

Testimony of

Mr. Tyson Slocum

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Public Citizen's Energy Program

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Consolidation in the Energy Industry: Raising Prices at the Pump?

Thank you, Mr. Chairman and members of the Committee on the Judiciary 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 35-year old public interest organization with over 160,000 members nationwide. We represent consumer interests through research, public education and grassroots organizing.

I testified before the U.S. Senate Commerce Committee in September 2005 on how recent oil company mergers have diminished competition, leading to higher prices for consumers. I also testified before the U.S. House in September on how lax regulations over the natural gas industry were contributing to high prices.

Recent mergers in the domestic oil refining industry have consolidated control over refined products like gasoline, making it easier for a handful of companies to price-gouge consumers. This price-gouging has not only been officially documented, but it is also evident in the record profits enjoyed by large oil companies. Since 2001, the five largest oil refining companies operating in America--ExxonMobil, Valero, ConocoPhillips, Shell and BP--have recorded \$272.2 billion in profits. While of course America's tremendous appetite for gasoline plays a role, uncompetitive practices by oil corporations are a cause--and not OPEC or environmental laws--of high gasoline prices around the country.

When communicating to the general public and lawmakers, oil companies downplay these record profits by calculating profits differently when they communicate with Wall Street and shareholders. When speaking to 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 measurement ExxonMobil uses when talking to investors and Wall Street. For example, here's a choice excerpt from their 2004 annual report: "ExxonMobil believes that return on average capital employed is the most relevant metric for measuring financial performance in a capital-intensive industry such as" petroleum.

For example, ExxonMobil's 2004 10-k filed with the U.S. SEC shows that that company's global operations enjoyed a 23.6% 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% rate of return on average capital employed, while domestic refining returned 28.6%. The company is making its biggest profit margins off the U.S. market.

The oil industry has also been falsely using the weather as an excuse for their record profits. Oil and gasoline prices--and oil company profits--were rising long before Hurricane Katrina wreaked havoc. U.S. gasoline prices jumped 23% from June 6 to Aug. 22 (Katrina made landfall at New Orleans on August 29). Indeed, profits for U.S. oil refiners have been at record highs. In 1999, U.S. oil refiners made 22.8 cents for every gallon of gasoline refined from crude oil. By

2004, they were making 40.8 cents for every gallon of gasoline refined, a 79% jump. And, according to industry analysts, those profit margins have soared even higher in 2005, to 99 cents on each gallon sold.

Faced with these facts, Congress and the White House instead recently passed energy legislation that does nothing to address any of the fundamental problems plaguing America's energy policies--after all, if it did, why are having this hearing today? As a whole, the Senate voted to approve HR 6, the "comprehensive" energy bill, by a vote of 74 to 26, even though the only "comprehensive" aspect of the legislation is the \$5 billion in subsidies to oil companies. Section 1329 allows "geological and geophysical" costs associated with oil exploration to be written off faster than present law, costing taxpayers \$1 billion over the next decade. Section 1323 provides owners of oil refineries \$400 million in tax breaks over 10 years. Sections 1325-6 allows natural gas companies like ExxonMobil to save \$1.035 billion by depreciating their property at a much faster rate than current law. A number of provisions provide roughly \$1 billion in royalty relief. And Title IX, Subtitle J of the energy bill creates a new \$1.5 billion spending program that benefits oil companies seeking to drill deepwater wells. The only possible explanation for why Congress would bestow these subsidies on oil companies are the \$55 million in campaign contributions by the oil industry to Congress and the White House since 2001, with 81% of that total going to Republicans.

And environmental regulations are not restricting oil drilling in the United States. An Interior Department study concludes that federal leasing restrictions--in the form of wilderness designations and other leasing restrictions--completely block drilling of only 15.5% of the oil in the five major U.S. production basins on 104 million acres stretching from Montana to New Mexico. While only 15.5% is totally off-limits, 57% of America's oil reserves on federal land are fully available for drilling, with the remaining 27.5% featuring partial limitations on drilling. This report contradicts industry claims that environmental laws are squelching production.

