

Here's Why Gasoline Prices Continue to Soar

By: [Andrew Brod](#)

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Article:

Few things get Americans more riled up than rising gasoline prices. I was going to write "high gasoline prices," but whether gasoline prices are *high* is a separate question, and one I'll address at the end of this column. In contrast, it's undeniable that gasoline prices have been rising over the last few months.

Earlier this month, according to the widely cited Lundberg Survey, the national average price for a gallon of regular unleaded gasoline was \$1.79. (The [GreensboroGasPrices.com](http://www.greensborogasprices.com) website indicates that the average price in Greensboro has been closer to \$1.70.) Since December, prices have increased by over 31 cents per gallon nationwide.

Why is this happening? In the popular imagination, the usual suspects have been trotted out. Some people blame price-gouging oil companies. Others blame government taxes. And of course there's everyone's favorite, OPEC, the Organization of Petroleum Exporting Countries.

Let's begin by discarding what *hasn't* caused the recent price increases. It makes no sense to blame taxes, because gasoline taxes have been virtually unchanged. It might be reasonable to blame taxes for high prices, but not for rising prices. For example, the federal excise tax on gasoline has been fixed at 18.4 cents per gallon since 1994, while retail prices have increased roughly 50 percent in that time.

In addition to the federal tax, North Carolina drivers pay a state tax of 24.3 cents per gallon, which is right at the national average. The tax is pegged in part to the average wholesale price in the state and is adjusted accordingly every January and July. Because the wholesale price didn't rise much during the second half of 2003, the state gasoline tax increased by only a tenth of a cent in January.

We can also discard the notion that price-gouging oil companies are behind this, because there's little evidence that they're actually gouging prices. It's hard to call a company a price-gouger unless its high prices are associated with high profits, and oil profits aren't as high as you'd think.

To be sure, the oil industry often does generate large dollar profits. In 2000, the major oil companies earned a record \$53 billion, which corporate critics called excessive. However, those profits don't seem so large when placed in context. A *Business Week* analysis of corporate profits in the five years 1998-2002 found that oil and gas companies had a profit margin of 4.7 percent of sales, while the all-industry average was 5.2 percent.

The profit picture improved in 2003, as the oil and gas industry's margin rose to 7.4 percent, a bit above the all-industry average of 6.5 percent. Even so, the oil industry's profit margins aren't high enough to justify a charge of price-gouging, especially when one considers how some other industries did. For example, the banking industry's margin was 19 percent in 2003!

Oil-industry profits are big in dollar terms because companies have to cover the massive capital investments required to locate, refine, and distribute oil and oil products. And those profits aren't always big, even in dollar terms. After that record year of 2000, industry profits fell to \$38 billion in 2001 and \$7 billion in 2002.

What about OPEC? The oil cartel recently announced production cuts designed to boost the future price of crude oil, which has been hovering a little over \$30 per barrel. But that doesn't do much to explain the gasoline-price increases that have taken place up to now.

OPEC wields less market power than it once did, and therefore oil prices are affected by many factors in addition to OPEC's actions. The price of crude oil has been on a gradual upward trend in recent years, in part because of continued anxiety about terrorism and Mideast oil supplies, and in part because of increasing demand in fast-growing China. (It always seems to come back to China, doesn't it?)

However, even though gasoline prices have hit record highs (in non-inflation-adjusted terms), oil prices have not. They were actually higher a year ago, right before the U.S. invasion of Iraq. So while oil prices appear to explain some of the rise in gasoline prices, they're clearly not the whole story.

So far we've discarded taxes, price-gouging, and OPEC as causes of the recent price increases. Crude-oil prices appear to be playing some role, but there has to be something else going on. And there is, a complicated stew involving refining capacity, the difference between summer and winter gasoline, and the regional patchwork of government-mandated gasoline blends.

Every spring, oil refiners prepare to switch to summer blends designed to protect air quality in warm weather. Because they don't want to produce too much winter gasoline as summer approaches, and because the summer blends are slightly more expensive to make, refiners sometimes go too far in drawing down their stocks of winter gasoline. The result, as we've seen this year, is a late-winter shortage.

On top of that, the highly regional focus of the roughly 20 different blends of gasoline makes it difficult for refiners to move gasoline from place to place. And that's important because bottlenecks happen. There have been a number of refinery fires recently, including one last month at the country's third-largest facility. But supply disruptions often cannot be fixed by bringing in gasoline from other regions because the blends don't match.

For example, a refinery in central Illinois cannot easily serve the Chicago market just a three-hour drive to the north. The Chicago-Milwaukee blend of gasoline is specially geared to air-quality issues in that region, and the refinery in central Illinois focuses on blends for other markets. The state of California, home to some of the country's highest gasoline prices, has a special gasoline formulation that is a function not only of the federal government's mandates, but also its own high air-quality standards.

Regional shortages push up regional prices, and often the price increase spills over to other regions thanks to the efficiency of commodity markets and the fear of further supply disruptions.

So even though gasoline supplies often cannot cross regional boundaries, fears about gasoline supplies do. These bottlenecks wouldn't be so significant if refining capacity had kept pace with our demand for gasoline. Over the last 20-odd years, the American economy has done a lot of growing, and our demand for gasoline has grown even faster. But U.S. refining capacity actually decreased by 10 percent between 1981 and 2002. The decrease has been even more pronounced in certain regions, most notably California.

The good news is that industry forecasters expect gasoline prices to moderate in the coming months, as the various supply problems get worked out. And if *Washington Post* reporter Bob Woodward's new book, "Plan of Attack," is accurate, Saudi Arabia will exert its influence on OPEC to push oil prices downward this summer in an effort to help President Bush's reelection prospects.

We've seen why gasoline prices have been rising. But are they high? By historical standards, the answer has to be no. Even with the recent increases, gasoline is cheap when adjusted for inflation. The real (i.e. inflation-adjusted) price of gasoline was 60 percent higher in 1981 than it is today. But even decades before OPEC came

on the scene, gasoline was expensive in real terms. The inflation-adjusted price way back in 1934 was 50 percent higher than today. There are few commodities on which inflation has had so little effect.

So the next time you buy gasoline, try to keep a sense of history about you. Maybe it won't feel so bad to fill up.