**Statement by John Felmy**
**Chief Economist, American Petroleum Institute**

**House Judiciary Committee**
**Antitrust Task Force**
**Hearing on "Prices at the Pump: Market Failure and the Oil Industry"**

**May 16, 2007**

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I am John Felmy, chief economist of API, the national trade association of the U.S. oil and natural gas industry. API represents nearly 400 companies involved in all aspects of the oil and natural gas industry, including exploration and production, refining, marketing and transportation, as well as the service companies that support our industry.

The oil and natural gas industry understands America's frustrations about gasoline prices. Higher prices are a burden to households and potentially threaten the economy. However, the evidence overwhelmingly demonstrates that higher prices reflect an imbalance between supply and demand, worsened at least in part by policy failures, which the current price-control proposals will make still worse. The contention that higher prices are driven by market failure or market manipulation, including the holding back of supplies, is not credible. The prices are a symptom of larger energy challenges facing the nation and must be addressed in other ways.

U.S. oil companies are working extremely hard to provide Americans with the fuels they need and demand.

U.S. refineries have been making record amounts of gasoline, about 8.85 million barrels per day to date this year (see Figure 1). However, less imported gasoline has been available. Typically, imports make up about 12 percent of gasoline supply. Less foreign gasoline has been available in part because of spring refinery maintenance in Europe and an 18-day French port-workers' strike in March, which led some European refiners to reduce production. As a result, total U.S. gasoline supplies have struggled to keep up with demand, which has been extremely strong. During the first quarter of 2007, total U.S. gasoline demand set a record, increasing almost 2 percent over the same period in 2006.

The most important factor in higher gasoline prices has been higher crude oil prices. More than half the cost of gasoline is attributable to the cost of crude oil. Crude oil prices have fluctuated significantly, driven by lingering geopolitical tensions, OPEC's continuing production controls, and worldwide demand growth. Oil companies do not set the price of crude. It is bought and sold in international markets, with the price for a barrel of crude reflecting the market conditions at the time of purchase. It is well recognized that the market for crude oil has tightened. World oil demand reached unprecedented levels in 2006 and continues to grow due to strong economic growth, particularly in China and the United States. World oil spare production capacity – crude that can be brought online quickly during a supply emergency or during surges in demand – is near its lowest level in 30 years.

In addition, the annual switchover to "summer blend" gasoline required by EPA has occurred, and this warm-weather gasoline is more expensive to produce. The

switchover lowers yields per barrel of oil and requires a large supply drawdown to meet regulations, which reduces inventories.

Finally, despite record U.S. gasoline production, regularly scheduled refinery maintenance and unexpected problems relating to extreme weather, external power outages and other incidents have prevented refiners from making even more gasoline. Maintenance is a normal procedure, though it has been delayed, in some cases, by damage suffered from the catastrophic hurricanes in 2005. While maintenance curtails refining operations temporarily, it helps ensure the long-term viability of the refinery and protects the health and safety of workers.

In short, the recent price increases reflect the forces of supply and demand. And the same is true for past price increases that have been thoroughly investigated by government agencies who would not have hesitated to take the industry to task if illegal or improper activity had been discovered. Invariably, these agencies have explained price spikes by supply/demand conditions. The evidence is overwhelming that refiners are not withholding supplies or otherwise manipulating the market.

Here, for example, is what the U.S. Federal Trade Commission said in May 2006 as a result of an investigation:[1]

> "… the best evidence available through our investigation indicated that companies operated their refineries at full sustainable utilization rates. Companies scheduled maintenance downtime in periods when demand was lowest in order to minimize the costs they incur in lost production. Internal company documents suggested that refinery downtime is costly, particularly when demand and prices are high. Companies track these costs, and their documents reflected efforts to minimize unplanned downtime resulting from weather or other unforeseen calamities. Our investigation uncovered no evidence indicating that refiners make product output decisions to affect the market price of gasoline. Instead, the evidence indicated that refiners responded to market prices by trying to produce as much higher-valued products as possible, taking into account crude oil costs and other physical characteristics. The evidence collected in this investigation indicated that firms behave competitively."

