

ENERGY PRICES AND PROFITS

JOINT HEARING
BEFORE THE
COMMITTEE ON
COMMERCE, SCIENCE, AND
TRANSPORTATION
AND THE
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE
ONE HUNDRED NINTH CONGRESS
FIRST SESSION

NOVEMBER 9, 2005

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ENERGY PRICES AND PROFITS

WEDNESDAY, NOVEMBER 9, 2005

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE,
AND TRANSPORTATION, AND THE
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Washington, DC.

The Committees met jointly, pursuant to notice, at 9:27 a.m. in room SD-106, Dirksen Senate Office Building, Hon. Ted Stevens, Chairman, Committee on Commerce, Science, and Transportation and Hon. Pete V. Domenici, Chairman, Committee on Energy and Natural Resources, presiding.

OPENING STATEMENT OF HON. TED STEVENS, U.S. SENATOR FROM ALASKA

Chairman STEVENS. If I may, there is a question that has been raised before we start the hearing. The question whether Senator Domenici and I should administer oaths to these witnesses at today's hearing was raised by a letter that I received this morning at 8:10 a.m., after it was delivered to the press. As a matter of fact, there is a story in the Seattle paper about the request having been denied already.

I remind the witnesses as well as the members of these committees, Federal law makes it a crime to provide false testimony. Specifically, section 1001 of title 18 provides in pertinent part: "Whoever in any matter within the jurisdiction of the legislative branch of the Government of the United States knowingly or willfully makes any material false, fictitious, or fraudulent statement or representation shall be fined under this title or be imprisoned not more than 5 years or both."

I have reviewed the rules of the Senate and the rules of the Commerce and Energy Committees in effect in this Congress and the relevant provisions of title 2 of the U.S. Code. There is—could we have quiet, please. There is nothing in the standing rules of our committee rules or the Senate which requires witnesses to be sworn. The statute has the position that everyone before, appearing before the Congress, is in fact under oath.

These witnesses accepted the invitation to appear before our committees voluntarily. They are aware that making false statements and testimony is a violation of Federal law whether or not an oath has been administered.

I shall not administer an oath today.

Senator BOXER. Mr. Chairman.

Chairman STEVENS. And we look forward to questions.

Senator Cantwell.

Senator CANTWELL. Mr. Chairman, I did send you a letter co-signed by eight of my colleagues asking that the witnesses be sworn in. This rare joint hearing—

Chairman STEVENS. I did not yield to make a statement. We are ready to go. We have a statement process. Do you have any—

Senator BOXER. Mr. Chairman, I would like the committee to vote on whether we swear—

Chairman STEVENS. There will be no vote. It is not in order at all. It is not part of the rules that any vote can be taken to administer an oath. It is the decision of the chairman and I have made that decision.

Senator BOXER. Mr. Chairman, I move that we swear in the witnesses.

Chairman STEVENS. And I rule that out of order.

Senator CANTWELL. I second the motion.

Chairman STEVENS. Thank you very much. That is the last we are going to hear about that because it is out of order.

Senator BOXER. Mr. Chairman, Mr. Chairman. Could I just ask for a little clarification here? If the Senator makes this request and there is a second, why would we not have a vote on that?

Chairman STEVENS. Because you cannot vote to put in the rules something that is not there.

Senator CANTWELL. Mr. Chairman.

Chairman STEVENS. This is not a business meeting. There is no way to put this into the rules. This is a matter for the chairman to decide and I have made the decision.

Senator DOMENICI. Mr. Chairman, I want to say—

Chairman STEVENS. Pardon me. It specifically says in the rules the President of the Senate, Speaker of the House, or a chairman of any committee can make the decision.

Chairman DOMENICI. And Mr. Chairman, I concur.

Chairman STEVENS. Now, if we could come to order, and I would hope that we would have—I do believe that we do not wish to have standing room only in this. There are plenty of seats. Please take your seats.

This is a joint committee meeting, gentlemen, and we have together determined that myself and Senator Domenici and Senator Inouye and Senator Bingaman will make opening statements, and after that time we will listen to the witnesses, and following that time Senators will be recognized by the early bird on each committee.

We encourage the witnesses to limit their statements to 10 minutes each if that is agreeable. I think it has been. We shall have a limit according to an agreement between the chairmen and ranking members of each committee to 5 minutes each on opening statements.

Over the last 2 years, energy prices have tripled, the cost of oil has risen at least once to \$70 a barrel. All Americans know now that the cost of energy is going up. But in the wake of the Hurricanes Katrina, Rita, and Wilma there is fear about how sharply these prices have risen. Americans are now concerned whether they should be paying so much more for energy when our energy companies are recording record profits.

Today we are going to hear testimony from: Lee Raymond, chairman and CEO of the Exxon Mobil Corporation; David O'Reilly, chairman and CEO of the Chevron Corporation; James Mulva, chairman and CEO of ConocoPhillips; Ross Pillari, chairman and CEO of British Petroleum of America; and John Hofmeister, president and U.S. Country Chair of Shell Oil Company.

We thank you gentlemen for coming to appear before us today voluntarily. This hearing is an opportunity for your companies, the major energy companies of our country, to address these concerns. We do sincerely want to listen to your thoughts.

This is a joint hearing. The members of each committee are here today and, as I indicated, each Senator will be entitled to ask questions for 5 minutes. I urge that the witnesses be succinct in their answers as possible and that witnesses observe the timer clocks which should be visible to all concerned.

In my judgment these hearings should be a respectful discussion about our Nation's energy prices. I intend to be respectful of the positions these gentlemen hold. In turn, I know that each of you as witnesses understand that those of us at this table have a duty to our constituents and to all Americans to seek the information we will seek today.

Specifically, we want you to discuss the steps your industry plans to take to alleviate price concerns and we need to gain your perspective on some of the initiatives Members of Congress have proposed that aim to assist communities in meeting these increased costs.

I now yield to Chairman Domenici.

**STATEMENT OF HON. PETE V. DOMENICI,
U.S. SENATOR FROM NEW MEXICO**

Chairman DOMENICI. Thank you very much, Mr. Chairman.

Fellow Senators and witnesses: Let me first say that I want to thank Majority Leader Frist for requesting this joint hearing and thank all the Senators who are here to participate. I think all of you know that we represent constituents—added all up, we represent the American people. Every day that we are in office and every day that we go home, we hear what our people and what the American people are worried about and what concerns them.

Americans have been experiencing painfully high prices at the pump. Whether you think so or not, they think so. Americans are facing dramatically increased winter heating fuel prices, especially of natural gas. You see a story on the front page of the *Post* today about an aluminum company, because of natural gas prices being so high, may indeed close up.

Most Americans in most of the polls show that our people have a growing suspicion that the oil companies are taking unfair advantage of the current market conditions to line their coffers with excess profits. Now, I am telling you what we are hearing and what Americans are saying. Some Senators are proposing a windfall profits tax. From all I know, it did not work before; it probably will not work again.

Still, I expect the oil companies' witnesses to provide some assurances about how you plan to use your recent profits to provide a stable source of energy to the United States and to pursue to the

maximum extent possible lower oil prices and lower gas prices. The oil companies' witnesses owe the company an explanation and they owe it to us as those who represent the people.

I expect the witnesses to answer whether you think your current profits are excessive and to talk about what they intend to do with the reserves and the profit accumulations that they have. This may not in past times be relevant as you think of it, but it is relevant to the American people at this point, and I believe you have to tell us about it.

Now, there are a variety of factors that have pointed to the reasons for the high prices. Some weigh exports to China, India; increased geopolitical risks; and of course the hurricanes in the Gulf. Some of these factors are out of your control, but we hope you will explain nonetheless why the prices are so high.

There are other factors, however, such as the lack of refining capacity, which the American people believe is urgent. I say to all of you that time is urgent, that we address these issues, like expanding refining capacity, increasing production here at home, and providing some balance in the supply-demand internationally so we might expect a stabilization of prices of crude oil and thus gasoline and derivatives at least, if not causing them to go down substantially.

Things look a little better this week than they did 3 or 4 weeks ago. We would like to know what you think about that trend. Is it going to continue or is it just a spurt? We know gasoline has come down dramatically. What do you think about the future?

With that, I thank you for coming here and I thank all the Senators for attending. Mr. Chairman, it is a privilege to co-chair this with you. I think before the day is out we might get the American people some answers. Thank you.

Chairman STEVENS. I will next call on Senator Inouye, co-chair of the Commerce Committee.

**STATEMENT OF HON. DANIEL K. INOUE,
U.S. SENATOR FROM HAWAII**

Senator INOUE. Thank you, Mr. Chairman.

The past several weeks have been very painful for the people of the United States. It has been the time of Katrina, it has been a time of suffering, of death. It has been a time when hospitals were destroyed. Americans were called upon to make record-breaking contributions. Sacrifices were made in every quarter.

Yet at the same time, we saw Americans lined up at gas pumps waiting to pay \$3 and much more for their gasoline. I think Americans are concerned. Then suddenly they have thrust upon them headlines saying "Record-Breaking Profits." In the midst of suffering, in the midst of sacrifice, record-breaking profits.

I have nothing against making profits. After all, it makes capitalism live.

Mr. Chairman, I think, although the rules are very clear that the chair has the responsibility to decide whether to have witnesses sworn before they testify. If I were a witness I would prefer to be sworn in so that the American people can be assured that the testimony that we are about to give would be the honest truth and

nothing but the truth. If I were a witness, I would demand that I be put under oath.

[The prepared statement of Senator Inouye follows:]

PREPARED STATEMENT OF HON. DANIEL K. INOUE, U.S. SENATOR FROM HAWAII

The recent record-setting gas prices created two story lines that many of us find difficult to reconcile. While many Americans described their struggle to make ends meet, your companies were reporting windfall profits. I have little doubt that you will present a spirited defense of your record earnings, but you can understand why our Committees are concerned.

While our colleagues on the Energy Committee oversee oil production and supply, we on Commerce oversee factors that effect pricing and demand. We have three principal areas of jurisdiction in this discussion: price gouging and the role of the Federal Trade Commission, vehicle standards, and the science of energy and fuel efficiency.

In the short term effort to understand the high gas prices, I believe the FTC should play a more active role and it has the authority to do so. If it continues to pursue its role more narrowly, then Congress needs to provide further guidance and legislation defining specific authorities. As such, I am an enthusiastic, original co-sponsor of Sen. Cantwell's legislation on price gouging, and I am hopeful that our Committee will examine it soon.

Over the long term, we must address our national oil demand, which is a well-known and urgent economic vulnerability. One of the most immediate and effective steps we can take to remedy our dependence on oil is to increase the fuel efficiency standards of our cars, SUVs, and light trucks in a meaningful way. By affecting the demand side of the equation, we can help bring down the prices.

Our Committee oversees the nation's science priorities, and we can help target them towards a solution to this problem. As many experts have recommended, we can help our automakers transition, in part, through our national scientific investments. Through the research and development of advanced, lightweight, strong, composite materials as well as alternative energy sources, we can work together to create the vehicles of the future that meet—if not exceed—the new efficiency standards without sacrificing safety.

We know that oil is a finite resource, and we know that India and China's oil consumption is growing exponentially and will, at some point, exceed our own. We are all rapidly headed to the bottom of the barrel, and it is my hope that, together, we wisely prepare for this reality.

I recognize that energy independence cannot be achieved overnight, but I find it troubling that the energy companies exhibit an unmistakable reluctance to lead the nation toward an energy independent future. We do not expect you to put yourselves out of business, but we do expect you to be innovators and leaders in the effort to help create a sustainable energy future for our country.

Chairman STEVENS. The next statement will be by Senator Bingaman.

Senator Bingaman is recognized.

**STATEMENT OF HON. JEFF BINGAMAN,
U.S. SENATOR FROM NEW MEXICO**

Senator BINGAMAN. Thank you very much. I welcome the witnesses, thank them for being here, and I look forward to learning all I can at this hearing.

It strikes me that the focus of the hearing is on the high price of gas that people are paying at the pump, on the high price of natural gas and home heating oil for our homes this winter as the temperatures drop. I am sorry, frankly, that we were not able to accommodate the request I made to have a consumer representative, a representative of one of the consumer groups, on one of the panels today. I think that would have added to our discussion.

I do believe that there are some concrete steps that we need to discuss and I hope the witnesses will be able to address these. Let me mention a few. No. 1, there are eight different bills pending

here in the Senate that relate to this issue of price-gouging and whether we should have a Federal statute similar to what the State statutes that exist. It is my view that that would be an appropriate thing for us to do. I would like to see us pass such a statute before we adjourn here in the next few weeks, this session of Congress.

A second concrete idea is the Low Income Home Energy Assistance Program. We need to fund that at the fully authorized level. We have tried to do that now several times. We had a floor vote on October 5, another on October 20, and another on October 26. Each time that has been turned down. I think again we need to fully fund that program before Congress adjourns this session.

The third proposal that I would have is that we need a high-profile national public education campaign to encourage conservation. This is something that everyone seems to think is a good idea, but no one is willing to pay for. The Federal Government has not committed the funds to pay for this. As far as I know, the industry has not either. I will refer to that again in just a moment.

A fourth item I believe we need to go ahead with is the Lease Sale 181. That clearly is something that should have been done some time ago. It was on track to be done when this Administration came into office. For political reasons, for reasons related to the politics of Florida, frankly, it was put off. There is no legislative action required in order for this to be accomplished. It is strictly an administration decision and I wish they would make the decision to go ahead with that lease sale.

A fifth item, I believe we should once again get back to increased fuel efficiency in cars, trucks, and SUVs in this country. That is a subject we tried to deal with in the energy bill. We were unsuccessful. I hope we can take some action on that. Over the long term that would do a great deal of good, I believe, for our country.

Two specific things that I would just ask the witnesses to respond to: What can your companies, what can the oil and gas industry itself, do to help with this public education campaign for conservation? I think that clearly much more is needed there. Second, what help can be provided to these LIHEAP programs around the country?

Thank you very much.

Chairman STEVENS. Thank you very much.

Senator, we did have in our committee, two separate hearings on price-gouging. We have had such hearings already.

Now we are going to turn to the witnesses. The first witness will be Mr. Lee Raymond of ExxonMobil. Mr. Raymond—pardon me.

I hope all members will look at the clocks in front of them and keep track of their own time, please.

**STATEMENT OF LEE R. RAYMOND, CHAIRMAN AND CHIEF
EXECUTIVE OFFICER, EXXON MOBIL CORPORATION**

Mr. RAYMOND. Thank you, Mr. Chairman. Chairmen Domenici and Stevens, Co-Chairman Inouye, and ranking member Bingaman, and committee members: Thank you for the opportunity to discuss the important issues being raised about ExxonMobil and the industry.

The increases in energy prices following Hurricanes Katrina and Rita have put a strain on Americans' household budgets. We recognize that. After all, our customers are your constituents. And we recognize our responsibility to make energy available to them at competitive costs. It is also our responsibility to engage in an open, honest, informed debate on our energy future, grounded in reality, focused on the long term, and intent on finding viable solutions.

I would like to make three points in my allotted time. First, given the scale and long-term nature of the energy industry, there are no quick fixes and there are no short-term solutions. Second, petroleum company earnings go up and down since prices for the openly and globally traded commodities in which we deal are volatile, but our ongoing investment programs do not and they cannot if we are to meet growing energy demand. Third, as the response to Hurricanes Katrina and Rita have proved, markets work even under the most extraordinary circumstances. Permitting them to function properly is the kind of leadership required to meet the future energy challenges that we all face.

Let me elaborate on each point in turn. Currently, the world's consumers use the equivalent of 230 million barrels of oil equivalent every day from all energy sources. That is 400 million gallons an hour or 67 billion gallons a week. Because of the size and strength of the U.S. economy, Americans consume a fifth of this total, more than any other country. At current market prices, the bill for the world's petroleum consumption is more than \$2.5 trillion a year. That is greater than the U.S. Government's entire annual budget.

The petroleum companies represented here today help meet that enormous demand, but we are a relatively small part. Consider this. ExxonMobil is the world's largest nongovernment petroleum company, with a market capitalization of about \$350 billion and operations in 200 countries and territories. Almost three-quarters of our business is outside of the United States. On an average day we produce over 4 million oil equivalent barrels. That is about 3 percent of the world's daily oil and gas appetite.

It is also important to keep in mind the long-term time lines in which we operate. In politics time is measured in 2, 4, or 6 years based on the election cycle. In the energy industry time is measured in decades based on the life cycles of our projects. For example, ExxonMobil just announced first oil and gas production from our Sakhalin-1 project in Russia's Far East. We began work on the project over 10 years ago when prices were very low, and we expect it to produce for over 40 years. All told, that is more than 50 years for one project. 50 years is 25 Congresses and 12 presidential terms. 50 years ago Dwight Eisenhower was President of the United States.

So what does that mean for policymaking? It means, given the scale and long-term nature of our business, effective policies must be stable, predictable, and long-term in their focus. History teaches us that punitive measures hastily crafted in reaction to short-term market fluctuations will likely have unintended negative consequences, including creating disincentives for investment in domestic projects.

Think back to the 1970s, when we were all in an energy crisis here in this country. First price controls, then punitive taxes were tried to manage petroleum markets. They contributed to record prices, shortages, and gasoline lines. As the Government withdrew from attempting to manage the markets, prices began to come down. In fact, net of taxes, prices in real terms for petroleum products like gasoline, diesel fuel, heating oil, and jet fuel have actually declined over the last 25 years.

Which brings me to my second point: The petroleum industry's earnings are at historic highs today, but when you look at our earnings per dollar of revenue, a true apples to apples comparison, we are in line with the average of all U.S. industry. Our numbers are huge because the scale of our industry is huge.

How are these earnings used? We invest to run our global operations, to develop future supply, to advance energy-producing and saving technologies, and to meet our obligations to millions of our shareholders. Last year, with \$40 a barrel oil and high earnings, Exxon invested almost \$15 billion in new capital expenditures and more than \$600 million in research and development. In 1998, when crude prices were as low as \$10 a barrel, our earnings were lower, at about \$8 billion, but we invested \$15 billion in capital expenditures that year as well.

In fact, over the last 10 years ExxonMobil's cumulative capital and exploration expenditures exceeded our cumulative annual earnings. So when we keep investing in the future when earnings are high as well as when they are low.

The current discussion on building new grassroots refineries is interesting. Building a new refinery from scratch takes years, even if regulatory requirements are streamlined. Current refining economics are almost irrelevant to that decision. For us, a faster and more practical way to add capacity has been to expand our existing refineries. It is much more efficient because the basic infrastructure is already in place. Over the last 10 years, ExxonMobil alone has built the equivalent of three average-sized refineries through expansions in efficiency gains at existing U.S. refineries.

I should add that we would also like to invest even more in this country, especially in exploring for and producing new supplies of oil and natural gas, if there were attractive economic opportunities to do so. But the fact is that the United States is a mature oil province, domestic production is declining, and limited opportunities for new investments that have been made available to us.

Finally, my third point: Markets work if we let them. Hurricanes Katrina and Rita were a one-two punch to the petroleum industry as well as to many of your constituents. At one point some 29 percent of U.S. refining capacity was shut down. The Congressional Budget Office estimates the hurricanes caused between \$18 and \$30 billion in energy sector infrastructure losses.

But we are recovering. Our diligent and dedicated employees went above and beyond to repair the damage and get back to work. Credit also goes to the Federal Government. Release of the crude from the SPR, temporary easing of regulations such as gasoline specification and the Jones Act enabled us to reallocate resources effectively and efficiently.

But most importantly, credit goes to our free market system. The hurricanes showed that markets work even under the most extraordinary conditions. Prices for products did increase, of course, but there was no panic and no widespread shortages. Retailers responded to the short-term supply disruption, consumption decreased, and imports increased to make up the shortfall. In a word, markets worked. And letting markets work will enable us to meet our future energy challenges.

In just 25 years, global energy demand is expected to increase nearly 50 percent, with oil and natural gas needed to meet the majority of that demand. The energy industry is meeting this challenge. Government can best help by promoting a stable and predictable investment environment, reinforcing market principles, promoting global trade and efficient use of energy, and implementing and enforcing rational regulatory regimes based on sound science and cost-benefit analysis.

It is this kind of leadership that is required of all of us to meet the future energy challenges we all face.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Raymond follows:]

PREPARED STATEMENT OF LEE R. RAYMOND, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, EXXON MOBIL CORPORATION

Chairmen Domenici and Stevens, Co-Chairman Inouye, Ranking Member Bingaman, and Committee Members. Thank you for the opportunity to discuss the important issues being raised about ExxonMobil and the industry.

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It is our responsibility to engage in an open, honest, informed debate about our energy future . . . grounded in reality . . . focused on the long-term . . . and intent on finding viable solutions.

In that spirit, I would like to make three points during my allotted time.

First, given the scale and long-term nature of the energy industry, there are no quick fixes or short-term solutions.

Second, petroleum company earnings go up and down with the volatility in the openly and globally traded commodities in which we deal, but our ongoing investment programs do not—and they cannot, if we are to meet growing energy demand.

And third, as the response to Hurricanes Katrina and Rita proved, markets work, even under the most extraordinary circumstances. Permitting them to function properly is the kind of leadership required to meet the future energy challenges we all face.

Let me elaborate on each point in turn.

ENERGY INDUSTRY SCALE AND TIMELINES

As you consider energy policy—just as when we consider corporate strategy—it is essential to understand the sheer size of the petroleum industry and the extended timelines in which we operate.

Currently, the world's consumers use the equivalent of 230 million barrels of oil every day from all energy sources.¹ That's 400 million gallons an hour, or 67 billion gallons a week. Because of the size and strength of the U.S. economy, Americans consume a fifth of this total, more than any other country.

You are accustomed to dealing in large budget figures, so let me try putting it in those terms. At current market prices, the bill for the world's petroleum consumption is more than \$2.5 trillion a year. That's greater than the U.S. government's entire annual budget.

The petroleum companies represented here today help meet that enormous demand—but we are a relatively small part.

¹ExxonMobil Energy Outlook.

Consider this. ExxonMobil is the world's largest, non-government petroleum company, with over 86,000 employees, a market capitalization of about \$350 billion, and operations in 200 countries and territories. In fact, almost three-quarters of our business is outside the United States.

On an average day, we produce over 4 million oil equivalent barrels. That is about 3 percent of the world's daily oil and gas appetite.

Now, in addition to the energy industry's enormous scale, it is also important to keep in mind the long-term timelines in which we operate.

In politics, time is measured in 2, 4 or 6 years, based on the election cycle.

In the energy industry, time is measured in decades, based on the lifecycles of our projects.

For example, ExxonMobil just announced first oil and gas production from our Sakhalin-1 project in Russia's Far East. We began work on the project over 10 years ago when prices were very low, and we expect it to produce for over 40 years. All told, that's more than 50 years for one project.

Fifty years is 25 Congresses and 12 Presidential terms. It is longer than any Senator has served in the history of this body. Or think of it this way—50 years ago, Dwight Eisenhower was President.

So what does this mean for policymaking? It means, given the scale and long-term nature of our business, effective policies must be stable, predictable and long-term in their focus.

History teaches us that punitive measures, hastily crafted in reaction to short term market fluctuations, will likely have unintended negative consequences—including creating disincentives for investment in domestic projects.

Think back to the 1970s—when we were in an energy crisis in the U.S.

First price controls and then punitive taxes were tried to manage petroleum markets. In addition to contributing to the record gasoline prices consumers were paying by March 1981, they contributed to shortages and gasoline lines. As the government gradually withdrew from trying to actively manage petroleum markets, prices began to come down. In fact, if you exclude the effect of state and federal taxes, prices in real terms for petroleum products like gasoline, diesel fuel, heating oil and jet fuel have actually declined over the last 25 years.² Today's higher prices are still less than the prices that resulted from government controls in the early 1980s.

Which brings me to my second point.

EARNINGS AND INVESTMENTS

The petroleum industry's earnings are at historic highs today. But when you look at our earnings per dollar of revenue—a true apples-to-apples comparison—we are in line with the average of all U.S. industries.³ Our numbers are huge because the scale of our industry is huge.

How are these earnings used?

We invest to run our global operations, to develop future supply, to advance energy-producing and energy-saving technologies, and to meet our obligations to our millions of shareholders.

Last year, when oil prices averaged a little under \$40 a barrel and earnings were high, ExxonMobil invested almost \$15 billion in new capital expenditures and more than \$600 million in research and development.

And in 1998, when crude oil prices were much lower—as low as \$10 a barrel for a time—so were our earnings, about \$8 billion. But we invested \$15 billion in capital expenditures that year as well.

In fact, over the last 10 years, ExxonMobil's cumulative capital and exploration expenditures have exceeded our cumulative annual earnings.⁴

So, we keep investing in the future when earnings are high as well as when they are low.

If we are to continue to serve our consumers and your constituents, corporate and government leaders alike cannot afford to simply follow the ups and downs of energy prices.

We must take a longer-term view.

The current debate on building new grassroots refineries is a good example. Building a new refinery from scratch takes years—even if regulatory requirements are streamlined.

² See also: Appendixes A and B,* *Price Increase of Consumer Goods*, and *Commodity Price Increases*, respectively.

* Appendixes A-F have been retained in committee files.

³ See, Appendix C, *How Do Oil Industry Earnings Compare to Other Industries?*

⁴ See, Appendix D, *ExxonMobil Long-Term Earnings and Investment History*.

Current refining economics are almost irrelevant. And once a refinery begins operations, it takes years more for that refinery to pay back its investment.

For us, a faster, more practical and economical way to add capacity has been to expand our existing refineries. It is much more efficient because the basic infrastructure is already in place. We have invested \$3.3 billion over the last five years in our U.S. refining and supply system.

Over the last ten years, ExxonMobil alone has built the equivalent of three average-sized refineries through expansions and efficiency gains at existing U.S. refineries.

And industry-wide, while the number of refineries in the United States has been cut in half since 1981, total output from U.S. refineries is up by 27 percent over this same period, a percentage which almost exactly matches the rise in overall product demand.⁵

I should add that we would like to invest even more in this country, especially in exploring for and producing new supplies of oil and natural gas—if there were attractive, economic opportunities to do so. But the fact is the United States is a mature oil province, domestic production is declining from those areas that are accessible to the industry, and limited opportunities for new investment have been made available to us.

MARKET LEADERSHIP

Finally, my third point. Markets work—if we let them.

The response to Hurricanes Katrina and Rita proved the point. These storms were a one-two punch, to the petroleum industry as well as to many of your constituents. At one point, almost 29 percent of our domestic refining capacity was shut down, and all told, the Congressional Budget Office estimates the hurricanes caused somewhere between \$18 billion and \$30 billion in energy sector infrastructure losses.⁶

But we are recovering. Crude oil supply was quickly rerouted, refineries rapidly came back on-line, investors kept cool-headed, and production in the Gulf has been gradually restored.

Credit for this goes, in part, to the energy industry, especially our diligent and dedicated employees who went above and beyond to repair the damage and to get back to work.

Credit also goes to the Federal Government. Release of crude from the Strategic Petroleum Reserve and the temporary easing of regulations such as gasoline specifications and the Jones Act enabled us to reallocate resources effectively and efficiently. That helped.

But most importantly, credit goes to our free market system. The hurricanes showed that markets work, even under the most extraordinary conditions.

Even before the hurricanes made landfall, shippers rerouted tankers, refiners recalibrated output, traders reallocated resources, investors moved capital, and consumers began to change their consumption patterns.

Prices for products did increase, of course, but there was no panic and no widespread shortage. Retailers responded to the short-term supply disruption, consumption decreased, and imports increased to make up for the shortfall.

The remarkable recovery would not have been possible had the millions of Americans impacted by the storms—energy producers, refiners, suppliers, retailers and consumers—not had a free hand to respond. Markets enabled them to do so.

And letting markets work will enable us to meet our future energy challenges.

In just twenty-five years, global energy demand is expected to increase nearly 50 percent, with oil and natural gas needed to continue to meet a majority of that demand.⁷

An estimated 100 million barrels of oil equivalent in new production is required during this time frame, as well as an estimated \$17 trillion in new investment.⁸

To be sure, much of future demand growth will be in developing countries like China and India. But because oil is a global commodity—like corn or copper—failing to meet demand abroad means higher prices for Americans at home.

The energy industry is meeting this challenge, and will continue to do so. Government can best help by promoting a stable and predictable investment environment, reinforcing market principles, promoting global trade, promoting the efficient use of

⁵ See, Appendix E, *How Do Fewer U.S. Refineries Affect Supply?*

⁶ Statement of Douglas Holtz-Eakin, Congressional Budget Office, “*Macroeconomic and Budgetary Effects of Hurricanes Katrina and Rita*,” before the House Committee on the Budget (October 6, 2005).

⁷ See, Appendix F, *Will Energy Demand Continue to Increase?*

⁸ International Energy Agency, *World Energy Outlook* (2005).

energy, and implementing and enforcing rational regulatory regimes based on sound science and cost/benefit analyses.

It is this kind of leadership that is required of all of us to meet the future energy challenges we all face.

Thank you.

Chairman STEVENS. Thank you very much.

Our next witness is Mr. O'Reilly. I am looking for your title. We are happy to have your testimony, Mr. O'Reilly. You are chairman of Chevron.

**STATEMENT OF DAVID J. O'REILLY, CHAIRMAN AND CHIEF
EXECUTIVE OFFICER, CHEVRON CORPORATION**

Mr. O'REILLY. Thank you, Senator. Thank you, Chairmen Domenici and Stevens, ranking member Bingaman, and Co-Chair Inouye, and committee members.

I am here today representing 53,000 Chevron employees as well as millions of shareholders who have put their trust and confidence in our company, and I welcome the opportunity to talk together about working to deliver reliable energy supplies at reasonable costs to all Americans.

I would like to make several points today. First, we have seen a situation of tight supplies and growing demand for energy for several years. The recent hurricanes in the Gulf Coast magnified that situation. Secondly, Chevron is investing aggressively to increase energy supplies. Since 2002 we have invested what we have earned. Thirdly, conflicting government policies and restricted access to opportunities make it difficult to invest here in the United States. Finally, I will make a few brief suggestions as to how I believe we can work together to create a more robust climate for U.S. energy investment.

Let me provide some context which will illustrate my first point. We are here today to talk about energy prices, which came to the forefront following the hurricanes that devastated the Gulf Coast region, including the oil and gas industry. They disrupted oil and gas production, our pipeline network, and our refining and distribution operations. I personally visited our operations in the aftermath of the storm and it is difficult to appreciate the devastation in the Gulf Coast unless you have visited it firsthand.

We were fortunate that no Chevron employees lost their lives, but many hundreds lost their homes and their possessions. Nonetheless, these same employees continue to work around the clock to resume normal operations, to get supplies to market. I could not be prouder of their heroic performance in the face of unimaginable adversity.

Clearly, we experienced price volatility in the wake of the hurricanes. These price fluctuations reflected the fact that the storms shut in one-third of U.S. oil and gas production and one-fourth of U.S. refining capacity. Price volatility was also driven by localized panic buying, which led to temporary shortages of gasoline. As we began to normalize distribution and production in the days and weeks that followed, prices began to moderate.

But the more important issue is that we have been operating in a tighter supply situation for some time now. I have been talking about this for the last year and a half, but I am happy to discuss it with the committees today. Today's energy markets are being

shaped by several forces. Growing demand for energy, particularly in Asia, for example China and India, but also here in the United States, has resulted in decreased spare capacity in global crude oil supplies and the global refining system.

Oil production in mature basins, particularly in Europe and North America, has been declining. New developments are occurring, but in challenging and capital-intensive locations outside of OPEC countries, such as the deep water, the Arctic, and oil sands. Meanwhile, OPEC production has increased, but is now approaching its current capacity to deliver.

That brings me to my second point: Chevron is doing everything we can to expand and diversify the world's energy resources. We are doing it at huge cost and significant risk in some of the most challenging areas. We are doing it to assure supplies to our customers while providing a reasonable return to our investors. Since 2002 our company has invested \$32 billion in our business. During the same time period our earnings were \$32 billion. In other words, we invested what we earned.

Our investments flow to the areas of greatest opportunity and long-term return. In the United States, for example, 90 percent—that is 90 percent—of our capital program for oil and gas production is focused in the Gulf of Mexico because it is open for investment. While our investment in the United States is significant, it is important to note that about two-thirds of our capital program—that is 65 percent—is outside the United States because of the relatively limited opportunities here at home.

Investments in energy projects outside the United States also benefit U.S. consumers because they increase global supplies. However, let me give you an example of the type of inefficiencies that can occur when U.S. investment is discouraged. In our search for natural gas in the United States we have found many promising areas off-limits to development. For example, in the late 1980s we made a significant discovery of natural gas in an area of the eastern Gulf of Mexico called Destin Dome, approximately 25 miles off the coast of Florida. At the time it was estimated that Destin Dome held enough natural gas to supply one million—that is one million—American households for 30 years.

Chevron and its partners could not get the permits to develop the field because of opposition at the local level in Florida as well as a maze of regulatory and administrative barriers at the Federal level. We reluctantly relinquished the leases as part of a settlement reached with the Government in 2002.

So what actions are we taking now to supply natural gas to this market? We are co-leading a project to produce and liquefy natural gas in Angola, shipping it to an import facility in the U.S. Gulf Coast, and then piping it to the market. The customers will be the same customers who could have been supplied by natural gas just miles off the coast of Florida.

This brings me to my final point. How can we create a policy environment that stimulates more investment in energy production and allows those investments to be made more efficiently? As I have stated, the industry cannot pursue its potential in the United States without the right government policies in place. The energy bill passed earlier this year was a start, but there is more we can

do. I have offered a detailed list of policy recommendations in my written testimony, so I want to just quickly summarize four of them here.

First, the U.S. Government should open areas currently off-limits for the environmentally responsible exploration and development of oil and gas.

Second, there is a critical need to rationalize regulations that create barriers to the efficient development and operation of energy infrastructure, for example siting of LNG terminals and expansion of refineries. There is also a need to reduce the number of boutique fuels.

Third, we need to continue effective public-private partnerships that stimulate energy efficiency and research and development of potential new energy sources.

Finally, the Government should look at all of its policies—environmental, trade, and foreign policy—and ensure that they are aligned towards achieving strategic energy objectives.

Senators, I believe that if the U.S. Government can work with our industry as partners to eliminate barriers to investment, investment will follow. It is clear that the policy choices we have made in the past have had consequences. So too will the policy decisions made from this point forward. It is important that Congress and the American people recognize the choices that face us, understand their implications, and plot a constructive path forward.

Thank you for the opportunity to comment. I appreciate it.

[The prepared statement of Mr. O'Reilly follows:]

PREPARED STATEMENT OF DAVID J. O'REILLY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CHEVRON CORPORATION

INTRODUCTION

Thank you, Chairmen Domenici and Stevens, Senators Bingaman and Inouye, and Committee Members. My name is Dave O'Reilly, and I am Chairman and CEO of Chevron Corporation. I am here today representing Chevron employees as well as the shareholders who have put their trust and confidence in our company.

I welcome this opportunity to talk about working together more effectively to enhance our country's energy security and deliver reliable supplies of energy at a reasonable cost to all Americans. There are few industries more central to the vitality of the United States, or that touch more American households, than the oil and gas industry. Chevron takes this responsibility very seriously and I hope the information that I will share with you today will help you better understand the challenges we face—and the value that our industry provides to American consumers and the American economy.

Chevron is a global energy company whose roots go back 126 years to the Pacific Refining Co. in California. We are the second-largest oil and gas company based in the United States, with approximately 53,000 employees worldwide and a presence in more than 180 countries around the world. We are involved in virtually every aspect of the energy industry—from crude oil and natural gas exploration and production to the refining, marketing and transportation of petroleum products. We also have interests in petrochemicals and power generation assets and are working to develop and commercialize future energy technologies.

Let me start by providing some context. We are here today to talk about energy prices, which came to the forefront following Hurricanes Katrina, Rita and Wilma. These hurricanes were devastating to the entire Gulf Coast region, including the oil and gas industry. They disrupted oil and gas production in the Gulf of Mexico, the network of pipelines in the region and many refining operations. I personally visited our operations in the aftermath of the storms. It is difficult to appreciate the devastation created by the hurricanes until you stand on the ground in south Louisiana and Mississippi. We were fortunate that no employees of Chevron lost their lives during the hurricanes, but many hundreds of our employees lost their homes and prized possessions. Despite this huge personal loss and tremendous family disrupt-

tions, those very same employees have been working around the clock to resume normal operations as quickly as possible to get supplies to market (Attachment A;* Chevron's response). I could not be prouder of their heroic performance in the face of almost unimaginable adversity.

The hurricanes had a clearly recognized dramatic impact on the domestic energy supply infrastructure. The storms temporarily shut in almost one-third of U.S. oil and gas production and one-fourth of U.S. refining capacity. This resulted in higher prices and volatility. Price volatility at the retail pump was also driven by localized panic buying of gasoline supplies, which led to temporary shortages. Every oil and gas company in the region had difficulty resupplying the market in those first days following the storms because power outages had shut down pipeline infrastructure, crippling the ability to move supplies into impacted areas. The temporary supply shortages had ripple effects elsewhere in the United States, and in the European and Asian markets, reflecting the interdependence of global energy markets. As distribution and production began to normalize in the weeks that followed, the market began to reflect that in moderating prices (Attachment B, regular gasoline prices). However, although most of the refining capacity has been restored, as of last week approximately one million barrels per day of crude oil and five billion cubic feet per day of natural gas remained shut in while repairs to facilities severely damaged by the storms are being made. I can assure you that my company continues to do everything we can to resume normal operations on the Gulf Coast as rapidly as possible.

However, the larger and more important issue we need to address is that we have been operating in a tighter supply situation for some time now, brought about by fundamental changes in the energy equation. Growing global demand for energy, particularly from China and India but also in the United States, has resulted in decreased spare capacity in global crude oil supplies and the global refining system. Oil production in mature areas, particularly in Europe and North America, has been declining. New developments are occurring, but in challenging and capital-intensive locations, such as the deepwater, the Arctic, and oil sands in Canada and extra heavy oil in Venezuela. Meanwhile, OPEC production has been increased, but is now approaching its current capacity to deliver.

Fundamentally, today's energy prices are a reflection of the current interplay between supply and demand, as well as complex regulatory and geopolitical forces. The hurricanes magnified this underlying trend and showed how vulnerable supplies are to disruptions. These impacts were felt not only in the United States, where the hurricanes occurred, but in energy markets around the world. The tightness of supply, and global energy interdependence, are issues that I have been discussing for the past year-and-a-half with a variety of our stakeholders. I have been urging fresh new policy prescriptions in response (Attachment C, select speeches).

