GASOLINE PRICES, OIL COMPANY PROFITS, AND THE AMERICAN CONSUMER

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON ENERGY AND COMMERCE

HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

MAY 22, 2007

Serial No. 110–51

Printed for the use of the Committee on Energy and Commerce
energycommerce.house.gov

U.S. GOVERNMENT PRINTING OFFICE
37–690 PDF WASHINGTON : 2007

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON ENERGY AND COMMERCE

JOHN D. DINGELL, Michigan, *Chairman*

HENRY A. WAXMAN, California
EDWARD J. MARKEY, Massachusetts
RICK BOUCHER, Virginia
EDOLPHUS TOWNS, New York
FRANK PALLONE, JR., New Jersey
BART GORDON, Tennessee
BOBBY L. RUSH, Illinois
ANNA G. ESHOO, California
BART STUPAK, Michigan
ELIOT L. ENGEL, New York
ALBERT R. WYNN, Maryland
GENE GREEN, Texas
DIANA DEGETTE, Colorado
Vice Chairman
LOIS CAPPS, California
MICHAEL F. DOYLE, Pennsylvania
JANE HARMAN, California
TOM ALLEN, Maine
JAN SCHAKOWSKY, Illinois
HILDA L. SOLIS, California
CHARLES A. GONZALEZ, Texas
JAY INSLEE, Washington
TAMMY BALDWIN, Wisconsin
MIKE ROSS, Arkansas
DARLENE HOOLEY, Oregon
ANTHONY D. WEINER, New York
JIM MATHESON, Utah
G.K. BUTTERFIELD, North Carolina
CHARLIE MELANCON, Louisiana
JOHN BARROW, Georgia
BARON P. HILL, Indiana

JOE BARTON, Texas
Ranking Member
RALPH M. HALL, Texas
J. DENNIS HASTERT, Illinois
FRED UPTON, Michigan
CLIFF STEARNS, Florida
NATHAN DEAL, Georgia
ED WHITFIELD, Kentucky
BARBARA CUBIN, Wyoming
JOHN SHIMKUS, Illinois
HEATHER WILSON, New Mexico
JOHN B. SHADEGG, Arizona
CHARLES W. "CHIP" PICKERING, Mississippi
VITO FOSSELLA, New York
STEVE BUYER, Indiana
GEORGE RADANOVICH, California
JOSEPH R. PITTS, Pennsylvania
MARY BONO, California
GREG WALDEN, Oregon
LEE TERRY, Nebraska
MIKE FERGUSON, New Jersey
MIKE ROGERS, Michigan
SUE WILKINS MYRICK, North Carolina
JOHN SULLIVAN, Oklahoma
TIM MURPHY, Pennsylvania
MICHAEL C. BURGESS, Texas
MARSHA BLACKBURN, Tennessee

PROFESSIONAL STAFF

DENNIS B. FITZGIBBONS, *Chief of Staff*
GREGG A. ROTHSCHILD, *Chief Counsel*
SHARON E. DAVIS, *Chief Clerk*
BUD ALBRIGHT, *Minority Staff Director*

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

BART STUPAK, Michigan, *Chairman*

DIANA DeGETTE, Colorado
CHARLIE MELANCON, Louisiana
Vice Chairman
HENRY A. WAXMAN, California
GENE GREEN, Texas
MIKE DOYLE, Pennsylvania
JAN SCHAKOWSKY, Illinois
JAY INSLEE, Washington
JOHN D. DINGELL, Michigan *(ex officio)*

ED WHITFIELD, Kentucky
Ranking Member
GREG WALDEN, Oregon
MIKE FERGUSON, New Jersey
TIM MURPHY, Pennsylvania
MICHAEL C. BURGESS, Texas
MARSHA BLACKBURN, Tennessee
JOE BARTON, Texas *(ex officio)*

CONTENTS

Page

GASOLINE PRICES, OIL COMPANY PROFITS, AND THE AMERICAN CONSUMER

TUESDAY, MAY 22, 2007

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS,
COMMITTEE ON ENERGY AND COMMERCE,
Washington, DC.

The subcommittee met, pursuant to call, at 12:59 p.m., in room 2123, Rayburn House Office Building, Hon. Bart Stupak (chairman) presiding.

Present: Representatives Melancon, Green, Inslee, Dingell, Whitfield, Walden, Murphy, Blackburn, and Barton.

Staff present: John Arlington, Kyle Chapman, Alan Slobodin, Peter Spencer, Shannon Weinberg, Brian McCullough, Will Carty, Matthew Johnson, and John Stone.

OPENING STATEMENT OF HON. BART STUPAK, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. STUPAK. This hearing will come to order. Today we have a hearing on gasoline profits. Each Member will be recognized for 5 minutes

The American public is paying record high gas prices while Big Oil companies are reaping record profits. Across our Nation, people are struggling to pay to fill their gas tanks and their frustration with gas prices is boiling over. In my vast rural district, my constituents have to travel the longest distances to and from work, and there are little or no public transportation options. Many people can't afford higher gas, so they are putting it on credit cards and digging deeper and deeper into debt.

I was at a funeral last Saturday, and when the monsignor greeted me, he said, "My God, Bart, you have to do something about these gas prices." The monsignor explained how gas was $3.28 per gallon when he drove to the rectory in the morning and it jumped 21 cents by the time he left that night. In 10 hours, a gas station had raised its prices 21 cents to $3.49 per gallon. That was on Saturday. Our collective prayers must have worked, because on Sunday gas prices dropped 10 cents to $3.39 per gallon. In 4 days, gas prices went up 21 cents, then dropped 10 cents, and remain at $3.39 today in northern Michigan.

I received a call from a constituent who owns several gas stations throughout northern Michigan and Wisconsin. The station owner told me how he had to raise gas prices 15 cents overnight, and his competitor in the same town raised his prices 16 cents. He added

that there is no excuse for his supplier to raise prices other than the fact that refineries continue to raise their prices dramatically.

Today's hearing will explore why gas prices have continued to be at record high levels, even as the price for a barrel of crude oil is lower than last year. We will be investigating the factors that go into the price of a gallon of gas and whether or not gouging is occurring in the oil and gas industry.

According to the Energy Information Administration, EIA, the average price of gasoline from 2002 through 2007 has more than doubled, while the consumer price index has risen only 13.6 percent. According to EIA's Web site, the nationwide average for gasoline is now $3.22 per gallon. This is higher than any time in our history, and we have yet to reach the peak driving season for 2007.

The Government Accounting Office has estimated that each additional 10 cents per gallon of gas adds $14 billion to Americans' annual gas bill. In effect, this is an enormous transfer of wealth, billions of dollars from consumers to the oil industry.

Many people wonder just what factors make up the price of a gallon of gasoline and what is reasonable profit for each company along the supply and distribution chain. Why do we have wild fluctuation in the price of gas from day to day, week to week?

In answer to some of these questions, we know that the price of crude oil and refinement of oil into gasoline make up 75 percent of the price of gasoline.

Big Oil is often quick to blame world crude prices, but that argument doesn't appear to be the full story. In April 2007, a barrel of oil cost $63. In April 2006, a barrel of oil was $70.

Despite the fact that crude oil was $7 cheaper per barrel than last year, gas prices are approximately 50 percent higher. Clearly, this year's run-up in gas prices has not been the result of crude oil prices but some other factor or factors.

Many have pointed to the oil refineries as the most recent cause for high gas prices. Since 1980, more than 200 U.S. refineries have been closed, and a new refinery has not been built since 1976. In 1981, U.S. refineries were operated by 189 different companies. Today, the remaining refineries are operated by about 60 companies. For the past 25 years, more than 50 percent of the refineries have been closed, and the number of companies owning refineries is less than one-third of what it was.

We will hear today from the GAO, Government Accounting Office, about their 2004 study, which confirmed that these mergers have caused higher gas prices.

Historically, the average profit margin between a barrel of crude oil and a barrel of refined gas, known as the crack spread, has been around $8 to $9 per barrel, or 20 cents profit per gallon of refined gasoline.

Today, the profit margin is $30 a barrel, as reported in a May 18, 2007 Wall Street Journal article.

Based on a $3 gallon of gas, that is roughly 70 cents in refinery profits for every gallon of gas. In fact, according to the oil industry publication Platts, the crack spread on the June futures market is nearly $36 a barrel.

Unfortunately, $4 a gallon of gas is right around the corner for America's consumers.

As a result of these enormous profit margins, in the first 3 months of 2007, Valero, the Nation's largest refinery company, announced profits of $1.1 billion, up 30 percent over last year.

ExxonMobil refineries made $1.9 billion in the first quarter of 2007. Chevron reported over $1.6 billion in refining profits.

These high refining margins have led to record profits throughout the oil industry. During the first three months of 2007, Royal Dutch Shell's profits were $7.3 billion. Chevron made $4.7 billion. ConocoPhillips reported more than $3.5 billion. And ExxonMobil's total profits for the first quarter were more than $9.2 billion.

In order to crack down on price gouging, the Federal Trade Commission needs to define when the oil industry is gouging the American consumers.

I have introduced legislation, the Federal Price Gouging Prevention Act, H.R. 1252, to protect American consumers from being gouged at the pump.

Similar to my legislation last year, H.R. 1252 would give the Federal Trade Commission the authority to investigate and punish those who artificially inflate the price of energy.

The FTC would be empowered to exercise this authority at each stage of the energy production and distribution supply chain.

Over 120 members have already co-sponsored this legislation, and I look forward to moving it soon.

In its spring 2006 study on gas prices after Hurricane Katrina, the FTC found that 23 percent of the refineries, 9 percent of the wholesalers and 25 percent of the retailers studied had price increases that "were not substantially attributable to increased cost" and "could not attributed to national market trends."

In his concurring statement, FTC Commissioner Jon Leibowitz admitted that, "The behavior of many market participants, on balance, leaves much to be desired."

According to the Washington Post, after Hurricane Katrina, refinery profits were 255 percent higher than they were the year before, as we show in our chart over there.

While 29 States and the District of Columbia currently have State price gouging laws, these States typically do not have the resources to go after refineries and oil companies.

Last week, however, Kentucky Attorney General Greg Stumbo announced that after an 18-month investigation, he has filed suit against three oil companies he believes gouged Kentucky residents after Hurricanes Katrina and Rita.

Citing the absence of a Federal price gouging statute, Stumbo is the first attorney general to file suit against major oil refiners.

While consumers pay record prices, oil companies make record profits. Unfortunately, the big oil companies are not reinvesting these record profits into the safety and infrastructure of their refineries.

When I asked British Petroleum's chairman in a hearing last week whether cost-cutting pressures could have led to a culture that discouraged preventative maintenance, his response was, "It not only could have, we believe it did."

Even with record profits, BP cut preventative maintenance to save money, which as of yesterday led to another oil pipeline shutdown in Alaska.

This reduced preventative maintenance to cut costs so they can increase profits and corporate executive pay and bonuses jeopardizes the Nation's most strategic oil supply and risks the health and safety of workers.

This was most apparent in BP's Texas City refinery disaster that killed 15 workers and injured 180 others.

By investigating the factors that go into a gallon of gas, Congress must work to protect consumers from price gouging and market manipulation.

I wish to thank all the witnesses today, especially Mr. Pruss, who will be testifying on behalf of Michigan's governor, Jennifer Granholm.

And I look to each and everyone's testimony.

Last, I will note that we invited four of the major oil companies to testify, but all of them declined our invitation.

In addition, the head of the President's Council on Economic Advisors expressed interest in testifying. They were invited, too. But later, they declined as well.

With that, I would yield to my friend, Mr. Whitfield of Kentucky, for an opening statement.

We have 8½minutes on votes, to let members know. Let's get through Mr. Whitfield's opening statement. We will go vote. After that, we have 2-minute votes, so I don't think it will be that long. We will probably need about a half hour.

Mr. Whitfield, please?

OPENING STATEMENT OF HON. ED WHITFIELD , A REPRESENTATIVE IN CONGRESS FROM THE COMMONWEALTH OF KENTUCKY

Mr. WHITFIELD. Mr. Chairman, thank you very much, and we certainly look forward to this hearing today on gasoline prices.

I must say that many of us on this side—and like all politicians, there is not any issue of greater interest to us than gasoline prices and the impact that it is having on the American public. But we also are quite frustrated by the process involved in this particular legislation.

I know that, Chairman Stupak, you have been a leader on this issue for some time, but your bill has been introduced for some time, and it is our understanding that your bill, with some changes to it, will be coming to the floor this week for a vote before the Memorial Day recess, and that we have certainly not had any opportunity to see that legislation and do not really have any idea what the final bill is going to look like.

And I think it is imperative that the American people also—while they are focused on the profits of major oil companies, that they also focus on the fact that in 2006, for example, 387 million gallons of gasoline were consumed each day in America.

In 1970, that figure was 243 million gallons a day were consumed, so that is a 59 percent increase. So the demand for gasoline continues to escalate in America, and we are consuming more gasoline than any other country in the world.

I would also note that in May 2006, the Federal Trade Commission completed an extensive congressionally mandated investigation to determine whether gasoline prices were being manipulated

and to determine whether price gouging actually followed the events of Hurricane Katrina.

The investigation was extensive. It involved lawyers, economists, pricing experts and many others, and it went on for many months.

The investigation did not uncover any evidence of manipulation to increase prices or to manipulate prices but did find limited instances of price gouging by retailers, price gouging as defined by the statute mandating the investigation. I might say that in that statute, price gouging was basically looking at prices a month or so after Katrina and compared it to a month or so before Katrina, so it was a relatively simplified formula for determining price gouging. Evidence did show that the price of crude oil is the largest cost component of gasoline and that that certainly contributes to gasoline price spikes.

Also, refinery production problems—and we have had four or five refineries right now that are not at full capacity because of fires and other production problems. And then we have some low inventories right now.

Now, in your opening statement, Mr. Stupak, you mentioned that Attorney General Stumbo has filed complaints in Kentucky against Marathon Oil Company and some others, which is true. Kentucky does have a State price gouging statute.

But I would also note that these State laws prohibiting price gouging—none of them have adopted a common definition or standard for price gouging. Every one of them is different. And of course, we do not have a Federal price gouging statute, and that is, I know, what your bill is about, and that is what is being considered.

But I would also point out that the Federal Trade Commission in their report to the Congress advised Congress that if it enacts a price gouging statute, it is essential that the language be clear and easy to enforce and included mitigating factors such as market factors for supply and demand.

And that is why I genuinely believe that the legislation we passed last year on price gouging—I think Heather Wilson's language—in which we allowed the Federal Trade Commission and its experts to define the definition of price gouging and unconscionable pricing, is actually better than the language of H.R. 1252, which uses language like unconscionable pricing will include pricing that is unconscionably excessive, which is pretty vague, pretty broad, and I think it is going to invite a lot of legal lawsuits.

In addition to that, it indicates that the seller is taking unfair advantage, unusual market condition. So at least those of us—and I think every Member of Congress is concerned about price gouging, but we want a bill that gives us the best opportunity to address this problem.

And I think that is why many of us are quite concerned that when this bill goes to the floor, it is going to be on the suspension calendar, there will not be an opportunity to amend it on the floor, and we actually are not going to have an opportunity at full committee to deal with it, either.

But I once again want to thank you for your leadership on this issue, and we certainly look forward to the witnesses today as we explore this important topic.

Mr. STUPAK. Well, I thank the gentleman from Kentucky.

We have up to 10 votes on the floor. The good news is some of them are 2-minute votes. I would expect we would be back by 2 o'clock.

I hate to inconvenience our witnesses, but we are going to have to recess until 2 o'clock. Thank you.

Yes, Mr. Green?

Mr. GREEN. Can I do my 5 minutes first?

Mr. STUPAK. You have 2 minutes and 14 seconds left.

OK. We will go do our votes, and we will come back. Thank you.

[The prepared statement of Mr. Green follows:]

PREPARED STATEMENT OF HON. GENE GREEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. Chairman, thank you for holding this hearing today on gasoline prices, oil company profits, and the American consumer.

Few issues we debate here in Congress are as personally felt by every consumer and business in the U.S. as energy prices. Over the past 2 weeks, the average price of self-serve gasoline rose more than 11 cents for an all-time record of $3.18. Rising as fast as gas prices is the anger and confusion of the American public who are asking themselves, why am I paying so much for a tank of gas?

I hope today's panel will help shed some light on this very complex issue so Congress can address the root cause of high energy prices and not move in a direction that, however well-intentioned, may hurt American consumers.

No one here in Congress likes to see American families struggle to pay higher prices at the pumps. Families are digging deeper and deeper into their pocket books for gas, and when prices increase, less money is available for other critical needs like medicine, groceries, or savings. Unfortunately, driving less sometimes isn't an option when moms and dads must drive to work, take kids to school, or go buy groceries. These families must make tough choices, and so too must Congress when facing different policy proposals meant to address our energy security.

Fortunately, we can use history as a guide to tell us what worked and what didn't when the U.S. faced rising energy costs.

OPEC nations in the 1970's placed an embargo on oil shipments to the U.S. which caused the price of oil to skyrocket here at home. In response, President Nixon instituted a program to control prices and allocate supplies through Government intervention. This program was an abysmal failure. Long lines at the pump and an inefficient gas supply system proved Government interference in free-market processes only compound—not help—the problem.

Most recently, after Hurricanes Katrina and Rita hit the Gulf Coast region in 2005, average gasoline prices rose close to 50 cents per gallon. Fearing potential price gouging, Congress directed the Federal Trade Commission (FTC) to conduct an investigation into nationwide gasoline prices and possible price gouging in the aftermath of Hurricane Katrina. The FTC concluded that "the price increases were predicted by the standard supply and demand paradigm of a competitive market." In fact, the FTC found that wholesale prices "increased by less than what one would expect given the losses in production capacity due to the hurricanes." Time after time, government investigations into price spikes by the FTC and the Department of Energy have all come to the same conclusion: increases in gasoline prices were generally explained by market forces of supply and demand, not by market manipulation.

Current petroleum and gasoline prices are set by a complex mix of factors, including global crude prices, increased world and U.S. demand, refinery capacity and maintenance schedules, gasoline imports, prescriptive fuel mandates, and geopolitical events. Most of these factors are out of industry's and retailer's control. For those that aren't, I believe the FTC should continue to aggressively pursue anti-competitive conduct or evidence of market manipulation to the fullest extent of the law.

We here in Congress should do all we can to protect consumers, but we should do so in a way that helps remedy the actual versus the perceived problem.

While there is no quick fix for gasoline prices, we need to evaluate proposals to promote energy conservation, new alternative and renewable sources of energy, encourage increased refinery capacity, and increase domestic supplies of oil and natural gas resources.

Thank you Mr. Chairman, and I look forward to working with you and other Members on improving the energy security of the U.S. I yield back.

[Recess.]

Mr. STUPAK. We are just waiting for a Member to come back who has not given their opening statement. There is a couple of them who will be coming.

When I said 2 o'clock, I should have told you I meant central time. My district actually has two time zones.

The subcommittee will come to order. We will continue with opening statements. We will start with Mr. Inslee from Washington for an opening statement.

OPENING STATEMENT OF HON. JAY INSLEE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WASHINGTON

Mr. INSLEE. Thank you. I look forward to this testimony today. Just a couple of things to say.

I just hope this week the U.S. Congress, while gas prices are going up, will also rise the Federal Government's ability to deal with this issue and pass a bill to give the FTC authority to clearly and concisively deal with predatory pricing.

If gas prices go up, so should the ability of the Federal Government to deal with predatory pricing to the extent that it exists. And I am hopeful this week that will be added to the tool box of our ability to deal with these issues.

But second, I hope that we will look ultimately at some of the markets that could add to the volatility of gas prices. We have seen a 60-cent increase just in the last year in the State of Washington. We now average about $3.44 a gallon when you included taxes.

And when you have volatility, I believe that itself is a problem for consumers. And I hope that we can take, at the appropriate moment, a look at the markets, the speculative markets, that may be a cause for this volatility.

But third—and this is an important point that I hope we will make at some point today—we are going to do some short-term things to deal with potential predatory pricing issues.

But ultimately, we have got to add competitors to oil and gas in our transportation sector in order to get a handle on prices.

Long term, we have to give consumers a choice in fuels, because when we get a choice in fuels, the consumers will be the king, not just the oil and gas industry, when they pull up to the pump.

Consumers in the next decade ought to have the ability to make a choice whether they are going to have cellulosic ethanol, not just corn ethanol, but the second-generation cellulosic ethanol, with flex fuel vehicles, and a requirement, if necessary, to get the pumps put in with E–85 pumps.

When that happens, Americans will be king of the pumps, not just the oil and gas company, because you can pull up to the pump and make people bid for your service just like people get that right in Brazil.

And that is why I will be introducing my new Apollo energy project later. I think it is a significant way to move forward to give people a choice in fuels.

Second, we ought to have a right to use electricity to fuel our cars. I drove a car that gets 150 miles a gallon when you use the first 40 miles to use electricity.

When Americans have the ability to use electricity, or cellulosic ethanol or biodiesel in their cars, they will finally be able to deal with these increasing prices associated with oil and gas.

And we have to have a comprehensive, aggressive, visionary energy policy in this country to truly break the addiction to oil and gas in this country. And so I am looking forward to a chance to do that.

And I will rest at this point.

Mr. STUPAK. I thank the gentleman.

Mr. Barton of Texas for an opening statement, please?

OPENING STATEMENT OF HON. JOE BARTON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. BARTON. Thank you, Mr. Chairman.

Let me say something positive before I say some things that are not quite so positive. I think it is important that the Congress establish a record on why gasoline prices are where they are.

And I think it is important that the Energy and Commerce Committee and this subcommittee, the Oversight and Investigations Subcommittee, lead that effort.

So as the ranking member on the minority side, I am not at all opposed to this hearing. I am not opposed to this subject. I am opposed to what is going to happen tomorrow on the floor, however and I am opposed to the way the witnesses for this hearing have been obtained.

We are not going to hear anybody today who actually goes out and tries to find oil in this country. We are not going to hear from anybody who tries to refine oil into the various petroleum products, including gasoline.

We are not going to hear from anybody who transports those products to market either by pipeline or truck. We are not going to hear from anybody who operates terminals at the wholesale level.

And apparently, we are not going to hear from anybody who owns a gasoline station. Now, I say apparently, because there may be one witness that is involved in that.

So what we are going to do is have a hearing about gasoline prices without actually hearing from any of the people who find the oil, who make the products, who distribute the products, who transport the products, and who sell it to us.

Now, I think that is wrong. In the last Congress, we had hearings similar to this, and we had all those people here. Plus, we had all the people that then the minority, the Democrats, wanted on some of the consumer side.

We had a fair and balanced hearing or set of hearings. That is the way it should be.

We, the Republicans, asked the majority, the Democrats, on the committee to invite some of the trade associations who represent some of the folks that I have just talked about. We were turned down.

And as I pointed out, when we held these same hearings in the last Congress, we invited all those people plus more.

It would be nice to hear from the American Petroleum Institute, the National Petrochemical and Refiners Association, the National

Association of Convenience Stores, maybe even the Society of Independent Gasoline Marketers of America.

Those folks were all available. They were willing to testify—at least they told the minority staff that they were willing to testify. And they are not here today. And I think that is a shame.

In addition to gasoline prices and oil company profits, at issue in this hearing is anti-price gouging legislation. Nothing wrong with that.

Again, in the last Congress, we passed anti-price gouging legislation twice on the floor of the House of Representatives. It did not ever pass the Senate, but it passed the House on two different occasions.

Apparently, the Energy and Commerce Committee, which had a legislative markup at least once in the last Congress, is not going to be afforded an opportunity to hold a legislative hearing or to mark up any of the legislation that, again, is supposedly going to be on the floor tomorrow.

Now, I just got a bill somewhere that, I am told, is the bill that is actually going to be on the floor tomorrow, H.R. 1252 as amended. I am going to study it very carefully this evening.

It would have been nice to have had a legislative hearing about it. It would have been nice to have been invited by the majority to participate in some negotiations, perhaps to offer some amendments, perhaps to have a markup. That is not going to happen.

Now, I understand that gasoline prices are higher than we wish they were. Apparently, the Democratic staff has put out a handout that shows that when President Bush became President, it was $1.47, and today it is $3.22. I am not going to argue with that.

I will point out that when the Democrats took control of the House of Representatives on January of this year, it was $2.33. And today, I filled up in Arlington, VA, it was $3.19. That is 86 cents in 4 months.

We keep up that rate, and it will be close to $5 by the end of the year. So if I were a Democrat and talking about the price when Bush took over, I wouldn't crow too much, because on a percentage basis, since they have taken over, it has gone up almost 33 percent, and it is heading north a lot faster.

We feel the pain at the pump—we, the Republicans. And our constituents feel it. Our staffs feel it. As I said, I paid $3.19 a gallon this morning, and I felt it then.

But I did get to fill up. I didn't have to wait in line. I wasn't limited to 10 gallons. And if I didn't want to pay $3.19, I didn't have to pay it. I could have just not gotten gasoline.

I did notice on the way to work that there was one station selling it for $3.17, and I could have saved 2 cents a gallon if I had gone to a different gas station.

One thing that we don't need is price controls. And I am afraid that if we head down the road that this H.R. 1252 appears to be heading down that that is what we are going to get.

Now, I have a number of other things I would like to say, Mr. Chairman, but my time is already expired, and I do appreciate the process of 5-minute opening statements, so I am going to limit that.

But I am very upset that we are not having a real legislative hearing. I am very upset that we are not having a markup. I am

very upset that we are putting a bill on the suspension calendar that no Republican has been given any input into. And I just think that is flat wrong.

With that, I yield back.

[The prepared statement of Mr. Barton follows:]

PREPARED STATEMENT OF HON. JOE BARTON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Our hearing opens this morning with some remarkable absences. We will not hear from anyone who drills for oil. Nor will we hear from anyone who refines oil into gasoline. And we won't get to hear from anybody who transports oil or gasoline by pipeline or by truck. How about a terminal operator? No. And what about a gasoline station? No. So we're going to have a hearing about gasoline prices without actually hearing from the people who find the oil, who make the gasoline, who transport it, and who sell it to us. This is unfortunate.

The Republican members of this committee requested that the Democrats invite the industry associations representing everyone in the gasoline "food chain"—from oil well to gas pump—but our request was denied. The American Petroleum Institute, the National Petrochemical and Refiners Association, the National Association of Convenience Stores, and the Society of Independent Gasoline Marketers of America were available to testify. It is a pity the record will not reflect their insights.

In addition to gas prices and oil company profits, at issue in this hearing is anti-price gouging legislation. It is unfortunate that the Energy and Commerce Committee will not be afforded an opportunity to hold a legislative hearing or a markup on a piece of legislation that is so important to consumers and that could have a broad and deep impact on our Nation's economy. Mr. Stupak's bill would benefit from committee consideration. At the very least, it should have a trigger, which comes into force after the Secretary of Energy has determined that there is a bona fide problem with supply. There should be mitigation factors, especially a clear definition of what constitutes price gouging so that those subject to the Act will have some idea of what they are being ordered not to do.

Everyone feels the pain at the pump—our constituents feel it, our staff feels it, I feel it. We all want to do something about high gas prices, but effectively instituting price controls on gasoline—which is what H.R. 1252 as written would do—is the worst possible solution. If you like spot shortages and lining up to buy your gasoline, you're going to love this bill.

Price controls didn't work in the early 1970's. They didn't work in the late 1970's. And they won't work now.

Instead, price controls will further constrict an already tight supply and result in greater demand, which results in higher prices. This is not an emotional debate where one's personal beliefs and moral code dictate their stance on a solution. This is economics. There is a finite and known result to price controls. Simple supply-and-demand economics explains the result—as supply tightens while demand grows, there is less product available on the market, which drives price increases. Supply will decrease if Congress institutes price controls. Oil companies and independent gas stations alike will turn off their pumps rather than face 10 years in jail because they had to raise their prices in order to cover the inevitable cost increase of obtaining gas after a natural or a man-made disaster. And for the record, let's be clear on one thing—the FTC has conducted numerous studies on this topic and has never—I repeat, never—found a single instance of widespread, collusive price gouging.

Anti-gouging legislation is based on the faulty assumption that price increases are due to the greed of Big Oil and refineries (whose industry groups, again, were not afforded an opportunity to speak today). In fact, what is driving up the price of gasoline is not these companies, but rather record high consumer demand, both domestic and international. Compounding the problem is the anomaly that domestic demand did not fall off this spring as it historically has during the period in which refineries must go offline in order to perform the required annual maintenance and switch to summer blends. Further driving up the cost of gasoline, we are importing historically low levels of refined product due to anomalies in the European market. When we have a restricted supply with increased demand—or even static demand—prices go up.

The only way to drive down the price of gas is to increase supply and decrease demand: we must increase domestic crude inventory. We must increase refinery capacity. We must streamline refinery permitting. Oil companies are not sitting idly by, merely reaping the benefits of high prices driven by the world crude market. In-

dustry has added the equivalent of 10 new refineries over the last 10 years. Publicly announced plans indicate the addition of the equivalent of eight more refineries over the next 4 years. At the same time, we must decrease demand. We must continue research into the use of alternative fuels. We must adopt higher efficiency standards for vehicles. We must also educate consumers with proven fuel saving tips.

Mr. Chairman, I thank you for holding this hearing because it affords the public an opportunity to see the difference between Republicans and Democrats. Fuel prices are important to all of our constituents and if we follow your solution, our people are going to pay more and get less—when they can find any gasoline at all. I hope the next time we take up this matter, it will be for the purpose of increasing the supply of gasoline and decreasing the price instead of grandstanding for the reporters in the audience.

Mr. STUPAK. Let me just respond briefly, if I may, to the gentleman's request or statements there.

We have accepted on the hearing we have here today—there are four witnesses invited by the majority, three that are invited by the minority. We accepted your request to have EIA here. They are here. We accepted your request to have Mr. Montgomery, an oil industry analyst on the second panel. He is here.

The National Petroleum Refiners Association have advised us they did not wish to be part of any panel.

As far as American Petroleum Institute, instead of having a lobbying group, we would rather hear from Big Oil. We invited ExxonMobil, Shell Oil, Chevron, Valero, the largest oil refiner in the United States. They turned us down.

You know, we sought testimony from the Department of Energy's policy office but were told that no one was available on the date of our hearing due to the Chinese trade conference.

On Monday, we were contacted by the White House. The chair of the Council of Economic Advisors asked to testify. We graciously extended that to him. It would have been four minority witnesses, four majority witnesses.

A few hours later, they called us back, said because of scheduling conflicts they could not testify.

So I think we have been more than generous with providing minority, the administration and industry with an opportunity to be heard here today.

I hope that the minority would work with us to bring ExxonMobil, Shell Oil, Chevron Oil, Valero and the rest of them to come testify before the American people. They never testified when you were in the majority, and we would like to hear from them.

We will be having other hearings. We have an unfair manipulation of prices that I would like to have hearings on. We have to do something with natural gas and FERC regulation yet. So I look forward to it.

As far as the legislation coming to the floor, when you were in the majority, Mr. Barton, I learned some things bad and some things good.

One of the things I learned from you is take a piece of legislation and bring it right to the floor, just like you did last year with the Wilson legislation.

It was introduced on Tuesday, May 2. We never saw it. On Wednesday, May 3, we had a vote on it—no hearing on it, no markups, no nothing. So I learned from you.

Mr. BARTON. Would the gentleman yield on that point?

Mr. STUPAK. Sure.

Mr. BARTON. What you just said, as you said it, is literally true. The second time we brought the price gouging bill up, we did it just like you said. And I wasn't too happy about that, but I had to do it.

But the first time we brought it up, we had a full committee markup. You had an amendment in committee that failed. You were given the right to offer that same amendment on the floor. And then I think you offered a version of it as a motion to recommit.

Are we going to have a legislative hearing or a committee markup of this legislation any time in the near future?

Mr. STUPAK. As the chairman said, sometimes some of these scheduling issues and how legislation comes to the floor—it is out of our control.

And you are right, my legislation was a substitute to the Barton amendment, which never came to the floor, but I did offer it as a substitute.

So that means H.R. 1252, as you see it before you, has been around for well over a year. It is not like it is a brand new piece of legislation like the Wilson legislation was on the floor.

We all wish we would get things the way we want. Sometimes the process moves a little quicker than what we would like. We actually had a hearing last week on parts of H.R. 1252 before the Judiciary Committee.

We are having this hearing today not on H.R. 1252 but on gas prices and the impact on the American people. And I hope we can have further hearings on that subject, as the ranking member suggested.

With that, I would turn to Mr. Dingell of Michigan for an opening statement.

OPENING STATEMENT OF HON. JOHN D. DINGELL , A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Chairman DINGELL. Mr. Chairman, thank you. I commend you for conducting this hearing into the pressing matter of gasoline prices. American consumers today face the highest gasoline prices in history, and apparently the worst is not yet over.

The American Automobile Association and others forecast that prices are likely to go even higher. For many, high energy prices are an economic crisis.

At today's prices, the average American family will spend $2,413 more than they did in 2001, more than double what was spent then. This is, no doubt, going to be very difficult for most, as family incomes have not kept pace with the rapid rise in gasoline prices.

Similarly, those businesses, large and small, that do not enjoy the comfort of high profit margins are experiencing severe pain. Trucking companies, taxi drivers and other businesses that depend on gasoline and petroleum products are feeling the pinch.

Rising gas prices, in turn, increase the price of goods and services throughout the economy. The results could be disastrous for both individuals and for the economy as a whole.

At the same time this is taking place, the current administration seems to be unable or perhaps unwilling to do anything about the problem.

Today, we will hear testimony from the Government Accountability Office, which, after conducting an exhaustive study, concluded that mergers and consolidations in the oil industry have contributed to an increase in the price of gasoline.

Yet the Federal Trade Commission will disagree and cite a list of things that they have done to preserve competition amongst oil companies and refineries.

Most of us would like to see the results of that competition, if such there be.

There will no doubt be a debate over the fine points of the various economic models to explain each side's conclusions.

But in the end, we are left with one irrefutable conclusion. Gas prices have risen dramatically following 10 years of increasing concentration in the oil industry.

We also will hear testimony that the current rise in gasoline prices is not due to skullduggery on the part of OPEC, but rather to a lack of refining capacity.

Perhaps it is time for the FTC to investigate this matter more closely and determine whether the lack of refining capacity is a coincidence of unplanned facility outages at multiple locations, or whether, as some argue, it is a manufactured shortage.

Finally, I am concerned that some of the less scrupulous in our society may seek to take advantage of those shortages by raising prices to unconscionable levels unrelated to the cost of providing the product.

It is essential that we have tools in place to address this kind of behavior.

Mr. Chairman, I congratulate you for pursing this issue, and I look forward to reviewing today's testimony.

I particularly want to welcome Mr. Stanley Pruss, who appears here today on behalf of Governor Granholm, who has successfully dealt with gasoline price gouging in Michigan.

I would like to say just one thing, and I say this with affection and the utmost respect for my dear friend Mr. Barton.

During the brief time that I have been chairman since the 1st of January, I have sought with all diligence to approach the high quality of leadership and the extraordinary capacity and ability with which he ran this committee during the time when he was chairman.

And I say this, again, with the utmost respect. We are here, I note, to bring to the House floor a bill, and we are trying to do it as well as he did. But as the record will show, last year, about this time of year, we had the same bill. It was taken to the floor. It was introduced 1 day on behalf of one member of this committee—a very outstanding member, by the way—and was put on the floor the next day, and it was proceeded on under suspension.

I could think of nothing better on my part than replicating the extraordinary leadership which has been demonstrated by my dear friend Mr. Barton, and I look forward to hearing further comments about the way that we are following his extraordinary leadership and competence in these matters.

I thank you.

Mr. STUPAK. I thank the chairman.

Next, we will hear from Mr. Walden of Oregon, please, for an opening statement.

Mr. WALDEN. Well, thank you, Mr. Chairman. I am going to actually waive my opening statement in lieu of additional time for our witnesses. I am very concerned about this issue and hope to probe deeply.

Mr. STUPAK. Mr. Melancon, please, for an opening statement.

OPENING STATEMENT OF HON. CHARLIE MELANCON , A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. MELANCON. Thank you, Mr. Chairman.

First, I would like to thank you for holding this hearing today. My constituents, as everyone else's, have dealt with the rising price at the pump for some time. With the change over to summer blends of gasoline, the late spring tends to be when consumers experience the first major price spikes of the year. And of course, hurricane season presents its own unique set of problems, like the potential for prolonged closure of refineries and shutting production.

Mr. Chairman, the farmers, fisherman and other businessmen and women who depend on reasonable transportation costs to turn a profit, along with the working people of my district and of this country, long for affordable fuel.

The high cost of gasoline adds up for working people who are trying to make ends meet.

America has a crisis of supply and demand on its hands. The good news is that this Congress has a lot of political will to help solve this crisis.

I believe that we can help reduce prices at the pump, but our ability to reduce those prices depends on responsible conservation, increasing production, growing refining capacity and incubating new energy technologies to help take demand pressure off our overburdened market.

I hope this committee and Congress will pursue a responsible conservation agenda, and I look forward to working toward that goal. It is only right that we should try to be good stewards of the earth's God-given resources. A responsible conservation policy will help take pressures off of gasoline supplies.

I was happy to work with Senator Landrieu and other members of the Congress in the last session to pass legislation that would encourage an increase in oil and gas production in the Gulf of Mexico.

While fossil fuels present many problems in terms of their carbon emissions and environmental impact, it is clear that they will be the primary component of our Nation's energy supply for the foreseeable future and possibly longer.

Given that reality, I strongly believe that now is not the time to discourage exploration and production of oil and natural gas. Now is not the time to place additional restrictions on companies that produce and supply this country's energy needs.

We are also committed to incubating new technologies like coal gasification and carbon sequestration, and investing in the time-tested non-carbon emitting energy sources like nuclear.

But those do not solve the immediate needs of consumers during this summer's driving season. My observation is that we have a bottleneck in the supply chain.

We can't pump oil out of the ground quick enough, and we can't seem to refine it fast enough to meet the demands of this Nation.

Oil is traded on the world market, and its price is set there, not at the retail level. All prices can be volatile, and they often correlate with the retail gasoline prices.

However, retail gasoline prices are heavily dependent on refining capacity and on inventories of gasoline. The refining bottleneck causes American consumers to pay premium at the pump for policy makers' failures to plan for increased demand.

I hope this hearing helps us understand that we must work through conservation, increasing production, investigating alternate sources of energy and increasing refining capacity in order to reduce the pressure on this market.

Thank you, Mr. Chairman, and I thank you for the witnesses today.

Mr. STUPAK. I thank the gentleman.

When does the hurricane season start? Right around now, I know. June 1, OK. We had snow this weekend up in my district in some parts, so you are a little ahead of us in the weather.

Mr. Murphy, for an opening statement, please?

OPENING STATEMENT OF HON. TIM MURPHY, A REPRESENTATIVE IN CONGRESS FROM THE COMMONWEALTH OF PENNSYLVANIA

Mr. MURPHY. Thank you, Mr. Chairman and Ranking Member Whitfield, today.

We meet to discuss some of the issues involving rising gasoline prices, or at least one part of the issue.

But I am concerned, and I hope we look at the real reasons why prices are rising and some of the roles that Congress has played in contributing to that so that we may make some changes.

And it has to do with the simple laws of supply and demand. Until we find ways to increase supplies and reduce consumer demand for gasoline, we will continue to be susceptible to price spikes such as those we are now experiencing. And that places a real burden on families.

Let's keep in mind what contributes to the cost of gasoline at the pump. Crude oil is about 56 percent of the cost. Taxes, about 18 percent of the cost. Refining, nearly 17 percent of the cost. Distribution and marketing, about 9 percent of the cost.

And overall, what we have seen is that oil costs have doubled since 2004, tripled since 2001, and have gone up some 600 percent since the 1980's. Back then, it was $11, and it has gone up above $70.

One thing we should not do about high gasoline prices is to adopt legislation that would establish artificial controls over prices in the name of protecting the consumer.

I believe we did that before in the Nixon administration. We also did some things in the Carter administration. And I remember vividly long gas lines, frustrated motorists, and that did not solve our problem.

Our gasoline imports have risen from 10 percent to 30 percent at times after Hurricane Katrina because we did not have the oil refining capacity. It costs much more to refine oil overseas and bring it over here.

It is sort of like if you are in Pittsburgh and you decide to go out and buy a pack of gum, and you drive to Chicago to do it instead of finding a way you can buy at a local store.

The U.S. will grow in its demand over the next 20 years to use oil. When demands increase and supplies do not, prices go up. And Congress has added to this problem.

We have continued to grow in our dependence on other nations and oil. Many countries like OPEC have manipulated production to increase our costs dramatically, and they make massive profits.

They also use the money to purchase weapons and to fund terrorism directly. What a terrible, terrible thing it is, that we find that whenever we put gasoline in the tanks of our cars, we are funding both sides in the war on terror.

But when we refuse to allow drilling of our own oil on our Atlantic coast, on our Pacific coast, on our Gulf coast, in our western States, on Federal lands in Alaska, despite abundant supplies of oil, or when we look at ways that we are not increasing our supplies, et cetera, all of this has been some things that have contributed to cost, including what this Congress has done in the last couple months in increasing taxes on domestic oil explored in our own Gulf of Mexico.

While Cuba and other nations are exploring within those boundaries, we still say no.

When we refuse to build support for building more refineries, we contribute to shortages. And we end up increasing the price by importing the gasoline, as I said before.

When we do not develop new sources of energy, and we refuse to look at such things as coal, and nuclear, and hydrogen fuel cell, and fund the research on this, we are contributing to higher costs.

When we don't emphasize conservation on every level, we are contributing to increased costs.

When we hear people preach about global warming and conservation while they fly about the Nation in their private jets, we are contributing to those costs.

When everything is as simple as leaving your cell phone plugged in after it is charged, to leaving computers on, to leaving lights on, and all the things that America does to waste energy, isn't it time that we began to look at the real sources of the cost of high gasoline, instead of just looking at price gouging concepts at the pump, which we cannot even define?

Every time this Congress has had an opportunity to increase supply, we have continued to say no. And yet we continue to import more and more from other nations—as I said, nations who fund the weapons used against our soldiers. And this is over half the cost of oil.

When are we going to learn that we have supplies? And if we want to reduce costs, we need to start looking for our oil. We need to start using coal. We need to have clean coal technology. We need to fund hydrogen fuel cell research.

We need to demand more conservation in our vehicles. We need to look more at how our cars can be more efficient, how our highways can be more efficient, how our public transit systems can be funded.

This is the cause of our problems of high gasoline prices. Isn't it time that Congress really looked at this? And instead, it is pointing a finger here and there and said we ought to deal with this more comprehensively.

Mr. Chairman, I know your commitment to work toward energy independence and working these issues, and I hope that these are some things we can all agree on to work on in the future to really reduce gasoline costs. Thank you.

Mr. STUPAK. I thank the gentleman.

Mrs. Blackburn for an opening statement.

OPENING STATEMENT OF HON. MARSHA BLACKBURN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TENNESSEE

Mrs. BLACKBURN. Thank you, Mr. Chairman. I want to thank you and Ranking Member Whitfield for holding the hearing today.

And to our witnesses, welcome. We appreciate that you are here. And I think that as you have heard from the opening statements, it is no secret that the increasing cost of gasoline is a pertinent issue. It is on the mind of every single American.

And in west Tennessee in my district, it will cost the average family nearly $60 to drive from one end to the other. It is a trip of 428 miles.

And that is enough to give you heartburn as you are talking about maybe going from Memphis to Nashville, or up to Clarksville, or out to the river for our Memorial Day holiday.

And yet the news reports announcing record profits for the large integrated oil companies provide our constituents little pain relief.

I have said a couple of times over the weekend that it is more like a three-alarm barbecue sauce at Memphis in May, which is something that has been taking place in our district.

Our constituents, therefore, have a right to ask questions about the rising cost of gasoline, and Congress has the responsibility to provide them with some answers that are free of political talking points and rhetoric.

They want to know why this is taking place, and they want to know if there is anything that we can do about it, and what the cause of it is.

However, it does concern me that some Members of Congress appear to be falling into the trap of political rhetoric.

It is too easy to simply try to do a connect-the-dots between, and I will quote from today's hearing, gas prices, oil company profits and the American consumer, and immediately point toward alleged marketplace manipulation and price gouging. It is a bit unfair to travel that route.

Strong laws already exist to prevent this immoral and illicit corporate behavior, and I support rigorous enforcement of those laws to protect the interest of our American consumers and of our constituents.

What I cannot support, on the other hand, is a politically motivated legislative approach that will demonize America's small business owners who operate convenience stores, filling stations and neighborhood truck stops.

And let's make no mistake about this. Those are precisely the individuals who wear a target on the back, or they feel as if they wear a target on their back, not the large, integrated oil companies.

And that is how they feel if we advance legislation to crack down on price gouging that adopts vague language, employs heavy-handed criminal penalties and unenforceable civil penalties that no small business owner can afford.

It would not only be legislative overkill, one might even call it unconscionable excessiveness.

Mr. Chairman, here are a few inconvenient facts that are missing from this debate today, as I see it. Convenience stores and filling station owners supply gasoline to the American consumer in every single congressional district, city and neighborhood across this country.

Ninety-five percent of these are independent small business owners who operate between one and three stores. The average convenience store owner earns a $33,000 profit per year. Many of these are the local community meeting place.

That is what we find in our district. They are the local gathering spot. And they are not people who are going to go and gouge their neighbors, their fellow church members and their friends.

And, Mr. Chairman, I have a statement from National Association of Convenience Stores, and I would ask unanimous consent to enter that for the record.

Mr. STUPAK. It is not appropriate. We would object to it. We will not have outside groups enter statements through Members. That has always been the policy of this subcommittee. So we cannot accept it.

Mrs. BLACKBURN. OK. Thank you, Mr. Chairman.

Mr. STUPAK. I thank the gentlewoman. Do you have any further on your——

Mrs. BLACKBURN. Yes, I do.

Mr. STUPAK. OK.

Mrs. BLACKBURN. Yes, I certainly do. And I thank the chairman for yielding back and do reclaim my time.

And I would just mention these small stores are not the portrait of a manipulating marketplace villain. They are small business owners.

And I certainly hope that throughout the course of this debate that my colleagues and I can move beyond a short-sighted temptation to engage in price gouging finger-pointing.

Instead, what we need to do is talk about what it really will take to reduce the cost of gasoline. And that is a common-sense, balanced approach to address the dwindling energy production capacity and the future of renewable energy for this country.

Many on this side of the aisle are working on just that very issue, and I invite my colleagues in the majority to join us, and let's address the real need for reform.

I thank the witnesses.

I yield the balance of my time.

Mr. STUPAK. I thank the gentlelady.

In this legislation, priority is given, if we are going to look for price gouging, at those who sell $500 million worth of sales. In my neck of the woods, that is not mom-and-pop grocers or gas stations. That is a pretty good size, just for the record on that.

If there are no other members seeking to be recognized for opening statements, I will now call our first panel of witnesses to come forward.

On our first panel, we have the honorable William E. Kovacic, Commissioner of the Federal Trade Commission. We have Mr. Guy Caruso, Administrator, Energy Information Administration. Mr. Stanley Pruss, deputy director, Michigan Department of Environmental Quality. And Mr. Thomas J. McCool, Director, Center of Economics, Applied Research and Methods, U.S. Government Accounting Office, GAO.

It is the policy of this subcommittee to take all testimony under oath. Please be advised that witnesses have a right to have counsel under the rules of the House to be present during their testimony.

Do any of you four witnesses wish to be represented by counsel? Mr. Kovacic, Mr. Caruso, Mr. Pruss, Mr. McCool? OK.

Please rise, raise your right hand and take the oath.

[Witnesses sworn.]

You are now under oath.

Mr. Kovacic, we will start with you, sir. Opening statement.

TESTIMONY OF WILLIAM E. KOVACIC, COMMISSIONER, FEDERAL TRADE COMMISSION

Mr. KOVACIC. Chairman Stupak, members of the subcommittee, thank you for the opportunity to review the Federal Trade Commission's competition policy program concerning the petroleum sector.

To provide a perspective on what we do, I would like to focus on activities from the past few years. The foundation of our program is law enforcement. In the past year alone, we have pursued several matters of note.

In April, the commission filed a lawsuit to block the proposed purchase by Western Refining of Giant Industries. The FTC alleged that the transaction would raise the price of gasoline in northern New Mexico.

We are presently awaiting a decision from the Federal district court on our motion for a preliminary injunction.

In January, the commission opposed the $22 billion deal by which Kinder Morgan would have been taken private by its management and a group of investment firms. The commission obtained adjustments to protect competition in the transportation and temporary storage of gasoline and other petroleum products in the southeastern United States.

Last November, Chevron and USA Petroleum abandoned a transaction by which Chevron would have bought most of USA Petroleum's retail gasoline stations in California.

The FTC had been conducting an investigation into that proposed deal, and USA Petroleum's president said that resistance from the commission induced the parties to abandon the deal. In addition, in late 2005, the commission opposed the Aloha's purchase of terminal facilities in the Hawaiian islands.

Earlier in the same year, the FTC settled a monopolization case challenging Unical's behavior in the process by which the California Air Resources Board set standards for gasoline sold in that State. The settlement has generated savings of roughly $500 million per year to consumers of gasoline in California.

These and other FTC law enforcement initiatives draw heavily upon the second element of our program: Namely, research and studies involving the petroleum sector.

These investments guide our pursuit of cases and inform our use of non-litigation policy tools.

In May 2006, as this committee's members have discussed, the commission presented to Congress its report on the investigation of gasoline price manipulation and post-Katrina gasoline price increases.

The report examined whether energy firms had manipulated gasoline prices and described how energy markets responded to the destruction caused by Hurricanes Katrina and Rita.

In December 2006, the FTC also issued a report on the current state of ethanol production in this country.

In May 2002, the FTC began a project to monitor wholesale and retail gasoline prices and the prices of diesel fuel to identify possible anticompetitive practices.

That project continues today. We track prices in 360 cities across the country and in 20 major wholesale markets.

The third element of our program is cooperation with other public bodies. The FTC is not the only public body with competition policy duties in the energy sector.

Improved cooperation with other public authorities at the national, State and local levels can help each institution spend its competition resources more effectively. I view more effective cooperation as vital to future policy success in this area.

To this end, last September, the FTC and representatives of various State attorneys general, including the State of Michigan, held a day-long workshop to discuss competition and consumer protection issues involving gasoline pricing.

The participants regarded this event as a useful step toward improving Federal and State efforts to address developments of common concern.

The fourth element of our program is public consultation in the form of public hearings, seminars and workshops.

Public consultations have enabled us to gain deeper insight into developments, many of the type that this committee has discussed, affecting industry and consumers, to identify major emerging trends and to help build a consensus about appropriate policy responses.

One month ago, the commission convened 3 days of hearings on Energy Markets in the 21st Century: Competition Policy and Perspective.

The hearings studied old and new fuel cycles, demand side issues involving transportation, lessons from past regulatory strategies, and the vulnerability of the United States to supply and demand shock.

The proceedings featured an extraordinary group of participants, at least one additional person you will hear on the next panel of this session. Energy companies, think tanks and universities participated, as well as government agencies and consumer groups.

This improved our understanding of how we can best use our policy tools and suggested paths that the Nation's energy policy might usefully take in the future.

I welcome your comments and questions.

[The prepared testimony of Mr. Kovacic follows:]

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

Prepared Statement of the Federal Trade Commission

Market Forces, Competitive Dynamics, and Gasoline Prices: FTC Initiatives to Protect Competitive Markets

Presented by
William E. Kovacic
Commissioner

Before the

Subcommittee on Oversight and Investigations

Committee on Energy and Commerce

U.S. House of Representatives

May 22, 2007

I. Introduction

Mr. Chairman and members of the Subcommittee, I am William E. Kovacic, a Commissioner of the Federal Trade Commission. I am pleased to appear before you to present the Commission's testimony on FTC initiatives to protect competitive markets in the production, distribution, and sale of gasoline and other petroleum products.[1]

The petroleum industry plays a crucial role in our economy. Indeed, few issues are more important to American consumers and businesses than the decisions being made about current and future energy production and use. Not only do changes in gasoline prices affect consumers directly, but the price and availability of gasoline also influence many other economic sectors. No other industry's performance is more deeply felt, and no other industry is more carefully scrutinized by the FTC.

