TRANSCRIPT OF PROCEEDINGS

UNITED STATES SENATE

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COMMITTEE ON THE JUDICIARY

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CONSOLIDATION IN THE ENERGY INDUSTRY:

RAISING PRICES AT THE PUMP?

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Washington, D. C.

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WEDNESDAY, FEBRUARY 1, 2006

United States Senate,
Committee on the Judiciary,
Washington, D.C.

The Committee met, pursuant to notice, at 9:31 a.m., in room SD-226, Dirksen Senate Office Building, Hon. Arlen Specter, Chairman of the Committee, presiding.

Present: Senators Specter, DeWine, Cornyn, Coburn, Kohl, Feinstein, Feingold, and Schumer.

OPENING STATEMENT OF HON. ARLEN SPECTER, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Chairman Specter. Good morning, ladies and gentlemen. The Judiciary Committee will now proceed with this hearing on the consolidation in the energy industry, and the impact of raising prices at the pump, and the impact on natural gas, and the impact on so much of the core concerns of our economy.

We have seen a spike in gasoline prices to extraordinary heights. In the wake of Katrina they were $3.07 a gallon. They are now at virtually record highs at $2.38 a gallon, so we know it was not all Katrina.

We have seen extraordinary concentration in the energy

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industry. We have had a string of consolidations which are really staggering when you see a list of them. I knew about them, but when I see them itemized, it is overwhelming. This summer the FTC approved Chevron's acquisition of Unocal and Valero's acquisition of Premcor. A couple of years ago Valero acquired Ultramar Diamond Shamrock, and Phillips merged with Conoco. In 2001 Chevron bought Texaco, and Ultramar Diamond Shamrock acquired Total, and it is a very long list which I will put in the record because I am not going to take more than 5 minutes in an opening statement.

You had the disclosures this week that Exxon Mobil reported that it earned more than $36 billion in the year 2005, which is the largest corporate profit in United States history, and similar profits were reported by Chevron and Valero. I must say, that having been an appropriator for a long time in this Senate and seeing big figures in the billions, I am somewhere between impressed and astounded by these profits. It raises a real question as to whether something has to be done on the merger and acquisition field. We have had the Sherman Act for a long time. We have had the Clayton Act for a long time, and Congress has sat back and has not legislated in the field, and it just may be time to legislate in this field with what is going on with all of the complexities of OPEC oil and our dependence, which we heard the President talk about last night, and we see these record profits, and we see really serious questions raised about the citizenship of the oil companies.

This Committee has been very, very heavily engaged on many, many matters the past few months, class action and bankruptcy, circuit judges, two Supreme Court confirmations, and we have not had a chance to really look at this field, but when we saw an open Wednesday we decided to schedule these hearings, and we got the cold shoulder from the oil industry. We were turned down by oil executives, the CEOs, seriatim. We were turned down by Mr. John Hofmeister, President of Shell; Ross Pillari of BP America; James Mulva of ConocoPhillips; Rex Tillerson of Exxon Mobil; David O'Reilly of Chevron Corporation; and Bill Gray of Valero Energy Corporation. We only provided a week's notice, but that is not too bad for the Judiciary Committee on the kind of schedule we undertake and we maintain. We do know that when these companies or other constituents have a problem, they want action from us in less than a week. If somebody calls for an appointment, it is usually for the same day, maybe the next. A week is a lot of notice to give a Senator around here to get some action from us.

We are going to be holding a follow-up hearing on February 28th, where we will expect those individuals to appear. We said if they could not make it on their personal schedules, we could understand, but we want somebody from their departments to come in and answer some very basic questions. I do not like to have to issue subpoenas. We had to issue a subpoena recently in our asbestos issue when we could not get disclosure as to who was contributing how much money, and if we need to issue subpoenas we can do that too. We face enormous problems which are impacting in an overwhelming way on Americans at the gas pump and heating oil, and we intend to do something about it.

I will now yield to the distinguished member of the Antitrust Subcommittee.

OPENING STATEMENT OF HON. HERBERT KOHL, A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator Kohl. I thank you, Mr. Chairman, for calling this hearing today.

Let me begin by saying how disappointed I am, as the Chairman is, that the representatives of the oil industry have refused to appear here. It is not right that this industry will not answer questions of the American people through their elected representatives about the historically high prices of gasoline and home heating fuels. Therefore, I urge, as the Chairman has suggested, that we might just have to issue subpoenas under our jurisdiction to compel the attendance of the industry CEOs.

Throughout the last few years the oil and gas prices have continued to spike upwards, repeatedly reaching new highs. After retreating from last summer's record prices of more than $3.00 per gallon, gas prices are moving up once again. Yesterday the Milwaukee General Sentinel reported gas prices jumped 25 cents just on Monday in the Milwaukee area, reaching nearly $2.50 a gallon. The national average has risen 51 percent from its level of just a year ago. Price increases for home heating oil and natural gas are following closely behind.

The pain felt from consumers for these price increases is real and it is growing. Price increases are a silent tax that steals hard-earned money away from American consumers every time they visit the gas pump and every time they raise their thermostat to keep their home warm. In my own State of Wisconsin the Governor recently estimated that families with an average annual income of $40,000 a year will pay $2,000 more this year to drive their cars and heat their homes than last year.

While consumers suffer from these price increases, the oil industry seems only to get richer and richer. Yesterday we all read the astounding news of Exxon Mobil's profit reports, $36 billion for all of last year, which as the Chairman indicated, is a record high for any company in the history of our country. Exxon Mobil is not alone. Chevron reported that its fourth quarter profit climbed 20 percent over last year, a record that continued the most prosperous stretch in that company's 126-year history.

Oil companies defend high energy prices as merely a reflection of higher worldwide crude oil prices, prices which they argue they must pass on to consumers. There is no doubt that the selfish and illegal actions of the OPEC oil cartel raises the price for crude oil, but the basic question remains, why should paying higher prices for crude oil lead to record high profits for the companies that refined this oil? One obvious answer is that oil companies are charging high prices and gaining record profits simply because they can. Every American needs to purchase gas to fuel our cars to get to work or to go to school, and all of us need to heat our homes.

Of course, we can expect private businesses like the oil companies to seek to charge the highest prices they can to maximize return to their shareholders. But energy is a necessity for millions of Americans, so our obligation in Government is to protect consumers when the market does not.

The Government is not doing nearly enough to protect consumers. Mergers and acquisitions in the oil industry, more than 2,600 since the 1990s, as counted by the GAO, have left a dangerous level of consolidation in their wake. GAO has found that this has led to higher gas prices, so we need to ask the question as to whether our antitrust laws are sufficient to handle this level of consolidation?

This increased industry concentration has another effect as demand in prices increase. We would expect refining capacity to expand if the market were competitive. Instead, numerous refineries have been closed. More than half of all those existing 25 years ago have been closed, and none have been opened recently. Refining capacity has become a bottleneck, limiting supply and causing price spikes whenever an accident occurs. Indeed, oil industry critics argue that oil companies have not chosen to expand refining capacity in order to gain market power to keep prices high, and the stats seem to bear this out.

So it is time for us to think of new solutions and new policies to restore competition in this industry. I believe we need to start by ending the refining bottleneck. That is why I have introduce S. 1979, a bill to direct the Secretary of Energy to establish and operate a strategic refining reserve.

Second, oil companies should not be able to tighten supplies further in time of shortage by exporting needed fuels abroad. So I would also urge passage of S. 1996, which is my bill to authorize the Secretary of Energy to stop the exportation of gasoline and home heating oil when supply falls short.

Reform of our antitrust laws, I believe is needed. A first step would be passage of our NOPEC legislation to subject the members of the OPEC oil cartel to U.S. antitrust law. The increasing level of consolidation and record industry profits also leave little doubt that merger enforcement should be strengthened. In this regard we should give serious consideration to revisions of the antitrust agencies' merger guidelines to take into account the special circumstances of the oil industry.

I think this is an important hearing. We thank our witnesses for being here, and I very much appreciate the Chairman calling this hearing.

Chairman Specter. Thank you very much, Senator Kohl.

Senator Cornyn, would you care to make some introductory comments?

OPENING STATE OF HON. JOHN CORNYN, A U.S. SENATOR FROM THE STATE OF TEXAS

Senator Cornyn. Thank you very much, Mr. Chairman. I appreciate the opportunity. Thank you for convening the hearing. I regret, like you do, and Senator Kohl, that on short notice that the CEOs of a number of the oil companies were unable to change their schedule to be here with us, but I trust they will be on February 28th, and look forward to hearing from them.

I know this hearing follows on an earlier hearing that was held before a combined committee of the Energy and Commerce Committee, where many of those oil executives did appear. I look forward to hearing the testimony of the representatives of the Government Accountability Office and the Federal Trade Commission. It sounds like they have a little different analysis in terms of the impact of consolidation on oil and gas prices. Congress can legislate, and we can actually repeal laws from time to time, and do, but we cannot repeal the laws of supply and demand. The fact is that there is growing demand in a globalized economy for limited and scarce natural resources. I applaud the President's emphasis last night on trying to further limit our dependence on imported energy, which obviously has national security implications. It has tremendous implications for our economy.

I see my former colleague, Attorney General Blumenthal, at the table, and we served together as State Attorney Generals, and I know the State Attorney Generals play an important role when it comes to enforcement of antitrust laws, and look forward to hearing from him and others.

Just to make sure that we begin to scrape the surface of what is necessarily a very complex issue, and the question of causation, I guess, is one that intrigues me the most. Is consolidation the cause of high prices at the pump, the high price of oil, or is it something else, or is it a range of other factors? My own impression is that it is a range of factors, and I hope we get a chance to explore that range in the course of these hearings, both today and on the 28th.

I have a chart here from the American Petroleum Institute, which shows where those profits go. According to at least the API--and I would like, if I may, have it made part of the record.

Chairman Specter. Without objection it will be made part of the record.

Senator Cornyn. It shows that in 2005, 64 percent of the profits of oil companies went into exploration. Certainly, I know that none of us would want to do anything that would have an impact on our ability to explore for and develop more resources. Obviously, increasing the supply, if demand remains static, would necessarily decrease the cost.

The other sort of dichotomy I hear set up sometimes when people talk about this issue is big oil and big corporations on one hand, and consumers and little people on the other. But I just want to point out that here again the question of who owns big oil, the fact is that there are a lot of shareholders, people maybe even in the audience or listening on C-SPAN or wherever that own stock in some of these companies. Certainly, their pension plans and retirement plans may own stock in them. So I think it is important that we recognize that this is not some monolithic faceless, nameless creature that is easy to demonize, but rather, this has an impact on real people and their ability to support themselves or their families or provide for their retirement.

