EASING PAIN AT THE GASOLINE PUMP: FINDING SOLUTIONS FOR WESTERN WOES

HEARING

BEFORE THE

SUBCOMMITTEE ON ENERGY POLICY, NATURAL RESOURCES AND REGULATORY AFFAIRS

OF THE

COMMITTEE ON GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

MAY 28, 2004

Serial No. 108–203

Printed for the use of the Committee on Government Reform

Available via the World Wide Web: http://www.gpo.gov/congress/house
http://www.house.gov/reform

U.S. GOVERNMENT PRINTING OFFICE

96–091 PDF WASHINGTON : 2004

For sale by the Superintendent of Documents, U.S. Government Printing Office
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EASING PAIN AT THE GASOLINE PUMP: FINDING SOLUTIONS FOR WESTERN WOES

FRIDAY, MAY 28, 2004

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON ENERGY POLICY, NATURAL RESOURCES AND REGULATORY AFFAIRS,
COMMITTEE ON GOVERNMENT REFORM,
Henderson, NV.

The subcommittee met, pursuant to notice, at 10 a.m., in Henderson Convention Center and Visitor's Bureau, 200 South Water Street, Henderson, NV, Hon. Doug Ose (chairman of the subcommittee) presiding.

Present: Representatives Ose, Schrock, and Tierney.

Also present: Representatives Porter and Gibbons.

Staff present: Barbara F. Kahlow, staff director; Melanie Tory, professional staff member; Megan Taormino, press secretary; Lauren Jacobs, clerk; and Krista Boyd, minority counsel.

Mr. OSE. Good morning. I want to welcome everybody to today's hearing of the Subcommittee on Energy Policy, Natural Resources and Regulatory Affairs. I ask consent to allow Congressman Gibbons and Congressman Porter to join us. Hearing no objection, so ordered. I would like to turn to our host, Congressman Porter.

Mr. PORTER. Thank you, Mr. Chairman. Good morning and welcome to Henderson, NV. We appreciate the committee being here and your staff, and on behalf of the whole Las Vegas community we appreciate this bipartisan approach to a very serious challenge that we're facing in Las Vegas and regionally in California, Arizona.

I hope you all have an opportunity to enjoy our community of Henderson, Las Vegas. It is a great place and one of the fastest growing communities in the country. 5,000 to 7,000 people a month are moving into our community and with that comes numerous challenges. We're very, very proud of what we have as a community so please enjoy your stay; and, to the staff, we appreciate you being with us from Washington, and we look forward to a very productive meeting this morning with solutions to help families in Nevada.

Thank you very much.

Mr. OSE. Thank you, Congressman Porter. Here is the way this works. We're going to have two panels of witnesses today. First will be folks associated with the State or local governments. Second will be private citizens and the organizations they represent. There is no open testimony here. People who are testifying have been invited. They have written statements. We'll be submitting those

statements to the record. There are copies of those statements outside the door if you care to follow along.

The way these hearings proceed is that each of us up here will make an opening statement. Statements are limited to 5 minutes in turn. We alternate between Republicans and Democrats. I do want to compliment my friend John Tierney from Massachusetts for traveling this far. I know it's not easy, but it is appreciated.

Now, there will not be questions from the audience during the course of this hearing. That's not the way congressional hearings proceed. These are invited witnesses and they will be the ones that we direct our inquiry to. With that we will proceed.

Mr. Gibbons, you are our co-host here. I'll turn to you next.

Mr. GIBBONS. Mr. Chairman, I want to thank you and this committee for allowing me, a nonmember of this committee, the generous opportunity to appear and be a panel member with you and I do thank you and Mr. Tierney for that courtesy. I also want to thank my colleague Jon Porter for spearheading this effort to bring attention to a national level problem, high price of gasoline as it affects not just Nevada but every American over this holiday and preceding days.

As we all know, the price of gasoline in Nevada alone has risen 60 cents since January of this year and it's anticipated that it will rise and continue to steadily increase over the next several months. This has brought a great deal of concern to many Nevadans because we are a tourist industry based State. In order to have our economy flourish we need to be able to bring tourists to Nevada.

One of our principal means by which tourist arrive in Nevada, of course, is by the vehicle and we are beginning the Memorial weekend, a period of time when Las Vegas and Nevada alone flourishes with tourism in an effort to seek an entertainment value for their time over the weekend.

So Nevada, like California, is suffering from high gas prices, and I want to say there are several causes of that high gasoline cost, one of which of course is the fact that OPEC does control a great deal of the supply and has actually a hostage holding effort and effect on the price of gasoline.

I know that in the 108th Congress I and our colleagues have made a strong effort to pass an energy policy to give the United States an opportunity to create meaningful efforts to regulate and control the price of fuel that affects each and every one of our lives. We need to have that bill passed both through the Senate. There are disagreements among individuals, disagreements among bodies, disagreements among parties with regard to the passage of the energy bill, but nonetheless, the energy bill is the basis by which a sound policy for energy problems in this country must be addressed.

We're hoping today that by this hearing we can allow more dialog to be brought forward that will allow for us to understand the energy problem, and to understand why the fuel costs in this Nation are rising dramatically, and we hope that through the testimony that is also going to be presented here today that we'll find solutions to those problems. Whether those solutions are government, regulatory, restricted permitting, needs to expand our own domestic production of oil and gasoline for this country's energy

problem, a need to back away from our dependence upon foreign supplies of oil and gas which in fact do change the market conditions dramatically, and we also need to look at, in my view, a broad effort alternative energy solution to our dependence on fossil fuels in this country.

Mr. Chairman, I'm looking forward to the testimony of the witnesses that will appear before you today and again I want to thank the committee for holding this hearing in Nevada, holding it here in Henderson. I want to thank Mr. Porter one more time and I want to thank the audience for being here and the people who are going to be testifying before you today. Again, it's a real honor and privilege for me to be here on your committee. Thank you, Mr. Chairman.

Mr. OSE. Thank you. Gentlemen, I would like to ask your consent to enter into the record the statement of Congresswoman Shelley Berkley regarding this hearing. Shelley is actually engaged in activities related to another of her committees, International Relations, and is not able to join us today, but we will put this statement in the record.

I would now like to recognize my friend from Massachusetts, Mr. Tierney, for purpose of opening statement.

Mr. TIERNEY. Thank you, Mr. Chairman, thank you, Mr. Porter, for hosting this out here and the people of Henderson, NV, for their courtesies. I enjoy being out here, and I want to thank you, Mr. Chairman, for having another in a series of hearings on the important issue of energy and the cost of energy. We've done it at several locations, one in my district up in Massachusetts and seems to be an issue that periodically raises its head as we'll see in some of the testimony.

I don't think I need to repeat what might also be mentioned by others here but obviously between January of this year and May the U.S. average gasoline price has increased 50 cents or more. It's been most dramatic in the West, I believe, but in Massachusetts you should know our current price is $2.06 a gallon. That's about 57 cents higher than it was last year at this time. Families are going to spend about $375 on average more for gas this year than they did last year and about an average of $540 more per year than they did in 2002, eating up just about all of any tax break they may have gotten over the last several years. This affects the family car but also truckers, shippers, and many small businesses, all who are suffering from these skyrocketing prices.

Comments from the industry and from the Bush administration run the gamut, run from somewhat plausible contributing reasons all the way to flat-out excuses. Mostly, as studies like that done by the Consumer Federation of America and Consumers Union earlier this year show, the explanation for the high and volatile price of gasoline offered by the industry and the Bush administration is so oversimplified and incomplete that it must be considered at best misleading. At worst, it's wrong because it points to policies that do not address important underlying causes of the problem and, therefore, will not provide a solution.

First, let me say there may well be merit to the issue raised by Mr. Ose and others from his delegation. California has been a pioneer in environmental policy and generally they have found the

price to be higher but acceptable. In California refiners truly can, if they can truly produce gasoline that is cleaner or as clean an alternative as that comprised of 2 percent ethanol by weight, then the EPA should act on the State's request for relief. We've had other hearings on that and I think we'll talk about that again today.

With that said, eliminating the small gasoline markets that result from efforts to tailor gasoline to microenvironments of individual cities will not increase refinery capacity, nor improve stockpile policy to ensure lower, less volatile prices if the same handful of companies dominate the regional markets. Markets should be expanded by creating more uniform product requirements. These should not result in a relaxation of clean air requirements.

Blaming tight refinery markets on the Clean Air Act requirements to reformulate gasoline ignores the fact that in the mid-1990's the industry adopted a business strategy of mergers and acquisitions to increase profits that was intended to tighten refinery markets and reduce competition at the pump.

Blaming high gasoline prices on high crude oil price also ignores the fact that over the past few years the domestic refining market and marketing sectors have imposed larger increases on consumers at the pump than crude price increases would warrant. In other words, while they pass on the cost of higher crude prices, they don't stop there. They jack the prices up higher still, padding their profits.

Claiming that the antitrust laws have not been violated in recent price spikes ignores the fact that forces of supply and demand are weak in the energy markets and that local gasoline markets have become sufficiently concentrated to allow unilateral actions by oil companies to push prices up faster and keep them up longer than would normally be warranted in a vigorously competitive market.

What price increases are not caused by cost increases are the result of profit increases, a sign of the exercise of market power and the market failure. Net operating income for the domestic downstream industry, refining and marketing side of the business, have tripled from 1997 to 1999 to 2001. While profits were down in 2002, due to the serious economic downturn and the post September 11, 2001 travel slowdown, they have skyrocketed since.

In 2000, the petroleum industry reported a return on equity of 25 percent, more than twice the historic average for the industry and about 50 percent more than what other large corporations earned. 2003 was the equivalent of another year of record profits. So far, the first quarter of 2004 has also been incredibly profitable, especially in the downstream operations.

A good part of the reason for these spikes in price come from mergers and acquisitions. This wave of mergers and acquisitions in 2003 saw 52.2 percent of the U.S. oil refinery industry controlled by just five companies, that compared to 34½ percent in 1993. 78½ percent was controlled by the top 10 companies in 2003 as compared to 55.6 percent in 1993.

Companies have let supplies become tight in their area and they have kept the stocks low. There is too few competitors to counter this strategy. Companies can simply push prices up when demand increases with no fear the competitors will keep their prices down

to steal customers. Individual companies don't feel compelled to quickly increase supplies with imports because their control of refining and distribution ensures that competitors won't be able to deliver supplies to the market in their area. Operating at very high levels of capacity places strains on the physical infrastructure and renders it susceptible to accidents.

Let me make one point, Mr. Chairman, refineries have been closed by business, not by government. In the 1980's the policies of support for smaller refineries ended. That accounted for the loss of over 100 refineries from 1980 to 1983. Since then scores of others have been shut down. In 1990 alone 50 or more refineries were closed. Since 1995 more than 20 have been shut. The number of operating refineries have been reduced 13 percent since just 1995. Refineries get larger but they get smaller in number and they're owned by fewer and fewer entities. Over the period of 1980 to 2000 the number of firms engaged in refining in the United States has declined by two-thirds.

Let me make another point. Blaming the decline of capacity relative to demand on the Clean Air Act does not stand close scrutiny. Consolidation of the industry is a business decision that began long before the changes in the Clean Air Act amendments of 1990 and continued after the adjustment to changes in gasoline formulation.

Moreover, stock levels are down. Number of days of demand for gasoline that is held in storage has gone from 4 to 5 days down to just 1 or 2 days. Any stock levels are no accident. They are a result of business decisions.

In the face of all this industry activity, the Bush administration stands idle, merely watching as prices on regular Americans rise and profits on the President, Vice President Cheney's cronies skyrocket. The President continues to divert oil for the Strategic U.S. Petroleum reserve, even though it's at an all-time high, 660 million barrels. This purchases 170,000 barrels per day. According to Valero Energy Corp. CEO William Greehey, if the President stopped purchasing for the oil reserve it would signal to the commodity traders that the White House is serious about oil prices and the prices would fall fast.

The President's administration sanctions refinery mergers. They've approved 33 oil refinery takeovers worth $19½ billion and haven't even tried to block one.

The President continues to fail to jawbone OPEC or the Saudis into increasing supplies despite the fact that there is a 2000 campaign promise to do just that and criticized President Clinton for not doing that. We can only hope the administration is not waiting for a politically opportune time to take action as was asserted in Bob Woodward's book Plan of Attack, in essence that the Saudis would act to lower prices closer to election time.

Finally, the President's energy bill does nothing to address overconcentration or conservation. It does nothing that would lower prices much. Instead, it gives billions of dollars of taxpayers' money, large oil companies in the form of subsidies and tax breaks with no real conservation requirements.

The administration's own analysis concludes that the legislation's incentives to reduce our reliance on foreign sources of oil will have only negligible success. In fact the administration's own analysis

indicates it will reduce net imports only 1.2 percent between now and 2025. It's hard to think that's worth billions of dollars in taxpayer money in subsidies and tax breaks.

The Department of Interior concluded only 15 percent of the oil in the 104 million acres of Federal land between Montana and New Mexico is currently unavailable due to wilderness designation and other environmental restrictions. So we can, therefore, conclude that the vast majority of oil reserves on Federal land are easily accessible for drilling. Environmental laws do not need to be weakened in order for America's needs to be supplied.

Mr. Chairman, I've joined a number of colleagues in writing the President seeking action, and I'd like with unanimous consent to submit a copy of that letter.

Mr. OSE. No objection.

[The information referred to follows:]

Congress of the United States
Washington, DC 20515

May 25, 2004

The Honorable George W. Bush
President of the United States
White House
1600 Pennsylvania Ave
Washington, D.C. 20500

Dear President Bush:

Gasoline prices continue to climb to record highs, with the national average now at $2.06 a gallon, and prices topping $2.32 in some areas. While the oil industry blames environmental regulations and OPEC, there is substantial evidence that anti-competitive practices by domestic corporations—made possible by recent mergers—are partly to blame for high gasoline prices. We believe only an increase in government oversight can restore the transparency and accountability consumers need.

In the last six years, mergers between BP and Amoco (1998), Exxon and Mobil (1999), BP Amoco and Arco (2000), Chevron and Texaco (2001), Valero and Ultramar/Diamond Shamrock (2001), and Conoco and Phillips (2002) created huge new oil companies that have control over the most significant factor impacting gasoline prices: domestic refineries. Today, the largest five refiners operating in America—ConocoPhillips, Royal Dutch Shell, ExxonMobil, BP and Valero—control over 52% of domestic refining capacity. The top 10 (which includes ChevronTexaco, Citgo, Marathon, Sunoco and Tesoro) control 78.5%. This level of concentration is far greater than just a decade ago, when the largest five refiners controlled 34.5% of the market, and the largest 10 owned 55.6%.

Armed with significant market share, these oil companies can more easily pursue anti-competitive activities that result in price-gouging. The U.S. Federal Trade Commission (FTC) concluded in March 2001 that oil companies pursued "profit-maximizing strategies" to intentionally withhold gasoline supplies as a tactic to drive up prices.[1] In addition, deregulation of energy trading markets (like the ones exploited by Enron) has removed transparency from oil and natural gas futures markets, allowing oil companies and Wall Street investment banks to potentially manipulate prices on these markets.

While some claim the stalled energy bill will provide new supplies to the market and therefore force down prices, the Energy Information Administration concludes that the billion dollar subsidies the energy bill would provide to energy corporations will neither significantly increase production nor lower prices for consumers.[2]

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[1] Final Report of the Federal Trade Commission. Midwest Gasoline Price Investigation. March 29, 2001.

[2] Summary Impacts of Modeled Provisions of the 2003 Conference Energy Bill. February 2004. Energy Information Administration. Office of Integrated Analysis and Forecasting. U.S. Department of Energy.

Effectively addressing high gasoline prices will take six steps—none of which are included in the energy legislation. We ask you to support these steps and take the necessary actions to implement them.

First, require oil companies to expand gasoline storage capacities, require them to hold significant amounts in that storage, and reserve the right to order these companies to release this stored gas to address supply and demand fluctuations.

Second, block mergers that make it easier for oil companies to manipulate gasoline supplies—and take steps, such as forcing companies to sell assets, to remedy the current highly concentrated market.

Third, re-regulate energy trading exchanges that were exploited by Enron and continue to be abused by other energy traders.

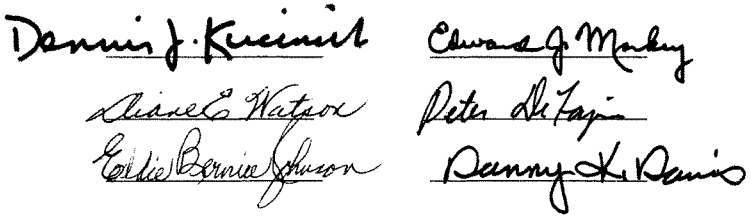
Fourth, discontinue filling the Strategic Petroleum Reserve while prices are high and conduct a study of building crude and product reserves that can be used as economic stockpiles to dampen price increases.

Fifth, reduce oil consumption by implementing strong fuel economy standards. Substantially improving CAFE standards over a ten-year period would reduce the oil used by one-third in 2020 and save consumers $16 billion at the gas pump.[3]

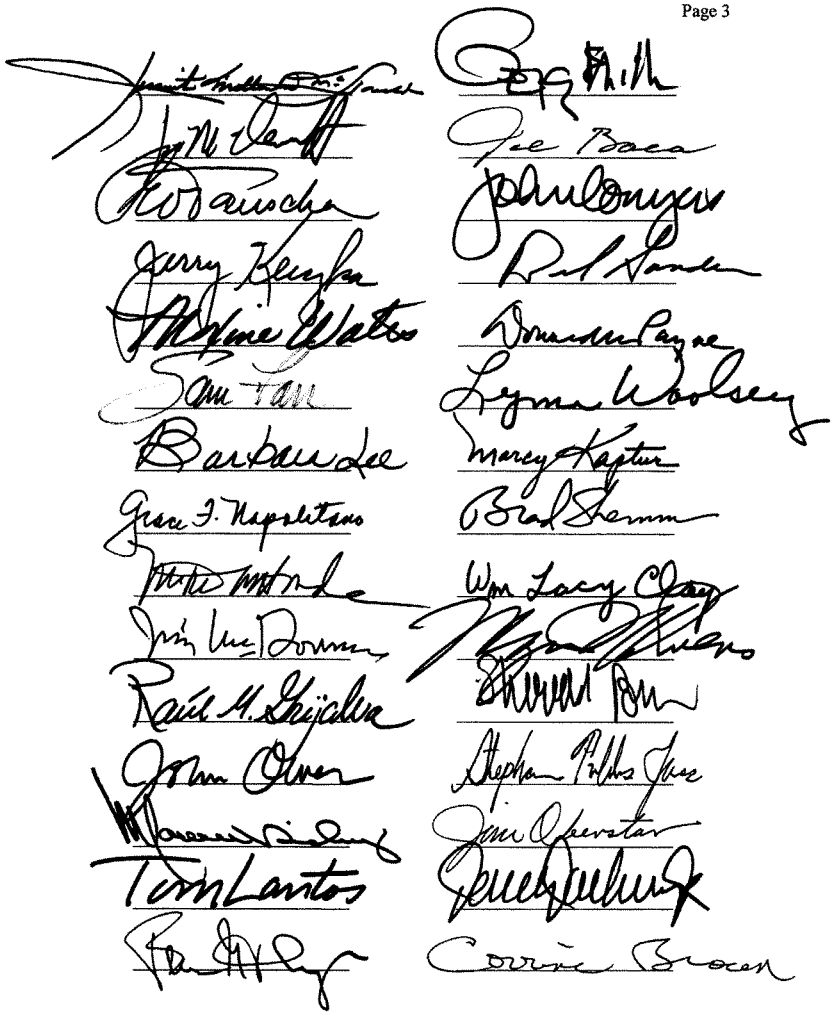
Sixth, request the Federal Trade Commission conduct a study of the reasons why the market forced the closure of over 50 predominantly small and independent refiners in the past ten years and assess how to bring fair competition back to the refinery market and thus expand capacity.

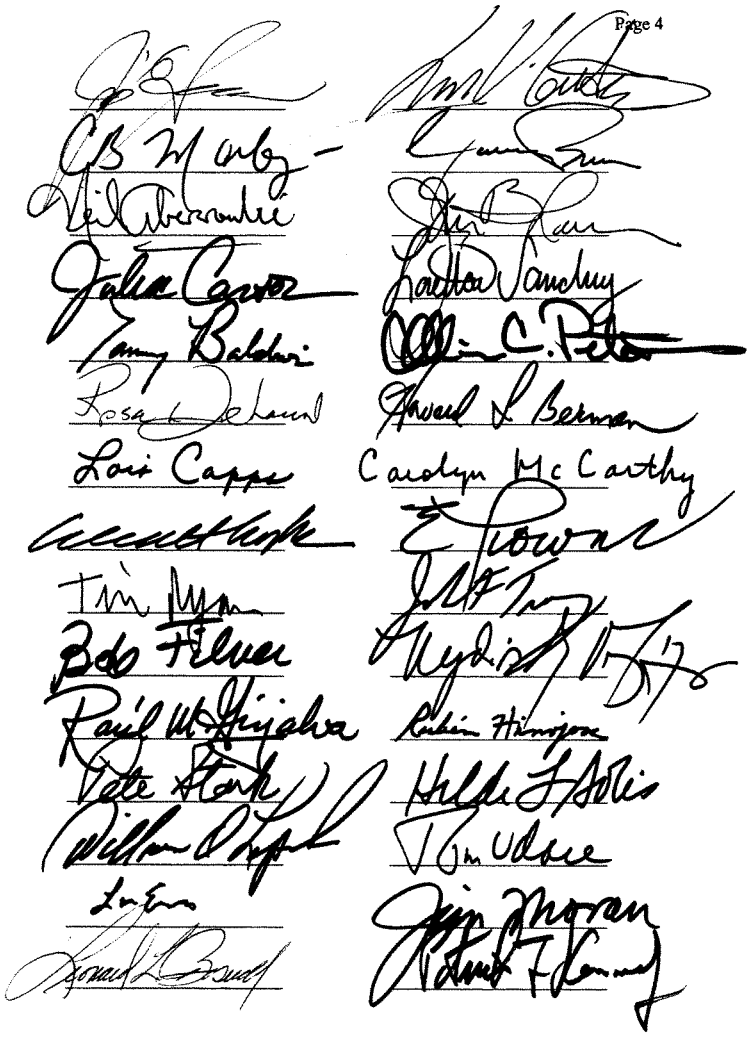
By employing all six of these strategies, substantial reductions in the price of gasoline are attainable. We urge you to support these strategies.

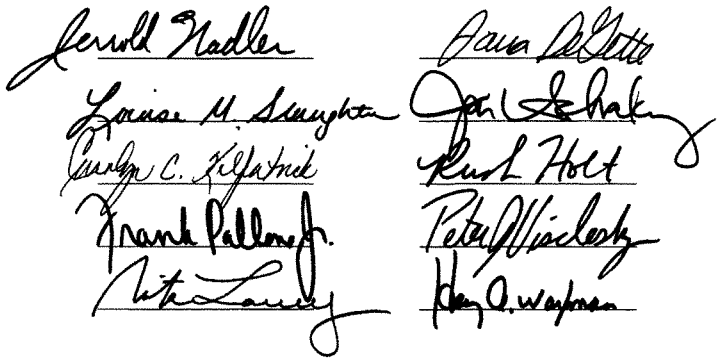
Sincerely,



[3] National Academy of Sciences, "Effectiveness and Impact of Corporate Average Fuel Economy (CAFE) Standards," (2002).







Mr. TIERNEY. Here are some of the things we believe we should do. We should require the oil companies to expand storage capacity, require them to hold significant amounts in that storage, and reserve the right to order the companies to release the stored gas to address supply and demand fluctuations.

We should block mergers that make it easy for oil companies to manipulate gasoline supplies and take steps, such as forcing asset sales, to remedy the current highly concentrated market: Discontinue filling the strategic petroleum reserve while the prices are so high; consider building crude and product reserves that can be used as economic stockpiles to dampen price increases. We did that recently in the Northeast and it worked quite well. We should consider doing it in other areas.

Reduce oil consumption by implementing strong fuel economy standards. Substantially improving CAFE standards over a 10 year period to reduce the oil used by a third in 2020 and save consumers $16 billion at the gas pump. We should re-regulate energy trading exchanges that were exploited by Enron and continue to be abused by other energy traders.

We should have the Federal Trade Commission study the reasons why the market forced the closure of over 50 predominantly small and independent refiners in the past 10 years and assess how to bring fair competition back to refinery market and thus expand competition.

Mr. Chairman, it's strategies such as these, not the administration's billions of dollars in giveaways to its cronies in faulty legislation, not the industries crying wolf over environmental regulations when in fact it's the industries' decision to cause less competition and decreased supply and capacity that result in the higher prices. That's what we need and hopefully there will be other suggestions. Thank you.

Mr. OSE. Thank you for his comments. We're now going to our host for purpose of an opening statement. Congressman Porter.

Mr. PORTER. Again, thank you, Mr. Chairman. I appreciate you being here today. I'm looking across the room and wondering how many were around when we were paying about 20 cents a gallon for gas. I think there are a couple here. I can remember filling my 1968 Volkswagen. I think it cost me about $3 or something to fill the tank. That gives my age. I'm a ripe old age of 49. I remember the early seventies, 1973, 1974 with the oil embargo. I do not wish for that to ever happen again to the United States of America although I would love to have 20 cents or 25 cents a gallon. The Nevada economy, Las Vegas, Henderson specificly, is tourist dependent. How do tourists get here? They either come by car or by air; almost 50/50. Close to 40 million visitors a year come into Nevada economy. Add to that the fact that we're growing at 6,000 to 7,000 people a month. Although we may have a State of a little over 2 million people, with an additional 40 million in tourist, we are very, very dependent upon the cost of fuel. Not only for our economic future, to make sure that tourists can visit Nevada at a reasonable cost, but for our residents, moms and dads and families that are trying to get to work.

Nevada is truly a part of a regional economy. What happens in California directly impacts Nevada. What happens in Arizona di-

rectly impacts Nevada. Our sister States, although much larger, have a huge influence over our economic future, whether it be visitors or whether it be the cost of fuel.

There are a number of issues that have come forward in light of the increased prices in Nevada and in the region in the past few months and I've asked staff to come up with a few key areas that appear to have caused a major increase in our fuel. One, of course I mentioned that we're a part of the whole region, but with gas tightening the markets around the world, the U.S. growth in gasoline supply is not keeping pace with the growth in demand.

One of the serious challenges is truly supply and demand. Over the last 20 years many refineries have closed. I think there are different opinions and we'll probably hear many opinions as to why, but the fact is they've closed. And, no refineries have been built since 1976. However, demand for gasoline has remained strong and continues to increase at about 2 percent a year. The result is an ever-increasing imbalance between supply and demand.

It's my understanding that the current refineries are operating at about 95 to 96 percent of their capacity. There is ample crude oil available but we don't have the refineries to process that for whatever reason. I'm sure we're going to hear about it this morning.

The ethanol mandate in California. From January to March, refineries in California transition from winter-grade gasoline to harder to produce summer-grade gasoline. This year, because of overlapping Federal and State regulations, California refineries were required to begin blending their gasoline with ethanol. There are lots of opinions on ethanol as to how it impacts the environment, but the fact remains that they began blending this year.

As a result of the blending properties of ethanol, California gasoline productions ability was decreased by almost 10 percent, causing upward pressure on gasoline prices in California, Nevada, and in the Southwest. Because Nevada receives almost all of our gasoline from California, these changes also exert upward pressure on Nevada's gasoline prices.

The cost of crude oil, you know, as I talked about my 1968 Volkswagen in the early seventies and the oil embargo, at that time about 30 percent of our resources in this country were dependent upon foreign oil. Now, in 2004, we're more dependent than ever, at almost 63 percent on foreign oil. Now, let's use a little common sense. Sixty-three percent dependency on other countries and their economies and their political problems and their challenges can and do hold us hostage.

The cost of a barrel of crude oil has increased from about $25 to an all-time high of $41.85. This is due to a strong demand in the United States and China. China is importing all it can find. They don't care about the grade. We do as we should be very cautious and be careful with the crude that we bring into the States. They don't care.

Production cuts by the Organization of Petroleum Exporting Countries [OPEC], political instability in Iraq and Venezuela. As a rule of thumb a dollar increase in the cost of a barrel of crude oil translates into about 2½ cent increase at the gas pump. Those are some of the key areas that I think specific to Nevada. Also, we

have a challenge here with storage in Nevada. We have limited storage space, which is another challenge as I've heard from the wholesalers and suppliers here in the great State of Nevada.

What can be done to address some of these prices in the short-term? Because today we're here to talk about some short-term fixes but really some long-term solutions as the morning unfolds. But what are some of the things we can do in the short-term?

Well, there are a few things that we can take, that consumers can take to decrease the amount of their hard-earned money that goes to the cost of gasoline, things that we have taken for granted. One, we certainly can combine some of our trips to the grocery store, but in reality simply checking inflation in tires would help immensely right now, here and today. Now, this isn't a big government suggestion. This is just some common sense approach. Of course carpooling, and I applaud the Regional Transportation Commission here in Nevada for working on the monorail, an additional resource that's being proposed here in the Henderson corridor. All of these things are actually in the works today, and I consider some short-term solutions. Long-term I believe is why we're here today also and probably most important.

Some possible solutions that will be addressed today include expanding and enhancing the petroleum infrastructure, including additional refineries and being able to expedite regulations. I want to make it clear, when I talk about expediting approval process, it's not about changing or weakening or making our environmental regulations more lax. We must preserve and protect the environment and that's the priority. But we all know how government can be. It can be very slow, inefficient. We need to elevate the priority of oil production as we have energy in the Southwest over the last 24 months.

The fuel challenge we're having today is almost parallel to the electricity problem we're having in the Southwest. The difference is when it comes to fuels, we can't bring in fuel from the Northwest, from Oregon or Idaho, or from other States, because there are over 60 different fuels being used in different communities. Now, in fairness, they follow the proper regulations that have been proposed. I applaud Christine Robinson here, the Air Quality Control Board of Clark County. As you know, I helped reorganize that agency just last year. But, each community has different options.

One of the possible solutions, as we're looking at the supply side solution, is to make sure that we look at some of these regulations in a regional basis. So, we may not need 60 different boutique fuels across the Southwest or the West. We can combine and still meet the important stringent requirements of the Clean Air Act.

Increasing imports of finished gasoline, that's another option. I'm not suggesting necessarily that we do that, but we can purchase additional gasoline that's already been refined from other countries. And fuel blending, of course the number of boutiques as I mentioned and the blending of components, but No. 4 which is really important to Nevada is finding a way to have additional gasoline storage and capacity right here in southern Nevada.

The demand side is critical. Improving vehicle fuel economy, encouraging the use of alternative fuels, hybrid vehicles, providing in

public incentives for public transportation and carpooling. These are some of the solutions that I think will be mentioned today.

In conclusion, Mr. Chairman, during the hearing we're going to investigate why consumers are paying so much at the pump. More importantly we'll discuss potential short- and long-term solutions to address the rise in gasoline prices. By the end of the day only clean renewable energy sources can meet our growing energy needs while protecting the economy, freeing us from foreign suppliers and maintaining our commitment to the environment. Thank you, Mr. Chairman.

Mr. OSE. Thank you, Congressman Porter. I want to add my compliments to the others. I don't know whether your people here in Clark County or Henderson know exactly the type of Member you are, but the reason we're here today is to get you off my back. That's why we're here. Jon Porter has dogged me to death about the importance of this issue to this area and I thank the gentleman for being persistent in that regard.

Mr. PORTER. Thank you.

Mr. OSE. I want to ask unanimous consent, actually I think this is normal, unanimous consent that Mr. Gibbons' written statement be entered into the record; without objection, so ordered.

I want to recognize the vice chairman of the subcommittee from Virginia, gentleman, who is recognized, Mr. Schrock.

Mr. SCHROCK. Thank you, Mr. Chairman. Thank you for holding this very timely and important hearing. I also want to thank our Nevada colleagues, Congressman Porter, Congressman Gibbons, for having us in their wonderful State and I was amused, Jon, when you said you were bemoaning the fact that you were at the ripe old age of 49. I would kill to be 49 again. So don't feel so bad. There is a lot of life ahead of you.

I wasn't going to come here today because I live in Virginia; it was a long haul. I didn't get here until last night, and I have to speak at a commencement ceremony at 9 a.m. tomorrow at home. But like the chairman, Jon Porter said you will be here because this is such an important issue, and it really is. As I left home, we were well into our $2 range as well, and I never thought we'd see that in Virginia. I can assure you that's why I'm here because Jon said for me to be here, and, consequently I am.

We all know why we're here. That's because gas prices have reached record highs and Americans want to know the answers to two very important questions: How did we get to this point and what do we do about it now?

To answer the first question of how we got to this point, the answer is that America has gone too long without a national energy policy and we have all been forced to adopt a fly by-the-seat-of-your-pants approach. Though Congress and the administration have tried over the last few years, we have not been able to agree on a plan that sets the course in the right direction with regards to an energy plan. This lack of policy have forced Americans to be beholden to foreign producers, to their oil supply, and we have been held hostage by the decisions of OPEC so that our loss is their gain.

In May 2001, the administration came out with a policy statement outlining their plan for tackling America's energy needs. The

bulk of these initiatives required congressional action, which has not yet taken place 3 years later. It is clear that some have chosen to make this stalemate and the resulting energy crisis a political issue rather than seeking out real solutions.

The House passed an energy bill conference report last year. The Senate has yet to pass that legislation. The House has done its part in establishing a national policy, but like any other issue, we're waiting for the Senate to take issues.

So where do we go from here? Well, I think that passing the current energy bill would be a giant step in the right direction and while not including all the policies that will get gas prices and other energy sources on track, it will put in place a number of measures to boost production, curb consumption, and encourage the use of alternative fuel. Once we get the energy conference report out of the way, we can move on to the more difficult issues of boosting domestic production by drilling in Alaska and increasing the refinery capacity right here in America.

We're here today to hear from our witnesses and to get their input from where we are heading and how we can point this ship in the right direction. I was in the Navy for 24 years. I understand how important it is to have a ship aimed in the right direction. The same is true with this energy policy. I thank my colleagues again for hosting us in their fine State and I look forward to hearing from our witnesses this morning. Thank you, Mr. Chairman.

Mr. OSE. Thank you, gentleman. First of all I want to say how much fun I had a year and a half ago when I brought my family through this part of the country on a Christmas vacation. We actually went right down Lake Mead Boulevard and on over to Hoover Dam. We were inspected just like everybody else. Doing their job. My family did spend the evening here, and we had a great time. This is a great part of the country and my kids and I and my wife thank you for the opportunity to come here.

As we were driving out here today, I was watching the gasoline stations on the corners trying to keep track of the different pricing. It was clear that the pricing here is no different perhaps than it is in California. Everybody is above $2.25 for regular. It's as high as $2.43 for premium. I think we're all somewhat unsettled by that.

The purpose of this hearing is to try and examine the root causes of that. Why is it that we're in this situation where we find few alternatives and the only near term or immediate thing we can do is pay through the nose for fuel?

Now, Congressman Tierney and I have been on the road for 4 years looking at this, different areas, different times of the year, and while we may differ in terms of a number of things, some of the things we have found I think we consistently understand. No. 1, we have an imbalance between supply on one hand and demand on the other. We have growth in demand that is exceeding growth in capacity to refine. So the differences, the imbalance, are growing, not shrinking.

As Congressman Porter said, we're impacted by events in Venezuela, Iraq, and Indonesia, and by growth in the economy in China where demand for oil has gone through the roof. In effect,

we find ourselves in a marketplace where we're having to bid against people who previously could not afford to bid against us.

There are a any number of ways to address this. We can talk about CAFE standards, which are the fuel efficiency standards. We can talk about increased production domestically. We can talk about increased ability to import. We can talk about alternative means of propulsion, whether they be carbon based or otherwise for our vehicles. But whatever, whatever you want to do, the reality is that 97 percent of the means of propelling our vehicles remains based on petroleum. That's a fact. Cannot get around that. It's not going to change by tomorrow.

