Consumer Federation of America

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

on behalf of

THE CONSUMER FEDERATION OF AMERICA
and
CONSUMERS UNION

on

PRICES AT THE PUMP: MARKET FAILURE AND THE OIL INDUSTRY

Before the

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

May 16, 2007

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE

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

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

PAIN AT THE PUMP

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

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

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

MARKET POWER, PRICE INCREASES AND EXCESS PROFITS

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

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

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

ABUSE OF MARKET POWER IN THE REFINING SECTOR

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

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

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

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

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

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

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

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

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

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

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

To address short term spikes in prices:

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

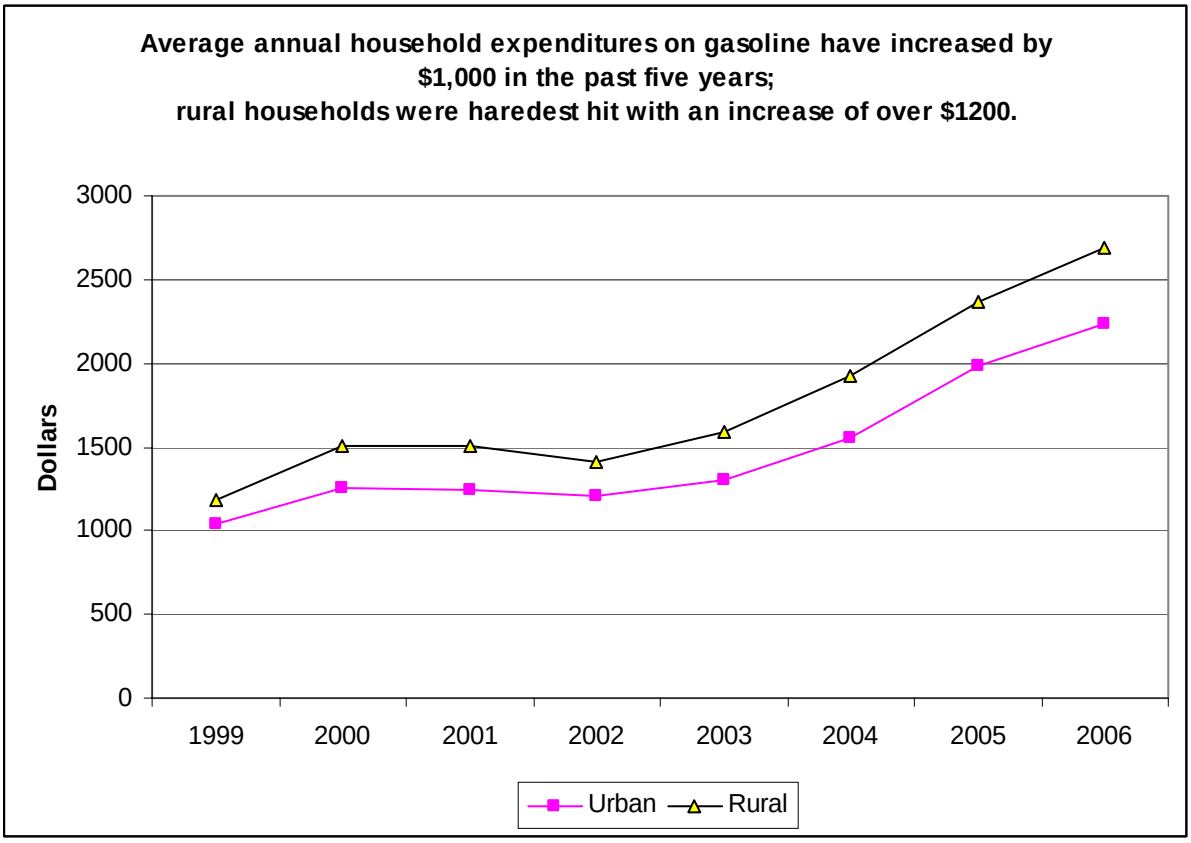
To address long term fundamental change in the supply-demand balance in this sector