I know there are a lot of different issues that we need to talk about here, and certainly, I believe our antitrust laws are important. We believe in competition. We believe in fair competition, not unfair competition, and certainly, I share the concerns of all the Committee in making sure those laws are complied with.

If there are additional laws that need to be passed, I look forward to working with you, Mr. Chairman, and Senator Kohl, who, of course, is ranking member of the Antitrust Subcommittee, to try to come up with sensible solutions to the challenges that confront us. I hope we do not engage, and I trust we will not--I know how careful and how thorough this Committee has typically been--in knee-jerk solutions, which actually have the impact of exacerbating the problem, such as some of the ill-conceived windfall profits legislation that has been proposed, that actually, I think, would hurt our domestic production, would increase our dependence on imported energy, and ultimately hurt the consumer.

So I look forward to working with you. Thank you for giving me the opportunity.

Chairman Specter. Thank you, Senator Cornyn. We ordinarily do not have opening statements beyond the Chairman and the ranking member, but I know Senator Cornyn has a very key constituent interest here. From my early days in the Kansas oil fields, I have great admiration for what happened in Texas compared to the stripper production that was in my home county, and I wanted to give Senator Cornyn an opportunity to speak early on the subject.

In the interest of fairness, we are going to have opening statements from all those present. I think we can manage that within the two-hour time limit. Senator Feinstein?

OPENING STATEMENT OF HON. DIANNE FEINSTEIN, A U.S. SENATOR FROM THE STATE OF CALIFORNIA

Senator Feinstein. Thank you very much, Mr. Chairman.

I also serve on the Energy Committee. I did not hear your statement, but I identify very strongly with the statement of Senator Kohl, and I think he is right on. I am one that has watched this happen over the years. Oil prices have risen 118 percent, just to take a time during the Bush presidency, and gas prices have gone up 58 percent. You have the 2005 Exxon Mobil annual profit, $36 billion, you have $11 billion in the fourth quarter, and I can go on for some of the others.

I was very interested by a comment in the GAO report, which I would like to read, because I think it strikes at the heart of what this hearing is about. Before I read it, let me just say that what I have noticed is a kind of purposeful oil restraint on refineries. No one builds new refineries. Consequently, in California, they function at maximum capacity all the time. So given more oil, they are constrained, they cannot refine it.

Let me quote from the report. "The 1990s saw a wave of merger activity in which over 2600 mergers occurred involving all three segments of the U.S. petroleum industry--almost 85 percent of the mergers occurred in the upstream segment (exploration and production), while the downstream segment (refining and marketing of petroleum) accounted for about 13 percent, and the midstream segment (transportation) accounted for about 2 percent. Since 2000, we found that at least 8 additional mergers have occurred, involving different segments of the industry."

"This wave of mergers contributed to increases in market concentration in the refining and marketing segments of the U.S. petroleum industry. Econometric modeling we performed of eight mergers that occurred in the 1990s, showed that the majority resulted in small wholesale gasoline price increases--changes were generally between 1 and 7 cents per gallon." I think that is interesting, small wholesale prices, but extraordinary retail prices right now.

What I have learned is that although a certain cost center will do very well and another cost center will not, that the industry does not really shift from one cost center to the other to reduce the price at the pump. The cost center sort of has to sustain itself, and I think there is probably no issue in which people are more aroused, and has a bigger dent, at least in my State, on the average person's pocketbook, because if you fill up your tank at $20 a tank it is one thing, if you are filling it up at $40 and $50 a tank and you have to use two to three tanks a week to get to and from work, it is a very big deal in your life.

What I found--and I hope the gentlemen will comment on it--is an absolute resistance of the industry to any sounding of an alarm bell. Nothing changes. The profit margins just continue to go way up, and there seems to be no consumer loyalty. That is what we all found with Enron. So if we look deeply, we find there is very little oversight of the entire energy sector of our economy, and this is showing that it is a problem. It is showing that you can really increase gas prices to the sky's the limit, and continue to rake in tremendous profits. People say, "Oh, no, you cannot consider a windfall oil profits tax." Well, if the industry will not respond and will not help the consumer out, what course is Government left with? That is really my question, and I really hope the panel will address that.

Chairman Specter. Thank you very much, Senator Feinstein.

We had not intended to go to opening statements, but we have, and I called on Senator Feinstein ahead of Senator Feingold. That is the second time I have done that. I will try not to do it in the future. We will come to you, after we hear from Senator DeWine, who is the Chairman of the Antitrust Subcommittee.

OPENING STATEMENT OF MIKE DEWINE, A U.S. SENATOR FROM THE STATE OF OHIO

Senator DeWine. Mr. Chairman, thank you very much. I want to thank you for calling this very important hearing today.

As we all know, our energy costs are soaring. In my home State of Ohio, like most places in the United States, gas prices have been rising steadily. Making matters worse, many analysts predict these prices only will get higher in the coming months. Prices for home heating oil are also on the rise, which is extremely disturbing to our constituents. These price hikes hit all of us in our day-to-day lives, and hit the most vulnerable Americans the hardest. Even more frustrating, it seems that every day another oil company reports record-breaking profits while American consumers pay higher prices. So it is critical that we take steps to figure out the problem and ultimately fix it.

We recently have seen a wave of mergers in the oil industry, and these mergers and their effects on consumer prices have been a priority of the Antitrust Subcommittee. Senator Kohl and I have worked together for years to preserve competition in the petroleum industry. We have conducted investigations into many of these mergers, and raised numerous concerns about them with the FTC.

Additionally, back in the year 2000 we asked the FTC to investigate the gasoline price spikes which hit the Midwest. In response, they set up an intensive ongoing monitoring program within the industry to make sure that they could find and stop illegal price gouging. We believe this program has been an effective law enforcement tool and it has prevented at least some of the abuse that might have otherwise occurred.

Nonetheless, fuel prices continue to rise, and naturally, this has led to discussion about whether oil industry mergers have increased prices to consumers.

Today's hearing will be a good opportunity to explore this very issue, but I think it is important to note that even those who think that these mergers have increased price, such as the GAO, believe that the effect has been relatively small, usually about a penny or two per gallon. Others argue that the price effect is somewhat higher. But either way, it is clearly not the biggest part of the problem.

The biggest problem is simply crude oil. Bluntly, we do not have enough of it, and we rely too much on it. Our country, although blessed with great natural resources, is sorely lacking in crude oil. Try as we might, we cannot drill our way out of this crisis. So we must take a much broader approach to our energy problem and limit our reliance on oil.

Mr. Chairman, we have the ability to do just that. The United States does have one fossil fuel in great abundance, and that, of course, is coal. Of course, coal brings its own challenges. We have all seen and been horrified by the tragic deaths of the miners recently in West Virginia and also Kentucky. As a member of the HELP Committee and Appropriations Committee, I participate in hearings on mine safety issues. We cannot emphasize enough that we must take aggressive and prompt action to improve mine safety, and protect the life and health of our miners. We need to invest the time and the money to figure out how to mine coal more safely, burn it more cleanly, and use it to power our economy, but coal, clearly, can work for America.

We need to go further, however, than that. We need to conserve, we need to increase fuel efficiency, and we need to invest in safer nuclear technology, wind power, solar power, biomass, as well as in fuel cells. My home State of

Ohio is a leader in developing fuel cell technology, and I have been very supporting of efforts to fund this technology. It is extremely promising.

Clearly, Mr. Chairman, we have a lot to do on energy policy in general, as the President pointed out last night. In the meantime, however, this hearing is an excellent opportunity to make sure that our antitrust laws are being applied properly, and eliminate any opportunities for companies in the petroleum industry to unduly increase the fuel prices we all pay.

On a final note, Mr. Chairman, I want to say how disappointed I am as well that the oil executives declined to attend our hearing today. It would be useful to the Committee to hear their views on fuel prices, and I welcome the announcement that you made hear this morning.

I thank you.

Chairman Specter. Thank you, Senator DeWine.

Senator Feingold, I understand that you do not wish to make an opening statement.

Senator Feingold. No, I would like to make a very brief opening statement.

Chairman Specter. Fine. You are recognized.

OPENING STATEMENT OF HON. RUSSELL D. FEINGOLD,

A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator Feingold. Mr. Chairman, I want to thank you, and of course, the ranking member, Senator Kohl, for holding this important hearing today, and I do appreciate the chance to say a few words. I want to thank the witnesses for agreeing to participate in today's discussion.

I am here this morning because I am deeply concerned about the high gasoline prices that are hurting especially Wisconsinites and consumers across the country. It is as if we are conducting an uncontrolled experiment into how far our constituents' pocketbooks can be stretched. That cannot go on. It is time for the Federal Government to grab the reins back, conduct the necessary oversight over these energy markets, and adopt appropriate solutions. Our constituents are demanding action, and they deserve it.

Even a casual reader of the news knows that the oil industry is coming off a record-breaking year of profits, with one company, Exxon Mobil, becoming the most profitable company in U.S. history, the most profitable quarter of any company at any time in our Nation's history.

As these profit reports come out, my constituents are asking many questions such as why high prices do not seem to be bringing new investment in the oil and gas sector to increase the supply of refined petroleum products. Wisconsinites always expect straight talk, and it is long past time that they got it from Congress and from the oil industry, which as everyone said, I am pleased to hear--

although we are not pleased about it--that they are not present today. I have been concerned about consolidation in the oil-gas sector for a while, just as I have been concerned about consolidation of the electricity sector due to the repeal of the Public Utility Holding Company Act. I strongly opposed that step in the Energy Policy Act of 2005. The country is now seeing the consequences, and unfortunately, they are not positive, so I hope we learned some lessons from that.

I do thank the witnesses, and I thank you, Mr. Chairman.

Chairman Specter. Thank you, Senator Feingold.

Senator Coburn?

OPENING STATEMENT OF HON. TOM COBURN, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

Senator Coburn. Thank you, Mr. Chairman.

I think it is really important for us to focus on markets. There is no question if there is collusion, we ought to be about fixing that and changing the law to affect it. But some of the things I have heard today disturb me. One is nobody mentions the impact that speculators on NYMEX have had. All you have to do is look at natural gas. It has been as high as $15.60 per million BTU. It hit 7.60 last week, it is about $9.00 now. Most of that is not based on true takings and hedging of consumers or distribution companies, it is based on pure speculation. I remember back in the 1970s when silver was trying to be cornered by one group of individuals. The way they solved that problem is they took the hedging out, the speculative hedging out, by saying you have to take delivery. It might be very wise for us to look at the component of speculation.