In order to increase supply, there are estimates as high as $20 billion being needed to upgrade facilities that refine petroleum into fuel, whether it be diesel or regular or premium or what have you. Now, others have spoken about the winter to summer changeover in fuel and I'm sure a number of our witnesses will testify about that today so I'm not going to touch on that.

Over in California there is a refinery that's being closed. Shell Oil is closing its Bakersfield refinery. Stated reasons appear to be they can't get enough heavy fuel oil out of the Kern County supply source to efficiently supply the Bakersfield refinery. I want to explore that today. I want to ask the people who are experts in this field whether that's the case.

Frankly, if Shell is going to close their refinery, why don't they put a price on it and sell it? Now, it's my understanding that there have been 21 inquiries made as to the status of that refinery, its condition, what the price is, but there has been no final closure on that. I would hope to have some of our witnesses speak to that today.

[The prepared statement of Hon. Doug Ose follows:]

Chairman Doug Ose
Opening Statement
"Easing Pain at the Gasoline Pump: Finding Solutions for Western Woes"
May 28, 2004

Welcome to exciting Henderson, Nevada. The fact that we are holding this hearing in the Las Vegas area today is no accident. Today marks not only the beginning of the Memorial Day weekend but also the start of the summer driving season. Over the weekend, an estimated 200,000 people will pack up their cars and hit the road to enjoy all that Las Vegas has to offer.

As you may have noticed as you drove here today, gasoline in the Las Vegas area is currently a whopping $2.28 per gallon. In my district in California, the average price is $2.29. Although these numbers are unsettling, they are by no means surprising.

For the last four years, my Subcommittee has held annual hearings on this very issue. Over the years, two things have remained the same — gasoline prices rise every spring and summer, and the increases have always been explained by the basic economic principle of supply and demand. Until policymakers begin to address the factors affecting the balance between supply and demand, consumers will continue to be subjected to this vicious cycle.

According to the Energy Department's Energy Information Administration, U.S. demand for gasoline is expected to increase an average 2 percent per year. In part, this demand is due to the improving domestic economy and the increase in sales of sport utility vehicles.

Conversely, oil refinery capacity has gradually decreased over the last 20 years and is expected to remain stagnant in the near-term. To some extent, this is due to the cost of complying with Federal and State environmental regulations. The National Petrochemical and Refiner's Association estimates that refiners will need to invest about $20 billion in the next decade to comply with environmental regulations. As a result, less capital will be available for refinery maintenance and expansion.

On the larger scale, growth in global demand for crude oil is also beginning to outpace growth in global supply. Significant demand increases in China, political instability in Iraq and Venezuela, and recent actions by the Organization of Petroleum Exporting Countries (OPEC) have tightened the global market and have driven crude oil prices to record highs.

In addition to these domestic and international factors, California's gasoline supply is being influenced by a *de facto* ethanol mandate. This mandate, a result of overlapping Federal and State regulations, decreases the State's gasoline supply by 10 percent for 8 months of the year and may actually increase air pollution.

Compounding this loss is the impending closure of Shell Oil's Bakersfield, California refinery, which produces 2 percent of the gasoline and 6 percent of the diesel sold in California. Together, the ethanol mandate and the refinery closure, will translate into a 12 percent loss in gasoline production capacity in California. This will have a significant impact on consumers in California, Arizona and Nevada next summer.

The price of gasoline directly affects the pocketbooks of hard-working Americans. And, as is evident by this laundry list of problems plaguing the gasoline markets in the U.S., there are some very serious issues that policymakers should address if we want to provide consumers some relief.

To that end, today's hearing will examine potential short and long-term solutions. 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. It is important to remember that every solution has both benefits and costs.

I look forward to a frank and open discussion with our witnesses, which include: Richard Burdette, Energy Advisor to Governor Guinn, State of Nevada; William Keese, Chairman, California Energy Commission; Lynette Evans, Policy Advisor Regulatory Affairs, Office of Governor Napolitano, State of Arizona; Joe Sparano, President, Western States Petroleum Association; Sean Comey, Media Relations Representative, American Automobile Association of Northern California, Nevada and Utah; David Hackett, President, Stillwater Associates; and, Tyson Slocum, Research Director, Public Citizen's Energy Program.

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

[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.

summertime, 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

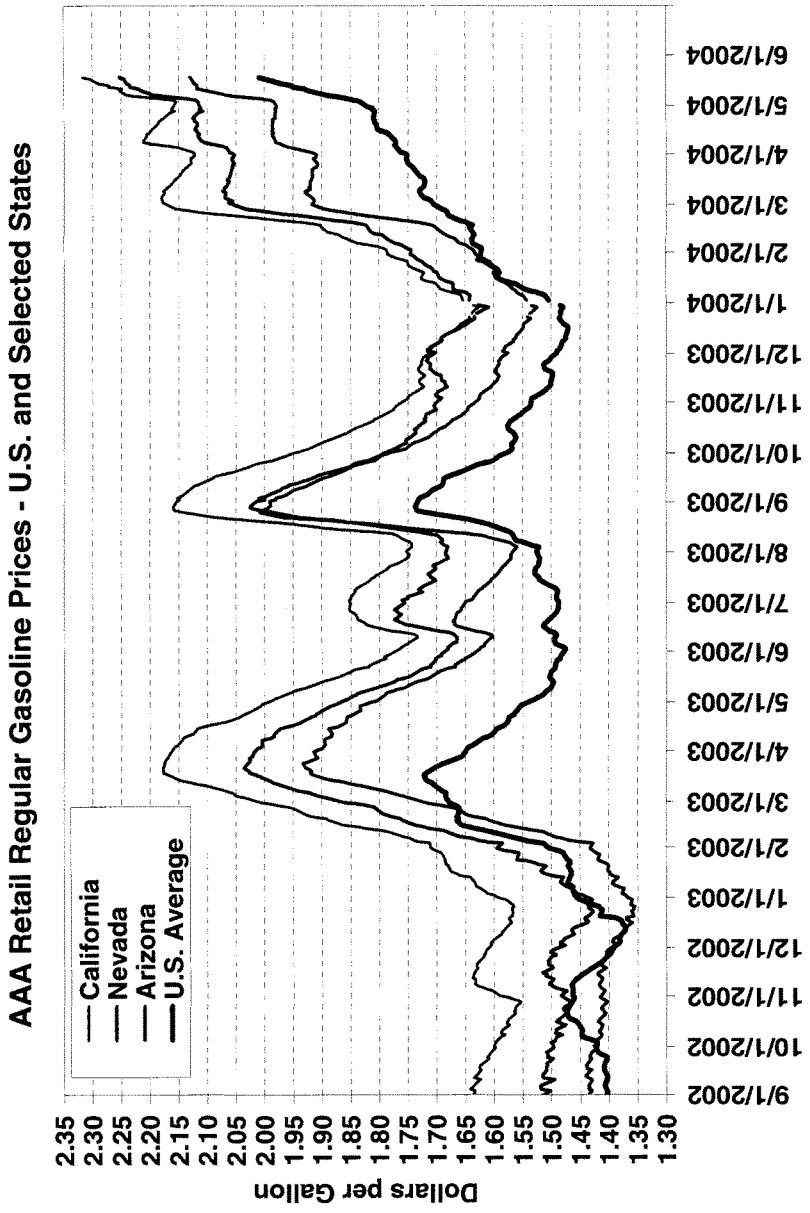
[3] By February 27th, inventories had decreased from 15 million barrels to 11.5 million barrels, which is approximately 800,000 barrels below the 2003 level. According to the California Energy Commission (CEC), this tightness in supply of gasoline on the West Coast "contributed to the current run-up 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.


AAA Retail Regular Gasoline Prices - U.S. and Selected States
California
Nevada
Arizona
U.S. Average
Dollars per Gallon
2.35
2.30
2.25
2.20
2.15
2.10
2.05
2.00
1.95
1.90
1.85
1.80
1.75
1.70
1.65
1.60
1.55
1.50
1.45
1.40
1.35
1.30
9/1/2002
10/1/2002
11/1/2002
12/1/2002
1/1/2003
2/1/2003
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Attachment B

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

Mr. OSE. I do want to just go through and introduce our witnesses here. We're going to have two panels of witnesses. Our first panel is comprised of the following individuals: Richard Burdette, who is the energy adviser to Governor Guinn here in the State of Nevada, William Keese, who is the chairman of the California Energy Commission, and who has testified in front of this subcommittee regularly, and Lynette Evans, who is the policy advisor on regulatory affairs for Governor Napolitano in the State of Arizona.

Our second panel, four individuals, is comprised of Joe Sparano, president of Western States Petroleum Association; Sean Comey, media relations representative of AAA of Northern California, Nevada, Utah, an organization I used to be on the board of directors for; Mr. David Hackett, president of Stillwater Associates; and, Tyson Slocum, research director for Public Citizen's Energy Program.

Again, we're taking testimony from these invited witnesses who have statements for the record which will be entered into the record which we have copies of outside that door back there for anybody who wants to follow along as they summarize. With that I would ask the first panel, Mr. Burdette, Mr. Keese, Ms. Evans to come forward and join us up here.

Standard practice in our subcommittee as well as full Committee on Government Reform is to swear our witnesses in. If you all will please rise.

[Witnesses sworn.]

Mr. OSE. Let the record show the witnesses answered in the affirmative. The first witness on the first panel is Mr. Dick Burdette, who is the energy advisor to Governor Kenny Guinn here in the State of Nevada. He is also the director of the Nevada State Office of Energy. Sir, welcome to our subcommittee hearing. You're recognized for 5 minutes.

STATEMENTS OF RICHARD BURDETTE, ENERGY ADVISOR TO GOVERNOR KENNY GUINN, STATE OF NEVADA; WILLIAM KEESE, CHAIRMAN, CALIFORNIA ENERGY COMMISSION; AND LYNETTE EVANS, POLICY ADVISOR REGULATORY AFFAIRS, OFFICE OF GOVERNOR JANET NAPOLITANO, STATE OF ARIZONA

Mr. BURDETTE. Thank you, Mr. Chairman and members. Let me add, Governor Guinn welcomes you and thanks you for offering us the opportunity to talk a little bit about our views and the continuing challenge of gasoline prices in Nevada, California and Arizona.

We are linked pretty closely together. Nevada is greatly dependent on the availability and price of gasoline, diesel fuel, and jet fuel, and as the prices of those fossil fuels rise it directly affects our employment, our tax base, and, of course, nearly every one of our citizens.

It is going to take a little bit of an academic tack here because I think the problem is academic. Much has been said about the preference for using the free market to allocate products to consumers. This, of course, is what markets do. When this is done efficiently, we call them competitive or free. When markets are not free, goods and services are not allocated efficiently and economic

rents, that's a term that is less inflammatory than excess profits, economic rents are collected usually by suppliers.

The truth is that there are virtually no free markets or competitive markets in the classical sense. To an economist the word implies a series of standard assumptions such as the market allows easy price discovery. The price discovery during the Western energy crisis 3 years ago, electricity, was exceedingly difficult because as FERC determined some market participants manipulated the electricity market and extracted substantial rents that nearly bankrupted Nevada's electric utilities and the State of California. Nevertheless, we still refer to those markets as free or for those who like to hedge their bets as governed by free market principles.

Unfortunately, there exist a crucial defect in the gasoline market that is even more fundamental. In a reasonably free gasoline market, when supply shortages occur, prices increase until they are high enough to allocate available gasoline to its most efficient use. Generally this means that some refiners will collect rents, ordinarily a bad thing. But in a free market these rents are used to provide the capital needed to expand, to build new refineries, and to attract new capital. Those who fail to make those kind of investments would lose market share and profitability. Most importantly when that happens consumers benefit.

We can spend a lot of time pointing fingers at who created the market that we have now, but in my opinion we in the West have allowed ourselves to drift or perhaps be nudged into a situation that is economically unsound. We don't want the government to ration gasoline but we are increasingly aware that the rents collected, principally by refiners, are not being used to serve the public interest as they would be in a free market.

The international crude market is not a free market either. It's characterized by institutional collusion of OPEC. The consequence is higher crude prices now exceeding $40 a barrel. If we had known that crude prices would remain high, the domestic supply of crude would increase substantially. After all, there is a whole lot more $40 a barrel oil than there is $23 a barrel oil. Unfortunately we don't know that. And, the ability of OPEC to drop prices is very effective in minimizing competition from renewable energy development, hydrogen technology and other methods we would take here in the United States.

Crude prices, however, are like the tidal forces beneath waves. The waves are the price spikes generally caused by conditions unique to our Western market and are similar to State taxes and gasoline environmental attributes that affect the price level but generally, not always but generally do not affect price spikes. Price spikes are caused by excess demand, when demand exceeds supply. But because refiners are operated so close to full capacity it is sometimes possible, not possible for them to make enough product for peak demand.

Supply interruptions cause—also result in price spikes and unwarranted collection of rents. Unplanned maintenance of refineries is an especially troublesome type of interruption. It is very difficult to ascertain whether the occurrence or duration of an unplanned maintenance outage was the result of a legitimate problem or withholding capacity. The situation is uncomfortably close to the elec-

tricity crisis of 2000 and 2001. But, in this market it may not even be illegal to withhold capacity. Governor Guinn and Senator Reid had just such concern in mind when they jointly asked the FTC for a systematic method of overseeing the western petroleum market.

With regard to solution, the most direct solution for our refined products supply problem is to build more refineries. While it may still be possible, this is very unlikely and improving the short-term refining capacity has been largely a matter of relying on imports. There is one potential mid-term solution which is not fully developed: ethanol and biodiesel, not generally available.

With regard to demand-side problems, demand-side options, the easiest thing to do is to get people to live closer to their job, to have cars with higher mileage, or to offer public transportation. But, in any event, changing behavior is a long-term process. That would be helped most by what we want the least, high gasoline prices.

[The prepared statement of Mr. Burdette follows:]

Prepared Statement of Dick Burdette
Energy Advisor to Governor Kenny Guinn
And Director, Nevada State Office of Energy

to the

Committee on Government Reform
Subcommittee on Energy Policy, Natural Resources
& Regulatory Affairs

Las Vegas, Nevada
May 28, 2004

Easing Pain at the Gasoline Pump: Finding Solutions for Western Woes

Mr. Chairman and Members of the Committee:

Thank you for offering me the opportunity to discuss Nevada's perspective on the continuing challenge presented by the price volatility of gasoline and other refined petroleum products in western states generally, but particularly in Nevada, California and Arizona. As you might surmise, Nevada's geography, with two large population centers – both dependent in significant measure on tourism – and remote farming and ranching communities, results in considerable reliance on the availability and price of gasoline, diesel fuel and jet fuel. When prices of these fossil fuels rise, this reliance produces consequences that directly affect employment, our tax base and, of course, nearly every citizen.

It is also important for me to thank this Committee, the Energy Information Agency and the California Energy Commission for their ongoing efforts to provide analysis, objective information and sustainable relief to all transportation energy consumers in the west.

Western Refined Products Markets Are Not "Free" Markets

Much has been said about the preference for using a "free market" to allocate products to consumers. This is, of course, what markets are supposed to do. Moreover, they perform this function in the most efficient manner, when the markets are "free." Conversely, if a market is not free, the manner in which it allocates goods and services is not necessarily efficient. It is also likely that economic "rents" – a less inflammatory term than "excess profits" – are collected when markets are inefficient.

The truth is that there are virtually no markets that are "free," or competitive, in the classical sense of the word. To an economist the word implies, for example, (1) that no one market participant has the ability to unilaterally affect the market price, (2) that information – price discovery – is easily accomplished, (3) that there are no implicit or explicit subsidies, and a series of other standard assumptions. For example, the market for automobiles is often thought of as being free, but in fact, there are a relatively small number of manufacturers. Individual

companies in the resulting oligopoly are able to extract rents by carefully managing pricing strategies, even in the absence of collusion.

Price discovery during the western energy crisis three years ago was exceedingly difficult because, as the Federal Energy Regulatory Commission determined, some market participants manipulated the electricity and natural gas markets and extracted substantial rents that nearly bankrupted the Nevada electric utilities and the State of California. Perhaps it would also be useful to speak with representatives of Boeing and ask them how effective allegedly anti-competitive government subsidies have been in sustaining their European competitor.

Nonetheless, we still refer to the markets for automobiles, wholesale electricity and aircraft as "free" – or, for those who like to hedge their bets – as "governed by free market principles." And, if the only defects in the western gasoline market were the limited number of competitors or the difficulty of determining the "market price" or the intrusion of government subsidies, I would not object.

The crucial defect or fatal flaw of the gasoline market is more fundamental. In a reasonably free gasoline market, when supply shortages occur, prices would increase until they are high enough to allocate available gasoline to its most efficient use. Generally this means that some suppliers will collect rents, ordinarily a "bad" thing. But in a free market these rents are used to provide the capital needed to build new refineries. The rents may also attract new capital to the market. Those who failed to make such investments would lose market share and perhaps profitability. But that is not what happens in the western gasoline market. The rents are, indeed, extracted, but they are not reinvested to improve supply capacity, nor is the system self-correcting. Every time a supply interruption occurs in Nevada – a pipeline is shutdown, a refinery fire occurs, a port facility is unable to offload crude – a price spike occurs. Consternation and investigations ensue, but the root cause is never identified. And the rents…it should be clear where they end up.

The result often is, in my opinion, an unjust result – in times of supply crisis, the market is not efficient and rents (sometimes quite substantial) are retained by suppliers who, basically, are unable to apply them in a manner that would be beneficial to the market.

Who is at fault? The refiners…probably not. There is no evidence that I'm aware of that they have colluded or behaved illegally, and board members of those companies have an obligation to maximize returns to their shareholders. Speculators…probably not. There is a great deal of uncertainty in gasoline markets and speculators perform the useful function of shifting risk to those who are willing to accept it – at a price commensurate with the risk. The State of California because a new refinery can't be built…probably not. Seventy percent of the state is already non-attainment. The Environmental Protection Agency…probably not. Clean Air Act requirements, I believe, generally reflect the will of the Congress and of the people.

Rather, it is my opinion that we in the west have allowed ourselves to drift into a situation that is economically untenable. We are, appropriately, cowed by alternative forms of market allocation – regulation, or rationing, by the government or "first-come-first-served" – both quite objectionable. But we are increasingly aware that the rents collected, principally by the refiners, are not being used to serve the public interest, ***as they would be in a truly free market***.

Organization of Western Markets

There are actually four market segments to what I have been calling the western gasoline market; and they involve not only gasoline, but also other refined products and additives. To begin to address the problem it is important to understand how these four market segments interact and how they respond to the types of events that cause price spikes. The four segments are (1) the international crude market, (2) the refined-products market, (3) the wholesale distribution market, and (4) the retail market. A special branch of economics dealing with limited natural resources governs the first of these segments but, with that one exception, the output of one segment becomes the input to the next.

The international crude market is not a free market. It is characterized by the institutional collusion of the Organization of Petroleum Exporting Countries (OPEC). Such collusion is illegal in the United States. The consequence is higher crude oil prices, now exceeding forty dollars per barrel. If it were known that crude prices would remain this high, the domestic supply of crude would increase substantially. After all, there is a great deal more $40 per barrel oil than there is $23 per barrel oil. Unfortunately, it is not known what the price of crude will do six months from now and that is why there are speculators and that is why there are risk premiums. This ability of OPEC to drop prices is very effective in minimizing competition from renewable energy development and hydrogen technology.

That said, OPEC does not cause price spikes in western U.S. markets. Crude prices are like tidal forces beneath the waves. The waves are the price spikes caused by conditions unique to our markets. Crude prices certainly have contributed to the current high price of gasoline, but not directly to spiking. Similarly, state taxes do not cause price spikes. Taxes are generally fixed and are, hopefully, consistent with the development and repair needs of individual states. Nevada, for example, has high gasoline taxes, but must deal with a very large number of square miles and a very rapidly growing population, both of which place extraordinary demands on the need for highway funds. Finally, exceptionally clean burning gasolines, such as California reformulated gasoline blendstock for oxygenate blending (CARBOB) should not cause price spikes on a going-forward basis. As western states moved away from the additive methyl tertiary-butyl ether (MTBE) in 2002 and 2003, significant spiking did occur. And, while this environmental choice may affect the general price level of gasoline, like taxes and crude oil prices, it should not cause spiking (this statement depends, in part, on how seasonal blends are handled and State Implementation Plans are administered on a going-forward basis).

Distributor wholesale and retail markets generally do not cause price spikes. It is true that price movements in the international crude and refined-products segments of the market will affect inventory levels. It is also likely that the tendency for retail prices to rise quickly and fall slowly is linked to both the distributor wholesale and the retail market segments, largely due to the storage capacity owned both by wholesalers and retailers.

Normal pipeline operation does not cause price spikes. Reno, NV is connected to refineries located in northern California by an eight-inch pipeline that originates in Rocklin, CA and ends at a tank farm in Sparks, NV (it then continues on to Fallon, NV to serve the naval air station). All types of refined products are shipped in this pipeline, including gasoline, diesel fuel and jet fuel. Las Vegas, NV is connected to refineries located in southern California by an eight-inch pipeline and a fourteen-inch pipeline, both if which begin in Colton, CA and terminate in

Kinder Morgan, Rebel Oil and McCarran Airport facilities in Las Vegas, NV. The eight-inch pipeline provides jet fuel to McCarran, while the other delivers gasoline, diesel, and military fuels. Fuel additives are either mixed in storage tanks or, in the case of ethanol, splash blended in delivery trucks. Fuels throughout the state are typically delivered by truck. This type of batch delivery may also be used to supplement interstate deliveries to the more urban areas, but attempts to meet all of the demand in this way are likely to be insufficient and usually result in some level of supply interruption. Importantly, pipeline rates are cost-of-service regulated, so the owner of all three pipelines used to serve Nevada, Kinder Morgan, should have a very limited ability to collect economic rents [the Federal Energy Regulatory Commission (FERC) may soon be heard on this subject].

What, then, causes price spikes? Price spikes are caused by excess demand; that is, when demand exceeds available supply. Because the refineries are operated so close to full capacity, it is possible for them simply not to be able to make enough product at times of peak demand. Given the growth rates in all three states served by the existing refineries, it seems that this situation will occur more and more frequently.

Supply interruptions can also result in price spikes and unwarranted collection of rents by refiners. There have been four types of interruptions: (1) unplanned maintenance of refining facilities, (2) seasonal changes in the need for gasoline additives, (3) abnormal pipeline operations, such as breaks or emergency repairs, and potentially, (4) limitations in the unloading of tankers or pumping of domestic reservoirs. The fourth is added in the event that crude deliveries to a refinery are reduced, but not below a minimum level needed to recover fixed costs.

Unplanned maintenance of refineries is an especially troublesome category. All of the refineries in California are old, so maintenance, of all kinds, is to be expected. On the other hand, it is very difficult to ascertain whether the occurrence or duration of an unplanned maintenance outage was the result of a legitimate problem or the withholding of capacity. This situation is uncomfortably close to the electricity crisis of 2000 and 2001, where FERC – eventually – determined that manipulation, in the form of withholding capacity, actually occurred. It took two years to make that determination where the federal government had unprecedented access to the books and records of the companies suspected of manipulation. It is not clear just exactly how the government (state or federal, or both) would proceed against a refinery that simply withheld capacity. It's a matter for the lawyers to sort out, but my concern is that it may not even be illegal.

Governor Guinn and Senator Reid had just these concerns in mind when they jointly sought Federal Trade Commission review of the price spike earlier in the year. At the very least, gasoline consumers in these three states need some form of systematic oversight of the refined-products market segment to protect them from market manipulation that would be as easy to accomplish, as it would be financially rewarding. Refiners not only regulate themselves with regard to operating and maintenance practices (excluding safety regulation), they also are able to shield much of their cost data from governmental oversight. This is the equivalent of the fox both guarding the chicken house and counting the chickens.

Seasonal formula changes, pipeline breaks and abnormalities in crude oil deliveries also have the potential to produce supply interruptions that result in price spikes. These events, however, do not uniformly benefit any market participant, but they almost always result in higher prices for consumers.

"Finding Solutions for Western Woes" – the Supply Side

The most direct solution of our refined products supply problem is to build more refineries. While it may still be possible to improve the capacity of existing refineries, it seems very unlikely that new refineries can be built before growth in the Nevada, California and Arizona markets simply overwhelms the meager existing "excess" capacity. Improving short-term refining capacity is, then, largely a matter of relying on the importation of refined products, a practice common in the eastern U.S. This has obvious consequences on our balance of payments and reliance on foreign suppliers.

There is one potential mid-term solution that is of interest in Nevada, though a comprehensive evaluation has not yet been completed. Renewable transportation fuels, largely ethanol and biodiesel, offer an opportunity to offset market growth. Such fuels are good substitutes and are generally cost competitive when crude oil is about $35 per barrel, or more. Biodiesel is already being produced in Nevada and expansions and new facilities are planned. Ethanol and ethanol refineries, however, have yet to prove their suitability for broad-based development in Nevada. Of particular concern are the economics associated with shipping grain feedstock to the state – Nevada can't grow enough without significantly expanding the use of water for farming. The primary question being whether the resulting product would be cost-competitive with ethanol refined elsewhere and shipped to Nevada. Also, ethanol production in farming states typically requires about 4 gallons of water for each gallon of ethanol. At this rate, to add 5 percent ethanol to gasoline consumed in Nevada would require about 200,000,000 gallons of water each year, not a trivial sum for our state.

The long-term solution is widely believed to be some form of hydrogen technology. It is very discouraging to hear some of those involved in developing this technology say, in informal conversations, that hydrogen fueled automobiles are decades away. I believe that we don't really have decades, so the commitment of federal funds to hydrogen research and deployment seems like a wise investment.

"Finding Solutions for Western Woes" – the Demand Side

The most direct demand-side solution also appears to be unattainable, at least in the short-run, because it involves changes in individual behaviors. There are three behaviors that bear most directly on reducing demand for gasoline: vehicle gas mileage, proximity of ones employment to his/her home, and the decision to opt for public transportation. Broad-based programs to reduce drunk driving and to encourage the use of automobile seat belts have shown that it is possible to change behavior, but not without significant commitment by all branches of government with the aid of private sector champions. Besides, a lot of Nevadans are independent and don't appreciate being told by the government what they should do. In any event, this is a long-term process which would be helped most by what we want the least – high gasoline prices.

Aside from informational campaigns, there are myriad ways to "tinker" with the relative cost of gasoline. For example state governments could enact sales and gasoline taxes that shift the tax burden to owners of inefficient vehicles; much the way highway space at peak times is preferentially allocated to vehicles with multiple passengers – carpool lanes. Another, more direct approach, would be for the federal government, the National Highway Traffic Safety Administration, to seek meaningful increases in the Corporate Average Fuel Economy (CAFE) standard – one that would include pick-up trucks and sport-utility vehicles and access hybrid technology now becoming available. States could also require that driver education classes include specific instruction on vehicle fuel economy. But the real point is that demand reductions will mostly be unremarkable and opportunistic. They will be tied to an on-going careful analysis of what behaviors and equipment produce the least efficient transportation, and then taking steps to encourage modification of that behavior or elimination of that equipment. These changes come slowly because, ultimately, the one essential hallmark of a truly free market is that consumers make their own decisions about the goods and services they buy.

Mr. OSE. I thank the gentleman. Our next witness, chairman of the California Energy Commission, has been before us in the past, testified on any number of things, and is a welcome guest here. Mr. Keese, you're recognized for 5 minutes to summarize your testimony.

Mr. KEESE. Thank you, Mr. Chairman, members of the committee. I was noticing that we have an AAA chart over here on the wall. I believe our last hearing was at the last peak we had. The good news, I guess, it looks like says $2.40 is as high as it will go. That's as high as their chart goes.

I'm going to briefly summarize what has happened on our price increases, what the impacts have been, and the measures that California is looking at. Crude actually does contribute to the price, as we heard when the barrel goes up $1, the price of gas goes up 2½ cents. That's a cost factor that the refineries have. It's OPEC but California relies on Kern and California relies on Alaska. The oil isn't quite as good but our price goes up commensurate. They've gone up 25 percent since January 1st and our prices have gone up pretty much the same as we've heard from the members of the committee.

We had a particular problem this spring because with the turnaround from using MTBE to switching to ethanol, coinciding with the turnaround that refiners take to move from winter-grade to summer-grade gasoline, 9 I believe of our 13 refineries decided to have major outages. They put away inventories to cover their needs during that time. So we went in to the turnaround time with historically high inventories. Well, a number of the refineries that weren't going to go out went out at that time. A number of the refineries that were going to come back on in 2 or 3 weeks didn't come back in 2 or 3 weeks. We went through historically low level of inventories which started our price spike.

We do import product and we import the ingredients for gasoline. Unfortunately, our capacity to import liquid products has been going down as our ports have been shutting down their tankage. We had tankers that couldn't get into port and had to divert to other ports.

Our price reached $2.27 last week. We may hear higher from AAA. It's a little higher. We see a leveling out about this time. The diesel situation was actually worse and coincided with the time for spring planning which is a heavy demand time. As you know, up in the Sacramento area we had a rupture of the Kinder Morgan pipeline. That and a rumor that the Energy Commission was on the verge of declaring an energy emergency, which we can do drove prices up another nickel or dime. We were not. We were in the investigative stage, not about to declare an emergency. Diesel got to $2.34.

We are an island, somewhat, but we are affected by conditions in other regions. We routinely import from out of the country, out of the State, but they have to give a fuel that will meet our specifications. We compete with imports for these other areas. Most of their markets are closer than California. We have to pay a premium to get it shipped to us. That adds money.

I'd like to say just one thing about ethanol. We did add ethanol. We like the flexibility of not having to add ethanol. Ethanol does

not contribute to the price, however. Ethanol ingredients today are cheaper than gasoline ingredients. So, we do not expect if there is a major change in Washington and they give us the waiver, we do not expect to see California refiners leaving ethanol. It's the cheapest ingredient. We would like to see them have an alternative to import alkylates. If they can import alkylates that will probably keep the price of ethanol down and the price of gasoline down.

Price is up 65 cents. I think I'll just stop right there. We do supply virtually all of Nevada's fuel. We supply most of Arizona's fuel and we supply much of Oregon's fuel.

The alternatives available to us are to restrain prices, increase refinery capacity. We're not going to build a new one. We need to change the rules so we can expand the ones we have.

Increase imports. We have to change the rules in the ports, let more product get in. Perhaps we have to pipe it from the coast inland to store it, but we have to counteract this idea that the ports want to move to container cargos for some liquid cargos and we have to reduce demand. We've asked for the waiver. We certainly hope that rumored discussions taking place back in Washington will culminate in getting the waiver. The flexibility, as I say, of a refiner to either use ethanol or not is what will bring down the price.

We need to have permission to study about the problems in the ports. We're going to have workshops in the next month on that issue and we hope to solve that problem.

I'm going to defer discussion of the Shell refinery to others who would like to talk about that. I guess our other hope is that the Federal Government will look at CAFE standards. CAFE standards can help, and we'd like to see fuel cell light-duty vehicles incentive as another strategy. Thank you.

[The prepared statement of Mr. Keese follows:]

Prepared Witness Testimony of William J. Keese, Chairman
California Energy Commission to the
Committee on Government Reform
Subcommittee on Energy Policy, Natural Resources and
Regulatory Affairs
(May 28, 2004)

Mr. Chairman and members of the Committee:

I welcome the opportunity to discuss California's experiences with gasoline and diesel price and supply problems during the last few months and to share some ideas that may help direct us to finding some solutions to those challenges. I will try to briefly summarize what factors have contributed to these price increases, what the impacts have been, and what measures the State of California believes would help alleviate those impacts.

Recent Fuel Price Trends and Causes

The price of crude oil to a very large degree determines the price of transportation fuels. Although California receives about 48 percent of its crude oil supply from in-state oil fields, it is not protected from increases in oil prices caused by events elsewhere in the world. The price of Kern River crude oil, a benchmark California heavy oil, has risen 26 percent, from $27.13 per barrel on January 1 to $34.25 per barrel on May 19. Likewise, Alaska North Slope crude oil has risen 29 percent, from $31.34 per barrel on January 1 to $40.28 per barrel on May 19.

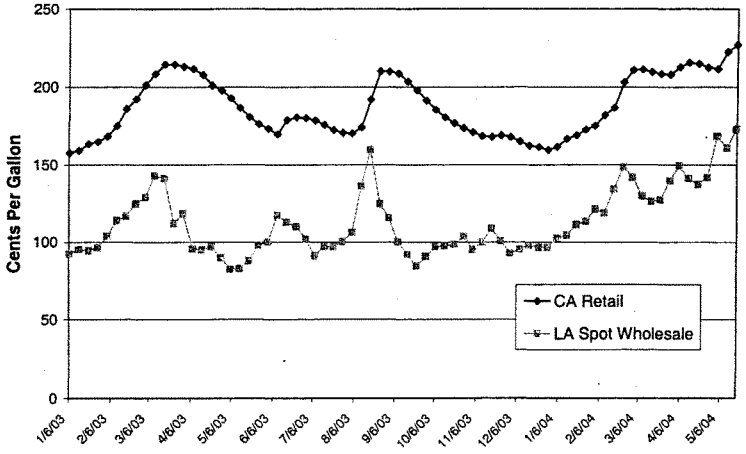
The reasons for these high crude oil prices include:

- A war premium on oil that developed during the buildup to the Iraq War continues today along with continued sabotage of pipelines and other facilities in Iraq;
- OPEC implementation of production limits, even as prices have exceeded the group's preferred price range;
- Devaluation of the U.S. dollar, in which most oil is traded, against other currencies;
- Very high demand for oil in the U.S. and Asia, particularly in China, with accelerating economic growth;
- Relatively low inventories of crude oil in the U.S. for much of the spring;
- Continued diversion of oil into the Strategic Petroleum Reserve; and
- High shipping rates.

Crude oil price increases, however, only explain part of the large increases in California fuel prices. At the start of the California refinery maintenance season

earlier this year, inventories of transportation fuels were unusually high because the planned maintenance schedule was particularly heavy. Problems that developed during restart procedures at several facilities, combined with unplanned outages at other refineries, caused a severe depletion of these inventories. As companies sought to cover their obligations with purchases on the spot market, wholesale prices increased sharply and retail prices soon followed. Difficulties obtaining shipments of imported gasoline have been compounded by instances of port congestion that slowed deliveries or, in one reported case, even forced the diversion of a tanker to another port. According to the U.S. Energy Information Administration, the wholesale and retail prices of regular-grade reformulated gasoline in California reached $1.73 and $2.27 per gallon, respectively, on May 17, compared to $1.03 and $1.62 per gallon on January 5 (see figure below).

California Retail & Wholesale Regular Gasoline Prices
(January 2003 to Present)



Source: U.S. Department of Energy

Ordinarily, as facility maintenance is completed and operations are restored, fuel prices eventually decline. This year, however, problems persisted and new outages occurred, particularly in diesel-producing units. These problems occurred just as agricultural diesel demand began to rise with good weather and the start of spring planting, and with refiners primarily focused on maximizing gasoline production and imports. Adding to the uncertainty were the rupture of

the Kinder Morgan pipeline near Suisun Bay and erroneous rumors that the Energy Commission had declared an energy emergency based on supply shortages rather than a regional distribution problem. As a result, retail diesel prices in California rose to $2.34 per gallon on May 17, 2004.

California's fuel prices are also linked to national trends. Gasoline demand in the U.S. has risen to high levels, helping generate record-high U.S. gasoline prices. Although California is considered somewhat of an island as far as its gasoline and diesel markets, it is still very much affected by conditions in other regions. We routinely require imports from out-of-state, and only a limited number of supply sources can provide fuels meeting California's clean-burning fuel specifications. We must compete with other areas for imports of these clean-burning finished products and essential blendstocks. Typically, this competition also requires paying additional transportation premiums to bid supplies away from regions closer to sources of supply. The higher cost of these imported fuels sets the price of all barrels of similar product, even if only relatively small amounts are imported.

