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CRUDE OIL: THE SOURCE OF HIGHER GAS PRICES?

HEARING

BEFORE THE

SUBCOMMITTEE ON ANTITRUST, COMPETITION POLICY AND CONSUMER RIGHTS

OF THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

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CRUDE OIL: THE SOURCE OF HIGHER GAS PRICES?

WEDNESDAY, APRIL 7, 2004

UNITED STATES SENATE,
SUBCOMMITTEE ON ANTITRUST, COMPETITION POLICY AND CONSUMER RIGHTS, COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:53 p.m., in room SD–226, Dirksen Senate Office Building, Hon. Mike DeWine, Chairman of the Subcommittee, presiding.

Present: Senators DeWine, Specter, Craig, Kohl, Leahy, and Schumer.

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

Chairman DEWINE. Good afternoon. Let me welcome all of you to the Antitrust Subcommittee hearing on the causes of higher gas prices in the United States.

As most Americans know, we are in the middle of another round of painful increases in gasoline prices. The national average has reached a new record high for self-serve unleaded gas, and that is about $1.80 per gallon. Recently, in my home State of Ohio, gas prices have been even higher. In Marietta, Ohio, for example, gas was $1.84 per gallon recently. In Cleveland, it was $1.86, and in Columbus it topped out at $1.88 at some stations. Many analysts predict that prices could break the important psychological barrier of $2.00 per gallon this summer.

Although the prices this time around seem particularly high, the American consumer has unfortunately been here before. Since the 1970's, when we first experienced the so-called oil shocks, periodic price spikes seem to have become as predictable as the seasons changing. Though these spikes no longer surprise us, they continue to harm consumers, weaken the economy and leave us with an important question: What, if anything, should lawmakers be doing to address this recurring problem?

Today, we hope to address that question in a setting where we can explore the reasons for high-price gasoline and consider possible policy steps. We do have excellent panelists and we will hear from a number of experts who will offer their perspectives on the root causes for higher gasoline prices.

But I want to stress one thing upon which I think there will be universal agreement. The single most important factor affecting gas prices in the United States is the price of crude oil. We have a chart over there which indicates that.

As we can see from our chart, as of March 2004, crude oil is the largest single component of the gasoline price, making up nearly half of the overall price that consumers pay at the pump. Beyond that, the Federal Trade Commission has said that changes in crude oil prices account for approximately 85 percent of the variability of gasoline prices. In other words, the changes in crude oil prices lead directly to the gasoline price spikes that cause so much economic distress.

Of U.S. imported crude oil, more than 40 percent comes from OPEC member nations. Last week, OPEC met in Austria and decided to cut production by 4 percent, down about 1 million barrels to 23.5 million barrels per day. The price of a barrel of oil is already very high, between $35 to $38 per barrel. And according to some analysts, the price is likely to break the $40-per-barrel ceiling.

Of course, OPEC's decision to decrease supply likely will increase U.S. gasoline prices further, causing American consumers to suffer more. That is why last week Senator Kohl and I reintroduced our No Oil Producing and Exporting Cartels Act of 2004, or our NOPEC bill.

The purpose of the bill is to end OPEC's flagrant violation of our antitrust laws. This is hard-core cartel behavior and should not be tolerated. If OPEC were a group of international oil companies getting together to set prices and cut output, it could be prosecuted under U.S. antitrust laws. But to this day, OPEC continues to receive special treatment under U.S. antitrust law. Our bill would remove the legal obstacles that have protected OPEC until now and gives our antitrust enforcement agencies the tools they need to prosecute OPEC.

First, NOPEC, this bill, responds to a 1979 Federal district court opinion that found that OPEC's activities were, and I quote, "governmental," not "commercial," and therefore protected from prosecution under the Foreign Sovereign Immunities Act.

Second, our bill responds to a 1981 Federal court of appeals decision where the court refused to hear that same case against OPEC based on the so-called "act of state doctrine," which states that a court will not judge the legality of the sovereign acts of a foreign country.

Finally, our bill gives the Department of Justice and the Federal Trade Commission explicit authority to prosecute OPEC. In short, our bill says to OPEC, no more special treatment under U.S. antitrust law. One of our expert witnesses today will offer his legal analysis of our proposed law and we look forward to his testimony.

We are going to try to move the NOPEC bill and are hopeful that if it becomes law, it will help restore market discipline to crude oil prices. But even if we do manage to get crude oil prices back in line with the laws of supply and demand, there is a range of other factors that affect gasoline prices, and we will consider those today as well.

For example, the proliferation of specialty gases creates a particularly complex part of the supply problem, as our chart over there indicates, as well. In the United States, as we can see from this chart, a number of State and local governments have different gasoline grades that they use to achieve EPA mandates for cleaner

air. There are currently 18 different grades sold in the United States. This creates two supply problems. First, it reduces the availability of substitutes to cushion supply and price shocks. Second, it makes importing gas harder because many foreign refiners do not provide non-conventional gas grades.

Refining capacity is another part of the gasoline supply problem and a number of people believe it is the key problem we are facing today. There are about 145 refineries currently operating in the United States. In the last 15 to 20 years, no new refineries have been built and about 75 have been closed.

Although the efficiency of the remaining refineries has been improved, refinery capacity is still strained. In fact, refinery capacity utilization rates are running at about 90 to 95 percent today. This leaves the system with very little margin for error, because a fire or other accident that temporarily shuts down a refinery cannot be easily accommodated by increased output from another refinery. Even worse, there is no solution on the horizon. Despite the high demand for gasoline, refiners are unwilling to build new refineries because of cost, environmental issues and expected local opposition.

Another controversial aspect of the gasoline pricing problem is the issue of concentration within the refining industry. Those who have followed the work of this Subcommittee are well aware of the merger wave that rolled through the U.S. economy in the 1990's. That wave engulfed the petroleum industry as well.

Mergers such as Exxon–Mobil, BP–Amoco and Conoco–Phillips clearly increased concentration levels both upstream, in exploration and production, and downstream, in refining and retailing. Now, whether or not this concentration has reached a level high enough to raise competition concerns is a matter of some dispute.

For example, in 1983 the top five refiners controlled approximately 35 percent of the U.S. domestic refining market. In 2003, that number increased to over 50 percent. From a pure antitrust merger analysis point of view, I question whether these concentration levels are high enough to merit serious concern, but we will consider this issue during the course of today's hearing.

In addition, we will examine a number of other secondary factors contributing to the recent increase in gas prices, such as strong growth in the U.S. and China's demand for oil. Finally, we will touch today on the state of competition in the market for natural gas, which is also selling at prices approaching historic highs.

Let me now turn to my friend and colleague, the Ranking Member of the Subcommittee, Senator Kohl.

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

Senator KOHL. Thank you, Mr. Chairman.

Mr. Chairman, we are reminded everyday when we drive by a gas station that Americans are paying record levels for a gallon of gas. Gas prices now average $1.78 a gallon nationally and $1.80 in my State of Wisconsin. Prices over $2.00 a gallon are now common throughout our country.

These rising gas prices are felt throughout the economy. They are a silent tax that takes hard-earned money away from Americans every time they visit the gas pump. Higher gas prices drive

up the cost of transportation, harming every sector of the economy from aviation to trucking. Those costs are passed on to consumers in the form of higher prices for manufactured goods. Higher oil prices also mean higher heating and electricity costs.

So let's examine the cause of these rising prices. First, we need to look at the price of crude oil. Indeed, the FTC states that 85 percent of the variability in the cost of gasoline can be accounted for by the price of crude oil. Simply put, the cost of crude oil moves the price of a gallon of gas. And as we all know, OPEC sets the price of oil.

OPEC's actions to manipulate the oil market cost Americans billions of dollars every year. If the members of OPEC were private companies and not nations, they long ago would have been prosecuted for engaging in illegal price-fixing.

The bill that Senator DeWine and I introduced last week, and which passed the Judiciary Committee unanimously in 2000, would end this injustice by subjecting OPEC to antitrust suits in U.S. courts. While NOPEC is not a panacea, a lawsuit or threat of a lawsuit will give our Government the first real weapon it has ever had to deter OPEC from its seemingly endless cycle of price increases.

But restraining OPEC is not the entire answer. There are other factors that lead to higher gas prices. In the face of ever-increasing demand and higher prices, the domestic oil industry has not responded as we would have expected by increasing refinery capacity. Instead, numerous refineries have been closed—about 75 over the past 15 years—and none have been opened for many years, but it must also be said that existing refineries have also increased their capacity.

Refinery capacity, now operating at 95 percent, has become a bottleneck, limiting supply and causing price spikes whenever an accident occurs. Indeed, critics argue that oil companies have chosen not to expand refining capacity in order to gain market power in order to keep prices high. While there are clearly barriers to expanding refinery capacity, at the same time the antitrust authorities must not permit oil companies with market power to deliberately withhold supply to raise prices.

In addition, mergers in the oil industry have left a dangerous level of consolidation in their wake. The oil companies not only drill the oil, but they also refine it and they also own the gas pumps as well. The five largest oil companies now control more than half of our domestic refining capacity and more than 60 percent of the national retail gasoline market. This level of concentration, magnified in some areas, permits just a few competitors to control prices. Just as importantly, this consolidation has virtually eliminated independent retailers and refiners and the competition that they provide. Where there has been a high degree of integration between refiners and retailers, consumers pay higher prices.

For the last 4 years, Senator DeWine and I have repeatedly called upon the FTC to study the cause for high prices. The FTC should remain vigilant in monitoring gas price increases, but it must do more. Antitrust authorities must scrutinize future oil industry mergers with a keen eye toward preserving the competitive benefits of independent retailers and refiners.

So, Mr. Chairman, it is time for action to end the ever-escalating pattern of gas price increases that are regularly inflicted on our Nation's consumers. Our NOPEC bill is one place to start, but we must also do more to ensure that the conditions exist to lower gas prices for all Americans.

Thank you, Mr. Chairman.

Chairman DEWINE. Senator Kohl, thank you very much.

Senator Specter.

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

Senator SPECTER. Thank you, Mr. Chairman. At the outset, Mr. Chairman, I thank you for convening this very timely hearing. There is no doubt that the actions by OPEC are drastically increasing the cost of gasoline and oil in the United States.

On February 10, OPEC curtailed oil production by 1.5 million barrels a day, and then on March 31 an additional 1 million barrels a day. Oil has now reached the staggering price of $38 a barrel, which is the highest it has been since the Gulf War, in 1991.

I believe that our Department of Justice and our Federal Trade Commission have been lax in not acting against the clear-cut violation of U.S. law, conspiracy and restraint of trade, which is clear-cut on what OPEC has been doing for years. I have studied this issue in some detail, and on April 11, 1998, I wrote to President Clinton outlining a course of action for lawsuits to hold OPEC responsible. I wrote the same letter to President Bush on April 25, 2001.

Mr. Chairman, I would ask unanimous consent that both of those letters be made a part of the record.

Chairman DEWINE. Without objection, they will be made part of the record.

Senator SPECTER. The essential points which I made in these letters—they really are, in effect, a legal brief—are that a suit in Federal court would be appropriate under U.S. antitrust laws, and there is not immunity under act of state or sovereign immunity. When they are engaged in a commercial transaction, there is no doubt they are subject to the antitrust laws. There has been an evolving recognition of international law that they are bound by the antitrust laws, which was a possible defense early in the interpretation of the antitrust laws.

The letter which I sent to President Clinton was cosigned by you, Mr. Chairman; the ranking member, Senator Kohl; Senator Thurmond; Senator Schumer; and Senator Biden. It is high time that that action was taken. I believe the action can be taken under existing law, but I do believe, Mr. Chairman, that the legislation which you have reintroduced, Senate bill 2270, is a very good bill. It removes it from a common law interpretation so that there is specific legislation which provides that sovereign immunity does not bar an action or that the act of state does not bar an action.

So it is really time to get on with it, and the American people are clamoring for relief. It is just really outrageous that we are being gouged by OPEC at the gas pump. We have had a very heavy winter. We are now about to provide for LIHEAP, low-income energy assistance, $2 billion-plus.

It is high time we focused on the fact that the Saudis are not our friends on so many lines. On terrorism, which they are sponsoring under the guise of helping charitable organizations, 15 of the hijackers on 9/11 were from Saudi Arabia. And they are continuing to gouge the American consumers and it is time we acted to stop them. So I hope this hearing will provide an impetus to do just that.

Thank you, Mr. Chairman.

Chairman DEWINE. Senator Leahy.

STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM THE STATE OF VERMONT

Senator LEAHY. Thank you, Mr. Chairman.

I am going to be home this weekend and when I go to the gasoline pump and I am pumping gasoline in my car, my neighbors in Middlesex, Vermont, are going to say, Pat, what is going on? Why are we paying so much? If we have a Vermont farm, why are our profit margins, which are historically thin anyway, being cut out entirely by this?

Frankly, I have to say that not enough is being done by our Government or by others to cut down the price of fuel. I hope that today's hearing tells both the administration and foreign governments that the American people and the Congress demand that we use the tools we have available to keep gasoline prices affordable. I feel as one Vermonter that if we don't have enough legal tools, then let's find some more and pass those.

We know, and most Americans do, why high prices are at the pump. The OPEC cartel sets production quotas for member countries and prevents the free market from setting crude oil prices. I agree very much with the Senator from Pennsylvania when he says we ought to realize that the Saudis are not the great friends that they say they are. I think they have demonstrated that in one thing after another.

As of April 5, the U.S. Department of Energy reports the nationwide average price of a gallon of gasoline is $1.78. Now, on this chart, just to give you an idea, that is an increase of $.60 since the year 2001. Some are saying it may go up to $3.00 this summer. That is going to be like what we saw in real dollars during the shortages of the early 1980's. And that seems likely, since OPEC met on March 31 and they decided to cut the output of oil even further, not only cutting it by a million barrels a day, but they wanted to increase that.

A Nigerian petroleum advisory says that they are considering raising prices $3.00 a barrel. That is going to increase costs to consumers, small businesses and, in my State, the dairy industry, among others. Vermont dairies are experiencing 40-percent higher fuel prices.

In a normal time, we ask the famous question "Got milk?" Today, we ask "Got enough money for gas?" To give you an idea, in a typical dairy operation in the Northeast it adds $5,000 to their costs. This shouldn't be falling on all of us.

I think Senator DeWine and Senator Kohl deserve thanks for their leadership on the NOPEC bill. It is obvious that we are not going to get help otherwise to deal with the gas crisis that is a

threat to our families, our farmers, our truck drivers. If the administration can't say no OPEC, then we ought to try to do it.

OPEC has tried to dismiss criticism about the high price of gasoline through disingenuous arguments. Actually, the consumption of oil has remained relatively level over the past few years, and nobody could say with a straight face that a 60-percent increase per gallon in price is because of tough environmental rules by the Bush administration. Give me a break. This is not right. In fact, there is a letter by Senator Bingaman to the President, and I would ask that that be made part of the record.

I am glad to see this hearing. I wrote to Senator Hatch urging such a hearing a couple of weeks ago. I have praised both Senator DeWine and Senator Kohl so many times in these hearings that I am afraid it may hurt them back home, but I just want to praise you two one more time. This is an important hearing.

I will put the rest of the statement in the record.

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

Chairman DEWINE. Thank you very much.

Senator Schumer.

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

Senator SCHUMER. I want to thank you, Mr. Chairman, for holding this hearing. I want to thank you and Senator Kohl for being leaders on this issue, as you are on so many other antitrust issues. I want to thank our witnesses today, as well, and appreciate the opportunity to talk about natural gas as well as oil, although obviously I want to talk about both.

Let me say, Mr. Chairman, that I believe that the Federal Government has an obligation to take decisive, aggressive and immediate action to curtail energy price spikes and make sure that energy costs stop creating hardships for working families throughout the United States.

I am sure everyone here is familiar with the legend of the Bermuda Triangle, where planes and ships mysteriously disappear and are never heard from again. Well, over the past few months, American consumers feel like the same thing has happened to their energy dollar. But this triangle is the Saudi triangle, composed of OPEC, big oil companies and a lack of action by the administration to stem the tide of increasing prices.

At one point in this triangle we have OPEC, which just last week announced its continued commitment to reducing production by a million barrels a day, despite the fact that crude oil was already approaching record prices. The decision is motivated purely by greed and a desire to bolster budgets and increase profits for OPEC's largest producers, like Saudi Arabia, by taking money out of the wallets of average American families.

There are also indications that more OPEC action to pinch us at the pump may be on the way. They have sort out thrown out the window the $28 ceiling and they are now maximizing their profitability because basically no one is stopping them and they have been getting a green light.

At the second point in the triangle is the trend of consolidation in the oil industry. Over the past 5 years, mergers between the biggest players in the market and increasing vertical integration have made consumers more vulnerable to exploitation at the pump. Currently, the top five oil companies in the U.S. control 14 percent of global production—almost as much as the Middle Eastern members of OPEC—over half of domestic refiner capacity and 60 percent of the retail gasoline market.

This lack of competition has made the oil and gasoline markets vulnerable to market manipulation through the withholding of supply and other means, leading to longer, increasingly frequent price spikes and weakening any downward pressure on prices that exists in healthy and competitive markets.

To make matters worse, these highly concentrated companies are sometimes directly tied to OPEC producers, as in the case of Motiva, a 50–50 venture between Shell and Saudi Aramco. The companies do nothing but benefit from high prices by reaping windfall profits and creating a win-win scenario for big oil at the expense of the American consumer. As prices go up and as OPEC raises prices, oil company profitability goes up. So they are on board for the ride.

At the third point of the triangle, I regret to say, Mr. Chairman, lies the administration, which has a "hear no evil, see no evil, do no evil" attitude. They have not taken any aggressive action to provide needed relief to the American driver. It is bad enough that it hasn't happened so far, but if they don't do anything soon, gas prices are going to be sky-high as we go into the summer months.

OPEC's ability to brazenly raise prices and fill its coffers is in part as a result of the administration's inability to engage and influence oil-producing nations to cooperate with U.S. needs and as a consequence of hostility that the administration's foreign policy has engendered toward America throughout the world.

The President says he is close to the Saudi royal family, but time and time again when dealing with the Saudis, it is America that gets the short end of the stick. They tolerate Wahabbi extremists who preach hate and terror against the U.S., they refuse to allow our law enforcement the access it needs to investigate crimes, and now they are holding us hostage to high gas prices.

What Uncle Sam gave us with the tax cuts, the $400 rebate every family got, he is now allowing the Saudis to take away with exorbitant prices at the pump. The President has the power to weigh in against the Saudis, but he is not using it. It is time he did. So we have this new Bermuda triangle—OPEC, consolidated big oil and a do-nothing policy from the administration.

Let me say we have some weapons. First, we should stop adding 100,000 barrels of oil a day to the SPR. A majority of Senators voted for that amendment. The administration has also missed an opportunity to prevent gasoline price spikes by failing to approve oxygenate waiver requests from States like New York and California, which are being forced to use ethanol this summer, raising prices. Most importantly, they refuse to use the SPR as our ace in the hole against the Saudis and against big oil and bring prices down.

As you know, Mr. Chairman, I have been advocating this for a long time. It took me about a year to get the Clinton administration to use it. When they did, prices went down; they stayed down. And the amount of oil in the SPR went up because the swap enabled us to get more oil for what we put into the market several months later.

So we need a long-term solution—that is not what we are here to talk about today—that involves both new exploration and conservation. But we need a short-term solution, lest our economy go down the drain. I hope that we can break the influence of this triangle, get to work and do something good to reduce prices.

Thank you, Mr. Chairman.

Chairman DEWINE. Senator Craig.

STATEMENT OF HON. LARRY CRAIG, A U.S. SENATOR FROM THE STATE OF IDAHO

Senator CRAIG. Well, Mr. Chairman, I largely came to listen today to our colleagues, and certainly to those who are experts in this field.

All of us are concerned about high prices at the pump, but why should we be surprised? This Congress has refused to act in any progressive manner to increase production in this country for the last decade. So the blame game is now underway and we will hold hearings, as we should.

At the same time, a decade and 39 States' investigations have not yet pointed to effective wrongdoing on the part of any producer in large part. What we have is a dysfunctional market today because we no longer control our destiny. We can bite around the edges, if we wish to, and we will, and we will try to find someone else to accuse.

I have given in the last two weeks three speeches on the floor of the U.S. Senate on this issue. I am certainly no expert in it, but I have studied it closely as a member of the Energy Committee for the last 7 years. The problem is the U.S. Congress today, and the consumers of America ought to know it.

We are no longer allowing this Nation to produce in any and every way we should. We should be encouraging the production of domestic oil, we should be encouraging the development of natural gas, we should be encouraging the building of necessary infrastructure like the Alaska natural gas pipeline, we should be encouraging the use of renewable fuels like ethanol, we should be encouraging more renewable energy. We should be encouraging the construction of new nuclear plants, clean coal technology, new hydrogen production, promoting energy efficiency and increasing the R and D on a variety of technologies.

The Senator from New York and I differ a little, but at the same time there are many things on this issue we tend to agree on. The manipulation of SPR during the Clinton years effectively changed the price at the pump by one cent. Those are the facts on the books.

So I am here to listen. It is obvious I have strong opinions on this issue. I think the consumers are gaining strong opinions on this issue, as they should. I hope they reflect on Congress' unwill-

ingness or inability to act on this issue in any progressive and comprehensive form for well over a decade.

Thank you, Mr. Chairman.

Chairman DEWINE. We will turn now to our colleague and friend, Senator Ron Wyden.

STATEMENT OF HON. RON WYDEN, A U.S. SENATOR FROM THE STATE OF OREGON

Senator WYDEN. Thank you very much, Mr. Chairman. I very much appreciate your giving me the chance to come. I would ask, with your indulgence, if my full remarks could be made part of the record.

Chairman DEWINE. They will certainly be made part of the record.

Senator WYDEN. I thank you.

First, it is obvious if you want to get anything important done in this town, it has got to be bipartisan, and I congratulate you and Senator Kohl for doing that. That is what it is going to take to really make some changes in this area. And that is what the public is asking. The public is saying, are you all in Washington going to do anything or are you just going to talk about it?

What I would like to do is just outline briefly what I think would be an effective bipartisan package in this area. Let me start by saying that I think the gasoline consumer is about to be hit by a perfect storm, and there are really three factors behind this storm that is coming.

The first is what we have all talked about today, the OPEC shenanigans. The second involves refinery cutbacks, and the third involves the Federal Trade Commission sitting on its hands in the face of documented anticompetitive practices.

I would just say, Mr. Chairman, that I think if we took your bill which deals with OPEC and my legislation, which is S. 1737, the Gasoline Free Market Competition Act, we could systemically tackle those three factors that come together to create what I call the perfect storm.

First, with respect to OPEC, put me down as a cosponsor of your legislation.

Chairman DEWINE. We will add your name. We appreciate it. Thank you.

Senator WYDEN. Look, I have been saying all week OPEC stands up for OPEC. Anybody who thinks OPEC stands up for the American consumer thinks Colonel Sanders stands up for the chickens. I mean, it is just a preposterous idea that OPEC is going to do anything for the consumer. So I am very glad that you and Senator Kohl have teamed up in that area, and I want to be a cosponsor of your legislation.

But I think we ought to be clear, and the Consumer Federation has offered an interesting report in this area that, for example, oil company refinery margins are taking an even bigger bite out of the consumer's pocket, as is the OPEC cartel. That is why I would very much like to merge my bill with the fine bill that you and Senator Kohl have because while taking action against OPEC will be very constructive, it won't provide full relief if Congress looks the other

way when it comes to anticompetitive practices right here in our markets here at home.

So just as you, Chairman DeWine and Senator Kohl, seek to provide new tools with respect to dealing with OPEC, that is what I am seeking to do with respect to making sure we have competition in our markets in this country. And to illustrate the need for my bill, I would like to talk about what is going on in Bakersfield, California, right now with the refinery cutbacks because I think it provides a textbook case of how these anticompetitive practices are perpetrated in our country.

Obviously, when you ask about what is going on on the West Coast, they are saying what does that mean for us in Ohio and Wisconsin and other parts of the country? But what I offer up is inaction by the Federal Trade Commission on the growing problem of refinery shutdowns, which is clobbering my constituents now and is going to hurt people all over this country.

What has happened in Bakersfield exemplifies how these refinery shutdowns are going to hurt people across the Nation. Suffice it to say there were 24 refineries that closed between 1995 and 2001. So you are talking about a combined capacity of more than 800,000 barrels per day, including many on the West Coast of the United States.

I got involved in this issue with respect to refinery cutbacks, Mr. Chairman and colleagues, in 2001 when we came upon some internal oil company memos involving the closed Powerine refinery in southern California. One of the company documents then revealed that if the Powerine refinery was restarted, the additional gasoline supply on the market could bring down gas prices by two to three cents a gallon. And it called for, and I quote, "a full-court press to keep the refinery down." So you have oil company documents that called for keeping a refinery down while they are saying that it could increase profit margins.

That refinery was about 20,000 barrels per day. The one we are talking about in Bakersfield, which services the whole West Coast, about a third of my constituents, involves 70,000 barrels per day. So if Bakersfield goes down, this is going to be very, very harmful to the entire West Coast of the United States.

I will tell you, Mr. Chairman and colleagues, this Bakersfield deal smells. First, we know that Shell has made no significant effort to try to find a buyer in that area. Second, a number of independent experts have documented that there is a substantial amount of oil in that area in the San Joaquin Valley. Recent news articles have reported both Chevron–Texaco and the State of California estimate that the San Joaquin Valley, where the Bakersfield refinery is located, has a 20- to 25-year supply of crude oil remaining.

The Bakersfield paper indicated that there are 300 more new wells now being pursued this year than last year. And Texaco, Shell's former partner in the Bakersfield area, is actually increasing its drilling. So this certainly calls into question Shell's claim that a lack of available oil supply is the real reason for closing the refinery. Another reason to question Shell's claim about the availability of crude oil is the fact that Shell is currently the subject of an inquiry that we know about for misstating its crude oil reserves.

So I have repeatedly asked the Federal Trade Commission to look into this and other anticompetitive practices, and they have just been AWOL. I know you are going to have them testify today. They have talked in the past about being concerned. They have talked in the past about doing sort of informal surveys, when our constituents are getting mugged at the pump. They have abdicated their responsibilities.

By the way, Mr. Chairman, just so it is clear that my concern here is bipartisan, I don't think the Clinton administration covered itself with glory over at the Federal Trade Commission either. I think this is a systemic problem and it needs to be dealt with in a bipartisan fashion.

So let me wrap up, if I might, by saying exactly the three areas that my legislation would change that I think would give us some tools to deal with the refinery cutbacks, the anticompetitive practices, and I think could complement the kind of work that you and Senator Kohl are trying to do with respect to OPEC.

First, under my legislation the Federal Trade Commission would be empowered to issue cease and desist orders to prevent individual companies from gouging consumers. This is not allowed under current law, so we would give them cease and desist powers to prevent gouging of consumers when it is perpetrated by an individual company.

Second, we would stipulate that the Federal Trade Commission would have the authority to put the burden on the oil companies to show that certain practices, such as the Bakersfield refinery shutdown or red-lining and zone pricing which has been found in the past—that the company has got to show that this doesn't reduce supply or drive up prices when we are talking about concentrated markets.

This would apply, Mr. Chairman and colleagues, in the just over 25 States where there are concentrated markets. Senator Craig and I represent such an area. I hardly ever disagree with my friend from Idaho on these kinds of things. I would just say in response to my colleague's comments that the Federal Trade Commission has said in the past that there has been zone pricing and red-lining. They said they can't do anything about it and that is why I think this legislation is needed, Mr. Chairman.

What we have seen in the past is the Federal Trade Commission sets out a bar that is absolutely unachievable with respect to showing that there are anticompetitive practices in the marketplace. The Federal Trade Commission has been arguing that they can only prosecute if they find out and out, blatant collusion, which savvy oil companies are not going to be involved in. They don't have to do that. They are not going to go to a smoke-filled room; they are not going to show up at a steakhouse and decide, well, let's set gasoline prices tonight. They are way too savvy for something like that.

So that is why I would like to give the Federal Trade Commission these additional tools in S. 1737—the question of cease and desist powers, and the authority in markets where there is concentration to shift the burden of proof, such as we find with the Bakersfield refinery or red-lining and zone pricing.

In a case like Shell's Bakersfield refinery, the Federal Trade Commission could issue under my legislation, Mr. Chairman, a cease and desist order to halt shutdown of the refinery. Because California is a highly concentrated market, Shell would be required to show that closure of the refinery would not have an anticompetitive impact by reducing supply or increasing the price of gas.

If Shell can show that it would be increasing its production at the company's other West Coast refineries to make up for lost production at Bakersfield, the closure under my legislation could still be allowed to go forward. But my legislation would protect the consumer where an oil company was closing its refinery as part of a deliberate effort to reduce supply and to drive up prices.

Suffice it to say, Mr. Chairman and colleagues, the problems that we are seeing we are going to have for some time to come. The Energy Information Administration came to the Committee that Senator Craig and I serve on saying that there will be continued vulnerability of future gasoline price spikes.

Mr. Chairman, I would wrap up by way of saying I don't think there is a silver bullet here. I am supporting your bill because I think it is a significant step forward for the reasons that you have outlined, and particularly important today because the Saudi foreign minister said last week he wasn't even contacted with respect to this most recent production cut.

But I would only say that I think we need to complement your fine legislation with the kind of measure that I am advocating that will get the Federal Trade Commission off its hands. You ask this commission what single thing have they done to help the gasoline consumer. I can't find one step that they have taken. By the way, it goes back a few years and we haven't seen any action that they have taken to help the gasoline consumer.

I don't think that is acceptable. I want it understood, as you and I have in so many other instances, and I want to work with you in a bipartisan way. Senator Craig and I have talked about these issues a number of times over the years on the Senate Energy Committee, and I will look forward to working with you, colleagues, to try to deal with making sure the consumer gets a fair shake in the gas market.

Chairman DEWINE. Senator Wyden, thank you very much for a very provocative statement. It certainly gives the Subcommittee a lot of things to think about, and we will use some of your statements as questions when the next panel comes up.

Thank you very much.

Senator KOHL. Mr. Chairman?

Chairman DEWINE. Senator Kohl.

Senator KOHL. I would like to ask consent that Senator Feingold's statement be placed in the record.

Chairman DEWINE. Without objection.

Let me invite our next panel to come up right now and I will begin to introduce the panel as they come up.

Mr. William Kovacic is a recognized expert in both antitrust law and government contracts law, and has published extensively in both fields, most notably as coauthor of *Antitrust Law and Economics in a Nutshell*. He presently serves as general counsel at the Federal Trade Commission.

Mr. John Felmy is the chief economist at the American Petroleum Institute. He also serves as the Chairman of the Policy Committee of the Alliance for Energy and Economic Growth.

Dr. Justine Hastings is an assistant professor in the Yale Department of Economics. Her current research interests lie in vertical integration, competition and product differentiation, and she has written extensively on the petroleum industry.

Professor George Bermann is professor of law at Columbia University, where he has taught since 1975. He is recognized as an expert on European Union law and has written many articles and several books.

Dr. Mark Cooper is the Director of Research at the Consumer Federation of America, where he works on economic policy, among other issues. Dr. Cooper has testified before the Subcommittee in the past and we welcome him back.

Let me just say to all of our witnesses we are going to have 5 minutes. We have your written testimony and it will be made a part of the record. But we are going to limit you to 5 minutes, if you could just summarize, please, and then we will have the opportunity for questions.

Mr. Kovacic, you can start, please.

STATEMENT OF WILLIAM E. KOVACIC, GENERAL COUNSEL, FEDERAL TRADE COMMISSION

Mr. KOVACIC. Thank you, Mr. Chairman and members of the Subcommittee. I am pleased to appear before you today to discuss the FTC's initiatives to promote competition in the supply of gasoline. My written statement presents the views of the Federal Trade Commission, and my spoken comments today are my views and not necessarily those of the commission or its members.

The FTC's energy program reflects the agency's acute awareness of the vital role that competition policy in the petroleum industry plays in safeguarding consumer interests. Today, I will first describe the FTC's competition program in petroleum, and then I will identify lessons that the agency's work concerning gasoline prices has yielded.

The FTC's competition program in petroleum has four elements. The first is to challenge mergers that are likely to reduce competition and injure consumers. Since 1981, the commission has taken enforcement action against 15 major petroleum mergers. Four transactions were either abandoned or blocked as a result of commission or court action. In the other 11 cases, the FTC required the parties to divest substantial assets in markets where competitive harm was likely to occur.

From data the FTC recently released concerning enforcement programs from 1996 through 2003, it is evident that the FTC's remedial requirements have been more demanding in petroleum markets than for any other area of commerce in which the commission is active.

The second activity at the FTC is to detect and prosecute antitrust violations that do not involve mergers. For example, in March of 2003 the FTC issued an administrative complaint alleging that Unocal violated the FTC Act by deceiving the California Air Re-

sources Board in connection with regulatory proceedings to develop standards for reformulated gasoline.

Unocal, the commission alleges, misrepresented that certain technology was non-proprietary and in the public domain at the same time that Unocal was seeking patents that would enable it to charge substantial royalties if CARB mandated Unocal's technology in the refining of summer reformulated gasoline. The commission has charged here that Unocal's conduct, unless enjoined, could cost California consumers hundreds of millions of dollars per year.

The third activity is to monitor petroleum industry behavior to detect possible instances of anticompetitive conduct. Nearly 2 years, the FTC launched an initiative to monitor gasoline prices to identify unusual movements in prices and examine whether apparent anomalies might result from anticompetitive conduct.

The FTC's economists have developed a statistical model for identifying such price movements. They look at price movements in over 20 wholesale and over 350 retail markets across the country. If our staff detects unusual price movements in an area, it studies the possible causes, and follow-up efforts typically have involved extensive cooperation with State attorneys general, State energy officials, and the Department of Energy.

If our staff concludes that the unusual price movement likely results from a natural cause—that is, a cause unrelated to anticompetitive conduct—it investigates no further. Our experience to date indicates that unusual movements in gasoline prices typically have what we consider to be a natural cause. If there are competitive problems, the monitoring project and our expanded cooperation with Federal and State agencies have put us in a better position to identify and address these problems than at any time in recent memory.

In recent years, the commission has also conducted intensive non-merger investigations involving refining and distribution practices in the western and midwestern United States. I would like to acknowledge the role that Chairman DeWine and Senator Kohl have played in inspiring the agency to undertake the midwest gasoline pricing investigation, even though the two investigations I have mentioned uncovered no basis to find an antitrust violation.

The last activity of the FTC is to collect data and perform research to develop a better understanding of what affects gasoline prices and to improve our knowledge base about the consequences of our enforcement decisions. In 2001 and 2002, the commission held conferences on these topics and is currently updating a comprehensive report on merger enforcement in the petroleum sector since 1989.

Let me finish by turning to the lessons that we derived from our program so far. First, the paramount factor affecting both the level and movement of gasoline prices in the United States indeed is the price of crude oil. Changes in crude oil prices account, as Senator Kohl's introductory remarks and yours, Mr. Chairman, mentioned, for approximately 85 percent of the variability of gasoline prices.

Second, crude oil and refined products inventories significantly affect gasoline prices at retail. At one of our conferences, the Energy Information Administration reported that high crude oil prices

indeed not only affect gasoline prices directly, but indirectly as well, by reducing inventories.

There are indeed tighter inventory situations, but what we found, in general, is that by adopting just-in-time techniques, on average, there is the possibility that gasoline prices over time are lower than they would be if just-in-time techniques were not used widely.

Third, our conferences and investigations have highlighted the generally high levels of utilization in the refining and transportation segments of the industry—conditions that do make interruptions attributable to fires and other breakdowns a possible cause of price spikes.

Last, the interaction of environmental quality requirements and gasoline does supply a fourth important factor. There is no question in this country that pollution control has yielded massive benefits. At the same time, we have identified in our hearings and proceedings that such controls have added at times to the cost of refining crude oil, and thus to the price of gasoline. Finally, our research and conferences indicate that other Federal and State laws sometimes tend to increase gasoline prices.

Let me finish by saying that competition policy unquestionably helps assure that the petroleum industry is and remains competitive. The commission has devoted substantial effort and resources to enforce the antitrust laws and to scrutinize behavior in this sector. We will continue to do so in the future. Higher prices for petroleum products deeply affect the quality of life in this country, and we are keenly aware of that. We will also seek to attack conduct that disturbs the proper functioning of the market where antitrust violations can be shown.

I look forward to the opportunity to address your questions.

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

Chairman DEWINE. Thank you very much.

Dr. Felmy.

STATEMENT OF JOHN FELMY, CHIEF ECONOMIST AND DIRECTOR OF POLICY ANALYSIS AND STATISTICS, AMERICAN PETROLEUM INSTITUTE

Mr. FELMY. Thank you, Mr. Chairman and members of the Subcommittee. I am John Felmy, Chief Economist and Director of Policy Analysis and Statistics of the American Petroleum Institute. API is a national trade association representing more than 400 companies engaged in all sectors of the U.S. oil and natural gas industry. API is pleased to have the opportunity to present a statement on gasoline and natural gas, and urge Congress to enact national energy policy legislation.

The recent spikes in gasoline prices are primarily due to fundamentals in the supply and demand for crude oil. Demand for crude oil has risen due to a cold winter and strengthening economies. Unrest in key supplying countries such as Venezuela and Nigeria, and lower Iraqi production have kept world supplies tight.

OPEC continues to operate under production quotas and has recently confirmed its intent to cut production by a million barrels per day, to 23.5 million barrels a day, potentially worsening the

current situation. However, there is no guarantee member nations will reduce output sufficient to comply.

The United States continues to import more than 60 percent of the crude oil and petroleum products used each day to provide Americans the products they need. While 20 percent of current imports are from the Middle East, the U.S. Energy Information Administration, EIA, expects that figure to climb substantially as the gap between U.S. oil production and consumption widens.

In addition to higher crude prices, several other factors have affected gasoline prices. We have experienced refinery problems; a Mississippi River accident that shut down traffic for several days; the difficulty of switching from winter to summer fuel in California; the introduction of new low-sulfur gasoline, Tier II; the bans of MTB in gasoline in New York, Connecticut and California; and sharply higher demand.

I have attached two papers that elaborate on these points, and I have a chart here that shows the complex nature of the crude oil and gasoline markets. I don't have time in my verbal statement to elaborate, but I will be happy to answer questions later.

As a consequence of all these factors, gasoline prices have reached a record level, unadjusted for inflation, of over $1.76 per gallon, while, adjusted for inflation, the real price of gasoline has fallen over 40 percent from a peak of $2.77 in 1981. The real cost of crude oil and manufacturing, delivering and marketing gasoline has fallen over the past 20 years, while the real cost of Federal and State taxes has risen.

Demand for gasoline continues to be strong as our economy grows. Gasoline production is running at record levels this year to date. However, inventories are low because of strong demand and lower imports. Imports play an important role even though 90 percent of the gasoline we use is refined in this country. High tanker freight rates, low European inventories and increasingly more restrictive U.S. fuel specifications have contributed to the curtailing of gasoline imports.

What then can be done about the situation? Some want to suspend filling the Strategic Petroleum Reserve and releasing the 150,000 barrels a day currently going into the reserve onto the marketplace. That would have negligible effect on supply because the amount made available is equivalent to only about two-tenths of 1 percent of world supply.

The SPR was established as a back-up in the event of a real supply emergency shortfall, not a non-market mechanism aimed at influencing prices. Turning to the reserve when prices go up sends precisely the wrong message to the marketplace at exactly the wrong time. Unintended consequences may include foreign nations curtailing production.

Let me also briefly discuss the situation in natural gas markets. Like gasoline, natural gas has increased substantially in price over the past 2 years. We have seen three price spikes in 3 years, and prices remain high due to high demand and low supply growth. Weather, economic growth and continued increases in demand for gas by electricity generators have kept prices over $5 per million Btus. The industry has responded to the higher prices by operating more drilling rigs searching for natural gas. We have also contin-

ued our efforts to obtain access to lands that are currently off limits to exploration for natural gas.

API has argued for several years that we need a national energy policy that increases supplies, streamlines regulation, fosters energy efficiency and growth in renewables, and allows for increased infrastructure to get supplies to consumers. The Senate was only two votes short of passing an energy bill that contains provisions that would have helped consumers. A comprehensive energy bill needs to be passed and sent to the President for his signature. Failure to pass meaningful energy legislation will increase the risk that we will stay on the energy price treadmill.

Thank you, Mr. Chairman. I am prepared to answer some questions.

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

Chairman DEWINE. Dr. Felmy, thank you very much.

Dr. Hastings.

STATEMENT OF JUSTINE S. HASTINGS, ASSISTANT PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Ms. HASTINGS. Mr. Chairman, members of the Subcommittee, my name is Justine Hastings. I am an Assistant Professor of Economics at Yale University and a faculty research fellow at the National Bureau of Economic Research Program on Industrial Organization. I hold a Ph.D. in economics from the University of California at Berkeley and I have previously testified at the United States Senate Governmental Affairs Committee, Permanent Subcommittee on Investigations, hearings into Gasoline Prices: How Are They Set?

The focus of my research over the past few years has been primarily on firm conduct, competition and consumer behavior, and much of my work has been applied to the gasoline industry. Through my research projects, I have analyzed extensive data on retail market structure, wholesale market structure and retail and wholesale gasoline prices for a diverse group of metropolitan areas for a time covering about the past decade.

I have used this data to examine, among other things, vertical and horizontal market structure, vertical meaning relationships between upstream firms or producing firms, such as refiners, and retail firms, such as gasoline stations, and horizontal market structure, meaning kind of the structure of the market within either retail or at the refinery level, and the effects of these types of market structures on prices and competition through firm incentives.

I have also examined the effects of consumer demand and consumer behavior and preferences on gasoline competition, and I am currently completing a study funded through the National Science Foundation on the determinants of wholesale price discrimination, which you may have heard referred to as zone pricing, and what are the effects of this pricing policy on gasoline retail prices and wholesale prices.

I am also currently working on a project with colleagues at Yale and at the University of California at Berkeley examining the effects of environmental regulations that we are discussing today on market structure, arbitrage rates between markets, and gasoline price levels and volatility.

