ONE HUNDRED EIGHTH CONGRESS

Congress of the United States

House of Representatives

COMMITTEE ON GOVERNMENT REFORM

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May 20, 2004

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

FROM: Doug Ose

SUBJECT: Briefing Memorandum for Field Hearing, "Easing Pain at the Gasoline Pump: Finding Solutions for Western Woes"

On Friday, May 28, 2004, at 10:00 a.m., the Government Reform Subcommittee on Energy Policy, Natural Resources and Regulatory Affairs will hold a field hearing on gasoline markets in Arizona, California, and Nevada. It will be held in the Sierra Room of the Henderson Convention Center and Visitors Bureau, which is located at 200 Water Street, Henderson, Nevada. The hearing is entitled, "Easing Pain at the Gasoline Pump: Finding Solutions for Western Woes."

In June 2001, April 2002, and July 2003, the Subcommittee held hearings on gasoline markets, entitled "Gasoline Supply – Another Energy Crisis?," "Fuel Markets: Unstable at Any Price?," and "California Gasoline Markets: From MTBE to Ethanol," respectively.

From January to May 2004, U.S. average gasoline prices increased nearly 50 cents, peaking at $2.01 per gallon on May 20th. The most drastic increases were seen in the West, as gasoline prices in Arizona, California, and Nevada far surpassed the $2 per gallon mark and remained at record highs for several weeks (see Attachment A). Diesel prices also reached record highs in these three States, reaching $2.22 in Arizona, $2.48 in California, and $2.31 in Nevada.

Although gasoline prices typically increase in the spring and summer months, this year's increases began earlier and have lasted longer than in most years, raising concerns from consumers and policymakers. The most recent price run-up also raised questions about the effect of gasoline prices on the recovering State economies. Despite the alarming nature of the current high gasoline prices, increases are not uncommon or unexpected in the West because of the tight balance between domestic and international supply and demand.

World Oil Markets

Since the cost of crude oil determines about 40 to 50 percent of the total price of gasoline, changes in the world oil market directly affect the price that consumers pay at the pump. On average, a one-dollar increase in the cost of a barrel of crude oil translates into a 2.5-cent increase in the price of a gallon of gasoline at retail gas stations.

Beginning in February 2004, the cost of crude oil began to increase substantially, averaging about $35 per barrel. This is 20 percent higher than crude oil costs in September 2003, and only slightly less than the levels seen in the beginning of 2003, when world crude prices increased because of the production disruption in Venezuela and the increasing hostilities in Iraq. By May, the cost of a barrel of crude oil reached $41.85, the highest price in the 21-year history of crude futures trading on the New York Mercantile Exchange. The Energy Department's Energy Information Administration (EIA) attributed these increases to rising world demand, low inventories, concerns over the production of the Organization of Petroleum Exporting Countries (OPEC)[1], and instability in Iraq and Venezuela.

Refinery Transition Period

At present, there are 13 gasoline-producing refineries in California. These refineries produce about 90 percent of the gasoline consumed in California, and provide gasoline to Arizona and Nevada via Kinder Morgan pipelines. Arizona and Nevada's reliance on California gasoline exports often leaves them vulnerable to the volatility of California's gasoline market. Likewise, California's gasoline prices can be influenced by events in neighboring States, as shown by the gasoline price spike that occurred in California following the Arizona pipeline rupture.

Each year, between January and March, refineries in California begin routine maintenance and the transition from winter to summer-grade gasoline. In anticipation of this period, refineries increase their inventories of gasoline and blendstocks during the fall and winter months, when demand for gasoline is usually lower. However, if planned maintenance requires more time than originally allotted, or, if unexpected outages occur, inventories are drawn down, supply is tightened, and prices rise. Typically, prices do not immediately subside because of the lack of available replacement supply and the amount of time required to deliver gasoline from the international market to retail stations in Arizona, California, and Nevada.[2]

During the first three months of 2004, routine maintenance was planned for 9 of the 13 refineries in California. At the same time, all of the refineries were required to begin the difficult seasonal gasoline transition. This year, due to the ban on methyl tertiary-butyl ether (MTBE), which became effective January 1st, and the requirement to blend gasoline with ethanol in the

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[1] On February 10, 2004, OPEC announced it would lower its production quota from 24.5 million barrels per day to 23.5 million barrels per day, effective April 1, 2004. This 1 million barrel per day reduction is in addition to a 1.5 million barrel per day reduction resulting from reining in overproduction. In April, OPEC production exceeded the newly set quotas by an estimated 2.3 million barrels per day.

