reveals a systemic effort to prevent, obstruct, stall, and discourage development of carbon-based resources. This strategy is articulated by Secretary Geithner and is observable in actions by Administrator Jackson and Secretary Salazar. Unfortunately for Americans struggling with higher gas prices, Administration rhetoric will provide no relief. However, the Administration’s actions can inflict more pain.

In March 2009, Treasury Secretary Timothy Geithner explained to Senator John Cornyn (R-Texas) that the Obama Administration planned to increase taxes on domestic oil and gas producers even though this policy will decrease domestic oil production and increase America’s dependence on foreign oil and gas:

Senator, as you know, and I think it’s clear in the proposal, we don’t believe it makes sense to significantly subsidize the production and use of sources of energy that are dramatically going to add to our climate change imperative.

... But as I said, the overall objective is not to be providing ongoing subsidies to forms of energy production that are going to add to this critical long-term imperative of climate change.  
(emphasis added)

...And I think this is a reasonable policy, given the overall objective of again making sure we’re not providing artificial

<sup>4</sup> Neil King Jr. and Stephen Power, *Times Tough for Energy Overhaul*, WALL STREET J. (Dec. 12, 2008), available at <http://online.wsj.com/article/SB122904040307499791.html>.

<sup>5</sup> President Barack Obama, Remarks by the President in the State of the Union Address (Jan. 25, 2011), available at <http://www.whitehouse.gov/the-press-office/2011/01/25/remarks-president-state-union-address>.

incentives, to produce and use energy that's going to make our broader climate-change imperatives worse.<sup>6</sup> (emphasis added)

Translation: in order to achieve the President's vision of a carbon free economy, the production and development of fossil fuels would be punished.

#### **Phase One: Cap-and-Trade**

Since his first day in office President Obama has worked to advance his "green energy agenda." This agenda was originally manifested in the President's cap-and-trade scheme, which was summarily rejected by Congress. Cap-and-trade legislation, "a combination of energy taxes and carbon controls"<sup>7</sup> failed to garner enough support to pass both houses of Congress. "Realistically, the cap-and-trade bills in the House and the Senate are going nowhere," said Senator Lindsey Graham (R-SC), who was trying to fashion a bipartisan package of climate and energy measures. "They're not business-friendly enough, and they don't lead to meaningful energy independence. . . . What is dead is some massive cap-and-trade system that regulates carbon in a fashion that drives up energy costs."<sup>8</sup> Some view the massive failure of cap-and-trade as the impetus for the President's renewed focus on clean energy: "cap and trade by another name."<sup>9</sup> Failing to pass cap-and-trade, the Administration turned to regulation to do what it couldn't via Congress. Namely, EPA issued the controversial endangerment finding for CO<sub>2</sub> and other greenhouse gases (GHGs). This finding put in motion the onerous mechanisms of the Clean Air Act which imposes enormous costs on consumers of carbon-based fuel.

Before EPA issued the Endangerment Finding for Greenhouse Gases under the Clean Air Act (CAA), the White House and the agency had been warned by economists, legislators, and their own advisors that the GHG regulations would impose a high cost on the economy via higher energy prices and increased uncertainty. Former Energy and Commerce Chairman Dingell famously stated in April 2008 that regulating GHGs under the CAA would result in a "glorious mess"<sup>10</sup> that would wreak havoc on the economy. In March 2009, then-Ranking Member Issa warned EPA that, . . . the immediate result of issuing an endangerment finding is that thousands of American small businesses, already struggling in one of the toughest economic [climates] our generation has ever seen, will be thrown into a sea of legal uncertainty, further depressing their ability to stay viable.<sup>11</sup> Bottom line: the Administration knew that the implementation of EPA's GHG regulations would have a large economic impact. During consideration of cap-and-trade legislation, a top White House economic official warned that, "if you don't pass this [cap-and-trade] legislation then. . . the EPA is going to have to regulate in this area. And it is not going to

<sup>6</sup> *The President's Fiscal Year 2010 Budget Proposal, Part One: Hearing Before S. Comm. on Finance*, 111<sup>th</sup> Cong. (2009).

<sup>7</sup> Iain Murray and William Yeatman, *Cap and Trade*, NAT'L REVIEW ONLINE, March 12, 2010.

<sup>8</sup> John M. Broder and Clifford Krauss, *Advocates of Climate Bills Scale Down Their Goals*, NEW YORK TIMES, Jan. 26, 2010.

<sup>9</sup> Kimberley A. Strassel, *Cap and Trade Returns from the Grave*, WALL STREET J. ONLINE, Jan. 28, 2011, available at [http://online.wsj.com/article\\_email/SB10001424052748703893104576108501552298070-lMyQjAxMTAxMDIwODEyNDgyWj.html](http://online.wsj.com/article_email/SB10001424052748703893104576108501552298070-lMyQjAxMTAxMDIwODEyNDgyWj.html).

<sup>10</sup> *A Glorious Mess*, WALL STREET J. (Apr. 12, 2008).

<sup>11</sup> Letter from the Hon. Darrell E. Issa, Ranking Member, Oversight Committee to the Hon. Lisa P. Jackson, Administrator, U.S. EPA (Jan. 13, 2010).

be able to regulate in a market-based way, so it's going to have to regulate in a command-and-control way, which will probably generate even more uncertainty."<sup>12</sup>

### **Phase Two: Promote “New Energy;” Discourage “Yesterday’s Energy”**

The Administration remains steadfast in its efforts to force a shift from oil and gas to so-called “clean energy.” In its recent report on energy policy,<sup>13</sup> the Administration pays lip service to the proposition that America needs to expand domestic oil and gas production, but offers no serious plan to accomplish the expansion. Instead, it promotes “clean energy” policies that would decrease domestic oil and gas production, ignoring the evidence that such policies would contribute to higher gasoline prices and increase America’s dependence on foreign oil, as well as contribute to the further loss of American jobs. In his 2011 State of the Union address, the President stated “none of us can predict with certainty what the next big industry will be or where the new jobs will come from,” yet only a few moments later he predicted that the next big industry will be clean energy: “. . . clean energy breakthroughs will only translate into clean energy jobs if businesses know there will be a market for what they’re selling. So tonight, I challenge you to join me in setting a new goal: By 2035, 80 percent of America’s electricity will come from clean energy sources.”<sup>14</sup>

The President’s push for clean energy tomorrow comes at the expense of affordable energy today. The United States has an abundance of carbon-based fuels; yet, restricted use will artificially and unnecessarily raise the cost of energy for U.S. consumers. America’s combined energy resources are the largest on earth. They eclipse Saudi Arabia (3rd), China (4th) and Canada (6th) combined – and that’s without including America’s shale oil deposits.<sup>15</sup> U.S. proven reserves of oil total 19.1 billion barrels, reserves of natural gas total 244.7 trillion cubic feet, and natural gas liquids reserves of 9.3 billion barrels.<sup>16</sup> “That’s enough oil to maintain America’s current rates of production and replace imports from the Persian Gulf for more than 50 years.”<sup>17</sup> Undiscovered technically recoverable oil in the United States is 145.5 billion barrels, and undiscovered technically recoverable natural gas is 1,162.7 trillion cubic feet.<sup>18</sup>

### **Alternative Energy: Is it Really Green?**

Converting from a carbon-based economy towards “greener” energy would be costly in more ways than one. “In its headlong rush to go ‘green,’ the United States may simply be trading reliance on one type of import for reliance on another.”<sup>19</sup> To convert to clean energy the United

<sup>12</sup> Jonah Goldberg, *Dirty Moves Behind Pitch for Cleaner Air*, BOSTON HERALD (Dec. 13, 2009).

<sup>13</sup> *Blueprint for a Secure Energy Future* (Mar. 30, 2011), available at [http://www.whitehouse.gov/sites/default/files/blueprint\\_secure\\_energy\\_future.pdf](http://www.whitehouse.gov/sites/default/files/blueprint_secure_energy_future.pdf).

<sup>14</sup> President Barack Obama, Remarks by the President in the State of the Union Address (Jan. 25, 2011) available at <http://www.whitehouse.gov/the-press-office/2011/01/25/remarks-president-state-union-address>.

<sup>15</sup> Peter C. Glover, *U.S. Has Earth’s Largest Energy Resources*, ENERGY TRIBUNE (Mar. 24, 2011), available at <http://www.energytribune.com/articles.cfm/6933/US-Has-Earths-Largest-Energy-Resources>.

<sup>16</sup> Gene Whitney, et al., *U.S. Fossil Fuel Resources: Terminology, Reporting, and Summary*, CRS REPORT TO CONGRESS, Nov. 30, 2010.

<sup>17</sup> Press Release, U.S. Senate Committee on Environment and Public Works, *Government Report: America’s Combined Energy Resources Largest on Earth* (Mar. 11, 2011).

<sup>18</sup> *Id.*

<sup>19</sup> Robert Bryce, *POWER HUNGRY* (Public Affairs) (2010).

States “will need rare earth commodities produced by the Chinese as well as lithium mined by a handful of foreign countries.”<sup>20</sup> China has a near-monopoly on rare earths, controlling between 95-100 percent of the elements essential to most clean energy technologies including wind turbines, hybrid cars, solar panels, computers, and batteries.<sup>21</sup> Instead of importing foreign oil from multiple countries, adopting clean energy technologies would require the United States to become reliant on the Chinese to provide these essential elements.

Besides all the other problems with becoming dependent on China for the sole supply of rare earth elements necessary to increase America’s use of so-called clean energy, increasing the demand for these elements would only add to China’s coal and oil consumption. China is the world’s second largest energy consumer. Coal supplied the vast majority (71 percent) of China’s total energy consumption of 85 quadrillion British thermal units (Btu) in 2008. Oil is the second-largest source, accounting for 19 percent of the country’s total energy consumption. While China has made an effort to diversify its energy supplies, new sources of renewable energy account for only 4.2 percent of China’s energy consumption.<sup>22</sup> EIA estimates that China’s absolute coal consumption should nearly double to 112 quadrillion Btu by 2020.<sup>23</sup> The logic of using more carbon-based fuels in China to create more clean energy in the United States is flawed. CO<sub>2</sub> is highly diffuse in the atmosphere such that emissions in China impact the United States as much as emissions originating in California. It is also a fallacy that a conversion to clean energy would create new jobs in the United States. In addition to the jobs that will be lost in the oil and gas production industry to subsidize the Obama Administration’s conversion to so-called clean energy, “China’s near-monopoly control of the green elements likely means that more of the new manufacturing jobs related to “green” energy products will be created in China, not the United States.”<sup>24</sup>

In addition to solar and wind, biofuels intended to reduce or replace U.S. gasoline consumption are already costing taxpayers and are not a long-term practical solution<sup>25</sup> for replacing carbon-based fuels. Total agriculture-based biofuels production accounted for only about 5% of total U.S. transportation fuel consumption (on a gasoline-equivalent basis) in 2010. Federal biofuels policies have had costs, including unintended market and environmental consequences and large federal outlays (estimated at over \$7 billion in 2010).<sup>26</sup> In a 2010 study, the Congressional Budget Office estimated “taxpayers incur a cost of \$1.78 for replacing 125,000 Btus of energy supplied by petroleum fuels with 125,000 Btus supplied by ethanol.”<sup>27</sup> This year, the corn-ethanol sector will produce about 13.8 billion gallons of ethanol, the energy equivalent of about 9.1 billion gallons of gasoline . . . the domestic-drilling sector provides about

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<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> Energy Information Administration, Country Analysis Briefs: China (Nov. 2010), available at <http://www.eia.doe.gov/EMEU/cabs/China/pdf>.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> James Jordan and James Powell, *The False Hope of Biofuels*, WASHINGTON POST, July 2, 2006.

<sup>26</sup> Randy Schnepf, *Agriculture-Based Biofuels: Overviews and Emerging Issues*, CRS REPORT FOR CONGRESS,

Jan. 11, 2011.

<sup>27</sup> USING BIOFUEL TAX CREDITS TO ACHIEVE ENERGY AND ENVIRONMENTAL POLICY GOALS, A CBO Study (July 2010)

36 times as much energy to the U.S. economy.<sup>28</sup> Thus the entire U.S. corn crop would supply only 3.7 percent of our auto and truck transport demands. Using the entire 300 million acres of U.S. cropland for corn-based ethanol production would meet only about 15 percent of the demand.<sup>29</sup> Tim Searchinger, a research scholar at Princeton University's Woodrow Wilson School, says that biofuels don't make much sense because it "takes a huge amount of land to produce a modest amount of energy." The key issue, says Searchinger, is scale. He points out that even if we used "every piece of wood on the planet, every piece of grass eaten by livestock, and all food crops, that much biomass could only provide about 30 percent of the world's total energy needs."<sup>30</sup>

Regardless, the Obama Administration continues to emphasize unaffordable clean energy policies at the expense of domestic carbon-based resources. A recent post on the White House blog summarizes the President's position.<sup>31</sup> The post and the accompanying graphic<sup>32</sup> demonstrate that the Obama Administration's true position with domestic oil and gas production is to increase that industry's taxes in order to provide subsidies for clean energy including electric cars and public transportation.<sup>33</sup>

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<sup>28</sup> Robert Bryce, *Obama's Happy Talk on Energy*, NATL. REVIEW (May 10, 2011).

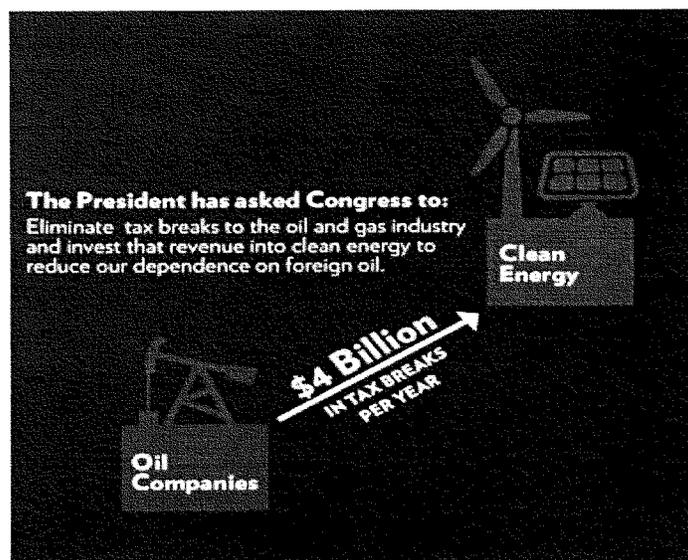
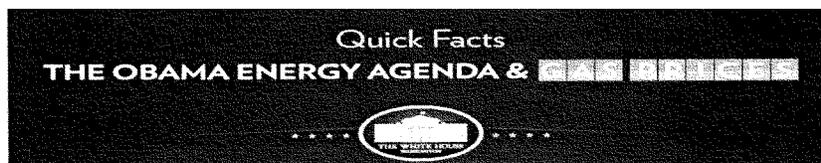
<sup>29</sup> *Id.*

<sup>30</sup> Robert Bryce, *Biofuel Delusions*, COUNTERPUNCH (Dec. 31, 2010).

<sup>31</sup> The President on Jobs & Gas Prices, White House blog (May 6, 2011) *available at* <http://www.whitehouse.gov/blog/2011/05/06/president-jobs-gas-prices-read-his-remarks-download-graphic>.

<sup>32</sup> [http://www.whitehouse.gov/sites/default/files/gas\\_graphic\\_blogsized.jpg](http://www.whitehouse.gov/sites/default/files/gas_graphic_blogsized.jpg)

<sup>33</sup> The White House blogger encouraged everyone to "check it out below, or download it, print it, send it to your family, or hang it on your wall to add a splash of color."