Through my research, I have gained substantial knowledge about the gasoline industry, and my independent academic research and acquired knowledge will form the basis of my comments and answers before this Subcommittee today. I would like to make a few quick points or broad points and then I would be happy to answer questions related to them during the questioning session.

First, crude oil prices explain a substantial amount of retail gasoline prices in most parts of the country. We have heard a figure of .85, 85 percent, a couple times so far today, and I put a quick table in my written statement that shows that if you went even State by State, with very limited data that I just had someone pull off the Web for me, that varies actually by State from 69 percent to 91 percent. So the question is, yes, it is a big fraction, but what is making the difference between 69 percent in some States and 91 percent in other States? Market structure, both vertical and horizontal, and environmental regulations are also going to be contributing to gasoline price levels, that 69-percent to 81-percent difference.

My second point is that in markets where supply is very tight, inelastic demand for gasoline is going to lead to large price changes in response to small supply disruptions. In very tight markets, every firm actually may have market power to unilaterally increase market price. It is not anticompetitive. It is a factor of inelastic demand and a tight supply.

Increasing the number of refineries in key markets may ease this tightness. And it is something we may not want to discuss, given environmental regulations and concerns, but it is something we are going to have to bring to the table. If new refineries are also new competitors in the market and, in addition, if they are relatively unintegrated, have a smaller downstream component, they may act to increase competition even further after entry.

My third point touches on environmental policy. Environmental policy needs to be designed to incorporate the secondary effects of market structure, not just the effects on pollution. Smart environmental policy looks at market structure when looking at how to achieve an ultimate goal of pollution standards.

Fourth, governmental regulations such as minimum mark-up laws, divorcement legislation, fair wholesale pricing or, as you have heard it referred to today, zone price elimination, and government-owned refineries or strategic gasoline reserves in most cases will actually make consumers worse off. I will be happy to address each of these issues during the questioning session.

Finally, any policy that comes out of this or any other legislation session must really be founded in credible and sound statistical analysis, guided by economic principles, in order to ensure that the welfare of American consumers and taxpayers is maximized through efficient and competitive markets.

Thank you.

[The prepared statement of Ms. Hastings appears as a submission for the record.]

Chairman DEWINE. Mr. Bermann.

STATEMENT OF GEORGE A. BERMANN, WALTER GELHORN PROFESSOR OF LAW AND JEAN MONNET PROFESSOR OF EUROPEAN UNION LAW, COLUMBIA UNIVERSITY SCHOOL OF LAW

Mr. BERMANN. Thank you, Mr. Chairman and the other members of the Subcommittee. In the few minutes that I do have, I would like to address three questions very briefly and they have to do with the three dimensions that I see in the bill that is before me and before yourselves, and those three dimensions are the substance of the Sherman Act, the Foreign Sovereign Immunities Act as the source of sovereign immunity defense that OPEC countries might assert, and last, and most complicated, the act of state doctrine, to which reference has been made. Because I want to discuss three subjects and I have 5 minutes, the math suggests that I need to move quickly.

With respect to the Sherman Act, the bill before me and before yourselves seem to me to make it very plain, and perhaps desirably so, that foreign states are indeed subject to the Sherman Act. I say that because at least one district court has expressed the view that foreign states are not subjects of the Sherman Act. The bill makes that clear.

Secondly, the court of appeals in that same case expressed doubt that international cartels constituted violations of the Sherman Act, saying that there was an insufficient consensus to that effect, and I think the bill would address that problem, as well, arising under the Sherman Act.

With respect to the Sherman Act, I have simply one question that I would raise and one doubt I entertain, and that is why the absence of the Clayton Act from the legislation. In the two pieces of litigation that have been brought, both the Sherman Act and the Clayton Act have been evoked, the latter primarily because it gives rise to claims for injunctive relief.

Turning to the Foreign Sovereign Immunities Act, there was, and there is to this day debate over whether the activity of the OPEC countries and OPEC itself, were it a proper defendant, constituted a commercial activity. As you well know, the Federal courts are divided as to whether they do or do not constitute commercial rather than governmental activity.

The creation of a new, independent exception to the principle of sovereign immunity in the FSIA which this bill would also do would obviate the necessity of characterizing price collusion, output collusion, as commercial or governmental by creating an independent, self-standing statutory exception.

A final word of cautionary note with respect to the Foreign Sovereign Immunities Act, and indeed with respect to the Sherman Act, is the bill requires direct, substantial and reasonably foreseeable effect on U.S. markets. And there is at least one Federal court that has found that the OPEC activity was not proximately causally related to the price effects reported in the U.S. market. I think that difficulty that one might encounter is endemic to any statute that contains the formula of direct, substantial and reasonably foreseeable effect on U.S. markets.

The act of state doctrine is my last subject. On this, I need to be a little more complex, but there are some clear lines to be

drawn. The act of state doctrine was the reason why in the one suit that has been brought to the level of the court of appeals that that suit could not proceed. The act of state doctrine was characterized as preventing that cause of action from being pursued.

There is no question in my mind, as my written testimony indicates, that Congress has the authority to override the act of state doctrine to whatever extent it wishes to do so. Congress has done so in the past in a small number of very isolated instances, but there is no doubt in my mind, under international and constitutional law alike, that Congress has the authority to do so, even though you will hear and you will read that the act of state doctrine has constitutional underpinnings, and I quote the United States Supreme Court.

Those constitutional underpinnings are separation of powers scruples, and it seems to me quite clear that Congress has the right to tell the courts that the courts do not need to defer to Congress. That does not strike me as a disturbance of the separation of powers.

Finally, mention should be made of the possibility that other doctrines besides the act of state doctrine might get in the way of successful prosecution of a claim under the amended legislation. The political question doctrine, general principles of international comity, the forum non conveniens doctrine and foreign government compulsion strike me as the four most likely candidates, for reasons I don't have time to go into because I see a red light. I would simply say that I think none of those is a serious problem, and I would be glad to answer questions to that effect.

I would simply add that I believe, however, that we should pay some attention to the fact that the Supreme Court, to the extent that it has spoken, has suggested that the Sherman Act itself in its own content incorporates considerations of international comity, and that those considerations might lead a court to decline to enforce the Sherman Act in certain international scenarios.

Thank you.

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

Chairman DEWINE. Dr. Cooper.

STATEMENT OF MARK COOPER, DIRECTOR OF RESEARCH, CONSUMER FEDERATION OF AMERICA, ON BEHALF OF CONSUMER FEDERATION OF AMERICA AND CONSUMERS UNION

Mr. COOPER. Mr. Chairman, members of the Subcommittee, the headlines in the energy news that are never written are about the domestic petroleum industry. They include the fact that domestic gasoline refining and marketing operations have increased pump prices by about $50 billion in the past 4 years, and domestic natural gas well head prices have increased by over $80 billion, separate and apart from anything that OPEC has done.

The bottom line that is overlooked is an increase in the after-tax profits of domestic petroleum companies of well over $50 billion in the same 4 years. The story behind those headlines that doesn't get coverage is how a merger wave in the mid–1990's dramatically increased the concentration of the petroleum industry and enabled it to make business decisions that restricted capacity, eliminated

competition from independents and rendered many markets uncompetitive and vulnerable to manipulation.

When markets are tight, there are not a lot of suppliers around and prices get sticky. Individual companies can put them up quickly and don't feel pressures to lower them. This is especially true for energy products because large investments in physical facilities are necessary to deliver product, and that means that the flow can't be increased in the short term.

On the demand side, these are necessities consumers can't cut back. So market power is augmented when supply and demand elasticities are low. It takes less of a market share to gain power over price, but the antitrust authorities don't adjust their thinking.

Storage and economic stockpiles are critical here, but the industry has done a miserable job of ensuring that enough product is available to meet demand without dramatic increases in price. Just-in-time in the oil industry means never there when you really need it. Every accident or blip in the market becomes an excuse to trigger a price increase, and people wring their hands, oh, we didn't have supplies, we didn't have storage. Who chose not to have storage? Business decisions.

Moreover, by failing to expand capacity, they are operating their facilities at very high rates of utilization, which makes accidents more likely to happen. If there were more competition, if there were the threat of losing your customers when the shelves go bear, they would have more facilities and they would keep more in storage and we would not have these wild price swings.

Three years ago, we outlined a comprehensive policy to implement permanent institutional changes that would reduce the chances that markets will be tight and reduce the exposure of consumers to the opportunistic exploitation of markets when they do become tight. Those recommendations made sense then; they make even more sense today.

We would all want a quick fix, immediate relaxation of prices, but what consumers need is the end of the roller coaster and the ratchet of constant volatility with ever-mounting prices. We would love to break the pricing power of OPEC, which would relieve a great deal of the pricing problem, but the short-term prospects are not promising there either.

There, too, we need long-term solutions that address fundamentals. We must restore reserve margins by increasing energy efficiency that takes demand out of the world market, but also reduces demand in tight domestic markets, which also suffer from the abuse of market power.

In the 1990's, we built two fleets of gas-guzzlers—SUVs on the roads and natural gas-fired power plants, particularly that fire up in the summer to run our air conditioners. They have kept domestic markets tight. Efficiency can produce a tremendous saving that has the double impact of relaxing the tightness of both international and domestic markets.

We must increase the flexibility of downstream capacity in the gasoline industry. We closed those refineries—that is, the oil industry closed those refineries after mergers as a function of their business decisions to consciously tighten markets and increase profits. We are suffering from that today. We have to have policies that

promote economically-and socially-responsible storage. There is no excuse for repeatedly being short. Those are business decisions. Public policy can influence those business decisions.

The pending energy legislation does not substantially advance the four key elements of a national energy policy. We must expand domestic refining capacity by studying who closed what, why, and where are the sites that we could redevelop, instead of simply complaining about unidentified environmental obstacles. Those refineries were there; they can be reopened. We need a more competitive domestic sector. We need rules that dictate when you have to have storage and how you should use it. We have to take the fun and profit out of market manipulation.

It may very well be that none of the behaviors I have mentioned violate the antitrust laws. That doesn't make them right. It simply tells us that we need a new set of laws that get at this behavior which is actually imposing immense pain on the American consumer and our economy.

Thank you, Mr. Chairman.

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

Chairman DEWINE. Senator Specter.

Senator SPECTER. Mr. Kovacic, has the FTC ever considered antitrust action against OPEC?

Mr. KOVACIC. I don't know, Senator. I know the commission has certainly for a period going back over decades had an active hand in studying crude oil markets. Indeed, in the—

Senator SPECTER. I am interested in OPEC. If you don't know, you don't know. I would suggest the FTC ought to consider that, and I would also suggest that the FTC ought to send somebody today who could give us an FTC policy about OPEC. That is the central thrust of the hearing and that is the statute which we are looking at.

Professor Bermann, isn't there at least a prime facie case to get to a jury on OPEC being in violation of the antitrust laws on conspiring to restrain trade when they are working with other countries to limit production and in a context where there is a rising cost of gasoline?

Where you have a couple of doctrines on sovereign immunity and that turns on whether it is a commercial activity or a governmental activity, it seems to me that it is clearly a commercial activity when they are selling oil to us. And you have the act of state doctrine where the courts have said there is flexibility and it depends upon the evolution of international legal principles. A great deal has happened in the intervening time since the International Association of Machinists case was decided.

Just to cut through it, without taking them up one by one, couldn't an aggressive prosecutor make a case that would get to the jury or the fact-finder if it is a bench trial?

Mr. BERMANN. Well, certainly, as to the merits—that is to say you asked whether the activity in question would represent anticompetitive behavior within the meaning of the Sherman Act. I think the answer is most certainly yes, and one court has so held in an action brought in the year 2001 that hasn't yet been mentioned against OPEC.

Senator SPECTER. The one in Alabama?

Mr. BERMANN. Yes, the suit in Alabama that actually rendered a judgment adverse to OPEC and issued an injunction to OPEC, but which was vacated, and which vacatur was sustained on appeal on the ground of inadequate service of OPEC in Vienna, Austria, on technical grounds.

Senator SPECTER. Well, I am glad you brought that case up because at least there is a Federal court determination that there was a violation of the U.S. antitrust laws. The judgment was vacated because OPEC didn't defend. They were disdainful of coming into the Federal court, and they later raised technical objections and came in after a judgment had been entered against them. But at least that is authority for the proposition that U.S. antitrust laws were violated by OPEC.

Mr. BERMANN. Well, the district court actually found that the violation was per se. The district court actually found it was a per se violation of the antitrust laws.

Senator SPECTER. I know what per se means, but somebody who may be watching on C–SPAN may not.

Mr. BERMANN. A per se violation is an act that in itself, without more, constitutes a violation.

Senator SPECTER. That means it is a pretty clear-cut situation?

Mr. BERMANN. A clear-cut case of a violation. It was vacated only on grounds that service was technically inadequate, and it was technically inadequate because OPEC refused to accept service of process in Vienna, Austria, where it was located.

Senator SPECTER. Certainly, they had notice. They knew they were being sued. That wasn't any surprise to them, but we all understand that service and jurisdiction are matters to be decided under technical rules.

Mr. BERMANN. They conceded notice.

Senator SPECTER. They conceded notice?

Mr. BERMANN. OPEC conceded notice, yes.

Senator SPECTER. Well, we have got too much to discuss to get into the issue as to whether the court inappropriately dismissed the case on technical grounds.

When you talk about causation, that is a fact question. Where you have OPEC limiting production by 2.5 million barrels, and doing so at a time when gasoline prices are rising, that would depend upon the skill of the prosecutor in putting on the evidence as to whether the evidence was sufficient to establish a causal connection.

Mr. BERMANN. You are entirely right about that. It is a matter of a combination of basic factual showing and a skillful and convincing characterization of the facts.

Senator SPECTER. Well, I am a little at a loss to know why our law enforcement agencies have not pursued the matter. It is a matter of great concern to the American people. It is a matter of enormous financial cost on gasoline going up—we have already seen all the fancy charts and heard the statistics—and heating oil going up.

In your judgment, an action could be maintained under existing law which would get to the fact-finder or get to a jury?

Mr. BERMANN. It could be maintained under existing law. My remarks about the bill were oriented toward the fact that the bill re-

moved doubts. Any doubts about the principal matters are subject to one or two lingering doubts that I alluded to.

Senator SPECTER. Well, I am glad you took up the bill because I think it is a good bill. I have already complimented Senator DeWine on it for initiating it. The legislation is good, so that we don't have to get into the intricacies as to whether you have a commercial activity or a governmental activity, or the flexibility of the act of state doctrine. So I think we ought to pass it.

Mr. BERMANN. You are right in those respects.

Senator SPECTER. It is pretty hard to pass something in Congress these days. So my hope would be that the FTC would take a look at this matter, or that the Justice Department would take a look at it.

Mr. Kovacic, the FTC ordinarily exercises jurisdiction on gasoline matters, but there is nothing to stop the Department of Justice from initiating an antitrust violation, is there?

Mr. KOVACIC. There would not be. Any matter involving a criminal allegation would be handled by the Department of Justice, and we do have a process between us by which, if the Justice Department said they had better capability to pursue a matter, they could.

Senator SPECTER. Professor Bermann, there could also be a private action under the antitrust laws for treble damages, could there not?

Mr. BERMANN. That is correct, and both lawsuits to which reference has been made—the one from 1979, on appeal in 1981, and 2001, on appeal in 2003—were private lawsuits seeking damages and/or injunctive relief.

Senator SPECTER. Do you have any idea why some aggressive private lawyer—there are lots of antitrust suits brought as private prosecutors—why such an action has not been initiated?

Mr. BERMANN. Well, those two were initiated.

Senator SPECTER. Beyond that, something more recently.

Mr. BERMANN. Why there haven't been more? Well, I think the act of state doctrine and the Foreign Sovereign Immunities Act have operated as some sort of brakes on that process. I didn't mention this in my oral testimony, nor, in fact, in my written testimony, but I think that, as I read the bill—and I sought clarification on this question—the Federal Trade Commission and the Attorney General would have exclusive authority to enforce these provisions.

Now, I stand to be corrected in my understanding of the bill, but I understand the bill to so state. That would seem to me, while it would prevent any future private parties from bringing antitrust suits against the OPEC countries, it would go a very long way to defeating any arguments that might be based on the act of state doctrine, because after all the act of state doctrine is intended to protect the political prerogatives of the legislative and executive branches. And if those actions are authorized by Congress and decided upon to be brought by the Federal Trade Commission or the Department of Justice, then there is no reason left for anybody to even think about the act of state doctrine.

Senator SPECTER. Professor Bermann, do you think that the provision as to enforcement being with the Attorney General or the Federal Trade Commission would raise any question as to the right

of a private litigant under the treble damage provisions to initiate a private lawsuit?

Mr. BERMANN. Well, I think it would raise that question because I believe that the bill is ambiguous on that point and it is more than arguable that a recital that enforcement shall be—the exact language is "The Attorney General of the United States and the Federal Trade Commission may bring an action to enforce this section."

That is ambiguous as to whether that is exclusive or not exclusive of the existing rights of private parties to do so, and I would recommend that any such legislation clarify that point. The consequences of clarifying that one way or another are quite significant.

Senator SPECTER. Well, I think we ought to make that modification. My judgment would be that there could be private enforcement. When you say "may," I think that leaves the leeway, but there is no reason to have any doubt about it.

Taking up the issue of a legal action under existing law, is there any real basis, where you have the sovereign immunity question which turns on whether it is commercial activity or governmental activity, to conclude that this is a clear-cut commercial activity?

Mr. BERMANN. Well, courts have differed over that, and one reason they differ over that is because sometimes the judgment as to whether an activity is commercial is based upon the nature of the activity and sometimes it is based upon the purposes or policies underlying the activity.

Senator SPECTER. Where it is to make money, is there any doubt?

Mr. BERMANN. No doubt, no doubt. But where natural resources are involved, a good many courts, including in cases outside this sector altogether, have held that the management of a country's natural resources—even if dealt with in ways that are commercially familiar to us, the very fact that they are natural resources renders it governmental.

The courts have a bit of a problem with characterizing foreign countries' control of their natural resources as purely commercial. Some have and some have not. The virtue of this bill is that it would make it no longer necessary for the exception to sovereign immunity to depend upon whether we accentuate or don't accentuate the natural resources character of oil and petroleum.

Senator SPECTER. Okay, that is fine. I think we ought to get the bill, but in the interim I would like to see the Justice Department do something about it. I think your opinion is a solid that there is a basis to pursue, notwithstanding the sovereign immunity doctrine, on the ground that this is really a commercial activity.

May the record show that there was a nod in the affirmative.

Mr. BERMANN. Yes, sir.

Senator SPECTER. On the act of state doctrine, the International Association of Machinists case talked about the flexibility of it and on the availability of internationally-accepted legal principles. Since the Ninth Circuit opinion in 1981, there has been in the 1990's a significant increase in efforts to seek compliance with basic international norms through international courts and tribu-

nals, and an emerging consensus in international law that price-fixing by cartels violates such international norms.

Would you agree with that?

Mr. BERMANN. Yes, I would.

Senator SPECTER. Well, then I think the stage has been set for an aggressive prosecution here, Professor Bermann. I appreciate your background and your insights and your research. I think an aggressive prosecution would be well received.

The worst that could happen, Mr. Kovacic, would be to lose, and that is not such a dire consequence when the stakes are as important as they are.

Mr. BERMANN. Mr. Senator, if I may, in the case that began in Alabama and went up to the Eleventh Circuit, the act of state doctrine was found to be inapplicable to the action against OPEC. It was found to be inapplicable because OPEC's activity was commercial, and, secondly, because OPEC's activity was taking place in Vienna, Austria, which is not on the territory of the states in question.

So the most recent decision that we have been referring to is a decision that addressed the act of state doctrine and found it to be inapplicable to these circumstances. That is a decision of 2001 and not in any respect weakened in the appellate ruling of 2003.

Senator SPECTER. Well, that is an important observation to show that some of these legal hurdles have already been overcome and that there is precedent.

Senator DeWine and I used to be prosecuting attorneys, and a prosecuting attorney ought not to take a case that doesn't have a sound policy and that he doesn't have sufficient evidence to get to a jury. But when you weigh the importance of the matter, as I would weigh the importance of going after OPEC in their collusive practices and the consequences at least sequentially of rising gasoline and rising oil prices in the United States, we are dealing with very substantial financial matters for the American consumer.

Dr. Cooper, would you like to see a test case brought representing consumers?

Mr. COOPER. We are big fans of test cases. Frankly, clearly, one of our problems is that, in my opinion, OPEC has fought an economic war against the American consumer and we have not responded at that level.

Senator SPECTER. That is not the only war they have fought against us.

Mr. COOPER. I understand, but the point is that we definitely think that we support this legislation to remove any doubts. There is absolutely no reason why we can't defend ourselves from this sort of attack.

Senator SPECTER. Mr. Kovacic, would you think it appropriate for the FTC to consider an enforcement action against OPEC under the antitrust laws?

Mr. KOVACIC. Senator, I don't have instructions from the commission to address this, so I answer in my own capacity.

Senator SPECTER. Sure.

Mr. KOVACIC. I see this as involving a number of extremely complicated issues. I agree completely with the suggestion that the behavior would be unmistakably illegal. By any of our standards, if

these were private enterprises, our Department of Justice would highly likely prosecute them criminally and seek to imprison the individuals involved. So the culpability of the behavior under our legal standards is unmistakable.

If I could mention for a moment the things that might make us hesitate, one is that obtaining discovery in such a matter might be relatively difficult. Enforcing a judgment might be relatively difficult.

Senator SPECTER. Offending the sovereign, you say?

Mr. KOVACIC. Obtaining discovery and enforcing a judgment would be complex. If I think of the practical steps that would be taken, these would likely be fairly elaborate and long-running as we dealt with those issues.

Senator SPECTER. If you can't get discovery, if they don't submit to discovery, you get a default judgment. If you go after assets, OPEC has plenty of assets within the long arm of U.S. law.

Mr. KOVACIC. If I could offer another possibility, in the international work we do a number of countries raise objections to policies that the United States follows which they allege to be matters of cartelization. I wonder if they would pass their own accord collateral legislation to bring their laws to bear upon our own policies, and I think of the matter of agricultural commodities as being one.

Senator SPECTER. Supply for the record—I don't want to go on too much longer—where the United States might be exposed.

Dr. Felmy, do you think an aggressive prosecution here might be warranted?

Mr. FELMY. Senator, I am not an attorney. I am not qualified to make a statement on that particular issue.

Senator SPECTER. Well, because you are not an attorney may make you well qualified, Dr. Felmy.

Senator SPECTER. Dr. Hastings, you are a Ph.D. That certainly gives you qualifications.

Ms. HASTINGS. Yes, but in economics, unfortunately, not in law. So I joint have a joint J.D.–Ph.D. I am an economist and I examine industrial organization, so market structure and firm behavior. So I am really not able to speak to the extent to which we could successfully litigate antitrust laws against OPEC.

Senator SPECTER. Okay, thank you. This transcript ought to be sent over to both the commission and the Attorney General, at least with my thinking, and I will discuss it with my colleagues beyond. Both Senator DeWine and I, as a I said before, were prosecutors, and I initiated many actions which were original actions, sued under the nuisance laws people who were spraying asbestos and closed down commercial buildings; prosecuted for first-degree murder a defendant who did not touch the victim, made new law on first-degree murder without contact. The law is an evolving body which responds to aggressive prosecutions when you have a good factual basis and you have a policy to be enforced.

Senator DeWine, thank you very much for convening the hearing and thank you very much for the latitude on my questioning.

Chairman DEWINE. Well, Senator Specter, thank you very much. I think you all can see why we brought my senior partner here to prosecute the case for the DeWine–Kohl bill here today.

Thank you, Senator, very much.

Senator SPECTER. Thank you.

Chairman DEWINE. I will reserve my questions.

Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman. I want to thank the witnesses. I apologize for missing a few of you. We had a Banking hearing at the same time.

First, I want to ask a little bit about natural gas to Kovacic and the others. We had a dramatic price spike in natural gas last year. This last winter, it was much higher than it had been before. Yet, if you looked at supply and demand, it wasn't terribly different. In fact, it was a little less stringent this past winter than it was in the previous winter.

Has the FTC investigated last winter's price spikes? If so, what is the status of the investigation? If not, since you can't speak for the commission, what are your thoughts? Gas just went through the roof. Obviously, it is a different type of market than oil, with pipelines and everything else. Tell me what you think.

Mr. KOVACIC. Senator, our work to date has basically been focused on looking at mergers involving natural gas companies, seven in the past two-and-a-half years. In the course of those investigations, we have had some occasion to look at behavioral issues in the industry. But to my knowledge, we don't have a current investigation simply looking at conduct, but I would be happy to check that and to report to you.

Senator SCHUMER. Would it be within the purview of the FTC?

Mr. KOVACIC. Yes, it would, sir.

Senator SCHUMER. And would it be in the purview to see if the mergers that have occurred have helped contribute—one of my premises is we have had less and less competition in the energy industry, and that has in part increased the price, whether it be overseas with Senator DeWine's bill, with OPEC, or domestically with the mergers that we have seen throughout the 1990's, by the way many of them under Democratic administrations. This is hardly a partisan-type issue.

Mr. KOVACIC. We have several projects underway to look at the consequences of past petroleum mergers. Again, speaking for myself, I think it is a wise policy for the commission to expand its efforts to assess the effects both of past decisions to prosecute and not to prosecute. In one area not involving petroleum or natural gas, the commission has begun to do this in health care.

Without being able to predict how the agency will act in the future, I see a growing interest in looking in the rear view mirror to see the actual consequences of what we have done. So my view is that is wise policy.

Senator SCHUMER. Good. That would be very helpful. I hope you will do it. Tell the commissioners about that.

Mr. KOVACIC. I will, sir.

Senator SCHUMER. Dr. Hastings, as the economist with only a Ph.D. and not a J.D. who has maybe studied these markets a little bit—

Ms. HASTINGS. I am not an expert in natural gas markets. I am an expert in gasoline markets, and they are very different.

Senator SCHUMER. But just using your knowledge as an economist, given the fact that we have pipelines from gas fields con-

nected and they are generally monopolies—that is, you can't go to two different natural gas producers and the natural gas companies have a limit in terms of who they can get the gas from. I have asked lots of people and no one has come up with a good explanation as to why natural gas spiked so in price last year, this past winter.

Ms. HASTINGS. I am not an expert to speak to that.

Senator SCHUMER. Do you, Dr. Cooper, have anything to say about it?

Mr. COOPER. Well, in my testimony we look at natural gas and we observe that over the past four or 5 years, natural gas has risen much more rapidly than crude oil.

Senator SCHUMER. Correct.

Mr. COOPER. The domestic market has changed in the last 5 years to close that gap. What changed was the majors, the same folks who are concentrating the refinery industry, moved into the natural gas market in a big way. They invest differently, they behave differently, they manage their assets differently. So the same attitudinal factors that look at the way they maximize their profit as opposed to compete for market share afflict the natural gas market, in my opinion, as they do the domestic gasoline market.

The other point is that the natural gas price is now set in the spot markets, the hubs. Well, it turns out that most of those hubs didn't even exist 10 years ago and we are now discovering that all of them have been afflicted by manipulation. Almost daily, you read press accounts from the Federal Energy Regulatory Commission discovering that people were mis-reporting gas, et cetera. So these are very thin markets.

There is a court case going forward. Just a couple of weeks ago, I believe a Federal district court judge allowed the case to go forward and he pointed out that on any given day in 2001, Enron accounted for 40 percent of the gas being transacted at the Henry hub. Now, the Henry hub is the key referent price. The Department of Energy has discovered that that is setting the price of natural gas, and it is tracking crude much more closely than it used to do.

Enron controlled 40 percent of the transactions in that market. When Enron went away, for clearly very, very nasty reasons, these markets got to be very thin and they have been laboring along. They are not transparent, and the Federal Energy Regulatory Commission is struggling to figure out how to get real clear price signals out of the gas market and still doesn't have a program.

Again, the fundamentals in this industry are exactly like the gasoline industry—inelasticity of supply in the short term, inelasticity of demand in the short term. So last spring, with a natural gas crisis, the prices popped up and everyone was wringing their hands about how storage wasn't adequate again. How did that happen? It is a business decision.

When the stocks finally moved up over the course of the summer, by the end of the winter people pointed out there was more in storage than there was in the previous 2 years and the price is still too high. So this is market that is not setting prices in a competitive, pro-consumer manner.

Senator SCHUMER. So you would recommend the FTC do what Mr. Kovacic said maybe they should do?

Mr. COOPER. But they have to begin to look at these markets given what we know about the inelasticity of supply and demand. If we just do routine antitrust analysis, as Senator DeWine, if you look at their market shares, they don't look very concentrated, although certainly some of the gasoline markets have gotten very concentrated.

But knowing the economic fundamentals, knowing about how inelastic are supply and demand, that magnifies market power. And maybe we can't do that under the antitrust laws. Maybe we need different laws that are on different premises, but that is a fundamental problem.

Senator SCHUMER. Like I mentioned before, my great concern is this sort of triangle I mentioned—OPEC, a small number of large oil companies and administration friendliness to that.

In your testimony, Dr. Cooper—and I am going to ask Mr. Kovacic and Dr. Felmy this—you made a point that when OPEC raises its international price, American oil companies greatly profit even more from their domestic production, where their cost of production stays the same or is on the same curve as it was before. But because the international price has gone way up, they make much more in profit. Certainly, the profits of the oil companies seem to be quite in sync with the increase in price, not exactly, but pretty close.

Just give me a yes or no on that. Is that true, Dr. Cooper?

Mr. COOPER. There is price-following behavior in both the domestic oil market and the natural gas market. The interesting thing is that one of the reasons the large industrial gas users in this country are screaming is because in the rest of the world gas is not exhibiting that price-following behavior. They are losing their jobs to other markets where the price of natural gas doesn't run up every time the price of crude runs up. Now, we can have a debate about why those foreign markets behave differently.

Senator SCHUMER. It means it is not inexorable. That is what it means.

Mr. COOPER. That is right. It is not inexorable.

Senator SCHUMER. The big oil companies sort of like it when OPEC raises prices because then the world price goes up and their domestic production is more profitable.

Do you agree with that, Mr. Kovacic? Again, you can speak for yourself, not for the commission.

Mr. KOVACIC. Yes, sir. I know that we have done work looking at trends in profitability and attempting to explain them. I don't have a good sense of exactly what our research has shown on the point you ask, but I would be happy to check that and submit that in writing to you.

Senator SCHUMER. You could submit that in writing.

Do you have any thoughts on that, Dr. Hastings?

Ms. HASTINGS. On the profitability of oil companies coinciding with the profitability—

Senator SCHUMER. The price that OPEC sets, yes.

Ms. HASTINGS. No, I have not looked into that issue.

Senator SCHUMER. Okay, and I will bet Dr. Felmy doesn't quite agree with what I said, so let's give him a chance.

Mr. FELMY. Well, actually, Senator, because domestic prices move with world prices, because oil is an international commodity, you will see for that roughly, I guess, 35 percent of the crude oil that we actually produce here to use, higher margins for that crude as world prices go up.

Senator SCHUMER. So if an oil company were interested, at least in the short term, in maximizing their profits, they would be happy, at least—let's not get into collusion, but they would be happy to see OPEC raise its price?

Mr. FELMY. Well, it depends on whether or not you are a refiner or a producer. If you are refiner, the answer is a decided no. If you are a producer, it tends to benefit you.

Senator SCHUMER. Overall, let's take Exxon Mobil—something that never should have existed, in my opinion; it should be Exxon and it should be Mobil. Those were the two biggest in my area and they were allowed to merge.

Doesn't Exxon Mobil do better profitability-wise when OPEC raises its price, because at least the domestic share—

Mr. FELMY. I am not an expert, sir, on the split between the refining, production, chemicals and all the other businesses that large corporations such as Exxon Mobil have ongoing. So I can't speak to that, sir.

Senator SCHUMER. Do you want to say something, Dr. Hastings?

Ms. HASTINGS. Well, I don't know Exxon Mobil's exact ratio of production to consumption of crude oil. If they are a net producer of crude oil, then they benefit from it. If they are a net consumer of crude oil, they don't benefit from it. It depends on the balance of their—

Senator SCHUMER. Assuming that there is pure competition at the selling end, which there isn't.

Ms. HASTINGS. I am sorry. I didn't quite understand.

Senator SCHUMER. Even if they are a consumer, if they can pass all of that along in an inelastic way to the person who buys gasoline, home heating oil or whatever else, it is not going to hurt them even on their consuming side. They gain on the production side. Because of these mergers, they have an inelastic demand curve on the consumption side and it is a win-win.

Ms. HASTINGS. Not necessarily.

Senator SCHUMER. Go ahead and explain to me why.

Ms. HASTINGS. Well, it depends. Imagine the opposite happening, the opposite being, as Mr. Felmy pointed out, suppose that Exxon was actually not a producer, but only a refiner. Before Tosco merged with Conoco Phillips, Tosco would have been in this category. So they are only going to be purchasing crude oil. Then your assumption is actually that they are going to pass a hundred percent of that crude oil price on to retail.

Senator SCHUMER. But Tosco is not a fair example because they didn't own gasoline stations.

Ms. HASTINGS. They did own gasoline stations before they merged with Conoco Phillips. They owned the West Coast refining and marketing assets of Unocal Corporation. They owned the Circle K chain since 1996.

Senator SCHUMER. Did they have the same kind of market dominance that, say, Exxon Mobil has at the pump in my area or any part of the country?

Ms. HASTINGS. Most definitely, in Arizona.

Senator SCHUMER. In Arizona?

Ms. HASTINGS. Most definitely, in Arizona.

Senator SCHUMER. So Tosco would have made money in Arizona.

Ms. HASTINGS. And they most definitely had a large market share. And I am not agreeing that they would have made money in Arizona. They also had a large market share in California.

Senator SCHUMER. Do you know what percent?

Ms. HASTINGS. It depends on the metropolitan area. So I am thinking somewhere between 12—no, probably about 10 percent, 12 percent. I could be off on that.

Senator SCHUMER. I think that is a lot less than Exxon Mobil has in my area. True?

Ms. HASTINGS. Perhaps.

Senator SCHUMER. Oh, yes, more than perhaps.

Ms. HASTINGS. I actually just looked at the percent that Exxon Mobil has in the New York metropolitan area.

Senator SCHUMER. Good. What is it?

Ms. HASTINGS. I am just not remembering off the top of my head, but I think it is probably closer to 20 percent. So, yes, they have a large market share in your area.

Senator SCHUMER. What do you say to this, Dr. Cooper?

Mr. COOPER. Well, the point is that they are integrated, and that has been one of the trends is that you have got more integrated refiners. So it is more and more difficult to talk about the refining sector because this is an integrated operation.

Senator SCHUMER. Right. That is what I was trying to say.

Mr. COOPER. So the point is that if you look at the bottom line of Exxon Mobil this year, folks, it is through the roof, and it is driven significantly by crude oil prices, but also by the ability to keep—if there were price resistance at the point of sale, the rise in crude prices would have squeezed down the domestic spread, and it did not.

If you look at our testimony, the reason we are having so much shouting today is that both domestic spread and crude oil prices, the input prices, are at historic highs for an April, and it is the combination of that. I understand you could hypothesize other reasons, but the simple fact of the matter is that there is no elasticity of demand at the point of sale.

Senator SCHUMER. Right, and Dr. Hastings made the point because she had to go to something that doesn't exist now, a large refiner that didn't have production. That was Tosco, and who bought Tosco? I don't even know. Who bought them?

Ms. HASTINGS. Conoco Phillips.

Senator SCHUMER. Conoco Phillips, a seller and a producer.

Ms. HASTINGS. By the way, Tosco was just the first thing that came to my head.

Senator SCHUMER. I understand, I understand, but I don't think Tosco was the biggest sort of refiner qua refiner.

Ms. HASTINGS. It might have actually been the largest independent refiner at the time of the purchase.

Senator SCHUMER. That is what I am saying. The point I am making is the greater consolidation, vertical and horizontal, in this industry over the last several years has created less competition and has created not only higher prices, but a greater incentive, either implicitly or even explicitly, for OPEC and the oil companies, the big ones, not everybody, to cooperate.

I just have one more question here, and the Chairman has been very generous. This is about ethanol. Last week, there were rumors that the administration might have granted both New York and California a waiver from the ethanol mandate, and prices dropped for energy futures on the NYMEX. I think they went down 5.2 percent for gasoline and 4.2 percent for crude oil.

Anyone can answer this. Isn't this empirical evidence that the waivers, if we were to allow New York, California and whatever other States wanted to that are far away from the corn-growing ethanol-producing centers—if we were to allow those States to meet the clean air standards by cracking gasoline somewhat differently, prices would come down some.

Does anyone want to agree or disagree? Yes, Mr. Kovacic.

Mr. KOVACIC. We haven't tried to measure the exact effects of the substitution you mention, Senator, but an unmistakable finding that we have made is that measures that can be taken to preserve general levels of air quality while introducing more flexibility into the supply system, have possibilities in many areas to put greater downward pressure on prices. A more flexible supply and distribution system consistent with broad air quality goals is better for the competitive process.

Senator SCHUMER. Dr. Felmy.

Mr. FELMY. I would agree, Senator, that any measure that allows you to be able to increase the flexibility so that refiners can meet clean air without prescriptive solutions for that introduces flexibility. It also introduces the possibility of additional imports. So we would agree with that position and we support waivers for everyone.

Senator SCHUMER. Does anyone disagree with that?

Mr. COOPER. I agree with it, with a caveat. Bigger markets are better for consumers as long as the players in the markets are more. If it is the same players in the same big markets, I am not sure you diminish their market power. So when we look at making these bigger markets, we have to also make sure we increase the competitiveness of those markets or we may end up on a treadmill.

Senator SCHUMER. One final question. This is for Mr. Bermann. We left the legal questions to the former prosecutors, Senator DeWine and Senator Specter. But as a cosponsor of Senator DeWine's legislation, given that OPEC is a cartel specifically designed to manipulate price, does the involvement of U.S. companies with OPEC raise any domestic antitrust issues?

In other words, does the fact that some of the oil companies also own some of the production in the OPEC nations, such as whatever the name of that company is that I mentioned in my opening—Motiva, the old Aramco—does that raise any antitrust issues independent of the good legislation that Senator DeWine has offered?

Mr. BERMANN. Well, the fact that those companies might be dealing with foreign governments would not immunize them in any re-

spect. The law has never gone any further than to say only the compulsion of a foreign government would operate as a defense.

So if you had the kinds of predicate acts that you are thinking of, there is no question that I think the Sherman Act could apply to them. And the fact that they are dealing with or consorting with foreign governments will not immunize them.

Indeed, if I can revert to the act of state doctrine, the courts have held routinely that the act of state doctrine only applies when the legality of what a foreign government does is in question and not when, if you will, the good faith or bad motivation of the foreign government is indirectly implicated.

Senator SCHUMER. Do you agree with that, Mr. Kovacic, and does the FTC agree with that?

Mr. KOVACIC. Again, speaking in my own capacity, I think Professor Bermann has accurately described the requirement that there be compulsion. So the issue of fact would be, in the concession arrangements that govern their activities in these countries, are there measures in those arrangements that provide the requisite compulsion. I think his technical assessment is correct.

Senator SCHUMER. So would that mean that, say, Shell, which has ownership in Saudi Arabia and is part of this Aramco, which is part of OPEC, is susceptible to FTC action for what they do here because of their big network and operations here?

Mr. KOVACIC. In any instance in which we would look at foreign behavior in these circumstances, we would generally take the view that without compulsion, for example, the behavior in question is fair game. So that would be the crucial factual issue.

Senator SCHUMER. Thank you, Mr. Chairman. I appreciate your having this hearing.

Chairman DEWINE. Senator, thank you very much.

Mr. Bermann, you have made some good suggestions on how we can improve this bill and we are certainly going to take a look at that. I want to thank you for that. That is one of the reasons we have these hearings.

You made the point about the state of the law and told us a little bit about that, and we appreciate that.

I might say there has been some editorial comment about this proposed bill that we couldn't do this because there are legal impediments. And I would just say your testimony has pointed out, I think, the fact that this bill would remove any legal impediments. Whatever legal impediments are out there—and that is an open question—but whatever legal impediments are out there, this bill eliminates them. That is why we introduced the bill.

It is problematic whether or not suits could be brought now or not. I think they could be, but the whole purpose today of this bill is to make it so that prosecution can move forward, and make it clear that the antitrust laws of this country do, in fact, apply.

The idea of the Department of Justice enforcing the antitrust laws against cartels is something that happens all the time, and they do it against not just domestic companies; they do it against foreign companies. It wasn't too many years ago there was a lawsuit brought by the Department of Justice. It was an international cartel case against, I believe, German and Swiss firms for a vita-

mins cartel. That case was successful. Foreign executives, I believe, were sent to jail. Two firms paid a fine of over $700 million.

So the United States can reach the assets; the Justice Department can reach those assets. We can attach those assets. We can bring those people into court. I have faith in the ability of the lawyers at the Justice Department to get the job done, and that is why we have this bill to remove the impediments and let them go about their business and do their job and enforce our antitrust laws. This is the only major area that I know of where we say they can't do it, and we think they should be able to do it.

Mr. Kovacic, we have heard testimony today complaining about the FTC's efforts to investigate the petroleum industry. In your testimony, you talked about a number of actions and investigations that the FTC has conducted in this area, but it seems clear to me that consumers still believe that they are looking at a very dysfunctional market.

What else can the FTC do?

Mr. KOVACIC. I think one of the most important things, Mr. Chairman, is to bring to a complete conclusion a great deal of the research that we have been doing that comes both from the active, almost real-time monitoring of price changes, the consequences of our retrospective assessments of completed transactions, the continued work that we are doing to enlist expert outsiders to tell us more about the industry—to bring that to a successful conclusion so that our understanding of the precise phenomena in question is more complete, to have a better sense, for example, of precisely how specific transactions or activities have affected market outcomes.

I have heard on a number of occasions Senator Wyden express his frustration, his disappointment with the inquiries. But our view has been in this and other areas that are terribly complex that the sound empirical foundation is the indispensable basis for making good policy. One of the first and most important things we can do is to bring those efforts to a close as a foundation for doing more work.

