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April 18, 2002

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

FROM: Doug Ose

SUBJECT: Briefing Memorandum for April 23, 2002 Hearing, "Fuel Markets: Unstable at Any Price?"

On Thursday, April 23, 2002, at 2:00 p.m., in Room 2154 Rayburn House Office Building, the Subcommittee on Energy Policy, Natural Resources and Regulatory Affairs will hold a hearing on gasoline prices and related issues. The hearing is entitled, "Fuel Markets: Unstable at Any Price?"

In the last several weeks, gasoline prices have risen more than 25 cents per gallon. Recent years have seen dramatic price increases in gasoline during the spring as demand increases and refiners must switch from winter to summer formulations to meet environmental regulations. The double combination has typically lead to general increases in prices nationwide as well as regional price spikes.

Last year, the Subcommittee held a hearing on gasoline prices on June 14, 2001. At the time, nationwide prices had reached $1.71 per gallon with some areas of the country experiencing prices over $2.00 a gallon for regular unleaded gasoline.

Crude Oil Markets

Recent unrest in the Middle East and labor protests in Venezuela have increased uncertainty over the supply of crude oil. The cost of crude oil directly affects the cost of refined gasoline products. Imports account for 60 percent of the crude oil processed. While the U.S. imports oil from a wide variety of countries, the bulk of the oil imports come from a small number of oil exporting countries. Both Venezuela and Iraq are among the top five oil exporters to the U.S. (see chart at the end of this memo).

Market Volatility and the Growing Number of Gasoline Types

Another factor that adds to the potential for volatility when inventories are low is the increase in the number of distinct types of gasoline. Today's gasoline market is comprised of many types of gasoline that serve different regional markets to meet varying Federal and State environmental requirements.

While producing specialized products for only those areas with air quality problems is seen as an efficient means of cleaning the air, the increase in boutique fuels adds a level of complexity in production, distribution and storage of gasoline. An example of such complexity was reported in the Wall Street Journal on April 4, 2002, when the main terminal for Phillips Petroleum in Phoenix literally ran out of gasoline.

The result of this targeted approach to air quality has been to balkanize the gasoline market and to create gasoline market islands. The primary examples are California and the Chicago/Milwaukee areas, in which the required gasolines are unique, and only a limited number of refineries make the products. The inventories of gasoline used in these regions can be drawn down rapidly in response to unusually high demand or a supply problem at one of the few refineries producing the specialized products, or in one of the pipelines delivering the products. Prices for gasoline in these regions then surge. If other gasoline markets are not tight, the price surges may be limited to the specialized gasoline regions, as is often the case in California.

Ethanol and MTBE

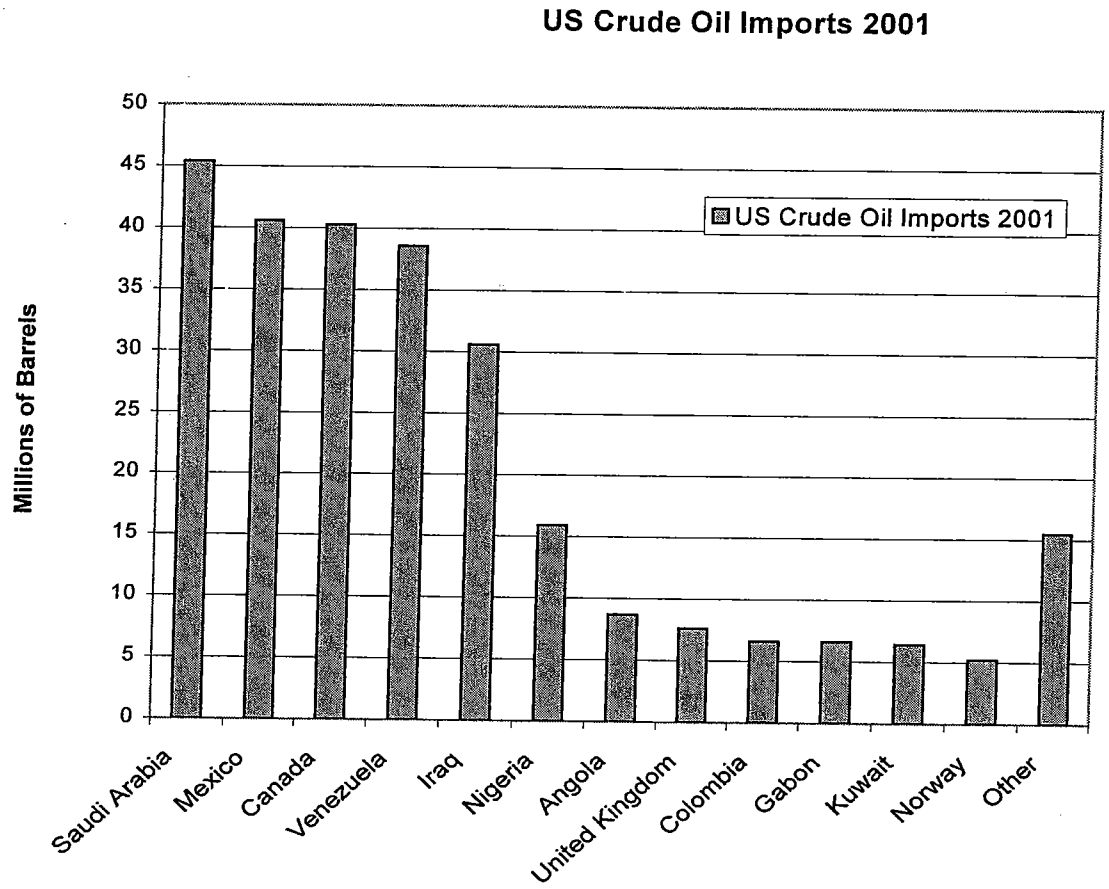
In addition to balkanized markets, future gasoline markets may become even less stable as refiners deal with the effects of phasing out the fuel additive MTBE and replacing it with ethanol. Under the Clean Air Act, refiners selling gasoline in areas with severe air pollution are required to add oxygenated fuel additives to the gasoline. Currently, two additives -- MTBE and ethanol -- constitute nearly all the oxygenates added to fuel. MTBE consumption in the U.S. is nearly 300,000 barrels per day.

The Senate energy bill (S. 517) currently being debated would ban the use of MTBE and require an annual consumption of renewable fuels at 2 billion gallons a year accelerating to 5 billion gallons by 2012.

According to the Energy Information Administration (EIA), the provisions of the Senate energy bill banning MTBE and requiring a renewable fuels standard will increase the average cost of reformulated gasoline by 9.0 to 10.5 cents per gallon. EIA estimates that the provisions will result in higher annual costs to consumers of $6.37 billion a year.

Invited Witnesses

Vicky Bailey, Assistant Secretary for Policy and International Affairs, Department of Energy; Mary Hutlzer, Acting Administrator, Energy Information Administration; William Kovacic, General Counsel, Federal Trade Commission; David Montgomery, Vice President, Charles River Associates; Nicholas Economides, Director, Hart Downstream Energy Services; and Gordon Rausser, Professor of Economics, University of California, Berkeley.



Source: Energy Information Administration, "Year to Date Imports of Crude Oil and Petroleum Products Into the United States by Country of Origin, January -January 2002."