

Testimony of David J. Hackett, President, Stillwater Associates LLC
Before the House Committee on Government Reform
Subcommittee on Energy Policy, Natural Resources, and Regulatory Affairs
Henderson, Nevada
May 28, 2004

Good morning, ladies and gentlemen, my name is David Hackett and I am President of Stillwater Associates LLC. Stillwater Associates is a consulting company with an energy policy practice that focuses on the supply, demand and price of gasoline in the United States.

I have been invited here today to address the issues around high gasoline prices, and to specifically address the affects that government regulations – federal, state, and local, have had on the cost of gasoline. I also will make recommendations on steps that government can take to improve gasoline supply and therefore reduce gasoline price rises and price volatility.

I have worked in the oil industry for more than twenty-five years, starting with Mobil Oil in supply, distribution and trading of gasoline, jet fuel, diesel and crude oil. Stillwater Associates was formed in 1998, and the firm has been retained by a number of government agencies to study high gasoline prices. For the California Energy Commission, we have conducted studies that included the creation of a Strategic Fuel Reserve, MTBE Phase Out, and Petroleum Marine Infrastructure. Studies for the State of Hawaii have included Gasoline Price Controls and Ethanol production. Last year, Stillwater Associates provided assistance to the Department of Energy's Energy Information Administration's studies, which were requested by this committee, on California gasoline prices and the forecast for gasoline supply in New York and Connecticut.

Clearly, the most significant impact that government regulations have had in recent times on gasoline prices has been the oxygen mandate and then the subsequent MTBE ban. Starting in 2002, we warned that an MTBE ban would result in a reduction of gasoline supply to the region and higher prices for consumers. The additional gasoline supply needed to meet demand would have to be imported by tanker from distant refineries. Recently, Stillwater Associates calculated that the MTBE ban in California, coupled with the mandate to blend with ethanol, is costing consumers in the Pacific Southwest – California, Arizona, and Nevada, more than \$2 billion dollars per year. (See slides) This cost is measured by comparing retail prices in the region with national average prices. Regional retail prices used to be about 10 cents per gallon over the national average. Since 2003, this region has averaged more than 20 cents per gallon higher.

In many respects, today's high gasoline and diesel prices are the result of government policy, or lack of policy. This morning I will make five specific recommendations for government policy makers.

These recommendations are:

1. Eliminate the oxygenate mandate
2. Cancel Unocal's patents on gasoline
3. Improve local permitting processes so that necessary infrastructure can be constructed in a timely manner
4. Rationalize the number of grades of gasoline that are required around the country
5. Improve oil company reporting to appropriate government agencies.

Relative to the elimination of the oxygen mandate, in 1998 refinery economics modeler MathPro Inc. estimated that the cost for local refiners to produce California cleaner burning gasoline without ethanol would be reduced by about 2 cents per gallon or \$300 million per year.¹ Today, Stillwater Associates believes that elimination of the oxygen mandate will make it easier for offshore refiners to make CARB gasoline because they will not have to reject clean burning butane and pentane from their gasoline blends.

As to the patent issue, Unocal was granted patents in the mid 90's for cleaner burning gasoline, including gasoline that qualifies under California's strict specifications. These patents have held up under legal challenge, but they are being reviewed on other grounds.

Stakeholder interviews have been a key part of Stillwater Associates process in developing our studies. Over the last two and a half years we have conducted some 100 interviews with all segments of the oil industry, including refiners, traders, brokers, dealers, jobbers, and logistics service providers. During these interviews, we consistently heard from potential importers that they refuse to import gasoline into California because of the Unocal patents.² As well, refiners on the West Coast told us that blending around the Unocal patents, to avoid infringement, reduces the efficiency of their operations.³ We estimate that the import concerns and refinery inefficiency costs gasoline consumers in California about \$150 million per year. Further, patent issues have impacted gasoline prices in Chicago and New York Harbor.⁴ Congress should direct the Federal Trade Commission and the Patent and Trademark Office to step up their investigations into the Unocal gasoline patent case.

