



**ConsumersUnion.org**  
*Nonprofit Publisher of Consumer Reports*

## **TIME TO CHANGE THE RECORD ON OIL POLICY**

**RECORD GASOLINE PRICES AND OIL COMPANY PROFITS  
REQUIRE AGGRESSIVE POLICIES TO REDUCE DEMAND AND PROTECT  
CONSUMERS FROM ABUSIVE BUSINESS PRACTICES**

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**August 2006**

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## EXECUTIVE SUMMARY

### Time for a Change in Energy Policy

Five years ago the Consumer Federation of America began examining the gasoline price ratchet and outlined a pro-consumer policy response that emphasized fuel efficiency, competitive reform and enhanced oversight of the oil industry to alleviate tight market conditions and protect consumers from abuse. In the intervening years, none of our recommendations were implemented. Instead, Congress and the Administration adopted many pro-industry policy measures, including the most recent initiative to allow off-shore drilling in the Gulf Coast.

Things have gone from bad to worse for consumers. Gasoline prices and oil company profits continue to skyrocket. This summer's increase in the domestic spread alone – the amount oil companies take for domestic refining and marketing – is over \$.30 per gallon higher than last summer. The summer driving bill for consumers this summer compared to last summer will be about \$12 billion higher due to the increase in the domestic spread.

While drilling bills that can do little to lower prices or solve our national “oil addiction” in the long term have passed both houses of Congress, efficiency and consumer protection legislation is stalled. Some members of Congress have recognized that the U.S. needs a change in direction for its energy policy. In a rare show of bipartisanship in this Congress, some Republicans and Democrats have joined hands to introduce legislation that will:

- set an aggressive overall goal for national oil savings of 10 million barrels a day over a quarter of a century;
- dramatically improve the fuel efficiency of autos and light trucks – doubling the miles per gallon in a quarter of a century,
- provide consumers sound information about the fuel consumption of their vehicles, when they purchase them and, with dashboard displays, as they drive them,
- subject the oil industry to greater oversight by antitrust and commodity trading agencies.

Congress and the Administration need to get behind these proposals, and enact meaningful energy policies.

This paper updates our previous analyses. The understanding the underlying causes of recent price increases is critical to designing policies to address the problem. Over the past half decade our analyses have shown that the major oil companies get away with market abuse because policymakers have done nothing to address the fundamental energy problem or the market power problem. By studying the behavior of the oil companies we come to understand that the industry-friendly drilling policies cannot solve the nation's oil problem and we come to appreciate even more why the fuel economy legislation bottled up in Congress must be the most important part of any plan to end our “addiction to oil.”

## **Excess Profits**

The evidence shows that the oil industry has turned the domestic refining industry into a cash cow. Compared to the late 1990s, in the first half of this year the domestic spread has been over \$.40 per gallon higher. Profits have increased much faster in the U.S. refining sector – from \$1 billion in 2002 to a projected \$29 billion in 2006 – than in the foreign refining operations of the same companies. Consolidation in the industry and a refusal to add sufficient new capacity have given the oil companies market power over gasoline prices.

Profits have soared in both absolute and relative terms. Oil companies now earn more in a single year than they did in a five year period of the late 1990s. The rate of profit – the return on equity – is at record levels. In fact, six of the seven highest years occurred since 1999.

Compared to the Standard and Poors Industrials, the oil companies have earned excess profits of \$120 to \$160 billion. These excess profits have not been invested in the industry. In that five year period, net income exceeded net, new investment by about \$120 billion. The industry is throwing off cash, which piles up in oil company bank accounts and has been used to buy back company stock.

## **The Public is Ready for Change**

Our surveys show the public supports greater fuel efficiency legislation, currently stalled in Congress. More than three-quarters of the respondents *support* requiring major increases in the fuel efficiency of cars, as well as requiring auto companies to boost alternative fuel vehicles from 3% to 25% of the new car fleet. Those polled also support requiring auto manufacturers to put mileage stickers on all new cars, include mileage prominently in advertising, and add dashboard displays that show the miles per gallon consumed while the car is being driven. This strong support reflects a growing concern about gasoline prices (four-fifths of respondents) and Mid-East oil imports (three-quarters of respondents).

# I. INTRODUCTION

## A. BROKEN RECORDS

In July of 2001, with consumers suffering from the second of two, consecutive summer price spikes in gasoline, the Consumer Federation of America issued the first in a string of reports on the oil industry. Our findings pointed to a complex interplay of factors contributing to the volatility of gas prices in the market.

This paper demonstrates that the price ratchet results from a combination of inadequate capacity and inadequate competition in the industry. The underlying tight market condition is the result of both increasing demand and business decisions that slowed the growth of long-term capacity. The price spiral occurs because suppliers who face weak competition find they can act unilaterally in a tight market to quickly increase prices, stabilize them at higher levels and make huge profits. Public policy must recognize all three factors--supply, demand and competition--if the price ratchet is to be broken in a consumer-friendly fashion.<sup>1</sup>