The Use of Ethanol and Transition to Summer-Grade Gasoline

The shift away from MTBE in gasoline has necessitated the use of ethanol because the U.S. Environmental Protection Agency (EPA) has not granted California a waiver from the minimum oxygen requirement. Ethanol is the only type of oxygenate that can be used in California. As stated in my testimony before this Committee in July 2003, the cost of ethanol has not been a direct cause of recent price spikes in the state. The price of ethanol purchased by refiners under typical contracts has usually been less than that of gasoline. There were no shortages of ethanol or significant difficulties blending the new gasoline.

The oxygenate requirement has, however, complicated the process of blending gasoline that meets air quality rules. Phase 3 reformulated gasoline for ethanol blending is a more difficult formulation to produce for refiners outside the U.S. The market price has risen for premium blending components with the appropriate properties of high octane, low sulfur, and low volatility. The recent phase-out of MTBE in New York and Connecticut has increased competition for these premium components. This is particularly true during the low-volatility summer gasoline season because the use of ethanol requires backing out some of the cheaper gasoline components, such as butanes and pentanes, and replacing them with higher cost blendstocks, such as alkylate.

The value of an oxygenate waiver, as California has requested from the EPA, would be primarily due to longer-term gains in flexibility in refining operations, rather than short-term insulation from the ethanol spot market. Most of the volume of ethanol used in California gasoline production is purchased by

contract, with prices fixed or indexed to gasoline prices. If enough California refiners decided that production of non-oxygenated gasoline made economic sense and adequate storage was available to segregate it from oxygenated gasoline, California purchasers of ethanol would be able to take advantage of changes in the relative prices of ethanol versus gasoline and other blendstocks.

Shell Bakersfield Refinery Closure

Shell plans to cease refining operations at its Bakersfield refinery by October 2004. The company intends to continue operating its terminal at the facility beyond that date. This refinery currently produces much of the gasoline and diesel consumed in the region by processing heavy San Joaquin Valley crude oil. The refinery also produces other petroleum products, such as butane, petroleum coke, and unfinished oils that are primarily exported out of California.

Shell has committed to supplying enough fuel to meet their contractual obligations following the closure of the Bakersfield refinery, either from their facilities, other companies' refineries, or imports. Independent marketers without contracts are an important supply source for local agricultural users and municipalities and could be negatively impacted by the Bakersfield refinery closure. This independent demand could be supplied by other California marketers expanding their presence in Bakersfield, increased production from the Kern and San Joaquin refineries, or from out-of-state.

Increasing deliveries from outside the region requires resolving a variety of logistical issues regardless of whether these supplies arrive by truck, rail, or pipeline. Increasing truck deliveries to Shell's Bakersfield terminal would be the least difficult. Additional truck traffic and increased vehicular air pollutant emissions could be issues of concern for residents and environmental groups, but this would be partially offset by reduced emissions and reduced refinery truck traffic following the refinery's closure. Shell's terminal currently receives some rail shipments of crude oil, but modifications would be required to handle gasoline and diesel. Remaining questions include whether other parties would have access to the terminal and whether segregation capability, storage capacity, and truck rack capacity are adequate. Additional volumes of fuels could be shipped to the Fresno terminal on Kinder Morgan's North Line, but this would be only a portion of lost output from the refinery, would require modifications at the Fresno terminal and Concord pump station, and would take one to two years to complete. Access to the pipeline could be constrained, as well, especially during summer. Expansion of the Fresno terminal to receive additional truck traffic could also be an option.

Impacts of Fuel Price Increases in California

California drivers consumed about 15.7 billion gallons of gasoline in 2003, almost 12 percent of U.S. demand, or about 43 million gallons per day. Compared to early January 2004, the price of gasoline has risen about 65 cents per gallon. This increase costs California consumers about $28 million per day in additional expenditures compared to January just for gasoline. The state also consumes about 2.7 billion gallons of diesel per year, with substantial additional daily expenditures due to the recent price increases. Diesel price increases negatively affect agricultural and trucking interests as well, and potentially increase the cost of farm products and goods moved by truck or rail transport. Jet fuel prices have also increased sharply, compelling airlines to add surcharges to their ticket prices to cover increased fuel costs.

The price impacts of supply problems in California extend beyond the state's borders as well. California supplies substantial levels of transportation fuels to neighboring states. Nearly all of Nevada's gasoline, diesel and jet fuel, about 150 thousand barrels per day, comes from California. California also supplies most of Arizona's transportation fuels (almost 140 thousand barrels per day), and much of Oregon's (about 37 thousand barrels per day). Total gasoline delivered to these states from California amounts to nearly seven million gallons per day. Put another way, for every six gallons of gasoline consumed in California, one gallon is delivered to these neighboring states. The price impacts resulting from the dependence of these states have been amply demonstrated during the last year, especially during outages of pipelines delivering products from California.

Short- and Long-Term Responses

On top of the immediate problems of fuel supply in the face of unusually high short-term demand growth, the long-term demand for gasoline in California is expected to grow at about 1.4 percent per year and diesel at 1.9 percent per year. Refinery production capacity growth is only expected to average about 0.5 percent per year over that period. Three general approaches can be applied to address this growing shortfall between what we consume and what we produce: increase refinery production capacity, increase imports, and reduce demand. Each of these approaches can be further divided into short-term and long-term responses.

Short-Term Options

As discussed above, California has pursued a waiver from the federal oxygenate requirement in order to increase refinery flexibility. California's request for a waiver is based on several studies, including the EPA's own Blue Ribbon Panel

finding that a minimum oxygen content is not necessary to make gasoline that meets emission reduction requirements. Furthermore, due to the volatility of ethanol, refiners have to adjust gasoline blending practices by reducing other volatile components in the production of gasoline, and replacing them with more costly blendstocks. California's refineries need the ability to make gasoline with or without oxygenates, as situations warrant.

Otherwise, little can be done about increasing refinery production capacity in the short-term. There are provisions under state law, however, for the California Air Resources Board (CARB) to grant an emergency variance from certain state-mandated fuel specifications to enable a company to produce fuel while it makes unscheduled repairs. The variance requires the payment of a mitigation fee for each gallon of fuel that does not meet CARB specifications. Revenues from the mitigation fee would be placed in an escrow account that is used to fund clean air projects.

The variance can be granted in response to a request from a refinery making unscheduled repairs. If a refiner requested a variance, CARB would contact the Energy Commission for a current assessment of the market conditions, inventory, and production levels as part of their determination of the conditions of the variance. The ability of a fuel specification variance to increase supply would depend on the time of year and market conditions at the time of the variance. The increase in Reid Vapor Pressure (RVP), a measure of gasoline volatility, may increase supplies during summer months but have no impact later in the year.

Increasing imports in the short-term could potentially be accomplished by relaxing throughput limits at marine bulk terminals, or by expanding capacity of pipelines moving fuel from wharfs to inland facilities. Throughput limits do exist as part of California's air district permit conditions. The lifting of these limits would not typically increase the actual throughput substantially without modifications to equipment or facilities. These types of modifications take time and may not make economic sense unless made permanent. Facilities have been built with capacities exceeding throughput limits, but these capacities are not substantially higher than the throughput limits. Procedures exist, however, for seeking relief from air district regulations through administrative processes.

Southern California petroleum marine terminals are highly utilized, particularly during periods of high demand for imports. We are concerned that new storage capacity expansions might be restricted by lack of access to the distribution network. Firms in a position to grant that access may not feel that it is in their economic interest to do so. Regulations pertaining to this area are unclear. The Federal Energy Regulatory Commission can regulate pipeline rates, but has determined that it cannot force a pipeline to connect with facilities of competing firms. We are concerned that this barrier to entry for new or expanded storage facilities will reduce the state's ability to import needed products.

Reducing fuel demand in the short-term can be problematic because of the high cost of rapidly-changing energy-using technologies, such as purchasing a high-mileage vehicle, and because much driving is non-discretionary. However, the Energy Commission has assessed several potentially useful options for voluntary fuel conservation and has made this information available on its website. These options include: using public mass transit, car pooling, telecommuting, driving at the speed limit, limiting unnecessary use of air conditioning, minimizing idling, and maintaining the vehicle properly (by replacing dirty air filters, keeping tires fully-inflated and getting regular tune-ups).

Mandatory conservation measures, such as strictly-enforced speed limits, could be used. If the Governor declares a state of emergency, other measures, including requiring large employers (500 or more employees) to operate emergency transportation management programs to increase ridesharing that would result in fuel savings, could be invoked as part of a state of emergency declaration. However, declaring an emergency comes with the considerable risk that motorists will immediately respond by filling up their gasoline tanks, worsening the actual fuel shortage, and that traders will see it as a signal to bid up the price of supplies.

Long-Term Options

In the long-term, more substantial changes in the way we supply and consume transportation fuels can be considered. To enhance the industry's long-term ability to import finished fuels and blendstocks, expansions of marine terminal, pipeline, and storage infrastructure may need to be encouraged. The Commission has sponsored a study of the state's marine infrastructure to assess its ability to accommodate imported petroleum products. The study identified current and future constraints within the system of wharves, storage tanks, and pipelines that could impair the ability of importers to deliver cargoes to the state. The Commission believes that these constraints do impact imports of gasoline and diesel, and that this may reduce the supply of gasoline available during a disruption. The potential problems are most serious in Southern California, where the bulk of the increased quantities of imported crude oil and finished petroleum products would be received.

The time and complexity of acquiring permits to construct facilities were identified in our study as a major impediment for adequate marine and storage facilities. The high costs of the permitting process result in a shortage of storage capacity that leads to higher lease rates for tanks, with gasoline suppliers holding lower inventories than they might otherwise choose. The Commission has also sponsored a detailed study on the permitting of petroleum product storage facilities, which identified some redundant and burdensome regulatory processes, and recommended improvements to the permitting process. The

most critical action would be to provide statewide authority for implementing and enforcing California's existing Permit Streamlining Act (PSA).

The PSA establishes strict timelines for agencies to conduct permit application reviews and issue decisions. These timelines are frequently not met, without penalty to the permitting agency. Little effort appears to be made to comply with the PSA, since it is not well known among stakeholders in the permitting process. No agency within California is responsible to implement the PSA, and this appears to be a fundamental problem. This issue is very complex, but a permitting process solution could yield significant benefits by eliminating duplicative efforts and providing a time-certain process with decision-making authority.

Finally, the Energy Commission and CARB are jointly addressing the long-term impacts of petroleum dependence on the California economy and environment. Several long-term options that could be used to reduce petroleum demand include:

- Doubling the fuel-use efficiency of light-duty vehicles, including cars, pickups and sport utility vehicles, to 40 miles per gallon;
- Using Fischer-Tropsch fuel, which is derived from natural gas at remote production facilities and has very clean and useful blending properties, as a 33 percent blending agent in diesel fuel in order to extend distillate supplies;
- Introducing fuel cell light-duty vehicles in 2012, increasing to 10 percent of new sales by 2020, and to 20 percent by 2030.

This study found that improving fuel efficiency using existing and emerging technologies could dramatically reduce petroleum demand. For most options studied, fuel savings for consumers would exceed the costs of more fuel-efficient vehicles. Increased fuel use efficiency requires the exercise of federal authority, however, and would obviously have the greatest cumulative benefits implemented at a national level. The Commission encourages Congress to propose legislation that would advance this strategy, in particular increases in the Corporate Average Fuel Efficiency (CAFE) standards.

This joint agency study and some of the other reports relating to transportation fuels that have been produced recently by the Energy Commission and are available on the Commission's website (www.energy.ca.gov) are shown in the following table.

Recent Transportation Fuel-Related Reports from the California Energy Commission

Report Title	Status	Date
2003 Integrated Energy Policy Report	Final Commission Report	December 2003
California Alternative Fuels Infrastructure Program Evaluation 2003	Consultant Report	December 2003
Ethanol Supply Outlook	Final Staff Report	October 2003
Permit Streamlining for Petroleum Product Storage	Final Consultant Report	October 2003
Gulf Coast to California Pipeline Feasibility Study	Final Commission Report	September 2003
California Clean Fuels Market Assessment Report 2003	Consultant Report	August 2003
Feasibility of a Strategic Fuel Reserve in California	Final Commission Report	July 2003
Reducing Petroleum Dependency in California	Joint Agency Report	August 2003
Causes for Gasoline and Diesel Price Increases in California	Staff Reports	March to November 2003
Economic Benefits of Mitigating Refinery Disruptions	Consultant Report	July 2002
Marine Product Tanker Fundamentals, Economics and Outlook	Consultant Report	March 2002
Supply Potential for Petroleum Products in the U.S. Gulf Coast	Consultant Report	March 2002
MTBE Phase Out in California (including Appendix of Stakeholder Comments)	Consultant Report	March 2002

Mr. OSE. I thank the gentleman. Our third witness on the first panel is Ms. Lynette Evans. She is a policy advisor for regulatory affairs to Governor Napolitano in Arizona. Ma'am, welcome. It's a pleasure to have you here. We do have your statement, and we've read it. We recognize you for 5 minutes to summarize.

Ms. EVANS. Chairman, members of the subcommittee, thank you for inviting me here today to testify about the impact of high gas prices on the State of Arizona. I just wanted you to recognize that also present with me today is the assistant attorney general, Emma Lehner, representing the Arizona Attorney General's Office, and they submitted written testimony for the subcommittee.

Needless to say, this is a timely topic. In fact, since March when our office was initially asked to testify until early this week, the average price throughout the Nation has risen more than 18 percent and it seems we set new records every day. Usually Arizona prices tend to be among the highest in the country. Our retail prices typically track the ups and downs of the California market minus 10 to 20 cents. This pattern is largely due to our State's dependence on California refineries.

Arizona has no refineries, no shipping ports, and as a result we import all of our gasoline and are dependent on two pipelines to supply almost all of our fuel. Approximately 60 percent of the fuel consumed in Maricopa County comes from California and remaining 40 percent from Texas and New Mexico. The Phoenix area alone consumes 65 percent, roughly 109,000 barrels of the State's average daily gasoline supply.

Our relative isolation from the primary supply sources became painfully clear last summer when the east pipeline ruptured and seriously disrupted the gasoline distribution system in Phoenix for several weeks. At the peak of the disruption, we estimate that more than half of all the gasoline stations in Maricopa County were forced to close and ran dry. At the same time, pump prices rose approximately 60 percent.

Now, at the beginning of this year the average price for a gallon of gas in Arizona was $1.53. By early this week, it had increased a total of 40 percent to $2.15 a gallon and I think it's even up more today. Even recognizing seasonal variations, the price is still 47 cents more than the same point last year.

Now, at the same time there has been lots of media coverage about the increased profits enjoyed by the oil industry. The Oil Price Information Service data indicates that refinery margins are currently above 35 cents a gallon, which is significantly above the 2000 through 2003 average of 15 cents per gallon.

Now, interestingly, despite these high prices, driving behavior does not change much. According to a recent survey conducted by AAA, record numbers of drivers are expected to hit the road for this weekend and hotel occupancy rates in Arizona are expected to be higher than average.

Instead, consumers do appear to be responding in other ways. Last week CNN reported that SUV sales have slipped 22 to 33 percent over the last quarter. While this is definitely encouraging to hear that consumers may be adjusting their behavior, it's difficult to predict whether this apparent move toward fuel conservation will last.

There are some industry concerns that our State has. According to Bloomberg News there have been 33 mergers in U.S. oil industry, I think that was mentioned earlier, during the last 4 years alone. Unlike other markets the petroleum industry offers the greatest benefit to consumers when they have options. I am concerned that the continuing consolidation of the industry is decreasing choice and depressing competition. We need to take a more careful and holistic look at mergers as they're being proposed and better analyze how they will impact the overall market.

In the short-term, the Governor in February wrote to President Bush requesting an investigation of the high prices. Nine of the Governors later joined the request and sent a second letter to President Bush. Unfortunately, the administration has declined to undertake such an investigation. Needless to say, we are disappointed by this decision, and Governor Napolitano along with 10 other Governors have written the President to urge reconsideration and several State attorney generals have made similar pleas. There is no reason why the Federal Government should not begin an immediate inquiry into why prices and profits have risen simultaneously at the expense of American consumers.

Long-term, we need to reevaluate our overall energy policy. In Arizona, there has been some discussion about the possibility of a new in-State refinery. I'll say that our office is certainly receptive to exploring opportunities that would increase the fuel supply for Arizona and our regional sister States.

In order to successfully address this issue we need to look beyond today, even the next year, and do some real long-term planning. That means increasing CAFE standards, promoting the manufacture and purchase of fuel-efficient hybrid vehicles, and exploring nonconventional fuel sources.

Hybrid vehicles are proving to be popular with buyers despite the limited production of these cars to date. Continuing existing Federal tax incentives for these kinds of vehicles will encourage drivers to purchase more hybrids. I also recommend we reexamine current tax laws that offer tax deductions for the purchase of fuel inefficient vehicles like Hummers.

Without long-term solutions we may end up like policymakers nearly 30 years ago who were faced with supply shortages during the 1970's. That fuel crisis was followed by lots of talk of reducing our dependence on foreign oil and fossil fuels, but ultimately very little has changed. Fossil fuels are a finite resource that we should be weaning ourselves from. We must be proactive now or our future gasoline crises will be even more devastating to consumers and our economy. Thank you.

[The prepared statement of Ms. Evans follows:]

TESTIMONY OF
LYNETTE EVANS
POLICY ADVISOR REGULATORY AFFAIRS
FOR GOVERNOR NAPOLITANO OF ARIZONA

UNITED STATES CONGRESS
COMMITTEE ON GOVERNMENT REFORM
SUBCOMMITTEE ON ENERGY POLICY, NATURAL RESOURCES AND REGULATORY AFFAIRS
MAY 28, 2004

FIELD HEARING ON "GASOLINE PRICES"
HENDERSON, NEVADA

Members of the Subcommittee, thank you for inviting me to testify today about the impact of high gas prices on the state of Arizona. Needless to say this is a timely topic. In fact, since March when our office was initially asked to testify until early this week the average price throughout the nation has risen 18 percent and it seems we set new records every day. Arizona is certainly not immune from this national trend, and like every other part of the country, is struggling with record-breaking gasoline prices coupled with unexpected price spikes.

Prices in Arizona

Usually, Arizona prices tend to be among the highest in the country. Our retail prices typically track the ups and downs of the California market minus 10-20 cents. This pattern is largely due to our state's dependence on California refineries.

Arizona has no refineries or shipping port. As a result, we import all of our gasoline and are dependent on two pipelines to supply almost all of our fuel. Approximately 60 percent of the fuel consumed in Maricopa County comes from California and the remaining 40 percent from New Mexico and Texas. The Phoenix area alone uses 65 percent, or 109,000 barrels (4.6 million gallons) of the state's average daily gasoline supply.

Our relative isolation from the primary supply sources became painfully clear last summer when the east pipeline ruptured and seriously disrupted the gasoline distribution system in Phoenix for several weeks. At the peak of the disruption, we estimate that more than half of all the gasoline stations in Maricopa County ran dry and were forced to close. At the same time, according to AAA, pump prices in Phoenix rose about 60 cents.

In the wake of the summer rupture and subsequent disruption, Governor Napolitano appointed a task force to look into the issue and make recommendations to help prevent, or reduce the severity of, a future disruption. The task force is also looking at gasoline prices. One basic underlying assumption that seems to be widely accepted early in the

task force's review, is that the price of gasoline will continue to rise and that in general the days of cheap fuel are numbered. The last few months have followed that trend.

At the beginning of this year, the average price for a gallon of gas in Arizona was $1.53. By early this week, it had increased 40 percent to $2.15 a gallon. Even recognizing seasonal variations, the price is still 47 cents more than the same point last year. The price volatility has been even more obvious in the Phoenix metropolitan area where at one point the average price increased nearly 10 cents per gallon in just a forty-eight hour period.

As a person who takes calls from the public about prices, I can tell you that this unexpected price inflation is impacting Arizonans in a variety of ways. Everyone from taxi drivers to pizza deliverers has felt the crunch. Even more distressing is the impact on our retired and fixed income citizens who do not have the flexibility to adjust to these higher prices. Many small business owners have been forced to pass on the higher cost to customers through so called "fuel charges" and there are growing concerns that these prices are contributing to inflationary growth and hurting our economy.

At the same time, there has been lots of media coverage about the increased profits enjoyed by the oil industry. One recent Arizona Republic article reported that five of the top gasoline companies are reporting an average profit increase of 90 percent. In addition, the Oil Price Information Service (OPIS) data indicates that refinery margins are currently above 35 cents/gallon -- significantly above the spring 2000-2003 average of 15 cents/gallon. It is difficult to understand why consumers are being squeezed so hard at the pump at a time when profits for the industry have been so high.

Impact on Tourism and the Economy

Interestingly, despite the high prices, driving behavior has not changed much. According to a recent survey conducted by AAA, record numbers of drivers (approximately 30.9 million) are expected to hit the road for the Memorial Day Holiday. And hotel occupancy rates in Arizona are expected to be higher than average. High gasoline prices do not appear to be hampering many people's holiday travel plans.

Instead consumers appear to be responding in other ways. Last week, CNN reported SUV sales have slipped 22-33 percent over the last quarter and most of the major manufacturers have announced significant cash back offers (between $2,000 - $5,000) to try to spur sales. While it is encouraging to hear that consumers may be adjusting their behavior, it is difficult to predict whether this apparent move toward fuel conservation will last.

Industry Concerns

According to Bloomberg News, there have been 33 mergers in the US oil industry, during the last four years. Like other markets, the petroleum industry offers the greatest benefit to consumers when they have options. I am concerned that the continuing consolidation

of the industry is decreasing consumer choice and depressing competition. We need to take a more careful and holistic look at industry mergers as they are being proposed and better analyze how they will impact the overall market place.

The same can be said for Arizona's pipeline system. The energy company Kinder Morgan owns both of the pipelines mentioned earlier. This same company will soon be the major owner of several of the fuel storage facilities in Phoenix. And they own considerable holdings in California and Nevada. I do not doubt there are benefits and efficiencies that can be gained from certain consolidations, but the monopoly like status enjoyed by this and other companies should be of greater concern to all of us.

Solutions

Short-term

In late February, Governor Napolitano wrote to President Bush requesting an investigation of the high prices. Nine other Governors later joined her request and sent a second letter to President Bush. Unfortunately, the Administration has declined to undertake such an investigation. Needless to say, we are disappointed by this decision. Governor Napolitano and ten other Governors have written the President to urge reconsideration and several State Attorney Generals have made similar pleas to Attorney General Ashcroft. There is no reason why the federal government should not begin an immediate inquiry into why prices and profits have risen simultaneously at the expense of American consumers.

Long-term

Long-term, we need to re-evaluate our overall energy policy. In Arizona, there has been some discussion about the possibility of an in-state refinery. I understand that the refinery proponents have submitted written testimony for today's hearing. Our office is certainly receptive to exploring opportunities that would increase the fuel supply for Arizona.

In order to successfully address this issue we need to look beyond today or even the next year and do some long-term planning to secure our future. That means increasing CAFE standards, promoting the manufacture and purchase of fuel-efficient hybrid vehicles and exploring non-conventional fuel sources.

Hybrid vehicles are proving to be popular with buyers despite the limited production of these cars to date. Continuing existing federal tax incentives for these kinds of vehicles will encourage drivers to purchase more hybrids. I also recommend we reexamine current tax laws that offer tax deductions for the purchase of fuel inefficient vehicles like Hummers.

Without long-term solutions we may end up like policy makers nearly thirty years ago, who were faced with supply shortages during the 1970's. That fuel crisis was followed

by lots of talk of reducing our dependence on foreign oil and fossil fuels, but ultimately very little has changed. Fossil fuels are a finite resource that we should be weaning ourselves from. We must be proactive now or future gasoline crises will be even more devastating to consumers and our economy.

Thank you again for allowing me to present Arizona's perspective on this issue.

Mr. OSE. Thank you, Ms. Evans. Now what happens next is we go through a round of questions for our witnesses. Typically, the questioning proceeds in 5 minute increments. We'll just go one, one, one, one, one. The panelists are asked to keep their answers brief, again, to respect the Member's 5 minutes. We can always followup in writing with clarification and the like.

We're going to recognize our host for the first round of questions. Congressman Porter, I recognize you for 5 minutes.

Mr. PORTER. Thank you. I'm going to come to the home team here for a second.

Mr. SCHROCK. Smart move.

Mr. PORTER. This past December, seems to me it was somewhere around Christmas, in our big sister State of California there was a challenge in that there were floods that caused the pipeline to break, our single pipeline into southern Nevada for fuel. I know that there is a certain finite amount of storage in Nevada to help allow for emergencies in the line. My question would be should we be looking at additional pipelines into Nevada also?

Mr. BURDETTE. Mr. Porter, absolutely. We have three pipelines into Nevada from California. There are actually two. There are two right together in the south and one up north. Actually, the pipe didn't break in December, but it shut down because they had to fix the overlayment.

But, the point is very well taken. Obviously, capacity is helpful, storage capacity is helpful to the distributor, both the distributor market, wholesale market and retail market. Yes, we should have more pipelines and yes, it would be nice to have one from a different source than California. Take some of the pressure off them and give us some reliability.

Mr. PORTER. Can you cover for us briefly and followup at some point what steps the Governor is taking in Nevada today to help with the fuel crisis? Are there some things that we need to know as Members of Congress to put into our findings?

Mr. BURDETTE. Well, I think, to be frank, there are limited options available to the Governor. I think the primary initiative is we want to make sure that no matter how flooded the market is, that there is some oversight at the Federal level, some access to books and records or some effort to deal with the principal problem.

The principal problem is the investment of the excess profits that are earned, I'm sorry, rents that are earned are not plowed back into something that benefits people, benefits our consumers and California's consumers and Arizona's consumers, and an effort that would somehow try to deal with that constructively we would be very enthusiastic about supporting.

We are interested in much of the research that my colleague to my left and the CEC is doing. CEC does very fine work and is very helpful not only to California but it's helpful to us as well. We have begun to try to work more closely, and I think that's important for us. We can learn a lot from California and not always from mistakes either.

Mr. PORTER. We know someday they're going to fall off into the ocean so we want to be prepared, right, when California drops into the ocean. I ask those questions to make sure we're not duplicating some of our efforts and make sure we can coordinate.

The storage situation has come up in our research from Washington but also from those suppliers here in southern Nevada. Any thoughts on the storage and things that we can do to help with that?

Mr. BURDETTE. There are private forces that have increased the amount of storage, particularly after the problem we had with pumping power during the energy crisis. There were approximately 120,000 barrels of storage capacity increased in the Las Vegas area, largely for regular gasoline and commercial diesel, plus, and I don't have the number for the airport, but we did increase airport jet fuel capacity storage as well.

I think private forces are working reasonably well there but we are short. We would certainly be supportive and helpful if we can in that regard.

Mr. PORTER. One additional question, Mr. Chairman? Mr. Keese, from a regional perspective, California, Nevada, with the boutique fuels, I understand the Clean Air Act and believe that those steps should be followed. Is there some things that we can do more regionally to make sure that there is additional fuels available between the two States?

Mr. KEESE. Actually, yes. I was interested to hear the line of your questioning because over the last 2 or 3 years in California we looked at three alternatives that the legislature asked us specifically to look at. New refinery capacity perhaps, perhaps State owned, storage capacity, and a pipeline from Houston.

New refinery, probably impossible. We are going to be working very actively on allowing more expedited permitting process on current refineries.

Storage is a major problem because the fuels are fungible. You have to keep moving them through. Yes, some enhancement but it does add to the cost of the product. We wind up thinking that we'd like to see the pipeline from Houston and if the pipeline from Houston even only goes to Phoenix and Las Vegas and meets your needs, it frees up plenty of supply in California. So, the pipeline is a very viable thought. We would love to talk to you about the pipeline.

Mr. PORTER. Thank you. Thank you Mr. Chairman.

Mr. OSE. Gentleman from Massachusetts.

Mr. TIERNEY. Mr. Burdette, you were talking during your testimony about outages. I understand it's so concentrated refineries now, so few being around and the stress under which they're working that we're liable to have more accidents, really working at capacity for a good deal of time. I suppose outages are somewhat a necessary part of the business during particular times.

At some point, when we start to see the number of unplanned outages happen with the frequency that we've been witnessing, particularly this past year and others, should we be concerned about probably having some sort of investigation as to whether any of these are planned outages as opposed to accidental or coincidental outages.

Mr. BURDETTE. Congressman, I guess a couple of things about that. First off, it isn't surprising equipment as complicated and as old as the equipment to see unplanned forced outages we call them in the electric business, forced outages, unplanned outages, but I'm

not, I'm not an expert on refineries. I don't have credentials that could comment technically about what you said.

As an economist, I look at it though and I am very worried about whether these unplanned outages are as unplanned as perhaps they may have been described. The problem I think is that it's not illegal for them to be withheld.

Mr. TIERNEY. I would agree. I would agree. The other part of your testimony, these rents as you like to call them, you're much nicer than I am I guess, these excess profits, most industries in a free market would reinvest some of that money into capital needs of their business. You would want to fix your refineries or make storage capacity, whatever. That's not happening in this industry, is it.

Mr. BURDETTE. That's correct, it's not. Not in the refineries that serve our State. I'm not sure about elsewhere but it's not happening here.

Mr. TIERNEY. Mr. Keese, you indicated that you don't think there will be any refineries in California. Would you explain to me why that's the case? You think society won't allow it or the industries won't invest the money or what is it?

Mr. KEESE. Correct.

Mr. TIERNEY. Both of those.

Mr. KEESE. Society won't allow it and, therefore, it becomes easier to do it in New Zealand or Australia or someplace else. There is investment taking place a broad.

Mr. TIERNEY. So, not in my backyard.

Mr. KEESE. Not in my backyard.

Mr. TIERNEY. How many refineries have been closed in California during the last 5 years.

Mr. KEESE. I'm going to guess one.

Mr. TIERNEY. In the last 10 years.

Mr. KEESE. Probably two or three small ones and then we have Shell, looks like it's going to go down. That's of great concern to us, and I guess where I come from I can understand shutting down a 7-year-old essentially refinery that was three small refineries on different pieces of property combined. I can understand the economics of it. What I want to see is that 6 percent of California's diesel and 2 percent of California's gasoline that came out of that is replaced. I'd like to see a commitment to do that.

Mr. TIERNEY. From the industry.

Mr. KEESE. Yes.

Mr. TIERNEY. I'm a little concerned. I do think we need to streamline the whole process, permitting process. I know most of these refineries have been expanded. A lot of them have been expanded. We have fewer refineries but they're larger and controlled by fewer and fewer people on this and it gets to be an issue there.

The other way to go about it, of course, Ms. Evans, is to do more conservation in the CAFE standards out there. What is your State doing about the standards and conservation?

Ms. EVANS. Actually Arizona is one of the leading States when it comes to purchase of the State vehicles that are alternative fuel regarding the vehicles. The only problem with that is apparently one of the big national producers, Chevy, is going to be not producing the Cavalier which is one of the common vehicles we use, but

we've been very proactive in making sure the State buys those type of vehicles and less dependent on gasoline.

Mr. TIERNEY. I was just sharing with the chairman that we've had people that talk about increasing the fuel efficiency standards generally get jumped on both by the industry and by labor unions because everybody has worked together, decided this is a bad thing. In fact, I was hoping they would join together and ask us help retooling facilities and keep the industry going, keep the jobs going and move in that direction so we can make the kind of vehicles we would.

It makes a lot more sense to me than giving out subsidies to everybody, doesn't make a lot of sense to me to look at the President's energy bill who moves away from conservation, away from alternatives, loads it up on fossil fuel industries and subsidies that don't do much for anybody. In the long-run, we have to look at that industry perhaps not making fuel-efficient cars, let them retool. Got other countries do it. Perhaps we ought to look in that direction. Thank you.

Mr. OSE. Thank you. Gentleman from Nevada, Mr. Gibbons.

Mr. GIBBONS. Thank you very much, Mr. Chairman, Ms. Evans and gentlemen. Thank you very much for your testimony today. It's been very helpful. Mr. Burdette, maybe I'm going to ask you a question that you know or do not know. If you don't, that's fine.

Would you for us, for me individually, break down the cost of a gallon of gasoline for us. Tell us what the various percentages are that are related to taxes, production, refinery, transportation, etc., and then tell us the second part of that question, which ones can we control? Which ones can we affect that are under our control that will make a difference in the price of gasoline today?

Mr. BURDETTE. Thank you, Mr. Gibbons. First of all, we're only talking about 25 percent that we can directly affect because roughly half or a little bit more is the price of crude. That obviously goes up and down as the price of crude goes up and down. About a quarter or more, maybe 30 percent, is taxes.

In Nevada we have fairly high taxes and the—I believe there is good reason for that. We are a pretty partially populated State. We have long roads and we have in places where we do have lots of people, a lot of growth, a lot of capital required. So taxes and cost of crude are the overwhelming majority of the cost we deal with. They're not always the cause of the spikes that we see.

The cause of the spikes that we're seeing, in my opinion, is in that last 25 percent where we're talking about the cost of refining and the cost of distributing, storing it, piping it and finally making it available at retail. We have some ability to control that but this is a free market. Particularly the distribution and the retail side of that market there is a fair amount of competition in our State and that folks have different places to go.

So there is probably not a great deal that can be done to effect the price there which is why I focused mostly, at least my comments, on refining and the fact that the market seems to absolutely forget those, the rents that are collected there that should be helping us that aren't.

Mr. GIBBONS. Let me ask a followup question if I may. Perhaps either Mr. Keese or Ms. Evans would like to add to this. If we cap

those rents or production profits that you're speaking of, what would be the short-term and indeed the long-term effect of such an action.

Mr. BURDETTE. Frankly, Mr. Gibbons, I'm not sure how the Governor would answer that so I'm going to answer it for myself. I really don't believe that caps are a good idea. They may sound great and may work just fine for 6 months or a year, but eventually they get you in trouble because they skew investment also.

Because our markets aren't perfect, we try to gain from our markets those things that a free market would give us. So, what I believe we need is a method of perhaps even working with refiners, working with the other States to find a way to use those profits, and it would be hard to define but use those profits in a constructive way that would help relieve the supply shortage. Perhaps to purchase the diesel that is going to hurt Nevada, by the way, just as badly as California when and if Bakersfield shuts down.

Mr. PORTER. Mr. Chairman, if I can yield time.

Mr. OSE. Gentleman from Nevada would yield.

Mr. GIBBONS. I'll yield.

Mr. OSE. Stop the clock for a minute.

Mr. PORTER. Thank you. I appreciate that. I could possibly help with the question of the cost of fuel on the taxes. We're the fifth highest in the country. Federal tax of course is 18.4 cents per gallon. Second highest. Sorry. State taxes are 18 cents. County and sales tax is 14.4 which equals about 15.8 cents per gallon.

Now, let's define a little step further. I applaud local governments. In the early 1990's in southern Nevada they put forth a petition, initiative petition that was voted on by the people of Nevada, to help fund our streets and highways. So, this is an example of how Nevada has been paying its own share and its fair share if not more than its fair share. But part of the reason that we are some of the highest is because of local initiative petitions that were exerted by the community to help fund our streets and highways. I want to enter that for the record.

Mr. OSE. Senior member of Nevada delegation.

Mr. GIBBONS. Thank you, Mr. Chairman. I appreciate Mr. Porter's clarification on that issue as well. It was a very important point to have been made. I don't know if I gave Mr. Keese or Ms. Evans an opportunity to answer the final question about the controlling of profits, capping of those profits. Your philosophy, your ideas, should it be done?

Because it seems to me that part of the issues, part of the concerns are in fact the mergers of companies; therefore, the ability of these companies to make larger profits which seems to be economic stimulus of American economy to begin with. But what's your individual thoughts on capping those? Should we do it in fact?

Mr. KEESE. I'll answer specifically. I think it would be extremely difficult. I also have electricity under my purview. Let me make a quick distinction here. If you have three or four generating plants and you shut one down, we saw that you can drive the price up and profit. If you have an oil refinery, you have contracted, committed to supply everything that comes out of that refinery. If you have an inadvertent shutdown, you go next-door to your neighbor

and you pay that economic rent to them to buy the product at a higher price to meet what your commitment was. You lose.