Source: The President on Jobs & Gas Prices, White House blog (May 6, 2011) available at <http://www.whitehouse.gov/blog/2011/05/06/president-jobs-gas-prices-read-his-remarks-download-graphic>.

#### **Punitive Tax Increases**

The Obama Administration wants to tax American oil and gas production to subsidize its clean energy agenda. Higher taxes will disproportionately and negatively impact American job creators in the independent oil and gas production market. Over the long run it will decrease domestic production and make the United States more vulnerable to world events.

In its FY2012 budget, the Obama Administration requests over \$60 billion in direct tax and fee increases (over ten years) on American energy production. Some of the most substantial energy tax and fee proposals in the President's FY 2012 budget include:<sup>34</sup>

- Repeal Domestic Manufacturing Tax Deduction for oil and natural gas (\$18.2 billion)
- Repeal expensing for intangible drilling costs (\$12.4 billion)
- Repeal percentage depletion for oil and natural gas wells (\$11.2 billion)
- Repeal percentage depletion tax on oil, gas and mineral properties (\$4.9 billion for corporations, \$890 million for individuals)

The Administration plans to use these tax increases to subsidize and promote the electric vehicle industry and other clean energy projects. Jack Lew, director of the Office of Management and Budget, describes the Obama Administration's philosophy behind the tax increases requested in the FY2012 budget:

To invest in the industries and jobs of tomorrow, we invest \$148 billion overall in research and development. And this supports our goal of putting a million electric vehicles on the road by 2015, doubling our share of electricity from clean energy by 2035, and reducing energy use in buildings by 20 percent by 2020.

In part, we pay for this by eliminating 12 tax breaks that now go to oil, gas and coal companies, which will raise \$46 billion over 10 years.<sup>35</sup> (emphasis added)

The Administration characterizes the deductions and credits slated for elimination as "tax preferences," or "oil and gas subsidies" that are costly to U.S. taxpayers and do little to either provide incentives for increased production or reduce prices to consumers.<sup>36</sup> The President refers to them as "special" and "unwarranted"<sup>37</sup> "giveaways."<sup>38</sup> This characterization is inaccurate: the vast majority of these deductions and credits are widely available to all manufacturers. For example, the President's proposal to eliminate the expensing of intangible drilling costs would single out the oil and gas industry for discriminatory tax treatment. Intangible drilling costs

<sup>34</sup> Press Release, U.S. House of Representatives, Committee on Natural Resources, *Budget Watch* (Feb. 14, 2011), available at <http://naturalresources.house.gov/News/DocumentSingle.aspx?DocumentID=225077>.

<sup>35</sup> Jack Lew, Office of Management and Budget, White House Press Briefing, (Feb. 14, 2011) available at <http://www.whitehouse.gov/the-press-office/2011/02/14/press-briefing-omb-director-jack-lew-and-cea-chairman-austan-goolsbee-bu>.

<sup>36</sup> FY2012 federal budget request, Terminations, Reductions, and Savings, Dept. of Energy, p. 52.

<sup>37</sup> Letter from President Barack Obama to Rep. John Boehner, Rep. Nancy Pelosi, Senator Harry Reid, and Senator Mitch McConnell (April 26, 2011) (on file with author).

<sup>38</sup> Press Release, White House, Weekly Address, *Taxpayer Subsidies for Oil Companies are Neither Right, nor Smart, and They Should End* (Apr. 30, 2011), available at <http://www.whitehouse.gov/the-press-office/2011/04/30/weekly-address-taxpayer-subsidies-oil-companies-are-neither-right-nor-sm>.

(IDCs) are non-salvageable items that can be expensed in the year that they were incurred.<sup>39</sup> This tax treatment applies equally to shoe salesman as it applies to the oil and gas industry. For example, if a shoe salesman buys a shoe for \$10 and sells it for \$20, he doesn't depreciate the shoe over 7 years, he expenses it. Similarly, there are a host of temporary, non-salvageable items called IDCs that some oil and gas companies can expense such as drilling services, mud, cement, testing services, things that are done before a well is completed and producing any oil or gas.<sup>40</sup>

Moreover, the oil and gas industry receives \$2.8 billion in targeted tax incentives, less than 3 percent of all incentives, and far less than its smaller rivals in energy production, the renewable energy sector which receives \$11.3 billion.<sup>41</sup> The non-profit Tax Foundation questions why the Administration is penalizing the oil and gas industry by attempting to repeal tax deductions that are widely available to many other manufacturing sectors and warns that other manufacturing sectors may soon be penalized as well if they fall out of favor with the Administration:

Why, suddenly, should companies that produce t-shirts, hamburgers, toys, software, or rap music be qualified to receive the tax benefit but oil companies should not be? According to the explanation in Treasury's Green Book, environmental politics account for this distortion of sound tax and economic policy. The President promised during the G-20 Summit in Pittsburgh, to "phase out subsidies for fossil fuels so that the United States can transition to a 21st century energy economy."<sup>42</sup> (emphasis added)

Former Democratic Congressman Harold Ford, Jr., also questions the need for tax increases and why the Administration wrongly labels tax credits as subsidies:

Why, when gas prices are climbing, would any elected official call for new taxes on energy? And characterizing legitimate tax credits as "subsidies" or "loopholes" only distracts from substantive treatment of these issues. Lawmakers misrepresent the facts when they call the manufacturing deduction known as Section 199—passed by Congress in 2004 to spur domestic job growth—a "subsidy" for oil and gas firms. The truth is that all U.S. manufacturers, from software producers to filmmakers and coffee roasters, are eligible for this deduction.<sup>43</sup>(emphasis added)

<sup>39</sup> *Pathways to Energy Independence: Hydraulic Fracturing and Other New Technologies: Field Hearing before H. Comm. on Oversight and Government Reform*, 112<sup>th</sup> Cong. (2011) (statement of Rock Zierman, CEO, California Independent Petroleum Association, available at [http://oversight.house.gov/images/stories/Testimony/5-6-11\\_Zierman\\_Testimony.pdf](http://oversight.house.gov/images/stories/Testimony/5-6-11_Zierman_Testimony.pdf)).

<sup>40</sup> *Id.*

<sup>41</sup> Sean A. Hodge, *Putting Corporate Tax "Loopholes" in Perspective*, TAX FOUNDATION SPECIAL REPORT (Aug. 2010) (No. 184).

<sup>42</sup> *Id.*

<sup>43</sup> Harold Ford, Jr., *Washington vs. Energy Security*, WALL STREET J., May 11, 2011.

Many of these proposed tax changes, including repealing the expensing of intangible drilling costs, have the effect of removing incentives available only to non-integrated companies (also referred to as “independents”).<sup>44</sup> Independent oil producers—those who get oil and natural gas out of the ground and do not refine, transport, market, or have retail sales of petroleum products—develop 95 percent of domestic oil and gas wells.<sup>45</sup> Independents produce 68 percent of domestic oil and produce 82 percent of domestic natural gas.<sup>46</sup> While integrated companies (i.e. Chevron, Shell, BP) with vastly more capital may survive these tax increases in the short run, the independents will essentially be killed<sup>47</sup> and good jobs will be lost.

For those lucky enough to survive, eliminating tax credits and deductions for independents will certainly decrease capital investment and thus domestic exploration and production. Independents currently invest 150% of their domestic cash flow back into development.<sup>48</sup> In 2010, upstream independents are estimated to have spent \$62.6 billion on capital expenditures (capex).<sup>49</sup> This translates to the creation of six direct and 33 total upstream jobs for every \$1 million dollars of capex. In value added terms, every \$1 million dollars of capital expenditure results in \$2.4 million of direct and \$5.1 million of overall contribution to GDP.<sup>50</sup> In terms of taxes, every \$1 million dollars of capex results in \$1.1 million of total tax revenue generated in the upstream sector.<sup>51</sup> According to Rock Zierman of California Independent Petroleum Producers, “only independent producers can fully expense IDC on American production. Therefore, if you eliminate IDC expensing, there would be less capital available in the current year to reinvest in new drilling operations. This equals less production, period.”<sup>52</sup> Even though the entire domestic natural gas and oil sector claimed only \$2 billion in deductions in 2010, independent producers could lose as much as \$12 billion in the first year after this deduction was repealed.<sup>53</sup> Devon Energy, an independent producer in Oklahoma, estimates that eliminating IDC expensing could cost it \$1 billion in the first year. “That would equate to our complete drilling program in the Barnett Shale. . . . That looks to us like it’s a totally wrongheaded policy that would penalize companies that are most efficient at producing resources that power the nation.”<sup>54</sup> Higher taxes equal less investment and more dependence on

<sup>44</sup> Robert Pirog, CONGRESSIONAL RESEARCH SERVICE, OIL AND NATURAL GAS INDUSTRY TAX ISSUES IN THE FY2012 BUDGET PROPOSAL (Mar. 3, 2011).

<sup>45</sup> Independent Petroleum Association of America, *Fact Sheet: Increasing Taxes on America’s Independent Natural Gas and Oil* (2011), available at [http://www.ipaa.org/news/docs/Tax\\_Issue\\_Talking\\_Points\\_02-2011.pdf](http://www.ipaa.org/news/docs/Tax_Issue_Talking_Points_02-2011.pdf).

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> IHS GLOBAL INSIGHT (USA) INC., THE ECONOMIC CONTRIBUTION OF THE ONSHORE INDEPENDENT OIL AND NATURAL GAS PRODUCERS TO THE U.S. ECONOMY (April 2011), available at <http://www.ipaa.org/news/docs/IHSFinalReport.pdf>.

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Pathways to Energy Independence: Hydraulic Fracturing and Other New Technologies: Field Hearing before H. Comm. on Oversight and Government Reform*, 112<sup>th</sup> Cong. (2011) (statement of Rock Zierman, Chief Executive Officer, California Independent Petroleum Association), available at [http://oversight.house.gov/images/stories/Testimony/5-6-11\\_Zierman\\_Testimony.pdf](http://oversight.house.gov/images/stories/Testimony/5-6-11_Zierman_Testimony.pdf).

<sup>53</sup> Telephone Interview with Chip Minty, Devon Energy (May 11, 2011).

<sup>54</sup> *Pathways to Energy Independence: Hydraulic Fracturing and Other New Technologies: Field Hearing before H. Comm. on Oversight and Government Reform*, 112<sup>th</sup> Cong. (2011) (statement of William A. Whitsitt, Executive Vice President, Devon Energy), available at [http://oversight.house.gov/images/stories/Testimony/5-6-11\\_Whitsitt\\_Testimony\\_FINAL.pdf](http://oversight.house.gov/images/stories/Testimony/5-6-11_Whitsitt_Testimony_FINAL.pdf)

foreign sources of oil. Less capital investment will lead to more dependence on foreign oil.

Repealing these tax credits and deductions will not only decrease capital investment and domestic exploration and production, but it will also eliminate good-paying jobs. The exploration and production portion of the industry employs about 500,000 workers at a wage rate over 50 percent higher than the average of all manufacturing.<sup>55</sup> With unemployment rising to 9% in April 2011,<sup>56</sup> America needs to create more jobs, not eliminate existing jobs by increasing taxes to subsidize clean energy technologies that are not capable of filling the void:

Annually raising taxes on the industry by billions of dollars would reduce investment in American oil and natural gas development, cost thousands of U.S. jobs, and, over time, reduce both energy production and the taxes and royalties generated from it. It would also increase imports. We wouldn't reduce the deficit, and necessary government investments could be adversely affected. Those advocating tax increases, therefore, would be cutting off their nose to spite their face. Those who want more revenue should work to increase access to available U.S. oil and natural gas reserves, which have a long-term government revenue potential approaching \$2 trillion. That could reduce the deficit and help finance critical government programs without raising energy costs and reducing supplies.<sup>57</sup>

While removal of these tax credits and deductions may be appropriate in conjunction with broad-based tax reform that reduces net tax rates, eliminates unnecessary burdens on job creators, and simplifies tax compliance, simply removing these provisions without tax relief elsewhere would have the effect of discouraging oil and gas exploration and development even more. Far from seeking tax code simplification, or even additional revenues to reduce our deficits, the Administration is quite openly seeking ways of paying for the subsidies it would like to provide to "green energy" while at the same time making carbon-based energy more expensive.

Unfair tax treatment is just one piece of evidence in a two-year pattern of Administration policies that discriminate against oil and gas development in the United States. This discrimination hurts not only the energy independence of the country but local economies across the nation. The remainder of this report will provide examples of some of those policies in each of five geographic regions most likely to feel the repercussions: Appalachia, the Rocky Mountains, the Gulf, Alaska, and Texas.

<sup>55</sup> Independent Petroleum Association of America, *Fact Sheet: Increasing Taxes on America's Independent Natural Gas and Oil* (2011), available at [http://www.ipaa.org/news/docs/Tax\\_Issue\\_Talking\\_Points\\_02-2011.pdf](http://www.ipaa.org/news/docs/Tax_Issue_Talking_Points_02-2011.pdf).

<sup>56</sup> BUREAU OF LABOR STATISTICS, EMPLOYMENT SITUATION SUMMARY (May 6, 2011).

<sup>57</sup> Press Release, American Petroleum Institute, *Joint Committee study ignores harm of raising taxes* (May 13, 2011), available at <http://www.api.org/Newsroom/jcomm-ignores-harm.cfm>.

### I. APPALACHIAN REGION

The shale gas reserves of Appalachia are a game changer for the future of American energy security. The United States has 2,552 trillion cubic feet (TCf) of potential natural gas resources, enough to last 110 years at current usage rates. Almost one-third of these resources are from shale gas -- considered uneconomical to extract until just a few years ago.<sup>58</sup> Newly recoverable shale reserves, both oil and gas, have revitalized the oil and gas industry in Appalachia and across the United States -- from North Dakota to south Texas to California. The Marcellus Shale formation lies below many of the Appalachian states and extends up to New York. In 2002, the U.S. Geological Survey estimated the Marcellus held 1.9 TCF of natural gas.<sup>59</sup> In 2009, the Department of Energy estimated the Marcellus holds 262 TCF of recoverable natural gas.<sup>60</sup>

The key to unlocking these additional reserves is a new application of a proven technology called hydraulic fracturing ("fracking"). Fracking has the potential to reposition America from a country beholden to the Middle East for energy to a nation that has used ingenuity to utilize domestic resource exhaustion, but the Administration is threatening to kill the technology with unnecessary federal regulation. Advancements in fracking, coupled with the ability to drill horizontally, allow producers to access more gas with fewer wells. After drilling vertically downward to a shale formation, the producer can turn the drill bit and drill horizontally through the formation. After drilling, a mixture of water, sand, and chemicals can be injected into the well to open up small cracks within the shale formation to allow the gas to travel to the well. The Energy Information Administration says that "without horizontal drilling and hydraulic fracturing, shale gas production would not be economically feasible because the natural gas would not flow from the formation at high enough rates to justify the cost of drilling."<sup>61</sup> Fracking and horizontal drilling also reduce the environmental footprint necessary to tap this natural gas.<sup>62</sup>

The combination of fracking with horizontal drilling is making shale oil recoverable as well, greatly increasing our recoverable oil reserves around the country. The Bakken Shale in North Dakota is a stunning example. As a result of horizontal drilling, coupled with fracking, Bakken production increased from less than 3,000 bbl/d in 2005 to over 230,000 bbl/d in 2010. The Bakken's share of total North Dakota oil production rose from 3% to 75% over those five years.<sup>63</sup> Thanks in part to fracking, unemployment in North Dakota is now the lowest in the country -- just 3.8%.<sup>64</sup>

North Dakota is not alone. Companies are investing billions of dollars to tap into oil deposits in Colorado, Texas, California, Oklahoma, and Louisiana as well. By 2015, these fields

<sup>58</sup> Energy Information Administration, *What is shale gas and why is it important?* (Apr. 4, 2011), available at [http://www.eia.doe.gov/energy\\_in\\_brief/about\\_shale\\_gas.cfm](http://www.eia.doe.gov/energy_in_brief/about_shale_gas.cfm).

