DEBUNKING OIL INDUSTRY MYTHS AND DECEPTION: THE $100 BILLION CONSUMER RIP-OFF

A REPORT ON RISING GAS PRICES AND INDUSTRY PROFITS

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SKYROCKETING PRICES, SKYROCKETING PROFITS
&
OIL COMPANY FAIRY TALES ABOUT WHY

EXECUTIVE SUMMARY

This report finds that the oil industry has exhibited a long-term pattern of strategic underinvestment, mismanagement of capacity and the gaming of gas prices. This is resulting in record breaking costs for consumers at the pump and record profit margins for industry. The report estimates that as a result of anti-competitive practices, oil companies have achieved more than $100 billion in excess profits, compared to comparable Standard and Poors Industrial companies. Finally, it points to failure on the part of the Administration and Congress to reign in an oil industry bent on profiting from supply and demand pressures.

Major oil companies have

- achieved more than $100 billion in excess profits from 2000 to 2005 as a result of anti-competitive practices;
- strategically underinvested in refinery capacity to tighten supplies and gain market power over gasoline prices;
- carried out a deceptive and misleading PR campaign telling a huge profit story to Wall Street and a small profit story on Main Street;
- sought to blame factors other than their own behavior for higher consumer gasoline prices.

The report examines overall profits in the industry and the rate of on investment in the sector. It highlights trends within the industry that point to mergers and consolidation by major oil and gas companies that have eliminated competition and provided the trigger for strategic underinvestment in refinery capacity, which has allowed refiners to earn ever higher margins on gasoline. The report includes an analysis of the domestic

refining sector, looking at the “domestic spread” - the large and variable spread between the price of crude and the price of product, which is set by local conditions like the number of refineries, the extent of competition in refining markets, and the strength of demand. It shows a direct link between long-term structural changes and the behavioral changes in the industry, drawing the connection between business strategies to increase profitability and pricing volatility.

The report documents the industry’s long standing public relations campaign to mislead the public and policymakers. It shows that the industry tells very different stories on Wall Street and Main Street. On Wall Street oil companies point to their soaring return on equity and cash flow as proof of their huge profitability, while on Main Street they point to profit as a percentage of sales and ignore cash flow to claim less than stellar results. In our capitalist economy, as the companies know, return on equity and cash flow are what matter since this is what attracts capital and drives up stock prices. The industry’s earnings are astronomical by historical standards.

To protect consumers from further price gouging by the industry, the report recommends the following concrete policy recommendations for addressing supply and demand side influences on gas prices. The recommendations include:

- a windfall profits tax triggered by specific circumstances with increased revenue funneled back into expanding our refining capacity and promoting fuel efficiency.

- concrete steps for reducing fuel consumption through aggressive, targeted improvements to vehicle fuel efficiency standards.

- 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.

I. INTRODUCTION

A. The Never Ending Story

In six of the past seven years, as gasoline prices have soared to record levels several excuses have been offered at different times, including the cost of crude oil,[1] refinery outages and maintenance,[2] lack of gasoline in storage,[3] unexpected surges in demand,[4] or the weather. Two things are constant, however, there is a shortage of refinery capacity and oil company profits continue to go up, up and up.

This year's scapegoat of choice – a shortage of ethanol – is particularly misleading. The oil company story starts with a clever attempt to make it appear that Congress mandated an immediate switch to ethanol,[5] which it did not. The Energy Policy Act of 2005 requires refiners to utilize an increasing percentage of renewable fuels. The Renewable Fuels Standard that kicked in beginning January 2006 requires refiners to utilize at least 4 billion gallons of renewable fuels, a target that was surpassed in 2005 and there was no mandate to switch this spring. But the oil companies, *en mass*, chose to switch from MTBE to ethanol after the government told them that they could meet the requirements of the Clean Air Act however they wanted.[6]

Once we set that record straight, we find a more typical story of oil industry mismanagement. Failing to plan carefully, the companies have created a surge in demand for ethanol. Even though they have known for a long time that ethanol must be handled differently than other additives, they did not prepare their refineries or distribution facilities to make the shift in an orderly and timely fashion by arranging for transportation and storage.[7] With little competition, companies do not fear being caught short, because each knows that when they raise prices, there is no one to steal their customers. The result of this mismanagement is the anomaly of all anomalies, gas station outages in Texas.[8]

It is not clear that there is a physical shortage of ethanol,[9] as capacity in the industry has been expanding rapidly.[10] At the same time there have been an unusually high number of refinery maintenance shut downs because the industry lacks spare capacity. As a result of prior decisions by the oil companies to close refineries and a 30-year refusal to build new

ones, the closure of three refineries on the Gulf Coast has stretched the industry's limited capacity.

One thing that is certain is that the cost of ethanol being added to gasoline simply does not account for the huge surge in prices. The head of the Energy Information Agency recently admitted that the actual cost of ethanol could only add a few of cents per gallon to the price of gasoline.[11] Instead, the huge gasoline price run-up can be traced back to tight refinery capacity, lower refinery operations, the rising cost of crude oil and sharply higher refinery margins.

A similar pattern of strategic actions and mismanagement was evident in the first price spike of the new millennium in the upper mid-West in the summer of 2000. A report by the Federal Trade Commission (FTC) noted:

> The spike appears to have been caused by a mixture of structural and operating decisions made previously (high capacity utilization, low inventory levels, the choice of ethanol as an oxygenate), unexpected occurrences (pipeline breaks, production difficulties), errors by refiners in forecasting industry supply (misestimating supply, slow reactions), and decisions by firms to maximize their profits (curtailing production, keeping available supply off the market).[12]

The ethanol scapegoat, as the other scapegoats before it, is simply another effort by the major oil companies to distract the public and policy makers from the underlying truth. On the other side, calls for investigations of windfall profits and price gouging identify the symptoms, not the disease:

- **This is a concentrated industry that lacks competition and has achieved market power over price through mergers and strategic decisions to keep refining capacity tight.**

Thus, the problem is not "just" supply and demand. The problem is a market in which the forces of supply and demand are too weak to prevent abuse of consumers.

- **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 to cause oil industry profits to decline.**

The major oil companies get away with market abuse because they can and because policymakers from one Congress and one administration to the next have done nothing to address the fundamental market power problem.

B. Overview and Outline of the Report

The Consumer Federation of America began pointing this problem out after the second gasoline price run-up of the new millennium in early 2001.[13] The first price spike in mid-2000 could have been an accident, even though there was evidence, as noted above, that a systematic problem was afflicting the industry. By the second price run-up the pattern was becoming clear. We called it a roller coaster and a ratchet. We have now been through eight cycles and the cost to consumers has mounted into the hundreds of billions of dollars.

This paper updates that previous analysis. It starts with an analysis of the domestic refining sector in Section II. While it is certainly true that the price for crude, and therefore the profitability of both domestic and foreign production (for which the major oil companies account for a significant portion), are set by the global cartel, that is not true of refining. There is a large and variable spread between the price of crude and the price of product, which is set by local conditions – the number of refineries, the extent of competition in refining markets, and the strength of demand. The evidence shows that the oil companies have turned the domestic U.S. refining sector into a huge cash cow.

Section III examines overall profits in the industry and the rate of re-investment in the sector. It estimates more than $100 billion of excess profits. Two different approaches point to this conclusion – first a comparison of the return on equity earned by the oil companies to the return on equity earned by the Standard and Poors Industrial companies and second, a comparison of capital expenditures to cash flow. The industry is throwing off and unable to absorb a huge quantity of free cash flow.

This massive windfall was far too large to hide behind the ethanol illusion, so the oil companies have continued their

broader public relations charade, which tries to make their profits look average. Section IV shows that they tell very different stories on Wall Street and Main Street. On Wall Street they point to their soaring return on equity and cash flow as proof of their huge profitability, while on Main Street they point to profit as a percentage of sales and ignore cash flow to claim less than stellar results. In our capitalist economy, as the companies know full well, return on equity and cash flow are what matter since this is what attracts capital and drives up stock prices. The industry's earnings are astronomical by historical standards.

