U.S. Gasoline Prices in the Context of the World Oil Market

Opening Statement of James L. Smith, Ph.D.
Before the Joint Economic Committee
May 23, 2007

1. Many factors contribute to the high level of gasoline prices we currently see, and to the continuing volatility in prices that keeps us wondering what to expect next.

   a. The number one factor is the tight link that connects gasoline prices to the cost of the crude oil feedstock from which gasoline is refined. Over the past 15 years, 95% of the month-to-month gasoline price fluctuations we have observed are directly accounted for by changes in the cost of crude oil feedstock. Some previous studies had pegged this dependence at 85%, but my research indicates that it has increased in recent years.

   b. Dependence on the cost of crude oil feedstock is not the only factor responsible for changes in the price of gasoline, but its impact is so predominant that it usually overwhelms all other factors.

   c. We can not easily attain any desirable outcomes for U.S. motorists without keeping this dependence on crude oil prices in clear focus.

2. Crude oil prices are not determined within the U.S. marketplace—rather crude prices are determined in a global market that is not dominated by U.S. players.

   a. The models and assumptions of the world oil market that we might have relied on 40 years ago (indeed, the market that we all grew up with) are no longer relevant. The structure of the world oil market has changed in fundamental ways.

b. The biggest change, one that we are all still learning to grapple with, is the replacement of multinational oil companies (the so-called "seven sisters") by National Oil Companies—which are quasi political/economic organizations that control access to the resource base and determine the supply of oil in most major oil producing nations of the world.

c. The "seven sisters" (or what remains of them: BP, Exxon, Shell, Total, Conoco, Chevron, and ENI) provide only about 1/6th of our crude oil. NOCs provide more than half of the total supply.

3. The crude oil market is not competitive, and this is no secret. The members of OPEC (now 12 in number) deliberately attempt to manipulate the price of crude oil for their benefit—and sometimes they succeed. The NOCs are the instruments by which control is exercised.

a. OPEC members do not share with or cede control of the price mechanism to the multinational oil companies. The multinationals themselves do not have enough crude oil reserves or production to influence the price.

b. If you wish to deal with gasoline prices in a manner that addresses the long-run interests of American motorists, then you need to deal with OPEC. OPEC is the problem.

4. What are the options for dealing with OPEC? Precious few.

a. Legal challenges have been discussed; you can try to win in court. Personally, I believe this is a tough road. The

OPEC members are sovereign nations, with economies that are highly specialized and dependent on oil. They have even more at stake than we do.

b. Encourage the development and growth of alternative supplies (of oil and other forms of energy). This would directly diminish OPEC's ability to control prices and instill greater competition.

c. Discourage oil consumption. The impact on OPEC of reduced consumption is less direct and probably less potent than developing alternative supplies because OPEC reserves are the low-cost reserves. When demand slacks and prices fall, it is the high-cost production flows that are backed out of the market—that's not OPEC. We could actually see our dependence on OPEC rise as consumption falls—if other changes are not made to stimulate alternative supplies of oil and energy.

5. Summary

Gasoline prices are driven by crude oil prices. The volatility we see at the gasoline pump is a mere reflection of the underlying volatility that characterizes the world crude oil market. Any new policy initiative, to be effective, must be framed in the context of the world oil market and judged by its ability to tame the factors that are driving that market.