S. HRG. 109–939

# CONSOLIDATION IN THE ENERGY INDUSTRY: RAISING PRICES AT THE PUMP?

## HEARINGS

BEFORE THE

## COMMITTEE ON THE JUDICIARY UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

FEBRUARY 1, AND MARCH 14, 2006

**Serial No. J–109–57**

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# CONTENTS

**FEBURARY 1, 2006**

STATEMENTS OF COMMITTEE MEMBERS


| | Page |
|---|---|
| Coburn, Hon. Tom, a U.S. Senator from the State of Oklahoma | 9 |
| Cornyn, Hon. John, a U.S. Senator from the State of Texas | 4 |
| DeWine, Hon. Mike, a U.S. Senator from the State of Ohio | 7 |
| prepared statement | 104 |
| Feingold, Hon. Russell D., a U.S. Senator from the State of Wisconsin | 8 |
| prepared statement | 107 |
| Feinstein, Hon. Dianne, a U.S. Senator from the State of California | 6 |
| Kohl, Hon. Herb, a U.S. Senator from the State of Wisconsin | 2 |
| prepared statement | 114 |
| Leahy, Hon. Patrick J., a U.S. Senator from the State of Vermont, prepared statement | 142 |
| Schumer, Hon. Charles E., a U.S. Senator from the State of New York | 10 |
| Specter, Hon. Arlen, a U.S. Senator from the State of Pennsylvania | 1 |


WITNESSES


| | |
|---|---|
| Blumenthal, Richard, Attorney General, State of Connecticut, Hartford, Connecticut | 15 |
| Hamilton, Timothy A., Founder and Executive Director, Automotive United Trades Organization, Seattle, Washington | 20 |
| Kovacic, William E., Commissioner and former General Counsel, Federal Trade Commission, Washington, D.C. | 11 |
| McAfee, R. Preston, J. Stanley Johnson Professor of Business, Economics and Management, and Executive Officer for the Social Sciences, California Institute of Technology, Pasadena, California | 16 |
| Slocum, Tyson, Director, Public Citizen's Energy Program, Washington, D.C. | 18 |
| Wells, Jim, Director, Natural Resources and Environment, Government Accountability Office, Washington, D.C. | 13 |


QUESTIONS AND ANSWERS


| | |
|---|---|
| Responses of Richard Blumenthal to questions submitted by Senators Specter and Kohl | 36 |
| Responses of Tim Hamilton to questions submitted by Senators Specter, Feingold, and Kohl | 40 |
| Responses of William E. Kovacic to questions submitted by Senators Specter, Kohl, and Feingold | 47 |
| Responses of Preston McAfee to questions submitted by Senators Specter and Kohl | 62 |
| Responses of Tyson Slocum to questions submitted by Senators Kohl and Specter | 67 |
| Responses of James Wells to questions submitted by Senators Feingold and Kohl | 72 |


SUBMISSIONS FOR THE RECORD


| | |
|---|---|
| American Petroleum Institute, Houston, Texas, statement | 74 |
| Blumenthal, Richard, Attorney General, State of Connecticut, Hartford, Connecticut, statement | 96 |
| Hamilton, Timothy A., Founder and Executive Director, Automotive United Trades Organization, Seattle, Washington, statement | 108 |

Page

Kovacic, William E., Commissioner and former General Counsel, Federal Trade Commission, Washington, D.C., statement ..... 116
McAfee, R. Preston, J. Stanley Johnson Professor of Business, Economics and Management, and Executive officer for the Social Sciences, California Institute of Technology, Pasadena, California, statement ..... 144
Slocum, Tyson, Director, Public Citizen's Energy Program, Washington, D.C., statement ..... 167
Wells, Jim, Director, Natural Resources and Environment, U.S. Government Accountability Office, Washington, D.C., statement and attachment ..... 176

---

**MARCH 14, 2006**

STATEMENTS OF COMMITTEE MEMBERS

Page

Cornyn, Hon. John, a U.S. Senator from the State of Texas, prepared statement ..... 450
DeWine, Hon. Mike, a U.S. Senator from the State of Ohio ..... 191
prepared statement ..... 452
Durbin, Hon. Richard J., a U.S. Senator from the State of Illinois, prepared statement ..... 454
Feingold, Hon. Russell D., a U.S. Senator from the State of Wisconsin, prepared statement ..... 457
Feinstein, Hon. Dianne, a U.S. Senator from the State of California ..... 188
Kohl, Hon. Herb, a U.S. Senator from the State of Wisconsin, prepared statement and press release ..... 472
Leahy, Hon. Patrick J., a U.S. Senator from the State of Vermont ..... 190
prepared statement ..... 480
Specter, Hon. Arlen, a U.S. Senator from the State of Pennsylvania ..... 187

WITNESSES

Alioto, Joseph M., Partner, Alioto Law Firm, San Francisco, California ..... 198
Boies, David, Chairman, Boies, Schiller and Flexner, LLP, Armonk, New York ..... 193
Borenstein, Severin, E.T. Grether Professor of Business and Public Policy, Haas School of Business, University of California at Berkeley, Berkeley, California ..... 200
Greene, Thomas, Chief Assistant Attorney General, California Department of Justice, Sacramento, California ..... 196
Hofmeister, John, President, Shell Oil Company, Houston, Texas ..... 227
Klesse, Bill, Chief Executive Officer, Valero Energy Corporation, San Antonio, Texas ..... 226
Lautenschlager, Peg A., Attorney General, State of Wisconsin, Madison, Wisconsin ..... 195
Mulva, James J., Chairman and Chief Executive Officer, ConocoPhillips, Houston, Texas ..... 223
O'Reilly, David J., Chairman and Chief Executive Officer, Chevron Corporation, San Ramon, California ..... 225
Pillari, Ross J., President and Chief Executive Officer, BP America, Inc., Chicago, Illinois ..... 229
Tillerson, Rex W., Chairman and Chief Executive Officer, ExxonMobil Corporation, Irving, Texas ..... 221

QUESTIONS AND ANSWERS

Responses of Joseph M. Alioto to questions submitted by Senators DeWine, Specter, Leahy, Kohl, and Schumer ..... 249
Responses of David Boies to questions submitted by Senators Specter, Leahy, DeWine, Kohl, and Schumer ..... 270
Responses of Thomas Greene to questions submitted by Senators Specter, Feingold, DeWine, Kohl and Schumer ..... 279
Responses of John Hofmeister to questions submitted by Senators Specter, DeWine, Feingold, Kohl, and Schumer ..... 296
Responses of Bill Klesse to questions submitted by Senators Specter, DeWine, Feingold, Kohl, and Schumer ..... 306

Page

Responses of Peg A. Lautenschlager to questions submitted by Senators Specter, Leahy, Kohl, DeWine, and Schumer ..... 318
Responses of James J. Mulva to questions submitted by Senators Specter, Schumer, Kohl, DeWine, and Feingold ..... 324
Responses of David J. O'Reilly to questions submitted by Senators Specter, Schumer, DeWine, Feingold, and Kohl ..... 350
Responses of Rose J. Pillari to questions submitted by Senators Specter, DeWine, Feingold, Kohl, Schumer ..... 362
Responses of Rex W. Tillerson to questions submitted by Senators DeWine, Feingold, Kohl, Schumer and Specter ..... 375

SUBMISSIONS FOR THE RECORD

Alioto, Joseph M., Partner, Alioto Law Firm, San Francisco, California, statement ..... 398
Boies, David, Boies, Schiller and Flexner, LLP, Armonk, New York, statement and attachments ..... 400
Borenstein, Severin, E.T. Grether Professor of Business and Public Policy, Haas School of Business, University of California at Berkeley, Berkeley, California, statement ..... 447
Greene, Thomas, Chief Assistant Attorney General California Department of Justice, Sacramento, California, statement ..... 458
Harris, John, Speaker of the House, Alaska State Legislature, Anchorage, Alaska, letter ..... 464
Hofmeister, John, President, Shell Oil Company, Houston, Texas, statement .. 465
Klesse, Bill, Chief Executive Officer, Valero Energy Corporation, San Antonio, Texas, statement ..... 469
Lautenschlager, Peg A., Attorney General, State of Wisconsin, Madison, Wisconsin, statement ..... 474
Mulva, James J., Chairman and Chief Executive Officer, ConocoPhillips, Huston, Texas, statement ..... 484
O'Reilly, David J., Chairman and Chief Executive Officer, Chevron Corporation, San Ramon, California, statement ..... 507
Pillari, Ross J., President and Chief Executive Officer, BP America, Inc., Chicago, Illinois, statement ..... 531
St. Albans Cooperative Creamery, Inc., Leon Berthiaume, General Manager, St. Albans, Vermont, statement ..... 535
Tillerson, Rex W., Chairman and Chief Executive Officer, ExxonMobil Corporation, Irving, Texas, statement ..... 538

# CONSOLIDATION IN THE ENERGY INDUSTRY: RAISING PRICES AT THE PUMP?

**WEDNESDAY, FEBRUARY 1, 2006**

U.S. SENATE,
COMMITTEE ON THE JUDICIARY,
*Washington, DC.*

The Committee met, pursuant to notice, at 9:31 a.m., in room SD–226, Dirksen Senate Office Building, Hon. Arlen Specter, Chairman of the Committee, presiding.

Present: Senators Specter, DeWine, Cornyn, Coburn, Kohl, Feinstein, Feingold, and Schumer.

## OPENING STATEMENT OF HON. ARLEN SPECTER, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Chairman SPECTER. Good morning, ladies and gentlemen. The Judiciary Committee will now proceed with this hearing on the consolidation in the energy industry, and the impact of raising prices at the pump, and the impact on natural gas, and the impact on so much of the core concerns of our economy.

We have seen a spike in gasoline prices to extraordinary heights. In the wake of Katrina they were $3.07 a gallon. They are now at virtually record highs at $2.38 a gallon, so we know it was not all Katrina.

We have seen extraordinary concentration in the energy industry. We have had a string of consolidations which are really staggering when you see a list of them. I knew about them, but when I see them itemized, it is overwhelming. This summer the FTC approved Chevron's acquisition of Unocal and Valero's acquisition of Premcor. A couple of years ago Valero acquired Ultramar Diamond Shamrock, and Phillips merged with Conoco. In 2001 Chevron bought Texaco, and Ultramar Diamond Shamrock acquired Total, and it is a very long list which I will put in the record because I am not going to take more than 5 minutes in an opening statement.

You had the disclosures this week that Exxon Mobil reported that it earned more than $36 billion in the year 2005, which is the largest corporate profit in United States history, and similar profits were reported by Chevron and Valero. I must say, that having been an appropriator for a long time in this Senate and seeing big figures in the billions, I am somewhere between impressed and astounded by these profits. It raises a real question as to whether something has to be done on the merger and acquisition field. We have had the Sherman Act for a long time. We have had the Clayton Act for a long time, and Congress has sat back and has not leg-

islated in the field, and it just may be time to legislate in this field with what is going on with all of the complexities of OPEC oil and our dependence, which we heard the President talk about last night, and we see these record profits, and we see really serious questions raised about the citizenship of the oil companies.

This Committee has been very, very heavily engaged on many, many matters the past few months, class action and bankruptcy, circuit judges, two Supreme Court confirmations, and we have not had a chance to really look at this field, but when we saw an open Wednesday we decided to schedule these hearings, and we got the cold shoulder from the oil industry. We were turned down by oil executives, the CEOs, seriatim. We were turned down by Mr. John Hofmeister, President of Shell; Ross Pillari of BP America; James Mulva of ConocoPhillips; Rex Tillerson of Exxon Mobil; David O'Reilly of Chevron Corporation; and Bill Gray of Valero Energy Corporation. We only provided a week's notice, but that is not too bad for the Judiciary Committee on the kind of schedule we undertake and we maintain. We do know that when these companies or other constituents have a problem, they want action from us in less than a week. If somebody calls for an appointment, it is usually for the same day, maybe the next. A week is a lot of notice to give a Senator around here to get some action from us.

We are going to be holding a followup hearing on February 28th, where we will expect those individuals to appear. We said if they could not make it on their personal schedules, we could understand, but we want somebody from their departments to come in and answer some very basic questions. I do not like to have to issue subpoenas. We had to issue a subpoena recently in our asbestos issue when we could not get disclosure as to who was contributing how much money, and if we need to issue subpoenas we can do that too. We face enormous problems which are impacting in an overwhelming way on Americans at the gas pump and heating oil, and we intend to do something about it.

I will now yield to the distinguished member of the Antitrust Subcommittee.

## STATEMENT OF HON. HERB KOHL, A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator KOHL. I thank you, Mr. Chairman, for calling this hearing today.

Let me begin by saying how disappointed I am, as the Chairman is, that the representatives of the oil industry have refused to appear here. It is not right that this industry will not answer questions of the American people through their elected representatives about the historically high prices of gasoline and home heating fuels. Therefore, I urge, as the Chairman has suggested, that we might just have to issue subpoenas under our jurisdiction to compel the attendance of the industry CEOs.

Throughout the last few years the oil and gas prices have continued to spike upwards, repeatedly reaching new highs. After retreating from last summer's record prices of more than $3.00 per gallon, gas prices are moving up once again. Yesterday the Milwaukee General Sentinel reported gas prices jumped 25 cents just on Monday in the Milwaukee area, reaching nearly $2.50 a gallon.

The national average has risen 51 percent from its level of just a year ago. Price increases for home heating oil and natural gas are following closely behind.

The pain felt from consumers for these price increases is real and it is growing. Price increases are a silent tax that steals hard-earned money away from American consumers every time they visit the gas pump and every time they raise their thermostat to keep their home warm. In my own State of Wisconsin the Governor recently estimated that families with an average annual income of $40,000 a year will pay $2,000 more this year to drive their cars and heat their homes than last year.

While consumers suffer from these price increases, the oil industry seems only to get richer and richer. Yesterday we all read the astounding news of Exxon Mobil's profit reports, $36 billion for all of last year, which as the Chairman indicated, is a record high for any company in the history of our country. Exxon Mobil is not alone. Chevron reported that its fourth quarter profit climbed 20 percent over last year, a record that continued the most prosperous stretch in that company's 126-year history.

Oil companies defend high energy prices as merely a reflection of higher worldwide crude oil prices, prices which they argue they must pass on to consumers. There is no doubt that the selfish and illegal actions of the OPEC oil cartel raises the price for crude oil, but the basic question remains, why should paying higher prices for crude oil lead to record high profits for the companies that refined this oil? One obvious answer is that oil companies are charging high prices and gaining record profits simply because they can. Every American needs to purchase gas to fuel our cars to get to work or to go to school, and all of us need to heat our homes.

Of course, we can expect private businesses like the oil companies to seek to charge the highest prices they can to maximize return to their shareholders. But energy is a necessity for millions of Americans, so our obligation in Government is to protect consumers when the market does not.

The Government is not doing nearly enough to protect consumers. Mergers and acquisitions in the oil industry, more than 2,600 since the 1990's, as counted by the GAO, have left a dangerous level of consolidation in their wake. GAO has found that this has led to higher gas prices, so we need to ask the question as to whether our antitrust laws are sufficient to handle this level of consolidation?

This increased industry concentration has another effect as demand in prices increase. We would expect refining capacity to expand if the market were competitive. Instead, numerous refineries have been closed. More than half of all those existing 25 years ago have been closed, and none have been opened recently. Refining capacity has become a bottleneck, limiting supply and causing price spikes whenever an accident occurs. Indeed, oil industry critics argue that oil companies have not chosen to expand refining capacity in order to gain market power to keep prices high, and the stats seem to bear this out.

So it is time for us to think of new solutions and new policies to restore competition in this industry. I believe we need to start by ending the refining bottleneck. That is why I have introduce S.

1979, a bill to direct the Secretary of Energy to establish and operate a strategic refining reserve.

Second, oil companies should not be able to tighten supplies further in time of shortage by exporting needed fuels abroad. So I would also urge passage of S. 1996, which is my bill to authorize the Secretary of Energy to stop the exportation of gasoline and home heating oil when supply falls short.

Reform of our antitrust laws, I believe is needed. A first step would be passage of our NOPEC legislation to subject the members of the OPEC oil cartel to U.S. antitrust law. The increasing level of consolidation and record industry profits also leave little doubt that merger enforcement should be strengthened. In this regard we should give serious consideration to revisions of the antitrust agencies' merger guidelines to take into account the special circumstances of the oil industry.

I think this is an important hearing. We thank our witnesses for being here, and I very much appreciate the Chairman calling this hearing.

[The prepared statement of Senator Kohl appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Senator Kohl.

Senator Cornyn, would you care to make some introductory comments?

## STATEMENT OF HON. JOHN CORNYN, A U.S. SENATOR FROM THE STATE OF TEXAS

Senator CORNYN. Thank you very much, Mr. Chairman. I appreciate this opportunity. Thank you for convening this hearing. I regret, like you, and Senator Kohl do, that on short notice the CEOs of a number of the oil companies were unable to change their schedule to be here with us. But, I trust they will be in attendance on February 28th, and look forward to hearing from them.

I know this hearing follows on an earlier hearing that was held before a combined Committee of the Energy and Commerce Committee, where many of those oil executives did appear. I look forward to hearing the testimony of the representatives of the Government Accountability Office and the Federal Trade Commission. It sounds like they have a little different analysis in terms of the impact of consolidation on oil and gas prices. Congress can legislate, and we can actually repeal laws from time to time, and do, but we cannot repeal the laws of supply and demand. The fact is that there is growing demand in a globalized economy for limited and scarce natural resources. I applaud the President's emphasis last night on trying to further limit our dependence on imported energy, which obviously has national security implications. It has tremendous implications for our economy.

I see my former colleague, Attorney General Blumenthal, at the table, and we served together as State Attorney Generals, and I know the State Attorney Generals play an important role when it comes to enforcement of antitrust laws, and look forward to hearing from him and others.

Just to make sure that we begin to scrape the surface of what is necessarily a very complex issue, the question of causation is one that intrigues me the most. Is consolidation the cause of high

prices at the pump, the high price of oil, or is it something else? Is it a range of other factors? My own impression is that it is a range of factors, and I hope we get a chance to explore that range in the course of these hearings, both today and on the 28th.

I have a chart here from the American Petroleum Institute, which shows where those profits go. According to at least the API—and I would like, if I may, have it made part of the record.

Chairman SPECTER. Without objection it will be made part of the record.

Senator CORNYN. It shows that in 2005, 64 percent of the profits of oil companies went into exploration. Certainly, I know that none of us would want to do anything that would have an impact on our ability to explore for and develop more resources. Obviously, increasing the supply, if demand remains static, would necessarily decrease the cost.

The other sort of dichotomy I hear set up sometimes when people talk about this issue is big oil and big corporations on one hand, and consumers and little people on the other. But, I just want to point out that, here again, the question of who owns big oil? The fact is that there are a lot of shareholders, people maybe even in the audience or listening on C–SPAN or wherever that own stock in some of these companies. Certainly, their pension plans and retirement plans may own stock in them. So, I think it is important that we recognize that this is not some monolithic faceless, nameless creature that is easy to demonize, but rather, this has an impact on real people and their ability to support themselves or their families or provide for their retirement.

I know there are a lot of different issues that we need to talk about here, and certainly, I believe our antitrust laws are important. We believe in competition. We believe in fair competition, not unfair competition, and certainly, I share the concerns of all the Committee in making sure those laws are complied with.

If there are additional laws that need to be passed, I look forward to working with you, Mr. Chairman, and Senator Kohl, who, of course, is Ranking Member of the Antitrust Subcommittee, to try to come up with sensible solutions to the challenges that confront us. I hope we do not engage, and I trust we will not—I know how careful and how thorough this Committee has typically been—in knee-jerk solutions, which actually have the impact of exacerbating the problem, such as some of the ill-conceived windfall profits legislation that has been proposed, that actually, would hurt our domestic production, would increase our dependence on imported energy, and ultimately hurt the consumer.

So, I look forward to working with you. Thank you for giving me the opportunity.

Chairman SPECTER. Thank you, Senator Cornyn. We ordinarily do not have opening statements beyond the Chairman and the ranking member, but I know Senator Cornyn has a very key constituent interest here. From my early days in the Kansas oil fields, I have great admiration for what happened in Texas compared to the stripper production that was in my home county, and I wanted to give Senator Cornyn an opportunity to speak early on the subject.

In the interest of fairness, we are going to have opening statements from all those present. I think we can manage that within the 2-hour time limit. Senator Feinstein?

**STATEMENT OF HON. DIANNE FEINSTEIN, A U.S. SENATOR FROM THE STATE OF CALIFORNIA**

Senator FEINSTEIN. Thank you very much, Mr. Chairman.

I also serve on the Energy Committee. I did not hear your statement, but I identify very strongly with the statement of Senator Kohl, and I think he is right on. I am one that has watched this happen over the years. Oil prices have risen 118 percent, just to take a time during the Bush presidency, and gas prices have gone up 58 percent. You have the 2005 Exxon Mobil annual profit, $36 billion, you have $11 billion in the fourth quarter, and I can go on for some of the others.

I was very interested by a comment in the GAO report, which I would like to read, because I think it strikes at the heart of what this hearing is about. Before I read it, let me just say that what I have noticed is a kind of purposeful oil restraint on refineries. No one builds new refineries. Consequently, in California, they function at maximum capacity all the time. So given more oil, they are constrained, they cannot refine it.

Let me quote from the report. "The 1990s saw a wave of merger activity in which over 2600 mergers occurred involving all three segments of the U.S. petroleum industry—almost 85 percent of the mergers occurred in the upstream segment (exploration and production), while the downstream segment (refining and marketing of petroleum) accounted for about 13 percent, and the midstream segment (transportation) accounted for about 2 percent. Since 2000, we found that at least 8 additional mergers have occurred, involving different segments of the 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 we performed of eight mergers that occurred in the 1990s, showed that the majority resulted in small wholesale gasoline price increases—changes were generally between 1 and 7 cents per gallon." I think that is interesting, small wholesale prices, but extraordinary retail prices right now.

What I have learned is that although a certain cost center will do very well and another cost center will not, that the industry does not really shift from one cost center to the other to reduce the price at the pump. The cost center sort of has to sustain itself, and I think there is probably no issue in which people are more aroused, and has a bigger dent, at least in my State, on the average person's pocketbook, because if you fill up your tank at $20 a tank it is one thing, if you are filling it up at $40 and $50 a tank and you have to use two to three tanks a week to get to and from work, it is a very big deal in your life.

What I found—and I hope the gentlemen will comment on it—is an absolute resistance of the industry to any sounding of an alarm bell. Nothing changes. The profit margins just continue to go way up, and there seems to be no consumer loyalty. That is what we all found with Enron. So if we look deeply, we find there is very

little oversight of the entire energy sector of our economy, and this is showing that it is a problem. It is showing that you can really increase gas prices to the sky's the limit, and continue to rake in tremendous profits. People say, "Oh, no, you cannot consider a windfall oil profits tax." Well, if the industry will not respond and will not help the consumer out, what course is Government left with? That is really my question, and I really hope the panel will address that.

Chairman SPECTER. Thank you very much, Senator Feinstein.

We had not intended to go to opening statements, but we have, and I called on Senator Feinstein ahead of Senator Feingold. That is the second time I have done that. I will try not to do it in the future. We will come to you, after we hear from Senator DeWine, who is the Chairman of the Antitrust Subcommittee.

## STATEMENT OF HON. MIKE DEWINE, A U.S. SENATOR FROM THE STATE OF OHIO

Senator DEWINE. Mr. Chairman, thank you very much. I want to thank you for calling this very important hearing today.

As we all know, our energy costs are soaring. In my home State of Ohio, like most places in the United States, gas prices have been rising steadily. Making matters worse, many analysts predict these prices only will get higher in the coming months. Prices for home heating oil are also on the rise, which is extremely disturbing to our constituents. These price hikes hit all of us in our day-to-day lives, and hit the most vulnerable Americans the hardest. Even more frustrating, it seems that every day another oil company reports record-breaking profits while American consumers pay higher prices. So it is critical that we take steps to figure out the problem and ultimately fix it.

We recently have seen a wave of mergers in the oil industry, and these mergers and their effects on consumer prices have been a priority of the Antitrust Subcommittee. Senator Kohl and I have worked together for years to preserve competition in the petroleum industry. We have conducted investigations into many of these mergers, and raised numerous concerns about them with the FTC.

Additionally, back in the year 2000 we asked the FTC to investigate the gasoline price spikes which hit the Midwest. In response, they set up an intensive ongoing monitoring program within the industry to make sure that they could find and stop illegal price gouging. We believe this program has been an effective law enforcement tool and it has prevented at least some of the abuse that might have otherwise occurred.

Nonetheless, fuel prices continue to rise, and naturally, this has led to discussion about whether oil industry mergers have increased prices to consumers.

Today's hearing will be a good opportunity to explore this very issue, but I think it is important to note that even those who think that these mergers have increased price, such as the GAO, believe that the effect has been relatively small, usually about a penny or two per gallon. Others argue that the price effect is somewhat higher. But either way, it is clearly not the biggest part of the problem.

The biggest problem is simply crude oil. Bluntly, we do not have enough of it, and we rely too much on it. Our country, although blessed with great natural resources, is sorely lacking in crude oil. Try as we might, we cannot drill our way out of this crisis. So we must take a much broader approach to our energy problem and limit our reliance on oil.

Mr. Chairman, we have the ability to do just that. The United States does have one fossil fuel in great abundance, and that, of course, is coal. Of course, coal brings its own challenges. We have all seen and been horrified by the tragic deaths of the miners recently in West Virginia and also Kentucky. As a member of the HELP Committee and Appropriations Committee, I participate in hearings on mine safety issues. We cannot emphasize enough that we must take aggressive and prompt action to improve mine safety, and protect the life and health of our miners. We need to invest the time and the money to figure out how to mine coal more safely, burn it more cleanly, and use it to power our economy, but coal, clearly, can work for America.

We need to go further, however, than that. We need to conserve, we need to increase fuel efficiency, and we need to invest in safer nuclear technology, wind power, solar power, biomass, as well as in fuel cells. My home State of Ohio is a leader in developing fuel cell technology, and I have been very supporting of efforts to fund this technology. It is extremely promising.

Clearly, Mr. Chairman, we have a lot to do on energy policy in general, as the President pointed out last night. In the meantime, however, this hearing is an excellent opportunity to make sure that our antitrust laws are being applied properly, and eliminate any opportunities for companies in the petroleum industry to unduly increase the fuel prices we all pay.

On a final note, Mr. Chairman, I want to say how disappointed I am as well that the oil executives declined to attend our hearing today. It would be useful to the Committee to hear their views on fuel prices, and I welcome the announcement that you made hear this morning.

I thank you.

Chairman SPECTER. Thank you, Senator DeWine.

Senator Feingold, I understand that you do not wish to make an opening statement.

Senator FEINGOLD. No, I would like to make a very brief opening statement.

Chairman SPECTER. Fine. You are recognized.

## STATEMENT OF HON. RUSSELL D. FEINGOLD, A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator FEINGOLD. Mr. Chairman, I want to thank you, and of course, the ranking member, Senator Kohl, for holding this important hearing today, and I do appreciate the chance to say a few words. I want to thank the witnesses for agreeing to participate in today's discussion.

I am here this morning because I am deeply concerned about the high gasoline prices that are hurting especially Wisconsinites and consumers across the country. It is as if we are conducting an uncontrolled experiment into how far our constituents' pocketbooks

can be stretched. That cannot go on. It is time for the Federal Government to grab the reins back, conduct the necessary oversight over these energy markets, and adopt appropriate solutions. Our constituents are demanding action, and they deserve it.

Even a casual reader of the news knows that the oil industry is coming off a record-breaking year of profits, with one company, Exxon Mobil, becoming the most profitable company in U.S. history, the most profitable quarter of any company at any time in our Nation's history.

As these profit reports come out, my constituents are asking many questions such as why high prices do not seem to be bringing new investment in the oil and gas sector to increase the supply of refined petroleum products. Wisconsinites always expect straight talk, and it is long past time that they got it from Congress and from the oil industry, which as everyone said, I am pleased to hear—although we are not pleased about it—that they are not present today. I have been concerned about consolidation in the oil-gas sector for a while, just as I have been concerned about consolidation of the electricity sector due to the repeal of the Public Utility Holding Company Act. I strongly opposed that step in the Energy Policy Act of 2005. The country is now seeing the consequences, and unfortunately, they are not positive, so I hope we learned some lessons from that.

I do thank the witnesses, and I thank you, Mr. Chairman.

Chairman SPECTER. Thank you, Senator Feingold.

Senator Coburn?

**STATEMENT OF HON. TOM COBURN, A U.S. SENATOR FROM THE STATE OF OKLAHOMA**

Senator COBURN. Thank you, Mr. Chairman.

I think it is really important for us to focus on markets. There is no question if there is collusion, we ought to be about fixing that and changing the law to affect it. But some of the things I have heard today disturb me. One is nobody mentions the impact that speculators on NYMEX have had. All you have to do is look at natural gas. It has been as high as $15.60 per million BTU. It hit 7.60 last week, it is about $9.00 now. Most of that is not based on true takings and hedging of consumers or distribution companies, it is based on pure speculation. I remember back in the 1970s when silver was trying to be cornered by one group of individuals. The way they solved that problem is they took the hedging out, the speculative hedging out, by saying you have to take delivery. It might be very wise for us to look at the component of speculation.

The second thing, the reason new refineries are not being built is because the bureaucracy and the cost to establish new refineries is about 10 times higher than expansion of existing refineries. Somebody mentioned Valero. Valero is expanding refineries like crazy, but they do not build new ones because we have set up so many impediments, that they cannot, the cost to do that.

Finally, the very idea that somebody would suggest that the increased prices are not leading to new exploration, all you have to do is look at the exploration companies and the major oil companies that they are doing. There is significant increase in exploration. It is growing like crazy. Multiple exploration companies are

based in Oklahoma, and they are building rigs, and we are using the rigs as fast as we can in this country based on demand.

The final thing I would say, is with increased prices coming, decreased overhead has relationship to that price, and I am not at all surprised by the increase in profits, because as you increase volume over a fixed overhead, it all falls directly to the bottom line. I would also note that the oil and gas industry's average Federal tax bite is 38.5 percent. They paid $44 billion into the treasury of this country this last year, $44 billion from one industry. It is going to be greater than that this year. So it is fine for us to say that there should not be collusion, and I agree with that. We should be aggressive to make sure that does not happen, but it is not fine for us to say that we do not want markets to help us allocate scarce resources, and if our tendency is to control prices or to put a windfall profit tax, all we are doing is shooting ourselves in the foot.

Let's go prosecute those people who are colluding, those people who are fixing prices, but let's let the market help us solve our energy needs.

Thank you, Mr. Chairman.

Chairman SPECTER. Thank you, Senator Coburn.

Senator Schumer.

**STATEMENT OF HON. CHARLES E. SCHUMER, A U.S. SENATOR FROM THE STATE OF NEW YORK**

Senator SCHUMER. Thank you, Mr. Chairman. I thank you for holding this hearing.

Let me just say that, you know, as somebody who loves America, I try to study what makes other societies that have achieved greatness decline. The one issue that seems to be throughout, Roman Empire, British Empire, is failure to deal with problems ahead of time, waiting till those problems are right at the door and it is much too late. And if there was ever an example of that, it is the energy problems that we have. We could solve those much more easily today than we will be able to in 10 or 15 years, and we are not, and I worry about it.

I was disappointed, Mr. Chairman, in the President's state of the union. I do not think you can solve the oil problems unless you solve the problems of oil companies. The President said last night that Americans were addicted to oil, but this administration is addicted to oil companies, and we are not going to achieve energy independence until the administration breaks its addiction. Just look at last year's heralded energy bill. Last year's energy plan gave Americans $3.00 a gallon gasoline and record profits for the oil companies.

So one can hope that this new plan is better, but a plan that does not mention raising mileage standards for cars, does not mention ways to really conserve, which is the No. 1 way to deal with our problems, is not going to get very far in terms of energy independence.

On the issue of the large oil companies, I have talked to CEOs—these are not average consumers or liberal Democratic think tanks—CEOs of major companies that buy things like jet fuel, diesel fuel, heating oil, every one of them thinks there is not real competition. How can there be when you have so few companies out

there. One of the great mistakes this country made was to allow Exxon and Mobil to merge. That was done during a Democratic administration, but it never should have happened. Let No. 1 and No. 2 merger when you only have a handful of big producers? And as long as there is not much more competition, you are not going to get anywhere. Why did all the prices spike up at the same time, why on the West Coast right after Katrina, where there is no Gulf oil, did the price almost go up as much as it did in places like New York that use Katrina Gulf oil? And why is it that when the spot market goes up, the price at the pump goes up two, 3 days later; when the spot market goes down, it takes weeks for it to go back down?

The answer is simple: there is not real competition. There is what they call price leadership. No one is saying there is collusion. That would be, as my good friend from Oklahoma said, against the law. But everyone follows one another. This happens in any major industry where there are only a few competitors. It happened in the credit card industry, for instance, when everyone's rate was at 19.8 percent a few years ago.

The idea of looking into big oil from an antitrust perspective, I think, Mr. Chairman and Senator Kohl, are extremely timely. I do not know if we can ever undo the mergers that were done, but the best antidote here is real competition. When the oil companies are not interested really in alternatives, they make their money in fossil fuel, when there are so few of them, and when the policies that this administration proposes do not work, when it seems that the oil companies have a veto over any proposal the administration makes, so you do not get anything real tough, I worry about the future of this country.

Chairman SPECTER. Thank you, Senator Schumer.

We now turn to our first witness, Federal Trade Commissioner William Kovacic; a very distinguished record, extensive work with the Federal Trade Commission, being an attorney there in 1979 to 1983 time range, and currently a Commissioner; educational background is from Princeton bachelor's degree and law degree from Columbia; and a professor at Georgetown University Law School, and formerly a professor at Washington College of Law, American University, and George Mason University School of Law.

Thank you for joining us today, Commissioner Kovacic, and we look forward to your testimony.

**STATEMENT OF WILLIAM E. KOVACIC, COMMISSIONER AND FORMER GENERAL COUNSEL, FEDERAL TRADE COMMISSION, WASHINGTON, D.C.**

Mr. KOVACIC. My pleasure, and thank you, Mr. Chairman, and the other members of the Committee. I am grateful for the opportunity to discuss consolidation in the petroleum industry and to review the FTC's program to protect consumers in this singularly important sector. My written statement provides the views of the Commission, and my spoken comments and responses to your comments and questions do not necessarily reflect the views of my colleagues.

Since the turn of the 20th century, no industry in this country has commanded closer attention from the U.S. antitrust authori-

ties. So it is today for the Federal Trade Commission. I want to highlight four dimensions of the FTC's competition policy program for the petroleum sector.

First and foremost is law enforcement. I think everything that a competition agency does is based on its willingness to enforce the laws. Collateral policies are important, but that is the foundation of what an agency does. Activities of the past year attest to the significance and scope of the FTC's law enforcement program. The Commission achieved a major settlement to resolve competitive concerns associated with Chevron's acquisition of Unocal. The centerpiece of this settlement was Chevron's agreement not to enforce certain of Unocal's patents. The enforcement of those patents would have caused California consumers to spend hundreds of millions of dollars per year for gasoline. The settlement resolved earlier FTC allegations that Unocal had wrongfully manipulated the process by which the State of California set standards for gasoline.

In the Aloha case, the FTC sued to block a merger that allegedly would have increased concentration in the distribution of gasoline in the Hawaiian Islands. The suit induced the parties to take measures that resolved the FTC's concerns.

These matters reflect the FTC's consistent practice of the past 25 years of eliminating anticompetitive overlaps and addressing serious problems where they arise.

The second element is in the investigation, monitoring and analysis of developments involving petroleum products. As this Committee is well aware, Congress has requested the FTC to undertake two closely related studies which have been combined in a single undertaking, and the FTC is now conducting an investigation of whether petroleum companies improperly manipulated supplies or wrongfully boosted prices in the wake of Hurricanes Katrina and Rita. To this end, the FTC recently denied a petition by Exxon Mobil to curtail the scope of its inquiry. We will publish the results of the study in the late spring, as mandated by Congress. In performing this investigation the FTC is drawing upon the knowledge it has gained from two major reports it published in the past 2 years on mergers and product pricing respectively. The FTC also will use what it has learned from its continuing program referred to by Senator DeWine, and program partly inspired by the advice of Senators DeWine and Kohl on the Antitrust Subcommittee. It is a program to monitor pricing anomalies in over 300 metropolitan areas in the United States.

The third ingredient is to assess the soundness of our program. One year ago the FTC hosted a conference to discuss efforts by the FTC and the Government Accountability Office, represented here today by my colleague, Jim Wells, to assess the impact of FTC merger policy. In the past year the FTC has used the results of this conference to refine its techniques for assessing the effects of its merger enforcement program. I agree wholeheartedly with the spirit expressed by members of this Committee today that it is essential for us to continually review and assess the soundness of what we have done before. Where these and related inquiries suggest improvements, be assured that we will make them.

Finally, the FTC is working to improve cooperation within the large archipelago of Federal agencies and State authorities cur-

rently engaged in policy activities that affect competition in this sector. Improvements in the framework of information sharing and consultation have genuine promise to improve the Nation's competition policy initiatives involving petroleum products.

Let me close on a personal note, in this, my first appearance before this Committee since becoming a Commissioner less than a months ago. Thirty years ago I spent 1 year working as a legislative assistant on Philip Hart's Antitrust Subcommittee staff. One of my main responsibilities was the petroleum industry. That experience gave me a strong and continuing interest in energy policy. During my tenure as an FTC Commissioner I will give energy issues my highest priority. I hope today is the first of many occasions that I will have to meet with you, your colleagues and your staff to discuss the FTC's efforts to develop competition and consumer protection programs that best serve American consumers.

I look forward to your questions and comments.

[The prepared statement of Mr. Kovacic appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Commissioner Kovacic.

We now turn to Mr. James Wells, who is the Director of the GAO Department on Energy, Natural Resources and Environment, a graduate of Elon College and the Executive Development Course at Harvard University Kennedy School of Government. He has been with the Government Accountability Office since 1969 and has authored several important GAO reports, including the recent one on the Effects of Merger and Market Concentration in the Petroleum Industry.

Thank you for coming in today, Mr. Wells, and we look forward to your testimony.

**STATEMENT OF JIM WELLS, DIRECTOR, NATURAL RESOURCES AND ENVIRONMENT, GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, D.C.**

Mr. WELLS. Thank you, Mr. Chairman, and members of the Committee. We too welcome the opportunity to participate in this important hearing today.

When gasoline prices go up, people notice. According to the experts, each additional 10 cents per gallon of gasoline adds $14 billion to America's annual gasoline bill. The daily press reporting of record industry profits is creating a heightened tension between those that supply the product and those that use and pay for it. The absence of the CEOs of the major oil companies today doesn't help that. When GAO issued its report detailing our extensive study of the impacts of mergers in the gasoline industry, people noticed.

The industry currently can only make so much gasoline from the available crude oil. Our cars, our trucks, they need more than we can make domestically, and we are paying to import more than 40 million gallons of gasoline a day to meet our needs. Given the importance of gasoline to our economy, it is essential to understand the market for gasoline and how prices are determined. In summary, we would say crude oil prices are clearly the fundamental

determinant of gas prices paid at the pump. With crude oil prices at about $67, as they are today, we have $2.50 gasoline.

However, other factors also affect the gasoline prices, including things like the limited refining capacity here in the United States. The gasoline inventories being maintained currently by the refiners and marketers of gasoline are only half of what it was a few years ago. There are regulatory factors placed on the gasoline marketplace, such as national air quality standards, introduced special blends that have been linked to higher gasoline prices, and we would add, a determining cost at the pump is the large number of oil company mergers that raises concerns about potential anticompetitive effects, as we have talked about today, because mergers and increasing numbers of mergers could result in greater market power, and potentially allowing prices to rise and be maintained over a period of time above competitive levels.

We studied the merger activities in the 1990s and coined a phrase, the wave of over 2,600 mergers that led to the increased market concentration in the refining and market segments or downstream segments of the industry. Clearly, in the mid 1990s there were 24 States that had moderately concentrated markets. Four or 5 years later, after this wave of mergers, 46 States, including the District of Columbia, had moved from mildly or moderately concentrated to highly concentrated.

Since our study, another 8 fairly significant mergers have occurred. Our detailed study of the 8 that we did in the earlier study found that in the majority of these mergers wholesale prices, as Senator Feinstein had alluded to, had increased, typically being passed on at the retail level anywhere from 1 to 7 cents per gallon.

Since 2000 we found at least another 8 fairly significant additional mergers have occurred, and while we have not performed tests on these mergers that have involved over $90 billion worth of assets, these additional mergers would further increase industry concentration.

Mr. Chairman, I will stop here and just say that there are a whole lot of things beyond just the high cost of crude oil that are causing consumers to pay more. The gasoline industry is very complex. It is true that forces such as the rapid growth of world demand, boosted by China's extraordinary pace of development, have put unprecedented pressure on the global crude oil supply and demand balance. The resulting high prices of crude oil have clearly pushed company profits dramatically higher at the same time that the consumers are feeling this pinch of higher gasoline prices at the pump.

However, in a concluding type of way, while the global oil market may be beyond our immediate control, at least in the short term we can ensure, as this Committee hearing will help address the proper application of oversight, that our domestic market remains competitive. A hearing like this is clearly an important one to ensure that all the players in this environment, you, the Congress, the regulatory agencies with the FTC and Department of Justice, and even, yes, the GAO auditors here who do work for you, that we are engaged in performing oversight to see what is causing the marketplace to react the way it is.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Wells appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Wells.

We turn now to Connecticut Attorney General Richard Blumenthal, a position he has held for 15 years. He has an undergraduate degree from Harvard, Yale Law School, U.S. Attorney for Connecticut, Administrative Assistant to Senator Ribicoff and also assistant to Senator Moynihan, law clerk to Justice Blackmun, brings a very, very distinguished record to the witness table.

Thank you for coming down today, Mr. Attorney General, and we look forward to your testimony.

**STATEMENT OF RICHARD BLUMENTHAL, ATTORNEY GENERAL, STATE OF CONNECTICUT, HARTFORD, CONNECTICUT**

Mr. BLUMENTHAL. Thank you, Mr. Chairman, and Senator Kohl for having us today and giving us this opportunity to speak about an issue that is so tremendously important to my constituents, as it is to yours. I want to thank my former colleague, the Senator from Texas, for being here, and I know he still shares the perspective that I bring to this table, which is one of State law enforcement and trying to use the laws that we have now to make sure that there is real competition.

If I have one message for you today, it is that we need help. There needs to be a sense of outrage among Federal law enforcement as there is among State law enforcement about the results that we see, and the damage that we see to our economies from anticompetitive conduct.

We formed a task force. It includes virtually every Attorney General in the United States. I am on the Executive Committee of that task force. We have taken action against price gouging in many States. We have either prosecuted or we are initiating action against retailers and some wholesalers, who misuse their market power. But our reach, in terms of authority, and our resources, are limited. We need help, and we are not getting it. That is, very simply, the bottom line for me as a law enforcer.

I know from all of the studies that I have reviewed—and they go back to 2001 with the FTC's own report on withholding of supplies, although it found no overt, purposeful collusion, the 2004 GAO study, a raft of other studies that show increasing concentration so that now about 50 percent of all the domestic refining capacity and oil production is controlled by just five companies, and 60 percent of the retail market by those same five companies. Even without collusion, what we see on the streets and the gas stations of Connecticut and throughout the country is that that market power leads inexorably to anticompetitive conduct. That is what we need to stop through measures that I believe should avoid, as Senator Cornyn observed, simplistic solutions or knee-jerk reactions. I happen to favor a windfall profits tax, but that tax will not change the structure of the industry.

I propose some measures in my testimony—and I will be brief in closing because I know the time is limited—such as a 1-year moratorium on all mergers; a focused investigation going to the very top of this industry at every level, involving States as well as the FTC and the Department of Justice, that focuses attention, and gets the

attention of this industry; a ban on zone pricing which divides States and even cities into different geographic areas, and thereby inhibits competition by, in effect, curtailing competition among the retailers; expanding refinery capacity; mandating minimum levels of inventory; lessening our dependency on gasoline through conservation efforts and alternative fuels. I welcome the President's focus on this aspect of the problem, but we need to deal with the world as we face it now.

The concentration of power that we see has real-life consequences for our consumers, and the mere fact of an investigation focused on the industry and on the New York Mercantile Exchange, as Senator Coburn suggested, I think will itself have a very important effect. What we saw in the wake of our investigation was that prices began to come down as soon as we sent subpoenas, as soon as we issued letters, as soon as our focus was on the industry, and I think that, at other levels, conduct can be affected as well. I think the law needs to be changed. We need tougher laws, but we also need a sense of urgency from Federal law enforcement in this area.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Blumenthal appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Attorney General Blumenthal.

Our next witness is Professor Preston McAfee, who is with the California Institution of Technology, bachelor's degree from the University of Florida, master's from Purdue and PhD in economics also from Purdue; been a Professor of Economics at the University of Texas and University of Chicago, and MIT; has written extensively on antitrust monopolies mergers; author and co-editor for economics journals for more than 25 years.

We appreciate you being with us today, Professor McAfee, and we look forward to your testimony.

**STATEMENT OF R. PRESTON MCAFEE, J. STANLEY PROFESSOR OF BUSINESS, ECONOMICS AND MANAGEMENT, AND EXECUTIVE DIRECTOR FOR THE SOCIAL SCIENCES, CALIFORNIA INSTITUTE OF TECHNOLOGY, PASADENA, CALIFORNIA**

Mr. MCAFEE. Thank you, Mr. Chairman, and members of the Committee.

I have worked extensively with the Federal Trade Commission in evaluating mergers, including the Exxon Mobil and BP Arco mergers. As part of my study of these mergers, I had access to a substantial number of documents, on Exxon Mobil in particular, 125 million pages of documents. I am pleased to be here today to discuss the economic issues I have researched and how they pertain to the examination of antitrust applied to the oil industry.

Let me start by applauding the Committee's investigation of the sequence of mergers, rather than focusing on any specific merger. All too often antitrust enforcement focuses only on the merger at hand, without asking how that merger fits into the larger picture of industry evolution. It is my understanding—and I am not an attorney—that comparing mergers to the status quo, as dictated by court precedent—and in many cases this is not appropriate—there are circumstances where the status quo is unlikely to persist, and

hence, is not the relevant benchmark for comparison. In the oil industry, as I will discuss in a moment, there is pressure to create very large firms. A decision made by antitrust authorities to block or permit a specific merger does not eliminate that pressure.

How does this logic apply to the oil industry? For a medium-sized oil company, development of a single field can be "bet the company project." The risk of bankruptcy is deadly on Wall Street, so a medium-sized oil company is just not in a position to take on the very large risks of large developments. Many of these risks associated with international development are not created by physical and technical challenges, although, of course, there are plenty of these, but are in fact created by political challenges like unstable governments, rebel groups and the like, shifting national borders. So size helps here as well by improving a company's bargaining power.

So while I think in general it's very important to consider industry evolution in the context of evaluating mergers, in the specific case of oil industry, the industry evolution is putting great pressure on the firms to grow internationally.

The Federal Trade Commission does a very thorough job investigating oil company mergers. I should know. And if you do not like what their conclusions are, you can actually blame me for part of it. Big mergers have generally required extensive divestitures to preserve domestic competition, and the production and retailing of gasoline have not become more concentrated in recent years.

Let me turn to vertical integration. Oil companies are the quintessential vertically integrated firms, a phrase which here means that a single company performs all of the activities to get oil from the ground and into gas tanks: exploration, drilling, pumping, oil transport, refining, gasoline transport and retailing. In recent decades economists' understanding of the effects of vertical integration have changed. The classical Chicago School view of vertical integration is that vertical integration had no effect. Based on this view, mergers could be analyzed level by level. But we now know that that is not a good plan, that vertical integration does have an effect.

The problems of firms that meet each other in multiple markets is clearest in my home State of California. West Coast gasoline transport is controlled by an oligopoly of 7 firms, who also control refining and retailing. These firms use each other's transport facilities and trade gasoline, and to put it bluntly, they have a gun to each other's head, which makes it very difficult for any firm to engage in aggressive pricing, or even to sell gasoline to entrants like Costco. The Federal Trade Commission is well aware of this threat, and we were very careful to make sure that it did not get worse during the recent mergers.

Unilateral effects. Game theory has been popularized by the book and movie "A Beautiful Mind," and in fact, since 1994, 23 individuals have received the Nobel prize in economics, and 12 of those prizes were for game theory. In antitrust game theory issues are known as unilateral effects, and they barely register in antitrust court cases even though they have been present in the DOJ Merger Guideline since 1982.

I am running out of time. I will sum up.

Perhaps the most important conclusion I would leave with the Committee is that we are fortunate that the hysteria of the 1970s has not returned and that Americans have accepted the high price of fuel without demanding regulations that caused so much damage to our fuel supply back then. Over the past 30 years this country has deregulated trucking, airlines, rail, gasoline, oil, natural gas and long distance telephony. It is in the process of deregulating electricity and local telephony, and overall, the deregulation of the U.S. economy has produced enormous gains for American consumers. We should not let problems—and this is not to say that they are not real problems, because they are—return us to the 1970s.

Finally, I appreciate the questions and issues that motivate these hearings. Our understanding of antitrust continues to progress, and the oil industry has been a test case for antitrust enforcement for nearly a century. I also suspect that to oil company executives, it feels more like the cross-hairs antitrust than a test case.

[The prepared statement of Mr. McAfee appears as a submission for the record.]

Chairman SPECTER. Thank you, Mr. McAfee.

Our next witness is Mr. Tyson Slocum. He is the Acting Director of Public Citizen's Energy Program, a position he has had since the year 2000. He has a bachelor's degree from the University of Texas—

Mr. SLOCUM. Bachelor degree, although University of Texas is such a great school, that I think a bachelor's degree equals a master's degree.

Chairman SPECTER. So be it.

[Laughter.]

Chairman SPECTER. Author of three books on energy issues.

Thank you for coming in today, Mr. Slocum, and the floor is yours.

**STATEMENT OF TYSON SLOCUM, DIRECTOR, PUBLIC CITIZEN'S ENERGY PROGRAM, WASHINGTON, D.C.**

Mr. SLOCUM. Mr. Chairman, thank you very much. I too am disappointed that the oil companies are not here to defend their record profits. The last time the oil companies were before Congress, in November, they were allowed to present their testimony without testifying under oath, and today I was not administered such an oath, and I do not know if it is possible for me to be administered an oath for my testimony today, Mr. Chairman. I would like—

Chairman SPECTER. Yes, it is.

Mr. SLOCUM. May I be administered an oath, Mr. Chairman?

Chairman SPECTER. No.

[Laughter.]

Mr. SLOCUM. OK.

Chairman SPECTER. You are not the Chairman of this Committee, Mr. Slocum.

Mr. SLOCUM. Yes, sir, that is correct.

Chairman SPECTER. Somebody else got confused about that a couple of weeks ago.

[Laughter.]

Mr. SLOCUM. I would just to, for the record, say that my testimony today, I swear to be the truth, so help me God, Mr. Chairman.

Chairman SPECTER. You can be charged with making a false official statement even though you are not sworn, so there are criminal penalties available to you, Mr. Slocum. They are available to you, so be careful.

[Laughter.]

Mr. SLOCUM. Yes, sir. Mr. Chairman, I have done an enormous amount of research into the correlation between the record profits by the industry, and the record prices that consumers are paying. My research clearly shows that there is a direct connection between all the recent mergers that we have allowed in the petroleum industry and these record prices which translate into the record profits.

Now, my research, I took a look at what the market concentration was in the refining sector 10 years ago and compared it to what the market concentration is today after a number of very large mergers of not only vertically integrated oil companies, but refining companies as well.

In 1993, the largest five oil refiners in the United States controlled 34.5 percent of national refining capacity. The largest 10 in 1993 controlled 55.6 percent of capacity. Now fast forward to 2004 after a number of very large mergers. The largest five now have 56.3 percent of capacity, so today the largest five refiners control more capacity nationally than the largest 10 did a decade ago, and the largest 10 refiners today control 83.3 percent of national refining capacity. That is alarming levels of concentration.

My findings have been confirmed by various Government investigations, including the Government Accountability Office. They issued a great report in May of 2004 which clearly showed a link between all of these recent mergers that led to industry consolidation, which translated into higher gasoline prices. The GAO report specifically found high levels of concentration on the East and West Coast and in the Midwest, where we have seen a majority of the severe price spikes. It is very important to know that this GAO report underestimates the true price influence because their analysis of market concentration refining industry ends in the year 2000.

Since 2000, of course, we have allowed the mergers of Chevron and Texaco, and Conoco and Phillips, and a large independent refiner, Valero, has acquired a number of refining companies. So if anything, the analysis done by GAO has become much worse from a consumer and antitrust standpoint since their analysis ends in 2000.

The Federal Trade Commission issued a very interesting investigation in March of 2001. They took a look at price spikes specifically in the Midwest. They found evidence of unilateral withholding on the part of oil refiners, and I am quoting from an excerpt from that FTC report. They say, "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 antitrust laws. In each instance the firms chose strategies they thought would maximize their profits."

Most certainly the companies are maximizing their profits, Exxon Mobil, $36 billion in last year alone. What is interesting is that Federal Trade Commission has disputed some of the GAO findings, saying that their methodology was wrong. But how can the FTC certify that markets are fully competitive, if they themselves have found evidence of unilateral withholding? If one company can unilaterally withhold, that clearly means that there is inadequate competition, because if there was plenty of competition, another competing firm would be very happy to step in and supply the market. So the fact that evidence of unilateral withholding exists is clear evidence that we uncompetitive markets, and again, it is due to all the recent mergers that we have allowed.

What is the exact financial result from all this—

Chairman SPECTER. Mr. Slocum, could you summarize at this point, please?

Mr. SLOCUM. Yes. There is a table that the Department of Energy puts out that shows refiner profit margins by year. In 1999, for example, U.S. oil refiners made 22.8 cents per gallon refined. By 2004 that margin had increased to 40.8 cents per gallon refined. That is an 80 percent jump, and I think that clearly illustrates the lack of adequate competitiveness.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Slocum appears as a submission for the record.]

Chairman SPECTER. Thank you, Mr. Slocum.

Our final witness is Mr. Tim Hamilton. He is the founder and Executive Director of the Automotive United Trades Organization, a position he has held and an organization he has run for some 20 years now; has been a petroleum industry consultant, and he has testified before many legislative bodies and assisted the FTC and Department of Justice in investigations. Mr. Hamilton, we appreciate you coming in, and we appreciate your testimony.

**STATEMENT OF TIMOTHY A. HAMILTON, FOUNDER AND EXECUTIVE DIRECTOR, AUTOMOTIVE UNITED TRADES ORGANIZATION, SEATTLE, WASHINGTON**

Mr. HAMILTON. Thank you. For the record, my name is Tim Hamilton. There is some good news here: I am not an economist, so I am going to do this as simple as I can.

I got in the business in 1974 with Exxon when I was 24-years-old. I filed my first tax return when I was 12. I learned from the street up. If you want to know what happened with Katrina, if you want to know why San Francisco is higher than LA, I can show you. I know how the gasoline moves. In the industry you would come to me if you wanted to figure out how to build a gasoline convenience store or purchase a string of stations, and try to figure out what the oil companies are doing. I do not care about their profits, does not bother me. "Profit" is not a bad word. I worry about the way they get it.

The way they get it is simple: count the trucks. When we consolidated the industry, not having a law degree, I learned very simple phenomena. Antitrust laws busted up the Rockefeller Trust, so we did not have one company holding all the gas in one tank and dictating terms. What happened through mergers and acquisitions and changes in industry, is that the industry put all of its gas back in one tank. Today the Standard Oil Trust has been restructured physically and logistically, but on paper there are four identities. So there is an incentive to short market.

And what happens is real simple. Following Katrina or following a refinery fire in California, what you see is they count the trucks. As the gas comes into the tank from the refinery, they have removed it by exporting or curtailing production so there is very little there, minimal reserves. So when we have a problem with the increase in price or increase in demand, spring plant, kids get out of school, or a refinery problem, what happens is there is a draw. It is called a drawdown. So as the trucks go out and the level of the tank starts to hit the bottom—and we are sitting on sometimes a two or 3-day supply—they go, "How many trucks came in today? 90. How much gas came in? 90 trucks worth or 95, or 80. Oh, 80? Raise the price 10 cents. How many came in today? 85. Raise the price 10 cents." And they do it until it balances.

I went into the first gas lines in 1974 when I tried to order my first load of gas. I have been experiencing and watching and analyzing gas rationing at the pump. The market now calls it allocation by the market supply. It is rationing, it is eBay. We have a shortfall. The bigger the shortfall you make it, the more trouble you are in.

Antitrust laws prevented collusion. We have an Internet and technology today where I can show you that every one of these limited suppliers that is left, can change their price instantaneously. The other ones, no. They know how many gallons they have. They share the same tank. They know when the fuel is coming in. They know what transport is coming, everything. There is no trade secrets in the gasoline business. When you know this, you are provided an incentive to raise price by rationing it. We get the price up so high because of restriction at the refinery, that it brings the price of crude up. If you got the price of crude to fall dramatically, but it took $3.00 a gallon to keep you from running out today, the price would not go down. In fact, if you were OPEC and you wanted to get a share of that money, you did not want Exxon Mobil to have it all, you would raise the price of crude. Like if we went from 14.95 for a 2 by 4, what do you think it does to logs on a landing? It is sucking the crude oil up, unless you have a disruption, such as in Iran, that people are worried about.

I will summarize by saying this. I work all over the West with folks trying to figure out alternative fuels, trying to figure out how to use ethanol, how to do everything that the President mentioned last night. It is going to take 15, 20 years, trust me. Between now and then we have got this Committee. How do we use oil we are hooked on and stuck with and how is it sold? And you need to understand how to count the trucks, and to know who bought the gas and who is on first, and how none of the fuel sold in the futures market goes anywhere other than one dock in New York Harbor,

but can affect the price of gasoline in Idaho. These things you need to know.

Thank you.

[The prepared statement of Mr. Hamilton appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Hamilton.

We will now proceed to 5-minute rounds of questioning, and to the extent witnesses can make answers brief, all of the Senators would be appreciative because we do not have a whole lot of time.

Commissioner Kovacic, beginning with you, you have heard the testimony of Mr. Wells about concentration of power, Attorney General Blumenthal about concentration of market power leads inexorably to increased prices, an interesting conclusion by Mr. Hamilton about restructuring of Standard Oil, kind of have some of the overtones of collusion in all six companies agreeing not to appear here today. What can the possible justification be for some 2,600 mergers in the last 15 years, including the merger of the biggest and the second biggest company, in a context where the prices are sky high, $2.36 a gallon; every 10-cent increase leads to $14 billion from the American consumers; cries of pain coming from everybody who goes to the gas pump. How can the FTC justify allowing so many mergers?

Mr. KOVACIC. Senator, in most instances the significant mergers were not allowed to proceed without qualifications, and as Professor McAfee mentioned, in the large number of transactions, the Commission took a great deal of care to demand divestitures where the Commission believed that any competitive overlaps would lead to price increases.

Chairman SPECTER. Well, you could have some qualifications, but you still end up with a merger. Commissioner Kovacic, would you like to slow down that merger process if you had different statutes to work under? When you worked as an attorney for the Commission, did you ever say, "I wish Congress would do something here to give us some more power to stop this. We do not have the power under existing law?"

Mr. KOVACIC. In many respects, as your question suggests, our decisions take place in the context of what courts are permitting us to do. For my own part, I do have concerns when we look at the general direction of our merger jurisprudence over the past 30 years. I wonder whether or not that jurisprudence has begun in some instances to place excessive demands on the agencies in the type of proofs that's required.

Chairman SPECTER. Excessive demands on the agencies and not enough demands on the Congress. That is a fair accusation. Is that what you are saying?

Mr. KOVACIC. I would say that I think we are approaching the point at which a broader reconsideration of whether the lines are drawn in the right place is appropriate, and I—

Chairman SPECTER. I have watched the merger and acquisition field in more than oil, everywhere you turn around.

Attorney General Blumenthal, you have had a lot of experience. Do you think we need to revise Federal laws?

Mr. BLUMENTHAL. I do, Mr. Chairman, and the Commissioner has put it very politely, that the law places excessive demands on

the agencies like the FTC. I would establish a presumption in the law that, for example, if the HHI index, the Herfindahl-Hirschman Index, is at a certain level, the presumption should be against a merger. I would put a presumption in the law that the industry bears the burden of showing a benefit to the consumer from any merger in a concentrated market.

Chairman SPECTER. That is a good idea on shifting the burden of proof and the presumption, but how about some fundamental restructuring of our antitrust laws? We have not done a bit of that in decades. They have just been static. And there have been enormous changes and enormous resiliency and enormous innovation and brilliance on the part of the companies in all fields. How about something very fundamental on changing our laws?

Mr. BLUMENTHAL. I think that the Congress ought to consider fundamentally restructuring the law to take account of the challenges of enforcement that relate to modern technological advances, the use of e-mail, for example, that may disguise or inhibit prosecution of collusion, making detection, apprehension and prosecution more difficult. I think that there needs to be a restructuring that essentially takes account of the anticompetitive trends in the American corporation today, and—

Chairman SPECTER. My red light is about to go on. Years ago, a judge in the Eastern District of Pennsylvania named Ganey, sent some electric company officials to jail. Do you think that might be salutary?

Mr. BLUMENTHAL. Any time an executive goes to jail, it has a very salutary effect, as I know from my personal experience, as you do from yours. But let me just add, on the Exxon Mobil merger, I opposed that merger repeatedly. I opposed the merger even after the divestiture, which we called completely inadequate. It involved some sale of retail outlets in the Northeast. I had no significant or material effect, and that is another area where restructuring the law may be appropriate.

Thank you, Mr. Chairman.

Chairman SPECTER. Thank you. My red light went on in the middle of your answer.

Senator Kohl?

Senator KOHL. Just to followup on the Chairman's point, the merger has already occurred. You know, it is not as though we can fix the problem by tightening up our restrictions and laws on mergers. The mergers have occurred, and as you point out, Mr. Slocum, some 10 companies control 80 some percent of the capacity. So if we are going to do something significant and serious, do we need to undo these mergers? Should we be breaking up some of these largest companies to get back to a status of true competition? What do you think, Mr. Kovacic?

Mr. KOVACIC. I do not think we have seen any basis for going back and rolling back specific transactions to effectuate divestitures, but I would add that I think a major focal point of the investigations that this body has insisted that the FTC perform is indeed to develop a better basis for understanding precisely what effects we have had with merger policy over time. This collaboration, which I would add does involve a close cooperation with our

State counterparts, is designed in many respects to answer these questions.

Another hesitation I would have, Senator—and I would agree completely this is an area which merits continuing attention—is as we have alluded to in the comments so far, our own assessment and those of outsiders who have looked at the work of the GAO, that we applaud the effort they have taken, we do dispute the soundness of some of the specific findings. So my general view is that an effort to go back and restructure transactions that have taken place would not be merited at this time, but I agree with you completely, and the tenor of many comments on this panel, that this is an area that warrants our continuing efforts to ask whether we got those transactions right.

Senator KOHL. Who would like to comment that we should, in an effort to get back to competition, that we really need to undo some of these mergers? Mr. Blumenthal.

Mr. BLUMENTHAL. Yes, Senator Kohl. Even under current law, breaking up a company would be an appropriate remedy for a court to order if there has been misuse of monopolistic power, if there has been predatory pricing, or if there has been other misuse of market power, breaking up, cracking down on bigness, is an appropriate remedy, even under current law. So that is why I think the investigation is essential, and it ought not be just a survey or a study, it should go to the misuse of monopolistic power that all of us sense exists to some extent. We know at the State level it exists to some extent. There are indications of it from our investigation. But, really, we need effective partners in this effort.

Senator KOHL. Another question before my time expires, a strategic refining reserve operated by the Government to really act as a break on the monopolies that the industry has on refining capacity, I have a bill in to authorize the Government to build a strategic refining capacity reserve. Do you think this would be a good idea? Do you think we ought to do it, or wouldn't that have an impact on the ability of these companies to just summarily raise prices? Mr. McAfee?

Mr. MCAFEE. Canada tried this with Petro-Can, and Petro-Can became the high-priced firm in the industry. Generally, running a refinery is quite a complex task. If the Federal Government decides that is what it wants to do, it should probably subcontract the work, and if it doing that, then in essence all it is doing is becoming a guaranteed buyer. So I think that it is going to be hard to make that actually add to our capacity.

In contrast, working to try to make it possible for new entrants to enter and to remove the restrictions that block new entrants from entering the refining business would actually be a great help to the industry in improving competitive effects.

Senator KOHL. Mr. Slocum?

Mr. SLOCUM. I actually think that it is a very sound idea. I think that having the Government build at least one refinery would help mitigate some of the market power that we have seen, and quite frankly, I do not understand why the large oil companies are not building new refineries. Just like Enron and Ken Lay during the California energy crisis, when that company blamed environmental laws for the lack of adequate supply, I think too, I see similar prob-

lems with the oil industry's arguments. The fact is, is that there is a small company called Arizona Clean Fuels, it is not affiliated with any of the vertically integrated companies. They have obtained State air quality permits, they have obtained draft Federal air quality permits to build a very large refinery outside of Phoenix, Arizona. My question to the oil companies is, if a small startup company can go through the permitting process to build a refinery, why cannot the world's richest corporation, Exxon Mobil, do the same with its almost unlimited resources? It is not in their financial interest.

Senator KOHL. Thank you.

Thank you, Mr. Chairman.

Chairman SPECTER. Thank you very much, Senator Kohl.

Under our early bird rule, we go next to Senator Cornyn.

Senator CORNYN. Thank you very much, Mr. Chairman.

Thank you. There is so much to talk about and so little time. I am reminded of a quotation I have read and heard that says, when your only tool is a hammer, you tend to think of every problem as a nail. Translating that into the present context, obviously, there are some things Congress can do, and I am glad we are looking into what we can do, but there are some things we cannot do. For example, the largest single factor in the price of gasoline is the price of a barrel of oil. Obviously, we have some problems with that. One has to do with our own sort of shooting ourselves in the foot by putting a lot of our domestic oil reserves out of bounds, particularly off of the Pacific Coast, off of the coast of Alaska, and onshore at ANWR, along the Gulf Coast, closer to where I live, and, of course, along the Atlantic Coast. Obviously, that reduced supply increases the price, and translates into higher prices at the gas tank.

When it comes to actual refining capacity, the number of refineries has gone down, that is true, and I think we have heard an explanation or at least a partial explanation for that. The environmental regulation—overlays Government imposes on the creation of new refineries—makes it not as economically advantageous as increasing the capacity of existing refineries. And, in fact, while the number of refineries has gone down, the refining capacity has expanded dramatically by expanding existing refineries and thus the supply.

We all know political instability is a problem. When Iran says, "If you vote to refer us to the IAEA because of our nuclear ambitions and we threaten to cutoff the oil supply, our oil exports, it sends shock waves throughout the market, creating instability." And, of course, as I mentioned earlier, the matter of demand continues to be a chronic problem.

Professor McAfee, if I may ask you this, with regards to the profits of oil companies, which seem to be the focus of concern for so many, my understanding is that their profits, in terms of the dollar profit based on sales, is actually not out of line with other industry. For example, over the last 5 years, the oil and natural gas industry's earnings averaged 5.8 cents compared to an average for all U.S. industries of 5.5 cents. If we want to get into the business of windfall profits taxes or regulating American industry, there are a number of other industries including the banking industry, the

pharmaceutical industry, the real estate industry, health care, insurance, software and services, consumer durables, food, beverage and tobacco, that actually generate a greater profit for each dollar sale. Could you respond to or comment on that, please, sir?

Mr. MCAFEE. Absolutely. The way economists and Wall Street looks at profits are, are the profits large enough to cover the risk? So if the oil industry is composed of various levels of risk, exploration, extremely risky. Rates of return for exploration should be in the 17 to 20 percent range. On the other hand, refining, less risky but still fairly risky, what with price volatility, so again, you would be looking at 15 percent. The actual percentage return in the oil industry is on the order of 10 percent, and so in fact, looks low by Wall Street standards. That is why you see that it is lower than many other industries like banking in rates of return, or newspapers, for example. And newspapers, not so risky, and yet, much higher rates of return.

Senator CORNYN. Thank you, Mr. Chairman.

Chairman SPECTER. Thank you very much, Senator Cornyn.

Senator Feinstein?

Senator FEINSTEIN. Thank you. Mr. Chairman, I was just thinking, you know, this is really an interesting hearing. I thank you. I think people testifying are very candid and very frank, and I think that's very useful.

And I think it leaves us with a very big problem. We have a whole airline industry capitulating partially because of the price of fuel which drives astronomical problems for the industry because they cannot raise prices because of deregulation. Just look at the profits of these companies in 2005 over 2004: Exxon, 43 percent profit; Chevron, the best, 6 percent; ConocoPhillips, 66 percent profit; Valero, 100 percent profit in a year, despite all of the things that are happening. I think that big oil in America has the consumer in a real vise, and I think it is up to us to do something about it.

Dr. McAfee, let me ask you this question. You study this. You have no axe to grind in this thing at all. If we could do one thing to create a sense of responsibility in this sector of the energy economy in one sense of consumer respect, what would that one thing be?

Mr. MCAFEE. You kind of caught me off guard.

Senator FEINSTEIN. I know, it is hard to answer.

Mr. MCAFEE. Let me start with the consumers because that is actually part of my prepared statement. Many Americans do not shop around, and in my home in Pasadena, going two miles distance you can find prices that vary by 10 cents. The only reason you can find that is because people, some people are buying at 10 cents more, and a sort of "back of the envelope" calculation says if a third of the population will pay an extra dime, the average price, not the maximum price, but the average price will rise also by a dime, and the maximum price by 20 cents. This is just the rational response of profit-seeking firms to the fact that some consumers are not shopping around.

Now, we may not want them to shop around, but that would be a way of reducing some of the profits on refining and on retailing, as if people were more cognizant of the price. One thing that is im-

portant is shopping around confers effects on other people. That is, if I shop around, because that pushes down the prices, makes demand more elastic, that will cause the other people to benefit.

Senator FEINSTEIN. That is fine, but we are a legislative body. And if the figures are correct—and I have no reason to doubt this study that Mr. Slocum has done—and you have 10 companies controlling 85 percent of the market, and 5 companies controlling, what is it, 55 percent of the market?

Mr. SLOCUM. That is correct.

Senator FEINSTEIN. Something is wrong. What can we do to break this up? I thought Senator Kohl asked a very pertinent question, and everybody kind of backed away from it. But there is a problem out there and it is an oligarchy.

Mr. MCAFEE. Most of our largest industries, in fact, pretty much every mature industry—that is to say not a brand new industry—is controlled by an oligopoly. When you have two, three firms you get pretty nervous. Four firms, five firms, you are starting to see pretty competitive pricing, and when you get to seven or eight, usually—and of course, vertical integration is a problem here—but usually you start to see quite competitive outcomes.

One thing I would like to say about breaking up the industry is if you break up the oil industry with its current level of concentration because of the level of concentration, you are going to have to go after airlines, automobiles, steel and many other sectors of the economy where the concentration levels look at least as large.

Senator FEINSTEIN. Mr. Blumenthal, do you see where I am going? I mean, there is so much force not to touch big oil in this Congress, I am looking for one thing that is doable that we can do that will be helpful, that will give the consumer a market that at least relates to their concern. I do not understand how in the energy sector—and this I found through Enron and others in California—there is no consumer loyalty, as there might be in any manufacturing or other things.

Mr. BLUMENTHAL. If I can answer very directly, although it is not a panacea, it is not a magic bullet, abolishing zone pricing would not only make consumers more aware of the phenomenon that Professor McAfee has so ably described, but also eliminate some of those disparities and drive prices down, because right now a lot of retailers are bound by the price that they are charged, which in turn is dictated by computer runs that the big oil companies do in deciding who can bear what kinds of burdens. And they divide the States and the city of San Francisco or Los Angeles or Pasadena into different areas, more likely the States into different areas, and charge disparate prices, often higher in the inner cities because they know those consumers are less likely to shop around, as well as higher in the suburbs.

But I just want to add a footnote. I think that any sort of breaking up of a company depends on a finding of misuse of its power. So if you talk about airlines or automobiles which are certainly by no means in the same economic position, and perhaps not misusing their power in the same way, you are not talking about that remedy.

Senator FEINSTEIN. Excellent point. Thank you. I think my time is up.

Thank you, Mr. Chairman.

Chairman SPECTER. Thank you Senator Feinstein.

Senator Coburn?

Senator COBURN. Thank you.

I was pretty interested in Senator Kohl's idea about a distillate reserve, not distillate refineries capacity, but distillate reserves. I would like your comment. If we had a significant distillate reserve in this country, much like our petroleum reserve, but it was designed to use and smooth out price disruptions, what would you think of that? Anybody want to answer? Go ahead.

Mr. HAMILTON. The Northeast heating oil reserve, the same problem we had in Canada, it is triggered by a price that gets so high, you know, they did not want to let go of it. So if you created a reserve like that—and it is important to understand that diesel is the key, everybody says gas, follow the diesel. It went up way above regular unleaded because when we raised the price, we did not have discretionary driving. So we are driving this diesel up, killing everybody out there in small business and agriculture, and it is the one thing that you could do, but you would have to do it in multiple spots. You would have to do it in six or seven spots, and then the most important thing that you do is follow the industry.

When the price started to move, dump it. Do not let some unforeseen thing happen or get it real complicated on the trigger mechanism. Trigger it by the price because that is what you are after, and everything else will flow.

Senator COBURN. I want to ask this question, and anybody that wants to answer it, can. If there are anticompetitive behavior ongoing, whether it is through vertical integration or through pricing mechanisms at the wholesale level, where is it? If it is there, where is the anticompetitive behavior? What level? Is it in exploration? Is it in production? Is it in refining? Is there anticompetitive behavior in refining, or is it in distribution? Where is the anticompetitive behavior that would create artificial price increases?

Mr. SLOCUM. I think the evidence suggests that the bulk of it is in downstream, in refining, because that is where we have seen very, very high levels of concentration, and the practices by the refiners ends up having an influence on the price of crude oil, which does not make any sense, but often I see traders changing their positions on crude oil depending upon what stocks are of gasoline. Then when you add in the fact that we have got a number of vertically integrated companies that are into exploration and production, and they own their own downstream facilities, you have got a lot of trading within affiliates that the Government does not seem to be very good at tracking at this point.

Senator COBURN. Yes, sir?

Mr. KOVACIC. Senator, one consequence of the merger reviews that we do—and I think Professor McAfee gave you a flavor of what we do—we look at extraordinary volumes of information when we look at mergers, sometimes what the parties call outrageously extraordinary volumes of information. Sometimes it is like standing under Niagara Falls with a Dixie cup when you look at the amount of material that comes in. But in our merger reviews we are extraordinarily attentive to finding, written in electronic evidence of

classic anticompetitive behavior, that is, illegal agreements under rivals, illegal improper exclusionary behavior among rivals, and in our many examinations we have seldom found that kind of classic anticompetitive behavior. On some occasions when we have found it, we have challenged it separately. That was the essence of the Unocal case.

What we are doing again in the current investigations, which involve the use of compulsory process—these are not mere surveys or voluntary inquiries—is taking another look to look again for this information, because what we found from our experience is that for both express collusion, but even for tacit agreements where you have arms-length understandings, people have to write that down. They have to document how the system operates, and communicate that to people who day in and day out make hundreds of decisions.

I want to assure you that we look carefully for exactly that evidence.

Senator COBURN. Thank you.

Professor?

Mr. MCAFEE. The place that I am most concerned has to do with entry of independents, independents like Race Track or Wa-Wa or Costco are actually quite disruptive on any kind of cooperative agreements. They serve us well as consumers. The problem, say for Costco, is that in order for Costco to start selling gasoline, it has to buy it from a refiner. If the refiners all understand that that will undercut them at the retail level, and there are not very many of them, and in some sense, there is no one to break out as an independent refiner, it is very hard for Costco to enter, and it has not entered very strongly on the West Coast relative to the East Coast where you have independent refiners.

My major concern is actually the vertical integration concern, and not that these companies are not building refinery capacity as best they can, but that they are not letting independents in, and that makes for a cushier environment. But east of the Mississippi—excuse me—east of the Rockies, with so many refineries and so much interconnectedness, it is not really as serious an issue as it is west of the Rockies where you only have seven firms.

Senator COBURN. Thank you, Mr. Chairman.

Chairman SPECTER. Thank you, Senator Coburn.

Senator DeWine?

Senator DEWINE. Mr. Kovacic, in response to the price spikes on the West Coast and the Midwest in 2000, Senator Kohl and I, as Chair and Ranking Member of the Antitrust Subcommittee, sent the FTC letters requesting that the Commission investigate the causes of these price hikes, and look for possible price gouging and price manipulation. As a result, as you know, the FTC has developed and maintained a program of gasoline price monitoring, which continues to this day. We are hopeful that your numerous investigations and price monitoring has prevented at least some anticompetitive behavior in these markets.

First, let me ask you, do you think the program has been helpful? And next, do you have a sense of whether the illegal price gouging or price manipulation is still happening today?

Mr. KOVACIC. I think it has been very helpful, Senator. It has given us a much better market-by-market appreciation for what is

taking place in the market that not only informs our understanding of phenomena in the individual metropolitan areas, but it feeds back into what we do when we look at mergers. Second, it has been a good platform for developing cooperation with our State counterparts and the State Attorneys General office to build a form of information sharing and cooperation that did not exist before. I think there is a lot more we can do to put information that we gather in the course of these activities into the public domain to facilitate debate in this body and discussion among our energy policy counterparts.

I do think what we are seeing in the course in the course of that inquiry—and I think it will be enriched by what we learn in the course of the pending investigations—is a better understanding of precisely why prices went up, in what instances did firms make a conscious decision or not to withhold product from the market? I think that the inquiry that we are doing now is very much informed by what we learn through this process, so that I expect that what we will be able to report to you at the end of the spring is a fuller assessment and a more complete factual assessment of exactly why the phenomena we saw took place.

Senator DEWINE. We can look for that at the end of the spring?

Mr. KOVACIC. Yes, sir, and I am failing to recall the exact date by which that is required, but we will be on target.

Senator DEWINE. That is fine.

Mr. WELLS. Senator?

Senator DEWINE. If you could?

Mr. WELLS. Absolutely. I could quickly respond that we appreciate the excruciating detail in which the FTC has designed their studies to assess mergers, and I think the big fundamental difference between what they do and what we did in our study was, they typically look at the trees, and we had an opportunity to look at the forest, and we came up with different results. So maybe they need to consider how they actually are assessing mergers.

Senator DEWINE. Mr. Wells—yes?

Mr. BLUMENTHAL. If I could?

Senator DEWINE. Quickly, please. Five minutes is not long.

Mr. BLUMENTHAL. Resources for both the FTC—Mr. Kovacic, I know of his work as General Counsel, he has worked very hard and energetically. The Congress could make a very profoundly important statement by mandating additional resources for exactly the kind of antitrust work that we have been discussing this morning.

Senator DEWINE. Mr. Wells, Mr. McAfee, Mr. Blumenthal, Mr. Hamilton, have testified that the oil companies have been shutting down refineries to manipulate the supply of gasoline and increase their profits. On the other hand, the oil companies claim that refining is a real boom or bust industry which makes it hard to estimate how much capacity they really will need, and that too many regulations really prevent them from building new refining capacity. Who really is right?

Mr. WELLS. I know we have heard that from the industry. I know there were 300 refineries, and now there are fewer than 150. Instead of building new refineries, they mention deterrents like "not in my back yard," or "it costs too much." We also know that we are going offshore and buying and bringing in gasoline. It is

cheaper to buy it in Europe and bring it here than it is to produce it, from an economic standpoint.

I think a big question to ask the industry today, given the record profits that they are entertaining today, do they still stand behind the statement that it is too expensive to build a new refinery?

Senator DEWINE. Good question.

Professor McAfee?

Mr. MCAFEE. One thing, ski resorts make their money in the winter. The oil industry is much the same. In 1998 and 1999, when prices were very low, the oil industry was actually not making much money, and that reason for not building new refinery capacity made a fair bit of sense.

Today with the prices so high, we would expect to see more investment in refinery capacity.

Senator DEWINE. Mr. Slocum?

Mr. SLOCUM. I spent a lot of time reading the corporate annual reports of oil companies, and Exxon talks about and breaks down its profit margins in its U.S. oil refining business, and they have not released their 2005 annual report yet, so we do not have that level of detail, but their 2004 annual report, available at exxonmobil.com, shows that their U.S. oil refining return on average capital employed in 2004 in the United States was 28.6 percent rate of return.

And Exxon Mobil, when they are talking to shareholders and to Wall Street, they emphasize the return on average capital employed, and they never use this other thing that they talk about when they are dealing with the general public, trying to deflect attention away from their profits. Exxon Mobil, when they are talking to the general public, uses the simplistic return compared to total revenues. But if you look at the way they talk to Wall Street, they use return on average capital employed, in 2004, 29 percent rate of return on their oil refining business. That is a pretty healthy margin.

Senator DEWINE. Mr. Hamilton?

Mr. HAMILTON. Look to Bakersfield, and the highest prices, the higher margin of what Wall Street calls refinery heaven, and a company decided to close their refinery rather than sell it in a monumental fight over that that I was involved with, and the great discrepancy between what the company said and what everybody else said, and their own internal documents. They made a lot of money back at other refineries by closing that one down. That shortened the market, and those are the people you return to to cure the problem, and it still continues one. When you go to the environmental rules and regulations, in the old days, you could not meet to decide how many refineries you had and who had them and what size they were. It would have broke antitrust laws.

But even in the environmental rules and regulations—and I sat in a lot of them—and we had annoyingly environmental regulators acting as meeting facilitators to determine who would market and who would set up barriers to entry, and how much volume would be there, and the companies had an opportunity that was never granted them before, and it is something that was missed.

Senator DEWINE. Thank you, Mr. Chairman.

Chairman SPECTER. Thank you very much, Senator DeWine.

Without objection, we will put into the record a statement by Senator Leahy, ranking member.

Senator Schumer?

Senator SCHUMER. Thank you, Mr. Chairman. I thank our witnesses.

I would like to get into the mechanisms of supply and demand, and start off by asking Mr. Kovacic and Professor McAfee questions, and then ask some of the others to respond.

Now, if supply and demand were working in a Adam Smithian sense, we had 10,000 suppliers that could supply oil to anybody, and there were a spot market, as there is now, which is a pretty free market type situation, would it not be that two things would not happen that happen now. First, the price goes up on the spot market 10 cents a gallon, but because there is oil in the pipeline that has not been purchased for weeks or even months, that if there were real competition, anybody who raised their price immediately just reading in the newspaper that the spot market is 10 cents higher, would be undercut by somebody else? Question one.

Second. If we had a real supply and demand model, wouldn't it be such that the price would go—there would not be any stickiness when the price goes down, it would go up and down related to the spot market equally?

Mr. KOVACIC. With apologies to Adam Smith, most of the economic commentary since his formative work had suggested that he missed the lot, and among the things he missed are how sticky in both directions adjustments can be.

I would say that over a reasonable period of time you would expect those phenomena to take place. There has been a lot of attention devoted—

Senator SCHUMER. OK, but you are not—I am not asking whether we agree with Adam Smith or not, and I think the people who picked you for the FTC would be surprised that you do not agree with Adam Smith. I am asking, if we had 1,000 suppliers and there were real competition, would the price go up immediately to where the spot market is a day later, even though supply in the pipelines, so to speak, the price had been lower for the two, 3 weeks? You want to answer that, Professor?

Mr. MCAFEE. I would be glad to. The answer is it should go up immediately, and it should go down immediately, according to Adam Smith. It does neither, as measured, and that can be a lot of reasons for that, in particular—

Senator SCHUMER. Why would it go up immediately? Why wouldn't Company 212, which would make a nickel profit rather than the full dime profit, sell it for the nickel?

Mr. MCAFEE. Because we know that it is going to be a dime, say, 2 months from now, and by waiting 2 months and holding onto my gasoline—

Senator SCHUMER. No, they are not holding onto it. You are missing the model, and you know more about economics than I do. But this is an ideal situation. I am a gas station. I have 1,000 suppliers. Somebody is going to say tomorrow, even though the spot market went up 10 cents, since my costs were the 10 cents lower, I will only charge 9 cents or I will only charge 8 cents.

Mr. MCAFEE. No, sir.

Senator SCHUMER. Why?

Mr. MCAFEE. Because those holders of gasoline, the people that you are asking to sell it for 9 cents have the option of delay, and that option alone is—

Senator SCHUMER. Not if there are 1,000 suppliers competing.

Mr. MCAFEE. A billion suppliers does not matter. What matters is the amount of gasoline, and the hypothesis you have put on the table is that gasoline is now worth 10 cents more than it was yesterday. If that is true, everyone should get the 10 cents. Now—

Senator SCHUMER. OK. Second point you agree with—no, no, I only have a limited amount of time.

Mr. MCAFEE. And the second point is absolutely right, and the people that study this find that in fact prices go up in about 2 weeks, but it takes them 6 weeks to come down.

Senator SCHUMER. What does that indicate?

Mr. MCAFEE. Well, there is a lot of dispute about what that indicates, but it certainly does demonstrate that it does not function like an Adam Smith market.

Senator SCHUMER. I would say it indicates that there is a lack of competition of real free market Adam Smithian competition.

Do you want to comment, Mr. Hamilton and Mr. Blumenthal?

Mr. BLUMENTHAL. I will just say briefly, because I know your time is limited, that I made some statements earlier about one of the practices that creates this stickiness, which is zone pricing. There are all kinds of rules. The retailer, the gasoline station, the guy who pumps your gas, is a franchisee very often. He is bound by all kind of rules as to how he can sell his gas, as to what gas is sold to him. He cannot buy from those 1,000 suppliers. He is limited. And those kinds of limits in the market are what inhibit competition.

Senator SCHUMER. Mr. Hamilton?

Mr. HAMILTON. Through an event that can be triggered by them, the branded refiners, and separate the two branded refiners, the prices they charge the unbranded stations that do not carry a major flag, are often referenced to the spot. So if these boys triggered the spot, which they do regularly, sometimes with a phone call, that jumps up 10 cents. That raises the wholesale price to all these stations that compete with the branded refiner.

Senator SCHUMER. Understood.

Mr. HAMILTON. They can right behind it, OK? And up goes your price. And this is done through the Internet just like, boom. And to quote one up and down overnight mass, OK? Now they get it up. Now the spot goes back down. The guys who were forced up by the spot increase, margins increase tremendously, but there is a reluctance to lower their price on the street because they know it will trigger response from the guys, it is going to trigger response from Exxon Mobil. So there is—

Senator SCHUMER. What kind of response would that be?

Mr. HAMILTON. They would go down with them, and so the volumes will not change, they will not increase their market share, so I am not going to screw with the big boys, and the way they are going to do it is what he said, zone pricing. I lowered the price across the street wherever you have your station. If you try to

lower yours back, you are not going to get any market share. These boys control—

Senator SCHUMER. So there is no elasticity in a classic free market sense.

Mr. HAMILTON. The seven players control the business, period.

Senator SCHUMER. One final quick question, just yes or no—

Chairman SPECTER. You are way over time, Senator Schumer, but go ahead.

Senator SCHUMER. If there were 25 players instead of 7, would it be better. Just yes or no? How many of you think it would be better?

Mr. HAMILTON. Yes, it would be better.

Senator SCHUMER. OK. Mr. Blumenthal is shaking his head yes.

Mr. BLUMENTHAL. I would agree it would be better.

Senator SCHUMER. Professor?

Mr. MCAFEE. Better for domestic supply, worse for international supply.

Senator SCHUMER. OK. We will figure that one out another time. What will you say, Mr. Kovacic?

Mr. KOVACIC. Better in some markets, perhaps worse in others.

Senator SCHUMER. Thank you, Mr. Chairman.

Chairman SPECTER. Thank you, Senator Schumer.

Professor McAfee, we push ahead sometimes interrupting because we want to get more answers, and I think that is understandable, but you were in the middle of one answer for Senator Schumer. Did you want to supplement that or finish that?

Mr. MCAFEE. I thought I had finished it, but I am happy to elaborate.

Chairman SPECTER. If you finished it, that is fine.

Thank you very much, gentleman. We very much appreciate your testimony. We would like you to do a couple of things on supplementing the record if you would. We would be interested to know from each of you whether you think the concentration of power in and of itself increases prices, and if so, why?

We would also be interested in having a written response as to whether you think legislation would be appropriate here, and what kind of legislation you would suggest? You do not have to be a lawyer to give us your ideas—a number of you are not. It may be helpful not being a lawyer. Just give us your ideas as to the direction you think the legislation, where it ought to go.

And the third response that we would appreciate is to what extent do you think the increased profits will really find their way into exploration, where we are very concerned about not impeding exploration? And you have some evidence already which Commissioner Kovacic and GAO and Mr. Wells would know about, but to the extent any of you have any insights on that, I think the Committee would be very interested to know your feeling there.

I think it has been a very productive—sure, go ahead, Senator Kohl.

Senator KOHL. I would like also to ask one inquiry maybe from the GAO. If the seven big guys that you refer to, if their profits were cut in half in any given year, because people think that it is all about they are making so much money and the consumer is paying a fortune for it. That may be true. But if their profits were

cut in half, what impact would that have on the price of gasoline to a consumer over a year's time. If you could get that information to us, I think that would give us some indication of where we are in terms of trying to figure out what is going on here.

Senator FEINSTEIN. Mr. Chairman, could I ask one question, something that they might fill us in on.

Chairman SPECTER. Go ahead, Senator Feinstein.

Senator FEINSTEIN. How you would see zone pricing being changed to bring about the best effect for the consumer.

Chairman SPECTER. You are asking this for the record for written supplements.

Senator FEINSTEIN. For the record.

Chairman SPECTER. Yes, that is fine.

Thank you all very much. This is the first of a number of hearings we are going to have on this subject, and we are going to actively review the legislative course, perhaps with Commissioner Kovacic's statement that Congress should do a little more here, what Attorney General Blumenthal said, and what GAO has done, and those of you who are consumer advocates.

Thank you very much, and stay tuned.

[Whereupon, at 11:29 a.m., the Committee was adjourned.]

[Questions and answers and submissions for the record follow.]

# QUESTIONS AND ANSWERS

## State of Connecticut

RICHARD BLUMENTHAL
ATTORNEY GENERAL

Hartford

March 10, 2006

The Honorable Arlen Specter, Chairman
Senate Judiciary Committee
224 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Specter:

Thank you again for the opportunity to speak before your committee on the subject of gasoline prices. I appreciate your committee's interest in this critical issue I am writing to respond to several follow-up questions posed by Senator Kohl and you.

**Senator Specter's questions:**

*1. Does the concentration of power in the energy industry, in and of itself, increase prices? If so, why?*

Highly concentrated markets or oligopolistic industries increase the likelihood of higher prices for consumers With limited barriers to entry, such markets may facilitate collusion or parallel pricing by competitors. The gasoline refining market is a clear example of lack of effective competition and substantial barriers to entry into the market enabling companies to restrict supply in order to increase gasoline prices and reap huge profits.

*2 Would legislation be appropriate and what kind of legislation would you suggest?*

I have urged Congress to approve a moratorium on oil industry mergers until Congress or the Federal Trade Commission thoroughly examines this industry. Congress and the Federal Trade Commission should establish a presumption that a merger in this industry violates antitrust law unless the acquiring firm can prove a clear consumer benefit. In addition, Congress should prohibit zone pricing and require minimum inventory levels for gasoline

*3. To what extent do you think increased profits for energy companies will find their way into exploration?*

Decisions on whether to explore for new sources of oil are driven by an analysis of the cost of exploration and price of crude oil in relation to the investment return on other investment opportunities rather than based on profits from other sectors.

*4. If profits of the seven big companies were cut in half in any given year, what impact would that have on the price of gasoline to a consumer over a year's time?*

The problem is not only the size of profits -- now at record levels -- but the system that enables and encourages them. I have argued for establishing minimum gasoline inventory levels and heightened competition in the refining industry These steps would limit gasoline price spikes especially during a market disruption or supply shortage and expand supply of gasoline during a regular market Consumers would benefit significantly by paying less for gasoline than under the current market system

*5. How would you change zone pricing to bring about the best effect for consumers?*

Consumers benefit from robust competition Under zone pricing, the market fails to dictate the price of gasoline at the retail level. Rather, executives at major oil company headquarters decide what the retail price will be by artificially increasing the wholesale price of gasoline to certain retailers. Eliminating zone pricing will allow competition to determine what is the best price for gasoline

**Senator Kohl' questions**

*1. Do you believe market concentration and lack of antitrust enforcement is causing oil industry manipulation of prices? If so, what are the biggest deficiencies in antitrust enforcement?*

In 2002, I testified that market concentration led to higher gasoline prices because the industry has the power to manipulate prices during a shortage and garner huge profits. This is still the case today If the market was truly competitive, the consistent pattern of shortages followed by huge profit spikes would result in expansion of refinery and distribution capacity. This has not happened The industry has not expanded refinery capacity to meet new demand In fact, companies have no profit motive to do so in this current market

The problem is rooted in federal antitrust approval of significant mergers and acquisitions As I indicated in my testimony, federal regulators have allowed the Northeast

gasoline market to move from moderately concentrated to highly concentrated. This consolidation should have been stopped. In a highly concentrated market, participants reap higher than normal profits and deter competitive entrants, especially in the refinery market.

*2. Can antitrust enforcement agencies prevent the closing of existing refineries or examine the failure to open new ones?*

Antitrust law does not prevent market participants from unilaterally deciding to reduce refinery capacity based on market conditions. Further, I am unaware of any evidence that the closures of refineries is based on a conspiracy among industry participants to reduce supply. However, by allowing the concentration of existing refinery capacity in fewer and fewer companies, the federal government has effectively ceded substantial economic power -- and market power -- to a select few companies.

*3. What do you think of establishing a strategic refining reserve to produce 5% of the domestic demand for gasoline and other fuels in order to prevent market manipulation?*

I support the establishment of a strategic refining reserve or other mechanism to ensure adequate gasoline reserves in the event of market disruption such as an unexpected refinery shut-down due to weather or mechanical problems. I have suggested a federal requirement that refineries maintain a specified inventory level of refined product in order to ensure adequate supply in case of an unexpected market disruption. A strategic refining reserve would accomplish the same goal.

*4. Do you believe the oil companies have an incentive to keep supplies tight and drive up prices? What can be done?*

The gargantuan profits reported by the refiners after every market disruption provide clear evidence that oil companies have an incentive to keep supplies tight even during a market disruption. As you indicated in your question, the March, 2001 Federal Trade Commission report quoted an oil company executive as stating that he would take higher profits on lower volume rather than sell more gasoline thereby driving down prices. The market is not working. The question is whether a given company can secure a larger return from increased prices or from more sales at a stable price. As recent events indicate, I believe the oil companies have opted for the former approach. One of the options for fixing this broken market is to develop a strategic reserve or otherwise ensure adequate gasoline inventory. Another is to toughen FTC enforcement of antitrust laws to prevent even further market consolidation.

*5. How can industry profits rise when the price for oil is also rising?*

Industry profits keep rising because the companies are able to charge higher prices for gasoline. Tight gasoline inventories allow refiners to charge more for the gasoline produced from their refineries. Those higher prices eventually are paid by the consumer. The general law of supply and demand indicates that when prices and profits rise, new suppliers enter the market. This is not happening in this market because of the significant market power concentration and the high costs of entry into the refining market.

Thank you again for the opportunity to comment on this critical issue. Please contact me if you have any questions or need further information.

Sincerely,

RICHARD BLUMENTHAL

RB/RFK/pas

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*"Keeping the Wheels Rolling in Washington State"*

March 8, 2006 Via email, hard copy by mail

Chairman Arlen Specter
Senate Judiciary Committee
224 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Specter:

Thank you for the invitation to attend the hearing regarding "Consolidation in the Energy Industry: Raising Prices at the Pump" on February 1, 2006.

I submit the following comments to the follow-up questions submitted by yourself and Senators Feingold and Kohl that were addressed to my attention.

**Chairman Specter:**

*1. Does the concentration of power in the energy industry, in and of itself, increase prices? If so, why?*

Yes. Antitrust merger reviews failed to understand the complexity of the industry and the importance of competition between refineries in different regions of the U.S. and internationally.

Example--- prior to the merger, if ARCO, Union 76 or another company was to fail to maintain adequate inventories or build adequate refining capacity to supply its stations in the West, a price spike in California would create an incentive for BP to capitalize on the high price by sending in gasoline from its refineries in the Far East. The same would go with Midwest refiners such as Amoco, Conoco, and Phillips. As the incoming product increased supplies, prices would fall, sometimes below operating costs, creating a disincentive local refiners to cut production capacity or lower reserve inventories levels.

Now that BP/Amoco/Arco have merged, BP would be reluctant to send in fuel from the Far East or the former Amoco refineries it controls in the Midwest and Gulf as it would undermine the high price it is receiving at the former ARCO refineries in LA and Puget Sound. ConocoPhillips would be in the same position as movement of product from its Midwest refineries undermine the price it is getting from the former 76 refineries it now controls in Los Angeles and San Francisco.

Page 2- Hamilton

Prior to the consolidation of refinery ownership, a regional shortage causing price spikes would attract supply from refineries outside the region. Since prices could fall, often below operating costs for periods longer than the high prices lasted, local refiners sought to insure adequate inventories were on hand to avoid price spikes. With mergers consolidating refinery ownership across the country, shorting the market is assured to raise prices without intervention from former competitors that are now part of the same family. Inventory levels and refining capacity to demand ratios have fallen drastically since the mergers and price spikes are a common event.

2. *Would legislation be appropriate, and what kind of legislation would you suggest?*

Yes. I would direct federal initiatives to matters where federal authority preempts the powers of the individual states.

**15 U.S.C. 2801-2806** The Petroleum Marketing Practices Act (PMPA), preempts state authority and is the exclusive statute dealing with termination or nonrenew of branded motor fuel supply contracts. Passed following the Arab Oil Embargo, the act did not contemplate the need to insert a right for small businesses whom own their own stations to terminate the oil company.

Over the last decade, the branded companies have required independent marketers whom own their own stations to sign up to 20 year "no-cut" contracts as a condition of getting branded supply. In essence, these contract provisions dramatically extended vertical integration beyond the stations owned by the company by taking control of stations owned by small business.

Since their portfolio of station owners can not terminate to switch suppliers when unsatisfied, the companies are no longer under pressure to price competitively at the wholesale level. A significant barrier to entry is also constructed as competitors from outside a particular region find it difficult to enter new markets as the contract terms block them from soliciting existing station operators.

A single sentence amendment to the PMPA could on its own, without any further actions or steps required, increase competition between the companies and see the return of the "gas wars" which disappeared with the introduction of the long term no-cut supply contracts.

**Future Trading and the "Spot Market"-** An equal focus should be placed on "paper markets" such as the NYMEX and the so-called "spot market.

A federal prohibition against the practice of suppliers "tieing or referencing" wholesale prices to the highly volatile and speculative NYMEX would remove the incentive of the industry to create price volatility in the futures market to trigger price increases without a change in existing commodity trading procedures.

The so-called "spot market" is not a physical location that actually exists as is the case with a commodity trading system such as the Chicago Mercantile or NYMEX. Rather, the spot price is an unconfirmed report of a price one company charges another

for bulk quantities (barges, etc.) published by industry information companies such as OPIS and Platts. Spot sales are not monitored or regulated and often act as a commodity trading platform without governmental oversight.

Speculation by traders and other activities of the refiners (such as exporting to short the market) commonly result in great fluctuations in the price and are usually the percussor to a regional price spike. An appropriate legislative action would be to place oil company traders and other currently unregulated and secretive industry platforms that process the exchange of the actual liquid barrels under existing commodity trading laws. Again, this could be accomplished without intervention into the current scheme used to currently regulate commodity and futures trading.

**Additional Initiatives-** I offer the following additional initiatives:

- Increase the transparency of the industry;
- Mandate that the industry increase refining capacity and maintain appropriate levels of inventory in each region or Petroleum Allocation Defense District (PADD);
- Create a strategic reserve for motor fuels in each PADD that would be triggered when a price spike is underway; and
- Empower the Department of Energy to suspend exporting of gasoline and distillate during price spikes to countries where optional sources of supply are available.

*3. To what extent do you think increased profits for energy companies will find their way into exploration?*

The dramatically increased profits of the international giants are likely to be channeled outside the U.S. to areas such as the former Soviet Union. Due to the risks and capital required, deep-water drilling that holds the greatest potential for volume will remain the domain of the international majors. The independent or smaller exploration companies based in the U.S. profiting from the increase in crude prices will hold the best chance for increased exploration in the continental U. S. The independent refiners do not drill and the majority of their increased profit will likely be allocated between modernization, acquisitions, debt reduction, and stock holder dividends.

*4. If the seven big companies had their profits cut in half in any given year, what impact would that have on the price of gasoline to a consumer over a year's time?*

Zero, if accomplished by the imposition of "Excess Profit taxes". The exception would be a program where the taxes collected are some how directly returned to consumers in the form of a tax credit when filing federal income taxes.

The increase in profits of the seven largest oil companies are a reflection of the

impact of higher pump prices on profit margins of the entire industry. While certainly speculation, a prediction of a $1 per gallon reduction in the average U.S. pump price wouldn't be far off the mark if profits throughout the industry returned to historical levels.

*5- How would you change zone pricing to bring about the best effect for the consumer?*

Zone pricing can be "pro-consumer" or "anti-competitive" depending on its application. In actual practice, its usually the later.

Zone pricing refers to refiners charging different wholesale prices to service stations supplied directly by the refiner from the same truck loading terminal. Since direct delivery is limited to primarily major metro markets along the Atlantic and Pacific coastlines, zone pricing is seldom seen in the majority of markets in the nation supplied by distributors or jobbers. Using a narrow focus, I would advocate prohibition against oil companies using the practice to vertically fix retail prices at independently owned or operated stations.

**Senator Feingold-**

*As you know, in March 2001, the FTC put out a report detailing its investigation into Midwest gasoline pricing. The report outlined how companies unilaterally engage in economic withholding, with one company withholding supplies in order to increase prices. It is my understanding that most FTC economic models show significant competition in the refining sector. If this is the case, and if there is in fact significant competition in the refining sector, how is economic withholding possible? Is it possible that the economic models are wrong or inadequate?*

I have attached a pdf file of a study into the Midwest price run up of 2000 that I conducted on behalf of the Foundation For Taxpayer and Consumer Rights (FTCR). This study was the first to recognize that the industry intentionally withheld supplies from the Midwest to prop up prices. While severely criticized by the American Petroleum Institute (API) in a dedicated press release challenging the findings, the study motivated an investigation by the Wall Street Journal that confirmed oil companies intentionally withheld supplies to avoid "undermining the price". Based on prior FTC decisions to not acknowledge similar practices in past investigations, the story in the WSJ is likely the reason the withholding made it into the public record.

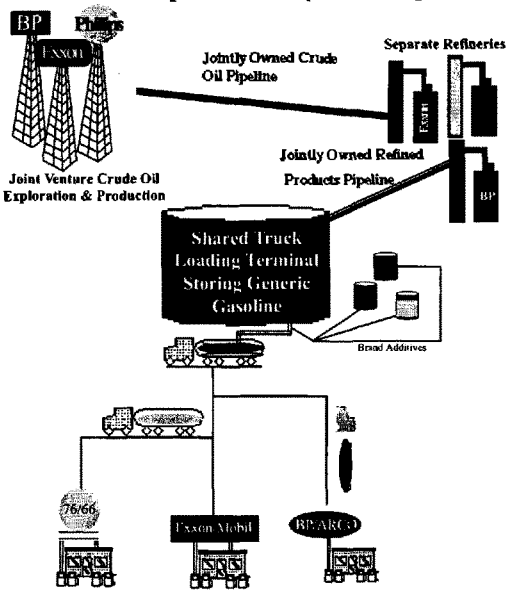
The key to understanding why withholding works today is recognition of the shared distribution system and horizontal relationships used in the industry shown in

Since the gasoline is primarily generic or fungible, the companies commonly store their gasoline in the same tank. Since the inventory becomes a commonly held pool, if one company is short, all are basically short as well.

When a shortfall occurs, regardless of whether the impact is common to all or Page

5- Hamilton

**Example Of The Horizontal Relationships Utilized By Oil Companies**




singularly effects a particular company, all the companies spike prices upward to slow consumption down so the shared supply in the tank doesn't run dry. Since "gouging laws" don't apply to wholesale increases from suppliers, the price will go high as needed to force consumption down to avoid lines at the pump. Since the increase is pure profit, all equally share in the increased profits.

If any one of the companies bring in supplemental supplies from a refinery outside the region, the price falls for all the companies. Accordingly, all are reluctant to bring in replacement supplies that would "undermine the price". It would take a company with a refinery outside the region, that did not operate one inside the region, for an incentive to exist that would bring in additional supplies.

As explained in my answer to question 1 from Senator Specter, the mergers allowed by the FTC further complicated the problem surfacing in the Midwest as outside supply was controlled primarily by the same companies owning the local refineries. Direct collusion is not needed as all know what the volume is at any time in the shared tank. Since they are "all drinking from the same cup", a shortage by one of the companies sharing the tank insures the others are short as well. A financial incentive is provided for all if those having access to supplies outside the region simply decide to "park the barges on the Mississippi".

Absent undeniable evidence of direct collusion, the FTC will report "*no evidence of illegal behavior was found in our investigation*". On cue, the API and the individual companies will blitz the airways with "the FTC says we aren't guilty..."

The failure of the typical economic modeling used in antitrust reviews to recognize the unique characteristics of the industry are a key to the FTC's inability to recognize then, and it's continuing denial today, of the harm that was has occurred from the "merger-mania" that restructured the industry. The modeling used simply failed to recognize the following:

- The market power given to the companies allowed anyone of them to drive prices;

Page 6- Hamilton

- "Tacit collusion" , while legal, can be just as harmful to consumers as direct collu sion;
- The horizontal relationships developing and introduction of cleaner-burning fuel standards following decontrol in 1981 created a fungible product stored in a shared distribution system that tied the few remaining identities into a "all for one and one for all" alliance wherein all the players gained if a single party shorts the market; and
- The use of age-old regional market consolidation indexes during merger re views did not adequately consider how the consolidation of refinery ownership across the different regions of the U.S. would provide an ability to 'withhold" sup plies and create an incentive to short the market.

**Senator Kohl-**

*1 (a). In your experience, is the exporting by U.S. oil companies of refined products – such as gasoline, diesel, and home heating oil —overseas a problem? Does it drive up the cost of fuel?*

Yes, and No to both questions. The qualifier needed to be added to the questions are identification of the product, the region and the time of the year.

Since 1997, the West has been plagued by "the parade of ships" that seem to load up supplies of motor fuel for export just in front of the spring plant and summer drive. The loss of available local supplies right in front of expected increases in demand spike prices by 65 to 90 cents per gallon in a matter of days. The FTC has been fulled apprised of the situation and absent evidence of collusion, will take not action to discourage the activity.

Another problem overlooked when examining exporting is the need to disregard political boundary lines that separate the U.S. from its neighbors. To eliminate the excess refining capacities in the U.S. as a means to increase refinery margins was an expressed goal as late as 1998. By using refineries in the U.S. to supply Mexico, Canada, and other countries in the Americas, the industry effectively reduced our refining capacities. Further, in addition to diverting capacities away from the U.S., the industry avoided competition from new foreign refineries that could have been built in other countries with far less stringent environmental regulations. Refineries that today, could be reducing the demand for U.S. refined products and even more importantly,, currently supplying refined products back into the United States.

One example of many--Mexico did not build modern new refineries even though it is one of the largest crude producers. Instead, Shell Oil 50 percent of its Deer Park refinery in Houston to the government owned oil company of Mexico. Mexican crude is refined in Texas and then, approximately 1 million gallons of unleaded gasoline heads back to the east coast regions of Mexico. At the same time, tankers regularly transport gasoline and especially diesel from refineries in Washington and California to Pacific ports in Mexico, Latin America, and other countries far south as Chile.

*b) I have introduced legislation to give the Secretary of Energy the authority to prohibit the export of any refined petroleum product when supply is expected to fall below demand (S. 1996). What do you think of this legislation?*

If drafted properly, it would be a helpful tool to avoid gas lines or outages. Unfortunately, supply in the U.S. is going to fall below demand on an annual basis, especially during the spring and summer. While gasoline gets more attention, the larger threat is the diesel and heating oil which is in far greater demand worldwide. One would want to insure that suspensions did not create "retaliation" by others whom are reliant on supplies from refineries in the United States.

*2. I have introduced a bill to direct the Secretary of Energy to establish and operate a strategic refining reserve (S. 1979). This reserve should have the capacity to produce at least 5 percent of the domestic demand for gasoline, diesel and aviation fuel. I believe this reserve would be an important step to ending the oil companies' stranglehold over the market, and their ability to manipulate supply in order to have market power. What do you think of this idea?*

As stated earlier, a "system" of strategic reserves located in each of the 5 regions of the nation would be helpful provided the trigger mechanism for releases is a price spike. However, the failure to require oil companies to maintain adequate inventories outside the reserves will result in the industry simply cutting back on its inventory to anticipate the impacts of the reserves. These factors are at the root of many's dissatisfaction with the NE Heating Oil Reserve.

In closing, I am always available to assist the honorable members of Congress.

Respectfully,

Tim Hamilton

Tim Hamilton
Executive Director

Office of the Commissioner

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

March 8, 2006

The Honorable Arlen Specter
Chairman
Committee on the Judiciary
United States Senate
Washington, D.C. 20510

Dear Chairman Specter:

I am pleased to respond to the questions from Members of the Committee on the Judiciary that you sent me with your letter of February 10, 2006, as well as the questions that you and Senator Feinstein asked at the conclusion of the Committee's February 1, 2006 hearing on petroleum industry consolidation.[1]

**Questions from the Honorable Arlen Specter**

**Question 1:** *Does the concentration of power in the energy industry, in and of itself, increase prices? If so, why?*

**Answer 1:** The number of firms that compete in an economically well defined market – and their sizes in the market relative to one another – are important facts that we consider when evaluating the vitality of competition. One key element of our merger analysis is the potential

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[1] To the extent that your own written questions are identical in substance to your questions as they appear in the transcript of the February 1 hearing, I have phrased your questions as they appear in the attachment to your February 10 letter. My reply to your fifth question – concerning zone pricing – also responds to Senator Feinstein's question on that topic at the end of the hearing.

As with my responses to the Committee'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.

change in concentration in a well defined market. As a general matter, when concentration in a well defined market will remain low after a merger, the transaction poses little or no risk of increasing the likelihood of coordinated interaction among competitors or the probability of anticompetitive unilateral conduct by the merged firm. As the level of concentration increases, the likelihood grows that any particular merger will enable firms in that market to exercise market power and raise prices through either coordinated interaction or an exercise of unilateral market power. Nonetheless, concentration data are just the starting point in the complicated analysis of the level of competition in any industry. This analysis applies in both merger and nonmerger contexts.

There is no simple, absolute relationship between market concentration levels and prices – or, for that matter, between concentration and profit margins – that tells us when mergers must be blocked or when anticompetitive conduct in a market is likely. The relationship between market prices and concentration levels is very complex, as confirmed by the FTC's decades of experience conducting in-depth antitrust analyses involving hundreds of markets with greatly varying structural conditions. Many years of academic economic research seeking to estimate quantitatively the relationship between price and concentration also reveal the complexity of the price-concentration relationship.[2] For example, some markets are very competitive despite high concentration. There may be vigorous rivalry among a small number of firms, each of which wants to grow the business and take market share from its competitors. As a result, sound antitrust analysis must consider factors beyond concentration. Among the factors that we examine in addition to market concentration are (1) the nature of competition within the market; (2) how the merging parties, or the practices under scrutiny, are especially important to competition in that particular market; (3) barriers or impediments to entry into the market; and (4) potential merger-specific efficiencies.

In sum, the structural characteristics of a market play a significant role in the FTC's examination of competition in any industry. Although our analysis accounts for each industry's distinctive attributes – its technology, the nature of foreign competition, the regulatory environment, and other important factors – market concentration and other structural issues loom large in our antitrust examination not only of energy markets but of any other segment of the economy.

**Question 2:** *Would legislation be appropriate, and what kind of legislation you would suggest?*

**Answer 2:** I do not think that changes to the antitrust laws are necessary to maintain competition in the petroleum industry. Beginning with the adoption of the Sherman Act in 1890, Congress ordinarily has cast the country's antitrust statutes in broad terms. This approach has

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[2] For a concise, recent review of the economic literature on the empirical relationship between price and concentration – including a discussion of the many measurement, statistical, and conceptual problems in properly estimating the relationship – *see* Dennis W. Carlton and Jeffrey M. Perloff, *Modern Industrial Organization*, Ch. 8 (4th ed. 2005).

given courts and enforcement agencies valuable flexibility to incorporate the latest developments in economic learning. In large part because of this design choice, the existing antitrust laws have been effective, adaptable tools for promoting competition objectives and maximizing consumer welfare, not only in petroleum markets but also throughout the economy. The antitrust laws, which have been used effectively to challenge anticompetitive mergers as well as unlawful conduct in petroleum markets, have served as the strong foundation for the FTC's antitrust enforcement program regarding mergers and joint ventures in the oil industry.

**Question 3:** *To what extent do you think increased profits for energy companies will find their way into exploration?*

**Answer 3:** It is difficult to provide a specific estimate of how current increased profits will translate into increases in crude oil exploration. Profit levels at integrated oil companies – firms that explore for as well as refine oil – and at independent petroleum exploration companies depend heavily on crude oil price levels. Integrated oil companies and independent exploration companies have increased or decreased their exploration investments over time in response to changes in crude oil prices. For example, when oil prices were relatively high in the early 1980s, firms increased their exploration expenditures. After crude prices fell in the late 1980s and remained relatively low, exploration expenditures also fell. Then, after crude oil prices began to increase after 2000, exploration expenditures began to rise again.

History shows that expected returns from crude oil exploration play a critical role in decisions whether to invest in additional exploration. As crude prices increase, oil companies' cash flow typically increases, making additional funds available to invest in exploration. Firms also might fund investments in exploration and development by taking on additional debt or selling additional equity shares. Of course, all of these potential means of funding exploration have costs. There is a direct cost of capital associated with increased debt or equity – as determined by the capital markets – while increased cash flows entail an opportunity cost inasmuch as a firm must forgo alternative uses for these funds (such as investments in other parts of the company, or dividend payments to compensate holders of the company's equity shares). Investments in exploration will not be justified unless the returns are expected to exceed the costs associated with the investments.

The expected return on an investment in crude oil exploration depends on firms' expectations of future prices over the life of the investment, the expected costs of finding and developing new crude oil sources, and the anticipated regulatory and geopolitical environment. Expectations regarding future crude oil prices over time appear generally to be based in part on then-recent price trends, which explains the observed tendency of exploration efforts to follow in the same direction as crude oil prices.

Public policies can affect the incentives to explore for oil. The government can affect the profitability of exploration in many ways, including by changing the royalty structure, changing the tax code, or changing how firms are required to operate their leases. For example, if

companies believe that some part of their returns will be taxed away, they will be less likely to make new investments. We should be particularly mindful of the nation's experience with the oil windfall profits tax in the 1980s. That program was designed to capture "excess profits" from existing and newly developed domestic crude oil under a somewhat complicated scheme of differing tax rates. The unintended consequence was that the windfall profits tax reduced the incentive to exploit and develop domestic crude oil reserves. A report by the Congressional Research Service estimated that the tax reduced domestic oil production by between three and six percent.[3]

**Question 4:** *If the seven big companies had their profits cut in half in any given year, what impact would that have on the price of gasoline to a consumer over a year's time?*

**Answer 4:** The answer to this question depends on what causes the large short-term profit cut. If natural market forces – such as a fall in crude oil prices – were the cause of lower profits, then consumers would undoubtedly be better off. Generally, profits for the major integrated oil companies increase or decrease with corresponding changes in crude oil prices. Most profits earned by the major integrated oil companies come from the production of crude oil, with a smaller portion attributable to refining and marketing. At the same time, crude oil prices are the primary determinant of the price of gasoline. Consequently, if there were a change in the oil markets that reduced profits at the crude stage – for example, an important recession in the world that reduced crude oil demand and crude prices – that change would be associated with lower gasoline prices as well.

On the other hand, if major integrated oil companies' profits were cut in half due to an unanticipated change in the tax code, while oil market fundamentals did not change, then there likely would be little impact on gasoline prices in one year's time. Production at existing refineries and oil wells would be unlikely to change in the short run because most investments that will affect gasoline prices in the next year have already been made. In this short-run period, the firms would be expected to maximize pre-tax profits as before, even though the tax code change would reduce what they can retain. In the longer term, however, the tax change – even if temporary – likely would decrease investments, resulting in lower future output of both crude oil and gasoline. Lower expected rates of return on future investments – stemming from firms' anticipation of additional taxes if prices were high in the future – likely would cause such investments to shrink.

**Question 5:** *How would you change zone pricing to bring about the best effect for the consumer?*

**Answer 5:** "Zone pricing" refers to a branded refiner's practice of charging identical delivered wholesale prices – typically referred to as "dealer tankwagon" or "DTW" prices – to its

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[3] Congressional Research Service, *The Windfall Profit Tax on Crude Oil: Overview of the Issues*, Report No. 90-442 (1990).

lessee gasoline dealers in a certain geographic area, where each station faces a similar set of competitive circumstances. Some observers have contended that this practice could be used to facilitate horizontal wholesale price-fixing by branded refiners, or might be used by a single branded refiner to deter new competition by targeting price reductions to local areas where it faces entry.

FTC investigations have revealed no evidence that price zones are being used to coordinate wholesale prices. The price zones delineated by one branded refiner seldom coincide with the zones that another branded refiner uses. Variations in wholesale gasoline prices further suggest that branded refiners are not using zone pricing to collude on wholesale gasoline prices. Our research also has indicated that zone pricing does not necessarily deter significant entry.[4]

Zone pricing may yield procompetitive benefits in some situations. For example, zone pricing may provide branded refiners with the flexibility to meet localized competition, and thus may result in lower average retail prices than when a branded refiner charges the same DTW price to all of its lessee dealers. Economic research suggests that, under some circumstances, a ban on zone pricing would lead to significantly higher wholesale (and retail) prices in formerly low-priced zones, while not producing significantly lower wholesale (and retail) prices in previously high-priced zones. The reason for this result is that requiring a uniform wholesale price tends to reduce price competition in those zones where it formerly was most intense, but generates little or no reduction in wholesale (and thus retail) prices in previously high-priced zones. This occurs in part because refiners recognize that dealers in those high-priced areas, facing relatively little competition, have little incentive to pass on to consumers any reductions in wholesale prices that the refiners grant them.

My conclusion that a ban on zone pricing might lead to higher average retail prices is consistent with Professor McAfee's assessment. In Congressional testimony from 2002 that he appended to his prepared testimony for the Committee's February 1 hearing, Professor McAfee observed that such a ban might have unintended consequences for consumers:

> One man's surcharge is another man's discount. Relative to uniform pricing, zone pricing increases prices in the areas with little competition and/or rich consumers and reduces prices in the areas with the most competition and/or the poorest consumers. Elimination of zone pricing by statute will tend to force an average

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[4] *See* Bureau of Economics, Federal Trade Commission, *The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement* 223 n.17 (2004) (showing significant entry in San Diego despite the existence of branded refiners' price zones), *available at* http://www.ftc.gov/os/2004/08/040813mergersinpetrolberpt.pdf.

markup to all. This amounts to a transfer from poorer areas and/or areas with lots of competition to richer areas and/or areas with little competition. Overall, a ban on zone pricing will likely hurt the neediest segment of society.[5]

Because the competitive implications of zone pricing are complex, the FTC applies a rule of reason analysis to the practice rather than categorically condemning it. The Commission will challenge any instance of zone pricing that on balance is likely to harm consumers by facilitating collusive or other anticompetitive behavior, but it will not challenge the practice when it is clear that it makes the market more competitive. The tools of antitrust analysis enable the agency to differentiate zone pricing that is anticompetitive from zone pricing that is not.

**Questions from the Honorable Herbert Kohl**

**Question 1:** *In most competitive industries, when there are high prices, high profits to be made, and soaring consumer demand, we would expect to see an expansion of capacity to meet this demand. Yet in the oil industry this has not happened. Instead of opening new refineries, the industry has closed more than half of all that existed 25 years ago. In 1981, there were 324 refineries operating in the United States – today there are 149. Overall national refining capacity has declined by more than 5% while demand has continually risen. Oil industry critics suggest that this is no accident – that oil companies actually prefer to keep supplies tight in order to be able to gain market power to raise price.*

*(a) Does the failure of the oil industry to open new refineries suggest the presence of anti-competitive conduct?*

**Answer 1(a):** Because so many other factors and trends can have an impact on any individual firm's capacity decisions, the closing of some refineries and the absence of new refineries do not necessarily suggest the presence of anticompetitive conduct.[6] First, gasoline demand has not risen continually over the last quarter century. In particular, gasoline demand fell from 7.4 million barrels per day in 1978 to 6.5 million barrels per day in 1982 in response to sharply higher gasoline prices and a weak economy during that period. After the collapse of crude oil and gasoline prices in the mid-1980s and the continued growth of the economy, the

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[5] Prepared Statement of R. Preston McAfee before the Committee on the Judiciary, United States Senate, App. 2 at 28 (Feb. 1, 2006).

[6] Although no new refinery has opened in the United States for several decades, there are plans to open a new refinery in Arizona with a capacity of 150,000 barrels per day. The owners of this proposed refinery are in the process of securing a long-run supply of Mexican crude oil and satisfying various regulatory requirements. *See* Ken Alltucker, "Refinery Project Moves Forward," *The Arizona Republic* (Nov. 23, 2005), *available at* http://www.arizonacleanfuels.com/news/2005/112305_AZR_SENER.htm.

demand for gasoline increased but did not reach 7.4 million barrels per day again until 1993. In light of these demand fluctuations, we would not have expected to see a steady expansion of capacity over the last 25 years.

Second, over the longer run, a decrease in the number of refineries generally has not been accompanied by a decrease in distillation capacity. With the exception of the late 1970s through 1981, the long-run trend since World War II has been for the number of refineries in the U.S. to decrease, but for the average size of refineries (as measured by capacity to distill crude oil) to increase.[7] Competitive pressures over this extended period appear to have favored larger, more efficient refineries. In general, the trend toward fewer but larger refineries has been accompanied by increases in total industry refining capacity. For example, although approximately 20 refineries closed in the past decade,[8] total industry refining distillation capacity increased by 12 percent, from 15.3 million barrels per day in 1996 to 17.1 million barrels per day at the beginning of last month. This capacity increase is equivalent to the addition of roughly 15 new average-sized refineries.

Third, the quantity of gasoline and other products produced from each barrel of crude oil refined has risen, as refining processes have improved. A refinery's capability to produce gasoline and other products depends not only on distillation capacity but also on such "downstream" processing units as the cracking, reforming, and hydrotreating facilities that process crude oil and other inputs beyond the distillation stage. These units, which allow the conversion of more of a barrel of crude oil into higher-valued products – such as gasoline, diesel, heating oil, and jet fuel – are critical to a refiner's ability to satisfy the more demanding product specifications required by regulation. Downstream processing units also allow refineries to make more effective use of lower-quality – but also less expensive – crude oils to produce higher-valued refined products. Overall, the capacity of the petroleum industry's downstream refinery

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[7] A number of programs subsidized small refineries before 1981. These programs – particularly the oil allocation programs of the 1970s – led to the construction of many inefficient refineries that produced asphalt and small amounts of fuels for local consumption, often from local crude oil sources. These refineries were subsidized based on their crude runs, not their gasoline output; as a result, many of them produced no gasoline. Many of these refineries produced asphalt (and possibly some gasoline) but sold the remaining partially processed intermediate products to larger refiners. As a result of these transactions, larger refiners likely reduced the amount of crude oil run through their distillation units. Many of the small, inefficient refineries were no longer viable after the government subsidies ended in 1981, and overall demand for refined products fell at the same time. More than 100 refineries closed between 1981 and 1985.

[8] Five of these 20 refineries did not entirely exit the market, since their operations were integrated into adjacent refineries.

units has increased more quickly than distillation capacity.[9] An important benefit of these additions to downstream processing capacity (and other technological improvements) is that the nation's refining industry gets more high-valued products out of a barrel of crude than before. It took 12.5 percent more crude oil for the average refinery in 1982 to produce a given amount of gasoline, diesel, home heating oil, and jet fuel than is required today.[10] Today's new technology has the same effect as if one were to continue using the old technology but add crude distillation capacity. The industry has improved its yields of higher-valued products while having to process crude oil of steadily decreasing average quality[11] and while meeting increasingly demanding regulatory requirements.

Fourth, the decline in the number of refineries generally has occurred at smaller firms and has not been a consequence of mergers. Nearly all of the refineries that have closed were owned by firms that have left the industry – firms whose very exit from the business meant that they would enjoy no marketplace gain from an agreement to reduce output. In many cases, these refineries closed because of the high capital costs that would have been required to continue operating under stricter environmental regulations for gasoline and diesel. Economies of scale make the investments required to continue operating proportionately much higher for small refineries, and many smaller refineries decided to shut down rather than invest the new capital required to continue operating.

Fifth, in recent decades refining sector profitability generally has not been favorable to the opening of new refineries (or to the expansion of existing refineries). Rates of return on investments in refining have been low in recent decades – so low that they likely account to some degree for the lack of investment in new refineries or in even more expansions to refinery capacity. Refining margins also have been volatile, and a focus only on recent, short-term profit results can be misleading. For example, although refining margins are presently high by long-term historical standards, the major oil companies had an annual loss of $1.4 billion in refining and marketing as recently as 2002.

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[9] For instance, between 1981 and 2005, total hydrotreating capacity increased 66 percent (from 8.5 million barrels per day to 14.1 million barrels per day); total thermal cracking capacity increased 57 percent (from 1.6 million barrels per day to 2.5 million barrels per day); and total catalytic hydrocracking capacity increased 79 percent (from 0.9 million barrels per day to 1.6 million barrels per day).

[10] For example, in 1982, refinery output as a percentage of crude inputs was 53.2 percent gasoline, 23.3 percent distillate, and 6.7 percent jet fuel – a total of 83.2 percent. (The remaining 16.8 percent consisted of lower-valued products, including residual fuel oil, asphalt, road oils, petroleum coke, and still gas.) By 2005, those percentages had increased significantly, to 57.1 percent gasoline, 26.2 percent distillate, and 10.2 percent jet fuel – a total of 93.5 percent.

[11] These increases in refinery efficiency have an important secondary effect. As the worldwide demand for crude oil increases, refineries encounter a shortage of low-sulfur ("sweet") crude oil and have to use lower-quality crudes.

Sixth, to meet U.S. demand, imports of finished refined products, blendstocks, and intermediates supplement domestic refining capacity. Imports of refined petroleum products have increased in recent years and are expected to become even more important. Decisions to add domestic refining capacity, including the opening of new refineries, will be affected by expectations concerning the availability and competitive influence of imports.

*(b) Is there anything the FTC can do about the oil industry closing existing refineries, and failing to open new ones?*

**Answer 1(b):** A reduction in output is indispensable to raising prices. Antitrust doctrine and policy strictly condemn agreements to reduce output. No such condemnation attaches to an individual firm's independent business decision to reduce its output. In a dynamic economy – with fluctuations in demand, the rise and growth of new producers, and differences in rates of growth among geographic regions, among other factors – we expect some firms to reduce output, to close production facilities in some geographic areas and open or expand facilities in others, and to build new facilities or upgrade existing facilities encompassing new technologies while closing plants that use outmoded processes. Firms continually make these types of adjustments to their production facilities independently and for valid business reasons, and the antitrust laws do not prohibit such adjustments.

By contrast, if competitors were to agree to close any of their production facilities pursuant to a price-fixing agreement, then that agreement would be actionable under the antitrust laws. Despite exhaustive scrutiny in both merger and conduct investigations, the FTC's examinations of the petroleum industry have not revealed evidence of a conspiracy to shut down productive capacity. The increase in total U.S. petroleum refining capacity during the shutdown of older, less efficient refineries indicates that firms in the industry concluded that they could best expand production to satisfy growing demand by concentrating operations in a reduced number of larger, significantly more efficient refineries. Given the absence of evidence of a collusive agreement to close refineries and the structure of the petroleum industry – with no firm in a position to have a material effect on industry output through its independent decisions to increase or reduce production – there is no legal or economic rationale for challenging a firm's unilateral decision to shut down one of its facilities. To date, no single firm could shut down a profitable refinery and be confident that it could thereupon raise prices enough to enjoy increased profits from its remaining productive assets.

Although the Commission's past investigations have not unearthed evidence of illegal collusion to restrict refining capacity, the agency (as described above) is in the midst of an intensive investigation to determine whether the price of gasoline has been manipulated through, among other means, reductions in refinery capacity. The Commission will address this subject in its report to Congress due in spring 2006.

**Question 2:** *I have introduced a bill to direct the Secretary of Energy to establish and operate a strategic refining reserve (S. 1979). This reserve should have the capacity to produce at least 5 percent of the domestic demand for gasoline, diesel and aviation fuel. I believe this reserve*

*would be an important step to ending the oil companies' stranglehold over the market, and their ability to manipulate supply in order to have market power. What do you think of this idea?*

**Answer 2:** The bill that you have introduced appears to assume that oil companies have engaged in significant anticompetitive behavior. As you know, pursuant to Section 1809 of the Energy Policy Act of 2005, the FTC is currently investigating whether the price of gasoline has been manipulated – an investigation that encompasses refining and other levels of the petroleum industry.[12] Until the results of that investigation become available, I can offer only limited observations about S. 1979.

