STATEMENT OF

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BEFORE THE

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Rising Crude Oil and Gasoline Prices

Thank you, Mr. Chairman. I would like to begin by thanking the Committee for the opportunity to testify on behalf of Mark Mazur for the Energy Information Administration.

With gasoline prices at $1.66 this week, compared to $1.11 on average last June, consumers have become very concerned over why this increase has occurred. A number of factors have combined to create this situation: tight crude oil markets, which resulted in low crude oil and product stocks and high crude oil prices, some pipeline and refinery supply problems, and a difficult transition to summer-grade Phase II RFG.

Crude oil continues to be a large factor in explaining the price increases over year-ago levels. West Texas Intermediate crude oil price has risen from a low point in December 1998 of under $11 per barrel to $34 recently. While $34 is far from the inflation-adjusted $70-per-barrel historical high seen in 1981, the change has been rapid. Rapid changes can impact consumers more initially than absolute levels since individuals and organizations generally budget and plan for small changes from recent history. From a year-ago June, crude price increases have contributed about 33 cents per gallon to the increase in the price of gasoline.

The crude oil price rise is the result of a shift in the global balance between production and demand. Crude oil markets tightened in 1999 as OPEC and several other exporting countries reduced supply, while, at the same time, the economic recovery in Asia stimulated demand growth. In 1999, world oil demand exceeded production by over 700 thousand barrels per day, reducing world inventories by nearly 270 million

barrels. Crude oil inventories as well as product inventories fell, and by the end of 1999, inventories were at very low levels – especially in the United States as shown in Figure 1.

OPEC has been increasing supply, and early data indicate we may be seeing a more typical seasonal stock-building pattern. But stock levels are still very low, and a normal stock build will not help the gasoline market much this summer.

In 1999, crude oil prices rose faster than product prices, squeezing refinery margins. Figure 2 shows that in June 1999, the difference between wholesale gasoline prices and West Texas Intermediate crude oil price averaged less than 6 cents per gallon, compared to the more typical 10-12 cents per gallon seen at this time of year. But low crude oil and product stocks in 2000 have now increased product prices relative to crude oil. Where the differences between gasoline wholesale prices and crude oil prices were low last year, they are high now at about 20 cents per gallon, 14 cents higher than in June last year. That is, the low gasoline inventories are probably adding about 10 cents per gallon to the price of gasoline over what we would typically expect this time of year. But some regions have experienced much higher price increases over year-ago June than the 47 cent-increase stemming from crude oil and low stocks.

EIA has been pointing out that with low stocks and a market short on crude oil, the gasoline market is likely to see increased volatility this summer. The Midwest was our first incident. Several pipeline and refinery problems caused stocks to fall to 13 percent below their 5-year average at the end of May. Prices in the Midwest were bid up rapidly as concern over supply adequacy grew for both conventional gasoline and reformulated gasoline. But reformulated gasoline in the Chicago and Milwaukee areas drew most of the attention initially as these prices increased more than 30 cents per

gallon over conventional prices. As shown in Figure 3, The Midwest RFG price increases appeared to be similar to price surges we are used to seeing in California since the start of their RFG program.

There are several reasons why the Midwest RFG prices responded so strongly to the supply problems:

The Midwest RFG market is small (13% of Midwest gasoline), which limits nearby supply options;

This was the first year of Phase II RFG, and some refiners had difficulty making the transition from Winter to Summer-grade. In the Midwest, ethanol is used to make RFG, which requires a unique blend of other components in the gasoline with very low vapor pressure (i.e., tendency to evaporate). In several cases, refiners had to bring gasoline components in from other refineries to meet the new gasoline specifications;

Finally, different refineries in the Midwest produced different amounts of RFG than in prior years, causing distribution system adjustments.

In isolated markets like the RFG market in the Midwest or the California gasoline market with its geographic isolation and unique gasoline, supply problems cannot be resolved as quickly as in broader markets. Today, the U.S. refinery system has little excess capacity, and the growth in the number of distinct gasoline types that must be delivered to different locations increases the potential for temporary supply disruptions and increased volatility.