The Commission's testimony today addresses the Subcommittee's inquiries in two parts. It first reviews the basic tools that the Commission uses to promote competition in the petroleum industry: challenging potentially anticompetitive mergers, investigating potential nonmerger antitrust violations and prosecuting actions where appropriate, and monitoring industry behavior to detect possible anticompetitive conduct. This review of the Commission's petroleum industry agenda highlights the FTC's contributions to maintaining competition in the industry. The Commission places a premium on careful research, industry monitoring, and investigations to understand current petroleum industry developments and to identify obstacles to competition,

---

[1] This written statement represents the views of the Federal Trade Commission. My oral presentation and responses to questions are my own and do not necessarily represent the views of the Commission or any other Commissioner.

whether arising from private behavior or from public policies. The petroleum industry's performance is shaped by the interaction of extraordinarily complex, fast-changing commercial arrangements and an elaborate set of public regulatory commands. A well-informed understanding of these factors is essential if FTC actions are to benefit consumers.

The second part of this testimony reviews the Commission's additional efforts to examine and analyze issues of importance to consumers in the petroleum industry – including conferences, workshops, studies, and reports.

Recently gasoline prices have been rising. Over the past three months, retail gasoline prices have increased between 80 and 90 cents per gallon ("cpg"), depending on location. The national average price of gasoline has risen from approximately $2.20 per gallon in early February to over $3.05 per gallon as of May 7, 2007. Increases in crude oil prices have played a relatively minor role in this increase in retail prices.[2] Rather, the lion's share of the recent increase in gasoline prices appears to be attributable to three factors: refinery outages, increased demand for gasoline, and decreased gasoline imports.[3]

A number of refineries have experienced outages in recent months due to fires and

---

[2] For example, the price of West Texas Intermediate ("WTI") benchmark crude oil increased from about $1.40 per gallon for the week ending February 10 to between $1.52 and $1.55 per gallon in the last few weeks – a change of approximately 12-15 cpg over the same three-month period.

[3] Refinery margins have grown because the gap between gasoline demand and supply has widened. For example, the weekly average refining margin on conventional gasoline – *i.e.*, the spot market price of gasoline minus the spot price of WTI crude – increased from 10-15 cpg during January and February to 70-80 cpg for the week that ended May 5, 2007. Oil Price Information Service and Department of Energy, Energy Information Administration.

equipment failures.[4] Meanwhile, gasoline demand has been strong, and gasoline consumption since the beginning of 2007 has increased 1.8 percent over last year. Average weekly consumption since April 2007 was 1.4 percent higher than a year earlier, even though weekly prices reported by the Department of Energy's Energy Information Administration ("EIA") since the beginning of April are averaging 2.9 percent higher than the previous year. Gasoline imports, which make up 10 to 15 percent of United States gasoline supply, are down from 2006 levels – 8 percent since the beginning of April and 10 percent since the beginning of this year.[5] This reduction in imports means that approximately 1 percent less gasoline supply is available in the United States this year compared to last year. With increased demand, lower imports, and because of recent refinery outages, U.S. inventories of gasoline fell well below normal monthly levels in April and early May of 2007. The most recent data for May 2007, however, show some re-stocking of gasoline inventories.

There is a perception that gasoline prices always increase. Gasoline prices, however, have fluctuated sharply in recent years – from the 2005 price spike after Hurricanes Katrina and Rita to the sharp decrease in prices in the months after the hurricanes; from the increase in prices

---

[4] Examples of refinery outages due to fires and equipment failures include: (1) Chevron's Richmond, California refinery, which had a fire just as it was going into a turnaround for maintenance, resulting in its scheduled shutdown being extended by one month (Platt's Oilgram News, April 30, 2007); (2) BP's Whiting, Indiana refinery, which was forced to operate at half-capacity due to a hydrotreater failure (Bloomberg News, April 24, 2007); (3) Valero's McKee, Texas refinery, which was shut down for two months due to a fire and will operate at half capacity until the end of the year (Energy Intelligence Group, April 11, 2007); (4) ExxonMobil's Torrance, California refinery, in which a sulfur recovery unit failed while another such unit was being overhauled (Energy Intelligence Group, April 4, 2007); and (5) Chevron's El Segundo, California refinery, which had a fire affecting two coking units at the refinery, resulting in reduced output (Energy Assurance Daily, April 3, 2007).

[5] Department of Energy, Energy Information Administration.

during spring 2006 to the dramatic decrease last fall and winter; and then to the dramatic price increase of the last three months. These increases naturally have caused concern and dissatisfaction among gasoline consumers. The Commission considers it an essential part of its responsibility to keep a close eye on the industry and to look for any pricing or other activity that may not reflect purely competitive decisions based on the ordinary forces of supply and demand.

II. FTC Activities to Maintain Competition in the Petroleum Industry

A. Merger Enforcement

Although the FTC does not regulate energy market sectors, the agency plays a key role in maintaining competition and protecting consumers in energy markets. The Commission has been particularly vigilant regarding mergers in the oil industry that could harm competition. It examines any merger and any course of conduct in the industry that has the potential to decrease competition and thus harm consumers of gasoline and other petroleum products. A review from January of this year of horizontal merger investigations and enforcement actions from fiscal year 1996 to fiscal year 2005 shows that the Commission has brought more merger cases at lower levels of concentration in the petroleum industry than in any other industry.[6] Unlike in other industries, the Commission has brought enforcement actions (and in many cases, obtained

---

[6] The Horizontal Merger Guidelines that serve as a guide to merger enforcement by the FTC and the Department of Justice categorize market concentration, as measured by the Herfindahl-Hirschman Index ("HHI"), into three concentration zones. (The HHI is computed by squaring each firm's market share and summing the squares.) A market with an HHI below 1,000 is considered "unconcentrated." A market with an HHI between 1,000 and 1,800 is "moderately concentrated," while a market with an HHI over 1,800 is classified as "highly concentrated." The likelihood of enforcement agency interest in a merger or acquisition generally increases as HHI levels rise, although concentration levels are only a starting point for the searching analysis of potential competitive effects that is necessary to determine how a particular transaction may affect competition and consumer welfare.

merger relief) in petroleum markets that are only moderately concentrated.[7]

Most recently, the Commission filed for a preliminary injunction in federal court and issued an administrative complaint against a petroleum industry transaction – Western Refining's proposed acquisition of Giant Industries. On April 12, 2007, the Commission filed its complaint in the U.S. District Court for the District of New Mexico, alleging that the proposed acquisition would lead to reduced competition for the bulk supply of light petroleum products to northern New Mexico.[8] In the complaint, as amended, we allege that Western and Giant are two of only a small number of firms capable of responding to higher prices or quantity decreases in the bulk supply of gasoline to northern New Mexico, and that Giant would have increased its supply of gasoline to that area absent its acquisition by Western.[9] Following the district court's April 13, 2007, issuance of a temporary restraining order against consummation of the transaction, the trial of the preliminary injunction action took place last week, and the court is expected to rule soon on the Commission's request for an injunction. The FTC issued an administrative complaint against the merger on May 3, 2007.[10]

---

[7] Federal Trade Commission Horizontal Merger Investigation Data, Fiscal Years 1996-2005 (Jan. 25, 2007), Table 3.1, et seq., *available at* http://www.ftc.gov/os/2007/01/P035603horizmergerinvestigationdata1996-2005.pdf; FTC Horizontal Merger Investigations Post-Merger HHI and Change in HHI for Oil Markets, FY 1996 through FY 2003 (May 27, 2004), *available at* http://www.ftc.gov/opa/2004/05/040527petrolactionsHHIdeltachart.pdf.

[8] *Federal Trade Commission v. Paul L. Foster, Western Refining, Inc., and Giant Industries, Inc.*, Civil Action No. 07cv352 JH/ACT (D.N.M. Apr. 12, 2007), *available at* http://www.ftc.gov/os/caselist/0610259/index.shtm.

[9] *See* http://www.ftc.gov/os/caselist/0610259/070430weterngiantfirstamndcmplt.pdf.

[10] Two other recent FTC law enforcement actions also involve the energy sector, although not the petroleum industry. The Commission issued an administrative complaint on

Also, on March 14, 2007, the FTC challenged the acquisition of energy transportation, storage, and distribution firm Kinder Morgan by Kinder Morgan management and a group of investment firms, including private equity funds managed and controlled by The Carlyle Group and Riverstone Holdings. Because the proposed transaction threatened competition between Kinder Morgan and Magellan Midstream – a major competitor of Kinder Morgan in terminaling and distributing gasoline and other light petroleum products in the southeastern United States – the Commission ordered the parties in effect to turn Carlyle's and Riverstone's interest in Magellan Midstream into a passive investment.[11]

In November 2006, Chevron and USA Petroleum abandoned a transaction in which Chevron would have acquired most of the retail gasoline stations owned by USA Petroleum, the

---

March 14, 2007, challenging Equitable Resources' proposed acquisition of The Peoples Natural Gas Company from Dominion Resources. According to the FTC's complaint, the acquisition would result in a monopoly in the distribution of natural gas to nonresidential customers in certain areas of Allegheny County, Pennsylvania, including Pittsburgh. *See* http://www.ftc.gov/os/adjpro/d9322/0703admincmp.pdf. Following the Pennsylvania Public Utility Commission's approval of the merger, the FTC also filed a request in the federal district court in Pittsburgh, seeking a preliminary injunction against the transaction. On May 14, 2007, the court granted defendants' motion to dismiss on state action grounds; the Commission has requested an injunction pending appeal.

In addition, in November 2006, the FTC challenged EPCO's proposed $1.1 billion acquisition of TEPPCO's natural gas liquids storage businesses. The FTC approved a consent order that allowed the acquisition to be completed only if TEPPCO first divested its interests in the world's largest natural gas liquids storage facility in Mont Belvieu, Texas, to an FTC-approved buyer. *EPCO, Inc., and TEPPCO Partners, L.P.*, FTC Docket No. C-4173 (Oct. 31, 2006) (consent order), *available at* http://www.ftc.gov/os/caselist/0510108/0510108c4173do061103.pdf.

[11] *TC Group L.L.C., et al.*, FTC Docket No. C-4183 (Mar. 14, 2007) (consent order), *available at* http://www.ftc.gov/os/caselist/0610197/index.shtm.

largest remaining chain of service stations in California not controlled by a refiner. USA Petroleum's president acknowledged that the parties abandoned the transaction because of resistance from the FTC.[12]

The Commission filed a complaint on July 27, 2005, in federal district court in Hawaii, alleging that Aloha Petroleum's proposed acquisition of Trustreet Properties' half interest in an import-capable terminal and retail gasoline assets on the island of Oahu would reduce the number of gasoline marketers from 5 to 4 and could lead to higher gasoline prices for Hawaii consumers.[13] The case was resolved through the parties' execution of a 20-year throughput agreement that will preserve the competition that we believed was threatened by the acquisition.[14]

In June 2005, the FTC challenged the acquisition of Kaneb Services and Kaneb Pipe Line Partners – companies that engaged in petroleum transportation and terminaling in a number of markets – by Valero L.P., the largest petroleum terminal operator and second largest operator of liquid petroleum pipelines in the United States.[15] The complaint alleged that the acquisition had the potential to increase prices in bulk gasoline and diesel markets.[16] The FTC's consent order

---

[12] *See* Elizabeth Douglass, *Chevron Ends Bid to Buy Stations,* L.A. TIMES, Nov. 18, 2006, *available at* http://www.latimes.com/business/la-fi-chevron18nov18,1,7256145.story?coll=la-headlines-business&ctrack=1&cset=true.

[13] *Aloha Petroleum Ltd.,* FTC File No. 051 0131 (July 27, 2005) (complaint), *at* http://www.ftc.gov/os/caselist/1510131/050728comp1510131.pdf .

[14] FTC Press Release, *FTC Resolves Aloha Petroleum Litigation* (Sept. 6, 2005), *available at* http://www.ftc.gov/opa/2005/09/alohapetrol.htm.

[15] *Valero L.P.*, FTC Docket No. C-4141 (June 14, 2005) (complaint), *at* http://www.ftc.gov/os/caselist/0510022/050615comp0510022.pdf.

[16] *Id.*

requires the parties to divest assets sufficient to maintain premerger competition, including certain Kaneb Philadelphia-area terminals, Kaneb's West pipeline system in Colorado's Front Range, and Kaneb's Martinez and Richmond terminals in Northern California.[17] In addition, the order forbids Valero L.P. from discriminating in favor of or otherwise preferring its Valero Energy affiliate in bulk ethanol terminaling services, and requires Valero to maintain customer confidentiality at the Selby and Stockton terminals in Northern California. The order succeeds in maintaining import possibilities for wholesale customers in Northern California, Denver, and greater Philadelphia and precludes the merging parties from undertaking an anticompetitive price increase.

These are only the most recent actions; the FTC has challenged, or obtained modifications of, numerous other mergers and acquisitions. Indeed, statistics on FTC merger enforcement in the petroleum industry show that, from 1981 to 2007, the agency filed complaints against 21 petroleum mergers. In 13 of these cases, the FTC obtained significant divestitures.[18]

---

[17] *Valero L. P.,* FTC Docket No. C-4141 (July 22, 2005) (consent order), *at* http://www.ftc.gov/os/caselist/0510022/050726do0510022.pdf.

[18] *See, e.g., Chevron Corp.*, FTC Docket No. C-4023 (Jan. 2, 2002) (consent order), *at* http://www.ftc.gov/os/2002/01/chevronorder.pdf; *Valero Energy Corp.,* FTC Docket No. C-4031 (Feb. 19, 2002) (consent order), *at* http://www.ftc.gov/os/2002/02/valerodo.pdf; *Conoco Inc. and Phillips Petroleum Corp.*, FTC Docket No. C-4058 (Aug. 30, 2002) (Analysis of Proposed Consent Order to Aid Public Comment), *at* http://www.ftc.gov/os/2002/08/conocophillipsan.htm. Not all oil industry merger activity raises competitive concerns, however. In 2003, the Commission closed its investigation of Sunoco's acquisition of the Coastal Eagle Point refinery in the Philadelphia area without requiring relief. The Commission noted that the acquisition would have no anticompetitive effects and seemed likely to yield substantial efficiencies that would benefit consumers. *Sunoco Inc./Coastal Eagle Point Oil Co.,* FTC File No. 031 0139 (Dec. 29, 2003) (Statement of the Commission), *at* http://www.ftc.gov/os/caselist/0310139/031229stmt0310139.pdf. The FTC also considered the likely competitive effects of Phillips Petroleum's proposed acquisition of Tosco. After careful scrutiny, the Commission declined to challenge the acquisition. A statement issued in

Of the eight other matters, the parties in four cases abandoned the transactions altogether after agency antitrust challenges; one case resulted in a remedy requiring the acquiring firm to provide the Commission with advance notice of its intent to acquire or merge with another entity; another case (the above-mentioned Aloha/Trustreet matter) was resolved with the announcement of a throughput agreement to preserve competition;[19] yet another case (the Chevron/Unocal matter, discussed below) was resolved with the parties' agreement not to enforce certain patents on CARB gasoline; and a final case (the above-mentioned Carlyle/Riverstone matter) resulted in certain ownership interests being made passive and the prohibition of exchanges of competitively sensitive information.

The Commission's merger investigations also are relevant to the detection of nonmerger antitrust violations. FTC oil and gas merger investigations during the past decade uniformly have been major undertakings that have reviewed the pertinent facets of the relevant markets. These investigations have involved the review of thousands of boxes of documents in discovery, examination of witnesses under oath, and exhaustive questioning of outside experts. All of this provides FTC staff with a greater understanding of the industry, which should assist in detecting and investigating potentially anticompetitive conduct.

B. Nonmerger Investigations into Gasoline Pricing

---

connection with the closing of the investigation set forth the FTC's reasoning in detail. *Phillips Petroleum Corp.*, FTC File No. 011 0095 (Sept. 17, 2001) (Statement of the Commission), *at* http://www.ftc.gov/os/2001/09/phillipstoscostmt.htm.

[19] BUREAU OF ECONOMICS, FEDERAL TRADE COMMISSION, THE PETROLEUM INDUSTRY: MERGERS, STRUCTURAL CHANGE, AND ANTITRUST ENFORCEMENT (2004) [hereinafter PETROLEUM MERGER REPORT], *available at* http://www.ftc.gov/os/2004/08/040813mergersinpetrolberpt.pdf.

In addition to scrutinizing mergers, the Commission aggressively polices anticompetitive conduct. When it appears that higher prices might result from collusive activity or from anticompetitive unilateral activity by a firm with market power (that is, the kinds of activity that can lead to artificially higher prices), the agency investigates to determine whether unfair methods of competition have been used. If the facts warrant, the Commission challenges the anticompetitive behavior, usually by issuing an administrative complaint.

1. *Unocal*

On March 4, 2003, the Commission issued an administrative complaint against Unocal, stating that it had reason to believe that Unocal had violated Section 5 of the FTC Act.[20] The Commission alleged that Unocal deceived the California Air Resources Board ("CARB") in connection with regulatory proceedings to develop the reformulated gasoline ("RFG") standards that CARB adopted. Unocal allegedly misrepresented that certain technology was non-proprietary and in the public domain, while at the same time it pursued patents that would enable it to charge substantial royalties if CARB mandated the use of Unocal's technology in the refining of CARB-compliant summertime RFG. The Commission alleged that, as a result of these activities, Unocal illegally acquired monopoly power in the technology market for producing the new CARB-compliant summertime RFG, thus undermining competition and harming consumers in the downstream product market for CARB-compliant summertime RFG in California. The Commission estimated that Unocal's enforcement of its patents could potentially result in over $500 million of additional consumer costs each year.

---

[20] *Union Oil Co. of California*, FTC Docket No. 9305 (Mar. 4, 2003) (complaint), *at* http://www.ftc.gov/os/2003/03/unocalcmp.htm.

Additional concerns arose when Chevron and Unocal proposed to merge. Although Unocal had no horizontal refining or retailing overlaps with Chevron, it had claimed the right to collect patent royalties from companies that had refining and retailing assets (including Chevron). If Chevron had unconditionally inherited these patents by acquisition, it would have been in a position to obtain sensitive information and to claim royalties from its own horizontal downstream competitors. Chevron, the Commission alleged, could have used this information and this power to facilitate coordinated interaction and detect any deviations.

The Commission resolved both the Chevron/Unocal merger investigation and the monopolization case against Unocal with consent orders requiring Chevron's agreement not to enforce the Unocal patents.[21] The FTC's settlement of these two matters was a substantial victory for California consumers. The Commission's monopolization case against Unocal was complex and, with possible appeals, could have taken years to resolve, with Unocal receiving substantial royalties – and consumers paying higher prices – in the interim. The settlement provided the full relief sought in the monopolization case and also resolved the only competitive issue raised by the merger. With the settlement, consumers benefitted immediately from the elimination of royalty payments on the Unocal patents, and potential merger efficiencies could result in additional savings at the pump.

2. Investigation and Report on Manipulation and Post-Katrina Price Gouging

In May 2006, the Commission completed an extensive, Congressionally-mandated

---

[21] *Chevron Corp.*, FTC Docket No. C-4144 (July 27, 2005) (consent order), *at* http://www.ftc.gov/os/caselist/0510125/050802do0510125.pdf; *Union Oil Co. of California,* FTC Docket No. 9305 (July 27, 2005) (consent order), *at* http://www.ftc.gov/os/adjpro/d9305/050802do.pdf.

investigation[22] to determine whether gasoline prices were being affected by manipulation[23] and to determine whether "price gouging" occurred following Hurricane Katrina.[24] The investigation included the full-time commitment of a significant number of attorneys, economists, financial analysts, and other personnel with specialized expertise in the petroleum industry. Based on our knowledge and expertise from previous investigations and studies, and the concerns raised by knowledgeable observers and market participants about competition in this industry, the Commission and its staff focused substantially on levels of the industry and parts of the country where problematic behavior was most likely to have occurred and to have had an effect on consumers.[25]

---

[22] FEDERAL TRADE COMMISSION, INVESTIGATION OF GASOLINE PRICE MANIPULATION AND POST-KATRINA GASOLINE PRICE INCREASES (Spring 2006), *available at* http://www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf.

[23] "Price manipulation" is not a defined legal or economic term. As used in the Commission's report, the term "price manipulation" included (1) all transactions and practices that are prohibited by the antitrust laws (including the Federal Trade Commission Act) and (2) all other transactions and practices, irrespective of their legality under the antitrust laws, that tend to increase prices relative to costs and to reduce output.

[24] No federal statute identifies a legal violation of "price gouging," and state laws prohibiting price gouging have not adopted a common definition or standard to describe the practice. The statute mandating the post-Katrina pricing investigation effectively defined price gouging, for purposes of the investigation, as an average price of gasoline available for sale to the public following the hurricane that exceeded its average price in the area for the month before the hurricane, unless the increase was substantially attributable to additional costs in connection with the production, transportation, delivery, and sale of gasoline in that area or to national or international market trends. Accordingly, for the report we analyzed whether specific post-Katrina price increases were attributable either to increased costs or to national or international trends.

[25] The FTC undertook another major nonmerger investigation during 1998-2001, examining the major oil refiners' marketing and distribution practices in Arizona, California, Nevada, Oregon, and Washington (the "Western States" investigation). FTC Press Release, *FTC Closes Western States Gasoline Investigation* (May 7, 2001), *available at* http://www.ftc.gov/opa/2001/05/westerngas.htm. The agency initiated the Western States

The Commission's investigation did not uncover any evidence of manipulation to increase prices aside from limited instances of price gouging as defined by the statute mandating the post-Katrina pricing investigation.[26] Evidence indicated that the price of crude oil, the largest cost component of gasoline, contributed to most of the gasoline price increases that occurred from early 2002 until just before Hurricane Katrina struck the United States. Higher refining margins caused some of the remaining increase.[27]

---

investigation out of concern that differences in gasoline prices in Los Angeles, San Francisco, and San Diego might be due partly to anticompetitive activities. The investigation uncovered no basis to allege an antitrust violation, and the Commission closed the investigation in May 2001.

In addition, the Commission conducted a nine-month investigation into the causes of gasoline price spikes in local markets in the Midwest in the spring and early summer of 2000. As explained in a 2001 report, the Commission found that a variety of factors contributed in different degrees to the price spikes. Midwest Gasoline Price Investigation, Final Report of the Federal Trade Commission (Mar. 29, 2001), *available at* http://www.ftc.gov/os/2001/03/mwgasrpt.htm; *see also* Remarks of Jeremy Bulow, Director, Bureau of Economics, Federal Trade Commission, *The Midwest Gasoline Investigation*, *available at* http://www.ftc.gov/speeches/other/midwestgas.htm. Primary factors included refinery production problems (*e.g.*, refinery breakdowns and unexpected difficulties in producing the new summer-grade RFG gasoline required for use in Chicago and Milwaukee), pipeline disruptions, and low inventories. Secondary factors included high crude oil prices that contributed to low inventory levels, the unavailability of substitutes for certain environmentally required gasoline formulations, increased demand for gasoline in the Midwest, and *ad valorem* taxes in certain states. The industry responded quickly to the price spike. Within three or four weeks, an increased supply of product had been delivered to the Midwest areas suffering from the supply disruption. By mid-July 2000, prices had receded to pre-spike or even lower levels.

[26] *But see* Concurring Statement of Commissioner Jon Leibowitz (concluding that the behavior of many market participants leaves much to be desired and that price gouging statutes, which almost invariably require a declared state of emergency or other triggering event, may serve a salutary purpose of discouraging profiteering in the aftermath of a disaster), *available at* http://www.ftc.gov/speeches/leibowitz/060518LeibowitzStatementReGasolineInvestigation.pdf.

[27] Margins in any competitive market can be expected to increase, at least in the short run, during periods of strong demand.

The Commission analyzed various aspects of refinery operations to determine whether refiners manipulated, or tried to manipulate, gasoline prices. Staff investigated whether refiners manipulate prices in the short run by operating their refineries below full productive capacity in order to restrict supply, by altering their product output to produce less gasoline, or by diverting gasoline from markets in the United States to less lucrative foreign markets. Staff also investigated allegations that companies refused to invest sufficiently in new refineries for the purpose of tightening supply and raising prices in the long run. Staff found no evidence to suggest that refiners manipulated prices through any of these means. Instead, the evidence indicated that refiners responded to market prices by trying to produce as much higher-valued products as possible, taking into account crude oil costs and physical characteristics. The evidence also indicated that refiners did not reject profitable capacity expansion opportunities in order to raise prices.

The Commission also examined the extent to which infrastructure constraints gave pipelines the ability or incentive to manipulate gasoline prices, or limited the ability of marketers to move additional supply to specific markets when an unexpected need arose. The evidence we obtained during our investigation did not suggest that pipeline companies made rate or expansion decisions to manipulate gasoline prices. Similarly, we found no evidence suggesting anticompetitive activity involving refined product terminals.

Inventory levels have declined since at least the early 1980s, covering periods when the real price of gasoline was declining and increasing. Our investigation did not produce evidence, however, that oil companies reduced inventory in order to manipulate prices or exacerbate the effects of price spikes due to supply disruptions. Maintaining inventories is costly, both in terms

of the value of assets held and in terms of the actual costs of storing the product. The decline in inventory levels reflects a trend that is not limited to the petroleum industry. As in many other major industries, lower inventory holdings likely allowed oil companies to free up capital to invest in other areas and save storage costs. Low inventories, however, provide little cushion for gasoline supplies when there is an unexpected disruption.

Hurricanes Katrina and Rita caused substantial damage to the nation's petroleum infrastructure. In the week after Hurricane Katrina – which caused the immediate loss of 27 percent of the nation's crude oil production and 13 percent of national refining capacity – the average price of gasoline increased by about 50 cents per gallon in six representative cities. About 35 cents per gallon of the post-Katrina price increase dissipated by the time Hurricane Rita hit. Rita damaged another 8 percent of crude production and, even accounting for the refineries affected by Katrina and back online, 14 percent of domestic refining capacity was lost.

In light of the amount of crude oil production and refining capacity knocked out by Katrina and Rita, the sizes of the post-hurricane price increases were approximately what would be predicted by the standard supply and demand paradigm that presumes a market is performing competitively. Thus the regions of the country that experienced the largest price increases were those that normally receive supply from areas affected by the hurricanes.

Evidence gathered during our investigation indicated that the conduct of firms in response to the supply shocks caused by the hurricanes was consistent with competition. After both hurricanes, companies with unaffected assets increased output and diverted supplies to high-priced areas. This is what we would expect in competitive markets and what the affected consumers needed. Refiners deferred scheduled maintenance in order to keep refineries

operating. Imports increased and companies drew down existing inventories to help meet the shortfall in supply.

The Commission's assessment of potential price gouging as defined in the relevant legislation revealed that the average gasoline price charged by eight of 30 refiners analyzed increased five or more cents per gallon more than the national average price trend for this period. Once geographic locations of sales and channels of distribution were taken into account, however, individual refiners' price increases appeared comparable to local market trends in almost every instance.[28]

Based on an analysis of retail pricing data and retailer interviews, the Commission concluded that some "price gouging" by individual retailers, as defined by the relevant statute, did occur to a limited extent. Local or regional market trends, however, explained the price increases in all but one case. Exceptionally high prices on the part of individual retailers generally were very short-lived. Interviews with retailers that charged exceptionally high prices indicated that at least some were responding to station-level supply shortages and to imprecise and changing perceptions of market conditions.

The Commission's spring 2006 report to Congress, as well as testimony delivered to the full Senate Commerce Committee the day after we released the report, addressed a number of important policy issues arising from the investigation, including the important role of prices in a market-based economy and the misallocation of resources that can stem from attempts to cap or control prices. Underscoring the crucial role of the antitrust laws in ensuring that consumers are

---

[28] *But see* Concurring Statement of Commissioner Jon Leibowitz at 1-2, *available at* http://www.ftc.gov/speeches/leibowitz/060518LeibowitzStatementReGasolineInvestigation.pdf.

offered competitive market prices for gasoline, the report and testimony pointed out the problems that price gouging legislation can engender, including interference with the market's pricing mechanism that is likely to lead to even worse shortages and more harm to consumers. The Commission advised Congress that if it enacts a price gouging statute despite these considerations, it will be important to make the law as clear to businesses and easy to enforce as possible. In addition, the Commission urged Congress to include important mitigating factors in any price gouging statute, including allowance for market factors of supply and demand and the maintenance of incentives for firms to increase supply into a disaster-affected area.

C. Price Monitoring Project

In a program unique to the petroleum industry, the Commission actively and continuously monitors retail and wholesale prices of gasoline and diesel fuel.[29] FTC staff monitors gasoline and diesel prices to identify "unusual" price movements[30] and then examines whether any such movements might result from anticompetitive conduct that violates Section 5 of the FTC Act. FTC economists developed a statistical model for identifying such movements. The agency's economists regularly scrutinize price movements in 20 wholesale regions and approximately 360 retail areas across the country. In no other industry does the Commission so closely monitor prices.

The staff reviews daily data from the Oil Price Information Service, a private data

---

[29] *See* FTC, *Oil and Gas Industry Initiatives*, *at* http://www.ftc.gov/ftc/oilgas/index.html.

[30] An "unusual" price movement in a given area is a price that is significantly out of line with the historical relationship between the price of gasoline in that area and the gasoline prices prevailing in other areas.

collection agency, and receives information weekly from the public gasoline price hotline maintained by the U.S. Department of Energy ("DOE"). The staff monitoring team uses an econometric model to determine whether current retail and wholesale prices are anomalous in comparison to the historical price relationships among cities. When there are unusual changes in gasoline or diesel prices, the project alerts the staff to those anomalies so that we can make further inquiries into the situation.

This gasoline and diesel monitoring and investigation initiative, which focuses on the timely identification of unusual movements in prices (compared to historical trends), is one of the tools that the FTC uses to determine whether a law enforcement investigation is warranted. If the FTC staff detects unusual price movements in an area, it researches the possible causes, including, where appropriate, through consultation with the state attorneys general, state energy agencies, and the EIA. In addition to monitoring DOE's gasoline price hotline complaints and the OPIS data, this project includes scrutiny of gasoline price complaints received by the Commission's Consumer Response Center and of any similar information provided to the FTC by state and local officials. If the staff concludes that an unusual price movement likely results from a business-related cause (*i.e.*, a cause unrelated to anticompetitive conduct), it continues to monitor but – absent indications of potentially anticompetitive conduct – it does not investigate further.[31] The Commission's experience from its past investigations and from the current monitoring program indicates that unusual movements in gasoline prices typically have a business-related cause. FTC staff further investigates unusual price movements that do not

---

[31] Business-related causes include movements in crude oil prices, supply outages (*e.g.*, from refinery fires or pipeline disruptions), or changes in and/or transitions to new fuel requirements imposed by air quality standards.

appear to be explained by business-related causes to determine whether anticompetitive conduct may underlie the pricing anomaly.[32] Cooperation with state law enforcement officials is an important element of such investigations.

III. Additional Efforts to Examine Markets and Promote Competition

A. 2007 Energy Conference

In addition to its law enforcement investigations and its price monitoring project, the Commission spends significant resources examining and analyzing issues of importance to consumers in the petroleum industry. An important recent development in this regard was the public conference on "Energy Markets in the 21st Century: Competition Policy in Perspective" that the FTC hosted for three days last month. The conference brought together leading experts from the government, industries in the energy sector, consumer groups, and academia to exchange information and ideas about critical issues related to energy development, transportation, marketing, and use. Speakers at the conference addressed such topics as "Savvy Consumers in the Energy Marketplace," "New Frontiers of Energy," "The Current Implications of the World Energy Situation for United States Energy Supplies," and "How Do Energy Markets Work Within the Framework of Government Policy Choices?" The conference website contains numerous presentations by the panelists and a number of informative background papers.[33] The Commission expects to release a written report presenting findings from the conference.

---

[32] For example, following up on observations of anomalous pricing patterns affecting multiple cities over the past year, staff currently is examining bulk supply and demand conditions and practices for gasoline and diesel in the Pacific Northwest.

[33] *See* http://www.ftc.gov/bcp/workshops/energymarkets/index.shtml.

B. Ethanol Report

Last December, the Commission issued its second annual report on the current state of the United States ethanol industry, including measurements of market concentration using capacity and production data.[34] The study concluded that U.S. ethanol production currently is not highly concentrated, and that market concentration had decreased by between 21 and 35 percent since the date of the first ethanol report. The study also examined the possible effect on concentration of agreements between ethanol producers and third-party marketers. By attributing the producers' market shares to marketers when producers make such agreements, FTC staff derived alternative estimates of market concentration. The study concluded that the level of concentration in ethanol production would not justify a presumption that a single firm, or a small group of firms, could wield sufficient market power to set or coordinate price or output levels. The report noted, however, that the staff does rule out the possibility that future mergers within the industry may raise competitive concerns.

C. FTC/NAAG Workshop on Petroleum Issues

On September 21, 2006, the FTC joined with the National Association of Attorneys General to sponsor a workshop on key issues in the petroleum industry. With a substantial number of FTC staff and more than 50 representatives of state attorney general offices in attendance, the day-long program focused on such issues as mergers, consolidation, and other structural trends in the petroleum sector; petroleum product pricing and distribution practices in the aftermath of natural disasters and other severe supply interruptions; and law enforcement

---

[34] Federal Trade Commission, 2006 REPORT ON ETHANOL MARKET CONCENTRATION (Dec. 1, 2006), *available at* http://www.ftc.gov/reports/ethanol/Ethanol_Report_2006.pdf.

issues of mutual interest to the Commission and state attorneys general. The workshop, which built upon a long history of cooperation between the FTC and state officials in conducting petroleum industry investigations, afforded participants an excellent opportunity to share information and perspectives about the most fruitful ways to conduct law enforcement proceedings and studies in this sector of the economy.

D. Gasoline Price Changes Report

In July 2005, the Commission published its study explaining the competitive dynamics of gasoline pricing and price changes.[35] This study grew out of conferences of industry, consumer, academic, and government participants held by the Commission over the preceding four years, as well as years of research and experience, and sheds important light on how gasoline prices are set. As described in the Commission's report, in general, the price of gasoline reflects producers' costs and consumers' willingness to pay. Gasoline prices rise if it costs more to produce and supply gasoline, or if people wish to buy more gasoline at the current price – that is, when demand is greater than supply. Gasoline prices fall if it costs less to produce and supply gasoline, or if people wish to buy less gasoline at the current price – that is, when supply is greater than demand. Gasoline prices will stop rising or falling when they reach the level at which the quantity consumers demand matches the quantity that producers will supply.

How consumers respond to price changes will affect how high prices rise and how low they fall. Limited substitutes for gasoline restrict the options available to consumers to respond to price increases in the short run. Because gasoline consumers typically do not reduce their

---

[35] FEDERAL TRADE COMMISSION, GASOLINE PRICE CHANGES: THE DYNAMIC OF SUPPLY, DEMAND, AND COMPETITION (2005), *available at* http://www.ftc.gov/reports/gasprices05/050705gaspricesrpt.pdf.

purchases substantially in response to price increases, they are vulnerable to substantial price increases.

Furthermore, producers' responses to price changes will affect how high prices rise and how low they fall. In general, when there is not enough gasoline to meet consumers' demands at current prices, higher prices will signal a potential profit opportunity and may bring additional supply into the market. Additional supply will be available to the extent that an increase in price exceeds the producers' cost of expanding output.

E. Petroleum Merger Report

In 2004, the FTC staff published a study reviewing mergers and structural changes in the petroleum industry, as well as the antitrust enforcement actions that the agency had taken over the past 20 years with respect to petroleum industry mergers.[36] This study, the third in a series of reports dating back to 1982 (and covering mergers since 1971), found that mergers of private oil companies have not significantly affected worldwide concentration in crude oil, and that concentration for most levels of the petroleum industry has remained low to moderate. In addition, FTC merger investigations and enforcement have helped prevent further increases in petroleum industry concentration.

IV. Conclusion

High gasoline prices are a drain on consumers' budgets, particularly low-income working Americans who need cars and trucks to travel to and from their jobs. Policymakers are right to be concerned about this issue, and enforcers should – and do – vigorously pursue any evidence of market manipulation or otherwise anticompetitive conduct leading to those higher prices.

---

[36] PETROLEUM MERGER REPORT, *supra* note 19.

Where genuinely anticompetitive conduct is found, the Federal Trade Commission aggressively enforces the antitrust laws in the petroleum industry. The Commission has taken action whenever a merger or particular conduct has violated the law and threatened the welfare of consumers or competition in the industry. The Commission continues to search for appropriate targets of antitrust law enforcement, to monitor retail and wholesale gasoline and diesel prices closely, and to study this industry in detail.

Thank you for this opportunity to present the FTC's views on this important topic. I look forward to answering your questions.

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

Office of the Commissioner

July 31, 2007

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
United States House of Representatives
Washington, D.C. 20515

Dear Chairman Dingell:

I am pleased to respond to the questions from Representative Gene Green which you sent to me on July 16 regarding my testimony at the May 22, 2007, hearing of the Subcommittee on Oversight and Investigations on "Gasoline Prices, Oil Company Profits, and the American Consumer."[1]

Question 1: Commissioner Kovacic, in your testimony you state that the Commission has "brought more merger cases at lower levels of concentration in the petroleum industry than in any other industry." Given this statistic, do you feel FTC is particularly vigilant to oil industry mergers?

Answer 1: Yes. I think that the Commission has been particularly vigilant in applying Section 7 of the Clayton Act and Section 5 of the FTC Act to oil industry mergers. The Commission released data earlier this year regarding FTC merger enforcement overall and in certain industries, including the petroleum industry.[2] Among other things, these statistics show that for mergers in which the post-transaction Herfindahl-Hirschman Index[3] would be under 1,800 (that

---

[1]As with my responses to the Subcommittee's questions at the hearing, these answers present my personal views and do not necessarily represent the views of the Federal Trade Commission or of any other Commissioner.

[2]Federal Trade Commission Horizontal Merger Investigation Data, Fiscal Years 1996-2005 (Jan. 25, 2007), Table 3.1, et seq., *available at* http://www.ftc.gov/os/2007/01/P035603horizmergerinvestigationdata1996-2005.pdf.

[3]The Horizontal Merger Guidelines used by the Commission and the Department of Justice categorize market concentration into three zones as measured by the HHI, which is a statistical measure of concentration in a relevant market. An HHI below 1,000 is characterized as "unconcentrated" – a circumstance in which an agency would be unlikely to challenge a

is, moderately concentrated), the Commission brought enforcement actions in 24 out of 39 petroleum industry mergers, as opposed to only 56 actions out of 127 total mergers in all industries.

The FTC does not apply different merger standards to different industries. We apply the same standards across the board. We do, however, give particular scrutiny to the petroleum industry because of its paramount importance to the American economy and consumers. The Commission has developed deep and broad expertise in this industry over the years. On a weekly basis, Commission staff monitors prices in this industry looking for evidence of anticompetitive behavior. The Commission has investigated every major petroleum merger in the last twenty-five years, and we use our expertise to challenge and remedy those transactions that present the risk of post-merger anticompetitive behavior. Our unparalleled resource commitment to protecting competition and consumers in this industry results in an active and successful merger program.

Question 2: Another witness today has submitted in their testimony that FTC is "not adequately protecting consumers . . . by allowing too many mergers and taking a stance too permissive to anti-competitive practices." How do you respond to this accusation?

Answer 2: I do not agree that our enforcement program in the petroleum industry is too permissive on any level. As noted in the answer to Question 1, the Commission has taken enforcement actions at lower levels of concentration in the petroleum industry than it has across industries generally. In each enforcement instance, the remedy obtained by the Commission has been sufficient to restore fully the level of competition that existed before the merger occurred. The divestiture ordered in the Exxon/Mobil case, for example, was among the largest divestitures in the history of antitrust enforcement. The divestiture order required, among other things, Exxon/Mobil to sell or assign over 2,400 retail stations and divest an important refinery in California, terminal operations on the East Coast, and a pipeline running from the Gulf Coast to the East Coast.[4] It is Commission policy to insist on a complete remedy in every relevant market in which anticompetitive effects are likely to occur.

---

merger. An HHI between 1,000 and 1,800 is considered "moderately concentrated," where a merger resulting in an increase of 100 potentially raises significant antitrust concerns. An HHI over 1,800 reflects a "highly concentrated" market, where a merger resulting in an increase of 50 potentially raises significant concerns, and an increase of 100 creates a rebuttable presumption that the merger creates, enhances, or facilitates the exercise of market power. U.S. Dep't of Justice and Fed. Trade Comm'n, *1992 Horizontal Merger Guidelines* (Section 4 on Efficiencies revised April 8, 1997), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,104.

[4]*Exxon Corp.*, C-3907 (Jan. 26, 2001) (consent order), *available at* http://www.ftc.gov/os/2001/01/exxondo.pdf.

The Commission has a similarly robust enforcement program with respect to conduct in the petroleum industry. In 2005, the Commission entered into a successful settlement of its monopolization case against Unocal; the FTC's consent order is estimated to save California consumers over $500 million per year in the cost for CARB gasoline.[5] Moreover, in the last 10 years, Commission staff has conducted important and extensive investigations of gasoline prices and industry practices on the West Coast,[6] in markets in the Midwest,[7] and in markets affected by infrastructure damage as a result of Hurricanes Katrina and Rita.[8] During these investigations the Commission did not find credible evidence of unilateral or collusive anticompetitive conduct. It is important to note here that the antitrust laws are not violated simply because prices rise, even if they rise a substantial amount in a short period of time. There are many legitimate reasons why prices rise, including strong and increasing consumer demand and infrastructure problems that reduce supply. The antitrust laws proscribe only those price increases that result from anticompetitive conduct, such as horizontal price-fixing and exclusionary abuse of market power.

Question 3: To the best of your memory, how many investigations or studies has FTC conducted regarding allegations of potential price gouging or price manipulation? Have any of these studies determined any evidence of manipulation?

Answer 3: There is no federal "price gouging" statute. Thus, the Commission's investigation of price gouging itself consisted of one investigation undertaken pursuant to a Congressional directive. The Commission issued a report in May 2006 on its investigation of gasoline price manipulation and the pricing of gasoline following Hurricane Katrina. The investigation found no evidence that petroleum companies were acting to manipulate supply in order to raise gasoline prices. As for post-Katrina pricing, the Commission identified 15 firms that met the technical definition of "price gouging" established in the Congressional legislation that mandated the

---

[5] *Union Oil Co. of California*, FTC Docket No. 9305 (Mar. 4, 2003) (complaint), *available at* http://www.ftc.gov/os/2003/03/unocalcmp.htm; *Union Oil Co. of California*, FTC Docket No. 9305 (Aug. 2, 2005) (decision and order), *available at* http://www.ftc.gov/os/adjpro/d9305/050802do.pdf; *Chevron Corp. & Union Oil Co. of California*, FTC Docket No. C-4144 (Aug. 2, 2005) (decision and order), *available at* http://www.ftc.gov/os/caselist/0510125/050802do0510125.pdf.

[6] FTC Press Release, *FTC Closes Western States Gasoline Investigation* (May 7, 2001), *available at* http://www.ftc.gov/opa/2001/05/westerngas.htm.

[7] Midwest Gasoline Price Investigation, Final Report of the Federal Trade Commission (Mar. 29, 2001), *available at* http://www.ftc.gov/os/2001/03/mwgasrpt.htm.

[8] FEDERAL TRADE COMMISSION, INVESTIGATION OF GASOLINE PRICE MANIPULATION AND POST-KATRINA GASOLINE PRICE INCREASES (Spring 2006), *available at* http://www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf.

investigation, but reported that regional and local market conditions explained the price increases in virtually all such instances.

As noted above, in connection with its responsibility to enforce the antitrust laws, the Commission has undertaken numerous investigations of the petroleum industry, both merger and nonmerger. Since 1973, the FTC has conducted more than 190 petroleum industry investigations, most of them involving mergers. These investigations have resulted in at least 44 enforcement actions, including final orders, complaints issued or filed in court, and matters in which a transaction was abandoned after initiation of a Commission investigation. Moreover, as my testimony indicated, the FTC continuously monitors gasoline and diesel prices across the country to identify unusual price movements that might result from anticompetitive conduct.

The Commission's nonmerger antitrust investigations have included examining allegations of monopolization, horizontal price fixing, vertical price fixing, and predatory pricing. The agency has reviewed practices and allegations directly focusing on gasoline pricing in a number of specific instances and has conducted analyses of whether anticompetitive behavior might explain gasoline price irregularities. The FTC vigorously investigated West Coast gasoline price practices in the early 1980s, gasoline prices in the spring of 1989, certain West Coast gasoline pricing practices from the late 1990s to 2001, and Midwest gasoline prices in 2000. These investigations did not unearth instances of market manipulation. Inquiries into more recent instances of gasoline price increases are ongoing.

Question 4: **FTC Chairman, Deborah Platt Majoras, testified to Congress last year on FTC's investigation of Post-Katrina Gasoline Price Increases. She commented on proposed Federal price gouging legislation and stated that several factors should be considered to enact a price gouging statute to have the smallest adverse impact on rational price incentives. These factors include the need for the legislation to clearly define the price gouging statute, account for increased business costs, provide for consideration of local, national, and international market conditions, and account for a market-clearing price.**

- **Can you elaborate on why FTC considers these provisions so critical to any proposed price-gouging bill? What are the implications if these provisions are omitted from any legislation Congress may enact?**

Answer 4: As I noted above, there has never been a federal statute prohibiting "price gouging." There is a reason for that. Federal antitrust law is designed to prevent the abuse of private market power that may empower sellers to charge prices other than those that they would charge in a competitive market. This is based on the assumption that competition, and market prices, provide the greatest quantity and quality of goods and services for consumers. Thus, even though market prices sometimes may be higher than consumers would like, we should hesitate to make it a violation of law for sellers to charge a price that is the result of the interplay of competitive

market conditions – even if that price is higher than we would like.

During times of unusual product shortage, such as occurred in many parts of the country after the hurricanes, market prices will naturally rise as demand temporarily outstrips supply. These rising prices help clear the market – that is, equalize supply and demand – without the need to resort to long lines or other inefficient methods of product allocation. They do this by providing the incentive for suppliers to take the financial risk to bring extra product into the market – as the petroleum companies did by shipping additional supplies of gasoline from Europe (and other foreign locations) into the United States after the hurricanes – and by providing the incentive for consumers to consume less gasoline by forgoing or postponing unnecessary automobile trips while product is short – which they did after the hurricanes in response to higher prices.

Thus, if price gouging legislation is to be enacted, Congress should take care not to destroy the incentives inherent in the natural price flexibility of the American economy that ameliorate price spikes during disaster periods by dampening demand and increasing supply. By taking account of the factors enumerated in Chairman Majoras's May 2006 testimony, Congress would acknowledge that not all price increases in the face of temporary product shortages should be deemed to constitute gouging. Even some advocates of price gouging legislation have recognized that a wholesaler or retailer needs to recover its increased costs and must be able to respond to unusual market conditions. Any legislation should account for these factors.

Another issue raised by price gouging legislation is how to define the offense. The offense must be defined so that wholesalers and retailers can comply with the statute. I strongly believe that Congress has the duty to define the conduct that it would prohibit – especially when criminal penalties may be involved. Because price flexibility is crucial for the efficient functioning of the economy (perhaps even more so during disaster periods), defining the offense of price gouging has proved particularly challenging. The definitions contained in the numerous state price gouging statutes and in various forms of proposed federal legislation have varied widely and would capture or leave out vastly different kinds and amounts of business conduct. It is a policy decision for Congress to decide where to draw the line between legal and illegal conduct, particularly criminal conduct, in an area where the distinction is difficult to discern and where it is important not to discourage conduct that ultimately is benign or procompetitive.

I think there would be serious implications if Congressional price gouging legislation failed to take account of the factors addressing costs and market conditions. Such legislation would severely restrict price flexibility in times of market disruption caused by natural disaster. The result might be that the period of supply/demand imbalance would extend beyond what it would have been if businesses were able to price according to market conditions. Although it is impossible to predict exactly how affected businesses may react, a possible consequence of a bill that does not account for increased costs or market conditions is that small businesses lacking sophisticated legal counsel – particularly gasoline retailers – may temporarily shut down rather than risk violating the price gouging statute, especially if the offense is punishable as a serious crime and offenders are subject to imprisonment and large fines. That result would benefit no one.

Question 5: As you know, GAO commissioned a report which analyzed the effects of petroleum industry mergers from 1997-2000, which alleged that in six of the eight transactions examined, mergers caused gasoline prices to increase. Did FTC agree with these findings, and if not, what problems did FTC have with the study?

Answer 5: In May 2004, the Government Accountability Office released a report that purported to analyze how eight petroleum industry mergers or joint ventures carried out during the late 1990s affected gasoline prices.[9] The Commission regards evaluations of past enforcement decisions as valuable elements of responsible antitrust policymaking,[10] and it supports the goal of the GAO inquiry – to evaluate the consequences of past decisions by the federal antitrust agencies. Accordingly, our own staff has conducted retrospective analyses of past merger decisions.[11]

Nevertheless, I believe the GAO report suffered from a number of significant technical deficiencies that cause us to question its findings. Although I will not recount here all of the problems that FTC staff identified in the GAO report, I will describe three significant deficiencies. First, the GAO's econometric models did not properly control for the numerous factors that cause gasoline prices to increase or decrease. These omissions undermine the GAO report's estimates of the effects of concentration and mergers on wholesale gasoline prices. Second, the GAO report did not measure concentration in any properly defined geographic market. Instead, GAO used markets defined to be coextensive with Petroleum Administration for Defense Districts ("PADDs") – a concept that Commission economists have found not to contribute usefully to the sound analysis of a petroleum merger's competitive effects.[12] Third, by

---

[9]GAO, *Energy Markets: Effects of Mergers and Market Concentration in the U.S. Petroleum Industry* (May 2004).

[10]For my own views on this subject, *see* William E. Kovacic, *Using Ex Post Evaluation to Improve the Performance of Competition Policy Authorities*, 31 J. CORP. L. 503 (2006).

[11]*See, e.g.,* John Simpson and Christopher T. Taylor, *Michigan Gasoline Pricing and the Marathon – Ashland and Ultramar Diamond Shamrock Transaction* (Bureau of Economics Working Paper 278) (July 2005) (forthcoming as *Do Gasoline Mergers Affect Consumers' Prices,?* J. LAW & ECON.); Christopher T. Taylor and Daniel S. Hosken, *The Economic Effects of the Marathon – Ashland Joint Venture: The Importance of Industry Supply Shocks and Vertical Market Structure* (Bureau of Economics Working Paper 270), published in 25 J. OF INDUS. ECON. 421 (Sept. 2007 No. 3).

[12]The correct definition of a market in merger review is a detailed, fact-intensive inquiry that involves both product and geographic components. We must ascertain for which product (or products) the transaction may harm competition, and we also must determine the geographic area over which any anticompetitive effects will be felt. In our analysis of petroleum mergers,

focusing exclusively on *wholesale* prices, the GAO report failed to address the effects of concentration and mergers on *retail* gasoline prices. FTC staff's research indicates that wholesale price effects are not necessarily indicative of retail price effects – the effects that concern consumers buying gasoline at the pump. These mistakes and omissions significantly undermine the results of the GAO study.

For a more complete discussion of these and other issues with the GAO report, please see the Commission's technical staff report, *available at* http://www.ftc.gov/ftc/workshops/oilmergers/ftcstafftechnicalreport122104.pdf. In that report, our staff replicated the results in the GAO report and then showed that those results are not robust to alternative specifications. The FTC also hosted a conference, "Estimating the Price Effects of Mergers and Concentration in the Petroleum Industry: An Evaluation of Recent Learning," on January 14, 2005, where a panel of eminent independent economists discussed the GAO report as well as FTC work on merger retrospectives. Information on that conference, including the transcript, is available at http://www.ftc.gov/ftc/workshops/oilmergers/index.shtm.

Mr. Chairman, thank you for the opportunity to participate in the hearing on May 22, 2007, and to respond to Representative Green's questions.

Sincerely,

William E. Kovacic
Commissioner

---

national, state, or PADD-wide "markets" rarely correspond to properly defined geographic markets. (PADD I consists of the East Coast. PADD II consists of the Midwest. PADD III includes the Gulf Coast. PADD IV consists of the Rocky Mountain region. PADD V is made up of the West Coast plus Alaska and Hawaii.)

Mr. STUPAK. Thank you, Commissioner.

Mr. Caruso, please, for an opening statement, sir? Five minutes. If you want to submit a longer statement, it will be for the record.

