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Statement of Dr. Mark Cooper
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On

Consumer Effects of Retail Gas Prices

Before the

Judiciary Committee Antitrust Task Force
United States House of Representative

May 7, 2008

Mr. Chairman and Members of the Committee,

My name is Dr. Mark Cooper. I am Director of Research at the Consumer Federation of America.[1] I greatly appreciate the opportunity to testify yet again on the burden that rising gasoline and energy prices are putting on household budgets.

The Rising Energy Burden on Household Budgets

There is no doubt that rising energy prices are crushing the budgets of American households. We estimate that household spending on gasoline has increased from about $1200 in 2002 to over $3000 in 2008 (see Attachment 1).

Gasoline is only the tip of the energy iceberg for three reasons –

- consumers bear the burden of rising energy prices indirectly in the prices they pay for a wide range of goods and services.
- gasoline prices influence the price of crude oil, and
- crude oil influences the price of fossil fuels across the entire energy complex, and

Gasoline price increases are not the only energy price increases consumers have endured. Direct expenditures for energy by households include natural gas for heating and cooking, heating oil, and electricity. Combining increases in the cost of this residential energy with gasoline into total household energy or "energy at home," I estimate that from 2002 to 2008 household energy expenditures increased from about $2600 to over $5300. This increase of about $1900 represents an increase from 5 percent of household income to 8 percent.

To put this expenditure in perspective, I contrast expenditures at home for energy with expenditures at home for food and health care. Energy at home has shot past these other basic necessities dramatically (see Attachment 2).

Unfortunately, household energy expenditures are not the end of the story. The energy consumed by households accounts for only one-third of the total energy consumed (about 11 percent for gasoline and 22 percent for the residential energy, see Attachment 3). In other words, two thirds of the energy consumed in the country is used to produce goods and services. Tracking how much burden this places on households is a complex task. However, there are some obvious sectors that have attracted attention. The energy consumed in the transportation sector that is not gasoline consumed by households turns up in the cost of the

[1] The Consumer Federation of America is an advocacy, research, education and service organization established in 1968. CFA has as its members some 300 nonprofit organizations from throughout the nation with a combined membership exceeding 50 million people. As an advocacy group, CFA works to advance pro-consumer policy on a variety of issues before Congress, the White House, federal and state regulatory agencies, state legislatures, and the courts.

goods transported by truck and train. Commercial energy, used to light stores and buildings, will turn up in the retail price of good sand services. One example that has recently received a great deal of attention is the food sector. The production, processing and distribution of food consume about 8 percent of all the energy used in the nation, the cost of which turns up in the price of food. In a sense, netting out exports, energy related food costs that are passed on to consumers are over half as large as the direct gasoline costs at the pump.

The burden on household budgets discussed above is for the average household. Needless to say, the burden on lower income households is much greater. Although lower income households spend less on energy and other necessities, energy expenditures take a larger share of their income and household budgets. In 2005, the last year for which we have complete data, home energy expenditures took about 14 percent of the income for households in the bottom fifth of the income distribution (incomes below $17,579), compared to the national average where home energy took about 5 percent of income.

The Energy Price Spiral

The U.S. is afflicted with skyrocketing gasoline prices because of a combination of rising demand and faltering supply both at home and abroad. On the supply-side a combination of an international crude oil cartel and a tight domestic refining oligopoly have systematically under-invested in production capacity. By failing to expand production capacity to meet demand and provide a reasonable reserve in an industry with very low supply and demand elasticities that is prone to accidents and disruptions, the markets became tight and volatile. It is certainly true that tight global crude oil markets push up the price of gasoline, but it is also true that a tight refinery market in the U.S. pushes up the price of gasoline and ultimately pulls up the price of crude. These two domestic effects do not receive a great deal of attention, but they are important.

While crude oil is the largest component of the cost of gasoline, there have been months during the past five years when the domestic spread (the amount the domestic and refining account for at-the-pump price) has been over $1 gallon (see Attachment 4).

Those high domestic margins create a tug of war between OPEC and the domestic refining industry over the extraction of consumer surplus, a wrestling match has become so economically crippling that even the *Wall Street Journal* and the Energy Information administration have commented on it.

The U.S. gasoline market plays a critical role in the energy complex because it accounts for about one quarter of all the gasoline consumed in the world and one-eighth of the entire refined petroleum product. Thus, it is by far the single largest product market in the oil sector. As gasoline prices rise, OPEC receives the signal that the market will support higher prices. As refiner margins rise, OPEC, which is a rent seeking cartel, pushes for higher crude prices to recapture ‘its’ share of the available rents.

Things have gotten so bad in the U.S. gasoline market that even the Energy Information Administration, in one of its weekly reports, recognized that the tight U.S. gasoline market may be "pulling up" the price of crude. "In other words, if U.S. gasoline markets are tight, they may 'pull up' crude oil prices to a degree, given that tight downstream capacity makes each gallon of product produced that much more valuable, increasing the value of the crude used to produce the refined product."[2]

A *Wall Street Journal* story made a similar point.

> Two years ago when gasoline prices in the U.S. surged to the then-lofty level of $2 a gallon, the Organization of Petroleum Exporting Countries sprang into action, seeking to provide relief by pledging to boost oil production.
>
> Now with gasoline topping an average of $3.20 a gallon nationwide, OPEC officials say they see no reason to open the oil spigot.
>
> OPEC's new attitude reflects a tug of war in the global oil patch over how the profits from a barrel of oil are divided up between the world's producers – which develop oil deposits and pump oil -- and its refiners who process it into fuels like gasoline.
>
> In recent years, the balance in the world's oil-supply system has shifted, giving the refining industry more power and more profit…
>
> Privately, OPEC members are irked that U.S. refining margins – the profit refiners make in turning crude into gasoline and other products – have soared in recent months…
>
> OPEC officials say that if they pump more oil and depress world oil prices, U.S. gasoline prices might remain high, and the result would be even wider refining margins. In essence, OPEC would be putting more money into the pockets of refiners while its own revenue would be hurt by declining crude prices.[3]

OPEC's response to rising crude oil prices continues to be to point the finger back at the consuming nations. "Chakib Kheilil, the president of the global cartel, who is also the Algerian Energy Minister, said: "There are big pressures on OPEC and some consuming nations would like to present OPEC as being behind current high prices. But the truth is the current prices are linked to US economic problems as well as to the value of the dollar."[4]

While the crude cartel and the domestic refinery oligopoly drive up the rents collected from consumers, they have neglected the production side. There is little if any spare capacity in the global crude oil market. Only 3 percent of the world oil reserves are located in the United States, but the U.S. consumes more than 25 percent of the world's petroleum products.