Second, I think bringing to a successful close cases such as the Unocal case that I mentioned before, which we allege—our opponents in this case would strongly dispute my characterization—literally involves hundreds of millions of dollars for California consumers, direct pass-through effects, to establish the principle that the regulatory process which is so important to the operation of this industry—clean air and clean water controls, other controls that govern the behavior of the industry—cannot be gamed, that firms subject to them cannot lie or misrepresent their behavior.

And again I must emphasize I am offering the allegations in the commission's complaint. These aren't proven facts. To demonstrate that principle successfully would be, I think, a critical addition to our competition policy about what it says in petroleum and elsewhere about the manipulation of regulatory schemes that do affect competitive outcomes.

I think we have the humility, Senator, in listening to all of the representations here about additional avenues for research and analysis, to continue to pursue those paths. I am quite at peace with the process that continues to bring upon us possibilities for

additional analysis, new research, new areas for examination. Our process of policymaking takes those into account, so most certainly we would carefully consider and reflect upon the results of this proceeding as well.

Chairman DEWINE. Let me ask you, do you agree with Dr. Cooper's assessment that refining is excessively concentrated, and if so, does that mean that the FTC got it wrong when it reviewed the big mergers of the 1990's in the petroleum industry?

Mr. KOVACIC. When we look carefully at the contributions that the mergers in question made to concentration in refining, we find that those adjustments were modest, at most. Indeed, it is very difficult to detect, I believe, direct, convincing links between the mergers we permitted, with conditions, with large divestitures, and notable increases in concentration in these markets. So I think that we and Dr. Cooper would have quite a debate about exactly how those mergers influenced refining concentration in those markets.

Chairman DEWINE. Well, let me move to another area. There seems to be widespread agreement that petroleum companies run their refineries at a very high capacity, yet don't build up new capacity to meet potential demand increases.

We know that there are some difficulties in increasing refining capacity. We have talked about this a little bit today; environmental permitting, for example. But on balance, it seems as though there ought to be some way the industry could boost refining capacity.

Why don't we see more refining capacity come on line? Is there any other industry that comes to mind where producers run at this very high capacity year after year and don't take any steps to increase capacity? What is the difficulty here?

Mr. KOVACIC. I think part of what we have observed, Mr. Chairman, is that utilization rates, at least in the past couple of years, to some extent have been falling a bit, so that we don't have the level of tightness that prevailed before.

I would have to check, Mr. Chairman, to look at exactly what our experience base tells us about actual improvements in the capacity of specific facilities that do remain on line. And if you will permit me to do so, I would like to supplement my answer with a fuller response.

Chairman DEWINE. That would be fine. You can submit that.

Mr. KOVACIC. But our impression is that certainly in some areas with respect to some facilities, we are seeing enhancements that do increase the capacity of existing facilities.

Chairman DEWINE. Dr. Felmy, have you ever done a study estimating what price we would pay for crude oil if it were subject to the free market instead of being fixed by OPEC?

Mr. FELMY. I have really not, Mr. Chairman. An economist looks at cartels and has an academic view of how things go, but then when you transfer that analysis to the real world, there are many other things that happen. Cartel behavior is very complex. Behavior of non-cartel members is also very complex. You also have dramatic changes in demand over time which can also affect the prices. So I don't have an analysis of that.

Chairman DEWINE. Dr. Hastings, do you?

Ms. HASTINGS. I do not have an analysis of that.

Chairman DEWINE. Dr. Hastings, your testimony mentions that the Energy Information Administration of the Department of Energy collects data, but does not let academics have access to detailed data for research purposes. You also note that the Department of Energy does not have grant programs for economists to do research on energy policy, and as a result the economic research into energy policy suffers.

Can you explain your thoughts about these two points maybe in more detail to us?

Ms. HASTINGS. Sure. In order to examine many of the questions that we have been discussing here, an applied economist needs to be able to get access to detailed data that would allow them to understand better issues. For example, suppose I wanted to look at the following question: Was there strategic capacity entry into markets that were regulated by reformulated gasoline requirements? How did firm choose capacities to enter into these markets? Are we going to be ready to supply Milwaukee's market when they introduced a specific type of gasoline only for that market?

Price volatility went up substantially there, so did mark-ups, and the number of firms supplying unbranded gasoline decreased substantially after that introduction. So suppose you might want to ask the question, how tight are markets? Did firms anticipate this tightness when setting capacities when they went into the market?

In order to look at something like that, you would actually need to look at refinery-level production decisions, and there is no way to actually get that information even though the Energy Information Administration has such information. Typically, the only thing that one can get access to is very average data across the whole country or perhaps across a large part of the country on an aggregated basis, kind of monthly or yearly information.

One of the things that maybe Mr. Kovacic might agree with me on is that there is a real need for sound empirical work in industrial organization to look at a lot of these questions. What is going on in natural gas? What is the effect of having these micro markets for different reformulated gasoline on prices, on competition, on who decides to enter and who doesn't? Those questions could be answered with good data.

Currently, for the projects that I have done, it is incredibly difficult to get such detailed data and it takes a long time for an academic to get a hold of this data. Labor economists were in a similar position before the Census Bureau introduced a program that allowed labor economists to look at detailed data at the Census Bureau, confidential data on firm production decisions, for example, in manufacturing, on consumer behavior at the consumer level.

What they did is introduce a program by which academic could apply to get access to the confidential data. It is a very stringent application process. Once they are granted this application, they actually have to go to the Census Bureau to use the data. They can't take confidential data off-site. But having this access, this program set-up, led to a huge boom in the sound empirical knowledge base of labor-related policies such as minimum wage laws, et cetera.

Before that time, labor economists and labor issue policymakers were in the same position that many regulatory policymakers find

themselves in today. Having a program modeled after what the Census Bureau did perhaps at the Energy Information Administration may lead to the same boom in knowledge and understanding of what is affecting these energy markets.

Chairman DEWINE. Dr. Cooper, we have heard testimony that it is too hard to open a new refinery due to such reasons as huge costs, environmental issues and local opposition.

Do you disagree with these reasons? I mean, is that what the problem is?

Mr. COOPER. It is not that I disagree with the reasons. It is that we have observed the closure of refineries, which were clearly industrial sites that supported those refineries. They were permitted to exist in those locations. They were closed, we know, as part of a business strategy to diminish capacity. So what we asked for several years ago was a study of those sites, a detailed analysis of why were they closed, what would it take to get them open, would there be people who are interested in reopening them.

I think Dr. Hastings has sort of raised the interesting question, because the really interesting thing is that the Federal Trade Commission which studied the first price spike in 2000 actually asked exactly that question, the question she asked about: How do strategic decisions in the reconfiguration of refineries to meet the reformulation requirements affect supply in that market.

The FTC asked that question not with the detailed data that she would like to have, but by interviewing all of the behaviors and the actors in those markets. And they concluded that, based on those interviews, strategic decisions had been made about how much capacity to have in a market that tightened them and cut off independents.

Two years ago, the RAND Corporation did another study, based again not on the detailed data that she would like, but on the same sets of interviews, and they concluded exactly the same thing. So now we have the qualitative evidence on business decisions. Senator Wyden repeats his internal memos almost on a daily basis that those decisions were made.

So the answer is you hear the excuse that it is too hard to locate, it is too expensive, but you look at the people who have studied it and you discover that this was intended to increase the profitability of refineries, that it was intended to accomplish certain sets of things. The definitive answer comes in a backward look around each of those price spikes with the data that Dr. Hastings has mentioned.

But I submit that there is another explanation. Now, we are through 4 years of unhinging in the gasoline market and nobody has looked at this issue in detail repeatedly, aggressively. What we get is excuses rather than explanations and analysis.

Chairman DEWINE. Well, I want to thank you all very much for your testimony. It has been very, very helpful and it has been a very instructive hearing. We have had a lot of interest in this hearing and we do appreciate your testimony. This Subcommittee will continue to monitor this issue and we are going to continue to push forward and move forward on our bill.

Thank you very much.

[Whereupon, at 5:08 p.m., the Subcommittee was adjourned.]

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

QUESTIONS AND ANSWERS

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May 3, 2004

Robin Blackwell
Antitrust, Competition Policy and Consumer Rights Subcommittee
United States Senate, Committee on the Judiciary
161 Dirksen Senate Office Building
Washington DC 20510

Dear Ms. Blackwell:

I am in receipt of Chairman DeWine's letter of April 23, 2004, posing written questions from subcommittee members. Attached are my responses.

Please let me know if I can be helpful in additional ways.

Yours sincerely,

George A. Bermann
Walter Gellhorn Professor of Law, Jean Monnet Professor of European Union Law, and Director, European Legal Studies Center

Response by **PROFESSOR GEORGE A. BERMANN**
to follow-up questions
from the
SUBCOMMITTEE ON ANTITRUST, COMPETITION POLICY AND CONSUMER RIGHTS
UNITED STATES SENATE COMMITTEE ON THE JUDICIARY

Follow-up questions from Senator DeWine:

1. On the one hand, I believe that NOPEC would operate not only to insulate antitrust suits from defenses based on the "act of state" doctrine, but also from the closely related "political question" doctrine.

On the other hand, arguably, international comity considerations might cause courts not to apply the Sherman and/or Clayton Acts to scenarios in which important regulatory interests of other countries are involved and in which there is a serious risk that application of our legislation to those scenarios will create conflicts with the policies of those other countries. Again arguably, the Supreme Court decision in *Hartford Insurance Co. v. California*, 509 U.S. 764 (1993), could produce that result, as could application of the principle set forth in Sections 403 and 415 of the Restatement (Third) of Foreign Relations.

However, it should be remembered that conflict with other countries' policies does not in itself prevent application of U.S. regulatory law to international scenarios. In the presence of such a conflict, the courts would still proceed to a balancing analysis along the lines of *Hartford Insurance* or the Restatement. In the end, it seems to me unlikely that application of the antitrust laws to the OPEC cartel would be considered "unreasonable" under these standards. I further believe that the specificity of congressional intent embodied in NOPEC would seriously blunt any such risk.

2. NOPEC does need to specify whether the contemplated enforcement is civil or criminal or both.

3. As noted above, I think one effect of NOPEC would be to render application of the "political question" doctrine unlikely, whether action were brought by the Department of Justice or the Federal Trade Commission.

It is crucial, as I mentioned in my testimony, to clarify whether these bodies' standing to proceed against OPEC is exclusive or not. My assumption had been that that was NOPEC's intention, but the bill's language is quite unclear as to that. There is much to be said for exclusivity.

Follow-up questions from Senator Kohl:

1. I cannot say why the FTC and Justice Department have desisted from filing suit. I do not know to what extent anticipation of the act of state doctrine, political question doctrine or

objections based on international comity will explain it.

Passage of NOPEC will, as my answer to Senator DeWine's first question indicated, largely remove any legal barriers. However, it is entirely possible that the FTC and Justice Department may remain reluctant to act. Removal of the act of state doctrine and political question doctrine would presumably prevent the courts from throwing any such suit, but I do not see how they can require the FTC or Justice Department to bring such a suit.

2(a): If the members of OPEC were private companies rather than foreign nations, they would most certainly be subject to litigation under the antitrust laws and they would almost certainly be found to incur liability .

2(b): The only other conceivably principled difference is that the OPEC nations are managing their essential natural resources. I do not think that should in the end make a difference, but it might to some, including some courts.

3: It would remove the leading legal obstacles to the bringing of antitrust actions against OPEC or the OPEC countries. (However, as mentioned above, it does not, as drafted, compel such actions to be brought.)

4. I believe it is reasonably clear that the Sherman Act would authorize injunctive relief under these circumstances. But, for some reason, litigants have added Clayton Act claims to shore up their requests for injunctive relief. I would suggest that you inquire among antitrust law experts as to the putative advantages of the Clayton over the Sherman Act in respect of injunctive relief.

Follow-up questions from Senator Craig:

1-3. As other than an economist, I defer to the other witnesses with respect to these questions.

4. The original Sherman Act gives no indication, one way or the other, as to its international scope, and I do not believe that its legislative history does either. However, the Federal Trade Antitrust Improvements Act of 1982 specifically addresses the circumstance sunder which the antitrust laws "shall ... apply to conduct involving trade or commerce .... with foreign nations," as does Section 415 of the Restatement (Third) of Foreign Relations.

George A. Bermann
Walter Gellhorn Professor of Law and Jean Monnet
Professor of European Union Law
Columbia University School of Law
New York, New York

May 3, 2004

Gasoline Price Hearing Questions From Senator Craig

We have been experiencing a period of sustained high oil prices. Do you think that the investment community now "believes" that these high prices are the new reality?

To the extent that high oil prices have slowed the economy and depressed stock prices, the investment community has adapted to the new reality.

Has the industry accepted the high prices to the point that investment behavior and expectations have changed?

The industry has accepted the high price as a profit opportunity and has adjusted its behavior to increase profits. It has not taken it as a signal to invest in exploration or accelerate development and production from existing fields. In fact, the industry is producing a smaller percentage of its reserves and holding back on investing in exploration.

Do you think that the root of current oil price volatility can be traced to OPEC cuts?

Only in part. Domestic prices are high because of both record high international crude prices and record high domestic margins on refining and marketing. Moreover, when international crude prices rise, domestic prices follow. That does not happen in all oil producing nations. Of the recent price increases, half can be traced to the domestic spread and almost one quarter to increases in domestic crude prices.

Job Loss Question

A recent Energy Journal article entitled "Oil Price Shocks and the Macroeconomy" (written by an energy consultant, a researcher at the Oak Ridge National Laboratory and a DOE staffer) examined the link between oil price shocks and job losses. One of the studies reviewed in the article concluded that

(1) An oil price increase results in twice as many job losses as an interest rate increase; and
(2) The economy loses 10 times as many jobs following an oil price increase as it adds after an oil price decline.

What are your thoughts on this analysis?

It has now become quite clear that oil price increases depress spending, increase inflation and drag down the economy. Every major oil price increase was followed by a recession. Recent job figures indicate that this historic relationship still holds.

Strategic Petroleum Reserve

What kind of impact would a diversion of SPR volumes have on the market place and prices for consumers?

Little, if any impact. While it does not make sense to continue filling the strategic petroleum reserve with the most expansive oil in history, it is a mistake to believe that ceasing the fill will significantly affect world oil prices.

Questions Submitted by Senator Patrick Leahy Hearing before the Committee on the Judiciary "Crude Oil: The Source of Higher Gas Prices?" April 16, 2004

Questions for Dr. Mark Cooper, Director of Research, Consumer Federation of America

Your analysis indicates that the "domestic spread," defined as the share of the pump price accounted for by the refining and marketing of gasoline, "increased somewhat in 2000, but it moved up more sharply after the election, peaking in the spring of 2001."

What should the Administration be doing to address your concerns about the "domestic price spread"?

My testimony outlined the long-term solution that we have been advocating since mid-2001.

The administration should move aggressively to alleviate pressures on both domestic and global markets by increasing fuel efficiency and reducing demand.

An inventory of refineries closed in the past ten years should be conducted to identify the best candidates for reopening.

Requirements to maintain stocks on hand to meet surges in demand should be implemented.

The President should jaw bone the industry to lower its record domestic margins and profits.

I am concerned about potential high prices for heating oil for next winter in Vermont, and in other northern states.

What are your thoughts regarding the potential for significantly higher heating oil costs later this year – does your analysis suggest consumers will continue to be burdened by record high prices?

Our analysis shows that heating oil spreads jumped up sharply since the November 2000 election. With oil prices high and domestic markets concentrated and tight, the likelihood of continued high prices is very high.

Response to follow-up questions for John Felmy of the American Petroleum Institute from the Antitrust, Competition Policy, and Consumer Rights Subcommittee hearing entitled "Crude Oil: The Source of Higher Gas Prices?" on April 7, 2004.

May 27, 2004

American Petroleum Institute
1220 L Street, NW
Washington, DC 20007
202-682-8000

Response to Questions from Senator DeWine:

1) The volatility in prices we see today is the direct result of the tight balance between supply and demand in both the crude and gasoline markets. Tight supplies have historically pushed prices higher, as buyers bid prices upward to ensure their customers have supplies they need. In a tight market, even small changes in supply have been known to have a dramatic impact on prices. The confluence of many factors such as fears of OPEC supply-cuts, tensions in Venezuela, instability in the Middle East, exploding demand in Asia and limited global refining capacity are all having influencing gasoline prices. Furthermore, US energy policy does not address these needs in a comprehensive, consistent, or adequate manner. Comprehensive energy legislation is needed to mend the fragmented energy policy of the United States and hedge against further volatility in the global marketplace. The comprehensive energy bill conference report to H.R.6, which is currently in the Senate, contains the requisite provisions that will help mitigate the risks of the current energy situation, and put the United States on a solid energy footing.

2) There is no one thing that will lower gasoline prices in the short-run. Fragmented, ad hoc policy measures are a major cause of the United States' current vulnerability to volatile oil prices. The unprecedented global economic growth of the past two decades has also inflated global demand for oil to exceptional levels. Therefore, it is necessary to have a comprehensive, focused, and modern energy policy to facilitate reliable future energy supplies. Such legislation exists in the comprehensive energy bill conference report to H.R.6.

3) There are two major obstacles to expanding refining capacity: environmental and economic constraints. First, environmental regulations and community resistance make it is very difficult to site new facilities or expand existing ones. Second, fragmented energy policy and the unpredictability it creates make the necessary capital investments riskier ventures than they otherwise should. Despite the closing of refineries in the last ten years, aggregate capacity has increased more than 10 per cent. Today, refining capacity stands at 16.8 million barrels of oil per day.

4) Reopening a refinery would encounter the same hurdles as opening a new facility (See Answer 3). In addition, the older facilities would need to be rebuilt and updated to meet current safety and environmental requirements. It is not just a matter of turning on a switch and immediately adding refinery capacity.

5) When crude oil markets are tight around the world, it is difficult for refiners to significantly increase their inventories of crude, as some have urged. Crude oil stocks have been drawn down as refiners use more crude oil from inventory to keep products flowing to consumers.

6) Gasoline distributors would face the same problems as refiners, and the marketplace (thus consumers) would be adversely affected.

Response to Questions from Senator Leahy:

1) API cannot respond to a question on the economics of dairy farming or the USDA's findings. With respect to gasoline prices and oil company profitability, the first-quarter profit margins for the industry in 2004 are 6.9%, compared to a profit margin of 7.5% for all U.S. industry. Oil and natural gas industry profits are in line with, if not below the average of, American industry as a whole. This trend has persisted through the last half-decade, as oil & natural gas companies have incurred high operating costs associated with locating, developing and delivering the energy resources upon which our economy depends, while also maintaining exemplary safety and environmental standards.

2) The largest contributor to the price of gasoline is the price of crude oil. Increases in pump prices are directly correlated to increases of crude oil prices on the world market. Many factors contribute to the movement of oil prices – many of which are not dependent on domestic stimuli. The most recent run-up on prices can be attributed to the following factors: exploding global demand in burgeoning economies (namely China and India); higher energy demand due to the current US economic boom; uncertainty created by fears of supply cuts; instability in Venezuela and the Middle East; threats of terrorism; a weak dollar; and fragmented energy policy. The confluences of disparate factors do not have a simple short-term fix. The most sensible solution is to implement a comprehensive energy policy that addresses domestic gasoline markets, new sources of production, energy efficiency, and alternative forms of energy.

Response to Questions from Senator Kohl:

1) It is nearly impossible to predict the historical price of oil without OPEC. There are simply too many factors involved to revise the economic history of the world since 1970.

2) The Federal Trade Commission testified before the Senate Judiciary Committee on April 7, 2004, that "changes in crude oil prices account for 85% of the variability of gasoline prices." As reported to Congress in a letter from API dated May 20, 2004, $0.99 of every gallon of gasoline was attributable to the cost of crude oil. On average state and local taxes accounted for $0.43 per gallon, while refining and marketing costs made up the remaining 30%.

3) Oil companies do not manipulate the supply of gasoline.

4) (a) There are two major obstacles to expanding refining capacity: environmental and economic constraints. First, environmental regulations and community resistance make it is very difficult to site new facilities or expand existing ones. Second, fragmented energy policy and the unpredictability it creates make the necessary capital investments much riskier ventures than they otherwise should be. Despite the closing of refineries in the last ten years, aggregate capacity has increased more than 10 per cent. Today, refining capacity stands at 16.8 million barrels of oil per day.

   (b) Reopening a refinery would encounter the same hurdles as opening a new facility (See Answer 4a). In addition, the older facilities would need to be rebuilt and updated to meet current safety and environmental requirements. It is not just a matter of turning on a switch and immediately adding refinery capacity.

5) (a)(b) and (c) The Federal Trade Commission (FTC) routinely scrutinizes the oil industry, its practices and structure. The FTC addressed these issues on April 7, 2004 before the Senate Judiciary Subcommittee on Antitrust, Competition Policy, and Consumer Rights.

6) Requiring refiners to keep mandatory inventories is not advisable. If companies were forced to maintain a requisite inventory, it could exacerbate the supply situation, and also force refiners to incur costs storing and maintaining these surpluses. When crude oil markets are tight around the world, it is difficult for refiners to significantly increase their inventories of crude, as some have urged. Crude oil stocks have been drawn down as refiners use more crude oil from inventory to keep products flowing to consumers.

7) It is impossible to predict what the price of gasoline will be in the next ten years. Volatility may continue if inaction persists with our national energy policy. It will be necessary over the next decade to locate, develop and deliver new forms of domestic energy. Fragmentation in policy will only continue to augment these problems, while also creating the potential for new and unforeseen difficulties in the future. It is critical, therefore, for the Senate to pass the comprehensive energy bill conference report to H.R. 6.

Response to Questions from Senator Craig:

1) API cannot answer how the investment community perceives oil price increases.

2) API cannot sufficiently answer this question as there are too many factors influencing oil price volatility. To identify one of these factors as the sole perpetrator of oil price volatility would be inaccurate.

3) The Energy Journal article is interesting, and if the conclusions are true, highlights the need for comprehensive energy legislation to address America's energy problems. API believes that the comprehensive energy bill conference report to H.R. 6 represents a national energy policy that will provide for our energy needs into the future.

4) A release of oil from the Strategic Petroleum Reserve (SPR) would have a minimal (at best) effect on gasoline prices. It is also conceivable that the effects of such a policy could be disastrous. First, the intent of the SPR is for strategic energy security purposes in times of a national disaster, war, or act of sabotage aimed at our energy supply. Releasing oil supplies from the SPR to alleviate prices would alter the purpose of the reserve to a market-fixing mechanism. When this has been done in the past, the best result was a minimal, and temporary, decrease in the price of gasoline. The long-run structural problems of tight supplies would not be addressed and it is possible that OPEC, or even non-OPEC producers, could curtail production. Furthermore, if a disaster did strike, the United States would no longer have a reliable supply of energy that could fuel the country.

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Senator DeWine, Chairman
Subcommittee on Antitrust, Competition Policy, and Consumer Rights
Committee on the Judiciary
United States Senate
Washington, DC 20510-6275

Dear Senator DeWine:

The following are answers to the follow-up questions sent to me from the Senators on the Subcommittee on Antitrust, Competition Policy, and Consumer Rights. Please let me know if you have any further questions. I hope that the hearings provided an informative discussion for the Committee members on issues affecting gasoline and crude oil prices.

Best Regards,

Justine S. Hastings

I. Follow-up Questions from Senator DeWine

1. Please explain why you oppose "Fair Wholesale Pricing" legislation.

"Fair Wholesale Price" legislation, "Zone Price Elimination", "Branded Open-Supply" legislation and "Uniform Wholesale Price" legislation are four names for legislation that are aimed at eliminating wholesale price discrimination by refiners to their lessee-dealer or contract dealer stations.[1,2]

Currently refiners price discriminate between their lessee dealer and contract dealer stations – charging different prices to different retailers based on the competitive environment at their local stations. Stations in markets where customers are less price-sensitive pay a higher wholesale price than stations of the same brand in markets where customers are more price-sensitive. Price discrimination happens in many markets. For example, movie theaters charge one price to a senior citizen and a higher price for non-seniors. If the government were to force movie theaters to charge one price to all customers, it is highly unlikely that they would offer everyone the senior-citizen low price. In fact, theaters may find it profit maximizing to raise all prices to the full faire. The overall price effect from the elimination of price discrimination depends on i) the price-sensitivity of seniors, ii) the price-sensitivity of non-seniors, and ii) the relative volumes of senior and non-senior ticket sales. The same reasoning holds true in wholesale gasoline markets.

Eliminating price discrimination may i) increase or decrease average prices depending on the refiners' portfolios of stations, ii) lead to the closure of stations in highly competitive markets, ii) redistribute wealth from consumers in markets with high price-sensitivity to consumers in markets with low price sensitivity. For example, if relatively wealthy consumers purchase gasoline in markets with low price-sensitivity, eliminating price discrimination could be a very regressive policy.

2. Please explain further why independent refiners and retailers are important for competition, and discuss any specific proposals on how to preserve independent refiners and retailers in an efficient market.

Independent refiners have a different competitive behavior than integrated refiners in particular in markets with market power at the wholesale level. If refiners can influence wholesale prices in a market, then an integrated refiner may have an incentive to increase wholesale input costs to independent retailers in order to increase its own profits at the retail level.[3] If the integrated refiner's retail segment competes with independent retail stations, the integrated refiner can increase its retail profits by increasing the wholesale gasoline cost to its retail competitors. An unintegrated (or independent) refiner cannot benefit from this cost-raising strategy.

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[1] Estimation of the effects of the elimination of wholesale price discrimination is the focus of a current research project that I am completing. The project is funded by the National Science Foundation, award abstract #0242112.

[2] For an explanation of vertical contracts and corresponding pricing mechanisms between refiners and retailers, please see my written statement before the California State Assembly hearings in April 2004.

[3] See J. Hastings and R. Gilbert "Vertical Integration in Gasoline Supply: An Empirical Test of Raising Rivals' Costs," University of California Energy Institute Working Paper #84 (2001), and J. Hastings written statement before the United States Senate, Committee on Governmental Affairs, Permanent Subcommittee on investigations, pp. 5-6.

In addition, the unintegrated refiner sells commodity gasoline at the distribution rack. Customers can purchase this homogeneous product from the supplier posting the lowest price. Hence, the unbranded wholesale market is very competitive provided that there are enough firms with sufficient quantity to compete in this market.

Independent retailers are also important for competition because i) they have less product differentiation than branded stations, leading to more intense price competition, ii) they can switch refiner/suppliers without cost, making demand for unbranded wholesale gasoline perfectly elastic, leading to highly competitive prices (assuming that there is not substantial monopoly power in the unbranded wholesale gasoline market). Therefore they increase competition in wholesale and retail markets.[4]

To further understand the effects of independent retailers and independent refiner/wholesalers on retail and wholesale prices, please see the discussion in my written statement before the California State Assembly (April 2004) and my statement, the statement of Professor R. Preston McAfee, and the staff report presented at the United States Senate, Committee on Governmental Affairs, Permanent Subcommittee on Investigations (US Senate PSI) hearings and report on "Gasoline Prices: How are they Set?"

Possible Proposals:

i. The design of environmental regulation should always incorporate secondary effects on market structure and competition in order to design and implement policy in an efficient and optimal manner.
ii. Regulations such as "Below Cost Pricing" or "Minimum Markup Laws" should not be passed.[5] They are typically aimed at reducing price competition at the retail gasoline level, particularly from independent, unbranded retail chains. The justification for reducing price competition is often based on a predatory-pricing argument that does not seem credibly given the market characteristics of retail gasoline markets.

II. Follow-up Questions from Senator Kohl:

1.

a. How important is OPIEC in setting the world price of crude oil?

OPEC is a cartel that can significantly affect the world price of crude oil. Jointly, the cartel can influence market price by restricting output below competitive levels. It is not clear how successful the cartel has been over their history at maintaining cartel prices. I am not aware of an academic study that has assessed the success of the OPEC cartel in maintaining crude oil prices at higher than competitive levels.

b. In your view, how responsible is the price of crude oil for the rising price of gasoline?

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[4] For the effects of independent retailers on retail prices see for example, Margaret Slade (*International Journal of Industrial Organization*, December 1986), Janet Netz and Beck Taylor (*Review of Economics and Statistics*, February 2002) and Justine Hastings (*American Economic Review* March 2004).

[5] One such law was just passed in the state of New York this past April. It is called the New York Motor Fuels Marketing Practices Act.

The price of crude oil is a highly significant determinant of the price of gasoline nationwide. Please see the answer to the next question.

c. Do you agree with Mr. Kovacic's statement in his written testimony that the price of crude oil accounts for 85% of the variability in the price of gasoline in the United States?

Crude oil price levels explain a substantial amount of the variation in gasoline prices across the United States. This is evident in Table 1 presented in my written testimony submitted to the committee. These very simple statistics based on very limited data suggest that the majority of variation in retail prices is explained by variation in the price of crude oil.

However, in some markets (California, Arizona, Illinois), crude oil prices explain less of the variation in gasoline prices. Another example is given in Table 2 of my written statement before the California State Assembly in April of this year. Comparing the crude oil price spike of October, 1990 and the spike of March, 2003 we see that the inflation-adjusted difference between retail prices and crude oil prices is the same for markets in Texas and Utah, but the difference has more than doubled in California markets. Hence, based on the 1990 difference between retail and crude oil prices, the crude oil price explained only around a half of the retail price levels in California in March of 2003. For a discussion of the factors that affect California retail gasoline prices, please see my written statement and the written statement of Professor Richard J. Gilbert before the California State Assembly, and my written statement and the written statement of R. Preston McAfee before the US Senate PSI.

2. Do you believe that oil companies and refiners have an incentive to keep supplies off the market, or to keep supplies tight, in order to gain market powe r and drive up prices? Does this happen and what can we do to prevent this?

A company only has incentive to restrict supply if they can raise prices and increase profits by doing so. A firm must have significant market power in order for a unilateral decrease in supply to be profitable. There are only two fairly recent instances that I know of where there has been direct evidence of companies with market power unilaterally acting to restrict supply in order to increase profits in the gasoline industry.

The first is evidence that British Petroleum exercised market power by exporting crude oil to Asia in order to raise the spot price of Alaskan North Slope crude oil on the West Coast.[6] The second event was evidence of unilateral exercise of market power uncovered in the Federal Trade Commission's report, "Midwest Gasoline Price Investigation."[7] Some suppliers in the market for Midwest gasoline acted to unilaterally exercise market power by restricting supply in order to maximize profits by keeping prices high.[8]

What can be done? Unilateral exercise of market power that already exists is not illegal under antitrust laws. Incorporating the secondary impacts of market structure and competition into the design of environmental regulation is important in preventing inadvertent increases in market

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[6] For a discussion of this strategy please read the statement of Professor R. Preston McAfee before the United States Senate Committee on Commerce, Science and Transportation Subcommittee on Consumer Affairs, Foreign Commerce, and Tourism on April 25, 2001.

[7] http://www.ftc.gov/opa/2001/03/midwest.htm.

[8] See the Federal Trade Commission's report mentioned above, as well as the report issued by the US Senate PSI report on "Gas Prices: How Are They Set?", May 2002, pp. 145-150.

power due to regulation. In addition, taking actions to increase the amount of independent academic research into market structure, firm strategy and behavior, and competition in energy markets is also a key to creating a base of knowledge from which to assess the impacts of regulatory policy on market structure.

3. What is your explanation for the number of refinery closures and the lack of refinery openings during the past 20 years?

My understanding, although I am not an expert on this, is that many refineries closed during the 1980's in response to deregulation of 1970's policies created during the oil crisis. Further refinery closures may be due to environmental regulation and the cost of compliance for smaller refiners with reformulated fuels and other requirements, or to strategic capacity decisions in response to localized gasoline content regulations. The effects of i) regulation, ii) regulatory uncertainty and iii) proliferation of boutique fuels on refining capacity certainly need to be explored further. The lack of new refinery construction may be due to NIMBYism, permitting bottlenecks and the high cost of environmental compliance.[9] The non-material costs of building or expanding a refinery are substantial. Perhaps the federal government could investigate what could be done to increase the efficiency of the environmental permitting process.

4. Please explain how and why independent refiners and retailers are important for competition in retail and wholesale gasoline markets?

Please see the response to Senator DeWine's follow-up question number 2.

5.

a. In your view, has consolidation affected the price at the pump, and should we be worried that this increasing level of consolidation will make it easier for firms to exercise market power?

There is market power in some markets in the United States, and other markets are very competitive. In competitive markets there may be consolidation that will not affect the ability of firms to exercise market power. We should not be completely opposed to or worried about consolidation *in general.*

b. Do you believe that antitrust enforcement agencies have been vigilant in acting to prevent anticompetitive mergers in the gasoline industry?

The Federal Trade Commission has been acting to prevent anticompetitive mergers and design divestiture requirements that preserve the pre-merger level of competition in the market place in recent decisions on gasoline mergers as outlined in the Horizontal Merger Guidelines. In recent mergers, they have brought in top academic experts to further understand the underpinnings of competition in gasoline markets, and use this understanding to guide merger policy and enforcement.[10]

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[9] For example, in Connecticut, firms wanting to simply expand the number of racks at a distribution terminal (nothing near to building a new refinery) have experienced wait times for Title V permits in excess of 3 years.

[10] For example, the recent theoretical paper by Professors Kenneth Hendricks and R. Preston McAfee, "A Theory of Bilateral Oligopoly with Application to Mergers" was created based on data made available to these researchers during their work as experts in the ExxonMobil merger. This paper aims to incorporate

c. Has the fact that the vertical integration resulting from consolidation caused the loss of independent refiners and retailers, and therefore harmed competition and had a negative effect on price competition?

For a further understanding of market competition and independent refiners and retailers please see the answer to Senator DeWine's follow-up question number 2. Please also see my working paper with Professor Richard J. Gilbert, "Market Power, Vertical Integration, and the Wholesale Price of Gasoline" (2002). We find that in a broad panel of markets in the United States during the 1990's that both vertical and horizontal measures of wholesale and retail market structure are positively correlated with the relative price of gasoline across time and across metropolitan areas. You can find a further discussion of these findings in my written statement before the US Senate PSI.

6. Do you believe that the FTC gives appropriate weight to the vertical consequences of mergers and acquisitions in the petroleum industry?

The Federal Trade Commission and the Department of Justice have as guidelines for merger policy the 1994 Horizontal Merger Guidelines. Note that the name contains only the word *Horizontal.* There are no current associated *Vertical* Merger Guidelines. Therefore it is difficult to define the 'appropriate' weight to be given to vertical issues by these regulatory agencies. There is a large body of academic literature from the early 1990's to the present on the effects of vertical integration and contracting on conduct, market power and barriers to entry. The question may be instead whether or not the next revision or amendment or adjustment of merger guidelines should include guidelines that further incorporate vertical issues as well.[11]

7. Do you believe that we should stop filling the strategic petroleum reserve because doing so would decrease demand for oil and therefore decrease oil and gasoline prices?

I am not an expert on world crude oil markets. However, my understanding is that, in the context of the world market for crude oil, the daily volume of oil going into the reserve is a very small percentage of total market supply. A rough estimate might be one-tenth-of-one-percent. Given this, ceasing to fill the SPR is likely to have a negligible effect, if any, on the price of gasoline.

8. What is your opinion of Mark Cooper's proposal that refiners be required to keep a reserve inventory of gasoline as a buffer against supply disruption in order to prevent price spikes?

I have not looked in detail at Dr. Cooper's specific proposal. In general, streamlining environmental and related costs of increasing storage and fuel transportation capacity will lower the costs of private market provisions of storage, transportation and arbitrage, facilitating the private market efficient provision of inventory and storage, and potentia lly increasing the ability to take advantage of arbitrage opportunities.

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vertical concentration and its effects on market power and firm conduct into a basic guideline for merger policy similar to the HHI (Herfendahl Hirschman Index).

[11] For an example of an adaptation to the current HHI to incorporate vertical issues, see by Kenneth Hendricks and R. Preston McAfee, "A Theory of Bilateral Oligopoly with Application to Mergers."

III. Follow-up Questions from Senator Leahy:

1. What factors currently affect gasoline prices and how important are oil prices in determining the price of gasoline?

Crude oil price levels explain a substantial amount of the variation in gasoline prices across the United States. This is evident in Table 1 presented in my written testimony submitted to the Committee. Please see my written response to Senator Kohl's follow-up question number 1.

2. What steps could be taken to make our domestic gasoline markets more competitive?

In general, many gasoline markets in the United States are very competitive. Because regions of the country vary significantly in i) horizontal market structure, ii) vertical market structure, and iii) environmental regulations, policies that may improve competition in some markets may not be applicable to others. There are, however, several things that the federal government can do (or not do) to preserve competitive markets where they currently exist, and prevent concentrated markets from becoming more concentrated.

i. Do not pass legislation that hinders competition and unnecessarily interferes with the market place. Legislative proposals such as the following will most likely not improve competition or improve market efficiency:
   a) Minimum mark-up laws
   b) Below cost pricing laws
   c) FTC 'watch zones' or price-cap regulation
   d) Divorcement legislation
   e) Zone Price Elimination or Fair Wholesale Pricing legislation
ii. We need to be careful to understand the competitive implications of environmental policy and incorporate secondary effects on market structure and competition into our design of environmental regulation.
iii. We need to build up a knowledge base of cutting-edge academic work on market structure and competition in energy markets by facilitating secure access to energy data in the same manner that the Census Bureau currently facilitates secure academic access for empirical research to government collected census data.

IV. Follow-up Questions from Senator Craig:

1. **A recent Energy Journal article entitled "Oil Price Shocks and the Macroeconomy: What has been learned since 1996" by Donald Jones, Paul Leiby and Inja Paik, examined the link between oil price shocks and job losses. One of the studies reviewed in the article concluded that**
   a. **An oil price increase results in twice as many job losses as an interest rate increase; and**
   b. **The economy loses 10 times as many jobs following an oil price increase as it adds after an oil price decline.**

   What are your thoughts on this analysis?

The authors of the article cited above adeptly summarize the difficulties of estimating a causal relationship between oil price shocks and macroeconomic variables of interest such as

unemployment and productivity. In general, there are many factors that confound identification of causal relationships in models of the productivity and unemployment in the macro-economy. Exogenous interventions as well as treatment and control groups are difficult to identify and isolate. Oil price shocks might not be exogenous to changes in economic activity if the cartel finds collusion more difficult to sustain during times of high demand. In addition, endogenous policy responses confound attempts to separately identify their effects from those of the oil prices.

2. **What kind of impact would a diversion of SPR volumes have on the market place and prices for consumers?**

I am not an expert on world crude oil markets. However, my understanding is that, in the context of the world market for crude oil, the daily volume of oil going into the reserve is a very small percentage of total market supply. A rough estimate might be one-tenth-of-one-percent. Given this, ceasing to fill the SPR is likely to have a negligible effect, if any, on the price of gasoline.

3. **In January 2003, EIA published a paper entitled "Gasoline Price Pass-through" that concluded:**
   "[D]espite allegations of compe titive irregularities in retail markets, it appears that most of the movement in retail prices (on a national and regional basis) is predetermined by movements in spot prices."
   Do you agree or disagree with EIA's analysis?

On a national basis, it is reasonable that movements in spot prices of gasoline are substantially positively correlated with movements in retail prices. In fact, as some Senators cited a statistic during the hearings stating that approximately 85% of variation national average retail gasoline prices can be explained by variation in the spot price for crude oil. Since crude oil is the major productive input into gasoline production, this should not be surprising. Similarly, the spot price of gasoline may in many markets accurately reflect the opportunity cost for a refiner of selling a gallon of gasoline through a partially or fully integrated retail outlet. Hence, profit maximization would indicate that spot prices and retail prices should be correlated.

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

)ffice of the General Counsel

May 25, 2004

The Honorable Mike DeWine
Chairman
Subcommittee on Antitrust, Competition
Policy and Consumer Rights
Committee on the Judiciary
United States Senate 20510

Dear Senator DeWine:

I appreciated the opportunity to present the Commission's testimony at the Committee's April hearing on gasoline prices. It is important to air these issues in such a forum in order to increase transparency for consumers and market participants. This letter answers several questions for the record that were asked of me during my oral testimony and the subsequent follow-up questions provided to FTC staff.

Questions asked at the hearing

1) What avenues of retaliation would be available to OPEC if the FTC initiated an antitrust lawsuit against the government-sponsored cartel?

A U.S. government-initiated antitrust suit could provoke retaliation by OPEC countries. Retaliation is possible in the antitrust sphere because, along with the OPEC nations, the U.S. government follows a policy of requiring output restrictions and providing price supports for certain products, most notably a number of agricultural commodities. Additionally, producers of agricultural products enjoy antitrust immunity for certain joint activity.[1] Foreign trade in agricultural products occurs in an immense and complicated worldwide market and is highly contentious due to various government initiatives to protect domestic producers. Trade in

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[1] *See* Capper-Volstead Act, 7 U.S.C. § § 291-292. Section 1 of this Act provides that "persons engaged in the production of agricultural products . . . may act together . . . in collectively processing, preparing for market, handling, and marketing in interstate and foreign commerce, such products of persons so engaged."

agricultural commodities is a constant subject of negotiations conducted by the executive branch of the U.S. government. If U.S. courts were to find antitrust liability for foreign nations that coordinated output restrictions and price supports for crude oil, foreign courts might well find the same liability for similar conduct of the U.S. government over agricultural products.

In addition to specific legislation protecting and promoting agricultural products, there are at least two U.S. statutes that provide some form of antitrust immunity for joint activity designed to promote foreign sales of any U.S. products or services. Both the Webb-Pomerene Act and the Export Trading Company Act immunize joint conduct that may have otherwise anticompetitive effects overseas as long as the impact is not felt in the United States.[2] An insistence by the United States that OPEC domestic policies not have anticompetitive consequences in the United States could be met with the same demand vis a vis Webb-Pomerene associations and holders of Export Trading certificates.

Besides antitrust-related retaliation, it is probable that OPEC nations would retaliate against a successful lawsuit by trying to inflict harm to the U.S. economy in other ways that may be beyond the antitrust sphere. Nations that rely on oil revenue for a large share of their national income will likely use whatever means are available to prevent those crude oil prices from falling to a market-determined level. Those means might include placing trade restrictions against U.S. companies that face strong European and Asian competitors for sales to OPEC countries. An even more severe method of retaliation, of course, is a crude oil embargo. Those who remember gasoline lines and buying on even or odd numbered days know that OPEC is familiar with, and willing to use, an embargo to advance its interests at the expense of American consumers.