[2] California refineries run at or near capacity (at a rate of about 95 percent utilization). If a refinery incurs difficulties, it is unlikely that another California refinery will be able to provide additional gasoline. Instead, the refinery must seek gasoline on the highly competitive international market.

4summertime, this transition was more difficult. Although refinery inventories of gasoline were above historical averages, an unusually high degree of refinery start-up problems quickly reduced available supply.[3] Additional refinery problems in April and a pipeline rupture on April 27th exacerbated the tightness of the gasoline market.

Market Competition

Over the last 20 years, the number of refineries in California has declined as a result of the deregulation of petroleum product markets in 1981 and the passage of the Clean Air Act Amendments of 1990. These closures and various consolidations have significantly reduced the State's production capacity, and have reduced competition within the industry. Due to lengthy permitting issues, costly environmental regulations, and low product prices, the CEC believes it is unlikely that new refineries will be built in California in the near future.

On November 13, 2003, Shell Oil announced that it intends to close its Bakersfield, California refinery by October 1, 2004. This refinery produces 2 percent of the gasoline, and 6 percent of the diesel, consumed in California. Shell explained that this closure was warranted because the continued decline of the refinery's primary oil supply (San Joaquin Valley Heavy Crude) had rendered the plant uneconomical.

Although the announcement of the expected closure went relatively unnoticed, recent increases in gasoline prices on the West Coast, and in California particularly, has brought increased scrutiny to the issue. Beginning in February 2004, several State and Federal policymakers requested that the Federal Trade Commission (FTC) investigate the affect of the Bakersfield refinery on the California gasoline market, as well as the recent gasoline price increases in the West.

Environmental Regulation

As a result of the Clean Air Act Amendments of 1990, and other Federal, State, and local air quality programs, gasoline and diesel has become progressively cleaner in the U.S. However, these air quality improvements came with some costs. Be it in the form of upgraded refinery facilities or processes, reduced gasoline volumes, decreased fungibility, or diminished import sources, these changes directly impact supply and demand, and translate to increased prices at the gas pump.

Historically, Californians have accepted these costs and have been pioneers in environmental policy. However, due to the Federal oxygen requirement, and the State ban on MTBE, Californians have become subjected to a *de facto* ethanol mandate. This mandate not only reduces the supply of California's gasoline by 10 percent for 8 months of the year but also may prove to be detrimental to the State's air and water quality. The Governor of California, with the support of the California Congressional Delegation, is currently seeking a waiver from

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[3] By February 27th, inventories had decreased from 15 million barrels to 11.5 million barrels, which is approximately 800,000 barrels below the 2003 level. According to the California Energy Commission (CEC), this tightness in supply of gasoline on the West Coast "contributed to the current run-up of prices in California, and is the primary cause of the increased differential in California gasoline prices relative to the rest of the U.S" (Testimony of Pat Perez, Manager, Transportation Fuels Office, CEC before the Attorney General's Task Force on California Gasoline Pricing, March 11, 2004).