¹ "Potential Economic Benefits of the Feinstein-Bilbray Bill, An analysis performed for Chevron Products Company and Tosco Corporation by MathPro Inc.", MathPro Inc., March 1999

² "MTBE Phase Out in California", California Energy Commission consultant report, March 2002

³ "California Strategic Fuels Reserve", California Energy Commission revised consultant report, July, 2002

⁴ "Midwest Gasoline Price Investigation, Final Report of the Federal Trade Commission", Federal Trade Commission, March 2001

Through our work for the California Energy Commission, we came to realize that it is difficult, expensive, and time consuming for companies to make infrastructure improvements in order to improve the manufacture and importation of oil products into this market.⁵ For example, Kinder Morgan Pipeline was asked by the military to build three jet fuel tanks in Kinder's tank farm in Carson, California.⁶ It took them more two years to get permits to construct these facilities. That type of unnecessary delay has helped to complicate the oil industry's ability to import more fuels into the region.. In another example, a company has requested permission from the Port of Los Angeles to build an oil terminal on that company's leased property. When asked about the issue, an official is quoted as saying "We don't need the addition of any more facilities of this nature whatsoever."⁷ Clearly, local decision makers are having an impact on the supply of fuel to the entire region. In 2003, the CEC commissioned a separate study to look into permitting which substantiated our Stakeholders' input.⁸ The Energy Commission needs the resources required to implement that report's recommendations.

Over the years, individual states have decided to mandate changes in gasoline composition sold in their jurisdictions to help achieve air pollution reduction goals. Many of these programs have had success from an air quality perspective, but at unnecessarily high cost to gasoline consumers. There are an estimated eighteen different types of gasoline sold today across the country. This is the "boutique fuel" problem that you hear discussed. When gasoline supplies are adequate and logistics networks are operating properly, this balkanization of fuel types is merely inefficient. However, when supplies are tight, or during seasonal transitions, or when pipeline breaks occur, price spikes can happen. The price spike in Chicago in 2000 is one example.⁹ Another is the spike after the pipeline break outside of Phoenix last August.¹⁰ State and Federal governments need to work together to rationalize the number of grades of gasoline. Although the correct number is not clear at the present, it is probably five or fewer grades.

Government agencies do not collect, analyze or publish the proper data in a timely fashion to help industry participants, government officials or the public to understand the supply and demand issues in the marketplace. Agencies like the EIA and CEC are hampered by budgetary constraints, legislative policies, and

⁵ "MTBE Phase Out in California", California Energy Commission consultant report, March 2002

⁶ "California Strategic Fuels Reserve", California Energy Commission revised consultant report, July, 2002

⁷ "Letters fuel port, LAXT fight over site's future", Daily Breeze, May 8, 2004

⁸ "Analysis of Petroleum Storage Permitting Options", California Energy Commission draft report, prepared by ICF Consulting, March 2003

⁹ "Midwest Gasoline Price Investigation, Final Report of the Federal Trade Commission", Federal Trade Commission, March 2001

¹⁰ "2003 California Gasoline Price Study Final Report", Office of Oil and Gas, Energy Information Administration, U.S. Department of Energy, November 2003

confidentiality concerns. On the other side of this coin, industry makes reports to all sorts of government agencies – the California State Lands Commission, the Army Corps of Engineers, the CEC and the EIA, among others. These reports are frequently duplicative and redundant. While this issue is not glamorous, it is critical to understanding the markets. We have recommended improved data acquisition and analysis to CEC¹¹ and to the State of Hawaii.¹²

Finally, we have one demand side suggestion. Experts say that if motorists properly inflated their tires, they could save 6% on gas mileage.¹³ Assume everyone did that and reduced their gasoline demand by merely 2%. That would save about 180 thousand barrels a day of gasoline, the equivalent production of a new refinery or the delivery of eighteen tanker loads of gasoline imports every month.