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[2] Energy Information Administration, *This Week in Petroleum*, May 3, 2006, p. 2

[3] Bhusahn Behree and Ana Campoy, "Why OPEC Idles as Gas Prices Reach New Higher: Cartel Balmes Refiners, Cites Flush Oil Supplies, Tug of War Over Profits," *Wall Street Journal*, May 25, 2007.

[4] Suzy Jagger, "Oil Prices Could Stay as High as $110 a Barrel this Year, says OPEC," *Timesonline*, March 24, 2008.

Gasoline accounts for about 40 percent of all petroleum products supplied to U.S. consumers, and when all vehicle fuels are included that share increases to about 50 percent. This consumption drives the demand for imported crude oil and refined products. In fact, in recent years, the import of gasoline has more than doubled. Because the U.S. simply does not have the crude oil resources to keep up with rising gasoline consumption, oil imports have skyrocketed (see Attachment 7).

There is also a disastrous shortfall in domestic refinery capacity (see Attachment 8). The refinery shortfall has doubled to over 3 million barrels per day since the early 1990s. Yet, in spite of our growing dependence on imports and the shortage of refining capacity, our domestic stockpile has decline sharply (see Attachments 9 and 10), leaving us vulnerable to supply shocks and making gasoline and energy markets extremely volatile.

Speculation Increases the Upward Pressure on Prices

Speculation has also played an increasing role in driving up the price of crude oil and gasoline. On April 29, 2006, the *New York Times* ran a front-page article under the headline "Trading Frenzy Adds to Jump in Price of Oil."[5] The *Times* article opens with a brief paragraph on the conditions in the physical market but then devotes about 36 column inches to the proposition that financial markets are adding to the price increase.

> "A global economic boom, sharply higher demand, extraordinarily tight supplies and domestic instability in many of the world's top oil-producing countries – in that environment higher oil prices were inevitable.
>
> But crude oil is not merely a physical commodity . . . . It has also become a valuable financial asset, bought and sold in electronic exchanges by traders around the world. And they, too, have helped push prices higher…
>
> "Gold prices do not go up because jewelers need more gold, they go up because gold is an investment," said Roger Diwan, a partner with PFC Energy, a Washington-based consultant. "The same has happened to oil…"
>
> "It is the case," complained BP's chief executive, Lord Browne, "that the price of oil has gone up while nothing has changed physically."[6]

Three key factors serve to drive the price spiral higher: volume, volatility and risk. The structure and availability of markets plays a role in allowing the volumes to increase.

> Changes in the way oil is traded have contributed their part as well. On Nymex, oil contracts held mostly by hedge funds – essentially private investment vehicles for the wealthy and institutions, run by traders who share risk and reward with their partners – rose above one billion barrels this month, twice the amount held five years ago.

[5] Jad Mouawad & Heather Timmons, *Trading Frenzy Adds to Jump in Price of Oil*, N.Y. TIMES, Apr. 29, 2006, at A-1.
[6] *Id.*

> Beyond that, trading has also increased outside official exchanges, including swaps or over-the-counter trades conducted directly between, say, a bank and an airline. . . .
>
> Such trading is a 24-hour business. And more sophisticated electronic technology allows more money to pour into oil, quicker than ever before, from anywhere in the world. [7]

The influx of new money is sustained by movements of different institutions and individuals into the market. "Everybody is jumping into commodities and there is a log of cash chasing oil," said Philip K. Verleger Jr., a consultant and former senior advisor on energy policy at the Treasury Department."[8] Attachments 5 and 6 show that the amount of trading in commodities has quintupled in the past five years (which is coincident with the explosion of prices) and that energy commodities are driving that increase in trading.

This fundamental observation had been offered a couple of years earlier in a front page *Wall Street Journal* article entitled, "Oil Brings Surge in Speculators Betting on Prices: Large Investors Playing Ongoing Rise is Increasing Demand and Price Itself:"[9]

> Oil has become a speculator's paradise. Surging energy prices have attracted a horde of investors – and their feverish betting on rising prices has itself contributed to the climb.
>
> These investors have driven up volume on commodities' exchanges and prompted a large push among Wall Street banks and brokerage firms . . . . to beef up energy-trading capabilities. As the action has picked up in the past year, those profiting include large, well-known hedge funds, an emerging group of high-rollers, as well as descendants of once-highflying energy-trading shops such as Enron Corp.[10]

The notion is that the continual influx of money represents too much money chasing too few goods. By mid-2006, the Permanent Subcommittee on Investigations of the U.S. Senate had concluded that the estimates of a speculative premium on oil had risen to $25 dollars per barrel, or about one third of the world price.[11]

The most recent run up in crude prices has triggered similar concerns about the impact of financial speculation and trading on prices.

> "Oil is the new gold," said James Burkhard, director of global oil market analysis at the Cambridge Energy Research Associates consulting firm. "Oil has some intrinsic value, and that value remains even if the dollar depreciates."

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[7] *Id.*
[8] *Id.*
[9] Gregory Zuckerman & Henry Sender, *Oil Brings in Speculators Betting on Prices – Large Investors Playing Ongoing Rise is Increasing Demand and Price Itself*, WALL ST. J., Aug. 24, 2004, at. A-1.
[10] *Id.*
[11] Permanent subcommittee on Investigations, Committee on Homeland Security and Governmental Affaires, United States Senate, *The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on The Beat*, June 27, 2006.