The aftermath of the hurricanes also highlighted challenges that are specific to the U.S. energy market—the concentration of oil and gas production in the Gulf of Mexico, the lack of spare refining capacity in the U.S. refining network (Attachment D, spare refining capacity) and the complexity of transporting numerous blends of gasoline from one part of the country to another under the current system of fuel specifications. The temporary waivers of those specifications by the Environmental Protection Agency (EPA), and numerous states, were some of the most effective actions government took following the hurricanes. This played a constructive role in alleviating regional gasoline shortages, and provided a glimpse of how regulatory reform can make markets work more efficiently.

Chevron is investing aggressively in the development of new energy supplies for American businesses and consumers and will continue to do so. We believe that the increased awareness of energy issues facing the United States provides a good framework for a discussion of steps that the industry and government can take together to create a climate for enhanced investment that promotes economic and environmentally sound production of energy supplies.

HOW DID WE GET HERE?

The energy situation in the United States today reflects a number of factors, most notably the increasing demand for transportation fuels and natural gas. But it also reflects the increasing complexity of the regulatory and permitting processes governing the industry. Numerous laws and regulations passed during the last 35 years have affected the petroleum industry. The early 1970s witnessed the passage of significant environmental legislation, the creation of the EPA, and a growing public resistance to development, i.e. "not in my backyard" (NIMBY). These were well-inten-

* Attachments A-D have been retained in committee files.

tioned initiatives that created significant benefits for the environment. But over time, even as the oil and gas industry made great advances in its environmental stewardship capabilities, these pieces of legislation promulgated hundreds of federal, state and local collateral regulations—many of which have had the consequence of limiting energy production.

The balance between regulatory benefits and economic benefits in our industry has been lost and it is time to look at ways we can restore that equilibrium.

Moratoria, for instance, have closed off access to vast areas of our offshore exploration. In the 1980s, increasing public opposition to leasing led to Congressional pressure for annual moratoria in specific areas. By 1990, individual moratoria were so numerous that President H.W. Bush declared a blanket moratorium that applied to virtually the entire United States' coastline, except for a few locations. In 1998, President Clinton extended the ban for an additional 10 years to 2012. Federal offshore drilling is currently only allowed in Mississippi, Alabama, Louisiana, Texas and parts of Alaska.

At the same time, regulatory hurdles have hindered onshore oil and gas development. The Bureau of Land Management (BLM) manages about one-eighth of U.S. land. Projects on federally-managed lands supply about 34 percent of total U.S. natural gas and 35 percent of total U.S. oil production. The majority of this land is in the western states, including Alaska. The Federal Land Policy and Management Act of 1976 (FLPMA) is the guiding legislation for BLM's management of public lands and mineral estates—the purpose being to balance a variety of competing land uses including cattle grazing, recreational use, resource development and environmental protection. Existing environmental regulations and BLM processes for oil and gas regulations make obtaining leases and permits to produce difficult. The Arctic National Wildlife Refuge (ANWR) is another area currently “off-limits” and the debate on whether to open it up for drilling has been going on for many years. As a result of government policies, responsible oil and gas development has been channeled away from Alaska, the Rocky Mountains, and offshore regions toward the more accessible areas along the Alabama, Mississippi, Louisiana and Texas coasts. For these same reasons, investment has been channeled outside the United States as well.

The refining sector too has undergone many changes as it has responded to a need to become more efficient and to comply with environmental laws. No refineries have been built since 1976 and their number has dwindled substantially, from 325 in 1981 to 148 today. Despite that drop, the overall capacity of the U.S. refining system has been steadily increasing since 1994. Current capacity stands at around 17 million barrels per day, up from 14.5 million in 1994. Refineries today are extremely efficient, operating at almost maximum capacity—nearly 95 percent. But a variety of factors make it challenging to expand current refining infrastructure:

- Historically low economic returns in the refining business.
- Timing and cumulative impact of environmental rules resulting in high costs for building new equipment.
- Delays in obtaining permits and NIMBY challenges.
- Multiple regulatory requirements to make a variety of cleaner burning gasolines, which has resulted in a proliferation of boutique fuels.
- Regulatory uncertainty regarding alternative fuels.

Together, limited access to domestic supplies and constrained refining capacity in the United States have created a situation in which the United States has become increasingly dependent on imports of all forms of petroleum. Today, the United States imports 58 percent of its crude oil requirements and 15 percent of its natural gas—compared to 42 percent of its crude oil, and eight percent of its natural gas in 1990. Imports of gasoline, jet fuel and diesel have risen from 12 percent of consumption in 1990 to 22 percent today.

At the same time, the American Petroleum Institute estimates that there are more than 131 billion barrels of oil (enough to produce gasoline for 73 million cars and fuel oil for 30 million homes for 60 years) and more than 1,027 trillion cubic feet of natural gas (enough to heat 125 million homes for 120 years) remaining to be discovered in the United States. Much of the area where this exploration and subsequent production could occur is currently off-limits.

WHAT CHEVRON IS DOING TO MEET AMERICA'S ENERGY NEEDS

Now, let me turn to what Chevron is doing to increase energy production. Where we can, we are investing aggressively all across the energy value chain. Since 2002, Chevron has invested \$32 billion in capital expenditures worldwide—compared with

\$31.6 billion in earnings for the same period. In other words, we invested more than we earned.

This year alone, Chevron's capital investment program is estimated to exceed \$10 billion worldwide. This is a 20 percent increase over our spending last year.

Highlights of our current and planned investments in the United States include:

- The \$3.5 billion Tahiti project, one of the Gulf of Mexico's largest deepwater discoveries. We have begun construction of the floating production facility to be installed there. When complete, the facility will have a capacity of 125,000 barrels per day of oil and 70 million cubic feet per day of natural gas. It is scheduled to begin production in 2008.
- A \$900 million project to develop the Blind Faith Field in the deepwater Gulf of Mexico. This field is expected to provide 30,000 barrels of oil per day and 30 million cubic feet of natural gas per day. It is scheduled to begin production in 2008.
- Continuing evaluation work on several deepwater Gulf of Mexico discoveries (e.g., Great White, Tonga, Sturgis, Tubular Bells), which have the potential to become significant investment opportunities in the future, with direct benefits for U.S. consumers.
- Stepping up to the technical challenges presented by deepwater operations in the Gulf of Mexico. In November of 2003, Transocean and Chevron announced what was at the time a new world water-depth drilling record for a well in 10,011 feet of water in the Gulf of Mexico. Also, our successful Tahiti well test completed in September 2004 in 4100 feet of water and at 25,812 feet subsea was the deepest successful well test in the history of the Gulf of Mexico.
- Proceeding with significant investments in our U.S. refineries. Since 2001, including 2005 estimates, we will have invested over \$1.5 billion in our U.S. refineries to meet various clean fuels requirements, comply with environmental regulations, maintain safe and reliable operations and increase capacity. Of that, about \$900 million was invested in our two California refineries (El Segundo and Richmond) and almost \$500 million in our Mississippi refinery (Pascagoula).
- Recent investments in our El Segundo refinery will enable us to increase gasoline production by about 10 percent. We also have begun the permitting process at our Richmond refinery to improve utilization. We expect these projects to increase our gasoline production by about seven percent at this refinery. Likewise, we have announced a significant investment for expansion at our Pascagoula refinery that will also enable increased gasoline production.
- Building Liquefied Natural Gas (LNG) projects in countries in the Atlantic and Pacific "basins", which will result in needed additional natural gas supplies for the U.S. market. To accommodate these new supplies, Chevron is pursuing a portfolio of options for LNG import terminals in North America. For example, in Mississippi we have an application with Federal Energy Regulatory Commission (FERC) to own, construct and operate an LNG import terminal near our Pascagoula refinery.
- In addition, we have committed for terminal capacity of 700 million cubic feet per day at the Sabine Pass LNG import facility currently being built in Cameron Parish, Louisiana. This is a terminal use agreement for the next 20 years.

While U.S. spending is significant, nearly 65 percent of our capital and exploratory expenditures have been directed towards investment opportunities outside the United States. As with any well-run company in any industry, our investments have gone to areas where there is opportunity to invest and earn reasonable, long-term returns for the risks taken.

But, it is inaccurate to think that investments in energy projects outside the United States do not benefit U.S. consumers. They do. Since oil is a globally-traded commodity, any investment anywhere in the world that adds to supplies tends to benefit all consumers, including those in the United States. And, while natural gas is not yet a globally-traded commodity, industry investments are rapidly moving us in that direction. Likewise, investments in global refinery capacity are generating additional supplies of petroleum products which benefit U.S. markets.

Outside the United States Chevron is investing significantly in exploration and development projects in, for example: Nigeria (oil and natural gas); Kazakhstan (oil); Angola (oil and natural gas); Australia (natural gas); Indonesia (oil and natural gas); Thailand (natural gas); Venezuela (oil and natural gas); the United Kingdom (oil and natural gas); Canada (oil); and gas-to-liquids (GTL) facilities in Nigeria, which will use natural gas to develop ultra-clean diesel fuels that will be available for world markets.

Chevron is expanding its natural gas business, which is very capital-intensive. Unless natural gas is consumed near where it is produced (and then pipelined to market), the gas must be liquefied, shipped, re-gasified, and then transported via pipeline to consumers. We have three very large projects in this category—in Angola, Nigeria and Australia—that we are working on to bring natural gas resources found outside the United States to American markets.

In our search for natural gas in the United States, we have identified many promising areas currently off-limits to development. For example, in the late 1980s, we made a significant discovery of natural gas in the Eastern Gulf of Mexico called Destin Dome, approximately 25 miles off the coast of Florida. At the time, it was estimated that Destin Dome held enough natural gas to supply one million American households for 30 years.

Chevron and its partners could not get permits to develop the field because of opposition in Florida and a maze of regulatory and administrative barriers at the federal level. After a long, expensive and frustrating effort to move forward, we relinquished the leases as part of a settlement reached with the government in 2002.

So, what actions are we taking now to supply natural gas to this market? We are co-leading a project to produce and liquefy natural gas in Angola, ship it across the Atlantic Ocean to a regasification facility in the U.S. Gulf Coast, and transport it via pipeline to the market. The customers will be those same customers in Florida and the Southeast who could have been supplied by natural gas just miles off the shore of Florida.

This is clearly not an efficient and economic use of resources for the United States, or the rest of the world for that matter. Yet it is the direct result of our historical energy policies.

Similarly, U.S. energy policies have required significant investments in refining and marketing operations in order to meet environmental and new fuel specifications. From a U.S. energy policy perspective, the focus has been on environmental and fuels investments, not on investments that add to production capacity.

Over the past decade, we have made substantial investments in projects to meet fuel specification and environmental objectives. We have invested in reformulated fuels for the California market and to prepare for additional blending of ethanol. We have invested to meet changing gasoline sulfur specifications, and new ultra-low sulfur diesel specifications to meet the requirements of new diesel engines.

Even then, meeting these requirements has not always been easy or without risk. For example, the state of Georgia and the EPA delayed implementing new fuel specifications for the city of Atlanta after our Pascagoula refinery had already invested in facilities to meet the new requirements. As another example, it took us nearly 12 months just to get the local permit to build an ethanol blending tank at our Richmond refinery in California to meet a combination of federal and state fuel requirements.

Chevron has also invested to increase the efficiency, reliability and capacity of our refining operations in the United States. In some instances, when we have debottlenecked and have added to capacity, we have had to pay severe penalties to do so. Because of the lack of clarity surrounding permitting rules, our company, along with most other majors in the industry, has had to reach settlements with the EPA over whether such routine maintenance, repair and replacement activities trigger the New Source Review permitting requirements.

In addition to the investments I have just outlined, Chevron has spent more than \$1 billion since 2000 on the next generation of energy by focusing on the pragmatic development of renewable and alternative energy sources, and the creation of more efficient ways of using the energy we already have.

Since 1992, Chevron has taken steps that have reduced companywide energy use per unit of output by 24 percent. This is the result of having strong energy efficiency strategies, and business units that develop, share and adopt energy best practices across the corporation.

Chevron has also made a successful business of developing energy efficiency solutions for the external market. Our subsidiary, Chevron Energy Solutions, is a \$200 million business that has developed energy efficiency and renewable projects for large-scale facilities operated by the U.S. Postal Service, the Department of Defense, hospitals and public schools.

Chevron is the world's largest producer of geothermal energy and we are investing sensibly but aggressively in the development of alternative fuel sources. In 2004, the U.S. Department of Energy selected Chevron to lead a consortium that will demonstrate hydrogen infrastructure and fuel-cell vehicles. Over a five-year period, the consortium will build up to six hydrogen energy service stations with fueling facilities for small fleets of fuel-cell vehicles and capacity to generate high-quality electrical power from stationary fuel cells.

Chevron is 50 percent owner of Cobasys, a manufacturer of environmentally friendly advanced batteries for applications such as hybrid electric vehicles and stationery power applications. We have made significant investments in this venture, including the construction of a factory, to help meet the growing demand for batteries in these applications. Cobasys has received battery pack purchase orders from customers for upcoming hybrid electric vehicle production programs.

Chevron has one of the largest solar photovoltaic installations in the United States, a 500 kw solar array, at our Bakersfield, California production location.

THE ROLE OF THE U.S. GOVERNMENT

Even with the investments we are making now, more is required to meet future demand for energy.

We acknowledge the work of the Congress in passing the Energy Policy Act of 2005, a start toward securing America's energy future. We believe, however, that there are additional steps that must be taken by Congress and the Administration:

- First, impediments to access for exploration should be removed. This would include ANWR, areas in the Rocky Mountain region, and Continental shelves.
- Second, the permitting process for LNG facilities, refineries, and other energy infrastructure should continue to be streamlined. There should be a coordinated, integrated and expeditious review. There should be a clearly defined and simple process with specific deadlines. One agency should be designated as accountable for meeting overall guidelines. Overlapping authority and conflicting or redundant processes should be eliminated. Also, the Federal Government should help educate state and local government, as well as the public, about the need for these facilities.
- Third, there is a need to rationalize the proliferation of boutique gasolines. The recently passed legislation by the House of Representatives contains provisions that would limit the number of boutique fuels. Rationalizing the current slate of boutique fuels is critical to improving the current supply situation by bringing fuel specifications into alignment with the regional manufacturing, supply and distribution systems. Additionally, granting EPA authority to temporarily waive and pre-empt state fuel requirements in situations like we just experienced will result in quicker response to such emergencies.
- Fourth, as with the U.S. Department of Energy's leadership and support of hydrogen projects, the Federal Government should continue to support joint ventures with private enterprise to advance technology and develop alternative energy supplies.
- Fifth, Congress and the Administration should continue to support development of clean coal and nuclear power as important sources of additional energy supplies.
- Sixth, the government should recognize the growing interdependence of energy markets and work actively with other countries to provide additional secure sources of energy and to ensure a level investment playing field across national boundaries.

THE ROAD AHEAD

Clearly, we face a significant challenge. But I would suggest that when it comes to energy policy, we should acknowledge the new equation we face and work together to develop new solutions.

Today, energy markets are globally interdependent. As a nation, we import an increasing percentage of our energy from abroad. Clearly, in the wake of this year's hurricanes, the importance of our ability to get energy supplies from abroad was critical to our recovery. In moving forward, we should recognize this interdependence as we pursue energy policies.

Historical divisions are irrelevant in the energy equation we now face. When a single hurricane can knock out nearly 10 percent of our nation's gasoline supplies, it is clear that a new approach to dealing with energy issues is needed. This is no time for a divisive, business-as-usual energy debate. The time for pragmatic and unified action is here.

The good news is that energy goals advanced by well-meaning advocates on both the supply and production side, as well as the conservation and alternative-energy side, do not have to be at odds. We saw some evidence of this when the long-awaited 2005 energy bill was signed into law by the President earlier this summer. It was a start. But the hurricanes have shown that in many respects it did not go far enough.

We need to shift the framework of the national energy dialogue to acknowledge that improving America's access to oil and natural gas, investing in new energy

sources such as hydrogen fuel cells and renewables, and developing clean coal and nuclear power sources are, in fact, complementary goals that can help create affordable, reliable energy supplies. The American public has shown in the past that when they know the facts, they will cast aside partisanship in favor of pragmatic solutions. Given the state of the country's current energy situation—constrained supplies and volatile prices—Americans deserve that kind of discussion.

So let's begin now to reframe the debate. Here are three ideas that can help guide a new national dialogue:

First, we need to begin viewing energy as an asset to be optimized, not a liability to be managed. We need to let go of the old paradigm that energy development and environmental stewardship cannot co-exist. If we use the assets we have more effectively, while also seeking to diversify our energy supply, our nation will be well on its way toward greater energy security.

Second, we need to rationalize the complex thicket of regulations and permitting requirements that is acting as a bottleneck to the efficient development and operation of energy infrastructure, particularly in the refining sector.

Third, we need to broaden the goal of energy efficiency beyond individual actions such as turning down the thermostat, as effective as they can be. The next generation of energy efficiency, which will be driven by human ingenuity and technology, must target enterprise solutions such as "smart" buildings, hybrid vehicles and the development of ultra-clean diesel fuels from natural gas. The Federal Government can play a constructive role in enabling increased investment in energy efficiency, as it did earlier this year by renewing the Energy Savings Performance Contracting Program, which enables businesses to make their facilities more efficient and then recoup the capital investment with the money saved from lower energy use.

We can do all these things. Having seen our employees respond to the hurricanes, I know Chevron is up to the challenge of helping to meet our future energy needs. America is equally up to that challenge. But it will require crossing hardened political and ideological lines toward a new national consensus on energy policy.

The interrelationship of such a policy with our national security, trade, economic, and environmental policies will have to be clearly recognized, and the necessary balances examined, debated and resolved with the understanding and support of the American public. This will require significant skill and leadership from our government.

For too long, Americans have been led to believe they can enjoy low oil and gasoline prices with less exploration and refining. The hurricanes have shown that this equation is not sustainable. As we move forward, let's not default to quick fixes, partisan solutions, or unrealistic goals. Let's be clear-headed and pragmatic. A bi-partisan, public-private commitment to these goals will help protect America from the next energy crisis, and safeguard America's quality of life.

Thank you.

Chairman STEVENS. Thank you very much, Mr. O'Reilly.

Our next witness is the chairman and CEO of ConocoPhillips, James Mulva.

**STATEMENT OF JAMES J. MULVA, CHAIRMAN AND CHIEF
EXECUTIVE OFFICER, CONOCOPHILLIPS**

Mr. MULVA. Good morning. I welcome this opportunity to demonstrate what our company, ConocoPhillips, is doing now and what we are committed to doing in the future to help the United States achieve greater energy system at an affordable cost.

Today's higher prices are a function of longer term supply and demand trends and lost energy production during the recent hurricanes. While ConocoPhillips does not expect the prices we see today to continue, we do want to give you an appreciation of the challenges that lie ahead in supplying the United States and the world's energy needs.

For example, exploration and development projects typically cost several billion dollars, but have no revenues for 7, 8, sometimes 10 years, and they have substantial technical, capital, political, and price risk. Our industry is experiencing rapid cost increases due to high steel prices and service industry costs, and also because host

governments, including the United States, limit access to reserves or make the terms too unattractive. Thus the opportunities that are available for us tend to be the more remote, complex, and higher cost type projects.

The fragile balance of world energy supply and demand was brought into sharp focus when Hurricanes Katrina and Rita disabled a major portion of America's productive capacity. Given the amounts of devastation, we believe that the energy industry did a commendable job of resuming operations as fast as humanly possible and redistributing supplies from other regions and countries, thereby avoiding a much larger supply disruption. As a testament to the industry's success, AAA reported on November 2 that gasoline prices have declined for the 26th consecutive day, to a level below where they were prior to the hurricanes.

ConocoPhillips lost one-third of its domestic refining capacity as a result of the shutdown of three of our refineries. One of our refineries is down for a week, another for 45 days, and the last is expected to resume partial operations by year's end. To increase gasoline supplies to affected areas, our company redirected supply from some of our other refineries in the United States, we deferred turnaround work at three of our other countries refineries, and imported gasoline from Europe, and we worked around the clock to resume and restore our operations.

Immediately after Katrina's and Rita's arrival, our company froze gasoline prices in the impacted States at all of our company-owned stations and convenience stores for several days and then lagged price increases in the spot market by nearly 50 percent. Essentially all of our company's gasoline marketing is done through independent marketers and, although antitrust laws prevent us from giving them specific guidance on pricing, we urged all of them to use restraint in setting their prices.

ConocoPhillips is and has always been against any form of price-gouging. If we become aware that any of our independent marketers were doing this, that would be grounds for revoking our branded name from that dealer. We know that many State attorneys general are requesting reviews and we are ready to open our records to them to show that we do not conduct, condone, or tolerate price-gouging.

ConocoPhillips reported third quarter 2005 net income of \$3.8 billion, which is up 89 percent from the same quarter last year. With respect to U.S. refining and marketing income, this segment accounts for about 33 percent of the 89 percent increase. Now, translating this increase in U.S. refining and marketing earnings to earnings per gallon sold, earnings were up 4 cents per gallon from last year, that is from 5 cents per gallon in the third quarter of 2004 to 9 cents per gallon in the third quarter of 2005.

So how is this possible when the industry average retail price for gasoline went up 67 cents per gallon from the third quarter of 2004 to the third quarter of 2005? So let me explain what happened with the 67-cent increase from one year to the next. 54 cents per gallon went for higher crude oil and feedstock costs that we must pay to run through our refineries. The oil that we purchase usually represents 85 to 90 percent of the total cost of running our refineries.

Operating and marketing costs remained flat on a per-gallon basis, while taxes increased 3 cents per gallon due to the higher earnings. In addition, 6 cents per gallon represents retail industry taxes and margins that our company is not exposed to because our U.S. marketing operations are predominantly wholesale activities. That leaves us with 4 cents per gallon additional profit, which is 6 percent of the total increase in gasoline prices from 1 year to the next.

Based on ConocoPhillips's third quarter revenues of about \$50 billion, the \$3.8 billion of income represents a profit margin of 7.7 cents per dollar of sales, near or below the average of all U.S. industry. With this level of profit in the highest price environment our industry has experienced in 22 years after adjusting for inflation, we do not see this as a windfall.

At ConocoPhillips we have ramped up our investment significantly in recent years, from \$6 billion of investment in 2003 to \$9.5 billion in 2004 to more than \$11 billion expected this year. For 2006 we are forecasting \$12 billion in capital investment. Over the last 3 years our company delivered about \$26 billion of earnings, but has reinvested over \$26 billion right back into the business to expand capacity in terms of production and refining capacity. In 2005 our company has earnings of about \$10 billion year to date, or about a billion dollars a month, but our capital investments are also close to one billion dollars a month.

ConocoPhillips has been at the forefront in recent years in growing its refining capacity. Over the past 5 years we spent \$4 billion in worldwide refining, of which \$3.2 billion was primarily spent to expand and modernize our refineries in the United States. Before the two hurricanes, we announced an incremental investment program. This is now \$4 to \$5 billion on top of our maintenance and other refinery investments of \$1 to \$2 billion per year aimed at growing our U.S. refining capacity. With these expansions and improvements, we expect to be producing 15 percent more clean fuels, such as gasoline, diesel, and heating oil, by the end of this decade. That is the equivalent of adding at least one world-scale refinery to our domestic refining system.

As the largest energy producer in Alaska, we are working closely with the State of Alaska and others to bring North Slope natural gas to the lower 48 market through a new pipeline expected to cost \$20 billion. The line will add as much as 4.5 billion cubic feet per day to the Nation's gas supply. This represents about 8 percent of current U.S. production. ConocoPhillips recently agreed in principle to the basic fiscal terms with the governor of Alaska, which is a significant step in moving this important project forward.

We are also investing aggressively in bringing liquefied natural gas, LNG, to the U.S. market. We are progressing LNG projects in Qatar, Nigeria, and aggressively pursuing projects in Russia, Venezuela, and Australia. These are all multi-billion dollar projects.

Our country sorely needs additional refining capacity, pipelines, and other critical energy infrastructure, including LNG receiving terminals. The private sector will make these investments without need of any new government incentives. However, the industry needs governments at all levels to streamline permitting and envi-

ronmental review processes so we can make these investments and add to our energy supplies.

We also encourage you to give more serious consideration to the issue of resources access. With the entire east and west coast and the eastern Gulf of Mexico and key areas in Alaska all closed to entry, it is understandable why the supply-demand balance is tight.

We also want to express support for the development of all energy sources—coal, nuclear, alternative energy—as well as conservation and efficiency standards. We will need to include all of these to diversify our supply sources and put some extra capacity back into our energy system.

We caution against advancing short-term proposals that will restrict the industry's ability to re-invest its funds on finding and producing more energy. While these make powerful headlines, the fact remains that such proposals invariably reduce investment and supplies. In addition, these proposals would hurt the competitiveness of the U.S. energy companies as we seek to compete for resources around the world.

That completes my prepared remarks. Thank you, Mr. Chairman.

[The prepared statement of Mr. Mulva follows:]

PREPARED STATEMENT OF JAMES J. MULVA, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CONOCO PHILLIPS

INTRODUCTION

Good morning, members of the energy and commerce committees. My name is James Mulva, and I serve as chairman and chief executive officer of ConocoPhillips. ConocoPhillips currently serves as chair of the American Petroleum Institute but my comments today reflect only the views of ConocoPhillips.

ConocoPhillips appreciates the invitation to testify and respond to your questions regarding the energy situation facing the United States today. ConocoPhillips fully appreciates your and the American public's concerns regarding supply availability and cost. In fact, we welcome the opportunity to demonstrate what ConocoPhillips has accomplished, and what we will continue to achieve to supply the energy required in the market place.

In this statement and when answering your questions to the best of my ability, I will from time to time express my opinions, beliefs and predictions about future events. As I'm sure you appreciate these future events are subject to risks and uncertainties, many of which are described in our public filings, which I refer you to.

Let me begin by giving you a brief description of our company. ConocoPhillips is an international, integrated energy company, headquartered in Houston, Texas and operating in 40 different countries with year-to-date September 2005 annualized revenues of \$175 billion and assets of \$104 billion. We are the third largest integrated energy company in the United States, based on market capitalization, oil and gas proved reserves and production, and the second largest refiner in the United States. But a company is more than its revenues and assets—it is its employees, shareholders and the communities it touches. We are comprised of approximately 35,800 employees, who own about 5 percent of our shares through company-sponsored benefit plans. Approximately 83 percent of ConocoPhillips' stock is owned by more than 2,000 different mutual funds, representing investments by a wide array of individuals and businesses, as well as numerous private and public pension plans.

Our investors expect a combination of growth and returns from our company. Our job is to meet these expectations by operating our facilities well and holding costs down when markets are strong or soft, and by expanding our investments when markets signal that new supplies are needed. For the last 20 years, the petroleum industry has had sub-par returns, which limited the capital available for investment. Within the past two years, the price signals have encouraged the industry to recalibrate the investment dial to higher, more aggressive levels of spending. Until recently, accelerated levels of investment were not encouraged because growing global demand could be met largely from spare oil production capacity in Russia and

in OPEC countries, and by taking advantage of spare global refining capacity and spare capacity in oilfield services and supplies. That situation has changed, and today the industry can offer the prospects of profitable growth as it steps up its investment in huge, complex energy projects around the world. We feel confident that this response will lead to a moderation of prices and increased energy security.

GLOBAL ENERGY CHALLENGES—SUPPLY/DEMAND

You have asked us here today to explain the record high prices recently observed at the gasoline pump as well as prices of other fuels such as natural gas and home heating oil. The higher prices we see today were many years in the making.

Crude oil prices are the main driver of gasoline and other product prices, as noted in a recent Federal Trade Commission report. The report indicated that over the last 20 years, changes in crude oil prices have explained 85 percent of the changes in the price of gasoline in the United States. Crude oil prices are determined in the international market by thousands of entities based on the market conditions that day.

Global crude prices have been rising since 2002 as a result of the U.S.-led global economic recovery, leading to exceptional oil demand growth and rapid industrial growth in the developing economies of Asia. Over the last decade, oil demand in China and India doubled, and is expected to double again by 2020. Strong U.S. and global economic growth are certainly desirable but the consequence of strong growth is a rise in the demand for commodities, including oil. If incremental supplies are not immediately forthcoming, then prices rise to encourage new investments, and prices have indeed risen for most commodities, including oil, in recent years.

This exceptional demand growth over the last few years has left little surplus crude oil production capacity available in the world today. Concern about geopolitical risk in various oil-producing countries in the face of limited spare production capacity has helped drive oil prices higher. While ConocoPhillips doesn't expect the prices we see today to be sustained, we do want to give you an appreciation of the challenges that lie ahead in supplying the U.S. and the world's energy needs.

Our typical exploration and development project costs several billion dollars up front and does not generate production or revenues for 7-8 years. Our projects also have high technical, capital, political and price risks. Commodity prices have always been cyclical in nature and we can't invest based on the assumption that the present price situation will persist when our projects often last for 30 years. So the first challenge is investing these large sums in an atmosphere of great price uncertainty.

Another challenge is that it takes an ever increasing amount of capital to keep production in the mature oil and gas fields in the United States and the north sea from declining. We will eventually lose this battle.

After two decades of declining costs, our industry has experienced rapid cost increases over the last five years. Some of this increase is a reflection of high steel prices and the high level of industry spending, with the oil services industry struggling to keep pace. However, costs also are rising because international oil companies don't have access to low-cost reserves, primarily because host governments, including the United States, don't allow access to reserves or make the terms too unattractive. The opportunities available to us tend to be more remote, complex, or involve lower quality crude oil that requires higher prices to be economically produced.

Resource access is a particular problem for natural gas in the United States, since the most highly prospective areas are off limits for drilling or the permitting requirements are so onerous that the prospect becomes uneconomic. Given industry decline rates of 30 percent per year in existing lower 48 natural gas wells, and the long lead times in liquefied natural gas (LNG) and arctic gas pipelines, the United States will be short of gas in the near-term. The only way to solve this problem is by making more acreage available, especially in the eastern Gulf of Mexico.

Another challenge is that much of the investment required in energy today is for energy infrastructure in consuming countries, such as refineries, liquefied natural gas receiving terminals, and pipelines. In the United States, nimby (not-in-my-backyard) sentiments have caused costly delays and even the abandonment of these important infrastructure projects.

The final challenge I would like to raise is that the petroleum industry for the last 20 years has had sub-par returns, which limited the capital available for investment. Between the difficult years of 1990 and 2002, the average return on equity for the petroleum industry was 11.3 percent, lower on average than the 12.6 percent return for the S&P 500. The refining & marketing sector has an even lower historical return on capital than the total petroleum sector. Between 1990 and 2002, the

refining and marketing sector had a return on capital employed of 5.0 percent versus 7.1 percent for the total petroleum industry.

The refining sector has been particularly challenged because so much of the capital spending has been directed toward on site environmental needs and the production of clean fuels. In addition to investing heavily to meet federally mandated fuel specifications, refineries have put substantial capital into addressing state and local boutique fuel requirements, which have added to the cost of producing gasoline and reduced the fungibility of product.

We also cannot ignore the negative impact that federal and state regulatory processes have had on discouraging new grass roots refineries. The process for siting and securing the many permits necessary for a refinery are lengthy and difficult. We have found this to be the case in our on-going efforts to expand refinery capacity at existing locations. Historically, there has been substantial excess refining capacity outside of the United States, allowing for relatively low-priced product imports. Given strong demand growth of recent years, the amount of excess capacity has been reduced, which is sending price signals globally to expand capacity. Governments also need to recognize the importance of international trade in our industry, and should avoid doing anything that might impede the free flow of crude oil, refined products, capital and people.

Given the enormous size and risk of the investments our industry is contemplating, we need an adequate return to bring these investments to fruition. Unfortunately, returns in our industry are highly cyclical. Today, we are in an up-cycle but we saw our last down-cycle as recently as 1998 when crude oil prices fell to \$11 per barrel. There will undoubtedly be another down cycle in the future, and we have to build the financial strength to withstand these even as we increase substantially our capital employed in this sector.

We want you to know that despite these enormous challenges our industry has collectively invested nearly \$380 billion in energy supplies and infrastructure over the last five years.

IMPACT OF HURRICANES

Much has been written about the devastation of Hurricanes Katrina and Rita and how they disrupted peoples' lives. The storms also provided a wake up call on the fragile balance in global energy supply and demand and the vulnerability of this country's energy infrastructure in the Gulf Coast area. The Office of Management and Budget recently estimated that the energy industry will spend somewhere between \$18 billion and \$31 billion to bring operations back on line.

Heavy damage from the two hurricanes all but closed down the refinery infrastructure in the region. Immediately after the storms, about a third of total U.S. refining capacity was not in production. Today, about 800 thousand barrels per day, or about 5 percent of total U.S. refining capacity, is still not operating. That includes some 247,000 barrels per day from ConocoPhillips' Alliance refinery, south of New Orleans, which suffered severe flooding. We expect to see Alliance back up in partial operation by year's end.

Some 100 offshore production platforms were destroyed by the storms. After hurricane Rita, nearly all of the crude oil production in the Gulf of Mexico was shut in, as was 75 percent of the industry's natural gas production. Today about 800 thousand barrels per day or about half of federal Gulf of Mexico crude oil production, and 4.7 billion cubic feet per day, or nearly half of the natural gas production remain shut in. Additionally, many other sectors of energy, including utilities and pipelines suffered significant damage from these storms. We are pleased to report that ConocoPhillips was able to restore 100 percent of its operated production within five days after Hurricane Katrina made landfall, and 97 percent of its operated production within 10 days after Hurricane Rita made landfall.

Right now, the focus of attention is supply security and price but when we look back, it will be recognized that the energy industry did a commendable job in getting the infrastructure back on its feet in a hurry, and that we avoided what could have been a much larger supply disruption. Despite the fact that the 1,100 ConocoPhillips employees were personally impacted by the hurricanes, many were immediately back working on returning our facilities to production as rapidly as possible. As a testament to industry's success in bringing in new supplies after the hurricanes, AAA reported on November 2 that gasoline prices have declined for the 26 consecutive day, and the U.S. average price, and prices in most states, are lower than they were prior to the hurricanes. The data also shows that retail prices in the Gulf Coast rose by a much smaller percentage than spot gasoline prices after both storms, demonstrating pricing restraint by the industry.

While gasoline prices were on the front page prior to the hurricanes, there is little doubt that the back-to-back storms greatly exacerbated price increases, especially in the impacted states. As a result of massive refinery shutdowns, there was an immediate increase in the spot price of gasoline. This price rise encouraged gasoline supplies from around the world to be diverted to the United States. Gasoline imports from the beginning of September through the end of October were 35 percent higher than they were during the same period last year. With increased supply, prices then readjusted downwards rapidly. This demonstrates that the market works.

Diesel supplies have proved to be more difficult to import than gasoline supplies because of the tight global diesel supply/demand balance, and particularly strong demand for diesel fuel in Europe, which prevented some product from being diverted to the United States. This also demonstrates the risks of biasing consumers towards one fuel over another. Diesel has benefited from advantageous tax treatment for decades in several European countries. As a result, diesel demand now exceeds gasoline demand, prices are rising and U.S. customers who use the same product as heating oil are paying more. Diesel market tightness in the U.S. has also been exacerbated by refineries maximizing gasoline versus diesel production to meet immediate consumer gasoline needs. As the refining industry prepares to meet the congressionally-mandated deadline for producing low-sulfur diesel by June 1, 2006, you may continue to observe erratic pricing in diesel markets next year.

There continue to be concerns about home heating oil and natural gas as we enter the winter months. Weather, and its impact on demand, will determine how prices react. The problem with natural gas is that there is still 9 percent of U.S. supply shut in and there is little additional liquefied natural gas supply available for import this winter. In fact, there have been reports of several European and Asian buyers paying U.S. price levels of \$12 per million British thermal units for spot LNG cargoes so that the cargoes wouldn't be redirected to the United States. Thus, it is important that governments at all levels encourage consumers to conserve natural gas this winter.

There will be substantial new supplies of LNG starting in 2008-2009, when the first slate of LNG projects dedicated to U.S. markets comes on line. However, it should be noted that virtually all of the LNG receiving terminals currently being constructed are in the western Gulf of Mexico. Given our recent experiences with hurricanes, it would seem prudent to also build some of the LNG terminals on the east and west coasts.

OUR RESPONSE—HURRICANE IMPACTED SUPPLIES AND PRICES

ConocoPhillips, one of the largest refiners in the United States, temporarily lost one-third of its domestic capacity as the result of the shutdown of three refineries. Of the three refineries, one was down for about one week, another for 45 days and the alliance refinery mentioned previously is expected to be back up in partial operation by year end.

I am proud of the performance of our employees as they handled this supply short fall. We carefully managed our limited, available gasoline and diesel inventories to ensure that local and federal emergency responders were given top supply priority within the areas impacted by the hurricanes.

To increase gasoline supplies to affected areas, ConocoPhillips redirected supply from some of its other refineries, deferred turnaround work at three other company refineries, imported gasoline from Europe, and worked around the clock to safely restore operations. Affected ConocoPhillips plants worked diligently to restore temporary power and operations that allowed rapid blending and shipping of all available products stranded in storage just prior to the hurricanes.

With respect to diesel, when all three of our refineries were down, we lost 200,000 barrels per day of diesel production. This created a shortage and severely limited our ability to supply our normal spot and term diesel customers in Texas, the Southeast and Oklahoma. We couldn't import a significant volume of diesel fuel because of the strong demand in Europe, and because of the limited import capability on the Gulf Coast. To help balance available supply with demand, ConocoPhillips had to discontinue all discretionary spot sales and purchase additional supplies on the spot market to fulfill all of our term contracts.

Getting two 100-year hurricanes in four weeks that temporarily shut down 30 percent of the nation's refining capacity led to product price increases in the physical and financial markets. But immediately after Katrina's and Rita's arrival, ConocoPhillips froze gasoline prices in the impacted states at all company-owned stations and convenience stores for a few days, and then lagged price increases in the spot market by nearly 50 percent. We also requested our independent marketers to use restraint in setting prices and not to do anything to tarnish our branded

name. Essentially all of ConocoPhillips' branded sales are done through independent marketers. Anti-trust laws prevent us from giving our independent marketers any specific guidance on pricing. We only own 350 outlets in the United States, which represents three percent of ConocoPhillips' refining capacity. At no time did we lead price increases; we showed restraint and intentionally lagged behind prices in the financial and physical markets.