Fortunately, wholesale prices in the Midwest began to decline more than a week ago, indicating that supplies have been increasing relative to demand. RFG retail prices

fell over 12 cents per gallon and conventional gasoline fell over 7 cents last week. Wholesale prices indicate that we could see further declines, if no more pipeline or refinery problems occur. Retail prices normally lag wholesale prices both when wholesale prices increase as well as when they decline, so, without further supply problems, we can expect retail prices to fall further.

While the first hurdle of the transition from Winter to Summer-grade gasoline is behind us, we may experience more volatility before the summer is over. Consumers are not expected to cut back much on their consumption. As we enter the high gasoline demand season, refiners will be pushed to just meet demand. With low stocks and refineries operating at high utilizations, any supply disruptions could trigger another price runup.

Although consumers are now focusing on gasoline, EIA is concerned about winter distillate and natural gas supplies as well. Distillate stocks are currently well below normal. Even with a normal inventory build during the summer and early fall, we will enter the Winter with lower-than-normal stocks. Natural gas is showing signs of not building adequate inventories this summer for consumption next winter, and prices have been high. Not only does this mean industry and utility customers might want to use more distillate this winter than last, it indicates utilities might use more distillate this summer to meet peak cooling needs if natural gas prices are high through the summer. This could reduce the distillate stock build, resulting in very low distillate inventories before winter begins.

This concludes my testimony. I would be glad to answer any questions that you might have.

Figure 1

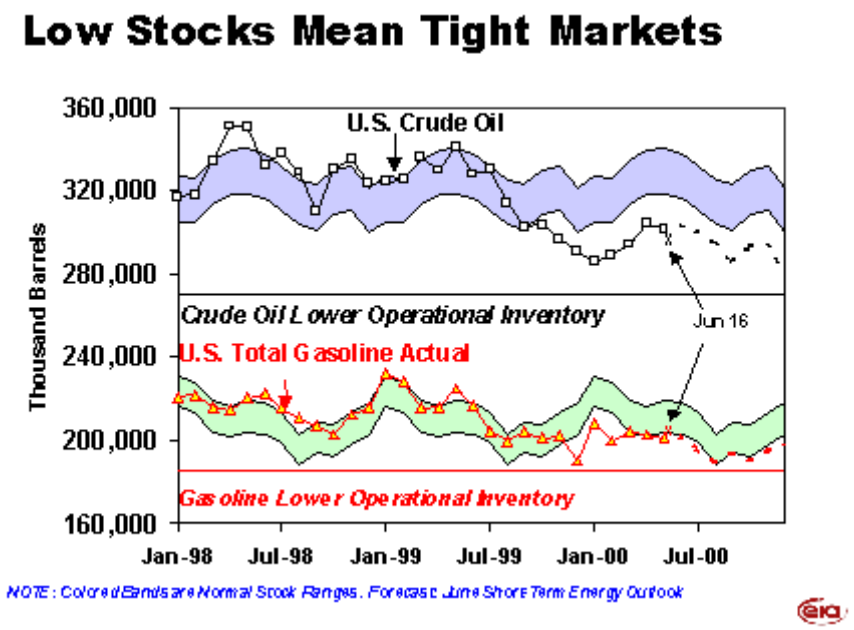
Low Stocks Mean Tight Markets
360,000
320,000
280,000
240,000
200,000
160,000
Thousand Barrels
U.S. Crude Oil
Crude Oil Lower Operational Inventory
Jun 16
U.S. Total Gasoline Actual
Gasoline Lower Operational Inventory
Jan-98
Jul-98
Jan-99
Jul-99
Jan-00
Jul-00
NOTE: Colored Bands are Normal Stock Ranges. Forecast: June Short Term Energy Outlook
eia

Figure 2

Figure 3