Economic Newsletter for the New Millennium

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THE ECONOMICS OF CRUDE OIL PRICES AND THE IMPACT OF COMPETITION, OR THE LACK THEREOF

To paraphrase an old saying, they can price gouge some of the people all of the time and all of the people some of the time, but with a reasonable passage of time, they cannot price gouge all of the people all of the time…or can they???

When the oil cartel, OPEC, began in 1973 to price gouge oil buyers by seizing production and pricing decisions from the SEVEN SISTERS and restricting production, the duration of these periods of economic carnage lasted about one to two years. This pattern can be seen in 1973, 1978 and 2004-2008.

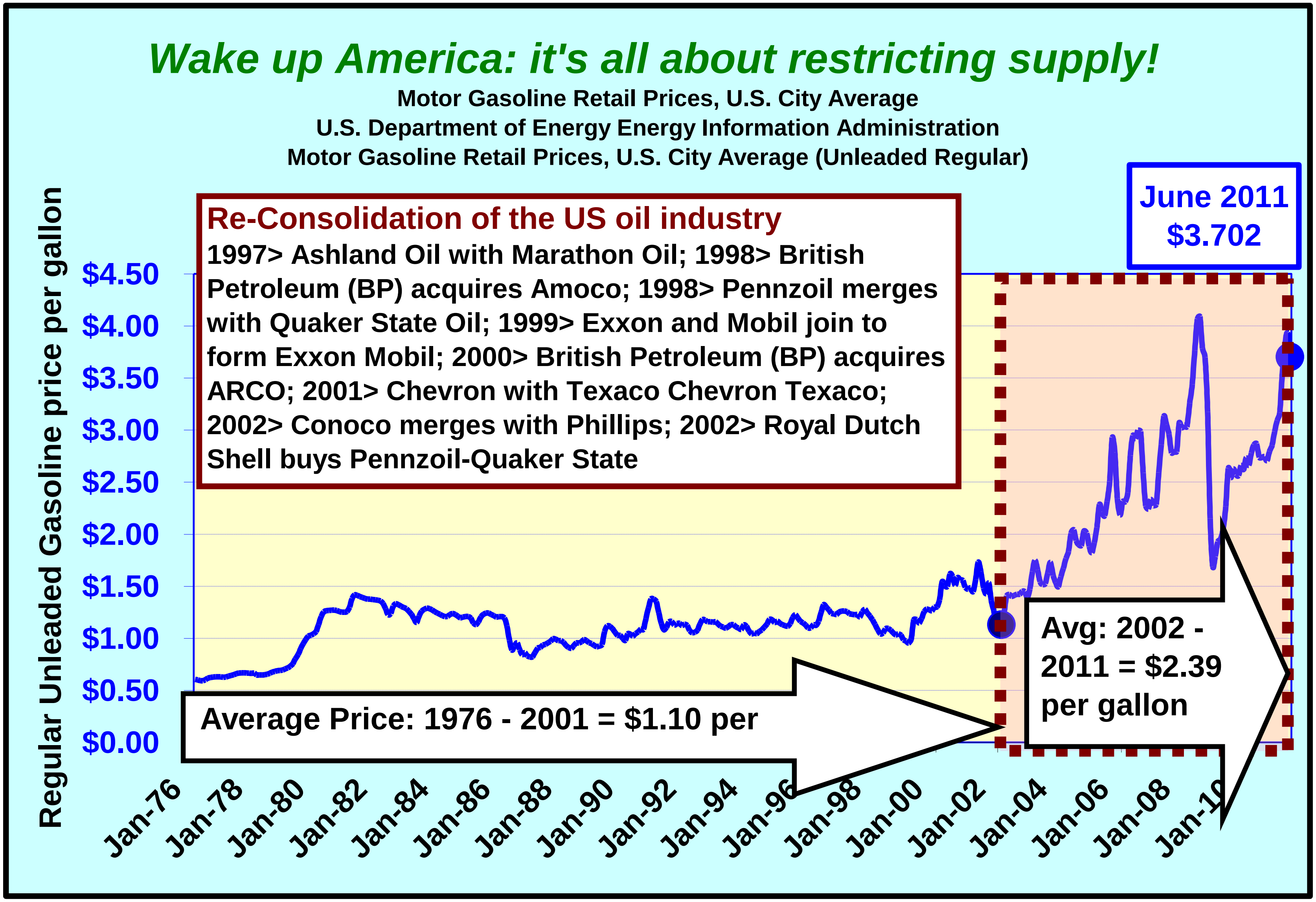
The Nature and Possible Solutions to the Current Energy Challenge