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

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

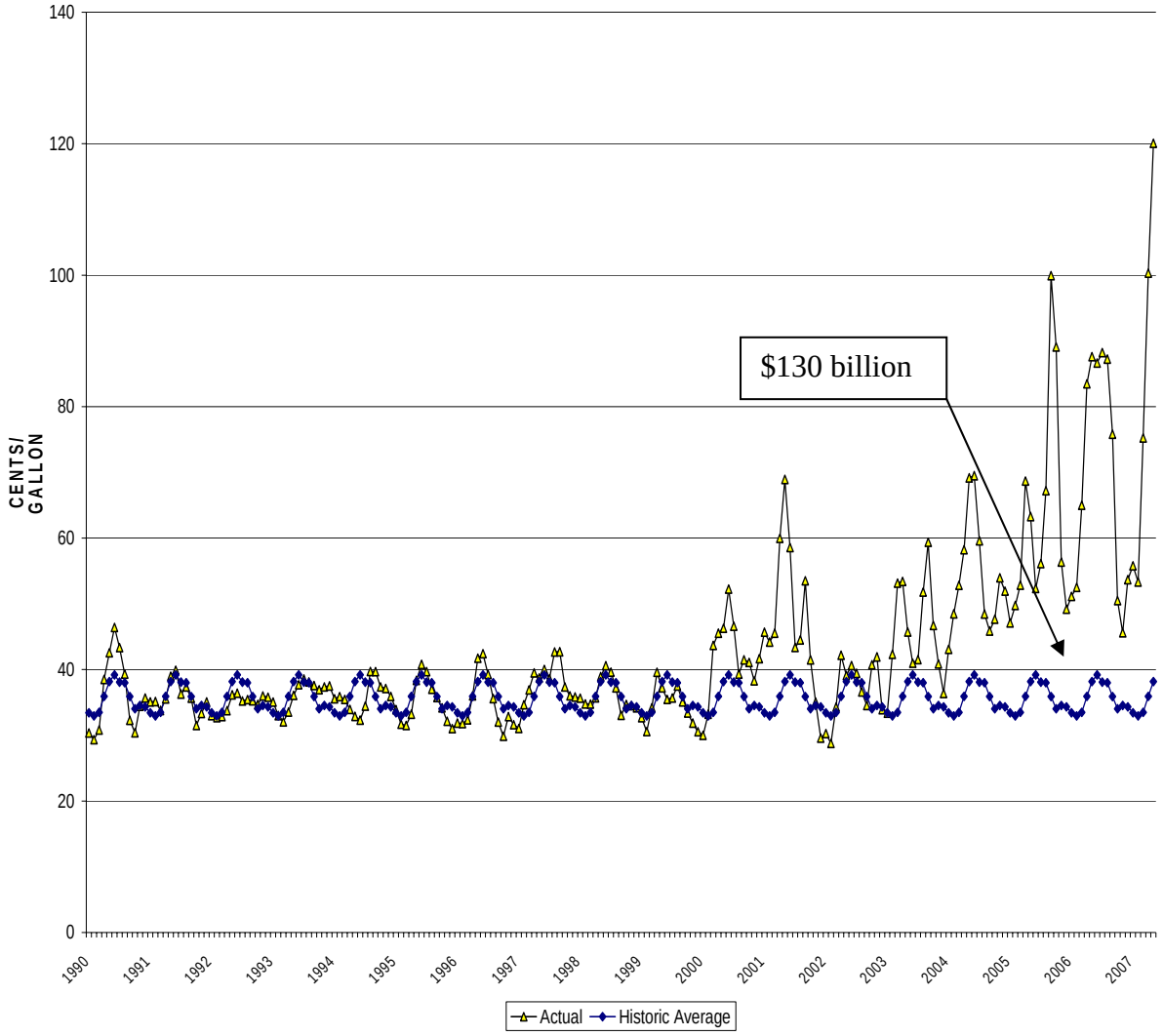
EXHIBITS

Exhibit 1: Household expenditures on Gasoline



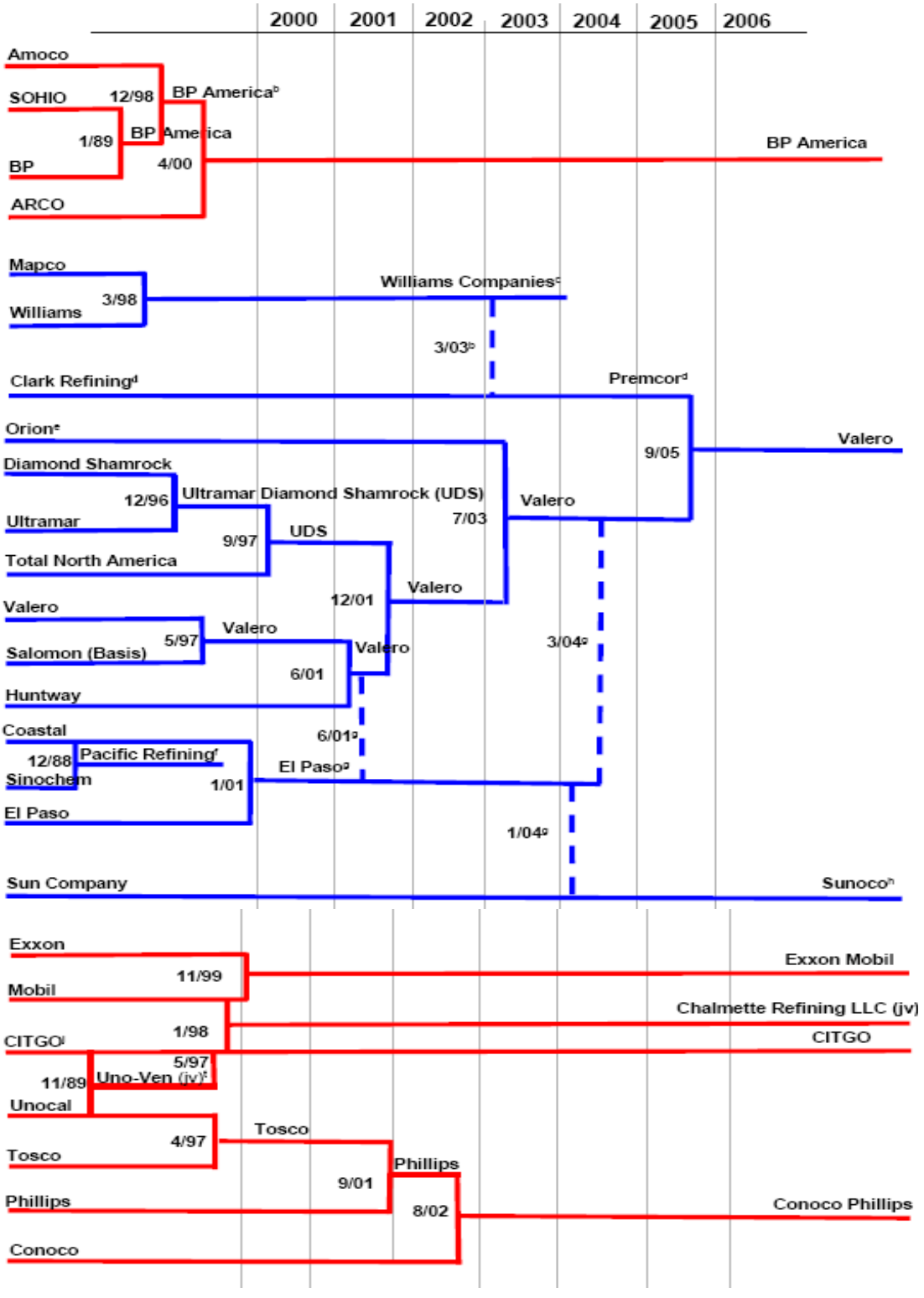
Source: U.S. Department of Labor, Bureau of Labor Statistics, *Consumer Expenditure*, 1999-2005. 2006 expenditures estimated based on 2005-2006 price increase from Energy Information Administration, *U.S. All Grades All Formulations Retail Gasoline Prices.*

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



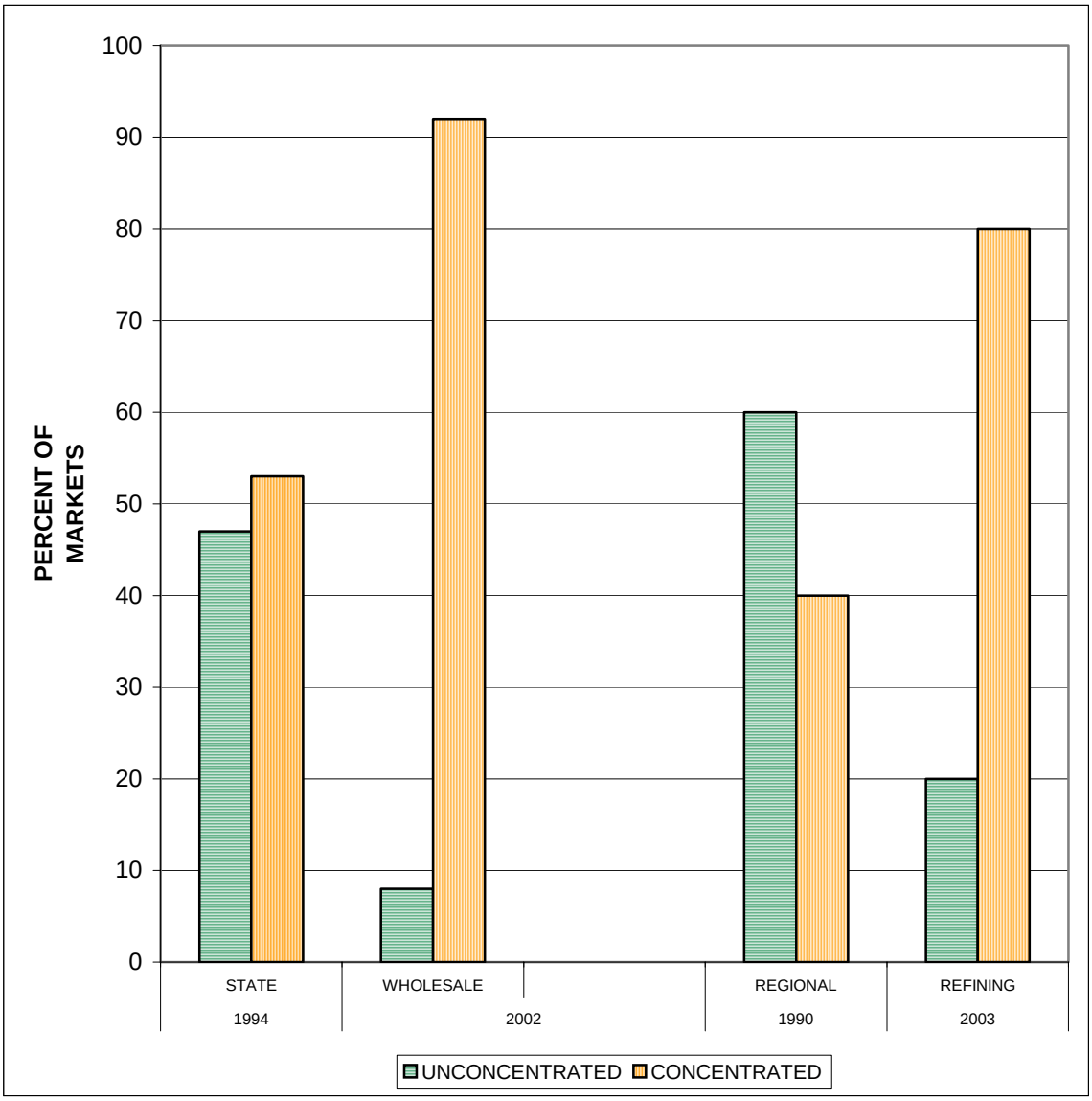
Source: Energy Information Administration, Data base, *Prices and Product Supplied.*

