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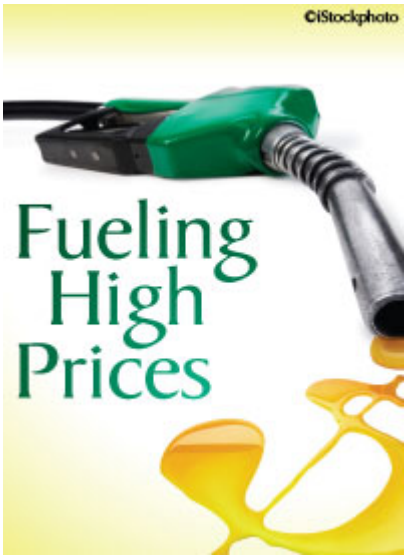
Fueling High Gas Prices



While the execution of the world's most wanted man, al-Qaeda leader Osama bin Laden, gave President Obama a boost in his overall approval rating, a *New York Times*/CBS News poll revealed that his approval rating on handling the economy has fallen through the floor, with 38 percent approving and 57 percent disapproving. The President responded to this potential obstacle to his reelection by announcing that the U.S. Department of Justice would set up an Oil and Gas Fraud Working Group, to be organized as an arm of the Financial Fraud Enforcement Task Force, in order to investigate possible illegal manipulation of gasoline prices.

History Shows No Mystery

History shows that this is a very typical response by politicians, as they desperately look for scapegoats, in order to draw attention away from the role that they themselves have played in contributing to the situation. Whenever gasoline prices increase significantly in a relatively short period of time and, in conjunction with that, the news media report that the profits of oil companies are also rising, one can predict, almost like clockwork, widespread outrage. The public becomes convinced that oil companies are working together in an effort to drive up the price of gasoline. Cries of "obscene profits" arise in the media, along with demands that the state and federal governments "do something" about the high cost of gasoline. Politicians fall all over themselves getting to the nearest microphone, in order to condemn the "price gouging" being perpetrated by the oil companies on the helpless American public and to threaten the imposition of "windfall profits" taxes, among other actions.

That is precisely what has been happening. I have already received several e-mail messages on the subject of lowering gasoline prices from U.S. Senator Herb Kohl of Wisconsin, where I reside. In the latest message, he stated, "While Congress doesn't have direct authority to set gas prices, we do have some ability to influence the elements that contribute to high prices at the pump, such as our dependence on foreign oil. We can address this issue in part by reigning [sic] in the power of the Organization of the Petroleum Exporting Countries (OPEC). For more than a decade, I have proposed a bill — the No Oil Producing and Exporting Cartels Act (NOPEC Act) — that would subject OPEC to U.S. antitrust law." Senator Kohl went on to claim that, if his NOPEC Act were passed by Congress, it would give the U.S. Department of Justice the tools it needs to enforce the antitrust laws against the OPEC oil cartel.

That is a classic example of political and economic grandstanding, because we have very little, if any, leverage over OPEC, due to our heavy dependence on imported oil. If Senator Kohl were really serious about lowering gasoline prices, he would be working to reduce the federal government's restrictions on

the production of crude oil right here in the United States. Maybe he has not seen the results of a recent CNN/Opinion Research poll, which revealed that 69 percent of Americans favor increased offshore drilling for crude oil and natural gas.

U.S. Senator Bernie Sanders of Vermont has also chimed in, "The skyrocketing price of gas and oil has nothing to do with the fundamentals of supply and demand, and has everything to do with Wall Street firms that are artificially jacking up the price of oil in the energy futures markets.... The same Wall Street speculators that caused the worst financial crisis since the 1930s through their greed, recklessness and illegal behavior are ripping off the American people again by gambling that the price of oil and gas will continue to go up." Being a self-described socialist, it is perhaps not surprising that Senator Sanders would downplay the role of supply and demand in a free-market economy and misrepresent the role that speculators play in it.

When people expect the price of a commodity to rise in the future, due to an anticipated shortage caused by an increase in demand or a decrease in supply, the logical thing to do is to buy more of it now and store it for future use or sale. This is what oil speculators do. Then, if the shortage occurs and prices go up, they can sell the oil for a profit, bringing more supply into the market. Their selling during the shortage brings prices down from what they would have been had the speculators not acted. Speculators are not "artificially jacking up the price of oil," as Senator Sanders charges. They are taking risks, because those who guess wrong lose money. One should remember that, for every speculator that is buying oil, there is a speculator that is selling oil. In the end, one of them is going to make money, and the other one is going to lose money.