<sup>59</sup> NATIONAL PARK SERVICE, POTENTIAL DEVELOPMENT OF THE NATURAL GAS RESOURCES IN THE MARCELLUS SHALE 2 (Dec. 2008).

<sup>60</sup> DEPARTMENT OF ENERGY, MODERN SHALE GAS DEVELOPMENT IN THE UNITED STATES: A PRIMER (April 2009).

<sup>61</sup> *Id.*

<sup>62</sup> Press Release, America's Natural Gas Alliance, *Safe, Responsible Drilling*, available at <http://www.anga.us/media/41084/safe%20responsible%20drilling.pdf>.

<sup>63</sup> *Id.*

<sup>64</sup> Jonathan Fahey, *New Drilling Method Opens vast oil fields in US*, THE ASSOC. PRESS (Feb 9, 2011).

could yield as much as 2 million barrels of oil per day – more than the Gulf of Mexico produces today -- boosting domestic oil production by 20 to 40%.<sup>65</sup> According to Credit Suisse, development of these fields could reduce oil imports by 60% by 2020.<sup>66</sup>

Despite the success of fracking, federal agencies appear to be in a race to see which one can regulate it first. The Department of Interior announced last November that it will consider regulating fracking on federal lands.<sup>67</sup> The EPA, which concluded seven years ago that fracking "poses little or no threat" to drinking water supplies,<sup>68</sup> is revisiting the issue. Having found no evidence that fracking chemicals reach drinking water, EPA now wants to study the entire lifecycle of the water used. In addition, DOE has convened a study group to review the fracking process. In a written statement, DOE Secretary Steven Chu stated, "I am looking forward to hearing from this diverse, respected group of experts on best practices for safe and responsible natural gas production."<sup>69</sup> Although the study groups members are certainly highly respected, a survey of their biographies indicates none has recent industry experience with the advancements in the technology.<sup>70</sup>

As Chairman Fred Upton of the Energy and Commerce Committee pointed out,<sup>71</sup> the duplicative efforts of DOI, DOE, and EPA run contrary to the Administration's pledge to eliminate government waste and streamline processes. It mirrors the President's favorite example of the headache caused by agency jurisdiction, "The Interior Department is in charge of salmon while they're in fresh water, but the Commerce Department handles them when they're in saltwater. I hear it gets even more complicated once they're smoked."<sup>72</sup> Federal regulation by EPA, DOE, and DOI would cause needless delay and uncertainty along with multiple additional layers of red tape. Ultimately, federal intervention will chill investment and decrease energy independence.

Additional regulation of fracking is unnecessary because, as EPA Administrator Lisa Jackson pointed out, fracking is not an unregulated activity.<sup>73</sup> Quite the opposite - the states, not the federal government, have always regulated the process and have done so with a solid track record. Officials in state after state have gone on the record to say that fracking has not caused

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> Ben Geman, *Interior mulls policy on disclosure of gas 'fracking' fluids*, THE HILL E<sup>2</sup> WIRE (Nov. 30, 2010).

<sup>68</sup> ENVIRONMENTAL PROTECTION AGENCY, EVALUATION OF IMPACTS TO UNDERGROUND SOURCES OF DRINKING WATER BY HYDRAULIC FRACTURING OF COALBED METHANE RESERVOIRS STUDY (2004), available at [http://water.epa.gov/type/groundwater/uic/class2/hydraulicfracturing/wells\\_coalbedmethanestudy.cfm](http://water.epa.gov/type/groundwater/uic/class2/hydraulicfracturing/wells_coalbedmethanestudy.cfm).

<sup>69</sup> Press Release, Department of Energy, Secretary Chu Tasks Environmental, *Industry and State Leaders to Recommend Best Practices for Safe, Responsible Development of America's Onshore Natural Gas Resources* (May 5, 2011).

<sup>70</sup> *Id.*

<sup>71</sup> Press Release, House Energy and Commerce Committee, *Administration's Inefficiencies Exposed: Plans for Yet Another Study on Fracking Wastes Federal Funds on Duplicative* (May 5, 2011).

<sup>72</sup> Colin Sullivan, *STATE OF THE UNION: Obama quip on salmon oversight fails to amuse Earthjustice*, E & E DAILY, Jan. 26, 2011.

<sup>73</sup> *Oversight Hearing on Public Health and Drinking Water Issues: Hearing before S. Comm. on Environment & Public Works*, 112<sup>th</sup> Cong. (2011) (testimony of Lisa Jackson, Administrator, U.S. Environmental Protection Agency), available at: [http://epw.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing\\_ID=c8713cf7-802a-23ad-4d51-bd8e2c8a7bd3&Witness\\_ID=d9783076-0a81-4f6a-895a-c34d7f21cc4d](http://epw.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=c8713cf7-802a-23ad-4d51-bd8e2c8a7bd3&Witness_ID=d9783076-0a81-4f6a-895a-c34d7f21cc4d).

any problems and any reports to the contrary are inaccurate.<sup>74</sup> As evidence, consider the following examples:

- David Neslin, Director of the Colorado Oil and Gas Conservation Commission: “There has been no verified instance of harm to groundwater caused by hydraulic fracturing.”<sup>75</sup>
- Jennifer Means, Pennsylvania Dept. of Environmental Protection: “So far it has not been our experience that the fracking process has caused any water-supply issues.”<sup>76</sup>
- James Welsh, Commissioner of Conservation, Louisiana Dept. of Natural Resources: “The Louisiana Office of Conservation is unaware of any instance of harm to groundwater in the State of Louisiana caused by the practice of hydraulic fracturing.”<sup>77</sup>
- Harold Fitch, Director of the Office of Geological Survey, Michigan Department of Environmental Quality: “Hydraulic fracturing has been utilized extensively for many years in Michigan, in both deep formations and in the relatively shallow Antrim Shale formation. There are about 9,900 Antrim<sup>78</sup> wells in Michigan producing natural gas at depths of 500 to 2000 feet. Hydraulic fracturing has been used in virtually every Antrim well. There is no indication that hydraulic fracturing has ever caused damage to ground water or other resources in Michigan.”<sup>79</sup>

The Obama Administration itself has even conceded that it has no evidence of fracking ever contaminating groundwater.<sup>80</sup> Nevertheless, fracking has become a political football.

Those opposed to fracking have twisted the results of recent scientific studies to support their argument. The most recent example is a study published by Duke University researchers entitled, “Research and Policy Recommendations for Hydraulic Fracturing and Shale-Gas Extraction” which supposedly “shows one downside of fracking.”<sup>81</sup> A close examination of the

<sup>74</sup> Lee Fuller, *March Madness: Small Group in Congress Renews Efforts That Could Cost Jobs, Undercut American Energy Security*, ENERGY IN DEPTH, Mar. 17, 2011.

<sup>75</sup> INTERSTATE OIL AND GAS COMPACT COMMISSION, REGULATORY STATEMENTS ON HYDRAULIC FRACTURING SUBMITTED BY THE STATES, June 2009, available at <http://www.iogcc.state.ok.us/Websites/iogcc/Images/2009StateRegulatoryStatementsonHydraulic%20Fracturing.pdf>

<sup>76</sup> Dennis J. O’Malley, *Gas drilling forum offers hope, dispels myths*, TIMES TRIBUNE, Oct. 20, 2010, available at <http://thetimes-tribune.com/news/gas-drilling-forum-offers-hope-dispels-myths-1.1051387>.

<sup>77</sup> INTERSTATE OIL AND GAS COMPACT COMMISSION, REGULATORY STATEMENTS ON HYDRAULIC FRACTURING SUBMITTED BY THE STATES (June 2009), available at <http://www.iogcc.state.ok.us/Websites/iogcc/Images/2009StateRegulatoryStatementsonHydraulic%20Fracturing.pdf>.

<sup>78</sup> The Antrim Shale is a formation in the Michigan Basin.

<sup>79</sup> *Id.*

<sup>80</sup> *Federal Drinking Water Programs: Hearing Before the Environment and Public Works Committee*, 111<sup>th</sup> Cong (2009) (testimony of Peter Silva, Assist. Admin. For Water), see also, Press Release, U.S. Senate Committee on Environment and Public Works (Dec. 8, 2009), available at [http://epw.senate.gov/public/index.cfm?FuseAction=Minority.PressReleases&ContentRecord\\_id=70289be8-802a-23ad-479d-ca2d6f6b36cd&Region\\_id=&Issue\\_id=](http://epw.senate.gov/public/index.cfm?FuseAction=Minority.PressReleases&ContentRecord_id=70289be8-802a-23ad-479d-ca2d6f6b36cd&Region_id=&Issue_id=)

<sup>81</sup> Robert B. Jackson et al, *Research and Policy Recommendations for Hydraulic Fracturing and Shale-Gas Extraction*, Duke University Center on Global Change (May 2011) available at

research, however, reveals that the study does not in any way support the conclusion that fracking is responsible for the contamination of the ground water tested by the researchers. In fact, the author concedes that, “the study found no evidence of contamination from hydraulic fracturing fluids or saline produced waters.”<sup>82</sup> Moreover, in an interview with Bloomberg TV Today on May 10, 2011, Robert Jackson, one of the primary authors of the study, stated clearly that the study “should not be taken as proof that the process [hydraulic fracturing] is dangerous.”

Interestingly, despite the Administration’s concerns about the safety of fracking here in the United States, it promotes the technology abroad. The State Department has a program called the Global Shale Gas Initiative which started “in April 2010 in order to help countries seeking to utilize their unconventional natural gas resources to identify and develop them safely and economically.”<sup>83</sup> While threatening to make production of the resources here at home uneconomical, the Administration hypocritically encourages others to seize the fracking revolution as a path to energy independence.

## II. GULF OF MEXICO

Regulations relating to Outer Continental Shelf (OCS) drilling are promulgated under the Outer Continental Shelf Lands Act (OCSLA). It is the basis for most federal regulation affecting exploration and drilling in the waters off the U.S. coast.<sup>84</sup> OCSLA establishes broad five-year planning periods for offshore leasing across the OCS, as well as other processes for leasing, development, and production of natural resources. The Bureau of Ocean Energy Management, Regulation, and Enforcement (BOEMRE), formerly known as the Minerals Management Service (MMS), administers this Act.

For nearly 30 years, the vast majority of U.S. waters were under a federal moratorium, which prohibited exploration and development of much of the OCS. In the summer of 2008, gas prices rose to over \$150 a barrel, and the price at the pump exceeded \$4 a gallon, creating immense pressure to open up new domestic sources of oil. In response, President Bush and a Democratically controlled Congress allowed a legislative moratorium to expire on September 30, 2008.<sup>85</sup> This opened 500 million additional acres for new energy production that contain an estimated 14 billion barrels of oil and 55 trillion cubic feet of natural gas.<sup>86</sup> However, the promise of expanded access to the OCS and the accompanying increase in domestic supplies of energy was short lived.

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[http://nicholasinstitute.duke.edu/climate/policydesign/researchandpolicyrecommendationsforhydraulic-fracturingandshale2010gasextraction/at\\_download/paper](http://nicholasinstitute.duke.edu/climate/policydesign/researchandpolicyrecommendationsforhydraulic-fracturingandshale2010gasextraction/at_download/paper).

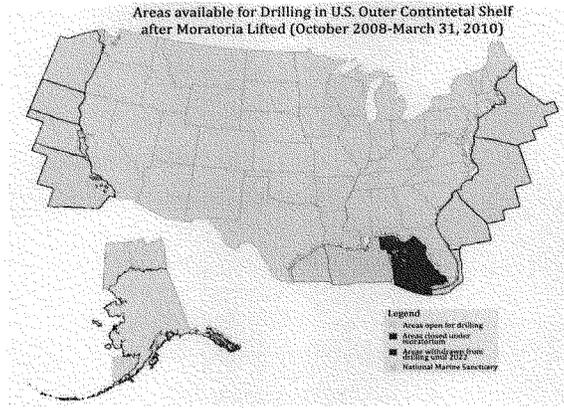
<sup>82</sup> *Id.*

<sup>83</sup> GLOBAL SHALE GAS INITIATIVE, U.S. DEPARTMENT OF STATE, (last visited May 20, 2011) *available at* <http://www.state.gov/s/ciea/gsgi/index.htm>

<sup>84</sup> 43 U.S.C. § 1331 et seq.

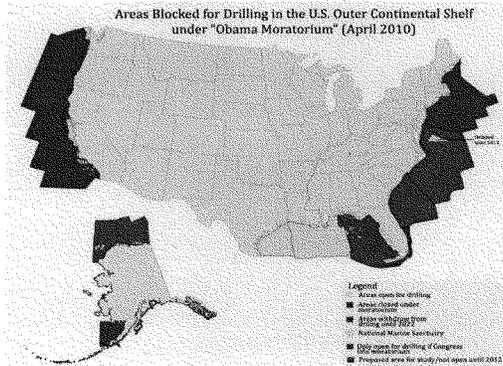
<sup>85</sup> CURRY L. HAGERTY, OUTER CONTINENTAL SHELF MORATORIUM ON OIL AND GAS DEVELOPMENT 7 (CRS 2011).

<sup>86</sup> Press Release, U.S. House of Representatives Committee on Natural Resources, *The New Obama Plan Has Americans Seeing Red*, (Dec. 1, 2010)



Source: Press Release, U.S. House of Representatives Committee on Natural Resources, *The New Obama Plan Has Americans Seeing Red*, (Dec. 1, 2010)

On March 31, 2010, President Obama announced a revised plan for the exploration and development of oil reserves in U.S. waters.<sup>87</sup> While White House officials framed the changes as a way to reduce U.S. reliance on foreign oil and create jobs, in reality, it was a significant retraction from the 2008 decision to lift the moratorium. Under the Obama plan, the majority of the areas open for drilling were once again closed, cutting off access to all of the Pacific Coast, the Northeastern Atlantic and Bristol Bay in Alaska, which put 13.14 billion barrels of oil and 41.49 trillion cubic feet of natural gas back under lock and key.<sup>88</sup>



<sup>87</sup> *Id.*  
<sup>88</sup> *Id.*

Source: Press Release, U.S. House of Representatives Committee on Natural Resources, *The New Obama Plan Has Americans Seeing Red*, (Dec. 1, 2010)

### Tragedy in the Gulf

Within weeks of the President's announcement, an explosion aboard the *Deepwater Horizon* on April 20, 2010, further changed the course of events for offshore development. A series of human and system failures on the part of BP p.l.c. and their subcontractors made the created a devastating reality for the people on the Gulf Coast.<sup>89</sup> As the post incident investigations revealed, a series of avoidable errors, sometimes as basic as changing the batteries on a back up device, or observing red flags, such as the unsafe escalation of pressure readings, could have prevented the ecologic disaster and the spilling of 4.1 million barrels of oil into the Gulf of Mexico.<sup>90</sup>

### Gulf Moratorium

In the aftermath of the explosion aboard the *Deepwater Horizon*, Department of Interior Secretary Ken Salazar twice ordered a six month moratorium on deepwater drilling in U.S. waters.<sup>91</sup> The Secretary's orders effectively banned much of the economic activity that sustains the Gulf states, particularly Louisiana. At that time, many residents of Louisiana expressed their fear that the moratorium had the potential to inflict more pain on the region than the spill itself, and it was imposed over the vehement objections of local leaders and their constituents.<sup>92</sup> Moreover, Department of Interior executed this sweeping decision without consulting with safety experts on the wisdom of imposing an outright ban on all drilling activity in the Gulf, and without conducting an economic analysis of the impact his decision would have on the economy and the nation.<sup>93</sup>

### First Moratorium

On June 15, 2010, President Obama announced a far reaching six-month moratorium on nearly all drilling in the Gulf.<sup>94</sup> The moratorium applied to new drilling in water depths greater

<sup>89</sup> NATIONAL COMMISSION ON BP DEEPWATER HORIZON OIL SPILL AND OFFSHORE DRILLING REPORT TO THE PRESIDENT: THE GULF OIL DISASTER AND THE FUTURE OF OFFSHORE DRILLING 155-22 (Jan. 2011), available at <http://www.oilspillcommission.gov/sites/default/files/documents/FinalReportChapter4.pdf>.

