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PRICES AT THE PUMP: MARKET FAILURE AND THE OIL INDUSTRY

HEARING

BEFORE THE

ANTITRUST TASK FORCE

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

MAY 16, 2007

Serial No. 110–84

Printed for the use of the Committee on the Judiciary

Available via the World Wide Web: http://judiciary.house.gov

U.S. GOVERNMENT PRINTING OFFICE

35–451 PDF WASHINGTON : 2008

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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PRICES AT THE PUMP: MARKET FAILURE AND THE OIL INDUSTRY

WEDNESDAY, MAY 16, 2007

HOUSE OF REPRESENTATIVES,
ANTITRUST TASK FORCE
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Task Force met, pursuant to notice, at 1:13 p.m., in Room 2141, Rayburn House Office Building, the Honorable John Conyers, Jr. (Chairman of the Task Force) presiding.

Present: Representatives Conyers, Davis, Smith, Chabot, and Keller.

Staff present: Stacey Dansky, Majority Counsel; Mark Dubester, Majority Counsel; Stewart Jeffries, Minority Counsel; and Brandon Johns, Majority Staff Assistant.

Mr. CONYERS. The hearing of the Antitrust Task Force will come to order.

Good afternoon.

As summer approaches, consumers are panicking over the price of gasoline at the pump. Prices have skyrocketed. Today's average U.S. price of a gallon of gas is $3.03, short just barely of the record high reached in September of 2005 after Hurricane Katrina hit.

In Michigan, gas prices have reached their highest levels ever, at $3.27 a gallon. My State is now the third most expensive State for gasoline in the country, behind only California and Illinois.

Now, how did we get to this crisis, and what are the solutions?

Cartels, the OPEC cartel, to be specific, which accounts for the two-thirds of the world's oil reserves and over 40 percent of the world's oil production. Most significantly, OPEC's oil exports represent about 70 percent of the oil traded internationally. This affords them considerable control over the global market.

Its net oil export revenues should reach nearly $395 billion this year, and its influence on the oil market is predictably dominant, especially when it decides to reduce or increase its levels of production. For years, this conspiracy has unfairly driven up the cost of imported crude oil to satisfy the greed of oil exporters.

We have long decried OPEC but, sadly, no one in the Government has tried to take any action. Because the Subcommittee Chairman, Bart Stupak, of Michigan is here and I happen to know that he is also chairing his own hearing in another room around the corner, I will suspend my statement, invite our colleague, Mr. Stupak, to join us here, and with the approval of the rest of the Members of the Task Force and the Ranking Chairman——

Mr. CHABOT. We have no objection.

Mr. CONYERS. Thank you.

We would invite Bart Stupak to begin.

He has been a Member of this body since 1992, has served on the Energy and Commerce Committee as Chairman of the Oversight and Investigation Subcommittee and will be holding hearings looking into the causes behind rising gas prices.

He is also a leader in the Democratic Caucus on Energy Issues and is the author of the Federal Price Gouging Prevention Act, which would give the Federal Trade Commission the authority to investigate and punish those who unreasonably inflate the price of energy.

Without objection, his statement will be entered into the record.

And we welcome you to the Judiciary Committee, the Task Force on Antitrust. Welcome, Bart.

TESTIMONY OF THE HONORABLE BART STUPAK, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. STUPAK. Thank you, Mr. Chairman, Mr. Chabot, thank you, and thank you for the courtesy.

I am in a hearing with British Petroleum. We are looking at the Texas City explosion that occurred in 2005 in which 15 people were killed, another 180 people injured and also what has happened up at Prudhoe Bay where we shut down our oil fields, America's most strategic oil field, last summer because of leaks.

And it looks like it is, testimony is showing us, through lack of maintenance while they had record profits. In fact, during that period of time, they received $106 billion in profits from 1999 to 2005 but yet they cannot maintain their maintenance which led to explosions and deaths and things like that.

But today we are here to talk about gas prices.

You are right, Mr. Chairman, on the 22nd of this month, we will hold hearings on the price gouging legislation and other legislation we have.

Today, on the news, you heard that nationwide average price for gasoline hit $3.10 a gallon. This is higher than any time last year, and we haven't even begun the summer driving season. While consumers pay record prices, oil companies make record profits.

For years, big oil has told us that the cost of a gallon of gas is directly related to the price of crude on the world market. However, in April of this year, a barrel of crude oil was $63. A year before, last year, a barrel of crude was $70. Despite the fact that crude is $7 a barrel cheaper than last year, gas prices are almost 50 cents higher per gallon. Clearly, there is more at play than simply the price of crude oil.

Since 1980, more than 200 refineries in the U.S. have been closed. Only one new major refinery has been requested and environmental permits were permitted within a year for that refinery. It was chosen, though, the oil companies chose never to build it.

Oil companies complain there is too much environmental red tape, but as I said, since 1976, only one application for a new refinery has occurred, and those permits were approved forthwith.

In fact, there is evidence that the oil companies have intentionally reduced refinery capacity to drive up gas prices. The Oversight Investigations Committee—I will leave you the internal documents from Mobil, Chevron and Texaco—in 1995 and 1996, specifically, advocated that these companies limit domestic refining capacity to drive up prices.

Today, there are fewer independent refineries in the United States, according to the May 2004 GAO study. The four or five largest oil companies now own the majority of the refineries, giving these companies a significant amount of control over the entire distribution process, from exploration for oil to the gas that goes in your tank. Shrinking refinery capacity and a reluctance to invest in new infrastructure have significantly restrained gasoline supplies, driving refinery profits to record highs.

Take, for example, after Hurricane Katrina. Refinery profits were 255 percent higher than they were the same time the previous year. The average profit margin between a barrel of crude oil and a barrel of gasoline now, today, is $30, as reported in the May 3 BusinessWeek article.

That is about 70 cents in refinery profits based on a $3 per gallon of gas. So according to experts, the spread or the profit should be $8 or $9 a barrel, not the $30 we see today. At $8 or $9 a barrel for a refinery, they earn about 20 cents a gallon, which is a reasonable profit margin.

As a result of these enormous profits, in the first 3 months of 2007, Valero, the Nation's largest refinery, announced $1.1 billion in profit. That is up 30 percent over last year. ExxonMobil's refineries alone made $1.9 billion in the first quarter.

I have introduced legislation, the Federal Price Gouging Prevention Act, to protect American consumers from being gouged at the pump. It is H.R. 1252. It would give the FTC, Federal Trade Commission, the authority to investigate and punish those who artificially inflate the price of energy. The FTC would be empowered to exercise its authority at each stage of energy production and distribution supply chain. The legislation applies to gasoline, diesel fuel, crude oil, natural gas, home heating oil and propane.

Over 100 Members of Congress have already co-sponsored this legislation.

I have also introduced the Prevent Unfair Manipulation of Prices, the PUMP Act, H.R. 594. the PUMP Act would increase the oversight by the Commodity Futures Trade Commission of over-the-counter energy trading. According to the April 30 Financial Times, the CFTC, Commodity Futures Trading Commission, has taken the rare step of having to issue subpoenas to McGraw-Hill, which produces trade publications on energy trading.

Because the CFTC does not have the authority to ask traders for this information, it is instead forced to take legal action against third party publications. Without proper oversight, energy prices can be driven up by fear, greed and speculation.

Economists have estimated that improving oversight of these markets would eliminate the fear premium on crude oil and lower the price by as much as $20 a barrel, or almost 50 cents per gallon.

By passing these two bills, Congress can reign in the excessive profits made by the oil companies and the speculation of unregu-

lated energy markets. Just counting the 50 cents per gallon of excess profit on refineries and 50 cents per gallon of fear premium—we call it fear premium—these two bills could save consumers $1 per gallon at the pump.

In addition, I encourage this Committee to continue to investigate the influence that big oil has on the price of gasoline, including a May 2004 GAO report, because they do talk about is there collusion between the companies, why have they failed to invest in refinery infrastructure?

So I want to thank this Committee for allowing me to testify. I look forward to take any questions you may have.

[The prepared statement of Mr. Stupak follows:]

PREPARED STATEMENT OF THE HONORABLE BART STUPAK, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Chairman Conyers and Members of the Committee, gas prices are causing Americans significant financial hardship, and I appreciate the work this Committee is doing to address this problem. Thank you for allowing me to appear before you today.

Last week, the nationwide average price for gasoline hit $3.07 a gallon. This is higher than any time last year, and we have yet to reach the peak driving season for 2007. As we approach Memorial Day and increased summer driving, gas prices are expected to be even higher. While consumers pay record prices, oil companies make record profits.

For years, Big Oil has told us that they have no control over gas prices because it is dependent on world crude oil prices.

However, in April, a barrel of oil cost $63. A year before, a barrel of crude oil was $70. Despite the fact that crude oil was *$7 a barrel cheaper* than last year, gas prices were almost *50 cents per gallon higher*. Clearly, there is more at play than simply the world crude oil market.

Since 1980, more than 200 refineries in the United States have been closed. Demand for gasoline continues to grow every year, but a new refinery has not been built since 1976. Only one new major refinery has requested environmental permits in the past 30 years. While the permits were granted, the refinery was never built.

The oil companies complain that there is too much environmental red tape. The truth is that very few companies have even tried to build new refineries, instead opting to upgrade existing facilities and run them as close to capacity as possible.

In fact, there is evidence that oil companies have intentionally *reduced* refining capacity to drive up gas prices.

Internal documents from Mobil, Chevron, and Texaco in 1995 and 1996 specifically advocated that these companies limit domestic refining capacity to drive up prices.

Today, there are fewer independent refineries in the United States, according to a May 2004 Government Accountability Office (GAO) study. The 4 or 5 largest oil companies now own the majority of refineries, giving these companies a significant amount of control over the entire distribution process, from exploration to your gas tank.

Shrinking refinery capacity and a reluctance to invest in new infrastructure have significantly restrained gasoline supplies, driving refinery profits to record highs.

For example, after Hurricane Katrina, refinery profits were 255 percent higher than they were at the same time a year before, according to the *The Washington Post*.

The average profit margin between a barrel of crude oil and a barrel of refined gasoline is now $30, as reported in a May 3, 2007 *Business Week* article. That's about 70 cents in refinery profits for every $3 gallon of gas. According to experts, $8 or $9 a barrel, or about 20 cents a gallon, is a more reasonable profit margin.

As a result of these enormous profit margins, in the first three months of 2007, Valero, the nation's largest refinery company, announced profits of $1.1 billion, up 30% over last year. ExxonMobil's refineries alone made $1.9 billion in the first quarter of 2007.

Other oil companies have enjoyed similar profits. During the first 3 months of 2007, Royal Dutch Shell's profit was $7.3 billion. Chevron reported $4.7 billion, up 18 percent from last year. ConocoPhilips made more than $3.5 billion. And ExxonMobil's profits were more than $9.2 billion.

I have introduced legislation, the *Federal Price Gouging Prevention Act* (HR 1252) to protect American consumers from being gouged at the pump.

H.R. 1252 would give the Federal Trade Commission (FTC) the authority to investigate and punish those who artificially inflate the price of energy. The FTC would be empowered to exercise this authority at each stage of the energy production and distribution supply chain.

The legislation applies to gasoline, diesel fuel, crude oil, natural gas, home heating oil, and propane.

Over 100 Members of Congress have already co-sponsored this legislation, and I look forward to moving it soon.

I have also introduced the Prevent Unfair Manipulation of Prices (PUMP) Act, HR 594. The PUMP Act would increase oversight by the Commodity Futures Trading Commission of over-the-counter energy trading.

According to an April 30 *Financial Times* story, the CFTC has taken the rare step of issuing a subpoena to McGraw-Hill, which produces trade publications on energy trading. Because the CFTC does not have the authority to ask traders for this information, it is instead forced to take legal action against third-party trade publications.

Without proper oversight, energy prices can be driven by fear, greed, and speculation. Economists have estimated that improving oversight of these markets would eliminate the "fear premium" on crude oil and lower the price by as much as $20 a barrel, or almost 50 cents per gallon of gasoline.

By passing my two bills, Congress can reign in the excessive profits made by the oil companies and the speculation on unregulated energy markets.

Just counting the 50 cents a gallon of excess profit by the refineries, and the 50 cents per gallon of fear premium, these two bills could save consumers up to $1 a gallon at the pump!

In addition to my legislation, I encourage this Committee to investigate the influence the Big Oil has on the price of gasoline. Is there any collusion between these companies? Why have they failed to invest in refinery infrastructure?

As Chairman of the Oversight and Investigations Subcommittee in Energy and Commerce, I have scheduled a hearing on gas price gouging and the factors that go into the price of gasoline.

I thank the Committee for allowing me to testify, and I look forward to your questions.

Mr. CONYERS. Well, we have decided that we will send you the questions in writing and then incorporate them into the hearing, Bart Stupak, but thank you for getting us started.

Mr. STUPAK. Thank you, Mr. Chairman.

Mr. CONYERS. Not only do you have one piece of legislation for us to examine, but two, and we want to get further descriptions of them to include in the record. I don't want to take up anybody's time here.

Mr. STUPAK. Well, take a look at the PUMP Act, Mr. Chairman. About half the trades on the oil market are not being subject to any kind of Government oversight, and that is when you do get the fear, speculation and greed. Everything we have looked at we can save $20 a barrel if we just put oversight. I am not saying regulation, I am just saying oversight. Why are some of the trades on the oil market subject to oversight and the others are not?

Mr. CONYERS. I thank my colleagues.

And I thank you.

And we will now recess for two votes that are pending. And we stand in recess.

Mr. SMITH. Mr. Chairman, may I——

Mr. CONYERS. Yes?

Mr. SMITH. Just a point of personal privilege, if I may.

Mr. CONYERS. Absolutely.

Mr. SMITH. I want, while we are here and before we get interrupted by the votes, want to congratulate you on a happy birthday today.

Now, there are a couple ways to look at this. We could maybe look at it, Jack Benny said he was 39 forever. I won't ask whether you have doubled Jack Benny or not, but it is a credit to you that you are as active and vibrant and alert and take the initiative you do. There is no sign of any age whatsoever, and we appreciate that in our Chairman.

On a more partisan note, the fact that you are so hale and hearty should be reassuring to John McCain, I would assume. [Laughter.]

Mr. CONYERS. Well, thank you very much, Ranking Member Lamar Smith. I am just so happy you didn't ask for my age, because I have lied and misrepresented it for so many years, I am not sure what it really is at this point. [Laughter.]

So the Committee stands in recess, and thank you so very much. [Recess.]

Mr. CONYERS. The Committee will come to order. The Antitrust Task Force continues its hearing intermittently between our responsibilities on the floor.

Our next witness is not a stranger to the Committee. Mark Cooper is Director of Research at Consumer Federation of America. He is responsible for analysis and advocacy in the area of telecommunications, media, digital rights, economic and energy policy. He has provided expert testimony in more than 250 cases for public interest clients, including attorneys general, people's council and citizen interveners before State and Federal agencies, courts and legislators in almost four dozen jurisdictions in the United States and Canada. A Yale University Ph.D., a Fulbright fellow and author of numerous books and articles.

Welcome, Mr. Mark Cooper, and you may begin.

TESTIMONY OF MARK N. COOPER, DIRECTOR OF RESEARCH, CONSUMER FEDERATION OF AMERICA

Mr. COOPER. Thank you, Mr. Chairman and Members of the Committee. I appreciate the opportunity to offer the consumer perspective on rising gasoline prices.

American gasoline consumers are fed up, mad as hell, and they have good reason to be. Over the past 5 years, the average household expenditure for gasoline has increased by over $1,000. A major cause of this immense increase is the failure of Federal antitrust authorities to prevent the abuse of market power by oil companies and the failure of the Administration and Congress to enact policies to address the problems that plague the gasoline market.

Between January of this year and the first week in May, gasoline prices increased about 80 cents per gallon. Over 60 cents was the result of an increase in the amount taken by domestic refining and marketing. In the past 5 years, the increase in price paid to domestic refining and marketing has cost consumers over $130 billion.

Consumers believe that gasoline prices are unreasonable and that there is something the Administration and Congress can do about it, and our analysis shows they are right. The domestic refining sector has become so concentrated that these price increases represent the abuse of market power in the industry.

The merger wave of the past decade dramatically reduced the number of refineries and companies in the wholesale market. As a result, the vast majority of markets in the U.S. are concentrated.

Lacking competitive pressures, the industry has failed to expand refinery capacity adequately and dramatically reduced the amount of gasoline in storage. This makes markets vulnerable to price surges, even when routine maintenance is conducted, not to mention unexpected events. The companies put up prices, blame supply and demand, but they are the cause of the supply side problem.

With prices rising faster than cost, net income in U.S. refining has increased sharply, far faster than in foreign refining. Oil companies' profits have increased far more than profits at comparable U.S. non-oil companies, setting records in 3 of the last 4 years. Excess profits in the past 4 years exceed $200 billion.

The increase in cash flow is so great that the industry cannot absorb it, so it is throwing huge quantities of cash—stock buybacks, debt reduction, dividends and huge piles of cash. Net new investment has been paltry compared to the growth of net income, especially in domestic refining.

This is great for their Wall Street performance, but it is bad news for Main Street America.

This industry has all of the characteristics of market failure: Basic structural conditions of low elasticity of demand and supply; concentration and barriers to entry; conduct, including lockstep pricing, conscious parallelism in which each of the individuals mutually reinforces the other; bad management, so bad that they can't even handle routine maintenance without interrupting supply and putting prices up; and, finally, performance, high prices, excess profit, underinvestment and in the inability to absorb cash flow. This is a picture of fundamental market failure.