Congress can restore accountability to oil and gas markets and protect consumers by supporting Public Citizen's 5-point reform plan:

- ? Implement a windfall profits tax and close loopholes allowing oil companies to escape paying adequate royalties.
- ? Launch an immediate investigation, including the use of subpoena, into uncompetitive practices by oil companies.
- ? Strengthen anti-trust laws by empowering the Federal Trade Commission to crack down on unilateral withholding and other non-collusive anti-competitive actions by oil companies.
- ? Re-regulate energy trading exchanges to restore transparency.
- ? Improve fuel economy standards to reduce demand.

Recent Mergers Create Uncompetitive Markets

Over 2,600 mergers have been approved in the U.S. petroleum industry since the 1990s. 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, and in December ConocoPhillips acquired Burlington Resources. A number of independent refineries have been closed, some due to uncompetitive actions by larger oil companies, further restricting capacity. As a result, consumers are paying more at the pump than they would if they had access to competitive markets and five oil companies are reaping some of the largest profits in history.

Although the U.S. is the third largest oil producing nation in the world, we consume 25% of the world's oil every day, forcing us to import oil. We are also the third largest oil producing nation in the world, providing us with 42% of our daily oil and gasoline needs.

Sixty percent of the oil consumed in America is used as fuel for cars and trucks. Ten percent is for residential home heating oil, with the remainder largely for various industrial and agricultural processes (only 1.2% is to fuel electric power).

Middle Eastern OPEC nations supply only 14% of America's oil and gas. Other OPEC nations--Indonesia, Nigeria Venezuela--supply 13%, and non-OPEC nations--such as Canada, Mexico, Norway and England--provide 31% of our oil and gas needs.

So it isn't so much an OPEC oil cartel, but rather a corporate cartel that should concern policymakers. Consider that the top five oil companies also produce 14% of the world's oil. Combined, these five companies produce 10 million barrels of oil a day--more than Saudi Arabia's export of 8.73 million barrels of oil a day.

The consolidation of downstream assets--particularly refineries--also 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.

In 1993, the five largest U.S. oil refining companies controlled 34.5% of domestic oil refinery capacity; the top ten companies controlled 55.6%. By 2004, the top 5--ConocoPhillips, Valero, ExxonMobil, Shell and BP--controlled 56.3% and the top ten refiners controlled 83%. As a result of all of these recent mergers, the largest 5 oil refiners today control more capacity than the largest 10 did a decade ago. This dramatic increase in the control of just the top five companies makes it easier for oil companies to manipulate gasoline by intentionally withholding supplies in order to drive up prices. Because most of the largest companies are also vertically integrated, they enjoy significant market share in oil drilling and retail sales.

The proof is in the numbers. Profit margins for U.S. oil refiners have been at record highs. In 1999, U.S. oil refiners made 22.8 cents for every gallon of gasoline refined from crude oil. By 2004, they were making 40.8 cents for every gallon of gasoline refined, a 79% jump. And, according to industry analysts, those profit margins have soared even higher in 2005, to 99 cents on each gallon sold. It is no coincidence that oil corporation profits--including refining--are enjoying record highs.

Consumer advocates like Public Citizen aren't the only ones saying this. A May 2004 U.S. Government Accountability Office report agreed with Public Citizen 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--long before the mergers that created ChevronTexaco-Unocal, ConocoPhillips-Burlington Resources, and Valero-Ultramar/Diamond Shamrock-Premcor.

And in March 2001, the U.S. Federal Trade Commission concluded in its Midwest Gasoline Price Investigation:

The completed [FTC] investigation uncovered no evidence of collusion or any other antitrust violation. In fact, the varying responses of industry participants to the [gasoline] price spike suggests that the firms were engaged in individual, not coordinated, conduct. Prices rose both because of factors beyond the industry's immediate control and because of conscious (but independent) choices by industry participants...each industry participant acted unilaterally and followed individual profit-maximization strategies...It is not the purpose of this report - with the benefit of hindsight - to criticize the choices made by the industry participants. Nonetheless, a significant part of the supply reduction was caused by the investment decisions of three firms...One firm increased its summer-grade RFG [reformulated gasoline] production substantially and, as a result, had excess supplies of RFG available and had additional capacity to produce more RFG at the time of the price spike. This firm did sell off some inventoried RFG, but it limited its response because selling extra supply would have pushed down prices and thereby reduced the profitability of its existing RFG sales. An executive of this 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.