The petroleum industry has routinely been accused of price gouging whenever there are sudden changes in oil and natural gas prices. In a report published earlier this year, the Federal Trade Commission stated that the vast majority of its investigations have revealed market factors to be the primary drivers of both price increases and price spikes. ConocoPhillips is and has always been against any form of price gouging. If we became aware that any of our independent marketers were doing this, that would be grounds for revoking our branded name from that dealer. We know that many state attorney generals are requesting reviews, and we are ready to open our records to them to show that we do not conduct, condone or tolerate price gouging.

EARNINGS AND INVESTMENTS

Since there has been a lot of focus on energy company earnings in the third quarter, we want to explain our earnings and how much of them we have reinvested.

COP reported third-quarter 2005 net income of \$3.8 billion, up 89 percent from this quarter last year. 48 percent of this increase comes from our worldwide oil and gas exploration and production operations, 38 percent of this increase comes from our worldwide refining and marketing operations and 15 percent comes from our strategic alliance with LUKOIL, which we entered into during the fourth quarter of 2004.

With respect to U.S. refining & marketing income, this income represents 33 percent of the 89 percent increase. Earnings from our U.S. refining and marketing operations were about \$1.1 billion in the third quarter of 2005, compared with \$505 million a year ago. Earnings per gallon sold were only up 4 cents per gallon from last year, from 5 cents per gallon in third-quarter 2004 to 9 cents per gallon in third-quarter 2005.

The industry average retail price for gasoline went up 67 cents per gallon from third quarter 2004 to third quarter 2005 (\$1.93 per gallon to \$2.60 per gallon). Contrasting the retail price increase with ConocoPhillips' 4 cent per gallon increase, begs the question:

Where did all of this difference go?

- 54 cents per gallon went for higher crude oil and feedstock costs that we must pay to run through our refineries. Normally, the oil that we purchase represents 85 to 90 percent of the total cost of running our refineries.
- operating and marketing costs remained flat on a per gallon basis, while taxes increased 3 cents per gallon due to higher earnings.
- in addition, 6 cents per gallon represents retail industry taxes and margins that ConocoPhillips is not exposed to because our U.S. marketing operations are predominately wholesale activities.
- that leaves 4 cents per gallon profit or 6 percent total increase in the gasoline price.

ConocoPhillips' third-quarter revenues of about \$50 billion generated about \$3.8 billion of income. This represents a profit margin of 7.7 cents per dollar of sales, near or below the average of all industries. With this level of profit in the highest price environment our industry has experienced in 22 years, adjusted for inflation, we don't see a windfall.

We also fear that people are mistaking the size of our earnings for a windfall, not realizing the enormous levels of investment required to achieve those earnings and bring new energy supplies to the market.

Let me tell you how much ConocoPhillips is investing, and the rate which spending has ramped up in recent years. ConocoPhillips invested about \$6 billion in 2003, growing to \$9.5 billion in 2004, an estimated \$11.4 billion in 2005 (annualized year-to-date third-quarter actuals) and \$12 billion forecasted in 2006, which is double the 2003 level.

ConocoPhillips has been investing its earnings back into maintaining and expanding supplies. We have had 2005 earnings of about \$10 billion year-to-date—about \$1 billion a month, but our capital investments are also close to \$1 billion a month. In fact, over a three-year timeframe, using 2003-2004 reported results and 2005 annualized year-to-date third-quarter actuals, ConocoPhillips earnings are about \$26 billion but investments are just over \$26 billion. In 2006, we intend to increase

our capital spending despite the fact that we expect to have a lower price environment, increased cost pressure and lower earnings.

OUR INVESTMENT STORY

ConocoPhillips has been aggressively investing in refining, and in developing new natural gas supplies for the United States. The projects described below are all very large and will require significant capital expenditures in the future.

Industry analysts, some of whom questioned the economics of our decisions, will tell you that we have been at the forefront in recent years in growing the company's refining business when most of our competitors were focusing on exploration and production. Over the past five years, ConocoPhillips has spent \$4.0 billion worldwide, of which \$3.2 billion was spent domestically, to expand and modernize our refineries and upgrade marketing operations.

Going forward, we are planning an expanded incremental investment program, whereby we expect to invest \$4-5 billion, on top of our maintenance and other refinery investments of \$1-2 billion per year. This investment program is aimed at growing our U.S. refining capacity by about 11 percent and improving our capability of handling lower quality oils in order to make 15 percent more clean fuels such as gasoline, diesel and heating oil by 2011. These expansions will add enough clean fuels product to be the equivalent of adding one world scale refinery to our domestic refining system.

ConocoPhillips will continue to be proactive and we applaud industry efforts to expand capacity and add new refineries. We do not need any new government incentives to make these investments. However, we do need thorough—but expedited—permitting and regulatory environmental reviews so we can quickly make the investments, thereby adding capacity and refined product supply.

ConocoPhillips is making major investments in North American arctic natural gas through the Mackenzie Delta pipeline and Alaskan North Slope pipelines. The initial development of the Mackenzie Delta will access 6 trillion cubic feet of gas, which is expected to come on stream in 2011 at approximately 1 billion cubic feet per day. As other fields are added, the pipeline will have the capacity to be expanded to 1.8 billion cubic feet per day. The total cost of this pipeline is estimated to be at least \$6 billion.

The Alaskan North Slope presently has an estimated 35 trillion cubic feet of natural gas, which would increase total U.S. gas reserves by approximately 20 percent. When the pipeline connecting this gas with the lower 48 market is completed, about 4.0-4.5 billion cubic feet per day will be added to natural gas supplies. This equates to about 8 percent of present U.S. natural gas production. This project exemplifies what we have been saying about capital intensive projects that require many years before we see a return on the investment. The Alaska pipeline alone is expected to cost about \$20 billion and take ten years before the first cubic foot of gas is sold on the market. Two weeks ago, ConocoPhillips joined Governor Murkowski of Alaska in announcing that we have reached an agreement in principle on terms and conditions that would move the Alaskan natural gas pipeline closer to reality. Once agreement is completed by all gas owners, the Alaska legislature will, hopefully, act on that agreement, passing it quickly. While it is not a short term solution, gas from Alaska will, eventually, make a sizable contribution in addressing the market problems we are anticipating for natural gas.

ConocoPhillips is also investing aggressively in bringing liquefied natural gas (LNG) to the U.S. market. We are progressing LNG projects in Qatar and Nigeria and aggressively pursuing projects in Russia, Venezuela and Australia. These are all multi-billion dollar projects. We will bring our first cargo of Qatari gas to the United States in 2009. We are also developing an LNG supertanker to bring gas to the United States. We are participating in the construction of an LNG regasification facility at Freeport, Texas. We are pursuing a second LNG regasification terminal in Compass Port, offshore Alabama, although it is currently bogged down in the permitting process. We are committed to making the investments in these two facilities, which total over \$1.5 billion. We are also pursuing permitting of regasification facilities on the east and west coasts as well as an additional Gulf Coast terminal.

To bolster U.S. and global oil supplies, ConocoPhillips is expanding conventional crude production in Venezuela, Russia and the Far East. There is likely to be a bridge of unconventional heavy oil and natural gas before the world transitions to alternative fuels in a large way. ConocoPhillips has invested and continues to invest heavily in unconventional heavy oil production in Venezuela and Canada. Our company announced just last week that we will be partnering with a Canadian company to develop the \$2.1 billion Keystone pipeline, which will bring over 400 thousand

barrels per day of much needed Canadian heavy oil production to our U.S. mid-continent refineries.

There is an estimated 7 trillion barrels of unconventional heavy oil in place versus conventional estimates of 3 trillion barrels. Technology improvement will be important in raising the present low recovery rates of unconventional heavy oil. We are also building additional upgrading capacity in our refineries to process unconventional heavy crude. We have also developed technology for turning natural gas into a slate of clean refined oil products, which will enhance clean diesel supplies.

As for alternative energy sources, ConocoPhillips is presently focused more on research and development and monitoring versus making large capital investments, given the tremendous uncertainty about which technologies will be accepted in the market place and how much their cost can be reduced so they can compete with conventional forms of energy. However, we recently had a successful experiment with renewable diesel, and we are conducting other tests to evaluate technologies to produce gasoline and other liquid fuels from non-petroleum feedstock. We are cognizant of U.S. Department of Energy and International Energy Agency projections that the market share of renewable fuels, including hydropower, will likely be less than 14 percent by 2025-2030 due to the technological, economic and environmental challenges of most of these alternatives.

AVOIDING FUTURE SUPPLY DISRUPTIONS & PRICE RUN UPS

Before we get to solutions for supply and price issues, we would like to point out that you can not completely avoid supply disruptions and price run ups when you have incidents such as two 100-year back-to-back hurricanes and massive shut-downs of energy infrastructure. However, the industry and markets do respond rapidly, although never as quickly as the consumer would like. And even after these devastating hurricanes, prices are now below where they were before the storms. Market forces work and interfering with the market would exacerbate supply short falls and stifle investment. And representing a company who participates in the market every day, I can't say it more emphatically—ConocoPhillips will not condone or tolerate price gouging.

What this country sorely needs is additional refining capacity, pipelines, and other critical energy infrastructure. The private sector will likely make these investments without need of any new government incentives. However, the industry does need governments at all levels to be thorough—but at the same time—to streamline permitting and environmental review processes so we can make these investments and add energy supplies.

Our company would also support moving away from “boutique” fuels to more standardization of refined products. This will make it easier to redistribute products during times of shortage and should reduce price volatility in normal market conditions.

Our company is particularly concerned about permitting and the NIMBY issues associated with building new LNG receiving terminals. LNG offers the most promising option for meeting the growing natural gas needs of American consumers in the near term. ConocoPhillips and other companies here today have searched the four corners of the globe to find and contract for new sources of LNG to bring to the U.S. market. We have made these arrangements on the premise that there will be regasification terminals built and ready when the gas arrives. But, the permitting and approval of new regasification terminals is occurring significantly slower than we expected and many are being delayed or may be cancelled, altogether, due to the “NIMBY” or “not in my back yard” attitude that exists in many communities where they are planned.

The siting of LNG terminals was addressed in earlier energy policy legislation. However, Washington, the states and the individual localities where these facilities are planned need to have continued dialogue and cooperation on siting issues. There also needs to be better cooperation among the various federal agencies charged with evaluating and permitting these facilities. If America does not secure these badly-needed supplies, you can be sure that companies representing other nations that are hungry for new energy supplies will step in and secure available LNG supplies in the not-too-distant future.

If you asked us what you could do that would have the greatest positive impact on supplies, it would be to give more serious consideration to the issue of access to resources. Let me emphasize that ConocoPhillips is not pursuing the opening of national parks, the Everglades and other such sensitive areas to energy development. But with the entire east and west coasts, the eastern Gulf of Mexico and key areas in Alaska all closed to entry, it is understandable why supply/demand is tight. The industry's only access to new offshore development remains the central and western

Gulf of Mexico. Immediately after the hurricanes, industry was criticized by some members of Congress for concentrating too much of its resources in the Gulf region. We are concentrated there because that is where the available resources are and that is where policies from Congress have kept us.

The eastern Gulf of Mexico probably has more natural gas potential for consumers than about any place in the lower 48 states. When Outer Continental Shelf Lease Sale 181 was withdrawn from development, another key prospect for finding badly-needed natural gas reserves was removed from consideration. We would encourage the Senate to consider reinstating that sale and revisiting access in other areas. Our industry has the technological know-how and the track record necessary to protect Florida's treasures and, at the same time, explore and produce in the eastern gulf in a safe and environmentally-responsible manner.

The Rocky Mountain region of the country is another area where new natural gas production can make a difference. But the leasing and permitting process has hampered development in areas such as the San Juan basin of New Mexico and the Powder River basin to the north. Funding and staffing appears to be improving but continues to be a key problem in these areas. Local BLM personnel are doing a commendable job with what they have but more funding for permitting and related staffing must be directed to those areas.

The last area that we wanted to express support for was the development of all energy sources—coal, nuclear, alternative energy with appropriate environmental safeguards—as well as conservation and efficiency standards. We will need to include all of these to diversify supply sources and put some needed slack back in our system.

These are the areas where we need your help to better enable us to meet the energy demands of America and help our country continue to grow. What we do not need are ideas that sound good to some but have never worked and invariably reduce investment and supplies. We are against windfall profit taxes, price controls and mandatory allocations.

According to a 1990 report of the Congressional Research Service, the windfall profits tax that was signed into law in 1980 and repealed in 1988 drained \$79 billion in industry revenues during the 1980s that could have been used to invest in new oil production—leading to 1.6 billion fewer barrels of oil being produced in the U.S. from 1980-1988. The tax reduced domestic oil production as much as 6 percent, and increased oil imports as much as 16 percent. In addition, this tax would not take into account the significantly higher costs the industry is facing today.

Finally, any tax that drains investment dollars from U.S. oil companies reduces their ability to compete with foreign companies. Of the world's currently known conventional oil and gas reserves, only 7 percent is held by the international oil companies. This means America's energy companies face a tremendous challenge in gaining access to large, reliable sources of oil and gas around the world. Federal tax policies that jeopardize the competitive strength of America's energy representatives could weaken our ability to meet the nation's needs now, and for years to come.

We are not in favor of any special taxes levied on our industry to support the Low Income Home Energy Assistance Program (LIHEAP). While we believe this is a very worthy program, we think it is a bad precedent to have private industry support a federally-funded program. In addition, this will reduce the level of investment we will be able to make, thereby reducing the development of new supplies.

We agree there is a need for added supply and we want to participate in providing it. Levying additional taxes will obstruct our ability to do that. There is a direct correlation between energy investment and energy supply.

Our company and the industry are fully aware of the public distrust and concern about the rapid rise in energy prices. However, the higher prices were caused in part by sub-par returns that led to under-investment in the energy sector for several decades. Only now are returns approaching levels that economically justify a major step up in energy investments, and there is no guarantee that current return levels will persist over the life of the investment. We are making the necessary investments in added production and refining capacity but are concerned that proposed legislation will hinder our ability to make future investments.

CONCLUSION

Meeting U.S. and global energy needs over the next 30 years will require a tremendous amount of investment. The International Energy Agency calculated that \$16 trillion would be required to meet global energy needs and \$3.5 trillion would be needed to meet U.S. energy needs. We need to work together to meet such an enormous challenge. Our industry should do what we do best—finding new energy supplies and bringing them to the market. We ask that you do what you do best

. . . help American companies stay strong competitors in the global energy market . . . and streamline the regulatory processes and remove other barriers that discourage energy investment at home.

I would like to commend Chairmen Domenici and Stevens for your committees' tireless efforts over the past few years to address energy policy. The legislation that has been enacted, thus far, is a notable start in addressing the energy needs of this country. But there is more work to be done in removing barriers to investment.

We need to have better communication and work more closely in a transparent way with key stakeholders—governments and consumers—to develop a sound long-term energy program, which we have not had for many decades. This program needs to stress investment, supply expansion, conservation and alternative energy sources. Our company plans to play a proactive role in meeting U.S. and global energy challenges and looks forward to working with you to achieve this mutual goal.

Chairman STEVENS. Thank you very much.

Our next witness is Mr. Ross Pillari, chairman and chief executive officer of British Petroleum America.

Mr. Pillari.

STATEMENT OF ROSS J. PILLARI, PRESIDENT AND CEO, BP AMERICA, INC.

Mr. PILLARI. Thank you. Good morning, Chairmen Stevens and Domenici and members of both committees. As I have submitted my written comments for the record, I will just summarize the key points in my oral comments this morning.

BP America employs 40,000 people in the United States and we are a major producer of crude oil and natural gas. We operate five refineries and supply gasoline and distillate fuels in 35 States.

As you have already heard, 2005 has been an unusual and challenging year for our industry and company, both in the United States and around the world. We have experienced very tight supply-demand in global crude oil markets, resulting in high crude oil prices. This tightness reflects strong economic growth and increased demand throughout the world, particularly in the Far East.

Combined with reduced production from Iraq and Venezuela at times this year, the overall impact on crude supply was a reduction in the historical excess crude oil capacity by nearly two-thirds, to less than one million barrels per day, significantly impacting the price of crude oil.

In the second half of the year, the refined product supply-demand picture was also affected by a series of natural disasters in the world, including Hurricanes Katrina and Rita here in the United States. These disruptions to refinery production and logistics infrastructure resulted in a sharp increase in finished product prices. Markets with disrupted supply sources sought to attract supply from unaffected areas of the United States and the world product markets.

There has been extensive media coverage and analysis of the impact the hurricanes have had on the communities in the Gulf Coast region. The difficulties faced by these areas in the recovery continues to be a concern for all of us. BP operations in the affected areas, particularly in Texas and Louisiana, were also severely impacted. Producing platforms, pipelines, and terminals in the Gulf of Mexico were shut down during the most severe periods of the storms, suffering damage and lost production. Onshore distribution facilities were damaged by both storms, resulting in an interruption to logistics, infrastructure, and refinery supply.

Refineries had to be shut down or curtailed and thousands of employees were displaced from their homes. We estimate that our lost production was nearly 135,000 barrels per day in the third quarter and nearly 160,000 barrels a day of oil equivalent in the fourth quarter, and that damage to our facilities will clearly be in the tens of millions of dollars.

We do expect most of the BP-operated production facilities to be back onstream by year end. Importantly, the severe impact of these storms made it impossible to respond as quickly as we would have liked to the immediate needs of many of our customers and communities. Displaced staff, utility outages, damaged equipment, and the inability to operate terminals and refineries in many of the affected areas hampered initial recovery efforts.

In the face of these unusual external conditions, the market response was what you would expect in a global commodity market. Available product supplies were bid up as demand exceeded supply. Geographic areas not affected by the hurricanes experienced increased demand from buyers looking to move supply to the storm-damaged areas, causing upward price movement in both the storm-damaged and the unaffected areas. Product prices in Europe also increased as domestic marketers began importing product immediately to meet demand in the United States.

Consequently, while consumers experienced difficult and rapid increases in prices throughout the country, these same increases resulted in a market that was able to attract supply.

We recognized these effects are not desirable for our customers and we made every effort to increase supplies and minimize the extent of these disruptions. We regret any continuing problems and are working diligently to solve them.

In recent weeks, fuel prices have dropped dramatically, down to levels similar to last spring, reflecting the increased supplies arriving from unaffected areas, including the global markets. Additional supplies will reach the market as Gulf Coast refinery operations return to normal and we would expect the market to react again.

Specific actions taken by BP in response to the storms included: providing housing, transportation, and temporary relocation for employees and their families displaced by the storms; we prioritized fuel deliveries to emergency service and health organizations; contributed to date over \$12 million to relief agencies in all of the affected areas; we have imported over 30 million barrels of gasoline, diesel, and jet fuel for delivery into markets in the Northeast, Florida, and the Gulf Coast. We have reversed the pipeline at our Texas City refinery dock to accept marine shipments and deliver imported product into the Colonial pipeline. We have arranged offshore loading from platforms to permit delivery of crude oil while awaiting the startup of pipeline operations.

I would like to note that recovery of offshore operations was greatly aided by government response to requests for expedited permits and waivers. At retail, the Government support of temporary fuel spec waivers allowed us to redistribute available fuels to the most distressed areas. We are very grateful for this support.

In recent months, our efforts have been focused on repairing our facilities and returning to normal operations. In the future we look forward to continuing to invest and build on our extensive U.S.

asset base. In the last 5 years, the BP group has averaged \$13 to \$15 billion each year in new capital investment. The largest single placement of that investment, approximately \$31 billion or roughly half of our global total investment, has been here in the United States.

Our non-U.S. investment is also important to the United States as it provides secure options for incremental supply. This is particularly important in times of market disruptions, as seen recently with the hurricanes. For example, BP was able to quickly bring fuel from our Rotterdam refinery to the East and Gulf Coast markets immediately following the storms.

Our U.S. investments have included continued expenditures in mature operations, such as \$700 million per year in Alaskan North Slope field, a 30 percent increase in lower 48 natural gas investment over the last 2 years to nearly \$1.5 billion already this year, and over \$650 million per year in refinery investment.

For the future, we see continued opportunities to invest in the United States. Projects currently announced include: \$2 billion for new development and infill drilling in the Wamsutter natural gas field in Wyoming, increases U.S. natural gas supplies; two proposed LNG projects, one on the east coast and one on the Gulf Coast, at a cost of nearly \$1.2 billion. These projects will allow us to further access our natural gas position in Trinidad and elsewhere in the world and bring this product to the United States. Nearly \$2 billion planned spend to increase the use of Canadian heavy oil and improve our upgrading capability in BP's refineries here in the United States, which also provides a secure North American source of crude oil supply.

We plan to invest over \$2 billion per year over the rest of the decade as part of our continuing program to invest a total of over \$15 billion in exploration and production in the Gulf of Mexico. We also plan to invest in our share of the nearly \$20 billion Alaska natural gas pipeline to bring Alaskan gas to the lower 48.

Also, outside of the normal oil and gas area, over the past 5 years we have invested more than \$500 million in our solar and alternative energy business and continue to see this as a growing area of importance for our company and the country.

In closing, we believe the events of 2005 reflect unusual challenges to the global markets for oil and gas. We know we have a responsibility to help meet these challenges and we have been working hard to fulfil that role. BP has a long history of business activity and significant investments in the United States. We will continue to offer quality products, enhanced energy options, and continue to invest in support of our customers and the energy needs of the Nation.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Pillari follows:]

PREPARED STATEMENT OF ROSS J. PILLARI, PRESIDENT AND CEO, BP AMERICA, INC.

My name is Ross Pillari and I am President and CEO of BP America. BP America is the U.S. holding company for the BP Group. BP America employs 40,000 people and produces 666,000 barrels of crude oil and 2.7 billion cubic feet of natural gas per day. We operate five refineries that process nearly 1.5 million barrels a day of crude oil, and a system of pipelines and terminals throughout the United States

that supply over 70 million gallons per day of gasoline and distillate fuels to customers in 35 states.

2005 has been an unusual and challenging year for our industry, both in the United States and around the world. We have experienced very tight supply/demand in global crude oil markets resulting in high crude oil prices. The tightness reflects the continued growth in demand in the Far East combined with strong global economic growth. Together with reduced supply from Iraq and Venezuela, the overall impact on crude supply in 2005 was a reduction in the historical excess crude oil capacity by nearly two thirds to less than one million barrels per day. During the year, crude oil prices ranged from \$45 per barrel WTI early in the year to nearly \$70 per barrel WTI in the third quarter and are now again near \$60 per barrel WTI as supplies are more in balance with demand.

In the second half of the year, the refined product supply/demand picture was also affected by a series of natural disasters in the world including Hurricanes Katrina and Rita here in the United States. These disruptions to refinery production and logistics infrastructure resulted in a sharp increase in finished product prices as markets with disrupted supply sources sought to attract supply from unaffected areas of the United States and the world product markets.

There has been extensive media coverage and analysis of the impacts the hurricanes have had on the communities in the Gulf Coast Region. The difficulties faced by these areas, and their recovery continues to be a concern for all of us.

Many BP employees were directly affected by the storms including the need to evacuate, and in many cases the loss of their homes and property. BP operations in the affected areas, particularly Texas and Louisiana were severely impacted. Producing platforms for both oil and gas in the Gulf of Mexico were shut down during the most severe periods of the storms, suffering damage and lost production. Underwater pipelines and onshore distribution facilities were damaged by both storms resulting in a logistical interruption to refinery supply. Refineries had to be shut down or curtailed and thousands of employees were temporarily displaced from their homes.

The impact of these extraordinary storms on our operations has not yet been fully determined but we estimate that lost production was nearly 135 thousand barrels of oil equivalent a day during the third quarter and nearly 160 thousand barrels a day of oil equivalent in the fourth quarter, and that damage to our facilities will be in the millions of dollars. We expect most of the BP operated production facilities to be back on stream by year end.

More importantly, the severe impact of these storms made it impossible to respond as quickly as we would have liked to the immediate needs of many of our customers and communities. Displaced staff, utility outages, damaged equipment and the inability to operate terminals and refineries in many of the affected areas hampered initial recovery efforts.

In the face of these unusual external conditions, the market response was what you would expect in a global commodity market. Available product supplies were bid up as demand exceeded supply. Geographic areas not affected by the hurricanes experienced increased demand from buyers looking to move supply to the affected areas causing upward price movement in both the storm damaged and the unaffected areas. The rest of the world was also impacted. Product prices in Europe increased as domestic marketers began importing product to meet demand in the United States.

Consequently, while consumers experienced difficult and rapid increases in prices throughout the country, these same increases resulted in a market that was able to attract supply and minimize large scale supply disruption. We recognize these affects are not desirable for us or our customers, and we made every effort to increase supplies and minimize the extent of the disruptions. We regret any continuing problems and are working diligently to solve them.

In recent weeks, fuel prices have dropped down to levels similar to last spring, as the market has shown the balancing effect expected when supply moves to meet demand. The market has attracted increased supplies from unaffected areas including the global markets and the price has fallen to reflect the market driven supply/demand equilibrium. Additional supplies will reach the market as Gulf Coast refinery operations return to normal.

In addition to the expected workings of the market, the industry responded to the crisis by adjusting its operations to meet the circumstances and restrictions created by the storms.

Specific actions taken by BP in response to these conditions include:

- Provided housing, transportation and temporary relocation for employees and their families displaced by the storms.

- Identified emergency service and health organizations and prioritized fuel deliveries to meet their needs.
- Contributed, to date, over \$12 million to relief agencies in all of the affected areas (from BP, employees and branded partners).
- Imported over 30 million barrels of gasoline, diesel and jet fuel for delivery into markets in the Northeast, Florida and the Gulf Coast.
- Reversed a pipeline at our Texas City refinery dock to accept marine shipments and deliver product into the Colonial Pipeline while the refinery recovers from the storm damage.
- Optimized the use of available supplies of boutique fuels through waivers of fuel content requirements to help meet the needs of highly impacted areas.
- Arranged offshore loading from platforms to permit delivery of crude oil in the face of pipeline interruption.

Recovery of offshore operations was greatly aided by government response to requests for expedited permits and waivers. On the downstream side, the government's support of temporary waivers of fuel specifications allowed us to redistribute available fuels to the most distressed areas.

While some areas continue to have tight supplies, including unfortunately, occasional runouts, the supply situation is returning to normal and as noted above, prices at the wholesale and retail level are returning to levels similar to earlier this year.

In recent months, our efforts have been focused on repairing our facilities and returning to normal operations. But, it is important to recognize that BP has continued to maintain and grow a significant base of United States production and refining assets.

In the last five years, the BP Group has averaged \$13 to \$15 billion each year (excluding acquisitions) in new capital investment. The largest single placement of that investment, approximately \$31 billion or roughly half of our global total investment, has been here in the United States.

It is important to recognize the global nature of oil markets, means that investment outside of the United States significantly affects our nations crude and product availability by creating secure options for supply. This is particularly important in times of market disruptions as seen recently with the hurricanes. For example, BP was able to quickly bring fuels from our Rotterdam Refinery in the Netherlands to the East and Gulf Coast markets.

Our investments in the United States, of \$6 billion per year, have included continued expenditures in mature operations such as \$700 million per year in Alaskan North Slope fields, a 30 percent increase in lower-48 natural gas fields over the last two years to \$1.5 billion this year, and over \$650 million per year in refinery investments. Additional investments have also been made to maintain terminal and pipeline capability and to meet new regulations affecting distribution and marketing.

For the future, we see continued opportunities to invest in the United States. Projects currently announced include:

- \$2 billion for new development and infill drilling in the Wamsutter natural gas field in Wyoming. This investment is expected to double BP's net production to 250 million standard cubic feet by the end of the decade.
- Two proposed LNG projects, one on the East Coast and one on the Gulf Coast at a cost of \$1.2 billion. These projects will allow us to access our natural gas position in Trinidad and elsewhere in the world; and if approved, potentially add 2.4 billion cubic feet send out capacity to supply markets in the United States.
- \$2 billion planned spend, to increase the use of Canadian heavy oil and improve our upgrading capability in BP's refineries, also securing a North American source of crude oil supply.
- \$2 billion per year sanctioned investment through the rest of the decade as a part of our continuing program to invest over \$15 billion in exploration and production in the Gulf of Mexico.
- BP has publicly announced its intention to participate in the nearly \$20 billion Alaskan Natural Gas Pipeline to bring Alaskan gas to the lower 48. We, together with other interested parties, are nearing completion of a commercial agreement with the State of Alaska.
- Over the past five years, we have invested more than \$500 million in our solar and alternative energy business and continue to see this as a growing area of importance.

In closing, we believe the events of 2005 reflect unusual challenges to the global markets for oil and gas. We know we have a responsibility to help meet these chal-

lenges and we are working hard to fulfill the role we play in helping the nation recover from these extraordinary events.

BP has a long history of business activity and significant investments in the United States. We will continue to offer quality products, enhanced energy options and invest in support of our customers and the energy needs of the nation.

Chairman STEVENS. Thank you very much, Mr. Pillari.

Our next witness is John Hofmeister, president and chair of the Shell Oil Company of America.

STATEMENT OF JOHN HOFMEISTER, PRESIDENT, SHELL OIL COMPANY

Mr. HOFMEISTER. Mr. Chairman, members of the committee: Thank you for the opportunity to be here. I would like to discuss the energy issues of concern to you, to Shell, and to the American people.

We face serious energy challenges here and also around the world, for which there are no perfect solutions or easy alternatives. Every avenue—increasing crude supplies, building refinery capacity, repairing hurricane damage, developing new technologies—presents a challenge and requires a significant and sustained investment. Basically, demand for energy around the world is growing, thanks to strong economies. In fact, I fear the alternative.

Consequently, there is a fragile supply-demand balance, leading to current energy prices. And yes, industry profits are large in total dollars, but they represent an average return on sales in cross-industry comparisons. Shell earned \$9 billion in the third quarter of this year, a 50 percent improvement, for three quarters of the year. But three points I would make about those profits.

First, they are determined largely by the price of crude and the price of crude is set on world markets. We do not set or control the price of crude.

Second, as profits rise so do our tax payments. Shell's global tax payments are up 55 percent this year, totaling more than \$14 billion.

Third, where do these profits go? They go back into the business. Over the past 5 years Shell has reinvested the equivalent of 100 percent of our U.S. profits in U.S. energy projects. And future investments of billions of dollars will be required to meet future energy demand.

Energy projects are becoming more complex, more costly, more technologically demanding, and many take a decade or longer to reach fruition. The EIA estimates \$20 trillion—that is \$20 trillion—will be needed by 2030 to develop the necessary supplies and infrastructure to meet global demand in the future.

The surge in demand has had a dramatic impact on the costs of doing business. The cost of an onshore rig in this country this year has more than doubled. The cost of a deep water rig is now up to or over \$300,000 or more per day. The cost to develop a deep water field, reaching \$2 billion. The cost to build or expand a refinery, for example a 200,000 to 300,000 barrel per day refinery, costs in the range of \$3 to \$3.5 billion. The cost to build a major greenfield LNG facility can be in the range of \$5 to \$6 billion.

But these investments are critical if the energy needs of today and tomorrow are to be met. At Shell we are making those investments and we are making them here in the United States. In the

offshore, Shell will continue to be an industry leader in the deep water Gulf of Mexico, a frontier we pioneered more than a decade ago. In the past 5 years we have produced nearly one billion barrels of oil and invested more than \$7 billion just in the Gulf.

Onshore, Shell has new natural gas prospects, both conventional and unconventional, under way in Washington, North Dakota, Texas, and across other regions of the United States. In Alaska we just invested \$45 million to acquire 84 licenses this year to develop Alaska's vast resources and we are working on additional opportunities.

In the oil sands, Shell Canada's major Athabasca oil sand project is unlocking significant resources and plans to expand this project will require many billions of dollars.

Oil shale. We have an exciting project in Colorado where we are testing a unique process designed to release huge oil shale resources. Shell's technology has the potential to recover more than ten times per acre as much as traditional retort technologies and in a more environmentally sensitive way.

Coal. I am in discussions with ten or more States about how to tap the Nation's abundant coal resources using our coal gasification process to efficiently and cleanly convert coal to power, gas, chemical feedstocks, liquid fuel, and hydrogen.

LNG. Shell is investing to bring more LNG to the United States. We currently have LNG import capacity at two existing LNG terminals and have proposed to build two additional LNG projects, one in the Gulf and one in the Northeast, to serve U.S. markets.

In refining, our joint venture company, Motiva Enterprises, is considering a major investment to increase capacity at one or more of its Gulf region refineries. Expansion projects are being considered in the range of 100,000 to 325,000 barrels per day.

In pipelines, in Louisiana, Shell is investing \$100 million in an interstate pipeline to help transport refined product to markets in southeastern, mid-Atlantic, and Northeastern States.

In renewables, Shell Hydrogen is a leader in pursuing realization of a hydrogen future. Shell Wind has nearly 700 megawatts of power in the United States, a figure we expect to grow. We are investing hundreds of millions in alternative energy and alternative fuels each year and we are committed to continuing these investments in the future.

But I cannot talk about Shell's investments in the United States without mention of the tremendous costs involved in recovering from recent hurricanes. Hurricanes Dennis, Katrina, Rita, and Wilma and others brought into sharp focus the fact that the Nation's energy supply-demand balance is fragile. Katrina and Rita tore through the Gulf of Mexico production sites, blasted the refinery belt in the Southeast, and roughed up the terminal and pipeline networks that feed products to half the country. Key parts of the Nation's energy infrastructure were brought to a standstill. Recovery costs are estimated between \$18 and \$31 billion to the industry, and Shell bears its share of that cost.

But it is Shell people and their response that I would like to tell you about in this instance. Nearly one-fourth of Shell's U.S. staff was directly affected by the storms, about 5,000 people and their families. Despite their own losses, losses in some instances horrific,

these dedicated professionals returned to work only hours after the storms passed. We had employees lifted from their roofs in New Orleans and we had employees in the convention center. But these employees returned to work and have been there 24 hours a day 7 days a week, fixing damaged platforms, refineries, pipelines, terminals, and service stations. They did so efficiently and safely. I commend them and I thank them.

We continue the task of bringing our facilities back on line. Just this week, I am pleased to say that we announced our commitment to return full well to New Orleans, a city that we admire, in early 2006, to bring 1,400 staff back to their offices in central New Orleans.

Let me close with a comment about how we see ways policy-makers can help the industry and help secure an energy future. Congress might consider policies that will in the first instance allow responsible access to more domestic resources; secondly, to encourage conservation; third, to streamline regulatory requirements to speed the delivery of projects; and fourth, to educate the work force of the future, to train the next generation of energy professionals, men and women who will develop future energy resources, future energy innovations, and future energy solutions.

The facts are we have in this country the natural resources, the financial capacity, and the human capability to secure our energy future. The long-term success of American energy development can and should be predicated on government enabling a responsible industry to work on behalf of American energy requirements.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Hofmeister follows:]

PREPARED STATEMENT OF JOHN HOFMEISTER, PRESIDENT, SHELL OIL COMPANY

I am John Hofmeister, President of Shell Oil Company. I appreciate the opportunity to appear before you today to discuss the energy issues important to the Congress, to America's energy providers and to consumers.

Shell Oil Company is an affiliate of the Shell Group, which operates in more than 140 counties and employs more than 112,000 people worldwide. About 22,000 people work for Shell in the United States in a diverse range of energy activities:

- Shell produces approximately 700,000 gross boe/d (Shell gross) of oil and natural gas in the U.S.
- Shell operates or has an interest in seven U.S. refineries with a capacity of more than 1.6 million barrels per day.
- Seventy-five percent of Americans live within five miles of one of our approximately 17,500 retail sites (Shell-branded gasoline stations and Jiffy Lube facilities) in the U.S., where an average of more than six million customers are served per day.
- We operate five chemical plants in the U.S., which focus on the production of bulk petrochemicals and their delivery to large industrial customers who, in turn, use them to make many of the essential materials of our modern world.
- We are a key capacity holder at two of the nation's existing Liquefied Natural Gas (LNG) facilities, Cove Point and Elba Island, and have announced proposals to build two additional, large LNG receiving terminals in the U.S., which will be critical in meeting the nation's growing need for natural gas with potentially lower-cost global supply sources.
- Shell Trading Gas & Power, through Coral Energy, has more than 5,000 megawatts of electricity capacity in the U.S.
- Shell WindEnergy has interests in more than 630 megawatts of clean, renewable wind power capacity in the U.S., and we have just announced a major wind project in West Virginia.
- Shell Solar Industries, based in California, manufactures solar photovoltaics in the U.S.

- Shell Hydrogen opened the nation's first hydrogen fuel dispenser at a Shell retail station. It's about 10 minutes from the Capitol and I invite you to visit to experience what we hope will be a common retail experience in the future. More hydrogen dispensing sites are under development.
- Shell is leading the way on other fuels of the future with its investments in biofuels, cellulosic ethanol and gas-to-liquids fuels.

I would like to use my time this morning to discuss four areas of interest:

1. The economics of the energy business and the growing demand/supply challenges;
2. The impact of hurricanes Katrina, Rita and Wilma on our business and on the price of energy;
3. What Shell is doing to increase energy production in this country and abroad; and
4. Initiatives Congress might take to help address the energy concerns that are becoming increasingly apparent and urgent.

My primary message is that we face fundamental and pressing energy challenges. There is no soft option or soft landing. Every route forward has significant economic, environmental and technological challenges. Every solution will require significant investment.

ECONOMICS OF THE ENERGY BUSINESS

Mr. Chairman, high energy prices and industry profits are matters of concern to Congress, to your constituents and to our customers. Our industry is extremely cyclical, and what goes up, almost always comes down. That dynamic has proven to be true time and time again. For example, the U.S. Energy Information Administration (EIA) reported that only three years ago (in 2002), returns on investment for U.S. petroleum companies were only 6.5 percent, and refining and marketing returns were negative. The challenge is to manage our business in the face of these severe price fluctuations.

As to profits, oil and gas industry earnings per dollar of sales are in line with all U.S. industry during the second quarter of 2005. The energy industry overall earned 7.6 cents for every dollar of sales, compared to an average of 7.9 cents for all U.S. industry. True, the total dollar numbers are large, but so are the billions of dollars that petroleum companies have invested to supply energy to U.S. consumers—and will need in order to re-invest to meet future demand in a safe and environmentally sustainable way. It is this re-investment potential that is critical.