Mr. GIBBONS. So it's not——

Mr. KEESE. Unforced outage at a refinery is a loss. Now, if Chevron has to go to Shell and pay an extra 30 cents a gallon to buy it because that's what Shell wants, is that an excess profit? And then, when Chevron does the same thing to Shell when Shell goes out and Chevron says, well, I want 40 cents. There is winners and there is losers is what I would say. It seems to me it would be very difficult to try to figure out. You get taxed when you win. You get a credit when you lose.

Mr. GIBBONS. Mr. Chairman, I know my time is up.

Mr. OSE. Ms. Evans, I think Mr. Tierney and I are interested in Ms. Evans' answer.

Ms. EVANS. Absolutely. I have the same caveat that Mr. Burdette had is that haven't had a direct conversation with the Governor about this particular issue, but I think from our perspective we would like to see a little more transparency to understand exactly what's going on in marketplace to ensure we don't have market manipulation going on, that we don't have refineries that are purposely making decisions to shut down to increase their profits. So at this time, I'd hate to speak to whether or not we would need a cap that is a little more down the road. Transparency first.

Mr. TIERNEY. Yield the floor.

Mr. OSE. Certainly.

Mr. TIERNEY. Mr. Keese, are you telling me you don't think that industry raises its prices to recoup that loss at some point down the chain.

Mr. KEESE. Oh, I think throughout many different segments, production, refining, distribution, it does, and I don't want to be misunderstood. You see those spikes over there, we want them down. We don't want those spikes.

Mr. TIERNEY. I want to make sure I was clear with your answer. They may temporarily have to go somewhere else and use those rents to replace them, but in the long run they can charge more for the product they do generate.

Mr. KEESE. Certainly try to recoup it.

Mr. TIERNEY. Thank you.

Mr. OSE. Gentleman from Virginia.

Mr. SCHROCK. Thank you, Mr. Chairman. Ms. Evans, for whatever it's worth if you can't get Chevys, Ford in 90 days will be coming out with the new Escape.

Ms. EVANS. I've heard it.

Mr. SCHROCK. It's going to be a hybrid. My wife drives a current Escape. My son is No. 4 on the list of 20,000 to get the new Escape and I'm dying to see what it's going to look like. It's good that they're doing that. It's going to be interesting to see when that happens.

We're talking about these rents and such and I understand that. The refineries are just saying they're playing by the rules that Congress set up for them. There is an FTC report from 2001. Long time ago. It said the commission found no evidence of conduct by the refiners. Are we the problem? Is Congress the problem? Could we fix this? Don't be politically correct. Tell us what you think.

Mr. BURDETTE. I'm sorry, are you addressing the question to me.

Mr. SCHROCK. All three of you. If we're the problem we need to know it because everything emanates from there that causes some of these problems. If we have to change the way the game is played then so be it.

Mr. BURDETTE. I personally don't believe that Congress is the problem, although, by the way——

Mr. SCHROCK. I was hoping you would say we were. We could fix it.

Mr. BURDETTE. The new Ford hybrid won't count. It's not an alternative fuel vehicle. Now that's controlled by the feds, not by the government.

Mr. SCHROCK. What do you mean "won't count."

Mr. BURDETTE. We can't use Prius or Ford, the new Ford because it doesn't comply with the Clean Air Act. We're a clean cities initiative, which requires alternative fuel. The definition of alternative fuel doesn't include savings of fossil fuel. But that's——

Mr. SCHROCK. But that's our fault, right.

Mr. BURDETTE. Well, I think it's EPA.

Mr. SCHROCK. That is our fault, yes or no.

Mr. BURDETTE. Yes, sir, it's a Federal problem.

Mr. SCHROCK. Good. If we're truly interested in getting people into hybrid cars we need to change the rules of the game so they can get in them.

Mr. BURDETTE. To get the States more involved, sure, that would help out.

Mr. KEESE. You could fix that. Arizona buys alternative fuels, natural gas vehicles. They can't buy hybrid because they get 40 or 50 or 60 because it doesn't meet the requirement. You can change that. That's yours to change.

Mr. SCHROCK. OK.

Mr. BURDETTE. The broader issue is one that we fell into, I think. 1950, by the way, I remember driving in the 1950's.

Mr. SCHROCK. Good. I'm glad there is somebody here besides me that remembers that.

Mr. BURDETTE. Maybe Bill, too. We rely almost as an article of faith on the free market to deal with many of our markets, all of them, and true, we should and did in this market but this market has changed. This is not the same market that existed in 1950's, and the same level of faith and its ability to drive the kinds of results, the kinds of outcomes are very different, and so the Congress in 1950 faced a very different problem than the Congress of 2004. Again, the aim is to get results that mirror what a free market would give us.

Mr. SCHROCK. In Nevada, for instance, would Nevada be prepared to build their own refinery? I'm probably going to get asked that in Virginia. Everybody says not my backyard, but if we don't do it in our backyard then we're going to have to depend on foreign oil companies to provide it. We're going to continue to have these problems. Could you or would you build one in Nevada, Arizona as well?

Mr. BURDETTE. We have one refinery that is underutilized in Tonopah. We are much more fragile than Virginia but, yes, we'd have to go through the permitting process.

Mr. OSE. If I understand the issue on the Tonopah refinery is the throughput to the refinery does not allow the refinery to actually meet its total capacity; is that correct?

Mr. BURDETTE. That's correct. It's also a problem with the crude itself.

Mr. OSE. It's a little broader than just will you build a refinery. It also relates to the infrastructure that feeds the refinery.

Mr. BURDETTE. Absolutely. Yes, sir. Yes, Mr. Chairman.

Ms. EVANS. If I could speak to that point, too. I think the economics and in some other panels have mentioned is not necessarily there to afford a new refinery in United States. It's much less expensive generally for someone to go out of the country and build a refinery than have one here brand new in the United States.

Mr. SCHROCK. How do we solve that?

Ms. EVANS. Well, I think——

Mr. SCHROCK. Tell me why you think it's cheaper out there than it is here.

Ms. EVANS. Well, a small portion of that, and I can't say exactly how much, probably does go to some of the permitting and those areas that do add some cost. There is labor costs that are obviously less expensive outside the United States. On the cost of importing could be offset through increased price in the United States and we've been willing to pay those prices so far.

Mr. SCHROCK. Really no answer to it, is there.

Ms. EVANS. I think short-term it is a challenge. We're looking at very high prices that we're seeing this summer. Again, to think more long-term, to look at our overall demand and supply, reducing that demand, making ourselves more efficient, energy efficiency, and conservation I think will get us a long way, not all the way but a long way toward reducing our dependence.

Mr. SCHROCK. One of the ways is using hybrid cars but the Federal Government won't allow the local jurisdiction to use it. There is something wrong here somewhere.

Ms. EVANS. Absolutely.

Mr. SCHROCK. We're talking out both sides of our mouth when we say that. We up here have to get that fixed for people like you at home.

Ms. EVANS. Absolutely. If I could speak to I realize it's not a large percent of the market but the fact that they have a Federal tax incentive that indirectly creates an incentive for a purchase of a Hummer is not the kind of policy that we want to be encouraging.

Mr. SCHROCK. I agree. Thanks, Mr. Chairman.

Mr. OSE. Mr. Keese, I was unclear about your testimony. Was it the Commission or the State of California that was advocating for a new pipeline from Texas, Houston?

Mr. KEESE. The legislature asked us to study the three alternatives. We essentially came to the conclusion that the first two aren't feasible. The pipeline is feasible. As the Energy Commission, yes, we would like to encourage the expansion of that pipeline but it isn't the California part that's the problem. It's other States.

Mr. OSE. Has the State of Texas said they're willing to expand the pipeline.

Mr. KEESE. Mr. Hackett probably knows quite a bit about this who is on the next panel. There is a segment of the pipeline that is having difficulty getting permitted to operate at a higher capacity as I understand it.

Mr. OSE. In what State.

Mr. KEESE. We'll ask Mr. Hackett.

Mr. OSE. Do you know if any inquiry has been made to the State of New Mexico that they would be willing to permit a larger pipeline.

Mr. KEESE. I don't know if it's been a direct request. I know our people have been in contact with the other States.

Mr. OSE. Do you know anything about that?

Ms. EVANS. I can speak quickly. The pipeline we're discussing is the Long Horn pipeline. It comes out of west Texas. The problem that we have in Arizona is that pipeline although would expand the capacity would stop in Arizona at the Kinder Morgan pipeline which currently has an 8 to 12-inch pipeline. It would get bottlenecked basically in El Paso because there is no additional expansion on the pipeline. Although it would introduce Gulf Coast product, it wouldn't necessarily increase the amount of product that comes in in total.

Mr. OSE. Would you support expanding the Kinder Morgan pipeline?

Ms. EVANS. Absolutely. I think I told you that seriously has to be considered. I have concerns that the estimation by Kinder Morgan about the growth of the State are a little low and they aren't anticipating the kind of growth that we should be experiencing and the expansion that we need.

Mr. OSE. Do you speak for the Governor on that issue.

Ms. EVANS. I believe so I do.

Mr. OSE. In terms of being willing to support expansion of Kinder Morgan pipeline?

Ms. EVANS. I believe I do, yes.

Mr. OSE. What about Governor Guinn, would he have any objection to the expansion of the Kinder Morgan pipeline.

Mr. BURDETTE. I haven't had direct conversation. I would be very surprised if he would not, that he would not support an expansion of that pipeline from Arizona to Nevada.

Mr. OSE. You would be very surprised if he would not support it?

Mr. BURDETTE. Support it.

Mr. OSE. Let's put that in a positive. You would expect him to support it?

Mr. BURDETTE. I would expect him to support it, yes, sir.

Mr. OSE. When we talk about these pipelines that is jurisdictional in many respects to FERC and we actually do have a bite of that apple and I'm just trying to make sure geography of which this pipeline would pass that we're not going to have some unintended impediment places in the way.

Mr. BURDETTE. It would pass almost entirely through Arizona.

Mr. OSE. I understand that. Also, take a stem from there and head it north to Vegas.

Mr. BURDETTE. Yes, sir.

Ms. EVANS. Certainly we want to have consideration for where the pipeline is, what the expansion is, proximity to homes and all those other factors. In general, with the right situation I would be surprised if we would not support its passage.

Mr. OSE. At the existing right-of-way today at the Kinder Morgan pipeline seems to be that the pipeline is 8 or 12 inches.

Ms. EVANS. It varies between 8 and 12 inches.

Mr. OSE. Seems to me if we move 1 foot over to the side we'd have room for another 8 or 12-inch pipeline.

Ms. EVANS. Right. Well, the concern obviously in Arizona is when we experienced a rupture—if I could give you a little more detail. The rupture that we had actually spewed gasoline over homes that were under construction. No one was in the area. We didn't have any deaths or injuries. Obviously people in the community are concerned about the safety and reliability of these lines.

Mr. OSE. What's the spacing between lines that the State of Arizona would require?

Ms. EVANS. Well, we have not nailed down a specific number. I think right now we're at the stage where we feel like there should be adequate disclosure to the people that live near there so at least they know what they are purchasing and what risks might be associated with that but we haven't determined specific distance between a pipeline and the neighborhood.

Mr. OSE. We do have an existing pipeline through this neighborhood.

Ms. EVANS. That's right.

Mr. OSE. It did have a rupture?

Ms. EVANS. It did have a rupture.

Mr. OSE. Did it cause price spikes?

Ms. EVANS. Yes, absolutely.

Mr. OSE. If I understand correctly from Mr. Keese's testimony, that the creation of additional 8 or 12-inch buried pipeline bringing refined product or otherwise from Texas would allow fuel that is currently coming from California to both Nevada and Arizona to then stay in California. Is my logic correct?

Mr. KEESE. Yes.

Mr. BURDETTE. Yes.

Mr. KEESE. It would offer both those States options to get it where it's cheaper. Get it from California if it's cheaper, get it from Houston if it's cheaper.

Mr. OSE. The nature of the crude that comes from Texas westerly on the existing pipeline, is that the same type of crude that's currently usable in the refineries in——

Mr. KEESE. Product. We're talking about product, gasoline, diesel, aviation gas.

Mr. OSE. My time has expired. The gentleman from Massachusetts.

Mr. TIERNEY. My reaction was a reaction to something Mr. Shrock said. I think the Federal role can be significant. One, the Federal Trade Commission can certainly look at mergers. I understand that people aren't alleging that there has been an antitrust violation, but I want to read to you a couple reports. One is the March 2001 report from the FTC. It said the completed FTC investigation uncovered no evidence of collusion or any other antitrust

violation. In fact, the varying responses of industry participants to the gasoline price spike suggest that the firms were engaged in individual, not coordinated conduct. Prices rose both because of factors beyond the industry's immediate control and because of conscious but independent choices by industry participants, each industry participant acted unilaterally and followed individual profit and acquisition strategies.

One firm increased its summer-grade gasoline production substantially, as a result had excess supplies of RFG available and had additional capacity to produce more RFG at the time of the price spike.

This firm did sell off some inventory RFG, but it limited its response because selling extra supply would have pushed down prices and thereby reduced the profitability of the existing RFG sales.

I think what you're talking about there is no current law against that except that as I read and as the FTC's own merger considerations, rules and regulations allow for they can still decide that this consolidation of the market is too extreme. It may not amount to a monopoly of the antitrust law but would be too extreme.

An executive of a company made clear that he would rather sell less gasoline and earn a higher margin on each gallon sold than sell more gasoline and earn a lower margin. So, on that theory a RAND study which came out in 2003 made pretty much the same point. The central tactic is to allow markets to become tight by relying on existing plant and equipment to the greatest possible extent, even if that ultimately meant curtailing output of certain refined product, again not investing the profits that are made on that.

Talking about having some storage capacity. We did that with the Northeast oil during the winter season and it worked out pretty well. We Ought to perhaps think about having more of those storage capacities around, ability to have that when the fluctuations are coming in. Things like that I think that the government can do, some minor regulations on that.

Otherwise, I'm not sure that this industry is ever going to reinvest the resources it needs into its capital, do what it has to do to get the NIMBY, not-in-my-backyard attitude resolved. This industry may decide that profit going up is a happier day for them. It's not a totally free market. There has to be some modicum of regulation when we let them make the same—reasonable that somehow serve the public good. The length of a filing as necessary to our human existence as these fuel products have become and I think that may be appropriate for us to make sure we do some modicum of regulation. Thanks, Mr. Chairman.

Mr. OSE. Mr. Gibbons.

Mr. GIBBONS. Mr. Chairman, I, first of all, want to thank our witnesses on this panel for being here today.

Mr. OSE. We're not done with them yet.

Mr. GIBBONS. This is my one last opportunity to ask a question before I got shut off. I wanted to thank them.

Mr. SCHROCK. Just like the oil.

Mr. GIBBONS. Before they shut it off. I guess my concern is, Mr. Burdette, I want to direct my final question to you, if we look at the price of gasoline as I asked earlier, the percentage you indi-

cated was 50 percent of that price is due to taxes and crude oil. Was that——

Mr. BURDETTE. Seventy-five percent. Fifty percent for crude.

Mr. GIBBONS. That makes it even more difficult. When I look at the price of crude oil going up from $30 to $40 per barrel, that's a $10 barrel increase times the 2, 2½ cent gallon cost per gas, that would make it a 25 cents increase in per gallon cost. So, the overall crude oil which seems to be the villain here is only a small part if it's 75 percent of the increase in the cost of gasoline.

Mr. BURDETTE. Mr. Gibbons, one of the things that we haven't talked about at all is speculation in how that affects the market. I know this is a very controversial subject, but speculation exists. It exists because we don't know what the Saudis will do 3 months from now. We don't know what's going to happen in Iraq. We don't know what's going to happen to political instability in Venezuela.

But, there are people who are willing to take that risk and they will buy it and there is a risk premium, whether there is no market that says here is the risk premium for petroleum, but there are risk premiums in petroleum and those risk premiums are paid and they are a significant part of—and I wasn't careful about does that belong with the crude price or is that in the extra 25 percent, but the point is right now risk premiums are very high because of the instability and because of the new demand from China and because of—well, many reasons. Risk premiums are an important part of the situation today.

Mr. GIBBONS. Well, I agree with Mr. Tierney about the fact that we need to start looking at our production capability, building new refineries. We have all 30 year infrastructure legacy refineries that are going to be growing in their need for repairs and maintenance as they get older, as any large or aging system would. I think it behooves us, including California, to start looking at the ability to supply the demands within our region and our areas.

The NIMBY issue which is something that is troubling a lot of us out here, well, it troubles everybody across America, has to be resolved politically. It is something that all of us are responsible for addressing. I think that's probably one of the biggest solutions to cause, being able to generate a given supply or a constant supply to meet a growing demand or increase in demand as we have in this country. Again, thank you, Mr. Chairman for indulging me in my questions.

Mr. OSE. The gentleman from Virginia.

Mr. SCHROCK. I don't have anything further.

Mr. OSE. I want to go back to something Mr. Burdette said. Refinery at Tonopah, roughly 5,000 barrels per day production capacity.

Mr. BURDETTE. I don't know, Mr. Chairman.

Mr. OSE. Are there any plans to expand its capacity?

Mr. BURDETTE. Not that I'm aware of. I don't expect so. It uses crude from a railroad valley in central and eastern Nevada. It is crude that is not, not particularly suited for transportation fuels.

Mr. OSE. The information I have is as of 2002, it indicates the State has crude oil production of 2,000 barrels per day.

Mr. BURDETTE. That's about right. We make about a million and a half a year is top production. It's a little bit more than that.

Mr. OSE. You have a refinery in Tonopah that's processing 5,000 or can process up to 5,000 barrels per day.

Mr. BURDETTE. I don't know that number, Mr. Chairman.

Mr. OSE. What I'm trying to get at is the infrastructure that delivers the crude to the refinery, there is a difference here of 3,000 barrels per day and it's coming from somewhere. Where is it coming from?

Mr. BURDETTE. The crude that's cracked in Tonopah is shipped out of State to finish its refining process. It's refined——

Mr. OSE. It's cracked in Tonopah.

Mr. BURDETTE. In fact not completely. It's just an initial step in Tonopah. I'm going to have to learn more about exactly what happens in Tonopah and will be happy to supply you with additional details.

Mr. OSE. As I scratch around for solutions to the problems here in Nevada that will help us in California, it seems to me that with the refinery already in operation in Tonopah, that I think your testimony a little while ago was had unused capacity because of throughput constraints. With one already established it would seem to me we could move forward with or maybe you guys more accurately could go forward with a permit application to either expand the refining process from simply the first cut on the crack or expand the capacity beyond the 5,000 barrels a day that would go to some degree toward addressing deficit here in the State.

Mr. BURDETTE. Our problem is that we don't have crude that is suitable for making transportation fuels.

Mr. OSE. Very heavy.

Mr. BURDETTE. A lot of wax.

Mr. OSE. Maybe we need to figure out how to get you a pipeline that brings you crude.

Mr. BURDETTE. The economics, if the economics are there we have communities like Tonopah that are anxious for economic development. There is not to say that there aren't people who won't be concerned about it.

Mr. OSE. Now, as it relates to the petroleum infrastructure—I know that Congressman Shrock has a plane to catch. Don't feel badly he has to leave. As it relates to Arizona, California, Nevada, each of you probably have a better understanding of the infrastructure within the State. Are each of your States looking at ways to expand the infrastructure, for instance, to allow a greater amount of throughput or to permit larger refineries from capacity standpoint? Start with Arizona.

Ms. EVANS. I am aware, and I mentioned in my testimony, that there is a discussion about a refinery in Yuma which is in the western part of the State. I'm not sure exactly where they are in the process. Again, I think they submitted written testimony. To the extent again that we can meet our air quality standards and end up the community is receptive we would certainly be open again to increasing the supply to the State and the region.

Mr. OSE. Is the State advocating for the development of a refinery somewhere in Arizona.

Ms. EVANS. I don't think advocating would be the appropriate term for us at this stage. We are watching, we're monitoring, we're interested, but not necessarily advocating at this point.

Mr. OSE. What about in California?

Mr. KEESE. As I mentioned, we have identified the problems in the ports for import and in the refineries for expansion. We use to see refiners capacity creep about 2 percent a year. It's now under half percent. That's not enough. There is an active proposal in California, the legislature and in the administration, to look at a streamlined licensing process for expansion of refineries without changing any environmental laws.

Mr. OSE. How about in Nevada?

Mr. BURDETTE. In Nevada we are actively pursuing both ethanol and biodiesel production. We currently produce about 3 million gallons of biodiesel down south. We're opening new biodiesel facilities up north. They are marginal fuels at best, marginal addition.

We are concerned about the economics of ethanol. The fact is we have some renewable resources that we can use to provide energy for a refinery for ethanol that would help the cost but we still have to deal with the fundamental cost of shipping unit trains of grains into the State, processing it, and selling the byproducts and making that productive, and we haven't got somebody who is quite ready to that, frankly.

Mr. OSE. Flip this question around. Instead of looking at it from the State's perspective about what the State can or should be doing, within your respective States what recommendations would you make to the Federal Government about how to help the States with their infrastructure? Mr. Keese.

Mr. KEESE. I would think that probably would get around to the port situation which is the ability to bring in the product that Arizona and Nevada will need to. It will probably have to come through California. There well may be something that the Federal Government can do there. We're in the analytical stage right now. I don't have the——

Mr. OSE. Mr. Burdette.

Mr. BURDETTE. Pipelines are clearly important part of our infrastructure. We should acknowledge that California's air quality is affected by the amount of fuel they make for Nevada. We're grateful for that, but the truth is we need additional pipelines. Additional pipeline infrastructure and storage infrastructure would be helpful for us. Not sure we need a great deal of Federal help on that but certainly on the pipeline we would. That's a FERC jurisdiction.

Mr. OSE. Ms. Evans.

Ms. EVANS. I would reiterate that in any dynamic activity, it might be changing since, but one issue we looked at in the State of Arizona is our west pipeline and east pipeline. East pipeline was older, west line was a little bit newer and the tariff was higher in the west line so we were wondering and concerned that might be creating some kind of disincentive perhaps on the part of the company to expand that pipeline. That was one issue that we were looking at and would have some FERC obviously.

Mr. OSE. Mr. Tierney.

Mr. TIERNEY. Thank you very much. The witnesses are great. Mr. Keese, if you had the port situation resolved is that going to increase the transportation costs of getting that material inland.

Mr. KEESE. We have to solve that, the tankage also but I don't think it would—gives you options. The option we're talking about on the pipeline is that there is excess refining capacity in Houston today. So, the pipe would be full.

Mr. TIERNEY. Thank you very much all of you.

Mr. OSE. I want to thank this panel for their participation. We have questions that may have occurred to any of the Members up here that we will forward to you in writing. We appreciate timely response. Generally once you've got them, you will have 10 days to 2 weeks to respond. We'll be in touch. We appreciate you guys participating. We'll take a 5 minute recess.

[Recess.]

Mr. OSE. Welcome back. I am pleased to welcome our second panel of witnesses. We are joined on the second panel by Mr. Joseph Sparano, president of Western States Petroleum Association; Mr. Sean Comey, media relations representative for AAA of northern California, Nevada, Utah; Mr. David Hackett, president of Stillwater Associates; and Mr. Tyson Slocum, research director for Public Citizen's Energy Program.

Gentlemen, you saw on the first panel we swore everybody in. We do that for everybody. We're not picking on you. If you'd all rise, raise your right hands.

[Witnesses sworn.]

Mr. OSE. Let the record show that the witnesses answered in the affirmative. As you saw in the first panel, what we do is we ask our witnesses to summarize in 5 minutes the essence of their testimony. We have received your written statements and they have been entered into the record. I'm sure that Mr. Tierney and I have both read them. To the extent that you can briefly summarize we'd appreciate it so we can get right to the questions.

Mr. Sparano, you're recognized for 5 minutes.

STATEMENTS OF JOSEPH SPARANO, PRESIDENT, WESTERN STATES PETROLEUM ASSOCIATION; SEAN COMEY, MEDIA RELATIONS REPRESENTATIVE, AAA OF NORTHERN CALIFORNIA, NEVADA AND UTAH; DAVID HACKETT, PRESIDENT, STILLWATER ASSOCIATES; AND TYSON SLOCUM, RESEARCH DIRECTOR, PUBLIC CITIZEN'S ENERGY PROGRAM

Mr. SPARANO. Thank you, Congressman, other members of the committee. Appreciate the opportunity to testify today. The Western States Petroleum Association is a trade association that represents companies that explore for, produce, refine, transport and market petroleum products in six western States: California, Nevada, Arizona, Oregon, Washington and Hawaii. I've worked in the petroleum industry for 35 years and have held positions including CEO and chairman and president of regional businesses.

We've been engaged with State policymakers exploring how to address many of the petroleum supply-side and demand-side issues that were raised in your staff report. My testimony will focus primarily on gasoline price issues and, as importantly, ways to improve the current situation.

To put current gasoline prices in perspective, I used Bureau of Labor Statistics data covering 20 years to compare the real growth in gas prices to other products and services we use every day. What

I found is that gasoline prices have risen far less at 19 percent than most everything else we use in our lives including food, clothing, housing, health care, electricity and college tuition which is up about 400 percent during the same period.

Gasoline prices in the West are a function not only of local and regional market conditions but also worldwide petroleum market conditions. According to the Energy Information Administration [EIA], nearly one-half the price of a gallon of gasoline is a result of crude cost.

Crude prices have risen dramatically over the past several months to almost $42 a barrel. They are currently settled near record highs. According to the EIA, and other experts, crude costs have increased due to surging worldwide demand and tightening of supplies by OPEC.

Another reason gasoline cost more in the West is the fact that gasoline taxes are generally higher here; about 52 cents per gallon in both Nevada and California. As was mentioned earlier, higher margins, several folks mentioned higher margins, they do not equal profits. Margins do not equal profits.

In addition to those comments, demand for gasoline on the west coast and cities like Phoenix and Las Vegas has grown at a significant rate. In California, demand has grown at two to four times the rate of in-State production capacity increases. This growing imbalance between supply and demand growth is due in part to regulatory barriers to expanding refineries and other infrastructure. This means there is an increasing reliance on importation of blending stocks and finished products, subsequently higher marginal costs to supply the western marketplace. This puts a lot of pressure on an already inadequate infrastructure.

Whether it's in the area of refining capacity, pipeline capacity, port handling and storage equipment, marketing facilities or terminals, removal of permitting constraints and barriers to infrastructure projects are needed to improve capacity and reliability.

Throughput limits on refinery equipment and ports, repetitive environmental compliance reviews and continuous permit delays when our industry wants to add refining capacity or more retail units all need immediate attention. These barriers stop or slow down construction of new petroleum facilities and upgrades to existing equipment that together would allow petroleum companies to more effectively and efficiently produce, transport and sell more gasoline in the West or to import fuels from other areas. Of course, as with any industry, projects must also meet shareholders' and boards of directors' economic criteria in order for any implementation to proceed.

Well, given that, what can be done? Here are some specific observations and suggestions. Most of my remarks will focus on California State policies. This is because many of the refineries, other forms of petroleum infrastructure that are located in California provide fuel products to Nevada, Arizona and other parts of the west.

The first area of improvement is to avoid counterproductive policies. For example, California State government has been sending less than positive signals to the business community in general and to our industry in particular that it does not want companies to in-

vest in new facilities and to add new jobs. High operating and administrative costs and the challenges of complying with cost-ineffective environmental regulations have made it difficult for investments, companies and jobs to stay in the State.

In addition, our industry must constantly fight back legislative proposals that would dramatically increase the cost of doing business.

Permit reviews need to be streamlined. Permit streamlining and establishing policies to ensure timely processing of permits by State agencies, local air districts and regional water boards are critical components of improving business competitiveness. California Energy Commission's Integrated Energy Policy Report contains some specific recommendations for permit system streamlining.

Another of the critical areas affecting permitting is the Federal New Source Review. New Source Review reforms adopted by the Federal Government but negated by the California legislature in 2003 do promote permitting and construction of critical energy projects without increasing emissions or negatively impacting the environment or local communities.

Another effort that will help the situation will be to create consolidated permitting for energy projects. We strongly urge development of consolidated State-level permitting agency whose intervention could be requested by project proponents when duplicative or counterproductive regulatory requirements endanger a project.

To succeed in this effort we must eliminate overlapping and conflicting regulations. Unnecessary regulatory processes that add cost without adding value environmentally should be eliminated. This can be done without sacrificing environmental standards or diminishing local control over land use decisions that affect community values. One agency could manage the permitting of many energy facilities.

In fact, California Energy Commission has just launched an Order Instituting Investigation focusing on examining the causes of petroleum intrafracture development constraints. WSPA is participating in this process.

Obtaining a waiver of the Federal minimum oxygenate mandate would also be very helpful. WSPA has long supported California in its effort to exempt the State from the Federal EPA's requirement that gasoline include an oxygenate. Since the removal of MTBE from California's gasoline formula, the only viable oxygenate additive is ethanol. Being forced to use ethanol entails additional costs, limits refiner flexibility and may even reduce production capacity.

California's air quality agencies agree that our industry can continue to produce the cleanest gasoline on the planet without the addition of ethanol. A waiver would provide the flexibility for California refineries to produce and marketers to sell cleanest fuel available as efficiently and cost effectively as possible. What we would like is to be able to use ethanol when it is economically attractive and when market conditions support that choice.

Private and public sector research into alternative fuel is also important. Our industry is working closely with California legislators to produce a bill that would help us move forward and level the playing field for new refinery and other infrastructure projects.

Let me finish up here, just a couple of points to make, in California there were 33 refineries in 1985. Now there are 13. We haven't built one since 1969. Thirty-five years without a new refinery in the State. Despite that, petroleum industry in the last 20 years has met the challenge of reliably supplying our customers with all types of products despite continually growing demand and increased regulatory hurdles. I believe we can continue doing this but we really need a concerted and cooperative effort with all the parties that are involved here today. Thank you.

[The prepared statement of Mr. Sparano follows:]

WSPA
Western States Petroleum Association

Testimony of Joe Sparano, President, Western States Petroleum Association
Before the US House Government Reform Subcommittee
On Energy Policy, Natural Resources and Regulatory Affairs
Henderson, NV – May 28, 2004

Mr. Chairman and Members:

Thank you for giving me the opportunity to testify today. My name is Joe Sparano and I am President of the Western States Petroleum Association. We are a trade association that represents companies that explore for, produce, refine, distribute and market petroleum products in the six western states of Nevada, California, Arizona, Oregon, Washington and Hawaii.

We have been engaged with policymakers in many of our states, exploring how to address many of the petroleum supply side and demand side issues that were raised in your staff report. My testimony will primarily focus on some of the pros and cons of the approaches.

But first, I would like to commend your staff for their very sophisticated discussion of the western region's fuel marketplace. Your Committee's May 20 briefing memorandum accurately observed that fuel prices have experienced a number of ups and downs over the past years.

To put gasoline prices in perspective, I went to the Bureau of Labor Statistics website to compare the real growth in gas prices to other products and services we use every day, over a period of more than twenty years. What I found is that gasoline prices have risen far less than most everything else we use in our lives including food, clothing, housing, health care, electricity and our kids' college educations.

In addition, your staff report correctly pointed out that gasoline prices in the west are a function not only of local and regional market conditions, but also worldwide petroleum market conditions. According to the Energy Information Administration (EIA), nearly one-half of the price of a gallon of gasoline is attributable to crude oil costs.

And as your staff report stated, crude oil prices have risen dramatically over the past several months and are currently at record highs. According to the EIA and other experts, crude costs have increased due to surging worldwide demand and a tightening of supplies by OPEC.

Another reason gasoline costs more in the west is the fact gasoline taxes are generally higher here, about 52 cents per gallon in Nevada and California.

In addition, demand for gasoline on the west coast and in cities like Las Vegas and Phoenix, has grown at a significant rate. In California alone, demand has grown at 2 to 4 times the rate of in-state production capacity increases, due to regulatory barriers to expanding refineries

and other infrastructure. This means there is an increasing reliance on importation of blending stocks and finished products, and subsequently higher marginal costs to supply the western marketplace. Simply put, the existing petroleum infrastructure for handling production, storage, transportation and marketing of fuels efficiently throughout the region is inadequate.

Whether it is in the area of refining capacity, pipeline coverage and capacity, port handling and storage equipment, facilities terminals and related storage capacity, removal of permitting constraints and barriers to infrastructure projects are needed to improve capacity and reliability.

Areas such as unnecessary throughput limits on refinery equipment and ports, repetitive environmental compliance reviews for refining and marketing facilities and continuous permit delays when we want to add capacity or more retail units, all need immediate attention.

These barriers stop or slow down construction of new petroleum facilities and upgrades to existing equipment, that together would allow petroleum companies to more efficiently produce, transport and sell more gasoline in the west, or to import blending components or finished product from other areas.

Additionally, as with any industry, projects must also meet shareholders' and Boards' economic criteria in order for implementation to proceed.

What can we do? Here are some specific observations and suggestions.

Most of my remarks will be focused on California state policies, because many of the refineries and other forms of petroleum infrastructure that are located there provide most of the fuel products to Arizona, Nevada and other parts of the west. We've also been most actively engaged with policy-makers in California, in dealing with the infrastructure barriers that exist.

The first area of interest is to avoid counterproductive policies. State government, and I'm speaking here specifically about California, has been sending less than positive signals to the business community in general and to our industry in particular, that it does not want companies to invest in new facilities and to add new jobs. High-energy costs, sky- rocketing workers compensation costs and the high costs of complying with cost-ineffective environmental regulations have made it difficult for investments, companies and jobs to remain in the state.

In addition, our industry must constantly fight back legislative proposals that would dramatically increase the cost of doing business. Those proposals have included a billion dollar per year refinery gate tax that so far has been defeated, but looms as a potential cost.

Permit reviews also need to be streamlined. Permit streamlining and establishing policies to ensure timely processing of permits by state agencies, local air districts and regional water boards are critical components of improving the state's business competitiveness. The Energy Commission's Integrated Energy Policy Report (IEPR) contains specific recommendations for permit system streamlining.

Another of the critical areas for permitting is New Source Review. Rather than react hostilely to federal NSR reforms, as the California Legislature did by passing SB 288 (Sher), we have urged the Legislature instead to provide authority to CARB and the local districts to adopt those federal NSR reforms. Those reforms would promote permitting and construction of critical energy projects without increasing emissions or negatively impacting the environment and local communities.

Another effort that will help the situation will be to create consolidated permitting for energy projects. We strongly urge the development of a consolidated permitting agency whose intervention could be requested by project proponents when duplicative or counterproductive regulatory requirements endanger a project.

We must eliminate duplicative, overlapping and conflicting regulations. The state should pursue opportunities to eliminate unnecessary regulatory processes that add cost without adding value to environmental protection. This can be done without sacrificing environmental standards, or diminishing local control over land use decisions that affect community values.

One agency could manage the permitting of major energy facilities such as: additional electrical self-generation; significant oil and natural gas production increases; new LNG terminals and facilities; retail marketing facilities; additional pipelines; and, refinery capacity additions or facility expansions.

In fact, the California Energy Commission has just launched an Order Instituting Investigation (OII) regarding the causes of petroleum infrastructure development constraints. It has delegated the investigation to its Siting Committee.

The Siting Committee proposes to conduct information-gathering workshops to look at petroleum infrastructure development trends and identify factors that have constrained the state's petroleum infrastructure and have limited the supply of transportation fuels. WSPA will be participating in this process and would be happy to provide you information from this process as it moves forward.

Obtaining a waiver of the federal minimum oxygenate mandate would also be very helpful. WSPA has long supported the state in its effort to exempt California from the federal EPA's requirement that gasoline include an oxygenate. Since the removal of MTBE from California's gasoline formula, the only viable oxygenate additive is ethanol. Being forced to use ethanol entails additional costs, limits flexibility and reduces production capacity even more.

California's air quality agencies agree that industry can continue to produce the cleanest gasoline on the planet without the addition of ethanol – a waiver would provide the flexibility for California refiners to produce and marketers to sell the cleanest fuel available as efficiently and cost-effectively as possible. WSPA has also advocated for almost two years to both the Arizona and Nevada state agencies responsible for fuel formulations, that they remove the mandated requirement for the highest level of ethanol addition to their wintertime gasoline.

The private and public sectors must also continue research into alternative fuels. In addition to removing barriers to increasing gasoline production, another key component of successful future energy policy will be the increased use of alternative, non-petroleum fuels.

