



May 15th Senate Hearings on Oil and Gas: We May Have A Problem

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On May 15th, the Senate [Committee on Energy and Natural Resources](#) conducted a hearing entitled **Short-Term Energy Outlook Summer 2007: Oil and Gasoline**. You can watch the web cast [here](#). I have done so, and this essay will be about my impressions of the hearing.

You can find the testimony of the various witnesses at the links below:

[Mr. Guy Caruso - EIA Administrator](#)

[Paul Sankey](#)

[Geoff Sundstrom](#)

[Kevin Lindemer](#)

Mr. Sankey is an analyst with Deutsche Bank, Mr. Sundstrom represents AAA, and Mr. Lindemer is an [analyst with Global Insight](#). The witnesses really knew their material, although Mr. Sundstrom seemed terrified and Mr. Caruso had to make sure some of his answers were "politically correct." On one occasion Mr. Caruso stated that the EIA does not foresee that cellulosic ethanol is going to scale up to even a billion gallons by 2030, and one senator said "Isn't that in direct contrast to what the president thinks?" Then some pretty nifty tap-dancing ensued.

The Q&A, in my opinion, was an embarrassing display of partisan politics, and revealed serious deficiencies in some of the senators' understanding of energy issues. Some Republican senators took the opportunity to push for coal-to-liquids and drilling in ANWR, and some Democrats did a bit of grandstanding over windfall profits - directly ignoring the answers the witnesses were giving them.

For example, Paul Sankey had explained that oil companies lost a lot of money in the 80's and 90's, and therefore investments fell off. A couple of different senators kept asking the same question again and again: "Yeah, but why aren't they investing today, with record profits?" Sankey's answer to this question was that they **are** investing today. His answer - delivered numerous times - was merely ignored.

Sankey didn't mince words at all, and at one point told the committee to keep in mind that these record high prices are less than half the level of the prices in Europe.

Anyway, here were some of the more interesting exchanges which I transcribed myself. [Senator Craig Thomas](#) was the first to demonstrate that he didn't understand the answer to a question:

Senator Craig Thomas: Most any time that you have great markets and so on, you also have investment, like in the refineries. When the market is there, and the price is high, I don't understand the lack of incentive to invest.

Paul Sankey: The incentive is there, and the companies are now investing, it's just not an issue that you can expect that 4 years after companies are making losses, that suddenly there is an exponential increase in investments in refining capacity. It's just not that simple. It's a very tough market out there for any kind of infrastructure investment, as I mentioned you have competition from the Canadian heavy oil sands, you have competition from Asia, in Europe; but these companies are increasing their investments. The fact is that the companies are deploying capital to the best of their ability. One disincentive for investment is brought about by uncertainties in regulation and government interference. One concern they have is that regulations will cause them to lose money if they invest now. In my opinion it's in your interest to maintain a stable regulatory environment to encourage investment.

Senator Craig Thomas: I agree with that. But if lack of infrastructure is causing the price to go up, and the companies are not investing in infrastructure then it seems to be a bit of a contradiction."

So, right after Sankey says they are investing, Senator Thomas can't understand why they aren't investing. I lost count of how many times Sankey went through this routine. You would think eventually his answer might sink in.

Immediately after the above exchange, [Senator Ron Wyden](#) from Oregon apparently awoke from a slumber, because he asked the same question:

Senator Wyden: Mr. Sankey, quick question. You stated that in the 80's and 90's, there were poor returns for the companies, and that contributed to their problems. But now we also have the problem of starving investment in refineries, but we have record profits. Certainly that's been the case for the last 5 or 6 years. Why wouldn't the companies have invested in refineries and in the infrastructure - the things that were missing in the 80's and 90's - in the last 5 or 6 years?

Paul Sankey: This goes to the same point. You had losses as recently as 2002, and there have been changes in regulations - potential threats to gasoline as the fuel you want to make in this country. If you are talking about an investment of 2 or 3 billion dollars, it's immensely expensive now to add refineries, and there are huge amounts of uncertainties over how much it will ultimately cost you because of all the other challenges that there are out there with global energy infrastructure competing away the staff and materials to do the job. But **even amongst all that, we have some fairly significant investment going on right now.** One of the subtleties here is that we may not be adding a tremendous amount of capacity, but in terms of our ability to upgrade more complex heavy, sour crude there is very definitely a surge of investment going on.

Senator Wyden: I can see the argument, and you make it eloquently in your paper for not going forward with investments in the 80's and 90's; it just doesn't make sense given these record profits.

You have to wonder whether he heard a word that Sankey said. Is he just posturing? Or is he not paying attention? Or does he not understand that investments are actually being made (as I show in later)? Yes, these are the people formulating our energy policy.