The potential for severe economic dislocation that would likely be the result of a government antitrust lawsuit against OPEC leads me to reiterate the Commission's statement before the House Judiciary Committee in March of 2000. There, the Commission noted that "a decision to bring an antitrust case against OPEC would involve not only, 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 would have profound implications for the United States, which places buying and selling restrictions on myriad products. Any decision to undertake such a challenge ought to be made at the highest levels of the Executive Branch, based on careful consideration by the Department of Justice, the Department of State, and other affected agencies."[3]

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[2] *See* Webb-Pomerene Act, 15 U.S.C. §§ 61-66; Export Trading Company Act of 1982, 15 U.S.C. § 4011-4021.

[3] Federal Trade Commission, Prepared Statement, "Competitive Problems in the Oil Industry," Richard G. Parker, Director, Bureau of Competition, Before the Committee on the Judiciary, United States House of Representatives (March 29, 2000), at 10.

2) Did the FTC take any action when natural gas prices increased substantially in the Northeast last winter?

Commission lawyers and economists made informal inquiries into the rise of natural gas prices in the Northeast during the winter of 2003-2004. These inquiries indicated that market forces were the likely cause of the price changes. Tight capacity and a long term secular increase in demand (that is, an increase persisting over more than one business cycle) have kept constant pressure on prices, and weather-related increases in demand always lead to higher prices in winter. At the retail level, natural gas prices remain regulated by the states with short-term price increases mostly limited to pass through of higher costs. Commission staff also monitored several investigations under way at the Commodity Futures Trading Commission to determine whether natural gas futures prices had been subject to manipulation by traders, but those allegations related to national markets. In January 2004, the CFTC settled charges that several firms had falsely reported natural gas prices and attempted to manipulate futures prices.[4]

The FTC has conducted several investigations involving the natural gas industry that have focused on market power issues. The most recent case helped to preserve a competitive market for the delivery of natural gas into the Kansas City area by requiring Southern Union Company to terminate an agreement to manage the Central pipeline as a condition of buying the competing Panhandle pipeline from CMS Energy.[5] Another case of this type involved a proposed merger between an electric power distributor (DTE) and a natural gas distributor (MichCon) that both serve the Detroit, Michigan area.[6] The FTC was concerned that the merger would reduce competition, for example, by reducing discounts offered by MichCon to customers contemplating investments in on-site electricity generation fueled by natural gas. DTE and MichCon competed against each other for customers who have a choice between distribution services for electricity or natural gas. The case was settled with a consent agreement by which the acquirer, DTE, divested a perpetual right to use a portion of MichCon's natural gas distribution system in the Detroit area to a new entrant. The settlement was modeled on release capacity arrangements, which were effectively implemented previously for interstate natural gas pipelines. The Commission has brought a number of other merger cases designed to insure competitive natural gas markets.[7]

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[4] Commodity Futures Trading Commission, "U.S. Commodity Futures Trading Commission Imposes a Total of $50 million in Civil Penalties on Six Energy Trading Firms," Press Release (Jan. 28, 2004).

[5] *Southern Union Co.*, FTC Dkt. C-4087 (July 22, 2003) (consent order).

[6] *DTE Energy Co.*, FTC Dkt. C-4008 (May 18, 2001) (consent order).

[7] *See Shell Oil Co.*, FTC Dkt. C-3843 (Oct. 1, 1998) (consent order); *Duke Energy Corp.*, FTC Dkt. C-3932 (May 5, 2000) (consent order); *FTC v. Questar Corp.*, No. 2:95CV 1137S (D. Utah 1995) (transaction abandoned); *Williams Cos. Inc.*, FTC Dkt. C-3817 (June 17, 1998) (consent order); *El Paso (PG&E)*, FTC Dkt. C-3997 (Jan. 30, 2001) (consent order); *El Paso (Coastal)*, FTC Dkt. C-3996 (Jan. 29, 2001) (consent order); *CMS Energy Corp.*, FTC Dkt.

Commission staff has also commented to state regulatory bodies on methods of ensuring a competitive environment for natural gas distribution during periods of market deregulation. Most recently, the staff provided comments to the Georgia Public Service Commission about proposed standards for determining whether prices for natural gas paid by retail customers are constrained by market forces.[8] Natural gas distribution is still highly regulated by the states, but efforts at deregulation are occurring in a number of states. As market forces replace regulatory regimes, efficiency in distribution should be enhanced and prices should gravitate toward their long term competitive levels. The Commission is committed to assisting the states in that process.

3) Do increases in crude oil prices increase the profits of firms in the petroleum industry?

The effect of crude oil prices on the profitability of a firm in the U.S. petroleum industry depends on that firm's position in the production and sale of crude oil. Many petroleum firms engage exclusively in the exploration and production of crude oil. As of 2003, there were about 7,000 domestic "independent" crude oil producers. These independent producers vary widely in size but have operations that are either exclusively or nearly exclusively confined to upstream operations. For these firms, an increase in world oil prices unambiguously improves profitability, while profitability suffers when crude prices fall.

Other petroleum firms only have operations confined to downstream operations, that is, refining crude oil or product transport or marketing. An increase in crude oil prices reduces the profitability of these companies. For example, a refiner that purchases all its crude oil on the market will have reduced profitability from higher crude prices. Even though such a refiner may be able to pass on all or nearly all of the increase in crude prices, quantity demanded falls in response to the higher product prices. Similarly, firms that operate product pipelines will have lower profits from higher crude oil prices to the extent that reduced product demand by end-users reduces the demand for pipeline transport. The same would be true for marketers that buy gasoline, diesel fuel and other products from refiners for resale at the wholesale or retail levels.

Many large, well-known petroleum firms are vertically integrated across upstream and downstream levels, though the extent of this integration varies from firm to firm. Even the largest integrated petroleum companies are not necessarily self-sufficient in crude oil. Many buy significant quantities of crude to supply their own refineries, although the degree they are either "long" or "short" of crude oil relative to their own refinery needs varies from firm to firm. Consequently, an increase in crude oil prices on the profits of these vertically integrated firms

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C-3877 (June 2, 1999) (consent order); *PacifiCorp.*, FTC File No. 971 0091 (Feb. 18, 1998) (proposed consent order) (transaction abandoned).

[8] Federal Trade Commission, Comment of the Staff of the Bureau of Economics and the Office of General Counsel to the Georgia Public Service Commission, "Standards for Determining Whether Natural Gas Prices Are Constrained by Market Forces," (April 25, 2003).

potentially has multiple effects: increased profitability on their own crude production, but offset to some extent by higher input costs on purchased crude and the resulting reduction in quantity demanded for refined products. While the net effect will vary from firm to firm depending on its particular circumstances as a producer and purchaser of crude oil, the crude production of the major vertically integrated firms appears typically large enough to make the first effect stronger, generally resulting in a positive relationship between crude oil prices and overall firm profitability.

4) What steps has the industry taken in recent years to increase or upgrade refining capacity?

According to Energy Information Administration ("EIA") data, the *annual* average domestic refinery atmospheric distillation capacity utilization rate reached record levels in 1997 (95.2%) and 1998 (95.6%) after rising fairly steadily since the early 1980s.[9] In more recent years, annual average distillation capacity utilization has eased somewhat, falling to 92.5% percent for 2003; refinery distillation capacity utilization for the 4 week period ending May 14, 2004 stood at 93.9%, the most recent period for which data is available.[10]

Total refinery distillation capacity has increased since 1998. Total distillation capacity was 15.71 million barrels per day ("MMBD") in 1998.[11] As of May 2004, industry distillation capacity stood at 16.89 MMBD.[12] Although no new refineries were built in the U.S. during this period, this increase of approximately 1 MMBD of industry capacity at existing facilities represents an 7.5 percent increase since 1998. This increase in crude oil distillation capacity is roughly equivalent to adding 9 average sized refineries to industry supply.

Refineries' production capabilities cannot be fully measured by crude oil distillation capacity alone. Various processing units downstream of crude oil distillation are used to break down, build up, or otherwise treat the hydrocarbon molecules in crude oil. These downstream processing units enable a refinery to use a wider range of crude oils and to make a broader array of refined products, including motor fuels with more demanding specifications. Generally increased downstream capabilities allow refiners to make more higher valued products, such as gasoline, from a given barrel of crude oil. Downstream capabilities of U.S. refiners have continued to increase over time. For example, between 1998 and 2003, total industry

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[9] Energy Information Administration, *Annual Energy Review 2002*, Table 5.9.

[10] Energy Information Administration, *Weekly Petroleum Status Report*, May 14, 2004, Table 2. Annual capacity utilization for 2003 based on average of reported monthly capacity utilization rates.

[11] Energy Information Administration, *Annual Energy Review 2002*, Table 5.9.

[12] Energy Information Administration, *Weekly Petroleum Status Report*, May 14, 2004, Table 2.

downstream charge capacity increased from 31.70 MMBD to 33.70 MMBD, an increase of 6.3 percent.[13]

In addition to capacity increases and upgrades at the refinery level, there have been notable improvements in product pipeline capacities in recent years. For example, the FTC examined bulk product supply conditions affecting the Midwest in its investigation of price spikes affecting that area in the spring of 2000. Since that time product pipeline capacity from the Gulf to the Midwest has increased significantly. The Centennial pipeline, with a capacity of 210 MBD, opened in 2002.[14] Explorer, another major pipeline bringing refined products from the Gulf to the Midwest, added 110 MBD of capacity in a expansion project which was completed in 2003.[15]

Follow-up Questions

Senator Kohl

1) Under current law, would the FTC or the Justice Department be likely to file suit against OPEC members for violating U.S. antitrust law? If your answer is in the negative, please explain why not – aren't cartels of competitors that limit supply or fix price illegal?

As a substantive matter, competitor cartels that limit supply or fix prices are illegal under U.S. antitrust laws. However, the U.S. antitrust agencies must account for considerations beyond the substantive merits of a case before bringing such a lawsuit. Filing an antitrust lawsuit against OPEC would be a highly complex operation. Assuming that OPEC's conduct is a per se violation of U.S. antitrust laws, there still would be numerous obstacles to the successful prosecution of the suit. The federal courts have dismissed two private lawsuits due to issues of service of process, foreign sovereign immunity, and the act of state doctrine.[16] As the courts have

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[13] Energy Information Administration, "Table 4, U.S. Refineries and Refining Capacities", available at http://www.eia.doe.gov/emeu/finance/usi&to/downstream/update/table4.html. Total downstream charge capacity includes capacities for vacuum distillation, thermal cracking, catalytic cracking, catalytic reforming, catalytic hydrocracking and catalytic hydrotreating.

[14] *See* Marathon Oil Company, "Marathon Ashland Petroleum, LLC," available at http://www.marathon.com/Our_Business/Marathon_Ashland_Petroleum_LLC/

[15] *See* Willbros Group Inc., "Explorer Mainline Expansion," available at http://www.willbros.com/pdf/0277.pdf

[16] *See Prewitt Enterprises, Inc. v. OPEC,* No. 03-11580 (11th Cir. Dec. 18, 2003) (slip op.) (affirming dismissal due to inability under the Federal Rules of Civil Procedure to serve OPEC in its Austrian headquarters without OPEC's consent); *International Association of Machinists v. OPEC,* 477 F.Supp 553 (C.D. Cal. 1979) (OPEC's actions protected by the Foreign

interpreted these issues in the two private lawsuits, it seems unlikely that a government antitrust lawsuit would prevail under current law. Further, as discussed above, other practical and policy factors may affect the value of a lawsuit.[17]

2) I am very concerned by the FTC's conclusion [in the Midwest Gasoline Report] that oil companies can manipulate shortages in supply to drive up gas prices. Is there nothing the FTC can do to prevent such behavior? Why or why or not?

The Commission's investigation of the gasoline price spike in the Midwest in spring 2000 concluded that a variety of factors caused the price increase in question. The primary factors were various refinery production problems and pipeline breaks, all of which contributed to low product inventories at that time. The Commission also concluded that firms made errors in forecasting on the amount of supply available from other firms and the ability of other firms to respond to any shortages.

The Commission found no evidence of illegal collusion to reduce output or raise price. Firms were found to have acted unilaterally and followed individual and often differing profit-maximizing strategies. There was no indication that the firms were coordinating output decisions, consistent with their errors in forecasting rivals' output abilities. Some firms made better choices than others in view of the supply disruption problems that were the primary causes of the price spike. In examining the actions of industry firms, the Commission did find that *one* firm, which had increased its gasoline production substantially, and hence was not short of product like some of its competitors, chose not to sell additional product from its inventory because market prices would be reduced as a result. The Commission did not conclude that oil companies manipulated shortages.

The firm that had decided to increase production of the relevant gasoline grade (reformulated gasoline or "RFG') found itself with unexpectedly very strong demand for its product. This firm, like any other profit-maximizing firm, decided to charge what the market would bear and to release its inventory over time consistent with profit-maximization. The one firm enjoyed higher profits for a limited period before supply problems affecting its competitors were resolved. This sort of temporary situation is not the kind of sustained market power that is the concern of antitrust enforcement. Although the Midwest price increase was severe, it was brief. As soon as prices in the Upper Midwest exceeded those in the Gulf Coast by more than normal levels, refiners took steps to increase supplies into the affected areas. This process only

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Sovereign Immunities Act), *aff'd on other grounds,* 649 F.2d 1354 (9th Cir. 1981) (dismissal affirmed due to the inappropriateness of judicial remedy under the act of state doctrine due to international comity reasons and domestic considerations of separation of powers), *cert. denied,* 454 U.S. 1163 (1982).

[17] The proposed NOPEC legislation would remove some of these obstacles to a suit against the OPEC countries, in particular foreign sovereign immunity and act of state doctrines. However, other difficulties would remain.

took a few weeks, in large part due to the time it takes additional refined product to move 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 below the level before the spike. By that time any short-run advantage enjoyed by refiners who made correct production choices and had relatively ample supply on hand would have been completely dissipated.

Absent collusion, taking advantage of a temporary inventory that other firms lack to sell at high prices does not violate the antitrust laws. There are a number of reasons why it should not do so. Our markets depend on investors supplying private capital for profit to manufacture the goods and services demanded by consumers. Prices are the signal markets used to let investors know that additional capital is needed in any particular market. If an investor guesses right and provides capital in advance of consumer demand, it would be counterproductive to take away the profits that provided the incentive to invest in the first place. Prices would not perform their proper signaling function, and investment incentives would be distorted. Fluctuating prices in response to sudden movements in demand or supply are an inevitable consequence of a market economy. When demand increases or supply decreases unexpectedly, some firms may have a temporary ability to gain extraordinary profits until demand falls or supply increases in response to the higher prices. The alternative is price regulation by the government that dampens price fluctuations in response to supply and demand changes. Such an intrusive regulatory system imposes its high price on consumers.

3) (a) In your view, how has [oil company] consolidation effected [sic] the price consumers pay for gasoline?

I do not believe that industry consolidation has resulted in anticompetitive price increases for gasoline or other refined products. The FTC has successfully challenged all instances where mergers threatened increases in market concentration, which after taking other factors into account (such as entry), were large enough to increase significantly the likelihood of collusion or unilateral market power. It should also be noted that petroleum mergers may generate cost savings, and to the extent markets remain competitive, savings will be passed on to consumers in the form of lower prices than would otherwise exist.

In each of the mergers listed in the question as examples of major oil company consolidation – Exxon/Mobil, BP/Amoco, and Chevron/Texaco – the FTC required substantial relief before approving the transactions. In Exxon/Mobil, the settlement involved the sale of over 2,400 retail gasoline stations, in what was described as "the largest retail divestiture in Commission history,"[18] Exxon's Benecia, California refinery, two light products terminals, pipeline overlaps in the Southeast and Alaska, and other assets. In BP/Amoco, the FTC required the sale of 134 retail gasoline stations and nine light products terminals, and required BP to allow

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[18] FTC press release, "Exxon/Mobil Agree to Largest FTC Divestiture Ever in Order to Settle FTC Antitrust Charges; Settlement Requires Extensive Restructuring and Prevents Merger of Significant Competing U.S. Assets," November 30, 1999, at http://www.ftc.gov/opa/1999/11/exxonmobil.htm (viewed on May 10, 2004).

over 1,600 gasoline stations to switch brands with no penalty.[19] In Chevron/Texaco, the merged firm divested Texaco's interest in two joint ventures, including ownership or interest in eight refineries, 115 terminals, 13,700 branded gasoline stations, and various pipelines. The FTC also ordered divestiture of Texaco's interest in a natural gas pipeline system in the Gulf of Mexico, its interest in a fractionation plant in Texas, and its general aviation business in 14 states.[20] The FTC also required substantial relief in other industry mergers and joint ventures, including Phillips/Conoco (divestiture of two refineries and other assets) and BP Amoco/ARCO (divestiture of ARCO's interests in Alaskan North Slope oil fields and other assets).

As for merger retrospectives, FTC staff recently published a study that analyzed the price effects of the 1998 joint venture of Marathon and Ashland, a consolidation affecting refining and marketing in the Midwest which the Commission did not challenge.[21] This FTC staff study found no adverse effects at either the wholesale or retail level that could be associated with that joint venture. FTC staff is currently working on retrospectives of other petroleum mergers. FTC economists are also updating previous FTC studies on mergers and structural change in the petroleum industry. The new report, which will focus on industry developments since 1985, has two basic goals: to inform public policy concerning competition in the industry and to make more transparent how the FTC analyzes mergers and other competitive issues in the industry.

(b) In light of this consolidation, do you believe that the FTC has been sufficiently vigilant with regards to consolidation in this industry?

Yes. The FTC has reviewed every significant petroleum industry merger since the early 1980s. During that time the FTC has taken enforcement actions whenever mergers were likely to have resulted in significant reductions in competition. These enforcement actions have remedied potential problems in over 200 relevant markets. The Commission recently released data on past merger enforcement that showed almost all of the enforcement actions taken in moderately concentrated markets were in the oil industry. We believe FTC merger policy has been vigilant

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[19] FTC press release, "BP/AMOCO Agree to Divest Gas Stations and Terminals to Satisfy FTC Antitrust Concerns; Gas Stations in 30 Southeast and Midwest Markets Affected, Nine Petroleum Terminals To Be Divested," December 30, 1998, at http://www.ftc.gov/opa/1998/12/bpamoco.htm (viewed on May 10, 2004).

[20] FTC press release, "FTC Consent Agreement Allows the Merger of Chevron Corp. and Texaco Inc., Preserves Market Competition; Order Would Require Texaco to Exit Existing Equilon and Motiva Joint Ventures," September 7, 2001, at http://www.ftc.gov/opa/2001/09/chevtex.htm (viewed on May 10, 2004).

[21] Christopher T. Taylor and Daniel S. Hosken, "The Economic Effects of the Marathon-Ashland Joint Venture: The Importance of Industry Supply Shocks and Vertical Market Structure," FTC Working Paper No. 270, March 2004, at http://www.ftc.gov/be/workpapers/wp270.pdf (viewed on May 19, 2004).

and aggressive, and has helped insure a highly competitive oil industry at all levels of distribution.

4) Academic studies, including those of our witness Professor Hastings, have found that the presence of independent retailers and refiners in a market keeps prices down. Please explain how the FTC addresses the loss of independent retailers and refiners resulting from mergers and acquisitions in the petroleum industry in its consideration of these transactions.

First, our analysis of industry developments over the last decade finds no significant trend towards increased vertical integration between refining and marketing in recent years; that is, toward overall loss of independent retailers and refiners. The extent of vertical integration between refining and marketing differs across the nation. Although there are instances when independent retailers and refiners have been acquired or have exited the market, there have been other cases when such entities have either entered or expanded. Independent refiners such as Valero, Tesoro and Premcor have risen to national prominence in recent years. Major integrated refiners such as BP, Shell, ConocoPhillips have sold refineries to such firms, sometimes as part of FTC divestiture requirements, sometimes voluntarily. Recently, ConocoPhillips divested most of its marketing assets in the Northeast, although it remains in the refining business in that area. At retail, firms independent of the major oil companies, including chains such as Sheetz, WaWa, and Racetrac, and hypermarkets such as Wal-Mart and Costco, have increased their share in many areas.

With regard to the treatment of independents in antitrust analysis, the FTC's overall approach is to examine each merger at each relevant level of the industry and to consider theories of anticompetitive behavior arising from vertical integration when appropriate. Because much of the economics literature on vertical integration suggests that vertical integration can have substantial consumer benefits, including reductions in transactions costs and elimination of successive markups between different industry levels,[22] it is important to examine each transaction on its own merits.[23] In examining horizontal merger overlaps, the FTC takes into account vertical aspects of the relevant markets, especially as those aspects may affect entry conditions. For example, entry conditions into gasoline marketing may be more difficult in some

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[22] For example, see Jeffrey Church and Roger Ware, *Industrial Organization: A Strategic Approach*, 2000, pp. 684-86.

[23] Dr. Hastings analyses, referred to in the question, have a number of methodological issues and the results have multiple interpretations. In the paper examining the ARCO-Thrifty transaction the price effect she finds may be due to re-branding and not vertical integration. In the paper examining the Tosco-Unocal transaction, there is no examination of how this transaction affected retail prices. In examining the effects of a vertical merger it is crucial to look at retail, and not simply wholesale, prices. The vast majority of academic studies examining the effects of vertical integration in the petroleum industry conclude that vertical integration lowers gasoline prices.

geographic areas where refiners are extensively integrated into retailing or have contractual relationships with distributors (often referred to as "jobbers") which makes it difficult for many jobbers to switch to an entering brand.

5) What is the basis for your statement in your written testimony that the price of crude oil accounts for 85% of the variability in the price of gasoline in the United States?

A regression of the monthly average national price of gasoline (excluding taxes) on the monthly average price of WTI crude shows that the variation in the price of crude explains approximately 85 percent of the variation in the price of gasoline. Data are from the Energy Information Administration and for the period between January 1984 through October 2003. Regressions based on time periods shorter than this approximately 20 year span may show either a lesser or greater amount of the variability in gasoline prices explained by crude oil prices.

This estimate is consistent with Dr. Hastings' testimony at these hearings. She calculated gasoline price/crude oil price correlations at the state level (for an unknown time period). For the fifteen states reported in her testimony, the average fraction of gasoline price variability explained by crude oil prices was 85.03 percent. As Dr. Hastings found, the correlation between gasoline prices and crude oil prices varies somewhat across the nation, although in all cases gasoline price variability is primarily due to variability in crude oil price changes. For example, Dr. Hastings found a range of approximately 70 percent for California and 91 percent for South Carolina. South Carolina uses only conventional gasoline and is supplied largely by major product pipelines which pass through the state on their way north from the large refinery centers in the Gulf. California, with its own unique fuel specification and relative isolation from refinery centers in other parts of the U.S., has historically been more susceptible to supply disruptions. These supply disruptions can cause significant gasoline price changes independent of crude oil price changes.

6) Looking into the future, how will the policies of oil-producing countries and continued global economic growth affect the price and availability of gasoline? What can we expect the price of gasoline in the United States to be in ten years? And, if you expect it to be significantly higher, what steps can we take <u>now</u> to prevent these price increases?

The price of gasoline in the United States ten years from now depends on many factors. You have mentioned several, including new sources of demand in Asia and political unrest in oil-producing countries. New sources of supply, conservation efforts and alternative energy sources for powering transportation are other important factors. These factors can be affected through efforts of private investors, consumers, the Congress, and the Administration to react to predictions of higher gasoline prices. The FTC's role will be to make sure that all facets of the oil industry, as well as alternative energy industries, face competitive markets free from collusion or unilateral exclusionary tactics. It is beyond our expertise to predict future demand and supply trends and future prices.

Senator Leahy

1) Do you agree that over the last several years the OPEC policies that require OPEC nations to tighten oil supplies have been the major determinant of crude oil – and therefore U.S. domestic gasoline – prices?

We have not studied OPEC's behavior sufficiently to offer a quantitative estimate of the impact of OPEC behavior (either jointly or the behavior of its individual members) on crude oil prices. While OPEC price and output policy clearly has affected world crude oil prices, other factors such as demand trends, output decisions of non-OPEC producers and political events also have played important roles.

2) In light of the current high price of gasoline, has the FTC taken a comprehensive look at past mergers – both those allowed and those that were blocked – to examine whether or not the FTC is meeting its goal to maintaining a competitive marketplace in its enforcement actions?

FTC economists have completed a retrospective on the Marathon-Ashland (MAP) joint venture to determine whether there was a price increase associated with this transaction, which the Commission did not challenge. This study measures the price effects in Louisville, Kentucky resulting from the MAP joint venture. MAP was an early transaction in the recent era of petroleum mergers, and it caused sizeable changes in concentration. Staff found no evidence of increased retail or wholesale gasoline prices resulting from MAP. The paper, Bureau of Economics Working Paper 270, "The Economic Effects of the Marathon - Ashland Joint Venture: The Importance of Industry Supply Shocks and Vertical Market Structure," is available at http://www.ftc.gov/be/workpapers/wp270.pdf

FTC economists are currently working on additional merger retrospectives.

Senator DeWine

1) In your written testimony you say that it is the FTC's experience that "unusual movements in gasoline prices typically appear to have a natural cause." Are "natural" market forces the principal cause for the current price increase in gasoline?

The price of West Texas Intermediate ("WTI"), an important benchmark crude oil, has increased from a low of approximately $28 a barrel in September of 2003 to over $40 a barrel in May of 2004. At $28 dollars a barrel, crude costs 67 cents per gallon and at $40 a barrel it costs 95 cents per gallon. During the same period Gulf spot gasoline prices have increased from 81 cents per gallon to $1.32 per gallon. Depending on the starting and ending points of the comparison, the change in the price of crude oil is approximately one-half of the change in the price of gasoline.

The remainder of the change in the price of gasoline is caused by several factors. These factors include increased demand and changes in gasoline supply. On top of typical seasonal increase in gasoline during this time of year, gasoline demand in the United States is 3-4 percent higher this spring than last year.[24] To put this increased demand in context, between 1993 and 2003 demand increased by less than 2 percent per year. Given a short run demand elasticity for gasoline of 0.2, all else equal a demand increase of 1 percent would lead to a 5 percent price increase in gasoline. In addition, this is the first year of lower sulfur gasoline regulations in the United States. These new sulfur regulations increase the cost of production and make it more difficult to import gasoline from outside the United States. Gasoline production is up over 4 percent from last year, but gasoline imports are 10 to 20 percent lower than this time last year.

As the price of gasoline has increased in the United States in the past few months, there have been few regional differences in the rate of increase. Prices across the United States have increased at approximately the same rate. World gasoline prices, as measured by spot prices in Rotterdam and Singapore, are very similar to the wholesale price of gasoline in the United States, suggesting that there is increased demand and tight refining capacity worldwide, not just in the United States.

2) Do you think there is any merit to the argument that the petroleum refining market is overly concentrated and therefore prone to tacit collusion?

The FTC has always been concerned about the potential for mergers in properly defined relevant markets to increase the likelihood of coordinated interaction, including tacit collusion. As a result, the FTC has taken actions to block refinery mergers when an increase in concentration may increase the likelihood of such anticompetitive behavior. For example, in recent years the FTC has challenged several refining mergers that would have increased concentration by 100 points or more in moderately concentrated markets in the production and sale of CARB gasoline, the fuel specification required for sale in California. Since the Shell/Texaco joint venture in 1997, the Commission has not allowed any increase in concentration in California.

At the same time, when the FTC has investigated petroleum markets in merger cases or in cases such as the Midwest Gas Price investigation, it has not found that refining markets have been prone to tacit collusion. Note that tacit collusion is one form of what antitrust enforcers refer to as "coordinated interaction." Coordinated interaction refers to actions by a group of firms that are profitable for each of them only as a result of the accommodating reactions (for example, output limitations) of others. Accordingly, coordinated interaction involves behavior beyond merely a firm recognizing that its output decisions may sometimes have an impact on prices or a recognition that rivals' output decisions may have discernible impact on market prices. It requires that some degree of coordination or agreement be reached between competitors. Absent that meeting of the minds, there can be no antitrust violation.

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[24] Energy Information Administration, *Weekly Petroleum Status Report*, May 14, 2004.

Senator Craig

1) We have been experiencing a period of sustained high oil prices. Do you think that the investment community now "believes" that these high prices are the new reality? Has the industry accepted the high prices to the point that investment behavior and expectations have changed? Do you think that the root of current oil price volatility can be traced to OPEC cuts?

It is not clear whether the current high prices for crude oil will be sustained for a long period. Looking at the experience of the early 1980s, crude prices rose (in 2002 dollars) from around $14 per barrel in 1979 to $35 per barrel in 1981, then returned to $23-28 between 1983 and 1985 before collapsing to $10 in July 1986.[25] An important component of future prices is the cost of drilling future production. A recent article in the *New York Times* by well-known industry analyst Daniel Yergin[26] noted that, despite predictions that the world is "running out of oil" dating back to at least the 1880s, new technology and opening or reopening of new territories, such as deep offshore fields, has allowed known reserves to grow.

Drilling activity has responded to the incentives created by higher crude oil prices. In the United States, drilling is near a two-and-a-half year high.[27] It is not clear whether this increased level of activity reflects a generally-held belief that current crude oil prices will stay at these levels for an extended period, or whether drilling will increase even more if the market comes to believe that prices will stay at current levels for an extended period.

To the extent that OPEC countries are producing less than they would choose to produce unilaterally, and to the extent that OPEC production reflects the marginal source of crude oil supply onto world markets, OPEC output restraints will have the effect of increasing crude oil prices above a competitive level. However, there is some doubt as to how effective the announced reductions in OPEC members' quotas has been. The International Energy Agency (IEA), which tracks actual OPEC production against "target" levels, reports that eight of the ten OPEC nations (excluding Iraq) exceeded the old (November 2003) quota in March, and that these nations produced at a level that would also have exceeded the lower April 2004 quota.[28]

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[25] Energy Information Administration, "Petroleum Chronology Graph," at http://www.eia.doe.gov/pub/oil_gas/petroleum/analysis_publications/chronology/petrochrohotgraph.htm, 2000 (visited 5/7/04).

[26] Daniel Yergin, "Imagining a $7-a-Gallon Future," *New York Times*, April 4, 2004.

[27] "US drilling activity continues near 31-month high," *Oil & Gas Journal*, May 7, 2004. Rig count was at 1,153 compared with 1,021 during the same period last year, an increase of 13%.

[28] International Energy Agency, "Oil Market Report, at http://omrpublic.iea.org/ (visited 5/10/04).

The IEA concluded that "the cut in the production target may be purely symbolic," and that "cuts in actual April supply are likely to be modest," with Algeria, Libya, and Qatar desiring a higher share of OPEC production and increasing production from Iraq more than offsetting small reductions from other nations.

One reason to think that current crude oil pricing is being driven by worldwide crude oil demand, rather than OPEC supply cuts, is that OPEC countries other than Saudi Arabia have little or no excess production capacity.

In addition, one component of the high price of crude oil is said to be a "terror risk premium". The price of crude oil increased following attacks on oil facilities in Iraq and Saudi Arabia. Oil industry analysts have suggested that this risk premium is in the range of four to eight dollars a barrel.[29]

2) What are your thoughts on the analysis suggesting that an oil price increase results in twice as many job losses as an interest rate increase, and that the economy loses 10 times as many jobs following an oil price increase as it adds after an oil price decline?

It is outside our expertise to assess the macroeconomic impact of crude oil price changes and interest rate changes.

3) What kind of impact would a diversion of SPR volumes have on the market place and prices for consumer?

World oil demand in 2003 was about 78 million barrels per day (b/d),[30] while scheduled deliveries to the SPR between May and October 2004 average about 140 thousand b/d, or about 0.18% of worldwide demand. This demand is roughly comparable to that from one moderately sized refinery. At the national average retail price for gasoline of 184.4 cents per gallon (cpg),[31] reducing demand by 0.18% would decrease prices by 0.8 to 1.7 cpg[32] for the duration of the

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[29] Octane Week, May 10, 2004 and New York Times, May 12, 2004.

[30] Petroleum Industry Research Foundation, Inc., "The SPR, the Royalty in Kind Program, and Oil Prices," August 2003.

[31] As of May 3, 2004. Energy Information Administration, "This Week in Petroleum," May 5, 2004.

[32] This assumes no supply response during the relevant time period, and an elasticity of demand between -0.2 and -0.4, which is in the range of most studies of gasoline demand. If the elasticity of supply is positive, the effect on price will be smaller. In addition, this assumes complete pass-through of cost reductions from crude production through refining, transportation, wholesaling, and retailing. If the effort is sufficiently short-lived, it may be the case that not all cost changes are completely passed through to consumers, and the effect on price will be smaller.

effort. Of course, there would be a corresponding price increase when shipments to the reserve resumed. The actual effect would likely be substantially smaller if other producers cut back production (or increased inventories) rather than compete against SPR crude oil.

Thank you for giving the Commission the opportunity to answer follow-up questions to the hearing and to explain more fully the Commission's work in insuring a fully competitive gasoline industry. Please do not hesitate to contact me if I may be of further assistance.

Sincerely,

William E. Kovacic
General Counsel

FTC Enforcement Actions in the Petroleum Industry, 1981-2002

Firms (Year)*	Markets Affected	Theory of Anti-competitive Effects	Post Merger Concentration (HHI) (Assuming No Relief)	FTC Enforcement Action
Mobil/ Marathon[1] (1981)	Wholesale marketing of gasoline and middle distillates in various markets in the Great Lakes area	Unilateral / Coordinated[2]	Not publicly available[3]	FTC sought preliminary injunction, but before hearings were held Mobil withdrew tender offer as a result of injunction in a separate, private litigation
Gulf/Cities Service[4] (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
	3. Pipeline transportation of refined products into the Mid Atlantic and Northeast	Unilateral[5]	Not publicly available	As above
Texaco/Getty[6] (1984)	1. Refining of light products in the Northeast[7]	Unilateral	Not publicly available	Divestiture of Texaco refinery at Westville, NJ
	2. Pipeline transportation of light products into the Northeast	Unilateral / Coordinated[8]	Not publicly available	Texaco required to support all Colonial pipeline expansions for ten years
	3. Pipeline transportation of light products into Colorado	Unilateral / Coordinated[9]	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[10]	Not publicly available	Texaco required to supply crude oil and crude pipeline access to former Getty customers under specified terms
Chevron/ Gulf[11] (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.

FTC Enforcement Actions in the Petroleum Industry, 1981-2002 *(continued)*

Firms (Year)*	Markets Affected	Theory of Anti-competitive Effects	Post Merger Concentration (HHI) (Assuming No Relief)	FTC Enforcement Action
	2. Transport of light products to the inland Southeast	Coordinated[12]	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
	4. Transport of crude oil from West Texas/New Mexico	Unilateral / Coordinated[13]	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
Conoco/ Asamera[14] (1986)	1. Bulk supply (from refineries and pipelines) of gasoline and other light products to eastern Colorado	Unilateral[15] / 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
PRI/Shell[16] (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
Sun/Atlantic[17] (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
Shell/Texaco[18] (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

FTC Enforcement Actions in the Petroleum Industry, 1981-2002 *(continued)*

Firms (Year)*	Markets Affected	Theory of Anti-competitive Effects	Post Merger Concentration (HHI) (Assuming No Relief)	FTC Enforcement Action
	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[19]	Not applicable	Ten year extension of crude oil supply agreement.
	5. Pipeline transportation of refined light products to the inland Southeast U.S.	Coordinated[20]	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
	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
BP/ Amoco[21] (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
Exxon/ Mobil[22] (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 Change >100 to Post-merger >1800 Change >50 (all inferred)	Divestiture of all Exxon (Mobil) owned outlets and assignment of agreements in the Northeast (Mid-Atlantic) region

FTC Enforcement Actions in the Petroleum Industry, 1981-2002 *(continued)*

Firms (Year)*	Markets Affected	Theory of Anti-competitive Effects	Post Merger Concentration (HHI) (Assuming No Relief)	FTC Enforcement Action
	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[23]	Post-merger >1800 (inferred)	Divestiture of either party's pipeline interest
	9. Transportation of Crude Oil from the Alaska North Slope	Coordinated[24]	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

FTC Enforcement Actions in the Petroleum Industry, 1981-2002 *(continued)*

Firms (Year)*	Markets Affected	Theory of Anti-competitive Effects	Post Merger Concentration (HHI) (Assuming No Relief)	FTC Enforcement Action
	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
	12. Refining and marketing of jet turbine oil worldwide	Unilateral[25]	Pre-merger >5625	Divestiture of Exxon jet turbine oil manufacturing facility at Bayway, NJ, with related patent licenses and intellectual property
BP/ARCO[26] (2000)	1. Production and sale of Alaska North Slope ("ANS") crude oil	Unilateral[27]	Post-merger >5476 Change 2640	FTC filed in federal District Court, then reached consent; divestiture of all of ARCO's Alaska assets[28]
	2. Bidding for ANS crude oil exploration rights in Alaska	Unilateral[29]	Post-merger >1800 (inferred) Change >50 (inferred)	As above
	3. Transportation of ANS crude oil on the Trans-Alaska Pipeline System	Unilateral / Coordinated[30]	Post-merger >5600 Change 2200	As above
	4. Future commercialization of ANS natural gas (potential competition)	Unilateral / Coordinated[31]	Not applicable	As above
	5. Crude oil transportation and storage services at Cushing, Oklahoma	Unilateral[32]	Post-merger >1849 for storage >2401 for pipelines >9025 for trading services Changes >50 (inferred)	Divestiture of all of ARCO's pipeline interests and storage assets related to Cushing
Chevron/ Texaco[33] (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

FTC Enforcement Actions in the Petroleum Industry, 1981-2002 *(continued)*

Firms (Year)*	Markets Affected	Theory of Anti-competitive Effects	Post Merger Concentration (HHI) (Assuming No Relief)	FTC Enforcement Action
	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[34]	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[35]	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[36]	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[37]	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
Valero/UDS [38] (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

FTC Enforcement Actions in the Petroleum Industry, 1981-2002 *(continued)*

Firms (Year)*	Markets Affected	Theory of Anti-competitive Effects	Post Merger Concentration (HHI) (Assuming No Relief)	FTC Enforcement Action
	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
Phillips/ Conoco[39] (2002)	1. Bulk supply (via refining or pipeline) of light petroleum products in eastern Colorado	Coordinated	Post-merger > 2600 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 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 Change > 1600	Divestiture of Phillips' terminal at Spokane
	4. Terminaling services for light products in the Wichita, Kansas area	Unilateral / Coordinated	Post-merger > 3600 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 Change > 1200	Divestiture of Phillips' propane business at Jefferson City and E. St. Louis; contracts giving buyer nondiscriminatory access to market at Conway, KS
	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[40]	Not publicly available	Divestiture of Conoco's gas gathering assets in each area

FTC Enforcement Actions in the Petroleum Industry, 1981-2002 *(continued)*

Firms (Year)*	Markets Affected	Theory of Anti-competitive Effects	Post Merger Concentration (HHI) (Assuming No Relief)	FTC Enforcement Action
	9. Fractionation of natural gas liquids at Mont Belvieu, Texas	Unilateral / Coordinated[41]	Not publicly available	Prohibitions on transfers of competitive information; voting requirements for capacity expansion
Shell/Pennzoil Quaker State[42] (2002)	Refining and marketing of paraffinic base oil in U.S. and Canada	Unilateral / Coordinated	Post-merger >2300 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

Source: Compiled from FTC complaints, orders, and analyses to aid public comment.

Note:
*This table chronologically lists enforcement actions, beginning with the FTC's first challenge of a major petroleum merger in 1981. 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 the following calendar year.

[1] 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.

[2] 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 Table 2A-1 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.

[3] 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 1000 for ten of the eighteen SMSAs and exceeded 1000 for another three.

[4] 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.

[5] 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.

[6] Texaco/Getty (1984), Complaint ¶ 15-59.

[7] 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.

[8] 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.

[9] 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.

[10] 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.

[11] Chevron/Gulf (1984), Complaint ¶ 15-41.

[12] 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.

[13] 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.

[14] Conoco/Asamera (1986), Complaint that the Commission voted to pursue.

[15] The Preliminary Injunction Complaint in Conoco/Asamera alleged that the merger would create a dominant firm in the relevant markets. Conoco/Asamera (1986), Complaint that the Commission voted to pursue ¶ 15.

[16] FRI/Shell (1987), Complaint ¶ 6-12.

[17] Sun/Atlantic (1988), Complaint and Order.

[18] Shell/Texaco (1997), Complaint ¶ 10-37; Analysis of Proposed Consent Order to Aid Public Comment.

[19] 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.

[20] Shell owned 24% of Plantation Pipeline and Texaco owned 14% of Colonial Pipeline. Shell/Texaco (1997), Complaint ¶ 32.

[21] BP/Amoco (1998), Complaint ¶ 8-21; Analysis of Proposed Consent Order to Aid Public Comment.

[22] Exxon/Mobil (1999), Complaint ¶ 8-54; Analysis of Proposed Consent Order to Aid Public Comment.

[23] Exxon owned 49% of Plantation Pipeline and Mobil owned 11% of Colonial Pipeline. Exxon/Mobil (1999), Complaint ¶ 13.

[24] Exxon and Mobil owned 20% and 3%, respectively, of the Trans-Alaska Pipeline System (TAPS), the only means of transporting Alaskan North Slope (ANS) crude oil to the port facilities at Valdez, AK. Exxon/Mobil (1999), Complaint ¶ 14.

[25] 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.

[26] BP/ARCO (2000), Complaint ¶ 10-66; Analysis of Proposed Consent Order to Aid Public Comment.

[27] 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 2836. Their contribution to the post-merger HHI would have been 5476. BP/ARCO (2000), Analysis of Proposed Consent Order to Aid Public Comment.

[28] 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.

[29] 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.

[30] BP (50%) and ARCO (22%) both held interests in TAPS. Their contribution to the HHI would have been 2984 pre-merger and 5184 post-merger. There were five other owners of TAPS; Exxon held 20% (see note 24 *supra*), 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 3400 pre-merger or of 5600 post-merger. BP/ARCO (2000), Analysis of Proposed Consent Order to Aid Public Comment.

