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PRICE GOUGING

HEARING

BEFORE THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

MAY 23, 2006

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ONE HUNDRED NINTH CONGRESS

SECOND SESSION

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PRICE GOUGING

TUESDAY, MAY 23, 2006

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The Committee met, pursuant to notice, at 10 a.m. in room SD–562, Dirksen Senate Office Building, Hon. Daniel K. Inouye, presiding.

OPENING STATEMENT OF HON. DANIEL K. INOUYE, U.S. SENATOR FROM HAWAII

Senator INOUYE [presiding]. Pursuant to the direction of the Chairman of the Committee, I call the meeting to order. The Federal Trade Commission's expedient work on this price gouging report is most gratefully received by this Committee. However, we find the findings do not explain what many consumers experienced in the aftermath of the hurricane. This report, for example, does not convince the Committee that consumers were treated fairly.

No doubt, gasoline prices were bound to rise after Katrina. However, consumers in Atlanta were asked to pay $6 dollars a gallon, more than twice the national average at that time, and anecdotal evidence suggests that they were not alone. And nothing in this report helps us to understand how such pricing could be considered lawful and legitimate.

The FTC initially refused to investigate price gouging. In fact, at our last hearing, Chairman Majoras suggested that, contrary to consumers' experiences, pressure and a compromise in the Congress forced the FTC to produce this report. It was noted at that time that the 180-day timeline was too short to fully understand what happened. The oil and gasoline markets are very complex, and frankly, the FTC chose to base a lot of its work for this report on previous work and evidence collected from other investigations in order to meet the deadline. Ironically, the FTC found an important piece of evidence, steep increases in profit margin, directly related to Katrina, yet it declined to examine this in the report.

Both the abbreviated timeline and the FTC's unmistakable reluctance to investigate leave the Committee questioning the report's findings. From what I've read and observed thus far, I am not convinced that the FTC was able to thoroughly analyze what happened in the Gulf Coast or its subsequent impact to the East Coast markets. If the FTC needed more time to understand the post-Katrina price variations, it should have requested an extension.

I am inclined to support legislation that provides the FTC with clear and effective authority to prosecute incidences of price

gouging, despite FTC Chairman Majoras' opposition. This authority would allow the FTC to continue to investigate incidents, such as the post-Katrina fluctuations, without waiting for the Congress to compromise on reporting requirements.

We have heard testimony from several attorneys general that have utilized this kind of authority to the benefit of consumers, and I believe it makes little sense not to grant the Federal Government's consumer watchdog similar power.

With that, I would like to call the first witness. And the first witness is the Honorable Deborah Platt Majoras, Chairman of the Federal Trade Commission.

STATEMENT OF HON. DEBORAH PLATT MAJORAS, CHAIRMAN, FEDERAL TRADE COMMISSION

Ms. MAJORAS. Thank you, Mr. Co-Chairman, Members of the Committee. I'm Deborah Platt Majoras, Chairman of the Federal Trade Commission. I appreciate having the opportunity to present the Commission's testimony on the findings of our investigation which we conducted pursuant to Section 1809 of the Energy Policy Act of 2005 and Section 632 of the Commission's Appropriations Legislation for Fiscal Year 2006. The Commission conducted a single investigation in response to these two directives and yesterday, we issued our final report.

While I will briefly explain the Commission's findings, my brief remarks cannot do justice to this lengthy and thorough investigation. I urge all interested parties to read the complete report which is on our website, ftc.gov.

The written testimony represents the views of the Commission entity. And I would like to recognize my fellow Commissioners who are here with me today, Commissioner Pamela Jones Harbour, Commissioner Jon Leibowitz, Commissioner William Kovacic, and Commissioner Thomas Rosch. All of whom are sitting with me today.

My oral presentation and responses to questions are my own and do not necessarily represent the views of any individual Commissioner. The FTC conducted this investigation against a backdrop of increasing gasoline prices over the past few years which reached new highs late last summer when two significant hurricanes, less than 1 month apart, ravaged our Gulf Coast. Even as prices have increased, demand has remained high as ours is a society on the go and Americans depend heavily on their cars for mobility.

Even before Hurricanes Katrina and Rita hit in succession, consumers and Members of Congress were raising questions about why the price of gasoline had been increasing. And then following Hurricane Katrina, the price rose quickly by about 45 cents on average, causing financial hardships for many consumers. By the end of November, prices had fallen to pre-hurricane levels, only then to increase significantly again this spring.

Americans are concerned, and they depend on us to provide answers. This report provides them as well as Members of Congress and other policymakers with useful information that can be used to make decisions about energy usage and energy policy.

Since August 2005, the Commission has expended substantial resources on this investigation, including the full-time commitment of

a significant number of attorneys, economists, financial analysts, paralegals, research analysts, and other support personnel with specialized expertise in the petroleum industry. We issued hundreds of CIDs, subpoenas, and 6(b) orders in an effort to obtain documents and testimony from firms at all levels of the oil industry.

The first part of the report presents the Commission's findings and analysis on whether refiners or firms at other levels of the industry manipulated or tried to manipulate gasoline prices. Staff investigated whether refiners manipulated prices in the short run by running the refineries at less than full capacity, by altering their product output to produce less gasoline, or by diverting gasoline from markets in the United States to less lucrative foreign markets.

The staff also investigated allegations that companies refused to invest sufficiently in new refineries for the purpose of tightening the supply and raising prices in the long run. Staff investigations revealed no evidence to suggest that refiners manipulated prices through any of these means. Instead, the evidence indicated that refiners responded to higher gasoline prices by producing as much of this now, higher valued product as possible, taking into account crude oil costs and other physical characteristics.

Moreover, the pace of capacity growth resulted from market forces. While it is true that no new refineries have been built in this country since 1976, refining capacity, nonetheless, has increased as refiners have made significant expansions to existing refineries that since 1996, would equal 15 average sized new refineries.

The Commission also examined the extent to which infrastructure constraints give pipelines the ability or incentive to manipulate gasoline prices, and we found no evidence of that. Similarly, we found no anti-competitive activity in terminal markets. Although inventory levels have declined since at least the early 1980s, our investigation did not produce evidence that oil companies reduced inventory in order to manipulate prices or exacerbate the effects of price spikes. Instead, like so many other major industries that have been changing over time, these lower inventory holdings allowed oil companies to become more efficient and lower their cost.

The second part of the report focuses on the effects of Hurricanes Katrina and Rita on our gasoline markets. Hurricanes Katrina and Rita caused substantial damage to the Nation's petroleum infrastructure. In the week after Katrina, which caused the immediate loss of 27 percent of our Nation's refining capacity—I'm sorry, of our Nation's crude oil production, and 13 percent of national refining capacity, the average price across six representative cities increased by 50 cents.

About 35 cents per gallon of that post-Katrina price increase had dissipated by the time Hurricane Rita hit. Rita then damaged another 8 percent of crude oil production and even accounting for the refineries affected by Katrina that were by that point back on line, 14 percent of domestic refining capacity was lost as a result of Rita.

We looked at what happened and compared it to the sizes of the post-hurricane price increases that we might have predicted there

to be in a competitive market, and they were approximately what we would expect to find. For example, the regions of the country that experienced the largest price increases were those that normally receive supply from the areas that were affected by the hurricanes. Further, the conduct of firms in response to the supply shocks caused by the hurricanes was consistent with competition.

After both hurricanes, companies with unaffected assets increased their output and diverted supplies to these high priced areas that needed the supply. Refiners deferred scheduled maintenance in order to keep the refineries operating. Imports increased and companies drew down their existing inventories to help meet the shortfall. And this is what we would expect to see in a competitive market.

The assessment of potential price gouging, as defined in Section 632, revealed that the average gasoline price charged by eight of 30 refiners analyzed increased five or more cents more per gallon than the national average. And using the Section 632 definition, we concluded that those eight met the definition of price gouging. But, they wouldn't necessarily have met the other definitions that Members of Congress have put forth, so we went further and looked to see whether any other market conditions could explain the increases and found, that, in fact, regional or local market conditions did appear to explain the conditions in almost every instance.

Then, we looked at retail pricing data and performed the same analysis, concluding that six individual retailers engaged in price gouging, as defined by Section 632. There again, however, local or regional market trends seemed to explain the price increases in all but one case. In sum, we did not find that any of this activity violated the federal antitrust laws, and that the market was working according to the laws of supply and demand.

The conclusion of our investigation does not end our examination of the petroleum industry. We will, of course, continue to enforce the antitrust laws to prohibit business behavior and mergers that may have anti-competitive effects. And in addition, on April 25th, the President directed us to work with the Department of Justice and the Department of Energy to conduct a new inquiry into current gasoline prices and the reasons for the increases.

We will do that and we are looking to see what other issues we might explore, including recent increases in profitability. We understand that consumers have been frustrated as they work to factor significant price increases into their budgets. It is important that we have an understanding of these markets.

A fresh examination of the cost and benefits of all regulation at the Federal, state, and local levels that impacts supply and demand is probably warranted and we stand ready to participate on a going forward basis in any constructive debate among policymakers and to add our expertise where appropriate.

Thank you very much, Mr. Co-Chairman.

[The prepared statement of Ms. Majoras follows:]

PREPARED STATEMENT OF HON. DEBORAH PLATT MAJORAS, CHAIRMAN, FEDERAL TRADE COMMISSION

Introduction

Chairman Stevens, Co-Chairman Inouye, and Members of the Committee, I am Deborah Platt Majoras, the Chairman of the Federal Trade Commission. I am pleased to appear before you to present the Commission's testimony on the findings of our investigation pursuant to two separate directives from Congress.[1] Section 1809 of the Energy Policy Act of 2005 requires the Federal Trade Commission ("Commission" or "FTC") to "conduct an investigation to determine if the price of gasoline is being artificially manipulated by reducing refinery capacity or by any other form of market manipulation or price gouging practices."[2] In addition, Section 632 of the Commission's appropriations legislation for Fiscal Year 2006 directs the Commission to conduct an investigation into nationwide gasoline prices and possible price gouging in the aftermath of Hurricane Katrina.[3] Because the issues raised by these two statutory commands are closely related, the Commission conducted a single investigation in response to these directives. Our investigation is now complete, and yesterday we issued our final Report.

In my testimony today, I will describe the major issues addressed in our Report and present the Commission's evidentiary findings. I will conclude by discussing the policy implications of the Commission's findings, and by offering some recommendations for Congress's consideration in its ongoing efforts to protect consumers in petroleum markets.

Since August 2005, the Commission has expended substantial resources on this investigation, including the full-time commitment of a significant number of attorneys, economists, financial analysts, paralegals, research analysts, and other personnel with specialized expertise in the petroleum industry. Even with this commitment of resources, it was not possible to study every pricing and output decision in this very complex industry. Thus, based on our knowledge and expertise from previous investigations and studies—and the concerns raised by knowledgeable observers and market participants about competition in this industry—the Commission and its staff focused substantially on levels of the industry and parts of the country where problematic behavior was most likely to have occurred and to have had an effect on consumers.[4]

"Price manipulation" and "price gouging" are not defined legal or economic terms and therefore must be defined for purposes of the Report. Neither antitrust law nor economics defines "price manipulation" precisely,[5] and Section 1809 does not provide a definition for the Commission to apply. As used in the Report, the term "price manipulation" includes (1) all transactions and practices that are prohibited by the antitrust laws, including the Federal Trade Commission Act, and (2) all other transactions and practices, irrespective of their legality under the antitrust laws, that tend to increase prices relative to costs and to reduce output.[6] Transactions and practices that violate the antitrust laws include anticompetitive mergers, acquisitions, and joint ventures, collusion among competitors to fix prices or output, and monopolization or attempts to monopolize.

Although widely understood to refer to significant price increases (typically during periods of unusual market conditions), the term "price gouging" similarly lacks an accepted definition. It is not a well-defined term of art in economics, nor does any Federal statute identify price gouging as a legal violation. States that prohibit price gouging have not adopted a common definition or standard to describe the practice. For example, the statutes do not describe the extent to which cost or other considerations (such as whether a declared emergency is pending) play a role in determining whether a price increase is "price gouging." In Section 632, Congress directed the Commission to treat as evidence of price gouging any finding that "the average price of gasoline available for sale to the public in September 2005, or thereafter . . . exceeded the average price of such gasoline in that area for the month of August 2005, unless the Commission finds substantial evidence that the increase is substantially attributable to additional costs in connection with the production, transportation, delivery, and sale of gasoline in that area or to national or international market trends." Accordingly, we analyzed whether specific post-Katrina price increases were attributable either to increased costs or to national or international trends.

I. The Expertise of the Commission on Petroleum Industry Matters

The Commission's Bureau of Competition and Bureau of Economics have significant petroleum industry experience, both from enforcing the antitrust laws and from conducting research and industry analyses. The Commission has investigated every major merger in the petroleum industry over the past 25 years. The Commission

also has conducted major investigations of petroleum marketing and pricing practices on the West Coast and in the Midwest. During each investigation, the Commission obtained documents, economic data, and testimony from merging parties and other industry participants and used this evidence to determine whether to take law enforcement action to prevent potential anticompetitive effects.

Since 1981, the Commission has identified 20 large petroleum mergers that it believed would have reduced competition and harmed consumers.[7] The agency obtained relief that resolved the competitive issues in 16 of these transactions, and the parties abandoned the other four after the Commission formally challenged the transactions. The Commission conducted a careful evaluation of each transaction to ensure that the agency obtained adequate remedies where necessary.

In addition to merger enforcement, the Commission's economists have researched pricing and other competition issues in the petroleum industry.[8] Since 2002, the Commission's economists also have monitored wholesale and retail prices of gasoline to identify potential anticompetitive activities that might require greater investigation. Today, this project tracks retail prices of gasoline and diesel in some 360 cities and wholesale (terminal rack) prices in 20 major urban areas. Over the past several decades, the Commission has gained an understanding of the domestic petroleum industry, how participants in the industry compete, and how prices of gasoline and other refined petroleum products are set.

II. The History of the Investigation

In August and September of 2005, the Commission, through its staff, began planning and organizing the investigation mandated by Section 1809 of the Energy Policy Act and the anticipated legislation that became Section 632. The planning process focused in part on how to seek the best and most complete information in the time permitted. Staff identified issues requiring analysis, information necessary to analyze those issues, and strategies to obtain that information. Staff then identified the targets of the investigation, including all gasoline and petroleum distillate wholesalers with $500 million or more in annual sales, as well as appropriate retailers. Staff began conducting voluntary interviews with a number of firms and also consulted with various Federal agencies, including the Department of Energy, the Department of Commerce, the Commodity Futures Trading Commission, the Department of the Treasury, and the Internal Revenue Service.

The Commission's staff conducted more than 65 voluntary interviews with industry participants and state and Federal agencies. Staff interviewed petroleum refiners, wholesalers, retailers, terminal companies, pipeline owners and operators, traders, price reporting services, and representatives from various state agencies, including the National Association of Attorneys General and individual representatives from state attorney general offices and state consumer protection agencies.

In early November 2005, the Commission issued the first of 139 Civil Investigative Demands (CIDs)—similar to subpoenas—to a wide spectrum of petroleum industry firms in order to obtain information relevant to the investigation. CID recipients included integrated and unintegrated refiners, pipeline owners and operators, terminal owners, and petroleum marketers.[9] One set of CIDs sought information directly relevant to Section 632. Another set of CIDs directed individual terminal owners to provide information relevant to aspects of petroleum futures markets. The Commission also issued 99 orders pursuant to Section 6(b) of the Federal Trade Commission Act,[10] seeking profitability and tax expenditure information required by Section 632 from retailers that were investigated by state attorneys general for post-Katrina price gouging,[11] as well as follow-up CIDs seeking from refiners certain additional data necessary to conclude our profitability analysis under Section 632. In February 2006, staff conducted sworn investigational hearings (similar to depositions) of industry officials regarding various issues in the investigation. The Commission also purchased a large volume of wholesale and retail pricing data from the Oil Price Information Service (OPIS), a private data-collection company, to complement information secured directly from market participants and from firm-level EIA data.

III. Summary of Key Findings and Recommendations

A. Part I of the Report

1. Refining

Evidence indicated that the price of crude oil, the largest cost component of gasoline, contributed to most of the gasoline price increases that occurred from early 2002 until just before Hurricane Katrina struck the United States. Higher refining margins caused some of the remaining increase, although margins in any competi-

tive market can be expected to increase, at least in the short run, during periods of strong demand. [12]

The Commission analyzed various aspects of refinery operations to determine whether refiners manipulated, or tried to manipulate, gasoline prices. Staff investigated whether refiners manipulate prices in the short run by running their refineries below full productive capacity in order to restrict supply, by altering their product output to produce less gasoline, or by diverting gasoline from markets in the United States to less lucrative foreign markets. Staff also investigated allegations that companies refused to invest sufficiently in new refineries for the purpose of tightening supply and raising prices in the long run. Staff's investigation revealed no evidence to suggest that refiners manipulated prices through any of these means.

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 documents 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.

The evidence also showed that companies operated their refineries—and determined the product quantities they would produce—with the goal of maximizing their profits, taking market prices as a given factor. 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 behaved competitively. Firms employ computer models that rely on simplified assumptions in order to make decisions about production and capacity. These models allow refineries to determine the most profitable slate of products, given refinery input costs and market-based price forecasts. To the extent that these models take price as a given, refiners' use of such models does not signify an ability to influence prices through short-run production decisions. Refiners may occasionally modify or override the computer models to take into account market factors, such as limited product demand for some fuel specifications, but such departures appeared limited during our investigation.

Our investigation revealed no evidence that companies export product from the United States in order to raise domestic prices. Export levels are relatively low, compared to the level of imports entering the United States. Pre-existing supply commitments and product that is unacceptable for use in the United States constitute the bulk of exported refined products. Further, our investigation indicated that an attempt to manipulate gasoline prices by exporting products from the United States likely would result in more imports into the domestic market, as indicated by the increased imports that arrived in response to the hurricanes.

Refining capacity has increased over the past 20 years, even as the number of refineries has declined. The industry added capacity by expanding existing refineries, which appears to be more economical than building new refineries. Domestic refinery expansions have been significant, but they have not kept pace with rising demand over the same period. Nevertheless, our investigation did not uncover evidence suggesting that expansion decisions resulted from attempts by refineries, acting either unilaterally or in concert, to acquire or exercise market power. Rather, the evidence suggested that the rate of capacity growth was a response to competitive market forces that made further investment in refining capacity unprofitable.

2. Bulk Distribution Infrastructure

The bulk supply distribution infrastructure, consisting of pipelines, marine vessels and terminals, adds very little to the delivered cost of gasoline. The Commission examined the extent to which infrastructure constraints gave firms the ability or incentive to manipulate gasoline prices, or limited the ability of marketers to move additional supply to specific markets when an unexpected need arose.

Pipelines generally are the most cost-effective way to transport refined petroleum products. In the short run, pipelines can affect the flow of supply into markets through the rates they charge for transporting product. In the long run, decisions whether to expand play an important role in the ability of pipelines to respond to increasing demand. The evidence we obtained during our investigation did not suggest that pipeline companies made rate or expansion decisions to manipulate gasoline prices. First, FERC generally regulates the rates that interstate pipelines charge, and pipeline companies generally charge the FERC maximum rate unless competition from other pipelines compels them to offer discounted rates to win busi-

ness. Second, pipeline companies appear to make expansion decisions for reasons unrelated to gasoline prices, except to the extent that rising gasoline prices may signal a need for more pipeline capacity to serve a given market. Pipeline companies generally expand only when they are assured of having a sufficient volume of product committed to the new pipeline, because expansion involves significant sunk costs, regulatory barriers, and the risk of idle pipeline capacity.

Gasoline also moves to markets within the United States on marine vessels—tankers and barges—along the Nation's waterways and coasts. Two Federal laws, the Jones Act and the Oil Pollution Act, apply to marine vessels and have had the effect of reducing the supply of ships qualified to move gasoline within the United States. The evidence indicated that refiners have reacted to this by increasingly entering into long-term charter arrangements with shipping companies to ensure a supply of vessels to transport their product during normal market conditions. This, however, has reduced the number of ships available on the spot market to traders seeking to move fuel in response to supply shortages.

Terminals are essential to the bulk supply infrastructure because they provide storage for marine vessel and pipeline deliveries. Many refiners that also sell gasoline ("refiner/marketers") own terminals in various markets, and use those terminals primarily—if not exclusively—to store product for their own needs. Public terminals (*i.e.,* terminals owned by companies that do not refine or market gasoline) exist in many markets and provide access to any bulk seller willing to pay to use the terminal. The presence of public terminals minimizes the ability of refiner/marketers to use their terminals to restrict supply into specific markets. In recent years, refiner/marketers have sold terminals to public terminal companies, reducing even further any ability to manipulate prices by restricting terminal access. As a result, competition appears sufficient in most areas to limit the potential for price manipulation.

3. Product Inventory Practices

Inventory levels have declined since at least the early 1980s, covering periods when the real price of gasoline was declining and increasing. In more concrete terms, inventory levels have declined since 1993 from a level sufficient to meet consumption for a full month to a level sufficient to meet consumption for less than 80 percent of a month. Our investigation did not produce evidence, however, that oil companies reduced inventory in order to manipulate prices or exacerbate the effects of price spikes due to supply disruptions. Instead, the decline in inventory levels reflects a trend that is not limited to the petroleum industry. As in many other major industries, lower inventory holdings allowed oil companies to become more efficient and to lower costs. The evidence indicated that oil companies attempt to use historical experience to determine what inventory levels would be sufficient to meet unanticipated changes in demand or supply. Inventories were a significant factor in enabling the markets to recover from the shocks stemming from Hurricanes Katrina and Rita, as discussed more fully below.

4. Other Issues Involving Potential Gasoline Price Manipulation

The evidence did not reveal a situation that might allow one firm (or a small collusive group) to manipulate gasoline futures prices by using storage assets to restrict gasoline movements into New York Harbor, the key delivery point for gasoline futures contracts. In addition, the evidence did not support a theory that firms used published bulk spot prices to manipulate prices, either (a) by falsely reporting trades to the major price publishing services, or (b) by affecting published prices in thinly traded markets by reporting actual, legitimate, small-volume trades opportunistically priced above or below competitive levels. [13]

B. Part II of the Report

In the week after Hurricane Katrina—which caused the immediate loss of 27 percent of the Nation's crude oil production and 13 percent of national refining capacity—the average price of gasoline increased by about 50 cents per gallon in 6 representative cities analyzed in this part of the Report. About 35 cents per gallon of the post-Katrina price increase dissipated by the time Hurricane Rita hit. Rita damaged another 8 percent of crude production and, even accounting for the refineries affected by Katrina and back online, 14 percent of domestic refining capacity was lost. In the 6 selected cities, during the first week after it hit, Rita caused an increase of 25 cents per gallon in the average price of gasoline. Four weeks after Rita, these prices returned to pre-Katrina levels. By the beginning of December 2005, these prices had returned to the levels prevalent at the start of summer 2005, showing that most of the price effects of the hurricanes had dissipated by that time.

The price increases after the hurricanes varied substantially by region. For example, the average price in Baltimore increased by 65 cents per gallon after Katrina,

while the average price in Los Angeles increased by 20 cents per gallon. In addition, the range (or "dispersion") of both wholesale and retail prices within particular cities far exceeded typical levels immediately after the hurricanes. For example, the typical range of prices within a band encompassing the middle 50 percent of prices in a given urban area, on average, spans from 3 to 10 cents per gallon. After Katrina, prices in that middle 50 percent range rose by a factor of 2 to 3, or 12 to 18 cents per gallon. High dispersion is evidence that some firms increased prices more than most other firms—evidence that should be considered in a search for price gouging as defined in Section 632.

In light of the amount of crude oil production and refining capacity knocked out by Katrina and Rita, the sizes of the post-hurricane price increases were approximately what would be predicted by the standard supply-and-demand paradigm that presumes a market is performing competitively. The regions of the country that experienced the largest price increases were those that normally receive supply from areas affected by the hurricanes. In the cities with the largest price increases, the sizes of the increases were consistent with the standard supply-and-demand competitive paradigm. Moreover, in general, the wholesalers and retailers that raised prices the most within particular cities in the weeks following the hurricanes were not firms that experienced increases in market power (stemming, for example, from the closing of rivals). Rather, they were firms that experienced the largest reductions in their own supplies and the greatest increases in their own costs.

Evidence gathered during our investigation indicated that the conduct of firms in response to the supply shocks caused by the hurricanes was consistent with competition. After both hurricanes, companies with unaffected assets increased output and diverted supplies to high-priced areas. This is what we would expect in competitive markets. Refiners deferred scheduled maintenance in order to keep refineries operating. Imports increased and companies drew down existing inventories to help meet the shortfall in supply.

In its assessment of potential gasoline price gouging as defined in Section 632, the FTC examined price, cost, and profit margin data for large sellers of petroleum products—refiners and wholesalers—and for retailers that were targets of state price gouging enforcement actions in the aftermath of Katrina. Financial data for 30 refiners were analyzed. Although there were exceptions, refiners generally saw increased profit margins in September 2005 compared to August 2005. Between August and September 2005, the average gasoline price charged by 8 of the 30 refiners analyzed increased five or more cents per gallon more than the national average price trend for this period. Seven of these eight refiners also had increased profit margins during the same period, indicating that average cost increases did not substantially explain the firms' higher average prices. Accordingly, the findings that individual refiners' prices increased substantially more than the national average trend, accompanied by increased profit margins, meet Section 632's definition of price gouging.

Further investigation and analysis revealed evidence that may explain the price increases of these refiners and their profit uplifts. Refiners vary significantly in terms of where, and through which channels, they distribute product. Hurricane Katrina's impact on prices differed significantly across geographic regions, and refiners that sold relatively more of their gasoline in higher-priced regions had average price increases greater than the increase in the national average. In addition, refiners varied significantly in the extent to which they sold gasoline through their owned-and-operated retail outlets, through franchised dealers supplied on a delivered price basis, through branded jobbers supplied on a branded rack price basis, through unbranded jobbers supplied on an unbranded rack price basis, and through bulk sales to other refiners or other major resellers on a bulk spot price basis. Because of time lags and differing contractual relationships between sellers and buyers, the relative prices for sales through these various distribution channels changed significantly in response to changing market conditions, such as those associated with the major supply disruptions from last year's hurricanes. Once geographic locations of sales and channels of distribution were taken into account, individual refiners' price increases appeared comparable to local market trends, except in one case. In that case, which involved a very small refiner, further inquiry indicated that the refiner's acquisition costs for the gasoline it was obligated to supply increased significantly beyond the level suggested by the aggregated accounting data because of hurricane damage.

Staff also evaluated financial operating data for 23 large wholesalers that had no refinery operations (8 of which also had some retail operations). Staff found that the operating margins of these wholesalers generally did not increase, suggesting that higher costs primarily caused their price increases. A few non-refining wholesalers, however, did enjoy significantly higher operating margins, and their price increases

constitute price gouging under the Section 632 definition. Nevertheless, a further analysis of the evidence reveals that they derived these gains from either (1) retail operations in areas that experienced the largest post-Katrina price increases, or (2) activities such as futures market trading or distillate sales.

The Commission also examined margin and price data for 24 individual retailers that had been the targets of state price gouging actions. Although one might have expected these retailers generally to satisfy the criteria for price gouging set forth in Section 632, this proved not to be the case. As a group, these retailers did not have significantly increased operating margins in September 2005, nor were their average price increases much different from the change in the national average retail price from August to September 2005. Nevertheless, in September, six of these retailers (1) earned significantly higher monthly average gross margins, and (2) increased their average prices at least five cents per gallon more than the national average price increase in September compared to August 2005. Accounting for regional price differences associated with the hurricanes' impact, one retailer of the six significantly exceeded the benchmark average price increase.

Based on these findings and other analyses of retail pricing data and retailer interviews, the Commission concludes that some price gouging by individual retailers, as defined by Section 632 (which is premised on a comparison to national average prices), did occur to a limited extent. Local or regional market trends, however, seemed to explain the price increases in all but one case. Exceptionally high prices on the part of individual retailers generally were very short-lived. Interviews with retailers that charged exceptionally high prices indicated that at least some were responding to station-level supply shortages and to imprecise and changing perceptions of market conditions.

C. Part III of the Report—Policy & Recommendations

At the heart of the Congressional mandates is an inquiry into the prices for gasoline and all other refined petroleum products, which have risen substantially in the past 2 years. Higher gasoline prices cause substantial economic hardship for consumers. Sharing a profound interest in protecting consumers, both Congress and the Commission naturally are focused on this issue.

Section 632 of the Science, State, Justice, Commerce, and Related Agencies Appropriations Act of 2006 directs the Commission to investigate price gouging in the aftermath of Hurricane Katrina and, based on the agency findings, to recommend possible legislation that might be needed to protect consumers from price gouging. Section 1809 of the Energy Policy Act of 2005 also requires that the Commission submit any recommendations along with its investigational findings. The Commission investigated the higher prices that occurred after the hurricanes and has considered the experience of several states that sought to enforce their price gouging statutes during this emergency period. The states' enforcement experience provides some insight into the enforcement process under price gouging statutes.

The challenge in crafting a price gouging statute is to be able to distinguish gougers from those who are reacting in an economically rational manner to the temporary shortages resulting from the emergency. This is more than just a problem for legislators and prosecutors. Gasoline suppliers may react to this difficulty in distinguishing gougers by keeping their prices lower than they rationally would. Consumers, in turn, may have no incentive to curb their demand as they would in response to a higher price. Other suppliers may have no incentive to send new supplies to the affected area, as they would if the price increased. The possible result may be long gasoline lines and shortages. In short, any decision to enact Federal price gouging legislation should be made with full awareness of both sides of the possible tradeoff.

1. The Critical Role of Prices

Consumers might be better off in the short run if they did not have to pay higher prices for the same quantity of goods; in the long run, however, distortions caused by controls on prices would be harmful to consumers' economic well-being. Prices serve a crucial function in market-based economies. They are signals to producers and consumers that tell how to value one commodity against another, and where to put scarce resources in order to produce or purchase more or fewer goods. If these price signals are distorted by price controls, consumers ultimately might be worse off because producers may manufacture and distribute an inefficient amount of goods and services, and consumers may lack the information necessary to properly value one product against another. Moreover, even in periods of severe supply shock, such as a major reduction in production or distribution caused by a natural disaster like the 2005 hurricanes, higher prices signal consumers to conserve and producers to reconfigure operations to better prepare for the next supply shock.

Thus, if there is a "right" price for a commodity, it is not necessarily the low price; rather, it is the competitively determined market price. Relative to past prices, a competitive market price may sometimes be low, and it may sometimes be high; but it will send an accurate signal to producers to manufacture a sufficient amount of goods and services that consumers want to buy at that price, and an accurate signal to consumers to reallocate purchase decisions.

If prices are constrained at an artificial level for any reason, then the economy will work inefficiently and consumers will suffer. Economists have known for years that price controls are bad for consumers, and the deleterious effect extends far beyond strictly fixed prices.[14] The constraint need not be total or permanent to have adverse effects. "Soft" price caps that allow for some recovery of price increases, or a price gouging statute that temporarily constrains prices during periods of emergency, still may have the effect of misallocating resources by reducing the incentives to produce more and consume less.[15] Thus, any type of price cap, including a constraint on raising prices in any emergency, risks discouraging the kind of behavior necessary to alleviate the imbalance of supply and demand in the marketplace that led to the higher prices in the first place. A temporary price cap may have an especially adverse effect on incentives as producers withhold supply in order to wait out the capped period.

An artificially low price may cause producers to shift their fungible resources (of which capital is the most fungible) to other markets. Sooner or later, the result may be shortages, and the relatively scarce goods may be allocated by some method other than a market-clearing price. Experience with past markets in which prices have been held artificially low through price controls has included such results as consumers waiting in lines (and often burning scarce fuel while waiting), a politically designed allocation system, or an illegal "black market" in which the market price is charged.

2. The Important Role of the Antitrust Laws

The antitrust laws are designed to protect consumers by ensuring that they are offered competitive market prices. The antitrust laws seek to protect consumers against high prices that result from price fixing and from other market distortions that almost inevitably lead to higher prices. The Commission, along with the U.S. Department of Justice, is charged with protecting consumers by maintaining competitive markets, to make sure that the prices charged in markets are not artificially fixed or manipulated by private interests. The Commission's work in the petroleum industry over many years conforms to this mandate. The agency protects consumers by ensuring that markets remain competitive, and that the price charged in each market is free from collusion or the exercise of market power.

Congress determined long ago that the Nation's economy should largely be free from government regulation and that the national common market should be governed by the principles of competition.[16] In enacting the antitrust laws, however, Congress also recognized that markets can be distorted by concentrations of market power. The antitrust laws are not designed to prevent prices from increasing; rather, they are designed to prevent firms from using market power to raise prices artificially.

The antitrust laws cover three primary areas—collusion among competitors (including price fixing), anticompetitive mergers, and monopolistic and other exclusionary unilateral practices. The Commission has been active in each area in the petroleum industry.

3. Price Gouging—State and Federal Perspectives

There is no Federal statute that prohibits price gouging. Twenty-nine states and the District of Columbia, however, have laws that prohibit the excessive pricing of motor fuels and other commodities during periods of abnormal supply disruption (normally triggered by a declaration of emergency by the President, the Governor, or local officials).[17] These laws provide for civil penalties, criminal penalties, or both. Commission staff looked at the experience of the states in enforcing their price gouging statutes as information relevant to the enactment and enforcement of a possible Federal statute.[18]

4. Federal Price Gouging Legislation

Consumers understandably are upset when they face dramatic price increases within very short periods of time, especially during a disaster. In a period of shortage, however—particularly with a product, like gasoline, that can be sold in many markets around the world—higher prices create incentives for suppliers to send more product into the market, while also creating incentives for consumers to use less of the product. Higher gasoline prices in the United States after Hurricanes

Katrina and Rita resulted in the shipment of substantial additional supplies of gasoline to the United States from foreign locations. [19]

If pricing signals are not present or are distorted by legislative or regulatory command, markets may not function efficiently and consumers may be worse off. Accordingly, our competition-based economy generally allows a seller, acting independently in its own business interests, to set prices as it chooses, and relies on market forces—rather than government intervention—to determine the prices a seller can seek.

In addition, it can be very difficult to determine the extent to which price increases are greater than "necessary." Our examination of the Federal gasoline price gouging legislation that has been introduced and of state price gouging statutes and enforcement efforts indicates that the offense of price gouging is difficult to define. Moreover, throughout antitrust jurisprudence, one area into which the courts have refused to tread is the question of what constitutes a "reasonable price." Ultimately, the lack of consensus on which conduct should be prohibited could yield a Federal statute that would leave businesses with little guidance on how to comply and would run counter to consumers' best interest.

For all of these reasons, the Commission cannot say that Federal price gouging legislation would produce a net benefit for consumers. If Congress nevertheless proceeds with passing Federal price gouging legislation, several factors should be considered in order to enact a statute that will be most likely to attack gouging while having the smallest adverse impact on rational price incentives. First, any price gouging statute should define the offense clearly. A primary goal of a statute should be for businesses to know what is prohibited. An ambiguous standard would only confuse consumers and businesses and would make enforcement difficult and arbitrary.

A price gouging bill also should account for increased costs, including anticipated costs, that businesses face in the marketplace. Enterprises that do not recover their costs cannot long remain in business, and exiting businesses would only exacerbate the supply problem. Furthermore, cost increases should not be limited to historic costs, because such a limitation could make retailers unable to purchase new product at the higher wholesale prices.

The statute also should provide for consideration of local, national, and international market conditions that may be a factor in the tight supply situation. International conditions that increase the price of crude oil naturally will have a downstream effect on retail gasoline prices. Local businesses should not be penalized for factors beyond their control.

Finally, any price gouging statute should attempt to account for the market-clearing price. Holding prices too low for too long in the face of temporary supply problems risks distorting the price signal that ultimately will ameliorate the problem. If supply responses and the market-clearing price are not considered, wholesalers and retailers will run out of gasoline and consumers will be worse off.

IV. Conclusion

Under existing antitrust laws, the Commission has a strong role to play in this area. As noted above, enforcing the antitrust laws strictly to prohibit business behavior that has anticompetitive effects will have a major impact in keeping markets free so that prices are set by competitive forces, not by manipulation or "gouging." Beyond that, the Commission will remain vigilant about any distortions that may harm competition and consumers in petroleum markets. Moreover, the Commission will vigorously implement and enforce any additional legislation that is enacted.

On April 25, 2006, the President directed the Department of Justice to work with the Commission and the Department of Energy to conduct an inquiry into current gasoline prices and the reasons for their more recent increases. [20] The makeup of this investigating group presents the opportunity to examine a range of issues and conduct by market participants potentially affecting the underlying supply and demand factors that ultimately shape prices in the long run. In the context of this directive, the Commission also is considering whether to conduct further inquiry into other topics—for example, oil company profitability—and is working to identify any other aspects of the petroleum industry that may warrant further economic examination. The Commission also will continue to evaluate and upgrade its gasoline and diesel price monitoring project. This is an ongoing process to ensure that our detection efforts are as robust as possible. In addition, we will continue with consumer education projects to help consumers make informed decisions in the energy marketplace.

The legal and industry enforcement expertise of the Commission, bolstered by the Justice Department's long history of aggressive enforcement against criminal cartels, should enable this investigation to determine whether any petroleum compa-

nies have engaged in conduct that would violate the antitrust laws to the detriment of consumers. If any illegal activity is uncovered, it will be prosecuted by the appropriate agency.

The addition of the Department of Energy to the investigating group brings an added level of expertise in energy markets. The Department's long experience in data collection across all energy markets will provide the information necessary to study and make recommendations about macroeconomic trends in energy use, imports, alternative fuels, and other issues that go far beyond traditional law enforcement.

The Commission also is working with many state attorneys general to add to our understanding of their laws, to continue to refine our analysis of petroleum industry issues, and to improve our working relationships. We will conduct a seminar on petroleum matters with state attorneys general and their staffs in September 2006.

Past Commission law enforcement investigations in the petroleum industry have concluded that supply and demand forces are the ultimate drivers of prices to consumers. The Commission, however, will continue to monitor this industry closely and investigate any potential illegal activity.

Further, that does not, and should not, end the debate about appropriate government energy policy. Consumers understandably are frustrated to be told that no laws are being broken even as prices increase substantially. It is important that they gain a better understanding of the working of energy markets. Gasoline prices—and energy prices in general—depend on the actions of all consumers and producers, and those actions can be changed. They can be modified over time by policies designed to make supply more responsive to high prices or to shift demand toward alternative energy sources. There are numerous initiatives that would have the effect of holding down future increases in gasoline prices. These actions do not relate directly to antitrust enforcement, but any policy that increases the supply of products at competitive prices may increase consumer welfare, as long as the costs of that policy decision do not outweigh the benefits.

