

More Pain at the Pump: Gas Prices High and Going Higher

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American consumers can't catch a break. Jobs are hard to find and wages are stagnant for those who are still working. And now higher gasoline prices threaten to take the few pennies that are still rolling around at the bottom of the piggy bank.

Currently, U.S. gasoline consumption is relatively low, as a result of consumer belt-tightening and the fact that 7.6 million jobs have been lost in the recession, forcing millions of motorists off the roads. Most economists would say that these conditions should lead to a drop in gasoline prices. Add in the winter season -- a period when gasoline sales are at their lowest, due to less leisure travel -- and Americans should be enjoying a nice decrease in gasoline prices.

But what's happened in the past six months? Gas prices have risen about 30 cents to a U.S. average price of \$2.75 per gallon for unleaded regular, according to gasoline price surveyor [gasbuddy.com](#). Prices in the U.S.'s high-cost areas are already approaching or exceeding \$3 for unleaded regular 87 octane gasoline, with prices ranging from \$2.92 in New York City to \$3.08 in San Francisco.

And the news gets worse: Prices are likely to rise heading into spring and summer.

Low Demand, High Prices: What Gives?

Demand for gas is low, but prices are high and likely to rise: What's going on here?

The biggest culprit, as is almost always the case in the gasoline market, is the price of oil, which is up a more than 100% since bottoming near \$35 per barrel in December 2008. ([Oil](#) traded down \$2.50 to \$80.02 per barrel on Tuesday.) Every \$1 increase in the price of oil adds about 2.5 cents to the price of a gallon of gasoline, if refiners and gas stations pass that added cost along.

Why has the price of oil risen so much in the past year? Most traders say it's a combination of traders anticipating rising oil demand in Asia in 2010, and institutional investors' purchases of oil as an inflation hedge and/or as a hedge against a further weakening of the [U.S. dollar](#). It's important to remember that oil is not only a commodity; it's also an asset for investors, and that

has boosted crude's price above where it typically would be today, given modest U.S. and global oil demand.

There's no shortage of oil. Inventories in the U.S. and around the world are brimming, and at OPEC's last meeting in December, the major issue concerned whether the group would cut -- not increase -- production, due to modest global oil demand. At the meeting, OPEC chose to [maintain its current production quotas](#).

Where's the price of oil headed from here? Assuming the U.S. and global economies continue to recover, oil is most likely headed higher, probably \$10 higher to \$90, and a return to \$100 per barrel oil by the end of 2010 is not out of the question. The conservative estimate, a \$10 increase, would mean an increase in gasoline prices by about 20-25 cents per gallon.

Refiners Feel the Pinch

The second major reason U.S. gasoline prices are rising is tied to the companies that actually produce the product. Refiners' margins -- the profit they earn from refining crude oil into gasoline -- have dropped, so they've decreased production, which has resulted in less gasoline being made. Refiners are buying high-cost crude, but gasoline demand remains modest, which lowers the price they can sell the refined crude (gasoline) for. As the profit margin shrinks to unacceptably low levels, refiners stop refining gasoline.

Here's the tell-tale refinery stat, from U.S. Energy Information Administration data: Refinery capacity utilization was [91.3% in January 2008](#) but has dropped to [79.9% this January](#).

Still, despite the refinery cutbacks, which have boosted gasoline's price some, one alarming fact that motorists should note is that refiners are still not able to charge as much as they typically would for their refined gasoline, due to modest demand; the pricing power is not there.

In other words, although gasoline prices have risen some, they would have risen much more, perhaps as much as 20-30 cents per gallon more, had gasoline demand been stronger in the United States. Modest U.S. gasoline demand has actually kept gasoline prices below where they typically would be, given an \$80 per barrel oil price.

The Trend Is Up

Assuming the price of oil stays about the same, rising seasonal demand in the spring and summer and increased consumption from more drivers as the U.S. economy finally starts to create jobs (possibly as early as March) will lead to a likely 10-20 cent per gallon increase -- even more in higher-cost metro areas. And if oil rises to \$90, tack another 20-25 cents on to gas prices.

This means that by early summer, the average price for regular unleaded could hit \$3.25 per gallon.

The likely rise in fuel costs will take its toll on the U.S. economy. Every \$1 per barrel rise in oil decreases U.S. GDP by about \$100 billion per year and, every one cent increase in the gasoline

price decreases U.S. consumer disposable income by about \$600 million per year. Further, any sustained average gas price over \$3.50 per gallon will likely trim the modest tailwind the U.S. economy is currently feeling from slowly reviving consumer spending.