

Energy Security vs. Energy Independence

Editorial

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The price of crude oil is currently hovering around \$95 per barrel, matching the inflation-adjusted highs set in early 1980 (depending on how the adjustment is calculated, \$38 a barrel then would be worth \$96 to \$103 or more today). Ironically, oil prices have peaked just as Congress is about to iron out the differences between House and Senate versions of energy legislation passed earlier this year.

Upon gaining control of Congress in the 2006 election, the leadership of the Democratic Party stated that the goal of the new majority was "to achieve energy independence, strengthen national security, grow our economy and create jobs, lower energy prices, and begin to address global warming." The energy legislation now pending in Congress will achieve none of these objectives. Indeed, it will make things worse, especially with regard to energy security.

The House version of the energy bill raises oil industry taxes by nearly \$16 billion by repealing the 2004 manufacturers' tax credit for exploration, production, and refining, and by changing the tax treatment of foreign oil-related income. The presumed revenues would then be used to fund "renewable" and energy-efficiency incentives.

The House bill also repeals several incentives created by the 2005 Energy Policy Act, designed to increase domestic production of oil and natural gas—something that is necessary if the United States is to reduce its dependence on imported oil—by repealing new royalty relief for deep water production as well as incentives for tapping "deep gas" in shallow gulf waters.

The House legislation also requires that 20 percent of electrical output be generated from "renewable" energy sources. The Senate mandates a *sevenfold* increase in bio-fuels production. The Senate version also requires a 40 percent increase in the Corporate Average Fuel Economy (CAFE) standard to 35 mpg by 2020.

The provisions of both bills are at odds with the stated goal of the Congressional majority. Charles River Associates, a highly respected economic analysis firm, has explored the adverse economic impact of the pending legislation. But the bills will also threaten US energy security.

Energy security is not to be confused with "energy independence." The latter is a chimera, especially in this age of global interdependence. Energy independence is the mantra of those who stress "renewable" sources of energy, e.g. wind, solar, and biofuels, alternatives that, for technological and economic reasons, are far too expensive and unreliable to compete on the market with oil and gas and therefore must be subsidized.

Advocates of energy independence would repeat the mistakes of the 1970s and early 80s during which time the government attempted to micro-manage the energy market and pick winners and losers. The results were dismal then and there is no reason to believe the outcome would be any different today. Congress has apparently not learned that the reason such energy sources need subsidies in the first place is that they possess serious economic and technological shortcomings.

The problem is apparent when considering the case of the most popular bio-fuel: ethanol. In fact, ethanol producers have benefited from preferential treatment since 1978. The hope that it would become viable in a few years and get "off the dole" has never been realized.

There is another problem with bio-fuels mandates. As any student in an Econ 101 class can tell you, human action generates unintended consequences. Increases in ethanol production, even before the volume mandated by the Senate bill, have led to the diversion of land and corn from food production and animal feed, increasing food prices for US consumers. And even if the nation's entire corn crop were devoted to ethanol production, it would still only meet a fraction of annual U.S. gasoline demand.

While energy independence is a pipe dream, energy security is achievable. Unlike the former, the goal of which is to become self sufficient in the production of energy, the latter focuses on increasing the *supply* of energy by exploiting all of the sources available to us.

For instance, current policy discourages the production of domestic oil and natural gas. Energy security suggests that we should expand access to non-park federal lands in the West, Alaska, and under the waters off our coasts. These areas hold an estimated 635 trillion cubic feet of recoverable natural gas—enough to meet the needs of the 60 million American homes fueled by natural gas for over a century—and an estimated 112 billion barrels of recoverable oil—enough to produce gasoline for 60 million cars and fuel oil for 25 million homes for 60 years.

The pending legislation does nothing to increase oil and gas production in the United States, something that is necessary if we are to reduce our dependence on imports. On the contrary, the House version of the energy bill makes it more difficult to produce oil and gas by limiting access to domestic reserves and raising costs to producers.