These fuels are expected to give consumers more choices and help California and other western states meet their ever-increasing transportation product demands and clean air objectives. WSPA's member companies are actively engaged in research in several alternative fuels areas including hydrogen fuel cells and gas to liquids technology.

Our industry is working with several California legislators and the Schwarzenegger Administration to move forward on legislation that will begin improving the "playing field" for energy investments and facility operations.

For example, we support California state legislation being considered to declare petroleum infrastructure a statewide priority of significance and receive expedited rulemaking, permitting, and resource planning. The legislation could recognize the importance that petroleum plays in the energy stability of the State and basically treat petroleum infrastructure in the same way power plants were treated during the electricity crisis.

This type of bill would establish lead responsibility in state government with special authority to assess the condition of California's petroleum infrastructure. It could ask the Governor to direct by Executive order, Cal-EPA and CARB to assist local air districts in implementing best management practices and expediting project permitting.

California's Governor could also convene a special meeting of those states with an interest in cleaner burning fuels, to organize a joint campaign targeting the waiver of the federal oxygenate mandate, as well as a campaign to improve Corporate Average Fuel Economy (or CAFÉ) mileage efficiency standards.

Earlier this week, California's Governor launched a "Flex Your Power at the Pump" initiative designed to promote common sense practices for consumers and businesses to conserve gasoline. A unified Western States effort could help promote simple consumer activities such as keeping tires properly inflated and keeping vehicles tuned, activities that could have a remarkable impact on reducing gasoline demand.

These efforts would represent a positive step toward addressing the tight supply and demand balance that exists in the Western Region.

Here are a few more pointed observations.

It is important for our industry, Federal and State leadership and special interest groups to all look in the mirror and understand that our current situation didn't just happen overnight. The anti-business and economic policies of some of the states, the federal government and special interest groups, have for years produced a climate of non-investment, diminishing supplies versus demand and marketplace volatility.

There are some interesting facts that support previous observations:

For the US overall, there were 321 operating refineries in 1981, with a total capacity of 18.6 million B/D. In 2004, there are 149 refineries, with a total capacity of 16.8 million B/D (a reduction of 1.8 million B/D). No new refinery has been built in the US since 1976.

In California, there were about 30 gasoline-producing refineries in the early 1980's, with a total crude capacity in excess of 2 million B/D. Now, there are 13 refineries left, with a capacity of just under 1.9 million B/D. No new refinery has been built in California since Exxon built the Benicia plant in 1969.

There are also no refineries in Nevada, Arizona and Oregon, three western states that receive some to almost all of their gasoline, and in some cases, diesel fuel supplies from California.

In Closing:

Over the past 20 years, the petroleum industry has met the challenge of reliably supplying our customers with all types of products despite the challenging influences of growing demand and increased regulatory hurdles. We have done this while making and selling the cleanest products on the planet at the cleanest facilities anywhere, and while selling that product at competitive prices.

I believe our industry can continue to meet this challenge, but we will need the cooperation of the public sector and other interested parties, to reduce barriers that tend to discourage companies from investing in the west.

Either we win or we lose together. It really is that simple.

WSPA
May 28, 2004

Mr. OSE. Thank the gentleman for his testimony. Mr. Comey, AAA of northern California, Nevada and Utah. Welcome, sir. We've had your statement in writing, we appreciate its submittal. Please summarize in 5 minutes.

Mr. COMEY. Thanks. Let me start by saying that we're probably going to have to amend that chart because $2.40 may not be the top of where we go this summer. My apologies about that.

AAA began tracking gas prices in the mid-1970's as a service to our members and to the public. Our survey tracks 60,000 gas stations nationwide every day and the results are released to the public and media.

The price of gasoline, like few other consumer goods, seems to strike a raw nerve among consumers. No other consumer product's price is displayed so prominently in public places.

When it comes to buying gasoline, many feel they have few practical alternatives. The majority of driving is not a matter of discretion. People need to drive to get to and from work, take their children to school, go shopping, and for many there are really no other realistic or convenient alternatives.

For people who use a lot of fuel, like families forced to commute a long distance from their homes to their jobs in order to find affordable housing, a hike in gas prices can have a significant impact on the family budget. It can mean the difference between being able to balance their checking account at the end of the month and going deeper into debt. Or gas prices can influence their other spending decisions, forcing consumers to cut back on other purchases so they have enough money to fill their gas tanks.

Unlike many consumer products, the cost of gasoline is subject to dramatic fluctuations. After reviewing the data available on gas prices over the last 3 years some patterns are apparent. Prices tend to increase in March and April. The seasonal increase in gas prices is generally attributed to the refineries switching their production over to summer-blend fuel. Supplies tend to decrease at that time as refineries use up their winter blend of gasoline before switching over to the summer blend.

This year that trend began early with significant increases in February which is normally a period of the year when we expect to see relatively stable prices. During the summer we often see prices increase around the 4th of July weekend which is typically one of the biggest holidays during the year in terms of automobile travel. Prices also tend to rise in late August, early September around Labor Day weekend, another holiday with large numbers of driving vacations. This typically marks the end of the season characterized by high fuel consumption.

In general, prices in the summertime tend to be higher than winter, largely due to higher demand. Generally prices tend to move up or down by less than 10 cents per month. California and Nevada, however, are susceptible to dramatic price swings when experiencing supply or distribution problems or when crude oil prices change significantly.

Since 2000, here in Nevada, there have been 21 months where the price of a gallon of regular unleaded gasoline has changed by 10 cents or more. For purposes of comparison nationwide, the average price has changed by 10 cents or more only 14 times during

the same period of time. So, Nevada consumers have seen far more price volatility than residents of many other States.

Statewide average price per gallon in Nevada is usually among the highest in the Nation. Typically only Hawaii and California residents pay more. Right now Nevada drivers are paying about 25 cents more than the national average, 2003 was a particularly volatile year. Prices hit record highs throughout Nevada and California in late March. At that time the statewide average in Nevada was $1.97 per gallon, an increase of 29 cents per gallon from the previous month. Although that would look like kind of a bargain today. Again, analysts at the time largely attributed the situation to the rise in the price of crude oil. Crude oil hit nearly $40 per barrel in February of that year during the buildup to the war in Iraq. It was back down to about $28 a barrel by mid-April and consumer gas prices also declined between April and May as a result.

In 2004 gas prices have risen significantly since the beginning of the year. Between January and May, the Statewide average price for a gallon of regular unleaded in Nevada increased by 58 cents a gallon, a jump of nearly 35 percent. Again, the high cost of crude oil seems to be the main cause of the price hike.

What can we do about the problem? Any meaningful change would team to have to address both supply and demand. On the supply-side of the ledger AAA of northern California, Nevada and Utah would support plans to increase domestic production, reserves and fuel distribution in order to increase the certainty that consumers will have a reliable source of transportation energy as long as these steps could be undertaken in an environmentally responsible manner. Likewise, we would also back a reduction in dependency of oil imports, again, in an environmentally responsible manner.

In terms of reducing demand we believe it is important to promote transportation energy efficiency and continue research in this area in order to provide a wide variety of fuel-efficient technologies. A wider range of options, including hybrid vehicles, would give consumers more choices when it comes to vehicle purchasing and use.

We also support the elimination of the oxygenate requirement for fuel that was discussed before. We believe we can meet the requirements set by the Clean Air Act without being forced to use ethanol. Cleaner emissions could be achieved by requiring tougher performance standard rather than by insisting on a particular ingredient.

To summarize, the pattern that we've seen emerging over the last few years, prices rise, consumers complain, politicians investigate, then prices go back down again, we shift the focus of our attention to other issues, and then after a period of time the cycle repeats.

As George Santayana once wrote, "Those who cannot learn from history are doomed to repeat it." In some respects history may serve as our guide in attempting to understand and ultimately solve this problem.

At the onset of the oil embargo in the 1970's, many Americans drove a car powered by gas-guzzling V8 engine. By the end of the decade the Honda Accord, much more fuel efficient vehicle, was one of the most popular cars in the country. It wasn't because people just wanted a more fuel-efficient car. It was a car they actually

wanted to buy. Technology really rose to meet the challenge of the times and perhaps it may do so again. But, based on the pattern we've seen over the last couple years it may take a more sustained period of unpleasantness such as what happened three decades ago in order to precipitate some of those changes.

Unfortunately, there is no quick-fix to this situation. If there was an easy answer I suspect we would have found it a long time ago. At AAA of northern California, Nevada and Utah we believe that today's high gas prices underscore the need to keep exploring alternative fuels, step up conservation efforts, and implement a national energy policy that will meet our transportation needs without sacrificing the environment. Thank you.

[The prepared statement of Mr. Comey follows:]

Sean Comey
AAA Northern California
Energy Policy Subcommittee of the House Government Reform Committee
Gasoline Price Hearing
May 28, 2004

Good Morning. Thank you for asking AAA to participate in these proceedings. I have brief statement that I hope will useful to the members of the committee and then I would be glad to try to answer any questions you may have.

First, a quick explanation of who we are and what we do: Established over 100 years ago, AAA of Northern California, Nevada and Utah strives to serve as a consumer advocate for our more than 4 million members and the entire community.

AAA began tracking gas prices in the mid-70's as service to our members and the public. Our survey tracks 60,000 gas stations nationwide each day. The results are released to the public and the media.

The price of gasoline, like few other consumer goods, seems to strike a raw nerve among many consumers. No other consumer product's price is displayed so prominently in public places.

When it comes to buying gasoline, many consumers feel they have few practical alternatives. The majority of driving is not a matter of discretion. People need to drive to get to and from work, to take their children to school and to go shopping. For many, there are no other realistic or convenient options.

For people who use a lot of fuel, like families forced to commute a long distance from their homes to their jobs in order to find affordable housing, a hike in gas prices can have a significant impact on the family budget. It can mean the difference between being able to balance their checking account and going deeper into debt every month. Or gas

prices can influence their spending decisions, forcing consumers to cut back on other purchases so they have enough money to fill up their gas tanks.

Unlike many consumer products, the cost of gasoline is subject to dramatic fluctuations.

Reviewing the data available on gas prices over the last three years, some patterns are apparent. Prices tend to increase in March and April.

The seasonal increase in gas prices is generally attributed to the refineries switching their production over to the summer fuel blend. Supplies tend to decrease at that time as refineries use up their winter blend of gas before switching over to the summer blend.

This year, the trend began early, with significant increases in February, which is normally a time of year when we expect relatively stable prices.

During summer, we often see prices increase around the 4th of July weekend, which typically is one of the biggest holidays of the year in terms of automobile travel.

Prices also tend to rise in late August/early September around Labor Day weekend, another holiday with large numbers of driving vacations. This typically marks the end of the season characterized by high fuel consumption.

In general, prices in summertime tend to be higher than in winter, largely due to higher demand. Generally, prices tend to move up or down by less than 10 cents per month. California and Nevada, however, are susceptible to dramatic price swings when experiencing supply or distribution problems, or when crude oil prices change significantly.

Since 2000, here in Nevada, there have been 21 months when the price of a gallon of regular unleaded gasoline has changed

by ten cents or more. Nationwide, the average price has changed by ten cents or more 14 times during the same time period. Nevada consumers have seen far more price volatility than residents of many other states.

The statewide average price per gallon in Nevada is usually among the highest in the nation. Typically, only Hawaii and California residents pay more. Right now, Nevada drivers are paying about 25 cents more than the national average.

Here is a brief history of gas prices and what caused them to rise and fall over the last couple of years:

In 2001: Prices rose leading into the summer months, then fell dramatically for the rest of the year as the slow economy resulted in decreased gasoline consumption and the price of crude oil fell. There was a price spike after the September 11th terrorist attacks. Some communities reported sporadic panic buying. Price gouging investigations were initiated in several states. Subsequently, prices declined.

In 2002: Prices went up as they usually do in the early spring, then remained steady throughout the summer due to strong supply levels. We did not see the usual decline in prices at the end of the summer. Energy analysts generally blamed increasing tensions with Iraq as one of the main forces pushing the price of crude oil upwards.

2003 was a particularly volatile year. Prices hit record highs throughout Nevada and California in late March. At that time, the statewide average in Nevada was $1.97 per gallon, an increase of 29 cents per gallon from the previous month. Again, analysts largely attributed the situation to a rise in the price of crude oil. Crude hit nearly $40 per barrel in February during the build up to the war in Iraq. It was back to about $28 a barrel by mid-April and consumer gas prices also declined between April and May as a result.

In 2004: Gas prices have risen significantly since the beginning of the year. Between January and May, the statewide average price for regular unleaded in Nevada increased by 58-cents a gallon, a jump of nearly 35-percent. Again the high cost of crude oil seems to be the main cause of the price hike.

In response to mounting frustration and anger among consumers, AAA has been encouraging drivers to do what they can to fight back.

First, we advise consumers to shop aggressively for the lowest price. Many of us have fallen into the habit going to the same gas station when we need to fill up. We may have shopped around when we first choose that gas station, but since prices change frequently, the cheapest station today could be the most expensive the next time your gas gauge is on "E."

While there is dubious value in traveling a long distance to save a few cents per gallon, there's often a less expensive station that is equally convenient to the one where you normally fill up. By simply paying attention to the posted prices at the gas stations you pass during your normal routine, you'll know what a fair price is when you need fuel.

Second, don't buy high-octane fuel if you don't need it. Fewer than ten percent of cars on the road need premium grade fuel, yet the mid-grade and premium grades of gasoline account for up to 30-percent of gasoline purchased by consumers.

Many people buy the high-octane gas in the mistaken belief that it will enhance engine performance or increase the lifespan of their vehicle. The best bet is to consult your owner's manual and if the manufacturer does not specifically require you to use premium fuel, don't buy it. If you do, you're just wasting your money.

Third, check your tire pressure inflation. For every pound of pressure your tires are under inflated, you can lose up to two percent of your gas mileage. Many people just look at their tires to gauge whether they are properly inflated. You can easily be off by five pounds or more and your tires may appear to be just fine, but you could be using ten percent more gas than necessary.

Beyond these steps, what can we do about the problem? Any meaningful change would seem to have to address both supply and demand.

On the supply side of the ledger, AAA Northern California, Nevada and Utah would support plans that would increase domestic production, reserves and fuel distribution in order to increase the certainty that consumers will have a reliable source of transportation energy, as long as these steps could be undertaken in an environmentally responsible manner.

Likewise, we would also back a reduction in dependency upon oil imports, again, in an environmentally responsible manner.

In terms of reducing demand, we believe it is important to promote transportation energy efficiency and continue research in this area in order to provide of a wide variety of fuel-efficient technologies. A wider range of options, including hybrid vehicles, would give consumers more choices when it comes to vehicle purchasing and use.

We also support elimination of the oxygenate requirement for fuel. We believe that we can meet the requirements set by the Clean Air Act without being forced to use ethanol. Cleaner emissions could be achieved by requiring a tougher performance standard rather than by insisting on a particular ingredient.

To summarize, we have seen a pattern emerge over the last few years:

- Prices rise.
- Consumers complain.
- Politicians investigate.
- Prices go down.
- We shift our focus to other issues.
- After a period of time, the cycle repeats.

As George Santayana wrote, "Those who cannot learn from history are doomed to repeat it." In some respects, history may serve as our guide in attempting to understand and ultimately solve this problem.

At the onset of the oil embargo in the 1970's, many Americans drove a car powered by a gas guzzling V8 engine. By the end of the decade, the much more fuel efficient Honda Accord was one of the most popular cars in the U.S. Spurred by popular demand, technology improved to meet the challenge of the times. Perhaps it may again, but based on the pattern we've seen over the last couple of years, meaningful change may only take place after a more sustained period of unpleasantness, similar to what happened three decades ago.

Unfortunately, there's no quick fix to this problem. If there was an easy answer, we would have found it a long time ago.

At AAA of Northern California, Nevada and Utah, we believe today's high gas prices underscore the need to keep exploring alternative fuels, step up conservation efforts, and implement a national energy policy that will meet our transportation needs-without sacrificing the environment.

SC 5/25/04

Mr. OSE. Thank the gentleman. The next witness, president of Stillwater Associates, David Hackett. Sir, welcome. I appreciate your participation.

Mr. HACKETT. Thank you, Mr. Chairman. Good afternoon, ladies and gentlemen. I've been invited here today to address the issues around high gasoline prices and to specifically address the effects that government regulations, Federal, State, local, have had on the cost of gasoline. I will also make recommendations on steps that government can take to improve gasoline supply and, therefore, reduce gasoline price rises and price volatility.

Stillwater Associates has been retained by a number of government agencies to study high gasoline prices. California Energy Commission we conducted studies that included creation of a strategic fuel reserve, MTBE phaseout and petroleum marine infrastructure. Our 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, and that's California, Arizona, Nevada, more than $2 billion per year.

In many respects today's high gasoline prices and diesel prices are the result of government policy, or lack of policy. This afternoon I'll make five specific recommendations for policymakers. These recommendations are: one, eliminate oxygenate mandate; two, cancel Unocal's patents on gasoline; three, improve local permitting processes so that necessary infrastructure can be constructed in a timely manner; four, rationalize the number of grades of gasoline that are required around the country; and, five, improve oil company reporting to appropriate government agencies.

Relative to the elimination of the oxygen mandate, in 1998 refinery economics modeler MathPro, Inc., estimated 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. 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-1990'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.

We estimate that they pad the cost to consumers $150 million a year.

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. I've listed a couple examples here. The telling one though is with the Port of Los Angeles Mr. Keese mentioned earlier. This was a quote from the local paper. There is a company that wants to build an oil terminal on their property in the port. 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."

Then of course 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.

Then we've got representation here on reporting. Government agencies don't collect, analyze, or publish the proper data in a timely fashion to help participants in the marketplace understand the supply and demand issues. Of course on the other side you can argue that industry makes reports to all sorts of government agencies, and so all that, that whole recording process needs to be sorted out and it comes back to the transparency that Arizona spoke about a few minutes ago, trying to understand what's going on.

We've got a demand side suggestion. Experts say if motorists properly inflated their tires, they could save 6 percent on gas mileage. Assume everyone did that and reduced their gasoline demand by merely 2 percent. That would save about 180,000 barrels a day of gasoline, the equivalent production of a new refinery or the delivery of 18 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.

[The prepared statement of Mr. Hackett follows:]

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.

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[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 confidentiality concerns. On the other side of this coin, industry makes reports

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[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", Torrance 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

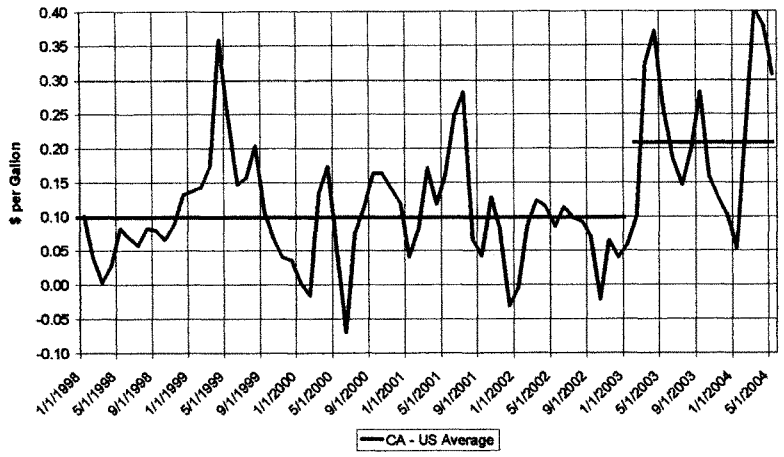
to all sorts of government agencies – the California State Lands Commission, the Army Corps of Engineers, the CEC and the EIA, among others. These reports are frequently duplicative and redundant. While this is issue is not glamorous, it is critical to understanding the markets. We have recommended improved data acquisition and analysis to CEC[11] 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.

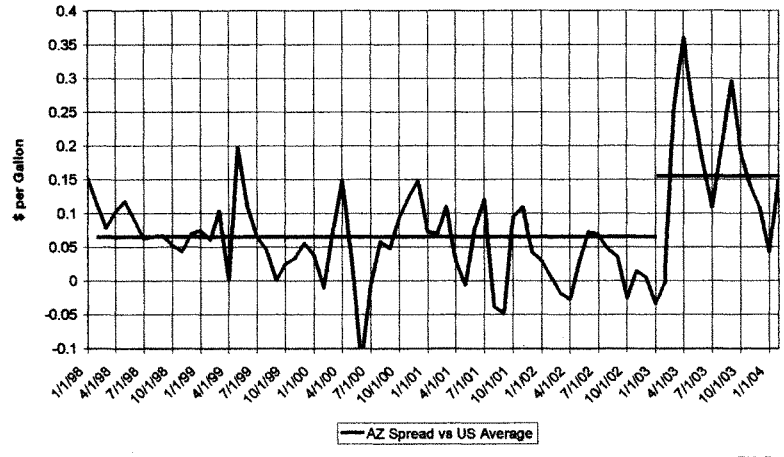
[11] "California Marine Petroleum Infrastructure", Stillwater Associates presentation to California Energy Commission public workshop, April 2003
[12] "Study of Fuel Prices and Legislative Initiatives for the State of Hawaii", Stillwater Associates LLC for the Department of Business, Economic Development, and Tourism, August 2003
[13] http://www.ftc.gov/bcp/conline/pubs/autos/gasave.htm

California vs. US Average
Retail Regular Spread



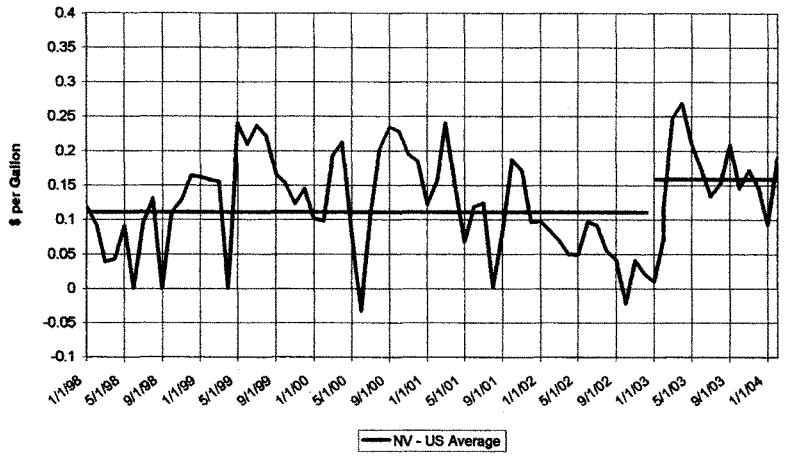
EIA Data, except Stillwater Associates estimates for Feb – May 2004 data

Arizona vs. US Average
Retail Regular Spread



EIA Data

Nevada - US Average
Retail Regular Spread



EIA Data

Mr. OSE. I thank the gentleman for his testimony. Our final witness on the second panel is Mr. Tyson Slocum. He is the Research Director for Public Citizen's Energy Group. Sir, we've received your testimony, welcome your participation. I Recognize you for 5 minutes to summarize.

Mr. SLOCUM. Mr. Chairman, thank you for having me here today. Two months ago I released a report called Mergers, Manipulation and Mirages: How Oil Companies Keep Gasoline Prices High, and Why the Energy Bill Doesn't Help. And among other conclusions that I reached in the course of my research I found that recent mergers, for example, those between Exxon and Mobil, Chevron and Texaco, and Conoco and Phillips, among others have resulted in dangerous levels of concentration in the domestic oil industry, particularly in the refining sector.

My research documented that in just one decade as a direct result of mergers, largest five oil refiners went from owning one-third of capacity to over one-half, and the largest 10 refiners went from owning 55 percent of refinery capacity to nearly 80 percent. It is not just Public Citizen's reaching these conclusions. Just yesterday the U.S. General Accounting Office released this report, "Effects of Mergers and Market Concentration in the U.S. Petroleum Industry." Among the conclusions that this Federal agency reached was GAO's economic analyses indicate that mergers and increased market concentration generally led to higher wholesale gasoline prices in the United States.

Prior to that, in March 2001, the U.S. Federal Trade Commission, which is the agency that is supposed to be enforcing antitrust laws, found that oil companies, because of their large market share, were able to unilaterally intentionally withhold gasoline supplies from the marketplace for the sole purpose of engaging in what they called profit maximization strategies, what I would call price gouging.

Now, while the Federal Trade Commission found those practices were perfectly legal, now I'm not an attorney but I do know right from wrong and I think it is wrong, Mr. Chairman, that oil companies are intentionally price gouging consumers in the United States today and I think that Congress has many tools at its disposal to help address this crisis.

Unfortunately, none of those tools are included in the energy bill which has been championed by many in Congress and by the current administration. That's because the current energy bill has zero chapters or portions of it that address industry consolidation. In fact, the energy bill as crafted by Congress would make matters worse by repealing the Public Utility Holding Company Act which is one of the Federal Government's most effective structural regulations over the energy industry, and if the energy bill became law, companies like ExxonMobil freed from PUHCA's restrictions would be able to acquire electric utilities, natural gas utilities, and other electric assets that are currently regulated by PUHCA.

If we are experiencing damaging levels of concentration within the domestic refining sector, just imagine what would happen if PUHCA was repealed and the same companies with a stranglehold over gasoline markets were allowed to engage in that kind of behavior in our electricity and natural gas markets as well.

The solutions that Public Citizen's advocates that are unfortunately not included in the energy bill would be to mandate minimum storage requirements. One of the key problems that I found and Federal investigations have found is that financial incentives exist in today's uncompetitive gasoline markets for companies to restrict capacity. The FTC clearly found that the inelasticity of some of these reformulated blend requirements in certain markets make it very easy for these companies to unilaterally withhold gasoline.

If an entity is unilaterally withholding, that is clear evidence of uncompetitive market. A solution would be to have mandated storage requirements that the government could also order its release and that would take away the financial incentive of these companies to engage in these manipulative behaviors.

Another option would be to launch a serious multi-agency investigation of these anticompetitive practices and possibly a comprehensive review of recent mergers that have been approved and whether or not those recent mergers have indeed resulted in these anticompetitive practices.

There are other solutions as well. We could implement fuel-economy standards that would reduce our demand. The United States uses 25 percent of the world's oil and we can also improve our management of the Strategic Petroleum Reserve by ceasing filling it. We're already at 92 percent capacity. Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Slocum follows:]

Buyers Up • Congress Watch • Energy Program • Global Trade Watch • Health Research Group • Litigation Group
Joan Claybrook, President

May 28, 2004

Testimony of Tyson Slocum, Research Director Public Citizen's Energy Program

Before the Subcommittee on Energy Policy, Natural Resources and Regulatory Affairs of the U.S. House of Representatives' Committee on Government Reform

"Easing Pain at the Gasoline Pump: Finding Solutions for Western Woes"

Thank you, Mr. Chairman and members of the House Subcommittee on Energy Policy, Natural Resources and Regulatory Affairs for the opportunity to testify on the issue of gasoline prices. My name is Tyson Slocum and I am Research Director of Public Citizen's Energy Program. Public Citizen is a 30-year old public interest organization with over 125,000 members nationwide. We represent consumer interests through research, public education and grassroots organizing.

We were the first national consumer group to show that the California electricity crisis of 2000-01 was the fault of market manipulation by a handful of companies, and that state and federal environmental regulations had nothing to do with the crisis.

More recently, we released *Mergers, Manipulation and Mirages: How Oil Companies Keep Gasoline Prices High, and Why the Energy Bill Doesn't Help* which documents, among other things, how recent mergers in the domestic oil refining industry have consolidated control over gasoline, making it easier for a handful of companies to price-gouge consumers. This price-gouging has not only been officially documented, but it is also evident in the record profits enjoyed by large oil companies. Since 2001, the five largest oil companies operating in America have recorded $125 *billion* in after-tax profits. It is uncompetitive practices—not OPEC or environmental laws—that are to blame for high gasoline prices.

Congress can remedy this price-gouging by taking two broad actions. First would limit the financial incentives oil companies have to keep gasoline supplies artificially tight by mandating minimum storage of gasoline, reevaluating recent mergers, investigating

anti-competitive practices, and re-regulating oil trading. Second would be to increase domestic oil supplies by improving fuel economy standards and to temporarily cease filling the Strategic Petroleum Reserve.

Gas prices in the Western U.S. are currently more than 10% higher than the national average. Consumers are paying more in the west than elsewhere because oil companies are exploiting the inelastic supply created by RFG blends to engage in anti-competitive behavior. Is the solution, then, to rid the market of the clean-burning fuel requirements, or to rid the market of manipulation practices? Public Citizen believes that we must begin by doing all we can to hold oil companies accountable and stop them from engaging in anti-competitive behavior.

Recent Mergers Create Uncompetitive Markets

Over the past few years, mergers between giant oil companies—Exxon and Mobil, Chevron and Texaco, Conoco and Phillips, just to name a few—have resulted in just a few companies controlling a significant amount of America's gasoline, squelching competition. A number of independent refineries have been closed, some due to uncompetitive actions by larger oil companies, further restricting capacity. As a result, consumers are paying more at the pump *than they would if they had access to competitive markets* and five oil companies are reaping some of the largest profits in history.

Although the U.S. is the third largest oil producing nation in the world, we consume 25% of the world's oil every day, forcing us to import oil. Domestic sources of oil (nearly 30% of our domestic oil is produced in Alaska and California, and three-quarters of our domestic oil comes from Alaska, California, Texas and the Gulf of Mexico) provide 37% of our daily crude oil needs. Middle Eastern OPEC nations supply only 15% of our total crude oil needs, and non-OPEC nations—such as Canada, Mexico, Norway and England—provide 34% of our daily oil.

All of the large oil companies, such as ExxonMobil and ChevronTexaco, have financial dealings with Middle East OPEC nations. ExxonMobil obtains more than a quarter of its oil from Middle East OPEC nations; ChevronTexaco more than 40%.

While our reliance on imported oil overall has increased, from 43% in 1989 to 63% in 2003, the consolidation of downstream assets—particularly refineries—play a bigger role in determining the price of a gallon of gas. Recent mergers joined vertically integrated companies owning significant market shares of exploration, production, refining, and marketing of oil and gas. As a result, just five companies now control 48% of domestic crude oil production, 50.3% of domestic refining capacity, and 61.8% of the domestic retail gasoline market. These mega-companies are major international producers, controlling 14.2% of global oil production.

In 1993, the five largest oil companies operating in the U.S. controlled one third (34.5%) of
domestic oil refinery capacity; the top ten companies controlled 55.6%.

In just ten years, because of mergers, the largest five oil companies now control half (50.3%) of domestic oil refinery capacity, while the top ten control 78.5%. This dramatic increase in the control of just the top five companies—from one third of capacity in 1993 to one half of capacity in 2003—makes it easier for oil companies to manipulate gasoline by intentionally withholding supplies in order to drive up prices. Because the largest companies are vertically integrated, in addition to their control over refining capacity, they enjoy significant market share in oil drilling and retail sales.

The proof is in the numbers. The domestic gasoline spread—the price of a gallon of gas, minus the cost of crude oil and taxes—has increased by 30% from the mid-1990s to 2004. The domestic spread measures the share of a gallon of gas charged by refiners and marketers. In the mid-to late-1990s, the domestic spread averaged 39 cents per gallon. But during the post-merger period from 2000-04, the average domestic spread has been 51 cents. This translates to an increase in U.S. gasoline prices of $55 billion, the amount by which U.S. consumers have been price-gouged. It is no coincidence that oil corporation profits—including refining—are enjoying record highs.

Consumer advocates like Public Citizen aren't the only ones saying this. In March 2001, the U.S. Federal Trade Commission concluded in its *Midwest Gasoline Price Investigation*:

The completed [FTC] investigation uncovered no evidence of collusion or any other antitrust violation. In fact, the varying responses of industry participants to the [gasoline] price spike suggests that the firms were engaged in individual, not coordinated, conduct. Prices rose both because of factors beyond the industry's immediate control and because of conscious (but independent) choices by industry participants...each industry participant acted unilaterally and followed individual profit-maximization strategies...It is not the purpose of this report - with the benefit of hindsight - to criticize the choices made by the industry participants. Nonetheless, a significant part of the supply reduction was caused by the investment decisions of three firms...One firm increased its summer-grade RFG [reformulated gasoline] production substantially and, as a result, had excess supplies of RFG available and had additional capacity to produce more RFG at the time of the price spike. This firm did sell off some inventoried RFG, but it limited its response because selling extra supply would have pushed down prices and thereby reduced the profitability of its existing RFG sales. ***An executive of this company made clear that he would rather sell less gasoline and earn a higher margin on each gallon sold than sell more gasoline and earn a lower margin. Another employee of this firm raised concerns about oversupplying the market and thereby reducing the high market prices. A decision to limit supply does not violate the antitrust laws, absent some agreement among firms. Firms that withheld or delayed shipping additional supply in the face of a price spike did not violate the antitrust laws. In each instance, the firms chose strategies they thought would maximize their profits.***

Although federal investigators found ample evidence of oil companies intentionally withholding supplies from the market in the summer of 2000, the government has not taken any action to prevent recurrence. Since the report's release, two additional mergers, ChevronTexaco and ConocoPhillips, have been approved.

Requiring oil companies to increase the size of their storage capacities, mandating them to hold significant amounts of product in that storage, and reserving the right to order these companies to release this stored oil and gas would significantly limit the ability of oil companies to intentionally withhold gasoline to raise prices.

A congressional investigation uncovered internal memos written by major oil companies operating in the U.S. discussing their successful strategies to maximize profits by forcing independent refineries out of business, resulting in tighter refinery capacity. From 1995-2002, 97% of the more than 920,000 barrels of oil per day of capacity that has been shut down were owned by smaller, independent refiners. Were this capacity to be in operation today, refiners could use it to better meet today's reformulated gasoline blend needs.

In California, independently-owned refinery capacity of 100,000 barrels of oil per day has been shut down since 1995, even though they were relatively new. The Coastal Corporation's 50,000 barrels of oil per day Pacific refinery 25 miles north of San Francisco was shut down in 1997, despite the fact it was only 29 years old. Castle Energy's 46,500 barrels of oil per day Powerine refinery 12 miles southeast of Los Angeles was shut down in 1995, although it was less than a decade old. Castle Energy's CEO at the time, Joseph Sparano, told *The San Francisco Examiner* in June 1995 that "operating as a small, independent refinery in California has been very difficult because of the competition and poor refining economics."

An internal Mobil document helps explain why independent refineries like Powerine had such a tough time. The Mobil document highlights the connection between an independent refiner producing CARB (cleaner burning California Air Resources Board) gasoline, the lower price of gasoline that would result from the refinery being in operation, and the need to prevent the independent refiner from operating:

If Powerine re-starts and gets the small refiner exemption, I believe the CARB market premium will be impacted. Could be as much as 2-3 cpg (cents per gallon)...The re-start of Powerine, which results in 20-25 TBD (thousand barrels per day) of gasoline supply...could...effectively set the CARB premium a couple of cpg lower...Needless to say, we would all like to see Powerine stay down. Full court press is warranted in this case.

As a result of uncompetitive practices, made easier by the wave of mergers, three-quarters of the refinery capacity in California-Arizona-Nevada is controlled by the five largest oil companies operating in the United States (ExxonMobil, ChevronTexaco, ConocoPhillips, BP and Shell). When the 20% share controlled by the large

independents Valero and Tesoro is included, only seven percent of the refinery capacity is owned by "true" independent, smaller refineries.

Precedent exists for oil companies manipulating energy supplies in order to price-gouge consumers. In July 2003, a subsidiary of oil giant BP agreed to pay $3 million to settle allegations brought by the Federal Energy Regulatory Commission that the company "manipulated electricity prices" in California. In March 2004, a subsidiary of Royal Dutch/Shell agreed to a preliminary payment of $7.8 million to FERC to settle allegations the company manipulated supplies and prices of power in California.

FTC Not Adequately Protecting Consumers

At the same time that the FTC concludes that refining markets are uncompetitive, the agency consistently allows refining capacity to be controlled by fewer hands, allowing companies to keep most of their refining assets when they merge, as a recent overview of FTC-approved mergers demonstrates.