A fresh examination of the costs and benefits of all forms of regulation—Federal, state, and local—that impact the supply of gasoline may be warranted. Policies that influence demand also should be considered. A constructive debate among policymakers is what is needed, and the FTC stands ready to participate and add our expertise where appropriate.

ENDNOTES

[1] This written statement presents the views of the Federal Trade Commission. My oral presentation and responses to questions are my own and do not necessarily represent the views of the Commission or any other Commissioner.

[2] Energy Policy Act of 2005, Pub. L. No. 109–58 § 1809, 119 Stat. 594 (2005) (Energy Policy Act).

[3] Science, State, Justice, Commerce, and Related Agencies Appropriations Act, 2006, Pub. L. No. 109–108 § 632, 119 Stat. 2290 (2005) (Section 632).

[4] The Commission's investigation examined the subjects that Congress directed the Commission to study in the Energy Policy Act and Section 632, but the Report does not address certain other issues of public interest in the petroleum industry that are beyond the purview of the investigation. For example, the Report does not examine crude oil production and exploration, in which—as recent Commission reports have shown—U.S. refiners compete with refiners around the world to obtain crude oil (and currently rely on foreign crude oil for more than 65 percent of their needs). Even the largest private oil companies control only a very small fraction of world crude oil production, and significant price manipulation through control of crude oil by private oil companies therefore appears highly unlikely. The Organization of Petroleum Exporting Countries (OPEC), however, plays a significant role in the pricing of crude oil and, accordingly, in the pricing of gasoline. For a discussion of OPEC's effect on crude oil prices, see Federal Trade Comm'n, Gasoline Price Changes: the Dynamic of Supply, Demand and Competition 22–23 (2005) (Gasoline Price Changes Report).

[5] "Price manipulation" is a term that appears in areas of the law other than antitrust, however. For example, although the Commodity Exchange Act bans price manipulation in futures markets, see 7 U.S.C. § 13(a)(2), the statute does not define manipulation, and courts and others have struggled to define the term. *See, e.g., In re* Soy Bean Futures Litig., 892 F. Supp. 1025, 1043 (N.D. Ill. 1995) ("[T]here is a 'dearth of settled caselaw' on price manipulation; as a result the courts and the CFTC are still struggling to define the basic elements of the claim and to differentiate between fair means and foul in futures trading."). In addition, the Federal Energy Regulatory Commission (FERC) recently imposed a condition on all current and future market-based tariffs that prohibits "[a]ctions or transactions that are

without a legitimate business purpose and that are intended to or foreseeably could manipulate market prices, market conditions, or market rules for electric energy or electricity products." *See* Order Amending Market-Based Rate Tariffs and Authorizations, 105 FERC ¶ 61,218 (2003).

[6] Under this definition, "price manipulation" includes instances in which one or more firms temporarily may each have an increased incentive and ability to raise prices relative to costs and reduce output because markets have been disrupted by supply problems arising from natural disasters or by sudden and unanticipated changes in demand. In our view, this type of conduct should not be illegal because it entails each individual firm's independent decisions about how to allocate sales of its products among markets.

[7] Investigations in which the Commission determined that the merger presented a problem, and significant structural relief was obtained, include Valero L.P., Valero Energy Corp., et al., FTC Dkt. No. C–4141 (July 22, 2005) (divestiture of Kaneb terminal and pipeline assets in northern California, eastern Colorado, and greater Philadelphia area); Phillips Petroleum Co., FTC Dkt. No. C–4058 (Feb. 7, 2003) (divestiture of Conoco refinery in Denver, Phillips marketing assets in eastern Colorado, Phillips refinery in Salt Lake City, Phillips marketing assets in northern Utah, Phillips terminal in Spokane, Phillips propane business at Jefferson City and East St. Louis); Valero Energy Corp., FTC Dkt. No. C–4031 (Feb. 19, 2002) (divestiture of UDS refinery in Avon, California, and 70 retail outlets); Chevron Corp., FTC Dkt. No. C–4023 (Jan. 2, 2002) (divestiture of Texaco's interests in the Equilon and Motiva joint ventures, including Equilonms interests in the Explorer and Delta pipelines); Exxon Corp., FTC Dkt. No. C–3907 (Jan. 26, 2001) (divestiture of all Northeast and Mid-Atlantic marketing operations of the two parties and Exxon's Benicia, California, refinery); British Petroleum Co. p.l.c., 127 F.T.C. 515 (1999) (divestiture of terminals in nine markets, and divestiture of BP's or Amoco's retail outlets in eight geographic areas); and Shell Oil Co., 125 F.T.C. 769 (1998) (resulting in divestitures of Shell's refinery in Anacortes, Washington, pipeline interests in the Southeast, and retail outlets in San Diego County, California).

[8] Representative research includes Jeremy I. Bulow, *et al., U.S. Midwest Gasoline Pricing and the Spring 2000 Price Spike,* 24 Energy J. 121 (2003); Christopher T. Taylor & Jeffrey H. Fischer, *A Review of West Coast Gasoline Pricing and the Impact of Regulations,* 10 Int'l J. Econ. Bus. 225 (2003); David W. Meyer & Jeffrey H. Fischer, the Economics of Price Zones and Territorial Restrictions in Gasoline Marketing (Bureau of Econ., Fed. Trade Comm'n, Working Paper 271, 2004); John Simpson & Christopher T. Taylor, Michigan Gasoline Pricing and the Marathon-Ashland and Ultramar Diamond Shamrock Transaction (Bureau of Econ., Fed. Trade Comm'n, Working Paper 278, 2005); Christopher T. Taylor & Daniel S. Hosken, the Economic Effects of the Marathon-Ashland Joint Venture: the Importance of Industry Supply Shocks and Vertical Market Structure (Bureau of Econ., Fed. Trade Comm'n, Working Paper 270, 2004) (forthcoming in Journal of Industrial Economics).

[9] The Commission based its request for profitability data on a form used by the Energy Information Administration (EIA) of the U.S. Department of Energy. The EIA uses this form to collect revenue, cost, and profit information from major energy-producing firms operating in the United States. Each company submitted its response to the FTC's data request. The companies also granted waivers that allowed the EIA to provide other company-specific information that that agency routinely collects from the industry, including data on production, capacity, shipments, and inventory.

[10] Section 6(b), 15 U.S.C. § 46(b), empowers the Commission to require the filing of annual or special reports or answers in writing to specific questions for the purpose of obtaining information about "the organization, business, conduct, practices, management, and relation to other corporations, partnerships, and individuals" of the entities to which the inquiry is addressed.

[11] Staff identified more than 105 retailers accused of price gouging by state law enforcement authorities. Due to the late timing of identification and previous data requests sent to retailers identified in state actions, the Commission issued the 99 orders pursuant to Section 6(b) of the Federal Trade Commission Act.

[12] One measure of "refining margin" is the price at which the refiner sells finished product minus the refiner's acquisition cost of crude oil.

[13] Any evidence of this form of manipulation more likely would exist in individual company trader files—a massive volume of documents that staff did not seek and could not have reviewed within the given time. Such a detailed investigation would be appropriate when a Federal agency becomes aware of specific allegations or suspicions that such conduct is occurring.

[14] *See* William J. Baumol & Alan S. Blinder, Economics: Principles and Policy 53 (2d ed. 1982) ("The consequences [of price controls] usually are quite unfortunate, exacting heavy costs from the general public and often aggravating the problem the legislation was intended to cure.")

[15] Office of Governor Linda Lingle, *Governor Approves Gas Cap Repeal,* May 5, 2006, available at *http://www.hawaii.gov/gov/news/releases/2006/News__Item.2006–05–05.5815*.

[16] Over the years, Congress has passed a number of industry-specific statutes imposing regulation, including price regulation. Prices have been fixed through regulation in airlines, trucking, and other industries originally deemed ill-suited for market-based price competition. Regulations also have been passed to meet goals other than competition, and although these regulations have price impacts, a policy decision has been made that control of prices can be tolerated in order to achieve other goals such as health care and safety. At certain times, Congress has even placed general price controls on all industries. The price of gasoline was strictly regulated during World War II, and the market was cleared through a system of ration coupons.

A general consensus has emerged, however, that in most markets competition is more effective than any form of price control in ensuring that consumers get the full benefits of innovation and productive and distributive efficiencies. Numerous formerly regulated industries have been substantially deregulated. Consumers are best protected when markets are kept free and open. These benefits to consumers depend, of course, on law enforcement agencies that can keep markets competitive and free from distortion and manipulation. This is the role of the Federal Trade Commission.

[17] See National Conf. of State Legislatures, *State Laws and Regulations: Price Gouging* (Oct. 8, 2004), available at *http://www.ncsl.org/programs/energy/lawsgouging.htm*.

[18] Several states and the Canadian Competition Bureau investigated post-hurricane high gasoline prices and potential price gouging and concluded, largely consistent with the Commission's Report, that market forces were for the most part responsible for the higher prices. See David R. Baker, *Anti-Gouging Laws Don't Cut Gas Prices: State Probed 50 Potential Cases; No Charges,* San Fran. Chronicle, May 6, 2006, at A1, available at *http://www.sfgate.com/cgi-bin/article.cgi?file=/c/a/2006/05/10/MNGQHIOUJP1.DTL* (California Attorney General investigates 50 of more than 1,150 complaints, finds no evidence of price gouging); Press Release, Attorney General Rob McKenna, *McKenna Encourages Conservation, Reports No Evidence of Price-Fixing So Far,* Apr. 26, 2006, available at *http://www.atg.wa.gov/releases/2006/rel__No__evidence__Of__Price__Fixing__042606.html;* Office of the Attorney General, State of Arizona, Consumer Protection Section, 2005 Gasoline Report Hurricane Katrina, Apr. 26, 2006 (Arizona "investigation did not uncover any illegal conduct"), available at *http://www.azag.gov/consumer/gasoline/PublicGasReport2005.pdf*; Canadian Competition Bureau, *Competition Bureau Concludes Gasoline Pricing Examinations,* Mar. 30, 2006 (finding "no evidence of a national conspiracy to fix gasoline prices"), at *http://www.competitionbureau.gc.ca/internet/index.cfm?itemid=2046&lg=e*.

[19] Total gasoline imports into the United States for September and the first 3 weeks of October 2005 were approximately 34 percent higher than imports over this period in 2004. See Energy Info. Admin., U.S. Dep't of Energy, *Petroleum Navigator: Weekly Imports & Exports* (shows receipts of crude oil and petroleum products into the 50 states and the District of Columbia from foreign countries, Puerto Rico, the Virgin Islands, and other U.S. possessions and territories), available at *http://tonto.eia.doe.gov/dnav/pet/pet__move__wkly__dc__NUSZ00__mbblpd__w.htm* (last updated May 3, 2006).

[20] A number of Members of Congress also have requested that the Commission investigate recent increases in gasoline prices. See, *e.g.,* letter of April 24, 2006, from Speaker of the House Dennis Hastert and Senate Majority Leader Bill Frist to President Bush; letter of April 28, 2006, from Senators Mike DeWine and Herb Kohl to FTC Chairman Majoras and Attorney General Gonzales.

Senator INOUYE. Thank you. Our next witness is Dr. Behravesh.

STATEMENT OF DR. NARIMAN BEHRAVESH, CHIEF ECONOMIST/EXECUTIVE VICE PRESIDENT, GLOBAL INSIGHT

Dr. BEHRAVESH. Thank you, Mr. Co-Chairman. I appreciate the opportunity to speak on this important issue. In my comments this

morning, I will endeavor to answer four questions. First, what is behind the recent rise in oil and gasoline prices? Second, how much of the rise in gasoline prices is due to gouging? Third, how much are high gasoline prices hurting consumers? This is very important, obviously. And then finally, what should Congress do?

On the first question as to what has happened, and why are oil and gasoline prices so high, the answer is really very mundane. Simply, demand has been growing faster than supply.

There's a long history here, but even for those attempting to look for evidence of market manipulation, the overwhelming evidence is that the recent rise has been due to market fundamentals. Part of this goes back to the 1990s when oil prices were very low. With low oil prices, there was very little incentive for consumers to conserve. There was very little incentive for oil producers, whether it be oil companies or oil exporting countries, to invest in exploration and drilling. And so basically, supply fell way behind demand. You can see that in the chart pack. If I could beg your indulgence and refer to it from time to time?

Chart 1 shows the reduction in OPEC spare capacity. We are running on very, very thin capacity margins right now. This, in large part, explains why oil prices are so high. Now, there are a variety of other factors as well that have been alluded to, namely on the refining side. Certainly, no new refineries have been built in 30 years. Any investment in refineries was discouraged by the low oil and gasoline prices in the 1990s, and also by a variety of environmental restrictions.

This is not just a story about oil, but it's a story about all commodities. If you look at Chart 2, you can see that oil prices have been rising in tandem with other commodities. We're in the midst of a commodities boom, although the markets have corrected a little bit recently. The reason for this is very strong global growth and a reluctance on the part of all commodity extracting companies and countries to make major investment for fear that the next commodity crash would burn them.

So, we've seen across the board in many commodities markets, a reluctance to make major investments in new mines or new facilities. So, we are in the midst of a very sharp and sudden rise in commodities prices. This has been going on for about three years now.

Now from our perspective, both supply and demand for oil and gasoline will respond in time. Unfortunately in the meantime, oil prices will remain high. The oil markets are going to remain very tight because of the capacity constraints I alluded to earlier. So, it will take some time for oil prices to come down.

Our forecast, for the next 2 to 3 years, is for oil prices to stay above $60 a barrel. Given that markets are so tight, they're extremely vulnerable to any kind of disruption, whether it be another hurricane or some geopolitical event in the Middle East. Markets are extremely vulnerable right now to any event which would cause a supply disruption.

On the gasoline side, some of the recent rise has been due to the so called "ethanol problem," where the mandated use of ethanol has created some bottle necks in the distribution system and that has created a bit of a spike in prices. Already, this is beginning to

ease. So, we could see gasoline prices staying around $3 dollars a gallon through the summer, but we expect them to come down to about $2.50 by the end of the year and probably stay there for a couple of years.

Question number two, how much of the rise in gasoline prices is due to price gouging? And here, I refer you to Charts 3 and 4, which look at the components that make up gasoline prices. There are four components: number one, oil prices. Number two, refiners margins. Those are the profit margins of refineries. Number three, taxes. And number four, dealer margins.

If you look at what happened in the Katrina period and recently, you do see two spikes in refiners margins. You don't really see much movement in the dealer margins.

What happened? In the post-Katrina situation there was a scare. Basically, with the refineries down, as was mentioned earlier by the Chairman of the FTC, we had a scare and a severe shortage. And that showed up basically, in a bidding up, in the marketplace, of gasoline prices. This is apparent in the higher margins. These then came down very dramatically as the refineries came back on stream, as the fear factor subsided, and as it became apparent that there would indeed be enough gasoline supplies, after about a month of these disruptions.

More recently, we've had another spike. Almost all of this is due to, again, the ethanol problem. This largely has to do with the fact that ethanol is produced in the middle of the country. It has to get to the coast, and the railway, and pipeline distribution systems just aren't yet set up to handle the flow, and this has created some crunches in the refineries.

So, you put all this together and ask, what's the bottom line here? The bottom line is there is very little evidence so far, of systematic—I underlined the word systematic—anti-competitive behavior by either refiners or dealers. Now that does not rule out individual cases of price gouging by some dealers. I'm not suggesting there's none of that. But, there's no evidence of systematic price gouging.

Third question, how much are gasoline prices hurting? Clearly, there is hurt, but let's put it into some perspective. If you look at gasoline prices in Chart 5, you can see that relative to other prices—relative to inflation, relative to the CPI—gasoline prices for two decades, actually fell behind inflation. Basically, they fell in inflation adjusted terms. Recently, they've risen for the reasons we talked about. So finally, after a three decade period, gasoline prices have caught up with inflation.

If you look at the bottom of Chart 6, you can see that even with the recent rises, inflation adjusted after tax income has far outpaced gasoline prices. Gasoline prices, after you adjust for inflation, they haven't really changed relative to the 1980 levels. Whereas inflation adjusted income, has doubled during that period. So basically, gasoline spending and energy spending by the typical U.S. household, has fallen during this period.

My last slide, on the last page, shows you both energy spending by households and gasoline spending by households as a percent of take home pay. And you see that after a long period, these shares have risen recently. But if you accept our forecast that oil prices

will stay high but come down a little bit, we actually expect these burdens to ease. So, there is some relief in sight for the typical household in the U.S.

Finally, what should Congress do? Here, I think I have some concerns. While it may be tempting to consider regulatory fixes, it's unclear how new regulation is going to fix the fundamental supply and demand problem that we have in oil and gasoline markets.

I certainly understand the concern about possible price gouging, but it's unclear to me how new regulation will help. In fact, there's always the risk that increasing regulations will discourage new supplies from coming on the market.

I think there are a number of things Congress can do. One is, to streamline the gasoline market. One obvious thing is to reduce the number of gasoline grades. The proliferation of gasoline grades has made the gasoline distribution system a nightmare. I think simplifying that will ease some of the production bottlenecks that we have out there.

Another thing Congress can do as a medium to long term fix, is through the tax code or in other ways, to encourage both the production and the purchase of fuel efficient cars. That will go a long way toward reducing our dependance on imported gasoline, and imported oil.

And finally, again, to acknowledge that high gasoline prices do hurt, especially low income people. Their share of gasoline expenditures is higher than average and they are being hurt disproportionately. So, there is scope for Congress to provide some relief for low income families.

Thank you very much, Mr. Co-Chairman.

[The prepared statement of Dr. Behravesh follows:]

PREPARED STATEMENT OF DR. NARIMAN BEHRAVESH, CHIEF ECONOMIST/ EXECUTIVE VICE PRESIDENT, GLOBAL INSIGHT

Mr. Chairman,

Thank you for inviting me to speak before the Senate Committee on Commerce, Science, and Transportation on the very important topic of the recent rise in gasoline prices. In a series of brief questions and answers below, I will endeavor to address some of the key issues behind recent trends in oil and gasoline prices, and their consequences for U.S. households and U.S. policymakers.

What Is Behind the Recent Rise in Oil and Gasoline Prices?

- The reason for the recent rise in oil and gasoline prices is quite mundane—demand has been rising faster than supply. While it may be tempting to look for market manipulation by energy suppliers, the evidence so far points overwhelmingly to market fundamentals as being the principal drivers of price.
- Low energy prices in the 1990s provided little incentive for energy consumers around the world to conserve, or for energy producers to invest in exploration and drilling (let alone alternative fuels and technologies). Thus we have seen a very troubling decline in OPEC spare capacity (see Chart 1). Moreover, low refining margins in the 1990s, combined with significant expenditures to comply with environmental regulations, held down investment in new refineries.
- The rise in energy prices is part of a broader global commodities boom (see Chart 2). Since 2003 global growth has been very strong, with the United States and China being the principal locomotives. In the meantime, most suppliers of commodities (including OPEC) have been reluctant to increase capacity, fearing that as soon as the new supplies hit the markets, prices would collapse. This has been the experience of the oil industry for much of the last 25 years.
- Both supply and demand will respond—in time—to high prices. However, this adjustment is likely to take a few years, and prices are likely to remain at ele-

vated levels. Global Insight predicts that oil prices will average above $60 a barrel through 2008.

- Some of the recent spike in gasoline prices can be attributed to distribution problems with ethanol, which Global Insight expects will be resolved in the near term. We expect gasoline prices to maintain a level near $3.00/gallon nationwide average for the summer driving season and then fall to around $2.50 per gallon and remain at roughly that level for much of 2007.

How Much of the Rise in Gasoline Prices Is Due to Price Gouging?

- Since 2002, oil prices have tripled and gasoline prices have more than doubled (see Charts 3 and 4). With two exceptions, almost all the rise in gasoline prices has been the result of the rise in oil prices.
- In the immediate aftermath of Hurricane Katrina, gasoline prices did spike. Almost all of this was due to the disruption of refining capacity in the Gulf of Mexico. This can be seen in Chart 4 as a rise in the refiners' margins, and was due to markets bidding up prices in a panic reaction to the refinery damage. The high prices were required to attract new supplies from overseas and to send a signal to consumers to reduce demand. The refiners' margin dropped sharply by late fall, as refineries were brought back on line, imports responded, and market fears subsided.
- The recent rise in refiners' margins is the result of new mandates on the use of ethanol in gasoline and the inadequacy of the current distribution system to keep up with the current demand. Global Insight expects that margins will fall again as the system adjusts through improved supplies and moderating demand. In fact, over the past couple of weeks, refiners' margins have already begun to come down as gasoline inventories have risen since late April.
- The movement of dealers' margins over the past couple of years shows no evidence of a systematic rise.
- Bottom line: there is very little evidence of systematic anti-competitive behavior either by refiners or dealers, despite anecdotes about price gouging right after Hurricane Katrina.

How Much Are High Gasoline Prices Hurting?

- Since 2002, gasoline prices have moved up sharply. However, between the early 1980s and the late 1990s, gasoline prices fell on an inflation-adjusted basis (see Chart 5). In fact, gas prices have only recently reached their 1980 levels, adjusted for inflation.
- More important, if you compare gasoline prices with after-tax household income, gasoline prices have continued to lag, even after the recent sharp rises (see Chart 6). Another way of looking at this is to measure the change in gasoline purchases as a percent of take-home pay. Here again, while this share has risen from its average of around 2.0 percent in the late 1980s and 1990s to around 3.5 percent now, it is still below the early-1980s share of 4.5 percent.
- However, it is important to acknowledge that for low-income families, the share of take-home pay used for gasoline is higher than average (possibly twice as high). This means that the recent rise in gas prices is more of a hardship for these families.

What Should Congress Do?

- While it may be tempting to consider regulatory fixes to address the current high oil and gasoline prices, additional regulations will do nothing to solve the fundamental supply-demand problems in energy markets. On the contrary, there is a risk that additional regulations could discourage more supplies of both crude and refined products from being brought to the market.
- Congress could act to reduce the number of grades of gasoline in the United States market. Over the last 10 years the number of grades has proliferated. This has resulted in reduced capacity to manufacture and distribute gasoline, raised the cost, and reduced industry flexibility.
- Congress can ease the medium- to long-term crunch in gasoline and energy markets by encouraging both the production and use of fuel-efficient vehicles.
- Finally, there is a need for some short-term relief for low-income families, who have borne a disproportionate burden of higher gasoline taxes.

Chart 1: OPEC Spare Capacity and Price

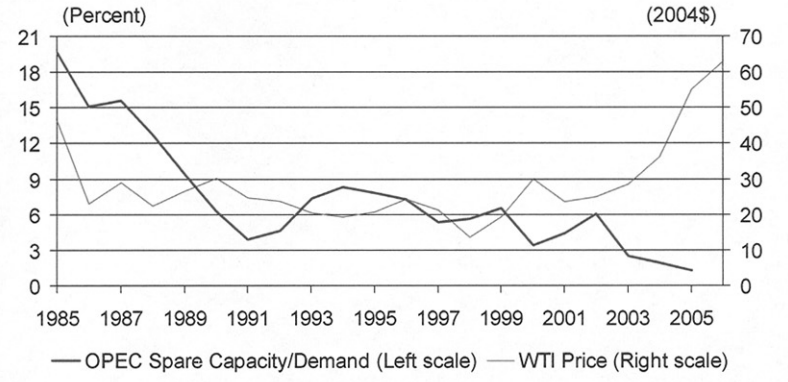

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Chart 2: With OPEC Surplus Gone, Oil Is Now Just Another Cyclical Commodity

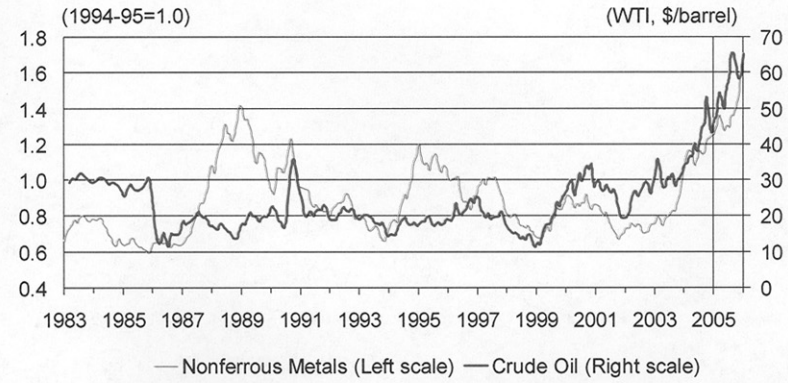

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Chart 3: Components of the Pump Price of Gasoline

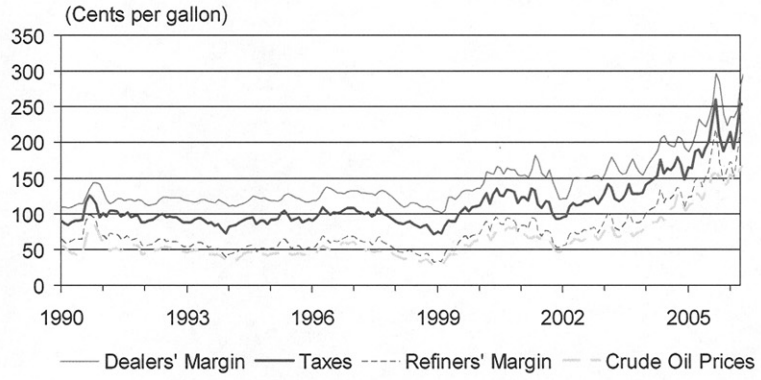

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Chart 4: Components of the Pump Price of Gasoline

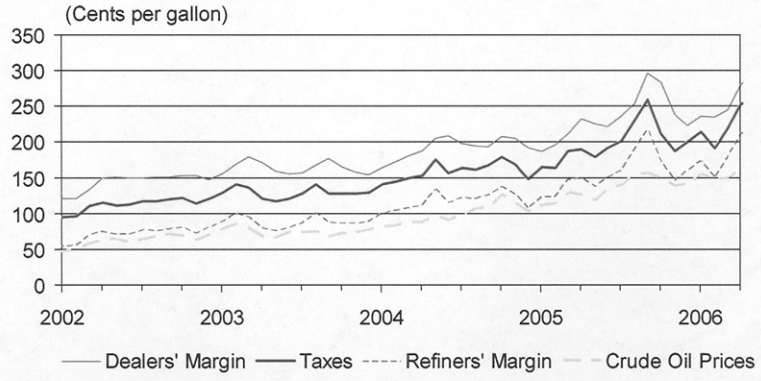

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Chart 5: Gasoline Prices Have Barely Kept Up With Inflation

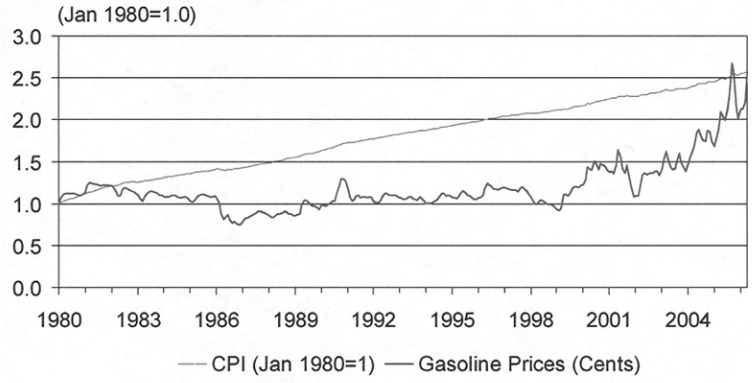

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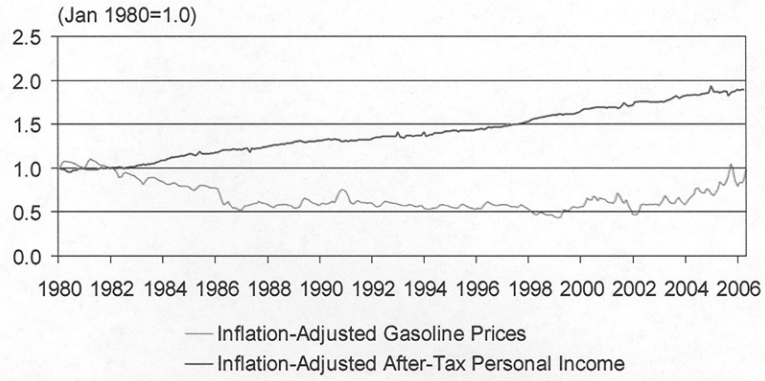
Chart 6: The Rise in Take-Home Pay Has Far Exceeded the Rise in Gasoline Prices



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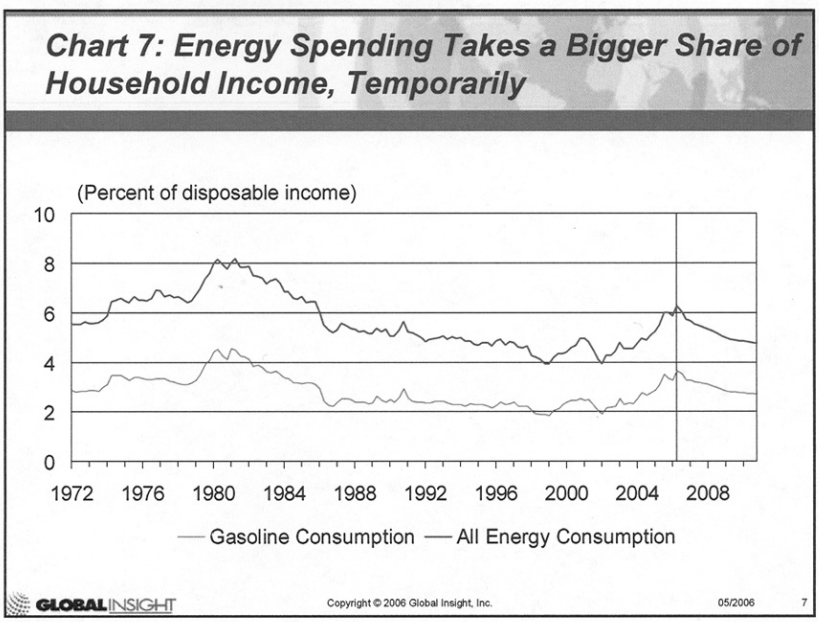


Senator INOUYE. Thank you very much, Dr. Behravesh. Our next witness is the President of the National Petrochemical & Refiners Association, Mr. Bob Slaughter.

STATEMENT OF BOB SLAUGHTER, PRESIDENT, NATIONAL PETROCHEMICAL & REFINERS ASSOCIATION (NPRA)

Mr. SLAUGHTER. Thank you, Mr. Co-Chairman and other members of the Panel. I want to thank you for the opportunity to present NPRA's view on the current gasoline market including the subject of price gouging.

Our formal statement is an exhaustive treatment of the refining industry's commitment to serving American consumers. It talks of such things as the fact that the industry has added the equivalent of one new refinery a year—in capacity additions at existing sites over the last 10 years and that the industry already has announced additions to U.S. refining capacity between 1.4 million barrels a day, an 8-percent increase, or even 2 million barrels a day over the next 4 years, which also demonstrates the continuing commitment of the industry.

Senator LOTT. What was the percent?

Mr. SLAUGHTER. It's 8 percent, Mr. Lott. That is a 1.4 million barrel increase. A 2 million barrel increase would be about 12 percent.

The gasoline market today reflects supply and demand. The arithmetic is not complicated. What is happening is what the textbooks say should happen. With domestic demand for refined products accelerating, outpacing the ability to meet U.S. needs with domestic supplies, together with ever-increasing global demand for

the same products, market volatility will continue, at least for the near future. The situation is unsatisfactory, but it can only be addressed by increased supply. In the meantime, policymakers must resist turning the clock backward to the failed policies of the past. Experience with market interference in the 1970s and 1980s such as price constraints, allocation controls, and punitive taxes demonstrate not only the failure of these programs, but also their adverse impact on both fuel supplies and consumers.

I want to make very clear to the panel today, that refiners reject and condemn improper pricing policies. Current gasoline prices have adversely affected some consumers and the industry understands their concerns. In an attempt to respond to consumer dissatisfaction, some policymakers have questioned the industry's pricing and investment policies. NPRA offers the following response: Price gouging is a term that by its very nature is imprecise and extremely subjective. It is extremely difficult, if not impossible, to define or reduce to statutory language. Author Thomas Sowell had this to say about defining price gouging: it means prices higher than what observers are used to. In other words, prices under normal conditions are supposed to prevail under abnormal conditions. This completely misunderstands the role of prices, Mr. Sowell says.

If Federal price gouging legislation is enacted, the term's inherent ambiguity will inevitably lead to interpretations that Congress intended to impose price controls. The result will be that consumers will relive the supply shortages, long lines at gas stations, and other added costs and inconveniences of the 1970s. NPRA hopes that Congress will continue to reflect on this history and change its mind about the wisdom of any policies that result in additional government intervention in the fuels market.

NPRA and its members understand public and congressional concern about high gasoline prices. But policymakers should be cautious about taking any action that suggests that price controls are the answer to today's gasoline market conditions. The Nation's 10 year experiment with government intervention into fuel markets during the 1970s led to many problems. Consumers were even prohibited from purchasing gasoline on certain days of the week. That history does not suggest that price controls are an acceptable template for Congressional or Administration action this year.

The most effective way to maintain adequate gasoline supplies at reasonable prices is continued reliance on market mechanisms, not price regulation or other actions that interfere with and distort market realities that both refiners and consumers must face.

Many factors drive the transportation fuels market. Among these are: geopolitical uncertainties which affect the price of crude oil, refiners' primary feedstock; increasing global demand for crude oil; the challenge of complying with significant specification changes for both reformulated gasoline and highway diesel; and the rising cost of other materials and inputs such as natural gas, construction materials, and labor.

The Nation's refiners operate in an environment in which all these factors, together with strong demand for gasoline and other products, cannot be ignored. As always, NPRA members must continue to concentrate on the very serious business of providing se-

cure supplies of refined products to consumers even under the current difficult and challenging market conditions.

The tight gasoline markets of the past several years have led to dozens of investigations of the industry at the state and Federal levels. In each case, the industry has been cleared of wrongdoing. Today, as then, allegations of refiner price-fixing, price-gouging, and other illegal pricing practices are patently false.

Just to talk about one report in particular, after a 9-month FTC investigation into the cause of price spikes in local markets in the Midwest during the spring and summer of 2000, FTC Chairman Robert Pitofsky, who is a recognized expert in antitrust law and a Clinton appointee stated, "There were many causes for the extraordinary price spikes in Midwest markets. Importantly, there is no evidence that the price increases were a result of conspiracy or any other antitrust violation. Indeed, most of the causes were beyond the immediate control of the oil companies." We've heard a very similar result from all of these studies that have been conducted.

To summarize, allegations of refiner price-fixing, gouging, or other illegal practices are patently false, as repeatedly shown by the FTC and other Federal and state investigations. NPRA regrets that the definitive results of these investigations are rarely announced with the same enthusiasm and media attention given to news of their initiation.

Thank you, again, for the invitation to appear today. We look forward to your questions.

[The prepared statement of Mr. Slaughter follows:]

PREPARED STATEMENT OF BOB SLAUGHTER, PRESIDENT,
NATIONAL PETROCHEMICAL & REFINERS ASSOCIATION (NPRA)

Chairman Stevens, Co-Chairman Inouye, and other members of the Senate Commerce, Science, and Transportation Committee, NPRA, the National Petrochemical & Refiners Association, appreciates this opportunity to present its views on the current gasoline market including the subject of "price gouging." My name is Bob Slaughter, and I serve as NPRA's President. As you know, NPRA is a national trade association with over 450 members, including those who own or operate virtually all U.S. refining capacity, as well as most of the Nation's petrochemical manufacturers, who use processes similar to those of refiners. Our testimony today will concentrate on factors directly impacting the current gasoline market and allegations of "price gouging" which, although almost totally unsubstantiated, have been the subject of continuing concerns expressed by policymakers and the public.

Introduction

The gasoline market today reflects supply and demand, and the arithmetic is not complicated. What is happening is what the textbooks say should happen. With domestic demand for refined products accelerating, outpacing the ability to meet U.S. needs with domestic supplies, together with ever-increasing global demand for the same products, market volatility will continue, at least for the near future. This situation is unsatisfactory, but it can only be addressed by increased supply. In the meantime, policymakers must resist turning the clock backward to the failed policies of the past. Experience with market interference in the 1970s and 1980s such as price constraints, allocation controls, and punitive taxes demonstrate not only the failure of these programs, but also their adverse impact on both fuel supplies and consumers.

To summarize our message, NPRA urges policymakers in Congress and the Administration to encourage domestic production of an abundant supply of petroleum, oil products, and natural gas for U.S. consumers. Rather than engaging in a fruitless search for questionable quick-fix solutions, or even worse, taking actions that could be harmful, we urge Congress, the Administration, and the public to exercise continued patience with the free market system as the Nation adjusts to a volatile energy market. The Nation's refiners are working hard to meet rising demand while

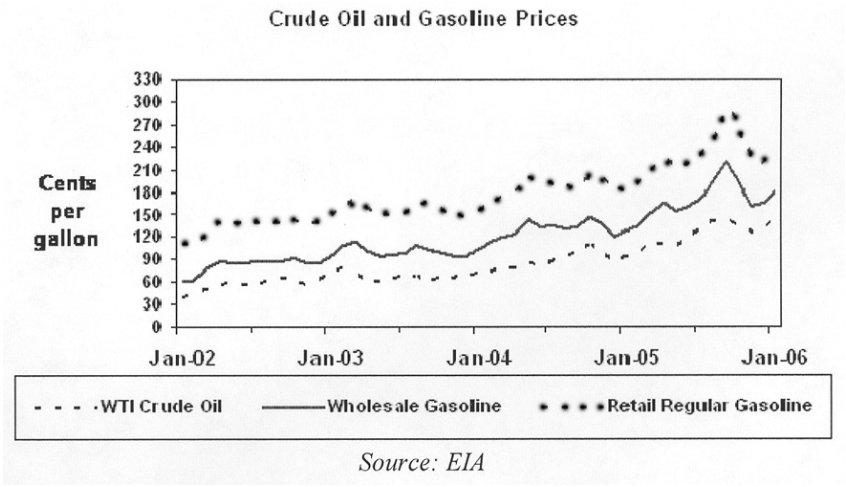
complying with extensive regulatory controls that affect both our facilities and the products we manufacture.