TESTIMONY OF GUY CARUSO, ADMINISTRATOR, ENERGY INFORMATION ADMINISTRATION

Mr. CARUSO. Thank you, Mr. Chairman. I appreciate the opportunity to represent the Energy Information Administration today.

EIA is an independent statistical and analytical agency within the Department of Energy.

Because we have an element of statutory independence with respect to our activities, our views are strictly those of EIA and should not be construed as representing those of the Department of Energy or the administration.

And today, I will focus on EIA's most recent short-term outlook for crude oil and gasoline markets and discuss the factors contributing to high prices and continued uncertainty in these markets.

Global oil markets have tightened for crude oil and light petroleum products, especially gasoline, with commercial inventories dropping sharply since the end of September, reflecting strong demand in the U.S. and globally, production cuts by the Organization of Petroleum Exporting Countries, OPEC, and only moderate increases in non-OPEC production.

Increasing global demand for light products has put pressure on refining capacity worldwide, and we project crude oil prices to average in the mid $60 per barrel this summer.

Retail prices for regular gasoline have increased from $2.17 per gallon at the end of January to $3.22 per gallon as of yesterday. This compares with a $2.84-per-gallon average last summer.

Against the background of already tight world oil markets, global geopolitical uncertainties continue to affect global oil supply and transportation.

Geopolitical uncertainty in a number of countries in the Middle East and Africa will continue to keep markets on edge.

For example, Nigeria's problems have aggravated the gasoline situation both internally and globally because this country produces largely light and sweet crude oil, which is used by the world's refineries to maximize production of gasoline.

Turning to gasoline markets, we expect gasoline markets will likely remain fairly tight, although we do anticipate some improvements over the next several months.

Gasoline inventories, which typically build slightly in April, sharply declined last month because of refinery outages, both planned and unplanned, and lower than normal imports.

Gasoline supply has been affected more than usual by refinery outages this spring, as U.S. refineries typically have higher outages during the first quarter as they reduce production of gasoline and other products to prepare for the maximum production season of the spring and summer.

This year, outages have extended into May and, along with lower imports and seasonally rising gasoline demand, contributed to a steep inventory decline and upward price pressures in April and May.

Refinery throughputs have just begun to show the seasonal increase typical at this time, and are expected to increase over the next several months, which should ease pressure on gasoline prices.

Gasoline imports, critical to meeting U.S. summer consumption needs, are lagging last year's levels and thus have been affecting prices.

Low gasoline inventories in Europe have resulted in limited volumes available for export to the United States thus far in 2007.

Total U.S. gasoline imports have recently returned to about 1.2 million barrels per day, and imports at or above that level are likely to be needed to avoid persistent upward pressure on gasoline prices.

In conclusion, Mr. Chairman, the combination of tight crude oil and refined product markets, along with ongoing geopolitical concerns, leave crude oil and gasoline markets poised for continued volatility this summer.

If gasoline production increases during the rest of May and imports increase, gasoline markets may ease somewhat, causing prices to recede from their current high levels.

However, with the hurricane season approaching and continued tight refinery conditions, low gasoline inventories and increased demand for summer travel, upward pressure for gasoline prices remains a concern.

In sum, Mr. Chairman, most of the risks point to upward pressure on prices because of limited refinery capacity, low inventories and relatively low imports.

With that, Mr. Chairman, that concludes my oral remarks. I would be happy to answer questions at the appropriate time.

[The prepared testimony of Mr. Caruso follows:]

STATEMENT OF GUY CARUSO

ADMINISTRATOR

ENERGY INFORMATION ADMINISTRATION

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

COMMITTEE ON ENERGY AND COMMERCE

U. S. HOUSE OF REPRESENTATIVES

MAY 22, 2007

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to appear before you today. The Energy Information Administration (EIA) is the independent statistical and analytical agency within the Department of Energy. We are charged with providing objective, timely and relevant data, analyses, and projections for the Congress, the Administration, and the public. While we do not take positions on policy issues, our work can assist energy policymakers in their deliberations. Because we have an element of statutory independence with respect to our activities, our views are strictly those of EIA and should not be construed as representing those of the Department of Energy or the Administration. Today, I will focus on EIA's recent short-term projections for petroleum and gasoline prices and discuss the factors contributing to high prices and continued uncertainty in these markets.

Global oil markets have tightened sharply since the beginning of the year, both for crude oil and light petroleum products, especially gasoline and distillate fuel. Commercial oil inventories have dropped considerably since the end of September, reflecting strong oil demand, production cuts by Organization of Petroleum Exporting Countries (OPEC) members, and only modest increases in non-OPEC production. Increasing global demand for light products has put significant pressure on refining capacity in the United States and elsewhere. Given these conditions of increasing demand without commensurate increases in supply, prices have been increasing and will remain highly sensitive to actual or anticipated risks, such as geopolitical events, whose probabilities are often very difficult to quantify.

EIA released its *Short-Term Energy Outlook* on May 8 and we project average West Texas Intermediate (WTI) crude oil prices of about $66 per barrel this summer compared with over

$70 per barrel last summer. We are also projecting that WTI prices will average about $64 per barrel annually in both 2007 and 2008. In recent months, however, movements in benchmark WTI prices have not provided an accurate gauge of overall oil market developments. An alternative price—Brent crude oil—increased from $50 per barrel in mid-January to $69 per barrel by early April. As of early May, the Brent crude had dropped back into the mid-$60s.

Retail, regular grade, gasoline prices have increased from $2.17 per gallon at the end of January to $3.10 per gallon on May 14, compared with the $2.84 per-gallon-average of last summer. U.S. regular motor gasoline prices are projected to average $2.95 per gallon this summer, with a peak monthly average of $3.01 in May and again in August. However, prices vary significantly by region: for example, EIA's data for May 14 show an average price of $2.92 per gallon in the Gulf Coast region and $3.38 in the West Coast region. California, in particular, has customarily experienced the highest prices in the United States due to several factors, including stricter environmental standards, which mandate a more expensive form of gasoline, and the relative isolation of West Coast markets from other supply sources. On the other hand, States in the Gulf Coast region are reporting among the lowest prices in the country due to their proximity to oil fields and refineries.

Recent gasoline price developments reflect both changes in oil markets and factors specific to gasoline markets, as outlined in the following two sections of my testimony.

Oil Markets

World oil markets are projected to remain tight, sustaining high crude prices this summer as well as for the next several years due to continued growth in oil demand, little growth in non-OPEC supply, and continued production restraint by OPEC members. OPEC's production cuts, in combination with a growing demand for oil that is exceeding the growth in non-OPEC supplies, have reduced Organization for Economic Cooperation and Development (OECD) commercial oil inventories from their historically high levels to levels in the middle of the normal range. EIA estimates that OECD inventories declined by 1.1 million barrels per day in the first quarter of 2007 (compared with an average inventory draw over the past 5 years of 0.3 million barrels per day for that quarter). Forward cover (the number of days that inventory can cover projected consumption) is expected to decrease to the low end of the normal range by the end of 2007 **(Figure 1).**

Despite the recent increases in world oil prices, global oil consumption is projected to grow by 1.4 million barrels per day in 2007 and by 1.6 million barrels per day in 2008. About one-half of the projected growth is in China and the United States. Preliminary first-quarter 2007 data indicate that U.S. consumption rose by over 500,000 barrels per day, of which 160,000 barrels per day was gasoline, and Chinese consumption rose by about 400,000 barrels per day, relative to first-quarter 2006 levels. Colder weather relative to last year and robust personal disposable income growth were both major contributors to higher U.S. demand. Double-digit economic growth continues to drive Chinese oil demand growth.

Non-OPEC production increases are projected at roughly half of the global demand growth, with production (excluding Angola) rising by roughly 0.8 million barrels per day in both

2007 and 2008. Output growth from non-OPEC countries reflects strong gains from new projects in the Caspian Sea, Sakhalin Island in far-eastern Russia, Africa, Brazil, and the United States (**Figure 2**). However, declining production from mature basins in the North Sea, the Middle East, Mexico, and Russia will offset the growth potential from these new projects. If these projections for demand and non-OPEC production materialize, demand for OPEC oil will rise accordingly.

From the third quarter of 2006 to the first quarter of 2007, OPEC members cut crude oil production by 1.1 million barrels per day to reduce the buildup in global oil stocks. In the coming months, OPEC members will need to consider accommodating rising demand for their oil, especially the demand for seasonal stock building, to maintain inventories in the middle of the 5-year average range. Our estimates for OPEC crude oil production (including Angola) suggest an increase of 1.6 million barrels per day by the fourth quarter of 2007 (compared with first-quarter 2007 levels) would be required to hold inventories to such levels. The largest increase could occur in Saudi Arabia, which is expected to increase total production by almost 250,000 barrels per day. If the majority of the current shut-in capacity in Nigeria of up to 800,000 barrels per day is brought back online, Nigeria could be producing as much as 2.7 million barrels per day by December 2007. However, ongoing unrest in the Niger delta will continue to hinder the return of that production capacity.

Even though new crude oil production capacity increases are projected during the next 2 years in OPEC countries (particularly in the Persian Gulf), continued strong global demand growth and the need for a seasonal inventory build will limit OPEC's spare capacity growth. On balance, EIA expects OPEC spare capacity to average 2.5 million barrels per day in 2007 and 2.8 million barrels per day in 2008 compared with an average spare capacity of 1.3

million barrels per day in 2006. However, recent increases in spare capacity levels due to reduced production have come at the expense of reduced forward supply cover.

Against the background of already tight world markets, global geopolitical uncertainties can create real or perceived threats to global oil supplies and transport. Events can also create spillover effects on neighboring countries. Geopolitical uncertainty in a number of different countries in the Middle East and Western Africa has kept and will continue to keep the market on edge. For example, Nigeria's problems have aggravated the gasoline price situation because the country produces largely light and sweet crude oil, which is used by the world's refineries to produce products such as gasoline.

The lack of timely demand data, especially in emerging markets in the Middle East, Africa, and Asia, may also lead OPEC and other major oil producers to misread prevalent market conditions. OPEC members have not yet raised production levels to meet higher demand for their crude oil this summer, including normal stock building. These factors create imbalances in the market, increase market volatility, and cause upward pressure on energy prices.

U.S. Gasoline Markets

The recent rise in crude oil prices, coupled with tight gasoline markets as evidenced by inventories rapidly falling to very low levels (**Figure 3**), is expected to push average U.S. regular grade motor gasoline prices from an average of $2.24 per gallon in January to an average of $3.01 per gallon in May. EIA expects gasoline prices could then ease slightly in upcoming months before returning to May's levels again by the end of the summer. With

refinery production expected to improve during the rest of the May and import volumes increasing over the last few weeks, gasoline markets may ease somewhat causing gasoline prices to recede from their current high levels. However, with the hurricane season approaching, continued tight refinery conditions--both in the United States and elsewhere--low gasoline inventories, and increased demand for summer travel, upward pressure on gasoline prices will remain in force. As a result, the average price of gasoline for the summer driving season (April through September) is projected to be $2.95 per gallon, up 11 cents per gallon from last summer's average.

Gasoline inventories, which typically build slightly in April, sharply declined last month because of the high incidence of refinery outages and low imports. Total motor gasoline inventories at the end of April were estimated to be 193 million barrels, more than 14 million barrels less than last April and 12 million barrels less than the lower end of the typical range for this time of year. Gasoline inventories are expected to remain tight throughout the summer, which will keep pressure on gasoline prices and likely result in higher margins and retail prices than those seen last summer.

Gasoline supply has been affected more than usual by refinery outages this spring. U.S. refineries typically have high outages during the first quarter, reducing production of gasoline and other products. This year, outages have extended into May and, along with low imports and seasonally rising gasoline demand, contributed to the sharp inventory decline and price pressure in April. While accurate statistics on refinery outages are scarce, preliminary refinery inputs in April were about 300 thousand barrels per day lower than the average level for the period 2003 through 2005. (Last year's numbers reflect unusual hurricane-damaged refinery outages.) During April, EIA estimated that domestic refinery

outages may have reduced gasoline production by 150 thousand barrels per day over average outages for that period. Refinery throughputs have just begun to show the seasonal increase typical at this time and are expected to increase over the next several months, which should ease pressure on gasoline prices. Should large refinery shutdowns or curtailments occur this summer, gasoline prices could rise well beyond our current forecast, especially given that U.S. inventories (the immediate source of incremental supplies) are already low.

Gasoline imports, critical to meeting U.S. consumption needs, are lagging last year's level and, thus, also affecting prices. Gasoline imports are an important source of supply to the United States in the months leading up to the peak summer season, when they contribute to a seasonal build in inventories before demand peaks, as well as during the summer months. However, in the 10-week period ending April 6, total gasoline imports averaged 920,000 barrels per day, down 220,000 barrels per day compared to the same period last year.

Low gasoline inventories in Europe have resulted in limited volumes available for export to the United States. At the same time, refinery problems in Venezuela have reduced its gasoline exports to the United States by 40 percent, from an average of 75 thousand barrels per day in January through September 2006 to 44 thousand barrels per day in October 2006 through February 2007. In addition, disruptions to refinery activity in Nigeria have caused that country to seek additional gasoline supplies in the world market, thus adding to the global competition for scarce gasoline supplies. Total U.S. gasoline imports recently began to increase significantly, reaching more than 1.5 million barrels per day for the week ending May 11. Imports at or above roughly 1.2 million barrels per day are likely to be needed to avoid persistent pressure on gasoline prices.

Prices not only respond to uncertainties in crude supplies, refining, and import availability, but also to weather, particularly the threat of hurricanes, which presents a major uncertainty in petroleum (and natural gas) market forecasts. Shut-in production from hurricane activity is difficult to predict because the severity of tropical weather and the associated impacts on production have fluctuated widely from year to year. For example, no production was shut-in during 2006 as a result of tropical weather disturbances, in contrast to the devastation caused by Hurricanes Katrina and Rita in 2005. For the 30 years prior to 2005, hurricanes caused a seasonal average of about 4.5 million barrels of cumulative shut-in crude oil production, which is well below the estimated 165 million barrels that was shut-in after Hurricanes Katrina and Rita. Our short-term projections account for the normal seasonality of crude oil production, which reflects, in part, temporary shut-ins resulting from hurricanes. Our current projection of domestic crude oil production in the third quarter 2007 is about 70,000 barrels per day lower than the projected average production rates in the second and fourth quarters, or more than 6 million barrels total for the third quarter. However, should hurricane damage to petroleum infrastructure (upstream and/or downstream) exceed our base case assumption, crude oil and gasoline prices would be expected to increase substantially.

Conclusion

The combination of tight crude oil and refining markets, along with ongoing geopolitical concerns, leaves crude oil and gasoline markets poised for continued volatility this summer. However, with refinery production expected to improve during the rest of the May and import volumes increasing over the last few weeks, gasoline markets may ease somewhat causing gasoline prices to recede from their current high levels. However, with the hurricane

season approaching, continued tight refinery conditions--both in the United States and elsewhere--low gasoline inventories, and increased demand for summer travel, upward pressure on gasoline prices will remain in force.

This concludes my testimony, Mr. Chairman. I would be pleased to answer any questions you and other Members may have.

Figure 1

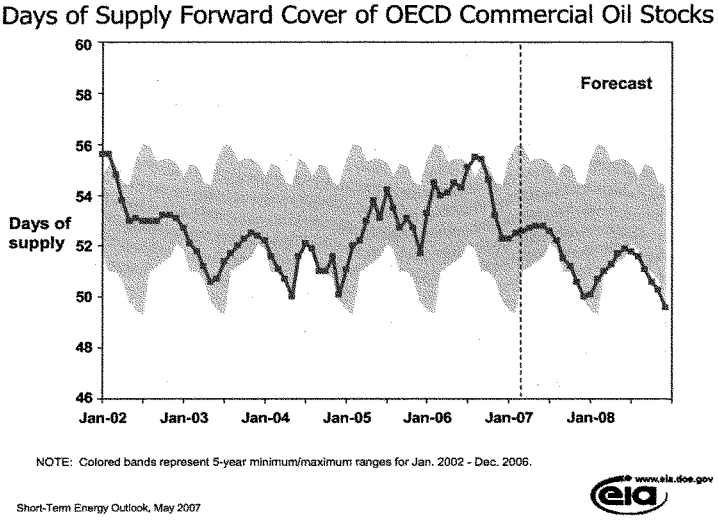


Figure 2

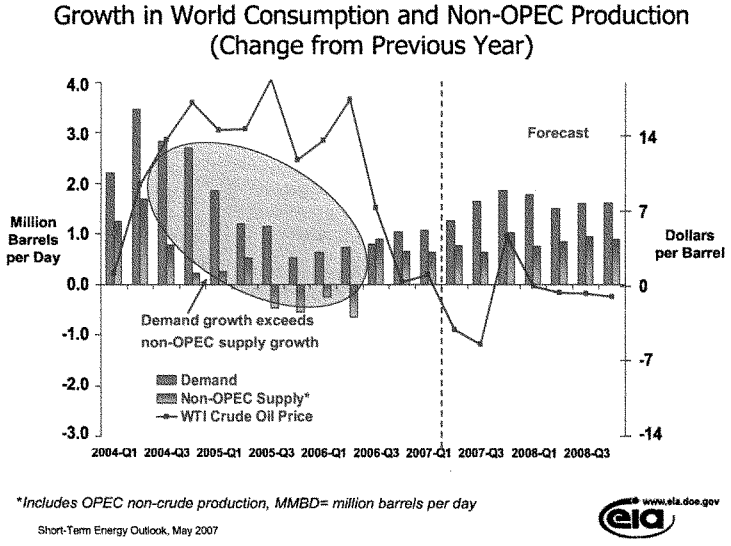
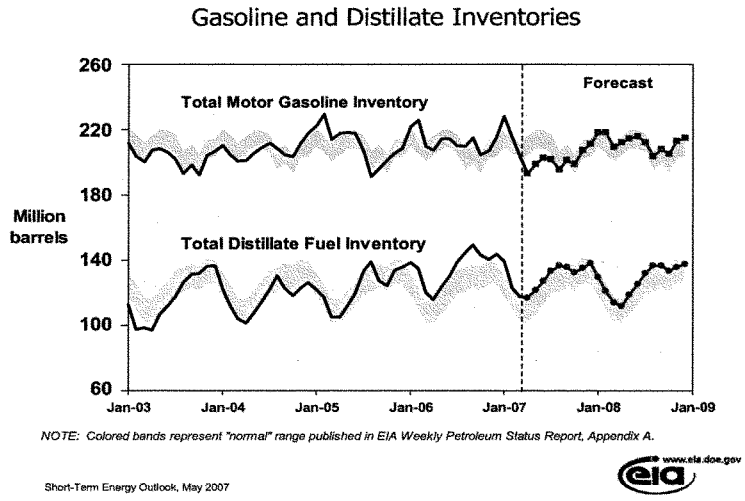


Figure 3


Gasoline and Distillate Inventories
260
220
180
140
100
60
Million barrels
Total Motor Gasoline Inventory
Total Distillate Fuel Inventory
Forecast
Jan-03
Jan-04
Jan-05
Jan-06
Jan-07
Jan-08
Jan-09
NOTE: Colored bands represent "normal" range published in EIA Weekly Petroleum Status Report, Appendix A.
Short-Term Energy Outlook, May 2007
www.eia.doe.gov
eia

Department of Energy
Washington, DC 20585

August 8, 2007

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

On May 22, 2007, Guy F. Caruso, Administrator, Energy Information Administration, testified regarding "Gasoline Prices, Oil Company Profits, and the American Consumer."

Enclosed are the answers to two questions that were submitted by Representative Green to complete the hearing record.

If we can be of further assistance, please have your staff contact our Congressional Hearing Coordinator, Lillian Owen, at (202) 586-2031.

Sincerely,

Eric Nicoll
Acting Assistant Secretary
Congressional and Intergovernmental Affairs

Enclosures

cc: Representative Bart Stupak

QUESTIONS FROM REPRESENTATIVE GREEN

Q1 Mr. Caruso, in your testimony you state that global oil consumption is projected to grow by 1.4 million barrels per day in 2007 and by 1.6 million barrels per day in 2008, much of which is from increased demand from the U.S. and China. Using long-term forecasts, what are the worldwide projected oil consumption demands 10 to 20 years down the road for quickly growing economies like China or India? How will this affect gas prices in the future?

A1 According to the Energy Information Administration's (EIA) *International Energy Outlook 2007* (*IEO2007*), world petroleum and other liquids demand increases from 82.5 million barrels oil equivalent per day in 2004 to 117.6 million barrels per day in 2030, an increment of 35 million barrels per day. Developing countries (including China and India) will account for much of this increase in global demand over the next twenty-five years. Indeed, China and India are expected to be among the world's fastest growing liquids consumers, and these two countries combined account for about one-third (11 million barrels per day) of the world's incremental liquids consumption over the projection period in the *IEO2007* reference case.

The retail prices of petroleum products, including motor gasoline, largely follow changes in world crude oil prices. In EIA's *Annual Energy Outlook 2007* reference case, world oil prices fall to about $50 per barrel (all prices are in real 2005 dollars, unless otherwise noted) in 2014 ($59 per barrel in nominal dollars) from the current high price environment, but then increase slowly to about $59 per barrel in 2030 ($95 per barrel in nominal dollars). The reference case projections for average U.S. motor gasoline prices follow the same trend, falling from $2.32 per gallon in 2005 to $1.95 per gallon in 2014 ($2.33 nominal), and then rising to $2.15 per gallon ($3.47 nominal) in 2030.

Q2 Given these new demands, can gas prices be reduced without increased global oil and natural gas exploration?

A2 Although it is possible that gasoline prices could be reduced without increased global oil exploration, we don't think it is the most likely case. For example, a major technological breakthrough that made large volumes of unconventional fuel supplies available at low cost would cause gasoline prices to decline. Unconventional supplies include gas-to-liquids, coal-to-liquids, very heavy oils, biofuels, and oil shales. Likewise, a technological breakthrough that produced dramatic improvements in vehicle efficiency and caused a decline in gasoline consumption might also result in lowered gasoline prices.

The supply and demand projections in the EIA reference case do not, however, anticipate dramatic technological advancements on the order necessary for such scenarios, so our most likely case requires increased global oil exploration and development activity to temper increases in gasoline prices.

Mr. STUPAK. Thank you.

Mr. Pruss, for an opening statement, please.

TESTIMONY OF STANLEY PRUSS, DEPUTY DIRECTOR, MICHIGAN DEPARTMENT OF ENVIRONMENTAL QUALITY

Mr. PRUSS. Thank you, Mr. Chairman, members of the committee.

My name is Stanley Pruss, and I appreciate the opportunity to address the issues of high gasoline prices, oil company profits and the effects on the American consumer.

I am appearing on behalf of Michigan Governor Jennifer Granholm, and she has submitted written testimony to this committee which reflects her active engagement on issues relating to the high price of fuel for more than eight years.

As Michigan's attorney general, Governor Granholm was engaged in a 3-year investigation in part with the Federal Trade Commission to examine and understand the price spikes that occurred in the Midwest, particularly in the summer of 2000.

That FTC study, reported on March 29, 2001, indicated that at least one petroleum company had deliberately withheld supplies and inventories because they were concerned that the release of those supplies would result in lower prices.

Governor Granholm testified May 2, 2002 before the Senate on gas pricing issues, and she has continued to be, as I said, very actively involved in these issues.

Her testimony today is broader than mine. Mine is limited to the events that occurred in association with September 11th, 2001.

At that time, I was the assistant attorney general in charge of the Michigan Consumer Protection and Antitrust Division.

We had long been involved in the investigation of high gasoline prices, but on that tragic day—shortly thereafter, we began to receive a number of calls at our complaint intake section of sharply spiking prices.

This trickle of information soon became a deluge. And after a short time, all of our intake lines were jammed with consumers calling in reporting prices that were, on September 11, ranging statewide between $1.60 and $1.80 a gallon, but in a very short period of time, hours, reached as high as $5 a gallon.

Attorney General Granholm came down to the division. We engaged our staff attorneys, our investigators and our complaint intake staff, and we mapped out a strategy to deal with this phenomenon.

We instantly entered this information that we received from consumers into our database in real time. We tried to be precise. We tried to capture the price of petroleum. We asked the consumer what they thought it was prior to the escalation in price. We recorded the location.

And our protocol was that if we received two or more consumer complaints about a single gasoline retailer, we then routed an investigator to do a visual verification. With that confirming evidence, we felt we had sufficient information to move under Michigan's consumer protection act.

Like many other States, Michigan has a price gouging statute that is an analogue to H.R. 1252, at least as introduced.

The Michigan consumer protection act prohibits charging a consumer a price that is grossly in excess of the price at which similar property or services are sold.

Unlike most States, but like H.R. 1252, this standard is not tied to a declaration of an emergency or a national emergency. The attorney general is free to use this any time the attorney general encounters unusual market conditions, as in H.R. 1252.

To address what was clearly price gouging activity, as I said, we mobilized our staff. We collected this information. And ultimately, we issued notices of intended action against 46 gasoline retailers in the State of Michigan.

This notice of intended action required by statute recited the violation, the factual basis for the violation, the violation of the statute, demanded that the retailer cease and desist in the escalated prices, demanded restitution, and outlined the consequences of noncompliance with the notice of intended action.

The statute allows the recipients of this notice to have an opportunity to confer, and the long and short of this enforcement initiative was that almost all of these stations entered into what is called an assurance of discontinuance, or a settlement agreement, whereby they promised, covenanted, to provide restitution to all consumers who were overcharged on that day and the days following as well as pay civil penalties.

Two stations chose not to settle consensually, and we did file suit against those gas stations. They interposed defenses that were both factual and legal.

As you heard today, their factual defense suggested that there is no such thing as price gouging in the marketplace, and that retailers have to purchase their next load of fuel based upon the sale of their present inventory, and that they have to be anticipatory, and when events like this occur, it was reasonable for them to escalate prices in anticipation of price hikes at the wholesale level.

We asked for proof in that regard: Did you receive notices of imminent price hikes? To the best of my recollection, no such proofs were forthcoming.

The legal defenses interposed were again, like what you have heard today, particularly from Representative Whitfield, that the term "grossly excessive" or "unconscionable" is inherently indefinite.

And this defense was interposed as being unconstitutionally vague, so vague as not to allow a party to understand what kinds of behavior are prohibited by law.

Although our initiative didn't result in an appellate decision in this regard, a judge did opine that the Michigan consumer protection act, which prohibits grossly excessive pricing, was not unconstitutionally vague.

And to the best of my understanding, although I have not been engaged in this area for a while, no court has found standards of unconscionability and standards that prohibit gross disparities in pricing as being unconstitutionally vague.

[The testimony of Mr. Pruss follows:]

TESTIMONY OF STANLEY F. PRUSS

Good afternoon. My name is Stanley Pruss and I appreciate the opportunity to address the issues of high gasoline prices, oil company profits and impacts on the American consumer.

I am appearing on behalf of Michigan Governor Jennifer Granholm. The Governor has submitted written testimony to this committee which reflects her active engagement on the issue of high petroleum prices for more than 8 years. As the attorney general of the State of Michigan, Governor Granholm investigated petroleum industry pricing and participated, with the Federal Trade Commission, in an investigation in Midwest price spikes that occurred in the summer of 2000. In her capacity as Governor, she has continued to have a leadership role in urging Congress to enact legislation in several key areas—all directed at alleviating the pain American consumers experience at the pump.

Governor Granholm's testimony goes beyond mine in that it constitutes a broader assessment of the situation facing consumers. Governor Granholm's testimony outlines the causes of high gasoline prices and price volatility and offers specific remedies, including support for H.R. 1252, as introduced.

My statement will be limited to price-gouging with respect to retail sale of gasoline and Michigan's experience in that regard.

I served as the assistant attorney general in-charge of the Consumer Protection and Antitrust Division under Michigan Attorney General Granholm. While we were long focused on the causes of high gasoline prices and the effect on Michigan consumers, the tragic events of September 11, 2001 precipitated occurrences that profoundly affected consumers around the country with immediate and harsh consequences beyond their grief and sympathy. I speak, of course, of price-gouging.

Like many other States, the Consumer Protection and Antitrust Division of the Michigan Department of Attorney General administers a Consumer Complaint Section that receives and records consumer complaints. Within minutes of the terrorist attack on the Trade Center, we began to receive complaints from consumers around the State of sharply elevated prices at the pump. This stream of complaints quickly became a deluge, literally tying up all our intake lines.

The complaints had a common theme: Gasoline prices that were generally between $1.60–$1.80 per gallon prior to the attack were being increased precipitously by some, but not all gasoline retailers, to as high as $5 per gallon. The complaints were coming in from all over the State. Attorney General Granholm came down to the Division to meet with staff attorneys, investigators and intake staff to assess the situation and to identify and direct our course of action.

Price gouging falls under Michigan Consumer Protection Act (MCPA). The MCPA prohibits unfair, deceptive or unconscionable methods, acts of practices in trade or commerce, and these prohibited methods, acts or practices are specifically enumerated and defined.

They include "charging a consumer a price that is grossly in excess of the price and which similar property or services are sold."

Unlike most State laws that address price gouging (and like H.R. 1252, as introduced), the Michigan price-gouging prohibition is not effectuated or triggered by a declaration of emergency. Of the at least 28 States that have price-gouging provisions, I believe only the Michigan and Maine statutes are not dependent on emergency declarations.

To address what was clearly price-gouging activity, our Division established a protocol to identify, evaluate and confirm price-gouging occurrences. Attorney General Granholm assigned additional support staff to the Division. Complaint information and details were carefully recorded into a database as they were received. When we received two or more complaints from consumers concerning a single gasoline retailer, an investigator was routed to location of the retailer to confirm the price. From this universe of putative violators we selected the most egregious for legal action under the MCPA.

Under the MCPA, the enforcement process was initiated by the issuance of a "Notice of Intended Action" that recited the factual basis for the violation, the statutory provisions that were violated, and the consequences that would ensue. The "Notice of Intended Action" demanded that the unlawful activity cease and desist, indicated that restitution to consumers would be required, and civil penalties would be exacted. It also explained that the recipient would have an "opportunity to confer" to offer explanations or defenses to the action. Finally, it set forth a process through which the recipient could consensually resolve the violations through execution of an "Assurance of Discontinuance" that incorporated these elements.

Ultimately, we issued "Notices of Intended Action" to 46 gasoline retailers. The vast majority of these retailers entered into Assurances of Discontinuances that re-

quired full restitution to any consumers who could prove through receipts or credit card statements that they were over charged. Some retailers chose to make refunds even to those consumers who did not have proof of purchases. In addition to restitution, approximately, $30,000 in civil penalties were collected. We filed lawsuits against two gasoline retailers. These were ultimately resolved prior to trial.

The defenses interposed by the gasoline retailers were both factual and legal. Some retailers maintained that their price escalations were justified under the circumstances. This explanation typically was based upon the assertion that the retailer must pay for the next load of petroleum from the wholesaler with the receipts derived from the existing inventory. They asserted it was not unreasonable to anticipate immediate price increases at the wholesale level. Some indicated that they were put on "notice" by wholesalers that sharp increases should be anticipated and that they should raise prices. However, no one, to the best of my recollection, could substantiate such claims.

Others asserted that there can be no such thing as a "grossly excessive" price or "price-gouging" in the marketplace and that such price spikes are not actionable. In legal terms they assert that statutes like the MCPA and H.R. 1252 are unconstitutionally vague because terms like "unconscionable" and "grossly excessive" are too indefinite to provide effective notice of behaviors that sanctionable. While the Michigan price-gouging effort did not result in any appellate decisions, a lower court judge did opine that he did not find the "void for vagueness" defense compelling.

In conclusion, as someone who has supervised the enforcement of price-gouging actions, I believe that a Federal statute like H.R.1252 can be an effective, indeed essential, legal mechanism to not only combat price-gouging activity but to deter such occurrences from happening. It is a certainty that there will be future public emergencies and unusual market conditions that result in economic hardship, if not actual harm, to American consumers. It is imperative that both Federal and State law enforcement authorities be equipped with the appropriate means of protecting consumers.

Thank you.

Mr. STUPAK. Thank you, Mr. Pruss.

Mr. McCool, opening statement, please, sir?

TESTIMONY OF THOMAS MCCOOL, DIRECTOR, CENTER FOR ECONOMICS, APPLIED RESEARCH AND METHODS, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. MCCOOL. Mr. Chairman and members of the subcommittee, we are pleased to participate in today's hearing to discuss the factors that influence the price of gasoline.

Few issues generate more attention and anxiety among American consumers than the price of gasoline. Periods of price increases are accompanied by high levels of media attention and consumers questioning the causes of higher prices.

The most current upsurge is no exception. For the average person, understanding the complex interactions of the oil industry, consumers and the government can be daunting.

Given the importance of gasoline for our economy, it is essential to understand the market for gasoline and what factors influence the prices that consumers pay.

In this context, my testimony today addresses the following questions: What key factors affect the price of gasoline? And what effects have mergers had on market concentration and wholesale gasoline prices?

Let me sum up by making the following observations. Over the long term, the price of crude oil is a major determinant of gasoline prices.

Crude oil and gasoline prices have generally followed a similar path over the past three decades and have risen considerably over the past few years.

A number of other factors also affect gasoline prices, including increasing demand for gasoline. Now, while demand has fluctuated over the long term, it has increased pretty steadily over that period by about 1.6 percent a year over the past 35 years.

At the same time, refinery capacity in the United States has not expanded at the same pace as demand for gasoline in recent years, which, coupled with high refinery capacity utilization rates, reduces refiners' ability to sufficiently respond to supply disruptions.

Gasoline inventories maintained by refiners or marketers of gasoline have also seen a downward trend in recent years.

Now, this follows similar trends in many other industries moving to just-in-time delivery processes, but it is true that the average inventory held by U.S. oil companies went from about 40 days of consumption in the early 1980's to about 23 days in 2006.

Also, regulatory factors such as national air quality standards that have induced some States to switch to special gasoline blends have also been linked to high gasoline prices.

Finally, consolidation of the industry can also play a role in determining gasoline prices. For example, mergers raise concerns about potential anticompetitive effects because mergers could result in greater market power for the merged companies.

At the same time, these mergers could lead to efficiency gains, enabling the merged companies to lower prices.

To that particular topic, the 1990's saw a wave of merger activity in which over 2,600 mergers occurred in all segments of the U.S. petroleum industry.

This wave of mergers contributed to increases in market concentration in the refining and marketing segments of the U.S. petroleum industry.

Qualitative evidence suggests that mergers may also have affected other factors that can impact competition, such as vertical integration and barriers to entry.

Econometric modeling that we performed of eight mergers involving major integrated oil companies that occurred in the 1990's showed that after controlling for other factors, including crude oil prices and refinery capacity utilization, supply disruptions, and also inventories, the majority of these mergers resulted in wholesale gasoline price increases, generally in the range of 1 cent to 2 cents a gallon, though one particular case went up 7 cents per gallon.

Additional mergers since 2000 are likely to increase the level of industry concentration. However, because we have not performed modeling on these mergers, we cannot comment on any potential effect on gasoline prices at this time.

We are, however, in the process of updating our previous study and plan to look at more recent mergers.

Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions you or other members of the subcommittee may have.

[The prepared testimony of Mr. McCool follows:]A

United States Government Accountability Office

GAO

Testimony

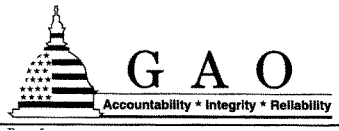
Before the Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, House of Representatives

For Release on Delivery
Expected at 1:00 p.m. EDT
Tuesday, May 22, 2007

ENERGY MARKETS

Factors That Influence Gasoline Prices

Statement of Thomas McCool, Director
Applied Research and Methods



GAO
Accountability · Integrity · Reliability

Highlights

Highlights of GAO-07-902T, a report to the Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, House of Representatives

May 22, 2007

ENERGY MARKETS

Factors That Influence Gasoline Prices

Why GAO Did This Study

Few issues generate more attention and anxiety among American consumers than the price of gasoline. The most current upsurge in prices is no exception. According to data from the Energy Information Administration (EIA), the average retail price of regular unleaded gasoline in the United States has increased almost every week this year since January 29th and reached an all-time high of $3.10 the week of May 14th. Over this time period, the price has increase 94 cents per gallon and added about $20 billion to consumers' total gasoline bill, or about $146 for each passenger car in the United States.

Given the importance of gasoline for the nation's economy, it is essential to understand the market for gasoline and the factors that influence gasoline prices. In this context, this testimony addresses the following questions: (1) what key factors affect the prices of gasoline and (2) what effects have mergers had on market concentration and wholesale gasoline prices?

To address these questions, GAO relied on previous reports, including a 2004 GAO report on mergers in the U.S. petroleum industry, a 2005 GAO primer on gasoline prices and a 2006 testimony. GAO also collected updated data from EIA. This work was performed in accordance with generally accepted government auditing standards.

www.gao.gov/cgi-bin/getrpt?GAO-07-902T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Tom McCool at (202) 512-2642 or mccoolt@gao.gov.

What GAO Found

The price of crude oil is a major determinant of gasoline prices. However, a number of other factors also affect gasoline prices including (1) increasing demand for gasoline; (2) refinery capacity in the United States that has not expanded at the same pace as the demand for gasoline; (3) a declining trend in gasoline inventories and (4) regulatory factors, such as national air quality standards, that have induced some states to switch to special gasoline blends.

Consolidation in the petroleum industry plays a role in determining gasoline prices as well. For example, mergers raise concerns about potential anticompetitive effects because mergers could result in greater market power for the merged companies, potentially allowing them to increase and sustain prices above competitive levels; on the other hand, these mergers could lead to efficiency effects enabling the merged companies to lower prices. The 1990s saw a wave of merger activity in which over 2600 mergers occurred in all segments of the U.S. petroleum industry. This wave of mergers contributed to increases in market concentration in the refining and marketing segments of the U.S. petroleum industry. Econometric modeling that GAO performed on eight of these mergers showed that, after controlling for other factors including crude oil prices, the majority resulted in wholesale gasoline price increases—generally between about 1 and 7 cents per gallon. While these price increases seem small, they are not trivial because according to FTC's standards for merger review in the petroleum industry, a 1-cent increase is considered to be significant. Additional mergers occurring since 2000 are expected to increase the level of industry concentration further, and because GAO has not yet performed modeling on these mergers, we cannot comment on any potential effect on gasoline prices at this time. However, we are currently in the process of studying the effects of the mergers that have occurred since 2000 on gasoline prices as a follow up to our previous work on mergers in the 1990s. Also, we are working on a separate study on issues related to petroleum inventories, refining, and fuel prices.

Mr. Chairman and Members of the Committee:

We are pleased to participate in the Energy and Commerce Committee's hearing to discuss the factors that influence the price of gasoline. Few issues generate more attention and anxiety among American consumers than the price of gasoline. Periods of price increases are accompanied by high levels of media attention and consumers questioning the causes of higher prices. The most current upsurge in prices is no exception. Anybody who has filled up lately has felt the pinch of rising gasoline prices. Over the last few years, our nation has seen a significant run up in the prices that consumers pay for gasoline. According to data from the Energy Information Administration (EIA), the average retail price of regular unleaded gasoline in the United States reached $3.10 per gallon the week of May 14, 2007, breaking the previous record of $3.06 in September of 2005 following Hurricane Katrina. This year, from January 29th to the present, gasoline prices have increased almost every week, and during this time the average U.S. price for regular unleaded gasoline jumped 94 cents per gallon, adding about $20 billion to consumers' total gasoline bill, or about $146 for each passenger car in the United States. Spending billions more on gasoline constrains consumers' budgets, leaving less money available for other purchases.

However, for the average person understanding the complex interactions of the oil industry, consumers and the government can be daunting. For example, gasoline prices are affected by the decisions of the industry regarding refining capacity and utilization, gasoline inventories, as well as changes in industry structure such as consolidations; by consumers' decisions regarding the kinds of automobiles they purchase; and by government's regulatory standards. These are some of the key factors affecting gasoline prices that we will discuss today.

Given the importance of gasoline for our economy, it is essential to understand the market for gasoline and what factors influence the prices that consumers pay. You expressed particular interest in the role consolidation in the U.S. petroleum industry may have played. In this context, this testimony addresses the following questions: (1) what key factors affect the prices of gasoline? (2) What effects have mergers had on market concentration and wholesale gasoline prices?

To address these questions, we relied on information developed for a previous GAO report on mergers in the U.S. petroleum industry, the GAO primer on gasoline markets, and a previous testimony on gasoline prices and other aspects of the petroleum industry.[1] We also reviewed reports and other documents by the Federal Trade Commission (FTC) on the U.S. petroleum industry.[2] In addition, we obtained updated data from EIA. This work was performed in accordance with generally accepted government auditing standards.

In summary, we make the following observations:

- The price of crude oil is a major determinant of gasoline prices. A number of other factors also affect gasoline prices including (1) increasing demand for gasoline; (2) refinery capacity in the United States that has not expanded at the same pace as demand for gasoline in recent years, which coupled with high refinery capacity utilization rates, reduces refiners' ability to sufficiently respond to supply disruptions; (3) gasoline inventories maintained by refiners or marketers of gasoline that have seen a general downward trend in recent years; and (4) regulatory factors, such as national air quality standards, that have induced some states to switch to special gasoline blends that have been linked to higher gasoline prices. Finally, consolidation in the petroleum industry plays a role in determining gasoline prices. For example, mergers raise concerns about potential anticompetitive effects because mergers could result in greater market power for the merged companies, potentially allowing them to increase and sustain prices above competitive levels; on the other hand, these mergers could lead to efficiency effects enabling the merged companies to lower prices.

- The 1990s saw a wave of merger activity in which over 2,600 mergers occurred in all segments of the U.S. petroleum industry. Almost 85 percent of the mergers occurred in the upstream segment (exploration

[1]GAO, *Energy Markets: Effects of Mergers and Market Concentration in the U.S. Petroleum Industry*, GAO-04-96 (Washington, D.C.: May 17, 2004); GAO, *Motor Fuels: Understanding the Factors That Influence the Retail Price of Gasoline*, GAO-05-525SP (Washington, D.C.: May 2005); GAO, *Energy Markets: Factors Contributing to Higher Gasoline Prices*, GAO-06-412T (Washington D.C.: February 1, 2006).

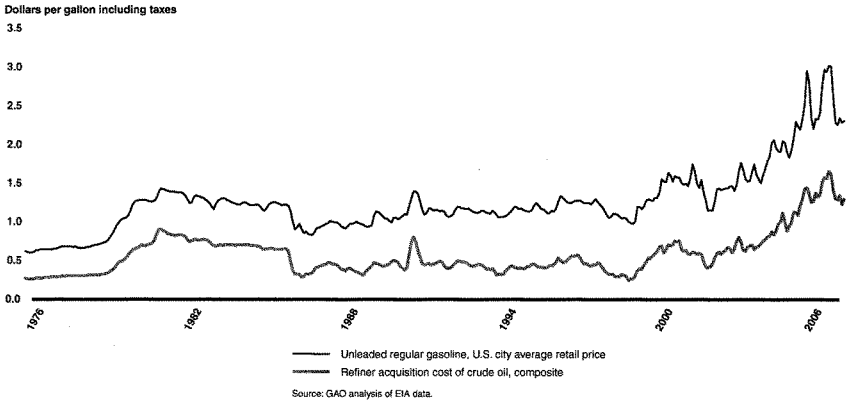
[2] See, for example, *FTC, The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement*, An FTC Staff Study, August 2004.

and production), while the downstream segment (refining and marketing of petroleum) accounted for 13 percent, and the midstream (transportation) accounted for about 2 percent. This wave of mergers contributed to increases in market concentration in the refining and marketing segments of the U.S. petroleum industry. Anecdotal evidence suggests that mergers may also have affected other factors that impact competition, such as vertical integration and barriers to entry. Econometric modeling we performed of eight mergers involving major integrated oil companies that occurred in the 1990s showed that, after controlling for other factors including crude oil prices, the majority resulted in wholesale gasoline price increases—generally between about 1 and 7 cents per gallon. While these price increases seem small, they are not trivial because according to FTC's standards for merger review in the petroleum industry, a 1-cent increase is considered to be significant. Additional mergers since 2000 are expected to increase the level of industry concentration. However, because we have not performed modeling on these mergers, we cannot comment on any potential effect on gasoline prices at this time.

Crude Oil Prices and Other Factors Affect Gasoline Prices

Crude oil prices are a major determinant of gasoline prices. As figure 1 shows, crude oil and gasoline prices have generally followed a similar path over the past three decades and have risen considerably over the past few years.

Figure 1: Gasoline and Crude Oil Prices—1976-2006 (Not adjusted for inflation)



Source: GAO analysis of EIA data.

Also, as is the case for most goods and services, changes in the demand for gasoline relative to changes in supply affect the price that consumers pay. In other words, if the demand for gasoline increases faster than the ability to supply it, the price of gasoline will most likely increase. In 2006, the United States consumed an average of 387 million gallons of gasoline per day. This consumption is 59 percent more than the 1970 average per day consumption of 243 million gallons—an average increase of about 1.6 percent per year for the last 36 years. As we have shown in a previous GAO report, most of the increased U.S. gasoline consumption over the last two decades has been due to consumer preference for larger, less-fuel efficient vehicles such as vans, pickups, and SUVs, which have become a growing part of the automotive fleet.[3]

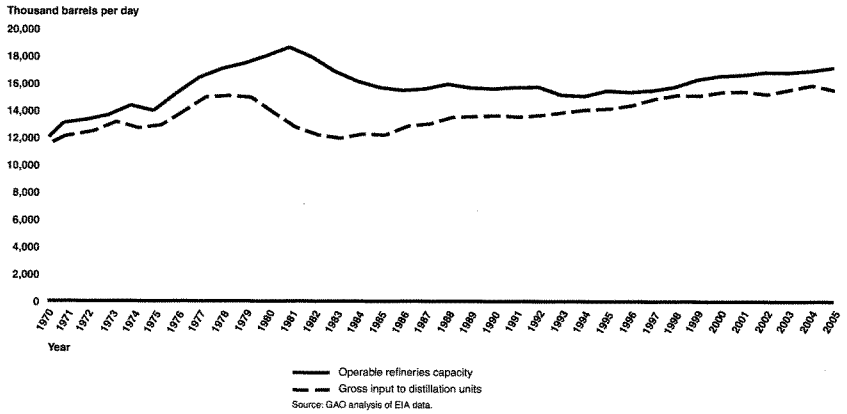
Refining capacity and utilization rates also play a role in determining gasoline prices. Refinery capacity in the United States has not expanded at

[3] GAO, *Motor Fuels: Understanding the Factors That Influence the Retail Price of Gasoline*, GAO-05-525SP, (Washington, D.C.: May 2005).

the same pace as demand for gasoline and other petroleum products in recent years. According to FTC, no new refinery still in operation has been built in the U.S. since 1976. As a result, existing U.S. refineries have been running at very high rates of utilization averaging 92 percent since the 1990s, compared to about an average of 78 percent in the 1980s.[4] Figure 2 shows that since 1970 utilization has been approaching the limits of U.S. refining capacity. Although the average capacity of existing refineries has increased, refiners have limited ability to increase production as demand increases. While the lack of spare refinery capacity may contribute to higher refinery margins, it also increases the vulnerability of gasoline markets to short-term supply disruptions that could result in price spikes for consumers at the pump. Although imported gasoline could mitigate short-term disruptions in domestic supply, the fact that imported gasoline comes from farther away than domestic supply means that when supply disruptions occur in the United States it might take longer to get replacement gasoline than if we had spare refining capacity in the United States. This could mean that gasoline prices remain high until the imported supplies can reach the market.

[4] The ratio of input to capacity measures the rate of utilization.

Figure 2: U.S. Refinery Capacity and Capacity Utilization, 1970 to 2005



Source: GAO analysis of EIA data.

Further, gasoline inventories maintained by refiners or marketers of gasoline can also have an impact on prices. As have a number of other industries, the petroleum industry has adopted so-called "just-in-time" delivery processes to reduce costs leading to a downward trend in the level of gasoline inventories in the United States. For example, in the early 1980s U.S. oil companies held stocks of gasoline of about 40 days of average U.S. consumption, while in 2006 these stocks had decreased to 23 days of consumption. While lower costs of holding inventories may reduce gasoline prices, lower levels of inventories may also cause prices to be more volatile because when a supply disruption occurs, there are fewer stocks of readily available gasoline to draw from, putting upward pressure on prices.

Regulatory factors play a role as well. For example, in order to meet national air quality standards under the Clean Air Act, as amended, many states have adopted the use of special gasoline blends—so-called "boutique fuels." As we reported in a recent study, there is a general consensus that higher costs associated with supplying special gasoline blends contribute to higher gasoline prices, either because of more

frequent or more severe supply disruptions, or because higher costs are likely passed on, at least in part, to consumers. Furthermore, changes in regulatory standards generally make it difficult for firms to arbitrage across markets because gasoline produced according to one set of specifications may not meet another area's specifications.

Finally, market consolidation in the U.S. petroleum industry through mergers can influence the prices of gasoline. Mergers raise concerns about potential anticompetitive effects because mergers could result in greater market power for the merged companies, either through unilateral actions of the merged companies or coordinated interaction with other companies, potentially allowing them to increase and maintain prices above competitive levels.[5] On the other hand, mergers could also yield cost savings and efficiency gains, which could be passed on to consumers through lower prices. Ultimately, the impact depends on whether the market power or the efficiency effects dominate.

Mergers in the 1990s Increased Market Concentration and Led to Small But Significant Increases in Wholesale Gasoline Prices; However the Impact of More Recent Mergers is Unknown

During the 1990s, the U.S. petroleum industry experienced a wave of mergers, acquisitions, and joint ventures, several of them between large oil companies that had previously competed with each other for the sale of petroleum products.[6] More than 2,600 merger transactions occurred from 1991to 2000 involving all segments of the U.S. petroleum industry. These mergers contributed to increases in market concentration in the refining and marketing segments of the U.S. petroleum industry. Econometric modeling we performed of eight mergers involving major integrated oil companies that occurred in the 1990s showed that the majority resulted in small but significant increases in wholesale gasoline prices. The effects of some of the mergers were inconclusive, especially for boutique fuels sold in the East Coast and Gulf Coast regions and in California. While we have not performed modeling on mergers that occurred since 2000, and thus cannot comment on any potential effect on wholesale gasoline prices at this time, these mergers would further increase market concentration nationwide since there are now fewer oil companies.

Some of the mergers involved large partially or fully vertically integrated companies that previously competed with each other. For example, in

[5]Federal Trade Commission and Department of Justice have defined market power for a seller as the ability profitably to maintain prices above competitive levels for a significant period of time.

[6]We refer to all of these transactions as mergers.

1998 British Petroleum (BP) and Amoco merged to form BPAmoco, which later merged with ARCO, and in 1999 Exxon, the largest U.S. oil company merged with Mobil, the second largest. Since 2000, we found that at least 8 large mergers have occurred. Some of these mergers have involved major integrated oil companies, such as the Chevron-Texaco merger, announced in 2000, to form ChevronTexaco, which went on to acquire Unocal in 2005. In addition, Phillips and Tosco announced a merger in 2001 and the resulting company, Phillips, then merged with Conoco to become ConocoPhillips.

Independent oil companies have also been involved in mergers. For example, Devon Energy and Ocean Energy, two independent oil producers, announced a merger in 2003 to become the largest independent oil and gas producer in the United States at that time. Petroleum industry officials and experts we contacted cited several reasons for the industry's wave of mergers since the 1990s, including increasing growth, diversifying assets, and reducing costs. Economic literature indicates that enhancing market power is also sometimes a motive for mergers, which could reduce competition and lead to higher prices. Ultimately, these reasons mostly relate to companies' desire to maximize profits or stock values.

Proposed mergers in all industries are generally reviewed by federal antitrust authorities—including the Federal Trade Commission (FTC) and the Department of Justice (DOJ)—to assess the potential impact on market competition and consumer prices. According to FTC officials, FTC generally reviews proposed mergers involving the petroleum industry because of the agency's expertise in that industry. To help determine the potential effect of a merger on market competition, FTC evaluates, among other factors, how the merger would change the level of market concentration. Conceptually, when market concentration is higher, the market is less competitive and it is more likely that firms can exert control over prices.

DOJ and FTC have jointly issued guidelines to measure market concentration. The scale is divided into three separate categories: unconcentrated, moderately concentrated, and highly concentrated. The index of market concentration in refining increased all over the country during the 1990s, and changed from moderately to highly concentrated on the East Coast. In wholesale gasoline markets, market concentration increased throughout the United States between 1994 and 2002. Specifically, 46 states and the District of Columbia had moderately or highly concentrated markets by 2002, compared to 27 in 1994.