A Problem With the Profits?

Nevertheless, the profits of the oil companies do appear to be inordinately large at times, even excessive. But that is because the oil industry itself is so huge. Actually, as a percentage of total sales, the profit margins of oil companies turn out to be a bit lower than the average across all manufacturing industries, which is presently around nine percent, and much lower than in a number of industries, such as beverages (22 percent), pharmaceuticals (19 percent), and computers (17 percent). For example, ExxonMobil Corp., the world's largest publicly traded oil company, reported first quarter (January-March 2011) net income of $10.7 billion. Although that seems like one heck of a lot of money, it has to be put into the proper context, namely, it has to be compared to sales revenue, which was $114 billion. That means that ExxonMobil had to spend more than $103 billion to earn that net income, which works out to a profit margin of 9.4 percent and is roughly in line with the national average for all companies. Profit margins for some other oil companies were even lower: 8.5 percent for Chevron and five percent for Shell. Compare that to the profit margin for Google (27 percent) or Apple (25 percent) or McDonald's (20 percent). Where is the outrage over their profits?

As hard as it is to believe, even at almost $4.00 per gallon, the price of gasoline in America is actually a relative bargain, not only compared to what it costs in most other countries, but also compared to what it cost decades ago in this country relative to household income. Adjusted for inflation and changes in disposable household income, Americans were paying the equivalent of more than $5.00 per gallon in 1955, according to a study done by the Cato Institute. Of course, that's no consolation to millions of Americans, whose limited discretionary income is being eaten up by rising gasoline prices. Indeed, a *USA Today*/Gallup poll revealed that almost 70 percent of Americans say that the high cost of gasoline has had a noticeable impact on their financial situations, and more than half claim that they have had to make cutbacks in other areas of their household budgets.

To those who entertain the notion that oil companies are driving up gasoline prices, we have to ask some seemingly logical questions: “If oil companies can control gasoline prices to such an extent, then why would prices ever go down?” Also, “Why would oil companies drive up prices, when they know the terrible public relations problems it causes, and the retribution they could bring on themselves by the government?” After all, when oil companies made so-called “windfall profits,” back in the 1970s, the government imposed price controls and higher taxes (which led to shortages, even higher prices, and long lines at filling stations). In fact, gasoline prices do fluctuate, and to understand why requires an understanding of the factors that affect supply and demand, and how they interact, as well as other factors affecting price.

First of all, it should be pointed out that there is a seasonal cycle that influences the price of gasoline. Most gasoline is used in passenger vehicles, so when people drive determines when people use gasoline. The busiest American driving season is Memorial Day weekend through Labor Day weekend, with gasoline consumption the highest during those summer months. That seasonal driving pattern shows up in gasoline prices, which generally rise from late winter toward Memorial Day and remain relatively high through the summer. Gasoline prices generally fall after Labor Day and are lower during the winter months. In spring, crude oil refiners begin shifting their product mix from heating oil toward gasoline in order to build inventories in advance of the summer driving season.

The summer buildup affects gasoline prices in other ways. As refiners shift their product mix toward gasoline, they must more extensively process the crude oil, pushing up production costs. Storing gasoline from the spring to the summer also adds to the overall costs. After Labor Day, the product mix begins to shift away from gasoline, as refiners start to build up their winter supplies of heating oil. The forces pushing up gasoline prices then begin to unwind.

This year’s prolonged cold weather in the Northeast, where heating oil is most heavily used, caused refineries to delay their switch from the winter product mix that emphasizes more heating oil to the summer product mix that centers on gasoline. The result was lower inventories and higher prices for gasoline. At the same time, unusually heavy snow melt led to flooding along the Mississippi River, which impeded some refinery operations. The result was a delayed increase in gasoline production and earlier-than-usual increases in gasoline prices.