Energy security also suggests that we should reverse our rejection of nuclear power. According to data compiled by the World Association of Nuclear Operators, all of the key indicators of nuclear plant performance—from unplanned reactor shutdowns to radiation exposure—have shown high levels of safety at U.S. nuclear power plants during the past decade. Nuclear energy is also efficient (France gets 75 percent of its electrical power from nuclear energy). The efficiency of nuclear power has improved by 36 percent since 1990, the equivalent of adding over 23 1,000 megawatt power plants.

The requirement for energy diversity and clean air would seem to support expansion of nuclear-generated electricity, yet no new nuclear plants have been ordered since 1979. Indeed, since nuclear power accounts for about 75% of the nation's clean power generation, and since it is the only base-load energy source that can make a decisive contribution toward reducing greenhouse-gas emissions, it ought to be embraced by environmentalists. But environmental activists have not only obstructed the construction of new nuclear power plants but also opposed renewing the licenses of nuclear power plants currently in operation.

There are other options as well for exploiting domestic sources of energy: recovering oil from shale, converting coal into liquid fuels, and exploiting the vast deposits of unconventional natural gas available domestically.

What proof is there that increasing the supply of energy by freeing up domestic resources will enhance energy security? The best example of how the market, not government pursuit of energy independence, contributes to energy security is President Ronald Reagan's decision to lift price controls on oil in 1981.

At the time, the price of oil was at a level that, in real terms is only now being matched, thanks to the decision by the Organization of Petroleum Exporting Countries (OPEC) to curtail output. Domestic price controls ensured that the OPEC cartel would face little or no competition in the production of oil. Domestic price controls were exacerbated by other wrongheaded policies stimulated by the two "energy crises" of the 1970s. One of the most egregious was the infamous "windfall profits" tax designed to punish oil companies for alleged profiteering. But since it applied to even newly discovered oil, its main impact was to discourage the exploration and drilling that would have increased oil supplies.

Although the energy problems of the 1970s were traceable to government policies, Reagan's decision to deregulate oil prices was ridiculed by policy makers, especially those who had served in the previous administration. For instance, Frank Zarb, who had been Jimmy Carter's "energy czar," predicted that decontrolling the price of crude oil would lead to gasoline prices of \$10 a gallon.

Instead, the world price of oil plummeted, helping to fuel the extraordinary economic growth of the 1980s. The reason for this outcome should be clear to anyone with an ounce of economic sense. As long as the OPEC cartel faced little competition in the production of crude oil, its members benefitted from keeping the commodity in the ground, confident that increasing demand would make it more valuable in the future.

Reagan's deregulation of crude oil prices created incentives for domestic producers to invest in exploration and to increase production. The threat of increased output by non-OPEC producers destroyed the discipline among OPEC members necessary to restrict production to maintain high prices. But facing the likelihood that an increase in supply would lead to lower future prices, OPEC producers increased output in the hopes of maximizing profits before prices fell. The cascading effect caused oil prices to tumble.

As in the 1970s, US energy policies have essentially restricted the exploitation of domestic sources of energy. Curtailed supplies have combined with rapid worldwide energy demand to increase the price of oil and other sources of energy. This provides leverage to foreign producers and threatens US energy security. Freeing up domestic energy resources will do today what President Ronald Reagan's decision to deregulate oil prices in 1981 did then: cause oil prices to fall, thereby enhancing US energy security.

Of course, environmentalists will object to policies that provide access to domestic energy sources. But environmental concerns need to be placed in proper context. The production of any economic good entails "opportunity cost"—the highest valued alternative that must be given up in order to acquire the desired good. Thus the acquisition of one normal good must be balanced against one's desire for other normal goods. All economic decisions involve "trade-offs."

But environmentalists often act as though the value of a pristine environment is infinite, permitting no trade-offs at all. When such a view has taken hold in policy debates, the consequences can be severe. Environmental concerns have become a centerpiece of the US political economy, but they must be balanced against the requirement for affordable energy and energy security. Congress's pending energy legislation fails to do so.

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