Shell companies are in business to create economic value through the reinvestment of earnings in new technology, new production, refining and product distribution infrastructure and environmental and product quality improvements. As such, we continue to build our portfolio of integrated gas, unconventional resources and material oil projects. Recognizing that the energy consumed today is made possible by investments made years or even decades ago, we continue to reinvest earnings to help ensure a secure energy future. For example, over the past five years, Shell companies have invested approximately 100 percent of U.S. after-tax earnings in U.S. projects to meet the future needs of consumers. Investments of this magnitude require long-term fiscal stability.

The prices of oil and natural gas—which are set on the world market—fluctuate substantially and dramatically. Today we have \$60 per-barrel oil; just six years ago oil was under \$20. Similarly, we have recently experienced \$12 per mmbtu natural gas; just six years ago, natural gas was under \$3, while unleaded gasoline was averaging less than \$1.20 per gallon, including taxes. In fact, with warm weather and the return of supply lost to the hurricanes, the price of natural gas dropped \$3 per mmbtu last week (week of 10/31/05).

Even further, the first hearing of the Senate Energy and Natural Resources Committee held during the 106th Congress just six years ago related to the low-price environment and the state of the petroleum industry. The Committee recognized the potential impact of the low-price environment—noting, for example, the number of wells being shut in and the drop in rig counts across the country.

These low prices were largely attributed to two factors. First, the return of Iraqi crude oil to global markets caused an increase in supply, driving prices down by \$5-6 dollars per barrel, according to the EIA. Second, the Asian financial crisis caused a drop in demand, again affecting price.

Today, the market forces of supply and demand are driving prices up. Oil prices reached an all-time high last year, an average of more than \$41 a barrel for West Texas Intermediate (WTI). So far this year the average is over \$50, with prices rising to around \$70.

The U.S. is not self-sufficient in energy, importing more than 60 percent of its raw energy materials from other countries. The U.S. has to compete for oil in world markets. For crude oil, it competes with large refining centers such as Rotterdam and Singapore. For petroleum fuels such as gasoline, diesel and heating oil it competes with Germany, Japan, China, India and others.

The prices for many fuels are determined in the global marketplace. Buyers and sellers of fuels—energy companies, marketers, futures traders—continually compete via auctions or other transparent mechanisms to balance their needs. Auctions and fuel trading take place around the globe, but there are major centers in London, Singapore and New York. Fuel prices move up and down based on world demand and supply pressures.

For example, brownouts in China last summer raised the demand for diesel fuel to run generators, which in turn bid up the price of diesel. Asian buyers were successful bidders for cargoes, but diesel prices were higher around the globe. A drought in Spain this summer increased LNG requirements to run generators. To obtain additional LNG, Spain bid for excess cargoes and the result was higher LNG prices around the globe.

The September hurricanes created shortages of gasoline and other fuels, resulting in higher prices in all global trading markets. In the aftermath, Shell imported gasoline and other fuels—purchased at prices that were set in the global marketplace—to compensate for lost production from our damaged Gulf Coast refineries.

Similarly, natural gas prices in most markets in the United States are determined by the interaction of many buyers and sellers. The shut-in gas production during the past two months has averaged over 10 percent of total U.S. output. This production loss raised the fear of not meeting appropriate start-of-winter storage levels. As a result, the market bid up gas prices to levels that encouraged switching and averted a storage shortfall.

As in the late 1970s and early 1980s, we expect that high prices will stimulate supply and reduce demand. But these responses take time. There are indications that Americans have reduced demand for vehicle fuels. Yet on a global basis, high economic growth is stimulating global energy-demand growth in spite of high prices, particularly in major emerging economies like China.

On the supply side, large projects can take a decade or longer to reach fruition and the projects are riskier and require higher capital investment. Industry investments in oil and gas production, refining and LNG facilities are accelerating.

As we look to the future, there are major challenges. Global demand for primary energy is likely to continue to grow, and for the foreseeable future, must largely be met by oil, gas and coal. Keeping pace with this growth will be challenging. IEA estimates that some \$16 trillion will be needed by 2030 to develop supplies and build energy infrastructure. It will require very large investments in complex, costly and technologically demanding projects.

This demand is already placing upward pressure on costs:

- An onshore rig that cost \$9,000 per day one year ago costs \$15,000 per day today. In the deepwater, the cost of floating rigs has doubled to \$300,000 per day. The cost to develop a major deepwater field is between \$1.5 and \$2 billion.
- On the refining side of our business, building a new refinery or greatly expanding capacity at existing refineries is a multi-billion-dollar proposition. The American Petroleum Institute (API) has estimated that a 200,000 to 300,000 barrel-per-day greenfield refinery could cost up to \$3 billion to build in the U.S.
- To develop one Bcf/d of LNG requires an investment of \$5-6 billion, which would mean, according to the U.S. ETA, that the industry would have to invest \$50-60 billion if U.S. LNG imports grow by approximately 10 Bcf/d in the next 10 years.

So, while energy prices are high, the cost of energy projects is also rising in tight markets for equipment and skills. We must foster and fund technological innovation in an atmosphere of uncertainty. We must work to maximize recovery from existing fields, access more difficult and unconventional resources, develop more efficient ways of producing energy and cleaner fuels, and curb emissions from energy processes.

HURRICANE IMPACT AND RECOVERY

Shell and Motiva People. The landfall of Hurricane Katrina and the subsequent devastation of New Orleans and surrounding Gulf Coast communities affected some of our key facilities and nearly 4,600 of our staff and their families. Our first priority immediately following the storms was ensuring our staff and their families

were safe and providing assistance to them so they could return to work as soon as possible to assess damage, begin repairs and restart facilities.

We invested heavily in locating and ensuring the safety of our staff and their families—including going door-to-door, when necessary, to make sure everyone was okay. Following Hurricane Rita, we moved quickly to locate our nearly 1,000 employees who work and live near our Motiva Port Arthur refinery. All told, during the course of the hurricanes, we had nearly a quarter of our U.S. staff directly affected by the storms.

After Hurricane Katrina, we began a large-scale temporary movement of staff from New Orleans to Houston and surrounding facilities. We moved rapidly to gain adequate accommodations in and around the impacted facilities or the new temporary work sites. I am very pleased to share that on Monday of this week (11/7/05), Shell Exploration and Production announced its commitment to return to its New Orleans office. We expect to have a substantial number of currently displaced New Orleans Shell employees back home and back at work in the city we cherish early next year and expect almost all to return within the first half of 2006. We also have offered to the Governor and the Mayor some of the best minds in the world to assist with a successful, transparent and integrated rebuilding program that will help New Orleans.

More than 4,400 pay, loan, employee assistance and payroll re-direct requests have been implemented to date in association with these disasters, totaling nearly \$23 million. These requests consist of 2,360 employee interest-free loans for \$20.7 million, and 1,642 assistance payments of \$250 each—totaling \$407,000—for employees who have been housing displaced friends and family, and 190 relocation supplements totaling \$1.4 million.

Shell and Motiva Operations. A fragile supply/demand balance and vulnerable energy infrastructure were facts prior to the hurricanes. But the devastating impact of the storms on the energy industry gave these facts visibility and sharper focus. Like all of the companies represented here this morning, Shell plans and invests for the long term, but we live in the present, and we must deal with major dislocations such as those caused by hurricanes Katrina, Rita and Wilma.

Hurricanes Katrina and Rita tore through the heart of the Gulf's oil and gas producing areas, through the Gulf Coast refinery belt, and through the heart of the industry's terminal and pipeline networks that feed products to half the country. Our Mars platform withstood winds of 175 miles per hour for four hours; it was damaged, but the damage is repairable and it will be back in service again.

As of today (11/09/05) Shell has restored Gulf of Mexico production to more than 200,000 boe per day (Shell share) of the approximately 450,000 boe per day (Shell share) prior to Hurricane Katrina (operated and non-operated). Good progress continues to be made on key assets, including Ursa, Mensa and the Auger pipeline and an additional 150,000 boe per day (Shell share) is expected to return to production during fourth quarter 2005. Approximately 15 million barrels (Shell share) were deferred in third quarter 2005 and approximately 18 million barrels are expected to be deferred in fourth quarter 2005. Production from the Mars platform is expected to resume in the second half of 2006.

To give you an idea of the enormity of the challenge ahead of us, I can tell you that one of our tasks is to examine every foot of pipeline 3,000 feet below the surface of the Gulf of Mexico—something that has never been done before. The Congressional Budget Office has estimated that Hurricanes Katrina and Rita inflicted losses on the energy sector estimated at \$18 to \$31 billion—and Shell certainly bore its share of that damage.

Critical operations continued while our employees, retailers and wholesalers suffered from the same devastation as their neighbors. I am extremely proud to represent these dedicated professionals who began to return to our manufacturing sites, pipelines, distribution terminals and service stations only hours after the storms passed. Despite their own losses, they continued to work to bring our critical facilities back on line for the American people—and that they did so without incurring any health, safety or environmental incidents.

MEETING FUTURE ENERGY CHALLENGES

Today's profits will finance re-investments and new projects that will lay the foundation for greater energy supplies. As in the past, both energy prices and costs are expected to be cyclical, but Shell is committed to providing growing energy supplies. As stated, developing these energy resources will require a tremendous capital investment by our company, year in and year out, in periods of prices high and low. Let me highlight some of our plans and projects.

North America Exploration and Production. Shell's Exploration & Production (E&P) North American businesses are dedicated to growing the North American energy supply. Our commitment is underpinned by a history of investing billions of dollars every year in the development of future domestic energy sources and defining new frontiers. Years of investment in technology and people enabled Shell to lead the industry into the Deepwater Gulf of Mexico, beginning with the development of our Auger field more than a decade ago. Over the past five years in the Gulf of Mexico alone, Shell gross production has been nearly one billion barrels of oil equivalent, and over the same period Shell has reinvested almost \$7 billion in new offshore supply capacity. That same level of determination and commitment continues today.

Shell is aggressively pursuing natural gas prospects in a number of onshore North American basins. It is our goal to build new supply positions by developing both conventional and unconventional gas resources. Today Shell is drilling for new natural gas supplies in the Gulf of Mexico, Washington state, North Dakota, Texas, and the U.S. and Canadian Rockies.

Alaska Gas Pipeline. Alaska holds vast resources of natural gas that can be brought to market in the Lower 48. Shell is making significant investments in Alaska in the search for more supply. This year alone we have spent \$45 million purchasing leases in the Federal waters of the Beaufort Sea and the recent State's sale in the Bristol Bay area. Shell is excited about the opportunities that exist in Alaska.

Unconventional Resources. Shell is making significant investments in unconventional resources—oil sands, oil shale and coal. By 2010, EIA estimates that unconventional gas reserves will account for more than 50 percent of total U.S. reserves, up from 46 percent in 2002.

We have a major oil sands resource project in Athabasca, Canada, with bitumen from the Muskeg River mine piped 500 kilometers south to be turned into synthetic crude in the world's largest hydro-upgrader adjacent to Shell's Scotford refinery. Most bitumen is upgraded by coking. The Scotford upgrader is the only one based exclusively on adding hydrogen—enabling it to provide a 103 percent yield rather than the normal 85 percent. The plan now is to expand capacity from the present 155,000 barrels a day to more than 500,000 by 2015. This will require many billions of dollars of further investment in mining and upgrading facilities.

Shell is investing in oil shale in Colorado, where we are testing a process to unlock very large oil shale resources by conversion in the ground—using electric heaters to gradually heat the rock formation to release light oil and gas. This technology has the potential to recover more than 10 times per acre as much as traditional retort technologies, in a more environmentally sensitive way.

In order to meet growing U.S. energy needs, the entire portfolio of domestic fuels will be required. Given the abundant coal resources in the U.S., Shell also is looking at technologically sophisticated ways to use coal more efficiently and cleanly. Given the very large remaining coal resources—particularly here in the United States—it is important to make these technologies viable. Currently, Shell is working with 12 states—including New York, Pennsylvania, West Virginia, Ohio, Indiana, Montana, Colorado, Wyoming, Utah, California, Arizona and Texas—on the opportunities that exist with coal.

Coal gasification offers an efficient way of using coal for power, town gas, chemical feedstock, liquid fuel and hydrogen. New technology has made coal gasification cleaner and more efficient. The Shell process provides more than 99 percent carbon conversion efficiency. Integrated coal gasification combined cycle power—IGCC—produces 10 to 15 percent less carbon dioxide emissions than the best conventional coal generation. It should be as cost-effective as traditional coal-fired generation with full modern environmental clean-up equipment.

In the U.S., for example, new IGCC offers an attractive way to use coal with the added advantage of the potential to capture the carbon dioxide—produced as a high-pressure concentrated stream in the gasification process—for sequestering underground. We are working with the Queensland government in Australia on the feasibility of building an IGCC power plant with 85 percent of the carbon dioxide sequestered in this way. The aim is to have it in operation by 2010. Coal gasification for power generation is likely to expand significantly in the coming years.

Liquefied Natural Gas (LNG). It is clear to Federal and state government that clean-burning natural gas is critical as an energy bridge to future renewable and other energy resources, and LNG is a key component of this fuel portfolio, even with northern frontier gas. LNG is safe with a proven track record, easy to handle, clean burning with low carbon emissions and utilizes environmentally friendly operations in which to provide energy.

According to the EIA, today the U.S. consumes one-quarter of the world's natural gas and is forecasted to outpace other major markets in year-over-year LNG import

growth. World demand is estimated to increase from 6.4 tcf in 2004 to 22.4 tcf by 2020, with the U.S. making up 15 to 20 percent of the total forecasted LNG demand.

As a global industry leader, at Shell we are committed to leveraging our strong global supply position and industry experience to rise to the challenge of providing imported LNG as a critical supplement to domestic gas and other fuel sources in order to meet the country's growing energy needs—because we believe it is right for America. We are proceeding with the Broadwater project in Long Island Sound and the Gulf Landing project for offshore Louisiana.

Given the opportunity through approval of proposed facilities in the U.S., LNG can be a significant source of the North American gas supply, as it represents the potential to provide approximately 10 percent of the North American natural gas supply by 2010. In fact, by 2010, we estimate that Shell's projects alone could result in 2 to 3 Bcf/d of LNG import capacity to serve U.S. markets, growing to 4 or 5 later in the next decade. However, this fuel source opportunity for the American public represents a significant, long-term capital investment for many energy companies, including Shell.

Downstream/Refining. Our joint venture refining company, Motiva Enterprises LLC, is considering a capital investment strategy to increase refining capacity at one or more of its Gulf region facilities. Expansion projects being considered range from 100,000-325,000 barrels per day. In Louisiana, we are investing in a \$100 million intrastate pipeline project to facilitate the transportation of refined product into existing interstate pipelines that serve markets in Southeastern, mid-Atlantic and Northeastern states.

WHAT SHOULD POLICYMAKERS DO?

Let me address the role that policy initiatives might play in increasing domestic production and refining capacity to enable us to meet the increasing demand for natural gas.

Outer Continental Shelf (OCS) Access. Given the sustained high energy demand in the U.S. and globally, the key driver impacting oil and gas prices is supply. Although our company is actively exploring for oil and gas in all the areas in North America currently available, we are doing this with one hand tied behind our back, as most of the Outer Continental Shelf (OCS) is off the table for exploration and development.

The U.S. Government estimates that there are about 300 trillion cubic feet of natural gas and more than 50 billion barrels of oil yet to be discovered on the OCS surrounding the Lower 48. When you then add the Alaska OCS, you contribute the potential for another 122 trillion cubic feet of natural gas and 25 billion barrels of oil. If Congress wants to address high oil prices, they must address domestic supply issues, such as the limited access to oil and gas exploration off our coastlines.

U.S. dependence on the Gulf Coast for domestic oil and gas supply and refining capacity became obvious to every American in the aftermath of Hurricanes Katrina and Rita. The strategic importance of the Gulf of Mexico production and refinery capacity was highlighted after Katrina shut in 92 percent of the Gulf's oil output and 83 percent of its natural gas production. For years, the Gulf of Mexico has shouldered the burden of the U.S. offshore energy production. Urgent action is needed to broaden the U.S. oil and gas production base to other parts of the country if we are to ensure reliable and adequate energy supplies for all Americans in the future.

A step in the right direction for Congress would be to pass OCS revenue-sharing legislation to provide funds, needed by states and communities with production off their coasts, to mitigate the impacts of offshore development.

Earlier I mentioned Shell's interest in Alaska. In order for us to continue to grow in this area, two things need to occur:

1. Ensure fair and equitable access to the proposed natural gas pipeline; and
2. Continue to provide new opportunities for exploration leasing.

Streamline Government Processes. Governments at all levels—federal, state, local—should take the initiative to remove unnecessary bureaucratic barriers that inhibit investment. If the bureaucracy is too slow or too uncertain, investments will go elsewhere. Permit streamlining is an admirable goal, one that should be pursued to attract needed investment, not as a tactic to avoid responsible environmental behavior.

Conservation. Energy efficiency and conservation dearly affect demand and that, in turn, affects the market. The political viability of conservation policies is unclear. I will just note that at Shell, we have found significant cost savings in our own facilities from energy conservation. I would encourage all industries, governments and

individuals to stress the need for conservation and efficiency in daily operations and activities.

Workforce. We welcome Congressional initiatives that will help secure a future energy workforce. Today, nearly 50 percent of all oil and gas industry workers are over the age of 50. Only 15 percent are in the age range of 20s to mid-30s. The available skilled workforce is aging, and interest in energy-related educational opportunities is shrinking. University enrollment in petroleum engineering is down from 11,000 students in 1993 to 1,700 today. And the number of universities with petroleum engineering degrees has fallen from 34 to 17.

It is the engineers, scientists, inventors, drillers, geologists and skilled trades people who will actually do the work needed to meet our energy needs. To this end, Shell has funded a number of initiatives, including two training facilities—one in Wyoming and one in Louisiana—that will train returning veterans and others.

Finally, we respectfully request that Congress “do no harm” by distorting markets or seeking punitive taxes on an industry working hard to respond to high prices and supply shortfalls.

CONCLUSION

In conclusion, the world faces fundamental and pressing energy challenges. Demand is likely to be robust despite high prices. The investment necessary to meet this demand will be significant. Prices are high, but input costs are rising everywhere, driven by tight capacity along the supply chain. As I said in my opening remarks, every route forward has major challenges—economic, environmental and technological. I trust that my remarks have given you a sense of how we can meet these challenges.

Thank you.

Chairman STEVENS. Now we will enter a period for questions. In the beginning I am going to yield to Senator Domenici and Senator Bingaman to start the questions.

Chairman DOMENICI. Thank you very much, Mr. Chairman.

For the Senators, let me suggest that we both decided on the rules for how we are going to do this. We are going to follow a kind of modified early bird rule, meaning we are going to go back and forth between Republican and Democrat. As I have it on my side, so you will know, I am first, followed by Senators Bingaman, Alexander, Dorgan, Murkowski, Wyden, Craig, Feinstein, Martinez and Salazar, and we will go on from there.

But I think we both have agreed on a second proposition. If your turn comes up under the early bird and you are not here, then you will go to the bottom of the list and start over again. Now, we have to do it that way or else we are not going to know where we are and Senators are not going to know when they have to be here.

Now, that is not counted against my time, I assume, because I do not have very much time.

First of all, I did want to say something—I did want to say something that would maybe make you smile, and I hope witnesses will. We are glad to hear the constructive suggestions you have made. I am very hopeful. You must know we know most of them. You are repeating what we have heard. Most of them ought to be done. We will try in the future to see what we can do together to implement them.

But obviously we have some very serious questions to ask you because our people are asking us. I will tell all of you, I come from an energy State, but in almost every occasion upon my return to New Mexico the first person that puts out their hand and says, hello, Pete, or hello, Senator, follows up with a question: Why don't you bring the price of crude oil down, Pete? What is happening? Who is setting the price of that oil?

So my first question is, since most of my people and I believe most Americans that we hear from want to know, how is the price of oil set? Who sets it? Why does it go up? How does it come down?

Actually, my constituents and I believe most Americans think that somebody rigs these prices, that in the process somebody is getting ripped off, and they think it is them, the constituents who have asked me and the constituents of America who ask this question.

So I want to ask you, and please, in the few minutes you have, somebody describe in detail how the price of oil is set, because I close by saying if that is not rational, then are you rigging the price of oil or is somebody rigging the price? Who chooses to answer the question first?

[No response.]

Chairman DOMENICI. No volunteers? We will go the way we started. Mr. Raymond?

Mr. RAYMOND. I will volunteer.

Chairman DOMENICI. Thank you. That is called an involuntary volunteer.

Mr. RAYMOND. Senator, that is an extraordinarily complex question that you have just asked. I think, as I made in my comment, in the comments I made, the U.S. companies that are represented here in terms of the total amount of production that they have, that they contribute to the world supply, is relatively modest. Our own company is less than 3 percent and we are the largest producer.

The facts are that the world supply pool, many, many countries contribute to that and many companies operate in those countries. But obviously the big actors in the equation are Russia and the Middle East countries and OPEC.

Chairman DOMENICI. Now, Mr. Raymond, let me interrupt. I want to know something as simple as this. Oil comes out of the ground. It is either put in a boat or put in a pipeline. It then moves. At some point somebody buys it. At some point it assumes a price. That price may be only fixed one time or it may be fixed a number of times. Then it goes to another place and gets refined.

I need to know from you, tell me from the time it comes out of the ground, how is the price set?

Mr. RAYMOND. Well, let us talk for a moment about the easiest place to talk about is Saudi Arabia.

Chairman DOMENICI. Okay.

Mr. RAYMOND. A month before the month in which we are going to lift the crude, the Saudis tell us what the crude price will be for that month, and we have the alternative of either saying we will nominate and they will tell us we can lift, we can lift that crude. If we lift that crude, we are going to pay the price that they have said what you have to pay in order to buy that crude oil.

Chairman DOMENICI. What does "lift" mean?

Mr. RAYMOND. To have a ship show up and take it away.

Chairman DOMENICI. Be ready to take it.

Mr. RAYMOND. That is exactly right. At this point there are no pipelines out of Saudi Arabia, so it all goes out by ship.

They say, here is the price, and the alternative we have is to buy it or not buy it.

Chairman DOMENICI. Okay.

Mr. RAYMOND. Now, how they determine what that price, what the price is that they are going to set would only be speculation on my part, but I would have to say when you look at that data that the prices they set for the forthcoming month generally are very reflective of world market conditions apparently as they see them.

Chairman DOMENICI. What does that mean, world market conditions?

Mr. RAYMOND. Well, they look around the world and see what people are willing to pay per barrel of crude oil. It is traded in the North Sea, it is traded in Singapore, it is traded all over the world.

Chairman DOMENICI. So if the price is short they can ask high prices and they will get it; is that right?

Mr. RAYMOND. That is exactly right.

Chairman DOMENICI. Okay. Now, when we hear the word "speculators" purchase it or it is bought in bidding, where does that occur?

Mr. RAYMOND. Well, that happens basically on the mercantile exchanges. That could happen in New York, it could happen in Singapore, it can happen in London. Those exchanges, those markets, Senator, are open 24 hours a day all around the world.

Chairman DOMENICI. But Mr. Raymond, what we would like to know is what does that mean? Do they also respond to Saudi Arabia or do they bid up the price afterwards?

Mr. RAYMOND. They bid up the price afterwards. The Saudis—to be specific about the Saudis, the Saudis will only sell to end users. That is to say, the Saudis will only sell to refiners. The Saudis have never had any interest in being involved in, I will call it, the speculative market. As a matter of fact, if we were to contract—we have a long-term contract with the Saudis. If we buy crude oil from them, if for some reason, say for example we had a hurricane, had to shut down the Baytown refinery, we have some crude oil, we do not know what to do with it, before we could sell it to somebody else we would have to go back to the Saudis and tell them that we intend to sell it to someone else and who that other party is, because they want to make sure they sell only to end users.

Chairman DOMENICI. Mr. Raymond, let me interrupt now. Why don't you do this for me. Put yourself in my shoes. I am there talking to that person and they say: How is the price of oil set? How do I answer that person?

Mr. RAYMOND. The price is set on the world market by willing buyers and sellers as to what willing sellers are willing to sell it for and willing buyers are willing to pay for it.

Chairman DOMENICI. All right. Now, who makes the profit in that, in that—I do not think my constituent would understand that, nevertheless.

Mr. RAYMOND. Well, okay. Well, let's stay on the example that we are on. The Saudis set the price. At that point that establishes the price for Saudi Aramco or the Saudi government. We then, in the case say we bought the cargo of crude oil, we will take it to a refinery. We run it through the refinery and the product markets then determine what the margin was in the refinery. But we bought the crude oil at world market price.

Chairman DOMENICI. All right. Thank you very much. My time has expired. I am not sure my constituent is pleased with the answer, but nonetheless. Not displeased; they do not understand it.

Senator Bingaman.

Senator BINGAMAN. Thank you again for being here. I wanted to ask about what can be done over the next 6 months, particularly as we go through this winter, to deal with the high prices that consumers are going to be faced with, both at the pump and in heating their homes. It strikes me that not a whole lot more can be done other than what is being done to affect supply over that period, being the next 6 months, but a significant amount could be done on the demand side to encourage conservation. I think each of you have indicated that you believe that the Government has a legitimate role in conservation.

I have been urging the Secretary of Energy to have a high profile public education campaign to encourage conservation over these next several months, and it occurs to me that each of you and your corporations have substantial advertising budgets. Would it make sense and would you be willing to participate in a public-private partnership that would try to put on this kind of a public information campaign for the American people to assist to the extent possible in reducing demand over this period?

Let me ask you, Mr. Raymond, and just down the line if people have responses?

Mr. RAYMOND. Well, Senator, I think it is fair to say as best I can recollect every person that is a member of this panel in one form or another over the last couple of years have made a lot of public statements about the need for America and the world, not only America, to become more efficient in its use of energy. I think all of us feel very strongly about that, and through the API of course we continue to support programs to do that. I think that is the appropriate vehicle for the industry to deal with the question that you have just raised.

In terms of whether there can be a viable corporate and/or API, industry relationship with the Government through the Secretary of Energy, I would think that that is something that we ought to look at very, very carefully and see if there can be a constructive role.

Senator BINGAMAN. Thank you very much.

Any of the rest of you have thoughts on that?

Mr. O'REILLY. Senator, I agree, energy conservation is probably one of the cheapest sources of additional supply that we can generate in the near term. Our company is running advertising currently and we are also participating with API and would be interested in working with the DOE to the extent that something constructive can be done.

I think it is important that we look at both the demand side and the supply side, however, and I would not want to lose—each side is important here. We need to be conservation-minded, but we also need to recognize that supply is an important factor.

Thank you.

Senator BINGAMAN. Mr. Mulva.

Mr. MULVA. Senator, with respect to supply, first on the refineries, we have to get them up and running, the ones that are down

as a result of the hurricane. So we need to make sure we do everything we can, and we are, to restore that capacity because that adds supply. I know all the companies, including our own, will be looking at how can we import additional supplies because it may be in one part of the world, in Europe, it may be it is a warmer winter or whatever, that we can take some supply from one part of the world and bring it in and add supply.

With respect to conservation and more efficient use of energy, we certainly have supported your ideas as a company and I am sure as an industry we are very willing to explore just those concepts of working together with the government to see what we can do to really work on conservation and more efficient use of energy.

Senator BINGAMAN. Mr. Pillari.

Mr. PILLARI. Senator, I will not repeat the comments on supply. We are working very hard to get it there. On the conservation message, I think, yes, we would be willing to explore what we might be able to do. I do not think it is enough. I think each one of us—certainly in our company we believe that there are things that we should do, particularly in those markets where we are very active. So in California, for example, this year we will have several million dollars in a program called A-Plus For Energy, which is about teaching conservation in secondary high schools. I believe those kinds of programs need to continue.

Mr. HOFMEISTER. Senator, as soon as we saw the production shutdowns in the Gulf of Mexico we launched a conservation communication program with our 17,000 stations around the Nation. We believe in that quite firmly. Very specific steps that Americans can take.

Then I would support Mr. Mulva's comments on improving imports in order to meet supply requirements.

Senator BINGAMAN. Let me ask one other question before my time expires. Most of the growth in demand for oil in this country is in the transportation sector. Would you agree with me that it is time that we go ahead and raise fuel economy standards on vehicles in this country?

Mr. Raymond.

Mr. RAYMOND. Well, I do not want to get into the political aspects of that. I think that is more appropriately in your bailiwick. But I think the general proposition that we have to find ways to make the transportation system in this country more efficient in the use of energy is one that I would strongly support.

Senator BINGAMAN. Thank you very much.

Anybody else want to comment on that? If not, I have gone through my 5 minutes.

[No response.]

Senator BINGAMAN. Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Stevens.

Chairman STEVENS. Thank you very much.

I have a letter,* gentlemen, from the American Petroleum Institute referring to the request from the chairman of the Senate Finance Committee to determine whether the industry would contribute to the program we call LIHEAP. In it—I do not know if you

*The letter can be found in the appendix.

have seen the response, but in it Red Kavenny points out that the estimated cost to restore all of the industry assets that were affected by the storms in the Gulf, as you mentioned, some \$18 to \$31 billion, will all be shouldered without government assistance.

But I do not find that it has really taken a position with regard to whether at this time the industry has in mind being willing to take any action that might assist in terms of this Low Income Housing Home Energy Assistance Program that is really growing considerably.

Is it possible that your industry would join, at least to the extent of helping to find ways to make it more efficient? It just seems we have this program every year and the impact of the LIHEAP expenditures do not reduce the costs. They do not bring about more efficiency. Could you go together and help design ways that that program could in effect use less energy in order to help people meet the costs? Anyone been involved in this?

[No response.]

Chairman STEVENS. I hate to do it, Jim, but you are the chairman of the board.

Mr. MULVA. Mr. Senator, first of all, as an American I can say that we all feel very much for those who are less fortunate with respect to heating bills and whatever. We want to make sure that they get the energy and what they need. But as an industry we feel that it is not a very good precedent to be looking at one industry to help fund necessarily those, government programs as such. We think that is more in the realm of the Government should be doing that.

What we need to be doing as an industry, though, is what we have been talking about, and that is spending all of our money to add capacity and be pushing very, very hard on energy efficiency. One of the things that I would see is certainly we support the Government programs, the LIHEAP program, but not as an industry—it is not necessarily a good precedent.

For our company, we would like to see what we can be doing to help more than what we have already done over the short period of time, but the medium and the long period of time, is helping the Gulf Coast areas where we have our facilities, our employees and constituencies and residents and stakeholders, so we can help them recover from the hurricanes.

So we want to do all these things, but we also want to do what we can with respect to energy efficiency over time so we can reduce the cost or have more affordable energy for all consumers.

Chairman STEVENS. Hopefully I will be back with other questions, but, addressing BP, I was amazed to find recently that there is a provision in the Marine Mammal Act that provides that the refinery in the State of Washington is prohibited—all government agencies are prohibited from doing anything to assist the refinery there to refine oil other than for consumption in the State of Washington.

Now, Idaho has no refinery. Oregon has no refinery, and the oil from our State goes right by there. If we repeal that, would that assist the area by having increased refinery capacity for the Northwest States?

Mr. PILLARI. Yes, it would, Senator. As you know, we are supportive of doing that. Currently the way the Magnuson Act works, if there are not changes made there we will have to reduce our gasoline production by about 10 percent at our Cherry Point refinery, which would reduce the amount of gasoline that would go to Oregon, Washington, and California.

I think the second point would be, with that kind of a restriction, a refinery like Cherry Point, which has good options for expansion, those options would just not be able to be taken up.

Chairman STEVENS. If we repeal that section there would be a possibility that that Billingham refinery could be enlarged, particularly if we can get more oil back in the pipeline from production in ANWR, is that right?

Mr. PILLARI. We would like to take a look at expanding that refinery if this is removed, yes.

Chairman STEVENS. Very well.

I will have later questions.

Senator Inouye.

Senator INOUE. Thank you very much.

Two months ago on September 9, AAA Mid-Atlantic issued the following press statement: "A growing chorus of Exxon dealers in the Washington metro area are raising their voices and accusing the world's largest oil company, ExxonMobil, of profiting from the exorbitant prices at the pump in the wake of Hurricane Katrina, a spokesman for AAA Mid-Atlantic confirmed today. In candid conversations with AAA Mid-Atlantic, a handful of local dealers accused the oil giant of raising the wholesale price to service stations by 24 cents in a 24-hour period."

Since then, two members of this panel have introduced measures to prevent price-gouging. They define price-gouging as "unconscionably excessive." Mr. Raymond, would you consider 24 cents in a 24-hour period as being unconscionably excessive?

Mr. RAYMOND. Well, I think, Senator, first you need to realize that I am sure all of those stations or nearly all of them, we have nothing to say about the price that is at the pump. That is the individual dealer who makes that decision. It is only in our company-operated retail stores, which in the United States is only about 7 percent of the stores that bear the Exxon logo, do we actually control the price. In all the rest of the stores, the dealer individually decides what to do with that price.

Now, in terms of what happened to the wholesale price of gasoline at the end of—or at the beginning really of Katrina, I can only comment to you the directive that our people had, which was that in the directly affected hurricane areas, which we really had difficulty with operations simply because we had no electricity, so stations cannot operate, the roads were not passable so you could not get trucks on the roads to deliver gasoline anyway—but outside of that area, the directive was to minimize the increase in price while at the same time recognizing if we kept the price too low we would quickly run out at the service stations and have shortages.

So it is a tough balancing act, because we were not interested in ever having our stations be in the position where it appeared that there would be a shortage, because we all remembered very clearly what happened in the 1970s when that happened.

So whether the number you have in fact is accurate I do not know. But I can tell you the philosophy we had was related not at all to the concept of gouging. The concept we had was to try and maintain orderly supply wherever we could around the country.

Senator INOUE. Would you suggest that the local dealers who accused you of raising their wholesale prices to service stations by 24 cents in a 24-hour period, they were not being quite honest?

Mr. RAYMOND. I do not know if they are being honest. I just do not know if that data is accurate, frankly. But I can tell you what the philosophy that the company had in terms of trying to deal with the issue we had after the hurricanes.

Senator INOUE. When your company heard about this press release by the AAA, did you respond?

Mr. RAYMOND. As a matter of fact, I think as I recall—this is a long way from Dallas, Texas. But as I recall, the comment was made that a couple of our people in the company did have conversations with the AAA and did talk with the dealers.

Senator INOUE. I gather that all of you are in favor of alternative sources of fuel, such as hydrogen, and you would be in favor of improving CAFE standards?

Mr. RAYMOND. I think for me my comment has been again, I do not want to get into the politics of that. That is in your bailiwick, but I am and I have been supportive for a long time of having the transportation sector become more efficient. Whether that is CAFE standards or some other way to do that, that is a decision, I think a political decision you have to deal with.

Senator INOUE. Thank you all very much.

Chairman STEVENS. Thank you.

We will now come to a period of individual members being recognized under the early bird rule, and the Energy Committee will go first.

Chairman DOMENICI. Senator Alexander, you are next, then Senator Dorgan.

Chairman STEVENS. For 5 minutes each, gentlemen.

Chairman DOMENICI. Right, 5 minutes each.

**STATEMENT OF HON. LAMAR ALEXANDER,
U.S. SENATOR FROM TENNESSEE**

Senator ALEXANDER. Mr. Hofmeister, the focus of these hearings like this always seems to be on gasoline, which is a big problem. But to my way of thinking natural gas prices are a bigger problem for our country. If gasoline prices had gone up recently as fast as natural gas prices have, gasoline would be at \$6 or \$7 a gallon. We hear many statistics about tens of thousands of good blue-collar jobs moving overseas. At the moment there are 50 new chemical plants being built in China, where natural gas as a raw material is much cheaper than it is here; one new chemical plant being built in the United States.

Now, all of you have something to do with natural gas. Mr. Hofmeister, I believe Shell even helps make electricity from natural gas, which is increasingly a way we have been using natural gas in this country. My question is, as a way of reducing the price of natural gas for homeowners, farmers, and manufacturers so we can keep more jobs in this country, would it not make sense to require

that the newer natural gas plants, which use about half as much—which are twice as efficient as the old natural gas plants—would it not make common sense to require in this emergency that we use the newer natural gas plants to make electricity rather than the old ones or instead of the old ones or before the old ones? We call that the more efficient dispatch of natural gas.

I understand there are some issues on the other side. But help us come up with a common sense way to use these natural gas plants that are twice as efficient as the old ones as a way of bringing down prices. The estimates we have are that if we were to do that it would save enough—it would lower retail natural gas prices by 5 percent within a few years and it would save enough natural gas to equal 600,000 homes, which is the size of the city of Memphis or the size of the city of Fort Worth.

Mr. HOFMEISTER. Senator, I think the expertise that we have on this subject is on the supply side. I do agree with you that natural gas is perhaps the single most critical energy issue that the Nation is facing. In part it is directly related to the hurricanes. In the case of our own platforms producing natural gas offshore Gulf of Mexico, we have a serious pipeline damage problem which came about from the drifting of oil rigs due to the force of the storms, in which some of these oil rigs, which are temporary structures and move around the Gulf, actually were forced by the storm to drag their anchors and their anchors attached to our pipelines, seriously damaging our pipelines.

Senator ALEXANDER. We had big problems in natural gas long before the hurricanes, and we had new natural gas plants that we could have been using instead of old ones. Don't you have some of these new ones?

Mr. HOFMEISTER. We are actually not in the gas—we are in the gas distribution business, not in the gas usage business. So the utilities would probably be more expert in this, to your specific question.

But the real supply side issues I think are access to more gas fields, in which we have been working with members of Congress to try to achieve more access, but also LNG. LNG is——

Senator ALEXANDER. Sir, I understand all that and I have a limited amount of time. But you do not believe that using new, more efficient natural gas plants would make common sense rather than older, less efficient natural gas plants as a way of lowering the price?

Mr. HOFMEISTER. I think my point is that is a question for the utilities which are using our gas, not for the suppliers.

Senator ALEXANDER. So you do not know the answer to that?

Mr. HOFMEISTER. Correct.

Senator ALEXANDER. Mr. O'Reilly, when I talked to auto company executives—Toyota, General Motors, Nissan—they are investing hundreds of millions of dollars in fuel cell vehicles and hydrogen. Some of them give surprisingly optimistic views about how soon they will be able to produce a commercial vehicle at a price people can afford and drive, which will go a long way toward reducing demand for oil and therefore hopefully stabilizing or reducing the price of gasoline.