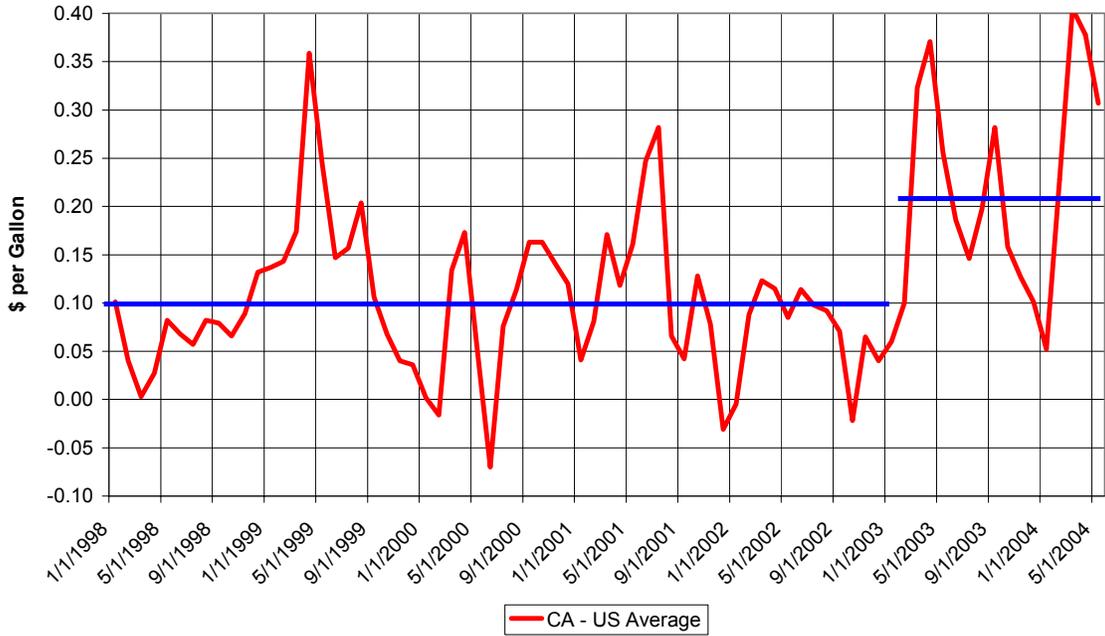
It is Stillwater Associates' conclusion that the root cause of high gasoline prices in this region are government regulations, including the California ban on MTBE and the continuation of the oxygenate mandate which have reduced gasoline supply. Government policies limiting gasoline supply expansion are adding to the problem.

¹¹ "California Marine Petroleum Infrastructure", Stillwater Associates presentation to California Energy Commission public workshop, April 2003

¹² "Study of Fuel Prices and Legislative Initiatives for the State of Hawaii", Stillwater Associates LLC for the Department of Business, Economic Development, and Tourism, August 2003

