Statement

of

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I am Red Cavaney, President and CEO of the American Petroleum Institute (API).

Thank you for this opportunity to present the views of API on rising oil prices and the efficiency and effectiveness of the Executive Branch's response. API is a national trade association representing all sectors of the U.S. oil and natural gas industry. Our members understand their customers' concerns over the recent higher gasoline prices. They know people rely on gasoline to get where they need to go and that higher prices can affect their lifestyles and wellbeing. Our industry works hard to ensure consumers have a readily available and affordable fuel supply – a fact borne out by history.

Over the past decade, gasoline has been more affordable than ever. Adjusted for inflation, 1998 prices were the lowest ever; in 1999, they were second lowest. Prices have been low because companies have competed hard to reduce their costs and because supplies have been plentiful.

But as everyone knows, gasoline prices in 2000 have increased – not to record levels, but far above where they were 12 to 18 months ago. And in the Midwest, they are above the higher national average. There are four main reasons:

First, world crude oil prices have sharply risen, the result of a decision by international oil producers to remove millions of barrels per day of crude oil off world markets while

demand was increasing. Since crude oil accounts for about 60 percent of the cost of gasoline (excluding taxes), an increase in crude prices directly impacts the price at the pump. Over the past two months, the cost of crude has risen 35 percent.

Second, inventories have been lower than usual. With crude prices high, companies have built them more slowly. And prior to June 1, companies were clearing storage tanks of winter-time fuels to accommodate the new cleaner-burning gasoline, which also affected how much supply

was available in the system to meet fuel shortfalls that occurred later in the Midwest due to pipeline and other problems. Pipelines are critical because Midwest refineries make less than 85 percent of the gasoline consumed there.

Third, demand for gasoline has been increasing, as it usually does during the beginning of the driving season. According to the Department of Energy's Energy Information Administration, "gasoline demand in the Midwest seems to be growing more strongly in 2000 than it has for the past couple of years in this region."

Fourth, the difficult-to-make, cleaner-burning gasoline which was introduced on June 1 costs more to manufacture everywhere, but special problems developed in the Midwest, where ethanol is the typical oxygenate component. Refiners weren't able to make quite as much special base fuel as quickly as needed. That tightened supplies, pushing up prices.

Other factors have also played a role, including the Unocal patent infringement case that has created uncertainty and risk for many companies making cleaner-burning reformulated gasoline. Refiners, importers and blenders have publicly indicated that they may avoid possible infringement of the patents by making or importing less reformulated gasoline. Not surprisingly, reformulated gasoline imports have averaged less than typical for this time of year.

For all of these reasons, today's gasoline supplies haven't been enough to meet demand at the record low prices that consumers enjoyed not long ago. That's why prices rose. This conclusion is completely consistent with the findings of a just-issued Congressional Research Service report and the Energy Information Administration's latest report (June 20, 2000).

The price increases have been painful, but supplies have been well allocated. Moreover, the higher prices are providing incentive to companies to get every gallon of gasoline to market they can. Refineries supplying the Midwest are running all out, and added supplies are beginning to exert downward pressure on prices.

In fact, spot prices for the Chicago market started falling back on June 7, less than a week after the new gasoline was introduced, and have fallen 30 percent since. Prices at the consumer level typically follow trends in spot markets at varying intervals, depending on how much higher-priced product is still in the system and other factors. There have already been some reports of pump prices beginning to decline.

Gasoline is much like many other commodity products, although it differs in one important aspect. When a drought reduces the corn harvest or a freeze cuts citrus production, prices go up. When corn gets expensive, people can switch to potatoes or some other product where supplies are more plentiful and prices lower. For gasoline, substitutes aren't readily available, so consumers feel stressed.

Yet, the system ultimately works to their advantage. Over the longer term, gasoline prices have been trending downwards.

The average retail price of gasoline reached $1.22 per gallon in 1999. This is the second lowest average annual pump price (in inflation-adjusted 2000$ terms) of the entire 81-year history of recorded pump prices. Average prices in 1998 were lowest. Prices started rising in March 1999 and continued to increase into 2000, reaching $1.71 in June.

Motor gasoline prices have declined sharply since 1981 when real pump prices reached a high of $2.53 per gallon (in 2000$). So the real cost of gasoline to consumers today remains below its 1981 peak. The decline can be attributed largely to lower crude costs, but manufacturing, distribution, and marketing costs are lower as well. Only taxes have increased.