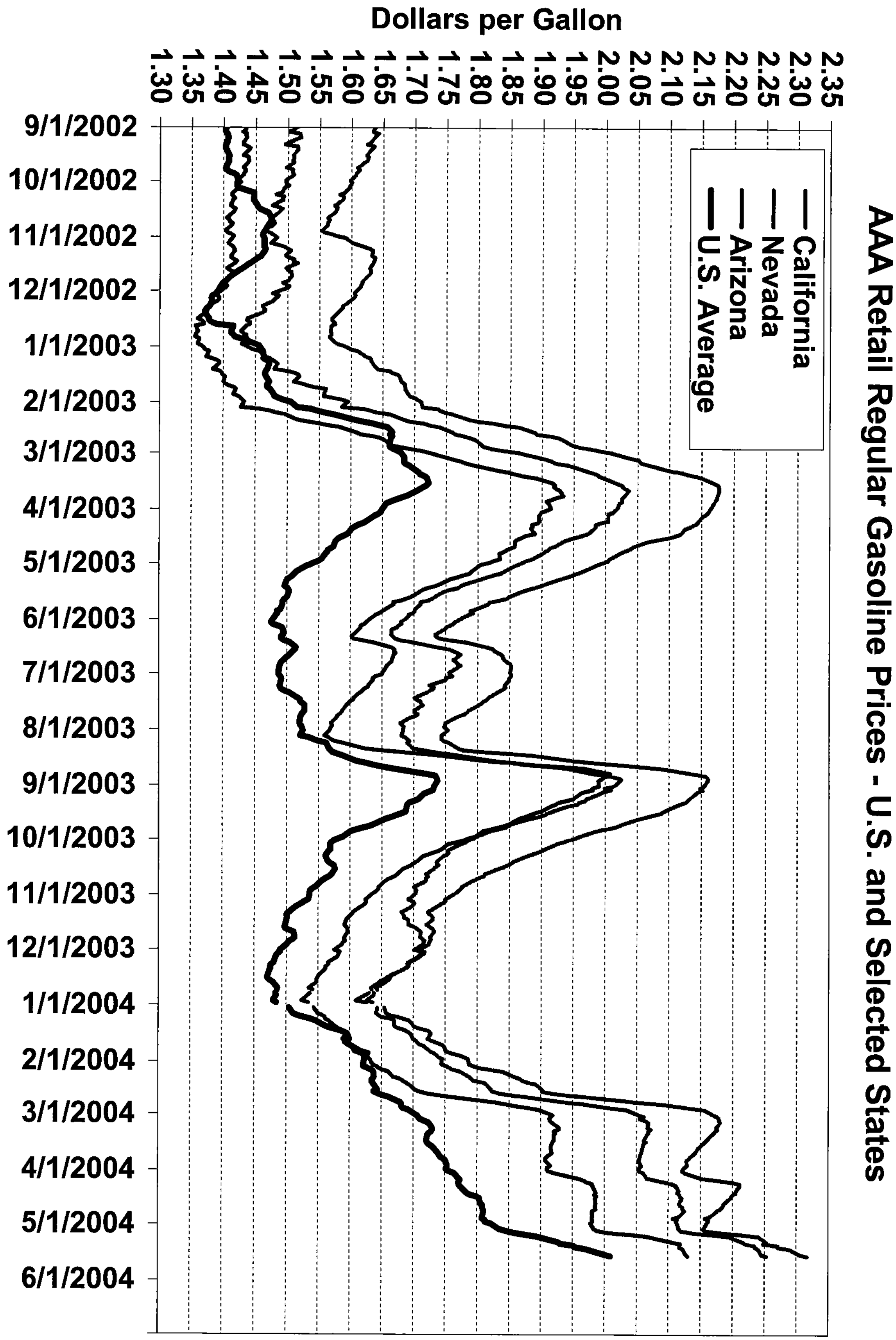
this requirement from the U.S. Environmental Protection Agency (EPA). On February 12, 2004, based on hearings and analysis by my Subcommittee, I requested EPA to promptly grant California's waiver request (see Attachment B).

Solutions

The hearing will explore potential solutions for reducing gasoline prices in the West, and in the U.S. as a whole. Possible supply-side solutions include: streamlining environmental laws and regulations, reducing the number of boutique fuels, increasing imports of finished gasoline and fuel blending components, and adding additional gasoline storage capacity. Potential demand-side solutions include: improving vehicle fuel economy, encouraging the use of alternative energy or hybrid vehicles, and providing incentives for public transportation and carpooling. Each of these solutions has costs and benefits that policymakers and consumers must consider.

Invited witnesses include: Richard Burdette, Energy Advisor to Governor Guinn, State of Nevada; Lynette Evans, Policy Advisor Regulatory Affairs, Office of Governor Napolitano, State of Arizona; William Keese, Chairman, California Energy Commission; Sean Comey, Media Relations Representative, AAA of Northern California, Nevada and Utah; Joe Sparano, President, Western States Petroleum Association; and, David Hackett, President, Stillwater Associates.

Attachment A



Attachment B

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February 12, 2004

The Honorable Michael Leavitt
Administrator
U.S. Environmental Protection Agency
Ariel Rios Building
1200 Pennsylvania Avenue, N.W.
Washington, DC 20460

Dear Administrator Leavitt:

I am writing to urge the Environmental Protection Agency (EPA) to expeditiously approve California's January 28, 2004 amended request for a waiver from the Federal minimum oxygen requirement in reformulated gasoline (RFG).

Currently, California refiners are beginning the difficult process of transitioning from winter to summer-grade gasoline. In 2004, due to the Federal oxygen requirement, and the State ban on methyl tertiary-butyl ether (MTBE), which became effective January 1, 2004, California will be subjected to an unwarranted *de facto* ethanol mandate. This mandate is unnecessary given that California refiners are capable of producing gasoline that is as clean or cleaner than gasoline comprised of 2 percent ethanol by weight.