[31] 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.

[32] 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.

[33] Chevron/Texaco (2001), Complaint ¶ 12-57; Analysis of Proposed Consent Order to Aid Public Comment.

[34] 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.

[35] 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.

[36] 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.

[37] 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 led to the sharing of competitively sensitive information and might also have permitted the merged firm to exercise unilateral market power. Chevron/Texaco (2001), Analysis of Proposed Consent Order to Aid Public Comment.

[38] Valero/UDS (2001), Complaint ¶ 13-21; Analysis of Proposed Consent Order to Aid Public Comment.

[39] Phillips/Conoco (2002), Complaint ¶ 8-135; Analysis of Proposed Consent Order to Aid Public Comment.

[40] 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.

[41] 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.

[42] Shell/Pennzoil-Quaker State (2002), Complaint, Analysis of Proposed Consent Order to Aid Public Comment.

SUBMISSIONS FOR THE RECORD

Testimony of
Prof. George A. Bermann
(Walter Gellhorn Professor of Law and Jean Monnet Professor of European Union Law
Columbia Law School, Columbia University, New York, New York)

before the Antitrust Subcommittee of the Judiciary committee of the U.S. Senate (April 7, 2004)

I have reviewed the Bill, currently under consideration in this subcommittee, designed to permit legal action to be brought in U.S. court on account of alleged price-faxing and other collective anti-competitive activity by the members of OPEC (the Oil Producing and Exporting Countries).

U.S. courts have previously held that, while OPEC is not a foreign sovereign (or foreign sovereign instrumentality) entitled to assert the defense of sovereign immunity in US court to an action brought against it under the antitrust laws, such an action cannot proceed on account of what is known as "the act of state doctrine." The act of state doctrine essentially causes courts to refrain from entertaining claims (even against non-sovereign defendants) to the extent that adjudicating them requires judging the validity of official acts taken by foreign governments in a governmental capacity on their own territory, even if those acts have effects in the US.

The proposed legislation would do several things. It would amend the Sherman Act to remove any entitlement of foreign states to invoke sovereign immunity in any suit under that Act accusing them of limiting production of oil or gas or petroleum products, fixing prices as to those products or otherwise restraining trade in them. It would reinforce this by also amending the Foreign Sovereign Immunities Act (FSIA) to establish a new exception to the principle of immunity for such claims. Finally, it would also amend the Sherman Act to render the act of state doctrine expressly inapplicable to such an action.

Let me address the issues that seem bearing most directly on the Bill's effectiveness.

1) *Congressional authority to declare a foreign state a proper defendant to a Sherman Act claims.*

I do not believe that there is any constitutional or international law impediment to Congress seeking statutorily to extend, or confirm, the application of legislation such as the Sherman Act to foreign governments. Whether to do so is a political determination for Congress to make.

Nor is it necessary that, in doing so. Congress, make foreign governments subject to the full range of claims that might be brought under such a statute. Congress is free to carve out claims relating to oil, gas and petroleum products for separate treatment and to subject foreign states to liability only as to them.

2) *Congressional authority to establish exceptions to common law principle of sovereign immunity to suit, such as an exception for Sherman Act violations in the oil, gas and petroleum products sector.*

Having declared foreign states subject to the Sherman Act in the circumstances described, the next question is whether sovereign immunity operates as a bar to the federal (or state) courts entertaining such an action.

Sovereign immunity is a common law doctrine and, as such, subject to abrogation by Congress. In enacting the FSIA in 1976, Congress confirmed the presumption of sovereign immunity, but established certain categorical exemptions, so that sovereign immunity would not be a defense to the assertion of jurisdiction or imposition of liability in a case falling within any such exemption. Congress has subsequently added to the list of exceptions. In no case has Congress' creation of exceptions to the FSIA been challenged on constitutional or international law grounds, and there is no reason to think that this Bill's creation of a new exception would be vulnerable on any such grounds.

3) *Congressional authority to declare the act of state doctrine inapplicable.*

Like sovereign immunity in the pre-FSIA days, the act of state doctrine is a common law doctrine and thus, in principle, subject to abrogation by Congress pursuant to its exercise of legislative power over interstate commerce and foreign affairs. Congress has statutorily abrogated the act of state doctrine in a few narrow circumstances, but otherwise largely left its definition and scope of application to the courts.

There is, in my judgment, no serious impediment to abrogating the act of state doctrine in the context of the class of legal actions contemplated by the Bill before you.

It is true that the doctrine has been described by the Supreme Court as predicated on the separation of powers and, to that extent, as having "constitutional underpinnings." The basic idea is that the courts should refrain from making judgments that could seriously embarrass or disrupt our country's foreign relations, relations for which our political rather than judicial branches are chiefly responsible. However, it is difficult to see how the prerogatives of the political branches would be impaired by such a Congressional declaration.

Congress is itself one of the political branches. The Executive is the other and, as I read the Bill, only the Attorney General of the United States and the Federal Trade Commission may bring an action covered by the Bill. (Admittedly, the FTC is an independent regulatory agency, rather than an executive branch agency, but I do not consider this decisive. It seems to me unlikely that the FTC would bring such an action without prior consultation of the State Department, the Justice Department and other relevant executive branch agencies.)

It is true that abrogation of the act of state doctrine in this field would deprive the

judiciary of the right to invoke or apply that doctrine, and to that extent it limits judicial freedom. But this is not the sort of limitation on freedom that concerns the constitutional separation of powers. After all, the effect of the act of state doctrine is to cause the courts *not* to exercise their otherwise proper jurisdiction, and so the only effect of the act of state doctrine's abrogation is to *free* the courts from that abstention. Far from disturbing the separation of powers, the abrogation serves to restore it.

The other "leg" of the act of state doctrine is what has come to be known as "international comity," that is to say, respect for foreign nations. Of course, for Congress to authorize suits against foreign states, and for US courts to entertain them, risks offense to foreign states, and this is a proper concern for Congress to take into account in deciding whether statutorily to abrogate the act of state doctrine under a given set of circumstances. But if Congress addresses that question and decides, in light of countervailing considerations, in favor of abrogating the act of state doctrine, there should be no constitutional or international impediment to doing so. The act of state doctrine serves to restrain the courts in circumstances when Congress *has not* expressly spoken to the question of proceeding against foreign states; it does not apply when Congress *has* expressly so spoken.

In reflecting on whether abrogating the act of state doctrine is a politically desirable or undesirable step to take, I would be influenced by knowing whether the new "enforcement" section of the Sherman Act (sec. 7A(d)) means to make the Attorney General and the Federal Trade Commission the sole and exclusive plaintiffs in Sherman Act claims under the circumstances covered by this Bill. I initially read the bill as making their "standing" exclusive, but on re-reading the legislative language I see that that is not clear. Arguably Section 7A(d) merely adds them as possible plaintiffs, without detriment to the standing of private parties to bring civil actions under the Sherman Act. From the point of view of containing damage to foreign relations, it may be preferable for the Attorney General and Federal Trade Commission to have sole authority to enforce the Sherman Act in this sphere and for the legislation clearly to so state.

4) *Other abstention doctrines.*

Admittedly, the act of state doctrine is not the only potentially applicable judicial abstention doctrine. Occasionally courts invoke the "political question" doctrine and "international comity" more generally. I do not recommend, however, that either of these be addressed specifically in the legislation. Apart from the awkwardness of doing so, I am confident that courts would read any express abrogation of the act of state doctrine in the circumstances described in the Bill as equally setting aside the application of the political question doctrine and international comity under those circumstances.

As for the defense of foreign sovereign compulsion, that is arguably a substantive legal defense to an antitrust action against private parties. I do not see how it could plausibly be invoked by the foreign sovereign itself or by a group of foreign sovereigns.

March 24, 2004

The President
The White House
Washington, D.C. 20500

Dear Mr. President:

I am concerned about the impact that rising petroleum and petroleum product prices are having on the American economy, American consumers and American jobs. The Short Term Energy Outlook released earlier this month by the Energy Information Agency (EIA) underscores these concerns:

> *"Gasoline prices remained tight and crude oil prices rose again in February [ending the month above $36/bbl]. The prospects for oil prices diminishing significantly prior to the driving season have weakened, and there is a high likelihood of additional gasoline price increases this spring. Even if unexpected significant refinery or pipeline disruptions are avoided, national monthly average regular gasoline pump prices are projected to reach a peak of about $1.83 per gallon this spring. Summer (April to September) gasoline prices are now expected to average about $1.74 per gallon this year. This would be a record in nominal dollar terms and the highest inflation-adjusted summer average since 1985. For 2004 as a whole, national regular gasoline pump prices are now expected to average $1.67 per gallon, 10 cents higher than our previous projection. About half of the increase reflects higher crude oil prices, with the remainder reflecting the impact of low inventories, robust demand, and uncertain availability of gasoline imports."*

EIA Administrator Guy Caruso testified on energy prices before the Senate Committee on Energy and Natural Resources on March 4. He stated that the average household paid $200 more for gasoline in 2003 than in the previous year. It is worth noting that the EIA data he presented were national averages for families without children. When two children are added to this calculation, along with regional factors for states like California or Texas where the average number of miles driven is greater than the national average, the combined increase in fuel costs may in fact double.

As EIA data clearly shows, fuel prices across the board are near historic highs. This includes not just gasoline, but diesel and jet fuel as well. Jet fuel prices, according to an article in USA Today last week, are at their highest level in a year, up more than 30 cents

over the last decade's average. Leading U.S. airlines increased fares by $5 last month in order to offset the high cost of fuel. The American Transport Association estimates that every penny increase in average jet fuel prices translates into increased costs for the industry of $180 million. This year's average price is running 17 cents above last year's average. If this continues, the airlines will face some $2.7 billion in increased fuel costs.

We can no longer ignore the rising cost of these important transportation fuel products, and of natural gas, that are so central to our nation's economy security. American consumers and American businesses need relief, and they need it now. I believe that there are specific steps that the Administration can take right now to relieve the current tightness in our fuels markets and to put our national fuels system on a better long-term footing.

Increasing Domestic Supplies of Natural Gas

The first set of specific steps the Administration could take to address current high prices involves increasing our domestic supply of natural gas.

- **Reprogram additional funds in FY 2004 to Federal oil and gas programs and request supplemental funds to reverse the cuts to Federal oil and gas programs in the Administration's FY 2005 Budget Request**

Federal programs to support increased domestic oil and gas production have fared poorly in your most recent Budget Request to the Congress, despite the many public statements of support for such increased production by Administration officials.

One case in point is the Oil and Gas Management Program in the Bureau of Land Management (BLM) of the Department of the Interior. This is the program that governs onshore oil and gas production on Federal lands. The 94,000 Federal onshore oil and gas wells currently account for 11 percent of U.S. natural gas production and 5 percent of our oil production. Your own Administration's figures show that there is a backlog of oil and gas lease applications and drilling permits on Federal lands of about 2,100 for the current fiscal year. Instead of taking aggressive action to reduce this backlog to zero over the next year, your latest Budget Request cuts $3 million from the budget of the Oil and Gas Management Program, with the difference to be made up by raising fees on the independent oil and gas producers for each lease application or drilling permit that they apply for.

As a result of this "status quo" level of effort in the BLM, your Budget Request estimates that the bureaucratic backlog in BLM will only decline by 200 in FY 2005, for a net backlog of 1,900 lease applications and drilling permits. This is woefully inadequate in light of current high prices. Instead of making it more costly for domestic producers to look for oil and gas on Federal lands, and doing little or nothing to make the necessary resources available in the field to speed the processing of leases and permits, the Administration should be asking Congress for a much greater increase in this budget.

I recommend that you take the following three actions to boost domestic natural gas production:

1. Request that FY 2004 funds be immediately reprogrammed to start reducing the drilling backlog at BLM;
2. Submit a supplemental request for an additional $8 million for FY 2005 to take the backlog to zero; and
3. Direct the BLM to abandon the notion of a rulemaking that would erect greater fiscal barriers to the exploration and production of oil and gas on Federal lands.

A second set of deep budget cuts affecting natural gas production can be found in your Budget Request for the Department of Energy's oil and gas R&D programs. These programs are focused on providing independent producers with access to new technologies that make domestic production of oil and gas more efficient and effective. Your Budget Request for FY 2005 cuts these programs by nearly half. One particularly important program, DOE's Petroleum Exploration and Production Research, would be slashed by 84 percent under your Administration's proposal. Again, given the need to sustain domestic production and the strong support for these programs on a bipartisan basis, these are difficult funding decisions to justify.

I recommend that, at a minimum, you submit a supplemental request of $37.1 million for FY 2005 for DOE oil and gas R&D programs, so that these programs can be maintained at their current level of funding.

Relieving Gasoline Price Pressure for Consumers

The next set of steps I would recommend deal with relieving price pressure on gasoline for consumers.

- **Temporarily suspend using royalty-in-kind oil to fill the Strategic Petroleum Reserve**

The Senate has voted in favor of temporarily suspending the use of oil taken in-kind by the Federal government to fill the Strategic Petroleum Reserve. I supported that action, proposed on a bipartisan basis by Senators Carl Levin (D-MI), Susan Collins (R-ME), and Hillary Rodham Clinton (D-NY). While the Senate vote was not binding on the Administration, the idea of not diverting oil from the market to fill the Strategic Petroleum Reserve at a time of exceptional tightness in oil markets makes sense at least as a signal to the market that the Administration recognizes the depth of economic hardship being caused by current high prices. I recommend that you direct the Secretary of Energy to suspend this policy temporarily, to be reinstated when oil prices return to more normal levels.

- **Press the Organization of Petroleum Exporting Countries (OPEC) to increase oil supply**

The Organization of Petroleum Exporting Countries (OPEC) has successfully managed the global oil market with an increasing degree of precision since its announcement in March 1998 of a pact to lower output and keep oil prices within a $22-28 per barrel price band. Supply has been tight and prices have remained high in particular over the past 12 months.

On February 10, 2004, OPEC announced a surprise agreement to cut its output quotas by 1 million barrels a day, or 4 percent, starting in March, because of concern that prices may fall once winter ends in the northern hemisphere. Meanwhile, crude oil prices in New York reached a 13-year high of $38.18 a barrel on March 17, two weeks before OPEC's next meeting.

Given the economic impact that high energy prices are having on American families and businesses, your Administration needs to act more aggressively to combat the mounting economic crisis. With a decrease in supply, the demand for oil could send prices at the gasoline pump well above $2 a gallon this summer.

It is time that this Administration use every means at its disposal to bring down high energy prices. OPEC has limited its production of oil to drive prices higher and collect additional profits. This is not acceptable. I recommend that the Administration exert diplomatic pressure on OPEC to abandon its agreement of February 10 and to increase oil supplies instead.

- **Fine-tune the current gasoline sulfur regulation to ease price pressures on consumers**

EPA is in the process of implementing a new rule on sulfur in gasoline. This rule sets the acceptable level of sulfur in gasoline at 120 ppm as of January 1, 2004. Over the next two years, this level will drop to only 30 ppm. The move to cleaner, more sulfur-free transportation fuels is necessary and should continue. The rule rewards companies that achieve early reductions in their operations' baseline level of sulfur to generate sulfur credits for use in 2005.

An additional level of special credits called "allotments" was developed to reward companies which made significant capital investment. The rule, however, does not have a reliable mechanism for independent fuel importers to participate in the system if markets are tight and the number of allotments they need to buy (to stay in compliance) are not available. I recommend that the Administration revise this rule to allow independent importers to carry a small deficit balance in case they are unable to buy enough allotments. By doing so, we will facilitate the ability to move more gasoline that is currently on the world market to U.S. consumers this summer, without compromising environmental protections.

If unexpected significant refinery or pipeline disruptions occur, or if gasoline prices rise to levels that cause significant economic harm, I recommend that your Administration be prepared to issue an emergency rule allowing the use of the sulfur credits for 2005 in this year. This additional flexibility in the use of sulfur credits would not result in any greater emission of sulfur dioxide over the two-year period of 2004-2005, but would add to the ability to bring more gasoline into the United States so that consumers are not paying more than they should.

- **Develop a national fuels strategy**

While some of the preceding actions show how fuel prices can be temporarily moderated by lowering barriers to fuels already on world markets this summer, we need to get our national fuels system in order for the longer term. Although your Administration published a general report on national energy policy in 2001, our country still lacks a focused national fuels strategy. Current policies on issues such as the operation of the Strategic Petroleum Reserve (SPR) are simply outdated. The Administration has made no progress towards stopping and reversing the increasing balkanization of U.S. fuel markets – a balkanization that hits every consumer right in the pocketbook with higher fuel prices than necessary. And there has been no attempt over the past few years to build consensus around a balanced approach to both increase the supply of refined fuels and increase the efficiency of our oil use economy-wide.

The SPR was created in 1975 in response to the fuel supply crisis we encountered due to the Arab oil embargo of 1973. Back then, the United States benefited from significant excess refining capacity and discretionary stocks. Today, nearly 30 years later, circumstances have changed considerably. Oil companies, like many U.S. businesses, have adopted just-in-time inventory management practices. Demand for transportation fuels in the U.S. has grown dramatically. Yet, we have not built any new refineries, we have just required existing ones to operate at full capacity. Our refineries are now having difficulty keeping up. Today, more than 30 percent of gasoline supplied to East Coast markets is imported.

These changed circumstances and new needs call out for a number of policy initiatives that should be undertaken as part of a broader national fuels strategy.

First, such a strategy should look at how conservation in transportation fuel use can be enhanced. Instead of debating on the merits of any single approach to the problem, it would be more productive if the Administration were to set a policy target for itself of oil savings it would like to achieve economy-wide over the next 10 years. This would give the Administration and the public a yardstick to evaluate the effectiveness of various policy proposals. Such a target would likely be broadly supported across the political spectrum. In the Senate, one such proposal for an oil savings target was supported last year by a vote of 99-1. I recommend that the Administration set such a policy target, after public consultation.

Second, the Department of Energy and the Environmental Protection Agency should start addressing the need for further refining capacity in areas, such as the East Coast, that are now importing gasoline to keep pace with demand. States, localities, consumer groups, environmental groups, and industry should all be invited to participate in a process to identify measures to facilitate capacity expansion. For such a process to succeed, there would have to be credible actions ongoing at the same time to spur increased conservation. I believe that such a process would identify the current barriers to building additional refining capacity, such as permitting and financial disincentives. I would recommend that you immediately set such a process in motion, and that you issue a report to the Congress and the public within six months, identifying specific options for improving regulatory practices or streamlining permitting processes in order to increase U.S. refining capacity.

Third, the Administration needs to review its policies regarding the operation and use of the SPR. Right now, we lack "rules of the road" for tapping the SPR that are clearly defined and clearly understood. As I have pointed out in previous letters to the Department of Energy, a clearer understanding of how SPR oil will be managed in a new environment of volatile markets and increasingly higher prices would provide more certainty to the market. That, in turn, would restrain speculative price swings when supplies are tight. I urge you to initiate a rulemaking on proper management of the SPR in a high-price environment. This should encompass a serious conversation with consumers, producers and public policy makers about how to manage our strategic oil reserves to best benefit our nation, with adequate consideration of the interests of all parties, but particularly that of consumers and the taxpayer.

Fourth, when fuel markets are tight, product flexibility is crucial. If a region needs more gasoline than its refineries can produce, or if a refinery or pipeline shuts down unexpectedly, flexibility becomes the key factor determining the speed at which motor fuels can be supplied from other regions to meet the shortfall and dampen price spikes to consumers. The proliferation of "boutique" fuel specifications across the country has greatly reduced the overall flexibility and efficiency of our fuels system. It is a major factor in the increasing fragility of our fuels system to price spikes.

The Clean Air Act authorized states to regulate fuels (through Federally-approved state implementation plans) in order to attain a national air quality standard. That was the right policy, but the implementation has been flawed. There are now dozens of different kinds of fuels being required by different States, all with Federal approval, leading to more than 110 formulations of these boutique fuels throughout the United States. These 110-plus different fuel types make the use of existing transportation infrastructure for fuels much less efficient, and correspondingly more expensive to run. Those costs get passed directly on to consumers. The large number of fuel types also limits flexibility in product distribution, particularly if a disruption occurs. Consumers pay for that lack of flexibility whenever there is a price spike.

As you may recall, your 2001 energy policy report directed the Environmental Protection Agency (EPA) to study "opportunities to maintain or improve the environmental benefits

of state and local boutique clean fuel programs while exploring ways to increase the flexibility of the fuels distribution infrastructure, improve fungibility, and provide added gasoline markets liquidity." Despite that three-year-old directive, your Administration has not taken any significant steps to reduce the growth of these boutique fuels.

I believe it is time for the Administration to take real action to reduce the proliferation of boutique fuels. This is necessary if we are to increase the ability to provide adequate supply of gasoline and other fuels in times of disruption or in tight markets, such as those we will see this summer. As a cornerstone of a national fuels policy, I recommend you direct the Administrator of the EPA, with technical assistance as needed from the Secretary of Energy, to require revisions of state implementation plans to reduce the overall number of fuel specifications by at least a factor of five, and preferably closer to a factor of ten.

- **Encourage IEA to correct its strategic stock modeling methods**

The International Energy Agency's (IEA) monthly oil market report is critically important to the global oil market. The supply, demand and stock figures that IEA projects each month literally turn markets. Energy experts tell me that the method IEA uses to calculate monthly demand and supply figures is flawed, and that it encourages OPEC to "undershoot" the market in terms of the amount of crude oil it supplies to the world market. A revision to the strategic stock calculation methodology could fix this.

The root of this flaw lies in the fact that the current IEA market report treats stocks of oil in the major consuming countries as a fixed, invariable amount. But this treatment of stocks is not realistic, and its effect on IEA's models is to bias them towards understating the amount of oil that OPEC needs to produce for the world market – the so-called "Call on OPEC." Recently it appears that OPEC has given great credence to the "Call on OPEC" in determining what it should supply to the market. Further, key OPEC nations such as Saudi Arabia have at times interpreted IEA data to mean that the IEA will not punish certain behavior by the cartel to maintain high prices, so long as they meet the "Call on OPEC" levels.

Given the importance of this IEA forecast methodology, it is crucial that it be based on the best possible real-world data, and not on a static and unrealistic treatment of stock levels. A more real-world treatment of stocks in IEA's oil forecast methodologies would alleviate some of the tension which many analysts believe is keeping crude prices higher than they otherwise might have be.

I recommend that your Administration engage vigorously with the IEA to improve the realism of the models underlying its monthly oil market report. That change, though seemingly esoteric, could make a real difference at the pump to Americans.

I believe that carrying out the 13 recommendations I have outlined in these six areas will help to relieve some of the pressure in our fuels markets that consumers will otherwise be seeing in the days and weeks ahead, and set the stage for a long-term improvement in our

fuels security. None of these 13 recommendations requires new legislative authority from Congress -- you already have the power to implement them. I hope that you will consider these recommendations and promptly take action on them.

Sincerely,

Jeff Bingaman
Ranking Member

cc: The Honorable Spencer Abraham
Secretary of Energy

Industrial Energy Consumers of America
One Thomas Circle, NW, Tenth Floor, Washington, D.C. 20005

Telephone 202-223-1661 Fax 202-530-0659 www.ieca-us.org

March 23, 2004

46 Month Natural Gas Crisis has Cost U.S. Consumers Over $130 Billion

Executive Summary

The U.S. natural gas crisis began 46 months ago in June, 2000 and has had a staggering direct and indirect economic impact on all consumers, the U.S. economy and especially on manufacturing. Residential, commercial and industrial consumers have paid $130 billion dollars more for natural gas during the 46-month natural gas crisis when compared to the price paid for the previous 46 month period, an 86 percent increase. Unfortunately, there is no end in sight to these high and sustained natural gas prices that are the highest in the world.

The increased price of natural gas has cost industrial consumers $66 billion, residential consumers $39 billion and commercial consumers $25 billion. Every penny of the $130 billion could have been prevented and was totally unnecessary. The U. S. is blessed with enormous natural gas reserves yet we do not lift drilling moratoriums.

Drilling for more natural gas and the recent California forest fires are a perfect analogy. In the name of protecting forests, certain groups fought efforts to thin the trees out and to take a balanced approach to managing the forests. Now, everyone knows that balance is needed, that forests should be thinned and there is a price to pay for inaction.

In the case of the forest fires, the people of California became the victim. In the last 46 months, all consumers, including a lot of families with fixed income, became the victim of high natural gas prices. Manufacturing workers, who lost their jobs to overseas manufacturers with cheaper natural gas, also became the victim. The jobs lost may never return.

When prices of natural gas rose significantly in June of 2000, it began to impact manufacturing jobs immediately and still is today. Manufacturing employment has fallen for 43 consecutive months. Since July 2000, the number of factory jobs is down by over 2.8 million.

Every U.S. economic recession has been preceded by high-energy prices and the recent recession was no different. IECA believes the natural gas crisis started in June 2000.

Government officials say the U.S. recession officially began in March 2001. In our view the US economy is unlikely to fully recover without globally competitive energy.

High sustained natural gas prices are a hidden tax on consumers, depressing disposable personal income and savings, and ultimately consumer spending which accounts for two-thirds of the economy. High natural gas prices are a tax on every person and company because natural gas is used as both a fuel and raw material for the production of everything from fertilizer to plastics for computers to heating homes and water. Sustained high natural gas prices impede economic growth and severely impacts competitiveness of industry.

The Real Cost is Much More

The real cost of the crisis is much more than $130 billion when one considers other direct and indirect impacts of sustained high prices on industrial and residential consumers.

The $130 billion cost estimate does not include:

- Consumption of natural gas by electric utilities and the ultimate impact high prices have caused by increasing the price of electricity.
- Lower demand for natural gas by manufacturing because of "demand destruction," caused by high prices.
- Reduction of operating rates in the manufacturing sector and the resultant loss of efficient capacity utilization caused by high natural gas prices.
- Impact to downstream customers. For example, farmers have reduced their consumption of high cost natural gas based fertilizers resulting in lower agricultural crop yields, which leads to higher food prices for all Americans.
- Loss of manufacturing jobs, plant shutdowns, corporate bankruptcies, loss of capitalization, loss of competitiveness and profitability.
- Impact to residential electricity bills, higher food cost and the difficult choices for fixed income families.
- Financial loss of corporate related tax income and higher heating and cooling bills on states, cities, county governments, school systems and financial pressure on human services.

The Impact of High Natural Gas Costs on Manufacturing is Significant

Manufacturing plays an important role in the economic health of our country and we must recognize that affordable energy, including natural gas, is essential. In the past, the affordability of U.S. energy was a key factor in manufacturing building their factories here. Now, the non-globally competitive price of natural gas and natural gas feedstock is forcing manufacturing companies to produce their products elsewhere.

According to the National Association of Manufacturers, manufacturing accounts for 22 % of GDP growth, contributes one-third of the economy's productivity growth, creates more business activity and jobs in other sectors than any other industry, performs 62 % of U.S. private sector R&D, pays the highest wages –18 % higher than the national average and makes two-thirds of all U.S. exports.

National Energy Policy Implications

The blame for these high prices does not rest on the oil and gas companies, it rests mostly on federal and state policy makers. Congress and states must work together to break the impasse between the environment and the need to increase supplies of natural gas.

Unfortunately, the end of the crisis is no-where in sight. It is the belief of the Industrial Energy Consumers of America (IECA) that the Energy Policy Act of 2003 will not by itself resolve this crisis. The legislation includes many provisions that will help but these will not be enough to turn this situation around. More is needed.

Resolving the crisis takes a combination of policies. We must increase production of natural gas and increase use of coal for base-load electricity generation. The high price of natural gas is due to the combination of relatively flat natural gas production despite increasing rig count and the significant increase in demand for natural gas by the electric utility industry

Natural gas consumption by the electric utility industry is a major problem. From 1992 to 2002 natural gas demand by the electric utility industry increased 60.5% and accounted for 93.6% of the nations' increase in natural gas demand.

According to the Energy Information Administration (EIA), US natural gas consumption from 1992 to 2002 rose 2.227 billion cubic feet/day, an increase of 11 percent. In that same time period, natural gas consumption from the electric utility industry increased by 2.085 billion cubic feet/day or 60.5 percent. The increased electric utility demand for natural gas accounted for 93.6 percent of the entire US net increase. The EIA forecasts continued large annual increases in natural gas use for power generation. This is unacceptable.

This enormous increased demand without an equivalent increase in supply has increased the price of natural gas on all consumers. The electric utility industry has alternative energy sources to produce power while industrial consumers, farmers and homeowners do not. The current situation puts consumers in competition with the electric utilities for purchases of natural gas and consumers are losing- paying both higher natural gas and electricity prices as a result.

Increasing use of coal for power generation solves this problem. Use of clean coal technology allows use of coal for power generation in an environmentally acceptable manner. Coal has several hundred years of supply and power generation using coal is a low cost option. As a power generation fuel, coal is far more reliable than natural gas

because several months of coal supply can be stored on site, while natural gas is only reliable so long as the gas flows.

Increased demand for natural gas has largely been driven by government air quality regulations. Air quality issues are important and cannot be ignored and we acknowledge the EPA/utility rule making that is underway. The Interstate Air Quality Rule and the Utility Mercury Reduction Rule must be "natural-gas-neutral". This means the EPA action on this rule must not directly or indirectly increase the demand for natural gas.

There must be a way of accommodating progress in clean air quality while not putting additional pressure on natural gas demand that is costing Americans billions in higher natural gas and electricity prices.

For more information on this report or for information on the Industrial Energy Consumers of America and how you can help increase the affordability of natural gas, please contact us at 202-223-1661 or visit us on the web at www.ieca-us.org.

Sincerely,

Paul N. Cicio
Executive Director

The Industrial Energy Consumers of America is a 501 (C) (6) nonprofit organization created to promote the interests of manufacturing companies for which the availability, use and cost of energy, power or feedstock play a significant role in their ability to compete in domestic and world markets. IECA supports a diverse, robust and affordable supply of energy. IECA membership represents a diverse set of industries including: plastics, cement, paper, food processing, chemicals, fertilizer, insulation, steel, industrial gases, pharmaceutical, and brewing. IECA board members are senior energy procurement managers.

Price Impact Calculation Methodology

The $130 billion price impact calculation uses the monthly average of the daily published closing price of the Henry Hub spot index price, considered to be the most widely used cash price index in the United States. The 46-month average price from June 2000 to March 2004 was $4.44/MM Btu. The previous 46-month average price from January 1997 through May 2000 was $2.39/MM Btu. This means consumers paid $2.05/MM Btu more for natural gas during the natural gas crisis, an 86 percent increase.

REPORT DATA

Average Price Calculation

	Dollars / MM Btu
Average price of 46 months prior to June, 2000	$2.39
Average price of 46 months starting with June, 2000	$4.44
Price Difference	$2.05
Percent change	85.8%

Price Impact Calculation on Industrial Consumers

Year	Months	Annual Volume, TCF	46 Month Volume, TCF
2000	7	9.40*	5.483
2001	12	8.45*	8.45
2002	12	8.29*	8.29
2003	12	8.06**	8.06
2004	3	8.06**	2.015

Total Volume	32.30 TCF
Total MMBtu	32,298,333,333
Cost Impact	$66,269,002,592

Price Impact Calculation on Residential Consumers

Year	Months	Annual Volume, TCF	46 Month Volume, TCF
2000	7	4.99*	2.9111
2001	12	4.78*	4.78
2002	12	4.92*	4.92
2003	12	5.07**	5.07
2004	3	5.07**	1.2675

Total Volume	18.95 TCF
Total MMBtu	18,948,333,333
Total	$38,877,769,259

Price Impact Calculation on Commercial Consumers

Year	Months	Annual Volume, TCF	46 Month Volume, TCF
2000	7	3.22*	1.878
2001	12	3.04*	3.04
2002	12	3.12*	3.12
2003	12	3.15**	3.15
2004	3	3.15**	0.7875

Total Volume	11.98 TCF
Total MMBtu	11,975,833,333
Total	$22,571,748,703

Henry Hub Monthly Average of Daily Spot Natural Gas Price

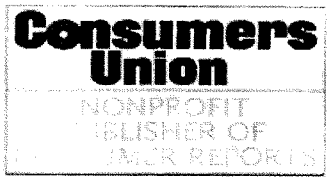
	1996	1997	1998	1999	2000	2001	2002	2003	2004
Jan		$3.99	$2.25	$1.80	$2.36	$9.91	$2.61	$4.96	$6.15
Feb		$2.96	$2.04	$1.81	$2.61	$6.22	$2.03	$5.66	$5.77
Mar		$1.78	$2.26	$1.64	$2.61	$5.03	$2.39	$9.11	$5.00
Apr		$1.85	$2.32	$1.88	$2.89	$5.35	$3.40	$5.14	
May		$2.51	$2.27	$2.35	$3.08	$4.87	$3.36	$5.12	
Jun		$2.31	$2.03	$2.23	$4.37	$3.73	$3.37	$5.95	
Jul		$2.16	$2.37	$2.28	$4.36	$3.16	$3.26	$5.30	
Aug	$2.30	$2.19	$1.93	$2.62	$3.83	$3.19	$2.95	$4.69	
Sep	$1.83	$2.57	$1.63	$2.90	$4.62	$2.34	$3.27	$4.93	
Oct	$1.85	$3.16	$2.07	$2.55	$5.29	$1.86	$3.72	$4.44	
Nov	$2.72	$3.30	$2.00	$3.06	$4.50	$3.16	$4.13	$4.45	
Dec	$3.90	$2.55	$2.12	$2.14	$6.02	$2.28	$4.13	$4.86	

1 MCF = MM Btu

* Energy Information Agency

** Estimate

March, 2004 price is an estimate



TESTIMONY OF
DR. MARK COOPER,
DIRECTOR OF RESEARCH
CONSUMER FEDERATION OF AMERICA,
ON BEHALF OF CONSUMER FEDERATION OF AMERICA
AND CONSUMERS UNION

ON

CRUDE OIL: THE SOURCE OF HIGHER PRICES?

BEFORE THE SENATE JUDICIARY COMMITTEE, ANTITRUST,
COMPETITION POLICY AND CONSUMER RIGHTS
SUBCOMMITTEE

APRIL 7, 2004

Mr. Chairman and Members of the Committee,

My name is Dr. Mark Cooper. I am Director of Research of the Consumer Federation of America. The Consumer Federation of America (CFA) is a non-profit association of 300 pro-consumer groups, which was founded in 1968 to advance the consumer interest through advocacy and education. I am also testifying on behalf of Consumers Union, the independent, non-profit publisher of *Consumer Reports*.

I greatly appreciate the opportunity to appear before you today to discuss the problem of rising gasoline prices and gasoline price spikes.

The headlines about rising energy prices that are not often written involve the structure of the domestic oil and gas industry and how this allows price manipulation at the pump.

- The gasoline refining and marketing segments of the domestic industry have increased pump prices by $50 to $60 billion in the past four years and domestic natural gas wellhead prices increased by $80 to $100 billion, separate and apart from anything that OPEC has done.

- The bottom line that is overlooked is that at least $50 to $60 billion of after tax windfall profits have gone to the domestic petroleum industry in the past four years.

- The story behind the headline numbers that does not get coverage is that a merger wave in the mid-1990s dramatically increased the concentration of the petroleum industry into the hands of a small number of giant, vertically integrated companies whose business decisions restricted capacity, undermined independents and rendered many markets uncompetitive and vulnerable to manipulation.

Decisions by the oil cartel to increase crude prices have cost consumers, but private business decisions about stockpiles and product supply, and the failure of public policy to slow the growth of demand by promoting efficiency, have cost much more.

Three years ago the analysis we provided in a report entitled *Ending the Gasoline Price Spiral*[1] showed that the explanation given by the oil industry and the Bush Administration for the high and volatile price of gasoline is so oversimplified and incomplete[2] that it must be considered at best misleading. At worst, it is wrong because it points to policies that do not address important underlying causes of the problem and therefore will not provide a solution.

- Blaming high gasoline prices on high crude oil prices ignores the fact that over the past few years the domestic refining and marketing sector have imposed larger increases on consumers at the pump than crude price increases would warrant.

- Blaming tight refinery markets on Clean Air Act requirements to reformulate gasoline ignores the fact that in the mid-1990s the industry adopted a business strategy of

mergers and acquisitions to increase profits that was intended to tighten refinery markets and reduce competition at the pump.

- Claiming that the antitrust laws have not been violated in recent price spikes ignores the fact that forces of supply and demand are weak in energy markets and that local gasoline markets have become sufficiently concentrated to allow unilateral actions by oil companies to push prices up faster and keep them higher, longer than they would be in vigorously competitive markets.

- Eliminating the small gasoline markets that result from efforts to tailor gasoline to the micro-environments of individual cities will not increase refinery capacity or improve stockpile policy to ensure lower and less volatile prices, if the same handful of companies dominate the regional markets.

- Blaming natural gas price increases on crude oil prices ignores that fact that natural gas wellhead prices have increased much faster than the price of oil. Natural gas markets lack liquidity and transparency and have been manipulated. The merger wave led by the major petroleum companies has impacted the natural gas market.

Thus, the causes of record energy prices involve a complex mix of domestic and international factors. The solution must recognize both sets of factors, but the domestic factors must play an especially large part in the solution, not only because they are directly within the control of public policy, but also because careful consideration of what can and cannot be done leads to a very different set of policy recommendations than the Administration and the industry have been pushing, or the Congress is considering in the pending energy legislation.

Because domestic resources represent a very small share of the global resources base and are relatively expensive to develop, it is folly to exclusively or predominantly pursue a supply-side solution to the energy problem. The increase in the amount of oil and gas produced in America will not be sufficient to put downward pressure on world prices; it will only increase oil company profits, especially if large subsidies are provided, as contemplated in pending energy legislation. Moreover, even if the U.S. could affect the market price of basic energy resources, which is very unlikely, that would not solve the larger structural problem in domestic markets.

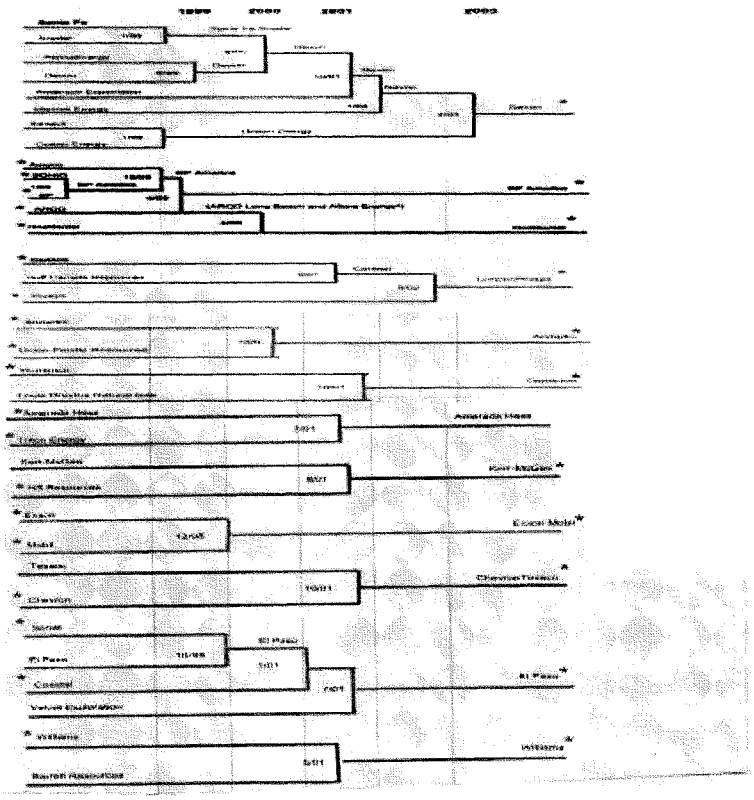
The Underlying Structural Problem in Domestic Petroleum Markets

Our analysis shows that energy markets have become tight in America because supply has become concentrated and demand growth has put pressure on energy markets. This gave a handful of large companies pricing power and rendered the energy markets vulnerable to price shocks. While the operation of the domestic energy market is complex and many factors contribute to pricing problems, one central characteristic of the industry stands out – it has become so concentrated in several parts of the country that competitive market forces are weak. Long-term strategic decisions by the industry about production capacity interact with

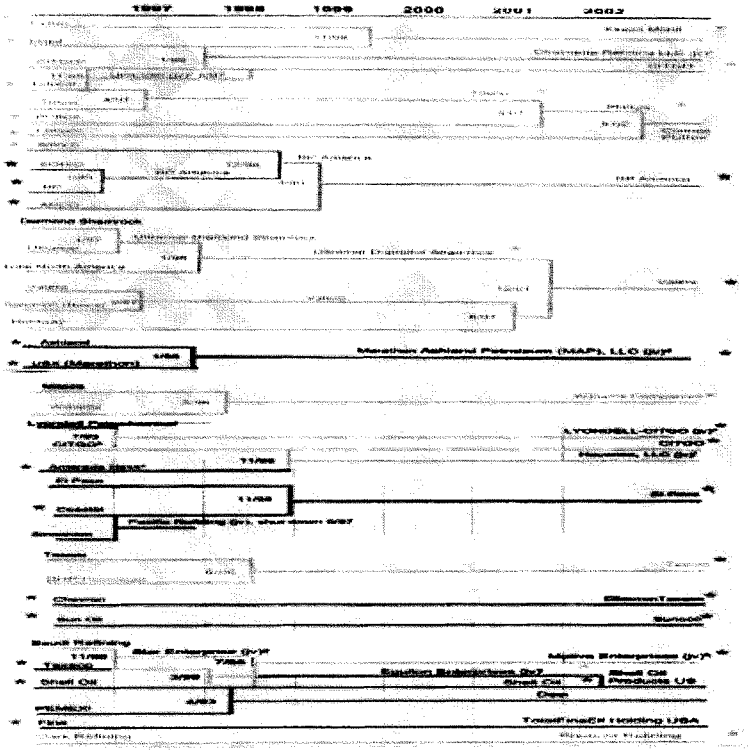
short-term (mis)management of stocks to create a tight supply situation that provides ample opportunities to push prices up quickly. Because there are few firms in the market and because consumers cannot easily cut back on energy consumption, prices hold above competitive levels for significant periods of time.