The pain felt by consumers is ultimately the result of a policy failure at every level. Antitrust officials approve too many mergers and imposed weak conditions on those that went through so that they could not discipline market power. Congress and the Administration have stood idly by and done nothing to help consumers.

We believe that to address the short-term problem of price spikes, we need a strategic refinery reserve and a strategic product reserve that are dedicated to ensuring we have excess capacity sufficient to discipline pricing abuse.

We need antitrust authorities that really do their job and look very closely at unilateral actions that raise prices. We need authority to make sure they can look at those kinds of behaviors.

We need commodity market regulators who look at all the market, and we need joint Federal-State task forces to oversee both the physical and financial markets, so we have more eyeballs with different perspectives overseeing this vital energy commodity.

To address long-term problems, we need fundamental changes in supply and demand. We have to accelerate the day when we will use less oil by setting aggressive, concrete targets for reducing American oil consumption, above all, increasing CAFE standards.

We need a national policy that promotes the research, production and use of biofuels in a socially and environmentally responsible manner.

Now is the time to act. Six years ago was the time to act. Hopefully, the current round of spikes, which has gotten everybody's attention, will finally convince policymakers to take some measures

that alleviate the pain that Americans have been suffering at the pump.

Thank you.

[The prepared statement of Mr. Cooper follows:]

PREPARED STATEMENT OF MARK N. COOPER

Consumer Federation of America

STATEMENT OF DR. MARK N. COOPER
DIRECTOR OF RESEARCH
CONSUMER FEDERATION OF AMERICA

on behalf of

THE CONSUMER FEDERATION OF AMERICA
and
CONSUMERS UNION

on

PRICES AT THE PUMP:
MARKET FAILURE AND THE OIL INDUSTRY

Before the

ANTITRUST TASK FORCE,
JUDICIARY COMMITTEE ,
UNITED STATES HOUSE OF REPRESENTATIVES

May 16, 2007

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE

My name is Dr. Mark N. Cooper. I am Director of Research at the Consumer Federation of America. I appear before you today, as I have many times in the past on this issue, on behalf of the Consumer Federation and Consumers Union.

I greatly appreciate the opportunity to explain why gasoline prices are rising and to suggest what you can do about it. Six years ago we analyzed the first price spike of the new millennium and we have issued a dozen subsequent reports. I have submitted several of these for the record as documentation of the points I will make in my statement today. I have also prepared a series of exhibits attached to my remarks that update many of the analyses I presented to Congress in the past six years.

PAIN AT THE PUMP

American gasoline consumers are fed up with rising gasoline prices and they have good reason to be. **Over the past five years the average annual household expenditure for gasoline has increased by over $1,000** (see Exhibit 1). Rural households have been particularly hard hit because they spend about 20 percent more for gasoline than their urban brethren. **A major cause of this immense increase in consumer cost is the failure of Federal antitrust authorities to prevent the abuse of market power by oil companies and the failure of the Administration and Congress to enact policies that will fix the failures that plague the gasoline market.**

Between January 2007 and the first week in May, gasoline prices increased about 80 cents per gallon and over 60 cents (more than three quarters) was the result of an increase in the amonnt taken by domestic refining and marketing. The domestic refining and marketing take is know as the domestic spread and it is equal to the price consumers pay at the pump minus the cost of crude oil and taxes. If the increase in the domestic spread we have seen in the first week of May holds for the rest of the month, consumers could pay $8 billion more for gasoline this month alone. **In the past five years, the increase in the price paid to domestic refining and marketing has cost consumers over $130 billion** (see Exhibit 2).

Four fifths of respondents to one recent poll believe that gasoline prices are unreasonable, compared to the cost of other goods and services. In other polls **between three fifths and four fifths of respondents believe there is something the Administration and Congress can do about high gasoline prices.** Our analysis shows they are right.

MARKET POWER, PRICE INCREASES AND EXCESS PROFITS

Our analysis shows that the domestic refining sector has become so concentrated that these price increases represent the abuse of market power in the industry.

- The merger wave of the past decade dramatically reduced the number of refineries and companies in the wholesale market (Exhibit 3).

- As a result, the vast majority of markets in the U.S. are concentrated (Exhibit 4).
- Lacking competitive pressures, the industry fails to expand refinery capacity, resulting in a lack of spare capacity (Exhibit 5). It has dramatically reduced the amount of gasoline in storage, making the markets vulnerable to price surges even when routine maintenance is conducted (Exhibit 6).
- With prices rising far faster than costs, net income in U.S. refining has increased sharply (Exhibit 7), far faster than in foreign refining (Exhibit 8).
- Oil company profits have increased far more than profits at comparable companies (Exhibit 9), setting records in three of the past four years (Exhibit 10).
- Excess profits in the past five years exceed $200 billion (Exhibit 11).
- The increase in cash flow is so great that the industry cannot absorb it, so it is throwing off huge quantities of cash (Exhibit 12).
- Net new investment has been paltry, compared to the growth of net income (Exhibit 12), especially in domestic refining.

ABUSE OF MARKET POWER IN THE REFINING SECTOR

Oil company mergers over the past couple of decades have allowed a tight oligopoly to emerge in most markets in the United States (see Exhibit 3). The number of major refiners has been slashed in the past decade, to just half a dozen. **As a result, eighty percent of the nation's regional refining markets and state wholesale gasoline markets are highly concentrated** (see Exhibit 4)**.**

When markets for a commodity like gasoline, which has very low elasticities of supply and demand, become this concentrated, market power – the ability of companies profitably to raise prices above costs – is the result. **Supply has become a strategic variable** in U.S. oil markets, subject to the control of a handful of companies. **The domestic oil oligopoly has systematically under-invested in refining capacity and reduced the amount of gasoline held in storage. Lacking spare capacity, the industry cannot perform normal maintenance without increasing prices and it has no reserves should accidents happen** (see Exhibit 5). High capacity utilization makes the sector more vulnerable to accidents. The amount of gasoline in storage has also been dramatically reduced over the past decade (see Exhibit 6). As a consequence, when the minimum operating inventory needed to keep the system running is taken into account, there are only a couple of days of supply on hand, a very small cushion in an industry that is prone to accidents and outages.

By creating a sitnation of extremely tight supply, the oil companies gain control over price at the wholesale level. They have exercised that market power to raise prices and the result has been a dramatic increase in the profitability of refining and overall oil company profits. This exercise of market power in domestic refining markets stands in sharp contrast to the profitability of refining in the rest of the world. The major oil companies own

refineries in the United States and overseas. **The profitability of refining operations in the U.S. has grown far faster than the profitability of their overseas refineries** (see Exhibits 7 and 8). The difference can be explained by the fundamental change and lack of competitiveness in the market structure of the domestic refining sector and the under-investment in capacity.

Based on the return on equity of comparable firms, which is the basic measure of profitability on which oil companies themselves rely when they report their earnings to their shareholders, oil companies are earning far too much (see Exhibits 9 and 10). In the past five years, they have set record after record. Total company profits reflect increased profits on crude oil and natural gas, as well. In the quarter century between 1974 and 1999, major oil companies had a higher return on equity than all manufacturing only twice. Since 2000, their return on equity has exceeded all manufacturing six of seven years, and every year since 2002. **Excess profits earned by oil companies in 2003-2006 are about $200 billion** (see Exhibit 11).

Oil company profits have risen so qnickly that they simply cannot absorb the huge quantity of cash, accumulating hordes of current assets – buying back stock, paying down debt and piling up cash – or increasing dividends. The American majors have been particularly laggard, throwing off cash and making little, net new investment in the industry (see Exhibits 12 and 13). This is good news for their Wall Street performance, but bad news for the people on Main Street.

In spite of a massive increase in refining profits, investment in refinery capacity has not increased because barriers to entry into the refining sector are high and the oligopoly has no interest in creating spare capacity (see Exhibits 14). Exxon, which has set profit record after profit record has made little investment in domestic U.S. refining (see Exhibit 15) and declared it does not intend to build any new refineries in the U.S.

IT DID NOT HAVE TO BE THIS WAY: CONGRESS AND THE ADMINISTRATION HAVE FAILED TO ACT TO SOLVE THE PROBLEM AND ALLEVIATE THE SUFFERING

The past half decade of abuse of market power did not have to happen. The oil industry did not need the huge increase in profits to stay in business. The oil companies could have increased refinery capacity much more than they have – keeping over 50 refineries open and keeping storage levels up. They chose not to because there was not enough competition to force them to make these investments.

The pain felt by consumers is ultimately the result of a policy failure at every level. **Anti-trust officials approved too many mergers and imposed weak and inadequate remedies on the mergers they opposed. Congress and the Administration stood idly by and did nothing to help the consumer**. Although numerous bills have been introduced in past Congresses that might have increased the supply of refining capacity, increased the amount of product held in storage, improved oversight over the domestic oil industry and commodity markets, reduced demand for gasoline by increasing the fuel efficiency of the vehicle fleet and dramatically lower oil imports, none of these bills passed.

On May 10, 2006, exactly a year ago, I testified before the Senate Energy Committee and identified six broad areas for policy action.

To address short term spikes in prices:

- We need a strategic refinery reserve and a strategic product reserve that are dedicated to ensuring we have excess capacity sufficient to discipline pricing abuse.
- We need anti-trust authorities that really do their job and look very closely at unilateral actions that raise prices.
- We need commodity market regulators who look at all the markets.
- And, we need joint federal state task forces to oversee both the physical and financial markets – so we have more eyeballs with different perspectives – overseeing vital energy commodities.

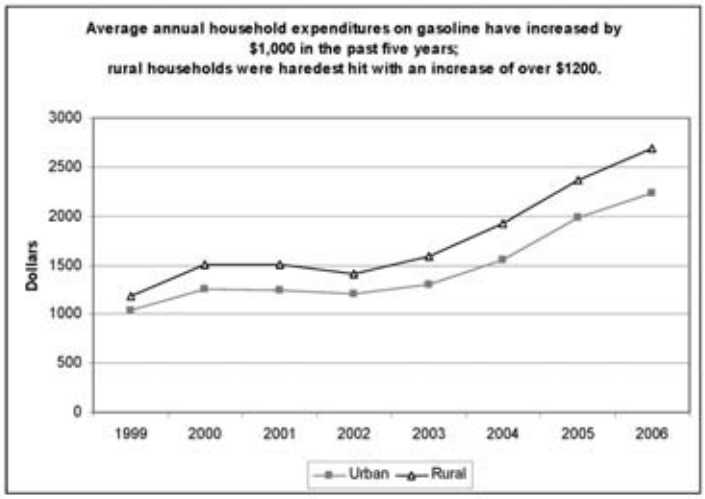
To address long term fundamental change in the supply-demand balance in this sector

- We have to accelerate the day when we will use less oil by setting aggressive, concrete targets for reducing America's oil consumption.
- We need a national policy that promotes the research, production and use of biofuels in a socially and environmentally responsible manner.

These six areas of policy action are the same areas we outlined in a report released in August 2001. **Now is the time to act. Six years ago was the time to act.** Hopefully, the current round of price spikes will convince policy makers to take steps to build a better future for American consumers by addressing a market whose forces are working against the American people and for the interests of a few huge companies. I look forward to working with the Committee to implement policies that can solve the nation's oil problem.

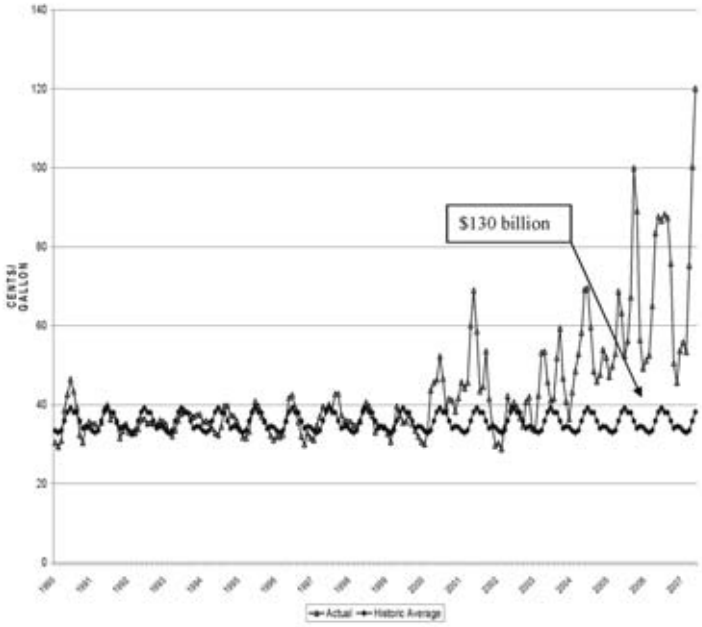
EXHIBITS

Exhibit 1: Household expenditures on Gasoline



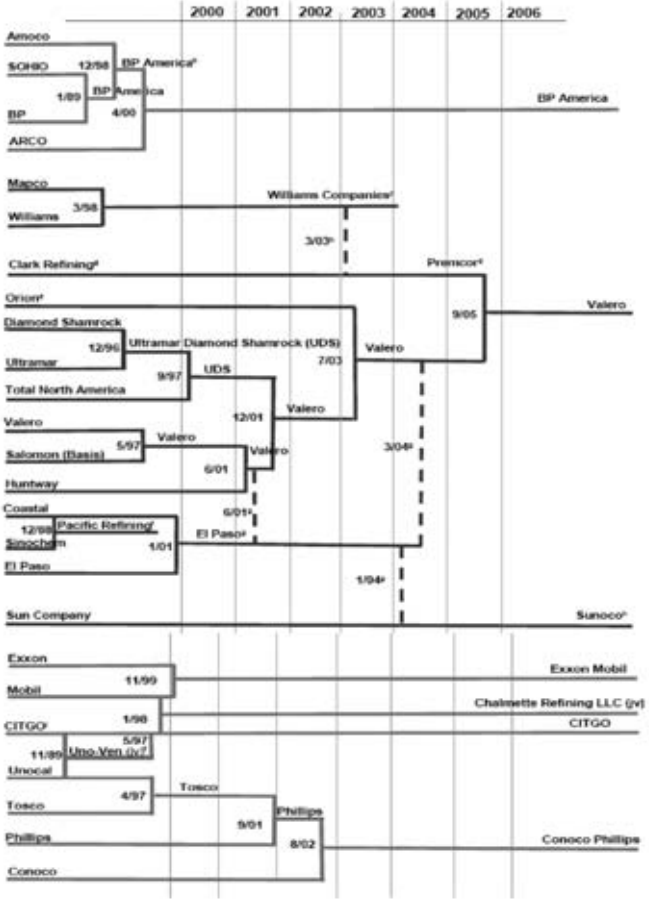
Source: U.S. Department of Labor, Bureau of Labor Statistics, *Consumer Expenditure*, 1999-2005. 2006 expenditures estimated based on 2005-2006 price increase from Energy Information Administration, *U.S. All Grades All Formulations Retail Gasoline Prices.*

Exhibit 2: The Domestic Spread (Pump Price minus Crude and Taxes): The Role of Domestic Refining and Marketing in the Rising Gasoline Prices



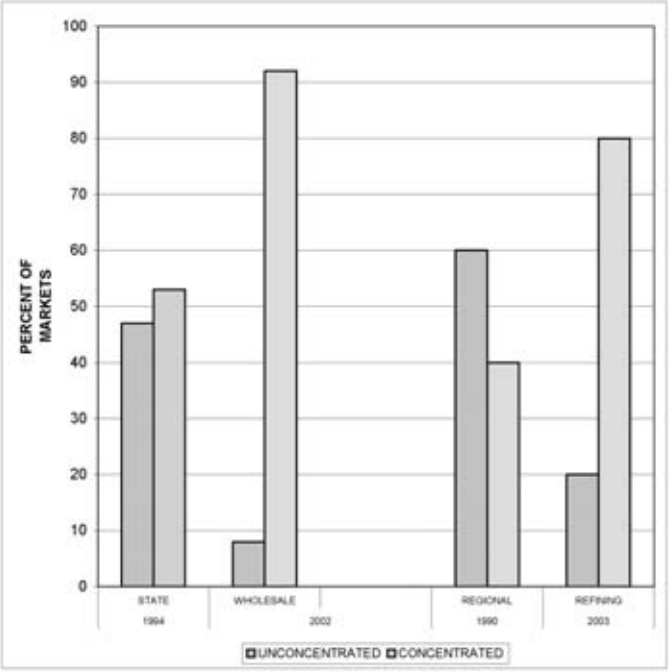
Source: Energy Information Administration, Data base, *Prices and Product Supplied.*

Exhibit 3: Mergers have severely Reduced the number of Refiners



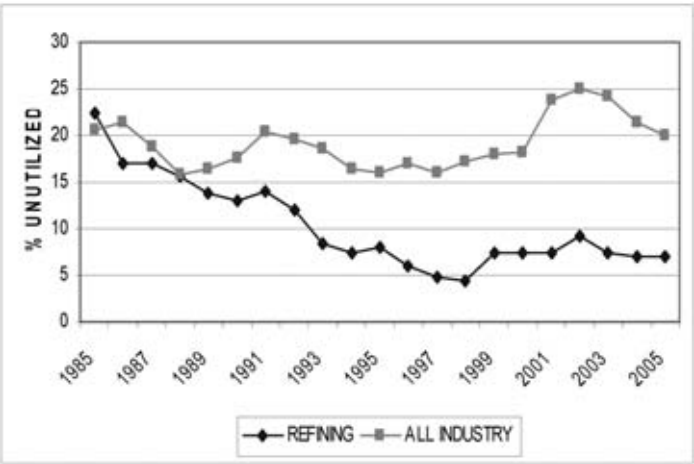
Source: http://tonto.eia.doe.gov/FTPROOT/financial/mergers/dwnstream.pdf

Exhibit 4:
The Merger Wave Concentrated Regional Refining and State Wholesale Markets



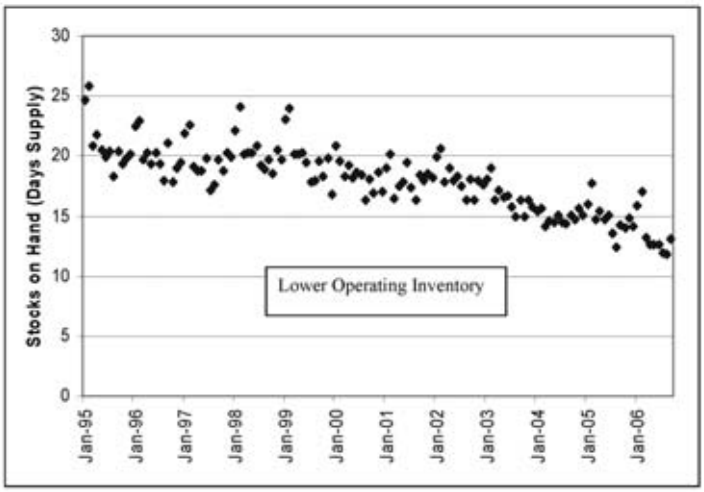
Source: Government Accountability Office, *Energy Markets: Effects of Mergers and Market Concentration in the U.S. Petroleum Industry* (Washington, May 2004), Figure 18.

