



2010 2nd Quarter Stock Market Commentary

THE TYRANNY OF THE FEW

"The best argument against democracy is a five-minute conversation with the average voter."

- Winston Churchill

Billy Joe Johnson is a man you would not like to meet in a dark alley. Johnson is a white supremacist, drug and alcohol abusing, serial killer. In 1991 he savagely beat another inmate to death with an ax handle. In 2002 he executed a snitch with a point blank shot to the head in Anaheim. Two years later he murdered another man by clubbing him with a claw hammer. Currently serving a 45 year sentence in the California state prison system for his crimes, he has also confessed to two previously unsolved murders. The state psychiatrist has described him as a low IQ sociopath. But in requesting that he receive the death penalty, Johnson has performed a risk-benefit analysis that would make an economics professor proud. California currently has 685 inmates in San Quentin's Death Row. Only 13 men have actually been put to death since 1977 when the death penalty was reinstated, none in the last four years. Johnson estimates that the mandatory appeals required by California law before a death sentence can be carried out will take at least 24 years, making him more than 70 years old. In the meantime, he will "enjoy" a larger single cell, while other maximum security prisoners have to share a smaller two-bunk room. Death row inmates have more telephone privileges and have contact visits in private rooms, rather than the communal halls in other institutions. They receive breakfast and dinner in their cells, and have exclusive control over their own television and CD player. It currently costs California \$49,000 per year to house a maximum security inmate, compared to \$138,000 for a death row inmate. Ignoring inflation, the taxpayers will incur over \$2.1 million in expenses because of a dysfunctional appeals process. It is hard to make a case that capital punishment serves as a deterrent when criminals prefer that sentence.

The case of Billy Joe Johnson is a dramatic example of the nation's collective obsession with placing adherence to the legal process above common sense. Unfortunately, this has dire economic consequences for all of us. Two of the biggest issues facing the United States currently are the stubbornly high unemployment rate and the need to create a cohesive national energy policy. President Obama sees these issues as inextricably linked; the \$787 billion stimulus bill included \$59 billion in new clean energy tax breaks. The tax breaks, he claimed, will help create 300,000 new jobs and double the supply of renewable energy. According to the White House web site, alternative energy technologies should reduce our dependence on foreign oil and the destabilizing effects of climate change.

One technology which would seem to be consistent with the guiding principles set forth is solar power. Renewable (as long as the sun rises the next day), abundant, non-polluting and silent, it would seem to be a source of energy whose “day in the sun” has arrived. Over the past few years, utility giants Pacific Gas & Electric and FPL Group (Florida Power & Light), with financing provided by Goldman Sachs, in conjunction with a passel of Silicon Valley start-ups, have filed applications to build solar power plants on federal land in California’s Mojave Desert. They have the support of such prominent environmental groups as the Natural Resources Defense Council, the Environmental Defense Fund and the Sierra Club.

But the supporters didn’t anticipate the vehement opposition of the less well-known Wildlands Conservancy, which persuaded California’s Senator Diane Feinstein to introduce legislation banning renewable energy development on more than a million acres of the Mojave, including the land on which the coalition had filed its application. While hundreds of thousands of acres remain available as potential solar farm sites, the prohibited land is nearest to power transmission lines and the populous Southern California market. A separate lawsuit has challenged the project because of its potential impact on water resources. And for good measure, yet another suit has challenged any development because of the threat it poses to the desert tortoise. To quote Governor Arnold Schwarzenegger, “If we cannot put a solar power plant in the Mojave Desert, I don’t know where the hell we can put it”.

This inability to allow the needs of society at large to trump the procedural maneuvers of organized minorities translates directly into lost job opportunities. Most of the technological breakthroughs over the past forty years that made solar cells economically feasible occurred in labs that were federally funded with tax dollars. Yet Japan was the first to commercialize the construction of solar panels for homes and businesses. Now China has overtaken Japan to produce 35% of the world’s solar cells and 49% of polysilicon wafers, the main material used in solar cells. The U.S. makes just 5% of cells. Even American companies like First Solar, which is opening a new plant every three months and creating 4,000 jobs/year, is building 86% of its capacity in Germany and Malaysia, as both Asian and European countries have done more to stimulate domestic demand.