Throughout this statement, NPRA will outline and discuss key factors that provide perspective on the current and future supply and demand outlook for petroleum products. We will begin with a discussion of characteristics of the current gasoline market and allegations of "price gouging."

Refined Product Market Fundamentals

A discussion of the domestic refining industry must begin with a description of three fundamental facts that guide refined product markets. These fundamentals are: (1) the cost of crude oil is the primary driver of the cost of refined product; (2) the balance between supply of and demand for refined products is extremely tight, and; (3) free-market pricing balances the system to the maximum benefit of consumers.

As the chart below clearly demonstrates, the price of crude oil leads the price of wholesale and retail gasoline.



Source: EIA

In addition to the cost of crude oil, the tight balance between refining capacity and refined product demand must be taken into account in order to understand price changes. Refiners have been steadily expanding capacity at facilities in order to keep pace with ever-growing demand. Over the past 12 years U.S. refining capacity has increased by over 2 million barrels/day (b/d), the rough equivalent of a new average-size refinery every year. In spite of this growth, refinery utilization rates remain extraordinarily high, often approaching 98 percent during the summer months. These high rates of utilization reflect the thin margin between supply and demand, which causes even moderate disruptions in the system to be reflected in significant price changes. In addition, the major event of 2005, Hurricanes Rita and Katrina's disruption of key U.S. refined product pipeline service and the destruction of significant portions of Gulf Coast refining assets, caused a temporary but considerable spike in transportation fuel prices.

In spite of the serious damage these storms inflicted on the domestic refining industry, no significant, long-lived transportation fuel shortage occurred during this period. The rapid return to service of significant portions of the transportation fuels industry may be attributed to several factors: quick action by the Federal Government to waive temporarily regulatory requirements and release crude oil from the Strategic Petroleum Reserve; the efforts of the dedicated employees of the industry, as well as their employers, who managed to return significant assets to service in a short time; and most importantly, price signals provided by the free market. Increased prices, which averaged over $3.00/gallon nationwide for a brief period, moderated demand and attracted both a record amount of refined product imports and ramped up production from U.S. refineries not damaged by the storms. Subsequently, prices moderated and returned to pre-storm levels by the end of November.

Without an increase in price, there would have been little incentive to attract increased amounts of refined products to the United States, or to run refining facilities outside of the affected area at higher utilization rates. Without an increase in

prices, long-lived and wide-spread fuel shortages may have occurred. In short, the market worked, to the benefit of consumers and the national economy.

Refined Product Pricing: Crude Oil & Competition

Two important factors must be kept in mind when examining the price of refined products. First, the cost of crude oil is the single greatest driver of petroleum product prices. In June of 2005 the U.S. Federal Trade Commission released a landmark study titled: "Gasoline Price Changes: The Dynamic of Supply, Demand and Competition." This study determined that "Worldwide supply, demand, and competition for crude oil are the most important factors in the national average price of gasoline in the U.S." and "the world price of crude oil is the most important factor in the price of gasoline. Over the last 20 years, changes in crude oil prices have explained 85 percent of the changes in the price of gasoline in the U.S." According to EIA data, crude oil constitutes 55 percent of the cost of a gallon of gasoline, refining 22 percent, taxes 19 percent and distribution and marketing 4 percent. Second, the refining industry is robustly competitive. Some critics of the industry argue that recent mergers have reduced competitiveness and led to an increase in fuel prices. This assertion is simply wrong. The U.S. refining industry is highly competitive. Fifty-four refining companies, hundreds of wholesale and marketing companies, and more than 165,000 retail outlets compete in the U.S. market. The largest U.S. refiner accounts for just 13 percent of the Nation's total capacity, and large integrated companies own and operate only about 10 percent of retail outlets. (For comparison, Archer Daniel Midland, the largest producer of fuel ethanol in the U.S., controls nearly 25 percent of the U.S. ethanol market.) No one company, or group of companies, sets gasoline prices. Rather, in the U.S. refining industry, the laws of supply and demand drive competitive behavior and determine pricing.

Refiners Reject and Condemn Improper Pricing Practices

Current gasoline prices have adversely affected some consumers and the industry understands their concerns. In an attempt to respond to consumer dissatisfaction, some policymakers have questioned the industry's pricing and investment policies. NPRA offers the following response to these allegations:

"Price Gouging"

"Price gouging" is a term that is by its very nature imprecise and extremely subjective. It is extremely difficult, if not impossible, to define or reduce to statutory language. Author Thomas Sowell had this to say about defining "price gouging": ". . . prices higher than what observers are used to are called 'gouging.' In other words, prices under normal conditions are supposed to prevail under abnormal conditions. This completely misunderstands the role of prices."

If Federal "price gouging" legislation is enacted, the term's inherent ambiguity will inevitably lead to interpretations that Congress intended to impose price controls. The result will be that consumers will relive the supply shortages, long lines at gas stations and other added costs and inconveniences of the 1970s. NPRA hopes that Congress will continue to reflect on these facts and change its mind about the wisdom of any policies that result in additional government intervention in the fuels market.

NPRA and its members understand public and Congressional concern about high gasoline prices. But policymakers should be cautious about taking any action that suggests that price controls are the answer to today's gasoline market conditions. The Nation's ten-year experiment with government intervention into the fuel market during the seventies led to gasoline shortages and long lines at gas stations. Consumers were prohibited from purchasing gasoline on certain days of the week. That history does not suggest that price controls would be an acceptable template for Congressional or Administration action this year.

The most effective way to maintain adequate gasoline supplies at reasonable prices is continued reliance on market mechanisms, not price regulation or other actions that interfere with and distort market realities that both refiners and consumers must face.

Many factors drive the transportation fuels market. Among these are: geopolitical uncertainties which affect the price of crude oil, refiners' primary feedstock; increasing global demand for crude oil; the challenge of complying with significant specification changes for both reformulated gasoline and highway diesel; and the rising cost of other materials and inputs such as natural gas, construction materials and labor.

The Nation's refiners operate in an environment in which all these factors, together with strong demand for gasoline and other products, cannot be ignored. As always, NPRA members must continue to concentrate on the serious business of

providing secure supplies of refined petroleum products to consumers even under the current difficult and challenging market conditions.

Federal and State Gasoline Market Investigations

The tight gasoline markets of the past several years have led to dozens of investigations of the refining industry at the state and Federal levels. In each case, the industry has been cleared of wrongdoing. Today, as then, allegations of refiner price-fixing, price-gouging, and other illegal pricing practices are patently false.

The Attorney General of Nebraska recently appointed a task force to investigate prices in that state. In a report issued in January 2006, the task force found that "hurricanes in fall 2005 functioned similarly to OPEC supply restrictions, producing higher prices, lower output, and elevated profits. . . ." Referencing price movements in recent years, the report notes that, "increases in the price of a barrel of oil accounted for 62.5 percent of the rise in gasoline prices between June 2004 and October 2005. Declines in refinery capacity utilization and increases in the share of oil imported accounted for the rest of the difference." Additionally, the task force concluded that similar studies at the Federal and state level, "have not found violations of law, and they generally have found competitive markets affected by worldwide conditions."

Another study, conducted by the Office of the Attorney General of Florida, examined price increases in that state in 2004 and found that the major factors affecting prices in that state were: "consumer demand for gasoline," "refinery capacity," "refinery utilization," "inventories," "supply issues," and "lagged response in gasoline imports." Importantly, the study found no evidence of anticompetitive behavior.

These reports repeat the findings of numerous others, including a 9-month FTC investigation into the causes of price spikes in local markets in the Midwest during the spring and summer of 2000. At the conclusion of that investigation, FTC Chairman Robert Pitofsky (a recognized expert in antitrust law) stated, "There were many causes for the extraordinary price spikes in Midwest markets. Importantly, there is no evidence that the price increases were a result of conspiracy or any other antitrust violation. Indeed, most of the causes were beyond the immediate control of the oil companies."

To summarize, allegations of refiner price-fixing, "gouging," or other illegal practices are patently false, as repeatedly shown by the FTC and other Federal and state investigations. NPRA regrets that the definitive results of these investigations are never announced with the same enthusiasm and media attention given to news of their initiation.

Domestic Refining Capacity: Working To Meet Demand and Improve the Environment

One-hundred-forty-eight refineries currently operate in the United States, producing record volumes of some of the cleanest transportation fuels in the world. These refineries, located in 33 states, have a combined capacity of over 17.335 million barrels per day (b/d) and, as previously stated, often operate at extremely high utilization rates, which approach 98 percent during the peak driving season. These figures are far above the 82 percent average utilization rate of other manufacturers. Despite these significant efforts, U.S. product demand continues to outstrip domestic supply. Imports now account for more than 10 percent of the gasoline used by U.S. consumers. Regionally, this figure is higher, as in the case of the Northeast, where imported products account for over 20 percent of total supply. In light of the strong demand for gasoline and other petroleum products, domestic refiners have worked hard to expand existing facilities. Over the past 10 years, domestic refining capacity has increased substantially, by an average of 177,000 barrels per day (b/d) of production each year. In simpler terms, this means that the U.S. refining industry has added the equivalent of one new, larger than average refinery, each year for the past decade.

Looking forward, the industry has announced publicly that over 1.4 million b/d in new capacity is slated to come online in the next few years. Secretary of Energy Bodman recently stated that he expects 2 million barrels/day of new U.S. refinery capacity will be added over the next 3 years. With these expansions, total domestic capacity will reach an all time high as shown in Attachment I. It remains doubtful, however, that even these expansions will be sufficient to meet expected U.S. demand growth; that means that the Nation will continue to depend on imports of finished product and gasoline blendstocks.

Capacity expansions have occurred and will continue despite difficult and time-consuming obstacles, including complex permitting requirements and reviews, uncertainties involving the New Source Review program, increasingly stringent environmental requirements, and the difficulty of attracting sufficient investment in one

of the world's most capital-intensive industries. NPRA continues to believe that encouraging the growth of domestic refining capacity is a vital component of U.S. energy policy, and congratulates Congress on efforts to encourage capacity additions.

The Refining Industry Is Making Large Investments To Expand Capacity and Output; Mergers and Acquisitions Have Resulted in Increased Capacity and More Competition

Much has been made of the fact that a new grassroots refinery has not been built in the United States in over thirty years. There are compelling reasons why: obstacles to permitting and constructing such a facility include enormous start-up capital requirements, environmental regulations, a history of low refining industry profitability, and the "Not In My Backyard" (NIMBY) public attitude. Equally important, costs to construct a new grassroots refinery would require an investment averaging $17,000 per daily barrel of capacity and, at a minimum, would take 10 years to complete. On the other hand, capacity expansions at existing facilities cost in the range of $9,000 to $12,000 per daily barrel and can be completed in 3 to 4 years. In short, expansions can help meet demand more quickly and cost effectively than construction of a new, green-field refinery complex. This means more fuel for consumers in a shorter time period than a hypothetical new refinery could provide.

Significantly, while the industry has not constructed new grassroots facilities, improved management techniques and technological advances allow existing facilities to produce ever greater amounts of refined product. Refiners have also made substantial investments in technologically advanced process units that have increased the yield of gasoline and other valuable "light end" products from the same amount of raw crude input. Further, similar investments have been made in units designed to process a wider slate of crude oil, enabling the production of light products from heavier and sour crude oil feedstocks.

As previously mentioned, refiners have added significant capacity at existing sites. In 1981, the average refinery in the United States had approximately 57,000 b/d of crude oil distillation capacity. Today, the average refinery has a capacity of over 110,000 b/d. Due to high capital requirements and increasing environmental restrictions, the industry closed small, inefficient facilities and has relied on economies of scale to save on construction costs and bring new capacity on line more quickly through expansion at existing sites.

Without mergers and acquisitions, some of the individual refineries now operating might not have remained economically viable and capacity expansions and other improvements simply could not have been accomplished. One such example is Sunoco's refinery complex in the metropolitan Philadelphia area which now has over 550,000 barrels/day of capacity. If Sunoco were unable to operate these facilities as a synergistic unit, this production might not be available for consumers. Phillips Petroleum's (now ConocoPhillips) acquisition of the Tosco refinery system increased capacity and maintained refinery viability on a nationwide basis, as did Tosco's initial purchase of underperforming facilities. Additionally, Valero Energy Corporation has increased the productive capacity of the refineries it has acquired by an aggregate of nearly 400,000 barrels per day over the past several years and plans more extensive expansions in the future. An examination of other mergers and acquisitions tells the same story: refineries have been kept operating and have often been expanded as the result of mergers and acquisitions.

Replacing MTBE With Ethanol Has Affected Gasoline Markets this Year

Recently, refiners undertook and completed annual turnarounds to prepare for the changeover from wintertime to summertime fuel blends. A complication for this year's efforts was the need for additional maintenance at facilities damaged by Hurricanes Katrina and Rita, or in the case of one major facility, an accident. In addition, there was a need for deferred maintenance at those facilities originally scheduled for repair work during late summer/early fall of 2005, but which operated at higher rates of utilization and continued to produce fuel for consumers in the aftermath of these storms, while other refineries were shut for storm-related repairs.

While these events could not have been predicted and both industry and government worked diligently to minimize their impacts, the fact remains that both direct actions and overt inaction by the Federal Government can impact and complicate the supply picture. The results of these policy decisions can and do influence marketplace conditions and increase volatility. For example, select provisions from the Energy Policy Act of 2005 created marketplace conditions that placed increased strain on the Nation's transportation fuels supply this year.

Although The Energy Policy Act of 2005 eliminated the 2 percent oxygenate requirement for Federal RFG, the Act did not provide defective product limited liability relief for MTBE which the industry urged Congress to enact. Further, the rules

implementing the removal of the 2 percent oxygenate requirement were published by EPA just this month, leaving refiners in regulatory limbo regarding RFG and the 2 percent oxygenate requirement. Refiners were thereby forced to make decisions regarding the transition from the production of wintertime to summertime fuels (required by Federal environmental law) in the February/March 2006 time frame. This situation evidently encouraged many refiners to move ahead quickly to remove MTBE from the fuel supply, to ensure that summertime 2006 RFG would still contain 2 percent oxygenate to ensure compliance with EPA regulations.

This rapid MTBE removal/ethanol switch had been predicted by many industry observers, and Congress was informed on multiple occasions that the failure to adopt MTBE limited liability would impact supply. The result was considerable (but clearly anticipated) pressure on ethanol supply and fuel distribution infrastructure. Unfortunately, many who ignored industry's call for help on MTBE liability are now questioning the actions of the refining industry as it attempts an as smooth as possible transition to summertime RFG while complying with the renewable fuels (ethanol) mandate also enacted in the Energy Policy Act of 2005.

A substantial increase in demand for ethanol due to MTBE replacement and the mandate have caused prices for the blendstock to rise rapidly. At the same time, the logistical challenges of changing from gasoline blended with MTBE to gasoline blended with ethanol (as well as transporting the ethanol to areas for the first time) resulted in unique challenges for a few wholesalers and retailers. Refiners, as well as other participants in the transportation fuels industry, worked very hard to minimize these impacts, but they occurred nonetheless. The recent market disruptions were very limited and addressed in short order, and the system is currently adjusting to significantly reduced MTBE use. The experience demonstrates, however, that Congress, in spite of being informed by industry and outside experts and observers, often fails to consider fully the fuel supply impacts of legislation and implementing regulations.

Other Supply Impacts of Regulations

Other significant government intervention and regulations, especially environmental requirements, have had a major impact on fuel supplies. Unlike most industries, refiners comply with regulations for both their product fuels and for their facilities. In essence, the industry is impacted doubly by many environmental programs and faces numerous other regulatory burdens simultaneously as illustrated by the attached Fuels Timeline (see Attachment II). While refiners support and encourage continued environmental progress, NPRA believes that policymakers have tended to overlook and take for granted the supply side of the environmental-energy equation. It is imperative, in our opinion, that determining the impact on supply be fully embedded in the policymaking process. In working with policymakers on improvements to fuels and facilities, NPRA has often commented that industry needs time, flexibility or more realistic standards to minimize negative impacts on fuel supply. Policymakers, however, often opt to promulgate regulations that are "technology forcing," constructed with limited and often theoretical "margins of safety," and requiring implementation in the shortest time possible—all without adequate attention to fuel supply impacts.

NPRA characterizes this current environmental agenda as a "regulatory blizzard," consisting of about a dozen new Federal programs from 2006–2012 (see Attachment III). The majority of these regulations will have a direct impact on supply. Unfortunately, regulators have not properly sequenced or coordinated the implementation of these requirements, literally stacking them one on top of the other. Current fuel markets reflect, in many aspects, the impact of these multiple fuel and stationary source requirements.

Taking Fuel Supply for Granted

NPRA developed several supply-oriented recommendations to increase supply as the Energy Policy Act of 2005 was debated. Specifically, the Association recommended that Congress repeal the 2 percent oxygenation requirement for Federal RFG; avoid a Federal ban or mandatory phase-out of MTBE; resist calls for an ethanol mandate; extend limited product liability protection to MTBE; avoid unnecessary changes in fuel specifications; and take steps to increase natural gas production and supply. Unfortunately, political considerations resulted in the exclusion of most recommendations as part of the Energy Policy Act of 2005.

Our recommendations were supported by two landmark refining studies issued by the National Petroleum Council (NPC), an advisory group to the Department of Energy. The NPC issued a report on the state of the refining industry in 2000, urging policymakers to pay special attention to the timing and sequencing of any changes in product specifications. Failing such action, the report cautioned that adverse fuel

supply ramifications could result. Unfortunately, this warning has been almost totally ignored, resulting in the market volatility we have experienced over the past few years.

On June 22, 2004, former Energy Secretary Abraham asked the NPC to update and expand its refining study and a report was released December 2004. The June 22, 2004 NPC report included the following recommendations: immediate implementation of comprehensive New Source Review reform; revision of the NAAQS compliance deadlines and procedures to take full advantage of emission reduction benefits from current clean fuels and engine programs; caution in implementation of the ultra-low sulfur diesel regulations; limited liability protection against defective product claims for MTBE; further study of the boutique fuels issue and approval of new fuels only when cost effective relative to other emission reduction options; regulations based on sound science, cost effectiveness, and energy impacts; streamlined permitting; and several other proposals. Few of the NPC recommendations have been implemented; frankly speaking, policymakers and opinion leaders have almost totally ignored the findings of these important reports.

Congress Should Resist Changes in Current Fuel Specifications

As illustrated by the NPRA Regulatory Blizzard (Attachment III) and Fuels Timeline (Attachment II) cited previously, refiners face numerous challenges and fuel specification deadlines. Further complicating this picture by adding new programs, or even eliminating existing ones, will not benefit consumers. Last minute changes will increase uncertainty and upset expectations based on current law.

NPRA Opposes Further Reductions of Boutique Fuels

Current calls for the reduction of "boutique fuels," for example, may not provide the supply-relief that many advocates think. NPRA believes that any attempt to limit the number of viable fuels in regions or nationwide may be counter-productive, and certainly no such change would have a positive impact now or during this summer. Boutique fuel programs in many cases represent a local area's attempt to address its own air quality needs in a more cost-effective way than with RFG. While boutique fuels are often blamed for episodic price variations during limited supply disruptions in specific regions, their overall impact on local economies is a net positive when compared to the alternative—a requirement for RFG.

Historically, the primary driver that led local areas to create boutique fuels was to attain the 1-hour ozone NAAQS. When considering fuel controls, such areas often sought to avoid RFG, either due to concerns about (1) cost, or (2) the use of MTBE and/or ethanol, or both. Areas that needed VOC (hydrocarbon) emissions reductions to achieve ozone attainment have been likely to favor lower RVP controlled conventional gasoline (CG) vs. RFG since low RVP CG is more cost effective. Areas that require NOx emissions reductions to achieve ozone attainment are likely to favor CG as well because both CG and RFG will return similar NOx emission reduction benefits with the implementation of the Federal Tier 2 gasoline sulfur program.

Congress passed significant provisions affecting boutique fuels just last year which have not yet been fully implemented. Clean Air Act Section 211(c)(4)(C) was amended by the Energy Policy Act of 2005 and requires a joint effort by EPA and DOE to review motor fuel control choices by states, and further requiring both agencies consider the regional supply implications of such requests (see section 1541 of Pub. L. 109–58). Also, before granting a waiver of Federal preemption, the Administrator of EPA is now required, after consultation with the Secretary of Energy and after notice and comment, to determine that the fuel control choice will not cause fuel supply or distribution interruptions, or have a significant adverse impact on fuel producibility in the affected area or contiguous areas before approving the new fuel. NPRA strongly supports this important focus on supply-side impacts. Congress should allow time for implementation of this new system before contemplating any changes.

The Energy Policy Act of 2005 also includes another provision addressing boutique fuels. Under this provision, EPA may not approve a motor fuel in a new State Implementation Plan if it increases the number of approved fuels as of September 1, 2004, and unless EPA finds, after review and comment, that the new fuel will not cause supply or distribution disruptions or have an adverse impact on fuel producibility in the affected area or in contiguous areas, and unless the fuel was already in use in the same PADD (with the single exception of summer 7.0 psi RVP conventional gasoline). By November 2005, EPA was to publish a list in the Federal Register of motor fuels in all State Implementation Plans as of September 1, 2004, by state and PADD for public review and comment. Additionally, the Act requires a report by August 2006 of a joint EPA/DOE study on boutique fuels, including ef-

fects on air quality, fuel availability and fungibility. These provisions have also not yet been implemented.

Congress should avoid further confusion and potential disruption in the fuels market and rely on the scheduled joint EPA/DOE study on boutique fuels as a basis for any future legislative initiatives on this subject. In short, NPRA supports further study of the boutique fuels phenomenon as outlined in last year's energy bill, and urges Congress to resist imposition of any additional motor fuel specification changes. Further changes in motor fuel specifications in the 2004–2010 time frame could very well result in additional, unwarranted supply constraints. Existing requirements already provide significant challenges due to the impact of Tier 2 gasoline sulfur regulations, ultra-low sulfur diesel regulations, revised mobile source air toxic rules, and the impact of revised ozone and particulate matter National Ambient Air Quality Standards, and others (see Attachment III).

Certain actions could be taken by Congress to address the proliferation of fuel formulas without mandating specification changes. Key drivers for future boutique fuel proliferation are the 8-hour ozone NAAQS and PM 2.5 NAAQS. Some areas will doubtless seek to add fuel controls as they develop State Implementation Plans to demonstrate attainment. Many are looking at additional unique requirements for local areas, especially where stationary source options are limited or can't be implemented quickly. Thus, states look to short-term, localized fuel controls to meet excessively compressed NAAQS attainment deadlines. These deadlines are not aligned with Federal controls, either existing or in the early stages of implementation (Tier 2 Gasoline & Vehicle standards, Heavy Duty Highway and Non-road Diesel Sulfur standards, etc.). This situation not only prevents states from counting real and significant emission reductions in the time required for compliance, but also adds considerable and unnecessary cost to the overall NAAQS program.

States and local areas need more time to demonstrate attainment or credit for existing regulatory requirements that will deliver emission reductions over time. Congress should direct that states be allowed credit for emission reductions through 2020 that result from Federal fuel control programs already in place. If this is done, much of the interest in and perceived need for states to enact new motor fuel controls will be alleviated.

Further, it is evident that variations in motor fuels may be reduced with implementation of current regulatory programs. For example, EPA published the Mobile Source Air Toxics Phase 2 proposal (71 FR 15804; 3/29/06). The primary feature is a proposed reduction in the average annual benzene content in all gasoline (conventional gasoline plus RFG) to 0.62 vol percent. This would eliminate a current toxics control distinction between RFG and CG. Furthermore, the recent removal of the oxygen content requirement for Federal RFG reduces the difference between winter RFG and winter CG and between summer RFG and summer 7.0 psi RVP CG. In addition, the average sulfur content of RFG and CG is identical because of the Federal Tier 2 Gasoline Sulfur program. Therefore, differences between RFG and CG are diminishing, which should reduce the attractiveness of new boutique fuels as alternatives to RFG.

In sum, NPRA does not support boutique fuels legislation that changes existing specifications. Any new legislative menu of motor fuel choices (which NPRA does not support) must recognize investments already made by the petroleum industry to produce boutique fuels and comply with existing mandates. Failure to consider and balance supply implications, as well as air quality impacts, risks making the current supply situation worse.

EPA Should Promulgate RFS Standards This Year/Congress Should Preempt State Ethanol Mandates and Suspend the Tariff on Imported Ethanol

The Energy Policy Act of 2005 includes a renewable content requirement for motor vehicle fuels, the Renewable Fuels Standard (RFS) provision. The RFS will be administered by EPA and require the increased use of ethanol, biodiesel or other renewable fuels in motor fuels. It is an obligation for gasoline refiners, blenders, and importers. EPA published a Direct Final Rule with a limited set of RFS standards for 2006 that included collective compliance, not individual refinery compliance. This Direct Final Rule was effective on February 28, 2006.

NPRA advocates a program that is understandable, allows unambiguous enforcement, promotes adequate flexibility for refiners and gasoline importers, and is developed with full recognition of its impact on energy supplies. The comprehensive RFS final rule, effective in 2007, should be in place as early as possible before January 1, 2007. Meeting this timetable may be difficult because the Agency has not yet released a proposal for public comment.

Congress set limits on the proliferation of new fuels in the 2005 Energy Policy Act. Unfortunately, new state ethanol, biodiesel or renewable fuel mandates can evade Congressional efforts to limit the number of fuels. These programs should be preempted by the Federal Renewable Fuel Standard pending the same energy supply impact analysis required for changes in local gasoline and diesel standards. Congress and the Administration should not grant a free pass to new ethanol and biodiesel mandates that proliferate fuel requirements and negatively impact supply.

NPRA urges Congress to consider at least a temporary suspension of the 54 cent per gallon protective tariff imposed on most imports of ethanol into the United States. Ethanol prices have more than doubled over the past year, and the President of ethanol's trade association testified 2 weeks ago that the ethanol price was $2.90 per gallon, compared to only $2.38 per gallon for gasoline. *Amazingly, on Friday, May 19th the ethanol prices were even higher: $3.30–3.40 in New York Harbor.* Greater openness to ethanol imports should be adopted as U.S. policy because those imports could act to restrain runaway price inflation of ethanol such as that we are currently seeing.

The ethanol lobby argues that there is no reason to suspend the tariff because additional imports are not available. If so, no damage will be done to ethanol if a suspension is approved. But NPRA believes that imports will materialize if it is clear that the prohibitive tariff is suspended. Ethanol currently enjoys a 52 cent per gallon Federal subsidy, numerous state subsidies, a mandate that all or nearly all of the ethanol produced in the U.S. be purchased by refiners regardless of its price, and a prohibitive tariff to block imports. Clearly, tariff suspension should be tried as one way to reduce fuel prices paid by U.S. consumers.

Other Recommended Policy Actions

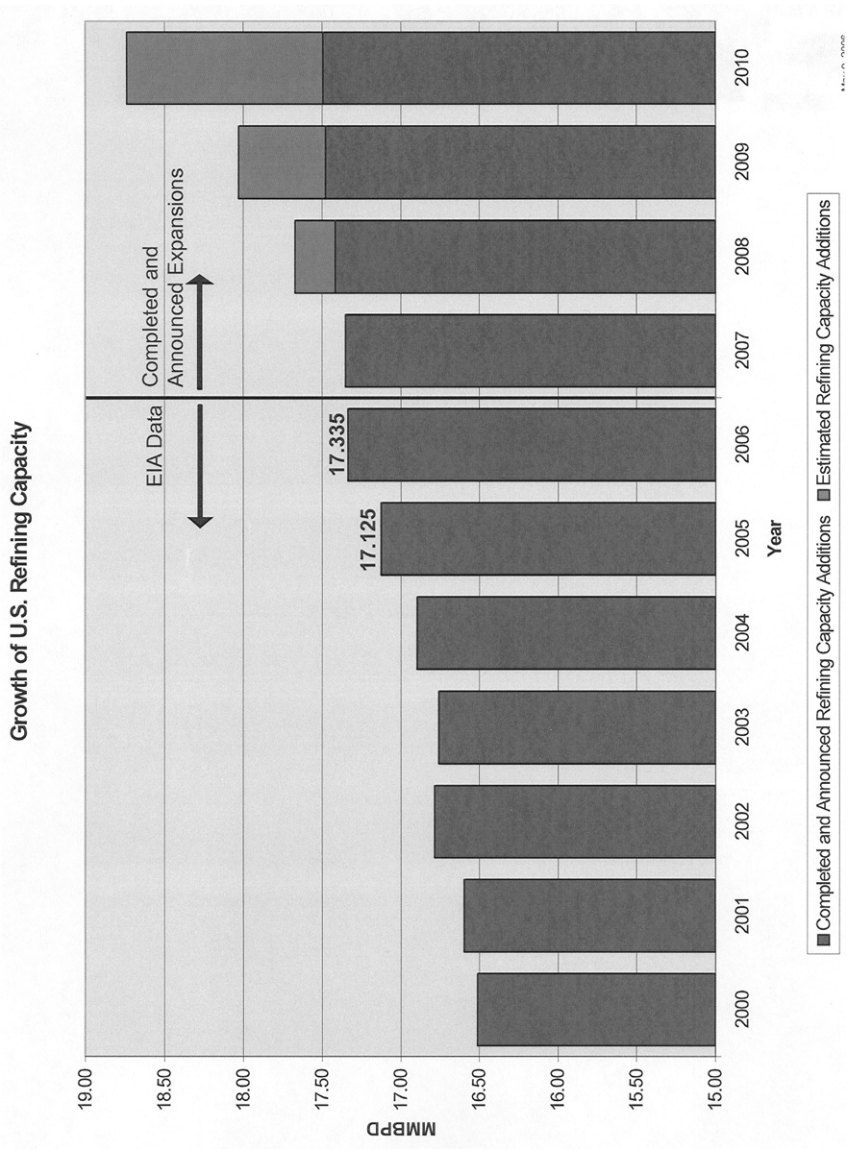
Congress can and should take appropriate action to help refiners meet the transportation fuel needs of the American public. Regardless of industry profitability, the simple fact remains that supply and demand for refined products are in an extremely tight balance. The refining industry is still working to recover fully from the impact of Hurricanes Rita and Katrina. Additionally, several upcoming regulatory requirements should be carefully monitored for adverse supply impacts. Necessary and prudent actions include the following:

- *Make increasing the Nation's supply of oil, oil products and natural gas a number one public policy priority.* Now, and for many years in the past, increasing oil and gas supply has often been only a secondary concern of policymakers. Oil and gas supply concerns have played second fiddle to whatever policy goal seemed politically popular at the time. As discussed above, the 2000 NPC study of the refining industry urged policymakers to pay special attention to the timing and sequencing of any changes in product specifications. Failing such action, the report cautioned that adverse fuel supply ramifications may result. We repeat that this warning has been widely disregarded.
- *Resist tinkering with market forces, including imposition of "windfall profits" taxes, LIFO repeal or elimination of foreign tax provisions.* Market interference that may initially be politically popular leads to market inefficiencies and unnecessary costs. Policymakers must resist turning the clock backward to the failed policies of the past. Experience with price constraints and allocation controls in the 1970s demonstrates the failure of price regulation, which adversely impacted both fuel supply and consumer cost. The State of Hawaii has just canceled its less than one-year old gasoline price regulation because it led to higher prices and supply uncertainty. A windfall profits tax would discourage investment in refineries, which is needed to expand domestic production capacity and produce cleaner fuels.
- *Remove barriers to increased supplies of domestic oil and gas resources.* Refineries and other important onshore facilities have been welcome in limited areas throughout the country, including the Gulf Coast. However, policymakers have restricted access to much-needed offshore oil and natural gas supplies in the eastern Gulf and off the shores of California and the East Coast. These areas must follow the example of Louisiana and many other states in sharing their energy resources with the rest of the Nation. This additional supply is sorely needed.
- *Expand the refining tax incentive provision in the Energy Act.* Reduce the depreciation period for refining investments from 10 to 5 years in order to remove a current disincentive for refining investment. Consider allowing expensing under the current language to take place as the investment is made rather than when the equipment is actually placed in service. Alternatively, the percentage

expensed could be increased as per the original legislation introduced by Senator Hatch.

- *Review permitting procedures for new refinery construction and refinery capacity additions.* Seek ways to encourage state authorities to recognize the national interest in increased domestic refining capacity by reducing the time needed to get a permit for expansions and other refinery projects.
- *Keep a close eye on several upcoming regulatory programs that could have significant impacts on gasoline and diesel supply.* They are:
  - —Design and implementation of the credit trading program for the ethanol mandate (RFS) contained in the recent Energy Act. This mechanism is vital to ensure smooth implementation without adverse effects on gasoline supply. Refiners have been working closely with EPA to accomplish this key task.
  - —Implementation of the ultra low sulfur diesel highway diesel regulation. The refining industry has made large investments to meet the severe reductions in diesel sulfur that take effect June 1. We remain concerned about industry's ability to produce the necessary volumes and the distribution system's ability to deliver this material at the required 15 ppm level at retail. If not resolved, these problems could affect America's critical diesel supply. Industry is working closely with EPA on this issue, but time left to solve this problem is almost gone.
  - —Phase II of the MSAT (mobile source air toxics) rule for gasoline. Many refiners are concerned that the proposed regulation could be overly stringent and impact gasoline supply. We hope that EPA will finalize a rule that protects the environment and avoids reducing gasoline supply while protecting the environment.
  - —Implementation of the new 8-hour ozone NAAQS standard. The current implementation schedule set by EPA has established ozone attainment deadlines for parts of the country that will be impossible to meet. EPA has not made needed changes that would provide realistic attainment dates. The result is that areas will be required to place sweeping new controls on both stationary and mobile sources in a vain effort to attain the unattainable deadlines. The CAIR rule and ULSD diesel program will provide significant reductions to emissions within these areas when implemented. These reductions will not come soon enough to be considered unless the current unrealistic schedule is revised. If not, the result will be additional fuel and stationary source controls which will have an adverse impact on fuel supply and could adversely affect U.S. refining capacity. This issue needs immediate attention.

NPRA's members are dedicated to working cooperatively with government at all levels to ensure an adequate supply of transportation fuels at reasonable prices. But we feel obliged to remind policymakers that action must also be taken to improve energy policy in order to increase supply and strengthen the Nation's refining infrastructure. We look forward to answering the Committee's questions.