Exhibit 5: Oil Companies carry much less spare capacity in refining than other industries



Source: Calculated from Board of Governors of the Federal Reserve System, Federal *Reserve Statistical Release, Industrial Production and Capacity Utilization;* Energy Information Administration, U.S. Department of Energy, *U.S. Percent Utilization of Refinery Operable Capacity.*

Exhibit 6: Declining Stocks of Gasoline Render the Market Vulnerable

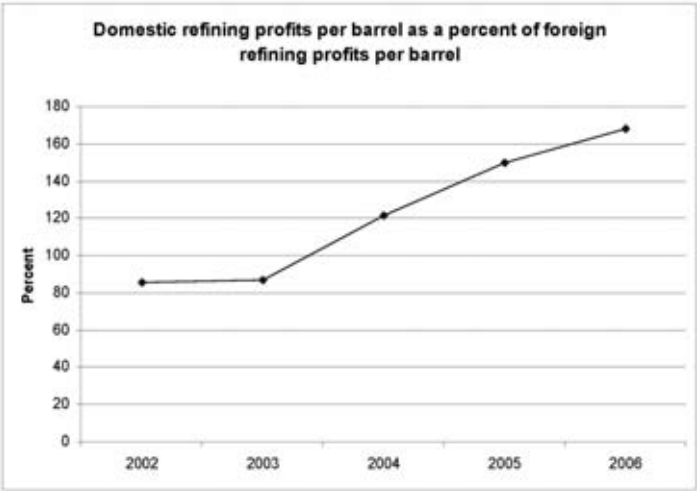


Source: Energy Information Administration, Data base, *Stocks and Product Supplied.*

Exhibit 7: Net Income in Domestic v. Foreign Refineries Owned by Major Oil Companies

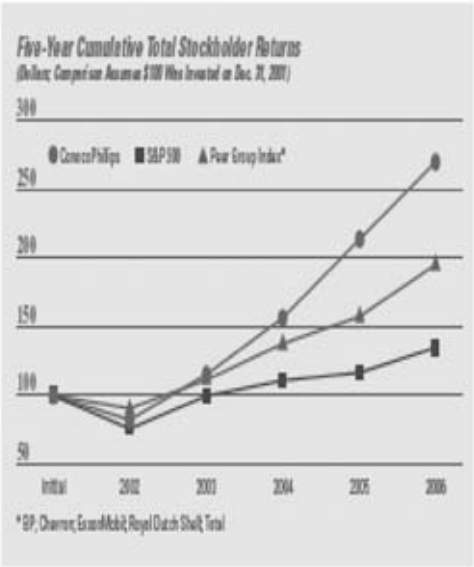
Energy Information Administration, Selected Financial and Operating Data for a Consistent Set of Major Energy Companies: First Quarter 2002 (Q102) Through Fourth Quarter 2006 (Q107)

Exhibit 8: Net Income Per Barrel in U.S. Refineries as a Percentage of Net Income Per Barrel in Foreign Refineries Owned by Major U.S. Oil Companies.



Energy Information Administration, Selected Financial and Operating Data for a Consistent Set of Major Energy Companies: First Quarter 2002 (Q102) Through Fourth Quarter 2006 (Q107)

Exhibit 9: U.S. Major Oil Company Total Return in the Past Five Years Exceeds the S&P 500 by a Wide Margin.

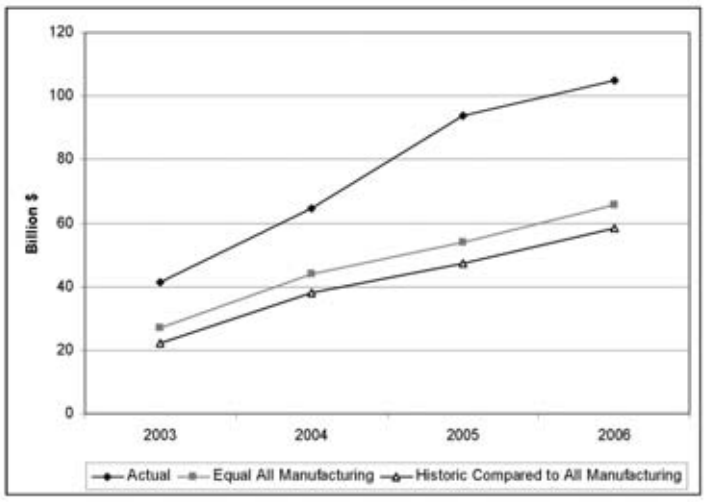


ConnocoPhillips, Annual Report, 2006, p. 9.

Exhibit 10: Major Oil Company Return on Equity is Far Above Historic Levels

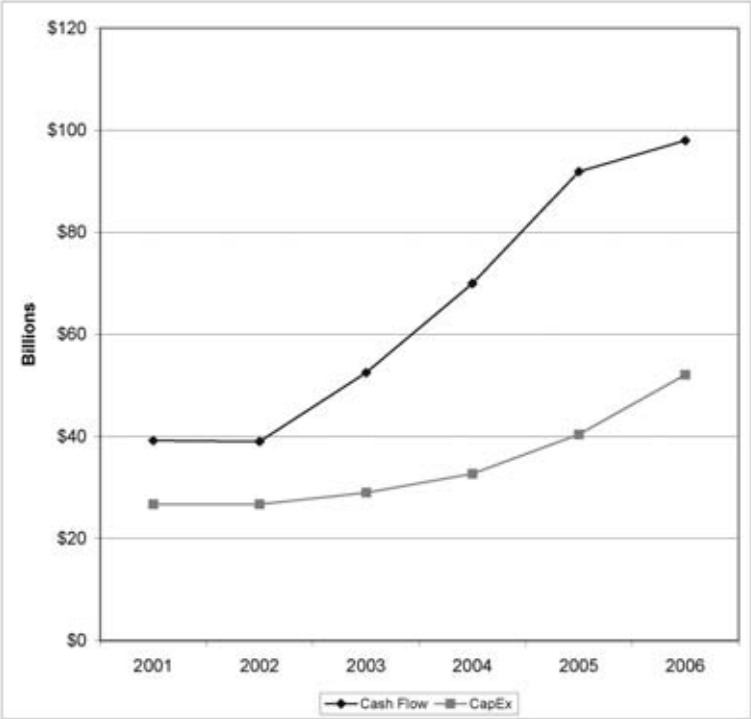
Sources: Energy Information Administration, *Performance Profiles of major Energy Producers: 2005* (Washington, D.C.:U.S. Department of Energy, December 2006.

Exhibit 11: Excess Profits (Net Income) of Major Oil Companies



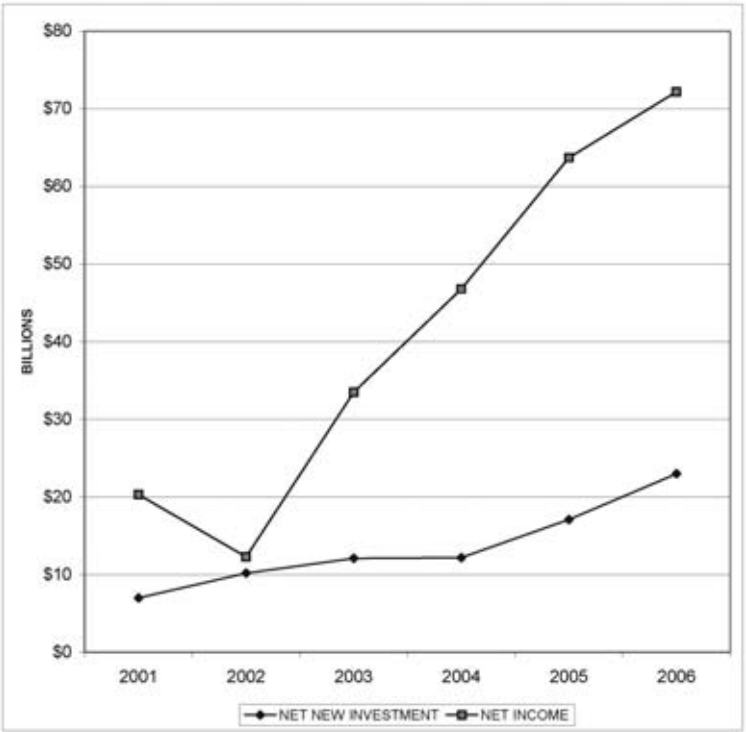
Source: energy Information Administration, *Performance Profiles of Major Energy Producers: 2005* updated to 2006 with U.S. Census Bureau, *Quarterly Financial Report* and company annual reports. Net income is for FRS companies, which represent about 60 percent of the petroleum sector.

Exhibit 12: Capital Expenditures by American Majors Have Not Kept Up With Cash Flow, Resulting in a Huge Throw off of Cash



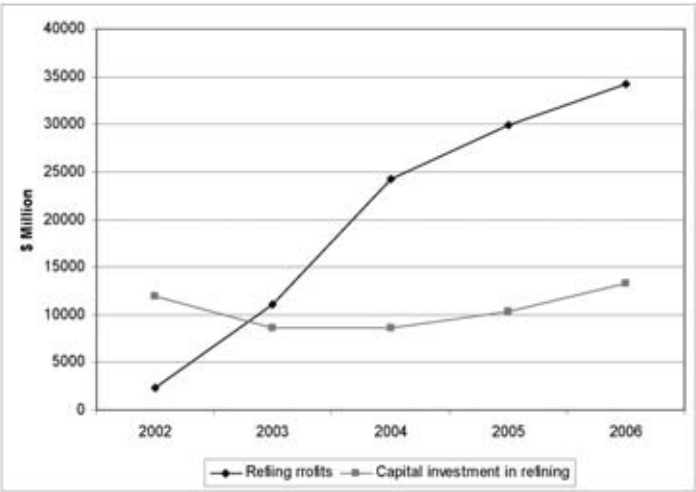
Source: ExxonMobil, 2006, pp. 15-23, 2005 Financial & Operating Review, pp. 2, 23; Chevron, Chevron, 2006 Supplement to the Annual Report, pp. 6 2005 Supplement to the Annual Report, pp. 2, 6. ConocoPhilips, Annual Reports 2006, pp. 64, 66; 2005, p. 66, 2002, p. 65.

Exhibit 13: Net New Investment by American Majors (Capital Expenditures in Excess of Depreciation) Have Been Paltry Compared to Net Income



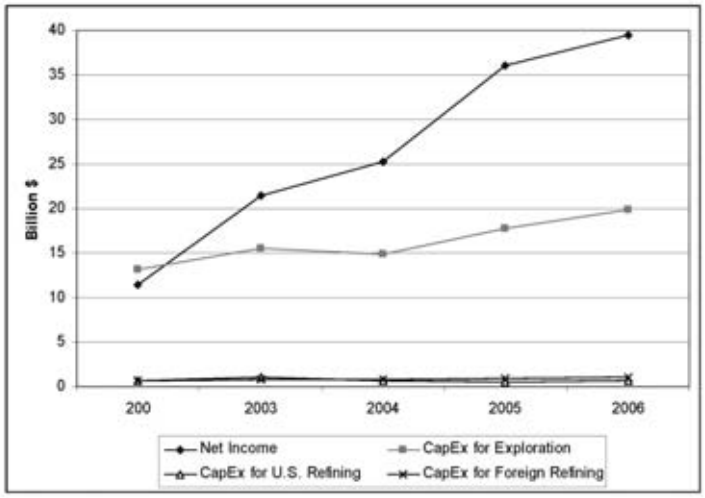
Source: ExxonMobil, 2006, pp. 15-23, 2005 Financial & Operating Review, pp. 2, 23; Chevron, Chevron, 2006 Supplement to the Annual Report, pp. 6 2005 Supplement to the Annual Report, pp. 2, 6. ConocoPhilips, Annual Reports 2006, pp. 64, 66; 2005, p. 66, 2002, p. 65.

Exhibit 14: Despite Massive Increases in Refinery Profits, Capital Investment in Refining Capacity has been Flat



Energy Information Administration, Selected Financial and Operating Data for a Consistent Set of Major Energy Companies: First Quarter 2002 (Q102) Through Fourth Quarter 2006 (Q107)

Exhibit 15: For ExxonMobil, while net income has skyrocketed, investment in U.S. Refining Capacity has been stagnant



Source: ExxonMobil, Annual Report, 2006, pp. 3, 18

Mr. CONYERS. Thank you, Mr. Cooper.

Because of time constraints, we are going to call on Attorney General Richard Blumenthal from Connecticut as the next witness.

He has advocated reforms in the health insurance industry, has fought unfair utility rate charges, has led the fight against big tobacco in terms of their deceptive marketing aimed at children, has investigated insurance industry abuses. In other previous public services he was administrative assistant to United States Senator Abe Ribicoff, aide to former United States Senator Daniel Moynihan and was a law clerk to the Supreme Court Justice Harry Blackmun. He has also worked with the NAACP Legal Defense Fund, has served in the Connecticut House of Representatives, and we are delighted that his schedule would permit him to join us for this important hearing before the Antitrust Task Force today.

We welcome you, Mr. Attorney General.

TESTIMONY OF THE HONORABLE RICHARD BLUMENTHAL, ATTORNEY GENERAL FOR THE STATE OF CONNECTICUT

Mr. BLUMENTHAL. Thank you so much, Mr. Chairman. I am honored to be before you and have long admired the great work that you have done in the consumer area and so many other areas where I have observed the many contributions that you have made. And so I am particularly honored to be here before you.

Mr. CONYERS. Thank you.

Mr. BLUMENTHAL. And particularly so on this subject, which concerns consumers as much or more than any. I have found that there is none that angers and outrages the consumers of the country more, and with great reason, than this one precisely because of the statistics that you have just heard from Mr. Cooper, which are so compelling and persuasive as to the need for fundamental change.

This market is not just failed, it is dysfunctional, and it overpowers consumers and causes abuses, enables those abuses in a way that virtually none other in the country today.

As I was driving here from the airport, I thought back to a meeting that I had with the United States Attorney General less than a year ago involving a number of my colleagues from all around the country, both Republican and Democrat attorneys general, who met with him and the chairman of the FTC with the single purpose of persuading them to begin a Federal investigation. And, unfortunately, our plea went unheeded then. There has been no effective Federal investigation.

We pleaded with Attorney General Gonzalez and FTC Chairman Majoras Platt to begin an investigation of the oil industry, and we offered our partnership in that work. All 50 attorneys general have a task force investigating monopolistic abuses on the part of the oil industry, but we lack the authority and expertise and resources of the Federal Government, and so we invited, we beseeched the Federal Government to join with us in that investigation, and so far they have declined to do so.

There is a need to provide greater authority but also to use that authority effectively to enforce the law. The law without enforcement is dead letter.

And so as we review what can be done to change the law, I think at the top of the priorities ought to be the kinds of demands that you have made, Mr. Chairman, other Members of the Committee and Congress that the Justice Department be more aggressive and vigorous in enforcing these laws that protect against antitrust and consumer abuses.

I am here to strongly support the legislation that you have proposed that would enable antitrust enforcement against OPEC. By an accident of interpretation in the Federal courts, we lack that authority now, but there is no clearer instance of monopolistic pricing than on the part of those OPEC countries. And if they were entities in any way within the reach of law, there would be no question that they were breaking laws and doing business in the United States. And so I strongly support that measure.

I also believe that we ought to have, as a remedy under the antitrust laws, the potential to break up the big oil companies if they abuse their market power. Clearly, there is a concentration of power.

I know my colleague, Mr. Felmy, differs on that point. He says that there is robust competition, no concentration of power. I think there is virtual unanimity among economists that there is a concentration of power. Indeed, I have fought it. For example, the ExxonMobil merger, and the statistics, support that view overwhelmingly.

The question really is what to do about it—whether they are capable of using that power wisely or whether they need to be policed and stopped from abusing it—and I think they have clearly demonstrated that they will abuse it unless antitrust authorities apply the laws with the potential remedy of breaking up some of the concentration.

I also support in my testimony—and I won't go through every detail, because it is in the testimony, and I would simply ask for permission to make it a part of the record—a 1-year moratorium on any future mergers; a prohibition against any oil company merger in a highly concentrated market unless there is a showing by the FTC that there is a benefit to consumers; a series of steps to expand refinery capacity and product inventory levels, which are a vital weak point in the system now; a series of measures, including banning zone pricing, which divides geographic turf. Big oil companies divide that turf, deciding what consumers can pay in different geographic areas and through their agreements with franchisees enforce those kinds of rules on them.