It should come as no surprise to anyone that the price of gasoline is largely dependent on the price of crude oil, since gasoline is produced from crude oil. In fact, 68 percent of the cost of a gallon of gasoline today is determined by what the refiners have to pay for the crude oil that they must purchase, according to the U.S. Energy Information Administration. Refining the crude oil into gasoline contributes 13 percent to the cost of gasoline at the pump. Distribution (pipelines and trucks) and marketing (filling stations) adds another seven percent. Finally, the national average of state and federal taxes piles on the last 12 percent of the total.

Embargoes at Home and Abroad

Once upon a time, America was able to produce, within its borders, all of the crude oil and gasoline it needed. In the 1950s and 1960s, filling stations engaged in so-called “gas wars” that sometimes drove the price of gasoline below 25 cents per gallon. Eventually, however, U.S. crude oil production peaked and started to drop, rising consumption caused demand to exceed supply, and America began importing crude oil in order to meet its energy needs. Today, the United States has to import most of the crude oil it consumes. As a result, American oil companies have become price takers, not price makers.

Nowadays, the price maker is OPEC, which accounts for about 40 percent of the world's production of crude oil and holds more than two-thirds of the world's readily obtainable crude oil reserves. Through the setting of production quotas among its member countries, OPEC can influence the price of crude oil, driving it upward or downward almost at will.

This was not always the case, however, because OPEC once had so much excess production capacity that, when prices were high, some OPEC countries cheated on their allotted quotas, resulting in excess production that eventually drove prices down, sometimes dramatically. For example, such overproduction caused crude oil prices to collapse from almost $34 per barrel during December of 1985 to less than $10 per barrel during May of 1986. Saudi Arabia, whose massive production capacity made it the so-called "swing producer," then lowered its production, restricting supply, and prices moved back upward again. Significant price fluctuations have occurred many times since then, due to continued cheating on OPEC production quotas, remedial action by Saudi Arabia, and geopolitical factors, such as Iraq's invasion of Kuwait in 1990 and the Gulf War that followed in 1991.

A logical question would be: "So, why isn't something like that happening now, especially considering that the price of crude oil has recently risen above $100 per barrel?" Ordinarily, one might reasonably expect to see the price of crude oil drop considerably from such a level. But OPEC's excess production capacity is not as high as it once was, and member nations have learned that their cartel's unity benefits all members, especially considering that crude oil is not an inexhaustible resource.

On the supply side of the equation, political instability in Iraq has thus far prevented it from attaining pre-U.S. invasion crude oil production levels. And Iraq's former Oil Minister recently predicted that the country would only be able to meet half of its planned production goal by 2017. Anti-government rebels are causing production problems in Libya, as well. Some people have trouble understanding how overseas turmoil could have such a profound effect on the price of crude oil. As one gas station owner put it, "We don't even get our gas from Libya." But Libya produces more than two percent of the world's crude oil supply, so taking that much crude oil out of the global supply chain in a tight market has a significant effect on the prices of both crude oil and gasoline. (Look at it this way: Although the United States may not buy oil from a given country, other countries do. When that supply is restricted, those other countries then turn to our suppliers, which ultimately results in driving up prices for everyone.) Finally, OPEC member Indonesia is now importing, not exporting, crude oil.

Crude Politics

Another geopolitical issue is also having an impact on the price of crude oil. For the past several years, Iran has very bluntly stated that it intends to pursue a uranium enrichment program, while simultaneously calling for the destruction of Israel. As a result, there has been open speculation that the United States and/or Israel might launch pre-emptive military strikes against Iran. Iran has responded by declaring that, should such attacks occur, it would take retaliatory action and close the Strait of Hormuz, thereby blocking the shipping of crude oil out of the entire Persian Gulf area. The uncertainty surrounding the possibility of such events, together with the other Middle East tensions, has caused a risk premium, estimated to be as much as $10 to $20 per barrel, to be built into the crude oil futures contracts traded on the New York and London commodity exchanges. At 42 gallons per barrel, that risk premium works out to about 24 cents to 48 cents per gallon of gasoline.

On the demand side, while consumption of petroleum products in Western Europe and Japan has remained roughly the same over the past three decades, consumption in the United States has doubled. This is primarily owing to America's high use of gas-guzzling sport utility vehicles, pickup trucks, and

vans, and our higher economic and population growth. Consumption in Western Europe and Japan has been kept in check by fuel prices that are almost double those in the United States, as well as by their relatively stagnant economies and population levels. In addition, the U.S. commercial trucking industry has experienced extraordinary growth (all of those imported goods from China piling up at West Coast ports have to be transported around the country somehow), greatly increasing the demand for diesel fuel. And then there is the burgeoning size of new residential housing units in America, which increases the demand on energy sources for heating and air conditioning.