In general, reserves can be an important component of national economic policy if there is a desire to insure against future economic disruptions. Where the costs of such disruptions would be high – such as an impairment to the defense of the country, or a severe effect on the national economy during an embargo of crude oil shipments – federal policy has been to establish reserves of one kind or another. Thus, the Defense Department and the Department of Energy both maintain strategic reserves of crude oil. For several reasons, reliance on reserves as a means of responding to normal market fluctuations – rather than as a way to respond to an embargo or another type of severe crisis – has not been a preferred policy.

The proposed refining reserve would be costly. According to news reports, the proposed new refinery in Arizona will cost $2.5 billion to build. Six refineries of that size would be needed to fulfill the requirements of the proposed refinery reserve. Furthermore, if the proposed reserve is also responsible for supplying the required renewable fuels, 14 average-sized ethanol plants would need to be constructed (since oil refineries do not produce renewable fuels). Challenging issues also are likely to arise regarding the siting of the refineries, arrangements for their crude oil and other raw inputs, and the distribution and allocation of their output.

Refineries operate most efficiently when running close to full capacity. Presumably the reserve refineries established pursuant to S. 1979 would usually operate significantly below capacity in order to be able to expand their output at times of supply disruptions (or at such other times as are deemed appropriate). As a result of these below-capacity operations, the revenues collected by the reserve refineries typically may fail to cover the significant fixed costs inherent in maintaining a working refinery. Even if these government-sponsored refineries were able to match private sector efficiency, they likely would need ongoing subsidies to meet operating and maintenance expenses and to fund future capital investments.

The construction and operation of the reserve refineries also may have unintended consequences for the incentives of firms operating in the private sector. Decisions by private refiners to make investments – including the decision to stay in business – are based on a long-term perspective. At the same time, profit margins in the refinery industry are volatile. Thus, if a government-sponsored refinery reserve behaves in a way that reduces the times when returns

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[12] *See* note 3, *supra*, and accompanying text.

earned by the private sector would otherwise have been temporarily above average, this may discourage certain investments and may encourage the closure of some refineries that are now marginally viable. In effect, government-sponsored refinery capacity may crowd out private investments in the industry.

**Question 3**: *In March 2001 the FTC released the report of its investigation into the Midwest gas price spikes that occurred the previous year, an investigation that Senator DeWine and I requested. The FTC report found no evidence of collusion between competitors in violation of the antitrust laws.*

*However, the report also found that a significant part of the supply disruption was due to strategic decisions of individual oil companies to withhold supply from the market. The report stated that one company was concerned about "oversupplying the market and thereby reducing high market prices." The report also found that an executive of another company made clear that he "would rather sell gasoline and earn a high margin in each gallon sold than sell more gasoline and earn a lower margin." Yet the FTC concluded it could not bring any action because this was unilateral conduct not involving agreements among competitors.*

*I was very concerned by the FTC's conclusion in 2001 that oil companies could manipulate shortages in supply to drive up gas prices. And I was also concerned by the FTC's finding that it could not take any action. Does it remain the FTC's position that there is nothing the FTC can do to prevent such behavior? In your view, does the FTC need additional authority to take action against unilateral action of oil companies designed to raise price?*

**Answer 3:** The Commission's Midwest Gasoline Price Investigation did not conclude that firms manipulated shortages or withheld petroleum products from the market in order to keep prices high. Rather, the Commission determined that some firms increased their Gulf Coast production of gasoline for shipment into the Midwest after it was clear that higher prices in the Midwest would make such shipments profitable. The Commission also found that one firm had excess inventory for a short period, accurately anticipated a tight market, and sold a portion of its inventory in an attempt to maximize profits at temporarily higher prices. In the context of localized product shortages caused by refinery production problems and pipeline disruptions, the Commission found no conduct – either collusive or on the part of any individual firm – that violated the antitrust laws. The salient conclusion by the FTC was that "[t]he gasoline price spike in the Midwest was short-lived. Soon after prices spiked, additional gasoline was produced and imported to the region, and prices dropped as quickly and dramatically as they had risen."[13] Rather than withhold gasoline, most firms moved extra product into the region in order to take advantage of higher prices, and consumers benefitted accordingly.

Several factors that contributed to the price spike in the Midwest in the summer of 2000

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

were largely beyond the immediate control of the industry participants. For example, the refiners that supply gasoline to the Midwest experienced significant production problems in the spring of 2000 that disrupted ordinary operations and contributed to the general tightness of both conventional gasoline and reformulated gasoline ("RFG") in the Chicago and Milwaukee areas. In addition, further supply disruptions resulted unexpectedly from the failure in the first half of 2000 of two pipelines that serve the Midwest.[14] These problems were exacerbated because gasoline inventories in the Midwest were at or near minimum operating levels in May and June 2000.[15]

On the other hand, although the principal causes of the Midwest price spike were largely beyond the immediate control of industry participants, the industry as a whole made errors in supply forecasts and underestimated the potential for supply shortages in the Midwest in the spring and early summer of 2000. For instance, in determining how they would comply with the stricter EPA regulations for summer-grade RFG that took effect that spring, three Midwestern refiners each independently concluded that it would be most profitable to expend capital on refinery upgrades only to the extent necessary to supply their branded gas stations and fulfill their contractual obligations. In the aggregate, these three firms ended up producing 23 percent less summer-grade RFG in 2000 than in 1999. As a result of these decisions, these three firms could not produce summer-grade RFG to sell on the spot market, as they had when prices rose in prior years. Once these firms realized the significance of the RFG shortfall in the Midwest and calculated that it made economic sense to ship extra product into the area, they adjusted their output mixes at Gulf Coast refineries and produced and shipped more RFG by barge into the Midwest. The fact that these firms did not ship product into the Midwest until it became clear that such shipments would be profitable is not evidence of an agreement among them but only of rational economic behavior – even if each firm reached its decision after trying to gauge how its competitors would behave.

As noted above, not every firm made the same misestimation regarding supply shortages.

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[14] The Explorer Pipeline, which transports gasoline from refineries on the Gulf of Mexico to Chicago, was closed by a rupture for five days in March 2000, and its capacity was thereafter reduced to 90 percent until December 2000. In addition, the Wolverine Pipeline – which carries one-third of Michigan's gasoline supply – was shut down for nine days in June 2000 by a rupture near Jackson, Michigan, and subsequently operated at only 80 percent of capacity for a month, causing shortages in Detroit and northern Ohio.

[15] Gasoline inventories were low in the Midwest in the spring and summer of 2000 because of the high price of crude oil and the expectation (reflected in futures prices) that crude oil prices would fall. Oil companies hoped to rebuild inventories with lower-priced crude oil in the future. In addition, many industries, including the petroleum industry, have moved to just-in-time distribution techniques in recent years. Finally, the Explorer Pipeline break made it impossible to rebuild inventories in advance of the summer driving season. As a result of these factors, low inventory levels made it more difficult to respond to unexpected supply problems.

One firm made a different decision in 1999 and increased its summer-grade RFG production substantially. This firm, which had excess supplies of RFG and had capacity available to produce even more RFG at the time of the price spike, therefore faced very strong demand for its product. As any other firm operating in our market system would do, it decided to charge what the market would bear and to release its inventory over time consistent with profit-maximization. Having correctly anticipated the market, this company was able to sell at higher prices while its competitors scrambled to get more product into the market, and it made higher profits for a limited period before its competitors resolved their supply problems.

I reiterate that the Commission found no evidence that firms in the industry agreed to limit supply into the Midwest in order to take advantage of higher prices. Rather, once the extent of the supply disruption became apparent, the firms moved more product from the Gulf Coast into the Midwest, and prices dropped sharply. No additional authority is needed to insure that competitive conditions prevail in petroleum markets. Indeed, attacking the behavior of the one firm that correctly forecasted the market – and earned higher profits because of its foresight – would reduce investment incentives for the future and would inevitably lead to longer and more severe disruptions the next time supply is compromised in a petroleum market.

**Question 4**: *Because of the rise in the worldwide price of crude oil, our oil companies must pay higher and higher prices to obtain the crude oil they refine into gasoline, heating oil and other petroleum products. Yet as the price they pay for this raw material rises, their profits also rise. In your view, how can this be? How can the industry's profits rise as the price for the raw material it uses to make its products rise?*

**Answer 4:** There are several reasons why petroleum company profits may rise even as crude oil prices rise. For integrated petroleum companies, the answer is straightforward: they own crude oil. As the worldwide market price of crude oil rises, integrated companies (such as ExxonMobil, Chevron, BP, and Shell) find that the profits they generate from their upstream business rise – and may exceed the increased costs that are passed on to the downstream businesses.

The story is more complicated for independent refiners. Input cost is only one factor in the level of current profits, although an important one in the petroleum industry. Efficiency in manufacturing and distribution and demand for the final product are other important variables that determine the overall level of corporate profit. Efficiency in refining operations is particularly important as the cost of crude oil rises. Higher crude oil prices trigger efforts to build and operate more technologically complex and efficient refineries in order to get a larger and more profitable mix of refined products from each barrel of crude oil. Some independent refiners, such as Valero, own refineries configured to process high-sulfur ("sour"), heavy crude oil. In periods of high demand for refined products, the price of West Texas Intermediate sweet crude oil may increase more than the price of sour crude. Therefore, because it purchases sour crude, Valero's input costs may increase less than other refiners' costs (and less than might appear from reported figures, which generally track sweet crudes). Thus, the cost of a unit of refined product will not necessarily rise at the same rate as the cost of a unit of crude oil.

In addition, other factors beyond input costs may lead to higher final product prices. A strong increase in demand for the final product may have a greater effect than input costs or other factors. The worldwide demand for refined products has been strong for the last few years. Indeed, it is the main reason why crude oil prices have been rising so much during the same period. This demand pull can lead to higher profits for refiners even as they continue to pay more for their main input.

**Questions from the Honorable Russell D. Feingold**

**Question 1:** *During the hearing, you expressed concern that the antitrust analysis that the FTC uses to review oil industry mergers has put the burden of proof on the regulator to show that the merger will not be in the best interest of consumers. You testified: "I would say that I think we're approaching the point at which a broader reconsideration of whether the lines are drawn in the right place is appropriate." In your opinion, where should the lines be drawn?*

**Answer 1:** The Merger Guidelines developed by the Department of Justice and the FTC provide a suitable analytical framework for evaluating the competitive effects of petroleum industry mergers and establish sensible quantitative and qualitative tests for enforcement.[16] My concern is that some recent judicial decisions have interpreted these Guidelines and applied existing merger jurisprudence in ways that (a) underestimate the possibilities for industry participants to raise prices following a merger, and (b) unduly increase the burden that the government must bear to demonstrate that a proposed transaction is likely to have adverse competitive effects.

**Question 2:** *As you know, in March 2001, the FTC put out a report detailing its investigation into Midwest gasoline pricing. The report outlined how companies unilaterally engage in economic withholding, with one company withholding supplies in order to increase prices. It is my understanding that most FTC economic models show significant competition in the refining sector. If this is the case, and if there is in fact significant competition in the refining sector, how is economic withholding possible? Is it possible that the economic models are wrong or inadequate?*

**Answer 2:** Although the FTC's work is always guided by sound economic theory and empirical research, the only formal economic model on which the agency regularly relies as an enforcement tool in the petroleum industry is the model that underlies our Gasoline and Diesel Price Monitoring Program.[17] As you may know, this nearly four-year-old program tracks retail

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[16] *See* U.S. Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines (1992, *revised in* 1997), *available at* http://www.ftc.gov/bc/docs/horizmer.htm.

[17] *See* http://www.ftc.gov/ftc/oilgas/gas_price.htm for more information on this program. In addition, the FTC staff has undertaken econometric retrospectives of some consummated

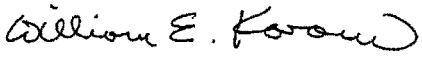
gasoline and diesel prices in 360 cities across the nation and wholesale prices in 20 major urban areas. FTC economists use an econometric model to determine whether current retail and wholesale prices are statistically anomalous in comparison with historic price relationships among geographic areas. Unusual changes in prices in particular areas may indicate anticompetitive behavior in the area requiring further scrutiny by FTC staff. The economic model used in this Price Monitoring Program is not designed to measure the general competitiveness of the refining sector, but – had the program been active at the time of Midwest gasoline crisis of 2000 – the model would have promptly indicated widespread and significant pricing anomalies in the Midwest that would have received immediate and extensive review by FTC staff.

As I said in my answer to Senator Kohl's third question, the Commission's Midwest Gasoline Price Investigation found no collusive agreement to withhold product, determined that only one firm correctly predicted the tight market, and concluded that that firm released its product into the market to take advantage of the higher prices and maximize its profits. That one firm behaved as a rational firm would in such circumstances, and none of its conduct violated the antitrust laws.

I would add that the Midwest gasoline crisis helps illustrate the types of competitive responses to supply disruptions that typify the petroleum industry. Although the Midwest price increase was severe; it was brief. As soon as prices in the Upper Midwest exceeded those on the Gulf Coast by more than normal levels, refineries took steps to increase supplies into the affected areas of the Midwest. This process took a few weeks – a period that stemmed in large part from the time it takes to move additional refined product from the Gulf to the Midwest by pipeline or barge. The supply response was so significant that Midwest prices fell sharply (and for a time were even below the level that prevailed on the Gulf Coast before the Midwest spike). By that time, any short-run advantage enjoyed by refineries that made correct production choices (and had relatively ample supply on hand) would have been completely dissipated.

Mr. Chairman, I appreciate having had the opportunity to respond to these important questions.

Sincerely,



William E. Kovacic
Commissioner

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mergers in the petroleum industry in order to determine whether wholesale or retail prices were affected by the transaction in particular geographic areas.

**Chairman Arlen Specter**
**Follow-up Questions**
**Consolidation in the Energy Industry: Raising Prices at the Pump?**
**February 1, 2006**

**Response of R. Preston McAfee**

1. Does the concentration of power in the energy industry, in and of itself, increase prices? If so, why?

Modern economic analysis suggests that concentration increases prices through a variety a routes, including differentiated products (e.g. distinct consumer perceptions of the quality of gas stations), unilateral effects (ability to withdraw a small amount of quantity and send prices up) and tacit collusion (conscious parallelism). All of these effects are exacerbated by concentration. However, overall the oil industry is not especially concentrated relative to other mature industries.

2. Would legislation be appropriate, and what kind of legislation would you suggest?

I would advise against judicial or antitrust legislation that specifically targets the oil industry. Instead, I would suggest that it might be time to revisit the antitrust laws more broadly. There have been great advances in the economic understanding of firm behavior over the past quarter century, advances which are not reflected in the antitrust laws. The antitrust laws generally are quite constrained by precedents set in a time when the economic understanding of competition was limited relative to today. With that said, however, I always advise care and prudence in amending law – this is not a matter for urgent action, but rather review and reconsideration.

3. To what extent do you think increased profits for energy companies will find their way into exploration?

Oil price increases in 1974, and again in 1981, lead to dramatic increases in the supply of oil, in Alaska, and by nations including Mexico, UK and Venezuela. Much of this oil didn't become available until the mid-1980s, in spite of the fact that the incentives for exploration started in the mid-1970s. This is probably the best bet for a time-frame: today's high prices will make a lot of new oil available around 2015. That oil might come from the new Asian republics, Africa or from off-shore sites. Some of it will require enormous investments and some of it will involve very large risks.

4. If the seven big companies had their profits cut in half in any given year, what impact would that have on the price of gasoline to a consumer over a year's time?

Provided the tax is on profits and not on gasoline, a 50% profit surtax would be unlikely to have noticeable effects today. However, it would discourage exploration, because the willingness of the government to take away large profits implies a reduction in the return to investment, as well as an increase in risk.

5. How would you change zone pricing to bring about the best effect for the consumer?

This is a topic that is not very well understood by the community, or even by some professional economists. The first thing to understand is that elimination of zone price might *increase* the average price – one man's price increase is another man's price cut. Some prices will rise, others fall. There is not reason to think that forcing common pricing will reduce the average price.

High priced zones include (i) affluent areas, (ii) areas with little competition, including rural areas, and (iii) dangerous areas, usually in the inner city. The lowest prices generally arise in high competition highway settings and in suburban locations with discount stations. An attempt to prevent zone pricing (e.g. by forcing companies to offer a common price in counties) will likely increase prices in the suburban and highway settings, decrease prices in the more affluent and rural areas, and cause some inner city stations to close. In addition, a ban on zone pricing can be defeated merely by using franchise stations (who are free to set their own retail prices.

In addition to zone pricing, oil companies may charge different prices for wholesale gasoline to retailers. Some portion of these charges pays the company back for investment in the station, but sometimes it is price discrimination. Yale University's Justine Hastings, who has testified before this committee on numerous occasions, has a proposal to eliminate wholesale price discrimination, which could improve the overall competitiveness of stations without increasing prices anywhere.

**Senator Kohl's Follow-Up Questions for Oil Consolidation Hearing**

**Response of Preston McAfee**

1. In most competitive industries, when there are high prices, high profits to be made, and soaring consumer demand, we would expect to see an expansion of capacity to meet this demand. Yet in the oil industry this has not happened. Instead of opening new refineries, the industry has closed more than half of all that existed 25 years ago. In 1981, there were 324 refineries operating in the United States – today there are 149. Overall national refining capacity has declined by more than 5% while demand has continually risen. Oil industry critics suggest that this is no accident – that oil companies actually prefer to keep supplies tight in order to be able to gain market power to raise price.

(a) Does the failure of the oil industry to open new refineries suggest the presence of anti-competitive conduct?

It isn't the number of refineries that matters, but the amount of refining capacity that matters to the industry. For example, the number of refineries on the West Coast has dropped, but this is because CARB gasoline requirements killed the smaller refineries. Meanwhile, overall refining capacity has expanded substantially, because existing refineries have increased capacity.

With that said, however, excess capacity has been reduced relative to, say, 1970. I think this is mostly part of an economy-wide trend toward operating leaner facilities, just-in-time production, and minimizing cost. We see the same phenomenon in factories making coffeemakers and cameras. I don't see this reduction in excess capacity as a consequence of anti-competitive conduct (see next answer). However, the tightness of refining capacity increases both the risk and consequences of anti-competitive conduct, and calls for greater vigilance in antitrust, because excess capacity is not a likely constraint on anti-competitive behavior.

(b) In your view, is there anything the antitrust enforcement agencies can, or should, do about the oil industry closing existing refineries, and failing to open new ones?

No. I don't think the government can second-guess the decision to close a refinery, as California tried to do with the Shell refinery in Bakersfield. The government could try to ease the regulatory burden of modernizing such facilities, if regulation is actually a problem. (I'm not an expert on the regulatory burden of operating oil refineries, however.)

Refinery closures are unlikely to arise through cartel activity. Usually cartel allocations are based on capacity, so cartel members want to have a large capacity so as to receive a larger allocation. Consequently, it is difficult for a cartel to induce members to close refineries and in fact closure of plants is more likely an indication of the *absence* of an organized cartel.

2. In the last 15 years there has been a tremendous amount of consolidation in the oil industry – the GAO counts 2600 mergers and acquisitions in this industry since the 1990s alone. 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.

Many wonder whether new rules or merger guidelines are necessary because of the special circumstances in the oil industry. For example, it is not easy to increase capacity to meet growing demand because of environmental and other restrictions to building new refineries. In addition, demand is highly inelastic -- consumers cannot respond to higher prices by buying substitute products – people must buy gas to drive to work, and must buy heating oil or natural gas to heat their homes in the winter.

In your view, should the FTC/Justice Department's merger guidelines be revised for mergers in the oil industry because of these special conditions?

It just isn't fair to say that the Exxon/Mobil merger increased industry concentration. Divestitures included pipeline ownership, a refinery and 770 stations. While concentration has increased overall, it is still lower than many other mature industries with significant scale economies. Increased concentration is a natural consequence of the maturing of industries, and not in itself a cause for alarm, provided adequate competition exists.

The oil industry is not special from the point of view of the merger guidelines, although it is an important industry, like electricity and transportation. The merger guidelines were designed with industries like the oil industry in mind.

It is my opinion, however, that antitrust enforcement doesn't do a very good job recognizing the effect of vertical integration, and the oil industry is quite vertically integrated. This is less a problem of the agencies than of the precedent-bound courts. The main problem of vertical integration from an antitrust standpoint is that vertical integration often creates interdependence, which in turn reduces competition for a given level of concentration. That phenomenon isn't specific to the oil industry, but of course is relevant to the oil industry. Our understanding of these issues has advanced dramatically just in the past few years.

Thus, I think it is a good time to take a look at antitrust enforcement generally, and ask whether it is consistent with the understanding developed by economists over the past quarter century. The oil industry is only one, albeit a major one, in such an investigation.

3. Because of the rise in the worldwide price of crude oil, our oil companies must pay higher and higher prices to obtain the crude oil they refine into gasoline, heating oil and other petroleum products. Yet as the price they pay for this raw material rises, their profits also rise. In your view, how can this be? How can the industry's profits rise as the price for the raw material it uses to make its products rise?

Oil companies own a small percentage of the total world production of oil, but the absolute amount of oil owned – both in reserves and in processing – is large. As the price of oil rises, the value of these stocks of oil rises along with the price. The increased value of these inventories is a portion of the record profits. These profits are analogous to the losses sustained by owners of oil as the price of oil fell in the mid-1980s, losses which bankrupted some firms.

A second consideration driving increased profits is the increase in volatility in the industry, which also increases profits to compensate for the greater variation in profit levels.

Nevertheless, there has been an increase in refining margins, that is, in profits over and above the cost of oil. Other things equal, in a competitive industry a cost increase is associated with a fall in operating margins, not an increase. Some this increase is due to the effects of hurricane Katrina, which reduced refining capacity and impaired our ability to get oil to the Gulf Coast refineries. It is difficult for me to believe that hurricanes are the whole story.

Another portion of the increased margin may be due to arbitrage. If investors, or for that matter automobile drivers, expect future gasoline prices to be higher, they buy gasoline today. Consumers normally keep their gasoline tanks a quarter full, and if consumers fear price increases, they tend to fill their tanks, driving prices up. Such speculative purchases tends to force current prices to rise to expected future levels, which may leave current prices substantially higher than historical costs. (If arbitrage is the reason, however, it is peculiar because NYMEX traded future prices are *lower* than current prices, suggesting arbitragers are expecting oil prices to fall over the next year.)

It would be reasonable to further investigate the reasons for increased margins. Several government agencies – the FTC, the DOJ, and the DOE – have the ability to carry out such a study. Such a study might alleviate the concerns of American consumers without unnecessarily increasing the uncertainty about government intervention facing the industry, which so destructive to economic activity.

Tyson Slocum responses

Sen. Kohl

## Question 1.
## Should the FTC/Justice Department's merger guidelines be revised for mergers in the oil industry?

Yes. S.2557, introduced in the 109th Congress, is a great first step, as it prevents the anti-competitive practice of unilateral withholding. But additional legislation must be implemented to counter the very strong bias in recent years in the antitrust area at federal courts in favor of a "rule of reason" rather than a "per se illegal" analysis of alleged anticompetitive conduct. A perfect example of how the courts are undermining anti-trust laws is the recent Supreme Court decision *Texaco v Dagher*.[1]

## Question 2
## a) Does the failure of the oil industry to open new refineries suggest the presence of anti-competitive conduct?

Yes. 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.

In 1993, the five largest U.S. oil refining companies controlled 34.5 percent of domestic oil refinery capacity; the top ten companies controlled 55.6 percent. By 2005, the top five—ConocoPhillips, Valero, ExxonMobil, Shell and BP—controlled 55 percent and the top ten refiners controlled 81.4 percent. 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. 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.

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*

[1] www.supremecourtus.gov/opinions/05pdf/04-805.pdf

> *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.*[2]

ExxonMobil and other 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.

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.[3] 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."[4]

### b) Is there anything the antitrust enforcement agencies can do about the oil industry closing existing refineries, and failing to open new ones?

Yes, an immediate investigation—including the use of subpoena—must be initiated to determine the level of intentional actions by the oil industry to maintain tight refinery supplies.

### 3. Do you believe oil companies have an incentive to keep supplies off the market, or to keep supplies tight, in order to gain market power and drive up price? Does this happen – either at the time studied in the March 2001 or at other times? What can we do to prevent this?

Yes, oil companies do have an incentive to keep supplies off the market. The U.S. Federal Trade Commission found evidence of anti-competitive practices in its March 2001 *Midwest Gasoline Price Investigation*:[5]

> *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.*

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[2] Jeffrey Ball, "As Gasoline Prices Soar, Americans Resist Major Cuts in Consumption," May 1, 2006.
[3] *Refiner Sales Prices and Refiner Margins for Selected Petroleum Products, 1989-2005*, www.eia.doe.gov/emeu/aer/pdf/pages/sec5_53.pdf
[4] Steve LeVine and Patrick Barta, "Giant New Oil Refinery in India Shows Forces Roiling Industry," August 29, 2006.
[5] www.ftc.gov/os/2001/03/mwgasrpt.htm

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 1995-2004, 97 percent of the more than 929,000 barrels of oil per day of capacity that has been shut down were owned by smaller, independent refiners.[6] Were this capacity to be in operation today, refiners could use it to better meet today's reformulated gasoline blend needs.

**Question 4.**
**Because of the rise in the worldwide price of crude oil, our oil companies must pay higher and higher prices to obtain the crude oil they refine into gasoline, heating oil and other petroleum products. Yet as the price they pay for this raw material rises, their profits also rise. In your view, how can this be? How can the industry's profits rise as the price for the raw material it uses to make its products rise?**

First, vertically-integrated companies like ExxonMobil are large producers of oil, and they are often transferring oil to their own domestic refineries. Second, the refining profit margins I cited in response to question 2a show that the companies have been able to counter the rise in crude oil by making up the difference with huge profits at the refining level.

**Question 5.**
**Does the exporting of refined products—such as gasoline, diesel and home heating oil—drive up price?**

Since our current level of exports—425 million barrels in 2005[7]—is relatively small, I don't think exports currently are causing high prices. However, there is potential for this to be a problem, particularly in the exporting of refined products, and therefore I think prudent policy would dictate a limit or a ban on future exports.

**SENATOR SPECTOR QUESTIONS**
**Question 1.**
**Does the concentration of power in the energy industry, in and of itself, increase prices? If so, why?**

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[6] Energy Information Administration Form EIA-820, *Annual Refinery Report.*
[7] http://tonto.eia.doe.gov/dnav/pet/pet_move_expc_a_EP00_EEX_mbbl_a.htm

Yes. oil companies are also exploiting their huge market control and lax regulatory oversight to price-gouge Americans. For example, in June 2006, the U.S. Commodity Futures Trading Commission (CFTC) brought charges against BP for manipulating the entire U.S. propane market, and CFTC 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 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... [and the CFTC] is currently investigating various aspects of BP's crude oil trading and storage activities in the US since 2003."[8] Investigations are expanding into manipulation of crude oil and gasoline futures markets, and "many trading firms had received CFTC demands for information, suggesting that the investigation went beyond BP."[9]

Oil companies, financial firms and other energy traders are increasingly exploiting their control over infrastructure assets, parlaying the knowledge of the movements of energy through the systems they control to make big bets on the futures exchanges. Glenn Dubin, co-founder of the hedge fund Highbridge Capital (that is financially backed by JP Morgan) explained when buying a big stack in Louis Dreyfus: "Owning physical assets such as pipelines and storage facilities is crucial to investing in the energy business," said Dubin. "That gives you a very important information advantage. You're not just screen-trading financial products."[10]

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. 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. This concentration has led to skyrocketing profit margins.

## Question 2.
## Would legislation be appropriate, and what kind of legislation would you suggest?

We should strengthen antitrust laws by empowering the Federal Trade Commission to crack down on unilateral withholding and other anti-competitive actions by oil companies; re-regulate energy trading exchanges to restore transparency and impose firewalls to stop energy traders from speculating on information gleaned from the companies' affiliates; and establish a Strategic Refining Reserve to be financed by a windfall profits tax on oil companies that would complement America's Strategic Petroleum Reserve.

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[8] www.sec.gov/Archives/edgar/data/313807/000102123106000617/b843546-6k.htm

[9] John R. Wilke, Ann Davis and Chip Cummins, "BP Woes Deepen With New Probe," *The Wall Street Journal*, August 29, 2006

[10] Saijel Kishan and Jenny Strasburg, January 8, www.bloomberg.com/apps/news?pid=20601014&sid=aBnQy1boldFo

**Question 3.**
**To what extent do you think increased profits for energy companies will find their way into exploration?**

Bigger profits will indeed increase the amount of capital that the oil industry allocates for exploration and production. But the companies are also spending record amounts of their capital on other things that are not useful for consumers or America's energy supply. For example, since January 2005, the largest five oil companies in America—ExxonMobil, ChevronTexaco, ConocoPhillips, BP and Shell—have spent $145 *billion* buying back their stock and paying dividends.

**Question 4.**
**If the seven big companies had their profits cut in half in any given year, what impact would that have on the price of gasoline to a consumer over a year's time?**

The results would be dramatic. As I mentioned earlier, 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.[11] 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." Clearly, if their refining profit margins drop, the price of a gallon of gas should drop, too.

**Question 5.**
**How would you change zone pricing to bring about the best effect for the consumer?**

Zonal pricing should be made illegal. Connecticut Attorney General Richard Blumenthal recommended that Congress adopt the following language to outlaw zonal pricing:

"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…a person engaged in the business of furnishing gasoline to retail distributors of gasoline shall sell gasoline to all retail distributors of gasoline at the same base price minus any bona fide volume discount and plus any actual transportation cost. The invoice for the sale of such gasoline shall indicate the base price and any discounts or transportation costs. Such base price shall not be adjusted more than once in any 24-hour period and shall be the rack price as posted in the oil price information service."
Finally, Congress should amend the Petroleum Marketing Practices Act, 15 USC § 2801 et seq., to prohibit major oil companies from dictating the source of supply of the brand name gasoline.

[11] *Refiner Sales Prices and Refiner Margins for Selected Petroleum Products, 1989-2005*, www.eia.doe.gov/emeu/aer/pdf/pages/sec5_53.pdf

Senate Judiciary Committee Hearing on Consolidation in the Oil and Gas Industry Held
February 1, 2006

GAO's Response to Follow-Up Questions of Senators Feingold and Kohl for the Record

Senator Feingold's question and our response:

The GAO and FTC have come to different conclusions on the question of whether consolidation in the oil and gas industry has increased gasoline prices. Can you comment on the FTC's criticism of the GAO's methodology?

Answer:

We believe that the debate between GAO and FTC reflects a general difference in approach—we performed a retrospective analysis of the effects of specific mergers on gasoline prices, while the FTC has typically done prospective analysis prior to making their decisions about proposed mergers. We believe that both are necessary—a prospective analysis is needed to identify potential anti-competitive impacts of proposed mergers and a retrospective analysis is needed to evaluate the quality of FTC's past decisions. FTC criticized GAO's methodology for analyzing merger effects in the U.S. petroleum industry in the 1990s. We strongly disagree with FTC's criticism and have rebutted FTC's criticism point-by-point in our report, *Energy Markets: Effects of Mergers and Market Concentration in the U.S. Petroleum Industry*, (GAO-04-96, May 2004). We used sound, state-of-the art econometric methodology in our analysis and our results are consistent with previous studies. In addition, our methodology was peer reviewed by outside experts who generally approved of it, and we also utilized the services of a prominent expert on econometrics and oil industry economics who gave us expert advice on the methodology throughout the study and reviewed our model findings. Finally, other approaches may be informative and we encourage independent analysis of this important policy issue by FTC and other parties.

Senator Kohl's questions and our response:

1. For the years 2004 and 2005, please estimate what the wholesale price of gasoline would be if the profits of the five largest oil companies were half of what these companies actually earned.

We have not studied the profits of oil companies specifically, so our answer to this question will have to be more conceptual than precise. Historically, because the price of crude oil is the fundamental determinant of gasoline prices, gasoline prices have tended to follow oil prices. Thus, when oil prices have fallen as they did in 1998, gasoline prices have also dropped and, in 2004 and 2005 when oil prices rose, gasoline prices followed. Profits in the oil industry are also affected by crude oil prices because many oil companies produce crude oil as well as refined petroleum products—oil industry profits fell in 1998 and have risen over the 2004-2005 period,

in some cases reaching historically high levels recently. So conceptually, industry profits and gasoline prices tend to move in the same direction. However, the link between profits and gasoline prices is more complicated because oil companies also earn profits from selling gasoline and in other segments of the industry. Because we have not studied how refining profit margins are related to gasoline prices, as well as profit margins in the other segments of the industry, we cannot be more precise at this time. While we have not studied the causes of oil company profits directly, we have discussed the fluctuations in refining margins in a recent primer on gasoline prices, *Motor Fuels: Understanding the Factors That Influence the Retail Price of Gasoline,* (GAO-05-525SP, May 2005). In this primer we showed that, from 1995 through 2004, monthly average refining margins in the United States fluctuated between several dollars per barrel loss (negative margins) to almost 20 dollars per barrel. However, we have not evaluated refining margins since 2004 or in the context of today's high oil and gasoline prices.

2. I request that you update the estimates in your May 2004 Report titled "Effects of Mergers and Market Concentration in the U.S. petroleum Industry" (GAO-04-96) to reflect changes in the wholesale price of gasoline resulting from mergers and acquisitions which occurred after those studied in your Report (that is, mergers and acquisitions occurring in 2000 and thereafter). A letter formally making this request to GAO will follow.

Consistent with our Congressional protocols, we will respond in writing within 10 calendar days of receiving your request to acknowledge receipt of the request and will initiate a meeting with your staff within 30 calendar days of the request to discuss GAO's ability to respond.

# SUBMISSIONS FOR THE RECORD

**Statement for the Record of the**

**American Petroleum Institute**

**for the**

**Senate Judiciary Committee**

February 1, 2006

API is a national trade association representing more than 400 companies involved in all aspects of the oil and natural gas industry, including exploration and production, refining, marketing and transportation, as well as the service companies that support our industry.

The oil and natural gas industry recognizes the concerns across the country over the higher energy costs American consumers and businesses have been facing this year. It is also aware of contentions that the consolidation that has occurred in the industry over the last decade has led to higher prices. This statement will attempt to address those concerns and to offer the proper context in which to view both energy prices and company mergers.

A brief overview of the industry's status is in order. With the hurricane season past and much, but not all, of the lost Gulf of Mexico production and refining back on line, oil and natural gas prices have receded. But no one should conclude that we aren't facing some tremendous energy challenges ahead. The most recent forecasts of the United States Department of Energy's Energy Information Administration (EIA) indicate we still haven't escaped our energy predicament. Its sobering message to consumers: Strong demand, hurricane affected production and infrastructure limitations could help keep markets tight and prices volatile for the foreseeable future.

Complicating the overall supply/demand situation are numerous contributing factors. The new federal energy law eliminates the reformulated gasoline oxygen requirement in May, and ultra-low sulfur diesel will be introduced starting June 1. The industry is working hard to meet these new requirements, but they are major transitions and will present a challenge that could decrease supplies.

America's oil and natural gas industry is an industry that has undergone great transformations in recent decades. Whereas once it produced two types of gasoline – leaded and unleaded, it now has 17 formulations. Twenty years ago there were 200 refineries producing about 250 billion gallons of product. Today there are just 148 making 330 billion gallons per year (Chart 1).

It should be noted at the outset that the Federal Trade Commission did a thorough analysis of the potential effects of each large oil company merger – 16 since 1981[1]. In 12 of those cases, the agency mandated significant divestitures of assets before it approved the merger and in the other four, the parties abandoned the proposed transaction altogether. In addition, the FTC has continued to monitor the industry and – in its own

[1] See FTC, "The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement," August 2004 and "Gasoline Price changes: The Dynamic of Supply, Demand, and Competition," June 2005.

words – "remain vigilant" regarding potential anticompetitive conduct. Again, to quote the FTC: "In no other industry does the FTC maintain a price monitoring project such as its project to monitor retail gasoline and diesel prices." Any allegation that the federal government has been lax in its oversight of oil company mergers is simply not credible.

### Economic factors led to mergers

The oil company mergers we saw during the 1990s occurred in response to economic pressures and regulatory requirements. These pressures and requirements were the catalysts of change. During the 1990s, the oil industry earned relatively poor rates of return on their investments. This was especially true in the refining sector, which was hard hit with the need for new investment in technology and equipment to produce cleaner-burning fuels to meet clean air standards set by the Clean Air Act of 1990. This Act had a major impact on the operation of refineries in the United States and the return on investment realized at the time (Charts 2).

Technological advancements have helped refineries produce more from existing facilities than they did in the past. In addition, the elimination of subsidies under the government regulations after 1981 led to the closure of many smaller, less-efficient refineries throughout the1980s and 1990s. Those refineries left standing did a better job of bringing product to market for less. The further consolidation benefited consumers. We can see this in the gradual decline in the refiner/marketer margin, measured as the difference between the refiner's composite crude oil acquisition cost and the retail price of gasoline minus gasoline taxes (Chart 3). The margin represents the cost of doing business. It includes operating costs, capital expenditures, labor, rent and all the other expenses associated with running a business, including the profits earned from the business

Back in 1980 the cost to refine, distribute and retail gasoline, or the refiner/marketer margin, averaged about 99 cents per gallon (in inflation-adjusted terms). By 1990 it averaged more than 63 cents per gallon, and by 2000 the margin had declined to 54 cents per gallon. It increased briefly in 2001 as a result of colder than normal weather over the 2000-2001 winter and supply disruptions due to pipeline outages and the introduction of new blends of gasoline as required under the Clean Air Act. The refiner/marketer margin has since come down to an average of 48 cents per gallon in 2005. Multiplying these reductions by the 330 billion gallons of petroleum products consumed translates into billions of dollars of savings for consumers. American consumers benefit every day from these improvements and efficiency gains.

The consolidation in the refining sector has increased measurements of industry concentration, but according to the FTC, *"despite some increases over time, concentration for most levels of the petroleum industry has remained low to moderate."*[2] This is illustrated in Chart 4 which shows that even though concentration in the refining sector has increased since 1997, the concentration ratio is still less than it is for many other industries.

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[2] FTC, The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcements, August 2004, p.3.

### A worldwide market for crude oil

This information relates only to the downstream sector of the market – the refining and marketing sector. When we look at the upstream sector – exploration and production we must recognize we are tied to a worldwide market for crude oil. The price of oil is set on the global market by the forces of supply and demand. When demand is growing rapidly and supplies are tight, buyers typically bid the price up in order to secure supplies for their customers. The higher price acts as a magnet for supplies. It encourages more production and discourages consumption. The market is always looking for a new balance.

The price of crude is the consequence of thousands upon thousands of individual decisions made on the world market every day. No one company or group of companies has control over that price. In terms of market power, large international oil companies own less than 10 percent of the world's oil resources. According to the FTC, *"recent large major oil companies have had little impact on concentration in world crude oil production and reserves."* [3] And, as noted by the FTC in their June 2005 report on gasoline price changes *"The world price of crude oil is the most important factor in the price of gasoline. Over the last 20 years, changes in crude oil prices have explained 85 percent of the changes in the price of gasoline in the U.S."*[4]

So, when consumers pull up at the gasoline pump, they should know that the price they pay reflects not just the costs to refine and distribute and retail gasoline – costs which have been trending downward - but also a world market for crude and the competition for supplies in that market.

### The GAO report

With this backdrop in mind, let's turn to the report of the General Accounting Office regarding mergers, issued in 2004.[5] The GAO was asked examine the price effect of the wave of mergers that occurred in the U.S. oil and natural gas industry in the 1990s. They found that *"increased market concentration generally led to higher whole gasoline prices in the U.S. from the mid-1990s through 2000."* GAO's results are measured to within fractions of a cent. It found, for example, that wholesale prices for *"conventional gasoline increased by less than one-half cent per gallon, on average from 1994 through 2000. The increases were larger in the West than in the East—the increases were between one-half cent adone cent per gallon in the West, and about one-quarter cent in the East (for branded gasoline only) on average."* (p.11). Given the number of mergers GAO attempted to analyze at once, and the limitations of the data available to it, as well as the approach it used in its analysis, there is simply no way it could trace price effects with sufficient credibility.

The FTC, in a statement issued by Chair Timothy J. Muris shortly after its release,

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[3] FTC, "The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement, August 2004, p.5.
[4] FTC, "Gasoline Price Changes: The Dynamic of Supply, Demand, and Competition," June 2005
[5] GAO, "Effects of Mergers and Market Concentration in the U.S. Petroleum Industry," May 2004.

had this to say about the GAO report:

*"In 30 years as an antitrust enforcer, academic, and consultant on antitrust issues, I have rarely seen a report so fundamentally flawed as the GAO study of several oil mergers that the Federal Trade Commission investigated under by predecessor, Robert Pitofsky. As the Commission unanimously said in its August 2003 letter to the GAO, this report has major methodological mistakes that make its quantitative analyses wholly unreliable; relies on critical factual assumptions that are both unstated and unjustified; and present conclusions that lack any quantitative foundation. As a result, the report does not meet GAO's own high standards of "accountability, integrity, and reliability" that one expects from its reports and publications."*[6]

At the heart of the problem with the GAO's approach is the idea of causality. Essentially, GAO arrived at its conclusion that the mergers that occurred during the 1990s increased the wholesale price of gasoline by measuring the difference between the price a refiner pays for crude oil and the price of the gasoline sold at the refiners rack. It measured this price for a period before the mergers took place and for a period after the mergers, and saw an increase after the merger and concluded the merger was the cause.

This approach is surprisingly simplistic and misguided. It only accounts for a refiner's crude costs; it leaves out all the costs incurred by a refinery, such as capital costs, energy costs, and labor costs. And it does this at a critical juncture in the history of U.S. refineries – just when massive investments in capital expenditures were being made by refineries to comply with the 1990 Clean Air Act. Between 1994 and 2003, for example, the refining sector spent $47 billion on environmental expenditures alone. Furthermore, GAO dismissed the need to examine these other costs because, it said, "these inputs comprise a small share of the inputs used to produce gasoline" since "crude oil costs constitute about 66 percent of total refining costs." (GAO, p.1 15). When results are measured in pennies and fractions of pennies, as GAO's are, leaving out 34 percent of the equation is a stunning omission. (Chart 5)

The GAO also completely ignored the introduction of new types of gasoline. Over the period studied, the first two phases of the Clean Air Act provisions were introduced that required two new more costly blends of reformulated gasoline. Also, over the period several new higher cost "boutique" blends of gasoline were introduced. GAO ignored this cost increase and simply attributed the rise in price due to the mergers.

In addition, the cost of crude oil will vary as a share of the cost to refiners. It is not always 66 percent. It depends, in large measure, on the price of the crude, as well as capital costs, energy cost and labor costs. This can and does vary quite a bit. There was a lot of volatility in the price of crude oil at exactly the time of the mergers. In 1998, for example, the price of crude dropped to just $10 a barrel, from around $20 a barrel. Anytime you have sharp changes in crude prices, you'll see price adjustments being made at varying speeds and heights throughout the wholesale and retail market. Chart 6 offers an idea of the complexity of the distribution chain.

Also, there are a number of different kinds of crude oil and different prices for these

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[6] "Statement of Federal Trade Commission Chairman Timothy J. Muris on the GAO Study on 1990s Oil Mergers and Concentration Released Today," May 27, 2004, www.ftc.gov/opa/2004/05/gaostatement.htm

crudes. The GAO used the price of West Texas Intermediate crude for its analysis. This is a reference spot market price. A better measure of what U.S. refiners actually pay for their crude oil is to use the refiner's composite acquisition cost. This is a volume-weighted average of the price of domestic crude oil and imported crude oil. Domestic crude oil is more expensive, on average, than the heavier imported crudes. That differential was growing in the 1990s. At the same time, refineries were becoming more technologically sophisticated in order to produce cleaner-burning fuels. The most advanced of them were able to take advantage of the growing difference in price between the lighter crude and the heavier imports and process more of the heavier cheaper imports (See Charts 7 and 8). We can see from these charts that if we are measuring changes in the difference between a refiner's rack and the WTI price, we'll get a different answer than if we use one of the other crude prices. The results vary by several cents per gallon. This is important to note because the GAO's results are measured to within fractions of a cent. This kind of precision, given the variables the GAO measured, is simply not credible.

### Refinery utilization rates

This isn't the only problem with its analysis. GAO's interpretation of inventory information and refinery utilization rates is uninformed. For example, it correlates *national* refinery utilization rates with city rack prices. It does this because it said that regional data was not available. This is inaccurate. The national utilization rate is an inadequate choice for studying local markets. GAO was apparently unaware that weekly regional utilization rates *are* available for the 12 refining districts from both API and the Energy Information Administration.

Refinery utilization rates are high. Typically, they average over 90 percent of their capacity. For most industries, utilization rates are in the 80 percentile. Refinery utilization rates peaked in the late 1990s because capacity additions and imports took some pressure off the need to run refineries so hard. They have since climbed back up to 93 percent in 2004, and even with the devastation from hurricanes Katrina and Rita, managed to averaged 90.4 percent in 2005. (See Chart 9).

Refinery utilization rates will fluctuate widely during the year and in different parts of the country for different reasons. In a typical year, refineries shut down for routine maintenance before they gear up to produce a new slate of products. So, for example, refiners will shut their operations down in the fall in advance of the winter season and will start producing more distillate for heating oil and less gasoline than they will in the spring and summer months when the demand for gasoline is at its peak. This process became increasingly complicated during the 1990s because of the number and variety of new fuel specifications being introduced during that time in response to the Clean Air Act. Different cities, counties, and states adopted different fuel specifications with different implementation dates. This added to the volatility of gasoline prices during that time. It truly complicates the job of discerning merger price impacts from fuel specification impacts.

Even if the GAO had used the refining districts for its analysis, rather than national averages, its analysis would not account for such things as "formulation changes, supply

disruptions, refinery outages, and changes in imports." (FTC to GAO, p.178). It is not enough to have a utilization rate and a price and from that infer some relationship. We really need to know the information behind that rate or the correlation is meaningless.

### Inventories

Another variable the GAO relied on to explain the availability and price of gasoline at the wholesale level is an inventory ratio, which the GAO defined as "the ratio of gasoline inventories to expected demand." (p.115) GAO apparently intended inventory levels as a proxy for "supply" or the supply curve, but in reality the supply curve includes not just the potential to draw from inventories, but the potential for refineries to produce gasoline and the potential for imports.

The ratio does not account for something as simple as the summer/winter blend difference for gasoline. Summer blends tend to be more costly to produce because evaporation must be reduced, which leads to more costly inputs to keep octane levels up. That doesn't have anything to do with the inventory ratio used by GAO, and strongly suggests there may be a type of seasonal price variation that would not be captured by that variable.

In addition, changes in inventory holding costs can affect inventory levels. For example, when oil prices are high, a refiner might decide to hold a smaller inventory and rely more on producing gasoline when needed. This might be more a reflection of the prices and not have any direct relationship to the tightness or slackness in the gasoline market. Also, there has been a steady decline in privately held inventories for many years, reflecting growing efficiencies of operations and the steady decline in the market share of several products with high seasonal fluctuation (residual fuel for electricity generation and distillate for home heating, for example). In short, GAO's simplistic assumption that "prices will increase if inventories are low relative to demand and decrease if inventories are high relative to demand" (p.115) does not sufficiently capture the *reasons* for changes in inventories and has the causality of the relationship backward.

### GAO Silent on Retail Price Effects of Mergers

Finally, we find it surprising that GAO never once mentions the retail price of gasoline in the areas it measured wholesale prices. That would be one of the first things most analysts would check wholesale price results against. GAO's silence on this is telling. No doubt a spot check would show results all over the board.

The bottom line is that the consolidation that occurred in the oil and natural gas industry in the 1990s took place as a consequence of economic pressures and regulatory requirements. These catalysts for change forced companies to realize economies of scale and to cut costs further. Evidence of the savings from this effort can be found in measurements of the downward trend in refining and marketing margins. These savings have been passed along to consumers. The market is healthy and very competitive.

### The Market works

Because the market does remain healthy and competitive, it is imperative that it be permitted to continue functioning as freely of artificial restraints as possible. As we have consistently maintained, the answer to our energy situation is to increase supply, reduce demand and expand and diversify infrastructure.

In attempting to meet the challenges we face, it is also important to do no harm. The worst thing Congress could do now would be to repeat the mistakes of the past by overriding the structures of the free marketplace. Imposing new controls, allocation schemes, new taxes on industry, or other obstacles will only serve to make the situation much worse.

### Company earnings in perspective

It is evident that much of the renewed focus on industry consolidation is a result of both the higher prices of various fuels as well as the perception that the industry is reaping windfall profits. It is our hope that a better understanding of those earnings and how they compare with other industries will discourage potentially harmful action on the part of our national leadership. The oil and natural gas industry is among the world's largest industries. Its revenues are large, but so are its costs of providing consumers with the energy they need. Included are the costs of finding and producing oil and natural gas and the costs of refining, distributing and retailing it.

The energy Americans consume today is brought to us by investments made years or even decades ago. Today's oil and natural gas industry earnings are invested in new technology, new production, and environmental and product quality improvements to meet tomorrow's energy needs. *Oil & Gas Journal* estimated that the industry's total U.S. spending in 2005 was $85.7 billion, compared with $80.7 billion in 2004 and $75.5 billion in 2003. It also estimated that exploration and production spending in the U.S. grew 6 percent and that total upstream oil and gas spending in the United States was nearly $66 billion.

The industry's earnings are very much in line with other industries and often they are lower. This fact is not well understood, in part, because the reports typically focus on only half the story – the total earnings reported. Earnings reflect the size of an industry, but they're not necessarily a good reflection of financial performance. Earnings per dollar of sales (measured as net income divided by sales) provide a more relevant and accurate measure of a company's or an industry's health, and also provide a useful way of comparing financial performance between industries, large and small.

For the third quarter of 2005, the oil and natural gas industry earned 8.2 cents for every dollar of sales compared to an average of 6.8 cents for all U.S. industry. For the second quarter of 2005, the oil and natural gas industry earned 7.7 cents for every dollar of sales compared to an average of 7.9 cents for all U.S. industry. Over the last five years, the oil and natural gas industry's earnings averaged 5.8 cents compared to an average for all U.S. industry of 5.5 cents for every dollar of sales. (See Charts 10 and 11)

It is also important to understand that those benefiting from healthy oil and natural gas industry earnings include numerous private and government pension plans, including

401K plans, as well as many thousands of individual American investors. While many shares are owned by individual investors, firms, and mutual funds, pension plans own 41 percent of oil and natural gas company stock. (See Chart 12) To protect the interest of their shareholders and help meet future energy demand, companies are investing heavily in finding and producing new supplies and in new refinery capacity.

### Questions about royalties

We would also like to briefly address the question of royalties paid by the oil and natural gas industry to the federal government because the issue has been in the news lately.

By statute, royalties are paid on "value of production," a wellhead concept, which may be different than the final selling price that increasingly occurs downstream from the wellhead. When this occurs, the costs of certain post-production costs such as transportation and processing must be deducted to arrive at the "value of production."

It is important to understand that the Gulf Coast – where much of this country's oil and natural gas production occurs – was hit by two major hurricanes that crippled production for months and caused the loss of more than 100 million barrels of crude oil production and more than 500 billion cubic feet of natural gas. If production is down, it is only natural that royalty payments would also be down. In addition, the hurricanes seriously disrupted electronic reporting toward the end of 2005.

In short, MMS sets the rules and companies comply with these rules. It is impossible to obtain a true picture of the royalties paid by the industry simply by looking – as recent news articles have done – on invalid assumptions and comparisons, misinterpreted government data and incomplete information.

Because the potential for misunderstanding of royalties is so great, the industry has strongly urged the adoption of an expanded RIK program, as authorized in the Energy Policy Act of 2005. The payment of royalties through the RIK program simplifies royalty obligations and ensures that government gets appropriate royalties. Expansion of this program would help eliminate any questions as to what the value of the fuel should be.

### Solutions

We should focus on increasing supplies and encouraging conservation. The Energy Policy Act of 2005 signals a first step in a much-needed effort to enhance energy security and ensure the reliable delivery of affordable energy to consumers. Nevertheless, much remains to be done.

We can no longer afford to place off limits vast areas of the Eastern Gulf of Mexico, off the Atlantic and Pacific coasts, and offshore Alaska. Similarly, we cannot afford to deny Americans consumers the benefits that will come from opening the Arctic National Wildlife Refuge and from improving and expediting approval processes for developing the substantial resources on federal, multi-use lands in the West.

In fact, we do have an abundance of competitive domestic oil and gas resources in the U.S. According to the latest published estimates, there are more than 131 billion

barrels of oil and more than 1000 TCF of natural gas remaining to be discovered in the United States.

Much of these oil and gas resources – 78 percent of the remaining to be discovered oil and 62 percent of the gas – are expected to be found beneath federal lands and coastal waters. The amount here is enough oil to power 55 million cars for 30 years AND heat 24 million homes for 30 years. And there is enough natural gas to heat 60 million homes that use natural gas for 120 years.

Federal restrictions on leasing put significant volumes of these resources off limits, while post-lease restrictions on operations effectively preclude development of both federal and nonfederal resources. Addressing these restrictions is critical.

And, while we must focus on producing more energy here at home, we do not have the luxury of ignoring the global energy situation. In the world of energy, the U.S. operates in a global marketplace. What others do in that market matters greatly.

For this country to secure energy for our economy, government policies must create a level playing field for U.S. companies to ensure international supply competitiveness. With the net effect of current U.S. policy serving to decrease U.S. oil and gas production and to increase our reliance on imports, this international competitiveness point is vital. In fact, it is a matter of national security.

Beyond easing the way for greater development of oil and natural gas, we must also address the nation's refinery capacity challenge. The record-high gasoline prices, while primarily caused by increased crude oil prices and exacerbated by Hurricanes Katrina and Rita, have underscored the fact that U.S. demand for petroleum products has been growing faster than – and even exceeds – domestic refining capacity. While refiners have increased the efficiency, utilization and capacity of existing refineries, these efforts have not enabled the U.S. refining industry to keep up with growing demand.

The U.S. refining industry has been expanding a little more than 1 percent per year over the past decade – the equivalent of a mid-size refinery being built each year. In order to create the opportunity for increasing the growth of U.S. refinery capacity, government policies are needed to create a climate conducive to investments to expand domestic refining capacity.

In addition, many of the steps the federal government could take to help the refinery capacity situation are covered in the December 2004 National Petroleum Council (NPC) study, *Observations on Petroleum Product Supply – A Supplement to the NPC Reports "U.S. Petroleum Product Supply – Inventory Dynamics, 1998" and 'U.S. Petroleum Refining – Assuring the Adequacy and Affordability of Cleaner Fuels, 2000."*

The NPC study suggested that the federal government should take steps to streamline the permitting process to ensure the timely review of federal, state and local permits to expand capacity at existing refineries.

For example, new-source review (NSR) requirements of the Clean Air Act need to be reformed to clarify what triggers these reviews. Some refineries may be able to increase capacity with relatively minor adjustments, but are unsure if the entire facility's permit review would be triggered – a burdensome and time-consuming process.

In addition to the administrative issues deterring new refining capacity investments, there are financial constraints as well. Attracting capital for new refinery capacity has been difficult with refining rates of return historically averaging well below the average for S&P Industrials. Over the 10-year 1994-2003 period, the return on investment for the refining and marketing sector was 6.2 percent or less than half as much as the 13.5 percent for S&P Industrials. In only one year between 1977 and 2003 did the average return of refiners exceed the average for the S&P Industrials.

While taking these factors into account, it is important to remember that the oil and natural gas industry operates in a global marketplace. Many oil and gas companies are global companies, whose U.S. investment decisions compete not only with decisions as to how to allocate capital investments in the U.S. among various sectors of the industry, but also with competing demands and investment needs overseas. In a global marketplace, companies will make the best economic investment decisions in order to bring affordable petroleum products to consumers. Imports may be the more economical option than new U.S. refineries, but that is a decision to be left to the global marketplace. Government policies must encourage, not interfere with, the global marketplace.

### Conclusion

The industry recognizes the frustration and hardship felt by consumers as a result of higher prices and a basic misunderstanding of industry earnings and the causes and effects of industry mergers. The market is healthy and very competitive.

Policymakers must resist efforts to override the structures of the free marketplace. Imposing new controls, allocation schemes, new taxes on industry, or other obstacles will only make the situation worse. Enactment of new tax measures on the oil and natural gas industry is counterproductive. Increases in taxes directly reduce investments in our nation's oil and natural gas resources, hamper the expansion of refining capacity, and put U.S.-based companies at a competitive disadvantage with foreign national oil companies, who control more than 90 percent of the world's oil and gas resources.

Addressing the nation's energy problems is an enormous long-term challenge. If we all do our part—industry providing energy products, government removing barriers and increasing access to supplies, and consumers using fuel more wisely—America will be able to sustain its economic growth.

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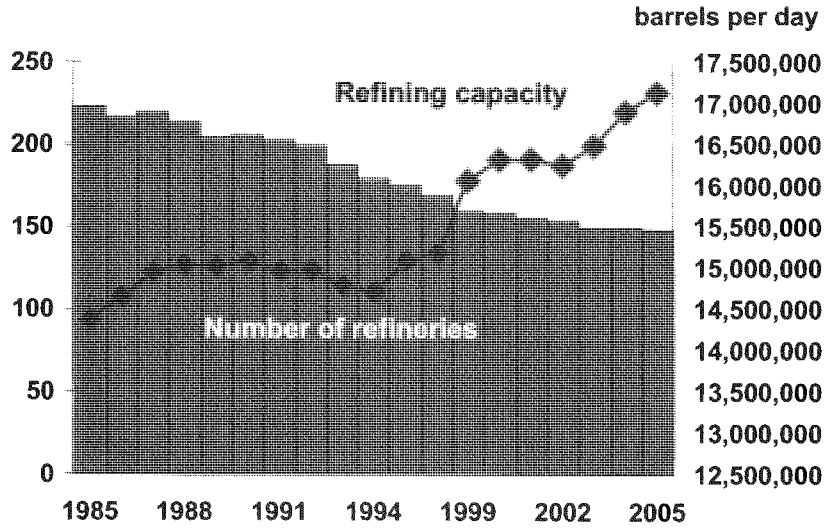
**Chart 1**

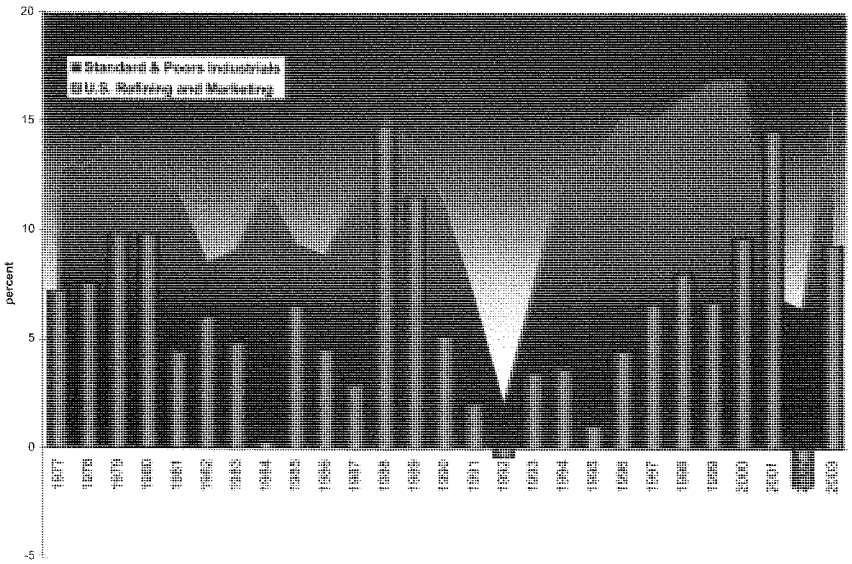



Source: EIA

**Chart 2**

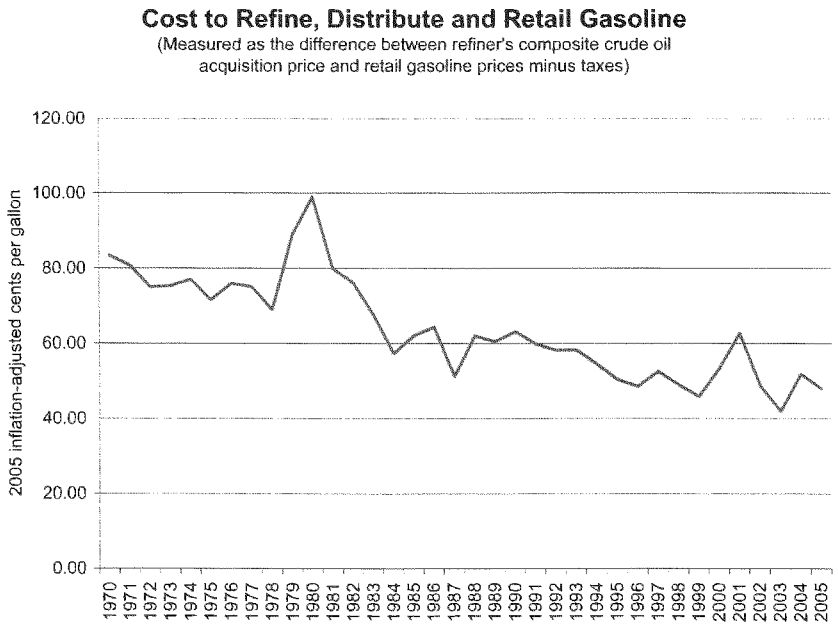
**Refiner's and S&P Industrials Return on Investment**

**(net income / net investment in place)**




Source: U.S. Department of Energy, Performance Profiles of Major Energy Producers

**Chart 3**




Source: EIA for crude and retail gasoline prices. API for taxes.

**Chart 4**

**Refinery concentration has increased since 1997, but remains in line with many other industries**

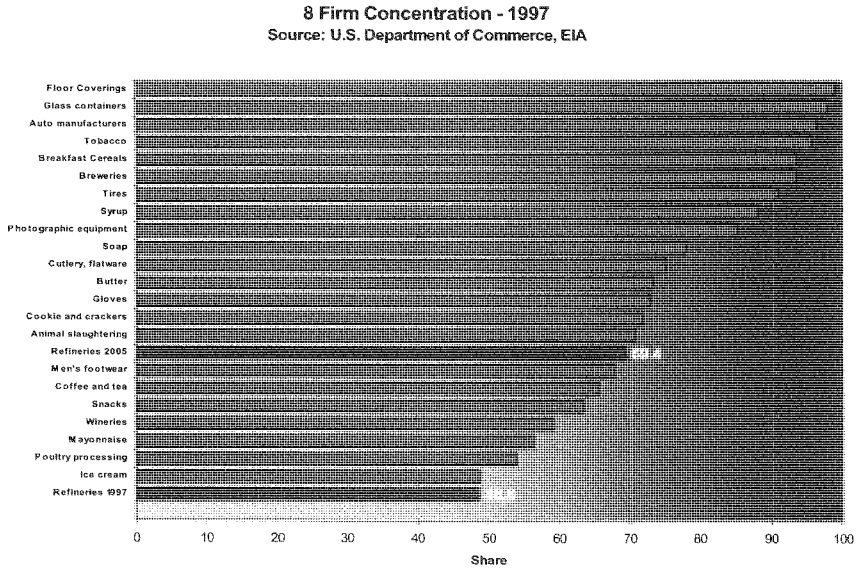
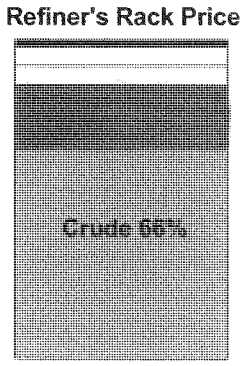


Chart 5

## Refiner's costs—GAO left out 34% of equation

Refiner's rack price less crude price

Before △ After = GAO attributes to merger impact




Energy 2%
Services 6%
Labor 6%
Capitol 20%

GAO assumed these costs were constant. They are not.

**Chart 6**

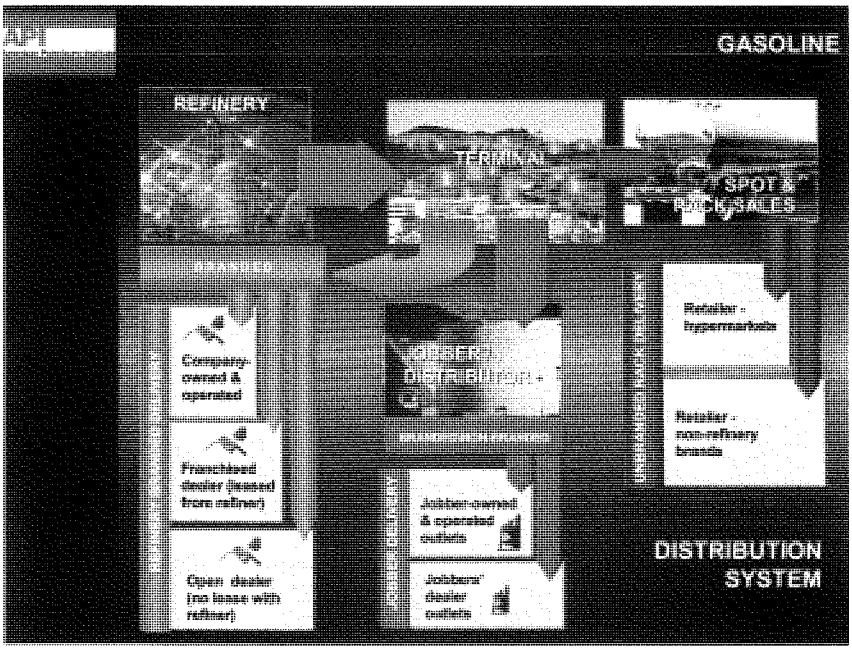
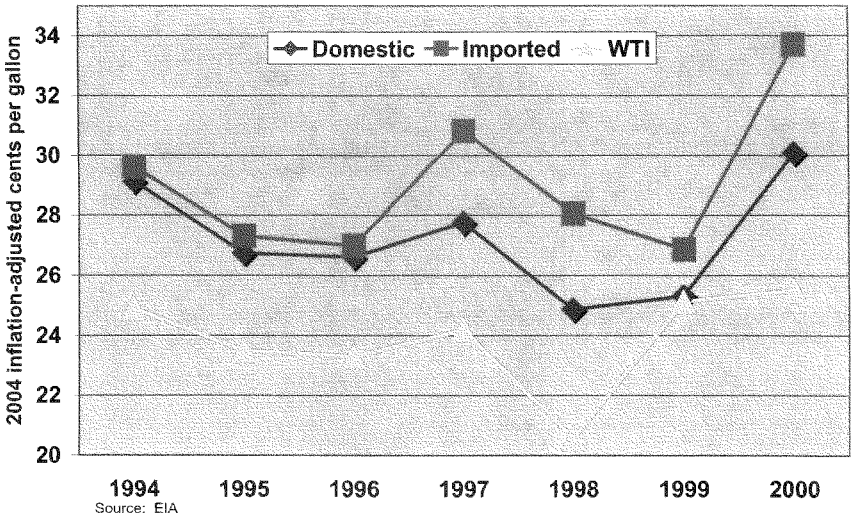

GASOLINE
REFINERY
TERMINAL
SPOT &
SALES
Company-owned & operated
Franchised dealer (leased from refiner)
Open dealer (no lease with refiner)
Jobber-owned & operated outlets
Jobbers' dealer outlets
Retailer - hypermarkets
Retailer - non-refinery brands
DISTRIBUTION SYSTEM

**Chart 7**

**Refiner Margins Differ by Crude Price**

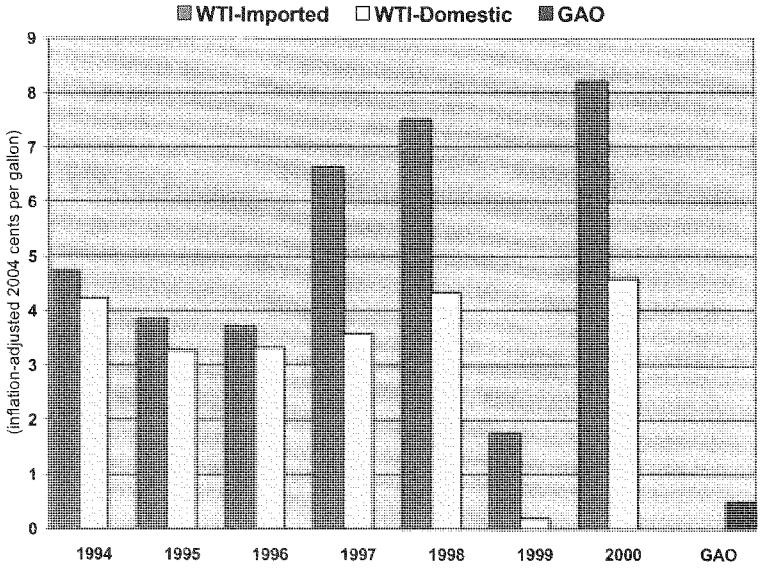
(measured as difference between price of crude oil and retail price of gasoline minus taxes)




Source: EIA

**Chart 8**

**Which crude price used to calculate a refiner's margin makes a big difference.**




Source: EIA WTI prices minus imported and domestic price of crude oil and GAO, "Effects of Merges and Market Concentration in the U. S. Petroleum Industry," May 2004..

**Chart 9**

**Refinery utilization rates**

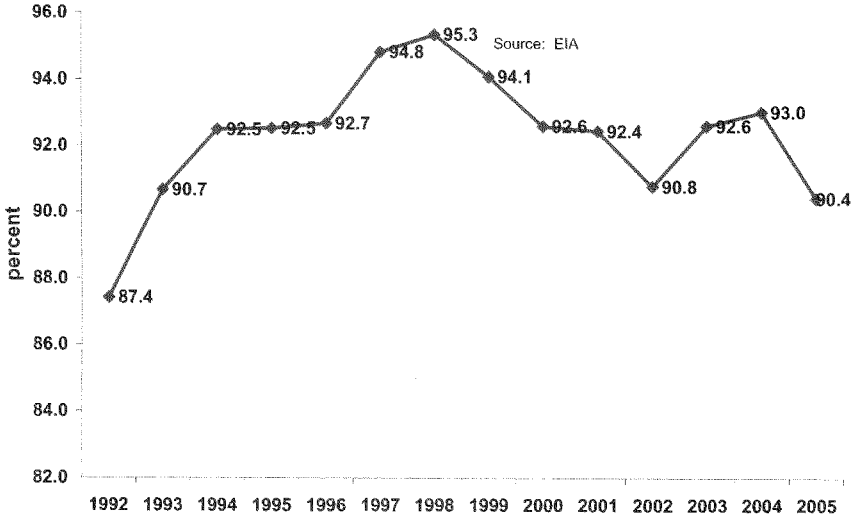
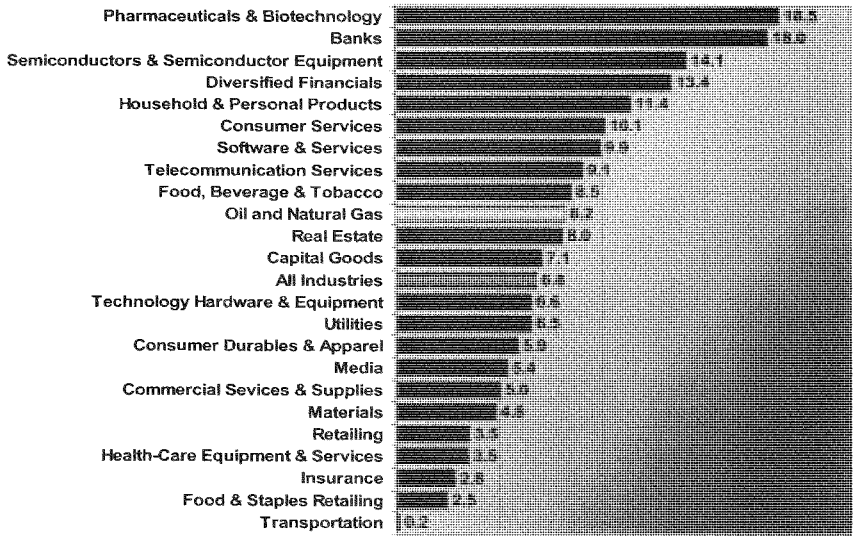


**Chart 10**

**3rd Quarter 2005 Earnings**

(cents per dollar of sales)

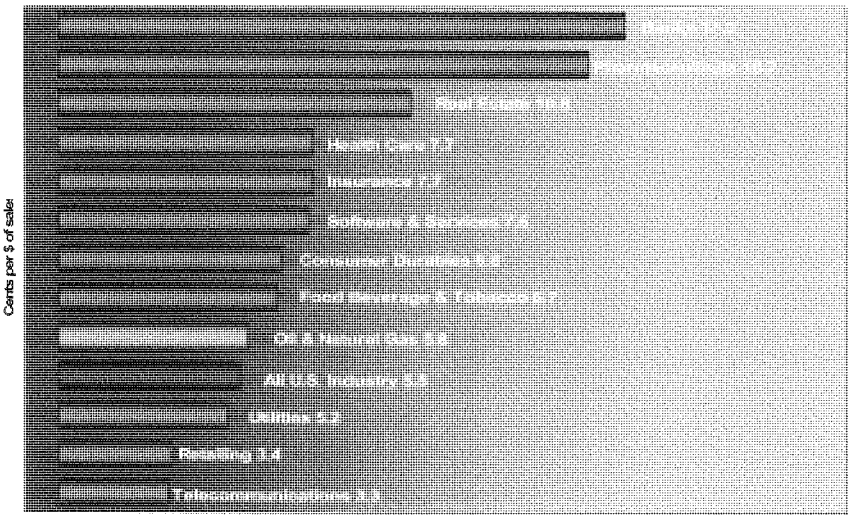



Source: Based on company filings with the federal government as reported by the Oil Daily for oil and natural gas and by PricewaterhouseCoopers LLP from data compiled by Standard & Poor's Compustat for all other industries.

**Chart 11**

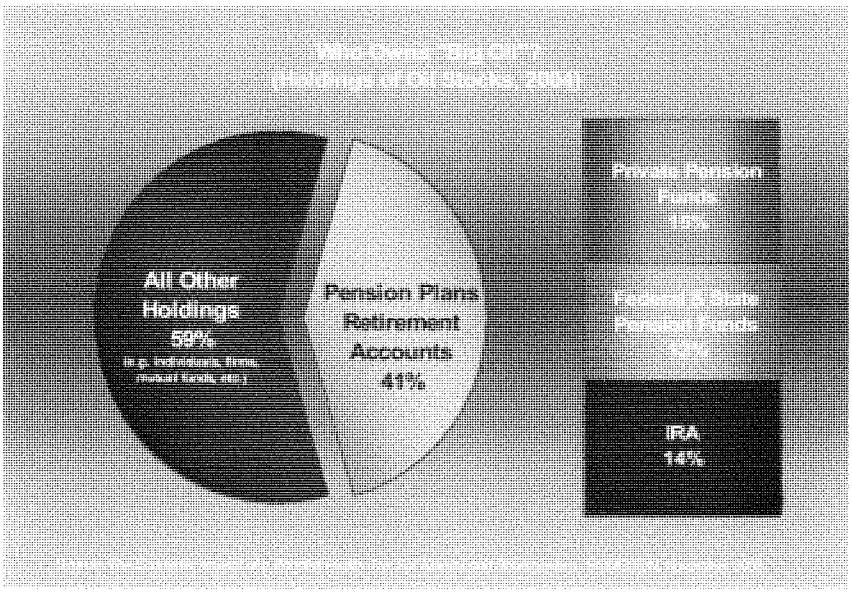
**Oil industry earnings are very much in line with other industries**

**Profit Averages - Last Five Years**
**(September 2000 - September 2005)**




Source: API calculations based on company filings with the federal government as reported by *Business Week*, the *Oil Daily* and PricewaterhouseCoopers LLP.

**Chart 12**


Who Owns Big Oil?
(Holdings of Oil Stocks, 2004)
All Other
Holdings
59%
Pension Plans
Retirement
Accounts
41%
Private Pension
Plans
10%
Federal & State
Pension Funds
10%
IRA
14%

RICHARD BLUMENTHAL
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Office of The Attorney General
**State of Connecticut**

***TESTIMONY OF***
***ATTORNEY GENERAL RICHARD BLUMENTHAL***
***BEFORE THE SENATE COMMITTEE ON THE JUDICIARY***
***FEBRUARY 1, 2006***

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.

REMARKS
JUDICIARY COMMITTEE HEARING
"Consolidation in the Energy Industry: Raising Prices at the Pump"
U.S. SENATOR MIKE DEWINE
FEBRUARY 1, 2006

Mr. Chairman, thank you for calling for this important hearing today. As we all know, our energy costs are soaring, and in my home state of Ohio, like most places in the United States, gas prices have been rising steadily. In Lima, Ohio, for example, regular unleaded gas was $2.39 per gallon; in Cleveland, it was $2.35; and in Columbus at some stations, it was over $2.37. Making matters worse, many analysts predict that these prices only will get higher in the coming months. Prices for home heating oil are on the rise, as well.

These price spikes hit all of us in our day-to-day lives, and hit the most vulnerable Americans the hardest. Even more frustrating, it seems that every day another oil company reports record-breaking profits, while American consumers pay higher prices. So, it's critical that we take steps to figure out the problem, and ultimately fix it.

As we all know, the price of crude oil is the largest single component of the price of gasoline. In fact, the Federal Trade Commission (FTC) estimates that changes in crude oil prices account for about 85 percent of the change in gas prices. Unfortunately, however, the crude oil market is notoriously unreliable. OPEC, an illegal international price-fixing cartel, controls a great deal of it, and many of the other significant sources of crude oil are found in extremely volatile parts of the world, controlled by governments that are often unfriendly to U.S. interests.

Our country, although blessed with great natural resources, is sorely lacking in crude oil. Try as we might, we can't drill our way out of this crisis. Crude oil prices, unfortunately, will remain out of our control. And, on top of that, demand continues to escalate -- not only from the United States and other established industrial nations, but most recently from the booming economies of China and India. This combination of unsteady supply and increasing demand is a sure recipe for price increases, and that is exactly what we have seen.

But, there are a range of other factors that affect gasoline and heating oil prices, as well, and one of the most controversial is the issue of mergers in the oil industry. Mergers, such as Exxon-Mobil, BP-Amoco, and Conoco-Phillips, have increased concentration levels throughout the industry, and especially in refining. Although many of those mergers have increased the efficiency of the remaining refineries, refineries currently are operating at about 90 to 95 percent of capacity today, which leaves the system with very little margin for error, as we saw after last year's hurricanes. Even worse, there is no solution on the horizon. Despite the high demand for gasoline, we haven't built a new refinery in over 25 years because of cost, environmental regulations, and local political opposition.

These mergers and the effects on refining and consumer prices have been a priority of the Antitrust Subcommittee, and Senator Kohl and I have worked together for years to preserve competition in the petroleum industry. We have conducted investigations into many of these

mergers and raised numerous concerns about them with the FTC. Additionally, we asked the FTC to institute a monitoring program within the industry to make sure that they could find and stop illegal price-gouging, which they have done and continue to do.

The FTC certainly has spent a great deal of time and effort investigating this industry, but some believe that increased concentration has increased consumer prices despite their efforts. Today's hearing is a good opportunity to examine whether our antitrust laws are being fully utilized to protect consumers and competition, and how we might do better in the future.

But, even if we conclude that increased consolidation in the petroleum industry has increased prices, it is clearly only a small part of the problem. The GAO, which will testify today, believes that consolidation has led to price increases, but even they only estimate a price increase of about 7cents/gallon -- at most -- as a result of the mergers. Others argue that the price effect is somewhat higher, but either way it is clearly not the biggest part of our problem. Our problem, as I have stated earlier, is crude oil; bluntly, we don't have enough of it, and we rely too much on it. We must take a much broader approach to our energy problem and limit our reliance on oil.

We have the ability to do just that. The United States does have one fossil fuel in great abundance -- and that's coal. Of course, coal brings its own challenges. We have all been horrified by the tragic deaths of the miners in West Virginia and Kentucky in the last few weeks.

As a member of the HELP and Appropriations Committees, I have participated in hearings on mine-safety issues, and I can't emphasize enough how we must take aggressive and prompt action to improve mine safety and protect the life and health of our miners. We need to invest the time and money to figure out how to mine coal more safely, burn it more cleanly, and use it to power our economy. Coal can work for America.

But, we need to go further than that.

We need to conserve. We need to increase fuel efficiency. And, we need to invest in safer nuclear technology, wind power, solar power, biomass and especially, in fuel cells. Northeast Ohio is a leader in developing fuel cell technology, and I have been very supportive of efforts to fund this technology. It is extremely promising.

Last night, in his State of the Union address, President Bush announced he would support a big increase in funding for a wide range of these energy options. Congress must support that effort. And of course, I would be remiss if I didn't remind the members of this Committee that we should send a signal to OPEC that their price-fixing won't be tolerated. The best way to do that is to pass the NOPEC bill, which Senator Kohl and I have written, which would make clear that the Department of Justice can prosecute OPEC for price-fixing.

Clearly, we have a lot to do on energy policy, generally. In the meantime, however, this hearing is an excellent opportunity to examine the smaller, but still very important, question of whether consolidation in the petroleum industry has led to higher prices, and if so, what we can do to improve competition and protect consumers from further price increases.

We need to make sure that our antitrust laws are being applied properly and eliminate any opportunities for companies in the petroleum industry to unduly increase the fuel prices we all pay.

On a final thought, Mr. Chairman, I want to say how disappointed I, too, am that the oil executives declined to attend our hearing today. It would be useful for the Committee to hear their views on fuel prices, and I hope we have that opportunity in the future.

Thank you, Mr. Chairman.

News From:

# U.S. Senator Russ Feingold

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## Statement of U.S. Senator Russ Feingold
## *At the Judiciary Committee Hearing*
## *On Consolidation in the Oil and Gas Industry*

**February 1, 2006**

I want to begin by thanking the Chairman and Ranking Member for holding this important hearing today. I would also like to thank the witnesses for agreeing to participate in today's discussion.

I am here this morning because I am deeply concerned about the high gasoline prices that are hurting Wisconsinites and consumers across the country. It's as if we are conducting an uncontrolled experiment into how far our constituents' pocket books can be stretched. That can't go on. It is time for the federal government to grab the reins back, conduct the necessary oversight over these energy markets, and adopt appropriate solutions. Our constituents are demanding action, and they deserve it.

Even a casual reader of the news knows that the oil industry is coming off a record-breaking year of profits, with one company (Exxon Mobil) becoming the most profitable company in U.S. history. As these profit reports come out, my constituents are asking many questions, such as why high prices don't seem to be bringing new investment in the oil and gas sector to increase the supply of refined petroleum products. They are also wondering when we are going to commit – in more than just buzz phrases – to a new energy policy that significantly reduces our dependence on oil.

Wisconsinites expect straight talk, and it is long past time that they got it from Congress and from the oil industry, which is unfortunately not present today.

I've been concerned about consolidation in the oil and gas sector for a while, just as I have been concerned about consolidation in the electricity sector due to repeal of the Public Utility Holding Company Act. I strongly opposed that step in the Energy Policy Act of 2005. The country is now seeing the consequences, and unfortunately, they are not positive.

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**Testimony of Timothy A Hamilton,**
**Senate Judiciary Committee**
**Washington, DC February 1, 2006**

Mr. Chairman, Honorable Members of the Committee, for the record my name is Tim Hamilton. I am the Executive Director of AUTO, a non-profit trade association of independent gasoline wholesalers and retailers that operate approximately 400 gasoline service stations and convenience stores in Washington State. I also serve as a consultant in the industry advising small businesses, trade groups, state government, and consumer groups such as the Foundation for Taxpayer and Consumer Rights (FTCR) based in Santa Monica, CA.

My career in the industry began when I bought my first Exxon gasoline station in 1974 in McCleary, Washington. When I tried to order my first load of gasoline Exxon refused to deliver and our little town experienced the gas lines of the Arab Oil Embargo era previously only seen on television. I subsequently operated a Shell station near Aberdeen where I experienced the reappearance of gas lines a second time in 1980. The last station I operated was a Union 76 station in our state capitol of Olympia.

I appreciate the invitation to testify before the committee. At least in my industry, I believe it extremely important that public policy makers recognize that the federal antitrust laws no longer provide the protections anticipated by its drafters.

Decades of consolidation, regulatory lobbying and legal maneuvering by the industry following federal decontrol in 1981 has resulted in formation of international corporations that dwarf the Standard Oil Trust and other monopolies that gave birth to the antitrust concept. One can hardly criticize the drafters for failing to anticipate the evolution of PC computers, internet communications and other modern technology that currently allows the industry to legally use tacit collusion that nearly mirrors the monopolistic powers of the Standard Oil Trust. The same applies to envisioning that the industry would use environmental initiatives to meet, divide up markets, and create barriers to entry and other anti-competitive institutions.

My career in governmental affairs and public policy began in 1984 when I formed AUTO and lobbied passage of the Washington Gasoline Dealers Bill of Rights (RCW 19.120). Since then I have experienced near continuous interaction in industry litigations, antitrust regulatory actions, and responded to requests for assistance from federal, state, and local elected officials in WA, OR, HI, CA, AZ, NV, MT, MI, and the Provincial Governments in Quebec and Nova Scotia. I sat on the California Attorney General's Task Force on Gasoline Prices and provided expertise to the California Energy Commission.

During regulatory reviews of mergers and acquisitions in the industry, I often interacted with the Merger and Acquisition Division of the FTC. The experience was disturbing as antitrust theories of the FTC often lacked common sense. As an example, one FTC

counsel explained to me that if one company controlled every gas station in WA, OR, and CA the FTC would not object and further more, they wouldn't want to even know about it.

The mergers and acquisitions occurring within the petroleum industry has greatly reduced competition between oil companies. The first region to fully feel the effects was the West. The competitive decline created an oligopoly, which is defined as "A market condition in which sellers are so few that the actions of any one of them will materially affect price and have a measurable impact on competitors."

The oil companies themselves provided insight into the dangers presented by oligopolies. In opening arguments in the antitrust suit filed by the state of Hawaii against the companies in 1998, the attorney leading off for the companies explained high pump prices with ***"Once you decide it's an oligopoly, you've got an explanation for the phenomenon of the high prices, the high margins, the high profits, the lack of vigorous price competition. That explains it all."***

The failure of federal antitrust law to fully consider all the impacts of a worldwide merger has been troubling as well. The review process concentrates on the combined market share created by a consolidation of assets of the two companies in a particular region. If the consolidation exceeds a certain level, divestitures are required to bring the number in line with antitrust review levels adopted in the 80's. Seeming missing from this exercise was recognition that these mergers could create economic incentives for oil companies to create artificial shortages that resulted in regional price spikes that inflated company profits.

Using BP's acquisition of Amoco and ARCO as an example, prior to the merger if ARCO or other refiners in the West failed to provide enough gasoline or diesel the price would rise. The increase in price created a financial incentive for those not doing business in the region to ship in gasoline. AMOCO could ship in supplies from the Midwest and BP could bring it from refineries in the Far East. The same example applies to ConocoPhillips, which were Conoco, Phillips 66, and Union 76 prior to their mergers.

Following the mergers, BP lost the financial incentive to ship in gasoline from its previously acquired Amoco refineries in the Midwest during a price spike in the West. Such an action would undermine the higher price the company was receiving for gasoline made in its newly acquired Arco refineries in LA and Puget Sound. The same would occur for the managers at ConocoPhillips who be reluctant to ship in gasoline in amounts adequate to lower the prices as it would be enjoying increase margins at the former Union 76 refineries it acquired in LA and San Francisco.

The same problem exists when antitrust reviews fail to consider the international effects. The oil companies haven't built a new refinery in the U.S. in 30 years even though consumption has increased by 33 percent. The industry is quick to point out difficulties complying with environmental standards. Yet, the companies fail to mention new

refineries that could supply the needs of the Americas were not built in Canada, Latin America, or South America.

As an example, Shell sold half its Deerpark refinery in Houston, Texas to the government of Mexico. Instead of a new Mexican refinery supplying gas and diesel to the U.S. market, over a million gallons of unleaded fuel per day flowed out of Houston to eastern ports in Mexico before and after Katrina. Out West where farmers, loggers, and truckers were painfully paying over $3 per gallon for diesel, cargoes from refineries in WA, CA, and HI cruised south to unload in Mexican ports on the Pacific side.

The key to higher pump prices and increased profits for the companies lies buried in the "supply and demand" scenario. Simply put, if demand exceeds supply, prices go up. Unfortunately, this creates a conflict of interest between American consumers and the oil companies. The industry has a tremendous financial incentive to take steps that insure the supply does not exceed the supply.

A key ingredient for success was the removal of the refinery surplus existing in the U.S. at the time of decontrol. An internal Chevron memo publicly released by Senator Ron Wyden acknowledged the industry goals with "*A senior energy analyst at the recent API convention warned that if the US petroleum industry doesn't reduce its refining capacity it will never see any substantial increase in refinery margins.*" Similar memos from Texaco and Mobil discussed how the larger companies were closing down their refineries. The combined weight of the large companies was utilized to lobby for technical language in environmental rules that would discourage smaller competitors from operating refineries reduce supply by limiting competition from alternative fuels.

It is hard to believe drafters of antitrust laws envisioned an environmental regulatory process where a handful of companies could knowingly and legally sit down together in a "smoke-free room" to discuss limiting supply and competition. I am convinced that while unsuspecting regulatory staff acted as meeting facilitators, the industry used the opportunity to reached understandings on refinery retrofits that limited local refinery production and created barriers to entry for competitors.

Today, the industry acts in unison to limit supply as a means to drive up price. A key component is the large shared storage tank located near a refinery, pipeline, or seaport terminal where the companies commingle their gasoline or diesel. The companies use a complicated formula of contracts or exchange agreements to divide up the supplies produced locally or imported into the area. Computers at each company track the fuel supply of not only their inventory, but also the inventory of competitors throughout the entire region. Shipping and pipeline schedules are tracked to show when and where fuel will be exported or imported, the volumes involved, the impact on local inventories and the identification of the industry participant.

One company on its own or in concert with others can export, delay or divert scheduled imports, or cut back production at a local refinery. This independent actions draws down their portion of the supply in the shared tank. All the competitors are aware of the

shortfalls (often even before event occurs). The initiating company then starts raising prices directly or indirectly to its gasoline stations. Utilizing third party reporting services and internet technology, the other companies immediately recognize a price spike is underway and counter with increases of wholesale prices to their stations operators. Sometimes gasoline marketers will receive up to four changes in price in a single 24-hour period.

As the companies monitor each price increase from competitors on their computer screens, consumers see pump prices skyrocket across the region and complain bitterly of price fixing. Elected officials turn to the Federal Trade Commission (FTC) asking for investigations. The FTC typically issues a study report stating no illegal behavior was found and the oil companies kick out press releases proclaiming how "we didn't do anything wrong!"

Prior to Katrina, one of the best examples outside of the West occurred in the Midwest in 2000. A study I conducted with FTCR looked into the price run up in the Midwest following the introduction of an ethanol blend of cleaner burning fuel. The study concluded the companies profited by the price spike, which could have been avoided, if the companies had not taken measures to "short the market". While the American Petroleum Institute
issued a press release severely criticizing my conclusions, a short time later the Wall Street Journal, a Senate Investigation, and a reluctant sounding FTC independently seemed to confirm my observations of the following:

- the companies lowered historical gasoline production in the area following meetings and negotiations with the regulatory community on retrofitting refineries;
- the companies dramatically reduced local inventories in the shared tanks which triggered a price spike to slow consumption down to meet available supply; and
- at least one company admitted it intentionally withheld supplies available at its refinery outside the region to avoid undermining the high prices it was receiving at its Great Lakes region refinery.

Price spikes have become nearly annual events out West. The spike typically begin each year following a rash of exporting that empties those large shared storage tanks just in front of the increased demand that comes with the spring plant and kids getting out of school. Especially with diesel, the exporting shows how a loss of a very small percentage of supply can create a remarkable increase at the pump.

Our trade group first raised public attention to the exporting when it published an article titled "The parade of ships" in 1997. The article documented how the companies loaded ships with gasoline and nearly before the ships cleared the harbors in Seattle, San Francisco, and Los Angeles the price spiked at the pump across the West. Chevron and others placed distributors on allocation and limited deliveries to gas stations. I provided all the information to the FTC including the names of the ships and the jumps in price in

a letter dated 9/19/97 and received the expected thank you followed by no further response.

In 2004, the Orange County Register did a similar story as the companies admitted gasoline that could have been sold in the West found its way across the Pacific right before the spring drive. Not to be outdone, the LA Times reported how cargoes of ultra low sulfur diesel was exported out of CA to Chile in June of 2005 when diesel prices in the West were setting all time records.

It is important to note that very little trade secrets exist in the production and distribution of motor fuel. Rest assured, all of the oil companies can track their competitors exports, monitor refinery production levels, recognize the diversion of import cargoes to other locations and all the other factors that effect availability of supply and the price at the pump. The primary motivation for the companies claiming a need for confidentiality is to insure that the public is kept in the dark.

A CLASSIC EXAMPLE of frustration with antitrust law is the recent attempt by Shell Oil to close its highly profitable refinery in Bakersfield, California. Already short on fuel and home to some of the highest prices for diesel and gasoline, Shell attempted to bulldoze the refinery rather than sell it. During initial open meetings with effected employees, the Shell spokesman claimed the company would never sell the plant. The bulldozing was desired to prevent a new competitor from entering the market. The company claimed the decrease in production at Bakersfield was expected to increase profits for Shell at its remaining refineries in Puget Sound, Los Angeles, and San Francisco.

Shell's intentions alarmed the entire West. Elected officials pushed Shell to sell the refinery rather than close it and some asked the FTC to investigate. The company claimed it was losing money in Bakersfield and its wells in nearby California fields were running dry. The FTC agreed to investigate and announced its report would be completed sometime after Shell was scheduled to send the bulldozers through the refinery.

Shell's public comments and letters to Senator Boxer and others contained statements that were totally contradictory to prior statements reported by the effected employees. Further, internal Shell documents smuggled out by employees and posted by the FTCR at www.consumerwatchdog.org showed Bakersfield was receiving awards for its efficiency and earning profits in excess of those typically posted by its other refineries in the U.S. The gross discrepancy between Shell's written communications to elected officials and its own internal documents cast is a prime example of the reliability of industry statements.

The company was obviously "disappointed" that its employees disclosed the internal documents. After watching television broadcasts throughout California featuring interviews with employees sitting behind dark curtains explaining the companies intentions, Shell eventually sold the refinery to Flying J.

Ironically, the FTC subsequently issued an investigation report that seems to state that federal antitrust laws do not apply when a company decides to close a production facility. Fortunately, the report was not released until after the efforts spearheaded by California Attorney General resulted in a sale to a new operator. The FTC report encourage others to attempt to close refineries in the U.S. and if such occurs, undoubtedly cast a large shadow on any attempts by state AGs to protect regional supplies of gasoline or diesel.

As major participant in the debate, I personally feel that if the FTC had completed its efforts before Shell inked a deal with Flying J, the state of California could have found its legal position undermined by the FTC report. Ironically, my reading of the FTC report on Bakersfield finds it went beyond just explaining the limitations of existing laws in such matters. The report seems to attempt to provide Shell a public relations defense for its actions, which if correct is a disturbing testament to its orientation.

Often I am asked "How high will the prices go". My first response is to return a question with "Well, how much will you pay to get to work when the gas gauge is on empty?" I then add "Can't tell for sure, but one thing for certain is the oil companies are going to take this country on one heck of a ride over the next 5-10 years."

HERBERT KOHL
WISCONSIN

# United States Senate

WASHINGTON, DC 20510

**Statement of U.S. Senator Herb Kohl**
**"Consolidation in the Energy Industry: Raising Prices at the Pump?"**
**February 1, 2006**

Mr. Chairman, thank you for calling this hearing today. Let me begin by saying how disappointed I am that the representatives of the oil industry have refused to appear. It is simply unconscionable that the industry will not answer the concerns of the American people, through their elected representatives, about the historically high prices of gasoline and home heating fuels. Therefore, I urge the Judiciary Committee to issue subpoenas under its jurisdiction, as soon as possible, to compel the attendance of the industry CEOs.

Throughout the last few years, oil and gas prices have continued to spike upwards, repeatedly reaching new record highs. After retreating from last summer's record prices of more than $ 3.00 per gallon, gas prices are moving up once again. Yesterday the Milwaukee Journal Sentinel reported gas prices jumped 25 cents on Monday in the Milwaukee area, reaching nearly $ 2.50 per gallon. The national average price has risen 51% from its level just a year ago. And the price increases for home heating oil and natural gas are following close behind.

The pain felt by consumers from these price increases is real and it is growing. These price increases are a silent tax that steals hard earned money away from American consumers every time they visit the gas pump and every time they raise their thermostat to keep their family warm. In my home state of Wisconsin, the Governor recently estimated that families with an average annual income of $ 40,000 will pay $ 2,000 more this year to drive their cars and heat their homes than they did last year.

While consumers suffer from these price increases, the oil industry seems only to get richer and richer. Yesterday we all read the astounding news of ExxonMobil's profit reports – a profit of $ 10.7 billion for last quarter and more than $ 36 billion for all of last year. These were the highest profits ever recorded by a U.S. corporation. ExxonMobil is not alone -- just last week, Chevron reported that its fourth-quarter profit climbed 20 percent to $4.14 billion, a company record that continued the most prosperous stretch in the oil company's 126-year history.

The oil companies defend high energy prices as merely a reflection of higher worldwide crude oil prices, prices which they argue they must pass on to consumers. And there is no doubt that the selfish and illegal actions of the OPEC oil cartel raise the price for crude oil. But the basic question remains – why should paying higher prices for crude oil lead to record high profits for the companies that refine that oil?

- more -

One obvious answer is that oil companies are charging high prices – and gaining record high profits -- simply because they can. Every American needs to purchase gas to fuel our cars to get to work or school, and all of us need to heat our homes. Of course, we can expect private businesses -- like the oil companies -- to seek to charge the highest prices they can to get the maximum return for their shareholders. But energy is a necessity for millions of Americans, so our obligation in government is to protect consumers when the competitive market does not.

And the government is not doing nearly enough to protect consumers. Mergers and acquisitions in the oil industry – more than 2600 since the 1990s as counted by the GAO -- have left a dangerous level of consolidation in their wake. The GAO has found that this has led to higher gas prices. We need to ask the serious question as to whether our antitrust laws are sufficient – or are being sufficiently applied – to handle this level of consolidation.

This increased industry concentration has another effect. As demand and prices increase, we would expect refining capacity to expand if the market was competitive. Instead, numerous refineries have been closed – more than half of all those existing 25 years ago – and none have been opened for many years. Refinery capacity has become a bottleneck limiting supply and causing price spikes whenever an accident occurs. Indeed, oil industry critics argue that oil companies have chosen not to expand refining capacity in order to gain market power to keep prices high. And the statistics seem to bear this out – from 1999 to 2004 U.S. oil refiners increased the profits they made on each gallon of gas by 79%.

So it is time for us to think of new solutions and new policies to restore competition in the oil industry. We need to start by ending the refining bottleneck. That is why I have introduced S. 1979, a bill to direct the Secretary of Energy to establish and operate a strategic refining reserve. Second, oil companies should not be able to tighten supplies further in times of shortage by exporting needed fuels abroad. So I would urge passage of S. 1996, my bill to authorize the Secretary of Energy to stop the exportation of gasoline and home heating oil when the supply falls short at home.

Reform of our antitrust laws is needed as well. A first step would be passage of our NOPEC legislation to subject the members of the OPEC oil cartel to U.S. antitrust law. The increasing level of consolidation and record industry profits also leave little doubt that merger enforcement should be strengthened. In this regard, we should give serious consideration to revisions to the antitrust agencies' merger guidelines to take into account the special circumstances of the oil industry.

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

**Prepared Statement of the Federal Trade Commission**

**Petroleum Industry Consolidation**

**Presented by**
**William E. Kovacic**
**Commissioner**

**Before the**
**Committee on the Judiciary**
**United States Senate**

**February 1, 2006**

## I. Introduction

Mr. Chairman and members of the Committee, I am William 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 through our vigilant and comprehensive merger program.[1]

The petroleum industry plays a crucial role in our economy. 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 so carefully scrutinized by the FTC.

Recent events highlight the importance of the petroleum industry to consumers and the U.S. economy. Prior to Hurricane Katrina, increasing crude oil prices had resulted in rising gasoline prices during much of 2005. Despite these rising prices, the demand for gasoline during the summer of 2005 was strong and exceeded summer demand in 2004. Then, in this already tight market, Hurricanes Katrina and Rita severely disrupted the important Gulf Coast supply of crude oil and gasoline. At one point, over 95 percent of Gulf Coast crude oil production was shut in, and numerous refineries and pipelines were damaged, lacked electrical power, or had to be restarted.[2] In the week after Hurricane Rita, more than one-fourth of United States refining

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[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.

[2] *See* Minerals Mgmt. Serv., U.S. Dep't of the Interior, Release No. 3328, *Hurricane Katrina Evacuation and Production Shut-in Statistics Report as of Tuesday, August 30, 2005*, *at* http://www.mms.gov/ooc/press/2005/press0830.htm.

capacity was not operating. In the periods immediately following Katrina and Rita, gasoline prices rose sharply to $3.00 per gallon or more in many markets.

Substantially in response to the price effects of this massive supply disruption, demand for gasoline fell somewhat in the weeks after Hurricane Katrina. This reduced demand – together with increased gasoline output from refineries not affected by the hurricanes, the resumption of a sizeable fraction of production in the hurricane-damaged region, and increased gasoline imports – brought both wholesale and retail gasoline prices back down to pre-hurricane levels by the end of last November.[3]

Although we analyze each petroleum merger according to numerous market facts surrounding the transaction, an overall analysis of merger policy in the petroleum industry necessarily takes a longer and broader view. Over the past 20 years, the Commission's merger policy has been consistent across administrations. Applying sound principles of law and of economics, it has been designed and focused to prevent the accumulation and use of market power to the detriment of consumers.

Over the past two decades, the petroleum industry has undergone a structural upheaval, punctuated by a burst of large mergers in the late 1990s. A number of other industries also saw a large number of mergers in that time frame. However, certain forces unique to producing and distributing petroleum products have spurred the transformation of that industry. Technological,

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[3] Several refineries in the Gulf Coast area are still running at reduced capacity or remain inoperable. Yet, despite this reduced capacity, it appears that the rebound in gasoline prices that the country has experienced since early December has largely been attributable to rising crude oil prices, which have been affected by recent world events, especially in Iran and Nigeria. The Commission will examine this further in the course of the two investigations the agency is conducting pursuant to Congressional directives, described *infra* pp. 14-15.

economic, and regulatory factors have led toward reliance on a smaller number of larger, more sophisticated refineries that can process different kinds of crude oil more efficiently. The development of crude oil spot and futures markets has reduced the risks of acquiring crude oil through market transactions – as opposed to owning crude oil extraction and production assets – thus contributing to a decline in vertical integration between crude oil extraction and production and refining among the major oil companies. A number of major integrated firms have restructured to concentrate on one or more segments of the industry, and a number of unintegrated refiners or retailers have entered. Domestic crude oil production has fallen, and foreign sources have supplied an increasing share of the crude oil refined in the United States, thus enhancing the importance of competition in the world market for crude oil. That competition has intensified over the last decade with the dramatic increase in crude oil demand from newly industrializing countries.

**II. The FTC's Expertise in the Petroleum Industry**

Since the early 1980s, the FTC has been the federal antitrust agency primarily responsible for addressing petroleum industry competition issues. The Commission has closely scrutinized prices and examined any merger and nonmerger activity in the gasoline industry that had the potential to decrease competition and thus harm consumers. The Commission and its staff have developed expertise in the industry through years of investigation and research, pursuant to our primary function as a law enforcement agency tasked with preventing "unfair methods of competition,"[4] as well as mergers or acquisitions whose effect "may be substantially to lessen

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[4] Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45.

competition, or tend to create a monopoly."[5] Under Section 5 of the FTC Act and Section 7 of the Clayton Act, the agency has carefully examined proposed mergers and has blocked or required revisions[6] of any that have threatened to harm consumers by reducing competition.[7] Indeed, in 2004, the Commission released data on all horizontal merger investigations and enforcement actions from 1996 to 2003.[8] These data show that the Commission has brought more merger cases at lower levels of concentration in the petroleum industry than in any other industry. Unlike in other industries, the Commission has obtained merger relief in moderately concentrated petroleum markets.

In 2004, the FTC staff also published a study reviewing the petroleum industry's mergers

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[5] Section 7 of the Clayton Act, 15 U.S.C. § 18.

[6] FTC enforcement action has played an important role in the restructuring of the petroleum industry over the past 20 years. The Commission has allowed mergers to proceed when the overall transaction was efficient and procompetitive but has required divestitures to remedy the anticompetitive effects that might have arisen in particular relevant markets. These FTC orders permitted the merging firms to achieve the economic benefits of the transaction while curing the potential anticompetitive effects through divestiture to a third party.

[7] Since 1981, the FTC has filed complaints against 20 large petroleum mergers. In 13 of these cases, the FTC obtained significant divestitures (and in one of these cases, *Exxon/Mobil*, the Commission required the largest divestiture ever sought by the agency, including divestiture of over 2,000 retail stations and a refinery). Of the seven other matters, the parties in four cases abandoned the transactions altogether after FTC antitrust challenges; another 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; in another case, *Chevron/Unocal*, the FTC's order prohibits the enforcement of certain patent rights; and in the final matter, the Commission obtained dismissal of the complaint (*Aloha Petroleum*) based on changed circumstances that restored allegedly threatened competition.

[8] Federal Trade Commission Horizontal Merger Investigation Data, Fiscal Years 1996-2003 (Feb. 2, 2004), Table 3.1, *et seq.*; 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.

and structural changes as well as the antitrust enforcement actions that the agency has taken in the industry over the past 20 years.[9] This was the Commission's third such report since 1982.[10] Like its predecessors, the 2004 Report had two basic goals: to inform public policy concerning competition in the petroleum industry, and to make more transparent how the Commission analyzes mergers and other competitive phenomena in this sector.

Several themes emerged from the Commission's study of changes in the petroleum industry over the past two decades:

- Mergers of private oil companies have not significantly affected worldwide concentration in crude oil. This fact is important, because crude oil prices are the chief determinant of gasoline prices.

- Despite some increases over time, concentration for most levels of the United States petroleum industry has remained low to moderate.

- Intensive, thorough FTC merger investigations and enforcement have helped prevent further increases in petroleum industry concentration and avoid potentially anticompetitive problems and higher prices for consumers.

- Economies of scale have become increasingly significant in shaping the petroleum industry. The United States has fewer refineries than it had 20 years ago, but the average size and efficiency of refineries have increased, along with the total output of refined products.

- Industry developments have lessened the incentive to vertically integrate throughout all or most levels of production, distribution, and marketing. Several significant refiners have no crude oil production, and integrated petroleum

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

[10] *See* Federal Trade Commission, *Mergers in the Petroleum Industry* (Sept. 1982), *available at* http://www.ftc.gov/os/2004/08/040813mergersinpetrol82.pdf; Staff Report of the Bureau of Economics, Federal Trade Commission, *Mergers in the U.S. Petroleum Industry 1971-1984: An Updated Comparative Analysis* (May 1989), *available at* http://www.ftc.gov/os/2004/08/040813mergersinpetrol84.pdf.

companies today tend to depend less on their own crude oil production. In addition, a number of independent retailers purchase refined products on the open market.

- Some significant independent refiners have built market share by acquiring refineries that were divested from integrated majors pursuant to FTC enforcement orders.[11]

## III. Merger Enforcement in the Petroleum Industry

The Commission has gained much of its antitrust enforcement experience in the petroleum industry by analyzing proposed mergers and challenging transactions that likely would reduce competition, thus resulting in higher prices.[12] For more than 20 years, the FTC has been the federal antitrust agency primarily responsible for reviewing conduct in the petroleum industry to assess whether it is likely to reduce competition and harm consumer welfare. In this role, the FTC has devoted substantial resources to investigating and studying the industry. For example, during the period of large oil industry mergers in the late 1990s, the Bureau of Competition spent almost one-fourth of its enforcement budget on investigations in energy industries.

The Commission investigates every substantial petroleum industry merger. Many transactions, particularly smaller ones, raised no competitive concerns and required no

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[11] Last year the Commission issued a report on the various factors that influence the price of gasoline and other refined petroleum products. *See* Federal Trade Commission, *Gasoline Price Changes: The Dynamic of Supply, Demand, and Competition* (2005), *available at* http://www.ftc.gov/reports/gasprices05/050705gaspricesrpt.pdf. Lessons of this report included the findings that worldwide supply, demand, and competition for crude oil are the most important factors in the national average price of gasoline in the United States. Other important factors impacting retail gasoline prices include retail station density, new retail formats, environmental factors, state and local tax rates, and state and local regulations.

[12] Section 7 of the Clayton Act prohibits acquisitions whose effect "may be substantially to lessen competition, or to tend to create a monopoly" "in any line of commerce or in any activity affecting commerce in any section of the country." 15 U.S.C. § 18.

enforcement intervention. A case-by-case analysis is necessary to find the relevant markets in which competition might be lessened, to assess the likelihood and significance of possible competitive harm, and to fashion remedies to ensure that competition is not reduced in those relevant markets and consumers consequently are not harmed.[13] It is important to note that mergers can be, and often are, efficiency-enhancing and procompetitive.

The FTC's analysis of petroleum mergers follows the same Department of Justice/Federal Trade Commission Horizontal Merger Guidelines that the agencies use to analyze mergers in other industries.[14] Consistent with advances in economic learning and case law developments,

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[13] 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. GAO, *Energy Markets: Effects of Mergers and Market Concentration in the U.S. Petroleum Industry* (May 2004). The Commission regards evaluations of past enforcement decisions as valuable elements of responsible antitrust policymaking, and is supportive of the goal of the GAO inquiry – to evaluate the consequences of past decisions by the federal antitrust agencies. However, the Commission believes the GAO report suffered from a number of significant deficiencies. Although we will not recount all of the problems with the GAO Report that our staff has identified, we will describe three particularly significant deficiencies here. 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. Third, by 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. These mistakes and omissions significantly undermine the results of the GAO study. *See* Prepared Statement of the Federal Trade Commission Before the Committee on Energy and Commerce, Subcommittee on Energy and Air Quality, U.S. House of Representatives, *Market Forces, Anticompetitive Activity and Gasoline Prices – FTC Initiatives to Protect Competitive Markets* (July 15, 2004), *available at* http://www.ftc.gov/os/2004/07/040715gaspricetestimony.pdf.

[14] 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 ("Merger Guidelines"). Based on the results of joint DOJ/FTC workshops (held in February 2004) that assessed the practical efficacy of the Merger Guidelines in light of 12

although merger analysis begins with concentration data, emphasis is placed on qualitative factors that indicate whether a merger will increase the ability of the merging parties to exercise market power in one or more properly defined relevant markets[15] by curbing output unilaterally or by coordinating their behavior with rival suppliers.

Despite increases in concentration at some production levels over the last two decades, particularly since the mid-1990s, most sectors of the petroleum industry generally remain unconcentrated or moderately concentrated. In addition, the growth of independent marketers and hypermarkets has increased competition at the wholesale and retail levels in many areas.

Some mergers have led to increased concentration. An increase in concentration from a merger, however, is not by itself a sufficient basis for finding that a merger is anticompetitive. Where concentration changes raise concerns about potential competitive harm, the FTC conducts a more detailed investigation. When it has concluded that a merger is likely to reduce competition, the FTC has required divestitures or sought preliminary injunctions. Many of the mergers the FTC challenged would have lessened competition significantly if they had proceeded

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years of experience, FTC Chairman Majoras has announced that the FTC, along with DOJ, will develop a Commentary on the Merger Guidelines to bring greater transparency to the agencies' application of the Guidelines to merger analysis. The Commentary will clarify how the agencies apply the Guidelines and will enhance the dialogue between the agencies, businesses, legal advisors, and the public.

[15] The correct definition of a market in pre-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 must also determine the geographic area over which any anticompetitive effects will be felt. In our analysis of petroleum mergers, national, state, or PADD-wide "markets" rarely correspond to properly defined geographic markets. ("PADD" stands for "Petroleum Administration for Defense District." 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.)

as originally planned. Our antitrust remedies prevented those increases: through carefully crafted divestitures, the Commission has mandated the elimination of competitively problematic overlaps between the merging parties while allowing the competitively unobjectionable – or even efficiency-enhancing – portion of a transaction to proceed.[16]

Collectively, mergers have raised competitive concerns at all of the various levels of the petroleum industry, but the majority of FTC actions have targeted downstream activities, *i.e.*, refining, refined products pipelines, terminals, and marketing. The competitive concern generally has been that the merger would enable the merged firm to raise prices in a market for products that it sells to the next level of the industry (*e.g.*, refined products sold to wholesalers, or wholesale products sold to retailers) through either unilateral or coordinated behavior. A key element in assessing the potential for adverse competitive effects is to determine the alternatives available to customers, including whether more distant suppliers are viable options. Some enforcement actions have been based on a potential competition theory; some on competitive problems involving market power held by a buyer or a group of buyers; and some on vertical concerns relating to the ability of a single firm or a coordinating group of firms to raise the costs of other firms in the industry, to the injury of consumers.

Several recent investigations illustrate the FTC's approach to merger analysis in the petroleum industry.[17] An important recently completed case challenged Chevron's acquisition of Unocal. When the merger investigation began, the Commission was in the middle of a

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[16] *See also supra* note 6.

[17] The attached appendix shows every Commission merger enforcement action in the petroleum industry since 1981.

monopolization case against Unocal in which the FTC's administrative complaint alleged that Unocal had deceived the California Air Resources Board ("CARB") in connection with regulatory proceedings to develop the reformulated gasoline ("RFG") standards that CARB adopted. The complaint further charged that Unocal had 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.

The proposed merger between Chevron and Unocal raised the additional concern that, by unconditionally inheriting Unocal's patents through the acquisition, Chevron 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 settled both the merger and the monopolization matters with separate consent orders that compelled Chevron to forgo enforcement of the Unocal patents, thus preserving competition in all relevant merger markets and securing complete relief on the monopolization claim.[18]

Another merger case that resulted in a divestiture order resolved a complaint concerning the acquisition of Kaneb Services and Kaneb Pipe Line Partners (companies that engaged in

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[18] *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.

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. The complaint alleged that the acquisition had the potential to increase prices in bulk gasoline and diesel markets.[19] The FTC's divestiture 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.[20]

Most recently, the Commission filed a complaint on July 27, 2005, in federal district court in Hawaii, alleging that Aloha Petroleum's then-proposed acquisition of Trustreet Properties' half interest in an import-capable terminal and retail gasoline assets on the island of Oahu would have reduced the number of gasoline marketers and could have led to higher gasoline prices for Hawaii consumers.[21] To resolve this complaint, the parties executed a 20-year throughput agreement with a third party that will preserve competition allegedly threatened by the acquisition.[22]

In the past few years, the Commission has brought a number of other important merger

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

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

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

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

cases. One of these challenged the merger of Chevron and Texaco,[23] which combined assets located throughout the United States. Following an investigation in which 12 states participated, the Commission issued a consent order against the merging parties requiring numerous divestitures to maintain competition in particular relevant markets, primarily in the western and southern United States.

Another petroleum industry transaction that the Commission challenged successfully was the $6 billion merger between Valero Energy Corp. ("Valero") and Ultramar Diamond Shamrock Corp. ("Ultramar").[24] Both Valero and Ultramar were leading refiners and marketers of gasoline that met the specifications of the California Air Resources Board, and they were the only significant suppliers to independent stations in California. The Commission's complaint alleged competitive concerns in both the refining and the bulk supply of CARB gasoline in two separate geographic markets – Northern California and the entire state of California – and the Commission contended that the merger could raise the cost to California consumers by at least $150 million annually for every one-cent-per-gallon price increase at retail.[25] To remedy the alleged violations, the consent order settling the case required Valero to divest (1) an Ultramar refinery in Avon, California; (2) all bulk gasoline supply contracts associated with that refinery;

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[23] *Chevron Corp.*, FTC Docket No. C-4023 (Jan. 2, 2002) (consent order), *at* http://www.ftc.gov/os/2002/01/chevronorder.pdf.

[24] *Valero Energy Corp.*, FTC Docket No. C-4031 (Feb. 19, 2002) (consent order), *at* http://www.ftc.gov/os/2002/02/valerodo.pdf.

[25] *Valero Energy Corp*, FTC Docket No. C-4031 (Dec. 18, 2001) (complaint), *at* http://www.ftc.gov/os/2001/12/valerocmp.pdf.

and (3) 70 Ultramar retail stations in Northern California.[26]

An additional example is the Commission's 2002 challenge to the merger of Phillips Petroleum Company and Conoco Inc., alleging that the transaction would harm competition in the Midwest and Rocky Mountain regions of the United States. To resolve that challenge, the Commission required the divestiture of (1) the Phillips refinery in Woods Cross, Utah, and all of the Phillips-related marketing assets served by that refinery; (2) Conoco's refinery in Commerce City, Colorado (near Denver), and all of the Phillips marketing assets in Eastern Colorado; and (3) the Phillips light petroleum products terminal in Spokane, Washington.[27] The Commission's order ensured that competition would not be lost and that gasoline prices would not increase as a result of the merger.

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[26] *Valero Energy Corp., supra* note 26.

[27] *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. For example, 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 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.

Acquisitions of firms operating mainly in oil or natural gas exploration and production are unlikely to raise antitrust concerns, because that segment of the industry is generally unconcentrated. Acquisitions involving firms with de minimis market shares, or with production capacity or operations that do not overlap geographically, are also unlikely to raise antitrust concerns.

To sum up structural changes and merger enforcement policy in the last two decades, mergers have contributed to the restructuring of the petroleum industry but have had only a limited impact on industry concentration. The FTC has investigated all major petroleum mergers and required relief when it had reason to believe that a merger was likely to lead to competitive harm. The FTC has required divestitures in moderately concentrated markets as well as in highly concentrated markets.

**IV. Current FTC Activities in the Petroleum Industry**

In addition to its merger and nonmerger law enforcement work in the petroleum industry, the Commission continues to study this industry closely. Recently, Congress turned to the Commission to investigate whether businesses have manipulated markets and prices to the detriment of consumers. Section 1809 of the Energy Policy Act of 2005[28] mandates an FTC investigation "to determine if the price of gasoline is being artificially manipulated by reducing refinery capacity or by any other form of market manipulation or price gouging practices," while Section 632 of the Science, State, Justice, Commerce, and Related Agencies Appropriations Act of 2006[29] requires the Commission to investigate possible gasoline price gouging in the aftermath of Hurricane Katrina. In response to both legislative commands, the Commission has launched an investigation to scrutinize whether unlawful conduct affecting refinery capacity or other forms of illegal behavior have provided a foundation for price manipulation. The FTC staff is looking at pricing decisions and other conduct in the wake of Hurricane Katrina to understand what has occurred and identify any illegal conduct. The Commission issued civil investigative demands to

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[28] Pub. L. No. 109-58, § 1809, 119 Stat. 594 (Aug. 8, 2005).

[29] Pub. L. No. 109-108, § 632, 119 Stat. 2290 (Nov. 22, 2005).

a substantial number of companies in this investigation, and our lawyers and economists have been analyzing the data that we have collected, including information received from staff's contacts with the Department of Energy, the DOE's Energy Information Administration, and other government agencies. Although I cannot provide more complete details about this ongoing investigation, the Commission anticipates reporting to Congress on the findings of this investigation this spring. Any identification of unlawful conduct will result in aggressive FTC law enforcement activity.

**V. Conclusion**

The Federal Trade Commission has an aggressive program to enforce the antitrust laws in the petroleum industry. The agency has taken action whenever a merger or nonmerger 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 analyze and bring cases against any merger that is potentially anticompetitive, 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.

**FTC Merger Enforcement Actions in the Petroleum Industry Since 1981**

| Firms (Year)* | Markets Affected | Theory of Anti-competitive Effects | Concentration (HHI) | FTC Enforcement Action |
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| **Aloha/Trustreet (2005)**[1] | 1. Gasoline Marketing in Hawaii | Unilateral/ Coordinated | Post-merger 2744 Change 220 | Complaint resolved with 20 year terminal throughput agreement for new gasoline marketer |
| | 2. Gasoline Retailing in Oahu | Unilateral | Not publicly available | As above |
| **Chevron/Unocal (2005)**[2] | Marketing and refining of CARB RFG in California and smaller markets therein | Coordinated | Highly (HHI > 1800)or moderately concentrated (HHI > 1000) | Chevron's constrained from enforcing Unocal's patents on CARB RFG. |
| **Valero/Kaneb (2005)**[3] | 1. Terminaling of light products in the Philadelphia area | Coordinated | Post Merger >1800 (inferred) Change>50 (inferred) | Divestiture of Kaneb's three Philadelphia area terminals |
| | 2. Terminaling of light products in the Colorado Front Range | Coordinated | Post Merger >1800 (inferred) Change>50 (inferred) | Divestiture of Kaneb's West Pipeline system, including associated terminals |
| | 3. Terminaling of light products in Northern California | Coordinated | Post Merger >1800 (inferred) Change>50 (inferred) | Divestiture of two Kaneb terminals in Northern California |
| | 4. Terminaling of Ethanol in Northern California | Coordinated/ Vertical | Not publicly available | As above and information firewall and third party access terms required |
| **Shell/Buckeye (2004)**[4] | Terminaling of gasoline, diesel, and other light petroleum products within a 50-mile radius of Niles, Michigan | Coordinated | Post-merger 3600 Change 800 | Prior approval for acquisition of Western Michigan terminal required. |

[1] Complaint, filed in U.S. District Court, District of Hawaii, CV05-00471 (2005); FTC Press Release (September 6, 2005). Prior to the beginning of district court hearings, Aloha entered into a 20 year throughput agreement with Mid Pac Petroleum. Since this agreement resolved the FTC's concerns with the challenged transaction, the FTC asked the court to dismiss the complaint.
[2] Chevron/Unocal (2005), Complaint ¶¶ 13-19, Analysis of Proposed Consent Order to Aid Public Comment.
[3] Valero/ Kaneb (2005), Complaint ¶ ¶ 15-76; Analysis of Proposed Consent Order to Aid Public Comment.
[4] Shell/Buckeye (2004), Complaint ¶¶ 7-19, Analysis of Proposed Agreement Containing Consent Order to Aid Public Comment.

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| **Magellan/ Shell[5] (2004)** | Terminaling of light products in the Oklahoma City area. | Coordinated | Post-merger > 4300<br>Change > 1200 | Divestiture of Shell's Oklahoma City terminal assets |
| **Shell/Pennzoil Quaker State[6] (2002)** | Refining and marketing of paraffinic base oil in U.S. and Canada | Unilateral / Coordinated | Post-merger >2300<br>Change >700 | Divestiture of Pennzoil interest in lube oil joint venture; Pennzoil sourcing of lube oil from third party lube oil refiner frozen at current level |
| **Phillips/ Conoco[7] (2002)** | 1. Bulk supply (via refining or pipeline) of light petroleum products in eastern Colorado | Coordinated | Post-merger > 2600<br>Change > 500 | Divestiture of Conoco refinery in Denver and all of Phillips marketing assets in eastern Colorado |
| | 2. Bulk supply of light petroleum products in northern Utah | Coordinated | Post-merger > 2100<br>Change > 300 | Divestiture of Phillips refinery in Salt Lake City and all of Phillips marketing assets in northern Utah |
| | 3. Terminaling services in the Spokane, Washington area | Unilateral / Coordinated | Post-merger 5000<br>Change > 1600 | Divestiture of Phillips' terminal at Spokane |
| | 4. Terminaling services for light products in the Wichita, Kansas area | Unilateral / Coordinated | Post-merger > 3600<br>Change > 750 | Terminal throughput agreement with option to buy 50% undivided interest in Phillips terminal |
| | 5. Bulk supply of propane in southern Missouri | Unilateral / Coordinated | Post-merger 3700<br>Change > 1200 | Divestiture of Phillips' propane business at Jefferson City and E. St. Louis; contracts giving buyer nondiscriminatory access to market at Conway, KS |

[5] Magellan/Shell (2004), Complaint ¶¶ 8-15, Analysis of Proposed Consent Order to Aid Public Comment.
[6] Shell/Pennzoil-Quaker State (2002), Complaint ¶¶ 8-16, Analysis of Proposed Consent Order to Aid Public Comment.
[7] Phillips/Conoco (2002), Complaint ¶¶ 8-135; Analysis of Proposed Consent Order to Aid Public Comment.

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| | 6. Bulk supply of propane in St. Louis | Unilateral / Coordinated | Post-merger > 7700 Change > 1000 | As above |
| | 7. Bulk supply of propane in southern Illinois | Unilateral / Coordinated | Post-merger > 7700 Change > 1000 | As above |
| | 8. Natural gas gathering by pipeline in certain parts of western Texas and southeastern New Mexico (Permian Basin) | Unilateral[8] | Not publicly available | Divestiture of Conoco's gas gathering assets in each area |
| | 9. Fractionation of natural gas liquids at Mont Belvieu, Texas | Unilateral / Coordinated[9] | Not publicly available | Prohibitions on transfers of competitive information; voting requirements for capacity expansion |
| **Valero/UDS[10] (2001)** | 1. Refining and Bulk Supply of CARB 2 gasoline for northern California | Unilateral / Coordinated | Post-merger > 2700 Change > 750 | Divestiture of UDS's refinery at Avon, CA, bulk gasoline supply contracts, and 70 owned and operated retail outlets |
| | 2. Refining and Bulk Supply of CARB 3 gasoline for northern California | Unilateral / Coordinated | Post-merger > 3050 Change >1050 | As above |
| | 3. Refining and Bulk Supply of CARB 2 gasoline for state of California | Coordinated | Post-merger > 1750 Change > 325 | As above |
| | 4. Refining and Bulk Supply of CARB 3 gasoline for state of California | Coordinated | Post-merger >1850 Change > 390 | As above |
| **Chevron/ Texaco[11] (2001)** | 1. Gasoline marketing in numerous separate markets in 23 western and southern states | Coordinated | Post-merger range from 1000-1800 Change >100 to Post merger >1800 Change >50 (all inferred) | Divestiture (to Shell, the other owner of Equilon) of Texaco's interests in the Equilon and Motiva joint ventures (including Equilon's interests in the Explorer and Delta Pipelines) |
| | 2. Marketing of CARB gasoline in California | Unilateral / Coordinated | Post-merger range >2000 Change >50 | As above |

[8] Phillips owned 30% of Duke Energy Field Services (DEFS); DEFS and Conoco were the only gatherers in the Permian Basin. Phillips/Conoco (2002), Complaint ¶¶ 69-71.

[9] Phillips owned 30% of DEFS, with representation on its Board of Directors; DEFS held an interest in two of the four fractionators in the market. Conoco partially owned and operated a third, Gulf Coast Fractionators. The merger would have given the combined firm veto power over significant expansion projects and might have led to the sharing of competitively sensitive information. Phillips/Conoco (2002), Complaint ¶¶ 76-79

[10] Valero/UDS (2001), Complaint ¶¶ 13-21; Analysis of Proposed Consent Order to Aid Public Comment.

[11] Chevron/Texaco (2001), Complaint ¶¶ 12-57; Analysis of Proposed Consent Order to Aid Public Comment.

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| | 3. Refining and bulk supply of CARB gasoline for California | Unilateral / Coordinated | Post-merger 2000 Change 500 | As above |
| | 4. Refining and bulk supply of gasoline and jet fuel in the Pacific Northwest | Coordinated | Post-merger > 2000 Change > 600 | As above |
| | 5. Refining and bulk supply of RFG II gasoline for the St. Louis metropolitan area | Coordinated[12] | Post-merger > 5000 Change > 1600 | As above |
| | 6. Terminaling of gasoline and other light products in various geographic markets in California, Arizona, Hawaii, Mississippi, and Texas | Unilateral / Coordinated | Post-merger range >2000 Change >300 | As above |
| | 7. Crude oil transportation via pipeline from California's San Joaquin Valley | Coordinated | Post-merger > 3300 Change >800 | As above |
| | 8. Crude oil transportation from the offshore Eastern Gulf of Mexico | Unilateral[13] | Post-merger >1800 (inferred) Change >50 (inferred) | As above |
| | 9. Natural gas transportation from certain parts of the Central Gulf of Mexico offshore area | Unilateral / Coordinated[14] | Post-merger >1800 (inferred) Change >50 (inferred) | Divestiture of Texaco's 33% interest in the Discovery Gas Transmission System |
| | 10. Fractionation of natural gas liquids at Mont Belvieu, Texas | Unilateral / Coordinated[15] | Not publicly available | Divestiture of Texaco's minority interest in the Enterprise fractionator |
| | 11. Marketing of aviation fuels to general aviation in the Southeast U.S. | Unilateral / Coordinated | Post-merger > 1900 Change > 250 | Divestiture of Texaco's general aviation business to an up-front buyer |
| | 12. Marketing of aviation fuels to general aviation in the western U.S. | Unilateral / Coordinated | Post-merger > 3400 Change > 1600 | As above |

[12] Chevron held a 17% interest in Explorer Pipeline, and Texaco and Equilon (Texaco's joint venture with Shell) together held 36%. Explorer is the largest pipeline supplying bulk Phase II Reformulated Gasoline (RFG II) to St. Louis; at the time, Equilon also had a long-term contract that gave it control of much of the output of a local St. Louis area refinery. Chevron/Texaco (2001), Analysis of Proposed Consent Order to Aid Public Comment.

[13] Equilon owned 100% of Delta, and Chevron owned 50% of Cypress; these two pipelines were the only means of transporting crude from the Eastern Gulf of Mexico to on-shore terminals. Chevron/Texaco (2001), Analysis of Proposed Consent Order to Aid Public Comment.

[14] Texaco owned 33% of the Discovery Gas Transmission System; Chevron and its affiliate Dynegy together owned 77% of the Venice Gathering System, one of only two other pipeline systems for transporting natural gas from this area. Chevron/Texaco (2001), Analysis of Proposed Consent Order to Aid Public Comment.

