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Testimony
of
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Mr. Chairman,

Thank you for inviting me to speak before the Senate Committee on Commerce, Science and Transportation on the very important topic of the recent rise in gasoline prices. In a series of brief questions and answers below, I will endeavor to address some of the key issues behind recent trends in oil and gasoline prices, and their consequences for U.S. households and U.S. policy makers.

What Is Behind the Recent Rise in Oil and Gasoline Prices?

- The reason for the recent rise in oil and gasoline prices is quite mundane—demand has been rising faster than supply. While it may be tempting to look for market manipulation by energy suppliers, the evidence so far points overwhelmingly to market fundamentals as being the principal drivers of price.
- Low energy prices in the 1990s provided little incentive for energy consumers around the world to conserve, or for energy producers to invest in exploration and drilling (let alone alternative fuels and technologies). Thus we have seen a very troubling decline in OPEC spare capacity (see Chart 1). Moreover, low refining margins in the 1990s, combined with significant expenditures to comply with environmental regulations, held down investment in new refineries.
- The rise in energy prices is part of a broader global commodities boom (see Chart 2). Since 2003 global growth has been very strong, with the United States and China being the principal locomotives. In the meantime, most suppliers of commodities (including OPEC) have been reluctant to increase capacity, fearing that as soon as the new supplies hit the markets, prices would collapse. This has been the experience of the oil industry for much of the last 25 years.
- Both supply and demand will respond—in time—to high prices. However, this adjustment is likely to take a few years, and prices are likely to remain at elevated levels. Global Insight predicts that oil prices will average above $60 a barrel through 2008.
- Some of the recent spike in gasoline prices can be attributed to distribution problems with ethanol, which Global Insight expects will be resolved in the near term. We expect gasoline prices to maintain a level near $3.00/gallon nationwide average for the summer driving season and then fall to around $2.50 per gallon and remain at roughly that level for much of 2007.

How Much of the Rise in Gasoline Prices Is Due to Price Gouging?

- Since 2002, oil prices have tripled and gasoline prices have more than doubled (see Charts 3 and 4). With two exceptions, almost all the rise in gasoline prices has been the result of the rise in oil prices.
- In the immediate aftermath of Hurricane Katrina, gasoline prices did spike. Almost all of this was due to the disruption of refining capacity in the Gulf of Mexico. This can be seen in Chart 4 as a rise in the refiners' margins, and was due to markets bidding up prices in a panic reaction to the refinery damage. The high prices were required to attract new supplies from overseas and to send a signal to

consumers to reduce demand. The refiners' margin dropped sharply by late fall, as refineries were brought back on line, imports responded, and market fears subsided.
- The recent rise in refiners' margins is the result of new mandates on the use of ethanol in gasoline and the inadequacy of the current distribution system to keep up with the current demand. Global Insight expects that margins will fall again as the system adjusts through improved supplies and moderating demand. In fact, over the past couple of weeks, refiners' margins have already begun to come down as gasoline inventories have risen since late April.
- The movement of dealers' margins over the past couple of years shows no evidence of a systematic rise.
- Bottom line: there is very little evidence of systematic anti-competitive behavior either by refiners or dealers, despite anecdotes about price gouging right after Hurricane Katrina.

How Much Are High Gasoline Prices Hurting?
- Since 2002, gasoline prices have moved up sharply. However, between the early 1980s and the late 1990s, gasoline prices fell on an inflation-adjusted basis (see Chart 5). In fact, gas prices have only recently reached their 1980 levels, adjusted for inflation.
- More important, if you compare gasoline prices with after-tax household income, gasoline prices have continued to lag, even after the recent sharp rises (see Chart 6). Another way of looking at this is to measure the change in gasoline purchases as a percent of take-home pay. Here again, while this share has risen from its average of around 2.0% in the late 1980s and 1990s to around 3.5% now, it is still below the early-1980s share of 4.5%.
- However, it is important to acknowledge that for low-income families, the share of take-home pay used for gasoline is higher than average (possibly twice as high). This means that the recent rise in gas prices is more of a hardship for these families.