<sup>90</sup> DEEPWATER HORIZON ACCIDENT INVESTIGATION REPORT 21-29 (2010), available at [http://www.bp.com/liveassets/bp\\_internet/globalbp/globalbp\\_uk\\_english/incident\\_response/STAGING/local\\_assets/downloads\\_pdfs/Deepwater\\_Horizon\\_Accident\\_Investigation\\_Report.pdf](http://www.bp.com/liveassets/bp_internet/globalbp/globalbp_uk_english/incident_response/STAGING/local_assets/downloads_pdfs/Deepwater_Horizon_Accident_Investigation_Report.pdf).

<sup>91</sup> *Costing American Jobs, Increasing Energy Prices*, U.S. House Committee on Natural Resources, available at <http://naturalresources.house.gov/Issues/Issue/?IssueID=15410>.

<sup>92</sup> RANKING MEMBER DARRELL ISSA, OVERSIGHT & GOV'T REFORM COMM., HOW THE WHITE HOUSE PUBLIC RELATIONS CAMPAIGN ON THE OIL SPILL IS HARMING THE ACTUAL CLEANUP 12-14 (2010), available at [http://oversight.house.gov/images/stories/Reports/7-1-10\\_OGR\\_Report\\_-\\_How\\_the\\_White\\_House\\_Public\\_Relations\\_Campaign\\_on\\_the\\_Oil\\_Spill\\_is\\_Harming\\_the\\_Actual\\_Clean-up.pdf](http://oversight.house.gov/images/stories/Reports/7-1-10_OGR_Report_-_How_the_White_House_Public_Relations_Campaign_on_the_Oil_Spill_is_Harming_the_Actual_Clean-up.pdf).

<sup>93</sup> *The Economic Effects of the Offshore Drilling Moratorium*, S. Comm. On Small Business, 111<sup>th</sup> Cong (2010) (testimony of the Honorable Rebecca M. Blank, Under Secretary for U.S. Economic Affairs, Department of Commerce).

<sup>94</sup> Remarks by the President to the Nation on the BP Oil Spill, June 15, 2010, available at <http://www.whitehouse.gov/the-press-office/remarks-president-nation-bp-oil-spill>.

than 500 feet, and suspended drilling on 33 wells currently under construction.<sup>95</sup> The President's action is based on a recommendation from Secretary Salazar, contained in a May 27, 2010, report on "Increased Safety Measures for Energy Development on the Outer Continental Shelf."<sup>96</sup> According to a report issued by the Inspector General for the Department of Interior, the Secretary's recommendation to impose a moratorium was not peer reviewed and was not supported by the scientists and industry experts who had otherwise been cooperating with the Administration.<sup>97</sup>

The moratorium was immediately challenged by providers of support services to offshore oil and gas operations, who argued the decision to impose a moratorium was arbitrary and capricious.<sup>98</sup> On June 22, 2010, a federal court ruled that the plaintiffs were likely to succeed on their claim and preliminarily enjoined enforcement of the suspension.<sup>99</sup> This decision was affirmed by the 5<sup>th</sup> Circuit Court of Appeals.<sup>100</sup>

In the order blocking the Department of Interior from enforcing the moratorium, Judge Feldman specifically cited his belief that the Department actively sought to distort the opinions and advice of "five of the National Academy experts and three of the other experts," which publically stated that they do not agree with the six month moratorium on drilling, because the moratorium actually increases the risk of an oil spill once drilling is resumed.<sup>101</sup> Moreover, the Judge pointed to the adverse economic impact of a broad based moratorium, stating that:

"It is only a matter of time before more business and jobs and livelihoods will be lost. The defendants trivialize such losses by characterizing them as merely a small percentage of the drilling rigs affected, but it does not follow that this will somehow reduce the convincing harm suffered. The effect on employment, jobs, loss of domestic energy supplies caused by the moratorium as the plaintiffs (and other suppliers, and the rigs themselves) lose business, and the movement of the rigs to other sites around the world will clearly ripple throughout the economy in this region."<sup>102</sup>

### Second Moratorium

Despite the judicial decision to invalidate the original moratorium, Secretary Salazar announced a nearly identical moratorium on July 12, 2010. Billed as "a temporary pause on deepwater drilling to provide time to implement safety reforms,"<sup>103</sup> the second moratorium

<sup>95</sup> Memorandum from Upstream Insight on Moratorium Halts US Deepwater Drilling For Six Months (June 3, 2010).

<sup>96</sup> DEPT. OF INTERIOR, INCREASED SAFETY MEASURES FOR ENERGY DEVELOPMENT ON THE OUTER CONTINENTAL SHELF, May 27, 2010.

<sup>97</sup> OFFICE OF THE INSPECTOR GENERAL, DEPT. OF INTERIOR, FEDERAL MORATORIUM ON DEEPWATER DRILLING (2010).

<sup>98</sup> *Hornbeck Offshore Services v. Salazar*, No. 10-1663 (E.D.La, 2010).

<sup>99</sup> *Id.*

<sup>100</sup> *Hornbeck Offshore Services v. Salazar*, No. 10-30585 (5<sup>th</sup> Cir., 2011).

<sup>101</sup> *Hornbeck Offshore Services v. Salazar*, No. 10-1663 (E.D.La, 2010).

<sup>102</sup> *Id.* at 22.

<sup>103</sup> Press Release, Department of the Interior, *Sec. Salazar Issues New Suspensions to Guide Safe Pause on Deepwater Drilling* (July 12, 2010), available at <http://www.doi.gov/news/doinews/Secretary-Salazar-Issues-New-Suspensions-to-Guide-Safe-Pause-on-Deepwater-Drilling.cfm>.

appears to merely be a post hoc rationalization of the original moratorium. The new moratorium did nothing to address the economic concerns of the community or the safety concerns raised by experts. In fact, a *New York Times* editorial stated that the second ban is “as strong as the first ban.”<sup>104</sup> According to Dan Juneau, President of the Louisiana Association of Business and Industry:

“[The new moratorium] seems to be geared toward rigs with blowout preventers which everyone in the deep waters have and many in the shallow waters do as well. It is a reaffirmation that the Obama administration is going to keep things shut down, in spite of the 5<sup>th</sup> Circuit’s ruling.”<sup>105</sup>

It appears that the economic impact of the moratorium was never considered by the Administration. A decision memorandum authored by BOEMRE Director Michael Bromwich to Secretary Salazar states that “economic effects may be considered in determining the scope of any suspension of drilling activity.”<sup>106</sup> However, according to testimony of Rebecca M. Blank, Under Secretary for U.S. Economic Affairs at the Department of Commerce, the Administration never once conducted a study of the economic impact the moratorium would have on the Gulf Coast economy and on oil production.<sup>107</sup> Charlotte Randolph, President of Lafourche Parish in Thibodaux, Louisiana, expressed her concern to Committee staff that “nine out of her top ten” taxpayers are employed in the oil and gas industry, which will be directly impacted by the moratorium.<sup>108</sup> In Louisiana coastal communities such as Houma, Morgan City and Lafayette, one out of every three jobs is related to the oil and gas industry; these jobs are now in jeopardy along with the \$12.7 billion in total wages earned by employees working in the Gulf Coast oil and gas industry. Their unemployment would result in decreased tax receipts and additional budget restrictions for a Parish that is already experiencing a very lean year.<sup>109</sup> According to an analysis performed by the Gulf Economic Survival Team, Louisiana and its Parishes stand to lose \$150 million to \$700 million in state and local sales tax revenue due to the moratorium, thereby negatively impacting all government services, from police and fire protection, to schools and hospitals.<sup>110</sup>

Former Democratic Senator Bob Graham and William K. Reilly, who were appointed to head the President’s Commission to investigate the BP oil spill, have expressed criticism over the nature and duration of the moratorium. After hearing testimony from a variety of local

<sup>104</sup> Editorial, *A New, and Necessary, Moratorium*, NY TIMES, July 13, 2010, available at <http://www.nytimes.com/2010/07/14/opinion/14wed1.html>.

<sup>105</sup> Email from Dan Juneau, President, La Assoc. of Bus. & Indus. to Committee Staff (July 15, 2010).

<sup>106</sup> Memorandum from Director Bromwich on Options Regarding the Suspension of Certain Offshore Permitting and Drilling Activities on the Outer Continental Shelf (July 10, 2010).

<sup>107</sup> *The Economic Effects of the Offshore Drilling Moratorium*, S. Comm. On Small Business, 111<sup>th</sup> Cong (2010) (testimony of the Honorable Rebecca M. Blank, Under Secretary for U.S. Economic Affairs, Department of Commerce).

<sup>108</sup> Interview with Charlotte Randolph, President, Lafourche Parish, in Thibodaux, LA (June 15, 2010).

<sup>109</sup> *Id.*

<sup>110</sup> Louisiana Mid-Continent Oil & Gas Association, *Impacts of President Obama’s Order Halting Work on 33 Exploratory Wells in the Deepwater Gulf of Mexico* (May 28, 2010) available at <http://www.gulfeconomicsurvival.org/facts-and-figures>.

officials, Mr. Reilly stated that, “It’s not clear to me why it should take so long.”<sup>111</sup> Former Senator Graham echoed these concerns, reportedly saying that the moratorium was a burden on the economic life of the Gulf Coast.<sup>112</sup> He said the federal government has had nearly three months to inspect the rigs in the Gulf and wondered why it was taking so long to determine whether they can safely restart operations.<sup>113</sup>

### The Permittorium

Secretary Salazar announced the end of the moratorium on October 13, 2010. According to many in the industry, this declaration provided little relief. The moratorium in the Gulf of Mexico was replaced by a “permittorium” – whereby drilling activity remained at a standstill not by operation of law – but because of inaction on the part of BOEMRE. Prior to the disaster, Mineral Management Service (MMS) processed and issued permits to drill in two weeks.<sup>114</sup> However, not a single deepwater permit was issued by BOEMRE until U.S. District Judge Martin Feldman ordered the agency to take action on five permits by March 19, 2011, and by March 31, 2011, on two additional permits.<sup>115</sup>

On February 28, 2011, BOEMRE finally issued the first deepwater drilling permit since the explosion aboard the *Deepwater Horizon*.<sup>116</sup> The permit was issued to Noble Energy, and allows them to resume drilling which they had started before April 20, 2010. Specifically, the permit allows Noble Energy to drill a by-pass well in Mississippi Canyon Block 519, approximately 70 miles south east of Venice, La. An operator drills a bypass well in order to drill around a mechanical problem in the original hole to the original target from the existing wellbore. In this case, Noble Energy will be drilling around the plugs set in the original well when drilling was suspended in order to complete the long delayed project.

Since February, BOEMRE has approved 13 additional deepwater permits – 11 of which simply allow operations to resume on a previously approved well. Only one permit has been issued for a well that had not been previously approved.<sup>117</sup> On May 10, 2011, Judge Feldman issued an additional order requiring BOEMRE to act on six additional applications within 30 days. In his decision, Judge Feldman determined that, “the government has presented no credible assurances that the permitting process will return to one marked by predictability and certainty.”<sup>118</sup> (emphasis added) He went on to say that “Processing a scant few applications is at

<sup>111</sup> John M. Broder, *Offshore Drilling: To Pause or Not to Pause*, NYTIMES, July 13, 2010, available at <http://green.blogs.nytimes.com/2010/07/13/offshore-drilling-to-pause-or-not-to-pause/>.

<sup>112</sup> *Id.*

<sup>113</sup> *Id.*

<sup>114</sup> Mary Romano, Peter Blumberg, *U.S. Appeals for Delay in 30-Day Order on Drill Permits*, BLOOMBERG BUSINESS WEEK, March 13, 2011.

<sup>115</sup> *Enco Offshore Co., et. al. v Kenneth Lee “Ken” Salazar*, 2011 WL 692029 (E.D. La. 2011).

<sup>116</sup> Press Release, Bureau of Ocean Energy Management, Regulation and Enforcement, *BOEMRE Approves First Deepwater Drilling Permit To Meet Important New Safety Standards in Gulf of Mexico* (Feb. 28, 2011), available at <http://www.boemre.gov/ooe/press/2011/press0228.htm>.

<sup>117</sup> Status of Drilling Permits & Plans Subject to Enhanced Safety and Environmental Requirements in the Gulf of Mexico, Bureau of Ocean Energy Management, Regulation and Enforcement (last visited May 19, 2011), available at [http://www.gomr.boemre.gov/homepg/offshore/safety/well\\_permits.html](http://www.gomr.boemre.gov/homepg/offshore/safety/well_permits.html).

<sup>118</sup> *Enco Offshore Co., et. al. v Kenneth Lee “Ken” Salazar*, 2011 WL 692029 (E.D. La. 2011).

best a tactical ploy in a real world setting.”<sup>119</sup> Moreover, it has severe implications for the future productivity of the region. It generally takes five to ten years once a permit is issued to bring the oil to market.<sup>120</sup>

In addition to the immediate impact on the residents of the Gulf Coast, the year long pause in drilling operations will probably mean a decline in domestic output of crude oil according to analysts.<sup>121</sup> Deep-water drilling in the Gulf accounts for about 1.25 million barrels of oil a day – or about one-quarter of America’s domestic crude oil production. The Gulf contribution is expected to drop by about 180,000 barrels a day, in 2011, according to the U.S. Energy Information Administration.<sup>122</sup>

### **Regulations Following the Spill**

As a result of the BP Oil Spill, BOEMRE promulgated a series of regulations that coincided with the entire reorganization of the agency from the former MMS. These reforms are some of the most aggressive changes to offshore oil and gas production in U.S. history and range from new rules covering safety, oversight, and environmental protection for permitting, drilling, and development processes for oil and gas operations. In some cases, these new regulations apply to both offshore operations themselves as well as the businesses that deal directly with offshore rigs – many of which are small businesses. The regulated community, state officials, and even BOEMRE staff have raised concerns about the feasibility and practicality of these new regulations. After *Deepwater Horizon*, it is clear that a new, safer system is necessary for drilling in the Gulf of Mexico; however, the focus of any regulatory changes must be on continuing safe drilling in the Gulf. The latest regulations promulgated by BOEMRE do not appear to promote this goal of drilling and instead create a significant amount of uncertainty and confusion within the offshore oil and gas community.