The second thing, the reason new refineries are not being built is because the bureaucracy and the cost to establish new refineries is about 10 times higher than expansion of existing refineries. Somebody mentioned Valero. Valero is expanding refineries like crazy, but they do not build new ones because we have set up so many impediments, that they cannot, the cost to do that.

Finally, the very idea that somebody would suggest that the increased prices are not leading to new exploration, all you have to do is look at the exploration companies and the major oil companies that they are doing. There is significant increase in exploration. It is growing like crazy. Multiple exploration companies are based in Oklahoma, and they are building rigs, and we are using the rigs as fast as we can in this country based on demand.

The final thing I would say, is with increased prices coming, decreased overhead has relationship to that price, and I am not at all surprised by the increase in profits, because as you increase volume over a fixed overhead, it all falls directly to the bottom line. I would also note that the oil and gas industry's average Federal tax bite is 38.5 percent. They paid $44 billion into the treasury of this country this last year, $44 billion from one industry. It is going to be greater than that this year. So it is fine for us to say that there should not be collusion, and I agree with that. We should be aggressive to make sure that does not happen, but it is not fine for us to say that we do not want markets to help us allocate scarce resources, and if our tendency is to control prices or to put a windfall profit tax, all we are doing is shooting ourselves in the foot.

Let's go prosecute those people who are colluding, those people who are fixing prices, but let's let the market help us solve our energy needs.

Thank you, Mr. Chairman.

Chairman Specter. Thank you, Senator Coburn.

Senator Schumer.

OPENING STATEMENT OF HON. CHARLES E. SCHUMER,

A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator Schumer. Thank you, Mr. Chairman. I thank yo for holding this hearing.

Let me just say that, you know, as somebody who loves America, I try to study what makes other societies that have achieved greatness decline. The one issue that seems to be throughout, Roman Empire, British Empire, is failure to deal with problems ahead of time, waiting till those problems are right at the door and it is much too late. And if there was ever an example of that, it is the energy problems that we have. We could solve those much more easily today than we will be able to in 10 or 15 years, and we are not, and I worry about it.

I was disappointed, Mr. Chairman, in the President's state of the union. I do not think you can solve the oil problems unless you solve the problems of oil companies. The President said last night that Americans were addicted to oil, but this administration is addicted to oil companies, and we are not going to achieve energy independence until the administration breaks its addiction. Just look at last year's heralded energy bill. Last year's energy plan gave Americans $3.00 a gallon gasoline and record profits for the oil companies.

So one can hope that this new plan is better, but a plan that does not mention raising mileage standards for cars, does not mention ways to really conserve, which is the number one way to deal with our problems, is not going to get very far in terms of energy independence.

On the issue of the large oil companies, I have talked to CEOs--these are not average consumers or liberal Democratic think tanks--CEOs of major companies that buy things like jet fuel, diesel fuel, heating oil, every one of them thinks there is not real competition. How can there be when you have so few companies out there. One of the great mistakes this country made was to allow Exxon and Mobil to merge. That was done during a Democratic administration, but it never should have happened. Let number one and number two merger when you only have a handful of big producers? And as long as there is not much more competition, you are not going to get anywhere. Why did all the prices spike up at the same time, why on the West Coast right after Katrina, where there is no Gulf oil, did the price almost go up as much as it did in places like New York that use Katrina Gulf oil? And why is it that when the spot market goes up, the price at the pump goes up two, three days later; when the spot market goes down, it takes weeks for it to go back down?

The answer is simple: there is not real competition. There is what they call price leadership. No one is saying there is collusion. That would be, as my good friend from Oklahoma said, against the law. But everyone follows one another. This happens in any major industry where there are only a few competitors. It happened in the credit card industry, for instance, when everyone's rate was at 19.8 percent a few years ago.

The idea of looking into big oil from an antitrust perspective, I think, Mr. Chairman and Senator Kohl, are extremely timely. I do not know if we can ever undo the mergers that were done, but the best antidote here is real competition. When the oil companies are not interested really in alternatives, they make their money in fossil fuel, when there are so few of them, and when the policies that this administration proposes do not work, when it seems that the oil companies have a veto over any proposal the administration makes, so you do not get anything real tough, I worry about the future of this country.

Chairman Specter. Thank you, Senator Schumer.

We now turn to our first witness, Federal Trade Commissioner William Kovacic; a very distinguished record, extensive work with the Federal Trade Commission, being an attorney there in 1979 to 1983 time range, and currently a Commissioner; educational background is from Princeton bachelor's degree and law degree from Columbia; and a professor at Georgetown University Law School, and formerly a professor at Washington College of Law, American University, and George Mason University School of Law.

Thank you for joining us today, Commissioner Kovacic, and we look forward to your testimony.

STATEMENT OF HON. WILLIAM E. KOVACIC, COMMISSIONER AND FORMER GENERAL COUNSEL, FEDERAL TRADE COMMISSION, WASHINGTON, D.C.

Mr. Kovacic. My pleasure, and thank you, Mr. Chairman, and the other members of the Committee. I am grateful for the opportunity to discuss consolidation in the petroleum industry and to review the FTC's program to protect consumers in this singularly important sector. My written statement provides the views of the Commission, and my spoken comments and responses to your comments and questions do not necessarily reflect the views of my colleagues.

Since the turn of the 20th century, no industry in this country has commanded closer attention from the U.S. antitrust authorities. So it is today for the Federal Trade Commission. I want to highlight four dimensions of the FTC's competition policy program for the petroleum sector.

First and foremost is law enforcement. I think everything that a competition agency does is based on its willingness to enforce the laws. Collateral policies are important, but that is the foundation of what an agency does. Activities of the past year attest to the significance and scope of the FTC's law enforcement program. The Commission achieved a major settlement to resolve competitive concerns associated with Chevron's acquisition of Unocal. The centerpiece of this settlement was Chevron's agreement not to enforce certain of Unocal's patents. The enforcement of those patents would have caused California consumers to spend hundreds of millions of dollars per year for gasoline. The settlement resolved earlier FTC allegations that Unocal had wrongfully manipulated the process by which the State of California set standards for gasoline.

In the Aloha case, the FTC sued to block a merger that allegedly would have increased concentration in the distribution of gasoline in the Hawaiian Islands. The suit induced the parties to take measures that resolved the FTC's concerns.

These matters reflect the FTC's consistent practice of the past 25 years of eliminating anticompetitive overlaps and addressing serious problems where they arise.

The second element is in the investigation, monitoring and analysis of developments involving petroleum products. As this Committee is well aware, Congress has requested the FTC to undertake two closely related studies which have been combined in a single undertaking, and the FTC is now conducting an investigation of whether petroleum companies improperly manipulated supplies or wrongfully boosted prices in the wake of Hurricanes Katrina and Rita. To this end, the FTC recently denied a petition by Exxon Mobil to curtail the scope of its inquiry. We will publish the results of the study in the late spring, as mandated by Congress. In performing this investigation the FTC is drawing upon the knowledge it has gained from two major reports it published in the past two years on mergers and product pricing respectively. The FTC also will use what it has learned from its continuing program referred to by Senator DeWine, and program partly inspired by the advice of Senators DeWine and Kohl on the Antitrust Subcommittee. It is a program to monitor pricing anomalies in over 300 metropolitan areas in the United States.

The third ingredient is to assess the soundness of our program. One year ago the FTC hosted a conference to discuss efforts by the FTC and the Government Accountability Office, represented here today by my colleague, Jim Wells, to assess the impact of FTC merger policy. In the past year the FTC has used the results of this conference to refine its techniques for assessing the effects of its merger enforcement program. I agree wholeheartedly with the spirit expressed by members of this Committee today that it is essential for us to continually review and assess the soundness of what we have done before. Where these and related inquiries suggest improvements, be assured that we will make them.

Finally, the FTC is working to improve cooperation within the large archipelago of Federal agencies and State authorities currently engaged in policy activities that affect competition in this sector. Improvements in the framework of information sharing and consultation have genuine promise to improve the Nation's competition policy initiatives involving petroleum products.

Let me close on a personal note, in this, my first appearance before this Committee since becoming a Commissioner less than a months ago. Thirty years ago I spent one year working as a legislative assistant on Philip Hart's Antitrust Subcommittee staff. One of my main responsibilities was the petroleum industry. That experience gave me a strong and continuing interest in energy policy. During my tenure as an FTC Commissioner I will give energy issues my highest priority. I hope today is the first of many occasions that I will have to meet with you, your colleagues and your staff to discuss the FTC's efforts to develop competition and consumer protection programs that best serve American consumers.

I look forward to your questions and comments.

1 [The prepared statement of Mr. Kovacic follows:]

Chairman Specter. Thank you very much, Commissioner Kovacic.

We now turn to Mr. James Wells, who is the Director of the GAO Department on Energy, Natural Resources and Environment, a graduate of Elon College and the Executive Development Course at Harvard University Kennedy School of Government. He has been with the Government Accountability Office since 1969 and has authored several important GAO reports, including the recent one on the Effects of Merger and Market Concentration in the Petroleum Industry.

Thank you for coming in today, Mr. Wells, and we look forward to your testimony.

STATEMENT OF JIM WELLS, DIRECTOR, NATURAL RESOURCES AND ENVIRONMENT, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, D.C.

Mr. Wells. Thank you, Mr. Chairman, and members of the Committee. We too welcome the opportunity to participate in this important hearing today.

When gasoline prices go up, people notice. According to the experts, each additional 10 cents per gallon of gasoline adds $14 billion to America's annual gasoline bill. The daily press reporting of record industry profits is creating a heightened tension between those that supply the product and those that use and pay for it, i.e., the absence of the CEOs of the major oil companies today. When GAO issued its report detailing our extensive study of the impacts of mergers in the gasoline industry, people noticed.

The industry currently can only make so much gasoline from the available crude oil. Our cars, our trucks, they need more than we can make domestically, and we are paying to import more than 40 million gallons of gasoline a day to meet our needs. Given the importance of gasoline to our economy, it is essential to understand the market for gasoline and how prices are determined. In summary, we would say crude oil prices are clearly the fundamental determinant of gas prices paid at the pump. When crude oil prices, as they are today at $67, $68, we have $2.50 gasoline.