To estimate the effect of mergers on wholesale gasoline prices, we performed econometric modeling on eight mergers that occurred during the 1990s: Ultramar Diamond Shamrock (UDS)-Total, Tosco-Unocal, Marathon-Ashland, Shell-Texaco I (Equilon), Shell-Texaco II (Motiva), BP-Amoco, Exxon-Mobil, and Marathon Ashland Petroleum (MAP)-UDS.

- For the seven mergers that we modeled for conventional gasoline, five led to increased prices, especially the MAP-UDS and Exxon-Mobil mergers, where the increases generally exceeded 2 cents per gallon, on average.
- For the four mergers that we modeled for reformulated gasoline, two—Exxon-Mobil and Marathon-Ashland—led to increased prices of about 1 cent per gallon, on average. In contrast, the Shell-Texaco II (Motiva) merger led to price decreases of less than one-half cent per gallon, on average, for branded gasoline only.[7]
- For the two mergers—Tosco-Unocal and Shell-Texaco I (Equilon)—that we modeled for gasoline used in California, known as California Air Resources Board (CARB) gasoline, only the Tosco-Unocal merger led to price increases. The increases were for branded gasoline only and were about 7 cents per gallon, on average.

Our analysis shows that wholesale gasoline prices were also affected by other factors included in the econometric models, including gasoline inventories relative to demand, supply disruptions in some parts of the Midwest and the West Coast, and refinery capacity utilization rates.

Concluding Observations

Our past work has shown that, the price of crude oil is a major determinant of gasoline prices along with changes in demand for gasoline. Limited refinery capacity and the lack of spare capacity due to high refinery capacity utilization rates, decreasing gasoline inventory levels and the high cost and changes in regulatory standards also play important roles. In addition, merger activity can influence gasoline prices. During the 1990s, mergers decreased the number of oil companies and refiners and our findings suggest that these changes in the state of competition in the industry caused wholesale prices to rise. The impact of more recent mergers is unknown. While we have not performed modeling on mergers that occurred since 2000, and thus cannot comment on any potential effect

[7]Unbranded (generic) gasoline is generally priced lower than branded gasoline, which is marketed under the refiner's trademark.

on wholesale gasoline prices at this time, these mergers would further increase market concentration nationwide since there are now fewer oil companies.

We are currently in the process of studying the effects of the mergers that have occurred since 2000 on gasoline prices as a follow up to our previous report on mergers in the 1990s. Also, we are working on a separate study on issues related to petroleum inventories, refining, and fuel prices. With these and other related work, we will continue to provide Congress the information needed to make informed decisions on gasoline prices that will have far-reaching effects on our economy and our way of life.

Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions you or the other Members of the Committee may have at this time.

GAO Contacts and Staff Acknowledgments

For further information about this testimony, please contact me at (202) 512-2642 (mccoolt@gao.gov) or Mark Gaffigan at (202) 512-3841 (gaffiganm@gao.gov). Godwin Agbara, John Karikari, Robert Marek, and Mark Metcalfe made key contributions to this testimony.

Mr. STUPAK. Thank you, Mr. McCool.

And thank you, all witnesses.

Unfortunately, we have six votes on the floor—this one currently, and then we have five that will take at least 5 minutes each, so we are probably at least a good half hour. We are going to have to recess.

And I hate to do this to you gentlemen, but it is one of these days. The good news is that these will be the last votes of the day and we can continue to go.

Commissioner Kovacic, you said we might be here till 8 o'clock tonight. I guess you had better insight onto the House floor schedule than I did.

Mr. KOVACIC. That wasn't a request, by the way, Mr. Chairman. [Laughter.]

Feel free to depart from the request if you want.

Mr. STUPAK. Well, let's get these votes out of the way, and we will be back, and we will finish up. And we have another panel after that.

OK, we are in recess until 45 minutes. Thank you.

[Recess.]

Mr. STUPAK. OK, the committee will be back in order. Unfortunately, Mr. Pruss had to grab an airplane and get back to Michigan, and I understand Mr. Sundstrom from AAA on our next panel also had to do the same.

I just hope that during all these many delays we had today gas prices haven't gone up. But you never know.

We are going to start with the questioning.

Mr. Whitfield, if it is OK with you, we will go 10 minutes.

Mr. WHITFIELD. Sure.

Mr. STUPAK. And maybe we can get a little order going, except Mr. Walden has 13 minutes since he waived his opening. OK.

Mr. Caruso, if I may start with you, please, sir. Remember, all witnesses are still under oath.

Looking at this USA Today article that was in the paper, "Gas Prices Approach 1981 Record", it quotes your organization, EIA, that the nationwide average of gasoline is $3.218, up 11.5 cents in the past week, and just a half penny shy of the inflation-adjusted record.

When will we see the record, the next day or two?

Mr. CARUSO. What we do look at is wholesale prices, and that normally is a precursor of what retail prices will do.

Mr. STUPAK. Sure.

Mr. CARUSO. And as of today, our models indicate there still is some pass-through that has not reached the retail level.

It is always difficult to be precise about that, because——

Mr. STUPAK. But chances are we will probably break the record tomorrow.

Mr. CARUSO. Well, in our case, we put them out every Monday.

Mr. STUPAK. Right. Well, let me ask you this. The record price for gas, and even when adjusted for inflation—but there is not the scope or magnitude of the reasons why we normally see for gas prices to go up.

In March 1981, Iran-Contra war had started about that time, I believe. Crude oil inventories are being maintained in this country.

Refineries have some unplanned disruptions, but nothing like the disruptions we saw after Hurricane Katrina.

Yet gas prices at the pump will set a new record, probably this week, while big oil profits are the most ever of any company. Other than profit-taking, is there any other event that would explain what is driving these prices?

Mr. CARUSO. Well, as I mentioned, every component of the supply stream, which is the refinery outages that are keeping production up to now lower than we would have expected for this time of the year, inventories are low, and imports up to now have been lower than normal—so what that all means is that the system is stretched very thin, and therefore there is no cushion to respond to any unexpected either outages or——

Mr. STUPAK. But we haven't seen those outages to drive the prices we are paying now. I guess that is the point I am trying to make. There is no major event to drive these kinds of prices other than probably profit-taking.

Mr. CARUSO. It is the total system that is stretched thin, and when there is no other cushion except price, it takes a large price increase in a commodity that has very low responsiveness in the short term, so it takes very high prices to rebalance the market once it gets out of balance.

Mr. STUPAK. And you cited those things in your testimony. In fact, on page 7 of your testimony I am looking—and the end of the first paragraph says as a result, the average price of gasoline for the summer driving season, April through September, is projected to be $2.95 at the pump, up 11 cents from last summer.

Well, right now, today, we are off by about 27 cents. So all those factors you just mentioned—you used that to make your prediction that it would be 11 cents higher than last year, but we are already 27 cents—so we are about 38 cents higher than last year.

Do you wish to revise those numbers? Can we expect prices to go down?

Mr. CARUSO. Well, we are still thinking that if imports do reach the levels that we hope they will, which is 1.2 million barrels a day or even higher, on average, this summer, and some of these refineries that are out come back on as planned, we can boost domestic production.

The combination of those things should lead to some easing of gasoline prices.

Now, as I pointed out in the testimony, this assumes a lot of things going right, and that the risks that we still face out there, both geopolitically and with industrial accidents, still indicate that there is likely to be upward pressure on prices.

Mr. STUPAK. OK.

Mr. CARUSO. And the hurricanes that you mentioned in your——

Mr. STUPAK. Right, but they are not here yet.

Mr. CARUSO. Exactly. It is a risk.

Mr. STUPAK. And usually in April we would start restocking, and we usually have excess gasoline. We don't this year.

Mr. CARUSO. That is exactly right.

Mr. STUPAK. OK.

Commissioner Kovacic, if I may ask you a couple questions, in GAO's testimony they say that in the 1990's the mergers resulted

in a 1-cent to 7-cent increase, depending on how you are looking at it, in the wholesale gasoline price, and a 1 percent increase FTC considers significant.

Is that a true statement?

Mr. KOVACIC. We do, indeed, consider that percentage increase to be significant.

Mr. STUPAK. And that is when you are looking at the mergers, right?

Mr. KOVACIC. Exactly. And though we greatly admire and applaud the efforts that GAO did to do the study, as you are aware, Mr. Chairman, we do have serious quarrels with the methodology and the results, but we do, indeed, use exactly the threshold you mentioned in looking at mergers.

Mr. STUPAK. OK. And when we are talking about mergers, you indicated—and you testified to some of the mergers you were doing, and I believe your testimony shows there were about 21 complaints you filed on mergers in the 1990's.

Mr. KOVACIC. That is correct, sir.

Mr. STUPAK. OK. But my concern was, in looking at the GAO report and some of the others that were documented, there were 2,600 mergers in the 1990's. That is about less than 1 percent of the total mergers.

Especially if you take a look at like when Exxon and Mobil—that was the largest supplier with the second. You didn't file any objections on that one.

Mr. KOVACIC. We actually did challenge that. It produced the largest package of divestitures that the commission has ever obtained as a remedy to a merger.

Mr. STUPAK. OK. How come you didn't mention that one in your testimony, then?

Mr. KOVACIC. I believe it is. In my spoken remarks, I was covering more recent events, but I believe in the prepared statement it is included.

And though I have never seen the entire data set of the 2,600 transactions—but my intuition, Mr. Chairman, is that the vast majority of those involved comparatively small transactions involving production operations.

Mr. STUPAK. Would you look at page 12 of your testimony?

Mr. KOVACIC. Yes, sir.

Mr. STUPAK. And I am looking at footnote No. 24. And you are talking about the Federal statute when we are trying to look at price gouging after Katrina.

Mr. KOVACIC. Yes, indeed.

Mr. STUPAK. And the statute mandated how you do your investigation—effectively defined price gouging.

Now, so would you say that is the definition of price gouging, as an average price of gasoline available for sale to the public following the hurricane that exceeded its average price in the area for the month before the hurricane, unless the increase was substantially attributable to additional costs in connection with production, transportation, delivery and sale of gasoline?

Mr. KOVACIC. I think if I were picking a composite of all of the approaches that have been used in the State legislation and tested

by Congress, that is the best approximation to a synthesis that I would suggest.

Mr. STUPAK. OK. And then after Hurricane Katrina, I said in my opening statement that we found 23 percent, you didn't study all of them, but 23 percent of the refineries that were studied, 9 percent of the wholesalers and 25 percent of the retailers had price increases that were not substantially attributable to increased costs and "could not be attributable to national market trends."

In other words, there was some gouging going on, price gouging going on.

Mr. KOVACIC. The one footnote I would add to that, Mr. Chairman, is that one of the screens we were asked to use was not simply to consider the effective national trends but also local and regional market trends.

And when we took those into account, most of the transactions—the activity that was caught by our initial screen tended to fall by the wayside, so that when we look at adjustments related to local and regional circumstances, not simply national or international conditions, those tended to fall by the wayside.

Mr. STUPAK. But those that fall at the wayside, you would agree with me, 23 percent of refineries and 9 percent of wholesalers and 25 percent of the retailers studied had price increases that would equate to price gouging using this definition found in footnote number 24.

Mr. KOVACIC. Except that when you take the clause, Mr. Chairman, that talks about the sale of gasoline in an area or to national or international market trends, and if you took account of regional, local trends, that percentage would drop considerably.

Mr. STUPAK. OK. So there was some, and we don't know what the amount is. Is that fair to say?

Mr. KOVACIC. Yes. I would be happy to provide a more specific number to you for the record, sir.

Mr. STUPAK. OK. On page 2, you talk about the average refining margin was about 10 cents to 15 cents per gallon in January and February.

Mr. KOVACIC. Yes, sir.

Mr. STUPAK. And now we are up to 70 percent to 80 percent, you say in your testimony.

Mr. KOVACIC. Yes, sir.

Mr. STUPAK. So that is a 55-cent to 65-cent increase in price per gallon just for refinery, and that is all profit, right?

Mr. KOVACIC. I would suspect that a substantial amount of it is, yes, sir.

Mr. STUPAK. OK. Where do you draw the line here? When do we start hitting the excessive profit? We already have testimony that the crack spread is going to be 36 cents. That is based on $30 a barrel.

Now we are going to hit 36 cents here in June. That is what the futures are already trading for. So that is probably going to get up closer to about 80 cents per gallon of all profit.

Where are we hitting the excessive profit here, profit-taking?

Mr. KOVACIC. We don't have a good functional definition for that. In our experience, that is not an amount we have ever sought to

calculate or have been pressed to calculate for both our consumer protection and competition work.

What we have also noticed is an enormous degree of volatility just in the past six months of what those margins have been.

Mr. STUPAK. OK, but if you look at it—and, Mr. Caruso, correct me if I am wrong. But in September and October 2006, gas prices actually dropped 60 cents.

Mr. KOVACIC. Indeed, they did.

Mr. STUPAK. And then now we are up, I think Mr. Barton said, 94 cents or 86 cents, since the first of the year. So that is about $1.50, $1.54 spread there, in about 6 months.

You might call it volatility, but I think there is a lot of room for profits in these where you can play with these margins all you want. At what point do we pass where it is gouging?

I mean, if you are at $3, and you have got a $1.50 spread you are playing within 6 months, where are you at this point where you are taking excessive profit, especially when 10 cents increase is a $14 billion transfer from the consumer to the Big Oil companies?

Mr. KOVACIC. In our experience, we have never had an occasion in applying our authority to provide a definition for what the ceiling or the excessive amount is.

Mr. STUPAK. Well, that is because you have no law on price gouging, right? You have always had to look at antitrust and competitive natures like that, not a price gouging——

Mr. KOVACIC. That is correct.

Mr. STUPAK. So would a price gouging law then help you answer these questions?

Mr. KOVACIC. I think that were the Congress to adopt one—and I do want to emphasize to you that were the Congress to adopt one, we would faithfully execute it—that would press us to develop the kind of functional definition that we have been talking about.

Mr. STUPAK. OK. Thank you. My time is up.

But, Mr. Caruso, one more, if I may. What percentage of the price of a gallon of gas is risk premium associated based on fear and speculation?

Mr. CARUSO. Well, there is no good agreement on what that is. You can hear analysts—anywhere from $5 to $20 per barrel, which means 10 cents to 40 cents.

Our view is when there is fear of supply loss in the marketplace for example, there could be a natural disaster, like hurricanes, or you are worried about Nigeria or Iran, and you as a refiner were to go out and add inventories to prepare yourself for those eventualities, that adds to the price of, in this case, crude oil, in our view, that is part of the market functioning.

If you are fearful of a supply loss, and you respond to that by adding inventories, that certainly puts upward pressure on price. That is one type of fear.

There is another part of it which you don't—there has been financial speculation, and again, it is in some views that that adds liquidity to the market, which is good. Others say that is pure risk premium.

Mr. STUPAK. Well, that is another piece of legislation I have.

My time has expired. I turn to Mr. Whitfield of Kentucky for questions, please.

Mr. WHITFIELD. Thank you, Chairman Stupak.

And I also want to thank you all for your patience. I mean, how frequent is it that you get to come to a hearing room and stay for 4 hours or 5 hours in the afternoon, and particularly with such personalities as us, right?

Mr. Caruso, let me ask you a question. We hear about these record profits in the oil companies, and we have a lot of constituents who are paying these high prices.

But I will note that it doesn't seem to be affecting many of them in their willingness to stop driving. A lot of them have to drive for work, and so they are still paying the prices.

But as administrator of the Energy Information Administration, you certainly have reviewed and looked at a lot of statistics.

Now, how would you explain that the oil profits are so high at this particular time of high prices in the oil and gas business, retail gas particularly—if you are speaking to a Rotary Club, how would you explain that to the Rotary Club members?

Mr. CARUSO. Well, I think perhaps to get to that level, I would use an analogy of other markets, such as real estate, where we have seen hot markets for real estate and prices of homes double and triple. Therefore, individuals who own those homes don't—take their house off the market because they think that is a——

Mr. WHITFIELD. So the demand is so high that you can just make more profit. You can just charge a little bit more and make more profit.

Mr. CARUSO. I think that is the bottom line, and this particular case—is that the demand is high and supply is limited.

But more important than a lot of products, there is this what economists call very low price elasticity, so that you need a very high price increase for small changes in supply or demand to rebalance the market.

And for example, we use about a 0.05 short-term elasticity, which, to put that in, something that is maybe understandable, is it would take a 100 percent increase in the price to change the demand by 5 percent.

Mr. WHITFIELD. I think for the average citizen, they understand our free market system, the way it works, and that high demand, prices go up, and so forth.

And so as long as they are convinced that there is not price gouging going on, or advantage being taken of them, then they feel pretty good about things.

Now, Mr. Pruss in his testimony talked about how the present governor, when she was attorney general in Michigan, brought 46 claims against retail outlets and accused or charged all of them with price gouging.

Now, I know enough about just the practical aspects of the legal system that if you take a couple of retail outlets, and they may be individually owned or a mom-and-pop operation, and the attorney general comes in and says, "I am accusing you of price gouging, and if you will sign this consent agreement and agree to do this and this, then we will forget it and we will move on," and I can understand how a lot of people would just sign those and move on.

But he also said, Mr. Kovacic, that they worked very closely with the Federal Trade Commission on those cases. Now, were you there at that time?

Mr. KOVACIC. I was, Congressman, but we did not work with them in the formulation of their cases.

Mr. WHITFIELD. OK.

Mr. KOVACIC. We have had extensive discussions over time about the types of cases they brought and how they have developed them, but we were not their partner.

Mr. WHITFIELD. Well, was it your all's impression that price gouging was going on by those individual retailers, or do you have an opinion of that?

Mr. KOVACIC. Well, I think, as suggested in Mr. Pruss' comments, these matters don't generate records.

Mr. WHITFIELD. OK. So there are no records.

Mr. KOVACIC. There is nothing really to take a look at.

Mr. WHITFIELD. So they simply signed these agreements to get out of it.

Mr. KOVACIC. I believe in most instances—and you will recall his closing comment that these tend not to generate published opinions that are easily accessible to outsiders.

Mr. WHITFIELD. I would also note that, I guess, 29 States and the District of Columbia do have price gouging statutes, and it is very seldom, at least from my knowledge—and if I am incorrect, you all can tell me. It is very seldom, from my knowledge, that charges are brought against large oil companies, or refiners or anything else under these price gouging statutes. It seems, generally speaking, that the small independent retailer is the one that gets hit with it.

Would that be accurate or not accurate?

Mr. KOVACIC. I think that is an accurate characterization of experience with the States, yes.

Mr. WHITFIELD. OK. Now, we are going to have on the floor of the House one day this week, as we did last year, a price gouging bill, and one of the definitions is if the price is unconscionably excessive.

Now, Mr. Pruss indicated that the highest court in Michigan ruled that phrase was not unduly vague, and so therefore was certainly legal.

But it is my understanding that the Federal Trade Commission is on record in opposing a Federal price gouging law. Is that correct?

Mr. KOVACIC. That is correct, sir.

Mr. WHITFIELD. And you say because it would actually do more harm to consumers than good. Now, could you explain that position?

Mr. KOVACIC. Again, addressing this in the capacity of someone who is giving you my professional judgment about what would take place, and not speaking to whether or not we would apply a law that you would adopt, but as an adviser to you on this issue, one of our concerns is that a measure of this type that is coupled with powerful criminal penalties—and I know some of the proposals have maximum sentences for individuals of up to 10 years.

You take the comparatively ambiguous definition, you couple it with the possibility of a 10-year maximum prison sentence for the

individual who transgresses—that is likely to induce a great deal of caution, I believe, in how one behaves.

So to simply give one example of the concerns I have, that mixture of features, I think, could be very discouraging, certainly to the small retailer, but to the larger refiners who would also be subject to the operation of the law itself.

That is, a definition that is comparatively ambiguous and has not been well defined in the course of implementation in the States, plus a 10-year sentence for individuals, I believe is going to induce a great deal of caution in providing supply responses.

Mr. WHITFIELD. Right. Now, if the House passes this bill, and the Senate passes this bill and the President happened to sign it, the Federal Trade Commission would be vested with the authority to prosecute under this price gouging bill.

Mr. KOVACIC. Exactly right, and in the case of the criminal matters, to refer them to the Department of Justice.

Mr. WHITFIELD. How difficult would it be to bring a case against a Shell Oil Company or a ExxonMobil using this kind of language?

Mr. KOVACIC. I think these would be very demanding matters. They are certainly not impossible. We are accustomed to dealing with complex, difficult matters at our agency.

But being familiar with the very firms we would face, because we do face them as opponents in other settings, these would be particularly challenging matters, because I think as the committee realizes, in order to come up with a sensible definition, it has to be sensitive to cost justification arguments and to the national, regional and local market circumstances standard that we were talking about before. Yet it is the application of those very standards that tends to involve, I would expect, a very elaborate and fact-intensive inquiry into the actual operations of the firm.

So impossible by no means. We do lots of difficult things, and we do the difficult things very well. Yet these would be very demanding matters to pursue.

Mr. WHITFIELD. But even if the definition remains relatively vague, and we do not give you the opportunity to define price gouging, I am assuming that despite the complexity of it that the American people would still be better off having a Federal price gouging statute than not.

But is it the commission's position that you are opposed to a Federal price gouging statute?

Mr. KOVACIC. As to your last question, yes. My concern is that the uncertainty it would create would have a tendency—and I can't prove this to you by any rigorous calculus, but my intuition is that it would create hesitation in the response to shortages, and that might tend to exacerbate rather than to mitigate shortages.

Mr. WHITFIELD. Thank you, Mr. Chairman. My time has expired.

Mr. STUPAK. Mr. Inslee for questions.

Mr. INSLEE. Thank you.

I think I saw in Mr. McCool's testimony discussions of geopolitical uncertainty in a number of different countries in the Middle East has kept and will continue to keep the market on edge.

Mr. McCool, is there any way to put any parameters at all what those uncertainties translate to in the prices at the pump?

Mr. MCCOOL. Congressman, I really don't know that we would be able to answer that. I mean, earlier, Mr. Caruso actually suggested that this idea of uncertainty certainly has an effect on supply, and inventories and things like that.

But it is, I think, very difficult to put any kind of meaningful quantitative measure on that, except to know that geopolitical uncertainties clearly have some effect.

Mr. INSLEE. Has the Iraq war translated into increased prices that consumers are now paying in America for gasoline to drive their cars?

Mr. MCCOOL. I don't know the answer to that, sir.

Mr. INSLEE. Is it uncertainty of the type that may have an impact on——

Mr. MCCOOL. It would increase the level of uncertainty, yes, sir.

Mr. INSLEE. Could you describe part of the amount that Americans are paying at the pump today as a tax associated with the war started by this President?

Mr. MCCOOL. Again, I think the level of uncertainty in the world—it may or may not be greater. I can't quantify it.

Mr. INSLEE. Well, did the Iraq war make it drive prices down?

Mr. MCCOOL. I don't know. We don't know what the counterfactual is, Congressman, so it is hard to really answer that question.

Mr. INSLEE. Well, most of the people who have any understanding of the impact of war in my district believe that it had some impact on oil prices, and it is not been beneficial, and my constituents are now paying at the pump for a misguided war. I will just tell you that is their belief, for whatever that is worth.

I want to ask about the consolidation in the industry. I was looking at the GAO report of May 2004, and I assume this has been discussed. I had been in another hearing about energy issues.

During the period of 1991 to 2000, there were over 2,600 merger transactions within the various segments of the U.S. petroleum industry. That is what the GAO report found.

They found that concentration in the wholesale gasoline market increased substantially from the mid 1990's so that 46 States had either moderately or highly concentrated wholesale gasoline markets.

They found that the availability of less expensive unbranded gasoline decreased substantially.

And even though this took place, there has not been, as far as I know, an instance where the Federal agencies, at least during this administration, have challenged any of the mergers that have led to higher concentration.

Is that all of yours' understanding?

Mr. KOVACIC. Congressman, all of the transactions you are talking about took place through the year 2000.

They were reviewed by our predecessors, and whatever relief was achieved was achieved well before George Bush came to Washington in January 2001.

Mr. INSLEE. I appreciate that, and has this administration taken any action involved in any of the mergers to prevent them and prevent further consolidation?

Mr. KOVACIC. Indeed, we have, sir. As my spoken remarks and my written text point out, I review a number of transactions where we have challenged specific mergers.

And indeed, at this moment, we are before one of our Federal courts awaiting a decision on the latest, a combination of the Western Refining Company and Giant Industries.

Mr. INSLEE. And what percentage of the mergers have you challenged?

Mr. KOVACIC. I don't have a precise number, although the best data I have seen—that is, when you take the rate of merger challenges by the Federal Trade Commission in this decade, I believe it is almost identical to the rate of challenges during the previous decade.

Mr. INSLEE. During your tenure, have you actually come out against mergers, or you just have asked for some divestiture after the merger?

Mr. KOVACIC. I believe in at least four of the transactions, we have gone to court to block them outright. And in at least one of those instances, the parties then proposed a settlement that we found acceptable.

But I can give you the precise numbers on that as well, Congressman.

Mr. INSLEE. I would appreciate that. That would be helpful.

Mr. KOVACIC. Yes, sir.

Mr. INSLEE. While I have got you on the line here, do you believe that consolidation has resulted as a partial reason for some of the price hikes Americans have experienced?

Mr. KOVACIC. As I mentioned a moment ago, we deeply respect the work of the GAO that you referred to before. That is, it is an absolutely sensible and necessary element of good public policy that agencies take steps to evaluate the effects of what they have done.

We do have a serious dispute with the GAO about the soundness of the results that they have identified.

But notwithstanding that dispute—that is, we disagree fundamentally with their findings—we are devoting additional efforts to do our own assessments of whether or not we have erred in those earlier judgments, and to incorporate that into the formulation of policy looking ahead.

Mr. INSLEE. One of my concerns is that it is my belief that unless we break this addiction to oil, we are all going to be exposed to increasing prices.

Even if we do some of the things we need to do, which is to pass this antipredatory pricing bill, and even if we do slow down the rate of consolidation and hopefully can then increase refinery capacity—even if we do do some of these common-sense things—that unless we develop whole new revolutionary systems of fueling our transportation system, we are still going to be behind the eight-ball because of the huge increase in demand from China and other developing nations, because of the relative limited refining—or, excuse me, pumping capacity of the world, and that we really need to develop whole new systems of powering our transportation system.

Mr. KOVACIC. Congressman, I think you would find many of your concerns echoed in the 3 days of proceedings we had a month ago

at our agency on energy policy, where a recurring theme of many speakers, I think, echoes your own remarks.

Namely, what we need is a far more fundamental reassessment of energy supply and demand patterns, perhaps a more basic examination of how we live, where we get supplies, what supplies are available to us, demand side considerations.

I think you would find that many of the themes you have identified were addressed again and again by our speakers who would agree with you emphatically.

Mr. INSLEE. Well, there is a bill, and perhaps I can ask your comment, I will be introducing. It is called the New Apollo Energy Act.

And we call it the New Apollo Energy Act because many of us believe that we need a revolution that is as ambitious and visionary in transportation fuels as Kennedy led the country to be in 1061 to go to the moon.

And in this bill, we will take measures such as assisting our domestic industry for retooling costs. We have a bill called the Health Care for Hybrids bill that will help the development of hybrid technology distribution.

We will be proposing a bill for plug-in hybrids that can get 150 miles a gallon, that go 40 miles on your electricity.

You plug it in at night and you go 40 miles, and then if you want to go more than 40 miles you use either ethanol or gasoline. You get 150 miles per gallon of your fuel.

We have bills that will include efforts to increase efficiency of battery technology to try to fulfill the remaining steps for battery technology.

And we will have a bill to substantially increase cellulosic ethanol, the second generation of biofuels. Of course, everyone talks about corn ethanol now, but we need a second generation.

So I would just ask for your comments from the panel as to whether those steps make sense and whether or not, long term, they might be beneficial to really break the back of this slippery slope of eternally rising gas prices that we are having.

Mr. KOVACIC. I think that there are any number of ways that this country can tap what is an unsurpassed degree of technical capacity, and that a variety of approaches along the lines you mention are quite worthwhile.

The one footnote I would add to it—and I think of my father's experience, who worked in the nuclear power sector, when we lived in southeastern Michigan for 13 years, indeed, in Chairman Dingell's district, where I first met him in 1959.

I think part of what we discovered with that experience with the fission fuel cycle is that it invariably turns out to be somewhat harder than we think it might be, that the mere fact of technical feasibility does not always dictate successful implementation.

So I would endorse efforts to use the remarkable technical capacity we have to explore alternatives.

My only thought would be that given the humbling experience we have had in closing the gap between the excellent concept and the successful implementation that we realize that it turns out often to be harder than we thought.

Mr. INSLEE. Right. Well, it is hard, and that is why we need to get started, and that is why we need to be aggressive. And today,

we are spending less than one-half on developing these technologies than we were in 1979.

We spend less on energy research in the entire United States budget than we spend in three weeks in the Iraq war. And that is a pathetic comment on our refusal to date to really try to break the oil addiction habit.

And I hope that this hearing helps promote the New Apollo bill so that we can move forward and really get a new revolutionary transportation fueling system, which this country deserves. Thank you.

Mr. STUPAK. I thank the gentleman.

A couple questions, if I may.

Mr. Kovacic, if I may, in the legislation that is being proposed and we will take up later this week, it basically says it is unlawful for a person to sell crude oil gasoline, natural gas or petroleum distillates at a price and we go unconscionable and things like that.

You would agree with me, the FTC has pretty much sort of identified price gouging. I mean, you have a working definition of it, do you not?

Mr. KOVACIC. We have certainly developed proposals that we think are the best things we have seen.

And as the committee goes forward in developing its work, as the House works on this, notwithstanding any reservations I mentioned, we are at your disposal to work with you, your colleagues, your staffs on suggesting specific adjustments that we think are——

Mr. STUPAK. So those cases that the FTC saw after Hurricane Katrina, where they say they were "not substantially attributable to increased costs" and "could not be attributed to national market trends," that is a price gouging definition in a way.

Mr. KOVACIC. It is, and I would simply add the gloss that I mentioned before that also takes account of regional and local market trends, too, sir.

Mr. STUPAK. And that is what the legislation says. And actually, we give you 180 days to develop that definition, so it is not an impossible task.

And then you already have some guidelines that the FTC has relied upon in the past, as your footnote No. 24 in your testimony has indicated.

Mr. KOVACIC. It is, and my request to the committee is that to the extent that you can make the specific policy choices—because in many ways, this is uncharted territory for us.

I don't know outside the field of public utility regulation that we have used approaches of this kind on a national scale.

It is enormously helpful to us that you and your colleagues, to the extent you can, be as specific as you can about the appropriate standard.

Mr. STUPAK. And you indicated that these dealings you have with oil companies, especially on some of these mergers—they are pretty complex litigation, correct?

Mr. KOVACIC. Some of the most complex that we have, yes, sir.

Mr. STUPAK. So if we are going to bring price gouging against multinational corporations, we probably want the expertise of the

FTC to do it, then, because you deal with these folks from time to time.

Mr. KOVACIC. Without undue boastfulness, I would say that the Federal Trade Commission has the best complement of competition policy analysts in the field of petroleum in the world.

Mr. STUPAK. So you are willing to do your price gouging if the legislation becomes law.

Mr. KOVACIC. I would say if the legislation becomes law, we have the greatest expertise to apply it.

Mr. STUPAK. We mentioned—I did, at least, in my opening—Attorney General Stumbo from Kentucky, Mr. Whitfield's home State, bringing this case—I think he brought 70 cases of price gouging after Hurricane Katrina.

Mr. KOVACIC. Yes.

Mr. STUPAK. Did the FTC work with him as you indicated you worked with Governor Granholm in Michigan?

Mr. KOVACIC. We did not work with them on the formulation of those cases, though when we did the Katrina report, we asked our colleagues in the States to share with us as much as they could their actual experience in bringing cases under their own laws.

And I do think, Mr. Chairman, that a fuller and deeper collaboration on our part with our State counterparts, even in the absence of new legislation—a fuller discussion about how local markets work would be an enormously valuable addition to the oversight of the sector.

Mr. STUPAK. Well, let me ask you this. The chart we point out earlier, from the ground to the pump, over there—it is the Washington Post looking at the price from September 2004 to September 2005.

And the cost of refinery went up 255 percent, as documented by that article, and it is part of our reference we have used many times on this committee.

Now, that is a national average. Now, wouldn't that constitute price gouging, 255 percent over a 12-month period?

Mr. KOVACIC. It would matter a lot to me how long it persisted, and part of that is the concern that, as my colleagues have mentioned, our system is so fragile.

There is so little room for error that comparatively small disruptions tend to have an enormous effect.

Mr. STUPAK. But those small disruptions affect the folks, our constituents, in that area, right?

Mr. KOVACIC. Unmistakably.

Mr. STUPAK. So like in 2005 when gas prices shot up in the Saginaw area, right outside my district, 74 cents in 1 day, while that is a small disruption to the FTC, that is real loss to consumers in that area.

Mr. KOVACIC. It is a powerful impact on local consumers, and there is no question that that causes enormous distress.

What we have seen in other industries is that it is the signal—and it is a bitter signal, to be sure, but it is the signal that draws more supplies into the area. So the reason concern of us is how long does it persist.

Mr. STUPAK. And the penalties here, in answer to Mr. Whitfield, you indicated may produce a great deal of caution amongst oil companies to move around supplies.

But you would also have to agree with me that the caution could be not to engage in these actions where you see 74 cents increase in 24 hours, or 255 percent increase in refining, could it not?

Mr. KOVACIC. It certainly could in some instances discourage what we might define as inappropriate behavior, and in particular I am thinking of instances in which people are not engaged in a repeated interaction with their customers.

That is, in most instances, and your constituents far better than I do, of course. All of you do. But my intuition is that the local gasoline dealer—and this is perhaps what Congresswoman Blackburn was mentioning. The local retailer encounters her customers again and again and again and in many ways is making investments in the community in goodwill. That person has no incentive to behave badly for short-term gain.

They might panic. They might make bad judgments. But they are not likely to be acting out of malice. It is the person who is engaged in one off transactions.

Mr. STUPAK. Now, I don't disagree with you. That is why the legislation says you have got to have $500 million in sales before we look twice at you. That is not mom and pop that Mrs. Blackburn was talking about.

But they are sort of captive, are they not? If I am handling ExxonMobil's gasoline, and they decide to run up the price, as my gas station owner told me over the weekend, 15 cents in one night, I don't have that much choice but to jack it up 15 cents or I eat the cost, right?

Mr. KOVACIC. That is right.

Mr. STUPAK. So mom and pop and the gas station owners are really at the mercy of the supplier or the refiner, are they not?

Mr. KOVACIC. The reason I mentioned mom and—they do depend on their existing supplier base. The reason I mentioned mom and pop is that—and perhaps I am misreading the text. The text that I have is that mom and pop may not be the priority, but they are covered.

Mr. STUPAK. Yes. Mom and pop are covered for those circumstances where you go—as Mr. Pruss indicated, when gas is running about $1.60—you go to $5 because you are afraid you may not have some supply tomorrow.

I think we would all agree that is price gouging, unless, in fact, you run out of gas tomorrow and there is none for you.

But the concern we have, as I indicated in our opening—that you know, we have seen, because of these mergers, over 200 refineries closed in the 1980's.

Today, the remaining refineries are operated by about 60 companies, where at one time it was 189 different companies running the refineries.

And we have all indicated today the more you merge, the more you merge, the greater chance there is not only to increase price because of the merger but also to influence and manipulate the price in the market, is there not?

If less people control the market, the greater the ability to manipulate the price.

Mr. KOVACIC. In general terms, at a specific point, that is true. Why I am hesitating a bit and stumbling a bit about is that that level of concentration nationwide is so dramatically small compared to so many of our other sectors that is a comparatively unconcentrated market.

That is, to have the bulk of the Nation's refinery capacity in the hands of 60 companies compares very favorably, if we are just looking at concentration, to the vast swath of American commerce for major goods and services.

Mr. STUPAK. So that is about 30 percent, what we had not even 20 years ago.

Mr. KOVACIC. Yes. Many of the disappearances were comparatively small companies that built artificially small refineries during the 1970's when we created a subsidy scheme that encouraged them to do it.

But in many sectors—imagine airlines. Imagine semiconductors. Imagine software. To think that there would be 60 companies instead of the number we have—that is, just looking at the numbers and taking that on its own terms, that is a big number in our economy.

Mr. STUPAK. We did that. We had those kind of numbers before we deregulated in the 1980's, and we are sort of all paying for it now.

Mr. KOVACIC. Not across the board. In many areas, that experience——

Mr. STUPAK. Take airlines. OK? I will tell you, come try to fly to my district some time.

Mr. KOVACIC. I have had many experiences, I think, flying that very same carrier to that very same airport in Romulus, and going onward, as you have, in many instances.

Mr. STUPAK. No, no, Romulus is easy. That is Detroit. Try to come to the Upper Peninsula of Michigan. Before deregulation, we could do it. Now we cannot.

Mr. KOVACIC. I would say the studies I am familiar with that look at the experience with the greater number of people who fly now, compared to where we were in 1978 when the reforms took place, airline deregulation, with lots of stickiness in places, has been a great success.

Although a certain merger that I think generated many of the circumstances we are talking about—Republic Northwest—the Department of Justice in the 1980's tried to stop it, and the Department of Transportation said go ahead. That unmistakably was a competition policy failure.

Mr. STUPAK. Well, the American people aren't seeing it in the studies. We are seeing it in our wallets in the lack of service.

Mr. Whitfield has a couple questions he would like to ask.

Mr. WHITFIELD. Yes, I would just make the comment that all of us, obviously, are interested in protecting the American consumer, and wrapping up this panel—the testimony that I have heard is that widespread price gouging has not been detected by any formal examination.

There has been sporadic retail price gouging at the retail level that may have occurred simply because small retailers did not have enough money to defend themselves and entered into some consent agreement.

The large oil companies, refiners—no one has gone after them, even though 29 States and the District of Columbia have laws in effect.

And I know that the attorney general of Kentucky has filed some complaints, and we will see how that works out.

But the testimony I heard today talked about basically these price increases that have hit recently have been the result of, one, refinery outages, the capacity—some of them are down; two, inventory is low; three, imports are low; and four, the demand is up.

And all of those—and I do look forward to Mr. Slocum's testimony, because he is with the Public Citizen's Energy Program, and I would be anxious to hear what he has to say as well.

But thank you all very much for your testimony, and this bill on price gouging will be on the House floor this week. It will be on suspension, so there won't be an opportunity to amend it.

But hopefully we can move forward and continue to address this issue. Thank you.

Mr. STUPAK. I want to thank this panel, and thanks for your patience. It has been a long day. And thanks for helping us with this issue. Thank you. This panel is excused.

We will call up our second panel of witnesses.

Next we have Mr. Tyson Slocum. He is the director of Public Citizen's Energy Program. And also, Mr. David Montgomery, vice president, CRA International here in Washington, DC.

And Mr. Sundstrom had to leave, but his written testimony will be part of our record.

[The prepared statement of Mr. Sundstrom follows:]

TESTIMONY OF GEOFF SUNDSTROM, DIRECTOR, PUBLIC AFFAIRS, AAA, HEATHROW, FL

Chairman Stupak, Ranking Member Whitfield, and members of the subcommittee, my name is Geoff Sundstrom, and I am AAA's director of Public Affairs. I am the association's primary spokesperson on motor fuel issues and have oversight responsibility for AAA's widely-sourced Fuel Gauge Report Web site which tracks national, State and local fuel prices each day. I also work with local AAA clubs on fuel price inquiries from members and the media in your home states.

AAA appreciates your invitation to appear before the Energy and Commerce Subcommittee on Oversight and Investigations to discuss the current escalation in gasoline prices. AAA's concern revolves around the impact rising prices have on consumers.

As you may know, AAA is the largest paid-membership organization in North America. Earlier this year we achieved the milestone of having 50 million members in the United States and Canada. Our members drive approximately 25 percent of all the motor vehicles in operation in the U.S. Using figures from the U.S. Department of Transportation, we estimate AAA members will purchase approximately 33 billion gallons of gasoline this year and at current prices will spend more than $100 billion on gasoline.

The important question is: With prices having risen more than 80 cents a gallon this year, are Americans driving less? The fact is that consumers at different income levels are affected differently by higher prices. There are affluent people in America for whom spending an additional $100 per month on gas is not an issue. Some people have other transportation options and flexibility and can reduce their consumption of higher-priced fuel. But the vast majority of Americans have no choice but to absorb the extra $50, $100, or $150 a month in gas prices. They have to go to work, take children to daycare, and go to the grocery store. This is not discretionary travel that can be limited.

Like it or not, gasoline is a significant part of many Americans' budgets. When gas prices increase, there is less money to save, invest or spend on goods and services. The extra expense results in a sacrifice elsewhere in a family's budget—groceries, healthcare, college savings, retirement planning.

Part of what we do at AAA is help motorists understand what they can do to reduce the burden of high gas prices, from vehicle maintenance to trip-chaining, to purchasing more efficient vehicles, there are things that Americans can do to mitigate the impacts of high fuel prices. We also work to help motorists understand what is going on in the fuel markets, and in times of crises, like after the hurricanes of 2005, to help them understand how their decisions can impact what happens in the market.

Unlike others that frequently comment on gasoline pricing, AAA has no involvement in the regulation, refining, shipping, blending or sale of gasoline. We do not trade oil and gasoline futures, operate hedge funds, sell mutual funds, distribute investment newsletters or make commissions on the sale of energy stocks.

AAA has increasingly found itself involved in the great national debate on America's energy future and has filled an important niche in objectively monitoring the price of fuel, advising consumers about fuel conservation and, to a limited degree, helping motorists anticipate what they might expect to pay to fuel their personal vehicles in coming months and years.

The summer travel season—which is important to our quality of life and crucial to the financial success of tens of thousands of tourism-related businesses across the country—is around the corner. On Memorial Day weekend we forecast that 38.3 million Americans will travel 50 miles or more, an increase of 1.7 percent from last year. Also, roughly 32.1 million travelers, or 84 percent of the total, will drive, up 1.8 percent from last year. During this time, American consumers will experience the highest average prices they have ever paid for gasoline. On Sunday, May 13, AAA's daily, online Fuel Gauge Report Web site recorded a highest-ever nationwide average price for self-serve regular gasoline of $3.073 per gallon. Since that time, the average price of self-serve regular has increased an additional 13 cents per gallon.

We have crossed the $3 per gallon threshold twice before. Prices topped out at $3.036 per gallon on August 7 of last year, after Israel invaded Lebanon. That price nearly reached the then-record average price of $3.057 per gallon paid by Americans on Labor Day Monday of 2005, after Hurricane Katrina temporarily closed or damaged critical oil and gasoline infrastructure along much of the Gulf Coast.

As frustrating and unpleasant as our two previous national experiences with $3 gasoline have been, both were accompanied by an oil price at or exceeding $75 per barrel and a natural or man-made disaster with the real or perceived ability to block the flow of petroleum for some period of time.

This summer is clearly different, however. This year, $75 oil prices and dramatic news about hurricane damage or a possible war throughout the Middle East are absent. Instead, we have high gasoline prices even though oil prices have rested comfortably near the $60 per barrel target set by OPEC for most of this year, amidst crude inventories that are routinely described as plentiful. Without OPEC, Mother Nature, or an imminent man-made catastrophe to blame for the high price of gasoline, it's fair to wonder : why?

I am certainly not appearing before this committee today to say that AAA has the answer. But as near as we can tell, there are strong indications the problem lies at least in part with the fact that the domestic refineries that supply gasoline to America's network of filling stations, as well as the companies that import gasoline from abroad for sale here, have been slow to supply the wholesale distribution network as consumer demand for their product has continued to rise.AAA leaves it to the experts at the U.S. Department of Energy to cite the specific numbers behind this situation. But we are concerned about the number and frequency of refinery outages this year and the impact that it has had on the system. There is clearly little margin for error. The fact that America is somehow losing ground in its ability to supply enough gasoline to our economy—not oil, which this committee knows is a different problem—is troubling. With the vast quantities of data generated and analyzed by public and private institutions and industry economists and statisticians, Americans should be able to expect that those who refine oil into gasoline can anticipate demand growth, plan to meet that growth, and then make the necessary investments in plants, equipment and labor to provide the fuel at a cost that has some semblance of stability.

AAA would like to say that no one can know with certainty the price of gasoline this summer. For example, it was our belief the national average price of self-serve regular would not exceed $3 per gallon this Spring, but this was before anyone knew gasoline inventories would drop for 12 consecutive weeks as refiners continued to

report equipment problems. Instead, what AAA tries to do is identify and describe a trend that points to a top or bottom for fuel pricing. We do this to help consumers anticipate what their monthly fuel expenses will be.

With that said, let's look at what we know right now: We know that gasoline inventories are critically low especially on the west coast; our refining and distribution infrastructure are stressed due to maintenance/investment issues, but also due to the introduction of ethanol into the blending process and our boutique fuel requirements; increased imports of gasoline, which have been growing, are hoped for but not assured; hurricane season is on the way; and much of the world's oil production shipping still takes place in a dangerous part of the world. We also know the stock market has just had a record run, demand for gasoline remains strong, and the summer travel season—which is important to our quality of life and crucial to the financial success of tens of thousands of tourism-related business across this country—is around the corner.

Knowing these things, and using our experience watching gasoline prices, the wholesale and retail gasoline prices generated for AAA by Oil Price Information Service, and the production, inventory and import numbers produced by DOE, AAA thinks prices are likely to move somewhat higher. But the much- predicted $4 per gallon gasoline will not materialize as a national average price unless the oil price marches into the $75 per barrel or higher range—a scenario that is only likely if an unknowable event such as a hurricane or geo-political conflict were to seriously threaten or disrupt energy flows. In making the projection to media that a $4 per gallon average gasoline price was not probable, AAA has been described in the last few weeks by some analysts as "conservative" and "not wanting to panic" consumers. In fact, our views simply reflect our interpretation of the best available data and analysis.

In closing, AAA would like to address the notion that if the price of gasoline goes high enough Americans will significantly reduce their gasoline consumption and help solve our energy problem. Again, though we do advocate that motorists conserve fuel and choose fuel efficient vehicles, AAA does not believe that Americans are frivolously driving around wasting either gasoline or money. According to AAA's most recent study of driving expenses, it costs 52.2 cents per mile to own and operate a typical new vehicle in the United States. That's $52.20 to drive 100 miles—and this number was calculated using an average fuel price from the fourth quarter of last year of just $2.26 per gallon. What we have seen based on many years of watching Americans' driving habits is that motorists reduce their discretionary driving only based on a significant slowdown in the economy and the possibility of job loss, or in response to gasoline shortages. While no one wants to pay high gasoline prices—and those prices do not inflict pain equally since those at the lower end of the economic scale are disproportionately burdened by rising prices - much of our driving is essential and at this point is not easily traded for other modes of transportation. Whether the result of geopolitical, refining, or distribution factors, the fluctuations in fuel prices underscore the Nation's vulnerability and the need to take a broad approach to securing a more diverse and sustainable supply of energy into the future. AAA acknowledges that fossil fuels will play a critical role in our Nation's economy for the foreseeable future, but we strongly believe steps must be taken to decrease our reliance on oil and refined gasoline to ensure the strength of our economy, the security of the Nation, and our way of life.Thank you again Mr. Chairman for allowing me to testify here today, and I look forward to answering any questions that you may have.

Mr. STUPAK. And as Members know, they can submit written questions, and we will leave the record open for 30 days, as is customary, for written records for any member who would like to be here.

Gentlemen, as you know, it is the policy of the subcommittee to take all testimony under oath. Please be advised that witnesses have a right under the rules of the House to be advised by counsel during testimony.

Do any of you wish to be represented by counsel? Mr. Slocum?

Mr. SLOCUM. No.

Mr. STUPAK. Mr. Montgomery?

Mr. MONTGOMERY. No.

Mr. STUPAK. OK. Would you rise and raise your right hand and take the oath?

[Witnesses sworn.]

The record should reflect both witnesses have replied in the affirmative.

Let me again extend my thank you to you for staying around. I know it has been a long afternoon. We have been in and out on the floor.

But, Mr. Slocum, if you would, your opening statement, please.

TESTIMONY OF TYSON SLOCUM, DIRECTOR, PUBLIC CITIZEN'S ENERGY PROGRAM

Mr. SLOCUM. Sure. Mr. Chairman and Mr. Whitfield, thank you very much.

My name, again, is Tyson Slocum. I am director of the Energy Program with Public Citizen. My organization represents over 100,000 consumers across the United States, and so I am testifying on behalf of them, as our constituents.

So the hearing is on gasoline prices and oil company profits, and what are some of the policy descriptions. And one thing that we have focused on at Public Citizen is some of the dynamic changes within the oil industry over just the last several years.

There is no doubt that there are several key variables that influence the price of oil and consequently the price of gasoline.

I think that one of the most important variables that often gets overlooked is what has been happening in the dynamics of the oil industry.

And one thing that is undeniable is that the number of mergers that have been approved over the last several years has dramatically changed the industry.

The industry is sometimes explained as a cyclical industry. These mergers, I would argue, are a direct response to that history of cycles of boom and bust. And these mergers were designed to put an end or to significantly limit that cyclical nature of the industry.

And I think that the proof is in the numbers. Public Citizen, compiling data obtained from the Energy Information Administration, shows that in 1993, for example, the largest five oil companies controlled roughly one-third of the national refining market share.

By 2005, the largest five controlled over 55 percent of the market. And the largest 10 controlled over 80 percent. That is a huge shift in the level of consolidation.

And that consolidation has resulted in higher prices at the pump. The GAO showed that in their 2004 study. And it is important to note that the GAO study stops in the year 2000.

Since 2000, of course, the mergers of Chevron Texaco, ConocoPhillips—Valero has been allowed to acquire several of its competitors. So since GAO's report ended, there have been a number of additional mergers.

And so Public Citizen is eager in seeing what the GAO comes up with as they are finishing the tabulations for that report.

So what is this consolidation translated into? The GAO concluded that it did result in higher gasoline prices. And again, all you have to do is look at the statistics.

The EIA, again, provides data on refining margins. And there, it is very clear. In the year that Exxon and Mobil were allowed to

merge, in 1999, the average refining margin in the United States was 18.9 cents.

By 2005, it had jumped 158 percent to 48.8 cents. That is in 2005. 2006 was another record-breaking year for the industry, so I think we can expect those refining margins to be far higher.

I took a look in BP's financial statements, for example, and saw that the refining margins at its U.S. operations—specifically, on the west coast—were almost triple that of their refining margins in their European operations.

And again, this is played out in ExxonMobil's financial statements. In their 10(k) annual report filed with the Securities and Exchange Commission, they reported a return on capital investment on their U.S. refining operations to be 66 percent. Compare that with their non-U.S. refining margin of 24.5 percent.

So again, international global oil companies are reporting the biggest profits, the biggest profit margins, on their American operations. And that, to me, is troubling.

A lot of the discussion has been on the merits of price gouging legislation. I think that it is clear that oil companies have been engaging in price gouging.

No doubt, oil companies work very hard to produce a critical commodity for the U.S. consumer and for the U.S. economy. And the are entitled to a fair and reasonable return on their hard work and ingenuity.

And the question is are these latest profit numbers—not just for 2006, not just for the first quarter of 2007, but over the last several years, they have demonstrated a pattern, a pattern of substantially high profits historically, and profits that will continue because of the dynamic changes within the industry resulting from industry consolidation.

Now, it would be one thing if the industry was using these record profits to then reinvest back into their aging infrastructure to help, long term, alleviate some of these pressures for consumers.

Again, the numbers tell a different story. For example, in ExxonMobil's 10(k) report, they show that they spent $824 million in capital investment on their U.S. downstream sector.

Compare that with $37.2 billion that ExxonMobil spent buying back its own stock and paying dividends to shareholders.

This shows that the high prices that consumers are paying at the pump are not being adequately reinvested into the aging infrastructure, but are simply going into the pockets of oil company executives and shareholders.

Granted, there are many lucky motorists out there who also happen to be shareholders of these companies. But the vast majority are not.

And so the issue here is why are consumers paying these record high prices when the oil companies are not adequately reinvesting their record earnings back into the aging infrastructure.

And Public Citizen would argue that this is a major contributing factor to a lot of the outages that we are seeing. Some of the witnesses in the previous panel testified to the fact that a number of the outages are unplanned.