II. DOMESTIC REFINING

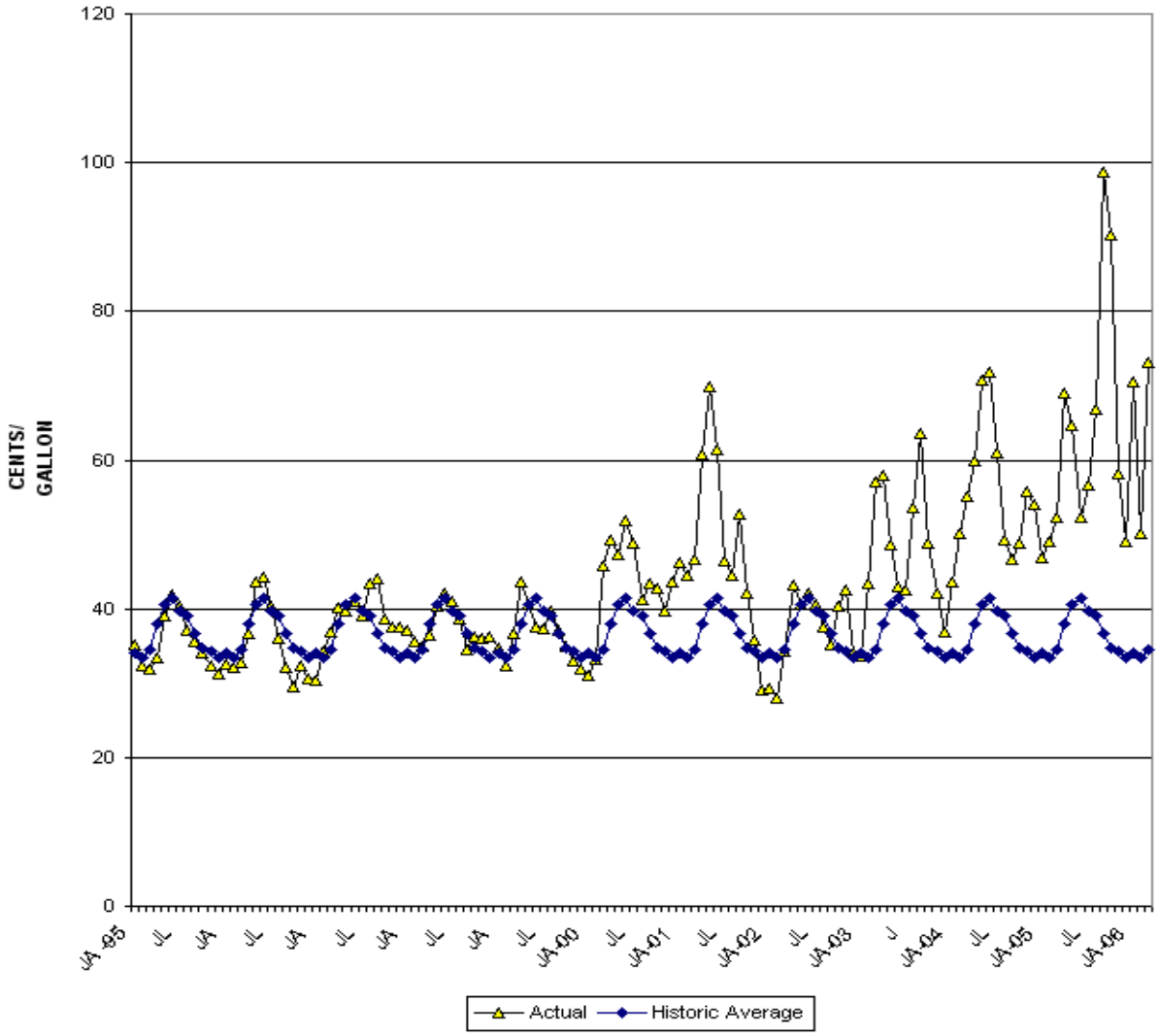
A. Domestic Refining As A Cash Cow

The most obvious indicator that we can use to see how industry is milking the refining sector is to examine the "Domestic Spread." The domestic spread is the difference between the refiner acquisition cost of crude oil and the pump price, net of taxes. That is, 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.

It is also important to note that the refining sector is largely integrated with the producing sector. A small number of large, integrated companies own both crude oil production and refining operations and account for the bulk of the total industry. For these companies, the choice of where profits are taken is a transfer pricing decision, but control of refineries in a tight market is the key to controlling price at the pump.

Exhibit 1 shows the domestic spread going back to January 1995.[14] There was a small increase in 2000, followed by a larger spike in 2001. During the recession of 2002 the spread returned to its historic levels. Since 2002, the spread has been above the historic average and steadily rising. In the first quarter of this year, it was over 30 cents per gallon above the historic average. In March 2005, even before the dramatic price increases of April, it was about 40 cents per gallon higher than the historic average.

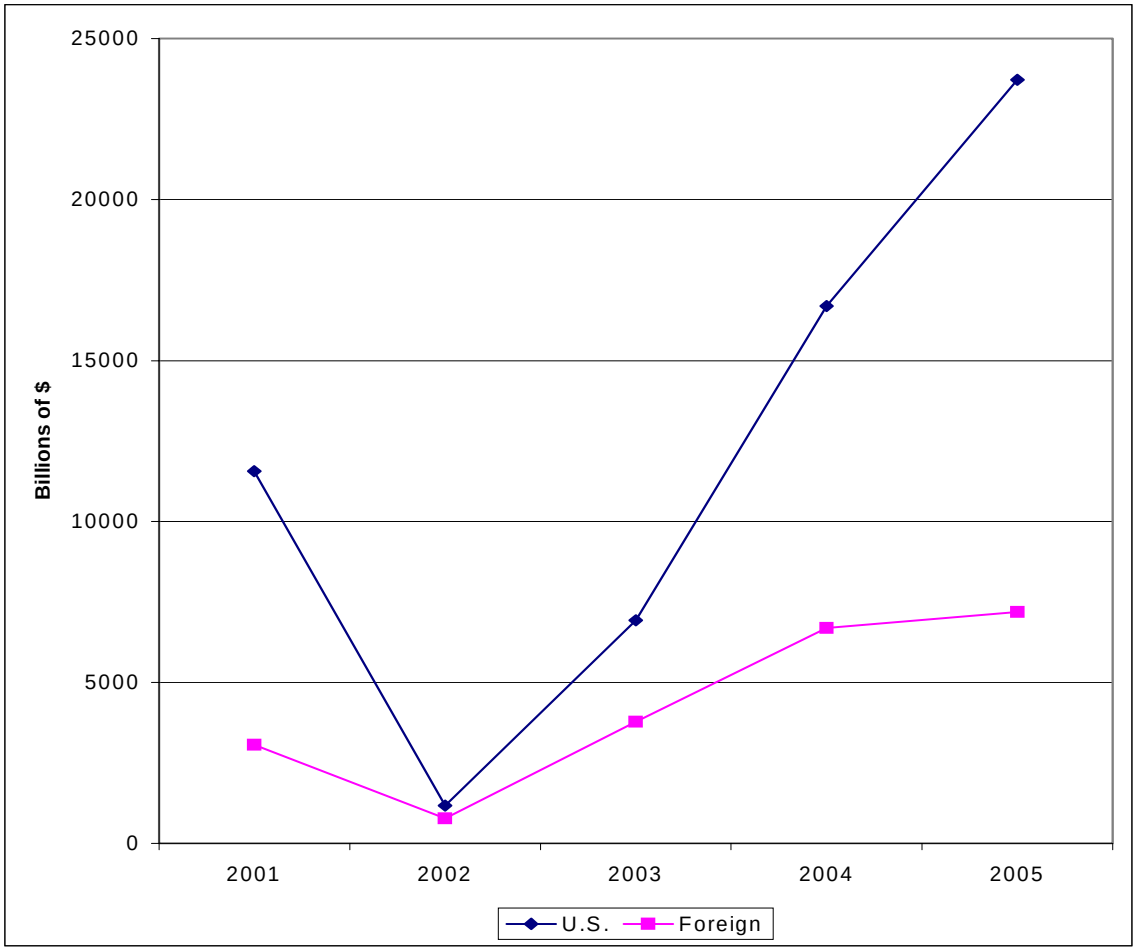
EXHIBIT 1:
GASOLINE DOMESTIC SPREAD
(Pump Price Minus Taxes and Crude)



Source: Energy Information Administration, Petroleum Data Base.

One of the most interesting ways to see how the companies have used the domestic refining sector to drive up gasoline prices is to compare the income from domestic refining operations to income from foreign refining operations. If the problem were really global then we would expect to see little difference between the domestic and foreign operations of these companies. In fact there was a huge difference (see Exhibit 2). Domestic U.S. refining has become a major profit center and cause of increasing prices.

EXHIBIT 2:
REFINING/MARKETING MARGIN – MAJOR OIL COMPANIES



Source: Energy Information Administration, *Selected Financial and Operating Data for a Consistent Set of Major Energy Companies.*

Net income increased for domestic U.S. refining operations from just over $1 billion in 2002 to almost $24 billion in 2005. It increased from under $1 billion for their foreign refining operations to about $7 billion over that period.

Output of refining operations – called throughput in the industry – grew modestly at both the domestic and foreign refineries. Thus, income per barrel of throughput at U.S. refineries grew much more rapidly. This increase in income comes out of the consumer's pocket in the price at the pump. The companies have almost doubled their rate of profit per barrel of throughput on domestic refining compared to foreign operations.