[15] Chevron owned 26% of Dynegy, which held large interests in two of the four fractionators in the market, and had representation on Dynegy's Board of Directors; Texaco held a minority interest in a third. The merger might have exercise unilateral market power. Chevron/Texaco (2001), Analysis of Proposed Consent Order to Aid Public Comment.

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| **BP/ARCO[16] (2000)** | 1. Production and sale of Alaska North Slope ("ANS") crude oil | Unilateral[17] | Post-merger >5476<br>Change 2640 | FTC filed in federal District Court, then reached consent; divestiture of all of ARCO's Alaska assets[18] |
| | 2. Bidding for ANS crude oil exploration rights in Alaska | Unilateral[19] | Post-merger >1800 (inferred)<br>Change >50 (inferred) | As above |
| | 3. Transportation of ANS crude oil on the Trans-Alaska Pipeline System | Unilateral / Coordinated[20] | Post-merger >5600<br>Change 2200 | As above |
| | 4. Future commercialization of ANS natural gas (potential competition) | Unilateral / Coordinated[21] | Not applicable | As above |
| | 5. Crude oil transportation and storage services at Cushing, Oklahoma | Unilateral[22] | Post-merger >1849 for storage >2401 for pipelines >9025 for trading services<br>Changes >50 (inferred) | Divestiture of all of ARCO's pipeline interests and storage assets related to Cushing |
| **Exxon/ Mobil[23] (1999)** | 1. Gasoline marketing in at least 39 metro areas in the Northeast (Maine to New York) and Mid-Atlantic (New Jersey to Virginia) regions of the U.S. | Unilateral / Coordinated | Post-merger range from 1000-1800<br>Change >100 to Post-merger >1800<br>Change >50 (all inferred) | Divestiture of all Exxon (Mobil) owned outlets and assignment of agreements in the Northeast (Mid-Atlantic) region |

[16] BP/ARCO (2000), Complaint ¶¶ 10-66; Analysis of Proposed Consent Order to Aid Public Comment.

[17] BP had a 44% share of ANS crude oil production at that time, while ARCO had a 30% share, implying that their contribution to the HHI was 2,836. Their contribution to the post-merger HHI would have been 5476. BP/ARCO (2000), Analysis of Proposed Consent Order to Aid Public Comment.

[18] The ARCO Alaska assets divested included crude oil exploration and production assets, 22% interest in TAPS, and specialized tanker ships. BP/ARCO (2000), Analysis of Proposed Consent Order to Aid Public Comment.

[19] BP and ARCO together won 60% of the Alaska state lease auctions during the 1990s, while the top four bidders won 75%. BP/ARCO (2000), Analysis of Proposed Consent Order to Aid Public Comment.

[20] BP (50%) and ARCO (22%) both held interests in TAPS. Their contribution to the HHI would have been 2,984 pre-merger and 5,184 post-merger. There were five other owners of TAPS; Exxon held 20% (*see* note 20 *infra*), and the four others' shares are not publicly available; including Exxon and assigning the four other firms equal shares yields a lower bound for the HHI of 3,400 pre-merger or of 5,600 post-merger. BP/ARCO (2000), Analysis of Proposed Consent Order to Aid Public Comment.

[21] The FTC alleged that BP Amoco, ARCO, and Exxon Mobil were the only three companies that held "sufficiently large volumes of gas reserves to have the potential to develop those reserves for significant commercial use." BP/ARCO (2000), Analysis of Proposed Consent Order to Aid Public Comment.

[22] BP and ARCO together accounted for 43% of storage capacity, 49% of pipeline capacity, and 95% of trading services at Cushing. BP/ARCO (2000), Analysis of Proposed Consent Order to Aid Public Comment.

[23] Exxon/Mobil (1999), Complaint ¶¶ 8-54; Analysis of Proposed Consent Order to Aid Public Comment.

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| 2. Gasoline marketing in five metro areas of Texas | Unilateral / Coordinated | Post-merger range from 1000-1800 Change >100 to Post-merger >1800 Change >50 (all inferred) | Divestiture of Mobil's retail outlets and supply agreements |
| 3. Gasoline marketing in Arizona (potential competition) | Coordinated | Not applicable | Termination of Exxon's option to repurchase retail outlets previously sold to Tosco |
| 4. Refining and marketing of "CARB" gasoline in California | Unilateral / Coordinated | Post-merger 1699 Change 171 (measured by refining capacity) | Divestiture of Exxon's refinery at Benicia, CA, and all of Exxon's marketing assets in CA, including assignment to the refinery buyer of supply agreements for 275 outlets |
| 5. Refining of Navy jet fuel on the west coast | Unilateral / Coordinated | Post merger >1800 (inferred) Change >50 (inferred) | As above |
| 6. Terminaling of light products in Boston, MA and Washington, DC areas | Unilateral / Coordinated | Post merger >1800 (inferred) Change >50 (inferred) | Divestiture of a Mobil terminal in each area |
| 7. Terminaling of light products in Norfolk, VA area. | Unilateral / Coordinated | Post merger >1800 (inferred) | Continuation of competitor access to wharf |
| 8. Transportation of light products to the Inland Southeast | Coordinated[24] | Post-merger >1800 (inferred) | Divestiture of either party's pipeline interest |
| 9. Transportation of Crude Oil from the Alaska North Slope | Coordinated[25] | Post-merger >1800 (inferred) Change >50 (inferred) | Divestiture of Mobil's 3% interest in TAPS |
| 10. Terminaling and gasoline marketing assets on Guam | Unilateral / Coordinated | Post-merger 7400 Change 2800 | Divestiture of Exxon's terminal and retail assets on the island |
| 11. Paraffinic base oil refining and marketing in the U.S. and Canada | Unilateral / Coordinated | Post-merger range 1000 to 1800 (inferred) Change >100 (inferred) | Relinquishment of contractual control over Valero's base oil production; long term supply agreements at formula prices for volume of base oil equal to Mobil's U.S. production |

[24] Exxon owned 49% of Plantation Pipeline and Mobil owned 11% of Colonial Pipeline. Exxon/Mobil (1999), Complaint ¶ 13.

[25] Exxon and Mobil owned 20% and 3%, respectively, of the Trans-Alaska Pipeline System (TAPS), the only means oftransporting Alaskan North Slope (ANS) crude oil to the port facilities at Valdez, AK. Exxon/Mobil (1999), Complaint¶ 14.

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| | 12. Refining and marketing of jet turbine oil worldwide | Unilateral[26] | Pre-merger >5625 | Divestiture of Exxon jet turbine oil manufacturing facility at Bayway, NJ, with related patent licenses and intellectual property |
| **BP/ Amoco[27] (1998)** | 1. Terminaling of gasoline and other light products in nine separate metropolitan areas, mostly in the Southeast U.S. | Coordinated | Post-merger range >1500 ->3600 Change >100 | Divestiture of a terminal in each geographic market |
| | 2. Wholesale sale of gasoline in thirty cities or metropolitan areas in the Southeast U.S. and parts of Ohio and Pennsylvania | Coordinated | Post-merger range >1400->1800 Change >100 | Divestiture of BP's or Amoco's owned retail outlets in eight geographic areas; in all 30 areas jobbers and open dealers given option to cancel without penalty |
| **Shell/Texaco[28] (1997)** | 1a. Refining of gasoline for the Puget Sound area | Unilateral / Coordinated | Post-merger 3812 Change 1318 | Divestiture of Shell refinery at Anacortes, WA; Shell jobbers and dealers given option to contract with purchaser |
| | 1b. Refining of jet fuel for the Puget Sound area | Unilateral / Coordinated | Post-merger 5248 Change 481 | As above |
| | 2a. Refining of gasoline for the Pacific Northwest | Unilateral / Coordinated | Post-merger 2896 Change 561 | As above |
| | 2b. Refining of jet fuel for the Pacific Northwest | Unilateral / Coordinated | Post-merger 2503 Change 258 | As above |
| | 3. Refining of "CARB" gasoline for California | Unilateral / Coordinated | Post-merger 1635 Change 154 | As above |
| | 4. Transportation of undiluted heavy crude oil to San Francisco Bay area for refining of asphalt | Unilateral[29] | Not applicable | Ten year extension of crude oil supply agreement. |
| | 5. Pipeline transportation of refined light products to the inland Southeast U.S. | Coordinated[30] | Pre-merger >1800 | Divestiture of either party's pipeline interest |
| | 6. CARB gasoline marketing in San Diego County, California | Coordinated | Post-merger 1815 Change 250 | Divestiture to a single entity of retail outlets with specified individual and combined volume |

[26] Exxon and Mobil together accounted for 75% of worldwide sales, and 90% of worldwide sales to commercial airlines. Exxon/Mobil (1999), Analysis of Proposed Consent Order to Aid Public Comment.
[27] BP/Amoco (1998), Complaint ¶¶ 8-21; Analysis of Proposed Consent Order to Aid Public Comment.
[28] Shell/Texaco (1997), Complaint ¶¶ 10-37; Analysis of Proposed Consent Order to Aid Public Comment.
[29] The Texaco heated pipeline was the only pipeline supplying undiluted heavy crude oil to the San Francisco Bay area, where Shell and a competitor refined asphalt. Shell/Texaco (1997), Complaint ¶ 15.
[30] Shell owned 24% of Plantation Pipeline and Texaco owned 14% of Colonial Pipeline. Shell/Texaco (1997), Complaint ¶ 32.

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| | 7. Terminaling and marketing of gasoline and diesel fuel on the island of Oahu, Hawaii | Coordinated | Post-merger 2160 Change 267 | Divestiture of either Shell's or Texaco's terminal and associated retail outlets |
| **Sun/Atlantic[31] (1988)** | Terminaling and marketing of light products in Williamsport, PA and Binghamton, NY | Coordinated | Not publicly available | Divestiture of terminal and associated owned retail outlets in each area |
| **PRI/Shell[32] (1987)** | 1. Terminaling and marketing of light petroleum products on the individual island of Oahu, HI | Unilateral / Coordinated | Not publicly available | FTC won preliminary injunction in U.S. District Court; prior approval required for future acquisitions |
| | 2. Terminaling and marketing of light petroleum products on the individual islands of Maui, Hawaii, and Kauai in the state of Hawaii (potential competition) | Unilateral / Coordinated | Not publicly available | As above |
| **Conoco/ Asamera[33] (1986)** | 1. Bulk supply (from refineries and pipelines) of gasoline and other light products to eastern Colorado | Unilateral[34] / Coordinated | Not publicly available | FTC voted to seek preliminary injunction; parties abandoned the transaction |
| | 2. Purchasing of crude oil in the Denver-Julesberg Basin of northeastern Colorado | Unilateral | Not publicly available | As above |
| **Chevron/ Gulf[35] (1984)** | 1. Bulk supply of kerosene jet fuel in parts of PADDs I and III and the West Indies and Caribbean islands | Coordinated | Not publicly available | Divestiture of one of two specified Gulf refineries in Texas and Louisiana. |
| | 2. Transport of light products to the inland Southeast | Coordinated[36] | Not publicly available | Divestiture of Gulf's interest in the Colonial Pipeline |
| | 3. Wholesale distribution of gasoline and middle distillates in numerous markets in West Virginia and the South | Coordinated | Not publicly available | Divestiture of all Gulf marketing assets in six states and parts of South Carolina |

[31] Sun/Atlantic (1988), Complaint and Order.
[32] PRI/Shell (1987), Complaint ¶¶ 6-12.
[33] Conoco/Asamera (1986), Complaint that the Commission voted to pursue.
[34] The Preliminary Injunction Complaint in Conoco/Asamera alleged that the merger would create a dominant firm inthe relevant markets. Conoco/Asamera (1986), Complaint that the Commission voted to pursue ¶ 15.
[35] Chevron/Gulf (1984), Complaint ¶¶ 15-41.
[36] Gulf owned the largest share, 16.78%, of Colonial Pipeline, while Chevron owned the second largest share, 27.13%, of Plantation Pipeline, Colonial's only direct competitor. Chevron/Gulf (1984), Complaint ¶¶ 25-26.

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| | 4. Transport of crude oil from West Texas/New Mexico | Unilateral / Coordinated[37] | Not publicly available | Divestiture of Gulf interests in specified crude oil pipelines, including 51% of Gulf's interest in the West Texas Gulf Pipeline Company |
| **Texaco/Getty[38] (1984)** | 1. Refining of light products in the Northeast[39] | Unilateral | Not publicly available | Divestiture of Texaco refinery at Westville, NJ |
| | 2. Pipeline transportation of light products into the Northeast | Unilateral / Coordinated[40] | Not publicly available | Texaco required to support all Colonial pipeline expansions for ten years |
| | 3. Pipeline transportation of light products into Colorado | Unilateral / Coordinated[41] | Not publicly available | Divestiture of either Texaco pipeline interest or Getty refining interests |
| | 4. Wholesale distribution of gasoline and middle distillates in various parts of the Northeast | Coordinated | Not publicly available | Divestiture of Getty marketing assets in the Northeast, and a Texaco terminal in Maryland |
| | 5. Sale and transport of heavy crude oil in California | Unilateral[42] | Not publicly available | Texaco required to supply crude oil and crude pipeline access to former Getty customers under specified terms |
| **Gulf/Cities Service[43] (1982)** | 1. Wholesale distribution of gasoline in various areas in the East and Southeast | Coordinated | Not publicly available | Gulf withdrew its tender offer after the FTC obtained a temporary restraining order prior to a preliminary injunction hearing |
| | 2. Manufacture and sale of kerosene jet fuel in PADDs I and III and parts thereof | Coordinated | Not publicly available | As above |

[37] Chevron owned a proprietary pipeline running from the West Texas/New Mexico producing area to El Paso, while Gulf owned the largest share of the West Texas Gulf Pipeline running from the producing area to the Gulf Coast and the MidValley Pipeline at Longview, TX. Chevron/Gulf (1984), Complaint ¶¶ 38-39.

[38] Texaco/Getty (1984), Complaint ¶¶ 15-59.

[39] At this time pipeline transport from the Gulf Coast was not considered to be in the relevant market for "the manufacture of refined light products." Texaco/Getty (1984), Complaint ¶¶ 19-21.

[40] Texaco owned 14.3% of Colonial Pipeline, "the dominant means of transporting additional refined light products into the Northeast region, supplying approximately 36.9 percent of total consumption . . . in 1982." Getty owned 100% of the Getty Eastern Products Pipeline. Texaco/Getty (1984), Complaint ¶¶ 33-35.

[41] Texaco owned 40% of the Wyco Pipeline, one of four pipelines delivering refined product to Colorado, while Getty owned 50% of the Chase Pipeline. Texaco/Getty (1984), Complaint ¶¶ 29-31.

[42] Both Texaco and Getty owned refineries and proprietary pipeline systems in the relevant market. While Texaco produced less heavy crude oil than it could refine, Getty produced more than it could refine on the West Coast. The Complaint alleged that the merger was "likely to increase Texaco's incentives and ability to deny non-integrated refiners heavy crude oil and access to proprietary pipelines." Texaco/Getty (1984), Complaint ¶¶ 50-57.

[43] Gulf/Cities Service (1982), Complaint for a Temporary Restraining Order and Preliminary Injunction Pursuant to Section 13(b) of the FTC Act ("Gulf/Cities Service Complaint"), ¶¶ 19-22. 1982 Merger Report.

| | | | | |
|---|---|---|---|---|
| | 3. Pipeline transportation of refined products into the Mid Atlantic and Northeast | Unilateral[44] | Not publicly available | As above |
| **Mobil/ Marathon[45] (1981)** | Wholesale marketing of gasoline and middle distillates in various markets in the Great Lakes area | Unilateral / Coordinated[46] | Not publicly available[47] | FTC sought preliminary injunction, but before hearings were held Mobil withdrew tender offer as a result of injunction in a separate, private litigation |
| Source: Compiled from FTC complaints, orders, and analyses to aid public comment. | | | | |
| * Note: This table lists enforcement actions in reverse chronological order, beginning with the FTC's most recent challenge of a major petroleum merger in 2004. The year cited is the year in which the merger was proposed and most of the FTC activity occurred; in some cases, a consent order was not final until a later calendar year. | | | | |

[44] Gulf and Cities Service owned 16.78% and 13.98%, respectively, of Colonial Pipeline. Since the merged firm's share would exceed 25%, it would be able to unilaterally block future pipeline expansion under the pipeline's rules. Gulf/Cities Service Complaint ¶ 19.

[45] Mobil/Marathon (1981), Memorandum of Points and Authorities in Support of the Federal Trade Commission's Complaint for Temporary Restraining Order and for Preliminary Injunction ("Mobil/Marathon Complaint Memorandum") 6, 26-27. 1982 Merger Report.

[46] While the theories of anticompetitive effects were not always clearly articulated in the earliest petroleum merger investigations, a careful reading of the complaint and accompanying materials suggests the type of effects the investigators had in mind. The classifications of theories for these early cases listed in this table are therefore based in part on the authors' interpretation of the complaints, court documents, and staff case memoranda. In the case of Mobil and Marathon, the merger would "enhance Mobil's market power" in the relevant markets by "doubling and tripling its share," (Mobil/Marathon Complaint Memorandum 26, 29) suggesting a likelihood of unilateral anticompetitive effects, and that it would increase concentration in already concentrated markets and remove a firm that had tended to act as a maverick, pricing aggressively and selling large volumes to independent retailers (Mobil/Marathon Complaint Memorandum 29-30) – pointing toward a theory of coordinated effects.

[47] The Complaint alleged that the firms' combined shares of wholesale gasoline sales exceeded 24.5% in eighteen SMSAs, reaching 44.0% in one city and 49.4% in another. While HHIs were not calculated at that time, the parties' contribution to HHI (that is, the sum of their squared shares) can be calculated from the market share data given (Mobil/Marathon Complaint Memorandum 27, Table 1). The parties' pre-merger contribution to HHI ranged between 500 and 1,000 for ten of the eighteen SMSAs and exceeded 1,000 for another three.

**Statement of Senator Patrick Leahy**
**Hearing in the Senate Judiciary Committee**
**"Consolidation in the Energy Industry: Raising Prices at the Pump?"**
**February 1, 2006**

The day before yesterday, the big oil companies posted their year-end profit reports for 2005. The five biggest – ExxonMobil, ChevronTexaco, ConocoPhillips, BP, and Shell -- trumpet raking in record profits for the year. In fact, ExxonMobil, with $36.7 billion in profit last year, turned the highest yearly profit in U.S. history for any business.

Even more striking is how these profits compare with years past. Since 1999, oil refiners have seen a 334 percent increase in yield made on each gallon of gasoline refined. These same companies have more than doubled their control over oil production. The oil companies claim that their increased costs justify gouging the consumers filling their gas tanks and heating their homes. This is obscene.

We will not be hearing from these companies today because they have declined to appear at this hearing. I am disappointed by their decision. Boycotting this hearing will not stifle our questions or the need for their accountability to Congress and American consumers.

I say it is time to invest in the American people. We applaud this hearing as part of a real move to investigate excessive market concentration in the oil industry that is stifling competition, constricting supply, and ultimately harming consumers. But once we understand it, we need to do something about it.

I am trying to do my part. I have called for a windfall profits tax that would recapture record profits and return it to the American people, I have introduced the bipartisan NOPEC bill, and I have worked with my colleagues to secure funding for the Low Income Home Energy Assistance Program (LIHEAP) that brings much needed heat during the cold winter months to low income families in places like Vermont that can't afford to pay record-breaking fuel prices. I urge my colleagues to stand up to the power of the oil companies in defense of the American public.

I was glad to hear the President sounding like a Democrat on energy last night in his State of the Union speech. I can only hope that his words mean that he has finally abandoned the failed policy of the Cheney energy task force that had worked in secret with Ken Lay and other energy industry bigwigs. Had we adopted the Democratic energy proposal on which Senator Bingaman and others have worked so hard over the last several years, we would be much farther along. Nonetheless, we welcome the President and, I hope, some congressional Republicans to the Democratic emphasis on alternative and renewable fuels. After all that the Bush Administration and the Republican leadership has done to advance the interests of the oil companies, including the attempts by House Republican leadership to insert special interest provisions in conference reports to give oil companies immunity for the environmental and health damage they cause, this reversal of position would be a good development for the American people.

Along with conservation, renewable energy is a key to a cleaner, more efficient energy future. If the President would work with us and follow through with sensible proposals, we can forge a bipartisan partnership, working together, we can do better to make this a safer more energy efficient and more prosperous country. I along with the rest of America will be watching to see if these statements are reflected in the President's policies and budget request, however.

As I said last night, I agree that we need to relieve America's dependence on foreign oil. Although the Mideast is not the source of the majority of our energy, its share has grown during this Administration. I also urge the President and the Republican leadership of Congress to work with us to relieve our dependence on foreign investors and on borrowing from Social Security to finance the record deficits and growing debt that their policies have created.

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**Prepared Statement of R. Preston McAfee**

**U.S. Antitrust Policy and the Oil Industry**

**Before the**

**Committee on the Judiciary**

**United States Senate**

**February 1, 2006**

STATEMENT OF R. PRESTON MCAFEE

## Introduction

Mr. Chairman and members of the Committee, my name is R. Preston McAfee. I am J. Stanley Johnson Professor of Business, Economics & Management and Executive Officer for the Social Sciences at Caltech.[1] In 1999 through 2001, I was retained by the Federal Trade Commission ("FTC") to provide expert economic analysis and potential testimony in connection with the FTC's investigations of the mergers of Exxon Corporation and Mobil Corporation, of British Petroleum PLC and the Atlantic Richfield Company, and Conoco and Phillips Petroleum. In addition, I provided assistance to the FTC in its investigation of the summer 2000 gasoline price increase in the Midwest. I have been actively involved in research on the effects of vertical integration on cooperative pricing behavior. I am pleased to be here today to discuss the economic issues that I researched, as they pertain to your examination of mergers in the oil industry in the United States.

As part of my studies of the two mergers, I had access to and studied a substantial amount of information, including the documents that the FTC had gathered in the course of its investigations. I am advised that much of this information was provided to the FTC under statutory authority that generally requires the FTC to keep the information submitted to it confidential,[2] and, except to the extent that information has independently been made public, I am not at liberty to disclose today information submitted to the FTC pursuant to confidentiality restrictions.

However, the U.S. District Court for the Northern District of California has ordered the release of some of the documents filed under seal in *FTC v. BP Amoco*, and I am at liberty to discuss those documents. In addition, some of the information I examined as part of my analysis was obtained from public sources.

I have attached a copy of my May, 2002 statement as Appendix 2 to the U.S. Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigations, which makes relevant points that I will not repeat here.

I would make the following points before this committee.

## Sequential Antitrust Enforcement

U.S. antitrust enforcement is both reactive and defensive. We respond to mergers after they are proposed by the merging parties, and we attempt to defend consumers from the threat of monopolization in evaluating the mergers. Usually this evaluation takes the form of asking "will the existing merger significantly increase the probability of the exercise of market power?" which would result in price increases for consumers. In doing so, we view the merger as the last merger that might arise in the industry, that is, we ask how the merger will likely affect U.S. consumers relative to the status quo.

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[1] I attach a copy of my *curriculum vita* for the Committee's reference.

[2] I was authorized to receive FTC confidential information as a consultant to the FTC, and I gave the FTC written assurances that I would not disclose confidential information that I received from the FTC.

The problem with this logic is that a given merger is rarely the last merger to be proposed. Consummated large mergers may set a new standard for what is acceptable, leading to additional mergers. A large merger may make the combined firm more effective, prompting rivals to seek analogous mergers. Conversely, rejection of a merger may open the door for mergers that are actually better for consumers. For example, the online job board named Monster, which is the largest online job board, proposed purchasing the number two company Hotjobs. This would have created a strongly dominant firm in national job boards, but since there are many local boards, it is by no means obvious that the Monster/Hotjobs merger would be blocked by the courts. Fortunately, Yahoo! stepped in during the process and purchased Hotjobs, creating two more effectively rivalrous firms. A Monster/Hotjobs combination would likely have deterred further Yahoo! investment in the industry and solidified national job boards around a single player. The market is much more competitive the way it turned out. The Monster/Hotjobs merger was evaluated on the basis of whether that specific combination would likely lead to a price increase, and not whether a rejection of the Monster/Hotjobs merger would likely lead to a more competitive industry and consequent price decreases.

In evaluating mergers, it isn't necessarily the status quo that is the relevant comparison, especially if the status quo is unlikely to persist. There is pressure for large oil companies to get larger, as I will discuss below. As a consequence, in evaluating mergers like Exxon-Mobil, BP-Arco and Chevron-Texaco, there is a need to recognize that the larger firms will get larger; rejecting a single merger is unlikely to stem this trend. Thus, from an economic perspective, the mergers should be evaluated with respect to whether they push the industry toward a more competitive configuration, or toward a less competitive configuration. Such reasoning need not be the same as whether the merger is no worse for consumers than the status quo.

The automobile industry provides an important example. In the 1960s, the automobile industry was primarily domestic, with few imports. Reductions in the cost of international transportation and in trade barriers resulted in a dramatic increase in international automobile trade, resulting in an industry that needed reconfiguration. Much of that reconfiguration has been accomplished through mergers and partnerships, which has made the world industry more efficient. In evaluating mergers in the auto industry, it is not appropriate to use the status quo as a benchmark because the industry is evolving with a predictable trend, even if individual mergers would be challenging to forecast.

The capacity rationalization in the defense industry during the 1990s provides another illustration of this point. There was no doubt that many mergers were necessary, given that U.S. spending on major weapons systems dropped to half its former level. With half the demand, a great deal of supply and resources needed to be removed from the market. Again, in this case mergers were considered as they arose. The effects of the merger of Boeing and McDonnell-Douglas was considered in isolation, rather than in the broader context of the continuing rationalization of capacity. Since *some* merger involving McDonnell-Douglas was necessary, *this* merger was approved. But rejection

of the Boeing and McDonnell-Douglas combination would likely have led to an alternate merger of McDonnell-Douglas and Northrop or Lockheed. Comparison of a Boeing and McDonnell-Douglas merger with other McDonnell-Douglas combinations may have led to the conclusion that the Boeing and McDonnell-Douglas did not preserve as much competition as could have been preserved.

The U.S. steel industry provides another good example of a market in which predictable reductions in total capacity have strong implications for the antitrust evaluation of any given merger.

As an economist, I am not in a position to comment on the legality of this kind of antitrust consideration. I can say that, as an economic matter, there are mergers where a comparison of a proposed merger against the status quo isn't the right consideration. We do see such logic in the "failing firm defense," in which we compare a merger to the likelihood that one of the parties exits the industry in bankruptcy, a situation that arose with the Greyhound-Trailways merger.

One industry where such considerations often play a role is in banking. The Federal Reserve has the influence to arrange "shotgun marriages" of failing banks and generally to manage the industry at a level uncommon in other industries. However, I am not suggesting that the antitrust authorities engage in managing industries, but rather evaluate mergers in the context of the long run evolution of the industry.

Now let me return to the oil industry. There is a common allegation that many of the oil company mergers are in reaction to others, that the combinations are created much like the fall of dominoes, each combination encouraging the others. Thus, the antitrust authorities should be concerned that each merger will encourage further concentration in the oil industry. As I noted above, I agree with such reasoning in principle.

However, the changing nature of production is in large part responsible for the increase in concentration in the oil industry. International exploration continues to become more arduous, and deeper. Riskier drilling requires a larger firm. Remote oil extraction has become much harder than it used to be. The technical problems – sophisticated drilling equipment, angled drilling, expensive seismology, remote and inhospitable conditions, and myriad languages and regulations – are only a portion of the challenges. Many of the challenges involve dealing with unstable or corrupt governments, rebel groups, and volatile transportation costs across constantly shifting national boundaries. In dealing with these sorts of challenges, a single development project represents a "bet the company" investment for all but the largest three or four oil companies. These firms have grown to the scale that they have primarily because that scale is necessary to mitigate the risks of international exploration. Scale helps not just spread risk over more projects, although it certainly does that, but it also helps deter corrupt local governments from attempting to expropriate oil company investments, as has happened in the past.

Thus, while I think that there are many reasons why mergers should not be analyzed in isolation, as a comparison of a proposed merger and the *status quo*. I applaud the fact

that this committee is taking a long-term view of industry evolution, and believe that incorporating long-term industry dynamics into our understanding of antitrust regulation will move us towards more efficient regulation.

**Mergers of Vertically Integrated Firms and Multi-Market Contact**

Oil companies are quintessential vertically integrated firms, a phrase which here means that a single company performs all of the activities to get oil from the ground and into gas tanks: exploration, drilling, pumping, oil transport, refining, gasoline transport, and gasoline retailing. These activities are known as a vertical chain (the convention is that consumers are "downstream," so retailing is downstream of refining), and Standard Oil of New Jersey, now Exxon-Mobil, was probably the first fully vertically integrated firm of any significance in the world. The oil industry remains dominated by vertically integrated firms.

In spite of the presence of enormous vertically integrated firms, there are many firms that are not vertically integrated. There are independent refiners like Koch Industries, and independent marketers like Wawa or RaceTrac. There are many firms that specialize in exploration, and a few, like Kinder-Morgan, that specialize in transportation and storage. These firms serve an important role in the industry, and evaluation of mergers requires an understanding of the interaction of vertically integrated firms. Fortunately, there has been a great deal of progress by the economics profession over the past decade in understanding the competitive interaction of vertically integrated firms.

Historically, the evaluation of vertically integrated firms involved a separate investigation of each level. If the merger did not injure competition at each level, the merger was deemed innocuous. But we now know that this reason is seriously flawed. Firms that interact in many markets, whether vertical markets or geographic markets, have options not available to those that interact in a single market, and those options must be assessed. I'm going to refer to such interactions as multi-market contact.

First, the risk of explicit collusion in the proverbial smoke-filled room is enhanced by multi-market contact. Executives of firms that deal with each other in multiple markets get to know each other better, and have more options for a *quid pro quo* in arranging collusive price-fixing. Price-fixing involves raising the price beyond competitive levels and therefore requires or results in a reduction of output. Such an output reduction creates the problem of allocating the reduced sales among the firms. Every firm would like others to reduce their output by a greater degree, and squabbling is a natural outcome. Multi-market contact means that output reductions can be allocated across several markets in such as way as to be fair to each participant. The extreme case involves giving each firm a safe market – providing home markets for each firm in which they are unchallenged. Factors such as 'multi-market contact' that reduce the difficulties of enforcing collusion enhance the value of collusion and increase its likelihood.

Second, even in circumstances where executives don't collude, the risk of sharing the market and engaging in "conscious parallelism," is enhanced by multi-market contact. "Conscious parallelism" is a phrase which here means that executives understand each other well enough to reach a collusive outcome without an explicit agreement. Multi-market contact helps firms and executives 'understand' each other better because opponents' behaviors are observed under more circumstances. In addition, firms have more tools with which to reach an implicit agreement of the form "don't compete vigorously against me, and I won't compete vigorously against you" if they compete with each other in multiple markets.

Multi-market contact was an important consideration in the evaluation of the Exxon-Mobil merger. In the West Coast, the same seven companies control transportation, refining and retailing. Consequently, they engage in competition at several different levels of operations. This gives them an important edge in reaching a cooperative outcome, to the detriment of consumers. For example, if one firm behaves aggressively in retail competition, that firm can be punished by the others in retail, in wholesale, or in transportation, whichever is more effective. Furthermore, these firms trade wholesale gasoline with each other and even use each others' transportation facilities on a regular basis. These 'trades' occur off-market, and are negotiated between the two trading firms on a case-by-case basis. While such trades may reduce market friction by smoothing supplies and reducing transactions costs, they may also serve to lessen competitive behavior. The interdependency between firms who 'swap' wholesale gasoline or transportation access on a regular basis implies that "they have a gun to each others' heads," and none can readily afford to compete too aggressively with the other. Relative to the more competitive market east of the Rocky Mountains, West Coast gasoline has a higher mark-up and generally higher prices, even adjusting for CARB gasoline standards. How large an effect this represents, however, is in doubt since other factors – the challenges of adding refining capacity and the "not in my backyard" syndrome, and specialty gasoline – also contribute to higher gasoline prices on the West Coast.

The DOJ and the FTC have the experience and expertise to address these issues and have incorporated them into the evaluation of oil company mergers. Vertical effects played a significant role in the evaluation of Exxon-Mobil. However, the application of antitrust law, which is based primarily on evaluating the direct effect on U.S. consumers, lags behind in recognizing the significance of vertical integration, multi-market contact and interdependence in merger analysis.

**Mergers of International Firms**

The Exxon-Mobil merger underscores the fact that oil company mergers are not focused on the United States, but occur in the context of a world market. While the world market is not perfectly integrated, it is strongly integrated. It is apparent that Exxon and Mobil did not care very much about merging their U.S. assets, and agreed to any reasonable divestitures needed to comply with U.S. law. The reason for the merger was focused on the international environment.

The international environment, however, may affect U.S. consumers. Exxon was considered by most to be better at international exploration than Mobil, while Mobil was better at operating retail outlets. Subsequent to the merger, Exxon-heritage employees came to direct Mobil-heritage exploration, while Mobil-heritage employees directed Exxon-heritage retailing. This is a means of spreading best practices, and results in efficiencies that benefit U.S. consumers. While some mergers, both in the oil industry and in other industries, fail to produce important synergies or spread best practices, it is worth noting that Exxon-Mobil appears to have improved the efficiency of both organizations.

Some mergers that have little or no direct consequence on U.S. consumers may have significant indirect consequences on U.S. consumers. For example, a merger that enables or encourages a domestic producer to move operations abroad may affect the U.S. production and trade balance. However, this is probably not an important consideration in the oil industry. Transportation costs ensure that most refining is performed domestically, and, indeed, environmental laws are a much more important consideration in the decision to refine gasoline abroad than mergers. Thus, while a potentially important consideration for antitrust policy applied in other industries, the international aspect of mergers is likely not important for oil industry mergers.

The increasing internationalization of business, which offers profound enhancements to the world's quality of life through increased competition and product variety, creates huge challenges in merger enforcement. Currently, there is little formal synchronization and harmonization between the U.S. and Europe, which operate independently and use distinct principles. Evaluating mergers that affect many nations will create conceptual and analytic challenges, and these challenges will grow over time. The U.S., Europe and Japan have been unable to harmonize our cell phone and television standards. How will we harmonize our antitrust standards in such a way as to promote vigorous competition throughout the world?

**Unilateral Effects**

Since 1994, twenty three individuals have received the Nobel Prize in Economics, and twelve of the prizes involved game theory. Game theory – popularized by the book and film *A Beautiful Mind*, is the study of interactions of small numbers of people or firms. Game theory has come to dominate economic analysis over the past thirty years. In antitrust parlance, game theoretic issues in mergers are known as unilateral effects. Yet the conclusions reached with game theory barely register in antitrust analysis even though they have appeared in the DOJ Merger Guidelines since 1982.

In the earlier view, mergers had effects because of the increased likelihood of explicit collusion and conspiracy. In this view, industries behaved either competitively or as a monopoly, and monopoly behavior arose because of a price-fixing conspiracy in the proverbial smoke-filled room. Now, however, economists understand that there are many shades of gray between explicit collusion and perfect competition. Such intermediate cases do not involve conspiracy, and arise simply because firms can unilaterally increase prices to some extent. The firm might not be able to raise prices all

the way to the monopoly level, but it may increase them substantially over competitive levels. The ability to unilaterally increase prices can arise through product differentiation, through imperfectly informed consumers, through geographical differentiation, or through other means.

Mergers can affect the ability of a firm to exercise unilateral market power by changing the nature of the competitive situation faced by the firm and by increasing the scope or opportunities for exercising market power. A merger might reduce the competitive level while leaving some competition. The existence of unilateral effects is well recognized by U.S. government agencies, and unilateral effect logic has played an important role in each of the merger analyses in which I have been personally involved. However, the earlier view of the competitive effects of mergers, focusing on collusion and conspiracies and ignoring unilateral market power, continues to dominate courtroom analysis.

I am not an attorney, and am not able to provide an analysis of the law. With that *caveat*, my understanding of the reasoning of the Court in permitting the merger of PeopleSoft and Oracle, a merger in which I testified, depended crucially on the earlier view of mergers. The reasoning goes like this:

> *Post-merger, there will be two firms providing enterprise resource planning software, Oracle and SAP. Given the nature of these companies, it is very unlikely that they will collude. If they don't collude, they must be competitive. Therefore there are no ill-effects of the merger.*

Every statement in this reasoning is correct except the premise that if the firms don't collude, they must be competitive. While the degree depends on the industry, two firms are not generally sufficient to ensure competitive market outcomes. In the airline industry, for example, increases in the number of firms serving a given city-pair apparently reduce prices even going from four to five firms. In gasoline retailing, going from three retailers to four retailers in a given geographic area results in lower markups and more competitive pricing. The number of competitors required to reach a very competitive outcome will vary with other industry factors. This is understood by economists, including staff economists at the antitrust agencies. However, we are often thwarted by historical precedent and by accepted reasoning in the Courts.

For example, the standard to prove a violation of the Sherman Act, Section 2, refers to a "dangerous probability of monopoly power." If 'monopoly power' means an explicit cartel acting as a monopoly, than this phrase makes perfect sense, but very narrowly restricts the ability of the antitrust laws to defend consumers against the exercise of monopoly power. Otherwise, however, this elegant phrase is challenging to connect with modern economic analysis.

There is a pressing need to modernize the underpinnings of the antitrust laws. That can be accomplished by new Court precedents or by modernization of the laws themselves.

With respect to the oil industry, it is my view that explicit collusion is not an important threat. Thus, the major threat created by oil company mergers involves unilateral

effects. Such threats arise through a variety of channels, including transportation, refining and retailing. For example, there are only two gasoline pipelines connecting the Gulf of Mexico and the Northeast. Any increase in concentration in control of these pipelines would risk price increases for gasoline transportation. In Exxon-Mobil, the FTC Commissioners sought and obtained divestitures to preserve the status quo.

In addition, there is ample evidence that competition at the retail level matters a great deal for final gasoline prices. Such evidence has been presented over the past few years in response to prior Senate hearings and investigations before the Permanent Subcommittee on Investigations and before this Committee's Subcommittee on Antitrust, in the form of committee reports and expert testimony. The FTC has been vigilant about insuring continued retail competition, and the standard applied has generally been to permit no increase in concentration in any geographic area. It is my view that vertical integration and interdependence matters as well. Much of antitrust analysis focuses only on horizontal concentration. However, independent retailers like RaceTrac, Wawa or Costco (Walmart) are usually more aggressive in pricing. This may be because their business model depends more heavily on large volumes and on sales of incidentals like cigarettes, sodas and snacks, or because their business model allows them to gain from the ability to shop for the lowest wholesale prices which offsets lower revenues from the lack of a major brand name. In places where such independents are present, the risk of increased concentration is less than in places where they are absent. For this reason, urban areas and the entire West Coast are much more at risk than suburban and rural areas or metropolitan areas in the southeast and Gulf Coast, which have a much larger independent retail and wholesale markets.

**Price Dispersion and Gasoline Pricing**

Prices for gasoline in Pasadena vary significantly. Driving two miles from my house, I often pass gas stations with a ten or even fifteen cents price difference for regular unleaded gasoline. In some cases, prices are five cents different for stations within sight of each other. Why?

Gasoline refiners, and to some degree retailers, charge different prices in response to the prices consumers are willing to pay. A substantial fraction of the gasoline-buying public is willing to pay more in order to purchase at specific stations, probably because they are more convenient, or nicer looking, or both. In some cases, the price differences arise simply because a fraction of customers don't pay attention or assume that all the stations have similar prices. The willingness of some consumers to pay more leads to pricing based on the specific location of the station, a phenomenon known by economists as price discrimination, by marketers as value-based pricing, and by oil companies as zone pricing.

The failure of some consumers to shop around can have a significant influence on the price. Consider, for example, a situation where a $2.00 price would prevail if all buyers were careful shoppers. Suppose 30% of the customers are willing to pay ten cents more than the lowest price, and some stations will increase prices to $2.10. But the reaction to this increase will generate price increases by other stations, which feedback to the

first group, and can easily result in a price range of $2.10 to $2.20, double the direct 10¢ effect. Thus, the fact that many Americans select their preferred gas stations on a basis other than price increases prices for all of us. Gasoline retailers respond to the nature of demand, and price increases are a consequence of the unwillingness of a portion of the buyers to shop for the best price.

While changes in customer behavior might reduce the overall price level, that is not necessarily a good thing, because those behavioral changes themselves come at a cost. Getting the lowest price for gasoline isn't the most important consideration for many Americans, who would, for example, rather be spending time with their family than driving from station to station to get the best price for gasoline. As a consequence, any policy that reduces the level of price discrimination may in fact make consumers worse off as a group.

Moreover, most of the analyses of price discrimination suggest that a reduction in competition will tend to *decrease* the dispersion of prices. The reduction in competition increases the lowest prices by more than it increases the highest prices, thereby reducing the dispersion. Thus, blocking mergers purely because of the existence of price discrimination appears ill-founded. On the other hand, price discrimination does show that there is some market power, and thus is correctly used as a test of the presence of market power. Moreover, price discrimination is extremely useful in identifying the size of relevant geographic markets.

**Conclusion**

Perhaps the most important conclusion I would leave with the Committee is that we are fortunate that the hysteria of the 1970s has not returned, and that Americans have accepted the high price of fuel without demanding price regulations, which caused so much damage to our fuel supply. It is important for us to resist an over-reaction, especially the kind that makes matters worse in an attempt to appear to be doing something.

Second, I appreciate the questions and issues that motivated these hearings. Our understanding of antitrust continues to progress, and the oil industry has been a test case for antitrust enforcement for nearly a century. I suspect that, to oil company executives, it feels more like the cross-hairs of antitrust than a test case. I appreciate the need to take a look at the overall evolution of the industry and to ask whether antitrust enforcement has facilitated the development of a competitive industry or permitted market power to increase. I consider that overall the oil industry remains a vibrant, strongly competitive industry, although close and careful scrutiny continues to be necessary and appropriate. I have tried to bring some of the cutting-edge considerations in the evaluation of oil company mergers to the attention of this committee.

**Appendix 2**

**Prepared Statement of R. Preston McAfee**

**U.S. Gasoline Prices**

**Before the**

COMMITTEE ON GOVERNMENTAL AFFAIRS

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

UNITED STATES SENATE

May 2, 2002

## Introduction

Mr. Chairman and members of the Committee, my name is R. Preston McAfee. I am Murray S. Johnson Professor of Economics and former Chair of the Department of Economics at the University of Texas at Austin.[3] In 1999 and 2000, I was retained by the Federal Trade Commission ("FTC") to provide expert economic analysis and potential testimony in connection with the FTC's investigations of the mergers of Exxon Corporation and Mobil Corporation and of British Petroleum PLC and the Atlantic Richfield Company. In addition, I provided assistance to the FTC in its investigation of the summer 2000 gasoline price increase in the Midwest, and have been retained by the FTC in an on-going investigation. Finally, I have been actively involved in research on the effects of vertical integration on cooperative pricing behavior. I am pleased to be here today to discuss the economic issues that I researched, as they pertain to your examination of gasoline prices in the United States.

As part of my studies of the two mergers, I had access to and studied a substantial amount of information, including the documents that the FTC had gathered in the course of its investigations. I am advised that much of this information was provided to the FTC under statutory authority that generally requires the FTC to keep the information submitted to it confidential,[4] and, except to the extent that information has independently been made public, I am not at liberty to disclose today information submitted to the FTC pursuant to confidentiality restrictions.

However, the U.S. District Court for the Northern District of California has ordered the release of some of the documents filed under seal in *FTC v. BP Amoco*, and I am at liberty to discuss those documents. In addition, some of the information I examined as part of my analysis was obtained from public sources.

I would make the following points before this subcommittee.

## The Competitive Performance of U.S. Gasoline Markets

- *West Coast wholesale gasoline markets are not integrated with the rest of the United States and must be analyzed separately from the east.*

West Coast wholesale gasoline markets are separate markets from the rest of the United States. Not only do those markets use different gasoline specifications (e.g., California Air Resources Board, or CARB, specifications), but there is no economical means of transporting gasoline from the major refining center of the U.S. Gulf Coast to California. Currently there is no pipeline moving gasoline from the Gulf Coast to the West Coast, although the plan to reverse the flow of the Longhorn Pipeline, which connects Houston and El Paso, might permit creating such a pipeline link. Sending gasoline by ship is relatively expensive. The Panama Canal cannot accommodate very large tankers and is expensive. Large tankers could go around South America, but this is a very long trip. Either way, it is expensive to ship gasoline from the Gulf Coast to the West Coast. Moreover, when the West Coast prices are sufficiently high to justify such shipments, the likely origin is the Caribbean rather the US Gulf Coast. Although shipments from the Caribbean arrive in California from time to time, these tend to be purchased by West Coast refiners to replace gasoline lost to planned refinery shutdowns, and not as a consequence of an attempt to arbitrage high West Coast prices.

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[3] I attach a copy of my *curriculum vita* for the Committee's reference.

[4] I was authorized to receive FTC confidential information as a consultant to the FTC, and I gave the FTC written assurances that I would not disclose confidential information that I received from the FTC.

- *The combination of inelastic demand and inelastic supply of gasoline magnifies the price effects of supply disruptions.*

An unusual feature of wholesale gasoline markets is the short-term unresponsiveness of both demand and supply to price changes, a characteristic that economists call "inelasticity." When prices rise substantially, consumers do not cut back their driving very much, so that the quantity of gasoline demanded falls very little. Put another way, it takes a large price increase to induce significant conservation in the short term, so that a fifty cent per gallon price increase might induce only 10% less consumption. Moreover, refineries run near capacity most of the time and cannot produce a great deal more gasoline without the installation of major capital equipment. Thus, in the short term, a refinery might be able to produce ½ percent more gasoline if the price justified it, but it takes a large price increase to reconfigure the inputs to produce even that much more gasoline.

- *Short run price changes can be three to five times the quantity changes.*

Because of the inelasticity of supply and demand, relatively small quantity effects are magnified into large price effects. A 10% shortfall in quantity, which might arise due to a fire in a refinery or a pipeline break, might require a 40% increase in price to clear the market – because consumers continue to drive almost as much, and the refineries cannot produce much more gasoline than they already do. The inelasticity of demand and supply imply that large price swings are normal – small supply disruptions create large price swings. The oil companies do *not* create such price changes – they are primarily a consequence of factors outside the control of the industry. These factors include the nature of consumer demand and the technology of refining capacity. The one factor that matters which the industry can control is storage, but storage is expensive, so it takes frequent, wide swings in price to make investments in increased storage capacity profitable.

- *Government-operated storage facilities, including a strategic gasoline inventory, serve no useful purpose.*

There is no market failure associated with storage of gasoline. As a result, the firms in the industry acquire a socially appropriate level of storage, the level at which the benefits of added storage equal the costs. Attempting to artificially inflate the level of storage will have a temporary effect at best, because the creation of government storage facilities will reduce the returns to privately held facilities and tend to eliminate private storage. This is a bad tradeoff for society.

If the costs of creating new storage have been artificially inflated by government regulation, government could act to reduce the costs by streamlining environmental regulations and eliminating redundant or useless regulation. However, real costs should be born by the firms and not subsidized by the government.

- *Minimum inventory laws are impractical and may serve to increase volatility.*

Minimum inventory requirements have major drawbacks. First, firms will tend to minimize the costs of meeting the law, and thus tend to inventory the products that are less expensive to inventory rather than the products that are most useful to inventory. Since reformulated gasoline tends to be more difficult to inventory, firms will tend to avoid inventories of RFG. Moreover, minimum inventory requirements prevent the market from running storage

efficiently, because the firms that operate storage most efficiently should be the main storage companies, not necessarily producers or consumers.

- *The foremost problems in storage are boutique fuels and regulatory burdens.*

Boutique fuels increase the problem of storage by eliminating pooling. By proliferating fuel types, the amount of storage needed to prevent significant price spikes rises. Storage works like insurance: it reduces costs to be large. By dividing the nation into many smaller, separate fuel types, we increase the costs of storage and reduce its effectiveness.

The regulatory hurdles facing storage creation are high. Gasoline is dangerous and spills are damaging to the environment. The danger to life and health necessitate government intervention in the form of safety and environment regulation, and these regulations exist for good social purpose. However, regulations can be misused. Where regulations can be made more efficient, it is worthwhile doing so, and a side benefit will be a reduced volatility of gasoline prices. Regulations – not economic incentives – prevent building refineries on the West Coast. The inability to build a new refinery suggests the regulatory burden is too high.

- *Oil companies can have at most a very modest effect on the price of oil. BP's attempt to manipulate the spot price of oil on the West Coast resulted in month-to-month changes of less than three cents per gallon.*

Blaming the oil companies for the high price of oil and gasoline is a common American pastime, but is not consistent with the facts. Oil companies control a small fraction of world oil, and have little ability to change the price of oil. In the one recent documented attempt to manipulate the spot price of oil, BP shipped a small fraction of its production to the Far East to boost the West Coast price. This resulted in modest changes in the spot price for oil, which translate into even more modest changes in the spot price for gasoline.[5] The scale of oil company operations, even for a giant like BP, is simply too small to make a large difference in the world price of oil.

- *OPEC can have a significant effect on world oil prices, but historically OPEC has not been a very successful cartel.*

Americans tend to fear OPEC, but the history of OPEC suggests that our fears have been substantially overblown. OPEC is not a very successful cartel. Cartels operate by restricting supply in order to boost the price. The only members of OPEC to significantly restrict supply are Saudi Arabia and Kuwait. OPEC's successes, especially in 1973 and 1981, have been more of a consequence of the joint exercise of market power by these two nations than of the collective or collusive exercise of market power by the remaining members. Of course, our alliance with these two producing countries takes on greater significance in light of their importance to OPEC's ability to exercise market power.

- *The tendency to reduce taxes when supply is temporarily disrupted is bad policy. The price must rise to ration demand to the available supply; removing the taxes does not change the price that consumers must pay to ration available supply, but transfers the taxes to the firms.*

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[5] Across-the-board increases in oil prices increase gasoline prices in approximately a one-for-one manner. The rate at which oil price increases that are not across-the-board pass through to consumers has not been quantified, and could range from zero to 100%. BP's increases were not across-the-board.

Illinois suspended collection of its sales tax during the price spike of summer, 2000. This is good politics but bad policy. The price increase was caused by a shortage, and the price charged to consumers had to rise to a point that equated supply and demand. Because of inelastic supply, few new supplies are induced by the removal of the taxes, which means the price consumers pay doesn't change very much in response to the tax removal. Consequently, the removal of the tax mostly results in increased revenue to existing sellers and does not lower the retail price very much if at all. (Illinois also made it illegal for sellers not to pass on the tax cut to consumers, a law that neglects the rationing role of prices entirely and has the effect of making market economics illegal.)

I like seeing taxes removed, but gasoline taxes are one of the most sensible taxes in the country. Gasoline taxes are mostly user fees designed to pay for roads used by gasoline consumers. It doesn't make sense to suspend them in the event of a supply disruption.

## West Coast Gasoline

- *West Coast gasoline refining and retailing is controlled by an oligopoly of seven firms: Chevron, Shell-Saudi Aramco,[6] BP-Amoco-Arco, Tosco[7], Valero,[8] Exxon-Mobil, and (likely) Tesoro.[9] These firms are interdependent and aware of each other's responses, which reduces the likelihood of fully competitive behavior. Vertical integration exacerbates the risk of non-competitive behavior.*

Concentration in any industry creates a concern that market power may be exercised, to the detriment of consumers. Gasoline refining and retailing on the West Coast are fairly concentrated, but not extraordinarily concentrated. At either level in the production chain, the concentration is high enough to create concern about new mergers. Moreover, those seven firms, along with an eighth firm (Kinder Morgan) control the terminaling facilities and pipelines, which permit the importation and transportation of gasoline in the market. The combination of control at all levels significantly exacerbates the risk of market power, and does so by two distinct means.

First, the control of refining and retailing creates an entry barrier, for any potential entrant must enter at two levels of production, rather than one. For example, if a grocery store decides it would like to enter gasoline retailing (a nationwide phenomenon), the grocery store would ordinarily contact an independent refiner to assure a source of supply. In the West Coast, however, there are no significant independent refiners; the grocer is forced to buy gasoline from a competitor in the retail market. In principle, the grocer could build a refinery to supply its needs, but in practice environmental concerns make a new refinery uneconomical, and in any case, grocers are unlikely entrants to the refining business. Similarly, an attempt to build a new refinery or expand an existing small refinery runs into the roadblock of finding adequate retail

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[6] The FTC required Texaco to drop out of the Equilon joint venture in order to merge with Chevron.

[7] Tosco was purchased by Phillips.

[8] Tesoro has been proposed as the purchaser of Valero assets to comply with the FTC consent decree to satisfy the antitrust laws in the purchase of Ultramar-Diamond Shamrock.

[9] These seven firms account for 96.3% of refining. In addition, Paramount and Kern together account for 3.6% of total refining.

capacity. Alternatively, a retailer could try to bring tankers of gasoline to the market, but then faces one independent supplier of terminaling facilities.

Second, the interconnection of the seven firms on the West Coast induces a more cooperative attitude than might arise otherwise, and a cooperative attitude by firms generally results in less price competition than is desirable. Several of the firms engage in "swaps," in which gasoline is exchanged to meet local needs. These firms buy from each other in the intermediate, bulk gasoline market. Such interdependence tends to mute competition. A firm that undercuts its rivals in one market faces a reaction by the rivals in other markets. For example, a firm that sells more at retail than it refines is hesitant to cut its retail price, for fear that its suppliers, who also compete at the retail level, will react by curtailing their bulk gasoline sales. Such interdependence may lead to prices above competitive levels without any illegal meetings or communications. In such a situation, the firms independently recognize their joint interest, which is called "tacit collusion" by economists.

- *The Federal Trade Commission is aware of the threat created by increasing vertical integration and interdependence.*

In my opinion, the FTC is very concerned that the West Coast market is less competitive than the market concentration would suggest. Its analyses have incorporated vertical integration issues and the public has been protected from increasing concentration.

- *There is no evidence of explicit collusion, and explicit collusion is unlikely.*

I have personally read a very large number of documents produced by oil companies as part of confidential investigations, and I have seen no evidence of explicit collusion, illegal meetings among executives, or other indications of conspiracy. I have personally examined sufficiently many documents that I believe I would have seen evidence if such evidence existed. I am confident that the oil companies are not engaged in an explicit conspiracy against the public.

It would be surprising if the oil companies were engaged in a "smoke-filled room" kind of conspiracy. These companies are among the world's most savvy about the antitrust laws, being one of the first major targets of the antitrust laws. Because of this history, the oil companies receive greater scrutiny than some industries, increasing the risks associated with a violation of the antitrust laws.

Moreover, it is difficult to motivate a manager in a large organization to engage in a price-fixing conspiracy (although management at ADM seems to have solved this problem!). The manager personally risks jail by such actions, but the benefits mostly flow to the shareholders. Consequently, it is rare for large corporations to engage in explicit price-fixing.

- *A single refinery outage can create a major price spike in the West Coast.*

In recent years, California has had a rash of refinery fires that disrupted supply and have sent short-run retail prices up by as much as fifty cents per gallon. Tosco's Bay Area refinery, now owned by Ultramar-Diamond Shamrock, had a rash of fires. From an industry perspective, these fires were profitable, sending prices up significantly with only a modest quantity disruption. The isolation of the West Coast market, combined with inelastic demand, creates a situation where volatility of prices is normal.

- *The Longhorn Pipeline, which connects Houston to El Paso, may help integrate the West Coast into the rest of the country's supply pool.*

When events are random, pooling can reduce risk. This is the basis of insurance – by pooling the risks we face, we obtain the relatively steady average loss. The isolation of the West Coast prevents it from being pooled with the rest of the nation's wholesale gasoline markets. It is possible to increase the extent to which the nation is integrated through the creation of a pipeline connecting the Gulf Coast with the West Coast. The Longhorn Pipeline will not accomplish this connection by itself, but requires an additional pipeline from El Paso to Phoenix. The Longhorn Pipeline is incredibly unpopular in my hometown of Austin due to environmental concerns.

## Eastern Gasoline

- *The eastern U.S. (east of the continental divide) has sufficiently many refiners and retailers to be very competitive. However, the "boutique fuels" problem slows competitive responses. Boutique fuels reduce and even prevent substitution across markets.*

The rest of the country is blessed with a large number of refiners and retailers. Thus, large discount retailers like RaceTrac have a steady source of supply. The vertical control concerns raised for the West Coast do not arise elsewhere in the U.S.

However, the U.S. is in danger of becoming a patchwork of separate geographic areas, due to what is called the "boutique fuels" problem. The ethanol-based reformulated gasoline used in Chicago and Milwaukee is used nowhere else, so when there was a supply disruption in the summer of 2000, gasoline could not be diverted from other parts of the Midwest to mitigate the short-run price increases. By some counts, there are more than forty gasoline types being produced in the U.S. to meet regulations established for local areas. While such a patchwork of fuel grades may alleviate local environmental concerns, boutique fuels separate our competitive marketplace into many less-competitive marketplaces. The proliferation of types of RFGs (reformulated gasoline) increases our vulnerability to small supply disruptions.

- *Some wholesale gasoline markets are served by one or two pipelines.*

Pipeline economics exacerbate the problem of boutique fuels. Pipeline economics are summarized by the familiar formula $\pi r^2$, or "pi r squared," which defines the area of a circle. Double the radius of a pipeline, and you quadruple the volume of the pipeline. This simple fact makes one pipeline more efficient than two smaller pipelines. Consequently, many places are served by only one or two pipelines. Pipeline economics exacerbate the effects of disruptions – there may be few alternate routes.

Moreover, boutique fuels create a further problem when combined with the nature of pipelines. Boutique fuels are transported by sending a large volume of one fuel, followed by a large volume of the next. The transition from one fuel to another creates a low value mixed fuel. (The mixture of MTBE-based and ethanol-based RFG produces a mix that is not environmentally sound, for example.) Thus, it is uneconomical to switch frequently from product to product and the loss associated with transportation grows the more types of fuels that are transported on a given pipeline. This makes geographic areas even more vulnerable to supply disruptions.

- *Long-distance transportation requires about four weeks, and refining plus transport takes around eight weeks, so a two-month response to an unexpected shortage is to be expected even in a competitive marketplace.*

Consider the retail gasoline price increase that occurred in Chicago in summer, 2000. How quickly could the market react? If a Gulf Coast refiner had a stock of Chicago-certified gasoline (ethanol-based RFG II), and the supplier could buy (or already had) pipeline space, the supplier could inject the gasoline into the pipeline. Three to four weeks later, the gasoline would arrive in Chicago. Thus, in the best circumstances, this kind of market reaction to a disruption requires a month. In practice, if the refinery is producing something other than the Chicago fuel and has to shut down and reorganize to produce the Chicago fuel, and the pipeline has to juggle its scheduled deliveries, at least an additional month is required for the fuel to arrive. Thus, realistically, a two-month lag to supply disruptions is reasonable, given the economics of refineries and pipelines.

- *The possibility of EPA waivers may slow supply responses.*

Some gasoline suppliers thought the EPA might issue waivers for Chicago and Milwaukee, and waited to see what the EPA would do. Such a concern on the part of oil companies is justified, because the EPA does issue waivers in some circumstances, and indeed did so in St. Louis. A company that races to bring RFG II to Chicago, only to have the EPA issue a waiver permitting ordinary fuel to be used, finds itself holding expensive gasoline that can only be sold at the price of inexpensive gasoline.

It is difficult to formulate policy to deal with the unpredictability of the EPA. There are going to be circumstances where the EPA should issue waivers, and others that don't merit waivers. Moreover, it is going to be difficult or impossible to specify in advance all the circumstances where the EPA should issue waivers. It is important, however, to understand the unpredictability of government can exacerbate supply disruptions by muting the responses of markets. Early, definitive announcements help markets perform.

- *The need to clean storage tanks between summer and winter creates a window of severe vulnerability to supply disruptions.*

Often summer fuels cannot be mixed with winter fuels and still meet EPA standards. The effect of the inability to mix means that the storage tank has to be emptied and cleaned before being refilled with summer fuel. Moreover, firms will generally wait until the very last week before summer fuel is mandated to switch, because cleaner summer fuel is more expensive to produce. This means that all of the storage tanks are empty the same week, which creates a week of severe vulnerability to a supply disruption.

## Antitrust

Recent oil company mergers have raised concerns that "big oil" will soon be in a position to increase prices freely. However, these mergers receive exacting scrutiny from federal antitrust agencies and antitrust concerns are eliminated by divestitures. Big mergers have positive aspects – Exxon-Mobil is using the best of both companies, in particular applying Exxon's overseas development skills to Mobil assets, and Mobil's operations and technology know-how to heritage-Exxon domestic operations. Developing the oil resources of foreign nations often requires a very large firm, one that can weather large-scale adversity and develop great resource pools.

- *Boutique fuels balkanize the large integrated eastern market, increasing short-term market power concerns.*

The proliferation of fuels encourages refineries to specialize and, thereby, reduces the intensity of their competition. At a minimum, the increase in the number of fuels creates short-term market power, because it takes rivals some time to respond to a reduction in supply by any one firm, and there are fewer rivals in a position to respond quickly.

- *There is some concern about concentration of retail outlets, primarily in the downtown areas of larger cities where building a new gasoline station is very difficult. Retail concentration is less of a concern in suburban or rural areas, where new stations are entering.*

Generally, retail gasoline margins are thin – about seven cents per gallon – and there is little or no antitrust concern about the level of concentration in retail gasoline. Margins are just sufficient to cover the fixed costs of operating the retail station. There is some antitrust concern in the larger cities, where there are few gasoline stations and it is difficult or impossible to obtain zoning permission to open a new station. Elsewhere, new stations are opening up, with the modern multiple-bay convenience store design. Entry prevents the exercise of market power, so areas with retail entry present no significant antitrust concerns.

- *The Federal Trade Commission does a thorough job investigating oil company mergers. Big mergers have generally required divestitures to preserve competition.*

I have been impressed with the overall quality of the analysis coming from the Federal Trade Commission. The FTC must identify the areas of potential antitrust concern and develop sufficient data and information sources to permit evaluation of the likely competitive effects of mergers involving oil firms. The Exxon-Mobil merger, with over one hundred million pages of document production, resulted in the hallways of the FTC being lined with boxes everywhere one went. The document *index* ran thousands of pages. Such a document production is daunting, and the FTC has done an impressive job identifying competitive issues and developing a case to take to court to protect competition. The issues in oil mergers range from owning shares in transportation pipelines to three-dimensional mapping technology. While consumers focus on gasoline, the FTC must evaluate the likely effects of the merger on many other products, such as jet fuel, diesel, asphalt, natural gas, lubricants and even candle wax. I can tell this committee that the FTC is very thorough and careful in its approach, and protects competition to the fullest extent of the law.

- *Exxon and Mobil sold thousands of retail stations and one of their two California refineries, along with shares in pipelines and various other assets.*

The divestitures obtained in the Exxon-Mobil merger could produce a sizeable oil company. This agreement serves as a model agreement. The combined company is a better company than its component parts, not because of any increase in market power, but because it has leveraged the best of both companies. This improved performance enhances competition, and benefits the American consumer. At the same time, where competition was threatened because of significant competitive overlaps, divestitures preserved competition.

- *BP sold all of Arco's Alaska assets to ensure competition in the search for North Slope oil. This divestiture actually increases competition, since BP's incentive to increase West Coast oil prices was eliminated by the purchase of Arco's retail outlets. BP stopped shipments of oil to the Far East after purchasing Arco's West Coast refineries.*

BP Amoco's takeover of Arco shows the insistence of the FTC to preserve competition. BP was initially unwilling to divest significant Alaskan assets, calling such a divestiture a deal-breaker. In spite of BP's tough posturing, the FTC sued to block the merger, which is the largest merger ever challenged by the FTC. After the lawsuit was filed, BP agreed to divest Arco's Alaskan assets, which were acquired by Phillips Petroleum for almost $7 billion, the largest divesture ever obtained by the FTC. This divestiture not only eliminates any competitive concerns, but in fact makes the merger pro-competitive. Because BP now owns West Coast refineries, its incentive to increase the spot price of oil on the West Coast is eliminated. The settlement represents a great victory for the antitrust laws, which have preserved competition on Alaska's North Slope, and a great victory for American consumers.

- *Vertical integration of West Coast firms magnifies the risk of non-competitive outcomes.*

Vertical integration by the seven major refiners decreases market competitiveness by several distinct means. First, entry is more difficult because a firm must enter at several levels (terminaling, refining and retailing) to produce and get the product to market. Second, the wholesale market and swaps (usually geographically-based exchanges) create an interconnection between the firms – they need each other. If BP-Arco buys wholesale gasoline from Chevron, BP-Arco is hesitant to take actions that might injure Chevron at the retail level. Similarly, actions by Chevron that would injure BP at the retail level harm Chevron at the wholesale level. Without any explicit conspiracy, such interdependence impedes pro-competitive behavior.

My assessment is that mergers of firms with West Coast gasoline assets require heightened scrutiny. Over the past five years or more, such mergers have received heightened scrutiny, with an increasing awareness that interdependence of the firms requires an analysis beyond the standard approach, because the standard approach does not recognize the significance of vertical integration in creating non-competitive outcomes.[10] The formulation of appropriate antitrust standards for vertical mergers is a subject in its infancy, but one of growing importance.[11]

- *Forced divestiture of retail outlets will likely interfere with efficient delivery of gasoline and is bad government policy.*

While mergers of firms operating on the West Coast are of greater concern because of the small number of refiners and retailers and the absence of independent operators at all levels of the production chain, a policy to artificially eliminate vertical integration is likely to do much harm

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[10] The standard approach does recognize the extreme of foreclosure, where a firm might shut down a rival through a denial of access to inputs. Vertical interdependence is related to foreclosure, for it considers the ability of firms to influence the behavior of rivals via pressure in other markets.

11 See, for example, Kenneth Hendricks, Joshua Fried, Preston McAfee, Melanie Williams and Michael Williams, "Measuring Antitcompetitive Effects of Mergers When Buyer Power is Concentrated," *Texas Law Review,* vol 79, no.1, 2001, 48-74.

and no good. Moreover, the vertical control issue arises only on the West Coast – for the rest of the country, there are independent refiners that can supply entering or growing retailers (such as grocery stores or RaceTrac), and independent retailers for the independent refiners to supply. Concentration levels are not so high as to create a concern.

There is not a great deal of competition for gasoline retailing in the center of many of the older large cities, such as Boston, New York and Detroit. The problem in these locations is NOT a problem of vertical integration but the simpler problem that there are few stations (due to high land value) and entry is very difficult. Entry is difficult primarily because land is expensive, but also because the existing stations (whether vertically integrated or not) lobby local zoning boards to prevent entry, using environmental threats as a reason.

There are many pro-competitive reasons for firms to be vertically integrated (operate at multiple levels of the production chain). In particular, vertical integration reduces risk by pooling, as with insurance, and it permits more complex contracting to solve a variety of incentive problems. Incentive effects are very important when various aspects of gasoline delivery that are difficult to monitor matter. Mobil has established a reputation for nicer stations, which serves the company and consumers well. Mobil's incentive and ability to create such a reputation requires a large scale of operation (to make it worthwhile) and the ability to tie its gasoline brand to its retail performance. Elimination of vertical integration would harm or even destroy the ability of a firm like Mobil (now Exxon-Mobil) to create such value for consumers.

A ban on vertical integration, or divorcement of retailing from other stages of operation, may do a great deal of harm. It is analogous to telling Starbucks to stick to coffee roasting and get out of the retail business.

- *Elimination of zone pricing may cause average retail prices to rise.*

Zone pricing refers to the policy of wholesale suppliers charging retail gasoline stations in different geographic zones different prices based on the nature of customers in that zone. Charging demand-based prices is common in gasoline markets and in many other industries as well. Economists call this price discrimination, while marketers use the softer term "value based pricing." Frequent flyer miles, Saturday night stayover fares, buy one get a second at half price, and senior citizen or student discounts are all examples of the same phenomenon. Even free delivery, in which different customers are charged the same prices in spite of different costs of service, is a form of price discrimination.

One man's surcharge is another man's discount. Relative to uniform pricing, zone pricing increases prices in the areas with little competition and/or rich consumers and reduces prices in the areas with the most competition and/or the poorest consumers. Elimination of zone pricing by statute will tend to force an average markup to all. This amounts to a transfer from poorer areas and/or areas with lots of competition to richer areas and/or areas with little competition. Overall, a ban on zone pricing will likely hurt the neediest segment of society.

Moreover, there is no economic prediction that average prices will fall. Refinery margins won't fall because refinery margins are determined by supply conditions at terminals rather than retail stations. Retail gasoline is quite competitive with very low profit margins in most areas. There is little scope for a significant price decrease.

## Conclusion

What can the government do to improve the reliability of delivery and price of gasoline to the U.S. consumer? The main points I would make before this committee are:

- There is only a limited role for government in reducing price volatility. Some level of fluctuations in price is unavoidable, caused by large-scale phenomena like demand increases, and short-term phenomena like pipeline breaks.
- Price volatility is not unambiguously bad. Gasoline prices are volatile because the value of gasoline varies over time. Stabilizing prices at a high level is much worse for consumers than volatile prices.
- Price controls are not a fix for price volatility. We lived through the gasoline lines of the 1970s, and I hope never to see those again. Preventing the establishment of market prices through price controls does not change the underlying conditions, but instead often creates severe shortages and eliminates investment. Price controls do severe damage, as anyone who has driven through the Bronx can verify, because rent controls destroyed the Bronx.
- Tax holidays during price spikes do not decrease the price to consumers but create transfers to oil companies.
- Volatility is increased by the proliferation of boutique fuels. As a nation, we should be aware that every time an area is assigned its own fuel specifications, the rest of us lose a bit of insurance. We should attempt to minimize the total number of distinct gasoline types used.
- The greater the extent to which the nation is interconnected, the less will be the volatility of gasoline prices. Promoting the construction of pipelines can reduce volatility by linking geographic areas more tightly. This may be an expensive fix with limited effects, however.
- Storage reduces volatility. Promoting the expansion of storage tanks is probably the least cost means of reducing volatility. However, such promotion should involve improvements in the regulatory environment, tax breaks or other inducements to the creation of storage facilities, rather than direct rewards to storage of gasoline itself, in order to minimize regulatory costs. It is important that the cure not be worse than the disease.
- Government-run storage will tend to crowd out private storage, which increases the overall cost of gasoline supply without increasing actual supplies.
- Industry executives are justifiably pessimistic about the ability of the nation to produce new refineries, especially in California. Even in their private documents, they say that there will never be a new West Coast refinery built. There is a role for the government to moderate the "Not in My Backyard" (NIMBY) mentality that prevents us from building adequate refineries, adequate electric power generation facilities, pipelines, electric transmission lines, and even cellular phone towers. Fortunately, my home state of Texas has relatively few NIMBY problems and we aren't in danger of losing our power. NIMBYism is approaching a crisis problem in some parts of our country.
- Forcing oil companies out of retail operations, e.g. divorcement, by legislation is likely to eliminate many of the benefits of vertical integration without encouraging competition.
- Elimination of zone pricing will not tend to reduce average gasoline prices, but instead increase prices in competitive and/or poor areas, while decreasing prices in less competitive and/or richer areas.
- Finally, let me end with a "big picture" remark. Over the past thirty years, this country has deregulated trucking, airlines, rail, gasoline, oil, natural gas, and long-distance

telephony. It is in the process of deregulating electricity and local telephony for business customers. Overall, the deregulation of the U.S. economy has produced huge gains for American consumers. We should not let a few problems – most notably the California electricity crisis and price spikes in gasoline – deflect us from our market economy or send us back to regulation. In almost all instances, competitive industries deliver more, higher quality goods to consumers than regulated industries. Regulation produced gasoline lines, which are worse in the long run than volatile prices.

Congress Watch • Energy Program • Global Trade Watch • Health Research Group • Litigation Group
Joan Claybrook, President

**February 1, 2006**

**Testimony of Tyson Slocum, Director**
**Public Citizen's Energy Program**

**Before the U.S. Senate Committee on the Judiciary**

**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[1]. 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

[1] This includes 4th quarter results for ExxonMobil and ConocoPhillips, but not Valero, BP or Shell's 4th quarter 2005 results.

return on average capital employed is the most relevant metric for measuring financial performance in a capital-intensive industry such as" petroleum.[2]

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).[3] 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.[4] And, according to industry analysts, those profit margins have soared even higher in 2005, to 99 cents on each gallon sold.[5]

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[6], even though the only "comprehensive" aspect of the legislation is the $5 billion in subsidies to oil companies.[7] 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[8] 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.[9]

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

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[2] www2.exxonmobil.com/corporate/files/corporate/ExxonMobilFO2004.pdf, page 29.
[3] http://tonto.eia.doe.gov/dnav/pet/hist/mg_tt_usw.htm
[4] *Refiner Sales Prices and Refiner Margins for Selected Petroleum Products, 1988-2004*, www.eia.doe.gov/emeu/aer/pdf/pages/sec5_53.pdf
[5] Justin Blum, "Gas Profit Guzzlers," *The Washington Post*, September 25, 2005, Page F01.
[6] www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=109&session=1&vote=00213
[7] www.citizen.org/cmep/energy_enviro_nuclear/electricity/energybill/2005/articles.cfm?ID=13980
[8] Sections 342, 344-346, 353-4 and 383
[9] www.opensecrets.org/industries/indus.asp?Ind=E01

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.[10] 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.[11]

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).[12]

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.[13]

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[10] *Scientific Inventory of Onshore Federal Lands' Oil and Gas Resources and Reserves and the Extent and Nature of Restrictions or Impediments to Their Development*, BLM/WO/GI-03/002+3100, January 2003, www.doi.gov/news/030116a.htm; www.blm.gov/nhp/spotlight/epca/EPCA_fact_sheet_draft06.htm

[11] *U.S. Petroleum Balance, 2004*, www.eia.doe.gov/pub/oil_gas/petroleum/data_publications/petroleum_supply_annual/psa_volume1/current/pdf/table_01.pdf

[12] *Adjusted Sales of Distillate Fuel Oil by End Use in the U.S., 2004*, http://tonto.eia.doe.gov/dnav/pet/pet_cons_821dsta_dcu_nus_a.htm

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[14] 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*:[15]

*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*

[13] *Net Imports of Crude Oil and Petroleum Products in the United States by Country, 2004*, www.eia.doe.gov/pub/oil_gas/petroleum/data_publications/petroleum_supply_annual/psa_volume1/current/pdf/table_29.pdf
[14] *Effects of Mergers and Market Concentration in the U.S. Petroleum Industry*, GAO-04-96, www.gao.gov/new.items/d0496.pdf
[15] www.ftc.gov/os/2001/03/mwgasrpt.htm

*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.*[16]

## 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

[16] http://wyden.senate.gov/leg_issues/issue/special.html

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 Underegulated

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.[17] 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.

[17] www.financialpolicy.org/fpfspb25.htm

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."[18]

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."[19]

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.[20]

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.[21]

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."[22]

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[18] *U.S. Strategic Petroleum Reserve: Recent Policy Has Increased Costs to Consumers But Not Overall U.S. Energy Security*, www.access.gpo.gov/congress/senate/senate12cp108.html

[19] www.forbes.com/work/feeds/ap/2005/09/02/ap2205084.html

[20] www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=108&session=1&vote=00218

[21] www.cftc.gov/opa/enf06/opa5150-06.htm

[22] Carl Hulse, "Republicans Ask Oil Industry for Help with Fuel Prices," *The New York Times*, October 26, 2005.

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.[23] 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[24] 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.

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[23] www.apta.com/research/stats/factbook/

[24] Edmund L. Andrews, "As Profits Soar, Companies Pay U.S. Less for Gas Rights," *The New York Times*, January 23, 2006.

## 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.[25] 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[26] 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).[27]

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.

[25] *Light-Duty Automotive Technology and Fuel Economy Trends: 1975 Through 2005*, EPA420-R-05-001, July 2005, www.epa.gov/otaq/cert/mpg/fetrends/420r05001.pdf

[26] On March 31, 2003, the U.S. Department of Transportation issued new light truck fuel economy standards, increasing the standard from 20.7 to 21.0 mpg for Model Year (MY)2005, to 21.6 mpg for MY2006, and to 22.2 mpg for MY2007.

[27] www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=109&session=1&vote=00157

United States Government Accountability Office

GAO

Testimony
Before the Committee on the Judiciary,
United States Senate

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# ENERGY MARKETS

## Factors Contributing to Higher Gasoline Prices

Statement of Jim Wells, Director
Natural Resources and Environment

GAO-06-412T

Mr. Chairman and Members of the Committee:

I am pleased to participate in the Committee's hearing to discuss the factors that influence gasoline prices, including oil company mergers. Soaring retail gasoline prices, increased oil company profits, and mergers of large oil companies have garnered extensive media attention and generated considerable public concern, particularly in the immediate aftermath of hurricanes Katrina and Rita. More recently, retail gasoline prices have fallen from those extremes but remain considerably higher than they were for much of the past decade. In 2004, the United States consumed about 20.5 million barrels per day of crude oil accounting for roughly 25 percent of world oil production. About half of the crude oil consumed in this country goes into production of gasoline. High gasoline prices impact the economy because of our heavy reliance on motor vehicles—the United States consumes roughly 45 percent of all gasoline consumed in the world. To put this in context, according to the Department of Energy's Energy Information Administration (EIA), nationally, each additional ten cents per gallon of gasoline adds about $14 billion to America's annual gasoline bill.

Data from the Energy Information Administration (EIA) indicate that there are currently 149 refineries in the United States with a total crude oil distillation capacity of about 16.9 million barrels per day. Demand for petroleum products has been rising at a faster rate than domestic refining capacity and the difference has come from imports, including gasoline from Europe. Although refining capacity has risen gradually since the mid 1980s as refineries are upgraded, no new major refinery has been built on the U.S. mainland in the last 25 years. Looking forward, domestic demand for petroleum products is projected to increase by about 20 percent by 2020, raising concerns about our ability to satisfy growing demand for gasoline and other petroleum products without increasingly relying on imports.

Given the importance of gasoline for our economy, it is essential to understand the market for gasoline and how prices are determined. In this context, this testimony addresses the following questions: (1) What factors affect gasoline prices? (2) What has been the pattern of oil company mergers in the United States in recent years? (3) What effects have mergers had on market concentration and wholesale gasoline prices?

To address these questions, we relied on previous GAO reports on gasoline prices and other aspects of the petroleum industry, including (1) a 2005 GAO

primer on gasoline prices, (2) a 2005 GAO report on the proliferation of special gasoline blends, and (3) a 2004 GAO report on mergers in the U.S. petroleum industry.[1] We also collected updated data from a number of sources that we deemed reliable. This work was performed in accordance with generally accepted government auditing standards.

In summary we found the following:

- Crude oil prices are the fundamental determinant of gasoline prices. A number of other factors also affect gasoline prices including (1) refinery capacity in the United States, which has not expanded at the same pace as demand for gasoline in recent years; (2) gasoline inventories maintained by refiners or marketers of gasoline, which have seen a general downward trend in recent years; and (3) 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, the structure of the gasoline market can play a role in determining 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 prices above competitive levels.

- The 1990s saw a wave of merger activity in which over 2600 mergers occurred involving all three segments of the U.S. petroleum industry—almost 85 percent of the mergers occurred in the upstream segment (exploration and production), while the downstream segment (refining and marketing of petroleum) accounted for about 13 percent, and the midstream segment (transportation) accounted for about 2 percent. Since 2000, we found that at least 8 additional mergers have occurred, involving different segments of the industry.

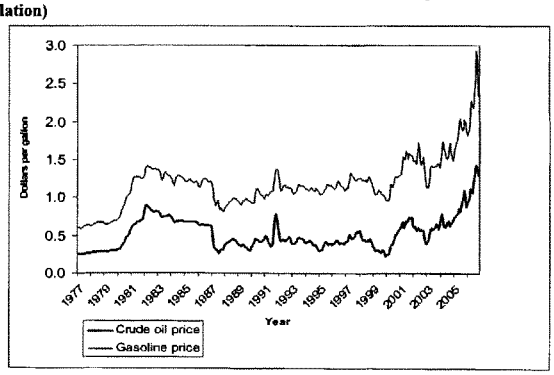
[1] See U.S. GAO, *Energy Markets: Effects of Mergers and Market Concentration in the U.S. Petroleum Industry*, GAO-04-96 (Washington, D.C.: May 17, 2004); U.S. GAO, *Motor Fuels: Understanding the Factors That Influence the Retail Price of Gasoline*, GAO-05-525SP (Washington, D.C.: May 2, 2005); and U.S. GAO, *"Gasoline Markets: Special Gasoline Blends Reduce Emissions and Improve Air Quality, but Complicate Supply and Contribute to Higher Prices,"* GAO-05-421, (Washington, D.C.: June 17, 2005).

- This wave of 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 that occurred in the 1990s showed that the majority resulted in small wholesale gasoline price increases—changes were generally between about 1 and 7 cents per gallon. The 8 additional mergers since 2000 did increase the level of industry concentration. However, because we have not performed modeling on these mergers, we cannot comment on any potential additional effect on wholesale gasoline prices.

## Crude Oil Prices and Other Factors Affect Gasoline Prices

Crude oil prices are the fundamental 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—1976-2005 (Not adjusted for inflation)**




Source: GAO analysis of data from the Energy Information Administration, Department of Energy, Monthly Energy Review, Monthly Refiner Acquisition Cost of Crude Oil, Composite and Monthly Motor Gasoline Prices, U.S. City Averages, Regular Unleaded Gasoline.

Refining capacity also plays a role in determining how gasoline prices vary across different locations and over time. Refinery capacity in the United States has not expanded at the same pace as demand for gasoline and other petroleum products in recent years. The American Petroleum Institute recently reported that U.S. average refinery capacity utilization has increased to 92 percent. As a

result, domestic refineries have little room to expand production in the event of a temporary supply shortfall. Furthermore, the fact that imported gasoline comes from farther away than domestically produced gasoline means that when supply disruptions occur in the United States it might take longer to get replacement gasoline than if we had excess refining capacity in the United States. This could cause gasoline prices to rise and stay high until the imported supplies can reach the market.

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 products 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 private companies held stocks of gasoline in excess of 35 days of average U.S. consumption, while in 2004 these stocks were equivalent to less than 25 days 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 also play a role. 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.

Finally, the structure of the gasoline market can play a role in determining 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 prices above competitive levels.[2] On the other hand, mergers could also yield cost savings and efficiency gains, which may be passed on to consumers through lower prices. Ultimately, the impact depends on whether market power or efficiency dominates.

[2]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.

## Mergers Occurred in All Segments of the U.S. Petroleum Industry in Recent Years for Several Reasons

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.[3] More than 2,600 merger transactions have occurred since 1991 involving all three segments of the U.S. petroleum industry. Almost 85 percent of the mergers occurred in the upstream segment (exploration and production), while the downstream segment (refining and marketing of petroleum) accounted for about 13 percent, and the midstream segment (transportation) accounted for about 2 percent. The vast majority of the mergers—about 80 percent—involved one company's purchase of a segment or asset of another company, while about 20 percent involved the acquisition of a company's total assets by another so that the two became one company.

Most of the mergers occurred since the second half of the 1990s, including those involving large partially or fully vertically integrated companies. For example, in 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.

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.

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

## Mergers in the 1990s Increased Market Concentration and Led to Small Increases in Wholesale Gasoline Prices, but the Impact of More Recent Mergers is Unknown

Mergers in the 1990s contributed to increases in market concentration in the refining and marketing segments of the U.S. petroleum industry, while the exploration and production segment experienced little change in concentration. Econometric modeling we performed of eight mergers that occurred in the 1990s showed that the majority resulted in small wholesale gasoline price increases. 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 additional effect on wholesale gasoline prices, these mergers would further increase market concentration nationwide since there are now fewer oil companies.

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.

While market concentration is important, other aspects of the market that may be affected by mergers also play an important role in determining the level of competition in a market. These aspects include barriers to entry, which are market conditions that provide established sellers an advantage over potential new entrants in an industry, and vertical integration. Mergers may have also contributed to changes in these aspects. However, we could not quantify the extent of these changes because of a lack of relevant data.

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.

- 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, crude oil price is the fundamental determinant of gasoline prices. Refinery capacity, gasoline inventory levels and regulatory factors 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 this change 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 additional effect on wholesale gasoline prices, these mergers would further increase market concentration nationwide since there are now fewer oil companies.

Our analysis of mergers during the 1990s differs from the approach taken by the FTC in reviewing potential mergers because our analysis was retrospective in nature—looking at actual prices and estimating the impacts of individual mergers on those prices—while FTC's review of mergers takes place necessarily before the mergers. Going forward, we believe that, in light of our findings, both forward looking and retrospective analysis of the effects of mergers on gasoline prices are necessary to ensure that consumers are protected from anticompetitive forces. In addition, we welcome this hearing as an opportunity for continuing

public scrutiny and discourse on this important issue. We encourage future independent analysis by the FTC or other parties, and see value in oversight of the regulatory agencies in carrying out their responsibilities.

Regardless of the causes, high gasoline prices specifically, and high energy prices in general are a challenge for the nation. Rising demand for energy in the United States and across the world will put upward pressure on prices with potentially adverse economic impacts. Clearly none of the options for meeting the nation's energy needs are without tradeoffs. Current U.S. energy supplies remain highly dependent on fossil energy sources that are costly, imported, potentially harmful to the environment, or some combination of these three, while many renewable energy options are currently more costly than traditional options. Striking a balance between efforts to boost supplies from alternative energy sources and policies and technologies focused on improved efficiency of petroleum burning vehicles or on overall energy conservation present challenges as well as opportunities. How we choose to meet the challenges and seize the opportunities will help determine our quality of life and economic prosperity in the future.

We are currently studying gasoline prices in particular, and the petroleum industry more generally, including an analysis of the viability of the Strategic Petroleum Reserve, an evaluation of world oil reserves, and an assessment of U.S. contingency plans should oil imports from a major oil producing country, such as Venezuela, be disrupted. With this body of work, we will continue to provide Congress and the American people the information needed to make informed decisions on energy 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 Subcommittee may have at this time.

## GAO Contacts and Staff Acknowledgments

For further information about this testimony, please contact me at (202) 512-3841 (or at wellsj@gao.gov ). Godwin Agbara, Samantha Gross, John Karikari, and Frank Rusco made key contributions to this testimony.

February 1, 2006

GAO

# Highlights

Highlights of GAO-06-141T, a report to the Committee on the Judiciary, United States Senate

## Why GAO Did This Study

Soaring retail gasoline prices, increased oil company profits, and mergers of large oil companies have garnered extensive media attention and generated considerable public concern. Gasoline prices impact the economy because of our heavy reliance on motor vehicles. According to the Department of Energy's Energy Information Administration (EIA), each additional 10 cents per gallon of gasoline adds about $14 billion to America's annual gasoline bill.

Given the importance of gasoline for the nation's economy, it is important to understand the factors for gasoline and how prices are determined. In this context, this testimony addresses the following questions: (1) What factors affect gasoline prices? (2) What has been the pattern of oil company mergers in the United States in recent years? (3) What effects have mergers had on market concentration and wholesale gasoline prices?

To address these questions, GAO relied on previous reports, including (1) a 2005 GAO report on gasoline prices, (2) a 2002 GAO report on the proliferation of special gasoline blends, and (3) a 2004 GAO report on mergers in the U.S. petroleum industry. GAO also collected updated data from a number of sources that we deemed reliable. This work was performed in accordance with generally accepted government auditing standards.

www.gao.gov/highlights/d06141thl

To view the full product, including the scope and methodology, click on the link above. For more information, contact Jim Wells at (202) 512-3841 or wellsj@gao.gov.

# ENERGY MARKETS

## Factors Contributing to Higher Gasoline Prices

### What GAO Found

Crude oil prices are the major determinant of gasoline prices. A number of other factors also affect gasoline prices including (1) refinery capacity in the United States, which has not expanded at the same pace as demand for gasoline and other petroleum products in recent years; (2) gasoline inventories maintained by refiners or marketers of gasoline, which as with trends in a number of other industries, have seen a general downward trend in recent years; and (3) 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, the structure of the gasoline market can play a role in determining 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 prices above competitive levels.

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. During this period, more than 2,600 merger transactions occurred—almost 85 percent of the mergers occurred in the upstream segment (exploration and production), while the downstream segment (refining and marketing of petroleum) accounted for about 13 percent, and the midstream segment (transportation) accounted for about 2 percent. Since 2000, we found that at least 8 additional mergers have occurred, involving different segments of the industry. 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.

Mergers in the 1990s contributed to increases in market concentration in the refining and marketing segments of the U.S. petroleum industry, while the exploration and production segment experienced little change in concentration. GAO evaluated eight mergers that occurred in the 1990s after they had been reviewed by the FTC—the FTC generally reviews proposed mergers involving the petroleum industry and only approves such mergers if they are deemed not to have anticompetitive effects. GAO's econometric modeling of these mergers showed that the majority resulted in small wholesale gasoline price increases. While mergers since 2000 also increased market concentration, we have not performed modeling on more recent mergers and thus cannot comment on any potential additional effect on wholesale gasoline prices.

# CONSOLIDATION IN THE OIL AND GAS INDUSTRY: RAISING PRICES?

**TUESDAY, MARCH 14, 2006**

U.S. SENATE,
COMMITTEE ON THE JUDICIARY,
*Washington, DC.*

The Committee met, pursuant to notice, at 10:30 a.m., in room SD–226, Dirksen Senate Office Building, Hon. Arlen Specter, Chairman of the Committee, presiding.

Present: Senators Specter, Hatch, Grassley, DeWine, Cornyn, Coburn, Leahy, Biden, Kohl, Feinstein, Schumer, and Durbin.

## OPENING STATEMENT OF HON. ARLEN SPECTER, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Chairman SPECTER. It is 10:30. The Judiciary Committee will now proceed with our hearing on concentration in the oil and gas industry, whether it has resulted in the raising of gas prices.

It was reported yesterday that the price of gasoline rose 11 cents over the past 2 weeks to $2.35 for a gallon nationally. At the same time, the price of crude oil dropped, a 7-cent-per-gallon drop. The Governmental Accounting Office in 2004 concluded that the increased concentration in the oil and gas industries has resulted in higher wholesale gasoline prices.

We have seen a phenomenal rise in the concentration with oil and gas companies. In the past decade, there have been some 2,600 mergers. This year the FTC approved Chevron's acquisition of Unocal and Valero's acquisition of Premcor. The largest transaction occurred in 1999 when Exxon merged with Mobil. Other transactions have included British Petroleum's acquisition of Amoco, Marathon's joint venture with Ashland Petroleum, and another joint venture which combined the refining assets of Shell and Texaco. ExxonMobil recently reported that it had earned over $36 billion in the year 2005, which is the largest corporate profit in U.S. history.

There are a variety of interpretations by the economists whether the mergers result in efficiencies in scale, whether they result in lower prices to the consumers. We do know that there have been a wave of mergers and acquisitions, and we do know at the same time that gasoline prices have risen and that the largest profits in the history of corporate America were reported by ExxonMobil last year, as I say, some $36 billion.

The Judiciary Committee has wrestled with this issue over the years, and this is the second of our hearings on this particular subject. Last week, I put into the Congressional Record a proposal for

legislation which was designed to bring comments. I did not introduce a bill, but only sought comments. Section 1 of the legislation would amend the Clayton Act by prohibiting oil and gas companies from diverting, exporting, or refusing to sell existing supplies with the specific intention of raising prices or creating a shortage. Section 2 amends the Clayton Act by prohibiting the acquisition of an oil or gas company or the assets of such company when the acquisition would lessen competition. That would modify Clayton on the language of substantially modifying competition.

The bill was reported inaccurately in a number of the media outlets. Section 3 would require the Governmental Accounting Office to evaluate whether divestiture is required by the antitrust agencies in the oil and gas industry. Mergers have been effective in restoring competition. Section 4 references a joint Federal-State task force, and Section 5 would eliminate the judge-made doctrine which prevents OPEC members from being sued for violations of U.S. antitrust laws.

Since the suggested legislation was circulated, I have had a number of comments from members on the Committee, and with some modifications, there are prospects of having a fair number of cosponsors of the legislation.

I have one inquiry. Why do I have a television screen with an unfamiliar face occurring?

OK. He is a witness who will be testifying. May we black him out until he appears as a witness, please?

[Laughter.]

Chairman SPECTER. A little startling to see him in my hearing room, not knowing why he was there.

Excuse us, Professor. We will come back to you.

Senator Leahy will be joining us momentarily. He and I were just over at the Judicial Conference, invited by the Chief Justice to update the chief judges of the circuits and the district courts, and I know he will be along shortly.

In his absence, let me yield to Senator Feinstein as the ranking Democratic present for an opening statement.

**STATEMENT OF HON. DIANNE FEINSTEIN, A U.S. SENATOR FROM THE STATE OF CALIFORNIA**

Senator FEINSTEIN. Thank you very much, Mr. Chairman.

Mr. Chairman, I also sit on the Energy Committee, and we have had the five big CEOs of the oil companies before us there, and I note that you will be having them here in the second panel this morning. And I appreciate that very much.

I would also like to welcome two Californians to the panel: Mr. Tom Greene of the California Attorney General's Office, and Mr. Joseph Alioto, a distinguished San Francisco attorney, which brings back a lot of memories for me.

You have pointed out, Mr. Chairman, that in the last decade we have witnessed dramatic consolidation of the oil and gas industry, and that consolidation has gone largely unchecked by the Federal Government. Highly concentrated oil and gas markets that exist today really raise very serious questions about the degree of competition that is actually left in the industry and the huge amount of market power that some of these companies now wield.

The GAO's testimony from the last hearing provides a picture of the vast scope of this consolidation: more than 2,600 mergers since 1991, most of them occurring in the second half of the 1990's, including those involving large partially or fully vertically integrated companies.

You mentioned in 1998 British Petroleum and Amoco to form BP Amoco, later merging with ARCO; in 1999, Exxon, the largest United States oil company, merging with Mobil, the second largest. Since 2000, we found that at least eight more large mergers have occurred.

In his testimony, Joseph Alioto likens the recent spate of mergers of U.S. companies to the reconstitution of the Standard Oil Monopoly that was broken up nearly a century ago. Although each of these mergers reduced the companies' costs, they were, nevertheless, followed by increases in prices for consumers. These price increases cannot be explained solely by the increase in the cost of crude oil. Last year was the most profitable year ever for American oil companies, and Exxon had the single most profitable year of any company in our Nation's history.

How much has the oil industry been consolidated? In 1991, the five largest oil companies controlled 27 percent of the Nation's gasoline stations. Today, five companies control 61 percent of those stations. A decade ago, the five largest oil companies controlled one-third of the Nation's refinery capacity. Today, five companies control 50 percent of the refinery capacity. In the last decade, five largest oil companies have doubled their control of oil production.

In my State, the top four refiners own nearly 80 percent of the market. Six refiners also own 85 percent of the retail outlets, selling 90 percent of the gasoline in California.

Now, even these numbers do not reveal the extent to which the oil market has been concentrated as the effect of market concentration is heightened by the high level of cooperation in the oil industry and the joint ventures that exist between many of the remaining companies. For example, as also described in Mr. Alioto's testimony—you won't have to give it, Joe—oil in terminals and refineries is exchanged and shared, depending on the needs of any particular company, due in part to this cooperative behavior, no company has built a new refinery in the United States in 30 years.

These mergers have had real impacts on Americans. A study of eight mergers in the 1990's by the GAO determined that a majority of the mergers resulted in increases in the wholesale price of gas, with each of these mergers costing between 1 and 7 cents per gallon. Another impact of the mergers is that they provided the oil industry with enough market power to create a zone pricing system, where refiners can target specific areas in a city where independent dealers are located and undersell them. We heard about that in the Energy Committee.

Attorney General Blumenthal testified at the previous hearing that, "If the wholesale supply of gasoline were truly competitive, the major oil companies would not be able to dictate the price of wholesale gasoline based on location." In order to respond to the problems posed by consolidation, I would like very much to work with you, Mr. Chairman, to craft legislation to help address these concerns. I think we have a real problem. I think we must address

it, and I thank you for taking the leadership with your suggested legislation in so doing.

Chairman SPECTER. Thank you very much, Senator Feinstein.

I now yield to our distinguished Ranking Member, Senator Leahy.

**STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM THE STATE OF VERMONT**

Senator LEAHY. Well, thank you, Mr. Chairman. I also commend you for doing this.

Chairman Specter and I were over at the Supreme Court earlier this morning. Mr. Boies and others have spent far more time over there than I have.

I am concerned this fuel crisis is draining hard-earned money from our families, our farmers, our factories, our businesses. I actually agreed very much with President Bush when he said in his State of the Union message that we are addicted to oil in this country. There are a number of things we should do. One is we should find, should really find alternatives, because right now we have foreign policy crises that are able to go on because we, the American public, are fueling some of these countries with what we are paying them, but also we lose our own flexibility.

I think as a first step we ought to enact a NOPEC bill into law. You know, for weeks we have been evaluating the security concerns prompted by a foreign government's ownership of a company to take over effective control of port facilities in six of our major ports. But at the same time, in the case of the oil cartels, government-controlled entities routinely collude to set prices, and they have also wielded their power to purposes create major supply and security concerns in the United States. We ought to be able to react to that, and I hope to join with the Chairman and Senators Kohl and DeWine and others on a new bill which would include this NOPEC legislation.

Oil companies have to realize they are not just in the business of making oil. They are in the business of supplying a reliable energy source to millions of Americans and are given numerous benefits and abilities to do that.

Now, it has not being parochial to say that this energy source is crucial to many in my home State of Vermont. I say that because you would see the same thing in many other parts of the country. Vermont's businesses, their families, their farmers, their hospitals, their colleges, they cannot operate without it. For a typical Vermont farmer, the impacts of the lousy planning of our oil giants can be catastrophic.

One farmer I have known for years, Harold Horgen, his dairy operation fuel costs on about 800 acres increased by $10,000 in 1 year. His costs went from just under $50,000 to just under $60,000 in 1 year. The overall increase in fuel costs for an average Vermont farmer last year was 43 percent. That is very significant in a small farming operation, a very significant surcharge. It may seem like pennies compared to the huge profit sums we are going to be discussing today, but to me and to all Vermonters, we know what the terrible consequences can be, forcing many farmers to make unfair choices between running their farms or heating their homes.

These are not choices anyone should be faced with, certainly not our hard-working farmers, and in a State where the temperature can drop to 10 degrees below zero, it is forcing many of our families to determine whether they are going to heat or eat.

Now, it is not just farmers in my home State of Vermont, but you have the same thing in Wisconsin and Pennsylvania and Idaho and California and others. I look at the record gasoline and home heating prices in comparison to the record profits of the oil companies. The answer may not be easy, but, boy, there is an enormous disconnect when oil companies are making more money in 1 year than many countries, than the net income of many, many countries.

So, Mr. Chairman, I commend you for doing this. You have a great panel here. I would ask to insert for the record a statement by Senator Feingold and also ask to include in the record a statement from the St. Albans Cooperative Creamery.

Chairman SPECTER. Without objection, those statements will be made a part of the record.

Our customary practice is just to have opening statements from the Chairman and Ranking, but I yielded to Senator Feinstein in Senator Leahy's absence, and we make an exception on antitrust cases because we have a very active Antitrust Subcommittee, and I want to yield now to the Chairman of that Subcommittee, who has authored some very impressive legislation. We have offered some in the past together, and some of it has been incorporated in the prospective bill which I introduced to the Congressional Record last week.

Senator DeWine?

**STATEMENT OF HON. MIKE DEWINE, A U.S. SENATOR FROM THE STATE OF OHIO**

Senator DEWINE. Mr. Chairman, I want to thank you for incorporating our NOPEC legislation in your bill, and I want to thank you also very much for holding this hearing. I am glad, Mr. Chairman, that we have representatives here today of the oil industry to discuss this very critical question that my constituents are asking. The question is: What is causing the high fuel prices that we are all so sick of paying?

We hear so many people who come and testify in front of Congress and say there is nothing wrong in the industry, and they tell us that the market is functioning normally. Yet my constituents in Ohio feel there is something wrong when they are paying record prices at the pump while oil companies are making record profits.

One of the causes of the skyrocketing gas prices certainly could be the mergers in the oil industries. Did the FTC allow to many oil industry mergers? Are the antitrust laws up to the challenges of dealing with the modern energy market? Should the antitrust agencies take a more aggressive approach in this market? These are all very legitimate questions.

I think it is clear that the agencies need to take a very hard look at any future mergers in this industry, and they should examine their past enforcement actions. Senator Kohl and I have worked hard in our Antitrust Subcommittee to encourage FTC monitoring and enforcement. And I am pleased that the Committee is considering your draft legislation, Mr. Chairman, which includes a provi-

sion that Senator Kohl and I have pursued since the year 2000 and that Senator Leahy just mentioned. That provision, of course, contains the language from our NOPEC bill, which the Senate passed last year.

Mr. Chairman, the biggest thing that we can do to control gas prices in the future is to lower crude oil prices, and one of the biggest causes of high crude oil prices is the illegal price-fixing of the OPEC cartel. Our NOPEC language makes it clear that the Antitrust Division of the Justice Department can prosecute OPEC for its illegal activities. America needs NOPEC as an effective tool to hold down prices.

The Chairman's draft legislation also addresses a concern some have expressed that certain oil companies may have acted to manipulate supply and requires a very important study of the legal standards for mergers and also of industry data sharing.

Mr. Chairman, I think this information will be very useful as we figure out what we can do to combat high energy costs. I look forward to discussing this draft legislation today.

Mr. Chairman, just to put this issue into historical context, I think it is interesting to remember that one of the first big antitrust cases ever prosecuted was, of course, the famous Standard Oil case. That case established most of the fundamental principles of antitrust law that continue to this day. One of those principles, to put it in everyday terms, is simply this: It is not illegal just to be big. In fact, it is even legal to be a monopoly. But what is not legal is when a company abuses its size or uses unfair tactics to shut out its competitors or harm competition.

As we examine the impact of mergers in the oil industry today, we should remember that we need to evaluate the conduct of these companies, not just the fact they have grown in recent years. It goes without saying, Mr. Chairman, that nobody is satisfied with the way this market is behaving, and none of us is happy with the high gas prices that we are paying.

So we do need to keep looking at the conduct of this industry and the role of the antitrust laws, and we need to keep looking very carefully. But most important, we need to find some way, any way, to help our citizens and businesses as we all struggle with increasing energy prices. We owe it to the American people and we owe it to our constituents at home.

Thank you, Mr. Chairman.

Chairman SPECTER. Thank you very much, Senator DeWine.

Would the witnesses please rise, and may we bring back Professor Borenstein on the monitor? Professor Borenstein has already got his right hand raised.

Raise your right hands. Do you solemnly swear that the testimony you will give before this Senate Judiciary Committee will be the truth, the whole truth, and nothing but the truth, so help you God?

Mr. BOIES. I do.

Ms. LAUTENSCHLAGER. I do.

Mr. GREENE. I do.

Mr. ALIOTO. I do.

Mr. BORENSTEIN. I do.

Chairman SPECTER. May the record show that each has said "I do" in response to the question.

We are going to lead this morning with Mr. David Boies, who is Chairman of Boies, Schiller and Flexner, serves as counsel for the plaintiffs in a case alleging that ExxonMobil and British Petroleum have conspired to withhold supplies of Alaska North Shore natural gas from the market. This litigation raises the issues which are articulated in Section 1 of the draft bill which has been circulated and put into the Congressional Record, which would amend the Clayton Act by prohibiting oil and gas companies from diverting, exporting, or refusing to sell existing supplies with the specific intention of raising prices or creating a shortage.

Thank you for joining us, Mr. Boies, and we look forward to your testimony.

I might add that, in accordance with our rules, statements will be 5 minutes in duration. We ask you to stay within that time limit to allow maximum time for dialog, questions and answers by the members. And we have, as you see, a very large representation of the Committee here today.

Mr. Boies, the floor is yours.

**STATEMENT OF DAVID BOIES, BOIES, SCHILLER AND FLEXNER, LLP, ARMONK, NEW YORK**

Mr. BOIES. Thank you, Mr. Chairman. I appreciate the opportunity to appear to address the important issues that the Committee has raised.

Let me begin by emphasizing something that I think we all know but is, nevertheless, worth talking about in a context of natural gas. And my remarks are going to be primarily limited to natural gas today.

We are paying in the United States record-high prices for natural gas. What you can see is the tremendous increase just from 1999 to 2005 to where it is virtually $13 per 1,000 cubic feet for gas. That is a price that imposes enormous hardships both on individual consumers and on businesses in this country. It causes individual consumers, even middle-class consumers, to have to choose between heating their homes in the wintertime and other needed expenses.

Now, we know that this is a function of supply and demand. I want to focus also on what the consequences of this supply and demand imbalance is to the companies that are the primary suppliers of natural gas. And, of course, what the Chairman has already indicated and other people have talked about are the tremendous increases in profits for Exxon and British Petroleum in the last few years. And profits by themselves are not bad. Profits often are indications of where there are opportunities to exploit the market. But where you have a market that is controlled not by the competitive free market forces but by the power of one or two or a few companies, what happens is that the free market forces break down. The role of profits breaks down. And what happens is that you have private companies in effect taking the consumer surplus that should be available to individuals, should be available to businesses.

What you can see, this is the $36 billion in 2005 that several people have mentioned. British Petroleum has less, only $22 billion in 2005. But, nevertheless, what is as important as the absolute size

is the trend line because you see the increase in profits together with the increase in natural gas prices.

Now, the reason for this is a supply and demand imbalance, and what I am trying to—one of the points I want to address today is the reason for that imbalance.

We all know that there are tremendous gas reserves in Alaska, but over decades of having control over those natural gas reserves, zero has been transported to the United States. Although in Prudhoe Bay the majority of oil has been produced, no natural gas has been exported off of the North Slope, either from Prudhoe Bay or Port Thompson or any other source. Despite the need for natural gas here in the United States, despite the availability of that natural gas in Alaska, none of it has been exploited. And in the United States we use approximately 22 trillion cubic feet of natural gas a year. There are 35 trillion cubic feet of proven reserves in Alaska and probably another 140 to 160 additional trillion cubic feet available. If you simply transported 4 to 6 billion cubic feet a day to the United States, it would have a tremendous effect on increasing supply, reducing price, and that could go on for 35 or 40 years, just utilizing what we know are the reserves in Alaska. And those reserves are probably actually much higher than the figures here indicate.

Eight billion cubic feet of gas a day is already extracted, comes out of the ground as a consequence of oil production. But instead of transporting that to the United States, it is reinjected in the ground. If they simply sold half of that into the United States, 4 billion cubic feet a day, it would have a tremendous effect on natural gas prices and supply. And there have been many pipeline proposals that have been made over the last 10 years to do just that. Yukon Pacific, MidAmerican Energy, TransCanada, and Alaska Gas Port Authority, which is my client, have all made proposals to bring this natural gas to market. In a competitive market, that is what would have happened. But, in fact, every single one of those proposals was refused, and the reason it was refused was because that allows the oil companies to keep control.

Here is a statement just last year from the CEO of Exxon about why they are refusing: because they know that by refusing they prevent the development of a pipeline that will bring the gas to the United States. As he says here, "We control it. If we won't commit, nobody will finance it, even with Federal loan guarantees which Congress passed. Nobody is going to finance it." So by controlling it, they, in effect, prevent the export of natural gas to the United States.

My time is up, and I would be pleased to respond to any questions that the panel will have later.

[The prepared statement of Mr. Boies appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Boies.

We now turn to Attorney General Peg Lautenschlager, Attorney General of the State of Wisconsin, who, along with four other State Attorneys General, conducted an investigation into natural gas pricing. According to information provided to me, that investigation concluded that volatility and increases in natural could not be entirely explained by changes in supply and demand. Thank you for

joining us, Madam Attorney General, and we look forward to your testimony.

**STATEMENT OF PEG A. LAUTENSCHLAGER, ATTORNEY GENERAL, STATE OF WISCONSIN, MADISON, WISCONSIN**

Ms. LAUTENSCHLAGER. Thank you, Mr. Chairman. It is a please to be here today, Mr. Chairman, and I thank you for affording us an opportunity to participate in this panel. As you indicated—and let me also say, too, that in seeing the draft that you are proposing, when to only are appreciative that you are considering some changes to this structure about these things, but also that you have included Attorneys General from the States as people who may be doing some enforcement, and we appreciate that inclusion.

That being said, for the States of Iowa, Missouri, Illinois, and Wisconsin, all consuming States of natural gas, the issue of natural gas prices, the continued upward increase of those prices, and the volatility of those prices has been of great concern. In the wake of Katrina and other events, we accordingly got together, the four States and the Attorneys General therefrom, in order to discuss natural gas prices. We brought in a variety of folks, talked to everybody from the industry to suppliers, utilities, and the like. And among the things we found is that while the tight supply in demand does in many ways deal with the gradual upward increase, it does not explain the volatility of the market.

So as a result of that, we started looking to try to determine exactly what does explain that, and among the things we found was this incredible correlation between the frequency of trading in the commodity market and the spikes in price that were going on. And this we found to be disconcerting, because as we looked at possibilities regarding things like market manipulation, we found out that indeed probably about 80 percent of the trading that goes on in these markets is unreported and not in any way recorded in a way which we can do an analysis.

So as a result of that, we became very concerned because we felt as though, you know, something did not pass what we would call in Wisconsin the so-called smell test, and as a result of that, we would like to explore further, but kind of met dead ends as we had no answers to this trading.

What we do know is this: We know that the upward volatility of natural gas prices cannot simply be explained by traditional supply and demand, and that is not to diminish the need for alternative fuel sources. It is not to say that demand reductions are not merited or worthy. But what it is to say is that we need to explore further.

Second, we found that obviously the financial markets are complex and lack almost completely any kind of transparency.

Third, we found that indeed there is consolidation in natural gas pricing. Right now about 20 percent of the market is controlled by one oil company, BP. The next three largest firms having market shares of about 10 percent, two of which are major oil companies, collectively control over 50 percent of the market.

Given the low elasticities of supply and demand, the reactions to the market to relatively small changes in the supply demand balance, the growing consolidation of ownership in the natural gas

market by companies that often have arms that engage in extensive trading presents a potential for market manipulation and other kinds of abuses. Accordingly, we believe that kind of putting all of your eggs in one basket when it comes to just a few energy companies has not served the American people well, particularly those of us in places that are cold, places that do not produce natural gas, and places which are very reliant on that product.

Thank you.

[The prepared statement of Ms. Lautenschlager appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Attorney General.

Our next witness is Senior Assistant Attorney General of the State of California, Mr. Tom Greene, California's chief antitrust attorney, and he conducted several investigations into the energy industry. He argued the celebrated case of *California* v. *ARC America* and won, upholding State indirect purchaser remedies.

Thank you for joining us, Mr. Greene, and the floor is yours for 5 minutes.

**STATEMENT OF THOMAS GREENE, CHIEF ASSISTANT ATTORNEY GENERAL, CALIFORNIA DEPARTMENT OF JUSTICE, SACRAMENTO, CALIFORNIA**

Mr. GREENE. Thank you, Mr. Chairman and members. At the outset, let me submit my prepared remarks for the record, and I would like to summarize briefly my comments.

Chairman SPECTER. Without objection, your full statement will be made a part of the record.

Mr. GREENE. Thank you, Mr. Chairman. And let me say as a line prosecutor that I am enormously pleased to see the language in your draft legislation. Let me turn to the high points, at least from my perspective.

With respect to NOPEC, we are prosecuting a case right now against Powerex arising from the electric emergencies in California in 2000–2001. Powerex is a wholly owned subsidiary of the government of British Columbia. They have asserted both of the defenses which your legislation and Mr. DeWine's legislation would address, that is, act of state and sovereignty immunity.

I must tell you as a prosecutor that it is enormously frustrating to have a company which, from my perspective and the perspective of most Californians, grossly abused our markets, simply say in essence the legal version of Olly, Olly, Oxen Free based on these two doctrines. If you could change this, we could have enormous impact in the courtrooms of America, and I think that we could make a big difference for the consumers of America as well.

Let me turn to the merger analysis. You have proposed a significant change in the standard under Section 7 to appreciable effects on markets. I can tell you, as someone who worked on all of the mergers that you discussed earlier, that standard change would make, again, a significant difference in the real world of antitrust litigation on the ground. These are extremely complex markets. When we dealt with ExxonMobil, for example, the focus was on the notion that these markets are international. At some level that is absolutely true, but they also have appreciable local effects, and we

need the tools—and I think this would provide an important tool—for us to be able to address those kinds of problems.

Finally, let me turn to the idea of a joint task force. As the former Chair of the Multistate Antitrust Task Force of the National Association of Attorneys General, let me share the perspective of the Attorney General to my left that this is an enormous recognition of the important role of State Attorneys General and State prosecutors. But I would like to mention something that is slightly orthogonal to the proposal you have here, which is the problem we have under Section 1 of the Sherman Act.

As Judge Posner and others have articulated, we are in a bit of a bind. Indeed, there is a fundamental paradox currently in the case law in the basic jurisprudence of antitrust to the effect that the more concentrated an industry—the economics of this suggest that the more concentrated the industry, the easier it is for the industry to coordinate with relatively little in the way of additional communications. The petroleum industry is classically a highly concentrated oligopoly.

So, on the one side, we have the economics of this suggesting that with great concentration comes the ability to communicate in a way which will allow firms to essentially reach a tacit agreement as to pricing and other important aspects of production.

On the other side of that, the emerging jurisprudence, at least in some of the most important circuit courts of the United States, taking what from my perspective—again, I am mostly a plaintiff in these kinds of cases. Taking a perspective on both *Monsanto* and *Matsushita* to the effect that you need very compelling evidence of the existence of an agreement, the combination of that jurisprudence and that economic reality is increasingly creating what I described, I think, in my prepared testimony as "the dirty secret of antitrust jurisprudence," which is that it is increasingly difficult to prosecute large concentrated industries in any effective way under Section 1 of the Sherman Act.

I think it would be an enormous contribution to your proposed joint task force's agenda if you took a look at that aspect of Section 1 in increasingly concentrated industries.

With that, Mr. Chairman and members, thank you for your attention, and I am certainly available to answer questions.

[The prepared statement of Mr. Greene appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Greene.

Our next witness is Mr. Joseph Alioto, who represented clients in more than 3,500 antitrust cases, according to his resume—that is a phenomenal number—and gone to trial, I am advised, in approximately 75 of those. He represented the plaintiffs in *Bray* v. *Safeway* in which he won the largest judgment in the history of antitrust at that time. Years ago, I think it was your father, Mayor Alioto, who appeared before this Committee. I think people would be interested to know that you are not Mayor Alioto, but you are his son, if that is correct.

Mr. ALIOTO. Yes, sir.

Chairman SPECTER. Because that is a question which has come to several of us in the interim, and your youthful appearance tells

us that you are not the former mayor, but I thought it would be worth just a moment to state that explicitly for the record.

Thank you for coming to Washington to testify, Mr. Alioto, and we look forward to your testimony.

**STATEMENT OF JOSEPH M. ALIOTO, PARTNER, ALIOTO LAW FIRM, SAN FRANCISCO, CALIFORNIA**

Mr. ALIOTO. Thank you, Mr. Chairman, and thank you, members of the Committee. It is a pleasure and an honor to be able to appear before you on this important issue, and also it is wonderful to be able to appear before the former mayor of San Francisco, now Senator from California, Senator Feinstein, whom I have known for many, many years.

I tried in my testimony to be as factual as I could, and the facts that I stated are not rumors and they are suppositions or they are not economic theories. These are facts which I developed from time to time during various cases, and they are important facts, and in many instances they involve cases in which the Federal Trade Commission or the Department of Justice previously allowed these kinds of activities to go forward, and I think without proper investigation. And I want to point out why I think that and what I think could be done.

But, first, I pointed out that in the Shell-Texaco joint venture situation, this was a situation in which the two companies combined their refining and marketing, and immediately after doing so—this is in the late 1990's. Immediately after doing so, when the crude oil was at its lowest since the Depression, when their own costs were at their lowest—that is what they claimed was the purpose of the joint venture—and when there was substantial overcapacity, they first raised the price of Texaco to equal Shell, which Texaco had ordinarily been below, and then they increased their prices by 50 to 70 percent. And there was absolutely no justification for it at all.

The second instance that I wanted to show you where they would act against the economic interests—and these are the chief executive officers, by the way, that are making these decisions. The second instance I gave to you in my program was Conoco and Phillips, and in Conoco and Phillips, the chief executive officers met some 40 times or more. One of the executive officers kept notes, and in those notes he revealed a number of different things, one of which was that the chief executive officer of Phillips wanted to go ahead with the merger because he was afraid that the oil prices would drop otherwise, and that he felt that this was a necessary thing to keep that going.

He also mentioned there that the idea was that the industry would be reduced to six or seven of the fully major integrated oil companies in the United States, and that, in fact, happened. He also mentioned—and I say it because Mr. Boies, my friend, had mentioned it. He also mentioned in these notes that, as far as Alaska goes, there was an informal agreement between Exxon and British Petroleum to operate the area, and Phillips itself that went into the area with $7 billion couldn't even go in to operate its own business, but had to yield to British Petroleum.

Now, all of these are matters of evidence, and they could have and should have been taken by the Government. But the Government never cross-examines any of the executives. At least that is what I have found. And there were two instances, which I also wanted to repeat in these areas, too, Mr. Chairman, and that is that it has been an excuse for most of these mergers that they are supposed to create efficiencies and they are also supposed to pass costs on to the consumer. But that, in fact, does not happen, and you can find that out if you question the chief executive officers, which I did. And I asked them in each of these instances, you were given this—the idea was it was supposed to be efficient, and you were going to pass these costs on to the public. Did you do that? And the answer was no. Do you intend to do it? No, of course not. And the efficiencies they are talking about are not efficiencies of the market; they are efficiencies of cartel. They agree to shut down various plants in order to create capacity, instead of modernizing the plants and hiring people.

I also gave you the evidence with regard to their meetings. They meet at least once a month, all the top executives. They exchange everything. They use each other's facilities. They use each other's refineries. They use each other's tankers. They swap their different stations. They swap their refineries. They have agreements. All of these were approved by the FTC, and when we fought them, we were able to show otherwise.

Finally, I just wanted to point out that the law itself under Section 7, under these mergers, I point it out that all of these are all the old Standard Oil Companies—Exxon, Standard Oil of New Jersey, buying Mobil, Standard Oil of New York; British Petroleum buying SOHO, Standard Oil of Ohio; and then as a combine, buying Amoco, Standard Oil of Indiana; and then as a combine, buying ARCO; Chevron buying Texaco; Chevron and Texaco having an agreement in Indonesia under Caltex that they would not import the oil Indonesia into the United States during the surplus problem. All of these issues are basic facts. All of them could be enumerated if the Government took a bit of time just to look at them.

Just briefly, I wanted to say this. I think the Committee should consider a private right of action. The farmers and the citizens are not able to bring these lawsuits because of the *Illinois Brick* case, and because of that, then there is no real prosecution except by the Government, and the Government simply will not do it.

Thank you.

[The prepared statement of Mr. Alioto appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Alioto.

We now turn to our final witness on the panel, Professor Severin Borenstein, who is the Grether Professor of Business Administration and Public Policy at the University of California, Director of the University of California's Energy Institute, Ph.D. in economics from MIT.

Thank you very much for joining us via satellite, Professor Borenstein, and we look forward to your testimony.

**STATEMENT OF SEVERIN BORENSTEIN, E.T. GRETHER PROFESSOR OF BUSINESS AND PUBLIC POLICY, HAAS SCHOOL OF BUSINESS, UNIVERSITY OF CALIFORNIA AT BERKELEY, BERKELEY, CALIFORNIA**

Mr. BORENSTEIN. Thank you very much. Can you hear me?

Chairman SPECTER. We do.

Mr. BORENSTEIN. OK. Thank you for inviting me. I am sorry I couldn't appear in person. My teaching schedule unfortunately conflicted with this.

I want to start out by pointing out that as of Friday, the wholesale price of gasoline was $1.66 a gallon on the New York Mercantile Exchange. Of that, $1.43 was the price of crude oil, so I think that puts in context right away that of that $1.66, only 23 cents is the refining margin. When we start talking about attacking market power in the refining industry, which I think there are real concerns about, we have to recognize that that is not going to do anything to change the world price of oil.

The world price of oil is set in the single world market for oil, which the U.S. oil companies really are not able to control. They are small players in that market. For the same reason that they are not big enough to control the price of oil or influence it significantly, their claims that we could have some real effect on the price of oil, for instance, by opening ANWR or drilling in more places in the United States are also not plausible. This is one big bathtub of oil, and the United States is a very, very small player in it.

The high oil prices right now are due to very strong growth in demand over the last 5 years and, as many of the panel members pointed out, the restriction of supply or the ability of OPEC to restrict supply. It is not just OPEC, I think, actually, because most of the members of OPEC actually are producing all they can. The real issue here is Saudi Arabia and, unfortunately, the NOPEC legislation I think would not get at that because Saudi Arabia holds the only real slack capacity now, and they are the ones who are really able to move the price of oil. That high oil price is most of the high price of gasoline right now.

Refining margins, the difference between the wholesale price of gasoline and the world price of oil, are higher than they have been up to about 5 years ago. For the prior 30 years, refining was a very bad business. These refineries made very poor returns. Basically, they built a bunch of refining capacity going into the early 1970's and then found themselves with much too much capacity after the oil shock. As a result, those margins were very low. They made very poor returns. That continued into the 1990's when demand growth finally caught up, and now instead of running at capacity utilizations of 75 percent, they are up to the 95-percent level; that is, this is a very tight refining market.

At the same time, as many have pointed out, concentration in the refining industry rose. The problem that we run into when we get into the situation of tight refining markets and concentrated markets is that there are two types of scarcity that can occur: natural scarcity because we actually really are short of refining capacity; and when there really is natural scarcity, prices should rise to reflect that. If we do not let them rise, we are going to get gas lines and shortages. The other possibility is artificial scarcity, that is,

scarcity created by players who find it in their interest to restrict output so that prices will go up. Unfortunately, when you get into a tight market and some of the players are of significant size, both of those outcomes are possible. And, unfortunately, in the oil industry it is very difficult to tell them apart.

A few years ago, I testified before the Senate Governmental Affairs Committee during the California electricity crisis and argued that we could see quite clearly the exercise of market power in that business. The reason I argued there that I thought we could see market power was it was a straightforward production process, put natural gas into a generating plant and electricity comes out, and you have a good idea of what the costs are. Unfortunately, the refining business is much more complex and second-guessing the refineries and offering incentives to produce a little more is quite difficult. As a result, I think it is extremely difficult to do empirical studies after the fact that actually show that the refiners are exercising market power. And with due respect to the General Accounting Office, I actually don't believe that their study does show that. I think it does show a correlation, but it falls well short of showing a causal effect of the mergers.

That said, I think now in a situation where the industry is sufficiently concentrated that we are in real danger of these firms having the incentive to raise prices by restricting output. As a result, I think what we need is a change in the enforcement of the antitrust law, at the very least. In the past, essentially what has happened in practice at the FTC is oil refining companies have said, look, there are big economies from this, you should let us merge. The FTC economists understand that it is very difficult to diagnose whether those economies are real or the companies are making them up. And, in fact, the companies don't have a clear idea of how big those economies are. So what we will do is we will look for the potential for an increase in market power.

I think we are now at the point where the potential for market power increases from additional mergers are quite serious, and we need a real shift in the burden of proof. Unless the refiners can show very clear, definitive economies, not hand-waving that says, of course, things get cheaper when we get bigger, mergers should not be allowed. I actually do not think that there is much evidence that the current market is exhibiting significant market power. I think if you look at the margins, they are higher. They are probably about 8 to 10 cents higher than they have been 5 years ago. Some of that is certainly natural scarcity. A few cents of it might actually be market power. But when you start looking at it in the context of today's prices, that is not where the big money is. The big money is in the extremely high price for crude oil that is being caused by the world market, and that is a result of very strong demand, and Saudi Arabia in particular may well restrict supply to keep prices high as they politically feel they can.

Thank you very much.

[The prepared statement of Mr. Borenstein appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Professor Borenstein.

We will now go 5-minute rounds by the members of the Committee. Beginning with you, Mr. Boies, if ExxonMobil and British

Petroleum were to change their practice, do you have any idea as to what the impact would be on natural gas prices in the United States?

Mr. BOIES. I think you can certainly say that the natural gas prices will go down. I think you can say they would go down substantially. I think it is difficult—

Chairman SPECTER. Can you be any more specific than that?

Mr. BOIES. Well, what I can say is that a single gas pipeline such as my client has proposed would bring 7 to 10 percent new capacity in. If you look historically, that would—if you looked at the price chart that we saw, that would bring the price down maybe as much as 20, 25 percent from the high that it is now.

Chairman SPECTER. Mr. Boies, we have very limited time. If you could supplement your answer by quantifying that and giving us the basis for your conclusion?

Mr. BOIES. Absolutely.

Chairman SPECTER. On your litigation, do you seek a mandatory injunction to compel them to sell the gas or to cooperate with somebody who builds a pipeline?

Mr. BOIES. We do. We do, Mr. Chairman.

Chairman SPECTER. Mr. Greene, you testified that more concentration brings a tacit agreement, I believe were your words. You cannot prosecute a tacit agreement. Or can you? You have to be able to prove it. Could you expand on your basis for concluding there is an agreement? That would be a conspiracy and restraint of trade. When you say tacit, you are putting it outside the ambit of a lawyer's proof, are you?

Mr. GREENE. I think I am trying to articulate to the Committee that highly concentrated industries oftentimes find their way to mutual accommodations, which is a classic of oligopoly behavior and is widely understood—

Chairman SPECTER. You say "usual accommodations"?

Mr. GREENE. They can frequently find their way to reducing output, increasing prices, simply because they understand each other's business.

Chairman SPECTER. How does that happen when it is outside of the purview of the tough prosecutor to be able to prove?

Mr. GREENE. Well, what has happened recently is that those agreements are facilitated by, in essence, the sharing of certain kinds of information, and I have suggested some of the ways that that is done in my prepared testimony. But because of the way the law is working currently, at least in many of the circuits in the United States, that is insufficient to establish the notion of an agreement or a combination within the purview of section—

Chairman SPECTER. Mr. Greene, because of the limitations of time, let me ask you to supplement your answer.

Mr. GREENE. Certainly.

Chairman SPECTER. To be as specific as you can on that point.

Mr. GREENE. I would be pleased to.

Chairman SPECTER. Madam Attorney General, you say that the volatility and increase in natural gas prices could not be entirely explained by changes in supply and demand. Are you suggesting that concentration of ownership could explain the volatility and increase in natural gas prices?

Ms. LAUTENSCHLAGER. Among the things we have looked at, Mr. Chairman, are indeed that. We have also looked at the trading activity that is done in the commodity market as best we can, given its opaqueness.

If you were to look at our written testimony, you can see from Exhibit ES–7, which is on page 6 of that testimony, a graph which shows the price at the wellhead of natural gas, and then you can the various spikes in that, and if you compare that with the changes in trading activity, you can see a pretty direct correlation.

Chairman SPECTER. Let me interrupt you again. Will you supplement that with specifics?

Ms. LAUTENSCHLAGER. Absolutely.

Chairman SPECTER. Mr. Alioto, when you testify about all of these concessions you have gotten from these CEOs, I would like to followup with you and get the specifics, get the specific cases and the specific language and the notes of testimony and the transcripts. But the question I have for you, when you have confronted the regulatory authorities and you chastise them for not doing cross-examination or the kind of skilled, incisive lawyer's work, what do they say?

Mr. ALIOTO. Well, what they do, Senator, is the law has always been clear in mergers, and we have had some very good decisions by the Supreme Court in the 1960s and 1970s. That is still the law. But what they now use is something called Merger Guidelines that is written by, apparently, attorneys in the Department of Justice and in the Federal Trade Commission, and they are very, very lenient, and they certainly are not in accord with what the Supreme Court decisions were.

So when we go into court, we have two things that we have a problem with. We are trying to use the law of the Supreme Court, but the Government comes in against us, along with the oil companies or others in anti-merger cases, and they are using their guidelines and they are using their authority, which is very effective with judges, especially in injunction cases when you are trying to break up mergers.

Chairman SPECTER. Thank you, Mr. Alito—Alioto. My red light went on—

Mr. ALIOTO. Not quite Alito, Senator.

[Laughter.]

Mr. ALIOTO. He cannot spell.

Chairman SPECTER. Thank you very much, Mr. Alioto. We are going to followup with you on the specifics. I am not going to ask any further questions because my red light is on. But I would ask Mr. Greene for an amplification of why he thinks amending Section 7 for appreciable lessening would help you more than substantial lessening.

Senator Leahy?

Senator LEAHY. Thank you. And Mr. Alioto is the only Italian-American on this panel. I will make sure I get it right. Later in this week I will be the Irishman on this panel.

[Laughter.]

Mr. ALIOTO. We are all Irish, Senator.

Senator LEAHY. Well, except for—not the only Irishman. As my mother would point out, she came from Italy.

Mr. Alioto, in your testimony—and this is sort of a followup on what Chairman Specter was saying—you mentioned that Congress does not need to pass new legislation to address the problems associated with the heavy consolidation in the energy industry, but we ought to enforce what is on the books. More specifically, you talked, if I am correct, of Section 7 to the Clayton Act. But if the Justice Department is unwilling to enforce the laws that are already on the books, what does Congress do to obtain stricter enforcement? I am concerned about what you said about the—very concerned about what you said about the guidelines the Department of Justice sets down. What do you do if they are not going to enforce the laws?

Mr. ALIOTO. I think that it is extremely important that the private right of action be reinforced by the Congress, that it be made clear that the private parties can bring actions under the anti-merger statute. As I think that that you know, Senator, farmers and citizens—many people are concerned about the farmers. They have basically no standing. They are not allowed to come in and file under the antitrust laws, and they are even given problems in the anti-merger statute.