I am interested in what any of you can tell us, starting with Mr. O'Reilly, about whether your companies in effect are turning from oil companies into energy companies? I start with Mr. O'Reilly because I know you have been interested in hydrogen. How soon—assuming one of the automobile companies does produce such a fuel cell vehicle at a competitive price, how soon will one of our large companies or some other company be able to do with hydrogen what we do now with gasoline, take it from the place it is produced to the automobile itself?

Mr. O'REILLY. Senator, we are working on hydrogen distribution and hydrogen manufacture as part of a DOE-auto company combination experiment in California. We see the challenges of hydrogen as how do you distribute it efficiently to the automobiles. So we are looking at distributed hydrogen production at service stations and loading facilities at the service station as well as commercial refueling centers in California, as I say, with the cooperation of DOE and in this case Hyundai.

The issue I think is distribution, and then one has to remember that at the source we still have to make hydrogen. We are making hydrogen today in California from natural gas. So it kind of comes back in a full circle to natural gas supply and then learning how to distribute hydrogen. If we can overcome those two, with time there will be hydrogen vehicles on the road.

But I think it is a little way off. The near term, I think the hybrid vehicle is a more pragmatic solution, and they are already in the markets, much more efficient than conventional automobiles. Of course, we are working in that area, particularly with the long-lived batteries that will support those automobiles. So we are working on these areas. There are some challenges to be overcome.

Chairman DOMENICI. Senator, your time is up.

Mr. O'REILLY. But I think we are on track.

Chairman DOMENICI. Thank you very much.

Senator ALEXANDER. Thank you, Mr. O'Reilly.

Chairman DOMENICI. Thank you, Senator.

Senator Dorgan.

Senator DORGAN. Mr. Chairman, thank you.

**STATEMENT OF HON. BYRON L. DORGAN,
U.S. SENATOR FROM NORTH DAKOTA**

I thank the witnesses for being here today. Mr. Raymond, you and others said, and I quote you, "Increases in oil prices following the hurricanes have put a strain." The fact is that oil prices were well above \$60 before the hurricanes formed up; is that not the case?

Mr. RAYMOND. Yes, Senator. The facts are—and I have said this publicly for a long time—the oil prices have been moving steadily up for the last 2 years, and I think I have been very clear in saying that I do not think that the fundamentals of supply/demand, at least as we have traditionally looked at it, have supported the price structure that is there.

Senator DORGAN. I understand that, but my point was you all seemed to make the case, and you started with it, that somehow this oil price problem is a result of hurricanes. I understand the dislocations of the hurricanes—

Mr. RAYMOND. No, I think the point I would make is that the hurricanes aggravated whatever problem was there to begin with.

Senator DORGAN. That is certainly true, and the price of oil was over \$60 a barrel before we heard the news of hurricanes. That is true as well, and I think an important point because it relates to the question of price and supply and demand.

Second, I would ask the question Senator Inouye asked of you. Your answer to him about this issue of the AAA and a 24-cent increase in 24 hours of Exxon's wholesale price, which angered your local dealers, you obviously did not investigate that because you do not know about it. I wonder why you would not investigate something like that. That is the sort of thing that would make notice here of people trying to evaluate what is going on. Your own branded dealers are complaining. Why would you not investigate that?

Mr. RAYMOND. As a matter of fact, my point I think to the Senator was that the people who are in charge of that, which are over here in Fairfax, did look into that. I think the comment that they have made back to us was that what was done—and I am not sure that 24 is the right number; that is the point I am making—was consistent with the directive that we had made in terms of trying to moderate the pricing, but at the same time maintain continuity of supply.

Senator DORGAN. Well, I understand your answer. My point is when you see these kinds of things I would expect they would be investigated with some great concern. But there are people here—I think Senator Inouye talked about oil and gas with respect to gouging. None of us know much about what is happening with respect to pricing. We see the pain of the consumers, we see the gain of the companies.

Let me ask, if I can, something that Senator Domenici tried to elicit from you. How do you respond to a consumer—you know, the notion with most challenges in this country is that we are all in this together. But with respect to this challenge, for consumers at least, it seems to be we are all in this alone, because on the one side you have those that have the energy exhibiting substantial pricing capability and the consumers having to pay substantial prices.

I think Senator Domenici was asking—I do not mean to paraphrase him, but—a consumer says to us, you know, Mr. and Mrs. Politician, what I see are big economic interests getting rich here. Your profits are very handsome. In fact, your individual compensation is very substantial. You are doing really well. On the other hand, there is dramatic pain for consumers.

In my part of the country, people going into the winter understand heating your home is not a luxury, it is a necessity, and they are going to pay a substantial amount more to heat their homes this winter, while they open the paper and they say: Boy, it is nirvana for you all, personally and for the companies.

How do you respond to those consumers in a way that says to them, well, this is the right thing and this is a fair thing? Anyone? Mr. Raymond, you want to answer that?

Mr. RAYMOND. I think, Senator, the point is when you say we are all in this together, I would broaden that to a world view: We are all in this together everywhere in the world. And the United

States, as has been demonstrated by the hurricanes, is just one of many players on the world stage that affect petroleum prices.

If tomorrow a number of refineries were to go down in Europe, the price of heating oil in your State would go up. That is the reality that we are in. And our job I think is first of all to make sure that the customers in fact do have supply. As all of us who have been around a long time remember, shortage is a disaster, and we do not want to go there.

That means we are going to have to pay the world market price for these products, no matter where they come from. In doing that, we recognize the consumers in the United States sometimes are going to have difficulty realizing that they are part of that world. But in fact they are, and our job is to get it to them at the most competitive price we can.

Senator DORGAN. Mr. Raymond, you have used the term "world market" many times. I notice you did not use "free market," because when I heard you describe the price you pay to the Saudis, you pull up to the Saudi pump, they say here is what it is going to be. That is not a free market. It is a longer discussion we ought to have at some point, but I think the consumers bear the brunt of a market that is not free, and your companies at this point are experiencing very substantial profits as a result of it. I think most consumers find it terribly unfair. Talk is cheap. They are saying to Congress: We want some action.

Chairman DOMENICI. Senator, your time has expired.

Senator DORGAN. Thank you very much.

Chairman DOMENICI. We will go to Senator Stevens for his side now.

Chairman STEVENS. We will now recognize Senator Burns, followed by Senator Boxer, for 5 minutes each.

**STATEMENT OF HON. CONRAD BURNS,
U.S. SENATOR FROM MONTANA**

Senator BURNS. Thank you very much for coming today, and I will tell you that my number one concern right now is the business of agriculture. We cannot increase the price of our product off of the farm. We cannot pass along our costs. I want you to write this down: It costs a bushel of wheat to buy one gallon of diesel. Gasoline has come down, diesel has not.

Then we get our product to the market and we are charged a surcharge from the rails and the trucks, which further depresses our price on the farm and it takes us out of our ability to compete with our product on the world market.

I understand what you are saying, Mr. Raymond, because I come out of the auction business and I know when you go to an auction that is the truest form of supply and demand. Who wants it and how bad do they want it?

So my concern now is the diversity of supply. We have heard of no new refineries being built in the past 30 years. Reason, we are not going to go into that. Are oil companies willing to invest in the use and/or expanding the refinement of biofuels or coal to fuels, that is gasification technologies? And if not, why not? Anybody can take a swing at that that can pick up a bat.

Mr. RAYMOND. Well, I will take a quick swing at it, Senator. First of all, I think, as the comments I made earlier, in fact while there has not been the construction of what we would call a new grassroots refinery, there has been continual expansion of the refining industry. As I commented, effectively in this country in the last 10 years we have built in essence three new refineries. They are inside the fence where refineries already were, and as a result they are much more efficient than if we had gone off in some green-field site and tried to do it.

In terms of are we willing to look at biofuels, we are willing to look at any feedstock that would enable us to be able to provide competitive supplies. In terms of coal gasification, we had projects on that 20, 30 years ago. The problem with them is that they are not economically competitive with traditional oil and gas supplies.

Senator BURNS. Now, I have a follow-up question on that and then I will let somebody else.

Mr. RAYMOND. Please.

Senator BURNS. Are refineries and biofuels or gasification plants treated the same as far as policy, taxation? Do they work under the same definitions as far as policy is concerned?

Mr. O'Reilly.

Mr. O'REILLY. Senator, biofuels, and if you include ethanol in that, obviously have additional tax incentives for manufacture. So they are not quite under the same policy. As far as I know, the underlying structure other than the tax incentives themselves are similar.

Senator BURNS. I just think that somewhere along the line our policy up here does not put them both on the same level so that the investments not only could flow to refinery capacity, but also into the use of more diverse areas of our supply. Am I going down the wrong road here, Mr. Mulva?

Mr. MULVA. No, Senator, I do not think you are going down the road. Anything that can support diversity and expansion of refining capacity is really something that we need to do and should do.

I will come back to your initial question, though, with respect to diesel. In our own company we lost three refineries as a result of the hurricane. They are coming back on stream. But we lost 200,000 barrels a day of diesel capacity. To put it in perspective, I think the State of Mississippi uses about 40,000 barrels a day of diesel.

We cannot really import it from Europe like we can gasoline because Europe has moved into, you might say, dieselization. So we cannot bring it in in the form of export from Europe imported into the United States. So what is really absolutely important for us is to get our capacity and our refineries back on stream. The best thing we can do is adding supply by efficiently running our refineries and getting them back on stream. It is going to be the best thing we can do to get diesel prices down.

Senator BURNS. Let the American people understand: Agriculture is going to get shut down. We are not going to turn on one tractor to produce food and fiber for this country under these kind of conditions. We have to do something different.

I thank the chairman.

Chairman STEVENS. Senator Boxer is recognized for 5 minutes.

Senator BOXER. Thank you, Mr. Chairman.

**STATEMENT OF HON. BARBARA BOXER,
U.S. SENATOR FROM CALIFORNIA**

I would like to put into the record a copy of a front page story in the *Washington Post* Tuesday, January 22, 1974, given to me by Senator Cantwell, showing Senator Scoop Jackson swearing in oil company executives. The headline: "Firms Say Oil Crisis Is Real, Deny Holding Supplies Back From the Market." I would like to put this in the record as a reminder of the way things used to be done around here, if I might.*

Chairman STEVENS. The chair has no objection, but we do not print photographs in the record.

Senator BOXER. Well, we can describe it then. That is fine.

Mr. Chairman, today's hearing in the mind of most of my constituents is about shared sacrifices in tough times versus big oil company greed.

Gentlemen, to all of you, I hope I can give you a bit of a reality check. Working people struggle with high gas prices and your sacrifice, gentlemen, appears to be nothing. I want to get to a very simple thing that everyday people can understand, and that is oil executive bonuses versus average U.S. salaries. I have a chart, and I do not go into all of you because some of you work for companies that do not have to file this information.

[Chart.]

In 2004, Mr. Raymond, your bonus was over \$3.6 million. This was on top of your salary of \$3.2 million and stock gains and other compensation of \$19 million.

Mr. O'Reilly, your bonus was almost \$4 million, in addition to a salary of \$1.5 million and stock gains and other compensation of \$11.2 million.

Mr. Mulva, your bonus was a little over \$4 million, on top of your \$1.5 million salary and \$2.7 million in stock gains and other compensation.

Gentlemen, this compares to an average American who makes \$23,276 per year. Each of your bonuses was more than 155 times greater than the typical American's yearly salary. And compare your bonuses to a worker on minimum wage, which Congress has not raised in 9 long years. That minimum wage worker makes \$10,713 per year. Each of your bonuses—forget the rest of it—each of your bonuses was more than 300 times greater than a minimum wage worker's annual pay.

So let me just ask you a question here. Will you consider making a major personal contribution and major corporate contributions from record profits to a charitable fund set up, hopefully with your efforts and community efforts, to help America's working families get relief from higher home heating oil prices or higher gas prices? Just a yes or no, if you would consider this.

Chairman STEVENS. We will stop the clock right here for you, Senator. We are permitted to have charts to show information that pertains to our issue. This chart is really publicity. I want you to know we are going to have a question about that later in our busi-

*The article has been retained in committee files.

ness discussion. But I would urge Senators to bring charts that demonstrate some information that is necessary for the consideration of the subjects before us. This does not seem to be that case.

Senator BOXER. Well, Mr. Chairman, if I could have 30 seconds without it being taken away since you interrupted my train of thought, let me just tell you something. I think that this is very much on point. People in our country are concerned about fairness and justice at a time of sacrifice.

But that is a difference between us, we should not try to stop each other from saying what we want to say. But we will discuss that, because I know at the end of the day you are a fair person.

Now, if I could have a second question and, Mr. Hofmeister, it is to you. Two years ago this month, your company Shell announced it was closing its oil refinery in Bakersfield, California, an oil refinery that supplied 2 percent of our State's gasoline. We already had some of the highest gasoline prices in the country and the community was up in arms.

In the end the refinery was sold, not closed, but only because of elected officials, in particular the attorney general of California. Now, today is your chance to please let us know why you told the people a number of falsities. And I want to say your company, not you personally, your company. You said that the refinery was not making money. You said it was not economically viable.

It was not true. Internal documents showed Bakersfield refinery was making about 55 cents profit per gallon, the biggest marginal profit of any Shell refinery in the country. The truth is it also was the most reliable Shell refinery in the country for 2003.

I ask consent to put those documents in the record that prove what I am saying is accurate. I ask consent to put those documents in the record, Mr. Chairman.

Chairman STEVENS. What documents?

Senator BOXER. If I could have a moment to explain the documents without it coming off my time, please.

Chairman STEVENS. If they are official documents—

Senator BOXER. They are official documents.

Chairman STEVENS. Without objection.

[The material referred to follows:]

SHELL OIL PRODUCTS US,
Houston, TX, April 13, 2004.

Hon. BARBARA BOXER,
U.S. Senator, Hart Senate Office Building, Suite 112, Washington, DC.

DEAR SENATOR BOXER: Thank you for your letter of April 9 regarding Shell's decision to close the Bakersfield refinery by October of this year. We appreciate your seeking information from Shell on this matter.

Shell has always been and remains willing to entertain any credible offers for the Bakersfield refinery. Shell has received nine inquiries from prospective buyers, but none of them has resulted in a credible offer to date. One inquiry came from an oil company, but they have indicated that they will not pursue further. Seven inquiries came from energy-related companies or other concerns, and another inquiry came from a company that was not interested in running the refinery as an ongoing concern. Out of all the inquiries, we have received only one written expression of interest thus far. In our view, a credible offer would begin with a written expression of interest and information showing adequate financial capability. While we are sharing information with this one party, it has not resulted in a credible offer to date.

As Shell representatives informed your staff during a briefing in Washington, D.C. last month, the decision to close the refinery is based on the fact that the refinery is not economically viable due to the continual decline of the crude which sup-

plies this land-locked facility. And we believe potential buyers would reach the same conclusion that we have about its economic viability. For this reason, we have not expended time or resources in an attempt to find a buyer and do not intend to do so. We will, however, continue to respond diligently to all inquiries and are prepared to negotiate with any credible potential buyers.

To give you a better understanding of how we reached our decision, let me share with you some facts. The Bakersfield refinery is configured to process San Joaquin Valley heavy crude, which it only gets from the Kern River Field, upon which the refinery has sat since 1932. Production from the Kern River Field declined by 6.4 percent in 2002 alone, according to production reports published by the California Department of Conservation. Transmission pipelines take San Joaquin Valley heavy crude away from the Kern River Field to several other refineries, including Shell's larger Martinez refinery near San Francisco, but there are no transmission pipelines or other economical means to bring crude to the Bakersfield refinery from other San Joaquin Valley fields.

Declining access to economic crude for this facility is a financial drain. The Bakersfield refinery lost \$24 million in 2001 and lost \$33 million in 2002. It made only \$4.7 million in 2003, which is an inadequate return on investment given Shell's investment of over \$200 million in the refinery. The refinery was projected to lose \$5.7 million in 2004. Even if the refinery is slightly profitable in 2004, we will not achieve an acceptable rate of return to justify continued investment in the facility. Furthermore, in February of this year, even with rising margins, we could utilize only 64 percent of the refinery's capacity largely due to our limited access to crude. Thus, with the low utilization rates projected to continue due to lack of access to enough crude, Shell cannot justify continuing to make investments in this facility.

Shell announced this closure decision eleven months in advance in order to give its employees, customers, the city of Bakersfield, the market, and other concerned parties as much time as possible to plan for the closure. As noted above, we remain receptive to any credible offers that we may receive over the next several months. But given what we believe to be the inevitable—the closing of the refinery based on economic reality—it would be a disservice to now introduce uncertainty into this process by delaying or indefinitely postponing the closing of the facility. Therefore, we do not intend to postpone closing the refinery.

I thank you again for your correspondence. Please feel free to contact me if you have any additional questions.

Sincerely,

LYNN L. ELSENHANS,
PRESIDENT AND CEO.

Base Oils Manufacturing
Port Arthur—Operations are running well.

Refining Margins
Wow.

Location	As of	Margin	Difference from plan				
			Latest	7 day	MTD	Last month	Last qtr
Norco	2-Apr	9.18	4.75	5.88	4.90	3.97	4.90
Port Arthur	2-Apr	7.85	3.81	4.46	3.92	3.15	3.92
Convent	2-Apr	10.19	5.41	6.08	5.49	4.56	5.49
Delaware City	2-Apr	7.19	2.82	3.56	2.98	2.77	2.98
Bakersfield	2-Apr	23.01	16.78	10.79	16.45	3.54	16.45
Los Angeles	2-Apr	22.93	17.54	11.06	16.91	3.81	16.91
Martinez	2-Apr	21.82	15.95	10.04	15.75	2.11	15.75
Puget Sound	2-Apr	14.96	10.94	5.73	10.47	0.92	10.47

Fellow Bakersfield Refinery Employee,

My best wishes to you and your loved ones this holiday season. May you experience the joy and promise this time of year represents.

As we have discussed before, we turned in excellent operational performance this year. We are the most reliable Shell U.S. refinery in 2003, and achieved world-class performance two years in row now. We have made quantum step improvements in

our environmental compliance, finishing well under our target again for the second straight year. We have reduced the expenses we control 15+ percent year over year, and have been one of the few Shell U.S. refineries to turn a profit. And, while we struggled with our attention to safety in a difficult first quarter, we've stepped forward and created a new culture and attitude for protecting ourselves and our co-workers; reducing injuries over threefold in the last half of the year.

We've done all this with the lowest personnel index in Shell refining in the country, making us comparatively the most productive and effective workforce in the system. All in all, an outstanding year by an exceptional group of people. Great, great job and I thank you for your contributions to this success.

As you well know, 2004 will bring its fair share of challenge and life change for us. Yet despite the level of difficulty, I am convinced there is no better group of people to face it with. I look forward to positive outcomes for all of us as we navigate the new year.

Sincerely,

JEFF KRAFUE.

Senator BOXER. Thank you.

At the end of the day there was a credible buyer. The refinery is up and running. So could you please explain why your company put out that word? That there were no buyers, that was not true. That the refinery was not reliable, that was not true. That the refinery was not making money, that was not true.

Was it because you wanted to control the supply of gasoline and make gasoline even more expensive to my people in California?

Mr. HOFMEISTER. Senator, I would like to thank you and the attorney general for the help that you gave us ultimately in the sale of that refinery.

Senator BOXER. Well, you were not happy when we intervened initially, but I am happy you are happy now.

Mr. HOFMEISTER. And the refinery is up and operating and Shell continues to support the new owners of that refinery in its technical requirements and in a smooth handover from one owner to the next.

Fundamentally, we had shopped the refinery around unofficially, but did not find buyers. We then decided to close it. The reason for closing it is that this is a refinery that is one of the oldest in the country, it is one of the smallest in the Shell system, and it is on multiple sites. So in other words, the refinery is not contiguous. It operates in different plots of land in the city of Bakersfield. So in terms of future investments as we look at the need for world-scale large manufacturing operations, what we really require are world-scale factories, and this was not going to get to world scale. It was impossible to expand it. It was impossible to link it up in the way in which refineries are to be linked up to meet our investment criteria.

So in the end it was sold. It is operating. We are delighted that the employees are still employed.

Senator BOXER. Well, Mr. Chairman, if I just might say this to you. This was a struggle to get Shell to cooperate with us. The attorney general had to force them, in essence, to open up their books. I just would say to you, I am very happy that you now think it was a good thing. At the time the people in charge there were not happy with us. It seemed to us and in retrospect still does that there was a desire to short the market even more.

Mr. Chairman, thank you.

Chairman STEVENS. Thank you very much.

Senator Domenici will yield now to his committee.

Chairman DOMENICI. On our side, Senator Murkowski and Senator Wyden.

**STATEMENT OF HON. LISA MURKOWSKI,
U.S. SENATOR FROM ALASKA**

Senator MURKOWSKI. Thank you, Mr. Chairman, and welcome to the members of the panel here this afternoon or this morning.

I would like to talk a little bit about the natural gas situation, following up on Senator Alexander's comments. People were shocked with the hit in the price of gas at the pump, but I think it is fair to say that this winter people across the country are going to be shocked when they look at their natural gas bills that we anticipate all across the country.

As we all know, Alaska has 35 trillion cubic feet of known natural gas reserves just waiting for a means and a mechanism to get to the market. Now, for about the past year or so the gas owners, Exxon, BP, ConocoPhillips, have been in negotiations with the other owner of the gas, the State of Alaska, to work a deal so that we can get the gas moving. Mr. Mulva, I appreciate your comments here this morning insofar as the tentative agreement that ConocoPhillips has reached with the State and we appreciate that.

Now, given that the third quarter profits that we have seen from the three companies that I just mentioned exceed the estimated \$20 billion cost of the entire pipeline project, I would like to direct a question to you, Mr. Raymond, and you, Mr. Pillari. What is holding Exxon up, what is holding BP up, from reaching a firm agreement with Alaska and actually committing to build this very vitally needed pipeline? Gentlemen?

Mr. RAYMOND. Well, Senator, I think we have been involved with the State of Alaska in discussing the building of a gas pipeline now for some 30 years. Fortunately, we did not do it earlier because it would have been an economic disaster for both the companies and the State.

The comment about the structure of the natural gas market I think is one that we are all concerned about, and the National Petroleum Council 3 years ago had an exhaustive report on that and it was updated a year ago. Frankly, the position that the country is in in natural gas is exactly what the NPC said was going to be the case.

In terms of our current discussions with the State and with the Governor, I am told by our people that we continue to make progress. The specific issues that are out there I think are more appropriately handled between the Governor and the people up there who are trying to negotiate it. I think the intent is, as we have had for a long time, is to come to a successful conclusion. But I think we have to recognize that it would probably be the largest single private project anywhere in the world, and therefore it is absolutely critical from our point of view that all the elements of the agreement be clear and the interaction between the gas operation and the oil operation at Prudhoe Bay also be clear.

Senator MURKOWSKI. Mr. Pillari.

Mr. PILLARI. The only thing I would add to that is I think progress has been made. We would like to see this pipeline built. My understanding is people are working 7 days a week to get the

details done. I think every company approaches a negotiation a different way. We would like to see all the details resolved before we agree to go forward, but we believe this project is a good project and we believe it will get done shortly.

Senator MURKOWSKI. I appreciate that air of optimism from you, Mr. Pillari. We do not want to be sitting here 30 years from now—as you point out, Mr. Raymond, it has been 30 years in the making already. And I appreciate the confidentiality of the terms of the agreement and the effort that has been made. But I think we need to be aware that there will come a point when the American consumer is going to say: Well, wait a minute; you have got all the gas up there, you have been trying to get this line going; is it these companies that are trying now to manipulate the price of natural gas and holding off and not moving forward with the project?

It may cause us here in Congress to question or revisit some of the incentives that we moved forward just last year to help facilitate this project. So I want to just put that on the record, that we do not want to be sitting here in another hearing a year or two from now saying, what happened, why have you not participated.

I just have a couple seconds remaining here. I want to put out also the issue of access to a natural gas pipeline and what it would mean under the FERC order that covered the gas line. There are some parameters to ensure access to others so that we guarantee line expansion in an equitable and an economic way, and I would just like to know that you would be willing to work with the State, essentially guarantee that access to expansion to the line. If I can have either Mr. Raymond or Mr. Pillari speak to that.

Mr. RAYMOND. If I may, Senator, I think the issue of access to the expansion of the line, while it is an interesting question, is not really the key question right now. The key question is to build the line to begin with. The question is not access to expansion.

The facts are—and I think people need to realize it—that even if we come to an agreement with the State on the construction of the line, it will be probably 10 years from now before that gas flows. The issue of natural gas in this country, while that can make a significant contribution years down the road, the more important question is in the near to medium term when we have to start dealing with imports of gas through LNG terminals. The facts are, Senator, we need to do it all.

Senator MURKOWSKI. We need to do it all and I understand from your full-page advertisement a couple days ago that you have got a \$14 billion commitment over in Qatar to assist with that LNG facility. We would just like to do what we can domestically. We recognize that it takes a while to get the Alaska gas on line, but we have got to get moving sooner than later.

Thank you, Mr. Chairman.

Mr. RAYMOND. I do not disagree with that.

Chairman STEVENS. Senator Wyden is recognized for 5 minutes.

Senator WYDEN. Thank you, Mr. Chairman.

**STATEMENT OF HON. RON WYDEN,
U.S. SENATOR FROM OREGON**

Gentlemen, the President said, and I quote: “With \$55 oil, we do not need incentives to oil and gas companies to explore. There are

plenty of incentives." Now, today the price of oil is above \$55 per barrel. Is the President wrong when he says we do not need incentives for oil and gas exploration?

If I could just have a yes or no answer, going right down the row beginning with you, Mr. Raymond.

Mr. RAYMOND. No, I do not think our company has asked for any incentives for exploration.

Senator WYDEN. Sir?

Mr. O'REILLY. Agreed.

Mr. MULVA. In my oral comments I said we do not need. What we do need, though, is access—

Senator WYDEN. Just a yes or no.

Mr. MULVA. Yes.

Senator WYDEN. Sir? The President is correct?

Mr. PILLARI. He is correct.

Senator WYDEN. Sir?

Mr. HOFMEISTER. Yes, he is.

Senator WYDEN. All right. Now, your companies have been charging record prices and getting record profits, but also getting record tax breaks. Now, the President says they are not needed. You have just told me they are not needed. But Congress just a couple of months ago gave you several billion dollars in new tax breaks on top of the tax breaks you already get.

My question to you is, why shouldn't Congress take back the billions of dollars in brand-new tax breaks, breaks that you have just told me are not needed, and use that money to help people who are hurting in our country? Mr. Raymond, your response?

Mr. RAYMOND. I have heard that comment made many times since the passage of that legislation and I have asked my people many times if they could identify what so-called tax breaks are in that legislation that would apply to ExxonMobil. The answer they come back with is, when you add it all up, that energy legislation is zero in terms of how it affects ExxonMobil.

Now, how it affects the industry, some other people can respond to.

Senator WYDEN. So you would have no problem, because I am on the Finance Committee and I am going to offer an amendment to take back the \$2.6 billion of brand-new tax breaks and use that money to help people who are hurting. You said you are not getting any?

Mr. RAYMOND. As far as my company is concerned, it does not make any difference whether it is there or not.

Senator WYDEN. Good, I am glad you will support me on Thursday.

Mr. RAYMOND. That is a different question.

Senator WYDEN. Sir?

Mr. RAYMOND. That is a different question.

Senator WYDEN. I think you have summed it up.

Just a yes or no answer. Sir?

Mr. O'REILLY. Senator, it is impossible to—

Chairman STEVENS. The Senator will suspend.

Our rules provide that the chairman has the duty to maintain good order, and any public demonstration of approval or disapproval indicated by people in the audience, it is the duty of the

chair to enforce on his own initiative and without any order by any Senator the decorum of this hearing. When the chair feels it is necessary to maintain order, he shall have the power to clear the room and the committee will continue in closed session so long as there is any doubt about the continued disruption of the hearing.

The Senator will proceed.

Senator WYDEN. Sir, right down the row?

Mr. PILLARI. Senator, it is impossible to give a yes or no answer, but if you permit me a sentence or two I will answer.

Senator WYDEN. I think what I need to know—you have told me the tax breaks are not needed. I want to take them away.

Mr. O'REILLY. I did not say that.

Senator WYDEN. You said the President was right that we do not need tax breaks. The price is over \$55 a barrel.

Mr. O'REILLY. If you forgive me, Senator, I would like to answer the question. That is, from our perspective it will have a minimal impact on our company, minimal. However, I think my understanding of those breaks, because they must affect others, is that whatever steps are taken by the Government, they should be done on a prospective basis so they do not penalize people that have made decisions based on the act that has already been adopted.

Thank you.

Mr. MULVA. Senator, with respect to oil and gas exploration and production we do not need incentives. What we need is access so that we can explore. Second, the recent energy——

Senator WYDEN. You will support my effort Thursday to take them back?

Mr. MULVA. The recent energy legislation that was passed, while it is a good step, did not do very much with respect to supporting and enhancing additional supply, which is what we really need, additional supply. And that goes back to access.

Senator WYDEN. The next witness?

Mr. PILLARI. I would agree with what has just been said and say it is a minimal impact on us. I would add that included in that bill is something about LNG siting, which I believe is very important.

Mr. HOFMEISTER. The bill for us is not material in any way, but I do think we are a large, diverse, and complex industry, in which many of the industry players see it differently than we do. I would say that there are some areas of the bill, such as coal gasification, which offers benefits to States, not only to industry.

Senator WYDEN. I just want the public to know you got \$2.6 billion of tax breaks, you have told me they are not needed. I hope you will support my effort to take them back and give that money to people who are hurting.

One last question for you, Mr. Raymond, if I might. You have been quoted as saying that speculation accounts for about \$20 of the current per barrel price of oil. Yet you have given us now several times multiple discussions about how the markets are working. Should we not rein in those speculators who by your own admission are accounting for \$20 of the current per barrel price of oil, in order to make markets work? Will you support legislation to rein in those speculators?

Mr. RAYMOND. Well, I think the point, Senator, is that that is part of the market. That is part of the market system. Now, in terms of—

Senator WYDEN. So speculation is good?

Mr. RAYMOND. I think you will find that many times speculation is a requirement for an orderly market. Now, I am not going to be here to defend the speculators on Wall Street. That is not my role in life. But I think the point I am trying to make to you is that that is an extraordinarily complex interaction to try and deal with that. The facts are that in the petroleum markets and the scene that has been set for the petroleum markets the uncertainty, political, all around the world, leads to speculation and that speculation does impact on the price of petroleum.

Beyond that, what you want to try and do with it, that is up to you.

Senator WYDEN. My time is up, Mr. Chairman. I am only saying that when you yourself say that speculation is such a big factor in this clobbering people are taking at the pump, it seems to me you owe it to the public to be aggressive in terms of trying to root out some of these abuses, and I hope you will try to do that when a group of us try to make those changes as well.

Thank you, Mr. Chairman.

Chairman STEVENS. Senator, I look forward to that debate on the floor. Since primarily that tax relief was for small refineries, we will be happy to have another panel of them come and answer your question and tell you why it is necessary.

The next Senators to question are Senator Smith and Senator Cantwell.

**STATEMENT OF HON. GORDON H. SMITH,
U.S. SENATOR FROM OREGON**

Senator SMITH. Thank you, gentlemen, for being here. Obviously this is a most important hearing to the pocketbooks of the American people.

It is my understanding that, while the price of crude has gone up about 40 percent this year, the price of gasoline has gone up 60 percent. Given that refining costs are essentially constant, can you explain to me or, more importantly, to the American people this growing disparity between crude oil and gasoline prices?

Mr. RAYMOND. Was this to me?

Senator SMITH. Any of you.

Mr. O'REILLY. I will take a turn.

There really are two markets at work, Senator. First of all, the crude oil market has a bearing on all of refined products, whether they are gasoline, jet fuel, or diesel, because underlying gasoline, jet fuel, and diesel you have inherently the raw material cost is crude. That is by far the biggest factor in the cost.

Crude is a global market and it functions, it moves up and down. Gasoline is not quite as global in a sense. It has regional characteristics that are both geographic and quality in nature. Some gasolines are different than others. For example, Oregon has a different gasoline than California. So you will see differences in gasoline markets that are related to supply.

Senator SMITH. Is 20 percent what it takes to account for those differences?

Mr. O'REILLY. Well, clearly if 15 percent of refining capacity comes out of the market, as it did during the period of the hurricane, you will have dramatic impacts on the product markets that are independent of crude, and I think that is what you are seeing. There has been more volatility in product markets, particularly this year, than in typical years.

Senator SMITH. I suppose I understand those kind of things. I have run a commodity business myself. But the concern that I have is that, while the Gulf can probably be explained by these incredible hurricane and natural events, however, the States these three Senators represent were not affected by that. We get no crude from the Gulf, yet the prices on the west coast spiked as well. I think that increase is really hard for me to explain in a town hall in Pendleton, Oregon.

Mr. O'REILLY. Well, as a west coast-based company I think I owe you help with the answer to that question. A lot of people do not fully appreciate that the west coast is deficit products and we typically bring product to the west coast from the Gulf Coast, from Asia, and at times from Europe, because the supply lines are so long.

When the Gulf Coast refineries went down because of the hurricanes, there was literally a bidding for the gasoline that is coming from these areas, and obviously prices in the Gulf Coast were so high that that is where the products moved. Then it caused an abnormal supply situation to occur on the west coast. It was not as dramatic as what happened in the Gulf or as volatile, but nevertheless it did impact the markets in California, it impacted the markets in Asia, as well as in Europe.

Senator SMITH. Well, look, I want—

Mr. MULVA. If I could answer one point.

Senator SMITH. Yes, please.

Mr. MULVA. All these points, the oil market certainly is a worldwide market and we have regional situations as a result of the hurricane or whatever. But there is something else that as an industry, when asked earlier when we started the hearing today what could be done, we have so many different fuel requirements and specifications from one season to the next across the United States that one of the things that we feel quite strongly that we need to do and certainly, as I think you working here in Congress and in the Senate could help us, is to go to more standardized fuels and get away from the boutique fuels.

That can help somewhat with respect to the changes and dramatic changes from products from one season to the next and within regions of the United States.

Senator SMITH. Let me also say, I do not know petrol, but I know the pea business. That was my business. If I owned the farm, if I owned the food processing plant, if I owned the distributorship and I owned the grocery store, then I am totally integrated. If I then posted enormous profits the likes of which the petroleum industry has posted, I would get a lot of attention.

My concern is your vertical integration on the west coast. When I see profits posted at \$9.9 billion, \$3.6 billion, after you have al-

ready accounted, as I understand it, for your capital investments, your taxes and more, I am hard-pressed to feel good about defending these kinds of increases when all of this vertical integration has taken place from the ground to the gasoline station.

This is a public relations problem that you have and it is a public policy problem we have. We need your help to solve it.

Thank you, Mr. Chairman.

[The prepared statement of Senator Smith follows:]

PREPARED STATEMENT OF HON. GORDON H. SMITH, U.S. SENATOR FROM OREGON

We are here today to discuss the oil industry, recent profits, and the effect of continued high gasoline prices on U.S. consumers. In this era when major oil companies control oil production from the ground to the gas pump, we need to ensure the American people that their isn't profiteering along the way.

Long after the winds and the water have subsided, Hurricanes Katrina and Rita are affecting our entire nation. The loss of life and the scope of the destruction in the Gulf region is almost beyond comprehension. We must continue to offer federal assistance as individuals and communities seek to rebuild.

The impact of higher gasoline prices on the rest of the nation, while less dramatic, is hampering our entire economy. Drivers felt the immediate impact on their wallets at the gas pump. Soon these higher costs will be reflected in higher prices for all the goods we buy.

The huge jump in gas prices nationwide in the days immediately following Hurricane Katrina spurred allegations of profiteering and price gouging. Even in Oregon, which is less reliant on Gulf of Mexico production, we had price spikes in the week following Katrina. That is why, as Chairman of the Subcommittee on Trade, Tourism and Economic Development, I requested early on that the Federal Trade Commission launch an investigation into these allegations.

This disaster also revealed a gap in federal laws pertaining to consumer protections and interstate commerce. Even though almost 30 states have enacted price gouging laws, there is no federal statute to protect consumers from price gouging in the wake of a major disaster.

That is why I introduced legislation aimed at ensuring consumers are protected in the future. My bill, S. 1743, the "Post-Disaster Consumer Protection Act of 2005," will provide additional authorities to the Federal Trade Commission to prevent oil and gas price gouging in the immediate aftermath of a declared disaster.

Under my bill, the President must declare a major disaster under the Stafford Act. For 30 days following the disaster declaration, it will be unlawful to engage in price gouging of oil or gas products.

The bill defines price gouging as a gross disparity in the price for the product charged after the disaster declaration as compared to prices charged by the same supplier during the 30 days immediately preceding the disaster. Price gouging will not include price increases attributable to increased wholesale or operational costs, international market trends, loss of production capability or loss of pipeline transmission capability.

The bill authorizes the Federal Trade Commission to determine what represents a gross disparity in pricing. The FTC will to punish violations under this act using its existing authorities under the Federal Trade Commission Act. Those authorities include seeking civil penalties of \$11,000 per violation; assessing fines or repayment of illegal gains; freezing assets; and seeking preliminary injunctions, cease and desist orders or temporary restraining orders.

I believe my bill provides needed authority to the Federal Trade Commission to protect consumers from being victimized in the wake of a disaster without hampering the normal functioning of the free market.

We are heading into the winter heating season, and the high cost of energy—particularly for home heating—is only going to put additional strains on family budgets. Individuals on fixed incomes, many of whom are elderly, are going to be among the hardest hit.

As Chairman of the Special Committee on Aging, I chaired a hearing earlier this year on the impact of high energy prices on seniors. Statistics revealed that energy prices were highly burdensome for this population. In the Coos-Curry County area of Oregon, 60 percent of seniors receiving assistance struggle to pay their utility bills or medications. Households in this part of my home state experienced an increase in utility bills by as much as 40 percent. Similar increases are being felt by retirees on fixed incomes across the state of Oregon and throughout the country.

On average, many low-income elderly citizens pay 10-20 percent of their annual income toward energy bills. With the high cost of gasoline and home heating expected to reach historic record highs this winter, the amount that older Americans on fixed incomes pay for energy can be expected to represent an even larger proportion of their income. No one should be forced to choose between heating their home and affording medicine and putting food on the table, but that is a decision many elderly households may be facing this winter.