And you have to wonder, would these have been avoided had the oil industry been more responsible with its record earnings and re-

invested more of their record profits back into the type of investments that consumers need to have access to an adequately competitive market.

So one of the solutions that Public Citizen supports is, I think, some sort of price gouging legislation. I think that right now, there isn't an adequate cop on the beat.

I think that the Federal Trade Commission hasn't had enough tools at their disposal to enforce the types of activities that we are seeing, particularly unilateral withholding and other things that fall between the cracks of our antitrust statutes.

And I think that a price gouging law would help fill in those cracks and provide the kind of enforcement that consumers need.

Public Citizen also believes that it is time to stop subsidizing mature, profitable oil companies. The taxpayer provides between $5 billion and $8 billion in subsidies a year.

That is between tax breaks, royalty relief and various Department of Energy spending programs to profitable oil companies. We think that those days of providing subsidies to big oil is no longer necessary.

And we would rather shift that money into the kind of investments that will help American families, things like expanding access to mass transit, giving bigger financial incentives for fuel-efficient and alternative fuel vehicles.

So I appreciate your time, and I look forward to any questions you may have. Thank you very much.

[The prepared testimony of Mr. Slocum follows:]

May 22, 2007

Testimony of Tyson Slocum, Director
Public Citizen's Energy Program
www.citizen.org

U.S. House Committee on Energy and Commerce, Subcommittee on Oversight and Investigations

"Gasoline Prices, Oil Company Profits, and the American Consumer"

Thank you, Mr. Chairman and members of the Subcommittee on Oversight and Investigations for the opportunity to testify on the issue of gasoline prices. My name is Tyson Slocum and I am Director of Public Citizen's Energy Program. Public Citizen is a 36-year old public interest organization with over 100,000 members nationwide. We represent consumer interests through research, public education and grassroots organizing.

Gasoline prices have nearly tripled in the last five years, creating financial hardship for millions of families, as the average annual expenditure on gasoline increased $1,000 for the typical family over that time.[1] While some households have been able to reduce their consumption in response to these high prices by either investing in a more fuel-efficient or alternative-fuel car, taking mass transit or weatherizing their home to cut down on home heating oil costs, most lack the financial resources to make such investments or lack access to alternatives to driving in their car. That explains why, even in the face of skyrocketing gasoline prices, consumption has not moderated.

While American families pay record high prices, oil companies are enjoying the strongest profits in the economy. Since 2001, the largest six oil companies operating in the United States—ExxonMobil, ChevronTexaco, ConocoPhillips, BP, Shell and Valero—recorded $477 billion in profits.[2] Recent entries to oil markets like investment banks, hedge funds and private equity firms have also been posting record earnings. While some of their profit clearly stems from certain aspects of global supply and demand, investigations show that a portion of these record earnings are fueled by market manipulation and other anti-competitative practices, made possible by the wave of recent mergers and weak regulatory oversight, thereby denying Americans access to competitive markets. To add insult to injury, oil companies enjoy billions of dollars worth of subsidies courtesy of the U.S. taxpayer at a time when the industry records record profits. Investing in America's communities—not Big Oil—is needed to provide families with access to alternatives.

Public Citizen research shows that oil companies aren't adequately investing these record earnings into projects that will help consumers, as the largest capital expenditure in 2006

---

[1] http://judiciary.house.gov/media/pdfs/Cooper070516.pdf
[2] Public Citizen calculations from company financial reports.

was to buy back stock and pay dividends to shareholders. America's addiction to oil is a major source of greenhouse gas emissions that cause global warming. Forty-four percent of America's world-leading carbon dioxide emissions are from the burning of petroleum products.[3] Until the oil industry takes the lead on prioritizing investments to curb America's addiction, Congress should take steps to revoke oil company subsidies or impose a windfall profits tax to finance sustainable energy solutions.

In addition, energy trading markets, where futures prices of oil and gasoline are set, were recently deregulated, providing new opportunities for oil companies and financial firms to manipulate prices. Investigations show that energy trading firms have not only exploited recently weakened regulatory oversight, but a new trend of energy traders controlling energy infrastructure assets like pipelines and storage facilities provide additional abilities to use "insider" information to help manipulate markets.

Public Citizen has a five point plan for reform:

- Repeal all existing oil company tax breaks, close loopholes allowing oil companies to escape paying adequate royalties and/or implement a windfall profits tax, dedicating the new revenues to financing clean energy, energy efficiency and mass transit.
- Strengthen antitrust laws by empowering the Federal Trade Commission to crack down on unilateral withholding and other anti-competitive actions by oil companies. Re-evaluate recently approved mergers.
- Establish a Strategic Refining Reserve to be financed by a windfall profits tax on oil companies that would complement America's Strategic Petroleum Reserve.
- Re-regulate energy trading exchanges to restore transparency and impose firewalls to stop energy traders from speculating on information gleaned from the companies' affiliates.
- Improve fuel economy standards to reduce gasoline demand.

Recent Mergers, Weak Anti-Trust Law Threaten Consumers

According to the U.S. Government Accountability Office, over 2,600 mergers have been approved in the U.S. petroleum industry since the 1990s.[4] In just the last few years, mergers between giant oil companies—such as Exxon and Mobil, Chevron and Texaco, Conoco and Phillips—have resulted in just a few companies controlling a significant amount of America's gasoline, squelching competition. And the mergers continue unabated as the big just keep getting bigger. In August 2005, ChevronTexaco acquired Unocal; ConocoPhillips acquired Burlington Resources in December 2005; and in June 2006, Anadarko Petroleum announced it was simultaneously acquiring Kerr-McGee and Western Gas Resources. ExxonMobil, ChevronTexaco, ConocoPhillips, BP and Shell produce 10 million barrels of oil a day—more than the combined exports of Saudi Arabia and Qatar.

---

[3] Available at www.eia.doe.gov/environment.html

[4] *Mergers and Other Factors that Affect the U.S. Refining Industry*, U.S. Government Accountability Office, July 2004, GAO-04-982T, Page 2, available at www.gao.gov/new.items/d04982t.pdf

Consumers are paying more at the pump than they would if they had access to competitive markets, and five oil companies are reaping the largest profits in history. Since 2001, the six largest oil companies operating in America have recorded $477 billion in profits. While of course America's tremendous appetite for gasoline plays a role, uncompetitive practices by oil corporations are a cause—more so than OPEC or environmental laws—of high gasoline prices around the country.

High prices are having a detrimental impact on the economy and national security. Imported oil represents one-third of America's trade deficit,[5] slows economic growth, adds to inflationary pressures and creates financial hardship for families and businesses.

Motorists are not getting any bang for their buck. While drivers are stuck paying record high prices, oil companies are spending more money buying back their own stock then they are on investing in their ageing infrastructure. The industry leader, ExxonMobil, spent $25.4 billion buying back its stock and paying dividends to its shareholders in 2006, while spending only $17.7 billion worldwide on its oil exploration and refining capital investment.

No Bang for Our Buck: ExxonMobil Spends More Buying Its Stock Than on Reinvesting in Its Ageing Infrastructure ($ billions)

	2005	2006	1st Q '07
Capital & Exploration Expenditures	**$ 17.7**	**$ 19.9**	**$ 4.2**
Upstream, U.S.	2.1	2.5	n/a
Downstream, U.S.	0.8	0.8	n/a
% invested in U.S.	16%	17%	n/a
Total Profit	$ 36.1	$ 39.5	$ 9.3
Total Profit Earned in U.S.	10.1	9.4	2.0
% of Profit Earned in U.S.	28%	24%	22%
Share Buybacks	$ 18.2	$ 29.6	$ 7.0
Dividend Payments	7.2	7.6	1.8
total for Shareholders	**$ 25.4**	**$ 37.2**	**$ 8.8**
% more spent on shareholders vs capital investment	**+44%**	**+87%**	**+108%**

In just the last few years, mergers between giant oil companies—such as Exxon and Mobil, Chevron and Texaco, Conoco and Phillips—have resulted in just a few companies controlling a significant amount of America's gasoline, squelching competition. Public Citizen research shows that in 1993, the largest five oil refiners controlled one-third of the American market, while the largest 10 had 55.6 percent. By 2005, as a result of all the mergers, the largest five now control 55 percent of the market, and the largest 10 dominate 81.4 percent (see Appendix 1). This concentration has led to skyrocketing profit margins. As a result of all of these recent mergers, the largest five oil refiners today control as much capacity as the largest 10 did a decade ago.

[5] Available at www.bea.gov/bea/di/home/trade.htm

The consolidation of downstream assets—particularly refineries—plays a big role in determining the price of a gallon of gas. Recent mergers have resulted in dangerously concentrated levels of ownership over U.S. oil refining. A recent government study revealed that the "source of potential market power in the wholesale gasoline market is at the refining level because the refinery market is imperfectly competitive and refiners essentially control gasoline sales at the wholesale level" and concluded that "mergers and increased market concentration generally led to higher wholesale gasoline prices in the United States."[6]

The industry has plenty of incentive to intentionally keep refining markets tight. ExxonMobil's new CEO told *The Wall Street Journal* that even though American fuel consumption will continue growing for the next decade, his company has no plans to build new refineries:

> *Exxon Mobil Corp. says it believes that, by 2030, hybrid gasoline-and-electric cars and light trucks will account for nearly 30% of new-vehicle sales in the U.S. and Canada. That surge is part of a broader shift toward fuel efficiency that Exxon thinks will cause fuel consumption by North American cars and light trucks to peak around 2020—and then start to fall. "For that reason, we wouldn't build a grassroots refinery" in the U.S., Rex Tillerson, Exxon's chairman and chief executive, said in a recent interview. Exxon has continued to expand the capacity of its existing refineries. But building a new refinery from scratch, Exxon believes, would be bad for long-term business.*[7]

ExxonMobil and other major oil companies are not building new refineries because it is in their financial self interest to keep refining margins as tight as possible, as that translates into bigger profits.

We're Not in Kansas Anymore

In 2005, Wall Street investment bank Goldman Sachs and private equity firm Kelso & Co. bought a 112,000 barrels/day oil refinery in Kansas, demonstrating how major energy traders are now acquiring hard energy assets.

Margins for U.S. oil refiners have been at record highs. In 1999, U.S. oil refiners enjoyed a 18.9 cent margin for every gallon refined from crude oil. By 2005, they posted a 48.8 cent margin for every gallon of gasoline refined, a 158 percent jump.[8] That forced *The Wall Street Journal* to conclude that "the U.S. market is especially lucrative, sometimes earning its refiners $20 or more on every barrel of crude oil they refine."[9] Another *Wall Street Journal* article notes:

> *On a per-barrel basis, the difference between crude prices and gasoline prices, known as the "crack spread" and considered to be a proxy for refining profit*

[6] *Mergers and Other Factors that Affect the U.S. Refining Industry*, U.S. Government Accountability Office, July 2004, GAO-04-982T, available at www.gao.gov/new.items/d04982t.pdf

[7] Jeffrey Ball, "As Gasoline Prices Soar, Americans Resist Major Cuts in Consumption," May 1, 2006.

[8] *Refiner Sales Prices and Refiner Margins for Selected Petroleum Products, 1989-2005*, available at www.eia.doe.gov/emeu/aer/pdf/pages/sec5_53.pdf

[9] Steve LeVine and Patrick Barta, "Giant New Oil Refinery in India Shows Forces Roiling Industry," August 29, 2006.

> *margins, widened to more than $23 a barrel [in March 2007], the highest level this year and up from this year's low of less than $5 on Jan. 31. Last year, the spread briefly topped $26 a barrel in April [2006], and following the devastation Hurricane Katrina of 2005, it ballooned to $40.87. In recent years, the spread has averaged about $10 a barrel...rising gasoline prices tend to lift crude prices because they boost refinery margins, leading to a rise in crude-oil demand."*[10]

Indeed, BP's most recent financial report shows that refining profit margins at their US operations are more than double the margins in other countries. In 2006, BP earned $9.14 for every barrel they refined in the Midwest, $12/barrel in the Gulf Coast and $14.84/barrel on the West Coast. Compare these returns with those at BP's English operations ($3.92/barrel) and Singapore ($4.22/barrel).[11]

While major oil companies haven't applied for a permit to build a new refinery, a small start-up has: Arizona Clean Fuels.[12] The company is successfully obtaining the necessary air quality permits to build the facility, which begs the question: if a small company can do it, why can't ExxonMobil, the world's most profitable corporation, do it?

Concentration of refinery markets has been compounded by consolidation in gasoline marketing. Refiners get gasoline to the market by distributing their product through terminals, where jobbers then deliver to retail gas stations. The number of terminals available to jobbers in the U.S. was cut in half from 1982 to 1997, leaving retailers with fewer options if one terminal raises prices.[13]

As a result of this strategy of keeping refining capacity tight, energy traders in New York are pushing the price of gasoline higher, and then trading the price of crude oil up to *follow* gasoline:

> *"Last time, Mother Nature intervened in the market [in the form of Hurricane Katrina]," [Larry] Goldstein [president of New York-based Petroleum Industry Research Foundation] said. "This time, prices are being driven by market forces," **with gasoline pulling crude and other forms of fuel higher**, he says.*[14]

Since gasoline futures are a more localized market than crude oil, it is easier for oil companies, hedge funds and investment banks to manipulate gasoline markets. Now that crude oil trading often follows the gasoline markets, the ability of these traders to exploit America's underregulated futures markets raises concerns that consumers are being price-gouged.

High domestic inventories are not suppressing prices. In April 2006, U.S. commercial inventories of crude oil surpassed 347 million barrels—the highest level since May

---

[10] Masood Farivar, "Crude-Oil Futures Decline as Gasoline Surges," March 17-18, 2007, Page B5.
[11] www.bp.com/liveassets/bp_internet/globalbp/STAGING/global_assets/downloads/B/bp_fourth_quarter_and_full_year_2006_results.pdf, page 8.
[12] www.arizonacleanfuels.com
[13] *The Petroleum Industry: Mergers, Structural Change and Antitrust Enforcement,* Federal Trade Commission, Table 9-1, August 2004, available at www.ftc.gov/os/2004/08/040813mergersinpetrolberpt.pdf
[14] Bhushan Bahree, "Oil Prices Show No Sign of Slowing," *The Wall Street Journal*, April 10, 2006.

1998.[15] Current amounts remain at historically high levels, demonstrating that while we have plenty of surplus crude, problems lie with accessing refined products. Consumers are paying a premium not because of problems in crude oil markets, but rather the problems in the refining markets. And the biggest problem in the refining market is the industry lacks financial incentive to expand capacity to create a surplus.

The U.S. Federal Trade Commission found evidence of anti-competitive practices in its March 2001 *Midwest Gasoline Price Investigation*:[16]

> *An executive of [one] company made clear that he would rather sell less gasoline and earn a higher margin on each gallon sold than sell more gasoline and earn a lower margin. Another employee of this firm raised concerns about oversupplying the market and thereby reducing the high market prices. A decision to limit supply does not violate the antitrust laws, absent some agreement among firms. Firms that withheld or delayed shipping additional supply in the face of a price spike did not violate the antitrust laws. In each instance, the firms chose strategies they thought would maximize their profits.*

Although federal investigators found ample evidence of oil companies intentionally withholding supplies from the market in the summer of 2000, the government has not taken any action to prevent recurrence. S.2557, introduced by Senator Arlen Specter (R-Penn.), and its House companion HR 5279 introduced by Representative John Conyers, would amend the Clayton Act to make it unlawful oil companies to engage in unilateral withholding.[17] But neither of these bills received a hearing in the 109th Congress.

A congressional investigation uncovered internal memos written by major oil companies operating in the U.S. discussing their successful strategies to maximize profits by forcing independent refineries out of business, resulting in tighter refinery capacity. From 1995-2005, 97 percent of the nearly 929,000 barrels of oil per day of capacity that has been shut down were owned by smaller, independent refiners.[18] Were this capacity to be in operation today, refiners could use it to better meet today's reformulated gasoline blend needs.

Taxing Oil Company Profits

Apologists for record oil company profits argue that the companies need and deserve record windfalls to provide the necessary market incentive to invest more money into increased energy production.

Public Citizen's analysis of oil company profits and their investments show that they are spending unprecedented sums on benefits for their shareholders in the form of stock buybacks and dividend payments and not adequately investing in sustainable energy that is necessary to end America's addiction to oil. Since January 2005, the top five oil companies have spent $172 billion buying back stock and paying out dividends. In

---

[15] Available at http://tonto.eia.doe.gov/dnav/pet/hist/mcestus1m.htm

[16] "Midwest Gasoline Price Investigation," available at www.ftc.gov/os/2001/03/mwgasrpt.htm

[17] Available at www.govtrack.us/data/us/bills.text/109/s/s2557.pdf

[18] Energy Information Administration Form EIA-820, *Annual Refinery Report.*

addition, they held $56 billion in cash.[19] This not only represents a huge transfer of wealth from consumers to oil company investors, but shows that oil companies are squandering opportunities to use their record profits to make investments that will end America's addiction to oil.

With nearly $1 trillion of combined assets tied up in extracting, refining and marketing petroleum and natural gas, the big five oil companies' entire business model is designed to squeeze every last cent of profit out of their monopoly control over fossil fuels. They simply will not make significant investments in anything else until their monopoly control over oil is spent.

Billions for Investors But Not for Sustainable Energy

	Profit Since 2005	Amount Spent on Stock Buybacks & Dividends Since 2005	Cash on Hand as of April 2007
ExxonMobil	$ 84,910,000,000	$ 62,600,000,000	$ 29,994,000,000
Shell	$ 57,985,000,000	$ 34,943,000,000	$ 11,184,000,000
BP	$ 46,910,000,000	$ 47,088,000,000	$ 1,956,000,000
ChevronTexaco	$ 35,937,000,000	$ 18,516,000,000	$ 11,800,000,000
ConocoPhillips	$ 33,440,000,000	$ 8,422,000,000	$ 860,000,000
Total	$ 259,182,000,000	$ 171,569,000,000	$ 55,794,000,000

And this monopoly control translates into unprecedented profits. When communicating to the general public and lawmakers, oil companies downplay these record earnings by calculating profits differently than they do when they speak to Wall Street and shareholders. Conversing with lawmakers and the general public, the oil industry highlights the small profit margins (typically around 8 to 10 percent) that measuring net income as a share of total revenues produces.

But that's not the calculation ExxonMobil and other energy companies use when talking to investors and Wall Street. For example, here's an excerpt from the company's 2005 annual report: "ExxonMobil believes that return on average capital employed (ROCE) is the most relevant metric for measuring financial performance in a capital-intensive business such as" petroleum.[20]

ExxonMobil's 2006 earning report shows that that the company's global operations enjoyed a 32 percent rate of return on average capital employed. And the company's rate of profit in the U.S. was even higher: domestic drilling provided a 37 percent rate of return on average capital employed, while domestic refining returned 66 percent. ChevronTexaco has posted record returns as well, reporting a 23 percent rate of return on average capital employed in 2006—the median return on capital employed for Chevron over the last 18 years was only 8.6 percent.

---

[19] Public Citizen calculations from company financial reports.

[20] Available at www.exxonmobil.com/corporate/files/corporate/sar_2005.pdf, page 19.

It isn't just oil producing nations like Saudi Arabia that get rich when the price of a barrel of oil exceeds $60—major oil producing corporations get rich, too. On average, it costs an oil company like ExxonMobil about $20 to extract a barrel of oil from the ground, while they sell that barrel to American consumers at the market price of $60/barrel. Indeed, a Merrill Lynch analyst estimated that "ConocoPhillip's overall 'finding and developing' costs last year were $18 a barrel, including barrels obtained through acquisitions."[21]

With oil companies failing to take action to protect America's middle- and low-income families from the high energy prices that fuel their profits, oil industry subsidies should be repealed with the proceeds invested in renewables, alternative fuels, energy efficiency and mass transit. Indeed, HR 6, which passed the House on January 18, 2007 repeals $14 billion in oil company subsidies over the next decade and dedicates the money to a new "Strategic Energy Efficiency and Renewables Reserve."[22] A windfall profits tax could be modeled on HR 2070, introduced in the 109th Congress.[23]

Naysayers argue that increasing taxes on oil companies or enacting a Windfall Profits Tax didn't work the last time it was tried. The Windfall Profits Tax of 1980-88 was ineffective not because of the tax itself, but because oil prices fell shortly after enactment of the tax due to global events unrelated to U.S. tax policy. Congress enacted the Windfall Profits Tax in 1980 after U.S. oil company profits surged following the Iranian Revolution and the resulting Iran-Iraq war, which caused oil prices to increase from $14/barrel in 1979 to $35/barrel by January 1981. But after 1981, crude oil prices steadily decreased until completely bottoming out in 1986-87 as demand slackened and as other oil producing countries increased their output. As the value of the commodity subject to tax fell, the effectiveness of the tax was diminished.

But that was then. *The Wall Street Journal* recently concluded that "a crash looks unlikely now, both because supplies remain tight and because of the large volumes of money that investors are pouring into oil markets."[24]

In addition to a Windfall Profits Tax, Congress needs to reform the royalty system imposed on companies drilling for oil and natural gas on public land. One-third of the oil and natural gas produced in the United States comes from land owned by the taxpayers, but royalty payments by oil companies have not been keeping up with the explosion in energy prices and profits enjoyed by the industry. A recent Inspector General audit of the U.S. Department of the Interior's Minerals Management Service concludes that oil companies are pumping oil from federal land without paying adequate royalties to taxpayers for the privilege. The report cites widespread cronyism, ethical breaches, decimated auditing staff and overreliance on information provided by Big Oil as culprits in the oil industry giveaway.[25] Meanwhile the Justice Department unexpectedly

---

[21] Russell Gold, "Big Oil's Earnings Gusher Starts to Slow," *The Wall Street Journal*, January 25, 2007, Page A2.
[22] For more information see www.citizen.org/pressroom/release.cfm?ID=2362
[23] www.govtrack.us/data/us/bills.text/109/h/h2070.pdf
[24] Bhushan Bahree, "Oil Settles Above $70 a Barrel, Despite Inventories at 8-year High," April 18, 2006.
[25] "Minerals Management Service's Compliance Review Process," December 2006, available at www.doioig.gov/upload/2007-G-00011.pdf

announced the welcome news that it has initiated criminal investigations into the Interior Department's oversight of oil companies.[26] Taxpayers must be fairly compensated for allowing oil companies the privilege of extracting resources from federally-owned land.

Public Citizen also recommends repealing all federal subsidies currently enjoyed by the oil industry and transferring those expenditures to renewable energy, energy efficiency and mass transit. Public Citizen estimates that the oil industry receives 65 percent of all federal government energy tax breaks and government spending programs, estimated at as much as $8 billion annually, including:[27]

- Excess of percentage over cost depletion.
- Credit for enhanced oil recovery costs.
- Expensing of exploration and development costs.
- Exception from passive loss limitation for working interests in oil and gas properties.
- Last in, first out accounting for vertically integrated oil companies.
- "Geological and geophysical" costs from Section 1329 of EPACT 2005.
- Oil refinery expensing from Section 1323 of EPACT 2005.
- Deductions for foreign taxes.
- Manufacturing tax deduction from Section 102 of HR 4520 passed in 2004.
- Various Department of Energy spending programs, including the Ultra-Deepwater drilling subsidy in Title IX, Subtitle J of EPACT 2005.

Other countries often feature higher gas prices than the U.S., but that is because they impose higher taxes on gasoline than we do. For example, the average federal, state and local gas taxes in the United States are 39 cents/gallon, compared to $2.06/gallon in Japan, $3.77/gallon in France; $4.12/gallon in Germany; and $4.33/gallon in the United Kingdom.[28] These high taxes are not only a disincentive to drive, but generate the revenue the countries need to help subsidize mass transit and other sustainable energy investments to actively provide citizens with alternatives to driving.

FTC Not Adequately Protecting Consumers

The Federal Trade Commission has contributed to the problem by allowing too many mergers and taking a stance too permissive to anti-competitive practices, as evidenced by the conclusions in its most recent investigation, for example, finding evidence of price-gouging by oil companies but explaining it away as profit maximization strategies and opposing federal price-gouging statutes.[29] This stands in stark contrast to the May 2004 conclusions reached by a U.S. Government Accountability Office report[30] which found

---

[26] Edmund L. Andrews, "Criminal Inquiries Look at U.S. Oil-Gas Unit," *The New York Times*, December 15, 2006.

[27] Based on data contained in *Inventory of Major Federal Energy Programs and Status of Policy Recommendations*, The U.S. Government Accountability Office, GAO-05-379, June 2005, www.gao.gov/new.items/d05379.pdf

[28] www.fhwa.dot.gov/ohim/mmfr/sep06/mftrates.htm

[29] "Investigation of Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases," available at www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf

[30] *Effects of Mergers and Market Concentration in the U.S. Petroleum Industry*, GAO-04-96, available at www.gao.gov/new.items/d0496.pdf

that recent mergers in the oil industry have directly led to higher prices. It is important to note that this GAO report severely *underestimates* the impact mergers have on prices because their price analysis *stops* in 2000—before the mergers that created ChevronTexaco-Unocal, ConocoPhillips-Burlington Resources, and Valero-Ultramar/Diamond Shamrock-Premcor.

The FTC consistently allows refining capacity to be controlled by fewer hands, allowing companies to keep most of their refining assets when they merge, as a recent overview of FTC-approved mergers demonstrates.

The major condition demanded by the FTC for approval of the August 2002 ConocoPhillips merger was that the company had to sell two of its refineries—representing less than four percent of its capacity. Phillips was required only to sell a Utah refinery, and Conoco had to sell a Colorado refinery. But even with this forced sale, ConocoPhillips remains the largest domestic refiner, controlling refineries with capacity of more than 2.2 million barrels of oil per day, or 13 percent of America's entire capacity. And the FTC allowed ConocoPhillips to purchase Premcor's 300,000 barrels/day Illinois refinery in 2004.

As a condition of the 1999 merger creating ExxonMobil, Exxon had to sell some of its gas retail stations in the Northeast U.S. and a single oil refinery in California. Valero Energy, the nation's fifth largest owner of oil refineries, purchased these assets. The inadequacy of the forced divestiture mandated by the FTC was compounded by the fact that the assets were simply transferred to another large oil company, ensuring that the consolidation of the largest companies remained high.

The sale of the Golden Eagle refinery was ordered by the FTC as a condition of Valero's purchase of Ultramar Diamond Shamrock in 2001. Just as with ExxonMobil and ChevronTexaco, Valero sold the refinery, along with 70 retail gas stations, to another large company, Tesoro. But while the FTC forced Valero to sell one of its four California refineries, the agency allowed the company to purchase Orion Refining's only refinery in July 2003, and then approved Valero's purchase of the U.S. oil refinery company Premcor. This acquisition of Orion's Louisiana refinery and Premcor defeats the original intent of the FTC's order for Valero to divest one of its California refineries.

In response to the Carlyle/Riverstone 2006 acquisition of Kinder Morgan, the FTC only required that Carlyle/Riverstone's investment in Magellan be changed to *passive*. The FTC required no firewalls or other restrictions between Goldman Sachs' energy trading affiliate (J. Aron) and the Kinder Morgan affiliate.[31]

Rule of Reason versus Per Se Antitrust Analysis

A recent Supreme Court decision continued an unfortunate trend of relying on the *rule of reason* rather than a *per se* analysis of alleged anticompetitive conduct. *Per se* offenses are those that are, on their face, illegal, with no economic justification. All *per se*

[31] "FTC Challenges Acquisition of Interests in Kinder Morgan, Inc. by The Carlyle Group and Riverstone Holdings," available at www.ftc.gov/opa/2007/01/kindermorgan.htm

offences are violations of section 1 of the Sherman Act. As the Supreme Court has argued:

> *...there are certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use.*[32]

Examples of *per se* antitrust violations include: horizontal and vertical price fixing, bid rigging, territorial allocation and tying arrangements.

A *rule of reason* standard, on the other hand, is one where the activity is judged in context and the reasonableness is considered. Therefore, an action that otherwise would be unlawful could be judged to be in compliance with the Sherman Act if the conduct surrounding the unlawful activity is deemed to justify it.

Clearly then, courts that favor a *rule of reason* standard over *per se* condone otherwise uncompetitive actions. Such is the case in *Texaco* v. *Dagher*, where the Supreme Court ruled in February 2006 that a joint venture Equilon between two competitors, Shell and Texaco, that resulted in the companies unilaterally setting prices that the venture charged customers.[33] As an amicus brief filed by the American Antitrust Institute explained:

> *Evidence suggests that Shell and Texaco officials had deliberately refrained from discussing brand pricing prior to the formation of the venture "because of anti-trust concerns." Of greatest significance, Respondents offered evidence that Equilon sharply raised the price of its gasoline, at a time when crude oil prices were stable or declining...Shell and Texaco were not seeking to create a more efficient competitor in a competitive marketplace, but to profit by lessening competition between the two former rivals."*[34]

But because the Court relied on a *rule of reason* analysis, this anti-competitive practice was deemed to be in compliance with the Sherman Act.

Energy Trading Abuses Require Stronger Oversight

Two regulatory lapses are enabling anti-competitive practices in energy trading markets where prices of energy are set. First, oil companies, investment banks and hedge funds are exploiting recently deregulated energy trading markets to manipulate energy prices. Second, energy traders are speculating on information gleaned from their own company's energy infrastructure affiliates, a type of legal "insider trading." These regulatory loopholes were born of inappropriate contacts between public officials and powerful energy companies and have resulted in more volatile and higher prices for consumers.

---

[32] *Northern Pacific Railroad Co.* v. *United States*, 356 US 1, 5 (1957)
[33] Available at www.supremecourtus.gov/opinions/05pdf/04-805.pdf
[34] At 3, 6, available at www.antitrustinstitute.org/archives/files/465.pdf

Contrary to some public opinion, oil prices are not set by the Organization of Petroleum Exporting Countries (OPEC); rather, they are determined by the actions of energy traders in markets. Historically, most crude oil has been purchased through either fixed-term contracts or on the "spot" market. There have been long-standing futures markets for crude oil, led by the New York Mercantile Exchange (NYMEX) and London's International Petroleum Exchange (which was acquired in 2001 by an Atlanta-based unregulated electronic exchange, ICE). NYMEX is a floor exchange regulated by the U.S Commodity Futures Trading Commission (CFTC). The futures market has historically served to hedge risks against price volatility and for price discovery. Only a tiny fraction of futures trades result in the physical delivery of crude oil.

The CFTC enforces the Commodity Exchange Act, which gives the Commission authority to investigate and prosecute market manipulation.[35] But after a series of deregulation moves by the CFTC and Congress, the futures markets have been increasingly driven by the unregulated over-the-counter (OTC) market over the last few years. These electronic OTC markets have been serving more as pure speculative markets, rather than traditional volatility hedging or price discovery. And, importantly, this new speculative activity is occurring outside the regulatory jurisdiction of the CFTC.

Energy trading markets were deregulated in two steps. First, in response to a petition by nine energy and financial companies, led by Enron[36], on November 16, 1992, then-CFTC Chairwoman Wendy Gramm supported a rule change—later known as Rule 35—exempting certain energy trading contracts from the requirement that they be traded on a regulated exchange like NYMEX, thereby allowing companies like Enron and Goldman Sachs to begin trading energy futures between themselves outside regulated exchanges. Importantly, the new rule also exempted energy contracts from the anti-fraud provisions of the Commodity Exchange Act.[37] At the same time, Gramm initiated a proposed order granting a similar exemption to large commercial participants in various energy contracts that was later approved in April 2003.[38]

Enron had close ties to Wendy Gramm's husband, then-Texas Senator Phil Gramm. Of the nine companies writing letters of support for the rule change, Enron made by far the largest contributions to Phil Gramm's campaign fund at that time, giving $34,100.[39]

Wendy Gramm's decision was controversial. Then- chairman of a House Agriculture subcommittee with jurisdiction over the CFTC, Rep. Glen English, protested that Wendy Gramm's action prevented the CFTC from intervening in basic energy futures contracts disputes, even in cases of fraud, noting that that "in my 18 years in Congress [Gramm's motion to deregulate] is the most irresponsible decision I have come across." Sheila Bair, the CFTC commissioner casting the lone dissenting vote, argued that deregulation of

[35] 7 USC §§ 9, 13b and 13(a)(2).

[36] The other eight companies were: BP, Coastal Corp (now El Paso Corp.) Conoco and Phillips (now ConocoPhillips), Goldman Sachs' J. Aron & Co, Koch Industries, Mobil (now ExxonMobil) and Phibro Energy (now a subsidiary of CitiGroup).

[37] 17 CFR Ch. 1, available at www.access.gpo.gov/nara/cfr/waisidx_06/17cfr35_06.html

[38] "Exemption for Certain Contracts Involving Energy Products," 58 Fed. Reg. 6250 (1993).

[39] Charles Lewis, "The Buying of the President 1996," pg 153. The Center for Public Integrity.

energy futures contracts "sets a dangerous precedent."[40] A U.S. General Accounting Office report issued a year later urged Congress to increase regulatory oversight over derivative contracts,[41] and a congressional inquiry found that CFTC staff analysts and economists believed Gramm's hasty move prevented adequate policy review.[42]

Five weeks after pushing through the "Enron loophole," Wendy Gramm was asked by Kenneth Lay to serve on Enron's Board of Directors. When asked to comment about Gramm's nearly immediate retention by Enron, Lay called it "convoluted" to question the propriety of naming her to the board.[43]

Congress followed Wendy Gramm's lead in deregulating energy trading *contracts* and moved to deregulate energy trading *exchanges* by exempting electronic exchanges, like those quickly set up by Enron, from regulatory oversight (as opposed to a traditional trading floor like NYMEX that remained regulated). Congress took this action during last-minute legislative maneuvering on behalf of Enron by former Texas GOP Senator Phil Gramm in the lame-duck Congress two days after the Supreme Court ruled in *Bush v Gore*, buried in 712 pages of unrelated legislation.[44] As Public Citizen pointed out back in 2001,[45] this law deregulated OTC derivatives energy trading by "exempting" them from the Commodity Exchange Act, removing anti-fraud and anti-manipulation regulation over these derivatives markets and exempting "electronic" exchanges from CFTC regulatory oversight.

This deregulation law was passed against the explicit recommendations of a multi-agency review of derivatives markets. The November 1999 release of a report by the President's Working Group on Financial Markets—a multi-agency policy group with permanent standing composed at the time of Lawrence Summers, Secretary of the Treasury; Alan Greenspan, Chairman of the Federal Reserve; Arthur Levitt, Chairman of the Securities and Exchange Commission; and William Rainer, Chairman of the CFTC—concluded that energy trading must not be deregulated. The Group reasoned that "due to the characteristics of markets for nonfinancial commodities with finite supplies ... the Working Group is unanimously recommending that the [regulatory] exclusion not be extended to agreements involving such commodities."[46] In its 1999 lobbying disclosure form, Enron indicated that the "President's Working Group" was among its lobbying targets.[47]

---

[40] "Derivatives Trading Forward-Contract Fraud Exemption May be Reversed," *Inside FERC's Gas Market Report*, May 7, 1993.

[41] "Financial Derivatives: Actions Needed to Protect the Financial System," GGD-94-133, May 18, 1994, available at http://archive.gao.gov/t2pbat3/151647.pdf

[42] Brent Walth and Jim Barnett, "A Web of Influence," *Portland Oregonian*, December 8, 1996.

[43] Jerry Knight, "Energy Firm Finds Ally, Director, in CFTC Ex-Chief," *Washington Post*, April 17, 1993.

[44] HR 5660, an amendment to H.R.4577, which became Appendix E of P.L.106-554 available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=106_cong_public_laws&docid=f:publ554.106.pdf

[45] *Blind Faith: How Deregulation and Enron's Influence Over Government Looted Billions from Americans*, available at www.citizen.org/documents/Blind_Faith.pdf

[46] "Over-the-Counter Derivatives Markets and the Commodity Exchange Act," *Report of The President's Working Group on Financial Markets*, pg. 16. www.ustreas.gov/press/releases/docs/otcact.pdf

[47] Senate Office of Public Records Lobbying Disclosure Database, available at http://sopr.senate.gov/cgi-win/opr_gifviewer.exe?/1999/01/000/309/000309331|30, page 7.

As a result of the Commodity Futures Modernization Act, trading in lightly-regulated exchanges like NYMEX is declining as more capital flees to the completely unregulated OTC markets, such as those run by the IntercontinentalExchange (ICE). Trading on the ICE has skyrocketed, with the 93 million contracts traded in 2006 representing a 120 percent increase from 2005, and the 12.6 million contracts traded in January 2007 a 166 percent increase from a year earlier.[48] This explosion in unregulated trading volume means that more trading is done behind closed doors out of reach of federal regulators, increasing the chances of oil companies and financial firms to engage in anti-competitive practices.

The founding members of ICE include Goldman Sachs, BP, Shell and Totalfina Elf. In November 2005, ICE became a publicly traded corporation. Goldman Sachs remains a significant shareholder of ICE, owning about 7.4 percent of the exchange's shares, while Morgan Stanley owns 7.3 percent and BP five percent.[49]

Goldman Sachs' trading unit, J. Aron, is one of the largest and most powerful energy traders in the United States, and commodities trading represents a significant source of revenue and profits for the company. Goldman Sachs' most recent 10-k filed with the U.S. Securities and Exchange Commission show that Fixed Income, Currency and Commodities (which includes energy trading) generated nearly 40 percent of Goldman's $37.7 billion in revenue for 2006. In 2005, Goldman Sachs and Morgan Stanley—the two companies are widely regarded as the largest energy traders in America—each reportedly earned about $1.5 billion in net revenue from energy trading. One of Goldman's star energy traders, John Bertuzzi, made as much as $20 million in 2005.

In the summer of 2006, Goldman Sachs, which at the time operated the largest commodity index, GSCI, announced it was radically changing the index's weighting of gasoline futures, selling about $6 billion worth. As a direct result of this weighting change, Goldman Sachs unilaterally caused gasoline futures prices to fall nearly 10 percent.[50]

A recent bipartisan U.S. Senate investigation summed up the negative impacts on oil prices with this shift towards unregulated energy trading speculation:

> *Over the last few years, large financial institutions, hedge funds, pension funds, and other investment funds have been pouring billions of dollars into the energy commodity markets—perhaps as much as $60 billion in the regulated U.S. oil futures market alone...The large purchases of crude oil futures contracts by speculators have, in effect, created an additional demand for oil, driving up the price of oil to be delivered in the future in the same manner that additional demand for the immediate delivery of a physical barrel of oil drives up the price on the spot market...Several analysts have estimated that speculative purchases*

[48] Available at www.theice.com/exchange_volumes_2005.jhtml
[49] Available at http://finance.yahoo.com/q/mh?s=ICE
[50] Heather Timmons, "Change in Goldman Index Played Role in Gasoline Price Drop," *The New York Times*, September 30, 2006.

> *of oil futures have added as much as $20–$25 per barrel to the current price of crude oil...large speculative buying or selling of futures contracts can distort the market signals regarding supply and demand in the physical market or lead to excessive price volatility, either of which can cause a cascade of consequences detrimental to the overall economy...At the same time that there has been a huge influx of speculative dollars in energy commodities, the CFTC's ability to monitor the nature, extent, and effect of this speculation has been diminishing. Most significantly, there has been an explosion of trading of U.S. energy commodities on exchanges that are not regulated by the CFTC...in contrast to trades conducted on the NYMEX, traders on unregulated OTC electronic exchanges are not required to keep records or file Large Trader Reports with the CFTC, and these trades are exempt from routine CFTC oversights. In contrast to trades conducted on regulated futures exchanges, there is no limit on the number of contracts a speculator may hold on an unregulated OTC electronic exchange, no monitoring of trading by the exchange itself, and no reporting of the amount of outstanding contracts ("open interest") at the end of each day.* [51]

Thanks to the Commodity Futures Modernization Act, participants in these newly-deregulated energy trading markets are not required to file so-called Large Trader Reports, the records of all trades that NYMEX traders are required to report to the CFTC, along with daily price and volume information. These Large Trader Reports, together with the price and volume data, are the primary tools of the CFTC's regulatory regime: "The Commission's Large Trader information system is one of the cornerstones of our surveillance program and enables detection of concentrated and coordinated positions that might be used by one or more traders to attempt manipulation."[52] So the deregulation of OTC markets, by allowing traders to escape such basic information reporting, leave federal regulators with no tools to routinely determine whether market manipulation is occurring in energy trading markets.

One result of the lack of transparency is the fact that even some traders don't know what's going on. A recent article described how:

> *Oil markets were rocked by a massive, almost instant surge in after-hours electronic trading one day last month, when prices for closely watched futures contracts jumped 8%...this spike stands out because it was unclear at the time what drove it. Two weeks later, it is still unclear. What is clear is that a rapid shift in the bulk of crude trading from the raucous trading floor of the New York Mercantile Exchange to anonymous computer screens is making it harder to nail down the cause of price moves...The initial jump "triggered more orders already set into the system, and with prices rising, people thought somebody must know something," Tom Bentz, an analyst and broker at BNP Paribas Futures in New York who was watching the screen at the time, said the day after the spike. "The more prices rose, the more it seemed somebody knew something."*[53]

---

[51] *The Role Of Market Speculation In Rising Oil And Gas Prices: A Need To Put The Cop Back On The Beat*, Staff Report prepared by the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs of the U.S. Senate, June 27, 2006, available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_senate_committee_prints&docid=f:28640.pdf

[52] Letter from Reuben Jeffrey III, Chairman, CFTC, to Michigan Governor Jennifer Granholm, August 22, 2005.

[53] Matt Chambers, "Rise in Electronic Trading Adds Uncertainty to Oil," *The Wall Street Journal*, April 10, 2007.

Oil companies, investment banks and hedge funds are exploiting the lack of government oversight to price-gouge consumers and make billions of dollars in profits. These energy traders boast how they're price-gouging Americans, as a recent *Dow Jones* article makes clear: energy "traders who profited enormously on the supply crunch following Hurricane Katrina cashed out of the market ahead of the long weekend. 'There are traders who made so much money this week, they won't have to punch another ticket for the rest of this year,' said Addison Armstrong, manager of exchange-traded markets for TFS Energy Futures."[54]

The ability of federal regulators to investigate market manipulation allegations even on the lightly-regulated exchanges like NYMEX is difficult, let alone the unregulated OTC market. For example, as of August 2006, the Department of Justice is still investigating allegations of gasoline futures manipulation that occurred *on a single day in 2002*.[55] If it takes the DOJ four years to investigate a single day's worth of market manipulation, clearly energy traders intent on price-gouging the public don't have much to fear.

That said, there have been some settlements for manipulation by large oil companies. In January 2006, the CFTC issued a civil penalty against Shell Oil for "non-competitive transactions" in U.S. crude oil futures markets.[56] In March 2005, a Shell subsidiary agreed to pay $4 million to settle allegations it provided false information during a federal investigation into market manipulation.[57] In August 2004, a Shell Oil subsidiary agreed to pay $7.8 million to settle allegations of energy market manipulation.[58] In July 2004, Shell agreed to pay $30 million to settle allegations it manipulated natural gas prices.[59] In June 2006, the CFTC brought civil charges against BP for allegedly manipulating the entire U.S. propane market.[60] In September 2003, BP agreed to pay NYMEX $2.5 million to settle allegations the company engaged in improper crude oil trading, and in July 2003, BP agreed to pay $3 million to settle allegations it manipulated energy markets.[61]

In December 2006, Oil giant BP admitted in a filing to the Securities and Exchange Commission that U.S. Commodity Futures Trading Commission staff "notified BP on November 21, 2006 that they intend to recommend to the CFTC that a civil enforcement action be brought against BP...alleging violations...of the Commodity Exchange Act in

---

[54] Leah McGrath Goodman, "Oil Futures, Gasoline In NY End Sharply Lower," September 2, 2005.
[55] John R. Wilke, Ann Davis and Chip Cummins, "BP Woes Deepen with New Probe," *The Wall Street Journal*, August 29, 2006.
[56] "U.S. Commodity Futures Trading Commission Assesses Penalties of $300,000 Against Shell-Related Companies and Trader in Settling Charges of Prearranging Crude Oil Trades" available at www.cftc.gov/opa/enf06/opa5150-06.htm
[57] "Commission Accepts Settlement Resolving Investigation Of Coral Energy Resources," available at www.ferc.gov/press-room/press-releases/2005/2005-1/03-03-05.asp
[58] "Order Approving Contested Settlement," available at www.ferc.gov/whats-new/comm-meet/072804/E-60.pdf
[59] "Coral Energy Pays $30 Million to Settle U.S. Commodity Futures Trading Commission Charges of Attempted Manipulation and False Reporting," available at www.cftc.gov/opa/enf04/opa4964-04.htm
[60] "U.S. Commodity Futures Trading Commission Charges BP Products North America, Inc. with Cornering the Propane Market and Manipulating the Price of Propane," available at www.cftc.gov/opa/enf06/opa5193-06.htm
[61] "Order Approving Stipulation and Consent Agreement," 104 FERC ¶ 61,089, available at http://elibrary.ferc.gov/idmws/common/opennat.asp?fileID=10414789

connection with its trading of unleaded gasoline futures...The U.S. Attorney for the Northern District of Illinois is also conducting an investigation into BP's gasoline trading." The announcement also confirmed that "the Commodity Futures Trading Commission is currently investigating various aspects of BP's crude oil trading and storage activities in the US since 2003."[62]

In May 2007, Marathon Oil revealed that CFTC staff was recommending an enforcement action against the company for its efforts "to manipulate the price of West Texas Intermediate crude oil."[63]

There is near-unanimous agreement among industry analysts that speculation is driving up oil and natural gas prices. Representative of these analyses is a May 2006 Citigroup report on the monthly average value of speculative positions in American commodity markets, which found that the value of speculative positions in oil and natural gas stood at $60 billion, forcing Citigroup to conclude that "we believe the hike in speculative positions has been a key driver for the latest surge in commodity prices."[64]

Natural gas markets are also victimized by these unregulated trading markets. Public Citizen has testified before Congress on this issue,[65] and a March 2006 report by four state attorneys general concludes that "natural gas commodity markets have exhibited erratic behavior and a massive increase in trading that contributes to both volatility and the upward trend in prices."[66]

While most industry analysts agree that the rise in speculation is fueling higher prices, there is one notable outlier: the federal government. In a widely dismissed report, the CFTC recently concluded that there was "no evidence of a link between price changes and MMT [managed money trader] positions" in the natural gas markets and "a significantly negative relationship between MMT positions and prices changes...in the crude oil market."[67]

The CFTC study (and similar one performed by NYMEX) is flawed for numerous reasons, including the fact that the role of hedge funds and other speculators on long-term trading was *not* included in the analysis. The *New York Times* reported that "many traders

---

[62] www.sec.gov/Archives/edgar/data/313807/000102123106000617/b843546-6k.htm

[63] www.sec.gov/Archives/edgar/data/101778/000110465907036538/a07-13350_110q.htm

[64] *The Role Of Market Speculation In Rising Oil And Gas Prices: A Need To Put The Cop Back On The Beat*, Staff Report prepared by the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs of the U.S. Senate, June 27, 2006, available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_senate_committee_prints&docid=f:28640.pdf

[65] "The Need for Stronger Regulation of U.S. Natural Gas Markets," available at www.citizen.org/documents/Natural%20Gas%20Testimony.pdf

[66] *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, available at www.ago.mo.gov/pdf/NaturalGasReport.pdf

[67] Michael S. Haigh, Jana Hranaiova and James A. Overdahl, "Price Dynamics, Price Discovery and Large Futures Trader Interactions in the Energy Complex," available at www.cftc.gov/files/opa/press05/opacftc-managed-money-trader-study.pdf

have scoffed at the studies, saying that they focused only on certain months, missing price run-ups."[68]

The CFTC has a troublesome streak of "revolving door" appointments and hiring which may further hamper the ability of the agency to effectively regulate the energy trading industry. In August 2004, CFTC chairman James Newsome left the commission to accept a $1 million yearly salary as president of NYMEX, the world's largest energy futures marketplace. Just weeks later, Scott Parsons, the CFTC's chief operating officer, resigned to become executive vice-president for government affairs at the Managed Funds Association. Former CFTC Lead Prosecutor Tony Mansfi recently left the Commission to join the DC firm Heller Ehrman, where he will work for Geoff Aronow—his old boss at CFTC. Such prominent defections hamper the CFTC's ability to protect consumers. As a result, a revolving door moratorium must be established to limit CFTC decision makers from leaving the agency to go to entities under its regulatory jurisdiction for at least two years.

Latest Trading Trick: Energy Infrastructure Affiliate Abuses

Energy traders like Goldman Sachs are investing and acquiring energy infrastructure assets because controlling pipelines and storage facilities affords their energy trading affiliates an "insider's peek" into the physical movements of energy products unavailable to other energy traders. Armed with this non-public data, a company like Goldman Sachs most certainly will open lines of communication between the affiliates operating pipelines and the affiliates making large bets on energy futures markets. Without strong firewalls prohibiting such communications, consumers would be susceptible to price-gouging by energy trading affiliates.

For example, In January 2007, Highbridge Capital Management , a hedge fund controlled by JP Morgan Chase, bought a stake in an energy unit of Louis Dreyfus Group to expand its oil and natural gas trading. Glenn Dubin, co-founder of Highbridge, said that owning physical energy assets like pipelines and storage facilities was crucial to investing in the business: "That gives you a very important information advantage. You're not just screen-trading financial products."[69]

Indeed, such an "information advantage" played a key role in allowing BP's energy traders to manipulate the entire U.S. propane market. In June 2006, the CFTC filed a civil complaint against BP, alleging that the company's energy trading affiliate used the company's huge control over transportation and storage to allow the energy trading affiliate to exploit information about energy moving through BP's infrastructure to manipulate the market.

BP's energy trading division, North America Gas & Power (NAGP), was actively communicating with the company's Natural Gas Liquids Business Unit (NGLBU), which handled the physical production, pipeline transportation and retail sales of propane. A

[68] Alexei Barrionuevo and Simon Romero, "Energy Trading, Without a Certain 'E'," January 15, 2006.
[69] Saijel Kishan and Jenny Strasburg, "Highbridge Capital Buys Stake in Louis Dreyfus Unit," Bloomberg, January 8, 2007, www.bloomberg.com/apps/news?pid=20601014&sid=aBnQy1botdFo

powerpoint exhibit to the civil complaint against BP details how the two divisions coordinated their manipulation strategy, which includes "assurance that [the] trading team has access to all information and optionality within [all of BP]...that can be used to increase chance of success [of market manipulation]... Implement weekly meetings with Marketing & Logistics to review trading positions and share opportunities."[70]

This shows that the energy traders were actively engaging the physical infrastructure affiliates in an effort to glean information helpful for market manipulation strategies. And it is important to note that BP's market manipulation strategy was extremely aggressive and blatant, and regulators were tipped off to it by an internal whistleblower. A more subtle manipulation effort could easily evade detection by federal regulators, making it all the more important to establish firewalls between energy assets affiliates and energy trading affiliates to prevent any undue communication between the units.

The *Wall Street Journal* reported that the government investigation goes beyond manipulation of propane: "investigators are examining, among other things, whether BP used information about its own pipelines and storage tanks at a key oil-delivery point in Cushing, Okla., to influence crude-oil price benchmarks that are set each day and influence billions of dollars of transactions."[71]

Financial firms like hedge funds and investment banks that normally wouldn't bother purchasing low-profit investments like oil and gasoline storage have been snapping up ownership and/or leasing rights to these facilities mainly for the wealth of information that controlling energy infrastructure assets provides to help one's energy traders manipulate trading markets. For example, according to *The Trader Monthly*, just one Morgan Stanley trader was able to earn as much as $25 million and "helped the bank dominate the heating oil market by locking up New Jersey storage-tank farms adjacent to New York Harbor." The publication also revealed that legendary trader T. Boone Pickens earned as much as $1.5 billion in 2005, for a rate of return exceeding 700 percent, which the editors believe "is the largest one-year sum ever earned."

In August 2006, Goldman Sachs, AIG and Carlyle/Riverstone announced the $22 billion acquisition of Kinder Morgan, Inc., which controls 43,000 miles of crude oil, refined products and natural gas pipelines, in addition to 150 storage terminals.

