CEI UpDate

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CHUMPS AT THE PUMPS?

GAS PRICE HIKES LINKED TO REGULATIONS, ANTI-ENERGY POLICY

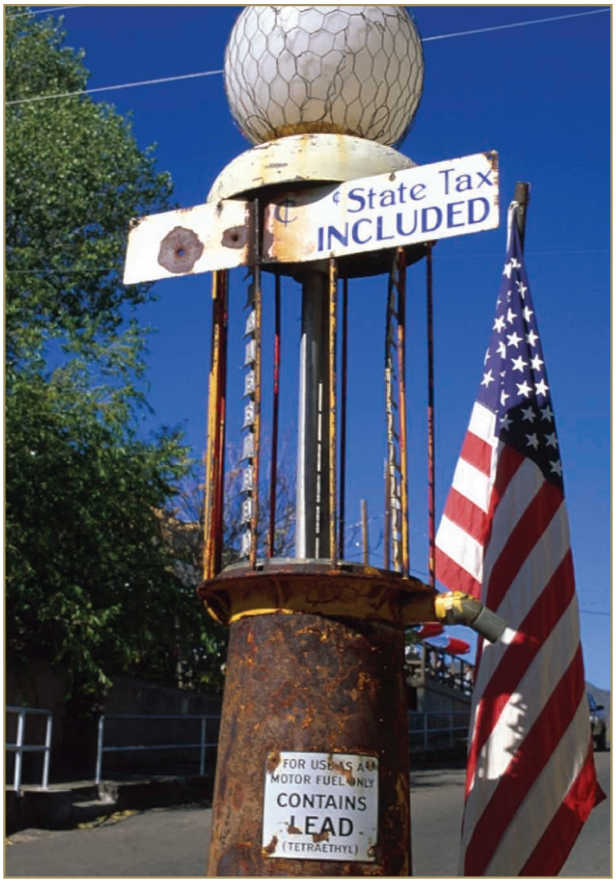
by Ben Lieberman

There are two main reasons for gasoline price increases in recent years and the upward spikes that have been projected for this summer — higher crude oil costs and federal motor fuel regulations. Unfortunately, the federal government continues to contribute to both, and there is little hope for relief in the years ahead.

The fluctuating cost of crude oil is responsible for approximately 40 percent of the price Americans ultimately pay at the pump. After staying extremely cheap during most of the 1990s, oil has become increasingly expensive in the last two years. A recent run-up in the price per barrel, from less than $20 in January to the mid-to-upper $20s since March, is the main reason for the 25-cent-per-gallon increase and a national average of $1.40 a gallon.

Many factors influence the global price of oil and explain the recent increases. For one thing, demand is stronger today than in the 1990s, when many Pacific Rim countries were mired in recession. In addition, the Organization of Petroleum Exporting Countries (OPEC) cartel has become more successful at setting production quotas and sticking to them. And unrest in the Middle East and Venezuela has also added a risk factor to the market price.

Unfortunately, the Senate missed its chance to help boost domestic oil production when it refused to include in the pending energy bill an amendment to allow drilling in Alaska's Arctic National Wildlife Refuge (ANWR). Granted, ANWR does not contain enough oil to dramatically reduce the



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In This Issue

FDA PLAYING KETCHUP ON PEDIATRICS RULE?

by Sam Kazman

UpDate's last article about the Food and Drug Administration's (FDA) Pediatric Rule was a warm and fuzzy piece four months ago entitled *"Ghosts of Lawsuits Past ... and Present."* Written in the spirit of Charles Dickens' *A Christmas Carol*, it explained how a recent court ruling upholding CEI's right to challenge FDA's rule had relied on litigation that we had brought long ago against another agency and another rule.

But the Pediatric Rule issue has gotten a lot more curious since then. The best guide to what's happened recently may not be Charles Dickens, but ketchup — as in the Reagan Administration's 1981 "ketchup-is-a-vegetable" fiasco.

A little background might be useful. Under Congress' medical drug approval process, a drug manufacturer determines what uses to officially claim for a new drug, and FDA decides whether the manufacturer's data support those claims. Once the drug is approved, however, physicians are free to use it for whatever conditions they see fit. Using a drug for a disease or patient population that's not on the label is known as "off-label use." This might sound fishy, but it's often medically justified. Chemotherapy drugs, for example, are often approved for use individually, but in practice most chemotherapy involves drugs used in combination because research indicates that this is more effective.

