

# **Statement of API Chief Economist John Felmy before the House Select Committee on Energy Independence and Global Warming**

May 9, 2007

I am John Felmy, Chief Economist of API, the national trade association of the U.S. oil and natural gas industry. API represents nearly 400 companies involved in all aspects of the oil and natural gas industry, including exploration and production, refining, marketing and transportation, as well as the service companies that support our industry.

The oil and natural gas industry understands the frustrations that consumers have expressed about gasoline prices. We recognize that these higher prices are adversely impacting individual households and potentially our economy.

## Higher Gasoline Prices: An Overview

For 12 of the last 13 weeks, the average U.S. retail price for regular gasoline increased, according to the Energy Information Administration.

Our member companies are doing everything they can to deal with this situation and meet the fuel needs of U.S. consumers. Crude oil inventories have been building and are 8.8 percent above the five-year average for this time of year. Year-to-date gasoline production is 8.83 million barrels per day, the highest ever (see Figure 1). Thanks to the industry's major investments in state-of-the-art refining technology, our companies are squeezing out more gasoline and diesel fuel from a barrel of crude oil this year compared

to past years (see Figure 2). Looking ahead, we expect to bring the equivalent of an additional eight new refineries into operation in the U.S. by 2011.

Despite the industry's all-out efforts, we are still faced with challenges that, in combination, have driven up gasoline prices. Most importantly, crude oil prices have fluctuated significantly, driven by lingering geopolitical tensions, OPEC's continuing production controls, and worldwide demand growth. More than half the price of gasoline is attributable to the cost of crude oil. Oil companies do not set the price of crude. It is bought and sold in international markets, and the price paid for a barrel of crude reflects the market conditions of that day.

A second major factor is that gasoline demand in the U.S. reached a record high in the first quarter of this year. The Department of Energy forecasts that demand will increase further in the "summer driving season" which begins this month. Moreover, nearly half of U.S. gasoline is blended with ethanol, so as demand has gone up, ethanol prices and the cost of ethanol-blended gasoline have risen as well.

In addition, the annual switchover to "summer blend" gasoline required by EPA has occurred and this warm-weather gasoline is more expensive to produce. The switchover requires a large supply drawdown to meet regulations. And less gasoline is available to import because of spring refinery maintenance in Europe, and a 17-day French port-workers' strike in March led some European refiners to reduce production (see Figure 3).

U.S. gasoline production this year is at all-time record high levels despite regularly scheduled refinery maintenance and several unexpected problems that have interrupted some refining operations. The maintenance is a normal procedure, though delayed, in some cases, by damage suffered from the catastrophic hurricanes in 2005. While maintenance curtails refining operations temporarily, it helps ensure the long-term viability of the refinery and protects the health and safety of our workers.

#### Factors in the cost of gasoline

In order to understand the higher costs of gasoline and other motor fuels, we need to consider them in the context of the world energy supply and demand situation.

We currently import more than 60 percent of the crude oil and petroleum products we consume. American refiners pay the world price for crude and distributors pay the world price for imported petroleum products. Whether a barrel is produced in Texas or Saudi Arabia or elsewhere, it is sold on the world market, which is comprised of hundreds of thousands of buyers and sellers of crude oil from around the world.

There is a fragile balance between the world's supply and demand for crude oil. Because of this tight market, any disruption of oil supply – or even the threat of a disruption – can push prices upward as buyers and sellers in the worldwide marketplace look to secure supplies for their customers.

It is well recognized that the market for crude oil has tightened. World oil demand reached unprecedented levels in 2005 and continues to grow due to strong economic growth, particularly in China and the United States. World oil spare production capacity – crude that can be brought online quickly during a supply emergency or during surges in demand – is at its lowest level in 30 years and is a critical factor to observe. Current spare capacity is low by historical standards. Accordingly, the world's oil production has lagged, forcing suppliers to struggle to keep up with the strong growth in demand.

The delicate supply/demand balance in the global crude oil market makes this market extremely sensitive to political and economic uncertainty, weather conditions, and other factors. Over the past several years, we have seen how the market has reacted to such diverse developments as dollar depreciation, cold winters, the post-war insurgency in Iraq, hurricanes in the Gulf of Mexico, the Venezuelan oil workers' strike in 2002-2003, uncertainty in the Russian oil patch, ongoing ethnic and civil strife in Nigeria's key oil producing region, and decisions taken by OPEC.

