STATEMENT OF

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on

PRICE GOUGING

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION
UNITED STATES SENATE

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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 the 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 five 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 five years between 1995 and 1999. More importantly, four of the five highest years for profit in the oil industry since the Arab oil embargo of 1973 have occurred in the past six years. I have submitted for the record our study of oil industry profits over the past two decades, which demonstrates over $100 billion dollars 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 dollars 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 dollars.

The most obvious indicator that market forces are working against consumers can be seen in the "Domestic Spread" over the past six 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 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 six years. If we had started working on effective solutions six years ago, we could be well into the mid-term of a long-term policy shift. Policy makers 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 Attorney Generals to monitor the structure, conduct and performance of gasoline markets, with an emphasis on unilateral actions that raise price.

To address long term fundamentals change 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 policy makers to take steps to build a better future for American consumers by addressing market who's 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.