### Archaeological Requirements on Operators

One of the most perplexing regulations promulgated by BOEMRE is the requirement that operators perform an Archaeological Assessment Report as part of National Environmental Policy Act analysis and in conjunction with the National Historic Preservation Act.<sup>123</sup> Under this new rule, any permitting applications that will propose bottom-disturbing activities require analysis of data and information about the potential existence of archaeological resources and the affect that proposed operations will have on these shipwrecks.<sup>124</sup>

<sup>119</sup> *Id.*

<sup>120</sup> Ayesha Rascoc, *U.S. Set to ‘Reopen’ Offshore Drilling Sector; ‘Significant Permits’; Upward Pressure on Oil Prices the Impetus*, National Post’s Financial Post & FP Investing, March 3, 2011, available at <http://www.nationalpost.com/todays-paper/setto+reopen+offshore+drilling+sector/4375547/story.html>.

<sup>121</sup> Mark Guarino, *Stricter Deep-Water Drilling Regulations Mean Gulf Coast Waters Are Likely to Yield Less Oil this Year; Energy Firms May Shift Attention Abroad*, CHRISTIAN SCIENCE MONITOR (Jan. 11, 2011).

<sup>122</sup> *Id.*

<sup>123</sup> Gulf of Mexico Archaeological Information, Bureau of Ocean Energy Management, Regulation and Enforcement (last visited May 20, 2011), available at <http://www.gomr.boemre.gov/homepg/regulate/environ/archaeological/introduction.html>.

<sup>124</sup> *Id.*

The application of this rule requires that operators literally become underwater archaeologists, entering a field where they have little experience. Operators must conduct ocean floor analyses with specialized equipment to determine if anomalies are shipwrecks with the potential to be impacted by exploration or drilling.<sup>125</sup> Furthermore, operators will be required to employ an underwater archaeologist to assist in the analysis of this data and to provide BOEMRE with survey data. When asked about how to implement this new rule, and more specifically if operators would need to hire an underwater archaeologist, BOEMRE representatives responded that they would have to make this hire and that the profession was not uncommon.<sup>126</sup> The archaeological assessment requirements are a prime example of the seemingly absurd and arbitrary nature of the new regulations placed on offshore drilling operations.

#### “Should-to-Must” Requirements

A new Workplace Safety Rule is another BOEMRE regulation intended to improve safety practices for offshore drilling operations. Unfortunately, its implementation has proven to be challenging in practice. This regulation requires that operators develop and maintain a Safety and Environmental Management System (SEMS).<sup>127</sup> A SEMS is a “comprehensive management program for indentifying, addressing and managing operational safety hazards and impacts, with the goal of promoting both human safety and environmental protection.”<sup>128</sup> In addition, the Workplace Safety Rule makes mandatory the practices in the American Petroleum Institute’s (API) Recommended Practice 75 (API RP 75).<sup>129</sup> The API RP 75 is a collection of best practices created by API as suggestions for operators to implement. BOEMRE issued a direct final rule, without the public’s input, making all aspects of the API guidance mandatory. The recommendations vary depending on the type of operation. They were not designed to be mandatory directives, and certainly not designed to be executed simultaneously. This fact was seemingly lost on BOEMRE, as the agency carelessly changed all “should” instructions to “must.”

After industry and affected states voiced strong objections based on the purpose and feasibility of the regulations, BOEMRE initiated a guidance document entitled “Supplemental Information Regarding Approval Requirements for Activities that Involve the Use of a Subsea Blowout Preventer (BOP) or a Surface BOP on a Floating Facility,” with the goal of displacing fear of the careless “should-to-must” change. In the guidance document, BOEMRE recognized that the incorporation of the API documents required that any “should” would be interpreted as “must” for purposes of the Code of Federal Regulations.<sup>130</sup> BOEMRE has indicated that it recognizes that some degree of flexibility is important for the feasible implementation of the API

<sup>125</sup> *Id.*

<sup>126</sup> Bureau of Ocean Energy Management, Regulation and Enforcement Industry Workshop (March 23, 2011).

<sup>127</sup> Bureau of Ocean Energy Management, Regulation and Enforcement.

*Fact Sheet on the Workplace Safety Rule On Safety and Environmental Management Systems (SEMS)*, available at <http://www.doi.gov/news/pressreleases/loader.cfm?csModule=security/getfile&PageID=45791>.

<sup>128</sup> *Id.*

<sup>129</sup> *Id.*

<sup>130</sup> Supplemental Information Regarding Approval Requirements for Activities that Involve the Use of a Subsea Blowout Preventer (BOP) or a Surface BOP on a Floating Facility, Bureau of Ocean Energy, Management, Regulation and Enforcement (last visited May 20, 2011), available at <http://www.boemre.gov/ooc/pdfs/DeepwaterGuidanceSupplement.pdf>.

incorporated documents.<sup>131</sup> To this end, BOEMRE is willing to consider, based on agency approval, other practices that may accomplish similar goals as those contained in the API document.<sup>132</sup> Despite these changes, uncertainty remains regarding the “should” to “must” regulations because the guidance document does not go far enough in relieving the burden of implementing regulations whose original intentions were merely industry-wide best practices. Due to the vague nature of the guidance document, the drilling community’s uncertainty is augmented because of concerns about whether in application BOEMRE will actually back off the “should-to-must” requirement.

A concern of small business involves the implementation of SEMS Workplace Rules. BOEMRE recognizes in its Workplace Safety Rule Fact Sheet that many large operators have already established SEMS programs; however, it does not mention the smaller operators or those businesses who work closely with operators. Small businesses that have contact with operators’ rigs will also be required to establish their own SEMS programs at the request of the large operators.<sup>133</sup> Small businesses are not situated to perform the same level of SEMS analysis that large-multinational corporations can – many of these small businesses that service large operators may be forced out of business if they cannot implement a SEMS program.<sup>134</sup> BOEMRE has not addressed the concerns of small business owners who work closely with large operators on the SEMS issue.

#### **Industry Strives to Make Drilling Safer**

The explosion aboard the Deepwater Horizon and the confusion in the subsequent days and months clearly demonstrated that MMS and BP had failed to adhere to rigorous safety standards. Moreover, there is agreement that changes needed to be made to the flawed system that allowed the disaster to occur. However, evidence suggests the regulations promulgated by BOEMRE do not promote the revitalization of a safe oil and gas industry in the Gulf; instead, they hinder production even when operators have made significant strides to become safer. For example, the oil industry made a substantial investment in safety by creating a rapid-response system to prevent another disaster like the BP Oil Spill.<sup>135</sup> BOEMRE’s regulations do not appear to take this into account.

In July 2010, in order to quell concerns regarding the safety of deepwater drilling, four of the largest oil companies, Exxon-Mobil, Shell, Chevron, and Conoco Phillips, committed \$1 billion to create a rapid-response system to deal with future potential oil spills.<sup>136</sup> This rapid response system includes the creation of modular containment equipment that would be available for use and could contain spills as deep as 10,000 feet and capture up to 100,000 barrels of oil a day.<sup>137</sup> A nonprofit organization known as the Marine Well Containment Company operates and maintains the emergency capability mechanism. Industry executives feel that this measure is

<sup>131</sup> *Id.*

<sup>132</sup> *Id.*

<sup>133</sup> *The Workplace Safety Rule on Safety and Environmental Management Systems (SEMS)*, Bureau of Ocean Energy Management, Regulation and Enforcement, available at

<http://www.doi.gov/news/pressreleases/loader.cfm?csModule=security/getfile&PageID=45791>.

<sup>134</sup> Interview with Lori Davis, President, Rig Chem (March 24, 2011).

<sup>135</sup> Jad Mouawad, *3 Oil Firms Commit \$1 Billion for Gulf Rapid-Response Plan*, N.Y. TIMES, Jul. 21, 2010.

<sup>136</sup> *Id.*

<sup>137</sup> *Id.*

sufficient to respond to the impact of any future blowout or spill that may affect the Gulf region, and it will restore the government and the citizens' confidence in the oil industry to operate with the proper safety precautions in place.<sup>138</sup> This unsolicited action demonstrates the industry's commitment to operate responsibly. However, BOEMRE's policies do not recognize the necessary and important contributions that industry has made.

### III. ALASKA

Alaska holds enormous oil and gas resources for the United States and development of those resources is critical for U.S. energy independence. A National Energy Technology Laboratory study estimates that this region has the potential for the exploration and development of as much as 28 billion barrels of economically recoverable oil and 125 trillion cubic feet of economically recoverable gas through 2050.<sup>139</sup>

An independent assessment of the potential for development of Alaska's Beaufort and Chukchi Sea OCS found that sufficient oil could be produced to completely eliminate the need for imports from one of the United States' largest foreign suppliers.<sup>140</sup> Average production from the OCS for the next 40 years could be 700,000 barrels per day, with a maximum of 1.45 million per day in 2030. In perspective, 700,000 barrels is more than the amount of oil the United States imported from Iraq (506,000 bbl/day) and Russia (137,000 bbl/day) combined in 2010.<sup>141</sup> Saudi Arabia, Mexico, Venezuela, and Nigeria each exported approximately one million barrels or less to the United States.<sup>142</sup>

Despite the enormous oil and gas potential, production in Alaska has steeply declined over the past few decades. In 1988, oil and natural gas liquid from Alaska's North Slope constituted 25 percent of total domestic production, 2.2 million barrels per day.<sup>143</sup> By 2007, production had dropped to 720,000 barrels per day, representing only 14 percent of domestic production.<sup>144</sup> The current Administration is largely to blame for Alaska's continued stagnation. Alaska Democratic Senator Mark Begich described the situation as "regulatory 'whack a mole' for developers in Alaska" as he introduced a bill intended to streamline offshore oil and gas development. "Each time we have one mole beat down, another one pops up and derails the progress. But this isn't a game. It's about the future of Alaska and the energy security of our country."<sup>145</sup>

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<sup>138</sup> *Id.*

<sup>139</sup> *Id.*

<sup>140</sup> *The American Energy Initiative: Jobs and Energy Permitting Act: Hearing before the H. Comm. On Energy and Commerce*, 112<sup>th</sup> Cong. (2011) (statement of David Lawrence, Executive Vice President, Shell), available at <http://republicans.energycommerce.house.gov/Media/file/Hearings/Energy/041311/Lawrence.pdf>.

<sup>141</sup> *Id.*

<sup>142</sup> *Id.*

<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

<sup>145</sup> S. 843, 112<sup>th</sup> Cong. § (2011).

### Moratorium Confusion

The BP spill in the Gulf of Mexico has created great uncertainty for companies seeking to drill thousands of miles away in Alaska. Prior to the spill, the Administration made statements supportive of further exploitation of oil and gas resources in the Arctic Outer Continental Shelf as well as elsewhere offshore.<sup>146</sup> After the spill, however, Secretary Salazar announced a 30-day review of offshore safety and put a hold on new permits until the review was completed. Soon after that, Interior announced a six-month moratorium on all deepwater drilling and suspended Shell's proposed drilling in the Beaufort and Chukchi seas, and imposed additional other restrictions on drilling and leasing in other regions.<sup>147</sup> All of these policy changes have created new uncertainties.

The moratorium on deepwater drilling, announced on June 15, 2010, and discussed in the previous section, did not specifically refer to Alaska. Yet this moratorium, and the subsequent moratorium, imposed on July 12, 2010, created significant uncertainty for companies attempting to drill in Alaskan waters. The second moratorium also did not mention Alaska, but a fair reading of the order appeared to prohibit the work Shell had planned for the Beaufort and Chukchi seas. The state of Alaska responded by suing Interior for violating the Outer Continental Shelf Lands Act and the Administrative Procedure Act.<sup>148</sup> In late November 2010, after the July moratorium had been lifted, the Department filed a motion explaining that the original moratorium did not cover Alaska and attributing permitting delays to "cautious" regulators.<sup>149</sup>

### \$3 billion and Still No Permit

The moratorium confusion following the BP oil spill was only the latest in a long series of delays for Shell's Alaskan project. Shell has been ready to commence exploring for oil and gas in the Alaskan OCS for four years. The company expects to create 54,700 jobs per year, generating \$145 billion in payroll income, and \$193 billion in government revenue by 2057 – all while reducing U.S. dependence on foreign oil.<sup>150</sup> Unfortunately for the American people, none of this has come to fruition because after five years, EPA still has not issued several of the 35 permits Shell needs to drill even a single exploratory well.<sup>151</sup>

Shell has spent more than \$3 billion on leases, environmental analyses, and permitting so far with no return on their investment.<sup>152</sup> The company holds 137 leases in the Beaufort Sea and 275 leases in the Chukchi Sea.<sup>153</sup> The federal government received \$2.2 billion in bonus bids for Shell's leases in the Chukchi Sea alone.<sup>154</sup> Initially, Shell planned to begin drilling in 2007 in the Beaufort Sea, just north and east of the North Slope and the Trans-Alaska Pipeline and

<sup>146</sup> President Obama, Remarks on Energy Security at Andrews Air Force Base (Mar. 31, 2010).

<sup>147</sup> Eric Lidji, *Alaska Offshore Special Report*, PETROLEUM NEWS (January 21, 2011).

<sup>148</sup> *Id.*

<sup>149</sup> *Id.*

<sup>150</sup> *Potential National-Level Benefits of Alaska OCS Development*, Northern Economics (February 2011), available at <http://www.northerneconomics.com/pdfs/ShellOCS/National%20Effects%20Report%20FINAL.pdf>.

<sup>151</sup> *Id.*

<sup>152</sup> Tim Bradner, *Shell expands Arctic exploration plans*, ALASKA J. OF COMMERCE, (May 6, 2011).

<sup>153</sup> *Id.*

<sup>154</sup> *Id.*

associated infrastructure.<sup>155</sup> Because of regulatory and legal challenges, its schedule slipped to 2010, and then 2011, and now 2012.

One of the principal obstacles to drilling is EPA's failure to issue an air pollution permit for the project. Since most new offshore drilling has occurred in the Gulf of Mexico under Interior jurisdiction, EPA has little experience with offshore permitting. That inexperience seems to be amounting to incompetence. Alaska Senator Lisa Murkowski testified before the House Energy and Commerce Committee, "If EPA cannot demonstrate some competency . . . then EPA should not expect to keep its authority for long."<sup>156</sup> After years of studying the issue, EPA granted an air permit last summer only to have it remanded by the EPA's Environmental Appeals Board in January for not adequately reviewing the potential health effects on people living on shore.<sup>157</sup> The closest village, located 70 miles from the proposed drill site and occupying one square mile, is home to 245 people. EPA Administrator Lisa Jackson told the Senate Energy Committee, "I believe that the analysis will clearly show that there is no public health concern here."<sup>158</sup> Shell continues to wait for the rest of EPA to conclude what its Administrator already has.

#### **National Petroleum Reserve Goes Unused**

On May 14, 2011, during his Weekly Address, President Obama announced that he intended to direct Secretary Salazar to conduct annual lease sales in Alaska's National Petroleum Reserve (NPR-A).<sup>159</sup> Given ConocoPhillips' experience so far trying to utilize a lease it already has in the NPR-A, those new leases may be worthless.

Despite nearly three million acres of the NPR-A already under lease, no one has yet to drill a single commercial well.<sup>160</sup> ConocoPhillips is trying to be the first with a project it says will produce up to 18,000 barrels of oil per day.<sup>161</sup> In February 2010, the Army Corps of Engineers rejected the company's plan to access the NPR-A by building a bridge over the Colville River, saying that drilling underneath the river and airlifting supplies would cause less environmental harm. The Corps finally decided to reconsider their earlier decision in December 2010, citing "additional evidence" not available at the time of the initial decision and talks with Native Alaskans.<sup>162</sup> Conoco Phillips is still waiting on the Corps to issue a final decision.