Prior to this huge purchase, Goldman Sachs had already assembled a long list of oil and gas investments. In 2005, Goldman Sachs and private equity firm Kelso & Co. bought a 112,000 barrels/day oil refinery in Kansas. In May 2004, Goldman spent $413 million to acquire royalty rights to more than 1,600 natural gas wells in Pennsylvania, West Virginia, Texas, Oklahoma and offshore Louisiana from Dominion Resources. Goldman Sachs owns a six percent stake in the 375-mile Iroquois natural gas pipeline, which runs from Northern New York through Connecticut to Long Island. In December 2005, Goldman and Carlyle/Riverstone together are investing $500 million in Cobalt International Energy, a new oil exploration firm run by former Unocal executives.

[70] www.cftc.gov/files/enf/06orders/opa-bp-lessons-learned.pdf
[71] John R. Wilke, Ann Davis and Chip Cummins, "BP Woes Deepen with New Probe," August 29, 2006.

In 2003, Morgan Stanley teamed up with Apache Corp to buy 26 oil and gas fields from Shell for $500 million, of which Morgan Stanley put up $300 million in exchange for a portion of the production over the next four years, which it used to supplement its energy trading desk.[72]

Solutions

- Re-regulate energy trading markets by subjecting OTC electronic exchanges to full compliance under the Commodity Exchange Act and mandate that all OTC energy trades adhere to the CFTC's Large Trader reporting requirements. In addition, regulations must be strengthened over existing lightly-regulated exchanges like NYMEX. Senators Feinstein, Snowe, Levin and Cantwell have introduced S.577 in the 110th Congress which would address many of these issues.
- Impose legally-binding firewalls to limit energy traders from speculating on information gleaned from the company's energy infrastructure affiliates or other such insider information, while at the same time allowing legitimate hedging operations.
- Congress must authorize the FTC and DOJ to place greater emphasis on evaluating anti-competitive practices that arise out of the nexus between control over hard assets like energy infrastructure and a firm's energy trading operations. Incorporating energy trading operations into anti-trust analysis must become standard practice for federal regulatory and enforcement agencies to force more divestiture of assets in order to protect consumers from abuses.
- A revolving door moratorium must be established to limit federal government decision makers from leaving the agency to go to entities under its regulatory jurisdiction for at least two years.

Raise Fuel Economy Standards to Lower Oil Consumption, Reduce Global Warming, Save Money at the Pump and Improve National Security

In the twenty years since the last fuel economy increases for passenger cars, vehicles have undergone a number of changes. Overall, vehicles are bigger, heavier, with more powerful engines and faster acceleration than they were twenty years ago.[73] Travel patterns have changed also—with a nearly 20 percent increase in vehicle miles traveled per year since 1995.[74] Although the U.S. is the third largest oil producing nation in the world[75]—producing more oil than Iran, Kuwait and Qatar *combined*—we consume one out of every four barrels used in the world every day, forcing us to import 66 percent of

[72] Paul Merolli, "Two Morgan Stanley M&A deals show bullish stance on gas," Natural Gas Week, Volume 19; Issue 28, July 14, 2003.
[73] Robert Heavenrich,. "Light Duty Automotive Technology and Fuel Economy Trends: 1975 through 2006." U.S. Environmental Protection Agency, Office of Transportation and Air Quality, July 2006.
[74] Federal Highway Administration, "Annual Vehicle Distance Traveled in Miles 1936-1995." April 1997, and "Annual Vehicle Distance Traveled in Miles and Related Data -2005." November 2006.
[75] Available at www.eia.doe.gov/emeu/cabs/topworldtables1_2.html

our oil and gasoline. In all, we use more than the next five biggest oil consumers (China, Japan, Russia, Germany and India) put together.[76]

Sixty percent of the oil consumed in America is used as fuel for cars and trucks. Nine percent is for residential home heating oil, with the remainder largely used for various industrial and agricultural processes (only 1.4 percent is to fuel electric power).[77] So improving efficiency in our transportation sector will go a long way to reducing our dependence on oil.

America's average vehicle fuel economy is lower today than a decade ago, forcing our less-efficient vehicles to use more gasoline and therefore increasing our need to import oil. The Environmental Protection Agency found that the average fuel economy of 2006 vehicles is 21 miles per gallon (mpg), compared to 22.1 mpg in 1988.[78] This drop is attributable in part to the fact that automobile fuel economy standards have not increased since 1985, and light truck standards are only about 5 mpg higher than they were 25 years ago. This has allowed the manufacturers to allocate efficiency improvements over the last 20 years to larger engines, faster starts and heavier vehicles. And sales of fuel inefficient SUVs and pickups have exploded: in 1987, 28 percent of new vehicles sold were light trucks, compared to 50 percent in 2005. Only now with gasoline prices over $3/gallon are SUV sales slowing down.

Billions of gallons of oil would be saved if significant fuel economy increases were mandated. Improving fuel economy standards for passenger vehicles from 27.5 to 40 mpg, and for light trucks (including SUVs and vans) from 22.2 to 27.5 mpg by 2015 (for a combined fleet average of 34 miles per gallon) would reduce our gasoline consumption by one-third.

After waiting twenty years for action on fuel economy, pressure from increased oil prices has brought national attention back to the need for improved fuel efficiency. Since January, there have been a flurry of legislative proposals, but not a single one provides a sufficiently stringent mandate for NHTSA to raise fuel economy. Existing proposals for increasing CAFE standards give NHTSA the authority to undermine potential improvements in fuel economy by opening the door for industry-biased economic analyses. Many of the proposals fail to guarantee a level of improvement.

In the State of the Union address, the president unveiled his "20 in 10" plan for reducing oil consumption by 20 percent in ten years. He proposes meeting this goal in two ways: 15 percent of the reduced consumption would come from mandating that 35 billion gallons of *alternative* or renewable fuel by 2017. This is a significant departure from the language in the Energy Policy Act of 2005, which mandated 7.5 billion gallons of renewable fuel by 2012, with the same percent of fuel being renewable fuel in 2013 and

---

[76] Available at www.eia.doe.gov/emeu/cabs/topworldtables3_4.html

[77] *Adjusted Sales of Distillate Fuel Oil by End Use in the U.S., 2005*, http://tonto.eia.doe.gov/dnav/pet/pet_cons_821dsta_dcu_nus_a.htm

[78] *Light-Duty Automotive Technology and Fuel Economy Trends: 1975 Through 2006*, July 2006, www.epa.gov/OMS/fetrends.htm

thereafter. The distinction between "alternative" and "renewable" fuel is important, particularly with respect to greenhouse gas emissions. Alternative fuels could potentially include coal-to-liquids fuel, an attractive prospect for the coal industry, but a potential environmental disaster, if sufficient precaution is not taken to capture and sequester carbon dioxide emissions. Without capture and storage, the use of coal-to-liquid fuel could potentially raise greenhouse gas emissions by 118 percent.[79]

The remaining five-percent reduction in oil consumption is to be attributable to increased CAFE standards. The president proposes restructuring the CAFE program for passenger cars to mirror the system implemented for light trucks. The light truck sliding scale system was developed under collaboration between Vice President Cheney and the Office of Management and Budget.[80] Extending the restructure of CAFE is counterproductive and unnecessary. Additionally, the restructure of the CAFE program for light trucks introduced marginal-cost/marginal-benefit criteria for assessing achievable increases; however, the economic analyses under the light truck rule have failed to properly account for significant externalized benefits. One notable failure is NHTSA's valuation of the benefit of reduced greenhouse gas emissions at zero.

Proposals in the House and Senate contain similarly weak mandates for improved fuel economy, preferring instead the setting of "targets" and giving the agency extensive latitude to set lower standards, further delaying progress in improving fuel economy. The 2002 National Academy of Sciences study assessing the CAFE program firmly established that the auto industry was capable of increasing the fuel economy of passenger cars and light trucks to 35 miles per gallon at a rate of 4 percent per year. This study is now five years old, used technology that was "off the shelf" even then, and did not consider hybrid electric technology as a means of improving fuel economy.

National attention has also been turned to the issue of global warming, and there is a sense of urgency on controlling greenhouse gas emissions. Extensive inquiry has been undertaken by committees in the House and Senate to explore the potential of greenhouse gas cap-and-trade programs at reducing greenhouse gas emissions. There has been a great deal of discussion about how such programs would be structured, including whether the program should be economy-wide or sector-by-sector.

In April, the Supreme Court decided *Massachusetts v. EPA*, finding that carbon dioxide was a pollutant under the Clean Air Act, and that the EPA could regulate carbon dioxide as a pollutant. The implications of this decision for motor vehicle carbon dioxide emission regulation are not clear. Regulation of carbon dioxide emissions from motor vehicles is tantamount to fuel economy regulation.

In this context, it is important not to lose sight of the need to improve fuel economy now, rather than waiting for all the questions about what regulatory schemes will be used to

---

[79] "Greenhouse Gas Impacts of Expanded Renewable and Alternative Fuels Use," U.S. Environmental Protection Agency, EPA420-F-07-035, April 2007.

[80] *See* Public Citizen, Comments on Reforming the Automobile Fuel Economy Standards (ANPRM), May 14, 2004, at 25-27, 33-43, *available at* www.citizen.org/documents/ACF938B.pdf

achieve greenhouse gas emissions reductions overall. Improved CAFE standards are consistent with reducing greenhouse gas emissions, and the CAFE program would not compete with sector-by-sector regulation of greenhouse gas emissions.

Contrary to the position taken by U.S. auto manufacturers, raising fuel economy standards could actually benefit automakers. Walter McManus at the University of Michigan Transportation Research Institute found that increased fuel economy standards could actually *improve* the financial positions of U.S. auto manufacturers.[81] The overreliance of U.S. automakers on the largest vehicles has led to significant weakening of the industry, and has also made it difficult for them to be responsive to changes in consumer attitudes about fuel economy. During the mid to late 1990s when oil prices were relatively low, fuel economy became less of a concern to consumers, but now that oil prices are on the rise again, consumers have been moving away from gas-guzzling SUVs back to more fuel efficient vehicles.

Ethanol's No Panacea

Politicians on both sides of the aisle have promoted ethanol as the solutions to America's addition to oil. But the crop fuel poses more problems than it solves.

The 2005 Energy Policy Act created a mandate of 7.5 billion gallons of ethanol to be blended into motor gasoline by 2012. Combined with a 51 cent tax credit paid for every gallon of ethanol that producers like ADM cash in for adding their corn-fuel to gasoline, and the U.S. corn ethanol industry is enjoying huge profits with the help of more than $2 billion in annual subsidies from taxpayers.

So what's the problem with ethanol? For starters, we're having trouble moving ethanol from the source of production (the Midwest farm belt) to the areas of consumption (the coasts). Without a dedicated pipeline network, we're forced to move ethanol by truck, rail and barge, resulting in huge supply bottlenecks. Second, corn ethanol production is inefficient, as it takes more energy to make than is gained when it is combusted as fuel in a car's engine. Finally, while the American farmer is the most productive in the world, she will never be able to produce enough crop fuel to fill the tank of every American car. Shifting crop production from food to fuel risks higher prices for the meals we eat.

What's the solution? Focusing on raising fuel economy standards, investing in mass transit and developing other alternative fuels like hydrogen or plug-in electric hybrids to reduce our oil consumption.

Opponents of increased fuel economy standards often claim that improving fuel economy could erode safety. The argument that improved fuel economy would be achieved by reducing vehicle weight is not supported by historical experience, and it is not supported by the significant innovations in fuel saving technology that have been introduced in the past twenty years. It is design and vehicle size, not weight, that are the biggest determiners of vehicle safety.

Improved fuel economy is long overdue. There are significant potential savings to be had from reducing our oil consumption. Raising the light duty vehicle fuel economy to 35

[81] McManus, W. 2006. *Can Proactive Fuel Economy Strategies Help Automakers Mitigate Fuel-Price Risks?*.

miles per gallon would save 1.1 million barrels of oil *every day*, saving approximately $65 million dollars a day. Additionally, the needs for reductions in greenhouse gas emissions and improved efficiency to reduce consumption of energy in every sector are urgent improvements for the future.

The auto and oil industry have fought tooth and nail against increases in fuel economy standards. From 1995 to 2002, their efforts in Congress resulted in zero appropriations for agency work, and now the agency gets only about a million and a half dollars a year, preventing it from doing research to demonstrate large increases are feasible. Since 2001, the PACs and executives of General Motors and Ford have made $5 million in campaign contributions to federal candidates, with 65 percent of that total going to Republicans. Combined with the Alliance of Automobile Manufacturers, the companies have spent an additional $137 million lobbying Congress and the executive branch over that same time period.[82]

Conclusion

This era of high energy prices and record oil company profits isn't a simple case of supply and demand, as the evidence indicates that consolidation of energy infrastructure assets, combined with weak or non-existent regulatory oversight of energy trading markets, provides opportunity for energy companies and financial institutions to price-gouge Americans. Forcing consumers suffering from inelastic demand to continue to pay high prices—in part fueled by uncompetitive actions—not only hurts consumers economically, but environmentally as well, as the oil companies and energy traders enjoying record profits are not investing those earnings into sustainable energy or alternatives to our addiction to oil. As a result, our consumption of fossil fuels continues to grow, and the impacts of global warming take their toll on our environment.

Reforms to strengthen regulatory oversight over America's energy trading markets and bolster anti-trust enforcement are needed to restore true competition to America's oil and gas markets.

[82] Compiled by Public Citizen from Center for Responsive Politics data, www.opensecrets.org

Appendix 1

Mergers Concentrate the U.S. Oil Refinery Industry: Changes in Control of Market Share 1993 to 2005

1993		2005	
Company	Market Share	Company	Market Share
Chevron	9.1%	ConocoPhillips-Tosco-Burlington Resources	12.8%
Exxon	6.6%	Valero-Ultramar-Diamond Shamrock-Orion Refining-Premcor-TPI	12.6%
Amoco	6.5%	ExxonMobil-Chalmette	11.7%
Texaco-Star Enterprise	6.2%	Shell-Motiva-Equilon-Pennzoil-Quaker State-Deer Park	9.3%
Mobil	6.0%	BP	8.5%
Top 5 in 1993	**34.5%**	**Top 5 in 2005**	**54.8%**
Shell	4.9%	ChevronTexaco-Unocal	5.8%
BP	4.4%	Sunoco	5.7%
Citgo (PDV)/Lyondell	4.2%	Marathon	5.6%
Arco/Lyondell	3.8%	Citgo-PDV	5.0%
Marathon	3.8%	Koch-Flint Hills	4.5%
Top 10 in 1993	**55.6%**	**Top 10 in 2005**	**81.4%**

Note: Lyondell refinery capacity in 1993 is equally split between two of its equity partners at the time, Citgo and Arco.

SOURCE: Compiled by Public Citizen's Energy Program <www.citizen.org/cmep> from corporate annual reports and U.S. Energy Information Administration data.

Appendix 2

In 2006, ExxonMobil's U.S. Operations Outpaced Rest of Company

	2001	2002	2003	2004	2005	2006
All ExxonMobil Operations						
Net income	$ 15,320,000,000	$ 11,460,000,000	$ 21,510,000,000	$ 25,330,000,000	$ 36,130,000,000	$ 39,500,000,000
Average Capital Employed	$ 88,000,000,000	$ 88,342,000,000	$ 95,373,000,000	$ 107,339,000,000	$ 116,961,000,000	$ 122,573,000,000
Return on Capital, Companywide	17.4%	13.0%	22.6%	23.6%	30.9%	32.2%
US Oil Production Only						
Net income	$ 3,933,000,000	$ 2,524,000,000	$ 3,905,000,000	$ 4,948,000,000	$ 6,200,000,000	$ 5,168,000,000
Average Capital Employed	$ 12,952,000,000	$ 13,264,000,000	$ 13,508,000,000	$ 13,355,000,000	$ 13,491,000,000	$ 13,940,000,000
Return on Capital	30.4%	19.0%	28.9%	37.0%	46.0%	37.1%
US Oil Refining Only						
Net income	$ 1,924,000,000	$ 693,000,000	$ 1,348,000,000	$ 2,186,000,000	$ 3,911,000,000	$ 4,250,000,000
Average Capital Employed	$ 7,711,000,000	$ 8,060,000,000	$ 8,090,000,000	$ 7,632,000,000	$ 6,650,000,000	$ 6,456,000,000
Return on Capital	25.0%	8.6%	16.7%	28.6%	58.8%	65.8%

SOURCE: Compiled by Public Citizen's Energy Program <www.citizen.org> from ExxonMobil's 10-k's filed with the SEC

Buyers Up • Congress Watch • Energy Program • Global Trade Watch • Health Research Group • Litigation Group
Joan Claybrook, President

July 18, 2007

John D. Dingell, Chairman
U.S. House of Representatives
Committee on Energy & Commerce
Washington, DC 20515-6115

Dear Chairman Dingell,

Below please find Public Citizen's responses to questions posed by The Honorable Gene Green:

1. ChevronTexaco is one of the world's largest producers of geothermal energy, but all of its geothermal operations are located in Indonesia and the Philippines—not in the Untied States. 99.9% of Chevron's 2006 profit ($17.115 billion out of $17.138 billion) is from the company's oil and gas operations, as its clean energy operations play a minuscule role at the company.

The largest geothermal facility in the world, The Geysers, is located in America and is not owned by any oil companies.

While BP is a large producer of PV solar, the division is tiny compared to other BP operations. Other non-oil companies, such as Kyocera Corp, GE, Spire Corp and Xantrex are bigger players in the market.

Because most hydrogen today is produced from natural gas, oil and gas companies are large producers of hydrogen.

While the oil and gas industry invests in renewable energy, the point Public Citizen and other critics have made is that oil companies are devoting only a miniscule portion of their record earnings back in to renewables. Indeed, Public Citizen research shows that the five largest oil companies have spent $171.6 billion since 2005 buying back their stock and paying out dividends to shareholders. ExxonMobil spent $3.3 billion on total U.S. capital investment in 2006, while at the same time spending $29.6 billion buying back its stock and spending an additional $7.6 billion paying dividends to shareholders.

2. If Congress implements a windfall profits tax, or simply repeals the billions of dollars oil companies receive in federal subsidies each year, the government could use those "new revenues" to initiate investment in renewable energy, energy efficiency and mass transit. The cost of raising taxes on oil companies would be borne by shareholders, not consumers.

3. Section 1323 of the Energy Policy Act of 2005 spends $842 million of the taxpayers' money from 2006 through 2011 allowing owners of oil refineries to expense 50% of the costs of equipment used to increase the refinery's capacity by at least 5%. This new tax break was enacted at a time of record profit margins for the U.S. refining industry. Public Citizen believes that big profits and high prices—concepts that some refer to as "the market"—are the reason for the industry's decisions to expand refining capacity. Public

Citizen does not endorse spending the taxpayer's money on an industry that is enjoying the biggest profits in the American economy. The federal budget deficient exceeds $200 billion annually, and with so many needs for health care, public education, funding for our troops and sustainable energy, Public Citizen does not think that oil companies should continue to receive billions of dollars in taxpayer subsidies.

4. Public Citizen advocates repealing LIFO and foreign tax credits only as they apply to the oil industry. Oil companies are enjoying record profits, and high market prices are providing all the necessary incentive for the industry to reinvest back in to exploration, production, refining and financing alternative energy.

5. Gasoline prices have nearly tripled over the last five years, but yet consumer demand has not moderated. That is because demand for gasoline is inelastic, meaning most motorists must continue consuming a minimum amount of fuel just to function in our modern society, no matter what the cost. Forcing consumers suffering from inelastic demand to continue to pay high prices—in part fueled by uncompetitive actions by oil companies—not only hurts consumers economically, but environmentally as well, as the oil companies and energy traders enjoying record profits are not investing those earnings into alternatives to our addiction to oil. As a result, our consumption of fossil fuels continues to grow, and the impacts of global warming take their toll on our environment.

Public Citizen does not support "artificially lowering" gasoline prices, but rather making sure that consumers have access to a fully competitive market. Recent mergers have consolidated market share among oil companies, and, when combined with lax regulatory oversight over the industry, have enabled oil companies to exploit consumers' inelastic demand to drive prices higher than would otherwise exist in an adequately competitive market. Public Citizen therefore seeks stronger consumer protections to ensure that oil companies are operating fairly, and not price-gouging motorists.

Please contact me if you have any questions.

Sincerely,

Tyson Slocum, Director
Public Citizen's Energy Program
tslocum@citizen.org

Mr. STUPAK. Thank you, Mr. Slocum.

Mr. Montgomery, please, your opening statement?

TESTIMONY OF DAVID MONTGOMERY, VICE PRESIDENT, CRA INTERNATIONAL

Mr. MONTGOMERY. Thank you, Mr. Chairman, Mr. Whitfield. I was pleased to accept your invitation to testify today. I realized, in looking at some of my footnotes, that I have been working on this subject for something like 30 years.

I am vice president of CRA International. I am co-head of our global energy environment practice. And I am an economist by profession and by training. I mention this as background.

My statements today are my own conclusions and do not necessarily represent the positions of either CRA International or any of our clients.

I have submitted a longer statement for the record, and I would like to make just four points in my remarks now.

The first is that prices set by a competitive market serve a useful purpose. They provide the incentives for new supplies to meet rising demand, and they allocate available supplies more efficiently among competing uses than any alternative method of rationing that we have devised.

When supply is limited, prices can be expected to rise high enough to keep demand from exceeding available supply. This can temporarily raise prices above cost, without any wrongdoing on anyone's part, as the normal result of competition for supplies.

Over time, high prices provide a signal for additional investment, and that supply competes away any difference between price and cost.But sometimes prices rise to extraordinary levels for the reasons that Mr. Caruso in particular mentioned, that when there is a supply interruption, it takes a very high price in order to bring demand down to those available supplies.

I think the experience of Hurricanes Rita and Katrina actually teaches the beneficial effects of rising prices. Prices rose not only in the region where the hurricanes made landfall, but throughout the eastern United States.

Those price increases caused drivers in areas not affected by the hurricanes to reduce their use of gasoline, which actually freed up more supplies to flow south to serve those who were in need.

At the same time, suppliers who were able to work in the Gulf region drew down their inventories. They purchased more costly supplies from overseas markets to serve the needs of the Gulf.

Refiners actually rushed repairs on damaged facilities, increased their utilization of operable refineries to what were extraordinarily high levels. They incurred additional cost in doing all of this.

All of these actions were in response to the incentives created by higher prices in the market.

Ironically, if you think about the flow of gasoline from north to south, it was consumers in the north who would have benefited if gasoline prices had not risen after Rita and Katrina, at the expense of those who were hit by the storms, who would have remained without fuel.

In all our experience with gasoline price increases, and I have been studying this since the 1970's, there has never been evidence

that those increases were caused by anything but the normal operation of a competitive gasoline market.

The regional gasoline price spikes that occurred in the past decade were investigated extensively by EIA and the Federal Trade Commission, and their conclusions in every case that I have found have been that gasoline price increases were due to the operation of supply and demand, in light of an interruption of supply, and the magnitude of price increases was consistent with the magnitude of the loss of supply, not consistent with cost, but consistent with what it took in a competitive market to bring demand down to equal available supply.

I don't have any finding in a competent analysis that widespread gasoline prices were due to any other explanation.

My third point would be that price increases are far from the worst thing that can happen to consumers when there is a shortage. Consumers don't win when prices aren't allowed to rise. Shortages are made worse, and those who need fuel most are often least likely to get it.

It seems paradoxical, but consumers would not be better off when prices are kept low by some form of government intervention.

But when supplies aren't available, something has to bring demand down to equal available supply. If it is not prices, then something else has to raise the cost of obtaining a gallon of gasoline.

In previous shortage situations in which we did have price controls, waiting caused the higher cost. And we have actually had sufficient experience with price controls to conclude with pretty good confidence that the lost value of time spent in lines is comparable to the out-of-pocket savings from lower costs.

For example, California, as it frequently does, created an experiment in what will happen when prices are kept artificially low. The State of California ordered Chevron to refund alleged overcharges by reducing the price of gasoline at the pump.

Long lines developed at the Chevron stations during the period of this refund program. There were lines at the Chevron station. There were no lines at other Chevron stations.

Economists who studied this event found through a series of interviews and statistical analyses that the value of time lost by motorists who chose to sit in gasoline lines was larger than the monetary saving provided by price control, which is pretty much what we would expect.

But something has to ration that supply of gasoline whose price is under controls.

My fourth point would be about the refining industry. The refining industry has swung from glut, to shortage, to glut over the past 30 years that I have been looking at it, certainly since the beginning of the 1980's.

Overall, that industry has had pretty low returns until this decade. And it is not just the level of returns for the industry up through the beginning of this decade. It is that in a volatile market like gasoline, it is only during the peaks that returns are adequate to motivate investment are earned.

It is a cyclical industry, and the incentive for expansion in a cyclical industry like refining comes from the profits earned during

the periods of tight capacity which provide almost all of the return on capital that justifies investment.

When we are in a period of excess capacity with depressed prices, which has always followed surges of investment in the industry, refiners' margins are only sufficient to cover their variable costs. They contribute little or nothing to the investments they made earlier.

Overall investment in refining can only recover if margins during the isolated periods of profitability rise above the level that would be required on a sustained basis.

The best explanation I have seen for current tight capacity is the fact that through the 1980's and 1990's, refiners were consistently losing money. And even after margins recover, it takes some time for expectations to adjust and for new capacity to be planned and built.

I would add a couple of other factors that are out of the control of refiners that haven't been talked about yet that I think have also served to tighten capacity.

One of them is regulations on fuel quality and sulfur content that have been put in effect in the past couple of years that have required additional processing and eat up capacity.

In the last couple of years, we have also eliminated, due to product liability and bans in some States, use of an additive, MTBE, that helped to stretch capacity.

And right now, our restrictions on ethanol imports are preventing access to economic supplies that could alleviate some of the tightness.

I also think that expectations of future developments may be diminishing the incentives for expansion of U.S. refineries.

We see in this Congress and from this administration proposed policies that would reduce gasoline demand, including tighter CAFE standards and a 20 percent goal for non-petroleum fuels. That signals a lack of need for refining capacity in the long run. That is a long-run investment that has to be made.

There are large capacity expansions now under way in the Middle East that will increase the supply of gasoline imports.

And finally, it strikes me that policies toward the refining industry that would eliminate the upside potential from refining margins are themselves a disincentive for investment.

Nevertheless, I see that EIA still expects a net addition of about a million barrels a day to capacity over the next 5 years.

To sum up, it is my opinion that since gasoline price controls were eliminated in the early 1980's, the market system has worked extremely well to move gasoline supplies to where they were needed, to avoid gasoline lines and serious economic disruptions.

Thank you for your tolerance of my time, and I would be happy to answer your questions.

[The prepared testimony of Mr. Montgomery follows:]

Prepared Testimony of
W. David Montgomery, Vice President
CRA International

Gasoline Prices, Oil Company Profits, and the American Consumer

Subcommittee on Oversight and Investigations
Committee on Energy and Commerce
U. S. House of Representatives

May 22, 2007

Mr. Chairman and Members of the Committee

I am honored by your invitation to appear today, as the Committee addresses questions about gasoline prices and the American consumer. I am Vice President of CRA International, co-head of CRA's global energy and environment practice, and an economist by profession and training. I have conducted research, published books and papers, and testified on oil markets, gasoline price controls and related subjects for the past 30 years. This testimony is based on a recent study that I conducted at the request of the American Council for Capital Formation. It is available for download at http://www.crai.com/pubs/pub_7024.pdf and has been accepted for publication in the *Journal of Competition Law and Economics*. My statements today are my personal conclusions and opinions, and do not necessarily represent positions of CRA International or any of our clients.

I would like to make 4 points:

Prices set by a competitive market serve a useful purpose. They provide the incentives for new supplies to meet rising demand, and they allocate available supplies most efficiently among competing uses.

In all our experience with gasoline price increases, there has never been evidence that those increases were caused by anything but the normal operation of a competitive market.

Price increases are far from the worst thing that can happen to consumers when there is a shortage.

The refining industry has swung from glut to shortage to glut, and overall has been losing money for decades, and in a volatile market like gasoline it is only during the peaks that returns adequate to motivate investment are earned.

The Function of Rising Prices

When demand exceeds available supply, rising prices serve to allocate limited supplies to their most highly valued uses. In an open competitive market, users for whom the scarce supply has the highest value are willing to pay the most. The market price is bid up until

consumers who place a lower value on using gasoline than the market price drop out, and prices rise until demand is driven down to a level equal to available supply.

At the same time that rising prices motivate consumers to conserve and forego uses of gasoline for which it is no longer worth paying the higher price, rising prices also motivate suppliers to take increasingly costly steps to increase supply.

We saw all these responses to higher prices in the aftermath of Hurricanes Rita and Katrina. Prices rose not only in the region where the hurricanes made landfall, but throughout the Eastern United States. These price increases caused drivers in areas not affected by the hurricanes to reduce their use of gasoline, and the fuel thus freed up flowed south to serve those in need. At the same time, suppliers drew down inventories and purchased more costly supplies from overseas markets to serve the need in the Gulf region. Finally, refiners rushed repairs on damaged facilities and increased utilization of operable refineries to extraordinarily high levels, in both cases incurring additional costs that were justified by the higher prices in the market.

The FTC's findings about the price increases after Rita and Katrina provide a good illustration of how higher prices work when there is a mismatch between supply and demand.

> "Nationally, gasoline supply (including domestic refining production and imports) decreased by 3.9% for the four weeks ending September 30 relative to refinery production and imports for the four weeks ending August 26, 2005. Using well-established estimates of consumer sensitivity to price, staff calculated the likely price effect of such a reduction in supply. This analysis suggests that, in the short-run and assuming no anticompetitive behavior or price manipulation, prices would have risen on average by about 19.7% in September. The actual average price of a gallon of regular grade gasoline in the month of September 2005 was $2.95, a 16.7% increase over the August average price. In the short-run, given the size of the supply disruption, prices should have risen on average more than they actually did. The likely reasons for the somewhat lower than expected price increase were increased imports, the seasonal decline in gasoline demand, and the drawing down of gasoline inventories."[1]

There is no need to take the FTC on faith. This is transparent economic analysis in which the facts and theory are clearly stated and abundantly support the conclusion.

The Record On Claims Of Price Manipulation

There have been numerous instances of regional price spikes in the past decade, all of which have been investigated extensively by the U.S. Department of Energy (DOE) and by the FTC. These studies include:

- An Analysis of Gasoline Markets Spring 1996, U.S. Department of Energy, June 1996

1 Federal Trade Commission. (Spring 2006). Investigation of Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases, p. 67. The 19.7% expected price increase is a function of a 3.9% reduction in gasoline output combined with a short-run price elasticity of gasoline of -0.2 (3.9% divided by -0.2). See Energy Info. Admin., U.S. Dep't of Energy, Petroleum Navigator: Weekly Retail Gasoline and Diesel Prices, at http://tonto.eia.doe.gov/dnav/pet/pet_pri_gnd_dcus_nus_w.htm (last modified May 1, 2006) (shows weekly retail prices of regular gasoline).

- EIA's Assessment of Summer 1997 Motor Gasoline Price Increase
- EIA's 2003 California Gasoline Price Study November 2003
- EIA's Inquiry into August 2003 Gasoline Price Spike
- The FTC's Midwest Gasoline Price Investigation
- The FTC's Study of Katrina and Rita Hurricanes

Their conclusions **in every case** have been that gasoline price increases were due to the operation of supply and demand in light of an interruption of supply, and that the magnitude of price increases was consistent with the magnitude of the loss in supply. There has never been a finding that gasoline price increases were caused by any manipulation of the markets.

There Are Worse Things Than Price Increases

Consumers don't win when prices are not allowed to rise. Shortages are made worse and those who need fuel most are least likely to get it. These points are made eloquently by one of the most distinguished practitioners in the field of law and economics, Judge Richard Posner. He recently wrote that:

> In times of catastrophe, with consumers hurting, the spectacle of sellers benefiting from consumers' distress, while (it seems) deepening that distress by charging them high prices, is a source of profound resentment, and in a democratic society profound resentments trigger government intervention.
>
> Such intervention is nevertheless a profound mistake, and not only from some narrow "economic" perspective that disregards human suffering and distributive justice. If "price gouging" laws or even merely public opinion deters refiners and dealers from charging the high prices necessary to equilibrate demand and (reduced) supply, there will be shortages. Consumers will still be paying a higher price than before the shortage, but they will be paying the higher "price" in the cost of time spent waiting on line at gasoline stations, or (if they drive less because of the shortage) in the form of restricted mobility. And those who need the gasoline the most, not being able to express their need by outbidding other consumers for the limited supply, will suffer the most from the shortages. The only beneficiaries will be people with low costs of time and non-urgent demand.[2]

Consumers Suffer More When Prices Do Not Increase

It seems paradoxical that consumers are not better off when prices are kept low by some form of government intervention. But when supplies are not available, something has to bring demand down to equal available supply. If its not prices, then it must be something else that raises the cost of obtaining a gallon of gasoline. In previous shortage situations in which price controls were imposed, waiting caused the higher cost. And we have had sufficient experience with price controls to conclude confidently that the lost value of time spent in line exceeds the out-of-pocket saving from lower prices.

2 The Becker-Posner Blog, October 23, 2005 Should Price Gouging in the Aftermath of Catastrophes Be Punished?—Posner http://www.becker-posner-blog.com/

For example, California created an experiment in what will happen when prices are kept artificially low. The State of California ordered Chevron to refund alleged overcharges by reducing the price it charged for gasoline at the pump. The result was a period of several months in which there were long lines at Chevron stations, and no lines at other stations that continued charging normal prices. This experience provided data for understanding how the decision of whether and how long to sit in line was made, and to quantify the cost of the time lost in waiting for gasoline and the amount of time cost that was required to ration available supply to meet demand. Two economists who studied this event[3] found that the added costs associated with price controls were 116 percent of the monetary saving provided by price controls.

Thus, in the most simplified form, price controls convert the transfer of income between buyers and sellers that normally occurs when prices rise into a pure waste of time. The higher payments that would be received by sellers remain in the economy, and in turn flow into higher corporate tax payments, additional investment, and higher returns to shareholders. Thus payments by consumers flow back to households through higher returns on capital and lower taxes. Time wasted can never be recovered.

While the historical record suggests that U.S. gasoline markets respond efficiently to supply shortfalls, the same cannot be said of efforts to control prices and allocate supplies through rules set by governments. History teaches us that price controls on gasoline have had unintended and undesirable consequences, even when they were designed with care and included very specific rules defining legal prices and mechanisms to allocate shortages.

Shortages made are made worse by effects on both the demand and supply side.

On the demand side, price controls make shortages worse by the reaction of consumers to the discovery that they cannot count on gasoline being available when they pull up to a pump. Thus price controls induce behavior that makes lines longer. More frequent fill ups due to fear of running out put more people in line, thus lengthening queues. Pump capacity at each individual retail station becomes an issue with the higher volume of customers resulting from more frequent fill ups; more pump capacity is needed for the same amount of total sales, which further compounds the slowing rate at which tanks can be filled.

On the supply side, price controls dissipate the motivation for producers to incur additional cost to relieve a shortage. In the case of Rita and Katrina, lost supplies were replaced with higher priced imports and refiners made extraordinary efforts to increase output and repair damage. Significantly greater harm would have been done by the hurricanes without these responses.

Those Most In Need May Suffer Most If Prices Cant Rise

Waiting does not allocate gasoline to the customers who put the greatest value on gasoline, but to those that have the combined highest value and lowest cost of waiting. Oil shortages and subsequent pricing restrictions in the 1970s revealed that regulations

3 Robert T. Deacon and Jon Sonstelie. "Rationing by Waiting and the Value of Time: Results from a Natural Experiment." Journal of Political Economy. 93.4 (1985).

cause markets to malfunction and created allocative inefficiencies. Indeed, loss of consumer satisfaction, a higher level of inflation, and increased unemployment resulted from the conditions.[4] Lower income families were disproportionately affected by these outcomes. While intuition tells us that lower prices might benefit lower income families, empirical evidence shows that choosing between a significantly cheaper gasoline station with wait time and a more expensive no-wait station is not highly sensitive to variations in income.[5] Rather, price caps in effect give individuals with more resources at their disposal, i.e. higher income, the advantage of using their resources to obtain the scarce good. Those with high values of time have an incentive to hire other with lower values of time to wait in line on their behalf.

In the case of Katrina and Rita, those in the region hit by the hurricane would have been most severely hurt by price controls. Evacuees did not have time to sit in the lines that would have been caused by prices below market clearing levels, and the entire region would have been short even further because supplies would not have been diverted from the North. Paradoxically, it was consumers in the North who would have benefited if gasoline prices had not risen after Rita and Katrina, and they would have done so at the direct expense of those trying to escape the storms and rebuild their homes.

It also appears that price controls in the past have had their most grievous effects on rural area. A study of the U.S. gasoline crises of 1973-1974 and 1979 revealed that the allocation program reduced supply most drastically in rural markets—imposing costs 75% higher than in urban areas.[6] Indeed, areas with extraordinarily low population densities are where gasoline is needed most since travel is necessary to obtain even the most basic of goods. Urban areas, on the other hand, provide easy substitutes to automobiles with well-developed public transportation systems and a higher density of commercial areas within walking distance. Price caps hurt rural areas even more by lowering incentives for petroleum distributors to incur additional costs needed to get gasoline to remote areas. Were markets able to determine the prices, rural areas would be willing to pay higher prices to induce distributors into driving the extra distance.

Who does get gasoline when prices do not rise? Those who don't have to get somewhere right away; who can send someone for them; who know something others do not.

Periods of Elevated Prices Provide The Only Incentive for Long Term Investment in Refining Capacity and Thereby Lead to Future Price Reductions

Capital intensive industries such as refining commonly experience fluctuations in supply, demand and prices, and are only able to recover their long term capital investment because of profits earned during periods of relatively high prices. Refining is one of many capital-intensive industries. This type of industry is characterized by large dollar expenditures in capital equipment and relatively small dollar expenditures in operating costs. These capital investments take long periods of time to implement and the resulting

4 George Horwich and David Leo Weimer. Oil Price Shocks, Market Responses, and Contingency Planning. Washington, D.C.: American Enterprise Institute, 1984, 101.

5 Robert T. Deacon and Jon Sonstelie. "Rationing by Waiting and the Value of Time: Results from a Natural Experiment." Journal of Political Economy. 93.4 (1985) : 639.

6 H.E. French III and William C. Lee. "The Welfare Cost of Rationing-by-Queuing Across Markets: Theory and Estimates from the U.S. Gasoline Crises." The Quarterly Journal of Economics February 1987: 107.

capacity can remain active for many decades. As such, firms must plan investments a long time in advance of their actual implementation and they frequently cannot know whether their competitors are going to make similar investments at the same point in time. These long lead times often cause an industry to cycle between periods of capacity constraints where profit margins may be high and thus encourage investment to periods of excess capacity where investors are unable to recoup their capital. The risk that accompanies cyclical profits means a higher cost of financing these large capital projects for the refineries.

The ability to recover capital investment at any point in time is highly dependent upon the real time level of excess capacity in the market. During periods of large excess capacity, refiners will bid down margins close to operating costs, recovering only part of their fixed costs and thus realizing relatively small margins and contributions towards capital recovery. Therefore, the long term profitability of the industry is dependent upon relatively short periods of time when capacity is tight and margins are robust in order to offset the long periods of excess capacity with low or negative margins.

Figure 1 shows that the major oil companies, which comprise the Financial Reporting System Survey (FRS)[7], had lower returns than the average for U.S. manufacturing through the 80s and 90s.[8] This lack of profitability has led to concerns about whether there will be sufficient investment to provide adequate capacity to meet product demand, cover occasional refinery outages and regional supply interruptions, and avoid increasing dependence on product imports.

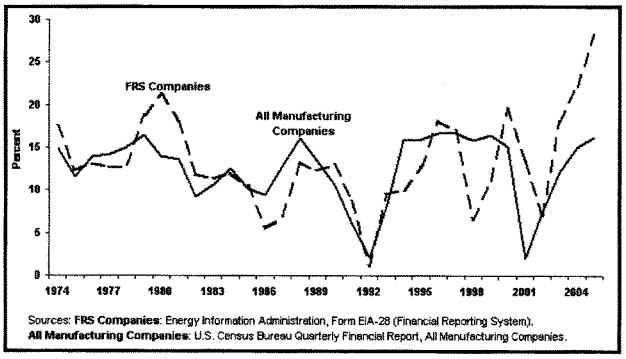


Figure 1. Return on Stockholders' Equity for FRS Companies and All Manufacturing Companies, 1974-2005[9]

Figure 2 shows that U.S. refinery return on investment (ROI) has historically been lower than other FRS companies lines of business, and thus even further below other U.S. industries.

7 List of 2005 FRS companies: http://www.eia.doe.gov/emeu/perfpro/about_frs.htm

8 FRS companies' return on stockholder's equity was on average 0.8 percentage points less than all manufacturing companies during the 80s and 90s.

9 http://www.eia.doe.gov/emeu/perfpro/fig06.htm

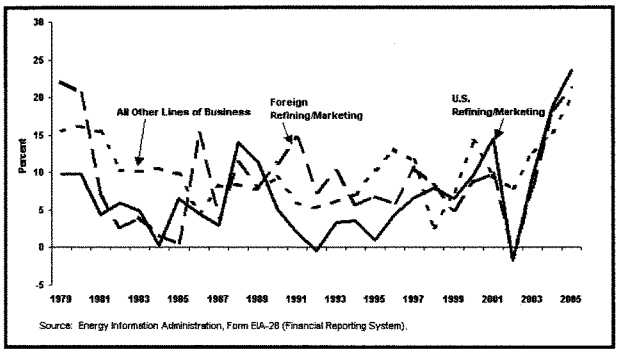


Figure 2. Return on Investment in U.S. Refining/Marketing and all Other Lines of Business for FRS Companies[10]

Low profitability has been caused by the cyclical character of the refining industry (Figure 1), with long periods of excess capacity and depressed margins alternating with occasional periods of tightness and elevated margins (Figure 3). Note that in Figure 3, the net margin, equal to the difference between gross margin and operating costs, is very small. It is this margin that must provide a return on investment. More recent data indicate that the net margin fell close to zero as recently as September – October 2006 and February – March 2007.[11]

Only recently has refining capacity become tight, largely due to six factors:

- Growing demand
- Regulations on fuel quality and sulfur content that require additional processing and eat up capacity
- Elimination, due to product liability lawsuits and bans in some states, of use of an additive, MTBE, that helped to stretch capacity
- Difficulties of siting and licensing new facilities due to environmental restrictions
- Tighter world gasoline markets, raising the cost of gasoline imports
- Restrictions on ethanol imports that prevent access to economic supplies

10 http://www.eia.doe.gov/emeu/perfpro/fig22.htm

11 Ana Campoy, "Refiners Cash In on High Gasoline Prices --- In Shift, Processors See More of Profit Windfall Than Producers of Oil," The Wall Street Journal, 18 May 2007

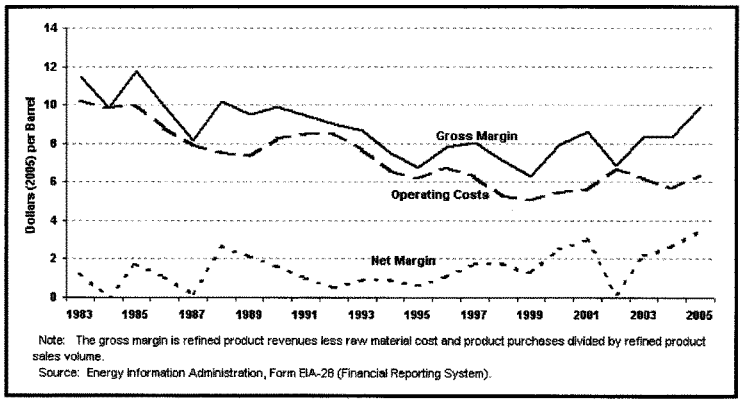


Figure 3. U.S. Refined Product Margins and Costs per Barrel of Petroleum Product Sold for FRS Companies, 1983-2005

The incentive for expansion in a cyclical industry like refining comes from profits earned during the periods of tight capacity, which provide almost all of the return on capital that justify investment. During periods of depressed prices, which have followed surges of investment, refiners' margins may only be sufficient to cover variable operating costs and contribute little to recover of the investments made earlier. The overall return on investment can only recover if margins during the isolated periods of profitability rise above the level that would be required on a sustained basis.

This is illustrated in Figure 4, which compares the margins required during intermittent periods of elevated prices to the margins that would be sufficient if there were no cycles in profitability. The cross-hatched area between the lines labeled "variable cost" and "long run marginal cost" represents the margin that would be required if prices and costs were constant to provide the required return on investment. The irregular line labeled "cyclical price" shows a typical pattern of prices. When the cyclical price exceeds long run marginal cost, the shaded area provides a margin greater than required to achieve a normal return to capital, and when the cyclical price is below the line the shaded area represents a margin less than required for full recovery of capital investment.

For illustration, assume that the entire cross-hatched area represents the margin that must be collected over the life of a refinery to provide its required return on investment. The "cyclical price" line is constructed so that the difference between the positive and negative shaded areas provides exactly the same net revenue. The areas labeled "windfall profits" would not be earned if there were a price cap set at "long run marginal cost." These so-called windfall profits (areas labeled with a "+") are in fact required if refiners are to receive a normal return on their investments, because they make up for lack of return to capital during periods when prices fall to variable cost (areas labeled with a "-"). Even a price cap set a long run marginal cost, which would be relatively generous by the

standards of actual proposals, would still prevent refiners from expecting to earn, over the life of the refinery, margins large enough to justify new investment.

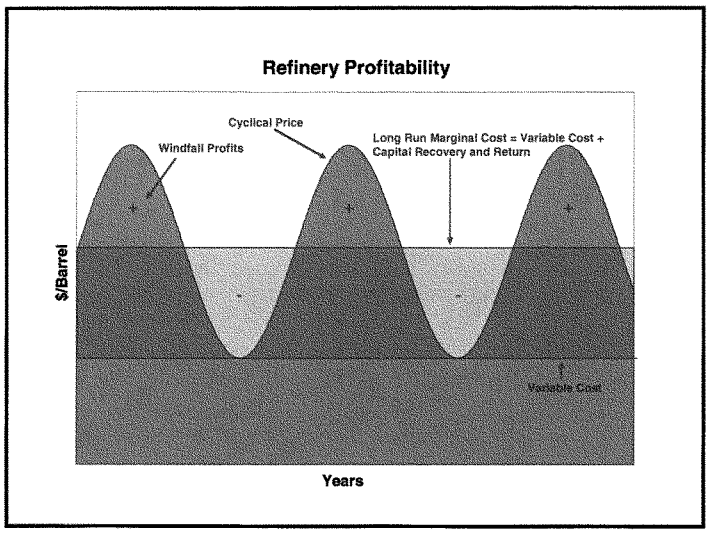


Figure 4. Refinery Profitability Depends On "Windfalls"

It is only if they expect to receive prices (net of taxes) above cost during periods of tightness that refiners can rationally expect to earn an adequate return on refining investments. It is the nature of a capital intensive; commodity industry like refining that there will be slack periods when excess capacity drives prices down to variable cost. Cumulative margins earned during slack periods are insufficient to provide normal returns on investment, because those margins rarely contain any recovery of capital at all. Policies toward refined product markets that cut off the upside for margins, even if they are cost based and allow recovery of capital charges as well as operating costs, thereby eliminate the prospect of earning sufficient margins to compensate for periods when there was no return to capital. Refiners have no safety net to avoid losses (relative to margins sufficient to provide a return on capital) during slack periods, and limits to cost-based prices would prevent them from recovering during tight periods. The result of policies that prevent free movement of prices for refined products would therefore be to lower the expected return on refining to levels too low to justify additional investment.

The long term consequences of this policy shift would be to bring about exactly the problems outlined above:

- Growing dependence on product imports from overseas.
- Lack of sufficient capacity to avoid periodic shortages when refinery outages occur.
- Lack of sufficient capacity to respond to regional supply interruptions.

Since gasoline price controls were removed, the market system has worked extremely well to move gasoline supplies to where they were needed and avoid gasoline lines and serious economic disruptions. That market response required more than price signals that revealed where products were needed; it also required sufficient capacity to respond at relatively low cost. Reducing incentives for refinery investment could tighten that capacity permanently, reducing the alternatives for alleviating shortages and raising costs. If there is no excess capacity, additional supplies can be found for a disrupted region only by prices high enough to discourage consumption. Policies that discourage the investment to create some excess refinery capacity would thereby force prices even higher when interruptions do occur.

Response to questions to W. David Montgomery from the Honorable Gene Green

Question 1: Dr. Montgomery, you mention in your testimony an experiment California recently undertook to refund to consumers alleged overcharges for gasoline at the pump. Can you further elaborate on this experience and lessons learned?:

Answer: In 1980, due to price controls in effect at the time, Chevron gasoline stations in California were required to sell gasoline at prices $.16 to $.21 lower than other stations. As a result, gasoline lines developed at those stations. Two economists, Professors Deacon and Sonstelle, interviewed the motorists to determine the average time they waited and amounts purchased, in order to estimate the value of time that they spent in line to obtain the lower priced gasoline. Deacon and Sonstelle concluded that just the value of time spent in line wasted about half of the cost savings available from the cheaper gasoline. [1]

Question 2: You mention a study by two economists on this event that found the added costs associated with price controls were 116 percent of the monetary savings provided by price control. How did this study come to this conclusion, and what does this teach us about interfering in the pricing of gas?

Answer: In a later paper, Deacon and Sonstele applied these findings to estimate how the added cost due to non-market allocation measures compares to the savings to consumers from lower prices. They developed a theoretical model of the kinds of behavioral responses that are caused by price controls, and concluded that several forms of wasteful behavior would be expected. Using data from the California study described in my response to Question 1, they found that in addition to waiting in line consumers increased the amounts purchased on each trip. These wasteful forms of behavior induced by price controls imposed time costs on consumers that were approximately equal to the benefits of lower prices.

The Deacon and Sonstelie model makes the realistic assumption that any purchase requires an expenditure of both time and money. The authors demonstrate that if the market price is controlled below the level that would equate supply and demand, the waiting time for a purchase will increase. If consumers are able to adjust the quantity that they purchase on each shopping trip, the theory further predicts that lines will be longer than if they continued purchasing the same quantity per trip.

Deacon and Sonstelie also develop a method for estimating the impact of price controls on consumers. It is composed of four elements: the additional time expended for waiting, the cost of increasing the amount purchased, the cost of misallocation among consumers who put different values on time, and the saving from the lower monetary price. Using data on willingness to wait in line and other costs derived from their analysis of the gasoline lines that developed when California ordered Chevron to sell gasoline at a discount, they estimated that the added costs associated with price controls were 116 percent of the monetary saving provided by price controls. Thus, in the most

1 Robert T. Deacon and Jon Sonstelie. "Rationing by Waiting and the Value of Time: Results from a Natural Experiment." Journal of Political Economy. 93.4 (1985).

simplified form, price controls convert the transfer of income between buyers and sellers that occurs when price rises into a pure waste of time. The higher payments received by sellers remain in the economy, and flow back to households through higher returns on capital and lower taxes. Time wasted can never be recovered.

Deacon and Sonstelie assume that price controls have no effect on the quantity supplied. When price conrols do reduce supply, as would normally be the case with a supply interruption when replacement supplies can be obtained at a cost, there is additional loss to the economy. Moreover, the time cost of buying gasoline must not just be enough to bring down to the level of supply observed in the market during the disruption. It must be enough to bring the level of supply down to the lower level of supply available when price controls prevent economic replacement supplies from being obtained.[2]

What this paper teaches us is that price controls do not benefit consumers. When there is a limit on available supplies, some mechanism must allocate those supplies among the consumers that want them. Price increases serve this function efficiently, by leading those who value the use of gasoline to reduce their use until demand equals available supply. With price controls, something else must reduce demand to equal available supply. That something else is the time wasted sitting in line. To reduce demand to equal available supply, the time cost of waiting must be high enough to reduce demand by the same amount that increases

Question 3: In Mr. Slocum's testimony (from Public Citizen), he states that "major oil companies are not building new refineries because it is in their financial self-interest to keep refining margins as tight as possible." He goes on to ask the question, why can't major oil companies build a new refinery today to meet demand? How would you respond to his question?

Answer: There is no evidence that refiners will show any restraint in building new capacity in order to sustain high prices. Historically, there have been repeated surges of investment in U.S. refining that competed away any increase in margins (see chart). As Mr. Kovacic testified, structurally the refining industry in the United States is highly competitive. Market shares in refining are so small that it would be impossible for any refiner to think that its unilateral decision to refrain from building an otherwise profitable refinery could have a material effect on national gasoline prices.