And, finally, I strongly support measures relating to conservation, alternative fuels, essentially, to reduce the dependency and, as it is called, addiction to big oil.

And I think that, again, to close where Mr. Cooper did, there is a need, as Mr. Felmy says, to avoid doing harm, first do no harm, but the point here is that there can be no more egregious harm than to watch prices rise at the pump, 50 cents higher than last year at this time, when crude is lower, $7 a barrel lower.

That is an outrage, and consumers are rightly angry about it, and I hope that the Congress will give States and State attorneys general some of the measure that I think can help us overcome it.

Thank you.

[The prepared statement of Mr. Blumenthal follows:]

PREPARED STATEMENT OF THE HONORABLE RICHARD BLUMENTHAL

RICHARD BLUMENTHAL
ATTORNEY GENERAL

55 Elm Street
P.O. Box 120
Hartford, CT 06141-0120

Office of The Attorney General
State of Connecticut

TESTIMONY OF
ATTORNEY GENERAL RICHARD BLUMENTHAL
BEFORE THE ANTITRUST TASK FORCE OF THE
HOUSE COMMITTEE ON THE JUDICIARY
MAY 16, 2007

I appreciate the opportunity to speak on the issue of the impact of mergers on gasoline prices

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

Consumers need and deserve swift Congressional action to halt oil company mergers, break up oil companies who misuse market power to engage in predatory practices against competitors and consumers and allow antitrust lawsuits against OPEC.

The record is replete with instances of oil company misuse of market power to crush competition. We need mandatory break up of oil companies that engage in predatory, anti-competitive acts. Further, antitrust law should be amended to specifically authorize lawsuits against foreign governments who engage in the same anti-competitive practices in the oil industry that are illegal for private companies under current law.

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

While consumers struggle to pay record heating oil and gasoline prices, the industry is drowning in cash. Witness the staggering level of oil industry profits in the wake of a horrible natural disaster -- Hurricane Katrina: Three companies reported quarterly profits exceeding $16 billion. More recently, Exxon Mobil took advantage of refinery shutdowns to raise its refiner margins by 50%, recording $9.28 billion in profits for the quarter. Astronomical profits at the expense of American consumers have been the rule, not the exception, again and again

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

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

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

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

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

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

(4) mandate breakup of any oil company that misuses market power to crush competition and increase gasoline prices;

(5) authorize antitrust lawsuits against OPEC for its monopolistic manipulation of oil supplies to raise prices;

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

(7) expand refinery capacity and mandate minimum oil product inventory levels; and

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

The effect of anticompetitive oil markets on gasoline prices is well-documented.

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

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

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

In 2004, the United States General Accounting Office (GAO) conducted an econometric study of 8 major mergers in the oil industry and concluded 6 caused higher prices for consumers.

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

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

In 2006, the GAO again reviewed the gasoline industry and determined that limited refinery capacity, deliberate industry reductions in inventory on hand and concentrated market power -- among other criteria -- increased gasoline prices.

In 2007, a research paper by Hayley Chouinard and Jeffrey Perloff in the B.E. Journal of Economic Analysis and Policy cited the impact of mergers on gasoline prices in various markets and cited numerous other expert analysis to conclude mergers and increased market power concentration have led to higher gasoline prices.

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

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

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

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

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

This change did not occur in a vacuum. Rather, in 1990, the HHI for our region was 1136 points, leading economists to conclude that the refining and marketing sectors were

"moderately concentrated." At this level, each and every merger should have been critically scrutinized. Many proposed acquisitions should have been flatly rejected by the FTC.

Lax antitrust enforcement has real life consequences.

In one example affecting Connecticut, the proposed Mobil-Exxon merger would have resulted in the top four gasoline companies controlling 73% of the retail market in half the metropolitan areas in the Northeast and Mid-Atlantic region. I strongly opposed this merger in comments to the FTC. While the FTC ordered divestiture of some assets, such divestiture did not prevent the market from becoming highly concentrated with its anti-consumer impact.

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

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

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

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

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

In another example of market consolidation leading to anti-consumer practices, the FTC examined a gasoline price spike in several Midwestern states during 2000 and found that the three refiners of summer-grade reformulated gasoline (not jointly according to the FTC) limited refinery upgrades to comply with stricter EPA standards so as to produce only enough gasoline to supply their branded gas stations and other existing contractual obligations. Even if such

decisions were made independently, the decisions clearly recognized that the other participants would not be risk increasing their summer grade production to increase market share There is clearly a problem with this market, replicated in many markets nationwide

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

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

1. Break up predatory oil companies

Congress should define certain predatory, anticompetitive acts that would require break-up of an oil company engaging in such conduct These acts should include threatening to take regulatory or legislative action to harm a competitor if the competitor is seeking to bring more oil or gasoline or competition into a market.

As an example, the Subcommittee Report recounted Shell's threat to seek enactment by the California legislature of a tax on imported gasoline if Texaco pursued its plan to import California CARB gasoline to relieve a shortfall in refinery output in that state This story was cited as only one example of major oil company efforts to squeeze supplies and raise prices.

In addition, predatory acts should include the deliberate and unilateral withholding of oil or gasoline supplies from a market for the sole purpose of increasing price and profits During the Midwestern price spike of 2000, one company deliberately withheld some gasoline, keeping prices and profits artificially high

Breaking up a monopolistic company is not unprecedented. AT&T was the subject of such action more than twenty years ago. More recently, Microsoft faced a potential divestment order in a federal antitrust lawsuit brought by state attorneys general

A mandatory break-up remedy would serve as a powerful deterrent to predatory practices that have stifled competition and raised consumer prices.

2. Antitrust lawsuit against OPEC

The Organization of Petroleum Exporting Countries (OPEC) -- Algeria, Angola, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates and Venezuela -- jointly decide how much oil to produce with a stated goal of keeping oil prices within a preferred price range This policy clearly and decisively violates United States antitrust laws. Yet, private citizens and governmental agencies are powerless to bring antitrust actions because federal law has been interpreted to not apply to OPEC's actions

A federal district court, in a case brought by the Machinists union against OPEC, held that the Foreign Sovereign Immunities Act of 1976, (the "Act") 28 *USC 1330 et seq*, prohibited lawsuits against OPEC for deliberately conspiring to limit oil production. The court found that

although the Act had created an exception from immunity for governmental actions that are commercial in nature, OPEC's actions were not commercial but rather decisions involving the use of the member nations' natural resources. *IAM v. OPEC*, 477 F.Supp. 553 (C.D. Cal. 1979), aff'd 649 F.2d 1354 (9th Cir. 1981).

On appeal, the Ninth Circuit declined to extend federal court jurisdiction over the matter citing the prudential 'act of state' doctrine that states the courts will not judge the legality a sovereign act of a foreign state. *IAM v. OPEC*, 644 F.2d. 1354 (9th Cir. 1981).

Both of these barriers to an antitrust lawsuit against OPEC can be addressed through legislation such as HR 2264, the No Oil Producing and Exporting Cartels Act of 2007. This legislation would hold OPEC accountable under the Sherman Antitrust Act for its concerted actions to increase the price of oil and gasoline.

3. Federal/state investigation into the oil industry

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

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

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

4. Moratorium on oil industry mergers

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

5. Oil company mergers in highly concentrated markets

New federal law should create a presumption that any merger in the oil industry in a moderately or highly concentrated market -- as defined by the HHI -- violates antitrust law unless the Federal Trade Commission finds clear and convincing evidence that consumers will

benefit, and that tangible, specific steps will be taken to assure consumers see lower prices and better services

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

6. Prohibit zone pricing

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

Zone pricing is used in almost every state: the major oil companies create artificial geographic areas and charge dealers different gasoline prices in each zone Mobil has 46 zones in a small state like Connecticut

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

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

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

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

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

The PMPA was enacted in 1978 to provide national standards for gasoline franchise agreements regarding the termination and nonrenewal of such franchise agreements

Unfortunately, while Congress, in approving the PMPA, recognized that gasoline dealers are in a weak bargaining position with the major oil companies over terms of the franchise agreement, the PMPA does not provide specific protection against unfairly burdensome franchise provisions foisted upon gasoline dealers by the major oil companies.

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

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

7. Expand refinery capacity/enact minimum inventory levels

Recent dramatic spikes in gasoline and heating oil have been due in large part to industry decisions that result in reduced inventory. This industry practice may lead to shortfall if something unexpected occurs such as sudden drop in temperatures or a refinery fire.

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

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

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

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

I urge Congress to carefully review these inventory practices and refinery closings and take steps that encourage or mandate increased inventory and refinery capacity. Although returning competition to these markets would result in additional inventory and less price

volatility, the current market requires some form of governmental oversight. Congress should consider ways to encourage competitors to expand into the refinery and distribution, lowering barriers to entry into the market.

8. Windfall profits tax to fund conservation

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

A windfall profits tax on oil company earnings could produce billions of dollars directed toward significant conservation measures. In Connecticut, our Energy Conservation and Load Management Fund has saved millions of kilowatts of electricity through targeted investments in conservation measures. Similarly, oil company profits should be used to reduce our dependence on oil.

We are becoming more, not less, dependent on oil. Consumption rose 2.6% last year, with additional increases predicted for the foreseeable future. Many solutions to this dependence also will result in cleaner air. We should pursue these goals with more vigor than ever.

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

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

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

Mr. CONYERS. Thank you so much. The documents you referred to will be incorporated into the record. There is so much that we can talk about and so little time to do it. So we will stay in touch.

Mr. BLUMENTHAL. Thank you.

Mr. CONYERS. The Chair wants to recognize the gentlelady from New Mexico, Heather Wilson, a senior Member of the Energy and Commerce Committee in the House, a leader in efforts to protect consumers from price gouging and who has led a bipartisan effort after Hurricanes Katrina and Rita to prevent price gouging during emergencies. We passed one of her pieces of legislation overwhelmingly just recently.

She serves also on the Environment and Hazardous Materials Subcommittee, Health Subcommittee and Telecommunications and Internet Subcommittee of the Energy and Commerce Committee. She is also on the Intelligence Committee and has been active, very active, in the subject matter that brings us here today.

And we will incorporate your full statement into the record and invite you to begin.

TESTIMONY OF THE HONORABLE HEATHER WILSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW MEXICO

Mrs. WILSON. Thank you, Mr. Chairman, and happy birthday.

Mr. CONYERS. Oh, thank you, just as long as you don't ask me how old I am.

Mrs. WILSON. I won't, sir.

Mr. CONYERS. Thank you so much.

Mrs. WILSON. Thank you, Mr. Chairman, and thank you for holding this hearing.

I believe very strongly that we need a balanced long-term energy policy for the country that makes America more energy independent, and there are a variety of ways to do that, but I think that everybody concerns when the price at the pump goes up to $3.10 a gallon, which is what it is, on average, and was $3.06 when I last filled up my car at I-25 and Alameda in Albuquerque. Drivers across the Nation are feeling the pinch in their pocketbook, and it is uncomfortably high.

There are a number of pieces to this puzzle, and part of addressing energy independence is to understand the factors driving prices and to mitigate those factors. That certainly means reducing demand and moving toward alternative fuels and E85 ethanol. The country of Brazil is almost completely energy independent. They import almost no oil, because they depend on E85, which is ethanol that they make from sugarcane, hydrogen and biofuels.

I would note that the Senate, with the leadership, in a bipartisan way, of Senator Bingaman and Senator Domenici, has passed the Senate Energy Savings Act, and that is now pending here in the House.

Whether it is hybrid vehicles or conservation or changing the way in which we calculate fuel savings for trucks, these are the kinds of things that can reduce demand.

At the same time, we have to diversify supply. We have got worldwide volatility and worldwide increases in demands in oil. We import over 60 percent of our oil from countries that generally don't

like us, and we don't want to be in that situation, whether it is violence in Nigeria and dealing with that or the fact that we are making some advances here in domestic exploration, including the passage of the Gulf of Mexico Security Act of 2006, so we diversify our sources of supply.

We have got supply chain bottlenecks, and some have mentioned also refinery capacity already. We have very little margin of error in our refinery capacity. We have got about 800,000 barrels per day in the United States of crude oil refining capacity that is currently offline, and that translates to about 400,000 barrels a day in lost gasoline production. In a normal season, about 100,000 barrels are offline.

One of the pieces, though, I think is to look at the issue of price gouging, and I have reintroduced my legislation that passed overwhelmingly in the House in the last Congress. I don't think Federal law adequately addresses price gouging. Currently, under the FTC, Federal Trade Commission, rules, they can investigate collusion, but they cannot investigate price gouging; they don't have the legal authority.

My bill would prohibit price gouging at any time for gasoline or diesel fuel, crude oil, home heating oil and biofuels. It would direct the Federal Trade Commission to come up with a definition of price gouging for both retail and wholesale.

One of the difficulties is that we have 30 States with price gouging laws and very different definitions of what that means. I think we need an extensive rulemaking in order to come up with a very good definition so everybody knows the rules of the road.

The bill provides for both criminal and civil sanctions as well as civil enforcement by the Federal Trade Commission as well as the State attorney generals if the FTC does not act.

I thank the Committee for its consideration of this legislation, and I look forward to working it through in this Congress.

Thank you, Mr. Chairman.

[The prepared statement of Mrs. Wilson follows:]

PREPARED STATEMENT OF THE HONORABLE HEATHER WILSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW MEXICO

Chairman Conyers and Ranking Member Smith, thank you for providing me the opportunity to testify before the House Committee on the Judiciary.

We need to make America more energy independent and that is going to take a long-term, balanced approach that deals with supply, demand and protecting consumers.

Americans are again seeing gasoline price spikes at the pump with prices reaching over $3 a gallon all over the country. Back home in Albuquerque, New Mexico, prices for unleaded gas range from $3.09 to $3.25. A month ago prices in New Mexico hovered around $2.80 and a year ago prices were around $2.90.

While price fixing, collusion and other anti-competitive practices are currently illegal on the federal level, there is no federal statutory prohibition against price gouging.

Following the Hurricane Katrina disaster, gasoline prices fluctuated up to $6 per gallon in some communities. I was concerned that current law does not adequately address price gouging that does not rise to the level of antitrust prohibitions.

Last Congress I introduced HR. 5253, the Federal Energy Price Protection Act of 2006. A little more than a year ago, on May 3, 2006 the House passed H.R. 5253 by a vote of 389–34. Unfortunately, the Federal Price Protection Act of 2006 stalled in the Senate.

I have reintroduced the Federal Energy Price Protection Act.

The Federal Energy Price Protection Act prohibits price gouging—at any time—in the market for gasoline, diesel fuel, crude oil, home heating oil, and biofuels.

The Federal Energy Price Protection Act directs the Federal Trade Commission to define by rule the terms "price gouging", "wholesale sale", and "retail sale". The existing state statutes in this area have vastly different definitions and interpretations. Under a rulemaking, the FTC would have the benefit of receiving, and the obligation to consider, comment from interested parties on the definition of price gouging. The Act directs the FTC to define price gouging within 6 months of enactment.

The Federal Energy Price Protection Act provides for strong civil enforcement by the FTC, by States' Attorneys General, and criminal enforcement by the U.S. Attorney General and the Department of Justice.

The Federal Energy Price Protection Act provides for civil penalties for price gouging. For "wholesale sale" violations, the penalties are 3 times the ill-gotten gains of the seller, plus an amount not to exceed $3 million, per day of a continuing violation. For "retail sale" violations, the penalties are simply 3 times the ill-gotten gains of the seller.

The Federal Energy Price Protection Act provides for criminal penalties. "Whole sale" violations will be punishable by a fine of no more than $150 million, imprisonment for not more than 2 years, or both. "Retail sale" violations will be punishable by a fine of no more than $2 million, imprisonment for not more than 2 years, or both.

At least 30 states have laws that prohibit price gouging or excessive price increases. Most states have laws that are triggered in the event of a declared emergency, with a few having laws that may be applicable at other times as well. Other states may also exercise authority under general deceptive trade practice laws depending on the nature of the state law and the specific circumstances in which price increases occur.

When defining "price gouging", the devil is in the details. Under the provisions of The Federal Energy Price Protection Act, the Federal Trade Commission would consider public comment in defining exactly what wholesale pricing is, what retail pricing is, and it gives them some regulatory authority to come up with definitions. The truth is, there are about 30 State laws. Some of those laws are very, very different, and it makes sense to allow the States and those involved to come up with a national definition that will work best for consumers in the marketplace.

The government doesn't set prices, but we do have a responsibility to prohibit price gouging and unfair manipulation of the markets. Opportunists should not be able to reap ill-gotten windfall profits on the backs of America's families, particularly when disaster strikes.

A federal statutory prohibition against price gouging is one piece of the puzzle. We also need to deal with other pieces of the puzzle as we move along, everything from building refinery capacity, encouraging more hydrogen-powered cars, using ethanol in our gas tanks, exploring for energy in America and in American waters and conservation so that America becomes more energy independent.

We need a balanced, long term energy plan for the country that makes us more energy independent.

Again, thank you for allowing me the opportunity to testify before the Committee on the Judiciary.

Mr. CONYERS. My congratulations to you for your past efforts, and we look forward to you continuing in this Congress.

I would like now to introduce our last witness, the Chief Economist and Director of the Statistics Department at the American Petroleum Institute, Dr. John Felmy. Twenty years' experience in energy economic and environmental analysis, Bachelor's and Master's in Economics from the Pennsylvania State University and a Ph.D. in the same area from the University of Maryland, a member of several professional associations, including the American Economics Association, International Association for Energy Economics, and is serving as the chairman of the Policy Committee of the Alliance for Energy and Economic Growth.