However, other factors also affect the gasoline prices, including things like the limited refining capacity here in the United States. The gasoline inventories being maintained currently by the refiners or marketed of gasoline is only half of what it was a few years ago. There are regulatory factors placed on the gasoline marketplace, such as national air quality standards, introduced special blends that have been linked to higher gasoline prices, and we would add, a determining cost at the pump is the large number of oil company mergers that raises concerns about potential anticompetitive effects, as we have talked about today, because mergers and increasing numbers of mergers could result in greater market power, and potentially allowing prices to rise and be maintained over a period of time above competitive levels.

We studied the merger activities in the 1990s and coined a phrase, the wave of over 2,600 mergers that led to the increased market concentration in the refining and market segments or downstream segments of the industry. Clearly, in the mid 1990s there were 24 States that had moderately concentrated numbers relating to the industry. Four or five years later, after this wave of mergers, 46 States, including the District of Columbia, had moved from mildly or moderately concentrated to highly concentrated.

Since our study, another 8 fairly significant mergers have found that the majority--excuse me. Our detailed study of the 8 that we did in the earlier study found that the majority of mergers that we examined of those 8, and wholesale prices, as Senator Feinstein had alluded to, had increased the wholesale price of gasoline typically being passed on at the retail level anywhere from 1 to 7 cents per gallon.

Since 2000 we found at least another 8 fairly significant additional mergers have occurred, and while we have not performed tests on these mergers that have involved over $90 billion worth of assets, these additional mergers would further increase industry concentration.

Mr. Chairman, I will stop here and just say that there are a whole of things beyond just the high cost of crude oil that are causing consumers to pay more. The gasoline industry is very complex. It is true that forces such as the rapid growth of world demand, boosted by China's extraordinary pace of development, have put unprecedented pressure on the global crude oil supply and demand balance. The resulting high prices of crude oil have clearly pushed company profits dramatically higher at the same time that the consumers are feeling this pinch of higher gasoline prices at the pump.

However, in a concluding type of way, while the global oil market may be beyond our immediate control, at least in the short term we can ensure, as this Committee hearing will help address the proper application of oversight, that our domestic market remains competitive. A hearing like this is clearly an important one to ensure that all the players in this environment, you, the Congress, the regulatory agencies with the FTC and Department of Justice, and even, yes, the GAO auditors here who do work for you, that we are engaged in performing oversight to see what is causing the marketplace to react the way it is.

Thank you, Mr. Chairman.

2 [The prepared statement of Mr. Wells follows:]

Chairman Specter. Thank you very much, Mr. Wells.

We turn now to Connecticut Attorney General Richard Blumenthal, a position he has held for 15 years. He has an undergraduate degree from Harvard, Yale Law School, U.S. Attorney for Connecticut, Administrative Assistant to Senator Ribicoff and also assistant to Senator Moynihan, law clerk to Justice Blackmun, brings a very, very distinguished record to the witness table.

Thank you for coming down today, Mr. Attorney General, and we look forward to your testimony.

STATEMENT OF HON. RICHARD BLUMENTHAL, ATTORNEY GENERAL, STATE OF CONNECTICUT, HARTFORD, CONNECTICUT

Mr. Blumenthal. Thank you, Mr. Chairman, and Senator Kohl for having us today and giving us this opportunity to speak about an issue that is so tremendously important to my constituents, as it is to yours. I want to thank my former colleague, the Senator from Texas, for being here, and I know he still shares the perspective that I bring to this table, which is one of State law enforcement and trying to use the laws that we have now to make sure that there is real competition.

If I have one message for you today, it is that we need help. There needs to be a sense of outrage among Federal law enforcement as there is among State law enforcement about the results that we see, and the damage that we see to our economies from anticompetitive conduct.

We formed a task force. It includes virtually every Attorney General in the United States. I am on the Executive Committee of that task force. We have taken action against price gouging in many States. We have either prosecuted or we are initiating action against retailers and some wholesalers, who misuse their market power. But our reach, in terms of authority, and our resources, are limited. We need help, and we are not getting it. That is, very simply, the bottom line for me as a law enforcer.

I know from all of the studies that I have reviewed--and they go back to 2001 with the FTC's own report on withholding of supplies, which it found then, although it found no overt, purposeful collusion, the 2004 GAO study, a raft of other studies that show increasing concentration so that now about 50 percent of all the domestic refining capacity and oil production is controlled by just five companies, and 60 percent of the retail market by those same five companies. Even without collusion, what we see on the streets and the gas stations of Connecticut and throughout the country is that that market power leads inexorably to anticompetitive conduct. That is what we need to stop through measures that I believe should avoid, as Senator Cornyn observed, simplistic solutions or knee-jerk reactions. I happen to favor a windfall profits tax, but that tax will not change the structure of the industry.

I propose some measures in my testimony--and I will be brief in closing because I know the time is limited--such as a one-year moratorium on all mergers; a focused investigation going to the very top of this industry at every level, involving States as well as the FTC and the Department of Justice, that focuses attention, and gets the attention of this industry; a ban on zone pricing which divides States and even cities into different geographic areas, and thereby inhibits competition by, in effect, curtailing competition among the retailers; expanding refinery capacity; mandating minimum levels of inventory; lessening our dependency on gasoline through conservation efforts and alternative fuels. I welcome the President's focus on this aspect of the problem, but we need to deal with the world as we face it now.

The concentration of power that we see has real-life consequences for our consumers, and the mere fact of an investigation focused on the industry and on the New York Mercantile Exchange, as Senator Coburn suggested, I think will itself have a very important effect. What we saw in the wake of our investigation was that prices began to come down as soon as we sent subpoenas, as soon as we issued letters, as soon as our focus was on the industry, and I think that at other levels conduct can be affected as well. I think the law needs to be changed. We need tougher laws, but we also need a sense of urgency from Federal law enforcement in this area.

Thank you, Mr. Chairman.

3 [The prepared statement of Mr. Blumenthal follows:]

Chairman Specter. Thank you very much, Attorney General Blumenthal.

Our next witness is Professor Preston McAfee, who is with the California Institution of Technology, bachelor's degree from the University of Florida, master's from Purdue and PhD in economics also from Purdue; been a Professor of Economics at the University of Texas and University of Chicago, and MIT; has written extensively on antitrust monopolies mergers; author and co-editor for economics journals for more than 25 years.

We appreciate you being with us today, Professor McAfee, and we look forward to your testimony.

STATEMENT OF R. PRESTON McAFEE, J. STANLEY PROFESSOR OF BUSINESS, ECONOMICS AND MANAGEMENT, AND EXECUTIVE DIRECTOR FOR THE SOCIAL SCIENCES, CALIFORNIA INSTITUTE OF TECHNOLOGY, PASADENA, CALIFORNIA

Mr. McAfee. Thank you, Mr. Chairman, and members of the Committee.

I have worked extensively with the Federal Trade Commission in evaluating mergers, including the Exxon Mobil and BP Arco mergers. As part of my study of these mergers, I had access to a substantial number of documents, on Exxon Mobil in particular, 125 million pages of documents. I am pleased to be here today to discuss the economic issues I have researched and how they pertain to the examination of antitrust applied to the oil industry.

Let me start by applauding the Committee's investigation of the sequence of mergers, rather than focusing on any specific merger. All too often antitrust enforcement focuses only on the merger at hand, without asking how that merger fits into the larger picture of industry evolution. It is my understanding--and I am not an attorney--that comparing mergers to the status quo, as dictated by court precedent--and in many cases this is not appropriate--there are circumstances where the status quo is unlikely to persist, and hence, is not the relevant benchmark for comparison. In the oil industry, as I will discuss in a moment, there is pressure to create very large firms. A decision made by antitrust authorities to block or permit a specific merger does not eliminate that pressure.

How does this logic apply to the oil industry? For a medium-sized oil company, development of a single field can be "bet the company project." The risk of bankruptcy is deadly on Wall Street, so a medium-sized oil company is just not in a position to take on the very large risks of large developments. Many of these risks associated with international development are not created by physical and technical challenges, although, of course, there are plenty of these, but are in fact created by political challenges like unstable governments, rebel groups and the like, shifting national borders. So size helps here as well by improving a company's bargaining power.

So while I think in general it's very important to consider industry evolution in the context of evaluating mergers, in the specific case of oil industry, the industry evolution is putting great pressure on the firms to grow internationally.

The Federal Trade Commission does a very thorough job investigating oil company mergers. I should know. And if you do not like what their conclusions are, you can actually blame me for part of it. Big mergers have generally required extensive divestitures to preserve domestic competition, and the production and retailing of gasoline have not become more concentrated in recent years.

Let me turn to vertical integration. Oil companies are the quintessential vertically integrated firms, a phrase which here means that a single company performs all of the activities to get oil from the ground and into gas tanks: exploration, drilling, pumping, oil transport, refining, gasoline transport and retailing. In recent decades economists' understanding of the effects of vertical integration have changed. The classical Chicago School view of vertical integration is that vertical integration had no effect. Based on this view, mergers could be analyzed level by level. But we now know that that is not a good plan, that vertical integration does have an effect.

The problems of firms that meet each other in multiple markets is clearest in my home State of California. West Coast gasoline transport is controlled by an oligopoly of 7 firms, who also control refining and retailing. These firms use each other's transport facilities and trade gasoline, and to put it bluntly, they have a gun to each other's head, which makes it very difficult for any firm to engage in aggressive pricing, or even to sell gasoline to entrants like Costco. The Federal Trade Commission is well aware of this threat, and we were very careful to make sure that it did not get worse during the recent mergers.

Unilateral effects. Game theory has been popularized by the book and movie "A Beautiful Mind," and in fact, since 1994, 23 individuals have received the Nobel prize in economics, and 12 of those prizes were for game theory. In antitrust game theory issues are known as unilateral effects, and they barely register in antitrust court cases even though they have been present in the DOJ Merger Guideline since 1982.

I am running out of time. I will sum up.

Perhaps the most important conclusion I would leave with the Committee is that we are fortunate that the hysteria of the 1970s has not returned and that Americans have accepted the high price of fuel without demanding regulations that caused so much damage to our fuel supply back then. Over the past 30 years this country has deregulated trucking, airlines, rail, gasoline, oil, natural gas and long distance telephony. It is in the process of deregulating electricity and local telephony, and overall, the deregulation of the U.S. economy has produced enormous gains for American consumers. We should not let problems--and this is not to say that they are not real problems, because they are--return us to the 1970s.

Finally, I appreciate the questions and issues that motivate these hearings. Our understanding of antitrust continues to progress, and the oil industry has been a test case for antitrust enforcement for nearly a century. I also suspect that to oil company executives, it feels more like the cross-hairs antitrust than a test case.