Growth of U.S. Refining Capacity
EIA Data
Completed and Announced Expansions
17.335
17.125
MMBPD
Year
19.00
18.50
18.00
17.50
17.00
16.50
16.00
15.50
15.00
2000
2001
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2003
2004
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2006
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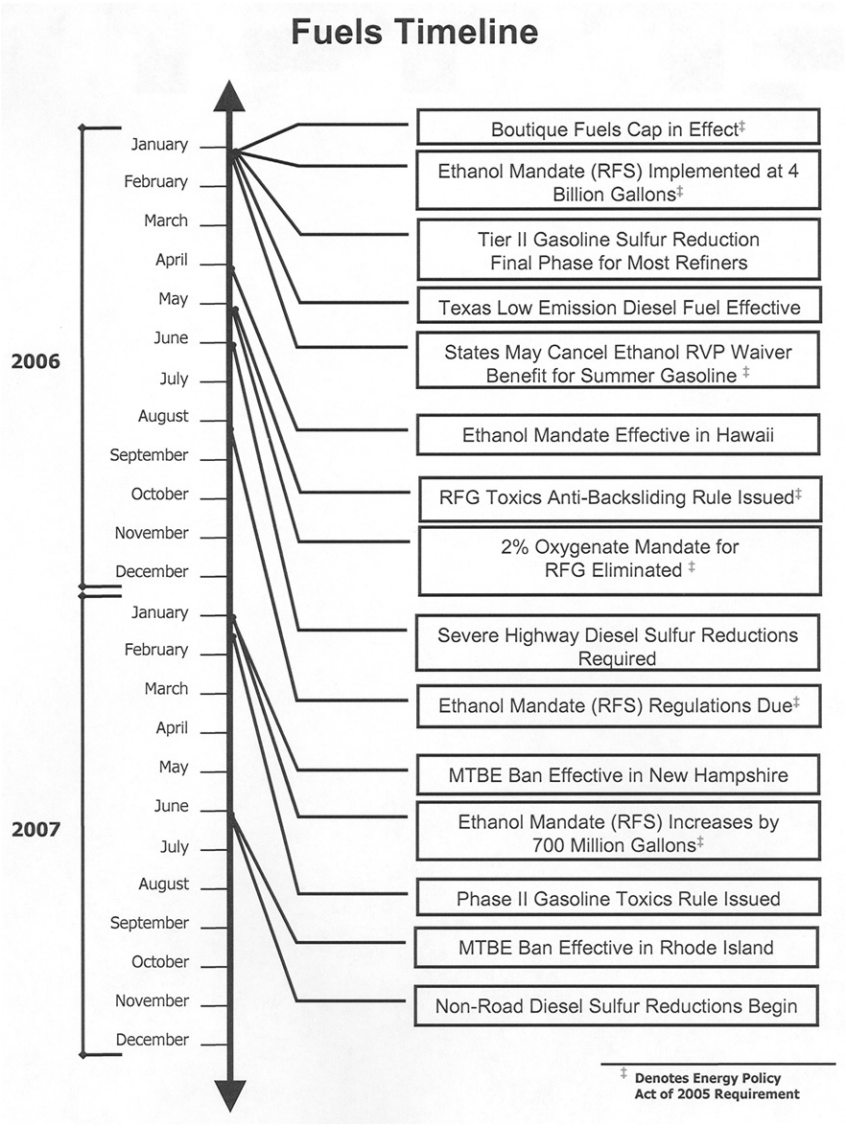
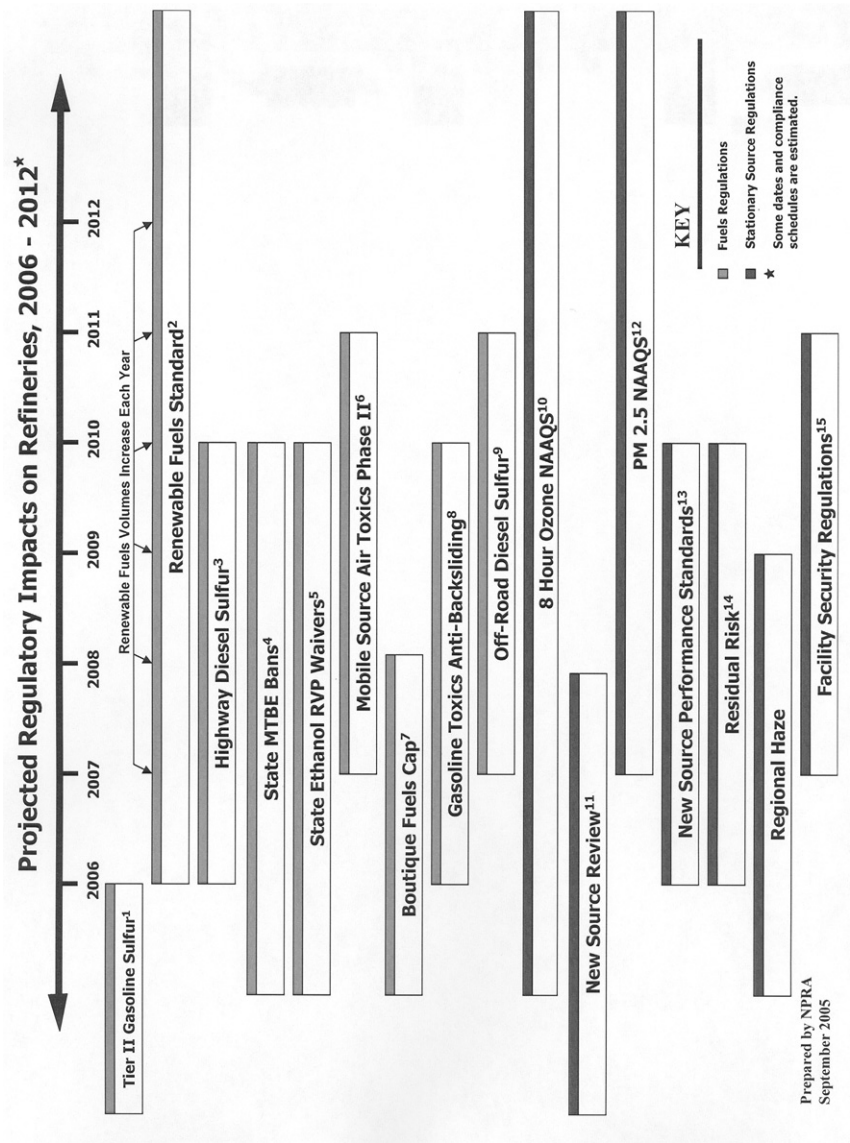
2010
Completed and Announced Refining Capacity Additions
Estimated Refining Capacity Additions


Fuels Timeline
2006
January
February
March
April
May
June
July
August
September
October
November
December
2007
January
February
March
April
May
June
July
August
September
October
November
December
Boutique Fuels Cap in Effect‡
Ethanol Mandate (RFS) Implemented at 4 Billion Gallons‡
Tier II Gasoline Sulfur Reduction Final Phase for Most Refiners
Texas Low Emission Diesel Fuel Effective
States May Cancel Ethanol RVP Waiver Benefit for Summer Gasoline ‡
Ethanol Mandate Effective in Hawaii
RFG Toxics Anti-Backsliding Rule Issued‡
2% Oxygenate Mandate for RFG Eliminated ‡
Severe Highway Diesel Sulfur Reductions Required
Ethanol Mandate (RFS) Regulations Due‡
MTBE Ban Effective in New Hampshire
Ethanol Mandate (RFS) Increases by 700 Million Gallons‡
Phase II Gasoline Toxics Rule Issued
MTBE Ban Effective in Rhode Island
Non-Road Diesel Sulfur Reductions Begin
‡ Denotes Energy Policy Act of 2005 Requirement


Projected Regulatory Impacts on Refineries, 2006 - 2012*
2006
2007
2008
2009
2010
2011
2012
Renewable Fuels Volumes Increase Each Year
Tier II Gasoline Sulfur[1]
Renewable Fuels Standard[2]
Highway Diesel Sulfur[3]
State MTBE Bans[4]
State Ethanol RVP Waivers[5]
Mobile Source Air Toxics Phase II[6]
Boutique Fuels Cap[7]
Gasoline Toxics Anti-Backsliding[8]
Off-Road Diesel Sulfur[9]
8 Hour Ozone NAAQS[10]
New Source Review[11]
PM 2.5 NAAQS[12]
New Source Performance Standards[13]
Residual Risk[14]
Regional Haze
Facility Security Regulations[15]
KEY
Fuels Regulations
Stationary Source Regulations
Some dates and compliance schedules are estimated.
Prepared by NPRA
September 2005

Notes:

1. Longer compliance time for refineries in Alaska and Rocky Mountain states as well as small refineries covered by the Small Business Regulatory Enforcement and Flexibility Act (SBREFA). Additional compliance time is available for these refineries if they produce ultra low sulfur highway diesel beginning in 2006.
2. The Energy Policy Act of 2005 includes a renewable fuels standard (RFS) which mandates the use of 4 billion gallons of renewable fuels starting in 2006. The mandate increases to 7.5 billion gallons in 2012. EPA must promulgate regulations by August 2006.
3. Longer compliance time for small refiners covered by SBREFA.
4. Approximately twenty-five states currently have MTBE bans in place and others may pass similar bans in the future.
5. The Energy Policy Act of 2005 allows state governors to petition EPA to eliminate the one pound RVP waiver for summer gasoline blended with ethanol.
6. Phase II Mobile Source Air Toxics Rule to be proposed in February, 2006. Final rule expected in 2007.
7. The Energy Policy Act of 2005 caps the number of motor fuels available for use in State Implementation Plans at the same level as those already in use as of September 1, 2004. EPA must publish a list of approved fuels by state and PADD by November, 2005.
8. Under the Energy Policy Act of 2005 EPA must promulgate a rule to implement RFG anti-backsliding adjustments that will maintain emissions at 2001 and 2002 levels.
9. The first phase of the off-road diesel sulfur program is effective in 2007 and the second phase is effective in 2011.
10. Ozone non-attainment designations made April 2004. State Implementation Plans (SIPs) are due by June 2007. Compliance, depending upon classification, required between 2007 and 2021. EPA promulgated a Phase 1 implementation rule in April 2004, but has not yet promulgated a Phase 2 rule.
11. New Source Review reform (RMRR) is subject to litigation. Refiners face uncertainty in meeting regulatory requirements. The NSR program was upheld in part by the courts however, part of the rule was remanded to EPA. Refiners support the reforms. EPA is continuing enforcement actions under the old rules.
12. EPA set a new PM 2.5 NAAQS in 1997 and designated nonattainment areas in December 2004, but has not yet promulgated implementation standards. EPA is currently conducting a five-year review of the standard.
13. EPA has entered into a consent decree with environmental organizations to review, and possibly revise, the New Source Performance Standards for petroleum refineries.
14. Proposed rule expected mid 2006.
15. The Senate and the Administration support new authority for DHS to regulate chemical security which will impact refiners. Many facilities currently meet Coast Guard regulations under MTSA.

Senator INOUYE. Thank you very much, Mr. Slaughter. And now, Dr. Mark Cooper, Director of Research, Consumer Federation of America.

STATEMENT OF DR. MARK COOPER, RESEARCH DIRECTOR, CONSUMER FEDERATION OF AMERICA (CFA)

Dr. COOPER. Thank you, Mr. Co-Chairman, Members of the Committee. Same facts, different story. I do not think all is well in the oil industry, but today let me start by pointing out that taken at face value, the FTC has produced an analysis that makes it clear no American consumer in his or her right mind would want to rely on the oil industry to deliver a vital commodity like this.

Its routine business practices cannot and will not deliver sufficient refinery capacity and adequate inventories to protect the American consumer from these vicious price spikes, which also just happen to be associated with sky rocketing oil company profits. They run their refineries at 90 plus percent capacity, and keep very slim inventories even though the ability of demand and supply to respond to disruptions in prices are virtually nonexistent in this industry. The average American manufacturing sector has four times as much spare capacity and inventory for commodities with infinitely higher supply and demand responses.

The oil companies do not have to manipulate or collude. They just have to exploit the tight market condition that is the result of their profit, maximizing business decisions. According to the FTC, last July the refining industry had some bad days before Katrina

and Rita struck. Little hurricanes, heat, lightening, fire, power failures, water cooling system failures, and other mysterious maladies reduced refining capacity. The industry reacted vigorously by raising prices. The domestic spread only went up a dime in July and August. That only cost American consumers $3.3 billion dollars. Then big hurricanes hit and they reacted even more swiftly, raising prices even higher.

Supply eventually responded. The cost to American consumers—another $7 billion dollars. And of course, almost all of that increase went to profits. Domestic refining profits for the year were up by $10 billion dollars. Exactly those price increases. The market worked. The consumers paid more and the companies made more.

This spring, the industry was visited by another plague: spring cleaning. It could not handle the switch over because it had insufficient spare capacity and it mismanaged reformulation. The industry reacted swiftly, increasing the domestic spread even higher than at the worst of Katrina, as far as I can tell, costing consumers another $12 billion. This is the oil industry at its best, according to the FTC. Responding to a tough situation on every point: inventory capacity, cost, profit, refinery sales, and concentration, the FTC has presented a positive picture that misleads. At its worst, I suggest the business strategy of consolidation and reduction of excess capacity has fundamentally altered the structure and behavior pattern of this industry, eliminating competition from market share based on price. They don't collude or manipulate, they just exploit.

Things have gotten so bad in the largest gasoline market in the world by far, ours, that even the EIA recently pointed out that tight U.S. gasoline markets may be pulling up the price of crude oil. In the *New York Times,* recently noted in an article headline, "Trading Frenzy Adds to Jump in Price of Oil," that some analysts believe a huge increase in trading volume, volatility, and risk are adding as much as 20 percent to the price of crude oil. That works out to 30 cents a gallon. When the domestic spread goes from 30 cents—up 30 cents a gallon, then 50 cents a gallon, when refining profits go up $10 billion in a year, when the trading premium is 30 cents a gallon, it signals that there's more consumer surplus, more rent to be extracted from the American consumer by the global cartel.

And by the way, when the cartel raises its price, the oil companies profit too. Rich American consumers have disposable incomes that the oil companies and OPEC can tax. That is what you heard looking at those real disposable incomes. Now the real rub comes when *Wall Street Journal* reported a conversation with the CEO of Exxon. Exxon, quote, ExxonMobil Corp says, "it believes that by 2030, hybrid gasoline, and electric cars, and light trucks will account for nearly 30 percent of the newer vehicle sales in the U.S. and Canada. That surge is part of a broader shift toward fuel efficiency that Exxon thinks will cause fuel consumption by North American cars and light trucks to peak around 2020 and then start to fall."

"For that reason, we wouldn't build a grass root refinery in the U.S.," Rex Tillerson, Exxon's Chairman and Chief Executive said. Exxon has continued to expand the capacity of its existing refin-

eries. But a new refinery from scratch, Exxon believes would be bad for long term business. I would add, good for consumers.

Tillerson, in his annual report and the other companies call it capital discipline and with $50 billion of new money in his pocket, cash, and Treasury stock garnered in the last 5 years, over $50 billion, he can afford to wait. I call it, not capital discipline, but exploitation and suggest that consumers cannot wait for 14 years or 24 years for relief.

It's time to stop looking for collusion and manipulation and start reducing exploitation. The $20 plus billion extracted from consumers in increased domestic spread, over the last 11 months, could have built two million barrels per day of refinery capacity. That would eliminate the tightness in the refining sector. It could put billions of gallons of gasoline into a strategic product reserve that could provide the cushion we need to absorb these shocks. The industry won't do it. But there is legislation in Congress that would.

In the long run, the only way for the American consumer to escape from this miserable state is if we double the fuel efficiency of our vehicle fleet much more quickly than the oil industry anticipates, and back out a couple of million barrels of oil with alternatives.

A bill requiring reduction of 10 million barrels per day has been introduced in the Senate. It does not rely in any way, on the oil companies. Smart move. They're part of the problem, not the solution. There is one way that they might contribute, however. If you need some money to fund these programs, you can find it in the $100 billion of excess profit sitting in oil company treasuries, which their capital discipline does not allow them to put into expanding refinery capacity or increasing inventories. You have the means to fix this problem. You can find the resources. It's time, after 6 years of a roller coaster and a rachet, for Congress to take some aggressive serious steps to serve the American gasoline consumer.

Thank you.

[The prepared statement of Dr. Cooper follows:]

PREPARED STATEMENT OF DR. MARK COOPER, RESEARCH DIRECTOR, CONSUMER FEDERATION OF AMERICA (CFA)

Mr. Chairman and members of the Committee,

My name is Dr. Mark Cooper. I am Director of Research at the Consumer Federation of America (CFA). I appear today on behalf of CFA and Consumers Union. The Consumer Federation of America (CFA) is a non-profit association of 300 pro-consumer groups, which was founded in 1968 to advance the consumer interest through advocacy and education. Consumers Union is the independent, non-profit publisher of *Consumer Reports.*

I greatly appreciate the opportunity to appear before you today to discuss the problem of rising gasoline prices and supply conditions.

The Impact of Rising Gasoline Prices

The American consumer is reacting to $3.00 per gallon gasoline prices differently now than they did last fall when I testified before the Committee about record high prices. At that time, the immediate cause was obvious, the hurricanes in the Gulf. Although, I raised concerns that price increases were unjustified and reflected fundamental problems in the industry. Profits soared last year, affirming the suspicions by many that oil companies were exploiting severe market conditions.

Today's gasoline prices highlight fundamental problems in the industry—a lack of competition that enables oil companies to exploit a tight market that they have created and preserved through strategic underinvestment and mismanagement. The

prospect of sustained high prices at these levels is alarming to the average American household. If gas prices average $2.75 per gallon over the course of this year, the typical family household will experience an increase of well over $1,000 to their annual gasoline bill compared to the late 1990s.

Fundamental Flaws in Market Structure

We have been pointing out what is wrong with this market for 5 years. Record high prices and profits today reflect a six-year trend in rising gas prices for consumers. The oil industry attributes this trend to rising crude oil prices and a string of supply disruptions in the market. A closer look at the structure and function of the oil industry and the economic forces at work, reveals a market in which the forces of supply and demand are too weak to prevent abuse of consumers. I submit for the record our study from 2004, which discussed this history in great detail.

There is not sufficient competition on the supply-side to force producers to expand capacity and alleviate pressures on prices. Demand is so inelastic that, when prices are increased, consumers cannot cut back sufficiently. Having kept markets tight and eliminated competition, the oil companies can exploit any excuse to drive prices and profits up.

To better understand what is going on with gas prices, we must look back over the last decade and chronicle the mergers that swept through the industry eliminating competition and resulting in refinery closings and reductions in storage of product, coupled with the long term refusals to build new refineries. I need only read the names of the major oil companies to remind you of the results—ExxonMobil, Chevron Texaco, ConocoPhilips Tosco Unocal, BP Amoco Arco. There are four, where there used to be eleven. As a result of that merger wave, four out of the five regional refining markets and 47 out of 50 state wholesale gasoline markets are concentrated.

The antitrust authorities will say they have not colluded. They don't have to. The industry has become so concentrated, the capacity has become so restricted, the barriers to entry so large, and it is so difficult for Americans to cut back on demand (economists say demand is inelastic), in short market forces in this industry are so weak, that they do not have to collude to raise the price level. Each company acts individually and knows full well that its brethren will act in a parallel way.

The industry will tell you that existing refineries have expanded, but clearly not enough to build the spare capacity to put downward pressures on price. They choose to keep so little spare capacities that they cannot even do spring cleaning without price run ups. They do not fear running on short supply because there is little competition to steal their customers. The industry has gained market power over price by strategic underinvestment in refinery capacity, just as OPEC has set the conditions for increases in the global cost of crude by restricting the addition of production capacity.

Excess Profits

Last year the oil companies earned more income than in the 5-years between 1995 and 1999. More importantly, 4 of the 5 highest years for profit in the oil industry since the Arab oil embargo of 1973 have occurred in the past 6 years. I have submitted for the record our study of oil industry profits over the past two decades, which demonstrates over $100 billion of excess profits in the 2000 to 2005 period.* We arrived at that estimate by comparing the return on equity of the oil companies to the Standard and Poor's industrials. We corroborated it with an examination of the huge cash-flow that they enjoyed, which is not being reinvested in the industry, since net new investment was a small fraction of net income over the 2000–2005 period. Free cash-flow is piling up in huge masses of current assets and stock repurchases.

Crude prices have gone up and so has the domestic spread and refiner margins. Interestingly, the net income the large oil companies earn on their downstream operations—predominately refining but also marketing—in the U.S. has increased by almost $23 billion since 2002 compared to the increase in net income by the oil company's foreign downstream operations, which have gone up by only about $7 billion.

The most obvious indicator that market forces are working against consumers can be seen in the "Domestic Spread" over the past 6 years. The domestic spread is the difference between the refiner acquisition cost of crude oil and the pump price, net of taxes. When we subtract taxes and crude costs from the pump price, we isolate the share that domestic refining and marketing take in the final price. The bulk of this is for refining. In the first quarter of 2006, it was over 30 cents per gallon

*The information referred to is retained in Committee files and is available online at *www.consumersunion.org/profitscover.pdf.*

above the historic average. In April 2006, even before the dramatic price increases of April, it was about 40 cents per gallon higher than the average.

The evidence is quite clear that rapid consolidation within the industry has changed the market fundamentals and behavior patterns. They simply do not compete on price to increase market share. They do not worry about running out of product, because they know they can simply raise the price of gas. They closed refineries for business reasons and refuse to build new ones for business reasons.

Pulling Up the Price of Crude

This huge increase in domestic spread and refiner margins may have another effect. Things have gotten so bad in the U.S. gasoline market that even the Energy Information Administration, in its most recent report *This Week in Petroleum,* recognizes that the tight U.S. gasoline market may be "pulling up" the price of crude. After all, the U.S. is the largest single oil consumer in the world and the largest gasoline market by far, accounting for over a quarter of the world-wide total. When the domestic spread and refining profits go up, it signals that there is more consumer surplus—more rent—to be extracted from the American consumer.

In recent years the upward pressure on prices and the demonstration of more rent to be extracted has been reinforced by commodity markets. The *New York Times* recently (April 29, 2006) noted in an article headlined, "Trading Frenzy Adds to Jump in Price of Oil," that some analysts believe a huge increase in trading volume, volatility and risk are adding as much as 20 percent to the price of oil. That works out to about 30 cents per gallon. I have submitted for the record a report I prepared earlier this spring for four Mid-West Attorneys General on the impact of commodity market trading on natural gas prices.* Therein I describe in detail the same factors—a continual increase in volume, volatility and risk—that are affecting both the crude oil and natural gas markets.

Recommendations

There are no short-term solutions, but I must remind you that the American gasoline consumer has been afflicted by this market for 6 years. If we had started working on effective solutions 6 years ago, we could be well into the mid-term of a long-term policy shift. Policymakers are going to have to reform the fundamental structure of this industry and change the underlying dynamics.

To address short-term spikes in prices, we recommend:

- Increased oil industry revenue funneled back into expanding our refining capacity.
- 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.
- Setting requirements that guarantee an increase in refining and storage capacity to deal with the industry's failure to build capacity and keep adequate stocks on hand by creating strategic refinery and product reserves.
- Mechanisms that prevent pricing abuse in the energy markets including formation of a joint task force of Federal and state Attorneys General to monitor the structure, conduct and performance of gasoline markets, with an emphasis on unilateral actions that raise price.

To address long-term fundamental change to the supply-demand balance in this sector, we recommend:

- Accelerating the day when we will use less oil by setting aggressive, concrete targets for reducing America's oil consumption. Specifically, we need concrete steps for reducing fuel consumption through aggressive, targeted improvements to vehicle fuel efficiency standards.
- A national policy that promotes the research, production and use of biofuels.

Hopefully, the current round of price spikes will convince policymakers to take steps to build a better future for American consumers by addressing market who has forces that are working against the American people and for the interests of a few.

Again, thank you for the opportunity to appear before you today. I look forward to working with the Committee on policies that can solve the Nation's oil problem.

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*This report is retained in the Committee's files and is available at *http://illinoisattorneygeneral.gov/consumers/natural__gas__report.pdf.*

Senator INOUYE. Thank you very much, Dr. Cooper. And I will arbitrarily set aside 10 minutes per Senator. Senator Dorgan?

STATEMENT OF HON. BYRON L. DORGAN,
U.S. SENATOR FROM NORTH DAKOTA

Senator DORGAN. Mr. Chairman, thank you. I came intending to ask a lot of questions. I think I'll use a portion of my time, perhaps a major portion of it, responding and making a statement if I might.

Last evening, I read the Federal Trade Commission report and I don't even know where to begin. Obviously, I'm disappointed. I think this is an Agency that has lost its teeth—a toothless Federal Agency. It reminded me of the hearings that I chaired when I was chairing the Subcommittee in Commerce dealing with Enron and we were told, don't worry, be happy. This is the market system. The market system will correct all of this.

It turns out, the more we unzipped the innards of what was going on, we discovered it was the market system plus criminal behavior. And that criminal behavior bilked folks on the western part of this country out of perhaps $10 billion or more. And so, the market system—we keep hearing the market system. The fact is, the market system isn't working very well.

Chairman Majoras and the Federal Trade Commission took a look at this stream of energy issues and only looked downstream. Started at the refinery, looked downstream, forgot to look upstream, didn't look at the oil industry, you only looked at half of the body of water here. You looked at refinery and downstream, you didn't look upstream.

And let me just describe how this all starts. One, OPEC Ministers sit in a room with the door closed and decide how much they're going to produce and how they want to affect price. Two, the oil companies, now with multiple names—you know they've all merged. The oil companies are bigger and stronger from blockbuster mergers and have more raw muscle in the marketplace. And three, the future's market has become an orgy of speculation. And those are the three elements that have a profound influence on the price of oil and gasoline.

And I would just commit again, that the Federal Trade Commission missed the entire upstream portion of it. Exxon has been mentioned here. Dr. Cooper, you mentioned ExxonMobil. Again, two names. Exxon and Mobil decided to get married and so, it's ExxonMobil. Exxon Mobil—$36.1 billion in profits last year. It was announced recently that their departed CEO has a retirement package of about $400 million. People say, well that's justifiable. Look at how well the company has done. Yes, well the company has done that well because of these enormous profits. The question is, did anybody do anything, for example, when in 2004 the average price of a barrel of oil was $40 and it's now $70, did anybody who was running Exxon do anything to affect that? No. They just rode the wave and got lots of money.

Exxon—$36.1 billion. What's it doing with that money? About a third of it is being used to buy back their stock. That's not finding additional energy supplies. Another portion of it is being used to, as Business Week described in the *Business Week* magazine: Drill

For Oil on Wall Street. There are no seismic crews looking for oil on Wall Street. There's no oil on Wall Street. Drilling for oil on Wall Street is simply trying to search for additional opportunities for mergers and greater concentration, which is antithetical to the interest of the American consumer.

So people say, well the oil industry is justified with its income, because it's going to use it to sink back into the ground to find additional supplies. Expand supply and therefore, reduce price or build additional refineries.

Take a look at what the major companies are doing with these profits. Just take a good hard look and then ask yourself whether it's in their interest to do things that bring down the price of a barrel of oil? It is not in their interest, at this point, they're making out just fine, thanks. But all the gain is on the side of the major oil companies. All of the pain is on the side of the American consumers and so, we will have people come to our tables again and say, do nothing. Be happy, the market system will work just fine. Well the fact is, the arteries of the free market system are plugged. When the arteries are clogged and plugged, the system doesn't work.

Now, I want to ask just two questions in the time I have remaining and then make a couple of other comments. Number one, Chairman Majoras, why did you not look upstream? You indicated that the price of oil has a significant impact on the price of gasoline. You also talked about Hurricane Katrina having some impact and I agree, it did. But that impact was relatively short lived and the price of gasoline is now around $3. And the price of gasoline before Katrina even formed in the Gulf, was very high. So, if oil had a significant part of this, why did you not look upstream rather than just prefer to look downstream?

Ms. MAJORAS. Thank you, Senator Dorgan. The reason that we decided to look from the refinery level down, is because we were asked to look at manipulation and we were asked to look at gouging. We know a lot about this industry and it's currently structured today. As you put it, the crude oil production is heavily, heavily influenced by OPEC and OPEC setting the price of a barrel of oil, and we already know that.

But what we also know is, that the crude oil production side of this is highly unconcentrated. The HHI, which is the measure we use for concentrated markets, is in the 100s. It is really. And even the large companies of the U.S. combined, have a very small percentage of crude oil production. Countries like Russia, countries in the Middle East, and so forth control much more, even individually, of the supply than do the large oil companies. So having 6 months to look at an entire industry and looking at where we thought manipulation would be most likely to be found would be where supply is tighter, we started with refinery level and went down.

Senator DORGAN. Let me ask a question about the crude oil stocks if I might. It's interesting to me, we have all of this discussion about the market system, you know the markets. And I use to teach economics, I think the free market system is the best allocator of goods and services, by far, that I'm aware of. But it needs a referee. Occasionally the free market system doesn't work.

Judge Judy on TV, a somewhat out of sorts television judge, makes $25 million and the Chief Justice of the Supreme Court makes what—$180,000? The market system? I guess, but sometimes there are bizarre results from the market system. Or, a third baseman in baseball makes the equivalent of 1,000 high school teachers. You know the market system. But, you need a referee. Especially with something that is as important to all Americans, like the price of gasoline and the price of oil, that you need a market system that works with a referee that's looking over their shoulders.

My feeling is we have completely toothless tigers these days in terms of regulation. But crude oil stocks a year ago, May of 2005, 334 million barrels, this is the crude oil stocks that are referenced week by week, 334 million barrels a year ago, 346 million barrels now. That is May 12, 2006. And as you look at the pattern of crude oil stocks increasing, if the market system works, why would you not see a decrease in the price of gasoline?

Dr. BEHRAVESH. Would you like me to answer that question?

Senator DORGAN. That would be fine, Doctor.

Dr. BEHRAVESH. I think there are a couple of factors going on here. One is, that even with those stocks, demand has been growing very strongly in the U.S. and China. But in addition to that, so you've got the market fundamentals——

Senator DORGAN. But there's no shortage.

Dr. BEHRAVESH. I understand that, Senator. The market still, is quite tight. If you look at those stocks as a percent of overall demand, they're very small. And on top of that, you've had what some people refer to as the fear factor, mainly concerns about not just hurricanes, but the events in Iran, the events in Iraq, and Nigeria, and Venezuela, a variety of factors that have created uncertainty and jitters in the market.

So in that sense, you're right that the inventory situation isn't being fully priced in. But I think it's being offset to some extent, by some of these worries in the marketplace.

Senator DORGAN. So you see? But you understand what I'm saying, I look at carryover stocks or rather, the crude oil stocks and I say, they're up almost 10 million barrels from a year ago and the price of gasoline goes up, up, up. You know, we went down to $2 a gallon post-Katrina. Now, we're up around $3 a gallon, continuing to go up and the crude oil stocks are up. It seems to me, the market doesn't work for the American people very well in this circumstance. Would you agree?

Mr. Raymond was before us some while ago and he told us how wonderful things were. I guess from his vantage point, things were going pretty well. Would you agree that it's in his interest and his company's interest to continue to see robust pricing?

Dr. BEHRAVESH. I won't pass judgment on that, Senator.

Senator DORGAN. Well, let me agree with my own assertion then. The fact is, his compensation depended on it. His company's stock price depended on it. And so, they don't have any interest in making this work. Dr. Cooper?

Dr. COOPER. I wanted to add one point, because you heard about the boom in commodities starting about 3 years ago. And you heard about the fear factor. Now, fear—that fear factor plays out in those

commodity markets, right? If you look at that commodity market, the regulated exchanges, we don't know what goes on in the unregulated over the counter market. We don't have authority to oversee that. There's legislation before this body that might do that.

The increase in the number of dollars chasing the same amount of crude oil has been phenomenal. Almost a tenfold increase every month, $7 or $8 billion or more comes into that commodity market, chasing the same quantity of physical goods.

If you're an economics professor, you know the definition of inflation. The first one you teach, is too much money chasing too few goods. There's a lot of cash that is constantly swung into that market that constantly extends the long positions and drives up the price, creates volatility which makes it harder, as you heard, for people to part with those commodities. They might as well sell it tomorrow and when you're sitting on $50 billion in cash, there's no hurry to sell it. You have that process going on.

Senator DORGAN. Mr. Chairman, one observation, I don't want this fear factor thing to get around. Fear Factor is sort of a questionable television show that pays people to eat maggots and that sort of thing. You've all seen that television program "Fear Factor" here, cannot be explained, it seems to me to short circuit a market system that hurts consumers and helps the oil industry. That is not a satisfactory explanation for me.

Dr. BEHRAVESH. Mr. Chairman, can I just respond? I completely agree with you, Senator Dorgan. My only response was that they're offsetting factors here. I don't use the Fear Factor to explain what's gone on in the last 3 years. It plays a role on a temporary basis in markets. But, it does play a role. That's really the only point I'm making.

In terms of the commodities markets, I think certainly there has been some speculation. Speculators may have played a role, not just in oil markets, but in copper markets, in steel markets, etc. But again, sustained price rises are driven by the fundamentals of demand and supply, where demand worldwide for oil and other commodities has been rising very rapidly in the last 3 years.

Senator INOUYE. Thank you. Senator Lott?

STATEMENT OF HON. TRENT LOTT,
U.S. SENATOR FROM MISSISSIPPI

Senator LOTT. Thank you very much. I appreciate you allowing me to go next, even though under the pure early bird procedure, I'd be a little bit later on. But just on behalf of Senator Stevens, who did have to go to an urgent meeting at the White House, thank you all for being here.

I found your testimony certainly, very interesting. Let me ask a few questions, first. Madam Chairman, I'm interested in the FTC's role in monitoring pricing and I'd be specifically interested in how you think Federal laws on price gouging would affect the marketplace?

Ms. MAJORAS. OK. Thank you, Senator Lott. A couple of years ago, the FTC began a system in which we monitor weekly prices, weekly average retail prices in 360 cities across the United States and also, I think it's about 30 wholesale markets across the United

States. So, we are monitoring prices on an ongoing basis. And if we see something anomalous, something that's a price spike, or something that's not seeming to stay with the average, we take a look to find out what has happened. And that might give us an indicator whether there might be anti-competitive conduct going on, which we could then further investigate under an antitrust investigation. So, that's one way that we're monitoring prices.

In terms of your question on price gauging, Senator, I can assure that we have been very concerned about consumers who are suffering great hardship from these prices, certainly who did after an emergency like the hurricanes last fall, without question.

Our concern about price gouging legislation though, has been the following, if—and this was confirmed by our investigation, where we actually went out and we talked to retailers. If we have such a thing in place, and it is enforced vigorously, and by that I mean so that all retailers or refiners and the like, would really have to take this into account in their pricing. And they can't—they would then be very worried about raising the price in response to an emergency when supply is very, very low. And we often talk about price——

Senator LOTT. That's bad?

Ms. MAJORAS. It's bad for the following reason and we learned this in the 1970s, because price is not just a factor of cost. It's also a regulator of supply and demand. And when supply is tight, if you don't raise the price, you just simply run out of gasoline. And that is exactly what these retailers told us.

Many of them did not know when their next supply was coming in, did not know if they were going to run out of gasoline. What they knew, was that consumers were coming in and topping off their tanks and worrying about this. And so, they raised the price in an effort to try to temper that demand, so that they wouldn't run out of gasoline.

Senator LOTT. I don't believe that was always the motivation. Let me go to a second question here, 26 states I believe or thereabouts, have price gouging laws. Sixteen have taken some sort of action in this regard. Do you know, or have any statistics on that? What has been the number and the success rate, and has it really been aimed at oil companies, service station owners, distributors? Where are they seeming to indicate that maybe there is concern, if not a real problem?

Ms. MAJORAS. Well, we talked to state attorneys general over time, they have applied them, as I understand it, to other products. For example, I think recently, generators. But what we looked at for purposes of this study, was we looked at what they did in reaction to the prices after the hurricanes last fall. And what we found was that 9 states brought a total of 99 cases against price gouging.

Senator LOTT. I presume a lot of them are still pending?

Ms. MAJORAS. Some of them are still pending.

Senator LOTT. Were they across the board in terms of was it against the service station owners, or operators, or distributors, oil companies? Against whom?

Ms. MAJORAS. These were primarily against retailers and I believe a few against wholesalers. Most of them have been settled, as

I understand it. None have been litigated to a result. Some are still pending.

Senator LOTT. Doctor, thank you very much for being here. You mentioned something there, in the last part of your comments about the speculators. There is a feeling in the industry that a lot of this price increase has been by outrageous speculators just driving up the price for their own financial benefit. Is there something—there is no reason to ask you if that's true. I'm convinced it is. So, you couldn't affect my thinking one way or the other.

The question is, is there something we should do in that area? Should we have greater oversight? You know, the stock market when they have some kind of a blowout, they have some ceiling. They stop it. Is there something we should do there?

Dr. BEHRAVESH. That's a very good question, Senator Lott. I think what happens is, that often in these situations—it happened in the stock market, to some extent it's happened in the housing market, now it's happening in the commodities markets—toward the end of that boom, speculators jump onboard and push prices up even more. We saw it, as I said, in the stock market, the housing market, we've seen it recently in the commodities market.

How do you regulate that? I think it's very tough.

Senator LOTT. Does somebody in the government oversee that?

Dr. BEHRAVESH. As far as I know, the CFTC has some regulations.

Senator LOTT. Do they have some jurisdiction? I would like to get some information about, do we need to strengthen their hand in this area?

Dr. BEHRAVESH. That's certainly something worth looking at. But I think that this froth, in the market for commodities has been a factor. It's very important to say, that it's not just oil. But the commodities markets in general.

Senator LOTT. Anything that you could provide to me later, in maybe looking at how we could maybe have oversight, a little more action in that area. I'd be interested in your professional opinion.

Dr. BEHRAVESH. We'd be happy to do that.

Senator LOTT. Mr. Slaughter, I recently was meeting with a representative of a major oil producing company, giving him a hard time for not putting more oil into the market and sending it to the United States. He said, it wouldn't do any good. You couldn't refine it anyway. Now when I talked to refining people, I said, why would we build more refineries?

Well you know, we ought to be having a hearing at some point on what Congress has not done, or what Congress has done wrong over the last 30 years, that's gotten us into the fix we are in. Because I think we are a huge part of the problem. Now these statistics, you give 8 percent increase to maybe—baloney. We need more modern refining capacity. But we haven't had it. Why?

Well first of all, they say, well you can't make enough money in refining. But I think a lot of it's us, the law. I mean, there were taxes, permitting, processes, paperwork, environmental considerations, 25 percent of the cost of a new refinery is caused by all the crap you have to go through to build one. Now I think we need additional refining capacity. Do we?

Mr. SLAUGHTER. Yes. We do, Senator.

Senator LOTT. Well, what can we do to get it?

Mr. SLAUGHTER. Well, you've made a number of the important points. We would welcome the hearing that you're talking about, because we do believe that significant costs have been added to the building of new refineries or even expansion of existing capacity by Federal law, environmental requirements, zoning requirements, and in many instances NIMBY reactions. And we think Congress should focus on encouraging expansion in the refinery industry.

As part of the EPACT bill, there is one provision that does encourage expansion of refineries through some expensing provisions of the cost of the expansion for few years. But there's an endemic problem here. Now, the industry has been adding capacity. You know, the industry has added the equivalent of one refinery a year, for the last 10 years. ExxonMobil itself, has added the equivalent of 1 every 3 years.

Senator LOTT. When was the last time we had a new refinery built in America?

Mr. SLAUGHTER. No new refineries have been built in the U.S. since 1976. But the capacity has been increased several times, Senator. There's no difference between the capacity in an extension, and a capacity in a new refinery, except you get it faster and you get product out of it faster.

Senator LOTT. I just get so fired up about this whole area. Maybe there are not a lot of cases of price gouging. I think maybe Dr. Cooper's word exploitation is more accurate. Clearly, some of the things that have happened after the hurricane are absolutely outrageous and indefensible.

I believe the collective judgment of American people and in my state included, was much wiser than the collective judgment of the people in this room. They know when something is not quite right. They get an instinctive feeling and the justification for what has gone on in gasoline prices and staying up there, is very hard to explain.

I don't know if I've got enough time, but I've been very curious about the rise in the price of diesel fuel, for instance. Why is that? It used to be a lot cheaper than gasoline. Now all of a sudden, it's right up there and that also isn't moving, they say. Is it because we're refining a lot of it in the Gulf Region and some of the refiners have not gotten back online? There's something really fishy here. And when diesel prices go up in 1 week, after the hurricane, 50 cents a gallon. And what's curious to me, is how?

You know market systems. I know all about supply and demand. I took Basic 101 Economics when I was in college. It's used as a cover to defend bad conduct, in my opinion, in a lot of instances. When they jump up instantly, the price of a barrel of oil goes up $5 dollars in a day and boom—the price of gasoline at the pump goes up five cents a gallon that day. Now, I know it takes time to work through the market here and how about the companies just taking a little less profit while these anomalies work themselves out? Instead, there's been explosion right across the board.

My message to all of you, and to the oil companies in particular, I don't want to do something crazy. I voted against every regulatory effort in this area for 30 years. But the American people are

agitated about this and there better be some restraint shown, or the consequences are not going to be pretty.

Do you want to respond Mr. Slaughter?

Mr. SLAUGHTER. I just want to say particularly on diesel, there's a worldwide explosion in diesel demand. All over the world, there are no imports available. Largely, no imports available of diesel after Katrina or any other time. The higher prices after Katrina brought in a record number of gasoline imports. That took care of the supply problem on the gasoline side. In diesel, that's a much harder equation, because the imports are just largely not available, sir.

Senator INOUYE. Thank you very much. Senator Pryor?

STATEMENT OF HON. MARK PRYOR, U.S. SENATOR FROM ARKANSAS

Senator PRYOR. Thank you, Mr. Chairman. I ask that my statement be placed in the record.

[The prepared statement of Senator Pryor follows:]

PREPARED STATEMENT OF HON. MARK PRYOR, U.S. SENATOR FROM ARKANSAS

Throughout my career in public service, I have always believed that a lot of consumer protection has been about protecting the little guy—the person who doesn't have the resources to stand up to large companies who would try to take advantage of him.

There is undoubtedly a large consumer protection aspect to the job of the FTC—price gouging is a good example of the little guy versus the big corporation.

There is nothing a person can do to take reasonable steps to protect himself from abuses by members of the oil and gas industry, should they choose to abuse the market. The government has to do it for them. We have to look out for the little guy in this case.

From what I can read in the recommendations of the FTC's price gouging report, the Commissioners don't necessarily believe in this same type of consumer protection philosophy. It seems they don't believe that the government has any role in protecting consumers from massive run ups at the pump, even during times of emergency.

You can probably imagine how this notion that consumers should react to massive price spikes in gas markets by buying less gas doesn't sit well with my constituents.