I look forward to hearing from the witnesses here today and working with the Members of both committees to address these issues in the months to come.

Chairman STEVENS. Senator Cantwell.

**STATEMENT OF HON. MARIA CANTWELL,
U.S. SENATOR FROM WASHINGTON**

Senator CANTWELL. Thank you, Mr. Chairman.

Gentlemen, this committee was billed as an investigative hearing and I think you can imagine as the public looks at what some are saying will be \$100 billion in profits this year for the oil industry, while my constituents are losing their jobs or losing their pensions, that Americans want answers. So I am going to try in my 5 minutes to ask you some questions, and if you could give me yes or no answers that would be helpful.

First, I would like to know whether your companies in 2005 exported fuel, gasoline, diesel, outside of U.S. markets prior to Katrina? Just a yes or no answer.

Mr. RAYMOND. Well, Senator, there are no easy yes or no answers in this business.

Senator CANTWELL. Did you export fuel outside of the United States prior to Katrina in 2005? It is just a simple question.

Mr. RAYMOND. No, it is much more complex than that. Historically this country has exported some products. It is basically the way that the Caribbean and Central America live. So to the extent you say you cannot export to places that have been traditional export areas we go to, they will continue. If you are asking the question have we had discretionary exports that would be not in the historical pattern, for our company the answer to that is no.

Senator CANTWELL. I am asking a simple question: Did you export any fuel, gas or diesel, out of the United States during 2005? It is a simple question. Prior to Katrina.

Mr. O'Reilly, yes or no?

Mr. O'REILLY. Senator, we import a lot more than we export, but we always export because the Caribbean is dependent on our refineries in the Gulf Coast.

Senator CANTWELL. Mr. Mulva? Yes or no will do.

Mr. MULVA. Senator, we as a result of the hurricane, we did not export product—

Senator CANTWELL. Prior to Katrina. I am asking prior to Katrina.

Mr. MULVA. We did export product prior to Katrina.

Senator CANTWELL. Thank you.

Mr. PILLARI. I do not have the details, but I would think we did, to places like Mexico and Canada and the Caribbean.

Senator CANTWELL. Thank you.

Mr. HOFMEISTER. We both import and export.

Senator CANTWELL. Thank you.

Did any of you sell product outside of the United States in this same time period for a smaller profit than you would have made if you would have sold the product in the United States?

Mr. RAYMOND. I do not know the answer to that question.

Senator CANTWELL. Mr. O'Reilly, do you know?

Mr. O'REILLY. Impossible to answer without checking.

Mr. MULVA. I do not know the answer.

Mr. PILLARI. I do not know.

Mr. HOFMEISTER. Do not know.

Senator CANTWELL. Thank you.

Will you gentlemen provide information about how much gas and diesel your companies exported in 2005 and whether you sold any of that product for a lower profit than you would have made in the United States? Will you provide the committee with that information?

Mr. RAYMOND. Sure.

Senator CANTWELL. Could you answer for the record?

Mr. O'REILLY. We will get it for you.

Mr. MULVA. Yes, we will.

Mr. PILLARI. Sure.

Mr. HOFMEISTER. Yes.

Senator CANTWELL. Do you know of any instance in which your companies might have diverted supply, that is any instance where you had a ship heading towards the United States destined for the U.S. market with supply and the petroleum products en route to the United States were diverted?

Mr. RAYMOND. No.

Mr. O'REILLY. Senator, the other way around. Without bringing in products from places like Europe and Asia to the west coast, we would—

Senator CANTWELL. I am just asking—

Mr. O'REILLY. I would just like to clarify. We would have been shorter of product on the west coast.

Mr. MULVA. Senator, no, not that I am aware of.

Mr. PILLARI. No, I do not believe so.

Mr. HOFMEISTER. Senator, there were cases where ships were on their way to this country but there was no more capacity, no room to bring the imports into this country, particularly in the New York harbor, where the capacity was simply unable to take more imports.

Senator CANTWELL. Would you provide this information to the committee as well?

Mr. HOFMEISTER. Yes.

Senator CANTWELL. Thank you.

Now, I only have a few minutes left and I would hope that the members before us today would speak to the issue of the spot market, because, having dealt with this situation with Enron, where all my colleagues here heard that this was about the fact that we just did not have enough supply and it was environmentalists that were holding things up or it was the process, only to find out it was not so much about production but about manipulation of supply.

I want to know whether you gentlemen will help us reform the spot market sales and lack of transparency that occurs in the off-market exchanges, the fact that we do not know what these records

and trades were, there is no ability to track that. So would you disclose your sales in this off-exchange, in the spot markets, for this same time period in 2005?

Mr. RAYMOND. I have no problem with that. We are basically not in those markets.

Mr. O'REILLY. With clarification, I would be happy to provide that.

Mr. MULVA. Yes, I think with further clarification we would provide it. We are essentially in the physical markets, not necessarily the financial markets. So we would share that information.

Mr. PILLARI. We would be happy to work with you on what it is you are looking for and then provide it.

Mr. HOFMEISTER. The same.

Senator CANTWELL. Thank you.

Thank you, Mr. Chairman. I think this is a very critical, important issue, the fact that we have lack of transparency and product inventories have changed drastically. This industry has moved to just in time inventories and so, instead of having 26 days of reserves, we now have 5 days of reserves or something of that nature. Let us find out.

But I think that that leads to a manipulation of supply that increases price prior to Katrina. The spot market fluctuation has to have transparency.

Thank you, Mr. Chairman.

Chairman STEVENS. We now recognize Senator Martinez and Senator Landrieu for 5 minutes each.

**STATEMENT OF HON. MEL MARTINEZ,
U.S. SENATOR FROM FLORIDA**

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

Mr. O'Reilly, the first question is to you. I heard your testimony about the area of the Destin Dome, which happens to be in my State of Florida, and one of the questions—well, frankly, one of the things I hear when I go home is folks not only asking what is going on with the prices, but they also do say: Thank you for protecting our beaches, thank you for protecting Florida.

So in that vein, in addition to economic considerations, environmental considerations, I wonder if you are aware of the fact that very close to the Destin Dome is one of the largest Air Force bases in the United States, in fact the largest land area in the United States, the Eglin Air Force Base, which utilizes extensively the Gulf of Mexico for military training missions? Are you aware of that presence there?

Mr. O'REILLY. Yes, I am, Senator.

Senator MARTINEZ. Would it be also part of the consideration of not drilling immediately 25 miles off the coast of Florida immediately south of Eglin Air Force Base, the fact that military missions and training and testing would be impeded if there were platforms in that immediate area just south of Eglin Air Force Base?

Mr. O'REILLY. Senator, I do not—I think it is a policy decision that the Government should make. This was done on what I would call a bipartisan basis. I am just pointing out it is a policy decision. We can either develop the gas or we can leave it there. It is a government choice.

Senator MARTINEZ. But there are policy considerations in why we make certain decisions.

Mr. O'REILLY. That is correct.

Senator MARTINEZ. Which then have ramifications I do understand.

Mr. O'REILLY. That is correct. That was the point in one of my recommendations. Policy alignment is I think a very critical issue, and I am just pointing out that it is difficult for us to develop resources unless the policies are there to support them.

Senator MARTINEZ. Your example then went on to talk about liquefied natural gas from Angola. The fact is that there are other means by which gas product can get to Florida, through pipelines over land, and those are really the more normal routes by which gas comes to Florida, since there are no liquefied plants that I am aware of in the State of Florida anyway?

Mr. O'REILLY. No, there are not, that is correct, Senator.

Senator MARTINEZ. So that is not really how Florida receives its gas product, Angola?

Mr. O'REILLY. It will be, because it will get into the pipelines and ultimately arrive in Florida.

Senator MARTINEZ. Not today.

Mr. O'REILLY. In a few years, Senator.

Senator MARTINEZ. This is for all of you now. I recently had an opportunity to become aware of some of the things that are being done in Brazil and have been done over the years in Brazil with the use of ethanol in their mix of fuels. As the leading energy companies in our country as it relates to gasoline and servicing of our folks that attempt to move about in our transportation network with the fuels that we currently have, I want to know what each of your companies is doing about the future. I want to talk about the thinking that we have as to what we will do for tomorrow that will be different than what we have been doing in the past.

In Brazil they are utilizing ethanol extensively as a mix into their gasoline. In addition to that, I understand from what I was told while there that every single gas station outlet in the country has a pump that will pump ethanol. I know that the automobile companies there, Ford and GM for two, are developing vehicles that will soon be on the market that will allow them to run on either ethanol or on more traditional gasoline.

I do believe in the ingenuity of our industry. I do believe in the ability of the American know-how to be re-energized and for us to become not so wedded to what someone decides on a given day in Saudi Arabia that they will sell us crude oil for, but that we will be independent of that and that we will be independent of irrational and unstable dictators south of the border that control a substantial percentage of our fuel.

What are each of your companies doing for us to develop that ingenuity and that know-how into independence of fossil fuels as we have known them in the past, utilizing renewables, utilizing ethanol and maybe other technologies as well? We will begin with you, Mr. Hofmeister. I noticed we have started at the other end of the table. I want to give you an equal opportunity.

Mr. HOFMEISTER. Thank you, Senator. We are heavily involved in the ethanol business in Brazil and that is a good business.

Senator MARTINEZ. Why are we not doing it here?

Mr. HOFMEISTER. Well, in fact we are the world's largest marketer of ethanol and we are doing it here. We are shipping daily tens of thousands of gallons—barrels, I should say—of ethanol to different parts of this country. We are also investing in cellulose ethanol, which is a more derivative form of ethanol. We are both passive investors in companies that are doing it and in which we are funding their research, but also in our own laboratories.

We are investing in biofuels, in a wide range of biofuels, not just ethanols, to test their viability. And we are working closely with the auto manufacturers on their engine designs to see to it that the long-lived nature of engines is protected with the introduction of these biofuels in such a way that we can also handle the climate change issues. What I mean by that is the existing climates of North and South and East and West of this country.

We are also—4 miles from here, we are selling hydrogen in a retail station and we believe that the hydrogen business, working in a partnership with General Motors, is a very good future business for us. But it is many years into the future before it really does touch many of the consumers in the United States.

Senator MARTINEZ. Gentlemen, I realize my time has expired. If anyone can give a similar answer, that's fine. If not, I would take it in writing from each of you.

Mr. PILLARI. Senator, I would just add that we are an extremely large user of ethanol. We will continue to grow our ethanol use. We have hydrogen sites, pilot sites, now in Florida, Michigan and California. We are working with auto manufacturers on what they are going to do with engines. So it is a very similar story.

Chairman STEVENS. The Senator's time has expired. I am sorry. Senator Landrieu.

Senator MARTINEZ. Thank you, Mr. Chairman.

Chairman DOMENICI. Now Senator Feinstein.

Chairman STEVENS. I had made a mistake.

**STATEMENT OF HON. DIANNE FEINSTEIN,
U.S. SENATOR FROM CALIFORNIA**

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

Welcome. It is my impression that refineries in the United States are virtually at capacity and yet no new refineries are planned. I wrote to each CEO earlier asking what you were going to do to try to see that prices are lowered or whether you would cooperate to see that prices are lower, and I received no affirmative answer. I did, however, receive a letter from Mr. Bindra, Mr. O'Reilly, of Chevron, which with respect to refinery production indicates that Chevron is increasing the total California refinery production capacity by roughly 20,000 barrels per day. That is 800,000 gallons a day. It is a 10 percent increase as I understand it in production. And that the Richmond refinery has already submitted permit applications for the city of Richmond and the Bay Area Quality Management District, and that modernization is under way at El Segundo. So I think that is good news.

But Deutschebank reported that refining margins on the west coast have doubled in 2 years, going from \$11.99 in 2003 to approximately \$24.60 in the third quarter of 2005. So it appears that

oil companies are holding back adding refining capacity because it helps increase margins.

Now, I know you have spoken about expansion, but I would like to know how much of your profit margin is due to refining and what justification you have for such huge refining margins?

Mr. RAYMOND. Well, Senator, if I may, I recall the letter you sent, but I think in our case as I recall it was directed primarily toward California. You probably do not recall, no need that you would, that at the time that Exxon and Mobil merged each one of the companies owned a refinery in California. The Federal Trade Commission and the State of California made it very clear that we could only own one refinery and they were not interested in our making any additional investments in any refining in California. So, given that that was the circumstance a few years ago and we now only own one refinery, we probably are not the right people to talk to.

Senator FEINSTEIN. Mr. O'Reilly?

Mr. O'REILLY. Senator, with two refineries—and of course we are in the process, as you point out, of expanding both; they are in the permitting phase. The one at El Segundo is under way. The one in Richmond is in the permitting phase and we hope to be able to expand there in the coming year if the permits are all approved.

The issue in California is really twofold. It is also an issue of the investments that have been required there to meet the unique California gasoline and the very strict environmental regulations. And I am not squabbling at all about the fact that we need strict environmental regulations, but the capital that has been invested in California is enormous over the last decade to meet those.

So I think the issue for us is to continue to work on expansion and to try to assure that we can meet the market needs. Today we bring gasoline into California from places as far as Europe to supply the needs because of its unique formulation and the fact that the expansion prospects at our refineries are difficult to accomplish.

So I think we are on the right track, but it is a constant battle.

Senator FEINSTEIN. I think perhaps I was a little too subtle. What I am trying to get at is it would appear if you look at the profit margins that the industry is purposely keeping refining capacity low. I tried to say, to recognize your expansion at Chevron, but it would appear that overall there is a purposeful effort to keep refining capacity tight because it increases profit margin. That is what I am trying to get at, because the profits have been enormous due to this.

It seems to me—and I have always been told, we do not have refining capacity in California, you cannot add any more regardless. Therefore it seems to me that what we need to do is increase refining capacity all over this Nation.

Mr. Mulva?

Mr. MULVA. Senator, we are one of the largest refiners in the United States and we operate in all regions of the United States. Several years ago we started embarking on a program to expand capacity as well as to modernize our refineries to handle the lower quality crude oils that will be made available over time that are

imported from Canada, from Central America, as well as from the Far East and from the Mideast.

So what that does is not only are we adding capacity—and we, our company, announced a \$4 billion program over and above what we normally do to add capacity and modernize our refineries, so we can make more jet fuel, more heating oil, more gasoline, more diesel. So we have looked upon—historically this business has not had the returns that we have experienced in the last several years. But the utilization of capacity, refining capacity, has moved up from less than 80 percent years ago to essentially full utilization.

So we are, our company and as you heard from the other people on this panel today, we are significantly putting money to add capacity and increasing our capability to handle the lower quality crude, so we make the transportation fuels and the clean fuels that the consumer and the public needs.

Chairman STEVENS. The Senator's time has expired. I am sorry.

Senator FEINSTEIN. Thank you.

Chairman STEVENS. We yield 5 minutes to Senators Hutchison and Pryor.

**STATEMENT OF HON. KAY BAILEY HUTCHISON,
U.S. SENATOR FROM TEXAS**

Senator HUTCHISON. Thank you, Mr. Chairman. Mr. Chairman, I was looking up some of the tax breaks that were mentioned earlier and trying to determine where those might be applied to oil companies. One is allowing natural gas distribution lines to be depreciated over 15 years instead of 20 to encourage more gas distribution lines. Another is an incentive for deep drilling in the Gulf, which we have had for a long period of time because of the risk and the cost that is added, and the Gulf being one of the few places that we can really drill on our shores.

So my question is this. You say, well, we can do without the tax breaks, but when you are making the decisions about where you can put your money most productively do 15-year depreciation rules instead of 20-year depreciation rules, or incentives for something as expensive and risky as deep drilling in the Gulf, does it make a difference in where you start making allocation decisions as opposed to not needing it?

Mr. RAYMOND. Senator, I think the problem you get into here is that each company views that somewhat differently. I think in our own case when we look at the specific issues you talk about the conclusion we came to is that they will not significantly alter the programs that we have in any of those areas. That does not—but in saying that, that does not mean that is the case for every company.

Senator HUTCHISON. Let me just ask anyone else, because we are trying to do things that will spur building of refineries, building of pipelines, and more production in our country, and we are trying to determine the best way to do that. So I am trying to see if there are certain incentives for doing things that you might not do making a business decision in those areas that have been put in our tax bills.

Mr. O'REILLY. Senator, I think that from our perspective the more important thing for refining is the permitting side of the busi-

ness. It is one thing to have a 15 or a 20-year depreciation schedule, but it is another thing to get it started. One of the problems that we face are things like new source review, which is in litigation, and the rules around new source review.

If you take it—if you fix the furnace in your home, you should not have to go back and re-permit all of the other energy-consuming efficiencies in your home. Yet that is what we have to do in refineries. So it is a complex issue.

Frankly, I would much prefer from our company's perspective to see streamlined permitting than to see—to me, that is a much more important barrier to overcome than tax incentives.

Mr. RAYMOND. I would share that view, Senator. I do not think, at least in the last 20 years that I can speak for, that we have ever come here and asked for a financial incentive to do anything. If there are things to be done, it is more in the regulatory process and the access issues that are more fundamental to our investment outlook in this country.

Senator HUTCHISON. Could I just pursue that, because if you are saying that the regulatory environment—and I will tell you that I have heard this many times from other companies' CEO's, not just oil and gas—that the reason refineries or other investments in manufacturing are not made in the United States but are instead made overseas is because the regulatory environment is more stable and more predictable in other places—are you saying that that is the issue that we need to address more than any other for incentives for building refineries?

Mr. Mulva?

Mr. MULVA. Senator, I think the prior comments are certainly applicable, but what we definitely need is really the streamlining of regulations and permits to allow us to expand. One of the things we do on refineries is our ability to expand capacity generally speaking is about half the cost of building a new refinery. So if we can have accelerated permitting and whatever to expand, we can bring on capacity far more quickly.

With respect to the upstream part of the business, exploration and production, we really need access. Now, the panel that is here today are representing the larger integrated companies. But as you know, we have numerous, many, many independent producers in the United States who develop a great deal of oil and gas. From all of us, integrated companies and the independent producers, what we really need is access to explore, to drill and add capacity of oil and gas versus incentives on the upstream part of the business.

Senator HUTCHISON. Thank you, Mr. Chairman.

Chairman STEVENS. You must stop there, Senator.

Senator Pryor is recognized for 5 minutes.

**STATEMENT OF HON. MARK PRYOR,
U.S. SENATOR FROM ARKANSAS**

Senator PRYOR. Thank you, Mr. Chairman.

Senator Sununu and I were talking a minute ago about how we feel like we are at Thanksgiving dinner and you have put us at the children's table. Is there a reason for that?

Chairman STEVENS. I remember a Senator told me once how much time you have to log to get from your seat to mine.

[Laughter.]

Senator PRYOR. Fair enough, fair enough.

Let me just say that I have a concern and maybe even a suspicion, and it is basic Adam Smith economics, and that is in a market economy you have supply and demand and that works pretty well unless there is market manipulation. I think what you are hearing voiced from us and our constituents is that we have concerns about market manipulation. I do not have any evidence of that. I cannot point out four or five things that I am basing that on. But I will tell you right now, that is something I am very concerned about and I am looking at.

Mr. Raymond, if I can start with you. One of the disconnects in this price of gasoline issue and the oil industry right now, one of the real disconnects in my mind, is your profits—and not to single you out, but your profits have risen dramatically in what you posted in the third quarter. That is obvious to everyone. Many times today the panel has talked about the hurricanes and how disruptive the hurricanes have been and what the adverse effects of the hurricanes have been.

Are you telling the committee today that had we not had the hurricanes that your profits would be even higher?

Mr. RAYMOND. That is a hard question to answer. I do not believe I would say that that is the case. I think the focus on the hurricanes is related to the question about what happened to gasoline prices in this country as a result of when 30 percent of the refining capacity had to go off line because of the hurricanes.

The broader issue of the general level of profitability I think is somewhat different. As I commented, 75 percent of our profits come from outside of this country. They have nothing to do with our U.S. operations. When you then start to focus on the U.S. operations, I will be the first to comment to you that we are at the high point of a cycle. We go through many cycles. I can recall with pain when the crude oil price was \$10 a barrel. Consumers of course were very happy because gasoline was less than a dollar a gallon. We are now on the other end of the cycle.

But in our business we have to manage through the cycles, and the question is what is the profitability through the cycle, not at any point in time.

Senator PRYOR. You understand the concern I have on that, though?

Mr. RAYMOND. I understand that, and I think I made that comment earlier today. I certainly do understand it. But the other side of it is people need to realize we are in a commodity business, there are ups and downs in a commodity business, and our job is to manage through the ups and downs with a view towards the long-term, which is what we try and do.

Senator PRYOR. Mr. Hofmeister, let me ask you, and I hate to ask you to keep your answers very brief because we just have 5 minutes today. In your opening statement you talked about crude prices going up, and we all have seen that on the world market. What is the connection between the price of crude and profits?

The reason I ask that is it is intuitive to me that when your crude price goes up, in other words your feedstock price goes up, you are probably—and actually you are, going to have to pass that cost on to the consumer and your profits would go down. But it appears that we are in a market right now where your crude oil prices have been at an all-time high and your profits have been at an all-time high. So what is the relationship between crude prices and profits?

Mr. HOFMEISTER. Well, I think it is largely driven by demand. The demand is what is driving up the end price that consumers pay. It is also driving up crude. In other words, the availability of crude is simply not sufficient at this point in time to meet all of the demands put upon that crude and as a result the pull on the available crude is keeping crude prices high, the demand for products is keeping product prices high. That is yielding the profits that we see.

Senator PRYOR. Okay. We know that from the ground up it is very expensive to build a new refinery. Is that correct? What is the estimated cost on a new refinery?

Mr. HOFMEISTER. It really depends on the size of the new refinery.

Senator PRYOR. Okay. Well, here is my question for you, because I notice that Shell had posted about a \$9 billion profit in the third quarter. Is it your intention —

Chairman STEVENS. Senator, this is your last question, please.

Senator PRYOR. Yes, sir.

Is it your intention to take those profits and build a new refinery?

Mr. HOFMEISTER. Senator, in September we commissioned an engineering study to look at alternatives between several hundred thousand barrel per day expansions up to a 325,000 barrel per day expansion in a single site. We will see the results of those studies probably in the first quarter and then be in a position to make a decision whether to go forward or not.

Chairman DOMENICI. Back on our side, if I have got it right it is Senator Thomas and then Senator Landrieu.

**STATEMENT OF HON. CRAIG THOMAS,
U.S. SENATOR FROM WYOMING**

Senator THOMAS. Thank you, Mr. Chairman.

Thank you, gentlemen, for being here. I have got several questions. I will do it quickly and hope you can do it quickly.

In terms of the industry, it seems like in business usually as your volume goes up you make more profits, but the percentage of profit on the sales remains about the same. Is that true over the last 5 years, 10 years, in the industry? Has the profit as a percentage of total sales remained somewhat the same or has it increased? Anybody?

Mr. RAYMOND. I think the answer to that over the last 10 years is it has gone up somewhat, because in the early part of that period they were extraordinarily low.

Senator THOMAS. Okay. But the profit—

Mr. RAYMOND. They have gotten now up to about the average of all U.S. business. In the early part of that period they were well below that.

Senator THOMAS. So these higher profits are at least a fundamental part of having higher sales?

Mr. RAYMOND. That is right.

Senator THOMAS. Okay. Coal remains our largest fossil fuel resource. Generally, are you guys interested in looking at the diesel fuel from a coal kind of alternative? Is that something that you look at and are willing to be interested in?

Mr. RAYMOND. We have over a long period of time, Senator. We have had a number of research projects going back to the mid-1960s that looked at converting coal into liquid fuels, and continue to be interested.

Senator THOMAS. So you do not see that as a conflict with your interest in oil?

Mr. RAYMOND. No, no.

Senator THOMAS. Okay, good.

Mr. Raymond, I guess you specifically. You indicated that in 1998 crude oil was \$10 a barrel, your company made \$15 billion in capital expenditures. Last year your prices were over \$40 and you still made \$15 a barrel. Do you invest more money when you make more profit?

Mr. RAYMOND. What we generally try and do, Senator— the numbers were back in 1988 we made \$8 billion and we invested 15; last year we made 24 and we invested 15; this year we are going to invest 18 or 19. Our objective over time is to clip off the peaks and the valleys and try and have it generally up-trend with regard to the investments. Year to year you have to be careful because there can be big projects in one year versus another. So you have to be careful.

Senator THOMAS. So you try to even it out over a period of time.

Mr. RAYMOND. Yes, that is the intent.

Senator THOMAS. Specifically, I guess in Wyoming, for example, one of the alternatives is to have CO₂ secondary recovery, and we are doing quite a bit. Anadarko, for example, has a program. You produce a good deal of it at the Chute thing.

Mr. RAYMOND. Yes, we do.

Senator THOMAS. But you do not put it on the market. Why not?

Mr. RAYMOND. The CO₂?

Senator THOMAS. Yes.

Mr. RAYMOND. Well, I think all the studies have indicated, given what the location is of the Chute Creek plant versus where the location is for the CO₂ to be injected into the reservoirs, generally up until the prices that have gone up in the last year the transportation was uneconomic.

Senator THOMAS. But now that the price—for instance, you have a pipeline going up to Salt Creek. That is a long ways.

Mr. RAYMOND. But the point is that if people felt that the crude price were sustainable even close to the current levels then it would likely be that the CO₂ would become economic.

Senator THOMAS. I got you.

We talked some earlier or you talked some earlier about, importantly I think, educating the public as to what some of the issues

are in your industry. You have been talking about for some time an educational program. Exxon has not joined in that. What is your position on that?

Mr. RAYMOND. Actually, we have had an educational program that the company has funded for 15 or 20 years.

Senator THOMAS. I know, but the industry has talked about one.

Mr. RAYMOND. Well, that is the API. I hate to just pass it off to the API, but Exxon has supported programs like that for years.

Senator THOMAS. This is the one that has to do with like the livestock deduction for contribution and so on.

Mr. RAYMOND. I understand.

Chairman DOMENICI. Senator, I hate to interrupt, and do not charge this to him, but I just wonder, do you mind when you ask the questions if other than Mr. Raymond might answer some of them?

Mr. RAYMOND. Please.

Chairman DOMENICI. Just because he was first does not mean he should handle all of them.

Senator THOMAS. Well, a couple of those were specifically for Exxon.

Chairman DOMENICI. Oh, I am sorry.

Senator THOMAS. I might ask Shell if you are interested in shale oil in Wyoming as well as Colorado?

Mr. HOFMEISTER. Absolutely, Senator.

Senator THOMAS. I know that.

No, I understand. I just want to say specifically, to say that I know your companies, and Shell specifically to mention, and the others have, too, have made considerable contributions to environmental kinds of things and are interested in making sure that as we move toward access— and I agree with you entirely on access; there is a great deal more access available, but we have to do it in a way that is environmentally sound, and I think we can do that and I appreciate it.

So I will yield my time.

Chairman DOMENICI. Thank you very much, Senator.

I think on our side Senator Mary Landrieu from Louisiana.

**STATEMENT OF HON. MARY L. LANDRIEU,
U.S. SENATOR FROM LOUISIANA**

Senator LANDRIEU. Thank you, Mr. Chairman.

I thank the panel. It has been a long morning and we are going to continue on for a while. But first let me begin by thanking each of you and the companies for what you did to save lives, to save property, to restore the communities along the Gulf Coast.

Sometimes the Members of Congress do not quite understand the tremendous investments and number of people that it takes to supply gas and oil for this country. But those of us from Louisiana and Texas, Mississippi, Alabama, have a little better idea. I know the heroic work that all of your companies did to save lives, to get people out of the Gulf, out of harm's way. I know that your employees, having lost their own homes, and some of your suppliers lost their own businesses, stayed up 24/7 so that we could keep the lights on in New York and California and New Jersey and Florida. So I just want to thank you all for what you did.

No. 2, I understand that there is angst, as it should be, by consumers, residential and industrial consumers, because the prices are high. When prices are high, our economy is affected in negative ways. But I do want to say to the members of this committee that look at Louisiana as a producer that we are also a great consumer of energy. So the Senators from Louisiana and Texas can argue both sides of this argument, and I would say we serve as a pretty good bellwether about trying to hit the right balance.

In other words, when prices are high we make a little money because we are producers, but because we consume so much energy to produce for our industrial base we also feel the burden of those high prices. So Louisiana's policies are a good bellwether because we are a balance.

Having said that, let me just go on the record to say the tax incentives that, Senator Wyden, you inferred in your comments are mostly directed to independent petroleum producers. For the record, they produce 85 percent of the wells in the United States are run, not by the big oil companies that are represented here, but by independent producers.

Sixty-five percent of the country's natural gas are produced by these independent companies, which are smaller, many of them located in Louisiana and Texas, but some of course in Wyoming and the Midwest. They need these tax incentives because they are smaller. They do not have the international reach. They are not able to basically hedge against the volatility of the price. That is why most of these tax cuts or tax credits, tax incentives, are in the record. So I just wanted to submit that for the record.

Let me ask. One of you mentioned that it takes so long to put a new refinery in the United States that it really diminishes your interest in doing so. Would any one of you want to answer for the record how quickly you can build a refinery in either Brazil or China compared to the building of a refinery in the United States? Just roughly, does it take you half the time, a fourth of the time, or about the same time?

Let us start with—

Mr. RAYMOND. Well, Senator, we are in the midst of starting to construct a major refinery in China—

Senator LANDRIEU. Just quickly, if you can, just generally.

Mr. RAYMOND. An integrated chemical plant—it will take about 3½ years.

Senator LANDRIEU. What does it take here?

Mr. RAYMOND. The comparable time would be 7 or 8.

Senator LANDRIEU. What about you, Mr. O'Reilly?

Mr. O'REILLY. 4 years for the last one we built, which was in Thailand.

Senator LANDRIEU. How long would it take you here?

Mr. O'REILLY. Double that.

Mr. MULVA. Similar experience in terms of time of construction, but it takes quite a bit longer on the permitting side in the United States compared to other locations.

Senator LANDRIEU. So would it be fair to say that for all of you it takes about at least twice as long to build a refinery here?

Mr. MULVA. I do not know if it is twice as long, but —

Senator LANDRIEU. 40 percent, 35, 40 percent more?

Mr. MULVA. It could be. But the other thing that is very important is we think we can add an equivalent amount of capacity by expanding our current facilities than to build, and get the same effect. We get the supply into the marketplace and the consumer far more quickly.

Mr. PILLARI. I think an important part in the United States is we have multiple layers of government and in some parts of the world it does not exist that way. So if we can do parallel processing of permitting I think it would be helpful to us.

Chairman STEVENS. Senator, this will be your last question, please.

Senator LANDRIEU. Okay, thank you, Mr. Chairman.

Let me ask on the OCS access. Are you aware that only 2.5 percent of OCS has been explored in the Nation? And are you aware that there would be additional supplies of oil and gas that could supply and help us with the demand situation? And do you support any sort of revenue-sharing, starting with Mr. Hofmeister from Shell?

Mr. HOFMEISTER. We are fully aware and we look forward to the inventory that the energy bill calls for, and we would support more revenue-sharing.

Mr. PILLARI. We are interested in what the report will say. We want to take a look at each part of it. And while I have not personally been involved in revenue-sharing, we would be interested in looking at anything.

Chairman STEVENS. Thank you very much.

Senator LANDRIEU. Can they just finish, Mr. Chairman?

Mr. MULVA. We certainly support and are willing to consider all alternatives in revenue-sharing.

Mr. O'REILLY. The same answer.

Mr. RAYMOND. The same.

Senator LANDRIEU. Thank you very much.

[The prepared statement of Senator Landrieu follows:]

PREPARED STATEMENT OF HON. MARY L. LANDRIEU, U.S. SENATOR FROM LOUISIANA

The one-two punch of Hurricanes Katrina and Rita has focused this country's attention on our energy situation like never before. The short term impact to oil and gas production in the Gulf of Mexico is unprecedented and the full impacts are likely to be still felt for months to come.

As a result of Hurricanes Katrina and Rita blowing through the Gulf Coast last month, almost 45 percent of normal daily oil production in the Gulf of Mexico—which represents thirty percent of the nation's oil production—and 41 percent of the normal daily gas production in the Gulf of Mexico—which represents over 20 percent of the natural gas produced domestically—were offline as of yesterday. 11 percent of the nation's refining capacity is down or in the process of re-starting—40 percent of nation's capacity when fully operational. A number of natural gas processing plants with an aggregate capacity of just under 8 billion cubic feet a day were not active as of last week. That equates to about 13 percent of our daily consumption of natural gas.

While prices were up significantly even before these storms hit they have been at record levels in their aftermath: oil hovering at or above \$60 a barrel and natural gas over \$14 per thousand cubic feet.

The past two months have made clear something to the rest of the country that those of us who live along and represent the Gulf Coast have known for years: as oil and gas production goes in the Gulf of Mexico so goes the price and supply of oil and gas for the rest of the country.

Production on the outer continental shelf requires thousands of miles of pipelines and onshore refining capacity. Louisiana is the heart of this activity, hosting some 80 percent of the production in the OCS.

Just a snapshot would show that 34 percent of the nation's natural gas supply and 30 percent of the nation's crude oil supply is produced in or offshore Louisiana or flowing through the state. 16 percent of the total U.S. refinery capacity, half of the Strategic Petroleum Reserve facilities and the nation's only deepwater super-tanker port, LOOP, as well as several major LNG terminals are located in Louisiana.

With the companies represented here today experiencing record profits and the discussion focused on what can and should be done with those profits, I can only hope that some of the discussion will focus on re-investing some of these profits back into the areas that have served as this industry's platform over the last fifty years.

Most of the testimony today from these five witnesses touched upon the need to develop other areas of the OCS where production is currently prohibited. It is estimated that sixty percent of the oil and natural gas still to be discovered in U.S. will come from the OCS. However, today only 2.5 percent of the 1.76 billion acres that make up the OCS are leased. 97 percent of all OCS production is restricted to the Central and Western Gulf of Mexico with most of the Pacific Coast and the Eastern Gulf of Mexico as well as the entire Atlantic Seaboard off limits.

While I support this effort, I must remind my colleagues and witnesses at the table today that the areas where oil and gas presently takes place in the Gulf of Mexico are going to continue to supply our country with a substantial amount of its oil and gas for the foreseeable future. Therefore sharing of the current revenues to provide a robust and stable source for coastal impact assistance for host states is critical.

Louisiana and the other Gulf Coast states have experienced the boom and bust nature of the oil industry over the years. Now as you experience record profits we expect reinvestment in our region.

Some of the companies represented here today recognized the value of my state's coast to its interest well before either Hurricane Katrina or Rita made landfall. I hope in the aftermath of these storms that role is clear to everyone.

Prior to Hurricanes Katrina and Rita, Louisiana was losing more than 24 square miles of our coastal land each year. Katrina and Rita may have accelerated the land loss by several years. The erosion of Louisiana's coast is of fundamental interest to all of us because these coastal wetlands and barrier islands are the first line of defense for protecting the offshore and onshore energy infrastructure in the Gulf of Mexico against the combined wind and water forces of a hurricane. In fact, a recent report by Louisiana State University found that every 2.7 miles of healthy marsh can reduce storm surge by as much as a foot. As a result of coastal erosion, many pipelines that were once well protected are now exposed and subject to open sea conditions.

Preserving these vital wetlands and the billions in energy investments they protect are vital for the continuation and expansion of the energy production in the Gulf of Mexico the country so desperately relies on every day. Yet, as the barrier islands and coastal wetlands of Louisiana continue to wash away, more offshore and onshore infrastructure will be damaged by storms less destructive than Katrina and Rita. Without energy assets like Port Fourchon, LA-1 and the 20,000 miles of pipeline that crisscross our state, it would literally be impossible to access the mineral resources of the OCS.

To maintain and even increase production from off our coasts we must reinvest in the infrastructure that makes all of the activity possible: port facilities, roads to transport equipment and supplies, erosion control or barrier island and wetlands storm protection. The high prices and disrupted supply we confront today due to the impact of Katrina and Rita have only made the situation more urgent. The continued erosion of Louisiana's coastal wetlands presents a clear and present danger to our national energy security and makes our trading and commercial position in the world economy more vulnerable.

Thanks to the leadership of the Chairman and Ranking Member of this Committee and the good work of the Energy Conferees in the House and Senate, Louisiana, as well as other coastal producing states, will receive a significant amount of coastal impact assistance through the Energy Policy Act of 2005. The wisdom of that policy should be clear to everyone. The need to do more apparent.

I call on the companies represented here today follow Shell Oil Company's lead and take a public stand in support of robust revenue sharing with coastal producing states and join our efforts to accomplish this important goal in the near term.

Chairman STEVENS. We will now call on Senators Sununu and Bill Nelson.

**STATEMENT OF HON. JOHN E. SUNUNU,
U.S. SENATOR FROM NEW HAMPSHIRE**

Senator SUNUNU. Thank you, Mr. Chairman.

I apologize to you, I suppose, in a manner of speaking, in that I do not have a list of questions for the panel. I think the panel in very reasonable opening statements tried to make a few points from their perspective. Their profits are about 8 percent of revenues. It is a lot of money because they are very big companies. 8 percent of revenues for net income is about what the national average is at the moment. And obviously, being large companies, you have invested a great deal in capital expenditure, and I suppose that is fine as far as it goes.

For our part, State and Federal regulators have passed a lot of byzantine regulations that result in about 100 different formulations of gasoline and other fuels to be sold. We all know that no one wants a refinery built in their back yard, and I think those are some of the access issues and the regulatory issues that we absolutely need to deal with.

But we all know what is really on the table here or what is really being discussed, and that is some kind of discriminatory tax program, a windfall profits tax of sort. I do have great concerns about that, in that we have a pretty clear picture of what that means already, both theoretically and in practice. One of the things that were handed out, this is a memo, "Joint Committee Staff." I assume this was put together by all the staff. There is a summary of a Congressional Research Service report, which is a nonpartisan group that supports all of us.

I want to read from this summary of a 1980 CRS report on the windfall profit tax on crude oil, which sounds great when you are making a ton of money and we want to show that we are trying to do something about gas taxes. But I think it is important that we talk about what a windfall tax really is.

In 1980—this is reading from the summary—"the Federal Government enacted a windfall profit tax. The windfall profit tax was a tax on oil produced domestically in the United States. In economic terms, the windfall profit tax increased the marginal cost of domestic oil production." I do not know if we are really for increasing the domestic cost of oil production, but that is what a tax tends to do, is increase the cost of things.