The other alternative energy source which is currently economically viable is wind power. Once the capital cost of erecting wind turbines has been incurred, wind is free, produces no greenhouse gases, and is available both at night and on cloudy days. While turbines are tall, they occupy a small footprint, and so the land on which they are constructed can be used for other productive purposes, such as agriculture. Even in rural areas that are remote from the electrical grid, wind turbines can generate power that can be used locally. In 1999, a consortium called the Cape Wind Project proposed building the nation’s first offshore wind farm in Nantucket Sound, to help mitigate New England’s heavy dependence on oil. Despite the overwhelming support of most environmentalists for promoting the use of non-fossil fuels, various levels of environmental review stalled the project for years. But the delaying tactics were just beginning. Senator Ted Kennedy vehemently opposed the project, because it would spoil the view from the Kennedy family compound in Hyannisport. Another lawsuit was filed claiming the project would lower property values by destroying the view. Other suits claimed that it would kill migratory birds, represent a threat to private aviation, and destroy the fishing industry. The Cape Wind Project successfully overcame every obstacle, at a cost of over \$45 million, and late last year it looked like construction might finally begin. The Project’s developer, Energy Management Inc. placed an order for 130 turbines with Siemens. But then the project hit an unexpected roadblock when the National Park Service agreed with the Wampanoag Aquinnah and Mashpee that Nantucket Sound should be listed on the National Register of Historic Places. They ruled that the Project would disrupt the tribes’ spiritual sun greetings and submerged burial grounds, despite the fact that the National Register has previously only been used for specific properties, and that the tribes only used the land under the Sound *before the last Ice Age*. If this decision is ultimately upheld, it will mean that other federal bodies of water can receive similar designation, slowing any offshore development. As bizarre as this decision seems, it

could have been worse. The Aquinnah had actually tried to get the entire Atlantic Ocean added to the National Register.

In late April the Interior Department gave approval to proceed with this long delayed project in a scaled-back form, but ordered additional seabed surveys. Three hours after the decision, the Alliance to Protect Nantucket Sound filed yet another lawsuit. Legal experts estimate that lawsuits may be able to stall the project for yet another five years. Contrast this decade-long delay with the fact that the entire Hoover Dam project went from conception to completion in five years.

Compare this to Europe, where 2,000 megawatts of offshore generating capacity are already operating, and 40,000 additional megawatts are scheduled to be built by 2020, enough to power 25 million homes. Not surprisingly, General Electric has just announced that it is investing approximately \$150 million in a turbine plant in the United Kingdom, creating jobs that could just as easily have been created here if only there was end-market demand. I am sure that our oil producing friends around the world will continue to supply us with an unlimited supply at reasonable prices despite our unwillingness to take constructive action to reduce our oil dependence. Aren't you?

Renewable energy projects are not the only victims of "proceduralism". Consider the efforts of Rio Tinto, one of the world's largest mining companies, to develop the Kennecott Eagle nickel mine in Michigan's Upper Peninsula. The United States is fortunate to have vast reserves of many raw materials, but is one of the last venues that mining companies consider when planning a project. Rio Tinto first proposed this mine on a 90 acre site in 2002. It would create 500 construction jobs and 200 permanent jobs in an area currently suffering from over 20% unemployment. Rio Tinto has had to obtain literally dozens of permits from local municipalities, the state and federal government, all of whom regulate pollution in water and air. The company has had to provide air and water quality samples, survey maps of potential water leaching, designs for wastewater storage, and plans for reclamation, such as replanting of vegetation. It has faced lawsuits from the Yellow Dog Watershed Preserve concerning the project's impact on wild blueberries that grow in the area, among other issues. After more than seven years, a state agency finally issued the water, air and mine permits necessary to begin. But Rio has yet to receive a federal water permit. According to an international mining advisory group, of the twenty five top mining countries in the world, the United States is tied with Papua New Guinea for the longest approval process. In the meantime, we remain one of the largest purchasers of raw materials from Australia, Brazil, Canada and Africa of minerals which we could mine at home. It is worth noting that both Australia and Canada have environmental laws governing mine construction that are comparable to those in the U.S., but projects typically move from the drawing board to approval in one to two years in both countries. It is the legal and regulatory climate that creates the difference.