Exhibit 3: Mergers have severely Reduced the number of Refiners



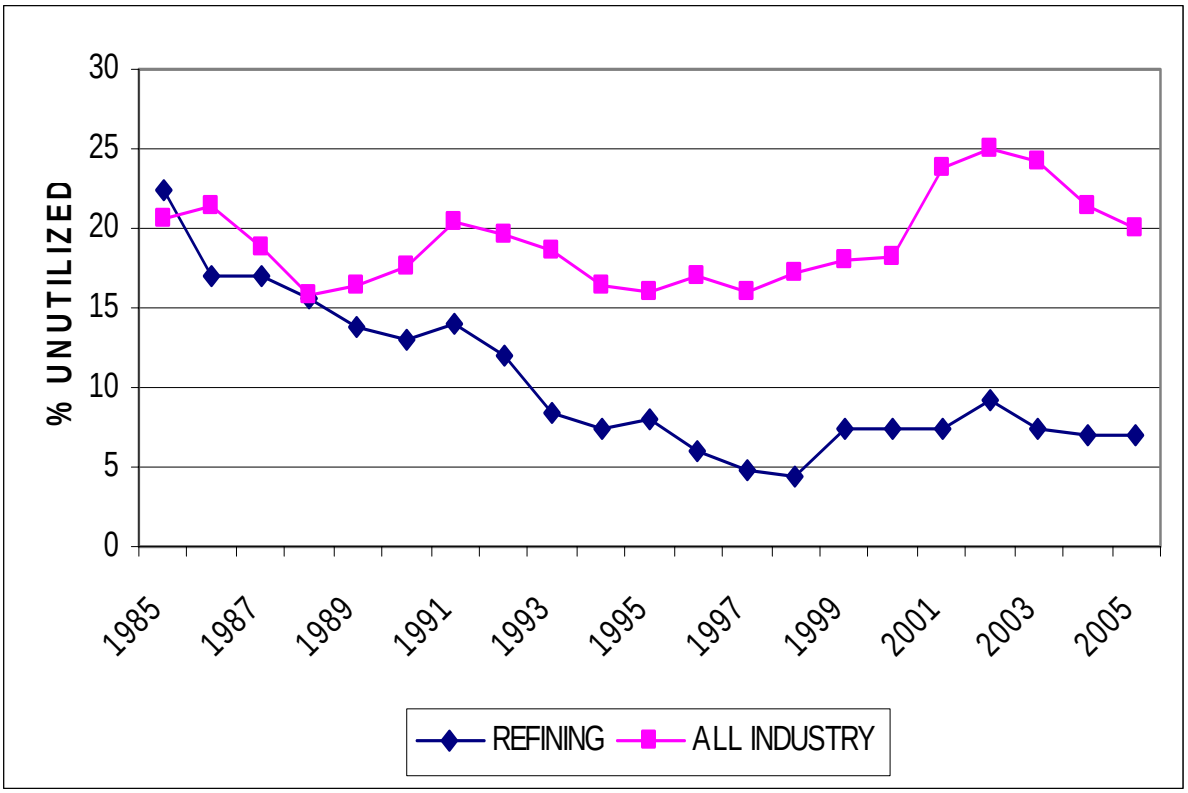
Source: http://tonto.eia.doe.gov/FTPROOT/financial/mergers/dwnstream.pdf

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



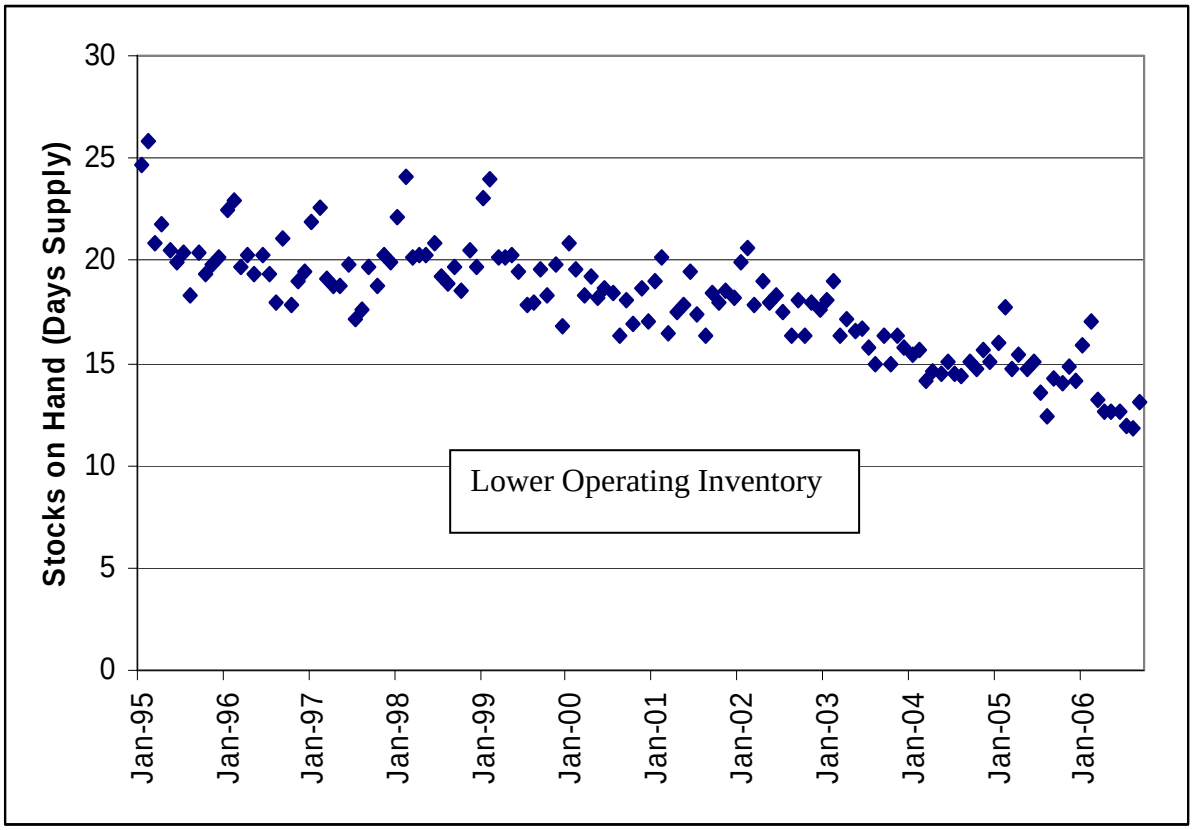
Source: Government Accountability Office, *Energy Markets: Effects of Mergers and Market Concentration in the U.S. Petroleum Industry* (Washington, May 2004), Figure 18.