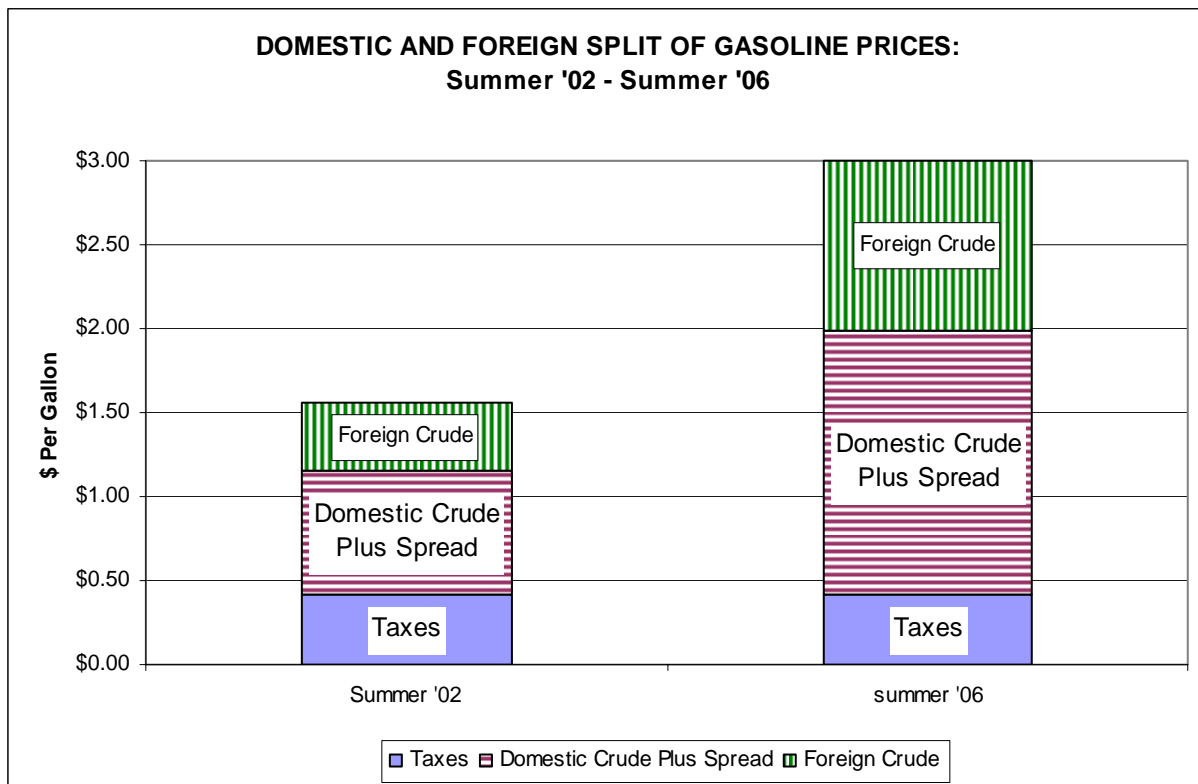
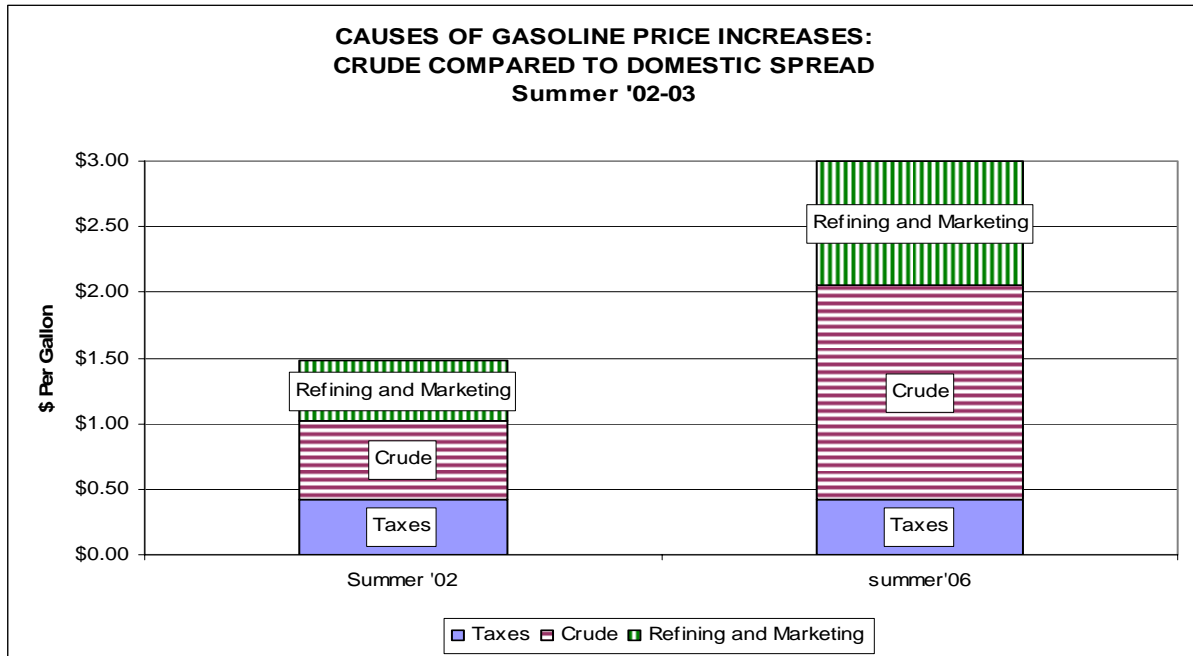
We concluded that due to weak market fundamentals it was critical that national policy address increasing the fuel efficiency of the vehicle fleet, restoring competitive pressures within the oil industry, and subjecting the industry to greater oversight for anti-consumer and anticompetitive behavior.<sup>2</sup> Our reports noted that the National Energy Policy, written by a task force headed by Vice President Cheney,<sup>3</sup> outlined a very different set of policies, focused more on simplistic supply-side policies that do little to pave the way for a secure energy future.

In the intervening five years, almost all of the recommendations of the Cheney task force have been implemented, while none of our recommendations have been acted on.<sup>4</sup> As we feared, the economics surrounding energy prices are going from bad to worse. In six of the past seven years, gasoline prices have soared to record levels. A variety of excuses have been offered to explain the price spikes, including the cost of crude oil,<sup>5</sup> refinery outages and maintenance,<sup>6</sup> lack of gasoline in storage,<sup>7</sup> unexpected surges in demand,<sup>8</sup> and the weather. Three things, however, remain constant: a shortage of refinery capacity; soaring prices, and record-breaking oil company profits.

The public relations strategy of the oil industry and its defenders has been to claim that the problem lies within the supply and demand chains, and to place blame on OPEC and rising global crude prices. A close look at the industry's quarterly earnings, however, presents a much more complex picture. The pressure points on the price increases are not only the world price for crude and the market conditions explained by supply and demand. Domestic factors account for a significant part of the price increase and there has been a massive increase in oil company profits (see Exhibit 1).

For example, in the summer of 2002 gasoline prices averaged about \$1.50. In the summer of 2006, they will average about twice as much - about \$3.00 per gallon. Of the \$1.50 increase, 46 cents is the result of increases in the domestic spread – the amount oil companies collect from consumers for refining and marketing. Thus, about one-third of the increase in the price of gasoline is the result of the increase in the domestic spread. Looked at in another way, because domestic oil

Exhibit 1:



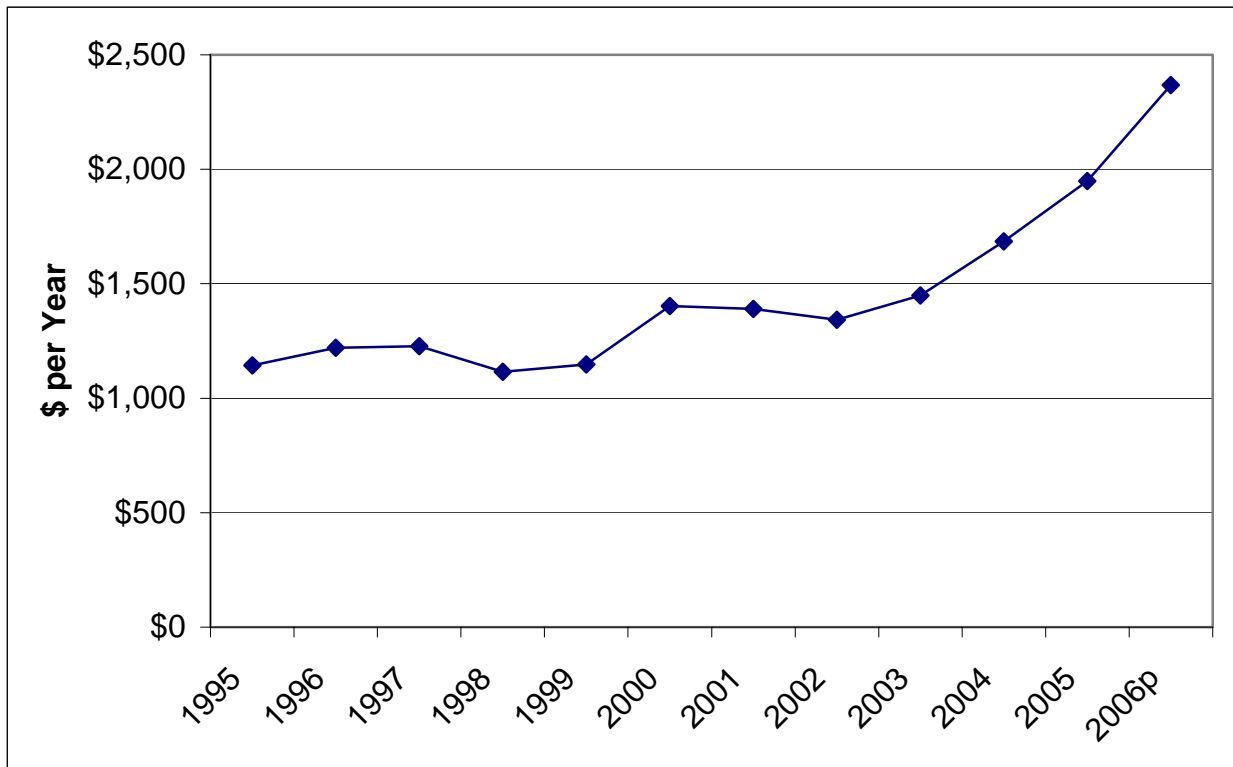
Source: Energy Information Administration, Database.

companies produce a substantial amount of crude oil refined for the domestic market, a significant part of the price increase goes to domestic companies, not foreign producers. Combining the huge increase in the domestic spread with the increases in crude oil prices charged by domestic companies, we find that almost \$.85 of the total \$1.50 per gallon increase went to domestic companies.

Another perspective can be gained by noting that when the President signed the Energy Policy Act of 2005 last August, the domestic spread for June and July stood at about 60 cents per gallon. For June and July 2006 the domestic spread was about 94 cents. In other words, American consumers paid 34 cents more per gallon in June and July 2006 than a year earlier for the domestic spread. At this pace, the increase in the domestic spread for the summer 2006 driving season will cost consumers over \$12 billion more than it did in 2005.

Household budgets have been hammered by rising prices (see Exhibit 2). Annual household gasoline expenditures increased by over \$800 dollars between 1995-1999 and 2005. If the 2006 average price finishes at \$2.80 a gallon, that will add over \$400 to the average household bill. The \$1200 increase in energy costs has begun to drag down spending and the economy.

**Exhibit 2:  
Household Gasoline Expenditures**



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

In our 2001 paper and others since, we argued that rising oil industry profits are the result of strategic business decisions by oil producers, domestic and foreign.<sup>9</sup> On the domestic front, a pattern of strategic action and mismanagement was evident in the first price spike of the new millennium, in the upper mid-West in the summer of 2000. As 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).<sup>10</sup>

This pattern does not emerge in well-functioning markets. Over the past decade the refining market has become highly concentrated and the industry has achieved market power over price through mergers and strategic decisions to keep refining capacity tight. The problem of a concentrated market is compounded by the fact that 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.

## **B. The Failure of Energy Policy**

As prices and profits have mounted to record levels, so too has public frustration and concern. Fourth-fifths of respondents to a recent national random sample public opinion poll conducted by Opinion Research Corporation for the Consumer Federation of America said they were concerned about gasoline prices.<sup>11</sup> Almost three quarters said they were concerned about imports of Mid-East oil. They also expressed strong support for programs to improve the fuel efficiency of the vehicle fleet. Over three quarters of respondents support requiring major increases in the fuel efficiency of cars and requiring auto companies to boost alternative fuel vehicles from 3% to 25% of the new car fleet. They also support requiring auto manufacturers to put a mileage sticker on all new cars, including mileage prominently in all advertising and adding dashboard displays that show the mileage as the car is driven.

Although Congress has legislation pending that would advance fuel efficiency and strengthen consumer protection, it has failed to put these bills to a vote. Instead, Congress recently passed legislation to expand offshore oil exploration, which will do little to affect gasoline prices or solve the nation's "addiction to oil."<sup>12</sup>

The futility of the preoccupation with the drilling strategy is clear in the numbers. America consumes about 25% of the oil and gasoline used by the entire globe, but we have only about 2% of the world's crude oil reserves.<sup>13</sup> Because the U.S. oil resource base has been exploited for over a century, there is little chance that a great deal more oil will be found here. According to the U.S. Department of the Interior, 85% of the resources in the coastal areas are already available for drilling



and the amount of oil in the newly opened areas is less than two percent of the world oil supply.<sup>14</sup> There is little chance this oil could lower prices. It is not likely to raise world oil production by much more than one percent over the course of a couple of decades. It is equal to only two years of U.S. oil consumption.<sup>15</sup>

Moreover, the drilling bills will not alleviate the shortage of refinery capacity or break the stranglehold currently enjoyed by a handful of companies on that sector. Indeed, because a small number of companies have gained market power over price through their control of refineries, the primary effect of the drilling bills will be to increase oil industry profits. It gives the oil industry the go-ahead to drill for 'cheap' oil in environmentally sensitive areas of the U.S., while they pocket higher 'world prices,' adding to their already excessive rate of profit.

### **C. Time for a Change of Direction in Energy Policy**

In the State of the Union speech, President Bush declared "we have a serious problem: America is addicted to oil." The Administration claims to have implemented 95% of the supply-side, industry-friendly recommendations of Vice President Cheney's National Energy Policy Task Force,<sup>16</sup> but that is not providing short-term relief, nor is it likely to be a long-term solution to the oil problem. The U.S. needs a bolder, longer term strategy if it is going to address and correct its oil addiction.

Ironically, while the Administration and Congressional leadership continue to push traditional supply-side strategies, many of the policies we have been advocating for years have garnered bipartisan support in Congress. In a rare display of bipartisanship in this Congress, rank and file members from both sides of the aisle have put forward aggressive proposals to cut oil consumption. Republicans and Democrats tried to get votes on these bills, as stand alone legislation and as amendments to the drilling bills, but they were rebuffed by the leadership.