The examples above are by no means isolated. Chicago's O'Hare International Airport has long been notorious for frequent delays which, because of its prominence as a hub for both United and American Airlines, tend to snarl air traffic across the country. Nearly every frequent flyer has a horror story to tell about missed meetings and flights because of time spent on the runway or waiting for a gate at O'Hare. But late last year O'Hare opened a new runway, and the results are startling. Despite being the second busiest airport in the United States, and the fourth busiest in the world, the on-time arrival rate has soared 27% in the ten months since the new runway opened. Delays at O'Hare are now less than at Dallas, Atlanta or Denver. But this was the first new runway at O'Hare in an unbelievable 37 years. On the same day that this runway was opened, Seattle's Sea-Tac Airport opened another runway that was first proposed over two decades ago. Despite the astonishing growth in air travel, these (and another in Washington, D.C. which also opened on the same day) were the first new runways to be opened in over twenty years at any of the twenty-five largest U.S. airports. NIMBY lawsuits (not in my backyard), environmental lawsuits and noise pollution lawsuits are causing the waste of billions of dollars and

billions of man-hours of lost productivity as the nation's air travel infrastructure falls woefully behind demand.

Nuclear power plants have been similarly stymied. The last nuclear power plant to be built in the United States was the River Bend plant in Louisiana, whose construction was started in 1977. There are over 60 anti-nuclear groups active in the country who have successfully blocked every proposal. This is despite the fact that in the United States there have been zero fatalities or adverse health effects from radiologic exposure from any commercial nuclear power plant. In independent studies over the period from 1970-1992, it was found that there were only 39 on-the-job deaths of nuclear power plant workers. During the same time period, there were 6,400 on-the-job deaths of workers at coal fired power plants, 1,200 on-the-job deaths of natural gas power plant workers and members of the general public caused by natural gas power plants, and 4,000 deaths of members of the general public caused by hydroelectric plants. Even worse, coal power plants are estimated to kill 24,000 Americans per year, due to lung disease as well as causing 40,000 heart attacks per year in the United States, and to collectively emit more than 100 times as much radiation as the nation's nuclear plants. Contrast the American nuclear landscape with that of France, where 80% of the nation's electricity is generated by nuclear power plants and that country has become the world's largest exporter of electricity.

As noted, many of our principal economic competitors do not face the same hurdles when implementing industrial policy. China is currently the third largest economy in the world, and its growth rate is roughly triple our own. But this growth comes with social and environmental costs. China's Three Gorges Dam, for example, is the largest electric generating facility in the world. Its 34 generators produce a staggering 22,500 megawatts. Construction began in 1994 and the project began generating power in 2008. While some construction is ongoing, the project is coming in roughly \$3 billion under budget. In order to build this facility, over 1.3 million people were displaced from their homes, water flows were changed which caused landslides, and numerous cultural and archeological sites have been flooded.

Brazil is the world's eighth largest economy. But its rapid growth has resulted in massive deforestation of the Amazon rain forest. Since 1970, deforestation has destroyed roughly 600,000 square kilometers of forest, equal to the areas of Great Britain, Italy and Switzerland combined. Brazil has more fresh water than any other country in the world. Yet its two largest cities, Rio de Janeiro and Sao Paulo, which have a combined 30 million people in their metropolitan areas, suffer periodic shut-downs of their water supply because pollution makes it unsafe to drink.

Few people would argue that we should permit the same unfettered growth here. But in a global economy, American manufacturers must compete head-to-head with those in countries that have far fewer barriers to low cost energy production, manufacturing, and infrastructure expansion. The painful lesson to be learned is that we can no longer have it all. Our willingness to tolerate endless procedural delays, which undoubtedly provides us with a safer and cleaner environment, comes with a higher unemployment rate, and a dependency for raw materials, like oil or rare metals, upon economies with less refined sensibilities.