Senator LEAHY. Am I correct that you feel that the Justice Department does not enforce Section 7 of the Clayton Act?

Mr. ALIOTO. There is no question about it, yes, and I told both of them that, and I just think it is terrible. I think they have abdicated their responsibility to the people with regard to the antitrust laws.

Senator LEAHY. Thank you.

Dr. Borenstein, can you hear me OK? Of course, now we have to turn you back on here. All right. Your written testimony states—let me read it—that "Oil industry claims that their profits are comparable to other industries are not credible." You also note that a major cause of high prices is that "some producers are able to exercise market power, most notably Saudi Arabia, which is able to move oil prices significantly with its output decision."

Now, Senator Specter, Senator DeWine, Senator Kohl, and I are going to introduce legislation called NOPEC that would allow, as you know, the Justice Department to take action against foreign entities, including governments, that manipulate prices. If Saudi Arabia was deterred by exercising its market power by limiting output, what effect would that have on American consumers at the pump?

Mr. BORENSTEIN. Well, I think right now the effect would actually be fairly small. Even Saudi Arabia has very little slack capacity. If they increased output by a couple million barrels a day, which is about as—well, one million is probably about as much as they could realistically get on the market—right now that could lower prices at the pump, somewhere off the top of my head I would guess about 10 cents a gallon. That still could be a fairly small piece because the world supply and demand situation is so tight right now.

Senator LEAHY. And is growing.

Mr. BORENSTEIN. And is growing. This situation is likely to get worse with real scarcity, regardless of any attempts to manipulate prices.

Senator LEAHY. Well, let me ask you another thing. For several years, the largest oil companies have received some significant tax breaks. They have insisted the windfall tax on their profits would hurt their business, probably raise prices at the pump. Senator Kohl had asked a question in a hearing in February on energy consolidation, and let me just followup.

If the six big oil companies had their profits halved for a year, what impact would that have on the oil companies?

Mr. BORENSTEIN. Well, I am not sure how they would have their profits halved. If you meant a windfall profits tax, essentially that would just come out of the oil companies. There is no way they could pass that on to consumers because they sell in the world oil market. In the longer run, it could change their incentives to invest in new oil exploration, and likely would. Would that have a significant effect on the oil market? That depends on how big they are in the world oil market, and the answer is actually they are probably not that large.

Senator LEAHY. Well, and a question that I would ask, Madam Attorney General, how does Congress go about bringing about more transparency? I mean, everybody has talked with us. I could ask the same question of everybody. I won't because my time is up, but how do we go about getting more transparency in these companies so we know what they are doing?

Ms. LAUTENSCHLAGER. Well, among the things that we would be very anxious to see Congress do would be to look at the trading markets themselves. As I indicated in that last graph that is in the written testimony, there seems to be a distinct correlation between volatility in the marketplace and the amount of trading. Some of the trading that is being done in over-the-counter markets and the like—which is not being done by registered traders, nor is it being reporter—oftentimes a commodity can exchange hands as many as 30 times from the wellhead until it gets to the market. These sorts of factors seem to be impacting this greatly, and just the registering of traders and the reporting of trades we think would lend some greater certainty to that market and afford us the opportunity to determine whether or not manipulation is taking place.

Senator LEAHY. I appreciate that, Mr. Chairman. I am wonder on this question of transparency if the other panel members could submit for the record. I raise this because I am also on the Agriculture Committee, which has jurisdiction over CFTC, and we will be looking at that question there, too.

Chairman SPECTER. We will hold the record open for at least a week.

Senator LEAHY. Thank you.

Chairman SPECTER. Supplemental questions can be submitted.

Senator DeWine?

Senator DEWINE. Thank you, Mr. Chairman.

Mr. Borenstein and Mr. Greene, a question for you. The oil companies claim increased capacity of about 14 percent. On the other hand, at the Committee's last hearing in February, several of our witnesses testified that the oil companies had been shutting down refineries to manipulate the supply of gasoline and to increase their profits. Who is right? Mr. Greene?

Mr. GREENE. I can only speak to the California markets with any particularity.

Senator DEWINE. You have to push that closer, Mr. Greene.

Mr. GREENE. I can only speak to the California markets with any particularity. At least at the refinery level of the industry that serves the State of California, I think that we have seen some modest increases in capacity. Attorney General Lockyer and our antitrust staff worked very hard with Shell Oil Company to make sure that they did not shut down their Kern County facility. That would have represented a reduction of roughly 10 percent of California's diesel supplies and 6 percent of our gasoline supplies. We were quite pugnacious, truthfully, with Shell, and they were going to simply shut that plant down. At the end of the day, we were very pleased that they, from our perspective, stepped up, did the right thing, and sold it. It has now been sold to a firm called Flying A. Flying A has made a commitment to the Attorney General that it will both continue to run the plant as a major refinery for both diesel and gasoline, and they have told us they will also expand capacity. That would be the report from the Far West.

Senator DEWINE. Professor Borenstein?

Mr. BORENSTEIN. Actually, both parties are probably right. The refiners are every year increasing the capacity of the refineries within their existing footprints. At the same time, a number of the older refineries have been shut down.

Are the refineries doing as much as they should be doing in a competitive market? That is very difficult to diagnose, unfortunately. They can certainly make a credible defense that they are doing all they can within economic standard to expand their output. At the same time, if you look at their incentives, certainly the amount of money they make does depend on how much refining capacity is off-line or brought down. The Katrina experience is quite clear on this. We saw refineries go out, and yet the refining profits of the companies went up, and that is because we are in a very tight refining market. Did they do everything they could to bring those refineries back up as quickly as possible—and they may have, but it is certainly very difficult to second-guess. And it is certainly the case that while those refineries were down, they were actually making more money. But that probably was primarily due to real scarcity. When there is a real scarcity, the prices should go up.

Senator DEWINE. Let me ask anybody on the panel who wants to respond, when we look at gasoline markets, it seems the consumers have more options than they do in some other industries, but despite the recent mergers, we still have half a dozen major oil companies testifying here today, and most of us have a variety of gas stations nearby where we live and work. Despite all these different competitors, gasoline prices keep going up.

Now, of course, crude oil prices are a big part of that, but some have also argued that the reason oil companies can get away with raising prices is that people have to buy gasoline. We have to do it every day. We need to drive, and we do not really have any other viable alternatives.

Do you think this means our antitrust laws should be tougher on mergers in the oil industry and use possibly different standards

when looking at these deals? Or is that factor already built into our legal analysis? And is there anything else that the antitrust laws can do to protect consumers from high gasoline prices? Anyone want to jump in on that?

Mr. ALIOTO. Well, I think, Senator, that it is not absolutely—it is not correct to suggest that because there are different brands in different areas that there is competition, because in many instances one oil company will own and operate under a number of different names, including, for instance, on the West Coast it was not Exxon, for example, or Shell or Texaco that were actually operating those stations, but it would be another station altogether. And what they do is when they swap their stations, they also swap their names. And so it is not really competitive.

And as I pointed out in my opening statement here, for instance, you had Shell and Texaco. There was always a price differential between Texaco and Shell, and Texaco and everyone else. But as soon as they had the joint venture, the first thing they did was to bring the Texaco price up and then they raised everything by 70 percent throughout the country.

Senator DEWINE. Mr. Borenstein?

Mr. BORENSTEIN. I think that the treatment—the law is certainly the same for oil and energy companies, so unfortunately, the treatment really shouldn't be. The DOJ guidelines that were referred to are very rough guidelines about market shares that don't take account of the inelasticity of demand, as you pointed out, that people need to buy gasoline and the fact that you can run into real supply constraints. So a simple-minded application of those Merger Guidelines is likely to lead you astray.

We saw this when the Federal Energy Regulatory Commission tried to use those guidelines in the electricity business. Likewise in the oil business, it is not a good economic analysis to take those guidelines and to slap them onto the oil business because the demand is so inelastic and because we are running into real supply constraints. At that point even firms with a fairly small market share are able to move the market.

Senator DEWINE. Thank you, Mr. Chairman.

Chairman SPECTER. Thank you very much, Senator DeWine.

Under the early bird rule, Senator Feinstein and Senator Schumer were here at the start. Senator Feinstein, you are recognized.

Senator FEINSTEIN. Thank you very much, Mr. Chairman.

Gentlemen and Madam Attorney General, ever since the California energy crisis, I have really been profoundly impacted by the way this energy sector of our economy functions. It seems to have no consumer loyalty, no real care or concern with what happens to the consumer. And I found this deeply disturbing. We are listening to the Enron trials. We have read transcripts of traders saying, "Let's just stick it to Grandma Millie." We have seen El Paso plug a pipeline with the purpose of forcing up the price of gas.

Mr. Attorney General, I want to thank you for the Attorney General's, you know, really, I think, effective litigation which has brought on literally millions of dollars of settlements in this case. But one of the things that is happening is that an increasing share of trading is now moving off of the regulated exchanges onto the unregulated over-the-counter exchanges, and more companies are

running these electronic trading facilities. Eighty percent of the energy markets are not regulated by the Federal Government.

I have tried twice in the past, and the Commodity Futures Modernization Act for reauthorization will shortly be before the floor of this body. It exempts energy trading from any regulation. I will have an amendment to provide transparency to the energy markets by requiring energy traders on electronic trading platforms to keep records and report their trades to the Commodity Futures Trading Commission so that Commission can exercise due anti-fraud and anti-manipulation oversight.

I would like to know if the Attorneys General will support this legislation.

Ms. LAUTENSCHLAGER. I think I could probably speak for all four of us who were involved in this Midwest thing in saying we absolutely would. That is one of our primary conclusions. While supply and demand and the inelasticity of these markets explains perhaps the gradual upward increase of prices, particularly of natural gas, it doesn't explain the volatility. But, clearly, that volatility has a direct correlation between increased trading and spikes in the market.

Our inability to access information about those trades is particularly frustrating to us, and your legislation would address just that. So we thank you for that, Senator.

Senator FEINSTEIN. So, in essence, this is a secret, hidden trading market.

Ms. LAUTENSCHLAGER. Absolutely. You know—

Senator FEINSTEIN. No audits, no records kept.

Ms. LAUTENSCHLAGER. Absolutely. Pork bellies, orange juice, soybeans—all of those things are more transparently traded than are these energy commodities.

Mr. GREENE. And if I may, Senator?

Senator FEINSTEIN. Mr. Greene?

Mr. GREENE. If I might add, the exemption from CFTC rules and regulation also means that the anti-fraud and anti-manipulation rules that the CFTC enforces are not applicable to those essentially off-book kinds of exchanges. And, indeed, when you look at some of the electronic exchanges that Enron, in fact, pioneered, sadly, for the consumers of California, that was exactly one of the major problems behind it. It was secret, and it was highly manipulative, and we all paid the price.

Ms. LAUTENSCHLAGER. Senator, if I might, too, you know, the price indices on which prices are based also come from only that 20 percent of the market share which are report and not necessarily well reported. So not only are we seeing that impact in terms of what seems to be the volatility of the market based on increased trading that is unreported, but also that impacts on where those price indices go, which causes a chain reaction. So we might add that to that, too.

Senator FEINSTEIN. Do you think any of this is responsible for this spike in natural gas?

Ms. LAUTENSCHLAGER. My sense is yes. I mean, the spikes that come and go tend to be absolutely related to trading numbers, and there has to be some sort of correlation. And, again, our ability to

see those markets better I think would afford us the opportunity to better analyze that and come up with answers for consumers.

Senator FEINSTEIN. Because my concern is what we are now seeing is the rebirth of fraud and manipulation, but in the natural gas market.

Ms. LAUTENSCHLAGER. It is hard to tell because we don't know what is going on. So I think you are getting precisely to the point, which is we need to be able to have information.

Senator FEINSTEIN. Thank you.

Thank you, Mr. Chairman.

Chairman SPECTER. Thank you very much, Senator Feinstein.

Senator Cornyn?

Senator CORNYN. Thank you, Mr. Chairman.

Thank you, ladies and gentlemen, for being here today and offering your expertise. You know, it is kind of confusing for all of us. As a matter of fact, the Federal Government is confused among itself. As you know, the Federal Trade Commission and the General Accounting Office have different views on the question before the Committee today—consolidation in the oil and gas industry, is it raising prices? And, of course, the Federal Trade Commission disagrees with the General Accounting Office's methodology and the like. But even assuming that the General Accounting Office's methodology is correct, it concludes that it probably had a difference of maybe 2 cents per gallon on gasoline, or perhaps under some instances it actually said that there were decreases of about 1 cent per gallon on average.

So I guess all of us can be forgiven, I hope, a little bit at being confused if, in fact, the two entities—the Federal Trade Commission and the General Accounting Office—that are supposed to understand and evaluate these issues and explain them to the rest of us appear to be in disagreement.

But while we are all looking for answers to the important questions of how we can get more supply and how we can help bring prices down, while Congress can pass new legislation—and I think Senator Specter has taken a serious attempt to try to address it, although I have some concerns about it—I think we ought to look perhaps at ourselves. I am talking about Congress being part of the problem here.

It strikes me that we are schizophrenic when it comes to our energy policy in this country because, on the one hand, we know that more supply, as Mr. Boies said, when it comes to natural gas, means that there will be a lower price, but yet we have policies in this country that enact moratoria on exploration and development of known reserves of natural gas offshore. We know that there is oil and gas available in places like the Arctic National Wildlife Refuge, and Congress has chosen to deny the exploration and development of that, which is strikes me if it would increase supply, then it would necessarily help bring the price down.

But I want to maybe ask Professor Borenstein, you talk about the demand and the scarcity of supply. Would you sort of put in a global context of why things have changed so dramatically here over the last 5 or 10 years in terms of competition for that supply between emerging economies like China and India? Has that had

a very direct impact on the costs we are seeing both on oil and refined product as well as natural gas?

Mr. BORENSTEIN. There is no question that the growth in world demand has been the major factor driving up crude oil prices over the last 5 years. I certainly do not believe, though, that we should view this as a problem created by China. China's demand is growing because it is a very underdeveloped country that is now trying to become a moderately underdeveloped country, and as a result, they want to consume more oil. I think certainly in my opinion they have just as much right to buy oil as we do on the world market, but the fact is as more of the world develops and wants to become particularly an oil-dependent transportation economy—because there are very few substitutes—it is going to drive up the world price of oil. That is an inexorable direction that we are going. Frankly, drilling in the United States is not going to change that more than a very minute amount, and, in fact, over the medium run, it doesn't look like we are going to bring on enough new oil supplies to significantly dampen the price. And I say that both reading the press about the oil exploration and looking at the oil futures market where people are making their own monetary bets on prices, and they see it staying around $60 a barrel as far as the eye can see.

Senator CORNYN. Well, it strikes me that part of our National Energy Policy has got to be reducing our almost complete dependence on oil and gas. As the President said, we need to diversify, as the Congress has passed an energy bill which has encouraged the use of nuclear power, for example, and finding ways to use the 300-year supply of coal that exists in this country that produces electricity for an awful lot of people.

Mr. Chairman, my time is up.

Chairman SPECTER. Thank you very much, Senator Cornyn.

Senator Schumer?

Senator SCHUMER. Thank you, Mr. Chairman.

Mr. Chairman, in the past, this Committee has received statements that discuss the economic vagaries and jargon used to justify a rubber-stamp mentality at the FTC. And I want to thank this panel because they break through a lot of that.

I think we need to step back and apply some common sense here. There are fewer more massive players in the markets. Prices have spiked. And what has gone up has not come down. Coincidence? I don't think so.

The result, of course, has been egregious profits for the mega oil companies. Exxon announced a record-breaking $10 billion in profit in the last quarter, with $36 billion in profit for all of last year, which is a record in corporate history.

Examine the numbers and it yields an inexorable equation. Concentration in the industry equals obscene prices plus record profits. My constituents experience this all the time, and we see prices going up by 50 cents in a day.

We hear, of course, that the price of oil is set on the world market and supply and demand are the root drivers. True as these things may be, it is simply naive to think that massive consolidation of the industry has no impact, particularly with the vagaries of price. Not only does it keep the price of oil high, but since these

companies don't invest in new sources of energy, it stifles innovation and leaves us dependent on oil.

In his State of the Union address, we heard the President say that America is addicted to oil. If that is so, then these behemoth oil companies are some of our biggest dealers. And we have heard a great deal of talk about the need for an international market, prices go up, we need consolidation to explore. That doesn't answer the consolidation in the downstream market. In other words, even if you have to consolidate for exploration, which I wouldn't concede, why do you have to consolidate with refineries and retail, which has happened as well? And consumers have been backed into a corner because the oil companies have been given free rein to corner the market, even in areas that have nothing to do with production.

Mr. Chairman, I think we should seriously explore divestiture, particularly on the downstream side, refining and retail, because what happens very simply is that the price of gasoline goes up even when there is an adequate supply of crude because of the consolidation in the downstream market.

So I would like to ask each of you two questions. First, do you agree with that downstream analysis? Wouldn't the market benefit from more independent activity in the downstream sector? Wouldn't the consumer be better served by competition, more of it among refiners and retailers, regardless of the issue of exploration and the high costs there? And, second, don't you think that if we had 100 or even 1,000 smaller oil companies selling oil, refining oil, that after Katrina we wouldn't have seen everybody, no matter how much Gulf oil they got, march in lockstep in terms of the prices? The West Coast, for instance, gets no Gulf oil, and their prices went up almost exactly the same as the areas that use Gulf oil?

Let me just start with Mr. Boies and work my way over, and I am not asking any more questions.

Mr. BOIES. I would agree, Senator. I think that everybody knows and certainly every businessman knows that if you can increase concentration, you can increase prices, you can increase profits. And while it is often very difficult to determine how much the profits have increased and how much the prices have increased as a result of concentration, we know the right direction and we know that competition is better than concentration. We know that the more competition you have at the downstream market, the better price and the better service consumers will get.

Senator SCHUMER. Ms. Lautenschlager?

Ms. LAUTENSCHLAGER. Thank you, Senator. Let me just say one quick thing, and that is in respect to the natural gas markets. And we in Wisconsin obviously—we were not impacted necessarily by suppliers in the Southeast during Katrina, and yet we saw those like spikes.

The natural gas market saw perhaps a 5-percent hit as a result of Katrina, but natural gas demand during that time also went down because of the loss of industry there. So maybe a 2-percent hit to the market, and yet we saw those incredible spikes. I think you are absolutely right. It is inexplicable for those reasons.

Senator SCHUMER. Mr. Greene?

Mr. GREENE. Thank you, Senator. Very thoughtful questions.

Our experience is that antitrust authorities have by and large not understood until recently the critical importance of retail and the downstream aspects of the business. What we perceive generally and I think what consumers oftentimes see is a pattern that we sometimes call a "rockets and feathers" pattern. Prices will rocket up, as they did post-Katrina. Actually, in California, our prices skyrocketed within 24 hours, and indeed none of our refineries are actually based in the Gulf Coast. But what happens is because of a relatively limited amount of competition at retail, it feathers down.

What I think is needed here, if it is at all possible, is an injection of competition at retail. The battleground frequently on the price of gasoline is fundamentally at the intersection level. If it is all majors at that intersection, those prices will feather down very, very slowly. If we could reinject more competition, more independence into that marketplace, that would be a definite plus.

Senator SCHUMER. Mr. Alioto?

Mr. ALIOTO. Thank you, Senator. I don't think that there is any question that if there were more competition, and especially in the refining and the retailing, that there would be significant decreases in prices. I think that it needs to be understood that these companies are exchanging their refined product, and they exchange the refined product between themselves at a price substantially less than the price they sell to their own retailers. The retailers are under complete control of the oil company. They are the buffer zone between the oil companies and the public. And as a result, if their price is going up, their margins are not much different, regardless of where it goes.

The Supreme Court once referred to them as "the vassals of the oil industry." There is no question that is exactly what happens. And there should be much more competition and divestiture in that area because a dealer cannot sell other gasoline even though it is coming out of the same refinery. And so they have to stick with their so-called brand, and the brands are insignificant because the owners of the various brands may be one company that is not the original competitor's.

Senator SCHUMER. Finally, Mr. Borenstein?

Mr. BORENSTEIN. Well, I am concerned about concentration in the refining business, the increase you see. I am more concerned still about potential future increases. I think that we are now on the cusp of being in a position where more increases would literally cause a problem.

At the same time I think that realistically this is not an issue that is going to affect the world price of oil, and it is a world market for oil, and that is the biggest reason that we are seeing high gasoline prices right now.

I also want to address the retail end. The fact of the matter is that although there is a lot of disagreement and tension between retailers and refiners, retail margins have fallen over the last few decades.

And it is very high to put the current high price of gasoline on some sort of problem of competition at the retail end. I think the concern we should have is at the refining end, and I think that might explain a few cents—market power in that area might ex-

plain a few cents of the current pricing, but to be completely honest, it is going to explain for more than 5 or 10 cents at the very most. All of what is going on right now is the very high price of world oil and that is because the world oil market is tight, and Saudi Arabia in particular is able to make it tighter.

Chairman SPECTER. Senator Coburn.

Senator COBURN. Thank you, Mr. Chairman. I would note for the record that the price of natural gas this morning is around $7 a million BTU, and in fact, we did see a tremendous spike in natural gas prices. Anybody want to explain why we saw that, any of our panelists?

Mr. BOIES. This spike in natural gas prices is due to an excess of demand over supply, and the issue is why do you have that excess, and whether or not what is happening is supply is being manipulated for purposes of restricting output and increasing price.

Senator COBURN. I would tend to disagree with that. I think the reason the price went up is pure speculation on the commodities exchange by people who did not have to take delivery of natural gas, and if you will recall, what did we do with silver and the Hunt brothers? How did we eliminate the manipulation of that market? What was the technique that was used?

Mr. BOIES. Well, actually, the Hunt brothers ran out of money.

Senator COBURN. But we also said you had to take delivery.

Mr. BOIES. Yes. But the problem is, as I indicated before, is that you have vast reservoirs of natural gas in Alaska, and none of it is being exported to the United States, zero over decades, and that elimination of that supply—

Senator COBURN. That is right. And none is being exported today, and the price is half of what it was 2 months ago. The point I am wanting to—I want to get back to what Senator Feinstein was talking about—is manipulation on the commodity markets of price based on speculators.

Mr. BOIES. There is no doubt that there is a tremendous amount of volatility that is increased and results from that speculation. I agree with you, and I agree with what was said earlier by the Attorney General completely, that without the transparency, those markets lead to a great deal of volatility. But if you look at the long-term increase, that is going to be due to supply as well. You have to address both of those issues.

Senator COBURN. I do not disagree with you, but the chart that Attorney General Lautenschlager put forward, if you go back to 1990—I can tell you, being from Oklahoma, $2 natural gas is not going to get any exploration for it. Nobody is going to hunt for natural gas at $2 at the wellhead. It does not pay, will not pay, will never pay again because of the cost. So let's assume that we have a $4 or $5 natural gas. My question to you is that price ought to increase demand. I am not denying your legitimate point that you see a problem with delivery there, but I think the big run-up that we saw here has more to do with speculation on the commodity markets than it has to do with price manipulation of either the gas producers or the consumers. In fact, there was artificial demand created on the basis of a run on the commodity markets, and there ought to be something either going to the Banking Committee or the Finance Committee to create the transparency in those mar-

kets, and also with a little rule, if you are going to do it, you have to take delivery.

Mr. BOIES. Right.

Senator COBURN. Take your trillion cubic feet of natural gas if you want to speculate on it, and let the hedge funds take it, and then let's see what they will do with it. They will choke on it.

And the same thing, I had a producer in my office that his estimate—Professor Borenstein, I would be interested in your response—he still thinks that there is $7 to $8 speculation priced into the world price of oil based on speculators only, not on people who are actually consumers of oil, and I would wonder what your thought is on that.

Mr. BORENSTEIN. Actually, I do not think that speculators are able to keep a long-term price spike in the market. I think certainly they participate in changes in beliefs about whether we are going to see a shortage. For instance, after Katrina, a number of non-gas companies got into the market, which was very tight, and thought that the price was going to spike substantially, and sure enough, that contributes to driving the price up.

However, the reason the prices have not gone up substantially is we have had until fairly recently a very mild winter, and that took the pressure off of those very limited supplies, and as a result we have seen the price, thankfully, come back down.

That said, I agree entirely with Senator Feinstein. In fact, back in 2001 when it first raised, that we need more transparency in these markets. The CFTC has rules to prevent the sort of squeezes that the Hunt brothers engaged in, but those rules need to be applicable. I am not sure you want to force the hedge companies to take delivery, but you certainly want to force them to unwind their position in a reasonable and timely way so it does not have disruption in the market.

Senator COBURN. I just have one other question for you, kind of as a free marketer. If I go out and produce 100,000 bushels of corn and the price is not any good, should I be forced to sell that?

Mr. BOIES. No. But I think that that does not really address the issue here, because certainly over the last 30 years the price of natural gas has been extremely high, and what you have seen is holding the natural gas off the market at a time when the price has been spiking. So this is not a situation in which you have very low prices and people are simply waiting. What you have are people holding the supply off the market for purposes of keeping prices high and making prices go higher.

Senator COBURN. Did you say over the last 30 years that the price of natural gas had been high?

Mr. BOIES. No. What I said is it has been increasing and they have had the natural gas there for 30 years. In order to believe that this is simply waiting for the price to go up, you would have to believe that there was not a time over the last 30 years when they thought it was profitable to market natural gas. You have arguments for exploration, drilling, and we need to drill more. We need to find more natural gas. And yet they have trillions and trillions and trillions of cubic feet of natural gas that are sitting there, already discovered, ready to be developed and they are not being developed. What I am saying is that there is a disconnect between

the argument—which I agree with—which we need to have more exploration, and the argument that says, well, we are just going to hold all this supply off the market.

Senator COBURN. Any other comments on that?

Mr. ALIOTO. I think that in the production you have to look at what Senator Schumer was talking about, but in production and exploration you have to deal with the numerous joint ventures among and between the oil companies so that the risk factor is very limited, and so they all share in what happened. So no one takes the major risk, and that when they do in fact get a find and get a product, they also have certain sharing and agreements. Like I pointed out, Senator, in your State, Phillips actually, the chairman of Phillips, in the notes with the Chairman from Conoco, had made a substantial investment in Alaska, some $7 billion. But he could not even operate it in Alaska, and the reason he could not was because he recognized, and the folks from Conoco recognized, that there was an agreement between Exxon and BP that the only operators in Alaska were going to be those two. And so he conceded to BP to operate what he bought.

Senator COBURN. Mr. Chairman, could I ask indulgence to ask one question of Professor Borenstein?

Chairman SPECTER. Yes, Senator.

Senator COBURN. In this makeup of the majors who have consolidated through the years, as a percentage of the natural gas market in this country, compared to the petroleum—excuse me—in comparison to the crude oil market, is there a big differential between market control on natural gas and on crude oil in this country among these majors?

Mr. BORENSTEIN. Look at the natural gas market. It is a continental market since it is very hard to import, and so the positions of these producers are much, much larger, even with the same domestic market share. The natural gas market has historically been considered very competitive, but in the last decade we have seen increases in concentrations and certainly there is increased concern when these markets get very tight as they are now, that have been met with even 20 percent or 10 percent market share, is able to move the market. In the world oil market these companies really are small players and really are not going to be able to move the market. They are going along for the ride, and, of course, they are making a lot of money at it.

Senator COBURN. But it is true that they control less natural gas than they do oil products in this country?

Mr. BORENSTEIN. That is true, I believe. Actually, I am not sure off the top of my head, but I think that looking at their control of natural gas, you have to recognize it within a domestic market, whereas looking at oil, you have to recognize that it is in the context of the world oil market.

Senator COBURN. Thank you, Mr. Chairman.

Chairman SPECTER. Senator Durbin.

Senator DURBIN. Thank you very much, Mr. Chairman.

Chairman SPECTER. I want to make a comment that Senator Coburn went a little over time. He has yielded back more time, however, in the past than any other member of the Committee, so

we gave him a little extra license. I just want the record to show that.

Senator Durbin.

Senator DURBIN. Thank you, Mr. Chairman. I want to thank the panel.

We write laws. We like to think that they will change things for the better. Senator Specter has a bill which he is introducing, which I would be happy to co-sponsor, the Petroleum Industry—

Chairman SPECTER. Thank you very much, Senator Durbin.

Senator DURBIN. Senator DeWine has a bill called the NOPEC bill, that I have co-sponsored in the past, that I believe is part of it. But when I listen to your testimony here, all the laws we pass may not make any difference at all. When I hear you give comment on the antitrust section of the Department of Justice and the Federal Trade Commission, they sound like lap dogs in a roomful of energy pit bills. So the question I have is this, even if we pass these new laws and create this new enforcement authority to try to break up some of this concentration of ownership, to try to create competition and give the consumers a fighting chance, do they have a fighting chance if the administration will not aggressively enforce the current laws or any new laws that we would enact?

Mr. ALIOTO. They have a fighting chance, Senator, if they are given the right to file suit under these laws.

Senator DURBIN. Private causes of action.

Mr. ALIOTO. Pardon me?

Senator DURBIN. Private causes of action.

Mr. ALIOTO. Private cause of action, because they are the only suits that are being brought. The Government, I would say in many of the antitrust cases in the last 10 years, the Government is on the side of the defendant, so the private right of action is the only one that is being effective, and if we have the right—unfortunately, in Senator Specter's legislation, this is just confined to—enforcement is just confined to the Attorney General. Give enforcement to the private party, and if you can, in terms of damages as well for what is going on, make it an indirect purchaser as well, that they can file suit, because if we cannot, the Government will not.

Senator DURBIN. I think that is a good suggestion.

Let me ask the others on the panel, have you seen evidence in the last 5–1/2 years of this administration, as we have watched the cost of energy bankrupt airlines, and cause such a tremendous drag on our economy, not to mention the hardship on businesses and families, have you see evidence of this administration, that they understand this concentration of power and the damage that these high energy prices are doing to our economy?

Ms. LAUTENSCHLAGER. Let me just say, Senator, that I agree with you on that premise, and I think that you are absolutely right.

That being said, from a practical standpoint, and somebody who has been involved in a variety of Government institutions over my professional career, that is why somebody like me comes to a Committee today and says, can we at least get transparency? Can we at least know who is doing what and hold them accountable, because at that point at least the ordinary citizen, somebody who is

not part of a special interest group, has at least the opportunity to see what is being done institutional.

Senator DURBIN. What I hear from you and Mr. Alioto, is at least give somebody on the outside of Government a chance to fight for consumers, because no one on the inside is doing it.

Ms. LAUTENSCHLAGER. I like fighting for consumers, Senator, but certainly, the Federal Government's practices have changed over the years.

Mr. GREENE. If I may, Senator?

Senator DURBIN. Mr. Greene.

Mr. GREENE. I do have the opportunity to work with people I think are quite good at both the U.S. Department of Justice and at the Federal Trade Commission, and I have been very impressed with their commitment to the public interest.

They do, however, operate within a structure, a legal structure which has become the legal equivalent of a hot house petunia. The elaborate economic analyses that are done really cut against sort of the common-sense notion that many of you have articulated today. Within that structure I think they are making a very sincere effort.

The kinds of statutory changes that Senator Specter and others are endorsing with his legislation changing the standards with respect to mergers, would be extremely helpful. I mean these cases are extremely time consuming. They are extremely expensive. All these merger cases, in ExxonMobil, for example, we took a portion of the document production from Exxon. I took over, essentially, half of our library in Los Angeles. I had, literally, 10,000 boxes of materials.

Senator DURBIN. Let me just say I understand it is a big fight, and it is a big issue. And when companies like United Airlines and other airlines are going into bankruptcy because of the cost of jet fuel, and because we see companies across America and families across America in hardship, I think it is worth the fight.

And one thing I want to add, and I do not know if Professor Borenstein will have a chance to reply, but when I listened to your first comment about the cost of gasoline on the market being $1.66 gallon, and a $1.43 can be attributed to crude oil prices, we know the price of a barrel of oil has gone up $60 and $70 a barrel. All of that is a good explanation for the high prices at the pump unless and until you consider that ExxonMobil registers record multibillion dollar profits in this atmosphere. So it is not input costs that are driving these alone. Clearly, there is profit-taking, the most massive profit-taking in the history of American industry at the same time.

We are in a situation now where we have no voice in saying to these giants, "You should not have done that. Your money ought to be coming back for the good of society that has paid the price for the gouging that is taking place at the gasoline pumps." So what do we get every day? We get a full-page ad in the Washington Post, explaining, "We really need this money, and we promise we are going to spend it well. We got some great ideas."

Mr. GREENE. I saw that ad myself this morning, Senator.

Senator DURBIN. Is it not wonderful that we get these ads every day? It makes me feel good.

Mr. GREENE. But I do think it is a fight, but it would be mst helpful if you would give us new tools to bring to that battle.

Senator DURBIN. New tools and new mechanics.

Chairman SPECTER. Thank you very much, Senator Durbin.

Senator Biden.

Senator BIDEN. Thank you very much, Mr. Chairman. Thank you for holding the hearing.

Professor, I would like to ask you a question. How much of the $1.66, as it relates to the crude oil cost, the world market price, how much of that would you call a terror premium? In other words, a lot of it is obviously supply and demand. Demand has increased greatly. The ability to increase supply rests basically only with Saudi Arabia now to any amount, a couple million barrels a day. But how much of that is a terror premium?

Mr. BORENSTEIN. I actually think relatively little of it is a terror premium because what we are facing right now is not supplies being held back in concern that they will maybe be needed later after a terrorist attack, but the world production capacity is really being pushed to its capacity. And all the other OPEC members, the United States and all the non-OPEC members, other than Saudi Arabia, are cranking out all the oil they can. Saudi Arabia is cranking out a lot of oil, though they are withholding 1 or 2 million barrels a day in capacity from the market. So it is very hard to attribute the high price to today's price of oil to a terror premium. I think most of it is being driven by the fact that we have strong demand, we have very inelastic demand, and we have one player who can restrict supply. Everybody else is already restricted by their capacity constraints.

Senator BIDEN. My second question, Professor—I did not support it, but we passed an energy bill in 2005 that has $2.6 billion in incentives for oil and gas incentives, and based on the profits, is any of that needed? I mean I do not quite get it. I was really impressed with your testimony. You seem balanced as can be. What is the deal? If we did not have any of that $2.6 billion in incentives for oil and gas companies, would they in any way alter their behavior, from an economic standpoint?

Mr. BORENSTEIN. I was certainly very sorry to see those incentives in the energy bill. I think with the price of oil where it is now, offering more incentives for oil exploration in the United States is just not a good policy. It is essentially handing money to the shareholders of the oil companies.

Before we start talking about windfall profits taxes, I think the first thing legislatively that should be done is a serious exploration of all the tax breaks that the oil companies got, and removal of most of them, because at this point I do not see the reason for the United States intervening to try to encourage certain things to the market, when the price is $60 a barrel.

Senator BIDEN. I find it fascinating that we want market forces to function, and I am preparing legislation to do just that, eliminate all the incentives. I was here during wage and price controls, and I was here during the time when we put a excess profit tax on oil companies. That is how long I have been here, Professor. I used to have hair like you, and that is how long ago it was. I think the chances of that happening are zero. But I think the changes

of—and we are going to get a chance to ask the oil executives this—let's just be free market guys here. Let's just get rid of all these incentives. You do not need them now. Granted, $2.6 billion over 10 years is not the end of the world, but it is a good place to start.

Let me ask David Boies, if I may. You heard earlier the Professor's testimony, where he basically is saying, as I understood him—and you correct me if I am wrong, Professor—that there is not a whole lot—I think your phrase was, there is a whole sea out there—what was the phrase you used—one big bathtub of oil, and we are very small players in it. And so as a practical matter, there is not much we are going to do in that big bathtub to affect the price of crude oil. I wonder whether, starting with you, David, if the panel agrees with that assertion?

And the second question I will get in before my 43 seconds is up, is if there is only one thing we could do from this panel, including you, Professor, what was the one thing you would like to see us attempt to change legislatively? There are my two questions.

Mr. BOIES. With respect to the bathtub of oil, my remarks were primarily directed toward natural gas, and I think the Professor would agree that the natural gas market is not a worldwide market. It is much more of a continental market. If you look at the spike in prices that came from about a 5 percent, 6 percent interruption in terms of Katrina, and you think that the Alaska gas supplies, if they would simply commit the gas to the pipeline, would increase supply in the United States between 7 and 10 percent, substantially more, maybe twice as much, you can get some idea of what the order of magnitude of the effect on price could be in the natural gas market if we could simply make them stop withholding that supply from the market.

Senator BIDEN. General?

Ms. LAUTENSCHLAGER. Thank you, Mr. Biden. I had the good fortune of meeting your delightful son a few weeks ago.

Senator BIDEN. He is smarter than I am.

Ms. LAUTENSCHLAGER. Let me say that from an enforcement standpoint, I think the transparency issue is huge, and I think it is something which is doable within the context of this Congress.

Senator BIDEN. Mr. Greene?

Mr. GREENE. I think, Senator, that the oil industry actually at some level is quite localized. Refineries are optimized for certain kinds of oil. For example, refineries in California, several of them are specifically designed to take Alaskan crude. They are not designed to take any other kind of crude. So when you are taking a look at a merger, for example, you have to take that into account.

At a higher level, of course, oil at some level is an international product and we have to think of it that way, but it is, in important ways, very local, and you can sort of analyze it that way.

In terms of the single most important thing I think you could do today for the people of the United States would be to enact NOPEC. That puts into play the power of the United States Judiciary and its prosecutors to address what I think is the single most important problem here, which is the international oil markets. If you do one thing, that is the thing I would certainly suggest.

Senator BIDEN. Mr. Alioto?

Mr. ALIOTO. I would point out, Senator, that I think one of the things is, as in this legislation, to prohibit—especially Americans—from agreeing not to import into the United States, like Chevron and Texaco had in their agreement, the Caltex agreement, for all the gas that they explored in the Far East. I think also that Saudi Arabia, as you may know, Saudi Refining Company is run by the Saudi Arabians. They were part of, and are part if, the Star Joint Venture that was part of Texaco. And they were part of that Shell-Texaco agreement, and they were part of the increasing in the prices when the crude oil was at its lowest since the Depression. So they are aware of that.

And I think NOPEC, I do not know whether or not it would be effective, but certainly a law like that—I think we have that under continental law—but certainly a law like that, that if they affect the United States, that we ought to be able to do something about it. But so long as we do not have to hear from the State Department that prevent us from—especially if you allow private parties to do it—so long as we do not have to hear from the State Department, which they come to us a lot if they think that we are interfering with international politics.

Senator BIDEN. Professor?

Mr. BORENSTEIN. Well, I think the one thing that this Committee could do practically is try to change the burden of proof in these merger cases, to tilt it more toward a real showing of economies. At the same time though I think this Committee has to recognize and help the public recognize that the main reason the gasoline prices are so high is out of our control and is a result of strong demand in the world market, and that that is a reality going forward. And the idea that Americans have a right to cheap, plentiful fossil fuel energy supplies is just out of sync with reality, and we need to explore alternatives so that we can reduce our addition to oil. As long as we are using oil as a transportation fuel, we are going to continue to be held up by the world oil market, particularly by the Middle East.

Mr. ALIOTO. I want to say that the idea that the prices of oil are out of our control is absolutely incorrect, and that it is a matter of combination and whether combinations can be broken up. These folks meet all the time, every month. They use the same facilities. They know exactly what they are doing. If they want to raise the price or lower it, they can.

Chairman SPECTER. We are going to proceed with the second panel. The Senate schedule calls for the budget resolution voting to start this afternoon at 3 o'clock. We had to start late today because of the Judicial Conference. Customarily this Committee begins promptly at 9:30, but we made the 10:30 start for that reason, and we are going to proceed right through.

Professor Borenstein, Thank you very much. Thank you very much, Mr. Alioto, Mr. Greene, Attorney General Lautenschlager and Mr. Boies. Your testimony has been very, very forceful and illuminating, and helpful. Thank you.

Senator BIDEN. I agree.

Mr. ALIOTO. Thank you, Senators.

Chairman SPECTER. We now call Mr. Rex Tillerson, Chairman and CEO of ExxonMobil; Mr. James Mulva, Chairman and CEO of

ConocoPhillips, Mr. David O'Reilly, Chairman and CEO of Chevron Corporation; Mr. Mr. Bill Klesse, CEO of Valero Energy Corporation; Mr. John Hofmeister, President, Shell Oil Company; and Mr. Ross Pillari, President and CEO and BP America, Inc.

Thank you for joining us, gentlemen. And if you will all rise, we will administer the oath.

Do each of you solemnly swear that the testimony you will give before this Judiciary Committee of the United States Senate will be the truth, the whole truth and nothing but the truth, so help you God?

May the record show that each answered in the affirmative.

We have been joined by Senator Kohl, who is the ranking on the Subcommittee, and I think it would be in order to recognize you, Senator Kohl, for an opening statement.

Senator KOHL. I thank you very much for that courtesy, Mr. Chairman. I do have a statement which I will insert into the record so we can get to questions.

Chairman SPECTER. Without objection, it will be made a part of the record.

Senator KOHL. Thank you.

[The prepared statement of Senator Kohl appears as a submission for the record.]

Chairman SPECTER. Our first witness will be Mr. Rex Tillerson, Chairman and CEO of ExxonMobil Corporation. Mr. Tillerson began his career with Exxon in 1975, holding numerous engineering, technical and supervisory assignments. More recently he served in several high-level positions with responsibility for Exxon's holdings in Russia on the Caspian Sea Region.

Thank you very much for joining us, Mr. Tillerson, and as announced previously, our Committee proceedings call for 5-minute opening statements. The floor is yours.

**STATEMENT OF REX W. TILLERSON, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, EXXONMOBIL CORPORATION, IRVING, TEXAS**

Mr. TILLERSON. Thank you, Chairman Specter and members of the Committee. With respect to the Committee's specific question, whether mergers and acquisitions in our industry have contributed to higher prices at the pump, my answer is no, and an examination of the facts do not support any other conclusions.

In our view the fundamental question is, if Americans are to continue to have access to secure, affordable energy from today's global marketplace, what qualities must U.S. energy companies have to successfully compete? We need companies that have the scale to compete, the financial strength to undertake the risk involved to make enormous investments, and the technological expertise to meet future needs and environmental expectations.

Let me begin with a scale. The energy industry follows what I call the law of large numbers. Although each unit of energy consumption is relatively small, multiply it by billions of consumers daily, it adds up to the world's largest industry. To give you a sense, in the amount of time scheduled for our panel, American will have consumed about 54 million gallons of oil. Given these volumes, naturally our earnings are large. For an American company

to succeed in this enormous industry, it needs sufficient scale. Having said that, ExxonMobil today accounts for a smaller global market share than Exxon and Mobil did together either years ago. And believe it or not, our share of the world's total energy production is less than 2 percent, and our share of global oil production is 3 percent.

The second quality American companies need to compete is financial strength. Financial strength allows us to undertake the enormous risk involved in making huge investments in energy-producing projects that take years to develop and bring into the global supply pool. Our costs are enormous. For ExxonMobil they included $185 billion last year to buy crude in the global market. That is because we do not produce enough crude oil to sufficiently feed our refineries. We produce about 2–1/2 million barrels a day of crude oil. That is about 3–1/2 million barrels a day less than we refine. Subtract the taxes and the cost from the price of gasoline, and our downstream earnings were less than 10 cents a gallon.

Over the last 5 years we have invested $74 billion in adding crude oil producing capacity, and developing liquified natural gas, and in building refining capacity, and in other projects to bring more secure, reliable, clean energy to Americans. If you look at our investments over the last 15 years, $210 billion in all, that exceeded our cumulative earnings.

Finally, U.S. energy companies need technology leadership. Sophisticated technology allows us to bring harder-to-reach energy resources to American markets in a safe and environmentally sound way. ExxonMobil is spending millions each day to extend efficiencies, develop new production capabilities, blend cleaner fuels, and fund breakthrough emissions reducing technologies.

One example of our scale, investment and technology at work, is the Alaskan natural gas pipeline. If this historic project proceeds as we hope, and with the support of Congress, the executive branch, and the State of Alaska, it will create 6,500 jobs, entail 54 million hours of work, and require over 5 million tons of steel. It will be the largest construction project of any kind ever undertaken in North America, requiring an investment of over $20 billion. When it is completed, it will provide Americans with access to a new source of secure, clean-burning natural gas.

In conclusion, we need energy companies that have the scale and financial strength to make the enormous investments, undertake the risk, and develop the new technologies necessary to provide Americans with greater energy access and greater energy security. ExxonMobil is one such publicly owned energy company, and one that I believe all Americans can be proud of.

Thank you.

[The prepared statement of Mr. Tillerson appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Tillerson.

Our next witness is Mr. James Mulva, Chairman of the Board of Directors, President and Chief Executive Officer of ConocoPhillips; became President and CEO after the 2002 merger between Conoco and Phillips. Prior to the merger he served as President and CEO for Phillips Petroleum.

Thank you very much for being with us today, Mr. Mulva, and the floor is yours for 5 minutes.

**STATEMENT OF JAMES J. MULVA, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CONOCOPHILLIPS, HOUSTON, TEXAS**

Mr. MULVA. Mr. Chairman, members of the Committee, thank you. Our company appreciates the opportunity to share the experience we have gained from the merger of Conoco and Phillips, and to demonstrate how such combinations of expertise and resources has benefited the U.S. consumers.

Recent consolidations in the petroleum industry have been driven by an increasingly challenging business environment. The principal challenge is access to oil and natural gas resources, not only here in the United States, but in many other nations around the world that supply about 60 percent of our country's petroleum needs. Government policies in the U.S. put the most highly prospective natural gas acreage off limits, and make it difficult to permit key energy infrastructure. Resources outside the United States are often controlled by host country national oil companies, which allow limited or no access by international oil companies, and which have recently increased competitive intensity by vying for the opportunities beyond their borders.

The most significant opportunities that are available to international oil companies today are generally projects that host country national oil companies decide to undertake jointly with foreign participants. These projects are often very large, complex and risky. They require financial strength, proven technologies, highly trained personnel and reliable access to the marketplace. Only large companies that have the financial capacity and technical resources to effectively develop these projects, and have sufficient diversification to manage the risk.

For U.S. companies to compete in today's environment of mega projects, they have grown in size commensurate with the growing magnitude, complexity and risk of available opportunities. The $36 billion merger of Conoco and Phillips was completed in 2002, was undertaken to form a company of sufficient size and scale to capture opportunities that could not be achieved by either company on a stand-alone basis. The combination also created a new U.S. company better able to compete in the world energy market through its stronger financial position, improved capital efficiency, and a leaner cost structure. The merger was necessary to sustain the company's long-term viability.

Briefly, here are two specific examples of benefits to the U.S. consumers that in all probability would not have happened without the combination of the companies' complementary technology and competencies. By coming Phillips LNG technical expertise with Conoco's gas marketing experience, ConocoPhillips has become a successful player in the global LNG business. Over the next decade, LNG will become a crucial component of America's gas supply in refining. The complementary refining technologies and best practices of the two companies are being shared across our entire refining system. These efforts have helped lower our cost structure, improve efficiency, and expand our capacity. Furthermore, the combination will help improve the feed stock position at several of our

U.S. refineries, by linking them with growing supplies of crude oil from the Canadian oil sands.

In short, the merger has opened the way for ConocoPhillips to increase supplies, which benefits U.S. consumers through lower prices and greater energy security. U.S. consumers also have benefited from the reduced cost and improved efficiency of our business, as this has allowed us to provide more reliable supplies at the lowest possible cost.

Looking ahead, ConocoPhillips is planning an expanded investment program in U.S. refining, which will produce 15 percent more clean fuel such as gasoline and diesel by the year 2011. The equivalent of adding one world-scale refinery to our domestic refining system. And we are also working close with the State of Alaska and others to bring North Slope natural gas to the lower 48 market through a new pipeline expected to cost over $20 billion.

We are investing aggressively to bring liquified natural gas to the U.S. market through our multibillion dollar projects in Qatar, Nigeria, while simultaneously pursuing opportunities in Russia, Venezuela and Australia.

Mergers and acquisitions have allowed ConocoPhillips to create a global petroleum company that is more capable of deploying significant investments to increase the supply of crude oil, natural gas and refined products to U.S. consumers. In fact, over the last 3 years, when our earnings totaled about $26 billion, our investments back into the business exceeded $27 billion. We intend for our high levels of reinvestment to continue with a 2006 investment program of nearly 17 to 18 billion dollars.

The key to improving energy security and reducing prices is increased investment by the energy industry across a diverse set of energy projects in both the upstream and downstream business segments. ConocoPhillips could not make the investments we are making today to increase energy supplies to American consumers without the company we have built in part through mergers and acquisitions over the last decade. We would not have the financial strength, the ability to handle large and complex projects, technologies, commercial skills or resource prospects. We believe that large, vigorous companies give consumers a stronger American voice in competing for the world's energy resources and providing them at a reasonable cost.

Therefore, we believe the Americans have a stake in keeping U.S. companies like ConocoPhillips competitive for the sake of our economy, as well as our energy security.

Thank you, Mr. Chairman, for allowing me to make these comments.

[The prepared statement of Mr. Mulva appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Mulva.

We now turn to Mr. David O'Reilly, Chairman and Chief Executive Officer of Chevron Corporation since the year 2000. A native of Dublin, Ireland, Mr. O'Reilly began his career with Chevron in 1968 as a process engineer.

Thank you for joining us today, Mr. O'Reilly, and we look forward to your testimony.

**STATEMENT OF DAVID J. O'REILLY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CHEVRON CORPORATION, SAN RAMON, CALIFORNIA**

Mr. O'REILLY. Thank you, Chairman Specter and Senator Leahy and members of the Committee. I am pleased to have the opportunity to discuss some of the important energy issues facing our country today.

I would like to make two points in my oral testimony. First, mergers in our industry over the past two decades have made U.S. companies more competitive and efficient in the production, refining and marketing of energy supplies.

For example, refining has seen remarkable productivity gains. Two decades ago there were about 220 refineries in the U.S. with a capacity of roughly 14.5 million barrels a day. Today there are one-third fewer refineries, but producing 20 percent more. Despite mergers, the top five U.S. refiners today have less market share than the five top competitors in many other business sectors, including airlines, long distance carriers, department stores and auto makers.

The gasoline market is also highly competitive. During Chevron's mergers with Gulf and Texaco, we divested significant marketing assets. Today Chevron is the No. 1 marketer in only three States—Nevada, Mississippi and Oregon.

All of these factors have helped moderate gasoline prices. Over the last several decades gasoline prices have increased at a lower rate than many other staples like food, housing and health care.

My second point is that scale matters. To illustrate this, I would like to show a chart that puts the size of our industry in perspective. At my left you can see that this chart shows who controls the world's oil and gas reserves. You will find it difficult to locate companies such as ours on this chart. We are dwarfed in size by national oil companies such as Saudi Aramco and Russia's Gazprom. ExxonMobil is the small red bar in the middle, and moving to the right, the next red bars are BP, Chevron, and Shell.

Today's energy projects, like the kind we are developing in the Gulf of Mexico deep water, are big and complex. They require highly skilled, large technologically advanced and well capitalized companies to manage them.

U.S. companies must develop the economies of scale to compete in the global marketplace. This helps us to gain access to additional and diverse supplies that find their way to the U.S. markets.

Investments by U.S. companies have helped increase oil production outside of OPEC. Since 1975, non-OPEC production has nearly doubled. Because we import over 60 percent of our oil and over 15 percent of our natural gas, the United States is now more energy interdependent than it ever has been. As the world's largest consuming Nation, the United States bears a unique responsibility in addressing global energy supply issues.

There are steps that policymakers can and should take to ensure more reliable and affordable energy supplies for American consumers. These include, first, improving the climate for investment in energy infrastructure; second, rationalizing U.S. gasoline supply to make it more fungible; third, increasing access to domestic oil and gas supplies; fourth, recognizing in U.S. trade and foreign pol-

icy that the United States and the rest of the world are interdependent; and finally, promoting further improvements in energy efficiency and diversification of U.S. energy supplies.

We stand ready to continue a productive dialog on how we can work together to create these policies.

Thank you, and I will turn back the rest of my time, Senator.

[The prepared statement of Mr. O'Reilly appears as a submission for the record.]

Chairman SPECTER. Thank you very much Mr. O'Reilly.

We turn now to Mr. William Klesse, Chief Executive Office and Vice Chairman of the Board of Valero Energy Corporation. He previously served as Executive Vice President and Chief Operating Officer with the responsibility for all operations, including marketing and refining. He began his career as a junior process engineer with Diamond Shamrock, was later acquired by Valero.

We appreciate your coming in today, Mr. Klesse, and the floor is yours for 5 minutes.

**STATEMENT OF BILL KLESSE, CHIEF EXECUTIVE OFFICER, VALERO ENERGY CORPORATION, SAN ANTONIO, TEXAS**

Mr. KLESSE. Thank you, Mr. Chairman, Ranking Member Leahy, members of the Committee. Thank you for having us here today. Valero Energy Corporation is an independent refiner. We entered the refining business in 1981 when we bought a 33,000-barrel-a-day refinery in Corpus Christi. Today, that refinery has a throughput capacity of 340,000 barrels a day. During the 1980s and most of the 1990s, refining was at a cyclical low. Other companies were exiting the business because of the continuing low profit margins and escalating environmental compliance costs, but Valero believed that the move toward cleaner fuels would tighten supplies and as demand grew, margins would improve. Valero was able to buy many refineries for as little as 10 to 20 percent of replacement costs. Since 1997, Valero has purchased 17 refineries, improving and expanding every one.

And while much has been made of the fact that no new refineries have been built in this country for more than 30 years because of poor returns, siting issues, and permitting, Valero has increased capacity of its 18 refineries by almost 20 percent, adding 533,000 barrels per day of refining capacity, including since 1997 nearly 400,000 barrels a day. That is equivalent to three world-scale grassroots refineries.

It is fair to say that if Valero had not acquired those refineries, much of that capacity expansion would not have occurred, and some of those facilities might have closed.

Improving refineries takes expertise and capital, and Valero has more in-house expertise and greater access to capital than many of the companies from which we have purchased the refineries.

Valero has invested approximately $8.2 billion to improve its refineries. Since 1997 through 2005, in refining we have spent 92 percent of our total net income. Since 1997, we have spent $2.4 billion on regulatory and environmental compliance. To completely comply with regulatory and fuel specifications, we will need to spend another $3.5 billion over the next several years. And new regulations continue to be drafted and adopted. Given the mag-

nitude of the investments required to meet new requirements, agencies must consider and mitigate their impact on supply and cost as well as on the refining industry's ability to remain profitable.

Each of Valero's acquisitions was thoroughly reviewed by the Federal Trade Commission and State Attorneys General. In fact, the FTC holds our industry to a much higher standard. In some cases, Valero had to divest some assets in a transaction. But in all cases, more refining capacity and higher annual production has resulted. And we have improved safety and reliability of all of those refineries.

Aside from supply disruptions like hurricanes, where our dedicated employees were able to get those refineries on very quickly, the largest single factor in rising fuel prices has been the cost of crude oil, which last year averaged $1.20 per gallon, or about 53 percent of the cost of gasoline. Valero is not in the exploration and production business. We do not benefit from the high oil prices. We purchase all our crude and feedstocks on the open market, and we are a large spot seller of gasoline.

It is also important to note that last year, a record year, the Gulf Coast crack for gasoline was $10.57 a barrel, or about 25 cents a gallon. The return on investment for Valero is good, but even at these numbers, if these refineries were on our books at full replacement cost, our return on investment would be low. Refining is a world business with thin margins and high capital costs. We must be careful about passing laws and regulations that negatively impact the business.

In summary, Valero has been saying since 1997 that worldwide demand for clean refined products would grow faster than supply, and we have been investing accordingly. Our investments and acquisitions have clearly increased U.S. gasoline and diesel production.

Thank you, sir.

[The prepared statement of Mr. Klesse appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Klesse.

Our next witness is Mr. John Hofmeister, President and Chairman of Shell Oil's U.S. affiliate. He joined Shell in 1997 as Director for Human Resources, and prior to that, served as Vice President for Human Resources for AlliedSignal.

Thank you very much for being with us today, Mr. Hofmeister, and we look forward to your testimony.

## STATEMENT OF JOHN HOFMEISTER, PRESIDENT, SHELL OIL COMPANY, HOUSTON, TEXAS

Mr. HOFMEISTER. Chairman Specter, Ranking Member Leahy, members of the Committee, I appreciate the opportunity to discuss the energy issues of concern to you, to Shell, and to the American people.

Shell has been producing energy in the United States for nearly 100 years. I am fiercely proud of the work of our tens of thousands of U.S. employees, and especially of the way that they have stepped up to the challenges of the past year.

Our U.S. operations are heavily concentrated in the Gulf Coast area. Hurricane Katrina knocked out more than half of our offshore production for more than 3 months. Two of our Louisiana refineries were damaged by Katrina, and two more in Texas were hit by Hurricane Rita. Nearly 4,600 employees were displaced by these storms.

Our people put in endless hours, even as they dealt with their own crises, to minimize supply disruptions to those who depend on fuel for the cars, homes, and businesses.

As a recent testament to our employees' resilience and commitment to our communities, Shell's evacuated operations have now returned to New Orleans.

Why am I describing all of this, Mr. Chairman? Lack of access to energy resources and the hurricanes are the roots of the angst American consumers are currently experiencing. When supply is limited and demand is not reduced, the consequence is higher prices. In a free market, that is how it works.

Growing global demand has been a major factor behind rising crude oil prices. Shell is making significant investments to meet this challenge.

Over the past 5 years, Shell has reinvested virtually all of our U.S. earnings into finding new supply, increasing production, improving refining capabilities, and developing new technologies:

For the past 5 years alone, Shell has invested over $1 billion per year in developing offshore oil and gas resources in the Gulf of Mexico.

We are aggressively pursuing natural gas prospects in North America, including Alaska.

We are making significant investments in unconventional resources—oil sands in Canada, oil shale in Colorado, and new cleaner coal technologies in 12 States.

We are investing in liquid natural gas projects that could result in 2 to 3 billion cubic feet per day of capacity by the year 2010.

We are investing in renewable energy sources as well—wind energy, solar CIS thin film technology, biofuels, and hydrogen.

On the refining side, we are looking at multi-billion-dollar expansion projects equal to the construction of a moderate-sized new refinery.

It takes an extraordinary level of financial strength to deploy such large amounts of capital in risky environments and in a cyclical industry. Fragmented or financially insecure players cannot afford such risk. To achieve what we have set out to do, we need your help, not new barriers.

Despite the apparent size of the major investor-owned energy companies, this remains a highly competitive industry. Consider the structure of our retail gasoline business, where the Shell brand has a 12-percent market share nationwide. Roughly 90 percent of Shell branded stations are owned by independent jobbers and retailers. Just last week, I met with over 1,700 wholesalers—all independent American business men and women, not one of whom was required to choose the Shell brand to display on their businesses.

We are seeing healthy new retail competition emerging with brands such as WaWa, Sheetz, and Turkey Hill.

From the perspective of Shell's transactions experience, in markets of concern to both Federal and State antitrust law enforcement agencies, mandatory divestitures were designed to prevent declines in the number of competitors or increases in concentration. And we have fully complied with such divestitures.

Prices are set on a competitive global market. The biggest component of the retail price of gasoline—and we have heard testimony this morning—is the price of crude oil. Crude oil prices are set on the deepest and most liquid commodity market in the world. Companies of all sizes populate these markets, and investor-owned companies such as Shell provide some competitive balance to large Government-owned oil companies.

The key to providing reliable and affordable energy for America's future is new supply. Some of the greatest potential untapped resources in the world are off limits here in the United States. It is ironic that some of the same voices that cry out for the lower prices also advocate restricting access to domestic sources that, with today's technologies, could be developed in an environmentally responsible manner.

Beneath Federal lands and coastal waters, there are estimated to be 102 billion barrels of recoverable oil and 635 trillion cubic feet of natural gas whose development is limited by Federal policies. If Congress wants to address supply and help consumers, provide a way to tap these resources.

Shell is committed to meeting America's energy needs. We stand ready and willing to work with Congress cooperatively to ensure that the United States has the energy required for continued economic growth and a sustained quality of life.

Thank you.

[The prepared statement of Mr. Hofmeister appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Hofmeister.

Our next witness is Mr. Ross Pillari, President and Chief Executive Officer of BP America and senior British Petroleum executive in the United States. He began his career with Standard Oil in 1972 where he served in a variety of positions, including Vice President of Wholesale Marketing and Distribution.

We appreciate your being with us today, Mr. Pillari, and the floor is yours.

## STATEMENT OF ROSS J. PILLARI, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BP AMERICA, INC., CHICAGO, ILLINOIS

Mr. PILLARI. Thank you, Chairman Specter, Ranking Member Leahy, and members of the Committee. My written testimony can be summarized in five points.

First, BP's growth has been a competitive response to marketplace realities. BP is in a competitive global business that requires broad capability and scale to participate effectively. Finding and producing new oil and gas to meet increasing demand requires significant financial resources and the ability to manage the associated risk. BP's growth has been a response to these market conditions and has provided the capability required to compete and meet the energy needs of the U.S. and global economies.

Second, our recent growth has been weighted toward exploration and production where scale is increasingly necessary to compete. Since consolidation in the late 1990s, the major part of BP's investments have been to find and produce oil and gas, which requires scale to meet the challenges posed by technical, logistical, financial, and permitting hurdles. Just one of these projects, the natural gas pipeline from Alaska, is expected to require investment of more than $20 billion over 10 years. A smaller BP would have found it difficult to participate. Similarly, a smaller company would have been greatly challenged to make the long-term investments required to find new oil and gas reserves in the Rockies and the deepwater Gulf of Mexico. These projects are high risk as they cost billions of dollars to complete and operate with no guarantee of success. But for all our current scale and breadth of capability, we still remain a small player in this global business, as you have already seen. Foreign national oil companies control more than 90 percent of the world's oil and gas reserves. By comparison, BP represents roughly 3 percent of global oil and gas production and less than 1 percent of global oil and gas reserves. Publicly owned global companies like BP play an essential role in competing for the supplies necessary to meet U.S. energy needs. Understanding this global role is an important consideration in any analysis of consolidation.

My third point is that BP's current refinery portfolio is designed to allow us to effectively compete in the U.S. refining industry. The U.S. industry today is more competitive and productive because of investment and improved efficiency. Today's refineries produce 80 billion gallons a year more product than U.S. refineries did 20 years ago. Additionally, today's refiners must respond to new regulatory requirements and make a greater variety of more costly and complex fuels. During the past 5 years, BP has invested roughly $3.5 billion in order to meet environmental regulations, fuel specification requirements, and maintain reliability and efficiency.

My fourth point is that the U.S. consumer today benefits from a highly competitive, diversified, and reliable retail gasoline market. The retail gasoline business in the U.S. has been through great change in the last 10 years and U.S. consumers have benefited as a result. We have seen increased competition from convenience store chains, large independent distributors, and the hypermarket share has quadrupled in this time period. Today, over 90 percent of BP's branded retail outlets are operated by independent business men and women who make their own decisions about which brand they choose and how they price. BP also supplies unbranded gasoline to independent retailers in many of our markets. All of these factors contribute to a highly competitive and reliable retail market.

Last, U.S. gasoline prices in 2005 were primarily impacted by supply/demand imbalances, not growth from consolidation. The price of gasoline in the U.S. is primarily a function of demand for crude oil and products relative to available supply, which is affected by both the domestic and global markets. These market factors would have been present whether the companies of the 1990s had consolidated or not. However, it is likely that the increased capability and scale of today's companies contributed to a more effi-

cient restoration of supply when it was necessary than we would have seen in the last 5 to 10 years.

Going forward, BP will continue to invest nearly $15 billion per year to find and produce new sources of hydrocarbon-based energy for our customers. For the longer term, BP expects to spend $8 billion globally over the next 10 years to develop solar, wind, and other forms of low-carbon energy.

In closing, 2005 reflects both the unusual challenges and opportunities of the global markets for oil and gas. BP benefited from participating in these markets but has also experienced less attractive outcomes in many previous years. This is a business that must have the economic capacity to operate on committed long-term investment cycles, yet manage through volatile revenue cycles. Creating the capacity to take these risks and supply the Nation's energy needs are important outcomes of the consolidation over the past 5 years.

Thank you.

[The prepared statement of Mr. Pillari appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Pillari.

We will now start the 5-minute rounds by each Senator. I will begin with you, Mr. Tillerson. Senator Durbin has stated his intention to co-sponsor the draft bill, and a number of other Senators on the Committee have indicated similar interest, and other Senators as well. Section 1 provides for an amendment to the Clayton Act by prohibiting oil and gas companies from diverting, exporting or refusing to sell existing supplies with the specific intention of raising prices for creating a shortage. Would you object to that amendment to the antitrust laws?

Mr. TILLERSON. Senator, I think the current antitrust laws are sufficient in terms of providing the oversight of the industry's activities in all areas, including that particular area. The concern I would have is that would put at risk certain optimization steps that the industry takes routinely to ensure supplies are made available around all regions of the United States.

Chairman SPECTER. If you have a specific intent to raise prices or create a shortage, you still would disagree with that provision?

Mr. TILLERSON. That's never been the intent of our activities in moving supplies around.

Chairman SPECTER. Then you would have a defense. But the point is, if you had a law which dealt with that kind of specific intent—I am looking at what Mr. Boies has testified to on the Northern Slope, and I think a lot of people are concerned that there has never been any natural gas come out of the Northern Slope.

Let me turn to you, Mr. Pillari, on this point. Why is there an arrangement between ExxonMobil and BP to reinject into the ground, rather than being sold to willing buyers in the face of concern that that natural gas is being diverted to keep prices high?

Mr. PILLARI. I think, Senator, I would make two points. First of all, the injection of natural gas back into the fields is significant in its ability to increase the amount of oil that comes out. It is used as part of enhancing the oil production of the field.

During the early years of—

Chairman SPECTER. Are there not other ways to do that?

Mr. PILLARI. There are many ways to do it, but during the early years of the field—don't forget the price of natural gas was quite low—during that time period we've always been interested in finding a project to bring that gas to the lower 48, and in fact, there is a proposal in front of the Alaskan legislature right now that has been agreed between the State of Alaska, the Governor and us, to make that happen.

Chairman SPECTER. Are you going to bring that natural gas from the Northern Slope to the United States?

Mr. PILLARI. That is the intent, sir, yes.

Chairman SPECTER. When?

Mr. PILLARI. As soon as we can. It will take anywhere from 8 to 10 years to build the pipeline.

Chairman SPECTER. Are you planning to build that pipeline?

Mr. PILLARI. We are planning to if the final legislation passes through the State of Alaska.

Chairman SPECTER. Mr. Mulva, the testimony of Mr. Alioto this morning you probably heard, in part said that the ConocoPhillips situation, the two chairmen and executive officers of the companies—and you were one of those people prior to the merger—met privately on many occasions. One of them kept notes of their meetings. Those notes reflect that the reason for the merger was a fear of oil prices decreasing, and that it would be necessary to reduce the number of major integrated oil companies in order to keep prices high. And after the merger, according to Mr. Alioto's testimony, sworn testimony today, prices were increased. Were you a party to any such meetings?

Mr. MULVA. Mr. Chairman, I don't recall any discussions along those lines.

Chairman SPECTER. Was there any meeting—were there meetings between the two CEOs? Must have been meetings.

Mr. MULVA. Absolutely there were meetings between the two CEOs, the former CEO of Conoco and myself as former CEO of Phillips.

Chairman SPECTER. Did either of you take notes?

Mr. MULVA. I believe the CEO of Conoco did. I did not. I can tell you—

Chairman SPECTER. Do you know whether his notes contained the information that Mr. Alioto has sworn to?

Mr. MULVA. Mr. Chairman, the purpose of discussions in the ultimate merger of Conoco and Phillips was essentially and totally directed towards making and creating a more competitive company than either—

Chairman SPECTER. Let me ask one final question before my red light goes on—

Senator BIDEN. Take more time.

Chairman SPECTER. No, no. I am going to quit. Is it a relevant question—

Senator BIDEN. You are on a roll. You can have my time.

Chairman SPECTER. I am going to finish my question because of two interruptions. If it had only been one interruption I would not finish the question.

Is it a relevant question to ask why the price of gasoline goes up 11 cents in a time period when the price of oil goes down on a 7-

cent per gallon drop? Is that a relevant question, Mr. O'Reilly? I am not asking you for the answer. I just want to know if it is a relevant question.

Mr. O'REILLY. Of course, Senator. If you have asked, it is a relevant question.

[Laughter.]

Mr. O'REILLY. It is.

Chairman SPECTER. Not necessarily. I have been in many court proceedings where the judge has sustained objections on relevancy lines.

Senator Leahy, if you want to pick it up, or somebody else does? But I want to stick with the time limits.

Senator LEAHY. Mr. Chairman, I have found this interesting, and I am sorry, because of my accident over the weekend, I have been in and out of this, but I listened to what Tom Greene said from California this morning. He said the enactment of NOPEC, our legislation, could provide them with the tools to get a price manipulation and price gouging by foreign oil cartels. The Committee has reported out NOPEC three times in the last 5 years. We even passed it, as I recall, sent it to the other body. Under heavy pressure, they killed it. I hope we may pass it again.

My question is this though. The President said in his State of the Union message—and I completely agreed with this—Congress must act to encourage conservation, promote technology, build infrastructure, must act to increase the energy production of homes so America is less dependent on foreign oil.

I went back and read the transcript of the joint hearing of the Energy and Commerce Committee in November. Each of you were asked what percentage of profits over the last 10 years have your companies reinvested in non-petroleum energy supplies in the United States. BP boasted quite a bit that they had had a $600 million investment in their alternative energy business over the last 5 years. That would be about 3 percent of BP's profits, not over the past 5 years, but in 2005 alone. And Exxon, Mr. Raymond simply replied a negligible amount.

Mr. O'Reilly, you said that the question of non-petroleum energy investments in the United States is not readily available in the company's accounting records. Are they available now?

Mr. O'REILLY. Yes, Senator. In fact, I responded in a subsequent followup written question on this matter.

Senator LEAHY. So how much?

Mr. O'REILLY. $300 million per year, Senator.

Senator LEAHY. Many would call these negligible, and I wonder where the investment goes. Chevron and Texaco has 2004 net income of $13.3 billion, buy back of $2.1 billion of its stock, accumulated 5 billion in cash. Where did the rest of it go?

Mr. O'REILLY. Well, Senator, our capital investment in that years was approximately $10 billion, so we reinvested the majority of what we earned in that particular year, and $3 billion went in dividends to our shareholders.

Senator LEAHY. And 2.1 billion went for buying back stock?

Mr. O'REILLY. That is correct, Senator. And over the last four years, as I testified, we've reinvested in the business everything

we've earned, and last year we made about $14 billion. Our capital budget for this year, 2005, is $15 billion.

Senator LEAHY. How do you respond to the testimony of Mr. Alioto, when he said consolidations led directly to the increases in prices in gasoline. He talked about 1999 and the FTC about Shell and Texaco had entered into a joint venture by their assets, and then Shell and Texaco first increased the price of Texaco gasoline to bring it in line with Shell, and then decided, well, heck, let's raise the price of both, 50 to 70 percent. He said a similar thing occurred when Conoco and Phillips merged. Judge Posner of the Seventh Circuit has noted the more contrary the industry, the less explicit the communication required to organize price limit production.

Every time there has been a merger, prices have gone up. Anybody want to respond to that? Is that just coincidence? Mr. Mulva?

Mr. MULVA. Mr. Senator, I think we can show for our company, and certainly for the industry, over the last decade, the results of inflation-adjusted real terms. In other words, the price of oil goes up or down, obviously, the cost of gasoline goes up or down. But if you take out the cost of oil, what you can see over this past decade is the efficiencies that have been gained by the companies as a result of consolidations, investments and organic growth.

Senator LEAHY. But the prices always go up after—

Mr. MULVA. Actually, the cost of operation has gone down during this time period. Obviously, in this past year it has gone up, and that's primarily as a result of inflation. It's the result of cost structure. It is also the result of the cost of crude oil. But over the past decade, results of our operations, they run more reliably, environmentally much stronger, much better, and the cost structure has come down for the reasons that other individuals who have given testimony, the industry, with fewer refineries, is running with much larger volumes, and therefore, the cost structure has actually come down.

Senator LEAHY. Anyone disagreeing with that?

Mr. KLESSE. I can say from Valero, every time we have made an acquisition, production has gone up afterwards.

Senator LEAHY. Does anyone disagree with Mr. Mulva?

[No response.]

Senator LEAHY. I will assume that nobody disagrees and everybody agrees.

Thank you, Mr. Chairman.

Chairman SPECTER. Thank you, Senator Leahy.

Senator DeWine.

Senator DEWINE. Thank you, Mr. Chairman.

Mr. Boies testified on the first panel and discussed the lawsuit which his client has brought against BP and ExxonMobil. So I have a question for Mr. Tillerson and Mr. Pillari. The basic allegation of the lawsuit is that the U.S. market needs natural gas, but instead of building a pipeline to ship natural gas from the Alaskan North Slope into the mainland U.S. market, BP and ExxonMobil have refused, and in fact, have acted together to prevent others from building pipelines as well. Let me quote from his testimony earlier this morning.

"ExxonMobil and BP have used a variety of illegal means to maintain a strangle-hold on the supply of natural gas on the North Slope and prevent it from ever reaching a market. They've acted together with the purpose of eliminating competition that could threaten their control over the development, marketing and pricing of natural gas."

Obviously, these are very serious allegations, and if they are accurate, they are extremely troubling. We need to increase, obviously, our supply of natural gas, and North Slope natural gas is an important potential source. Any action to prevent it from reaching American consumers is certainly something we would all be concerned about.

I realize, gentleman, there is a pending lawsuit. You may want to be careful in what you say, but I want to give you an opportunity to respond. First, maybe Mr. Tillerson.

Mr. TILLERSON. Well, Senator, I think it's regrettable that Mr. Boies has decided to attempt to try this case in front of this Committee. I would categorically state that his allegations are untrue, and we look forward to defending ourselves in that lawsuit, which is active, as you noted, and I think to say anything further than that would be inappropriate.

Mr. PILLARI. I would also say, Senator, that we also disagree with what he said. We'll defend it in court, but would add what I said earlier. There is a very strong, high-quality proposal sitting in the legislature in Alaska today which will bring that gas to market.

Senator DEWINE. As I said, it is a pending lawsuit, and you have to follow the advice of your lawyers, but that has been the testimony, and, of course, that is the testimony that we have in front of us, and, of course, that the American people have in front of them.

Mr. Mulva, many of you have stated that merging has given you the size that you need to engage in increasingly more expensive and riskier investments. You in particular said the market forces that push for larger and more diverse oil companies will continue to grow. Just how much bigger do you think that you really need to be? Could you give us any preview of what kind of merger activity we might expect in the future?

Mr. MULVA. My comments primarily relate to the merger of Phillips and Conoco back in 2002. We foresaw that the cost of the large projects, both in the upstream part of the business, exploration and production becoming more internationally focused, more challenging. We're going into deeper waters, more exotic environmental arctic regions. The cost of projects, exploration, production, LNG projects are billions of dollars. So we looked at the size of our company, the old Phillips and the old Conoco, and we felt that the merger of the two companies would give us the critical size financially, and the technology and resources to compete. So, therefore, we felt we are of the size that we can compete. We do not see that there is any necessity for our company to be looking at further acquisitions—

Senator DEWINE. I appreciate that. My time is almost out. Anybody else anticipate needing to be bigger?

[No response.]

Senator DEWINE. I take it by your silence the answer is no.

Mr. PILLARI. Sir, I would add that I think it's important for us to continue to look to grow on a global basis, and that will come through a variety of ways, including enhancements to our refineries, enhancements to our fields. So I think the issue of growth is one that, yes, in a continuously growing world, we will want to be a part of that.

Senator DEWINE. Does that include mergers?

Mr. PILLARI. I don't think we have any anticipated right now, but I wouldn't exclude anything.

Senator DEWINE. Mr. Hofmeister?

Mr. HOFMEISTER. Senator, I think it's important to note that I get approached repeatedly by small companies who do not have the financial capital or the human capital to achieve what they have set out to achieve what they've set out to achieve and ask to be bought. We look at those periodically and make decisions which we think are in the best interest of our shareholders. But in addition, we are in a race with oil companies, as you probably recognize from the chart, to increase our reserves. One way to increase reserves is by acquiring those reserve by purchasing them, basically, and I wouldn't rule out those possibilities.

Mr. KLESSE. Senator, we view ourselves, Valero, as a growth company in this business. It's been a relatively low-growth business my entire career, but we view ourselves as growth. So if a proper opportunity where the economics worked became available to us, we would continue to be very interested, and my comments demonstrated our commitment to the business and to the consumer.

Senator DEWINE. Thank you, Mr. Chairman.

Chairman SPECTER. Thank you, Senator DeWine.

Senator Biden.

Senator BIDEN. Mr. Chairman, thank you. Mr. Chairman, this is a really complicated subject, at least for a guy like me, and I understand the 5-minute rule, but I sometimes think in the interest of time we—at least for a guy like me—I find it hard to understand all of this in that quick a time. So I wish you had continued to ask questions.

But let me go to my questions. Mr. Tillerson, you pointed out that your profit was in line historically with other major corporations, but am I right or wrong that you all had a 30 percent return on equity last year?

Mr. TILLERSON. That's correct.

Senator BIDEN. And the average American corporation at a historic high had a 17 percent return in equity, right? Are you aware of that?

Mr. TILLERSON. That would sound about right.

Senator BIDEN. Any of you guys see the movie "Field of Dreams?" Seriously, it is a serious question.

Mr. TILLERSON. Yes, I saw it.

Senator BIDEN. Remember that line, "Build it and they will come?" Now, both ends of the table here have indicated that there is a need—you all have—for size and scale. Am I mistaken, or were there not at least three other outfits that were able to amass the 19 to 20 billion to build that gas pipeline? Didn't AGPA have Federal loan guarantees of $19 billion? They did not seem to have any

problem being able to guarantee the ability to build a pipeline, right? Or am I wrong about that?

Mr. TILLERSON. Well, Senator, as I indicated, there is some litigation surrounding this whole—

Senator BIDEN. No, no, that has nothing to do with litigation. Don't play that game.

Mr. TILLERSON. OK. All I would say is that the proposals had a number of flaws in them that made them, in our view, nonfinanceable. Those were never addressed. Those discussions were ongoing for some time. We have looked for options over many, many years of ways to bring the Alaska gas to the markets.

Senator BIDEN. You have been looking at it since 1990, have you not?

Mr. TILLERSON. I have been looking at it since the mid 1980s, Senator. That's the first time I worked on it.

Senator BIDEN. And for the record, by the way, we are not talking about exploration. Someone said the guys who criticize this are the same guys who talk about not wanting to drill in the North Slope. This gas pipeline has nothing to do with that legislation. This is fact. You are able to build it now. You were able to build it since 1980, I mean, at least legally able to build it if you wanted to build it, right? There is no question about that, assuming the State signs off, right?

Mr. TILLERSON. It's just a question of economics.

Senator BIDEN. And so I count here one, two, three, four, five, six times just in 2000, when six different operations have come to you guys and said, "We'll build it if you will guarantee us you will put gas in it." And you all said no, right?

Mr. TILLERSON. Yes.

Senator BIDEN. That is what I thought. Let me ask you another question.

Mr. TILLERSON. We were unwilling to be the financial guarantors of that pipeline, correct.

Senator BIDEN. Well, you were not a financial guarantor. That sounds good. But all you were doing was guarantee that you would supply the gas for the pipeline, right?

Mr. TILLERSON. That would provide the financial underpinnings for it.

Senator BIDEN. Well, I mean, that is like saying—anyway, I do not have time because of the 5-minute rule here. Let me ask you, do any of you need, to be able to do what you are doing now, $2.6 billion in incentives the Federal Government is having other taxpayers pay for?

Mr. TILLERSON. Well, Senator, we did not lobby for any—

Senator BIDEN. I did not say you did. I am just asking, do you need it?

Mr. TILLERSON. No.

Senator BIDEN. Because you all point out we have to find alternative energy. It seems to me we should take the $2.6 billion that you all are getting, and we should put it into encouraging alternative energy. We should go out and do that—right? What do you think?

Mr. MULVA. Senator, most of those incentives are directed toward energy in total, which is not necessarily the oil and gas business.

Senator BIDEN. Oh, it is mostly you guys.

Mr. MULVA. And second, it goes to independent producers, which are primarily the bedrock of most of our—

Senator BIDEN. But your company will not be upset if we take those away, right?

Mr. MULVA. Correct.

Senator BIDEN. None of you will object to us taking away those $2.6 billion of incentives as they apply to you, is that right?

I note for the record, everyone is saying OK.

Mr. KLESSE. Senator, excuse me.

Senator BIDEN. Do it quickly, I only have 24 seconds.

Mr. KLESSE. OK. Valero, we were interested in the incentives to expand refining capacity. That's our business, and we were interested in it.

Senator BIDEN. Do you still need it?

Mr. KLESSE. Do we need it?

Senator BIDEN. Do you need them to expand?

Mr. KLESSE. No.

Senator BIDEN. Good, OK, that is all I need. So they are all for my bill. I want the record to show no one thought it would be any problem withdrawing it for all of them. Even though I only have 2 seconds left, I yield.

Chairman SPECTER. Thank you very much, Senator Biden.

Senator Biden has the knack of finishing his questions within his time limit, so he does not have to abbreviate his questions.

Senator BIDEN. That is right.

Chairman SPECTER. I learned a lot from Senator Biden when he was Chairman of this Committee, and I am still learning.

Senator Cornyn.

Senator CORNYN. Thank you, Mr. Chairman.

We have heard some suggestions about what the U.S. Congress might be able to do to help bring down the cost of oil and gas for the American consumer, and each of you have explained, in your own way, why it is that the oil and gas industry has made quite a bit of money over the last year or so, but I must say, while each of you might be accused of your companies making quite a bit of money, that is not yet a crime in America. As long as we are going to be investigating companies making profits, you all actually fall way down on the list.

I note that all U.S. industry over the last 5 years, the profit averages were 5.5 percent. For the oil and natural gas industry it was 5.8 percent. And that if we really wanted to go with the industries that are making large profits over those large 5 years, we would be holding hearings on the banking industry or pharmaceutical industry or real estate, health care industry or the like.

But since it is not a crime to make a profit, and you have explained that the profits that you have made have allowed you to invest in further exploration and production, and hopefully, to increase supply to help bring prices down.

What I would be interested in hearing from you is what can the Government do that would be actually positive in terms of bringing

down the price of oil and gas? For example, would it be constructive or destructive of our goal of bringing that price down for the average consumer to pass a windfall profits tax, such as has been proposed in the United States Congress? Mr. Tillerson, do you have any comment on that?

Mr. TILLERSON. Well, Senator, the cost of gasoline, as I think others have stated, is comprised about 60 percent the cost of crude oil, about 20 percent the taxes that you and the State and local municipalities levy, and the other 20 percent is a function of our cost of refining, manufacturing, transportation and providing it to the retail outlet. So the piece that we work on is that 20 percent that we—on the oil side we buy it. You set the taxes. We work on it. So we need to be efficient.

One of the ways that you could improve the efficiency is to reduce the number of fuel specifications that are out there, the number of so-called boutique fuels, of which there have been some 20 in the past, and I know there are proposals to take this down to 5, which would greatly simplify the whole logistics and supply system within the country, and allow greater movements and freedom of movements of product around, which should benefit the consumer, because that brings efficiency to that 20 percent that we work on. To the extent we're efficient, that's what leaves us the profit margin we have, so we always are working hard to be efficient to create a penny, or two, or three, or four cents of profit that we can capture through our efficiencies.

On the oil supply side, it means investing heavily, broadly, globally around the world, and that takes huge sums of money, and to enact a so-called windfall profits tax certainly does not do anything to increase the supply of crude oil available for refining and making gasoline in the U.S.

Senator CORNYN. And I believe, Mr. Hofmeister, that you mentioned the last item that Congress has placed out of bounds on the natural gas reserves and oil reserves here in the United States that would, if tapped, explored, and developed, would increase supply and would help bring down that price of a barrel of oil, wouldn't it?

Mr. HOFMEISTER. There are numerous examples we could point to, Senator, of areas where we actually have licenses but we can't get permits because the MMS does not have sufficient staffing to review our license applications in order to grant a permit. So human resources going into that Department would certainly help us increase gas exploration, particularly in the Western Rockies.

There are many other examples of opening up the outer continental shelf that we could point to where we could explore. We can't produce, obviously, in the near term because we require exploration and engineering and so forth to take the time. But in addition, there are many opportunities in the new 5-year plan put forward by the Interior Department which give us opportunities—offshore Alaska, for example, or Chuckchi Sea or Bristol Bay. These are examples of areas where we could explore for gas and oil and, I think, bring many new supplies to the American people.

Senator CORNYN. Mr. Klesse, in terms of the regulatory environment and how it impacts the refinery capacity, I know Valero, as you pointed out, has expanded its refinery capacity quite a bit. But

in terms of what Congress has done or perhaps what it could do to make it more feasible to open new refineries, as opposed to just expanding existing refineries, are there things that you would advise Congress to do to help expand refinery capacity and then to make that supply greater, and then bring down the price of a gallon of gas at the pump?

Mr. KLESSE. Yes. When you look just at the refining piece, all of these regulations that keep coming out, when you give good people an opportunity to draft regulations when they don't have to consider cost or anything associated with it—supply, other items—you could imagine that we get very strict regulations. January 1st, lower gasoline sulfur. This summer, lower diesel sulfur for on-road. Next year, we have off-road diesel lower. It just goes on and on.

To give you an example, we are building a scrubber in Delaware at our refinery, $130 million. We are doing a second one on a coker, $130 million. So we need to be very careful on these type of laws.

Concerning the new refinery, Senator, I don't think the economics can support that. We would not have a new refinery on line today for 5 or 6 years if we started in the U.S. Southern California, East Coast, 2 years to get a permit, at best.

You have heard of NIMBY. Have you ever heard of BANANA—Build Absolutely Nothing Anywhere Near Anybody?

Senator CORNYN. Thank you.

Chairman SPECTER. Thank you, Senator Cornyn.

Senator Kohl.

Senator KOHL. Thanks, Mr. Chairman.

Mr. Tillerson, you and your colleagues place most of the blame on OPEC, arguing that you must pay higher and higher prices on the world market to obtain crude oil, which of course you refine into your products. Somehow, as the price that you have paid for this raw material has risen—and this is why we are here today—your profits also rose to record levels. To me, this is odd because in most competitive businesses with which I am familiar, profits fall, not rise, as the prices of raw material go up.

For example, the airline industry has seen the cost of its jet fuel rise sharply and this has not resulted in profits for the industry, but instead losses and bankruptcy for many of the companies in that industry.

So how can it be that your profits have reached record levels as the worldwide price of your major raw material, crude oil, has risen to record high prices? What is different about your industry?

Mr. TILLERSON. Well, first I would take exception to your statement that I blame OPEC for the high oil prices. I do not blame OPEC for the high oil prices. The high oil prices are a function of the global supply and demand, which is being driven by significant economic growth in some very large developing economies.

More than two-thirds of our earnings, our profits, are generated by our activities not in the United States. So they are generated in a number of countries around the world, some of which involved downstream activity, some of which don't. A lot of our earnings are generated in the E and P side of our business globally. So we are an accumulation of earnings from an upstream business, our downstream business, our petrochemicals business. So that—

Senator KOHL. I don't want to miss my chance to get a clear answer to the question. As the price of raw materials rises to a record level, every business I know loses money, or it doesn't make the profits it wants to make, unless it is able to pass that on directly to consumers, which in most competitive industries is not easily done. I mean, we all understand that dynamic. Well, how is it that you all can be paying record prices for raw material, for whatever reason, and yet have record profits, unless you are successfully able—as, for example, the airlines have not been able to do because that is such a competitive business, such a resistance from customers as prices go up. In your business, apparently, the resistance is not so deep from the customer at the pump so that you are able to pass that record-high price of raw materials on to your customer finally at the pump, and so you make record-high prices.

I am not suggesting this is necessarily wrong. I mean, I am not drawing that. I am just trying to understand clearly if that isn't what is happening.

Mr. TILLERSON. Well, your description is correct. The high price of crude oil has been passed ultimately along to the consumer of whatever the finished product may be, whether it is motor gasoline, jet fuel, lubricants, or subsequent petrochemical products that are affected by those prices.

Senator KOHL. And I appreciate that. And I am also, then, pointing out what we know here, is that your ability to pass that on to consumers has been so successful that, at least in this past year, you have made more money than you or any other company has ever made before. Just simply wanting to understand that. And I am not—you know, we are not here—at this point, I am not making a judgment. I am just trying to the fact.

Mr. O'Reilly, would you dispute what Mr. Tillerson has said?

Mr. O'REILLY. Senator, in recent times there has been an ability to pass it along because the economy has been so strong from a global perspective. But go back about 3 or 4 years in 2002, when the economy was very weak after 9/11, we were unable to do that. And actually, we had zero earnings in our refining and marketing business. So a lot depends on the economic conditions. But in the strong economic world we have had not just in the U.S. but globally in the last year or two, it has been possible to do that.

Senator KOHL. Yes, Mr. Mulva. Then I would like to make one comment.

Mr. MULVA. Senator, we are very different than the airlines because our fundamental business is we invest to explore and produce. So we participate in that. And along with the earnings that we make, with prices go up and they go down, which they do over time, also the governments who participate where we explore and produce—North America, the United States, and around the world—they also participate in terms of revenues as a result of this.

Senator KOHL. I appreciate that. And before I turn it back to chairman, I just—you know, we have different constituencies here. We are representing people back in our States and all across the country who are very upset, you know, with the price of gasoline. And it is hard to explain to them how you all, at a time of record-

high prices that you are paying for your raw material, are able to generate record profits.

And the answer we understand is that you are able to pass it on to the consumer, because you say it is a matter of, you know, demand and supply. But our constituents, your customers, who even though they need your product, and so they still buy it, aren't very happy with that explanation. I mean, if you all were losing money, they wouldn't have so much to complain about. But you can understand how—correctly or incorrectly, you can understand how they are upset at paying record-high prices while you all are making record-high profits. And we all understand this, because you are able to pass it on and they are not able to resist.

Thank you, Mr. Chairman.

Chairman SPECTER. Thank you, Senator Kohl.

Senator Grassley.

Senator GRASSLEY. I don't know what you ask when you are at the tail end of the questioning. You know, where Senator Kohl left off is what we hear all the time from our constituents, and you understand that is why we are here. It is an odd situation in America when you have water like this in a half pint, if you go downstairs in the dispenser you would pay a dollar for a pint. That is $8 a gallon. I never hear anybody complain at our convenience stores in Iowa about the price of water. There is probably more profit in this water and as much gouging as there is in gasoline, and yet I paid $2.25 in Des Moines for gas last weekend, which is higher than I want to pay—and I am not here to have a love fest with you, because I raise a lot of questions about what you folks do. But I wish that the consumers were consistent in the sense of having the outrage over water that I drink out of a tap. I am not going to pay this kind of price for this water.

[Laughter.]

Senator GRASSLEY. You folks have me kind of over a barrel. I need gasoline. I don't need this stuff.

But if you wonder why people are price-sensitive about gas and they are not price-sensitive about this, I can't explain it.

I am going to start with Mr. Tillerson. And it doesn't just relate to your $33 billion cash on hand, but more to a statement that you made that I take from the Wall Street Journal,quote, Growing volumes simply for the sake of increasing volumes does not produce superior returns.

Now, if that is not taken out of context, considering the cash on hand, considering the fact that I think most people think you are using that money for more production, to increase supplies and lower prices, isn't a statement that you just made kind of a form of market manipulation, or gouging at the pumps when you have the option of increasing supplies, but choose not to in an effort to boost the bottom line? Because that is what it seems the "produce superior returns" refers to.

Mr. TILLERSON. Senator, our shareholders have certain expectations of our success today and in the future. And these high earnings that we have enjoyed last year—and they are extraordinary; they come in an extraordinary environment—those accrue to the more than 2 million individual Americans who own our shares. A lot of pension plans, a lot of mutual funds that people own that

they are relying on for their retirement, I suspect a lot of people on this committee benefit from our success last year.

That statement that I made was to say if you are going to continue to be successful the way we have been successful, then you must invest wisely. And that means investing in volumes that will continue to generate positive results for our shareholders.

Now, having said that, we are investing at record levels today and have indicated that our expectations are we will continue to invest and increase those investments around the world. Our levels of investment are entirely a function of attractive opportunities available to us. And we would invest more if we had a greater array of attractive opportunities in which to invest and that we knew we could invest and carry those out in a prudent manner.

So we are not—we certainly, as you point out, we are not limited by our ability to invest as much as it is finding the sufficient quality opportunities to invest in. And that is why we have said for some time we would love to invest more in the United States, in North America. We already invest heavily in North America. It is the highest region of investment over the last 5 years for us. But we know there are other prospective areas in which we would invest if we were given access to those.

Senator GRASSLEY. I want to ask a question of any of you, and this is in regard to alternative energy. And most of you know I am a big promoter of ethanol. I have heard stories after stories about independent owners of franchised or branded stations who are prohibited from selling alternative or renewable fuels, so I would like to hear from some of you—will you commit to allowing independent owners of branded stations who choose to sell E–85 or B–20 to do so? Would you allow independent owners to purchase alternative fuels from any outlet so that they can purchase a fuel at the lowest cost?

Mr. TILLERSON. Senator, we have denied no request from any of our dealers who have asked for permission to sell unbranded E–85 at their sites. We have asked that they make it clear that it is not an ExxonMobil product, that we do not manufacture it, therefore we can't stand behind the quality. But we have granted every request by our dealers who wanted to install separate pump facilities under their canopy for E–85.

Senator GRASSLEY. I would like to hear from other companies, maybe not all of you, but at least—

Mr. O'REILLY. Senator, I would be willing to say that we already have what you have asked for. It is already out there. It can be under the canopy. Same quality issue. I would also add that we are probably the largest, certainly one of the largest sellers of ethanol today.

Mr. HOFMEISTER. Senator, we are in the same position as has been described. You may be aware that we are currently launching a pilot in Chicago, in conjunction with one of the automobile manufacturers, to test E–85. And I think that is an important point. E–85 needs to be tested in the marketplace before we go full-scale into E–85 supply. The reason for that is we don't fully understand or know the implications of E–85, and as a major brand, of course, the provider of that fuel will often be considered liable for such

fuel. And until we understand it, I think we need to really work at what are the conditions under which this would be sold.

Senator GRASSLEY. Most of the people I hear complaints from will assume liability. You don't have to have that liability.

Other companies? Are you willing to cooperate with E–85?

Mr. KLESSE. Senator, I would agree with what has been said.

Mr. PILLARI. Senator, of our 9,300 stations, 8,900 of them are independently operated and they are free to deploy E–85. We are also running a test program on E–85 in California to test its efficacy and its air pollution impacts, because California restricts how much ethanol can be used in gasoline today.

Mr. MULVA. Senator, we have the same comments that you have heard from the responses from the others already.

Senator GRASSLEY. My time is up, but this business of you having to test something when you have the president of—I think it is the CEO of Ford on television all the time saying how they are promoting their E–85 cars, it seems to me if you have the president of a major corporation like that, that is all the test you need. Leave it up to the consumer to make the decision.

Chairman SPECTER. Thank you, Senator Grassley.

Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman, and thank you all for coming.

My first question is to Mr. Tillerson. In this Committee we have heard testimony before on differences on how oil companies report earnings, depending on whom they are reporting to. For instance, you use net income as a share of total revenues produced with Congress, and return on average capital employed with stockholders. So in Exxon's case, the metric used with the public shows earnings of 8 to 10 percent, while the metric used with stockholders shows earnings of 24 percent. Saying one thing to the public, and then in your annual report you are talking another, with different metrics.

I want to know which set of earnings and profits did you report to the IRS last year. Were they identical to what your reported to shareholders?

Mr. TILLERSON. Senator, our reporting of our financial results have been consistent for years.

Senator SCHUMER. So you reported—

Mr. TILLERSON. There are no two sets of numbers anywhere. The numbers you refer to, one is a percent of net income on revenues, the other is a return on capital employed, which is a reflection of return on investments that have been made over many, many years.

Senator SCHUMER. So with the IRS, were your profits 8 to 10 percent or were they 24 percent?

Mr. TILLERSON. Our profits are reported on the basis of our net income, that is on our taxable net income.

Senator SCHUMER. Right. And what were they? Which number was it closer to when you had to pay your taxes?

Mr. TILLERSON. Well, we reported our profits on U.S. earnings last year and on our, on any—

Senator SCHUMER. What was the—for the IRS, what was the rate of return.

Mr. TILLERSON. I don't—well, we are in—our effective tax rate is above 41 percent.

Senator SCHUMER. Based on?

Mr. TILLERSON. Based on our net income.

Senator SCHUMER. And your net income was what percentage of your revenues?

Mr. TILLERSON. Well, our net income last year was 39 billion—$36 billion on revenues of $336 billion, roughly, something like that.

Senator SCHUMER. And that is what is in your IRS statement?

Mr. TILLERSON. Well, our tax filings are consistent with our financial reporting.

Senator SCHUMER. So that is what is in your IRS statement, revenues of whatever it was, 300-something in profits of 36 to 39. Is that right?

Mr. TILLERSON. It would be consistent with our SEC filings.

Senator SCHUMER. So that is what is in it, 36 to 39, right?

Mr. TILLERSON. Yes.

Senator SCHUMER. Thank you.

Next question, you have said, Mr. Tillerson, that you have no need, really, to pursue alternative fuels. OK? It seems to me your investment in alternative fuels, non-fossil fuel sources, is close to zero. Do you think that serves the public—first, is it? And second, do you think that serves the public interest as prices go up, up, up, up, up?

Mr. TILLERSON. Our investments in alternative fuel sources is in the area of technology. We do not see any of the currently available alternatives—

Senator SCHUMER. Technology on fossil fuels?

Mr. TILLERSON. Technology on alternatives, whether it be biofuels, breakthrough research on cellulosic conversion techniques, breakthrough research on other ways to commercialize coal, breakthrough research on, you know, on other sources of energy.

Senator SCHUMER. My time is limited, so what—how much did you invest in coal, the cellu—what is it?, cellu-what?

Mr. TILLERSON. Well, we are supporting—

Senator SCHUMER. How much did you invest in coal research?

Mr. TILLERSON. We are supporting breakthrough research at Stanford University.

Senator SCHUMER. How much did you invest?

Mr. TILLERSON. We committed $100 million to them over a period of time for work that they have under way.

Senator SCHUMER. One hundred million over how many years?

Mr. TILLERSON. Ten years.

Senator SCHUMER. That is $10 million a year. OK? How much did you invest in the biofuels?

Mr. TILLERSON. Well, that is part of that research—

Senator SCHUMER. That is part of the $10 million, OK. And how much did you invest in the cellulitic—I hope I am pronouncing it right.

Mr. TILLERSON. Well, Senator, I think your question is—

Senator SCHUMER. How much?

Mr. TILLERSON [continuing]. Are we investing heavily in alternatives, and we are not.

Senator SCHUMER. You are not.

Mr. TILLERSON. We are investing in technology and we are investing heavily in conventional oil and natural gas, which is the business we are in. We are not in those other businesses.

Senator SCHUMER. Right. OK. I just think the public ought to know how little. Ten million dollars a year in alternative-type fuels, when the price of fossil fuels is through the roof, to me doesn't seem to be serving the public. Now, you have a different view in terms of your shareholders, I understand that. But we have a public view.

Next question. This is on the royalties that you receive on Government lands. How much royalty relief have you received from the Department of Interior for exploration on public lands—I would like to get a number. With the prices this high, do you think you are still entitled to these royalties? And three, at what price threshold have you internally predicted that you wouldn't need a royalty to make exploration viable?

Mr. TILLERSON. Senator, we are currently not receiving any royalty relief on any Federal leases today. I don't know over what period of time you are asking your question, but I would be happy to—

Senator SCHUMER. Did you receive any last year?

Mr. TILLERSON. I don't believe so.

Senator SCHUMER. So you are not getting any royalties? Do think anybody else should?

Mr. TILLERSON. We are not receiving royalty relief today and I don't believe that we had any royalty relief that we took advantage of last year, either.

Senator SCHUMER. OK. And you don't expect to next year?

Mr. TILLERSON. I would not expect to next year.

Senator SCHUMER. With the price this high?

Mr. TILLERSON. Correct.

Senator SCHUMER. Thank you, Mr. Chairman.

Chairman SPECTER. Thank you very much, Senator Schumer.

The Committee would appreciate it if you would submit for the record and for our information and analysis of the draft bill, which is in the Congressional Record, we would like to have you take a look at it, have your lawyers take a look at it, tell us what part or parts give you heartburn, what you don't like, what you think might be done to accomplish the same objectives, give us the benefit of your thinking.

We would also like to have your thinking on what we might do to reduce consumption, something which is very much on the agenda. A number of the economists have commented about Congress ought to be doing more to reduce consumption. I have cosponsored some legislation trying to hold down the importation of fuel in the future, our own resources, but your companies are experts in this field and I have a hunch that you have a lot of insights as to what might be done to reduce consumption. We would appreciate your suggestions along that line.

Senator Biden asked you the question about incentives. We don't have enough time to really explore all of the issues that we would like. The Judiciary Committee has a very, very crowded agenda, as I think you know. You knew that from our Supreme Court con-

firmation hearings on Chief Justice Roberts and Justice Alito, but we have been working on asbestos, which touches your industry, and we have been working on immigration and many, many items.

So that when we invite you in and we have 5 minutes for you to talk—you all did a good job. You were well-prepared and your statements were concise, and we appreciate that. The Senators don't do quite such a good job. I try to limit my questions—I do limit my questions to 5 minutes. I stop when the red light goes on. Because if the Chairman doesn't, nobody else will. And if the Chairman doesn't, he can't ask the others to do so. Sometimes I have to interrupt people to keep us on time limits, even if it is a good line of questioning. If you see me running out of this hearing it is because I have a lot of constituents in the hall. I have a lot of Pennsylvanians in the hallway today. And you would think you would meet your constituents under some better circumstances, invite them into your office and your conference room, give them a cup of coffee. Well, you have to meet them in the hall.

And we would like to have gone into quite a number of other subjects, but we can't do everything.

On the incentives, there are a great many of them and there is active consideration as to whether they ought to all be maintained in the light of the current profits. We understand that the profits tend to be transitory—up and down, and lots of factors go into that. But if you could give us an analysis of the incentives, and you can doubtless particularize them faster than we can. You know what they are, which ones are important to you, which ones are the most important to you, and why they ought to be maintained. Because we are going to be looking at that issue and we want to give you a chance to put your best case forward.

I didn't pursue the question about the price of gas going up in the last 2 weeks by 11 cents when the oil prices dropped 7 cents per gallon, because I know there are a great many factors involved. But those are some of the considerations we have to deal with our constituents. If you would care to address that question in your written responses, I would appreciate it.

Well, that concludes our hearing. Again, my—

Senator KOHL. Could I just ask one more question?

Chairman SPECTER. Sure you may, Senator Kohl.

Senator KOHL. I thank you. I will just make this—

Chairman SPECTER. Senator Kohl is one of the most parsimonious members of this Committee in terms of the amount of time he consumes.

Senator KOHL. I thank you. And I will just ask this of Mr. O'Reilly. It could be anyone, but I don't want to prolong the hearing.

Much of the crude oil that your company and other U.S. oil companies refine into gasoline and other petroleum products, as we know, comes from your own oil fields. For example, according to your annual report, in 2004 Chevron produced 505,000 barrels of oil per day in the United States, more than 55 percent of your domestic refining capacity coming from product taken out of the ground by you in this country. And overall, the U.S. produces about 40 percent of the crude oil that we consume here in this country. So the cost to produce this oil domestically should not be affected

by the rising worldwide price of crude oil. Indeed, we have heard estimates that it costs only about—and it is an estimate; you can correct it—$12 to produce each barrel of oil from a U.S. oil field, which is a far cry, of course, from the $60 per barrel on worldwide commodity markets.

So the question is, why should the rising price of crude oil on international markets lead to higher prices with respect to petroleum products refined from your own domestically produced oil?

Mr. O'REILLY. Well, Senator, it is a truly global market. And with the increase in demand that we are experiencing around the world, there is a tremendous draw on crude from all parts of the world. Somebody mentioned earlier in the testimony, think of it as a big bathtub where oil goes into it and then people buy it out. And with the growth in demand in places like China—and by the way, not just China, the United States itself is growing. Demand is high and therefore higher prices are the natural response. The higher price is what then sends everyone to invest to grow production further. So the market is sending a signal at these higher prices.

The second point I would like to make is that the investment costs today of drilling for oil and producing it are very high. One example in the Gulf of Mexico that will yield about 120,000 barrels a day of crude oil is our Tahiti investment, which is $3.5 billion of investment to produce 125,000 barrels a day. I think that tells you a little bit that the market is incenting everyone to invest and that the capital costs, in addition to the operating costs, must be recovered from those investments.

Chairman SPECTER. Thank you very much, Mr. O'Reilly. Thank you, Senator Kohl.

That concludes our hearing.

[Whereupon, at 1:59 p.m., the Committee was adjourned.]

[Questions and answers and submissions for the record follow.]

# QUESTIONS AND ANSWERS

**Senator DeWine**
**Questions**
**Consolidation in the Oil and Gas Industry: Raising Prices?**
**March 14, 2006**

**QUESTIONS FOR ALIOTO, LAUTENSCHLAGER, BORENSTEIN, BOIES, GREEN:**

– We heard from the oil companies that the recent mergers have been important to give them the scale they need to engage in increasingly expensive and risky development projects. In fact, United States oil companies have consolidated and grown at roughly the same rate as other global players around the world. In most cases, the FTC allowed oil company mergers only after imposing a number of limitations on these mergers to prevent them from decreasing competition. **FIRST**, what more should the FTC do to prevent oil industry mergers from lessening competition?

**RESPONSE BY JOSEPH M. ALIOTO:**

The FTC should forbid absolutely any mergers, joint ventures or other cooperative agreements between or among any major vertically integrated oil companies. The cooperation between and among them now has resulted in substantial increases in prices to the public in the face of lower costs, unused capacity and huge profits from joint crude oil enterprises. The "limitations" placed on these mergers by the FTC have been cosmetic at best and contributed in no way to any increase in competition or the lowering of prices.

**QUESTION:**

How should U.S. energy policy work to prevent consolidation that leads to higher prices while still addressing the risk that an aggressive merger policy could keep U.S. companies relatively small in a way puts them at a competitive disadvantage to other global players?

**RESPONSE BY JOSEPH M. ALIOTO:**

At no time in the last 100 years have any of the major integrated oil companies been at any disadvantage against any other companies with regard to the production, transportation, refining, marketing and retailing of petroleum products. The major oil companies have been dealing on a global basis since the turn of the century. Even Aramco – a pretended antagonist – must cooperate with the majors, who once owned the majority interest.

The policy of the United States with regard to the oil industry as with any other industry should be one that favors the free enterprise system and the known benefits achieved by real competition where supply and demand determine the price and not a long intermecine cooperative relationship.

**QUESTIONS FOR ALIOTO, LAUTENSCHLAGER, BORENSTEIN, BOIES, GREEN:**

– If there was one change you could make to the antitrust laws to make oil and gasoline markets more competitive, what would that be?

**RESPONSE BY JOSEPH M. ALIOTO:**

The one change that would make oil and gasoline markets more competitive would be to ensure that private parties could bring antitrust cases if necessary, whether the private party is a direct *or indirect* purchaser. In particular, Section 4 of the Clayton Act, 15 U.S.C. §15(a), should be amended as follows:

"Except as provided in subsection (b), any person, who shall be injured in his business or property, *directly or indirectly*, by reason of anything forbidden in the antitrust laws may sue therefor in any district court of the United States in the district in which the defendant resides or is found or has an agent, without respect to the amount in controversy, and shall recover threefold the damages by him sustained, and the cost of suit, including a reasonable attorney's fee."

Section 16 of the Clayton Act, 15 U.S.C. §26, should be amended as follows:

"Any person, firm, corporation, or association, shall be entitled to sue for and have injunctive relief, in any court of the United States having jurisdiction over the parties, against threatened loss or damage, *direct or indirect*, by a violation of the antitrust laws, including sections two, three, seven and eight of this Act [15 USCS §§ 13, 14, 18, and 19], when and under the same conditions and principles as injunctive relief against threatened conduct that will cause loss or damage is granted by courts of equity, under the rules governing such proceedings, and upon the execution of proper bond against damages for an injunction improvidently granted and a showing that the danger of irreparable loss or damage is immediate, a preliminary injunction may issue: *Provided*, That nothing herein contained shall be construed to entitle any person, firm, corporation, or association, except the United States, to bring suit for injunctive relief against any common carrier subject to the jurisdiction of the Surface Transportation Board under subtitle IV of title 49, United States Code [49 USCS §§ 10101 et seq.]. In any action under this section in which the plaintiff substantially prevails, the court shall award the cost of suit, including a reasonable attorney's fee, to such plaintiff."

Moreover, it should be made plain, in legislative history or the statute itself, that these changes in Title 15 would in no way alter the prohibition against the use of the "passing on" defense, as proscribed by the Supreme Court in *Hanover Shoe, Inc. v. United Shoe Machinery, Inc.*, 392 U.S. 481 (1968).

## QUESTIONS POSED BY CHAIRMAN SPECTER

**QUESTIONS FOR JOSEPH ALIOTO:**

**QUESTION:**

1. You testified that you possess notes and other documents indicating that oil industry executives have discussed merging in order to impact the price of petroleum products. Please identify and describe the specific cases in which you obtained or used such notes or other documents. To the extent possible, please provide any such notes or other documents to the Committee. You also indicated that you deposed oil and gas company executives in these cases; to the extent possible, please provide the transcripts to the Committee.

**RESPONSE BY JOSEPH M. ALIOTO:**

Attached as Exhibit A is a copy of the handwritten notes by Archie Dunham, then Chief Executive Officer of Conoco, reflecting his conversations with James Mulva, Chief Executive Officer of Phillips Petroleum Company at their multiple secret meetings. These notes were produced in a private anti-merger case brought by my client entitled Amertrans, et al. v. Conoco, Inc. and Phillips Petroleum in the United States District Court in Tulsa, Oklahoma before Judge Sven Holmes, who later left the bench for private practice. I have redacted certain portions of the document because it was under a protective order. The non-redacted portions were read into the record and therefore are public. (The document was also produced to the FTC, which approved the merger.)

**"Agreement" Between Exxon and BP to Control Operations in Alaska**

On the third page of the document Mr. Dunham records a plainly unlawful secret agreement between Exxon and BP which was related to him by Mulva who apparently received the information from Mr. John Brown, then CEO of BP:

> "Alaska was costly ($7 Billion), but a good Acquisition. ... Exxon had an 'agreement' with BP that there would only be two operators in Alaska. Jim was worried that Exxon would drag the approval process so long that John Brown would back out of the Arco Acq. Thus Phillips yielded & asked BP to 'operate' Prudoe."

This quote also relates to question Number 5 by Senator Kohl with regard to the case by Mr. Boies in Alaska. The "agreement" between Exxon and BP and apparently acknowledged by the other major oil companies is direct evidence of a conspiracy to monopolize operations in Alaska.

**Interest in Merger Because of Worry over "Falling Oil and Gas Prices"**

On page 4 of the document Mr. Dunham records statements by Mr. Mulva with regard to his reasons for wanting to continue discussions toward a merger. The following appears:

> "He's worried about falling oil & gas prices & economy in this high expenditure time period and doesn't want to sell E&P (future growth properties) thus his interest in talking again.
>
> Together, we guar. longevity and best preserve our joint heritage & culture."

Before these statements the uncontroverted evidence was that Conoco and Phillips were "fierce competitors" but were making records profits.

**Prediction of Only 6 to 7 Remaining Energy Companies**

On page 4 the following appears:

> "Jim believes strongly in Integration. He believes it help (sic) Phillips secure E&P opportunities (CVI) and purchase crude oil. He believes there will only be 6-7 Energy Companies surviving long term and few independents. He believes you should <u>own</u> Downstream, not JV it. He always believed Phillips & Conoco should merge so in all of his JV deals he made sure none of Phillips' flexibility was restrained."

At the time Exxon (Standard of New Jersey) had acquired Mobil (Standard of New York); British Petroleum had acquired Soho (Standard of Ohio) and then as a combine acquired Amoco (Standard of Indiana) and then as a combine acquired Arco; Shell entered joint venture with Texaco and Saudi Refining; and Chevron (Standard of California) acquired Texaco from Shell.

At the Conoco Phillips preliminary injunction motion even the economist for the oil companies, Joseph Kalt, agreed that if you got to 6 you start to see "collusion, cooperation among them for purposes of doing something like exercising market power." He testified as follows:

> Q. Okay. Here you state, quote: "The general thrust of the DOJ/FTC Guidelines is consistent with economic analysis which finds that collusive coordination breaks down quickly as the number of firms rises above a handful."
>
> A. Yes.
>
> Q. Okay. Now, above a handful meaning five, six, is that what you mean?

A. Well, what our research indicates is that as you get the number of firms up in the range of four, five, six, you start to see cooperation among them, collusion, cooperation among them for purposes of doing something like exercising market power. It tends to breakdown quickly as you start to get above that level.

Q. Now, when you say there's four, five or six firms, that that effect begins to at least become a probability. Are you aware in this case that in conversations between Mr. Mulva and Mr. Dunham they were expecting that the firm numbers, that the firms in the industry, the oil industry, would get down to six or seven?

A. You read a quote of something like that.

Q. Yes.

A. I can't remember who it was from. You would presumably ascribe that quote to that quote to that individual.

Q. Have you heard that before from these individuals?

A. No.

Q. Or from Phillips or Conoco?

A. No.

Reporters Transcript, September 17, 2002, Hearing on Motion for Preliminary Injunction, Volume 1, pages 99 to 100.

**QUESTION**:

2. You testified that the oil and gas companies use each other's facilities, refineries and tankers, as well as swapping gas stations. Do these practices result in increased prices to consumers? If so, how?

**RESPONSE BY JOSEPH M. ALIOTO:**

In the Hilo trial the Chairman and Chief Executive Officer of Chevron, testified at the trial. Like the testimony of the CEO's of the other major oil companies, Mr. Kenneth Derr was forced to admit that the major integrated oil companies cooperate with each other at every level of the industry from exploration and production to the retail station. They joint venture on exploration and production. They are co-owners of the major pipelines. They use each other's tankers for the transport of crude oil. They exchange supply at their terminals. They exchange gasoline from their refineries. They market under each other's tradenames and they swap, exchange and eliminate gasoline retail

service stations. The Vice Chairman of Chevron characterized his competitors as "associates," because of their multiple cooperations. In addition, it was admitted that the CEO's and the other Senior Executive Officers including Chairmen, Executive Vice Presidents of Marketing meet on the average of once a month at social functions as well as trade association meetings.

# EXHIBIT A





Conoco Inc
Documentary Attachment 4(c)-34
December 17, 2001

10-16-01
w/ Jim Mulva
918 333 8486 (H)

Spring, 1999

REDACTED

• July 98 - Mulva called Browne (BP) on ARCO Alaska. Jim also initiated contact with DAVE O'Reilly as we wanted to JV chemicals with Chevron to generate cash for E&P (Subsequently, Jim told me that Phillips generated $1.0 Billion in cash from the transaction). The Chemicals JV is currently losing $60MM/qtr gross, but will generate $1.2-1.4 BM/yr gross at the top of the cycle. There are no provisions

PLAINTIFF'S EXHIBIT 79

in the Chemicals JV that prevent or restrict Phillips on a merger. The JV does have the "right" to make chemical investments on behalf of Phillips and Chevron, but not the obligation. JJ

REDACTED

Jim then approached Duke about JV Gas Processing to raise cash for Arco Alaska - Phillips retained 30% of JV and generated $1.2 Billion cash.

From: 9185925809 Page: 4/9 Date: 3/13/2006 5:22:26 PM

Sep-08-02 18:35 From-Cleary, Gottlieb et al +202-974-1999 T-045 P.28/75 F-685

**REDACTED**

Alaska was costly ($7 Billion), but a good Acquisition. Phillips' Debt to Capitalization Ratio is 37% after Acquisition. Used Chemicals and Gas Processing Cash ($2.2B) to reduce Debt %. Exxon had an "agreement" with BP that there would only be two operators in Alaska. Jim was worried that Exxon would drag the approval process so long that John Brown would back out of the ARCO Acq. then Phillips yielded & asked BP to "operate" Prudhoe.

From: 9185925809 Page: 5/9 Date: 3/13/2006 5:22:26 PM

Jim believes strongly in Integration. He believes it helps Phillips secure E&P opportunities (CVI) and purchase crude oil. He believes there will only be 6-7 Energy Companies surviving long term and few independents. He believes you should own Downstream, not JV it. He always believed Phillips & Conoco should merge so in all of his JV deals he made sure none of Phillips' flexibility was restricted.

**REDACTED**

He's worried about falling oil & gas prices, economy in this high expenditure time period & doesn't want to sell E&P (future growth properties) thus his interest in talking again.
Together, we great longevity and best preserve our joint heritage & culture.

REDACTED

REDACTED

REDACTED

Mulva worried that the State & Employees will view him as "cashing out of Okla", Moving HQ - will get nasty in press

REDACTED

**REDACTED**

## QUESTIONS POSED BY SENATOR LEAHY

**QUESTIONS FOR JOSEPH ALIOTO:**

**QUESTION:**

1.) Do you think there needs to be more transparency on the commodity exchanges, particularly natural gas transactions? If so, what steps can Congress take to increase transparency in the natural gas market? Should Congress require traders to register?

**RESPONSE BY JOSEPH M. ALIOTO:**

To the extent that prices are being manipulated by speculators, by oil companies themselves, or by other parties whose identities are unknown, increasing market transparency would help prevent artificial price manipulation. in order to avoid such price manipulations, identities of traders should be published, traders should be required to register, and all purchasers should be required to take delivery of the purchased commodities.

**Senator Kohl's Follow-up Questions for Oil Consolidation Hearing**

**FOR JOSEPH ALIOTO:**

**QUESTION:**

1. Oil companies must pay higher and higher prices from the world market to obtain the crude oil they refine into gasoline, heating oil and other petroleum products. Yet as the price the pay for this raw material rises, their profits also rise. How can this be?

**RESPONSE BY JOSEPH M. ALIOTO:**

All of the major integrated oil companies cooperate with each other in the exploration and production of crude oil. All of them make exploration and production a separate profit center as well as refining and marketing as separate profit centers. Therefore they make extraordinary amounts on the exploration and production (crude oil sales) as well as profits from refining and marketing. Because they are integrated they can manipulate the margins from the various levels.

**QUESTION:** How can the industry's profits rise as the price for the raw material it uses to make its products rises? Does this suggest to you any anti-competitive market conditions?

**RESPONSE BY JOSEPH M. ALIOTO:**

There is no question that major anticompetitive market conditions exist in integrated oil companies.

The industry's profits rise as the price for crude oil rises because industry players "sell" the crude oil to themselves, and to their competitors. Each oil company uses these "sales" to artificially bolster the upstream oil-production profits. In addition, when raw material prices go up, prices (but not profits) are also expected to rise.

However, profits accompanied by raw-material cost increases is indicative of collusion and an artificially manipulated market. Finally, because all of the major oil companies are fully integrated (unlike any other industry), they can manipulate their profits and allocate them to any level they want. Because they can do this, they are constantly exchanging and verifying price information by exchanging crude oil and refined products among and between themselves at so-called "transfer prices" and verifying price changes at retail whether the prices are going up or down in order to control any independent who attempts to start a price war.

In the Shell-Texaco joint venture approved by the FTC, Shell and Texaco first raised the price of Texaco to the same price as Shell, and then increased prices across the board throughout the United States some 50% to 70%, even though the crude oil prices were at the lowest since the Depression, their costs were supposedly substantially reduced by the joint venture, and there was

substantial over-capacity. Supply and demand played no part in this increase, nor does it play any part today, because of the few fully integrated oil companies

High prices and obscene profits will continue in the oil industry until competition is restored. That can only happen if the oil companies are prohibited from being fully-integrated.

**QUESTION**:

2. Much of the crude oil the U.S. oil companies refine into gasoline and other petroleum products comes from their own oil fields. For example, according to its annual report, in 2005 ExxonMobil produced 477,000 barrels of oil per day in the United States, more than 26% of their domestic refining capacity. 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, a price largely determined by the OPEC oil nations. So why should the rising price of crude oil on the international markets lead to higher prices with respect to petroleum products refined from the oil companies' own domestically produced oil? In your view, are the oil companies just profiteering with respect to the oil that comes from the oil fields they own?

**RESPONSE BY JOSEPH M. ALIOTO:**

See response above.

**QUESTION**:

3. In the last 15 years there has been a tremendous amount of consolidation in the oil industry – the GAO counts 2600 mergers and acquisitions in this industry since the 1990s alone. During this time, the FTC has approved almost all 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.

Many wonder whether new rules or merger guidelines are necessary because of the special circumstances in the oil industry. For example, it is not easy to increase capacity to meet growing demand because of environmental and other restrictions to building new refineries. In addition, consumers cannot respond to higher prices by buying substitute products – people must buy gas to drive to work, and must buy heating oil or natural gas to heat their homes in the winter.

(a) In your view, should the FTC's merger guidelines be revised for mergers in the oil industry because of these special conditions? If so, do you have any suggestions as to how the Guidelines should be revised?

**RESPONSE BY JOSEPH M. ALIOTO:**

The FTC guidelines are given a prestige they do not deserve. They were not written by legislators. They were not written by judges. In fact, no one knows who wrote them. Nevertheless, they have been given more importance than the law itself. The law with regard to mergers is well established. As Judge Posner wrote in *Hospital Corp. of America v. Federal Trade Commission*, 807 F.2d 1381 (7th Cir. 1986):

> The Commission may have made its task harder (and opinion longer) than strictly necessary, however, by studiously avoiding reliance on any of the Supreme Court's Section 7 decisions from the 1960's, except *United States v. Philadelphia Nat'l Bank*, which took an explicitly economic approach to the interpretation of the statute. The other decisions in that decade – in particular *Brown Shoe Co. v. United States*, 370 U.S. 294 (1962); *United States v. Aluminum Co. of America*, 377 U.S. 271 (1964); *United States v. Von's Grocery Co.*, 384 U.S. 270 (1966); and *United States v. Pabst Brewing Co.*, 384 U.S. 546 (1966) – seemed, taken as a group, to establish the illegality of any nontrivial acquisition of a competitor, whether or not the acquisition was likely to bring about or shore up collusive or oligopoly pricing. The elimination of a significant rival was thought by itself to infringe the complex of social and economic values conceived by a majority of the court to inform the statutory words "may ... substantially ... lessen competition." None of these decisions has been overruled.

Congress should make certain that any person threatened by a merger should have a right to sue, whether the threatened injury is direct or indirect, or whether the persons is a purchaser, seller, or competitor.

Congress should specifically prohibit the introduction into evidence in a private antitrust case any "non-objections" or "approvals" by the FTC with regard to any mergers or other claimed violations of the antitrust laws. Private parties ought not be encumbered by the claim by antitrust defendants that their conduct was in any way approved or sanctioned or not objected to by the government.

**QUESTION**:

(b) Section 7 of the Clayton Act currently states that mergers and acquisitions are illegal if the effect such an acquisition "may be substantially to lessen competition." Do you believe that standard should be modified for mergers in the oil and gas industry to lower the showing of competitive injury necessary to make a merger illegal?

**RESPONSE BY JOSEPH M. ALIOTO:**

Section 7 of the Clayton Act should require that the burden of proof should be placed on the defendants who seek the elimination of competition by a merger to prove that their merger (or acquisition) does not substantially lessen competition.

**QUESTION**:

(c) Would you support shifting the burden of proof in merger cases under the antitrust laws, so that the burden would rest on the parties to the transaction to prove that their transaction does not substantially injure competition, rather than having the burden rest on the government or other party challenging the merger?

**RESPONSE BY JOSEPH M. ALIOTO:**

Yes.

**QUESTION**:

4. Do you believe antitrust regulators should seek to require expansion of refining capacity as a condition of approving mergers in the oil industry? Or should conditions be placed that prevent closures of existing refineries?

**RESPONSE BY JOSEPH M. ALIOTO:**

No. Refining capacity would be increased and refinery enclosures would not take place so long as the oil companies are required to compete. The natural consequence of mergers of major companies like the integrated oil companies result in social and political harms as well as economic ones. The uncertainty caused by competition requires that a competitor attempt to anticipate the conduct of another competitor.

**QUESTION**:

5. The antitrust case David Boies has filed in Alaska is based on allegations that ExxonMobil and BP have refused to sell natural gas to a pipeline his clients seek to build in Alaska. His complaint alleges that they have done so in order to keep natural gas supplies tight to raise the price of natural gas.

Do you believe the antitrust laws as currently written are adequate to deal with a situation in which an oil company deliberately withholds supply in order to gain market power to raise the price? Do you support the legislation Senator Specter and I have drafted to make it unlawful for a supplier to refuse to sell petroleum products with the intention of raising price?

**RESPONSE BY JOSEPH M. ALIOTO:**

Already answered above with the following: The antitrust laws as presently written are adequate to deal with an oil company that deliberately withholds supply in order to raise prices. However, that law is not enforced. For example, as the CEO of Chevron testified, Chevron and Texaco had an agreement not to supply the United States with crude oil from their joint venture in Asia. This is a plain violation of the antitrust laws. However, no one seeks to enforce it. It is not a question of new laws, but a question of enforcement of existing laws. In this regard, the best guarantee, is to allow the private litigant the authority to file any cases in which the private litigant is injured directly or indirectly by a violation of the antitrust laws. Therefore, all that is needed is that Section 4 include the words "directly or indirectly" after the phrase "anyone injured in his business or property ..."

Certainly we would support the bill by Chairman Specter and by Senator Kohl. However Section 2(2)(a) line 6 "primary" should be eliminated. The conduct should be unlawful if one of the reasons is to create a shortage and not simply the primary reason.

Also, a new section should be added to Section 8 giving authority to private parties injured directly or indirectly by the conduct to sue.

**QUESTION**:

6. In most competitive industries, when there are high prices, high profits to be made, and soaring consumer demand, we would expect to see an expansion of capacity to meet this demand. Yet in the oil industry this has not happened. Instead of opening new refineries, the industry has closed more than half of all that existed 25 years ago. In 1981, there were 324 refineries operating in the United States – today there are 149. Overall national refining capacity declined by more than 9% from 1981 to 2004, while demand for gasoline rose 38% during that same period. Oil industry critics suggest that this decline in refining capacity is no accident – oil companies actually prefer to keep supplies tight in order to be able to gain market power to raise price. What's your view? Does the failure of the oil industry to open new refineries suggest anti-competitive conduct?

**RESPONSE BY JOSEPH M. ALIOTO:**

Yes.

**Follow-up Questions of Senator Charles E. Schumer**
**Senate Judiciary Committee Hearing**
**"Consolidation in the Oil and Gas Industry: Raising Prices?"**
**March 14, 2006**

For All Panel I Witnesses:

**QUESTION**:

1) We often here the justification for consolidation that resources abroad are more expensive to develop, but why does that mean we have to consolidate downstream at refining and retail levels? In 2004 the GAO found that market concentration in the downstream sector had increased significantly, and that oil company merger activity had in fact had an upward effect on gasoline retail prices. Wouldn't the market benefit from more independent activity in the downstream sector? Wouldn't competition and the consumer be better served by a higher degree of competition at each segment of the supply chain?

**RESPONSE BY JOSEPH M. ALIOTO**: Yes to both questions.

**QUESTION**:

2) In a market this tight on supply and this concentrated, where is the disincentive for oil companies to "take their foot off of the pedal" by only barely keeping place with market trends? Is it realistic with so much vertical integration, to assume that if a company does not act swiftly to a price signal another company will competitively respond?

**RESPONSE BY JOSEPH M. ALIOTO**:: No.

**QUESTION**:

3) We've seen a lot of the so called "rockets and feathers" phenomenon where prices spike, supposedly because retailers have to instantly react to the wholesale price, but then when the wholesale drops retail lags at the high price. What do you believe is the explanation for this phenomena and what role has consolidation played in creating it?

**RESPONSE BY JOSEPH M. ALIOTO**:: Consolidation has played a major role in the stabilization of prices. The retailer is not independent in a true sense. Rather, the so-called independent retailer is used as a buffer between the oil companies and the public.

April 20, 2006

**VIA HAND DELIVERY**

United States Senate
Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, D.C. 20510-6275

Dear Senators:

Thank you for the opportunity to address the Committee at the hearing entitled "Consolidation in the Oil and Gas Industry: Raising Prices?" I write for two purposes: (1) to respond to the additional questions submitted by members of the Committee, and (2) to correct certain misstatements made by Mr. Pillari of BP America and Mr. Tillerson of ExxonMobil.

Each question is addressed in the order in which it was provided to me.

**I. Committee Members' Additional Questions**

**A. Chairman Specter**

1. You testified that if ExxonMobil and BP were to sell natural gas from the North Slope in Alaska that the price of natural gas would fall substantially. Please supplement your testimony by quantifying the amount that prices would fall and provide the basis for your conclusion.

Alaska's North Slope contains tremendous reserves of natural gas, with 25-30 trillion cubic feet of proven reserves lying beneath Prudhoe Bay, and 8 trillion cubic feet of proven reserves lying beneath Point Thomson. In addition, estimates suggest that there are at least an additional 143 trillion feet of undiscovered reserves on the North Slope. The U.S. consumes 60 billion cubic feet of natural gas per day, and the Port Authority's pipeline system could supply 4-6 billion cubic feet (7-10%) of that consumption.