<sup>155</sup> *Id.*

<sup>156</sup> *The American Energy Initiative: Jobs and Energy Permitting Act: Hearing before the H. Comm. On Energy and Commerce*, 112<sup>th</sup> Cong. (2011) (statement of Senator Lisa Murkowski), available at <http://republicans.energycommerce.house.gov/Media/file/Hearings/Energy/041311/Murkowski.pdf>.

<sup>157</sup> Final Decision to Issue and OCS/PSD Permit to Shell Offshore Inc., for Exploration Drilling Operations in the Beaufort Sea, (last visited May 20, 2011) available at <http://yosemite.epa.gov/R10/airpage.nsf/Permits/beaufortap/>.

<sup>158</sup> *Id.*

<sup>159</sup> Press Release, White House, *Weekly Address: President Obama Announces New Plans to Increase Responsible Domestic Oil Production* (May 14, 2011).

<sup>160</sup> Phil Taylor, *Alaska lawmakers seek swift U.S. reconsideration of petroleum reserve drilling*, GREENWIRE (Dec. 14, 2010).

<sup>161</sup> Phil Taylor, *Alaska pols say petroleum reserve leases must be couples with permits*, ENVIRONMENT & ENERGY DAILY (May 18, 2011).

<sup>162</sup> Letter from David Hayes, Deputy Secretary, Department of the Interior, to Col. Reinhard Koenig, Army Corps of Engineers Alaska District (May 3, 2011). (on file with author)

A “curious” twist in the quest to develop NPR-A is the related action of other agencies. EPA and the U.S. Fish and Wildlife Service both designated the Colville River Delta as an “Aquatic Resource of National Significance,” a decision they made without notice and comment, but one that potentially has great consequences.<sup>163</sup> Sen. Murkowski’s spokesman called the move “capricious and done only to interfere with development.”<sup>164</sup>

### **Polar Bears**

There may be an even greater obstacle to oil production ahead of Shell and the other companies looking to produce oil and gas in Alaska. What the state and the industry reportedly fear the most is uncertainty related to the protection of the polar bear.<sup>165</sup> In 2008, the U.S. Fish and Wildlife Service (FWS), within Interior, decided to list the polar bear as a threatened species under the Endangered Species Act. That decision could greatly impact the future of oil and gas extraction in Arctic waters because of its broad ramifications.

The first concern is the reason for the polar bear’s inclusion on the list<sup>166</sup> – according to FWS, global climate change was causing a loss of sea ice, the polar bear’s habitat. On this basis, Interior could potentially have restricted any project, anywhere, by arguing that the project contributed to greenhouse gas emissions and, therefore, degraded the polar bear’s habitat. Fortunately, Interior did acknowledge this concern and modified regulations to specify that projects’ greenhouse gas emissions could not be linked to endangered species.

To protect the polar bears, in October 2009, FWS instead proposed a critical habitat for the polar bear covering more than 200,000 square miles of land and water.<sup>167</sup> This was later reduced once FWS recognized that Air Force bases and a few other manmade structures and communities would not be an appropriate habitat to protect.<sup>168</sup> The polar bear’s proposed critical habitat overlaps with a substantial part of the federal acreage already under lease in Alaska’s Arctic waters. FWS has yet to determine exactly how they will act to protect the “critical habitat area.”

All of this has provoked numerous lawsuits, from both sides of the issue. Alaska has sued over the critical habitat designation because of the enormous economic impacts to the state, which it estimates to be in the hundreds of millions over just the next 15 years.<sup>169</sup> In its cost analysis, FWS only considered consultation costs and inaccurately concluded that the designation would only cost the state about \$669,000 over 29 years.<sup>170</sup> Some members of

<sup>163</sup> Andrew Jensen, *Pebble next target for EPA Environmental Justice unit?*, ALASKA J. OF COMMERCE (Feb. 18, 2011).

<sup>164</sup> *Id.*

<sup>165</sup> Eric Lidji, *Alaska Offshore Special Report*, PETROLEUM NEWS, Jan. 21, 2011.

<sup>166</sup> Endangered Species Program, U.S. Fish & Wildlife Service, (last visited May 20, 2011), available at <http://www.fws.gov/endangered/index.html>.

<sup>167</sup> *Id.*

<sup>168</sup> U.S. Fish & Wildlife Service Polar Bear Information (last visited May 18, 2011), available at <http://www.fws.gov/home/feature/2008/polarbear012308/polarbears promo.html>.

<sup>169</sup> Press Release, Office of Governor Sean Parnell, *State Announces Intent to Sue*, (Dec. 21, 2010), available at <http://gov.alaska.gov/parnell/press-room/full-press-release.html?pr=5603>.

<sup>170</sup> *Id.*

Congress have also tried to reverse the decision by proposing legislation that would delist the polar bear, but the bill would not prevent Interior from adding other Arctic species to the list.<sup>171</sup>

#### **IV. ROCKY MOUNTAIN REGION**

The Rocky Mountain region has some of the richest resources in the entire country. Domestic production in this region, primarily on federal public lands, accounts for 11 percent of the nation's natural gas supply and five percent of its oil.<sup>172</sup>

Exploration and production in the Rocky Mountain Region is complicated by the vast federal presence, primarily in the form of land ownership. The federal government owns roughly 650 million acres of land in the United States – which equates to more than a quarter of the country's landmass.<sup>173</sup> These lands are primarily located in 12 western states. In the west, the federal government owns more than 50% of the land area.<sup>174</sup> By contrast, in the District of Columbia, established by the Constitution as a federal city, the federal government owns only 25% of the total acreage.<sup>175</sup>

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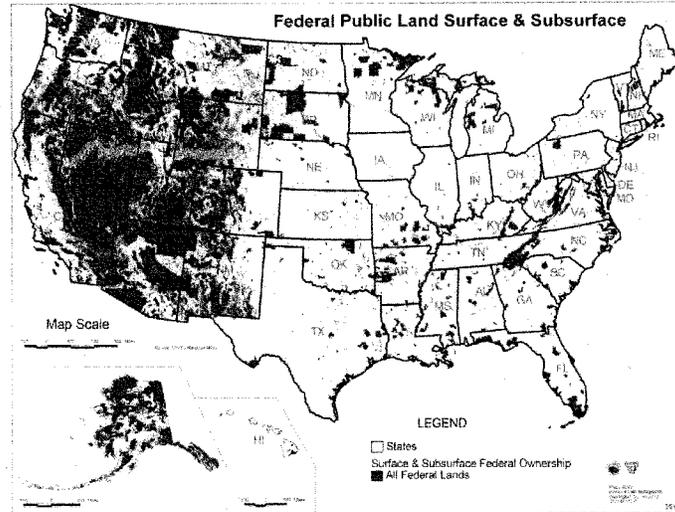
<sup>171</sup> H.R. 39, 112<sup>th</sup> Cong. § (2011).

<sup>172</sup> Oil and Gas, U.S. Department of the Interior Bureau of Land Management (last visited May 16, 2011), available at [http://www.blm.gov/wo/st/en/prog/energy/oil\\_and\\_gas.html](http://www.blm.gov/wo/st/en/prog/energy/oil_and_gas.html).

<sup>173</sup> Carol Hardy Vincent, *Federal Land Ownership: Current Acquisition and Disposal Authorities*, CRS REPORT TO CONGRESS (Dec. 16, 2010).

<sup>174</sup> *Id.*

<sup>175</sup> Ross W. Gorte et al, *Federal Land Management Agencies: Background on Land Resources and Management*, CRS REPORT TO CONGRESS (Feb. 9, 2009).



Source: Bureau of Land Management

Federal land is owned by taxpayers. Therefore, taxpayers must be compensated for its use. Federal and state treasuries benefit from the development of resources on Western lands. Unfortunately for the American people, the Administration has all but refused this potential revenue stream. Between 2008 and 2010, revenue from onshore federal royalties, rents, and bonuses has decreased 33%, from \$4.2 billion to \$2.8 billion. In 2008, there were 2,416 new oil and natural gas leases issued<sup>176</sup> on BLM land spanning 2.6 million acres.<sup>177</sup> In 2010, the number of new leases issued dropped nearly 50% to 1,308<sup>178</sup> and acres leased dropped to 1.3 million.<sup>179</sup> Combined with 2009, these acreage numbers are the lowest in over two decades.

Taxpayers would never know about this policy shift based on White House rhetoric. In a blog post at [whitehouse.gov](http://www.whitehouse.gov), the Administration writes "oil production last year rose to its highest level since 2003."<sup>180</sup> The blog post fails to explain that the vast majority of increased production is occurring on private lands, not public. For example, North Dakota alone produced

<sup>176</sup> Bureau of Land Management (last visited May 19, 2011) *available at* [http://www.blm.gov/pgdata/etc/medialib/blm/wo/MINERALS\\_REALTY\\_AND\\_RESOURCE\\_PROTECTION/energy/oil\\_gas\\_statistics.Par.32507.File.dat/chart\\_2009\\_03.pdf](http://www.blm.gov/pgdata/etc/medialib/blm/wo/MINERALS_REALTY_AND_RESOURCE_PROTECTION/energy/oil_gas_statistics.Par.32507.File.dat/chart_2009_03.pdf).

<sup>177</sup> Bureau of Land Management (last visited May 19, 2011) *available at* [http://www.blm.gov/pgdata/etc/medialib/blm/wo/MINERALS\\_REALTY\\_AND\\_RESOURCE\\_PROTECTION/energy/oil\\_gas\\_statistics.Par.24284.File.dat/chart\\_2009\\_04.pdf](http://www.blm.gov/pgdata/etc/medialib/blm/wo/MINERALS_REALTY_AND_RESOURCE_PROTECTION/energy/oil_gas_statistics.Par.24284.File.dat/chart_2009_04.pdf).

<sup>178</sup> *Id.*

<sup>179</sup> *Id.*

<sup>180</sup> *Expanding Safe and Responsible Energy Production*, White House blog, March 8, 2011, *available at* <http://www.whitehouse.gov/blog/2011/03/08/expanding-safe-and-responsible-energy-production>

almost 120 million barrels of oil in 2010, compared to just over 20 million in 2003.<sup>181</sup> The majority of North Dakota's production is on private land.

A slew of Obama Administration policies are to blame for the decreased production on federal land. The Department of Interior or EPA cause delays at each stage of the process.

### Deferred Leases

In order to drill on federal land, the producer must first obtain a lease. Companies make significant investments just to determine which parcels of land they want to lease.<sup>182</sup> The government then considers whether to lease those parcels that are nominated by the companies. Parcels may not be offered for lease for a variety of reasons, but this Administration is using some techniques of questionable legality. One of these techniques is the deferral of lease parcels. Established law dictates that leases be made available if authorized by resource management plans, which are developed with input from the public and the state.<sup>183</sup> If BLM desired to change the policies on which the resource management plans were based, an amendment to the plan is required. Rather than follow the established process, giving the public an opportunity for notice and comment, BLM has unilaterally instituted an additional level of planning and an opportunity to prevent leasing.<sup>184</sup>

The result has been the deferral of lease parcels and the loss of jobs and revenue. Ewing Exploration, a small business with six employees, provides an example of how this policy hurts local communities.<sup>185</sup> Ewing invested a total of \$3.5 million to explore the leases it purchased between 2005 and 2010 and nominated the additional ten parcels of federal land it need to fill out its drilling block. The company planned to develop 24 wells. One day before the sale, those ten parcels were withdrawn from the sale because they had to be "reprocessed in conformance with the new leasing reform process."<sup>186</sup> Now, those parcels will not be available until February 2012, a sixteen month delay. This delay has real economic consequences. Ewing's investors are receiving no return on their \$3.5 million investment – and may not be as willing to risk their money on public lands in the future. The deferral is also delaying payments of \$2.7 million per month in federal royalties and \$1.3 million per month in state taxes and royalties once the land is fully developed.

### Unissued and Withdrawn Leases

Having the lease actually be put up for sale and winning the bid is just the beginning. The Department of Interior holds hostage millions of dollars in unissued leases.<sup>187</sup> When a company

<sup>181</sup> North Dakota Industrial Commission Department of Mineral Resources (last visited May 20, 2011), available at <https://www.dmr.nd.gov/oilgas/stats/stateoilchart.pdf>.

<sup>182</sup> Internal Revenue Service (last visited May 20, 2011) available at [http://www.irs.gov/irm/part4/irm\\_04-041-001.html](http://www.irs.gov/irm/part4/irm_04-041-001.html).

<sup>183</sup> Adam Vann, *Energy Projects on Federal Lands: Leasing and Authorization*, CRS REPORT FOR CONGRESS (September 8, 2009).

<sup>184</sup> *Id.*

<sup>185</sup> Western Energy Alliance Washington D.C. Call-Up Briefing Book (April 2011), available at [http://westernenergyalliance.org/wp-content/uploads/2011/04/Briefing-Book\\_Final.pdf](http://westernenergyalliance.org/wp-content/uploads/2011/04/Briefing-Book_Final.pdf).

<sup>186</sup> *Id.*

<sup>187</sup> Western Energy Alliance, *Top Ten Ways the Federal Government Is Preventing Onshore Oil and Natural Gas Production* (Mar. 30, 2011).

wins a bid, it pays the federal government the amount it bid, which is called the bonus. Yet, the government does not necessarily issue the lease in return for the bonus, as the terms of the Mineral Leasing Act require it to do within sixty days. It is as if a new tenant signed a lease for an apartment, paid the owner a deposit, and was not given a key on the date designated for move-in. A Government Accountability Office report found that the Bureau of Land Management (BLM) failed to issue leases within this allotted time over 91% of the time from FY2007 through FY2009.<sup>188</sup>

Successful bidders also risk cancellation of their valid leases. In February 2009, the Interior Secretary withdrew 77 of the leases sold at the 2008 Utah lease sale because BLM had deviated "in important respects" from its normal oil and gas leasing procedures.<sup>189</sup> Secretary Salazar told reporters at the time of the announcement, "The policy positions of the department over the last eight years have really been driven out of the White House, and we're looking at many of those decisions."<sup>190</sup> Yet the Secretary's decision to withdraw 77 Utah leases was made without any consultation with the Utah BLM office.

Neither an independent investigation nor the federal courts upheld the Secretary's claims. The Department's Inspector General concluded that "no evidence to support the allegation that undue pressure was exerted on BLM personnel to complete the RMPs before the December 2008 sale or to include previously deferred parcels in the lease sale prior to the change in Administration."<sup>191</sup> While the investigation noted that the BLM "contributed to the perception that the sale was rushed prior to a change in White House administration," mere perception would not justify terminating contract rights. Over a year and a half later, a federal district judge issued a decision that confirmed that Secretary Salazar was outside of his legal authority to withdraw the parcels.<sup>192</sup> The Department of Interior later prevailed based on a technicality. The judge determined that the plaintiffs filed their complaint too late.<sup>193</sup>

In January 2011, the Department of Interior did it again. The Forest Service decided to withdraw leases it sold and issued, in 2005 and 2006, in the Bridger-Teton National Forest in Wyoming.<sup>194</sup> Relatively new legislation, the Wyoming Range Legacy Act of 2009, prohibits future lease sales in this region but explicitly protects the rights of those with existing leases. Likely recognizing its actions were on shaky legal ground, the Department of Interior has since decided to reconsider this decision.<sup>195</sup>

<sup>188</sup> U.S. GOVERNMENT ACCOUNTABILITY OFFICE, ONSHORE OIL AND GAS: BLM'S MANAGEMENT OF PUBLIC PROTESTS TO ITS LEASE SALES NEEDS IMPROVEMENT (July 2010).