The combined costs to manufacture, distribute, and market gasoline fell from an average of $0.69 per gallon in 1981 to $0.54 per gallon in June 2000. Taxes on gasoline in June amounted to 44.2 cents, including 18.4 cents per gallon in federal taxes, 23.8 cents per gallon in weighted average state taxes, and an estimated 2.0 cents per gallon in local taxes. For comparison, in 1981 when real pump prices reached a new high, taxes were just 31 cents per gallon. A large part of the tax increase can be attributed to federal taxes, which rose more than twice as much as state taxes.

Note, however, that state and local taxes vary widely by location. In Chicago, for example, total taxes on gasoline total 63.5 cents, including 45.1 cents in state and local taxes. These include a state motor fuel tax, a state environment tax, a basic state sales tax, a local state sales tax, a Chicago extra sales tax, a Cook County gas tax, and a Chicago gas tax.

In 1998, crude oil prices declined to $11 per barrel. Crude oil began 2000 at $25 per barrel. International oil producers took four million barrels per day of crude oil off world oil markets, driving up prices to $34.13 per barrel on March 7.

Following the OPEC agreement to raise output on March 27, 2000, crude oil prices began to fall, reaching a low for the year of $23.85 on April 10, 2000. As of June 12, crude oil prices have risen to above $30 per barrel. This was roughly triple what they were at their low point in late 1998.

Date	**Crude Price $/BBL**	**Gasoline Price $/Gal.**
1/4/00	$25.00	$1.314
3/7/00	$34.13	$1.539
3/20/00	$29.43	$1.569
4/10/00	$23.85	$1.516
5/1/00	$25.87	$1.461

6/12/00	$31.74	$1.664
6/16/00	$30.35	$1.771

Source: DOE/EIA

Gasoline price changes have followed crude price changes throughout the year. The sharp price declines of April following the March OPEC meetings were reversed because OPEC output did not address the fundamental tightness in world petroleum supply and demand conditions. World demand for petroleum products remains strong and output increases by OPEC merely met the existing, but not growing demand for products. As a result, prices returned to the over $30 per barrel level. The U.S. continues to import over 55 percent of our petroleum needs and remains at the mercy of world oil markets.

The oil and gas industry also introduced a new cleaner-burning, government-required gasoline to America on June 1, which has also been a factor in higher gasoline prices. This new fuel costs more to make everywhere, but special problems developed in the Midwest, where ethanol is the primary blending component. Refiners weren't able to make quite as much cleaner-burning gasoline as quickly as needed. That tightened supplies, pushing up prices. In some places, pipeline problems held back supplies.

The new cleaner-burning gasoline—called phase II reformulated gasoline (RFG)—must be made to extremely tight specifications. Providing a new fuel made to extremely stringent specifications presents a special challenge. Slight mixing of phase II RFG with other gasoline blends during storage or transportation may force companies to downgrade or reblend it, slowing and complicating manufacturing and distribution with possible impacts on fuel supplies.

Growth in the number of different grades of gasoline and distillate fuels grades, which must share the same distribution and storage system, has heightened the challenge of providing phase II RFG. It has made it more difficult to deal with unanticipated problems that can threaten the adequacy of fuel supplies.

In much of the Midwest, RFG contains ethanol, which tends to boost gasoline volatility. Refiners, therefore, must make the base phase II RFG gasoline to even tighter specifications to ensure that volatility levels in the final product meet government standards. Some companies have had to reblend basestock RFG supplies to be able to meet these specifications, and this has slowed down some deliveries. Also, extremely tight RVP specifications for summer grades of phase II RFG required refiners and marketers to virtually empty their tanks of winter grades before adding low-RVP summer grades so that summer grades could continue to meet RVP specifications.

Pipeline difficulties have also had an impact. The Midwest is a net importer of gasoline. It consumes more than its refineries can produce. Most of the additional gasoline is brought into the market by pipeline, although some is brought in by barge. Finally, several weeks ago, there was more demand for pipeline shipments than there was pipeline capacity. In addition, a major

pipeline suffered a leak and was shutdown for five days. When it resumed operations, it was at 80 percent of operating pressure over part of the pipeline. This reduced inventories in the market.

Unocal patent infringement case

Other factors have also played a role in the price increases, including the Unocal patent infringement case that has created uncertainty and risk for many companies making cleaner-burning reformulated gasoline. Refiners, importers and blenders have publicly indicated that they may avoid possible infringement of the patents by making less reformulated gasoline, and reformulated gasoline imports have declined.

A federal District Court upheld a Unocal fuel patent in 1997, awarding damages of 5.75 cents per gallon against six refiners in California for patent infringement. The District Court ruling was upheld by the U.S. Court of Appeals for the Federal Circuit last March. The refiners have until mid-August to ask the Supreme Court to review the Federal Circuit's decision. Unocal has four additional fuels patents that have not yet been tested in court.