While it is impossible to state precisely what the effect of this significant increase in supply would have on the price of natural gas, government and industry sources have estimated that if a natural gas pipeline system were built to bring Alaska North Slope gas to market, natural gas prices in the lower 48 states would be a minimum of seven (7) to twenty-two (22) percent lower than without a pipeline. In addition to lower prices, the supply of Alaska natural gas would also benefit U.S. manufacturers who use natural gas in the manufacture of their products and encourage the use of natural gas over more costly, less efficient and less environmentally friendly alternatives. For example:

- In February 2004, in response to a request from a House Subcommittee, the Energy Information Administration in the Department of Energy estimated that, with various supply restrictions, the wellhead price of natural gas would be **22%** higher without an Alaskan pipeline than with it.[1]

- In October 2003, the National Commission on Energy Policy, an 18-member bipartisan commission of the nation's leading energy experts, released a report detailing the findings of its in-depth economic modeling analysis of the effect that Alaska natural gas would have on prices. It concluded that an "Alaskan gas pipeline would be expected to provide a range of benefits to the U.S., including **10 to 20 percent** reductions in natural gas prices and net benefits averaging $4 billion annually. In addition to savings in natural gas expenditures, lower natural gas prices would also be expected to help preserve U.S. manufacturing jobs, enhance energy security, and reduce environmental compliance costs."[2]

- In September 2003, the National Petroleum Council, an advisory committee to the Secretary of Energy, released a report indicating that natural gas prices would be **7-15%** higher if an Alaska pipeline is not built or if its construction is delayed.[3]

It is important to note that all of these reports were released in 2003 or 2004, when prices for natural gas were substantially lower than they are today. Given the increase in prices since that time, it seems reasonable to infer that the impact on prices from the Alaska pipeline could be even more dramatic than these reports indicate. Thus, there can be no doubt that the pipeline would achieve substantial cost savings for American consumers.

**B. Senator Leahy**

1. Do you think there needs to be more transparency on the commodity exchanges, particularly natural gas transactions? If so, what steps can Congress take to increase transparency in the natural gas market? Should Congress require traders to register?

Some of the short term volatility in the natural gas market undoubtedly is caused by speculators. Requiring those markets to be more transparent, by means such as registration,

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[1] This analysis, entitled "Analysis of Restricted Natural Gas Supply Cases," can be found at <http://www.eia.doe.gov/oiaf/servicerpt/ngsupply/index.html> (last accessed Apr. 12, 2006). It indicates that the wellhead price of gas would be $4.60 in 2025 with a pipeline, versus $5.61 without it.

[2] The report, entitled "Increasing U.S. Natural Gas Supplies," can be found at <http://www.energycommission.org/files/contentFiles/increasing_gas_supplies_report2003_440ccc1c5ce98.pdf> (last accessed Apr. 12, 2006). The quoted text is on page 15 of the report (bold emphasis is added).

[3] Volume 2 of the report, entitled "Balancing Natural Gas Policy: Fueling the Demands of a Growing Economy," can be found at <http://www.npc.org/reports/NG2003-Int_Rpt-vol2.pdf > (last accessed Apr. 12, 2006). The relevant analysis is on page 206.

recording and maintaining trading data for future review or audit, may reduce some of the volatility in the market.

In the long term, however, prices in the natural gas markets are far more severely impacted by conduct that artificially restricts supply than by speculative conduct. My response to Senator Specter's question above illustrates the degree of consumer harm that can result from an agreement to artificially restrict the supply of gas from the North Slope. Therefore, any reform to prevent speculation in the market must go hand in hand with long-term structural reforms that address undue consolidation and the improper withholding of supply to inflate price.

**C. Senator DeWine**

1. We heard from the oil companies that the recent mergers have been important to give them the scale they need to engage in increasingly expensive and risky development projects. In fact, United States oil companies have consolidated and grown at roughly the same rate as other global players around the world. In most cases, the FTC allowed oil company mergers only after imposing a number of limitations on these mergers to prevent them from decreasing competition. First, what more should the FTC do to prevent oil industry mergers from lessening competition? Second, how should U.S. energy policy work to prevent consolidation that leads to higher prices while still addressing the risk that an aggressive merger policy could keep U.S. companies relatively small in a way puts them at a competitive disadvantage to other global players?

The FTC should take the following steps to prevent oil and gas industry mergers from decreasing competition:

a. The FTC must undertake a searching examination of all the agreements between and among competitors that could affect competition in a given market. Many of these agreements between competitors are not necessary to achieve their stated purpose, are substantially broader than necessary to achieve that purpose, or are used to facilitate collusion. Many of these agreements never receive antitrust scrutiny through the Hart-Scott-Rodino process or otherwise. Because the opportunities for collusion are so plentiful, heightened scrutiny of mergers that reduce the number of independent competitors is appropriate.

b. The FTC must recognize that (1) the natural gas markets are substantially narrower geographically than the market for crude oil; (2) the markets for the purchase and/or transportation of natural gas may be different than the markets for the sale of natural gas; and (3) that the competitive effects of the merger in each of these markets must be evaluated carefully.

c. The FTC must recognize that due to inelasticity of demand for natural gas, it is very easy for producers to profitably withhold supply to increase prices.

d. The FTC must undertake a searching, empirical examination of the effects of its decisions in past mergers in the oil and gas industry. The number of meaningful competitors on

the North Slope, for example, has been reduced by a series of large and small mergers and acquisitions to just three. Due to unit operating agreements and related agreements governing production, effective control of the North Slope resides in the unit operators of the largest units, ExxonMobil and BP. With a greater number of independent competitors, it would be much easier for a pipeline project to obtain the gas commitments necessary to build the pipeline.

As to the second question, ExxonMobil and BP already are among the very largest private corporations in the world. That certain state-owned enterprises may hold greater reserves in their respective countries does not diminish the market power that these companies possess in various markets in the United States. They already possess sufficient market power to prevent the commercial sale of Alaska North Slope gas, and they do so in part to ensure that they benefit from higher prices for natural gas they supply from other sources they control. An energy policy that fails to maintain competitive markets in the United States will have profoundly negative effects on American businesses and consumers.

2. If there was one change you could make to the antitrust laws to make oil and gasoline markets more competitive, what would that be?

The oil and gas industry is particularly susceptible to anticompetitive conduct because the industry is interlaced with various agreements relating to development, production, marketing and other subjects between and among competitors. As noted, many of these agreements never receive antitrust scrutiny of any sort. Thus, in addition to the legislation proposed by Senator Specter, this Committee should consider amending the Hart-Scott-Rodino Act to ensure that operating agreements and other agreements among competitors that could affect competition receive the same pre-transaction review as mergers and acquisitions.

**D. Senator Kohl**

1. Oil companies must pay higher and higher prices from the world market to obtain the crude oil they refine into gasoline, heating oil and other petroleum products. Yet as the price they pay for this raw material rises, their profits also rise. How can this be? How can the industry's profits rise as the price for the raw material it uses to make its products rises? Does this suggest to you any anti-competitive market conditions?

In the context of natural gas, the spike in prices – and profits – is due to an excess of demand over supply because the supply has been artificially restricted in order to maintain high prices and consumers cannot turn to other alternatives in the face of high prices. As I have noted, vast reservoirs of natural gas underlie Alaska's North Slope, yet despite increasing demand none of it has ever been delivered to the lower 48 states. Of course, it would be in every producer's self-interest to produce and market gas to meet the rising demand, but no producer has done so. Clearly, this suggests both (1) substantial market power in the hands of the large unit operators, ExxonMobil and BP, and (2) collusion between these firms to prevent the export of gas from the North Slope.

2. Much of the crude oil the U.S. oil companies refine into gasoline and other petroleum products comes from their own oil fields. For example, according to its annual report, in 2005 ExxonMobil produced 477,000 barrels of oil per day in the United States, more than 26% of their domestic refining capacity. 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, a price largely determined by the OPEC oil nations. So why should the rising price of crude oil on the international markets lead to higher prices with respect to petroleum products refined from the oil companies' own domestically produced oil? In your view, are the oil companies just profiteering with respect to the oil that comes from the oil fields they own?

My testimony has focused on the natural gas industry, and, respectfully, I will leave it to others who have studied the issue more closely to address the oil industry directly.

3. In the last 15 years there has been a tremendous amount of consolidation in the oil industry – the GAO counts 2600 mergers and acquisitions in this industry since the 1990s alone. During this time, the FTC has approved almost all 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.

Many wonder whether new rules or merger guidelines are necessary because of the special circumstances in the oil industry. For example, it is not easy to increase capacity to meet growing demand because of environmental and other restrictions to building new refineries. In addition, consumers cannot respond to higher prices by buying substitute products – people must buy gas to drive to work, and must buy heating oil or natural gas to heat their homes in the winter.

3(a) In your view, should the FTC's merger guidelines be revised for mergers in the oil industry because of these special conditions? If so, do you have any suggestions as to how the Guidelines should be revised?

As I noted above in response to Senator DeWine, the most important change in the pre-merger process that I would recommend is to amend the Hart-Scott-Rodino Act to require that non-merger agreements between competitors in this industry be subject to the notification, review and waiting periods of the Hart-Scott-Rodino Act.

As to whether the Merger Guidelines should be amended, it is important to remember that Guidelines are just that, guidelines, and they are not meant to be applied in a rote fashion. The Guidelines already call for enforcement agencies to take into consideration all relevant factors in the market. Thus, it is vital that, in evaluating mergers in this industry, the enforcement agencies bear in mind the unique factors that influence competition in this industry, e.g., extensive collaboration among competitors and inelasticity of demand. These factors show

that relatively small increases in concentration in this industry can have anticompetitive effects that would not necessarily be present with similar levels of concentration in other industries.

3(b). Section 7 of the Clayton Act currently states that mergers and acquisitions are illegal if the effect such an acquisition "may be substantially to lessen competition." Do you believe that standard should be modified for mergers in the oil and gas industry to lower the showing of competitive injury necessary to make a merger illegal?

Increased consolidation in the oil and gas industry is a serious concern, and anticompetitive conduct by producers has had severe effects in the market, especially on the most vulnerable consumers. Modifying the law to bar any merger or acquisition that may "appreciably diminish competition" may better enable the FTC, the DOJ, and private parties where necessary, to protect consumers and preserve competition.

3(c). Would you support shifting the burden of proof in merger cases under the antitrust laws, so that the burden would rest on the parties to the transaction to prove that their transaction does not substantially injure competition, rather than having the burden rest on the government or other party challenging the merger?

There are a number of reasons outside the merits, such as lack of resources or difficulties of proof, that could prevent enforcement agencies from challenging an anticompetitive merger. Placing the burden of proof to demonstrate that a proposed transaction does not cause competitive harm could be an effective means of ensuring that anticompetitive mergers in the oil and gas industry do not proceed.

4. Do you believe antitrust regulators should seek to require expansion of refining capacity as a condition of approving mergers in the oil industry? Or should conditions be placed that prevent closures of existing refineries?

Depending on the facts and circumstances of the particular merger, these kinds of restrictions may well be appropriate. That these type of nonstructural remedies would be deemed necessary in a particular merger, however, should raise questions with the enforcement agencies whether the merger should be permitted to proceed at all.

5. The antitrust case you have filed in Alaska is based on allegations that ExxonMobil and BP have refused to sell natural gas to a pipeline your clients seek to build in Alaska. Your complaint alleges that they have done so in order to keep natural gas supplies tight to raise the price of natural gas.

Do you believe the antitrust laws as currently written are adequate to deal with a situation in which an oil company deliberately withholds supply in order to gain market power to raise the price? Do you support the legislation Senator Specter and I have drafted to make it unlawful for a supplier to refuse to sell petroleum products with the intention of raising price?

As you know, the Port Authority's complaint charges ExxonMobil and BP with, among other things, colluding to withhold gas from the North Slope, a straightforward, *per se* violation of Section One of the Sherman Act. However, as this Committee also knows, proving collusion can be a lengthy, difficult, expensive and uncertain endeavor. Sometimes evidence of collusion is available. In the *Vitamins Antitrust Litigation*, for example, we were able to prove that the vitamin suppliers met and agreed to reduce output to the U.S. markets. But proof of collusion is difficult to find and often anticompetitive cartels are never exposed to the light of day. Moreover, it is possible for sophisticated firms in concentrated industries to coordinate to jointly withhold supply without directly communicating with each other.

The draft legislation would amend Section One of Sherman Act to prohibit unilateral withholding of oil and gas products when done with the intent of manipulating price, and would therefore address the some of the problems of proving collusion. This change would significantly simplify and expedite preventing and remedying anticompetitive output restrictions of these commodities. For this reason, the newly drafted legislation deserves serious review and consideration.

6. In most competitive industries, when there are high prices, high profits to be made, and soaring consumer demand, we would expect to see an expansion of capacity to meet this demand. Yet in the oil industry this has not happened. Instead of opening new refineries, the industry has closed more than half of all that existed 25 years ago. In 1981, there were 324 refineries operating in the United States – today there are 149. Overall national refining capacity declined by more than 9% from 1981 to 2004, while demand for gasoline rose 38% during that same period. Oil industry critics suggest that this decline in refining capacity is no accident – oil companies actually prefer to keep supplies tight in order to be able to gain market power to raise price. What's your view? Does the failure of the oil industry to open new refineries suggest anti-competitive conduct?

Because I have not studied the oil industry on this issue, I must respectfully decline to address this question with regard to oil. With regard to natural gas, however, the phenomenon described above, the withholding of supply in the face of increasing demand and prices, along with other evidence, clearly suggests that collusion has occurred.

**E. Senator Schumer**

1. We often hear the justification for consolidation that resources abroad are more expensive to develop, but why does that mean we have to consolidate downstream at refining and retail levels? In 2004 the GAO found that market concentration in the downstream sector had increased significantly, and that oil company merger activity had in fact had an upward effect on gasoline retail prices. Wouldn't the market benefit from more independent activity in the downstream sector? Wouldn't competition and the consumer be better served by a higher degree of competition at each segment of the supply chain?

Competition at each level of the supply chain benefits consumers. While competition in a downstream market is unlikely to cure structural competitive problems upstream, competition in the downstream market is nevertheless likely to provide some competitive benefits to consumers and should be encouraged. Moreover, competition in downstream or complementary markets can sometimes lead to greater competition in upstream markets that suffer from competitive problems. Thus, it is imperative for the agencies to attempt to maintain competitive conditions at every level of the distribution chain.

2. In a market this tight on supply and this concentrated, where is the disincentive for oil companies to "take their foot off of the pedal" by only barely keeping place with market trends? Is it realistic with so much vertical integration, to assume that if a company does not act swiftly to a price signal another company will competitively respond?

Consolidation provides companies with opportunities to increase profits by increasing scarcity and refusing to develop resources. My testimony detailed how that occurred on Alaska's North Slope. By creating artificial scarcity, ExxonMobil and BP ensure that gas prices will remain artificially high and that any supply disruption will cause a significant spike in prices and profits. In a truly competitive market, ExxonMobil and BP would have marketed this gas as soon as market price exceeded the cost of production and transportation. Clearly, they have not done so. Moreover, because the defendants have prevented the construction of a pipeline, competitors cannot respond to high prices by selling gas from the North Slope in the lower 48 states - their gas is stranded without a pipeline.

3. We've seen a lot of the so called "rockets and feathers" phenomenon where prices spike, supposedly because retailers have to instantly react to the wholesale price, but then when the wholesale drops retail lags at the high price. What do you believe is the explanation for this phenomena and what role has consolidation played in creating it?

As I have stated, I believe that in the natural gas industry, artificially high prices are maintained in the long term because of a lack of supply. ExxonMobil and BP benefit from price spikes and have no incentive when the price spikes to return the price to pre-spike prices quickly. Consolidation makes each spike last longer because competitors have less incentive to take sales away from each other during periods of high prices and more incentive and ability to maintain artificially high prices longer. If the cartel were broken and gas from the North Slope made available in the lower 48 states, there is no question that price spikes would not only be smaller and fewer, but that they would be substantially shorter as well.

**II. Correction of Misstatements by BP and ExxonMobil Executives**

I also write to correct certain misstatements made at the hearing by ExxonMobil Chief Executive Officer Rex Tillerson and BP America Chief Executive Officer Ross Pillari. I understand that Representative John Harris, the Speaker of the House of the Alaska Legislature, has written to the Committee to address some of these misstatements, but this issue is important enough that the correction bears repeating.

Mr. Pillari indicated that there was a proposal to build a pipeline currently pending before the Alaska Legislature. This is incorrect. In fact, ExxonMobil and BP have conditioned any pipeline deal on passage of a new tax bill that adjusts the tax rate on the production of Alaska oil and gas. They have not released their pipeline proposal to either the Alaska Legislature or the public, and they have indicated that they do not intend to do so unless and until the oil tax bill is enacted. Thus, contrary to Mr. Pillari's sworn testimony to the Committee, there is no gasline proposal before the Alaska Legislature.

In addition, Mr. Tillerson testified that ExxonMobil rejected the Port Authority's gas line proposal, as well as several other proposals, because ExxonMobil did not wish to be the "financial guarantor" of the project. The Port Authority has never asked ExxonMobil to provide any financial guarantee for the pipeline. The Port Authority intends to develop its own financing and, indeed, to utilize the $18 billion in federal loan guarantees available for this project. All the Port Authority has ever asked of ExxonMobil and BP is a commitment to provide it with gas when the pipeline is built. Mr. Tillerson's testimony on this point, therefore, is misleading and inaccurate.

Thank you again for the opportunity to testify before the Committee, and please do not hesitate to contact me with any additional questions.

Sincerely,

David Boies

**Supplemental Testimony of Thomas Greene, Chief Assistant Attorney General, California Department of Justice, Before the Senate Committee on the Judiciary Hearing Entitled "Consolidation in the Oil and Gas Industry: Raising Prices?"**

This submission responds to the Committee's additional questions at the hearing entitled "Consolidation in the Oil and Gas Industry: Raising Prices?"

**Questions Posed by Chairman Specter:**

1. **You testified that current case law in many circuits makes it difficult to prove and prosecute "tacit agreements" between competitors in highly concentrated industries. Please expand upon your testimony, and discuss what could be done to make prosecution of such agreements possible. If you have proposed legislative language, please provide that language to the Committee.**

The economic problem is that in industries like petroleum in which individual companies have market power it takes relatively little in the way of signaling or tacit coordination to reach a competitive détente that has the same effect as a traditional price-fix. Judge Posner describes this as a "paradox" because "the more conducive the market's structure to collusion without express communications, the weaker the plaintiff's case" is likely to be on the existence of a "combination" or "conspiracy" in restraint of trade.[1]

Posner suggests that factors like a concentrated market or inelastic demand should be used to understand the potential for tacit agreements. He lists seventeen attributes that are often associated with industries in which a tacit agreement to fix prices or withhold output might be found:

1. Market concentrated on the selling side;
2. No fringe of small sellers;
3. Inelastic demand at competitive price;
4. Entry takes a long time;
5. Buying side of market unconcentrated;
6. Standard product;
7. Nondurable product
8. The principal firms sell at the same level in the chain of distribution;
9. Price competition more important than other forms of competition;
10. High ratio of fixed to variable costs;
11. Similar cost structures and production processes;
12. Demand static or declining over time;
13. Prices can be changed quickly;
14. Sealed bidding;
15. Market is local;

[1] Richard A. Posner, *Antitrust Law 100* (2d. ed. 2001).

16. Cooperative practices; and
17. The industry's antitrust "record".[2]

Clearly, the petroleum industry has a number of these attributes, notably factors 3, demand is inelastic, that is, consumers will purchase about the same amount even if prices rise; 4, entry takes a long time; 5, the buyers side of the market is unconcentrated; 6, industry products meet specific chemical standards; 8, the major firms operate at the same levels; 9, price competition is critical; 10, industry costs and processes are similar; 12, prices can be changed quickly and 15, the industry works cooperatively[3].

Notwithstanding scholarship like Posner's, the federal circuits are split on what is required for a plaintiff to surmount a summary judgment challenge.[4] For example, in Posner's own opinion in *In re High Fructose Syrup*[5], the Seventh Circuit rejected a grant of summary judgment in large measure because the structure of the market was understood to favor tacit agreements. Notably the court also rejected the idea that cheating or lapses in the alleged agreement were inconsistent with the existence of an agreement.[6] On the other hand, the Eighth Circuit in *Blomkest Fertilizer, Inc. v. Potash Corp. of Saskatchewan*[7] ignored the implications of defendants' market power; gave broad deference to the defendants' characterizations of their activities as potentially pro-competitive and assessed each piece of evidence supporting the existence of an agreement separately.

These very different conclusions are driven by what are arguably inaccurate perspectives of the Supreme Court's summary judgment jurisprudence as articulated in *Monsanto Co. v. Spray-Rite Service Corp.*[8] and *Matsushita Electrical Industrial Co. v. Zenith Radio Corp.*[9] As noted by Posner, "[m]ost courts mistakenly regard tacitly collusive behavior as independent and therefore infer from the dictum in *Monsanto* that the plaintiff must negate the possibility that supracompetitive pricing was achieved without explicit agreement."[10] This confusion, in turn, has led another scholar to conclude that:

> The Monsanto/Matsushita approach places oligopoly regulation on its head. It applies the strictest standard to agreements that are least harmful to consumers and reserves the most lenient treatment for the most harmful types of arrangements.[11]

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[2] *Id.* at 69-79.
[3] See also Christopher R. Leslie, *Trust, Distrust and Antitrust*, 82 Tex.L.Rev. 515, 659-673 (2004) ("When competitors are allowed to cooperate in limited, legal ventures, the players can form sufficient trust to engage in illegal endeavors.")
[4] See generally, Thomas A. Piraino, Jr., *Regulating Oligopoly Conduct Under the Antitrust Laws*, 89 Minn.L.Rev. 9, 24-32 (2004).
[5] 295 F.3d 651 (7th Cir. 2002).
[6] *Id.* at 656. An extensive literature on oligopoly behavior concludes that firms in such markets are likely to occasionally cheat but that this is consistent with a tacit agreement to raise prices or withhold output. *See, e.g.*, Edward J. Green and Robert H. Porter, *Non-Cooperative Collusion Under Imperfect Price Information*, 52 Econometrica 1 (1984); Eric Rasmussen, *Games and Information: An Introduction to Game Theory* (1989).
[7] 203 F.3d 1028 (8th Cir. 2000).
[8] 465 U.S. 752 (1984).
[9] 475 U.S. 574 (1986).
[10] See Richard A. Posner, Antitrust Law 99-100 (2d ed. 2001)
[11] Piraina, supra n. 4 at 29.

The central, practical issue that challenges courts is whether a case should be advanced to trial in the absence of explicit evidence of a clear agreement in restraint of trade. Since there can be a very thin line between concerted action and unilateral conduct, particularly in industries like petroleum, the interpretation of potentially ambiguous conduct that might support either the existence of an agreement or parallel behavior by independent firms at summary judgment is crucial. The Supreme Court in its *Kodak* decision appears to have strongly counseled trial courts to allow potentially ambiguous evidence go to a jury "unless plaintiff's theory is economically senseless."[12] Notwithstanding the wisdom of such an approach when so little is required to allow an oligopoly to coordinate prices and production, some courts still go to great lengths to dismiss strong evidence of agreement in summary judgment proceedings.[13]

Since summary judgment is the crucial point at which cases like those brought against oil companies are dismissed, the committee may wish to consider instructing federal trial courts on the appropriate summary judgment standard in antitrust cases. An amendment offered in our Legislature by Senator Dunn of Orange County to his SB 1274 to California's basic antitrust law, the Cartwright Act,[14] may provide a model. Note that this amendment was offered to overturn the result in *Aguilar v.* ARCO[15], an oil company price-fixing case dismissed on summary judgment. The Dunn amendment provided that:

> ***In a motion for summary judgment or summary adjudication under this chapter, all of the following apply:***
>
> ***(1) A plaintiff may reasonably rely on circumstantial evidence and inferences drawn from circumstantial evidence.***
>
> ***(2) A plaintiff may reasonably rely on inferences from conduct that is as consistent with permissible competition as with restraint of trade or commerce unless a defendant demonstrates by a preponderance of evidence that allowing such inferences would have a detrimental effect on competition consistent with the goals of this Act and federal antitrust laws.***
>
> ***(3) A plaintiff is not required to submit proof that tends to exclude the possibility of pro-competitive conduct.***
>
> ***(4) A motion for summary judgment or summary adjudication may not be granted solely on the basis of denials by an officer, director or employee of the non-moving party.***

A "federalized" version of these concepts might look like:

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[12] *Eastman Kodak Co. v. Image Technical Services, Inc.*, 504 U.S. 451, 468-469 (1992)
[13] *See In Re: Baby Food Antitrust Litigation*, 166 F.3d 112 (3rd Cir.1999).
[14] California Business and Professions Code §§ 16700 et seq.
[15] 25 Cal.4th 826 (2001).

*In a motion for summary judgment with respect to the existence of an agreement in any action arising under section 1 of this Act, codified at 15 U.S.C. § 1, the following rules shall apply:*

1. *Plaintiffs may meet their burden of persuasion based on the evidence of agreement as a whole in combination with evidence of the industry's market structure;*

2. *Plaintiffs may meet their burden of persuasion based on evidence of a tacit agreement among defendants or a tacit agreement among one or more defendants and other persons;*

3. *The more substantial plaintiff's evidence of a market structure conducive to collusion, the less evidence is required in order for plaintiff to meet its burden of persuasion;*

4. *Plaintiffs may meet their burden of persuasion based on circumstantial evidence and inferences drawn from that evidence;*

5. *Plaintiffs shall not be required to rebut defendants' characterization of agreement evidence as neutral or pro-competitive unless the conduct challenged in the action constitutes an implausible restraint; and*

6. *Plaintiffs may meet their burden of persuasion even if there is evidence that defendants cheated on the alleged agreement or that the agreement lapsed for periods of time.*

*For purposes of this section:*

1. *"Agreement" has the same meaning as "contract, combination in the form of a trust or otherwise, or conspiracy" as those terms are used in section 1 of this Act;*

2. *"Implausible restraint" means a restraint of trade that is highly speculative or unlikely. This term does not include alleged agreements to fix or stabilize prices, limit production, allocate markets, boycott or injure competitors, fix prices vertically or tie the sale of one product or service to another;*

3. *"Market structure conducive to collusion" means a market structure that has one or more of the following attributes:*

    a. *Market concentration or market power on the selling side;*
    b. *No or a limited fringe of small sellers;*
    c. *Inelastic demand at competitive prices;*
    d. *Barriers to entry that limit entry in a reasonable amount of time;*
    e. *The buying side of the market is not concentrated;*
    f. *Products are standardized;*

*g. Products are non-durable;*
*h. Principal firms sell at the same level or levels in the chain of distribution;*
*i. Firms have similar cost structures and production processes;*
*j. Demand is static or declining over time;*
*k. Prices can be changed quickly;*
*l. Bidding is sealed;*
*m. Markets are small or local;*
*n. The existence of cooperative practices among industry participants not directly related to potential antitrust conduct;*
*o. A history of violations of the antitrust law in the industry; and*
*p. Such other evidence of structural elements conducive to collusion as the court may find reasonable.*

*4. "Summary judgment" means a pre-trial proceeding involving the presentation and assessment of evidence, including expert opinion, and includes the current procedure contained in Rule 56 of the Federal Rules of Civil Procedure.*

**2. You testified that amending Section 7 of the Clayton Act to prohibit oil and gas industry mergers that "appreciably diminish" rather than "substantially lessen" would help prevent anti-competitive mergers. Please explain why.**

Amending section 7 of the Clayton Act in this way will address the two most important weaknesses of contemporary merger analysis as it applies to the petroleum industry: (1) a lack of fealty to the plain language and legislative history of the Act, and (2) fetishization of market power screens over actual market power analysis.

The current language of section 7 of the Clayton Act, codified at 15 U.S.C. § 18, proscribes any merger that "may be substantially to lessen competition, or tend to create a monopoly." Although the substantiality requirement has changed over time[16], the dictionary defines "substantial" to mean "considerable in quantity: significantly great...being largely but not wholly that which is specified."[17] By contrast, "appreciable" means "capable of being perceived or measured."[18] Therefore, a common sense reading of the proposed language would be that it is designed to stop a merger in the petroleum industry if the challenger can show any perceptible or measurable negative effect on competition.

Current merger jurisprudence shows little fidelity to either the existing language of the Clayton Act or the expressed intent of Congress. This was not always the case. The most important early case interpreting the scope of section 7 of the Clayton Act after its modernization in 1950 spent twelve pages discussing the intent of Congress.[19] The Court noted particularly a Senate committee report that concluded that, "[t]he intent here...is to cope with monopolistic

[16] See generally 2 Von Kalinowski, Antitrust Laws and Trade Regulation 2nd § 30.01[3] at pp. 30-14 et seq.
[17] Merriam Webster's Collegiate Dictionary 1174 (10th ed. 1997).
[18] *Id.* at 57.
[19] *Brown Shoe Co. v. United States*, 370 U.S. 294, 311-323 (1962).

tendencies in their incipiency."[20] The principal danger of this new firm, as the Court saw it, was its ability to shut out a number of independent shoe manufacturers from sales of shoes to the retail arm of the new firm.[21] Applying the text of the Act in light of the intent of its drafters, the Court sustained a challenge against two shoe companies that would have created a firm with a 5% share of the retail market.[22]

In *United States v. Philadelphia National Bank*,[23] the Court dealt with the proposed merger of two banks that would have enjoyed a combined 36% of total bank assets and 34% of net loans in the four-county area in and around Philadelphia. Based on the legislative history of the Act, the Court concluded, "intense congressional concern with the trend toward concentration warrants dispensing, in certain cases, with elaborate proof of market structure, market behavior, or probable anticompetitive effects." [24]This led to a presumption that "a merger which produces a firm controlling an undue percentage share of the relevant market, and results in a significant increase in the concentration of firms in that market, is so inherently likely to lessen competition substantially that it must be enjoined in the absence of evidence clearly showing that the merger is not likely to have such anticompetitive effects."[25]

The trigger for this presumption was clarified in *United States v. General Dynamics*.[26] In this case, two coal companies sought to merge. At least facially, the transaction would have given the new firm a large share of the market. Looking below the raw statistics, however, both the trial court and the Supreme Court concluded that the new firm would not have the market strength suggested by its market share. Specifically the Court noted that the trial court had found that the acquiring firm was "facing the future with relatively depleted [coal] resources at its disposal, and with the vast majority of those resources already committed under contracts allowing no further adjustment in price.[27] Endorsing the trial court's rejection of current market share data as "proper indicators of future ability to compete", the Court found that the *Philadelphia National Bank* presumption had not been triggered. [28]

In the 1980's, the original intent of Congress and the subsequent federal jurisprudence concerned with relatively small increases in concentration, protected by the *Philadelphia National Bank* presumption was further eclipsed by a new paradigm that had its roots in laissez faire economics. This sea change was marked by the issuance of federal merger guidelines in 1982. Conceptualized as a statement of prosecutorial intent for the business community, these guides broke dramatically with the prior jurisprudence. Indeed, a standard text on antitrust law concludes that these guides "set forth a detailed analytical framework, largely economic in nature and devoid of citations—or fidelity—to the case law".[29] From a policy perspective, the guidelines were premised on the belief that "earlier Supreme Court decisions

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[20] *Id.* at 318, quoting, S.Rep. No. 1775, 81st Cong., 2nd Sess. 4-5. .
[21] *Id.* at 328-329
[22] *Id.* at 343-344.
[23] 374 U.S. 321, 330-330 (1963).
[24] *Id.* at 363.
[25] *Id.*
[26] 415 U.S. 486 (1973).
[27] *Id.* at 503.
[28] *Id.* at 510.
[29] Wayne D. Collins, *Mergers & Acquisitions*, 1 Antitrust Adviser 4th § 3.3 at 3-7 (Irving Sher ed. 2005).

reflected bad policy—if not bad law—and should not be followed, even though they had never been overruled or corrected."[30]

Although these are still just prosecutorial guidelines for the federal competition agencies, their importance has been exaggerated by practical limits on private actions. In 1977, the Supreme Court concluded that a competitor challenging a merger could not recover damages for losses due to increased competition from the merged firm. *Brunswick v. Pueblo Bowl-O-Mat.*[31] This common sense notion was extended, however, to preclude competitors from seeking injunctions, even against patently anticompetitive mergers in *Cargill, Inc. v. Montfort of Colorado, Inc*[32]. As noted by a frustrated Justice Stevens for the dissenters, notwithstanding proving "to the satisfaction of the District Court [citation omitted] and the Court of Appeal [citation omitted] that the merger…is illegal…the Court holds, however, that the merger should not be set aside because…[the injury to the plaintiff] does not constitute the kind of 'antitrust injury' that the Court described in *Brunswick Corp v. Pueblo Bowl-O-Mat* [citation omitted].[33]Although the Court did leave open the theoretical possibility that interested competitors might challenge anticompetitive mergers, this decision has practically eliminated private actions against mergers. With the exception of actions brought by state attorneys general, actions by the federal competition agencies, premised on these guides, represent the real standard of merger law in the nation today.

Although the guidelines are intended to identify mergers that "create or enhance market power" or "facilitate its exercise",[34]a keystone of the guides are the ranges of concentration identified as potentially actionable. Using a standard Herfindahl-Hirschman Index, the so-called HHI,[35] a post-merger index of 1000 or less will "ordinarily require no further analysis" by the federal agencies. [36]In markets in which the post-merger HHI is between 1000 and 1800, the transaction may "raise significant competitive concerns" depending on the application of various further analytic steps if, but generally only if, the merger increases concentration by 100 or more points. Id. Finally, a market with a post-merger HHI over 1800 begins to trigger presumptions of illegality but typically only if the merger increases concentration by 50 or more points. *Id.*

These ranges are important because the petroleum industry is generally considered only "moderately concentrated". While these ranges do not bind courts and the agencies themselves eschew limiting themselves to these guidelines when they litigate,[37] the guides are used by most courts as a toolbox for sorting out concentration and market power.[38] Using this toolkit, both

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[30] *Id.* at 3-24.
[31] 429 U.S. 477, 488 (1977).
[32] 479 U.S. 104, 120 (1986)
[33] *Cargill*, 479 U.S. at 123.
[34] U.S. Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines § 0.1 (rev. April 8, 1997),
[35] An HHI is determined by summing the squares of the market shares of firms in a relevant market. Markets for this purpose are two-dimensional constructs consisting of a product market and a geographic market.
[36] *Id.* at § 1.51.
[37] *Id.* at § 0.1 (Guidelines do not "describe how the Agency will conduct the litigation of cases it decides to bring."),
[38] See, e.g., *Federal Trade Commission v. Swedish Match*, 131 F.Supp.2d 151, 160 (D.D.C. 2000) (use of guides to establish markets for analysis); *United States v. Sungard Data Systems, Inc.*, 172 F.Supp. 172 (D.D.C. 2001) (use of guides to assist in market definition); *Federal Trade Commission v. Cardinal Health, Inc.*, 12 F.Supp.2d 34 (D.D.C. 1998) (adopting use of HHIs to measure concentration based on guides); *California v. Sutter Health System*, 130

the agencies and increasingly courts use the HHI screens as a sieve through which to test the competitive magnitude of a particular event or practice. Never intended to be more than a rough preliminary proxy for real market power, these screens have increasingly become the sine qua non of market power analysis—a fundamental inversion of their conceptual purpose.[39]

A number of recent, very large petroleum mergers have fallen just within or just outside the current HHI screens for mergers in moderately concentrated industries. Thus, despite public concern about these transactions and new evidence that they have increased prices to consumers by $0.01 to $0.07 per gallon,[40] these are not cases that dramatically violate the current guidelines so they are not easy cases to litigate given the broad acceptance of the guides.

One important explanation for this conundrum is that the HHI screens are based on general industry data. They do not properly take into account the effect of reduced competition in industries like petroleum in which demand is largely inelastic, that is, consumers will continue to purchase the product even when prices rise dramatically. In such a market, a small reduction in supply can have an outsized effect on consumers. From a technical perspective, demand inelasticity, coupled with supply inelasticity at high demand, that is more gasoline can't be made or imported in the short-run, means that small amounts of capacity withheld from the market can lead to dramatic price increases and even firms with relatively small shares of inframarginal capacity can affect prices, and profit from withholding supplies from the market. Federal guidelines and judicial expectations have to be recalibrated to take this into account. If not, the current system will continue to yield equivocal results for the public.

This problem is compounded by the way courts have decided cases since the guides were issued. For example, the guides do not suggest that concentration is a critical part of its analysis but rather a screen that may or may not lead to further investigation. Consistent with this approach, the D.C. Circuit largely eviscerated the *Philadelphia National Bank* presumption in *United States v. Baker Hughes, Inc*[41] by concluding that to make this presumption meaningful would impose an unfair burden on merging firms.[42] If the presumption starts out weak because

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F.Supp.2d 1109 (N.D.Cal. 2001) ("Although the merger guidelines are not binding, courts have often adopted the standards set forth in the Merger Guidelines for analyzing antitrust issues."); *United States v. Oracle Corp.*, 331 F.Supp.2d 1098 (N.D.Cal. 2003) (Guidelines a starting point for analysis; extensive analysis of potential coordinated and unilateral effects that led to approval of merger.)

[39] Neil B. Cohen and Charles A. Sullivan, *The Herfindahl-Hirshman Index and the New Antitrust Merger Guidelines: Concentrating on Concentration*, 62 Tex.L.Rev. 453, 469 (1983).

[40] U.S. Government Accountability Office, Energy Markets: Factors Contributing to Higher Gasoline Prices 2-3 (GAO-06-412, February 1, 2006) (Statement of Jim Wells, Director of Natural Resources and Environment).

[41] 908 F.2d 981 (1990).

[42] According to the *Baker Hughes* court, "[I]f the burden of production imposed on a defendant is too onerous, the distinction between that burden and the ultimate burden of persuasion—always an elusive distinction in practice—disintegrates completely." *Baker Hughes*, 908 F.2d at 99. In another application of this approach, in a case involving the admittedly concentrated market for coal from the Powder River Basin, the fact that by at least one measure the increase in concentration was only 49 (as opposed to 50) points in a concentrated market meant that "although the FTC has satisfied its prima facie case burden, the FTC's prima facie case is not strong, certainly less of a showing is required from defendants to rebut a less-than-compelling prima facie case." *Federal Trade Commission v. Arch Coal, Inc.*, 329 F.Supp.2d 109, 129 (D.D.C. 2004).

the screens are set too high for industries like petroleum, plaintiffs—and consumers--are doubly prejudiced.

Against the background of current merger law, the Committee should make clear that its new language is intended to make a clean break with the current guidelines. First, the Committee should make plain that the current HHI screens in the guidelines do not properly capture the significance of reductions in competition in the petroleum industry because, unlike most industries, demand in fuel markets is largely inelastic as is supply. Second, the Committee should consider interpreting its new language as reinvigorating the *Philadelphia National Bank* presumption so that if the agencies demonstrate a dangerous increase in concentration (taking into account the relatively inelastic demand in gasoline markets), the burden shifts decisively to the merging parties to clearly demonstrate that the merger will not harm competition. Third, the Committee should consider discussing the impact its new language may have on the acquisition or control of small, but strategic, assets like pipelines, docks, storage facilities and marine transportation. Such infrastructure is crucial to competition in the petroleum industry and needs the full protection of the law.

Finally, the Committee should make clear that this new language does not preclude actions against petroleum company mergers under current law. In fact, if one looks at the original intent of Congress in enacting the Clayton Act, much could be done. Specifically, *United States v. E.I. du Pont de Nemours & Co.*[43] concludes that federal agencies can reexamine a transaction subject to the Clayton Act decades after the transaction took place.

**Questions Posed by Senator Leahy:**

1. **Do you think there needs to be more transparency on the commodity exchanges, particularly natural gas transactions? If so, what steps can Congress take to increase transparency in the natural gas market? Should Congress require traders to register?**

Commodity exchanges are of critical importance to America's consumers and businesses, and transparency should be a given in such markets. California learned this the hard way during our energy crisis of 2000-2001. Enron On-Line was created as a new, computer-based commodity exchange for trading natural gas but was exempted from regulation by the Commodity Futures Trading Commission, notwithstanding its importance.[44] Beyond the purview of any regulatory oversight, this exchange became a seedbed for abuse of California consumers. Among other problems, we discovered that a single trader with Reliant engaged in regular, rapid-fire transactions on the exchange that caused prices to rise dramatically. Unbeknownst to other traders (or consumers), Reliant had a "netting agreement" with Enron that insured that while Reliant's trades would send prices on the exchange sky high, Reliant never had to pay those prices. These arrangements had two general effects: (1) prices on the exchange

[43] 353 U.S. 586 (1957).
[44] Bethany McLean & Peter Elkind, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* 96 (Penguin Group, 2003); *see also* Frontline at http://www.pbs.org/wgbh/pages/frontline/president/players/gramm.html.

rose precipitously, and (2) since many power contracts were indexed to prices on the exchange, prices rose even for gas that was not traded on the exchange.

These kinds of abuses are certainly possible in motor fuels because prices under inter-refinery supply agreements are also indexed to thinly traded, non-transparent exchanges. Thus wash trades and other tactics used in electricity and natural gas markets during our energy crisis could be used on unregulated commodity exchanges to affect prices in gasoline markets.

Although we successfully challenged both Reliant and Enron over these practices, such activities illustrate the dangers of letting energy trading devolve into practices pioneered by Diamond Jim Brady and other infamous traders from the Gilded Age. Congress and the Federal Energy Regulatory Commission have taken tentative steps to address some of these problems. In the Energy Policy Act of 2005, Congress authorized FERC to issue regulations to proscribe market manipulation under both the Natural Gas Act and the Federal Power Act.[45] These regulations were to be generally analogous to the standards applicable to stock exchanges contained in Rule 10(b) of the Securities and Exchange Act of 1934.[46]

Although this statute is an advance, it has important weaknesses. First, unlike the securities laws, neither section under the Energy Policy Act of 2005 can be "construed to create a private right of action.[47]This means that an already overworked regulatory agency is the only entity that can address market manipulation or potentially complex commodity frauds. Second, the regulations with respect to gas only apply to deals already "subject to the jurisdiction of the Commission."[48] This is understood to exclude both first sales and retail sales.[49] The exclusion of first sales in particular has the effect of excluding large numbers of transactions from the scope of the new rule. Finally, the new rule does not set up a registration requirement or set specific, exchange-wide market rules for exchanges buying and selling energy commodities.

Against this background, greater regulation of trading practices in energy markets by the Commodity Futures Trading Commission, specifically over-the-counter exchanges for derivatives, is wholly appropriate. But such oversight is precluded by exceptions in the Commodity Futures Modernization Act of 2000.[50] The most notable exceptions are for the derivatives and swaps that are increasingly important in energy markets.[51] Although the chairman of the CFTC argues that such exceptions make sense when sophisticated traders are involved[52], our experience with the California energy crisis was that even highly sophisticated

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[45] Pub.L.No. 109-58, §§ 315 (adding §4A to the Natural Gas Act), 1283 (adding §222 to the Federal Power Act).
[46] 15 U.S.C. §78j(b); see also 17 CFR 240.10b-5.
[47] Pub.L.No.109-58 §§315, 1283.
[48] 18 CFR 1c1(a).
[49] 114 FERC 61,047 ¶16 (January 19, 2006).
[50] . Pub.L.No.106-554, 114 Stat. 2763.
[51] An extremely useful table detailing these and other exceptions to CFTC jurisdiction over energy exchanges prepared by the U.S. Energy Information agency can be found at http://www.eia.doe.gov/oiaf/servicerpt/derivative/tbl14.html

[52] Reuben Jeffery III, chairman, Commodity Futures Trading Commission, "Futures and Derivatives: The Road Traveled and the Road Ahead", presented at the San Juan, Puerto Rico meeting of the American Bar Association

purchasers were abused in unregulated exchanges. And as Warren Buffett famously observed, under-regulated derivatives markets are "weapons of mass destruction."

Indeed, the notion that anti-fraud and other protections should be eliminated in markets merely because some of the customers are sophisticated is itself quite odd. The New York Stock Exchange is an extremely sophisticated market but no one would suggest that anti- fraud and other market rules are unnecessary. In fact, such rules and their effective enforcement are hallmarks of the NYSE. And such regulation makes this and similar markets more competitive and more secure, which, in turn, makes them bigger and more efficient.

In markets for motor fuels, petroleum and natural gas, traders should be registered and the same kinds of rules enforced by the Securities and Exchange Commission in stock markets should be extended to all major commodity markets including markets for derivatives and all other proxies for these commodities.

**Senator DeWine Questions:**

1. **First, what more should the FTC do to prevent oil industry mergers from lessening competition?**

First, any additional mergers, joint ventures or other inter-company agreements in this industry must be given the most searching scrutiny. This means initially that the Commission must modify its current procedures. Although the Commission has made petroleum issues a priority, use of HHI screens to quickly weed out less important transactions is not appropriate in this industry. At the least, Commission staff should be doing industry interviews and additional document demands in every new proposed merger in this industry.

Second, the Commission should formally review the effects of past merger approvals and settlements going back fifteen years. The GAO says that petroleum industry mergers have cost consumers and American business $0.01-0.07 per gallon. While it is natural for the Commission to dispute such findings, it is also clear that we all have far more information about these transactions now than we had when they were first proposed and approved. It is time to thoughtfully sort out if we got it right the first time around. A major candidate for such a review should be the approval of the take-over of the Thrifty chain of over 100 discount gas stations in southern California by ARCO in the mid-1990s. In hindsight, that appears to me to have been an error and should be reviewed. Other candidates for consideration for such a review include Equilon, the Shell-Texaco refining and marketing joint venture and various inter-refiner supply sharing arrangements.

Third, if we did get it wrong with respect to a merger or with respect to particular curative divestitures, the Commission, preferably in partnership with state attorneys general, should consider challenging any transactions that have proved to be inimical to competition in this industry. The case authority for such challenges, at least by federal agencies, is quite clear.

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Committee on Futures and Derivatives Instruments (February 3. 2006) at http://www.cftc.gov/opa/speeches06/opajeffery-7.htm

In *United States v. E.I. du Pont de Nemours & Co.*[53], the Supreme Court approved a challenge in 1949 to stock purchases made thirty years earlier. The Court concluded that, "[w]e repeat, that the test of violation of § 7 is whether, at the time of suit, there is a reasonable probability that the acquisition is likely to result in the condemned restraints." [54]By contrast, private plaintiffs, and potentially state attorneys general, may be subject to the defense of *laches* in such cases. [55]

This course of action should be undertaken only on two conditions. First, it must be clear that unwinding a merger transaction is clearly warranted by the facts. If not, the costs in terms of reasonable business expectancies and general problems in all markets will outweigh the benefits of any single challenge. Second, a broad-gauged attack on a completed transaction should be mounted only if additional spin-offs or other surgical relief cannot fix the competitive problem(s) with the original deal.

Fourth, the Commission should consider more aggressive use of its authority under section 5 of the Federal Trade Commission Act, codified at 15 U.S.C. § 45, root out "[u]nfair methods of competition" to review the many instances in which executives from competing oil companies interact and share information in joint ventures, swap arrangements and other situations to determine if those interactions are dangerous to competition. While the Commission lost a famous case involving practices that facilitated oligopoly pricing in the sale of the ethyl fuel additive[56], this case can and should be confined to its unique facts. And certainly current practices in the petroleum industry that appear to facilitate a non-rivalrous oligopoly in this crucial market should not be ignored because of a single case. At the least, a serious investigation focused on whether these many joint activities ablate competition and whether they may violate section 5 of the FTC Act is warranted.

2. **Second, how should U.S. energy policy work to prevent consolidation that leads to higher prices while still addressing the risk that an aggressive merger policy could keep U.S. companies relatively small in a way that puts them at a competitive disadvantages to other global players?**

U.S. oil companies are not small firms on the world stage. Despite recent articles suggesting that U.S. firms may be "surprisingly vulnerable"[57], they still seek and win leases in all areas of the world. And as evidenced by their work on the hostile North Sea leases, American companies dominate the technology used to extract oil from the most difficult drilling environments in the world.

While U.S. companies are not too small to compete in world markets, they do face new rivals, notably companies from China, Japan and India, as well as their traditional European competitors. And major U.S. companies are facing increasingly "demanding, even hostile

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[53] 353 U.S. 586 (1957)
[54] *Id.* at 607.
[55] *See, e.g., Garabet v. Autonomous Technologies Corp.*, 116 F.Supp.2d 1159, 1171-72 (C.D.Cal. 2000).
[56] *E.I. du Pont de Nemours & Co. v. Federal Trade Commission*, 729 F.2d 128 (1984),
[57]"Why You should Worry About Big Oil: Beyond the fat profits, the giants are surprisingly vulnerable", Business Week (May 15, 2006) at http://www.businessweek.com/magazine/content/06_20/b3984001.htm

foreign governments."[58] All companies are competing for oil that is harder to find and more expensive to extract as world demand increases.

Against this background, several policy initiatives make sense. First, we are faced by a fully functioning cartel in the Organization of Petroleum Exporting Countries. While not all producing countries belong to OPEC, this cartel substantially controls the price of world oil. The United States should begin to take legal steps to attack this cartel. A key first step would be to pass into law some version of the NOPEC legislation that you have drafted.

Second, we should begin to aggressively improve fuel economy in our automobiles and light trucks. If the United States can reduce its painful reliance on what appears to be a waning resource, we will be more secure economically and politically. Many engineers think that by combining already available technologies like continuously variable transmissions and the use of lighter steels we could significantly reduce our dependence on oil and the regimes that control it. These steps should begin now.

Third, we should stop getting in the way of importing ethanol from other parts of the world. As you may know, Brazil has led the western hemisphere in the use of ethanol. Although this nation is an ally, we impose significant tariffs on imports of ethanol from Brazil. Ethanol is part of gasoline today; and repeal of this tax can help consumers right now. And when more vehicles can use ethanol directly, repeal will make even more sense. This should be coupled with federal research and development support for the production of ethanol from cellulostic and other sources.

Finally, with respect to U.S. competition policy, I would view claims that more mergers are required to give U.S. firms more clout in international markets with enormous skepticism. That said, if we were to see a proposed BP-ARCO/ExxonMobil/ConocoPhillips merger, while the presumption should be strongly against such a deal, the parties should be given the opportunity to explain, if possible, how such a deal would be in the public interest.

3. **If there were one change you could make to the antitrust laws to make oil and gasoline markets more competitive, what would that be?**

I believe that your NOPEC proposal is the single most important change that can be made now to make petroleum markets more competitive.

**Senator Kohl's Follow-up Questions:**

1. **I have introduced a bill to direct the Secretary of Energy to establish and operate a strategic refining reserve. This reserve should have the capacity to produce at least 5 percent of the domestic demand for gasoline, diesel and aviation fuel. I believe this reserve would be an important step to ending the oil companies' stranglehold over the market, and their ability to manipulate supply in order to have market power. What do you think of this idea?**

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[58] *Id.*

This is an important initiative. Attorney General Lockyer recommended the creation of a similar reserve for California to address dramatic price spikes in the California market in 2000. Estimates at that time were that a properly sized reserve could save California consumers hundreds of millions of dollars. The analysis of this proposal is contained in our report entitled *Report on Gasoline Pricing in California* 48 (May 2000) which can be found at http://caag.state.ca.us/antitrust/publications/gasstudy/gasstudy2.pdf

2. **I have introduced legislation to give the Secretary of Energy the authority to prohibit the export of any refined petroleum product when supply is expected to fall below demand. In my view, in times of high demand and severe pressures on supply – such as we saw in the aftermath of the Hurricane Katrina and Rita disasters last Fall - it is simply unacceptable that U.S. oil refiners should ship their products out of the country. What do you think of this legislation?**

While we do have international obligations that we must honor, we must protect our own as much as possible. Consistent with whatever agreements and commitments we have made with friendly nations and customers, I would support such legislation as a short-term stopgap to address a supply emergency in the United States.

**Follow-Up Questions of Senator Charles E. Schumer:**

1. **We often hear the justification for consolidation that resources abroad are more expensive to develop, but why does that mean we have to consolidate downstream at refining and retail levels? In 2004 the GAO found that market concentration in the downstream sector had increased significantly, and that oil company merger activity had in fact had an upward effect on gasoline retail prices. Wouldn't the market benefit from more independent activity in the downstream sector? Wouldn't competition and the consumer be better served by a higher degree of competition at each segment of the supply chain?**

There is no necessary relationship between oil company mergers and finding new oil reserves. In fact, several major mergers have been driven by the perception that the target firm had proven reserves that were undervalued so the acquisition was an alternative to spending money on exploration and development in new or frontier areas.[59] A recent example of this was the acquisition of Unocal by Chevron. In that transaction, Unocal's assets were offshore leases off Central Asia with substantial estimated reserves.

The market would clearly be better if there was more competition in the downstream sectors of the petroleum industry. At retail, the majors have instituted price zones that allow each of them to effectively compartmentalize competition from independents and to efficiently counter price moves by other majors. The way this works is that individual stations report on their own prices and those of competitors. Based on experience over time, the companies and

[59] D.J. Peterson and Sergei Mahnovski, *New Forces at Work in Refining: Industry Views of Critical Business and Operations Trends* 15-16, n.2. (RAND 2003)

their principal consultant have determined the geographic areas of competition for each station. These areas are called price zones and can be a miles square or an individual intersection.

By comparing the prices at their own stations along with the gallons sold, the majors know that they may need to react to a price-cutter a mile away but not two miles away. Since the majors have developed ways to control prices at retail, even for supposedly more independent franchise dealers, this means that retail prices can be controlled by the refinery oligopoly to maximize profits. The implication for policy makers and consumers is that effective competition requires active, price-cutting competitors in as many price zones as possible.

In the refining sector, as noted in the next answer, companies have generally decided to eliminate or not expand capacity so the market is always on a knife-edge between adequate supplies and shortage. Additional competitors in this sector might view their own individual interests differently. Indeed, in a less comfortable oligopolistic market, some competitors might seek to expand market share based on growing their capacity to refine oil into products. This kind of competition would be of enormous benefit to consumers.

**2. In a market this tight on supply and this concentrated, where is the disincentive for oil companies to "take their foot off the pedal" by only barely keeping place with market trends? Is it realistic with so much vertical integration, to assume that if a company does not act swiftly to a price signal another company will competitively respond?**

In the refining portion of the market, petroleum companies have successfully reduced capacity in order to increase profits. Indeed, a 2003 RAND study reports that "the elimination of excess capacity" that existed in the 1980's and 1990's "represents a significant business accomplishment" for the industry.[60] "On the other hand", according to RAND, "the elimination of spare capacity generates upward pressure on prices at the pump and produces short-term market vulnerabilities" that can result in "acute (i.e. measured in weeks) supply shortfalls and price spikes."[61] [62]

A new perspective on this part of the business supports a "just enough" strategy. Partly such a strategy keeps costs at a minimum. But more importantly, refiners do not want to repeat the low-profit 1990's. Thus, many refiners question "the once universal imperative of a refinery not "going short"—that is, not having enough product to meet market demand." In fact, RAND reports that:

> Rather than investing in and operating refineries to ensure that markets were fully supplied all of the time, refiners suggested that they were focusing first on ensuring that their branded retailers are adequately supplied by curtailing sales to wholesale markets if needed. "The industry is a lot smarter", said one industry representative. "The 80s and

[60] *Id.* at 83
[61] *Id.* at xv-xvi.
[62] Parallel reductions in product storage facilities and inventories have had similar effects on consumers.

90s were ugly for refining. [Executives] know what caused it, and they don't want to do it again."[63]

This suggests that refiners have and will resist market signals if they think this will lead to "excess" capacity in the industry, leading to lower profits. This also suggests that antitrust authorities must be extremely alert to any increase in concentration among refiners because refinery capacity is the crucial bottleneck in the industry.

**3. We've seen a lot of the so-called "rockets and feathers" phenomenon where prices spike, supposedly because retailers have to instantly react to the wholesale price, but then when the wholesale drops, retail lags at the high price. What do you believe is the explanation for this phenomena and what role has consolidation played in creating it?**

The "rockets and feathers" pricing phenomenon is referred to by economic researchers as an asymmetric response to crude oil price increases, that is, product prices rise like rockets and fall like feathers.[64] While there is no scholarly consensus on how this occurs, I believe that three intersecting developments explain this phenomenon.

The first is the steady elimination of competitive, independent retailers. Typically, independent retailers were the first to cut prices, forcing majors to cut their own retail prices faster in the past.

Second, refiners have reduced relative capacity (including inventories and storage) since the 1980's and 1999's so majors do not always have fuel to supply independents. With the reduction in the number of independent refiners, independent retailers have become increasingly vulnerable to price spikes. What happens is that if supplies are short, the majors supply their own stations first. Meanwhile, independents buy on the wholesale spot market that may now be higher than the retail price at a major station. This pricing relationship is known as backwardation. In such a market, the few remaining, hitherto price-competitive independents cannot compete on price so they cannot discipline the majors.

Finally, majors use price zones to keep prices high when they do not face direct price competition from price-cutting independents.

To put these factors into context, when a refinery goes out or there is an increase in crude prices, majors will immediately price their products at higher replacement costs irrespective of what they paid for the product. This will be fully passed on to the spot market that is the normal source of fuel for independents. Although majors may not pass all of the increases through to their stations, prices always rise for their own stations and franchisees, often substantially. When

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[63] *Id.* at 16-17.

[64] Li-Hsueh Chen, Miles Finney & Kon S. Lai, *A threshold cointegration analysis of asymmetric price transmission from crude oil to gasoline prices*, 2005 Economics Letters 233(Reed Elsevier, 2005) at www.sciencedirect.com; Stephen P.A. Brown & Mine K. Yucel, *Gasoline and Crude Oil Prices: Why the Asymmetry?*, Economic and Financial Review 23 (Federal Reserve Bank of Dallas, 3rd Qtr. 2000); Severin Borenstein, A Collin Cameron & Richard Gilbert, *Do Gasoline Prices Respond Asymmetrically to Crude Oil Price Changes?*, 112 Quarterly Journal of Economics 305 (MIT Press, 1997)

the broken refinery comes back on line or crude costs subside, majors typically reduce prices only as necessary, typically first in those price zones with independents (if spot prices fall dramatically) and then extend cuts to other areas only as other majors start to drop. This tends to give consumers the impression that retail prices rocket up but only feather down.

Consolidation has touched every aspect of this problem. First, consolidations have touched hitherto highly price competitive segments of the retail market. A good example is the acquisition of ARCO, a traditionally price competitive firm, by BP. As to refinery capacity, the elimination of surpluses in the 1990's appears to be closely linked to the increased concentration in the market. And finally, the use of price zones allows majors to extend their oligopoly power efficiently down to street level, and provides an additional profit, typically realized as increased returns to their refinery operations.

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April 17, 2006

The Honorable Arlen Specter
Chairman, Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, DC 20510

**Attn: Mr. Barr Huefner**

Dear Mr. Chairman:

On behalf of Shell Oil Company, I am forwarding our answers to written questions from Committee members regarding the Judiciary Committee hearing on March 14, 2006 styled "Consolidation in the Oil and Gas Industry: Raising Prices?". As directed we are sending this material electronically as well.

If you have additional questions, please contact Jim Rich of my staff at 202-466-1425.

With kind regards.

Sincerely,

B. Malnak

Brian P. Malnak

**Questions posed by Senator Specter**

*To John Hofmeister:*

1.) Please provide an analysis of the draft bill, the "Petroleum Industry Antitrust Act of 2006," which was submitted to the Congressional Record earlier this month.

A: Analysis of Draft Bill, the "Petroleum Industry Antitrust Act of 2006"

Section 2 would make it unlawful for any person to "refuse to sell, or to export or divert" crude oil, refined oil products or natural gas, with the "primary intention" of affecting prices or supply in a particular market.

*Comment:* This provision could create a significant disincentive for suppliers of crude oil, refined oil products or natural gas to respond to different supply and demand conditions in different markets. Such restrictions on suppliers' economic responses to market conditions would likely have the unintended effects of increasing prices and reducing supply in affected markets.

Section 3 would amend Section 7 of the Clayton Act to establish a standard for evaluating the legality of proposed acquisitions of oil or gas companies that is different from the standard applicable to other industries. Acquisitions of oil or gas companies, or their assets, would be prohibited "if the effect of such acquisition may be to appreciably diminish competition."

*Comment:* This provision would create a unique and vague standard for a single industry that would differ in two important respects from the standard applicable to most other industries. The current standard allows companies in most industries to combine to achieve efficiencies, unless the combination would be likely to cause substantial economic harm. Section 7 of the Clayton Act currently requires proof that

- the effect of the acquisition "may be substantially to lessen competition, or to tend to create a monopoly"
- in a properly defined economic market ("in any line of commerce . . . in any section of the country").

The proposed amendment would substitute a vague standard, "appreciably diminish", for the current "substantially lessen" standard, which has been the subject of extensive interpretation by courts and regulatory agencies over the course of a half-century of enforcement. Worse still, the proposed standard appears not to have any economic foundation. Unlike the current standard, it would apparently not be applied in the context of a properly defined economic market. Thus, the proposed amendment would likely make it more difficult and costly for oil and gas companies to achieve the same kinds of

efficiencies of scale that companies in other industries are not only permitted, but expected, to achieve so that they can compete aggressively with their rivals.

Section 4 would require the GAO to conduct a study, within six months, of the effectiveness of divestitures by oil and gas companies pursuant to consent decrees entered by federal courts in antitrust cases brought by the federal antitrust enforcement agencies during the past ten years.

*Comment*: Among the many problems with this provision are:

- FTC consent orders involving divestitures are issued by the Commission, not by a court
- It is not clear that the GAO has, or could acquire within the specified time limit, sufficient expertise to study the effectiveness of oil and gas company divestitures required by federal court-ordered consent decrees as well as expertise in antitrust law and industrial organization economics to conduct such a study
- There is no apparent need for GAO to perform such a study, since
    - FTC consent orders and DOJ consent decrees are preceded by a public comment period, which affords affected parties an opportunity to raise any issues as to the likely effectiveness of a divestiture before it is ordered, and
    - After divestitures, affected parties have every incentive to bring to the attention of the enforcement agencies any problems with the effectiveness of the divestitures and to seek additional enforcement action.

Section 5 would create a joint federal-state task force to investigate "information sharing practices" among oil and gas companies.

*Comment*: This provision is unnecessary because oil and gas companies are continually subjected to antitrust investigations by federal and state antitrust agencies. Most recently, for example, the Florida Attorney General conducted an antitrust investigation and concluded, in August 2005, that gasoline price changes were attributable to supply and demand factors, not to anticompetitive conduct.

Section 6, the so-called "NOPEC" provision, would amend the Sherman Act to make it illegal for foreign states to enter into anticompetitive agreements to limit the supply, or maintain the price, of oil, natural gas, or any petroleum product, where such agreements have a reasonably foreseeable effect on market conditions in the US. The proposed amendment would authorize the Attorney General to bring legal actions against foreign states in US courts, and would deprive those states of the defenses of sovereign immunity and the act of state doctrine.

*Comment*: Aside from the significant issues of foreign policy, international law, jurisdiction and comity implicated by this provision, it appears likely to reduce OPEC members' incentives to supply oil to the US. If so, the provision would be likely to lead to higher, rather than lower, gasoline prices in the US.

2.) What steps can be taken to decrease consumption of oil and natural gas?

A: Let markets work and encourage fuel conservation and efficiency. During last year's hurricanes, Shell posted to its Web site easy tips on how to conserve fuel, and presently we have a "Fuel Stretch" campaign aimed at showing consumers how to get the most out of every fuel purchase they make. Shell has found significant cost savings in our own facilities from energy conservation.

3.) Please provide an analysis of the incentives offered to petroleum companies by the federal government that explains what the incentives are intended to do, which incentives are important to you, and why they should be maintained.

A: From time to time the Congress has passed a number of federal tax incentives to encourage domestic production of energy. A good example of this is HR 6, the Energy Policy Act of 2005(PL109-58). Among other things, PL109-58 contains various incentives designed to encourage domestic production of oil and gas and renewable fuels, and to increase domestic refining capacity.
In many cases, significant capital investment is required for energy projects with no return for many years. For example, in the OCS, it could take 10 years from the time a property is leased to initial production. Significant additional time is needed to recoup the capital invested. And such a facility could cost over $1 billion. Consequently, Shell supports and relies upon stable regulatory and fiscal policies that enable companies to develop energy projects and secure energy supplies. Furthermore, Shell supports reasonable incentives Congress deems in the national interest to encourage domestic production. In this regard, Shell supported PL 109-58, overwhelmingly approved by the Congress, which contains incentives for fossil and renewable fuels. Such incentives can help augment US security and promote emerging technologies.

4.) In the two weeks prior to March 14, 2006, the price of oil decreased seven cents per gallon, while the price of gasoline increased by eleven cents per gallon. Why would gasoline become more expensive during this period, despite a decrease in the cost of crude oil?

A: Prices in markets will vary as every market is subject to unique conditions. Fuel prices are affected by a number of factors including the cost of crude, formulation requirements, state taxes, refinery utilization, supply and distribution logistics, local market conditions, environmental regulations and operating costs. These factors vary in each market. Also, retail gasoline prices tend to move more slowly than the underlying cost of product. This "lag" effect is evident during periods when prices are rising as well as those times when prices are falling.

5.) With respect to the large mergers that your companies have engaged in over the past decade, what efficiencies have they produced that have benefited consumers, particularly in downstream markets?

A: Over the past five years, Shell has invested virtually all of our U.S. earnings into finding new supply, increasing production, improving refining capabilities and developing new technologies. It takes an extraordinary level of financial strength to deploy large amounts of capital in risky environments and a cyclical industry.

Efficiencies related to transactions Shell has undertaken help us to make significant investments in order to meet the growing consumer demand for energy. Our acquisition of Pennzoil-Quaker State Company helped Shell lower cost structures in manufacturing and distribution of lubricant products while achieving broader distribution. The resulting efficiencies allow our lubricant products to be competitively priced and distributed across multiple channels such as retail, fast lubes, fleets, and re-sellers.

**Question's Posed by Senator DeWine**

*To Tillerson, Mulva, O'Reilly, Klesse, Hofmeister, Pillari, Borenstein:*

1.) At our last hearing, we heard testimony that some of the gasoline price spikes can be attributed to regulations that create multiple grades of gasoline to comply with different environmental standards – so called "boutique fuels." What can we do to reduce the number of boutique fuels? What would be the effect of just requiring everyone in the industry to comply with the highest standard, and have just one fuel available?

A: Boutique fuels generally cost more to produce because they require special production and handling, which can cause inefficiencies in the distribution system. In the event that supply or transportation is disrupted, boutique fuels create the potential for significant price volatility because supplies cannot be readily shifted between areas.

Refiners now produce numerous, different fuels to satisfy state and federal requirements. There are several factors to consider when evaluating whether or not to reduce the number of boutique fuels such as ensuring air quality needs, the impact on supply, cost issues and distribution compatibility. After weighing those factors, we recommend reducing the number of gasoline formulations to approximately 5 in order to streamline and simplify this complex system. There is a proposal by API to consolidate fuel requirements to five standardized fuels, which Shell supports. The proposal would provide states with fuel options that ensure continued progress toward attaining air quality standards. The fuel options available to states would depend on air quality need, cost-effectiveness, the availability of other, more cost-effective emissions controls, and compatibility with the nation's gasoline manufacturing and distribution system.

*To Tillerson, Mulva, O'Reilly, Klesse, Hofmeister, Pillari:*

2.) In the last couple of months most of the oil industry has announced record-breaking profits for the last fiscal year. How much is your company investing annually in exploration, production and refining, and when will we see those investments pay off? And perhaps most important, what are you investing in alternative energy sources so we can help reduce domestic dependence on foreign oil?

A: The following table shows global capital investment by Shell for its Exploration and Production and Oil Products segments. The Refining amounts are a portion of the Oil Products total. Shell does not break out Renewables spending.

| RDS totals ($B USD) | | Capital Investment Total | EP | OP | Refining |
|---|---|---|---|---|---|
| | 2000 | 8.537 | 4.979 | 1.571 | 0.290 |
| | 2001 | 11.781 | 8.191 | 1.527 | 0.360 |
| | 2002 | 24.648 | 14.151 | 7.968 | 3.318 |
| | 2003 | 14.294 | 9.337 | 2.405 | 0.943 |
| | 2004 | 15.275 | 9.708 | 2.823 | 1.275 |
| | 2005 | 17.436 | 12.046 | 2.844 | 1.379 |
| Avg | | 15.329 | 9.735 | 3.190 | 1.261 |

OP amounts include Refining

When will investments pay off:
Shell makes strategic investments in the U.S. in order to help meet the energy demand here and to provide satisfactory returns for its investors. For competitive reasons, we do not provide details of assumptions we make relative to our investments. However, because of the size and variety of the investments, and the volatile nature of market conditions, it can sometimes take decades for the company to see a return on many of its investments.

Alternative energy sources:
Shell strongly believes in its investment in renewable energies is in the best interest of its shareholders. Investments to-date have delivered tangible results, making Shell a leader in many of these new technologies, such as biofuels, wind development and hydrogen fueling. Shell remains committed to increasing the world's supply of energy, by broadening its portfolio through the development of renewable energy sources. Shell has invested about $1 billion over the last five years in the solar, wind, and hydrogen businesses and is dedicated to continuing this commitment in the future to develop at least one of these as a commercial business. As with other businesses, the level of investment in the future will depend on our business development progress, the projects' profitability, and affordability.

**Question's Posed by Senator Feingold**

*To All of Panel II:*

1.) The President mentioned in his state of the union address that America is "addicted to oil", and outlined several steps - including increasing investments in alternative fuels - to end the addiction. What percentage of your R&D is dedicated to alternatives? In your response, please indicate how your company defines alternatives. In addition to

your R&D, what are your companies doing, as corporate citizens, to move away from fossil fuels?

A: As an energy provider for over 100 years, Shell is committed to increasing the world's supply of energy by broadening its portfolio through the development of renewable and alternative energy sources (biofuels, solar, wind, and hydrogen). In the last five years Shell has invested about $1 billion into these energies, and Shell is dedicated to continuing this commitment in the future to develop at least one of these as a major commercial business.

As a corporate citizen, Shell has made the commitment to develop renewable energies through sustainable investment in technology research and development and increase public awareness of the coming issues. Through its behavior as a responsible corporate citizen, Shell provides access to modern energy technologies, shifts towards low-carbon energy systems and meets growing demand while reducing environmental and social impacts.

**Question's Posed by Senator Kohl**

*To John Hofmeister:*

1.) An independent study by the consumers group Public Citizen found that from 1999 to 2004 U.S. oil refiners increased their profits they made on each gallon of gas refined by 79%. Don't these statistics show that it is not merely the rising worldwide cost of crude oil that accounts for high prices and other petroleum products? And does the success of your industry in passing along rising crude oil prices to consumers demonstrate that your companies have gained market power and that there is a failure of competition in this market?

A: Oil and gas industry earnings per dollar of sales are in line with all U.S. industry. During the second quarter of 2005, for example, the energy industry overall earned 7.6 cents for every dollar of sales, compared to an average of 7.9 cents for all U.S. industry. The total dollar numbers may be large, but so are the billions of dollars that petroleum companies have invested to supply energy to U.S. consumers – and will need to re-invest – to meet future demand in a safe and environmentally sustainable way.

Despite the apparent size of the major investor-owned energy companies, this remains a highly competitive industry. Consider the structure of our retail gasoline business where the Shell brand has a 12 percent market share nationwide. Roughly 90 percent of Shell branded stations are owned by independent retailers and "jobbers." We are seeing healthy new retail competition emerging with brands such as WaWa, Sheetz, and Turkey Hill.

2.) In most competitive industries, when there are high prices, high profits to be made, and soaring consumer demand, we would expect to see an expansion of capacity to meet this demand. Yet in the

oil industry this has not happened. Instead of opening new refineries, the industry has closed more than half of all that existed 25 years ago. In 1981, there were 324 refineries operating in the United States – today there are 149. According the Department of Energy, in the period from 1981 to 2004 overall national refining capacity has declined by more than 9% while demand for gasoline rose by 37%. Oil industry critics suggest that this decline in refining capacity is no accident – that oil companies actually prefer to keep supplies tight in order to be able to gain market power to raise price. Indeed, many economists believe this is a central reason why gas prices are so high.

So why hasn't your industry opened new refineries while closing so many existing ones? Does the failure of the oil industry to open new refineries suggest an effort to keep supplies tight?

A: According to information compiled by API, the number of U.S. refineries peaked in 1981, when there were 315 operating refineries. We believe that some owed their existence largely to government subsidies to small refiners that ended in 1981 and that many closed because they were small and inefficient. As the industry faced increasing requirements for cleaner fuels and improved environmental performance, the number of refineries continued to shrink-from 194 in 1990 to 144 at the end of 2004. However, growth in capacity at existing refineries has largely offset the effect of refinery closures-particularly in the later part of the last decade, with the result that total refinery capacity in the US has grown from 15.5 to 17 million barrels per day since 1990.

Shell has invested in new refining capacity in order to help satisfy demand.
From 1994 to 2004 Shell refineries in the US increased overall capacity by about 30 percent and invested significant capital expenditures to do so. Shell will continue to consider optimizing its refining assets in all markets to take advantage of existing site infrastructure for expansion and debottlenecking. Motiva recently announced that several options are being considered to increase production of gasoline, diesel and aviation fuels at its Gulf Coast refining network. Capacity expansion projects being considered range from 100,000 barrels per day to 325,000 barrels per day.

3.) In the last 15 years there has been a tremendous amount of consolidation in the oil industry – the GAO counts 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 has concluded that these mergers have raised gasoline prices.

(a) What is your view of the effects of these mergers on competition in your industry and the price of petroleum products?

A: From the perspective of Shell's transactions experience, in markets of concern to both federal and state antitrust law enforcement agencies, mandatory divestitures were designed to prevent declines in the number of competitors or increases in concentration. We fully complied with such divestitures.

Prices are set on a competitive global market. The biggest component of the retail price of gasoline -- about 60 cents out of every dollar – is the price of crude oil. Crude oil prices are set on competitive global markets where the large number of participants ensures the deepest and most liquid commodity market in the world.

(b) Are we likely to see even more consolidation in the years ahead? If so, what will this mean for competition in this industry?

A: We cannot predict the future of consolidation in our industry.

**Question's Posed by Senator Charles E. Schumer**

*To All Panel II Witnesses:*

1.) Would you please clarify which income figures your company reported to the internal revenue service last year for tax purposes, as well as the basis for those figures? Are these the same income figures reported to your shareholders? If different figures were used, what were they, what was their basis, and what is the rationale for this decision?

A: With respect to its US tax returns, Shell reports its taxable income to the Internal Revenue Service by making adjustments to its book income, as required by the US tax laws.

2.) Based on your written testimony, it appears that your company has put at most 5% of annual investment toward developing alternative energy technologies like hydrogen fuel cells, wind, solar, and others. What is the rationale for this investment strategy? Have you decided that investment in these energy sources is not in the interest of your shareholders?

A: Shell strongly believes in its investment in renewable energies is in the best interest of its shareholders. Investments to-date have delivered tangible results, making Shell a leader in many of these new technologies, such as biofuels, wind development and hydrogen fueling. Shell remains committed to increasing the world's supply of energy, by broadening its portfolio through the development of renewable energy sources. Shell has invested about $1 billion over the last five years in the solar, wind, and hydrogen businesses and is dedicated to continuing this commitment in the future to develop at least one of these as a commercial business. As with other businesses, the level of investment in the future will depend on our business development progress, the projects' profitability, and affordability.

3.) How much royalty relief have you received from the Department of Interior for exploration on public lands? Which public lands specifically? At what price threshold have you predicted internally that you would not need royalty relief to make exploration viable?

A: Shell would have received about $29 MM under DWRR from 2000 through 2005. However, because prices thresholds were exceeded at certain times, Shell paid $12.6 million in royalty due the government on certain leases during that period.

In total, from 2000 through 2005, Shell received $16.46 MM in royalty relief. Breakdown by year is:

| | |
|---|---|
| 2000 | $.150 MM |
| 2001 | $.119 MM |
| 2002 | $2.11 MM |
| 2003 | $4.68 MM |
| 2004 | $2.97 MM |
| 2005 | $6.40 MM |

The purpose of royalty relief is to provide incentives to explore for oil and gas in low priced and technologically challenging environments. Under the current commodity price environment, Shell does not need deepwater royalty relief. However, if prices fell back significantly the economics of deepwater projects would change and we might need deepwater royalty relief again.

Shell supports the price thresholds that have been set by the government. Shell does not set internal thresholds for the need for royalty relief. Royalty relief is regarded as an incentive that is weighed with all of the economics and risks of a project in making a decision on whether or not to develop.

VALERO ENERGY CORPORATION

**William R. Klesse**
Chief Executive Officer
and Vice Chairman

May 8, 2006

The Honorable Arlen Specter
Chairman
Committee on the Judiciary
United States Senate
224 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Specter:

On behalf of Valero Energy Corporation (Valero), thank you for giving me the opportunity to respond to the questions you have submitted on behalf of yourself, Senator DeWine, Senator Feingold, Senator Kohl and Senator Schumer. I also appreciated the opportunity to present Valero's views at your March 14, 2006 hearing on consolidation in the oil and gas industry.

Valero looks forward to working with the Committee. If you have any questions or concerns regarding this submission, please do not hesitate to contact me.

Sincerely,

Bill Klesse

William R. Klesse
Chief Executive Officer and Vice Chairman of the Board

Enclosure

cc: The Honorable Mike DeWine, United States Senator
The Honorable Russ Feingold, United States Senator
The Honorable Herbert Kohl, United States Senator
The Honorable Charles Schumer, United States Senator

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**Senator Arlen Specter**

**1. Please provide an analysis of the draft bill, the "Petroleum Industry Antitrust Act of 2006," which was submitted to the Congressional Record earlier this month.**

Answer: Valero understands and respects the motivation that is the basis for the legislation submitted in March 2006. However, Valero has some misgivings about the structure and likely effects of the proposal. Generally, the Act is based on the flawed assumption that concentration in the oil industry is responsible for adverse effects on consumer protection. Today's refining industry is highly competitive. Data do not support the conclusion that acquisitions have increased prices. In fact, we believe companies have become more efficient and continue to compete fiercely. There are 54 refining companies in the U.S., hundreds of wholesale and marketing companies, and more than 165,000 retail outlets.

The biggest U.S. refiner accounts for only about 13 % of the nation's total refining capacity; and the large integrated companies own and operate only about 5 % of all retail outlets. The Federal Trade Commission (FTC) thoroughly evaluates every merger proposal, holds industry mergers to the highest standards of review, and subjects normal industry operations to a higher level of ongoing scrutiny.

In 2004, the FTC published an FTC Staff Study "The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement." Among the points made in that publication was the following: "...mergers have contributed to the restructuring of the petroleum industry in the past two decades but have had only a limited impact on industry concentration. The FTC has investigated all major petroleum mergers and required relief when it had reason to believe that a merger was likely to lead to competitive harm..."

The experience of the refining sector is certainly not out of line with other industries. According to data compiled by the U.S. Department of Commerce, in 2003 the four largest U.S. refining companies controlled a little more than 40% of the nation's refining capacity. In contrast, the top four companies in the auto manufacturing, brewing, tobacco, floor coverings and breakfast cereals industries controlled between 80% and 90% of the market. Further, as noted above, several mergers in the refining industry have actively maintained and even increased refining capacity. Without such consolidation, the individual refineries involved might not have been economically viable. Valero alone has increased the productive capacity of the refineries it has acquired by an aggregate of over 500,000 barrels per day over the past several years.

The first section of the proposal - dealing with the criminalization of refusals to sell, diversions or exports - may well be an illegal trade barrier under WTO. Although the volume of petroleum products exported from the United States is not large, a de facto ban on exports would be an indefensible position in a global fuels marketplace. It is axiomatic that in a well-functioning marketplace, sellers choose among potential buyers based upon price. Read most broadly, the proposal seems hostile to this essential market behavior. De facto price controls should be unacceptable. The energy price and allocation controls of the 1970s resulted in supply shortages in the form of long gas lines. Studies have shown that, although intended to reduce costs, controls actually resulted in increased costs and greater inconvenience for consumers. Ultimately, the

refining industry will expand and this action almost assures that the expansions are international to maintain flexibility.

The second section - the prohibition of mergers - is completely unworkable and could be confiscatory under the takings clause of the Constitution. It reduces the test for a violation of the Clayton Act to a question whether an acquisition "may...appreciably diminish competition." This standard is so loose that it could lead to disapproval of almost any acquisition, which would radically diminish the value of the capital assets in question without the just compensation required by the Constitution. We do not believe the proposal constitutes a workable basis for regulating transactions. The dictionary definition of "appreciable" is simply "[p]ossible to estimate, measure, or perceive." This makes the test the regulators would use almost impossible for the regulated community to meet with any certainty.

The legislation's State-Federal task force concept appears flawed on two levels. First, the Committee had laid no predicate for the argument that information is currently shared in impermissible ways. Many analyses seem to contradict that any form of collusive behavior is influencing the fuels market. Second, the task force make-up seems unwieldy. FTC and DOJ must allow any state AG that "chooses to participate" onto the Task Force. There are 56 attorneys general in the United States.

Finally, in the current political environment, waiving OPEC's sovereign immunity, applying extraterritorial jurisdiction, and waiving the act of state doctrine is likely to add further impetus to an already threatening political situation which could well end in retaliation against U.S. commercial interests and further limitations on international free trade.

**2. What steps can be taken to decrease consumption of oil and natural gas?**

Answer: Valero is not an expert on demand-side policies in the United States. Clearly policies intended to encourage conservation and to enhance energy efficiency are the types of policies designed to decrease consumption of oil and natural gas. Development of true alternative fuels are another such policy, although it is important for Congress to consider the total fuel cycle for such alternatives to make sure that they have a positive energy yield and are cost effective.

**3. Please provide an analysis of the incentives offered to petroleum companies by the federal government that explains what the incentives are intended to do, which incentives are important to you, and why they should be maintained.**

Answer: It is Valero's understanding that most so-called "incentives" offered to the oil industry deal with oil and gas exploration and production, a sector of the industry in which Valero does not participate. By contrast, Valero's most important product – gasoline for use as a motor fuel – is actually subject to a hefty federal excise tax. That said, to the extent that incentives do spur on additional production that can be made available to refiners, we are generally supportive of such policies as a means to enhance supply of our major input, crude petroleum. An investment tax credit can be equally applied and will create more jobs and supplies.

**4. In the two weeks prior to March 14, 2006, the price of oil decreased seven cents per gallon, while the price of gasoline increased by eleven cents per gallon. Why would gasoline become more expensive during this period, despite a decrease in the cost of crude oil?**

Answer: As the Committee heard, the price of crude oil is a significant factor determining the price of refined product in the marketplace. However, reductions in crude prices often do not translate directly into gasoline price reductions at the pump in the short term. One market complexity is that contracts for a particular delivery term may be predicated on prices at the time the contract was entered. Even in the spot market, continued uncertainty can keep prices relatively high even as market participants react to decreasing crude prices. Of course, over time, sustained reductions in crude input costs result in sustained price stability for consumers. It is always about supply and demand for a particular commodity – crude oil or refined products.

**5. With respect to the larger mergers that your companies have engaged in over the past decade, what efficiencies have they produced that have benefited the consumer, particularly in downstream markets?**

Answer: As we have testified, Valero is a "pure play" refiner so we are in a good position to discuss the consumer benefits that have flowed from our acquisition of refinery assets. Specifically, Valero has increased the capacity of its 18 refineries by almost 20 percent since acquiring them, adding 533,000 barrels per day of refining capacity. That's the equivalent of building three world-scale grassroots refineries. We have also added and expanded existing units that allow us to process a wider variety of crudes. It's fair to say that if Valero had not acquired these refineries, much of this capacity expansion would not have occurred, and some facilities might have closed.

Improving refineries takes expertise and capital and Valero has more in-house expertise and greater access to capital than many of the companies from which we have purchased refineries. In the past this has made expansion easier while meeting costly regulatory requirements. Valero has invested approximately $8.2 billion to improve its refineries. Since 1997, we have spent $2.4 billion on regulatory and environmental compliance. To comply with probable regulatory and fuel specifications, we will need to spend another $3.5 billion over the next several years. And new regulations continue to be drafted and adopted.

Valero has learned that a responsible policy of strategic acquisitions can allow for a refiner to optimize the performance of the acquired facilities to allow for performance that the previous owner did not achieve. Growth proceeds through acquisition of refineries well below their replacement cost in the marketplace. Then, Valero typically optimizes, upgrades and expands the acquired refineries, to the benefit of shareholder and consumer alike.

**Senator DeWine**

**1. At our last hearing, we heard testimony that some of the gasoline price spikes can be attributed to regulations that create multiple grades of gasoline to comply with different environmental standards — so called "boutique fuels." What can we do to reduce the number of boutique fuels? What would be the effect of just requiring everyone in the industry to comply with the highest standard, and have just one fuel available?**

Answer: Valero well understands the complexities that can face production and distribution of gasoline when fuel regulations result in balkanization of the market. The more fungible the gasoline, the easier it is to bring gasoline to market. That said, some states and localities based their requests for special gasoline blends on a desire to achieve clean-air benefits while minimizing the costs associated with other clean-fuel formulations. Therefore, it is not always the case that a so-called "boutique" fuel is more costly to the consumer than the fuel environmental controls would otherwise dictate.

If the Congress were to limit fuel choice to the "highest" standard, the result would eliminate barriers to fungibility but at a very high cost to consumers. Such a move would heighten demand for certain blendstocks, while excluding other relatively clean blendstocks from the marketplace. The net result would be to shrink the national fuel pool to the detriment of consumers.

**2. In the last couple of months most of the oil industry has announced record-breaking profits for the last fiscal year. How much is your company investing annually in exploration, production and refining, and when will we see those investments pay off? And perhaps most important, what are you investing in alternative energy sources so we can help reduce domestic dependence on foreign oil?**

Answer: As we have testified, Valero is a "pure play" refiner and does not engage in oil and gas exploration and development and while marketing of gasoline is important to Valero, it only represents about 10 percent of the Corporation's assets. Therefore, Valero is in a good position to discuss the consumer benefits that have flowed from its acquisition of refinery assets.

Improving refineries takes expertise and capital and Valero has more in-house expertise with greater access to capital than many of the companies from which we have purchased refineries. In the past this has made expansion easier while meeting costly regulatory requirements. Valero has invested approximately $8.2 billion to improve its refineries. Since 1997, we have spent $2.4 billion on regulatory and environmental compliance. To comply with probable regulatory and fuel specifications, we will need to spend another $3.5 billion over the next several years. And new regulations continue to be drafted and adopted.

Valero has learned that a responsible policy of strategic acquisitions can allow for a refiner to optimize the performance of the acquired facilities to allow for performance that the previous owner did not achieve. Growth proceeds through acquisition of refineries well below their replacement cost in the marketplace. Then, Valero typically optimizes, upgrades and expands the acquired refineries, to the benefit of shareholder and consumer alike.

As for investments in alternative energy, Valero is coming to grips with the implementation of the Energy Policy Act of 2005. As you know, that Act contains a significant renewable fuels mandate with which Valero will comply to the full extent of the law. Valero has long been an innovator in the production of new fuels. Valero is recognized throughout the industry as a leader in the production of premium, clean-burning fuels such as reformulated gasoline, CARB Phase II gasoline, low-sulfur diesel and oxygenates.

**Senator Feingold**

**1. On February 1, 2006, while this Committee was conducting its first hearing related to consolidation in the oil and gas industry, reports came out that Valero Energy Corporation had restricted output from a refinery in Ohio by more that 10 percent because of lower profit margins. In late January, BP cut production between 10-15 percent at an Indiana refinery. These actions appear to indicate that reductions in the number of refineries have nothing to do with high prices, as some have indicated. In the face of record profits, why did your companies reduce refinery output?**

Answer: Valero strongly disagrees with the premise of the question that we cut production because of low profit margins. First, we made every effort to keep our conversion units full so that our gasoline production at the Lima, Ohio, refinery would be maintained at approximately the same level. Since we kept our conversion units full, it was obviously not a decision to reduce gasoline production because our gasoline yield is about the same. Valero did not cut gasoline production but in fact inventories in that area of the country are at 5-year highs.

The product reduction was for high-sulfur diesel (off road diesel) which there is little market for at the time of year in question. Such fuel is primarily sold for use in agricultural equipment and obviously there is not much agricultural work in the winter in areas typically served by the Lima refinery. As in years past crude runs were cut because there was no additional demand for diesel in the months where agricultural demand is reduced.

**2. The President mentioned in his state of the union address that America is "addicted to oil", and outlined several steps – including increasing investments in alternative fuels – to end the addiction. What percentage of your R&D is dedicated to alternatives? In your response, please indicate how your company defines alternatives. In addition to your R&D, what are your companies doing, as corporate citizens, to move away from fossil fuels?**

Answer: As we have testified, Valero is a "pure play" refiner and does not engage in oil and gas exploration, nor does Valero have a research and development division looking into alternative fuels. Given that Valero is not an integrated oil company, it has focused its investment strategy largely in the refining sector. Improving refineries takes expertise and capital and Valero has more in-house expertise and greater access to capital than many of the companies from which we have purchased refineries. In the past this has made expansion easier while meeting costly regulatory requirements. Valero has invested approximately $8.2 billion to improve its refineries. Since 1997, we have spent $2.4 billion on regulatory and environmental compliance. To comply with probable regulatory and fuel specifications, we will need to spend another $3.5 billion over the next several years.

Valero works diligently to ensure a reliable supply of an essential commodity for our nation and we do so while maintaining the highest standard of safety for our employees and a commitment to the environment and the community. We take great pride in our corporate citizenship. In 2005, our employees gave over $12 million to the United Way and volunteered in their communities more than 220,000 hours. However, we do not believe that moving away from our core business of refining falls under the realm of corporate citizenship.

**Senator Kohl**

**1. Valero's profits from last year exceeded $3.6 billion. And we all know how sharply gas prices rose last year, exceeding $3 dollars per gallons in many places last summer. You and your colleagues in the oil industry have placed most of the blame on the worldwide price of crude oil, arguing that you must pay higher and higher prices from the world market to obtain the crude oil you refine into gasoline, heating oil and other petroleum products. But somehow as the price you paid for this raw material rose, your profits also rose. This seems odd to me – in most competitive industries profits fall, not rise, as the price of their raw materials rise. For example, the airline industry has seen the cost of the jet fuel it must use rise sharply. This has not resulted in profits for the airline industry, but instead huge losses and bankruptcy for many airlines.**

**So how can it be that your profits have reached record levels as the worldwide price of crude has risen? How can the industry's profits rise as the price for the raw material it uses to make its products increases?**

Answer: Respectfully, Valero does not believe the comparison drawn in the question leads to an accurate inference. The refining industry and the airline industry are simply too dissimilar as economic sectors for valid comparisons to be made; the former is a commodity industry with largely inelastic demand; the latter is neither one, and many airlines have an outdated and inefficient business model that can not compete with new entrants. In the refining industry, price increases are typically precipitated by relative scarcity or uncertainty in the crude markets. Under laws of supply and demand, this scarcity is then reflected in available stocks of finished products. While the cost of the crude inputs increase, such costs are reflected in the price of the finished product. However, the relative scarcity conditions also improve refining margins, as they would in any other commodity industry as finished refined products have their own supply/demand balance, and crude oil is a derived supply/demand balance because crude oil must be refined.

Refining margins may be healthy now. However, in the ten-year period 1993-2002, average return on investment in the refining industry was only about 5.5%. This is less than half of the S&P industrials average return of 12.7% for the same period. Refining industry profits as a percentage of operating capital are not excessive. In dollars, they seem large due to the massive scale needed to compete in a large, capital-intensive industry. For example, a new medium scale refinery (100,000 to 200,000 b/d) would cost $2 to $4 billion. In short, company revenues can be in the billions, but so, too are the costs of operations.

When refining margins improve, more capital is available for investment in the sector, including capacity expansion and regulatory compliance. The Federal Trade Commission found in June 2005 that, "Profits play necessary and important roles in a well functioning market economy. Recent oil company profits are high but have varied widely over time, over industry segments and among firms...Profits also compensate firms for taking risks, such as the risks in the oil industry that war or terrorism may destroy crude production assets or, that new environmental requirements may require substantial new refinery capital investments."

**2. An independent study by the consumers group Public Citizen found that from 1999 to 2004 U.S. oil refiners increased their profits they made on each gallon of gas refined by 79%. Don't these statistics show that it is not merely the rising worldwide cost of crude oil that accounts for high prices and other petroleum products? And does the success of your industry in passing along rising crude oil prices to consumer demonstrate that your companies have gained market power and that there is a failure of competition in this market?**

Answer: The Valero experience has shown that acquisitions allow us to bring more capacity to market, thus benefiting consumers. Valero has increased the capacity of its 18 refineries by almost 20 percent since acquiring them, adding 533,000 barrels per day of refining capacity. That's the equivalent of building three world-scale grassroots refineries. We have also added and expanded existing units that allow us to process a wider variety of crudes. It's fair to say that if Valero had not acquired these refineries, much of this capacity expansion would not have occurred, and some facilities might have closed.

Improving refineries takes expertise and capital and Valero has more in-house expertise and greater access to capital than many of the companies from which we have purchased refineries. In the past this has made expansion easier while meeting costly regulatory requirements. Valero has invested approximately $8.2 billion to improve its refineries. Since 1997, we have spent $2.4 billion on regulatory and environmental compliance. To comply with probable regulatory and fuel specifications, we will need to spend another $3.5 billion over the next several years.

**3. In the last 15 years there has been a tremendous amount of consolidation in the oil industry – the GAO counts 2600 mergers and acquisitions in this industry since the 1990s alone. Indeed, almost all of 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 has concluded that these mergers have raised gasoline prices.**

**(a) What is your view of the effects of these mergers on competition in your industry and the price of petroleum products?**

Answer: See answer to Question No. 2 above for a discussion of Valero's experience with acquisitions resulting in tangible increases in refining capacity, to the great benefit of consumers. Beyond that experience, Valero respectfully disagrees with the premise of the question. As a general rule, today's refining industry appears to us as highly competitive. Data do not support the conclusion that acquisitions have increased prices. In fact, we believe companies have become more efficient and continue to compete fiercely. There are 54 refining companies in the U.S., hundreds of wholesale and marketing companies, and more than 165,000 retail outlets.

The biggest refiner accounts for only about 13 % of the nation's total refining capacity; and the large integrated companies own and operate only about 5 % of all retail outlets. The Federal Trade Commission (FTC) thoroughly evaluates every merger proposal, holds industry mergers to the

highest standards of review, and subjects normal industry operations to a higher level of ongoing scrutiny. In 2004 the FTC published a staff study entitled, "The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement." Among the points made in that publication was the following: "...mergers have contributed to the restructuring of the petroleum industry in the past two decades but have had only a limited impact on industry concentration. The FTC has investigated all major petroleum mergers and required relief when it had reason to believe that a merger was likely to lead to competitive harm..."

**(b) Are we likely to see even more consolidation in the years ahead? If so, what will this mean for competition in this industry?**

Answer: As we stated at the hearing, Valero is a growth company that will continue to evaluate acquisition opportunities for consistency with the Valero business model. As noted in our answer to Question No. 2 above, it has been Valero's consistent experience that it has increased the capacity of each of the refineries it has acquired, to the benefit of consumers, workers, and shareholders.

**Senator Charles Schumer**

**1. Would you please clarify which income figures your company reported to the internal revenue services last year for tax purposes, as well as the basis for those figures? Are these the same income figures reported to your shareholders? If different figures were used, what were they, what was their basis, and what is the rationale for this decision?**

Answer: The US income figures reported to our shareholders serve as the starting point for the determination of the taxable income figures that Valero reported to the Internal Revenue Service last year for tax purposes. In addition, the Company reported to the Internal Revenue Service the book/tax differences in reported income and expense amounts that it is currently entitled to pursuant to the US Internal Revenue Code. All such amounts are subject to an annual audit by the Internal Revenue Service.

**2. Based on your written testimony, it appears that your company has put at most 5% of annual investment toward developing alternative energy technologies like hydrogen fuel cells, wind, solar, and others. What is the rationale for this investment strategy? Have you decided that investment in these energy sources is not in the interest of your shareholders?**

Answer: As we have testified, Valero is a "pure play" refiner and does not engage in oil and gas exploration and development. While marketing of gasoline is important to Valero, it only represents about 10 percent of the Corporation's assets. Therefore, Valero is in a good position to discuss the consumer benefits that have flowed from its acquisition of refinery assets.

Given that Valero is not an integrated oil company, it has focused its investment strategy largely in the refining sector. Improving refineries takes expertise and capital and Valero has more in-house expertise and greater access to capital than many of the companies from which we have purchased refineries. In the past this has made expansion easier while meeting costly regulatory requirements. Valero has invested approximately $8.2 billion to improve its refineries. These investments have yielded tangible results for consumers, shareholders and workers alike: Valero has increased the capacity of its 18 refineries by almost 20 percent since acquiring them, adding 533,000 barrels per day of refining capacity. That's the equivalent of building three world-scale grassroots refineries.

Since 1997, we have spent $2.4 billion on regulatory and environmental compliance. To comply with probable regulatory and fuel specifications, we will need to spend another $3.5 billion over the next several years. And new regulations continue to be drafted and adopted.

Valero has learned that a responsible policy of strategic acquisitions can allow for a refiner to optimize the performance of the acquired facilities to allow for performance that the previous owner did not achieve. Growth proceeds through acquisition of refineries well below their replacement cost in the marketplace. Then, Valero typically optimizes, upgrades and expands the acquired refineries, to the benefit of shareholder and consumer alike.

As for investments in alternative energy, Valero is coming to grips with the implementation of the Energy Policy Act of 2005. As you know, that Act contains a significant renewable fuels mandate

with which Valero will comply to the full extent of the law. Valero has long been an innovator in the production of new fuels. Valero is recognized throughout the industry as a leader in the production of premium, clean-burning fuels such as reformulated gasoline, CARB Phase II gasoline, low-sulfur diesel and oxygenates.

**3. How much royalty relief have you received from the Department of Interior for exploration on pubic lands? Which public lands specifically? At what price threshold have you predicted internally that you would not need royalty relief to make exploration viable?**

Answer: Valero does not engage in oil and gas exploration and development. Therefore, we have received no royalty relief.

**STATE OF WISCONSIN**
**DEPARTMENT OF JUSTICE**

PEGGY A. LAUTENSCHLAGER
ATTORNEY GENERAL

Daniel P. Bach
Deputy Attorney General

114 East, State Capitol
P.O. Box 7857
Madison, WI 53707-7857

April 6, 2006

Senator Arlen Specter, Chairman
Senate Judiciary Committee
Attn: Barr Huefner
225 Dirksen Senate Office Building
Washington, DC 20510

**Re: March 14, 2006 Committee Hearing: "Consolidation in the Energy Industry: Raising Prices at the Pump? Part II"**
**Wisconsin Attorney General Peggy A. Lautenschlager's Responses to Supplement Questions**

Dear Senator Specter:

Enclosed, please find Wisconsin Attorney General Peggy A. Lautenschlager's written responses to the supplemental questions you forwarded to her from you and from Senators Leahy, Kohl, DeWine and Schumer with respect to the above-referenced hearing. Please place this in the record of the hearing, along with her previous written submission.

Thank you for your attention to this matter. Please contact me if you have further questions or desire additional information.

Very truly yours,

Christopher J. Blythe
Wisconsin Assistant Attorney General

Enclosure

**RESPONSES OF PEGGY A. LAUTENSCHLAGER, WISCONSIN ATTORNEY GENERAL, TO SUPPLEMENTAL QUESTIONS FROM MEMBERS OF THE SENATE JUDICIARY COMMITTEE**

**Re: March 14, 2006 Committee Hearing: "Consolidation in the Energy Industry: Raising Prices at the Pump? Part II"**

**Supplemental Question Posed by Chairman Specter**

Question for Attorney General Peggy Lautenschlager:

1. You testified that natural gas prices can not be entirely explained by supply and demand and spike during periods of heavy trading activity. Please discuss the link between trading and price volatility.

   Response by Attorney General Lautenschlager:

   Our report found a very strong correlation between increased trading activity of natural gas and increased upward price volatility of natural gas. As illustrated by chart ES-7 attached to my written testimony, trading activity and natural gas prices were relatively stable during the first 10 years of deregulation, beginning in the early 1990s. Volatility increased dramatically, however, beginning around the year 2000 and continuing to the present. This volatility corresponds directly to the emergence of high-volume trading of natural gas, first by Enron and later by the brokerage houses and hedge funds. In addition, the volatility is characterized by a "ratchet" effect. In other words, the price goes up and down dramatically, but both the peaks and the valleys seems to constantly rise, so that the price of natural gas is not only more volatile, its average price is constantly rising.

**Supplemental Question Posed by Senator Leahy**

Question for Attorney General Peggy Lautenschlager:

1. Do you think there needs to be more transparency on the commodity exchanges, particularly natural gas transactions? If so, what steps can Congress take to increase transparency in the natural gas market? Should Congress require traders to register?

   Response by Attorney General Lautenschlager:

   I definitely believe that we need more transparency in the natural gas markets, and virtually every company we spoke with in the course of our study, including utilities and producers, agreed that greater transparency would benefit everyone,

including consumers. Our study recommends the following steps that can be taken at the federal level:

- Increased oversight of the over-the-counter markets for natural gas, including requirements for registration of traders and reporting of all trades;

- Stricter limits on positions held by any one entity and expanded settlement periods for short- and long-term contracts, and restrictions on how much the price of natural gas can move on the markets before trading is temporarily halted for a "cooling off" period; and,

- Formation of a joint federal-state task force to examine critical questions about the supply-side of the physical market and the role of major oil companies, which straddle the physical and financial markets.

I believe that these measures are reasonable steps that the federal government can take that would increase the transparency of natural gas markets. Senator Feinstein has proposed an amendment to S. 1566 that would move us in the direction of the measures noted above.

**Supplemental Questions Posed by Senator Kohl**

Questions for Attorney General Peggy Lautenschlager:

1. Your office and three other Midwest Attorneys General recently released a report on the causes of higher natural gas prices. Your report found that commodity market speculation, rather than supply and demand, was responsible for much of the sharp increases in natural gas prices we have seen. What is it about the natural gas marketplace that makes it so vulnerable to price swings caused by commodity trading? And what specific legislative reforms would you recommend?

   Response by Attorney General Lautenschlager:

   Natural gas markets are particularly vulnerable to price swings for several reasons. First, demand for natural gas is relatively inelastic. When the weather is cold, consumers need to heat their homes and businesses, and most will not choose to simply turn their furnaces off if the price of natural gas goes up. Second, natural gas is not an easily substituted fuel. Most users of natural gas cannot easily substitute another fuel source, such as coal, fuel oil or propane; their equipment is generally designed to just burn natural gas. Third, because natural gas demand is relatively inelastic, upward pressure on the price of natural gas caused by increased trading can have an exponential, rather than an incremental,

effect. The legislative reforms I would recommend are noted above in my response to Senator Leahy's question.

2. I have introduced a bill to direct the Secretary of Energy to establish and operate a strategic refining reserve. This reserve should have the capacity to produce at least 5 percent of the domestic demand for gasoline, diesel and aviation fuel. I believe this reserve would be an important step to ending the oil companies' stranglehold over the market, and their ability to manipulate supply in order to have market power. What do you think of this idea?

   Response by Attorney General Lautenschlager:

   As you are aware, our study focused primarily on natural gas, but I do think that your proposal makes a great deal of sense in that it would help temper the effects of future crises, such as last fall's hurricanes. I also think it would help provide a buffer, as you suggest, against any attempts by major oil companies to manipulate the market by withholding supply.

3. I have introduced legislation to give the Secretary of Energy the authority to prohibit the export of any refined petroleum product when supply is expected to fall below demand. In my view, in times of high demand and severe pressures on supply – such as we saw in the aftermath of the Hurricane Katrina and Rita disasters last fall – it is simply unacceptable that U.S. oil refiners should ship their products out of the country. What do you think of this legislation?

   Response by Attorney General Lautenschlager:

   I think such legislation makes a great deal of sense, not only from a standpoint of protecting our economy, but for reasons of national security, as well.

**Supplemental Questions Posed by Senator DeWine**

Questions for Attorney Alioto, Attorney General Lautenschlager, Professor Borenstein, Attorney Boies and Assistant Attorney General Green:

1. We heard from the oil companies that the recent mergers have been important to give them the scale they need to engage in increasingly expensive and risky development projects. In fact, United States oil companies have consolidated and grown at roughly the same rate as other global players around the world. In most cases, the FTC allowed oil company mergers only after imposing a number of limitations on these mergers to prevent them from decreasing competition. First, what more should the FTC do to prevent oil industry mergers from lessening competition? Second, how should U.S. energy policy work to prevent consolidation that leads to higher prices while still addressing the risk that an

aggressive merger policy could keep U.S. companies relatively small in a way that puts them at a competitive disadvantage to other global players?

Response by Attorney General Lautenschlager:

While our study did not look at oil company mergers *per se*, I am not convinced that bigger is always better and more efficient in the oil industry any more than it is in government, for example. As regards the effect of mergers on competition, I think there is already ample evidence that the oil industry no longer produces competitive markets, as far as consumers are concerned. With respect to the ability of U.S. companies to remain competitive, judging by the record profits of U.S. oil companies over the past year, they would have a hard time convincing me that they are suffering from an inability to be competitive.

2. If there was one change you could make to the antitrust laws to make oil and gasoline markets more competitive, what would that be?

Response by Attorney General Lautenschlager:

The oil and gasoline markets have a number of characteristics that make them particularly vulnerable to collusive behavior. These characteristics include, but are certainly not limited to, an unconcentrated group of buyers with relatively inelastic demand for a product where prices can quickly change, and a relatively high concentration of suppliers with similar production processes and high barriers to entry. In this sort of market, enforcement of the antitrust laws is particularly difficult, because firms do not necessarily need to enter into a formal "agreement" in order to profit from tacit collusive behavior.

The recent experience with gasoline and natural gas markets following last fall's hurricanes provides an example. Markets in the western part of the U.S. saw the price of gasoline and natural gas rise dramatically, even though virtually none of their supplies of these two commodities comes from the Gulf production area that was affected by the hurricanes. If we had truly competitive markets, this would not have happened. With regard to specific changes to the antitrust laws that would address this issue, I would support the recommendations that California Assistant Attorney General Thomas Greene made in his testimony before the Committee on March 14, 2006.

**Supplemental Questions Posed by Senator Charles E. Schumer**

Questions for Attorney Alioto, Attorney General Lautenschlager, Professor Borenstein, Attorney Boies and Assistant Attorney General Green:

1. We often hear the justification for consolidation that resources abroad are more expensive to develop, but why does that mean we have to consolidate downstream

at refining and retail levels? In 2004 the GAO found that market concentration in the downstream sector had increased significantly, and that oil company merger activity had in fact had an upward effect on gasoline retail prices. Wouldn't the market benefit from more independent activity in the downstream sector? Wouldn't competition and the consumer be better served by a higher degree of competition at each segment of the supply chain?

Response by Attorney General Lautenschlager:

The increasing trend towards vertical integration of ownership in energy markets is certainly of great concern. Common ownership of each level in the production and distribution chain creates fewer points at which competition can work to keep prices low for the eventual end user. In addition, vertical integration can also reduce efficiency incentives. Consumers would certainly be well-served by a more competitive structure from top to bottom in the energy industry.

2. In a market this tight on supply and this concentrated, where is the disincentive for oil companies to "take their foot off of the pedal" by only barely keeping place with market trends? Is it realistic with so much vertical integration, to assume that if a company does not act swiftly to a price signal another company will competitively respond?

Response by Attorney General Lautenschlager:

Our recent experience tells us the current structure of the energy markets does not create downward pressure on prices. Oil companies know, for example, that they can sell plenty of gasoline, even when the price remains artificially high. Therefore, there is no incentive for them to lower prices, even in instances in which there otherwise might be competition.

3. We've seen a lot of the so called "rockets and feathers" phenomenon where prices spike, supposedly because retailers have to instantly react to the wholesale price, but then when the wholesale drops retail lags at the high price. What do you believe is the explanation for this phenomena and what role has consolidation played in creating it?

Response by Attorney General Lautenschlager:

I believe that consolidation plays a major role in perpetuating the "rocket and feather" syndrome. Mega-mergers and the vertical integration of the energy industry have lessened competition and created disincentives for efficiencies and competitive strategies. Inelasticity of demand for energy products makes market manipulation and anticompetitive behavior easier to accomplish. If the trend towards consolidation in energy industries continues, it will only make matters worse.

**J.J. Mulva**
Chairman and Chief Executive Officer

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April 6, 2006

The Honorable Arlen Specter, Chairman
Senate Committee on the Judiciary
224 Dirksen Senate Office building
Washington, D.C. 20510

Dear Chairman Specter:

Per your letter of March 21, please find responses from ConocoPhillips to the follow-up questions submitted by Members of the Committee relating to the March 14 hearing.

ConocoPhillips is most pleased to share our thoughts with the Committee on energy prices, consolidations and other related issues. Please let me know if additional questions arise or if the Company can be of further assistance to the Judiciary Committee.

Sincerely,

J. J. Mulva

Enc.

**Questions posed by Senator Specter**

James Mulva:

1.) **Please provide an analysis of the draft bill, the "Petroleum Industry Antitrust Act of 2006," which was submitted to the Congressional Record earlier this month.**

Analysis of the "Petroleum Industry Anti-trust Act of 2006",
(109th Congress, 2D Session, Draft of March 9, 2006)

**Section 2- Prohibition on Unilateral Withholding**

Overall, there are several aspects of the bill that are likely to inhibit free international trade of energy supplies. Section 2 of the bill will inhibit exports by creating an additional burden of establishing specific intent for the routine and normal movement of energy supplies. This Section will be particularly troublesome to countries in Latin America that depend on the U.S. for refined product supplies, and provide the U.S. with about 22 percent of its total crude supplies as well as significant refined product supplies. Inhibiting exports could also produce the perverse result that refiners would become more cautious about importing crude oil and holding crude oil inventories due to concerns over being unable to move one or more of the many refined products produced due to area-specific price dislocations, however temporary. Ultimately, these export restraints could also result in refineries having to shut-in production capacity when they don't have the logistics to market a particular product domestically, or when product does not meet U.S. specifications and they run into containment issues for that particular product.

The United States is a net importer of clean products. For example, in 2005, the United States exported 1.1 million barrels per day of finished petroleum products and blending components (excluding LPGs), but imported nearly three times that amount or 3.1 million barrels per day of finished petroleum products and blending components. Thus, the U.S. is a net importer by 2.0 million barrels per day. The North American market is also highly interconnected. There is a significant volume of cross-border energy trade between the United States, Mexico and Canada. In 2005, 624 thousand barrels per day or 18 percent of U.S. product imports came from Canada and Mexico. Also in 2005, the U.S. exported 418 thousand barrels per day of products to Canada and Mexico, which was 37 percent of total U.S. product exports. Canadian and Latin American sources also comprise half of U.S. crude imports, which highlights the importance of continued trade.

Imports and exports play a very important role in balancing U.S. and global oil supply and demand. If there is a disruption in one place, prices rise and attract imports from other places. Similarly, exports allow companies to transport and market product when logistically or economically it can't be moved to another domestic location, or if the product doesn't meet domestic specifications. In 2005, over 98 percent of the clean

products produced by ConocoPhillips refineries stayed in the United States. Logistical reasons for exports include an inability to find Jones Act tankers and pipeline bottlenecks, which force the product to be put on the water for export. In some cases, exports are key to relieve containment issues and maintain refinery production rates.

It will be difficult to establish "primary intention" because it is common industry practice to charter ships with a destination indicating "Any Safe U.S. or European port", "Any Safe European or Mediterranean port" or "Any Safe European or Asian port", etc. Ships are loaded at origin without a final decision being made as to the destination of the cargo with the exception of Jones Act constraints. As the ship embarks, the only decision made is the general direction the cargo will travel, with the final destination designated only when a purchaser commits to the cargo or when the greatest netback for that cargo has been identified. As a result, the final destination is often one of many destinations, which may or may not have been previously designated for the cargo. Further, in some market conditions, pricing of the cargo may be based on an index or other marker, in which ease the price is not known at the time the destination market is determined and the operative price in the bill is tested after the decision to sell is made.

ConocoPhillips' policy is to sell its refined products to realize the best netback in the marketplace. It is unclear under Section 2 of the bill what is required to establish the "primary intention" of a party exporting products to realize the best netback in the marketplace. Exports may be contracted in advance of loading, the product sold is often subject to logistical constraints, or the product is not marketable in the relevant regional market. Therefore, comparing the profitability of hypothetical alternative transactions is not possible. This is a significant problem with Section 2 of the bill, which provides that in determining whether a person has committed a violation, the court shall consider whether "the price obtained from exporting or diverting existing supplies is greater than the price obtained where the existing supplies are located or are intended to be shipped." The provision is simply not workable, and results in a comparison of the profitability of a hypothetical transaction that could not have been known at the time of the export sale.

**Section 3 – Prohibition on Certain Mergers in the Oil and Gas Industry**

The effect of this provision is to establish a standard of review for mergers and acquisitions in the oil and gas industry that is significantly different and more stringent than the review standard used for transactions in any other industry. The reason for this provision is unclear. Although a recent study by the Government Accountability Office concluded that mergers and acquisitions in the oil and gas industry may have resulted in a slight increase in the price of gasoline in some markets, the study was criticized by academics and by the Federal Trade Commission (FTC), the independent regulatory agency primarily responsible for reviewing mergers in the oil and gas industry.

Under the current standard of review set forth in Section 7 of the Clayton Act, the federal agencies with oversight responsibility (FTC or Department of Justice) examine the

proposed merger to determine whether the effect of the merger "may be substantially to lessen competition" in the relevant market. Transactions raise a concern when they have the likelihood of significantly reducing the number of major competitors within a relevant product or geographic market. The degree of competitive concentration in a market is measured using the Herfindahl-Hirschmann Index (HHI) analysis. A recent study of mergers by the FTC indicates that mergers in the oil and gas industry are reviewed at lower levels of market concentration than are mergers in other industries. Thus, there appears to be no need to change the existing, already-more-stringent standard of review to establish an even more stringent level of review for mergers in the oil and gas industry.

The "appreciably diminish" standard set forth in the proposed legislation would force governmental entities to block most, if not all, mergers in the oil and gas industry. Any consolidation in a relevant market may appreciably (capable of being measured) diminish competition. In the oil and gas industry, where the relevant market could be regional, national or even global, the "appreciably diminish" standard could be used to block all mergers. The proposal would effectively create a protected class of competitors, not subject to the vagaries of the global market place, and it will greatly impede the free movement of capital and properties and the most cost-efficient development of our oil and gas resources.

In light of the global nature of the oil and gas business, and the extraterritorial effect of U.S. antitrust laws, the adoption of the "appreciably diminish" standard could impact mergers of non-U.S. oil and gas companies operating in the United States or making sales into, or which impact our markets. This could undermine our efforts to establish comity with the European regulators who have recently amended their own merger review language to more closely reflect the U.S. "substantially to lessen" standard.

**Section 4 – Study by the Government Accountability Office**

It is not clear why such a study by the Government Accountability Office ("GAO") would be necessary. The agencies responsible for merger review currently monitor compliance with divestiture orders for a ten (10) year period, and have the ability to investigate and remedy (through court proceedings or consent orders) any situation where there has been a substantial lessening of competition, including approved mergers and acquisitions. In fact, the FTC has successfully obtained orders unwinding consummated transactions after the Hart-Scott-Rodino review period expired (see Chicago Bridge and Iron Works Co., June 2003). State Attorneys General and certain private parties can also challenge consummated transactions. The study required appears to replicate the existing review of oil and gas mergers previously conducted by the GAO, the reliability of which has been questioned by the FTC.

The legislation will give credibility to the prior GAO study, and would, as a practical matter, cause the FTC and Department of Justice to act on the GAO's findings, regardless of their beliefs as to the reliability of the GAO's conclusions.

Oil and gas markets change as competitors enter and leave, and as market shares increase and decrease through competition. The agencies responsible for administering the antitrust laws, and which monitor these markets today, are in a better position to determine whether additional action is required. A one hundred eighty (180) day study by an office with limited knowledge of these competitive markets does not appear necessary or warranted.

**Section 5 – Joint Federal and State Task Force**

Companies in the oil and gas industry participate in various trade associations and other organizations where non-competitively sensitive information is shared for a variety of purposes, for example, improving safety and environmental practices. Non-competitively sensitive information is shared by working interest owners in producing properties, and companies are required to provide voluminous data to governmental agencies such as the Energy Information Administration.

The oil and gas industry has been thoroughly investigated by State and Federal authorities throughout the years regarding mergers, gasoline pricing and natural disasters. As a result of last year's hurricanes, ConocoPhillips responded to eight (8) Civil Investigative Demands by Federal and State regulatory agencies, three (3) investigations by Senate Committees and sixteen (16) informal (telephone and letter requests for information) investigations from state regulators. We were not the only oil and gas company with this experience.

This provision for yet another open-ended, non-specific investigation of the industry is unwarranted. If there are specific concerns about unlawful coordination among oil and gas companies, they can and should be addressed by State and Federal authorities under existing laws.

**Section 6 – No Oil Producing and Exporting Cartels**

("NOPEC")

There is little doubt that the joint action of OPEC members would be unlawful under existing U.S. antitrust laws. The enforcement problem is that the activity is conducted by governments, not by private companies. The Supreme Court concluded that establishing production quotas was a government, not a commercial, activity and that the Sovereign Immunity doctrine insulated the OPEC countries from prosecution. The proposed legislation is designed to remove the Sovereign Immunity and Act of State defenses.

Given that prosecution rests with the Executive Branch (Department of Justice) under the Sherman Act, and the Executive Branch, through the State Department, has historically relied on diplomacy to deal with OPEC, it is high unlikely that the Department of Justice

would ever be authorized to bring suit against OPEC. Even if there were a decision to prosecute, enforcement of any judgment would be problematic.

There would also be concerns about supply adequacy if the United States, through this proposed legislation, were to constrain imports from OPEC nations. In 2005, about 5.5 million barrels per day or over 40 percent of U.S. crude and product imports were from OPEC member countries. This volume represented about 27% of U.S. oil demand. The U.S. Department of Energy projects that imports from OPEC countries will rise to 7.6 million barrels per day by 2030. The U.S. self-imposed trade restraint that could result from this proposal could result in the United States paying premiums to replace these OPEC barrels with oil from permitted sources, while non-U.S. parties receive the benefit of reduced prices that would result from the greater liquidity in non-U.S. markets. This would also have the effect of discouraging OPEC countries from expanding production capacity, which will be needed to satisfy global demand in the future.

**2.) What steps can be taken to decrease consumption of oil and natural gas?**

We support improved energy efficiency and conservation of natural resources. To that end, we believe good public policy should encourage energy efficiency in all applications inclusive of new appliances, industrial equipment, public buildings, homes and motor vehicles. Congress could consider offering incentives to automobile manufacturers to produce more efficient vehicles and maintain incentives to consumers for purchasing them. Tax incentives might also be offered to industrial facilities to improve efficiency at existing plants in the production of consumer products, including consumable goods like motor vehicle fuels. In addition, government's cooperative role with industry in high-risk pre-competitive research in alternative fuels and modes of transportation along with environmental sciences continues to play an important role in assuring adequate preparations for future generations. An example here is the government-industry cooperative efforts on hydrogen in the FreedomCAR and Fuel Partnership sponsored and facilitated by the U.S Department of Energy.

However, we don't believe that reduced consumption, alone, will likely be sufficient to encourage the energy security of the United States. We recommend that Congress also revisit the onshore and offshore moratoria policies it has enacted over the years, which currently make a huge percentage of America's domestic resources unavailable to consumers. This is a critical policy issue that impacts the prices of gasoline and natural gas.

**3.) Please provide an analysis of the incentives offered to petroleum companies by the federal government that explains what the incentives are intended to do, which incentives are important to you, and why they should be maintained.**

Below is an explanation of tax incentives and other provisions made available to petroleum companies by the federal government. The first two have been available for

some time. The others were recently provided by the Energy Tax Incentives Act of 2005 and the American Jobs Creation Act of 2004. Comments on the desirability of the tax incentives follow the description of all the incentives.

**a. Deduction for intangible drilling and development costs in the case of oil and gas wells.** This allows immediate deduction for 70% of the intangible costs for the drilling and development of domestic oil and gas wells that would otherwise be capitalized and recovered through depletion. The remaining 30% of these costs are capitalized and amortized over 5 years on a straight-line basis. This incentive encourages the drilling and development of oil and gas wells.

**b. Enhanced oil recovery credit.** This provision allows a tax credit equal to 15% of the taxpayer's qualified enhanced oil recovery costs, with an offsetting reduction in deductions for these costs equal to the amount of the credit taken. Qualified enhanced oil recovery costs are those involved in the application of one or more tertiary recovery methods on domestic projects. The credit is phased out as the price of crude oil rises. The American Jobs Creation Act of 2004 expanded this credit to include any expenses in connection with the construction of any qualifying natural gas processing plant capable of processing large volumes of Alaska natural gas.

**c. Natural gas distribution lines treated as 15-year property.** Gas distribution lines must be depreciated over 20 years under present law. The provision shortens the depreciation period to 15 years for any gas distribution lines the original use of which occurred after April11, 2005 and before January 1, 2011. The provision does not apply to any property which the taxpayer or a related party had entered into a binding contract for the construction thereof or self-constructed on or before April 11, 2005.

**d. Amortization of geological and geophysical expenditures.** The provision allows geological and geophysical amounts incurred in connection with oil and gas exploration in the United States to be amortized over two years. In the case of abandoned property, any remaining basis may no longer be recovered in the year of abandonment of a property as all basis is recovered over the two-year amortization period. The provision is effective for geological and geophysical costs paid or incurred in taxable years beginning after the date of enactment. We do not view this as an incentive since most industries can expense all of the costs of doing business in the year in which the expenditures are made.

**e. Expensing for refinery investments.** Allows taxpayers to expense (depreciate immediately) 50 percent of the cost of domestic refinery investments that increase the capacity of an existing refinery by at least 5 percent or increase the throughput of qualified fuels by at least 25 percent. Qualified fuels include oil from shale and oil sands. As a condition of eligibility, refineries of liquid fuels must report to the IRS on refinery operations (e.g., production and output).

**f. Determination of small refiner exception to oil depletion deduction.** Presently, a producer may qualify as an independent producer for this purpose if its refining operations (runs) do not exceed 50,000 barrels on any day in the taxable year during

which independent producer status is claimed. The provision increases the current 50,000-barrel-per-day limitation to 75,000. It also changes the refinery limitation on actual daily production to an average daily production for the taxable year.

**g. Arbitrage rules not to apply to prepayment for natural gas.** Arbitrage is the profit that results from investing the proceeds of tax-exempt bonds in higher yielding taxable securities. Tax law generally requires a rebate of arbitrage profits to the United States. This provision would create a "safe harbor" exception to the general rule that tax-exempt bond-financed prepayments violate the arbitrage restrictions. The exception applies to certain prepaid natural gas contracts, i.e., any contracts to acquire natural gas for resale by a utility owned by a governmental unit where the amount of gas to be purchased under the contract does not exceed certain limits. The limit is the sum of (1) the average annual natural gas purchased by customers of the utility within the service area during a 5 year testing period, and (2) the amount of natural gas that is needed to fuel transportation of the natural gas to the governmental utility. This provision would apply to all contracts issued after the date of enactment. This is more of a "safe harbor" for certain prepaid natural gas contacts, than an incentive.

**h. Natural gas gathering lines treated as 7-year property.** Uncertainty in the current law about the appropriate recovery period for natural gas gathering lines has led to litigation. This provision clarifies the law, establishing a statutory 7-year recovery period and a class life of 14 years for domestic natural gas gathering lines the original use of which commences with the taxpayer after April 11, 2005. In addition, no adjustment will be made to the allowable amount of depreciation with respect to this property for purposes of computing a taxpayer's alternative minimum taxable income. The purpose of this provision was to clarify a long-standing belief that gathering lines were to receive 7-year property treatment under the tax code, and it should not be considered to be an incentive.

**i. Cooperative pass-through of the expensing related to costs to comply with EPA sulfur regulations for small refiners.** The American Jobs Creation Act of 2004 included a provision to allow taxpayers to expense certain costs for investments to comply with EPA low-sulfur diesel regulations. The provision allows the deduction to be passed through to members of a cooperative if the cooperative makes an election on their tax return. This provision is more of a technical correction than an incentive.

**j. Modification of the credit for producing fuel from a non-conventional source.** The provision makes the credit for producing fuel from a non-conventional source part of the general business credit, so that unused credits may be carried back one year and forward 20 years.

**k. Extension of the credit for producing fuel from a non-conventional source for facilities producing coke or coke gas.** The provision adds a production credit for qualified facilities that produce coke or coke gas. Qualified facilities must have been placed in service before January 1, 1993, or after June 30, 1998 and before January 1, 2010. The production credit may be claimed beginning on the later of January 1, 2006,

or the date such facility is placed in service and ending on the date which is four years after such period began. The credit expires in January 1, 2010 or four years after the facility was placed in service, whichever is later.

**l. Certain Alaska natural gas pipeline property treated as 7-year property.** This provision reduces the depreciable life from 15 to 7 years for any natural gas pipeline located in Alaska that has a capacity of more than 500 billion Btu of natural gas per day.

Tax incentives, in general, are designed to encourage certain activities. The above incentives are no exception. Notwithstanding, we do not need all of these incentives to carry out our primary objective of delivering oil and gas-based energy to our markets.

However, to the extent that these incentives create economically viable projects that otherwise would not exist, they achieve the intended results. In this regard, the expensing of intangible drilling and development costs and the enhanced oil recovery credit have had positive effects on the production of domestic oil and gas. In addition, the two incentives regarding Alaskan natural gas pipeline and processing plant investments are valuable economic incentives to encourage the development and delivery of Alaskan natural gas. The expensing of refinery investments would also improve the economics of expanding refining capacity in the United States.

Regarding the 2-year amortization of geological and geophysical expenditures, this provision is helpful to the extent that it eliminates an administrative burden regarding the current treatment of these costs, which otherwise would have to be capitalized and only deducted when it was determined that the geological and geophysical data no longer had any value. The amortization period is less important than allowing amortization. Lengthening the period could achieve revenue neutrality and still deliver the administrative benefit for both the taxpayer and the IRS.

**4.) In the two weeks prior to March 14, 2006, the price of oil decreased seven cents per gallon, while the price of gasoline increased by eleven cents per gallon. Why would gasoline become more expensive during this period, despite a decrease in the cost of crude oil?**

Gasoline prices usually increase seasonally in March relative to crude prices as the spring and summer driving seasons approach, with their associated increases in gasoline demand coincident with system transition from winter to summer grades of gasoline. Government regulations reducing sulfur levels of gasoline and diesel this year are also tightening clean product supplies. In addition to the normal maintenance turnaround of refineries that occurs before driving season, industry turnarounds are being extended this year due to preparations to meet ultra-low-sulfur diesel specifications by June 1 of 2006. This is a deadline mandated by Congress. The Energy Information Administration cited reports of

heavy refinery maintenance in March.[1] Hurricane-impacted refineries may also be trying to repair damage and bring on new gasoline desulfurization equipment at the same time, which has been made more difficult by resource and equipment constraints. Extended turnarounds are probably tightening gasoline supplies.

The removal of MTBE from gasoline has also been a likely cause of reduced gasoline supplies. According to a recent report by the U.S. Department of Energy[2], most of the industry is moving away from MTBE before the 2006 summer driving season as a result of State bans due to water contamination concerns, continuing liability exposure from adding MTBE to gasoline, and perceived potential for increased liability exposure due to the elimination of the oxygen content requirement for reformulated gasoline (RFG) included in the Energy Policy Act of 2005. The Energy Policy Act of 2005 failed to offer liability protection for using MTBE in gasoline so domestic producers have largely tried to reduce its use before the oxygenate requirement is removed. MTBE, which is also an important source of octane, largely will be replaced by ethanol, which costs more, is more difficult to transport and must be stored in segregated tanks. In addition, ethanol-blended reformulated gasoline may not be commingled with MTBE-blended reformulated gasoline by federal mandate. Ethanol also has a higher vapor pressure than MTBE so light ends of the gasoline must be removed to meet mandated summer gasoline vapor pressure specifications. There is also likely to be a loss of imported supplies from those sources that cannot meet low-sulfur regulations, deliver MTBE-free product, or produce the high-quality blendstock needed to combine with ethanol.

**5.) With respect to the large mergers that your companies have engaged in over the past decade, what efficiencies have they produced that have benefited consumers, particularly in downstream markets?**

As we have already stated in our written testimony, our mergers, acquisitions and joint ventures have benefited consumers by reducing cost and improving the efficiency of our business, resulting in increased supplies of petroleum products for American consumers. Fundamentally, the supply of petroleum products depends on the ability of U.S. companies to access crude oil and natural gas and the ability of those companies to refine that crude oil into petroleum products for American consumers. Developing supplies of crude oil and natural gas requires petroleum companies to undertake ever larger and riskier projects, both domestically and abroad.

The transactions undertaken by ConocoPhillips have been motivated by and have subsequently achieved increased access to crude oil and natural gas, and increased

[1] U.S. Department of Energy, Energy Information Administration, "This Week in Petroleum", February 15, 2006

[2] U.S. Department of Energy, Energy Information Administration, "Eliminating MTBE in Gasoline in 2006", February 22, 2006

refining capacity to turn that crude oil into petroleum products. This increased supply has benefited – and can be expected to continue to benefit – American consumers through lower prices and greater energy security. These mergers and acquisitions also have strengthened the sustainability of the company's competitive position and long-term viability.

Conoco-Phillips Merger

This $36 billion merger of equals was completed on August 30, 2002. The rationale for this merger was to form a company of sufficient size and scale to address opportunities that could not be achieved by either company on a stand-alone basis. The merger was intended to develop a diversified growth portfolio and leverage the intellectual capital of the two companies. It also was intended to strengthen our financial position through diversifying earnings and cash flow, developing a stronger balance sheet and improving capital efficiency and the cost structure.

By the end of 2004, we documented $1.9 billion in cumulative cost and efficiency savings resulting from this merger. These synergies have benefited American consumers by increasing volumes and by enabling ConocoPhillips to increase investments and compete vigorously for international supplies of natural gas and crude oil.

