

**SENATOR KOHL'S FOLLOW-UP QUESTIONS FOR HEARING ON
"EXPLORING THE SKYROCKETING PRICE OF OIL"**

For Robert A. Malone

1. We all recognize that the anti-competitive actions of the OPEC cartel have an important role to play in higher gas prices. In your estimation what would a gallon of gas cost if there was no supply limits imposed by the OPEC cartel?

OPEC's influences the market in two ways: Members collectively seek to manage production levels, and individually manage production capacity within their own countries. Last year, according to DOE/EIA data, OPEC members participating in production cuts (all members but Angola and Iraq) reduced crude oil output by 700,000 b/d. This was a substantial contributing factor behind the increase in oil prices over the past year and half: The exact dollar impact is impossible to calculate.

- *Currently, however, DOE/EIA data shows that most OPEC members are producing at full capacity, with only Saudi Arabia holding significant spare capacity...spare capacity which the Saudi government has stated is akin to the strategic petroleum reserve in that it is reserved for supply emergencies.*

Equally important is the control OPEC members—and many other countries, including the US—exercise in limiting access to oil resources and therefore production capacity. The BP Statistical Review of World Energy shows that global proved oil reserves are sufficient to support growing levels of production for decades to come—and in fact proved reserves have tended to rise over time. But constraints on economically rational investment have limited the ability of global oil supply to rise to meet growing demand, another key contributor to the increase in oil prices in recent years.

2. The FTC has testified to the Antitrust Subcommittee that 85 % of the variability in the cost of gasoline is caused by changes in the

We absolutely agree with the FTC's conclusion that the vast majority of the variability in gasoline costs—and prices—is due to changes in crude oil prices. Using official DOE annual data for the US from 1985 - 2007, our figure is even higher: 95%.

In other words, the price of crude oil is—by far—the most important factor driving changes in US gasoline prices.

3. In your opinion, how much of the price of crude oil is due to the speculation by oil traders?

BP agrees with the CFTC, which has concluded that "there is little evidence that changes in speculative positions are systematically driving up crude oil prices." In his April 3, 2008 testimony before the Senate Committee on Energy and Natural Resources, CFTC Chief Economist Jeffrey Harris stated:

Given the relative stability of the makeup of participants and their positions in the markets and the absence of evidence that speculation has caused oil price changes, it appears that fundamentals provide the best explanation for crude oil price increases. These fundamentals can

be either broad factors that affect many markets—like the value of the dollar or general inflation fears—or factors particular to a market—such as strong demand from China and India for crude oil and other commodities. In addition, geopolitical events, such as tensions involving Venezuela, Nigeria, Iran, Iraq, Turkey and the Kurds have affected commodity markets, especially the energy and precious metals markets.

The price of crude oil reflects the forces of supply and demand as they exist at any given time – it is not possible to say what the price of crude oil “should be” apart from those market forces of supply and demand.

4. Many experts believe that one important reason for excessive speculation in oil is low margin requirements in oil commodity trading. Unlike with respect to many other commodities and the stock market, a trader can speculate in this market with very small amounts of money, as margin requirements are as low as 8 percent. Do you agree with these experts that margin requirements should be increased in oil trading markets in order to reduce speculation?

If the margin requirements are increased substantially this will likely lead to fewer investors using energy as an asset class. However, investors, speculators, and large traders generally are less constrained by capital requirements than smaller producers or hedgers.

While most investors would look at the underlying volatility, momentum, and correlation to the other assets in their portfolio before choosing to invest in energy, it is also true that the carrying costs of their positions influence the viability of energy in their portfolio.

Therefore we expect that any increase in the margin requirements will decrease activity and therefore decrease liquidity - quite possibly increasing volatility in price movements.

But not only speculators would be affected by increased margin calls. Increased margin requirements (if applied across the board) will make it more expensive, perhaps prohibitively so, for some producers and end users to use futures as a hedge. This will again decrease participation, increase volatility, and jeopardize the smooth operation of physical delivery of energy contracts.

There could be a move away from the margined exchanges into the un-margined and less transparent OTC markets. If the exchanges outside the US did not raise their margin requirements, participants could be attracted offshore.

Clearer reporting requirements would be a more effective way to monitor and control activity.

5. Much of the crude oil U.S. oil companies refine into gasoline and other petroleum products comes from their own oil fields. Overall, the U.S. produces about 40% of the crude oil it consumes. The cost to produce this oil domestically should not be affected in any way by the rising worldwide price of crude oil. So why should the rising price of crude oil on the international markets lead to higher prices with respect to petroleum products refined from your own domestically produced oil? Are American oil companies just profiteering with respect to the oil that comes from the oil fields they own in the United States?