#### ***A commitment to substantial reduction of oil consumption and imports.***

National oil consumption and foreign oil dependence are now widely recognized as pervasive problems affecting consumers, the economy, national security and the environment. A long-term commitment to reducing consumption of transportation fuel is the only way to address this problem. *The Vehicle and Fuel Choices for American Security Act* (S. 2025), a bi-partisan bill sponsored by senators Brownback (R-KS) and Bayh (D-IN), calls for reducing America's oil consumption by ten million barrels per day over the next quarter century. Similar legislation has been introduced in the House of Representatives: the *Fuel Choices for American Security Act of 2005* sponsored by Kingston (R-GA) and Engel (D-NY).

#### ***An increase in fuel efficiency requirements for vehicles.***

Automobiles and light trucks are the single largest source of oil consumption in the U.S., but an Environmental Protection Agency (EPA) report last month found the average fuel economy for vehicle fleets in the U.S. has not improved in two decades.<sup>17</sup> According to the Energy Information Administration (EIA), transportation fuel accounts for approximately 40 percent of all U.S. oil consumption.<sup>18</sup> Without legislation that sets aggressive targets for reducing U.S. oil consumption, our nation's dependence on foreign oil will continue to grow.

Bills have been introduced in the Senate that would improve the fuel efficiency of vehicles and should be considered in the current energy debate. For example, the *Ten in Ten Fuel Economy Act* (S. 3543), introduced by Senators Feinstein (D-CA) and Snowe (R-ME), and H.R. 3762, introduced by representatives Boelherth (R-NY) and Markey (D-MA), would require about 10 MPG increase in the fuel efficiency of cars and trucks over the next ten years. The *Fuel Economy Reform Act of 2006*, sponsored by Senators Lugar (R-IN) and Obama (D-IL), would extend that rate of improvement into the future, achieving about a doubling of the fuel economy of autos and light trucks over a quarter of a century.

These measures will “deliver” five to ten times as much capacity to oil markets than the drilling bills recently past.<sup>19</sup> And, the oil savings are sustainable for the long term, while the small increase in production that results from expanded drilling is not. Fuel efficiency is the most reliable and secure approach to reducing our dependence on foreign oil.

***A requirement that EPA update miles per gallon estimates on new vehicle window stickers and require manufacturers to use the accurate estimates in compliance with federal mileage standards, called Corporate Average Fuel Economy (CAFÉ) standards.***

Consumers Union, publisher of *Consumer Reports* magazine, has tested the accuracy of EPA's mpg claims for model years 2000 to 2006 and found the mileage promised on new car stickers to be inflated, more often than not, sometimes by as much as 50 percent.<sup>20</sup>

Congress has not allowed EPA to update its fuel economy data on window stickers since the 1980s. Even more faulty numbers, which date back to 1970s, are used by the National Highway Traffic Safety Administration to enforce compliance with the federal miles per gallon standards.

The *Ten in Ten Fuel Economy Act* would order EPA to update its decades-old fuel economy data to reflect real driving conditions and force the National Highway Traffic Safety Administration to use those numbers to enforce the miles per gallon compliance.

Several of these bills would require that auto manufacturers provide consumers with sound information about the fuel consumption of their vehicles when they purchase them, in their advertising and, with dashboard displays, as they drive them,

***An examination of the price raising business practices of the oil industry.***

The Senate needs to act on legislation that puts in place mechanisms for preventing pricing abuse by the oil industry. The oil industry is reporting record profits. Exxon Mobil reported second quarter 2006 profits at \$10.36 billion, the second largest quarterly profit ever recorded by a publicly traded U.S. company.

*The Oil and Gas Industry Antitrust Act of 2006* (S. 2557), sponsored by Specter (R-PA) and Kohl (D-WI) and voted out of the Senate Judiciary Committee, would allow the formation of a joint task force of federal and state attorneys general to monitor the structure, conduct and performance of gasoline markets.

***Create oversight on the trading of unregulated energy futures.***

According to a bipartisan report released by the U.S. Senate Permanent Subcommittee on Investigations, trading of energy commodities on unregulated electronic markets has been linked to rising gasoline prices by driving up crude oil prices as much as \$20-\$25 a barrel, which works out to \$.50 per gallon.<sup>21</sup> Regulatory oversight of energy commodities is needed to restore integrity to our price discovery markets.

*The Oil and Gas Traders Oversight Act of 2006* (S. 2642), sponsored by Senators Feinstein (D-CA), Snowe (R-ME), Levin (D-MI) and Cantwell (D-WA), would give the Commodity Futures Trading Commission (CFTC) oversight authority over unregulated energy futures. Consumers Union strongly urges the Senate to take up and pass this important piece of legislation.

### ***Expand Refinery Capacity***

Partisanship predominates on the issue of expanding refinery capacity. H.R. 3893, sponsored by Mr. Barton (R-TX), Chairman of the Energy and Commerce Committee, proposes subsidies for oil companies to build refineries. H.R. 5365, sponsored by the ranking member of the Committee, Mr. Dingell (D-MI), proposes to construct a strategic refinery reserve to be used to meet military needs and provide spare capacity to respond to market disruptions.

## **C. OVERVIEW AND OUTLINE OF THE REPORT**

The understanding the underlying causes of recent price increases is critical to designing policies to address the problem. Over a half decade our analyses have shown that the major oil companies get away with market abuse because policymakers, from one Congress and one administration to the next, have done nothing to address the fundamental market power problem.

By studying the behavior of the oil companies we come to understand that the industry-friendly drilling policies cannot solve the problem and we come to appreciate even more why the fuel economy legislation bottled up in Congress must be the most important part of any plan to end our “addiction to oil.”

This paper updates our 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 (a significant portion of which is accounted for by the major oil companies), is 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 well over \$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. Second, a comparison of capital expenditures to cash flow shows that the industry is throwing off and unable to absorb a huge quantity of free cash flow.