Under the Pediatric Rule, when FDA finds a drug being put to significant off-label pediatric use, it can require the manufacturer to conduct pediatric testing. If, for example, an adult-labeled antihistamine is being used for children, FDA can require pediatric testing even if the drug's producer wants to keep marketing it only to adults. If the company declines to do the testing, FDA can go as far as pulling the drug off the market entirely. (Note that the issue at hand is not whether pediatric-labeled drugs must be tested on children; such tests are already performed in order to receive FDA approval.)

In late 2000, CEI, together with the Association of American Physicians and Surgeons and Consumer Alert, sued FDA, arguing that it has no authority for this radical change in the drug approval process. Drug approval is already too long and expensive and the Pediatric Rule threatens to make it more so. For a pharmaceutical company deciding whether to proceed with a promising new drug, the rule adds a new element of uncertainty. Moreover, the rule is a backdoor way for FDA to begin regulating the practice of medicine, a move that would be extremely controversial if undertaken openly.

In recent months FDA had gotten increasingly nervous about the lawsuit. In late October the court denied the agency's motion to dismiss the case, and in January Congress passed a new law that expanded the incentives for *voluntary* pediatric testing, buttressing our claim that FDA's approach contradicted that of Congress. And then, in March, the fun really began.

On March 18, FDA asked the court to put our case on hold because it wanted to suspend the Pediatric Rule for two years in order to study it. The same day, three powerful congressmen fired off a letter to the White House, demanding that the rule stay in effect. The press had a field day with the theme of FDA leaving children unprotected. Two days later, as the heat built, an FDA official told Congress that the agency wasn't all that sure about suspending the rule. One month later, FDA announced that it would most definitely not suspend the rule at all. Now there is a bipartisan push in Congress to make the Pediatric Rule law.

What's this got to do with ketchup as a vegetable? That 1981 episode involved the Reagan Administration's attempt to reduce spending and increase school district flexibility by allowing ketchup to count as a vegetable in determining whether school lunches qualified for federal funding. The ill-fated proposal was issued so awkwardly, and with so little explanation, that some have long suspected that its clumsiness was a deliberate, and wildly successful, attempt at political sabotage.

FDA's cursory mid-March announcement concerning the Pediatric Rule was no less clumsy, with practically no explanation of the issues at stake. I'd love to get a look at the original document. Ketchup stains are so hard to remove.

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global price of oil or substantially reduce America's dependence on uncertain foreign sources, but it would have provided needed additional domestic supplies in the decades ahead and signaled U.S. resolve to become more energy independent. The ANWR decision is the latest of many federal restrictions on domestic oil production, which has declined as a result.

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According to the Department of Energy, oil prices will continue to rise over the next two decades and Washington deserves at least some of the responsibility for this trend. In addition to the cost of crude oil, federal environmental regulations — especially those created under the 1990 Clean Air Act amendments — have contributed to gasoline price fluctuations. The use of reformulated gasoline (RFG) is required in many U.S. metropolitan areas (including Baltimore, Chicago, Hartford, Houston, Los Angeles, Milwaukee, New York, Philadelphia, Sacramento, and San Diego), which currently costs an average of 11 cents-per-gallon more than conventional gasoline.

Conventional gasoline is also subject to several costly environmental regulations, which vary by state (and sometimes even by county) and change with the seasons. The large number of distinct "boutique fuels" required by government regulations has balkanized what was once a national market in motor fuel, thereby complicating petroleum logistics and further boosting prices.

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In addition, a number of new gasoline and diesel fuel regulations, enacted toward the end of the Clinton Administration and scheduled to take effect in the years ahead, are likely to further add to the cost of motor fuels.

To its credit, the Environmental Protection Agency has recently done a few things to reduce the regulatory burden. In particular, the agency has taken steps to ease the transition from the less stringent winter requirements for RFG to the more challenging summer specifications. The switchover from winter to summer blends was cited by many as a big part of the reason that prices had spiked above $2.00 in some parts of the country in May of 2000 and 2001.

But thus far, the Bush Administration has refrained from offering any substantive changes to the nation's motor fuel regulations, and has not stopped any of the Clinton fuel regulations from moving forward.