> For weeks now, oil industry analysts have watched in amazement as oil's price kept climbing, even though government statistics showed that the country had ample supplies of oil and gasoline on hand. Gloomy news about the economy should have pulled oil down, because demand for petroleum usually slumps in a recession. But the bull market barely shrugged.
>
> "If you look at the run-up we've had for the last $20 or so, there's no other explanation for it," said Michael Lynch, president of the Strategic Energy & Economic Research consulting firm. "You have days when there's absolutely no news - except the dollar going down - and oil will still go up $3."
>
> *Role of big investors*
>
> The role of big investors in this year's price spike infuriates some consumer advocates. Investors such as hedge funds may view oil as nothing more than a financial asset, but to the rest of the country, it's fuel. The mercantile exchange didn't even start selling crude oil futures - the most common form of oil investment - until 1983.
>
> "We're taking a financial instrument that barely existed 20 years ago and allowing it to drive a stake through the heart of our economy," said Judy Dugan, research director for the Foundation for Taxpayer and Consumer Rights.
>
> Sooner or later, analysts say, the fundamental issues of oil supply and demand should bring down oil prices.[12]

The upward pressure that speculation puts on prices is not limited to crude, but applies to the whole energy complex. Recent months have seen sharp increases in gasoline prices despite weakening fundamentals.

> Nymex gasoline futures have been rising, following oil, despite growing supplies of both commodities. Blame the falling dollar, which has made dollar-denominated oil contracts irresistible to foreign investors and to any investors looking for a safe haven for their money during a turbulent time in the stock market.
>
> This buying by investors has pushed oil futures to a series of records in recent weeks, and the rest of the energy complex -- which includes gasoline futures -- has followed.
>
> Unfortunately, consumers pay for this investment frenzy in the form of higher pump prices. And despite mounting evidence that Americans are cutting back on their gasoline habit -- and may cut back even more drastically as gas gets more expensive -- it may be some time before prices start responding to lower demand.[13]

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[12] David R. Baker, "Blame the Dollar for High Gas Prices," *San Francisco Chronicle*, Mark 18, 2008.
[13] John Wilen, "If people are driving less, why are gas prices rising?," *South Florida Sun-Sentinel.com*, March 18, 2008.

Growing global demand certainly has played a role in triggering the price spiral of recent years, but in a well-functioning market, steadily growing demand would not cause such a powerful upward surge in prices and a huge increase in volatility (see Attachment 11). It is the failure to invest on the supply-side, mergers resulting in highly concentrated markets, and barriers to entry that have allowed the cartel and the oligopoly to profit at the expense of the public. Speculation magnifies the upward spiral.

Policy Responses

Unfortunately, two decades of policy neglect have created this problem and there are no short-term solutions. We need a policy that is dedicated to reducing our oil consumption and expanding alternative energy sources in a responsible way. Congress took a huge step in that direction last year when it enacted the Energy Independence and Security Act. Now that we have started down that path, it is critical that we stay on it.

One thing we do not need is short-term gimmicks that divert our attention from the long-term goal. One such idea that has received a lot of attention and bipartisan support on the campaign trail is a gasoline tax holiday. We conclude that it is an awful idea. The basis for reaching that conclusion has been described in the above analysis.

First, because of the current supply/demand situation, the oil companies will eat part of the tax cut by simply expanding the domestic spread. It gives them more head-room to raise their share of the price. Any effort to recapture that increase in profit by increasing taxes on oil companies would have to prevent them from putting more profits in their pockets. Even if it did so, the end result would be that consumers just pay the tax through another route. Given the inelasticity of supply and demand, tax incidence analysis tells us the burden will be shifted to the consumer. A windfall profits tax may be a good idea under other circumstances, but coupling it with a gasoline tax holiday makes it too easy for oil companies to shift the burden to consumers.

Second, using the gasoline tax to flow rebates to consumers is a tax cut for the wealthy. As we have seen, lower income households consume substantially less gasoline than the national average. Upper income households consume a lot more, so they would get a disproportionate share of whatever part of the tax cut is passed through to consumers. Based on the 2005 Consumer Expenditure Survey, the wealthiest 20 percent of households (top quintile with incomes above $85,000)) consume 32 percent of all gasoline. The bottom 40 percent of all households (bottom two quintiles with incomes below $33,000) consume only 23 percent of all gasoline. Obviously, because they have lower income, they feel greater relief, but if providing relief to lower and middle income households is the objective, there are much more effective ways to accomplish the goal that do not fill the pockets of the wealthy at the same time.

Third, the gasoline tax holiday scrambles the incentives on energy consumption and turns gasoline taxes into a political football. It will induce people to drive more and divert

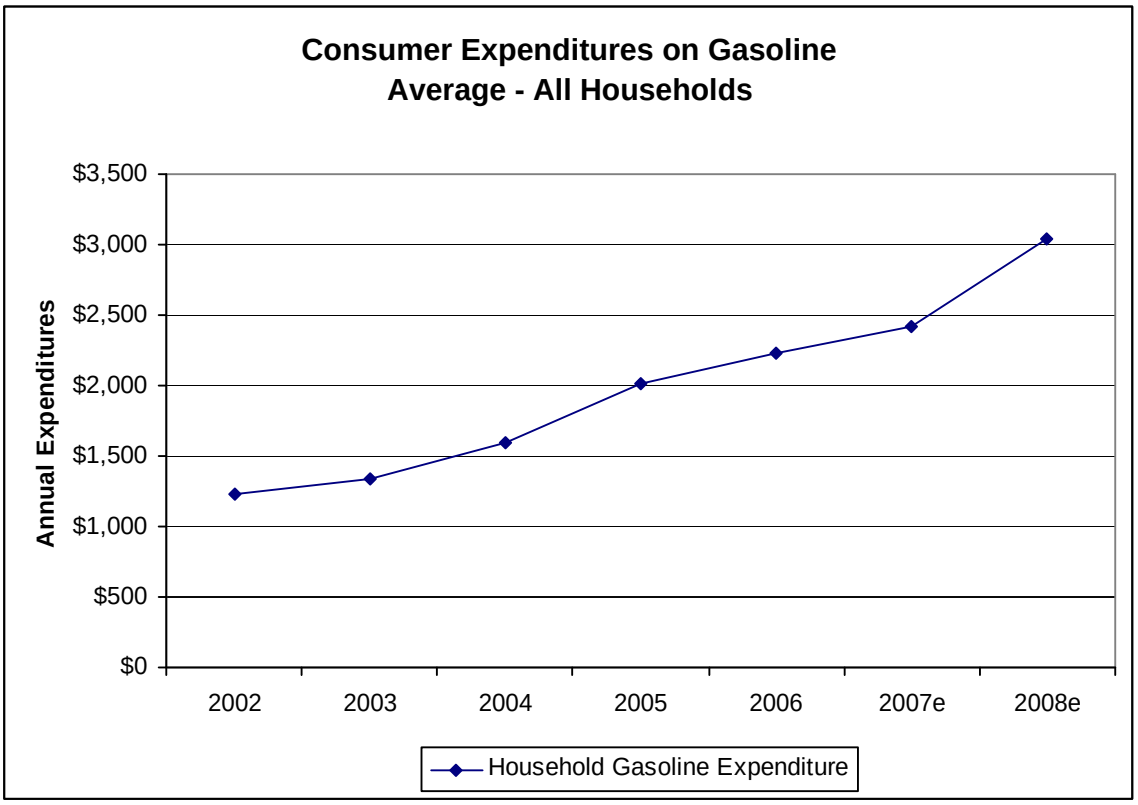
their attention from more efficient vehicles and alternative methods of transportation (at least temporarily), which is not the message we need to send.