We welcome you and look forward to your contribution to this hearing.

Mr. CHABOT. Mr. Chairman, before the doctor gets started, if I could just ask a question. We have got a vote on the floor, so we are going to head over for that, I guess, and there is a markup in

this room at 4 o'clock, and I was just wondering what the Chair was thinking relative to panel Members asking questions and that sort of thing.

Mr. CONYERS. We will go till 3:59.

Mr. CHABOT. Okay. Because we may not be back here for another——

Mr. CONYERS. Yes.

Mr. CHABOT. We have got two 20-minutes votes, they are saying.

Mr. CONYERS. That is life in the Congress.

Mr. CHABOT. Excellent. I just wanted to make sure we understood where we were at. Thank you, Mr. Chairman.

Mr. CONYERS. You are welcome.

Dr. Felmy, welcome to the Committee.

TESTIMONY OF JOHN FELMY, CHIEF ECONOMIST, AMERICAN PETROLEUM INSTITUTE

Mr. FELMY. Thank you, Mr. Chairman and Members of the Committee. We appreciate the invitation to present API's view on gasoline prices.

We recognize that consumers are frustrated with today's higher prices. However, the cause of the higher prices is an imbalance between supply and demand, worsened, at least, in part, by policy failures, which the current price control proposals could make worse.

Price control legislation fails to address this cause and is premised on this about how fuel is marketed. Our companies have been producing record amounts of fuel to supply their customers in highly competitive markets. The industry has supplied about 8.85 million barrels per day to date this year. However, because of maintenance at European refineries and a French port workers strike, less imported gasoline has been available. Gasoline imports typically make up about 12 percent of our supply.

As a result, total U.S. gasoline supplies have struggled to keep up with demand, which has been extremely strong. During the first quarter of 2007, total U.S. gasoline demand set a record, increasing almost 2 percent over the same period in 2006.

Besides record-breaking demand and sluggish imports, other factors have been contributing to higher gasoline prices. They include crude oil prices, which account for more than half the cost of gasoline and are set on international markets, the annual switchover to more expensive to produce summer blend gasoline required by EPA and regularly scheduled refinery maintenance and on-plan problems that have prevented refiners from making even more gasoline.

In short, the price increases reflect supply and demand, and the same is true for past price increases that have been thoroughly investigated by Government agencies who would not have hesitated to take the industry to task if illegal or improper activity had been discovered. Invariably, these agencies have explained price spikes by supply-demand conditions that had nothing to do with the manipulation of supplies or illegal agreements among companies.

A 2006 investigation by the U.S. Federal Trade Commission found "no evidence indicating that refiners make product output decisions to affect the market price of gasoline. Instead, the evi-

dence indicates that refiners responded to market prices by trying to produce as much high-value products as possible. The evidence collected in this investigation indicated that firms behave competitively."

Those who persist in suspecting that the industry is holding back supplies often cite the lack of new refinery construction. However, over the past 10 years, existing refineries have expanded capacity equivalent to building 10 new refineries, and based on public announcements of refinery expansions are projected to add capacity equivalent to an additional eight new refineries by 2011.

Another explanation advanced to explain high prices is industry mergers. Industry mergers have occurred only after careful FTC scrutiny to ensure competitiveness of all markets. There is no shortage of competitors today. The eight biggest refiners account for about 66 percent of the market at the beginning of 2006—a level of concentration that is comparable to other consumer products industries. There is nothing we are aware of in a professional peer-reviewed literature tying higher prices to mergers. In that category, I exclude a 2004 GAO report dismissed by the FTC as badly flawed.

In short, the justifications advanced in support of price control legislation are without merit. Price control laws could prevent the operation of laws of supply and demand, hamstring efforts to secure ample supplies of fuel to consumers. Such proposals are cousins of the disastrous price and allocation controls of the 1970's which led to gasoline lines, odd or even days and millions of angry motorists.

If price controls are enacted, the 12 percent of our daily gasoline consumption met by imports could be jeopardized. Because of artificially low prices, exporters would have less incentive to ship to U.S. markets. Also, they may prefer to ship to other markets rather than risk jail time or exorbitant fines supplying the U.S.

Finally, after a natural disaster in the U.S., the same disincentives could affect domestic suppliers, making it harder to end regional shortages that typically follow national disasters.

The U.S. oil and natural gas industry is doing everything it can to produce the fuels consumers demand. Markets work and have done more for consumers than price controls could ever hope to, but we also need policies that focus on increasing supplies, encouraging energy efficiency and conservation in all sectors of the economy, including transportation and reporting and promoting responsible development of alternative and non-conventional sources of energy.

At a minimum, we must do no harm. Price control laws threaten consumers and the Nation's energy security. We can do much, much better.

Finally, Mr. Chairman, I would like to submit for inclusion in the record the executive summary of a recent study by Professor Carol Dahl. Professor Carol Dahl is an economist at the Colorado School of Mines who has studied, at our request, many of the issues he discussed today.

Mr. CONYERS. Without objection, so ordered. We will include it.

[The information referred to follows:]

What Goes Down Must Come Up

A Review of the Factors Behind Increasing Gasoline Prices, 1999-2006

Carol Dahl, Ph.D.
Professor of Economics
Colorado School of Mines

April 2007

Executive Summary*

U.S. gasoline prices nearly tripled between January 1999 and July 2006. Consumers, policymakers, and the media have questioned why prices rose so quickly and why they remain so high.

In this paper, an independent expert in international energy markets reviews the available data and evaluates the various forces that have been suggested as possible causes for these price trends. She finds that recent price patterns are not unprecedented and are mirrored in the price behavior of other commodities.

There is no evidence that refiners have been able to block the behavior of a competitive market, and some of the factors that have been suggested as reasons for higher prices lack a theoretical basis or are incompatible with statistical evidence. The principal drivers of higher U.S. gasoline prices have been higher crude oil prices, higher operating costs, proliferating grades of gasoline, unexpected growth in demand, lower demand responsiveness, recovery from low and negative rates of return on investment in the 1990s, hurricanes, and regulatory uncertainty. Further, the evidence suggests that the higher profits have been accompanied by normal inventory and investment practices.

*For a complete copy of the report, please visit www.mines.edu.

Annual Real Gasoline Prices (1918–2006, September)

Note: 2006 price is weighted average through September.

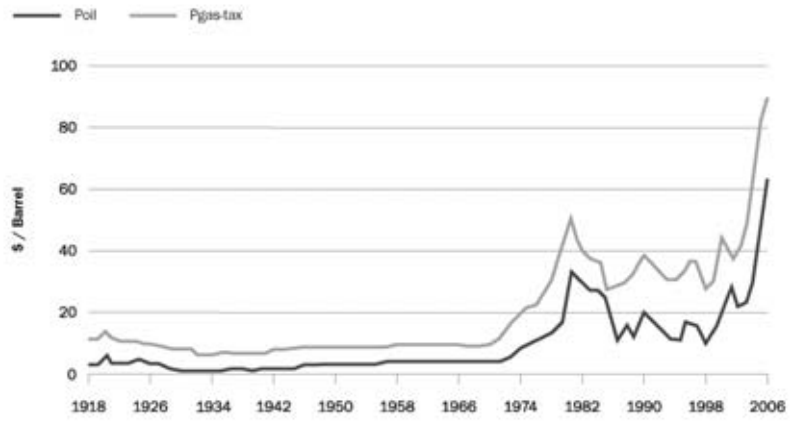
Sources: Prices from API, 1969, *Petroleum Facts and Figures* and EIA/DOE, 2006, *Annual Energy Review* updated from *Petroleum Navigator*, http://tonto.eia.doe.gov/dnav/pet/pet_pri_allmg_d_nus_PTA_cpgal_m.htm. Prices converted to real 2005 dollars using consumer price index from Department of Commerce *U. S. Historical Statistics Colonial Times to 1975* and Council of Economic Advisors, *Economic Report of the President 2006* updated from the Bureau of Labor Statistics, http://www.bls.gov/news.release/cpi.nr0.htm.

The current level of gasoline prices is not without precedent.

After adjusting for inflation, U.S. average gasoline prices in 2006 were lower than the average annual prices consumers paid in the period 1978 to 1982 and during the 1930s.

Recent price levels have been shocking primarily because consumers enjoyed unusually low gasoline prices for over a decade from 1986 to 1999.

Refinery Crude Oil Acquisition Price and Gasoline Price Less Tax (1918–2006, September)



Notes: 2006 price is weighted average through September; Poil values prior to 1947 are U.S. wellhead prices.
Sources: API, 1959, *Petroleum Facts and Figures*, *Petroleum Databook* (2005), and EIA/DOE, Monthly Energy Annual.

Movements in crude oil markets explain almost all of the change in gasoline prices over the period from 1999 to 2006.

Historical analysis shows that changes in crude oil prices explain about 97 percent of the variation in the pre-tax price of gasoline between 1918 and 2006. Over that period, a $1 per barrel increase in the crude oil price consistently generated an increase in the gasoline price of about 2.5 cents. Between January 1999 and summer 2006, crude oil prices more than quadrupled from $15.50 per barrel to over $65 per barrel. Based on the historical pattern, gasoline prices would be expected to increase by more than $1.15 per gallon in the same period. The actual increase in gasoline prices was slightly lower than this forecast amount. In addition, a small percentage of the increased cost of gasoline can be attributed to the increase in refiners' costs to purchase electric power, inorganic chemicals, and organic chemicals. These costs rose by 20 percent, 25 percent, and 45 percent, respectively, from 2000 to 2005.

Higher-than projected U.S. income levels exerted demand pressure on gasoline prices. The response of gasoline prices to this demand pressure indicates a tight competitive market rather than a market in which refiners have monopolistic pricing power.

In the United States, a 1 percent increase in income induces a 0.3 percent increase in gasoline demand within one year. An unexpectedly strong U.S. economy in 2004 and the first quarter of 2006 produced higher-than-forecast income growth, and thus higher-than-expected gasoline demand. Because of high refinery utilization rates and the long lead time required to add refinery capacity, short-term gasoline supplies are essentially inelastic (i.e., not very responsive to price changes). So demand levels that are greater than projections can cause dramatic short-term price effects.

In the short run, these price effects are not self-correcting because gasoline demand is not very sensitive to price increases. A doubling in prices has been estimated to produce a fall of only 4 percent in gasoline consumption in the first month. A recent study suggests that demand responses to price increases are even weaker today than they were in the 1970s, perhaps because consumers are less likely to view higher prices as permanent.

The changes in gasoline standards that have improved our environmental quality have also pushed up prices. The proliferation of "boutique fuels" has had the effect of reducing the capacity of the U.S. refining industry and increasing price volatility by limiting arbitrage possibilities.

Between 1990 and 2006, the number of different grades of gasoline increased from three to fourteen. This trend made refining more complex, requiring refineries to reconfigure their operations at lower production levels or invest money to sustain the same output. This product proliferation also reduced the market's ability to mitigate temporary geographic shortages by diverting gasoline from other regions, since different regions may not use the same products.

In August 2005, the Energy Policy Act removed the 2 percent oxygenate mandate effective immediately in California and after 270 days in the rest of the U.S. Many companies had been using Methyl Tertiary Butyl Ether (MTBE) as the only practical solution to meeting this mandate and chose to phase out MTBE in early to mid-2006. This Federal Act also required the use of greater volumes of renewable fuels, and so at the same time that MTBE was being eliminated from the gasoline supply, increased volumes of ethanol were being introduced. This resulted in some short-term supply disruptions due to change-over and supply logistics.

Some observers have claimed that increasing concentration in the refining industry has exerted upward pressure on gasoline prices. In fact, concentration and vertical integration have been decreasing.

A 2004 publication from the Government Accountability Office (GAO) stated that increased market concentration had led to higher gasoline prices. This report finds substantial weaknesses in the GAO methodology. In fact, the trend in the refining industry is toward slightly lower levels of concentration as refining operations are unbundled from oil companies into independent entities.

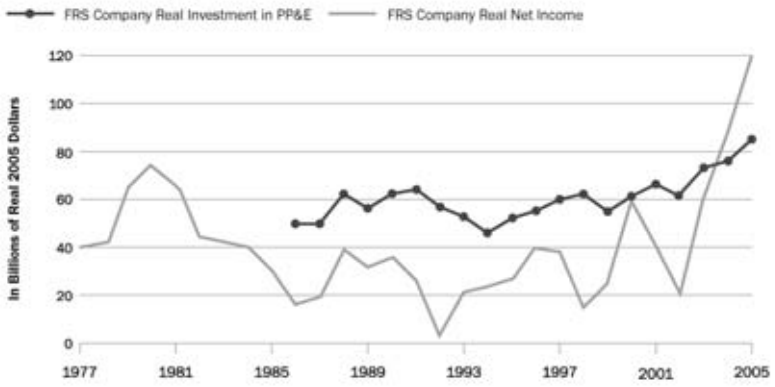
A 2004 report by the Federal Trade Commission (FTC) found that the oil industry is becoming less vertically integrated. According to the FTC (FTC, 2005), the share of U.S. refining capacity owned by independent refiners with no production operations rose from 8 percent in 1990 to over 25 percent in 2006. The FTC also found that trends in gasoline marketing are likely to increase competition and that price spikes are largely explained by such temporary and external phenomena as refinery accidents, bottlenecks, and the introduction of boutique fuels.

The magnitude of refiner profits is often exaggerated. From 1977 to 2005, the rate of return on investment in U.S. gasoline refining averaged less than 7 percent. This compares unfavorably with returns over the same period of 9 percent in durable goods and over 11.5 percent for the S&P 500 industrials.

The refinery sector is cyclical, with profits varying with capacity utilization. While a strong U.S. economy, hurricane-induced shortages, and the capacity squeeze prompted by new environmental standards created above-average profitability in 2004-2006, the industry has also experienced extended periods of low profitability and reported aggregate losses in 1992 and 2002.

The current profitability the industry enjoys is in large part the result of a massive restructuring in the 1990s that cut costs, increased economies of scale, and improved utilization rates. This restructuring has been essential to the survival of the increasing numbers of independent refiners that cannot use hydrocarbon production profits to subsidize low profitability in refining.

Net Income and Investment by Financial Reporting System Companies in Property, Plant and Equipment (1977–2005)

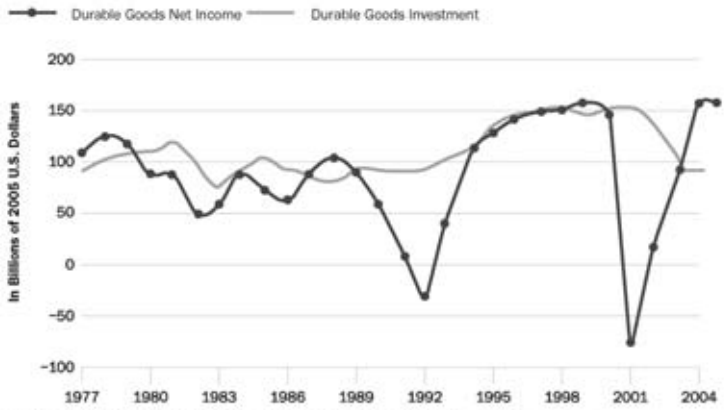


Note: Investment in PP&E taken from cash flows and excludes acquisitions and mergers.
Source: EIA/DOE www.eia.doe.gov/emeu/finance/frsdata.html. The FRS companies are listed in Appendix G.

The refining industry's investments in new capacity have been consistent with historical trends and prudent business practice. There is no evidence that investments have been artificially delayed in order to increase gasoline prices and industry profits.

Investment in capital-intensive industries does not directly track changes in profits or prices. Analysis of historical data shows that annual investments in refinery capacity are more stable than profits, with changes in profits causing a change in investment that is spread over three years. The pattern is similar in the durable goods sector where, for example, profits increased almost 75 percent in 2004, while investment in plant and equipment increased less than 1 percent. In the 1970s, additions to capacity following price increases that proved to be temporary led to years of inadequate profitability. The refining industry is now following prudent business practice by adding capacity incrementally, allowing time to gauge the long-term market response to higher prices. Refinery utilization rates in 1999 to 2006 were in the healthy 90-95 percent range, but were not generally higher than in 1992-1998.

Net Income and Investment by Property, Plant and Equipment by U.S. Durable Goods Industry
(1977–2005)

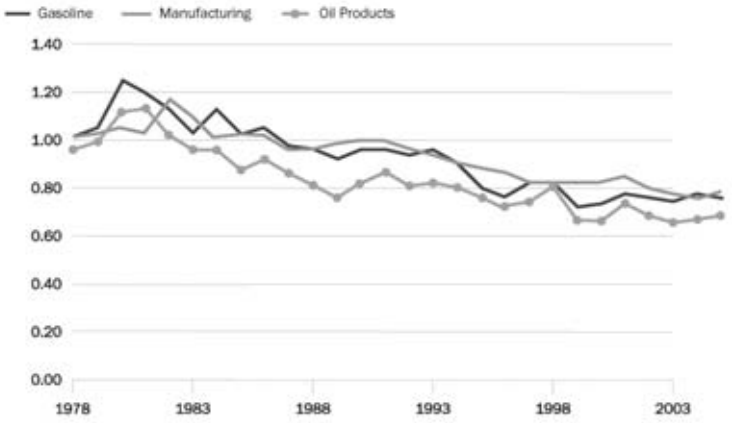


Note: Accounting changes in the durable goods industry in 1992 and 2001 make figures for those years inconsistent with prior years.
Sources: *Economic Report of the President: Corporate Profits by Industry 1965-2005* table B-92/table B-93 located at www.gpoaccess.gov/eop/tables06.html. Bureau of Economic Analysis Table 3.7ES. *Historical-Cost Investment in Private Fixed Assets by Industry* located at www.bea.gov/bea/dn/FA2004/TableView.asp#Mid.

