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TESTIMONY OF
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BEFORE THE SENATE COMMITTEE ON THE JUDICIARY
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I appreciate the opportunity to speak on the issue of whether consolidation in the gasoline industry has caused increased gasoline prices.

The answer is unequivocal: yes.

The Federal government's lax and lackluster enforcement of anti-trust laws has led to an explosion of mergers in the oil industry -- more than 2,500 in the past 15 years, or more than 150 mergers and acquisitions each and every year -- many of them profoundly anti-competitive and anti-consumer. More and more market power is concentrated in fewer and fewer hands.

The mega-companies that arose from this merger mania have aggressively used their ever-growing market clout to leave consumers at the mercy of increasing prices and unnerving market volatility. Big Oil has created a market on the brink, manipulating inventories and refinery capacity to the point that the slightest supply disruption sends prices -- and company profits -- skyrocketing. There is sufficient supply, but these newly created industry giants use their huge market power to keep a stranglehold on the spigot.

The gargantuan record-breaking $36 billion profit reported by Exxon Mobil for 2005 should be a rallying point for a windfall profits tax on major oil companies -- but also for intensive investigation of the abusive practices and monopolistic power that enable these outrageous revenues. This company's profits -- rising 40 percent over last year -- shows the immediate urgent need to curb monopoly power. A windfall profits tax is necessary, but not sufficient.

While consumers struggle with record high prices for heating oil and gasoline, the industry is awash in cash. Witness the staggering level of oil industry profits in the wake of Hurricane Katrina -- just three companies reported quarterly profits exceeding $16 billion. Exxon Mobil's reported profits of $10.7 billion in a single quarter -- $36 billion for the year -- make it the most profitable year for any American company ever. Astronomical profits at the expense of American consumers has been the rule, not the exception, again and again in recent years.

My office serves on the Executive Committee of a multi-state investigation of oil prices, prompted by the alarming and appalling abuses in the wake of Hurricane Katrina. A number of us have brought -- or soon will initiate -- enforcement actions against price gouging and related misconduct. But these enforcement actions are against gas station owners and others at the industry's retail level. We need action against the upper levels of the corporate chain where consolidation has concentrated huge market power.

In short, government tolerance of anti-competitive mergers and oil industry practices has enabled, even encouraged, the recent sharp rise in gasoline prices. Congress needs to take swift, aggressive action easing sky-high gasoline prices that hit hardest people of low and moderate means, who can only reduce by so much their consumption of such a vital commodity.

I strongly believe in free markets. Congress needs to restore the free market in oil products by breaking excessive market concentration that stifles competition and constricts supply.

I am here today to reiterate and reinforce with increasing urgency my plea that Congress:

(1) order an aggressive, comprehensive federal investigation, in partnership with the states to determine whether and how oil companies have misused monopolistic power -- much as federal and state antitrust enforcers combined and cooperated in a similar investigation regarding Microsoft;

(2) enact a one-year moratorium on oil industry mergers;

(3) prohibit any oil company merger in a highly concentrated market unless the Federal Trade Commission (FTC) specifically finds consumers benefit from the merger;

(4) ban zone pricing and other mechanisms that prevent gasoline retailers from obtaining gasoline at the best price;

(5) expand refinery capacity and mandate minimum levels of inventory of a significant source of energy; and

(6) lessen our dependency on gasoline through conservation efforts and alternative fuels.

In 2000 and again in 2002, I and other state attorneys general criticized the federal government's failure to aggressively stop harmful mergers in the oil industry. We have not been alone.

In 2002, the Senate Permanent Committee on Investigations concluded that market consolidation had led to too much market power in two few companies, harming consumers.

In 2004, studies by Public Citizen and others found that the gasoline market was uncompetitive, keeping prices artificially high in order to reap unconscionable profits.

In 2004, the GAO conducted an econometric study of 8 major mergers in the oil industry and concluded that 6 of them caused higher prices for consumers.

In 2005, the Foundation for Taxpayer and Consumer Rights agreed with the GAO's conclusion and cited an industry expert who concluded that the Federal Trade Commission (FTC) has been "ineffective" and a "negotiator for the oil companies."