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



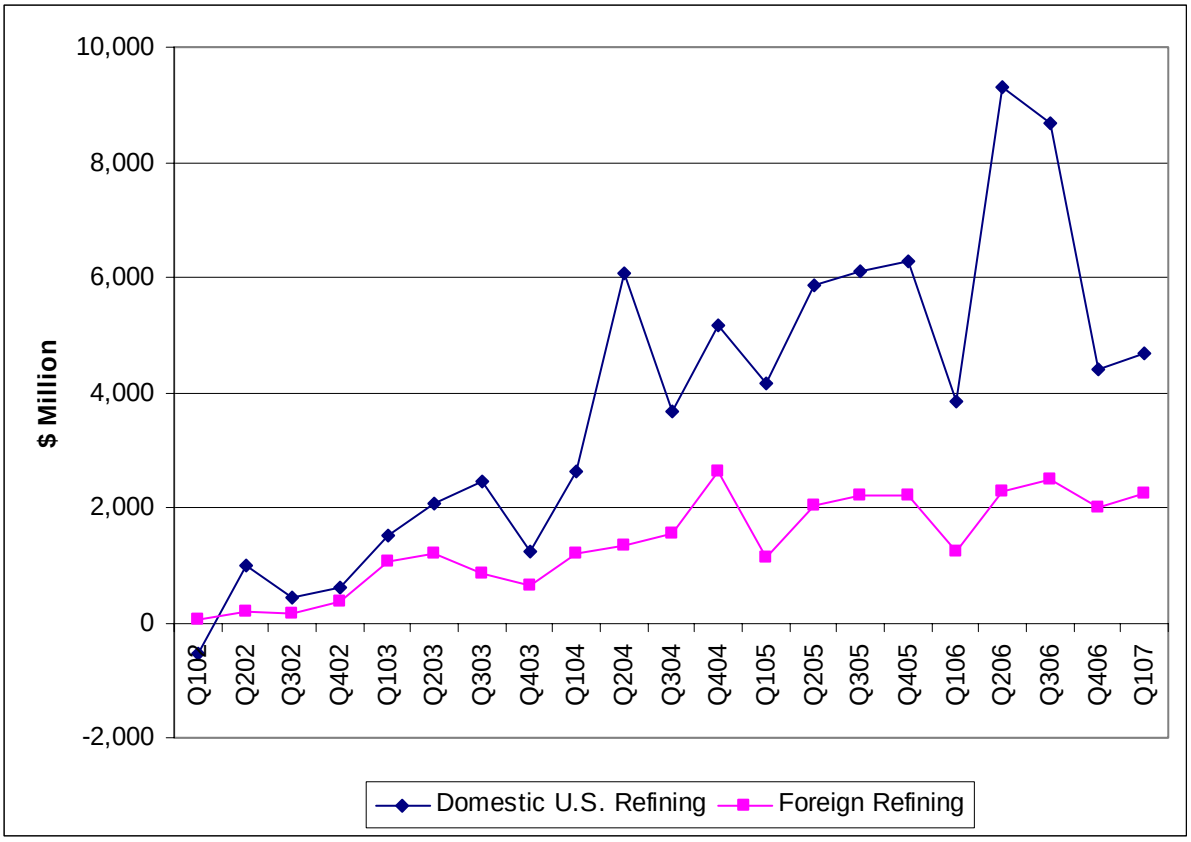
Source: Calculated from Board of Governors of the Federal Reserve System, Federal *Reserve Statistical Release, Industrial Production and Capacity Utilization;* Energy Information Administration, U.S. Department of Energy, *U.S. Percent Utilization of Refinery Operable Capacity.*

Exhibit 6: Declining Stocks of Gasoline Render the Market Vulnerable



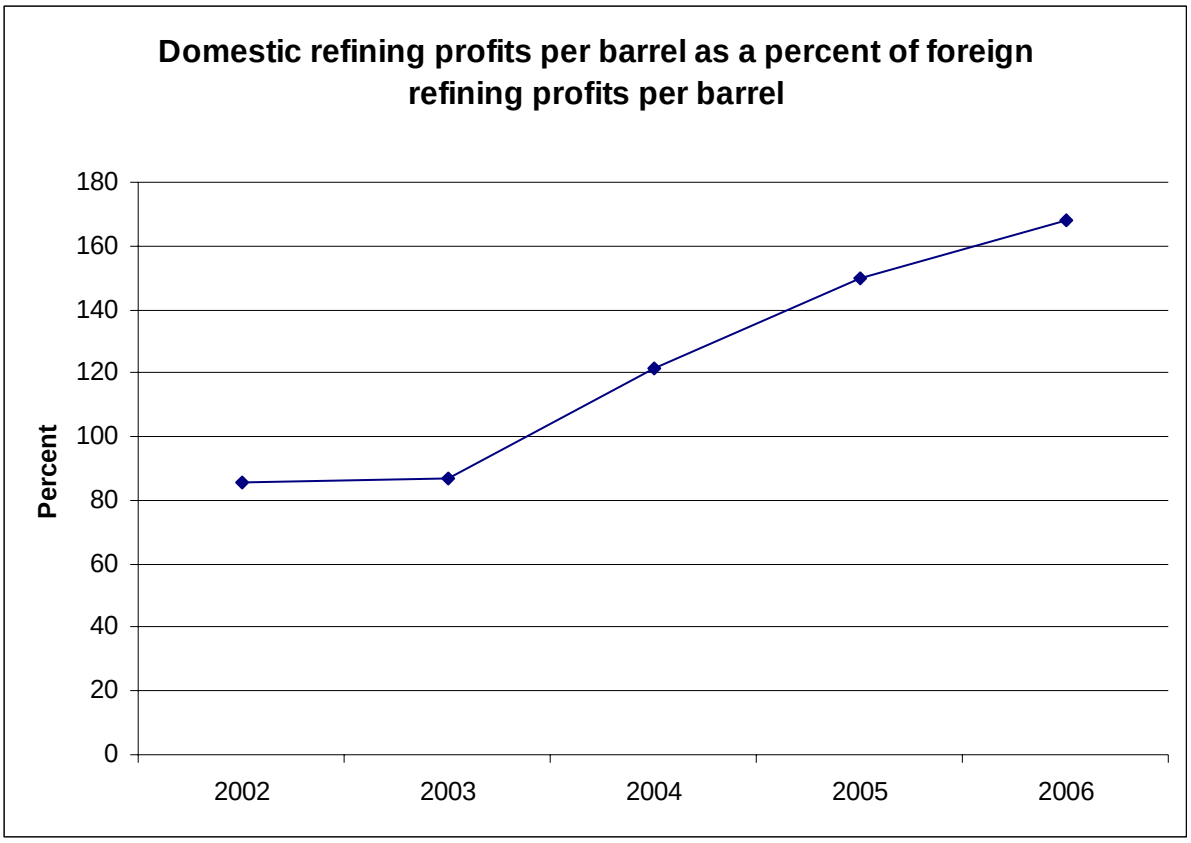
Source: Energy Information Administration, Data base, *Stocks and Product Supplied.*