Some are again accusing the industry of illegal activity. Our industry has been repeatedly investigated over many decades by the Federal Trade Commission and state attorneys-general. Of the more than 30 investigations that we are aware of, all have resulted in exoneration.

Some have proposed federal controls on fuel prices to prevent “price gouging.” Such measures would prove a disaster for the nation’s economy and hamper the oil and natural gas industry’s efforts to supply U.S. consumers with the fuel they need.

Pricing is the mechanism any market uses to balance supply and demand. Higher fuel prices are an inevitable and necessary consequence of supply shortages and they allow a market to rebalance itself by rationing scarce fuel supplies among consumers while also attracting new supplies. This was evident in the South after Hurricane Katrina. Higher fuel prices attracted additional fuel supplies, both domestic and imported, that eventually drove prices down – all without government intervention.

In fact, the Federal Trade Commission came to similar conclusions in a recently completed fuel pricing investigation. It found that, in nearly all cases, price increases, given the amount of production and refinery capacity knocked off-line, were approximately what would be predicted by supply and demand principles.

Price gouging legislation, by introducing price controls, interferes with normal market forces that can efficiently address supply/demand imbalances. History has demonstrated that price controls and allocations simply do not work. Price controls on crude oil and petroleum products were in effect from 1971 to 1981. They established price ceilings on domestically produced crude oil and refined products, keeping them artificially low compared to world prices. This resulted in decreased domestic crude production while domestic demand for crude and refined products increased, leading to a worsening of

shortages and increased oil imports. FTC Chair Deborah Majoras has also observed, “Price gouging laws that have the effect of controlling prices likely will do consumers more harm than good.”

Further, price gouging laws are vague and, therefore, difficult to comply with and enforce fairly. This legal uncertainty, especially when coupled with the serious risk of criminal penalties, fines, and civil liability, may discourage a supplier from doing business in an affected area and, therefore, delay a return to normal conditions.

#### Oil and natural gas industry earnings are comparable to those of other industries

There is also considerable misunderstanding about the oil and gas industry’s earnings, which are typically in line with other industries and are often lower. For 2006, the industry’s annual earnings averaged 9.5 cents on each dollar of sales. The average for all manufacturing industries was 8.2 cents or about a penny lower. From 2002 to 2006, average earnings for the industry stood at approximately 7.4 cents on each dollar of sales – a penny above the five-year average for all U.S. manufacturing industries.

It should not be forgotten that the energy Americans consume today is brought to us by investments made years or even decades ago. Today’s oil and natural gas industry earnings are invested in new technology, new production, and environmental and product quality improvements to meet tomorrow’s energy needs. Between 1992 and 2005, the industry invested more than \$1 trillion – on six continents – in a range of long-term energy initiatives: from new exploration and expanding production and refining capacity

to applying industry leading technology. In fact, over this period, our cumulative capital and exploration expenditures exceeded our cumulative earnings.

Furthermore, the industry's future investments are not focused solely on oil and natural gas projects. For example, one oil company is among the world's largest producers of photovoltaic solar cells; another oil company is the world's largest developer of geothermal energy; and the oil and gas industry is the largest producer and user of hydrogen. Over the last five years in North America alone, we have invested \$12 billion in renewable, alternative and advanced non-hydrocarbon technologies. In fact, when you add up all of the various types of emerging energy technologies, our industry, over the five years, has invested almost \$100 billion -- that's more than two and half times as much as the federal government and all other U.S. companies combined.

It also requires billions more dollars to maintain the delivery system necessary to ensure a reliable supply of energy and to make sure it gets where it needs to go: to industry customers. Americans' oil and natural gas use is expected to grow by one-third in the next 25 years. The industry is committed to making the reinvestments that are critical to ensuring our nation has a stable and reliable supply of energy today and tomorrow.

It is also important to understand that those benefiting from healthy oil and natural gas industry earnings include numerous private and government pension plans, including 401K plans, as well as many millions of individual American investors. While shares are owned by individual investors; firms, and mutual funds, pension plans own 41

percent of oil and natural gas company stock. To protect the interest of their shareholders and help meet future energy demand, companies are investing heavily in finding and producing new supplies.