http://byrned.faculty.udmercy.edu/2005%20Volume,%20Issue%202/2005%20Volume%20Issue%202.htm

> ***"In 2004 OPEC (Organization of the Petroleum Exporting Countries) and OPIC (our acronym for domestic big oil – Organization of the Petroleum Importing Countries) struck again and raised their per barrel price from $35 and along with massive speculation in oil futures fostered by the same***

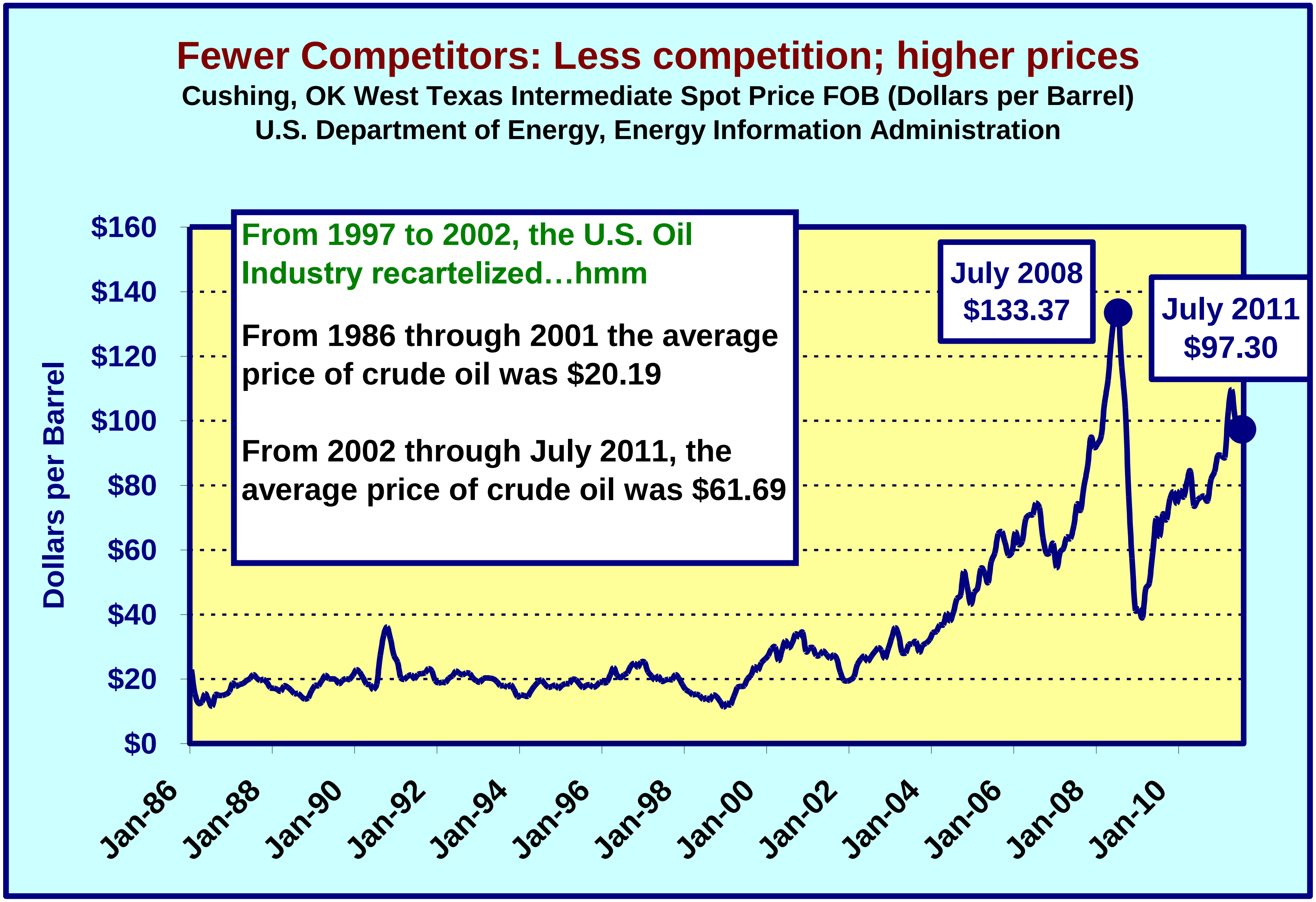
investment bankers that gave us (MBS) mortgage backed securities (CDOs, CDSs, etc.) and the financial chaos surfacing in 2008, the per barrel price rose to $145 in the June/July 2008.

