Market Perspectives

Working Paper: Are Gasoline Prices Too High?

Ben Pratt

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Introduction to this series…

Welcome to the "Market Perspectives" series of working papers. The purpose of these papers is to provide Koch employees with talking points and concepts that enable them to encourage others to consider the free-market perspective on current events and constructively deal with anti-market arguments or comments that often catch us off-guard in social situations.

I am a firm believer in the "crawl, walk, run…" theory whereby you master the basics before shooting for the stars. I am starting this series on a topic I feel somewhat familiar with – please forgive me the U.S. (and Wichita) centric perspective in this first paper. I promise that as I get my feet under me and have a chance to work with more of you in the various companies and offices around the world these papers will become more global in perspective or use other localities for examples.

None of the ideas or concepts contained within these papers is original; I am indebted to Charles Koch, the Market-Based Management team and many others for sharing and teaching them to me. However, the ways in which these ideas and concepts are expressed are my own – as well as any errors committed in the process. Read them with skepticism and challenge me if you disagree.

I will *highly* value your feedback: your constructive criticisms as well as suggestions for future topics. It will help me stay connected to reality and allow this series to improve whereby other readers across Koch will benefit from your effort, not just me. Please email me at ben.pratt@kochind.com – or you are welcome to call me at +1.316.828.5280.

Introduction

There's no doubt: gasoline prices are getting up there. The price at the pump for regular unleaded gasoline in Wichita is averaging near $1.90 per gallon and the price for a barrel of oil is hovering around $50.

It is not uncommon to hear concern expressed about "Big Oil's" market power and its ability to gouge us as consumers. Gas stations and oil companies seem to raise prices at any excuse – terrorism fears, hurricanes, political turmoil – and at the consumers' expense. A recent Wall Street Journal article reported that profits are way up in the energy sector companies. Is that fair?

It's important to resist simplistic explanations. Here are some things to think about in answering these questions.

What drives the oil and gasoline markets?

Before we embark on a more general discussion regarding the role of prices and the nature of competition in a free market, it might be useful to know something about the drivers of the international oil markets that supply the raw material for gasoline. Some of them are:

- Fear: fear of disruptions to the supply of crude oil due to war, threats of terrorism, and political tensions in places like Russia where its government and one of its biggest oil companies, Yukos, are in conflict.
- Increased demand / competition: China's demand for crude oil has increased about 40% over the last year. India's demand is way up too. The U.S., which consumes roughly a quarter of all the oil produced in the world, is having to compete more strongly with other countries who have growing demand.
- Decreased supply: It's getting more expensive to find and develop new oil reserves.
- Weather: a succession of hurricanes in key refining areas and crude oil entry points in the U.S. has disrupted supplies.

On the U.S. domestic refining side:

- There hasn't been a new refinery built in the U.S. since 1976, which means those that close aren't being replaced. In 1980 there were 300 U.S. refineries. In 2003 there were 149.
- They are expensive to build – even a small one costs as much as $1 billion. And millions of dollars per year are invested to comply with ever-changing regulatory requirements – over $45 billion was spent over the last decade in environmental improvements at existing facilities.
- Small refineries are uneconomical – they don't process enough fuel to cover their operating costs. And large refineries face strong opposition from environmental and consumer groups who don't want them in their backyards.

All of this adds up to big challenges in supplying fuel to the U.S. markets.

Sure, but those are all just great excuses to "Stick it to the Consumer."

The problem with the anti-market explanation of high prices at the pump – that the oil companies are "sticking it to the consumer" – is that the facts don't support it. Consider that gasoline prices in the US, when adjusted for inflation are still lower than they were during the oil shocks of the price-control Carter era. Prices were higher in 1981 during the fall of the Shah of Iran. When you account for purchasing power, anchoring the price of gasoline to wage rates, you have to go back to the 1950's.

Although our pocketbooks scream, "ouch!" at these recent price spikes, our actions speak louder still: few people are running to dump their SUV's for more fuel-efficient cars and car-pooling isn't all the rage currently. Not at these prices. But how is this possible? How has the real price of gasoline managed to stay effectively the same over a course of decades in the face of constant population growth and ever-increasing demand over the same period of time?

The answer lies in the power of markets to foster innovation, moderate behaviors to adjust to change quickly, and direct scarce resources to their highest-value uses. All without a central planning board of experts and all without coercion or use of force.

We all want to make money!!

Here's a (not) secret: those oil companies would love to charge *a lot* more for a barrel of oil or a gallon of gasoline! So why don't they charge $100 dollars a barrel for crude oil? Why not $100 for a gallon for gasoline? Competition, that's why.

If you are selling your house, don't you want to get as high a price as possible? What protects even the neediest home buyer from your desire to charge a very high price? It is because you aren't the only person selling a house. Even if the members of the OPEC cartel can manage not to compete with each other, they still have to compete with Russia and others. QuickTrip might *want* to charge $10 per gallon for its gasoline, but if it did so it would lose all its business to the other stations around town.