Fourth, since gasoline taxes are earmarked for the highway trust fund, it could drain the highway trust fund. Since the national highway system is infrastructure in need of repair, this is one earmark that is in the public interest. With a huge deficit and mounting national debt, engineering replacement revenues will pose a challenge, whatever the source of funds.

Finally, if the idea is to actually lower gasoline prices, then policies that attack the underlying problem in both the short- and long-term are more attractive. If the most recent run-up is seen as a temporary, speculative bubble, then policies that curb speculation and temporarily expand supply could be considered. Ultimately, a long-term solutions will do consumers the most good.

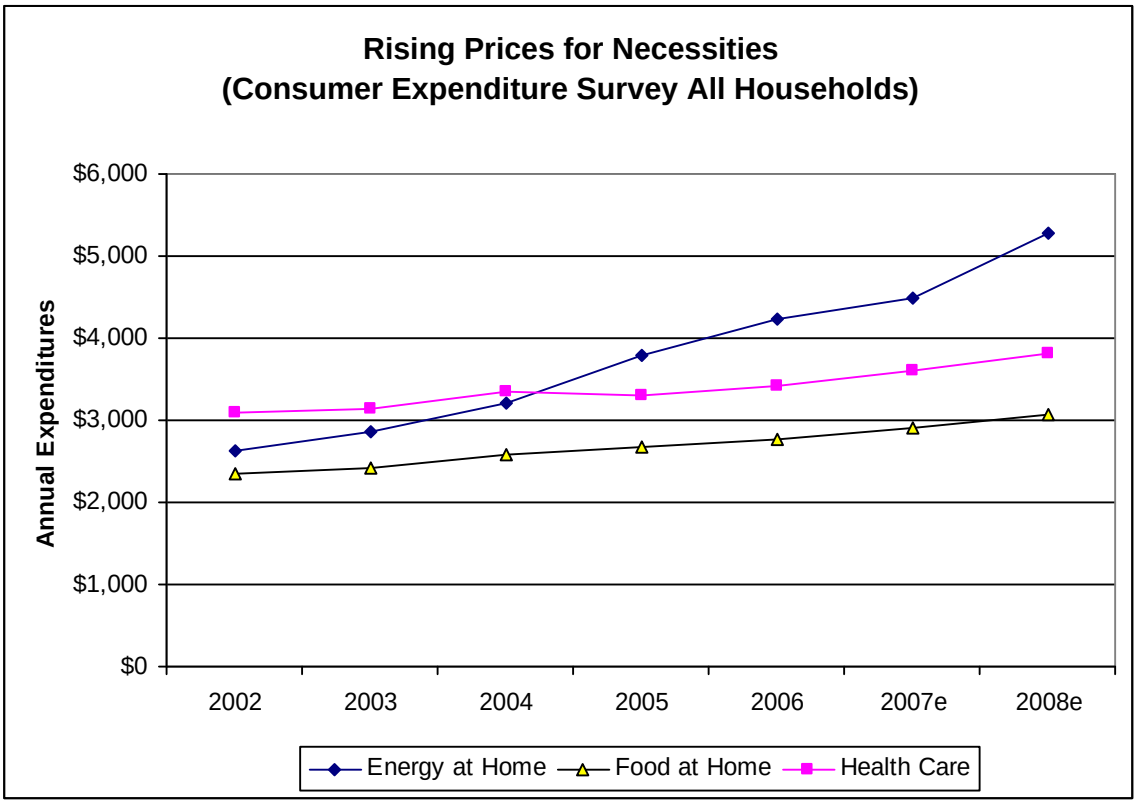
Without the abuse of market power in the crude oil and refining sectors, the summer price of gasoline would be in the vicinity of $2.00 a gallon rather than heading for $4.00 a gallon nationwide. A policy that gives relief of 18 cents a gallon for a few months and does nothing to address the systemic problem, even makes it worse, while allowing the oil companies to eat the tax holiday by raising prices, is at best a diversion and at worst a sham.