## II. DOMESTIC REFINING

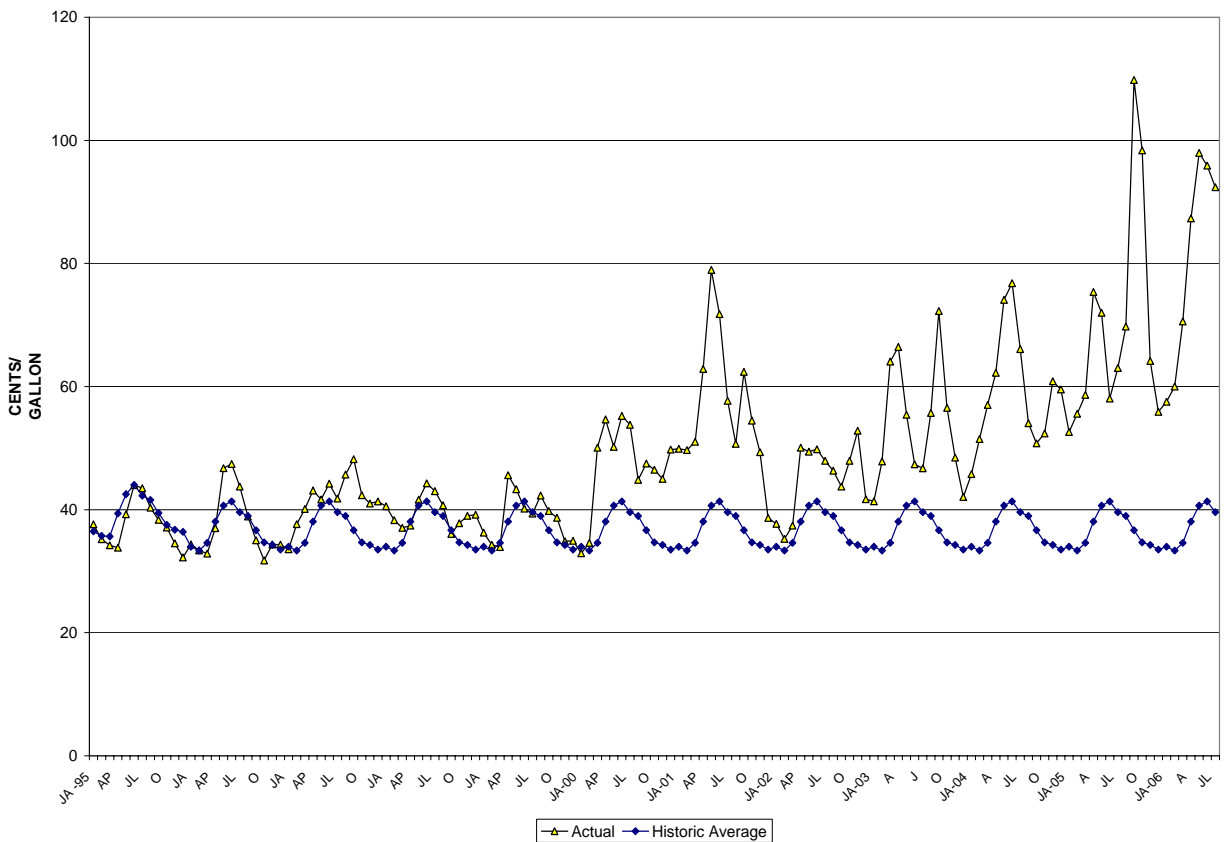
### A. DOMESTIC REFINING AS A CASH COW

The most obvious indicator that we can use to see how the 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 3 shows the domestic spread going back to January 1995.<sup>22</sup> There was a small

**Exhibit 3:**  
**Gasoline Domestic Spread (Pump Price Minus Taxes and Crude)**

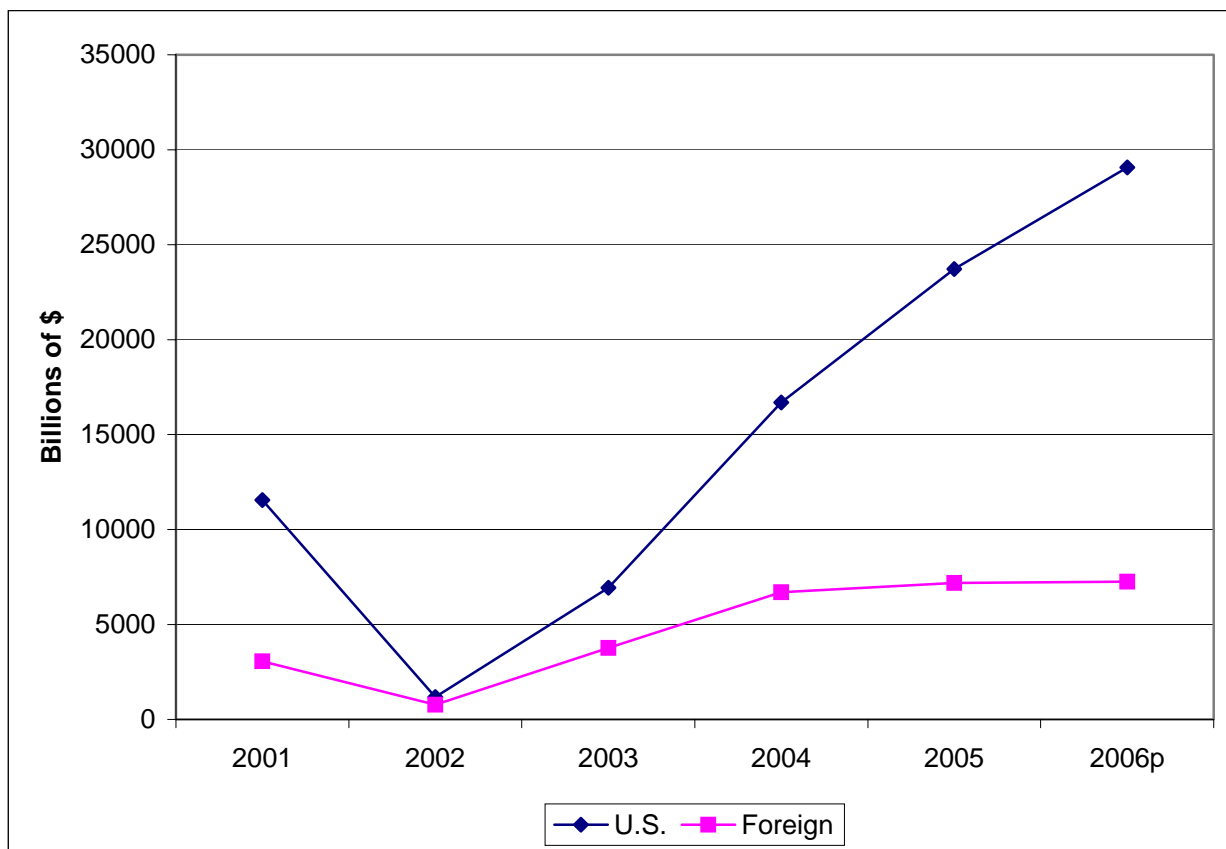


Source: Energy Information Administration, Petroleum Data Base.

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 half of this year it was over 40 cents per gallon above the historic average. That works out to about \$34 billion dollars in increased prices at the pump for consumers.

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 4). Domestic U.S. refining has become a major profit center and cause of increasing prices.

**Exhibit 4:  
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 and a projected \$29 billion for 2006. It increased from under \$1 billion for their foreign refining operations to about \$7 billion over that period. This contrast underscores how different markets can behave. Domestic refining capacity has become extremely tight as a result of investment decisions by oil companies.

## **B. CREATING TIGHT MARKETS AND KEEPING THEM TIGHT**

Documents from the mid-1990s indicate how a tighter market came about. Industry officials and corporate officers were concerned about how to reduce capacity, making observations such as the following, from a Texaco official, in a March 1996 memorandum, who said refinery overcapacity was “the most critical factor” facing the industry and was responsible for “very poor refining financial results.”<sup>23</sup> Another industry analysis from November 1995 that turned up in the files of Chevron Corporation stated that “if the U.S. petroleum industry doesn’t reduce its refining capacity, it will never see any substantial increase in refinery profits.”