It is the nature of competition that suppliers compete with suppliers and consumers compete with consumers. You don't compete with QuickTrip for that next gallon of gasoline. You compete with the guy at the pump next to you – and everyone else who wants to buy gasoline. When you sell your house you aren't competing with home buyers; you are competing with other home sellers. Competition between sellers drives prices down. Competition between buyers drives prices up.

The point is that we, the consumers of oil and gasoline – competing with one another – are the primary cause of high prices.

The importance of price signals.

But a high price is like a fever. It's both a symptom and a potential cure. While French fishermen are blockading the ports of Marseille to gas and oil tankers in protest of high fuel costs; while politicians are falling all over themselves to find scapegoats; miraculous things happen: without anyone's coercion, some people start walking right past the SUV's on the show floors looking for the smaller fuel-efficient cars. Some people phone up their neighbors and co-workers and ask if they want to car pool.

At $50 per barrel, countries within OPEC start cheating on each other to capture that market price. The Russian government begins feeling a lot of pressure to patch things up with Yukos and get that oil pumping again. Really smart people start looking for ways to find more oil or invent motors that are more efficient – or use a different fuel source.

In short: all the things you would want to have happen do so all by themselves. All coordinated through the mechanism of a price signal. This is the practical implementation of the phrase, "think globally, act locally:" Nobody needs to know what's going on in the world when they make their individual decisions – as long as prices are freely set, all the information they need to make the right choice is embedded in that price.

Markets make it happen.

The phrase "market" is a bit misleading. It isn't some vast impersonal thing that allows corporations or governments to control us or our wealth as so many anti-market arguments imply. It is simply a term used to refer to the continuous exchange of goods, services and ideas between millions of *individuals* within the context of laws and norms of behavior.

It is the countless actions of individuals that make up a market – in oil, gasoline or houses. In a <u>free</u> market, individuals communicate and trade within the context of private property and the absence of third party coercion. In a free market, buyer and seller will only transact if <u>both</u> perceive the exchange to be beneficial. The prices that emerge from those myriad millions of transactions send vital, complex information wrapped up in a very simple, concise message that guides our individual decisions.

We all want things on the cheap or for free. That is fundamentally different from getting it "stuck to us" as consumers by "big oil companies." We don't buy gasoline unless we subjectively value it higher than our perceived alternatives – i.e. the opportunity cost.

Although it seems unfair perhaps that an oil company may have supplies bought some time ago at much lower prices which it in turn sells at currently very high prices, who will remember or care when fears have subsided, corrections have been made and prices have gone down… when those same oil companies – having also bought supplies at today's high prices – must in the future sell them at those future lower prices?

What about Koch?

The companies of Koch Industries are impacted both positively and negatively by high oil and gasoline prices. We consume large quantities of electricity and oil products to create the products and services we supply to the markets. Flint Hills Resources certainly benefits from increased spreads between light-sweet and heavy-sour crude and improved sales margins. On the other hand, Invista, Koch Nitrogen, and our Chemicals business suffer due to increased production costs.

High prices also tend to invite more regulatory scrutiny in our industry, which increases our costs. It is also very tempting for regulators to attempt to "protect" consumers from high prices by introducing caps or price ceilings which eliminates the vital role that prices play in allowing markets to move products and services to their highest-valued and most efficient use.

Talking points, questions for consideration and further information.

There's nothing wrong with complaining about the high price of gasoline. We all want things to be cheaper or free. It's partially that desire that motivates changes in the market. But when discussion turns to blaming a supplier for "making too much money" or "sticking it to the consumer" here are some talking points or questions you might consider:

- What does it mean to "make too much money"? How much is too much? Often you can turn the lens around and consider it from the opposite angle. As an employee, do you feel like you make too much money? How much is too much for your salary?
- Some people think that gasoline should be rationed by the government by the criterion of need. How would you propose that the rationing authorities determine need? What factors ought to be considered? Location of home and work? Nature of occupation? Number and ages of family members? How easy to determine for millions of individuals whose factors are constantly changing? How fair do you think the result would be?
- Think of the millions of intermediate steps and transactions that had to occur to bring that gasoline to the tank of your car. From the thousands of services and people involved in designing, building the gasoline station all the way to the work involved in finding and extracting crude from the ground. How did it all get done to get that next gallon in your tank for less than two dollars? Were people forced to do it? Did they do it out of compassion? How did it all get coordinated?
- There is an old saying: "The cure for high prices is… high prices." What does that mean?
- Thanksgiving is a national holiday in the U.S., popularly celebrated at the end of Novembers with a turkey dinner. If the supply of turkeys in a particular November turned out to be unusually small, do you think a turkey shortage would result? Why or why not?

Some of the key mental models we use at Koch that were part of this paper:

- Human Action
- Role of Prices, Profit & Loss
- Spontaneous Order
- Subjective Value
- Opportunity Cost

Suggestions for further reading:

- Naked Economics by Charles Wheelan

- The Economic Way of Thinking by Paul Heyne
- Energy, The Master Resource by Robert Bradley, Jr.
- MBM Models Collection, Charles Koch and Tony Woodlief