4 [The prepared statement of Mr. McAfee follows:]

Chairman Specter. Thank you, Mr. McAfee.

Our next witness is Mr. Tyson Slocum. He is the Acting Director of Public Citizen's Energy Program, a position he has had since the year 2000. He has a bachelor's degree from the University of Texas--

Mr. Slocum. Bachelor degree, although University of Texas is such a great school, that I think a bachelor's degree equals a master's degree.

Chairman Specter. So be it.

[Laughter.]

Chairman Specter. Author of three books on energy issues.

Thank you for coming in today, Mr. Slocum, and the floor is yours.

STATEMENT OF TYSON SLOCUM, DIRECTOR, PUBLIC CITIZEN'S ENERGY PROGRAM, WASHINGTON, D.C.

Mr. Slocum. Mr. Chairman, thank you very much. I too am disappointed that the oil companies are not here to defend their record profits. The last time the oil companies were before Congress, in November, they were allowed to present their testimony without testifying under oath, and today I was not administered such an oath, and I do not know if it is possible for me to be administered an oath for my testimony today, Mr. Chairman. I would like--

Chairman Specter. Yes, it is.

Mr. Slocum. May I be administered an oath, Mr. Chairman?

Chairman Specter. No.

[Laughter.]

Mr. Slocum. Okay.

Chairman Specter. You are not the Chairman of this Committee, Mr. Slocum.

Mr. Slocum. Yes, sir, that is correct.

Chairman Specter. Somebody else got confused about that a couple of weeks ago.

[Laughter.]

Mr. Slocum. I would just to, for the record, say that my testimony today, I swear to be the truth, so help me God, Mr. Chairman.

Chairman Specter. You can be charged with making a false official statement even though you are not sworn, so there are criminal penalties available to you, Mr. Slocum. They are available to you, so be careful.

[Laughter.]

Mr. Slocum. Yes, sir. Mr. Chairman, I have done an enormous amount of research into the correlation between the record profits by the industry, and the record prices that consumers are paying. My research clearly shows that there is a direct connection between all the recent mergers that we have allowed in the petroleum industry and these record prices which translate into the record profits.

Now, my research, I took a look at what the market concentration was in the refining sector 10 years ago and compared it to what the market concentration is today after a number of very large mergers of not only vertically integrated oil companies, but refining companies as well.

In 1993, the largest five oil refiners in the United States controlled 34.5 percent of national refining capacity. The largest 10 in 1993 controlled 55.6 percent of capacity. Now fast forward to 2004 after a number of very large mergers. The largest five now have 56.3 percent of capacity, so today the largest five refiners control more capacity nationally than the largest 10 did a decade ago, and the largest 10 refiners today control 83.3 percent of national refining capacity. That is alarming levels of concentration.

My findings have been confirmed by various Government investigations, including the Government Accountability Office. They issued a great report in May of 2004 which clearly showed a link between all of these recent mergers that led to industry consolidation, which translated into higher gasoline prices. The GAO report specifically found high levels of concentration on the East and West Coast and in the Midwest, where we have seen a majority of the severe price spikes. It is very important to know that this GAO report underestimates the true price influence because their analysis of market concentration refining industry ends in the year 2000.

Since 2000, of course, we have allowed the mergers of Chevron and Texaco, and Conoco and Phillips, and a large independent refiner, Valero, has acquired a number of refining companies. So if anything, the analysis done by GAO has become much worse from a consumer and antitrust standpoint since their analysis ends in 2000.

The Federal Trade Commission issued a very interesting investigation in March of 2001. They took a look at price spikes specifically in the Midwest. They found evidence of unilateral withholding on the part of oil refiners, and I am quoting from an excerpt from that FTC report. They say, "An executive of one company made clear that he would rather sell less gasoline and earn a higher margin on each gallon sold, than sell more gasoline and earn a lower margin. Another employee of this firm raised concerns about oversupplying the market and thereby reducing the high-market prices. A decision to limit supply does not violate the antitrust laws absent some agreement among firms. Firms that withheld or delayed shipping additional supply in the face of a price spike did not violate antitrust laws. In each instance the firms chose strategies they thought would maximize their profits."

Most certainly the companies are maximizing their profits, Exxon Mobil, $36 billion in last year alone. What is interesting is that Federal Trade Commission has disputed some of the GAO findings, saying that their methodology was wrong. But how can the FTC certify that markets are fully competitive, if they themselves have found evidence of unilateral withholding? If one company can unilaterally withhold, that clearly means that there is inadequate competition, because if there was plenty of competition, another competing firm would be very happy to step in and supply the market. So the fact that evidence of unilateral withholding exists is clear evidence that we uncompetitive markets, and again, it is due to all the recent mergers that we have allowed.

What is the exact financial result from all this--

Chairman Specter. Mr. Slocum, could you summarize at this point, please?

Mr. Slocum. Yes. There is a table that the Department of Energy puts out that shows refiner profit margins by year. In 1999, for example, U.S. oil refiners made 22.8 cents per gallon refined. By 2004 that margin had increased to 40.8 cents per gallon refined. That is an 80 percent jump, and I think that clearly illustrates the lack of adequate competitiveness.

Thank you very much, Mr. Chairman.

5 [The prepared statement of Mr. Slocum follows:]

Chairman Specter. Thank you, Mr. Slocum.

Our final witness is Mr. Tim Hamilton. He is the founder and Executive Director of the Automotive United Trades Organization, a position he has held and an organization he has run for some 20 years now; has been a petroleum industry consultant, and he has testified before many legislative bodies and assisted the FTC and Department of Justice in investigations. Mr. Hamilton, we appreciate you coming in, and we appreciate your testimony.

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STATEMENT OF TIMOTHY A. HAMILTON, FOUNDER AND EXECUTIVE DIRECTOR, AUTOMOTIVE UNITED TRADES ORGANIZATION, SEATTLE, WASHINGTON

Mr. Hamilton. Thank you. For the record, my name is Tim Hamilton. There is some good news here: I am not an economist, so I am going to do this as simple as I can.

I got in the business in 1974 with Exxon when I was 24-years-old. I filed my first tax return when I was 12. I learned from the street up. If you want to know what happened with Katrina, if you want to know why San Francisco is higher than LA, I can show you. I know how the gasoline moves. In the industry you would come to me if you wanted to figure out how to build a gasoline convenience store or purchase a string of stations, and try to figure out what the oil companies are doing. I do not care about their profits, does not bother me. "Profit" is not a bad word. I worry about the way they get it.

The way they get it is simple: count the trucks. When we consolidated the industry, not having a law degree, I learned very simple phenomena. Antitrust laws busted up the Rockefeller Trust, so we did not have one company holding all the gas in one tank and dictating terms. What happened through mergers and acquisitions and changes in industry, is that the industry put all of its gas back in one tank. Today the Standard Oil Trust has been restructured physically and logistically, but on paper there are four identities. So there is an incentive to short market.

And what happens is real simple. Following Katrina or following a refinery fire in California, what you see is they count the trucks. As the gas comes into the tank from the refinery, they have removed it by exporting or curtailing production so there is very little there, minimal reserves. So when we have a problem with the increase in price or increase in demand, spring plant, kids get out of school, or a refinery problem, what happens is there is a draw. It is called a drawdown. So as the trucks go out and the level of the tank starts to hit the bottom--and we are sitting on sometimes a two or three-day supply--they go, "How many trucks came in today? 90. How much gas came in? 90 trucks worth or 95, or 80. Oh, 80? Raise the price 10 cents. How many came in today? 85. Raise the price 10 cents." And they do it until it balances.

I went into the first gas lines in 1974 when I tried to order my first load of gas. I have been experiencing and watching and analyzing gas rationing at the pump. The market now calls it allocation by the market supply. It is rationing, it is eBay. We have a shortfall. The bigger the shortfall you make it, the more trouble you are in.

Antitrust laws prevented collusion. We have an Internet and technology today where I can show you that every one of these limited suppliers that is left, can change their price instantaneously. The other ones, no. They know how many gallons they have. They share the same tank. They know when the fuel is coming in. They know what transport is coming, everything. There is no trade secrets in the gasoline business. When you know this, you are provided an incentive to raise price by rationing it. We get the price up so high because of restriction at the refinery, that it brings the price of crude up. If you got the price of crude to fall dramatically, but it took $3.00 a gallon to keep you from running out today, the price would not go down. In fact, if you were OPEC and you wanted to get a share of that money, you did not want Exxon Mobil to have it all, you would raise the price of crude. Like if we went from 14.95 for a 2 by 4, what do you think it does to logs on a landing? It is sucking the crude oil up, unless you have a disruption, such as in Iran, that people are worried about.

I will summarize by saying this. I work all over the West with folks trying to figure out alternative fuels, trying to figure out how to use ethanol, how to do everything that the President mentioned last night. It is going to take 15, 20 years, trust me. Between now and then we have got this Committee. How do we use oil we are hooked on and stuck with and how is it sold? And you need to understand how to count the trucks, and to know who bought the gas and who is on first, and how none of the fuel sold in the futures market goes anywhere other than one dock in New York Harbor, but can affect the price of gasoline in Idaho. These things you need to know.

Thank you.

6 [The prepared statement of Mr. Hamilton follows:]

Chairman Specter. Thank you very much, Mr. Hamilton.

We will now proceed to 5-minute rounds of questioning, and to the extent witnesses can make answers brief, all of the Senators would be appreciative because we do not have a whole lot of time.

Commissioner Kovacic, beginning with you, you have heard the testimony of Mr. Wells about concentration of power, Attorney General Blumenthal about concentration of market power leads inexorably to increased prices, an interesting conclusion by Mr. Hamilton about restructuring of Standard Oil, kind of have some of the overtones of collusion in all six companies agreeing not to appear here today. What can the possible justification be for some 2,600 mergers in the last 15 years, including the merger of the biggest and the second biggest company, in a context where the prices are sky high, $2.36 a gallon; every 10-cent increase leads to $14 billion from the American consumers; cries of pain coming from everybody who goes to the gas pump. How can the FTC justify allowing so many mergers?

Mr. Kovacic. Senator, in most instances the significant mergers were not allowed to proceed without qualifications, and as Professor McAfee mentioned, in the large number of transactions, the Commission took a great deal of care to demand divestitures where the Commission believed that any competitive overlaps would lead to price increases.