There are several reasons why we are not seeing additional expansion of refineries. Recently, refiners have had to allocate significant portions of their capital budgets to investments to repair damage from Hurricane Katrina and Rita and meet tighter product quality and emissions regulations. Additional discretionary investments to expand capacity take time to plan and execute, and a temporary spike in prices is not a sufficient economic reason to make those investments. What is required is the confident expectation of continued high demand and at least occasional periods of high margins. Another reason for lack of investment therefore would be the expectation that rising gasoline prices and proposed policies such as caps on greenhouse gas emissions and tight fuel economy standards will reduce demand for gasoline and make additions to capacity

2 Robert T. Deacon and Jon Sonstelie. "The Welfare Costs of Rationing by Waiting." Economic Inquiry. 27.2 (1989).

unprofitable. Another reason is the tight environmental regulations that raise costs of increasing capacity and severely limit available sites.

The most important reason why no rational refiner would invest in additional capacity is likely to be the current threat of price controls. Price controls eliminate the upside on prices that has been only source of a return on capital investment in U.S. refining in the past 30 years. Passage of price-gouging legislation will therefore virtually guarantee that there will be no additional refining capacity built in the United States.

It is only if they expect to receive prices above cost during periods of tightness that refiners can rationally expect to earn an adequate return on refining investments. It is the nature of a capital intensive; commodity industry like refining that there will be slack periods when excess capacity drives prices down to variable cost. Cumulative margins earned during slack periods are insufficient to provide normal returns on investment, because those margins rarely contain any recovery of capital at all. Price controls that cut off the upside for margins, even if they are cost based and allow recovery of capital charges as well as operating costs, thereby eliminate the prospect of earning sufficient margins to compensate for periods when there was no return to capital. Refiners have no safety net to avoid losses (relative to margins sufficient to provide a return on capital) during slack periods, and cost-based controls would prevent them from recovering during tight periods. The result of creating an expectation of price controls would therefore be to lower the expected return on refining to levels too low to justify additional investment.

Mr. STUPAK. Thank you.

We will start our questioning.

Mr. Slocum, you indicated that U.S. refineries versus non-U.S. refineries for ExxonMobil—66 percent return on their investment in the U.S. but 24.5 percent return outside the U.S.

Have you look at like Shell, which is Dutch-owned, and BP, British Petroleum? Is that a trend with them also?

Mr. SLOCUM. Sometimes the availability of data is inconsistent. ExxonMobil, to is credit, is extraordinarily detailed in providing details of its financial operations by segment and by geographic area.

BP does have some information, and I had talked about it earlier, and it is in my written remarks that I submitted with you.

And BP gave specific operating margins for its west coast operations, for its U.S. Gulf Coast operations, and then Singapore and Great Britain. And their refining margins were almost triple in the west coast.

They were almost three times as high as what they were in the United Kingdom, and a similar increase versus their operations in Singapore.

BP and Exxon are two industry leaders, but I would imagine that their experiences in terms of high refining profit margins in the United States versus their overseas operations is probably consistent.

Mr. STUPAK. Well, we have talked a little bit today about the crack spread, the difference between a barrel of crude oil and what it costs to refine it into gasoline.

And the spread right now is estimated to be $30, where traditionally it is $8 to $9. And for June trading, it is at $36. What is the crack spread, let's say, in Europe, if they break it down that detailed?

Mr. SLOCUM. That is a great question, and I do not know offhand.

Mr. STUPAK. OK. Do you think you can get back with us on that?

Mr. SLOCUM. Absolutely. I would be very happy to.

Mr. STUPAK. You also indicated, Mr. Slocum, that no one would begrudge anyone making a profit, even though a lot of us think some of these profits lately have been obscene.

But what is a reasonable return of investment? You said you don't begrudge them a reasonable return. What would a reasonable return, let's say, on a crack spread, let's say——

Mr. SLOCUM. In a capital-intensive industry, I think that if you are earning a 20 percent return on your capital investment, you are doing very, very well.

And you know, Chevron Texaco, I think their total global operations was between 24 percent and 26 percent return on capital investment.

I break out Exxon's total capital investment, return on their capital investment, on the very last page of my written testimony, and their global operations in 2006 returned them over 32 percent.

And then when you break it down by segment and by geography, they earned much bigger profit margins on their U.S. operations, particularly downstream, at almost 66 percent.

So I think when you are looking at around a 30 percent return, a 60 percent return, I think that that is far beyond what would be considered a fair and reasonable profit.

Mr. STUPAK. Thank you.

Mr. Montgomery, I take it CRA is opposed to H.R. 1252, the price gouging legislation we have been mentioning a little bit today.

Mr. MONTGOMERY. We take no position on legislation. First, I should be clear. I am not speaking for CRA International, my employer, at all. I am discussing my own opinions.

And my intention in my work and in being here is to try to discuss, as an economist who is familiar with the field, what the potential consequences of legislation might be. It is not to say I am for or against it.

Mr. STUPAK. Well, the reason why I asked the question—I am looking at your January 10, 2007 testimony. I believe that was before the Senate. And in there, you mention H.R. 1252 and a couple of Senate bills.

And my distinct impression, reading the testimony—you are not in favor of H.R. 1252.

Mr. MONTGOMERY. I am sorry, January 10, 2007? My memory may be failing me.

Mr. STUPAK. April 10, 2007. This was a report on the potential effects of proposed price gouging legislation, cost and severity of supply disruptions.

Mr. MONTGOMERY. Yes, I am looking at this report——

Mr. STUPAK. And on page seven, yes, you talked about S. 94, S. 1735 and H.R. 1252.

Mr. MONTGOMERY. I am sorry, this is a report. It is not testimony. I just wasn't connecting with what you were discussing.

Yes, have listed in this report three examples of price gouging legislation that were before the Congress at the time that I was writing it.

I was trying to write the report, as I said, to try to elucidate some of the economic consequences of this type of legislation.

Mr. STUPAK. OK. I noticed that the bill that was passed last year by Ms. Wilson wasn't mentioned in your remarks. Any reason for that? Because you do mention—S. 1735 was in the 109th Congress, same as the Wilson bill, which actually passed the House and went on to the Senate.

Has CRA taken any position on the Wilson bill, whether that was a good bill last year or a bad bill?

Mr. MONTGOMERY. No, and I think what happened was as I was producing the final draft of this report, since they really were intended as examples, because I wanted to discuss concepts of price gouging legislation, and kind of implications of price controls in broader markets.

They were the three examples that I was aware of that were under consideration. There was no intention to either exclude anything on purpose or include anything on purpose. They were the three examples I was aware of.

Mr. STUPAK. OK. I am looking at your testimony here today. And you mention the—let's make sure I get the right one here. I have

read quite a bit of your—yes, you mention on page three the FTC's Midwest gasoline price investigation.

And I think we had testimony earlier today that there actually was some—a refinery was found to withhold their product to the Midwest, and therefore that would constitute a price gouging by withholding the product, is that correct?

Mr. MONTGOMERY. No, not necessarily. To explain my reference to it here, what I have referred to in my testimony and what I discussed at more length in the report was my reading of that report—I am just simply telling you how I read it—was that it concluded that overall, the magnitude of the price increases investigated there were consistent with the operation of supply and demand.

They mentioned a few other factors such as some mistakes, some lack of preparation, but did not mention price gouging or market manipulation as responsible for the broad price increases observed in that market.

Mr. STUPAK. Well, let me ask you this question. There is an internal BP memo from 1999 that confirms the interest at least one oil company has had in limiting the supply of gasoline to the Midwest.

The memo identifies a number of options for consideration in order to reduce supply of gas in the Midwest. Among the options are shutting down capacity, exporting to Canada, lobbying for environmental regulations that would slow down the movement of gasoline in pipelines, shipping product other than gasoline in the pipelines, and providing incentives to others not to provide gasoline to Chicago and the Midwest.

That was what they found happened in the Midwest in some of these areas. Is that a legal practice underneath the oil and gas industry?

Mr. MONTGOMERY. I am not myself an antitrust lawyer, and I hate to—and I hesitate to offer an opinion about whether any particular act is legal or not legal.

My understanding under the antitrust laws is that an action which is taken unilaterally by a company purely for its own internal purposes without collusion or other cooperation is not contrary to the antitrust laws.

That is as far as I could go. I certainly don't know enough about the circumstances of this particular one to offer an opinion.

Mr. STUPAK. Well, but that would be contrary to your free market approach that you have sort of advocated here today, right?

Mr. MONTGOMERY. It could be. And we certainly are concerned about markets where there is one or such a small number of sellers that they are able to not only influence the price by their actions but they are able to do so profitably.

That is why the FTC and others apply their structural and other tests to ask whether the oil market or the refined product market is sufficiently competitive structurally that it would not be in the interest of an individual company to withhold supplies in order to raise prices, because the withholding would cost them more on the lost sales than their gain on the price on the remaining.

So it is, again, a matter of market structure and how that market structure is managed.

Mr. STUPAK. Well, you said you would like to make four points. Your second point was in all our experience—and I am reading now from your testimony on page one, your second point.

In all our experience with gasoline price increases, there has never been evidence that those increases were caused by anything but normal operations of a competitive market.

Now, we talked a lot about the crack spread used to be about 10 cents to 15 cents per gallon. Now we are up to 70 cents to 70 cents price per gallon.

Now, do you think that is normal operating? And actually, that is based on $30 a barrel, but now we are going to go up to $36 a barrel, so that crack spread is going to be even higher.

Now, why won't you provide more? Do you think that is anything but normal operations in a competitive market?

Mr. MONTGOMERY. I think it is the operation of a competitive market. I think we are not seeing that market subject to normal stresses at this point.

Mr. STUPAK. Well, if you are not seeing normal stresses, then why do prices keep going up?

Mr. MONTGOMERY. Because we are seeing abnormal stresses.

Mr. STUPAK. What are the abnormal stresses that—I mean, there is no Hurricane Katrina out there. There is no OPEC oil embargo. Our oil, as the first panel said, has been maintained relatively stable in this country.

Mr. MONTGOMERY. You are right. It is a combination of events. First, crude oil is high. Second, we are seeing extraordinary volatility in gasoline prices.

I was struck, and I mentioned it in my prepared statement because it was so remarkable, by an article in the Wall Street Journal a couple of days ago that was updating, if you like, data that I had looked at only through 2005 that indicated, actually, in early fall and late winter of this year, we were seeing essentially the refiners' margins drop back down to zero again.

They are bouncing around in an extraordinary way, and I think it is a combination of uncertainty in the market. There is no question about that.

It is very tight capacity, the tight capacity due to the reasons that I mentioned and others have mentioned, that have kind of not only prevented the expansion of capacity but have actually taken capacity away compared to a couple of years ago, many of them driven by policy events.

And we have had an extraordinary growth in demand for gasoline for driving which hasn't been knocked down completely by these price increases.

And we are having a very hard time getting gasoline supplies from the rest of the world, which normally supplements our refineries.

Adding all these things together are a market-based explanation of why we are seeing what we are seeing.

Mr. STUPAK. You certainly don't disagree with what was testified the last panel, and what I have alluded to and I have said before, and that you mentioned last fall, basically, running gasoline at a loss—that is because in September and October, they are trying to influence the outcome of the November election.

There was a 60-cent drop in gasoline in September and October, run up to the election—60-cent drop in gasoline prices. They took a loss.

Mr. MONTGOMERY. I find it extraordinary that an industry, with the number of players that Mr. Kovacic was describing, with—as I know from talking to the quite different political interests, were actually able to collude on doing something like that to influence an election.

Mr. STUPAK. Do you have any other explanation why it went down 60 cents in September and October of 2006 before the run-up of the election?

Mr. MONTGOMERY. Why it went down in September and October? Yes. We came off the RFG season. It is usually the reason why we see something there. Refining capacity is very tight.

Mr. STUPAK. So we can expect a 60-cent drop this year? That is the first time it has ever happened in the Nation's history in September and October, to have such a huge drop.

Mr. MONTGOMERY. Nothing is ever repeatable. And it was dropping from a very high level.

But the point is that when we come off the RFG season, the two big constraints that I was talking about—the problem with MTBE and the problem with fuel sulfur standards—become an awful lot less.

The cost of producing the very expensive fuel we have to blend with ethanol, because ethanol is not a particularly good blend stock—all of those costs start to drop at that time of year.

And if that is combined with other events, which I have not looked at, in terms of the amount of driving, coming down from a big——

Mr. STUPAK. That is the first explanation—RFGs—because it is usually, "Geez, we have got to raise gas prices, because we have got to limit our gas manufacturing, because we have got to move the home heating oil, because we are in the cold part of the season coming on up," so it is usually just the opposite.

Gas prices go up in the fall of the year, not down, because you are switching over from making gasoline for summer driving to home heating oil in the winter, for places like me that had snow last weekend.

Mr. MONTGOMERY. Actually, it works the other way around. Gasoline prices go up during the summer in order to induce the stockpiling of gasoline during the winter.

They drop during the fall and winter in order to induce the shift toward heating oil and away from gasoline.

Mr. STUPAK. Thank you.

Mr. Whitfield for questions, please.

Mr. WHITFIELD. Thank you, Mr. Chairman.

And thank you all for being with us today.

And, Mr. Slocum, you had mentioned that the large oil companies were not reinvesting in refineries, and I mean, that was what I had always understood, too. We have a lot less refineries today than we had a number of years ago.

But then I was reading this report by the Federal Trade Commission, and it says that while the number of refineries has fallen, the average size of existing refineries has increased, so that overall

industry distillation capacity increased from 15.3 million barrels per day in 1996 to 17.1 million barrels per day in 2005, or about 11.7 percent, and that this increase is equivalent to the addition of over 15 average-sized refineries at the average size of 115,700 barrels per day.

So it appears that we have actually more refinery capacity today than we did in 1996. Would you agree with that?

Mr. SLOCUM. I actually would agree with that. And I did not imply that oil companies are not reinvesting back in their infrastructure.

I did give a figure of $824 million that ExxonMobil alone spent on capital investment in the domestic downstream sector, which for them predominantly is refining. So they have been spending money.

The question is has it been adequate for an aging infrastructure, and has it been adequate in the growth of demand. Yes, indeed, refining capacity nationally has increased since 1996.

Mr. WHITFIELD. I am glad you pointed that out, because when we talk about it up on the Hill, we are always saying, "Oh, well, we haven't had any new refineries built," and yet we do have more capacity.

So I really appreciate your pointing that out.

Mr. SLOCUM. And I think the issue is has the capacity increase in refineries kept up with demand.

Mr. WHITFIELD. It has not.

Mr. SLOCUM. And that, it has not.

Mr. WHITFIELD. Yes, because we are approaching 400 million gallons of gasoline every day that we are using in America alone.

Now, I want to just touch on briefly these refinery margins that you referred to, and you were talking about a 64 percent or a 66 percent return in the U.S. operations and a 24.5 percent return in Europe. I believe it was somewhere in that neighborhood.

Mr. SLOCUM. Yes, sir. That is exactly correct, for ExxonMobil only.

Mr. WHITFIELD. Yes, and they say their refinery margins are calculated by taking the spot market price on gasoline and subtracting the spot market price on crude.

And so the spot market price on gasoline right now is going up because of the demand, and you would think, with the demand going up the way it is in the U.S., that actually our gasoline prices would be higher than in Europe.

And I know that Europe has a much higher tax rate on gasoline than we do, but if you remove their rate on the gasoline taxes and remove our rates, the actual price per gallon is rather comparable, if you remove the tax portion.

And so you would think that because the refinery margins here are so much greater because of the gasoline—the spot market prices being higher, that our prices would be higher here than in Europe, and yet it appears to be the reverse.

And just from your understanding of the market, why would the European prices be higher than in the United States?

Mr. SLOCUM. First, a clarification on those numbers for ExxonMobil. Those are not referencing a crack spread or refining margins from a crack spread.

Those are return on capital investment for their different segments. So it is a slightly different number, but telling a similar story.

And in terms of what is the comparable crack spread or gasoline price in Europe, I am not an expert on European gasoline markets, and so I actually do not know, and I cannot confirm whether or not, if you removed the very high levels of taxation, I do outline in my report what the exact levels of taxation are in various European countries and Japan.

I actually don't know whether or not—if you remove those high taxes, whether or not European prices are higher or not.

The crack spreads that I saw for BP and the crack spreads or the return on capital investment for ExxonMobil seemed to imply that prices would be lower, but again, I would have to investigate that. And I can get that data for you tomorrow, actually.

Mr. WHITFIELD. You would think that the European demand not being as great as in the United States, and they certainly are more accustomed to scooters and smaller cars and more public transportation than we are in America.

And the fact that they are closer to the Middle East and Russia than we are, so transportation costs should be less. But yet their prices are so much higher.

So in some ways, we are getting off easy in the U.S. even though it is against our culture to be able to accept gasoline prices approaching $4 a gallon.

Mr. SLOCUM. And actually, I mean, transportation costs for crude oil to this country aren't that high. I mean, the largest suppliers are the United States itself—I mean, we are the third-biggest producer of crude.

Canada is the single largest importer of crude, and Mexico isn't far behind, and so the United States also has fairly easy access to pipeline shipments of crude oil that help keep costs down.

Mr. WHITFIELD. But I was reading an article the other day, and it said that out of the 85 million barrels of oil being produced worldwide, the largest company in the U.S., ExxonMobil, is only producing 4.5 million.

So our largest oil company is only producing 4.5 million out of 85 million barrels being produced every day.

Mr. SLOCUM. And that number happens to be more than the Kingdom of Kuwait produces.

Mr. WHITFIELD. What is Saudi Arabia producing per day now, do you know?

Mr. SLOCUM. I think around 10 million barrels of oil a day. And they remain, I believe, the largest exporter. It is close with Saudi Arabia and Russia.

Mr. WHITFIELD. Right. One other point that I would just touch on, because you had mentioned this GAO report about the mergers and acquisitions contributing to increased prices, which may very well be the case.

But the Federal Trade Commission, who has responsibility for policing this—Mr. Kovacic testified that they disagreed with that GAO report.

And have you had the opportunity to look at why they disagreed with the GAO report in very much detail or not?

Mr. SLOCUM. I believe that they disagreed with some of the econometric methodology that GAO employed.

And it is Public Citizen's understanding that the econometric methodology that GAO used is pretty standard. And we didn't disagree with the methodology that the GAO employed.

And especially when you look at the other evidence, just the fact that consolidation has occurred, that margins in the downstream operations have mushroomed, we think it is a fair conclusion to make that consolidation has directly led to higher prices at the pump.

Mr. WHITFIELD. Mr. Chairman, I have no further questions.

Mr. STUPAK. Just one or two for me.

Mr. Montgomery, did you do a report for the American Council for Capital Formation regarding price gouging legislation?

Mr. MONTGOMERY. Yes. That is the one we were just discussing.

Mr. STUPAK. OK. Did you assist the American Council for Capital Formation, then, in writing its editorials to be placed in newspapers around the Nation?

Mr. MONTGOMERY. No. I haven't even read them.

Mr. STUPAK. OK.

Mr. Whitfield, any further questions?

Mr. WHITFIELD. No, sir.

Mr. STUPAK. Well, that concludes our questioning.

I want to thank our witnesses for coming today and your patience. Your testimony is part of the record.

I ask for unanimous consent that the hearing remain open for 30 days for additional questions. And if those Members who could not be here want additional time for questions, they will have 30 days.

And also, those witnesses who could not stay with us, we would submit those to them.

So without objection, the record will remain open for 30 days.

I ask unanimous consent the contents of our document binder be entered into the record.

Without objection, documents will be entered into the record.

This concludes our hearing. This meeting of the subcommittee is adjourned.

[Whereupon, at 6:36 p.m., the subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

May 21, 2007

MEMORANDUM

TO: Subcommittee on Oversight and Investigations Members and Staff

FROM: Committee on Energy and Commerce Staff

SUBJECT: May 22, 2007, hearing entitled, "Gasoline Prices, Oil Company Profits, and the American Consumer."

On Tuesday, May 22, 2007, at 1:00 p.m. in room 2123 Rayburn House Office Building, the Subcommittee on Oversight and Investigations will hold a hearing entitled, "Gasoline Prices, Oil Company Profits, and the American Consumer." The purpose of the hearing is to examine the factors underlying the recent sharp rise in gasoline prices, the effects of such increases, and the role of the Federal Trade Commission (FTC) in addressing this problem. The hearing will include testimony from State and Federal regulators with direct experience with this issue. The Subcommittee will also receive testimony from public interest groups and an oil industry analyst. Several of the largest oil companies and refiners were invited to testify, but declined the opportunity.

BACKGROUND

Retail prices of gasoline this summer are likely to be higher than ever, following record-setting summer prices in 2006. The prices in March and April of 2007 have already reached an all-time high for those months, and that trend is expected to continue for the next several months.

The following chart shows the average April prices of gasoline from 2002 through 2007: [1]

RETAIL GAS PRICES	
MONTH/YEAR	ALL GRADES, ALL FORMULATIONS
April 2002	$1.43.9
April 2003	$1.63.3
April 2004	$1.83.9
April 2005	$2.28.5
April 2006	$2.78.7
April 2007	$2.89.1

In contrast, over the same period that gasoline prices rose by more than 100 percent, the Consumer Price Index (CPI) rose only 13.8 percent.[2] The fact that gasoline prices were so significantly out of line with increases in the CPI raises questions about an unusual development in the oil market.

The sharp rise in gasoline prices imposes a very substantial cost burden on the average American consumer. By increasing the cost of transportation, rising gasoline prices affect the cost of goods and services throughout the economy and can even cause recession. The Government Accountability Office (GAO) has estimated that each additional 10 cents per gallon of gasoline adds $14 billion to Americans' annual gasoline bill.[3] In effect, this is an enormous transfer of wealth—billions of dollars—from consumers to the oil industry.

Factors Affecting Gasoline Prices

A number of factors affect the price of a gallon of gas, including the price of crude oil, refining capacity and output, wholesale and retail strategies (including zone pricing), and others.

---

[1] Energy Information Administration. See U.S. All Grades All Formulations Retail Gasoline Prices [http://www.eia.doe.gov]. The July 2006 per gallon average price of gasoline was $3.02 (compared with $2.33 for July 2005 and $1.95 in July 2004). The August 2006 price was $3.00 (compared with $2.53 for August 2005 and $1.92 for August 2004).

[2] See U.S. Department of Labor, Bureau of Labor Statistics, "Table Containing History of CPI-U U.S. All Items Indexes and Annual Percent Changes From 1913 to Present" (*sic*) [http://bls.gov/cpi].

[3] GAO citing EIA in *Factors Contributing to Higher Gasoline Prices*, Testimony before the Committee on the Judiciary, U.S. Senate, GAO-06-412T (Feb. 1, 2006) at p.1.

The two largest components that determine the price of gasoline, however, are crude oil price and refining capacity and output, which together account for 75 percent of the retail price of gasoline. The breakdown is as follows: crude oil, 52 percent; refining, 24 percent; taxes, 15 percent; and distribution and marketing, 9 percent.[4]

Crude Oil and OPEC

Crude oil prices are substantially affected by anticompetitive behavior in world markets. The Organization of Petroleum Exporting Countries (OPEC) accounts for more than two-thirds of global oil production, and OPEC's oil exports represent about 65 percent of the oil traded internationally. OPEC is by definition a cartel. Its main purpose is to exercise market power to maximize revenues for its member countries. While OPEC's ability to dictate world crude oil prices is subject to a number of limitations, its market dominance is a major factor in setting prices.

Approximately 40 percent of U.S. crude oil imports are from OPEC countries.[5] Nevertheless, while crude oil prices have risen steadily over the last few years, independent experts informed the Committee staff that there continues to be plenty of crude oil supply on the market, and, therefore, crude oil prices are not responsible for the recent surge in gasoline prices in the U.S.

Refining Capacity

There is a shortage of refining capacity in the United States. The existing refineries, operating at 95 percent of their capacity, which is the maximum, leave no room for unplanned stoppages. Nevertheless, no new refineries have been built in the U.S. since 1976. Moreover, mergers and consolidations in the oil industry over the last 10 years and the closing of many refineries over the past 25 years have increased concentration in the refining industry. In 1981, 189 firms owned 324 refineries. By 2001, 65 firms owned 155 refineries. Now, in 2007, there are only 149 refineries.

As the number of refineries has decreased, the capacity of existing refineries has not expanded at a rate equal to increasing demand. From 2000 to 2006, refinery capacity grew about 5 percent, from approximately 16.5 million to 17.4 million barrels per day.[6]

This lack of capacity, combined with the low inventories that the industry now maintains, means that when there is a disruption, such as planned maintenance or unplanned disasters such as Hurricane Katrina or a major fire, there are fewer stocks of gasoline available from which to

---

[4] See EIA *Gasoline and Diesel Fuel Update*, March 2007 data using base price of gasoline of $2.56 per gallon [http://www.eia.doe.gov].

[5] See EIA, *U.S. Imports by Country of Origin* [http://tonto.eia.doe.gov]. In 2005, the U.S. imported over 2 billion barrels from OPEC countries. Approximately 75 percent of this came from Saudi Arabia, Venezuela, and Nigeria.

[6] See EIA, *Number and Capacity of Petroleum Refineries* [http://www.eia.doe.gov].

draw. Critics argue that the refineries are able to increase their capacity, but they have made a strategic decision not to do so, in order to keep prices high. It would be startling if this were not true.

Market Concentration and Consolidation

A study of gasoline prices published in 2002 found that high market concentration exacerbates the factors that allow price spikes and increases. The study found that in a number of instances, oil refiners had sought to increase prices by reducing supply.[7]

Two years later, GAO concluded that mergers and increased market concentration generally led to higher wholesale gasoline prices in the mid-1990s through 2000. Six of the eight mergers GAO modeled led to gasoline price increases.[8]

Over the past 15 years, mergers and acquisitions have dramatically increased the degree of market concentration in the oil industry. In 1998, Marathon and Ashland Oil merged their downstream assets, and BP merged with Amoco. In 1999, Exxon merged with Mobil. In 2000, BP Amoco acquired ARCO. Changes in market share in the refining industry were substantial: in 1993, the top 5 companies had 35 percent of the refining market, and the top 10 companies had 56 percent. By 2005, the top 5 companies had 55 percent of the market, and the top 10 had 81 percent.

This high level of market concentration translates to market power because there is little risk that another company will present a competitive threat. Moreover, vertically integrated oil companies—large companies involved in oil production, refining, and marketing—have the ability to control both the input and the output from their refineries.

Oil Company Profits

The high degree of market concentration and lack of competition in the oil industry have resulted in record profits. Profits have increased substantially with high crude oil prices and low refinery capacity.

For example, ExxonMobil is both a producer and a refiner. The company tracks its profits by categorizing "upstream" earnings—associated with the extraction of crude oil—and "downstream" earnings—associated with the refining of crude oil into gasoline and other products that it sells to wholesalers and others. Over the past five years, ExxonMobil's earnings have increased dramatically, as illustrated by the following chart:

---

[7] See *Gas Prices: How Are They Set?*, a report of the Majority Staff of the Permanent Subcommittee on Investigations, Committee on Government Affairs, U.S. Senate (2002) at p. 7.

[8] See GAO, *Effects of Mergers and Market Concentration in the U.S. Petroleum Industry*, GAO-04-96 (May 2004).

Year	Upstream Earnings (in billions)[9]	Downstream Earnings (in billions) [10]	**Total Earnings (in billions)[11]**
2002	$ 9.6	$1.3	**$11.46**
2003	$14.5	$3.5	**$21.51**
2004	$16.7	$5.7	**$25.33**
2005	$24.35	$8.0	**$36.13**
2006	$26.2	$8.5	**$39.5**

Government Regulation

During the recent waves of mergers and acquisitions in the oil industry, including the combination of some of the largest and most profitable companies in the world, there has been little response from Government regulators. At the Federal level, the FTC has the primary responsibility for merger reviews for the oil industry, for monitoring gasoline prices, and for investigating possible antitrust violations under the Sherman Act and the Clayton Act. The FTC did not object to any of the major oil company mergers and acquisitions of the past 10 years.

No Federal law specifically addresses price gouging. The Energy Policy Act of 2005 did require the FTC to investigate whether the price of gasoline is being "artificially manipulated by reducing refinery capacity or by any other form of market manipulation or price gouging practices."[12] In May 2006, the FTC released its report, finding generally that sellers behaved competitively and that price increases in the aftermath of Hurricane Katrina were the result of increased costs, although there were limited instances of price gouging.[13]

A majority of States have price-gouging statutes. A number of States have successfully prosecuted gasoline price-gouging cases, but evidently only at the retail level. The prosecution of complex litigation against very large, multi-national corporations is not something in which States generally have sufficient resources to engage.

WITNESSES

[9] ExxonMobil 2006 Summary Annual Report at 18 ("Upstream Statistical Recap").
[10] Id. at 26 ("Downstream Statistical Recap").
[11] Id. at 5 ("Financial Highlights").
[12] Pub. Law No. 109-58 Sec. 1809, 119 Stat. 594, 1125 (Aug. 8, 2005).
[13] FTC, *Investigation of Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases* (2006) [http://www.ftc.gov/opa/2006/05/katrinagasprices.shtm].

Panel I

The first panel will be composed of four Government witnesses. ***Commissioner William Kovacic*** of the FTC will discuss the Commission's monitoring of the oil industry and gasoline prices, and the Commission's views and findings with respect to anticompetitive behavior, including price gouging. The Administrator of the Department of Energy's (DOE) Energy Information Administration (EIA), ***Guy Caruso***, will provide information on the oil industry generally and gas prices specifically. The EIA is DOE's research arm and is separate from the policymaking side of the Department. ***Mr. Stanley Pruss***, Deputy Director, Michigan Department of Environmental Quality, will testify with respect to his experience in successfully prosecuting gasoline price-gouging cases for the State of Michigan. Finally, ***Mr. Thomas McCool*** of GAO will discuss how the effects of mergers and market concentration in the oil industry, including GAO's finding regarding market concentration following recent mergers and acquisitions, have resulted in gasoline prices rising.

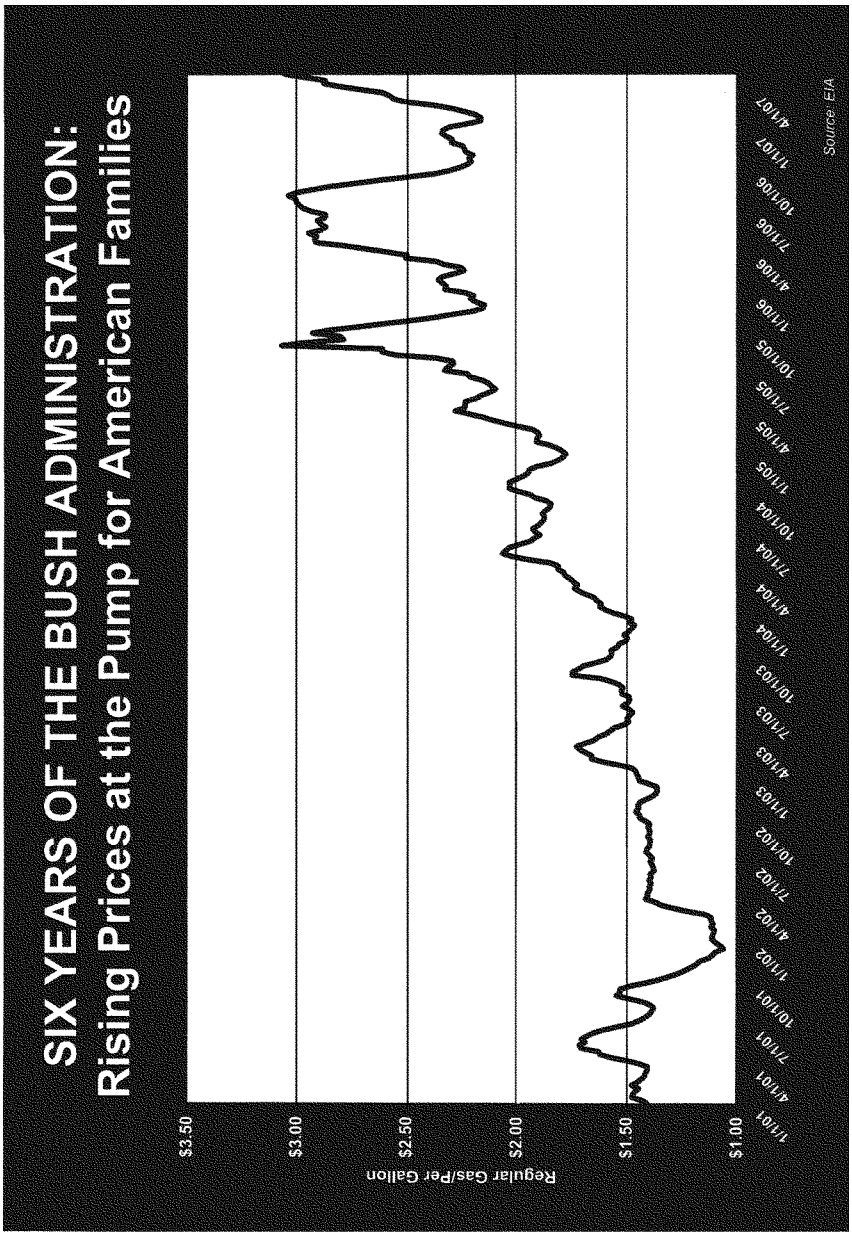
Panel II

The second panel will consist of the ***Mr. Geoff Sundstrom*** of the American Automobile Association who will discuss the effect of gasoline prices on consumers and present observations on the cause; ***Mr. Tyson Slocum*** of Public Citizen, a widely recognized authority on the economics of the oil industry and oil and gas pricing; and ***Dr. David Montgomery*** of CRA, Inc., a consulting firm whose clients include a number of oil companies. Mr. Montgomery is a former Deputy Assistant Secretary of Energy and Assistant Director of the Congressional Budget Office.

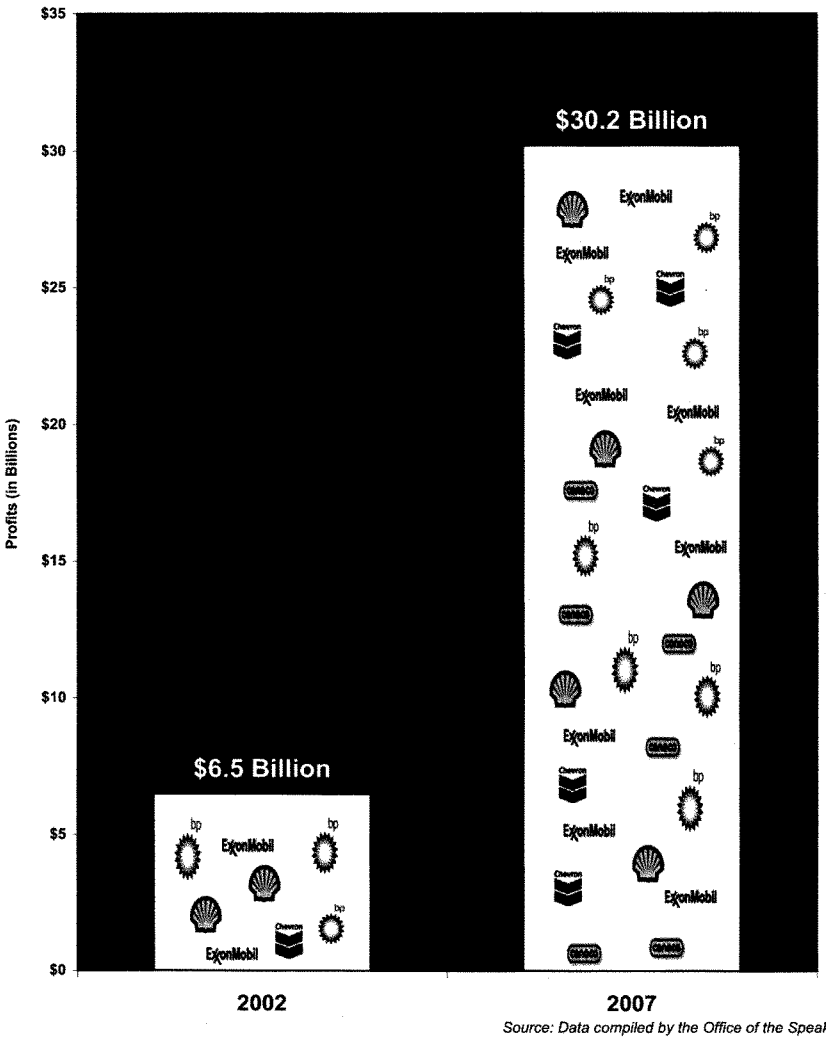
As mentioned earlier, invitations were extended to several of the largest integrated oil companies and refiners, who declined the opportunity to testify.

* * * *

If you have any questions, please contact John Arlington, Senior Investigative Counsel with the Committee staff, at extension 6-2424.


SIX YEARS OF THE BUSH ADMINISTRATION:
Rising Prices at the Pump for American Families
Regular Gas/Per Gallon
$3.50
$3.00
$2.50
$2.00
$1.50
$1.00
1/1/07
4/1/07
7/1/07
10/1/07
1/1/07
4/1/07
7/1/06
10/1/06
1/1/06
4/1/06
7/1/05
10/1/05
1/1/05
4/1/05
7/1/04
10/1/04
1/1/04
4/1/04
7/1/03
10/1/03
1/1/03
4/1/03
7/1/02
10/1/02
1/1/02
4/1/02
7/1/02
10/1/02
1/1/03
4/1/03
7/1/03
10/1/03
1/1/04
4/1/04
7/1/04
10/1/04
1/1/05
4/1/05
7/1/05
10/1/05
1/1/06
4/1/06
7/1/06
10/1/06
1/1/07
4/1/07
Source: EIA

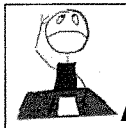
2007:
Another Record Year for Oil Company Profits
(1st Quarter Profits)



Source: Data compiled by the Office of the Speaker

OIL GIANT$' GIANT PAY

(2005)

	ANNUAL COMP.	TOTAL COMP.
ExxonMobil Lee Raymond	$7,699,882	$81,726,307
Chevron David J. O'Reilly	$5,540,964	$ 8,170,097
ConocoPhillips James J. Mulva	$5,710,289	$16,789,404
 Average Joe	$ 29,469	

Americans Are Paying More Than Double For Gas Than When President Bush First Took Office

Source: Energy Information Administration

Texaco Rim
EXHIBIT
780

Texaco

TRMI-REFINING
ACTION:
MAR 11 '96

CTW	IRSH
ASA	RFM
CAF	CAR
ORH	VMP
RCS	RAC
DKG	JAA
JCC	RHM
	MAR

TRACE DATE:
File Destroy

DATE: March 7, 1996

TO: Messrs. J. F. Boles
C. T. Walz
P. W. Tomlinson
A. S. Abay
C. A. Flagg
D. R. Hull
R. C. Sheffield
R. A. Pourciau

FROM: L. D. Hopkins

SUBJECT: FUTURE GASOLINE SPECIFICATIONS

There is a fuels issue of national significance which continues to gather momentum. The issue, being doggedly pursued by the American Automobile Manufacturers Association (AAMA), is one of: 1) altering ASTM gasoline specifications, and 2) finding a more 'efficient' process for making changes to fuel specifications.

From a long-range perspective, it appears that the AAMA are seeking benefits of tighter fuel standards that will come from: a) reducing the variability in gasoline that motorists purchase, and b) restricting key fuel parameters that are perceived to be costly or troublesome to vehicle control systems. Although perhaps presumptive, one could conclude that if the auto companies had their wish, gasoline would be defined as having a very narrow boiling range, be of constant density, be of constant energy content, and not contain any non-hydrocarbon compounds. In this manner, it is alleged, vehicle systems could be designed, built and operated at lowest cost and maximum emissions benefits, notwithstanding the fact that the gasoline suppliers would incur unbearable costs that the Auto's had avoided.

The natural instincts of fuel suppliers (API) to the above issue is a strong, unified defensive posture of taking action to see that the burden of 'fixing' a vehicle problem is not shifted to the oil industry. However, given the trend in recent years and the global drive for cleaner fuels, it is inevitable that the gasoline industry will continue to be regulated and/or pressured toward tighter gasoline specifications. Some suppliers may even voluntarily accede to the desires of the Auto's if they perceive a niche opportunity for competitive advantage.

The above situation was discussed at a Puget Sound Plant strategic planning meeting in January. From those discussions it became clear that this was not the most critical strategic challenge facing PSP. It was not even determined definitively to be a 'negative', given the business environment on the West Coast as discussed below.

As observed over the last few years and as projected well into the future, the most critical factor facing the refining industry on the West Coast is the surplus refining capacity, and the surplus gasoline production capacity. (The same situation exists for the entire U. S. refining industry.) Supply significantly exceeds demand year-round. This results in very poor refinery margins, and very poor refinery financial results. Significant events need to occur to assist in reducing supplies and/or increasing the demand for gasoline. One example of a significant event would be the elimination of mandates for oxygenate addition to gasoline. Given a choice, oxygenate usage would go down, and gasoline supplies would go down accordingly. (Much effort is being exerted to see that this happens in the Pacific Northwest.)

Within this context, the question was raised as to whether any parts of the AAMA fuel specification proposal (see 'Attachment 1' of the attached letter) would serve to benefit our most critical problem on the West Coast. For example, on the surface it would appear that a reduction in T90 maximum would serve to reduce gasoline supplies since it would drop the heavy end of gasoline down into the distillate pool (as one solution). But such a proposal raises many questions concerning the over-all impact on the refining markets, on Texaco and Star Enterprise, and on our competitive posture. In addition, the two examples used here would only incrementally serve to reduce supplies, whereas large adjustments are necessary. But they may be directionally beneficial.

The attached paper is a response to this issue raised during the PSP strategic planning session. It gives more in-depth treatment to the technical issues than it does to the business issues, but both require a lot more analysis, discussion and consensus-building before a conclusion can be reached for TRMI or Star Enterprise.

I would appreciate your review of this issue and advice as to whether you think we should put together a small work-group to assess the issue, identify opportunities, and develop a consensus on the proper position for Texaco/TRMI/Star Enterprise. From your responses, I will provide further direction. Please provide your reply by March 22, 1996.

LDH:

Copies for information: MDRedemer,GTJones

TEX 0018676

HIGHLY CONFIDENTIAL

SPEC 1 TX 011238 CONFIDENTIAL

780.2

Order Code RL33373

CRS Report for Congress

Oil Industry Profit Review 2005

Updated January 12, 2007

Robert Pirog
Specialist in Energy Economics and Policy
Resources, Science, and Industry Division

Congressional Research Service

Prepared for Members and Committees of Congress

Oil Industry Profit Review 2005

Summary

The increase in world oil prices that began in 2004 and continued into 2005 led to increasing revenues and net incomes for all sectors of the oil industry. In 2004 and continuing into 2005, increasing world demand, led by China, India, and the United States, created a tight market in both oil production and refining, at a time where spare capacity was already at historically low levels. In addition, in 2004 and 2005, world political events including the war in Iraq, political unrest in Nigeria, and the political climate in Venezuela, among others, contributed to a market psychology that pushed up prices.

In the U.S. domestic market, the effects of hurricanes Katrina and Rita continue to be felt both in oil production and oil refining. The hurricanes also contributed to the profitability of the oil industry in the U.S. market. However, while profits were high, the oil market demonstrated its ability to supply consumers as feared shortages associated with the hurricanes were very limited.

The profits of the five major integrated oil companies accounted for three quarters of all the profits earned by the integrated oil companies. In this group, oil production led the way as the most profitable segment, even though production of oil and natural gas generally declined.

On a percentage basis, the percentage growth in profits for the independent oil and gas producers was even higher than the integrated oil companies. Their total profit, however, was only about 15% of the profit of the integrated companies.

Independent refiners and marketers earned a 92% profit increase in 2005 compared to 2004. Valero, the largest firm in this group and the largest refiner in the United States, led the way with a 99% increase in profit and earned almost two thirds of the profit of the group as a whole.

High levels of profit, coupled with declining growth rates for profit, appear likely to continue in 2006. The potential volatility of the world oil market leaves any forecast for the industry uncertain.

This report will not be updated.

Contents

List of Tables

Oil Industry Profit Review 2005

The average spot market price for West Texas Intermediate (WTI), a reference grade of U.S. crude oil, was up 36.5% in 2005 compared to 2004, refinery capacity utilization rates ran in excess of 90% for much of the year, and two hurricanes, Katrina and Rita, struck the U.S. gulf coast, the location of a major portion of the U.S. oil production and refining industry. As a result of these, and other domestic and world oil market conditions, the oil industry as a whole, brought in record revenues, and earned record profits, in 2005.[1]

In 2005, the oil industry recorded revenues of $1.62 trillion, of which 81% was accounted for by the five major integrated oil companies. Profits for the industry totaled almost $140 billion, 76% of which were earned by the five major integrated oil companies, with the largest company, ExxonMobil, earning over 25% of the total profit. Although the financial results for the industry were at record levels, the performance of the various sectors of the industry, as well as individual companies within those sectors, varied, leaving some firms as relative under-performers compared to the industry leaders.

This report analyzes the industry's profit performance in 2005.[2] While recent profits in the oil industry are of interest to investors, analysts, and public policy specialists, among others, a longer term perspective is important in understanding the performance of the industry. For example, as recently as 2002, the financial picture in the oil industry was far different, with declining earnings in key sectors, such as refining. The oil industry historically has been cyclic, with periods of high earnings often followed by sharp declines, driven by movements in the world price of crude oil. For this reason, projections of future industry performance based on current performance are likely to be mistaken.

Integrated Oil Company Profits

Integrated oil companies operate in both the upstream (exploration and production) and the downstream (refining and marketing) segments of the industry. Among the integrated oil companies listed in **Table 1**, the five largest companies are usually identified as the major oil companies, or super-majors. ExxonMobil is the largest such company; its profits in 2005 were almost a third larger than either of its largest competitors, Royal Dutch Shell and BP.

---

[1] This report explicitly analyzes the production, refining, and marketing components of the industry.

[2] The profit performance of the oil industry since 2002 is analyzed in CRS Report RL33021, *Oil Industry Profits: Analysis of Recent Performance*, by Robert Pirog.

Table 1. Financial Performance of the Integrated Oil Companies, 2005

(millions of dollars)

Company	Revenues		Net income		Return on sales	Return on equity
	2005	% change	2005	% change		
ExxonMobil	370,998	24.5	36,130	42.6	9.7	32.5
Royal Dutch/Shell	306,731	15.1	22,940	30.4	7.5	25.2
BP	253,621	25.1	19,314	25.2	7.6	24.1
Chevron	198,200	27.6	14,099	5.8	7.1	22.5
Conoco Phillips	183,364	33.9	13,529	66.4	7.4	25.6
Marathon	63,673	27.6	3,022	140.4	4.7	25.8
Amerada Hess	22,747	35.9	1,242	27.1	5.5	19.7
Occidental	15,208	33.8	5,281	105.6	34.7	35.1
Murphy	11,877	42.1	846	20.7	7.1	24.4
Total	**$1,426,419**	**24.5**	**$116,403**	**36.4**	**8.2**	**26.8**

Source: *Oil Daily*, Profit Profile Supplement, vol. 56, no. 46, March 9, 2006, p. 10, and Financial Data by Company at [http://www.Hoovers.com/free/], and company annual reports.

Note: Percent change values reflect changes from 2004.

Revenue growth among the integrated oil companies in 2005 was driven by increases in the price of crude oil. Even though four of the nine companies experienced a decline in oil production, and seven of the nine experienced a decline in natural gas production, as shown in **Table 2**, their revenues increased on average by 24.5% in 2005. With output declining, it is likely that revenue growth was based on price increases.

Table 2. Upstream Results of the Integrated Oil Companies, 2005

Company	Net income		Oil production		Gas production	
	2005	% Change	(000 b/d)	% Change	(mm cf/d)	% Change
ExxonMobil	24,349	46.0	2,523	-1.9	9,251	-6.2
Royal Dutch/Shell	14,238	44.9	2,093	-7.1	8,263	-6.2
BP	25,491	41.0	2,562	1.2	8,424	-0.9
Chevron	11,724	23.5	1,669	-2.4	4,233	6.9
Conoco Phillips	8,430	47.8	907	0.2	3,270	-1.4
Marathon	2,998	76.2	191	12.4	932	-6.7
Amerada Hess	1,058	40.1	244	-0.8	544	-5.4
Occidental	6,293	46.7	431	1.4	674	5.8
Murphy	748	46.1	103	12.0	90	-35.7
Total	**$95,329**	**40.0**	**10,723**	**0.5**	**35,681**	**0.2**

Source: *Oil Daily*, Profit Profile Supplement, vol. 56, no. 46, March 9, 2006, p. 10.

Note: Percent change values reflect changes from 2004.

Two profit rates, return on sales and return on equity, are presented in **Table 1**. In an advertisement appearing soon after the oil companies announced their 4th quarter 2005 financial results, the American Petroleum Institute (API) sought to compare the returns earned in the oil industry to other American industries.[3] They compared return on sales in the oil industry to returns earned in seven other industries, as well as U.S. industry as a whole, for the period October 2000 through September 2005. They found that the oil and natural gas industry earned only 0.3% more than industry as a whole, and was ranked sixth of the eight covered industries, just above the average for all U.S. industry.[4] The integrated oil companies, earning returns of 8.2% on sales in 2005, exceeded the historical API rates of return by over 41%.

Since calculating return on sales dilutes the effect of growing total profits of the industry due to higher prices and growing revenues, another standard percentage measure of profitability, return on equity, is presented. This measure indicates the success of the company and industry in earning profit by utilizing the invested capital of the owners; the shareholders of the company. This measure is widely used by

---

[3] For example, *The New York Times*, January 30, 2006, p. A11.

[4] Banks led with returns of 17.3%, followed by pharmaceuticals at 16.2%, real estate at 10.8%, health care at 7.7%, software and services at 7.6%, oil and natural gas at 5.8%, utilities at 5.2%, retailing at 3.4%, and all U.S. industry at 5.5%.

investors and financial analysts in evaluating the performance of firms seeking access to capital markets. By this measure, the integrated oil companies returned 26.8% in 2005, over three times the return on sales. The industry leader, ExxonMobil earned 32.5%.[5] These rates of return are likely to assure these firms, and the industry's, position as a desirable investment as long as the price of oil remains high.[6]

Table 3. Downstream Results of the Integrated Oil Companies, 2005

Company	Net Income		Product sales (000 b/d)	
	2005	% Change	2005	% Change
ExxonMobil	$7,992	40.1	8,257	0.6
Royal Dutch/Shell	7,532	14.3	7.057	-7.1
BP	4,405	-15.9	5,888	-8.0
Chevron	2,766	-14.9	3,768	-3.6
Conoco Phillips	4,173	52.1	3,251	3.5
Marathon	3,013	114.3	1,455	3.9
Amerada Hess	515	14.2	456	6.5
Occidental	—	—	—	—
Murphy	125	52.4	358	5.6
Total	**$30,521**	**13.9**	**30,490**	**-2.8**

Source: *Oil Daily*, Profit Profile Supplement, vol. 56, no. 46, March 9, 2006, p. 10.

Note: Percent change values reflect changes from 2004.

Tables 2 and 3 disaggregate the upstream and downstream performance of the integrated oil companies in 2005. **Tables 1 and 2** show that upstream net income growth led overall corporate net income growth for most of the companies, and they earned almost 50% of their total net income from upstream activities. Although oil and gas production was up by less than 1% for each product, in oil, three of the four largest producers experienced declining output. In natural gas, four of the five largest producers experienced declining output, due to the hurricanes and other factors.

Table 3 presents financial results for the downstream activities of the integrated oil companies for 2005. While product sales were down by 2.8%, net incomes were up by 13.9%. ExxonMobil's performance was enhanced by its ability to increase sales while its major competitors suffered declines in sales ranging from 3.6% to 8%. Refinery operations were affected by hurricanes Katrina and Rita and other special

---

[5] ExxonMobil's return on assets, another common profit measure, was 17.4% in 2005.

[6] The key question for investors and others is whether these returns will continue in the future, something unknowable.

factors.[7] For example, the BP refinery at Texas City was out of operation in the third quarter 2005 due to an explosion and fire.[8] The effect of these events was that, despite high refining margins, several firms were unable to take full advantage of the earning potential that was available because of unexpected plant closures.