Rather than seeking ways to reduce the federal burden and ensure affordable and reliable gasoline supplies, some in Congress are spending their time engaging in political grandstanding on the issue. Sen. Carl Levin (D-Mich.), for example, recently released a massive study claiming that the oil industry is engaging in a number of illicit schemes to increase prices. But these allegations aimed at "big oil" have been repeatedly investigated and refuted by the Federal Trade Commission.

To make matters worse, the Senate energy bill contains provisions mandating that ethanol be added to gasoline. Though offered in tandem with a beneficial measure to simplify the RFG requirements, the bill would set rising targets for ethanol use over the next decade, culminating in a five-billion-gallon-per-year mandate by 2012. Ethanol, largely derived from Midwestern corn, costs twice as much to produce as conventional gasoline, so blending it into the nation's motor fuel supply is sure to add to prices. Unfortunately, ethanol's producers, including agri-business giant Archer Daniels Midland, comprise a powerful regional special interest that owns enough cornbelt legislators (including Senate Majority Leader Tom Daschle) to get this provision enacted.

Thus, Washington's penchant for expensive micromanagement of motor fuels will likely continue, and the driving public will remain chumps at the pumps for years to come.

Ben Lieberman (blieberman@cei.org) is a Senior Policy Analyst for CEI.

PUT NO STOCK IN THIS REFORM OPTION

by James V. DeLong

The Enron affair has accomplished the seemingly impossible — it has riveted public attention on technical issues of accounting. As a result, all sorts of "reforms" are getting hitched to the scandal locomotive, from revised auditing standards to controls over pension investments.

Corporate America is reacting with equanimity to most of these. But on one issue the companies stand shield-to-shield like Greeks at Thermopylae: They do not want to be forced to classify the cost of stock options as "expenses" that must be subtracted from reported earnings.

The companies thought they won this battle in 1995, when the U.S. Financial Accounting Standards Board retracted a proposal that options be expensed. It allowed firms, instead, to put in footnotes providing a valuation of options based on the Black-Sholes model (the widely used mechanism for valuing options of all kinds) and providing a number for earnings per share on a fully diluted basis.

In 2000, however, the International Accounting Standards Board resurrected the idea, and it has gained momentum since the Enron affair broke. Senator Carl Levin (D-Mich.) recently introduced a bill that would have the effect of requiring that options be expensed, various investors' groups have joined the pro-expense camp, and the potent name of Alan Greenspan was recently added to the list of proponents. The companies, led by the high-tech and venture-capital forces that are the most adamant anti-expensers, are in for a serious fight.

Corporate America is right on this issue, but it has a problem because it must make a complicated argument while its opponents can use a bumper sticker. In a scandal-driven milieu, this disadvantage is serious. The bumper sticker is that everybody knows that stock options are a way of rewarding employees, especially top management. So why not simply call a spade a spade, or a paycheck a paycheck, and treat options as a compensation expense?

The complicated answer to this has several parts. First, the valuation question is intractable, especially for a non-liquid option. No model is satisfactory, so why change the current system of disclosure when the new numbers are not necessarily more accurate and will certainly be more confusing? In any event, the cost to the shareholders is represented by the fully diluted earnings numbers, so requiring that the value also be expensed would be double counting. Besides, if investors want more numbers they can demand them. As the *Financial Times* reported on March 28, individual companies are already issuing special reports on the issue.

The second response is trickier, but more important. It concerns determining which set of earnings the value of the options would be charged against. The usual assumption is they are a cost to be matched against earnings over the life of the grant, or possibly at the time of the grant. But not so fast. Most of the value of the modern company is intangible — intellectual property, market knowledge, customer contacts, and so on. A Brookings Institution project notes that as of March 2000, only 31% of the market capitalization of the public non-financial companies could be ascribed to physical assets; the rest were derived from intangibles.

Such intangible capital comes from the minds of employees. The market is recognizing that their efforts produce a stream of earnings in the future, not just current earnings. They are creating capital. Therefore, dividing employee compensation into salary payments and capital stock simply recognizes the reality of the modern enterprise. Requiring that it all be treated as a current expense would be misleading because it would overstate current costs and understate investment. Indeed, the use of stock options has grown

immensely over the past two decades, apace with the growing importance of intangibles on corporate balance sheets. In 1978, intangibles accounted for only about 15% of market capitalization.