Chairman Specter. Well, you could have some qualifications, but you still end up with a merger. Commissioner Kovacic, would you like to slow down that merger process if you had different statutes to work under? When you worked as an attorney for the Commission, did you ever say, "I wish Congress would do something here to give us some more power to stop this. We do not have the power under existing law?"

Mr. Kovacic. In many respects, as your question suggests, our decisions take place in the context of what courts are permitting us to do. For my own part, I do have concerns when we look at the general direction of our merger jurisprudence over the past 30 years. I wonder whether or not that jurisprudence has begun in some instances to place excessive demands on the agencies in the type of proofs that's required.

Chairman Specter. Excessive demands on the agencies and not enough demands on the Congress. That is a fair accusation. Is that what you are saying?

Mr. Kovacic. I would say that I think we are approaching the point at which a broader reconsideration of whether the lines are drawn in the right place is appropriate, and I--

Chairman Specter. I have watched the merger and acquisition field in more than oil, everywhere you turn around.

Attorney General Blumenthal, you have had a lot of experience. Do you think we need to revise Federal laws?

Mr. Blumenthal. I do, Mr. Chairman, and the Commissioner has put it very politely, that the law places excessive demands on the agencies like the FTC. I would establish a presumption in the law that, for example, if the HHI index, the Herfindahl-Hirschman Index, is at a certain level, the presumption should be against a merger. I would put a presumption in the law that the industry bears the burden of showing a benefit to the consumer from any merger in a concentrated market.

Chairman Specter. That is a good idea on shifting the burden of proof and the presumption, but how about some fundamental restructuring of our antitrust laws? We have not done a bit of that in decades. They have just been static. And there have been enormous changes and enormous resiliency and enormous innovation and brilliance on the part of the companies in all fields. How about something very fundamental on changing our laws?

Mr. Blumenthal. I think that the Congress ought to consider fundamentally restructuring the law to take account of the challenges of enforcement that relate to modern technological advance, the use of e-mail, for example, that may disguise or inhibit prosecution of collusion, making detection, apprehension and prosecution more difficult. I think that there needs to be a restructuring that essentially takes account of the anticompetitive trends in the American corporation today, and--

Chairman Specter. My red light is about to go on. Years ago, a judge in the Eastern District of Pennsylvania named Ganey, sent some electric company officials to jail. Do you think that might be salutary?

Mr. Blumenthal. Any time an executive goes to jail, it has a very salutary effect, as I know from my personal experience, as you do from yours. But let me just add, on the Exxon Mobil merger, I opposed that merger repeatedly. I opposed the merger even after the divestiture, which we called completely inadequate. It involved some sale of retail outlets in the Northeast. I had no significant or material effect, and that is another area where restructuring the law may be appropriate.

Thank you, Mr. Chairman.

Chairman Specter. Thank you. My red light went on in the middle of your answer.

Senator Kohl?

Senator Kohl. Just to follow up on the Chairman's point, the merger has already occurred. You know, it is not as though we can fix the problem by tightening up our restrictions and laws on mergers. The mergers have occurred, and as you point out, Mr. Slocum, some 10 companies control 80 some percent of the capacity. So if we are going to do something significant and serious, do we need to undo these mergers? Should we be breaking up some of these largest companies to get back to a status of true competition? What do you think, Mr. Kovacic?

Mr. Kovacic. I do not think we have seen any basis for going back and rolling back specific transactions to effectuate divestitures, but I would add that I think a major focal point of the investigations that this body has insisted that the FTC perform is indeed to develop a better basis for understanding precisely what effects we have had with merger policy over time. This collaboration, which I would add does involve a close cooperation with our State counterparts, is designed in many respects to answer these questions.

Another hesitation I would have, Senator--and I would agree completely this is an area which merits continuing attention--is as we have alluded to in the comments so far, our own assessment and those of outsiders who have looked at the work of the GAO, that we applaud the effort they have taken, we do dispute the soundness of some of the specific findings. So my general view is that an effort to go back and restructure transactions that have taken place would not be merited at this time, but I agree with you completely, and the tenor of many comments on this panel, that this is an area that warrants our continuing efforts to ask whether we got those transactions right.

Senator Kohl. Who would like to comment that we should, in an effort to get back to competition, that we really need to undo some of these mergers? Mr. Blumenthal.

Mr. Blumenthal. Yes, Senator Kohl. Even under current law, breaking up a company would be an appropriate remedy for a court to order if there has been misuse of monopolistic power, if there has been predatory pricing, or if there has been other misuse of market power, breaking up, cracking down on bigness, is an appropriate remedy, even under current law. So that is why I think the investigation is essential, and it ought not to just be a survey or a study, it should go to the misuse of monopolistic power that all of us sense exists to some extent. We know at the State level it exists to some extent. There are indications of it from our investigation. But, really, we need effective partners in this effort.

Senator Kohl. Another question before my time expires, a strategic refining reserve operated by the Government to really act as a break on the monopolies that the industry has on refining capacity, I have a bill in to authorize the Government to build a strategic refining capacity reserve.

Do you think this would be a good idea? Do you think we ought to do it, or wouldn't that have an impact on the ability of these companies to just summarily raise prices? Mr. McAfee?

Mr. McAfee. Canada tried this with Petro-Can, and Petro-Can became the high-priced firm in the industry. Generally, running a refinery is quite a complex task. If the Federal Government decides that is what it wants to do, it should probably subcontract the work, and if it doing that, then in essence all it is doing is becoming a guaranteed buyer. So I think that it is going to be hard to make that actually add to our capacity.

In contrast, working to try to make it possible for new entrants to enter and to remove the restrictions that block new entrants from entering the refining business would actually be a great help to the industry in improving competitive effects.

Senator Kohl. Mr. Slocum?

Mr. Slocum. I actually think that it is a very sound idea. I think that having the Government build at least one refinery would help mitigate some of the market power that we have seen, and quite frankly, I do not understand why the large oil companies are not building new refineries. Just like Enron and Ken Lay during the California energy crisis, when that company blamed environmental laws for the lack of adequate supply, I think too, I see similar problems with the oil industry's arguments. The fact is, is that there is a small company called Arizona Clean Fuels, it is not affiliated with any of the vertically integrated companies. They have obtained State air quality permits, they have obtained draft Federal air quality permits to build a very large refinery outside of Phoenix, Arizona. My question to the oil companies is, if a small start-up company can go through the permitting process to build a refinery, why cannot the world's richest corporation, Exxon Mobil, do the same with its almost unlimited resources? It is not in their financial interest.

Senator Kohl. Thank you.

Thank you, Mr. Chairman.

Chairman Specter. Thank you very much, Senator Kohl.

Under our early bird rule, we go next to Senator Cornyn.

Senator Cornyn. Thank you very much, Mr. Chairman.

Thank you. There is so much to talk about and so little time, but let me just--I am reminded of a quotation I have read and heard that says, when your only tool is a hammer, you tend to think of every problem as a nail. Translating that into the present context, obviously, there are some things Congress can do, and I am glad we are looking into what we can do, but there are some things we cannot do. For example, the largest single factor in the price of gasoline is the price of a barrel of oil. Obviously, we have some problems with that. One has to do with our own sort of shooting ourselves in the foot by putting a lot of our domestic oil reserves out of bounds, particularly off of the Pacific Coast, off of the coast of Alaska, and onshore at Anwar, along the Gulf Coast, closer to where I live, and, of course, along the Atlantic Coast. Obviously, that reduced supply increases the price, and translates into higher prices at the gas tank.

When it comes to refining capacity, actually, the number of refineries has gone down, that is true, and I think we have heard an explanation or at least a partial explanation for that. The environmental regulation, the overlays Government imposes on the creation of new refineries, which makes that not as economically advantageous as increasing capacity of existing refineries. And in fact, while the number of refineries has gone down, the refining capacity has expanded dramatically by expanding existing refineries and thus the supply.

We all know political instability is a problem. When Iran says, "If you vote to refer us to the IAEA because of our nuclear ambitions and we threaten to cut off the oil supply, our oil exports, it sends shock waves throughout the market, creating instability." And, of course, as I mentioned earlier, the matter of demand continues to be a chronic problem.

Professor McAfee, if I may ask you this, with regards to the profits of oil companies, which seem to be the concern, the focus of concern for so many, my understanding is that the profits of the oil companies, in terms of the dollar profit based on sales, is actually not out of line with other industry. For example, over the last five years, the oil and natural gas industry's earnings averaged 5.8 cents compared to an average for all U.S. industry of 5.5 cents, and that there are other industries. If we want to get into the business of windfall profits taxes or regulating American industry, there are a number of other industries including the banking industry, the pharmaceutical industry, the real estate industry, health care, insurance, software and services, consumer durables, food, beverage and tobacco, that actually generate a greater profit for each dollar sale. Could you respond to that or comment on that, please, sir?

Mr. McAfee. Absolutely. The way economists and Wall Street looks at profits are, are the profits large enough to cover the risk? So if the oil industry is composed of various levels of risk, exploration, extremely risky. Rates of return for exploration should be in the 17 to 20 percent range. On the other hand, refining, less risky but still fairly risky, what with price volatility, so again, you would be looking at 15 percent. The actual percentage return in the oil industry is on the order of 10 percent, and so in fact, looks low by Wall Street standards. That is why you see that it is lower than many other industries like banking in rates of return, or newspapers, for example. And newspapers, not so risky, and yet, much higher rates of return.

Senator Cornyn. Thank you, Mr. Chairman.

Chairman Specter. Thank you very much, Senator Cornyn.

Senator Feinstein?

Senator Feinstein. Thank you. Mr. Chairman, I was just thinking, you know, this is really an interesting hearing. I thank you. I think people testifying are very candid and very frank, and I think that's very useful.

And I think it leaves us with a very big problem. We have a whole airline industry capitulating partially because of the price of fuel which drives astronomical problems for the industry because they cannot raise prices because of deregulation. Just look at the profits of these companies in 2005 over 2004: Exxon, 43 percent profit; Chevron, the best, 6 percent; ConocoPhillips, 66 percent profit; Valero, 100 percent profit in a year, despite all of the things that are happening. I think that big oil in America has the consumer in a real vise, and I think it is up to us to do something about it.

Dr. McAfee, let me ask you this question. You study this. You have no axe to grind in this thing at all. If we could do one thing to create a sense of responsibility in this sector of the energy economy in one sense of consumer respect, what would that one thing be?

Mr. McAfee. You kind of caught me off guard.

Senator Feinstein. I know, it is hard to answer.