Another big factor on the demand side in recent years has been the rise of China, India, and Brazil, which together have a total population of 2.7 billion and whose economies have been growing by leaps and bounds. China and India each have more than a billion inhabitants, together making up fully one-third of the global population, and their economies have been growing at nearly double digit rates for the past decade. China is now the world's second largest consumer of petroleum products. (In 2010, a total of 13.8 million passenger cars were sold in China; by comparison, U.S. auto sales were less than 11.6 million.) And like the United States, China has to import most of the crude oil it consumes.

Since 2005, the federal government has required the use of ethanol in gasoline: 12 billion gallons this year and as much as 22 billion gallons by 2022. Adding ethanol to gasoline was supposed to reduce our reliance on foreign oil and hold gasoline prices down. That would seem to make sense, since we can produce ethanol right here in America. But it has not worked out that way. As reported by the Manhattan Institute, ethanol production has increased sevenfold over the past decade, but oil imports have increased by more than 800,000 barrels per day over that same time period. As for keeping gasoline prices down, just check the nearest filling station to see how that is working out.

On top of that, the federal government's ethanol policy costs taxpayers around $6 billion annually in subsidies, and the ethanol itself causes additional wear and tear on engines and fuel lines. Romina Boccia, a policy analyst at the Independent Women's Forum, adds the following to the argument against ethanol:

Every gallon of ethanol created wastes energy. David Pimentel at Cornell University and Tad Patzek at the University of California, Berkeley estimate that making ethanol from corn requires twenty-nine percent more fossil energy than the ethanol fuel itself actually contains. Additionally, ethanol contains only about two-thirds of the energy contained in gas. That means that a gallon of ethanol-blended gas won't allow you to drive as far as if you bought straight up gas.

Ethanol subsidies also raise the prices for almost all the foods a typical American family eats every single day. Forty-one percent of U.S. corn production was devoted to ethanol in 2009. Corn used for ethanol cannot be used for animal feed, which raises the prices of meats and dairy at the grocery store. Corn is also contained in most sugared products in the form of high-fructose corn syrup. Because ethanol makes corn more scarce and expensive, the prices for many proc-essed foods, from staples such as bread and cereal to soups and condiments, are higher than they need to be. Moreover, as more and more fields are devoted to growing corn for ethanol, fewer fields are available for growing other grains, fruits, and vegetables, increasing prices for nearly any imaginable food product.

Federal government stimulus is also putting upward pressure on gasoline prices. When the Federal Reserve creates trillions of dollars out of thin air, in order to rescue the banks and the auto industry, and to engage in what it calls "quantitative easing," the value of the U.S. dollar declines relative to almost everything paid for in U.S. dollars. Because crude oil is traded in U.S. dollars, those who sell it on the world market will demand more dollars per barrel of crude oil, because those dollars are worth

less.

Now Democrats in Congress want to take away $4 billion in tax credits that the oil companies use to reduce their tax liabilities. That will do nothing to reduce the price of gasoline, because taxes are simply one of the costs of doing business, and those costs are passed on to the consumer.

The irony here is that, if there is any extortion or swindling going on in the crude oil market, government is the guilty party. As has been reported in many places, federal and state governments take an average of 59 cents per gallon of fuel taxes at the pump, almost six times the average of 10 cents per gallon of profit that the oil companies make. So, even if all of the oil industry profits were taxed away, a $4.00 gallon of gasoline would only drop to $3.90.

Environmentalists like to point out that the United States could never be self-sufficient in crude oil production, because we have just two percent of the world's reserves. But that figure only includes reserves that are already under production. It does not include the hundreds of billions, perhaps trillions, of barrels that have been locked up on the continental shelf, on federal land in Western states, or in Alaska. It should be obvious that the best way to reduce gasoline prices is to increase domestic crude oil production (as well as refinery capacity). But the federal government prefers to pursue an energy policy that transfers America's wealth to foreign countries. In the final analysis, the problem is not Big Oil; it is Big Government.