While it might appear from the data in **Table 3** that, contrary to popular belief, refining and marketing were under-performers in 2005, the results must be set against the performance of 2004. While net income grew by only 13.9% in 2005, this followed net incomes that had increased by 96.7% in 2004, allowing refining to lead industry profits in that year.[9] In other words, the increases of 2005 were above, and beyond, the gains made in 2004.

Hurricanes Katrina and Rita also affected downstream profitability. While the effects of the hurricanes served to raise refining margins and product prices, they accomplished that by closing a substantial fraction of the area capacity. Refinery utilization rates dropped to 75% at the beginning of October 2005 from 97% at the end of August 2005. Many of the major refiners, including ExxonMobil, ConocoPhillips, Chevron, Shell, BP, and Valero, all had refineries that were forced to close as a result of damage to the facility, or to support infrastructure. The result was that many companies were not able to take advantage of the high margins and profits because their facilities were non-operational. The high returns to operating refineries did provide an incentive to companies with damaged facilities to get them back on line as quickly as possible.

Independent Oil and Gas Producers

Table 4 presents financial results for 2005 for the independent oil and gas producers. Their revenues were only about 4% of that of the integrated oil companies, but their net incomes were over 14% of that of the integrated oil companies. With the exception of Devon and Andarko, which lost 13.4% and 13.9% of their oil production, respectively, as well as 7.4% and 23.1% of their natural gas production, all the companies in this group were able to expand output. However, the declines posted by Devon and Andarko led the group as a whole to show a decline of 2.8% in oil production, but a 2.4% increase in natural gas production.

---

[7] CRS Report RS22233, *Oil and Gas: Supply Issues After Katrina and Rita*, by Robert L. Bamberger and Lawrence Kumins, for more on the effects of the hurricanes.

[8] Jeff Gosmano, "Upstream Drives Strong Q4 Profits for Majors," *Oil Daily*, vol. 56, no. 46, March 9, 2006, p. 9.

[9] *Oil Daily*, Profit Profile, February 28, 2005, p. 8.

Table 4. Financial Performance of Independent Oil and Gas Producers, 2005
(millions of dollars)

Company	Revenues		Net income	
	2005	% Change	2005	% Change
Devon	10,741	16.9	2,920	34.2
Andarko	7,100	16.8	2,466	54.0
Burlington	7,587	35.0	2,683	75.7
Apache	7,584	42.2	2,618	57.3
Kerr McGee	5,917	34.5	3,420	702.0
Chesapeake	4,655	72.2	880	100.4
EOG	3,620	59.4	1,252	103.9
XTO	3,519	80.6	1,152	126.8
Pioneer	2,373	33.2	535	70.9
Newfield	1,762	30.2	348	11.5
Total	**$54,858**	**35.0**	**$18,274**	**91.9**

Source: *Oil Daily*, Profit Profile Supplement, vol. 56, no. 46, March 9, 2006, p. 11.

Note: Percent change values reflect changes from 2004.

For 2005, four of the ten companies in this group more than doubled their net incomes compared to 2004. The results for the fourth quarter 2005 were even better, as seven of the ten companies were able to more than double their net incomes compared to the fourth quarter of 2004. For the group as a whole, net income increased by 160.8% compared to the fourth quarter 2004. However, the performance of the firms was also affected by asset acquisitions and relinquishments.[10]

Independent Refiners and Marketers

Valero is the leading firm among the group of independent refiners and marketers. Valero accounted for 58% of the group's revenue and 64% of the group's net income. After its acquisition of Premcor, Valero became the largest refiner in the United States, with a total capacity of over 2.2 million barrels per day, over 13% of total U.S. capacity. The acquisition of Premcor by Valero contributed approximately 800,000 barrels per day of refining capacity at four refineries to the Valero total. Valero only had ownership of these facilities for one full quarter, the fourth, in 2005.

---

[10] Ibid.

Table 5. Financial Performance of Independent Refiners and Marketers, 2005
(millions of dollars)

Company	Revenues		Net income	
	2005	% Change	2005	% Change
Valero	82,162	50.4	3,590	99.0
Sunoco	33,764	32.4	974	61.0
Tesoro	15,170	35.1	507	54.6
Frontier	4,001	39.8	272	288.6
Holly	3,213	43.1	168	100.0
Alon	2,329	36.4	104	316.0
Total	**$140,639**	**43.3**	**$5,615**	**92.6**

Source: *Oil Daily*, Profit Profile Supplement, vol. 56, no. 46, March 9, 2006, p. 11.

Note: Percent change values reflect changes from 2004.

Independent refiners and marketers benefitted from the same set of market conditions that affected the integrated oil companies. These factors include refinery outages as a result of hurricanes Katrina and Rita, a wide price spread between high quality light sweet crude and lower quality heavy sour crude, high product prices, and high throughput at their operable refineries. It was reported that refiner margins exceeded $30 per barrel in September 2005. As a result of hurricane Katrina, gasoline prices on the New York Mercantile Exchange reached a peak equivalency of $122 per barrel, while crude oil, also high priced, was just above $70 per barrel. This $52 spread between crude oil and petroleum products was a key factor in the profitability of the entire refining industry in the fourth quarter of 2005.[11] The independent refiners and marketers earned one third of their 2005 profits in the fourth quarter of 2005.

2006 Profit Outlook

Crude oil prices finished the first quarter of 2006 above $65 per barrel. Residual effects from the hurricanes still inhibit domestic production of crude oil and natural gas, and although it is likely that high prices have slowed the pace of demand growth to some extent, oil market conditions remain tight. These factors suggest that profit levels are likely to remain high in the oil and natural gas industry, at least through the first quarter of 2006, and possibly throughout the year, unless the world price of oil unexpectedly declines.

---

[11] Matt Piotrowski, "Refiners Close 2005 With Stellar Profits," *Oil Daily*, vol. 46, no. 56, March 9, 2006, pp. 8-9.

Unless there is a sharp worsening of market conditions, profit growth rates, although not necessarily profits themselves, are on track to decline markedly in 2006. Given the high profit growth rates attained in 2005, these rates are likely to be sustained only by rapidly rising prices in the oil and petroleum product markets. Even though profits may remain at historically high levels, this outcome might be interpreted as disappointing by the financial community, affecting the ability of the oil companies to attract capital for risky projects through the financial markets.

The positive net income performance of the oil industry developed so quickly, and the magnitudes were so large in 2005, that they seemed to, perhaps, overcome plans to use the money. As a result, the major firms in the industry built up their cash reserves, with ExxonMobil, Chevron, and ConocoPhillips, the three largest integrated U.S. oil companies, together holding over $40 billion. In addition, special dividends were paid to shareholders and stock re-purchase plans were common in the industry.

This year may see the beginning of new investments in the industry resulting from the earnings of 2005. Time lags between earnings and increased investment activity are not uncommon in the oil industry. Because many of the companies in the industry have a global perspective, investment may or may not take place in the United States. In addition, the balance between refining investment and exploration and production will also likely reflect the profit expectations of the industry. Even if investment takes place outside the United States it will still contribute to world capacity. In a world market that is linked and interdependent, increased oil production and refining capacity anywhere in the world can benefit the U.S. market in terms of potential supply availability and relative price stability.

Conclusion

While the oil industry recorded high profits in 2004, they increased to record levels in 2005. A combination of factors, from political unrest to the effect of large hurricanes, tightened the oil and petroleum products markets, driving up prices, but not resulting in wide-spread shortages for consumers.

The industry approaches 2006 with a financial position that could result in expanded investment and capacity, either in the United States and/or worldwide. Expanded capacity is likely to reduce the near term ability of the industry to maintain the profit levels of 2006, but may be necessary in the longer term.

Memorandum May 18, 2007

TO: John Arlington
Committee on Energy and Commerce

FROM: Robert Pirog
Specialist in Energy Economics and Policy
Resources, Science, and Industry Division

SUBJECT: 2006 Oil Industry Profits

This memorandum is written in response to your request for 2006 profit data for the oil industry. **Tables 1** through **5** update the data in corresponding tables in CRS Report RL33373.

Please call me at 7-6847 if you have additional questions.

Table 1. Financial Performance of the Integrated Oil Companies, 2006 (millions of dollars)

Company	Revenues		Net Income		Return on sales	Return on equity
	2006	% change	2006	% change		
ExxonMobil	377,635	1.9	39,500	9.3	10.5%	34.6%
Royal Dutch/Shell	318,845	3.9	25,365	11.6	7.9	23.5
BP	270,602	10.9	22,253	15.2	8.2	25.7
Chevron	210,118	6.0	17,138	21.6	8.2	24.8
Conoco Phillips	188,523	2.8	15,550	14.9	8.2	18.8
Marathon	65,449	3.3	5,234	72.6	8.0	35.8
Hess	28,720	23.5	1,916	54.3	6.7	23.6
Occidental	17,661	21.0	4,182	-20.8	23.6	21.8
Murphy	14,307	20.5	638	-24.7	4.5	15.7
Total	$1,491,860	5.4	$131,776	13.4	8.8%	26.0%

Source: *Oil Daily*, Profit Profile Supplement, vol. 57, no. 50, March 14, 2007, p. 10, and Financial Data by Company at [http://www.Hoovers.com/free/], and company annual reports.
Note: Percent change values reflect changes from 2005.

Table 2. Upstream Results of the Integrated Oil Companies, 2006

Company	Net Income		Oil production		Gas production	
	2006	% Change	(000 b/d)	% Change	(mm cf/d)	% Change
ExxonMobil	26,230	7.7	2,681	6.3	9,334	0.9
Royal Dutch/Shell	15,198	6.7	2,030	-3.0	8,368	1.3
BP	29,647	13.3	2,475	-3.4	8,417	-0.1
Chevron	13,142	12.1	1,732	3.8	4,956	17.1
Conoco Phillips	9,848	16.8	1,129	11.0	4,970	52.0
Marathon	2,003	6.1	223	36.0	847	-9.1
Hess	1,763	66.6	257	5.3	612	12.5
Occidental	7,239	21.3	456	17.2	735	9.1
Murphy	616	-17.6	90	-12.6	75	-16.7
Total	$105,683	12.6	11,073	2.9	38,314	7.4

Source: *Oil Daily*, Profit Profile Supplement, vol. 57, no. 50, March 14 2006, p. 10.
Note: Percent change values reflect changes from 2005.

Table 3. Downstream Results of the Integrated Oil Companies, 2006

Company	Net Income		Product sales (000 b/d)	
	2006	% Change	2006	% Change
ExxonMobil	$8,454	7.3	7,247	-3.6
Royal Dutch/Shell	6,989	-1.6	6,485	-8.1
BP	5,667	9.3	5,801	-1.5
Chevron	3,973	43.6	3,621	-2.8
Conoco Phillips	4,481	5.3	3,476	6.9
Marathon	2,795	71.7	1,425	-2.1
Hess	390	-20.6	459	0.7
Occidental	—	—	—	—
Murphy	105	-16.0	385	7.5
Total	$32,854	11.6	28,889	-2.7

Source: *Oil Daily*, Profit Profile Supplement, vol. 57, no. 50, March 14,2006, p. 10.
Note: Percent change values reflect changes from 2005.

Table 4. Financial Performance of Independent Oil and Gas Producers, 2006 (millions of dollars)

Company	Revenues		Net Income	
	2006	% Change	2006	% Change
Devon	10,578	- 0.4	2,836	-2.9
Andarko	10,187	64.7	4,851	96.7
EnCana	16,399	12.5	5,652	65.0
Apache	8,289	9.3	2,547	-2.7
Noble	2,940	34.5	678	-8.1
Chesapeake	7,236	57.0	1,904	116.5
EOG	3,904	7.9	1,289	2.9
XTO	3,490	25.2	1,860	61.5
Pioneer	1,633	5.7	740	38.4
Newfield	1,673	-5.1	591	69.8
Total	$54,858	35.0	$18,274	91.9

Source: *Oil Daily*, Profit Profile Supplement, vol. 57, no. 50, March 14 2006, p. 11.
Note: Percent change values reflect changes from 2005.

Table 5. Financial Performance of Independent Refiners and Marketers, 2006 (millions of dollars)

Company	Revenues		Net Income	
	2006	% Change	2006	% Change
Valero	91,833	11.8	5,461	52.1
Sunoco	38,715	14.7	979	0.5
Tesoro	18,104	9.2	801	58.0
Frontier	4,796	19.9	379	37.8
Holly	4,023	32.1	268	60.5
Alon	3,198	37.4	157	51.0
Total	$169,669	13.2	$8,045	43.2

Source: *Oil Daily*, Profit Profile Supplement, vol. 57, no. 50, March 14, 2 06, p. 11.
Note: Percent change values reflect changes from 2004.

THE WALL STREET JOURNAL. ONLINE

May 18, 2007

Refiners Cash In on High Gasoline Prices

In Shift, Processors See More of Profit Windfall Than Producers of Oil

By ANA CAMPOY
May 18, 2007; Page A10

Record gasoline prices are changing the equation of the refining business, generating unprecedented profits for the companies that transform crude oil into fuel.

For every barrel of oil they use to make gasoline, refiners are pocketing more than $30 in profit before taxes and other expenses. That is the most they have reaped per barrel since Hurricane Katrina in 2005. The major producers of gasoline in the U.S. earned about $10 billion from their refining operations domestically and abroad in the first quarter, up 50% from a year earlier.

AT THE PUMP

- **Rising Margins:** Refiners' profit per barrel of oil used to make gasoline has grown as gasoline prices have risen.
- **Tight Supply:** Refinery outages, lower imports and continued customer demand have contributed to the rise in gasoline prices.
- **Industry Shift:** Big profits for refiners come as the profitability of producing oil has leveled off.

Analysts are projecting earnings will be even higher in the second quarter, due to lower-than-normal gasoline inventories. Rising demand, a string of refinery outages and a drop in gasoline imports earlier this year curbed supplies and raised prices. Some refiners, such as **Tesoro** Corp., are using the cash gusher to finance upgrades. Others, such as **Valero Energy** Corp., the largest refiner in North America in terms of capacity for crude oil and other feedstocks that go into the refining process, are shipping the cash back to shareholders by buying back shares.

The average retail price of a gallon of regular gasoline reached about $3.10 this week, up five cents from the week before and its highest level ever, according to the Energy Information Administration. A rise in oil prices is contributing -- yesterday benchmark oil futures jumped $2.31 per barrel, or 3.7%, to $64.86 on the New York Mercantile Exchange. In London, benchmark Brent crude oil futures rose $2.30, or 3.4%, to $70.27.

A Change in Who Profits

But crude oil is still 16% below its nominal high of $77.03 a barrel reached last year, underscoring a shift in the oil industry after more than three years of flush profits. Rising demand and prices fattened the bottom lines of companies across the industry. But gasoline's current run-up is mainly boosting profits for refinery operators, while the business of pumping oil out of the ground has seen its profits plateau or fall a bit.

Refiners have been on a roller coaster since hurricanes slammed into the nation's refining belt along the Gulf of Mexico in 2005. Gasoline prices spiked above $3 a gallon. That led to a rise in what the industry

calls the refining margin, or the difference between the price refiners pay for oil and the prices their fuels fetch. But gas prices eased, and refining margins collapsed in 2006.

Supply-and-demand economics aren't the only forces behind the current rise in fuel prices. Hedge funds and other investors have plunged into the gasoline futures market in recent years, creating more volatility and magnifying price swings.

"The fundamental factors don't come close to justifying either the current peak in margins, or even the elevation of margins of the last two to three years," says Mark Gilman, analyst at financial broker Benchmark Co.

In addition, the U.S. gets about 13% of its gasoline from abroad. Many refineries overseas have hit their own operating snags or are shifting to produce more diesel, which is growing in popularity in other countries.

Fuel prices aren't likely to stay this high for too long. Gasoline prices and margins are expected to fall in the next few years as major refining projects under way in Asia and the Middle East, as well as refinery expansions in the U.S., help fill the growing gap between domestic supply and demand.

Prices Likely to Moderate

Prices could start moderating later this year as more imports flow into the market and idled refineries come back on line. "The market does expect supply will rebound," says Anatol Feygin, head of global commodity strategy at Bank of America. Although Bank of America projects that average refining margins for the full year will rise to $12.71 from $12.15 in 2006, it expects them to fall to $9.50 in 2008 and to $8 in 2009.

For decades, there was too much refining capacity in the U.S., margins were crummy and many companies were closing or selling off refineries. In 1986, refiners made little more than $2 for every barrel they processed. "We used to commission studies to get rid of the refineries," says Fadel Gheit, who formerly worked at Mobil, now part of **Exxon Mobil** Corp., and is now senior energy analyst of Oppenheimer & Co. "We wanted to give them away."

Consolidators such as Valero acquired refineries on the cheap in the 1990s. The extra capacity disappeared, and when energy prices soared in recent years, so did refining margins.

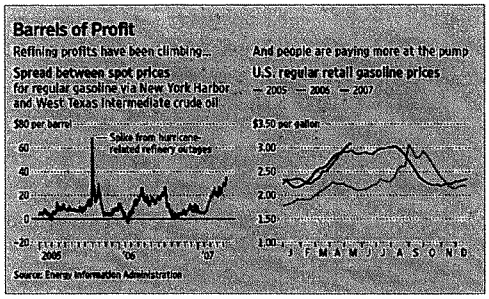
Now, refining operations are the stars of integrated oil behemoths such as Exxon and **Chevron** Corp. In the first quarter, lofty refining earnings at both companies helped offset declining profits from producing crude oil and natural gas. Exxon made $1.91 billion from its refining and marketing unit, up 50% from the previous year; Chevron posted earnings of $1.62 billion from refining, more than double the $580 million it made a year ago.

Marathon Oil Corp., a smaller integrated oil company, is constructing a $3.2 billion addition to its largest refinery, in Garyville, La. About half the output will be diesel fuel, which has had loftier prices in recent years than gasoline.

For pure refiners, the bonanza has been even greater. Tesoro's earnings rose more than one and a half times in the first quarter; **Sunoco** Inc., another big refiner, said profit more than doubled in the same period. Sunoco's stock price has risen more than 50% in the past few years, while Tesoro's share price has more than tripled.

Tesoro is plowing money back into operations. It is updating several refineries to reduce outages and modifying them to process heavy crude, which is a cheaper feedstock than low-sulfur oils and generates

higher margins. The company also recently bought a refinery from **Royal Dutch Shell** PLC.



Valero is cashing in. The company just agreed to sell its refinery in Lima, Ohio, for $1.9 billion. "Just as we bought assets at low prices when valuations were low, we are exploring options for unlocking the value of assets now that valuations are high," said Valero spokesman Bill Day. The company also just launched an ambitious share-buyback program.

'Not in My Backyard'

Hardly anyone is using the extra cash to build new refineries from scratch, says Nicole Decker, an energy analyst at Bear Stearns. "The permitting process is daunting, and there is a 'not in my backyard' mentality, which together, have stalled out proposals to build," she said.

President Bush's energy-conservation push may give refiners even less incentive to boost output in the short term. The president has proposed to increase alternative- and renewable-fuels use to 35 billion gallons a year by 2017, lessening the need for gasoline. This week, the Bush administration said it planned to substantially lift the fuel-economy standards for automobiles, another step designed to cut gasoline use.

Refiners are also reluctant to spend billions of dollars in building refineries because it would take years to recover their investment and they say they are unsure about future demand. The last new refinery in the U.S. opened in 1976. "It's a very, very cloudy investment picture," says Lynn Westfall, chief economist and senior vice president at Tesoro.

Write to Ana Campoy at ana.campoy@dowjones.com[1]

United States Senate
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
Committee on Governmental Affairs

Carl Levin, Chairman
Susan M. Collins, Ranking Republican

GAS PRICES: HOW ARE THEY REALLY SET?

REPORT

PREPARED BY THE

MAJORITY STAFF
OF THE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

RELEASED IN CONJUNCTION WITH THE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS' HEARINGS
ON APRIL 30 AND MAY 2, 2002

I. EXECUTIVE SUMMARY

A. Background

In June 2001, following the spike in the price of gasoline in the Midwest, the Chairman of the Permanent Subcommittee on Investigations, Senator Carl Levin, directed the Majority Staff of the Subcommittee to investigate the reasons for these price increases, and, in particular, whether the increased concentration within the refining industry has contributed to recent price spikes and price increases.

The Majority Staff's investigation encompassed issues concerning the structure of the domestic refining and marketing industry and the conduct of the participants in these markets. The staff interviewed representatives from a variety of segments of the downstream petroleum industry (refinery to gas station), including major refining and marketing companies, distributors of refined gasoline, service station owners and dealers, trade association representatives, lawyers and economists. The staff analyzed data obtained from the Energy Information Administration and wholesale and retail price data purchased from the Oil Price Information Service. The Subcommittee issued subpoenas to a number of major oil companies and one pipeline company for relevant refining and marketing documents from 1998 through 2001. In response, the Majority Staff received and reviewed 103 boxes of documents containing approximately 265,000 pages. Due to staff and time constraints, the Majority Staff focused on three regions of the country: the West Coast – California in particular; the Midwest – Michigan, Ohio, and Illinois in particular; and the East Coast – Maine and the Washington, D.C. area in particular.

This report presents the Majority Staff's findings regarding recent increases in gasoline prices and volatility, especially with respect to the effect of increasing concentration in the refining industry on gasoline prices.

B. Findings

1. In the past three years there have been extraordinary spikes in the price of gasoline and the price of gasoline has increased significantly.

Over the past three years, the price of gasoline has increased significantly. The 35-cent increase in the average annual price of regular unleaded gasoline from 1999 to 2000 (from $1.16 to $1.51 per gallon) had been matched only once in history – by the 34-cent average annual increase in 1980 that followed the Iranian revolution and the outbreak of war between Iran and Iraq.

The price of gasoline has also become more volatile than ever. Gasoline prices now regularly vary more in one month than they previously did in entire years. In late spring of 2000, prices in Chicago spiked to $2.13. In 2001, Midwestern prices spiked again, reaching over $1.90 per gallon in central Michigan. Just this spring, retail prices have increased faster than at any time in the past 50 years since gasoline prices have been tracked regularly.

2. Spikes in the price of gasoline are harmful to consumers and the economy..

Gasoline price increases can disrupt the entire U.S. economy. By increasing the cost of transportation, increases in the price of gasoline affect the costs of all goods and services. Last year's increases in the price of gasoline, along with rises in the prices of other petroleum products, helped push the American economy into a recession, and this year's increases are threatening the current recovery. These price increases result in large transfers of wealth from

consumers to a few companies that refine and market gasoline. Over the course of a year, each ten cent increase in the price of gasoline results in approximately an additional $10 billion in revenues to the oil companies. Price increases are particular burdens on people with fixed-incomes who depend on cars for their basic needs. Although through much of the 1990s the refining industry's profits were not above most other industries, the recent price spikes brought exceptional returns. For the year 2000, net income for major energy companies from refining and marketing was up 57 percent from income in 1999.

3. **The mergers in the oil industry over the last few years and the closing of many refineries over the past twenty years have increased concentration in the refining industry. In some states, the refining and marketing industry for gasoline is highly concentrated; in many states it is at least moderately concentrated.**

A large number of mergers and acquisitions in the oil industry in recent years has led to a significant consolidation of refining assets.

- In 1998, Marathon and Ashland Oil merged their downstream assets.
- In 1998, British Petroleum (BP) merged with Amoco
- In 1999, Exxon Corporation merged with Mobil Corporation.
- In 2000, BP/Amoco acquired ARCO.

Within the past year –

- Shell acquired Texaco's domestic downstream assets;
- Chevron, which had acquired Gulf Oil in 1994, acquired Texaco (other than downstream assets);
- Phillips acquired Tosco;
- Phillips announced a merger with Conoco;

- Valero acquired Ultramar Diamond Shamrock (UDS).

This wave of mergers has followed a general consolidation of assets within the refining industry over the past two decades. In 1981, 189 firms owned a total of 324 refineries; by 2001 65 firms owned a total of 155 refineries, a decrease of about 65 percent in the number of firms and a decrease of about 52 percent in the number of refineries. During this period the market share of the ten largest refiners increased from 55 percent to 62 percent.

As a result of this consolidation, in a number of regions, states, and cities across the country the wholesale and retail markets for gasoline in the United States are moderately to highly concentrated. In 2000, as measured by the Department of Justice/Federal Trade Commission guidelines for evaluating mergers, the gasoline wholesale market was "moderately concentrated" in twenty-eight states and "highly concentrated" in nine. According to the four-firm concentration ratio, which is another standard measure of market concentration, the wholesale market is a "tight oligopoly" in twenty-eight states (including the District of Columbia).

4. Over this same time period, the balance between supply and demand has become "tight."

Because of the decline in the number of domestic refineries, total domestic refining capacity is slightly lower now than it was twenty years ago. At the same time, demand has increased. As a result of these trends, at present supply and demand are very closely balanced. This is sometimes referred to as a "tight" market.

In 1981, when the number of refineries was at its highest, capacity utilization was at its lowest. Just over 68 percent of refining capacity was being used, meaning that nearly one-third of all domestic capacity was idle. During most of the 1980s and into the early 1990s, total

capacity remained high and excess capacity remained. This excess capacity led to low refining margins and a number of refinery closures. At the same time, many refiners invested capital to "de-bottleneck" their refineries to increase their efficiency, capacity and ability to process less expensive streams of crude oil.

Following the passage of the Clean Air Act Amendments of 1990, many refiners not only upgraded their facilities to produce cleaner fuels, but took the opportunity to add more capacity as well. Again, less efficient refineries were closed rather than upgraded.

In the United States today, 63 companies operate about 150 refineries with a combination distillation capacity of just over 16 million barrels per day. With the closure of many small refineries and the addition of new capacity to existing refineries, the average capacity of a refinery in the United States has increased by nearly 50 percent since 1970.

As demand has slowly but steadily grown, and refineries have closed, there is no longer an excess of refining capacity; the West Coast is even short. The annual average refinery utilization rate is now regularly greater than 90 percent, which is near maximum capacity.

5. **High concentration exacerbates the factors that allow price spikes and increases, a key one of which is the tightness of supply.**

6. **In concentrated markets refiners can affect the price of gasoline by their decisions on the amount of supply. In a number of instances, refiners have sought to increase prices by reducing supply.**

Economic principles dictate that markets in which a few firms have market power to affect overall supply will exhibit higher prices than more competitive markets. As long as sellers in a market can indirectly affect prices through their supply decisions, it can be expected that sellers will act in their self-interest to manage supply so as to maximize their profits; this

means that producers in a concentrated market will attempt to achieve and maintain a tight balance between supply and demand. This is increasingly the situation in the gasoline industry today.

A tight market optimizes profits for a refiner. When a market is in a tight balance or a little bit short, as it is in California and the West Coast today, imports will be necessary to satisfy peak demand and prices will be lifted by an amount at least equal to the cost to import marginal barrels from elsewhere. Moreover, as recent history in California and the Midwest demonstrates, when supply and demand are closely balanced and inventories are low, refinery or pipeline disruptions will cause immediate supply shortages. Because of the inelasticity of the price of gasoline, even relatively small supply shortages will lead to large increases in the price of gasoline and refining margins.

In California, which is the second largest market for gasoline in the world, the market is an oligopoly. Six refiners own or operate about 85 percent of the retail outlets in the state, which account for than 90 percent of the retail gasoline sold in the state. As a result, the few large refiners within the state have the ability to affect the price of gasoline through their individual supply decisions.

In California, retail gas prices are higher and more volatile than the rest of the nation; refining margins – the difference between refining costs and wholesale (rack) prices – are also higher. The high level of concentration and vertical integration within California's gasoline markets, the tight balance between supply and demand, low inventories, the state's unique gasoline specifications, and its geographic isolation from other refining centers contribute to these higher prices and margins.

Evidence from a recent lawsuit in California indicates that during the early- to mid-1990s, when supply exceeded demand, a number of refiners sought to limit the amount of supply available in order to tighten the supply/demand balance. To reduce supplies these refiners sought to increase exports, limit imports, eliminate the oxygenate mandate in gasoline, and prevent additional refinery capacity from operating.

Today, demand for gasoline in California slightly exceeds the available supply from within the state; imports are necessary to satisfy demand during peak driving seasons. Prices have risen to levels necessary to attract these imports. Because of the high degree of concentration and vertical integration between refiners and marketers within the state, as well as the other high barriers to entry into the California market, it is unlikely that any significant increase in imports or production will occur to alleviate this tightness.

The Midwest overall is less concentrated than California but has several pockets of high concentration in the wholesale market. The Midwest relies on imports from other regions, such as the Gulf Coast, for approximately 20 percent of its gasoline. It may take at least two to three weeks for additional supplies to arrive after a supply disruption within the region.

Low inventories have created the conditions for price spikes in the Midwest, which have occurred when demand has increased (near driving holidays) and/or the supply of gasoline was disrupted. Because demand for gasoline is inelastic, even a small reduction in supply or an increase in demand will lead to a large increase in price. Generally the extent of the price spike has depended on how quickly alternative supplies have been brought to the market and how much it cost to bring in those additional supplies.

Not unlike oil companies nationwide, oil companies in the Midwest have adopted just-in-time inventory practices, resulting in crude oil and product stocks that frequently are just above

8

minimum operating levels. And, in the spring of 2000 and 2001, the conversion from the production and supply of winter-grade gasoline to summer-grade gasoline further contributed to low inventories just prior to a seasonal increase in demand. With the stage set by those two factors, the oil companies took actions over these past two years in accordance with their profit maximizing strategies that significantly contributed to the price spikes when disruptions in supply occurred:

– During the spring of 2000, three major refiners determined it wasn't in their economic self interest to produce more RFG (reformulated gasoline) than that required to meet the demands of their own customers. That contributed to the shortness in the spot market for RFG, contributing to the price spike of spring 2000. While Marathon did have surplus RFG, it withheld some of it from the market so as to not depress prices.

– During the spring of 2001, the Energy Information Agency projected that gas inventories were the same or even less than in the spring of 2000. These low inventories and the tight balance between supply and demand again set the stage for the spring price spike that occurred when supply was disrupted.

– In the summer of 2001, major refiners affirmatively reduced gasoline production, even in the face of unusually high demand at the end of the summer driving season because of low refining margins, contributing significantly to the price spike of summer 2001.

Nationwide, in the winter of 2001 - 2002, demand fell and inventories rose following the tragic events of September 11, 2001. With reduced demand and higher inventories, prices fell. As a result, refining margins fell and refiners cut back on production in order to obtain higher margins. Along with the increase in the price of crude oil and market speculation, these

reductions in production were a significant factor contributing to the run-up in price in the late winter and continuing into the early spring of this year.

An internal BP memo from 1999 confirms the interest at least one oil company has had in limiting the supply of gasoline in the Midwest. The memo identifies a number of options for consideration in order to reduce supply in the Midwest. Among the options are: shutting down capacity, exporting to Canada, lobbying for environmental regulations that would slow down movement of gasoline in pipelines, shipping product other than gasoline in pipelines, and providing incentives to others not to provide gasoline to Chicago.

As the domestic refining market is currently structured, it is likely that supply and demand in certain markets will continue to remain in tight balance and vulnerable to disruptions.

7. Highly concentrated retail markets have higher retail prices.

Retail gasoline prices may vary considerably in different cities within the same geographic region. Some of these differences are attributable to the differences in the costs to transport gasoline from a refinery to the market and others are attributable to the characteristics of each market.

Industry documents obtained by the Subcommittee during the investigation provide evidence of what many have suspected but what has been controversial and elusive to demonstrate – that retail prices are higher in areas where there is greater market concentration, especially among the major brands. According to these documents, retail margins (the difference between the wholesale price and the retail price for gasoline) depend upon the characteristics of the local market: the degree of concentration, the market share of the major oil companies, the per capita income in the market area, the average volume of gasoline sold at each

gasoline station, and the presence of independents or "new era" marketers, such as convenience stores or hypermarkets with gasoline islands.

In a number of markets, many traditional-style independents have disappeared. These independents served to push prices down in their local markets. In some markets they have been replaced by "new era" competitors, which continue to have this effect.

In other markets, however, prices have risen when independents have left the marketplace. In California, for example, after ARCO purchased the Thrifty chain of independent gasoline stations prices increased in the areas formerly served by the Thrifty stations.

The presence of competitors other than a few major brands is critical to price competition in local markets.

8. Markets in which there is a high degree of vertical integration between refiners and marketers have higher wholesale and retail prices.

A high degree of vertical integration between gasoline refiners and marketers leads to a number of anti-competitive results, including higher wholesale and higher retail prices. In markets in which there are few independent *retailers*, not much gasoline will be bought at a wholesale price lower than the wholesale prices set by the integrated refiners. Similarly, in markets in which there are few independent *refiners*, there will not be much wholesale gasoline sold at a price lower than the wholesale price set by the integrated refiner. Integrated refiner/retailers have little incentive to sell to other retailers at low prices, since they will not want to undercut their own retailers.

As the markets in California and Arizona demonstrate, a high degree of vertical integration will contribute to the demise of the "spot" market for unbranded gasoline, which is typically sold at lower prices than branded gasoline. In a highly integrated market, the non-

integrated retailers will have difficulty finding reliable sources of supply and may be forced to exit the marketplace entirely.

A high degree of vertical integration makes it more difficult for refiners in other markets to export gasoline into the integrated market, as integrated firms will not want to have other refiners sell gasoline into their market and lower prices through additional supply. In a highly integrated market, the number of non-integrated retailers remaining in the market may not be large enough to economically bring in imports from elsewhere. Thus, as a practical matter, in a highly integrated market the integrated refiners will be the only ones who determine whether to import gasoline into the state during price spikes, or whether to increase overall supply into the state. These barriers to imports will lead to higher prices. Indeed, the evidence shows that in both California and Arizona the high degree of vertical integration has led to higher retail prices.

9. Oil companies do not set wholesale (rack) or retail prices based solely upon the cost to manufacture and sell gasoline; rather wholesale (rack) and retail prices are set on the basis of market conditions, including the prices of competitors. Most oil companies and gasoline stations try to keep their prices at a constant price difference with respect to one or more competitors. As a result of these interdependent practices, gasoline prices of oil companies tend to go up and down together.

Neither wholesale nor retail prices for gasoline are established on a cost-plus-profit basis. The wholesale price a refiner can obtain for refined gasoline is determined largely by the factors influencing the then-current supply and demand situation in the wholesale market, including the market's outlook for the future. Competitors' prices also are considered. Similarly, the price a retailer will charge for gasoline on any given day will not be equal to the cost to manufacture, transport, and sell the gasoline at the station with a reasonable profit; rather the retail price will

be set based upon the prevailing market conditions, including the retail prices of nearby competitors.

Most gasoline stations focus their retail pricing policies on the retail pricing of their competitor's outlets. Oil companies and station operators typically will survey the retail prices at nearby gasoline stations at least once a day.

Each company's formula for determining an appropriate retail or "street" price is different, but companies rely on a system of identifying which competitors are market drivers for a particular area. One type of pricing system prices directly against a specific market driver, usually a low priced competitor, such as Company X's price + 3 cents per gallon. Another method for pricing is to price at the average of the prices of all major market drivers. Sometimes the price is determined using a combination of both methods.

Companies state that if they attempt to increase the price of their product above the other retail prices in the area, they will lose volume to the retail outlets with lower prices. Companies state that if they lower their prices either they will run out of gasoline due to a run on their supplies, or their competitors will lower their price, too, and the net result for all of the stations in the area will be reduced margins. As a result of these interdependent pricing practices, retail gasoline prices move up and down together.

10. In Michigan and Ohio, these interdependent and parallel retail pricing practices have led to sharp daily increases in retail prices across the states.

The Majority Staff analyzed wholesale (rack) and retail data obtained from the Oil Price Information Service for the leading retail brands of gasoline in five states: Michigan, Ohio, Illinois, California, and Maine. In 2001, in Michigan and Ohio, and to a lesser extent Illinois, prices often increased by as much as 7 to 10 cents in one or two days, and then slowly fell over

the next several days, but not by as much as they had risen. These one- and two-day increases were often led by one brand, and sometimes two, in order to increase retail margins, and were almost always followed by other brands.

11. Oil companies use zone pricing to charge different prices for gasoline to different station operators, some of which are in nearby geographic areas, in order to confine price competition to the smallest area possible and to maximize their prices and revenues at each retail outlet.

Most oil companies follow the practice of grouping their retail outlets into geographic or market zones and charging their branded dealers (either lessee-operated or dealer-owned outlets) in different zones different prices for the same brand and grade of gasoline that is delivered from the company. This practice is called "zone pricing." Each oil company has its own zone system. The number of outlets in a zone, the shape of a zone and the number of zones in a particular area vary from zone to zone and company to company. In recent years zone size has been shrinking; some zones now contain only one retail outlet.

Oil companies argue that zones are created to account for differences in such factors as demand for their product and competition. Station dealers argue that the zone pricing policy is unfair, because it allows an oil company to charge gas stations in nearby geographical areas – sometimes on the same corner – different prices for the same gasoline. Almost all of the companies interviewed by the Majority Staff indicated they employed some form of zone pricing in order to respond to local competitive conditions.

Another rationale for creating zones is to enable particular stations to be able to charge higher prices without losing too much volume to nearby competitors. By determining the various "elasticity curves" in the area surrounding a gasoline outlet, marketing consultants believe they can determine how much prices can be raised at a particular station before

consumers will drive to other nearby stations. These consultants claim that zones enable retailers not only to be competitive with nearby stations, but also to maximize prices and revenues at each station.

12. For the many stations owned or leased by the major oil companies, it is the major oil company rather than the local dealer that determines the competitive price position of the local station and that benefits from higher prices and profit margins.

Refiners generally set the wholesale price of the gasoline they directly deliver to their dealers (called the "dealer tank wagon" price, or "DTW") by calculating an appropriate competitive retail price for the dealer – which is done by surveying the competitive prices in the retailer's local market – and then subtracting a fixed margin, usually between 7 and 10 cents per gallon. Although retail prices fluctuate, the dealer's margin stays fixed. In a number of cases dealers have reported that when they attempted to obtain a greater margin by increasing their retail prices, the refiner increased the DTW by a commensurate amount. As the retail price rises and falls, it is the refiner, rather than the dealer, that receives either the profit or the loss.

13. The "hypermarket" is rapidly expanding as a highly competitive format for selling gasoline.

The hypermarket, which is "a supermarket, other traditional retail store, or discounter (such as Wal-Mart or Costco) with a motor gasoline outlet in the parking lot," has rapidly become an extraordinarily competitive presence in the retail gasoline marketplace. Hypermarkets have captured almost half of the gasoline market in France and approximately one-quarter of the market in the United Kingdom. Although hypermarkets currently account for only about 3 percent of gasoline sales in the United States, it is highly likely that hypermarkets

will rapidly increase their gasoline business at the expense of major brand retail and convenience stores across the country, just as they have done in Europe.

If the anticipated growth in hypermarket occurs, it will result in additional significant changes in the composition of the retail marketplace. A number of distributors (jobbers) and small independent operations may be the most seriously threatened by the hypermarkets, as they tend to own or service smaller, older stations with fewer offerings which cannot compete either on price or on convenience with the hypermarkets. Even the most efficient stations with a traditional format may not be able to compete with the hypermarkets, as the traditional format requires a higher margin than a hypermarket just to break even. The extent to which major brands will themselves invest – either through discounts to their jobbers on wholesale purchases, or through site upgrades – to enable such sites to become competitive with new hypermarkets and convenience stores remains to be seen.

Although convenience stores and hypermarkets are major competitive forces in the gasoline retail market, it is unclear what the nature of the competition will be in the long run if these new formats force a significant number of smaller independents or smaller jobbers out of business. Traditionally, the smaller independents and jobbers have helped to keep prices low.

14. The Wolverine Pipeline case illustrates how control over storage facilities and pipelines can be used to limit gasoline supplies and competition in a market.

The Wolverine Pipeline transports gasoline and other products from Chicago to Michigan, Illinois, Indiana, and Ohio. Wolverine is owned by affiliates or subsidiaries of major oil companies, namely ExxonMobil, Equilon, Unocal, Citgo, and Marathon.

16

The Wolverine Pipeline is a major source of supply for the gasoline market in and around Grand Rapids, Michigan. Wolverine and its affiliates utilized their control of critical transportation and storage facilities to limit access to and competition in markets, particularly disadvantaging independent shippers of unbranded gasoline. In a recent challenge to a Wolverine rate request, the Federal Energy Regulatory Commission staff found that practices of Wolverine and its affiliates violated the Interstate Commerce Act, some for over twenty years. Had not the rate request been challenged, it is likely these discriminatory practices would have continued, and it would have been more difficult for independents to compete.

15. If concentration in the oil industry continues to increase, higher prices can be expected.

TESTIMONY OF MICHIGAN GOVERNOR JENNIFER M. GRANHOLM

BEFORE THE UNITED STATES HOUSE ENERGY AND COMMERCE COMMITTEE

May 22, 2007

INTRODUCTION

My name is Jennifer Granholm and I am the Governor of the State of Michigan. I appreciate the opportunity to submit written testimony on a matter that continues to be of the utmost concern for all Americans: the escalating cost and continued volatility of gasoline prices. I also appreciate the opportunity to voice my support for H.R. 1252 – the Federal Price Gouging Protection Act.

Five years ago this month, in my capacity as Attorney General for the State of Michigan, I testified on petroleum pricing issues before the United States Senate Governmental Affairs Committee, Permanent Committee on Investigations. I reported on our efforts to respond to the price gouging that occurred at the retail level immediately following the tragic events of September 11, 2001. As Attorney General, I mobilized our Department's resources and initiated legal actions against 46 gasoline retail establishments who charged anywhere from $2.50 - $5.00 per gallon for violations of the Michigan Consumer Protection Act.

Ultimately, we required these retailers to refund excess profits to their customers and pay civil fines and penalties. I believed then, and continue to believe today, that our laws and regulations must equip state attorneys general with appropriate tools to deter those who would exploit

emergencies, either national or local in scope, to obtain unconscionably excessive profits through price gouging.

In addition, when I last testified, Michigan had just completed three years of investigations aimed at ascertaining the causes and conditions that account for the price spikes and high gasoline costs that our consumers were encountering. At that time I addressed two issues that were within federal policymakers spheres of influence. These were:

1. The identification of the operative factors that result in constricted supplies in specific geographic markets; and
2. The detrimental effects on consumers of the increased concentration in the refining, distribution and marketing segments of the petroleum industry by the dominant industry actors.

The purpose of my testimony was to inform the discretion of Congress by conveying Michigan's experiences relating to these issues, with the hope and expectation that action would be taken by Congress and the Bush Administration to address the high cost and price volatility of gasoline at the pump.

Indeed, in the last four years I have written, petitioned and cajoled the Administration, in conjunction with many other Governors and consumer advocates, to improve and strengthen federal energy policy and to correct

the clear lack of effective federal oversight and control in these areas. We have asked for the reduction in the billions of dollars of federal oil and gas subsidies, caps or controls on windfall profits and importantly, that federal agencies, and in particular the Federal Trade Commission and the Department of Justice Antitrust Division, be given the *direction* and necessary resources to thoroughly review petroleum mergers so that anticompetitive mergers are not consummated.

In making these requests, I recognize that the price of petroleum products and price volatility are a function of a complex interplay of factors. These factors include the cost of crude oil, inventories of crude and refined product, refining capacity and capacity utilization, "just in time" product deliver practices, planned and unplanned disruptions, seasonal production of low-vapor fuels, vertical integration, merger activity and wholesale and retail marketing. Complexity, however, cannot excuse the appalling lack of federal attention and federal action, especially given the magnitude of the problem and the impacts on American consumers.

Not surprisingly, the failure to take effective measures has allowed the situation to further devolve, with gasoline prices now reaching all time highs. Currently, gas prices in Michigan are at record high levels, with the statewide average price paid for regular gasoline $3.321 for May 16, 2007,

as reported by AAA . http://www.fuelgaugereport.com/Mlavg.asp. Prior to this season, the record high average retail price for gasoline in Michigan was the August 2, 2006, reported high price of $3.09.

Further, where historical price spikes could be associated with causative factors such as the high cost of crude, full utilization of available refinery capacity, and natural disasters limiting production and distribution like hurricane Katrina, these factors now appear to be tenuously related to pricing or irrelevant.

Today, the price of crude oil has stabilized at roughly $61.00 per barrel, crude inventories are being maintained, refineries have encountered some unplanned disruptions[1] in refining capacity, but none approximating a Katrina-like event, yet *gasoline prices at the pump are at all time historical highs*. And so are petroleum industry profits.

The bottom line is simply this: Americans, today, are being compelled to transfer the contents of their wallets to big oil.

---

[1] A report issued this month by the Michigan Public Service Commission indicates that while crude oil inventories are generally close to their five-year average high for this time of year, gasoline inventories are down. This report also indicates that two unplanned outages have affected the refinery output for the Midwest region: the 160,000 barrel per day BP refinery in Toledo, Ohio shut down due to a loss of steam supply on April 21, 2007, is operating at half capacity and expected shortly to return to full operation; on March 22, 2007, the 410,000 barrel per day BP refinery in Whiting, Indiana had a fire that cut output in half and is not expected to return to full service until sometime next month. See Michigan Energy Appraisal, Michigan Public Service Commission (May 2007), http://www.dleg.state.mi.us/mpsc/reports/energy/.

The *net* profits of big oil are so huge as to be almost incomprehensible, exceeding the national budgets of most countries in the world. Exxon Mobil alone makes a profit exceeding *$1,300 every second.* The average household in the United States is spending 85 percent more on gasoline than they did five years ago. That amounts to almost $2,000 of family income spent on gas. Meanwhile industry profits have been skyrocketing. Here are the numbers:

Company	**2002**	**2003**	**2004**	**2005**	**2006**
	Net Income (in billions)[2]				
Exxon Mobil	$11.2	$21.7	$25.3	$36.1	$39.1
BP	$6.9	$10.4	$16.2	$19.3	$22.0
Royal Dutch/Shell	$9.6	$12.6	$18.5	$22.9	$25.4
Chevron	$1.2	$7.5	$13.3	$14.1	$17.1
Conoco Phillips	$.76	$4.6	$8.1	$13.5	$25.4
Totals	**$29.7**	**$56.8**	**$81.4**	**$105.9**	**$129.0**

What accounts, then, for the pain Americans are experiencing at the pump? Why is the present situation, which is completely unacceptable, apparently getting worse and not better? The explanation is complex, but lack of federal interest and the failure of the Bush Administration to effectively review and address industry consolidation have allowed the petroleum industry free reign to eliminate competition, control and

[2] Source *Oil Daily*, Profits Profile Supplement, vol 55, No 39, Feb 28, 2005; vol 56, No 46, Mar 9, 2006; 2006 profit rankings taken from 2005 Fortune 500 list available at http://money.cnn.com/magazine/fortune/Fortune500.

consolidate the distribution and marketing of petroleum products, and squeeze the consumer.

In May 2004 the General Accounting Office (GAO) issued its report[3] examining the effects of mergers and vertical integration of the petroleum industry on petroleum pricing. The report, by any standard, was a clarion call to action. The findings of the GAO include:

- During the period from 1991 to 2000 there were over 2,600 merger transactions within the various segments of the U.S. petroleum industry.
- Concentration in the wholesale gasoline market increased substantially from the mid-1990's forward so that by 2002, 46 states had either moderately or highly concentrated wholesale gasoline markets.
- The availability of less expensive unbranded gasoline decreased substantially.
- The now vertically integrated oil companies have sold or mothballed refineries leaving only enough refined products for their own branded needs.

[3] GAO-04-96, May 17, 2004

- Refiners shifted business to large distributors and retailers and new gasoline retailing chains like Wal-Mart and Costco.

The GAO's econometric analyses, as verified by renowned petroleum industry expert, Dr. Severin Borenstein, E.T. Grether Professor of Business Administration and Public Policy and Director of the University of California Energy Institute, indicated that *oil industry mergers and the resultant increased market concentration has, in fact, led to higher wholesale prices.*

As the GAO report documents, the petroleum industry has been aggressively engaging in mergers, acquisitions and joint ventures – ultimately to the detriment of consumers. In recent years consumers have been affected by a wave of some of the largest corporate mergers in United States history. For example, in 1998 British Petroleum (BP) merged with Amoco to form BP-Amoco which then acquired ARCO in 2000. Similiarly, Exxon, the nations largest petroleum company acquired Mobil, the nation's second largest petroleum company. These and other mergers have reduced the number of competitors at the refining level, as well as the downstream transportation, distribution and retail segments of the industry.

The University of California Berkeley economists Hayley Chouinard and Jeffrey Perloff have found that anticompetitive mergers could explain up to 10.3 cents per gallon difference in cross-state gasoline prices and

that producer mergers could add another difference of 8.9 cents per gallon.[4] In Michigan, each one-cent increase in the price of gasoline sustained over a year results in a payment by consumers of approximately $48.9 million.[5] It doesn't take a sophisticated economist to quickly do the math as to the impact that a ten-cent price differential associated with a merger will have on Michigan consumers.

Preserving competition in the supply of gasoline to independent marketers and retailers is essential to maintaining rigorous price competition on a fair and level playing field in the industry. Economist Justine Hastings, who has testified before Congress, indicates that "the independent station is the only type of station that can purchase gasoline from any refiner and independently set its retail markup, thus increasing competition at the wholesale and retail levels."

In this unregulated environment the potential for price manipulation is markedly greater. One year ago this week, the Federal Trade Commission issued its report on *Investigation of Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases*[6], documenting 15 examples of pricing at the refining, wholesale, or retail level that fit the relevant legislation's

---

[4]Chouinard, Hayley and Perloff, Jeffrey. *Gasoline Price Differences: Taxes, Pollution Regulations, Mergers, Market Power, and Market Conditions.* Abstract. October 2000.
[5] See Michigan gasoline tax collection summary at http://www.crcmich.org/TaxOutline/Transportation/gas.html.
[6] http://www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf

definition of evidence of "price gouging." Yet remarkably, the Federal Trade Commission concludes that no federal price gouging legislation is needed.

The failure of the Bush Administration and past Congresses to curb the abuses of the existing unregulated environment has wrought great harm on the American consumer, imposing additional economic hardships while enriching corporate interests with unprecedented and unconscionable excess profits. The time for effective federal action is long overdue. To afford American consumers protection for uncompetitive practices and to establish trust and confidence that government is vigilant, responsive and effective in addressing these issues I recommend the following:

First, new legal tools including appropriate civil fines and criminal penalties must be made available to redress and deter unfair and unconscionable industry practices. H.R. 1252 must be enacted. The legislation would prohibit gas price-gouging and unconscionably excessive profits during national emergencies or unusual market conditions, empower the Federal Trade Commission to seek tougher fines and criminal penalties for price gouging and unjust profits, and provide state attorneys general new powers to go after companies that violate the law.

Second, Congress must assure that federal agencies, and in particular the Federal Trade Commission and the Department of Justice Antitrust Division, have the necessary resources to thoroughly review petroleum mergers and prevent anticompetitive mergers. In light of the number of mergers, acquisitions and joint ventures taking place, it is critical that adequate resources be provided to ensure that federal antitrust enforcers have the means necessary to analyze past and future transactions.

Third, and perhaps most importantly considering the recent events, it is critically important that the Justice Department and federal Trade Commission staff have good leadership and receive appropriate direction and oversight to ensure that reviews are conducted appropriately, aggressively and free from political interference.

Fourth, the Senate should support S. 1238 imposing a 50 percent tax on profits after oil prices rise above $50 a barrel to control the grossly excessive profits of the petroleum industry. The Senate should approve the tax subsidy repeals contained in HR 6.

Finally, federal antitrust authorities should review the impact such acquisitions may have upon the ability of independent marketers and retailers to effectively compete on a level playing field. The preservation of

vigorous competition in the supply of unbranded gasoline is especially crucial. Antitrust enforcers should focus upon assuring that multiple sources of unbranded gasoline at the wholesale level exist to assure stable, competitively priced supplies for independent retailers, who play an important role in preserving low prices at the pump.

In conclusion, the economic pressure American consumers and families face can and should be mitigated. Unconscionable, grossly excessive profits resulting from rampant, unchecked market practices must be brought under control. In Michigan, the impacts of these practices are particularly acute on our families who are already dealing with the legacy of unwise economic policy. I continue to believe that the key to protecting consumers in Michigan and nationally is the promotion of healthy, vigorous competition among as many different petroleum refiners, marketers and retailers as possible. Consumers will stand to benefit the most if effective competitors have the capability to keep prices down and have an incentive to respond quickly in the event of supply dislocations.