B. Creating Tight Markets and Keeping Them Tight

Documents from the mid-1990s indicate how this came about. Industry officials and corporate officers were concerned about how to reduce capacity, with observations such as “if the U.S. petroleum industry doesn’t reduce its refining capacity, it will never see any substantial increase in refinery profits,” from a Chevron Corporation document written in November 1995. A Texaco official, in a March 1996 memorandum, said refinery overcapacity was “the most critical factor” facing the industry and was responsible for “very poor refining financial results.”[15]

Even the National Energy Policy Development Group formed in response to the 2001 price spike recognized that the reduction in capacity was the result of business decisions of oil companies. Government did not choose to close refineries and carry much lower stocks, private businesses did.[16]

> Ongoing industry consolidation, in an effort to improve profitability, inevitably leads to the sale or closure of redundant facilities by the new combined ownership. This has been particularly true of terminal facilities, which can lead to reductions in inventory and system flexibility. While excess capacity may have deterred some new capacity investments in the past, more recently other factors, such as regulations, have deterred investment.[17]

With oil companies merging and eliminating “redundant” capacity, it should not be surprising to find that capacity has become tight.

A 2003 RAND study of the refinery sector reaffirmed the importance of the decisions to restrict supply. It pointed out a change in attitude in the industry, wherein “[i]ncreasing capacity and output to gain market share or to offset the cost of regulatory upgrades is now frowned upon.”[18] In its place we find a “more discriminating approach to investment and supplying the market that emphasized maximizing margins and returns on investment rather than product output or market share.”[19] The central tactic is to allow markets to become tight by “relying on… existing plant and equipment to the greatest possible extent, even if that ultimately meant curtailing output of certain refined product.”[20]

> Indeed, many RAND discussants openly questioned the once-universal imperative of a refinery not "going short" – that is not having enough product to meet market demand. Rather than investing in and operating refineries to ensure that markets are fully supplied all the time, refiners suggested that they were focusing first on ensuring that their branded retailers are adequately supplied by curtailing sales to wholesale markets if needed.[21]

The Rand study drew a direct link between long-term structural changes and the behavioral changes in the industry, drawing the connection between business strategies to increase profitability and pricing volatility. It issued the same warning that the FTC had offered two years earlier – "Unless gasoline demand abates or refining capacity grows, price spikes are likely to occur in the future in the Midwest and other areas of the country."[22] As Rand put it

> For operating companies, the elimination of excess capacity represents a significant business accomplishment: low profits in the 1980s and 1990s were blamed in part on overcapacity in the sector. Since the mid-1990s, economic performance industry-wide has recovered and reached record levels in 2001. On the other hand, for consumers, the elimination of spare capacity generates upward pressure on prices at the pump and produces short-term market vulnerabilities. Disruptions in refinery operations resulting from scheduled maintenance and overhauls or unscheduled breakdowns are more likely to lead to acute (i.e., measured in weeks) supply shortfalls and price spikes.[23]

The "record levels" of profitability in 2001 were achieved with income in the sector of about $12 billion. Income in 2005 was almost twice as large.

A recent comment by the chairman of ExxonMobil reported in the *Wall Street Journal* makes it clear that the industry continues to behave in this anticompetitive, anti-consumer manner and will do nothing to alleviate the pressure on the refining market.

> Exxon Mobil Corp. says it believes that, by 2030, hybrid gasoline-and-electric cars and light trucks will account for nearly 30% of new 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 grassroots refinery," in the U.S. Rex Tillerson, Exxon's chairman and chief executive, said in a recent interview. Exxon has continued to expand the capacity of its existing refineries. But a new refinery from scratch, Exxon believes, would be bad for long-term business.[24]

Refinery expansion has not been sufficient to alleviate the pressure on price and this business strategy is likely to keep it that way for over a decade.

III. A HUNDRED BILLION DOLLARS OF EXCESS PROFITS

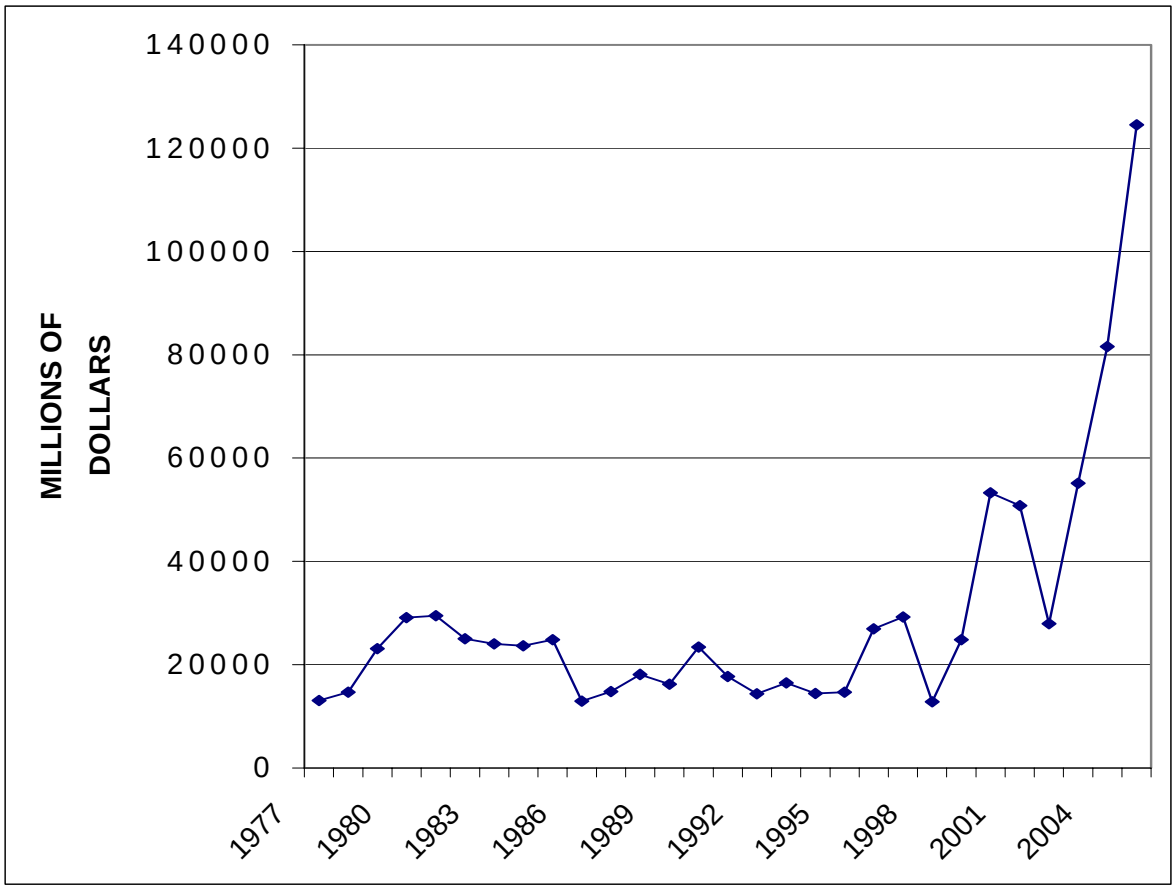
A. Return on Equity

The increase in profits of the major oil companies in 2005 was huge by any standard. The oil companies had an income of about $120 billion, which equaled the total of 1995-1999 inclusive (see Exhibit 3).

Placing this huge increase in profits in perspective is a challenge. The oil company executives like to point to profit as a percentage of sales because in a commodity business, where raw materials are a large part of costs, profits will look small. In a capitalist economy, however, it is return on equity that matters, since this is the return that attracts capital investment. By this standard, the oil company profits have been skyrocketing.

The Department of Energy noted in its most recent comprehensive analysis of The *Performance Profiles of Major Energy Producers* (for 2004) that the major oil companies, known as the FRS companies (large energy producers required to file in the Financial Reporting System), had experienced a sharp increase in income and profitability driven by product price increases.