The other exchange that I watched in disbelief happened between [Senator Robert Menendez](#) and Sankey:

Senator Menendez: Over the past few years, it seems that bracing for the onslaught of record high prices at the gas pump has become as common as planning for the summer vacation. And we see prices rise and fall, **we understand the concept of a changing supply and demand chain, that's not foreign to us**, but when we see no singular event, no visible cause for the increase in prices, consumers scratch their heads and try to figure out what's happening. This is the 3rd year in a row in which consumers are facing gasoline prices above the \$3/gallon mark. Yet there's no devastating hurricane this year; there's no single event at a refinery or in an OPEC country that explains why, in the first half of May, consumers are already experiencing sticker shock. Mr. Sankey, when you say there is no price manipulation through the whole supply chain, then **why do prices seem to spike during times of greatest motorist activities such as the summer, and Memorial Day weekend?** Now, I am sure that demand is part of the answer, but it seems that we find that it is in these time periods that the prices spike. Is that just convenience, that it just conveniently happens that way? **Is it just a pure coincidence?**

Now remember, Senator Menendez just said that he understands all about supply and demand, and now is asking if it's a coincidence that prices increase at the times of highest demand. If I had been a witness, it would have been hard for me to hide my disbelief at this question from another member of the Senate who happens to be formulating energy policy.

Paul Sankey: I would highlight once again, that BP has 2 of the 5 largest refineries in the U.S. effectively running at half capacity right now because of the safety issues. What happens in times of such tight capacity is that you have an extremely seasonal market. What happens is that at times of demand run-up, you begin to exceed available supply and prices rise exponentially, attempting to price out demand or encourage more supply. What you will find in such a tight market is that in winter you will suddenly get tightness in natural gas and heating oil, because there isn't that available spare capacity to address the sudden seasonal rise in demand, and when you get to driving season - because everyone loves to go to the beach on Memorial Day - what you find is that you exceed available supply and then prices rise exponentially.

Then Senator Menendez gets his facts completely wrong:

Senator Menendez: Isn't there a reality that we are paying for some industry decisions that actually reduced refining capacity in this country? I mean there was a

time that we had greater refining capacity, and the industry reduced that refining capacity, and as a result of making that decision, consumers today find themselves with exactly the consequences that you have described in your testimony before.

Sankey then tried to explain something about the cycle, but did not correct Senator Menendez on the key point: Refining capacity has not been reduced; it is at an all time high. Some refineries have been closed down, but the expansion of the existing ones far surpasses the lost capacity from those that were shut down. See [my essay addressing this](#).

But Senator Menendez continued:

Senator Menendez: My point is that the reduction in refining capacity helped drive up the cost.

Your point is incorrect, and you misinformed a lot of people when you made it. Perhaps this kind of misinformation explains some of your anger at the oil industry?

But don't take my word for it. Visit the EIA and [see the numbers for yourself](#). Refining capacity has increased by 2 million barrels per day in the past 10 years. And in the past 5 years? The years that the senators complained that no investments were being made? Refining capacity has increased since 2002 by 700,000 barrels a day - 250 million barrels a year. To put this in perspective, that amount is equal to 10.7 billion gallons, or about double the entire ethanol production in the U.S. That's the amount of refinery expansion that a number of senators on the committee pretended never happened because they believe no investments have been made (and this on top of the investments to upgrade heavy, sour crudes and to produce ULSD and ULSG).

Final Thoughts

I don't know if the committee members are really so uninformed, or whether they were just playing politics. You got the impression watching the web cast that they were making some statements just to make sure those were picked up by the media, regardless of whether they were accurate. Senator Wyden's comments are a perfect example. It was clearly explained to him that investments are being made, and then he turned around and asked why they weren't investing.

The comments from Senator Menendez may be another matter. He may actually believe that refining capacity has been reduced. But he is on the energy committee. He should understand the overall picture. This is important stuff, and we can't have energy policy being formulated by people who are either proceeding with half-baked ideas, or are just interested in scoring political points.

There is also one thing that all politicians must come to grips with. Let me make it crystal clear that I firmly support tough environmental regulations. I support the move to [ultra-low sulfur diesel](#) (ULSD) and gasoline. I support phasing out benzene in gasoline. I would also point out that [Senator Wyden has been actively involved in this issue](#). But the politicians have to understand that these regulations do have consequences. If you tell refiners they must install equipment to produce ULSD, there are four things to keep in mind.

First, this necessarily redirects capital that might have gone into expanding refining facilities. Second, it increases the costs of producing the fuel. Third, this additional level of processing reduces the overall product yield. Fourth, and perhaps of greatest importance, it increases the complexity of the refinery. Those are the consequences. The more complex the refineries are, the more unreliable they are going to be. So, when you formulate these sorts of rules, don't sit around and scratch your heads and ask "Gosh, I wonder why gasoline prices are going up?" Part of the reason gasoline prices are going up is because of the policies you have enacted. Many of which - as in the case of the aforementioned environmental regulations - I believe were the correct policies to adopt. Nonetheless, these are issues that helped to bottleneck the refineries and crimp supplies - driving up prices.

But I have to tell you that I am sick of the way these hearings are being conducted. I want you guys to put your heads together and formulate a coherent energy policy. Stop playing politics with this. It is far too serious a matter. The committee members also need to get up to speed ASAP on energy issues. We don't need members on the energy committee who have a tenuous grasp of these issues. Finally, listen to what your experts are telling you. If you are going to call expert witnesses to testify, don't completely ignore their testimony just so you can quote your canned sound bites. **START SOLVING SOME FLIPPING PROBLEMS!**



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