With the ensuing recession, oil prices fell back to around the $40 range only to rise back up well above the $100 per barrel range."



Wake up America: it's all about restricting supply!
Motor Gasoline Retail Prices, U.S. City Average
U.S. Department of Energy Energy Information Administration
Motor Gasoline Retail Prices, U.S. City Average (Unleaded Regular)
June 2011
$3.702
Re-Consolidation of the US oil industry
1997> Ashland Oil with Marathon Oil; 1998> British Petroleum (BP) acquires Amoco; 1998> Pennzoil merges with Quaker State Oil; 1999> Exxon and Mobil join to form Exxon Mobil; 2000> British Petroleum (BP) acquires ARCO; 2001> Chevron with Texaco Chevron Texaco; 2002> Conoco merges with Phillips; 2002> Royal Dutch Shell buys Pennzoil-Quaker State
Regular Unleaded Gasoline price per gallon
$4.50
$4.00
$3.50
$3.00
$2.50
$2.00
$1.50
$1.00
$0.50
$0.00
Average Price: 1976 - 2001 = $1.10 per
Avg: 2002 - 2011 = $2.39 per gallon
Jan-76
Jan-78
Jan-80
Jan-82
Jan-84
Jan-86
Jan-88
Jan-90
Jan-92
Jan-94
Jan-96
Jan-98
Jan-00
Jan-02
Jan-04
Jan-06
Jan-08
Jan-10

In the most recent supply restriction beginning in 2004, the newly re-cartelized American segment of the oil industry, unofficially joined the OPEC thugs and declared they would abide by the market. Of course a market with a cartelized structure which was completed between 1997 and 2002 is not a competitive market such as that of some cereal grains such as wheat which would come close to a perfectly competitive if government would cease its intervention as embodied in its farm policies.