EXHIBIT 3:
NET INCOME FROM PETROLEUM OPERATIONS OF MAJOR OIL COMPANIES

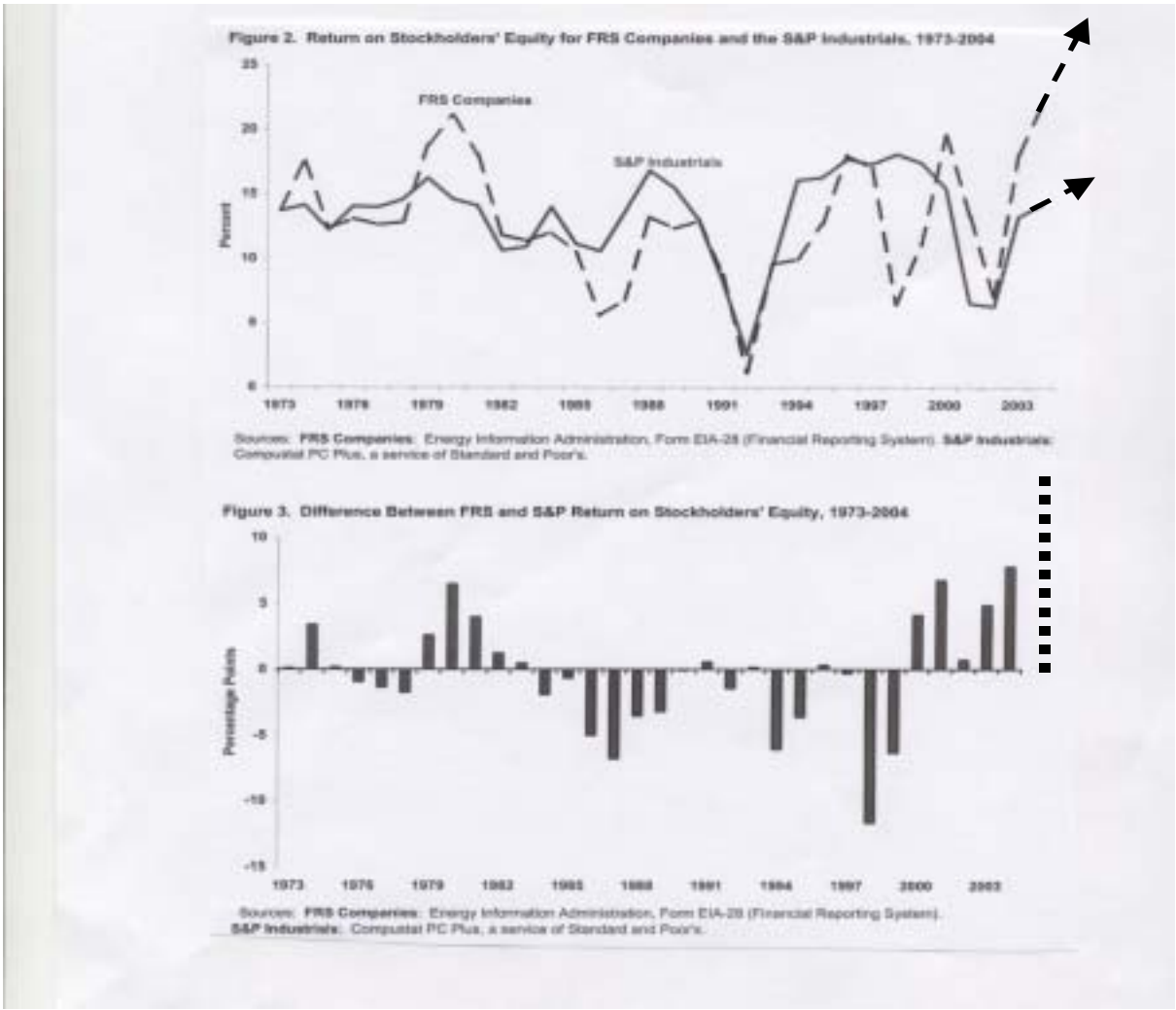


Source: Energy Information Administration, *Consolidated Statement of Income,* Financial Reporting System Public Data.

> Profitability – a measure of a company's or an industry's net income relative to the equity or capital provided by investors – rose to 22.1 percent, surpassing the previous peak of 21.1 percent in 1980. The return on stockholders' equity for the FRS companies has been substantially higher than that of the Standard & Poor's (S&P) Industrial companies for 4 of the past 5 years, a trend not seen since the high-price period of 1979-1981.[25]

In Exhibit 4 we have added estimates of the 2005 return on equity to the series presented by the Energy Information Administration. In 2005, net income and return on equity increased by sharply. In fact, 2004 and 2005 each set a record. Four of the five most profitable years since the oil embargo of

EXHIBIT 4:
RETURN ON EQUITY FRS COMPANIES AND S&P INDUSTRIALS 1973-2005



Source: Energy Information Administration, *Performance Profiles of Major Energy Producers: 2004,* March 2006, p. 3 for 1973-2004. 2005 estimated based on Energy Information Administration, *Financial News for Major Energy Companies, Fourth Quarter 2005, Financial News for Independent Energy Companies, Fourth Quarter 2005;* and Standard and Poors.

1973 have occurred since 2000. These huge increases are excessive by several critical measures.

The historic pattern over fifteen years, where oil companies earned somewhat less than the S&P Industrials is, in fact, the proper baseline. The return on equity should reflect the underlying risk in the sector. Wall Street measures riskiness by the variability of profits (measured by the Beta); the major oil companies are well below the average by this measure. The reason

is that demand for oil is highly inelastic; it does not fluctuate widely. Competition is weak and barriers to entry are high. As a result, the oil industry faces less business risk than other large companies.

Compared to the return on equity in the 1985-1999 period, in 2000-2005 the major oil companies have enjoyed a huge windfall (see Exhibit 5). If we assume the average return in 1985-1999 compared to the S&P Industrials in that period, the increase in 2000-2005 is about $150 billion in excess profits. That translates to over $200 billion in before tax profits, which is what the consumer pays. Even if we assume that the oil industry should have the same return on equity as the S&P Industrials, the excess since the start of the 21st century would be about $100 bilion in after tax profits, or about $150 billion in prices paid by consumers. By either measure, it is a huge windfall.

B. Free Cash Flow

The profits are excessive in another sense. They are so large that the industry simply cannot or will not reinvest them in the business (see Exhibit 6). The cash flow of the companies – made up primarily of net income plus depreciation, has also skyrocketed. Capital expenditures have not.
Depreciation and net income are the return of and on capital.

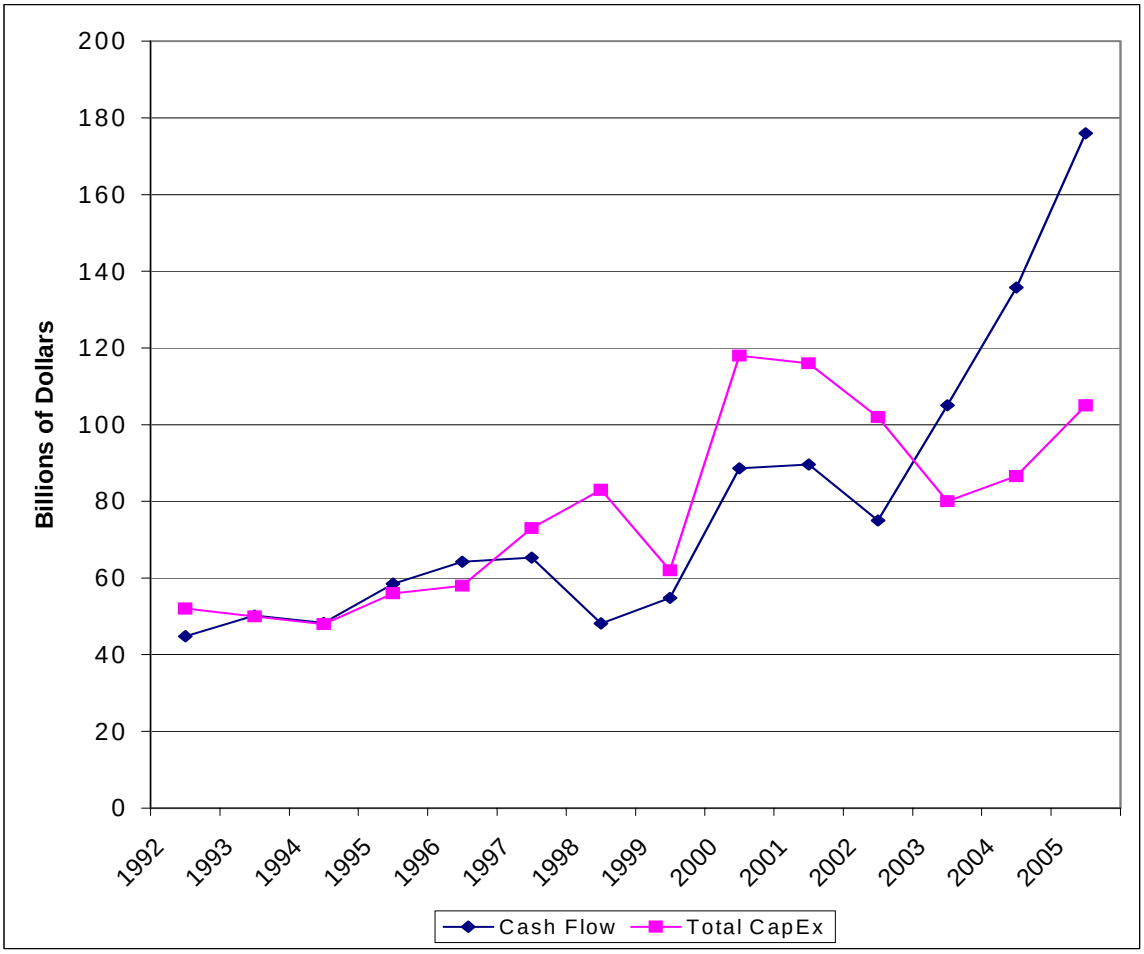
EXHIBIT 5:
2000-2005 OIL INDUSTRY PROFITS ABOVE HISTORIC LEVELS:
(BILLIONS OF DOLLARS)

BASE	AFTER TAX	BEFORE TAX
ROE EQUAL S&P INDUSTRIALS	97	145
1985-1999 AVERAGE (S&P INDUSTRIALS MINUS 3%)	140	209

Source: Calculated by author, see text.