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.<sup>24</sup>

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.<sup>25</sup>

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.”<sup>26</sup> 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.”<sup>27</sup> The central tactic is to allow markets to become tight by “relying on... existing plants and equipment to the greatest possible extent, even if that ultimately meant curtailing output of certain refined product.”<sup>28</sup>

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.<sup>29</sup>

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.”<sup>30</sup> 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.<sup>31</sup>

The “record levels” of profitability in 2001 were achieved with income in the sector of about \$12 billion. Income in 2006 was over 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.<sup>32</sup>

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. OVER 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. In 2006, the oil companies will have an income of about \$120 billion, which exceeds the total of 1995-1999 inclusive.

Putting this huge increase in profits in perspective is a challenge. Oil company executives like to point to profit as a percentage of sales. This makes profits look small because oil is a commodity business, where raw materials are a large part of costs. 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.

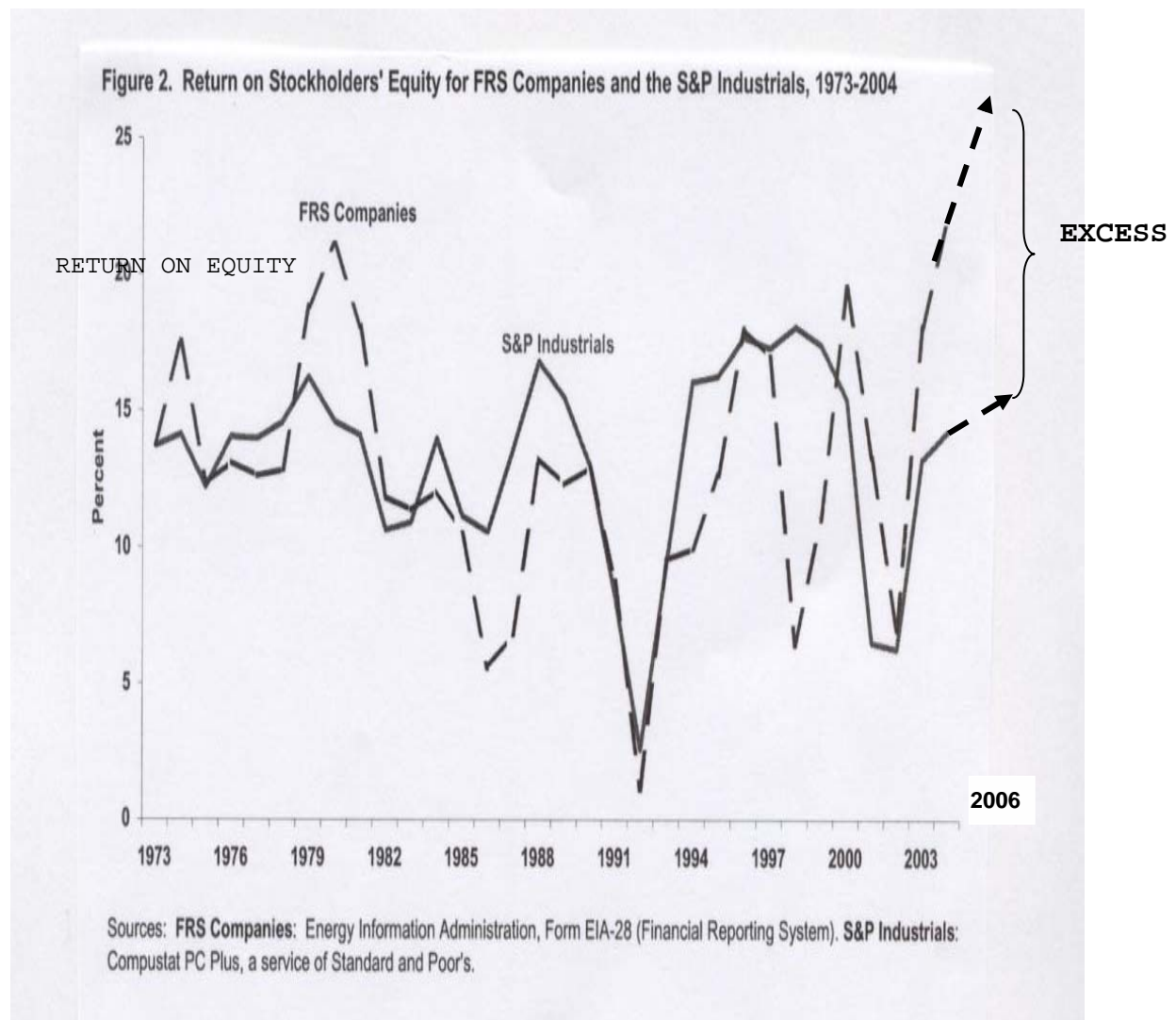
Profitability – a measure of a company’s or an industry’s net income relative to the equity or capital provided by investors – rose to 22.1 percent, surpassing the previous peak of 21.1 percent in 1980. The return on stockholders’ equity for the FRS companies has been substantially higher than that of 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.<sup>33</sup>

In Exhibit 5 we have added estimates of the 2005 and 2006 return on equity to the series presented by the Energy Information Administration. In 2005, net income and return on equity increased sharply. In fact, 2004 and 2005 each set a record, as will 2006. Five of the six most profitable years since the oil embargo of 1973 have come 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.



**Exhibit 5:  
Excess Return on Equity of Large Oil Companies Compared To Standard and Poors  
Industrials: 1973-2006**



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

Compared to the return on equity in the 1985-1999 period, from 2000-2006 the major oil companies have enjoyed a huge windfall (see Exhibit 6). If we assume the average return in 1985-1999 compared to the S&P Industrials in that period, the increase in 2000-2005 is over \$160 billion in excess profits. That translates to almost \$250 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 21<sup>st</sup> century would be about \$120 in after tax profits, or about \$180 billion in prices paid by consumers. By either measure, it is a huge windfall.

**Exhibit 6:  
2000-2006 Oil Industry Profits Above Historic Levels:  
(Billions of Dollars)**

	AFTER TAX	BEFORE TAX
BASE		
ROE EQUAL S&P INDUSTRIALS	120	180
1985-1999 AVERAGE (S&P INDUSTRIALS MINUS 3%)	164	245

Source: Calculated by author, see text.

**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 7). 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. When 2006 is tallied, the increase in cash flow above capital expenditures since 2000 has about over \$120 billion. Thus, this is a good estimate of the excessive profits of the oil companies over the same period.