Those who persist in suspecting, despite the massive evidence to the contrary, that the industry is holding back supplies often cite the lack of new refinery construction. While it is true that no new refinery has been built since the 1970s, companies have steadily increased the capacity of existing refineries and continue to do so. Over the past ten years, existing refineries have expanded capacity equivalent to building 10 new refineries and, based on public announcements of refinery expansions, are projected to add capacity equivalent to an additional eight new refineries by 2011.

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[1] "Investigation of Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases," U.S. Federal Trade Commission, May 22, 2006.

Another explanation advanced to explain higher prices is industry mergers. As with all industries, mergers have occurred only after careful FTC scrutiny to ensure the competitiveness of markets. There is no shortage of competitors today, and market power is not heavily concentrated. The eight biggest refiners account for 66 percent of the market, a level of concentration that compares favorably to other consumer product industries. There are close to 60 refining companies, about 142 refineries, and about 165,000 retail outlets, all but a small percentage of these outlets owned by small businessmen and women. A 2004 report by the FTC said that the share of U.S. refining capacity owned by independent refiners with no production operations rose from 8 percent in 1990 to over 25 percent in 2006.

A 2003 GAO report says that mergers affected prices by less than one half of one cent per gallon at the wholesale level, but the FTC dismissed the report as "fundamentally flawed" and full of "major methodological mistakes." It says the report's conclusion "lack any quantitative foundation." Beyond this suspect GAO report, we are unaware of anything in the professional literature tying higher prices to mergers. Indeed, in part as a result of the mergers, the industry has become more efficient, which has reduced costs to consumers, though this benefit has been masked by sharp increases in crude oil prices.

None of the arguments advanced to justify the price-control proposals has a strong factual and analytical basis, yet even if all did, price-control legislation would be a supremely bad idea. The proposals could interfere with the operation of the law of supply and demand, hamstringing efforts to secure and deliver ample supplies of fuel to consumers.

Today's proposals are cousins of the disastrous price and allocation controls of the 1970s. Those policies established price ceilings on domestically produced crude oil and refined products, keeping them artificially low compared to world prices. This resulted in decreased domestic crude oil production while domestic demand for crude oil and refined products increased, leading to a worsening of shortages and increased oil imports. It was the era of gasoline lines, odd or even days, and millions of angry motorists, victims of the misguided policies of their own government, which should have known better.

If price controls are enacted, the 12 percent of our daily gasoline consumption met by imports could be jeopardized. Overseas suppliers would not have an incentive to ship to U.S. markets if the price were kept artificially low. Also, they might prefer to ship to other markets rather than risk jail time or exorbitant fines in the U.S.

In addition, today's proposals contain vague pricing requirements that make it virtually impossible for marketers to know in advance if their actions will be found to be in or out of compliance and, therefore, will be extremely difficult to enforce fairly. For example, under these bills, how is a gas station operator to know whether a price increase of five, ten or fifteen cents a gallon will be considered "unconscionable?" This legal uncertainty, especially when coupled with the serious risk of jail time or exorbitant fines,

could discourage a supplier from doing business in areas affected by a natural disaster when supplies have been substantially reduced, thus delaying a return to normal conditions.

Price-control laws will not solve today's problems. The U.S. oil and natural gas industry is doing everything it can to produce the fuel supply needed to meet consumer energy needs. Congress needs to allow the oil and gas industry to invest today's earnings in meeting tomorrow's energy needs and continue to operate within a market system, which has done far more for consumers than price controls could ever hope to. However, the industry cannot meet U.S. energy challenges alone. Our nation's energy policy needs to focus on increasing supplies; encouraging energy efficiency and conservation in all sectors of the economy, including transportation; and promoting responsible development of alternative and non-conventional sources of energy.

At a minimum, we must do no harm. Price control laws threaten consumers and the nation's energy security. We can do much, much better.

**Appendix 1: oil and natural gas industry earnings**

Proponents of "price-gouging" proposals say they are partly justified by the oil and natural gas industry's large earnings. There is considerable misunderstanding about this. Companies' earnings are typically in line with other industries and often lower. For 2006, the industry's annual earnings averaged 9.5 cents on each dollar of sales. The average for all manufacturing industries was 8.2 cents or about a penny lower. From 2002 to 2006, average earnings for the industry stood at approximately 7.4 cents on each dollar of sales – a penny above the five-year average for all U.S. manufacturing industries.