#### Higher gasoline prices cannot be viewed in isolation

Rising gasoline prices are a burden on U.S. consumers – but they cannot be viewed in isolation from the U.S. energy situation. If we are to avoid price volatility and tight supplies and ensure that the fuel needs of U.S. consumers are met, we must focus on three areas: efficiency, technology, and diversity.

- First, America's energy companies must continue to improve our own energy efficiency, and encourage energy efficiency in other industries and by the American people;
- Second, we must increase the use of advanced energy technologies that allow us to develop our resources cleanly and responsibly; and
- Third, we must increase the diversity of our oil and natural gas supplies, both here at home and from around the world.

One of the first steps toward increasing our energy security is making the most of what we already have. We all need to become more energy efficient.

Our efforts go beyond just our operations. Last summer, our refineries began to deliver an impressive, new fuel that significantly reduces emissions and allows the increased use



of energy-efficient diesel engines. It's called Ultra Low Sulfur Diesel and it's the cleanest diesel fuel supplied in the world today – with a 97 percent reduction in sulfur content.

In addition to energy efficiency, our industry has researched and developed breakthrough technologies to help us find, develop and deliver energy. For example, we now have 4-Dimensional Imaging, which helps us better locate oil underground. Imagine a geoscientist watching multiple data screens of 3D visuals revealing exactly what exists below the surface – like stepping into the earth and seeing specific rock strata: sandstone, limestone, and salt domes, along with oil. Time being the fourth dimension, we can take snapshots of those underground reservoirs over time and overlay the pictures to see in which direction the oil is moving. That's how we find oil today. It's non-invasive and more environmentally-compatible than ever.

We also use what's called multi-directional drilling. We can drill down at one site, then turn left or right and drill for more than five miles, and then go further down or back up – whatever is needed to encounter the oil. Advanced techniques like this have dramatically reduced our environmental footprint. Today it's possible to develop nearly 80 square miles of area below the surface from a single two-acre site on the surface. These technological innovations are making a difference.

Just as we need to diversify the kinds of energy we use, we also need to acknowledge that a diversity of sources is the best way to ensure energy security and meet growing demand. Our country should be doing all it can to increase the amount of energy

produced in the United States. We should encourage the development of alternative and renewable sources of energy, which are growing at a rate faster than traditional sources.

However, it's important to place U.S. energy sources in the proper perspective.

According to the Energy Information Administration (EIA), renewable energy presently accounts for about 6 percent of our nation's energy use. And, this EIA figure is projected to climb to 7 percent over the next 25 years. Concurrently, the Department of Energy estimates that oil, natural gas, and coal will continue to meet approximately 86 percent of U.S. energy demand for at least the next two decades.

We have abundant volumes of oil and natural gas resources beneath federal lands and coastal waters. However, more than 85 percent of U.S. coastal waters that are up to 200 miles from our shores are off-limits to oil and natural gas exploration. These areas, and 75 percent of the technically available U.S. onshore areas, are "off-limits" or accessible only with significant restrictions -- despite federal government estimates that there is enough oil in these areas to power more than 60 million cars for 60 years and heat more than 25 million homes for 60 years. And there is enough natural gas to heat an additional 60 million homes for another 60 years.

### Conclusion

The U.S. oil and natural gas industry is doing everything it can to produce the fuel supply needed to meet consumer energy needs. However, the industry cannot meet U.S. energy challenges alone. Our nation's energy policy needs to focus on increasing supplies;

encouraging energy efficiency in all sectors of the economy, including transportation; and promoting responsible development of alternative and non-conventional sources of energy.

Congress needs to allow the oil and gas industry to invest today's earnings in meeting tomorrow's energy needs. To do otherwise will threaten our energy future. Congress can help by opening up more of the resource-intensive areas in our nation that are off-limits to new production. Because the market remains healthy and competitive, it is imperative that it be permitted to continue functioning as freely of artificial restraints as possible.