The price for crude oil is set by global forces of supply and demand, rather than the cost of production. In his April 3, 2008 testimony before the Senate Committee on Energy and Natural Resources, CFTC Chief Economist Jeffrey Harris stated:

Given the relative stability of the makeup of participants and their positions in the markets and the absence of evidence that speculation has caused oil price changes, it appears that fundamentals provide the best explanation for crude oil price increases. These fundamentals can be either broad factors that affect many markets—like the value of the dollar or general inflation fears—or factors particular to a market—such as strong demand from China and India for crude oil and other commodities. In addition, geopolitical events, such as tensions involving Venezuela, Nigeria, Iran, Iraq, Turkey and the Kurds have affected commodity markets, especially the energy and precious metals markets.

BP's refining business in the U.S. purchases most of the crude oil it processes from third parties, and it must pay the prevailing market prices for that crude. Similarly BP's refining business pays the prevailing market price when it uses BP's equity crude production. For BP's exploration and production business to unilaterally lower its equity crude prices to its refineries would leave BP vulnerable to claims relating to royalty payments owed state and federal governments, severance taxes owed, below-cost pricing, unfair business competition, bad faith, and other reputational issues from governments, distributors, and competitors. Furthermore, BP does not and cannot set the retail price of gasoline at the vast majority of its branded outlets – the retail price is set by independent business persons such as jobbers and dealers who own those sites. If BP wholesaled the gasoline to those independent business persons at below market prices, there would be no assurance the retail price would be set below the market price in the trade area. It would most likely result as increased margin for the station owners.

6. In the last 15 years there has been a tremendous amount of consolidation in the oil industry – in its 2004 report, the GAO counted 2600 mergers and acquisitions in this industry since the 1990s alone. Indeed, almost all the companies represented here today are a product of these mergers. During this time, the FTC has approved most of the oil industry mergers it has reviewed, including the gigantic ones like Exxon/Mobil, Chevron/Texaco, and Conoco/Phillips. While each one of these mergers may not have seemed problematic when reviewed, taken as a whole these mergers have greatly increased concentration in the industry. And the GAO concluded that these mergers have raised gasoline prices. The GAO is currently updating its 2004 study at the request of me and some of my colleagues.

What is your view of the effects of these mergers on competition in your industry and the price of petroleum products? And please predict whether we are likely to see even more consolidation in the years ahead.

BP agrees with the Federal Trade Commission that the GAO report should not be relied upon in making policy. As stated by the FTC:

The GAO report still contains major methodological mistakes that make its quantitative analyses wholly unreliable. It relies on critical factual assumptions that are both unstated and unjustified, and it presents conclusions that lack a quantitative foundation. Simply stated, the GAO report is fundamentally flawed.¹

¹Prepared Statement of the Federal Trade Commission titled “Market Forces, Anticompetitive Activity, and Gasoline Prices: FTC Initiatives to Protect Competitive Markets, presented by William E. Kovacic, General Counsel, Before The Subcommittee on Energy Policy, Natural Resources and Regulatory Affairs Committee on Government Reform United States House of Representatives (July 7, 2004) at 8.

Even if you take the conclusions of the GAO Report at face value, the GAO concluded that two of the transactions studied led to decreases in wholesale prices and the results from one of the transactions was inconclusive. This suggests that in at least some cases, integration can lead to lower prices. In the absence of any clear metric as to which transactions will lead to lower prices and which will lead to higher prices, any disincentive for further integration has the potential to lead to economic inefficiencies and higher costs for consumers.

As to consolidation and concentration in the market place, consolidation has allowed BP to compete in this global environment. Even after mergers such as BP's, the FTC has determined that the U.S. domestic oil and natural gas industry remains highly competitive, highly regulated and unconcentrated because retail gasoline is sold largely through independent dealers who face stiff competition.

The price of gasoline is largely dependent on the price of crude oil. And, current sources of crude oil are expensive and challenging to obtain. In the last five years, BP has invested more than \$30 billion dollars into energy investments in the United States. BP's size and scale allows the company to continue to increase both its crude oil production and long-term reserve base in the United States, while also investing in new alternative and renewable energy technologies.

BP's consolidation with Amoco and ARCO has allowed significant investment into its facilities and infrastructure at approximately \$700 million a year. Finding and producing oil and gas today requires greater scale to meet the challenges posed by greater technical, logistical, financial and permitting hurdles. For example, BP is currently working with others to invest in a pipeline to bring Alaska natural gas to consumers in the US Midwest.

BP is also using investment to find new oil and gas reserves in the deep water Gulf of Mexico; this exploration would most likely have overwhelmed a smaller company. These projects are extreme in every way – extremely risky, extremely large, extremely deep and extremely costly – and present unprecedented technical challenges.

Finally, BP remains a small player in this global business. Foreign national oil companies control more than 50 percent of global oil and gas production and more than 80 percent of the world's oil and gas reserves. By comparison, BP represented roughly 3 percent of global oil and gas production, and less than one percent of global oil and gas reserves.

It is impossible for BP to predict whether any further consolidation is contemplated among its competitors.