Fewer Competitors: Less competition; higher prices
Cushing, OK West Texas Intermediate Spot Price FOB (Dollars per Barrel)
U.S. Department of Energy, Energy Information Administration
From 1997 to 2002, the U.S. Oil Industry recartelized…hmm
From 1986 through 2001 the average price of crude oil was $20.19
From 2002 through July 2011, the average price of crude oil was $61.69
July 2008 $133.37
July 2011 $97.30
Dollars per Barrel
$160
$140
$120
$100
$80
$60
$40
$20
$0
Jan-86
Jan-88
Jan-90
Jan-92
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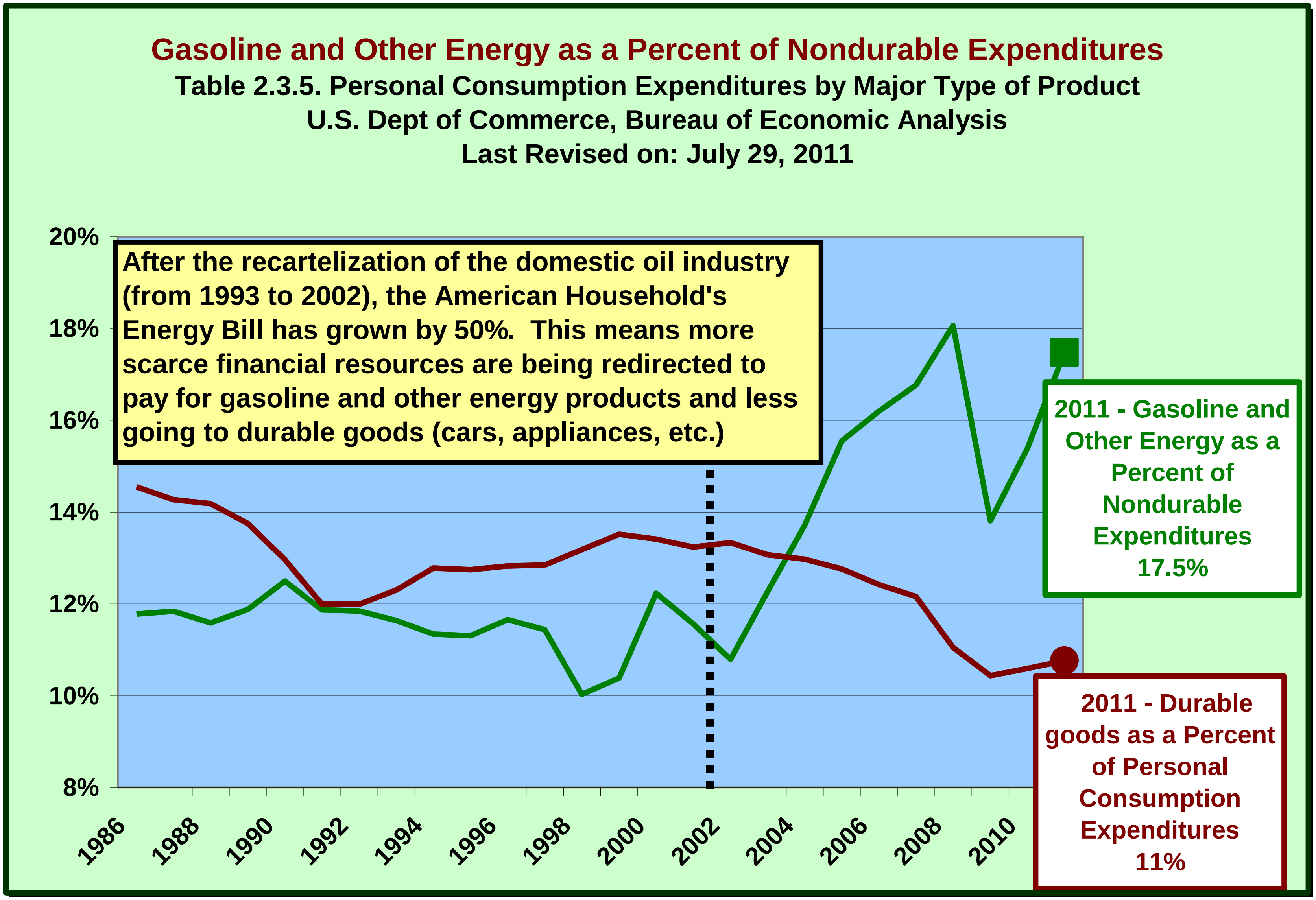
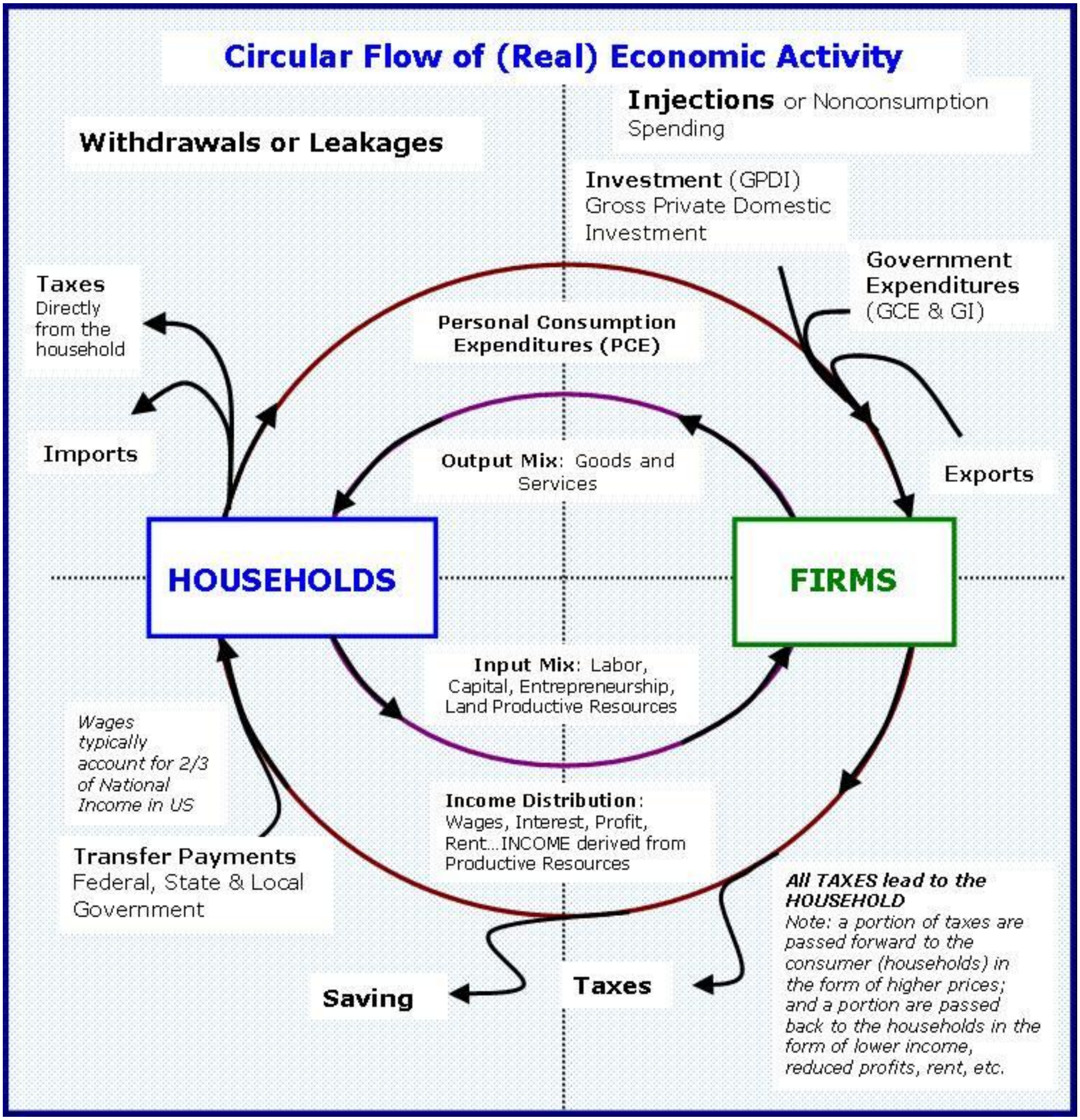
Jan-08
Jan-10