In the E&P (exploration, development and production) segment of the business, our increased scale, financial strength and diversification have allowed ConocoPhillips to expand our investments in traditional core areas as well as develop new legacy assets. The E&P business segment also benefited from the combination of the companies' complementary technologies. For example, Phillips possessed natural gas liquefaction technology and Conoco had a natural gas-to-liquids technology. Possessing both of these technologies has allowed the company to become a more effective global gas player. There were also substantial integration benefits associated with utilizing complementary competencies. For example, by combining Phillips' liquefied natural gas (LNG) technical expertise with Conoco's extensive gas marketing experience, ConocoPhillips has become a successful player in the global LNG business in the space of just three years. This puts our company in a strong position to help expand the supply of natural gas to American consumers over the coming years as the domestic supply of natural gas declines. Our increased size also gives us more leverage in procurement, which is an extremely important benefit in this highly capital-intensive business.

In the R&M (refining and marketing) business segment, we benefited from lowering our cost structure, which was made possible by sharing technology and best practices, optimizing crude supply and improving management of intermediate refining feedstock across our entire refining system. Unit cost reductions have resulted from initiatives in the areas of energy efficiency,

maintenance and procurement of goods and services. Additional benefits of technology and best-practice sharing have reduced the capital costs of projects.

The merger also resulted in increased efficiency in refining and marketing operations. We have been able to improve the reliability and increase clean refined product yields at our refineries by sharing technology and best practices across our refinery network. These include initiatives in preventative maintenance, reduced turnaround time, improved tuning and control of operating units, and installation of improved technologies. Conoco and Phillips both brought expertise in key technologies to the table. Conoco's strong petroleum coking technology skills were applied to Phillips' refineries, while Phillips' alkylation technology to increase feed and improve octane, along with Phillips' sulfur removal technology, were applied to Conoco's refineries.

Since the merger and up to the time of the outages caused by Hurricane Katrina at our Alliance refinery, refinery utilization improved from the low 90 percent range to the mid 90 percent range, which is equivalent to adding a 100 thousand barrel per day refinery. In addition to increased capacity utilization, we also have increased the nameplate capacity of our U.S. refineries by approximately 1 percent per year over the last two years.

Having additional U.S. refineries to upgrade is allowing us to bring additional crude oil from Canadian oil sands production into the United States. For example, we currently are expanding the capabilities of our Wood River refinery in Illinois to add both crude capacity and a large coker so it can handle additional volumes of crude oil from Canadian oil sands. We are also partnering with a Canadian company to build the Keystone Pipeline to bring an additional 435 thousand barrels per day of Canadian crude into the Midwestern United States. The combined ownership of Conoco's Canadian crude oil supply and Phillips' Wood River refinery facilitated this major investment. Again, our size and financial strength allow us to undertake major projects of this nature.

All across our post-merger refining system, we can point to numerous examples of higher crude throughputs stemming from our ability to balance crude oil supplies among our refineries. For example, crude oil throughput at our Sweeny, Texas refinery was maintained at higher levels during the Venezuelan supply disruption in 2003 due to our ability to divert the specialized crude from three of our other refineries to Sweeny, because the others could easily adapt to alternative supplies. In several instances, we have been able to maximize our refining system throughput during Gulf of Mexico storms that delayed crude oil deliveries. We have greater balancing options among waterborne cargoes, pipeline receipts and inventories. We also have greater volumes of gasoline and distillates since the merger because of our ability to balance intermediate and blendstock inventories among refineries. For example, we increased the supply of imported gasoline and gasoline blendstocks from Conoco's Humber refinery in England through Phillips' Bayway and Trainer refineries on the U.S. East Coast. We also move

premium gasoline blendstocks (e.g., alkylate, toluene) from our East Coast to West Coast refineries to increase the supply of CARB gasoline and to enhance octane. In addition, when we plan turnarounds, we can process intermediate products (not yet upgraded to a finished product due to capacity in turnaround) at other plants. With unplanned downtime, we can utilize stocks from other facilities to maintain supply to consumers.

We also have realized significant efficiency gains in pipelines and terminals in the United States since the merger. For example, we improved Canadian crude access on the Spearhead pipeline and improved crude import capability on the West Coast.

Divestitures stemming from the merger also moved refining capacity into the hands of new industry participants. While we did not believe it was warranted, in response to an FTC mandate before the merger was closed, our Woods Cross refinery in Utah was sold to Holly Corporation, and our Denver refinery in Colorado was sold to Suncor. In both cases, the new owners have invested to maintain output and to make new clean fuels at these refineries.

Phillips – Tosco Acquisition

This acquisition, which involved the exchange of $7 billion of Phillips stock for Tosco shares, was completed on September 14, 2001. The rationale for the transaction was to build critical mass, capture economies of scale and reduce the unit costs of R&M operations in the United States. We identified $280 million in pre-tax synergies from this transaction.

Sources of synergies for refining included increasing the ability to use lower cost crude oils, increasing operating reliability, increasing clean product yields, lowering operating costs, and utilizing Tosco's commercial expertise to maximize asset values (e.g., use lower cost feedstock). The acquisition also increased transportation volumes without a commensurate increase in costs through sharing best practices and centralizing services.

Perhaps the most important benefit in terms of volume expansion relates to the fact that ConocoPhillips is able to invest significantly more in the refining business than Tosco, as a smaller independent, was able to invest. Tosco invested about 70 to 80 cents per barrel of capacity during the late 1990s, while ConocoPhillips' investments have averaged about $1.25 per barrel over the last three years. Moreover, additional investments are expected.

ConocoPhillips also is upgrading Tosco's former refineries. As described above, these upgrades include expanding the processing capability of a significant portion of the Wood River refinery to increase crude capacity and access more Canadian unconventional heavy crude oil. The integration of Tosco's business, which was all in the R&M segment, with ConocoPhillips' production of these

crude oils facilitates these investments, in part by reducing the risk associated with the investments.

Conoco-Gulf Canada Acquisition

Conoco acquired Gulf Canada on July 16, 2001, in a transaction valued at $9.4 billion. One rationale for the acquisition was to increase Conoco's access to North American natural gas reserves, and thereby improve supply to American consumers. This goal is being realized as ConocoPhillips has utilized its greater financial strength and U.S. gas marketing position to increase the supply of Canadian natural gas to the United States from Gulf Canada production. ConocoPhillips expects that its financial strength and commercial skills also will enhance development of the supply of natural gas from the Mackenzie Delta gas-producing region in Arctic Canada. Since the acquisition, ConocoPhillips has applied its expertise in heavy-oil production and upgrading to the development of Gulf Canada's Canadian oil sands reserves. Crude oil from these reserves is increasingly being supplied to U.S. refineries as far south as ConocoPhillips' refineries in Illinois, Oklahoma and, in the near future, Texas. ConocoPhillips' investment in Gulf Canada also has ensured that the crude oil production resulting from these E&P investments has a home in refineries capable of processing these crude oils.

ConocoPhillips' Acquisition of Burlington Resources

On March 31, 2006, ConocoPhillips acquired Burlington Resources Inc. for approximately $34 billion. The rationale for this transaction was to increase ConocoPhillips' ability to supply North American natural gas and obtain high-quality, long-lived, low-risk natural gas reserves. This acquisition also provides near-term production growth, which complements the numerous long-term projects in our portfolio. This production growth is expected to come, in part, through ConocoPhillips' access to Burlington's technical capabilities, particularly its expertise in commercializing unconventional gas projects in coal bed methane and so-called "tight" gas. ConocoPhillips brings to the table better health, safety and environmental processes and operating capabilities. Increased natural gas production in the United States will benefit U.S. consumers in a time of ongoing recovery of natural gas production in the Gulf of Mexico from last year's hurricanes. We expect to achieve pre-tax annual synergies of $375 million, through portfolio optimization and operating expense reductions.

This acquisition also enhances the geographic diversity of projects within the United States and strengthens our supply position in Western Canada. The transaction also increases ConocoPhillips' weighting of its portfolio toward E&P. This positions the company to compete for higher-risk international opportunities to expand oil and natural gas oil supplies.

Other Transactions

ConocoPhillips also has used mergers and acquisitions as a means to refocus our core business investments on increasing the supply of natural gas, crude oil and refined petroleum products to American consumers. For example, ConocoPhillips sold most of its retail marketing operations over the last five years. Circle K assets were sold at the end of 2003 to Alimentation Couche-Tard Inc. Other retail assets were sold in 2004 to Sunoco and Getty Petroleum Marketing Inc. ConocoPhillips also formed the Duke Energy Field Services (or DEFS) Joint Venture with Duke Energy in 2000. DEFS is an integrated gas gathering, processing and marketing business. The formation of DEFS enabled the better provision of gas gathering and processing services to third-party producers in the United States using the existing Phillips (and, subsequently, ConocoPhillips) assets. Another example of refocusing was the completion of the ChevronPhillips Chemical joint venture on July 1, 2000. This joint venture reduced the cost structure and made ConocoPhillips' chemicals business more competitive on a global scale.

**Follow-up Questions of Senator Charles E. Schumer**
**Senate Judiciary Committee Hearing**
**"Consolidation in the Oil and Gas Industry: Raising Prices?"**
**March 14, 2006**

For All Panel II Witnesses:

1) **Would you please clarify which income figures your company reported to the internal revenue service last year for tax purposes, as well as the basis for those figures? Are these the same income figures reported to your shareholders? If different figures were used, what were they, what was their basis, and what is the rationale for this decision?**

In our 2004 Form 10-K filed with the U.S. Securities and Exchange Commission (SEC), we reported $14.4 billion as pre-tax income from continuing operations. The taxable income we report to the IRS will always be different than the pre-tax income we report to the SEC. The reporting to the IRS is dictated by the Internal Revenue Tax Code, while the reporting to the SEC and our shareholders is dictated by U.S. generally accepted accounting principles (GAAP). There are a multitude of differences between these two sets of rules. One of the most significant differences is the fact that our Form 10-K and annual report to our shareholders includes the earnings of our foreign subsidiaries, while this income is subject to taxation by other countries and is not subject to taxation in the U.S. until it is distributed as a dividend. Other differences include those related to the different accounting rules for items of income and deduction.

2) **Based on your written testimony, it appears that your company has put at most 5% of annual investment toward developing alternative energy technologies like hydrogen fuel cells, wind, solar, and others. What is the rationale for this investment strategy? Have you decided that investment in these energy sources is not in the interest of your shareholders?**

ConocoPhillips' current investments in alternative energy are primarily focused on development and evaluation of new technologies that leverage our internal capabilities, competencies and assets. We feel it is in the best interests of our shareholders to only invest where we add value, rather than passively or speculatively investing in emerging energy technologies. The alternative energy technologies we are currently investing in include novel hydrogen generation (for current use in refining and potential use in a hydrogen economy), clean coal technologies, gas-to-liquids, oil shale, gas hydrates and the development of second-generation biofuels. Our investment in these technologies will increase when they are deployed at commercial scale.

**3) How much royalty relief have you received from the Department of Interior for exploration on public lands? Which public lands specifically? At what price threshold have you predicted internally that you would not need royalty relief to make exploration viable?**

ConocoPhillips is not taking any royalty relief for exploration on onshore public lands nor have we taken royalty relief for offshore production.

For all Gulf of Mexico (GOM) shallow water production we pay royalty at a rate of 1/6th. For all deep water production (Magnolia, K2, Ursa and Europa) we pay royalty at a rate of 1/8th. This is the prescribed royalty rate and, therefore, would not be considered royalty relief.

On our Green Canyon properties, we pay royalties on a Net Profits Interest basis, which means we recover our costs before we start paying royalty. This is also not considered royalty relief.

We have been notified recently that we were eligible for royalty relief on Mississippi Canyon 265 from the late 1990s, when prices were much lower, but, to date, we have not taken any steps to claim relief retroactively. Therefore, in contrast with what was suggested by a New York Times article a month ago, we have not claimed nor taken any federal royalty relief in the Gulf of Mexico.

ConocoPhillips has not received any exploration royalty relief from the Federal government in Alaska.

**Price Threshold**

In answer to the final question related to price thresholds, it is important to note that each individual exploration prospect has its own unique characteristics. For example, the geographic location of the domestic exploration prospect, the potential size of any discovered resource and the estimated cost and amount of time required to develop the facilities and transportation structure all contribute to the individual characteristics of a possible development project. Different price thresholds may be required depending upon these characteristics.

If our exploration activity results in a discovery, we work through a series of internal development scenarios to determine whether an exploration play is economic and should be considered for development when compared to the company's other potential projects around the world. Price is just one component of several factors involved in this decision and the price needed to make a project economic will vary by project.

**Senator Kohl's Follow-up Questions for Oil Consolidation Hearing**

**For James Mulva**

**1. An independent study by the consumers group Public Citizen found that from 1999 to 2004 U.S. oil refiners increased their profits they made on each gallon of gas refined by 79%. Don't these statistics show that it is not merely the rising worldwide cost of crude oil that accounts for high prices and other petroleum products? And does the success of your industry in passing along rising crude oil prices to consumers demonstrate that your companies have gained market power and that there is a failure of competition in this market?**

First, 1999 is not an appropriate year from which to measure an increase in refining margins because margins were not typical in this year. Rather, in 1999, the Gulf Coast light oil spread, which is a simplified refining margin, was only about half of the 1994 to 2004 average level in real terms. Margins were unusually weak in 1999 due to low refinery capacity utilization in the U.S. and globally due to weak Asian demand after the Asian financial crisis that led to substantial excess refinery capacity there and surplus refined products supplies globally.

Global refinery margins have increased since 2002 as a result of a global economic recovery that led to exceptionally strong global oil demand growth, which has challenged the refining industry's ability to expand capacity at a commensurate pace. The United States and Europe have had the additional issues of mandated spending on clean fuels crowding out investments for expansion. Thus, demand growth outpaced refinery capacity additions.

Supply and demand conditions determine the degree to which higher feedstock costs are passed through to consumers. The FTC has stated that the vast majority of its investigations and studies on gasoline pricing have revealed that market factors are the primary drivers of both price increases and price spikes.[3]

**2. In most competitive industries, when there are high prices, high profits to be made, and soaring consumer demand, we would expect to see an expansion of capacity to meet this demand. Yet in the oil industry this has not happened. Instead of opening new refineries, the industry has closed more than half of all that existed 25 years ago. In 1981, there were 324 refineries operating in the United States – today there are 149. According the Department of Energy, in the period from 1981 to 2004 overall national refining capacity has declined by more than 9% while demand for gasoline rose by 37%. Oil industry critics suggest that this decline in refining capacity is no accident – that oil companies actually prefer to keep supplies tight in order to be able to gain market power to raise price. Indeed, many economists believe this is a central reason why gas prices are so high.**

[3] Chairman Deborah Platt Majoras, Federal Trade Commission, Prepared Statement of the Federal Trade Commission before the Committee on Commerce, Science and Transportation and the Committee on Energy and Natural Resources, United States Senate, "Market Forces, Competitive Dynamics, and Gasoline Prices: FTC initiatives to Protect Competitive Markets", November 9, 2005, page 20

**So why hasn't your industry opened new refineries while closing so many existing ones? Does the failure of the oil industry to open new refineries suggest an effort to keep supplies tight?**

There has been a reduction in the number of refineries operated in the United States but it is not related to mergers. Between 1973 and 1981, government control of the pricing and allocation of crude oil favored small refineries and provided incentives for companies to own and operate small, inefficient refineries. The elimination of these government incentives in 1981 spurred the eventual shutdown of many inefficient refineries. The number of domestic operable refineries declined from 319 in 1980 to 149 in 2004, but according to the FTC, refinery closures overwhelmingly have involved small, relatively unsophisticated facilities.[4]

The oil industry has done a commendable job of expanding and increasing the utilization of existing refineries. Despite the fact that the closure of inefficient refineries reduced the total number of refineries by more than half since 1980, this impact was more than offset by efficiency improvements that allowed the industry to increase total refinery runs by 14%.

The refining industry has historically not attracted sufficient investment because of unattractive returns. Between 1990 and 2002, it had a return on capital employed of 5.2% versus 7.1% for the total petroleum industry. Refining is highly capital intensive and the industry spends a great deal on mandated emissions reduction and clean fuels production, which generally do not earn a return on investment. Additionally, there has been substantial excess capacity outside of the U.S. until recently, allowing for relatively low-priced product imports. As a result of the domestic refining industry's low capital returns, coupled with difficulties in obtaining governmental permits, no grassroots refineries have been built in the United States since the mid-1970s.

While the U.S. refining industry is likely to make a substantial amount of new investments going forward in response to recent increases in refining margins and provisions of the National Energy Policy Act, substantial barriers remain for building grassroots refineries. In the most optimistic of cases, it would take several years to complete a grassroots refinery. The biggest barrier is that future refinery margins are not expected to be sufficient to justify the high cost of grassroots construction. Since the cost of expanding existing capacity is about half that of adding grassroots capacity, expansion is a more viable option[5]. Additionally, there is still a strong need to streamline the permitting process and provide more certainty on the future regulatory environment.

In addition to the above explanations relating to new refineries, it should be noted that any attempt to permit and build a new refinery is likely to face lengthy delays and

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[4] U.S. Federal Trade Commission, Bureau of Economics, "The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement", August 2004, page 7

[5] Bear Stearns, Not in My Backyard Report – The Prospects and Pitfalls of a Grassroots Refinery, October 4, 2005

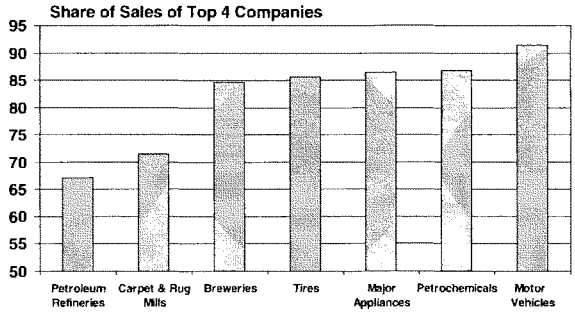
uncertainty due to continued opposition at the state and local community levels. We encounter this in our attempts to expand existing capacity at some of our refineries, and we are seeing it nationwide in attempts to permit and build other types of energy facilities, such as LNG terminals.

**3. In the last 15 years there has been a tremendous amount of consolidation in the oil industry – the GAO counts 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 has concluded that these mergers have raised gasoline prices.**

**(a) What is your view of the effects of these mergers on competition in your industry and the price of petroleum products?**

The chart below shows that despite the mergers, the U.S. petroleum refining industry is substantially less concentrated than other major industries. In addition, surplus refining capacity globally is an additional source of products for U.S. markets.

**Large Companies Account for a Smaller Share of Sales of Petroleum Refining Than for Other Major Industries**



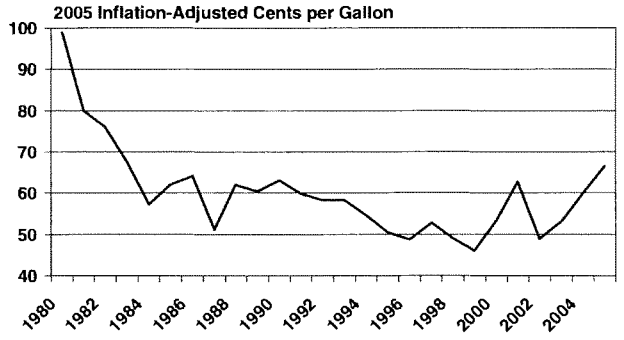

Sources: FactSet, Factiva & OneSource
Note: Industries are defined by 5-digit NAISC code. Sales are based on annual revenues for fiscal years 2004 and 2005, or most recent D&B data for private companies

The efficiencies resulting from the mergers would likely have reduced consumer product prices in the United States if all else was equal. Efficiency improvements over the last

two decades have resulted in substantial cost savings for consumers. The graph below shows the difference between refiners' crude acquisition cost and the pre-tax retail price of gasoline (which is the combination of the cost and profits from refining, distributing and marketing retail gasoline). The graph shows that the difference between cost and price fell from about 99 cents per gallon (real 2005 dollars) in 1980 to 49 cents per gallon in 2002. It subsequently increased to 66 cents per gallon in 2005 (real 2005 dollars) due to the impact of the hurricanes and tighter market conditions.[6] However, even at 2005 prices, this difference was still one-third lower than it was 25 years ago in real terms. This decline has occurred despite the increase in manufacturing cost for cleaner fuels.

**Cost to Refine, Distribute & Market Gasoline**

**(Measured as the difference between refiners' acquisition cost of crude and retail gasoline prices excluding taxes)**




Source: U.S. Department of Energy, API for taxes

It should also be noted that the FTC stated that the GAO report that indicated slight price increases resulting from mergers was "fundamentally flawed, with major methodological mistakes that make its quantitative analysis wholly unreliable" and it has "conclusions that lack any quantitative foundation[7]".

Based on our understanding, the study compared prices before and after the period in which mergers took place and then assumed causality without first taking into account the many other events that occurred during that period that could easily have caused prices to increase. For example, the study ignored the introduction of new types of gasoline. Over the period studied, the first two phases of the Clean Air Act provisions

[6] U.S. Department of Energy, Energy Information Administration, API for taxes

[7] Statement of Federal Trade Commission Chairman Timothy J. Muris on the GAO study on 1990s Oil Mergers and Concentration Released Today," May 27, 2004, www.ftc.gov/opa/2004/05/gaostatement.htm

were introduced that required two more costly blends of reformulated gasoline. Also, over the period several new "boutique" blends of gasoline were introduced, and the Department of Energy has stated that this causes price volatility. GAO ignored these factors and attributed the rise in price to mergers.

We believe a compelling argument can be made that mandatory fuel and environmental specifications enacted by Congress over the past two decades have had more of an impact on gasoline prices than have industry mergers.

**(b) Are we likely to see even more consolidation in the years ahead? If so, what will this mean for competition in this industry?**

We anticipate there will be further consolidation, particularly in the exploration, development and production part of the energy business due to limited resource access relative to the number of competitors and strong competition from national energy companies that have lower return requirements than energy companies that are not controlled by governments. Without further consolidation, U.S. energy companies will find it difficult to compete for new reserve opportunities.

**Senator DeWine**
**Questions**
**Consolidation in the Oil and Gas Industry: Raising Prices?**
**March 14, 2006**

**Q. Tillerson, Mulva, O'Reilly, Klesse, Hofmeister, Pillari, Borenstein - At our last hearing, we heard testimony that some of the gasoline price spikes can be attributed to regulations that create multiple grades of gasoline to comply with different environmental standards – so called "boutique fuels." What can we do to reduce the number of boutique fuels? What would be the effect of just requiring everyone in the industry to comply with the highest standard, and have just one fuel available?**

The Energy Policy Act of 2005 has initiated action on reducing the number of 'boutique' fuels in this country. First, it has eliminated the Northern type of Reformulated Gasoline, replacing it with the Southern type nationwide. The U.S. Environmental Protection Agency has not yet acted on this direction by Congress but we anticipate they will do so soon.

Additionally, EPACT05 has placed a limit on the number of boutique fuels, capping the number to those approved in State Implementation Plans as of September 1, 2004. This feature recognizes that infrastructure and delivery networks have been put in place to meet existing requirements but limits further proliferation of boutiques that could place supplies at risk. Further, Congress has directed the EPA, in consultation with the DOE, that action to approve a new fuel must be preceded by public input and a finding that the new fuel will not cause fuel supply or distribution interruptions or have a significant adverse impact on fuel producibility for the area. These are positive steps.

ConocoPhillips operates in nearly every state. As a result, we are not only impacted by the federal standards for fuel delivery but also individual state requirements. Every state approaches fuel regulations somewhat differently. As a result, we are faced on a daily basis with an array of local and state controls on fuel quality that differ either minutely or significantly. A harmonization of the state regulations toward common standards would be beneficial to supply flexibility.

EPACT05 has called for the EPA and DOE to undertake a joint study to determine how a federal fuels system could be developed to maximize motor fuel fungibility and supply while addressing air quality requirements. We fully support this study and will provide the agencies with the information needed to fulfill their obligation. We cannot predict the outcome of that comprehensive study but would anticipate some additional consolidations will be recommended. It is unlikely, however, that a single fuel type will be recommended due to the adverse consequences on supplies of adopting the most stringent fuel formulation on a national basis.

During the hurricanes of 2005, the importance of Federal and State regulations became more widely understood. Despite the federal government's issuance of quality waivers

on motor fuels, controlling state regulations remained in force that limited the industry's ability to respond. A super waiver of quality standards with overriding authority resting with the federal government during periods of supply disruptions would better enable the industry to respond quickly, and with certainty, during these crisis periods.

**Q. Tillerson, Mulva, O'Reilly, Klesse, Hofmeister, Pillari - In the last couple of months most of the oil industry has announced record-breaking profits for the last fiscal year. How much is your company investing annually in exploration, production and refining, and when will we see those investments pay off? And perhaps most important, what are you investing in alternative energy sources so we can help reduce domestic dependence on foreign oil?**

ConocoPhillips has been reinvesting our earnings in developing new supplies. We had earnings of about $13.5 billion in 2005 – about $1.1 billion a month, but our capital investments were also close to $1 billion a month. In fact, over a three-year timeframe, using 2003-2005 reported results, ConocoPhillips' earnings are around $26 billion but capital investments are just over $27 billion. Mistaking the size of our earnings for a windfall fails to acknowledge the enormous levels of investment and risk required to achieve those earnings and bring new energy supplies to the market.

The following table from the company's 2005 Form 10-K filing summarizes capital expenditures and investments for the reported segments.

**Capital Expenditures and Investments**

| | Millions of Dollars | | | |
|---|---|---|---|---|
| | *2006* Budget* | *2005* | *2004* | *2003* |
| ***E&P*** | | | | |
| United States—Alaska | *$ 861* | *746* | *645* | *570* |
| United States—Lower 48 | *949* | *891* | *669* | *848* |
| International | *5,663* | *5,047* | *3,935* | *3,090* |
| | *7,473* | *6,684* | *5,249* | *4,508* |

| | | | | |
|---|---|---|---|---|
| ***Midstream*** | *6* | *839* | *7* | *10* |
| ***R&M*** | | | | |
| United States | *1,820* | *1,537* | *1,026* | *860* |
| International | *1,671* | *201* | *318* | *319* |
| | *3,491* | *1,738* | *1,344* | *1,179* |
| ***LUKOIL Investment***** | *-* | *2,160* | *2,649* | *-* |
| ***Chemicals*** | *-* | *-* | *-* | *-* |
| ***Emerging Businesses*** | *26* | *5* | *75* | *284* |
| ***Corporate and Other****** | *217* | *194* | *172* | *188* |
| | $ *11,213* | *11,620* | *9,496* | *6,169* |
| ***United States*** | $ *3,856* | *4,207* | *2,520* | *2,493* |
| ***International*** | *7,357* | *7,413* | *6,976* | *3,676* |
| | $ *11,213* | *11,620* | *9,496* | *6,169* |
| Discontinued operations | $ *-* | *-* | *1* | *224* |

***Does not include any amounts for the pending acquisition of Burlington Resources Inc.**

****Discretionary expenditures in 2006 for potential additional equity investment in LUKOIL to increase our ownership percentage up to 20 percent, from 16.1 percent at December 31, 2005, are not included in our 2006 budget amounts.**

*****Excludes discontinued operations.**

Over the last 10 years, including both Conoco and Phillips activities prior to the merger, we have invested about $435 million in alternative energy supply technologies. Chief among these is our investment in gas-to-liquids technologies, which target the ability to economically develop and produce stranded natural gas reserves. Stranded natural gas reserves are those located in remote areas that cannot currently be economically transported to market. In addition, we have invested in coal-to-liquids technologies, and are stepping-up our investment in coal/petroleum coke gasification technologies, oil shale, gas hydrates and second-generation biofuels.

# Senator Feingold's Questions for the Record
# Judiciary Committee Hearing from 3/14/06

**1. <u>All of Panel II:</u>**
**The President mentioned in his state of the union address that America is "addicted to oil", and outlined several steps - including increasing investments in alternative fuels - to end the addiction. What percentage of your R&D is dedicated to alternatives? In your response, please indicate how your company defines alternatives. In addition to your R&D, what are your companies doing, as corporate citizens, to move away from fossil fuels?**

Over the last 10 years, including both Conoco and Phillips activities prior to the merger, we have invested about $435 million in alternative energy supply technologies. Chief among these is our investment in gas-to-liquids technologies, which target the ability to economically develop and produce stranded natural gas reserves. Stranded natural gas reserves are those located in remote areas that cannot currently be economically transported to market. In addition, we have invested in coal-to-liquids technologies, and are stepping-up our investment in coal/petroleum coke gasification technologies, oil shale, gas hydrates and second-generation biofuels. In total, these represent approximately one-third of our research expenditures.

ConocoPhillips is an oil and gas company and, as such, we are in the business of finding new sources of fossil fuels to meet consumer demands. Eventually, there will be an evolution into the next generation of fuels, but this evolution will not occur for some time. Research, including those areas described above, will help set the stage for that evolution, but in the interim, we believe our role as a good corporate citizen is to continue meeting consumer needs and improving the products we make to enhance quality of life and the environment.

Chevron

**Lisa B. Barry**
Vice President and
General Manager

**Policy, Government and Public Affairs**
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April 14, 2006

The Honorable Arlen Specter
Chairman
Senate Committee on the Judiciary
SD-224 Dirksen Senate Office Building
Washington, DC 20510-6275

Dear Chairman Specter:

Attached please find Chevron's answers to the follow up questions from the March 14, 2006 hearing. We appreciated the opportunity to testify at the hearing.

If you need anything further, please let us know.

Regards,

Lisa B. Barry

Attachment

Responses Submitted by Chevron to Follow-up Questions from the March 14, 2006 Hearing by the United States Senate Committee on the Judiciary

**QUESTIONS FOR THE RECORD**
**SENATOR SPECTER**

**1. Please provide an analysis of the draft bill, the "Petroleum Industry Antitrust Act of 2006," which was submitted to the Congressional Record earlier this month.**

Answer: Chevron believes that passage of one or more of the draft provisions could severely undermine U.S. oil and gas companies' efforts to remain competitive in what is an increasingly global market for fuel products. The company's concerns about each of the bill's sections are discussed in more detail in Attachment 1.

**2. What steps can be taken to decrease consumption of oil and natural gas?**

Answer: The U.S. government should encourage continuous improvement in the responsible use of energy. It should expand its efforts to educate consumers about the value of conservation, a message included in Chevron's ongoing advertising. As a large consumer of energy, the U.S. government should lead the way in becoming more energy efficient and continue to support its Energy Savings Performance Contracting Program. The energy bill enacted last year also provided some strong provisions on energy efficiency/conservation for the states and government agencies. Finally, the U.S. government should support research and development on advanced energy-saving technologies.

**3. Please provide an analysis of the incentives offered to petroleum companies by the federal government that explains what the incentives are intended to do, which incentives are important to you, and why they should be maintained.**

Answer: We believe incentives should encourage investment to strengthen the nation's energy security and economic health. Energy projects are risky investments and typically require extensive lead times before they result in actual energy production. Therefore, maintaining a stable fiscal and regulatory regime is critical to this industry which commits to significant long-term investments based on the rules in place at that time. Moving forward, we believe any new incentive(s) would need to be evaluated on their own merits.

**4. In the two weeks prior to March 14, 2006, the price of oil decreased seven cents per gallon, while the price of gasoline increased by eleven cents per gallon. Why would gasoline become more expensive during this period, despite a decrease in the cost of crude oil?**

Answer: The markets for crude oil and gasoline are separate markets, and snapshots of either market can be misleading. Over the long term, crude oil is the most significant factor influencing the price of gasoline as evidenced by the trends in historical price data. However, in the short term, there are many factors that can influence gasoline prices in a local market – gasoline supply, consumer demand, taxes, etc. Prices for both gasoline and crude oil are set by the market, and although they will trend together over the long

term, they will not necessarily move in correlation at any point in time. Figure 1 below shows the prices for WTI crude oil and U.S. retail gasoline since January of 2005.

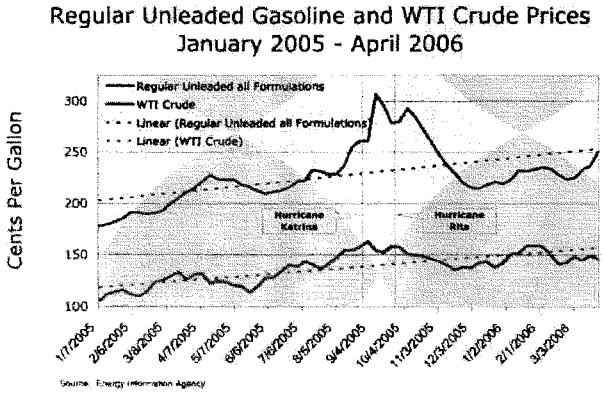



**Figure 1. U.S. Gasoline and WTI Crude Prices**

**5. With respect to the large mergers that your companies have engaged in over the past decade, what efficiencies have they produced that have benefited consumers, particularly in downstream markets?**

Answer: Chevron's merger and acquisition activity over the last decade has been driven primarily to gain strategic scale and efficiencies in our global upstream operations. The major synergy benefits of an upstream-driven merger are operating expense reductions, optimization of capital and exploratory expenditures and having greater technical, financial and other resources available to most efficiently pursue large project development to bring new energy supplies to market in a manner that benefits both stockholders and consumers.

Prior to the merger with Chevron, Texaco had entered into a joint venture of its U.S. refining and marketing operations with those of Shell in the mid '90s. However, as a consequence of Chevron's merger with Texaco, the FTC required the divestiture of Texaco's refining and marketing interests, which were sold to Shell. In 2005, Chevron acquired Unocal, which had no refining and marketing assets.

**QUESTIONS FOR THE RECORD**
**SENATOR SCHUMER**

**1. Would you please clarify which income figures your company reported to the internal revenue service last year for tax purposes, as well as the basis for those figures? Are these the same income figures reported to your shareholders? If different figures were used, what were they, what was their basis, and what is the rationale for this decision?**

Answer: Chevron's annual consolidated statement of income, which is provided to the company's stockholders and is included in the company's Annual Report on SEC Form 10-K, is prepared in conformity with accounting principles generally accepted in the United States (commonly referred to as GAAP). Taxable income reported to the Internal Revenue Service is based on the GAAP income statement adjusted to conform to the rules of the Internal Revenue Code.

**2. Based on your written testimony, it appears that your company has put at most 5% of annual investment toward developing alternative energy technologies like hydrogen fuel cells, wind, solar, and others. What is the rationale for this investment strategy? Have you decided that investment in these energy sources is not in the interest of your shareholders?**

Answer: Chevron has an active program with a broad R&D portfolio for the development of alternative energy and advanced technologies. Most alternative fuels and alternative energy technologies are in the R&D and demonstration/pilot stage and constitute a substantial component of our technology development budget (see response below). Our direct commercial investments are increasing as alternative energy technology and markets develop, but at this point are much smaller than our commercial investments in conventional oil and gas resource development. Very large investments are required to maintain and develop the oil and gas infrastructure and resources for providing reliable supplies to consumers today.

We believe our current investments in technology development are at an appropriate level. Our approach is founded on the belief that such investments must be economically sound to compete in the context of the company's broader energy technology development objectives and strategies. In considering any investments – including long-term opportunities such as alternative energy – Chevron seeks to protect and further shareholder interest, and to ensure that the investments we undertake offer the potential to provide acceptable returns in an appropriate timeframe.

In addition to investing in the development of alternative energy technologies, Chevron installs solar and fuel cell energy systems for public and institutional customers through our Chevron Energy Solutions subsidiary. Chevron Energy Solutions is among the five largest energy services companies in the United States that provide these kinds of systems. Chevron is also demonstrating the application of very large-scale solar power systems for oil field co-generation. Finally, Chevron has developed more than a quarter of the world's geothermal energy and is currently the world's largest geothermal energy producer.

**3. How much royalty relief have you received from the Department of Interior for exploration on public lands? Which public lands specifically? At what price threshold have you predicted internally that you would not need royalty relief to make exploration viable?**

Responses Submitted by Chevron to Follow-up Questions from the March 14, 2006 Hearing by the United States Senate Committee on the Judiciary

Answer: Since 2001, Chevron (Chevron, Texaco and Unocal) received an estimated $72 million of royalty relief on properties subject to Deep Water Royalty Relief and an estimated $20 million of royalty relief on properties subject to Shallow Water Deep Gas Royalty Relief. Within that same time frame, Chevron paid a total of approximately $2.8 billion in royalties to the federal government attributable to production from federal lands, both offshore and onshore. This $2.8 billion figure understates the total value of royalties paid by Chevron because it excludes the value of the large volumes of oil and gas delivered to the Government as royalty-in-kind.

Chevron received royalty relief on deepwater and shallow water Gulf of Mexico lease blocks. Since 2001, Chevron received Deep Water Royalty Relief on the following leases: Green Canyon Block 282 (off production since September 2005 due to hurricane damage); Mississippi Canyon Block 661 (off production since March 2005); Mississippi Canyon Block 705; Green Canyon Block 236 (off production since August 2004); Green Canyon Block 237 (off production since September 2005 due to hurricane damage); East Breaks Block 205; Garden Banks Block 409; Green Canyon Block 782; Green Canyon Blocks 562/563; and East Breaks Block 114 (off production since September 2002).

Since 2001, Chevron received Shallow Water Deep Gas Royalty Relief on the following leases: Grand Isle Block 90; South Marsh Island Block 217 (royalty relief volume limit reached in September 2005, royalties being paid since then); South Timbalier Block 136; South Timbalier Block 200; South Timbalier Block 35; West Cameron Block 54 Well; High Island Block 37 and West Cameron Block 48 (royalty suspension supplement received for drilling dry hole in excess of 18,000 feet true vertical depth).

Two other royalty relief programs may also apply to Gulf of Mexico leases. These are marginal property royalty relief and special case royalty relief. Our research to date indicates that Chevron has not participated in either of these programs.

Note that this response does not include information related to royalty rate reduction programs administered by MMS that are applicable to onshore public lands. These programs, which terminate this year, relate to the production of heavy crude oil and crude produced from "stripper wells."

While Chevron believes that current prices generally provide adequate incentive for today's deepwater exploration, we have not made any predictions around particular price thresholds. Chevron has always relied on the terms of its leases, including royalty relief where it applies, in evaluating project economics. Of course, individual exploration project viability and risk involve a complex set of economic, geologic, and other factors. We believe that the existing royalty relief program, which is limited to select leases, volumes and price thresholds, has worked well in achieving the purposes which Congress intended, namely to incent resource development on leases that may have otherwise gone undeveloped under economic conditions present at the time the royalty provisions were initially constructed. In fact, MMS has recently reported to Congress the success of its Deepwater Royalty Relief Program relative to increases in lease bonuses and drilling activity.

Responses Submitted by Chevron to Follow-up Questions from the March 14, 2006 Hearing by the United States Senate Committee on the Judiciary

**QUESTIONS FOR THE RECORD**
**SENATOR DEWINE**

**1. At our last hearing, we heard testimony that some of the gasoline price spikes can be attributed to regulations that create multiple grades of gasoline to comply with different environmental standards – so called "boutique fuels." What can we do to reduce the number of boutique fuels? What would be the effect of just requiring everyone in the industry to comply with the highest standard, and have just one fuel available?**

Answer: It is important to bring fuel specifications into alignment with the regional manufacturing, supply and distribution systems. As a good initial step, legislation passed last year by the House of Representatives contains provisions that would limit the number of boutique fuels to a specific slate of 4 choices for gasoline and 2 for diesel fuel. Also, granting EPA more authority to temporarily waive and pre-empt state fuel requirements in situations like we experienced during the hurricanes last year will result in quicker response to such emergencies.

We do not believe having just one fuel at the highest standard throughout the U.S. is feasible, necessary or cost effective. Having one fuel of the highest standard would mean requiring the use of California Reformulated Gasoline Phase 3 throughout the U.S. Given the number of areas that are attaining air quality standards, it does not appear necessary or appropriate to impose that formulation everywhere when one considers the significantly higher costs involved with making it.

**2. In the last couple of months most of the oil industry has announced record-breaking profits for the last fiscal year. How much is your company investing annually in exploration, production and refining, and when will we see those investments pay off? And perhaps most important, what are you investing in alternative energy sources so we can help reduce domestic dependence on foreign oil?**

Answer: Over the past four years Chevron earned $36 billion and reinvested $36 billion in the business. Last year, Chevron had net reported earnings of $14.1 billion. Chevron's worldwide investment program for 2006 is $14.8 billion – 34% higher than 2005 spending.

For 2006, $11.3 billion of Chevron's total spending program is targeted for investment in exploration, production and natural gas-related projects, including $3.3 billion in the United States. About $2.8 billion of total spending is targeted for refining, marketing and transportation, of which $1 billion is in the United States.

The oil and gas business is very capital-intensive. For example, in our upstream business we currently have over 20 projects, each with net total capital costs exceeding $1 billion and 45 projects with net total capital costs exceeding $500 million. Most of Chevron's

major capital projects are large long-term investments that will take many years to reach payout. For example, it may take 7 to 10 years to bring significant new sources online, from discovery to production.

Chevron is working on developing many forms of alternative and renewable fuels and energy sources and investing the amount necessary to pursue those endeavors practically. Since 2000, Chevron has spent more than $1 billion to develop alternative and renewable energy technologies and deliver energy efficiency solutions. In the near term, energy efficiency or conservation is the cheapest and most reliable "new' source of energy. Chevron is spending more than $300 million each year to test and develop alternatives and renewable forms of energy, including hydrogen, geothermal, advanced hybrid batteries, wind, solar and biofuels.

**QUESTIONS FOR THE RECORD**
**SENATOR FEINGOLD**

**1. The President mentioned in his state of the union address that America is "addicted to oil", and outlined several steps - including increasing investments in alternative fuels - to end the addiction. What percentage of your R&D is dedicated to alternatives? In your response, please indicate how your company defines alternatives. In addition to your R&D, what are your companies doing, as corporate citizens, to move away from fossil fuels?**

Answer: Chevron concurs with the projections of the Department of Energy and others that conventional hydrocarbons, which include oil, natural gas, and coal, will continue to provide the vast majority of energy supplies for the next few decades. However Chevron supports the diversification and the development of alternative energy supplies and more efficient use of energy to reduce projected demand. Chevron defines "alternative fuels and renewables" to include: hydrogen, bio-fuels (ethanol and bio-diesel), power generated from geothermal, wind, solar, stationary fuel cells, and advanced battery storage. Approximately 1/3 of our total R&D expenditures in 2005 were directed to alternative fuels and alternative energy (excluding geothermal). The remaining 2/3rds of our total R&D expenditures were focused on promoting technology advancements and efficiencies for conventional hydrocarbons, which as noted, remain our current, and immediate future, energy sources.

**QUESTIONS FOR THE RECORD**
**SENATOR KOHL**

**1. An independent study by the consumers group Public Citizen found that from 1999 to 2004 U.S. oil refiners increased their profits they made on each gallon of gas refined by 79%. Don't these statistics show that it is not merely the rising worldwide cost of crude oil that accounts for high prices and other petroleum products? And does the success of your industry in passing along rising crude oil prices to consumers demonstrate that your companies have gained market power and that there is a failure of competition in this market?**

Answer: The answer is no to both questions. The oil industry competes in a global marketplace and is intensely competitive, as confirmed by numerous government investigations and studies. Consolidation has allowed the oil industry to improve its efficiency and to compete in this global marketplace, where economies of scale and large size are needed to make the enormous capital investments required. Recent merger activity occurred in the last two decades when oil prices were lower, and finding additional efficiencies and deploying capital most effectively was critical to remaining competitive. Chevron's share of U.S. refining capacity has decreased from 6.8% in 1995, to a 5.4% share in 2005.

In addition, it should be noted the statement by Public Citizens referring to refiners' profits is not accurate. The statement relies on statistics published by the Energy Information Administration ("EIA") showing the difference between average refinery costs to acquire crude oil and average prices at which refineries sell gasoline to resellers. This is a "gross margin;" it does not represent refinery profits because other costs associated with manufacturing products (e.g. the cost of fuel to operate the refinery, catalyst costs, manpower costs, etc.) are not included in that particular calculation.

**2. In most competitive industries, when there are high prices, high profits to be made, and soaring consumer demand, we would expect to see an expansion of capacity to meet this demand. Yet in the oil industry this has not happened. Instead of opening new refineries, the industry has closed more than half of all that existed 25 years ago. In 1981, there were 324 refineries operating in the United States – today there are 149. According the Department of Energy, in the period from 1981 to 2004 overall national refining capacity has declined by more than 9% while demand for gasoline rose by 37%. Oil industry critics suggest that this decline in refining capacity is no accident – that oil companies actually prefer to keep supplies tight in order to be able to gain market power to raise price. Indeed, many economists believe this is a central reason why gas prices are so high.**

**So why hasn't your industry opened new refineries while closing so many existing ones? Does the failure of the oil industry to open new refineries suggest an effort to keep supplies tight or something anti-competitive going on?**

Answer: During the 1980s and early 1990s, the industry had spare refining capacity and was faced with the requirement to invest significant amounts of capital to comply with more stringent environmental regulations. In certain cases, it was uneconomic to make those incremental investments, which resulted in the closure of some refineries.

While it is true that the number of refineries has steadily decreased, total U.S. refining capacity has, in fact, increased (see Attachment D in Chevron's Written Testimony to the Judiciary Committee). Although no new refineries have been built for some time, many existing refineries have become larger, more efficient, and more complex (better equipped to handle less desirable but more readily available heavy and sour crude slates). A combination of the high cost to build a new refinery (billions of dollars), economic and regulatory uncertainty, lengthy and convoluted permitting processes, and lack of

acceptance from neighbors, all create significant disincentives for constructing new refineries and at times limit expansion of existing facilities.

**3. In the last 15 years there has been a tremendous amount of consolidation in the oil industry – the GAO counts 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 has concluded that these mergers have raised gasoline prices.**

**(3a) What is your view of the effects of these mergers on competition in your industry and the price of petroleum products?**

Answer: We believe that the referenced mergers as approved by the FTC with associated mandated divestitures were not injurious to competition. Industry structure varies greatly from industry to industry, and depends upon the costs of entry, capital intensity, technology, economies of scale, historical developments, the regulatory environment, and many other factors. The true level of competition in an industry often depends more upon these factors than on the number of mergers or on formal industry concentration measures. In fact, many industries, including automobile manufacturing, aircraft manufacturing, and home center retailing, are more concentrated than the petroleum industry.

The petroleum industry is very capital intensive and the leading companies operate globally; hence, they are very large in size, but their shares of market within regional and local distributive areas in the U.S. are well within competitive norms.

The market price of petroleum products derives from the price of crude oil and other inputs to the refining process and the supply of and demand for petroleum products. Chevron mergers have resulted in operating expense reductions, optimization of capital and exploratory expenditures, and having greater technical, financial and other resources available to most efficiently pursue large project development to bring new energy supplies to market in a manner that benefits both stockholders and consumers. Also as noted in Chevron's written and oral testimony – despite periods of volatility – gasoline prices have increased at a lower rate than many other consumer goods and services over the past 35 years.

**(3b) Are we likely to see even more consolidation in the years ahead? If so, what will this mean for competition in this industry?**

Answer: It is impossible to predict whether we will see more consolidation. Many capital intensive industries have tended to consolidate over time, but technological developments, changing economics and divestitures have created new competitors. We are now in a period of great change in the energy sector. With significant investment needed to provide new energy

supplies and to develop new technologies and alternative fuels, it is likely the industry will continue to evolve, which may include additional merger activity.

Responses Submitted by Chevron to Follow-up Questions from the March 14, 2006 Hearing by the United States Senate Committee on the Judiciary

**Attachment 1**
**Comments on Draft Bill "Petroleum Industry Antitrust Act of 2006"**

**Section 2: Unilateral Supply Decisions:** The bill could outlaw legitimate, efficiency-enhancing decisions that are appropriate responses to supply and demand conditions through its intent-based standard for establishing antitrust violations. For example, if this legislation had been in effect in 2005, a company would have exposed itself to the risk of liability if it had chosen to move supplies from the Pacific Northwest and Northeast to Hurricane-impacted areas of the U.S., where prices might have been higher due to supply disruptions. That is because the draft bill provides that an illegal intent to violate the antitrust laws can be demonstrated if the price a supplier obtains from moving product is greater than the price obtained where the existing supplies are located. This form of antitrust regulation, which seeks to define "intent" with reference to cost and price variables, is subject to gross misinterpretation. It runs counter to the general direction of antitrust law, which has come to focus on market power and competitive effects.

**Sections 3 and 4: Merger Review:** The overall goal of the draft merger provision is to reduce the burden of proof with respect to merger prosecutions from "substantially lessen competition" to "appreciably diminish competition." The phrase "substantially lessen competition" benefits from more than 50 years of Supreme Court precedents, as well as the well-established enforcement practices of the federal agencies under the economic tests of the Merger Guidelines. While the new language obviously must be intended to mean something different, it would take years of litigation to transform this ambiguous language into something that could be effectively and fairly applied by courts.

Moreover, industry-specific rules, particularly those dealing with mergers and acquisitions, tend to strand capital, distort investment incentives, and disadvantage U.S. competitors relative to international firms. Existing antitrust laws have proven to be sufficiently broad and flexible enough to address competitive problems across the full range of industry settings. These laws, including the procedures for premerger notification and review, have served our country well, and the U.S. model has been widely adopted around the world as a best practice. A recent Federal Trade Commission study of oil and gas mergers concluded that in applying the "substantially lessen competition" standard federal agencies have been <u>more</u> stringent in the oil industry than in most other industries – i.e., they have tended to challenge oil and gas industry mergers resulting in lower levels of concentration than in other industries. Competition remains intense, and mergers have helped firms like Chevron remain competitive in an increasingly global marketplace, where we compete against larger and increasingly aggressive foreign -- including many state-owned -- oil companies.

**Section 5: Information Exchanges:** The draft bill proposed to create a joint federal and state task force to review the scope of information exchanges occurring among industry participants. Chevron will comply with any obligations the company

may have regarding any information requests if a task force is formed, but it is not clear to us why a task force is necessary. In general, markets with more transparent information flows function more efficiently, encourage competition, and prevent distortions. By contrast, a lack of information can result in a poorly functioning market or facilitate market manipulation. Most commonly, firms might share information with a competitor that is related to a joint venture, joint production arrangement, or other legitimate collaborative activity in which both are involved. This is both normal and necessary in an industry that depends heavily on joint venture activity of various kinds to develop energy resources.

Information exchange within the oil and gas industry has been frequently investigated by federal and state antitrust authorities with virtually no meaningful enforcement actions. Thus, this feature of the bill seeks to address what has proven to be a non-issue. The costs of further investigations will simply increase industry compliance costs with no corresponding public benefit.

**Section 6: NOPEC:** Chevron has concerns that, as drafted, the legislation could outlaw legitimate joint venture and other collaborative activities between Chevron and national oil companies. The bill prohibits any joint action "to set or maintain the price" of petroleum products, but as the Supreme Court recognized in its recent *Dagher* decision, a joint venture must set the prices of the products it produces and sells. Thus, while Chevron certainly applauds the desire to improve the competitiveness of the world crude market, it is not clear to us that this will actually accomplish that purpose without some unforeseen and presumably unintended consequences. The relationships between the United States and the OPEC nations are complex, encompassing a broad range of security, geopolitical, economic and other foreign policy considerations. The draft legislation addresses only one dimension of that relationship. As a private company, Chevron is not privy to the facts that might influence those relationships and thus would not opine as to whether such legislation would be in the best interest of the United States. Ultimately, Chevron believes it is important for the United States government to constructively engage other governments, to ensure access to resources and to help open up the additional sources of energy the world needs.

**Senator Specter**
**Questions – Ross Pillari**
**Consolidation in the Oil and Gas Industry: Raising Prices?**
**March 14, 2006**

**Q1. Please provide an analysis of the draft bill, the "Petroleum Industry Antitrust Act of 2006," which was submitted to the Congressional Record earlier this month.**

*We respect Congress's role as policy makers, including its role in considering new regulation of the petroleum industry, and we appreciate the opportunity to comment upon the possible impact any new regulation might have. Our initial reaction to the draft bill "Petroleum Industry Antitrust Act of 2006" is that, while its intent is the creation of a more efficient energy market and greater US energy security, it risks causing unintended harmful effects and directly opposite outcomes.*

*The US economy has been well served for nearly a century by its antitrust laws and the application by regulators and courts of its well-established principles. These principles are flexible, balanced and capable of fit-for-circumstance application in a highly dynamic global economy. Equally important, these principles have the benefit of decades of construction and application and thus are well understood by regulators, regulated parties and other market participants alike. This long history of consistent construction and application and the relative certainty that it brings allows markets to operate predictably and efficiently. The petroleum industry presents no special exception in this context – it operates in the same world economy and pursuant to the same rules of supply/demand and other economic principles as other industries.*

*Section 2 of the proposed bill provides one example of the risk of harmful consequences. Section 2 would make it unlawful for a company to make or to decline to make certain hydrocarbon sales based upon the company's "primary intention of increasing prices or creating a shortage" either in the market where the products currently are or in the market where they are intended to be shipped. This standard is ambiguous and, consequently, would create uncertainty as to whether a range of presumably efficient conduct and normal market activity previously understood to be legal is now unlawful. This uncertainty, in turn would likely inhibit the natural movement of supply to match demand and could cause extreme price volatility.*

*For example, assume that both Chicago and Detroit markets are in tight gasoline supply/demand balance when, due to temporary supply disruption, the Detroit gasoline market tightens further. What are the consequences under this proposed bill for a company that sells gasoline stored in Chicago to a Detroit-area jobber, knowing in advance that a possible consequence of that sale may be to reduce supply in Chicago with a related Chicago price impact? What would be the consequence for that company if it "refused" to sell some volume to a requesting would-be buyer in Detroit? What if several sellers decided simultaneously to sell gasoline to buyers in Detroit with the eventual and apparent-only-later result that the market in Chicago grew temporarily tighter than the Detroit market?*

*The potential for uncertainty is further increased by the fact that a company's "primary intention" in making or declining to make a sale cannot be determined with precision at the time of decision. Under the proposed bill, a company's subjective "primary intention" may only be determined with precision after a sale or declined sale is challenged, evidence is developed and presented, a judge or jury makes its findings of fact on likely disputed evidence, and all appeals are exhausted. The determination of "primary intention" may be particularly hard to make when, as is often the case, other factors are involved. Taking the hypothetical circumstances from the preceding paragraph, what would be the outcome if one of the considerations influencing a possible seller was the poor credit position of the would-be buyer or other debated terms of sale, but those considerations were coupled with an awareness of the impact that any sale or "refusal" to sell would have on price and supply in Detroit and Chicago?*

*The considerations are slightly different in the international context because only one of the markets involves US consumers. But otherwise there is no difference – the same uncertainties and possibilities that presumably efficient conduct will be chilled remains. (To the extent that foreign transactions are chilled or burdened by this proposed new law, trade laws may also be implicated.)*

*Current antitrust law generally allows a private party to make decisions for its own "primary intentions" as to what to sell and when and where to sell it, premised on the belief that the aggregate effect of all such individual decisions will optimize efficient patterns of economic behavior. Burdening energy markets with transactional uncertainty and inefficiency is more likely to increase than to decrease energy prices and price volatility.*

*Section 3 of the proposed bill would prohibit certain mergers in the oil and gas industry if the effect of a transaction "may be to appreciably diminish competition." This new language standard for evaluating mergers and acquisitions does not have the benefit of years of application and construction as does the current language of the Clayton Act. So for a number of years the meaning of this new language would be uncertain, and its application – judging from most prior experience with new statutory language – likely would be uneven.*

*Uneven application of uncertain law is almost always costly and inefficient. In this particular context, it may result in parties avoiding some – perhaps many – efficient new combinations of assets that would benefit US energy markets and consumers alike and contribute positively to US energy security. Existing antitrust law is fully capable of regulating mergers and acquisitions in the oil and gas industry without the risk of uneven application of uncertain law.*

*Sections 4 and 5 of the proposed bill request studies. We agree that good public policy requires good information and analysis to aid its development. Our only observation here is that we would urge Congress to assure that qualified resources are devoted to these studies and that the work is conducted by objective professionals free from regional or*

*political influences in a manner most likely to result in methodologically sound data and analysis.*

*We have no observations to make with respect to section 6 of the proposed bill. These policy choices concern the relationship between the US and foreign nations and are for the US Government to make, not private companies. We would defer entirely to the US Government on this issue.*

**Q2. What steps can be taken to decrease consumption of oil and natural gas?**

*In this area BP supports the work of the Alliance to Save Energy, of which we are a member. I refer you to document they have prepared concerning energy efficiency measures. It contains several ideas on appliance and equipment standards, building codes, energy management, transportation efficiency and utility measures that may be helpful to inform the policy discussion. BP supports many of these provisions, particularly those that provide consumer incentives to purchase energy saving or alternative technology products. A direct link to the document can be found at: http://www.ase.org/uploaded_files/policy/Energy%20bill%20Provisions_Vision2010.pdf*

**Q3. Please provide an analysis of the incentives offered to petroleum companies by the federal government that explains what the incentives are intended to do, which incentives are important to you, and why they should be maintained.**

*A consistent, stable tax environment is of primary importance to BP, as it is to all taxpayers. Operating with certainty is key to the investment of funds at all commercial stages, including exploration, development and expansion. As to which "incentives" would be important to BP, we respectfully submit that this information is commercially sensitive and proprietary. We are willing to meet with you privately to discuss these matters under proper protections of confidentiality.*

**Q4. In the two weeks prior to March 14, 2006, the price of oil decreased seven cents per gallon, while the price of gasoline increased by eleven cents per gallon. Why would gasoline become more expensive during this period, despite a decrease in the cost of crude oil?**

*Over the course of a year there are frequently times when crude and street prices move in opposite directions.*

*Based on data published by EIA, the price of crude increased and decreased during the two week period prior to March 14. From February 28 to March 13 crude increased five cents during the first four days, fell nine cents over the next seven days, and rose 5 cents over the final few days in the two week period. The net change in WTI crude price from February 28 to March 13 was a one cent per gallon increase. Street prices increased eleven cents over that same period of time. Clearly crude prices and street prices can move independently and in opposite directions over short periods of time.*

*However, if we extend the analysis to the two week period prior to the time frame posed in the follow-up question, crude price rose more than three cents between February 14 and February 27. During that very same time period, street prices actually decreased by three cents per gallon. Although crude prices will ultimately have an impact on the price of finished product sold at retail locations over time, there is no direct and immediate linkage between the market price of crude and a retail gasoline price.*

*Day-to-day changes in street prices are caused by many factors including competitor price, cost of spot gasoline which is heavily impacted by supply and demand, transportation charges, taxes, volume/margin performance, etc. For BP, there is not a direct relationship between spot crude prices and our street price decision making. Retail street prices are determined by a different set of variables than crude price in the market place. The link in a trend between crude and street price increases or decreases over long periods of time is supported by data, but the supply chain is long and complex between the two, making any short-term correlation irrelevant.*

**Q5. With respect to the large mergers that your companies have engaged in over the past decade, what efficiencies have they produced that have benefited consumers, particularly in downstream markets?**

*The US refining industry today is more efficient and productive than the US refining industry of the past. Today, these refineries, through improved efficiency and investment, produce 80 billion gallons a year more product than US refineries did 20 years ago.*

*In response to regulatory requirements, refiners today must make a greater variety of more costly and complex fuels. BP has invested in larger and more sophisticated refineries in order to meet these requirements. BP operates five US refineries in Toledo (OH), Whiting (IN), Texas City (TX), Carson (CA) and Cherry Point (WA). These refineries represent less than nine percent of US refining capacity. Since the late '90s, BP has reduced its share of US refining by selling four US refineries. Each of these divested refineries continues to operate today.*

*During the past five years, BP has invested roughly $700 million per year in new capital focused primarily upon meeting environmental regulations, fuel specification requirements and maintaining reliability and efficiency. Last year, BP announced a two billion dollar option to bring Canadian heavy crude oil to our Northern US refineries in order to obtain access to secure North American crude oil.*

*In the last 10 years, we have seen increased competition from hypermarkets, convenience store chains and large independent jobbers. Since the late '90s, BP branded share of the retail market has been reduced to roughly 12 percent, while the hypermarket segment has quadrupled during this same time to nearly 11 percent. Today, over 90 percent of BP's branded retail outlets are operated by independent business men and women. BP also supplies unbranded gasoline to independent retailers in many of our markets. At the same time, supplies to these markets have been reliable and have responded quickly to natural*

*disasters and operating disruptions, with minimal outages. All of these factors contribute to a highly competitive retail market.*

**Senator DeWine**
**Questions – Ross Pillari**
**Consolidation in the Oil and Gas Industry: Raising Prices?**
**March 14, 2006**

**Q1. Participants in the oil industry routinely describe the retail market as highly competitive. If the markets for retail gasoline are so competitive, why do gas prices seem to spike up so quickly when we have a supply problem, but then take a long time to drift back down, even when the problems are resolved?**

*Day-to-day changes in street prices are caused by many factors including competitor price, cost of spot gasoline which is heavily impacted by supply and demand, transportation charges, taxes, volume/margin performance, etc. For BP, there is not a direct relationship between spot crude prices and our street price decision making. Retail street prices are determined by a different set of variables than crude price in the market place. The link in a trend between crude and street price increases or decreases over long periods of time is supported by data, but the supply chain is long and complex between the two, making any short-term correlation irrelevant.*

*Retail prices do tend to lag wholesale movements up and down over time, however retail prices do not move as a result of wholesale price changes alone. The wholesale price is only one of many factors that are considered when setting prices. Other factors that are considered when setting retail prices include competitor price, year-to-date volume and margin performance, supply, etc.*

**Q2. At our last hearing, we heard testimony that some of the gasoline price spikes can be attributed to regulations that create multiple grades of gasoline to comply with different environmental standards – so called "boutique fuels." What can we do to reduce the number of boutique fuels? What would be the effect of just requiring everyone in the industry to comply with the highest standard, and have just one fuel available?**

*BP supports efforts to reduce the number of boutique fuels across the U.S. This would increase the industry's ability to provide product to the American public by simplifying delivery logistics across the US. Typically, the more stringent the standards are for a "boutique fuel", the greater the cost to produce such a fuel. The production cost of a "boutique fuel" will likely vary from refinery to refinery. Retail and wholesale prices are a function of supply and demand and it is impossible to quantify the impact that cost has on short term prices. However, reducing the number of "boutique fuel" formulations to five would help to maintain air quality and reduce logistical constraints. The five-fuel slate for the summer season would consist of 9.0, 7.8 and 7.0 psi RVP conventional gasoline, RFG and CARB gasoline with CARB gasoline limited to California and its natural distribution system.*

*The recently passed Energy Bill establishes a "Cap" at the current number of boutique fuels in commerce. However, it also allows an individual state to adopt its own mandate for alternative fuel blends like 10% ethanol. These state-level mandates create new boutique fuel demands and exacerbate efforts to meet other federal fuel programs like the renewable fuels standard (RFS).*

**Q3. In the last couple of months most of the oil industry has announced record-breaking profits for the last fiscal year. How much is your company investing annually in exploration, production and refining, and when will we see those investments pay off? And perhaps most important, what are you investing in alternative energy sources so we can help reduce domestic dependence on foreign oil?**

*The following presents BP's capital expenditures over the 2000-05 periods.*

***Global Capital Expenditures ($millions)***

| *Total BP* | ***2000*** | ***2001*** | ***2002*** | ***2003*** | ***2004*** | ***2005*** |
|---|---|---|---|---|---|---|
| *Capital Expenditures* | *10,937* | *13,167* | *13,303* | *13,597* | *13,810* | *13,938* |

*Figures from BP's ARA and F&OI 2000-2005*
*Note: Data is provided since 2000 because that is the year when BP completed the major consolidation of the Arco and Burmah Castrol acquisitions. Using financial and operational data prior to 2000 would not be comparable as BP was a much smaller company than it is today.*

*Over the last 5 years BP has invested over $31 billion in the United States to serve our customers and help meet the nation's need for energy.*

*Our U.S. investments have included continued expenditures in mature operations such as $700 million per year in Alaskan North Slope fields, a 30% increase in lower-48 natural gas fields over the last two years to $1.5 billion this year, and over $650 million per year in refinery investments. Additional investments have also been made to maintain terminal and pipeline capability and to meet new regulations affecting distribution and marketing.*

*For the future we see continued opportunities to invest in the United States. Projects currently announced include:*

- *$2 billion for new development and infill drilling in the Wamsutter natural gas field in Wyoming. This investment is expected to double BP's net production to 250 million standard cubic feet by the end of the decade.*

- *Two proposed LNG projects, one on the East Coast and one on the Gulf Coast at a cost of $1.2 billion. These projects will allow us to access our natural gas position in Trinidad*

*and elsewhere in the world; and if approved, potentially add 2.4 billion cubic feet send out capacity of LNG to supply markets in the USA.*

• *$300 million to increase the use of Canadian heavy oil at BP's Midwest refineries in order to secure a North American source of crude oil supply.*

• *$2 billion per year sanctioned investment through the rest of the decade as a part of our continuing program to invest over $15 billion in exploration and production in the Gulf of Mexico.*

• *BP has publicly announced its intention to participate in the $20 billion Alaskan Natural Gas Pipeline to bring Alaskan gas to the lower 48. We, together with other interested parties, have recently completed a commercial agreement with the State of Alaska and are awaiting legislative approval.*

• *BP recently announced the creation of a new business unit called BP Alternative Energy. It will manage an investment program in solar, wind, hydrogen and combined-cycle-gas-turbine (CCGT) power generation, which could amount to $8 billion over the next ten years.*

*BP Alternative Energy Press Announcement:*
*http://www.bp.com/genericarticle.do?categoryId=2012968&contentId=7012352*
*BP Carson Hydrogen Project Press Announcement:*
*http://www.bp.com/genericarticle.do?categoryId=2012968&contentId=7014858*
*Carson Hydrogen Project Animation:*
*http://www.bpalternativenergy.com/liveassets/bp_internet/alternativenergy/how_it_works_hydrogen.html*

**Senator Feingold**
**Questions – Ross Pillari**
**Consolidation in the Oil and Gas Industry: Raising Prices?**
**March 14, 2006**

**Q1. On February 1, 2006, while this Committee was conducting its first hearing related to consolidation in the oil and gas industry, reports came out that Valero Energy Corporation had restricted output from a refinery in Ohio by more than 10 percent because of lower profit margins. In late January, BP cut production between 10-15 percent at an Indiana refinery. These actions appear to indicate that reductions in the number of refineries have nothing to do with high prices, as some have indicated. In the face of record profits, why did your companies reduce refinery output?**

*In January, 2006 BP's Indiana refinery crude throughput was at full capacity. However, based on the crude types and qualities available, refinery yields of gasoline declined. Also during this period, the Midwest market was experiencing very high inventory levels of finished gasoline. EIA data for the period reflect that inventories of gasoline and blend*

*stocks were at nearly a 3-year high while gasoline sales were at their lowest levels since early 2002. Refinery throughput is optimized daily, taking into account retail demand and inventory levels. Operational changes that occurred at Whiting reflect nothing more than a seasonal response to these supply/demand factors.*

**Q2. The President mentioned in his state of the union address that America is "addicted to oil", and outlined several steps - including increasing investments in alternative fuels - to end the addiction. What percentage of your R&D is dedicated to alternatives? In your response, please indicate how your company defines alternatives. In addition to your R&D, what are your companies doing, as corporate citizens, to move away from fossil fuels?**

*BP has invested approximately $600 million in our alternative energy business over the past five years. BP Solar is in the process of more than doubling its annual global manufacturing capacity from 90MW to 200MW to be complete by the end of 2006. The first part of that expansion is seen in a $25 million investment at our Frederick, Maryland plant - that part of the expansion project is now complete and the company is focusing on finalizing the rest of the expansion plan at facilities in Madrid, Bangalore, and Sydney.*

*In November 2005, BP announced a new business called Alternative Energy. This includes both zero-carbon renewable energies such as solar and wind, technologies to reduce the carbon impact of using fossil fuels (hydrogen power) and our gas-fired power business. Our stated intention is spend $8 billion in this business over the next 10 years.*

*The first major US carbon sequestration project for power in this business (the Carbon Hydrogen Power Plant) was announced a month ago. This spend will deliver 500 MW of power to the grid in the LA area. It is a joint project with Edison with the next major deadline being a detailed technical and economic study being complete in 2008. Current project costs are about $1 Billion. BP is conducting research on the use of biomass for the creation of a new fuel molecule. We believe technological advances over the next several years will allow cellulosic-based fuels to play a larger role in the transportation fuels sector. This will be good for both energy and agricultural policy BP has a firm commitment to ethanol based fuels as is evidenced by our having all of our 13,000 locations nationwide configured to sell ethanol based products. We are one of the largest sellers of ethanol based fuels, selling more than 575 million gallons and entering 20 new markets in 2005. We continue to evaluate ethanol based fuel products, their long-term viability as a renewable fuel as well as invest in technology to support the development of other renewable fuel products solutions.*

**Senator Kohl**
**Questions – Ross Pillari**
**Consolidation in the Oil and Gas Industry: Raising Prices?**
**March 14, 2006**

**Q1. An independent study by the consumers group Public Citizen found that from 1999 to 2004 U.S. oil refiners increased their profits they made on each gallon of gas refined by 79%. Don't these statistics show that it is not merely the rising worldwide cost of crude oil that accounts for high prices and other petroleum products? And does the success of your industry in passing along rising crude oil prices to consumers demonstrate that your companies have gained market power and that there is a failure of competition in this market?**

*Our review of the testimony to this Committee by Mr. Slocum (Director of Public Citizen's Energy Program) indicates that his references to increases in refiner profits are not the result of an independent study by his group and are not really about profits. Although twice in his testimony (at pages 2 and 4), he suggests that his figures detail refiners' "profits" and "profit margins," it is clear from his source material (referenced at page 2, footnote 6), that he is describing information from the Energy Information Administration (EIA) available at http://www.eia.doe.gov/emeu/aer/pdf/pages/sec5_53.pdf. The "refiner margin" for motor gasoline detailed by the EIA at the referenced source is not profit but rather "is the difference between the composite refiner acquisition price of crude oil and the price to resellers." As such, the cents per gallon numbers used by Mr. Slocum represent the entire crude-to-distributed-product differential from which all costs of acquisition, refining and distribution would need to be subtracted before determining any refiner's profits, if any, in a given year.*

*Mr. Slocum's testimony featured only a portion of the full 18 year (1988-2004) time period covered by the EIA table used as his source data. What that EIA data shows is that, during the period 1988-1999, that "refiner margin" ranged narrowly from a low of 21.6 cents (1995) to a high of 25.7 cents (1990) and averaged 23.3 cents. During the six years referenced by Mr. Slocum, that "refiner margin" ranged from 22.8 cents in 1999 to 40.8 cents in 2004 and averaged 30.7 cents. The average "refiner margin" during the full 18 year period was 25.8 cents. The "refiner margin" increased by 79% over the full 18 year period and also over the six years featured by Mr. Slocum (the "refiner margin" in 1988 and in 1999 was 22.8 cents compared to 40.8 cents in 2004). What these statistics show is that the "refiner margin" as defined by the EIA has been a portion of the ultimate consumer price for gasoline for 18 years (and, of course, at all relevant times), was relatively low for most of the 18 year period 1988-2004, and increased by 18 cents during the period 1999-2004 – an average of 3 cents per year. We agree that these statistics show that increases in the ultimate price of gasoline during the six year period 1999-2004 were not solely attributable to increases in the price of crude oil, but to this limited extent also reflected increases in the "refiner margin."*

*We do not agree that increases in consumer gasoline prices that correspond generally with increases in crude oil prices demonstrate that US refiners "have gained market power and that there is a failure of competition in this [US gasoline] market." US gasoline markets are competitive, and prices in those markets reflect the normal workings of supply and demand in the context of high and rising US gasoline demand.*

**Q2. In most competitive industries, when there are high prices, high profits to be made, and soaring consumer demand, we would expect to see an expansion of capacity to meet this demand. Yet in the oil industry this has not happened. Instead of opening new refineries, the industry has closed more than half of all that existed 25 years ago. In 1981, there were 324 refineries operating in the United States – today there are 149. According the Department of Energy, in the period from 1981 to 2004 overall national refining capacity has declined by more than 9% while demand for gasoline rose by 37%. Oil industry critics suggest that this decline in refining capacity is no accident – that oil companies actually prefer to keep supplies tight in order to be able to gain market power to raise price. Indeed, many economists believe this is a central reason why gas prices are so high. So why hasn't your industry opened new refineries while closing so many existing ones? Does the failure of the oil industry to open new refineries suggest an effort to keep supplies tight or something anti-competitive going on?**

*The focus on the number of US refineries is an irrelevant measure when evaluating refiner ability to meet consumer demand. The consolidation that occurred in the oil and natural gas industry in the 1990s took place as a consequence of economic pressures and regulatory requirements. These catalysts for change forced companies to realize economies of scale and to cut costs further. Whereas the industry once only produced two types of gasoline –leaded and unleaded, it now has 17 formulations. Furthermore, as the following chart prepared by API shows, twenty years ago there were 200 refineries producing about 250 billion gallons of product. Today there are just 148 making 330 billion gallons per year (Chart 1).*

*Since the late 1990's, BP has sold four refineries, each of which is still operating (Alliance, Mandan, Salt Lake City, and Yorktown). They represent about 3.6% of the current refining capacity in the US.*

*In general, new refinery construction has been largely uneconomic for most of the past 20 years due to the low level of profitability in the industry. And, although profitability has improved over the past few years, capital invested in refining has gone mainly for construction of pollution control equipment required by Federal and State regulations, and to construction of processing capability necessary to furnish fuels required by Federal fuels regulations BP is planning a $2 billion project focused on bringing Canadian crude to our existing Northern tier refineries (Whiting, IN; Toledo, OH, Cherry Point, WA).*

*This investment will improve the security of crude supply and give better assurance of keeping refinery runs at maximum. Modest increases in gasoline production are anticipated.*

*Outside the Canadian crude project, BP is spending approximately $700 million per year to insure that our US refineries operate safely, in an environmentally appropriate way and achieve a high degree of availability to the American public.*

**Q3. In the last 15 years there has been a tremendous amount of consolidation in the oil industry – the GAO counts 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 has concluded that these mergers have raised gasoline prices.**

**(a) What is your view of the effects of these mergers on competition in your industry and the price of petroleum products?**

*BP believes that our size and scale help the American people. It has allowed us to continue to grow crude oil production and a long term reserve base and rapidly provide product in times of crisis (i.e., the 2005 hurricane season).*

*The price of crude oil is set by world markets. BP's mergers have better positioned it to participate in the specific areas in Upstream that require large investments that only large companies are well equipped to manage. This provides America with access to a long term energy supply. The price of crude oil is tied to global markets and the supply / demand balance. It has allowed us additional access to global oil and gas which increases supply. However, for prices at the pump, there has been significant competition introduced into the system with the high volume resellers and hypermarkets. This has intensified competition in the retail market which in turn provides the American consumer with more options.*

*The GAO report has drawn some conclusions and much criticism from the oil industry and third parties. Our research has not found any impact on wholesale prices as a result of the mergers. We believe the global market activity, and the significant role the USA plays in this market is affecting domestic prices. The FTC, in a statement issued by Chair Timothy J. Muris shortly after its release, had this to say about the GAO report:*

*"In 30 years as an antitrust enforcer, academic, and consultant on antitrust issues, I have rarely seen a report so fundamentally flawed as the GAO study of several oil mergers that the Federal Trade Commission investigated under by predecessor, Robert Pitofsky. As the Commission unanimously said in its August 2003 letter to the GAO, this report has major methodological mistakes that make its quantitative analyses wholly unreliable; relies on critical factual assumptions that are both unstated and unjustified; and present conclusions that lack any quantitative foundation. As a result, the report does not meet GAO's own high standards of "accountability, integrity, and reliability" that one expects from its reports and publications."*

**(b) Are we likely to see even more consolidation in the years ahead? If so, what will this mean for competition in this industry?**

*BP can't predict whether more consolidation in the industry will be necessary or occur sometime in the future to meet the demands of the marketplace. Similarly, it also can't be ruled out. Regardless, based on objective measures industry's ability to meet growing consumer demand through periods of supply uncertainty demonstrates that the marketplace responds efficiently. We are confident that left unfettered the market will continue to provide the product the growing economy demands.*

**Senator Charles E. Schumer**
**Questions – Ross Pillari**
**Consolidation in the Oil and Gas Industry: Raising Prices?**
**March 14, 2006**

**Q1. Would you please clarify which income figures your company reported to the internal revenue service last year for tax purposes, as well as the basis for those figures? Are these the same income figures reported to your shareholders? If different figures were used, what were they, what was their basis, and what is the rationale for this decision?**

*Under the provisions of the Internal Revenue Code, corporate taxpayers are required to report in annual tax returns both their financial income and their taxable income. The former is comparable to what is reported to shareholders; the latter is determined by a strict application of the Internal Revenue Code, and ordinarily, is substantially different from what is reported to shareholders.*

**Q2. Based on your written testimony, it appears that your company has put at most 5% of annual investment toward developing alternative energy technologies like hydrogen fuel cells, wind, solar, and others. What is the rationale for this investment strategy? Have you decided that investment in these energy sources is not in the interest of your shareholders?**

*BP has invested approximately $600 million in our alternative energy business over the past five years. BP Solar is in the process of more than doubling its annual global manufacturing capacity from 90MW to 200MW to be complete by the end of 2006. The first part of that expansion is seen in a $25 million investment at our Frederick, Maryland plant - that part of the expansion project is now complete and the company is focusing on finalizing the rest of the expansion plan at facilities in Madrid, Bangalore, and Sydney.*

*In November 2005, BP announced a new business called Alternative Energy. This includes both zero-carbon renewable energies such as solar and wind, technologies to reduce the carbon impact of using fossil fuels (hydrogen power) and our gas-fired power business. Our stated intention is spend $8 billion in this business over the next 10 years.*

*The first major US carbon sequestration project for power in this business (the Carbon Hydrogen Power Plant) was announced a month ago. This spend will deliver 500 MW of power to the grid in the LA area. It is a joint project with Edison with the next major*

*deadline being a detailed technical and economic study being complete in 2008. Current project costs are about $1 Billion.*

*BP is conducting research on the use of biomass for the creation of a new fuel molecule. We believe technological advances over the next several years will allow cellulosic-based fuels to play a larger role in the transportation fuels sector. This will be good for both energy and agricultural policy.*

**Q3. How much royalty relief have you received from the Department of Interior for exploration on public lands? Which public lands specifically? At what price threshold have you predicted internally that you would not need royalty relief to make exploration viable?**

*The Deep Water Royalty Relief Act was enacted in 1995 as a program to promote energy production in federal offshore waters where production could otherwise prove uneconomic because of high exploration, development, and operating costs. BP is engaged in a multi-year $15 billion deepwater exploration and development program and through 2005 has received deep water royalty relief totaling $198.7m, none of which is attributable to leases in which price thresholds have been exceeded.*

*BP has honored and will continue to honor the terms of its federal leases. Believing that the Federal government will do the same, BP relies on its lease terms when making investment decisions. Proposed alterations to the royalty relief lease provisions will negatively impact our projects and could affect BP's future offshore oil and gas investments. Royalty relief was a Congressional incentive offered to the oil and gas industry to develop properties in areas of the Gulf of Mexico where development was technologically risky. Even in today's current high price environment, development in those areas of the Gulf of Mexico remains challenging.*

*The vast majority of BP's leases include price threshold provisions that eliminate royalty relief during high price periods. We continue to comply with all leases that contain price threshold provisions.*

**Daniel Nelson**
Vice President
Washington Office

April 7, 2006

The Honorable Arlen Specter
Chairman
Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Specter:

Enclosed please find our company's responses to the questions posed by respective committee members after the hearing you chaired on March 14, 2006.

Thank you for the opportunity to participate in the hearing and provide you with our views concerning the important energy policy challenges facing our country.

Sincerely,

*Enclosure*

**Exxon Mobil Corporation** 2000 K Street, NW, Suite 210, Washington, DC 20006

**Senator DeWine**
**Questions**
**Consolidation in the Oil and Gas Industry: Raising Prices?**
**March 14, 2006**

1. Tillerson, Mulva, O'Reilly, Klesse, Hofmeister, Pillari, Borenstein - At our last hearing, we heard testimony that some of the gasoline price spikes can be attributed to regulations that create multiple grades of gasoline to comply with different environmental standards – so called "boutique fuels." What can we do to reduce the number of boutique fuels? What would be the effect of just requiring everyone in the industry to comply with the highest standard, and have just one fuel available?

**Answer:** Today in the U.S. there are about 20 different gasoline formulations in use due to various mandates from the EPA, the states, and local jurisdictions. The most stringent standards are those mandated by the California Air Resources Board (CARB).

- The number of gasoline boutique fuel designations should be reduced to five formulations - conventional gasoline plus four fuels for National Ambient Air Quality Standard (NAAQS) non-attainment areas. The four additional options would be California Reformulated Gasoline (RFG) for California only; federal RFG for areas eligible under the Clean Air Act to opt-in to the RFG program; a 7.8 Reid Vapor Pressure (RVP) volatility control gasoline for modest non-attainment areas; and a more stringent 7.0 RVP volatility control gasoline for areas with a more significant non-attainment problem.
- Diesel fuel formulations should be limited to two grades: CARB diesel for California only and EPA diesel for the rest of the country.

CARB requires stringently refined gasoline and diesel to address California's unique air quality problems, which are the most severe in the country. Requiring these types of motor fuel nationwide could lead to a number of problems related to cost and supply.

- The stringent CARB specifications themselves will result in a reduction in gasoline and diesel production in the short term at a minimum.
- CARB gasoline and diesel is much more costly to produce. It would not be cost-effective to require these special products in areas that do not have the severe air quality problems found in California.
- Many refineries outside California are not capable of producing CARB gasoline and diesel. For some refineries, upgrading to produce CARB specification motor fuels would be uneconomic.

Even the GAO agrees that the number of gasoline blends contributes to higher prices. See, the June 2005 GAO Report to Congressional Requesters on Gasoline Markets - *Special Gasoline Blends Reduce Emissions and Improve Air Quality, but Complicate Supply and Contribute to Higher Prices.*

2. Tillerson, Mulva, O'Reilly, Klesse, Hofmeister, Pillari - In the last couple of months most of the oil industry has announced record-breaking profits for the last fiscal year. How much is your company investing annually in exploration, production and refining, and when will we see those investments pay off? And perhaps most important, what are you investing in alternative energy sources so we can help reduce domestic dependence on foreign oil?

**Answer:** Over the past fifteen years, ExxonMobil's cumulative capital and exploration expenditures have exceeded our cumulative earnings. Our total average annual capital expenditures have been approximately $14 billion, while our average annual net income has been approximately $13.4 billion. Last year, our capital investments totaled $17.7 billion. In the years 2007 - 2010, we anticipate increased annual capital investments to about $20 billion, on average, with the objective of boosting production capacity by over 20 percent by the end of the decade. ExxonMobil has made these investments with a long term view, not in response to market cycles.

On the topic of the world's interdependent economies, with energy an essential element of economic growth, it is only natural that trade in energy reflects that interdependence. However, if reducing dependence on foreign energy supplies is a policy objective, then the United States should be utilizing its domestic resources fully. Part of meeting the challenge of our future energy needs should be new policies authorizing exploration and production of abundant domestic oil and gas resources that are now closed to development. This is particularly true with respect to oil and gas deposits in the Outer Continental Shelf, the Rocky Mountain region, and in Alaska.

Our recent report, ***Tomorrow's Energy: A Perspective on Energy Trends, Greenhouse Gas Emissions and Future Energy Options (February 2006)***, addresses in Section 3 *Technology Options for the Longer Term.* In that section, we review the potential of emerging alternative energy technologies, including the challenges that need to be overcome, and, where relevant, ExxonMobil's involvement. The report is enclosed as Appendix A.

In the past five years, ExxonMobil has spent over $3 billion on energy research, focused largely on developing more efficient technologies for new and improved manufacturing processes in our Downstream and Chemical businesses, as well as for cost-effective solutions to access new oil and gas resources in challenging, frontier environments. In 2005 alone, we spent over $700 million on proprietary technologies that deliver competitive operating advantages and, in many cases, improve environmental performance.

ExxonMobil's primary focus with regard to renewable energy is on research to identify options that are commercially viable, as for example through Stanford University's Global Climate and Energy Project (GCEP), to which we plan to contribute $100 million. The GCEP is the largest privately-funded project of its type in the world, with a charge to accelerate the development of commercially viable energy technologies

that can lower greenhouse gas emissions on a worldwide scale (including hydrogen, solar and biomass energy and carbon sequestration). More details on GCEP can be found at http://gcep.stanford.edu. ExxonMobil also has an ambitious internal research program and we examine renewable fuels as part of this effort.

At present, ExxonMobil blends almost a million gallons of ethanol into our gasoline products every day in the U.S. This has required investment throughout our supply system. We expect to continue to increase our use of ethanol in the coming years to meet the expanded renewable fuel standard requirements imposed by the Energy Policy Act of 2005. Renewable fuels manufactured by today's technologies are generally more costly than petroleum-derived fuels and require government subsidies to be competitive.

**Senator Feingold's Questions for the Record**
**Judiciary Committee Hearing from 3/14/06**

1. All of Panel II:
The President mentioned in his state of the union address that America is "addicted to oil", and outlined several steps - including increasing investments in alternative fuels - to end the addiction. What percentage of your R&D is dedicated to alternatives? In your response, please indicate how your company defines alternatives. In addition to your R&D, what are your companies doing, as corporate citizens, to move away from fossil fuels?

**Answer:** Please see the previous answer provided in response to Senator DeWine's second question.

In addition, we view our role in helping provide for America's and other nations' energy needs as entirely consistent with our role as "corporate citizens." We are proud of the contribution our companies and others in America's energy industry have made to the American economy and modern living standards throughout the world. Billions of citizens in the developing world who do not yet have access to clean drinking water or electricity aspire to the living standards that abundant and affordable energy has made possible in our country. Most analysts are projecting nearly 50 percent growth in the world's use of fossil fuels in the next twenty five years as progress is made to make those aspirations become a reality -- and economic growth continues in the developed world.

**Senator Kohl's Follow-up Questions for Oil Consolidation Hearing**

**For Rex Tillerson**

1. An independent study by the consumers group Public Citizen found that from 1999 to 2004 U.S. oil refiners increased their profits they made on each gallon of gas refined by 79%. Don't these statistics show that it is not merely the rising worldwide cost of crude oil that accounts for high prices and other petroleum products? And does the success of your industry in passing along rising crude oil prices to consumers demonstrate that your companies have gained market power and that there is a failure of competition in this market?

**Answer:** Numerous studies have shown that there is a high correlation between changes in the price of crude oil and changes in the price of motor gasoline. The major factor in gasoline price is the price of crude oil, which has increased nearly threefold since 1999. In 2004-05, crude oil represented 49% of the price of a gallon of gasoline in the US, while taxes represented 22%, and refining and marketing costs, as well as margins, represented 29% of the price (DOE / Tax Foundation – through Nov. 2005).

Refining is a capital-intensive business with long-term investment horizons. As reported by the FTC's Bureau of Economics[1] financial returns in the U.S. refining industry have been below average over the long term. During the 1980s and 90s, the U.S. oil industry earned relatively poor rates of return on its investments, especially for the refining sector that needed to meet various environmental requirements, including for cleaner-burning fuels. According to the American Petroleum Institute, over the 10-year 1994 - 2003 period, the return on investment for the refining and marketing sector was 6.2%, or less than half as much as the 13.4% for the Standard and Poors Industrials.

U.S. refining is less concentrated than other industries such as automobiles, carbonated soft drinks and pharmaceuticals. There are about 50 different companies in the U.S. refining business, and consequently there is no failure of competition in this industry. Despite historically low rates of return and billions of dollars in nondiscretionary spending, competition among U.S. refiners has resulted in improvements in efficiency, further driving down costs to consumers.

Back in 1980, the cost to refine, market and distribute gasoline averaged about 95 cents per gallon (in inflation-adjusted terms), according to the API. By 1990, it averaged approximately 61 cents per gallon, and by 2000, it was 52 cents per gallon, which is about where it has remained over the last five years. Multiplying these reductions by the billion gallons of petroleum products consumed translates into billions of dollars of savings for American consumers.

[1] Federal Trade Commission, Bureau of Economics, The Petroleum Industry: Mergers, Structural Changes, and Antitrust Enforcement (August 2004).

2. In most competitive industries, when there are high prices, high profits to be made, and soaring consumer demand, we would expect to see an expansion of capacity to meet this demand. Yet in the oil industry this has not happened. Instead of opening new refineries, the industry has closed more than half of all that existed 25 years ago. In 1981, there were 324 refineries operating in the United States – today there are 149. According the Department of Energy, in the period from 1981 to 2004 overall national refining capacity has declined by more than 9% while demand for gasoline rose by 37%. Oil industry critics suggest that this decline in refining capacity is no accident – that oil companies actually prefer to keep supplies tight in order to be able to gain market power to raise price. Indeed, many economists believe this is a central reason why gas prices are so high.

So why hasn't your industry opened new refineries while closing so many existing ones? Does the failure of the oil industry to open new refineries suggest an effort to keep supplies tight or something anti-competitive going on?

**Answer:** Allegations that refinery capacity has been "artificially" restricted to keep supplies tight and prices high - particularly through U.S. refiners' "refusal" to build new refineries - are entirely contrary to fact. ExxonMobil has taken a long-term view of expanding its refining capacity through cost-effective enhancements to domestic refining capacity and new technologies to increase capacity utilization and efficiency.

During the period 1994 - 2004, ExxonMobil's investments have added the equivalent of three average-sized refineries (at 125,000 barrels per day) to domestic capacity. U.S. refiners as a whole have added the equivalent of 20 new, average-sized refineries during that period, increasing domestic crude distillation capacity by 12%, and light petroleum production by 16%. ExxonMobil alone increased the crude distillation capacity of the seven U.S. refineries it operates by 24%, more than twice the growth rate of 11% for U.S. refiners excluding ExxonMobil.

Since 1981, output, including gasoline production, from all U.S. refineries is up by over 25% even though the number of U.S. refineries fell by more than 50% over the same period. Higher cost and less efficient refineries were replaced by more efficient capacity expansions at the remaining facilities to better serve the consumer. While some cite the relative lack of new, grassroots refineries as evidence of the refiners' artificial restriction of U.S. capacity, those arguments wholly ignore the relative costs and benefits of incremental expansion. Building a new refinery is expensive and time consuming, given the significant costs associated with grassroots construction, approvals, and building new infrastructure (not to mention the risks of litigation and public opposition).

In contrast, adding capacity to existing facilities is faster and far more cost-effective. For example, recent public announcements indicate that while grassroots refinery capacity in the U.S. conservatively can cost as much as $18,000 per daily barrel of output, substantial capacity expansion projects typically cut that cost almost in half, and minor expansions can cost significantly less. While some criticize the incremental development of refinery capacity through expansion, this strategy reflects the most cost-effective approach to meeting the future supply needs of U.S. consumers.

3. In the last 15 years there has been a tremendous amount of consolidation in the oil industry – the GAO counts 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 has concluded that these mergers have raised gasoline prices.

(a) What is your view of the effects of these mergers on competition in your industry and the price of petroleum products?

**Answer:** The petroleum industry is relatively unconcentrated.[2] The four firm concentration ratio – the aggregate market share of the top four firms in an industry – is modest, with concentration ratios for both refining and marketing below the level found in many other industries. Industry concentration has remained modest despite significant merger activity because the Federal Trade Commission (FTC) has required divestitures in many transactions, conditioning merger approval on the sale of overlapping refining, pipeline, terminal, marketing and retail assets.[3] In fact, the FTC has held oil mergers to a uniquely high standard, routinely scrutinizing and challenging transactions in this industry at much lower concentration levels than it would challenge in any other industry.[4]

GAO's assertions notwithstanding, recent consolidation has not contributed to higher gasoline prices. Even taken at face value, the GAO study found that mergers were nearly as likely to lower gasoline prices, or to have no price effects, as to increase them. Yet GAO's study "contains major methodological mistakes that make its quantitative analyses wholly unreliable."[5] The FTC subjected a number of GAO's analyses to further

[2] *See Consolidation in the Energy Industry: Raising Prices at the Pump? Hearing Before the S. Comm. on the Judiciary*, 109th Cong. (Feb. 1, 2006) (prepared statement of Commissioner William Kovacic at p. 8), *available at* http://www.ftc.gov/speeches/kovacic/testimonyrepetroleumindustryconsolidation.pdf; *see also* FTC BUREAU OF ECON., THE PETROLEUM INDUSTRY: MERGERS, STRUCTURAL CHANGES, AND ANTITRUST ENFORCEMENT 3 (Aug. 2004), *available at* http://www.ftc.gov/os/2004/08/040813mergersinpetrolberpt.pdf.

[3] *See* FTC Merger Enforcement in the Petroleum Industry Since 1981, *available at* http://www.ftc.gov/ftc/oilgas/charts/merger_enforce_actions.htm.

[4] *See* FTC Horizontal Merger Investigation Data, Fiscal Years 1996-2003 (Aug. 31, 2004), *available at* http://www.ftc.gov/os/2004/08/040831horizmergersdata96-03.pdf.

[5] *See Market Forces, Anticompetitive Activity and Gasoline Prices: FTC Initiatives to Protect Competitive Markets, Hearing Before the Subcomm. on Energy and Air Quality of the H. Comm. on Energy and Commerce*, 108th Cong. (July 15, 2004) (testimony of the FTC containing discussion of flaws in GAO study).

scrutiny; with GAO errors corrected, the "price increases" disappeared.[6] Other FTC studies confirm that oil mergers have not lead to gasoline price increases.[7]

(b) Are we likely to see even more consolidation in the years ahead? If so, what will this mean for competition in this industry?

**Answer:** We have no way of knowing of the future plans of other oil industry members. With regard to ExxonMobil, it is not our practice to speculate about possible future investments. However, we continually look for investment opportunities to complement our existing asset portfolio. Our objective is to maintain a consistent focus on being an industry leader in asset performance, operational efficiency, and community and environmental responsibilities while meeting customers' expectations for our products, and in maximizing shareholder value.

[6] *See* FTC STAFF TECHNICAL REPORT, ROBUSTNESS OF THE RESULTS OF GAO'S 2004 REPORT CONCERNING PRICE EFFECTS OF MERGERS AND CONCENTRATION CHANGES IN THE PETROLEUM INDUSTRY (Dec. 21, 2004), *available at* http://www.ftc.gov/ftc/workshops/oilmergers/ftcstafftechnicalreport122104.pdf.

[7] *See* John Simpson & Chris Taylor, *Michigan Gasoline Pricing and the Marathon-Ashland and Ultramar Diamond Shamrock Transaction* (July 2005) (Bureau of Econ. Working Paper Series # 278); Chris Taylor & Dan Hosken, *The Economic Effect of the Marathon-Ashland Joint Venture: The Importance of Industry Supply Shocks and Vertical Market Structure* (March 2004) (Bureau of Econ. Working Paper Series # 270).

**Follow-up Questions of Senator Charles E. Schumer**
**Senate Judiciary Committee Hearing**
**"Consolidation in the Oil and Gas Industry: Raising Prices?"**
**March 14, 2006**

For All Panel II Witnesses:

1) Would you please clarify which income figures your company reported to the internal revenue service last year for tax purposes, as well as the basis for those figures? Are these the same income figures reported to your shareholders? If different figures were used, what were they, what was their basis, and what is the rationale for this decision?

**Answer:** The income reported to the Internal Revenue Service was our federal taxable income amount. This is consistent with book income as reported for financial statement purposes, but reflects requirements under the Internal Revenue Code and Treasury Regulations. The amount reported to shareholders was the financial book income amount as reported for financial statement purposes, calculated under Generally Accepted Accounting Principles.

2) Based on your written testimony, it appears that your company has put at most 5% of annual investment toward developing alternative energy technologies like hydrogen fuel cells, wind, solar, and others. What is the rationale for this investment strategy? Have you decided that investment in these energy sources is not in the interest of your shareholders?

**Answer:** Please see our prior response to Senator DeWine's second question.

3) How much royalty relief have you received from the Department of Interior for exploration on public lands? Which public lands specifically? At what price threshold have you predicted internally that you would not need royalty relief to make exploration viable?

**Answer:** ExxonMobil adheres to all applicable regulations in making royalty payments to the federal government. The Department of Interior provides royalty relief when certain criteria are met and only after production begins on a federal lease. Because ExxonMobil does not currently meet the criteria, we do not claim royalty relief on any of our producing federal leases. We are paying full royalty consistent with federal regulations and the terms of our leases.

Regarding the question on price thresholds to make exploration viable without royalty relief, our exploration investment decisions are based on existing regulations and lease terms. Therefore, we do not internally calculate or determine price thresholds or provisions that are inconsistent with the existing regulations.

In 2004, the MMS awarded ExxonMobil its prestigious Mineral Revenues Stewardship Award for excellence in the administration and payment of federal royalties, as well as its Safe Operations and Accurate Reporting Award.

**Questions posed by Senator Specter**

Rex Tillerson:

1.) Please provide an analysis of the draft bill, the "Petroleum Industry Antitrust Act of 2006," which was submitted to the Congressional Record earlier this month.

**Answer:** The requested analysis is attached as Appendix B.

2.) What steps can be taken to decrease consumption of oil and natural gas?

**Answer:** Energy is vital to economic progress and higher standards of living for people around the world. Government naturally plays a key role in helping enable not only the reliable supply of energy, but also the wise and efficient use of available resources. In this regard, government can rely on several fundamental principles and practices to help promote prudent use of available energy, and the most efficient, effective and viable energy market for consumers, suppliers and investors:

- Rely on open, competitive, free markets -- Government should strive to ensure a level playing field for all energy options, where the most economical and efficient energy solutions can be identified and deployed. These solutions should be based on free market pricing and the knowledge and judgments of individuals in the marketplace. As it relates to options to improve the wise use of energy, government is best to focus not on picking winners and losers, but rather on creating an open, competitive environment. This will enable the continual and efficient development, identification and deployment of advanced solutions.

- Avoid arbitrary manipulation of energy markets -- Discriminatory interventions, whether via subsidies, mandates, price floors/caps, tax policies and/or use restrictions, damage the foundation and function of a free market system, masking critical supply and demand signals, and inevitably harming those relying on such signals. Wise government policy will avoid arbitrary and undue incentives or penalties targeting a particular fuel, technology, or industry participant.

- Eliminate policy barriers to more efficient energy use -- Government should seek to eliminate and/or streamline laws and regulations that prevent or slow the transition to more efficient and economical uses of energy. For example, governments wanting to promote cogeneration investments, that benefit both industry and the public alike, must eliminate regulatory barriers (e.g., multiple and overlapping permit programs), as well as develop effective markets and market rules. These rules should include several characteristics, namely:

    1. Dispatch priority, as electricity and steam cannot be made independently and steam is integral to site operations;
    2. Nondiscriminatory access to the transmission grid allowing cogeneration investors access to markets and customers;

3. Use-based transmission / ancillary / back-up power charges -- charges based on actual use to support net internal load.

Even in the United States, not all markets possess these characteristics.

- Share knowledge -- Government should contribute to improved decisions by energy consumers and suppliers by sharing knowledge. Information of potential high value may include that related to energy markets in general, performance in specific areas related to best practices (e.g., cogeneration), and performance related to established standards (e.g., EPA mileage estimates on new vehicles; Energy Star appliance ratings; insulation ratings). Cost-effective sharing of general advice related to improving vehicle fuel economy and home energy use should also be made available to consumers.

- Support research and development (R&D) efforts
  - Government should ensure reliable and enforceable laws and regulations (e.g., intellectual property protections) are in place to encourage efficient investment in R&D by individuals and private enterprises.
  - Government-funded R&D should focus on basic science and technology breakthroughs at a pre-commercial stage; government can be most valuable in this regard when central coordination is likely to help advance substantial national economic benefits affecting a broad cross section of industries and market participants.
  - Government-funded demonstration projects should focus on key barriers to technology commercialization versus creation of potential markets.

3.) Please provide an analysis of the incentives offered to petroleum companies by the federal government that explains what the incentives are intended to do, which incentives are important to you, and why they should be maintained.

**Answer:** Three tax provisions in the Energy Policy Act of 2005 would benefit ExxonMobil somewhat, although none of the three would be material. In fact, the three items are modest enough that when added together, they are less beneficial than the cost of another provision in the bill.

The three positive tax items included in the 2005 Energy Policy Act are:

· Two year amortization of Geological and Geophysical ("G&G") expenditures, with a half-year convention.

· An election to expense 50% of refinery investments which increase the output capacity of an existing refinery by at least 5%, or which increase the throughput of qualified Section 29(c) fuels by at least 25%.

· A production tax credit, limited to four years, for coke and coke gas produced from facilities placed in service before 1/1/93 and between 6/30/98 and 1/1/10, up to an average BOE of 4,000 barrels per day, and effective for fuel produced and sold after 12/31/05. This provision was added during the conference and includes a credit phase-out tied to the price of crude (for example, in 2004, the phase-out would have begun with crude at $51.35, with full phase-out at a crude price of $64.46).

From ExxonMobil's standpoint, reinstatement of the Oil Spill Liability Trust Fund Tax, which is effective 4/1/06 and expires after 12/31/14, will cost us more per year than the three items above added together. In addition, the Leaking Underground Storage Tax ("LUST") was extended through 9/30/11, and expanded to include dyed fuel.

4.) In the two weeks prior to March 14, 2006, the price of oil decreased seven cents per gallon, while the price of gasoline increased by eleven cents per gallon. Why would gasoline become more expensive during this period, despite a decrease in the cost of crude oil?

**Answer:** Crude and gasoline markets are very competitive with thousands of market participants including producers and suppliers outside the United States. Prices for crude oil are set by worldwide markets comprised of thousands of willing buyers and sellers in a global auction reacting to near-term physical market factors and perceived future supply/demand imbalances. Gasoline prices are driven primarily by crude oil prices over the long-term but can be impacted in the short-term by many regional as well as local market factors.

When price changes are measured over a short period, there could be disconnects, with crude oil and gasoline prices moving in different directions. Crude prices can be affected in the short term by factors that include production problems, civil or terrorist threats in producing nations or other factors. Similarly, gasoline prices can be affected in the short term by factors such as planned or unplanned refinery turnarounds, weather, pipeline outages, variations in the level of imports, or a real or perceived supply/demand imbalance associated with changes in specifications or seasonal grade changes. Despite these short term disconnects, over the long term, the correlation between crude price and wholesale gasoline price is strong. Crude price is the single most important factor influencing the wholesale price of gasoline.

Specific to your question, NYMEX crude oil prices closed on Friday, March 10th at $59.96/bbl (or $1.428/gal) which was seven cents lower than the quote two weeks earlier. Over a similar period, NYMEX gasoline price was eleven cents higher. We are assuming these are the data points you reference in your question. If you looked at different points over the last couple months you would get different results; e.g., if you went back to the two week period prior to February 14, the prices for crude and gasoline changed at

different rates, with gasoline price falling about 46 cents/gallon while crude price fell only about 20 cents/gal.

ExxonMobil cannot explain all the reasons buyers and sellers decide on their position in each of the markets, but we can offer our suppositions.

During the particular two week time period in question, crude oil inventories, as reported by EIA, had increased to levels above prior year averages as refineries began planned turnarounds. Observing this increase, buyers and sellers of crude oil futures may have bid prices lower. It is important to note that while crude oil futures prices declined point to point, the market was and has been volatile, primarily driven by news of terrorism in various oil producing areas and the potential impact of a successful attack. As news of the terrorist threat subsided, normal supply/demand pressures may have become the dominant factor, resulting in overall lower prices.

NYMEX gasoline futures, however, were apparently experiencing different short-term supply/demand interpretations by buyers and sellers. Coupled with the planned turnarounds mentioned above, operating refineries began production of lower RVP, summer grade gasoline while simultaneously working to remove MTBE from the refining process. Also, various public statements may have added uncertainty, such as the Energy Information Administration's February 22 report on the impacts of the MTBE phase-outs, indicating that there may be a U.S. shortage of ethanol. It is entirely conceivable that the combination of these events may have created a perception of a near term supply shortfall based on projected demands, in spite of the fact that finished product inventories are within historical averages. These and other factors either perceived or real, may have influenced the decisions of thousands of willing buyers and sellers that trade NYMEX gasoline futures and prices moved higher.

The enormous investments required to bring crude and gasoline to market demand a long term view. From time to time, divergent short term price changes between crude and gasoline can occur; however, over the long term the correlation between crude and wholesale gasoline prices is strong, as seen from table below:

| Avg. price change | Crude(WTI) | Gasoline |
|---|---|---|
| 2004/2003 | +34% | +33% |
| 2005/2004 | +37% | +34% |

5.) With respect to the large mergers that your companies have engaged in over the past decade, what efficiencies have they produced that have benefited consumers, particularly in downstream markets?

**Answer:** After the merger of Exxon and Mobil, the combined company achieved worldwide operating efficiencies in excess of $7 billion, with much of this in the

downstream. In a highly competitive industry such as the petroleum industry, the majority of efficiency savings are ultimately passed along to consumers.[8]

On the upstream side of our business, the world has changed quite a bit in the last decade. Major opportunities for new oil and gas development require significantly more advanced technologies and huge investments. Increased global activity by state-owned oil companies has increased competition for large scale resources. The scale and technology leadership gained through the merger enables ExxonMobil to take the risks required to bring new resources on line and to compete more effectively in today's enormous global marketplace for energy. This also ultimately benefits energy consumers by providing increased and diversified supplies.

[8] See "Performance Profiles of Major Energy Producers 2004" by the DOE-EIA, specifically Figure 5 which shows that US average refining gross margin has trended downward, generally consistent with the downward trend in operating cost per barrel of product sold over the last two decades.

**APPENDIX A**

http://www.exxonmobil.com/Corporate/campaign/energynow.asp

**Appendix B**

## ExxonMobil Analysis of Draft "Petroleum Industry Antitrust Act of 2006"

The proposed Bill addresses two topics. Sections 2-5 deal with the application of the antitrust laws to the domestic oil industry. Section 6 attempts to apply U.S. antitrust laws to OPEC members and other foreign states. Since these two different topics raise distinct legal and policy issues, ExxonMobil will address them separately.

ExxonMobil opposes Sections 2-5 for three primary reasons: (1) they create unintended consequences harmful to the U.S. economy as a whole by both disrupting the normal functioning of the petroleum markets, and more significantly, impeding efforts to mitigate the effects of major supply disruptions; (2) they unfairly single out the oil industry for stricter antitrust standards that ignore the sound economic principles built into existing law; and (3) the proposed additional studies and investigations are unnecessary and duplicative of existing enforcement efforts and investigations. ExxonMobil also opposes Section 6, the so-called "NOPEC" provision, as being contrary to sound principles of international comity, potentially unenforceable, and potentially damaging to U.S. relations with foreign governments.

### Sections 2-5: The Domestic Antitrust Provisions

**The Proposed Changes to Existing Antitrust Law Will Lead to Unintended Harmful Consequences.**

a) Because the "primary intention" standard is so vague that it would encourage judicial second-guessing of product supply decisions, the Bill would make it extremely difficult for oil companies to respond to supply disruptions. The substantial uncertainty created by this new and untested standard would have the unintended effect of limiting the ability and incentive of producers to respond to market demands outside their local or normal areas of operation. During an emergency, refiners and marketers would not be able to move product to different areas without being concerned that such a movement might be said to have contributed to a price increase in the area where the product had been refined or stored. Thus, efficiency in supply flexibility would be significantly reduced.

Specifically, the efforts by ExxonMobil and others to re-establish the flow of light products after the recent hurricanes likely would not have occurred as quickly and efficiently if this legislation had been in force. The companies would have faced an impossible dilemma. They would have had to choose between being accused of "refusing to sell" part of their remaining Gulf Coast refinery production to purchasers in the Mid-Atlantic states, and thereby exacerbating the already short supply in that region, or of "diverting" product from the local markets to meet their needs, but creating a "shortage" of product and higher prices in the Gulf Coast states.

Similarly, sellers could be accused of a potential violation any time the transportation infrastructure faced an unexpected limitation. If a pipeline has an unexpected shut-down, would it be a violation for shippers on that line to export or "divert" product they would normally place into that line to an alternate, more accessible destination, even though the price in the alternate market is lower? Barriers to supply flexibility are likely to reduce output.

b) The vague standards of this Bill would also put oil companies at risk of being sued for normal, every-day supply decisions. The proposed amendment of the Clayton Act would be a major expansion of the regulatory and legal rules governing the petroleum industry, and would subject the industry members to multiple, costly litigation just to defend normal, pro-competitive operating practices. For example, it is unclear whether seasonal diversions of natural gas to storage from pipelines and distributors would be a violation. Storage of natural gas is important to address situations like hurricanes and to assist in addressing peak demand periods. Similarly, since no showing of market power or even market effect is required under the proposed Bill, a small gas well operator in West Texas who determined that, as a "prudent operator," it was in its (and its royalty owners') best interest to shut-in production (i.e., it was uneconomic to continue producing) might be subject to suit under this law.

Another example of the every-day problems this Bill would create involves long-term supply arrangements ExxonMobil and other companies have with their customers. When there is a sudden increase in spot prices, the price under those term contracts may end up being below the current spot market price. The company could be accused of "refusing to sell" to a spot purchaser that is offering a higher price because it would not breach its contract to supply its existing customers. This concept is applicable to both domestic and export sales.

An additional problem is that, by allowing a private right of action, rather than leaving enforcement of the new provisions to the Federal Trade Commission ("FTC") and/or Department of Justice ("DOJ"), the Bill provides no check on frivolous litigation. The vagueness of the "primary intention" standard would require extensive discovery no matter how tenuous the plaintiff's claim and would ultimately result in unwarranted and unproductive litigation.

c) The new proposed merger standard for the oil industry will create confusion and uncertainty and potentially bar beneficial, efficiency-producing mergers. There is a nearly 90 year history of case law and enforcement guidance that has given meaning to the "substantially lessen competition" standard of the Clayton Act. Based on those years of experience, DOJ and the FTC have developed a sophisticated antitrust analysis that is embodied in the DOJ/FTC Horizontal Merger Guidelines. These guidelines have enjoyed strong bipartisan support.

Moreover, there is no demonstrated need to create what appears intended to be a stricter standard here. The antitrust agencies have been clear – there is no *de minimus* price increase, or level of lost competition, that is not actionable under the current merger laws. There is no case law suggesting that "some" lost competition is acceptable. Since anticompetitive mergers are already proscribed by the law and attacked by the FTC, the necessary effect of the new standard would be to prohibit mergers that are at a minimum, competitively benign, and that could generate significant efficiencies and corresponding benefits to consumers.

In summary, to the extent the Bill is intended to change current antitrust standards related to unilateral conduct and mergers, which standards are based on years of well-developed and sound economic policy, it is simply a bad policy decision.

**The Proposed Bill Ignores Sound Economic Principles and Unfairly Singles Out the Oil Industry for Stricter Antitrust Treatment Than Any Other Industry.**

The Sherman Act already prohibits an anticompetitive agreement involving two or more competitors to withhold product from a market in order to increase price. Indeed, unless the companies were involved in some efficiency-enhancing economic integration of their operations, any such concerted

activity would likely be treated as a per se violation of the Sherman Act. The companies would be exposed to criminal prosecution and potentially large fines as well as treble damage actions, and the employees involved would face prison sentences.

Likewise, Section 2 of the Sherman Act and Section 5 of the FTC Act (as well as various state antitrust and consumer protection statues) already provide an appropriate standard for attacking unilateral, anticompetitive activity, such as withholding product from a market to raise prices. However, to avoid lawsuits that are unlikely to involve any substantial claim of anticompetitive harm, these sections require a showing that the defendant already has at least substantial market power, if not a dangerous probability of achieving monopoly power. This important limitation would be lost under the proposed Bill, which does not require any showing of market power for liability. In addition, in January 2006, pursuant to the Energy Policy Act of 2005, FERC promulgated new market manipulation rules (applicable to jurisdictional natural gas activities) which impose civil and criminal sanctions for any "device, scheme, or artifice" intended to impair, obstruct, or defeat a well-functioning market.

The FTC already scrutinizes the oil industry far more stringently than other industries. The FTC prosecuted 15 enforcement actions against petroleum industry mergers since 1981. It publicly acknowledges that in its merger enforcement involving this industry it applies a tougher standard, requiring oil merger divestitures at lower levels of concentration. Any condition that is likely to raise gasoline prices by even 1 cent per gallon is challenged.[1] Moreover, there is no empirical basis for the assertion that recent oil mergers have led to higher prices. In fact, the available evidence shows that recent mergers have allowed firms to lower the costs of exploration, production, distribution, and marketing of petroleum products. Even the recent GAO study of a number of mergers was unable to find a clear pattern of mergers that raised prices. Nevertheless, this proposed legislation would single out this industry for even stricter merger standards that go well beyond what can be justified by sound economics.

**The Proposed Additional GAO Study and Federal/State Task Force Are Unnecessary and Duplicative of Other, Ongoing Enforcement Efforts.**

The proposed additional GAO study is superfluous, because, in accord with the Energy Policy Act of 2005, the FTC is currently conducting an investigation "of the petroleum industry supply infrastructure from the refinery to the street level" and has issued subpoenas to approximately 200 companies across the United States. With regard to the proposed Federal/State Task Force, the petroleum industry has been the subject of significant and continuous antitrust scrutiny over the years. None of the numerous federal and state investigations of gasoline pricing have ever identified

[1] The merger of Exxon and Mobil in the late 1990s is a testament both to the stringency with which the FTC applies current law to mergers in the oil and gas industry and to the substantial efficiency benefits that would be lost if even mergers that undergo significant restructuring at the hands of an FTC applying the antitrust laws very strictly were blocked altogether. The merger of Exxon and Mobil was subjected to exhaustive scrutiny. The companies produced 40 million pages of documents. Scores of executives from both companies were deposed under oath. After nine months of investigation, the FTC required the parties to undertake one of the most substantial divestitures in history in order to be able to close the transaction. Among other conditions imposed, the FTC refused to allow *any* increase in concentration among refineries on the West Coast, requiring the divestiture of Exxon's Benecia refinery because Mobil owned another refinery in Southern California. In addition, Exxon and Mobil were required to divest *all* retail stations of either brand from Virginia to Maine (all the Mobil stations in Virginia, DC, Maryland, Delaware, Pennsylvania, and New Jersey, and all the Exxon stations in New York, Connecticut, Vermont, Massachusetts, Rhode Island, New Hampshire and Maine).

any anticompetitive exchanges of information. In any event, the FTC investigation referenced above includes, among other things, an inquiry into (i) policies and practices related to the public release of information about planned or unplanned refinery shutdowns; and (ii) communications with various price reporting services for sales of petroleum products on the West Coast.

**Section 6: The "No Oil Producing and Exporting Cartels Act of 2006 ("NOPEC")"**

While the intent of this section may be to promote increased oil production in OPEC countries, along with lower energy prices for American consumers, the more likely effect would be diminished diplomatic relations with OPEC nations, accompanied by greater instability in energy supplies and prices. This proposal could also have very negative economic and security ramifications beyond energy markets. American companies have invested many billions of dollars in assets around the world which would now be placed at risk of retaliatory actions. In addition, while hard to quantify, this legislation would likely undermine active alliances with OPEC-member nations in the war on terror and in Iraq.

Long-standing legal principles concerning "sovereign immunity" between nations and "the act of state doctrine" have been established to avoid the predictable and counterproductive chain of retaliations that can unfold when one nation unilaterally asserts unbounded legal authority over the sovereign affairs of another. Nearly 25 years ago, U.S. federal courts relied upon these principles in rejecting antitrust litigation against OPEC. While the draft Bill would attempt to nullify the application of these principles in allowing U. S. courts' jurisdiction over OPEC member nations, the Bill would not stave off the negative consequences that these doctrines were designed to avoid. Therefore, regardless of the resolution of the important issue of whether this proposal would be upheld on constitutional grounds, there is no question that it would constitute very harmful public policy.

**Potential Retaliation Against American Investments in Other Nations**

American companies have billions of dollars invested in OPEC countries, often through a variety of well-functioning operations. U.S. direct investment in OPEC nations stood at over $34 billion in 2004 (on a historical cost basis, according to the Bureau of Economic Analysis). U.S. oil companies have invested in resource development in these countries, particularly in Indonesia, the United Arab Emirates, Venezuela, Nigeria, Qatar, Algeria and Libya. A new law, such as the draft Bill, that carries the threat of potential seizure of OPEC country investments in the United States to satisfy legal judgments, could pose a significant threat of similar actions against U.S. investments in those countries.

**Potential Market Disruptions**

The United States now depends on a number of OPEC countries for critical, imported energy supplies on a daily basis. In 2005, the United States imported from OPEC nations over 1.7 billion barrels of crude oil, equating to about 32 percent of its oil supplies. Anything that could potentially jeopardize the current flow of these supplies to the United States would have a significantly negative economic impact. The proposed Bill would likely cause greater uncertainty and volatility in the world's oil and equity markets.

Legislation authorizing antitrust lawsuits against OPEC nations in the United States could invite many forms of retaliation. It could promote, for example, long term supply agreements with other

nations to meet their future supply needs, at the expense of the United States. Another form of immediate retaliation could include limitations on the percentage of OPEC production exports to the United States, which would benefit other oil importing nations (benefiting from greater supplies, lower prices) at the expense of the United States (less imported supply, higher prices). OPEC could also consider using currencies other than the dollar for denominating crude oil sales, which could weaken the dollar's status as the world's reserve currency.

Another possible impact would be the flight of investment from the United States by OPEC nations, and probably by other nations, if the U.S. were perceived as less committed to free trade. As of January 2006, OPEC nations held $77.6 billion in U.S. Treasury securities. Finally, OPEC nations could possibly retaliate in their global import patterns, displacing American imports with the competing products of other nations. In 2005, OPEC nations imported $32 billion in goods and services from the United States.

**The Proposed Legislation is Misdirected, as Recent Price Increases are Due to Global Market Factors, Including U.S. Policies Not to Produce its Own Energy Supplies**

World oil prices have nearly doubled in the past two years. Driven largely by the growing economies of the United States, China, India and the developing world, the demand for oil in the past three years has risen at nearly twice the average growth rate over the prior decade. At the same time, the "spare" amount of production capacity reached historic lows. The extent of OPEC's immediate ability to increase production and thereby increase the "spare" production level is unclear. Over the past several months, OPEC is reported to be producing at near full capacity. It is essential that new production capacity be brought on line to meet burgeoning world oil demand. Authorizing antitrust litigation and damages against OPEC nations would undermine constructive dialogue between oil-producing and oil-consuming nations.

While other countries may have the potential to expand their oil producing capacities through sustained capital investment programs, the United States stands essentially alone in prohibiting the development of its own known and highly prospective domestic oil and gas resources (in Alaska, the Rockies, and the Outer Continental Shelf). Our own domestic laws, in many cases, promote the very conduct that the draft Bill would seek to punish: "... limit[ing] the production or distribution of oil, natural gas, or any other petroleum product..." One could argue that if other nations enacted this draft legislation, it could be used to assert and collect damages against the United States in their courts. In addition, it could be extended beyond the petroleum sector to other sectors such as agriculture, where governments, including the federal government, have extensive policies that promote the cultivation of certain crops at the expense of others, with implications for global markets (including prices) for agriculture products.

The draft Bill's provisions could also reach activities far beyond OPEC. Legitimate joint national efforts to manage natural resources for entirely valid reasons, including security interests, environmental interests, or joint management of shared resources, could be subjected to challenge under this Bill.

**Negative Impact on National Security and Foreign Policy Objectives**

Many OPEC countries are of critical importance to the US in the war on terror, the war in Iraq, and the effort to bring stability and reform to the Middle East. While there is a clear need for reform in some OPEC countries, allowing economic damages against these nations through litigation in United States courts would have a highly counterproductive impact.

Practical issues regarding the pursuit and enforcement of a judgment under the draft Bill raise important security and sovereignty issues: How would jurisdiction be obtained over OPEC nations? How could a factual investigation be conducted and required, including demands for documents and witnesses located outside the United States? How would the United States government enforce a judicial remedy against OPEC member nation assets?

A NOPEC bill would also tend to undermine Arab-country support for a Middle East peace process.

**Longstanding Legal Doctrines Promoting Sound Foreign Policy Objectives Would Be Nullified by This Proposal.**

a) Sovereign Immunity. Subsection (c) of the draft Bill would repeal the doctrine of sovereign immunity which protects nations from being sued by each other in their respective courts. Chief Justice Fuller, writing for a unanimous United States Supreme Court in *Underhill v. Hernandez* (168 U.S. 250) (1897) found that:

> *Every sovereign State is bound to respect the independence of every other sovereign State, and the courts of one country will not sit in judgment on the acts of the government of another done within its own territory. Redress of grievances by reason of such acts must be obtained through the means open to be availed of by sovereign powers as between themselves.*

The doctrine was codified by Congress itself in the Foreign Sovereign Immunities Act of 1976. 28 U.S.C. section 1330 *et seq.* A federal district court relied upon it to dismiss antitrust litigation against OPEC in 1979 in the case of *International Association of Machinists v. OPEC,* 477 F.Supp. 553 (C.D. Cal. 1979), *affirmed,* 649 F.2d 1354 (9th Cir. 1981), *cert. denied,* 454 U.S. 1163 (1982).

This doctrine of "sovereign equality" is also recognized and upheld in the United Nations' charter, at Article 2 (1) and in other United Nations proceedings. The 1974 "Declaration On The Establishment Of A New Economic Order", UNGA Res. 320 proclaims a "new international economic order" based on "equity, sovereign equality, interdependence, and common interests and cooperation." That statement reiterates the principle of "non-interference in the internal affairs of other states." The Declaration recognizes the sovereignty of "every state over its natural resources and all economic activities."

The 1975 UN Charter on Economic Rights and Duties of States, UNGA 3281, also states that every State has a "sovereign and inalienable right to choose its economic system . . . without outside interference, coercion or threat in any form whatsoever." Id. at Ch. II, Art.1. That right includes the "full permanent sovereignty, including possession, use and disposal, over its wealth, natural resources and economic activity." Id. at Art. 2(1).

In March 2000 testimony before the House of Representatives, the Federal Trade Commission opposed a similar proposal to authorize antitrust litigation against OPEC. The FTC warned:

> *Finally, and perhaps most importantly, any enforcement action would raise significant diplomatic considerations. A decision to bring an antitrust case against OPEC would involve not only, and perhaps not even primarily, competition policy, but also defense policy, energy policy, foreign policy, and natural resource issues. In particular, any action taken to weaken a sovereign nation's defenses against judicial oversight of competition lawsuits, for example,*

> *would have profound implications for the United States, which places buying and selling restrictions on myriad products.*

The Senate should resist proposals to nullify, selectively, the application of this longstanding doctrine. This doctrine protects the interests of the United States with respect to the international investments of *its* citizens. To create a legislative exception that removes the doctrine's protections for countries on which we currently rely for energy would invite extensive litigation between the United States and other nations. This would include the potential seizure of U.S.-owned assets internationally.

b) The Act of State Doctrine. In the *International Association of Machinists v. OPEC* case, U.S. Court of Appeals for the Ninth Circuit relied on the "act of state doctrine" to affirm the district court's judgment to dismiss an antitrust lawsuit against OPEC. That doctrine "declares that a United States court will not adjudicate a politically sensitive dispute which would require the court to judge the legality of the sovereign act of a foreign state." 649 F.2d at 1358. The court observed:

> *When the courts engage in piecemeal adjudication of the legality of the sovereign acts of states, they risk disruption of our country's international diplomacy. The executive may utilize protocol, economic sanction, compromise, delay, and persuasion to achieve international objectives. Ill-timed judicial decisions challenging the acts of foreign states could nullify these tools and embarrass the United States in the eyes of the world. Id.*

Subsection (d) of the draft Bill would also repeal this longstanding doctrine to allow antitrust litigation against OPEC member nations. The doctrine appropriately recognizes that the Executive and Legislative branches of government are directly, constitutionally empowered to conduct international relations with other nations -- and that the courts are not so empowered and are ill-equipped to influence constructively the conduct of international affairs. Creating exceptions to such longstanding doctrines, which arose to protect the interests of the United States, would risk the counterproductive outcomes that courts, such as the one above, have strongly warned against.

# SUBMISSIONS FOR THE RECORD

**Testimony of Joseph M. Alioto**
**United States Senate Committee on the Judiciary**
March 14, 2006

Mr. Chairman and members of the Judiciary Committee:

Thank you for giving me the opportunity to address the topic: "Consolidation in the Oil and Gas Industry: Raising Prices?"

From my experience litigating many antitrust actions against all of the major oil companies over the last thirty-six years, I can attest to the fact that the consolidation in the industry has led directly to the increase in prices for gasoline. For example, in 1999 the Federal Trade Commission allowed Shell and Texaco to enter into a joint venture combining their assets in refining and marketing in the United States and nowhere else. Upon the formation of this joint venture, Shell and Texaco first increased the price of Texaco gasoline to bring it in line with Shell and then raised the prices of both Shell and Texaco gasoline in major metropolitan areas in the United States by fifty to seventy percent. Because Shell was the price leader in the United States, the other few major integrated oil companies followed. This was done in the face of the following economic facts: the price of crude oil was at its lowest since The Great Depression (accounting for inflation); the industry had excess capacity; and the cost of Shell and Texaco were dramatically reduced by a shutdown of many of their facilities in accordance with their joint venture agreement.

Another example is in 2002, the Federal Trade Commission allowed the merger of Conoco and Phillips resulting in the largest retailer and refiner in the United States. Subsequent to this merger, prices increased substantially, as was the intention of the executives who formed the merger. In the Conoco/Phillips case, the two chairmen and executive officers of the companies met privately on many occasions. One of them kept notes of their meetings. Those notes reflect that the reason for the merger was a fear of oil prices decreasing, and that it would be necessary to reduce the number of major integrated oil companies to six or seven companies, which in fact was done. The expert for Conoco and Phillips testified that reduction in the number of companies would easily lead to increases in prices.

As this Committee knows, there has been a plain effort by the oil companies to put back together the Standard Oil trust which was found illegal by the Supreme Court in 1911 and thereafter broken up into a number of companies around the United States. Since the late 1990's, Exxon (Standard Oil of New Jersey) was allowed to buy Mobil (Standard Oil of New York); British Petroleum, one of the Red Line members, was allowed to buy SOHO (Standard Oil of Ohio), and that combine, BP/SOHO, was allowed to buy Amoco (Standard Oil of Indiana), and that combine, BP/SOHO/Amoco, was allowed to buy ARCO, eliminating the principle price cutter in the industry. These acquisitions were followed by the Conoco (Standard Oil of Colorado) and Phillips merger, the Shell Texaco joint venture, and the subsequent purchase of Texaco from

Shell by Chevron (Standard Oil of California). All of these acquisitions were followed by substantial price increases, notwithstanding reduced costs, resulting in the largest profits ever reported by any companies in the United States.

In addition to these combinations, the oil companies cooperate with each other at every level of the industry, from exploration and production to retail. Almost all exploration and production is interwoven with joint ventures among and between the majors. The pipelines for the transportation of crude oil are jointly owned, and tankers owned by the oil companies are shared between and among themselves for the transportation of each other's crude oil. Oil and refined products in terminals and refineries are exchanged and shared depending upon the needs of any particular company or desire of any particular company to sell in certain territories. (This alone has resulted in the fact that no new refinery has been built in the United States in the last thirty years.) Gasoline stations are also swapped among and between the different oil companies with the result that obvious potential competition is eliminated.

In addition to all the foregoing, the Chairmen, Chief Executive Officers and Executive Marketing Vice Presidents of the major companies meet, on the average, once a month both at trade associations, resorts, social events, and golf, hunting and fishing outings.

In all of these different instances, the Federal Trade Commission and the Antitrust Division of the Department of Justice have allowed this activity to take place. Instead of applying the anti-merger and consolidation laws under Section 7 of the Clayton Act and the decisions of the Supreme Court interpreting that act, the FTC and DOJ have used a document entitled "Merger Guidelines," a document authored by unknown persons. In addition, the FTC and DOJ have published documents attempting to provide the means for major competitors, including the oil companies, to cooperate among and between themselves. And, sadly, the FTC and the DOJ have opposed any private plaintiff who sought to challenge these activities by the oil companies.

I respectfully submit to this Committee that no new laws are required, but rather a simple enforcement of the laws that presently exist. If they were enforced, none of these mergers and combinations would have been allowed and the price of gasoline would have been substantially lower.

Thank you.

Testimony

Before the Committee on the Judiciary, United States Senate

Statement of David Boies

Boies, Schiller & Flexner, LLP

Counsel for the Alaska Gasline Port Authority

Mr. Chairman, Members of the Committee, thank you for the opportunity to address the Committee on the important issues of rising energy prices and consolidation in the oil and gas industry. In particular, I would like to address certain anticompetitive practices in the oil and gas industry, the rising price of natural gas, and potential improvements in the antitrust laws to address these issues.

**Introduction**

As this Committee is well aware, for the last several years the price of natural gas has risen steadily and sharply. This trend significantly burdens the U.S. economy and the average American. As millions of people struggle to meet the rising energy costs, vast amounts of natural gas sit idle beneath Alaska's North Slope. The reason those resources have stayed in Alaska and have not been brought to market is that ExxonMobil and BP, the companies that control the production of most of those resources, have decided between themselves that they

would prefer to withhold this gas and maintain artificially high natural gas prices throughout the U.S., rather than market North Slope natural gas. Our client, the Alaska Gasline Port Authority, has brought an antitrust lawsuit challenging those practices. My testimony here today is not to argue that lawsuit, but to examine the behavior of those producers and the market structure to assist this Committee in determining whether any revision to the antitrust laws is necessary.

