

**STATEMENT OF
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**Increases in Crude Oil, Distillate Fuels and
Gasoline Prices**

I wish to thank the Committee for the opportunity to testify on the status of the global crude oil market and its effects on the U.S. heating oil, diesel fuel, and gasoline markets and prices. As I will illustrate, world demand exceeded crude oil production in 1999, largely as a result of the decline in production by the Organization of Petroleum Exporting Countries (OPEC) and several other exporting countries. Inventories were used to meet the excess demand, and prices rose in response. Today, world inventory levels are very low, resulting in high prices to consumers and leaving markets vulnerable to price spikes, such as that experienced earlier this year for heating oil and diesel fuel in the Northeast.

U.S. Dependence on Petroleum

Today, the United States is still heavily dependent on crude oil, in spite of the growth in use of other fuels like natural gas and coal. In 1998, petroleum supplied 39% of our energy needs. Since 1985, domestic crude oil production has been declining while oil product consumption has been increasing, resulting in a growing reliance on imports. Oil products are generally delivered at moderate average prices, that is, at prices that increase at or less than the rate of inflation. Because crude oil prices are set in a global commodity market, reflecting worldwide supply and demand, crude oil and thus product prices can take dramatic swings between low and high points, when overall supplies fall significantly above or below global demand.

Crude Oil Market and Recent Price Increases

Crude prices have changed significantly over the past year. Prices for West Texas Intermediate, a benchmark crude oil, have risen more than \$20 per barrel (48 cents per gallon) from under \$12 per barrel in mid February 1999 to peak over \$34 per barrel on March 7, 2000. Prices have moderated somewhat with the April delivery futures contract expiring at \$28 per barrel this past Tuesday. To put this in perspective, while \$34 per barrel represents the highest price since the Persian Gulf War, crude oil prices peaked in 1981 at \$70 per barrel in today's dollars (\$39 per barrel in nominal terms). Recent EIA forecasts show that these high prices have resulted in a decline in OPEC's market share of over 1% from fourth quarter 1999. Non-OPEC production in the fourth quarter was higher than expected, indicating higher oil prices may be stimulating more non-OPEC production than many analysts predicted.

Nevertheless, crude oil markets tightened throughout 1999 as OPEC and several other oil-exporting countries reduced supply, and, at the same time, recovery of Asian economies increased demand growth. In 1999, world oil demand exceeded production by over 1 million barrels per day for the year, reducing world inventories by nearly 400 million barrels. If OPEC were to keep production in the year 2000 at the levels seen in the first quarter, EIA estimates the shortfall in 2000 could be up to 2 million barrels per day. Should such production levels be sustained, the resulting higher prices would have adverse impacts on inflation and economic growth.

During 1999, crude oil prices rose faster than product prices, reducing refining margins. The squeeze on margins, on top of high crude oil prices, encouraged refiners to constrain crude oil purchases, restrict product output, and draw down inventory. By the end of 1999, world crude oil and product stocks sank to very low levels, and U.S. inventories were no exception. This pattern can be clearly seen in Figure 1.

Heating Oil Price Spike

Retail heating oil and diesel fuel prices (distillate prices) climbed steadily from early 1999 through the middle of January 2000, largely as a result of increases in crude oil prices. But distillate prices in the Northeast^[i] turned sharply upward in the third week of January. In a three-week period, New England residential heating oil prices, as shown in Figure 2, rose 78 cents (66 percent) to \$1.96 per gallon. During the same three-week period, New England retail diesel fuel prices (Figure 3) rose 68 cents per gallon (47 percent), to peak at \$2.12 per gallon. While Northeast prices were surging at the end of January, heating oil and distillate product prices in other parts of the country rose relatively little.

Prices peaked in early February, and are now dropping. By March 13 (the most recent data available), New England residential heating oil prices fell 61 cents to \$1.35 per gallon. As of March 20, New England highway diesel fuel was \$1.55 per gallon, down 57 cents from its peak. Since these are similar products, their prices usually move together.

Retail heating oil and diesel fuel prices follow the spot distillate markets, which had been driven by crude oil prices until recently. Figure 4 shows that spot crude oil prices for West Texas Intermediate (WTI) changed relatively little, even as No. 2 heating oil spot prices in the Northeast spiked dramatically. New York Harbor spot heating oil prices rose from about 76 cents per gallon on January 14 to peak at \$1.77 February 4 before falling back. Gulf Coast prices did not spike, but were probably pulled slightly higher as the New York Harbor market began to draw on product from other areas, again indicating the Northeast focus of this problem.

The late-January heating oil and diesel fuel price surges in the Northeast resulted from a unique combination of low inventories, weather, and supply problems. Low stocks leave little cushion to absorb sudden changes in supply or demand. Distillate stocks fell rapidly in late November through December as high crude oil prices and margin pressure discouraged production. By the beginning of January, East Coast inventories were running almost 4 million barrels, or 8 percent, below the low end of the normal range.

During the last half of January, cold weather in the Northeast not only increased demand, but also caused supply problems, with frozen rivers and high winds hindering the arrival of new supply. It was reported that utilities were buying distillate both for peaking power and, along with industrial and commercial users, to substitute for interruptible natural gas supplies, further adding to the market pressure.

Thus, with new supply being delayed and little inventory to cover the increased demand, prices spiked. Within weeks, a flood of imports attracted by the higher prices, along with domestic resupply, stopped the inventory decline, and prices dropped substantially. Although stocks remain low, with currently mild weather and only a few weeks of the traditional heating season remaining, a price surge like that seen in late January is unlikely.

Upcoming Gasoline Season

I would like to conclude my testimony by focusing on the outlook for gasoline. The tight crude oil market is also affecting the gasoline market. U.S. gasoline prices averaged \$1.53 this past Monday, an increase of 26 cents per gallon since the beginning of this year. Today, both U.S. crude oil and gasoline stocks are at very low levels (Figure 5) -- levels not seen for decades during this time of year. The same squeeze on margins that brought distillate stocks down to low levels also reduced gasoline stocks.

I would like you to focus on two time periods -- spring and summer. During March and April, refineries need to increase crude oil inputs by over 1 million barrels per day (Figure 6). With low stocks and a market short on crude oil, the situation is ripe for gasoline price volatility. Spot gasoline prices are already reflecting the tight gasoline supply-demand balance. In early March, spot gasoline prices on the Gulf Coast averaged almost 20 cents per gallon higher than crude oil prices -- a spread that is about 2 times the average for this time of year. While the Gulf Coast gasoline spread has fallen back now, the swing illustrates the volatility that can accompany low stocks.

But even after we get through the spring, we may see price volatility this summer as well. EIA expects to see high refinery utilization rates on top of precariously low gasoline stocks. This combination leaves little room for the unexpected. Unplanned refinery outages, delivery interruptions, import delays or demand increases can create price surges above levels shown in the EIA forecast. EIA is currently projecting regular gasoline prices to peak at \$1.56 per gallon this summer. Price volatility can result in a 20-25 cent per gallon price surge such as those seen in California historically, which brings the price to \$1.80 for a time. Although these prices are far from record highs in real terms, they have risen rapidly over a short period of time, attracting a great deal of consumer attention.

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