In 2005, the Congressional Research Service noted the highest profits in the gasoline industry occur in the refining and marketing sectors, finding that these profits were not simply the result of higher crude oil prices. Clearly, such profiteering contributes to higher gasoline pump prices.

Rampant mergers have significantly concentrated market power at every level of the gasoline industry. For example:

- Five companies control 61% of the 175,000 gasoline stations in the nation, compared to 27% in 1991;
- The five largest companies control 50% of the refinery capacity, as opposed to 1/3 of capacity ten years ago;
- The five largest oil companies have doubled their control of oil production in the past ten years;

In its 2002 study, Senate Permanent Subcommittee on Investigations (the Subcommittee Report) found that refining and supply was highly concentrated in 9 states and moderately concentrated in 28 states. Today, these markets are even more concentrated.

By 2004, the GAO concluded that lax FTC enforcement allowed mergers that dramatically increased market concentration in refining and marketing, especially on the East and West Coasts.

Connecticut, along with its sister states in the Northeast and Mid-Atlantic, have suffered most severely from this wave of mergers. According to the GAO, the Herfindahl-Hirschman Index (HHI), a renowned method of measuring market concentration for antitrust purposes, for the Northeast and Mid-Atlantic region increased by 683 points to 1819 points. At this level, economists conclude that the market is "highly concentrated."

This change did not occur in a vacuum. Rather, in 1990, the HHI for our region was 1136 points, leading economists to conclude that the refining and marketing sectors were "moderately concentrated." At this level, each and every merger should be critically scrutinized. Many proposed acquisitions should have been flatly rejected by the FTC.

Lax antitrust enforcement has real life consequences.

In one example affecting Connecticut, the proposed Mobil-Exxon merger would have resulted in the top four gasoline companies controlling 73% of the retail market in half the metropolitan areas in the Northeast and Mid-Atlantic region. I strongly opposed this merger in

comments to the FTC. While the FTC ordered divestiture of some assets, such divestiture did not prevent the market from becoming highly concentrated with its anti-consumer impact.

In the retail area, the merger trend has enhanced the power of industry players to use zone pricing. The FTC describes this practice as "oligopolistic." This term could easily apply to the entire industry.

So too, oil company decisions to close 50 refineries and merge with competitors have led to significant market concentration in the refinery and production segments of the oil industry. The Wall Street Journal recently reported that the six largest refiners control 59% of the refining market, representing a 50% increase in the concentration level of that market in 12 years. The FTC has reviewed and approved refiner company mergers with conditions and divestments designed to reduce the impact of the proposed mergers. Again, these conditions and divestments have failed to slow, let alone stop, the anti-competitive consequences of increasingly concentrated market power.

In its review of the California market, the Subcommittee Report found that the federal government allowed the refining market to become an oligopoly with the top four refiners owning nearly 80% of the market. Six refiners also owned 85% of the retail outlets, selling 90% of the gasoline in the state.

The Subcommittee Report also found that two thirds of the gasoline supplied to Michigan comes from 4 large refiners. Three of those four refiners also combine to own two thirds of the Wolverine Pipeline, one of the key sources by which gasoline is transported into the state. The refiners also have substantial interests in terminals. Vertical integration of this type allows a small number of firms to control the refiner sector of the oil industry and to maintain critical market power in the supply and retail segments.

In the refining and production area, the merger trend has produced a herd mentality, with innovative, rebel companies less likely to buck the industry. Refiners and producers can reduce refining and production levels causing widespread supply shortages and higher prices, knowing that there is little risk that another company will present any significant competitive threat. The Subcommittee Report found that refiners are as adverse to gaining market share through aggressive pricing as they are to losing market share. The companies' pricing is designed to simply maintain market niches and market share.

In another example of market consolidation leading to anti-consumer practices, the FTC examined a gasoline price spike in several Midwestern states during 2000 and found that the three refiners of summer-grade reformulated gasoline decided (not jointly according to the FTC) to limit the upgrade of their refineries to comply with stricter EPA standards so as to only produce enough gasoline to supply their branded gas stations and other existing contractual obligations. Even if such decisions were made independently, the decisions clearly recognized that the other participants would not be risk-takers and increase their production of summer grade gasoline to increase market share. There is clearly a problem with this market, replicated in many markets throughout the country.