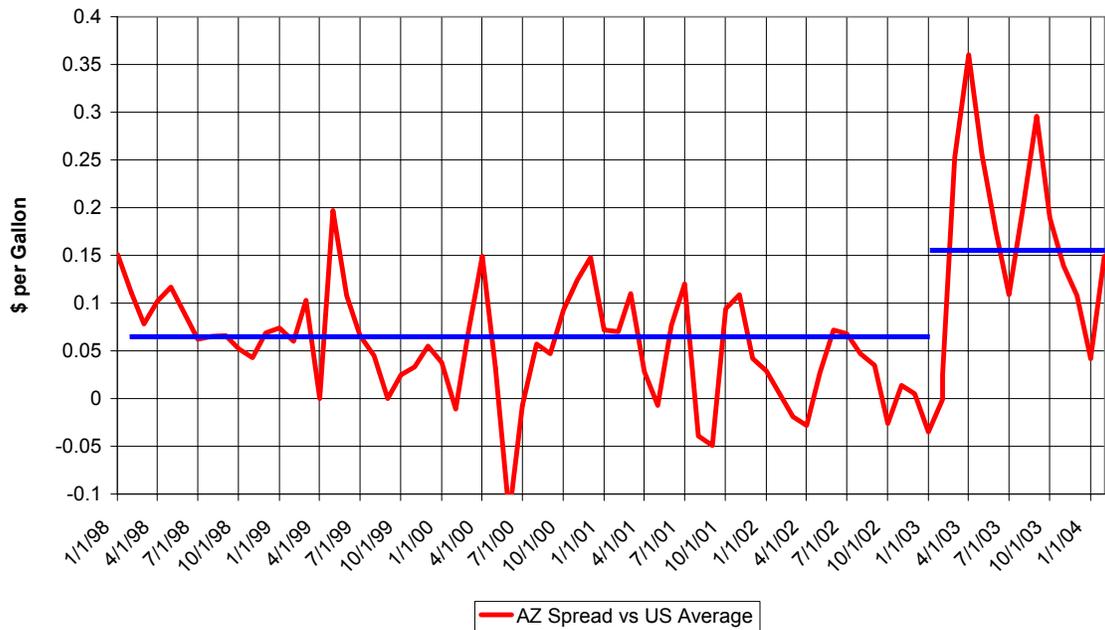
¹³ <http://www.ftc.gov/bcp/online/pubs/autos/gasave.htm>

California vs. US Average Retail Regular Spread



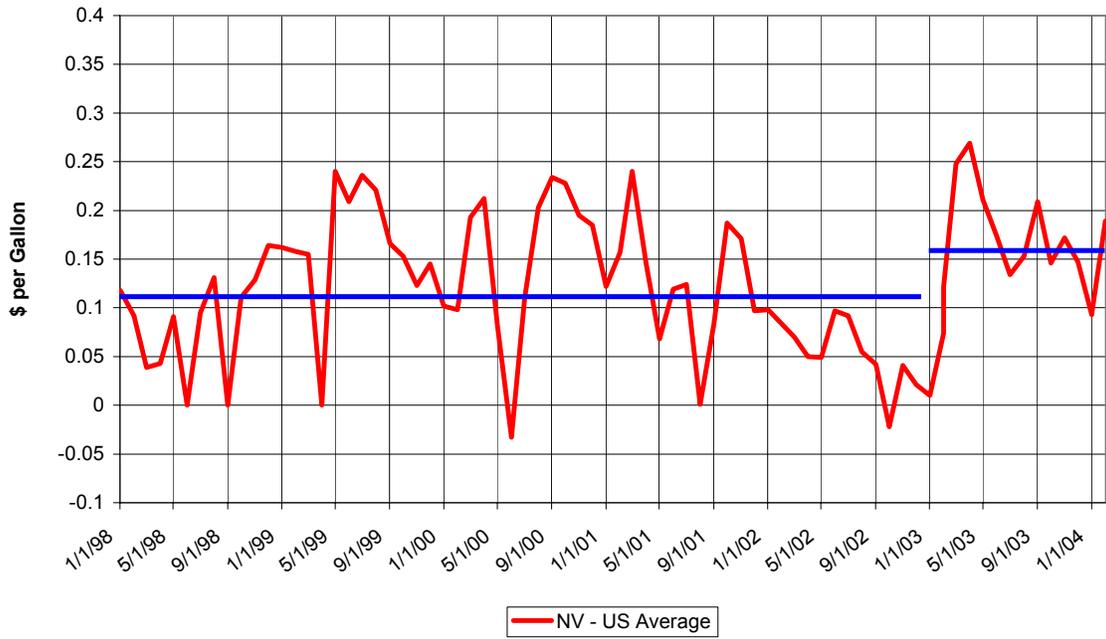
EIA Data, except Stillwater Associates estimates for Feb – May 2004 data

Arizona vs. US Average Retail Regular Spread



EIA Data

Nevada - US Average Retail Regular Spread



EIA Data