The increase in cash flow above capital expenditures since 2000 has been just over $100 billion. Thus, this is a good

EXHIBIT 6:
CASH FLOW AND CAPITAL EXPENDITURES



Source: Energy Information Administration, *Performance Profiles of Major Energy Producers,* various issues; *Annual Reports*.

estimate of the excessive profits of the oil companies over the period.

IV. MISLEADING THE PUBLIC AND POLICYMAKERS

There are two primary ways in which the oil companies attempt to divert attention from the reality of their excessive profits. In their public relations campaigns,

- they focus on profits as a percentage of sales, but never mention return on equity.

- They focus on total investment but never mention depreciation or cash flow.

While their public relations campaigns ignore the most prominent measure of profitability, their representations to stockholder do the exact opposite, giving prominence to the true indicators of profitability.

A. Return on Equity

The analysis in the previous section is based on the industry averages available in the federal reporting system and focuses on return on equity. This issue has taken on an extreme importance in the public policy debate over oil industry profits. The focus on return on equity is important. In fact, it is one of the primary measures that the oil companies use when they describe their performance to stockholders.

For example, the opening paragraph in the Chairman's Letter to ExxonMobil stockholders reads as follows:

> **2005 was an outstanding year for ExxonMobil** with net income of $36 billion, the highest in the history of the Corporation. Return on average capital employed increased to 31 percent. This success was spread across the company with Upstream, Downstream and Chemical Businesses all posting strong earnings. These results demonstrate the strength of our business model and its ability to capture fully the benefits of a robust business environment.[26]

There is no mention of profits per dollar of sales as the measure of financial performance in the letter, or anywhere else in the annual report. ExxonMobil's *Financial and Operating Review for 2005* gives even more details declaring on page 3 that "ExxonMobil is the leader of our industry."[27] The key financial indicators that it lists are "Record earnings and operating cash flow" and "Industry-leading return on average capital employed (ROCE) of 31 percent." On the next page is a graph entitled "ROCE Leadership."[28]

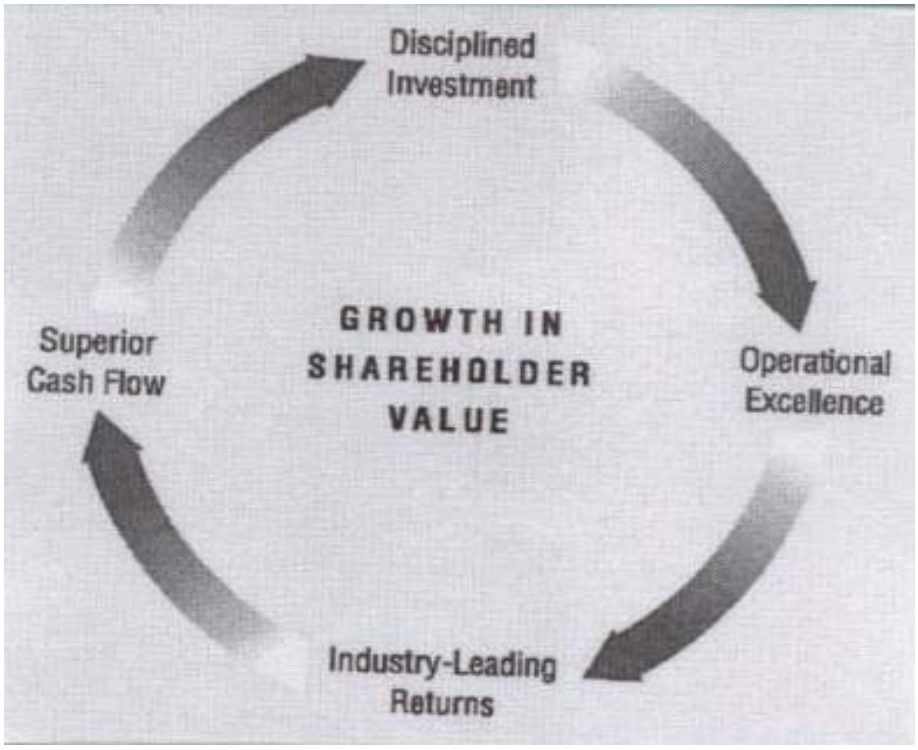
The ExxonMobil business model, described in a graph that follows a couple of pages after the letter to investors points to the investment strategies and financial numbers that are important (see Exhibit 7). These are not the numbers that the

industry advertises to the public in its public relations campaigns.

The other oil companies do much the same. The letter to stockholders from the chairman of ConocoPhilips starts with the following two paragraphs:

> At ConocoPhilips we welcome the relentless challenge of raising shareholder value. In 2005 we strived to meet that challenge by delivering good operational and financial performances, while investing in strong, value-building opportunities.
>
> The company's net income in 2005 was $13.5 billion, or $9.55 per share, compared to $8.1 billion or $5.80 per share, in 2004. This solid financial performance, coupled with $2.5 billion debt reduction, boosted the company's return on capital employed (RCOE) to 31.2 percent, compared to 23.2 percent a year earlier.[29]

EXHIBIT 7:
THE EXXONMOBIL BUSINESS MODEL



Source: ExxonMobil, Summary Annual Report 2005, p. 5.

The statement in the second paragraph of the Chevron Texaco letter to stockholders is similar:

> Our financial performance reflects the capital discipline that is necessary to create sustained value and growth. Net income in 2005 was $14.1 billion on sales and other operating revenue of $194 billion – representing record levels in both categories. Return on capital employed was a strong 21.9 percent.[30]

Thus, the first measure of performance to which the company points is return on capital. This number includes in the denominator both equity and debt. Return on equity tends to run considerably higher than return on debt. Return on capital employed in this industry tends to run higher than in other industries because the oil industry carries less debt as a percentage of total capital. Thus, for purposes of long-term comparisons, return on equity is a better measure, as it is not affected by changes or differences in the debt/equity ratio.

In contrast, when the oil companies defend their profits in public, they do not refer to this number. Instead, they point to profits as a percentage of sales, which makes little sense when used to compare industries that have very different levels of raw material inputs. How irrelevant is this ratio? In none of the three cases cited did the chairman of the company bother to report this ratio to stockholders, even though the numerator and the denominator were cited in every letter. They just do not bother to calculate the ratio because it has little relevance.

In light of this, the constant and repeated[31] use of different ratios on Wall Street and Main Street must be seen as a conscious effort to mislead the public.

B. Free Cash Flow

The second misleading number that the industry uses in public is total investment that is not placed in context of cash flow. For example, on the day ExxonMobil reported its profits, it took out large ads in the nation's leading newspapers informing the public that it has invested $74 billion since 2001.[32] Chevron has run similar a similar ad.[33]

We have already suggested that this number is misleading in our discussion of cash flow and capital expenditures. In the quote above, note that ExxonMobil listed operating cash flow as a

second indicator of its superior financial performance. When the companies tout their increases in capital spending, they ignore cash flow.[34]

To examine this issue in more detail, we examined the cash flow and capital spending of ExxonMobil, Chevron Texaco and ConocoPhilips. These are the three major oil companies that report on a consistent basis (BP and Shell are foreign registered companies). In their letters to stockholders, the companies tend to define their cash flow and capital expenditures very broadly (see Exhibit 8).