Besides the inherent difficulty of making this complex case in the political arena, the corporations have another handicap of which they are unaware. They do not know that they are in a battle over fundamentally political issues. They think the debate is all about the merits, and that once they explain their case their opponents will be convinced. Most of the high-tech community, which is most concerned because of its heavy reliance on stock options, is politically liberal, and thus confident in the honest intentions of a beneficent state. They could win on the merits. Stranger things have occurred in Washington. But it is not clear that the pro-expense-the-options forces give a rap about the merits, and the companies are likely to find them bafflingly unresponsive.

Conservatives crow over expanding stock ownership, convinced that this will make society less favorable to government regulation. Their opponents agree, so anything that promises to check the diffusion of stock ownership, especially something as well camouflaged as an accounting standard, is appealing. The press has noted the support among some investors for the expense-options view, but, on closer look, many of these consist largely of pension funds for public employees and unions. They have no reason to promote widespread direct-stock ownership by corporate employees.

Most of the value of the modern company is intangible — intellectual property, market knowledge, customer contracts, and so on.

In this politically charged world, when corporate America argues that the proposed rules would discourage stock options, especially for lower-level employees, its opponents smile. And when the companies point out that the new rules would actually obfuscate the earnings numbers, the opponents are indifferent.

One should not underestimate the political power of the high-tech world, but they would be well advised to think through the nature of the conflict they are in.

James V. DeLong (jdelong@cei.org) is a Senior Fellow at CEI.

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The Good, the Bad, and the Ugly

The Good: Pentagon Seeks Exemption from Rules that Hurt Readiness

After years of suffering in silence, the Pentagon is finally speaking up about how certain environmental rules may be hurting U.S. military readiness by severely restricting or halting the use of its live-fire training facilities (see November 2001 *Update* cover story). Whether or not folks on Capitol Hill are listening, and will be willing to weather a barrage of green flak to grant the military some relief from the most onerous environmental regulations, has yet to be shown. But an important hurdle was cleared with the recent vote by the House Military Readiness Subcommittee, chaired by Colorado Rep. Joel Hefley, to recommend minor adjustments to the Endangered Species Act (ESA) and Migratory Bird Treaty Act (MBTA) as they pertain to the military. The Pentagon is concerned that "critical habitat" designations for endangered species at military bases could greatly curtail their use, and is asking Congress to reverse a recent court ruling that has the potential to halt live fire training at any military base visited by migratory birds.

Of the eight legal "clarifications" sought by the Pentagon, only two were approved and passed along for the full committee's consideration as part of the fiscal 2003 Defense Authorization Bill. Two of them were bumped to other committees for jurisdictional reasons, and the four remaining issues will likely be the topic of future subcommittee hearings. But the battle, at least, has been joined, putting squarely before Americans the question of what comes first — national security or nature worship. "Do you want us to protect [endangered] fairy shrimp or do you want us to train our tank units so they're ready to go to war?" the director of base operations at California's Camp Pendleton recently asked the *San Diego Union Tribune*. "Right now we're protecting fairy shrimp. We can't do both."

The Bad: Regulatory Robbery Gets High Court's Rubber Stamp

In a decision of consequence to thousands of Americans who have seen the use and value of their land diminished or destroyed by federal, state, or local regulators, the U.S. Supreme Court recently ruled that a homebuilding moratorium near Lake Tahoe does not constitute a "taking" as defined by the U.S. Constitution because the prohibition at issue is a "temporary" one. Yet the ban must have felt permanent enough to hundreds of Tahoe landowners who saw their property values plummet as this supposedly "temporary" measure, begun in the early 1980s, stayed in effect for six long years. This courtroom reversal leaves the property rights of Americans dangling on a cobweb-thin question of semantics: Namely, what differentiates a "permanent" government rule from a "temporary" one, and at what point in time has that "temporary" regulation done permanent harm to a citizen's assets?

The decision elicited a sigh of relief from government officials and regulators who feared that they might have to pay up when their actions and ordinances deprive a citizen of his or her land value. It was a green light for the plague of "planners" that dream of remaking American communities according to their environmentally- or aesthetically-correct ideals. And it left countless landowners in Tahoe and across the nation twisting slowly in the wind, unable to build on or otherwise develop land acquired for that purpose, or to sell at a fair price land whose value has been regulated away.