"It reduced domestic oil production from between 3 and 6 percent." Are we for reducing domestic production? I hope not. "And increased oil imports from between 8 and 16 percent."

The CRS, Congressional Research Service, went on to say that "The windfall profit tax would reduce domestic oil production and increase the level of oil imports," which at the time was above 50 percent of demand. The profits tax was repealed in 1988 because it was an administrative burden on the Government and a compliance burden to the oil industry and because it made the United States more dependent upon foreign oil.

I will cut the summary of the Research Service report there. But I think it is important to understand that, as much as we all want to be seen as doing something here in Washington about high gas prices or what might be perceived as excess profits in the oil industry, we should not undertake legislation that has been proven in

the past to increase demand and increase dependence on foreign imports of oil.

Taxes that discriminate against specific industries, even one that may be as popular as the oil industry at the moment, are a bad idea. Tax surcharges on energy and the energy industry have been tried and they have failed in practice. That does not mean that there are not a whole lot of things that should be done better or practices that should be improved in your companies or legislation that even might be passed that could address concerns we have. But taxes and windfall profit tax are not one of them.

Even more troubling to me is the fact that these are being proposed now, on the heels of a huge energy bill that everyone on this combined committee voted for except for I think four of us. Senator Wyden voted against it, I voted against it, maybe two or three other members sitting in the room here today voted against this, because we do not need to be subsidizing oil and gas production, for all the reasons that were described in a very fair and reasonable way.

I think Senator Wyden is spot on when he talks about the need to go back and look at these provisions. There were over \$12 billion in different kinds of tax subsidies in that energy bill, not all of course going to the oil industry. There were billions more in spending, programs that subsidize research for oil and gas, for coal, for other areas of the energy industry, that simply are not needed. And I think it—

Chairman STEVENS. Senator, I am going to have to ask you to wind up, if you will.

Senator SUNUNU. I absolutely will wind up. I appreciate being given the 5 minutes, but my point is one of caution. I think we need to be a little bit more circumspect in the kind of policy ideas we are proposing. I think we need to go back and look at that energy bill, and I think it does not serve anyone's interest to just start trying to pass legislation to make it look like we are doing something when it is going to have counterproductive results.

Thank you, Mr. Chairman.

Chairman STEVENS. Senator Bill Nelson is recognized for 5 minutes.

**STATEMENT OF HON. BILL NELSON,
U.S. SENATOR FROM FLORIDA**

Senator NELSON. Thank you, Mr. Chairman.

To the oil industry's credit, in the immediate aftermath of September 11 you froze gas prices. That was a patriotic thing to do, so thank you. There was panic. Why did you not freeze gas prices in the aftermath of Hurricane Katrina?

Mr. O'REILLY. Senator, I can tell you that in our company's case, looking back on the affected areas in Mississippi, Louisiana, and southern Alabama, we did. However, outside of that area, to prevent a run on the bank we had to respond to the market, although I know from looking back historically our prices were conservative.

Mr. MULVA. Senator, for both hurricanes our companies in the three or four-State area, we froze prices for several days, but then in all of the markets what we looked at was the spot price went up very quickly. We set our prices and lagged the run-up in spot

prices by 50 percent. We lagged it slowly and used moderation. That was our approach because we felt supply would respond rather quickly and over time the spot market would come down, and so we lagged the market, the spot market, in every situation, and now we are back into a more orderly situation where you have the spot market at a little bit less for gasoline than the physical market.

Senator NELSON. In the aftermath of September 11, the price jumped about 40 cents a gallon and you all stepped in, froze the prices, and assured the distribution, and things settled down. In the aftermath of Katrina, likewise the price rose about 40 cents almost overnight, exactly overnight as a matter of fact, in gas stations. So why would there not be the similar response?

Mr. RAYMOND. It was a different set of circumstances. In 9/11—

Senator NELSON. Which is?

Mr. RAYMOND. In 9/11 the industry was not concerned about whether there was adequate supply. No refinery was affected, no shipment anywhere was affected. In Katrina and Rita, we were very concerned about the adequacy of supply since we had lost, A, a lot of refining capacity and, B, in the early days the ability to move the product around. The pipelines were shut down. We could not get supplies to service stations.

So from an industry supply point of view the circumstances were quite different. In our own case, in the directly affected areas we froze the price. As I commented earlier, outside those areas what we tried to do is maintain continuity of supply and at the same time avoid a shortage.

Mr. HOFMEISTER. Senator, from the point of view of Shell, we also froze prices in the area itself for a period of time, and then, like any non-economic decision, which it was, it had an unintended consequence, which was when the price was lifted it moved very, very rapidly, having other consequences for local citizens. Nonetheless it was the right thing to do at the time.

I think in addition, the debate that took place within our own company with respect to a wider freeze option is that the unavailability of supply for quite some time, which we knew would be weeks and in some cases turned out to be months, would create an artificial demand situation, in which we very seriously were concerned about outages in various markets around the country. And knowing that price is a rational mechanism to keep the balance there, we decided as we did.

Mr. PILLARI. Senator, I would, without repeating everything that has already been said, we also did freeze prices for a while. But I would not underestimate the importance of the fact that even today, unlike 9/11, we still have refineries and we still have infrastructure that is not in service. It is a very different situation.

Senator NELSON. Mr. O'Reilly, let me ask you. You have the leases that are left on Destin Dome off of northwest Florida. What are your plans for those leases?

Mr. O'REILLY. Senator, we relinquished the leases. I believe there are a few of them still in the hands of another company not represented here today. But we relinquished them after we settled out of court following our attempt to move forward with development.

Senator NELSON. All of yours were bought back, then?

Mr. O'REILLY. Correct, Senator.

Senator NELSON. Which company is it that still has the leases outstanding?

Mr. O'REILLY. I believe it is Murphy, but that is something that I would have to check.

Senator NELSON. And that is in an area about 20 miles off of Florida?

Mr. O'REILLY. That is 20 to 25 miles from the Panhandle, correct, Senator.

Chairman STEVENS. Senator, your time has expired. Sorry.

We now have Senators Allen and Burr, Snowe and Craig, and those will be the last Senators to question the panel this morning. We will not come back to this panel this afternoon. We will come back to another panel of attorneys general and the FTC.

Chairman DOMENICI. On our side, Senator Allen, you are next.

**STATEMENT OF HON. GEORGE ALLEN,
U.S. SENATOR FROM VIRGINIA**

Senator ALLEN. Thank you, Mr. Chairman.

Thank you, gentlemen, for being here. Let me go real quickly through some ideas where we can act presently to actually ameliorate and reduce the cost of gasoline, and a big picture view from you on how we can become less reliant, less dependent on foreign sources of energy.

Every spring around Memorial Day gas prices go up, regardless of hurricanes. It is because of the change in formulations. We have a proliferation of boutique, is what they are called, fuel specifications. Senator Burr from North Carolina and I have teamed up. I am trying to bring some common sense and expand refinery capacity, reduce prices at the pump. Rather than having 100 different blends or boutique fuels, which impact our limited refinery capacity which of course have a big impact on the pipelines that have to clean out that other blend before they bring in the boutique fuel. What we aim to do is get it harmonized and to say the three or four cleanest burning fuels to be used in the nonattainment areas, regions with poor air quality, and have that as a national standard. Let those jurisdictions or regions choose.

Some of you mentioned this in your remarks, the large number of fuel types that limit flexibility and product distribution, and particularly end up disrupting supply and increasing costs. In the event that this measure passed that Senator Burr and I are introducing, right quickly if you could, could you estimate for us what impact that would have in lowering the price per gallon at the pump for American consumers if that were in effect next year? Go through sequentially.

Mr. RAYMOND. I think, Senator, it is really impossible to do that. You would have to look at it area by area. But there is no doubt that the system would be much more efficient and that would be passed on to consumers.

Mr. O'REILLY. Senator, I agree with that comment. When the EPA waived some of the restrictions temporarily in the aftermath of the hurricanes, it enabled a much faster response because we were able to move gasoline from, say, Alabama into the Atlanta

market, which was very deficit and in trouble in the aftermath of Katrina. So you could see right away that the artificial barriers that exist and how much more efficiently the system could function. So I certainly support what you are trying to accomplish.

Senator ALLEN. Thank you.

Mr. MULVA. Senator, we support what you are trying to do. The initiative going away from boutique fuels to more standardization, it would not only be more efficient, but you will have fewer outages in a given location by having standardization of fuels.

Senator ALLEN. Thank you.

Mr. PILLARI. I do not think you can predict what the price would be, but what you can predict is that we could move fuels around much more efficiently and more flexibly, which means supply and demand would move into equilibrium more quickly, which would then have an impact on the market price.

Senator ALLEN. Lowering it, right?

Mr. PILLARI. It will certainly move into equilibrium.

Mr. HOFMEISTER. We believe that energy is a national resource rather than a State resource, so we would support simplification. Simply, we have a lot of experience in Europe with this and I think we could learn some lessons from looking across the ocean.

Senator ALLEN. Let me ask you all a question looking into the future. Obviously we need more production here in the United States for American consumers since it has a big impact on our economy, on jobs, and this is a national security issue as well. Having to worry about getting jerked around by some of these people in the Middle East or Venezuela is not the way the United States ought to be worrying about its national security.

There are innovations and some of you have touched on them, whether that is solar photovoltaics, obviously we need to have more nuclear, and clean coal. But as far as fuels, in the next 10 years what can our government do to help or stop hindering the actual use of, whether it is hydrogen, whether it is fuel cells, whether it is clean coal or these renewables, these biofuels? What can we do in 10 years to get our automobiles, rather than looking at just fossil fuels, looking at these renewables and innovative approaches? What can we do in your view to actually achieve this greater energy independence?

I am going to go the other way. Mr. Hofmeister?

Mr. HOFMEISTER. I really think this is the challenge for industry rather than government.

Senator ALLEN. What can we do to help or stop harming?

Mr. HOFMEISTER. I think in the area of research grants, in the area of enabling experimentation, in the area of enabling the auto companies in particular to test a variety of alternate ways of doing their business. I think in the case of hydrogen, though, we have to be careful. I think we have to take that one step at a time. I do not think we want to rush that because for the main purpose that this is something that is going to simply—we have to learn as we go. This is a whole new technology. We do not want to push that too fast.

Mr. PILLARI. I think, as was just said by Mr. Hofmeister, this is a role for us. I think a consistent fiscal policy so we know how we

will be treated for the long term I think would be helpful. I think reducing permitting issues—

Chairman STEVENS. I am sorry, Senator; your time has expired, and we have two extra Senators, two Senators who have come back after I announced there would be no more Senators. So we have a real problem here about time.

Senator ALLEN. Understood, Mr. Chairman.

Gentlemen, if you would please provide the answer to that question in writing, I would appreciate it.

Thank you, Mr. Chairman.

Chairman STEVENS. Senator Burr, you are recognized for 5 minutes, and then we will decide what to do with the other Senators.

**STATEMENT OF HON. RICHARD BURR,
U.S. SENATOR FROM NORTH CAROLINA**

Senator BURR. I thank the chair. I do not think I will take 5 minutes and that may help the chair's quandary as it relates to speakers. I think every question has been asked.

Let me thank all of you for your openness and willingness to be here. Is there anybody that disagrees that new refineries, defined as either expansion of current facilities or new facilities, is in fact needed? Anybody that disagrees that we need new capacity in refineries?

[No response.]

Senator BURR. Let the record show that nobody disagreed with that.

Several of you have mentioned that the new ultra-low sulfur diesel regulations that will take effect soon, which set new specifications for on-road highway diesel fuels, that would allow new heavy-duty trucks to reduce emissions by 90 percent, older trucks to run cleaner, and light-duty diesel vehicles such as SUVs to get significantly better fuel mileage, and for a greater range of diesel retrofit technologies to be used, that this is problematic right now from a standpoint of the date certain that is set.

Can I have each one of you comment on whether you can meet that date certain? Let us start with Mr. Hofmeister.

Mr. HOFMEISTER. Technically, we can. I think our big concern is in the distribution of the fuel and the fact that as it moves through pipelines it could pick up other sulfur molecules.

Senator BURR. Mr. Pillari?

Mr. PILLARI. That is the real issue for us as well. We can make it, but moving it is still problematic.

Mr. MULVA. Same issue for us.

Mr. O'REILLY. We can meet it at the refinery.

Mr. RAYMOND. Same comment, Senator. We can meet it at the refinery. The National Petroleum Council made some comments on that in the last year with some suggestions to the EPA as to how that would be managed.

Senator BURR. Well, my hope is, and I would encourage all of you, if we can solve the refinery issue, which you have said there is not an issue, hopefully collectively we can solve the distribution issue, which is moving it through a pipeline. I think it is important that we remember that, just like you have suppliers, there are manufacturers out there that have developed engines that are de-

signed with the intent of running on low-sulfur diesel, and anything that does not meet a time line that is in sync cheats one side or the other.

Mr. Chairman, I thank you for your indulgence. I yield back the balance.

Chairman STEVENS. Thank you very much.

Senator Snowe and Senator Craig, you are recognized for 5 minutes each.

**STATEMENT OF HON. OLYMPIA J. SNOWE,
U.S. SENATOR FROM MAINE**

Senator SNOWE. Thank you, Mr. Chairman.

I want to welcome all of you here today to answer some obviously very significant questions, certainly for the State that I represent, where 78 percent of Maine people depend upon home heating oil for their fuel. And all the more concern, given the prospects of winter. We have already experienced a 30 percent increase this year, which is 20 percent higher than it was last year as well. So more than a 50 percent increase and we have not yet had the onset of winter.

Home heating oil, natural gas, these are not your run of the mill commodities. These are basic necessities of life, and certainly that is true in Maine, as it is elsewhere throughout the country. There is a recent survey that indicated one in five people over the last few years went a day without some basic necessity, whether it is food or prescription drugs or forgoing paying their mortgage or rent payments, in order to pay for their fuel.

So it does stretch credibility in many ways, in listening to your responses here today, given the fact we are at record-breaking revenues, record-breaking profits. And that is understandable. You are in the profit-making business and you should be. But the question is that in the final analysis in making those record-breaking profits, it mirrored a time where people experienced historical increases in their fuel prices, whether it is home heating oil, natural gas, or gasoline.

It is really hard to understand, and certainly most difficult to explain to my constituents, as to exactly what would suggest that that was necessary during that period of time. I really would like to have a more direct explanation as to what we say to our constituents as to exactly why that would happen.

Can we start with you, Mr. Raymond?

Mr. RAYMOND. Well, we can, Senator. I think the point still is that we operate in worldwide commodity markets. The prices that we charge reflect those markets. I think our primary focus, number one on our list is always to make sure that there is adequacy of supply. We are not interested in shortages. In order to maintain that adequacy of supply, we have to participate in those worldwide markets, and that is ultimately what gets reflected to the consumer.

Senator SNOWE. Well, could you explain to me why— my office was approached by a captain of a tanker who said that there was a tanker that went to Chile a month after the hurricanes that was full of gasoline, that left for New Jersey?

Mr. RAYMOND. I cannot explain that, but I can assure you it was not one of ours, because other than the traditional exports that the country has always had to support the Caribbean and part of Latin America, we have not participated in exporting products from the United States.

Senator SNOWE. Have any of you? Did any of you in recent time during the hurricane and the aftermath?

[No response.]

Senator SNOWE. Is that true of all of you?

Mr. O'REILLY. Well, I am not sure what the question is, Senator. We had a question earlier about imports and exports of products and I think I made the point that for every one barrel—there are three barrels imported for every barrel exported. We are linked to Mexico, we are linked to Canada, and we are linked to the Caribbean. All of those markets kind of run as one, so there is traffic back and forth.

Senator SNOWE. Well, we get much of our supply from Canada, but we saw spikes, as everybody else did in America, for these major increases during this time.

Mr. O'REILLY. I think the hurricane—if I could get past—the hurricane definitely caused a spike in prices, Senator. But I think for heating oil there is a longer term concern, and that is that that part of the barrel, the heating oil and diesel part of the barrel that we call the distillate part of the barrel, is in high demand. Europe is converting its automotive fleet systematically from gasoline to diesel, which is putting more worldwide pressure on the supply of diesel.

That is why expanding our refining capacity in this country is so important, so that we can make more products such as diesel, and hence the comments I made in both my opening remarks as well as in my submitted written remarks about what government policies need to be in place to assure adequate supply to citizens of Maine and other States.

Senator SNOWE. Well, I would hope the industry would consider a supplemental fund for low income fuel assistance. I think that that certainly would be an appropriate gesture under these circumstances, given the profits that you are making, given the fact they are recordbreaking, certainly, even in the history of corporate America.

Chairman STEVENS. Thank you very much.

Senator Craig is recognized for 5 minutes.

**STATEMENT OF HON. LARRY E. CRAIG,
U.S. SENATOR FROM IDAHO**

Senator CRAIG. Mr. Chairmen, thank you both for the hearing.

Gentlemen, I hope you feel your time before this committee was productive. I think any objective person listening to the dialogue today that has gone on between this joint committee and you would come away a much better informed consumer than they did prior to listening, and I trust that you believe that to be a beneficial experience.

There is a great deal we know about your industry. There is a great deal the average citizen does not know. That gap of knowledge will probably never be completed or totally understood, as to

why you market the way you do, why you price the way you do, world markets, fungibility, and all those kinds of things that we on these committees look at on a regular basis.

Most of the questions have been asked. One specific to my State of Idaho has not been asked. I have an attorney general out there now scratching his head as to why Idaho gas prices are higher. I always try to go out into Virginia to fuel up because they are always 20 cents cheaper than they are here on Capitol Hill. But when Capitol Hill is cheaper than Idaho—and it is at this moment—I am frustrated.

Gas in Boise was \$2.50 a gallon, \$2.56 a gallon this weekend. It slipped a few cents in the market. So it is awfully difficult regionally in this country to understand why there are anomalies of the kind that we have, but we have them. So my attorney general is looking at it at this moment and a bit frustrated. But so are my consumers.

Two town meetings this weekend, and I can tell you of the 300 some total people who attended those town meetings with me what the number one question was. It was about you and your profitability. I must tell you, it is not terribly fun defending you, but I do, and I attempt to explain the markets. But I cannot explain this one.

Can you tell me why Idaho's price is now higher than Washington, D.C.'s, by a factor of 15 cents on the gallon? I doubt it. Go ahead, Mr. Raymond. You started to reach for the button.

Mr. O'REILLY. I was going to try, but go ahead.

Mr. RAYMOND. Well, I am going to let Dave answer, because my first comment to you, Senator, is since we hardly market anything in Idaho I do not have a dog in that fight.

Senator CRAIG. No, I know. I should have called Earl Holding down in Salt Lake with Sinclair, but I know what his answer is.

Mr. O'REILLY. We do market in Idaho, Senator, as you know. I think your question is a reasonable one and I can certainly understand why consumers would be concerned. I just have a couple of comments.

You made the point that, and I think I made it earlier, I think you might have heard, that we do have regional markets in the gasoline system. You have underlying crude prices that drive the general level of price for products, but then the regional markets have their own supply and demand characteristics. One of the issues in the inter-mountain area is that there has been tremendous economic growth and population growth in that area, and it is supplied by relatively small refineries. You mentioned Holding, for example, in Salt Lake. Well, there are other smaller refineries in that area that are faced with some very challenging investment propositions to meet the new fuel requirements. Some of these investments, I think the affordability of these investments for the small refiners to continue to supply the markets in the inter-mountain region is a big question.

So I think you are seeing a tightness in the market. I would assume that those prices will moderate, as they have been in other parts of the country.

Senator CRAIG. They are moderating, yes.

Mr. O'REILLY. And that should help. But it is becoming more of a challenge to supply product in the inter-mountain region, where in past years it was a relatively easy market to supply.

Senator CRAIG. Well, gentlemen, thank you all. One last concern. It has been expressed by others here on the panel in different ways, and that is the cost, the price of diesel today. When you look at rural States like Idaho that are tied to markets and economies around the country by truck, substantial disadvantages begin to occur. Diesel at the pump, certainly not wholesale or even large volume buying, this weekend in Idaho was about \$3.20 a gallon. For my farmers, who are seeing horrendously large input costs today because of what is going on in the diesel market along with the natural gas for fertilizers, are very, very frustrated at this moment.

I must tell you that, while the gas prices in Idaho are moderating, the diesel prices are just sitting there. To my knowledge they have not moved at all in the last month, except up. They have leveled off but they have not come down. I do not know that you can—you have already talked to the issue. You have talked what is going on in Europe. You have talked of trying to expand capacity in that area. But great economic dislocations are occurring today as a result of that price.

Thank you all very much.

Chairman STEVENS. Thank you, Senator Craig.

Senator Talent.

**STATEMENT OF HON. JAMES M. TALENT,
U.S. SENATOR FROM MISSOURI**

Senator TALENT. Thank you, Mr. Chairman. I understand you are in a hurry. I have two questions—

Chairman DOMENICI. Senator, we need to hear from you. You were here early and you are entitled to be heard.

Senator TALENT. Thank you, Mr. Chairman. I will try and be as brief as I can.

Mr. O'Reilly, I appreciated one part of your—well, a lot of your testimony, but one part of it especially I want to just read to you. It is on page 15: "Historical divisions are irrelevant in the energy equation we now face. When a single hurricane can knock out nearly 10 percent of our Nation's gasoline supplies, it is clear that a new approach to dealing with energy issues is needed. This is no time for a divisive business as usual energy debate."

Then the next page you say: "We need to shift the framework of the national energy dialogue to acknowledge that improving America's access to oil and natural gas, investing in new energy sources, such as hydrogen, fuel cells, and renewables are in fact complementary goals that can help create affordable, reliable energy supplies."

So investing in renewables is a complementary goal with investing in other kinds of energy, that is what I hear you saying here?

Mr. O'REILLY. Yes, Senator. I think the point I was trying to make in my testimony is I think we need to approach all forms of energy supply and not necessarily one at the expense of another, because I truly believe we are going to need it all.

Senator TALENT. Well, and I do too. I will say to you, sir, it would have been good to have that kind of help a couple of months

ago when we put the renewable fuel standard on the energy bill in this committee, and your industry uniformly fought it to prevent us setting a renewable fuel standard that would help us encourage the production of ethanol and biodiesel. So I do not know whether this is an eleventh hour conversion or maybe whether you were a dissenting voice at the time. But it would be good if we could work together in the future.

Are you in agreement with that?

Mr. O'REILLY. Absolutely.

Senator TALENT. Yes, I think so too.

One other thing I wanted to, area—because you answered the question about diesel, which is a question my farmers have got as well. Mr. Mulva, this is in your testimony. On page 4 you say: “Until recently, accelerated levels of investment were not encouraged because growing global demand could be met largely from spare oil production in Russia and in OPEC countries, and by taking advantage of spare global refining capacity and spare capacity in oil field services and supplies. That situation has changed and today the industry can offer the prospects of profitable growth as it steps up its investment in huge complex energy projects around the world.”

What you are describing it seems to me is the fact that you all view, and I think this is understandable, you view this as a global—it is a global market, and investment opportunities are global for you. That is a perspective I can understand. Now, Senator Allen touched on the point that for us, while we understand that the economics of this is global, we have particular interests in the United States of America that we have to protect as well.

So in other words, my concern is that if we just let global economics dictate investment and the creation of capacity, we may be in a situation where in some kind of a perfect world where there were no political differences between countries everybody would have adequate supply at affordable prices, but with that we may be in a situation where we have plenty of capacity around the world, but we are cut off from it because other governments control it and they do not want us to have it. Of course, we have seen that with OPEC and other situations.

Now, what would you suggest from our perspective that we can do to make certain that we have adequate capacity here and access here? We have talked about renewables, which is one way because that is produced here. But do you or any others have any suggestions along those lines?

And that is then all I have, Mr. Chairman.

Mr. MULVA. Senator, I did not have the opportunity of responding to the Senator before, but really—

Senator TALENT. Senator Allen raised the same point, which as you have no doubt noticed, the fact that one Senator raises a point will not keep other Senators from raising the same point. It is almost an encouragement.

[Laughter.]

Mr. MULVA. Senator, so I was prepared and I will give you the three points that I think that could really help us with respect to the upstream part of the business and the downstream refining part. We need access, access so we can explore. We need stream-

lined approvals in permitting and regulation. That is going to help us upstream and downstream. The third is it helps us if we have the flexibility of doing these things—in other words, I am saying no mandates as to how this is going to be accomplished. That helps us do what we do best, which is develop energy and supply for the marketplace.

Senator TALENT. So you are asking to be allowed to explore in areas where energy exists in the United States?

Mr. MULVA. Absolutely, and both upstream and downstream, in the refining side and the infrastructure side, the pipeline, we need streamlined permitting and regulation, not at the expense of the environment in any way, but we just need to get the permitting process and regulatory process streamlined.

When it comes down to renewables and whatever, we are all for that, but we do not need mandates as to how to do that.

[The prepared statement of Senator Talent follows:]

PREPARED STATEMENT OF HON. JAMES M. TALENT, U.S. SENATOR FROM MISSOURI

This past summer we passed the first significant energy legislation in 13 years. One of the key features of that legislation was the promotion of ethanol as a means of increasing our domestic supply of energy by growing it and thereby decreasing our dependence on foreign oil. As I recall, the companies you represent vigorously opposed ethanol then and continue to discourage its production and distribution now.

However, I believe we agree that sustained high energy prices are damaging to our economy and our way of life. It's been well documented that high prices for gasoline, diesel, and home heating fuels take money out of the pockets of all Americans, resulting in involuntarily reductions in discretionary income. This means it costs more to take the kids to school and soccer practice, to go to work, or to go anywhere for that matter. It also hurts small business as people pay more for gasoline have less to spend on other things.

All of you stated in your testimony that energy prices must come down. This can happen by increasing supply, something ethanol can help with, or by reducing demand. You've mentioned conservation as one form of demand reduction, but I am concerned that the reduced demand we will see and have already seen too much of is industries picking up and moving overseas, taking millions of good, high paying jobs with them.

Refining capability was at 97 percent pre-Katrina, according to the Energy Information Administration. That seems dangerously close to the edge of a supply shortage, one that increased use of ethanol can help alleviate. That tight of a margin implies a monopoly power to control price through withholding supply. Now I can see that there is competition for sales of gasoline to the consumer—gas stations on opposite sides of the street from each other post their prices for all to see and discount to keep business. There we are only talking about five or six cents of the \$3.00 or more per gallon of gasoline. The larger share of costs by far is in the production and refining sectors. Is there competition in the refining business? If there is, I would expect that the lowest cost supplier would be expanding to take business away from higher cost refiners, who would then become the industry's excess capacity.

Chairman STEVENS. Thank you very much.

The last Senator to be recognized for 5 minutes is Senator Lautenberg.

**STATEMENT OF HON. FRANK R. LAUTENBERG,
U.S. SENATOR FROM NEW JERSEY**

Senator LAUTENBERG. Thank you very much, Mr. Chairman, and my apologies for extending this hearing.

Gentlemen, I respect very much your corporate leadership. I come out of the corporate world and the company I started with a couple of poor guys from the same neighborhood now has over

40,000 employees and the longest growth record of any company in America at 10 percent each year over the previous year for 42 years in a row. So I respect your pursuit of profits.

But I also learned one thing in my corporate world and that is that there are obligations that extend beyond simply the profits. There are communal obligations, and particularly when you are in a business like you are, which is almost a commodity business.

I would like to ask a couple of things that would help me understand what has been taking place here. Did your company or any representatives in your companies participate in Vice President Cheney's energy task force in 2001, the meeting?

Mr. RAYMOND. No.

Senator LAUTENBERG. Sir?

Mr. O'REILLY. No.

Mr. MULVA. We did not, no.

Mr. PILLARI. No. I was not here then.

Senator LAUTENBERG. But your company was here.

Mr. PILLARI. Yes.

Mr. HOFMEISTER. Not to my knowledge.

Senator LAUTENBERG. In order to shake loose the pricing mechanism that exists within OPEC—and there is a pricing mechanism there and a quota for production; am I correct with that, in OPEC?

Mr. RAYMOND. There is a quota, but most people do not observe it.

Senator LAUTENBERG. Most people do not observe it. Well, let me ask you this. How would you feel if an opportunity was presented in law to say that if they engage in any quota-setting that they might not be permitted to join another international organization, particularly the WTO, which insists on free markets if you want to participate in the business opportunity as well as membership?

Now, I have got a suggestion—I have got it in written form—that the WTO, Mr. Chairman, exclude any organization—and by the way, it is in their charter anyway—and that OPEC be included for review as to whether or not their quota-setting violates WTO rules. And the fact is that Saudi Arabia would like to join and several members of OPEC are currently members of the WTO.

Does that strike any of you as a good idea, a bad idea?

Mr. O'REILLY. Senator, I will try to comment on this. I think the situation in the marketplace today is that all of the producers are producing flat-out, and my understanding is that Saudi Arabia in particular has indicated that it is adding capacity, in the process of adding capacity. They have made statements to that effect.

So what impact—I am not an expert on WTO, but my observation is that today every producer seems to be stretched, including the members of OPEC.

Senator LAUTENBERG. But they may be doing that, as Mr. Raymond said earlier, they may have an agreement to that effect. But the real outcome is that they could exceed the agreement. But there is an agreement—is there any dispute about that—as to what their quotas ought to be.

Mr. RAYMOND. No. No, I do not think there is, Senator. But I guess the point I would make, if you look at it from say the global oil markets, is that the whole consuming world is dependent on the same pool of resources, and to the extent that this country takes

action for whatever reason to disrupt that pool we end up penalizing ourselves.

Senator LAUTENBERG. Well, I do not know that we would disrupt the pool. They are still in this business because they need and they want the money that comes from their production. But they cannot have it both ways. The fact is that I have had for some time enormous resentment of the fact that when Saudi Arabia dialed 911 in the early 1990s and asked us to come in to save the life of their country, and then turned their back on us when problems fell the other way. It is an outrage and I do not think that we ought to let it go unnoticed.

Thanks, Mr. Chairman.

Chairman STEVENS. Thank you very much.

We are going to ask members to submit to their respective committees questions to be answered by the witnesses by tomorrow at noon.

Senator WYDEN. Mr. Chairman.

Chairman STEVENS. Written questions.

Senator WYDEN. Mr. Chairman.

Chairman STEVENS. Yes?

Senator WYDEN. Just on that point then, I really appreciate you and Chairman Domenici indulging me on this. I have been trying for many years to get at an anti-competitive set of practices involving zone pricing and red-lining—

Chairman STEVENS. Senator, I have got to be back here at 2 o'clock for another hearing.

Senator WYDEN. Mr. Chairman, I would just like to clarify that the response to the questions in this area that we could have promptly, say within the next 2 weeks. Would that be acceptable to you?

Chairman STEVENS. I think we will ask them to be as prompt as possible and 2 weeks if possible.

Senator WYDEN. Thank you, Mr. Chairman.

Chairman STEVENS. It depends on the questions that are asked how long it takes to get answers.

Senator WYDEN. Thank you.

Chairman STEVENS. But they will be delivered to the respective committees by noon tomorrow and the staff will submit them to the witnesses.

Chairman DOMENICI. Mr. Chairman.

Chairman STEVENS. Yes?

Chairman DOMENICI. Mr. Chairman, I know we want to get out of here. I want to do two things. First, I want to thank you for joining our committee or letting us join you, and thank the witnesses.

I want to make two quick observations. We did not get to ask you what you think about the future supply-demand situation. I hope you will do that for us, your own company's picture. Secondly, a comment with reference to my question on how is crude oil priced. I hope you are expert enough to do a better job in writing that out than you were in answering it here, to tell us how it is priced, what happens to it.

Second, could you do the same thing on natural gas, please? It comes out of the ground; what happens to it? How does it get to

\$6? How does it get to \$12? Who gets the money along the way? Can you do that for us?

Thank you, Mr. Chairman.

Chairman STEVENS. Thank you.

In my State, diesel is \$6 a gallon in rural Alaska today, diesel, and regular gasoline is over \$5. We have as great an interest in this subject as anyone. But I do thank you. I thank you for your interest in increasing supply. I think that is the answer for America, is to increase the supply and enter into a new phase of conservation. We have all supported that.

We appreciate your appearance here. This committee will stand in recess until 2 o'clock for the second panel.

[Whereupon, at 1:07 p.m., the Committee was recessed, and reconvened at 2:01 p.m.]

Chairman STEVENS. Could we ask the witnesses to take your places at the table, please.

This really is a continuation of the hearing we held this morning on energy prices. The purpose of this afternoon's hearing is to discuss whether States have the tools they need to address allegations of price-gouging and whether the Congress should require the Federal Trade Commission to increase its activities with regard to investigating these charges.

With us today are three State attorneys general. We thank you very much for taking the time and responding to our request. The New Jersey Attorney General, Peter Harvey; South Carolina Attorney General Henry McMaster; and the Arizona Attorney General Terry Goddard. We are also going to hear from Deborah Platt Majoras, Chairman of the Federal Trade Commission.

Hurricanes Katrina, Rita, and Wilma severely damaged our Nation's production and refining capabilities. We heard a lot about that this morning. In the immediate aftermath of these storms, there was a sharp rise in gasoline prices. Those of us elected to public office have a duty to our constituents and all Americans and we are concerned about these allegations of consumer price-gouging.

Several members have responded to these allegations by introducing price-gouging legislation. Some of those bills suggest that the States should be preempted by Federal legislation. Under these proposals, the Federal Trade Commission would monitor, investigate, and prosecute those suspected of price-gouging.

We are very interested in hearing from the witnesses their thoughts on how to determine what really constitutes price-gouging and whether the State and Federal Government—or the Federal Government is best equipped to address these activities. I look forward to your statements in this regard.

Senator Inouye.

Senator INOUE. Fine.

Chairman STEVENS. Senator Inouye waives.

Senator Bingaman, do you have a statement?

Senator BINGAMAN. Very briefly, Mr. Chairman. I welcome the witnesses. My understanding at least of the bill that I co-signed related to price-gouging is that it would not preempt the States. Rather, it would give to the Federal Trade Commission authority

to prosecute, just as some of the States currently have statutes that contemplate prosecutions or authorize prosecutions for price-gouging.

In fact, the idea would be that the Federal Government or the State would have the authority to pursue a case of this type and it would be up to the officials involved as to which chose to move ahead. So I would just make that one clarification.

But I look forward to the testimony and I will have some questions after the testimony. Thank you, Mr. Chairman.

Chairman STEVENS. Does any other Senator wish to make an opening statement?

[No response.]

Chairman STEVENS. If not, let us proceed with the witnesses that we have before us. I hope you do not mind, ma'am; we would like to hear from the attorneys general first to get the background here before we get to the FTC issue. So may I call on Mr. Harvey, Attorney General Harvey, first. You have to turn on your mike.

**STATEMENT OF PETER C. HARVEY, ATTORNEY GENERAL,
STATE OF NEW JERSEY**

Mr. HARVEY. That would help. Thank you.

Chairman Stevens, Co-Chairman Inouye, Chairman Domenici, ranking member Bingaman, and members of the two committees: I am Peter Harvey, attorney general of the State of New Jersey. Thank you for inviting me to testify today about energy pricing and profits. As New Jersey's top law enforcement officer, I filed lawsuits in September against three oil companies and a number of independent gas station operators alleging that they violated New Jersey's Motor Fuels Act and Consumer Fraud Act in connection with gasoline price increases in the wake of Hurricane Katrina.

New Jersey's citizens, like consumers in other States, were stunned by the steep price hikes that followed this tragic storm in the Gulf States. Similar to other States, New Jersey has a specific price-gouging law that is part of our Consumer Fraud Act. It applies, however, only when a state of emergency has been declared within our State. Its protections were not available to us following Katrina because this disaster occurred, as you know, in another region.

To protect our consumers, who rightly questioned whether they were being treated fairly and honestly, we thoroughly investigated what was happening at our gas stations in New Jersey and took the strongest legal action we could under our State laws. I am here to share our experience in New Jersey and discuss why I believe we need a Federal price-gouging statute that applies nationwide to the sale of essential goods and services following a disaster occurring in a particular region of the United States.

In the week after Katrina struck, gas prices in New Jersey soared upward to an average of \$3.16 by Labor Day. That was a dollar higher than the average price just one month earlier. Hundreds of concerned citizens telephoned New Jersey Consumer Affairs and the State Office of Weights and Measures, both of which are within the Attorney General's Office. The Acting Governor, Richard Cody, also expressed concern about escalating gas prices.

We responded by closely monitoring gas prices and investigating individual complaints regarding gas retailers. To be specific, we sent State, county, and municipal weights and measures inspectors to visit more than 500 of New Jersey's 3260 gas stations. The Office of Weights and Measures in the Division of Consumer Affairs has responsibility for ensuring that all commercial weighing and measuring devices, including gas pumps, accurately measure commodities being sold to consumers.

In this case, under our oversight and pursuant to our statutory enforcement authority, these State and local inspectors conducted broader investigations to ensure that gasoline retailers were complying with State laws and treating consumers fairly. They monitored price changes and demanded access to books and records that retailers are required by law to maintain and make available to State inspectors.

The inspectors identified over 100 violations of New Jersey's laws. On September 26, 2005, my office filed suit against three oil companies, Hess, Motiva Shell, and Sunoco, as well as various independent gas station operators. The suits alleged violations at 31 gas stations, 13 owned by the three oil companies and 18 independently owned. As I previously stated, without a declared state of emergency in New Jersey our State's price-gouging statute does not enable us to target gas retailers and suppliers who seek to profit unjustly as the result of a disaster occurring in another part of the country. In our suits we instead alleged specific violations of New Jersey's Motor Fuels Act and Consumer Fraud Act. Specifically, we alleged that the defendants violated a provision in the Motor Fuels Act that prohibits a gas retailer from changing gas prices more than once in a 24-hour period. We also alleged that price increases that violate the Motor Fuels Act constitute an unconscionable commercial practice, in violation of our Consumer Fraud Act.

In other instances, we alleged that defendants posted prices on roadside signs that were lower than the actual prices charged at the pumps, a violation of the advertising regulations under the Consumer Fraud Act that prohibit deceptive practices and misrepresentations in the sale of merchandise. In addition, we charged defendants with not maintaining and providing access to books and records required to be kept under the Motor Fuels Act.

We were able to pursue claims against these retailers who failed to obey our laws by their rapid escalation of prices. We do believe that part of the volatility in gas prices in New Jersey following Katrina was the result of retailers charging prices based, not on what they actually paid, but what they feared they might eventually pay or, worse yet, on what they thought they could get away with, given the market conditions.