Figure 1

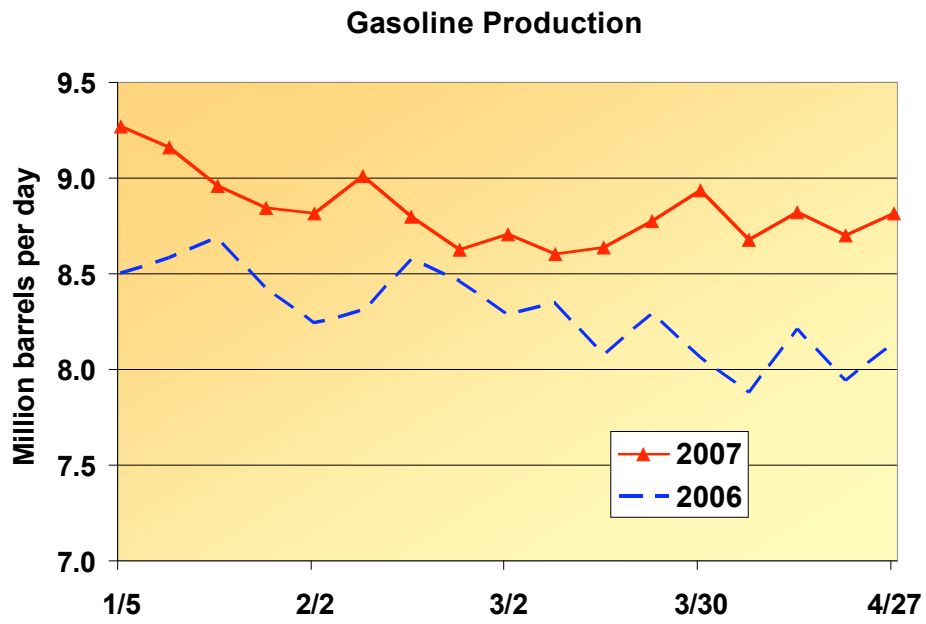


Figure 2

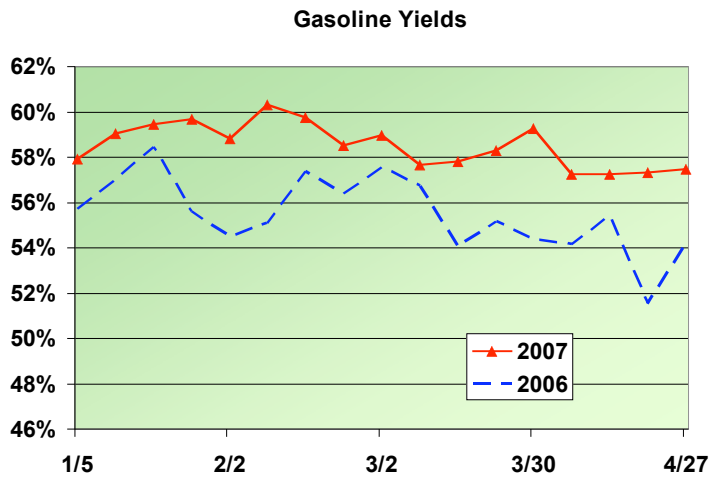
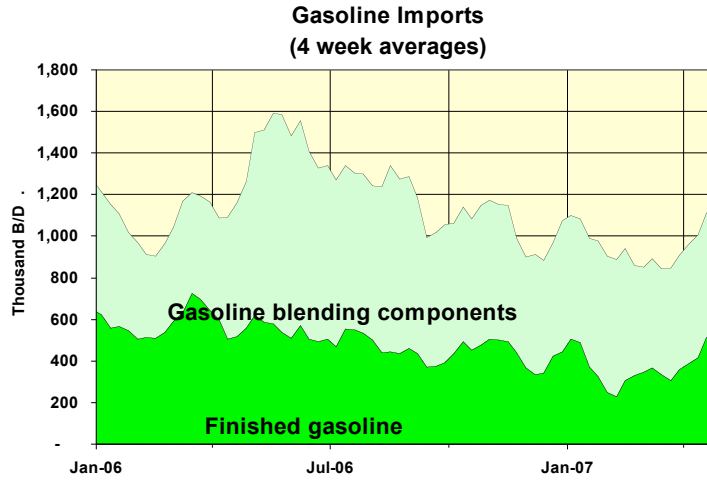


Figure 3



Source: American Petroleum Institute Weekly Statistical Bulletin