The major condition demanded by the FTC for approval of the August 2002 ConocoPhillips
merger was that the company had to sell two of its refineries—representing less than 4% of its domestic refining capacity. Phillips was required only to sell a Utah refinery, and Conoco had to sell a Colorado refinery. But even with this forced sale, ConocoPhillips remains by far the largest domestic refiner, controlling refineries with capacity exceeding 2.2 million barrels of oil per day—or more than 13% of America's entire capacity.

The major condition the FTC set when approving the October 2001 ChevronTexaco merger was that Texaco had to sell its shares in two of its joint refining and marketing enterprises (Equilon and Motiva). Prior to the merger, Texaco had a 44% stake in Equilon, with Shell owning the rest; Texaco owned 31% of Motiva, with the national oil company of Saudi Arabia (Saudi Aramco) also owning 31%, and Royal Dutch Shell owning the remaining 38%. The FTC allowed Shell to purchase 100% of Equilon, and Shell and Saudi Aramco bought out Texaco's share of Motiva, leaving Motiva a 50-50 venture between Shell and Saudi Aramco.

Prior to the merger, Texaco's share of Equilon and Motiva refinery capacity equaled more than 500,000 barrels of oil per day—which was simply scooped up by another member of the elite top five companies, Shell. Had the FTC forced Texaco to sell its share to a smaller, independent company, the stranglehold by the nation's largest oil companies could have been weakened.

As a condition of the 1999 merger creating ExxonMobil, Exxon had to sell some of its gas retail stations in the Northeast U.S. and a single oil refinery in California. Valero Energy, the nation's fifth largest owner of oil refineries, purchased these assets. So, just as with the ChevronTexaco merger, the inadequacy of the forced divestiture mandated by the FTC was compounded by the fact that the assets were simply transferred to another large oil company, ensuring that the consolidation of the largest companies remained high.

The sale of the Golden Eagle refinery was ordered by the FTC as a condition of Valero's purchase of Ultramar Diamond Shamrock in 2001. Just as with ExxonMobil and ChevronTexaco, Valero sold the refinery, along with 70 retail gas stations, to another large
company, Tesoro. But while the FTC forced Valero to sell one of its four California refineries, the agency allowed the company to purchase Orion Refining's only refinery in July 2003. This acquisition of Orion's Louisiana refinery defeats the original intent of the FTC's order for Valero to divest one of its California refineries.

Over-the-Counter Energy Disclosure is Underegulated

Contracts representing hundreds of millions of barrels of oil are traded every day on the London and New York trading exchanges. An increasing share of this trading, however, has been moving off regulated exchanges such as the New York Mercantile Exchange (NYMEX) and into unregulated Over-the-Counter (OTC) exchanges. Traders operating on exchanges like NYMEX are required to disclose significant detail of their trades to federal regulators. But traders in OTC exchanges are not required to disclose such information allowing companies like Enron, ExxonMobil, and Goldman Sachs to escape federal oversight and more easily engage in manipulation strategies.

A recent congressional investigation concluded that "crude oil prices are affected by trading not only on regulated exchanges like the NYMEX, but also on unregulated OTC markets that have become major trading centers for energy contracts and derivatives. The lack of information on prices and large positions in OTC markets makes it difficult in many instances, if not impossible in practice, to determine whether traders have manipulated crude oil prices."

Public Citizen has supported efforts to re-regulate energy trading by subjecting OTC markets to tougher oversight. But the latest such effort, an amendment to the energy bill, was rejected by the Senate by a vote of 55-44 in June 2003.

Raise Fuel Economy Standards to Lower Our Oil Consumption

Due to increasing numbers of gas-guzzling SUVs on America's roads and the absence of meaningful increases in government-set fuel economy standards, America's fuel economy standards are lower today than a decade ago.

In April, the Environmental Protection Agency found that the average fuel economy of 2004 vehicles is 20.8 miles per gallon (mpg), compared to 22.1 mpg in 1987—a six percent decline. This decline is attributable to the fact that fuel economy standards haven't been meaningfully increased since the 1980s. And sales of fuel inefficient SUVs and pickups has exploded: in 1987, 28% of new vehicles sold were light trucks, compared to 48% in 2004.

Billions of gallons of oil could be saved if significant fuel economy increases were mandated. Improving fuel economy standards for passenger vehicles from 27.5 to 40 mpg, and for light trucks (including SUVs and vans) from 20.7 to 27.5 mpg by 2015 would reduce our gasoline consumption by one-third.

Dramatic reductions in consumption will not only reduce strain on America's refinery output, but also on Americans' pocketbooks. Comparing two Americans with identical driving habits, one driving an SUV and one a regular passenger car, reveals that the person driving the passenger car saves $510 a year due to the superior fuel economy of passenger cars compared to light trucks.

Increase Domestic Supply Through Proper Management of the Strategic Petroleum Reserve

The purpose of the SPR is to "store petroleum to reduce the adverse economic impact of a major petroleum supply interruption to the United States." Federal law further states that the reserves can be tapped if the "President has found drawdown and sale are required by a severe energy supply interruption." A "severe energy supply interruption shall be deemed to exist if the President determines that an emergency situation exists and there is a significant reduction in supply which is of significant scope and duration; a severe increase in the price of petroleum products has resulted from such emergency situation; and such price increase is likely to cause a major adverse impact on the national economy." Previous presidents, such as Bill Clinton, have interpreted domestic price spikes like the ones the U.S. is now experiencing as satisfying the criteria to release reserves. In September 2000, President Clinton authorized the release of 30 million barrels of oil, which resulted in gasoline prices dropping 10% in six months.

At the same time that industry consolidation is limiting competition in the domestic production and refining sectors, the Bush administration has exacerbated domestic supply shortages through its mismanagement of the SPR. After September 11, 2001, the administration set a priority of filling the 700 million SPR to capacity. While the goal is

laudable, the administration has aggressively purchased oil from the market for delivery into the SPR regardless of the market price. To reach the goal, President Bush has been removing more than 100,000 barrels of oil every day from the domestic market, increasing the amount stored from 541 million barrels at the end of Clinton's term (77% capacity) to 650 million barrels today (more than 92% capacity). While previous administrations have typically filled the SPR only at times when oil prices were low and domestic supplies in surplus, President Bush has been filling it at times when prices are above $30/barrel and domestic supplies are tight. Moving so much oil out of an expensive, tight market
has made oil even more expensive here at home—a boon for oil company profits but a bust for consumers. As a result, Bush's policy is actually undermining the goals of the SPR.

If all Middle Eastern members of OPEC were to cease exports to the U.S., we could rely on the SPR, at current levels, to supply enough oil to the U.S. market for nearly 300 days. This is more than enough of a buffer to protect national security in the event of an oil embargo by nations most likely to carry out such an action.

Public Citizen agrees with Texas Republican Joe Barton, chairman of the House Energy and Commerce Committee, who earlier this month supported our position that President Bush should cease filling the SPR.

When the Senate passed a non-binding resolution by a vote of 52-43 buried as an amendment to unrelated legislation on March 11, 2004, mandating that President Bush merely stop filling the SPR, Wall Street speculators immediately drove down the price of crude oil 1.6%.

Federal Energy Bill Does Nothing to Address Overconcentration or Conservation

Contrary to recent statements by congressional leaders and Executive Branch officials, the
stalled energy bill will do nothing to reduce high prices of gasoline because it fails to either improve regulations of an oil industry that is over-concentrated or rein in demand by adopting tougher fuel economy standards. Instead, the legislation proposes just what the industry wants—giving billions of the taxpayers' dollars to large oil companies in the form of subsidies and tax breaks with no real conservation requirement.

The Bush administration's own analysis (*Summary Impacts of Modeled Provisions of the 2003 Conference Energy Bill*) concludes that the legislation's billions of dollars in incentives will have only a negligible success reducing our reliance on foreign sources of oil. The Bush administration report concludes that implementation of the energy bill

would reduce net petroleum imports only by 100,000 barrels of oil per day by 2010—a reduction equal to the amount of oil the Bush Administration removes from the market each day to place in the SPR.

Further, the energy bill would actually lead to increased concentration in the U.S. energy
industry by repealing the Public Utility Holding Company Act (PUHCA). PUHCA prevents
large, non-utility companies from controlling utilities without first divesting their nonutility businesses. If PUHCA is repealed, oil companies could also acquire electric and natural gas utilities, further consolidating economic control over the domestic energy industry..

Conclusion

The most effective way to protect consumers is to restore competitive markets is for Congress to adopt the following five proposals:

- Require oil companies to increase the size of their storage capacities, mandate them to hold significant amounts of product in that storage, and reserve the right to order these companies to release this stored oil and gas in order to address supply and demand fluctuations.

- Document how recent mergers have made it easier for large oil companies to engage in uncompetitive practices, and take concrete steps—including forced divesture of assets to independent companies - to remedy the problem of too few companies controlling too much of the market.

- Restore transparency to energy futures markets by re-regulating Over-the-Counter exchanges.

- Cease filling the SPR until oil prices fall below $30 per barrel.

- Reduce America's oil consumption by improving fuel economy standards.

Mr. OSE. Thank you for joining us today. We appreciate your testimony. Gentleman from Nevada.

Mr. PORTER. Thank you, Mr. Chairman. I guess I have a couple questions but first, Mr. Slocum.

Mr. SLOCUM. Yes.

Mr. PORTER. Regarding investigations, who else should be doing the investigations? You may have said it. I was trying to read your testimony as you were speaking, but is there some other steps we should be taking in that.

Mr. SLOCUM. I did not mention specific agencies. I think that getting all of the various antitrust entities such as the Department of Justice involved in this review of specific mergers, and in my written testimony that I've submitted to you, sir, I go through some of the problems where the Federal Trade Commission did not place adequate conditions on the approval of mergers. They allowed these companies, for example, when you merge fully vertically integrated entities like ExxonMobil or Chevron and Texaco to merge they were allowed to retain much of their downstream assets, and that as also concluded by the General Accounting Office they have found that has directly led to overconcentration of this industry which is leading to anticompetitive practices.

Mr. PORTER. Thank you. Regarding travel to Las Vegas, I guess this is an AAA question, you know this weekend begins one of the most popular weekends and moving into the season of tour and travel. At what point do you think the gas prices are going to keep people home?

Mr. COMEY. Right now they are not detering people from traveling. We're actually predicting a more robust travel season this year than we've seen since 2001. Despite the high gas prices, people are still traveling in large numbers. How long that will continue is uncertain. Our survey suggests that some people are adjusting their travel plans, taking shorter vacations closer to home. It doesn't seem to be adversely affecting tourist-dependent economies at this point.

The problem seems to be that these periods of unpleasantness with regards to high gas prices don't last long enough to really have a significant impact in terms of changing people's behavior. They kind of soldier on, they grumble at the gas pump, they go anyway. Whether or not that continues into the future is very uncertain. With global demand, particularly from China increasing, we may not have seen the end to these high prices.

The short answer is we don't exactly know when it will start undercutting economies like it does in Las Vegas. At the present time it does not.

Mr. PORTER. Do you track also the airline industry impact or I know you're an automobile association.

Mr. COMEY. I read press accounts and that sort of thing, but we don't do any independent research in regard to the airline industry. The airline industry seems to be reluctant to pass along the added fuel costs for competitive reasons, but people seem to be traveling by air in larger numbers than they have in the last couple years.

Mr. PORTER. For the balance of the panel, what I'm asked every day is what we can do today. I know we touched upon some things with the automobile efficiency, getting it repaired, serviced, tires,

6, 7 percent savings I think, Mr. Hackett, you mentioned that. Some other things people can do today to help with the problem. I know we're looking at some long-term solutions but what about some quick short-term fixes. Any suggestions?

Mr. COMEY. One of the main things, the suggestions that you referenced with regard to keeping your car in proper operating order, not accelerating rapidly, driving the speed limit, those are things that people might have heard. I try to focus on things that maybe they haven't heard of.

One of the biggest waste is buying higher octane fuel than you need. Fewer than 10 percent of the cars on the road actually require high octane fuel and consumers purchase between mid-grade and premium fuel up to 30 percent, that represents up to 30 percent of fuel purchases. It's less now with high prices. It's down to around 20 percent. But, if your car's manufacturer and the owner's manual does not specifically require you to use high octane fuel then you shouldn't buy it because you're just wasting your money.

People often will buy premium or mid-grade fuel in belief they can enhance engine performance, increase the life span of their vehicle. It's just not the case. You're not getting any value for your money if you're overbuying on premium fuel.

Tire pressure inflation I think is something that can have a big impact. For every pound of pressure that your tires are underinflated you can lose up to 2 percent of your fuel economy. A lot of people judge whether or not their tires are properly inflated based on looking at them. You can easily be off by 5 pounds and your tires would still work just fine, so that could be 10 percent of your gas mileage right there. People who are reluctant to use tire pressure gauge are probably also reluctant to change their own oil. So an easy way to get it checked is to make sure they do that when they change the oil. It is supposed to be part of the service. Sometimes they neglect to do it.

Also taking stuff out of your trunk. A lot of us use our trunks as mobile storage facilities. While it doesn't have a huge impact on gas mileage it does add up over time. Could be up to an extra tank during the course of a year. If a tank of gas costs $40, $50, do you really want to buy an extra one? Those would be the suggestions that we've been giving to consumers as some way they can combat this.

Also we encourage consumers to shop aggressively for lowest price on gasoline. Many of us may have chosen a gas station at one time because it had the lowest price but because prices fluctuate so much the cheapest station today could be the most expensive next week.

So, what AAA encourages people to do is just pay attention to the posted prices of gasoline as they're driving throughout their normal routine. That way they know what a fair price is once they have to fill up. It doesn't make sense to drive all the way across town to save a couple pennies on gas, although I have talked to consumers who are so bent out of shape about this issue that they will do that. It does pay to find a station that offers the best value and is equally convenient to the one you normally shop at.

I have told people who want to go the extra step further that if they politely discuss this with the station owner by saying, look,

your prices are out of line and I normally shop here but I'm going to go to your competition, I'll keep my eye on your price if you lower it, I'll be back, this is also a way for the consumers to use their dollars to send a message.

Mr. PORTER. Mr. Sparano, unless you have a——

Mr. SPARANO. I think Mr. Comey's comments are well taken. I think it's important for people to know that in the United States there are 160,000 service stations. In Nevada there are 1,008 as of last look. California has about 9,500. People do have a choice. It's a very competitive industry.

In California, according to the Lundberg survey, 10 percent of those 9,500 stations are owned and operated, that is with salaried employees, by the major corporations, some of which were mentioned earlier. The other 90 percent are either owned or leased by independent business people who are involved in making a living, and recently we saw an e-mail that floated around challenging folks to boycott stations. That just hurts the independent owner.

I think people can exercise their choice. They shouldn't drive too far as was suggested. They should do all the things that represent efficiency. But, this problem didn't start last week or last year or in 1999. It started 30 plus years ago when we stopped building refineries. We stopped building infrastructure.

The U.S. production of crude went from 10 million barrels a day to 5½ million barrels a day. The use of products in this country is now 20½ million barrels a day. We import as you mentioned earlier, Congressman, almost 63 percent. Twelve and a half million barrels a day. Ten of crude, two and a half of product comes from somebody else's refineries and production fields.

Those issues are important for us to focus on and they'll require longer term fixes. I think the AAA representative hit it right on the head when he talked about the kind of things that folks can do day in and day out.

Mr. PORTER. Mr. Hackett.

Mr. HACKETT. I can't add to the list.

Mr. PORTER. Mr. Slocum.

Mr. SLOCUM. I would respectfully challenge the contention that inadequate refinery capacity has been built. It's true that no new refineries have been built in a little while but we've got internal company documents that were turned up by a Senator from Oregon, Senator Ron Wyden, in a recent report that discusses explicit strategies by large refiners to muscle smaller independents out of the market.

For example, Castle Energy owned and operated a refinery just outside of Los Angeles called the Powerine refinery and it shut down in 1995 and at the time the CEO told the San Francisco Examiner that, "operating as a small independent refinery in California has been very difficult because of the competition and poor refining economics."

Now, at the same time, Senator Ron Wyden had in his possession an internal communication from the Mobil Corp., which is now part of ExxonMobil which states, "if Powerine restarts and gets the small refiner exemption, I believe the CARB market," which is the California—the cleaner burning California Air Resources Board gasoline blend, "I believe the CARB market premium will be im-

pacted. Could be as much as 2 to 3 cents per gallon. The restart of Powerine, which results in 20,000 to 25,000 barrels per day of gasoline supply, could effectively set the CARB premium a couple of cents per gallon lower. Needless to say, we would all like to see Powerine stay down. Full court press is warranted in this one."

That is an indication to me of some fairly aggressive tactics by larger companies using their dominance of the market to muscle smaller independents to intentionally restrict supplies so that they and not the market determine how much gasoline is available to consumers.

Mr. PORTER. I've got one more question.

Mr. OSE. Yield for one moment?

Mr. PORTER. Yes.

Mr. OSE. Because we have the person who actually ran the Powerine. Do you care to add to this.

Mr. SPARANO. Congressman, thank you. That has been misreported. I was chairman, CEO of Pacific Refining Co., an equally small independent refiner that was shut down in 1995. I can assure you after 35 years in this business that's not the way it operates. This country has lost 1.8 million barrels a day of refining capacity, not 10,000 barrels, not 180,000 which is a good size refinery. 1.8 million barrels a day since the mid-1980's.

I don't know where the report came from. I do know the FTC, the EIA, the CEC, the attorney general of the State of California on repeated occasions have examined the kind of allegations that are being made by the Citizen's group and have found no wrongdoing, not just no wrongdoing, nothing illegal, no collusion, no market manipulation.

So, as a head of a refining operation I will share with you that Pacific Refining in 1995 shut down because it spent 5 years and millions of dollars trying to get permits just to make CARB gasoline, not to expand, not to grow bigger, not to put someone else out of business; to make the gasoline that the State required.

We had tremendous amounts of resistance, influence by government officials to not proceed with our project despite the lack of belief that we would ever accomplish our task we did in fact get the permits and the partners who happened at the time to be a Texas corporation and a foreign national oil company, Peoples Republic of China specifically, they decided they weren't having much fun in this industry and they closed down the plant. I had to personally layoff 220 people.

I did examine as part of a team the Powerine refinery because one of our thoughts was if we could combine with Powerine we might be able to keep our plant open and keep all those people in business in both plants. It wasn't a very good operation. It didn't have the tools to be competitive. That's the fact.

Mr. OSE. I thank the gentleman for yielding.

Mr. PORTER. Thank you. Close to home, again, Bakersfield, what will happen, once it's shut down, to Nevada?

Mr. SPARANO. Shell has made a decision to shut down that refinery. They indicated that they are in a position where valley heavy crudes have been produced for probably 100 plus years. They don't have access to the kind of heavy crudes that make that refinery economic. It's been reported that it made money in the last 4 of 6

years. People have tossed around internal documents. The refinery made, according to Shell, $14 million in a 6 year period. That's not exactly what I would call excess profits.

The plant is older. It requires upgrades. It is a very difficult environment. Shell has indicated they will supply all of their contract customers with both gasoline and diesel. Where they get it is not certain. What happens in the marketplace I cannot predict whether others step in to fill the void or not.

The closure of that refinery which produces 2 percent of the gasoline for the State of California and 6 percent of the diesel may or may not have an impact. It's too early to tell. I'm sure that others will have the opportunity to fill the capacity when it leaves the marketplace.

Mr. PORTER. Thank you.

Mr. OSE. Thank you. The gentleman from Massachusetts.

Mr. TIERNEY. Thank you very much.

Mr. Sparano, I do think you'll agree these are business decisions, not building refineries. Government didn't decide to stop having refineries built.

Mr. SPARANO. I disagree.

Mr. TIERNEY. Can you point me to something that said the government came out and said we're not going to——

Mr. SPARANO. No, sir. It's not that——

Mr. TIERNEY. You want to tell me how it's all the regulations and all that, right.

Mr. SPARANO. No. If you were to build a new refinery today in the State of California, and you built a small one, 100,000 barrels——

Mr. TIERNEY. Let's talk about keeping the ones open that were open.

Mr. SPARANO. I'd like to answer your question.

Mr. TIERNEY. First of all—in fact, I've been through these hearings before. I've had other members from organizations like yours that tell us how it's the environmental regulations that is shutting them down. In fact, I sat through one hearing, we haven't built a new refinery, got a new permit for new refinery since God knows when. Only to find out from the administrator for the EPA said they haven't asked for any.

The fact, if you're not seeking any, you're not likely to get them. If you want to expand as you indicated was your thing and you did get your permit and then there is a business decision made to shut it down anyway, that's not the government.

From 1995 to 2002, 97 percent of the more than 920,000 barrels of oil per day of capacity that have been shut down were owned by smaller independent refiners. They either decided to shut down or they were squeezed out of the market, one or the other. I can assure you that you can't come up with an instance where the government ordered them to shut down.

Mr. SPARANO. I think we're almost playing with the chicken and the egg here. Who produced the regulations? It is the response or lack of the ability——

Mr. TIERNEY. You believe the regulations made them shut down.

Mr. SPARANO. If you run a refinery, as I have done in my career on more than one occasion, you face a myriad of costs. They're in

the millions of dollars. Those costs in large part are constituted by regulatory requirements of some sort. For example, in California——

Mr. TIERNEY. Some of the cost is.

Mr. SPARANO. I said in some respects they're made up of environmental costs. In California, between 1990 and 1995, refiners spent $5 billion. Someone said earlier that the industry doesn't reinvest its profits. $5 billion in a 5 year period, another billion to make clean diesel. Not to make extra product. To make clean diesel.

Regulations exist on the local level, on the county level, on the local air and water district level, on the State level and on the Federal level and they are multilayered. They are duplicative. They are very expensive to meet. You're correct, many of the refiners that shut down in the period you described, Congressman Tierney, were as a result of people not having the money to reinvest. That's a business decision.

Mr. TIERNEY. You say it's not having money. The profit in this industry has been phenomenal since 1997, 1998, 1999, 2001. It dipped a little in 2002 and then it went back up again. It's incredibly profitable again now. So the question is how much money is enough for these people to make a business decision to shut it down. If your profits are 50 percent higher than they were the year before, you decide it's not enough, you shut it down, it's not the government or its regulations shutting it down.

Now, let me just ask Mr. Hackett for a second. You talked about filling your tires. Mr. Comey, you talked about taking things out of your trunk. The fact is about 180,000 barrels a day that are being saved if people fill their tires. Right now the President continues to buy about 107,000 barrels a day for the reserves. If he just stopped buying that for the time being because the price is up so high, what impact would that have on the market? Would it send a message to people that the White House is serious about the supply? Would it have an impact.

Mr. HACKETT. As near as we can tell. Major impact would be the signal it would send. Volume is not very big on an overall basis. So that physically might not have a lot of impact on the market but it certainly does send a signal.

Mr. TIERNEY. Now, when we talk about the price at the pump is there any ability to defend that unbranded is going to be less expensive than branded supplies? Does anybody know that?

Mr. COMEY. Independent stations tend to be more competitive when there is a lot of supply because they buy on what's called the spot market meaning the stations that are affiliated with a large corporation get under contract the gasoline first and that price might be higher than the market price would set when supplies are good. When supplies are down, independent stations tend to be less competitive because they may be paying more on the spot market and the contracted stations that are part of the big chains may have actually a better deal.

It just goes to show you that shopping around is important. The independent station that had good value last year when you decided that was your gas station might be more expensive. So, it varies depending on what the supply situation is.

Mr. TIERNEY. Would independent refineries be more inclined to sell to the nonbranded?

Mr. COMEY. I'm not sure if I can answer that question.

Mr. SPARANO. Any independent refiners, some of those are independent refiners in that they are not associated with the bigger companies that have been mentioned but they have retail operations of their own. Both independent refiners and major refiners have segments of their production that may be sold to the independent gasoline stations.

I think there is an important point that I would like to share with you about concentration of stations. Another factor about where you might find the cheapest gas and whether it's an independent station flying independent flag or independently-owned station flying someone's brand or branded station, if you have 25 service stations in a 5 square mile area you're going to have a heck of a lot of competition. They're all going to be vying for the same motorists, having to meet the same amount of volumetric demand. If you have four or five stations in that same 5 square mile area they won't be nearly as competitive.

California is a wonderful example of that. Again, according to Lundberg, in Los Angeles there are almost 2,000 stations. In San Diego there are 700 and in San Francisco there is 130. That makes a big difference in terms of local pricing practices and the availability of affordable product to the local consumers.

Mr. TIERNEY. Same would be true with refineries, if you have fewer of those then the prices will also be expected to be impacted by that.

Mr. SPARANO. Prices are governed by local markets. Prices are an issue of supply and demand. I can't argue with the fact that we are barely meeting the demand requirements but that's because supply is increased, as Mr. Keese said earlier, at half a percent a year and demand is currently growing this year 5 percent more than the same period last year. That's a function of people's driving habits, where they drive, how much they drive and what they drive.

Mr. TIERNEY. You're not going to tell me the lack of refinery capacity has no impact on this.

Mr. SPARANO. I'm saying the lack of the ability of the refiners to construct more capacity and the restraints caused by the permit system, other local constraints and just the sheer cost of building all have influence.

Mr. TIERNEY. Just so I get it on the record because I read to you the RAND report, Public Citizen's report talked about General Accounting Office report; we've talked about consumer reports, had testimony of Mr. Wyden's committee on this. Are you saying to me, sir, that the only reason that these places shut down, those refineries which have been extraordinary number shut down not because of business decision but it's all because of government regulation?

Mr. SPARANO. No, I didn't say that, nor am I saying that.

Mr. TIERNEY. You would agree with me to some degree it's a business decision to shut these down?

Mr. SPARANO. I guess I would take it a step further. It's always a business decision. It's what causes the business decision to occur that's what's important.

Mr. TIERNEY. We lost 100 or more refineries from 1980 to 1983. Over 50 from 1990 on, over 20 since 1995. We lost two-thirds of the firms engaged in refinery business in the United States from 1980 to 2000. You think the primary culprit here is regulation?

Mr. SPARANO. I think the overwhelming number of regulations and the cost to meet those regulations, to buy land, to keep land, to pay taxes on land all have had influence over this. There were 301 refineries in the mid-eighties. There are 149 now. I closed one of them down personally so I feel this perhaps more than——

Mr. TIERNEY. I think you do. Step outside that one experience for a moment. This happened about the same time all the consolidations was happening in the market. Companies are gobbling each other up. We're ending up now with five companies essentially owning half of the capacity around here. You don't think there is any possibility these companies deciding this is a good thing to decrease, especially when we have all these internal memos coming from people telling us they have strategies to decrease the amount so they can increase their prices.

Mr. SPARANO. I'd like to make a couple of observations. First and foremost, there have been 29 investigations in the last 20 years that have said there is nothing illegal going on. Including not just the FTC that is responsible for making determinations but the attorneys general for the States.

Mr. TIERNEY. That's a nicety. I agree with you none of those reports have found there is collusion or other antitrust violations. What I'm saying to you is the high concentrations right now is you don't have to be a monopoly. You don't have to be violating antitrust to be able to have such a concentration in your particular region, whatever, that you can decide what you're going to do without being in fear of a competitor coming in and doing something else.

Again, I go right back to the finding that the FTC made. In addition to finding that there was no antitrust violation, it specifically found that the choices by industry participants, each industry participant acted unilaterally and followed individual profit-maximization strategies, that's essentially what it did. The firm did sell off some of its RFG. Didn't sell the rest, want to buy when the price is up. Executive of the company made clear that he would rather sell less gasoline and earn a higher margin on each gallon sold than sell more gasoline and earn a lower margin. That may not be illegal but as a matter of public policy I'm not sure it's good for this country's energy needs and the things people need.

I'm not trying to argue that your firm is out there breaking the law. I may be making the argument they are making business decisions for their shareholders which they believe is their obligation to do and that as public policy we may not have been doing what we can do to make sure that enough of the supply got out to where it had to be, the prices were in the range of where it should be and they had the kind of capacity on hand that is necessary. If companies are going to make those legal but tough decisions on that basis, going to shut down refineries and do things like that, maybe we ought to take a tough stand on this end.

Mr. SPARANO. Two important points, if I may respond, which I think there was a question in there somewhere.

Mr. TIERNEY. There wasn't.

Mr. SPARANO. OK. Industry, there has been a lot of talk about companies combining. Companies have combined over the last 10, 15 years for survival. We've gotten an industry that factually, according to Business Week, last 5 years makes a nickel on the dollar. I'm not in the habit of investing for a nickel on the dollar.

Mr. TIERNEY. Which industry are you talking about?

Mr. SPARANO. The petroleum industry. According to Business Week, the last 5 years, 5.2 percent, oil industry 5.3 percent. Business Week score card published quarterly. In the first quarter of 2004 petroleum industry made 6.9 percent, coal industry average 7½ percent. Business Week score card. I have it here.

Mr. TIERNEY. I've got what Business Week said about the profit. You can go where you want to go on that. I think the profit margins here, profits down 2002 but afterwards they went up. 2000 petroleum industry reported return on equity of 25 percent. That's a nickel? Twenty-five percent. That was twice the historic average for the industry which ain't so bad and was about 50 percent more than that of other large corporations.

Mr. SPARANO. Which year are you talking about, sir.

Mr. TIERNEY. Talking about 2000, 2002, 2003, 2004.

Mr. SPARANO. There is a point here. It's over a long period of time. This is not a one quarter or 1 year of the ultimate history of this business, the return on capital employed on refining is about a nickel.

Mr. TIERNEY. It ain't a nickel now.

Mr. SPARANO. It's better at the moment, grant that, but it has been over the long haul not a particularly profitable business. That's why companies have gotten together. That's why many companies have left the business. There are no people lining up that I know of at California's borders to build new plants.

Mr. TIERNEY. How would anybody break into a marketplace where five companies own over half of the capacity on that?

Mr. SPARANO. It's a great market.

Mr. TIERNEY. We can go back and forth on this. I find it hard pressed you want to be on the record saying that they're making 50 percent more than other corporations, large corporations and they're making twice the historic average for their own industry, that there is some sort of impoverished industry.

Mr. SPARANO. No. 1, I didn't say that. No. 2, what I did say, the industry made 6.9 percent profit margin in the first quarter of 2004. That's not 50 percent. It's not 25 percent.

Mr. TIERNEY. Disagree. Go ahead.

Mr. OSE. I thank the gentleman.

Mr. Slocum, what I get from your written statement a concern about the level of profits that the refining industry is making. As a percentage of sales what should the industry be making?

Mr. SLOCUM. That's a good question. And I think that——

Mr. OSE. Let me add, I'm sorry, I mischaracterized the question. From your perspective what advice would you give to us if we were to mandate what the return on sales should be?

Mr. SLOCUM. Well, I don't think that I advocate the government setting a return on sales. The primary tool that I was recommending to the committee, Mr. Chairman, was some sort of mandatory minimum storage requirements that the government could also

order its release during periods of tight supply and rising crisis and that would act as a deterrent against what we are now experiencing as a financial incentive by the industry to keep supplies tight.

I would not advocate that the government be in the business of telling a company how much profit it should or should not be making, nor am I saying that companies do not deserve to make a profit. Profit is what it is.

I think that there are tools that the government should develop to recognize that we have uncompetitive markets, and again it isn't just Public Citizen reaching these conclusions. It's economists with the Federal Government and others who have examined the industry and seen that these mergers are having negative impact and that it is the government's duty to take some affirmative steps to protect consumers and protect the economy.

Mr. OSE. As it relates to the storage issue, at what point in your thinking would the government direct the holding company, whatever company that held the petroleum product, at what point would the government order the release of that product?

Mr. SLOCUM. When some sort of either the Department of Energy or some sort of regional committee made up of Governors or other energy officials within regions or specific States could make a recommendation to the Federal Government to release those reserves because some sort of formal assessment and conclusion had been reached that supplies were too tight and, therefore, necessitate some sort of release of storage.

I clearly have not developed an enormous amount of detail on this. I think talking to other individuals who are familiar with the industry that it is one tool that may be successful in reducing prices and reducing some of the volatility that we're currently now experiencing.

Mr. OSE. I was curious of the details. Clearly you've got more thought to put into that?

Mr. SLOCUM. Yes, sir.

Mr. OSE. We may give you a question to that effect.

Mr. SLOCUM. I would be happy to answer that, Mr. Chairman.

Mr. OSE. Mr. Sparano, I want to talk to you. It's my understanding California consumption right now is around 15½ to 16 billion gallons of gas per year.

Mr. SPARANO. That's correct, according to the Energy Commission.

Mr. OSE. Nevada, it's about a billion gallons of gas per year. Arizona it's about 2½ billion gallons of gas per year. Do you have any information about what the refining capacity in the three States is?

Mr. SPARANO. Refining capacity in Arizona is zero for all intents and purposes. With all due respect to the Tonopah refinery, the capacity in Nevada is close to zero. In California, California refiners produce about 45 million gallons per day. If you put it in a refining term it's 1.1 million barrels per day of capacity of gasoline production. I think that's what you were asking, Mr. Chairman.

Mr. OSE. 1.1 million?

Mr. SPARANO. Barrels per day of gasoline produced by California refineries. That gasoline serves California consumers, about 60 to 70 percent of Arizona.

Mr. OSE. So 400 million barrels per year? 365 times 1.1?

Mr. SPARANO. Times 42 you get 16 billion gallons.

Mr. OSE. California is imbalanced. As a percent is there a 1 percent play, is there 5 percent play?

Mr. SPARANO. If I may describe the way the western region works because I think it's important to not just identify this as a California issue even though the bulk of the——

Mr. OSE. I live in California. That's why I'm interested.

Mr. SPARANO. Me, too. California produces and transports for sale about 60 percent of Arizona's gasoline, about 100 percent certainly of southern Nevada's gasoline, about 100 percent comes from California pipelines, and then we actually send about 30 to 35 percent of Oregon's gasoline requirements.

Now, when you add those up you say, well, if you use 45 million a day and you make 45 million a day and send a bunch out, it's backfilled. Washington refineries can make the California quality gasoline. We have the most stringent specifications in the world. We do get some product from there.

There is some product that is imported—I think the last numbers I saw, about 100,000 barrels a day of imports into California from either a United States or foreign source. So there is a balance you can draw around the five State area: Washington, Oregon, California, Arizona and Nevada. Roughly in balance every day.

I think in response to your question, there is not much of a buffer. I believe Chairman Keese touched on that earlier. Earlier this year there were a number of refineries that were undertaking planned maintenance and some of them did not startup on schedule and at the same period there were others that had some unplanned outages and as a result there were 9 or 13 experiencing some kind of problem. Set a very difficult situation in place whereby the supply in the region and nationally has been well behind last year's supply in terms of inventory gasoline.

Mr. OSE. The reason I ask the question is from an operational standpoint, one of the things we discovered in our examination of electricity was that historical standards within the industry were that you had a 7½ percent spending reserve and another 7½ percent standby in the event something went down. What is the historical tradition in the refining business? Is it to always run right at maximum?

Mr. SPARANO. No. Refiners in the 1980's were running in the 70 percent capacity range and because of the number of plants that have shut down that capacity utilization now is year to date about 91 percent nationwide. In California, I think Chairman Keese can support this, plants have run at about 95 percent of capacity.

That's essentially full because when you do that calculation it doesn't take into account the days that plants must be down every 3 or 4 years to do plant maintenance because the equipment doesn't run infinitely. It requires very costly and long-planned maintenance. Sometimes up to 2 or 3 years of planning go into creating maintenance planning. We're operating pretty much at full capacity and there is not a great deal, if any, spare capacity.

Mr. OSE. You're saying there is no margin of error?

Mr. SPARANO. There is very little margin for error.

Mr. OSE. It would seem like with no margin for error it just highlights the urgency with which we need to deal with this issue. Now,

let's say we do the deal with inflation. Was it you that had inflation of tires.

Mr. HACKETT. (Nodded.)

Mr. OSE. That adds 180,000 barrels.

Mr. HACKETT. Nationwide.

Mr. OSE. Per day? Per year?

Mr. HACKETT. 180,000 barrels——

Mr. SPARANO. If every driver——

Mr. OSE. It would save 180,000 barrels.