Mr. McAfee. Let me start with the consumers because that is actually part of my prepared statement. Many Americans do not shop around, and in my home in Pasadena, going two miles distance you can find prices that vary by 10 cents. The only reason you can find that is because people, some people are buying at 10 cents more, and a sort of "back of the envelope" calculation says if a third of the population will pay an extra dime, the average price, not the maximum price, but the average price will rise also by a dime, and the maximum price by 20 cents. This is just the rational response of profit-seeking firms to the fact that some consumers are not shopping around.

Now, we may not want them to shop around, but that would be a way of reducing some of the profits on refining and on retailing, as if people were more cognizant of the price. One thing that is important is shopping around confers effects on other people. That is, if I shop around, because that pushes down the prices, makes demand more elastic, that will cause the other people to benefit.

Senator Feinstein. That is fine, but we are a legislative body. And if the figures are correct--and I have no reason to doubt this study that Mr. Slocum has done--and you have 10 companies controlling 85 percent of the market, and 5 companies controlling, what is it, 55 percent of the market?

Mr. Slocum. That is correct.

Senator Feinstein. Something is wrong. What can we do to break this up? I thought Senator Kohl asked a very pertinent question, and everybody kind of backed away from it. But there is a problem out there and it is an oligarchy.

Mr. McAfee. Most of our largest industries, in fact, pretty much every mature industry--that is to say not a brand new industry--is controlled by an oligopoly. When you have two, three firms you get pretty nervous. Four firms, five firms, you are starting to see pretty competitive pricing, and when you get to seven or eight, usually--and of course, vertical integration is a problem here--but usually you start to see quite competitive outcomes.

One thing I would like to say about breaking up the industry is if you break up the oil industry with its current level of concentration because of the level of concentration, you are going to have to go after airlines, automobiles, steel and many other sectors of the economy where the concentration levels look at least as large.

Senator Feinstein. Mr. Blumenthal, do you see where I am going? I mean, there is so much force not to touch big oil in this Congress, I am looking for one thing that is doable that we can do that will be helpful, that will give the consumer a market that at least relates to their concern. I do not understand how in the energy sector--and this I found through Enron and others in California--there is no consumer loyalty, as there might be in any manufacturing or other things.

Mr. Blumenthal. If I can answer very directly, although it is not a panacea, it is not a magic bullet, abolishing zone pricing would not only make consumers more aware of the phenomenon that Professor McAfee has so ably described, but also eliminate some of those disparities and drive prices down, because right now a lot of retailers are bound by the price that they are charged, which in turn is dictated by computer runs that the big oil companies do in deciding who can bear what kinds of burdens. And they divide the States and the city of San Francisco or Los Angeles, or Pasadena into different areas, more likely the States into different areas, and charge disparate prices, often higher in the inner cities because they know those consumers are less likely to shop around, as well as higher in the suburbs.

But I just want to add a footnote. I think that any sort of breaking up of a company depends on a finding of misuse of its power. So if you talk about airlines or automobiles which are in certainly by no means the same economic position, and perhaps not using their power, misusing their power in the same way, you are not talking about that remedy.

Senator Feinstein. Excellent point. Thank you. I think my time is up.

Thank you, Mr. Chairman.

Chairman Specter. Thank you Senator Feinstein.

Senator Coburn?

Senator Coburn. Thank you.

I was pretty interested in Senator Kohl's idea about a distillate reserve, not distillate refineries capacity, but distillate reserves. I would like your comment. If we had a significant distillate reserve in this country, much like our petroleum reserve, but it was designed to use and smooth out price disruptions, what would you think of that? Anybody want to answer? Go ahead.

Mr. Hamilton. The Northeast heating oil reserve, the same problem we had in Canada, it is triggered by a price that gets so high, you know, they did not want to let go of it. So if you created a reserve like that--and it is important to understand that diesel is the key, everybody says gas, follow the diesel. It went up way above regular unleaded because when we raised the price, we did not have discretionary driving. So we are driving this diesel up, killing everybody out there in small business and agriculture, and it is the one thing that you could do, but you would have to do it in multiple spots. You would have to do it in six or seven spots, and then the most important thing that you do is follow the industry.

When the price started to move, dump it. Do not let some unforeseen thing happen or get it real complicated on the trigger mechanism. Trigger it by the price because that is what you are after, and everything else will flow.

Senator Coburn. I want to ask this question, and anybody that wants to answer it, can. If there are anticompetitive behavior ongoing, whether it is through vertical integration or through pricing mechanisms at the wholesale level, where is it? If it is there, where is the anticompetitive behavior? What level? Is it in exploration? Is it in production? Is it in refining? Is there anticompetitive behavior in refining, or is it in distribution? Where is the anticompetitive behavior that would create artificial price increases?

Mr. Slocum. I think the evidence suggests that the

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bulk of it is in downstream, in refining, because that is where we have seen very, very high levels of concentration, and the practices by the refiners ends up having an influence on the price of crude oil, which does not make any sense, but often I see traders changing their positions on crude oil depending upon what stocks are of gasoline. Then when you add in the fact that we have got a number of vertically integrated companies that are into exploration and production, and they own their own downstream facilities, you have got a lot of trading within affiliates that the Government does not seem to be very good at tracking at this point.

Senator Coburn. Yes, sir?

Mr. Kovacic. Senator, one consequence of the merger reviews that we do--and I think Professor McAfee gave you a flavor of what we do--we look at extraordinary volumes of information when we look at mergers, sometimes what the parties call outrageously extraordinary volumes of information. Sometimes it is like standing under Niagara Falls with a Dixie cup when you look at the amount of material that comes in. But in our merger reviews we are extraordinarily attentive to finding, written in electronic evidence of classic anticompetitive behavior, that is, illegal agreements under rivals, illegal improper exclusionary behavior among rivals, and in our many examinations we have seldom found that kind of classic anticompetitive behavior. On some occasions when we have found it, we have challenged it separately. That was the essence of the Unocal case.

What we are doing again in the current investigations, which involve the use of compulsory process--these are not mere surveys or voluntary inquiries--is taking another look to look again for this information, because what we found from our experience is that for both express collusion, but even for tacit agreements where you have arms-length understandings, people have to write that down. They have to document how the system operates, and communicate that to people who day in and day out make hundreds of decisions.

I want to assure you that we look carefully for exactly that evidence.

Senator Coburn. Thank you.

Professor?

Mr. McAfee. The place that I am most concerned has to do with entry of independents, independents like Race Track or Wa-Wa or Costco are actually quite disruptive on any kind of cooperative agreements. They serve us well as consumers. The problem, say for Costco, is that in order for Costco to start selling gasoline, it has to buy it from a refiner. If the refiners all understand that that will undercut them at the retail level, and there are not very many of them, and in some sense, there is no one to break out as an independent refiner, it is very hard for Costco to enter, and it has not entered very strongly on the West Coast relative to the East Coast where you have independent refiners.

My major concern is actually the vertical integration concern, and not that these companies are not building refinery capacity as best they can, but that they are not letting independents in, and that makes for a cushier environment. But east of the Mississippi--excuse me--east of the Rockies, with so many refineries and so much interconnectedness, it is not really as serious an issue as it is west of the Rockies where you only have seven firms.

Senator Coburn. Thank you, Mr. Chairman.

Chairman Specter. Thank you, Senator Coburn.

Senator DeWine?

Senator DeWine. Mr. Kovacic, in response to the price spikes on the West Coast and the Midwest in 2000, Senator Kohl and I, as Chair and ranking member of the Antitrust Subcommittee, sent the FTC letters requesting that the Commission investigate the causes of these price hikes, and look for possible price gouging and price manipulation. As a result, as you know, the FTC has developed and maintained a program of gasoline price monitoring, which continues to this day. We are hopeful that your numerous investigations and price monitoring has prevented at least some anticompetitive behavior in these markets.

First, let me ask you, do you think the program has been helpful? And next, do you have a sense of whether the illegal price gouging or price manipulation is still happening today?

Mr. Kovacic. I think it has been very helpful, Senator. It has given us a much better market-by-market appreciation for what is taking place in the market that not only informs our understanding of phenomena in the individual metropolitan areas, but it feeds back into what we do when we look at mergers. Second, it has been a good platform for developing cooperation with our State counterparts and the State Attorneys General office to build a form of information sharing and cooperation that did not exist before. I think there is a lot more we can do to put information that we gather in the course of these activities into the public domain to facilitate debate in this body and discussion among our energy policy counterparts.

I do think what we are seeing in the course in the course of that inquiry--and I think it will be enriched by what we learn in the course of the pending investigations--is a better understanding of precisely why prices went up, in what instances did firms make a conscious decision or not to withhold product from the market? I think that the inquiry that we are doing now is very much informed by what we learn through this process, so that I expect that what we will be able to report to you at the end of the spring is a fuller assessment and a more complete factual assessment of exactly why the phenomena we saw took place.

Senator DeWine. We can look for that at the end of the spring?

Mr. Kovacic. Yes, sir, and I am failing to recall the exact date by which that is required, but we will be on target.

Senator DeWine. That is fine.

Mr. Wells. Senator?

Senator DeWine. If you could?

Mr. Wells. Absolutely. I could quickly respond that we appreciate the excruciating detail in which the FTC has designed their studies to assess mergers, and I think the big fundamental difference between what they do and what we did in our study was, they typically look at the trees, and we had an opportunity to look across and look at the forest, and we came up with different results. So maybe they need to consider how they actually are assessing mergers.

Senator DeWine. Mr. Wells--yes?

Mr. Blumenthal. If I could?

Senator DeWine. Quickly, please. Five minutes is not long.

Mr. Blumenthal. Resources for both the FTC--Mr. Kovacic, I know of his work as General Counsel, he has worked very hard and energetically. The Congress could make a very profoundly important statement by mandating additional resources for exactly the kind of antitrust work that we have been discussing this morning.

Senator DeWine. Mr. Wells, Mr. McAfee, Mr. Blumenthal, Mr. Hamilton, have testified that the oil companies have been shutting down refineries to manipulate the supply of gasoline and increase their profits. On the other hand, the oil companies claim that refining is a real boom or bust industry which makes it hard to estimate how much capacity they really will need, and that too many regulations really prevent them from building new refining capacity. Who really is right?

Mr. Wells. I know we have heard that from the industry. I know they were 300 refineries, and they are down below 150. Instead of building new refineries, they rely on "not in my back yard," or "it costs too much." We also know that they are going offshore and bringing in gasoline and buying gasoline. It is cheaper to but it in Europe and bring it here than it is to produce it. They are using that from an economic standpoint .