The problem is not a conspiracy, but the rational action of large companies with market power. With weak competitive market forces, individual companies have flexibility for strategic actions that raise prices and profits. Individual companies can let supplies become

RECENT MERGERS AFFECTING FRS OIL AND GAS PRODUCERS



GENEALOGY OF THE 2001 FRS REFINERS



tight in their area and keep stocks low, since there are few competitors who might counter this strategy. Companies can simply push prices up when demand increases because they have no fear that competitors will not raise prices to steal customers. Individual companies do not feel compelled to quickly increase supplies with imports, because their control of refining and distribution ensures that competitors will not be able to deliver supplies to the market in their area. Because there are so few suppliers and capacity is so tight, it is easy to keep track of potential threats to this profit maximizing strategy. Every accident or blip in the market triggers a price shock and profits mount. Moreover, operating the complex system at very high levels of capacity places strains on the physical infrastructure and renders it susceptible to accidents.

It has become evident that stocks of product are the key variables that determine price shocks. In other words, stocks are not only the key variable; they are also a strategic variable. The industry does a miserable job of managing stocks and supplying product from the consumer point of view. Policymakers have done nothing to force them to do a better job. If the industry were vigorously competitive, each firm would have to worry a great deal more about being caught with short supplies or inadequate capacity and they would hesitate to raise prices for fear of losing sales to competitors. Oil companies do not behave this way because they have power over price and can control supply. Mergers and acquisitions have created a concentrated industry in several sections of the country and segments of the industry. The amount of capacity and stocks and product on hand are no longer dictated by market forces, they can be manipulated by the oil industry oligopoly to maximize profits.

Much of this increase in industry profits, of course, has been caused by an intentional withholding of gasoline supplies by the oil industry. In a March 2001 report, the Federal Trade Commission (FTC) noted that by withholding supply, industry was able to drive prices up, and thereby maximize profits.[3] The FTC identified the complex factors in the spike and issued a warning.

> The spike appears to have been caused by a mixture of structural and operating decisions made previously (high capacity utilization, low inventory levels, the choice of ethanol as an oxygenate), unexpected occurrences (pipeline breaks, production difficulties), errors by refiners in forecasting industry supply (misestimating supply, slow reactions), and decisions by firms to maximize their profits (curtailing production, keeping available supply off the market). The damage was ultimately limited by the ability of the industry to respond to the price spike within three or four weeks with increased supply of products. However, if the problem was short-term, so too was the resolution, and similar price spikes are capable of replication. Unless gasoline demand abates or refining capacity grows, price spikes are likely to occur in the future in the Midwest and other areas of the country.[4]

A 2003 Rand study of the refinery sector reaffirmed the importance of the decisions to restrict supply. It pointed out a change in attitude in the industry, wherein "[i]ncreasing capacity and output to gain market share or to offset the cost of regulatory upgrades is now frowned upon."[5] In its place we find a "more discriminating approach to investment and supplying the market that emphasized maximizing margins and returns on investment rather than product output or market share."[6] The central tactic is to allow markets to become tight.

> Relying on… existing plant and equipment to the greatest possible extent, even if that ultimately meant curtailing output of certain refined product… openly questioned the once-universal imperative of a refinery not "going short" – that is not having enough product to meet market demand. Rather than investing in and operating refineries to ensure that markets are fully supplied all the time, refiners suggested that they were focusing first on ensuring that their branded

> retailers are adequately supplied by curtailing sales to wholesale market if needed.[7]

The Rand study drew a direct link between long-term structural changes and the behavioral changes in the industry, drawing the connection between the business strategies to increase profitability and the pricing volatility. It issued the same warning that the FTC had offered two years earlier.

> For operating companies, the elimination of excess capacity represents a significant business accomplishment: low profits in the 1980s and 1990s were blamed in part on overcapacity in the sector. Since the mid-1990s, economic performance industry-wide has recovered and reached record levels in 2001. On the other hand, for consumers, the elimination of spare capacity generates upward pressure on prices at the pump and produces short-term market vulnerabilities. Disruptions in refinery operations resulting from scheduled maintenance and overhauls or unscheduled breakdowns are more likely to lead to acute (i.e., measured in weeks) supply shortfalls and price spikes.[8]

The spikes in the refiner and marketer take at the pump in 2002, 2003 and this year, were larger than the 2000 spike that was studied by the FTC. The weeks of elevated prices now stretch into months. The market does not correct itself. The roller coaster has become a ratchet. The combination of structural changes and businesses strategies has ended up costing consumers billions of dollars. Until the Federal government is willing to step in to stop oil companies from employing this anti-consumer strategy, there is no reason to believe that they will abandon this practice on their own.

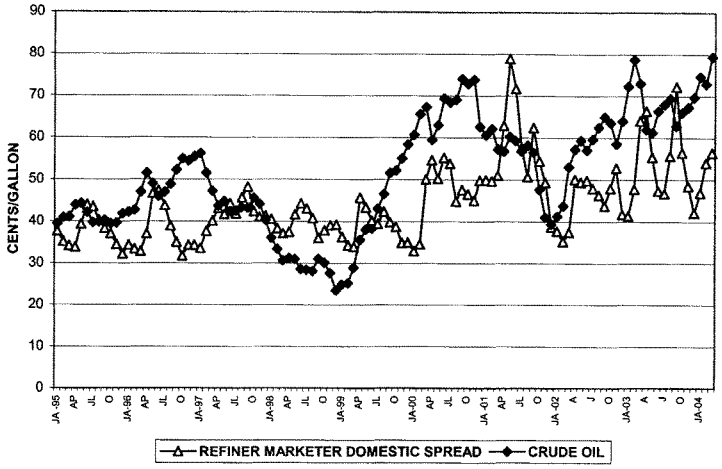
As we demonstrated in a report last year, entitled *Spring Break In the U.S. Oil Industry: Price Spikes, Excess Profits and Excuses,*[9] the structural conditions in the domestic gasoline industry have only gotten worse as demand continues to grow and mergers have been consummated. The increases in prices and industry profits should come as no surprise.

The Recent Gasoline Price Ratchets

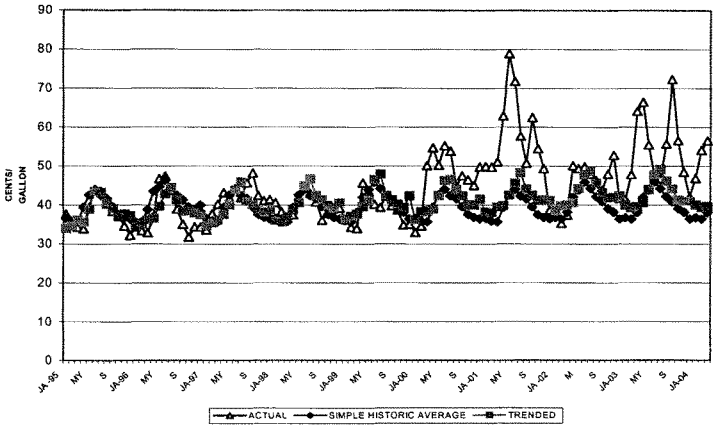
If we examine the two most important components of the pump price of gasoline, crude oil and the domestic refiner/marketer spread, we find that crude oil prices increased sharply in 1999 and 2000, peaking just before the election of 2000. However, **the record prices we see today are the result of the combination of historic highs in both crude and the domestic spread.**

The domestic spread is the share of the pump price accounted for by the refining and marketing of gasoline. It excludes the price of crude, which is set by OPEC (the Organization of the Petroleum Exporting Countries) and taxes. The domestic spread increased somewhat in 2000, but it moved up more sharply after the election, peaking in the spring of 2001. Thus, in

THE CONVERGENCE OF HIGH DOMESTIC REFINER/ MARKETER SPREADS AND CRUDE OIL HAVE PRODUCED THE RECORD HIGH GASOLINE PRICES



THE DOMESTIC SPREAD ON GASOLINE HAS SKYROCKETTED SINCE 2001



the spring of 2001, when the National Energy Policy Development Group was formed, crude oil prices were well off their historic highs, while the domestic spread was at its peak.

The price spike of early 2001, driven largely by domestic factors, was used as a justification for the formation of the National Energy Policy Development Group. The irony of the misplaced blame can be seen when we contrast crude oil pricing since January of 2001 and the domestic spread since January 2001. Crude prices fell much more than the domestic spread during the recession of winter 2001-2002. In 2003 the domestic spread spiked again before crude prices rose.

Compared to the simple historical average for the domestic spread, the domestic spread price shock resulted in increases of over $60 billion since 2000. Compared to a trended baseline, the domestic spread price shock resulted in increases of about $50 billion.

Natural Gas

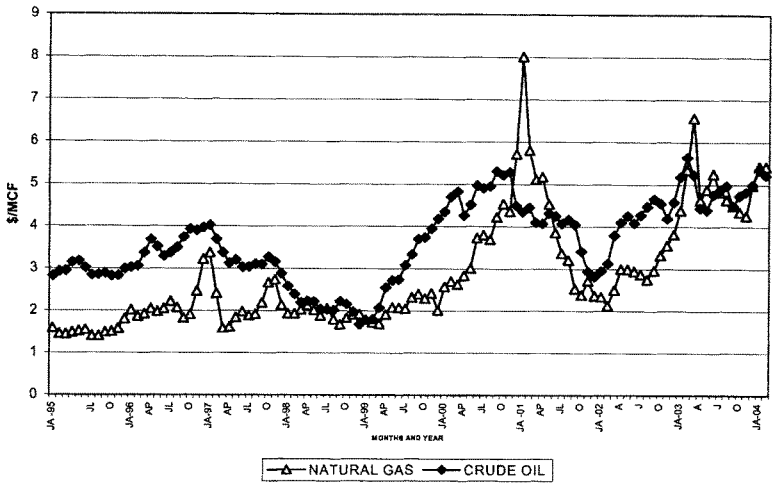
Behavior patterns in natural gas raise similar concerns. They cast doubt on the recent claim of the National Petroleum Council (NPC) that the natural gas resource base has suddenly changed.[10] First, as a factual matter, non-industry analysts disagree.[11] Second, to the extent that there is a change in resource recovery, it reflects business decisions over a number of years.

The move of the major oil companies into gas changed the nature of the sector.[12] Decisions by these majors to acquire reserves through mergers and acquisitions, rather than exploration, shifts resources.[13] Decisions about which types of wells to drill may change replacement rates.[14] Decisions about which well to produce and which well to cap, how much to inject into storage, how to use pipeline capacity and, ultimately, how to report prices, are affected by business decisions. The consolidation in the industry came hand-in-hand with the shift to acquisition of resources through mergers and a shift of drilling away from exploration. A couple of years latter the NPC concludes that a change in the understanding of the underlying resource base has occurred, when it may only be a change in the business strategies to develop the resource base that has occurred.

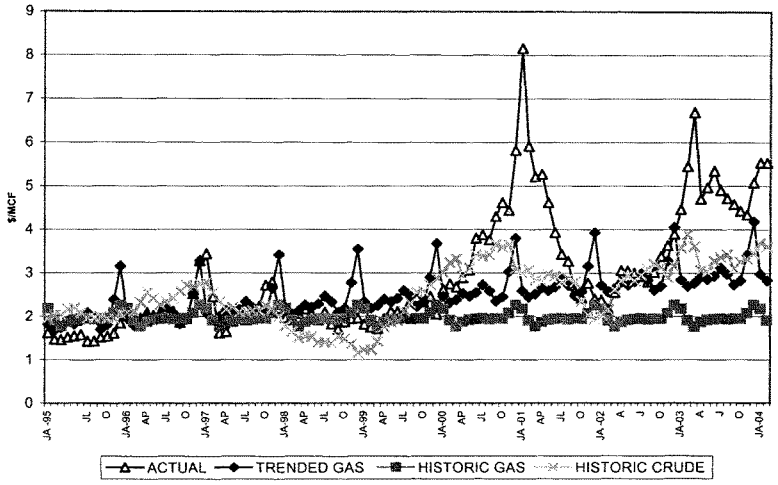
It is also important to recognize in the case of natural gas that the markets that drive the wellhead price are quite new. Most were set up in the 1990s, as part of the restructuring of the natural gas industry.[15] Enron played a large role in these markets, and when it collapsed, so too did much private trading.[16] Today, the markets are "very thin" and that raises concerns about trading, but the evidence is mounting that manipulation and abusive practices have long been part of these markets.[17]

The picture for natural gas wellhead prices is similar to the domestic spread.[18] Natural gas is overwhelmingly produced from domestic sources. There was a run-up in prices in mid-2000 and then a peak in early 2001, reinforcing the sense of an energy crisis. Prices tumbled

WELLHEAD PRICE OF NATURAL GAS



NATURAL GAS PRICES COMPARED
TO HISTORIC TRENDS



during the 2001-2002 recession, but have mounted again and have stabilized at over twice the level of the late 1990s.

We can compare the price of natural gas to the price of crude oil to isolate the change in domestic natural gas pricing behavior. It is certainly true that natural gas prices respond to oil prices, but because they are not substitutes in many uses, the correlation between the two sets of prices was moderate. Moreover, between January 1995 and January 2001, the average price of natural gas at the wellhead was 66 percent of the average price of crude oil. Since January 2001, it has averaged about 90 percent of the price of crude. The stakes are huge. The difference between a price trend for natural gas which did not close the gap with oil and what actually occurred is over $1 per thousand cubic feet (mcf), which totals to over $80 billion. Even in 2000, when domestic prices started to become volatile, it averaged 76 percent of the price of crude. Clearly, there was a shift in the domestic market behavior that started in 2000, but became most prominent in 2001 and later years.

The Industrial Energy Consumers of America used a simple average price to arrive at a much higher figure. Using their simple average, the increase since 2000 in natural gas wellhead prices would be about $150 billion. Even when stocks built up and passed historic levels, prices remained extremely high.[19] Using a trended historic gas price puts the figure at about $100 billion.

Profits

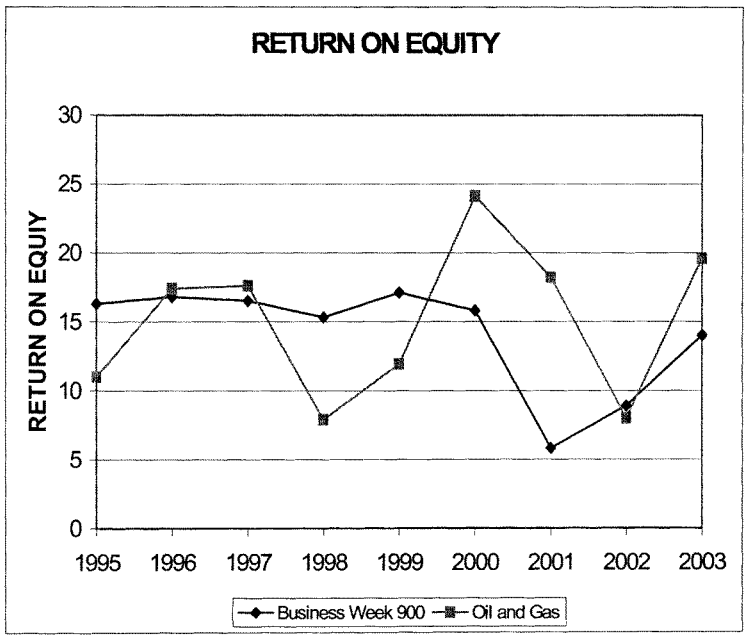
Since price increases at the pump and wellhead are not caused by cost increases, they result in increases in profits. Thus, after price, the second important indicator to which economic analysts look for signs of the exercise of market power and market failure is profits.

The bottom line, literally and figuratively, was a sharp run up in oil company profits from domestic refining and marketing in 2000 and 2001. Net operating income (income before special items and taxes) tripled from 1997-1999 to 2001.[20] While profits were down in 2002, due to very low prices early in the year as result of the severe economic downturn and travel slow-down following September 11, they skyrocketed in 2003. About half of the increase in the domestic spread has been carried to the bottom line in the form of operating income.

Since domestic petroleum companies are large owners of oil and gas reserves, they also profit from increases in the global price of oil. Starting in 2000 profits soared. *Fortune* reports return on equity of 25 percent in 2000,[21] while *Business Week* reports 22 percent.[22] This is almost twice the historic average for the industry and about 50 percent more than other large corporations achieved.[23] Profits were even higher in 2001. The weak economy lowered prices and profits early in 2002, but by the end of 2002, profits had increased dramatically and for the year, they were at about the average for the industry in the 95-99 period. The sharp price increases

in 2003 produced another very high level of profits. By the end of 2003 the industry was seeing record profits once again.[24]

If we compare the annual after-tax profits of the companies listed by *Business Week* in the oil and gas industry in the first four years of the new millennium to the last five years of the 1990s, we find a huge increase in profits. If recent profits are compared to the simple average of the 1995-1999 period, the increase is over $50 billion. This figure of $50 billion is based only on the companies included in the *Business Week* survey, which account for less than half of all domestic natural gas (and crude oil) production and about 80 percent of all refinery capacity. Thus, the total increase in profits across the entire sector is likely to be much larger. Even if we assume that the oil and gas sector 'should' have earned the national average for the very large firms included in the *Business Week* survey, the excess earnings since the turn of the millennium would be about $44 billion. The oil and gas companies have enjoyed a huge jump in profits compared to the other large corporations in the economy.



A Comprehensive Domestic Solution

We all would like immediate, short-term relief from the current high prices, but what we need is an end to the roller coaster and the ratchet of energy prices. That demands a balanced, long-term solution. Breaking OPEC's pricing power would relieve a great deal of pressure from consumers' energy bills, but the short-term prospects are not promising in that regard either. There, too, we need a long-term strategy that works on market fundamentals.

Three years ago we outlined a comprehensive policy to implement permanent institutional changes that would reduce the chances that markets will be tight and reduce the exposure of consumers to the opportunistic exploitation of markets when they become tight. Those policies made sense then; they make even more sense today. The Federal government has done little to move policy in that direction since it declared an energy crisis in early 2001.

To achieve this reduction of risk, public policy should be focused on achieving four primary goals:

- Restore reserve margins by increasing both fuel efficiency (demand-side) and refining production capacity (supply-side).
- Increase market flexibility through stock and storage policy.
- Discourage private actions that make markets tight and/or exploit market disruptions by countering the tendency to profiteer by withholding of supply.
- Promote a more competitive industry.

Expand Reserve Margins By Striking A Balance Between Demand Reduction and Supply Increases

Improving vehicle efficiency (reduction in fleet average miles per gallon) equal to economy wide productivity over the past decade (when the fleet average failed to progress) would have a major impact on demand. It would require the fleet average to improve at the same rate it did in the 1980s. It would raise average fuel efficiency by five miles per gallon, or 20 percent over a decade. This is a mid-term target. This rate of improvement should be sustainable for several decades. This would reduce demand by 1.5 million barrels per day and return consumption to the level of the mid-1980s.

Expanding refinery capacity by ten percent equals approximately 1.5 million barrels per day. This would require 15 new refineries, if the average size equals the refineries currently in use. This is less than one-third the number shut down in the past ten years and less than one-quarter of the number shut down in the past fifteen years. Alternatively, a ten percent increase in the size of existing refineries, which is the rate at which they increased over the 1990s, would do the trick, as long as no additional refineries were shut down.

Placed in the context of redevelopment of recently abandoned facilities or expansion of existing facilities, the task of adding refinery capacity does not appear daunting. Such an

expansion of capacity has not been in the interest of the businesses making the capacity decisions. Therefore, public policies to identify sites, study why so many facilities have been shut down, and establish programs to expand capacity should be pursued.

Efficiency improvements can be achieved in natural gas consumption as well, which can alleviate the tightness in that market and have a significant price disciplining effect.[25] The benefits can be achieved both directly through improvements in space heating and industrial applications, but also indirectly through reduction in electricity consumption because natural gas has become increasingly important for summer peak generation.

Expanding Storage And Stocks

It has become more and more evident that private decisions on the holding of crude and product in storage will maximize short-term private profits to the detriment of the public. Increasing concentration and inadequate competition allows stocks to be drawn down to levels that send markets into price spirals.

The Strategic Petroleum Reserve is a crude oil stockpile that has been developed as a mechanism to deal with dire emergencies that would result in severe shortfalls of crude.[26] It could be viewed and used differently, but it has almost never been used, and never aggressively used, as an economic reserve to respond to price increases. Given its history, drawdown of the SPR is at best a short-term response.

Private oil companies generally take care of storage of crude oil and product to meet the ebb and flow of demand.[27] The experience of the past four years indicates that the marketplace is not attending to economic storage. Companies do not willingly hold excess capacity for the express purpose of preventing price increases. They will only do so if they fear that a lack of supply or an increase in brand price would cause them to lose business to competitors who have available stocks. Regional gasoline markets appear to lack sufficient competition to discipline anti-consumer private storage policies.

Public policy must expand economic stocks of crude and product. Gasoline distributors (wholesale and/or retail) can be required to hold stocks as a percentage of retail sales. Public policy could also either directly support or give incentives for private parties to have sufficient storage of product. It could lower the cost of storage through tax incentives when drawing down stocks during seasonal peaks. Finally, public policy could directly underwrite stockpiles. We now have a small Northeast heating oil reserve. It should be continued and sized to discipline price shocks, not just prevent shortages. Similarly, a Midwest gasoline stockpile should be considered.

Taking The Fun and Profit Out of Market Manipulation

In the short term, government must turn the spotlight on business decisions that make markets tight or exploit them. Withholding of supply should draw immediate and intense

public scrutiny, backed up with investigations. State government should be authorized and supported in market monitoring efforts. A joint task force of federal and state attorneys general could be established on a continuing basis. The task force should develop databases and information to analyze the structure, conduct and performance of gasoline and natural gas markets.

As long as huge windfall profits can be made, private sector market participants will have a strong incentive to keep markets tight. The pattern of repeated price spikes and volatility has now become an enduring problem. Because the elasticity of demand is so low – because gasoline and natural gas are so important to economic and social life – this type of profiteering should be discouraged. A windfall profits tax that kicks in under specific circumstances would take the fun and profit out of market manipulation.

Ultimately, market manipulation, including the deliberate withholding of supply, should be made illegal. This is particularly important for commodity and derivative markets.

Promoting A Workably Competitive Market

Further concentration of these industries is quite problematic. The Department of Justice Merger Guidelines should be rigorously enforced. Moreover, the efficiency defense of consolidation should be viewed skeptically, since inadequate capacity is a problem in these markets. The low elasticity of supply and demand should be considered in antitrust analysis.

Restrictive marketing practices, such as zonal pricing and franchise restrictions on supply acquisition, should be examined and discouraged. These practices restrict flows of product into markets at key moments.

Consideration of expanding markets with more uniform reformulation requirements should not involve a relaxation of clean air requirements. Any expansion of markets should ensure that total refinery capacity is not reduced.

Every time energy prices spike, policymakers scramble for quick fixes. Distracted by short-term approaches and obsessed with placing the blame on foreign energy producers or environmental laws, policymakers have failed to address the fundamental causes of the problem. In the four years since the energy markets in the United States began to spin out of control we have done nothing to increase competition, ensure expansion of capacity, require economically and socially responsible management of crude and product stocks, or slow the growth of demand by promoting energy efficiency. We have wasted four years and consumers are paying the price with record highs at the pump and the burner tip.

SOURCE AND NOTES:

Exhibits:

Prices, quantities and trend line projections are based on U. S. Department of Energy, Energy Information Administration databases accessed by online publication URLs as follows: *Monthly Energy Review* – Gasoline: Table 3.4 for quantities supplied, Table 9.4, for pump prices; Natural Gas: Table 4.1 for production, Table 9.11 for Prices; Crude Table 3.1 for quantities, Petroleum *Marketing Monthly,* Table 1 for crude prices and Table 6 for prices net of taxes. Most recent months are calculated from weekly averages in *Weekly Petroleum Status Report, This Week in Petroleum, Natural Gas Weekly Update, Gasoline and Diesel Fuel Update.*

Mergers: Energy Information Administration, *Performance Profiles of Major Energy Producers: 2002,*February 2004, Figure 6; Energy Information Administration, *Performance Profiles of Major Energy Producers: 2001,* January 2003, Figure 33.

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UNITED STATES SENATOR • OHIO

Mike DeWine

FOR IMMEDIATE RELEASE
APRIL 7, 2004

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[AS PREPARED] STATEMENT BY U.S. SENATOR MIKE DEWINE (R-OH), CHAIRMAN OF THE SENATE JUDICIARY SUBCOMMITTEE ON ANTITRUST, COMPETITION POLICY AND CONSUMER RIGHTS "Crude Oil: The Source of Higher Gas Prices?"

Good afternoon and welcome to the Antitrust Subcommittee hearing on the causes for the higher gas prices in the United States. As most Americans know, we are in the middle of another round of painful increases in gas prices. The national average has reached a new record high for self serve unleaded gas -- and that is about $1.80 per gallon. Recently, in my home state of Ohio, gas prices have been even higher. In Marietta, gas was at $1.84 per gallon, in Cleveland it was at $1.86, and in Columbus, it topped out at $1.88 at some stations. Many analysts predict that prices could break the important psychological barrier of $2.00 per gallon by the summer.

Although the prices this time around seem particularly high, the American consumer has, unfortunately, been here before. Since the 1970s when we first experienced the so-called "oil shocks," periodic price spikes seem to have become as predictable as the seasons changing. Though these spikes no longer surprise us, they continue to harm consumers and weaken the economy and leave us with an important question: What, if anything, should lawmakers be doing to address this recurring problem?

We hope to address that question today, in a setting where we can explore the reasons for high gas prices and consider possible policy steps. We have an excellent panel and will hear from a number of experts who will offer their perspectives on the root cause for higher gas prices.

But, I want to stress one thing, upon which I expect there will be universal agreement: The single most important factor affecting gas prices in the United States is the price of crude oil. As we can see from the chart, as of March 2004, crude oil is the largest single component of the gasoline price, making up nearly half of the overall price that consumers pay at the pump. Beyond that, the Federal Trade Commission has said that changes in crude oil prices account for approximately eighty-five percent of the variability of gasoline prices -- in other words, the changes in crude oil prices lead directly to the gasoline price spikes and volatility that cause so much economic distress.

Of U.S. imported crude oil, more than forty percent comes from OPEC member nations. Last week, OPEC met in Austria and decided to cut production by 4 percent, down about 1 million

-more-

barrels to 23.5 million barrels per day. The price of a barrel of oil is already very high, between $35 to $38 per barrel and, according to some analysts, the price is likely to break the $40 per barrel ceiling.

Of course, OPEC's decision to decrease supply likely will increase U.S. gas prices further, causing American consumers to suffer more. That is why last week Senator Kohl and I reintroduced our "No Oil Producing and Exporting Cartels Act of 2004" or NOPEC.

The purpose of the bill is to end OPEC's flagrant violation of our antitrust laws. This is hard-core cartel behavior and should not be tolerated. If OPEC were a group of international oil companies getting together to set prices and cut output, it could be prosecuted under U.S. antitrust law. But, to this day, OPEC continues to receive special treatment under U.S. antitrust law. Our bill removes the legal obstacles that have protected OPEC until now and gives our antitrust enforcement agencies the tools they need to prosecute OPEC.

First, NOPEC responds to a 1979 federal district court opinion that found that OPEC's activities were "governmental" -- not "commercial" -- and therefore protected from prosecution under the Foreign Sovereign Immunities Act.

Second, NOPEC responds to a 1981 federal court of appeals decision where the court refused to hear that same case against OPEC based on the so-called "act of state doctrine," which states that a court will not judge the legality of the sovereign acts of a foreign country. Finally, NOPEC gives the Department of Justice and Federal Trade Commission explicit authority to prosecute OPEC. In short, our bill says to OPEC: No more special treatment under U.S. antitrust law! One of our expert witnesses today will offer his legal analysis of our proposed law, and we look forward to his testimony.

We are going to try to move the NOPEC bill and are hopeful that if it becomes law, it will help restore market discipline to crude oil prices. But, even if we do manage to get crude prices back in line with the laws of supply and demand, there is a range of other factors that affect gasoline prices, and we will consider those today, as well.

For example, the proliferation of specialty gases creates a particularly complex part of the supply problem. In the United States, as we can see from the chart, a number of state and local governments have different gasoline grades that they use to achieve EPA-mandates for cleaner air. There are currently eighteen different grades sold in the United States. This creates two supply problems: First, it reduces the availability of substitutes to cushion supply and price shocks; and second, it makes importing gas harder because many foreign refiners do not provide non-conventional gas grades.

Refining capacity is another part of the gasoline supply problem, and a number of people believe it is the key problem we are facing today. There are about 145 refineries currently operating in the United States. In the last fifteen to twenty years, no new refinery has been built and about seventy-five have been closed. Although the efficiency of the remaining refineries has been

improved, refinery capacity is still strained; in fact, refinery capacity utilization rates are running at about ninety percent to ninety-five percent. This leaves the system with very little margin for error, because a fire or other accident that temporarily shuts down a refinery cannot be easily accommodated by increased output from another refinery. Even worse, there is no solution on the horizon. Despite the high demand for gasoline, refiners are unwilling to build new refineries because of cost, environmental issues, and expected local opposition.

Another controversial aspect of the gasoline-pricing problem is the issue of concentration within the refining industry. Those who have followed the work of this Subcommittee are well aware of the merger wave that rolled through the U.S. economy in the 1990s. That wave engulfed the petroleum industry, as well.

Mergers such as Exxon-Mobil, BP-Amoco and Conoco-Phillips clearly increased concentration levels both upstream (in exploration and production) and downstream (in refining and retailing). Now, whether or not this concentration has reached a level high enough to raise competition concerns is a matter of some dispute. For example, in 1983, the top five refiners controlled approximately thirty-five percent of the U.S. domestic refining market; in 2003, that number increased to over fifty percent. From a pure antitrust, merger analysis point-of-view, I question whether these concentration levels are high enough to merit serious concern, but we will consider this issue during the course of today's hearing.

In addition, we will examine a number of other secondary factors contributing to the recent increase in gas prices, such as strong growth in the U.S. and China's demand for oil.

Finally, we will touch today on the state of competition in the market for natural gas, which also is selling at prices approaching historic highs.

I now turn to the ranking member of this Subcommittee, Senator Kohl.

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Statement of U.S. Senator Russ Feingold
At the Subcommittee on Antitrust, Competition Policy and Consumer Rights of the Senate Judiciary Committee Hearing on "Crude Oil: The Source of Higher Gas Prices?"

April 7, 2004

Mr. Chairman, I applaud the Committee for holding this very important hearing on high oil and gas prices. I am troubled by the accounts of price-fixing and market manipulation of gas prices across the nation, and I am equally concerned about OPEC's recent cuts in oil production.

I am proud to be an original cosponsor of S. 2270, the "No Oil Producing and Exporting Cartel Act of 2004," also known as the NOPEC Act, which was introduced by Senators DeWine and Kohl last week. I also cosponsored this bill in the 106th and 107th Congress and I will continue to fight to make OPEC subject to U.S. antitrust laws.

The reason we should subject OPEC to U.S. antitrust laws is simple: price-fixing and market manipulation by the OPEC oil nations are affecting the average U.S. consumer. The 2004 OPEC production cuts have resulted in huge increases in oil prices. OPEC instituted its production cut in February 2004, which reduced production by 2,000,000 barrels per day. From February to March 2004, crude oil prices have gone from $28 per barrel and now exceed $38 per barrel. These cuts represent an attempt to maintain artificially high crude oil prices in order to bring record profits to members of the OPEC cartel.

High gasoline prices are inextricably linked to high crude oil prices. And these high oil and gas prices hurt Americans across the nation and from all walks of life. Farmers, teachers, and small business owners are getting hit hard by these skyrocketing costs. For gasoline, the increases in crude oil prices have resulted in a pass-through of cost increases at the pump to an average national price of $1.80 per gallon. These are the highest gas

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(608) 828-1200

517 E. Wisconsin Ave.
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(414) 276-7282

First Star Plaza
401 5th St., Room 410
Wausau, WI 54403
(715) 848-5660

425 State St., Room 232
La Crosse, WI 54603
(608) 782-5585

1640 Main Street
Green Bay, WI 54302
(920) 465-7508

prices we have seen in 13 years.

We cannot allow this foreign oil cartel to wreak havoc on our economy. We must protect our economy by passing this legislation, and we must continue to encourage the Administration to pressure OPEC to increase production. The actions of this cartel have real consequences for Americans. And in an already shaky economy, high oil and gas prices can put working families over the financial edge. We owe to it to our fellow Americans to make this cartel subject to our antitrust laws.

I also hope the Committee will have the opportunity to address the issue of reformulated gasoline blends or "boutique fuels" and their impact on already high gas prices. This issue is of great importance in my home state of Wisconsin. In recent years, fuel supply shocks such as pipeline problems and refinery fires have contributed to gasoline price spikes in southern Wisconsin. Chicago and southeast Wisconsin use a specialized blend of reformulated gasoline to meet federal Clean Air Act requirements that is not used elsewhere in the country. When supplies of this type of gasoline run low, Wisconsin is unable to draw on supplies of gasoline from other areas.

Coupled with already high baseline gas prices, the boutique fuels problem creates a double whammy for many people in my state. I have worked hard with the senior Senator from Wisconsin to address this boutique fuels problem and I look forward to reviewing the testimony of our witnesses for any insight they may have about this issue.

# # #

Statement of the American Petroleum Institute

Submitted to

The U.S. Senate
Committee on the Judiciary
Subcommittee on Antitrust, Competition Policy and Consumer Rights

Washington, D.C.

April 7, 2004

Mr. Chairman and members of the Committee, I am John Felmy, Chief Economist and Director of Policy Analysis and Statistics of the American Petroleum Institute (API). API is a national trade association representing more than 400 companies engaged in all sectors of the U.S. oil and natural gas industry. API is pleased to have the opportunity to present a statement on gasoline and natural gas – and urge Congress to enact national energy policy legislation.

The recent spikes in gasoline prices are primarily due to fundamentals in the supply and demand for crude oil. Demand for crude oil has risen due to a cold winter and strengthening economies. Unrest in key supplying countries such as Venezuela and Nigeria and lower Iraqi production have kept world supplies tight. OPEC continues to operate under production quotas and has recently confirmed its intent to cut production by a million barrels per day to 23.5 million barrels a day, potentially worsening the current situation. However, there is no guarantee member nations will reduce output sufficient to comply.

The United States continues to import more than 60 per cent of the crude oil and petroleum products used each day to provide Americans the products they need. While 20 percent of current imports are from the Middle East, the U.S. Energy Information Administration (EIA) expects that figure to climb substantially, as the gap between U.S. oil production and consumption widens.

In addition to higher crude prices, several other factors have affected gasoline prices. We have experienced refinery problems, a Mississippi River accident that shutdown traffic for several days, the difficulty of switching from winter to summer fuel in California, the introduction of new low-sulfur gasoline (Tier II), the bans of MTBE in gasoline in New York, Connecticut and California and sharply higher demand. I have attached two papers that elaborate on these points.

As a consequence of all these factors, gasoline prices have reached a record level – unadjusted for inflation – of over $1.76 per gallon. When adjusted for inflation, the real price of gasoline has fallen over 40 percent from a peak of $2.77 in 1981. The real cost of crude oil and manufacturing, delivering and marketing gasoline has fallen over the past twenty years while the real cost of federal and state taxes has risen.

Demand for gasoline continues to be strong, as our economy grows. Gasoline production is running at record levels this year. However, inventories are low, because of strong demand and lower imports. Imports play a very important role, even though 90 per cent of the gasoline we use is

refined in this country. High tanker freight rates, low European inventories, and increasingly more restrictive U.S. fuel specifications have contributed to the curtailing of gasoline imports.

What, then, can be done about the situation?

Some want to suspend filling the Strategic Petroleum Reserve (SPR) and releasing the 150,000 barrels a day currently going into the reserve onto the marketplace. That would have a negligible effect on supply, because the amount made available is the equivalent of only about two-tenths of one percent of world supply. The SPR was established as a backup in the event of a real emergency supply shortfall, not as a non-market mechanism aimed at influencing prices. Turning to the reserve when prices go up sends precisely the wrong message to the marketplace at exactly the wrong time. Unintended consequences may include foreign nations curtailing production.

Let me also briefly discuss the situation in natural gas markets. Like gasoline, natural gas has increased substantially in price over the past two years. We have seen three price spikes in three years and prices remain high due to high demand and low supply growth. Weather and economic growth and continued increases in demand for gas by electricity generators have kept prices over $5.00 per million Btus. The industry has responded to the higher prices by operating more drilling rigs searching for natural gas. We have also continued our efforts to obtain access to lands that are currently off limits to exploration for natural gas.

API has argued for several years that we need a national energy policy that increases supplies, streamlines regulation, fosters energy efficiency and growth in renewables and allows for increased infrastructure to get supplies to consumers. The Senate was only two votes short of passing an energy bill that contains provisions that would have helped consumers. A comprehensive energy bill needs to be passed and sent to the President for his signature. Failure to pass meaningful energy legislation will increase the risk that we will stay on the energy price treadmill.

March 31, 2004

FYI on GASOLINE PRICES

Gasoline prices are higher because global crude oil prices are higher, and because gasoline markets are tight.

Crude oil prices are the highest since the start of the war in Iraq because worldwide supplies are tight.

All investigations of gasoline prices have found no wrongdoing and concluded that market forces of supply and demand are at work.

American oil industry profits are in line with those of other industries.

API®
American Petroleum Institute

THE COST of gasoline has gone up primarily because refiners are paying considerably more for crude oil, the principal cost component of a gallon of gasoline, and because gasoline markets are tight.

TODAY, A barrel of crude oil is selling at more than $36, or within pennies per gallon of last year's record high price leading up to the war in Iraq. The retail price of gasoline is also within a penny of last year's high, averaging $1.80 per gallon.

CRUDE OIL is bought and sold on the international marketplace and is subject to the forces of supply and demand worldwide. OPEC has reaffirmed its earlier decision to cut output by 1 million barrels per day to 23.5 million barrels and to rein in another 1.5 million barrels a day in over-production.

SUPPLIES OF crude oil are restricted, while worldwide demand has continued to grow, especially in Asia, where China's crude oil imports grew 30 percent last year.

TIGHT SUPPLIES have historically pushed crude prices higher, as buyers bid prices upward to ensure their customers have supplies. In a tight market, even small changes in supply have been known to have a dramatic impact on prices.

WE IMPORT more than 62 percent of the crude and products we consume. American oil companies pay the world price.

DEMAND for gasoline continues to be strong as the U.S. economy grows. Gasoline production is running at record levels so far this year, but inventories are low because imports are down. High tanker freight rates, low European inventories, and numerous and changing U.S. fuel specifications have curtailed imports into the U.S. As a result, supplies of gasoline are low.

THE U.S. GASOLINE market has become increasingly fragmented by government mandated new fuel specifications. Refiners now supply 18 different formulations of gasolines.

NEW GASOLINE formulations are being introduced in 2004, presenting new supply challenges to the industry. Effective January 1, the gasoline additive MTBE was banned in California, New York and Connecticut. These three states represent one-sixth of total U.S. gasoline sales and 45 percent of all reformulated gasoline sold nationwide. A new nationwide low-sulfur gasoline is also being introduced this year to further advance air quality.

INCREASED GASOLINE prices have generated calls for investigations. Some 29 different state and federal government investigations over several decades, have found no evidence of wrongdoing, no illegal activity. The most recent investigation into last summer's gasoline prices, by the Connecticut Department of Consumer Protection, found: "While numerous factors contributed to a sharp increase in gasoline prices this summer, wholesalers and retailers were not hiking prices to pad their profits."

OIL AND GAS industry profit margins have been very much in line with those of other industries — and often they are lower. During 2003, the profit margins of the oil industry averaged 6.4 percent compared to an average of 6.5 percent for all U.S. Industry (*Oil Daily* and *Business Week*).

Why gasoline prices are going up

1 High crude oil prices

2 Restricted world supplies

3 OPEC

4 Political instability in oil-rich nations

5 Strong global demand

6 China

7 US

Where does your gasoline $ go?

.44	.24	.32
Crude oil	Taxes	Refining/ marketing

8 Tight gasoline markets

9 Supply growth not keeping up with demand

10 US gasoline imports down sharply

11 New US fuel specifications

12 High transport rates

13 Low European inventories

14 Political instability: Venezuela

15 Record refinery production but constrained capacity growth

16 Environmental
New government-mandated fuel specifications

17 Political
'Not in my backyard'

18 Economic
Low rates of return for refiners

19 Strong demand growth

20 SUV growth

21 Growing US economy

For more details, see the text next to the corresponding numbers, on the back of this page.

Sources: EIA, API / April, 2004

Factors contributing to the recent rise in gasoline prices

1 High crude oil prices

Prices have increased from $29 to $36-$38 per barrel (17 to 21 cents per gallon) since December 2003.

2 **Restricted world supplies**

3 **OPEC** has decided to reduce its output by 1 million barrels per day to 23.5 million barrels, and to rein in another 1.5 million barrels a day in over-production.

4 **Political instability** in oil-rich nations, such as Venezuela, Nigeria and Iraq, has added uncertainty in the marketplace.

5 **Strong global demand**

Crude oil supplies are tight while worldwide demand has continued to grow. Significant growth has occurred in two segments of the worldwide economy:

6 **China:** China's crude oil imports grew 30 percent in 2003.

7 **United States:** The U.S. economy has continued to grow steadily in the last year, increasing the demand for energy.

8 Tight gasoline markets

Gasoline production is running at record levels but inventories are low because imports are down.

9 **Supply growth not keeping up with demand**

Gasoline production this year is running at record high levels, but inventories are low because imports are down.

10 **Gasoline imports down:** Imports are 10 percent lower than last year's level)

11 **New U.S. fuel specifications:** Exporters to U.S. markets may not have made investments necessary to provide new fuels required this season and may instead be selling gasoline elsewhere.

12 **High transport rates:** Transport rates have increased, making it more costly to sell further from home.

13 **Low European inventories:** European inventories are also at low levels and European refiners are filling their own tanks first.

14 **Political instability:** Turmoil in Venezuela, a leading oil and gasoline exporter, has cut down the amount of fuel available for the U.S. market.