Mr. HACKETT. Right.

Mr. OSE. Now, somebody mentioned CAFE standards. Let's say we take CAFE standards and we raise them from the current average 26 or 27 to 30?

Mr. HACKETT. How long do you assume it could take to turn it over——

Mr. OSE. If I'm the buyer of the vehicle it's like 14 years. You tell me.

Mr. HACKETT. Seven to 10 years.

Mr. OSE. Seven to 10 years to turn the fleet over?

Mr. HACKETT. Yes.

Mr. SPARANO. Mr. Chairman, one of the things that have happened as CAFE standards have improved vehicle mileage efficiency enormously since the early 1980's and into the 1990's, the vehicle miles driven and the demand for the product has gone up commensurately. So, despite the fact that CAFE standards have created an improvement in vehicle efficiency, more miles are driven, more gasoline is consumed. So I'm not sure that's an absolute method to get at reducing demand and bringing thing back into balance. I'm not negative on it at all. Please don't misunderstand me.

Mr. OSE. One of the things that Mr. Tierney and I and others in Congress struggle with, we have a range of choices. We can do a whole of bunch of X, a little of Y and some of Z or whatever. But I can tell you, the statistical data is very clear that as we seek to raise CAFE standards we're going to take weight out of vehicles and that's going to compromise the structural integrity of those vehicles.

We are making a tradeoff in terms of an increase in number of highway fatalities. Currently we're maybe at 50,000 a year nationwide. How many more do we want? How many more can we stomach?

Conversely, the tradeoffs that we make on the permitting side, I mean, if the argument is that if refining is such a profitable business, why aren't people lined up to do it because Lord knows money is cheap right now. Why aren't they lined up to do it? Why aren't they coming to the State, local, Federal permitting agencies and submitting their applications?

Mr. HACKETT. Some of the answer to that is the time that it takes to make the change. From my perspective—I'll agree with Mr. Sparano. For a long time refining was not a very good business to be in. Frankly, what happened is the government regulations that have constrained the supply have in fact put money in the refiners pockets.

Mr. OSE. Actually, I think Mr. Tierney is correct. The government regulations have been a conscious decision on the part of the

people of the United States that they want something and they've asked their elected official to pass statute and the agencies have adopted regulation to implement statute, and it may be that statute led to regulation that said New Source Reviews required or that we're going to reduce the particulate matter that comes out of the end of your tailpipe or what have you. That is a conscious decision. What I'm trying to highlight here is that we have made a series of conscious decisions that have had consequences.

Mr. HACKETT. Thank you, Mr. Chairman. From my perspective one of the consequences is that it's made refining profitable.

Mr. OSE. At $2.50 a gallon or whatever it is.

Mr. HACKETT. Well, probably less than that. In our analysis it's really sort of the last few years that these things have been profitable. A good place to go look at that is as Mr. Tierney indicated check the facts, look at the stock prices of the independent refiners, the Senecas, Valeros, the Desarros and the like. You can see how their stock prices have gone up dramatically, nearly doubled in some cases over the last perhaps 18 months or so. So you can see Wall Street talks ill of refiners. Lately they've caught on and they see that these independent refiners are making money. That's probably a good place to go to validate how much money they're making.

But, from my perspective what happened is the regulation—everybody in this room is for clean air and clean water and fair prices for gasoline. Nobody will dispute that. But in order to get those clean air and clean water regulations, that's wound up reducing the amount of gasoline that refiners in the United States can make and that's a fact. So then——

Mr. TIERNEY. Excuse me.

Mr. HACKETT. Yes, sir.

Mr. TIERNEY. Don't say that's a fact. It's an opinion. Cause and relation is your opinion. I'm going to point out once again when you blame the decline of capacity to those regulations you do away with the fact that this began, these decisions to close these things down began long before the Clean Air Act Amendments ever took effect and they continued long after.

Mr. HACKETT. Let me explain my opinion on a shutdown of refineries. There were 300 of them. Now there are 148. Most of that 150 or so that shut down, most of those went in the 1980's and those were primarily bonus. They were the result of government's support for refiners. Government essentially paid those guys to be in business. Once President Reagan de-controlled oil, they made a business decision to close down because they were losing money. Most of them went because of that.

So then we talk about mergers. When did the merger start? Merger started in mid-1990's. I want to say—let's pick 1996 because I can't quite remember. Mr. Sparano's refinery and the Powerine refinery both shut down in 1995. I think most of these refinery shutdowns have been primarily business decisions, but I can't find a cause and relationship between mergers and refinery shutdowns. I think there are other factors there.

Mr. TIERNEY. RAND found it, General Accounting Office found it, several other people found it.

Mr. HACKETT. I read the RAND report and I didn't reach that conclusion.

Mr. TIERNEY. RAND did.

Mr. HACKETT. That mergers shut down refineries?

Mr. TIERNEY. That had a lot to do with it, yeah. I read it into the record earlier twice.

Mr. OSE. You were fidgeting there. I'm the chairman of fidgeting. I watch for that.

Mr. SLOCUM. I can't remember if there was something specific I wanted to say or not.

Mr. OSE. If it comes to you, share it with us.

Mr. TIERNEY. I want to finish up with Mr. Hackett. I'll read you again from the 2003 RAND study. "Indeed, many RAND discussants openly questioned the once-universal imperative of a refinery not going short, that is not having enough product to meet market demand. Rather than investing in and operating refineries to ensure that markets are fully supplied all the time, refiners suggested that they were focusing first on ensuring that their branded retailers are adequately supplied by curtailing sales to wholesale markets if needed. Central tactic is to allow markets to become tight by relying on existing plant and equipment to the greatest possible extent, even if that ultimately meant curtailing output of certain refined product." So, basically, they were trying to curtail the output of the refined product.

Mr. HACKETT. I understand your point. I'm not disagreeing with that.

Mr. TIERNEY. The elimination of spare capacity generates upward pressure on prices at the pump, on and on from there.

Last thing, I think the Energy Information Agency, if that's—it's report in the first quarter of this year, "Twenty-four major energy companies reported overall net income of $13.9 billion on revenues of $198.3 billion during the first quarter of 2004. The level of net income for a quarter one of 2004 was significantly higher than in the first quarter of 2003, rising 18 percent."

Mr. SPARANO. That's 6 percent.

Mr. TIERNEY. Overall, the petroleum line of business registered an 8 percent increase in net income between first quarter of 2003 and first quarter of 2004, as the 3 percent increase in oil and gas production net income was augmented by a 30 percent increase in refining/marketing net income. Moreover, all lines of business fared better in first quarter of 2004 relative to first quarter of 2003.

Downstream petroleum operations in the United States majors rose from $2.9 billion first quarter of 2003 to $3.8 billion the first quarter of 2004. Higher U.S. gross refining margins contributed to a 41 percent increase in U.S. refining/marketing earnings from $1.8 billion in first quarter of 2003 to $2.6 billion in first quarter of 2004. Higher refining margins, despite higher fuel costs, is one of the basic reasons they cited as to why the earnings were higher.

Mr. OSE. Would you like to submit that for the record?

Mr. TIERNEY. Sure.

Mr. OSE. April 2004?

Mr. TIERNEY. January to March 2004.

Mr. OSE. Actually have the April 2004 report, EIA.

Mr. SPARANO. Mr. Tierney, in response to your comment to Mr. Hackett about refineries closing down due to mergers. I think just to clarify that point, one of the things that has occurred to a great extent when mergers have taken place is that refineries, the FTC has chosen to force the merging parties to divest in more and more refineries and that has in fact built the independent refiner asset base.

So I might characterize it more as a shift in the assets as opposed to the mergers themselves being merging of partners being forced to shut down facilities. They've shifted hands.

Mr. TIERNEY. One big company to another big company in the instances you talked about most recently, right?

Mr. SPARANO. From a major to an independent. Exxon Benicia refinery was sold to an independent first. The Shell refinery in Martinez is now run by an independent.

Mr. TIERNEY. They weren't asked to divest. In both those instances they gave up one refinery and then they passed it over to somebody else.

Mr. SPARANO. My point is not to argue how much. I just wanted to clarify that it's really not shutdowns. It's a shifting of ownership of those refineries. They're not shutting down. They're continuing to run.

Mr. TIERNEY. Everybody has testified here that there has been a significant number of shutdowns.

Mr. SPARANO. Not because of mergers. That's the point I'm trying to make. The mergers have resulted in the FTC and certain attorney generals forcing mergers to divest at one or more plants, or in the case of where there is petroleum, in ours they divested on production on the north slope.

Mr. TIERNEY. Once companies have merged and they close down facilities who is to say what the business reason was there. What we're saying is once they merged it was a better business decision for them, you know, to have less capacity than it was to not. That's what the internal memo says.

Mr. OSE. Are we all in agreement that we have less production today than we had previously?

Mr. HACKETT. No.

Mr. OSE. OK. Why not?

Mr. HACKETT. Because we can find this in the stuff we did for the California Energy Commission. If you look at gasoline production in California has been roughly constant.

Mr. OSE. Two million barrels per day?

Mr. HACKETT. Gasoline production are around 1.1 million barrels per day. It has grown slightly. That's the refinery people talk about. Fundamentally as the smaller refiners were shutting down, the bigger refiners were spending the money to make the upgrades that they needed in order to make CARB gasoline.

I can think of two shutdowns in California. One was post de-control of oil where uneconomic ones shut down because they couldn't make money without government support. The next was in the early to mid-1990's, that required like Pacific Powerine, Fletcher, Golden West, et al., shutdown because they couldn't raise the capital to make investments in order to make the new flavor of clean-burning gasoline. I can't think of one that, maybe it has, I can't

think of a refinery that has been shut down post-merger in the mid 1995 timeframe.

Having said all that I really don't care about that. My particular interest is coming up with more gasoline for consumers in the Pacific southwest region. Shuffling around who is running refineries only makes a difference in my view of the margin especially when we're short gasoline.

The issue here is how do you get more gasoline into this market. Do you expand the refineries? Do you expand the port handling facilities? What are those things that will make a physical difference and get 1 more gallon in here to help get the price down.

Mr. OSE. Is it your testimony that for whatever reason closures of refineries that have been discussed, that the production from those refineries has been replaced and we still have a constant, albeit slightly increasing level of supply in California?

Mr. HACKETT. Yes. Now, having said that, demand has grown faster than refinery production so that's why we're here today.

Mr. OSE. All right. I want to recognize Congressman Porter. I know he has a 2 p.m. meeting with a bunch of folks that he intends on attending, so as the host I thought I would give you another round here.

Mr. PORTER. Thank you, Mr. Chairman. What percentage of the gas retailers are independent in Nevada, approximately?

Mr. SPARANO. I don't know that number for Nevada. I'm not familiar with that at all.

Mr. PORTER. What would they be in California, ballpark?

Mr. SPARANO. California, about 90 percent of the stations are either owned or leased or franchised by independent owners. Now, saying that, they may be owned by a major and leased from the major and fly the brand but 10 percent, solid figure is that in California 10 percent of the 9,500 service stations are both owned and physically operated, staffed and salaried by major companies. The other 90 are a mix of lessee dealers, true independents.

I think I have the independent figure if you bear with me for a second. I believe I do have that for California, the exact independent figure according to Lundberg. It's about 30 percent I believe that are in the categories of job or distributor, non-major salary, non-major lessee and non-major opening dealers. They are all the ones that would simply have the ability to go buy their own supply and to sell it under their own brand, a flavor of that.

Mr. PORTER. If we were to talk about franchises, independent 90 some percent?

Mr. SPARANO. Yes.

Mr. PORTER. Had a question with status and numbers. That was in your testimony earlier?

Mr. HACKETT. Yes, it was.

Mr. PORTER. How best for us to streamline that process and who should be doing that?

Mr. HACKETT. Someone has to sit down and study the issue because as a practical matter it's all over the place. All kinds of government agencies using all kinds of computer systems.

The first step is to—is put a little—put some resources in to understanding exactly how big this problem is and what the likely so-

lutions are. This is the kind of computer system problem I think that companies solve all the time.

Mr. PORTER. Just want some consistency?

Mr. HACKETT. Sort of the issue here is it's very hard to know—what you really like to know is what's going on in the market. How much is really getting imported? How much is being moved from the Gulf Coast? I'll give you an example. The Corps of Engineers keeps track of port movement. Every time a boat goes in and out of a port it generates a piece of paper, electronic thing, and it goes to New Orleans.

New Orleans accumulates these reports. It's part of the water boring statistics group. I'm not complaining about it, but it takes them a year to turn around the data. So if I want to know how much gasoline if I'm helping Chairman Keese understand supply and demand in California and some of that is gasoline coming from the Gulf Coast, the best data I've got is a year old because it takes water boring data center a year to turn it around. That's an example.

Mr. OSE. Mr. Tierney.

Mr. TIERNEY. In a report for the Consumer Federation of America Consumers Union talk about with oil companies merging and eliminating redundant capacity, that's their assumption that you don't agree with it, should not be surprised to find capacity is not kept up. Refining capacity has not expanded to keep up with growth and demand. Documents from the mid-1990's indicate that industry officials and corporate officers were concerned about how to reduce capacity, and obviously because as you mentioned you don't think the industry was profitable, and they made—these are direct quotes from some of the corporate documents on that.

"If the United States petroleum industry doesn't reduce its refining capacity, it will never see any substantial increase in refinery profits." That from a Chevron Corp. document written in November 1995. A Texaco official, in a March 1996 memorandum, said "refinery overcapacity was the most critical factor facing the industry and was responsible for very poor refining financial results."

Some could argue that the companies merged and some of the capacity disappeared, whatever, because to have all that capacity out there made it less profitable. If that's the case I think one of the questions for us is what's going to increase that capacity and what's going to give those companies incentive to do that.

We're all agreed that the regulations, I think we all agree we want to have clean air to breathe and the environmental regulations ought not be disturbed. As I've said before, these things are going on long before the Clean Air Act got in. That's not really a viable argument. What are the incentives going to be? What is the taxpayer going to get in return?

Mr. SLOCUM. I think that there was an interesting example that, Mr. Chairman, you made earlier when talking about reserve capacities and you were comparing the fairly significant reserve requirements in electricity markets and you were discussing how it seems in oil and gas markets it's not that big.

It's interesting to note the history of electricity markets, which is actually my primary focus at Public Citizen is a heavily regulated industry up until fairly recently and the State Public Utility

Commission in California mandated that utilities have those reserve requirements for good reason, and now FERC is trying to do it through standard market design, trying to have regional markets where they will require participants selling market-based power to have certain minimum reserve requirements because they recognize that market power abuses occur when you do not have that kind of excess capacity. We've seen as the California energy crisis introduced to us that even with excess capacity you can have all sorts of manipulations if your market is not adequately supervised.

So, I think the question at hand here is how do we increase capacity. Well, the market by itself is not going to produce excess capacity. There are such significant barriers to entry, especially with these wave of mergers that have occurred that it's going to take some sort of government intervention in the marketplace to make it a more competitive market because competitive markets will flourish but it seems as though right now the elements are not there for successful competition and so—yes.

Mr. HACKETT. Let me tell you a story. The Kinder Morgan pipeline not only provides fuel up here to Las Vegas, but they also, and to Phoenix and Tucson, but they also have a large import terminal in the port of Los Angeles in the city of Carson. For at least 2 years Kinder Morgan has been trying to get permits to build two more gasoline storage tanks in their Carson storage tank terminal facility. If you've been to Carson, Carson is well refineries and storage tanks and the like.

They've been working on the permits for 2 years. The reason that they've been working on the, to build these tanks is they got an oil company who is not a California oil company, a trading company, an arbitrageur, to put up the money. They guaranteed that they'll rent the tanks over a long enough period of time for Kinder Morgan to be able to get their investment back.

In preparation for this meeting, talking with chairman of the staff, I got told that Kinder Morgan's permitting process has been derailed, 2 years into it, been derailed, going to be another 6, 9 months before they get the permits and they can start building the tanks which takes 6 months or so. In this particular little story here, what I observe is that here are companies willing to spend money to make the infrastructure improvements that they think will provide them with an adequate return and they're not allowed to.

Mr. OSE. You're saying the investor is going to park oil in those tanks waiting for the peaks and then put it into the market?

Mr. HACKETT. That's the kind of business that this particular business is in.

Mr. OSE. They are trying to get permits to build storage——

Mr. TIERNEY. That's the NIMBY issue. It's communities holding it up, right.

Mr. HACKETT. When we did our work with California Energy Commission, what we concluded was that a lot of the holdup is not inside the beltway or in Sacramento. It's the folks in the local planning communities who are making the decisions and holding these activities up.

Mr. TIERNEY. You don't have any equivalent, is what you're saying, if FERC when it wants to put a gas pipeline in somewhere can

actually do a taking and go through and there is very little local community can do about it but there is no equivalent what we're talking about here as far as for storage refinery or anything like that?

Mr. HACKETT. I think that is what Mr. Sparano and Chairman Keese is talking about.

Mr. TIERNEY. Is the industry prepared for some sort of a tradeoff, some incentive to increase capacity in return for limited regulation of either profit, excess profits, plow back in mandatorily back into this thing or some regulation that requires storage as Mr. Slocum talks about and consequently being able to direct that storage out when fluctuations are in place?

Mr. HACKETT. Let me address that. First is price controls. We looked at price controls for Hawaii and that doesn't work. Never have worked. They generally lead to higher prices of oil prices. Depending on the market, they can lead to shortages. We saw that in the 1970's. Mr. Porter left but I remember waiting in gas lines. That was prior to price controls. Price controls are a bad idea.

Second thing, fuel reserves. We thought about this a lot. In general they're bad ideas. They agreed to let us look at areas to supply. This is the stuff we've been talking about. Permitting and oxygenate mandate, etc.

But given that we took the legislature's money to do a report we figured one out, and so it turns out Energy Commission decided not to put any more resources into that particular idea but I think there is some interest—we did some interesting thinking about that.

But the fundamental issue here is that if the industry is not preparing enough inventory, somehow or other it's because they can't. You quoted days of supply going down. I think that's probably right. I think that's more the fact that inventories are not necessarily going down but demand is going up. And so, the denominator is getting bigger than the numerator. Get some effect there because they're not building facilities.

Mr. OSE. Are you saying the numerator is fixed but the denominator is getting larger?

Mr. HACKETT. That's right. I have to look at the numbers to make sure we're talking apples to apples.

Mr. SPARANO. I think I mentioned earlier and I hope I got it across, the amount—the demand increases are running at about four times the amount of production capacity increases and that does certainly have an influence on how much inventory you can hope to keep in place while it's being sucked away by demand. Dave raises a good point.

Back to one of your earlier points on what's responsible. It's very difficult for an industry that goes through years of permitting that gets stifled. You called it NIMBYism but NIMBYism uses the regulatory structure to fight projects in the neighborhood. I mean, that's the connection. I think you've got an industry that has run a pretty low return business, 5 cents on the dollar, and the reason people refine, gentlemen, is that you can't burn crude.

It is a very simple, and I don't mean to be glib, it's a very simple fact that in order to take that precious supply of hydrocarbon resource and turn it into something we can put in our cars and air-

planes and diesel trucks and locomotives, a huge amount of capital investment, time and effort and risk, capital risk, physical risk goes into making those products that we all use. And, it's not been a great return business, and there are people as David just described who are trying to fight their way into it and are not being allowed.

Mr. TIERNEY. So if, if people in the local level would allow these places in you're telling me that you think companies would go out and build more refineries?

Mr. HACKETT. I know of several examples. Of refineries? I'm sorry. My head is in tanks and pipelines and docks.

Mr. SPARANO. It's an important question. It's one that we both know no one can provide a guaranty because at the end of the day if you're going to spend $2 billion to build a new one you better have good economics and certainty for your shareholders that you'll be able to build the project in the timeframe.

Mr. TIERNEY. Set aside the regulatory issues on that, NIMBYism, whatever you want to say, we're talking about a demand that you tell me keeps going up, that it's not going to go down any time soon, and enough profit so this would be a reasonable investment for you to think they would make. So, my question is given those circumstances would you expect that the industry would go out there and do that or do you think they would keep what they have now?

Mr. SPARANO. I would say the environment is a lot better than it's been in the history of the planet. I don't think you can just ignore the fact that you can't just pick the quarter you like where you made money in refining but you didn't make money in production. These companies all have multi-national portfolios of assets. That whole balance is what has to be looked at.

Whether or not a company would take advantage of a refining opportunity in California, I don't know. I'm not privy to their economics. The dynamics of the marketplace appear to be improving such that becomes a better idea but there is no one who can guarantee that would happen.

Mr. TIERNEY. What if we prohibited the vertical integration? What if we didn't let refinery producers refine?

Mr. SPARANO. I think you probably break the model of the guy I admired, Adam Smith. I don't think that's how our country works.

Mr. TIERNEY. It's worked that way in the past, regulation on that. Maybe that's one way to look at it as long as they're integrated in that sense, we have a problem. Maybe if you set up the refining as a separate industry then there is——

Mr. HACKETT. As a student of the industry I think we've seen a lot of that. We've seen the rise of—what you've seen is the vertically integrated majors, the Shells, Exxons, et al., have sold off refining. Some of it is due to the FTC to sell off, if you couldn't merge you had to sell off refineries, and some of it is because there have been companies, Valero, you talked about Greehey, I think you quoted him, who built a big company on nothing but refinery. They've got about that much marketing and they have no crude oil whatsoever.

I think you can look to the marketplace and see in fact that kind of thing has already happened and so you don't have vertically integrated mergers in refining today as you did let's say 10 years ago.

Mr. TIERNEY. Four of the five companies are vertically integrated.

Mr. HACKETT. That's right. The other half aren't.

Mr. TIERNEY. But they've got over half the market.

Mr. HACKETT. How much competition is enough.

Mr. TIERNEY. Four of the top five companies are vertically integrated and they've got over half the market.

Mr. HACKETT. The nonvertically has the other half.

Mr. SLOCUM. The arguments that are made today about placing some of the blame on environmental regulations to me sound unfortunately very familiar. I worked extensively on trying to expose certain elements of the California energy crisis, and during the height of the crisis it was often said that environmental restrictions were the leading contributor to the power shortages.

Well, on April 8th of this year John Ashcroft held a press conference in Washington, DC announcing the criminal indictment of Reliant Energy, Houston-based company. In the remarks he made he mentioned how Reliant intentionally shut down four of its power plants. I understand I'm talking about power plants which are different from the oil industry obviously but there are some similarities in the economics. And, how Reliant intentionally shut down four power plants and publicly sent out press releases and their PR people, John Ashcroft said this on April 8th, and blamed environmental laws for the shut down of those power plants when actually it was the company's own economic strategies that led to the intentional shutdown of those plants.

So, I understand it's a little different but for me from looking at the industry, from reading other academic and economic surveys of the industry, I see where there are numerous economic incentives to mandate as tight margins as possible because they are going to make far more money, and I'm just afraid that we're going to have deja vu here where we are going to blame environmental regulations. We already did that before and we turned out to be wrong. I'm just afraid of placing all the blame on environmental regulations.

Sure, I think that there is some credibility to re-examine some of these reformulated blend requirements. We've got an enormous number of blends, possibly streamlining them should definitely be on the table but not without a very tough critique of the way that the oil industry conducts business today. It's been well documented that they do indeed engage in anticompetitive behavior and I don't think it's fair to place the blame solely on excessive permits or other sensible public health laws.

Mr. SPARANO. May I respond? That was a direct shot I believe at the industry. There are a couple of very simple things. We lost sight of something this morning. The cost of crude and the tax structure in this country create a very enormous segment of costs that is related to water refiner I guess to start with and what is transported in the market and I don't think we should lose sight of that, but that's not the real issue.

Mr. TIERNEY. Those are constants. The taxes remain constant. Set that aside. Talking about the crude.

Mr. SPARANO. Crude does move up and down and it's been more and more controlled in the last several years I've been in this business by increasingly smaller group of people I think that have a pretty dominant cartel position.

Mr. TIERNEY. Before you go, except over the last few years as crude prices go up the profit margins have also gone up more so than the crude so what we've seen has been that the company has not only taken the rise for the crude but taken the excess on top of that and that's pretty well documented.

Mr. SPARANO. I do not want to start us going around and around again on that. I'll stick to my original point if I might.

Mr. OSE. I've got a couple questions about solutions.

Mr. SPARANO. You have the gavel, sir.

Mr. OSE. Do you have a mortgage on your house?

Mr. SPARANO. I have a mortgage on my house and I live in an apartment. So I'm double blessed.

Mr. OSE. Mr. Comey, do you have a mortgage?

Mr. COMEY. Yes.

Mr. OSE. Do you have a mortgage?

Mr. HACKETT. Yes.

Mr. SLOCUM. No, sir. I'm a fairly young man.

Mr. OSE. I just wanted to touch on something. You suggested a cause of the electric crisis we had in California. The mortgage is a promise to pay some amount of money in the future. With all due respect to your conclusions as it relates to electric crisis which you brought up——

Mr. SLOCUM. Yes, sir.

Mr. OSE [continuing]. The sole cause and accelerant of that whole thing was an absolute refusal by the PUC to give the right to contract for future delivery of power at reasonable prices and traceable to one single individual, the rental. It followed PUC's refusal to do that?

Mr. SLOCUM. If I leave the doors to my apartment unlocked, does that give anyone the right to come in and take everything.

Mr. OSE. If the PUC removes the carpet and the paintings and the beds and the dining room table and everything else, you're not going to have much of a place to live and that's exactly what happened.

Mr. SLOCUM. The criminal convictions against several energy traders——

Mr. OSE. All followed from the PUC's refusal to give safe provisions for forward contracting of power purchases. It started in August 2001 when the PUC absolutely uniformly said we're not going to do it.

I want to go back to my question. I couldn't pass that one up, having paid that price. I want to get your collective opinions. We have in this country different air quality regions. Each of those air quality regions has a different fuel that they've adopted to comply with the Clean Air Act.

One of the things that just baffles me is, as I count, there are abouit 60 different boutique fuels, which means this refinery over here produces one kind, that refinery produces another and this

one produces a third, and the product from each of these refineries goes to a different air market. Have I got it right so far.

Mr. HACKETT. Well, that's the simplified version.

Mr. OSE. We're going to keep it simple until you expand on it. Now, this refinery goes down, it can no longer provide fuel to the air market that it otherwise is servicing and these other refineries can't either because they're all designed to provide fuel to different air markets.

What would be the impact of the Federal Government saying, OK, we're going to reduce 60 to 3 or 4 as a safe harbor, we're going to say if you cook these 3 or 4 fuels so that the exhaust coming out of people's tailpipes meet our air quality requirement, you're fine. What would be the result of that? Would we have more fuel or more fungible fuel? Would we have any abatement in price.

Mr. HACKETT. From our perspective, vulcanization of fuel is inefficient in normal times. If a refinery, for example, and I know something about this because we're currently——

Mr. TIERNEY. Can we all agree it's inefficient? Just go on from there.

Mr. HACKETT. Where it really gets to be a problem though is when there is some kind of supply constraint. Refinery goes down, pipeline breaks, something else happens and so that market can't be resupplied with its fuel and then you get the price spikes. You saw them in Chicago, saw them in Phoenix last summer and there are other examples. So it's the harmonization of fuels is going to be probably one step in reducing those price spikes because of regional——

Mr. OSE. Do you agree with that as a former producer.

Mr. SPARANO. As a person who represents the industry, I think one thing you have to take into consideration is that a lot of members of the industry, not just refiners but marketers and transporters have set up their systems and spent billions of dollars. It's $100 billion since 1990 for the whole industry for all varieties of investments. They've got investments built around this 18 boutique fuel map. So, there may be some complications there.

I'm guessing that there are some States like California that will insist if there are fewer boutique fuels that one and the most prominent one, that would be California's CARB fuel because it is in fact the cleanest one. So, that's an issue.

I want to get to one thing that you all can do. You asked about what are solutions. There is this I think very counterproductive Federal minimum oxygenate mandate that I think you can in fact influence the EPA to grant the waivers that are requested by California and New York. I think that would go a long way toward beginning to create greater flexibility on the part of refiners, greater fungibility in the system.

You can't put ethanol in at a plant. You have to build tanks at a terminal in order to put it in because it has some characteristics that make it unacceptable to transport. So, I think that's one of the big things you can do. You can also think about whether or not there is some relief EPA might grant on a plant basis for the SIPs. If I work as I've done——

Mr. OSE. You need to tell me what SIPs are.

Mr. SPARANO. I'm sorry. The State Implementation Plan. Each State has an air quality State implementation plan where they sign up for air quality improvements that they're going to make over a series of years.

While working with the Energy Commission, we really are working hard with coming up with permit streamlining and other ways to make the system work better. We're trying to work with the air districts. In California you have local ones throughout the State, to help them come up with ways to not only get emissions out of the air but fund them.

They went up often against the SIP and whether or not the emissions they take credit for are creditable against the SIP. It's something to look at, see whether or not there is a greater risk of emission reductions that might be credible again the SIP. That might promote more activity within a number of States that would both reduce emissions and allow proponents of projects to get them moving and to have a certainty of cooperation from those air districts because they all know that they all are going to get credit for that approval.

Mr. OSE. Are the processes that you're referring to that might be put into new construction significantly more efficient than those that might exist in the field today otherwise?

Mr. SPARANO. I think with every year the efficiency of refinery operation improves. The technology is so much better. The biggest piece of that is advanced computer control. So, yes, I think new projects will almost always be more efficient than old. The processes haven't changed that much. Catalytic cracking was invented in 1941 or earlier. It's the heart of every refinery, but it is those technological advances and controls that I think you will see year after year better and better.

Mr. OSE. Mr. Slocum.

Mr. SLOCUM. Yes, Mr. Chairman. Like I said a few moments ago, I do support revisiting all of these various reformulated blend and boutique fuel requirements, and I would potentially support a streamlining of that. There is no question that those multiple requirements make it far easier for the majors to manipulate the market as the FTC has found. That said, even streamlining those environmental regulations is not going to alter the fundamental disfunction that clearly are present in the domestic industry, particularly the refining industry.

The GAO is very clear it does not place the blame on boutique fuels. It places the blame on higher gasoline prices, on mergers and consolidation. And so, if we are going to examine a streamlining of these boutique fuels it should be done at the same time as an investigation and other attempts to obtain competitive domestic energy markets.

Mr. SPARANO. Before we put too much faith in the GAO report I would like to observe something I read in the paper today through the industry Internet.

Mr. TIERNEY. You put more faith in the paper.

Mr. SPARANO. I don't believe I said that. I said I read that.

Mr. OSE. Got it on the record as saying that?

Mr. SPARANO. The FTC has said in response to the report, which is 527 pages—I haven't read the whole thing. My little Blackberry

wouldn't accept it. FTC said the report, the GAO report is flawed, quote.

So there needs to be I think some examination before we run off too quickly and say that's the answer to all of our prayers.

Mr. OSE. We have a little time on our hands to do that. Mr. Hackett, Mr. Comey, anything you want to add?

Mr. HACKETT. I think that, Mr. Tierney, you observed and Mr. Slocum's bad behavior—apparent bad behavior on (inaudible) talked about how they would act, try to shut down competitive refiner or to withhold supplies from the market and that clearly happens, no question about that.

I think that these issues come back to things that government needs to do which is pay attention to this stuff but ensure there is adequate supply so that these guys got to compete. They don't get to a point where they can actually withhold stuff in the market because if they do the competitors will take their heads off.

Mr. OSE. That's Governor Wall right there.

Mr. TIERNEY. That's the issue though. How are we going to do that?

Mr. HACKETT. I do it from the supply side. Government works hard to ensure adequate supply. Government doesn't get in the way of Kinder Morgan and their customers spending money to import gasoline in California.

Mr. OSE. Well, there is a caveat though to that. We had testimony earlier about that pipeline that went through that neighborhood where we had a disruption in the pipeline and we lost the neighborhood. Government does have a duty for safety. I don't think you're suggesting any compromise of that?

Mr. HACKETT. No compromise to safety whatsoever. The issue here is the process of getting this stuff done.

Mr. OSE. All right.

Mr. TIERNEY. Thank you, Mr. Chairman.

Mr. OSE. Thank you for coming all this way.

Mr. TIERNEY. Thank you, witnesses.

Mr. OSE. I appreciate your testimony. If we do have additional questions, we'll send to you in writing. And we will appreciate a timely response. Again, our thanks to our host here at the convention center. Sorry he had to leave. It's been great being here. We're adjourned.

[Whereupon the proceedings concluded.]

[The prepared statements of Hon. Jim Gibbons and Hon. Shelley Berkley, and additional information submitted for the hearing record follow:]

Statement Before the House Government Reform Committee's Gas Prices

Field Hearing on Gas Prices in the West

5/28/2004
Speaker: Jim Gibbons
Location: Henderson, Nevada

Thank you Chairman Ose, and the other Members of the Committee for your generosity in allowing me to join the Subcommittee at this important field hearing today.

Thank you Congressman Porter for joining me in calling for this hearing.

Mr. Chairman, like you and your colleagues from California, Nevadans are also suffering tremendously from record-breaking gas prices.

In the opening days of the current 108th Congress, I made it one of my top priorities to work with my colleagues to craft and pass a comprehensive energy plan that included incentives to help boost domestic production of oil and other energy resources.

My strong support for the House-passed Energy bill stems not only from my deep dedication to providing Nevadans with the energy and fuel they need to live their lives, but also from my passionate commitment to lessening America's dependence on foreign-produced oil.

America is a land of abundant and diverse natural resources. Yet, if radical environmentalists and extremists continue their refusal to balance resources protection with responsible development of these valuable resources, Americans will have no choice but to look beyond our borders for the energy supply we require.

It is my belief that we can increase our domestic energy production—especially of alternative, renewable energies-- without harming our environment. A balance most certainly can be – and must be—struck.

Inflexible environmental policies force tens of thousands of American jobs overseas while doing very little to protect the environment worldwide.

In addition to the environmental considerations, there are serious national security reasons to explore for oil within our own borders.

With every additional restriction on Americans' ability to explore for oil within our own country, hardworking American taxpayers are forced to pay for oil produced in the Middle East and countries like Venezuela– representing some of the most volatile, politically and economically nations in the world.

As Chairman of the Subcommittee on Human Intelligence, Analysis and Counterintelligence of the House Select Committee on Intelligence, I am constantly updated on the latest threats coming from terrorists across the globe.

Just last week, suicide attackers launched three bomb-laden boats toward oil tankers in Basra resulting in a sabotaged Iraqi pipeline and a one-third cut in exports.

At this very moment, somewhere in the world, terrorists are concocting plans to harm Americans and our way of life.

The oil infrastructure in remote areas of South America, Asia, and the Middle East are prime targets for those who would like to wreak havoc on the American and world economies.
We must not let America be dependent on foreign oil.

As a result, we have only one viable option: we must increase domestic production of oil resources to ensure against annual gas-price hikes from continuing, and to protect future generations of Americans from the will of terrorists, unstable world economies, and other unforeseeable variables that exist outside America's control and realm of authority.

Of course, when we speak of expanding options to provide for domestic production of oil, we are not only speaking of increased refinery licensing and construction, but also of removing unnecessary restrictions on responsible exploration for oil in regions of our nation ripe with this precious resource.

My colleagues and I on the House Committee on Resources have worked for many years to craft a responsible plan for oil exploration in the Arctic National Wildlife Refuge.

Exploration and drilling in ANWR will increase domestic production by nearly twenty percent by the years 2025 and add an estimated 2.2 million jobs to the nation's work force.

As OPEC continues to hold our nation's consumers hostage with restrictions on the international oil supply, responsible exploration – representing only a small footprint in the vast ANWR region -- is a must.

The House of Representatives included this plan in the Energy Bill, yet partisan bickering among our colleagues in the Senate has rendered this vital legislation dead in the water. It is truly unfortunate that so many pundits and politicians refuse to accept such a valid and uplifting truth: Americans do not need to choose between environmental responsibility and energy production – we are able to accomplish both.

While the incentives for increased domestic production of oil resources included in the House-passed Energy bill are a phenomenal step in the right direction to lowering the cost of gasoline, it seems as if a resolution in Congress this year is nearly impossible.