Attachment 1



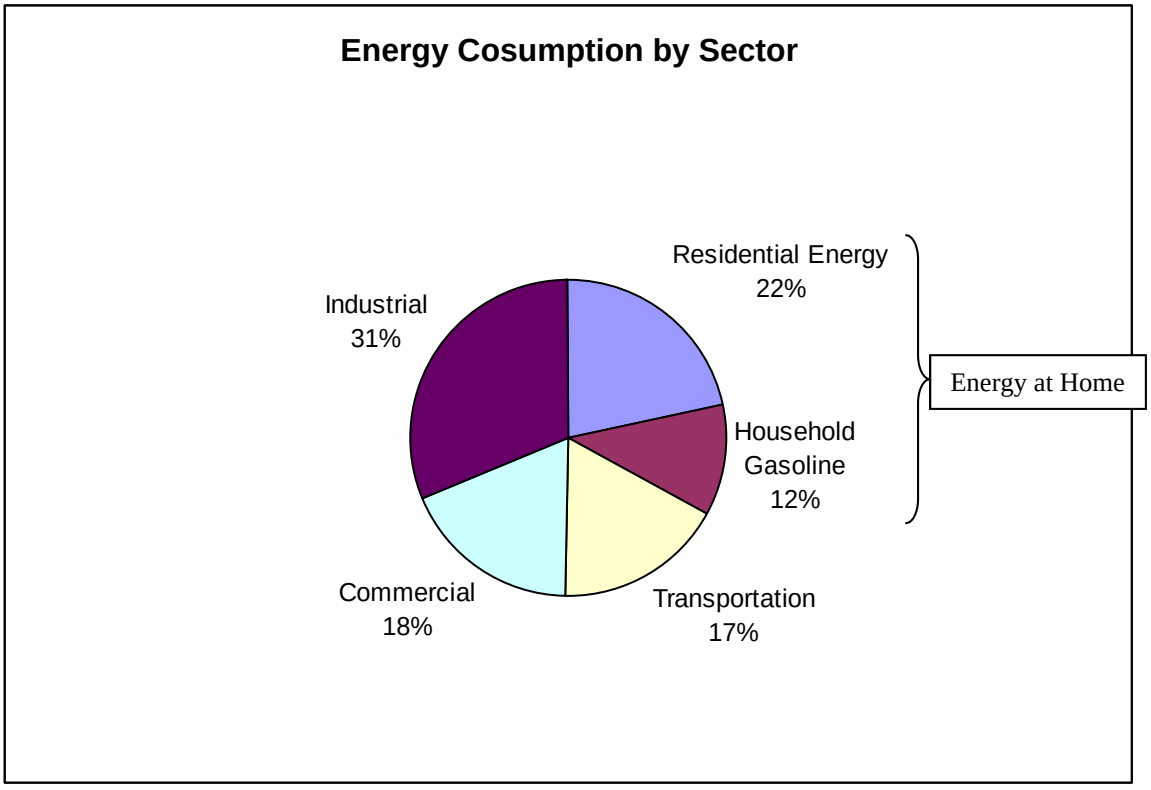
Source: Bureau of Labor Statistics, *Consumer Expenditure Survey*, through 2006, updated with the Consumer Price Index and Energy Information Administration, *Short Term Energy Outlook*. Assumes 5 percent cutback 2006-2008.

Attachment 2



Source: Bureau of Labor Statistics, *Consumer Expenditure Survey*, through 2006, updated with the Consumer Price Index and Energy Information Administration, *Short Term Energy Outlook*. Assumes 5 percent cutback 2006-2008 for energy, but no cutbacks for food at home and health care.

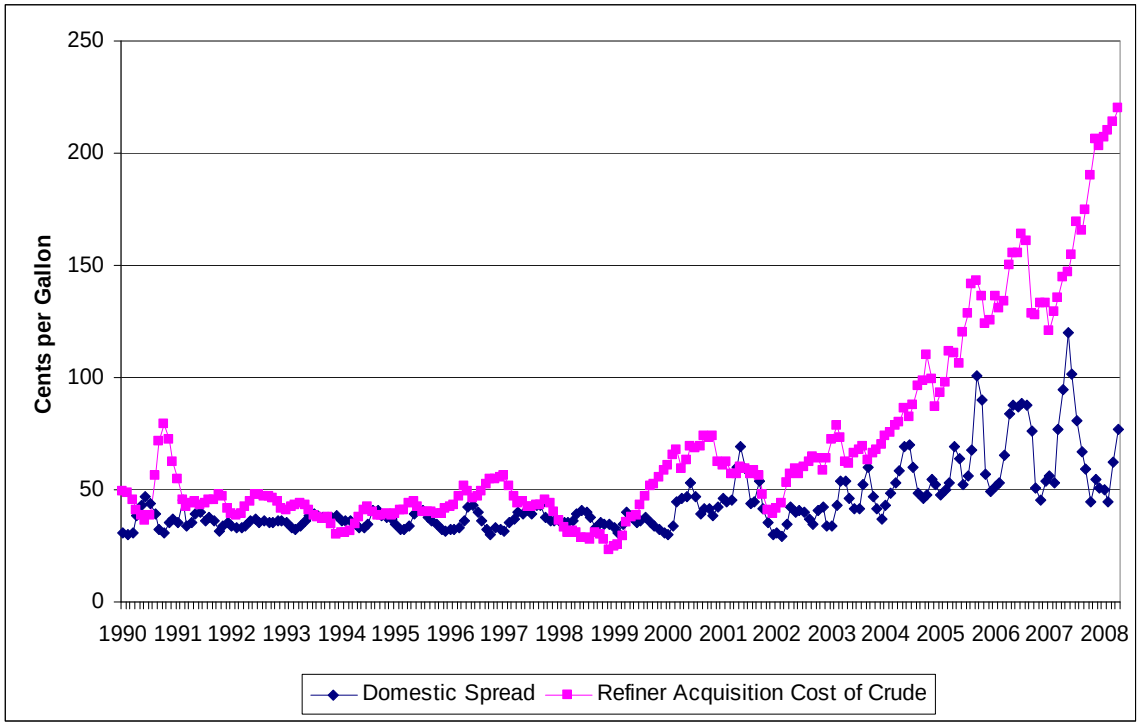
Attachment 3



Sources: Energy Information Administration (EIA), *Monthly Energy Review,* April 2008, Table 2.1 for overall energy consumption. Household gasoline is derived from the Bureau of Labor Statistics, *Consumer Expenditure Survey*, by estimating the number of gallons consumed per households (average expenditure/average price) and converting to Btu. This total is subtracted from the transportation total.

