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Comments of the R Street Institute Before the Railroad Commission of Texas

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April 14, 2020

IN RE: MOTION FOR COMMISSION CALLED HEARING ON THE VERIFIED COMPLAINT OF PIONEER NATURAL RESOURCES U.S.A. INC. AND PARSLEY ENERGY INC. TO DETERMINE REASONABLE MARKET DEMAND FOR OIL IN THE STATE OF TEXAS

The Railroad Commission of Texas ("Commission") invites written comments ahead of a conference on April 14, 2020 on a compliant to determine reasonable market demand for oil in Texas. These comments provide the overarching view of the R Street Institute—a nonprofit, nonpartisan public policy research organization headquartered in Washington, D.C. with an office in Texas. The R Street Institute offers its research capabilities and expertise to assist the Commission and its stakeholders in this endeavor, including participating in the April 14, 2020 conference.

As a general rule, oil production quotas are very inefficient economic policy. Curtailing oil production would be a strategic blunder, impose unnecessary costs, distort competitive relationships and undermine economic productivity and risk management. Paradoxically, it would leave Texans and the United States more vulnerable to future oil price shocks.

This is not an abstract, ideological position. The empirical track record of oil price and quantity controls is abhorrent. They are used pervasively in public policy and energy economics coursework as examples of government failure from scholars across the political spectrum.[1] On the other hand, these sources cite policymakers' commitment to economic deregulation of the oil and gas industry and reluctance to impose new regulations as major policy successes.[2]

The oil industry has successfully endured numerous supply- and demand-side shocks since the Commission last prorated production in 1973. The most recent oil price collapse occurred in 2014.

[1] E.g., see a joint report by the American Enterprise Institute and Brookings Institution by Clifford Winston, "Government Failure versus Market Failure: Microeconomics Policy Research and Government Performance," AEI-Brookings Joint Center for Regulatory Studies, 2006, p. 4. https://www.brookings.edu/wp-content/uploads/2016/06/20061003.pdf.
[2] Winston, 2006, p. 95. https://www.brookings.edu/wp-content/uploads/2016/06/20061003.pdf.

Prices plummeted below what the expert community believed to be the breakeven range for U.S. tight oil projects—between $60/bbl to $90/bbl.[3] American producers, facing tight or negative margins, responded by innovating aggressively. This drove the breakeven point down almost 40 percent from 2014 to 2019.[4] The resilience of American producers to maintain higher-than-expected output levels, driven by productivity gains and cost reductions, caught OPEC by surprise.[5] It now stands as a remarkable case study of the benefits of policymakers letting markets work.

The R Street Institute insists that, with this context in mind, policymakers not underestimate American ingenuity and focus instead on circumstances that drive productivity and encourage proper risk management.[6] Curtailing oil production undermines productivity by penalizing the most efficient producers and rewarding less efficient ones. Market incentives motivate firms to manage risk efficiently, whereas quotas undermine risk management and leave the industry more vulnerable to shocks in the future. Markets will ultimately reward firms who better manage their balance sheets, incur debt responsibly and hedge their positions appropriately.

Production quotas do not remedy any market failure and, historically, reflect regulators' lack of information in determining an efficient allocation of resources. Price signals are much better suited for the task. The Commission should not repeat the mistakes of the Alberta provincial government, which intervened in the market in 2018 to force Canadian companies to curtail production. The unintended consequences of the move included U.S. refiners indicating a shift away from artificially costly Canadian crude,[7] which harmed economic activity in both countries.

The Commission should rely on evidence and resist the temptation to artificially stabilize an industry, which naturally seems attractive during market turmoil. But highly uncertain and volatile market fundamentals are exactly the conditions under which markets outperform central planning the most. In this case, the information asymmetry between regulators and market participants is greatest during these periods, which is why the best way to organize industrial activity is to leave it to the judgment of the many, not the few.

Finally, the Commission should be mindful of the larger strategic ramifications of its actions. The pursuit of an "explicit cartelization" of oil markets would position the U.S. as an "implicit member of OPEC."[8] The R Street Institute stresses that the Commission instead propel what has made the U.S. oil industry the global innovative leader: a competitive, free-enterprise system.

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[3] R.L. Kleinberg, et al., "Tight oil market dynamics: Benchmarks, breakeven points, and inelasticities," *Energy Economics* 70 (February 2018), pp. 70-83. https://www.sciencedirect.com/science/article/pii/S0140988317304103#bb0405.

[4] Michael D. Plante and Kunal Patel, "Breakeven Oil Prices Underscore Shale's Impact on the Market," Federal Reserve Bank of Dallas, May 21, 2019. https://www.dallasfed.org/research/economics/2019/0521.

[5] See e.g., the "World Oil Outlook" reports of the Organization of the Petroleum Exporting Countries since 2016. https://www.opec.org/opec_web/en/publications/340.htm.

[6] Devin Hartman, "Oil Industry Deserves to Compete on Its Merits," *RealClearEnergy*, April 2, 2020. https://www.realclearenergy.org/articles/2020/04/02/oil_industry_deserves_to_compete_on_its_merits_488181.html.

[7] Dean Foreman, "Unintended Consequences in Alberta's Limits on Crude Output," American Petroleum Institute, Feb. 19, 2019. https://www.api.org/news-policy-and-issues/blog/2019/02/19/unintended-consequences-in-albertas-limits-on-crude-output.

[8] Benjamin Zycher, "Oil-Market Central Planning: Not Just for Socialists Anymore," *National Review*, March 30, 2020. https://www.nationalreview.com/2020/03/crude-oil-market-fixing-bad-idea/.

Respectfully submitted,

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