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 1995-2002, 97% of the more than 920,000 barrels of oil per day of capacity that has been shut down were owned by smaller, independent refiners. Were this capacity to be in operation today, refiners could use it to better meet today's reformulated gasoline blend needs.

An internal Mobil document helps explain why independent refineries had such a tough time. The Mobil document highlights the connection between an independent refiner producing cleaner burning California Air Resources Board (CARB) gasoline, the lower price of gasoline that would result from the refinery being in operation, and the need to prevent the independent refiner from operating:

If Powerine re-starts and gets the small refiner exemption, I believe the CARB market premium will be impacted. Could be as much as 2-3 cpg (cents per gallon)...The re-start of Powerine, which results in 20-25 TBD (thousand barrels per day) of gasoline supply...could...effectively set the CARB premium a couple of cpg lower...Needless to say, we would all like to see Powerine stay down. Full court press is warranted in this case.

FTC Not Adequately Protecting Consumers

At the same time that the FTC concludes that refining markets are uncompetitive, the agency 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 4% of its domestic refining 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 by far the largest domestic refiner, controlling refineries with capacity of 2.2 million barrels of oil per day--or 13% of America's entire capacity.

The major condition the FTC set when approving the October 2001 ChevronTexaco merger was that Texaco had to sell its shares in two of its joint refining and marketing enterprises (Equilon and Motiva). Prior to the merger, Texaco had a 44% stake in Equilon, with Shell owning the rest; Texaco owned 31% of Motiva, with the national oil company of Saudi Arabia (Saudi Aramco) also owning 31%, and Royal Dutch Shell owning the remaining 38%. The FTC allowed Shell to purchase 100% of Equilon, and Shell and Saudi Aramco bought out Texaco's share of Motiva, leaving Motiva a 50-50 venture between Shell and Saudi Aramco.

Prior to the merger, Texaco's share of Equilon and Motiva refinery capacity equaled more than 500,000 barrels of oil per day--which was simply scooped up by another member of the elite top five companies, Shell. Had the FTC forced Texaco to sell its share to a smaller, independent company, the stranglehold by the nation's largest oil companies could have been weakened.

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. So, just as with the ChevronTexaco merger, 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, just last month, 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.

Over-the-Counter Energy Disclosure is Underregulated

Contracts representing hundreds of millions of barrels of oil are traded every day on the London and New York trading exchanges. An increasing share of this trading, however, has been moving off regulated exchanges such as the New York Mercantile Exchange (NYMEX) and into unregulated Over-the-Counter (OTC) exchanges. The Bank of International Settlements estimates that in 2004, the global OTC market has grown to over \$248 trillion. Growth in global OTC derivatives markets has averaged 31.6% since 1990. Traders operating on exchanges like NYMEX are required to disclose significant detail of their trades to federal regulators. But traders in OTC exchanges are not

required to disclose such information allowing companies like Goldman Sachs, Morgan Stanley and hedge funds to escape federal oversight and more easily engage in manipulation strategies.

A recent congressional investigation concluded that "crude oil prices are affected by trading not only on regulated exchanges like the NYMEX, but also on unregulated OTC markets that have become major trading centers for energy contracts and derivatives. The lack of information on prices and large positions in OTC markets makes it difficult in many instances, if not impossible in practice, to determine whether traders have manipulated crude oil prices."

And these energy traders happily boast in public about how they're price-gouging Americans, as a recent Associated press 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."

Public Citizen has supported efforts to re-regulate energy trading by subjecting OTC markets to tougher oversight. But the latest such effort, an amendment to the energy bill, was rejected by the Senate by a vote of 55-44 in June 2003.