Gasoline and Other Energy as a Percent of Nondurable Expenditures
Table 2.3.5. Personal Consumption Expenditures by Major Type of Product
U.S. Dept of Commerce, Bureau of Economic Analysis
Last Revised on: July 29, 2011
After the recartelization of the domestic oil industry (from 1993 to 2002), the American Household's Energy Bill has grown by 50%. This means more scarce financial resources are being redirected to pay for gasoline and other energy products and less going to durable goods (cars, appliances, etc.)
20%
18%
16%
14%
12%
10%
8%
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2011 - Gasoline and Other Energy as a Percent of Nondurable Expenditures 17.5%
2011 - Durable goods as a Percent of Personal Consumption Expenditures 11%

Instead of such goals as efficiency and equity being approached when significant competition is present in a market, those economic welfare conditions are violated as huge amounts of excess profits and excess compensation to management and labor occur (in excess of these productive resources' opportunity costs and thus they are a violation of equity) and price, e.g. a barrel of crude oil exceeds marginal opportunity costs of selling it in the market (violation of efficiency).

Note bene, N.B.…Note well!
Definitions of equity and efficiency, etc.

Maybe it is time to point out why equity maximizes the consumer surplus subject to the constraint that productive resources receive their opportunity, no more and no less. We should also point out that profits are the reward to a productive resource (productive resources: Labor, capital (including equity and debt capital), entrepreneurship, and land) and to achieve equity this economic cost like the others such as labor should receive their opportunity costs, no more or no less. Violation of equity is a major reason for the huge inequality in the income distribution usually giving rise to government intervention and attempting to redistribute income and wealth, often very unsuccessfully.



As we have explained in articles on this web site for eight years, the promise of good things for the public from free market capitalism, are only realized when the markets are sufficiently competitive. Wall Street may praise unnecessary mergers and acquisitions and receive enormous profits, fees, and commissions for doing so, but the public will suffer from being exploited by an increase in market power if it results from these activities of the investment banking community.

The original Chicago school argued these points very clearly. Henry Simons, and later George Stigler and Milton Friedman were among the stalwarts of the Chicago until it morphed into the Second Chicago School that at least condones excessive rewards to productive resources whether it is to labor, management or equity capitalists. While Stigler and Friedman were associated most closely with the Second Chicago School, based on their adherence to neoclassicism, they were strong and strict adherents to competitive framework; with the former warning against what he termed as regulatory capture, where the regulators become captives of the regulatees – in short, regulatory agencies become the puppets of those they are regulating.

A maximization of producer surplus (formerly called economic rent) at the cost of drastically reducing the consumer surplus such as we are now experiencing in oil prices and the petroleum derivatives such as gasoline seems now to be acceptable and compatible with free market capitalism in this version of the Second Chicago School. The editors of this web site strongly disagree. If it waddles like a duck, quacks like a duck, and looks like a duck, it is highly probable that it is indeed a duck. **Consumers do not collude and collectively contrive to increase consumer surplus by restricting demand. Productive resources do however, restrict supply, whether they be business cartels like OPEC (Organization of the Petroleum Exporting Countries) and now OPIC (our acronym…Organization of the Petroleum Importing Countries), or labor unions like AFSCME (American Federation of State, County and Municipal Employees), UAW (United Autoworkers), or NEA (National Education Association) and its state and local affiliates.**

ENERGY, ENERGY, EVERYWHERE – BUT WHY DOES IT COST SO MUCH?
http://byrned.faculty.udmercy.edu/2007Vol/2007VolIssue1.htm

> *from…*
>
> *An Inquiry into the Nature and Causes of the Wealth of Nations (First published 1776)*

"People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."
-- Adam Smith

Book 1, Chapter 10
Of Wages and Profit in the Different Employments of Labour and Stock
http://www.econlib.org/library/Smith/smWN.html

From the Adam Smith Institute
(July 17, 1990)

"For Smith, government should not seek to subvert the creative process that is the market, but should establish the framework necessary to keep it alive. It should enforce competition. It should not give in to the well-argued demands of monopolists and would-be monopolists. It should punish people and authorities who conspire to fix prices, divide up markets, or restrict production. "Monopoly," wrote Smith, "is a great enemy to good management."

Michael Forsyth MP (British)
Adam Smith's Relevance for Today
http://www.adamsmith.org/smith/forsyth-speech.htm

In articles on other websites we have argued as have many others that the path to justice is best reached by ensuring as much competition in markets within a free market capitalistic system as possible.

http://www.catholicjournal.us/catholiceconomics/

"The effects of this increase in competition bring the income distribution closer to the theoretical economic welfare condition of equity -- consumers pay the lowest price possible consistent with the reward to resources equal to their opportunity cost -- and thus to conformity with commutative justice. It simultaneously causes the market price to approach the theoretical economic welfare condition of efficiency."

"As the distribution of income is more closely based on opportunity costs of the productive resources such as labor and capital, the closer is the economic system to conformity with distributive justice. This in turn reduces the need for government to reallocate income."