I think a big question to ask the industry today, given the record profits that they are entertaining today, do they still stand behind it is too expensive to build a new refinery?

Senator DeWine. Good question.

Professor McAfee?

Mr. McAfee. One thing, ski resorts make their money in the winter. The oil industry is much the same. In 1998 and 1999, when prices were very low, the oil industry was actually not making much money, and that reason for not building new refinery capacity made a fair bit of sense.

Today with the prices so high, we would expect to see more investment in refinery capacity.

Senator DeWine. Mr. Slocum?

Mr. Slocum. I spent a lot of time reading the corporate annual reports of oil companies, and Exxon talks about and breaks down its profit margins in its U.S. oil refining business, and they have not released their 2005 annual report yet, so we do not have that level of detail, but their 2004 annual report, available at exxonmobil.com, shows that their U.S. oil refining return on average capital employed in 2004 in the United States was 28.6 percent rate of return.

And Exxon Mobil, when they are talking to shareholders and to Wall Street, they emphasize the return on average capital employed, and they never use this other thing that they talk about when they are dealing with the general public, trying to deflect attention away from their profits. Exxon Mobil, when they are talking to the general public, uses the simplistic return compared to total revenues. But if you look at the way they talk to Wall Street, they use return on average capital employed, in 2004, 29 percent rate of return on their oil refining business. That is a pretty healthy margin.

Senator DeWine. Mr. Hamilton?

Mr. Hamilton. Look to Bakersfield, and the highest prices, the higher margin of what Wall Street calls refinery heaven, and a company decided to close their refinery rather than sell it in a monumental fight over that that I was involved with, and the great discrepancy between what the company said and what everybody else said, and their own internal documents. They made a lot of money back at other refineries by closing that one down. That shortened the market, and those are the people you return to to cure the problem, and it still continues one. When you go to the environmental rules and regulations, in the old days, you could not meet to decide how many refineries you had and who had them and what size they were. It would have broke antitrust laws.

But even in the environmental rules and regulations--and I sat in a lot of them--and we had annoyingly environmental regulators acting as meeting facilitators to determine who would market and who would set up barriers to entry, and how much volume would be there, and the companies had an opportunity that was never granted them before, and it is something that was missed.

Senator DeWine. Thank you, Mr. Chairman.

Chairman Specter. Thank you very much, Senator DeWine.

Without objection, we will put into the record a statement by Senator Leahy, ranking member.

Senator Schumer?

Senator Schumer. Thank you, Mr. Chairman. I thank our witnesses.

I would like to get into the mechanisms of supply and demand, and start off by asking Mr. Kovacic and Professor McAfee questions, and then ask some of the others to respond.

Now, if supply and demand were working in a Adam Smithian sense, we had 10,000 suppliers that could supply oil to anybody, and there were a spot market, as there is now, which is a pretty free market type situation, would it not be that two things would not happen that happen now. First, the price goes up on the spot market 10 cents a gallon, but because there is oil in the pipeline that has not been purchased for weeks or even months, that if there were real competition, anybody who raised their price immediately just reading in the newspaper that the spot market is 10 cents higher, would be undercut by somebody else? Question one.

Second. If we had a real supply and demand model, wouldn't it be such that the price would go--there would not be any stickiness when the price goes down, it would go up and down related to the spot market equally?

Mr. Kovacic. With apologies to Adam Smith, most of the economic commentary since his formative work had suggested that he missed the lot, and among the things he missed are how sticky in both directions adjustments can be.

I would say that over a reasonable period of time you would expect those phenomena to take place. There has been a lot of attention devoted--

Senator Schumer. Okay, but you are not--I am not asking whether we agree with Adam Smith or not, and I think the people who picked you for the FTC would be surprised that you do not agree with Adam Smith. I am asking, if we had 1,000 suppliers and there were real competition, would the price go up immediately to where the spot market is a day later, even though supply in the pipelines, so to speak, the price had been lower for the two, three weeks? You want to answer that, Professor?

Mr. McAfee. I would be glad to. The answer is it should go up immediately, and it should go down immediately, according to Adam Smith. It does neither, as measured, and that can be a lot of reasons for that, in particular--

Senator Schumer. Why would it go up immediately? Why wouldn't Company 212, which would make a nickel profit rather than the full dime profit, sell it for the nickel?

Mr. McAfee. Because we know that it is going to be a dime, say, two months from now, and by waiting two months and holding onto my gasoline--

Senator Schumer. No, they are not holding onto it. You are missing the model, and you know more about economics than I do. But this is an ideal situation. I am a gas station. I have 1,000 suppliers. Somebody is going to say tomorrow, even though the spot market went up 10 cents, since my costs were the 10 cents lower, I will only charge 9 cents or I will only charge 8 cents.

Mr. McAfee. No, sir.

Senator Schumer. Why?

Mr. McAfee. Because those holders of gasoline, the people that you are asking to sell it for 9 cents have the option of delay, and that option alone is--

Senator Schumer. Not if there are 1,000 suppliers competing.

Mr. McAfee. A billion suppliers does not matter. What matters is the amount of gasoline, and the hypothesis you have put on the table is that gasoline is now worth 10 cents more than it was yesterday. If that is true, everyone should get the 10 cents. Now--

Senator Schumer. Okay. Second point you agree with--no, no, I only have a limited amount of time.

Mr. McAfee. And the second point is absolutely right, and the people that study this find that in fact prices go up in about two weeks, but it takes them six weeks to come down.

Senator Schumer. What does that indicate?

Mr. McAfee. Well, there is a lot of dispute about what that indicates, but it certainly does demonstrate that it does not function like an Adam Smith market.

Senator Schumer. I would say it indicates that there is a lack of competition of real free market Adam Smithian competition.

Do you want to comment, Mr. Hamilton and Mr. Blumenthal?

Mr. Blumenthal. I will just say briefly, because I know your time is limited, that I made some statements earlier about one of the practices that creates this stickiness, which is zone pricing. There are all kind of rules. The retailer, the gasoline station, the guy who pumps your gas, is a franchisee very often. He is bound by all kind of rules as to how he can sell his gas, as to what gas is sold to him. He cannot buy from those 1,000 suppliers. He is limited. And those kinds of limits in the market are what inhibit competition.

Senator Schumer. Mr. Hamilton?

Mr. Hamilton. Through an event that can be triggered by them, the branded refiners, and separate the two branded refiners, the prices they charge the unbranded stations that do not carry a major flag, are often referenced to the spot. So if these boys triggered the spot, which they do regularly, sometimes with a phone call, that jumps up 10 cents. That raises the wholesale price to all these stations that compete with the branded refiner.

Senator Schumer. Understood.

Mr. Hamilton. They can right behind it, okay? And up goes your price. And this is done through the Internet just like, boom. And to quote one up and down overnight mass, okay? Now they get it up. Now the spot goes back down. The guys who were forced up by the spot increase, margins increase tremendously, but there is a reluctance to lower their price on the street because they know it will trigger response from the guys, it is going to trigger response from Exxon Mobil. So there is--

Senator Schumer. What kind of response would that be?

Mr. Hamilton. They would go down with them, and so the volumes will not change, they will not increase their market share, so I am not going to screw with the big boys, and the way they are going to do it is what he said, zone pricing.

I lowered the price across the street wherever you have your station. If you try to lower yours back, you are not going to get any market share. These boys control--

Senator Schumer. So there is no elasticity in a classic free market sense.

Mr. Hamilton. The seven players control the business, period.

Senator Schumer. One final quick question, just yes or no--

Chairman Specter. You are way over time, Senator Schumer, but go ahead.

Senator Schumer. If there were 25 players instead of 7, would it be better. Just yes or no? How many of you think it would be better?

Mr. Hamilton. Yes, it would be better.

Senator Schumer. Okay. Mr. Blumenthal is shaking his head yes.

Mr. Blumenthal. I would agree it would be better.

Senator Schumer. Professor?

Mr. McAfee. Better for domestic supply, worse for international supply.

Senator Schumer. Okay. We will figure that one out another time. What will you say, Mr. Kovacic?

Mr. Kovacic. Better in some markets, perhaps worse in others.

Senator Schumer. Thank you, Mr. Chairman.

Chairman Specter. Thank you, Senator Schumer.

Professor McAfee, we push ahead sometimes interrupting because we want to get more answers, and I think that is understandable, but you were in the middle of one answer for Senator Schumer. Did you want to supplement that or finish that?

Mr. McAfee. I thought I had finished it, but I am happy to elaborate.

Chairman Specter. If you finished it, that is fine.

Thank you very much, gentleman. We very much appreciate your testimony. We would like you to do a couple of things on supplementing the record if you would. We would be interested to know from each of you whether you think the concentration of power in and of itself increases prices, and if so, why?

We would also be interested in having a written response as to whether you think legislation would be appropriate here, and what kind of legislation you would suggest? You do not have to be a lawyer to give us your ideas--a number of you are not. It may be helpful not being a lawyer. Just give us your ideas as to the direction you think the legislation, where it ought to go.

And the third response that we would appreciate is to what extent do you think the increased profits will really find their way into exploration, where we are very concerned about not impeding exploration? And you have some evidence already which Commissioner Kovacic and GAO and Mr. Wells would know about, but to the extent any of you have any insights on that, I think the Committee would be very interested to know your feeling there.

I think it has been a very productive--sure, go ahead, Senator Kohl.

Senator Kohl. I would like also to ask one inquiry maybe from the GAO. If the seven big guys that you refer to, if their profits were cut in half in any given year, because people think that it is all about they are making so much money and the consumer is paying a fortune for it. That may be true. But if their profits were cut in half, what impact would that have on the price of gasoline to a consumer over a year's time. If you could get that information to us, I think that would give us some indication of where we are in terms of trying to figure out what is going on here.

Senator Feinstein. Mr. Chairman, could I ask one question, something that they might fill us in on.

Chairman Specter. Go ahead, Senator Feinstein.

Senator Feinstein. How you would see zone pricing being changed to bring about the best effect for the consumer.

Chairman Specter. You are asking this for the record for written supplements.

Senator Feinstein. For the record.

Chairman Specter. Yes, that is fine.

Thank you all very much. This is the first of a number of hearings we are going to have on this subject, and we are going to actively review the legislative course, perhaps with Commissioner Kovacic's statement that Congress should do a little more here, what Attorney General Blumenthal said, and what GAO has done, and those of you who are consumer advocates.

Thank you very much, and stay tuned.

[Whereupon, at 11:29 a.m., the Committee was adjourned.]

CONTENTS