We have all been working very hard on the demand side of this equation—I, Senator Cantwell, and other Members of this Committee have worked very hard to find ways to conserve and find alternative sources of energy to provide some relief from high gas prices. Just last week I introduced bipartisan legislation with Senator Lott that would raise and reform CAFE standards.

But that doesn't mean we absolve ourselves of all responsibility to make sure consumers are treated fairly now.

In Washington, D.C., you can take the Metro or ride the bus, but if you've ever been to Arkansas, you would know that we don't have a metro. Outside of the larger cities, we don't have many buses.

Consumers don't have a choice. They have to buy gas. They have to buy gas to get to work. They have to buy gas to pick up their kids after work. They have to buy gas to run their farms. They have to buy gas to get their products to market. They can't wait for prices to go down and drive less in the meantime.

They don't feel like they are getting a fair shake, and I tend to agree with them.

The oil and gas industry is very different than other manufacturing industries, and I don't feel that competition in the oil and gas industry has the same pricing effects as competition in other industries.

In most other industries, consumers have many choices. They can choose between many brands based on quality, price, looks, etc. Or they can choose not to purchase a product if the price is too high or the product is not a necessity.

In the oil industry, consumers do not have these choices. The distinctions between buying gas at Exxon and the Corner Pantry are little and often not distinguishable. Similarly, consumers do not have the choice to not buy gas.

Competition within the industry does not appear to put the same downward pressure on prices as in other industries. In other industries, consumers can choose not to buy the product. In doing so, they force companies to bring down their prices.

In this case, the only recourse consumers have is government action—they cannot choose to not buy the product, and are forced to buy the product at whatever price the industry determines.

This is unacceptable, and I am committed to finding both short term and long term solutions to this problem.

I thank the witnesses for appearing this morning and look forward to hearing their testimony. Thank you, Mr. Chairman.

Senator PRYOR. Let me first say a huge thank you to the Federal Trade Commission's professional staff. I know there are 3 or 4 of them here in the room and I know they worked a lot of hours on this and had about 6 months to do this. And I know they were very diligent. And so, I appreciate them. And I know even last night, around midnight, we got an email from one of them. So, I know they've been burning the midnight oil to try to get this report to us. And so, I want to thank them for that.

Chairwoman Majoras, let me start with you if I may. And I want to just ask about competition in the oil industry. The way I perceive the oil industry is it's different than most other industries. Oil, gasoline for consumers is a necessity. We don't have a choice on whether we're going to buy it or not. We pretty much have to buy it. And I think that our consumers in Arkansas really feel the pinch, just like Senator Lott said a few moments ago.

It's very, very hard for people to fill up their tank and pay about $3 a gallon and then open the business page and see the extraordinary profits the industry is making, what they're paying existing CEOs, et cetera, et cetera. It's very, very hard for people to swallow that.

The other thing about the oil industry, which is very unusual in my view, is that what we've seen in the last year or two, is that as the cost of the raw materials have increased, we've seen the industry's profits multiply. And that's very unusual. I'm not aware of any other industry where you see that. In most industries I'm aware of, when you see the raw materials increase, you see their profit margins decrease because it's a competitive marketplace and they're all feeling the competition.

So, what other industry behaves like the oil industry? Is there a similar industry out there, that you are aware of, that where the raw materials cost increases, that their profits multiply?

Ms. MAJORAS. Well I think, Senator Pryor, that it depends. There are some industries that do act like the oil industry at various parts of the chain. So for example, right now while we're seeing increased global prices for barrels of oil, which of course is a commodity, we're similarly seeing it in things like timber. Because the same countries like China and India, who are developing so quickly and using more oil, are also using more timber. So in some ways, it's reacting that way.

But there's no question, Senator, that particularly given that we have the OPEC cartel at the production end and they're setting the price, not necessarily based on the cost of extracting that oil out of the earth, they're setting it based on a lot of other factors. Nobody knows everything they do. So if their costs aren't going up,

but they're going up to $72 or $73 a barrel, then yes. You will see a profit increase without question.

Senator PRYOR. Well there again, you mentioned timber. And if you follow the timber industry and I don't know if you do, we have quite a bit of timber in Arkansas. What you're seeing is a lot of timber companies having to sell off their lands. For example, I think Weyerhaeuser just went through a divestiture of their lands around the country and again, there are a lot of economic reasons for that. But nonetheless, you don't see as timber costs increased, again of raw material, you don't see their profits just going through the roof.

And here again, it is very puzzling to me and to most Americans of why this phenomenon is happening. Why are they so incredibly profitable right now? I mean, I think we know. We are paying $3 a gallon. But we feel that because we're paying so much at the pump, they're just basically profiteering off a bad situation.

Ms. MAJORAS. I certainly do understand that, very much so. And I, too, have talked to a lot of consumers, sir, and understand what everyone is feeling. Most of the profit is being made at the crude oil production end. And as I said, that's OPEC setting the price and that's what a price——

Senator PRYOR. But that's not—I don't know if that's true. Maybe it is, you know. Are you saying that for—not to pick on one company. I mean, everybody wants to pick on Exxon. I'll just use it as an example, just because they've been in the news recently, but their profits are more than any company in the history of the world. Are you saying they profit there, as the crude oil comes out of the ground? Exxon profits right there?

Ms. MAJORAS. Sure. Because they charge the same price for a barrel of oil.

Senator PRYOR. OK.

Ms. MAJORAS. So, yes. They do. Most of their profit is coming from that end.

Senator PRYOR. OK.

Ms. MAJORAS. There are refining profits that have gone up over the last year, or so. And so, they are now making more profit also at the refining end than they have made in the past.

Senator PRYOR. All right. Well I have a concern that competition in the oil industry does not provide a sufficient price regulator like it does in most industries. In most industries where there is a competitive market price, the competition serves to keep the price low. And my sense is, it's not doing that in the oil industry.

Let me ask you a question now on a phrase that's in the report, throughout the report, and it is an "economically rational manner." You used that phrase basically to say, that these companies are acting in an economically rational manner. In your view, is that phrase—is that a synonym for you saying that the companies are doing nothing wrong?

Ms. MAJORAS. Well, it is not a legal term. It is not a legal phrase, sir. It is more of an economic term. But when we're looking to see whether the antitrust laws have been violated and to see whether there has been anti-competitive conduct going on, we do look at anti-competitive as the opposite of competitive, so we do look at

what we would expect to see in a competitive market. And that's where this economic phrase comes from and why we use it.

Senator PRYOR. Because I think you and I may be on the same page now that I hear that economically rational manner, that's one thing you look at. But certainly, there have been many, many instances in years past, where the Federal Government has stepped in to make sure that this economically rational behavior by companies doesn't hurt the public. For example, child labor laws, safety and health regulations, environmental protection regulations. So I think there is room there. Even if in your view, they are working in an economically rational manner, there may still be room there for the Federal Government to step in and do some good for the American public.

The other thing that I would ask you about, is in your report here and in your recommendations section, it really comes through that when you talk about price gouging statutes, you almost equate that with price controls. And I'm not aware of anybody that I know of, who's talking really about price controls. I think when people talk about price gouging statutes, what they're talking about is they mention some other state laws. Arkansas has a law right now on the books, where once an emergency is declared by the Governor and by the President, our statute kicks in. And basically, you can't increase certain things. You mentioned generators a few moments ago. That's one thing. But gasoline prices, et cetera are included and I used that when I was the Attorney General of my state on 9/11. And quite frankly, I think we used it very effectively and what it did, is overnight, it created a deterrent effect. It wasn't price controls.

In fact, we went after a number of gas stations in the state and with the vast majority of them, we looked at them and they could justify what they did and we said, fine. You can justify it. There was a small number. I've forgotten, 10–12, I don't remember how many that we felt like were price gouging by the definition of our statute.

So, are you just philosophically opposed to a price gouging statute? I guess that's what I'm hearing from you. You testified in the Committee a few months ago, you said you didn't like price gouging statutes. Here, you pretty much say that. Where are you on price gouging statutes?

Ms. MAJORAS. Well it's not just me, it's the career staff which I appreciate you applauding, Senator. Because, they have done a superb job on this, and it's just about every commentator who's written on this subject too, I've seen in the last several months.

The reason it can act as a price control, is because folks can't necessarily say how much they can raise the price. Senator Pryor——

Senator PRYOR. But you may want a price control in some circumstances, maybe.

Ms. MAJORAS. You might. Although, if you look at what happened in Hurricane Katrina, the fact that the price went up meant that supply was suddenly brought into the United States in droves. Supply from Europe and from other places, that meant the price came down faster than it probably would have.

But in addition, sir, we're talking at the retail level. And we went out and we saw this. We're talking about people in little glass booths who sell gum and candy and don't have an accountant or an economist. The folks that we found who met the price gouging definition were all independents—were all independent stations. Many of them didn't even speak good English. They didn't have records. They kept their records handwritten. So to say that we're going to say to them, you've got to get this price exactly right, or you might go to jail for it. That's where I'm worried about such a thing.

Senator PRYOR. Well, I understand. Let me say this about the retailer, by the way, the local retailer in gasoline is kind of like the local pharmacist. He has a huge amount of cost that he has to pay to get his product to market and we certainly want them to make a fair profit when they sell things. So I think here, like in pharmaceuticals, the problem is up the chain. It is not with the local retailer.

Senator INOUYE. Thank you very much. I wish to advise the audience here, that there's a vote at this moment. However, Senator Smith would like to conduct his questioning.

STATEMENT OF HON. GORDON H. SMITH,
U.S. SENATOR FROM OREGON

Senator SMITH. Thank you, Mr. Chairman. I would be happy to stay if you want to go vote and I'll just vote later. And as others come back, they can take over.

Senator INOUYE. The hearing will be resumed in 15 minutes, but go ahead.

Senator SMITH. Deborah, thank you for being here. Thank you for your work. In your report, which I have here, it states that the Commission cannot say—and I quote here, "the Commission cannot say that the Federal price gouging legislation would produce a net benefit for consumers." And yet, as I understand it, almost 100 price gouging cases have been settled by the states. It's hard for me to reconcile those two things: what the states have found and what this report asserts.

Ms. MAJORAS. Well, the states obviously applied their statutes, which have been passed and those legislatures have made a policy decision about what they would like to do. But the concerns that we have expressed about a Federal price gouging statute are as follows: if retailers believe that this—that a statute is passed in which they could go to prison for raising their price too high during a time when they don't even know when they're getting their next tank of supply, they don't know what it's going to cost them, and therefore, how much money they're going to need to pay for it, consumers are coming in droves to fill up their tanks. So, demand is still high. They take into account all of these factors.

So what they might decide to do instead and which some of them did after Katrina, is just let the gas run out at the current price, not raise the price at all, and just shutdown for a week when the gasoline runs out.

The other thing we're concerned about is, and if you read chapter 5, Senator Smith, which shows what happened after Katrina, the price went up and that signaled to the rest of the market to do a

couple of things. It signaled to refiners who had any excess capacity whatsoever, to produce more gasoline, get it to the places that needed it, and that also signaled to imports outside the United States. Suddenly, imports were all coming in from Europe, because the price was high. We don't want that effect to be taken away, because that actually turned out to be the best for consumers in the long run.

Senator SMITH. But do the states have a different standard for price gouging? Is it collusion or is it something different?

Ms. MAJORAS. The standards vary. Most of them require a state of emergency to be declared. Some of them have a system above some measure of cost. Some, I believe, some allow market conditions to be taken into account and that, above all else, is what I would advise you, Senator. If this body moves forward with legislation and that is to make sure that we can take into account the market factors.

Senator SMITH. Independent gasoline retailers in Oregon right now, are paying 30 to 40 cents a gallon more for unbranded gasoline than others are paying for branded gasoline. They're also having trouble getting enough supply, even with those increased prices. Is the FTC investigating whether large oil companies are using current market conditions to drive independents out of business?

Ms. MAJORAS. Well, we certainly are starting to now take a look at what's been going on in the last few months with prices and why they're so high. One of the reasons that we've seen the independents basically—and we saw it after Katrina, Senator Smith. Normally, the independents can charge lower prices than the brands, but after Katrina it was flipped and they had higher prices. And we looked to see why that was the case.

And the reason that was the case, is because when supply is tight, it's true that the branded companies supply their own stations first. And the independents who rely more on the sort of spot market, they had to wait for theirs. And their supply is not as assured and they don't have the same type of long term contracts.

So obviously, in this current investigation, if we see evidence of anti-competitive conduct just to push competitors out of the market place, we absolutely will take a very close examination of that.

Senator SMITH. I think that is very important. At least it is in the State of Oregon. So, I would appreciate it, if you looked at that. Can you tell me, are there regions of the country that the FTC found to be the most problematic? Are some more difficult than others?

Ms. MAJORAS. Do you mean after the hurricane, Senator Smith?

Senator SMITH. Just in this current cycle we're in.

Ms. MAJORAS. Basically gasoline, as you may know the country, for purposes of gasoline is divided into Petroleum Administration for Defense Districts (PADDs) and there are five and gasoline in PAD District IV, which is the Rocky Mountain Region and V, which is the West Coast, tend to have higher prices than the rest of the country. After Katrina, we saw very high prices in the Northeast because of how heavily dependent the Northeast is on crude oil and refined gasoline coming from the Gulf and because pipelines were damaged, that couldn't get to the Northeast. And demand in North-

east is very high. So during the hurricane, we saw it. But, yes, there are—different regions have different constraints, different taxes, different types of gasoline they have to use. So, there is variance in the regions.

Senator SMITH. Mr. Slaughter, I found it very distressing, the quote that Dr. Cooper used about the Chairman of ExxonMobil, as recorded in the *Wall Street Journal,* that not withstanding all the money they're making, that it is still insufficient to invest in refineries. That is clearly a bottleneck that is creating much of the distress that is going on now.

And Senator Lott talked about many of the regulatory impediments to putting up refineries, but this quote astounded me. Can you comment on that?

Mr. SLAUGHTER. Thank you, Senator, for giving me the opportunity to correct the record on that. ExxonMobil is the largest refiner in the world. They have more refining capacity throughout the world than any other refiner. That company itself, has added the equivalent of one new refinery every 3 years for the past 10 years.

The comment was simply that that particular company feels that it is less economic to build a new refinery than to add the same amount of capacity at an existing refinery site, which makes a lot of sense because you need a lower rate of return at an existing refinery site. You can have that capacity up in 3 years and consumers can be benefiting from the additional product.

If you try to build a new refinery in this environment—we discussed a little bit of this with Senator Lott—it could take at least 10 years. And at that point, you don't even know that you can perhaps, not even break ground. That's happened to the one refinery project that exists now in the U.S. for a new refinery in Arizona. So why should consumers have to wait 15 years, when expansions at existing sites can provide consumers with new product in 3 or 4?

Senator SMITH. And are they expanding existing sites?

Mr. SLAUGHTER. Yes, sir. They are expanding existing sites. Secretary Bodman the other day, said the total expansions in the U.S., he thinks are going to be 2 million barrels a day. That's a 12 percent increase in U.S. refining capacity in the next 3 to 4 years. Those are capacity extensions at existing sites.

Senator SMITH. So, he was not saying he wouldn't do anything?

Mr. SLAUGHTER. No, sir. They're major investors in refining.

Senator SMITH. Dr. Cooper, do you have a comment on that?

Dr. COOPER. This is not a zero sum choice. You can actually do both things if you felt pressed by competition to keep the customers. So over the last 5 years, while they have had this massive increase in profits, the net investment in domestic U.S. refining for ExxonMobil has been almost dead flat. If you look at the balance sheet of their net investment in plant, and refineries, it has been dead flat. They spent less than 1 percent of their net income expanding refinery capacity in the U.S. If they felt pressed by competition to have excess capacity so they wouldn't run short, they would actually spend a lot more on refineries. The zero sum came between building a new one and expanding an old one and is destined to keep us in a very, very tight situation.

Senator SMITH. Dr. Cooper, have we seen a significant margin spread between the price of crude and the fine product in the last year?

Dr. COOPER. Absolutely. We sit here today, the spread is probably 20 or 30 cents a gallon more than it was last year.

Senator SMITH. Is that driven by speculators or just by corporate decisions?

Dr. COOPER. That's the difference between the pump price and the refiner acquisition cost. The domestic spread, it's called, has been increasing steadily for the last 3 years. So certainly, crude prices have gone up, but that domestic spread has increased dramatically.

Senator SMITH. Mr. Slaughter, do you have a comment?

Mr. SLAUGHTER. Senator Smith, I just would point out the fact that over the last 15 years, there have been roughly two to three good years for refining return on investment in the United States. Two of them happened to have been the last two. The return on refining investment for the previous decade was 5 percent to 6 percent, which is only slightly better than you can get on a Treasury Note, with a lot of risk, and billions of dollars each year in new investment requirements, and environmental improvements.

The Congress and EPA have basically told the industry, that it should be spending money over the last 10 years in environmental improvements and that has somewhat crowded out money that might otherwise have been spent on capacity additions. We've spent billions of dollars in this decade. The refining industry will spend $20 billion on environmental projects. And at the same time, the good news is, they will add significant capacity this time.

Senator SMITH. Mr. Slaughter or Dr. Slaughter?

Mr. SLAUGHTER. Mister.

Senator SMITH. How many gallons of gasoline do refiners get out of a barrel?

Mr. SLAUGHTER. Forty-two. Well actually, of gasoline it's about half. There are 42 gallons in a barrel and the usual gasoline yield is between 47 and 50 percent at the average refinery.

Senator SMITH. Are there other products extracted from that?

Mr. SLAUGHTER. Yes, sir. About 23 percent is diesel and middle distillates.

Senator SMITH. What is the value, per barrel, of these other products? Have they gone up disproportionately to gasoline? How do they track that? That is what I want to know.

Mr. SLAUGHTER. The greatest indicator of product prices is always crude price, because the demand for our products is inelastic. That was the answer to Senator Pryor's question. The demand for our products is inelastic. So when the cost of our raw materials go up, people buy the products anyway and the profits go up. But, diesel has become a very popular product worldwide and diesel prices, for a lot of the last year, were running higher than gasoline prices. Europe has gone to diesel essentially, to drive light duty vehicles and passenger cars and they have tremendous demand for diesel there, as do many developing economies. One of the problems in the diesel market in the U.S., is that we're changing our specs to very aggressive environmental specs, which will make it even more

difficult to get imports of diesel into this country. So you've got to remember, sir, that return on all these products——

Senator SMITH. Are all the products that come from a barrel of crude tracking together or are some spiking more than others?

Mr. SLAUGHTER. Each has its own curve that it follows. Diesel and gasoline have had the highest return recently.

Senator SMITH. Deborah, if the price of crude is the reason why this is all happening, I believe you testified today that your report specifically did not consider collusion or price fixing upstream, because you said that is so uncontrollable. It's international issues, it is Russia, it's the Middle East, it's Africa, it's all over the place. You don't even have the authority to track that, do you?

Ms. MAJORAS. Well first of all, but for the fact that there is a cartel at that level, called OPEC, which, no, I can't do anything about. We certainly can take action against any private company at any place in the chain who is behaving anticompetitively if they do business in the United States and are harming our consumers. And we have in the past and we will continue to do it if that's the case. It's just that when we were looking at manipulation and gouging and we needed to look at where to put the resources in the 6 months we had, it seemed to us, given how little of the upstream supply chain—the big companies in the U.S., Congress was interested in control, that that was not the place to start.

Senator SMITH. And they have no control over the price of crude abroad, or they may be drilling and producing?

Ms. MAJORAS. Well, they have some control over it. But by comparison to the state-owned companies that are owned by the places I mentioned, it is much, much less.

Senator SMITH. I could talk to you all day, but I have to go vote. So, as the Chairman indicated, we will stand in a brief recess and I suspect soon, other colleagues will return. And thank you very much.

Ms. MAJORAS. Thank you, Senator Smith.

[Recess.]

STATEMENT OF HON. TED STEVENS, U.S. SENATOR FROM ALASKA

The CHAIRMAN [presiding]. My apologies, I was in a meeting at the White House. We'll be pleased to continue the hearing. Senator Boxer will be next for 10 minutes.

STATEMENT OF HON. BARBARA BOXER, U.S. SENATOR FROM CALIFORNIA

Senator BOXER. Thank you so much, Mr. Chairman. Well, I find this to be a very interesting hearing and I'm a little more than frustrated at this report.

Ms. Majoras, when you were nominated for this position, you and I had some very long talks and remember, you had represented Chevron in your former capacity in the private sector. And we talked a lot about whether that would color your views. Oh, no. It wouldn't. And I said, would you recuse yourself when it comes to Chevron? Well, you would follow the legal opinions, but I have to say, that in my opinion, after looking at this and I'm very dis-

appointed in the entire Commission in this report, that I just have to feel the consumers are left out.

And Dr. Cooper, I think you are right on target when you talk about exploitation. The collusion question is sort of a red herring in many ways, when you have basically five companies and they're vertically integrated, they don't have to collude with one another. They have got to just talk to themselves when they control everything except the price from OPEC. Which leaves me to question, Ms. Majoras, would you support, since you say you can't control the prices that OPEC puts out there, would you support legislation to put OPEC under the antitrust laws?

Ms. MAJORAS. Well there's no question that OPEC is a cartel and if the antitrust laws today were applied to OPEC, they would violate the antitrust laws.

Senator BOXER. Would you support legislation to put them under the American antitrust laws?

Ms. MAJORAS. I would not, because OPEC is made up of countries, of nations and that becomes a foreign policy decision for the executive branch, Senator Boxer. And I can't even imagine that a member of OPEC would show up for my lawsuit, which would make a mockery of our authority.

Senator BOXER. Well you ought to talk to Senator DeWine, because Senator DeWine, a Republican, has written this legislation. It has garnered bipartisan support, including from Mr. Grassley, from Senator Snowe, myself, and others who have looked at this very carefully. So, I'm going to send you this legislation. Maybe you can send it by your lawyers and see if they can take another look at it. Because, you know, there is a way we can solve some of our problems. But if we keep thinking the same way we thought for all these years, we're not going to do it.

Let me just say, if the oil companies were simply passing along the costs that they have faced and you've outlined some of their costs, we wouldn't see profits jumping the way they're jumping. The fact is, none—I certainly don't oppose them passing along their cost of doing business. That's what I learned when I was an economics major a way long time ago, that you take your costs and you add in a reasonable profit, and that's your price. OK? That doesn't take an advanced degree in economics.

So when here, we look at this. What do we see? In the first quarter, Chevron had profits up almost 50 percent and all the rest of them had profits up, so they didn't simply pass along their costs. And you look for collusion. And as I said, there is no reason to look for collusion, if you simply look at the way these oil companies are structured.

Now, I'm going to talk to you about a situation in California, where Shell Oil claimed that they were going to have to shut down their refinery in Bakersfield, because there were no buyers and because it was losing money. It was a terrible thing on their back. They had to get it off their back. It was losing money, they told me and they told the Congressional Delegation, and they told the Attorney General, and they told everybody: well bottom line is we realize that was 2 percent of the gasoline on the marketplace in my state and we couldn't afford to have a refinery close. They're not building any new refineries. They don't want to build them.

We've changed our laws in California. They like it this way, because they're vertical monopolies. It works beautifully. They're making more money now off refineries than ever before. It's a whole change. Just read *Fortune* magazine. It lays it out.

So Shell Oil tells us this. I take this to you. You do zero, nothing. As a matter of fact in this report, you gratuitously take them off the hook. You did nothing. It took the Attorney General of my state, a bipartisan delegation in my state to step up to Shell Oil and say, you're not telling the truth and we're going to prove it. We're going to find a buyer. And guess what? The Attorney General forced it. They found a buyer. And guess what? They didn't tell the truth. It was a huge moneymaker and that's why it was sold. And you can't even, in this report, tell the truth to the American people about that? You just brushed the whole thing off and swept it under the rug.

I'll tell you, we don't need an FTC like this. And I'm not just saying, your FTC. I'm saying, you go back and you see. You know, if the oil companies wanted to pay for a whitewash, they couldn't have gotten a better one. It's shocking. And that's why you hear Senator Lott ask the kind of questions he asks and why Senator Dorgan asked the kind of questions that he asked.

And I am asking you, Ms. Majoras, why is it that you couldn't look at the record and see that when Shell Oil testified here, they talked about how happy they were that we helped them find a buyer, and how wonderful this was. And you never even questioned them. And I wonder why? You knew. I've read what you wrote in the report. You read me part of the report that says that they didn't tell the truth before the Committee.

Ms. MAJORAS. It's not in the report. It's in the statement. We believe that we spent thousands of hours investigating the Bakersfield situation.

Senator BOXER. What's in your release? What did you do to help us? Give me one thing you did to help us.

Ms. MAJORAS. We've spent thousands of hours investigating whether they were violating the antitrust laws by not selling the refinery, which by the way, was tough. Because it's not illegal to not sell a refinery, unless you're colluding with someone.

Senator BOXER. Let me just tell you something, you did nothing to help. If it wasn't for my Attorney General, that refinery would have been shut down and you're supposed to care about consumers. This is what you wrote. There was no evidence that Shell possessed market power and no evidence of collusion amongst Shell and other refiners.

That wasn't the question. The question was, why did they lie and tell us that that refinery was a money-loser? Why did they lie and tell us there were no buyers? And you avoided it and I took you into my confidence, and you knew all of these details. Let me just say to you, this is an outrage. This is a complete outrage.

Newspapers in my state did better than you did by digging up the facts. The Attorney General of my state is a hero to me because of what he did. And if you had your way, with all of your thousands of hours of turning and shuffling paper, that refinery would have been closed down and we would've had 2 percent less gas on the market, which maybe would have made you happy if you like the

oil companies. Because then, they could've jacked up the prices even more.

And my colleague here, Senator Cantwell, has shown me a map, which I trust that you'll show. Here, she's holding it, in the red is where you've got the worst prices and guess what? In the places where we are in fact, producing oil, refining oil, and all the supply and demand talk aside, supply and demand works when you don't manipulate the supply.

And just ask Senator Cantwell, and myself, and others, Senator Wyden, Senator Smith, what happened when they said, it's just supply and demand, and the electricity crisis. Oh, it was just supply and demand. When they took those plants off for more maintenance, 10, 20, 30 times more maintenance than they ever did before when they played games. And luckily, luckily, we found out what they were doing. They were making jokes about old people who had to go without air conditioning. They made jokes about grandmas and grandpas. And you know what? Spend a little time with me when I go home and talk to the working people. Maybe you don't talk to the working people?

Ms. MAJORAS. I do talk to the working people.

Senator BOXER. I'm talking to you now. And I'll ask you a question and they will tell you that everyone knew what Shell was doing in Bakersfield and the fact that you gratuitously got them off the hook in this report, is something that we in California will never forget about this FTC. So when you talk to working people, what is it they tell you, Ms. Majoras, about the price of gas at the pump?

Ms. MAJORAS. They tell me a number of things. They tell me that they are concerned about gasoline prices and what it's doing to their budgets. They also tell me though, such things as well, it doesn't make them happy to see the big profits that our oil companies are making, nonetheless, they've sold houses in the past and they understand that when a certain product, sometimes it's scarce or the value of a product goes up, they don't give back money, even if the value of their house has gone up and they can sell it for more than which they bought it.

Senator BOXER. Wait a minute. Working people, when they talk to you about gas prices, talk to you about selling their house?

Ms. MAJORAS. Absolutely. Because it just happened last week, as a matter of fact.

Senator BOXER. How many people have done that and come up to you and said, oh, I understand the oil companies, by doing these profits. Because if I sold my house, I wouldn't get back my profit. Is that what you're saying they tell you about gas prices?

Ms. MAJORAS. A number of people have used that analogy, because it's been in—it's an analogy that they've seen in many of the major newspapers in this country where the analogy is made. And as a seller, this is the one place where consumers really relate to buying and selling. So, yes. They have said this. They have said this to me.

Senator BOXER. Let me say, I'm interested in this, Mr. Chairman.

The CHAIRMAN. Your time has expired.

Senator BOXER. I will go home and see if anyone brings up their house when they are talking about gas prices.

The CHAIRMAN. Thank you very much, Senator. Senator Snowe?

STATEMENT OF HON. OLYMPIA J. SNOWE,
U.S. SENATOR FROM MAINE

Senator SNOWE. Thank you, Mr. Chairman. Chairman Majoras, obviously there's a lot of frustration because the report appears to be limited in terms of its scope of examination and definition of price gouging analysis of the problem and certainly in terms of proposed solutions. I don't think it's enough to say that those states that have price gouging laws, can fill in the gap. Quite frankly, that is why it does require a national examination and requires a national law. This issue and how it impacts the American people is of national interest. Most certainly, at a time when the oil and gas industry has experienced historic profits and for those trading on the New York Stock Exchange. So rightfully, we would like to have a much more thorough, in-depth report. Frankly, it is a good idea to have national price gouging legislation so we don't leave it to the states. Thankfully, some of the states have taken up and filled the statutory vacuum that exists in the Federal Government with respect to this issue. Certainly, the Federal Government and your agency in particular, has the resources to examine these questions in-depth to ensure that the American people aren't ripped off, particularly at times like we saw last fall.

I was disturbed to even see in the report where it indicated that there were seven refineries, two wholesalers, and six retailers that had higher average gasoline prices in September 2005, compared to August of 2005. And that these higher prices were not attributable to either higher cost or to national or international trends. So there was evidence of price gouging. It was unclear what developed last fall with respect to your agency in terms of further pursuing this.

The analysis showed other factors such as regional and local trends that appear to explain the pricing of these firms. So what was the basis of that analysis? Was it based on what the states determined?

Ms. MAJORAS. No, Senator Snowe. It was based on our own analysis of local conditions when we compared. When we compared the various prices, we did it against the national average, because that is what Senator Pryor's piece asked us to do. But most of the pieces of legislation that have been proposed, have a different definition of price gouging, as do a lot of the states. So then, we went and we looked at well, what if you compared for these 15 people, what if you compared their prices to what people were charging locally. And there, we found that the five cents above the national average, which is what we used to define price gouging under 632, went away.

So in fact, you might be—what I wanted to make sure—we wanted to make sure you understand, was that you might be, if you just use national trends, you might be calling this guy a price gouger even though the guy across from him could be charging a price that is only a few cents less, and we didn't think that was really what the American people were so worried about and what Congress was getting at. So we were just giving you another piece of information.

So if you do decide to pass a price gouging statute, you have all the information in front of you.

Senator SNOWE. But you understand that there is not the entirety of the picture in terms of the entire issue of transparency and the futures market because other than those who trade on the New York Mercantile, those who trade electronically, trade over the counter, are not considered in this study, as I understand it.

So when this report said they were considering all the future's trading, this is not exactly accurate.

Ms. MAJORAS. Well no, ma'am. And we didn't imply that we had. We know that the futures issue is very important to Members of Congress and consumers. We're not experts in this, the CFTC is. We tried to look at one small piece of it and that is all we did.

Senator SNOWE. But that is my point. It's a narrow examination and doesn't that contribute a lot to the volatility of gas prices? I've heard this over and over again. And I think we need to get to the bottom of it and that is why I am supporting Senator Feinstein's legislation on the transparency question. There is so much of this futures trading that really is excluded. There's no way to know. There's no accountability. There's no reporting. Therefore, there's no way to account for what is happening. It can be done on the foreign exchange. It can be done on the intercontinental exchange, as I understand it, and these electronic trades are exempted. And about a third of the trades in the U.S. crude oil future's are conducted on this London exchange.

So, shouldn't we know exactly what's transpiring that could be contributing to the ratcheting up and skyrocketing of these prices. Wouldn't you agree?

Ms. MAJORAS. Well certainly, consumers deserve to know, no question, what is contributing to these prices going up. As to the futures aspect of it, we're just not experts. And I'm afraid, I can't comment further on that. Some experts have concluded this is contributing to the volatility. Some say, no, that's really not it. But I think a further examination of that would make some sense.

Senator SNOWE. But your investigative report indicated there was enough transparency for you to study the futures market. So obviously, it was a part of your study.

Ms. MAJORAS. Just a piece. We were asked to look at manipulation throughout the market and we looked to see whether because futures traders take delivery at the Port of New York, whether control over that Port of New York could be used to manipulate prices. That is what we looked at.

Senator SNOWE. Would you then agree that the FTC report is a very narrow examination?

Ms. MAJORAS. Absolutely. On that piece of it, it was. Yes.

Senator SNOWE. And that's exactly why I think that there shouldn't be an indication in your report that you've studied the futures market when in fact, it was a very limited portion of what was being done. And frankly, you could take a much more aggressive approach in recommending what needs to be done. I just don't think you ought to give an impression to the American people that you've done an in-depth, broad view investigation of what constitutes price gouging when in fact, you did not.

As described by your report, I think it gives a very inadequate and subpar approach to the whole issue of price gouging.

Ms. MAJORAS. Well, I'm sorry about that. We really—our people worked night and day. And we did the best we could.

Senator SNOWE. But the point is, that the FTC has enormous resources available in order to do a very thorough examination and that's the issue. And the fact is, to say that somehow, well, it's a limited view on the futures market. Yes, you can also make suggestions as to this is what we had to do, but this is what we could do. And you would have a very different picture if you had a requirement under the Federal law for national price gouging, would you not?

Ms. MAJORAS. I'm sorry. I don't understand your question.

Senator SNOWE. Would your report be very different today, if you had a national price gouging law?

Ms. MAJORAS. I'm sorry. I'm afraid I——

Senator SNOWE. Would you have a different picture if there was a requirement for a Federal law for price gouging? Would it be very different from the report you're giving today?

Ms. MAJORAS. I don't know whether the report would be different. I know if we had a Federal price gouging law, the FTC would enforce it. So sure, we would probably have different things to report, no question.

Senator SNOWE. Would you have more cases to examine?

Ms. MAJORAS. We very well may, yes. Depending upon what the standard is and how many cases we found, sure.

Senator SNOWE. If you expanded the transparency for our futures market, would you have a very different report?

Ms. MAJORAS. I don't think so, Senator Snowe. Because we didn't try to look at the entire futures market. Because as you pointed out, we're not experts and the CFTC is.

Senator SNOWE. It is a huge dimension. What about OPEC? You indicated that's a foreign policy issue. But again, they represent 66 percent of the world's oil production. So would that have a very different impact if we had a requirement under the law?

Ms. MAJORAS. I don't think OPEC would respond to a lawsuit in the United States.

Senator SNOWE. That's not the issue, right now. Let us worry about that. The point is, why not have a price gouging law on the books?

Ms. MAJORAS. Well, you could.

Senator SNOWE. Would it change the dynamic? Would it change the report?

Ms. MAJORAS. I don't think it would change the report, no.

Senator SNOWE. You don't?

Ms. MAJORAS. I don't think so. For what I tried to say, I don't think OPEC is going to respond to a lawsuit from the United States. I think they're going to laugh at it.

Senator SNOWE. Well I think, in the final analysis, I think it is whether or not these prices are in fact, price gouging at very difficult moments in time. I do not find credibility or have confidence in the outcome of the report. Granted, some of the shortcoming is because we have not passed a national law. But on the other hand, it's also indicates, from your prospective, that this is a very limited

version of what constitutes price gouging. Therefore, the report does not give a real and true picture. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. The next person on my list is Senator Lautenberg.

STATEMENT OF HON. FRANK R. LAUTENBERG, U.S. SENATOR FROM NEW JERSEY

Senator LAUTENBERG. Thank you very much. And I thank Senator Cantwell for permitting the order to go this way. You know, I sit here. I come out of the corporate world and ran a fairly big company, one that today, employs 44,000 people that I founded with two other fellows. And I look at the statistical analysis that is abundantly produced at the table and it reminds me of an old song, Say It Ain't So, if you say it isn't so, because I find cause and effect fairly well separated in many instances.

Ms. Majoras, what's the mission of OPEC? In crystalized form, what is their mission?

Ms. MAJORAS. Their mission is to set the global price of a barrel of crude oil, as I understand it.

Senator LAUTENBERG. And the WTO, says that if you attempt to fix prices—control exports—it's illegal under WTO auspices or controls and therefore, should not be allowed. Should OPEC, the members of OPEC be permitted to be members of the WTO as a consequence of the restrictions that WTO asserts are a requirement for membership?

Ms. MAJORAS. Gosh, Senator Lautenberg, I'm certainly not a trade expert and I don't know exactly how one——

Senator LAUTENBERG. Well, if you put one and one, and make two, it sounds like it, right?

Ms. MAJORAS. I'm sorry?

Senator LAUTENBERG. If you put one and one together and it comes out two, it sounds like it ought to be.

Ms. MAJORAS. Well there are countries that have belonged to WTO that violate the WTO rules and are sanctioned as a result of it.

Senator LAUTENBERG. Because while we search for reasons why the price of gasoline has gone like it has and we don't ascribe direct responsibility to the oil companies, I find—well, lack of refining capacity. But refining capacity has been restricted over the years. It's in fewer hands, even though the production is about the same capacity.

And I wonder why it is that the brilliant leadership in this oil industry hasn't decided some time ago, that hey, with a growth in population, et cetera just within our own country, why wouldn't it be necessary to prepare for the future? Companies do it all the time. They buy a product for inventory. They buy commodities to make their product. It's standard fare. And here, nothing happened over a whole bunch of years.

I look back at Exxon profits and if their behavior wasn't manipulative, it was unconscionable. Absolutely, unconscionable when the Chairman of Exxon walked away, leaving a trail of $145,000 daily in earnings, when 97 percent of the Americans don't make that in a year, and blithely going on taking a crushing termination bonus, makes me look back when I came to the Senate and left my com-

pany, I really short-changed myself. But the fact of the matter is, that when you look at that kind of an income, when it's being paid for by citizens seeking out a living across this country, it just doesn't make sense. And certainly, is no way to win favor for an industry that is as critical—and we come to the conclusion, that there is a monopoly available, that as Dr. Cooper said, leads to, I think, exploitation was probably the best way to describe it. Because then, it's not so excusatory, but it does say what happened here.

And when we talk about market mechanisms being a factor, the market mechanism theory doesn't work when you control a commodity in monopolistic form. There's too few people producing too little product for an essential commodity in the living of our society.

And Dr. Cooper, you said it. You were fairly clear and vigorous about it. We should be vigorous about it, instead of trying to defend what's going on. We should be looking for ways to change this. And I don't know whether ultimately legislation is called for maybe, reviewing the size of companies and making the market a more competitive place, taking on the actions against OPEC by asking, putting a lot of force in our request to the WTO, that they exclude them from membership because they're not following the rules. What do you think we ought to be able to do here to make a difference that has an effect on what it costs people?