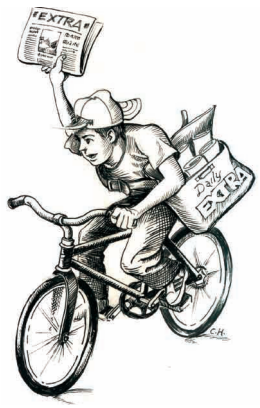
A court majority argued that because the Tahoe construction ban was "temporary," property owners had not been permanently and completely deprived of the value of their parcels. Because land-use regulations are "ubiquitous," Justice John Paul Stevens wrote for the majority, treating them as takings "would transform government regulation into a luxury few governments could afford." But dissenters, including Justices Rehnquist, Thomas, and Scalia, pointed out that the Tahoe development ban had dragged on for years, could conceivably stretch indefinitely into the future, and asked how long property owners should be expected to be held hostage to the whims of regulators before a "taking" has occurred. The majority's decision, wrote Rehnquist, "allows the government to do by regulation what it cannot do through eminent domain — i.e., take private property without paying for it."

The Ugly: Kids Mag Not Giving Readers the Straight Story

The fuzzy line between environmental "education" and indoctrination seems to have been crossed in at least one recent issue of *Scholastic News*, which may be the most widely read children's magazine in the nation. The article, geared toward 4th graders, included at least one sentence that caught the attention of a propaganda-wary parent. "During the winter," the article read, "illegal snowmobilers release harmful fumes as they zoom through Yellowstone National Park, scaring bison, wolves and grizzly bears that live there." The passage rankled at least one snowmobile enthusiast who called the magazine's editor to point out the following errors.

Snowmobiles are not illegal in Yellowstone, the person pointed out — at least not *yet*, though the federal government has been engaged in an effort to ban from "public" lands those citizens who don't choose to enjoy them in recreationally-correct ways. Snowmobiles do release fumes, the parent pointed out — though probably far less than the 1.5 million automobiles that move through the park in an average summer. Snowmobiles can't "zoom" any faster than 35 mph, it was further explained, and must stay on assigned roadways — the same ones autos use to "zoom" through the park in summer at much greater speeds. Bison don't give a second thought to snowmobiles, the editor was told. Wolves are rare sights even on snowshoes. And bears, as an educational magazine should have known, hibernate in winter.

Media Mentions



Senior Fellow James V. DeLong alerts newspaper readers to the brave actions of federal antitrust officials who may soon move to protect consumers from the threat of low-priced airfare:

"The Department of Transportation has launched still another investigation into Chicago-based Orbitz, the online source of travel information and reservations started up last June by a consortium of airlines. DOT wants to be sure that Orbitz is not 'anticompetitive,' and thus violating antitrust laws.

The new investigation succeeds the inquiry that was completed last spring, before Orbitz commenced business, and the follow-up inquiry conducted last fall, when the department wanted to be sure the company's actual operations were OK.

The real story is that industry incumbents are following the path blazed in the Microsoft case – trying to goad antitrust enforcers into suppressing innovation."

—*Chicago Sun-Times*, April 23

CEI President Fred L. Smith, Jr. clarifies misconceptions about the Bush energy plan:

Alan Colmes (co-host): "So is President Bush systematically chopping down environmental provisions to pander to big oil? ... Can we expect a fair and balanced view of oil in the Bush Administration?"

Fred Smith: "Well, you have to ask the question, if the arch druid had gotten elected, would we have a fairer break for affordable energy for America? I think Bush is basically a president who is playing a balancing role between economic needs and environmental needs and this Earth Day, the message is that, hey, things are getting better. The American people know they're getting better. There are other problems that are not better yet. We're focusing on the problems we should."

—*Hannity & Colmes* (Fox News Channel), April 22

Fred L. Smith Jr. again answers charges of anti-environmentalism in the White House:

Paul Begala (co-host): "There's no doubt that the polluters are (or maybe you would characterize them differently), the energy industry, is in charge of Bush, Inc?"

Fred Smith: "Afraid not ... We would've thought [that] if there was an influence, it would be Enron. Enron pushed for the Kyoto Treaty and the president walked away from it because he put affordable energy ahead of the environmental scare stories that the Europeans have been trying to thrust on us."

—*Crossfire* (CNN), April 22

Director of Risk and Environmental Policy Angela Logomasini alerts homeowners to yet another instance of chemical alarmism and expensive new rules:

"If you've been thinking about building a new deck, act now. Otherwise, you may find yourself paying an additional 20 percent or 30 percent for your project, and you might have to replace that deck sooner than expected. The reason: a group of 'green builders' and environmental activists think they know better than you what materials are safe for your families. They have pushed for — and have won — the elimination of the chemical that preserves the wood that you would use in those projects. You may have received letters in which environmentalists 'inform' you of the 'dire risks' posed by your deck, and they may have asked for help in this 'crisis': Please send money."