<sup>189</sup> *BLM Review of 77 Oil and Gas Lease Parcels Offered in BLM-Utah's December 2008 Lease Sale* (Oct. 7, 2009) available at [http://www.doi.gov/documents/BLM\\_Utah77LeaseParcelReport.pdf](http://www.doi.gov/documents/BLM_Utah77LeaseParcelReport.pdf).

<sup>190</sup> Juliet Epstein, *Salazar Voids Drilling Leases On Public Lands in Utah*, WASHINGTON POST, Feb. 5, 2009.

<sup>191</sup> U.S. DEPARTMENT OF THE INTERIOR OFFICE OF THE INSPECTOR GENERAL, INVESTIGATIVE REPORT: BLM UTAH LEASE SALE (2009).

<sup>192</sup> *Impact Energy Res., LLC v. Salazar*, 2010 U.S. Dist. LEXIS 91095 (D. Utah 2010).

<sup>193</sup> *Id.*

<sup>194</sup> Press Release, U.S. Department of Agriculture Forest Service, *Bridger-Teton Forest releases final Supplemental Environmental Impact Statement and Record of Decision on Wyoming Range Oil and Gas Leases* (Jan. 25, 2011).

<sup>195</sup> Press Release, U.S. Department of Agriculture Forest Service, *Bridger-Teton Forest Supervisor Withdraws Decision on Wyoming Range Leases* (May 5, 2011).

Even if the Department of Interior issues the lease, the successful bidder may not receive what it bargained for. In many cases, especially in Wyoming where BLM has actually issued leases, new restrictions are added to the leases that were not specified at the time of sale.<sup>196</sup> The severity of these restrictions, also referred to as stipulations, vary. Some, such as preventing drilling during the breeding season of a certain species, are fairly standard in the industry. Others, such as “No Surface Occupancy” which prohibits any surface disturbance on the lease, are so severe that they may render the lease worthless to the producer. Returning to the apartment analogy, these after-the-fact stipulations are akin to a tenant signing an apartment lease, carefully reading the contract to ensure there are no pet restrictions, paying a deposit, and then being told on move-in day that her dog will not be allowed in the building. The owner would essentially have changed the terms of the contract, just like the Department of Interior does when it adds stipulations.

### **NEPA Analyses and Project Approval Delays**

The Administration claims that oil and gas producers are hoarding leases on federal lands because they are using less than one-third of existing leases.<sup>197</sup> This criticism is grossly misleading because the Administration itself is often preventing the leaseholder from drilling on currently leased land. After a company wins a bid, pays the bonus, and is issued the lease, it must submit a project proposal to the Department of Interior, and an environmental analysis in accordance with the National Environmental Policy Act (NEPA) must be performed. The government does not bear the burden of performing this analysis; rather, the project proposer pays an agreed upon third party contractor to perform it.<sup>198</sup> Regardless, the NEPA analysis is taking years to complete, with some projects facing indefinite delays. Small Environmental Assessments regularly require four years, while the more involved Environmental Impact Statements easily take seven years.<sup>199</sup> White House Council on Environmental Quality guidance states these analyses should not take more than three months and twelve months, respectively. NEPA analyses often take more time than the guidance directs, but this Administration appears to be abusing the process. Environmental Impact Statements required just over three years to complete between 1994 and 2005; now the average EIS completion time is just under six years.<sup>200</sup> Projects in the West, for a variety of excuses, face even longer delays with no end in sight.<sup>201</sup>

### Wild Lands Policy

One of the most controversial techniques to delay project approval is the newly invented “wild lands” designation. Secretary Salazar issued an order last December directing BLM to

<sup>196</sup> Press Release, Western Energy Alliance, *Top Ten Ways the Federal Government is Preventing Onshore Oil and Natural Gas Production*, (March 2011), available at <http://westernenergyalliance.org/wp-content/uploads/2011/03/Western-Energy-Alliance-IPAMS-Position-Paper-Top-10-Ways-Onshore-Production-is-Being-Prevented.pdf>.

<sup>197</sup> Exploration and Production (Upstream), American Petroleum Institute, (last visited May 20, 2011), available at <http://www.api.org/aboutoilgas/sectors/explore/index.cfm>.

<sup>198</sup> National Environmental Policy Act (last visited May 20, 2011), available at <http://www.epa.gov/compliance/nepa/index.html>.

<sup>199</sup> *Id.*

<sup>200</sup> *Id.*

<sup>201</sup> *Id.*

redo a recently completed inventory of federal lands that took years to complete the first time around, diverting BLM's already limited resources.<sup>202</sup> Under the Secretary's new policy, the Department of Interior unilaterally determines that an area should be designated as wild lands and considered for wilderness protection. Under the 1964 Wilderness Act, "wilderness" is a designation that can only be made by Congress. To be considered "wilderness," the law says the land (1) must be at least 5000 contiguous acres in size unless a smaller area can be practicably preserved and used in an unimpaired condition, (2) have an appearance of naturalness, and (3) have either outstanding opportunities for solitude or primitive and unconfined recreation.<sup>203</sup> But under the new policy, BLM treats any land it decides to designate as "wild land" as "de facto wilderness," preventing productive uses of the land such as grazing, oil and gas extraction, and motorized recreation – and sidestepping Congress. In some cases, environmentalists have attempted to convince Congress to designate certain lands as "wilderness" for decades, but Congress has consistently and repeatedly declined.<sup>204</sup>

Some of the lands already designated as "wild lands" may confuse the novice nature-lover. It is not uncommon to find roads, active and inactive wells, agricultural improvements, and even air strips on proposed wild lands.<sup>205</sup> If lands visibly subject to multiple uses in the past still possess wilderness characteristics, then it must not be necessary to lock those lands away entirely in order to maintain wilderness characteristics. Locking away public lands is also in contradiction to the Federal Land Policy and Management Act of 1976.<sup>206</sup> FLPMA directs the BLM to manage public lands "on the basis of multiple use and sustained yield."<sup>207</sup> The wild lands policy permits neither. BLM Director Robert Abbey told Congress that he "believe[s] in, and [is] dedicated to, the BLM's multiple-use mission."<sup>208</sup> He also stated that any claims that the new wild lands policy has put a halt to new project and is preventing important economic activity in local communities is false.<sup>209</sup> Companies facing indefinite delays after investing millions of dollars likely disagree. Now, with the stroke of a pen, Secretary Salazar has granted "wild land" designations and effectively instituted an end-run around Congress.

#### EPA's Contribution to NEPA Delays

EPA is also responsible for delays at the project approval stage. A couple of examples best illustrate the effect of EPA's pressure on land managers conducting NEPA analyses. In one case, involving a large project of 1,250 wells in Wyoming, EPA inexplicably changed the type of air study it required. The companies involved in the EIS for the large project had already spent

<sup>202</sup> Press Release, U.S. Department of the Interior, Salazar, *Abbey Restore Protections for America's Wild Lands* (Dec. 23, 2010), available at <http://www.doi.gov/news/pressreleases/Salazar-Abbey-Restore-Protections-for-Americas-Wild-Lands.cfm>.

<sup>203</sup> Wilderness Act of 1964 (16 U.S.C. 1131-1136, 78 Stat. 890)

<sup>204</sup> H.R. 1925, 111<sup>th</sup> Cong. § (2009).

<sup>205</sup> Letter from Public Lands Advocacy to Ken Salazar, Secretary, Department of the Interior (January 31, 2011) (on file with author).

<sup>206</sup> Federal Land Policy and Management Act, Bureau of Land Management (last visited May 20, 2011) available at <http://www.blm.gov/flpma/>.

<sup>207</sup> *Id.*

<sup>208</sup> *The Impact of the Administration's Wild Lands Order on Jobs and Economic Growth: Hearing before the H. Comm. on Natural Resources*, 112<sup>th</sup> Cong. (2011) Statement of Robert Abbey, Director, Bureau of Land Management)

<sup>209</sup> *Id.*

\$2.5 million based on prior guidance from EPA.<sup>210</sup> In a second case, EPA asked a small business operating in Utah, Gasco Energy, to complete three rounds of air modeling for its 1,500 well project. EPA changed its request three times as to what type of air study it required, which resulted in years of delay and hundreds of thousands of dollars in unnecessary expenses.<sup>211</sup> EPA made these requests despite Gasco Energy agreeing to controls and other mitigation measures above and beyond those the law requires.<sup>212</sup>

#### Permitting Delays and Complications

The Department of Interior's next opportunity to delay production on the land is the permitting process. After receiving project approval, the producer may file an Application for Permit to Drill (APD).<sup>213</sup> Under the Energy Policy Act of 2005, BLM has thirty days to process an APD. However, by its own conservative estimate, BLM averages 206 days to process a permit.<sup>214</sup> In some BLM field offices, permits can take over two years.<sup>215</sup>

Even after a permit is issued, the company that applied for it may not be able to use it. In some cases there may be stipulation periods after the permit is issued. Some permits may be tied up in lawsuits. For others, the permit process might have taken so long that the land is now subject to new planning restrictions that prohibit development. One example of this occurred in the Powder River Basin. Years after applications were submitted, 2,400 permits were released at one time. By then, many companies had abandoned their plans, in part because of changes in the cost of natural gas and in part because of new restrictions associated with sage grouse and produced water. The uncertainty in the process results in companies taking their business elsewhere.<sup>216</sup>

### V. TEXAS

As oil and gas producers grow more and more frustrated with the obstacles to drilling on federal land out West, they look to private land in Texas. Texas leads the nation in the production of oil and natural gas. Texas produced 447,076 thousand barrels of crude oil<sup>217</sup> and 7,403,720 million cubic feet of natural gas in 2008. In comparison, Alaska produced 249,874 thousand barrels of crude oil and 398,442 million cubic feet of natural gas in the same year.<sup>218</sup> Texas also has more proved oil reserves (5,496,000 thousand barrels compared to 4,007,000 thousand in the Gulf, and 3,556,000 thousand in Alaska in 2009) and more wet natural gas

<sup>210</sup> *Id.*

<sup>211</sup> *Id.*

<sup>212</sup> *Id.*

<sup>213</sup> Energy Policy Act of 2005: Section by Section, Bureau of Land Management, (last visited May 20, 2011) available at [http://www.blm.gov/wo/st/en/prog/energy/epca\\_chart.html](http://www.blm.gov/wo/st/en/prog/energy/epca_chart.html).

<sup>214</sup> *Id.*

<sup>215</sup> *Id.*

<sup>216</sup> Powder River Basin Resource Council (last visited May 20, 2011) available at <http://www.powderriverbasin.org/>

<sup>217</sup> U.S. Energy Information Administration, State Energy Data 2008: Production, available at [http://www.eia.doe.gov/emeu/states/sep\\_prod/P6/PDF/P6\\_TX.pdf](http://www.eia.doe.gov/emeu/states/sep_prod/P6/PDF/P6_TX.pdf).

<sup>218</sup> U.S. Energy Information Administration, State Energy Data 2008: Production, available at [http://www.eia.doe.gov/emeu/states/sep\\_prod/P6/PDF/P6\\_ak.pdf](http://www.eia.doe.gov/emeu/states/sep_prod/P6/PDF/P6_ak.pdf).

proven reserves (85,034 billion cubic feet compared to 12,116 billion cubic feet in the Gulf and 9,183 cubic feet in Alaska) than either the Gulf or Alaska.<sup>219</sup>

Texas has weathered the recession better than most states,<sup>220</sup> due in no small part to a booming oil and gas production, and the state is fighting to keep EPA from interfering with its success. Under Obama, EPA put a spotlight on the state, seemingly assuming that a profitable oil and gas industry is an indication of insufficient regulation.

Last June, the EPA decided to strike down the “flex permit” system Texas has used since 1996, rejecting Texas-issued air-quality permits for refiners and other industrial plants.<sup>221</sup> Then, in December, EPA sent Texas regulators a letter saying it had “no choice” but to seize control of permitting in the state.<sup>222</sup>

#### **EPA Oversteps Texas Regulator**

Another high profile example of the EPA overstepping Texas regulators based on false claims of urgency came last December. The issue began when a landowner filed a complaint with the Texas Railroad Commission (RRC), the state oil and gas regulator, on August 6, 2010, stating that methane had contaminated water wells.<sup>223</sup> The RRC commenced a full investigation into the source of the methane within days of the complaint. Over the next several months, the RRC – with full cooperation from Range, the company that owned gas production wells nearby – collected samples, performed tests, and conducted interviews. The investigation found that homeowners in the area had reported gas in their water for decades. Chemical fingerprinting of the gas in the well indicated that it did not come from Range’s wells but from a shallow gas formation where wells were drilled in the early 1980s.<sup>224</sup> After finishing its investigation in March 2011, the RRC officially concluded that Range did not cause the water well contamination and that it likely came from the shallow gas formation.<sup>225</sup>

EPA, on the other hand, raced to issue an emergency order in December 2010, assuming the culpability of Range without the benefit of all the facts. EPA did not allow the RRC to finish its investigation,<sup>226</sup> did not discuss the results of independent EPA sampling with the RRC as the

<sup>219</sup> U.S. Energy Information Administration, U.S. Crude Oil, Natural Gas, and Natural Gas Liquids Proved Reserves, 2009, available at [http://www.eia.doe.gov/oil\\_gas/natural\\_gas/data\\_publications/crude\\_oil\\_natural\\_gas\\_reserves/cr.html](http://www.eia.doe.gov/oil_gas/natural_gas/data_publications/crude_oil_natural_gas_reserves/cr.html).

<sup>220</sup> Texas Economy at Glance, Bureau of Labor Statistics, available at <http://www.bls.gov/eag/eag.tx.htm>.

<sup>221</sup> Press Release, U.S. Environmental Protection Agency, *EPA Disapproves Texas Flexible Air Permit Program* (June 30, 2010).

<sup>222</sup> *A Focus on Texas' Economy, Energy Prices and Jobs: Field Hearing before the H. Comm. on Energy and Commerce, Subcomm. on Energy and Power*, 112<sup>th</sup> Cong. (2011) (statement of Greg Abbott, Attorney General, State of Texas)

<sup>223</sup> Press Release, Railroad Commission of Texas, *Railroad Commission's Active, Ongoing Investigation of Parker County Water Well Complaint* (Dec. 7, 2010), available at <http://www.rrc.state.tx.us/pressreleases/2010/120810.php>.

<sup>224</sup> *Id.*

<sup>225</sup> Press Release, Railroad Commission of Texas, *Railroad Commissioners Find Range Resources' Natural Gas Not Source in Parker County Water Wells* (March 22, 2011), available at <http://www.rrc.state.tx.us/pressreleases/2011/032211.php>.

<sup>226</sup> Press Release, Environmental Protection Agency, *EPA Issues an Imminent and Substantial Endangerment Order to Protect Drinking Water in Southern Parker County* (Dec. 7, 2010), available at

organizations had planned,<sup>227</sup> and did not give Range an opportunity to present important objective facts.<sup>228</sup> The Order directed Range to provide drinking water to the residents and to begin taking actions to correct the problem within 48 hours. The Order imposed costly requirements on Range, yet EPA has been unable to provide data indicating Range production activities contributed to the contamination of the wells. In addition to the cost of its voluntary cooperation with the Texas RRC, Range is incurring significant expenses defending itself—between \$1.5 million to \$1.75 million so far.<sup>229</sup> Such an act was unprecedented in Texas.