**The Rising Cost of Natural Gas**

The U.S. Department of Energy estimates that the U.S. average consumer price for natural gas for the winter of 2005-2006 increased 22.7% over last winter. Large and steady increases in natural gas prices are not new. Prices increased 13.1% in the winter of 2004-2005 and have risen by more than 150% over the last six years. Despite the moderating effect the most recent mild winter has had on natural gas prices, they are not expected to decline in the future.

Of course, the most vulnerable among us are the most affected by the rising prices. Millions of low income families need financial help to pay their energy bills. Millions more forgo other basic necessities to keep their utility service turned on.

**ExxonMobil and BP's Control of Alaska's North Slope Natural Gas**

In a competitive market, the steady climb in natural gas prices would have induced the producers to increase their efforts to bring more gas into the market

with the result of increasing supply and reducing prices. However, the natural forces of competition do not appear to be working on Alaska's North Slope, where the largest owners and developers of natural gas on the North Slope of Alaska, ExxonMobil Corporation and BP p.l.c., have jointly prevented North Slope natural gas from being brought to market.

The natural gas resources lying beneath the North Slope of Alaska are immense. Conservative estimates of proven natural gas on the North Slope exceed 35 trillion cubic feet (TCF). That gas in these quantities exists has been well known for over 30 years now. Some authorities estimate there are additional undiscovered gas resources in Alaska exceeding 150 TCF. By comparison, the total amount of natural gas consumed in the entire United States last year was approximately 22 TCF.

Ninety-four percent of the proven natural gas resources on the North Slope are owned by only three companies. Two of them, ExxonMobil and BP, together own 67% of those resources. Collectively they own over 60% of the natural gas resources in the Prudhoe Bay Unit ("PBU"), and over 75% of the working interests in the Point Thomson Unit ("PTU"). Their control over Alaska natural gas is further increased by unit operating agreements and ancillary agreements, many secret, that limit the production and development of lease interests in the PBU and PTU. For example, certain agreements effectively require both ExxonMobil and

BP to agree before either markets natural gas from the PBU (other than for limited on-site use). Moreover, BP is the unit operator for the PBU and ExxonMobil is the unit operator for the PTU. Thus, ExxonMobil and BP together control the development of almost all the gas resources that they do not own.

**ExxonMobil and BP's Anticompetitive Behavior**

Our complaint alleges that ExxonMobil and BP have used a variety of illegal means to maintain a stranglehold on the supply of natural gas on the North Slope and prevent it from ever reaching a market. They have acted together with the purpose of eliminating competition that could threaten their control over the development, marketing and pricing of natural gas.

For years they have refused to market North Slope natural gas. For example, natural gas is extracted every day on the North Slope as a by-product of the oil production process, but instead of being sold, it is re-injected into the ground. On the PBU, natural gas amounting to approximately eight billion cubic feet per day is extracted in connection with oil production. A small quantity is used for local operations and the rest is put back into the ground. No natural gas ever makes it off the North Slope. While re-injecting natural gas has the benefit in certain situations of increasing field pressure, it is not useful for this purpose in certain situations and there are virtually always more cost-effective approaches than abandoning the development of Alaska's immense natural gas resources.

ExxonMobil and BP's actions with regard to the PTU are even more egregious. For over 25 years, ExxonMobil and BP have ignored their duty to develop their leases and have failed to produce any gas or oil from the PTU.

In addition, ExxonMobil and BP have also engaged in a concerted effort to derail any gas pipeline that could be used to transport gas from the North Slope to domestic markets in the U.S. and elsewhere. ExxonMobil and BP know that without their commitment to supply a pipeline with gas, no pipeline sponsor will receive the financing to build a pipeline. As ExxonMobil's former CEO Lee Raymond stated:

> Then you have these competing pipeline proposals, which is fine if that's what you want to do. But the reality is, nobody is going to build a pipeline without the producers. You and I know how pipelines get built. The pipeline goes to the bank. The guy at the bank says, what are you going to put in your pipeline? Gas. Do you own the gas? No, I don't own the gas. Well, who does own the gas, and do you have a commitment from them that they are going to put it through the pipeline? Well, no, we don't have that. Then I don't think I'm going to give you much money to build a pipeline.

For several years the Alaska Gasline Port Authority has attempted to negotiate with ExxonMobil and BP for the purchase of natural gas. The Authority has secured significant senior permits, engineering studies, cost estimates and plans to build a natural gas pipeline. It also has $18 billion in loan guarantees available to it. Indeed, the Port Authority's pipeline could supply 7%-10% of the

total amount of natural gas used in the U.S. today. And with the amount of gas on the North Slope, it could provide that supply for decades. The only obstacle to the project is the producers' commitment to supply gas from the North Slope. Despite AGPA requests, ExxonMobil and BP have refused to engage in any discussion of the price or terms for the sale of North Slope gas.

ExxonMobil and BP's refusals to deal on the North Slope are not new. Over the years they have also jointly derailed projects proposed by other well-qualified pipeline sponsors such as Yukon Pacific Corporation, Warren Buffett's MidAmerican Energy Holdings Company, and TransCanada.

ExxonMobil and BP's refusals to deal run directly counter to their duties as leaseholders. BP has also violated the Charter BP entered into with the State of Alaska as a condition of its merger with Atlantic Richfield Co. In that Charter, BP agreed to negotiate in good faith with third parties for the sale of natural gas.

The result of ExxonMobil and BP's illegal conduct has been to artificially restrict the supply of natural gas and thereby artificially inflate the price of natural gas both in the U.S. and elsewhere.

ExxonMobil and BP's refusals to deal on the North Slope are a part of a pattern of manipulating and constricting supply in order to raise prices and increase their control of oil and gas markets. For example, in the mid-1990s, BP sold oil from Alaska in Asia at prices lower than it could have gotten in the U.S. in order to

tighten U.S. oil supplies and raise the price of oil shipped to refineries on the West Coast. This scheme was set out in an e-mail exchange between two BP employees, in which they discussed "shorting" the West Coast market to achieve West Coast "price uplift scenarios." One of these employees called the plan a "no-brainer." BP's conduct resulted in high prices at the pump for gasoline across the West Coast.

In addition to foiling all efforts by others to transport natural gas off the North Slope, ExxonMobil and BP have been stalling for years on coming to terms with the State on a pipeline deal. Now, mere months after we filed our lawsuit, ExxonMobil and BP claim to have reached a deal with the State. The terms of that deal have not been publicly disclosed, but we understand that it only sets out a timeline for continued study and negotiation. In other words, ExxonMobil and BP have not committed to construction of a pipeline, they have just agreed to continue to study and negotiate. Therefore, ExxonMobil and BP remain in control of the timing of any pipeline construction. This provides them with complete control over determining when North Slope natural gas finally comes to market, and permits them to extend the period of artificially high prices. Further, it is not certain that they will ever construct a pipeline. Any agreement by ExxonMobil and BP regarding marketing of North Slope gas must be viewed in light of their

ongoing failure to live up to their earlier agreements under their leases to develop this critical resource.

**The Legal Issues Presented by the Restriction on Output**

With this background, let me turn more specifically to the issues the Committee is studying. As this Committee knows, proving collusion can be a lengthy, difficult, expensive and uncertain endeavor. Sometimes evidence of collusion is available. In the *Vitamins Antitrust Litigation*, for example, we were able to prove that the vitamin suppliers got together in a room and agreed to reduce output to the U.S. markets. But proof of collusion is difficult to find and often anticompetitive cartels are never exposed to the light of day.

These problems can be particularly pronounced in the oil and gas industry. Generally speaking, it is safe to assume little good can come from situations where competitors sit down together and discuss prices or output. The mere opportunity to collude raises red flags. There are so many joint operations in the oil and gas business -- many of which apparently have received no antitrust scrutiny through the Hart-Scott-Rodino process or otherwise -- that there is great opportunity for collusion under cover of ordinary business.

Because of the anticompetitive conduct in the industry and the close associations among the operations of competitors across the globe, the regulatory

agencies and Congress should take a much more careful look at all levels of joint activity to discourage collusive activity

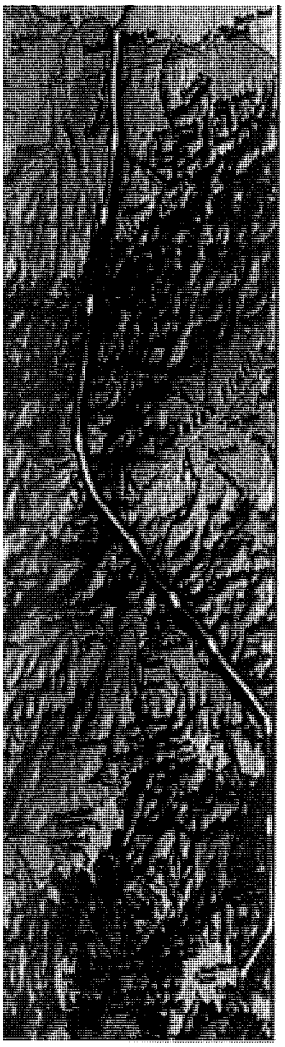
**Legislative Proposals**

The Committee was kind enough to share with me draft legislation designed to strengthen the current antitrust laws. This legislation proposes to prohibit unilateral withholding of oil and gas products when done with the intent of manipulating price, and to strengthen antitrust enforcement with regard to oil and gas industry mergers. It changes the standard for evaluating the possible anticompetitive effects of mergers and acquisitions in this industry, where increased consolidation is a serious concern, to bar any merger or acquisition that may "appreciably diminish competition." In addition, the legislation authorizes a study of the effectiveness of oil and gas industry divestitures previously required by the FTC and DOJ and the establishment of a joint federal and state task force to investigate information sharing among oil and gas industry participants. Finally, the legislation proposes to abrogate the doctrine of sovereign immunity and the act of state doctrine under certain circumstances.

I applaud the initiative of the Chairman and the Committee for addressing these important and timely issues. Even where output restrictions can be addressed under current law, the proposed legislation would significantly simplify and expedite preventing and remedying output restrictions of the sort engaged in by

ExxonMobil and BP to the detriment of American consumers. For this reason, this newly drafted legislation deserves serious review and consideration.

In addition to the proposed legislation, another idea that deserves serious consideration is an examination of Hart-Scott-Rodino requirements, and the enforcement of those requirements, to ensure that the various unitization agreements, unit operating agreements and ancillary agreements, and joint venture operating agreements in the oil and gas industry receive appropriate antitrust scrutiny.



# Alaska Gasline Port Authority

## Project Definition

AGPA
ALASKA GASLINE PORT AUTHORITY

January 2006

## Important Notice

The purpose of this document is to provide background information and assist the recipients hereof in obtaining a general understanding of the Alaska Gasline Port Authority ("AGPA") and its project. This document is not intended to form a sole basis of any investment decision or other decision to participate in the AGPA project and should not be considered as a recommendation or invitation by AGPA to make such decision. Each recipient hereof must make (and will be deemed to have made) its own independent assessment and appraisal of AGPA and its project after making such investigation, as it deems necessary in order to determine its interest and independently (and at its own cost) to have formed its own opinions and views.

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This document includes certain estimates and projections of the anticipated future performance of the AGPA project. Such estimates and projections reflect various assumptions made by AGPA and its advisors, concerning anticipated results, which assumptions may or may not prove to be correct. The actual outcome may be affected by changes in economic and other circumstances that cannot be foreseen or have not been anticipated. The reliance that can be placed upon the projections and forecasts is a matter of commercial judgment. No representation is made by the AGPA or its advisors as to the accuracy of such estimates or projections or as to the reasonableness of any assumptions used. The financial projections contained herein have been prepared and set out for illustrative purposes only and should not be taken as a commitment as to future performance.

**Table of Contents**

1. The Alaska Gasline Port Authority ..... 1
2. Project Overview ..... 1
3. Technical Support from the Bechtel Corporation ..... 4
4. Project Permitting ..... 4
5. Project Cost ..... 5
6. Funding Sources ..... 6
7. Project Schedule ..... 7
8. Technical Description and Construction Plan ..... 7
9. Project Economics ..... 12
10. Benefits to the Alaska State and Communities ..... 15
11. Advantages of the AGPA Project ..... 16
12. Project Risks and Mitigants ..... 17

## 1. The Alaska Gasline Port Authority

The Alaska Gasline Port Authority (***AGPA***) is a municipal port authority established on October 5, 1999, in accordance with the Alaska Municipal Port Authority Act (AS 29.35.600). AGPA was formed by the municipalities of the North Slope Borough, Fairbanks North Star Borough and the City of Valdez. An election was held in each of those municipalities and the voter approval for the formation of AGPA averaged approximately 80%.

AGPA was formed to develop a project that will commercialize Alaska's North Slope gas. The structure of AGPA's project has been designed to bring significant benefits to all project stakeholders: the North Slope producers, the State of Alaska, the municipalities of Alaska, and gas consumers in Alaska and the lower 48 United States.

AGPA is governed by a nine member Board of Directors, with each of the three member municipalities appointing three members for staggered terms of three years. The Chairman of the Board of Directors is Mayor Jim Whitaker.

Shortly following its formation, AGPA submitted to the Internal Revenue Service an application for a private letter ruling establishing that all of AGPA's income would be tax exempt. On January 24, 2000, the IRS issued the requested private letter ruling declaring that income to AGPA would be exempt from federal income taxes.

## 2. Project Overview

AGPA intends to build, or cause to build, a trans-Alaska gas pipeline, liquefaction and gas processing facilities and related infrastructure for the transportation of North Slope natural gas to market (the ***Project***). The Project consists of:

- **Pipeline:**

  An 806-mile overland gas pipeline from Prudhoe Bay to tidewater at Valdez that will run parallel to the existing Trans-Alaska Oil Pipeline (TAPS). This will be a dense-phase pipeline, designed to transport North Slope gas that is high in liquids content.

  The Pipeline will be designed to include a 195-mile spurline from Delta Junction (550 miles south of Prudhoe Bay) to the Alaska/Canadian border following the AlCan Highway. At the border, the gas would be transported through a new Canadian-owned pipeline to Alberta to tie into the existing gas transportation infrastructure and move the gas further south to the U.S. Midwest.

Gas transported to Valdez for liquefaction and gas transported along the AlCan Highway will share the first 550 miles of pipeline, resulting in significant economies of scale. The combined initial capacity of the Pipeline will be 4.5 billion standard cubic feet per day (***Bscfd***) of gas.

- **LNG Plant / LPG Extraction Facility**:

  An integrated liquefaction/fractionation facility in Valdez which will: (a) extract the liquid petroleum gases (***LPGs***) from the gas transported in the Pipeline; and (b) produce liquefied natural gas (***LNG***) for marine transportation to the West Coast of North America. Also included are storage facilities and vessel loading facilities for LNG and LPGs.

  The LNG Plant will consist of one to three process trains, which will be implemented according to a phased installation schedule for optimal timing of market entry. It is anticipated that the initial phase will include one train to deliver up to 1.1 Bscfd of LNG to the West Coast of North America.

- **Glennallen Spurline**:

  The Pipeline will include a tie-in at Glennallen for a spurline to the Matanuska-Susitna Valley (approximately 125 miles), to connect with the existing South Central natural gas grid and provide up to 0.5 Bscfd of gas to the South-Central Alaska and the Kenai Peninsula.

- **Gas Conditioning Plant**: A gas conditioning plant (***GCP***) will be built at Prudhoe Bay to remove carbon dioxide, water, and trace amounts of hydrogen sulfide from the natural gas feed and to compress and chill the gas to pipeline specifications. The GCP will also extract heavier (pentanes+) natural gas liquids (***NGLs***), which will be blended into the TAPS flow. The natural gas feed to the GCP will be raw gas, rather than residue gas from the existing gas processing facility at Prudhoe Bay. AGPA has assumed that the North Slope Producers would own and operate the GCP but is prepared to include it in its project scope if so preferred by the Producers.

LNG produced in Valdez will be shipped to regasification terminals on the West Coast of North America. The LPG extracted from the gas will be shipped to the best markets available in Asia or the United States.

AGPA has received Memoranda of Understanding (***MOUs***) from several West Coast receiving terminals in development:

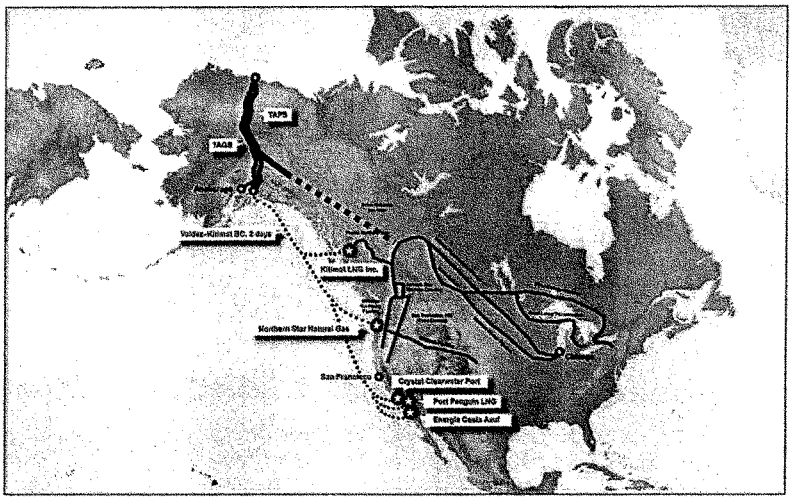
- Kitimat LNG, located in British Columbia, Canada
- Crystal Energy LLC, located offshore Southern California
- Penguin LNG, located offshore Southern California

- Northern Star Natural Gas, located in Bradwood, Oregon

In addition, Sempra LNG continues to express interest in receiving Alaska LNG at its Costa Azul terminal in Baja, Mexico.

The estimated LNG tanker voyage to the Kitimat LNG terminal and to Southern California is approximately two and four days, respectively. For gas transported to the Kitimat LNG terminal, the Project will not be subject to the Jones Act, as the gas composition will be altered through some liquid extraction at the receiving terminal in Canada. Furthermore, AGPA has received an MOU from the American Shipping Group/ Totem Ocean Trailer Express (***TOTE***), a private shipping company serving Alaska since 1975, with the American Shipping Group as its parent company. TOTE has submitted an MOU and a competitive price quote to AGPA whereby TOTE would provide U.S.-built LNG ships in full compliance with Jones Act for gas shipped to U.S. West Coast LNG receiving terminals.

**Figure 1 Destination Markets for Alaska Gas**




As shown in Figure 1, the Project will capture multiple segments of the integrated North American gas market. The Project will maximize the value of North Slope gas by allowing Alaska to capture both the West Coast and Midwest regional gas markets as early as 2012.

The assumed initial base case volumes are 4.5 Bscfd of gas at the Pipeline inlet, with 1.3 Bscfd transported to Valdez for liquefaction and liquids extraction, 3 Bscfd transported to the Midwest through Canada and 0.2 Bscfd for in-State consumption.

Project capacity can be expanded through the installation of additional LNG trains in Valdez, additional compression on the Pipeline (and related Canadian pipelines) and additional gas conditioning process trains at Prudhoe Bay.

## 3. Technical Support from the Bechtel Corporation

Shortly after formation, AGPA signed an MOU with the Bechtel Corporation (***Bechtel***) for technical assistance in analyzing the Project. On November 1, 1999, Bechtel initiated and engineering, procurement and construction (***EPC***) study with the following scope:

- determine engineering basis
- develop overall execution plan
- develop an EPC schedule
- provide preliminary assessment of environmental issues and project risks
- prepare +/- 20% cost estimate
- obtain two to three quotes for all major material and equipment

The Bechtel EPC Study was completed at the end of 2000 and was the result of over 55,000 hours of work. Since the original work was completed, the prices of steel, concrete, various equipment, and transportation have increased significantly. In March 2005, Bechtel performed a revision of the cost estimate to reflect these changes in market conditions.

## 4. Project Permitting

In order to expedite the permitting for the Project, AGPA has entered into an exclusive Option Agreement with CSX to purchase the equity of the entities which own the environmental data, studies, permits, and rights of way developed by the Yukon Pacific Corporation (***YPC***) in connection with an earlier version of the Project. Bechtel's environmental personnel have estimated that the use of this data and rights will enable the Project to save 18 to 30 months in permitting and construction time over any competing project.

YPC was formed in 1982 by two former Governors of Alaska, William Egan and Walter Hickel, for the sole purpose of building a trans-Alaska gas pipeline to tidewater at Valdez for the export of LNG. Over its many years of existence, YPC obtained numerous

permits and rights associated with such a project. The following is a list of these permits, in the order in which they were received:

- FERC Declaratory Order Regarding its TAGS Jurisdiction (May 27, 1987)
- Presidential Finding Approving Export of Alaska Natural Gas (January 12, 1988)
- Coastal Zone Consistency Determination (January 20, 1988)
- TAGS Project-wide Final EIS (June, 1988)
- Ahtna Corporation Right of Way Agreement (October 14, 1988)
- Federal Pipeline ROW Grant (October 17, 1988)
- State of Alaska Conditional ROW Lease (December 10, 1988)
- DOE/OFE Authorization for Export of Natural Gas (Order 350) (November 16, 1989)
- DOE/OFE Confirmation of Order 350 (March 8, 1990)
- Anderson Bay (LNG Terminal) Final EIS (March, 1995)
- FERC Authorization for Siting LNG/MT Facility (May 22, 1995)
- Anderson Bay LNG/MT Facility Air Quality (PSD) Permit (August 5, 1997)

All of the above permits remain valid today. AGPA anticipates updating the key siting permits with up-to-date environmental and technical information. Certain adjustments will be made to reflect AGPA's plan to shift the market for Alaskan LNG from Asia to the United States or to expand the pipeline facilities.

## 5. Project Cost

The EPC costs for the Project have been estimated as follows:

- **Liquefaction and LPG extraction facilities**: $2.1 billion for each process train (or approximately $280 per ton of installed LNG capacity), with a combined cost of $6.3 billion for the all three trains.
- **Pipeline**: The total cost of the Pipeline, including the spurline from Delta Junction to the Alaska/Canadian border is estimated to be $12 billion.
- **Gas Conditioning Plant**: The cost of the GCP for the fully ramped-up project is estimated to be $5.1 billion. The Bechtel EPC cost estimate for the GCP assumes no benefit from the use of existing North Slope infrastructure. The use of such existing infrastructure will reduce costs and improve project economics.

The Bechtel EPC cost estimates include:

- EPC contingency allowances (8%-20%, depending on cost component)

- allowance for cost escalation during construction
- contractor's profit margin

In addition to the Bechtel EPC cost estimates, the following pre-finance owner's costs have been assumed by AGPA:

- owner's contingency, estimated at 5% of EPC cost: $949 million
- construction insurance, estimated at 1% of EPC cost: $189 million
- line pack: $17 million
- O&M mobilization, G&A costs: $95 million
- development costs: $100 million for the total Project
- impact fees: $100 million
- permits acquisition payment: $60 million
- initial working capital: $20 million

Financing costs (interest during construction, fees, etc.) add an additional $3.8 billion to the AGPA Project capital cost.

## 6. Funding Sources

The capital required for most municipal organizations of this type is typically raised using a 100% debt structure. That debt is usually in the form of municipal bonds – both taxable and tax-exempt. The use of tax-exempt bonds is restricted, with some exceptions, depending on how much of the Project will be used for municipal purposes as opposed to private uses. In this case most of the Project will fall in the private use category. However, one exception to the private use restriction is for port facilities. AGPA believes it can potentially qualify over $3 billion of the Project bonds for tax-exempt treatment.

In November 2004, legislation was enacted by Congress (Public Law 108-324, the codified version of HR 4837, the Alaska Natural Gas Pipeline Act) which provides for a federal loan guarantee, up to a maximum of $18 billion, for 80% of the project cost of a qualified Alaska pipeline project selected by the Secretary of the Department of Energy. AGPA intends to apply for a federal loan guarantee under this authority.

AGPA will fund the remaining portion of the Project cost by raising non-guaranteed project debt. As tax-exempt debt cannot be federally guaranteed, AGPA will optimize the allocation of its tax-exempt and taxable debt issues by using the guaranteed debt for the portions of the Project that are not qualified for tax-exempt debt and raising tax-exempt debt for the portions of the Project that are eligible as port facilities or non-private use.

## 7. Project Schedule

The AGPA Project will enable the timely commercialization Alaska's gas. The use of existing YPC permits will enable the Project to save an estimated 18 to 30 months in permitting and construction time. The AGPA project does not rely on speedy resolution of various Canadian regulatory issues, legal disputes and aboriginal claims issues. Based a 48 month construction schedule and assuming start of construction at the end of 2007, AGPA will be able to deliver gas as early as 2012.

## 8. Technical Description and Construction Plan

### 8.1 Gas Conditioning Plant

The GCP has been designed to remove undesirable components to within LNG specifications. The undesirable components are moisture, carbon dioxide, hydrogen sulfide, benzene, and other heavy hydrocarbons. The GCP will compress and chill the feed gas to pipeline specifications.

The GCP consists of three major process sections: dehydration and mercury removal section, cryogenic process section, and pipeline gas compression and chilling section. There are two refrigeration loops, propane and ethylene, to support the cryogenic process. Complete specifications of utilities are included to make plant operations independent of the existing CGP to the maximum extent possible.

Equipment and piping located outdoors will be designed for arctic operation. In general, low temperature metallurgy will be utilized whenever equipment and material is exposed to low ambient temperatures and where the steel is subjected to operational stress or loading. This includes major structural steel members and pressure retaining parts including piping and vessels. All mechanical, electrical, and safety systems will be designed to withstand extremely low ambient temperatures without experiencing detrimental effects.

The construction execution plan for the GCP is based on modular fabrication at selected yards located world wide. Conventional over-the-road transportation cannot be considered for the prefabricated modules, which will be used to construct this plant due to their extreme weight and dimension. The only practical manner in which to move cargo of this size to the North Slope is by barge. Timing is an integral part of this plan as the shipping window into Prudhoe Bay is limited to the period when the ice recedes.

The project scheduling plan is to have barges originate from the U.S. Gulf Coast, from Asia Pacific, and from Dutch Harbor Alaska. The plan assumes that all available modules from Asia Pacific and vendor assemblies from the U.S. Gulf Coast will be loaded onto barges directly from their fabrication yards. Some modules and vendor assemblies originating from Europe will be loaded onto heavy lift or roll-on, roll-off

(RORO) vessels for shipment to Dutch Harbor Alaska, where they will be transferred to barges for the final leg of their journey.

Each barge will ship to Point Clarence to be properly fitted for the final voyage and to await open water in Prudhoe Bay. As conditions become favorable, the barge fleet will make the final move to Prudhoe Bay with tandem tows. Ice reconnaissance planes will also be deployed to chart ice pack motions and report to the barge fleet for navigation.

Docking facilities in Prudhoe Bay will be limited to the West Dock Two. This is the only dock suitable for unloading modules in Prudhoe Bay. However, the draft at this dock is estimated to currently be between 6-1/2 to 7 feet in depth. This is insufficient for the 400' x 100' barges when fully loaded and will require lightering from these large barges to smaller barges to safely discharge at the West Dock Two.

When the barges arrive at West Dock Two, they will be moored in a load-out position by the barge operator and ballasted to a position level and flush with the dock. There will be sufficient access at the dock for mooring two barges.

Self-propelled modular transporters will be required to move the modules from the barges to the construction site.

The work at Prudhoe Bay will consist of preparing the site, off-loading, setting, and interconnecting all modules, vendor assembles, and major columns. A small amount of non-module piping will be required. A competent contractor under Bechtel's direction, supplemented by specialty subcontractors, will execute the work at Prudhoe Bay.

Preliminary discussions with existing North Slope contractors indicate that there is sufficient camp capacity at Prudhoe Bay to accommodate the approximately 550 persons required to construct the GCP. The available space is located at the Frontier Camp, several camps near Deadhorse Airport, the ARCO Camp, and the BP Camp. Preliminary planning would house the craft personnel at the Frontier Camp and arrangements would be sought to house the non-manual staff at either the existing ARCO or BP camp. Camp catering, housekeeping, and camp operating services are available locally.

Construction equipment such as hydraulic cranes, tools carriers, and air compressors, are available for lease from several companies operating in Prudhoe Bay. Arctic fuel is produced by both ARCO and BP and is available from local bulk fuel distributors. Although construction temporary power is currently planned to be provided by diesel generators, electricity is generated at the North Slope.

### 8.2 Pipeline

The Pipeline will be built to accommodate initial gas volumes of around 4.5 Bscfd. The segment from Prudhoe Bay to Delta Junction may be built with up to 56-inch outside diameter, to enable an expansion to transport 6-7 Bscfd.

An operating pressure of 2,220 pounds per square inch - gauge has been determined, with two compressor stations initially installed along the route to maintain this pressure requirement for the initial volumes. Additional stations will be constructed as volume through the pipeline increases. Compressors will be driven by gas turbines. Compressor stations not needed for the initial flow condition will be equipped with pig traps and valves for station bypass and isolation to facilitate later expansion of the pipeline system.

Routing of the Pipeline is roughly parallel to and in relatively close proximity to the existing TAPS line. It is planned that a minimum 200-foot separation will be maintained between the Project's pipeline and TAPS, except at points where the pipelines may cross.

The Pipeline is assumed to be buried along its entire length, both for safety and to lower the overall cost of the system. Provision was made to operate the line by first chilling the gas to below freezing before introduction into the pipeline to prevent thawing of the permafrost.

Construction personnel will be accommodated in camps to be provided by the Project. A total of twelve camps are anticipated. Each camp will be sized to meet peak demands at its location. Two camps are located in close proximity to the planned location of the two compressor station sites and will be sized to accommodate both pipeline construction and compressor station construction personnel. Overall, camp sizes will range from 600-persons to 1100-persons based on a peak pipeline and compressor station staffing that is estimated to be in excess of 6,000.

Construction of the pipeline will be divided into multiple "spreads" (i.e., major construction segment assigned to one subcontractor). The spread subcontractors will be responsible for provision of all required labor and construction equipment. Sub-tier contractors will be used for specialty work.

A series of craft training programs, such as welder training, will be conducted as a coordinated effort between the prime construction contractor and the spread subcontractors. These training programs are intended to provide opportunities for local Alaska residents to qualify for jobs on the pipeline and to supplement the pool of qualified labor available to the Project.

Pipeline construction will utilize a combination of graded right-of-way, snow/ice workpads, and gravel workpads. Automatic welding will be used to improve both the quality and the speed of the welding effort. Ditching will be accomplished by a combination of explosives and by the use of chain-type trenching machines. Crossing of certain rivers and streams (e.g., major rivers, selected sensitive fish streams) may be installed by directional drilling or microtunneling in order to minimize potential environmental impacts. After installation and burial of the pipeline, the right-of-way will be restored in accordance with the Project's environmental plans.

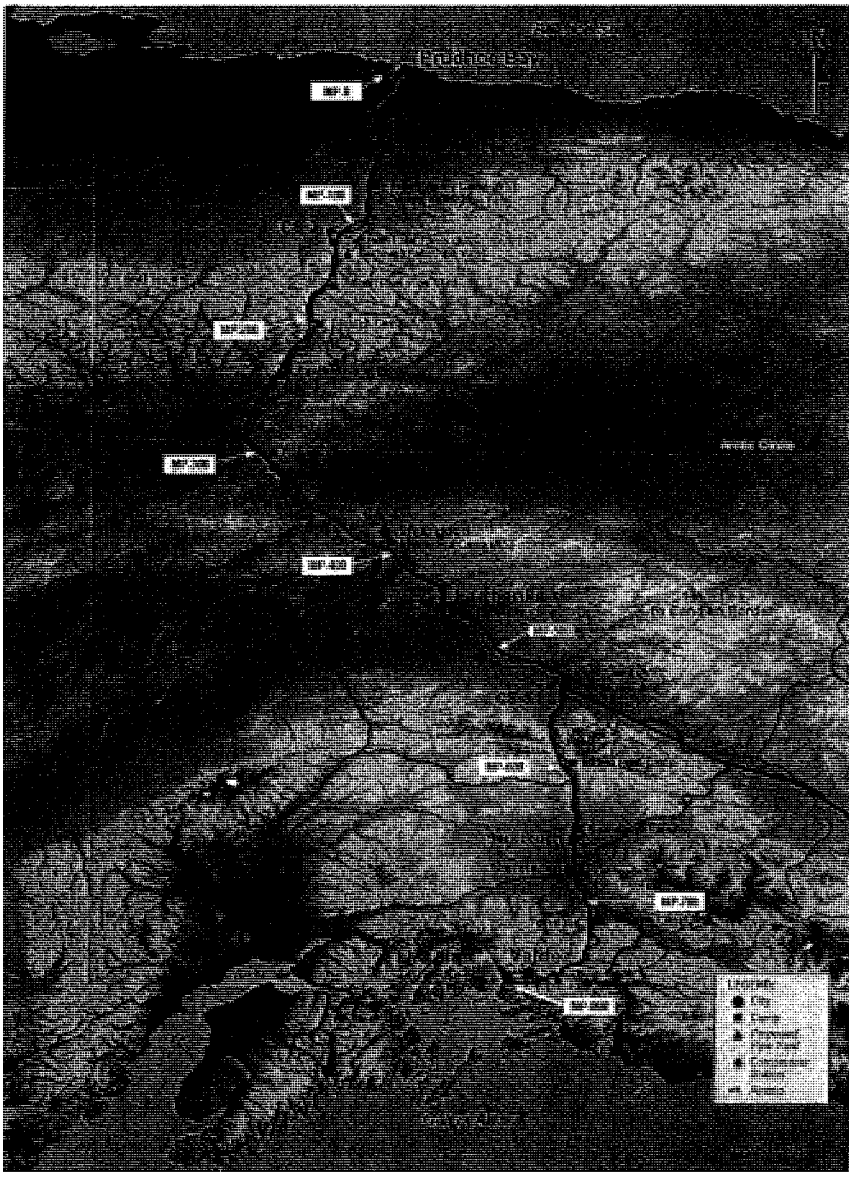
Compressor stations will be constructed on-site in lieu of modularization. Buildings will be shop-fabricated for field erection. Shop prefabrication of some piping may be

conducted to save overall capital cost. A concrete batch plant will be located at each station site due to remoteness. These batch plants will also service portions of the pipeline construction effort.

The pipeline and compressor stations will be installed in both the summer and winter seasons to take advantage of each season's unique conditions; i.e., summer's mild temperatures and extended daylight, and winter's cold to protect the permafrost. Whereas all-summer or all-winter construction runs the risk of unusual weather conditions severely impacting schedule, this year-round approach provides the greatest assurance of completing the job on schedule as the Project can better adjust to unusual weather extremes.

The routing of the Pipeline and planned location of construction camps is shown on Figure 2.

**Figure 2 Pipeline Route**



### 8.3 LNG Plant and LPG Extraction Facility

Liquefaction capacity will be installed incrementally through the installation of process trains. The AGPA Project anticipates up to three process trains, each with a liquefaction capacity of up to 1.1 Bscfd of gas (approximately 8 MMTA of LNG). The liquefaction facility has been designed on the basis of the Phillips Optimized Cascade process, which is a proven technology.

The Alaska LNG plant feed stream will have a high concentration of LPGs (propane and butante), requiring additional process equipment to strip LPG from the natural gas prior to production of LNG. The base case estimates LPG production of approximately 120 thousand barrels per day.

The LNG facility will include LNG storage tanks and two loading docks for ships. The Valdez site is an ideal harbor for large ocean-going vessels due to the deep water surrounding the site. Loading dock one will be approximately 270 feet long and loading dock two be 500 feet long. The design allows for one docked ship per loading dock with concurrent loading. LNG will be loaded from either loading dock and LPG will only be loaded from loading dock one.

LNG storage tank operating pressure is 15.4 psia. The LNG loading rate is 10,000 cubic meters per hour. Loading arm requirements are for two for loading, and one for vapor return (per loading dock).

During the first year of construction, an access road from TAPS to the LNG site will be constructed. It will be a gravel all weather road to enable the site to receive vehicles and reduce the risk and cost of marine operations. A construction camp for 2500 will be erected. During the first year, the construction activities will be initiated with the clearing and grading of the plant site. Blasting will be performed during the fall and winter months to maintain the schedule. During the blasting operation, the holes for the rock-anchoring program will also be drilled.

During the second year of construction, all of the first train mass foundations will be completed in the summer months and the pedestals will be completed in winter. Permanent steel formwork will be used to maximize productivity. Concrete will be provided from onsite batch plants.

## 9. Project Economics

The forecast economics of the AGPA Project are robust, providing significant economic benefits to the North Slope Producers and the State and communities of Alaska.

### 9.1 Gas Purchase Price Methodology

AGPA proposes to purchase North Slope gas at the inlet of the gas conditioning plant on a netback basis, whereby upon receipt of gas and LPG sales revenue, AGPA will pay the Project's operating costs, service its debt obligations, make certain payments to the State and municipalities and provide *all* the remaining proceeds to the North Slope Producers in the form of a netback purchase payment for the gas. The netback price is calculated as:

$$P = N / Q$$

where

P = Purchase price at GCP inlet

N = Netback revenue

Q = Quantity of gas purchased, in million British thermal units (***MMBtu***)

The value of N is calculated as follows:

(A) aggregate Project revenues from sale of gas, LPG and NGL

*less*

(B) Project operating costs:
- (i) O&M expenses
- (ii) LNG shipping and regasification costs
- (iii) costs of downstream gas infrastructure access and transportation to market
- (iv) GCP tolling charges payable to GCP operators

*less*

(C) interest expense and principal repayment on debt

*less*

(D) subordinated project expenses:
- (i) Permits acquisition payments
- (ii) Payment in lieu of property taxes (PILT)
- (iii) AGPA distribution to Alaska State and communities

*plus*

(E) cash in-flows:
- (i) funds returned from debt service reserve accounts (if any)
- (ii) interest earnings on cash deposits

### 9.2 Forecast Netback Prices

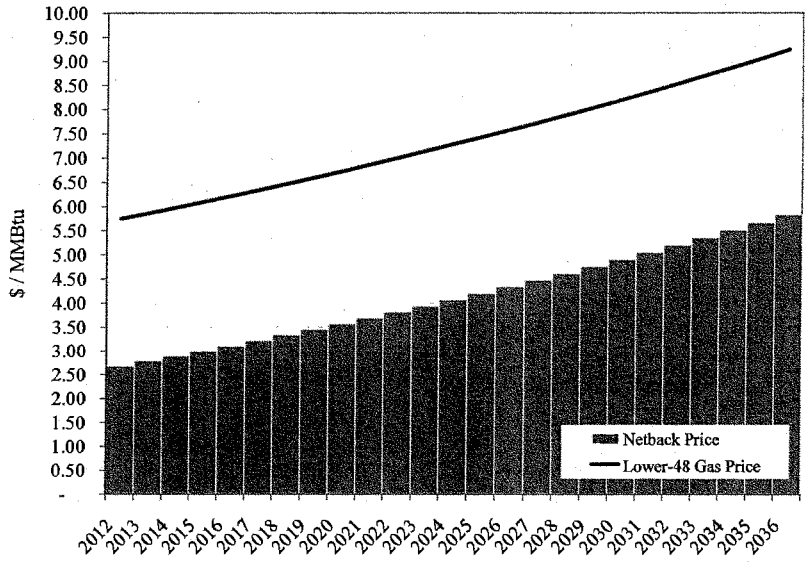
The AGPA base case assumes a Henry Hub gas price of $5.00 per MMBtu in constant 2005 dollars. Real prices are escalated at an assumed rate of inflation of 2% per annum

to obtain forecast nominal (money-of-the-day) prices for each year of the Project's operating period. The resulting nominal Henry hub price in 2012 is $5.74 per MMBtu.

The forecast netback prices at the GCP inlet depend in part on the location of the receiving terminals and the allocation of LNG volumes to each West Coast terminal for regasification. The netback prices at the Pipeline inlet for 2012 are projected to be in the range of $2.50 to $2.75 per MMBtu, depending on the assumed proportion of LNG allocated to each of terminal.

The base case assumes that equal LNG volumes are regasified at three receiving terminals in the Kitimat, Oregon and Southern California locations, resulting in a netback price at the Pipeline inlet of $2.68 per MMBtu in 2012. The netback price is projected to increase every year after 2012 in increments of $0.10-$0.15 per MMBtu. The assumed Henry Hub gas price and base case forecast netback price, in nominal terms, are illustrated below. The projected netback pricing will be adjusted when the regasification capacity allocation utilized by the Project is finalized.

**Figure 3 Base Case Nominal Henry Hub and Netback Prices**




The projected netback prices to the North Slope Producers are competitive. AGPA has a lower cost of capital than a private gas transporter, who will likely require a return on equity in the order of 14%), and AGPA income is exempt from income taxes. This reduces AGPA's cost of service and increases the netback value to the North Slope Producers.

The projected nominal netback revenue to the Producers in 2012 is $4.8 billion. Netback revenue increases every operating year thereafter, averaging $8.5 billion per year for the remainder of the assumed 30-year operating period.

Projected real (i.e., inflation-adjusted) netback revenue to the Producers is $4.1 billion in 2012, with an annual average of $5.3 billion for the remainder of the operating period.

## 10. Benefits to the Alaska State and Communities

The AGPA Project will generate substantial benefits to the State of Alaska and all Alaska communities. The AGPA Project will provide greater revenues to the State of Alaska and all Alaska communities than the proposed alternatives. It will result in significantly greater infrastructure investment in Alaska and will generate significantly greater long-term job creation in Alaska. The Project is expected to generate (a) 550 jobs at the GCP; (b) 7,200-13,200 jobs for the Pipeline; and (c) 2,500 jobs for the LNG Plant. It will also provide more gas for use in Alaska.

As part of its cost structure, AGPA will make two forms of payments to the State and all Alaska municipalities:

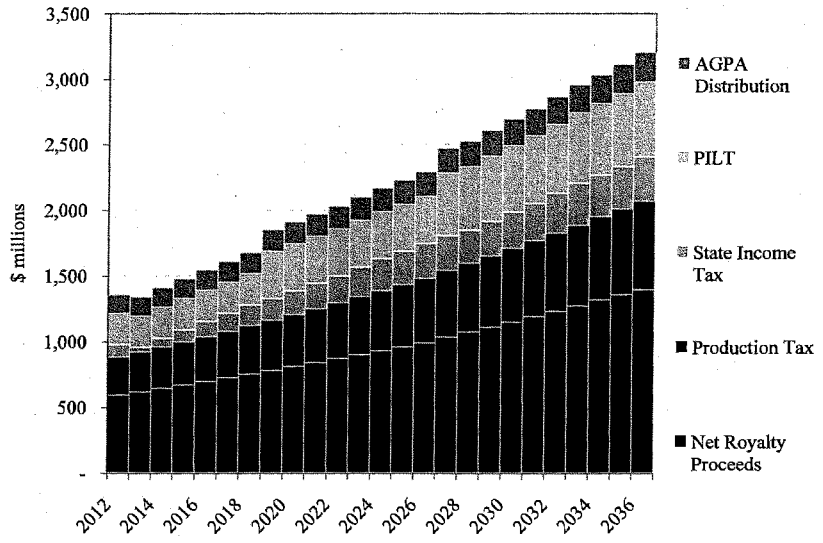
- Payment in lieu of property taxes (***PILT***)
- An annual distribution to Alaska communities (the ***AGPA Distribution***)

Funds from the AGPA Distribution will be distributed to all Alaska municipalities, based on population. The State will receive PILT payments for the portion of the Pipeline built on State land.

The Project will directly generate substantial revenues to the State from the upstream component of the Project: proceeds from royalty gas and NGL, production tax on gas and NGL, and State income tax on the upstream operations and the GCP (if privately owned). As the AGPA Project will achieve higher netback revenue due to its lower cost structure, the State will realize higher value on its upstream tax proceeds.

Figure 4 shows the projected nominal (money-of-the-day) revenues for the State and communities of the Alaska.

**Figure 4 Revenues to the State and Municipalities of Alaska**




## 11. Advantages of the AGPA Project

In marked contrast to the public opposition often found in other jurisdictions when oil and gas development is proposed, the vast majority of Alaskans support the development of the Alaska LNG Project:

- October, 1999: By an average of 80%, Fairbanks North Star Borough, North Slope Borough and Valdez voters authorize AGPA to build an All-Alaska gasline
- November, 2002: 62% of statewide voters authorize the Alaska Natural Gas Development Authority to build an All-Alaska gasline
- September, 2003: Backbone II, a state-wide organization co-chaired by former Governor Walter Hickel, is formed to support an All-Alaska gasline
- November, 2004: Alaska Municipal League representing over 160 Alaskan municipalities unanimously votes to support this Project
- November, 2004: Alaska Congressional Delegation clarifies law guaranteeing that federal incentives apply to an All-Alaska gasline

- May, 2005: A statewide poll concluded that 65% of Alaskans favor an All-Alaska gasline over all other proposed projects. Two former governors, Governor Jay Hammond and Governor Walter Hickel, as well as many prominent Alaskans including politicians and business and labor union leaders, publicly advocate this Project
- May, 2005: The All Alaska Alliance, consisting of state environmental organizations, organized labor and other state-wide entities have joined in a united effort to promote this Project
- August, 2005: The Alaska First organization, including of the largest public utilites in the State who depend on natural gas to supply energy to over 400,000 Alaska residents and are concerned about South-Central Alaska's loss of natural gas, was formed to support the Project

The AGPA Project will enable the commercialization of Alaska's North Slope gas on a timely schedule. In addition to preventing the loss of State and municipal revenue resulting from potential delays to competing projects, AGPA would allow Alaska to preserve market optionality for its gas. If the AGPA Project is not implemented quickly, Alaska may lose the West Coast market to alternative LNG suppliers, as the Producers are targeting the West Coast market from other projects.

AGPA is prepared to move forward the LNG or the AlCan Highway portion of the project, whichever is ready to proceed first. If the LNG project is implemented first, the Midwest market would remain available for future expansions via the AlCan Highway route. Alternatively, if West Coast market is captured by foreign LNG supplies, Alaska's future gas sales and expansions may be constrained or eliminated.

The "Y-line" concept proposed by AGPA, with a Highway project tie-in at the Delta Junction, would allow gas to be commercialized utilizing both routes to market. Sharing the line to the Delta Junction would reduce unit costs for both routes and would increase netback prices, while providing the greatest optionality to maximize the value of Alaska's gas in all potential markets.

Overall, the AGPA project will provide maximum use of Alaska's resources for the maximum benefit of Alaskans.

## 12. Project Risks and Mitigants

**Cost Overruns and Project Delays**

- The Project benefits from the world-class technical experience of Bechtel. AGPA's capital cost assumptions are based on the extensive technical work performed by the Bechtel engineering team and are conservative, including sizable contingencies and cost escalation allowances. The AGPA capital cost

estimates have been updated to account for recent price increases of materials and equipment.

- Significant portions of the Project will have relatively low risk of overruns due to the use of proven technologies and standardized designs. The liquefaction facilities at Valdez and the cost of LNG marine transportation and regasification will be subject to a relatively low level of cost uncertainty.

- The Pipeline has the highest risk of capital cost overruns, due to challenging terrain and conditions and the recent volatility of the price of steel. The Pipeline represents a smaller portion of the overall cost of the AGPA Project (about 50%) than in the case of competing overland pipeline projects via the Alcan Highway, for which the pipeline represents most of the capital cost.

- The Project has robust pro forma economics, indicating an ability to sustain relatively large increases in capital cost before the netback pricing at the North Slope becomes unprofitable.

- AGPA will implement a comprehensive EPC contracting strategy, seeking to mitigate cost overrun risk through the maximization of lump sum contracting to the greatest extent possible. AGPA will contract with world-class, experienced contractors, such as Bechtel, to manage the construction process.

- AGPA will seek commitments for contingent funding to be available in the event of cost overruns and Project delays.

**Operational Performance**

- AGPA will contract with experienced, world-class operators to manage the technical aspects of the Project during the operating period.

**Gas Market and Price Risk**

- AGPA intends to obtain long-term, firm supply commitments for North Slope gas.

- Projected decline in Lower-48 conventional gas production will create a strong demand for the Project's gas.

- The pro forma Project economics are strong and generate high netbacks at conservative base case price assumptions.

- The netback pricing arrangement proposed by AGPA minimizes the financial commitment of gas suppliers and mitigates their risk exposure to cover potential negative netbacks.

- Upstream investment requirements are relatively small in comparison with the revenue generation capacity of the Project.
- The relatively low-risk, high-reward upstream economics should provide a strong economic incentive for the gas suppliers to honor their performance obligations under the firm supply contracts.
- AGPA will contract with experienced gas marketers to maximize the value of Alaska's gas.

**LPG Market and Price Risk**

- The Project will maximize the value of Alaska's LPGs as it will be able to sell in the best available market in the Pacific Rim and the US Gulf Coast. Historically, the East Asia has been a premium market for LPGs. In contrast, the competing Alcan Highway projects will sell LPGs in Alberta and the Midwest, which are surplus markets that will not be able to absorb the large quantities of incremental LPGs without a significant increase in price discounts.
- AGPA will contract with experienced LPG marketers.

**Reserves Risk**

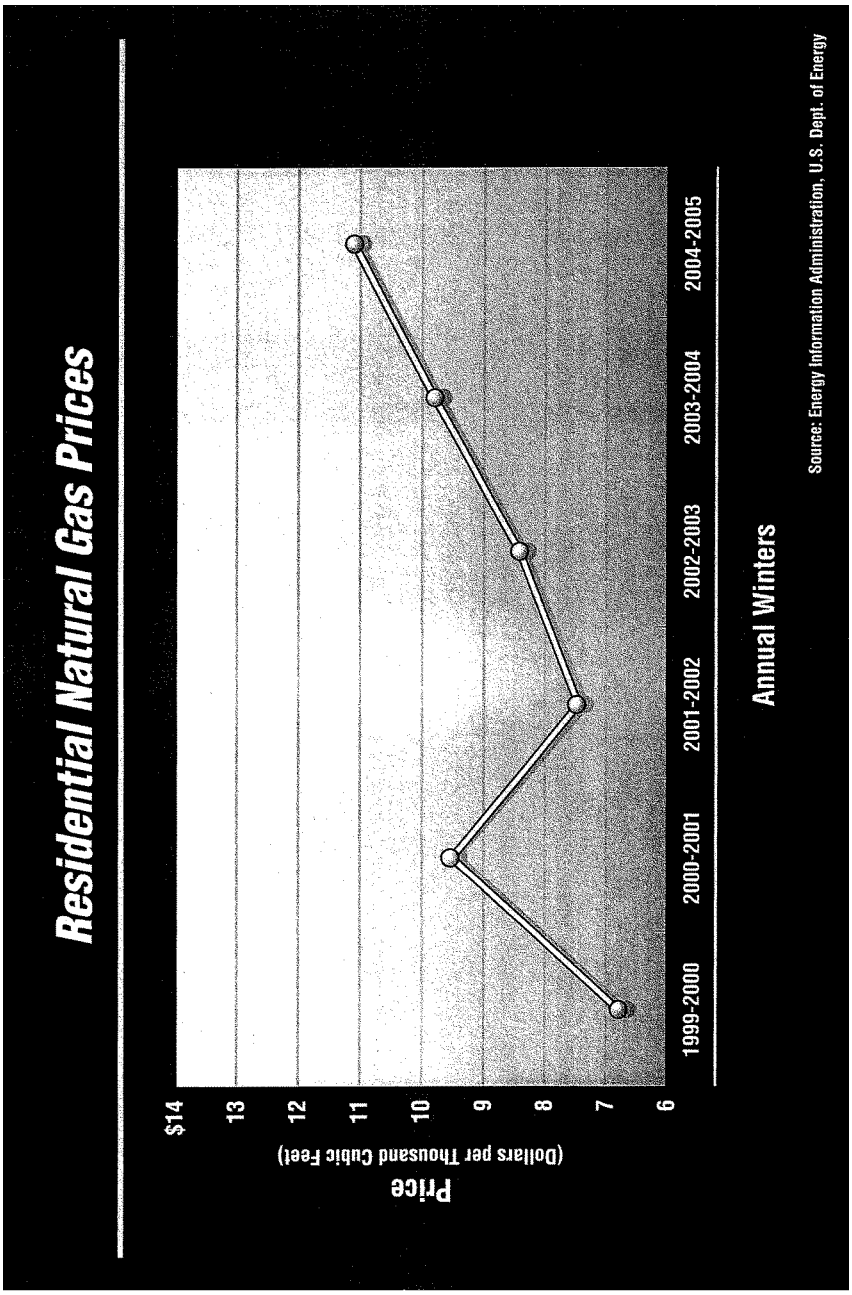
- The North Slope contains 35 Tcf of a known discovered gas resource. This gas has been discovered primarily as a result of exploration for oil. It is commonly believed that the undiscovered gas resource on the North Slope is a multiple of the known discovered resource, more than sufficient to supply the Project, with expansions, for decades.
- The prospect of an imminent trans-Alaska gas pipeline project is expected to spur extensive further exploration for gas on the North Slope in leases with prospective gas accumulations.

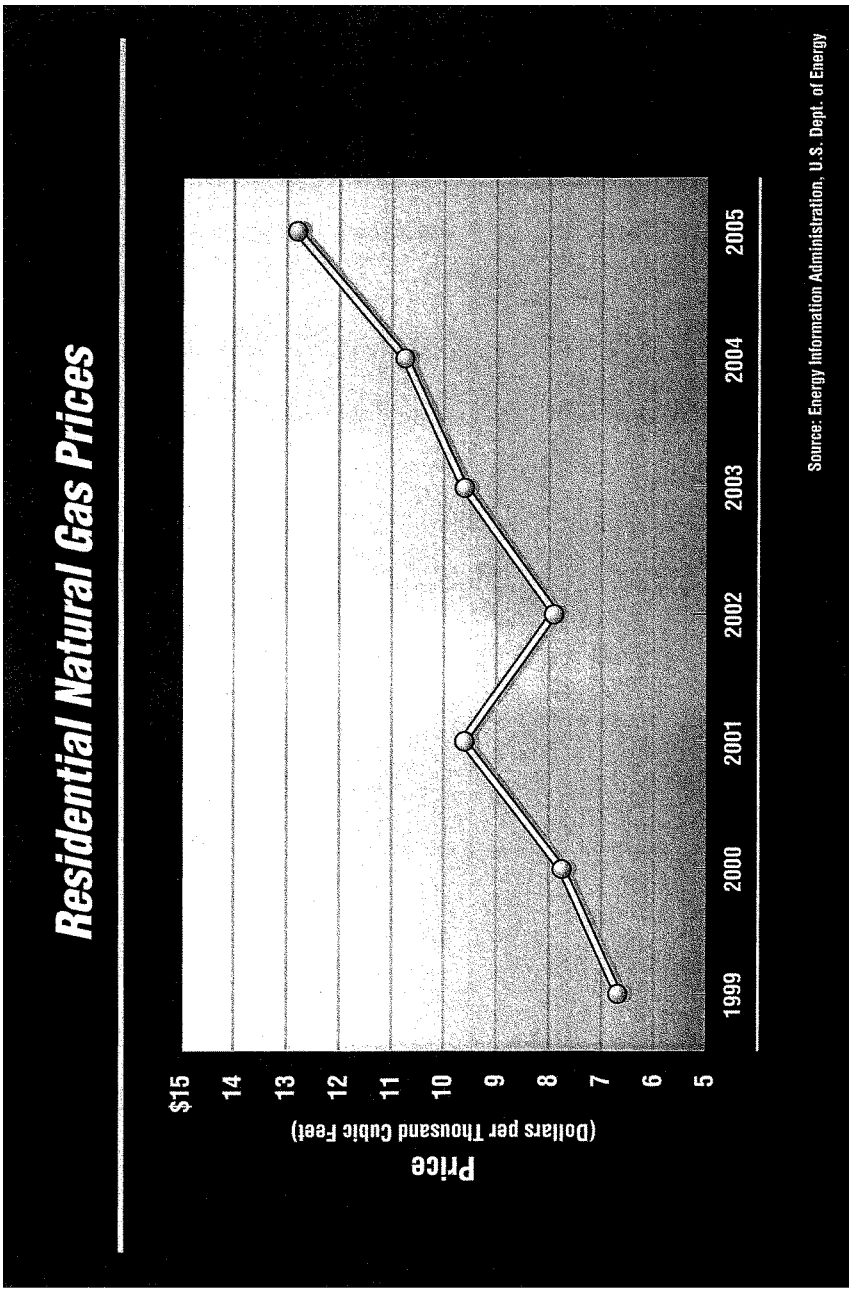
# Demonstrative Exhibits Used in Connection With Testimony of David Boies

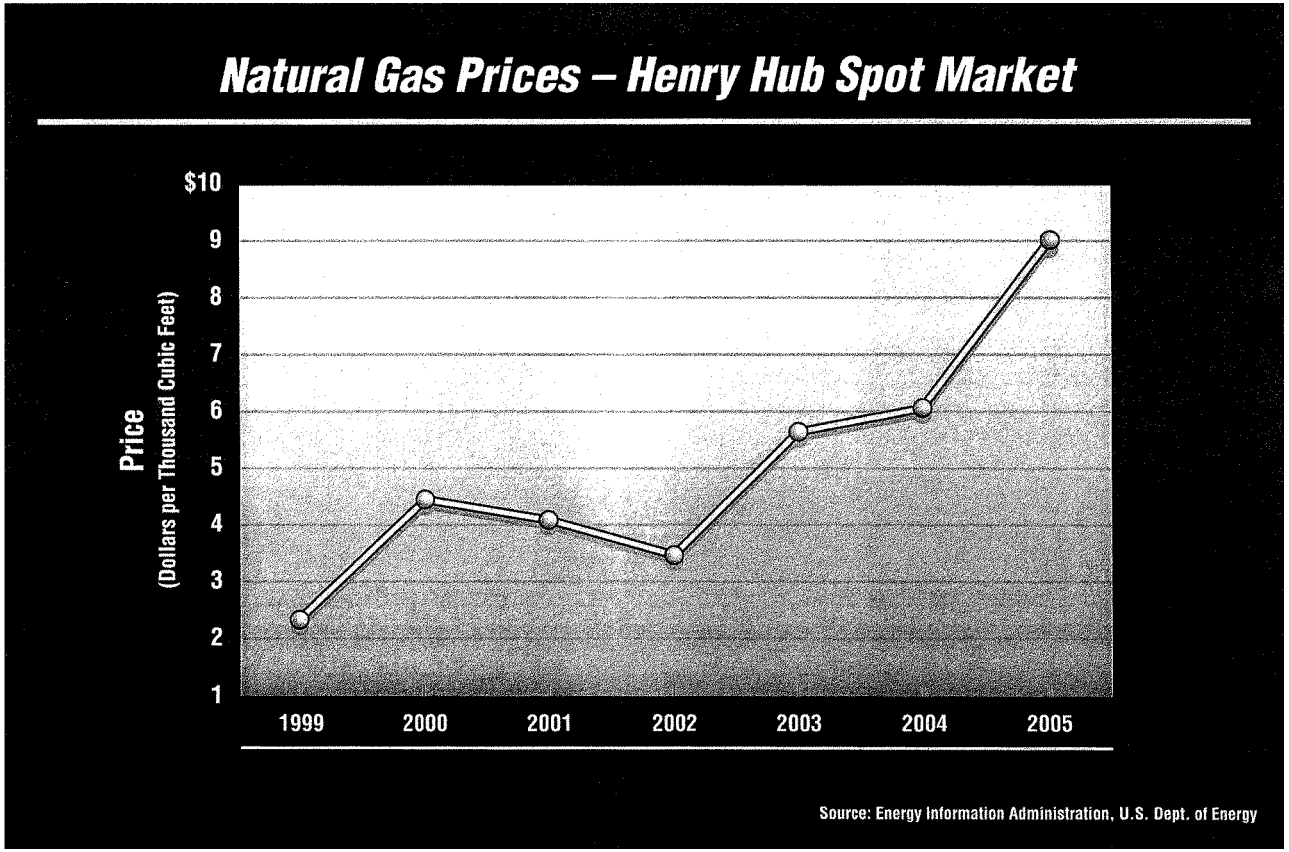
## Before the Committee on the Judiciary United States Senate

*March 14, 2006*

Hearing Entitled, "Consolidation in the Oil and Gas Industry: Raising Prices"

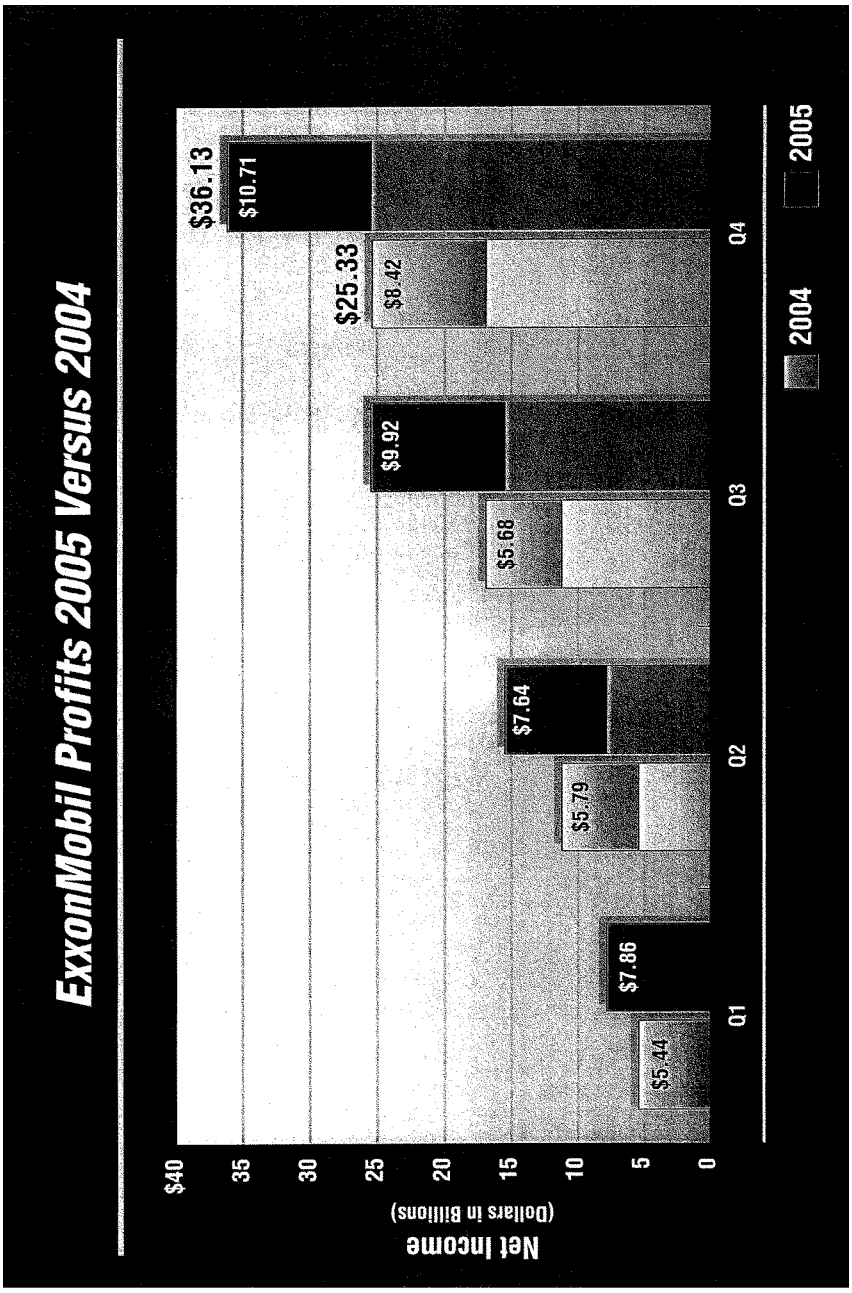

Residential Natural Gas Prices
Price
(Dollars per Thousand Cubic Feet)
$14
13
12
11
10
9
8
7
6
1999-2000
2000-2001
2001-2002
2002-2003
2003-2004
2004-2005
Annual Winters
Source: Energy Information Administration, U.S. Dept. of Energy

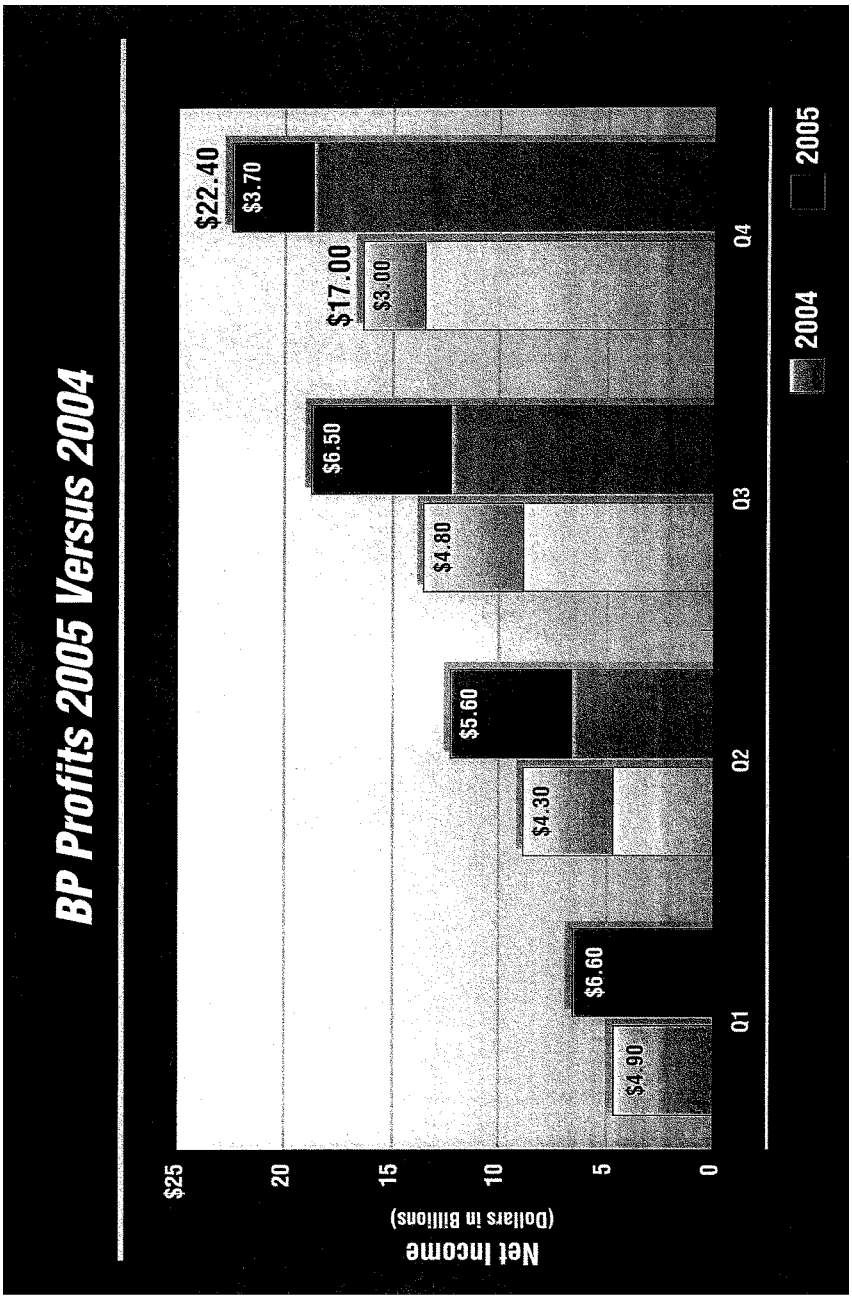

Residential Natural Gas Prices
Price
(Dollars per Thousand Cubic Feet)
$15
14
13
12
11
10
9
8
7
6
5
1999
2000
2001
2002
2003
2004
2005
Source: Energy Information Administration, U.S. Dept. of Energy


Natural Gas Prices – Henry Hub Spot Market
Price
(Dollars per Thousand Cubic Feet)
$10
9
8
7
6
5
4
3
2
1
1999
2000
2001
2002
2003
2004
2005
Source: Energy Information Administration, U.S. Dept. of Energy

## *ExxonMobil's and BP's Record Profits*

- ExxonMobil's profit of $36.1 billion in 2005 is the highest annual profit in U.S. history.
- BP's record profit of $22.4 billion in 2005 was a 32% increase over 2004.


ExxonMobil Profits 2005 Versus 2004
Net Income
(Dollars in Billions)
$40
35
30
25
20
15
10
5
0
$5.44
$7.86
$5.79
$7.64
$5.68
$9.92
$8.42
$25.33
$36.13
$10.71
Q1
Q2
Q3
Q4
2004
2005


BP Profits 2005 Versus 2004
Net Income
(Dollars in Billions)
$25
20
15
10
5
0
$4.90
$6.60
$4.30
$5.60
$4.80
$6.50
$3.00
$17.00
$3.70
$22.40
Q1
Q2
Q3
Q4
2004
2005

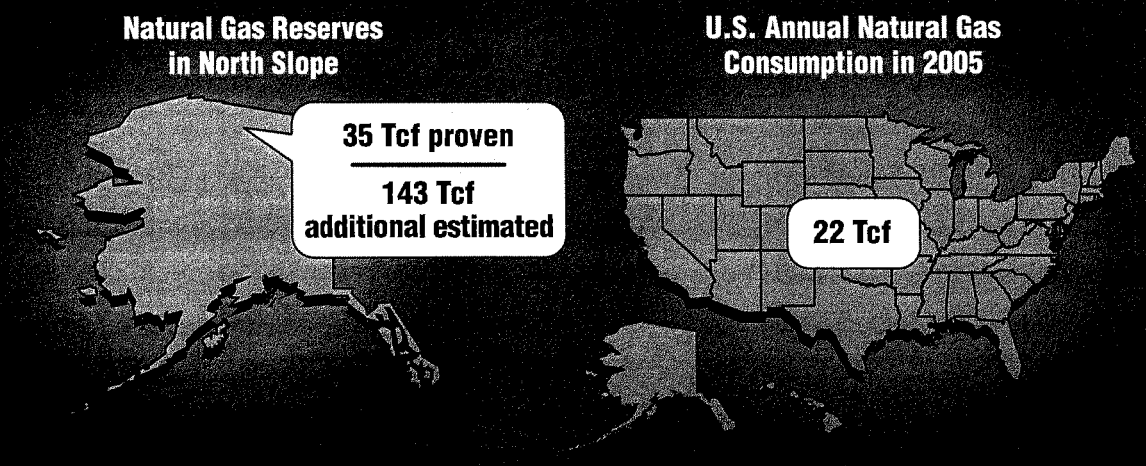
# Natural Gas and Oil Production from North Slope

| | Prudhoe Bay | | Pt. Thomson | |
|---|---|---|---|---|
| | Oil | Natural Gas | Oil | Natural Gas |
| Total Oil and Gas | ~15B** Barrels | 25-30 Tcf | < 200M Barrels | 8 Tcf |
| Remaining Oil and Gas | 3.3B Barrels | 25-30 Tcf | < 200M Barrels | 8 Tcf |
| Oil and Gas Shipped from North Slope | 11.6B Barrels | 0 | 0 | 0 |

** Estimated Resources Recoverable Using Current Technology

* Does not include oil and gas used on-site on the North Slope

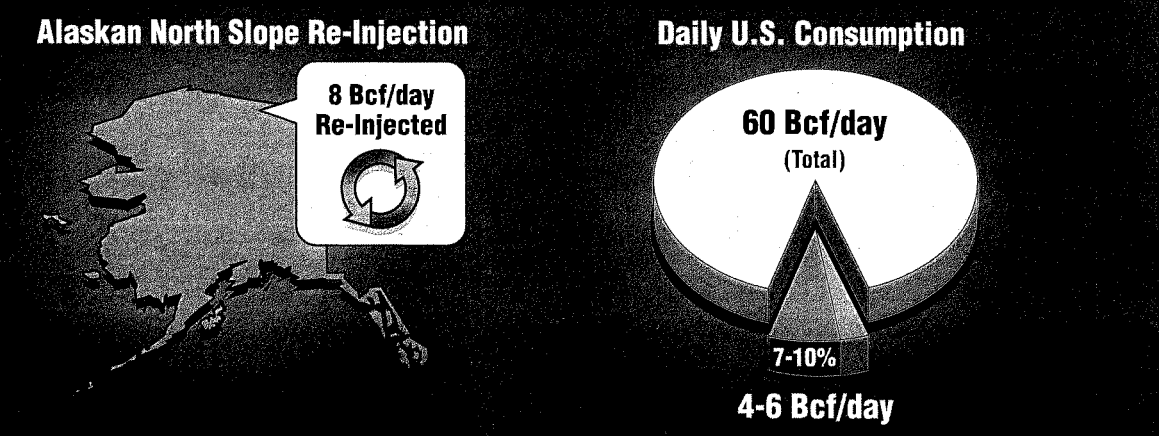
# Natural Gas Reserves and U.S. Consumption




- No natural gas has ever been exported from Alaska's North Slope.
- The AGPA pipeline could supply a substantial portion of the U.S. markets for over 35 years.

Sources: Alaskan Division of Natural Resources, Division of Oil and Gas, U.S. Geological Survey, U.S. Energy Information Administration

# North Slope Natural Gas and U.S. Consumption




- The equivalent of 13% of total U.S. daily consumption is extracted and re-injected on the North Slope every day.
- ExxonMobil and BP have refused to make available even half that amount to an independent gas pipeline.
- The AGPA pipeline could supply 4-6 Bcf/day, 7–10% of total U.S. daily consumption.
- An additional 4 Bcf/day to the U.S. markets would significantly increase supply and reduce the price of natural gas.

Source: Energy Information Administration, U.S. Dept. of Energy

## *Boycotted Pipeline Proposals*

- Yukon Pacific Corporation (YPC)
- MidAmerican Energy Holdings
- TransCanada
- Alaska Gasline Port Authority (AGPA)

# Pipeline Proposals Refused by ExxonMobil and BP

## *Efforts to Bring Gas to Market*

**1967**
Wildcat rig strikes oil and gas at Prudhoe Bay on the North Slope of Alaska.

**1977**
TransCanada subsidiaries' pipeline proposal endorsed by President Carter.

**1983**
Yukon Pacific Corporation (YPC) is formed to construct North Slope gas pipeline.

**1999**
AGPA is formed to construct North Slope gas pipeline.

**Early 2000s**
YPC negotiates with producers for more than a decade to purchase gas.

**REFUSED**
Producers refuse to sell gas to YPC.

**2001-2005**
AGPA negotiates to purchase North Slope gas.

**REFUSED**
Producers refuse to engage in meaningful negotiations.

**2002**
TransCanada, presents a detailed pipeline proposal.

**REFUSED**
Producers refuse to sell gas to TransCanada.

**2003**
MidAmerican Energy Holdings Company attempts to construct a North Slope pipeline.

**REFUSED**
Producers refuse to sell gas to MidAmerican.

**2004**
TransCanada submits another pipeline proposal.

**REFUSED**
Producers again refuse to sell gas to TransCanada.

**2005**
AGPA formally offers to purchase gas.

**REFUSED**
Producers refuse to respond to the offer.

**Today**
None of the estimated 35 trillion cubic feet of North Slope natural gas has ever been brought to market.

1960s | 1970s | 1980s | 1990s | 2000s

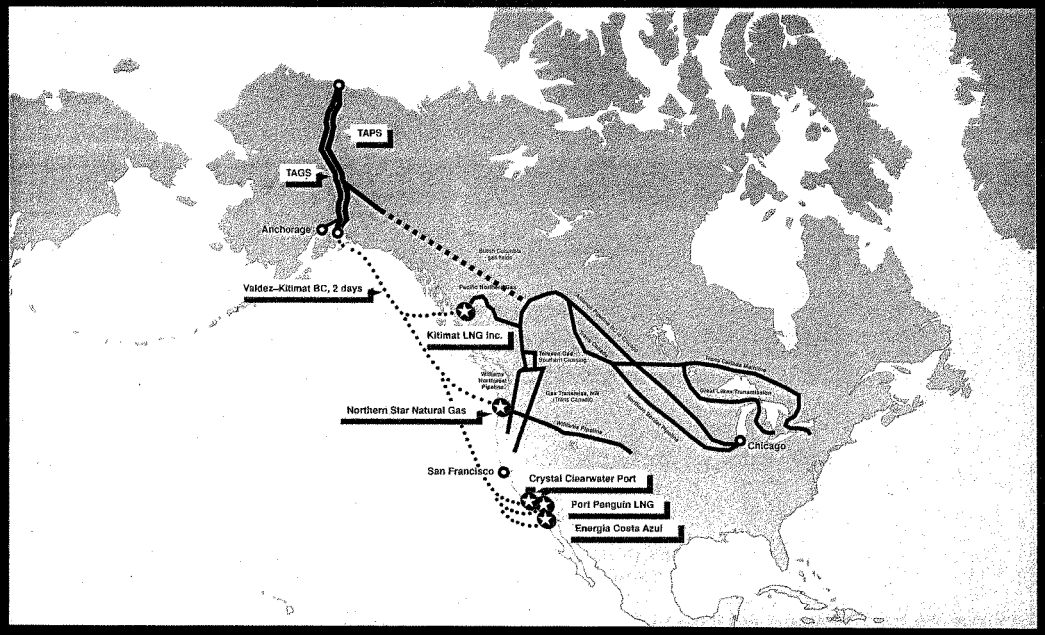
## *ExxonMobil CEO Lee Raymond Talks About Natural Gas*

"Then you have these competing pipeline proposals, which is fine if that's what you want to do. But the reality is, nobody is going to build a pipeline without the producers. You and I know how pipelines get built. The pipeline goes to the bank. The guy at the bank says, what are you going to put in your pipeline? Gas. Do you own the gas? No, I don't own the gas. Well, who does own the gas, and do you have a commitment from them that they are going to put it through the pipeline? Well, no, we don't have that. Then I don't think I'm going to give you much money to build a pipeline."

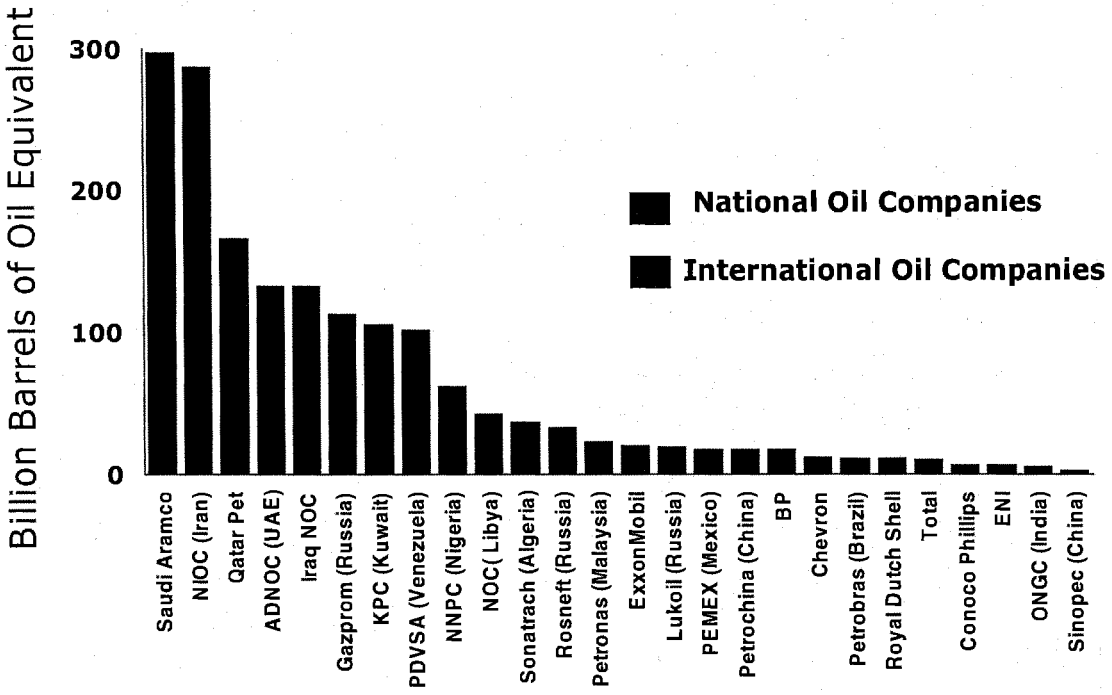
Excerpted from Energy Intelligence Group, Inc., *Natural Gas Week*, May 30, 2005

# AGPA Project: Gas Markets

***The AGPA Project will capture multiple segments of the North American gas market***



# National Oil Companies Control Most Of The World's Oil And Gas Proven Reserves



U.S. Senate
Committee on the Judiciary
March 14, 1996
Testimony of Severin Borenstein

I am E.T. Grether Professor of Business and Public Policy in the Haas School of Business at the University of California, Berkeley and Director of the University of California Energy Institute, which is located in Berkeley. I hold a Ph.D. in economics from M.I.T. I have studied oil and gasoline markets for about 20 years and have published numerous research and policy papers on competition and pricing in gasoline markets. Details of my publications and professional activities can be found at http://faculty.haas.berkeley.edu/borenste/. Since I became Director of the U.C. Energy Institute in 1994 I have done no private consulting in the energy industry. The views I will present do not represent those of the University of California or any other organization.

Although I believe the U.S. faces many challenges on the energy front, I've been asked to focus my comments today on competition issues in the U.S. oil and gasoline industry. I'd like to make the following points.

1. The world has a single highly integrated market for crude oil. No U.S. oil company has a large enough share of that market to be able to profitably exercise market power and raise prices. The world oil price has risen rapidly and is very high today compared to the recent past primarily because demand growth has been very rapid and crude oil production capacity is constrained in the short run. A second cause of the high prices is that some producers are able to exercise market power, most notably Saudi Arabia, which is able to move oil prices significantly with its output decision.

2. The record profits that the oil companies have reported recently are primarily due to the extremely high price of oil. If a company was expecting to make a profit selling oil at $25/barrel and it can now sell that oil for $60/barrel, the extra $35/barrel is nearly all profit. These companies did not cause the price of oil to go up. They are just the lucky beneficiaries of the tight world oil market.

   Oil industry claims that their profits are comparable to other industries are not credible. Spokespeople for the oil industry often compare their profits as a share of sales to other industries, but cross-industry comparisons of "return on sales" are meaningless. The measure varies wildly depending on the capital intensity of the business and the value added by the company in the vertical production/distribution chain. No business person chooses where to invest based on return on sales. This is purely a public relations attempt

to downplay the extremely high profits they have made because they were producing oil when the price of oil jumped.

3. High oil prices are the *primary* reason that gasoline prices are high. The wholesale price of gasoline was $1.69 on Friday (NYMEX futures price for delivery in April), of which $1.43 was the price of crude oil (NYMEX futures price for delivery in April). That leaves $0.23 that is going to the refining part of the value chain. Adjusted for inflation and the time of the year, this is in line with the last five years, but higher than most of the previous fifteen years. Still, it is not really plausible that more than a few cents per gallon of our current gasoline price is attributable to market power in the refining business. While that could still be millions of dollars per day in aggregate, it is a small piece of the extra hundreds of millions of dollars per day that U.S. gasoline consumers pay today compared to a few years ago.

4. For most of the last 30 years, oil refining has been a bad business. Capacity that was built in the 1960s in expectation of rapid demand growth was underutilized for decades following the 1970s energy shocks and high real oil prices that followed. With a large number of refining companies and low utilitization rates at refineries, the market was very competitive and refining margins were quite low. This changed during the 1990s as demand grew and no new refineries were built in the U.S. Margins have risen over the last few years as capacity utilization has risen.

5. In a tight refinery market as we are beginning to face in the U.S., producers are likely to receive higher margins without exercising market power simply because strong demand relative to supply pushes up prices in any market. Unfortunately, the same circumstances that create profits due to real scarcity of refining capacity also create the opportunity for some firms to push up prices further by creating artificial scarcity. When other producers are not in a position to expand their output, a refiner knows that restricting its own production is more likely to drive up prices.

6. I believe that market power in the refining industry is becoming a serious concern. In California, due to its special gasoline blend and shortage of refining capacity, this has already happened. In the early 1990s, when there was much more slack capacity, less concentration of ownership, and less regional differentiation of gasoline blends, I did not believe market power was a significant concern in refining.

7. Unfortunately, distinguishing between market power and real scarcity in the refining business is extremely difficult. Prices *should* rise if there is a real scarcity of supply. So, high

refining margins are certainly not proof of market power. In the short run, detection of market power requires determining that some companies are not producing all that they can even though the market price is above their incremental cost. Refineries are extremely complex facilities with many inputs and outputs, and many daily engineering and economic calculations. Second guessing these business choices is very difficult. For these and other reasons, the empirical research on the relationship between past mergers and increased market power in refining is unconvincing.

In contrast, in 2001 I testified before the Senate Committee on Governmental Affairs that electricity producers in California were exercising market power. I was able to reach this conclusion, because the process of converting natural gas to electricity is far simpler and it is much easier to identify when a generator is choosing not to run in order to raise market prices.

8. In the longer run, market power manifests in refiners failing to invest in capacity expansion that would be profitable considered in isolation. This is done in order to maintain restricted output and high prices. Again, however, it is very difficult to distinguish this from competitive behavior. Refiners face not just high capital costs, but also local and environmental opposition to refinery expansions and new construction. They also must be convinced that the refining market will remain profitable for decades before they can justify such an investment. It is virtually impossible for an outsider to infer from accounting data that there was a decision to restrict refining capacity in order to raise margins, rather than a hesitancy to build due to political and valid economic concerns.

9. So, if the incentive of refiners to exercise market power in present, but there are severe limitations on our ability to detect such exercise, what can public policy makers do? I would argue that we should take a very skeptical view of future mergers. There should be a significantly increased burden on refiners to demonstrate large efficiencies before a merger could be approved, because the risk of increased market power is now quite large. At the same time, there should be more detailed analysis of the *incentives* of refiners to exercise market power before and after a proposed merger. I believe that market power in the refining industry is not a significant cause of high gasoline prices today, but competition in the industry is not as robust as it was a decade ago. As a result, there should be greater scrutiny of changes in the composition of the industry that could further reduce competition.

# JOHN CORNYN

United States Senator - Texas
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FOR IMMEDIATE RELEASE
March 14, 2006

## CORNYN: CONGRESS SHOULD ACT ON ENERGY POLICIES THAT WILL LOWER COSTS, BENEFIT CONSUMERS

***'We should seek ways to expand domestic energy production – not penalize job creation'***

WASHINGTON—At a hearing of the Senate Judiciary Committee Tuesday, U.S. Sen. John Cornyn said Congress should act to lower prices at the pump and home energy costs by expanding domestic energy production. The hearing was titled "Consolidation in the Oil and Gas Industry: Raising Prices?" Cornyn said we should help oil companies become more efficient, rather than penalize them, so they can lower costs and help consumers.

"We spend an enormous amount of time debating and addressing the effects of higher energy prices, like prices at the pump or home energy costs, and then fail to act upon policies that would help alleviate the problem," Cornyn said. "For example, I think that many of us would agree that increasing our supply of energy would go a long way to address current prices."

Cornyn added: "In today's global economy, the world has many quickly growing economies and markets that have created an unprecedented demand for energy. Clearly, U.S. companies – and subsequently our own economy – are in competition with other countries around the world for energy supplies. Many of the oil company mergers that occurred in recent decades were a reaction to these changes in market forces as well as new regulatory requirements."

Four witnesses from Texas-based companies testified at the hearing:
--Rex Tillerson, Chairman and Chief Executive Officer, ExxonMobil Corp., Irving, Texas;
--James Mulva, Chairman and Chief Executive Officer, ConocoPhillips, Houston, Texas;
--Bill Klesse, Chief Executive Officer, Valero Energy Corp., San Antonio, Texas;
--John Hofmeister, President, Shell Oil Company; Houston, Texas.

"Clearly, energy prices are a significant concern to businesses as well as individual consumers," Cornyn said. "Global pressures will continue to have a significant effect on prices. But, I would submit that these oil company mergers that occurred as a result of this highly competitive market stand to benefit consumers."

Cornyn added: "Rather than looking for ways to penalize oil companies, we should help them become more efficient and increase the technology to recover oil and gas, so they can drive down costs. Congress should also earnestly seek out ways to better utilize our domestic sources of energy and increase the available supply."

In Texas, nearly 300,000 people were employed in the oil and gas industry in 2003.

***Below is the full text of Sen. Cornyn's statement at the hearing as prepared:***

Mr. Chairman, I hope that these series of hearings will provide an opportunity to fully examine and – in my estimation – help set the record straight about the oil and gas industry. There has been significant rhetoric in Congress about oil companies and how their operations affect energy consumers in the country. However, many of the sentiments expressed by detractors of the energy industry have been made out of context and without the proper perspective.

In today's global economy, the world has many quickly growing economies and markets that have created an unprecedented demand for energy. Clearly, U.S. companies – and subsequently our own economy – are in competition with other countries around the world for energy supplies. Many of the oil company mergers that occurred in recent decades were a reaction to these changes in market forces as well as new regulatory requirements. Under the scrutiny of the Federal Trade Commission and conducted in a transparent and competitive marketplace, these mergers occurred to meet the growing challenges. Particularly when one considers that the competition consists of vast, national oil organizations, it was critical that these companies looked for ways to increase capacity and efficiency to simply to remain competitive.

Clearly, energy prices are a significant concern to businesses as well as individual consumers. Global pressures will continue to have a significant effect on prices. But, I would submit that these oil company mergers that occurred as a result of this highly competitive market stand to benefit consumers. We all know that consumers will shop around for the lowest prices and will often drive to find the cheapest gas, even for only a few cents difference in price. Therefore, if a company offers higher prices, they will have difficulty keeping and attracting customers. Companies that are more efficient, better able to increase capacity, and drive down prices are better able to compete harder for consumer's business.

In regard to the federal government's role in the oil company mergers, the FTC and other stakeholders have scrutinized the oil industry for decades. The agency continues to closely monitor the industry. During the merger process, the agency has done an excellent job in using its authority to ensure markets remain competitive, many times by requiring companies to sell assets. Throughout the process, consumer interests were the paramount consideration.

While it is not specifically the topic of today's hearing, it is also worthwhile to consider industry profits into perspective. It is most telling to look at oil and natural gas industry earnings in the context of other industries. Over the last five years, the oil and natural gas industry earned roughly 5.7 cents for every dollar of sales compared to an average of 5.5 cents for U.S. industry overall. With earnings that close to the national average and in comparison with other sectors, like the banking or pharmaceutical industries, it is difficult to claim that oil industry profits are out of line.

In addition, policymakers must pursue solutions to our energy challenges that actually address the problem, rather than address each symptom. What I mean is that we spend an enormous amount of time debating and addressing the affects of higher energy prices, like prices at the pump or home energy costs, and then fail to act upon policies that would help alleviate the problem. For example, I think that many of us would agree that increasing our supply of energy would go a long way to address current prices. However, provisions like opening the Arctic National Wildlife Refuge, or ANWR, to responsible oil and gas development continue to fail. Also, states who are most impacted by high energy costs are also the states who fight hardest against opening areas off of their shores for exploration and development of domestic resources.

Clearly, we have many challenges ahead in regard to energy prices. It is critical that we look for ways to truly address the issue. Rather than looking for ways to penalize oil companies, we should help them become more efficient and increase the technology to recover oil and gas, so they can drive down costs. Congress should also earnestly seek out ways to better utilize our domestic sources of energy and increase the available supply.

-30-

UNITED STATES SENATOR • OHIO

# Mike DeWine

FOR IMMEDIATE RELEASE
MARCH 14, 2006

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(202) 224-2315

## REMARKS [AS PREPARED] - JUDICIARY COMMITTEE HEARING: "Consolidation in the Oil and Gas Industry: Raising Prices?"

Mr. Chairman, thank you for calling for this important hearing today; I'm glad that we have representatives of the oil industry here today to discuss this critical question: What is causing the high fuel prices that we are all so sick of paying?

Everybody comes to Congress and says that there's nothing wrong in the industry -- that the market is functioning normally. Yet, my constituents in Ohio feel that there's something wrong when they are paying record prices at the pump, while oil companies are making record profits.

One of the causes of the skyrocketing gas prices certainly could be the mergers in the oil industries. Did the FTC allow too many oil industry mergers? Are the antitrust laws up to the challenge of dealing with the modern energy market? Should the antitrust agencies take a more aggressive approach in this market?

I think it's clear that the agencies need to take a very hard look at any future mergers in this industry. And, they should examine their past enforcement actions. Senator Kohl and I have worked hard in our Antitrust Subcommittee to encourage FTC monitoring and enforcement, and I'm pleased that the Committee is considering your draft legislation, Mr. Chairman, which includes a provision that Senator Kohl and I have pursued since 2000. That provision contains the language from our NOPEC bill, which the Senate passed last year.

The biggest thing we can do to control gas prices in the future is to lower crude oil prices, and one of the biggest causes of high crude oil prices is the illegal price-fixing of the OPEC cartel. Our NOPEC language makes it clear that the Antitrust Division can prosecute OPEC for its illegal activities. America needs NOPEC as an effective tool to hold down prices.

The Chairman's draft legislation also addresses a concern some have expressed that certain oil companies may have acted to manipulate supply and requires a very important study of the legal standards for mergers and also of industry data-sharing. I think this information would be very useful as we figure out what we can do to combat high energy costs, and I look forward to discussing this draft legislation today.

*-more-*

Mr. Chairman, just to put this issue into historical context, I think it is interesting to remember that one of the first big antitrust cases ever prosecuted was the famous Standard Oil case, and that case established most of the fundamental principles of antitrust law that continue to this day. One of those principles -- to put it in everyday terms -- is this: It isn't illegal just to be big, and in fact, it's even legal to be a monopoly. What is not legal is when a company abuses its size or uses unfair tactics to shut out its competitors or harm competition. As we examine the impact of mergers in the oil industry today, we should remember that we need to evaluate the conduct of these companies, not just the fact that they have grown in recent years.

It goes without saying, Mr. Chairman, nobody is satisfied with the way this market is behaving, and none of us is happy with the high gas prices we are paying. So, we do need to keep looking at the conduct of this industry and the role of the antitrust laws, and we need to keep looking very carefully. And most important, we need to find some way -- any way -- to help our citizens and businesses as we all struggle with increasing energy prices. We owe it to the American people, and we owe it to our constituents at home.

###

**Statement of Senator Richard J. Durbin**

**Before the Senate Judiciary Committee**

**"Consolidation in the Oil and Gas Industry: Raising Prices?"**

**Tuesday, March 14, 2006**

Thank you, Mr. Chairman, for holding this important hearing today on the causes of rising energy costs. This is a follow up to last month's hearing in this committee that was called to examine a very timely issue and one that all of our constituents are struggling with everyday. Today, consumers are justifiably frustrated by the unaffordable energy prices. Consumers continue to face gasoline prices that are 15% higher than this time last year, which were higher than the year before.

On top of the sticker shock they face at the pump, millions of American families witnessed higher energy bills at home this winter. The U.S. Department of Energy estimated that the price for natural gas for the winter of 2005 to 2006 increased 22.7% over last winter, even though overall demand for energy did not increase.

Over the past few months, I have visited a number of struggling families in Illinois. These are hard working families who play by the rules, pay the bills, put food on the table, scrape together to cover health care costs, and barely have enough to cover other basic needs. For many in my state, it has been the choice of "heat or eat," and I am sure that my colleagues have all experienced this painful moment with their constituents as well.

One woman I recently visited is named Lois Runge of Normal, Illinois. Ms. Runge is a senior citizen living on a fixed income. She has used LIHEAP for years to help pay for her heating bills, but she told me during my visit that she is struggling more than ever during this winter as natural gas prices have skyrocketed. Ms. Runge now volunteers to help others with LIHEAP paperwork understanding how difficult it can be for those who do not know where to turn to for assistance.

I want to thank all the witnesses for participating in today's discussion. In particular, I am glad that, unlike at the hearing in February, we now have before us today representatives of the industry that controls the energy prices with an iron fist. I look forward to hearing the explanation in their own words for why these oil companies are forcing American consumers to pay record high energy prices during the same time that they pocketed over $100 billion last year in record profits.

Americans want answers. They want to know why their energy prices are so high. They want to know what Congress is doing to about it, and whether we are holding the oil industry to account.

Like millions of Americans who are paying record high prices at the pump or in home hearing costs, I am deeply troubled by the current laissez-faire structure of our energy markets. For too long, the oil and gas industry has flourished with little or no oversight from our government. During the past 15 years, the industry has consolidated significantly, with more than 2,600 mergers occurring in all segments of the petroleum industry.

It is evident that consolidation in the domestic oil refining industry has increased market concentration in every region of the country. These mergers have consolidated the industry to such a degree that the six companies represented here today control more than 56% of all domestic oil refinery capacity.

At the last hearing, expert witnesses considered whether there is a definite, direct, and provable correlation between the rampant consolidation and the rising cost of gas prices for consumers. But it does not take a Ph.D. in economics to understand that such high level of consolidation obviously reduces competition in the marketplace. And, any consumer can see that such concentration must have some impact on the prices at the pump and in our homes.

Today, I think we have to ask the hard questions to this panel of witnesses. Why are they continuing to raise prices when, at the very same time, they are reaping record profits? Where are these companies spending their record profits? Are existing governmental review processes adequate, or is this an industry so powerful that they can write their own rules? Do the Federal Trade Commission and the Justice Department have all the tools they need to review each merger?

I know that many of my colleagues have proposals to deal with this industry as I have offered a few of my own legislative proposals. I look forward to working with the Chairman and others on this committee to consider these proposals. There may be good legislative ideas in other committees as well that we should bring to the floor and pass this year in order to go to the heart of this continuing gas price problem.

Finally, I am deeply concerned about our country's continuing dependence on foreign oil. It is widely known that the United States holds less than 3% of the world's reserve of oil, yet our nation consumes about 25% of the entire world's oil supply. That is a fact of American life.

I assume the corporate executives from the oil industry will testify today that their new oil exploration is capital intensive. They will tell us that new oil resources are not located in the most easily accessible places on earth, nor are the countries that control such access always friendly to our nation's interests. But this simple fact should sound an alarm – a loud alarm – for policy makers.

We need to change the way Americans think about our energy consumption. We need a serious commitment, from this Administration, from Congress, and from businesses that we will no longer continue to rely on foreign oil as our sole energy resource.

President Bush recently admitted that we are addicted to oil. But we need to do more than acknowledge the obvious. We need to have a plan for overcoming that addiction.

Just imagine for a moment what $100 billion could do to change America's energy habits. Even if we invested a fraction of that amount to R&D, we can begin to improve the fuel economy of automobiles. We need to be smart about technology and find ways to rely on advances such as plug-in hybrids and other alternative fuel infrastructure.

Not only would this be a smart investment into our future, it would also be a much needed boost to our economy for fostering innovation and creating jobs at home. I hope the witnesses will have positive things to say about their companies' commitment to this endeavor.

Thank you.

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News From:

# U.S. Senator Russ Feingold

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**For Immediate Release**
**Contact: Trevor Miller - (202) 224-8657**

## Statement of U.S. Senator Russ Feingold
## *At the Judiciary Committee Hearing on Consolidation in the Oil and Gas Industry: Raising Prices?*

**March 14, 2006**

Good morning. I thank the Chairman and Ranking Member of both the full Committee and the Antitrust Subcommittee for holding this hearing. I remember from the February hearing on the topic of consolidation in the oil and gas industry, Mr. Chairman, that you were noticeably frustrated that certain industry representatives were not willing to attend, and I appreciate your resolve to follow through and hold today's hearing. I also appreciate your efforts, as indicated by the draft legislation you are circulating, to move forward to address what I believe is one of the underlying problems plaguing our consumers – consolidation in the oil and gas industry.

I also appreciate your giving the Attorney General from my home state of Wisconsin, Peg Lautenschlager, an opportunity to testify in Panel I. She has been working with her colleagues to consider factors behind the rise in natural gas prices and I hope that we will address the need for greater transparency in natural gas markets in the near future.

Today's hearing is vital to getting a grip on one of the most pressing problems facing our constituents every day. Consumers across the country face high gas costs and want to know why. To get them the answers they deserve, we must ask tough questions. I hope that today's hearing will conclude with us knowing more about any decisions to withhold supply, about tax breaks during times of record profits, about investments in alternatives, about environmental stewardship, and about opening more areas to drilling when those areas currently available for drilling aren't even being utilized. Each of these topics rightfully deserves its own hearing.

It is unfortunate that, as we hold this hearing, some of my colleagues continue an ill-advised effort to open up the Arctic National Wildlife Refuge to oil and gas drilling. I hope that the Senate will instead focus on real solutions to our pressing energy needs and on heeding the President's advice about addressing our country's addiction to oil.

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**Testimony of**
**Thomas Greene, Chief Assistant Attorney General,**
**California Department of Justice,**
**Before the Senate Committee on the Judiciary**
**March 14, 2006**
**Concerning "Consolidation in the Oil and Gas Industry: Raising Prices?"**

Good morning, Mr. Chairman and members. My name is Tom Greene and I am the Chief Assistant Attorney General for the Division of Public Rights for the California Department of Justice. I appear today on behalf of Attorney General Bill Lockyer who could not attend because of other duties in California.

By way of introduction, I am the past chief of our Antitrust Law Section and the former chair of the Multistate Antitrust Task Force of the National Association of Attorneys General. I also had the opportunity to chair Attorney General Lockyer's Gasoline Pricing Task Force, which examined the causes and consequences of spiking gasoline prices in California.[1]

My purpose today is to share our experiences with the treatment of petroleum companies by state and federal law, particularly federal antitrust law. Let me begin with our experience with California's price-gouging statute and then turn to federal antitrust issues.

**1. An Effective Price-Gouging Statute Must Encompass Refiners as Well as Retailers.**

California's price-gouging prohibition is found in Cal. Penal Code section 396, and applies to "essential consumer goods and services". The law is triggered if prices increase more than 10% after the declaration of an emergency. However, "a greater price is not unlawful if that person can prove that the increase in price is directly attributable to additional costs imposed on it by the supplies or the goods..." Just after Hurricane Katrina, our office received an avalanche of complaints about dramatically higher gasoline prices. This raised major concerns, not the least of which was the fact that Gulf refineries do not supply California stations except in very rare circumstances. We investigated dozens of the most egregious complaints and learned that the prices were spiking not because of the retailers that are covered by the law but by the refiners that supplied them. In considering new legislation, it is imperative to include refiners within its purview if it is to be effective.

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[1] Bill Lockyer, *Report on Gasoline Pricing in California* (Office of the California Attorney General, May, 2000), at http://caag.state.ca.us/antitrust/publications/gasstudy/index2.htm

**2. Section 1 of the Sherman Act Is Increasingly Irrelevant in Concentrated Industries, and Needs Reform to be Useful in the 21st Century.**

The Sherman Act was written at a time when *de jure* price-fixing cartels, often with elaborate management and oversight structures, were strangling the American economy. At that time, the fact that prosecutors and plaintiffs were required to demonstrate the existence of a "conspiracy" or "combination" was rarely dispositive. Today, however, our most important industries, including petroleum, are dominated by a small number of firms. Such oligopolies are interdependent, and carefully monitor each other's activities. In this environment, proof of a "combination" has become far harder, to the point that many federal courts have been unwilling to allow even substantial cases to go to federal juries so these powerful economic structures are largely outside the purview of the antitrust laws.

In terms of economic effects on consumers, there is "no vital difference between formal cartels and tacit collusive arrangements" often found in oligopolized industries.[2] Starting with Cournot in 1838 and continuing to the present, economists have found that concentrated industries lend themselves to prices and output levels that are less than optimum.[3] Chamberlin in 1960 concluded that "since the result of a [price] cut by any one is inevitably to decrease his own profits, no one will cut, and, although the sellers are entirely independent, the equilibrium result is the same as though there were a monopolistic agreement between them."[4]

Judge Posner of the 7th Circuit, and the author of the seminal book *Antitrust Law*, makes the point that the ability of firms, even in a relatively concentrated industry, to find their way to the equivalent of a shared monopoly price depends on a variety of factors, and that these factors are often conjoined with signals that can form the basis for a finding of a "combination" within the meaning of the Sherman Act.[5] He notes, however, that the more concentrated the industry, the less explicit the communications that are required to organize prices and limit production. This

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[2] Roger D. Blair & David L. Kaserman, *Antitrust Economics* 205-206 (1985) ("Section 1 attacks collusion because it is a joint effort to reap monopoly profits, and tacit collusion has a very similar impact.").

[3] See Thomas A. Piraino, Jr., *Regulating Oligopoly Conduct Under the Antitrust Laws*, 89 Minn.L.Rev. 9, 16-17 (2004).

[4] Edward Hastings Chamberlin, *The Theory of Monopolistic Competition: A Reorientation of the Theory of Value* 46-51 (7th ed. 1960); see also George J. Stigler, "A Theory of Oligopoly" in Stigler, *The Organization of Industry* 39 (1968).

[5] Richard A. Posner, *Antitrust Law* 60-93 (2d ed. 2001).

produces "the paradox that the more conducive the market's structure to collusion without express communications, the weaker the plaintiff's case" is likely to be.[6]

Many courts have not fully appreciated the fact that the most dangerous agreements may be in industries in which the tell-tale signs of a combination in restraint of trade are the most subtle. Confounding this necessarily delicate search for truth are two major summary judgment decisions of the U.S. Supreme Court. In *Monsanto Co. v. Spray-Rite Service Corp.*,[7] the Court noted in a vertical case that, on the question of the existence of a combination, "there must be evidence to exclude the possibility of independent action..." In *Matsushita Electrical Industrial Co. v. Zenith Radio Corp.*[8], the Court addressed what was regarded as a highly improbable price-cutting scheme that was intended to eventually allow Japanese manufacturers to take over the U.S. market. Under these circumstances, the Court substantially reigned in possible inferences to be drawn from circumstantial evidence of agreement.

Courts have split on the scope of *Monsanto* and *Matsushita* in cases involving concentrated industries and allegations of horizontal price-fixing. Some courts, notably the Eighth and Eleventh Circuits have read these cases broadly, and essentially foreclosed the finding of a "combination" within the meaning of the Sherman Act in concentrated industries.[9] Most troubling is the Eighth Circuit's *Blomkest Fertilizer* decision in which the court dismissed plaintiff's proofs item by item as "fundamentally unreliable" because they individually could be explained innocently. The court ignored the implications of concentration in this market and the evidence taken as a whole, points strenuously argued in a thoughtful dissent.[10]

This same approach was taken by the California Supreme Court in *Aguilar v. Atlantic Richfield Co.*[11] Taking a broad view of *Monsanto* and *Matsushita*, the court concluded that a plaintiff must at least show evidence that "tends to exclude" the possibility that alleged conspirators acted "independently", and then sustained a

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[6] David L. Meyer, *The Seventh Circuit's High Fructose Syrup Decision-Sweet for Plaintiffs, Sticky for Defendants,* Antitrust 67, 71 (Fall 2002).

[7] 465 U.S. 752, 768 (1984).

[8] 475 U.S. 574, 594-97 (1986).

[9] *Williamson Oil Co. v. Phillip Morris USA*, 346 F.3d 1287 (11th Cir. 2003); *Blomkest Fertilizer, Inc. v. Potash Corp. of Saskatchewan*, 203 F.3d 1028 (8th Cir. 2000).

[10] *Id.* at 1038-53.

[11] 25 Cal.4th 826 (2001).

grant of summary judgment for the defense notwithstanding significant evidence of oligopolistic coordination and communications.[12]

On the other hand, some courts have confined *Monsanto* and *Matsushita* to their facts. For example, the Ninth Circuit in *In re Petroleum Products* limited these cases to their specific facts. Specifically the court concluded that:

> Nor do we think that *Matsushita* and *Monsanto* can be read as authorizing a court to award summary judgment to antitrust defendants whenever the evidence is plausibly consistent with both inference of conspiracy and inferences of innocent conduct... Such an interpretation of *Matsushita* would seem to be tantamount to requiring direct evidence of conspiracy. This cannot be what the Court meant in *Matsushita*. Since direct evidence will rarely be available, such a reading would seriously undercut the effectiveness of the antitrust laws.[13]

Judge Posner has likewise been critical of a broad reading of *Monsanto*, concluding that "[m]ost courts mistakenly regard tacitly collusive behavior as independent and therefore infer from the dictum in *Monsanto* that the plaintiff must negate the possibility that supracompetitive pricing was achieved without explicit agreement."[14]

Judge Posner himself used this approach in *In re High Fructose Syrup*.[15] In reversing a grant of summary judgment, he warned of three "traps" that must be avoided in such cases: (1) weighing "conflicting evidence", a jury function; (2) failing to take into account "the evidence as a whole" and (3) failing to "distinguish between the existence of a conspiracy and its efficacy." He went on to assess the evidence, noting that "the structure of the...market, far from inimical to secret price fixing, is favorable to it."[16] A similarly thoughtful decision was enunciated by the Third Circuit in *In re Flat Glass*.[17] There the court concluded that a plaintiff that can

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[12] *Id.* at 857-59.

[13] 906 F.2d 432, 439 (9th Cir. 1990) .

[14] Richard A. Posner, *Antitrust Law* 100 (2d ed. 2001).

[15] 295 F.3d 651, 655 (7th Cir. 2002).

[16] *Id.* at 656.

[17] 385 F.3d 350 (3d Cir. 2004).

establish a conspiratorial motivation and acts against self-interest has simultaneously allayed the concerns of *Matsushita*.[18]

So what is the problem? Notwithstanding the careful scholarship of Judge Posner and others, '[l]ower federal courts have decided simply to grant summary judgment to defendants when the evidence of conspiracy is evenly balanced, or is ambiguous."[19]

This is particularly likely and problematic in cases involving concentrated industries, like petroleum. As a consequence, it is time to consider action, including legislative action, to provide a calculus that would use the Posner scholarship and the work of the more thoughtful federal courts to make possible the use of section 1 of the Sherman Act in concentrated industries. The committee could consider drafting legislation to establish this decision-making calculus or ask the federal competition agencies to provide a report and recommendation, presumably with significant input from the National Association of Attorneys General. But whichever strategy is chosen, absent broad change, a key element of the Sherman Act will become a sham without action very soon.

**3. Merger Analysis Must Take into Account Local Conditions and Not Reflexively Assume a Worldwide Market for Petroleum.**

The California Attorney General's office has been involved in every one of the recent petroleum mergers. Indeed, in partnership with our sister states of Oregon and Washington and our federal partner, the Federal Trade Commission, we have secured spin-offs of refineries and other assets in every one of these transactions, starting with the spin-off of the Exxon's Benicia refinery, a major source of clean fuels for western markets. In every one of these cases, the defense has argued that petroleum markets are international so that their mergers are minor developments in this worldwide market. In framing new legislation in this area, particular sensitivity will be required to address the broad market definition claims typically made in these cases.

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[18] Joseph Skocilich, *Issues in the Third Circuit: Narrower is Better—The Third Circuit's Latest Word on Conscious Parallelism and the Problem of Plus Factors: In Re Flat Glass*, 50 Vill.L.Rev. 1309, 1329 (2005), citing *In re Flat Glass*, 385 F.3d at 385.

[19] Thomas A. Piraino, Jr., *Regulating Oligopoly Conduct Under the Antitrust Laws*, 89 Minn.L.Rev. 9, 28 (2004).

## Conclusion

In conclusion, on behalf of Attorney General Bill Lockyer, let me thank you for allowing us to share our experiences in this important area. The committee should be applauded for its leadership in holding this hearing, and addressing the important issues being discussed today. Our office stands ready to assist you in any way we can. I would be pleased to answer any questions the committee may have.

MAR-22-2006 WED 03:00 AM FAX NO. P. 01

# Alaska State Legislature

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**John Harris**
**Speaker of the House**

Chairman Arlen Specter
United States Judiciary Committee
224 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Chairman Specter:

Thank you for holding the hearings on March 14, 2006 regarding "Consolidation in the Oil and Gas Industry Raising Prices". Given that the North Slope Producers, including Exxon Mobil and BP, reinject back into the North Slope every day an amount of gas equivalent to approximately 50 percent of the entire U.S. residential daily consumption, I followed your hearing with great interest.

However, I am very troubled by certain inaccurate statements made during testimony before your Committee by the presidents of both Exxon Mobil and BP. Ross Pillari, president of BP America, Inc. stated, "I would add what I said earlier; there is a very strong, high-quality proposal sitting in the Legislature in Alaska today that will bring that gas to market". The president of Exxon Mobil, Rex Tillerston, made a similar statement.

I am aware of no such legislation before the Alaska legislature at this time. We have been told that no gas contract would even be shown to the Legislature until after the oil tax legislation as negotiated between the North Slope producers and Governor Murkowski is passed by the Legislature. To say a gas contract is presently before the Alaska Legislature is absolutely not true.

I am bringing this significant misrepresentation to your attention since, if I were in your position, I would want such a misstatement brought to my attention.

Please do not hesitate to contact me should you have any questions whatsoever.

Sincerely,

John Harris
Speaker of the House

# TESTIMONY

# OF

# JOHN HOFMEISTER

# PRESIDENT, SHELL OIL COMPANY

## BEFORE THE

## UNITED STATES SENATE

## COMMITTEE ON THE JUDICIARY

## MARCH 14, 2006

**Chairman Specter, Ranking Member Leahy, Members of the Committee:** Good morning. I appreciate the opportunity to discuss the energy issues of concern to you, to Shell and to the American people.

Shell has been producing energy in the United States for nearly 100 years. I am fiercely proud of the work of our tens of thousands of U.S. employees, and especially of the way they have stepped up to the challenges of the past year.

- Our U.S. operations are heavily concentrated in the Gulf Coast area. Hurricane Katrina knocked out more than half of our offshore production for more than three months.
- Two of our Louisiana refineries were damaged by Katrina, and two more in Texas were hit by Hurricane Rita.
- Nearly 4,600 employees were displaced by the storms.

Our people put in endless hours -- even as they dealt with their own crises -- to minimize supply disruptions to those who depend on fuel for their cars, homes and businesses.

As a recent testament to our employees' resilience and commitment to our communities, Shell's evacuated operations have returned to New Orleans.

Why am I describing all this, Mr. Chairman? Lack of access to energy resources and the hurricanes are the roots of the angst American consumers are experiencing. When supply is limited and demand is not reduced, the consequence is higher prices – in a free market that's how it works.

Growing global demand has been a major factor behind rising crude oil prices. Shell is making significant investments to meet this challenge.

Over the past five years, Shell has reinvested virtually all of our U.S. earnings into finding new supply, increasing production, improving refining capabilities and developing new technologies:

- For the past 5 years alone, Shell has invested over $1 billion per year in developing offshore oil and gas resources in the Gulf of Mexico.
- We are aggressively pursuing natural gas prospects in North America, including Alaska.

- We are making significant investments in unconventional resources – oil sands in Canada, oil shale in Colorado, and new cleaner coal technologies in 12 states.
- We are investing in liquid natural gas projects that could result in 2 to 3 billion cubic feet per day of capacity by 2010.
- We are investing in renewable energy sources as well – wind energy, solar CIS thin film technology, biofuels and hydrogen.
- On the refining side, we are looking at multi-billion-dollar expansion projects equal to construction of a moderate-sized new refinery.

It takes an extraordinary level of financial strength to deploy such large amounts of capital in risky environments and a cyclical industry. Fragmented or financially insecure players cannot afford such risk. To achieve what we have set out to do, we need your help – not new barriers.

**Despite the apparent size of the major investor-owned energy companies, this remains a highly competitive industry.** Consider the structure of our retail gasoline business, where the Shell brand has a 12 percent market share nationwide. Roughly 90 percent of Shell branded stations are owned by independent retailers and "jobbers." Just last week I met with over 1,700 wholesalers – all independent American business men and women.

We are seeing healthy new retail competition emerging with brands such as WaWa, Sheetz, and Turkey Hill.

From the perspective of Shell's transactions experience, in markets of concern to both federal and state antitrust law enforcement agencies, mandatory divestitures were designed to prevent declines in the number of competitors or increases in concentration. And we have fully complied with such divestitures.

**Prices are set on a competitive global market.** The biggest component of the retail price of gasoline – about 60 cents of every dollar -- is the price of crude oil. Crude oil prices are set on the deepest and most liquid commodity market in the world. Companies of all sizes populate these markets, and investor-owned companies such as Shell provide some competitive balance to large government-owned oil companies.

**The key to providing reliable and affordable energy for America's future is new supply.** Some of the greatest potential untapped resources in the world are off limits here in the United States. It is ironic that some of the same voices that

cry out for lower prices also advocate restricting access to domestic sources that, with today's technologies, could be developed in an environmentally responsible manner.

Beneath federal lands and coastal waters, there are estimated to be 102 billion barrels of recoverable oil and 635 trillion cubic feet of natural gas whose development is limited by federal policies. If Congress wants to address supply and help consumers, provide a way to tap these resources.

**Shell is committed to meeting America's energy needs.** We stand ready and willing to work with Congress cooperatively to ensure that the United States has the energy required for continued economic growth and a sustained quality of life.

Thank you.

**TESTIMONY OF BILL KLESSE**
**CEO, VALERO ENERGY CORPORATION**
**SAN ANTONIO, TEXAS**

**Before the United States Committee on the Judiciary**
**March 14, 2006**

Chairman Specter and members of the Committee, my name is Bill Klesse, and I am the Vice Chairman and Chief Executive Officer of Valero Energy Corporation, an independent refiner based in San Antonio, Texas. Valero has 22,000 employees, 5,000 branded retail outlets and 18 refineries in the United States, Canada and the Caribbean with a combined throughput capacity of 3.3 million barrels per day (BPD).

We entered the refining industry in 1981 when we bought a 33,000 BPD refining operation in Corpus Christi, Texas. Today, that refinery has a throughput capacity of 340,000 BPD. During the 80's and most of the 90's, refining was at a cyclical low.[1] Other companies were exiting the business because of continuing low profit margins and escalating environmental compliance costs, but Valero believed that the move toward cleaner fuels would tighten supplies and as demand grew, margins would improve. Valero was able to buy many refineries for as little as 10 to 20 percent of replacement costs. Since 1997, Valero has acquired 17 more refineries, improving and expanding each one.

And, while much is made of the fact that no new refineries have been built in this country in more than 30 years because of poor returns, siting issues and permitting, Valero has increased the capacity of its 18 refineries by almost 20 percent since acquiring them, adding 533,000 barrels per day of refining capacity. That's the equivalent of building three world-scale grassroots refineries. We have also added and expanded existing units that allow us to process a wider variety of crudes.

It's fair to say that if Valero had not acquired these refineries, much of this capacity expansion would not have occurred, and some facilities might have closed.

Improving refineries takes expertise and capital and Valero has more in-house expertise and greater access to capital than many of the companies from which we have purchased refineries. In the past this has made expansion easier while meeting costly regulatory requirements.

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[1] Refining margins measured by the Gulf Coast (3 crudes [WTI] – 2 gasolines and 1 diesel) or 3-2-1 crack averaged $3.17 per barrel.

Valero has invested approximately $8.2 billion to improve its refineries. Since 1997, we have spent $2.4 billion on regulatory and environmental compliance. To comply with probable regulatory and fuel specifications, we will need to spend another $3.5 billion over the next several years. And new regulations continue to be drafted and adopted. Given the magnitude of investment required to meet new requirements, agencies must consider and mitigate their impact on supply and cost as well as on the refining industry's ability to remain profitable.

Each of Valero's acquisitions was thoroughly reviewed by the Federal Trade Commission and state attorneys general. In fact, the FTC holds oil industry mergers to the highest standard and subjects industry operations to constant scrutiny. In some cases, Valero has been required to divest assets in a transaction. But in all cases, Valero's purchases have resulted in more refining capacity and higher annual production. And, we have also dramatically increased the safety and reliability of our acquired refineries.

Of the 20 refineries in the U.S. that have earned the OSHA Voluntary Protection Program "Star Site" status, Valero currently owns and operates 10, and we are working toward the "Star Site" designation for all 18 of our refineries, even those outside the United States. Safe operation benefits consumers because it improves reliability and increases production.

Valero also was recently ranked No. 3 on *Fortune* magazine's list of the "100 Best Companies to Work For." Our dedicated employees enhance Valero's production levels and reliability. This was particularly apparent during the back-to-back Gulf Coast hurricanes last year. In the wake of Hurricane Katrina, our refinery just outside of New Orleans, Louisiana was back up and running within nine days. Our refinery in Port Arthur, Texas had extensive damage as a result of Hurricane Rita, yet our employees worked tirelessly to get it up and running in less than three weeks.[2]

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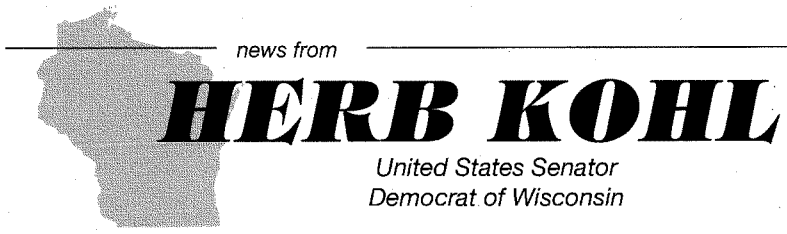
[2] Valero has also won the United Way's annual "Spirit of America" award twice highlighting Valero's commitment to our communities.

Aside from supply disruptions like hurricanes, the largest single factor in rising fuel prices was the cost of crude oil, which averaged $1.20 per gallon last year, or about 53% of the average cost of a gallon of gasoline. Valero is not in exploration & production, so we do not benefit from high crude prices. We purchase all of our crude oil and feedstocks on the open market.

And, while much has been said about refining profits, it is important to note that the average gasoline margin for U.S. Gulf Coast refiners in 2005 – the best year ever – was $10.57 per barrel, or about 25 cents per gallon of gasoline. Even in a good profit year like 2005, our overall net profit margin was still less than 4.4 percent of sales. The return on investment for Valero is good, but if these refineries were on our books at full replacement cost, returns even last year, would have been low. Refining is a world business with thin margins and high capital costs. We must be careful about passing laws and regulations that negatively impact the domestic refining industry.

In summary, Valero has been saying since 1997 that worldwide demand for clean refined products would grow faster than the available supply, and we have been investing and growing steadily. Our substantial investments have significantly increased U.S. gasoline and diesel production. Valero's acquisitions have provided increased gasoline and diesel production for the American consumers.

Thank you. I look forward to your questions.

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**FOR IMMEDIATE RELEASE:** **March 14, 2006**
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# KOHL ANNOUNCES LEGISLATION TO RESTORE COMPETITION TO THE OIL INDUSTRY

## *Six oil company executives called in to testify at Judiciary Committee hearing on high fuel prices today*

WASHINGTON – The Presidents and CEOs of six major American oil companies today testified before the Senate Judiciary Committee during a hearing on consolidation in the oil and gas industries, and U.S. Senator Herb Kohl said he will introduce legislation to restore competition in the business. While consumers pay rapidly rising prices for gasoline and home heating fuel, the oil industry continues to report record profits, including ExxonMobil's $36 billion last year, an all-time high for a U.S. corporation. Wisconsin Attorney General Peg Lautenschlager also testified at today's Judiciary Committee hearing.

"None of us questions the right of private businesses such as the oil companies to maximize the profits they earn for the benefit of their shareholders in a competitive market. At the same time, none of us should tolerate profiteering if it results from collusion, price gouging, market manipulation or other similar anti-competitive practices. And the realities of today's oil market cause many of us to worry that something more suspicious than simply competitive market forces are at work," Kohl said.

Kohl said there are several "red flags" with respect to the oil and gas industries. Despite burgeoning demand and high profits to be made, no new refineries have been opened in 25 years and more than half of those operating 25 years ago have been closed. Oil industry critics argue that oil companies have chosen not to expand refining capacity in order to gain market power to keep prices high. Furthermore, more than 2600 mergers and acquisitions have occurred in the oil industry since 1990, leaving a dangerous level of consolidation in their wake and, according to a GAO study, higher gas prices.

Kohl, a member of the Judiciary Committee, will introduce a bill with Committee Chairman Arlen Specter (R-PA) to give U.S. antitrust enforcers added tools to restore competition to this industry. The bill includes a prohibition on the withholding of petroleum products designed to

- more –

raise prices and Kohl's previously introduced legislation to subject the members of the OPEC oil cartel to U.S. antitrust law. The bipartisan legislation also establishes a joint state and federal task force to look at information exchanges between oil companies to ensure that they do not collude on pricing.

Kohl is also the author of legislation to direct the Secretary of Energy to establish and operate a strategic refining reserve and to authorize him to stop the exportation of gasoline and home heating oil when he supply falls short at home.

The oil company executives that testified at today's hearing included the CEOs of ExxonMobil, Chevron, ConocoPhillips, and Valero Energy Corp. and the Presidents of Shell and BP America.

# # #

**TESTIMONY OF WISCONSIN ATTORNEY GENERAL**
**PEG LAUTENSCHLAGER ON BEHALF OF MIDWEST ATTORNEYS**
**GENERAL NATURAL GAS WORKING GROUP**
Senate Judiciary Committee – March 14, 2006

Mr. Chairman and members of the Committee, thank you for this opportunity to speak with you here today.

Late last summer following Hurricanes Katrina and Rita, Americans saw gasoline prices surge to all-time highs, and six months later those prices have still not abated to previous levels. At the same time, consumers began hearing dire predictions of skyrocketing natural gas bills for the winter ahead; predictions that unfortunately proved to come true.

Many states, including Wisconsin, conducted their own individual inquiries into the enormous jump in gasoline prices and the industry's resulting record profits. At the same time, beginning in the fall of 2005, the offices of the Attorneys General of four Midwestern states, Wisconsin, Iowa, Illinois and Missouri, launched a joint investigation for the purpose of examining the reasons for the dramatic rise in natural gas prices. Our staff met with invited representatives of utility companies from each state, as well as with natural gas producers, to gather information and obtain frank perspectives about the causes of the projected dramatic price increases.

What we found surprised us. Our six-month investigation resulted in two primary conclusions: 1) the upward volatility of natural gas prices over the past several years cannot be simply explained by traditional supply and demand factors, contrary to what is commonly reported; and 2) the financial markets for natural gas are enormously complex, and there is an almost complete lack of transparency in the system.

Data collected for our report from both government and industry sources indicate that daily consumption of natural gas today is virtually unchanged from levels of ten years ago, contrary to media reports that routinely refer to "soaring" or "skyrocketing" demand. In addition, on the supply side, the reserve to production ratio has actually gone up the past six years and storage levels this fall and winter were at all-time highs. These facts are best illustrated on the charts attached and identified as Exhibits ES-2 and ES-3, part of a lengthy report detailing the findings of our investigation.

Physical market fundamentals – a tight supply/demand balance – are not adequate to explain either the short-term or long-term behavior of natural gas prices. This does not mean that tight markets do not matter – of course they do – but identifying physical market fundamentals is only the beginning of the story, not the end.

On the financial side, it is clear that financial markets for natural gas are far less regulated than the markets for many other less-essential commodities, there are few regulations for registration or reporting by brokers and, to make matters worse, information regarding who is holding what positions is almost non-existent or

unobtainable. Indices in the natural gas market are based largely on self-reported trades. Indeed, from a law-enforcement perspective, it is almost impossible to ascertain whether any antitrust, consumer or securities laws are being broken, in that we don't have access to the information typically used to conduct those sorts of investigations. We can't answer the most basic questions, such as who bought what, and when?

The widespread reliance on natural gas commodity markets to set prices is an extremely recent phenomenon, just over 15 years old. As evidenced by the wild, irrational swings in natural gas prices over the past several years, at a time when supply and demand were relatively stable, these new markets have not worked very well. Many of the industry representatives we spoke with believe these markets lack transparency and are vulnerable to abuse and manipulation.

The upward spiral of gas prices has an enormous impact on our economy and on consumers' checkbooks. Consider the following:

- The wellhead price of natural gas in the six-year period of 2000-2005 increased by over $400 billion dollars compared to the previous six years

- Winter heating bills in the Midwest this winter are projected to be up by $250 per household, or 28 percent, compared to last winter, despite a 5 percent decline in consumption and record levels of gas in storage. They are up by over $600 compared to five years ago.

- A $3 per million Btu rise in natural gas prices costs consumers an additional $5 billion per month.

- Natural gas prices climbed to all-time highs last fall and early winter, with spot prices exceeding $15 and wellhead prices exceeding $10 per million Btu for the first time ever. By contrast, gas prices had hovered around $2 to $4 per million Btu for much of the last two decades.

This story has a very human side to it as well, as evidenced by stories told to members of our investigatory committee. For example, one Illinois school district spent about $300,000 for heating in 2002. By 2005, it had jumped to $400,000. In fiscal 2006, it's approaching $700,000. That's more than double in four years. A retired factory worker in Chicago barely makes ends meet on $1,100 per month. Last December his gas bill balance was $430—double what it was at the same time last year. In Wisconsin it is estimated that 20,000 more families will be delinquent in their utility payments this winter compared to a year ago, despite extraordinarily mild temperatures during January. Without the assistance of public funds, those families will face service disconnections in the coming months.

This committee's examination of consolidation in the energy industries is an important issue that ties directly into the concerns raised in our report. For example, consider that BP, the largest marketer of natural gas, has a market share of over 20

percent. The next three firms have market shares of about ten percent. In other words, four companies (three of which are major oil companies) control about fifty percent of the U.S. natural gas market, and the concentration of ownership continues to increase.

Given the low elasticities of supply and demand and the reactions of the market to relatively small changes in the supply/demand balance, the growing consolidation of ownership in the natural gas market by companies that often have arms that engage in extensive trading presents the potential for market manipulation and other abuses. Putting all our eggs in the baskets of a few energy companies does not bode well for American consumers.

These price increases are a problem that is both regional and national, but which is not beyond our reach. A cooperative approach to this common problem is the most effective and efficient means to determine what legal strategies to employ or public policy changes to advocate to best address any avoidable financial harm to the citizens of our states. A comprehensive approach must be taken, with the states working with the federal government, including Congress, FERC and the CFTC, to arrive at a global solution that creates a more rational, transparent system of markets for energy commodities.