—*Detroit News*, April 9

CEI General Counsel Sam Kazman argues against the Food and Drug Administration's decision to require pharmaceutical companies to test new drugs on children:

"Who could possibly oppose a pediatric-testing rule for drugs? For starters, physicians and parents who realize that while this rule is supposed to protect children, it is far likelier to hurt them. Remember, the pediatric rule doesn't affect drugs that are specifically developed for children; those are already exhaustively tested under existing law. What the rule targets are adult drugs that physicians have found to be useful for kids, and it threatens to make them unavailable unless more testing is done."

—*USA Today*, April 8

Senior Policy Analyst Ben Lieberman reminds us about the stealthy ways new regulations are often passed into law:

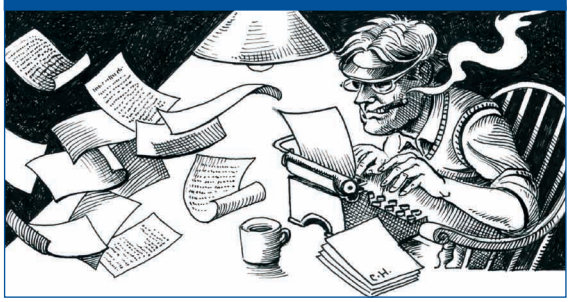
"What kind of ugliness lurks in the energy bill now before Congress? Just take a look at your toilet.

If it's a low-flush toilet, that is. These water-stingy models — notorious for expense, and for clogging and/or needing multiple flushes — were mandated under the 1992 Energy Policy Act, the last big energy law to come out of Washington.

The debate and press coverage of that bill focused entirely on the "big" issues. ... Not a single story informed homeowners that their bathrooms would be undergoing a federally-mandated overhaul."

—*New York Post*, April 2

...END NOTES



Harvard Law Professor Goes Bananas

The Chimpanzee Collaboratory, a new coalition of animal rights' groups, is pushing a proposal to enable non-governmental organizations to provide court protection to any chimp that is "subjected to the willful use of force or violence upon its body." The Collaboratory, bolstered by several million dollars in grants from a foundation created by RealNetworks CEO Rob Glasner, recently got an unexpected boost in the effort when noted Harvard law professor Lawrence Tribe jumped aboard. Tribe argues that because courts are willing to grant legal rights and duties to entities like corporations, "The whole status of animals as things ... needs to be rethought." Whether Tribe is expressing a genuine concern for chimp rights, or just trying to drum up more business for trial lawyers, remains to be seen.

Bureaucracy is Blooming Everywhere

Tyrone Drowley, a schoolboy living in the Australian town of Wonthaggi, was recently ordered by officials to stop operating his roadside chrysanthemum stand. Claiming it was unlawful for him to sell flowers without a $20 permit. When his mother inquired about purchasing the permit, she was then informed that her son would first need to purchase a $5 million public liability insurance policy, presumably in case one of his customers gets mauled by a rabid chrysanthemum. One can only hope the discouraged lad doesn't pull up stakes and seek his fortune elsewhere — by opening a lemonade stand here in the states, for instance, where he's likely to suffer a similar fate.

A Reasonably Discomforting Two-Inch Span

Paul Rein, the attorney who gained infamy by suing Clint Eastwood over disability accommodations at the actor's new hotel, is himself being sued under the Americans with Disabilities Act. George Louie, one of Rein's former clients, brought a suit against the attorney alleging that the toilet seat in his firm's restroom is two inches closer to the wall than federal guidelines allow.

Big Brother in the Back Seat

The United Kingdom's Commission for Integrated Transport reportedly is poised to recommend that the government begin tracking the movements of individual cars and trucks by Global Positioning System satellite responders placed on dashboards. Under the proposal, motorists would be charged roadway fees (read: taxes) according to levels of congestion. Although average weekday charges are projected to be around 3.5£-per-mile, London commuters could get tagged for as much as 45£-per-mile for driving during rush hour. Americans shocked by such an Orwellian scenario had better brace themselves — the U.S. Federal Highway Administration is currently funding research at a number of American universities to explore the feasibility of doing the same thing here.

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