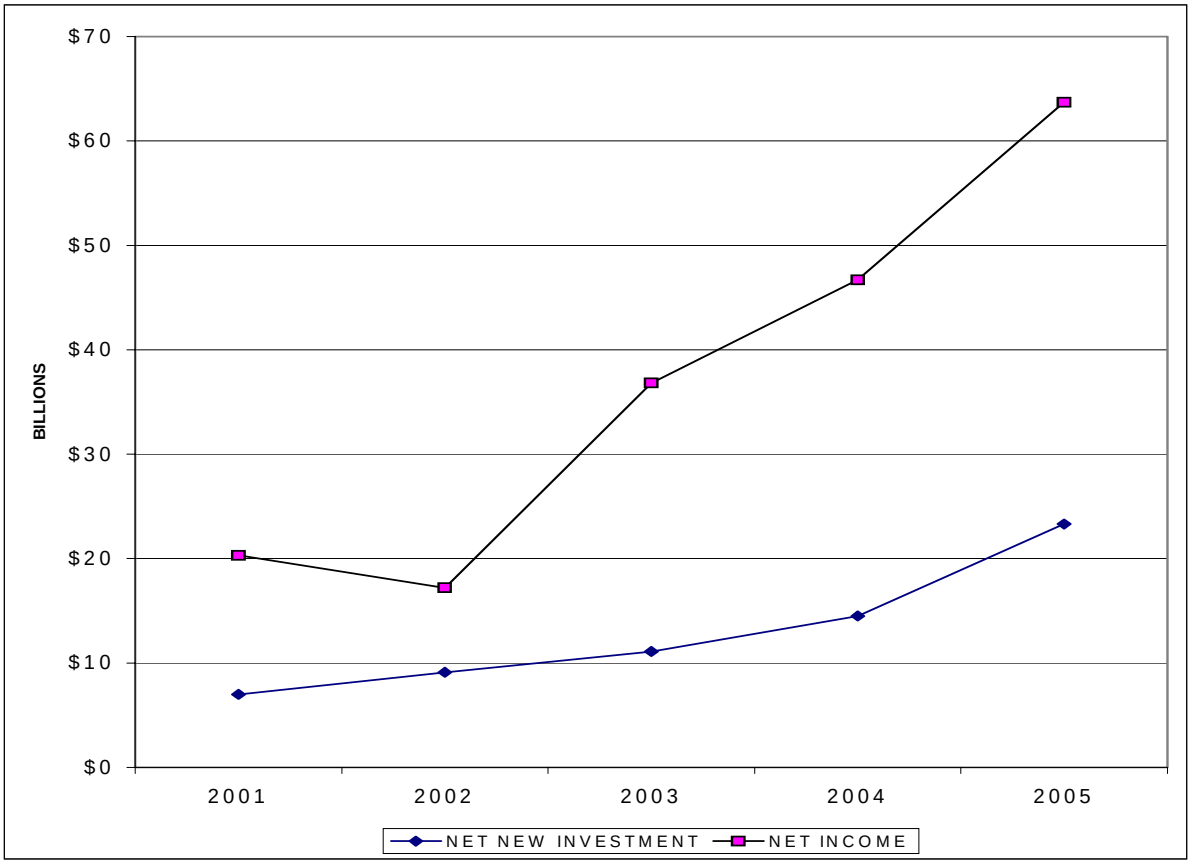
EXHIBIT 8:
CASH FLOW AND CAPITAL EXPENDITURE
(ExxonMobil, Chevron, ConocoPhillips)

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

As we observed for the entire industry, growth of cash flow vastly exceeded capital expenditures for these three companies. Cash flow increased by over 150 percent over the period, about three times as quickly as capital expenditures did. The oil industry was generating a huge quantity of free cash that was not being plowed back into the industry. The absolute size of the gap has become huge — $50 billion by 2005.

We can take a more fine-grained look at this question from the balance sheets of the companies. We can focus narrowly depreciation and income, i.e. return of and on capital. We can calculate the net new investment in the industry by subtracting depreciation from capital expenditure. Net new investment is the new capital invested in excess of depreciation (see Exhibit 9). Between 2001 and 2005, net new investment in the industry

EXHIBIT 9:
NET NEW INVESTMENT AND NET INCOME
(Exxon Mobile, Chevron Texaco, ConocoPhillips)

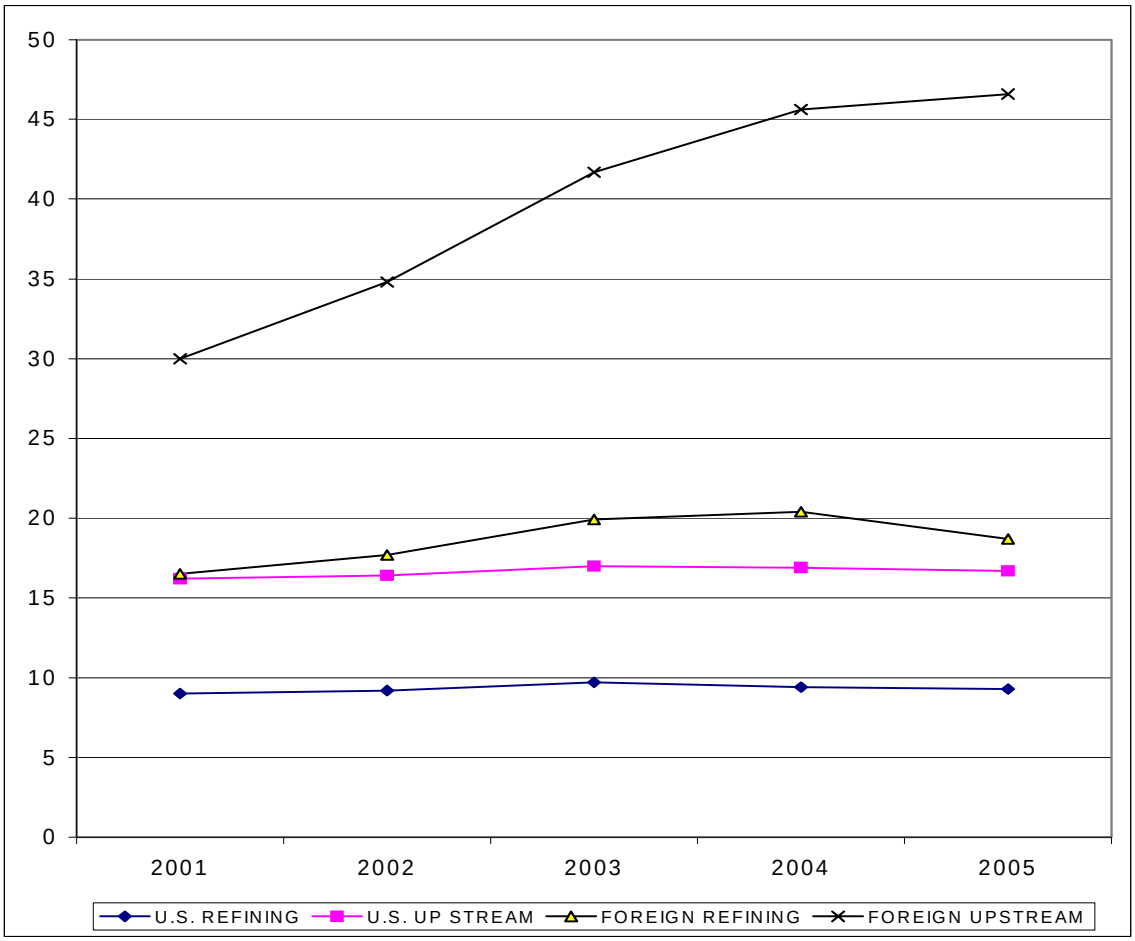


Source: ExxonMobil, *2005 Financial & Operating Review,* pp. 2, 23; Chevron, *2005 Supplement to the Annual Report,* pp. 2, 6. ConocoPhilips, *Annual Reports 2005,* p. 66, 2002, p. 65.

increased by about $15 billion, from $7 billion to $23 billion, while net income increased by $44 billion, from about $20 billion to about $64 billion. Over the period, net new investment totaled about $65 billion, net income totaled about $185 billion. Free cash is piling up at the companies at an astronomical rate.

ExxonMobil presents a figure for net investment in property, plant, and equipment that represents the outcome of the calculation we have presented above (see Exhibit 9). It is broken down for domestic and foreign operations and for upstream (production) and downstream (refining and marketing) operations. It covers the period from year-end 2001 to year-end 2005. It tells a story that really contradicts its glowing claims about investment. The total increase over the four years (since these are year end figures, they represent investments in 2002-2005)

EXHIBIT 10:
EXXONMOBIL NET INVESTMENT IN PROPERTY PLANT AND EQUIPMENT



SOURCE: ExxonMobil, *2005 Financial & Operating Review*, p. 20.

was about $18 billion, or about 25 percent of net income over the period. Note that investment in U.S. downstream operations has been almost flat, increasing a meager 3 percent. The increase in downstream investment in property, plant and equipment represents less than one-half of one percent of net income over the period.