Through increased market concentration, domestic refining capacity has diminished, even as demand has increased steadily. The predictable result has been extraordinarily tight supplies, barely meeting demand, leading to very volatile prices at the pump. Inadequate inventories, disruption in delivery systems and other factors make the market even more vulnerable.

In fact, one company deliberately withheld some of its gasoline inventory from the market during the Midwestern price spike of 2000, keeping prices and profits artificially high. The Subcommittee Report is replete with examples of industry efforts to maintain gasoline inventories at low-levels so prices would remain high. The report recounted Shell's threat to seek enactment by the California legislature of a tax on imported gasoline if Texaco pursued its plan to import California CARB gasoline to relieve a shortfall in refinery output in that state. This story was cited as only one example of major oil company efforts to squeeze supplies and raise prices.

When oil is in short supply, whoever may win, the consumer is a sure loser, and rightly a sore loser.

1. Federal/state investigation into the oil industry

The record is clear: the oil industry is not competitive, yields billions of dollars in profits while it constricts supply and drives up prices.

A joint federal-state investigation into the oil industry can determine whether some companies are using their market power to constrain competition in violation of federal and state antitrust laws. The investigation's report should also provide specific recommendations for changing federal and state supervision of mergers and acquisitions in the industry and, perhaps, divestment of certain acquisitions to spur competition.

This investigation should also analyze the role of the futures market in gasoline supply and price manipulation. While the major oil companies and suppliers are well-known to consumers, the futures market has a silent, stealth impact on gasoline prices. For example, a significant portion of gasoline wholesale supply in Connecticut is owned by private investors or investment houses. The investigation should determine whether investor-focused decisions exacerbate supply shortages or price spikes.

2. Moratorium on oil industry mergers

I urge Congress to enact a one year moratorium on any merger or acquisition of an oil industry company -- including cross-sector mergers and acquisition -- while Congress, FTC and the states work together to investigate this industry and improve current consumer protection statutes.

3. Oil company mergers in highly concentrated markets

New federal law should create a presumption that any merger in the oil industry in a moderately or highly concentrated market -- as defined by the HHI -- violates antitrust law unless the Federal Trade Commission finds clear and convincing evidence that consumers will benefit, and that tangible, specific steps will be taken to assure that consumers see lower prices and better services.

The FTC should take a tough approach to both horizontal as well as vertical integration mergers, recognizing that some mergers may tighten market control downstream. Mergers should also be critically examined to ensure that the merged company cannot pose significant barriers to entry by independents.

4. Prohibit zone pricing

Heightened scrutiny of oil industry mergers will take time to bring relief to consumers through increased competition but some immediate steps may be available. One immediate step could bring some reduction in gasoline prices: ban the practice of zone pricing and refiner and distributor control of the sale of gasoline to retailers.

Zone pricing is used in almost every state where the major oil companies artificially create geographic areas for purposes of charging different prices for gasoline to dealers within the zone. Mobil has established 46 zones in a small state like Connecticut.

The power of the major oil companies to charge inflated, excessive, arbitrary prices derives from gasoline dealer franchise agreements dictating that the gasoline dealers are required to purchase products from a single supplier. As a result of such sole source provisions, gasoline dealers are powerless to seek or shop for a cheaper supply of gasoline.

Zone pricing is invisible and insidious. It distorts the free market. It is possible only because of restrictive contracts that include sole source provisions. It benefits only the oil industry, to the detriment of consumers. Perhaps the industry's own consultant, MPSI, states it best in its promotional brochures quoted in the Subcommittee Report: "To **maximize profits**, you need to establish a large number of price zones..... **You will be able to charge more** in areas that can support higher prices..."

I urge this committee to consider legislation to specifically ban the practice of zone pricing either as a separate law, an amendment to the antitrust price discrimination statute (Robinson-Patman Act) or an amendment to the Petroleum Marketing Practices Act. The committee should consider the following language:

"No person engaged in the business of furnishing gasoline to retail distributors of gasoline may use a pricing system under which the wholesale price paid for gasoline by any such retail distributor is determined based on the location of the retail distributor in any geographic zone."