Attachment 4:

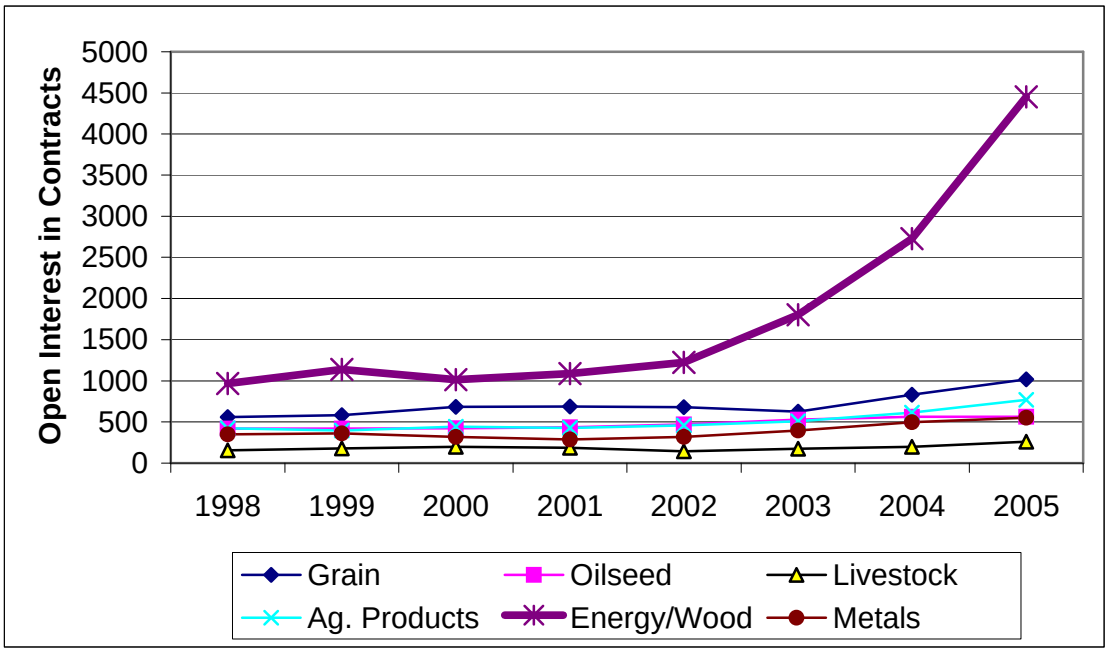
Record Gasoline Prices are the Result of Increases in Crude Oil Prices and the Domestic Spread (pump price minus crude oil and taxes)



Source: Energy Information Administration, Database available at www.eia.doe.gov

Attachment 5:

Trading Of Non-Financial Instruments (Average Month-end Open Interest)



Source: Commodity Future Trading Commission, Annual Reports: Futures Statistics by Major Commodity Group.

Attachment 6:

Trading has quintupled Since 2002

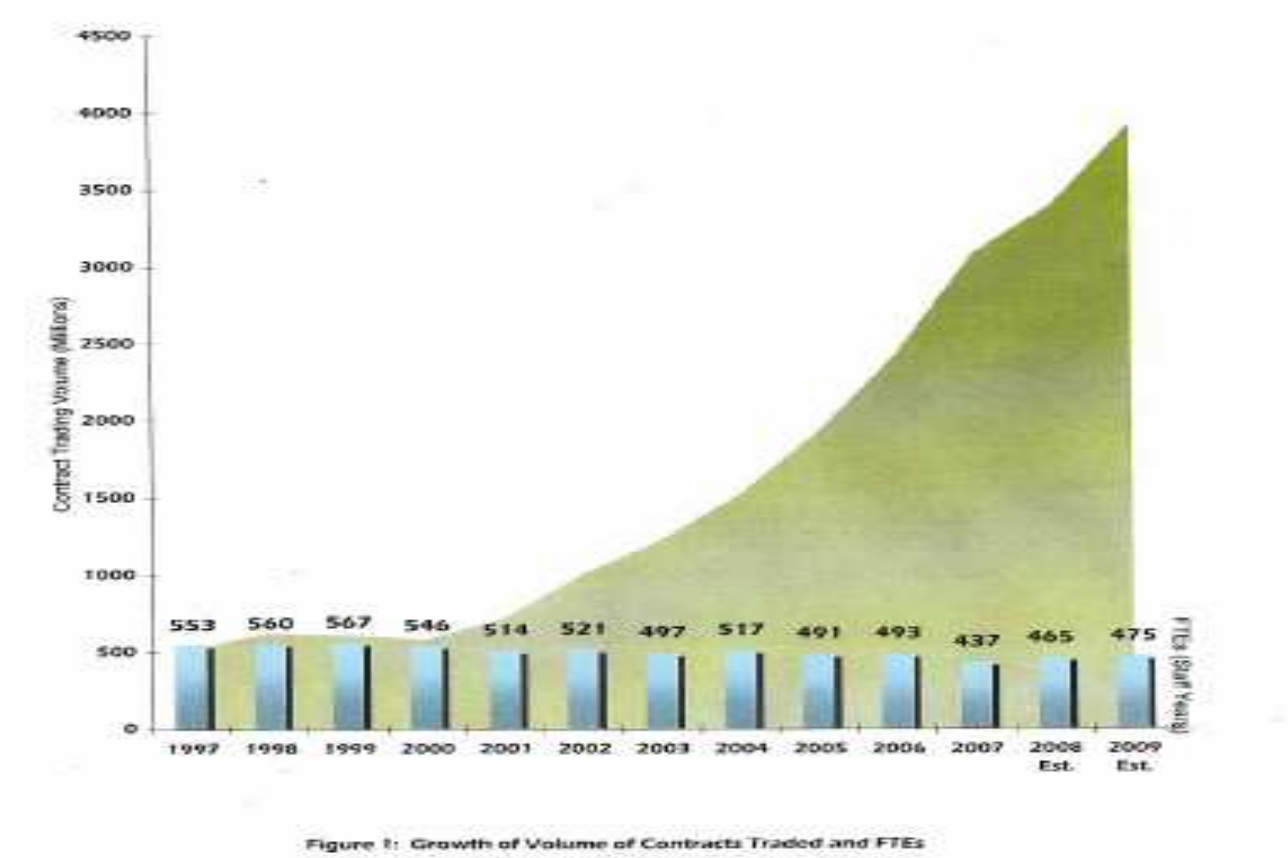
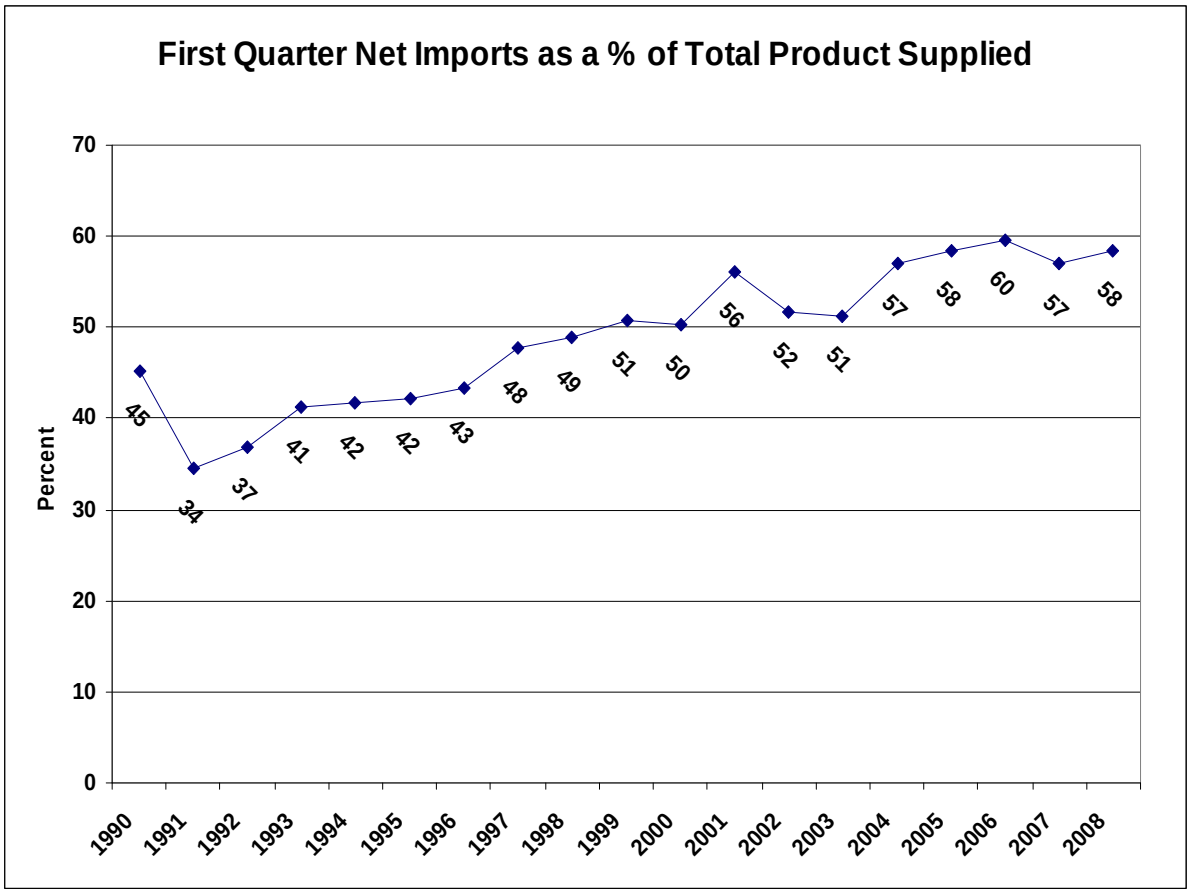