The oil companies have tried to divert attention from this huge cash flow with advertisements that point to their large capital expenditures. For example, on the day ExxonMobil reported its 2005 profits, it took out large ads in the nation's leading newspapers informing the public that it has invested \$74 billion since 2001.<sup>34</sup> Chevron has run a similar ad.<sup>35</sup>

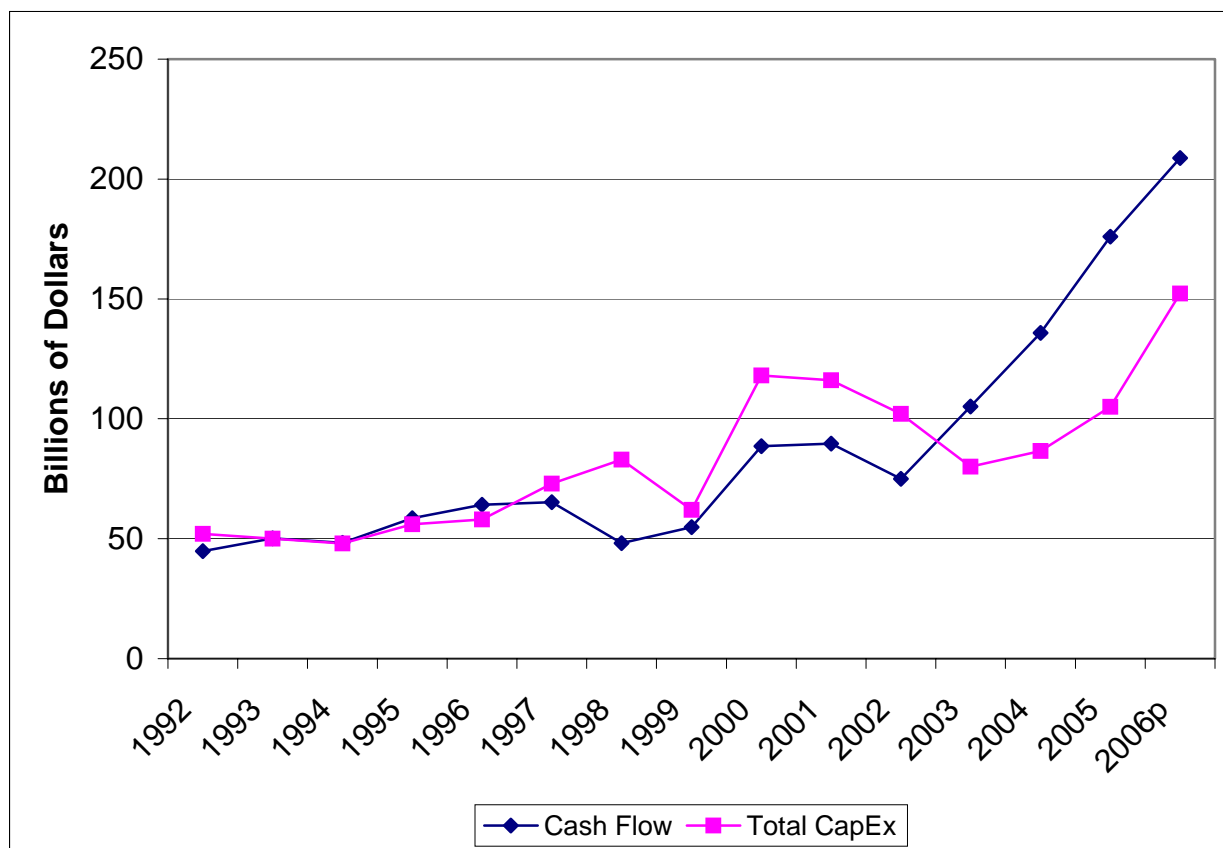
To examine this issue in more detail, we focused on the cash flow and capital spending of ExxonMobil, Chevron Texaco and ConocoPhillips. These are the three major oil companies that report on a consistent basis (BP and Shell are foreign registered companies). In their letters to stockholders, the companies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

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 on depreciation and income, i.e. return of and on capital.

## Exhibit 7:

### CASH FLOW AND CAPITAL EXPENDITURES



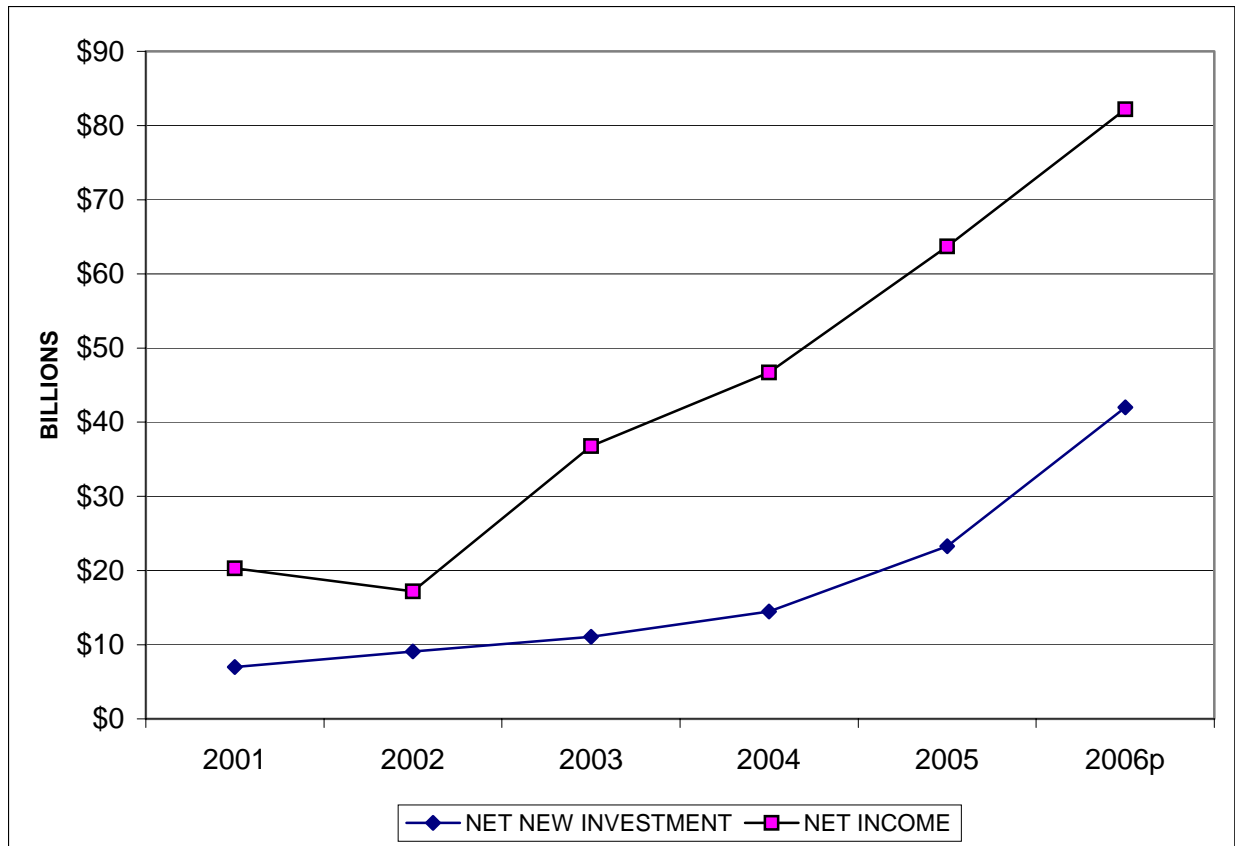
Source: Energy Information Administration, *Performance Profiles of Major Energy Producers*, various issues; *Annual Reports*.