Congress should also consider an amendment to the Petroleum Marketing Practices Act (PMPA), 15 U.S.C. 2801, et seq., prohibiting major oil companies from dictating the source of supply of the brand name gasoline.

The PMPA was enacted in 1978 to provide national standards for gasoline franchise agreements regarding the termination and nonrenewal of such franchise agreements. Unfortunately, while Congress, in approving the PMPA, recognized that gasoline dealers are in a weak bargaining position with the major oil companies over terms of the franchise agreement, the PMPA does not provide specific protection against unfairly burdensome franchise provisions foisted upon gasoline dealers by the major oil companies.

The power to impose zone pricing is solely based on the power of the major oil companies to control purchases by the gasoline dealers. If the wholesale supply of gasoline were truly competitive, and a Mobil gasoline dealer could purchase Mobil gasoline from any Mobil gasoline wholesaler, the major oil companies could not dictate the price of wholesale gasoline based on location. The dealer could simply choose another vendor of the same brand of gasoline at a more competitive price.

Thus, the PMPA could be amended to prohibit the anti-competitive provisions in gasoline dealer franchise agreements that dictate the wholesale source of gasoline. I suggest that the committee consider the following language: "No franchise, as defined in subdivision (1) of 15 USC 2801, shall limit the source of acquisition of gasoline by a retail distributor except that the franchisor may require that such gasoline is the same brand as the franchisor."

5. Expand refinery capacity/enact minimum inventory levels

Recent dramatic spikes in gasoline and heating oil have been due in large part to industry decision-making that has reduced available inventory. This industry practice may lead to a lack of available product, if something unexpected occurs such as sudden drop in temperatures or a refinery fire.

The Energy Information Administration has recognized the clear connection between price volatility and refiner inventory methods, finding that wholesale gasoline prices are bid up by more than the underlying cost increases when inventories are low. The Subcommittee Report also provides excellent examples of how industry profits from low inventories.

Present inventory practices increase profits while subjecting consumers to wide swings in gasoline prices and preventing quick industry adjustments to unexpected supply shortages or increased demand.

In the 1980's, refiner capacity averaged 77.6% which allowed for easy increases in production to address shortages. In the 1990's, as the industry closed refineries and adopted just-in-time inventory practices, refinery capacity rose to 91.4%, leaving little room for expansion to cover supply shortfalls.

These practices hardly inured to the benefit of consumers as refinery profits soared during the 1990's. During the 1980's, refiner margins averaged approximately 19 cents per gallon. In the 1990's the average refiner margin rose 23% to 23.4 cents per gallon. Mergers, refinery shut-downs and inventory practices resulted in an increased bottom line for oil companies and price volatility and uncertain supplies for consumers.

I urge Congress to carefully review these inventory practices and refinery closings and take steps that will encourage or mandate increased inventory and refinery capacity. Although returning competition to these markets would result in additional inventory and less price volatility, the current market requires some form of governmental oversight. Congress should consider ways to encourage competitors to expand into the refinery and distribution markets, lowering barriers to entry into the market.

6. Conservation

In addition to making the oil industry more competitive and pro-consumer, Congress should aggressively pursue policies designed to lessen American consumer exposure to decisions made by members of OPEC and other foreign sources of oil.

We are becoming more, not less, dependent on oil. Many solutions to this dependence will also result in cleaner air, so we should pursue these goals with more vigor than ever.

First, mass transportation should be encouraged. Safe, clean and convenient mass transportation would be used by many citizens.

Second, cars need to be more fuel-efficient. Congress needs to continue to pressure automobile manufacturers to increase the average miles per gallon for their fleet of cars. Back in the 1970's, automobile manufacturers complained that they couldn't make their 12 miles per gallon vehicles more efficient. Today, cars average 27 miles per gallon. Increasing that average to 45 miles per gallon would save 237 billion gallons of gasoline over a 5 year period.

Finally, we must increase our commitment of resources to development of alternative fuels and energy efficient technologies such as fuel cells.