Figure 1: Growth of Volume of Contracts Traded and FTEs

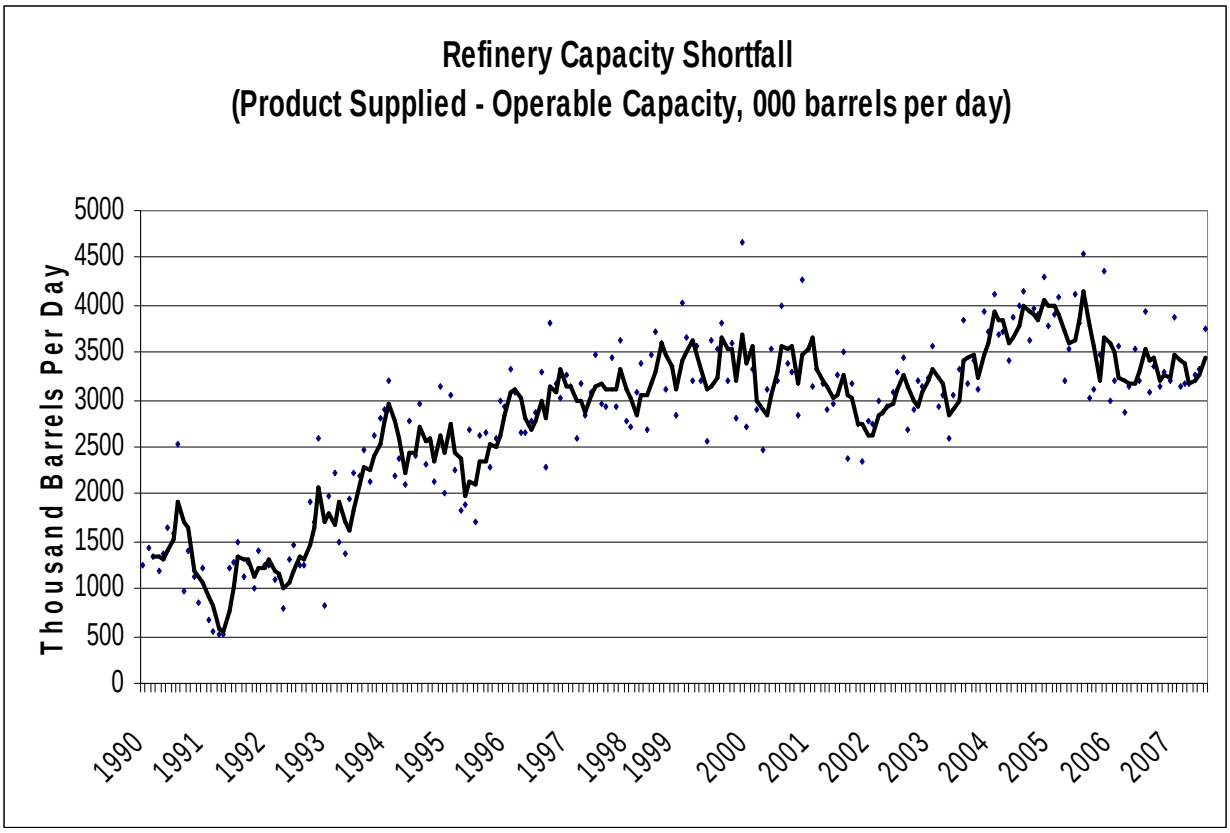
Source: Commodity Futures Trading Commission, FY 2009 President's Budget and Performance Plan, available at
http://www.cftc.gov/stellent/groups/public/@aboutcftc/documents/file/2009budgetperf.pdf