Dr. Behravesh—I'm mixing questions here, but one thing leads to another and we see that the rise in take home pay has far exceeded the rise in gasoline prices. Well, I don't know where you get that statistic or whether you chop off the ends, the ups and the downs, because there is no way—no way that a family in America today can support themselves on the kind of purchasing power they now earn. And as compared to what happens with oil prices or gasoline prices, somehow or another, it is misguided or manipulated in terms of the information flow that we get to justify this outrageous price gouging. And I use the term, not in the purest definition, but in what the effect is. What do you think we can do, Dr. Cooper?

Dr. COOPER. Well, my point of view in the long term, the most important thing we can do is take that 10 million barrels a day of demand out of the global market and out of the domestic market. We can do that on the demand side by improving the fuel efficiency of our fleet. We can do that on the supply side with alternatives.

We like alternatives, because alternatives have three characteristics that are really interesting. One, we get different raw materials. That is, corn competes with crude. Two, ethanol plants compete with refineries. And three, the farmers are not members of this global oil cartel. They tend to behave a little differently. And farmer cooperatives have moved very aggressively into this area, many of them members of CFA.

So if you take that 10 million barrels a day out of demand, you take it out of the control of the oil companies. Let's be clear, that is the key here, is you have a small number of players who actually have—every four of the five refining markets in this country are concentrated. Every state virtually, every state wholesale market is concentrated by the antitrust definition and the commodity that's

concentrated with no elasticity of supply or demand, very little. There is market power and much lower levels of concentration than in other industries. I think we also ought to build for the transition of having a strategic product reserve, a strategic refinery reserve, because the industry will not build that sufficient capacity to hold prices down. And above all, that we simply cannot define the definition of price gouging that emerges from this report it is simple and stunning.

I didn't realize it until I heard just now. If everybody raises prices, nobody's gouging. That was the local condition that excused the people who had raised their prices above the national average. And so, if you have that definition, you can never find gouging in a concentrated industry with very little elasticity of demand.

Senator LAUTENBERG. You know, Dr. Behravesh, the price of gasoline at the end of 2001 was close to about $1.06–$1.10 per gallon. Now if we look at the growth in cost or price rather—price, since that time, how does that square having gone up almost 300 percent, 280 percent, or whatever? How does that square with what was happening with wages in that period—purchasing power?

The CHAIRMAN. This is your last question, Senator.

Dr. BEHRAVESH. It's a very good question, Senator Lautenberg.

Senator LAUTENBERG. I have a warning that my timing is going to run out.

The CHAIRMAN. I'm warning him.

Dr. BEHRAVESH. I am allowed to answer?

Senator LAUTENBERG. You're allowed to run over. Talk as long as you want, but give me the right explanation.

[Laughter.]

Dr. BEHRAVESH. I'm happy to. A couple of points to be made, Senator. One is, you made the comment about where is the data coming from for inflation adjusted gasoline prices and take home pay. It's straight out of the Bureau of Labor statistics and numbers that I used here, which are basically both adjusted for the Consumer Price Index. I chose a long enough period so nobody could say, well you manipulated the data by picking the wrong sample period.

In terms of oil and gasoline prices, you're right. Again, a lot depends on what your starting point is. This is a market that goes through booms and bust. And we went through, to our benefit, a bust in the 1990s when oil and gasoline prices were very low. So when you start at that point, rather than say in the 1980s when they were higher—in the 1970s when they were even higher—then certainly the rise we've seen recently looks very dramatic and very troubling. I'll come back to this issue of who it's hurting, because it is hurting people.

But you have to understand that we had a decade of very low gasoline and oil prices. So if you use that as a basis of comparison, these numbers look outrageous. No question about it. But the question, the issue that I'm raising, is if you look at a long enough period of time, you look at how much take home pay has risen (after you adjust for inflation) and how much gasoline prices have risen, it turns out they haven't risen anywhere near as much. That's really a very simple basic point.

The other point that I think we have danced around a little bit is, where's the problem? The problem is oil prices, not so much gasoline prices. Oil prices tripled since 2002. Gasoline prices have gone up about 225 percent. So gasoline prices actually have risen less than oil prices. So the problem is oil prices.

It's important to keep that in perspective. Thank you.

The CHAIRMAN. Thank you very much. Senator Cantwell?

STATEMENT OF HON. MARIA CANTWELL,
U.S. SENATOR FROM WASHINGTON

Senator CANTWELL. Thank you, Mr. Chairman. And thanks for holding this hearing. And we've covered a lot of information so far, but I would like to cover three points if I could. And Dr. Cooper, thank you for your longer range vision on this issue, as well as your comments on protecting consumers in the short run. I think that you have hit the mark, as it relates to getting true competition for this product so that consumers really do have choice, both on higher fuel efficiency standards and on alternative fuel. So I thank you for that testimony.

I'm going to get back to you in a second. But I was showing this map earlier about West Coast prices and clearly, the higher prices in red, and orange, and yellow. And as we can see on the West Coast, we have some of the highest prices and we've consistently had some of the highest prices. So it's a particular point of concern for my constituents and it has been for a long time.

Now what I think is really interesting, something you can't detect from this map, you can see Seattle here. But one of the very—on the very top of the state, at the more red color, is a county that has access to basically three refineries. So we're talking about an area that has three refineries nearby. I think, two right in the county and one close by. And yet, they have some of the highest gas prices. So, my constituents from that particular county don't understand when it comes to this, just simple market economics and supply and demand. Because according to them, they should have some of the cheapest product.

So first of all, Chairman Majoras, I'm interested in this inventory issue because I think we've seen a very big shift in inventory. We've seen a tremendous transformation that I don't think you can just say, well it's happened in every industry. In other industries in manufacturing, there's a lot different competition. There's a lot of different competition for products and you can go choose something else, but there's not true competition for fossil fuel. And you're stuck with "just in time" inventory and the change to this system, consumers are in a totally different boat. I think that's exactly what Dr. Cooper was saying. But I'm curious, you don't even use the phrase "just in time" inventory in your comments. And we've had testimony before this Committee, from two other individuals. One was the Attorney General of Arizona, who basically raised this issue about the "just in time" inventory system. And said, "the effect is a constant and precarious supply and demand balancing act, which is exceedingly beneficial to the industry in lower operating cost, but very harmful to consumers as supply vulnerability has set the stage for price spikes." So that was an Attorney General's comment on that.

The Attorney General from California has also weighed in on that point. Basically talking about West Coast refineries and the fact that when there is a limited ability to augment that refinery production, just in time inventory is a phenomenon that exacerbates the supply problem. And as a result, during outages prices can rise dramatically.

So we've had two attorneys general, who have basically said, this is a pretty big problem. Your report basically concludes, in your section on inventory—I mean, I found it very elementary actually, condescending too. I think the intelligence of members who've been tracking this and have to be responsive to those people who are screaming about those prices. Your conclusion, juxatposed to those attorneys general was, your investigation found no evidence that firms have been making inventory decisions in order to manipulate prices. So drastically, two different conclusions.

First of all, I didn't see the words "just in time" inventory and I don't know if—I guess, my first question is, do you believe that low inventories help set the stage for price spikes?

Ms. MAJORAS. I do believe the lower the inventory, the greater the chance of price spikes. I do believe that, yes.

Senator CANTWELL. So why not be more aggressive in investigating the causes of those low inventories and what the United States could do about it? Dr. Cooper has recommended a couple of things to do about that.

Ms. MAJORAS. In this report, we were asked very specifically by Congress to see whether companies were manipulating the price in some way. And this is one of the ways we identified by which they might be able to manipulate the price. I didn't hear the attorneys general saying that it was used to manipulate the price, just that they were worried that there wouldn't be enough supply to mitigate price spikes. And there's no question that inventories have dropped.

Senator CANTWELL. I'll be happy to get you the Attorneys General from Arizona full testimony. Because I asked him about this specifically. And he said, that we don't have all the investigative power to investigate it and this is what we're concerned about. So the fact that you did have all the investigative power and didn't investigate, is a very big problem.

Ms. MAJORAS. But we did investigate it. That's the point.

Senator CANTWELL. Dr. Cooper?

Dr. COOPER. I would like to make a comment on the inventory and capacity discussion in that report, because it really is thoroughly misleading. And you put your finger on it, it's really important. When they talked about inventories, they made this comparison with other industries. But they didn't—they noted in a footnote, but didn't show on the graph that there's a substantial amount of that inventory that can't be drawn down. Because this system needs a minimal operating inventory and that has a dramatic impact on the picture you would see, and it would make the inventories look much smaller in the gasoline industry.

But the interesting thing is when they talked about capacity, they didn't bother to make a comparison with other industries. Why not? Well if you look at the spare capacity in the oil industry, it's about 5 percent. Most other industries have four or five times

that much. And so what you end up with here is this picture in a commodity with no elasticity of demand and supply so other industries can much more quickly, expand their capacity, consumers can cut back, and they need, actually probably five times as much on supply and demand, right?

And here's an industry, with one quarter the inventory and one quarter the capacity compared to other sectors. So those two conversations—discussions, really give you a completely misleading picture of why those two factors are so important. One more point——

Senator CANTWELL. I have two more things I want to get to.

Dr. COOPER. The Government Accountability Office, when they studied this capacity utilization and storage were absolutely critical. Now, they didn't see it as a policy variable, but that should've been a policy variable here.

Senator CANTWELL. My second point of investigation has to do with exports and we tried to get some of the industry officials to provide us with documentation about this. At first at a hearing, they said they would and then afterwards, they decided that they didn't want to provide us with that. But I find in one of the—really, it's a footnote here in the report. It's not even a major part of the report. But it's a case that we're familiar with. Well, on the West Coast, because it had to do with BP shipping product outside of the country. Basically, to lower supply in the United States and drive up the cost.

So why not do a more thorough investigation of the export market and the fact that the export of product for cheaper prices than could be gotten in the United States, is another way to suppress the supply. So why not more details on that?

Ms. MAJORAS. Well we did what we could in the time we had. We looked at this very specifically and we found absolutely not a shred of evidence that anyone was shipping this offshore in order to keep the price high here.

Senator CANTWELL. Well you have a footnote here that it was a Commission case. It says, such a concern is also underpinned in the Commission's investigation of the BP Arco merger which involved a major producer and seller of, in this case, Alaska North Slope crude oil by BP, which sought to price discriminate between West Coast refineries and companies in the Far East. So, that's not in your report?

Ms. MAJORAS. That's what the concern was.

Senator CANTWELL. But, it's somebody else's report. At least somebody put a footnote in from somebody else's report, then that has happened.

Ms. MAJORAS. That was the concern that it would happen if we let the merger go forward without some divestitures and we took care of the divestitures. In this investigation, we found no evidence that it was in fact occurring and very little exports were going away from the United States.

Senator CANTWELL. So, do you think that that's a problem and you should investigate more, or you don't think that's a problem?

Ms. MAJORAS. We didn't find any evidence that it's a problem.

Senator CANTWELL. I'm asking, do you think you should investigate that more?

Ms. MAJORAS. No, but if you think otherwise, we'll do it.

Senator CANTWELL. OK. The last question, because I only have a minute or so left, you did find in eight cases that eight firms showed price increases for gasoline that exceeded the 32 cent per gallon, or 5 cent per gallon above the national average benchmark that was established for this report. And seven of those eight refineries showed higher operating margins. So they were making money and obviously, you concluded that there couldn't be—those profit margins couldn't be explained. That's very telling and I would think that that would be a lead to investigate.

Now, when you look at the footnotes for all of that information, it has been redacted. It's all redacted information. Will you provide that information to the Committee, so that the Committee can understand? In these cases, where price manipulation has happened, exactly what has transpired? How did the price manipulation happen and how can we, as an oversight body, make sure that this isn't happening on a larger scale if we can't get access to the redacted information?

Ms. MAJORAS. I was required by law to redact the information. That's what the statute says I have to do, Senator Cantwell. So, I will work with the General Counsel's office to see whether that information could be provided to the Members of the Committee.

Senator CANTWELL. I thank the Chairman.

The CHAIRMAN. Thank you very much. I do regret that I didn't hear your testimony. I have had summaries of it from my staff. So I'd like to go into a few things on my time and I want to put my opening statement in the record without objection; I will assume there will be no objection.

[The prepared statement of Senator Stevens follows:]

PREPARED STATEMENT OF HON. TED STEVENS, U.S. SENATOR FROM ALASKA

We welcome the witnesses who appear before the Committee today, and thank you for your willingness to participate in this hearing.

The purpose of today's hearing is to examine the results of the Federal Trade Commission's (FTC) Congressionally-mandated investigation into whether the price of gasoline is being artificially manipulated, and if price gouging occurred in the aftermath of Hurricane Katrina. We look forward to hearing the results of the FTC's investigation and thank the Commission for its work.

The Committee will also hear testimony concerning factors that dictate the price of gasoline as it passes along the custodial supply chain, including the international and domestic supply of crude oil, refinery capacity, the cost of delivery to consumers, and state and Federal taxes. Those testifying will explain which among these factors has most contributed to the current levels of gasoline prices, and whether consumers are being exploited by any party along the supply chain.

It is not unusual for domestic retail gasoline prices to rise sharply immediately following an abnormal market disruption as retailers seek to hedge on unknown replacement costs. As many of you know, this rise in price often triggers consumer protests that gasoline suppliers are taking advantage of these disruptions as profiteers.

In the aftermath of any major market disruption, such as a natural disaster, terrorist attack, or geo-political instability in oil producing countries, allegations of exploitation by providers of essential goods and services often become more prevalent. The aftermath of last season's hurricanes and its long-term effect on the petroleum market has proven no different. Some call this "price gouging," while others consider it to be a product of simple economic market forces at work.

The Committee will seek answers from the witnesses today regarding the FTC's findings in its report, the economic impact of regulating oil and gasoline prices during abnormal market disruptions, and the need for enhanced Federal regulatory consumer protection authority to combat unconscionable price increases during such disruptions.

I look forward to a constructive dialogue with the witnesses.

The CHAIRMAN. But, Dr. Behravhesh, I'm a little confused about the problem of pricing in terms of, we've been told that the crude oil accounts were over half the costs of gasoline and there are other factors that cause it to rise.

Now I've been throughout the country this last month and I've paid as high as $3.75 to $2.60 for gasoline within this month in different parts of the country. So what really causes the price of gasoline to rise over the price of oil, in such a specter of change? It's much higher in portions of the country.

Dr. BEHRAVESH. A lot. Very much depends on geography, basically how close a particular market is to the refinery or to the distribution system. That can make a huge difference in terms of the local price of gasoline. Whether it's in Washington State, or in Alaska, or in Maine, or wherever, the distance and the cost of getting the gasoline from the refinery to that particular market, can make a huge difference. So transportation costs make a big difference in local markets. They wash out of the national average, of course. But in terms of local markets, most of these differences are due to transportation costs.

The CHAIRMAN. We've been told the speculative trading in terms of spot and futurist markets have a lot to do with this. Now, does that affect places like California and Arizona? I was in California, it was very high. Arizona was very high compared to other portions of the country. As a matter of fact, even higher than some places in my state and we have a transportation problem, as you know. We send our fuel, our crude oil, down to Washington or somewhere and then it comes back up as refined product. What about that? Is a portion of these increased costs due to speculation for spot and futures?

Dr. BEHRAVESH. Mr. Chairman, I think there has been some influence of speculation, certainly in recent months. As I said in my statement earlier, that has happened not just in oil markets, but in other commodities markets, and it often happens in the late stages of a boom. How big is it? We hear lots of different estimates. It's $5 a barrel in oil, tt's $10. I don't think it's $10—probably more like $5 is somehow or another related to speculation. Although, as I said, there's a lot of disagreement about that. Speculation affects the global and national prices much more than the local prices.

Speculation is a much bigger factor in global markets.

The CHAIRMAN. Well, I read in the material I was reading last night that Japan now has entered into buying as a government, buying futures, as India and China has. How much is that affecting our price system here?

Dr. BEHRAVESH. Well again, I think in the very near term it could have an impact, but yet in the longer horizon, I doubt if it's going to have a huge impact. The underlying trend is a huge and growing demand in India and China. That's really what's driving prices up globally.

The CHAIRMAN. Well, that's what I'm saying.

Dr. BEHRAVESH. Yes.

The CHAIRMAN. But this article said, they are actually, as a government, buying. Buying the oil, putting their money down for it for delivery two and 3 years out. Do you know about that?

Dr. BEHRAVESH. I'm aware of that, certainly to the extent they're buying forward—buying now for later—I'm sure it has pushed up the price, but eventually you would expect the price would come down as these governments take deliveries. And they've already bought the oil. So somewhere down the pike, you would expect prices to drop.

The CHAIRMAN. How much of it is affected by the domestic supply, the price of gasoline?

Dr. BEHRAVESH. In the U.S.?

The CHAIRMAN. How much does domestic oil production affect supply?

Dr. BEHRAVESH. Again, Mr. Chairman, this is a global market and as Chairman Majoras was saying earlier, one of the responses after Katrina was we actually imported a lot more oil and especially gasoline. We do import as the need arises. I don't see domestic production or refining being a major constraint at this point, because it is a global market.

The CHAIRMAN. But does it affect prices of gasoline?

Dr. BEHRAVESH. No question, in the near term.

The CHAIRMAN. If we had more domestic supply, would prices be less?

Dr. BEHRAVESH. I think in a crunch, as in Katrina, I think definitely. Our limited ability in a very short time horizon to import, did push the price up. That was definitely one of the things that was going on.

The CHAIRMAN. Mr. Slaughter, do you have any comments to my questions?

Mr. SLAUGHTER. Yes, Mr. Chairman. I would say about domestic production—increased domestic production of oil would be helpful. There is an international market for oil, but as you know, a number of areas in the United States, we have a possible access, in a relatively short period of time, to significant reserves that would be helpful both in the global market and in the domestic market.

And also, I would make the point that the Doctor is very right in what he is saying about international competition from India, China, and Japan. We're seeing that now in crude and that's affecting the crude prices. We're also going to see that in refined product prices like gasoline and diesel in future years. And the U.S. doesn't pay enough attention to the fact that we're going to have great competition for imports of gasoline and diesel in coming years, just as we are now for crude oil. And we don't pay enough attention to the impact on supply, of much of what we do on energy legislation and environmental legislation, because we are unable to keep up with growing demand in this country with domestic refinery additions, even though we're making them. And we're going to be out on the market in this increasingly competitive environment, looking for foreign sourced products and crude oil in a number of years, with some very strong competition against us. And I think we need to pay more attention to domestic production of oil, and gasoline, and diesel, and other products than we have in the past.

The CHAIRMAN. Some have called on Congress to cap gasoline prices. We did cap the price of crude oil once, in recent years. Do you believe it's possible for us to have a retail cap on gasoline prices?

Mr. SLAUGHTER. I think it would be counterproductive, Senator. The experiences with price controls on gasoline in the 1970s were fairly disastrous. The idea of a retail cap is basically going to make it so that demand cannot respond to market sources. We're going to end up with shortages and gasoline lines if we try to do something like that again. It worked out that way in the 1970s and I think that was an object lesson on what can happen.

I think, frankly, the answer to this high gasoline price experience and perception is increased oversight hearings and more information. But if you go the direction of price controls, consumers are going to lose in the end. They always have, sir.

The CHAIRMAN. Thank you, Ms. Majoras. We're in the process of drafting a price gouging bill that deals with this situation of multi-state operations. We have individual states with price gouging legislation, but in some instances, the Attorney General has indicated that they were unable to control the situation or even deal with the situation because there was a regional zone that covered more than one state. Have you looked at that? Shouldn't the FTC have jurisdiction there, where there's an allegation of price gouging that affects multi-state operations?

Ms. MAJORAS. Well certainly, if Congress wants a price gouging statute that can cover more than one state at a time, then certainly. Yes, the FTC would be the place and we would look at it on a multi-regional basis, certainly.

The CHAIRMAN. You found, as I understand it, 15 cases of price gouging, as it was defined in the report, and 14 were attributed to local or regional market trends. Do you think that we should have legislation that would define price gouging in another way?

Ms. MAJORAS. Well, I would expand the definition of price gouging beyond where it was in Section 632, so that all market conditions could be taken into account before someone is accused of price gouging. Most certainly, if we're going to slap criminal sanctions on these individuals, who—many of whom we found, Senator, when we went out and we talked to them, and we gathered the evidence about what happened, particularly at the retail level are relatively unsophisticated, running their business out of the glass booth, where they sell the gasoline doing the best they can.

The CHAIRMAN. I want you to see if you will give us the definition of price gouging. We've asked the attorneys general to give us one and they agreed on one. We would like to see how you would define price gouging in a Federal statute.

Ms. MAJORAS. Very well.

The CHAIRMAN. Thank you very much. Senator Pryor, you have come back for a second round?

Senator PRYOR. Yes, I have.

The CHAIRMAN. Senator Boxer wants 3 minutes before you, I believe.

Senator BOXER. That's OK.

The CHAIRMAN. You have the floor.

Senator PRYOR. How long is this round, Mr. Chairman?

The CHAIRMAN. I'd like to finish by 12:30, if we could. So, 5 or 6 minutes.

Senator PRYOR. I will try to be brief and I would appreciate if the panel could be brief in answers, because we are time constrained here. Dr. Behravesh, I am confused on something, because you gave out these charts earlier, chart 3 and 4, where you have these charts about how much cost is in a gallon of gasoline. And his dealers margin taxes are fine, it's margin crude oil prices. But a few moments ago, in response to one of Chairman Stevens questions you said a big factor in price differences is geography. I don't see geography listed in your chart here. Could you explain that?

Dr. BEHRAVESH. I think we were talking about regional differences. These wash out of the national level. But easily, I can imagine some regions and some markets below this average and some regions and markets above. I think that was the question I was answering.

Senator PRYOR. I just want to be certain on the usefulness of the chart, because it seems somewhat limited now that I've heard your questions. Let me ask this, a few moments ago, you probably heard Chairwoman Majoras say, that low inventories make the market prone to price spikes. Do you agree with that?

Dr. BEHRAVESH. I completely agree with that.

Senator PRYOR. You also said in your testimony, you talked about thin capacity and also we talked about tight markets today. Is that all the same thing?

Dr. BEHRAVESH. Very much so.

Senator PRYOR. And in your view—and it sounds like you understand the oil industry. In your view, are those low inventories, or tight markets, or thin capacity, are those the result of decisions made by the oil industry?

Dr. BEHRAVESH. Senator, I think it is more decisions made by OPEC frankly, than the oil industry itself. I think one thing that hasn't been said so clearly is the oil companies are largely marginalized these days. We can use whatever term we want to use, exploitation or whatever, but, they've very much gone along for the ride. But in the end, they're not in the driver's seat. This is very much a story about OPEC.

Senator PRYOR. I guess what I'm asking you is, what incentive do they have to increase their capacity, to increase their inventories, et cetera if as we've learned today, when markets are tight, their profits go up. It seems like they have every incentive in the world to keep the market tight and to create their price spike. Am I wrong on that?

Dr. BEHRAVESH. I think we have to be a little bit careful. First of all, the question is what room to maneuver do they have in terms of exploration and drilling? And the reality is, in the global markets they don't, because they don't have access to a lot of fields that they did before, because they are getting frozen out by the national governments.

On the refinery side, I think you've got your answer in terms of existing refining capacity being expanded. We can debate about is this capacity enough, or isn't enough, but it is being expanded. My sense is—again I'm no big expert in terms of the oil companies

themselves—they're doing what they can under very tight constraints. That's the sense I'm getting.

Senator PRYOR. Chairwoman Majoras, let me ask you if I can, we just have a few minutes left here and that is maybe a sensitive subject. I don't mean it to be sensitive, but as I understand it before you came to the Federal Trade Commission, you were a counsel for Chevron?

Ms. MAJORAS. I did 70 hours worth of work for them in 2004.

Senator PRYOR. Tell me about that. You mean, you were a lawyer and you just represented them on something?

Ms. MAJORAS. I was their lawyer at a law firm and worked on a piece of litigation for them, for a total of 70 hours.

Senator PRYOR. Did you represent other oil interest when you were in private practice?

Ms. MAJORAS. No. I never have.

Senator PRYOR. That clears up something in my mind. I didn't understand the nature of that. Is there anything, Chairwoman Majoras, in this investigation that you've given us today, that troubles you? Is there anything that gives you heartburn or gives you concern about the oil industry, as it exists today?

Ms. MAJORAS. I didn't find any law violation. We didn't find any law violations.

Senator PRYOR. I'm not just talking about law violations.

Ms. MAJORAS. But I wanted to make that point clear. The one thing that we don't—we can't totally explain, although I'm not sure it would be in the report if we could because it relates to what's going on right now is some of the basis for refining profit today, which when we do our investigation that we're about to start, that the President and the leadership of Congress have asked us to do, we're going to take a closer look at that and see where all of that is coming from.

We certainly understand why profits are high in some sense. But we want to be sure we have a full understanding, so we can explain it to consumers.

The CHAIRMAN. Senator, can you make this your last question?

Senator PRYOR. I would be glad to. So a last question for the panel, if Congress does pass a price gouging statute and I know there are some on the Committee and elsewhere that are working on one, what should that look like? I know you've talked before about how you don't like some price gouging statutes, but what are the elements of that, that you think would be beneficial to the marketplace?

Ms. MAJORAS. Obviously, we'd make sure you take into account cost. And I also would make sure you take into account supply and demand conditions that the retailers, wholesalers, and refiners are facing. Because that is going to be how they set their prices and we'd be happy to work with you, Senator Pryor, and anyone on the Committee on that.

Senator PRYOR. Anybody else?

The CHAIRMAN. I'm going to stop this soon. I have to leave at 12:30 and Senator Boxer wants a few minutes.

Senator PRYOR. I'll tell you what, we can talk about—why don't I talk to them after the hearing. How does that sound?

The CHAIRMAN. Senator Boxer?

Senator BOXER. Mr. Chairman, I think the FTC needs a reality check. You talk about independently-owned gas stations, do you know that there are hardly any left in this country? That is not what this Committee is upset about. We're on the side of the independent gas station. We're talking about the big guys here. And to be honest with you, Chairwoman Majoras, I think you're on their side. That is your right. But I think—I just want to tell you, in California we caught Shell Oil with their gas pump down.

They wanted to close a refinery that they owned. In your report, you call it a small refinery. How about this? It's 12th out of 21 in California in terms of refiners. I would ask unanimous consent to put this in the record?

You're editorializing here. You let them off the hook. The people in my state knew exactly what they were doing, because they are smart. The investigative reporters from republican newspapers and democratic newspapers knew what they were doing. The bipartisan congressional delegation knew exactly what they were doing. The attorney general of my state knew exactly what they were doing. You're the only entity in the country that didn't see what they were doing and you gave them a whitewash.

They lied to us in front of the Committee and I would ask unanimous consent to put into the record the letter that they wrote, in which they said they were absolutely looking for a buyer. When in truth, they were not.

I would ask unanimous consent to place in the record other documents that said, that they maintained that this refinery made no money. At the end of the day, it was a big profit maker.

And you let them off the hook. Why do I come back to this? Because we know the facts here. And when you say, you do a price gouging legislation, you tell Senator Pryor, I hope you will take into consideration cost, and supply and demand. Well as my kids would say, that's a ridiculous answer.

If you are just exhibiting the outgrowth of supply and demand, that's not any antitrust violation. That is not an anti-gouging situation. It is when you try to manipulate the supply if you're just passing on cost, so why would you even say that? Of course it's——

Ms. MAJORAS. It's in Senator Cantwell's legislation.

Senator BOXER. Of course, anti-gouging legislation doesn't deal with supply and demand. It deals with bad actors who are manipulating.

Ms. MAJORAS. Of course and it's in Senator Cantwell's legislation.

Senator BOXER. I'm just saying, your answer doesn't help us very much because obviously, we're not going after a raw supply and demand circumstance. We're not going after a circumstance where the cost is greater and it's passed on. We're going after a circumstance where the cost is greater and they pass that on plus billions of dollars. And you can shake your head all you want, Mr. Slaughter and I appreciate that you do a great job for the oil companies. The American people don't get it.

And last, in conclusion, in the favorite words my Chairman wants to hear, when you say you're with real people and you're asking them about prices at the pump, and they go into a dissertation about their home, that doesn't pass the smell test. And I would

invite you—and I don't know if you want to do this, but I would invite you to come out to California with me and talk to the real people who are working people.

Whether they own a home or they don't own a home, they're not going to sell the home to pay for the higher gas prices. So that answer shows your true colors in terms of your lack of empathy, understanding with your basic mission.

So, Mr. Chairman, I'm very disappointed in this report. I think it's a whitewash and worse. And we're going to keep working, even if it doesn't involve the FTC. Maybe we need to investigate the FTC.

Ms. MAJORAS. Do you want my response, Senator?

Senator BOXER. Anything you want.

Ms. MAJORAS. First of all, 60 percent of gasoline is still sold by independents. Just so you know.

Senator BOXER. In my state, it's 15 percent.

The CHAIRMAN. Senator, sometime we have to get to the end of this.

Ms. MAJORAS. The number is less in California, but throughout the country and those that we found that met the definition of price gouging who were retailers, Senator, were all independent, unbranded. And that's why I raised that earlier with some of the other Senators.

With respect to whitewashing on Shell Oil, our authority is to determine, Senator, whether someone is violating the laws we enforce. And that is what we did with respect to Shell in the Bakersfield situation. We didn't whitewash anything. We did an investigation and we determined whether the antitrust laws had been violated, and we found that they had not.

And finally, I guess I would give you the same invitation, Senator Boxer. I'm sorry you're displeased with the FTC, but I've never wanted to make this personal, but if you have any doubt whatsoever about my caring, and my empathy, and my background of working class for the people of American, then I would like to spend—suggest you spend some time with me. Because nobody who works with me, doubts that for one second.

Senator BOXER. That's fine. I'll be happy to spend as much time as you want. That's fine.

The CHAIRMAN. Thank you, Senator. Mr. Slaughter, Senator Boxer indicates that she believes that the majority of the gas stations are owned by the major oil companies and refiners, is that correct?

Mr. SLAUGHTER. Only about 10 percent of the service stations are owned and operated by major refiners, Mr. Chairman. The rest are operated by independent businessmen.

The CHAIRMAN. I do thank you and this is a very contentious issue. I think all Americans are concerned about gasoline prices. There's no question about that. But it's something we have to continue to explore. And I do thank all of you for your time, and patience, and your answers.

Senator Pryor would like to have each of you answer his last question in writing. If you would do that for him, we would appreciate it. He may give it to you in writing himself.

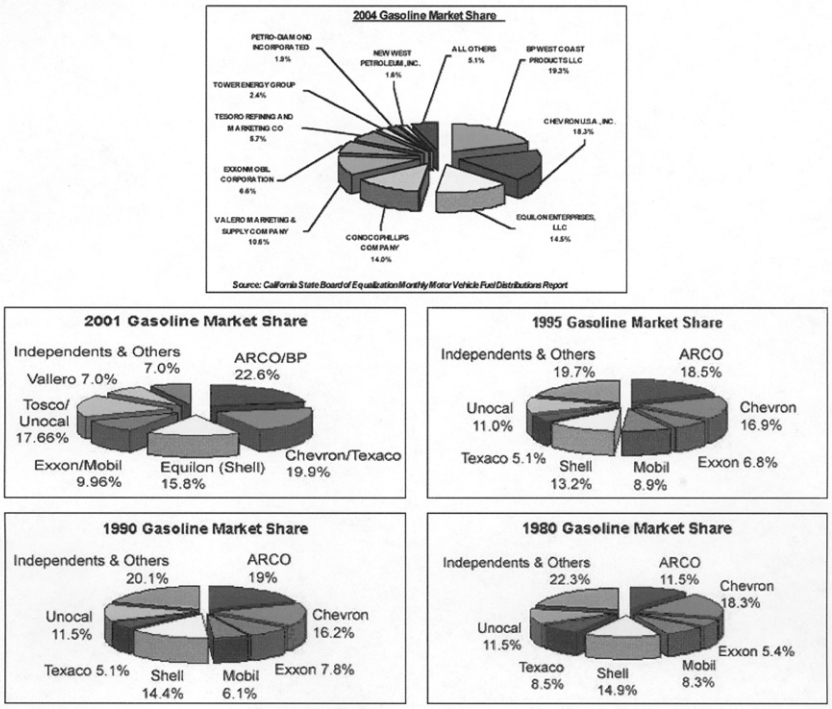
Senator BOXER. Before you put a—close the record, can I put a statement in the record about this 15 percent?

The CHAIRMAN. You can put whatever you want in the record, but the hearing is over.

Senator BOXER. Whether it's over or not, I'll put it in the record. Fifteen percent are independently owned in California.

[The information referred to follows:]

Gasoline Market Share in California



2004

Taxpayer	2004 Gallons
BP West Coast Products LLC	3,079,832,017
Chevron U.S.A., Inc.	2,910,858,984
Equilon Enterprises, LLC	2,310,094,796
ConocoPhillips Company	2,235,896,981
Valero Marketing & Supply Company	1,693,335,340
ExxonMobil Corporation	1,050,894,058
Tesoro Refining and Marketing Co.	915,684,803
Tower Energy Group	379,335,149
Petro-Diamond Incorporated	301,175,310
New West Petroleum, Inc.	248,176,975
All Others	816,448,499
Total	15,941,732,912

2001

Taxpayer	Market Share (in percent)
ARCO/BP-Amoco	22.60
ChevronTexaco (Chevron and Texaco from Equilon merged 10/9/01)	19.91
Equilon: Shell	15.80
ExxonMobil (merged 12/98)	9.96
Tosco/Unocal	17.66
Valero (Ultramar, Beacon)	6.99
Unbranded & Others	7.08

1995

Taxpayer	Market Share (in percent)
ARCO	18.5
Chevron	16.9
Exxon	6.8
Mobil	8.9
Shell	13.2
Texaco	5.1
Unocal	11.0
Independents & Others	19.7
Tosco	6.4
Ultramar	6.5
Unbranded	6.8

1990

Taxpayer	Market Share (in percent)
ARCO	19.0
Chevron	16.2
Exxon	7.8
Mobil	6.1
Shell	14.4
Texaco	5.1
Unocal	11.5
Independents & Others	20.1

1980

Taxpayer	Market Share (in percent)
ARCO	11.6
Chevron	18.5
Exxon	5.4
Mobil	8.3
Shell	14.9
Texaco	8.5
Unocal	11.5
Independents & Others	22.3

1965

Taxpayer	In 1,000 gallons of gasoline	Market Share (in percent)
Caminol	57,309	0.80
Coastal	13,493	0.19
Douglas	145,096	2.02

1965—Continued

Taxpayer	In 1,000 gallons of gasoline	Market Share (in percent)
Fletcher	43,442	0.60
Gold. Eagle	97,284	1.35
Gulf	314,005	4.37
Humble	77,445	1.08
Mohawk	52,140	0.73
Newhall	7,546	0.11
Powerine	155,322	2.16
Richfield	648,771	9.03
Seaside	63,338	0.88
Shell	1,143,160	15.91
Signal Oil-Gas	281,005	3.91
Soc.-Mobil	609,964	8.49
Standard Oil of Calif.	1,684,072	23.44
Sunland	25,813	0.36
Texaco	589,515	8.21
Tidewater	406,341	5.66
Time	67,063	0.93
Union	706,345	9.83
Total Calif.	7,183,161	

Information from 1965 Pacific States Gasoline Sales Tax Report. For more information, see: *http://home.pacbell.net/lcobb/gas65rpt.htm*

Sources: 1965, Pacific States Gasoline Sales Tax Report. For more information, see: *http://home.pacbell.net/lcobb/gas65rpt.htm.*

1980 and 1990, The Sacramento Bee, April 14, 1991, chart based on information supplied by the Lundberg Survey.

1995, California Energy Commission Fuels Office based on Fuel Taxes Paid compiled by California Board of Equalization.

2001, California Board of Equalization, 2000–2001 Annual Report, Statistical Appendix Tables, Table 25 (*http://www.boe.ca.gov/annual/table25_01.doc*).

Notes: Distributors are companies or individuals who make the first distribution of gasoline in California, and are responsible for payment of the tax. (Aircraft manufacturers and certificated or licensed carriers by air may be included within the definition of distributor.) "Broker" includes every person, other than a distributor or a retailer, who deals in lots of 200 or more gallons of gasoline.

Adjustments include temperature-corrected gallonage from broker returns, late returns, audits, interest, and penalties.

California's Oil Refineries

California's refineries are located in the San Francisco Bay area, Los Angeles area and the Central Valley. Statewide in 2004, refiners relied on Alaska for 21.7 percent of their petroleum supply, California for about 41.9 percent, with foreign sources providing the balance of 36.4 percent. Each day approximately two million barrels (a barrel is equal to 42 U.S. gallons) of petroleum are processed into a variety of products, with gasoline representing about half of the total product volume. (A list of refineries, their location and capacity is shown in the table below.)

Refineries can be classified as topping, hydroskimming or complex. Topping refineries are the least sophisticated and contain only the atmospheric distillation tower and possibly a vacuum distillation tower. The topping refiner's ability to produce finished products depends on the quality of the petroleum being processed. A hydroskimming refinery has reforming and desulfurization process units in addition to basic topping units. This allows the refiner to increase the octane levels of motor gasoline and reduce the sulfur content of diesel fuel. Complex refineries are the most sophisticated refinery type and have additional process units to "crack" the heavy gas oils and distillate oils into lighter, more valuable products.

Using a variety of processes including distillation, reforming, hydrocracking, catalytic cracking, coking, alkylation and blending, the refinery produces many different products. The four basic groups are motor gasolines, aviation fuel, distillate fuel and residual fuel. On a statewide average, about 12 percent of the product from California's refineries is aviation fuel, 13 percent is distillate fuel and 9 percent is residual fuel.

Complex refineries have the highest utilization rate at approximately 95 percent. Utilization rate is the ratio of barrels input to the refinery to the operating capacity of the refinery. Complex refineries are able to produce a greater proportion of light products, such as gasoline, and operate near capacity because of California's large demand for gasoline. Permitting Issues. It is unlikely that new refineries will be built in California. In fact, from 1985 to 1995, 10 California refineries closed, result-

ing in a 20 percent reduction in refining capacity. Further refinery closures are expected for small refineries with capacities of less than 50,000 barrels per day. The cost of complying with environmental regulations and low product prices will continue to make it difficult to continue operating older, less efficient refineries.

To comply with Federal and state regulations, California refiners invested approximately $5.8 billion to upgrade their facilities to produce cleaner fuels, including reformulated gasoline and low-sulfur diesel fuel. These upgrades received permits since low-sulfur diesel fuel regulations went into effect in 1993. Requirements to produce Federal reformulated gasoline took effect at the beginning of 1995, and more stringent state requirements for CARB reformulated gasoline went into effect statewide on April 1, 1996. That requirement was removed by Governor Gray Davis when it was found that the oxygenate, methyl tertiary butyl-ether or MTBE, was leaking from some underground storage tanks and polluting water supplies. MTBE was phased out and removed as of December 31, 2003, and replaced by ethanol.