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



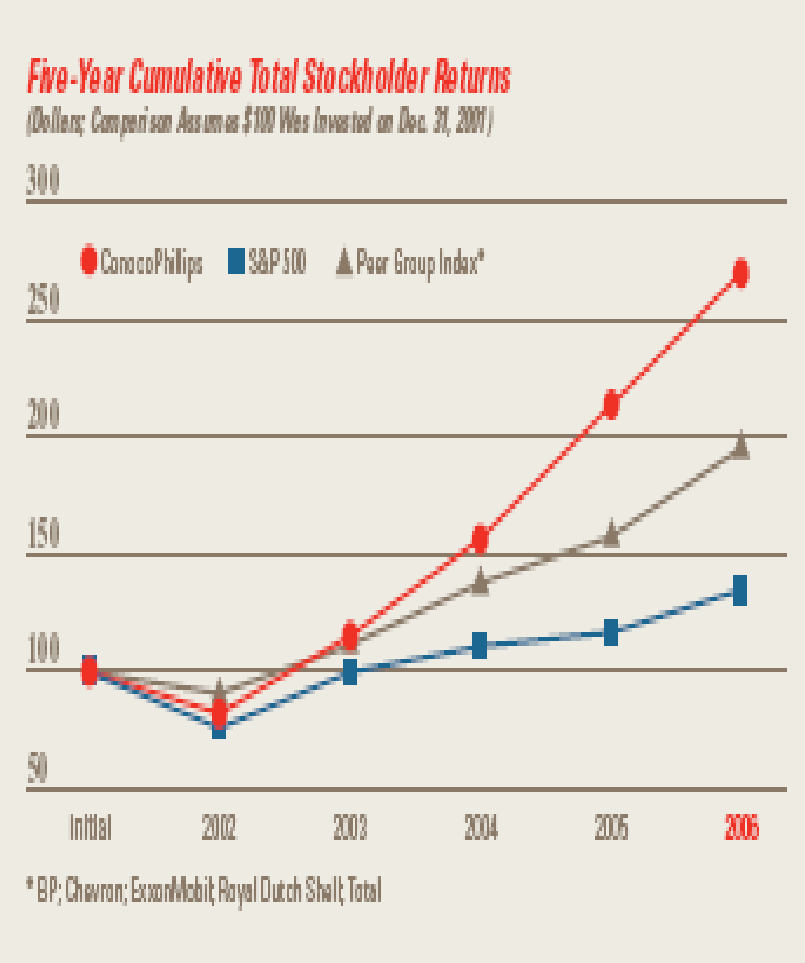
Energy Information Administration, Selected Financial and Operating Data for a Consistent Set of Major Energy Companies: First Quarter 2002 (Q102) Through Fourth Quarter 2006 (Q107)

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



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

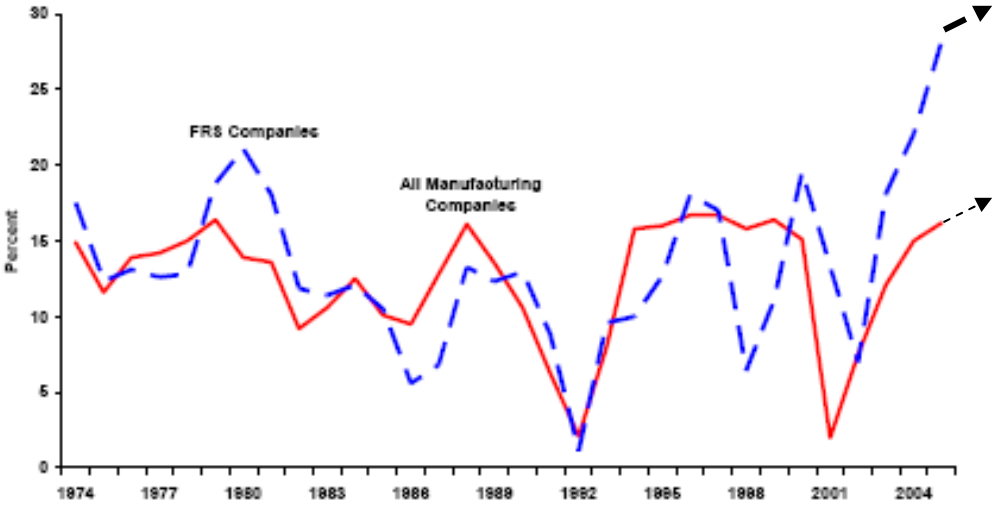
Exhibit 9: U.S. Major Oil Company Total Return in the Past Five Years Exceeds the S&P 500 by a Wide Margin.



ConnocoPhillips, Annual Report, 2006, p. 9.