Attachment 7:



Source: Energy Information Administration, Database, www.eia.doe.gov,

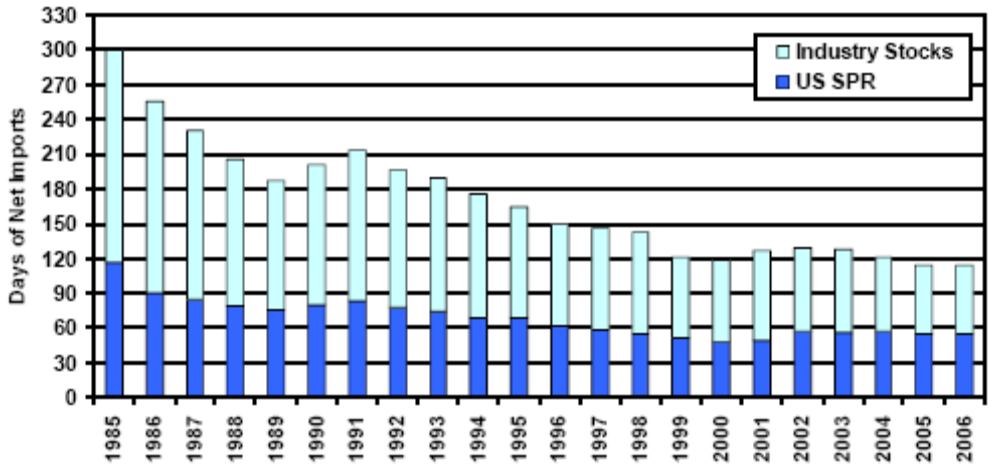
Attachment 8:
The Refinery Shortfall has Doubled Since the Early 1990s



Source: Energy Information Administration, Database available at www.eia.doe.gov

Attachment 9:

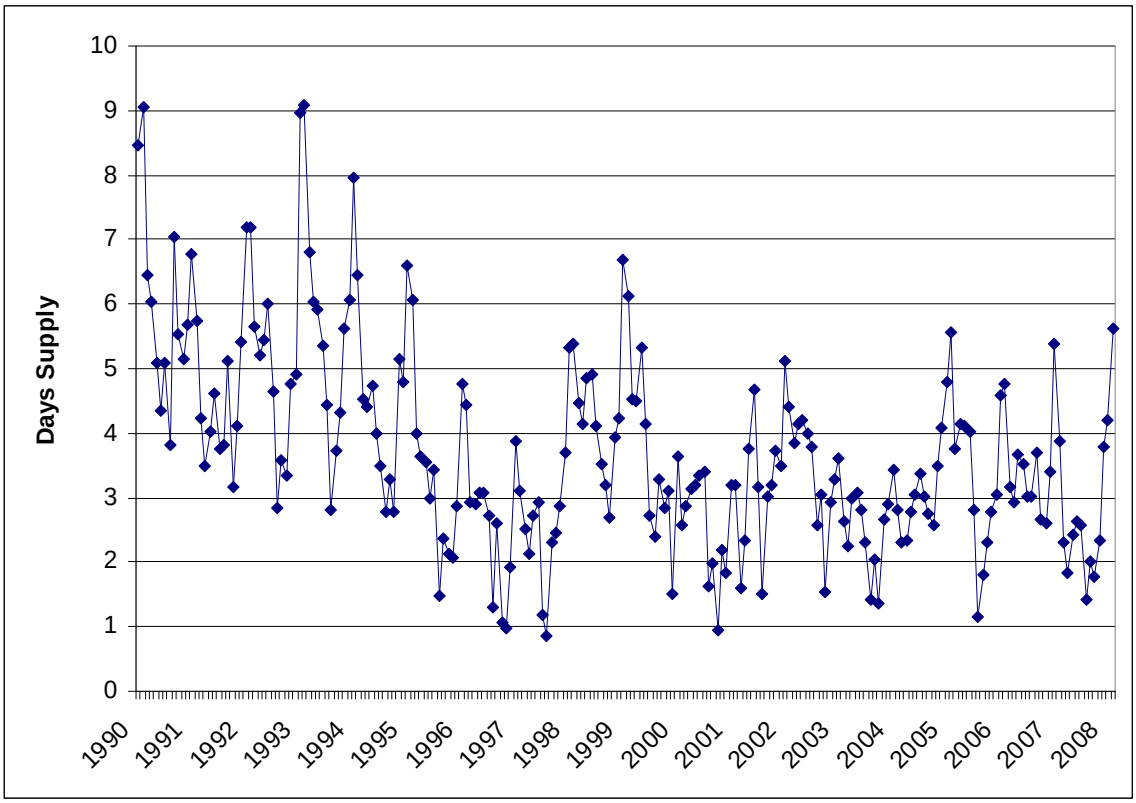
U.S. Crude Oil Stocks



Source: U.S. Department of Energy, *Strategic Petroleum Reserve Annual Report for Calendar Year 2006,* p. 30

Attachment 10:

Gasoline Inventories have plummeted compared to Demand
(Das Supply above Minimum Operating Inventories)



Source: Energy Information Administration, Database available at www.eia.doe.gov

Attachment 11

Physical, Financial and Regulatory Factors in the Explosive Spiral of Energy Prices