Refineries Outside of California That Can Produce California Gasoline

Domestic sources include refineries located in Washington State and the U.S. Gulf Coast. Foreign sources include Eastern Canada, Finland, Germany, U.S. Virgin Islands, Middle East, and Asia.

California Oil Refinery Locations and Capacities

Classification of refiners based on crude oil capacity (barrels per day)

Refinery Name	Barrels Per Day	CARB Diesel	CARB Gasoline
BP West Coast Products LLC, Carson Refinery	260,000	Yes	Yes
Chevron U.S.A. Inc., El Segundo Refinery	260,000	Yes	Yes
Chevron U.S.A. Inc., Richmond Refinery	242,901	Yes	Yes
Tesoro Refining & Marketing Company, Golden Eagle (Avon/Rodeo) Refinery	166,000	Yes	Yes
Shell Oil Products US, Martinez Refinery	154,900	Yes	Yes
ExxonMobil Refining & Supply Company, Torrance Refinery	149,000	Yes	Yes
Valero Benicia Refinery	144,000	Yes	Yes
ConocoPhillips, Wilmington Refinery	133,100	Yes	Yes
Shell Oil Products US, Wilmington Refinery	98,500	Yes	Yes
Valero (Ultramar) Wilmington Refinery	80,887	Yes	Yes
ConocoPhillips, Rodeo San Francisco Refinery	73,200	Yes	Yes
Big West of California LLC, Bakersfield Refinery	66,000	Yes	Yes
Paramount Petroleum Corporation, Paramount Refinery	50,000	Yes	Yes
ConocoPhillips, Santa Maria Refinery	41,800	No	No
Edgington Oil Company, Long Beach Refinery	26,000	No	No
Kern Oil & Refining Company, Bakersfield Refinery	25,000	Yes	Yes
San Joaquin Refining Company Inc., Bakersfield Refinery	24,300	Yes	No
Greka Energy, Santa Maria Refinery	9,500	No	No
Lunday Thagard, South Gate Refinery	8,500	No	No
Valero Wilmington Asphalt Refinery	5,900	No	No
Tenby Inc., Oxnard Refinery	2,800	No	No

Note: Data on this table represents total crude oil capacity not gasoline, distillate production, diesel fuel production or production of other products. Production potential varies depending on time of year and status of the refinery. A rule of thumb is that *roughly* 55 percent of total capacity is gasoline production (about 1.1–1.2 million barrels of gasoline—46 to 50 million gallons—is produced per day).
Source: California Energy Commission Fuels Office Staff.

Terminal Facilities

California's nearly 100 terminals receive petroleum and petroleum products by tanker, barge, pipeline, rail or truck. Most of California's terminals are marine terminals. At these facilities petroleum or product is transferred from or to tankers or barges. Tankers loaded with Alaska North Slope petroleum, for example, enter marine terminals in northern and southern California, where the crude oil is then sent to refineries by pipeline for processing. An example of pipeline receipts of petroleum at a terminal is heavy California petroleum produced in the Bakersfield area that is sent by pipeline to a refinery at Martinez.

Terminals also serve as refiner's wholesale distribution points for products. Product, such as gasoline, is sold to distributors (jobbers) who then sell to consumers through the distributors' own retail stations. The distributor may also resell the gasoline to other station dealers. Gasoline can also be sold directly to station dealers from the terminal. The marketing structure differs depending on the type of product being sold.

A terminal can be linked with several refineries and storage facilities and be supplied by privately-owned pipelines or a common carrier line. Total capacity at a terminal can range from a few thousand barrels to a few million barrels. The most apparent equipment at a terminal are the tanks used for storage and separation of different product grades. The number of tanks can range from a few to more than 70. Other equipment found includes piping, pumps, valves, and meters needed for bulk receipts and for loading racks used for small deliveries to trucks. Marine terminals have vessel length and water depth limits that dictate the size of tankers that can off-load at the facility.

Permitting Issues. Some of the environmental and safety issues associated with permitting petroleum and petroleum product terminals include:

- Changes in visual quality.
- Disturbances to vegetation and wildlife.
- Emissions from floating roof tanks.
- Potential water and soil contamination from earthquake-damaged tanks.
- Increased tanker traffic and potential for spills at marine facilities.

References

1. *U.S. Petroleum Refining, Meeting Requirements for Cleaner Fuels and Refineries,* Volume I, National Petroleum Council, August, 1993. This document is a comprehensive assessment of how environmental regulations impact the petroleum refining industry and U.S. consumers.

2. *Fuels Report,* California Energy Commission, December, 1995, Publication No. P300–95–017. The Fuels Report describes emerging trends and long range forecasts of the demand, supply and price of petroleum, petroleum products, natural gas, coal and synthetic and other fuels. It is the state's principal fuels policy document.

3. Petroleum Industry Information Reporting Act submittals from the petroleum industry to the California Energy Commission.

4. *Quarterly Oil Report,* Fourth Quarter 1993, April 1994, California Energy Commission, Publication No. P300–94–003. This report describes petroleum fuels market trends, price trends, refinery activity, oil production trends and petroleum company financial performance. It contains aggregated petroleum statistics for California based on industry submittals to the Commission including refinery utilization rates.

5. *1994 Annual Report,* Western States Petroleum Association.

Source: *Energy Aware Planning Guide II: Energy Facilities,* California Energy Commission, Publication No. 700–96–006, December 1996, Appendices B–24 and B–25.

Sacramento News and Review, May 8, 2003

AGASINATION

OIL GIANTS ARE TIGHTENING THEIR GRIP ON THE CALIFORNIA GAS MARKET, SQUEEZING SMALL RETAILERS OUT OF BUSINESS—AND CHARGING YOU MORE AT THE PUMP

By Jeff Kearns

Just off the freeway in North Sacramento, the various strata of the retail gasoline business are laid out along a busy road like the layers of a geological core sample.

Exit I–80 at Northgate Boulevard, head south, and the first gas station just past the sweeping curve of the offramp is a Shell station. For gas stations, this is prime, high-volume real estate. The bright yellow shape of the station's clam-inspired logo beckons exiting motorists. Below that, the station is clean and neat with new-looking pumps ready to take your credit or ATM card. On a day in mid-March, when gas prices were at their peak, unleaded self-serve gas at this station was at $2.159.

A few blocks south, there are two more stations across the street from one another. On the same day, a Chevron with a high price posted on the curb sat nearly empty on one side of the street, but the Arco AM/PM station across the street was packed, nearly every pump dispensing fuel at about a dime a gallon less than at the Chevron. Arco, a cash- or ATM-card-only operation, is the only discounter among the major brands. Farther south, there is a 76 station and then, as the

neighborhood starts to look just a little rougher, a Tesoro. It's nearly a mile from the freeway and is the last recognizable gas logo on the boulevard.

After that, there are more stations, but they are all independents, the kind that sell cheap gas and don't display corporate logos. The first one, on the left a few blocks past the Tesoro, is Northgate Liquor and Food. The two small islands under the canopy out front have old-style pumps without card readers. The station's small mini-mart is a modest building with faded advertisements taped in the windows. The store sells the usual items: liquor, cigarettes, candy and snacks. But the sign out front on that mid-March day listed one of the lowest gas prices in town: $2.039.

Inside, a steady stream of customers walked in and slid crumpled bills across the counter for gas. Navjot Singh, who runs the station for his uncle, put the bills in the register and thanked everyone. Propped up in the corner behind him, within easy reach but hidden from view, was an old wooden baseball bat.

Running a small, independent gas station is a tough business, but during price spikes like the one that sent fuel prices to record highs all over California this year, it becomes all but impossible for independents to make money selling gas.

Tony Riar, Singh's uncle, is one of the two co-owners of Northgate Liquor and Food. Every morning, he's up around dawn and off to open the gas station. He drives that same stretch of Northgate Boulevard that's lined by gas stations, and he checks the price at each station as he drives. The prices climbed at an incredible rate during the first months of the year.

After he gets to work, Riar calls his suppliers to find out who's cheapest. But on this day, the price for regular unleaded had jumped by another 2 cents a gallon since the last time he'd ordered gas, a couple days earlier. So, he picked the least expensive one and placed an order for a tanker to replenish the supply in the tanks buried underneath the station. Then Singh walked out to the street, where the sign read $2.019 for regular, and raised it by 2 cents. Singh then entered the change in the computer that runs and monitors the pumps.

But, although Riar's price had gone up by 2 cents, and he'd covered it by upping his own price 2 cents, he wasn't making money. By selling gas for less than what he paid for it, Riar was losing 2 cents for every gallon his customers pumped into their tanks, about 2,000 gallons on an average day.

What happens to a few independent gas stations doesn't usually concern anyone beyond the regulars who stop there. But increasingly, independents are being squeezed out of the California market. That's significant because independents play an essential role in keeping retail prices down, by providing competition. Without independents, oil companies that own refineries and control retail stations have much less incentive to compete by keeping their own prices low. In a state that guzzles 40 million gallons a day, that's something that could have serious implications for an economy that lives and dies by the gas flowing through its veins. For the most part, gas isn't really something consumers have much of a choice about buying, and even if they go cold turkey, fuel is a commodity that, either directly or indirectly, is part of the price of almost every product and service.

For small gasoline retailers like Riar, taking a loss when prices spike is now part of doing business. As an independent, Riar can buy gas from whichever local supplier has the best price. Branded stations, on the other hand, pay fixed prices set by supply contracts signed with major refiners. But when supplies tighten, those branded stations have priority over wholesale dealers that sell to independents like Riar, and the increased demand drives up wholesale prices. It's called an inversion. That kind of situation arises because refiners can produce more gas than the market needs, and the surplus is what usually goes to independents.

Branded stations make up about 70 percent of retail gas stations, according to a state estimate from 2000. Independent, unbranded stations and refinery-owned and -operated stations each make up about 15 percent.

Back in December, when gas prices were at relatively low levels, wholesale prices were at the lowest in a year. Riar could shop around and buy gas cheaper than the major-brand stations up the road. He could keep prices low and still make about 10 cents a gallon.

Part of the problem for independents is that California is an island, isolated from the supply networks that connect much of the rest of the country. Also, state clean-air laws mandate some of the cleanest burning gas in the world, and almost no out-of-state refineries are set up to produce it. On top of that, there are just 11 refineries in California, down from more than 30 in the mid-1980s, and those remaining refineries are in fewer hands. Five years ago, the world's biggest oil companies started a wave of consolidation that left the world energy market in the hands of about a half-dozen major players. In one of the largest consolidations, 2 years ago, San Ramon-based Chevron swallowed up Texaco in a $45 billion merger.

The question of how much profit refiners make comes up every time gas prices spike, when politicians, helpless to respond to the complaints of outraged constituents, start calling for investigations into allegations that oil companies are gouging consumers by keeping supplies low, which increases prices. Governor Gray Davis did it in March, when he asked the state energy and utilities commissions to probe gas prices. So did Senator Barbara Boxer, who requested a Federal inquiry.

At times like those, oil companies never want to talk about price spikes. They refer press calls to the Washington, D.C.-based American Petroleum Institute (API), the industry's lobbying group. API's standard response is that none of the price-gouging charges has ever stuck.

"We've had 25 requests by politicians to look into price gouging," said API spokesman Bill Hickman. "And we were exonerated every time."

And Chris Walker, a Sacramento lobbyist for an association of branded gas stations, said gouging allegations are a red herring. California's refiners aren't doing anything more than making money, he said, which gets easier as competition slackens. "It's not a grand conspiracy."

Though the state tracks oil-refiner margins (the difference between what a refinery pays for crude and how much it charges for gas), that number doesn't show how much the refiner profited for each gallon of gas produced.

The California Energy Commission breaks down the costs of a gallon of gas on its website. The figures break down how much goes to crude-oil costs, wholesaler costs and profits, refinery costs and profits, and taxes. The refiner cost-and-profit margin usually accounts for around 30 cents per gallon of gas sold at retail.

This year, according to state figures, refiner margins more than tripled in less than 3 months. On January 1, unbranded gas averaged $1.58 at the pump, with refiner margins of 21 cents per gallon. When prices peaked 10 weeks later, the same gallon of gas went for $2.14, but the refiner margin had shot up to 76 cents per gallon.

It may sound like refiners are holding consumers hostage, but state investigations have never found anything resembling a smoking gun. The most comprehensive study of the California market was issued by state Attorney General Bill Lockyer in 2000. The report, produced by a task force as part of an investigation that continues today, found no wrongdoing but also concluded that there's just not much competition in the state anymore. The main reasons are that refining capacity is tight and that the refiners who produce the state's gas also have a lot of the retail outlets locked up.

"Although similarly structured as other markets, the gasoline industry in California is more concentrated and vertically integrated than gasoline industries in other key refining areas of the United States," the report concluded. "In California in 1990, the refinery market share of the largest seven branded refiners was less than 80 percent. Today, just six refiners control 92 percent of the state's gasoline-refining capacity. These same six refiners account for more than 90 percent of the gasoline consumed in the state."

With a business partner, Riar bought his gas station in 1989 after giving up a Silicon Valley tech job to move to Sacramento. He was tired of living in the Bay Area, and Sacramento put him closer to the places where he hunts bear and deer. The switch meant hard work: Riar's workdays can stretch up to 10 or 12 hours, starting at 6 a.m. when he opens the gas station. Running the station himself and hiring family members to help is a way to keep costs down. "We are surviving because we don't count our hours," he said one morning. A lot of independents—the ones that are left, anyway—do the same, he said.

Five years ago, environmental laws mandated new underground storage tanks for all gas stations. Riar kept the mini-mart part of the gas station open while the old tanks were dug up and replaced. The work alone cost $165,000, but Riar weathered the disruption—something a lot of independents couldn't do.

Mini-market items like the food and drinks sold inside can be a saving grace because they usually have a much bigger margin than gas does (a soda, for example, might cost pennies but sell for dollars). But that's complicated by the fact that high gas prices mean customers have less money for other items, so they buy fewer sodas and candy bars. The challenge is to keep gas prices low enough to keep a steady stream of customers coming in the door.

"We're selling gas well because we're independent, but we're getting no profit," he said. "We have to sell the gas as cheaply as we can to keep going."

Adding insult to injury, Singh said, customers complained about the high prices and blamed him. The irony, of course, is that as he said this, the profits were being taken far up the supply stream, before one drop of gas went out the refinery gate.

Since the region's first refinery went up a century ago, Northern California has been getting almost all of its gas from refineries clustered around the Carquinez

Strait, in places like Martinez, Rodeo and Benicia. Today, there are five major refineries in the area, all taking oil from ships and pipelines and then pumping it through tubes inside a high-pressure furnace that breaks down crude oil's hydrocarbons into different compounds.

These refineries pump the finished fuel products through a network of underground pipelines to regional distribution centers. Sacramento's fuel comes to two terminals, one on Bradshaw Road and the other where Broadway meets the Sacramento River. At these distribution centers, or racks, gas is stored in tanks and then trucked to gas stations.

Most of the gas at the racks is already spoken for by branded stations that have supply contracts with refiners, but there's also surplus gas. The leftovers are what wholesalers buy and then sell to independent stations.

The system works until a hiccup—from minor things like bad mixtures of gas to big things like explosions—disrupts refinery output. When there's a shortfall, prices jump, and independent stations, which don't have supply contracts, end up paying much higher prices. If there's a severe shortage, independents also are the first to be refused.

That decline of independent retailers eliminates a key downward force on prices, said Severin Borenstein, director of the University of California Energy Institute at the University of California, Berkeley. "It's potentially quite serious because independents seem to be the real competitive force in retail. They're the ones that keep some check on the branded prices."

With just a handful of refiners left, Borenstein said, "the market has gotten pretty tight over the last few years. They're not running with a lot of excess capacity, so it has gotten a lot harder for the no-brand retailers to buy gasoline at the rack."

Will Woods, Executive Director of the Laguna Hills-based Automotive Trade Organizations of California, a group made up mostly of branded dealers, pinpoints Arco's 1997 acquisition of independent gas retailer Thrifty as the moment things started to get really hard for independent, unbranded stations. Thrifty was the last major supplier to independent retailers, and its disappearance eliminated a force that brought all gas prices down.

"When Arco and Thrifty merged, the trucks were lined up at the gate, and Arco was saying, 'Sorry. We don't have anything for you. We need it all for Arco.' In that time period, all but the 10 percent that are left have either gone out of business or branded up to become a branded dealer."

That made it even harder on gas stations that remained independent. Today, Woods said, unbranded independents make up about 10 percent of the state's gas stations, which helps keep California gas prices among the highest in the country. In Texas, where gas is cheap, half of all stations are independent.

Tom Dwelle, Chief Executive Officer of Auburn-based Nella Oil, is on the opposite end of the spectrum of independent retailers. His company owns 70 gas stations in California. Some stations are the company's own brand, Flyers, and others have contracts with major oil companies to sell gas at branded stations. Nella is also a fuel wholesaler, running 30 tanker trucks 24 hours a day.

Dwelle grew up south of Fresno, in Hanford, where his grandfather, Walter Allen, founded Beacon Oil in 1931. In 1979, he and his three brothers formed a sister company called Nella, starting with one gas station (the name "Nella" is "Allen" spelled backward). Beacon was later snapped up by Canadian oil giant Ultramar. (In an example of how mergers and acquisitions have brought some industry assets full circle, some of the 23 gas stations that Nella recently bought from Tesoro last year were Beacon stations first opened by Walter Allen.)

Nella does millions of dollars worth of business every year, but it's still a relatively small company, and it got hit hard during the price spikes.

When prices leap quickly, Dwelle said, he can't keep up by charging his customers more. "We're at their mercy," he said. "I can't go up and raise the street [price] up immediately by 5 cents, because Arco will eat my lunch."

In mid-March, Dwelle said he and a lot of other independent wholesalers and retailers were caught in the same bind, unable to cover high costs. That same trend, throughout the years, has been the factor that pushed many independents out of business when they couldn't keep up.

"There aren't any more moms and pops around" anymore, Dwelle said.

Dwelle knows firsthand about independents going under because his company bought some of the failed stations. In a hangar next to his office just off the tarmac at Auburn Municipal Airport, the Dwelle brothers keep some of the relics of the business, from old-fashioned gas pumps with clear glass tanks on top to old signs advertising long-forgotten brand names such as Big Dummy Gas, a station the Dwelles acquired more than two decades ago after the gas shortages of the late 1970s.

International supply disruptions, such as the labor unrest that shuttered Venezuela's state-run oil company this year, can cause some headaches, Dwelle said, but most problems are due to the tight supply in California.

When prices shot up, Dwelle said, the 10 to 12 cent margin he needed to make money selling gas vanished, leaving his stations to sell at a loss, just 5 cents profit per gallon. "We need 7 or 8 cents' margin to be profitable. That's the cost of opening the doors."

At the same time as factors like that force stations to close their doors every year, the consolidation among big refiners means there are fewer refineries competing with one another, so prices increase.

"In the old days, we had a lot of refiners, but 23 of them in California have closed in the last 15 years," Dwelle said. "I had great fun playing the suppliers off of each other, but we can't do that anymore because they're all joining forces."

Dwelle said his company was getting squeezed by high prices, but it wasn't something that would put him out of business. But it's different for some of the small stations his company supplies, some of which are coming close to closing—especially after having to pay for pricey underground tank upgrades a few years ago. Dwelle wouldn't name names, but he said he sees the signs when stations sell their trucks, pay employees poorly, don't provide benefits and don't invest in upgrades.

"If everything works right, then we can make a little profit. And in the end, fortunately, most years, it's more up than down. It's never really good, but you know, we're not dead yet."

With this year's price spikes, relief came not long after prices peaked. Crude oil, which had hit a 12-year high of $40 a barrel in February, dropped by $12 a barrel on the international market at the onset of the war in Iraq. By early April, wholesale gas prices in California had plummeted 40 cents from the highs they'd hit 2 weeks earlier.

Retail prices, however, dropped by only a couple cents. To make up for high wholesale prices, stations hike prices quickly and drop them very slowly.

On April 2, California Energy Commission (CEC) Chairman Bill Keese briefed reporters at the Capitol about the gas-price report requested by the Governor. But the answer to the question everyone wanted to know was "no." Just like all the other studies, this one found no smoking gun proving that refiners had done anything wrong. Instead, the report confirmed what oil companies have been saying all along: It's the market at work. As Lockyer had reported 3 years earlier, Keese also noted that a small group of refiners control 92 percent of the market. Keese also noted that consumption in California is increasing by 3 percent a year. The resulting increase in demand helps push up gas prices.

"We seek to reduce consumption and reduce exposure to the spot market," Keese said.

But in addressing the reasons for the price spikes, the CEC staff report also included a couple lines saying, in effect, that nobody knows how much refiners are pocketing when prices spike because there's no way to separate costs and profits. It was frustrating for oil watchdogs when refiner margins, usually about 30 cents, ranged from 19 cents to 76 cents.

Though there's no evidence that refiners are gouging consumers, Keese is predicting that prices will continue to be erratic for years. To fix that, the CEC is considering another strategy. Because tight supplies are the primary reason for the price spikes, one CEC proposal would create a gasoline reserve to be tapped when refiners get behind. The reserve originally was recommended by the attorney general's report in 2000 but was never pursued.

At Riar's station on Northgate, business has been up since the mid-March price spikes. On a weekday morning in the first week in April, Riar was the only one working at the store, and he was trying to keep up with a nonstop stream of customers.

The sign posted on the street was $1.979 for regular unleaded. Between customers, Riar said his delivery the day before had been at $1.79 and that he'd been back in the black since the week before.

Still, as his prices came down, so did the price at the Arco up the street. Even though Riar's lower wholesale prices made it possible to make a profit, it was still hard to compete. "We can't. We can't. There's no way. We try our best, but Arco's a big company. The price [our suppliers] are giving us is a good price, so sometimes we can beat Arco, but Arco usually beats us."

Riar greeted customers with a "How ya doin', boss?" He knows most of them by face, if not name. "You're late today," he said to one. "Are you working at that new store?", he asked another. Every transaction was punctuated by the constant electronic ding-dong of the door sensor. Customers came and went, buying a pack of menthols, a bottle of malt liquor, lottery tickets and, of course, a lot of gasoline,

which is invariably ordered the same way, by dollar value and pump number: "5 on five" and "10 on two."

Though it's a hard business, Riar said he wouldn't consider branding up with one of the majors—not that they'd be interested in a small station in an out-of-the-way area anyway.

The picture doesn't look rosy for independent gas retailers like Riar, and by extension their impact on prices, but consumers ultimately have more control over gas prices and supplies than they think. The answer, according to the CEC, is simpler than it seems: Shop around and don't guzzle so much gas.

Fellow Bakersfield Refinery Employee,

My best wishes to you and your loved ones this holiday season. May you experience the joy and promise this time of year represents.

As we have discussed before, we turned in excellent operational performance this year. We are the most reliable Shell U.S. refinery in 2003, and achieved world-class performance 2 years in row now. We have made quantum step improvements in our environmental compliance, finishing well under our target again for the second straight year. We have reduced the expenses we control 15+ percent year over year, and have been one of the few Shell U.S. refineries to turn a profit. And, while we struggled with our attention to safety in a difficult first quarter, we've stepped forward and created a new culture and attitude for protecting ourselves and our coworkers; reducing injuries over threefold in the last half of the year.

We've done all this with the lowest personnel index in Shell refining in the country, making us comparatively the most productive and effective workforce in the system. All in all, an outstanding year by an exceptional group of people. Great, great job and I thank you for your contributions to this success.

As you well know, 2004 will bring its fair share of challenge and life change for us. Yet despite the level of difficulty, I am convinced there is no better group of people to face it with. I look forward to positive outcomes for all of us as we navigate the new year.

Sincerely,

JEFF KRAFUE.

SHELL OIL PRODUCTS U.S.
Houston TX, April 13, 2004

Hon. BARBARA BOXER,
Senate Committee on Commerce, Science, and Transportation,
Washington, DC.

Dear Senator Boxer:

Thank you for your letter of April 9 regarding Shell's decision to close the Bakersfield refinery by October of this year. We appreciate your seeking information from Shell on this matter.

Shell has always been and remains willing to entertain any credible offers for the Bakersfield refinery. Shell has received nine inquiries from prospective buyers, but none of them has resulted in a credible offer to date. One inquiry came from an oil company, but they have indicated that they will not pursue further. Seven inquiries came from energy-related companies or other concerns, and another inquiry came from a company that was not interested in running the refinery as an ongoing concern. Out of all the inquiries, we have received only one written expression of interest thus far. In our view, a credible offer would begin with a written expression of interest and information showing adequate financial capability. While we are sharing information with this one party, it has not resulted in a credible offer to date.

As Shell representatives informed your staff during a briefing in Washington, D.C. last month, the decision to close the refinery is based on the fact that the refinery is not economically viable due to the continual decline of the crude which supplies this land-locked facility. And we believe potential buyers would reach the same conclusion that we have about its economic viability. For this reason, we have not expended time or resources in an attempt to find a buyer and do not intend to do so. We will, however, continue to respond diligently to all inquiries and are prepared to negotiate with any credible potential buyers.

To give you a better understanding of how we reached our decision, let me share with you some facts. The Bakersfield refinery is configured to process San Joaquin Valley heavy crude, which it only gets from the Kern River Field, upon which the refinery has sat since 1932. Production from the Kern River Field declined by 6.4

percent in 2002 alone, according to production reports published by the California Department of Conservation. Transmission pipelines take San Joaquin Valley heavy crude away from the Kern River Field to several other refineries, including Shell's larger Martinez refinery near San Francisco, but there are no transmission pipelines or other economical means to bring crude to the Bakersfield refinery from other San Joaquin Valley fields.

Declining access to economic crude for this facility is a financial drain. The Bakersfield refinery lost $24 million in 2001 and lost $33 million in 2002. It made only $4.7 million in 2003, which is an inadequate return on investment given Shell's investment of over $200 million in the refinery. The refinery was projected to lose $5.7 million in 2004. Even if the refinery is slightly profitable in 2004, we will not achieve an acceptable rate of return to justify continued investment in the facility. Furthermore, in February of this year, even with rising margins, we could utilize only 64 percent of the refinery's capacity largely due to our limited access to crude. Thus, with the low utilization rates projected to continue due to lack of access to enough crude, Shell cannot justify continuing to make investments in this facility.

Shell announced this closure decision eleven months in advance in order to give its employees, customers, the city of Bakersfield, the market, and other concerned parties as much time as possible to plan for the closure. As noted above, we remain receptive to any credible offers that we may receive over the next several months. But given what we believe to be the inevitable—the closing of the refinery based on economic reality—it would be a disservice to now introduce uncertainty into this process by delaying or indefinitely postponing the closing of the facility. Therefore, we do not intend to postpone closing the refinery.

I thank you again for your correspondence. Please feel free to contact me if you have any additional questions.

Sincerely,

LYNN L. ELSENHANS,
President and CEO.

SHELL OP U.S. AND MOTIVA REFINING UPDATE—5 APRIL 2004 *

Safety and Environmental

Safety Performance 2004			Environmental	
Location	Recordable Incidents YTD 2004	Lost-Time Incidents YTD 2004	Environmental Incidents YTD 2004	Environmental Incident Plan (Incidents/Yr)
Bay Valley				
Bakersfield	1	0	17	44
Martinez	0	0	5	44
Los Angeles	1	0	9	38
Puget Sound	4	2	4	17
Louisiana Complex				
Convent	2	1	5	40
Norco	6	0	6	35
Delaware City	7	1	70	65
Port Arthur	3	1	8	62
Deer Park	3	0	12	41
Totals	27	5	136	386

Note: OSHA recordables combine employee and contractor incidents

Safety—newly reported incidents: *Convent* (OSHA recordable and lost time incident: employee scalded from hot sewer water); *Delaware City* (OSHA recordable—employee treated for inhalation of butane vapors); *Los Angeles* (OSHA recordable—contractor performing asbestos removal required stitches following a foot injury due to a scraper); *Puget Sound* (OSHA recordable—turnaround contractor cut his hand while reattaching a loose hose, requiring stitches); *Norco* (OSHA recordable—instrument inspector cut his finger using a pocket knife, requiring stitches).

Environmental—newly reported incidents: *Martinez* (NO_x exceedence at the cogeneration unit); *Los Angeles* (NO_X exceedence and flaring stemming from a shutdown of a gas compressor at the hydrogen generation unit); *Delaware City* (two new inci-

* Compiled from latest information available at mid-day on April 5, 2004.

dents, the latest a CO exceedence during cat CO boiler startup); *Puget Sound* (noise complaint during startup of the cat cracker).

Operations—Crude Rates

Location	Plan	Actual		MTD Delta	% of Plan	Key Drivers
	CM	Latest	MTD			
Bakersfield	67	66	67	0	100	
Martinez	157	139	143	−14	91	
Los Angeles	91	55	51	−40	56	Coker fire Mar. 23
Puget Sound	135	135	125	−10	92	CCU & Alky 2 Turnaround
Convent	234	250	247	13	105	
Delaware City	175	180	177	1	101	
Norco	230	231	231	1	101	
Port Arthur	260	290	287	27	110	VPS−4, CRU−4 turnaround
Deer Park	293	310	312	19	106	
Bay Valley Complex	224	205	210	−15	93	
Louisiana Complex	464	481	478	14	103	

West Coast Refining

Martinez

Operations are running well.

Bakersfield

Operations are running well. Some planned maintenance work has been deferred in order to take advantage of very high margins.

Los Angeles

The coker remains down from the fire on March 23. Asbestos abatement completed last Wednesday (Mar. 31); work continues to dismantle damaged eletrical equipment. An estimate of outage time will not be available until Wednesday (Apr. 7). Other units run at reduced rates due to the coker outage.

Puget Sound

Operations are running well. The cat cracker has returned from the turnaround, *on schedule.* As its rates increase today, startups of the alkylation unit #2 and polymerization unit will follow in turn. Catalyst regeneration on reformer CRU1 is complete.

East/Gulf Coast Refining

Convent

Operations are running well.

Norco

Operations are running well.

Delaware City

Operations are running well. The cat cracker CO boiler is back online; cat rates are now increasing past 70 MB/d. The refinery is running down inventory to meet targets for the upcoming close.

Port Arthur

Rates at the reformer will increase back to normal today following completion of a blackburn process to remove excess coke. Otherwise operations are running well.

Deer Park

Operations are running well.

Base Oils Manufacturing

Port Arthur

Operations are running well.

Refining Margins

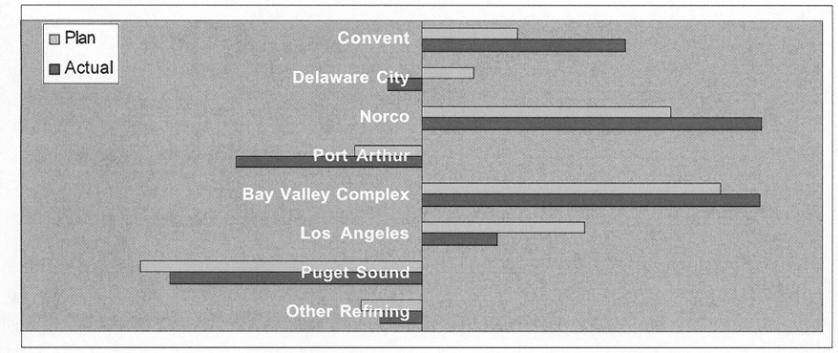
Wow.

Refining Margins (as of April 2)

Location	Margin	Difference from Plan				
		Latest	7-Day	MTD	Last Month	Last Qtr
Norco	9.18	4.75	5.88	4.90	3.97	4.90
Port Arthur	7.85	3.81	4.46	3.92	3.15	3.92
Convent	10.19	5.41	6.08	5.49	4.56	5.49
Delaware City	7.19	2.82	3.56	2.98	2.77	2.98
Bakersfield	23.01	16.78	10.79	16.45	3.54	16.45
Los Angeles	22.93	17.54	11.06	16.91	3.81	16.91
Martinez	21.82	15.95	10.04	15.75	2.11	15.75
Puget Sound	14.96	10.94	5.73	10.47	0.92	10.47

Net Income

From the Net Income estimate for March 2004:



The CHAIRMAN. Senator, the hearing is over.

[Whereupon, at 12:35 p.m., the hearing was adjourned.]

A P P E N D I X

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. DANIEL K. INOUYE TO HON. DEBORAH PLATT MAJORAS

Question 1. At the hearing held in November 2005 on price gouging, you stated that you thought an anti-price gouging statute is not the appropriate "tool" for enforcement and consumer protection. What do you believe to be the appropriate "tool" when it comes to keeping consumers from being taken advantage of, especially during a disaster?

Answer. In periods of shortages, higher prices encourage producers to increase supply to a market and encourage consumers to decrease demand. If prices are constrained at an artificial level for any reason, including in response to a price gouging statute, then the economy will work inefficiently by bringing in less supply and doing less to curb demand. Because a flexible price system is so important, I continue to believe that a Federal price gouging statute would do more harm than good for consumers, and for the economy in general.[1]

The FTC's enforcement of existing antitrust and consumer protection laws plays a key role in protecting consumers, both in normal circumstances and during emergencies.[2] Pursuant to the antitrust laws, the FTC and the Antitrust Division of the Department of Justice (DOJ) prosecute unlawful collusive behavior, monopolization, and anticompetitive mergers and acquisitions. We can best protect consumers from market disruptions, whether caused by natural disasters or by abuses of market power, by protecting competitive market forces and allowing them to restore the efficient supply of goods and services as quickly as possible. Controlling prices—through a price gouging law or otherwise—will distort those forces and delay recovery.

As described in the FTC Gasoline Report, during the months after Hurricane Katrina made landfall, the normal forces of supply and demand mitigated the dramatic post-hurricane price spike. Not only did the sudden rise in gasoline prices curb consumer demand—and thus immediately relieve the upward price pressure experienced in the aftermath of last year's Gulf Coast hurricanes—but higher gasoline prices also signaled suppliers to bring more product to the most severely affected areas of the country, further blunting the price increases. For example, imports of large quantities of gasoline to U.S. ports from Europe and other locations dampened the price increases.[3] In addition, because of increased refinery utilization and a shift in output from other products to gasoline, the production of gasoline increased at U.S. refineries outside the hurricane zone.[4] This increase in gasoline production—which became profitable for these refineries precisely because of the post-hurricane gasoline price increase—ultimately led gasoline prices back down following the initial shock of the hurricanes. Prices returned to pre-Katrina levels within 4 weeks after Rita and to pre-summer levels by the end of November.[5]

In addition to our antitrust investigative and enforcement work, last year the Commission committed its consumer protection expertise and resources to assist victims of the hurricanes to regain control of their financial lives and avoid scams, and to ensure that Americans' generous charitable donations were not siphoned off by

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[1] In any effort to craft and enforce a price gouging statute that would protect consumers during an emergency without leading to even greater shortages, the primary difficulty is to distinguish gougers from firms that are reacting appropriately to the situation. This also is a problem for gasoline merchants who face uncertainties of supply and lack sophisticated means of price-setting, for wholesalers who may choose not to supply the affected area because of artificially low prices, and for consumers who lack the incentive to curb demand.

[2] In addition, Congress has enacted—and the executive branch enforces—statutes designed to protect the health and safety of persons affected by a natural disaster. These laws cover evacuation from unsafe areas, emergency food supplies, housing, medical care, search and rescue services, and law enforcement.

[3] *See* FTC Gasoline Report at 79.

[4] *See id.* at 75.

[5] *See id.* at 61.

bogus fundraisers. The FTC's Division of Consumer and Business Education (DCBE) acted quickly to educate consumers about the specific risks posed by the hurricanes. When the hurricanes hit, DCBE quickly prepared new materials to address the many financial challenges faced by those displaced by the storms and separated from their financial and other records, to combat the heightened risk of identity theft, and to underscore the need for consumers to be on the alert for scams.

The FTC also participated in the Hurricane Katrina Fraud Task Force, which included members from the DOJ, the Federal Bureau of Investigation, the Postal Inspector's Office, and the Executive Office for United States Attorneys. The Task Force's work included tracking referrals of potential cases and complaints, coordinating with state and Federal law enforcement agencies to initiate investigations, matching referrals with the appropriate U.S. Attorney's offices, and ensuring timely and effective prosecution of Katrina fraud cases.

Question 2. The consolidation in the oil markets, which the Federal Trade Commission (FTC) allowed, has contributed to increased gas prices. Some believe this consolidation made it easier for the oil companies to charge what it wants in times of duress. Does the Commission have the tools to detect gouging at the wholesale level if the Congress gave you the necessary authority?

Answer. Pursuant to its authority under Section 7 of the Clayton Act,[6] the Commission has thoroughly investigated every significant petroleum industry merger over the past 20 years and, when it has concluded that a merger is likely to reduce competition, the agency has required divestitures or sought preliminary injunctions. Many of the mergers the FTC challenged would have lessened competition significantly if they had proceeded as originally planned. Our antitrust remedies prevented those increases: through carefully crafted divestitures, the Commission mandated the elimination of competitively problematic overlaps between the merging parties while allowing the competitively unobjectionable—or even efficiency-enhancing—portions of the transactions to proceed.

Although merger analysis begins with concentration data, that analysis must place substantial emphasis on the qualitative factors that indicate whether a merger will increase the ability of the merging parties to exercise market power by curbing output unilaterally or by coordinating their behavior with rival suppliers. The Commission's application of these principles to petroleum mergers has served to maintain competition in properly defined relevant antitrust markets. Indeed, there simply is no credible evidence that increases in oil industry consolidation have led to higher gasoline prices.

Moreover, despite increases in concentration at some production levels over the last two decades, particularly since the mid-1990s, most sectors of the petroleum industry at the national, regional, or state level generally remain unconcentrated or moderately concentrated. As measured by the Herfindahl-Hirschman Index,[7] refining concentration in PADDs II through V[8] remains moderate. Although the concentration for refining in PADD I had increased to 2,713 by January of this year, significant additional competition in this area is provided by Gulf Coast shipments and imports. Wholesale and brand-level retail concentration at the state level remains unconcentrated or moderate (that is, below 1,800) in most cases.[9] In addition, the growth of independent (nonintegrated) marketers and hypermarkets has increased competition at the wholesale and retail levels in many areas.

The challenge in crafting, and therefore enforcing, a price gouging statute is the ability to distinguish "gougers" from those who are reacting in an economically rational manner to temporary shortages resulting from an emergency. FTC staff has

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[6] Section 7 of the Clayton Act prohibits acquisitions that may have anticompetitive effects "in any line of commerce or in any activity affecting commerce in any section of the country." 15 U.S.C. § 18.

