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June 8, 2001

MEMORANDUM FOR MEMBERS OF THE SUBCOMMITTEE ON ENERGY POLICY, NATURAL RESOURCES AND REGULATORY AFFAIRS

FROM:

Doug Ose 

SUBJECT: Briefing Memorandum for June 14, 2001 Hearing, "Gasoline Supply: Another Energy Crisis?"

On Thursday, June 14, 2001, at 10:00 a.m., in Room 2154 Rayburn House Office Building, the Subcommittee on Energy Policy, Natural Resources and Regulatory Affairs will hold a hearing on the gasoline prices and related issues. The hearing is entitled, "Gasoline Supply: Another Energy Crisis?"

In April and early May, gasoline prices rose on average 31 cents per gallon nationwide to reach \$1.71 on May 14th. Some consumers experienced even higher increases. At the beginning of June, regular gasoline prices averaged \$1.68 per gallon in the United States. Prices have fluctuated between \$1.68 and \$1.71 for the last 5 weeks, possibly signaling a plateau in prices.

In addition to overall higher gasoline prices there are also sharp regional differences in prices. Regular gasoline averaged between \$1.55 and \$1.58 per gallon in the South Atlantic and Gulf Coast regions in May. As in 2000, Midwest and California drivers have seen some of the largest increases with prices averaging about 30 cents per gallon higher.

Over the past 2 months, gasoline inventories have generally improved, with end-May stocks coming in at close to year-ago levels and only 5 million barrels (2 percent) below normal, compared to 18 million barrels (8 percent) below normal at the end of March. Nationwide, according to Department of Energy, the prices of gasoline appear to have peaked and may begin to decline.

Supply

Low crude oil supplies set the stage for our current situation, as they did in 2000 both for heating oil and for gasoline. These low inventories originate from the tight world crude oil supply that has emerged since early 1999. In recent years, tight crude markets have lead to low supply.

OPEC

Actions taken by major oil exporting countries (OPEC) and several other crude oil exporting countries are largely responsible for the sharp increase in oil prices from the \$10 levels seen in December 1998. OPEC dramatically reduced crude oil production in 1998 and early 1999, so much so, that, even after four production increases last year, world inventories remain at extremely low levels. Furthermore, up until the last several months, scarce crude supplies encouraged high near-term prices relative to those for future delivery. This situation discourages inventory growth, and maximum refinery production, in other words refineries do not want to buy expensive crude in order to built up their stocks. It makes more business sense to wait until the price of crude falls.

Thus, with low crude oil and product inventories, little cushion exists today to absorb changing conditions, setting the stage for price volatility. Although world demand is projected to continue growing this year, OPEC's current plans imply even less production than last year, which will keep world inventories low and maintain crude oil prices close to \$30 per barrel for the remainder of the year

Gasoline Supply

Within the United States, gasoline inventories have been even lower this spring than they were last year. As of May 4th, U.S. gasoline inventories were about 4 percent below their seasonal 5-year average. Midwest inventories were even lower, ending the week almost 9 percent lower than their 5- year average, and 4% below last year's levels at this time. Such low gasoline inventories are partially a consequence of refineries' focusing strongly on distillate (heating oil and diesel fuel) production last winter, given that the United States entered the heating season with very low inventories.

Market Volatility and the Growing Number of Gasoline Types

Another factor that adds to the potential for volatility when inventories are low is the increase in the number of distinct types of gasoline. Today's gasoline market is comprised of many types of gasoline that serve different regional markets to meet varying State environmental requirements.

While producing specialized products for only those areas with air quality problems is seen as an efficient means of cleaning the air, the increase in boutique fuels adds a level of complexity in production, distribution and storage of gasoline.

The result of this targeted approach to air quality has been to balkanize the gasoline market and to create gasoline market islands. The primary examples are California and the Chicago/Milwaukee areas, in which the required gasolines are unique, and only a limited number of refineries make the products. The inventories of gasoline used in these regions can be drawn down rapidly in response to unusually high demand or a supply problem at one of the few refineries producing the specialized products, or in one of the pipelines delivering the products. Prices for gasoline in these regions then

surge. If other gasoline markets are not tight, the price surges may be limited to the specialized gasoline regions, as is usually the case in California.

MTBE and Reformulated Gasoline

The 1990 Clean Air Act required that the Environmental Protection Agency (EPA) establish a cleaner burning gasoline that would be used in areas that did not meet air quality standards – so called non-attainment zones. In designing the reformulated gasoline, one of the statutory requirements was that the reformulated gasoline includes 2 percent oxygenated fuel. Currently MTBE is the mostly commonly used oxygenate. As MTBE came into widespread use, it was discovered to have leaked into a number of groundwater systems. Several States, including California and New York, have already moved to phase out MTBE. In addition, EPA has recommended a nationwide phase out.

Because of groundwater contamination due to MTBE, California has asked EPA for a waiver from the Clean Air Act's oxygenate requirement.

Refinery Capacity Constraints

Refinery capacity limitations have also become a factor affecting the U.S. gasoline market, especially during periods of low inventories. The summer of 1997 was the first time the U.S. refinery system was pushed to its practical operating limits for gasoline production and was unable to respond adequately to unusually high gasoline demand. As a result, seasonally low inventories were rapidly depleted and prices surged. Since then, capacity has grown slightly more than demand, but the capacity situation is still tight during the summer.

With little inventory to absorb a supply/demand imbalance, and many refineries running at their practical limits, any supply problems, such as refinery outages, may not be resolved quickly. This factor increases the time that it takes to respond to a problem and thus increases the potential for price spikes and extends the time that prices will remain high. In addition, even if the world crude market begins to see more supply at some point in the future, lack of excess refining capacity may impede the ability of the system to remedy low inventory problems quickly.

Invited Witnesses

John Cook, Director Petroleum Division, Energy Information Administration; Robert D. Brenner Acting Assistant Administrator, Office of Air and Radiation, U.S. Environmental Protection Agency; Don L. Coursey, Ameritech Professor of Public Policy Studies, University of Chicago; Robert Slaughter, General Counsel, National Petrochemical and Refiners Association; Ben Lieberman; Senior Policy Analyst, Competitive Enterprise Institute; and A. Blakeman Early, Environmental Consultant, American Lung Association.