As a result, policy makers, industry experts, consumers, and lawmakers must work together to find alternative solutions to the problem of high gas prices.

That is why this Hearing today is so important.

We are gathered here in my home state today not to point fingers and place blame, but to work collectively and cooperatively together in identifying solutions that we can all agree upon so that American families can continue to enjoy the freedom to travel, the prosperity of commerce, and the homeland security they deserve.
Once again, I extend my deepest gratitude to you, Chairman Ose, to your colleagues, and to today's esteemed witnesses for filling your tanks with two-dollar and fifty cent fuel and traveling out here to the Silver State to address this important issue today.

I look forward to hearing the witness' testimony, and I yield back the balance of my time.

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Statement of Congresswoman Shelley Berkley
Subcommittee on Energy Policy, Natural Resources and Regulatory Affairs
Hearing on Gas Prices in California, Nevada and Arizona
May 28, 2004

Thank you, Mr. Chairman and Ranking Member Tierney for holding this hearing. The price of gasoline in Las Vegas has increased 60 cents since January. Today, Southern Nevadans are paying on average $2.24 per gallon for gasoline - $2.24 per gallon. For two consecutive months, the average price of gasoline has broken all-time record highs.

Working families and small businesses are struggling to keep up with these costs and see no end in sight to the escalating prices. I hear daily from working men and women worried that they are not going to be able to make ends meet if gas prices continue to climb.

Increased oil prices not only affect families and small businesses, they impact entire industries, such as commercial airlines, which are hard hit by skyrocketing prices. Maintaining a strong aviation system is vitally important to the travel and tourism industry in Las Vegas. Nearly half of our 35 million annual visitors arrive by air. The industry is highly vulnerable to sharp increases in fuel prices. Next to labor, jet fuel is the second highest operating cost. Every additional dollar per barrel of oil use adds $425 million to the airlines' operating costs. Airlines are still struggling to overcome the challenging period following September 11th, and if actions are not taken to reduce the cost of fuel, Americans' summer travel plans will be affected. Travelers just can't win under this scenario: they're going to get hit hard in the pocketbook whether they drive or fly.

While Nevadans are paying higher prices at the pump and businesses are absorbing or passing-on additional costs, large oil companies are reaping record profits. Compared to one year ago, Chevron-Texaco's 2004 first quarter profits are up nearly 300%, ExxonMobil's are up 125% and BP's profits are up 165%.

Consolidation of the refining industry has made it easier for oil companies to manipulate supplies and increase prices. With little competition to keep the market honest, the mega-oil companies have reduced refining capacity and maintained lower inventories, which have contributed to recent price spikes. My colleagues and I have written to the Federal Trade Commission (FTC) requesting that it investigate these practices, with focus on the Western states where price hikes have been most rampant, and put an end to any wrongdoing. Consumers should not be forced to line the pockets of these big oil companies that take advantage of the market to squeeze consumers for every extra penny.

I urge federal agencies, including the Department of Energy, the FTC, and appropriate financial regulatory entities, to investigate to see if the market has been manipulated to create artificial shortages, similar to how Enron and other energy companies created a false electricity supply crisis in 2001 to generate enormous profits at the expense of consumers, businesses, and government. With our economic future and our very security on the line, the lack of transparency in the business and marketing practices of the petroleum industry must be addressed, and answers must be found, once and for all. This is especially important in an era when the Administration in power has long and deep ties, personally, commercially, and politically with Big Oil. Clearly, the American people are entitled to know how the system works. After all, they are paying to support it.

We must also get answers to why the petroleum industry has been unable or unwilling to expand refining and storage capacity, even as the demand has dramatically increased over the past 20 years. It is my understanding that the refining capacity on the West Coast will soon be further reduced, even as we face a growing supply problem. We must develop national policy that removes us from being constantly on the brink of a crippling shortage of gasoline that would send prices even higher and certainly plunge our economy into a major recession.

The system, from top to bottom, is broken. America is overly reliant on foreign oil. The Organization of Petroleum Exporting Countries (OPEC) engages in collusion and price fixing. Earlier this year, OPEC members decided to cut production by 1.5 million barrels. Since then, the price of a barrel of oil has ballooned to $41, breaking all previous records. In the end, it is American consumers who pay the price for the volatility in the cost of gas. I urge the President to act immediately to pressure OPEC to increase production to the United States. The President assured us in 2000 he would be able to deal directly with OPEC leaders. He must move forward with a major diplomatic initiative to spell out to OPEC leaders that rapacious pricing of crude will damage the world economy, and ultimately harm everyone, including the OPEC nations.

The actions I list above address our immediate situation. However, we must also embark on a dramatically more serious and ambitious national effort to solve our energy woes for the long run. We cannot be looking back 20 years from now, with our children saddled with catastrophic energy shortages, and be saying, "Gee, if we'd only tackled this problem back in 2004." The time is now to act, and act decisively on long term energy strategy.

America must become energy independent. We must develop a long-term energy plan to wean the country from its over-reliance on foreign oil and harness renewable energy sources available here in United States.

Some in Congress insist that the passage of the energy bill proposed by George W. Bush is the answer to lowering gas prices and a long-term solution to our dependence on oil imports. This bill, which is the product of secret talks with oilmen and other special interest corporate representatives, is riddled with massive taxpayer giveaways to the oil, gas and nuclear industries. Instead, we should work in a bipartisan manner to enact legislation that encourages the development of renewable energy sources and provides incentives for Americans to manufacture and purchase hybrid and other fuel-efficient vehicles.

Renewable energy is the future of energy generation in this country. Nevada is poised to become a leader in the renewable energy production, such as geothermal, solar and wind. In 2001, Nevada passed a rigorous Renewable Energy Portfolio Standard (RPS) requiring that 15% of the State's energy be derived from renewable sources by 2013. States across the country should look to Nevada, and pass Renewable Energy Portfolio Standards and other incentives to boost alternative energy production.

If this country does not move forward with a new energy policy, consumers will only continue to be at the mercy of OPEC and other oil-producing nations and under the thumb of the big oil companies. The time to act is now. If not, we jeopardize the health of the economy and the future of our nation.

www.eia.doe.gov
Energy Information Administration

Short-Term Energy Outlook

April 2004

Summer 2004 Motor Gasoline Outlook

Summary

- **Gasoline markets are tight** as the 2004 driving season begins and conditions are likely to remain volatile through the summer. High crude oil costs, strong gasoline demand growth, low gasoline inventories, uncertainty about the availability of gasoline imports, high transportation costs, and changes in gasoline specifications have added to current and expected gasoline costs and pump prices.

- For the upcoming summer driving season (April to September 2004), **retail gasoline prices** (regular grade, all formulations) are projected to average $1.76 per gallon, about 20 cents above last summer. A 95-percent confidence range for the summer price average, excluding specific consideration of major supply disruptions, spans about 8 percent above or below the base case.

- **Motor gasoline demand** is projected to average 9.32 million barrels per day, a new high. Demand continues to rise annually as the number of drivers and vehicles rises along with the general population and the number of households. Average fleet-wide fuel efficiency is virtually unchanged from last year.

- Relatively tight inventory levels are expected to keep pressure on refinery output and import sources during peak demand periods.

Table MG1 summarizes the base-case summer motor gasoline market-related projections and offers comparisons with those of last summer.

Table MG1. U.S. Motor Gasoline Summer Outlook: Mid World Oil Price Case

	2003			2004			Change (%)		
	Q2	Q3	Summer	Q2	Q3	Summer	Q2	Q3	Summer
Prices (cents per gallon)									
WTI Crude Oil (Spot) [a]	**69.0**	**71.9**	**70.5**	*83.0*	*76.2*	*79.6*	*20.3*	*6.0*	*12.9*
Imported Crude Oil Price [b]	**60.9**	**65.2**	**63.1**	*75.6*	*69.0*	*72.3*	*24.1*	*5.9*	*14.6*
Wholesale Gasoline Price [c]	**96.3**	**103.7**	**100.1**	*122.1*	*112.3*	*117.2*	*26.8*	*8.3*	*17.1*
Retail Gasoline Price [d]	**152.5**	**160.3**	**156.4**	*180.5*	*171.7*	*176.1*	*18.3*	*7.1*	*12.5*
Stocks, Incl. Blending Components (million barrels)									
Beginning	**200**	**206**		*200*	*208*				
Ending	**206**	**197**		*208*	*201*				
Demand/Supply (million barrels per day)									
Total Demand	**9.045**	**9.194**	**9.120**	*9.268*	*9.364*	*9.316*	*2.5*	*1.9*	*2.2*
Total Output [e]	**8.194**	**8.317**	**8.256**	*8.449*	*8.463*	*8.456*	*3.1*	*1.8*	*2.4*
Total Stock Withdrawal (Incl. Blend. Components)	**-0.063**	**0.096**	**0.017**	*-0.092*	*0.083*	*-0.004*			
Net Imports (Incl. Blend. Components)	**0.913**	**0.780**	**0.847**	*0.910*	*0.818*	*0.864*	*-0.3*	*4.8*	*2.0*
Refinery Utilization (percent)	**94.8**	**94.0**	**94.4**	*95.3*	*95.7*	*95.5*			
Market Indicators									
Real GDP (billion 2000 dollars)	**10288**	**10493**	**10391**	*10839*	*10933*	*10886*	*5.4*	*4.2*	*4.8*
Real Income (bil. 2000 dollars)	**7754**	**7872**	**7813**	*8004*	*8029*	*8017*	*3.2*	*2.0*	*2.6*
Industrial Output (index, 1997=1.0)	**110.0**	**111.1**	**110.5**	*115.2*	*116.5*	*115.8*	*4.7*	*4.9*	*4.8*
Miles Traveled (mill. miles per day)	**8162**	**8228**	**8195**	*8305*	*8373*	*8339*	*1.8*	*1.8*	*1.8*
Average MPG (miles per gallon)	**21.5**	**21.3**	**21.4**	*21.3*	*21.3*	*21.3*	*-0.7*	*-0.1*	*-0.4*

[a]Cost of West Texas Intermediate (WTI) crude oil.
[b]Cost of imported crude oil to U.S. refiners.
[c]Price of gasoline sold by refiners to resellers.
[d]Average pump price for regular gasoline, all formulations, including taxes.
[e]Refinery output plus motor gasoline field production, *including* fuel ethanol blended into gasoline and new supply of oxygenates and other hydrocarbons for gasoline production but *excluding* volumes related to net imports of or inventory changes in motor gasoline blending components.
GDP = gross domestic product.
Notes: Minor discrepancies with other Energy Information Administration (EIA) published historical data are due to rounding. Historical data are printed in bold. Forecasts are in italic. The forecasts were generated by simulation of the Short-Term Integrated Forecasting System. Sources: Historical data: latest data available from: EIA, *Petroleum Supply Monthly*, DOE/EIA-0109 (http://www.eia.doe.gov/oil_gas/petroleum/data_publications/petroleum_supply_monthly/psm.html); *Monthly Energy Review*, DOE/EIA-0035 (http://www.eia.doe.gov/emeu/mer/contents.html); U.S. Department of Commerce, Bureau of Economic Analysis; Federal Reserve System; National Oceanic and Atmospheric Administration. Macroeconomic projections are based on Global Insight Forecast CONTROL0304.

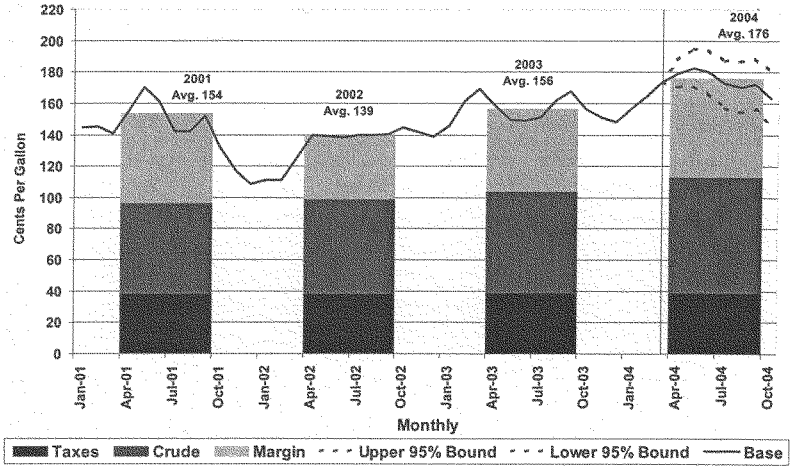
For updates to the monthly forecast, see http://www.eia.doe.gov/steo. For updates to this table, see http://www.eia.doe.gov/emeu/steo/pub/tabmg1.html. For the most recent petroleum data, see The Weekly Petroleum Status Report at http://www.eia.doe.gov/oil_gas/petroleum/data_publications/weekly_petroleum_status_report/wpsr.html.

Analysis

Crude Oil and Motor Gasoline Prices

Figure MG1 depicts recent and projected retail monthly motor gasoline price movements as well as average component costs for the summers of 2001 to 2004.

Figure MG1. Summer Retail Motor Gasoline Price* Cases
(Base Case and 95% Confidence Range)**



Regular gasoline retail price (including taxes), all formulations.

**The confidence range is based on the properties of the Short-term Model and excludes explicit consideration of major supply disruptions.*

The combined impact of high crude oil prices, continuing growth in demand, low inventories, and the ongoing transition from methyl tertiary butyl ether (MTBE) to ethanol in several regions are projected to contribute to high average motor gasoline prices for this driving season, as shown in the above chart. Retail regular gasoline prices are expected to average $1.76 per gallon, up 20 cents from last summer's average. Some months could see average prices at or above $1.80 per gallon. WTI crude oil prices, as represented by the West Texas Intermediate (WTI) benchmark, briefly surpassed $38 per barrel in late March, the highest

level since the first Gulf War in early 1991. Crude oil prices (WTI) are projected to average $33.40 per barrel (79.6 cents per gallon) for the summer.

Some factors contributing to recent and projected high crude oil prices are:

- High growth in world oil demand (including the United States, China and Other East Asia);
- Related increases in freight rates;
- Organization of Petroleum Exporting Countries' (OPEC) determination to limit oil output;
- Uncertainties surrounding the continued recovery of output and exports from Iraq as well as political unrest in Venezuela.

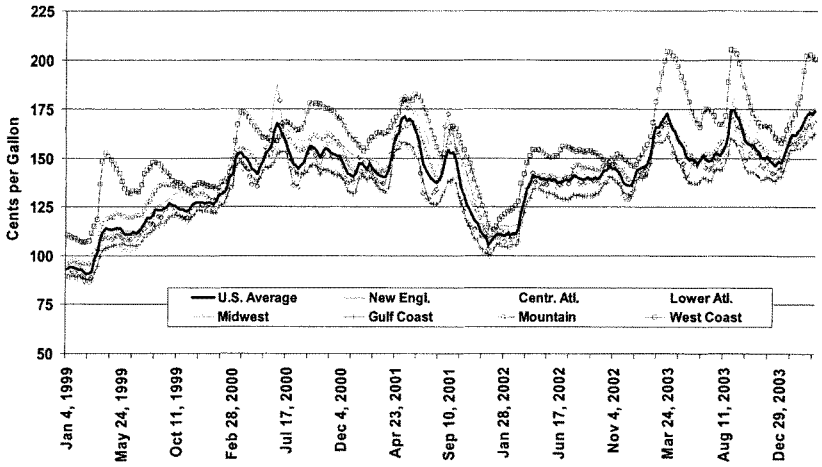
Factors affecting retail gasoline prices include:

- Expectations of high and volatile crude oil prices;
- Expectations of low motor gasoline stock levels for much of the summer, maintaining a need for high levels of domestic production and imports to meet demand;
- Additional transportation and blending costs related to the substitution of ethanol for MTBE in certain markets and the reduction in permissible sulfur content mandated by the Environmental Protection Agency.

The 95-percent confidence range in the graph reflects the estimated uncertainty based on the structure of the Energy Information Administration's (EIA) short-term model. The confidence interval does not include estimates of the impact of particular major crude oil or gasoline market supply disruptions.

In addition to the uncertainties mentioned above, there are regional variations in prices, as shown in Figure MG2. Based on the last five years of history, maximum interregional weekly price deviations among Petroleum Administration for Defense Districts (PADDs) have averaged 26 cents per gallon but have been as high as 50 cents. Differences in gasoline taxes (sales and excise) between States, which can be as much as 22 cents per gallon, contribute in part to the regional variations.

Figure MG2. U.S. Regular Gasoline Prices: Selected Regions



Gasoline markets in the United States have entered a period of uncertainty because of bans on the blending of MTBE into gasoline in California, Connecticut, and New York that took effect on January 1 of this year.[1] California was scheduled to ban the use of MTBE in January 2003, but the state delayed the ban for one year. However, many California refiners chose to follow the original schedule and MTBE blending fell by two-thirds in 2003, from an average 92,000 barrels per day in 2002 to 31,000 barrels per day in 2003. [2]

Fuel ethanol is used to replace MTBE in the production of reformulated gasoline. During the last year fuel ethanol production has increased from 177,000 barrels per day in January 2003, to 211,000 barrels per day in January 2004. MTBE

[1] Several other states have banned MTBE including Iowa (May 2000), South Dakota (July 2000), Nebraska (Jan. 2001), Colorado (May 2002), Michigan (June 2003), Nevada (Jan. 2004), and Washington (Jan 2004). These states do not have any reformulated gasoline program areas and the bans have not had an impact on gasoline markets. See Energy Information Administration, Motor Gasoline Outlook and State MTBE Bans, (Washington, DC, April 6, 2003).

[2] California Energy Commission. *Quarterly Report Concerning MTBE Use in California Gasoline.* Publication P300-02-002V4. (Sacramento, CA, February 2004, and earlier issues.) http://www.energy.ca.gov/mtbe/documents.

production has fallen over the same period from 170,000 to 107,000 barrels per day.[3]

The state MTBE bans are projected to increase the average price of reformulated gasoline in the affected areas. The price premium is higher during the summer than winter because of the required reduction in gasoline vapor pressure during the summer months.

The state MTBE bans also make those areas susceptible to price spikes over the very short term when there is an unexpected disruption to supply or increase in demand. The fracturing of the reformulated gasoline market into submarkets that contain either MTBE or fuel ethanol reduces the flexibility of the supply system to respond to supply-demand imbalances in a given area. The two reformulated gasoline products are not fungible, i.e., reformulated gasoline containing ethanol cannot be shipped to markets that sell reformulated gasoline with MTBE and vice versa.

Based on EIA's weekly gasoline price survey, regular gasoline averaged $1.74 per gallon in March. That was about 4 cents above the year-ago level and 26 cents above the 14-month low point of $1.48 per gallon seen last December. On a monthly average per-gallon basis, crude oil costs rose about 11 cents from December to March. Thus, margins (the difference between pump prices and crude oil costs) rose 15 cents per gallon over the 3-month period. Such an increase for December to March is similar to one seen in 1999-2000. However, the increase is actually much less than the 22 cents seen in 2002-2003. In those previous instances, margins continued to climb in April, and this is expected to be the case again this year, as marginal production and acquisition costs for gasoline continue to rise. For the summer, overall margins this year are expected to be comparable to those in 2001.

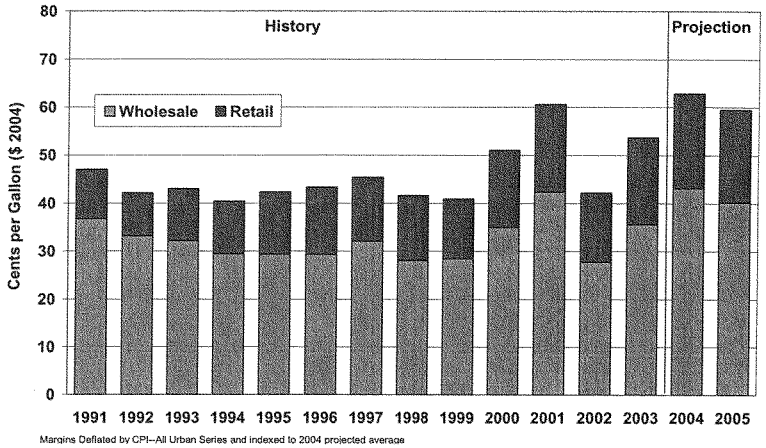
A longer perspective on the size of projected refiner margins for gasoline (wholesale price less crude-oil cost) and retailer margins (retail price, excluding sales and excise taxes, less wholesale price) is illustrated in Figure MG3, which summarizes average inflation-adjusted summer-season actual and projected spreads since 1991.

Figure MG3 shows that, before the summer of 2000, margins were low and generally declining. Those margins in 2000 and 2001 surged as implementation of Phase II of the reformulated gasoline regulations posed new unanticipated challenges for pipelines, refineries, and blenders. In the summer of 2002, looser

[3]Energy Information Administration, EIA-819M Monthly Oxygenate Report.. http://www.eia.doe.gov/oil_gas/petroleum/data_publications/monthly_oxygenate_telephone_report/motr.html

oil markets and improved inventory levels resulted in a reduction of margins to earlier levels. But the resumption of tighter oil markets during the summer of 2003 pushed margins closer to 2001 levels. This summer, with demand for gasoline up a projected 2.2 percent, inventories even lower than last year, possibly high gasoline import costs due to high transportation costs and tight gasoline supplies in Europe, and new costs associated with the ongoing transition to ethanol in several regions of the country, margins are expected to widen resulting in higher prices.

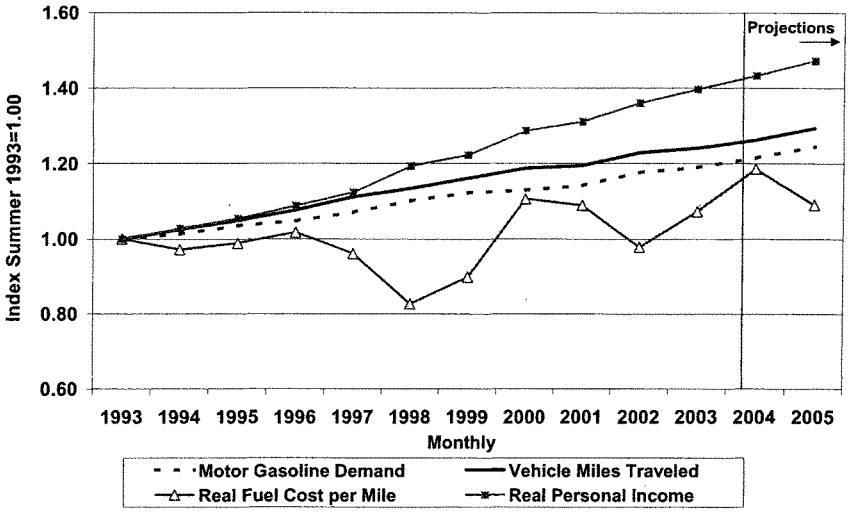
Figure MG3. Inflation-Adjusted Summer Motor Gasoline Margins



Motor Gasoline Demand

This summer, total domestic gasoline demand is expected to average 9.32 million barrels per day, a new seasonal record and 2.2 percent above the 2003 summer average. That demand growth is above the average of the previous 5 years despite high prices. Substantial increases in personal disposable income (and the general acceleration in domestic economic growth) are expected to bring gasoline demand and highway travel growth above the lower rates of the past few years. The gasoline demand growth projections would be stronger if not for a 10.5-percent increase in the inflation-adjusted fuel cost-per-mile. Figure MG4 summarizes both historical and projected trends in motor gasoline demand and related gasoline-market indicators.

Figure MG4. Summer Motor Gasoline Market Indicators

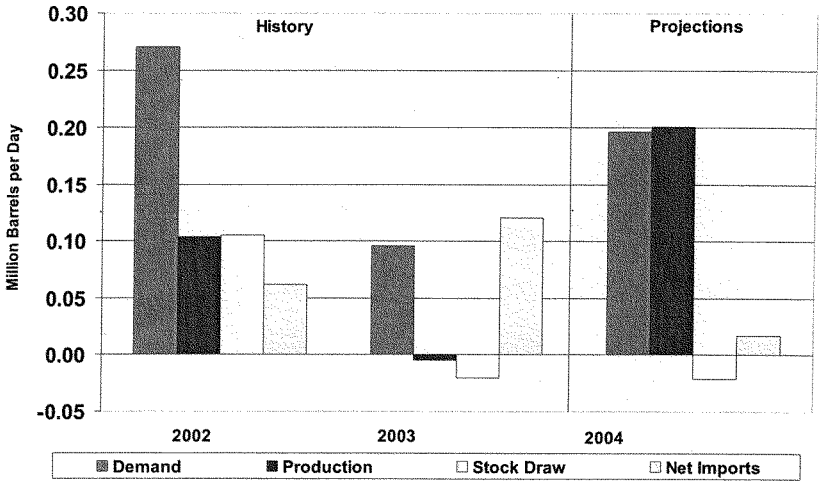


Motor Gasoline Supplies

Motor gasoline demand is supplied by three sources: primary inventories (including blending components), domestic refinery output, and net imports (including blending components). The experiences of recent summer driving seasons have raised concerns about the ability of these sources (and related distribution systems) to meet the demand. These concerns are based on the more stringent reformulation requirements resulting from the transition from MTBE to ethanol as an oxygenate, inventories close to their record lows, and potential refinery and pipeline outages. Figure MG5 illustrates projected demand and supply patterns compared to recent historical periods.

Compared to last summer, the 2004 driving season indicates twice as much gasoline demand growth, coupled with strong growth in refinery output (compared to no growth in the summer of 2003). The implied higher utilization rates and gasoline yields for U.S. refineries are expected to keep marginal production costs high.

Figure MG5. Summer Motor Gasoline Supply/Demand Growth Balance

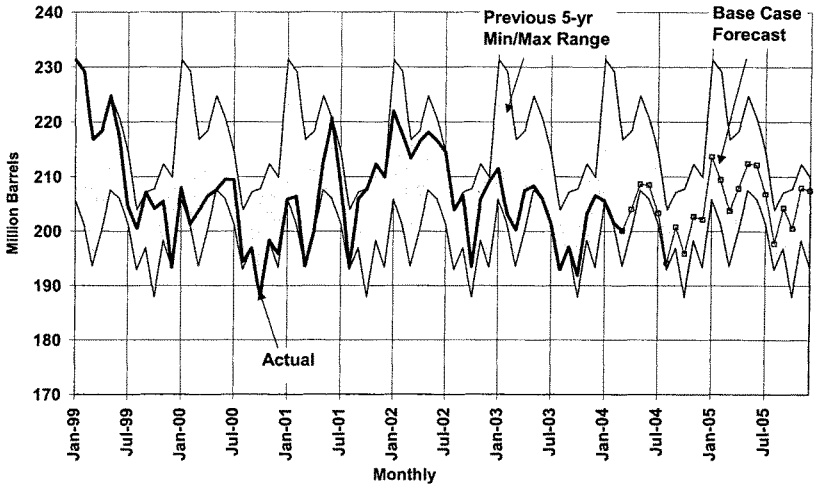


Note: Net imports and stock draw include blending components.

Motor Gasoline Inventories

Total primary motor gasoline stocks are currently at one of the lowest levels (for this time of year) seen in almost 30 years. Figure MG6 depicts recent and projected stock levels. Stocks were estimated to be 200 million barrels at the beginning of the summer driving season. This is about the same as at the beginning of the previous driving season and the second lowest in 30 years (tied with the March 1997 value, but higher than the 194 million barrels seen at the end of March 2001). End-of-season inventories are projected to be 201 million barrels, which is within the normal range.

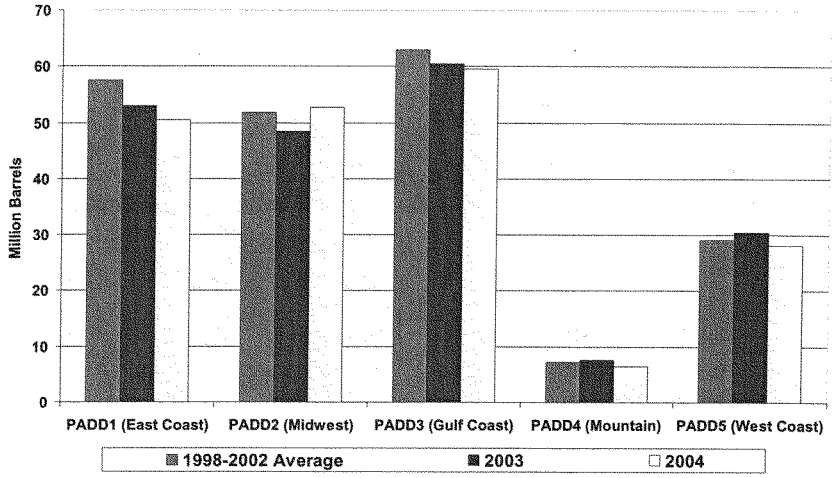
Figure MG6. Motor Gasoline Stocks



Low stock levels, especially during the first half of the driving season, are expected to contribute to continuing tight markets (even in the absence of unanticipated events that might otherwise affect gasoline supplies), leading to high margins and pump prices.

Figure MG7 summarizes historical stock levels by Petroleum Administration for Defense District (PADD). This chart shows that beginning-of-season PADD1 (East Coast) inventories are substantially below recent historical averages. That region derives 25 percent of its summer gasoline demand from imports (compared to less than 2 percent for the rest of the United States), and accounts for 88 percent of total U.S. imports. Although imports are expected to be up slightly from last summer's averages as a result of strong demand growth, the incremental foreign supplies may be hard to come by and are expected to be costly. PADD5 (West Coast) stocks appear to be more comparable to those in previous seasons. However, the geographical isolation and stringent oxygenate requirements are expected to constrain both pipeline and imported supplies in the West Coast, contributing to higher-than-average retail prices and greater price volatility than in the rest of the country.

Figure MG7. Motor Gasoline Stocks by PADD (as of March 31)



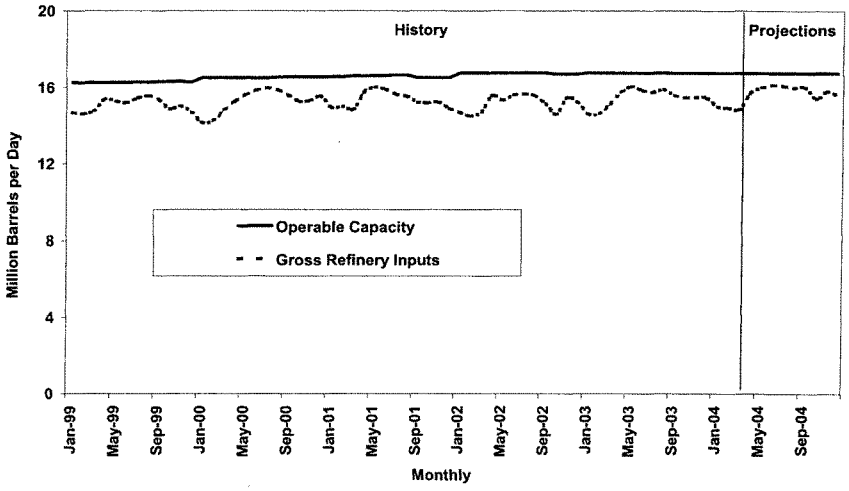
Domestic Motor Gasoline Output

For the summer, motor gasoline supplies are expected to be tight due to low stocks, more stringent reformulation requirements and lower sulfur content allowances. Moreover, refinery capacity has not expanded significantly since last summer. As a result, the need for increased refinery supplies of gasoline is expected to result in increased refinery marginal costs resulting from higher utilization rates and yields. Domestic output of motor gasoline is expected to average 8.46 million barrels per day, up about 200,000 barrels per day (2.4 percent) from last summer and a new record.

Refinery throughput and capacity data are shown in Figure MG8. Refinery utilization is expected to average 95.5 percent, higher than the 94.4 percent recorded last summer. Motor gasoline yields are projected to average 46.8 percent, up from 46.3 percent last summer. In the short term, utilization rates have been even higher, suggesting that refineries would be able to produce even more to meet unanticipated spikes in demand. However, marginal production

costs are expected to remain high as near-term input supplies remain tight and blending-related costs continue to climb.

Figure MG8. Refinery Capacity and Utilization



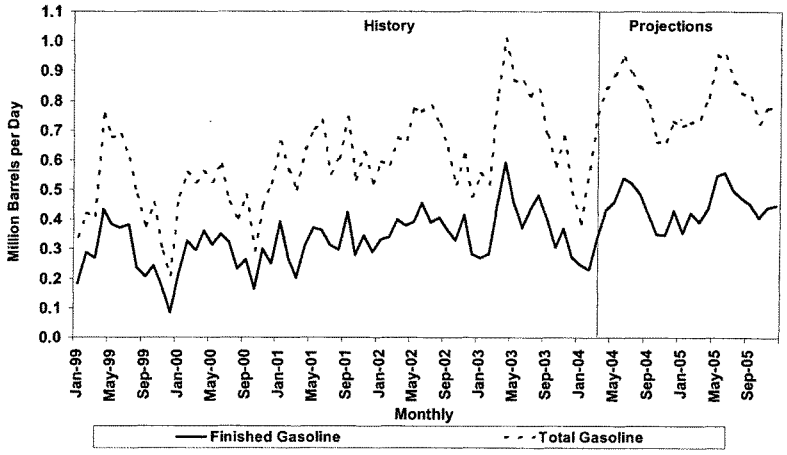
Net Imports of Motor Gasoline and Blending Components

Total net imports of finished motor gasoline and blending components are projected to average 864,000 barrels per day, up slightly from 847,000 barrels per day last summer. Imports are a significant source of motor gasoline on the East Coast (about 25 percent of total needs). Tighter specifications this summer and higher transportation costs are expected to keep net imports of gasoline from rising as fast this summer as they did in the 2003 driving season. Figure MG9 summarizes historical imports of motor gasoline and blending components since 1999.

Although the bulk of the imports come from Canada, Venezuela, and the Caribbean, Western Europe continues to be an important source of incremental supply into the United States. Imports of blending components have grown substantially since 1995, when the reformulated gasoline program was

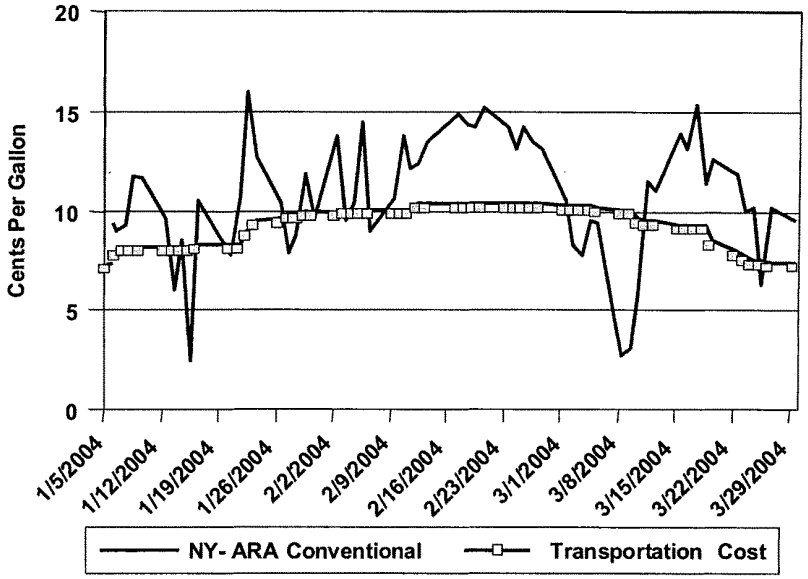
implemented, and have occasionally exceeded imports of finished motor gasoline, as shown in Figure MG9.

Figure MG9. Imports of Motor Gasoline and Blending Components



The difference between U.S. and Western European prices often exceeds transportation costs, resulting in a westward flow of motor gasoline. High transportation rates in recent periods have raised the bar on the size of transatlantic price differentials that would be necessary to induce spot cargos to flow towards the U.S. East Coast (Figure MG10). Transportation costs have abated in recent weeks, which may be taken as a sign that additional imports from Europe in the near term may not require significant new increases in East Coast spot prices.

Figure MG10. Conventional Gasoline Price Differentials Between New York and Europe and Transportation Costs



ARA = Amsterdam, Rotterdam, Antwerp