[7] The Commission and the Department of Justice measure market concentration by means of the Herfindahl-Hirschman Index (HHI), which is calculated by summing the squares of the market shares of all firms in the market. Under the DOJ/FTC Horizontal Merger Guidelines, markets with HHIs between 1,000 and 1,800 are deemed "moderately concentrated," while markets with HHIs exceeding 1,800 are deemed "highly concentrated."

[8] "PADD" stands for "Petroleum Administration for Defense District." PADD I consists of the East Coast. PADD II consists of the Midwest. PADD III includes the Gulf Coast. PADD IV consists of the Rocky Mountain region. PADD V is made up of the far Western states and includes Alaska and Hawaii.

[9] The correct definition of a market in an antitrust case is a detailed, fact-intensive inquiry that involves both product and geographic components. We must ascertain for which product (or products) the transaction may harm competition, and we also must determine the geographic area over which any anticompetitive effects will be felt. In our analysis of petroleum mergers, national, state, or PADD-wide "markets" rarely correspond to properly defined geographic markets.

looked at the experience of several states in enforcing their price gouging statutes as information relevant to the enactment and enforcement of a possible Federal statute. Our analysis found that terms characterizing price increases as "exorbitant," "unreasonable," or "unconscionable" require subjective interpretation that increases the difficulty of both compliance and enforcement. In addition, efforts to lend greater specificity by defining price gouging in terms of a specific percentage increase above pre-emergency prices may have the undesirable consequence of instituting a cap on prices with a pass-through for out-of-pocket costs.

Despite the inherent challenges associated with enforcing a potential Federal price gouging statute, I can assure you that the Commission will do its utmost to implement and enforce any additional legislation that is enacted. The Commission does not require additional tools to detect price gouging or any violations of current antitrust laws—whether at the wholesale level or at any other level of the petroleum industry. The Hart-Scott-Rodino Act requires merging parties to file information concerning all competitive aspects of the transaction with the Commission and DOJ and to wait a specified period before consummating the merger. In the context of the petroleum industry, this enables the FTC to conduct a thorough investigation and take action, if necessary, to block an anticompetitive merger or reach agreement with the parties concerning appropriate remedies. In addition, the Commission spends considerable resources searching all industries for violations of the nonmerger laws it enforces, and it has an active price monitoring program unique to the petroleum industry that is used to detect pricing anomalies. Once a violation is found, the Commission can employ strong measures to collect any additional information necessary to bring an effective case. The Commission can enforce subpoenas and civil investigative demands against investigative targets and third parties in merger and nonmerger investigations. These tools have proven—and should continue to be—sufficient to detect and investigate violations of the antitrust laws and price gouging, as that offense has been defined in various legislative proposals.

Question 3. Do you see this as something your agency will pay more attention to in the future and possibly take more stringent action to aid American consumers?

Answer. The Commission is acutely aware of the petroleum industry's importance to consumers and the economy as a whole, and vigorously seeks to identify, prosecute, and prevent any unlawful anticompetitive practices in the petroleum industry. We collect real-time gasoline price data through our price monitoring project and have brought merger cases at lower HHI levels in the petroleum industry than in other industries.[10] We will continue this aggressive approach to maintaining competition in this vital industry. Moreover, we search constantly for ways to use our resources most effectively to protect consumers from unwarranted uses of market power and the harm they cause.

Response to Written Questions Submitted by Hon. Frank R. Lautenberg to Hon. Deborah Platt Majoras

Question 1. How much would you say *speculation alone* is raising the price of oil?

Answer. I note, of course, that the Commodity Futures Trading Commission is responsible for the regulatory oversight of futures and derivatives trading—a subject that is therefore outside the FTC's primary area of expertise. Although it is impossible to say how much speculation alone affects the current price of oil, I can offer some observations about the impact of speculation on futures markets and on commodity markets and prices.

Two types of futures traders are at issue here. Commercial traders use futures or options markets to offset—or "hedge"—possible price changes in physical commodities, thereby attempting to lock in a cost or a profit margin. For instance, an airline may contract for future deliveries of jet fuel at a set price. By contrast, noncommercial futures traders, sometimes referred to as "speculators," have no need or desire to acquire physical commodities. They seek to benefit only from fluctuations in prices over time. It is clear that investments in oil futures and derivatives by non-commercial traders have increased dramatically recently. These investors have made bets that oil prices will increase in the future. Because of the relationship between futures prices and current prices, bidding up the prices for oil futures in financial markets contributes to an increase in spot prices for oil in commodity markets.

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[10] *See* Federal Trade Commission Horizontal Merger Investigation Data, Fiscal Years 1996–2003 (Feb. 2, 2004), Table 3.1 *et seq.;* FTC Horizontal Merger Investigations Post-Merger HHI and Change in HHI for Oil Markets, FY 1996 through FY 2003 (May 27, 2004), available at *http://www.ftc.gov/opa/2004/05/040527petrolactionsHHIdeltachart.pdf.*

Speculative activity in futures markets appears more likely to affect price volatility than to change average price levels over any sustained period. Former Federal Reserve Board Chairman Alan Greenspan recently testified that such investors "are hastening the adjustment process" in response to changes in oil supply and demand fundamentals, with the result in recent times that "oil prices have moved up sooner than they would have otherwise." [1] It is difficult, however, to quantify the extent to which non-commercial futures trading affects price volatility.

Some believe that non-commercial investments contribute to the appropriate allocation of oil supplies over time. Then-Governor Bernanke of the Federal Reserve Board explained in 2004 that "[s]ocial welfare is likely increased by informed speculation in oil markets because speculative activities make oil relatively more available at the times when it is most needed." [2] When futures prices increase because of speculation that oil prices are on the rise, such activity encourages producers to preserve additional oil inventories to meet future demand. To the extent that current prices also rise as a result, producers see immediate profit opportunities to increase output and, at the same time, consumers are encouraged to conserve. In effect, well-functioning futures markets and informed investments by non-commercial traders may facilitate the shifting of output from the present (when prices are relatively low) to the future (when they are expected to be higher), thereby increasing supplies in tight markets. Therefore, any government initiatives that would impede the price system in dealing with changes or disruptions in market conditions should be considered cautiously.

Question 2. Do you agree with Commissioner Leibowitz's concurring opinion—that OPEC is a—QUOTE—"villain" that has caused massive transfers of wealth from the United States to oil-exporting nations?

Answer. There is no question that OPEC, if composed of private companies instead of sovereign nations, would constitute a hard-core price-fixing cartel, subject to criminal prosecution under U.S. antitrust laws. OPEC systematically attempts to restrict output in order to keep world petroleum prices above levels that would prevail in a competitive market. OPEC's activities undoubtedly have caused wealth transfers from oil-consuming nations like the United States to oil-producing nations.

Sovereign nations enjoy several jurisdictional and substantive defenses to the antitrust laws that are not available to domestic or foreign private companies.[3] The sovereign immunity doctrine, substantially codified by Congress in the Foreign Sovereign Immunities Act of 1976 (FSIA),[4] holds that each independent sovereign is equal in sovereignty to all other states.[5] Thus, the courts of one nation generally have no jurisdiction to entertain suits against another nation.

Under the act of state doctrine, U.S. courts ordinarily will not decide a dispute involving the legality of the sovereign act of a foreign state. This doctrine deems a judicial remedy inappropriate in such cases for international comity reasons and

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[1] Statement of Alan Greenspan, President, Greenspan Associates LLC, before the Committee on Foreign Relations, U.S. Senate, at 4 (June 7, 2006), available at *http://foreign.senate.gov/testimony/2006/GreenspanTestimony060607.pdf.*

[2] Remarks by then-Governor Ben S. Bernanke, "Oil and the Economy," at the Distinguished Lecture Series, Darton College, Albany, Georgia (Oct. 21, 2004), available at *http://www.Federalreserve.gov/boarddocs/speeches/2004/20041021/default.htm.*

[3] *See* United States Department of Justice and Federal Trade Commission, Antitrust Enforcement Guidelines for International Operations, §§3.31 (Foreign Sovereign Immunity) & 3.33 (Acts of State) (Apr. 5, 1995), *reprinted* at 4 Trade Reg. Rep. (CCH) ¶13,107.

[4] 28 U.S.C. §§1330, 1602–11.

[5] Pursuant to an exception to the FSIA for an "action. . . . based upon a commercial activity," 28 U.S.C. §1605(a)(2), a foreign nation is deemed to have waived its immunity when it engages in "commercial activity." One U.S. district court, however, has held that the agreement among OPEC member nations was not commercial activity under the statute because it related to sovereign nations' choices about how to exploit natural resources within their control. As the court stated, "it is clear that the nature of the activity engaged in by each of these OPEC member countries is the establishment by a sovereign state of the terms and conditions for the removal of a prime natural resource—to wit, crude oil—from its territory." *Int'l Ass'n of Machinists* v. *OPEC,* 477 F. Supp. 553, 567 (C.D. Cal. 1979), *aff'd,* 649 F.2d 1354 (9th Cir. 1981), *cert. denied,* 454 U.S. 1163 (1982). *See also* American Law Inst., Restatement (Third) of the Law: The Foreign Relations Law of the United States, §443, Comment i (1986) ("An official pronouncement by a foreign government describing a certain act as governmental is ordinarily conclusive evidence of its official character."). Other courts have agreed that a nation's decisions concerning its natural resources are not subject to the jurisdiction of other nations. *MOL, Inc.* V. *Peoples Republic of Bangladesh,* 736 F.2d 1326, 1329 (9th Cir.) (abrogating a contract to export native fauna was within "Bangladesh's right to regulate its natural resources, . . . a uniquely sovereign function"), *cert. denied,* 469 U.S. 1037 (1984); *Rios* v. *Marshall,* 530 F. Supp. 351, 372 (S.D.N.Y. 1981) ("temporary removal of manpower resources" is not a commercial activity under the FSIA).

also in light of separation of powers considerations.[6] OPEC has successfully invoked both the foreign sovereign immunity and the act of state doctrines in defense against antitrust lawsuits brought in U.S. courts.[7]

Thus, although I agree that OPEC's activities have caused wealth transfers to oil-exporting nations, and that those activities would be naked antitrust violations if perpetrated by private firms,

I do not see a clear way to hold OPEC accountable in U.S. courts under current law. U.S. enforcement policy toward OPEC actions should be set at the highest levels of the executive branch, based on careful consideration by the Department of State, DOJ, and other appropriate agencies.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. DANIEL K. INOUYE TO DR. NARIMAN BEHRAVESH

Question 1. Dr. Behravesh directs Global Insight's entire forecasting process and is responsible for developing the economic outlook and risk analysis for the United States, Japan, Europe, and emerging markets.

Two rising powers, China and India, share the United States' affinity for automobiles and will surely put upward pressure on oil prices and increased competition for oil resources. With five million car sales in 2004, China became the world's third-largest car market, after the United States (17 million) and Japan (5.9 million). Within the next 2 or 3 years, according to David Thomas, head of China distribution for Ford Motor Company, China is going to become number two. By 2030, the Indian market is expected to reach 20 million, just behind the United States at 23 million and up from the one million sold in 2004.

Dr. Behravesh, with the exponential growth we are seeing in China and India's economies, particularly their automobile fleet, what is the economic outlook regarding petroleum products in the United States?

Answer. China's increasing demand for energy has already had a big impact on oil and gasoline prices over the past 4 years. In the next decade, India will join China as one of the largest markets for cars and gasoline. This will inevitably put further upward pressure on both oil and gasoline prices. Global Insight estimates that during the past 4 years, rapid energy demand growth in China and India has added about $15 per barrel to the price of oil. This price wedge is likely to increase to between $25 and $30 per barrel by 2030.

Question 2. With the increased international competition for oil supplies, do you see a greater chance of companies limiting their supplies to get a higher profit margin or just the opposite?

Answer. With strong demand growth in the next few decades, the profit margins of oil suppliers will increase, at least temporarily. Most of this will go to the oil exporting countries of the Persian Gulf, where a very large share of the proven oil reserves are to be found. While oil companies will benefit from sustained high oil prices, they are increasingly becoming marginalized in oil markets (*e.g.,* by being excluded from drilling in many of the lucrative oil fields). The longer oil prices remain high, the greater the likelihood that new supplies of traditional and alternative fuels will flood the market, eventually bringing prices back down to earth. History has shown, again and again, that markets do work, albeit sometimes very slowly.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. FRANK R. LAUTENBERG TO DR. NARIMAN BEHRAVESH

Question 1. Increasingly, prices are being guided by a continuing rush of investor funds into oil markets. *Institutional money managers are holding between $100 billion and $120 billion in commodities investments, at least double the amount 3 years ago and up from $6 billion in 1999.*

The flow of money into oil has been prompted by a spreading belief that demand for oil will continue to rise with global economic activity as supply tightens under the influence of several factors—among them: the West's escalating nuclear standoff with Iran; growing political violence in oil-rich Nigeria; and more broadly, steadily growing global economic activity. The three-year bull run in oil has been under-

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[6] The Supreme Court described the act of state doctrine as "a consequence of domestic separation of powers, reflecting 'the strong sense of the Judicial Branch that its engagement in the task of passing on the validity of foreign acts of state may hinder' the conduct of foreign affairs." *W.S. Kirkpatrick & Co.* v. *Environmental Tectonics Corp.,* 493 U.S. 400, 404 (1990) (quoting *Banco Nacional de Cuba* v. *Sabbatino,* 376 U.S. 398, 423 (1964)).

[7] *See supra* note 28.

pinned by strong global demand for fuel coupled with a prolonged shortage of spare capacity to pump crude. OPEC's spare capacity, for example, has fallen from six million barrels per day (mbd) in 2002 to just two million barrels per day this year, while production has risen from as low as 24 million barrels per day in 2002 to 29–30 million barrels per day today.

Since early 2005, the crude-oil market is in what traders call "contango," meaning futures contracts for a given product are priced higher than that same good for near-term delivery. The price of oil to be delivered 4 months from now is about $3 more than oil to be delivered next month.

Indeed, OPEC fears a return to "backwardation"—the opposite of contango—with near-term prices higher than long-term contracts. Such a flip-flop could prompt speculative buyers to dump inventories; prices could quickly drop $20 a barrel or more.

If OPEC had more spare capacity, how would that affect speculators' assessments of oil futures?

Answer. During the summer months, refineries normally run at about 96 percent of capacity. The lower utilization rate this summer is almost entirely due to the conversion to ethanol. Both the refinery and transportation bottlenecks created by this conversion process also explain why refiners' margins are abnormally high. Global Insight expects that as the problems associated with the switch to ethanol are worked out, capacity utilization will increase and margins will fall—most likely in the next two to 3 months.

Question 2. OPEC uses production quotas to keep the price of oil high by restricting supply. Because of the production quotas, OPEC nations have not had an incentive to expand their production capacity, leading to tight oil supplies. Non-OPEC nations, meanwhile, have increased their production significantly.

If OPEC had been expanding its capacity over the past decade or so, like non-OPEC countries have, would oil prices likely be lower today?

Answer. Based on recent research, Global Insight believes that if OPEC capacity were 1.5 million barrels a day higher than it is today (for a total of 3 million barrels per day), oil prices would be $10 lower because of market forces alone. Factoring in the speculative "premium" discussed above, the overall decline in prices would be $17 to $20 per barrel.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. DANIEL K. INOUYE TO BOB SLAUGHTER

Question 1. The National Petrochemical & Refiners Association (NPRA) speaks for the petrochemical and refining industries on issues important to their business. Their members include more than 450 companies, including virtually all U.S. refiners and petrochemical manufacturers. A fact sheet on the NPRA website states that domestic supply has not kept pace with demand. There are only 148 U.S. refineries today with a combined capacity of 17 million barrels per day, compared to 324 in 1981 with a combined capacity of 18.6 million barrels per day. The NPRA claims that it is becoming more difficult to build new refineries because of economic, environmental and political considerations, including site costs, environmental requirements, rates of return on investments, and the "not-in-my-backyard" (NIMBY) factor. The NPRA also contends that significant increases in U.S. capacity have been achieved through additions at existing sites, but not through new facilities.

A fact sheet on your website notes that there are currently 148 U.S. refineries with a capacity of 17 million barrels a day, down from a high in 1981 of 324 refineries with a capacity of 18.6 million barrels per day. You say that more refineries are not being built due to the environmental restrictions put on the companies. However, is it not true that the primary reason for downsizing of the refineries is mostly due to the mergers of large companies and not the requirements of environmental laws?

Answer. To the contrary, the mergers and acquisitions of refineries and assets have actually improved the stability and capability of the domestic refining industry. This progress occurred and continues to escalate despite the massive expenditures required to meet environmental goals, both at the facility and in the vital transportation and other fuels they produce.

The "downsizing" of the industry referred to in the question must be placed in the proper historic and economic context. While there were approximately 324 refineries with nearly 18.6 million barrels per day (b/d) of crude oil capacity in 1981 (equating to an average 57,000 b/d per facility), many of these facilities were solely dependent upon crude oil allocation controls for their economic survival. Once these government-imposed, and inefficient policies were abandoned, the refineries in ques-

tion simply did not have the economic strength needed to make the required capital expenditures for environmental controls and in necessary processing unit updates to keep them viable in a highly competitive marketplace.

Currently there are 148 refineries operating in the United States, with a combined capacity of over 17 million (b/d). This translates to an average crude oil capacity of 115,000 b/d. Without the recent mergers and acquisitions witnessed in the domestic refining industry, many of these facilities would most likely have suffered the same fate of other less efficient operations and closed. One example in which acquisitions were key to increased production is Sunoco's refinery complex in the metropolitan Philadelphia area which now has over 550,000 b/d of capacity. If Sunoco were unable to operate these facilities as a synergistic unit, this production might not be available for consumers. Similar examples are prevalent throughout the industry.

Question 2. The mergers and downsizing of refineries has decreased the amount of competition and has helped lead to historic profits for these companies. If refining capacity is considered a significant problem, how are companies using these historic profits to address it?

Answer. In light of the strong demand for gasoline and other petroleum products, domestic refiners have worked hard to expand existing facilities. Over the past 10 years, domestic refining capacity has increased substantially, by an average of 177,000 barrels per day (b/d) of production each year. In simpler terms, this means that the U.S. refining industry has added the equivalent of one new, larger than average refinery, each year for the past decade.

Looking forward, the industry has announced publicly that 1.4 million b/d in new capacity is slated to come online in the next few years. Some estimates project a possible increase of nearly 2 million b/d of capacity over the same time frame. With these expansions, total domestic capacity will reach an all time high.

Most, if not all of these capacity additions will occur at existing refinery sites. The cost to construct a new grassroots refinery would require an investment averaging $17,000 per daily barrel of capacity and, at a minimum, take 10 years to complete. On the other hand, capacity expansions at existing facilities cost in the range of $9,000 to $12,000 per daily barrel and can be completed in 3 to 4 years. In short, expansions can help meet demand more quickly and cost effectively than construction of a new, green-field refinery complex. This means more fuel for consumers in a shorter time period than any hypothetical new U.S. refinery could provide.

Significantly, although the industry has not constructed new grassroots facilities, improved management techniques and technological advances allow existing facilities to produce ever greater amounts of refined product.

It remains doubtful, however, that these expansions will be sufficient to meet expected U.S. demand growth, which means that the Nation's continued dependence on imports of finished product and blendstocks will continue.

Refining capacity has already expanded and will continue to do so despite difficult and time-consuming obstacles, including complex permitting requirements and reviews, uncertainties involving the New Source Review program, increasingly stringent environmental requirements, and the difficulties of attracting sufficient investment in one of the most capital-intensive industries. NPRA continues to believe that encouraging the growth of domestic refining capacity is a vital component of U.S. energy policy.

Question 3. In your previous testimony, before the Committee at the last hearing on price gouging on September 21, 2005, you stated, "Critics of mergers sometimes suggest that industry is able to affect prices because it has become much more concentrated, with a handful of companies controlling most of the market. This is untrue. According to data compiled by the U.S. Department of Commerce and by Public Citizen, in 2003 the four largest U.S. refining companies controlled a little more than 40 percent of the Nation's refining capacity." However, this is in contrast with the Federal Trade Commission's (FTC) March 2001 report on the Midwest Gasoline Price Investigation, which found no collusion or violations of antitrust laws, but said an executive of a company they investigated made it clear that he would rather sell less gasoline and earn a higher margin on each gallon sold than sell more gasoline and earn a lower margin. The FTC said that a decision to limit supply does not violate antitrust laws, unless there was agreement among firms.

In the Federal Trade Commission's (FTC) Midwest gas investigation report, the Commission noted that an executive at a refinery company stated he would rather sell less gasoline at a higher margin on each gallon sold than sell more gasoline and earn a lower margin. If this is the natural preference, it suggests that a consolidated refinery industry has the natural drive to limit supply to obtain a better margin. Is this how it works? Please explain.

Answer. A petroleum refiner is subject to two distinct markets. These are the raw materials he needs to purchase and the finished products he offers for sale. The prices of crude oil and the principal refined products, gasoline, diesel fuel and other distillates including home heating oil, are independently subject to variables of supply, demand, production economics, environmental regulations, and other factors. As such, refiners and non-integrated marketers can be at enormous risk when the prices of crude oil rise but the prices of the finished products remain static, or even decline.

Such a situation can severely narrow the crack and spread the margin a refiner realizes when he procures crude oil while simultaneously selling the products into an increasingly competitive market. Because refiners are on both sides of the market at once, their exposure to market risk can be greater than that incurred by companies who simply sell crude oil at the wellhead, or sell products to the wholesale and retail markets.

Given this situation, it is virtually impossible for a single refinery or refinery to manipulate margins. No matter which commodity is involved, any manufacturer might theoretically prefer to keep his acquisition costs low (by purchasing less raw materials) while selling less product at higher margins. The marketplace, however, is driven by supply and demand and the ability of producers to capture market share, while maintaining a satisfactory return on investment. Therefore, what any manufacturer of any product may "prefer to do" will not occur in a highly competitive and diverse market as exemplified in the U.S. domestic refining industry.

Question 4. In your testimony before the Committee, you argued that four refineries controlling 40 percent of the refining capacity does not constitute a dominant market position with the ability to control prices. We have seen multiple instances and industries with lower market concentration that had the ability to control prices. Why is the refinery industry different?

Answer. As we stated in our written statement, some critics of the industry argue that recent mergers have reduced competitiveness and led to an increase in fuel prices. This assertion is simply wrong. The U.S. refining industry is highly competitive and has been found to be so in many studies conducted before the FTC and others. Fifty-four refining companies, hundreds of wholesale and marketing companies, and more than 165,000 retail outlets compete in the U.S. market. The largest U.S. refiner accounts for just 13 percent of the Nation's total capacity, and large integrated companies own and operate only about 10 percent of retail outlets. (For comparison, Archer Daniel Midland, the largest producer of fuel ethanol in the U.S., controls nearly 25 percent of the U.S. ethanol market.) No one company, or group of companies, sets gasoline prices. Rather, in the U.S. refining industry, the laws of supply and demand drive competitive behavior and determine pricing.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. DANIEL K. INOUYE TO DR. MARK COOPER

Question 1. After prices stabilized in the months after Hurricane Katrina, consumers suffered another drastic increase in gasoline prices in the spring of 2006. Oil prices topped $75 per barrel in the third week of April and currently have decreased to approximately $72 per barrel. These oil prices have translated to unleaded gasoline costs averaging more than $3 per gallon across the country. According to the Department of Energy, the price of gasoline is almost 70 cents higher than this time last year. Due to the high prices and outcry from constituents, some states are trimming or cutting the gas tax to try and ease the pain at the pumps. Governors and State Legislatures in Maryland, South Carolina, Connecticut, Georgia, New York, and Nevada are currently pushing measures on the tax, while Texas, Minnesota, Delaware, and Idaho are considering the idea.

Some states are trying to deal with higher gas prices by suspending taxes on gasoline. Do you think this is a good short term solution or does it cause more of a problem in the future?

Answer. While I understand the desire to ease the pain of rising gasoline prices, cutting taxes is just a shell game. Current taxes do not cover the cost of maintaining roads, and to the extent that tax revenues must be replaced or services cut, consumers will feel the pain in another way.

Question 2. In your testimony, you state that collusion is not occurring between the big oil companies, and you note that they do not have to because so few of them control the market and they know if one raises the prices, the others will follow suit. The Federal Trade Commission (FTC) says that withholding supply does not violate anti-trust laws, so they cannot do anything about it. However, more than 2,600 mergers have been approved in the U.S. petroleum industry since the 1990s, cre-

ating non-competitive markets. Do you think this is the number one cause of gas price spikes or do other factors have a similar effect?

Answer. The mergers are the number one cause of the increase in refiner margins and the domestic spread. The domestic spread has increased by $.60 per gallon since July 2003, for example. With a tight oligopoly, the industry restricts capacity and lets a tight supply demand balance put upward pressures on prices. Over that period, the price of crude has increased by about $.90 per gallon.

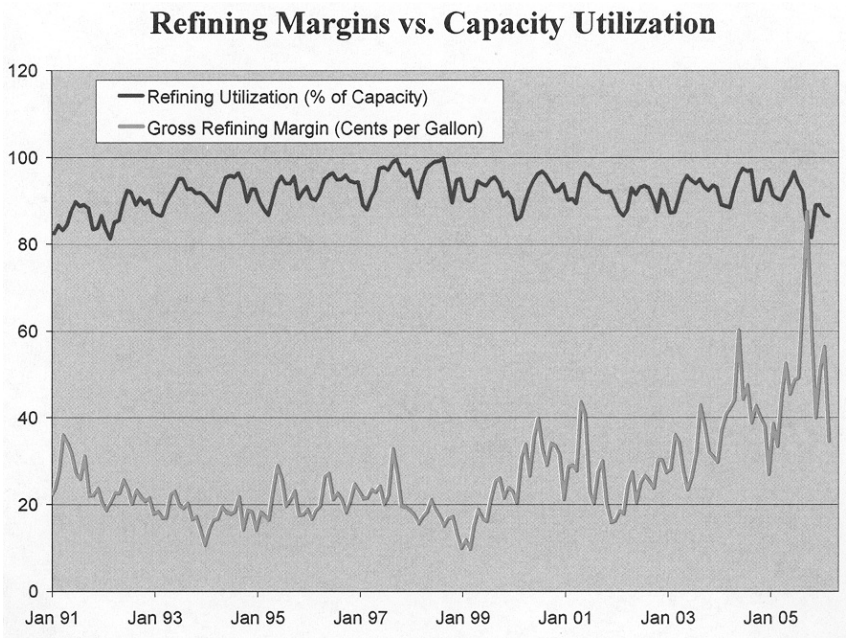
Question 3. You contend there is not enough competition on the supply-side to make producers expand their capacity, thereby lowering prices. In addition, you note that consumers cannot cut back on consumption sufficiently to reduce prices either, which leads to large profit margins for the big oil companies. What do you think the government needs to do to help prevent the industry from further downsizing and exerting even greater control over prices?

Answer. As outlined in my testimony, I believe we need a strategic product reserve, a strategic refinery reserve, and tougher antitrust laws that allow antitrust authorities to go after unilateral actions that raise prices in an area.

RESPONSE TO WRITTEN QUESTION SUBMITTED BY HON. FRANK R. LAUTENBERG TO ALL WITNESSES

Question. Gross refining margins—the difference between wholesale gasoline prices and crude oil prices—have skyrocketed recently, from a low of 14.3 cents per gallon in 2001 to 76 cents per gallon last week. This is a separate phenomenon than rising crude prices.

It is also more of a puzzle, because refiners are currently running at about 90 percent capacity, which is well in line with historic norms. Indeed, during 1998 refiners were briefly running at full capacity, 99.9 percent according to the Energy Information Administration. The chart below shows that refining output relative to capacity has little to do with refining margins, which have skyrocketed recently.



It is difficult to understand why refining margins should suddenly shoot up when capacity utilization is not out of line with historic levels.

According to the Energy Information Administration, refiners are currently operating at about 90 percent capacity, which is in line with historic norms. If refiners have the same amount of spare capacity as they have in the past, why have refining margins suddenly skyrocketed?

Answer from Dr. Nariman Behravesh. Global Insight estimates that approximately $7 to $10 of the current price per barrel of oil can be attributed to speculators' bet that oil markets will remain tight and that OPEC spare capacity will remain at around 1.5 million barrels per day. Thus, if OPEC had more spare capacity, this speculative "premium" would disappear.

Answer from Bob Slaughter. There is little or no relationship between the refining margin (crack spreads), which are the dollar-per-barrel value of a product or group of products compared with the acquisition cost of crude oil, and refining capacity utilization. Crack spreads are used as a proxy to estimate the gross margin obtained by processing a barrel of crude oil in a refinery. Historically, refining has been significantly less profitable than other industries during the 1990s. Gross refinery margins were squeezed at the same time that operating costs and the need for additional investment to meet environmental mandates had increased, further reducing the net refining margin. In addition, some of the investment made during the 1980s was designed to take advantage of the differential between the limited supply of higher quality crude oils and the increasing supply of heavier and higher sulfur crudes. When that differential narrowed, however, the financial return on those investments declined significantly. Thus, various trends in the 1990s led to a situation in which refining margins were relatively small or even nonexistent.

Refining margins have increased substantially in the recent past because the state of the gasoline market reflects a much different supply and demand situation than that of the 1990s. In essence, what is occurring in the current transportation fuels market is what the laws of economics suggest should be expected to happen. Domestic demand for refined products has accelerated, outpacing industry's ability to meet total demand with domestic supplies. This tight supply/demand balance, together with significant increases in global demand for these same products,(contrary to the situation that characterized the 1990s), has caused prices to rise in order to match the growth in consumer demand with available supplies.

Answer from Dr. Mark Cooper. Capacity utilization increased steadily over the late 1980s and 1990s, so the "historic norm" is only in comparison to recent years, not the long term situation.

Refinery capacity has not kept up with the growth in demand, resulting in tigher domestic markets and increasing imports. Imports provide less discipline for domestic pricing, especially in response to short term changes.

Stocks of gasoline, relative to demand, have also declined. These provide the initial response to any supply disruption or sudden increase in demand. Thus, the short term response has been more volatile.

Both the amount of refinery capacity and the quantity of product in storage are strategic variables within the control of the oil industry.

There has been a dramatic increase in the concentration of the refining sector, so the smaller number of players could exercise market power. They have exercised their market power by keeping capacity tight and supplies low, because they do not fear running out of supply. They know they can simply increase the price and not worry about losing their customers since the small number of companies will act in parallel fashion.

Answer from Hon. Deborah Platt Majoras. This is a complex and important issue that lacks easy answers. As you know, the President and the leadership of Congress recently directed the FTC, DOJ, and Department of Energy to analyze recent gasoline price increases and determine whether gasoline markets may be subject to illegal manipulation in any form. That work is underway, including an examination of issues relating to refinery margins and capacity utilization. The Commission will take swift and decisive action if our investigation or our gasoline price monitoring work reveals the use of illegal anticompetitive practices. At this time, I can offer the following general observations about refinery margins and capacity utilization.

Refinery margins have increased over the last several years and remain at high levels relative to the last 20 years. The average annual gross margin for conventional gasoline increased from about 10 cents per gallon in 2002 to 21.7 cents per gallon in 2005, while the corresponding gross margin for reformulated gasoline (RFG) increased from 12.8 cents per gallon in 2002 to 29.2 cents per gallon in 2005.[1]

[1] Gross refinery margins based on spot prices also have reached very high levels this year. The figure of 76 cents per gallon cited in the background to your question apparently refers to the margin between the Gulf spot price of reformulated gasoline blendstock for oxygenate blending (RBOB) and the spot price of crude oil in mid-May 2006. It is advisable, however, to be cautious in placing reliance on such margin data. For example, in the first 4 months of 2006, the RBOB margin was less than 28 cents per gallon. Refinery margins measured over a few days or a week may differ significantly from margins averaged over a longer period. Because longer time periods are more relevant to refiners' decisions to increase or decrease output, it is appro-

Meanwhile, refiners' net margins—which reflect other operating and direct product costs across all refined products—are much lower than gross margins, but they are still higher this year than in recent years. For the leading petroleum companies tracked by EIA's Financial Reporting System, refiners' net margins in 2004 (the most recent year for which data are available) averaged about 7.1 cents per gallon of refined product.[2] Like gross margins, however, refiners' net margins have increased since 2002, when they averaged only 0.4 cents per refined gallon.

Recent annual average refinery capacity utilization rates have been below the record annual level of 95.6 percent set in 1998—a level that, as you point out, was even higher during the summer of 1998.[3] By 2002, industry capacity utilization had fallen to 90.7 percent. Utilization rates increased modestly in the two following years, reaching 92.6 percent in 2003 and 93.0 percent in 2004.[4] Until the arrival of Hurricane Katrina last August, monthly industry capacity utilization rates in 2005 generally were close to those in the corresponding months of the previous several years.

As the FTC Gasoline Report explains, industry capacity utilization rates primarily are a function of planned or unplanned refinery downtimes, not of current profit margins.[5] Refinery downtimes reduce reported industry utilization rates, because the capacity affected by the downtimes typically is still considered operable—that is, it is included as available capacity—even when crude oil processing is suspended because of damage, repairs, or maintenance work. Unlike idle capacity in other industries, which may be switched on quickly and easily in response to higher prices—for example, "peaking plants" in electricity generation—operable refinery capacity affected by a downtime may not be available to respond to increased profit opportunities for a significant period.[6]

The relatively low reported capacity utilization rates since the beginning of 2006 reflect the lingering effects of Hurricanes Katrina and Rita. For example, the BP refinery in Texas City, Texas, which accounts for 2.6 percent of the Nation's refinery capacity, did not resume limited operations until April of this year.[7] The Murphy Oil refinery in Meraux, Louisiana, which accounts for 0.7 percent of national capacity, was still closed in late May.[8] Even though these refineries were closed for repairs, they still were counted in the EIA's measure of operable capacity, with the result that reduced industry utilization rates were reported this year. Other refineries deferred maintenance scheduled for last fall and early winter to later months

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priate to take a longer-term perspective in responding to your question about the relationship between high refinery margins and underutilized refinery capacity.

[2] U.S. Dep't of Energy, Energy Information Admin., *Performance Profiles of Major Energy Producers,* at 92, Table B32 (Mar. 2006). Net margins do not include certain other costs incurred by refiners, including fixed costs associated with general and administrative expenses, research and development costs, and depreciation expenses.

[3] Capacity utilization rates typically are used to measure a refinery's ability to distill crude oil, the first step in the refining process. A refinery's capacity to produce gasoline and other refined products, however, also depends on other processing units at the facility. See FTC Gasoline Report at 5.

[4] *Id.* at 22, Table 1–1.

[5] *Id.* at 6–7. There is, however, a seasonal relationship between utilization rates and margins because refiners schedule as many downtimes as possible during the non-summer months, when refining margins are generally lowest because of the weaker demand for gasoline. In addition, industry capacity utilization is affected by the extent to which alternatives such as imports yield cost savings compared to more intensive use of domestic refineries. Even if refining margins are high, refiners may have economic incentives to satisfy gasoline demand with cheaper imports rather than through additional crude runs. In this regard, it is notable that imports of finished gasoline and of blendstocks have been significantly higher in recent years than in the late 1990s.

[6] As the text implies, downtimes can be planned or unplanned. When refineries are running, they usually operate at maximum sustainable capacity when gross margins are as high as they have been in recent years. Refineries cannot run at such rates indefinitely, however, and must take downtimes for necessary maintenance or other improvements. Such planned downtimes may be scheduled months or even years in advance. The primary factor in arranging for planned downtimes is the regular maintenance schedule required to assure the safety and physical integrity of the refinery. Another factor that must be considered is the availability of specialized contract labor. Notably, such considerations as maintenance schedules and the availability of labor are independent of current or anticipated profit margins. Unplanned downtimes, which involve capacity closure due to refinery accidents or natural disasters, similarly affect industry capacity utilization rates in ways unrelated to profit margins.

[7] See *http://www.marketwatch.com/News/Story/Story.aspx?guid=%7B5C662A88%2D1C09%2D4664%2DBB71%2D4DE0B2CC84E6%7D&siteid=mktw; http://www.cattlenetwork.com/content.asp?contentid=40339.*

[8] See *http://www.bloomberg.com/apps/news?pid=10000100&sid=aNKO71oIVhwY&refer=germany.*

in order to make up for lost heating oil production following the hurricanes.[9] Following the completion of some maintenance and repairs, utilization rates have been increasing over the last couple of months, although they still fall somewhat short of the normal levels for this time of year.

The elimination of methyl tertiary-butyl ether (MTBE) from gasoline this spring also tended to reduce supply.[10] MTBE production in 2005 averaged 128,000 barrels per day, or 1.4 percent of the volume of gasoline supplied last year. Although ethanol use has increased, the increase in ethanol production from March 2005 to March 2006 (the last month for which data are available) was only 58,000 barrels per day, or 0.6 percent of gasoline supplied in 2005. Simply by reducing gasoline supply by 0.8 percent, the replacement of MTBE with ethanol has directly raised gasoline prices by between 10 and 15 cents per gallon.

The pace of refiners' conversions from MTBE to ethanol quickened during spring 2006 in response to last year's Energy Policy Act, which (1) required that gasoline contain on average 2.78 percent of renewable fuels (such as ethanol); (2) eliminated the fuel oxygenate requirement for RFG effective May 5, 2006; and (3) omitted any liability protection for refiners' use of MTBE.

In its recently concluded investigation of gasoline prices, the Commission specifically examined whether the decline from the peak utilization rates of the late 1990s might be evidence of market manipulation. Our investigation, however, uncovered no evidence of manipulation.[11] As stated previously, the FTC is continuing to devote attention to this important issue.

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[9] U.S. Dep't of Energy, Energy Information Admin., "This Week in Petroleum" (May 24, 2006).

[10] To comply with EPA requirements imposed by the 1990 Clean Air Act amendments, many refineries initially used MTBE as an oxygenate to boost octane and make gasoline burn more cleanly. Concerns were raised, however, that MTBE contaminates groundwater. In reaction, over the past 6 years, refineries in various areas of the country have been switching to ethanol-blended RFG. As refineries switch from MTBE to ethanol, they produce less gasoline, and in the summer months they must make even higher-quality gasoline blends than they made with MTBE. In addition, foreign suppliers that cannot deliver MTBE-free gasoline are unable to import gasoline into the United States to make up for this temporary shortfall. As a result, switching to ethanol-based RFG leads to higher prices, at least during the conversion process.

[11] FTC Gasoline Report at 6–7.