15 **Record refinery production but constrained capacity growth:** Gasoline production is running at 3 percent above last year's level.

16 **Environmental:** Numerous and changing fuel specifications require massive environmental investments – $49 billion in the last 10 years.

17 **Political:** Because of the not-in-my-backyard syndrome, refiners are finding it increasingly difficult to build new refineries, pipelines or other facilities to increase production.

18 **Economical:** Refiners have seen 10-year average rates of return of 5.4 percent, compared to S&P Industrials' 11.7 percent.

19 **Strong demand growth**

20 **SUV growth:** Sales of SUVs were up 18 percent last year, while car sales were down 4 percent.

21 **Growing U.S. economy:** According to the latest DOE estimates, growth in gasoline demand is averaging 4.5 percent.

Prepared Statement

of

Justine S. Hastings

Before

The United States Senate Committee on the Judiciary
Subcommittee on Antitrust, Competition Policy and Consumer Rights

April 7, 2004

Introduction

Mr. Chairman and members of the committee, my name is Justine Hastings. I am an Assistant Professor of Economics at Yale University and a Faculty Research Fellow at the National Bureau of Economic Research, Program on Industrial Organization. I have a Ph.D. in Economics from the University of California at Berkeley. Firm conduct, competition and consumer preferences are the focus of much of my research. In particular, my empirical research in these areas has been applied to the gasoline industry. I have analyzed extensive data on retail and wholesale gasoline market structure and prices for a diverse group of US metropolitan areas covering the 1990's. I have used this data to conduct independent, academic research into the relationships between vertical market structure and competition in gasoline refining and marketing. Two of my current research projects include an empirical assessment of the impacts of wholesale price discrimination on retail and wholesale gasoline prices and an empirical analysis of the affects of gasoline content regulation on market concentration, conduct and arbitrage. Through this research, I have gained a wealth of knowledge about the market structure of gasoline refining and marketing. My independent research and my acquired knowledge of the gasoline industry form the basis of my comments before this committee.

The theme of these hearings is to identify the factors that lead to increased gasoline prices, including but not limited to increases in crude oil prices, environmental regulation, and changes in market structure. I would like to make the following points to the Subcommittee.

The Contribution of Crude Oil Prices to Retail Gasoline Prices

- ***Rises in crude oil prices certainly contribute to increases in gasoline prices. Although crude oil prices are an important determinant of gasoline prices, they are not the only determinant. For a given crude oil price, the wholesale and retail prices of gasoline can be significantly different across regions of the country.***

Crude Oil is the major input to gasoline production, and therefore it is not surprising that variation in crude oil prices explains a significant amount of the variation in gasoline prices. The following simple table illustrates this point. Although a significant amount of variation in monthly average retail prices (excluding taxes) is explained by monthly average crude oil prices over time within a state, it is clear that crude oil price variation explains much more of the variation in retail prices in South Carolina, than it does in California.

Table I: Fraction of Variation in Average Retail Prices Attributable to Variation in Average Crude Oil Price [1]

State	Fraction of Retail Price Variation Explained by Variation in Crude Oil Price
Alabama	0.892
Arizona	0.714
California	**0.696**
Delaware	0.878
Georgia	0.907
Idaho	0.826
Iowa	0.849
Illinois	0.787
Massachusetts	0.875
North Carolina	0.906
New York	0.877
Ohio	0.852
Pennsylvania	0.900
South Carolina	**0.910**
Texas	0.886

The following sections discuss other factors that contribute to gasoline prices levels and volatility.

The Effects of Market Concentration on Gasoline Prices

- ***Fewer competitors may lead to increased market power***

Higher concentration in most industries leads to the concern over an increase or enhancement market power, which leads to higher-than-competitive price levels. Markets across the country vary considerably in the number of companies supplying or producing wholesale gasoline at the distribution rack. The number of competitors also has changed over the past decade as refiners and marketers have merged, and as various forms of environmental regulation over gasoline formulation and content have come into effect.[2] Antitrust merger policy is based on the principle that price-cost margins are increasing in the market concentration level, and market concentration is and has been a primary consideration in merger analysis – shaping the challenges to and divestiture requirements for mergers in the petroleum industry.

[1] Data were taken from the Energy Information Administration's (EIA) website. The retail data are the EIA's monthly average retail prices, excluding taxes, for each state from 1998-2003. The wholesale prices were averaged from the Daily WTI spot price for crude oil posted to the EIA's website.

[2] See Gilbert, Richard J. and Hastings, Justine, "Vertical Integration in Gasoline Supply: An Empirical Test of Raising Rivals' Costs" (June 2001). UC Berkeley Competition Policy Center Working Paper No. CPC01-21.

- ***Not only number of competitors, but the identity of competitors is important for competition. Independent refiners are uniquely important for competition.***
  - ***Independent refiners do not have an incentive to raise rival's input cost to increase retail profits.***
  - ***Independent wholesalers compete intensely on price in a homogeneous goods market with highly elastic demand.***[3]
  - ***Because of these factors, unbranded refiners ensure sufficient unbranded gasoline supply at competitive prices – this is necessary for the entry and survival of independent retailers, including new chains such as KMart, Walmart, Costco, and RaceTrac.***

Unbranded wholesale markets are truly competitive. They are the only market where gasoline is gasoline, and retailers are free to purchase from lowest price supplier. Unintegrated refiners compete on price, and unlike integrated refiners, have no integrated retail component that might benefit from increases in unbranded wholesale prices. Purchasers of unbranded wholesale gasoline are free to purchase from any supplier – enforcing intense price competition at the wholesale level.

In addition, a thick and competitive unbranded wholesale market leads to lower branded wholesale prices in markets with many dealer-owned stations. Branded retailers who own their own stations can choose to switch to the unbranded market (and drop their retail brand) if their branded refiner's wholesale price is excessively higher than the unbranded wholesale price. In this way, dealer-owned stations link competition in unbranded markets to competition in branded markets. Vertically integrated stations (whether lessee-dealer or company-operated) do not provide this competitive link, since the stations cannot switch between refiners over any period of time.

- ***Independent retailers are important for competition:***
  - ***They increase competition at retail level.***
  - ***They allow entry into concentrated wholesale markets.***

In addition, because independent retailers typically do not sell brand-differentiated gasoline, they tend to increase local retail competition, lowering retail prices.[4] In fact, in vertically concentrated markets where refiners are able to price discriminate in wholesale prices (charge different wholesale prices to their lessee or contract dealers), station level wholesale prices as well as retail prices are significantly lower in the presence of unbranded competitors.[5]

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[3] Demand is elastic since demanders (retailers) have zero switching costs only in the unbranded market. Branded stations have positive switching costs, lowering demand elasticity of branded refiners.

[4] See for example, Margaret Slade (*International Journal of Industrial Organization,* December 1986), Janet Netz and Beck Taylor (*Review of Economics and Statistics,* February 2002) and Justine Hastings (*American Economic Review* March 2004).

[5] From preliminary analysis of wholesale price discrimination in gasoline market. National Science Foundation Grant for 2003-2005 "Estimating Demand with Consumer Heterogeneity: an Application to Wholesale Price Regulation in Retail Gasoline Markets"

In addition, in markets with concentrated refining capacity, producers can increase prices above competitive levels only if there are barriers to entry. Market power at refinery level depends on the number of refiners – but it also depends on the ability of outside wholesalers to enter market when prices rise. Outside gasoline producers can only enter a market if they have access to transportation, terminal and storage facilities, and a significant number of non-captive, independent retail stations through which to sell their product.[6] It is important to note that large volume independent chains, such as RaceTrac, amplify the ability for outside entry into wholesale markets. Because they purchase to supply many stations (instead of a single station), they increase the ability for outside refiners to enter the market and supply their stations.[7] Antitrust and merger policy currently considers the effects of vertical structure on market conduct and the exercise of market power. Many of the aforementioned issues relating vertical market structure to wholesale and retail market conduct and performance were considered in the evaluation of the potential anticompetitive effects of recent petroleum industry mergers and in the design of divestiture requirements associated with those mergers.

- ***Even when market concentration as measured by firm market share is low, each firm may exercise market power if demand is very inelastic, and overall industry supply is at capacity.***

As demand increases to consume available supply at existing refining capacity, each firm may find itself with market power, even when the market is fairly unconcentrated. When demand is very inelastic and supply is also very inelastic, as would be the case in electricity markets and gasoline markets when demand is near the total production capacity of all firms, a small decrease in supply can result in a substantial increase in price. Hence every firm is able to affect market prices, even if every firm constitutes a relatively small fraction of total possible output. Factors such as market segmentation due to the environmental regulation of gasoline content may exacerbate the tightness of supply in many regulated markets.[8]

The Effects of "Boutique Fuels" on Market Performance

- ***Boutique Fuels segment markets, decreasing effective number of competitors***
- ***Reformulated Fuels Requirements change the identities of competitors and the competitive structure of the market place.***

Boutique fuels segment markets and increase refiner concentration in the following two ways. First, if there is a supply disruption, supply cannot be imported from other regions of the country to meet demand if other refiners in other regions of the country do not

[6] See also Statement of R. Preston McAfee before the U.S. Senate, April 25, 2001, Committee on Commerce, Science and Transportation, Subcommittee on Consumer Affairs, Foreign Commerce, and Tourism.
[7] See also Statement of R Preston McAfee before the U.S. Senate, May 2, 2002, Committee on Governmental Affairs, Permanent Subcommittee on Investigations.
[8] See the Federal Trade Commission Report on Midwest Gasoline Price Investigation, March 2001.

produce fuel that meets local emissions requirements. In addition, reformulated gasoline requirements may change the identity of competitors supplying the market by decreasing the number of unintegrated refiners competing in the unbranded gasoline market. Often large integrated refiners choose to upgrade to supply reformulated gasoline markets, but unintegrated refiners choose not to upgrade but to supply only conventional gasoline markets, effectively changing the composition of competitors in the reformulated gasoline market. The boutique fuels market will have a few, large integrated suppliers, and few to no unintegrated suppliers. This may lead to less wholesale market competition and higher wholesale prices for independent retailers.

Given the fact environmental regulation of gasoline content and formulation often causes unintegrated refiners to exit the market, it is not at all clear that bringing the whole nation under the most stringent gasoline standards will reduce price volatility. The secondary impact of such a regulation on market structure could substantially adversely affect market performance. It is possible that the adverse affects to market concentration could outweigh the gains from geographic integration.[9]

Comments on Various Regulatory Proposals in Retail Gasoline

- ***Wholesale price regulations such as "Fair Wholesale Pricing", "Branded-Open-Supply", and "Zone Price Elimination" will not increase competition.***
  - ***They may lead to higher average wholesale and retail prices as well.***

There are several proposals that require refiners to charge the same wholesale price to their Lessee-Dealer stations. Common names of these proposals are "Fair Wholesale Pricing", "Branded Open Supply" or "Zone Price Elimination." I will refer to these legislations as "Fair Wholesale Pricing" (FWP). FWP legislation would effectively force integrated refiners to charge the same wholesale price to all of their stations.

Currently refiners charge different wholesale prices to different franchised station. Preliminary statistical analysis suggests that refiners price discriminate based on factors that affect local demand elasticity. Economic theory suggests that competition between refiners is softened in markets where retailers have a small degree of market power if refiners can price through retailers instead of directly at the pump. FWP does not change this fact, since refiners will still set a wholesale price, which is transmitted through retailer's pricing decisions to the final customer, thereby muting competition between refiners. FWP will only change the profit maximizing price the refiner charges to its stations. Economic theory predicts that wholesale prices could actually *increase* if refiners are forced to charge one wholesale price. The profit maximizing single price to all stations may actually be *higher* than the average of the wholesale prices under price

[9] This is the topic of current research that I am conducting with colleagues at Yale and UC Berkeley into the price effects and market structure effects of gasoline content regulation.

discrimination. FWP may actually raise gasoline prices - making consumers worse off than they were before.[10]

- ***Divorcement will not lead to lower prices, and may increase inefficiency.***

Divorcement prohibits refiners from directly operating the stations they own, forcing them to have the station operated instead by a dealer. Several academic studies have presented evidence that divorcement will not lead to lower gasoline prices.[11] Divorcement does not decrease entry barriers into wholesale markets, and it does not increase competition in retail markets. Stations owned by a refiner are still integrated – regardless of whether a refiner or a lessee-dealer sets the retail price. In addition, if refiners have chosen company-operation at certain stations in order to minimize costs, forcing them to convert these stations to lessee dealers may lead to higher, less efficient, operating costs. In general, to maximize the benefit to consumers, we want to encourage firms to lower costs and lower prices – divorcement will accomplish neither of these goals.

- ***Minimum Mark-up laws do not increase competition in the short-run or the long-run. Minimum mark-up laws increase the price of retail gasoline without increasing competition. They may also lead to inefficiencies in gasoline retailing – they encourage an over supply of gasoline stations.***

Minimum mark-up laws (or sales-below-costs laws) are currently law in several states.[12] These laws typically require that retailers charge a 6 percent mark-up over cost. In the case of gasoline, this is supposed to lead to lower prices. Requiring a minimum mark-up will lead to higher prices in the short term if required mark-up is higher than the free-market mark-up. However, the goal of the legislation is to foster competition. Proponents of this law claim that major refiners will act to predatory-price (charge price below cost) independent retailers, forcing them out of the market. The refiners will then be able to raise prices and increase profits. So, in the long run, prices will be lower in states with minimum mark-up laws, because independent retailers will still be in the market, preserving competition. So even though there is a mandated mark-up, this mark-up prevents predatory pricing by oil companies, and preserves competition in the long run.

Empirical evidence rejects the hypothesis that these laws have acted to preserve independent marketers. For example, Utah has had a minimum mark-up law in place since 1987. New Mexico has never adopted this law. If the law accomplished its goal, we would expect to see independents exiting in Albuquerque, for example, while remaining (or even entering) in Salt Lake City. Examining the market share of independents in

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[10] From preliminary analysis of wholesale price discrimination in gasoline market. National Science Foundation Grant for 2003-2005 "Estimating Demand with Consumer Heterogeneity: an Application to Wholesale Price Regulation in Retail Gasoline Markets"

[11] See for example John Barron and J. Umbeck (*Journal of Law and Economics,* October 1984) Justine Hastings (*American Economic Review,* March 2004)

[12] New York has just passed such a regulation under the New York State Motor Fuels Marketing Practices Act, which will take effect at the end of this month.

Albuquerque and Salt Lake City refutes this claim. Both Salt Lake City and Albuquerque have seen an almost identical decline in the market share of independents over the 1990s - both by about 15 percentage points.

Not only is there empirical evidence showing that minimum mark-up laws do not preserve competition in the manner they claim, but they may induce inefficiency in the market. These laws benefit both independent and integrated stations. All stations, regardless of affiliation, are guaranteed a minimum profit. This may lead to an excessive number of gasoline stations – integrated or unintegrated. Consumers are worse off under this legislation. It is also important to note that it is illegal for a company to require a minimum mark-up on its own – that would be *resale price maintenance.*

A Final Suggestion

I would like to take this opportunity to impress upon you the following two facts: i) there is a need for independent academic research into factors that affect petroleum pricing in all markets and at all levels of the production chain, and ii) it is extremely difficult to acquire data to conduct such research. Private industry data is very expensive, and there is no single federal agency that funds economic research into energy policy, like the National Institute for Health (NIH) does for economic research into health-related policy questions. Perhaps we should introduce such grant programs for economists at the Department of Energy.

In addition, the Energy Information Administration collects data, but does not have a mechanism that allows it to be accessed by carefully screened academics at any meaningful level of aggregation. In comparison, the Census Bureau has worked hard at disseminating data in a range of aggregation levels, with corresponding levels of security to protect confidentiality. They have a model program of data organization and high security research centers that has significantly contributed to the production of high quality research, informing a large range of public policy decisions. The adoption of this program lead to a wealth of academic research into issues related to Labor Economics that have been tremendously informative to policy makers. We should encourage the development of similar programs at the government energy agencies, to increase independent research into industries as important to our economy as petroleum and electricity.

Summary and Policy Recommendations:

1. Crude oil price increases explain a considerable amount of increases in gasoline prices, however, differences in market structure due to horizontal and vertical concentration, as well as environmental regulations also contribute to increased gasoline prices.
2. Inelasticity of demand for gasoline leads to large price increases in response to small supply decreases. Increasing the number of refineries will expand supply and ease

tension in tight markets, lowering price volatility. Increasing the number of refineries may also decrease market concentration if the new refinery means a new competitor enters the market.

3. Optimal environmental policies should incorporate secondary impacts on market structure and competition as well the impacts on pollution abatement in order to maximize consumer welfare.
4. Wholesale price regulations such as "Fair Wholesale Pricing" or "Zone Price Elimination" do not increase competition in the market place, since retail outlets cannot switch between refiners when their refiner's wholesale price exceeds the price of another refiner. This type of legislation may actually increase gasoline prices
5. Below Cost Pricing legislation is typically aimed at preventing unbranded retailers such as Race-Trac, Costco, or Wawa from entering the market and/or increasing competition. They only serve to dampen price competition, and act to maintain or raise gasoline prices.

News from

HERB KOHL

United States Senator
Democrat of Wisconsin

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FOR IMMEDIATE RELEASE: **April 7, 2004**
Contact: Lynn Becker or Zach Goldberg **Phone: (202) 224-5653**

Statement of U.S. Senator Herb Kohl on gas price hearing

Mr. Chairman, we are reminded every day when we drive by a gas station that Americans are paying record levels for a gallon of gas. Gas prices now average $1.78 per gallon nationally; $1.80 in Wisconsin; and prices over two dollars per gallon are common.

These rising gas prices are felt throughout the economy. They are a silent tax that takes hard-earned money away from Americans every time they visit the gas pump. Higher gas prices drive up the cost of transportation, harming every sector of the economy from aviation to trucking. And those costs are passed on to consumers in the form of higher prices for manufactured goods. Higher oil prices also mean higher heating and electricity costs.

So, let's examine the cause of these rising prices. First, we need to look at the price of crude oil. Indeed, the FTC states that 85% of the variability in the cost of gasoline can be accounted for by the price of crude oil. Simply put, the cost of crude oil moves the price of a gallon of gas. And, as we all know, OPEC sets the price of oil.

OPEC's actions to manipulate the oil market cost Americans billions of dollars every year. If the members of OPEC were private companies, not nations, they long ago would have been prosecuted for engaging in illegal price fixing. The bill that Senator DeWine and I introduced last week, and which passed the Judiciary Committee unanimously in 2000, will end this injustice by subjecting OPEC to antitrust suits in U.S. courts. While NOPEC is not a panacea, a lawsuit or threat of a lawsuit will give our government the first real weapon it has ever had to deter OPEC from its seemingly endless cycle of price increases.

Restraining OPEC is not the entire answer. There are other factors that lead to high gas prices. In the face of ever increasing demand and higher prices, the domestic oil industry has not responded as we would have expected – by increasing refinery capacity. Instead, numerous refineries have been closed – about 75 in the last 15 years – 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, critics argue that oil companies have chosen not to expand refining capacity in order to gain market power to keep prices high. While there are clearly barriers to expanding refinery capacity, at the same time the antitrust authorities must not permit oil companies with market power to deliberately withhold supply to raise prices.

--More--

In addition, mergers in the oil industry have left a dangerous level of consolidation in their wake. The oil companies not only drill the oil, but they refine it and own the gas pumps as well. The five largest oil companies now control more than half of our domestic refining capacity and more than 60% of the national retail gasoline market. This level of concentration – magnified in some areas – permits a few competitors to control prices. Just as importantly, this consolidation has virtually eliminated independent retailers and refiners and the competition they provide. Where there has been a high degree of integration between refiners and retailers, consumers pay higher prices.

For the last four years, Senator DeWine and I have repeatedly called upon the FTC to study the cause for high prices. The FTC should remain vigilant in monitoring gas price increases, but it must do more. Antitrust authorities must scrutinize future oil industry mergers with an eye towards preserving the competitive benefits of independent retailers and refiners.

Mr. Chairman, it is time for action to end the ever escalating pattern of gas prices increases that are regularly inflicted on our nation's consumers. Our NOPEC bill is one place to start but we must do even more to ensure that the conditions exist to lower gas prices for all Americans.

# # #

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

Prepared Statement of the Federal Trade Commission

**Market Forces, Anticompetitive Activity and Gasoline Prices–
FTC Initiatives to Protect Competitive Markets**

Presented by William E. Kovacic

General Counsel

Before The

**Committee on the Judiciary
Subcommittee on Antitrust, Competition Policy and Consumer Rights
United States Senate**

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I. Introduction

Mr. Chairman and members of the Subcommittee, I am Bill Kovacic, General Counsel of the Federal Trade Commission. I am pleased to appear before you today at this hearing on the important topic of competitive prices for gasoline, and to present the testimony of the Federal Trade Commission.[1] The title of this hearing is particularly appropriate. As Figure One illustrates, changes in gasoline prices have historically tracked changes in the price of crude oil.[2] With crude oil prices at approximately $37, it is not surprising that we are seeing higher prices, nationwide, at the pump.

The FTC is a law enforcement agency with two related missions: to preserve competition in the marketplace for the benefit of consumers, and to protect consumers from deceptive or unfair practices that may injure them. The Commission's statutory authority covers a broad spectrum of sectors in the American economy, including the energy industry and its various components.

The significance of antitrust law enforcement is particularly clear in the petroleum industry; fuel price increases can strain the budgets of consumers and can have a direct and substantial impact on businesses of all sizes throughout the U.S. economy. Antitrust enforcement helps ensure that the petroleum industry is, and remains, competitive. During the

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

[2]Figure One (covering the period 1949 through 2002) also illustrates that the real price of gasoline has fallen dramatically since its historic high in the early 1980s. The difference between the price of crude oil (per gallon of gasoline) and the price of a gallon of gasoline has remained fairly constant for the same time period, generally around $.80 per gallon. (All figures are in 2002 dollars.) This is dramatically lower than the difference for the years preceding 1980.

period of large oil industry mergers, the Bureau of Competition has spent almost one-fourth of its enforcement budget on investigations in energy industries.

The Commission also performs functions beyond law enforcement. Congress established the agency to provide expert analysis of major trends affecting the American economy. Because of the importance of the petroleum industry to the American economy, and increased public concern about the level and volatility of gasoline prices in recent years, the Commission studies, on an on-going basis, the central factors that may affect the level and volatility of refined petroleum products prices in the United States. The Commission held public conferences on this topic in 2001 and 2002.[3] The Commission also is updating its 1982 and 1989 "Petroleum Merger Reports" to focus on mergers and structural change in the oil industry since 1985. In March, Commission staff economists released a retrospective study of the effects of the Marathon Ashland joint venture in Kentucky.[4]

In addition to the agency's conferences and research reports, the Commission actively monitors wholesale and retail prices of gasoline. About two years ago, the FTC launched an initiative to monitor gasoline prices to identify "unusual" movements in prices[5] and then examine

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[3]*FTC to Hold Second Public Conference on the U.S. Oil and Gasoline Industry in May 2002*, FTC Press Release (Dec. 21, 2001).

[4]Christopher T. Taylor and Daniel S. Hosken, "The Economic Effects of the Marathon-Ashland Joint Venture: The Importance of Industry Supply Shocks and Vertical Market Structure," Federal Trade Commission Bureau of Economics Working Paper (March 17, 2004) This paper examines the price effects of the Marathon-Ashland joint venture by comparing the wholesale and retail price of gasoline in a number of regions unaffected by the merger to the price of gasoline in Louisville, Kentucky. The transaction does not seem to have affected the relative price of gasoline in Louisville.

[5]Briefly, an "unusual" price movement in a given area is a price that is significantly out of line with the historical relationship between the price of gasoline in that area and the gasoline

whether any such movements might result from anticompetitive conduct that violated Section 5 of the Federal Trade Commission Act. FTC economists developed a statistical model for identifying such movements. They look at price movements in 20 wholesale and over 350 retail markets across the country. A map of these markets is attached (Figure Two).

Our gasoline monitoring and investigation initiative focuses on the timely identification of unusual movements (compared to historical trends) in gasoline prices to determine if a law enforcement investigation is warranted. If the FTC's staff detects unusual price movements in an area, it researches the possible causes, including, if appropriate, consulting with the state Attorneys General, state energy agencies, and of the Department of Energy's ("DOE") Energy Information Administration ("EIA"). The FTC's staff also monitors DOE's gas price "hotline" complaints. If the staff concludes that the unusual price movement likely results from a "natural" cause (*i.e.*, a cause unrelated to anticompetitive conduct), it does not investigate further.[6] The Commission's experience from past investigations and the current monitoring initiative indicates that unusual movements in gasoline prices typically have a natural cause. FTC staff further investigates unusual price movements that do not appear to be explained by "natural" causes to determine whether anticompetitive conduct may be a cause. Cooperation with state law enforcement officials is an important element of such investigations.

This testimony summarizes the Commission's recent enforcement activity, reviews its ongoing work to increase understanding of the factors that may affect the level and volatility of

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prices prevailing in other areas.

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

refined petroleum product prices, and discusses some of the factors that, based on the agency's experience, the Commission believes affect gasoline prices.

II. Merger Enforcement in the Oil and Gasoline Industries

The Commission has obtained much of its antitrust enforcement experience in the petroleum industry by analyzing proposed mergers. Merger enforcement protects a competitive marketplace, because it helps preserve rivalry that brings lower prices and better services to consumers. The Commission has extensive experience with merger investigations in the petroleum industry, and the FTC has challenged proposed mergers that likely would reduce competition, result in higher prices, and injure the economy of the nation or any of its regions.[7] Since 1981, the Commission has taken enforcement action against 15 major petroleum mergers. Four of the mergers were either abandoned or blocked as a result of Commission or court action. In the other 11 cases, the Commission required the merging companies to divest substantial assets in the markets where competitive harm was likely to occur. The agency's basic approach in those cases was to maintain the pre-merger levels of concentration in the relevant markets. The Commission recently released data on all horizontal merger investigations and enforcement actions from 1996 to 2003. Unlike in other industries, in mergers involving petroleum products, the Commission has obtained relief in moderately concentrated industries.[8]

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[7]Section 7 of the Clayton Act specifically prohibits acquisitions where the anticompetitive acts affect "commerce in any section of the country." 15 U.S.C. § 18.

[8]FTC, Horizontal Merger Investigation Data, Fiscal Years 1996-2003 (Feb. 2, 2004), Table 3.3.

Let me briefly describe two recent FTC merger investigations in this area. One involved Chevron and Texaco.[9] This transaction combined assets located throughout the United States. Twelve states participated in the FTC's investigation. The Commission entered a consent order with Chevron and Texaco requiring numerous divestitures to maintain competition in particular relevant markets, primarily in the western and southern United States. Among other requirements, the consent order required Texaco to: (a) divest to Shell and/or Saudi Refining, Inc. ("SRI") all of its interests in two joint ventures – Equilon[10] and Motiva[11] – through which Texaco had been competing with Chevron in gasoline marketing in the western and southern United States; (b) divest the refining, bulk supply and marketing of gasoline satisfying California's environmental quality standards;[12] (c) divest the refining and bulk supply of gasoline and jet fuel in the Pacific Northwest; and (d) divest the pipeline transportation of crude oil from the San Joaquin Valley.

Another important oil merger that the Commission challenged recently was the $6 billion merger between Valero Energy Corp. ("Valero") and Ultramar Diamond Shamrock Corp.

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[9]*Chevron, Corp.*, C-4023 (Dec. 18, 2001) (consent order).

[10]The Equilon venture was jointly controlled by Shell and Texaco, and its major assets included full or partial ownership in four refineries, about 65 terminals, and various pipelines. It marketed gasoline through approximately 9,700 branded gas stations nationwide.

[11]Motiva, jointly controlled by Texaco, Shell, and SRI, consisted of their eastern and Gulf Coast refining and marketing businesses. Its major assets included full or partial ownership in four refineries and about 50 terminals, with the companies' products marketed through about 14,000 branded gas stations nationwide.

[12]The California Air Resources Board mandates that gasoline sold in California meet certain specifications.

("Ultramar").[13] Both Valero and Ultramar are leading refiners and marketers of CARB gasoline in California (*i.e.* gasoline that meets the specifications of the California Air Resources Board ("CARB")), and are the only significant suppliers to independent stations in California. CARB 2 gasoline meets the current Phase 2 specifications in effect between 1996 and 2003, and was the only gasoline that could be sold to consumers in California. CARB 3 gasoline meets the proposed Phase 3 specifications effective since January 1, 2003, and is the only gasoline that can currently be sold to consumers in California. The Commission's complaint alleged competitive concerns in the refining and bulk supply of both CARB 2 and CARB 3 gasoline in 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.[14] To remedy the Commission's competitive concerns, the consent order settling the case required Valero to divest an Ultramar refinery in Avon, California; all bulk gasoline supply contracts associated with that refinery; and 70 Ultramar retail service stations in Northern California.[15]

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[13]*Valero Energy Corp.*, C-4031 (Feb. 22, 2002) (consent order).

[14]The Commission also alleged competitive concerns in the refining and bulk supply of CARB 2 and CARB 3 gasoline for sale in Northern California, contending that even a price increase of one cent per gallon would increase costs to those consumers by approximately $60 million per year.

[15]The Commission also considered the likely competitive effects of Tosco's proposed acquisition of Phillips Petroleum. After careful and close scrutiny, the Commission, by a vote of 5-0, declined to challenge the acquisition. The Commission's statement closing the investigation set forth its reasoning in detail. *Phillips Petroleum Corp.*, FTC File No. 001 0095 (Sept. 17, 2001) (Statement of the Commission). In its most recent complaint regarding an oil merger, the Commission alleged that the merger of Phillips and Conoco would harm competition in the Midwest and the Rocky Mountain region. The consent order settling the case required substantial divestiture of assets as well as additional relief. *Conoco Inc. and Phillips Petroleum Corp.*, C-4058 (Aug. 30, 2002)(Analysis of Proposed Consent Order to Aid Public Comment). The Commission recently closed its investigation of Sunoco's acquisition of the Coastal Eagle

III. Nonmerger Investigations Into Gasoline Pricing

The second important part of the Commission's enforcement function is to detect and stop anticompetitive nonmerger conduct. The Commission has been aggressive in investigating, and prosecuting when appropriate, instances of potentially anticompetitive nonmerger activity. When it appears that higher prices might result from collusive activity, or anticompetitive unilateral activity by a firm with market power, the agency investigates to determine if unfair methods of competition have occurred. If the facts warrant, the Commission challenges the anticompetitive behavior, usually by issuing an administrative complaint.

Several recent petroleum investigations deserve discussion. On March 4, 2003, the Commission issued an administrative complaint, stating that it had reason to believe that the Union Oil Company of California ("Unocal") had violated Section 5 of the FTC Act. The Commission alleged that Unocal deceived the California Air Resources Board ("CARB") in connection with regulatory proceedings to develop the reformulated gasoline ("RFG") standards that CARB adopted. Unocal allegedly misrepresented that certain technology was non-proprietary and in the public domain, while at the same time it pursued patents that would enable it to charge substantial royalties if CARB mandated Unocal's technology in the refining of CARB-compliant summer RFG. As a result of Unocal's activities, the Commission alleged, Unocal illegally acquired monopoly power in the technology market for producing the new CARB-compliant summer RFG. In addition, the Commission alleged that Unocal undermined

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Point refinery in the Philadelphia area without requiring any relief. The Commission's statement noted that the acquisition would not have any anticompetitive effects and that substantial efficiencies were associated with the transaction. *Sunoco Inc./Coastal Eagle Point Oil Co.*, FTC File No. 031 0139 (Dec. 29, 2003) (Statement of the Commission).

competition and harmed consumers in the downstream product market for CARB-compliant summer RFG in California.

The Commission's complaint further charged that these activities, unless enjoined, could cost California's consumers hundreds of millions of dollars per year. The complaint cited testimony of Unocal's expert, who estimated that 90 percent of any royalty paid to Unocal for its technology would be passed on to drivers in the form of higher gasoline prices. This case was dismissed by an Administrative Law Judge, and is currently on appeal before the Commission.

Another major nonmerger investigation occurred during 2000-2001, when the Commission conducted a substantial investigation of the major oil refiners' marketing and distribution practices in Arizona, California, Nevada, Oregon, and Washington (the "Western States" investigation). The agency initiated the Western States investigation out of concern that differences in gasoline prices in Los Angeles, San Francisco, and San Diego might be due in part to anticompetitive activities. The Commission's staff examined over 300 boxes of documents, conducted 100 interviews, held over 30 investigational hearings, and analyzed a substantial amount of pricing data. The investigation uncovered no basis to allege an antitrust violation. Specifically, the investigation detected no evidence of a horizontal agreement on price or output or the adoption of any illegal vertical distribution practice at any level of supply. The investigation also found no evidence that any refiner had the unilateral ability to raise prices profitably in any market or reduce output at the wholesale level. Accordingly the Commission closed the investigation in May 2001.

In performing these and other inquiries, the Commission distinguishes between short-term and long-term effects. While a refinery outage on the West Coast could significantly affect

prices, the FTC did not find that it would be *profitable* in the long run for a refiner to restrict its output to raise the level of prices in the market. For example, absent planned maintenance or unplanned outages, refineries on the West Coast (and in the rest of the country) generally run close to, or at, full capacity. If gasoline is in short supply in a locality due to refinery or pipeline outages, and there are no immediate alternatives, a market participant may find that it can increase prices - - generally for a short time only until the outage is fixed or alternative supply becomes available. However, this transient power over price – which occurs infrequently and lasts only as long as the shortage – should not be confused with the sustained power over price that is the hallmark of market power in antitrust law.

In addition to the Unocal and the West Coast pricing investigations, the Commission in 2001 issued a report on its nine-month investigation into the causes of gasoline price spikes in local markets in the Midwest in the spring and early summer of 2000.[16] The Commission found a variety of factors that contributed in different degrees to the price spikes. Primary factors included refinery production problems (e.g., refinery breakdowns and unexpected difficulties in producing the new summer-grade RFG gasoline required for use in Chicago and Milwaukee), pipeline disruptions, and low inventories. Secondary factors included high crude oil prices that contributed to low inventory levels, the unavailability of substitutes for certain environmentally required gasoline formulations, increased demand for gasoline in the Midwest, and, in certain states, *ad valorem* taxes. Importantly, the industry responded quickly to the price spike; within three or four weeks an increased supply of product had been delivered to the Midwest areas

[16]Midwest Gasoline Price Investigation, Final Report of the Federal Trade Commission (Mar. 29, 2001).

suffering from the supply disruption. In fact, from the firms' perspective, an "excessive" amount of product was delivered; by mid-July 2000, prices had receded to pre-spike or even lower levels.

The discussion above covers but a few of the gasoline pricing investigations to which the Commission has devoted substantial time and resources. To date, we have identified no instances of collusion between petroleum companies. That does not mean that collusion cannot occur, which is why the agency continues to be vigilant in pursuing its enforcement mission.

IV. Recent Commission Research on Factors That May Affect Prices of Refined Petroleum Products

Prices in any commodity may fluctuate dramatically for reasons unrelated to antitrust violations. A sudden surge in demand, or an unexpected problem in the supply chain, can cause prices to spike quickly. A change in the price of a necessary input can have a dramatic effect on the price of the final good.

Such price changes are disruptive to both consumers and businesses, but they are not, by themselves, evidence of anticompetitive activity. They can occur in some regional gasoline markets because of a unique combination of short-run supply and demand conditions. The amount of gasoline that can be supplied to a particular region can be inflexible in the short run because of various limitations of refining and transportation capabilities or product requirements unique to that region. The demand for gasoline, however, is inelastic. Thus, in the short run, changes in price do not heavily influence the amount of gasoline purchased by consumers. Under these conditions, when a sudden supply shortage jolts the market, perhaps due to a refinery fire or pipeline rupture, the normal consequence of even a relatively small shortage of supply is a

sharp increase in price until the amount of product desired at that price is equal to the volume available.

A. Gasoline Monitoring and Investigation Initiative

Regional price spikes for gasoline have occurred in various parts of the country, and, as you know, we have been experiencing rapid price increases for gasoline this spring as well. As noted above, the FTC is monitoring wholesale and retail gasoline prices in cities throughout the country, and will continue to analyze this data to seek explanations for pricing anomalies. A look at some recent price spikes illustrates the kinds of factors, other than crude oil prices, that affect retail price levels.

ARIZONA

At the end of last summer, gasoline prices increased sharply in Arizona. The average price of a gallon of regular gasoline in Phoenix rose from $1.52 during the first week in August to a peak of $2.11 in late August. Several sources accounted for these price movements. The majority of gasoline sold in Phoenix comes from West Coast refineries. A pipeline from Texas also brings gasoline into the Phoenix area but is usually at capacity, so the marginal supply comes from the West Coast.[17]

Product supplies on the West Coast were already becoming tight in early August following a number of unplanned refinery interruptions in California and an unplanned shutdown at a refinery in Washington. This placed upward pressure on prices on the West Coast and in Arizona. On July 30, 2003, Kinder Morgan's El Paso to Phoenix pipeline ruptured between

[17]Marginal supply is the last product brought into a market and effectively sets the equilibrium price. It is also the increment of product that can adjust in the short run to market conditions and thus ameliorate price spikes.

Tucson and Phoenix. With this disruption, most of Arizona immediately became much more dependent on California for its gasoline supplies. The outage immediately reduced the volume of gasoline delivered to Phoenix by 30 percent. With supplies reduced by 30 percent, a price increase is likely, and necessary to both attract additional volume and to reduce demand. Without a price increase, stations would likely run out of gasoline.

On August 24, Kinder Morgan opened a temporary by-pass of the pipeline section affected by the rupture, and prices quickly fell. The average price of regular gasoline began to drop immediately. (See Figure Three.)

Marked price increases in the wake of a sudden, severe drop in supply are a normal market reaction. Because gasoline is so important to consumers, a large price increase may be required to reduce immediate demand to equal the level of available supply following a large reduction in supply. Price increases in turn attract additional supplies, which should then cause prices to decline. This response occurred in the Kinder Morgan rupture. Retail prices in Phoenix increased during the week immediately following the August 8 pipeline rupture (the week ending August 16) to levels higher than predicted by historical relationships.[18] As California refineries increased supply shipments to Arizona (displacing refining capacity that could otherwise serve California markets), retail prices in Los Angeles increased above the

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[18]Price increases in Phoenix were not large enough to equate short run supply and demand. Gasoline was rationed by long lines of motorists, and a number of stations ran out of gasoline. *See e.g.*, Phoenix Gas Crisis Worsens, MSNBC News (Aug. 21, 2003) (only 45 percent of gasoline stations had product to sell), at http://www.msnbc.com/local/AZSTAR/A1061452904.asp?0cv=BB10; Phoenix Gas Stations Running Dry After Pipeline Shut Down, Associated Press (Aug. 18, 2003), at http://www.cnn.com/2003/US/Southwest/08/18/phoenix.gas.crunch.ap/.

predicted level during the following week (the week ending August 23). By the end of August, gasoline prices in the Phoenix area were declining; they continued to drop throughout September and October. In examining this pricing anomaly, the FTC staff consulted with the Attorneys Generals' offices in Arizona and California.

ATLANTA

Another recent price anomaly picked up by the monitoring project occurred in Atlanta, Georgia and surrounding counties. This anomaly is not the traditional price spike that attracts the public's attention. Instead, it took the form of a small, sustained increase. Atlanta and its surrounding counties have experienced gasoline formulation changes in the past few years that have differentiated it from the rest of the Southeast. On April 1, 2003, an interim low sulfur standard of 90 parts per million took effect. Additionally, Georgia soon required the 45-county area surrounding Atlanta to introduce a new 30 ppm low sulfur gasoline by September 16. These formulation changes increased the cost of producing gasoline. After the 90 ppm standard was implemented, gasoline prices in Atlanta increased.

After the 90 ppm standard was instituted in April and even more frequently after the 30 ppm standard was instituted in September, the Commission's monitoring project picked up small anomalies in Atlanta gasoline pricing. Atlanta and the surrounding area have experienced slightly higher prices relative to the historical level because of the greater costs of making low sulfur gasoline. This increase is illustrated at Figure Four.

MID-ATLANTIC AREA

A third pricing anomaly occurred in September and October of last year. Gasoline prices were generally falling nationwide in September-October 2003. However, the price of

reformulated gasoline in the New York, New Jersey, Connecticut and Philadelphia area declined more slowly than the price of gasoline in the rest of the country. The FTC monitoring model showed the price of gasoline in this region was unusually high even though prices were decreasing elsewhere. (See Figure Five.)

The FTC staff's examination of this anomaly, which included consultation with the state Attorneys General, showed that the elevated price in this area stemmed from a number of factors. In late August 2003, the Northeast was hit particularly hard by an increase in demand that drew down gasoline stocks in all regions of the United States. The August 14 blackout affected the Northeast, temporarily shutting down seven refineries. While the blackout appeared to have little immediate impact on U.S. retail gasoline prices, the reduction in supply from four refineries in Ontario, Canada, whose operations were hampered by the power outage significantly affected the price of gasoline in Ontario. Typically, the Northeastern states receive significant gasoline exports from Canada. Throughout much of August, however, wholesale prices in Toronto exceeded wholesale prices in Buffalo by approximately 25 cents per gallon, a sign that less product was likely being shipped into the Northeast from Canada. This situation is confirmed by a sizeable drop in exports of gasoline from Canada to the Northeast in August.[19] By the end of September rack prices in Toronto and Buffalo had returned to rough equality.

On top of the low inventories, the switch from summer to winter grade gasoline and the switch in New York and Connecticut from MTBE-blended reformulated gasoline to ethanol RFG both caused a disincentive to build inventories in August and September. While refineries in the

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[19]Import data compiled from tariff and trade data from the U.S. Department of Commerce, the U.S. Treasury, and the U.S. International Trade Commission

Northeast increased production during this period, important additional supply to this area comes by pipeline from the Gulf and imports from abroad. Both of these sources of supply require significant response times, however. Given the shipping lags and the impending switches in formulation, there was limited time to, and a disincentive to, ship additional summer specification RFG to the Northeast.