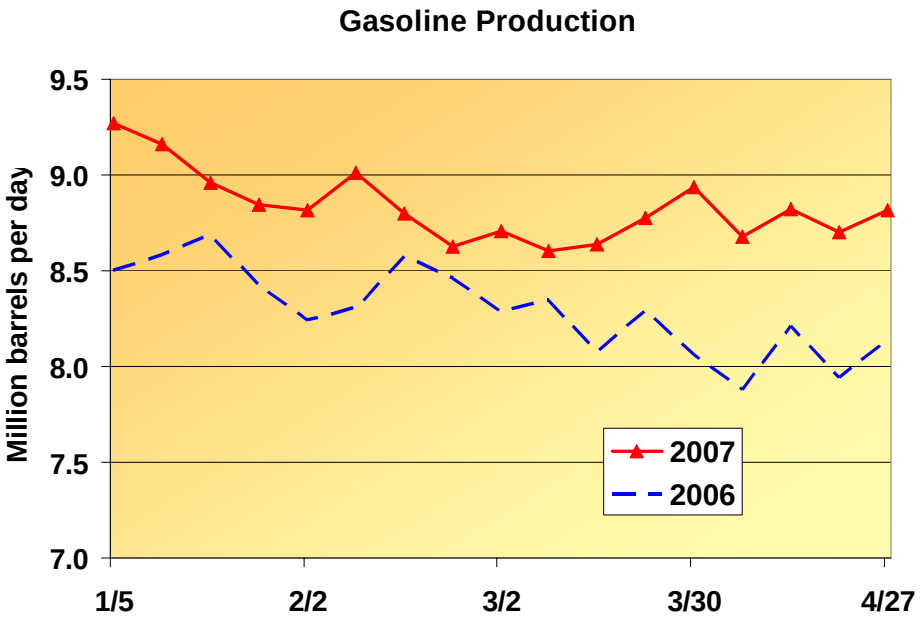
It should not be forgotten that the energy Americans consume today is brought to us by investments made years or even decades ago. Today's oil and natural gas industry earnings are invested in new technology, new production, and environmental and product quality improvements to meet tomorrow's energy needs. Between 1992 and 2005, the industry invested more than $1 trillion – on six continents – in a range of long-term energy initiatives: from new exploration and expanding production and refining capacity to applying industry leading technology. In fact, over this period, our cumulative capital and exploration expenditures exceeded our cumulative earnings.

Furthermore, the industry's future investments are not focused solely on oil and natural gas projects. For example, one oil company is among the world's largest producers of photovoltaic solar cells; another oil company is the world's largest developer of geothermal energy; and the oil and gas industry is the largest producer and user of hydrogen. Over the last five years in North America alone, we have invested $12 billion in renewable, alternative and advanced non-hydrocarbon technologies. In fact, when you add up all of the various types of emerging energy technologies, our industry, over the five years, has invested almost $100 billion – more than two and half times as much as the federal government and all other U.S. companies combined.

It also requires billions more dollars to maintain the delivery system necessary to ensure a reliable supply of energy and to make sure it gets where it needs to go: to industry customers. According to the EIA, Americans will need 28 percent more oil and 19 percent more natural gas in 2030 than in 2005. The industry is committed to making the reinvestments that are critical to ensuring our nation has a stable and reliable supply of energy today and tomorrow.

It is also important to understand that those benefiting from healthy oil and natural gas industry earnings include numerous private and government pension plans, including 401K plans, as well as many millions of individual American investors. While shares are owned by individual investors; firms, and mutual funds, pension plans own 41 percent of oil and natural gas company stock. To protect the interest of their shareholders and help meet future energy demand, companies are investing heavily in finding and producing new supplies.

**Figure 1**


Gasoline Production
Million barrels per day
9.5
9.0
8.5
8.0
7.5
7.0
1/5
2/2
3/2
3/30
4/27
2007
2006