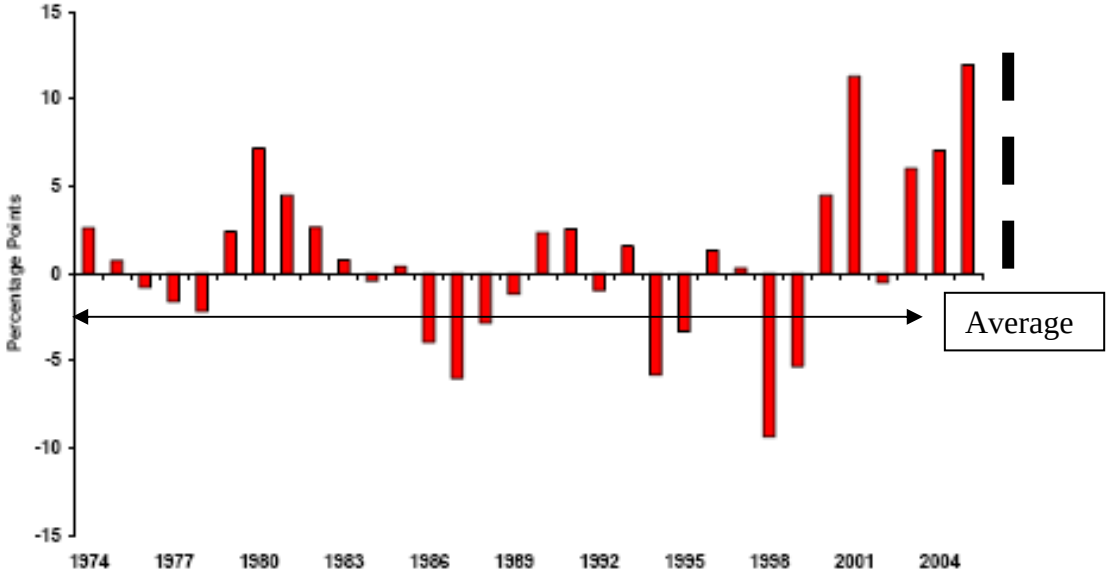
Exhibit 10: Major Oil Company Return on Equity is Far Above Historic Levels

Figure 2. Return on Stockholders' Equity for FRS Companies and All Manufacturing Companies, 1974-2005



Sources: **FRS Companies:** Energy Information Administration, Form EIA-28 (Financial Reporting System). **All Manufacturing Companies:** U.S. Census Bureau Quarterly Financial Report, All Manufacturing Companies.

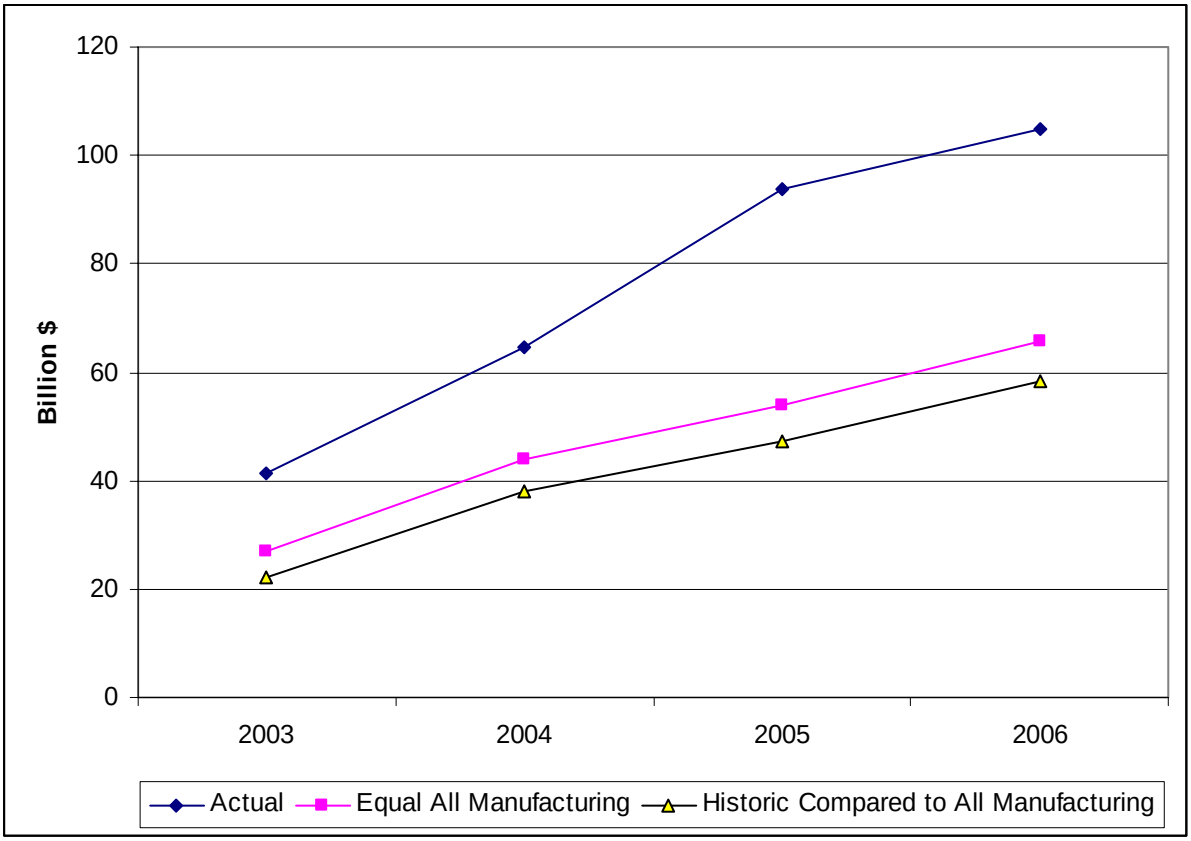
Figure 3. Difference Between FRS and All Manufacturing Companies Return on Stockholders' Equity, 1974-2005



Sources: **FRS Companies:** Energy Information Administration, Form EIA-28 (Financial Reporting System).
All Manufacturing Companies: U.S. Census Bureau Quarterly Financial Report, All Manufacturing Companies.