B. Conferences and Staff Reports Identifying Factors Affecting the Price of Gasoline

Besides our monitoring project, the Commission's public conferences over the past few years have increased our knowledge of the factors that affect the prices of refined petroleum products and enabled us to disseminate that information to the public. The conferences studied in detail the central factors that may affect the level and volatility of refined petroleum product prices. Below we review just a few of those factors.

The single most important factor affecting both the level and movement of gasoline prices in the United States is the price of crude oil. Changes in crude oil prices account for approximately 85 percent of the variability of gasoline prices.[20] When crude oil prices rise, as they have recently, gasoline prices rise. (See Figure One.) Crude oil prices are determined by supply and demand conditions worldwide, most notably by production levels set by OPEC countries. Additionally, other factors that affect the supply of and demand for crude oil, such as

[20] A simple regression of the monthly average national price of gasoline on the monthly average price of WTI crude shows that the variation in the price of crude explains approximately 85 percent of the variation in the price of crude oil. (This percentage may vary across states or regions.) This is similar to the range of effects given in United States Department of Energy/Energy Information Administration (EIA), "Price Changes in the Gasoline Market: Are Midwestern Gasoline Prices Downward Sticky?" DOE/EIA-0626, February 1999. More complex regression analysis and more disaggregated data may give a somewhat different estimate, but are likely of the same magnitude.

the fast growing demand for petroleum in China, influence the price of gasoline in the United States.

Inventories of both crude oil and refined products have an important effect on retail gasoline prices as well. At our conference, EIA reported that "OPEC [production] cuts and high crude prices affect gasoline prices directly through the feedstock cost but also indirectly by reducing gasoline inventories."[21] Participants also commented that average inventories for refined products have declined over time,[22] contributing to price spikes as additional supply is less available quickly to meet demand.[23] Lower inventory costs lower the average cost of producing gasoline, to the benefit of consumers.[24]

Participants in the FTC conference also noted that refineries and the pipelines used to transport gasoline to the pump are typically highly utilized. For example, national annual

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[21]Cook (EIA), Aug. 2 tr. at 52.

[22]Greene (Cal.), Aug.2. tr. at 11 ("[i]n the 1990's, reserves and inventories [in California] have declined roughly 20-plus percent."); Rothschild (Podesta/Mattoon), Aug.2 tr. at 82 (consistently below an average of 5 days of gasoline inventory). Cooper (Cons. Fed. of Am.), written statement at 21.

[23]EIA, Inquiry into August 2003 Gasoline Price Spike (Nov. 2003) (reporting that low inventories played a key role in Summer 2003 price spike).

[24]In a recent study of the petroleum inventory system, the National Petroleum Council concluded that the trend towards lower product inventories was "the result of improved operating efficiencies partially offset by operational requirements for an increased number of product formulations to comply with environmental regulations," noting also that "(s)ince holding inventory is a cost, there is an underlying continuous pressure to eliminate that which is not needed to meet customer demand or cannot return a profit to the holder." National Petroleum Council, *U.S. Petroleum Product Supply–Inventory Dynamics*, December 1998 at 11. The National Petroleum Council study also concluded (at 22) that "(c)ompetition has resulted in the consumer realizing essentially all of the cost reductions achieved in the downstream petroleum industry."

refinery capacity utilization between 1998 and 2002 averaged 92.7 percent. Refinery utilization rates are often higher during peak demand periods, such as during summer months when the demand for gasoline is very strong. Pipeline capacity is also stretched in some regions of the country for at least parts of the year, although various pipeline expansion projects that may relieve some pressure are underway. Although it is efficient to run these capital intensive facilities at high rates of capacity utilization, supply disruptions from unexpected refinery outages or pipeline failures may not be easily or immediately compensated for by other supply sources due to capacity limitations, resulting in substantial market price effects in some cases.

The interaction of environmental quality requirements and gasoline supplies was one area identified as deserving consideration by policymakers. It is clear that environmental regulations have yielded substantial benefits. Since 1970, emissions of the six principal air pollutants – nitrogen dioxide, ozone, sulfur dioxide, particulate matter, carbon monoxide, and lead – have been cut by 25 percent, even as vehicle miles increased by 149 percent.[25] However, these regulations add to the cost of refining crude oil, and to gasoline prices. The Environmental Protection Agency ("EPA") estimates that the cost of producing a gallon of reformulated gasoline is 4 to 8 cents per gallon more than the cost of producing conventional gasoline.[26] These costs may be higher during times of supply disruption, when significant marginal costs are incurred when firms attempt to quickly adjust previously determined production runs.

Additionally, several participants at the conferences reported that the proliferation of different environmentally mandated gasoline blends has reduced the ability of firms to ship

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[25]EPA, Air Quality and Emissions Trends Report (2002).

[26]Larson (EPA), May 8 tr. at 74.

gasoline from one region to another in response to supply disruptions.[27] (Figure Six illustrates the different fuel blends required in the United States.) The FTC staff's analysis of pricing anomalies, discussed infra, provides support for these concerns.

As part of its work to improve public understanding of the possible role of environmentally mandated fuels in contributing to price volatility and price spikes, Commission staff provided comments to the EPA in connection with that agency's preparation of the EPA's Staff White Paper, a response to the President's National Energy Report (May 2001). The President's Report directed the EPA Administrator to "study opportunities to maintain or improve the environmental benefits of state and the local 'boutique' fuels programs while exploring ways to increase the flexibility of the fuels distribution infrastructure, improve fungibility, and provide added gasoline market liquidity."[28] The FTC staff commented that the EPA might find it beneficial to use a framework similar to the one the FTC uses to analyze mergers, to determine the competitive effects likely to result from changes in fuel mandates in particular relevant markets.[29] The FTC staff has offered suggestions to the EPA as to how they

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[27]*E.g.*, Felmy (API), Aug. 2 tr. at 26; Cooper (Assoc. of Oil Pipe Lines), Aug.2 tr. at 102. According to one participant, "[t]ight specifications for reformulated gasoline sold in [California] and limited pipeline interconnections . . . isolate the California gasoline market from gasoline markets in the rest of the country," thus contributing to higher prices in the state. Gilbert (U. Cal.Berkeley), written statement at 3-4.

[28]*Study of Unique Gasoline Fuel Blends ("Boutique Fuels"), Effects on Fuel Supply and Distribution and Potential Improvements*, EPA Staff White Paper at 1-2.

[29]The FTC's experience shows that economically relevant gasoline markets are regional for refining and transportation, and local when considering gasoline distribution or retail sales. For example, a refinery that does not, or cannot in the short run, produce the type of gasoline currently in short supply in a certain region cannot be considered to be in that market for purposes of resolving short-run price spikes. FTC Staff Comment to EPA at 4.

might perform such an analysis.

Other federal and state laws and regulations were identified as affecting gasoline prices. A federal statute known as the Jones Act[30] increases the cost of transporting petroleum products by requiring that any product transported by vessel between U.S. ports be carried in domestically-built ships staffed by U.S. crews, which is more expensive than carriage by foreign-built, foreign-staffed ships. A recent government estimate of the total welfare cost of the Jones Act for all tanker shipping is $656 million dollars a year, based on the assumption that a foreign ship has operating costs of only 59 percent of a Jones Act ship.[31] The observed cost of transportation of refined petroleum products from the Gulf to the West Coast, 10-25 cents per gallon,[32] imply the Jones Act imposes an additional cost of about at least 4 cents per gallon during the times of the year when it is necessary to transport gasoline using Jones Act ships.

A number of states have regulatory schemes that substantially influence gasoline prices. Several states have divorcement statutes that require the unbundling of retail sales from upstream refining operations. Careful economic analyses of divorcement statutes conclude that such statutes have the effect of raising consumer prices.[33] Other regulatory statutes that appear to have

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[30]Sec. 27 of the Merchant Marine Act of 1920, 46 U.S.C. 883, 19 CFR 4.80 and 4.80(b).

[31]The Economic Effects of Significant U.S. Import Restraints, U.S. International Trade Commission, Pub. No. 3519 (June 2002).

[32]California Energy Commission, Gulf Coast to California Pipeline Feasibility Study (Aug. 2003).

[33]*See e.g.*, Michael Vita, "Regulatory Restrictions on Vertical Integration and Control: The Competitive Impacts of Gasoline Divorcement Policies," 18(3) J. of Regulatory Econ. 217-33 (Nov. 2000); Asher Blass and Dennis Carlton, "The Choice of Organizational Form in Gasoline Retailing and the Cost of Laws that Limit that Choice," XLIV(2)(Pt. 1) J.Law and Econ. 551 (2001).

have the effect of increasing gasoline prices include bans on self-service sales, and restrictions on below-cost sales, which appear to simply protect retailers from competition from more efficient competitors.[34] The FTC staff have recently provided comments on sales below cost legislation.[35]

V. Conclusion

The Commission has a long and continuing history with law enforcement investigations in the petroleum industry. The agency has expended substantial effort and resources to maintain and study competition in this industry. We will continue to do so in the future.

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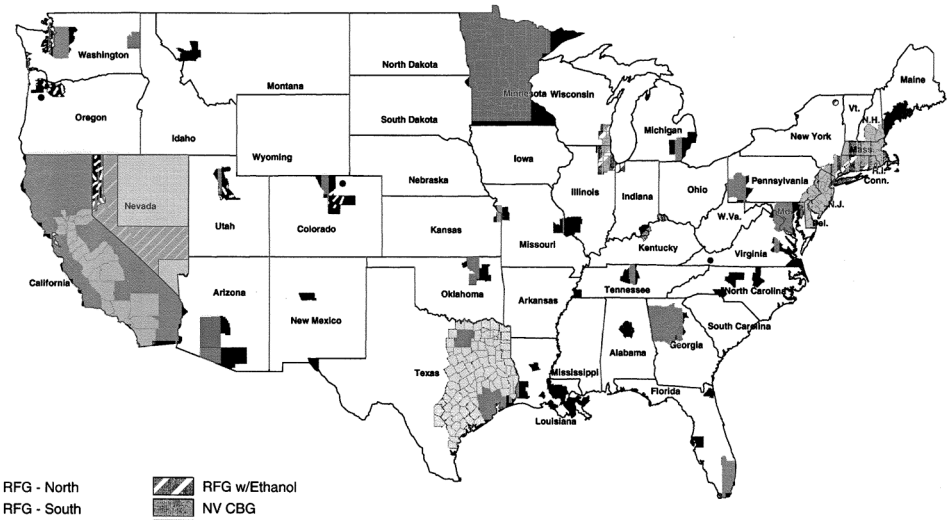
[34]Retail markets are being transformed by hypermarkets, which are high volume retail outlets mostly owned by or leased from grocery stores, mass merchandise retailers, large convenience stores or membership clubs. Hypermarkets have substantial economies of scale that enable them to sell at low prices. They may pump up to one million gallons of fuel a month. Hypermarkets, in some circumstances, can reduce their costs further by doing their own wholesaling. Some hypermarkets already buy their gasoline directly from the refineries through long term contracts. As of the fourth quarter of 2002, the market share for hypermarkets, nationally, was approximately 6%. See Energy Analysts International, Evolution of the High Volume Gasoline Retailer (February 13, 2003).

[35]*See* Letter from Susan Creighton, Director, FTC Bureau of Competition, et al., to Kansas State Sen. Les Donovan (Mar. 12, 2004), at http://www.ftc.gov/be/v040009.pdf; Letter from Susan Creighton, Director, FTC Bureau of Competition, et al., to Demetrius Newton, Speaker Pro Tempore of the Alabama House of Representatives (Mar. 12, 2004), at http://www.ftc.gov/be/v040005.htm; Letter from Susan Creighton, Director, FTC Bureau of Competition, et al., to Wisconsin State Rep. Shirley Krug (Oct. 15, 2003), at http://www.ftc.gov/be/v030015.htm; Letter from Joseph J. Simons, Director, FTC Bureau of Competition, et al., to Eliot Spitzer, Attorney General of New York (July 24, 2003), at http://www.ftc.gov/be/nymfmpa.pdf; Letter from Joseph J. Simons, Director, FTC Bureau of Competition, et al., to Roy Cooper, Attorney General of North Carolina (May 19, 2003), at http://www.ftc.gov/os/2003/05/ncclattorneygeneralcooper.pdf; *Competition and the Effects of Price Controls in Hawaii's Gasoline Market: Before the State of Hawaii, J. Hearing House Comm. On Energy and Environmental Protection et al.* (Jan. 28, 2003) (testimony of Jerry Ellig, Deputy Director, FTC Office of Policy Planning), at http://www.ftc.gov/be/v030005.htm; Letter from Joseph J. Simons, Director, FTC Bureau of Competition, et al., to Gov. George E. Pataki of New York (Aug. 8, 2002), at http://www.ftc.gov/be/v020019.pdf; Letter from Joseph J. Simons, Director, FTC Bureau of Competition, and R. Ted Cruz to Hon. Robert F. McDonnell, Commonwealth of Virginia House of Delegates (Feb. 15, 2002).

The American public needs to know what forces shape the performance of this vital sector of the economy. Higher prices for products that are critical to our citizens' quality of life and for the efficient functioning of the national economy are matters of serious concern. When price increases result from conduct that violates the antitrust laws, the FTC will take enforcement action.

I am pleased to answer your questions.

U.S. Gasoline Requirements

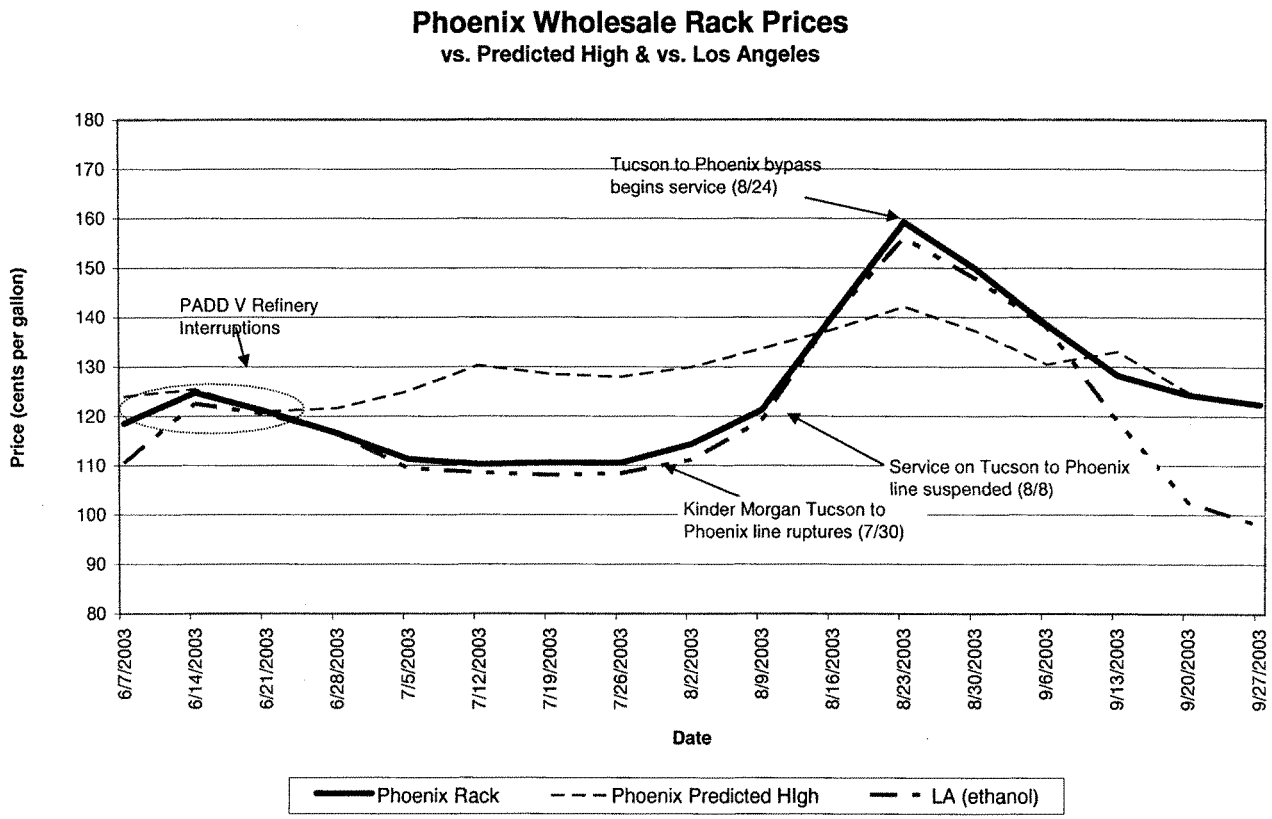


- RFG - North
- RFG - South
- Oxygenated Fuels
- CA CBG
- RFG/CA CBG
- AZ CBG
- Oxy Fuels/7.8 RVP
- Oxy Fuels/7.0 RVP
- Conventional
- RFG w/Ethanol
- NV CBG
- 7.2 RVP
- 7.0 RVP
- 7.8 RVP, MTBE-No Increase
- 7.8 RVP
- 7.0 RVP, 30 ppm S
- 300 ppm S
- 800 ppm S

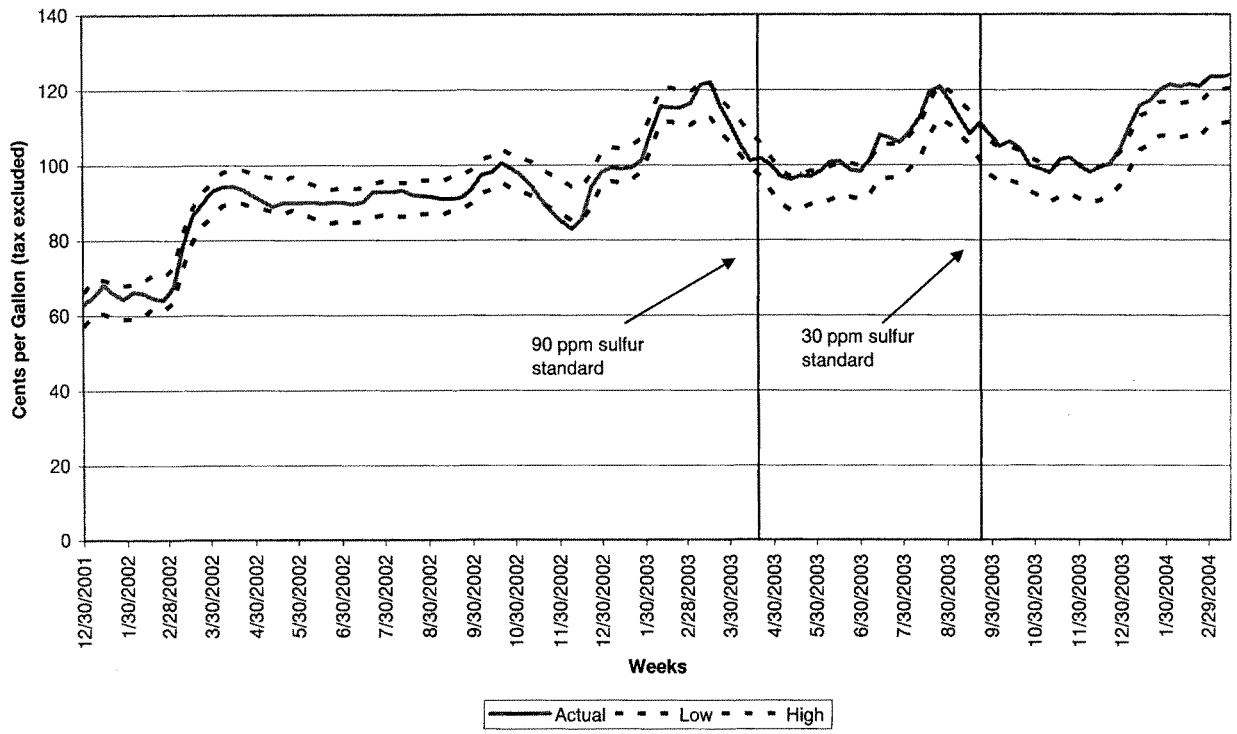
ExxonMobil
As of November, 2003

This map is not intended to provide legal advice or to be used as guidance for state and/or federal fuel requirements, including but not limited to oxy fuel or RFG compliance requirements. ExxonMobil makes no representations or warranties, express or otherwise, as to the accuracy or completeness of this map.

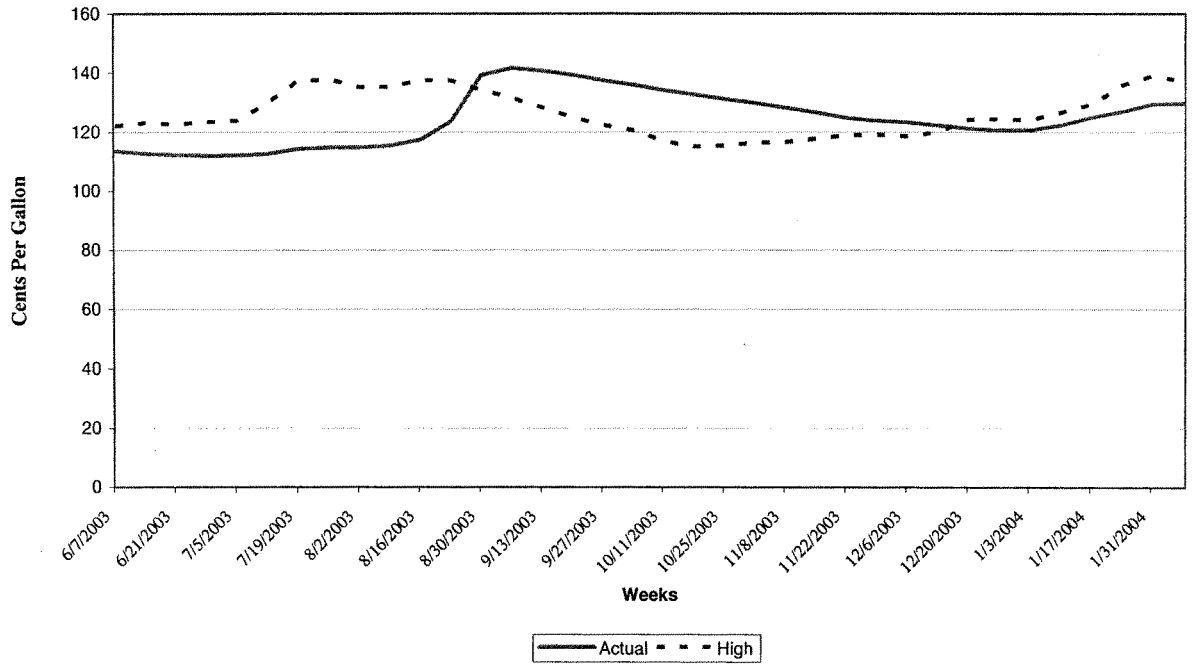
K.W. Gardner
GG0897

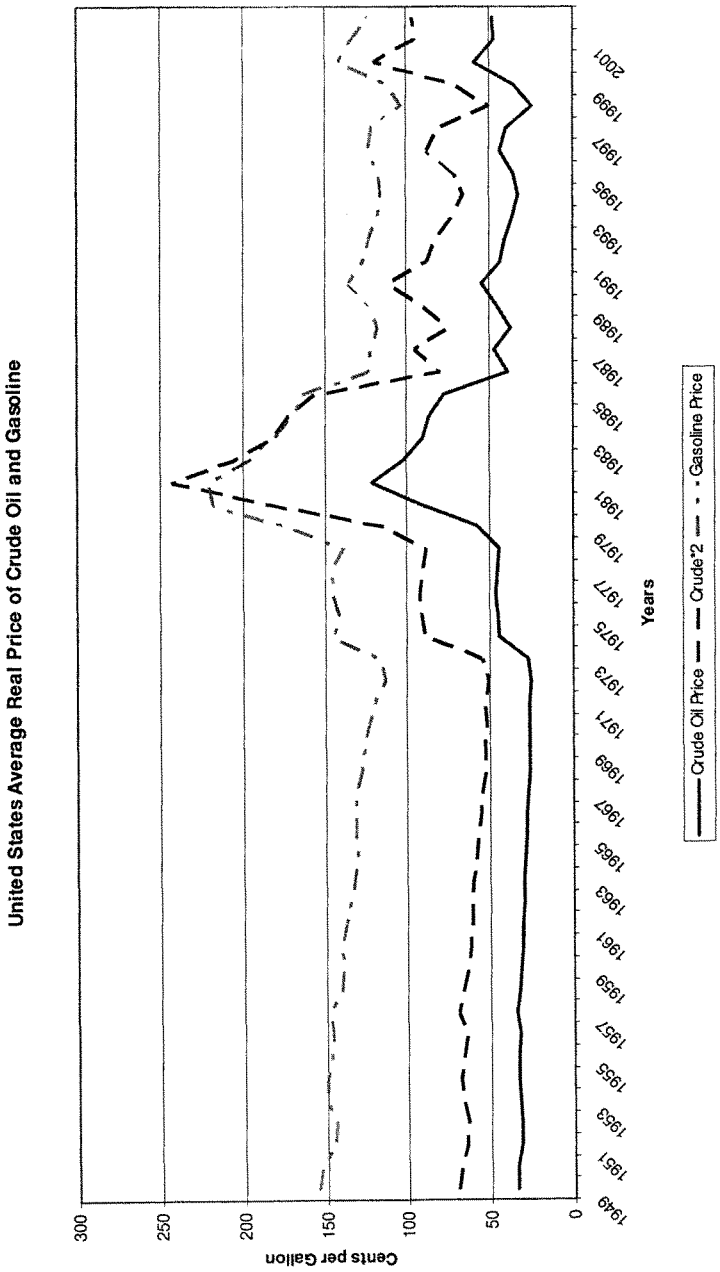

Phoenix Wholesale Rack Prices
vs. Predicted High & vs. Los Angeles
Price (cents per gallon)
180
170
160
150
140
130
120
110
100
90
80
Tucson to Phoenix bypass begins service (8/24)
PADD V Refinery Interruptions
Service on Tucson to Phoenix line suspended (8/8)
Kinder Morgan Tucson to Phoenix line ruptures (7/30)
6/7/2003
6/14/2003
6/21/2003
6/28/2003
7/5/2003
7/12/2003
7/19/2003
7/26/2003
8/2/2003
8/9/2003
8/16/2003
8/23/2003
8/30/2003
9/6/2003
9/13/2003
9/20/2003
9/27/2003
Date
Phoenix Rack
Phoenix Predicted HIgh
LA (ethanol)

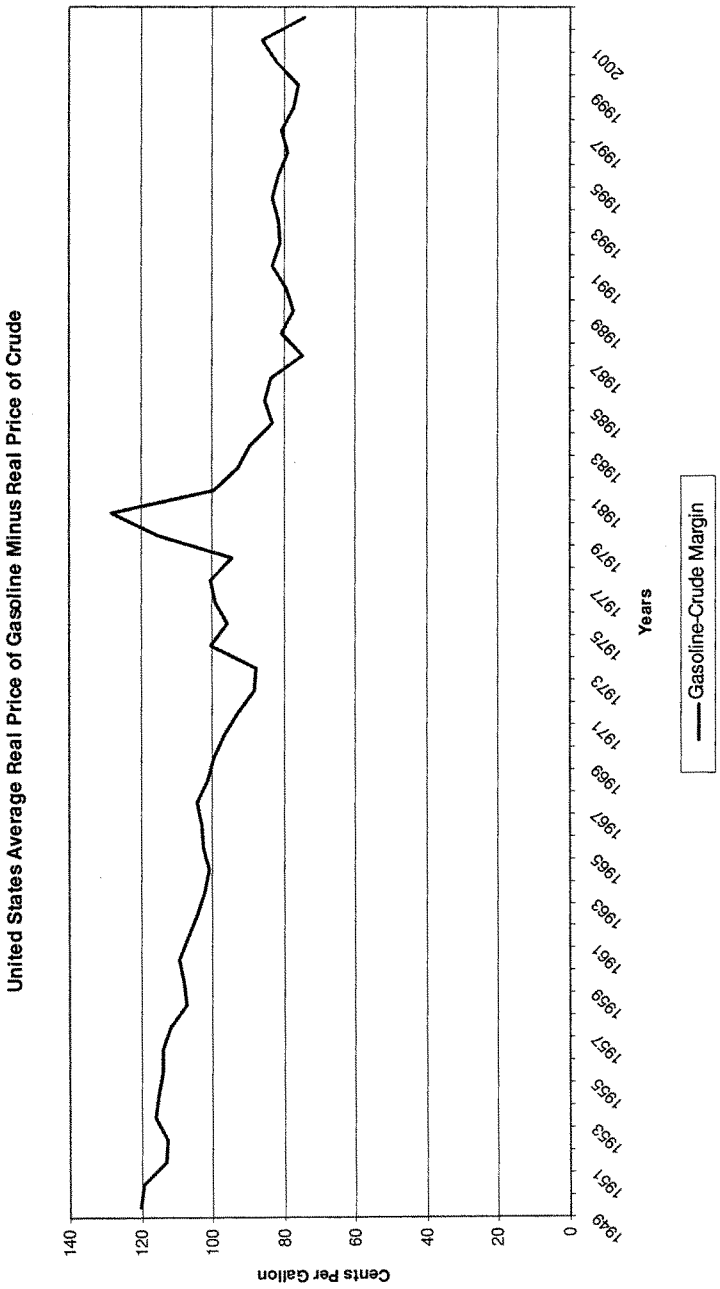
Actual and Predicted Price of Gasoline in Atlanta,Georgia
January 2001 - February 2004

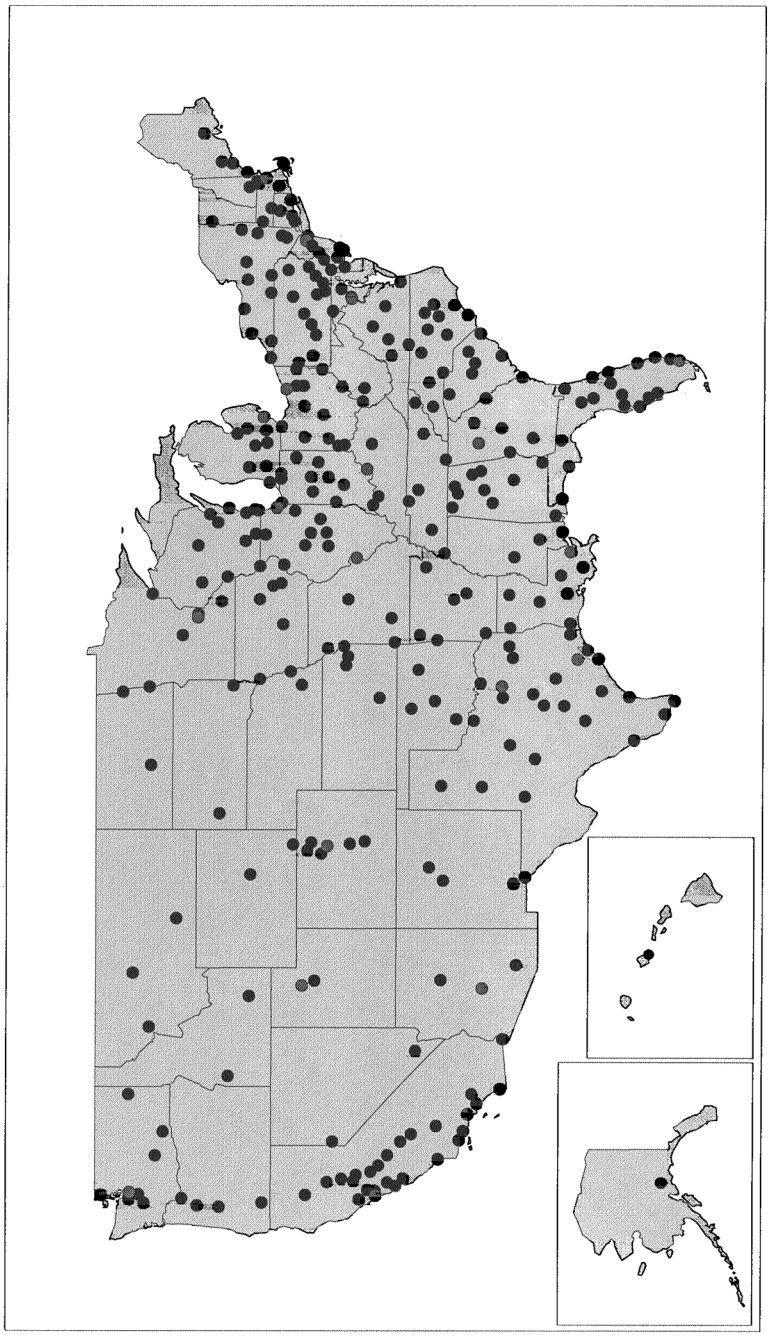


Actual and Predicted High Price of RFG Gasoline in New York, New York
June 2003-January 2004




United States Average Real Price of Crude Oil and Gasoline
Cents per Gallon
300
250
200
150
100
50
0
1949
1951
1953
1955
1957
1959
1961
1963
1965
1967
1969
1971
1973
1975
1977
1979
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
Years
Crude Oil Price
Crude*2
Gasoline Price


United States Average Real Price of Gasoline Minus Real Price of Crude
Cents Per Gallon
140
120
100
80
60
40
20
0
1949
1951
1953
1955
1957
1959
1961
1963
1965
1967
1969
1971
1973
1975
1977
1979
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
Years
Gasoline-Crude Margin



U.S. SENATOR PATRICK LEAHY

CONTACT: David Carle, 202-224-3693 VERMONT

Statement of Senator Patrick Leahy
"Crude Oil: The Source of Higher Gas Prices?"
Hearing Before the Subcommittee on
Antitrust, Competition Policy and Consumer Rights
April 7, 2004

This week, when my neighbors in Middlesex, Vermont go to the pumps, they will pay upwards of $1.70 per gallon of gasoline – for regular grade. And diesel fuels, which farmers depend on, are also experiencing historically high prices. When one of my neighbors asks me why they are paying so much, or why out-of-control gas prices are cutting in to the already-narrow profit margins of hard working Vermont farms, what can I tell them? Right now, to answer honestly, I have to tell them that the U.S. government is not doing anything to ensure that they pay a fair price at the pump. I hope that today's hearing signals – to both the Bush Administration and foreign governments – that the American people and their representatives in Congress demand that the Executive Branch use the tools it has to keep gasoline prices affordable for Americans and if we need more legal tools, we will provide them.

Today, we will hear testimony about the causes of rising gasoline prices, but most Americans already know why they pay such high prices at the pumps: The OPEC cartel that sets production quotas for member countries and prevents the free market from setting crude oil prices.

As of April 5, the U.S. Department of Energy reports that the nationwide average price of one gallon of gasoline is $1.78. As you can see from this chart, this is an increase of 60 cents per gallon since 2001, and some energy experts are predicting that the price of gas may rise to $2.50 or $3.00 per gallon this summer – numbers that would be comparable in real dollars to prices seen during the gasoline shortages of the early 1980s. Indeed, that seems likely since OPEC met on March 31, and decided to cut the output of oil even further. Not only has OPEC decided to cut production by a million barrels a day, they also are discussing a long-term price increase. The Nigerian petroleum advisory stated that OPEC was considering raising prices by $3 per barrel. If they move forward with this policy, the current prices will be the norm and not a spike.

These high energy costs are not only increasing costs to consumers, but to our small businesses and the dairy industry. Vermont dairies are experiencing diesel fuel price increases of 40 percent above historic averages. In normal times, Americans often ask themselves if they've "Got Milk." Today, our dairy farmers are asking themselves, "Got Enough Money for Gas?" As USDA's Cooperative Extension Office in New Hampshire recently found, the increasing energy costs may increase total costs for a 100-head dairy

operation in the Northeast by $5,000 or more. Dairy farms are extensive users of energy through their milking operations, planting, cultivating and harvesting of crops, fertilizers costs, and daily (or twice daily) milk hauling costs. This is an industry that recently faced an 18-month-period of record low milk prices. Now that milk prices have begun to turn around, our farmers are faced with the prospect of rising energy prices for the foreseeable future. This burden, created by OPEC's artificial price controls, should not and cannot fall on our farmers.

Addressing this concern, we have reintroduced the "No Oil Producing and Exporting Cartel Act of 2004," or NOPEC bill, S.2270. This legislation would subject OPEC to American antitrust laws. I thank Senators Kohl and DeWine for their leadership on this measure. By now it is clear that the Bush Administration is unable – or more accurately, unwilling – to deal with the gas crisis that is now a four-square threat to our families, our farmers, our truck drivers, our businesses and our economic health. If the Bush Administration will not say "no" to OPEC, then Congress should.

OPEC has recently tried to dismiss criticism about the high price of gasoline through disingenuous arguments. In fact, Department of Energy data show us that consumption of oil has remained relatively level over the last few years. And few could argue with a straight face that the 60 cent increase per gallon in price in the last two years could be explained by tougher environmental policies of the Bush Administration. To the contrary, this Administration has done everything it can think of to weaken environmental enforcement and policies.

Although we need to take immediate actions to bring gas prices down, we also need to do more to increase fuel efficiency in cars and trucks. Like so many other issues, the Bush Administration has put special interests above the public interest in blocking every attempt to improve fuel efficiency. If we are going to reduce our dependence on foreign oil, we have to push auto manufacturers to do more to get cars to go further on each gallon of gas.

The Administration shows no inclination to solve this problem, or even to begin to try. The President, who himself has a long history with the oil industry, had promised the American people that he could "jawbone" OPEC into not raising prices. Sadly, he has failed. Still, there are many other things he can do, and do now. I request that Senator Bingaman's recent letter to the President urging him to take a dozen steps now, without delay, be included in the record. When faced with gouging by OPEC, President Clinton made some reserves available to add to our domestic supply. Senator Kerry and others are urging that we supplement the domestic supply by slowing unnecessary contributions to the Strategic Petroleum Reserve, and that we develop and deploy clean energy technology and undertake responsible oil and gas development. Senator Wyden has proposed a Senate Resolution pushing the Bush Administration to pressure OPEC nations to increase oil production. I think it absolutely remarkable that the Administration failed to contact Saudi Arabia before OPEC's decision to cut production last week.

That being said, I am heartened to see this hearing today. I wrote to Chairman Hatch two weeks ago urging such a hearing and asking that this Committee contribute what it can to stem the rise in gas prices. I am hopeful that the testimony from our witnesses will help us move forward to contain rising gas prices and confront anticompetitive conduct where it occurs. We need to goad the Administration into long-overdue action. Sadly, the Administration did not think it was worth sending a witness or even testimony to this hearing. No one from the Department of Energy, whose Secretary used to serve as a Member of the Judiciary Committee, is providing testimony or ideas or action to stem rising gasoline prices. The silence from the Administration is deafening. It is difficult for Congress to take the lead in this crisis. But we will do what we can to work with the enforcement agencies to ensure that we bolster competition.

# # # # #

United States Senate Committee on the Judiciary

Crude Oil: The Source of Higher Gas Prices?

Written Testimony of

Mr. James B. Sloan

Antitrust Attorney

161 North Clark Street, Suite 3100, Chicago, Illinois 60601

Submitted to the Antitrust Subcommittee of the Judiciary committee of the U.S. Senate, April 21, 2004

It Is Truly Time for NOPEC

I have spent over thirty five years studying price fixing cartels and numerous forms of illegal restraints of trade in the United States and internationally. For the first time in my memory a Congressional committee is proposing a fundamentally sound step to promote a free market for oil.

I would like to commend Chairman DeWine and Ranking Democrat Kohl as well as the rest of the Subcommittee members for conducting hearings on this extremely timely and relevant matter. I applaud and fully support the congressional effort to engage United States' antitrust laws to break up OPEC and to promote the trade of the world's crude oil output in the free market place. It is time for a very strong statement on this issue by Congress and this proposed legislation is a bold and very powerful statement.

Since its conception in 1960, the OPEC member nations have succeeded in controlling the production, supply, and price of what is today almost forty-percent (40%) of the world's crude oil output. They have the power to increase gasoline prices in the United States at the pump by simply issuing a press release announcing consideration of a proposed cut in production, without regard to whether that actual cut ever materializes. America has allowed a small group of foreign nations to incrementally plunder its vital resources at will without protest or retaliation.

The Sherman Antitrust Act of 1890, the Clayton Act of 1914 and the Federal Trade Commission Act of 1914 prohibit OPEC-like cartels on American soil. Not allowing a *foreign state* to invoke sovereign immunity – when it limits the production of oil products, fixes prices as to those products or restrains trade in them – would allow *us*, as a people, to invoke our antitrust laws against <u>any</u> such joint action that does not recognize the free market as the arena for determining the supply and price of crude oil and its by-products.

Historically, when nations join together to boycott the shipment of vital goods to other nations, such acts would be considered acts of belligerency justifying wars. Consider the outcry if America and a small number of its grain producing allies used their market power to create an Organization Of Food Exporting Countries (OFEC) and restrict shipments of food (as well as other vital products) to members of OPEC. The OPEC countries and the world would view such action as a violation of all international law and view such actions as tantamount to acts of war. Yet, how are the actions of OPEC any different from an OFEC and how can they be justified or tolerated under international law and its norms and the antitrust laws of almost all western industrial nations?

In March 2000, Subcommittee member Senator Arlen Specter along with Senator Joseph Biden unveiled a letter to President Clinton that urged consideration of lawsuits against OPEC in the United States and the international courts. They stated:

> "The behavior of OPEC and other oil-producing nations in restraint of trade violates U.S. antitrust law and basic international norms, and it is injuring the United States and its citizens in a very real way. We hope that you will seriously consider judicial action to put an end to such behavior."

No nation has the right to artificially inflate the price of a commodity that is so valuable to another nation. The United States judicial system should intervene in the collusion of those nations that do.

This proposed legislation is a major step in denying OPEC any form of international legitimacy and can be the catalyst for a national and international effort and dialogue to end past policies of passive acquiescence in the largest price fixing cartel in the history of the world. It has been estimated that OPEC has unlawfully taken over three trillion dollars out of the economy of the United States since its existence.

This legislation is a major step in promoting the free trade of crude oil, the very lifeblood of our nation. And it is a major step in working with other nations to establish more effective international antitrust laws so that all crude oil production might be freely traded in the world's market place.

I submit this testimony for the record of the Subcommittee's hearings as an affirmation of my support for Senate Bill 2270.