Some analysts have argued that refinery capacity should be substantially higher and that such increases would reduce gasoline prices to $1.50 per gallon. Given that refiners needed $1.95 per gallon to cover their costs in 2005, this theoretical combination of higher capacity and lower prices would not be sustainable. While current high prices indicate that it is desirable to add refinery capacity, analysis suggests that the required additions are in line with the more modest expansion plans that refineries have announced.

Environmental regulations may have had the effect of reducing capacity additions. To produce fuel that complies with new standards, refiners must often make substantial investments that do not increase total output. Uncertainty about future regulations may also depress investment as refiners delay expenditures until they can accurately forecast the mix of products they must produce.

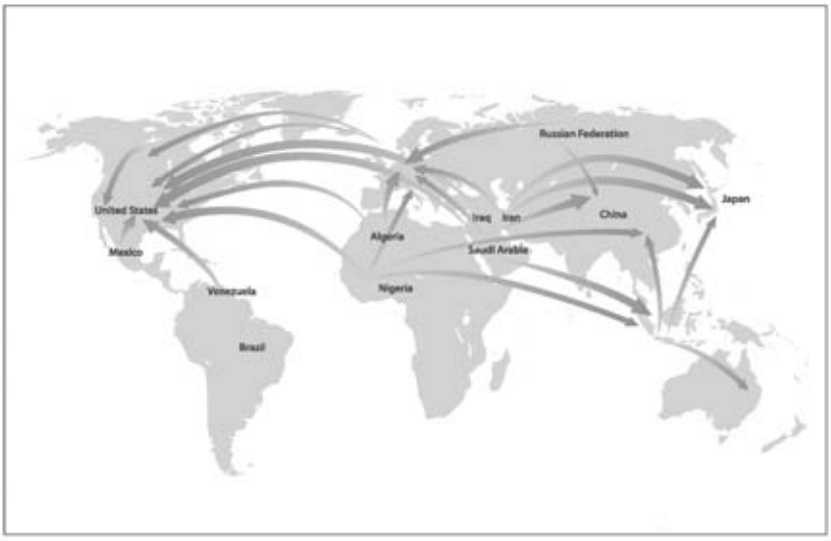
Index of Inventories to Sales for Gasoline, Oil Products and Manufacturing (1978–2005)



Sources: Manufacturing inventories and sales from the *Economic Report of the President* Gasoline stocks and sales from the EIA/DOE *Annual Energy Review*.

Lower gasoline inventories have not increased price volatility.

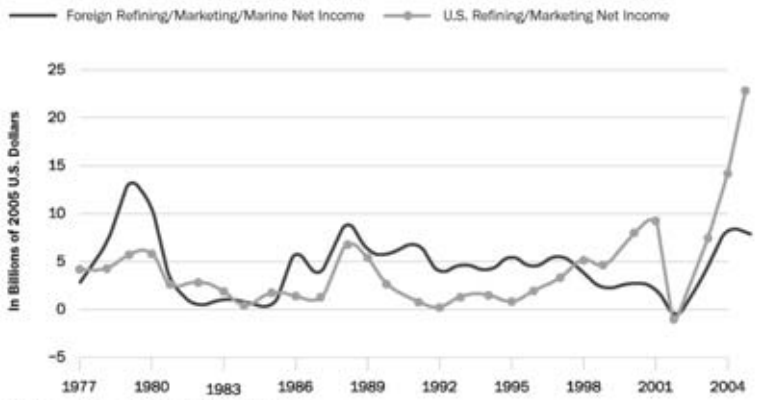
The ratio between gasoline inventories and gasoline sales has fallen steadily since 1980. The magnitude and pattern of this decline has been essentially the same in the gasoline industry as for the entire manufacturing sector, suggesting that what is responsible is continuous improvement in business practices rather than factors that are unique to the oil industry. Gasoline prices were less volatile between 1999 and 2006 than between 1979 and 1992, when inventory levels were substantially higher. The evidence suggests that it is not inventory levels, but volatile crude oil prices, that largely explain gasoline price volatility.



U.S. refiners cannot control the U.S. gasoline market. Trade and pricing patterns indicate that arbitrage moderates inconsistencies between U.S. and foreign markets.

Imports of petroleum products, although still providing only 5 percent of U.S. gasoline consumption, have grown at an annual rate of over 10 percent in the last decade. Increasing imports and highly correlated profit margins between Europe and the East Coast imply the existence of a robust arbitrage market across the Atlantic. In the Pacific, where differences in product specifications might be thought to reduce arbitrage opportunities, Asian refiners also act as a moderating influence by providing surplus product to U.S. markets as blending stocks.

Real Net Income of FRS Companies from U.S. Refining/Marketing and Foreign Refining/Marketing/Marine (1977–2006: III)

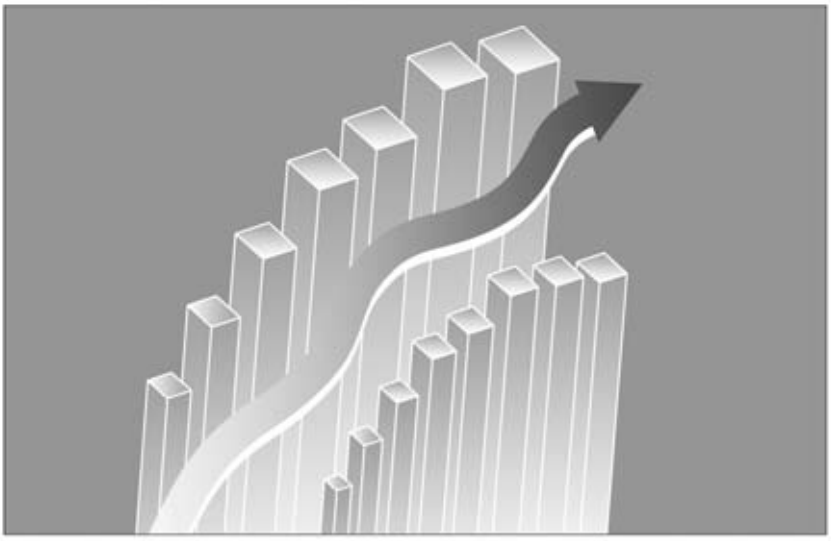


Notes: See footnote 14 for estimation methods used to compute 2006.

Source: Computed from values at www.eia.doe.gov/emeu/finance/frsdata.html update using data at www.eia.doe.gov/emeu/perfpro/news_m/consalent.html. The FRS companies are listed in Appendix G.

No evidence was found for the claim that U.S. refining is more profitable than foreign refining.

U.S. companies reported slightly higher absolute net income levels from domestic than from foreign refining operations. But their rates of return on investment in international refining averaged almost 14 percent from 1977 to 2005, compared to 7 percent domestically, and the profitability of foreign operations was also less variable. This pattern does not support the argument that refiners were able to abuse their market power in the U.S.



The argument that speculation in gasoline derivative markets bids up gasoline prices, and that these, in turn, bid up oil prices, is theoretically inconsistent and not supported by the evidence.

Studies consistently find that derivatives markets improve price stability. They are only destabilizing if speculators are wrong and have very deep pockets, a combination that cannot persist for long. A 2005 study by the Commodity Futures Trading Commission found no evidence that hedge fund and investment fund speculators bid up oil or natural gas prices. Rather, it found that they provided liquidity in the market and tempered price changes caused by underlying market fundamentals. The argument that speculative gasoline markets are "pulling up" world crude prices is also theoretically inconsistent with the argument that gasoline prices are high because of supply restrictions. The second argument would imply that gasoline consumption is lower than it otherwise would be -- which would put downward, not upward, pressure on crude oil prices.

About Carol Dahl

Carol Dahl is a Professor of Economics in the Mineral Economics Program at the Colorado School of Mines, as well as the Director of the Colorado School of Mines/Institute Français du Petrole Joint Degree Program in Petroleum Economics and Management. She received her B.A. degree in economics with distinction from the University of Wisconsin and her Ph.D. in economics from the University of Minnesota. She has published around 50 articles, made over 100 conference presentations, has numerous grants, has been a visiting professor at over 20 Universities and international organizations worldwide, and has supervised numerous Ph.D. students. She recently published her second book – *International Energy Markets: Understanding Prices, Policies, and Profits*. She is currently on the list of technical experts for the U.S. Fulbright Program and is on the editorial board and is assistant book review editor for *The Energy Journal*.

This research was supported by API. The views expressed herein are solely those of the author, and not necessarily those of API, its member companies, or the Colorado School of Mines.

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Mr. FELMY. Thank you, Mr. Chairman.

[The prepared statement of Mr. Felmy follows:]

PREPARED STATEMENT OF JOHN FELMY

I am John Felmy, chief economist of API, the national trade association of the U.S. oil and natural gas industry. API represents nearly 400 companies involved in all aspects of the oil and natural gas industry, including exploration and production, refining, marketing and transportation, as well as the service companies that support our industry.

The oil and natural gas industry understands America's frustrations about gasoline prices. Higher prices are a burden to households and potentially threaten the economy.

However, the evidence overwhelmingly demonstrates that higher prices reflect an imbalance between supply and demand, worsened at least in part by policy failures, which the current price-control proposals will make still worse. The contention that higher prices are driven by market failure or market manipulation, including the holding back of supplies, is not credible. The prices are a symptom of larger energy challenges facing the nation and must be addressed in other ways.

U.S. oil companies are working extremely hard to provide Americans with the fuels they need and demand.

U.S. refineries have been making record amounts of gasoline, about 8.85 million barrels per day to date this year (see Figure 1). However, less imported gasoline has been available. Typically, imports make up about 12 percent of gasoline supply. Less foreign gasoline has been available in part because of spring refinery maintenance in Europe and an 18-day French port-workers' strike in March, which led some European refiners to reduce production. As a result, total U.S. gasoline supplies have struggled to keep up with demand, which has been extremely strong. During the first quarter of 2007, total U.S. gasoline demand set a record, increasing almost 2 percent over the same period in 2006.

The most important factor in higher gasoline prices has been higher crude oil prices. More than half the cost of gasoline is attributable to the cost of crude oil. Crude oil prices have fluctuated significantly, driven by lingering geopolitical tensions, OPEC's continuing production controls, and worldwide demand growth. Oil companies do not set the price of crude. It is bought and sold in international markets, with the price for a barrel of crude reflecting the market conditions at the time of purchase. It is well recognized that the market for crude oil has tightened. World oil demand reached unprecedented levels in 2006 and continues to grow due to strong economic growth, particularly in China and the United States. World oil spare production capacity—crude that can be brought online quickly during a supply emergency or during surges in demand—is near its lowest level in 30 years.

In addition, the annual switchover to "summer blend" gasoline required by EPA has occurred, and this warm-weather gasoline is more expensive to produce. The switchover lowers yields per barrel of oil and requires a large supply drawdown to meet regulations, which reduces inventories.

Finally, despite record U.S. gasoline production, regularly scheduled refinery maintenance and unexpected problems relating to extreme weather, external power outages and other incidents have prevented refiners from making even more gasoline. Maintenance is a normal procedure, though it has been delayed, in some cases, by damage suffered from the catastrophic hurricanes in 2005. While maintenance curtails refining operations temporarily, it helps ensure the long-term viability of the refinery and protects the health and safety of workers.

In short, the recent price increases reflect the forces of supply and demand. And the same is true for past price increases that have been thoroughly investigated by government agencies who would not have hesitated to take the industry to task if illegal or improper activity had been discovered. Invariably, these agencies have explained price spikes by supply/demand conditions. The evidence is overwhelming that refiners are not withholding supplies or otherwise manipulating the market.

Here, for example, is what the U.S. Federal Trade Commission said in May 2006 as a result of an investigation:[1]

> ". . . the best evidence available through our investigation indicated that companies operated their refineries at full sustainable utilization rates. Companies scheduled maintenance downtime in periods when demand was lowest in order to minimize the costs they incur in lost production. Internal company docu-

[1] "Investigation of Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases," U.S. Federal Trade Commission, May 22, 2006.

ments suggested that refinery downtime is costly, particularly when demand and prices are high. Companies track these costs, and their documents reflected efforts to minimize unplanned downtime resulting from weather or other unforeseen calamities. Our investigation uncovered no evidence indicating that refiners make product output decisions to affect the market price of gasoline. Instead, the evidence indicated that refiners responded to market prices by trying to produce as much higher-valued products as possible, taking into account crude oil costs and other physical characteristics. The evidence collected in this investigation indicated that firms behave competitively."

Those who persist in suspecting, despite the massive evidence to the contrary, that the industry is holding back supplies often cite the lack of new refinery construction. While it is true that no new refinery has been built since the 1970s, companies have steadily increased the capacity of existing refineries and continue to do so. Over the past ten years, existing refineries have expanded capacity equivalent to building 10 new refineries and, based on public announcements of refinery expansions, are projected to add capacity equivalent to an additional eight new refineries by 2011.

Another explanation advanced to explain higher prices is industry mergers. As with all industries, mergers have occurred only after careful FTC scrutiny to ensure the competitiveness of markets. There is no shortage of competitors today, and market power is not heavily concentrated. The eight biggest refiners account for 66 percent of the market, a level of concentration that compares favorably to other consumer product industries. There are close to 60 refining companies, about 142 refineries, and about 165,000 retail outlets, all but a small percentage of these outlets owned by small businessmen and women. A 2004 report by the FTC said that the share of U.S. refining capacity owned by independent refiners with no production operations rose from 8 percent in 1990 to over 25 percent in 2006.

A 2003 GAO report says that mergers affected prices by less than one half of one cent per gallon at the wholesale level, but the FTC dismissed the report as "fundamentally flawed" and full of "major methodological mistakes." It says the report's conclusion "lack any quantitative foundation." Beyond this suspect GAO report, we are unaware of anything in the professional literature tying higher prices to mergers. Indeed, in part as a result of the mergers, the industry has become more efficient, which has reduced costs to consumers, though this benefit has been masked by sharp increases in crude oil prices.

None of the arguments advanced to justify the price-control proposals has a strong factual and analytical basis, yet even if all did, price-control legislation would be a supremely bad idea. The proposals could interfere with the operation of the law of supply and demand, hamstringing efforts to secure and deliver ample supplies of fuel to consumers.

Today's proposals are cousins of the disastrous price and allocation controls of the 1970s. Those policies established price ceilings on domestically produced crude oil and refined products, keeping them artificially low compared to world prices. This resulted in decreased domestic crude oil production while domestic demand for crude oil and refined products increased, leading to a worsening of shortages and increased oil imports. It was the era of gasoline lines, odd or even days, and millions of angry motorists, victims of the misguided policies of their own government, which should have known better.

If price controls are enacted, the 12 percent of our daily gasoline consumption met by imports could be jeopardized. Overseas suppliers would not have an incentive to ship to U.S. markets if the price were kept artificially low. Also, they might prefer to ship to other markets rather than risk jail time or exorbitant fines in the U.S.

In addition, today's proposals contain vague pricing requirements that make it virtually impossible for marketers to know in advance if their actions will be found to be in or out of compliance and, therefore, will be extremely difficult to enforce fairly. For example, under these bills, how is a gas station operator to know whether a price increase of five, ten or fifteen cents a gallon will be considered "unconscionable?" This legal uncertainty, especially when coupled with the serious risk of jail time or exorbitant fines, could discourage a supplier from doing business in areas affected by a natural disaster when supplies have been substantially reduced, thus delaying a return to normal conditions.

Price-control laws will not solve today's problems. The U.S. oil and natural gas industry is doing everything it can to produce the fuel supply needed to meet consumer energy needs. Congress needs to allow the oil and gas industry to invest today's earnings in meeting tomorrow's energy needs and continue to operate within a market system, which has done far more for consumers than price controls could ever hope to. However, the industry cannot meet U.S. energy challenges alone. Our

nation's energy policy needs to focus on increasing supplies; encouraging energy efficiency and conservation in all sectors of the economy, including transportation; and promoting responsible development of alternative and non-conventional sources of energy.

At a minimum, we must do no harm. Price control laws threaten consumers and the nation's energy security. We can do much, much better.

APPENDIX 1: OIL AND NATURAL GAS INDUSTRY EARNINGS

Proponents of "price-gouging" proposals say they are partly justified by the oil and natural gas industry's large earnings. There is considerable misunderstanding about this. Companies' earnings are typically in line with other industries and often lower. For 2006, the industry's annual earnings averaged 9.5 cents on each dollar of sales. The average for all manufacturing industries was 8.2 cents or about a penny lower. From 2002 to 2006, average earnings for the industry stood at approximately 7.4 cents on each dollar of sales—a penny above the five-year average for all U.S. manufacturing industries.