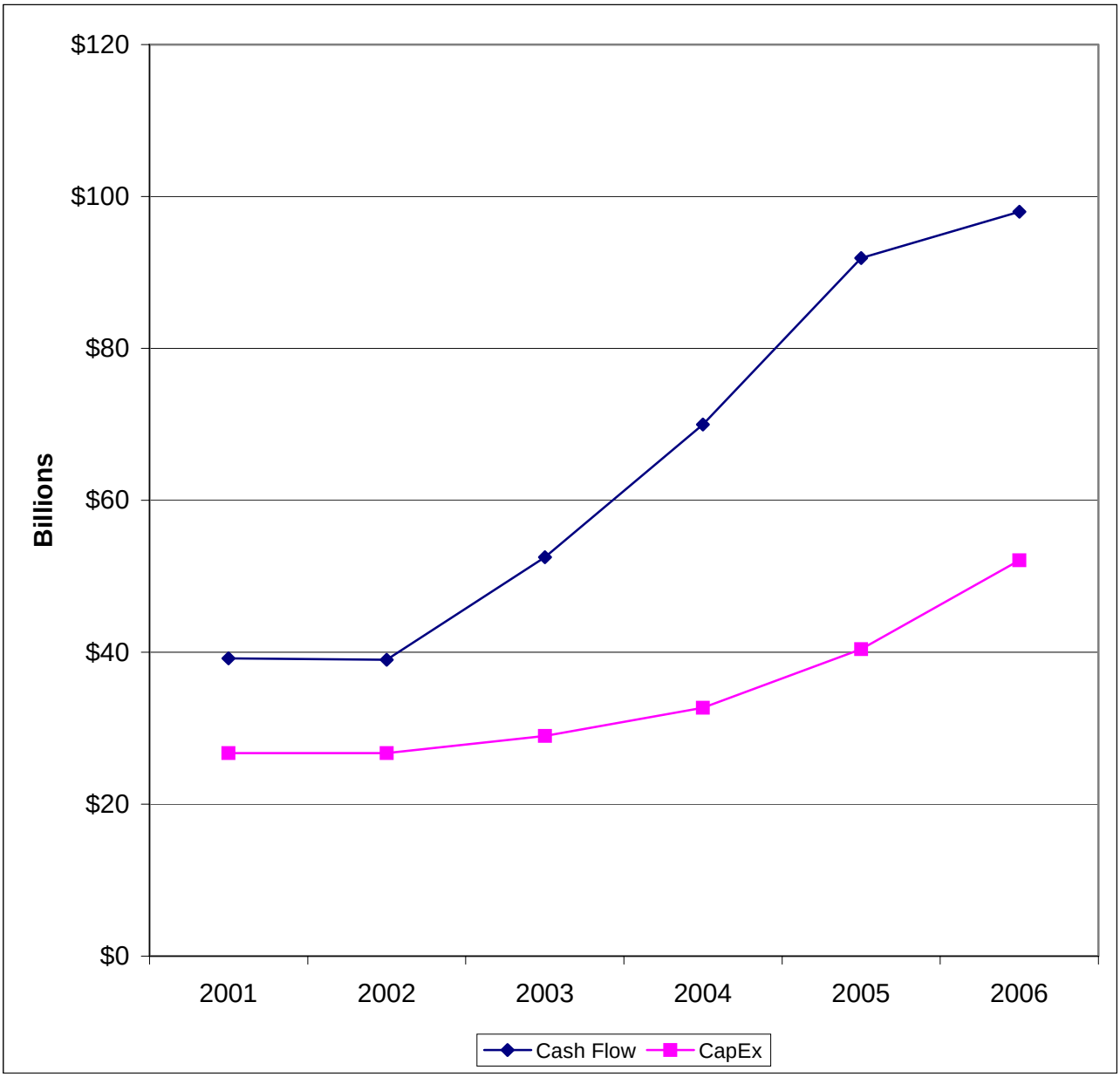
Sources: Energy Information Administration, *Performance Profiles of major Energy Producers: 2005* (Washington, D.C.:U.S. Department of Energy, December 2006.

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



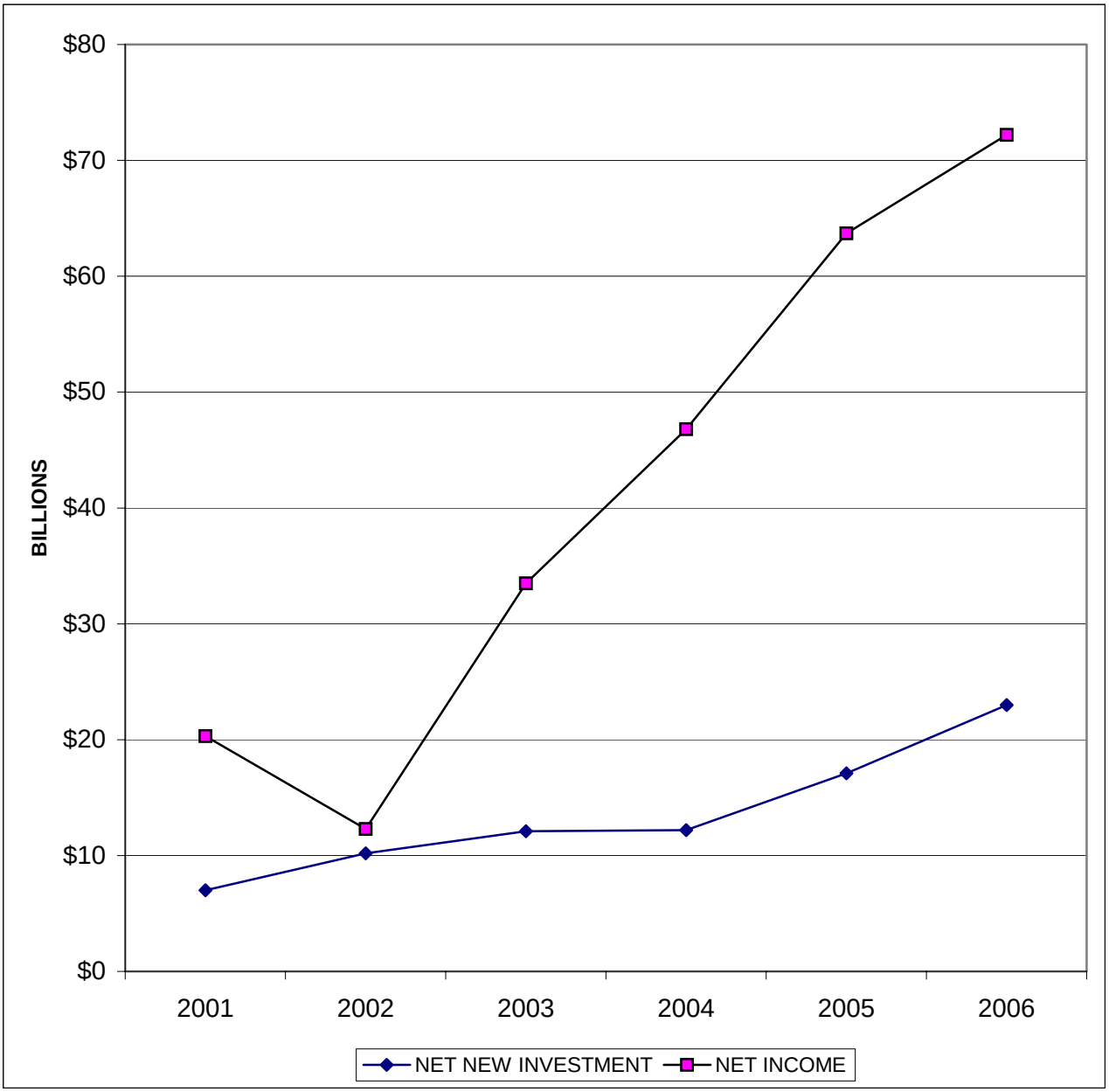
Source: energy Information Administration, *Performance Profiles of Major Energy Producers: 2005* updated to 2006 with U.S. Census Bureau, *Quarterly Financial Report* and company annual reports. Net income is for FRS companies, which represent about 60 percent of the petroleum sector.