What is clear as we examine this issue, however, is that we must not be satisfied with an explanation that rests solely on traditional notions of supply and demand. Our investigation does not support the commonly repeated mantra that "soaring" demand is driving natural gas prices. Both demand and supply have been relatively flat and steady over the past decade. The price of natural gas, meanwhile, has been all over the place, with peaks and valleys that constantly ratchet upwards. (See Exhibit ES-7, attached.) This pattern does not square with traditional economic analysis of supply and demand. In addition, it appears that a significant contributing factor has been a huge influx of money into largely unregulated financial markets, reinforcing the upward spiral of prices by increasing volatility and risk, and creating uncertainty. A lack of transparency in those speculative markets only makes matters worse.

To address this we submit the following initial list of recommendations:

- Increased oversight of the over-the-counter markets is needed, including requirements for registration of traders and reporting of trades;

- Stricter limits on positions held by any one entity and expanded settlement periods for short- and long-term contracts, and restrictions on how much the price of natural gas can move on the markets before trading is temporarily halted for a "cooling off" period; and,

- Formation of a joint federal-state task force to examine critical questions about the supply-side of the physical market and the role of major oil companies, which straddle the physical and financial markets.

Thank you for your attention to this issue of critical importance to so many Americans, and thank you for allowing us to share our perspectives with you hear today. We would be happy to answer any questions.

**EXHIBIT ES-2: NATURAL GAS DEMAND: 1995-2005**

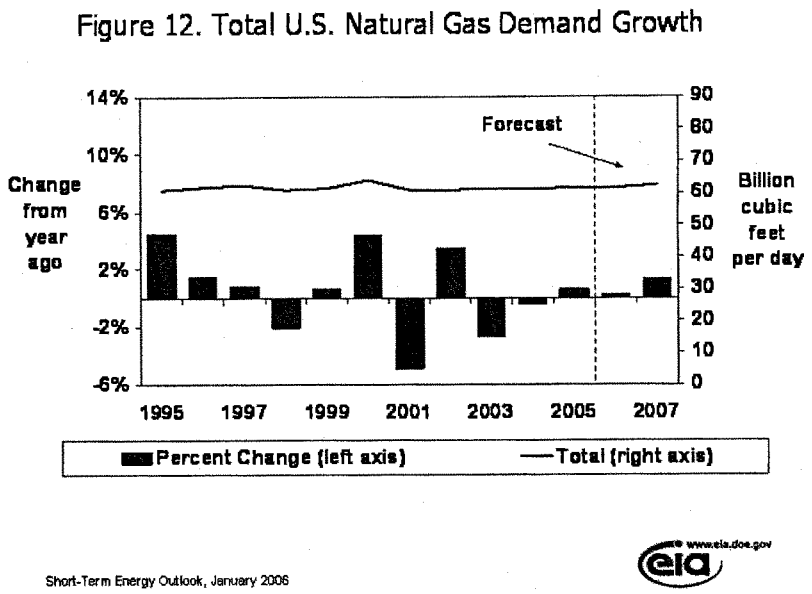
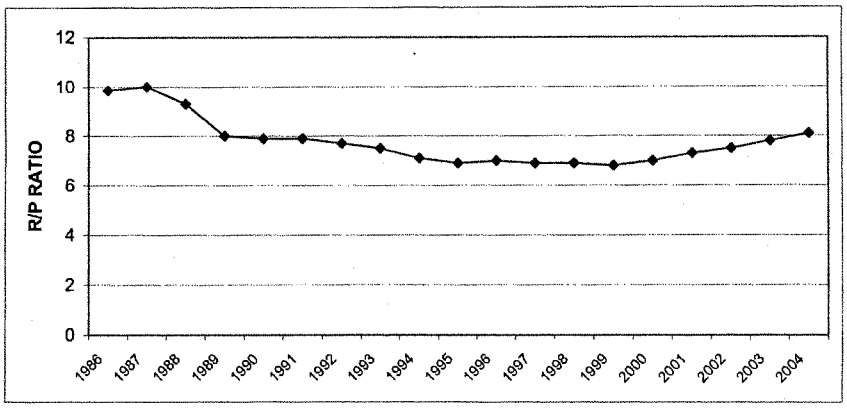
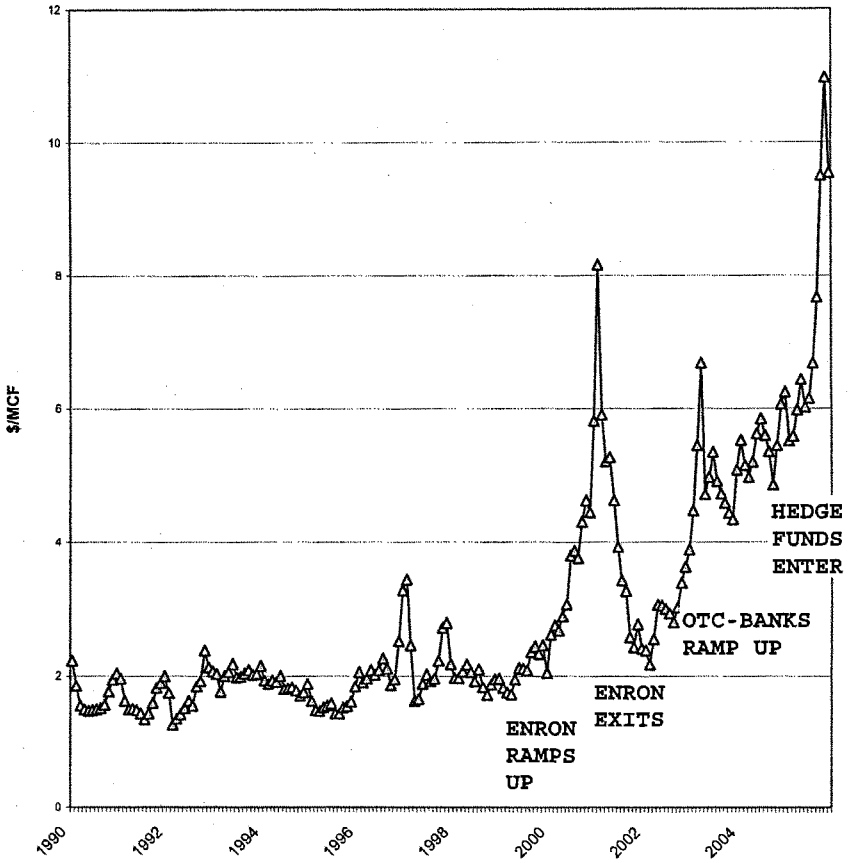



**EXHIBIT ES-3: NATURAL GAS RESERVE TO PRODUCTION RATIO**




**Source: Energy Information Administration, database.**

**EXHIBIT ES-7: WELLHEAD PRICES AND CHANGES IN TRADING ACTIVITY**




Source: Energy Information Administration, *Natural Gas Database.*

# U.S. SENATOR PATRICK LEAHY

CONTACT: David Carle, 202-224-3693 VERMONT

**Statement Of Senator Patrick Leahy,**
**Ranking Member, Judiciary Committee**
**Hearing On "Consolidation In The Oil And Gas Industry"**
**March 14, 2006**

I commend the Chairman for holding this substantive and timely hearing today. The Committee tackles a fundamental and widening crisis that affects every American family, every American farmer and every American business. The questions before us are as basic as these: When does the opportunity to repeatedly raise fuel prices, and to amass record-shattering profits on a scale never before known in our society, or in any society -- when does that reach the point of becoming a corrosive kind of greed that demands some kind of corrective action? Another question: At what point does the ever-tightening circle of energy suppliers become anti-competitive? And finally, how long should the overseas oil cartel be exempt from antitrust remedies?

America's fuel crisis continues to drain hard-earned money from our families, farmers, factories and businesses. This problem is made more complicated because, as President Bush observed in his State of the Union address, "America is addicted to oil."

I can only hope the President's public acknowledgement means he has finally abandoned the failed policy of Vice President Cheney's Energy Task Force that worked in secret with Enron's Ken Lay and with other well-connected energy industry folks to develop an energy policy that pads the pockets of the special interests, at the expense of consumers.

The time for Congress to act is long overdue. It was clear even at the time last year's energy package was signed into law that it already was a wasted opportunity of epic proportions when it comes to truly, practically and meaningfully addressing the oil addiction the President now cites. Flawed policies in essence continue to levy a hefty unofficial "tax" on the pocketbooks and balance sheets of millions of families, farms and businesses across the country. Each additional week without progress means continued hardship on Vermonters and millions of others nationwide in heating their homes or budgeting for all the other ways these escalating fuel costs are adding to their daily expenses.

As a first step, Congress should enact the NOPEC bill into law. For weeks we have been evaluating the security concerns prompted by a foreign government's ownership of a company that would take over effective control of port facilities in six of our major ports. Meanwhile, in the case of the oil cartels, government-controlled entities routinely collude

to set prices, and they have also wielded their power to purposely create major supply and security concerns in the United States. The time for our NOPEC reforms may have finally arrived.

The Senate has already passed this bill, which would make OPEC subject to our anti-trust laws. In fact, this Committee has approved the NOPEC bill three times. Regrettably, even though President Bush promised in the 2000 election to "jawbone OPEC," the Bush Administration and its friends in the House have scuttled the NOPEC bill and the relief it would bring to millions of Americans.

I am proud to join with the Chairman, Senators Kohl and DeWine and others on a new bill which includes our NOPEC legislation. This measure would make OPEC accountable for its anti-competitive behavior and allow the Justice Department to crack down on illegal price manipulation by oil cartels. It will allow the federal government to take legal action against any foreign state, including members of OPEC, for price fixing and other anti-competitive activities. The tools this bill would provide law enforcement agencies are necessary to fight OPEC's anti-competitive practices immediately, and they would help reduce gasoline prices now, rather than waiting another decade. It is time for the President to make good on his campaign pledge and join the bipartisan majority in the Senate which is saying "NO" to OPEC.

But we should not stop there. A windfall profits tax on the record-breaking profits that oil companies have been raking in would help consumers afford home heating oil now and for years to come. Such a levy could help provide refunds for consumers to help protect them from high home heating prices. It could also be used to finance practical investments for homeowners to upgrade their insulation, replace windows, and trade in their old appliances for more energy efficient ones. Revenues could also be used to encourage consumers to buy more fuel efficient hybrid cars.

We also must address the merger-mania within the oil industry. Over the last several years, oil company mergers have significantly diminished competition, leading to higher prices for consumers. The U.S. Government Accountability Office (GAO) concluded in a report that recent mergers in the oil industry have directly led to higher prices. This may seem like an obvious conclusion, but one that has gone too long without some kind of resolution.

And finally the time is long overdue to make a serious commitment to alternative fuels and renewable energy. We all heard the President's State of the Union address and his declaration of the need to address our dependence on foreign oil. However in reality the President is proposing to devote less to alternative and renewable energy resource development in inflation-adjusted dollars than was devoted to this goal in Fiscal Year 2001.

I am glad that the Committee will be returning to the Chairman's previous policy of putting witnesses under oath. Before the Committee today are executives from the five biggest oil companies. In a year when these corporations posted record profits, we also

saw them increase their prices. At $36.7 billion in profit last year, ExxonMobil turned the highest yearly profit in U.S. history for any business. Since 2001, the oil companies represented here have recorded $272.2 billion in profits. Since 1999, oil refiners have seen a 334 percent increase in yield on each gallon of gasoline refined because of prices they set, the lack of transparency, and the lack of effective regulation.

I suspect we will hear their reasons for price increases at a time when their corporations are posting record profits. But to ask Americans to pay more for gas so that a few corporations can boost the profit margin is unacceptable to me. American families are at the mercy of these companies to get to work, to go to school, and to run the businesses that pay their salaries. When all of you raise prices together, Americans are forced to meet that price.

I do hope each of the executives here today offers more than just a well-spun argument for higher prices to get higher profits. This cannot continue. In your careers, each of you has seen what happens when the foreign oil spigots are tightened or when disasters strike America. This requires a responsible and carefully-planned strategy. Instead of reading about what plan you have in place on the front pages of the newspapers, Americans read that as the prices at the pumps soar, so do your profit margins.

The rest of American rallies together when America is suffering. In contrast, instead of preparing for possible shortfalls or emergencies, it appears the oil industry has focused on taking advantage of consumers who have no alternatives. You are not in the business of making oil you are in the business of supplying a reliable energy source to millions of Americans.

That energy source for the time being is crucial to many in my home state of Vermont. Vermont's farmers, families, hospitals, colleges and businesses can not function without it.

For a typical Vermont farmer the impacts of your lousy planning can be catastrophic. I can give you one example from a Vermont farmer whom I have known for years, Harold Howrigan. His dairy operation fuel costs on about 800 acres increased by almost $10,000 in one year. His costs were $49,800 in 2004, and increased to $59,650 in 2005. The overall increase in fuel costs for an average Vermont farmer last year was 43 percent, meaning that each farmer is estimated to pay an additional $700 in fuel surcharges in 2006 alone. That may seem like pennies compared to the profit sums we will be discussing today, but to me, and to all Vermonters, we know what the terrible consequences can be: forcing many farmers to make unfair choices between running their farm or heating their home. These are not choices anyone should be faced with, certainly not our hard working farmers.

Vermont's dairy farmers, who get up everyday, well before the sun rises, whether it is minus 15 degrees, or whether it's pouring rain, or pelting snow, can not do their jobs without your product. It is not just farmers in my home state of Vermont. Farmers in

Wisconsin, Pennsylvania, Idaho, California, and other key states that provide our domestic milk supply are reliant on your product. That is how you get the cream for your morning coffee each day. So, after that cup tomorrow I would like you all to think about preparing for emergencies instead of preparing to take advantage of emergencies.

When I look at the record gasoline and home heating prices in comparison to the record profits of the largest oil companies, totaling tens of billions of dollars, it is clear that a change is necessary. The answer here is not easy, and change is not going to happen overnight, but the first steps must be taken, and they must be taken now.

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**TESTIMONY OF JAMES J. MULVA**

**CHAIRMAN AND CHIEF EXECUTIVE OFFICER**

**CONOCOPHILLIPS**

**BEFORE THE**

**UNITED STATES SENATE COMMITTEE ON THE JUDICIARY**

**ON**

**TUESDAY, MARCH 14, 2006**

Good morning, Mr. Chairman and Members of the Committee on the Judiciary. My name is James Mulva, and I serve as Chairman and Chief Executive Officer of ConocoPhillips, headquartered in Houston, Texas.

ConocoPhillips fully appreciates the concerns that you and your constituents have about energy prices. We think it is important to address the underlying causes of the recent increases in energy prices, and we thank you for giving us an opportunity to do so today.

The Committee specifically asked us to address the impact that consolidations in the energy industry have had on prices. We will share with the Committee the experience we have gained from our mergers and acquisitions and the roles they have played in forming ConocoPhillips as it operates today. We will demonstrate how these transactions were necessary responses to a very challenging and ever-changing business environment. Our mergers and acquisitions have enabled ConocoPhillips to compete more effectively by achieving the scale to undertake additional capital-intensive long-term projects, spreading political risk from global exploration, lowering costs and improving efficiency, all of which increase the short-term and long-term supply of petroleum products to U.S. consumers. We believe that this has led to lower energy prices than those that would have prevailed without the merger transactions.

Each of our significant transactions was extensively reviewed by the Federal Trade Commission (FTC). Where the FTC had any concerns about the effects of the transaction on prices to consumers, the Commission mandated significant divestitures of assets or other actions. The FTC has documented that it has pursued divestitures or challenged mergers in the oil industry at lower levels of consolidation than in any other industry[1] and

[1] Chairman Deborah Platt Majoras, Federal Trade Commission, Prepared Statement of the Federal Trade Commission before the Committee on Commerce, Science and Transportation and the Committee on Energy and Natural Resources, United States Senate, "Market Forces, Competitive Dynamics, and Gasoline Prices: FTC initiatives to Protect Competitive Markets", November 9, 2005, page 4

that "despite some increases over time, concentration for most levels of the United States petroleum industry has remained low to moderate".[2]

The FTC also has continued to monitor retail gasoline and diesel prices quite vigorously, tracking these prices in some 360 cities across the nation. And they have monitored wholesale prices in 20 major urban areas. The Commission has stated that the vast majority of its investigations and studies on gasoline pricing have revealed that market factors are the primary drivers of both price increases and price spikes.[3] States also have investigated gasoline and diesel prices. ConocoPhillips cooperates fully – both on a voluntary and a formal basis – with authorities and expends significant resources in providing information and other assistance to the authorities monitoring the petroleum industry.

In this testimony and when answering your questions to the best of my ability, I will from time to time express my opinions, beliefs and predictions about future events. As I am sure you appreciate, these future events are subject to risks and uncertainties. I refer Members of the Committee and other interested parties to our public filings, where we provide a more extensive description of our risk factors.

**Reasons for Petroleum Industry Consolidation**

Before describing ConocoPhillips' specific experience with mergers, we would like to share our general views on why the petroleum industry has been consolidating. As you know, there have been a significant number of mergers in the petroleum industry in the last decade, just as there have been in many other industries during this timeframe.

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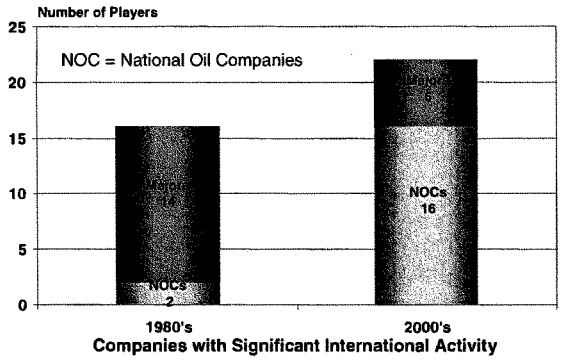
[2] Commissioner William E. Kovacic, Prepared Statement of the Federal Trade Commission Before the Committee on the Judiciary, United States Senate, "Petroleum Industry Consolidation", February 1, 2006, page 5

[3] Chairman Deborah Platt Majoras, Federal Trade Commission, Prepared Statement of the Federal Trade Commission before the Committee on Commerce, Science and Transportation and the Committee on Energy and Natural Resources, United States Senate, "Market Forces, Competitive Dynamics, and Gasoline Prices: FTC initiatives to Protect Competitive Markets", November 9, 2005, page 20

To some degree, the trend toward consolidation is being driven by globalization, with mergers giving companies from all industries sufficient scale and a lower cost structure to enable them to compete in a global arena. For petroleum companies, the global business environment has become particularly challenging as government-owned enterprises from both oil-producing and consuming nations have emerged as new global petroleum players, adding to competition in the marketplace. In fact, the chart below shows that the emergence of national oil companies competing outside their borders has more than offset the decline in the number of international oil companies due to mergers. Thus, the number of international competitors has increased since the 1980s.

**Global Competition: 1980s vs. 2000s**
**Emergence of NOCs as International Competitors**




*Source: PFC Energy & Internal Company data*

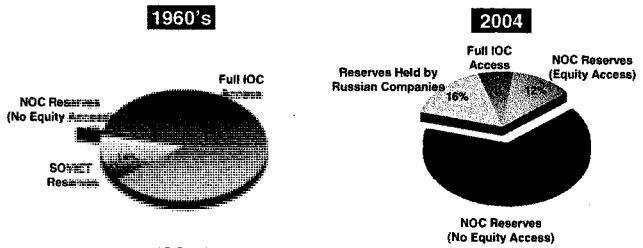
1980s: **NOCs:** Repsol, Petronas. **Majors:** Exxon, Mobil, BP, Amoco, Atlantic Richfield, Union Texas, Shell, Texaco, Chevron, Phillips, Conoco,Total, Petrofina, Elf.

2000s: **NOCs:** GP, Repsol, Statoil, KPC, CNPC, CNOOC, Sinopec, Petronas, Pertamina, ONGC, OIL, IOL, Gazprom, Ecopetrol, Sonatrach, Petrobras. **Majors:** ExxonMobil, BP, Shell, Chevron, ConocoPhillips,Total

The upstream segment of the petroleum business consists of exploration for and development and production (E&P) of crude oil and natural gas supplies. Access to crude oil and natural gas reserves is the principal challenge in the upstream segment of the petroleum industry today. In the United States, oil and gas production is declining, and the areas with the best prospects for exploration and development are off limits. These access restrictions extend well beyond the most environmentally sensitive areas. Constrained access increases the requirement for the U.S. energy industry to look for

resources abroad, where resources often are controlled by national oil companies. Resource access has been steadily eroding since the 1960s. As shown in the pie charts below, today international oil companies can directly access only 7 percent of the world's oil and gas reserves, with an additional 12 percent accessible through joint ventures with national oil companies.

## World Oil & Gas Reserves: 1960s vs. 2004
### Drift Toward Constrained IOC Access




IOC = International oil company
NOC = National oil company

*Source: PFC Energy, Oil & Gas Journal, BP Statistical Review 2005*
*NOTE: Excludes unconventional crude oil and bitumen reserves*

Competition for the limited resources available – combined with rising foreign government taxes – make it difficult for publicly traded and private oil companies to access resources with acceptable returns to our shareholders. This has led to declining organic reserve replacement rates for many international oil companies. Meanwhile, national oil companies from oil-producing and consuming nations, along with privately held Russian companies, are now competing globally and adding to the reserves access challenge.

The most significant opportunities that are available to privately held international oil companies today are projects that host-country national oil companies decide should be undertaken with foreign participation. These projects often are very large, complex and

risky. They require financial strength, proven technologies, highly trained personnel and reliable access to markets. Many of them are in developing countries and have substantial political and economic risks.

A typical ConocoPhillips exploration and development project costs several billion dollars of up-front investment and does not generate production or revenues for seven to eight years. For example, a project to produce and deliver liquefied natural gas (LNG) currently costs between $5 and $10 billion; similarly the Alaskan gas pipeline is expected to cost more than $20 billion. Only large companies have the financial capacity and technical resources to effectively develop these projects and have sufficient diversification to manage the risk. For U.S. companies to compete in today's environment of mega projects, they've grown in size commensurate with the growing magnitude, complexity and risk of available opportunities. The forces demanding larger and more diverse oil and gas companies will continue to grow in intensity in the years ahead.

Moving to the downstream segment, which includes the refining and marketing businesses (R&M), there has been a reduction in the number of refineries being operated in the United States over the last 25 years, but this is not a result of mergers. Between 1973 and 1981, there were federal government incentives for companies to own and operate small, and often inefficient, refineries. The elimination of these incentives in 1981 spurred the eventual exit of many inefficient refineries. The number of operable domestic refineries declined from 319 in 1980 to 149 in 2004. According to the FTC, refinery closures overwhelmingly have involved small, relatively unsophisticated facilities.[4] The large capital expenditures required for mandated specifications, such as clean fuels and emissions reductions, also were a likely factor in the closure of smaller, less efficient refineries.

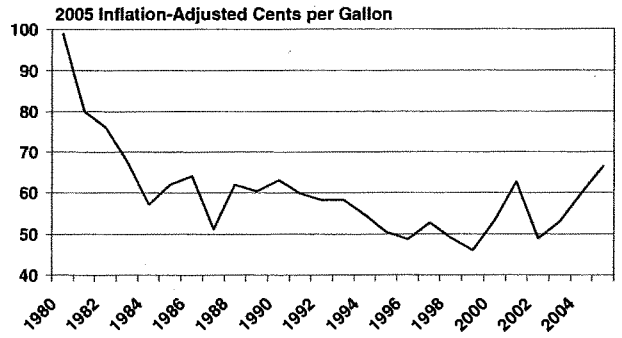
[4] U.S. Federal Trade Commission, Bureau of Economics, "The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement", August 2004, page 7

The oil industry has done a commendable job of expanding capacity and increasing utilization rates at existing refineries. Thus, while the number of refineries has declined since 1980, expansions and improved efficiency have allowed the industry to actually increase refinery production volumes by 14 percent.

Efficiency improvements over the last two decades also have resulted in substantial cost savings for consumers. The graph below shows the difference between refiners' crude acquisition cost and the pre-tax retail price of gasoline (which is the combination of the cost and profits from refining, distributing and marketing retail gasoline). The graph shows that the difference between cost and price fell from about 99 cents per gallon (real 2005 dollars) in 1980 to 49 cents per gallon in 2002. It subsequently increased to 66 cents per gallon in 2005 (real 2005 dollars) due to the impact of the hurricanes and tighter market conditions.[5] However, even at 2005 prices, this difference was still one-third lower than it was 25 years ago in real terms. This decline has occurred despite the increase in manufacturing cost for cleaner fuels.

**Cost to Refine, Distribute & Market Gasoline**

**(Measured as the difference between refiners' acquisition cost of crude and retail gasoline prices excluding taxes)**




Source: U.S. Department of Energy, API for taxes

[5] U.S. Department of Energy, Energy Information Administration, API for taxes

**ConocoPhillips' Merger Experience**

Let me begin the discussion about ConocoPhillips' merger and acquisition experience with a brief description of our company. ConocoPhillips is an international, integrated energy company, headquartered in Houston, Texas, and operating in 40 different countries with 2005 annual revenues of $179 billion and assets of $107 billion as of December 31, 2005. We are the third-largest integrated energy company in the United States, based on market capitalization and oil and gas proved reserves and production. We are the eighth-largest non-government controlled energy company globally based on market capitalization. We are the second-largest refiner in the United States, and the fourth-largest refiner in the world. But a company is more than its revenues and assets – it is its employees, shareholders and the communities it touches. We have approximately 35,600 employees, who own about five percent of our shares through company-sponsored benefit plans. Approximately 83 percent of ConocoPhillips stock is owned by more than 2,000 different institutional funds, representing investments by a wide array of individuals and businesses, as well as numerous private and public pension plans.

The descriptions and rationales for and cost and efficiency improvements resulting from the following transactions are described below:

- Conoco-Phillips merger
- Phillips-Tosco acquisition
- Conoco-Gulf Canada acquisition
- Purchase of equity interest in and joint ventures with LUKOIL
- ConocoPhillips-Burlington Resources pending acquisition
- Other transactions

I think you will see that these mergers, acquisitions and joint ventures have benefited consumers by reducing cost and improving the efficiency of our business, resulting in

increased supplies of petroleum products for American consumers. Fundamentally, the supply of petroleum products depends on the ability of U.S. companies to access crude oil and natural gas and the ability of those companies to refine that crude oil into petroleum products for American consumers. Developing supplies of crude oil and natural gas requires petroleum companies to undertake ever larger and riskier projects, both domestically and abroad.

The transactions undertaken by ConocoPhillips have been motivated by and have subsequently achieved increased access to crude oil and natural gas, and increased refining capacity to turn that crude oil into petroleum products. This increased supply has benefited – and can be expected to continue to benefit – American consumers through lower prices and greater energy security. These mergers and acquisitions also have strengthened the sustainability of the company's competitive position and long-term viability.

Conoco-Phillips Merger

Given the size and importance of the merger of Conoco and Phillips to our company's history, I would like to review this transaction in greater depth than the other transactions. This $36 billion merger of equals was completed on August 30, 2002. The rationale for this merger was to form a company of sufficient size and scale to address opportunities that could not be achieved by either company on a stand-alone basis. The merger was intended to develop a diversified growth portfolio and benefit from the intellectual capital of the two companies. It also was intended to strengthen our financial position through diversifying earnings and cash flow, developing a stronger balance sheet and improving capital efficiency and the cost structure.

By the end of 2004, we documented $1.9 billion in cumulative cost and efficiency savings resulting from this merger. These synergies have benefited American consumers by increasing volumes and by enabling ConocoPhillips to increase investments and compete vigorously for international supplies of natural gas and crude oil.

In the E&P segment of the business, our increased scale, financial strength and diversification have allowed ConocoPhillips to expand our investments in traditional core areas as well as in developing new legacy assets. The E&P business segment also benefited from the combination of the companies' complementary technologies. For example, Phillips possessed natural gas liquefaction technology and Conoco had a natural gas-to-liquids technology. Possessing both of these technologies has allowed the company to become a more effective global gas player. There were also substantial integration benefits associated with utilizing complementary competencies. For example, by combining Phillips' liquefied natural gas (LNG) technical expertise with Conoco's extensive gas marketing experience, ConocoPhillips has become a successful player in the global LNG business in the space of just three years. This puts our company in a strong position to help expand the supply of natural gas to American consumers over the coming years as the domestic supply of natural gas declines. Our increased size also gives us more leverage in procurement, which is an extremely important benefit in this highly capital-intensive business.

In the R&M business segment, we benefited from lowering our cost structure, which was made possible by sharing technology and best practices, optimizing crude supply and improving management of intermediate refining feedstock across our entire refining system. Unit cost reductions have resulted from initiatives in the areas of energy efficiency, maintenance and procurement of goods and services. Additional benefits of technology and best-practice sharing have reduced the capital costs of projects.

The merger also resulted in increased efficiency in R&M operations. We have been able to improve the reliability and increase clean refined product yields at our refineries by sharing technology and best practices across our refinery network. These include initiatives in preventative maintenance, reduced turnaround time, improved tuning and control of operating units, and installation of improved technologies. Conoco and Phillips both brought expertise in key technologies to the table. Conoco's strong petroleum coking technology skills were applied to Phillips' refineries and Phillips'

alkylation technology to increase feed and improve octane, along with Phillips' sulfur removal technology, were applied to Conoco's refineries.

Since the merger, refinery utilization has improved from the low 90 percent range to the mid 90 percent range, which is equivalent to adding a 100 thousand barrel per day refinery. In addition to increased capacity utilization, we also have increased the nameplate capacity of our U.S. refineries by approximately 1 percent per year over the last two years.

Having additional U.S. refineries to upgrade is allowing us to bring additional crude oil from Canadian oil sands production into the United States. For example, we currently are expanding the capabilities of our Wood River refinery in Illinois to add both crude capacity and a large coker so it can handle additional volumes of Canadian oil sands crude oil. We are also partnering with a Canadian company to build the Keystone Pipeline to bring an additional 435 thousand barrels per day of Canadian crude into the Midwestern United States. The combined ownership of Conoco's Canadian crude oil supply and Phillips' Wood River refinery facilitated this major investment. Again, our size and financial strength allow us to undertake major projects of this nature.

All across our post-merger refining system, we can point to numerous examples of higher crude throughputs stemming from our ability to balance crude oil supplies among our refineries. For example, crude oil throughput at our Sweeny, Texas refinery was maintained at higher levels during the Venezuelan supply disruption in 2003 due to our ability to divert the specialized crude from three of our other refineries to Sweeny, because the others could easily adapt to alternative supplies. In several instances, we have been able to maximize our refining system throughput during Gulf of Mexico storms that delayed crude oil deliveries. We have greater balancing options among waterborne cargoes, pipeline receipts and inventories. We also have greater volumes of clean products since the merger because of our ability to balance intermediate and blendstock inventories among refineries. For example, we increased the supply of imported gasoline and gasoline blendstocks from Conoco's Humber refinery in England

through Phillips' Bayway and Trainer refineries on the U.S. East Coast. We also move premium gasoline blendstocks (e.g., alkylate, toluene) from our East Coast to West Coast refineries to increase the supply of CARB gasoline and to enhance octane. In addition, when we plan turnarounds, we can process intermediate products (not yet upgraded to a finished product due to capacity in turnaround) at other plants. With unplanned downtime, we can utilize stocks from other facilities to maintain supply to consumers.

We also have realized significant efficiency gains in pipelines and terminals in the United States since the merger. For example, we improved Canadian crude access on the Spearhead pipeline and improved crude import capability on the West Coast.

Divestitures stemming from the merger also moved refining capacity into the hands of new industry participants. While we did not believe it was warranted, in response to an FTC mandate before the merger was closed, our Woods Cross refinery in Utah was sold to Holly Corporation, and our Denver refinery in Colorado was sold to Suncor. In both cases, the new owners have invested to maintain output and to make new clean fuels at these refineries.

Phillips – Tosco Acquisition

This acquisition, which involved the exchange of $7 billion of Phillips stock for Tosco shares, was completed on September 14, 2001. The rationale for the transaction was to build critical mass, capture economies of scale and to reduce the unit costs of R&M operations in the United States. We identified $280 million in pre-tax synergies from this transaction.

Sources of synergies for refining included increasing the ability to use lower cost crude oils, increasing operating reliability, increasing clean product yields, lowering operating costs, and utilizing Tosco's commercial expertise to maximize asset values (e.g., use lower cost feedstock). The acquisition also increased transportation volumes without a commensurate increase in costs through sharing best practices and centralizing services.

Perhaps the most important benefit in terms of volume expansion relates to the fact that ConocoPhillips is able to invest significantly more in the refining business than Tosco, as a smaller independent, was able to invest. Tosco invested about 70 to 80 cents per barrel of capacity during the late 1990s, while ConocoPhillips' investments have averaged about $1.25 per barrel over the last three years. Moreover, additional investments are expected.

ConocoPhillips also is upgrading Tosco's former refineries. As described above, these upgrades include expanding the processing capability of a significant portion of the Wood River refinery to increase crude capacity and access more Canadian unconventional heavy crude oil. The integration of Tosco's business, which was all in the R&M segment, with ConocoPhillips' production of these crude oils facilitates these investments, in part by reducing the risk associated with the investments.

Conoco-Gulf Canada Acquisition

Conoco acquired Gulf Canada on July 16, 2001, in a transaction valued at $9.4 billion. One rationale for the acquisition was to increase Conoco's access to North American natural gas reserves, and thereby improve supply to American consumers. This goal is being realized as ConocoPhillips has utilized its greater financial strength and U.S. gas marketing position to increase the supply of Canadian natural gas to the United States from Gulf Canada production. ConocoPhillips expects that its financial strength and commercial skills also will enhance development of the supply of natural gas from the Mackenzie Delta gas-producing region in Arctic Canada. Since the acquisition, ConocoPhillips has applied its expertise in heavy-oil production and upgrading to the development of Gulf Canada's Canadian oil sands reserves. Crude oil from these reserves is increasingly being supplied to U.S. refineries as far south as ConocoPhillips' refineries in Illinois, Oklahoma and, in the near future, Texas. ConocoPhillips' investment in Gulf Canada also has ensured that the crude oil production resulting from these E&P investments has a home in refineries capable of processing these crude oils.

ConocoPhillips' Acquisition of Stock Interest in LUKOIL and Subsequent Formation of Upstream Joint Ventures with LUKOIL in Russia

On September 29, 2004, ConocoPhillips announced a broad-based strategic alliance with LUKOIL, an international integrated oil and gas company headquartered in Russia. ConocoPhillips initially acquired 7.6 percent of LUKOIL ordinary shares for $1.99 billion through a government privatization process and began pursuing a near-term target of 10 percent equity ownership soon thereafter via tender or open market purchases, which the company achieved by year-end 2004. At year-end 2005, ConocoPhillips had increased its ownership in LUKOIL to 16.1 percent. ConocoPhillips has the right to purchase up to 20 percent interest in LUKOIL, which it plans to reach by year-end 2006. Simultaneously, ConocoPhillips and LUKOIL formed joint ventures to manage the exploration, development and production of crude oil fields in Russia and potentially in Iraq.

In addition to investment capital, ConocoPhillips provides these joint ventures with its experience in the international energy business and exposure to global best practices and technology, including Arctic and offshore operations, gas commercialization, refining, and information systems and reporting. This joint venture in Russia expands ConocoPhillips' opportunities to develop new supplies of crude oil in resource rich areas. As noted above, long-term access to crude oil for U.S. consumers must include increased access to international supplies of crude as oil production in the United States declines. ConocoPhillips' investments in the development of Russian crude with LUKOIL add an important new source of crude supply for American consumers. According to the U.S. Department of Energy, the United States presently imports about 12 million barrels per day[6] or 60 percent of its oil supplies. It is projected to grow to 17 million barrels per day by 2030 or 63 percent of projected supplies. Diversification of supply sources for imported oil will enhance energy security.

[6] Net of exports

ConocoPhillips' Pending Acquisition of Burlington Resources

On December 12, 2005, ConocoPhillips announced its intent to acquire Burlington Resources Inc. for $33.9 billion. All required regulatory clearances have been obtained. Completion of the transaction is subject to approval by Burlington Resources shareholders, and other customary closing conditions.

The rationale for this transaction is to increase ConocoPhillips' ability to supply North American gas and obtain high-quality, long-lived, low-risk gas reserves. This acquisition also provides near-term production growth, which complements the numerous long-term projects in our portfolio. This production growth is expected to come, in part, through ConocoPhillips' access to Burlington's technical capabilities, particularly its expertise in commercializing unconventional gas projects in coal bed methane and so-called "tight" gas. ConocoPhillips brings to the table better health, safety and environmental processes and operating capabilities. ConocoPhillips also has a lower cost structure than Burlington. Increased natural gas production in the United States will benefit U.S. consumers in a time of ongoing recovery of natural gas production in the Gulf of Mexico from last year's hurricanes. We expect to achieve pre-tax annual synergies of $375 million, through portfolio optimization and operating expense reductions.

This acquisition also enhances the geographic diversity of projects within the United States and strengthens our supply position in Western Canada. The transaction also increases ConocoPhillips' weighting of its portfolio toward E&P. This transaction also has significantly lower risk than mega projects in developing countries with uncertain development costs and fiscal regimes.

Other Transactions

ConocoPhillips also has used mergers and acquisitions as a means to refocus our core business investments on increasing the supply of natural gas, crude oil and refined petroleum products to American consumers. For example, ConocoPhillips sold most of

its retail marketing operations over the last five years. Circle K assets were sold at the end of 2003 to Alimentation Couche-Tard Inc. Other retail assets were sold in 2004 to Sunoco and Getty Petroleum Marketing Inc. ConocoPhillips also formed the Duke Energy Field Services (or DEFS) Joint Venture with Duke Energy in 2000. DEFS is an integrated gas gathering, processing and marketing business. The formation of DEFS enabled the better provision of gas gathering and processing services to third-party producers in the United States using the existing Phillips (and, subsequently, ConocoPhillips) assets. Another example of refocusing was the completion of the ChevronPhillips Chemical joint venture on July 1, 2000. This joint venture reduced the cost structure and made ConocoPhillips' chemicals business more competitive on a global scale.

**ConocoPhillips' Investment Plans**

As described above, mergers and acquisitions have allowed ConocoPhillips to create a global petroleum company that is more capable of deploying significant investments to increase the supply of crude oil, natural gas and refined products to U.S. consumers. ConocoPhillips invested about $6 billion back into our business in 2003. This amount grew to $9.5 billion in 2004 and $11.6 billion in 2005, which is nearly double the 2003 level.

ConocoPhillips has been investing its earnings back into maintaining and expanding supplies. We had 2005 earnings of $13.5 billion – about $1 billion a month, but our capital investments also were close to $1 billion a month. In fact, over the last three years, ConocoPhillips' earnings were about $26 billion while investments were just over $27 billion. ConocoPhillips expects to grow its base with continued high levels of investment. In 2006, we intend to maintain our higher investment rate to increase supply of crude oil, natural gas and refined products.

ConocoPhillips has been investing aggressively in refining, and in developing new natural gas and crude supplies for the United States. A few of our principal investment projects are described below. All are very large projects and will require significant capital expenditures well into the future.

- ConocoPhillips has been at the forefront in recent years in growing the company's refining business at a rate that was among the highest in the industry. Over the past three years, ConocoPhillips spent $4.2 billion worldwide, of which $3.4 billion was spent domestically, to expand and modernize our refineries and upgrade marketing operations. This includes environmental spending, including clean fuels, over the last three years of nearly $1.7 billion in our U.S. refining and marketing business.

- Going forward in refining, we are planning an expanded investment program, whereby we expect to invest $4-5 billion on top of our maintenance and other refinery investments of $1-2 billion per year. This investment program is aimed at growing our U.S. refining capacity by about 11 percent and improving our capability of handling lower quality crude oils in order to make 15 percent more clean fuels such as gasoline, diesel and heating oil by 2011. These expansions will add enough clean fuels products to be the equivalent of adding one world-scale refinery to our domestic refining system. We are accomplishing it by growing output at nine of our refineries rather than adding a grassroots refinery. Even our international refinery investments benefit U.S. consumers. For example, our planned investment in our newly acquired refinery in Germany is expected to allow us to significantly increase imports of gasoline to the United States.

- ConocoPhillips is making major investments in North American Arctic natural gas through the Mackenzie Delta and Alaska North Slope pipelines. The initial development of the Mackenzie Delta will access 6 trillion cubic feet of gas, which is expected to begin production in 2011 at approximately 1 billion cubic feet per day. As other fields are added, the pipeline capacity can be expanded to 1.8 billion cubic feet per day. The total cost of this pipeline is estimated to be at least $6 billion.

- The Alaska North Slope currently has an estimated 35 trillion cubic feet of natural gas, which, if commercialized, would increase total U.S. gas proven reserves by approximately 20 percent. Undiscovered gas reserves in that State are estimated to be much higher. When the pipeline connecting this gas with the lower 48 market is completed, about 4.0 - 4.5 billion cubic feet per day of new natural gas will be flowing to American consumers. This equates to about 8 percent of present U.S. natural gas production. The Alaska pipeline alone, using 2001 cost estimates, is expected to cost about $20 billion and take 10 years before the first cubic foot of gas is sold on the market. Producers on the North Slope reached agreement in principle with the Governor of Alaska on terms and conditions that would move the Alaska natural gas pipeline closer to reality. These agreements are now or should be soon pending before the Alaska legislature. Natural gas from Alaska will, eventually, make a sizable contribution in meeting the demand of U.S. consumers.

- ConocoPhillips is also investing to increase the supply of natural gas to U.S. consumers by bringing liquefied natural gas (LNG) to the United States. For LNG supply, we are moving forward with projects in Qatar and Nigeria and aggressively pursuing projects in Russia, Venezuela and Australia. These are all multi-billion dollar projects. We are scheduled to bring our first cargo of Qatari gas to the United States in 2009. For delivery of natural gas from LNG, we are participating in the construction of an LNG regasification facility at Freeport, Texas. We are pursuing two other LNG regasification terminals in Compass Port, offshore Alabama, and in Beacon Port, offshore Louisiana. These are currently in the permitting process. We are committed to making the investments in these facilities. We also are pursuing permitting a regasification facility on the West Coast of the United States, and are open to adding other terminals on all Coasts if we believe they will add value.

- To bolster U.S. and global oil supplies, ConocoPhillips is expanding conventional crude production in Venezuela, Russia and the Far East. There likely will be a bridge of unconventional heavy oil and natural gas before the world transitions to alternative

fuels in a major way. ConocoPhillips has invested and continues to invest heavily in unconventional heavy oil production in Venezuela and Canada. We also are partnering with a Canadian company to develop the $2.1 billion Keystone Pipeline, which will bring 435 thousand barrels per day of much needed Canadian heavy oil production to our U.S. Midwestern refineries.

**Reasons for Elevated Oil and Gas Prices**

While ConocoPhillips does not assume that the high oil prices in the last year will be sustained, we do want to give you an appreciation of the challenges that lie ahead in supplying U.S. and world energy needs. Government policies play an important role in either facilitating or detracting from the petroleum industry's ability to expand output sufficiently to meet consumer needs.

We believe that strong global energy prices today have been caused by a period of extraordinary demand growth in the face of little excess production capacity and frequent supply disruptions. Crude oil prices are the main driver of gasoline and other product prices, as noted in a recent FTC report.[7] The report indicated that over the last 20 years, changes in crude oil prices have explained 85 percent of the changes in the price of gasoline in the United States. Crude oil prices are determined in highly liquid and transparent U.S. and international markets by thousands of traders and other business entities based on the market conditions that exist on a given day.

Global crude prices have been rising since 2002 as a result of the U.S.-led global economic recovery, leading to exceptional oil demand growth and rapid industrial growth in the developing economies of Asia. Over the last decade, oil demand in China and India doubled, and is expected to double again by 2020. Strong U.S. and global economic growth are certainly desirable but the consequence of strong growth is a rise in

[7] U.S. Federal Trade Commission, "Gasoline Price Changes: The Dynamic of Supply, Demand and Competition", 2005, page iv of Executive Summary.

the demand for commodities, including oil. Higher prices inevitably will justify and encourage new investments to increase the supply of energy, whether in the form of oil and gas or alternative sources.

This exceptional growth in demand over the last few years has left little surplus crude oil production capacity available in the world today. Concern about geopolitical risk in various oil-producing countries in the face of limited spare production capacity has helped drive oil prices higher. The two large hurricanes experienced in the United States last year also disrupted most of Gulf Coast oil and natural gas production and refining capacity.

The refining industry has been challenged by a number of Congressional and State mandates, over the years, focused on significant spending on clean fuels and emissions reductions. This has diverted capital from capacity expansion. Federal and State regulatory processes also have discouraged the building of grass roots refineries and expansions of existing refineries. The process for siting and securing the many permits necessary for a refinery are lengthy and difficult. We have found this to be the case in our on-going efforts to expand refinery capacity at existing locations. The need to develop about 100 different "boutique" grades of gasoline in the United States in various localities also has increased the cost of manufacturing gasoline and reduced short-term product fungibility. The U.S. Department of Energy has reported that boutique fuels exacerbate price volatility and that reducing the number of fuel types likely will reduce the frequency and magnitude of price surges.[8] Our company would support moving away from "boutique" fuels to more standardized refined products. This will make it easier to redistribute products during times of shortage and should reduce price volatility in normal market conditions.

Another key factor in the price rise we have seen in recent years is the increase in the cost of finding, developing and producing a barrel of oil. Steel prices doubled between the

[8] U.S. Department of Energy, Energy Information Administration, "Gasoline Type Proliferation and Price Volatility", September 2002, page 4

end of 2002 and end of 2004, and they are a large cost component for our industry. In the last three years, onshore drilling costs in the U.S. rose 52 percent and the cost of tubular goods rose by 125 percent. These components represent about half the cost of onshore wells. Costs have been rising in part because the oil services industry has not been able to keep pace with the rapid spending increases by our industry. Shipping rates for large crude carriers also tripled between 2002 and 2004, raising the cost of imported crude. However, there also is a longer term trend of costs increasing because our industry does not have access to the lowest cost reserves, including in the United States. Thus, our industry is going after more remote, deeper water, more complex and lower quality reserves that inherently cost more than what we were developing a decade ago. Both Goldman Sachs and Sanford Bernstein recently estimated that oil replacement costs are currently around $50 per barrel, while they were closer to $35 per barrel in the early 2000s and $20 per barrel in the 1990s.[9] While some of this increase is, we believe, transitory, the cost increase relating to reduced resource access likely will remain.

Resource access is a particular problem for natural gas in the United States because the most highly prospective areas are off limits for drilling or the permitting requirements are so onerous that prospects become uneconomic. Given industry decline rates of 30 percent per year in existing Lower 48 natural gas wells and the long lead times for LNG projects and Arctic gas pipelines, gas supplies in the United States could well be tight over the next few years. The only short-term and long-term solution is to make more acreage available, especially in the Eastern Gulf of Mexico and the Rocky Mountain regions. We would encourage the reinstatement of lease sale 181 in the Eastern Gulf of Mexico. We also would encourage the Department of the Interior to ensure that the Bureau of Land Management has sufficient staffing to expedite permitting in the Rockies. Such measures can increase the supply to U.S. consumers in the near term. Outside the United States, we believe that the federal government should use diplomacy to encourage foreign producing nations to allow greater resource access at reasonable terms.

[9] Bernstein Research Call, November 4, 2005, page 2; Goldman Sachs, Jeff Currie, "The sustainability of higher energy prices, April 2005, page 21

Another challenge is the difficulty in permitting key energy infrastructure such as refineries, LNG regasification (receiving) terminals and pipelines in consuming countries like the United States. In the United States, regulation and NIMBY (not-in-my-back-yard) sentiments have caused costly delays and even the abandonment of some important infrastructure projects. In order to facilitate sufficient investment in key energy infrastructure the industry needs governments at all levels to be thorough, but at the same time, to streamline permitting and environmental review processes.

Our company is particularly concerned about permitting and the NIMBY issues associated with building new LNG receiving terminals. LNG offers the most promising option for meeting the growing natural gas needs of American consumers in the medium term. But, the permitting and approval of new regasification terminals is occurring significantly slower than we expected. Many are being delayed and face being cancelled altogether, due to challenges at the local level. As noted above, LNG is an important component of natural gas supply to U.S. consumers, particularly in light of the rapid production decline in existing U.S. natural gas wells.

The siting of LNG terminals was addressed in earlier energy policy legislation. However, the federal government, states and the individual localities where these facilities are planned need to have continued dialogue and cooperation on siting issues. There also needs to be better cooperation among the various federal agencies charged with evaluating and permitting these facilities.

Finally, what we do not need from the government are additional taxes that will reduce the industry's ability to invest and provide additional energy supplies. According to a 1990 report by the Congressional Research Service, the windfall profits tax that was signed into law in 1980 and repealed in 1988 drained $79 billion in industry revenues during the 1980s that could have been used to invest in new oil production – leading to 1.6 billion fewer barrels of oil being produced in the U.S. from 1980-1988. The tax reduced domestic oil production by as much as 6 percent, and increased oil imports by as much as 16 percent. Current proposals to increase the taxes of a selected few taxpayers

by taxing LIFO inventories and imposing double taxation on foreign earnings are little more than "stealth" windfall profits taxes and will detract from investment and harm the competitiveness of U.S. versus foreign energy companies.

The key to improving energy security and reducing prices is increased investment by the energy industry across a diverse set of energy projects in both the upstream and downstream business segments. Our industry is a global, highly competitive industry. ConocoPhillips could not make the investments we are making today to increase the supply of crude oil, refined products and natural gas to American consumers without the company we have built, in part through mergers and acquisitions, over the last decade. We would not have had the financial strength, the ability to handle large and complex projects, the technologies, commercial skills or resource prospects without the transactions we have completed over the years. We expect to continue our high rates of efficient investment to expand the supply of crude oil, refined products and natural gas to U.S. consumers.

Mr. Chairman and Members of the Committee, the mergers and acquisitions described to you today have been instrumental in making ConocoPhillips a world class competitor for oil and gas projects around the world. These consolidations have allowed us to become more efficient in developing these projects– projects that we would not have been able to compete for without the benefits brought by consolidations. Since much of our global market is focused on the United States and the American consumer, we believe these consolidations have had a positive impact by giving consumers a stronger American voice in competing for precious world resources and obtaining them at a lower cost. Americans have a stake in keeping the U.S. energy industry competitive, and we believe ConocoPhillips has been an important contributor to sustaining U.S. competitiveness internationally.

Thank you, Mr. Chairman and Members of the Committee for this opportunity to appear before you.

**David J. O'Reilly**
**Chairman & Chief Executive Officer**
**Chevron Corporation**

**Statement before the Hearing of the**
**Senate Judiciary Committee**

**March 14, 2006**

## Introduction

Thank you, Chairman Specter, Ranking Member Senator Leahy, and Committee Members. I am Dave O'Reilly, and I am Chairman and CEO of Chevron Corporation. I am here today representing Chevron employees and the shareholders who have put their trust and confidence in our company.

Chevron is a global energy company whose roots go back 126 years to the Pacific Refining Co. in California. We have approximately 53,000 employees worldwide and a presence in more than 180 countries. We have approximately 1.5 million shareholders globally. Our U.S. business is largely concentrated in the western, southern, and southwestern states. We are involved in virtually every aspect of the energy industry. In the United States, Chevron has crude oil and natural gas exploration and production operations in the Gulf of Mexico, Texas, the Rocky Mountains, California and elsewhere. We have refineries in California (El Segundo, Richmond), Hawaii, Utah, and Mississippi. We transport and market petroleum products throughout the west, Rocky Mountain region, south and southeast under the Chevron and Texaco brands. We also have interests in petrochemicals and power generation assets and are working to develop and commercialize future energy technologies.

I welcome this opportunity to talk about the changes that our industry – and my company – have been undergoing to maintain our competitiveness and meet the increasing global demand for energy. There are few industries more central to the vitality of the United

States, or that touch more American households, than the oil and gas industry. Chevron takes this responsibility seriously and I hope the information that I share with you today will help you better understand the value that our industry provides to American consumers and the American economy.

I would like to make three points today.

- Mergers in the U.S. oil and gas industry over the past 25 years have helped the industry become more efficient in the production, refining and marketing of energy supplies.

- These mergers have created benefits for the American consumer in the form of affordable, reliable and higher-quality fuels.

- Energy companies must achieve economies of scale to compete effectively in the global marketplace and be able to manage the complexities and risks that are inherent in the energy industry of the 21st century.

First I would like to provide some relevant context regarding Chevron's history of mergers.

**Chevron's Merger History**

Our company has gone through three significant mergers in the last 22 years, with Gulf (1984), Texaco (2001), and Unocal (2005). The Federal Trade Commission (FTC) has carefully reviewed each of these mergers. They were allowed to proceed only after careful and thorough antitrust review to ensure no adverse impact on competition.

At the time of our merger with Gulf Oil in 1984, both of our companies had significant exploration and production activities, as well as substantial downstream refining and marketing operations in the United States. Chevron was the largest refiner in the U.S.,

with more than 8 percent of total refining capacity. Immediately following the Gulf merger, the company's refining capacity climbed to roughly 14 percent of total U.S. capacity. As a condition of merger approval, the FTC mandated the divestiture of:

- One of two specified Gulf Coast refineries (Alliance, Louisiana).
- Gulf's interest in the Colonial Pipeline and other specified crude pipelines.
- All Gulf marketing assets in six states and parts of South Carolina.

Subsequent to this merger, Chevron voluntarily sold refining assets at Port Arthur, Texas and Philadelphia, Pennsylvania. These assets did not fit our long-term strategic plans and were sold to other entities that continued to operate the facilities. Some other, and much smaller, refinery facilities were also sold or shut down at later dates.

Our next merger occurred in late 2001, when Chevron acquired Texaco. Again, the FTC reviewed this merger thoroughly and ordered divestiture of the following significant assets:

- Texaco's interest in refining, marketing, and pipeline assets in the Equilon and Motiva joint ventures.
- Texaco's 33 percent interest in the Discovery Gas Transmission System and a minority interest in the Enterprise fractionator.
- Texaco's general aviation business.

Chevron was also required to give up the Texaco brand for a period of time in the U.S. as a condition of the merger.

The Texaco merger did not increase Chevron's refining capacity in the U.S. In fact, Chevron's relative share of capacity has declined. In 1995, our refining capacity was less than 7 percent of total U.S. capacity. Today, Chevron is the seventh-largest refiner in the country with approximately 5.5 percent of U.S. capacity. Our branded-gasoline marketing share, which was 6.1 percent in 1995, is now 6.5 percent. It is important to note that the vast majority of Chevron-branded service stations in the United States are operated by independent business men and women.

The Chevron-Texaco merger strengthened the company in several respects. It created a company with a much broader mix of quality assets, skills and technology. Our asset position was enhanced in many of the world's major and emerging areas for exploration and production. Our exploration capabilities were augmented, and we have been able to find new energy resources more efficiently as a result. (In 2005, we had an exploration success rate of 58 percent, a rate well above the industry average.) Our technology portfolio was broadened in the area of alternative energy technologies, such as fuel cells and hybrid batteries. And the skills and talent of the people brought together by the merger strengthened our organizational capability.

Our most recent merger with Unocal occurred last year. Like the other two, this merger was also reviewed and approved by the FTC, which made the following statement:[1] "*We want to emphasize that the merger will have no impact whatsoever on concentration at the retail or refinery levels. It is clear from all we have seen that Chevron's primary motivation is to gain access to Unocal's upstream oil reserves.*"

Unocal had no refineries or gasoline station assets in the United States or elsewhere. Thus, there was no change to Chevron's refining and retail marketing share as a result of this acquisition. However, Chevron did agree to give up patent rights previously owned by Unocal for reformulated gasoline.

As the FTC has observed in testimony before this committee on Feb. 1, 2006, this transaction was driven by the opportunities to further develop Unocal's oil and gas resources. The acquisition was a superb strategic fit in the U.S. Gulf of Mexico, Caspian Sea region and Southeast Asia, where real synergies between the two companies exist. By combining them, Chevron is in a better position to bring major resource development projects to market. This involves technology, capital, and project management skills.

[1] Statement of the Federal Trade Commission in the Matter of Union Oil Company of California, Docket No. 9305 and In the Matter of Chevron Corporation and Unocal Corporation File No. 051-0125, Docket No. C-4144

Moreover, Unocal also brought important people skills – in drilling operations for example – that complement the skills of Chevron's workforce.

The FTC has closely scrutinized industry mergers over the past 20 years, as well as their aftermath, and confirmed they had no adverse impacts on consumers.[2] In fact, the FTC has worked to ensure limited impact or limited harm to consumers by requiring certain divestitures. Attachment A shows several specific comments by the FTC regarding consolidation in the petroleum industry. In general the FTC has concluded:

- Mergers in the petroleum industry in the past two decades have had only limited impact on industry concentration,
- Crude oil prices are the primary factor accounting for the variability in gasoline prices, and
- Notwithstanding consolidation, firms have expanded refining capacity.

Throughout the recent history of mergers in the U.S. oil and gas industry, we believe the regulatory oversight process has worked, and was carried out with the best interests of the U.S. consumer in mind. With those same interests in mind, let me make several observations about the topic of today's hearing.

**Mergers have made the U.S. energy industry more efficient**

Over the past 25 years, the U.S. oil and gas industry has undergone cycles of consolidation that have been driven primarily by the need to operate more efficiently and to deploy capital more productively. Attachment B correlates merger activity in the industry to prevailing oil prices adjusted for inflation. Broadly, merger activity occurred when oil prices were low and the need to increase efficiencies was even more critical.

In 2001, Chevron's merger with Texaco led to annual cost savings of more than $2 billion. These savings were redeployed to a variety of more productive uses. If this

[2] Bureau of Economics, Federal Trade Commission, The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement (2004)

percentage of savings was typical and multiplied across all of the major oil industry mergers of the past 25 years, the level of financial efficiencies that have been created through consolidation becomes clear. As distinct from the broad trend, Chevron's acquisition of Unocal was not driven by cost efficiencies. While some cost synergies did exist, the Unocal merger made sense for other strategic reasons that will be elaborated on later.

Stronger financial positions, as a result of efficiency improvements, have enabled U.S. oil and gas companies to increase investments in key energy basins around the world. In 1975, OPEC accounted for about half of the world's oil production. However, as shown in Attachment C, investments by international oil companies and others have significantly added to the share of global oil production coming from other areas of the world, helping to diversify energy supplies. During this time period, the number of non-OPEC countries producing more than 500,000 barrels per day has risen from five to 19. A significant portion of this new investment is going into the development of natural gas supplies. The United States increasingly is becoming a net importer of natural gas to meet its needs and aggressive development of additional natural gas globally will ultimately enhance energy security in the U.S. The integration of Chevron and Texaco in 2001, in particular, enabled us to pool ownership interests in the huge Gorgon gas field in Australia and create the critical mass necessary to accelerate the development of this resource base as a new source of energy supplies.

Stronger financial positions and redeployed capital have also supported extensive investments in the refining sector to meet demand, improve environmental performance and produce cleaner fuels. These investments have resulted in remarkable capacity gains, as shown in Attachment D. Thirty years ago, the U.S. had approximately 220 refineries with a capacity of 14.5 million barrels per day. Currently, there are 148 refineries with a combined capacity of more than 17 million barrels per day. Hence, we have one-third <u>fewer</u> refineries producing about 20% <u>more</u> volume of gasoline and diesel fuels.

It is important to put the relative concentration of the U.S. petroleum refining sector into context. The fact is that concentration in the refining sector is in line with, and in many cases lower than, market share concentration in other major industry segments (Attachment E). Nor does any single company in the refining sector hold as dominant a share of the market as leading companies do in the long-distance telephone, airline manufacturing, automobile manufacturing and department store industries.

**Consumers Have Benefited from Merger Activity**

The second point I would like to make is that U.S. consumers have greatly benefited from merger-related gains. With these mergers, they have been able to rely on dependable, and increasing, supplies of energy -- energy developed and manufactured more cost-effectively to higher product quality standards with less environmental impact.

Despite periods of volatility, gasoline price increases are modest when compared to increases in the price of most consumer goods and services over the past 35 years. The price of gasoline today is lower than 1981 prices when adjusted for inflation (Attachment F). As noted by the U.S. Bureau of Labor Statistics, gasoline has risen at a slower rate than the average of all items, including such items as food, housing, vehicle repair, hospital & health services, and many other services. (Attachment G).

At the same time, the quality of gasoline refined in the United States has been greatly enhanced. Thirty years ago, our industry produced two types of gasoline – leaded and unleaded. We now produce some 17 different specifications of gasoline to meet federal, state and regional emissions standards. Over the past two decades, the industry has made significant capital investments to improve the efficiency and environmental performance of its fuels, which combined with advances in vehicle technology, have led to a dramatic reduction in tailpipe emissions.

Significant investments have also been made in the environmental performance and energy efficiency of the industry[3]. One of the most dramatic examples of improved environmental performance is associated with Hurricanes Katrina and Rita in 2005. The storms caused extensive damage to onshore and offshore facilities in the U.S. Gulf of Mexico. Yet investments made by the industry over the past several years in sophisticated sub-sea shutoff capabilities, and other technologies, proved very successful in protecting the environment from production-related leaks and spills as a result of those horrific storms.

**The Need for Scale**

My final point is that in today's global energy industry, achieving economies of scale is a competitive imperative. Attachment H demonstrates the scale of the energy industry today, and the relative position of traditional international oil and gas companies to national oil companies. National oil companies such as Saudi Aramco and Russia's Gazprom dwarf U.S. companies in terms of proven reserves. U.S. energy companies need the scale that is necessary to partner with these large national oil companies and gain access to critically needed energy resources that fuel America's cars, heat America's homes and power America's businesses.

At the same time, some national oil companies may be small in terms of resource holdings, but they have access to vast financial resources and are very focused on capturing assets to meet very large domestic energy demand. The U.S. is advantaged by having large, well-capitalized oil and gas companies that can compete with this group of "resource-seeking" national oil companies.

Moreover, ours is a large industry, with equally large risks. It requires scale to effectively manage the financial, operating, and geologic risks that are part of our business. Let me give you a brief example of the kind of risks we manage in our industry.

[3] Chevron has reduced its overall energy use across our operations by 24 percent since 1992.

One of our largest projects is a deepwater platform in the Gulf of Mexico called Tahiti. To give you an idea of the engineering challenge of Tahiti, the next time you take a transcontinental flight and the seatbelt sign goes off, take a look out the window. That's how deep we are drilling – approximately 5 miles below the ocean floor – to reach oil and natural gas deposits.

It requires new technology applications to withstand the intense pressure at those depths. It also requires an equally intense level of capital investment. Total costs of Tahiti are estimated at $3.5 billion, most of which will come from Chevron. Projects of this magnitude take anywhere from seven to 10 years to fully develop. Tahiti is the type of project that defines the future of oil and gas development – large, complex and capital-intensive. These projects require large, technically sophisticated and well-capitalized companies to manage them.

One of the primary drivers in our merger with Unocal was the fact that Unocal had reached the limits of its capabilities to economically develop projects on the scale of Tahiti. Chevron is able to apply the capital and technology necessary to maximize Unocal's asset and bring more energy supplies to the U.S. and world markets. A stand-alone Unocal could not have done this to the same extent, within the same timeframes. The company recognized this and merged with Chevron.

Chevron's planned capital spending program in 2006 is nearly $15 billion, an increase of 33 percent over 2005 – and more than we earned in 2005. Although our investments span our operations worldwide, about one-third, or nearly $5 billion, is targeted for U.S. operations. Chevron's investments are roughly equal to our level of earnings. From 2002 through 2005, Chevron invested $36 billion in the development of energy; during the same time period, our earnings were $36 billion. In other words, we invested what we earned.

These investments are aligned with our extensive queue of projects that are scheduled to come on line between now and 2008, bringing significant new supplies of energy to U.S. and global markets. Our development spending spans the energy value chain, which includes new oil and gas production, refinery expansions, the development of next-generation energy sources such as gas-to-liquids, and alternative and renewable sources.

About $3.3 billion of our 2006 capital budget is targeted toward U.S. upstream activities (exploration and production of crude oil and natural gas). In our downstream operations (the refining and marketing of petroleum products), 2006 worldwide spending is estimated at $2.8 billion, with $1 billion directed at U.S. operations. Spending is targeted for modifications to our refineries in Pascagoula, Mississippi, and Richmond and El Segundo, California that will enable increased gasoline production.

Over the past 25 years, economic, technological, and regulatory forces – both in the United States and elsewhere in the world – have required the industry to restructure to become more efficient and better capable of meeting the challenges of the global energy environment. Post-merger companies are stronger and more efficient, and have the needed scale, to explore, produce, refine and market energy products – and develop the increasingly sophisticated technology that is required to do so. These mergers have benefited our shareholders, our employees, and the American consumers who depend on us for affordable, reliable, secure energy sources.

**Access to resources has been, and remains, a challenge for the industry**

Access to energy supplies in the United States, and elsewhere around the globe, remains a challenge to the oil and gas industry. Moratoria in the United States, for instance, have closed off access to vast areas of our offshore exploration. In the 1980s, increasing public opposition to leasing led to Congressional pressure for annual moratoria in specific areas. By 1990, individual moratoria were so numerous that President George H.W. Bush declared a blanket moratorium that applied to virtually the entire United States coastline, except for a few locations. In 1998, President Clinton extended the ban for an

additional 10 years to 2012. Federal offshore leasing is currently only allowed off Mississippi, Alabama, Louisiana, Texas and parts of Alaska.

At the same time, regulatory hurdles have hindered onshore oil and gas development. Existing environmental regulations and Bureau of Land Management (BLM) processes for oil and gas regulations make obtaining leases and permits to produce on federally-managed lands difficult. The Arctic National Wildlife Refuge (ANWR) is another area currently off-limits and the debate on whether to open it up for drilling has been going on for many years. As a result of government policies, responsible U.S. oil and gas development has been channeled away from Alaska, the Rocky Mountains, and most offshore regions toward the more accessible areas along the Alabama, Mississippi, Louisiana and Texas coasts. For these same reasons, international oil companies like Chevron have increasingly channeled energy investments outside the United States. But because oil, refined products, and increasingly natural gas, are globally traded commodities, Chevron's investments outside the United States will create additional supplies of energy for world markets. This in turn will benefit U.S. and other consumers worldwide.

As mentioned earlier, the ownership of resources outside the U.S. creates another set of issues for our country. The potential dilemma arises because two-thirds of the world's proven oil and gas reserves are controlled by national oil companies with no equity access for outside investors allowed at present (see Attachment I).[4] Another 16% of reserves are held by Russian companies. Thus, the vast majority of reserves are held in places where private companies with private capital such as Chevron are not allowed to invest. It leaves international oil companies such as Chevron with access to less than 20 percent of the world's proven reserves.

[4] Source: PFC Energy

**Policy Recommendations to the U.S. Government**

The business environment for petroleum companies has changed significantly over the last two decades. To remain a viable thriving organization, companies such as ours must be able to compete fully in that changing environment. For Chevron, the three significant mergers we have undertaken in the last two decades have made us a stronger company – a company better equipped to compete and be successful on a global scale in the search for additional energy supplies and to make the investments for cleaner-burning fuels. This has benefited consumers at home and abroad.

In this environment, we believe it is unwise for Congress to take steps that disadvantage U.S. companies and hinder their ability to compete globally. Prime examples are two provisions in the Senate version of the tax reconciliation bill. One provision would change the long-established accounting methodology used throughout all industries by limiting the ability of some oil companies to use Last In-First Out (LIFO) accounting. The second provision would limit those same companies from taking a tax credit for income taxes paid to foreign governments against their U.S. tax on income earned in that foreign country. Both of these provisions are, in effect, punitive tax increases that would restrict the capital available to petroleum companies for investing in creating additional energy supplies. This would seriously harm their ability to compete, especially outside the United States. Tax policies that "tilt the playing field" against the U.S. petroleum industry will reduce future investments in energy at the very moment when more investment is needed. Such policies also run counter to our national security. Those provisions should be dropped from the tax reconciliation bill.

We acknowledge the work of the Congress in passing the Energy Policy Act of 2005, a start toward securing America's energy future. We still believe, however, that there are additional steps that must be taken by Congress and the Administration:

- **Improve the Climate for Investment in Energy Infrastructure.** U.S. lawmakers should provide greater investment certainty for companies by

not changing regulatory, tax or other requirements that discourage future investment.

The permitting process for refineries and other energy infrastructure should continue to be streamlined. There should be a coordinated, integrated and expeditious review. There should be a clearly defined and simple process with specific deadlines. One agency should be designated as accountable for meeting overall guidelines. Overlapping authority and conflicting or redundant processes should be eliminated. Also, the federal government should help educate state and local government, as well as the public, about the need for these facilities.

New Source Review (NSR) and other similar programs need to be reformed to provide more clarity in regulatory requirements and encourage refinery capacity, efficiency and reliability improvements without compromising environmental protection.

- **Rationalize the U.S. Gasoline Supply and Make it More Fungible.** There is a need to rationalize the proliferation of boutique gasolines. As a good initial step, legislation passed last year by the House of Representatives contains provisions that would limit the number of boutique fuels. Rationalizing the current slate of boutique fuels is critical to improving the current supply situation by bringing fuel specifications into alignment with the regional manufacturing, supply and distribution systems. Additionally, granting EPA more authority to temporarily waive and pre-empt state fuel requirements in situations like we experienced during the hurricanes last year will result in quicker response to such emergencies.

- **Increase Access to Domestic Oil and Gas Supplies**. Impediments to access for exploration should be removed. This would include opening

ANWR, areas in the Rocky Mountain region, and offshore for responsible oil and gas development.

- **Recognize that U.S. and Rest of World are Energy Interdependent in US Trade and Foreign Policy.** The government should recognize the growing interdependence of energy markets and work actively with other countries to provide additional secure sources of energy and promote energy efficiency.

- **Promote Further Diversification of U.S. Energy and Natural Gas Supplies.** Support for diversification by resource and geography is critical. The federal government should also continue to support joint ventures with private enterprise to advance technology and develop alternative energy supplies. A good example is the U.S. Department of Energy's leadership and support of hydrogen projects. Continued funding for that and similar activities will over time help lead to further diversification of energy supplies.

I appreciate the opportunity to testify and will be happy to answer any questions.

Attachment A

SELECTED STATEMENTS BY THE FEDERAL TRADE COMMISSION

In one recent report the FTC said:[5]

> *"Some increased concentration is due to mergers. An increase in concentration from a merger, however, is not sufficient to find that a merger was anticompetitive. Where concentration changes raise concerns about potential competitive harm, the FTC conducts more detailed investigations. The FTC has required divestitures or sought preliminary injunctions when it has concluded that a merger is likely to reduce competition. Many of the mergers the FTC challenged would have raised concentration significantly if they had proceeded as originally planned."* p. 15
>
> *"Most sectors of the petroleum industry at the national, regional, or state level generally remain unconcentrated or moderately concentrated."* p. 15
>
> *"In sum, mergers have contributed to the restructuring of the petroleum industry in the past two decades but have had only a limited impact on industry concentration. The FTC has investigated all major petroleum mergers and required relief when it had reason to believe that a merger was likely to lead to competitive harm. The FTC has required divestitures in moderately concentrated markets, as well as highly concentrated markets."* p. 16
>
> *"Many mergers involving petroleum products do not violate the antitrust laws. In some petroleum related mergers, the merging companies do not compete in the same relevant markets. In other cases, while the merging companies compete in one or more relevant markets, their market shares are sufficiently low that an attempt to increase price would be defeated by likely responses from actual or potential competitors (such as an increase in supply, or the repositioning of a competing product or a close substitute), or by consumers' switching their purchases to competing firms. Alternatively, the industry dynamics may be such that a merger will not increase the remaining firms' ability or incentive to coordinate pricing or output decisions. For example, a merger among firms operating in the same market may be procompetitive by enhancing the combined firm's ability to compete with the remaining firms or by reducing its incentive to coordinate with another firm's price or output decisions. Such cases do not warrant FTC enforcement action, because competitive harm is unlikely to occur."* p. 19-20

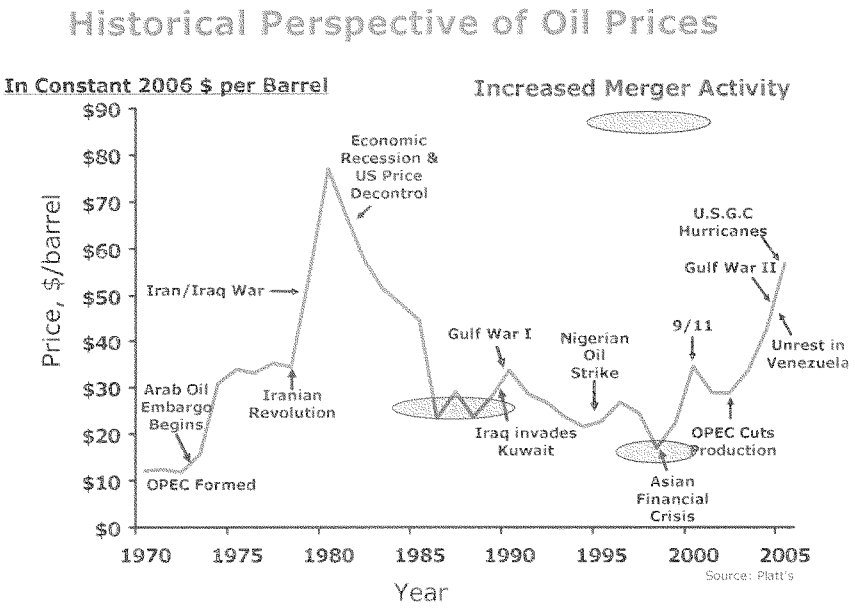
[5] Federal Trade Commission, "The Petroleum Industry: Mergers, Structural Change and Antitrust Enforcement," August 2004

In another statement[6] made last fall, the FTC analyzed the market dynamics and concluded the following:

> "*Crude oil prices as the primary factor accounting for variability of gasoline prices: Changes in crude oil prices account for approximately 85 percent of the variability of gasoline prices. When crude oil prices rise, so do gasoline prices. Crude oil prices are determined by supply and demand conditions worldwide.*" p. 5
>
> "*Excess profits are not the cause of higher prices: Our studies indicate that higher retail prices are not caused by excess oil company profits. Although recent oil company profits may be high in absolute terms, industry profits have varied widely over time, as well as over industry segments and among firms.*" p. 22
>
> "*FTC merger enforcement in the petroleum industry has been vigorous: These data show that the Commission has brought more merger cases at lower levels of concentration in the petroleum industry than in other industries. Unlike in other industries, the Commission has obtained merger relief in moderately concentrated petroleum markets.*" p. 6
>
> "*Notwithstanding consolidation, firms have expanded refining capacity: One of the reasons why long-term real prices have been relatively contained is that United States refiners have taken advantage of economies of scale and adopted more efficient technologies and business strategies. Between 1985 and 2005, U.S. refineries increased their total capacity to refine crude oil into various refined petroleum products by 8.9 percent, moving from 15.7 million barrels per day in 1985 to 17.133 million barrels per day as of August 2005. This increase – approximately 1.4 million barrels per day – is roughly equivalent to adding approximately 10 to 12 average-sized refineries to industry supply. Yet U.S. refiners did not build any new refineries during this time. Rather, they added this capacity through the expansion of existing refineries. They also have adopted processing methods that broaden the range of crude oils that they can process and allow them to produce more refined product for each barrel of crude processed. In addition, they have lowered inventory holdings, thereby lowering inventory costs (although lower inventory holdings may also make an area more susceptible to short-term price spikes when there is a disruption in supply).*"p. 21

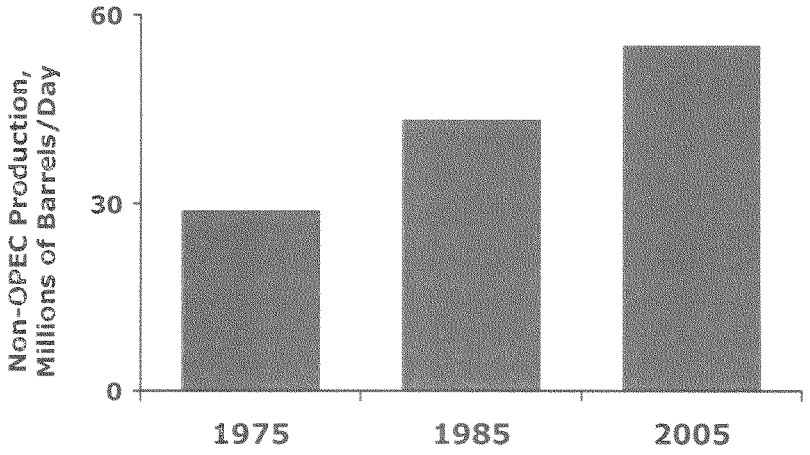
[6] "Market Forces, Competitive Dynamics, and Gasoline Prices: FTC Initiatives to Protect Competitive Markets," Prepared Statement of the FTC, presented by John Seesel, Associate General Counsel for Energy, Federal Trade Commission, before the Committee on Energy and Commerce, United States House of Representatives, September 7, 2005

ATTACHMENT B



ATTACHMENT C

## Companies Have Increased And Diversified Global Energy Production

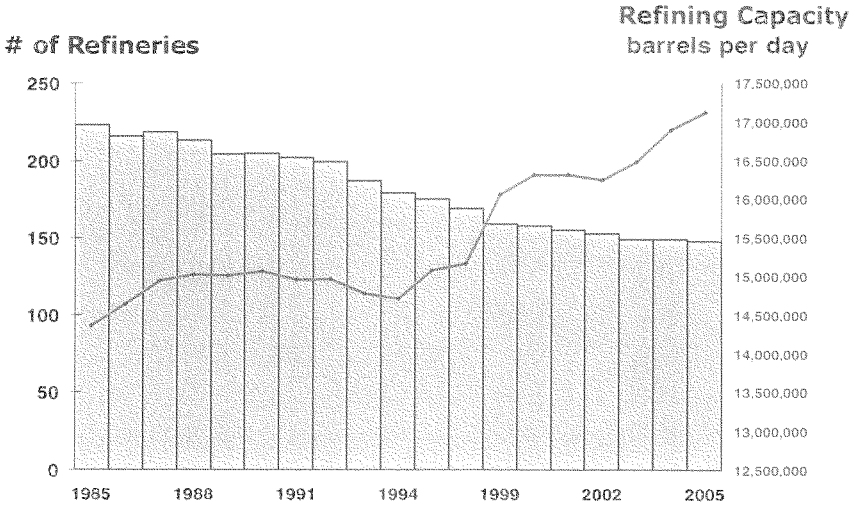



## Which Has Benefited Consumers Globally

Source: IEA Annual/Monthly Historical Data

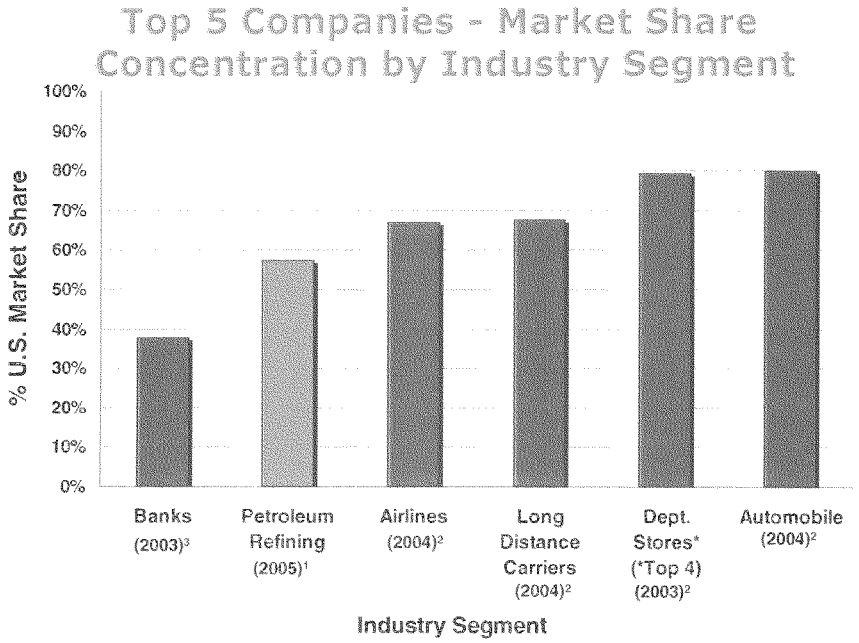
ATTACHMENT D

## The Number Of U.S. Refineries Has Declined, But Total Refining Capacity Has Increased



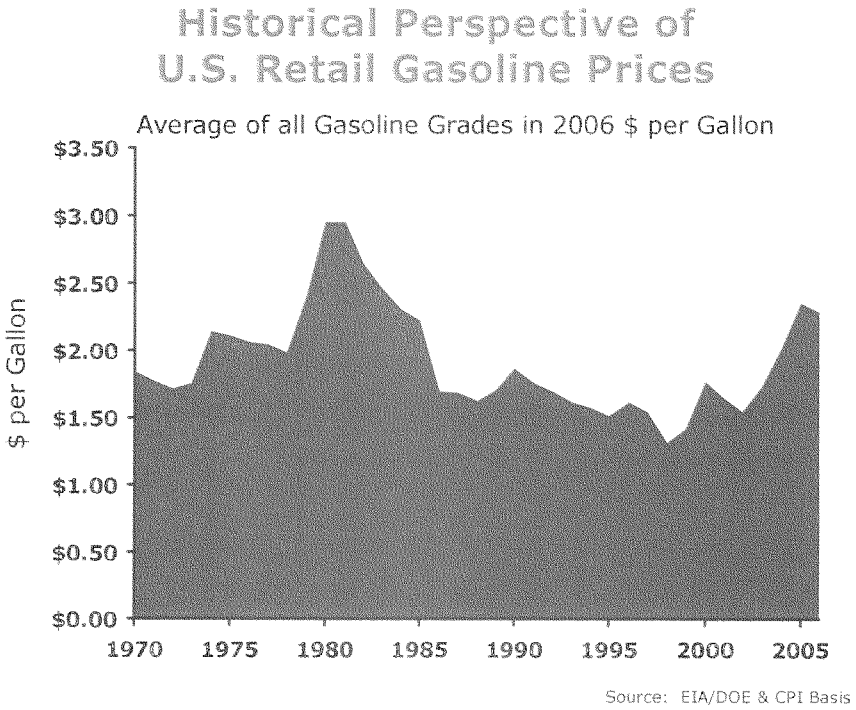

Source: EIA

ATTACHMENT E

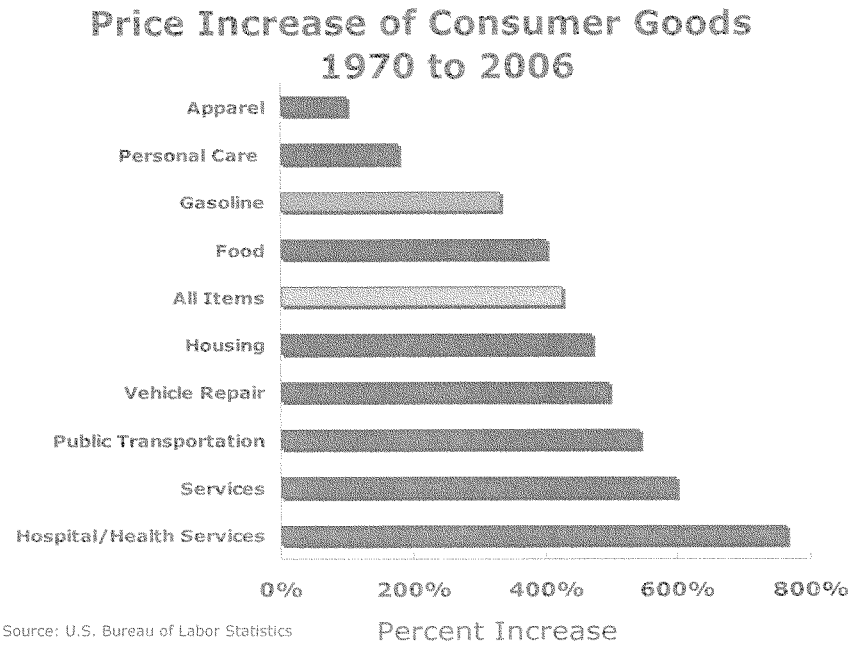



Source:
1. Oil & Gas Journal Data (2005)
2. Market Share Reporter (2006)
3. Jones, Kenneth D. and Tim Critchfield, "Consolidation in the U.S. Banking Industry: Is the Long Strange Trip About to End?" FDIC Banking Review, 2005, Volume 17, No. 4

ATTACHMENT F

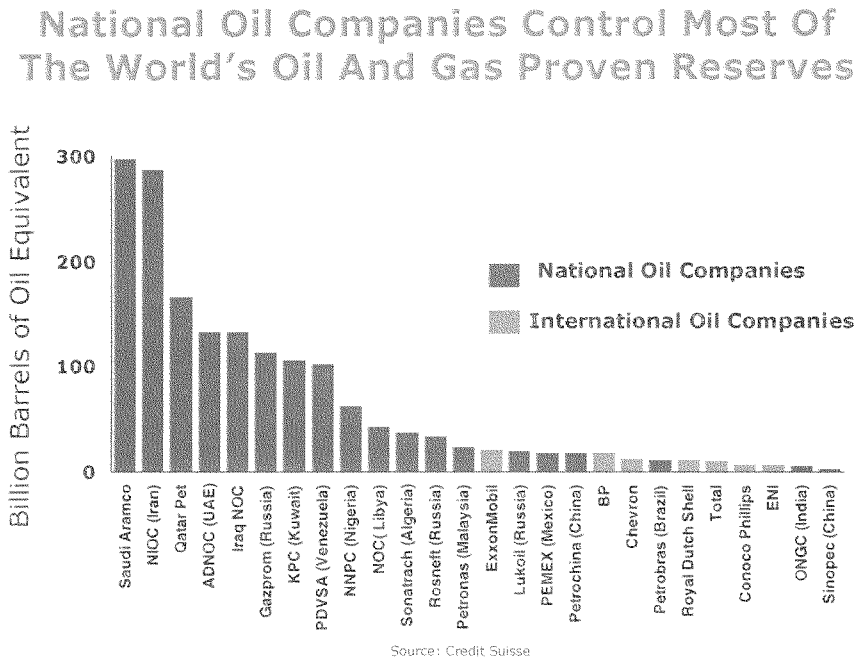


ATTACHMENT G

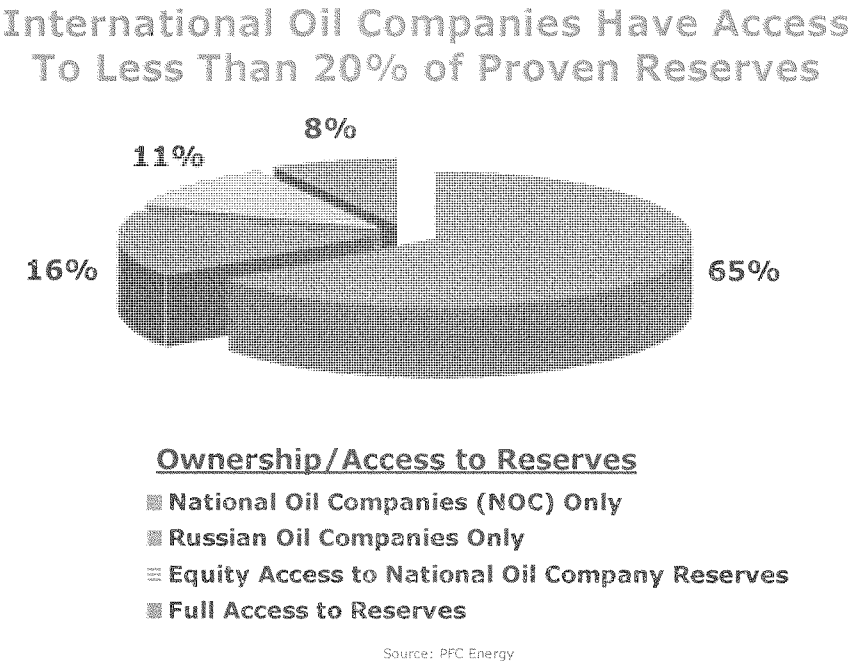



Source: U.S. Bureau of Labor Statistics

ATTACHMENT H



ATTACHMENT I



**United States Senate**
**Committee on the Judiciary**
**"Consolidation in the Energy Industry: Raising Prices at the Pump? Part II"**
**March 14, 2006**

**Written Testimony**
**Ross J. Pillari**
**President and CEO, BP America, Inc.**

As requested in the invitation to testify, I would like to comment on consolidation in the petroleum industry and its impact if any on current US retail gasoline prices. Let me first summarize the key points and then I will expand on each one of them.

1. BP's growth has been a response to marketplace realities requiring greater scale and capability.
2. Our recent growth has been weighted towards exploration and production operations where scale is increasingly necessary to compete.
3. BP's current refinery portfolio allows us to effectively compete in the US refining industry.
4. The US consumer today benefits from a highly competitive, diversified and reliable retail gasoline market.
5. US gasoline prices in 2005 were primarily impacted by supply / demand imbalances not BP's growth from consolidation.

**BP's growth has been a response to marketplace realities requiring greater scale and capability.**

BP is in a business that requires broad capability and scale to participate effectively in an increasingly competitive global market. Today's global economy consumes more energy than ever before, with US requirements making up 25 percent of this growing global demand. Investing, finding and producing new oil and gas to meet that demand requires significant financial resources and the ability to manage the associated risk. At the same time, the increasing demand for refined products requires ongoing investment in more sophisticated refineries that can compete by processing a wider variety of crude oils and still meet today's more stringent environmental requirements. BP has grown in response to these market based realities.

Our growth has enabled BP to supply oil, gas and refined products to US and global markets more efficiently and more effectively. We have been able to spread the benefit of intellectual capability from each organization over a larger integrated asset base. Our growth has allowed us to reduce the overhead costs associated with each barrel produced and with each gallon of product refined. Our greater size, combined experience, and know-how have provided us with the ability to compete for both domestic and foreign sources of oil and gas that we might not otherwise have realized. This increased scale also has allowed us to accept risks and participate in projects that smaller companies are unlikely to have undertaken.

**Our recent growth has been weighted towards exploration and production operations where scale is increasingly necessary to compete.**

BP's growth since the late '90s has resulted in a company weighted towards finding and producing oil and gas. Since consolidation in the late '90s, most of BP's revenues and profits have been derived from our oil and gas business. During that same period, the major part of BP's total capital expenditures has been invested in the oil and gas business, resulting in five consecutive years of 100 percent or more reserves replacement. The oil and gas projects in which BP is investing and from which we expect future supplies of energy to be produced include significant investment to supply the US markets. Among these are Alaska

natural gas, Gulf of Mexico deep water oil and gas, Rockies natural gas, and Trinidad gas that can be converted to liquefied natural gas.

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. This project is expected to require investment of more than $20 billion and span 10 or more years before revenues are realized. Participation in a project of this scale requires very large resources, and a smaller BP would have found it difficult to participate.

Investment to find new oil and gas reserves in the deep water Gulf of Mexico is another example of a set of projects that would have challenged and may well have overwhelmed a smaller company. These projects are extreme in every way - extremely large, extremely deep and extremely costly – and presented unprecedented technical challenges. The longer term risks are equally extreme, as demonstrated by the potential for hurricane damage and loss of production similar to what we experienced in 2005. However, our scale enables us to tap the breadth of resources necessary to remain committed to our investment strategy and to respond to such emergencies.

While BP's current scale and breadth of capability is necessary to compete effectively for new opportunities for finding and producing oil and gas, we remain a small player in this global business. Foreign national oil companies control more than 55 percent of global oil and gas production and more than 90 percent of the world's oil and gas reserves. By comparison, for 2005 BP represented roughly three percent of global oil and gas production, and less than one percent of global oil and gas reserves. Large global companies play an important role in competing for supplies to meet US demand which needs to be a factor in analyzing the impact of industry consolidation.

**BP's current refinery portfolio allows us to effectively compete in the US refining industry.**

The US refining industry today is more efficient and productive than the US refining industry of the past. Regulatory and market conditions led to a reduction in the number of US refineries during the past 20 years. Today, these refineries, through improved efficiency and investment, produce 80 billion gallons a year more product than US refineries did 20 years ago.

Additionally, today's refiners must do more than refiners of the past. In response to regulatory requirements, refiners must make a greater variety of more costly and complex fuels. BP has invested in larger and more sophisticated refineries in order to meet these requirements.

BP operates five US refineries in Toledo (OH), Whiting (IN), Texas City (TX), Carson (CA) and Cherry Point (WA). These refineries represent less than nine percent of US refining capacity. Since the late '90s, BP has reduced its share of US refining by selling four US refineries. All of these refineries continue to operate today.

During the past five years, BP has invested roughly $700 million per year in new capital focused primarily upon meeting environmental regulations, fuel specification requirements and maintaining reliability and efficiency. Last year, BP announced a two billion dollar option to bring Canadian heavy crude oil to our Northern US refineries in order to obtain access to secure North American crude oil.

While attention is focused on the refining margins of the past 12 months, a long term investment perspective must consider margins of the past and determine the risk for the future. Significant regulatory investment requirements and competition from imported product has kept the US refining business competitive and challenging.

**The US consumer today benefits from a highly competitive, diversified and reliable retail gasoline market.**

In the last 10 years, we have seen increased competition from hypermarkets, convenience store chains and large independent jobbers. Since the late '90s, BP branded share of the retail market has been reduced to roughly 12 percent, while the hypermarket segment has quadrupled during this same time to nearly 11 percent. Today, over 90 percent of BP's branded retail outlets are operated by independent business men and women. BP also supplies unbranded gasoline to independent retailers in many of our markets. At the same time, supplies to these markets have been reliable and able to respond quickly to natural disasters and operating disruptions, with minimal supply outages. All of these factors contribute to a highly competitive retail market.

**US gasoline prices in 2005 were primarily impacted by supply / demand imbalances not BP's growth from consolidation.**

The price of gasoline in the US is primarily a function of demand for crude oil and products relative to available supply, which is affected by both the domestic and global markets. During the past year, we have experienced very tight supply / demand balances in global crude oil markets resulting in high crude oil prices. This tightness reflects strong economic growth and increased demand throughout the world. In 2005, the refined product supply / demand balance was also affected by a series of natural disasters.

These disruptions caused sharp price increases in both US and world product markets. As a consequence, markets with disrupted supply sources attracted supply from less affected markets both domestically and globally. Consumers were unhappy about higher prices but for the most part were able to obtain the fuel they required. The higher prices attracted volume from other markets, and the negative impact of the disruptions on our nation's supply situation was significantly reduced by the efficient action of market forces.

These market factors would have been present whether the companies of the 90's had consolidated or not. However, it is likely that the increased capability and scale of today's companies contributed to a more efficient restoration of supply than we would have seen five to 10 years ago.

BP's primary role going forward is to continue to provide supply. BP will continue to invest nearly $15 billion per year to find and produce new sources of energy for our customers. We have already announced US investments of:

- Onshore / Rockies – 10 year $15 billion investment program for onshore development including over $2 billion for new development and infill drilling in the Rockies;
- Two proposed LNG terminals at a cost of $1.2 billion;
- A $2 billion option to upgrade our refineries and increase the use of secure Canadian heavy crude oil;
- $1.5 billion yearly spend in our Alaska business to maintain and improve production;
- Our share of the $20 billion Alaskan Natural Gas pipeline investment; and
- Continued investment of over $15 billion over 10 years in the Gulf of Mexico to find and develop oil and gas fields.

For the longer term, BP is making a commitment to develop low carbon power to targeted global markets in four areas: solar, wind, hydrogen power and gas-fired power. We expect to spend $8 billion globally in this business over the next 10 years.

**Conclusion**

In closing, 2005 reflects both the unusual challenges and opportunities of the global markets for oil and gas. In 2005, BP benefited from participating in these markets but has also experienced less attractive outcomes in many previous years. This is a business that must have the economic capacity to operate on committed long term investment cycles, yet manage through volatile long term revenue cycles. Creating the capacity to take these risks and supply the nation's energy needs are important outcomes of the consolidation over the past five years.

BP has a long history of business activity and significant investment in the US. We will continue to offer quality products, enhanced energy options and invest in support of our customers and the energy needs of the nation.

Thank you

**St. Albans Cooperative Creamery, Inc.**

**140 Federal Street**

**St. Albans, Vermont 05478**

The St. Albans Cooperative Creamery is a member governed dairy cooperative committed to providing service, selecting stable markets and achieving the greatest return for its members by offering quality products and innovative service to customers. The St. Albans Cooperative was established in 1919 and now 87 years later, it is the largest dairy cooperative in Vermont, marketing over three million pounds of milk each day from approximately 502 member farms. The St. Albans Cooperative has processing facilities in St. Albans, Vermont and has complete control of the processing and marketing of the processed product.

The St. Albans Cooperative Creamery, Inc. has member farms in Vermont, New York and New Hampshire. St. Albans Co-op has farms in the following counties in Vermont: Franklin, Chittenden, Addison, Orleans, Essex, Caledonia, Orange, Rutland, Washington, Grand Isle and Lamoille. In New York State, the cooperative has farms in Franklin, Clinton, St. Lawrence and Washington counties. In New Hampshire the cooperative has one farm in Coos County.

The Co-op received 1.259 billion pounds of milk from its producers in 2005 and grossed sales of over $226,000,000 from all operations. In 2005, the average member farm produced approximately 2.4 million pounds of milk. Approximately 12 percent of the Co-op's members are certified under the organic standards. In fiscal year 2005 this volume represented 2.6 percent of our member milk volume.

The 2006 Class III futures are significantly lower than they had been rated in 2005. This decrease in milk price combined with increasing operating costs will significantly impact the profitability of our member farms in 2006. The primary increase in operating costs is due to the increase in fuel costs that have been absorbed over the past 27 months. That impact can be felt in various areas at the Cooperatives facilities as well as at the member farm level.

The St. Albans Cooperative offers its members a fertilizer program, which allows its members to deduct fertilizer costs over the course of the year. The increased fertilizer cost is a prime example of how the increased fuel costs have negatively impacted the Cooperatives member programs. The fuel costs utilized to manufacture fertilizer has increased significantly, resulting in an average fertilizer price increase of 26.72% from April-04 to Jan-06 for all of the fertilizers offered through the Cooperatives program. The greatest individual price increase during that timeframe was on M/Potash 62% 0-0-60 fertilizer, which cost $198.00/ton in April 2004 compared to $292.00/ton in January 2006. This represents a 47.47% increase on M/Potash 62% 0-0-60 fertilizer.

The St. Albans Cooperative has seen increased fuel costs also effect the cost of farm related products at its Co-op Store. In 2004, 55 gallons of TDH Hydraulic oil cost $207.00 compared to a cost of $265.00 in 2005, resulting in a 28% increase in cost. The Co-op Store's suppliers are now charging a $5.00 per pallet fuel surcharge on all goods being delivered to the store, further cutting profits which ultimately are paid out to members who patronize the store.

The Cooperatives membership is effected by increased fuel costs in two main areas. The first being the increased expense of operating the farm. Below are actual figures of fuel cost increases at one of the Cooperatives larger member farms.

**St. Albans Cooperative Member Farm Fuel Cost Analysis**

| | 2004 | 2005 | Difference | % Increase |
|---|---|---|---|---|
| Low Sulfur Diesel | $29,788.00 | $42,217.00 | $12,429.00 | 41.72% |
| Regular Diesel | $42,556.00 | $57,273.00 | $14,717.00 | 34.58% |
| Oil | $6,891.00 | $10,500.00 | $3,609.00 | 52.37% |
| **Total** | **$81,239.00** | **$111,995.00** | **$30,755.00** | **42.89%** |

The overall increase in fuel costs for this member from 2004 to 2005 was 42.89%.

In May of 2005, due to increased fuel costs, the St. Albans Cooperative was forced to include a fuel surcharge for the transportation of milk. This is the second fuel cost increase that members have had to absorb, which is an amount above and beyond their hauling charge. From May of 2005 through October 2005, the Cooperatives members paid out $154,839.71 in fuel surcharges. Based on the average fuel surcharges charged from November 2005 through January 2006 (Average price per month-$30,205.38), members will pay out approximately $362,464.56 in FY06. This will result in an average fuel surcharge cost per farm of approximately $722.00 in FY06.

While the Cooperative has passed off a portion of the fuel surcharge to its members it has absorbed nearly 3 times that amount. In FY04 the Cooperative incurred $433,991.90 of fuel surcharge costs, compared to $947,149.74 in FY05. Based on the average fuel surcharges charged from November 2005 through January 2006 (Average price per month-$117,432.19), the Cooperative will pay out approximately $1,046,721.72 in FY06. This resulted in a 118% increase from FY04 to FY05 and then an estimated 10.51% increase in FY06. This increase in fuel surcharge will result in a negative impact on member farms reducing profitability on average by approximately $2000. Given the current supply and demand of the milk market the Cooperative cannot collect this

increased fuel surcharge from the marketplace, cutting into the profitability of the Cooperative.

Over the course of the past 2 years the Cooperative has seen a significant increase in operating costs, primarily due to increased fuel and natural gas costs. The Cooperative utilizes natural gas in the processing of its milk as well as fuel oil as a backup energy source. Below are figures of fuel and natural gas cost increases for FY04, FY05 and estimates for FY06.

**St. Albans Cooperative Operations Fuel Cost Analysis**

| | **FY04** | **FY05** | **FY06 (Nov. 05-Jan. 06)** |
|---|---|---|---|
| Fuel-gas | $645,250.06 | $859,330.75 | $325,179.59 |
| Fuel-propane | $1,817.25 | $2,639.79 | $755.50 |
| Fuel-oil | $47,068.34 | $30,942.75 | $59,124.76 |
| **Total Fuel Cost** | **$694,135.65** | **$892,913.29** | **$385,059.85** |

Note: Total fuel costs in first quarter of FY05 (Nov. 04-Jan. 05) totaled $227,858.29

In FY04 the Cooperative spent $694,135.65 on fuel costs, compared to $892,913.29 in FY05. That represents a 28.64% increase in fuel cost from FY04 to FY05. The Fuel-oil cost seen in the chart above represents the fuel oil utilized when the natural gas used for production is shut off and the Fuel-oil is used as a backup energy source. This backup energy source was utilized more often in FY04 than in FY05, thus explaining the drop in Fuel-oil cost from FY04 to FY05. The fuel cost for the first quarter of FY05 (Nov. 04-Jan. 05) was $227,858.29, which compares to $385,059.85 for the first quarter of FY06 (Nov. 05-Jan. 06). That has resulted in another 69% increase throughout the first quarter of FY06.

Fuel is an essential resource needed to operate the Cooperatives day-to-day operations as well as for the operation of its member farms. Fuel is utilized in the operation of plant processing equipment, forklifts, vehicles, tractors and other farm related equipment. Unfortunately, the over the past 27 months the Cooperative has seen its fuel costs more than double. This increase in operating costs combined with anticipated lower milk prices in 2006 will prove to be a major challenge for the Cooperative and its membership to overcome throughout the course of the next year.

Should you have any questions do not hesitate to contact Tom Gates or Leon Berthiaume at 1-800-559-0343.

Sincerely,

Leon Berthiaume

Leon Berthiaume
General Manager
March 13, 2006

*Rex W. Tillerson*
*Chairman and CEO, Exxon Mobil Corporation*
*Senate Judiciary Committee Hearing*
*March 14, 2006*

Thank you Chairman Specter, Ranking Member Leahy, and members of the Committee. I am pleased to appear before you today.

Energy is a topic on many Americans' minds. We know that your constituents need reliable supplies of affordable energy to fuel their vehicles, heat their homes, and run their businesses. And we know that they are raising important questions about how our industry is helping them meet these needs. After all, your constituents are our customers.

I welcome the opportunity to respond to these questions and yours today.

With respect to the Committee's specific question – whether mergers and acquisitions in our industry have contributed to higher prices at the pump – my answer is no.

In our view, the fundamental question is:

If Americans are to continue to have access to secure, affordable energy from today's global marketplace, what qualities must U.S. energy companies have to successfully compete?

First, we need companies that have the scale to manage a large and diverse portfolio of global projects and to compete with large foreign and government-owned companies.

Second, we need companies that have the financial strength to undertake the risk involved to make the enormous investments required to develop future energy supplies.

And third, we need companies committed to developing and utilizing leading-edge technologies to enable them to bring harder-to-reach resources to market. Furthermore, competitive companies must have the financial resources to make significant investments over time in research and development of new technologies to meet ever-changing environmental expectations.

I know at ExxonMobil we must utilize every aspect of our scale, all of our financial strength, and all of the talent and know-how of our 84,000 employees around the world in order to compete for access to new resources and to provide Americans with the energy they need.

Let's begin with scale. To understand why this is important, it is worth looking at the size of our market and the nature of our foreign competition.

Every day, consumers around the globe use 230 million barrels of oil equivalent from all energy sources. On a worldwide scale, oil is consumed at a rate of 40,000 gallons every second.

In the amount of time it takes me to make this brief statement, Americans alone will have consumed 6 million gallons of oil to drive to work, take their children to school, heat their homes, and perform countless other everyday tasks.

At current market prices, the bill for the world's oil and natural gas consumption is more than $2.5 trillion a year. That's greater than the U.S. government's entire annual budget in 2005.

Call it the law of large numbers. Each unit of energy consumption is relatively small. But multiplied by the billions of people who consume these units daily, it adds up to the world's largest industry, with enormous volumes, revenues, costs, earnings and investments.

ExxonMobil is the largest non-government company in this industry, so naturally our financial numbers are large, too.

The most obvious example is our earnings – over $36 billion last year. No doubt about it, we had an unusual and outstanding year. Even so, we earned less than 10 cents per dollar of sales. Many large industries earned in excess of 18 cents per dollar of sales last year.[1] And I'm not here to say that's a bad thing.

To understand how our earnings top other industries but our margins do not, it's worth talking through the math.

Our revenues are large because we deal in tremendous volumes. But our costs – including taxes – are large, too. Last year, our costs totaled $335 billion. Subtract costs from revenues, and that leaves us with less earnings per dollar of sales than many other industries, even during periods of high prices. Moreover, we invest much of these earnings in developing future opportunities, most of which take a decade or more to show a return.

The bottom line is that the global market for energy is enormous. And it is rapidly getting larger. The International Energy Agency estimates that the world will need close to 50 percent more energy in 2030 than we currently use today.

[1] See, e.g., Appendix A, *How Do Oil Industry Earnings Compare to Other Industries?*

Why? Because, as economies grow, so do their energy needs. That is certainly true for developing countries like China and India. But it also holds for developed countries like ours.[2]

America's demand for energy, and oil in particular, has stirred controversy.

We should recognize, however, that ready access to competitively-priced energy has been the foundation of our nation's economic success and an engine of tremendous job creation. It is an important part of the American Dream, and vital to building better lives for our children and grandchildren.

Now, within this rapidly growing marketplace, the competition is intense.

It includes many foreign government-owned national oil companies. In fact, seven of the top ten oil and gas companies worldwide today, as measured by liquid production, are state-owned.[3] ExxonMobil is the largest non-government energy company – and we rank number five on the list. No other American company is in the top ten.

Increasingly, these national oil companies, benefiting from government support and preferential access to resources, are not only producing their own nations' reserves, but also competing against non-government companies like ours for access to *other* nations' resources.

For an American company to succeed in this kind of competitive landscape, it needs scale.

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[2] See, Appendix B, *Growing World Energy Demand*
[3] *Petroleum Intelligence Weekly (12/12/05),* Largest Crude Oil Producers 2004

ExxonMobil's scale enables us to put highly skilled professionals using the best technology on the most promising projects worldwide at competitive costs.

Having said that, we are not disproportionately large relative to the global market as a whole.

In fact, today we account for a *smaller* share of the world's total energy production than Exxon and Mobil together did eight years ago.

And what percentage of the world's total energy do we now produce? Believe it or not, less than two percent.[4]

It would take about 55 companies the size of ExxonMobil to meet today's world energy demand.

So the first requirement to successfully compete and manage the risks of these huge investments is scale. The second is financial strength.

Because of the scale, long-term scope and capital-intensive nature of our business, it involves enormous cash flows. Last year, ExxonMobil alone incurred $335 billion in costs. That's more than the federal government's entire Medicare bill in 2005.

Taxes are an important component of these costs. In fact, over the past five years, our U.S. tax bill, including all forms of taxation, *exceeded* our U.S. earnings by $22 billion. And with two-thirds of our operations outside the United States, our total worldwide tax bill last year was nearly $99 billion. That excludes the significant revenues host governments, including governments in the United States, receive through royalties.

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[4] See, Appendix C, *ExxonMobil -- What Percentage of the World Energy Market?*

But the largest component of our costs is crude oil. Last year we spent $185 billion buying crude and products – making us the largest single net buyer of refining feedstock.

You might find that surprising, given that we are a major oil producer.

We do not, however, produce nearly enough to sufficiently feed our refineries. We produce about 2.5 million barrels of crude oil a day – about 3.5 million barrels less than we refine.

Understanding our costs helps put the prices Americans pay at the pump in perspective.

Last year, the average price in the United States of a gallon of regular gasoline was around $2.27.

On average, approximately 53 percent of that price reflects the amount paid for crude oil.

Twenty percent, on average, reflected the amount we paid in federal, state and local excise taxes.

The remaining 27 percent reflected refining, marketing and transportation.[5]

For our company, that 27 percent would be about 23 percent costs and about 4 percent earnings.

In other words, we only earned about 10 cents a gallon in our U.S. refining and marketing operations.

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[5] See, Appendix D, *Where Do Your Gas Dollars Go?*

So, as you can see, the price we pay for crude oil in the global marketplace is the primary factor in the price Americans pay for gasoline.

Another important way we use our financial strength is in investing in future energy supplies for American consumers.

The International Energy Agency estimates that over $6 trillion in oil and gas investment will be needed for the period 2004 through 2030 to meet the world's growing energy demand.[6]

That is nearly half the size of the entire U.S. economy.

To help meet this need, ExxonMobil is investing at record levels. Over the last five years, we've invested $74 billion – a third of it here in North America, more than any other continent.[7]

We are investing in a $14 billion project to increase supplies of Liquefied Natural Gas, much of it bound for the United States.

Our investments in West Africa have, over the last three years, increased crude production capacity by more than 1 million barrels a day gross from that one region alone.

We have also invested $3.3 billion over the last five years in our U.S. refining operations, mostly to comply with new fuel quality standards.

And through efficiency gains and technology, we have increased our U.S. refining capacity faster than the industry average. Over the last ten years, our capacity expansions in the United States equate to three new, average-sized refineries.

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[6] See, Appendix E, *Total World Energy Investment Required: $17 Trillion*
[7] See, Appendix F, *ExxonMobil Investments 2001 - 2005*

For the future, we anticipate our investments through the end of this decade to approach $20 billion each year.

Compare our investment numbers to our earnings over time. Over the last fifteen years, our investments – totaling $210 billion – have *exceeded* our cumulative earnings.[8] That's right. For the period of 1991 to the present, we have invested more than we have earned.

Although scale and financial strength are needed, U.S. energy companies also need to continue to develop and deploy new technologies.

For ExxonMobil, this is not only the lifeblood of our future, but one of the hallmarks of our past success.

Technology is the great enabler to access the world's ever more challenging oil and gas resources.

It enables us to drill in water deeper than the Empire State Building is tall bore horizontal wells under the ocean floor a distance from here to Alexandria, Virginia and operate in temperatures colder than the all-time record lows of nearly every state in the Union.

And it enables us to develop and use these resources in a safe and environmentally-sound way.

Our approach to developing new technology is three-pronged.

In the short term, we are developing and deploying the new capabilities needed to access challenged resources and extending efficiencies to reduce greenhouse gas emissions.

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[8] See, Appendix G, *ExxonMobil Long-Term Earnings and Investment History*

In the medium term, we are partnering with others to develop ways to help build engines and blend fuels that are cleaner and more efficient.

And over the long term, through projects such as the Global Climate and Energy Project at Stanford University, we are funding breakthrough efforts to accelerate development of commercially-viable energy technologies that can lower emissions on a worldwide scale.

Over the past five years, we have invested over $3 billion on these combined R&D efforts. That's nearly $2 million a day.

Such investments enable us to better access frontier resources – such as tight gas and oil sands found here in North America – and to produce energy for Americans faster, cheaper, cleaner.

Let me give you an example of our scale, investment and technology at work for Americans – the Alaska Natural Gas Pipeline.

If this historic transcontinental infrastructure project proceeds as we hope – and with the support of Congress, the executive branch, and the State of Alaska – it will create 6,500 jobs, entail some 54 million hours of work, and require between 5 and 6 million tons of steel.[9]

It will be the largest construction project of any kind ever undertaken in North America.

Along with our partners BP and ConocoPhillips, we look forward to seeing this project advance to the next phase.

[9] See, Appendix H, *Alaska Natural Gas Pipeline Project*

When it is completed, hopefully 10 to 12 years from now, it will provide Americans with a long-term, stable, secure new supply of clean-burning natural gas.

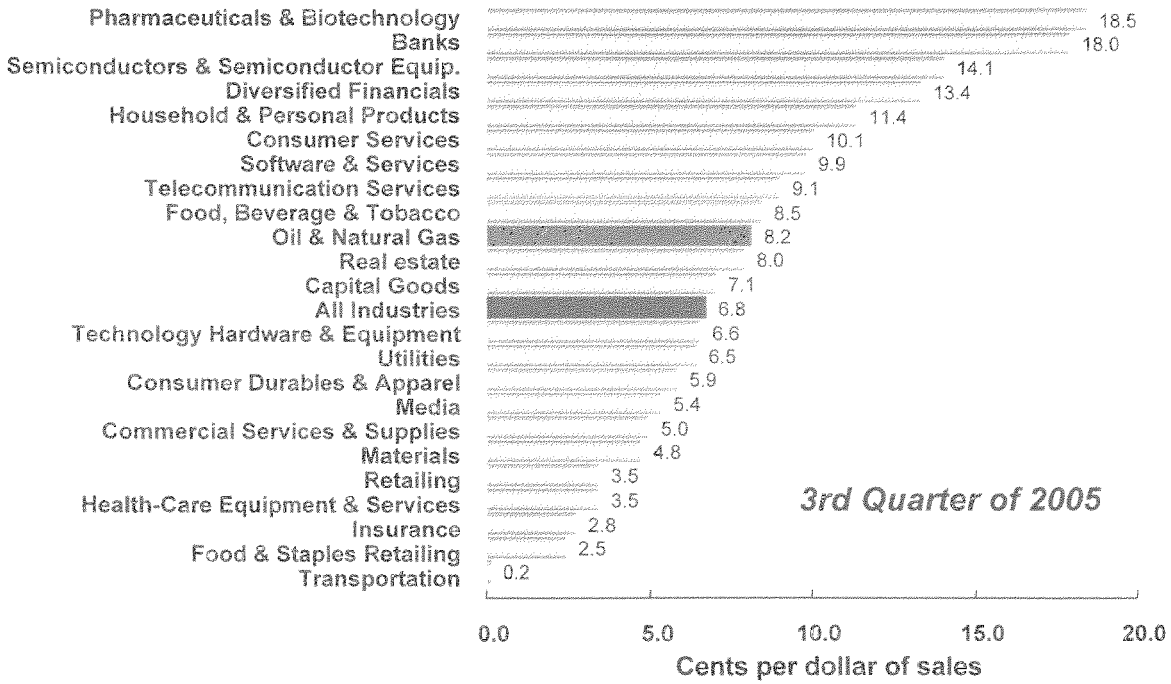
It will involve a massive investment – well over $20 billion, divided among ExxonMobil and our partners. We are able to undertake this risk and massive investment because we have the sufficient scale and financial strength.

In conclusion, when we look at the challenges ahead, we need U.S. energy companies that have the scale and financial strength to make the investments, undertake the risks, and develop the new technologies necessary to provide Americans with greater energy access and greater energy security.

ExxonMobil is one such energy company. And that is something our shareholders, our employees, our customers and our fellow Americans can be proud of.

Thank you.

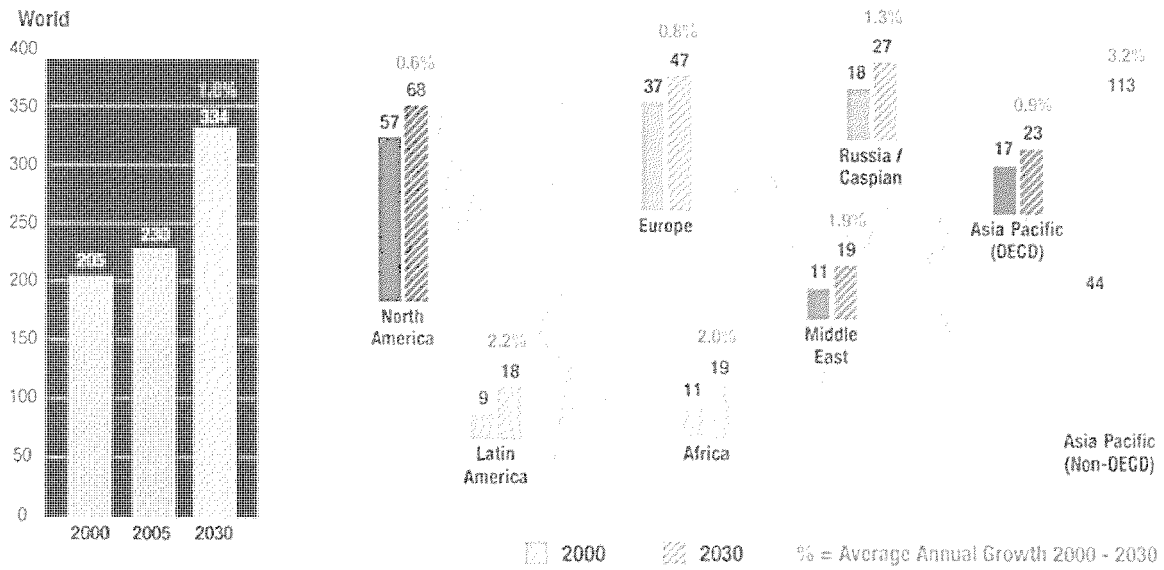
## How Do Oil Industry Earnings Compare to Other Industries?




*Source: Company filings as reported by Oil Daily for the oil and gas industry, and by Pricewaterhouse Coopers LLP from data compiled by Standard and Poor's Compustat for all other industries.*

# Growing World Energy Demand

*Millions of Barrels per Day of Oil Equivalent (MBDOE)*

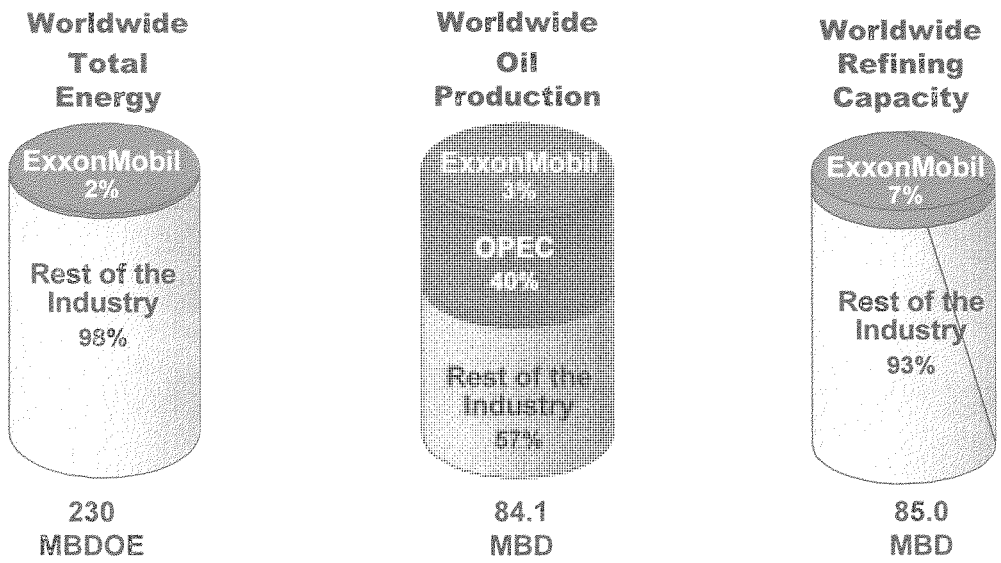



*Source: ExxonMobil Outlook for Energy (2005)*

Appendix C

## *ExxonMobil - What Percentage of the World Energy Market ?*

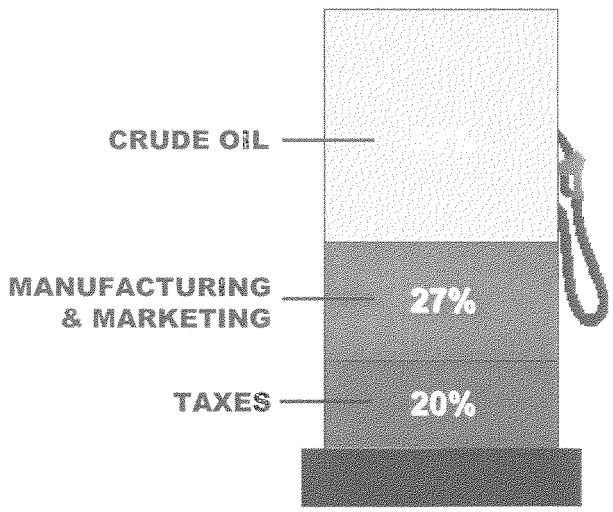
**2005**




*Source: EM Financial Reports, IEA, Oil & Gas Journal*

# Where Do Your Gas Dollars Go?

*Average U.S. gasoline price: 2005*

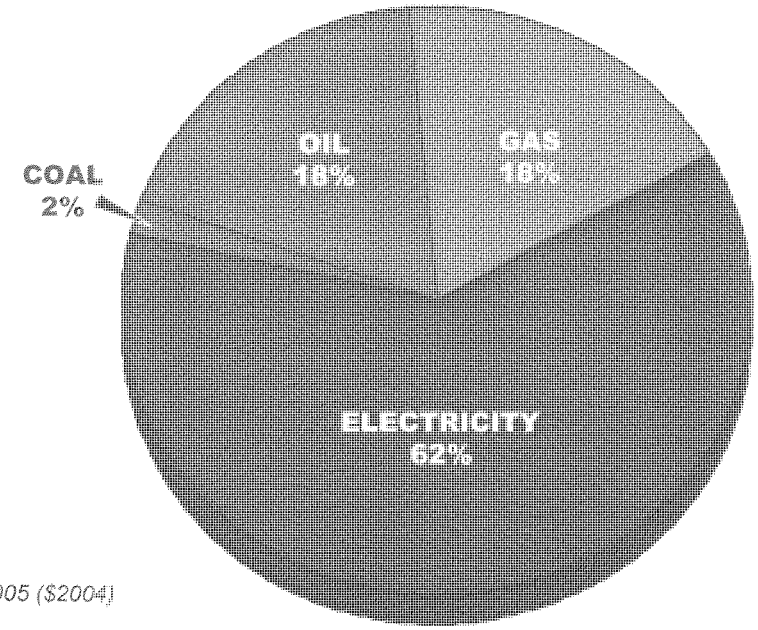



*Source: Energy Information Administration, U.S. Dept. of Energy. The average 2005 price for a gallon of regular gasoline was $2.27.*

# Total World Energy Investment Requirement: $17 Trillion

## World Energy Investment 2004-2030

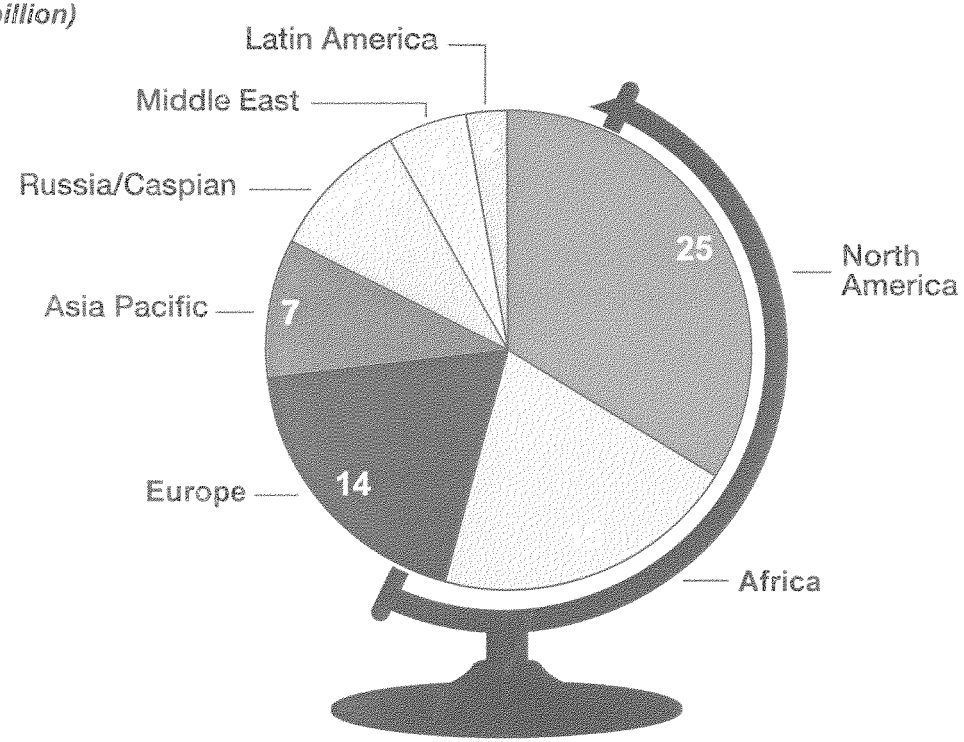
*Over $200 billion per year required in Oil and Gas*




*Source: IEA 2005 ($2004)*

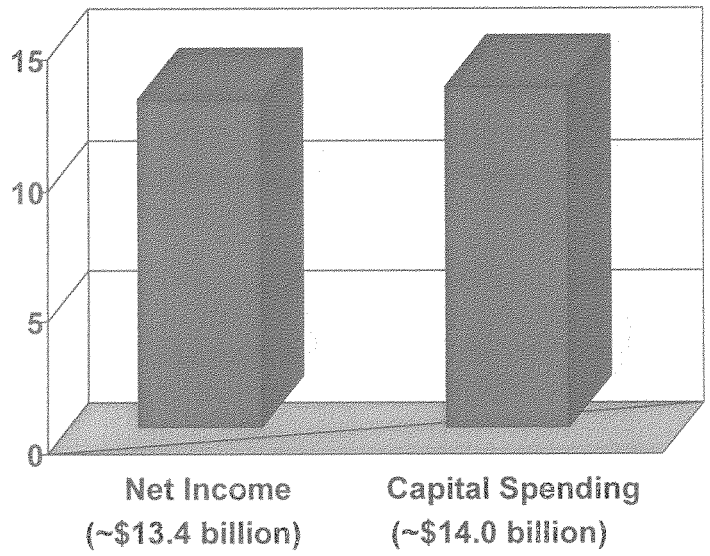
## *ExxonMobil Investments 2001-2005 ($74 Billion)*

*($U.S. billion)*



# ExxonMobil Long-Term Earnings & Investment History

## 15 Yr. Annual Average '91-'05 ($US Billion)




*Source: EM Financial Reports*

# Alaska Natural Gas Pipeline Project

## Total Project Costs ~ $20* billion +

State Ownership Investment ~ $4* billion

**The Resource**

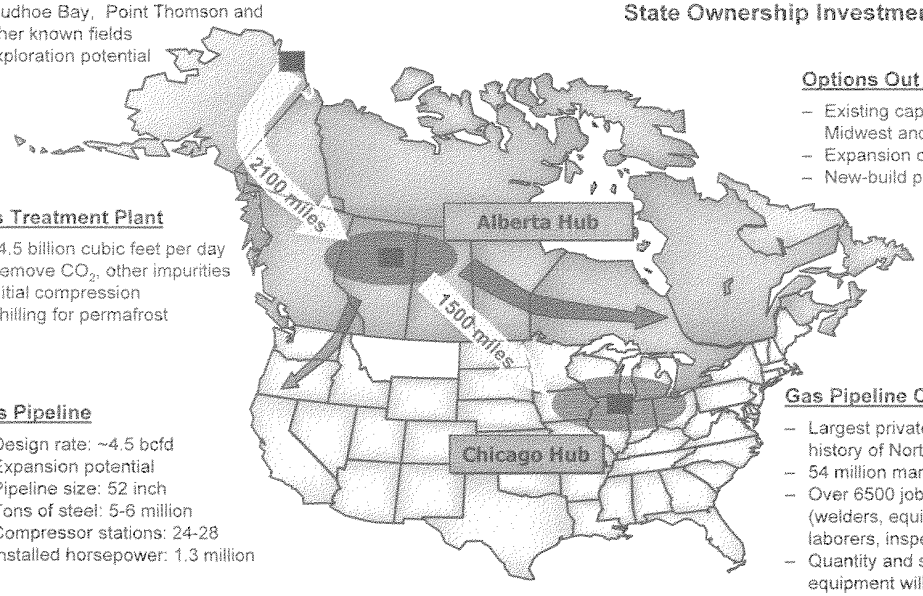
- ExxonMobil is largest holder of ANS discovered gas resource
- Prudhoe Bay, Point Thomson and other known fields
- Exploration potential

**Gas Treatment Plant**

- ~4.5 billion cubic feet per day
- Remove $CO_2$, other impurities
- Initial compression
- Chilling for permafrost

**Gas Pipeline**

- Design rate: ~4.5 bcfd
- Expansion potential
- Pipeline size: 52 inch
- Tons of steel: 5-6 million
- Compressor stations: 24-28
- Installed horsepower: 1.3 million




**Options Out of Alberta**

- Existing capacity to West Coast, Midwest and East Coast markets
- Expansion of existing systems
- New-build pipeline to Chicago

**Gas Pipeline Construction**

- Largest private construction project in history of North America
- 54 million man hours of construction
- Over 6500 jobs in Alaska and Canada (welders, equipment operators, laborers, inspectors, etc.)
- Quantity and size of construction equipment will stretch industry capacity (trenchers, bulldozers, sidebooms, etc.)

* In 2001$