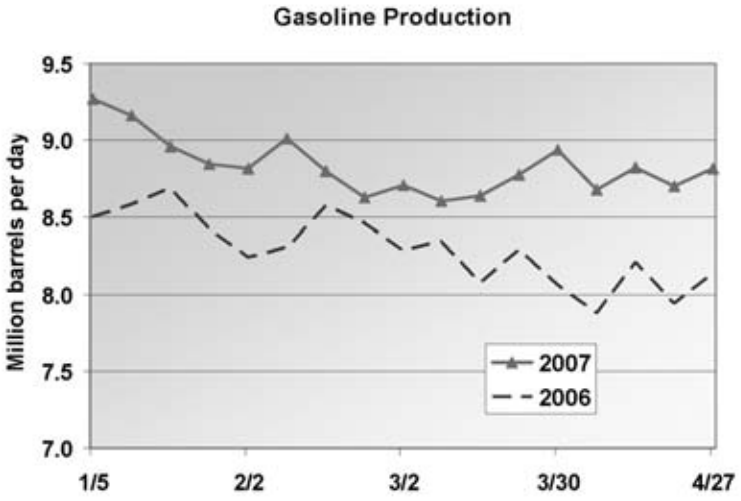
It should not be forgotten that the energy Americans consume today is brought to us by investments made years or even decades ago. Today's oil and natural gas industry earnings are invested in new technology, new production, and environmental and product quality improvements to meet tomorrow's energy needs. Between 1992 and 2005, the industry invested more than $1 trillion—on six continents—in a range of long-term energy initiatives: from new exploration and expanding production and refining capacity to applying industry leading technology. In fact, over this period, our cumulative capital and exploration expenditures exceeded our cumulative earnings.

Furthermore, the industry's future investments are not focused solely on oil and natural gas projects. For example, one oil company is among the world's largest producers of photovoltaic solar cells; another oil company is the world's largest developer of geothermal energy; and the oil and gas industry is the largest producer and user of hydrogen. Over the last five years in North America alone, we have invested $12 billion in renewable, alternative and advanced non-hydrocarbon technologies. In fact, when you add up all of the various types of emerging energy technologies, our industry, over the five years, has invested almost $100 billion—more than two and half times as much as the federal government and all other U.S. companies *combined*.

It also requires billions more dollars to maintain the delivery system necessary to ensure a reliable supply of energy and to make sure it gets where it needs to go: to industry customers. According to the EIA, Americans will need 28 percent more oil and 19 percent more natural gas in 2030 than in 2005. The industry is committed to making the reinvestments that are critical to ensuring our nation has a stable and reliable supply of energy today and tomorrow.

It is also important to understand that those benefiting from healthy oil and natural gas industry earnings include numerous private and government pension plans, including 401K plans, as well as many millions of individual American investors. While shares are owned by individual investors; firms, and mutual funds, pension plans own 41 percent of oil and natural gas company stock. To protect the interest of their shareholders and help meet future energy demand, companies are investing heavily in finding and producing new supplies.

Figure 1



Mr. CONYERS. Before we go to vote, just tell me, Dr. Felmy, how did Mr. Blumenthal and Mr. Cooper get it so wrong? Is there some way we can explain their understanding of the dimensions of the problem?

Mr. FELMY. Mr. Chairman, I am an economist. I fundamentally believe in markets, markets at work, and as I look at the data carefully, what I see is an industry that has, true, a shortage of refinery capacity through a whole host of reasons leading up over years. We faced enormous challenges this year in terms of what was actually happening with markets. Their perception of what is going on is simply different than my own. As an economist, I believe in markets.

Mr. BLUMENTHAL. And I believe in markets too, Mr. Chairman. This one simply isn't working because it has become so concentrated and power is in so few hands that have failed to expand refinery capacity when it is desperately needed, failed to maintain proper levels of inventory and thereby exposed the system to the shocks of pipelines bursting and other temporary phenomena and failed to be responsive to consumers. And the Federal Government bears a share of the responsibility, the Department of Justice and FTC, in failing to enforce the law.

So I think there is concentration of market power, clearly. The question is what to do about it, how to remedy it.

Mr. CONYERS. Mark Cooper?

Mr. COOPER. It is wonderful to believe in markets, but you also have to accept the proposition that sometimes they fail. And in this

case, this year we have got an excuse about some refineries out here and there. For the last 7 years, we have had a different excuse each year. And the simple fact of the matter is that once is an accident, twice is a surprise, six times means there is a fundamental flaw in the structure that has failed to build an industry that can actually deliver a stream of product at reasonable prices.

You can't look at oil company profits in the last 4 years and say they are not extreme, excessive. Last year, they were twice the average for the manufacturing sector, and they have averaged about seven or eight points over the last 4 years.

So if you look at the structural characteristics of the market, not just pray to it and believe in it, but analyze it, you have to conclude that there is a market failure here of immense proportions.

Mr. CONYERS. Heather Wilson, last word.

Mrs. WILSON. I am not an economist, Mr. Chairman, but I am a mom with a Subaru, and I think people are upset about how high their gas prices are, and it puts a real crimp in their pocketbook.

But we are not going to get out of this overnight. We need a balanced long-term energy plan for this country that makes us more energy independent and helps to keep the prices down. I am a big believer in competition.

Mr. CONYERS. Mr. Keller?

Mr. KELLER. Thank you.

Mr. Attorney General Blumenthal, I don't disagree with you on this NOPEC issue at all. I may even co-sponsor it.

But just for the sake of argument—you are a good attorney—do you believe, in your legal opinion, that if we pass this, that we will have jurisdiction over these OPEC nations in Federal court and that we would be in a position to enforce a judgment against them if we are able to acquire a judgment?

Mr. BLUMENTHAL. The answer to that question, a very central and obviously excellent question is unequivocally yes.

This measure would, very simply, have the effect of removing from the Federal Sovereign Immunities Act of 1976 the flawed interpretation, in my view flawed interpretation, given by the Ninth Circuit in the OEM case—I can give you the exact citation, *IAM v. OPEC,* 644 F. 2d 1354. It is a 1981 case and, essentially, in my view, extends immunity to the OPEC nations, wrongly interprets their commercial activities as acts of state rather than, in fact, economic and commercial activities.

But the Congress has the authority to apply jurisdiction—that is the key concept here—and it can through this measure.

Mr. KELLER. Time is running out.

Dr. Felmy, let me just get you the central question here to kind of sum up what the other side has said. There is no doubt that the majority of the cost in a gallon of gasoline is crude oil, and there is no doubt that crude oil is a commodity governed by the law of supply and demand, and there is nothing we can do in Congress to pass a law changing the law of supply and demand.

But it has been pointed out, both by Mr. Blumenthal and by Congressman Stupak, that in fact gas prices are 50 percent higher this year despite the fact that crude oil is $7 a barrel lower. And they say that something else is at play here, and, specifically, what they are alleging, just to be frank, is that oil companies are intentionally

not building any new refineries in the past 30 years because they want to drive prices up.

And to support that, they say three things: One, the idea that it is difficult to get environmental permits is false, they say, because only once in the last 30 years, they say, was a permit requested and it was granted; two, they say there are certain internal documents from the big oil companies that say that they want to limit refinery capacity to drive up prices; and, third, they point out that big oil companies like Exxon had $400 million to pay CEO Lee Raymond last year, why don't they use the money to build a new refinery.

So you tell me what your side is to those arguments.

Mr. FELMY. Thank you, Congressman.

The fact is the industry is expanding refinery capacity. As my testimony indicated, while we have not built a new refinery for 30 years, and I would say it is an enormous challenge to build a new refinery and to articulate that, I testified last week before Chairman Markey's Committee, and I would propose to submit the same letter that was provided by Arizona Clean Fuels in terms all the difficulties they have faced in terms of actually developing a new refinery.

Second, we have expanded existing capacity because it is easier to do so within the walls of the existing refineries. But even that is a challenge because you have complex permitting problems. You have also got local folks who don't want you there. When refineries were developed originally, they were out in the middle of nowhere. Now, communities have built up or they were on desirable waterfronts. People just simply don't want an industrial facility. So even expanding an existing one is.

And, finally, the industry produced record amounts of output this year, and that is a key factor that we are explaining, that it is a combination of both crude oil costs, which I mentioned, but also supply and demand fundamentals in terms of increased demand, a decline in imports and it was more than even a record production of output of gasoline could show.

Mr. KELLER. I don't have a Ph.D. in economics from Harvard or MIT, and you are an economist, so just explain it to me as if I am in 6th grade to help me out.

This is what they are saying, and I want your response. They are saying, a year ago crude oil was $70. This year, a barrel of crude oil is $63. Despite the fact that crude oil was $7 a barrel cheaper last year, gas prices are now $7 cheaper than they were last year, gas prices are 50 percent higher.

Why? I mean, what is the explanation for that?

Mr. FELMY. Well, first, I just looked at the AAA data from last year and a year ago gasoline prices were $2.93 and now they are $3.10, so I am not quite sure where 50 cents——

Mr. KELLER. So you take issue with the 50-cent issue to start with. Okay.

Mr. FELMY. In any case, there is no question it is not just crude oil. We have seen crude oil increase from earlier this year, and that is where you are talking about an increase from $50 a barrel to $66 they peaked out. But it is clearly a tight market, that it is an increased demand, it is a limitation of imports, which we have tradi-

tionally been able to increase from Europe, and so it is a combination of supply and demand factors. With less supply and more demand, you have a tighter market. That yields price increases.

Mr. KELLER. Mr. Blumenthal, you are one of the ones who made that argument. I would ask Congressman Stupak but he is gone. Why is it that gas is higher this year despite the fact that crude oil is $7 a barrel lower. What is your explanation?

Mr. BLUMENTHAL. Well, there are a number of explanations. Partly, he has given them. We have all repeated them. Lack of refinery capacity, concentration in the market, which gives power to the oil companies that impose, for example, zone pricing, geographic divisions of economic turf that are inherently anticompetitive, essentially a collection of anticompetitive practices, beginning with shortages of supply, lack of refinery capacity. There has been no new refinery built, albeit expansion of existing refineries but still not enough.

And I think credit, if I may use that term, has to be given where it also should lie to the OPEC cartel. They have failed to provide the supply that would enable lower prices, but with a lack of refining capacity, the question is whether the United States industry could really do anything productive with it.

Mr. KELLER. Let me follow up with that. Let's assume that the four or five largest oil companies own most of the refineries, and for sake of argument, they don't want to expand capacity.

Isn't it true that if I don't like the prices at my local ExxonMobil gas station, I can just go across the street to Chevron and BP? I mean, doesn't Chevron and BP keep Exxon honest, so to speak?

Mr. BLUMENTHAL. The simple answer is no.

Mr. KELLER. Why is that?

Mr. BLUMENTHAL. Well, talk to your constituents. They tend to rise together. Prices tend to go up——

Mr. KELLER. I talked to them all today, and everybody wants me to do something about it, and if I could change the law of supply and demand, I would do it. But I want you to tell me, I mean, you are the expert testifying, why is it that competition isn't sufficient in order to keep one group from price gouging the other?

Mr. BLUMENTHAL. Because there has been consolidation. In our part of the State—I know you are from Florida——

Mr. KELLER. I mean, are you alleging collusion, I guess, between these big companies?

Mr. BLUMENTHAL. We don't know, is the most honest answer. Certainly, conscious parallelism, at a minimum, exists, which is not collusion.

Mr. KELLER. If I talk to my constituents, do you think they would tell me the problem is conscious parallelism?

Mr. BLUMENTHAL. You won't get very far with your constituents talking about conscious parallelism, nor would I in court in an antitrust case, but we have more than enough evidence to begin a national investigation, which I have urged the Department of Justice to do, meeting with the United States Attorney General and the chairman of the FTC. There should be a Federal joint investigation. There should be not one but a series of investigations focusing at different levels of the industry.

Mr. KELLER. All right. And let me follow up, because I have just got to wrap up. I have got to go vote too.

Are you concerned if we pass the NOPEC law that you are advocating that these OPEC nations could possibly embargo oil to the United States like they did in 1973 as a response to such a lawsuit?

Mr. BLUMENTHAL. No, I am not concerned about that fact, because—or about that possibility, I should emphasize. All we are doing is require they submit to the jurisdiction of our courts, abide by our rules, play by those rules fairly and compete so as to be on a level playing field. And in my view, they have to do business with the United States.

Mr. KELLER. Okay.

Mr. Cooper, I know you want to respond, but since you are out there for the consumers and want the lowest possible prices, I assume you would be supportive of efforts to drill in ANWR, which would give us 16 billion barrels of oil, which is the equivalent of 58 years worth of oil from Iraq?

Mr. COOPER. It is our belief that drilling will do nothing to lower the price of oil.

Mr. KELLER. You don't think 16 billion barrels of oil——

Mr. COOPER. Absolutely not. It is a miniscule addition to supply, first of all. Second of all——

Mr. KELLER. Fifty-eight years' worth of oil from Iraq is miniscule?

Mr. COOPER. From Iraq?

Mr. KELLER. Fifty-eight years' worth of——

Mr. COOPER. In terms of the world supply, there is almost no difference. You add almost nothing in terms of the global supply from crude.

Second of all, it will do nothing to build any refineries.

Mr. KELLER. Let me just stop you. Do you oppose the ANWR drilling?

Mr. COOPER. We absolutely oppose ANWR drilling.

Mr. KELLER. And let me give you a follow-up question. What do you believe is the cause of the spike in gas prices? Do you believe it is lack of refinery capacity, or what is the nub of what you are trying to say?

Mr. COOPER. Since January, the overwhelming increase has come from domestic refining, up 65 cents a gallon that is taken by refiners. That is an uncontrovertible fact from the EIA's numbers. Sixty-five-cent increase in what is known as the domestic spread, that is the amount that domestic refining takes. This year, there is no doubt about that. After Katrina, there was no doubt about it.

Mr. KELLER. All right, Mr. Cooper.

Let me give you a chance, Dr. Felmy, because you are kind of outnumbered here. Do you want to respond to just the allegation as, "Hey, don't blame supply and demand. It is really the failure to increase your capacity and conscious parallelism on the part of the oil companies to let the prices go up."

What is your response on behalf of the Petroleum Institute to those allegations?

Mr. FELMY. Well, I don't know what conscious parallelism is, and I have heard that term in the past, but my interpretation is prices

move together because markets are at work. You have one price, the market-clearing price. So this notion of parallelism I have never understood from an economic context.

But the industry is working very hard. We have plans to expand existing refinery capacity even more. We have expanded it the equivalent of a new refinery every year for the last 10 years.

But we do face fundamental challenges. We have an import challenge this year, and we have continuing demand growth, and that has resulted in the higher prices.

Mr. KELLER. Why not build the new refineries? What is the short answer?

Mr. FELMY. Well, the short answer is, there are a whole series of hurdles you have to go through in terms of permitting, in terms of NSR conflicts, and you have to financially look at it, is it wise to build a new refinery to return a return to your shareholders, given the uncertainties going forward.

Mr. KELLER. Is it true that you all have only asked for one permit in the past 30 years and it was granted or is that a misstatement by Mr. Stupak?

Mr. FELMY. I don't know the answer to that, because it is such a large industry. I don't know that that is the case. I don't know yes or no.

Mr. KELLER. Let me ask you—and I hate to cut you off, but I have got to vote, I am already in trouble here—to wrap it up, you are an economist, is that correct?

Mr. FELMY. Yes, sir.

Mr. KELLER. Do you believe that someone who understands the law of supply and demand, that having 16 billion barrels of oil extra is irrelevant to the issue of price as a determinant of crude oil for supply and demand?

Mr. FELMY. There is no question to me that expanding production from anywhere in the world by the equivalent of 16 billion barrels is an increase in supply, and that will help a market in terms of whenever you have increased supply or reduced demand, it results, generally, in lower price.

Mr. KELLER [presiding]. Gentlemen, I want to thank you all. I have tried to be fair to all sides and get all your testimony out. I am going to have to recess this hearing at this point to go vote, but I very much appreciate you staying and answering the questions.

Mr. BLUMENTHAL. Thank you, sir.

Mr. KELLER. You bet.

[Recess.]

Mr. CONYERS [presiding]. The Chair recognizes the gentleman from Alabama, Mr. Artur Davis.

Mr. DAVIS. Thank you, Mr. Chairman.

Mr. Cooper, Dr. Felmy, let me get your attention back. I apologize to you, as I know the Chairman has, that, unfortunately, we have had a number of procedural votes, and we are none happier about it than you are, so I apologize that it has depleted your audience.

But I want to do is, frankly, use my time to ask you some of the questions people ask me when I go back home to see if you can make my answers better informed.

First question, a lot of people ask me, why are prices at the pump going up when there has not been a disruption in supply in the Middle East? I suppose we can argue about the level of production capacity we are getting in the Middle East, but I think it is hard to make the case there has been a major disruption in supply either.

So can either one of you quickly speak to that point: Prices going up, no disruption in supply. Why?

Mr. COOPER. This season, there is no doubt that it is a domestic problem, and, actually, Katrina was the thing that woke people up. Crude didn't go up, we didn't need crude, and we learned that there is a domestic problem. And the lack of refinery capacity; the inability of the industry to change over from winter fuels to summer fuels, which happens every year, that is no surprise, they have to do that every year; the fact that demand is growing—yes, that has happened every year for an awfully long time. There are no surprises here. So this is an industry that has mismanaged the simple basics of switching fuels and meeting demand which they know is increasing.

We believe that the underlying cause is a lack of sufficient competition, the competitive discipline that makes each individual company worry about running short and therefore adding more capacity so that they never have to tell their customers, "We are out" or that they have to raise their price. The fact that there are only two or three companies that they can look across the street, they see the price, they know no one else is going to come along, and so they both put the price up immediately. Most Americans think that that is not the way it is supposed to happen.

Mr. DAVIS. Let me ask a second question related to that, and, Dr. Felmy, perhaps you can chime in on this one.

The industry often says that, well, even if we had a stimulus and delivery from the Middle East, even if Saudi Arabia, for example, dramatically stepped up their production, even if we somehow had a surge in production in Iraq and Iraq returned to the oil market, that it wouldn't matter, because we haven't had a refinery built in a while.

A lot of people in your industry say, "Well, we haven't had refineries built for 25 years because of regulation, environmental standards." Can both of you weigh in on why the industry has not had more refinery development?