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



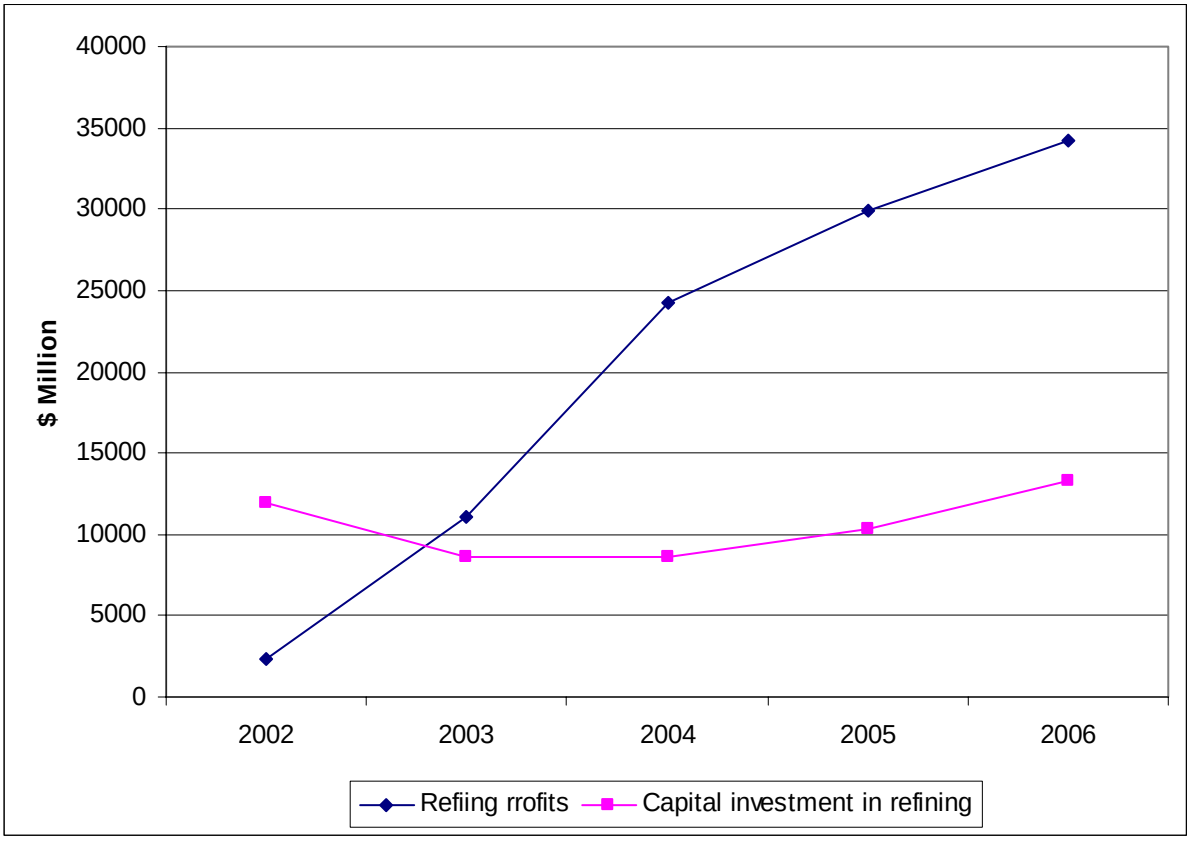
Source: ExxonMobil, 2006, pp. 15-23, 2005 Financial & Operating Review, pp. 2, 23; Chevron, Chevron, 2006 Supplement to the Annual Report, pp. 6 2005 Supplement to the Annual Report, pp. 2, 6. ConocoPhilips, Annual Reports 2006, pp. 64, 66; 2005, p. 66, 2002, p. 65.

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



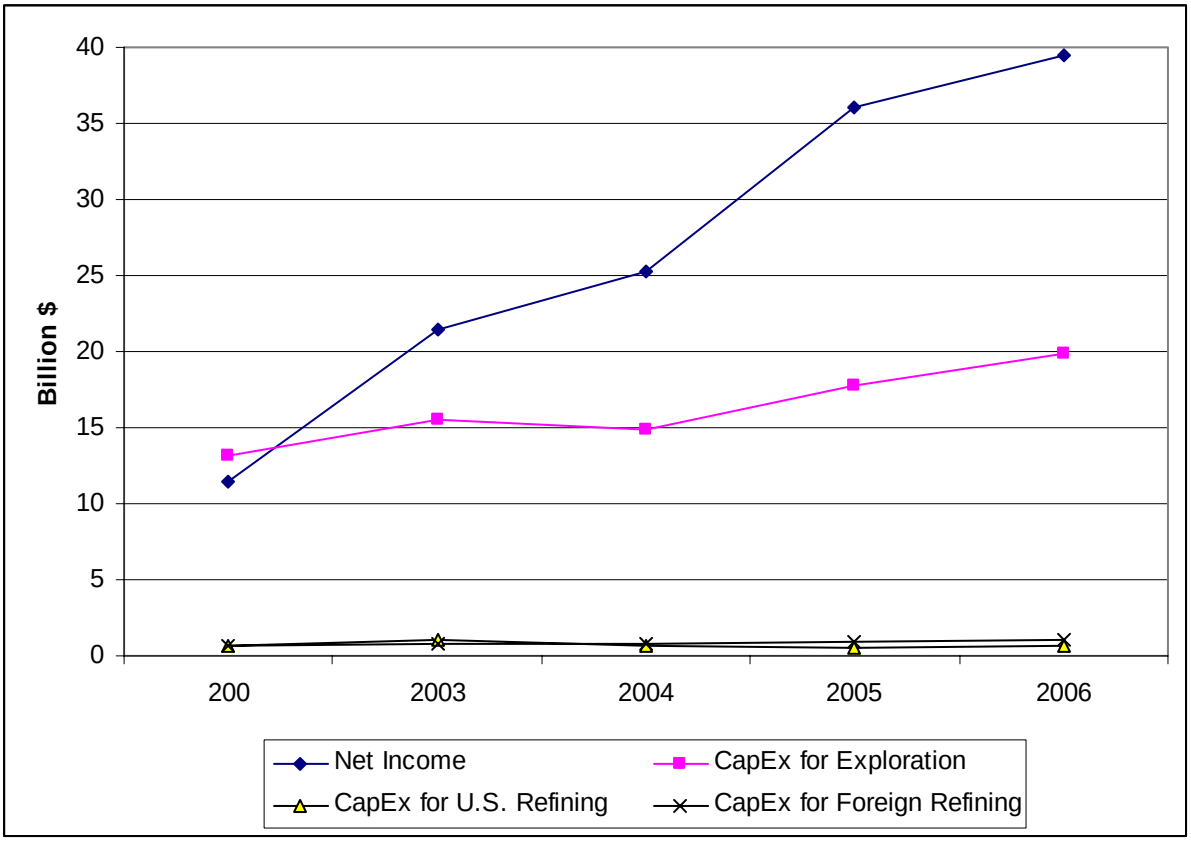
Source: ExxonMobil, 2006, pp. 15-23, 2005 Financial & Operating Review, pp. 2, 23; Chevron, Chevron, 2006 Supplement to the Annual Report, pp. 6 2005 Supplement to the Annual Report, pp. 2, 6. ConocoPhilips, Annual Reports 2006, pp. 64, 66; 2005, p. 66, 2002, p. 65.

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



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

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



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