The Committee has reviewed documents indicating that this action was coordinated with local environmental activists. EPA Regional Administrator Al Armendariz wrote in an email to his friends at the Environmental Defense Fund and Public Citizen just before issuing the press release, “We’re about to make a lot of news [...] [T]ime to Tivo Channel 8.”<sup>230</sup> He went on, “Thank you both for helping to educate me on the public’s perspective of these issues.” “Yee haw! Hats off to the new Sheriff and his deputies!” one activist replied.<sup>231</sup>

After issuing the emergency order, EPA shifted rapidly into spin mode, exaggerating the circumstances and misrepresenting the work already conducted by the RRC. “I believe we’ve got two people whose houses could explode. So we’ve got to move,” the Administrator told the *Dallas Morning News*,<sup>232</sup> attempting to justify his declaration of an “imminent and substantial endangerment to a public drinking water aquifer through methane contamination” from Range’s “fracked” production well.<sup>233</sup> In reality, the emergency basis was false. As the findings of fact attached to the order stated, the threat to the homes had already been evaluated, and one of the water wells had been disconnected from the home months earlier.

EPA also played into environmental rhetoric by highlighting that Range utilized hydraulic fracturing to produce natural gas. The Order did not allege the gas was a consequence of hydraulic fracturing, and EPA technical staff admitted that hydraulic fracturing in the Barnett Shale deep below the well could not be the cause of the gas occurring in the water wells.<sup>234</sup> Despite the well contamination having no connection to hydraulic fracturing, EPA included in their press release announcing the emergency order, “EPA believes that natural gas plays a key

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<http://yosemite.epa.gov/opa/admpress.nsf/e8f4f717970934e8525735900400c2e/713173b4bdceb126852577f3002cb6fb!OpenDocument>.

<sup>227</sup> In late October, EPA collected samples as well. EPA shared these results with RRC staff in late November and requested a meeting to discuss them, but on Dec. 1, 2010, the meeting was postponed. See Press Release, Environmental Protection Agency, *EPA Issues an Imminent and Substantial Endangerment Order to Protect Drinking Water in Southern Parker County* (December 7, 2010).

<sup>228</sup> Environmental Protection Agency, Findings and Emergency Order, Docket No. SDWA-06-2011-1208 (Dec. 7, 2010).

<sup>229</sup> Jack Z. Smith, *Range Resources calls EPA conclusions ‘sheer guesswork,’* STAR-TELEGRAM, May 2, 2010.

<sup>230</sup> Mike Soraghan, *Texas EPA Official’s E-Mails Show Federal-State Tension Over Sanctions on Natural Gas Drilling*, NEW YORK TIMES (Feb. 11, 2011), available at <http://www.nytimes.com/gwire/2011/02/11/11greenwire-texas-epa-officials-e-mails-show-federal-state-63373.html>. (e-mails available at [http://www.eenews.net/assets/2011/02/11/document\\_gw\\_03.pdf](http://www.eenews.net/assets/2011/02/11/document_gw_03.pdf)).

<sup>231</sup> *Id.*

<sup>232</sup> Randy Lee Loftis, *EPA: 2 Parker County homes at risk of explosion after gas from ‘fracked’ well contaminates aquifer*, DALLAS MORNING NEWS, Dec. 9, 2010.

<sup>233</sup> *Id.*

<sup>234</sup> Letter from Mark D. Whitley, Senior Vice President, Range Resources Corp. to Dr. Alfredo Armendariz, EPA Regional Administrator (Dec. 27, 2010).

role in our nation's clean energy future and the process known as hydraulic fracturing is one way of accessing that vital resource. However, we want to make sure natural gas development is safe."<sup>235</sup> Possibly not so coincidentally, Range is also a very active driller in the Marcellus Shale of Pennsylvania.

EPA has refused to cooperate with either the Range or the RRC to resolve the dispute. In January, the RRC held an open hearing to receive expert testimony on the issue. Several experts explained flaws in EPA's methodology, explaining that deep Barnett Shale had very low levels of nitrogen compared to the shallow Strawn formation.<sup>236</sup> Nitrogen, therefore, was the distinguishing fingerprint. If the well had high levels of nitrogen, then the contamination was not coming from the Barnett Shale where Range had drilled. EPA had failed to conduct this analysis, but RRC took the time to do it. EPA declined to participate in the open hearing. Some critics joked that "EPA had better things to do – like asking the Department of Justice to impose a \$16,500-a-day fine on the company for failing to comply with an order that EPA itself has neither the interest nor ability to defend or explain in an open forum."<sup>237</sup>

One Texas Railroad Commissioner called EPA's action "Washington politics of the worst kind. The EPA's act is nothing more than grandstanding in an effort to interject the federal government into Texas business. The Railroad Commission has been on top of this issue from Day 1. We will continue to take all necessary action to protect Texas lakes, rivers and aquifers. Texans have no interest in Washington doing for Texas what it did for Louisiana fishermen."<sup>238</sup>

#### **DOI Threatens Texas with "Endangered" Lizard**

The Fish and Wildlife Service (part of the Department of the Interior) has also found the Texas oil and gas industry to be an imminent threat, not to people but to lizards. The Fish and Wildlife Service has proposed placing the dunes sagebrush lizard that lives in New Mexico and west Texas on the Endangered Species List.<sup>239</sup> Endangered Species status would allow the Fish and Wildlife Service to limit oil and gas production in the Permian Basin of west Texas – which currently produces nearly 20% of the country's crude oil.<sup>240</sup> Thousands of acres could potentially be taken out of production as a result of the rule, without an economic analysis ever being performed.<sup>241</sup>

How the Fish and Wildlife Service would use the lizard to stop oil and gas production is not a secret. According to the official notice in the Federal Register: "We believe the following actions may jeopardize this species, and therefore [the Fish and Wildlife Service] would seek to conference with [the Bureau for Land Management] and [NRCS] on these actions: The lease of land for oil and gas drilling, Applications to drill, Applications for infrastructure through dunes (including, but not limited to pipelines and power lines), [Off-Highway Vehicle] activities,

<sup>235</sup> *Id.*

<sup>236</sup> *EPA MIA in Austin*, ENERGY IN DEPTH (Jan. 20, 2011), available at <http://www.energyindepth.org/2011/01/epa-mia-in-austin/>.

<sup>237</sup> *Id.*

<sup>238</sup> *Id.*

<sup>239</sup> Dunes Sagebrush Lizard, U.S. Fish & Wildlife Services (last visited May 20, 2011) available at <http://www.fws.gov/southwest/es/DSL.html>.

<sup>240</sup> Susan Montoya Bryan, *Small lizard sparks big debate in NM, Texas*, BLOOMBERG BUSINESSWEEK, Apr. 28, 2011.

<sup>241</sup> *Id.*

Seismic exploration, Continued oil and gas operations (release of pollution and routine maintenance)....<sup>242</sup>

The Fish and Wildlife Service would devastate the local oil and gas industry based on limited data. Locals say the government used a flawed methodology when it estimated the lizard population – it did not spend enough time looking for the lizards and did not know how to find them.<sup>243</sup> Regardless, the Fish and Wildlife Service has alternatives to declaring the lizard endangered. For example, voluntary conservation agreements between the federal government and landowners, like those successfully implemented in New Mexico, would help preserve the lizard's habitat while allowing production to continue.<sup>244</sup> According to the president of the Permian Basin Petroleum Association, "The best way [to protect the lizard] is for land owners and industry actually on the ground where the lizards are, who know how to protect the lizard, to be in charge instead of the feds putting up 'Do Not Enter' signs on every gatepost."<sup>245</sup> The public comment period closed on May 16, accordingly, the rule will most likely be issued by the end of the year.

### CONCLUSION

In his 2010 State of the Union address, President Obama declared: "the nation that leads the clean energy economy will be the nation that leads the global economy...America must be that nation."<sup>246</sup> Despite the fact that more than 80 percent of U.S. energy needs are met with carbon-based fuels that cannot be easily, cheaply or quickly replaced, the Obama Administration has been aggressively suppressing the utilization of these carbon-based fuels.

A pattern of evidence, as well as statements from before President Obama and Secretary of Energy Chu took office about the need for Americans to pay higher energy costs, raise alarming concerns about the existence of a campaign, across government agencies. This campaign aims to block carbon-based energy extraction, to tax it, and to otherwise increase its cost of use. The effort is occurring simultaneously with calls to heavily subsidize the development and use of "green energy."

While some may argue that there are benefits of having Americans pay more for gasoline, more for electricity, and more for home heating, the surreptitious implementation of such an agenda without public discussion or announcement appears highly inappropriate and contrary to the Administration's promises of transparency.

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<sup>242</sup> Endangered and Threatened Wildlife and Plants; 12-Month Finding on a Petition To List the Sonoran Population of the Desert Tortoise as Endangered or Threatened, 75 Fed. Reg. 78094 (proposed Dec. 14, 2010).

<sup>243</sup> *Id.*

<sup>244</sup> Press Release, U.S. Department of the Interior, *New Conservation Effort Benefits Rare Species in Southeastern New Mexico* (Dec. 8, 2008), available at [http://www.doi.gov/archive/news/08\\_News\\_Releases/120808.html](http://www.doi.gov/archive/news/08_News_Releases/120808.html).

<sup>245</sup> *Mella McEwen*, Could a Three-inch Lizard Collapse the West Texas Oil Industry?, Midland Reporter-Telegram (April 23, 2011) available at [http://www.mywesttexas.com/mobile/article\\_e7f32d45-fab8-5025-afa9-26a00d768910.html](http://www.mywesttexas.com/mobile/article_e7f32d45-fab8-5025-afa9-26a00d768910.html).

<sup>246</sup> *Id.*

What President Obama failed to accomplish through the so-called “cap and trade” program, his administration is attempting to accomplish through regulatory roadblocks, energy tax increases, and other targeted efforts to prohibit development of domestic energy resources. This includes actions at the Bureau of Ocean Energy Management, Bureau of Land Management, and U.S. Fish and Wildlife Service that have raised barriers to limit exploration and development of domestic energy resources. This includes moratoriums on offshore oil drilling, blockage/delay of onshore oil and gas leases, and even efforts to list certain lizard species on the endangered list at the expense of 20 percent of the Texas crude oil market, alone.

Thanks to advances in new technology, the U.S. energy industry has the opportunity to experience a renaissance by extracting resource deposits not even known to exist a generation ago. The opportunity to increase domestic oil production by as much as 40% in the next five years is at hand. Congress and the Obama Administration should herald this development, reducing barriers and streamlining processes so these firms can ramp up activity and production in an effort to achieve energy independence. Doing so would stabilize our sources of energy, create well-paying job opportunities for American workers, and improve our standing in the global marketplace by removing the volatile supply chains that currently impact our energy prices and availability.

The ability to utilize our nation’s rich natural resources may, however, be out of reach if the Obama Administration continues efforts to hinder domestic development of carbon based energy sources in an attempt to ignite a green energy revolution. While there are clearly needs and opportunities for green energy development, premature implementation of such technologies will come at the price of a premium over more affordable sources of energy. An effort to intentionally raise the costs of traditional energy sources is a dangerous strategy that will harm economic recovery and job growth. If past statements of key administration officials are indeed reflections of the policies they are pursuing, this strategy is playing a quiet but significant role in the higher energy prices Americans are currently paying.

**About the Committee**

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The Committee on Oversight and Government Reform is the main investigative committee in the U.S. House of Representatives. It has authority to investigate the subjects within the Committee's legislative jurisdiction as well as "any matter" within the jurisdiction of the other standing House Committees. The Committee's mandate is to investigate and expose waste, fraud and abuse.

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Committee on Oversight and Government Reform  
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Mr. KUCINICH. I want to just begin by letting the chair know how much appreciate the fact that you called this hearing, because what I note is interesting is, you know, while the witnesses may have some differences of opinion, the fact that there is concurrence suggests that there may be the potential for an alliance between conservatives in the House and those who are not conservative, or even liberal, on some of these economic issues, especially with respect to the role of the Fed. That is not a small matter. And I appreciate that you called this.

Dr. Baker, could you take a few minutes to explain the relevance of price inflation here and explain to us the relationship between the price Americans see at the gas pump and the supply of money? Do you have any thoughts on that?

Mr. BAKER. Well, in principle, what you can expect is that, in ordinary circumstances, gas prices rise with other prices. That is clearly not the sort of story that we are seeing today. So a conventional story of inflation driven by the money supply is that we throw out a lot of money, which we have done, and then, in response—and this has not happened—you would see all prices rising more or less at the same rate. You shouldn't expect to see changes in relative prices.

So we see gas, depending what we want to use as our starting point, but let's say we go back to \$2.50 a gallon and now we are at \$4, we seeing an increase on the order of 50 percent in the price of gas. We don't see anything like that almost anywhere else in the economy. We don't see that with rents, we don't see that with medical services, we don't see that with video equipment. I mean, pick whatever you want to look at, we don't see that.

So that suggests that something qualitatively different, something that has really very little to do with the supply of money is affecting the price of gas.

Mr. KUCINICH. Well, pull that out. So what does that suggest to you, then? I mean, I know you have said this before, but—

Mr. BAKER. So what I am saying is that, on the one hand, you have sort of the fundamentals of the market playing a very important role; that you have had rapid growth in the developing world that is increasing demand for oil. That is going to continue.

The second issue is the instability, which has, to some extent, affected the supply; it hasn't hugely affected it, but to some extent affected the supply. The instability in the Middle East, that could turn out to be a major factor in terms of actually affecting the supply if it were the case, for example, that Libya's oil were to come off world markets, that we would lose the supply from there, or one of the other major producers in the Middle East.

And then the third factor is simply that we clearly have some speculation in the market. People are betting that prices will be higher, and they are trying to take advantage of that and pick up the gains. And that, at least temporarily, pulls oil off the market, pushes up the price.

Mr. KUCINICH. I want to thank the chair for—and thank the witnesses for testifying. Those who represent trucking and businesses, you know, we appreciate your presence here. I think the chair has created a forum here for an important hearing.

And I look forward to working with you as we continue to try to find ways of letting our constituents know exactly what is going on and, you know, what we can do about it to try to take a new direction.

And, you know, finally, one of the things that I have advocated immediately with respect to the extraordinary profits that these oil companies are getting in this climate—for example, you know, Exxon, I think they had a \$10.7 billion profit in a single quarter—extraordinary—like, a 69 percent increase over the previous year, which is already pretty high—is to think about a windfall profits tax. You know, people have to make money, I got that. But when you are gouging people, you shouldn't get away with it.

So we should look for ways—and that wouldn't be at the pump. It would be on the profits. That is the difference. To try to find a way to try to discipline the oil companies so they aren't stealing from our constituents.

So, I appreciate the chair's opportunity to be here, and I look forward to continuing to work with you. Thank you.

Mr. JORDAN. I appreciate the ranking member's comments and input and help with the committee.

Just a quick response to the windfall profits suggestion. Probably not going to go there, as you would expect. But I have yet to figure out how raising taxes is going to lower gas prices. I just don't see how that is going to help Mr. Wannemacher in his business. I don't see how it is going to help the small-business owners Ms. Kerrigan represents.

Mr. KUCINICH. By not raising the price at the pump.

Mr. JORDAN. I just don't see how that is going to help our economy.

But I do want to thank our witnesses, particularly Mr. Wannemacher and Ms. Kerrigan coming in and giving us the small-business perspective, and our others on the Fed role and on the broader economic concerns. Thank you for being with us. I apologize again for having you have to stick around this late in the afternoon. But thank you for being here today and giving us this valuable testimony.

And we are adjourned.

[Whereupon, at 4:30 p.m., the subcommittee was adjourned.]