Mr. FELMY. There is the question of building a new refinery, but, as I have pointed out in my testimony, we have expanded the existing capacity the equivalent of a new refinery for every year for the last 10 years, and the public announcements are for an additional expansion of, I believe, an additional 1.6 million barrels a day of capacity going forward. So the industry is looking forward to increasing that capacity.

In terms of the Middle East and crude, there is no question if you look at the increases this year so far, you saw crude oil prices go from $50 a barrel to over $66 a barrel. So, clearly, part of it was cost; clearly, part of it is the turnover to the new summer price gasoline, which is an enormous challenge for the industry, because we effectively have to draw down inventory to very low levels so that

you are able to bring in the new summer-based gasoline and still be compliant with EPA standards. So it is a challenge.

Mr. DAVIS. Let me make sure I understand that. You are saying that the industry has stepped up the existing refinery capacity to the equivalent of building a new refinery.

Mr. FELMY. The equivalent of building a new refinery every year for the past 10 years.

Mr. DAVIS. Okay. Well, that is helpful to know, because every now and then we hear from some in industry that the environmental standards are just too heavy and we can't get new refineries.

Let me ask you one last set of questions. If you would jump in on this, Mr. Cooper. Instituting or reinstituting a windfall profit tax, would it have an impact on prices at the pump short or medium term?

Mr. COOPER. It would not have an impact on prices at the pump. What it would is tax away the windfall, the cash that has been piling up. The American majors have bought back over $60 billion in stock. Now, that is great for their stock performance on Wall Street, no doubt about it, but that is money that is not being put to productive use. The cash has piled up. They have increased their dividends, they have reduced their debt, they haven't put it back into the sector in a productive way.

So if you taxed away a windfall, you will have no effect on the efficient operation of that market. It is truly, in the last 4 years, a windfall that the industry could not absorb.

Mr. DAVIS. Well, let me ask you both one last question before I have to take my leave.

Both of you, is there anything that could be done from a regulatory standpoint by this Congress that would impact contemporary prices at the pump?

Mr. FELMY. In terms of contemporary prices, there is very little that can be done instantly to change supplies or demand. There is no question to encourage consumers to use gasoline wisely, to encourage them to properly tune their cars, to their inflate their tires, to drive sensibly. A softening of the demand is the one option that could help, and so advising consumers of what they can do is a potential hopeful aspect.

Mr. DAVIS. Mr. Cooper, would you like to weigh in?

Mr. COOPER. In the short term, the industry won't help us, we know that. The authority in the Congress to look at the market will not help us in the very short term. So, yes, consumers can try to cut back.

But let's be clear: We have spent a decade digging this hole. We have built over several decades a society that drives a lot. I would like to remind people, it is interesting, in many suburban communities in this country, it is illegal to walk to the grocery store. Now, I say it that way to get your attention. Because zoning laws have said we don't want commercial establishments in those neighborhoods, and we don't even want sidewalks in those neighborhoods. That is the way we have chosen to live, and it has increased demand, and the industry knows it.

So we are not going to change that in the short term. This is a long-term problem, but there are immediate things that can be

done that can start and send a signal in addition to some oversight. We think there is plenty of abuse that could be found if we had laws that let people look at unilateral action.

But your answer is, I think, to tell your constituents, "It took a long time to get in this hole, and it is going to take a long time to get out, but now is the time to start."

Mr. DAVIS. That is actually about what I tell them.

I yield back, Mr. Chairman.

Mr. CONYERS. Thank you very much.

Is there anything here, with two distinguished witnesses, at the end of a few minutes only left in this hearing, that we could attest to on the record that you do agree on?

Mr. COOPER. We agree that people ought to adjust their behaviors as best they can to lower their demand. That is something we always tell people, to think about the extra trip, to get your car tuned, to clean your air filter, to inflate your tires, to take the bags of sand that you threw in the trunk in the winter for traction, take them out in the summer, because you are burning gas.

We do agree on that. That is an important set of short-term things to do. But I suspect that is about as far as we go on our agreement.

Mr. FELMY. Mr. Chairman, I would agree with Mr. Cooper that——

Mr. CONYERS. Amazing.

Mr. FELMY [continuing]. Using energy wisely is something we agree on.

But I think we both share the interest in seeing expanding refinery capacity. It is a question of how you get there. And we feel that there are policies that the Congress can enact that would help us expand capacity. We feel we are already doing quite a bit. But I think that that is something that remains that could help consumers.

Mr. CONYERS. Could you take back to the industry, Dr. Felmy, that more and more of us want more refineries built, and quickly?

Mr. FELMY. Well, the industry very carefully looks at what expanded capacity has happened, what going forward is potentially possible, but it is an economic calculation that they have to look at very carefully in terms of returns to their owners. And there are large uncertainties out there that have just begun to come around, such as the proposals in the Senate for alternative fuels of 35 billion gallons, reducing gasoline demand that makes a further challenge in terms of doing the calculations on building that new capacity.

But, certainly, we understand the position, and I will communicate that to my management.

Mr. CONYERS. What do we tell the people, Cooper, that we are being put on hold here? I guess there is no way I can be optimistic about refineries. You tell me, on the other hand, that taxing the profits is not a real solution. So where are both of you leaving a concerned Member of Congress?

Mr. COOPER. Well, frankly, if you taxed away the profits, it depends what you did with them. I mean, if you took that $200 billion—I will just give you an example—which I see as excess profit, and you directed that to the auto industry, that is about half of

what the Transportation Department said it would cost to get us to 35 miles per gallon. Boy, that would be a real good use of those excess profits, and that kind of policy is something that we may have to look at. We may have to look at ways to incentivize the alternative solutions.

I think you heard an answer here about refineries that is really, really troubling. The chairman of Exxon earlier this year said, "We think gasoline demand will decline starting out in 2020 or so, and therefore we are not going to consider building new refineries. Well, that is 12 more years of pain. So they are not going to give you the solution to the refinery problem.

There was legislation introduced in the last Congress about a strategic refinery reserve. If the industry is not going to give us more refinery capacity because 16 years is a time horizon that they want to keep making all this money past 15 years, then this Congress is going to have to step in with a social return on capital that fits the needs of the people. We cannot wait for 15 years before they think the marketplace will start to create a balance or even your policy. Imagine what they said, "If you pass laws which reduce the demand for gasoline, we are not going to build refineries to reduce and improve the supply-demand balance." I think that is an outrage.

Mr. FELMY. Well, Mr. Chairman, there are several comments I could give to that, but the first is the discussion of the windfall profits tax. Our history with that tax when it was imposed in the eighties was a disaster. It increased the cost of the industry, it reduced production, as documented by the Congressional Research Service, and largely increased imports. I fail to see how that can help consumers.

Secondly, the companies are owned by millions of Americans. Taking money away from the industry is equivalent to taking away from millions of Americans who have invested their hard-earned savings in that. Fully, 41 percent of the equity of companies is owned by retirement plans of some type. So one has to be cautious in terms of where you are taking money from and what the impact is.

But the bottom line is it potentially raises cost, and that I fail to see how it can help consumers.

Mr. COOPER. Mr. Conyers, let me respond to the question about stock ownership. I suggest that if you go to your constituents and say, "Look, use your dividends from the oil companies to pay your gasoline bills," they will fall down laughing, and they might not send you back here.

That is not an answer to that question. Sure, there are investors here and there, but those investments are highly concentrated among richer people, yes, there are some pension funds in there, but, by and large, the average American is paying through the nose at the pump, and they are not getting it back in their dividends from oil company stock.

Mr. FELMY. Well, just as a point, Mr. Chairman, 485,000 folks in the State of Michigan are members of State and local pension funds that are invested in oil companies. And approximately 18 million Americans have similar types of investments. So one has to

be cautious that our companies are owned by millions of Americans.

But going forward, there are things that I believe we can do in terms of streamlining the regulation process, resolving questions about new source review for refineries, and it could help expand the existing plans already announced for an additional 1.6 million barrels a day of capacity.

Mr. CONYERS. I would like now to recognize the distinguished Ranking Member, Steve Chabot, of Ohio for concluding remarks.

Mr. CHABOT. Thank you very much, Mr. Chairman, and my opening statement and concluding remarks will all be contained in the same couple of minutes here.

I want to thank you for holding this important hearing today. There is not an issue that comes up more often when I am talking with my constituents back in Cincinnati than the high cost of gasoline at the pump. Every day, people raise questions about price fixing, questions about oil companies or service stations taking advantage of their market power to stick it to the consumer, and these concerns won't diminish until this Congress is willing to take steps to make energy more affordable to consumers.

The national average, as we have said, is anywhere from $3.10—last weekend, when I got gas back home, it was between $3.13 and $3.19 in my district, back in Cincinnati, and we haven't even entered the traditional summer driving season. That peak driving season starts around Memorial Day and ends around Labor Day.

Up 90 cents since January, and forecasters expect prices to continue surging through the summer months, and I don't have to tell anyone how these price hikes have and will continue to impact consumers and their families and ultimately weigh down the economy.

Over the last decade, it has become alarmingly clear that America is far too dependent on foreign oil to meet our energy needs. Disservingly, we import more than a third of the oil we consume and much of it from OPEC nations. At the same time, the number of refineries operating in the U.S. has decreased from over 300 to fewer than 150, with the last domestic oil refinery being built, as we know, back in 1976.

Various efforts have been announced by the current and previous Administrations, and bills have been introduced in Congress to address this ongoing problem, including exploring new sites in both ANWR and the Outer Continental Shelf in order to replenish domestic oil reserves. Yesterday, the president ordered stricter rules for automobile fuel efficiency and the use of alternative fuels.

There is no doubt that we need to focus on both short-and long-term strategies to address these issues. We need increased domestic production and refinery capabilities, and we need to put a stronger emphasis on alternative energy and conservation efforts.

The hearing today is important, although, obviously, it got very divided up, and we want to, I think, apologize to the witnesses. There were a whole series of votes that took place on the floor that sort of broke this hearing up, but we are all making the best use of it that we obviously can.

And it gives us the opportunity to examine these seasonal, if not daily, price surges from another perspective, through the antitrust lens. And, in particular, we have had the opportunity this after-

noon to examine whether OPEC's cartel structure plays a substantial role in this roller coaster ride and examined whether the oil industry consolidation that has taken place in this country has resulted in limited oil supplies and higher fixed gas prices and examined the effectiveness of measures that have been introduced to respond to this situation, such as H.R. 2264, the Conyers-Chabot-Lofgren NOPEC bill, which we reintroduced last week and also introduced it in the last Congress.

And also H.R. 1252, the Federal Price Gouging Prevention Act and the Federal Energy Price Protection Act of 2007, which have been introduced by two of our witnesses that we had here, the distinguished gentleman, Mr. Stupak, from Michigan and the distinguished gentlewoman, Mrs. Wilson, from New Mexico.

And, again, I appreciate the Chairman holding this hearing. I apologize for running out of time here, and I know that another Committee is coming in that is going to kick us out, and that is a Committee that we are all on also, so thank you again, Mr. Chairman.

Again, we apologize to the witnesses for any difficulty you might have had testifying and responding. It has been one of those days up here.

Mr. CONYERS. Well said.

We will keep the record open for 5 days for questions and answers that may come from both of you.

Thank you for this initial hearing. There is much more inquiry that is required here. This is not a simple subject, but you have gotten us off to a great start.

Dr. John Felmy, Mr. Mark Cooper, we thank you so much.

The hearing is adjourned.

[Whereupon, at 3:58 p.m., the Task Force was adjourned.]

APPENDIX

Material Submitted for the Hearing Record

PREPARED STATEMENT OF THE HONORABLE SHEILA JACKSON LEE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS, AND MEMBER, TASK FORCE ON ANTITRUST

SHEILA JACKSON LEE
18TH DISTRICT, TEXAS

WASHINGTON OFFICE:
2435 Rayburn House Office Building
Washington, DC 20515
(202) 225-3816

DISTRICT OFFICE:
1919 Smith Street, Suite 1180
The George "Mickey" Leland Federal Building
Houston, TX 77002
(713) 655-0050

ACRES HOME OFFICE:
6719 West Montgomery, Suite 204
Houston, TX 77091
(713) 691-4882

HEIGHTS OFFICE:
420 West 19th Street
Houston, TX 77008
(713) 861-4070

FIFTH WARD OFFICE:
3300 Lyons Avenue, Suite 301
Houston, TX 77020

Congress of the United States
House of Representatives
Washington, DC 20515

COMMITTEES:
JUDICIARY
SUBCOMMITTEES:
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IMMIGRATION, CITIZENSHIP, REFUGEES, BORDER SECURITY, AND INTERNATIONAL LAW
CRIME, TERRORISM AND HOMELAND SECURITY
HOMELAND SECURITY
SUBCOMMITTEES:
CHAIR:
TRANSPORTATION SECURITY AND INFRASTRUCTURE PROTECTION
BORDER, MARITIME, AND GLOBAL COUNTERTERRORISM
FOREIGN AFFAIRS
SUBCOMMITTEES:
AFRICA AND GLOBAL HEALTH
MIDDLE EAST AND SOUTH ASIA
SENIOR WHIP
DEMOCRATIC CAUCUS
VICE:
CONGRESSIONAL BLACK CAUCUS
CO-CHAIR:
CONGRESSIONAL CHILDREN'S CAUCUS
CO-CHAIR:
PAKISTAN CAUCUS

CONGRESSWOMAN SHEILA JACKSON LEE, OF TEXAS

STATEMENT BEFORE THE

COMMITTEE ON THE JUDICIARY

ANTITRUST TASK FORCE HEARING

"PRICES AT THE PUMP: MARKET FAILURE AND THE OIL INDUSTRY"

MARCH 16, 2007

I thank the Chairman and Ranking Member for the opportunity to participate in this important hearing today. I look forward to hearing from the witnesses about this important issue of skyrocketing gas prices. I am also pleased to welcome our distinguished panel of

witnesses: The Honorable Bart Stupak, The Honorable Heather Wilson, The Honorable Richard Blumenthal, Dr. John Felmy, and Mr. Mark Cooper.

Mr. Chairman, the purpose of this hearing is to discuss the competition in the oil industry and its effect on gasoline prices. It is important for Members of Congress to investigate whether these skyrocketing gas prices are being unfairly manipulated. We must do so because we owe that to the citizens of this country who are losing a significant portion of their hard earned incomes to the gas pump.

In fact, retail prices of gasoline this summer are likely to be higher than ever, following record-setting summer prices in 2006. The prices in March and April have already reached record-setting levels for those months, and there seems little reason to believe that trend will stop.

The increases in gasoline prices generally track the increase in the cost of crude oil, however, over the same period of time when crude oil rose from approximately $24 per barrel in April of 2002, through $63.40 per barrel in April 2007, In contrast, over the same time that crude oil and gasoline prices rose by about 100%, the Consumer Price Index rose 13.8% – from 177.1 (December 2001) to 201.6 (December 2006). The Government Accountability Office (GAO) estimated last year that each additional ten

cents per gallon of gasoline adds $14 billion to America's annual gasoline bill.

A number of factors affect the price of gas, including the price of crude oil, refinery capacity and output, environmental factors, market trading, and others. Because this hearing is an Antitrust Task Force, it is important for us to focus our attention on competition for crude oil and in the refinery industry.

A. Crude Oil and the OPEC Nations

Currently, crude oil is the primary raw material from which gasoline is made, accounting for 52% of the cost of gasoline. Crude oil is also used for petroleum products other than gasoline, such as jet fuel, other fuels, lubricants and other chemicals that are distilled from the crude. Petroleum products are used as raw materials in manufacturing and industry, heating homes and businesses, and generating electric power. Forty-four percent of the United States's consumption of petroleum is for gasoline, and the U.S. uses about 45% of all gasoline in the world.

OPEC accounts for more than two-thirds of global oil production, and OPEC's oil exports represent about 65% of the oil traded internationally. About 40% of the U.S. crude oil imports are from the OPEC countries. We need to try to find alternative resources or it is inevitable that these figures will continue to escalate.

In each of the years from 2002 to the present, the United States imported approximately two billion barrels per year from OPEC. Thus, every dollar increase in a barrel of crude oil means $2 billion in revenues to OPEC. As noted, a substantial portion of the increased price of crude oil is passed on to and paid by consumers in the form of increased gasoline prices, and these increased gasoline prices enrich the producers of crude oil around the world, including, for example, the governments of Saudi Arabia, Nigeria, and Venezuela.

The "No Oil Producing and Exporting Cartels Act of 2007" ("NOPEC") addresses this issue. NOPEC authorizes the Department of Justice to bring action in federal court against nations or other entities that participate in conspiracies to limit the supply, or fix the price, of oil. In addition, NOPEC expressly specifies that the doctrines of sovereign immunity and act of state do not exempt nations that participate in oil cartels from basic antitrust law. Identical legislation has passed the Senate Judiciary Committee this Congress.

B. The Oil Refineries, Market Power and Consolidation

The oil refineries comprise the second part of the equation when it comes to gas prices. Two issues that warrant attention are refinery capacity and market concentration and consolidation.

It should be clear to everyone in the industry that we have a shortage of refinery capacity in the United States. There had been no move by the oil companies to expand capacity even though the existing refineries are operating at 95% of their capacity because of this shortage. In fact, no new refineries have been built in the United States since 1976, despite the fact that demand for gasoline has increased. While there were 301 refineries in 1982, there are only 149 in 2007. And as the number of refineries has decreased, the capacity of the existing refineries has not expanded at a rate to meet the increased demand. I am looking forward to discussing these issues with the witnesses and hope that they can provide some viable solutions to curtail the soaring gas because our citizens deserve that we put our best efforts forward to supply them with some measure of relief from such high gas prices.

Thank you, Mr. Chairman, for convening this hearing. Again, welcome to the witnesses.

I yield back the remainder of my time.

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