If the Unocal patents stand, they could continue to impact supplies of RFG as refiners and importers individually evaluate their options. They could pay patent royalties on any infringing gasoline, reduce the amount of RFG they produce, or attempt to develop formulations that are outside the scope of the patents. Each option is likely to reduce the flexibility of refiners and increase the cost of making reformulated gasoline.

For all of these reasons, today's gasoline supplies haven't been enough to meet demand at the record low prices that consumers enjoyed not long ago. That's why prices rose. I should point out that this conclusion is completely consistent with the findings of a just-issued Congressional Research Service report and the DOE/EIA latest report of June 20, 2000.

The government can help reduce the potential for market volatility by making environmental regulations more reasonable and workable.

Environmental rules are an important driving force behind our cleaner air and water. But improvements are possible that would give companies more flexibility to adjust to problems that may have temporary impacts on supply and price.

The first step is to eliminate unnecessary rules. For example, let's repeal the federal oxygenate requirement for reformulated gasoline, which makes that fuel harder and costlier to manufacture but is completely unnecessary to improve air quality. EPA's Blue Ribbon Panel on oxygenates agreed that the requirement should be eliminated.

We should also ensure that new requirements produce substantial benefits with minimal threat to fuel supplies. EPA's new proposal to improve diesel fuel by reducing sulfur is right directionally, but it over-reaches which could seriously impact diesel supplies with no guarantee of added environmental improvements beyond those achieved by a more moderate approach.

Supplies could be affected because some companies now making diesel fuel may not want to make the huge investments that would be necessary to reduce sulfur as low as EPA wants. Less supply could result in market volatility. EPA assumes the sulfur reductions it is proposing will work with a new kind of vehicle emission reduction technology, but it has presented no evidence that this unproven technology will cut emissions to the desired level no matter how low sulfur content is set.

A less extreme reduction in sulfur—90 percent compared with EPA's 97 percent—would likely achieve comparable emission reductions at much lower cost, while reducing the potential for supply disruptions.

In addition, we should ensure that our laws and regulations allow oil and natural gas companies to drill where new petroleum supplies are most likely to be found. Many of the most promising locations in this country are now off-limits. But supplies there could be recovered with little or no environmental impact, and they would help moderate higher crude oil prices.

Today, we import some 55 percent of our crude oil, meaning that we are at the mercy of foreign oil producing countries. The current price situation has much to do with the cutback in production by those countries. It doesn't have to be this way. U.S. oil is in plentiful supply and our companies can continue to deliver the energy needed to meet America's needs, but they cannot draw upon our vast reserves unless greater access is provided to government lands for responsible exploration and development.

Since 1983, access to federal lands in the western United States—where 67 percent of our onshore oil reserves and 40 percent of our natural gas reserves are located—has declined by 60 percent. Our search for new domestic offshore oil and natural gas is limited to the Gulf of Mexico and Alaskan waters because of the congressional moratoria that have placed off-limits most of the rest of our coastal waters. Onshore, the President has used his executive powers to limit oil and gas activity on vast regions of government lands. Congress has refused to authorize exploration on that small section of the Arctic National Wildlife Refuge that was specifically set aside by law for possible exploration in 1980. More recently, the U.S. Forest Service moved to make it more difficult for our companies to explore for oil and natural gas on government lands when it announced a plan to bar road building in 43 million acres in the forest system.

Yet, technology has revolutionized how oil and natural gas are found and produced. For example, we now can produce more oil with fewer wells thanks to three-dimensional seismic equipment that locates hydrocarbons with greater precision and directional drilling technology that allows a variety of productive reservoirs to be accessed from one location. Fewer wells mean less disturbance of the environment. Offshore wells can now safely capture oil and gas in ocean depths of thousands of feet in areas far offshore.

We need to recognize that the oil and gas industry of the 21st century has the tools to decrease our dependence of foreign oil while protecting our environment.

The government can reduce the potential for market volatility by making environmental regulations more reasonable and workable and by considering the impacts on consumers of the reduced system flexibility brought about by the increasing complexity of the regulatory framework in which the industry must operate. Improved regulations would give companies more flexibility to adjust to problems that may have temporary impacts on supply and price. This applies especially to fuels regulations, including EPA's new diesel sulfur proposal, which sets a standard beyond what the technology will support. It also includes regulations that now restrict access to the most promising locations in this country to add to our supplies of oil and natural gas.

U.S. oil and natural gas companies know how to make and deliver gasoline, and all strive to be the lower cost provider. Even with occasional price spikes, they do a good job serving their customers. But with better regulations – still fully protective of the environment – they could do even better, and the risk of market volatility would be reduced.