V. CONCLUSION

A. Avoiding Distractions

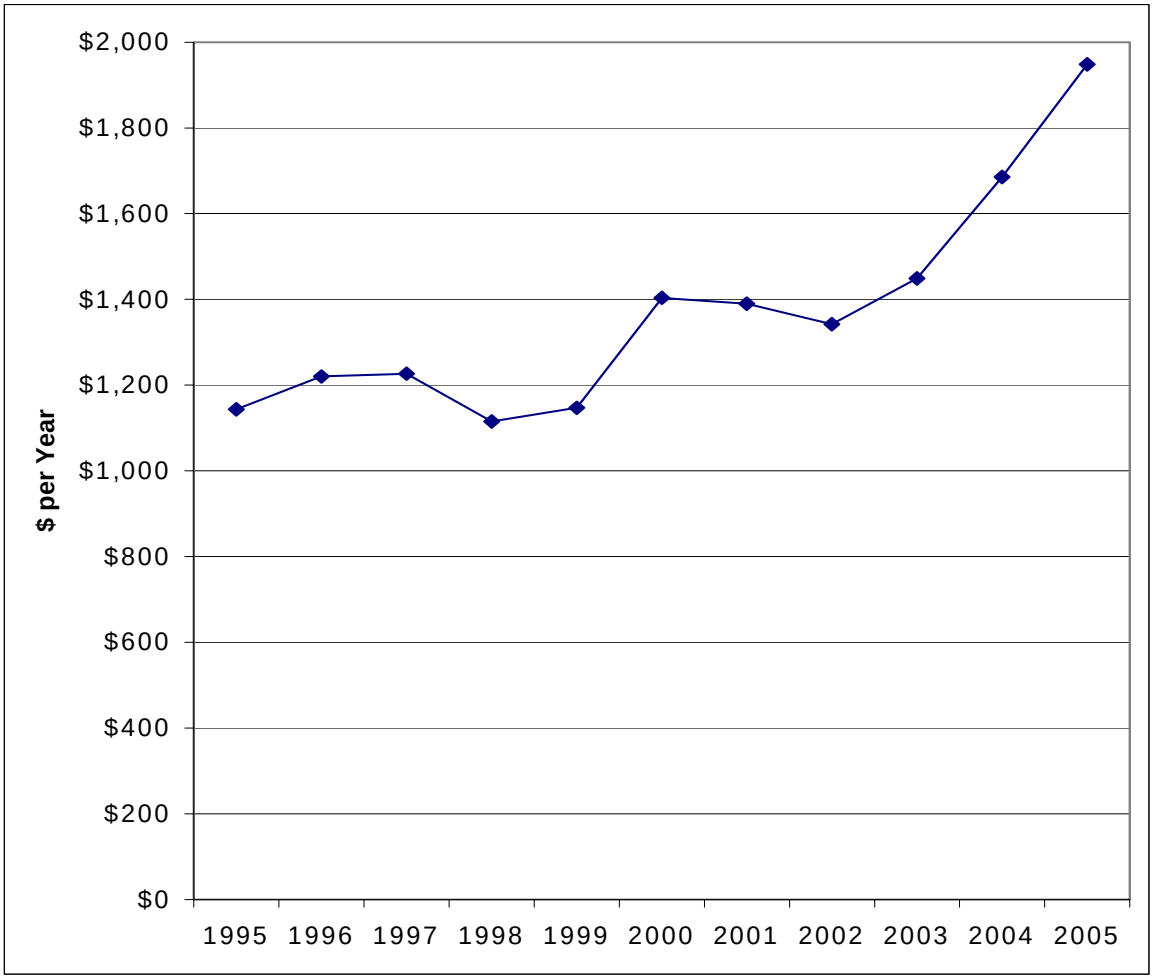
This analysis shows that the behaviors of the oil companies are consistent with the statement of the ExxonMobil CEO and the overall pattern in the industry. They are generating phenomenal returns but they are not investing significantly in refineries. Indeed, Exxon and the other companies emphasize "disciplined investment."[35] In this industry with inadequate facilities, a lack of competition and inelastic demand, for the consumer "disciplined investment" means underinvestment, tight markets and price spikes.[36]

Calls for windfall profits taxes and investigations into price gouging will grab a lot of headlines, while the major oil companies will try to shift the blame elsewhere. Both sets of activities fail to address the underlying problem.

Windfall profits at the oil companies and price gouging by refiners are symptoms of a very dangerous disease in the oil industry – its anti-competitive, anti-consumer market structure.

If we tax away the windfalls, it could offer consumers some immediate relief, but it will not do consumers any good in the long term, if we do not use the money to implement public policies that fundamentally change the underlying market conditions. The idea of using windfall profits taxes to fund rebates to consumers is attractive because household budgets have been hammered by rising prices, but we need to keep the orders of magnitude in mind (see Exhibit 11). Annual household gasoline expenditures increased by over $800 dollars between 1995-1999 and 2005. If the 2006 average price finishes at $2.75 a gallon, that will add over $400 to the average household bill. A rebate of $100, as has been discussed, does not go very far in easing the pain and it does nothing to solve the problem. Nor does it redress the grievance, as it amounts to $10 billion, which is one tenth of the excess profits.

EXHIBIT 11:
HOUSEHOLD EXPENDITURES FOR GASOLINE



Source: Bureau of Labor Statistics, *Consumer Expenditure Survey,* various issues; Energy Information Administration, *Petroleum Prices;*

Pushing the antitrust authorities to do investigations after they have been so lax in approving mergers and antitrust enforcement will likely not find "collusion." The industry has become so concentrated and lacking in competition that it has been able to pursue a policy of under-investing in refineries for so long companies do not need to collude to increase prices. They do so unilaterally and watch their brethren follow suit in parallel fashion, knowing that demand cannot respond. In short, consumers are trapped between a small group of powerful non-competing companies out to maximize profits and purposefully weak governmental authorities who consistently fail to strengthen or enforce the law.

B. Effective Policies for the Long-Term

We need policies that change the market fundamentals and we cannot rely on the oil companies to do the job – their record of underinvestment, mismanagement and deception teach us otherwise.

We need a strategic refinery reserve that is dedicated to building a strategic product reserve that is used to discipline rising gasoline prices. The oil industry has failed to build sufficient refinery capacity to handle even routine maintenance. The strategic purpose of the consolidation of the industry was to eliminate competitive pressure and competitive behavior in the refining sector. They have succeeded in gaining market power and only capacity created outside their control can solve that problem. It never will build enough so that spare capacity puts downward pressure on prices.

In our 2004 report,[37] we pointed out that we simply cannot produce ourselves out of the problem, yet that claim keeps coming back. Because domestic resources represent a very small share of the global resources base and are relatively expensive to develop, it is folly to pursue a supply-side solution to the energy problem.[38] The increase in the amount of oil and gas produced in America will not be sufficient to put downward pressure on world prices; it will only increase oil company profits. With a depleted, costly resource base that represents a very small share of the global total, domestic production simply cannot discipline the world price of oil.[39]

Further boosting the profitability of the petroleum industry with access to “cheap” resources in environmentally sensitive areas would not increase production a great deal, nor will it decrease prices to consumers. Over the past three years, the domestic oil and gas industry has enjoyed a huge increase in profitability, but the pricing abuse has gotten worse, not abated.

A substantial part of the problem and the long-term solution lies on the demand side in our vehicle fleet. The only hope, if we can believe the CEO of ExxonMobil is to accelerate that improvement dramatically. The recent decision of the Department of Transportation to raise the efficiency standard for trucks by a mere 1 mile per gallon is a disgrace, based on an economic analysis that assumes gasoline price over the next five years that are half what they are today.

Our 2001 report laid out an aggressive set of policy goals that went unheeded. In the past five years policy makers did little to address the underlying problem and consumers have paid a heavy price. The policy directions we outlined remain the directions we must go as a nation. The key principles were as follows:

- Restore reserve margins by developing both efficiency (demand-side) and production (supply-side).
- Increase market flexibility through stock and storage policy.
- Discourage private actions that make markets tight/or exploit market disruptions by countering the tendency to profiteer by withholding of supply.
- Promote a more competitive industry.
- Address the disproportionate burden that rising energy price place on lower income households.

The only thing that has changed is that we need to do more to move in these directions and faster to solve this problem.

The one additional area in which the need for public policy has become apparent since the 2001 report is oversight over financial commodity markets. These markets were “modernized” in 2001 and there is mounting evidence that high volume of trading, volatility and risk are adding to the upward spiral of prices.[40]

ENDNOTES

[1] Kovacic, William E., "Prepared Statement of the Federal Trade Commission," *Market Forces, Anticompetitive Activity and Gasoline Prices—FTC Initiatives to Protect Competitive Markets*, Subcommittee on Antitrust, Competition Policy and Consumer Rights, Committee on the Judiciary, United States Senate, April 7, 2004.

[2] Beattie, Jeff, "Gas Prices Still Climbing, EIA Says," *The Energy Daily,* April 12, 2004, citing Gary Caruso, Administrator of the Energy Information Administration.

[3] "Statement of John Cook, Director, Petroleum Division, U.S. Department of Energy, *Subcommittee on Energy and Air Quality, Committee on Energy and Commerce, U.S. House of Representative*, May 15, 2001, p. 1; U.S. Energy Information Administration, *Summer 2003 Motor Gasoline Outlook* (Washington, April 2003).

[4] Federal Trade Commission, *Midwest Gasoline Price Investigation* (Washington, March 29, 2001) cites a combination of structural factors, but the trigger was accidents.

[5] National Petroleum Refiners Association, *The Facts on U.S. Gasoline Supply,* "the Energy Policy Act of 2005 included an ethanol mandate, but failed to include liability protection for MTBE producers. With the removal of the federal oxygenate mandate in early May, it's expected that many refiners, pipelines and other users of MTBE will have made alternative plans. Domestic ethanol production is not adequate to replace MTBE use, so gasoline supplies could get squeezed." The American Petroleum Institute provides a similarly misleading presentation of the issue "It also fails to take into consideration that refiners are facing the complicated challenge posed by the repeal of the RFG oxygen mandate – which may result in having to add more ethanol to reformulated gasoline, making it more expensive to produce" (*API Statement on Comments Made by Sen. Charles Schumer,* April 19, 2006).