Moreover, this ethanol mandate will further strain refineries and gasoline infrastructures, which are already operating at or near capacity, and will reduce California's gasoline supply by 10 percent at a time when demand for gasoline within the State is growing. Together, these factors will greatly reduce the flexibility of California's gasoline market, thereby causing more frequent and intense gasoline price spikes. Additionally, this mandate may hinder the State's efforts to meet and maintain EPA's national ambient air quality standards (NAAQS) for ozone and particulate matter and may pose a threat to California's already limited water supply.

During the 107th and 108th Congresses, the House Government Reform Subcommittee on Energy Policy, Natural Resources and Regulatory Affairs, which I chair, held three hearings on ethanol production and use in the United States. The most recent, held on July 2, 2003, explicitly addressed the transition from MTBE to ethanol in California's gasoline market. This hearing not only considered the economic effects of the transition on consumers and industry but also examined the environmental repercussions of increasing ethanol use in California. At the hearing, Dr. Lynne Kiesling, Director of Economic Policy of the Reason Foundation, described many of the risks posed by ethanol to air and water quality. She also argued that neither MTBE nor ethanol is necessary to produce Federal RFG. Of particular interest is the fact that Dr. Kiesling cited EPA's own 1999 Blue Ribbon Panel report to support both of her assertions. If EPA's own data suggest that refiners are capable of producing non-oxygenated gasoline that is as clean or cleaner than ethanol-blended gasoline and that ethanol may pose a risk to groundwater, why has EPA, to date, refused to approve California's waiver request?

In addition to conducting these hearings, I also requested that the Energy Department's Energy Information Administration (EIA) conduct a study on the precise causes of the March 2003 gasoline price increases in California. EIA released its preliminary report in May 2003 and its final report in November 2003. Both reports determined that the transition from MTBE to ethanol was a factor in the gasoline price spikes in California in March, June, and August of 2003. More importantly, both reports emphasized the fact that blending ethanol with gasoline in California will reduce gasoline production by 10 percent for 8 months of the year. This means that California refiners will need to import more foreign oil and gasoline additives this year to make the same amount of gasoline they made before widespread ethanol blending began in the State. Clearly, this outcome is not economically or environmentally beneficial to California, or to the United States as a whole.

California has sought a waiver from the Federal minimum oxygen requirement for nearly five years. During this time, California submitted seven letters to the Administration (one to President Bush and six to EPA) seeking approval of its waiver request, and provided EPA with ample scientific data to support the use of non-oxygenated gasoline within the State. Despite these submissions, EPA has not yet approved California's waiver request. However, on February 2, 2004, EPA issued a proposed rule that would allow New Hampshire to opt-out of the Federal RFG program due to water contamination risks posed by MTBE (69 FR 4903-08). Under this plan, New Hampshire's refiners would not be required to blend their gasoline with 2 percent oxygen by weight; yet, they would be required to maintain the emission reductions realized from the use of MTBE-blended gasoline. If this plan is appropriate and scientifically sound for New Hampshire, why would California be denied the same opportunity?

At present, EPA is under court order (*Davis v. U.S. EPA*, 348 F.3d 772, 9th Cir. Cal., 2003, rehearing denied) to re-review California's request with full consideration of the effects that a waiver would have on EPA's NAAQS for both ozone and particulate matter. I request that EPA carefully consider the data presented in California's recent updated and expanded waiver request. These data clearly demonstrate that continued use of ethanol in California may potentially inhibit current State efforts to attain and maintain the NAAQS for ozone and particulate matter. I strongly urge EPA to promptly complete its review of California's waiver request.

California has been an environmental leader for many years, consistently setting the most stringent environmental quality standards and goals in the country. In seeking a waiver from the Federal oxygen requirement, California is attempting to continue this important tradition. Accordingly, I urge EPA to promptly approve California's waiver request. Doing so will not only save Californians millions of dollars but will also enable them to enjoy cleaner air and water.

Thank you for your attention to this request. If you have any questions about this letter, please contact Professional Staff Member Melanie Tory at 226-4376.

Sincerely,

Doug Ose
Chairman
Subcommittee on Energy Policy,
Natural Resources and Regulatory Affairs

cc The Honorable Tom Davis
The Honorable John Tierney