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 8). Between 2001 and 2005, net new investment in the industry 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 for the companies at an astronomical rate. Instead of using the cash to increase capacity, the companies have been buying back their stocks and increasing cash on hand. By the end of this year, the increase in cash and treasury stock since 2000 will exceed \$80 billion.

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.”<sup>36</sup> In an industry with inadequate facilities, a lack of competition

and inelastic demand, “disciplined investment” means underinvestment, tight markets and price spikes for the consumer.<sup>37</sup>

**Exhibit 9:  
Net New Investment and Net Income  
(Exxon Mobile, Chevron Texaco, ConocoPhilips)**



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.

#### IV. CONCLUSION

Our surveys show that the public supports the efficiency oriented legislation stalled in Congress.<sup>38</sup> More than three-quarters of the respondents *support* requiring major increases in the fuel efficiency of cars, as well as requiring auto companies to boost alternative fuel vehicles from 3% to 25% of the new car fleet. Those polled also support requiring auto manufacturers to put mileage stickers on all new cars, include mileage prominently in advertising, and add dashboard displays that show the miles per gallon consumed while the car is being driven. This strong support reflects a growing concern about gasoline prices (four-fifths of respondents) and Mid-East oil imports (three-quarters of respondents).

At least the rank and file in Congress have recognized that the “addiction to oil” from which this nation suffers requires a more aggressive and comprehensive approach to rehabilitation. Aggressive measures to reduce U.S. oil consumption must be the primary means of providing consumers relief from skyrocketing gasoline prices.<sup>39</sup> This is the best way to simultaneously reduce pressures on the global crude market and the domestic refining sector. It is time that the Administration and the Congressional leadership get the message.

## ENDNOTES

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- <sup>1</sup> *Ending the Gasoline Price Spiral: Market Fundamentals for Consumer-Friendly Policies to Stop the Wild Ride* (Washington, D.C.: July 2001), p. i.
- <sup>2</sup> *Id.*, Chapter V.
- <sup>3</sup> *Id.*, p. 4.
- <sup>4</sup> *Ask the White House Interactive Forum with Samuel Bodman* (March 9, 2005).
- <sup>5</sup> 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.
- <sup>6</sup> Beattie, Jeff, “Gas Prices Still Climbing, EIA Says,” *The Energy Daily*, April 12, 2004, citing Gary Caruso, Administrator of the Energy Information Administration.
- <sup>7</sup> “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).
- <sup>8</sup> Federal Trade Commission, *Midwest Gasoline Price Investigation* (Washington, March 29, 2001) cites a combination of structural factors, but the trigger was accidents.
- <sup>9</sup> *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 of 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 America 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.
- <sup>10</sup> Federal Trade Commission, *Midwest Gasoline*, pp. i... 4.
- <sup>11</sup> Consumer Federation of America, *Blueprint for National Energy Security* (Consumer Federation of America, May 2006).
- <sup>12</sup> *State of the Union*, January 31, 2006, p. 6.
- <sup>13</sup> Energy Information Administration, *International Petroleum (Oil) Reserves and Resources*, Most Recent Estimates, January 1, 2006.
- <sup>14</sup> U.S. Department of the Interior, *Report to Congress: Comprehensive Inventory of U.S. OCS Oil and Natural Gas Resources* February 2006, p. 20 and 72.
- <sup>15</sup> Compare Clifford Krauss, “Senate Bill Lifts Hopes of Big Oil Offshore,” *New York Times*, August 3, 2006, C-1, C-2; International Energy Administration, *International Energy Annual, Data and Analysis*; and Energy Information Administration, *Analyses of Selected Provisions of Proposed Energy Legislation: 2003*, September 2003.
- <sup>16</sup> See note 4.
- <sup>17</sup> Environmental Protection Agency, *Light-Duty Automotive Technology and Fuel Economy Trends: 1975 through 2006*, July 2006, p. iii.
- <sup>18</sup> See note 14.
- <sup>19</sup> H.R. 4409 targets 5 million barrels per day by 2025; S.2025 targets 10 million barrels per day by 2030. Increases in offshore production are not likely to exceed 1 million barrels per day in the mid-term.
- <sup>20</sup> Saccucci, Michael, et. al. *An In-Depth Comparison of Consumers Union’s Passenger Vehicle Average MPG Estimates with Those Published by EPA and NHTSA* (Yonkers, NY: Consumers Union, August 11, 2005).
- <sup>21</sup> *The Roel of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat*, Permanent Subcommittee

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on Investigations, United States Senate, June 27, 2006, p. 2.

<sup>22</sup> 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.

<sup>23</sup> “Oil Data Show Industry Role in Shortages a Possibility,” *The New York Times*, June 15, 2001.

<sup>24</sup> 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.”

<sup>25</sup> National Energy Policy Development Group, *National Energy Policy* (Washington, May 2001), p. 7-13 (hereafter NEPDG).

<sup>26</sup> 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.

<sup>27</sup> Peterson and Mahnovski, p. 42.

<sup>28</sup> Peterson and Mahnovski, p. 17.

<sup>29</sup> Peterson and Mahnovski, p. 17.

<sup>30</sup> Federal Trade Commission, *Midwest Gasoline*, pp. i... 4.

<sup>31</sup> Peterson and Mahnovski, p. xvi.

<sup>32</sup> Ball, Jerry, “As Gasoline Prices Soar, Americans Resist Major Cuts in Consumption,” *Wall Street Journal*, May 1, 2006, p. A13.

<sup>33</sup> Energy Information Administration, *Performance Profiles of Major Energy Producers: 2004*, March 2006, p. 2.

<sup>34</sup> *Washington Post*, April 27, 2006, p. A25; *New York Times*, April 27, 2006, p. A27.

<sup>35</sup> 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 has cost around \$25 million so far.”

<sup>36</sup> ExxonMobil Annual Report 2005, p. 5; Chevron uses the term “capital discipline,” Annual Report 2005, p. 2.

<sup>37</sup> Similarly, claims that reduction in storage is “just-in-time” delivery, frequently means never there when you really need it.

<sup>38</sup> Consumer Federation of America, *CFA Releases Blueprint for Lowering Gasoline Costs through Reduced Oil Consumption and Imports*, May 25, 2006.

<sup>39</sup> Mark Cooper, *50 by 2030* (Washington, D.C.: Consumer Federation of America, May 2006).