[6] Last year Congress passed the Energy Policy Act of 2005 which included a provision to eliminate the oxygenate standard as of May 6, 2006. This provision, which required the use of MTBE, ethanol, or other oxygenate to meet the provisions of the Clean Air Act, was vigorously supported by oil refiners who wanted "repeal of the two-percent oxygen requirement for RFG, as it reduces refiner flexibility to produce cleaner burning gasoline and is no longer necessary to meet air quality goals." (American Petroleum Institute)

[7] "Gasoline suppliers and marketers seeking to blend ethanol into gasoline this spring, assuming they can locate the ethanol at a reasonable price, will be forced to scramble to find storage for this ethanol at bulk terminals or will locate separate and at times distant ethanol storage facilities at which they will blend ethanol with gasoline," [Bill] Douglass [Society of Independent Gasoline Marketers of America] said. "These bulk storage infrastructure constraints will result in an added level of complexity in an already stressed gasoline supply distribution system," (UPI, March 30, 2006).

[8] "Gasoline Shortages Reported in Texas," *Reuters,* April 28, 2006.

[9] "The US will have enough **ethanol** to blend into gasoline during the current spike in demand as companies transition away from oxygenate MTBE, according to Valero Energy CEO William **Klesse**...'we think there is enough ethanol.'" (Platts, March 19, 2006)

[10] "RFA said ethanol production was a record 288,000 barrels a day during January for a total of 375.6 million gallons. Output was up by 8,000 barrels a day from

the preceding month and 47,000 barrels per day higher than January 2005. There are 97 ethanol plants in the United States with total capacity of 4.5 billion gallons. An additional 2 billion gallons of capacity is under construction." (Reuters, March 28, 2006)

[11] According to the Associated Press (April 11, 2006), [Guy] Caruso said the main reason for the jump in gasoline costs is the higher price of crude oil, which accounts for 19 cents of the projected average increase this summer. Refiners' shifting away from the additive MTBE also is putting pressure on supplies of corn-based ethanol, adding "a few pennies" of cost to motorists.

[12] Federal Trade Commission, *Midwest Gasoline*, pp. i... 4.

[13] *The Impact of Rising Prices on Household Gasoline Expenditures* (Consumer Federation of America, September 2005);*Over a Barrel: Why Aren't Oil Companies Using Ethanol to Lower Gasoline Prices?* (Consumer Federation of America, May 2005); *Record Prices, Record Oil Company Profits: The Failure Of Antitrust Enforcement To Protect American Energy Consumers* (Consumer Federation of America, Consumers Union, September 2004); *Fueling Profits: Industry Consolidation, Excess Profits, & Federal Neglect: Domestic Causes of Recent Gasoline and Natural Gas Price Shocks* (Consumer Federation of America and Consumers Union, May 2004); *Spring Break in the U.S. Oil Industry: Price Spikes, Excess Profits and Excuses* (Consumer Federation of America, October 2003): *Ending the Gasoline Price Spiral: Market Fundamentals for Consumer-Friendly Policies to Stop the Wild Ride* (Consumer Federation of America, July 2001). The results of these analyses have been presented to both houses of Congress: "An Oversight Hearing on Record High Gasoline Prices and Windfall Oil Company Profits," *Senate Democratic Policy Committee,* September 19, 2005; "Hurricane Katrina's Effect on Gasoline Supply and Prices," *Committee on Energy and Commerce, U.S. House of Representative,* September 7, 2005; "Testimony of Mark Cooper on behalf or The Consumer Federation of America and Consumers Union on the Status of the U.S. Refining Industry," *Subcommittee on Energy and Air Quality, Committee on Energy, U.S. House of Representatives, July 15, 2004;* "Testimony of Dr. Mark N. Cooper on Behalf of the Consumer Federation of American and Consumers Union on Environment Regulation in Oil Refining," *Environment and Public Works Committee,* May 12, 2004; "Testimony Of Dr. Mark Cooper, On Behalf Of Consumer Federation Of America And Consumers Union On Crude Oil: The Source Of Higher Prices? Before The *Senate Judiciary Committee, Antitrust, Competition Policy And Consumer Rights Subcommittee*, April 7, 2004; "Testimony Of Dr. Mark Cooper, Director Of Research, "On Gasoline Price Volatility," *Senate Commerce Committee*, October 9, 2003.

[14] For purposes of this analysis we go back to January 1995. January 1995 was the implementation date of the Clean Air Act Amendments. The Clean Air Act Amendments affected refinery operations and, in turn, gasoline prices.

[15] "Oil Data Show Industry Role in Shortages a Possibility," *The New York Times*, June 15, 2001.

[16] Federal Trade Commission, *Midwest Gasoline*, note 23, citing Organization for Economic Co-operation and Development and Department of Energy documents states, "Higher crude prices led producers to draw down inventories in anticipation of replacing them later at lower prices."

[17] National Energy Policy Development Group, *National Energy Policy* (Washington, May 2001), p. 7-13 (hereafter NEPDG).

[18] Peterson, D.J. and Sergej Mahnovski, *New Forces at Work in Refining: Industry Views of Critical Business and Operations Trends* (Santa Monica, CA: RAND Corporation, 2003), p. 16.

[19] Peterson and Mahnovksi, p. 42.

[20] Peterson and Mahnovski, p. 17.

[21] Peterson and Mahnovksi, p. 17.

[22] Federal Trade Commission, *Midwest Gasoline*, pp. i... 4.
[23] Peterson and Mahnovski, p. xvi.
[24] Ball, Jerry, "As Gasoline Prices Soar, Americans Resist Major Cuts in Consumption," *Wall Street Journal,* May 1, 2006, p. A13.
[25] Energy Information Administration, *Performance Profiles of Major Energy Producers: 2004,* March 2006, p. 2.
[26] ExxonMobil, Annual Report 2005, p. 2.
[27] ExxonMobil, 2005 Financial & Operating Review, p. 3.
[28] Id., p. 4.
[29] ConocoPhilips, Annual Report 2005, p. 4.
[30] ChevronTexaco, Annual Report, 2005, p. 2.
[31] The American Petroleum Institute features an analysis entitled *Making Sense Out of Oil and Natural Gas Prices*, contains three different graphs on profits per dollar of sales, but never mentions return on equity. See http://api-ec.api.org/filelibrary/Making-Sense-Oil-NaturalGasPrices.pdf, last visited on April 30, 2006.
[32] *Washington Post,* April 27, 2006, p. A25; *New York Times,* April 27, 2006, p. A27.
[33] Snyder, Jim, "Oil Industry Prepares $30 Million Fight Back," *The Hill,* April 26, 2006, p. 1, reports on the launch of a new public relations $30 million campaign by the American Petroleum Institute "to follow a national advertising effort that ahs cost around $25 million so far."
[34] The American Petroleum Institute analysis at presents the net income v. investment graph, but never mentions cash flow or depreciation.
[35] ExxonMobil Annual Report 2005, p. 5; Chevron uses the term "capital discipline," Annual Report 2005, p. 2.
[36] Similarly, claims that reduction in storage is "just-in-time" delivery, frequently means never there when you really need it.
[37] Record Prices, p. 51.
[38] Cleveland, Cutler J. and Robert K. Kaufman, "Oil Supply and Oil Politics: Déjà vu All Over Again," *Energy Policy*, 31, 2003, pp. 485-487, point out the obvious math of the situation.

> This policy will not increase significantly the US production of crude oil, will not reduce significantly OPEC's influence, and it will distort the US macroeconomy. These outcomes are caused by a policy that is not consistent with the depleted state of the domestic resource base and with the economics of international oil.
>
> In any plausible scenario, however, the actual effect will be close to zero. If OPEC correctly anticipates production from ANWAR (the Arctic Natural Wildlife Reserve), which would not be difficult given its long lead times, OPEC could slow additions to capacity very modestly such that its utilization rate (and its effect on price) would be changed relative to a scenario in which no oil is produced from the ANWR… Regardless of OPEC behavior, the 1-2 mbd [million barrels per day] from ANWR would reduce the OPEC's share of the world oil market by 2-3 percent. Such a change would be virtually undetectable given the large fluctuation in crude oil prices

[39] Holly, Chris, "EWG: Generous Leasing Policies Fail to Ease U.S. Oil Dependence," *Energy Daily*, p. 1, cites the conclusion that "of the 229 million acres offered for oil and gas development since the early 1980s, only 30 million acres – or 13

percent – have ever produced oil and gas…. This land has produced enough energy to satisfy only 53 days of U.S. oil consumption and 221 days of natural gas consumption."

[40] Mouawad, Jad and Heather Timmons, "Trading Frenzy Adds to Jump in Price of Oil," *New York Times,* April 29, 2006, p. A1. The analysis in Cooper, Mark, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral,* prepared for Midwest Attorneys General Natural Gas Working Group (Illinois, Iowa, Missouri, Wisconsin), March 2006, provides a detailed account of the factors affecting natural gas, which parallels the events in the oil market.