What Should Congress Do?
- While it may be tempting to consider regulatory fixes to address the current high oil and gasoline prices, additional regulations will do nothing to solve the fundamental supply-demand problems in energy markets. On the contrary, there is a risk that additional regulations could discourage more supplies of both crude and refined products from being brought to the market.
- Congress could act to reduce the number of grades of gasoline in the United States market. Over the last 10 years the number of grades has proliferated. This has resulted in reduced capacity to manufacture and distribute gasoline, raised the cost, and reduced industry flexibility.
- Congress can ease the medium- to long-term crunch in gasoline and energy markets by encouraging both the production and use of fuel-efficient vehicles.
- Finally, there is a need for some short-term relief for low-income families, who have borne a disproportionate burden of higher gasoline taxes.

Respectfully submitted,

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Chart 1: OPEC Spare Capacity and Price

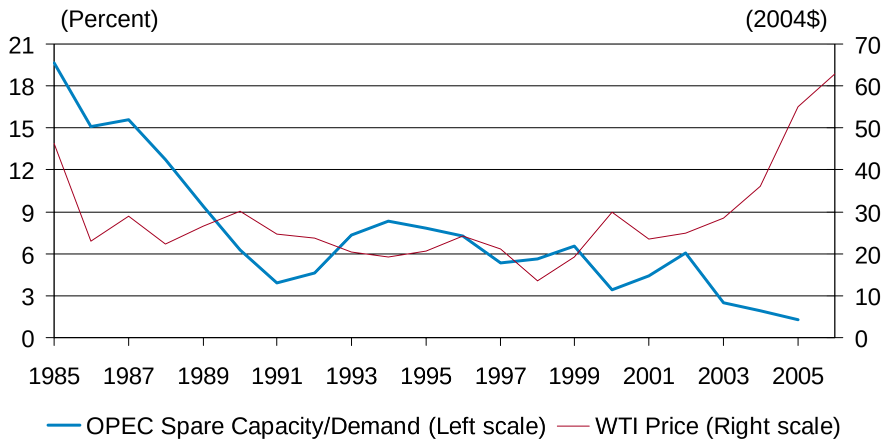

Chart 2: With OPEC Surplus Gone, Oil Is Now Just Another Cyclical Commodity

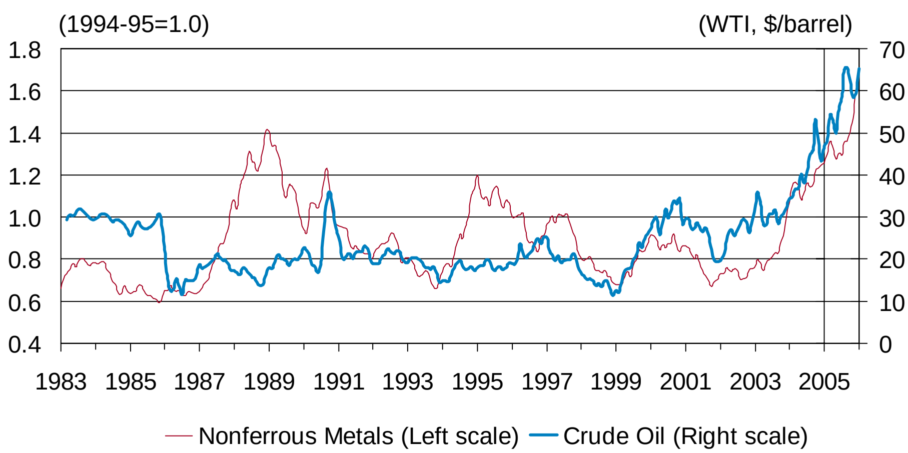

Chart 3: Components of the Pump Price of Gasoline

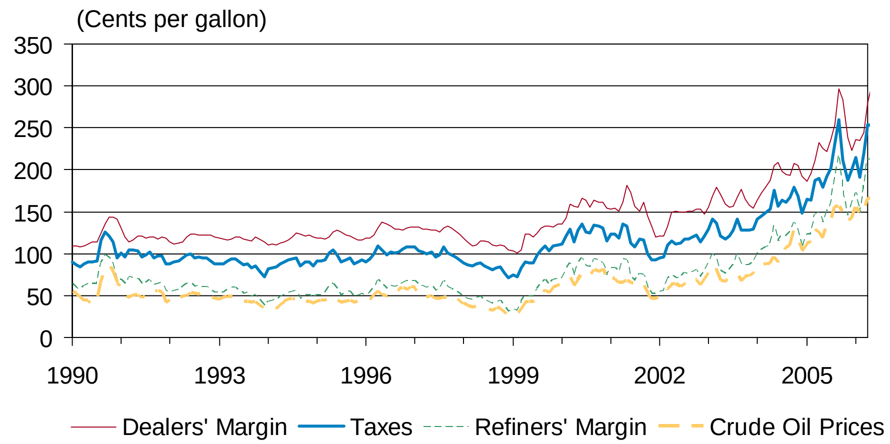

Chart 4: Components of the Pump Price of Gasoline

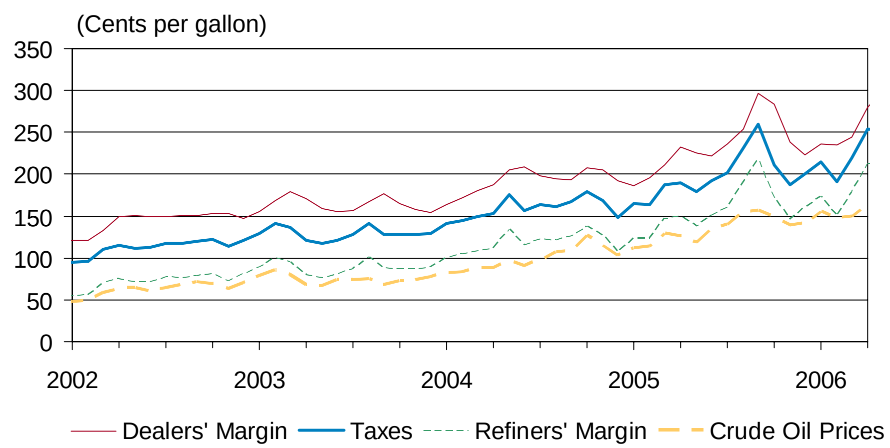

Chart 5: Gasoline Prices Have Barely Kept Up With Inflation

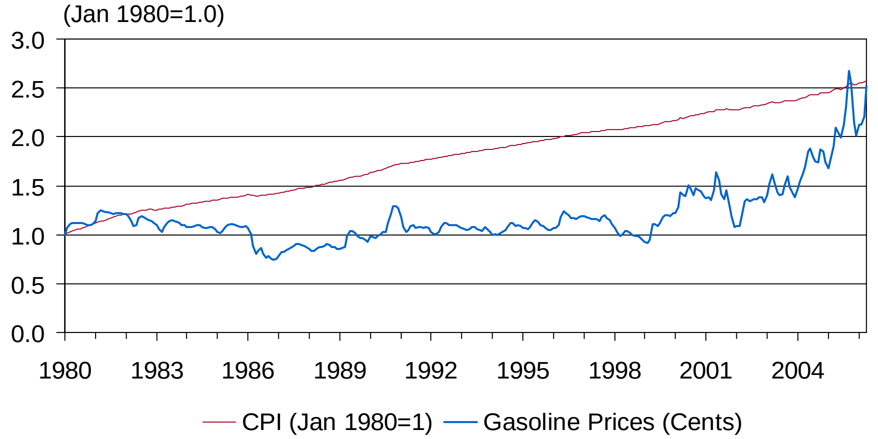

Chart 6: The Rise in Take-Home Pay Has Far Exceeded the Rise in Gasoline Prices

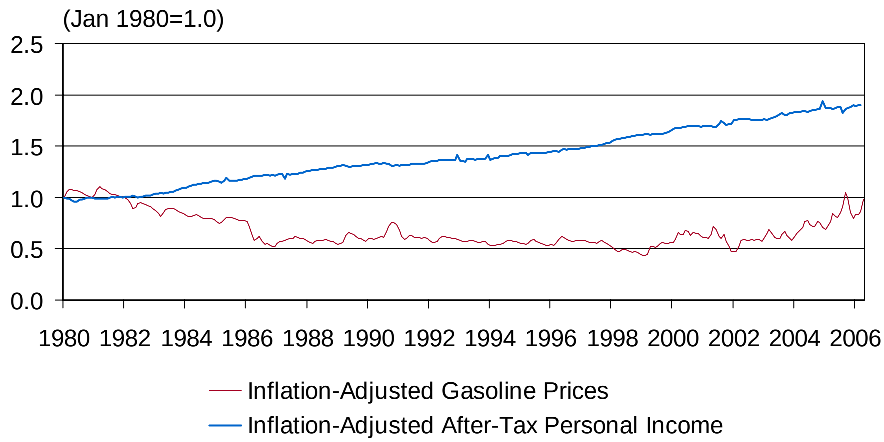

Chart 7: Energy Spending Takes a Bigger Share of Household Income, Temporarily