But manipulation occurs even on the regulated exchanges. Just last month, the U.S. Commodity Futures Trading Commission issued a civil penalty against Shell Oil for "non-competitive transactions" in U.S. crude oil futures markets.

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, a hedge-fund industry group that figures prominently in energy derivatives markets. Such prominent defections hampers the CFTC's ability to protect consumers.

Why We Need a Windfall Profits Tax

In most industries, when the main component (crude oil) of a product (gasoline) skyrockets in price, those higher costs eat into profit margins. But not the oil industry, because ExxonMobil and the other major oil companies operate as a type of monopoly, with massive oil production, refining and retail marketing operations.

House Speaker J. Dennis Hastert recently scolded the industry's profits, saying "It is time to invest in America...we expect oil companies to do their part to help ease the pain American families are feeling from high energy prices."

But only one company--Citgo--has bothered to heed Hastert's call. The company, a U.S. subsidiary of the Venezuelan state oil company, has dedicated tens of millions of dollars for low income American families in Chicago, New York, Boston and Maine.

With other oil companies failing to take action to protect America's middle- and low-income families from the high energy prices that fuel their profits, Public Citizen supports a Windfall Profits Tax. Proceeds from such a tax could not only provide refunds for consumers to help protect them from high home heating prices this winter, but the tax could be used to finance important investments. Proceeds from the tax could fund rebates for homeowners to upgrade their insulation, replace drafty windows and trade in their old appliances for more energy efficient ones. Revenues from the tax could be used to encourage consumers to buy more fuel efficient, hybrid or alternative fuel cars. And such a tax on oil companies could also be directed to state and local governments to fully fund public transportation. For example, in 2003 (the last year for which data is available), governments at the Federal, state and local levels spent a combined \$23.2 billion in subsidies for public transit systems. Compare that with the \$36 billion earned last year by ExxonMobil alone. Clearly, oil companies can afford to contribute more to investing in solutions to America's energy problems than they currently are.

Naysayers argue the Windfall Profits Tax didn't work the last time we tried it. 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 (oil) fell, the effectiveness of the tax was diminished.

But that was then. World oil markets aren't going to collapse anytime soon, because the major oil producers are already producing at full capacity, unlike the 1980s.

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 investigation concluded that while energy "prices nearly doubled from 2001 to 2005, the \$5.15 billion in gas royalties for 2005 was less than the \$5.35 billion in 2001. When oil and gas are combined, royalties were about \$8 billion in 2005, almost the same as in 2001." Taxpayers must be fairly compensated for allowing oil companies the privilege of extracting resources from federally-owned land.

Some states are addressing higher gasoline prices by suspending gas taxes. Public Citizen does not support such a move, as it not only fails to address the underlying market problems causing higher prices, but reduces revenues that states need to help finance solutions such as mass transit.

Raise Fuel Economy Standards to Lower Our Oil Consumption

Due to increasing numbers of gas-guzzling SUVs on America's roads and the absence of meaningful increases in government-set fuel economy standards, America's fuel economy standards are lower today than a decade ago.

The Environmental Protection Agency found that the average fuel economy of 2005 vehicles is 21 miles per gallon (mpg), compared to 22.1 mpg in 1988--a 5% decline. This drop is attributable to the fact that fuel economy standards haven't been meaningfully increased since the 1980s. And sales of fuel inefficient SUVs and pickups have exploded: in 1987, 28% of new vehicles sold were light trucks, compared to 50% in 2005.

Billions of gallons of oil could 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. But the U.S. Senate soundly rejected such a move on June 23, 2005 by a vote of 67 to 28 (5 abstentions).

Dramatic reductions in consumption will not only reduce strain on America's refinery output, but also on Americans' pocketbooks. Comparing two Americans with identical driving habits, one driving an SUV and one a regular passenger car, reveals that the person driving the passenger car saves \$510 a year due to the superior fuel economy of passenger cars compared to light trucks.