While some busy gas stations do get fuel deliveries more than once a day, others were charging increasingly high prices for the same gas that they had in the ground when the day or week began.

New Jersey's Motor Fuels Act, enacted in 1938, was indeed aimed at reducing volatility in gas pricing. However, this trust-busting era legislation was originally intended to maintain healthy competition by preventing one gas retailer, who was perhaps in a stronger financial position, from continuously undercutting a com-

petitor's prices to drive the competitor out of business. In other words, it was aimed at preventing predatory pricing.

The Motor Fuels Act still carries the penalty schedule originally enacted in 1938, with penalties ranging from \$50 to \$200 and retail license suspension. Unfortunately, these penalties are inadequate to punish an oil company, given the enormous revenue generated by the sale of gasoline.

While the Motor Fuels Act applies to the unlawful pricing conduct engaged in by certain oil companies in New Jersey, it does not get to the heart of the price-gouging issue that we experienced in the wake of Katrina. Our Consumer Fraud Act casts a wider net and carries penalties of up to \$10,000 for a first offense and up to \$20,000 for subsequent offenses. However, this law is also inadequate because it still does not get us beyond the gas retailer and onto the conduct of the supplier or refinery. Moreover, it does not provide penalties that for a big oil company represent more than a marginal cost of doing business.

We are here today because serious questions have been raised about why the major oil and gas companies posted record profits for the most recent quarter while consumers, who rely upon gas every day to get to work and run essential errands, were getting squeezed financially with record high prices, increased perhaps without any economic justification.

I believe that our experience with Hurricane Katrina clearly points to the need for a Federal price-gouging statute. When there is a state of emergency declared in New Jersey, we have the ability under the price-gouging provisions of our Consumer Fraud Act to take action against merchants operating within the State who reap unconscionable profits from essential commodities. In the impacted geographical area, we can prevent those affected by the disaster from being unfairly exploited by profiteers and sharp operators. However, when there is a disaster or emergency occurring in one area of the country that affects the supply and pricing of an essential nationally distributed product, as with Katrina, we cannot do much about it.

Congress should provide a mechanism that reduces the volatility of gas prices across State lines. Even if the States were to enact new laws to address these situations, a State by State approach would prove difficult and inconsistent. A nationwide problem demands a nationwide solution, though I would recommend one that does not preempt State remedies and ideally one that provides an enforcement for State attorneys general.

Let me make one thing clear. I am not talking about attacking profits. I am talking about attacking profiteering. There is a difference. Consumers should not face artificially inflated prices that bear no substantial relationship to the supply of goods. Congress has long recognized the need to curb profiteering. After the outbreak of the Civil War, Congress enacted the Federal False Claims Act to prevent false claims and overcharging by those who contracted with the Federal Government to provide essential services. Its impact has greatly expanded in recent years through private enforcement actions authorized under the law.

A Federal price-gouging statute should take effect, when needed, for a limited time span, perhaps for 60 days. The purpose of the

law should be to allow things to settle, just as the New York Stock Exchange can now close the market to prevent a crash if there is a large enough fall in stock prices. The factors involved in fuel pricing are complex and sustained attempts to control fuel prices might prove counterproductive. Ultimately, we must have a balance that accommodates business as well as the consumer. People must be able to buy essential goods such as food, gasoline, home heating oil, and electricity.

I would emphasize that in striking that balance we cannot lose sight of just how essential these goods are to Americans. For some, the cost of a tank of gas can be the obstacle that prevents them from driving to a doctor's appointment or to the grocery store for food. We hear stories during winter of elderly Americans who freeze to death because they run out of fuel oil and in summer of those who die in the heat for lack of electricity and air conditioning.

People should not have to make life or death decisions based upon prices that have been put out of their reach by profiteering. Many will not have a choice and the result will be death. Economics will self-select them to freeze, boil, or live in darkness. If Katrina teaches us nothing else, it should teach us that our emergency plans must include providing for the poor, the immobile, the sick and the elderly, in other words those with the least resources to help themselves.

Thank you for giving me the opportunity to testify here today and to make my views known to you, and I will take whatever questions you have when you wish to hear from me. Thank you.

[The prepared statement of Mr. Harvey follows:]

PREPARED STATEMENT OF PETER C. HARVEY, ATTORNEY GENERAL, STATE OF NEW JERSEY

Chairman Stevens, Co-Chairman Inouye, Chairman Domenici, Ranking Member Bingaman and Members of the two Committees, I am Peter Harvey, Attorney General for the State of New Jersey. Thank you for inviting me to testify today about energy pricing and profits.

As New Jersey's top law enforcement officer, I filed lawsuits in September against three oil companies and a number of independent gas-station operators alleging that they violated New Jersey's Motor Fuels Act and Consumer Fraud Act in connection with gasoline price increases in the wake of Hurricane Katrina. New Jersey citizens, like consumers in other states, were stunned by the steep price hikes that followed this tragic storm in the Gulf States. Similar to other states, New Jersey has a specific price gouging law that is part of our Consumer Fraud Act. It applies, however, only when a state of emergency has been declared within our state. Its protections were not available to us following Katrina because this disaster occurred in another region.

To protect our consumers, who rightly questioned whether they were being treated fairly and honestly, we thoroughly investigated what was happening at our gas stations in New Jersey and took the strongest legal action we could under our state laws. I'm here to share our experience in New Jersey and discuss why I believe that we need a federal price gouging statute that applies nationwide to the sale of essential goods and services following a disaster occurring in a particular region of the United States.

A. NEW JERSEY'S INVESTIGATION

In the week after Katrina struck, gas prices in New Jersey soared upward, to an average of \$3.16 a gallon by Labor Day. That was a dollar higher than the average price just one month earlier. Hundreds of concerned citizens telephoned the New Jersey Division of Consumer Affairs and the State Office of Weights and Measures, both of which are within the Attorney General's Office. The acting Governor, Richard Codey, also expressed concern about escalating gas prices. We responded by

closely monitoring gas prices and investigating individual complaints regarding gas retailers.

To be specific, we sent state, county and municipal weights and measures inspectors to visit more than 500 of New Jersey's 3,260 gas stations. The Office of Weights and Measures in the Division of Consumer Affairs has responsibility for ensuring that all commercial weighing and measuring devices, including gas pumps, accurately measure commodities being sold to consumers. In this case, under our oversight and pursuant to our statutory enforcement authority, these state and local inspectors conducted broader investigations to ensure that gasoline retailers were complying with state laws and treating customers fairly. They monitored price changes and demanded access to books and records that retailers are required by law to maintain and make available to state inspectors. The inspectors identified over 100 violations of New Jersey's laws.

B. OUR LAWSUITS AGAINST OIL COMPANIES AND GAS STATIONS

On September 26, 2005, my Office filed suit against three oil companies, Hess, Motiva Shell and Sunoco, as well as various independent gas-station operators. The suits allege violations at 31 gas stations: 13 owned by the three oil companies, and 18 independently owned. As I previously stated, without a declared state of emergency in New Jersey, our state's price gouging statute does not enable us to target gas retailers and suppliers who seek to profit unjustly as a result of a disaster occurring in another part of the country. In our suits, we instead allege specific violations of New Jersey's Motor Fuels Act and Consumer Fraud Act. Specifically, we allege that the defendants violated a provision in the Motor Fuels Act that prohibits a gas retailer from changing gas prices more than once in a 24-hour period. We also allege that price increases that violate the Motor Fuels Act constitute an unconscionable commercial practice in violation of our Consumer Fraud Act. In other instances, we allege that defendants posted prices on roadside signs that were lower than the actual prices charged at the pumps, a violation of the advertising regulations under the Consumer Fraud Act that prohibit deceptive practices and misrepresentations in the sale of merchandise. In addition, we charged defendants with not maintaining and providing access to books and records required to be kept under the Motor Fuels Act.

We were able to pursue claims against these retailers who failed to obey our laws by their rapid escalation of prices. We do believe that part of the volatility in gas prices in New Jersey following Katrina was the result of retailers charging prices based not on what they actually paid, but on what they feared they might eventually pay or, worse yet, on what they thought they could get away with given the market conditions. While some busy gas stations do get fuel deliveries more than once a day, others were charging increasingly high prices for the same gas they had in the ground when the day, or week, began. New Jersey's Motor Fuels Act, enacted in 1938, was indeed aimed at reducing volatility in gas pricing. However, this trust-busting era legislation was originally intended to maintain healthy competition by preventing one gas retailer, who is perhaps in a stronger financial position, from continuously undercutting a competitor's prices to drive the competitor out of business. In other words, it was aimed at preventing predatory pricing. The Motor Fuels Act still carries the penalty schedule originally enacted in 1938, with penalties ranging from \$50 to \$200 and retail license suspension. Unfortunately, these penalties are inadequate to punish an oil company given the enormous revenue generated by the sale of gasoline.

While the Motor Fuels Act applies to the unlawful pricing conduct engaged in by certain oil companies in New Jersey, it does not get at the heart of the price gouging issue that we experienced in the wake of Katrina. Our Consumer Fraud Act casts a wider net and carries penalties of up to \$10,000 for a first offense and up to \$20,000 for subsequent offenses. However, this law also is inadequate because it still does not get us beyond the gas retailer and onto the conduct of the supplier or refinery. Moreover, it does not provide penalties that, for a big oil company, represent more than a marginal cost of doing business. We are here today because serious questions have been raised about why the major oil and gas companies posted record profits for the most recent quarter when consumers who rely upon gas every day to get to work and run essential errands were getting squeezed financially with record high prices, increased, perhaps, without any economic justification. I believe that our experience with Hurricane Katrina clearly points to the need for a federal price gouging statute.

C. THE NEED FOR A FEDERAL PRICE GOUGING STATUTE

When there is a state of emergency declared in New Jersey, we have the ability under the price gouging provisions of our Consumer Fraud Act to take action against merchants operating within the state who reap unconscionable profits from essential commodities. In the impacted geographical area, we can prevent those affected by the disaster from being unfairly exploited by profiteers and sharp operators. However, when there is a disaster or emergency situation in one area of the country that affects the supply and pricing of an essential, nationally distributed product, as with Katrina, Congress should provide a mechanism that reduces the volatility of prices across state lines. Even if states were to enact new laws to address these situations, a state-by-state approach would prove difficult and inconsistent. A nationwide problem demands a nationwide solution, though I would recommend one that does not pre-empt state remedies and, ideally, one that provides an enforcement role for state attorneys general.

Let me make one thing clear: I am not talking about attacking profits; I am talking about attacking profiteering. There is a difference. Consumers should not face artificially inflated prices that bear no substantial relationship to the supply of goods. Congress has long recognized the need to curb profiteering. After the outbreak of the Civil War, it enacted the Federal False Claims Act to prevent false claims and overcharging by those who contracted with the Federal Government to provide essential services. Its impact has greatly expanded in recent years through private enforcement actions authorized under the law. A federal price gouging statute should take effect, when needed, for a limited time span, perhaps for 60 days. The purpose of the law should be to allow things to settle, just as the New York Stock Exchange can now close the market to prevent a crash if there is a large enough fall in stock prices. The factors involved in fuel pricing are complex, and sustained attempts to control fuel prices might prove counterproductive.

Ultimately, we must have a balance that accommodates business as well as the consumer. People must be able to buy essential goods such as food, gasoline, home heating oil and electricity. I would emphasize that in striking that balance, we cannot lose sight of just how essential these goods are to Americans. For some, the cost of a tank of gas can be the obstacle that prevents them from driving to a doctor's appointment or to the grocery store for food. We hear stories during winter of elderly Americans who freeze to death because they run out of fuel oil, and, in summer, of those who die in the heat for lack of electricity and air conditioning. People should not have to make life or death decisions based upon prices that have been put out of their reach by profiteering. Many will not have a choice, and the result will be death. Economics will self-select them to freeze, boil or live in darkness. If Katrina teaches us nothing else, it should teach us that our emergency plans must include providing for the poor, the immobile, the sick and the elderly—in other words, those with the least resources to help themselves.

Thank you again for the opportunity to testify. This is a critical issue, and I am prepared to offer whatever assistance you might request in the future as you address it. I look forward to answering any questions that you have for me today.

Chairman STEVENS. Thank you very much.

Next we will hear from the attorney general from South Carolina, Henry McMaster.

**STATEMENT OF HENRY McMASTER, ATTORNEY GENERAL,
STATE OF SOUTH CAROLINA**

Mr. McMASTER. Thank you, Mr. Chairman, members of the committee. I also appreciate the opportunity to discuss this with you today, this very important issue.

We have had some experience with this issue of price-gouging in South Carolina, which has indicated the need for strengthened laws in our State, and we are working on that now. We have made a proposal. It has not been introduced. It will not be until January.

Mr. Chairman, to answer your question, which is best equipped to deal with price-gouging, the State or the Federal Government, it might depend on whom the defendant is. If the defendant is a big oil company, then perhaps that should be a Federal question. Often a big oil—any big corporation that is located outside of the

jurisdiction of a State, particularly in a lengthy civil action, discovery, with lawyers and all the processes involved there with service of process and so forth, it may be better to have a Federal response if a response is necessary at all.

But as to the second question, Mr. Chairman, would we favor Federal preemption, the answer to that is a solid no, we would not. In our State the Federal authorities and the State authorities cooperate very closely together and we have no difficulty deputizing Federal agencies as State agents, deputizing State agents as Federal agents, and participating side by side with State and Federal prosecutors in the courtroom, whether it be Federal or State, to enforce the appropriate law. But we certainly would not want our laws in South Carolina that have been written with some specificity and utilitarian purpose for us to be preempted by something else.

We have a fairly good law now. The civil law is very broad, the price-gouging. That is the one on unfair trade practices, which outlaws as a civil offense anything that is unfair or deceptive, very much as the FTC does. It is almost the same thing. We have that and that is useful. But we have a price-gouging law which is a part of that that we need to tune up a little bit and I will mention that one specific point in a minute.

But back to the day of the hurricane and thereafter. We got 550 direct complaints to my office within just a period of a couple of weeks and we got about a thousand referrals from the Department of Energy. We did the best we could to analyze them all. We do not have that many people that we can send out to inquire.

But what we found out was interesting. The pre-Katrina prices in South Carolina, depending on where you were in the State, were about \$2.40 a gallon. A year ago, that is in November 2004, they were about \$1.88, \$1.90, or \$1.86. Just before, the day before the hurricane, they were \$2.40 on the average. Shortly after the hurricane on August 29, September 5 and 6, they had gone up, depending on the part of the State, to \$3.23, \$3.18, \$3.13, and people were starting to complain very vocally. In fact, people were starting to panic as well because of predictions, very dire predictions of the consequences of the hurricane. People were hoarding gas. There were people we read about and heard about filling up their tanks from their boats and both cars, all three cars, all that sort of thing, to be sure not to run out, and by the weekend many of the gas stations had plenty of gas but did not have any customers because everybody had already gassed up.

Our Governor, Mark Sanford, very wisely decided not to declare a state of emergency in South Carolina, which would have triggered our price-gouging statute, which has a criminal component, thinking—and I agreed with him on that—that to make such a declaration would have made matters worse. It would have caused people to panic even worse. What they had in Louisiana, Alabama, and Mississippi, that was certainly a state of emergency and a disaster, but what we had in South Carolina, while highly inconvenient and troubling, was nothing like what they had there. So he did not declare that and that was a good decision.

But when we got those complaints we then began investigating and we ran into the usual problems you run into, whether it is in

a civil case or a criminal case, and that is is the complaint credible. We learned a lot of times that the complaints that would come in of high prices simply had no basis in fact. Either people were mistaken, they were imagining things, or some in fact were just making it up, for reasons unknown to us.

We had a lot of instances where there were legitimate reasons. That is, the prices, as we later learned, had gone up, but only incrementally, not huge increases one after another, but they had gone up incrementally. But when we got the information on the prices that the gas stations were being charged, we saw that they were typically only 6 or 8 cents, maybe a little more, maybe a little less, higher than what they were being charged per gallon. I think the average was something between 2 and 12 cents per gallon.

There were other legitimate factors, quirks, odd things that happened. For instance, one employee raised the price way up to \$4.79 and he did so simply because he did not want to run out of gas, because if they ran out of gas and had to put up a sign then nobody would come into the store to buy all the other things they sell and that is where they make most of the money.

So that is what we ran into in our investigation. We gathered a lot of information. I am happy to say we had cooperation from everyone we asked. Marathon, Ashland, BP, Shell, ConocoPhillips, as well as American Petroleum Institute, the South Carolina Petroleum Marketers Association, all came and gave us information and maps and taught us about the two pipelines, the Colonial and the Plantation Pipeline, that come up from Louisiana and come and serve our State, and that is where most of our gas comes from. They gave us a lot of information.

What it boils down to is we have ended up with seven stations that were charging \$4.79 at the height of the prices that we are investigating now for purpose of seeing if we should bring a civil action against them under the Unfair Trade Practices Act, which is very broad. It again is anything that is unfair or deceptive. It is based on the FTC definition and for a private party it is treble damages and attorney's fees. If the Government brings the case it is \$5,000 per instance, which would be \$5,000 per sale. So that is a good law to have.

But what we need is a criminal law that goes into effect in the absence of a declaration of an emergency by the Governor. In our State, with our current law, again a part of the Unfair Trade Practices Act, says that if the Governor declares a state of emergency then the attorney general may bring a criminal case against someone who price-gouges in a number of commodities, including gas. Price-gouging is defined as an unconscionable increase in the price, which is based on a mathematical sort of a formula. You take the average price—it is all written in the law—for the 30 days prior to the event in question, take the average, and if the increase is an unconscionable increase over that then they are subject to criminal prosecution. It is a misdemeanor, \$1,000 or 30 days in jail or both. But of course you have your prosecutorial discretion that would go in there as well. You do not have to prosecute everybody.

What we are asking for is this. Because our governor wisely did not declare a state of emergency, we had no criminal law to use as a deterrent. A good specific criminal law that everybody can un-

derstand is a very good deterrent, we believe, particularly something like this that is not done in panic, not done as a result of alcohol and drugs and all those kind of things, but something that is calculated out to see how much profit is going to be made.

What we have asked for is an amendment to our price-gouging law that would allow the attorney general to bring a criminal prosecution against someone and have it triggered by our governor declaring a state of emergency in our State or the President declaring a state of emergency or—and this is the new part—a Governor or the President declaring a state of emergency in another State and the situation in that State having a direct impact on things in our State.

What that would have done would have been tailor-made for a situation as the one we experienced, where you had clearly states of emergency in Louisiana, Mississippi and Alabama, which because of those pipelines that come right through South Carolina and that is where we get the vast majority of our gas—Amerada Hess brings some in through the port. But that would have been tailor-made for such a prosecution and we think with the presence of that law we could have advised people and made public service announcements of the presence of that law and its ready application to those situations. We think that would have helped.

We still have—back to the seven that we have ended up with, we still have not decided what we are going to do with them. We do not have the information available. But what it boils down to is in South Carolina if our general assembly will give the State this criminal authority that I have just referred to, we think that we can handle things in our State with that. If they do not, we would be delighted to have a Federal law that would apply to these things.

Thank you very much.

[The prepared statement of Mr. McMaster follows:]

PREPARED STATEMENT OF HENRY MCMASTER, ATTORNEY GENERAL, STATE OF SOUTH CAROLINA

Thank you Mr. Chairman and members of the Committees on Commerce, Science & Transportation and Energy and Natural Resources for the opportunity to testify on the issue of price gouging during periods of abnormal market disruptions. My name is Henry McMaster and I am the Attorney General for South Carolina.

South Carolina's most recent experience with allegations of price gouging in the sale of a commodity occurred during the time periods immediately before and after Hurricanes Katrina and Rita struck the Gulf Coast on August 29 and September 24, 2005, respectively. The lessons learned in this period with regard to retail gasoline pricing are also applicable to possible price gouging for any other commodity which may result from abnormal disruptions in the market. For this reason, I will review the complexities of the gasoline pricing situation and then discuss its applicability to other commodities in general.

Like other states, South Carolina does not produce many of the resources necessary to drive its economy. With regard to gasoline, South Carolina does not have any native oil production; no refineries are located in South Carolina. South Carolina's supply of gasoline, as well as other commodities, is dependent on events which occur elsewhere.

My office received more than five hundred and fifty complaints directly from consumers and another 1,000 by referrals about alleged price gouging by gasoline retailers in South Carolina after Hurricanes Katrina and Rita struck the Gulf Coast. Our investigation of these complaints opened our eyes to the complexities of investigating allegations of price gouging, including (1) the difficulty of determining whether complaints are legitimate and credible, (2) the complexity of making determinations of whether price increases were truly "gouging" or were based on legiti-

mate business decisions or increases in the costs to the retailer, (3) the importance of having the tools necessary to investigate allegations of price gouging immediately while the data are fresh, and (4) the interdependence of all regions of the country with regard to price and supply allocation when a catastrophic event occurs. To conduct our investigation to enable us to understand the factors underlying the run-ups in the retail, price of gasoline, we met with representatives of the various companies involved in the flow of gasoline from its origin as crude oil to the pump at retail gasoline stations. Enforcement specialists from my office visited approximately one hundred gasoline retailers in twenty counties in South Carolina (we have 46). We have also met with representatives of Marathon Ashland Petroleum, LLC, BP America, Inc., Shell Oil Products US, and ConocoPhillips. Additionally, we had a conference call with the chief economist and others of the American Petroleum Institute, the trade association for the oil producers. To further understand the retail marketing of petroleum products, we met with representatives of the South Carolina Petroleum Marketers Association. We met with an oil jobber to help us understand the problems associated with supplying gasoline to retailers during a period when less gasoline is physically available for distribution than is needed to continue to supply retailers at the same rate as prior to a market disrupting event.

As demonstrated by our efforts, the investigation of price gouging complaints for any commodity will necessarily be a complex investigation. As the result of the on-site investigations of various retailers, we are doing follow-up investigations of four corporate entities that own seven retail outlets. The complexities of the production and marketing of any commodity, petroleum in particular, makes it difficult to determine whether price increases are the result of market forces and the workings of free enterprise or the result of short-term profiteering which takes untoward advantage of the market disruption. For example, we received a number of complaints about one multi-station retailer whose prices for regular gasoline went up to \$3.519 per gallon on September 29. However, after reviewing his records, it was determined that his supply costs had risen substantially in line with his retail prices, so that the price increases appeared to be the results of increased costs to the retailer rather than price gouging. The records of another retailer indicate that one of the retailer's employees, without direction from the retailer, made an unauthorized price increase out of panic because the employee thought the station would run out of gasoline; the employee wanted to slow down the sales volume in order to avoid running out of supply. As to the retailers under investigation, it is still too early to determine whether or not they acted improperly. But we have learned how difficult it is to make a determination of the true cause of fluctuations in market price.

Investigative powers which can be implemented immediately are necessary to determine whether rapid and large increases in the retail prices of any necessary commodity are the result of short-term profiteering or fraud instead of the market forces balancing the demand for the commodity with the available supply. South Carolina has those under the Unfair Trade Practice Act, 35-5-10 et seq.

The power to file civil actions concerning these changes in prices also arise under the Unfair Trade Practice Act. Further, during a declared state of emergency (by the Governor of South Carolina or the President of the United States), one specific section of the Act also makes it a crime (1) to rent or sell or offer to rent or sell a commodity (broadly defined, including goods and services) at an unconscionable price within the area for which the state of emergency is declared during the time period that the state of emergency is declared and (2) to impose unconscionable prices for the rental or lease of a dwelling unit, including a motel or hotel unit or other temporary lodging or self-storage facility. A willful violation constitutes a misdemeanor punishable by a fine of not more than one thousand dollars or imprisonment for not more than thirty days. An "unconscionable price" is a price which either represents a "gross disparity" between the price of the covered commodity and the average price at which the covered commodity was available during the thirty days prior to the declaration of the state of emergency or that "grossly exceeds" the average price that was readily available for the covered commodities and services in the trade area thirty days prior to the declaration of the state of emergency. A price is not considered to be an "unconscionable price" if the increase is attributable to additional costs incurred or regional, national, or international market trends. See South Carolina Statute § 39-5-145, a copy of which is attached as Attachment I.*

As mentioned, even without a declared emergency the Attorney General in South Carolina has the power to investigate and punish violations under the other sections of the Unfair Trade Practices Act, all civil in nature, which declares "unfair methods

* Attachments I-III have been retained in committee files.

of competition and unfair or deceptive acts or practices in the conduct of any trade or commerce" unlawful. The Attorney General may recover, on behalf of the state, civil penalties not exceeding five thousand dollars per violation for willful violations. See South Carolina Statutes §39-5-20 and §39-5-110, copies of which are attached as Attachment II. But other than price gouging during a declared state of emergency, there are no statutes which specifically address "price gouging" in South Carolina. This makes it difficult to prove price gouging, as the available statutory authority in non-emergency times is only the general prohibition against practices that are "unfair" or "deceptive", but which lacks a precise definition.

Under our competitive economic system, high prices or quick run-ups in prices are not and should not be illegal absent certain compelling circumstances. Taking risks and making a profit—or a loss—is the American way. To effectively fight true price gouging, however, we need authority to pursue price gougers in South Carolina when we are suffering an abnormal disruption of our market as the result of an event elsewhere. To this end, we are proposing an addition to South Carolina's price gouging statute which would apply to a direct and abnormal disruption in the market in South Carolina caused by an event happening outside of South Carolina which results in the governor of the other state, or the President, declaring a state of emergency or disaster. This approach recognizes the regional impacts of events and allows prosecutorial authorities to act quickly when unconscionable prices are being charged, without the necessity of a locally declared state of emergency. I believe such a law would have a salutary deterrent effect. See proposed amendment to South Carolina Statute §39-5-145, a copy of which is attached as Attachment III. I see no need for additional federal legislation on these points.

Thank you for the opportunity to testify before this Committee on the topic of price gouging. I will be glad to respond to any questions.

Chairman STEVENS. Thank you very much.

We will now hear from Arizona Attorney General Terry Goddard. We appreciate your coming and thank you.

**STATEMENT OF TERRY GODDARD, ATTORNEY GENERAL,
STATE OF ARIZONA**

Mr. GODDARD. Thank you, Mr. Chairman and members of the committees. It is a pleasure to be here to talk about our examination in Arizona of the gas market within our State and hope that it bears some analogies for your deliberations across the country. I will not talk about price-gouging because in Arizona we do not have a price-gouging statute. We do not have the advantages that have just been described to you. So perhaps I am the example of the absence of any kind of consumer protections in the area of gouging in prices. I cannot define "gouging" because we do not have a definition in Arizona.

What we do have to protect consumers are civil antitrust provisions and consumer fraud protections, and we have tried to use those both to investigate and, if the investigations prove fruitful, we will be able to assess penalties to benefit consumers. One such investigation has been completed and one is now under way.

These tools, however, in summary are pretty ineffective against what we have all been seeing in the gas market. For one thing, the antitrust laws depend on an overt conspiracy. They depend on meetings and communications, which in the gas market are not necessary. Everybody can see what the prices are, either in the public data or on the curb, and so that aspect of collusion is probably never going to exist in the gas industry.

Consumer fraud requires deceptive statements and, as I am going to show in a moment, usually it is news events that seem to trigger the disruptions and the supply interruptions which lead to higher prices.

In Arizona, we have two major examples of supply disruptions and price spikes. The first was in 2003 when our pipeline from Texas broke. It stopped delivering gas to the Phoenix metropolitan area and the consequences were severe for our State. And, in 2005 Hurricane Katrina also caused prices to spike significantly.

I cannot underestimate the disruption that these price increases of gasoline have caused to our economy. I know that has been true across the country. In Arizona we are particularly automobile dependent. We have very long distances to travel. Commuting by car is the only way to get around. We have very little public transportation. So getting to work for consumers in Arizona has been a real struggle with the price increases.

My office received hundreds, in fact in 2003 we in a couple of days received over a thousand, complaints from consumers who saw increases at the pump as price-gouging. So they were pretty ready to define it even if our legislature had not.

Now, we investigated through our civil investigative demands in 2003 and found no violation of the antitrust laws. But we did learn a great deal about the industry and about how gas was delivered to the State of Arizona. Perhaps the most surprising finding, given the general disruptive aspect that the increased prices had on our economy, was that both times, in 2003 and 2005, retailers and wholesalers increased their profits by two to three times during the supply disruption. During the time when everybody else was tightening their belts, profits soared.

In 2003 on July 30 the Kinder Morgan pipeline from Texas to central Arizona ruptured. It was 50 years old and it simply gave out. That disruption lasted off and on for about 2 weeks. The immediate reaction was panic. People literally pumped the stations dry and so the first weekend we had prices soaring to 40 to 50 cents above the national average, above \$2. It may seem cheap today, but at that point it was an incredible increase. Some stations went up to \$5 per gallon. That 2-week period was very difficult for our State and the Governor struggled to try to find ways to bring in additional supply.

Perhaps the best lesson that we got out of this whole difficulty was that, as a result of the pipeline break, we found how fragile our delivery system is. 90 percent of all the gas coming into Arizona comes in two pipelines, and when we tried to supplement the one that had broken using rail transportation or trucks we found it was extremely difficult. Rail was virtually impossible as a means to deliver any gas and truck capacity was extended elsewhere and the Governor had to request, and it was ultimately granted, an extension of permitted driver hours of 10 hours more per week in order to get trucks diverted to Arizona to help us move gas where the pipeline used to be. We applied for an EPA waiver because we have certain clean-burning fuel requirements for the center part of the State and that was granted very quickly.

We even tried to use military equipment but we found out that commercial nozzles would not service the military tankers. Most of our military tankers were in Iraq, but the ones that were in Arizona could not be used.

The other thing that we learned was that the industry's "just in time" delivery system leaves almost no cushion to protect con-

sumers. The reserves, such as they were, were gone instantly. There are virtually no tank farms in Arizona. We had at most 2 or 3 days of reserve in the best of times, usually almost none.

Now, in 2005 the Katrina experience showed some very similar aspects. A month before Katrina our prices were right at the national average. We did not vary very much from that. As soon as the hurricane hit and the crisis was on, everybody's prices went up, but ours went up faster and stayed higher longer. We paid 15 cents above the national average, which we found surprising as almost none of our gas comes from the Gulf Coast. Our prices for the first time in my memory went above California's. That seems an abomination of nature. For one thing, California has 10 cents per gallon higher taxes than we do, and we buy most of our supply there. We are subject to the same supply process. So how our prices got higher than theirs is very hard to understand.

But the bottom line, when all was said and done, was that retailer profits tripled. They went from an average of 10 cents a gallon prior to Katrina to above 30 cents a gallon afterward. We also found wholesalers—

Chairman DOMENICI. May I ask a clarifying question?

Chairman STEVENS. Sure.

Chairman DOMENICI. How did you determine that that went up that much? You just stated the profits went up how much? How was that determined?

Mr. GODDARD. The profits were a comparison between the wholesale prices that AAA was able to determine and the prices that were charged at the pump, our investigations confirmed that, but I am primarily citing the AAA.

We also found that wholesale profits went up an equivalent amount in one case from 9 cents before Katrina to 22 cents per gallon afterward.

Gas sales in Arizona are not, certainly as I understand the term, a competitive market. A supply disruption literally turns competition on its head. We had examples in our investigation of service stations who rushed to raise their prices. If they found somebody else down the block had raised a price, they would quickly match it. So instead of lowering prices through competitive pressure, we found they were going up. That I find hard to explain.

The industry explains it by saying that these stations were engaged in replacement cost pricing. In other words, they were trying to price their gas based on what the next load would cost. Well, at the very best that is a speculative and arbitrary exercise. If they err on the high side, obviously that results in more profits for them.

But the thing that we found most dramatic was that replacement cost pricing seems to apply when prices are going up, but it does not seem to apply when the cost of supply goes down. Up like a rocket, down like a feather, has now become a truism for how gas prices operate in our State.

Arizona also has a very fragile, as I have mentioned, and non-redundant delivery system—just two pipelines, almost no other capacity to get gas into Arizona, which has no local refinery, has no local access to crude. That means any supply disruption causes a

spike in prices. We now know a spike in price means increased profits for the oil industry.

So the bottom line, “just in time” supplies eliminate the buffers that protect consumers from supply disruptions, make consumers in Arizona incredibly vulnerable. Supply disruptions immediately led to price hikes and significant increases in industry profits.

I only hope that the huge profits that have been talked about in this committee this morning can, in some degree, be diverted into diversifying our supply system, making sure that States like Arizona—and I think it applies all across the country—have some buffers against supply disruption, have some way to protect consumers from sudden spikes in prices.

I also believe, with my colleagues, that we need a Federal anti-price-gouging statute, one that does not preempt the States, but allows us to use our unique knowledge and investigative capacity within our environment, but also that speaks to national problems, such as the Katrina situation.

It is a great pleasure to be here and I would be very happy to answer questions.

[The prepared statement of Mr. Goddard follows:]

PREPARED STATEMENT OF TERRY GODDARD, ATTORNEY GENERAL, STATE OF ARIZONA

INTRODUCTION

I respectfully submit this testimony as the Arizona Attorney General on behalf of Arizona’s consumers and businesses.

During two recent gasoline market disruptions, one in 2003 and one in 2005, our state has suffered from major gasoline price spikes that left consumers and business struggling to make ends meet.

Arizona consumers and businesses have little legal protection against arbitrary and excessive price hikes, since our state does not have anti-price gouging legislation. My Office has used every investigative tool at its disposal under Arizona’s civil antitrust and consumer fraud statutes, but these tools are less than effective against the practices of the oil and gas industry.

Just as I have strongly supported an anti-price gouging law for Arizona, I also support the enactment of a national anti-price gouging statute. A federal law, which would allow state Attorneys General to take action in their own state courts and compliment any existing state anti-price gouging measures, would greatly benefit this Nation’s consumers.

I. The Arizona Experience

A. The 2003 Pipeline Rupture: A Lifeline Broken

On July 30, 2003, the Kinder Morgan gasoline pipeline running from Tucson to Phoenix ruptured, cutting off approximately one third of Phoenix’s fuel supply.¹ Consumer “panic buying” exacerbated supply shortages, causing gasoline stations to run out of fuel and fuel prices to skyrocket. My Office received and verified consumer complaints that some retail stations were charging more than \$4 per gallon for gasoline. Although the broken pipeline primarily affected the Phoenix supply of gas, there were significant, if less drastic, price increases in the rest of our State as well (see Attachment A).^{1a} In the weeks following the pipeline rupture, my Office received more than 1,000 complaints of alleged “price gouging.”

The only tools at my disposal to investigate alleged violations of law during pipeline break were Arizona’s civil antitrust² and consumer protection statutes.³ Pursuant to Arizona’s antitrust act, the Attorney General may investigate alleged anti-competitive behavior and file a civil suit if there is evidence of collusion, such as price fixing, or exploitation of market power by a firm with a dominant market share. Our consumer fraud act prohibits the use of any deception or misrepresenta-

¹ The Phoenix metropolitan area is Arizona’s largest population center.

^{1a} Attachments A-C have been retained in committee files.

² Arizona Revised Statutes § 44-1401 et seq.

³ Arizona Revised Statutes § 44-1521 et seq.

tion made by a seller or advertiser of merchandise. While both statutory schemes are crucial consumer protection tools, they have proven ineffective in protecting Arizona consumers against sudden, drastic gasoline price increases inflicted during an abnormal market disruption.

After the pipeline break, my Office issued civil investigative demands to gasoline suppliers under Arizona's antitrust statutes, to determine whether any illegal, anti-competitive, or collusive behavior contributed to the soaring prices consumers were paying at the pump. The investigation revealed no violation of Arizona's antitrust laws but did reveal that profit margins during that period were two to three times higher than profit margins when there was no supply disruption.⁴ However, the increased profits earned by the wholesale and retail segments of the industry during and immediately after the supply disruption underscored the need for an anti-price gouging law that would protect consumers from profiteering during a supply emergency.

Our 2003 antitrust investigation following the pipeline break led me to conclude that there is a serious supply problem in Arizona and many Western states, especially during a supply disruption or emergency. The West's gasoline supply is tighter and thus more vulnerable to price spikes and product shortages than other areas of the country because we have very few pipelines to transport refined product,⁵ rapid population growth in Phoenix, Las Vegas, and Central and Southern California, geographic isolation from alternative suppliers, and specialized fuel blends, which may deter alternative suppliers from refining gasoline for the Western states.⁶

Moreover, the entire oil industry has moved to a "just-in-time" delivery system, vastly reducing the numbers of refineries nationwide, and minimizing inventories at storage sites ("tank farms"). The effect is a constant and precarious supply/demand balancing act, which is exceedingly beneficial to industry in lowered operating costs, but very harmful to consumers as supply vulnerability sets the stage for price spikes. The slightest interruption with one of the two pipelines or with any of the refineries that produce Arizona's special fuel blend causes shortages and price spikes in our gas market. This unstable supply situation creates an opportunity for oil companies and gasoline retailers to increase prices and profits during any supply disruption, and particularly during emergencies.

Among the surprises coming out of the post 2003 pipeline break investigation in Arizona was the discovery that the oil industry has so little flexibility. Arizona had almost no ability to obtain petroleum products by alternatives to the pipeline. It was not possible to move gas by tank car since the railroad yards had few storage tanks or facilities to off-load gas. In addition, there was little ability to ship large quantities of gas by truck on short notice. Not only were most of the tanker trucks already spoken for elsewhere, driver hour restrictions prevented overtime to relieve the pressure in Arizona. The Governor requested and received an extension of the overtime limits, which provided some relief. It was not possible to use the National Guard tank trucks since most were on deployment in Iraq and those remaining were incompatible with commercial nozzles. In addition, most military drivers were not licensed to carry petroleum products on the highways.

Additionally, the specialized fuel blends used in Arizona were hard to replace with alternative sources. As a result, the Governor requested, and was granted, a waiver by the Environmental Protection Agency, which allowed the Phoenix area to use conventional fuel for a limited period of time during the disruption. While these measures were intended to alleviate the supply shortages, they had minimal immediate effect since they took time to implement.

Although it seems counterintuitive, any calamity that disrupts the oil and gasoline market seems to benefit the oil industry. Virtually any bad news means higher prices and much higher profits for the industry. Since prices tend to come down much more slowly than they go up, all segments of the industry reap benefits. Given the financial windfalls involved, there is no incentive for industry to improve infrastructure or provide supply "cushions," as those measures would only stabilize prices and benefit consumers.

⁴Many other state and federal antitrust investigations failed to establish violations of anti-trust law.

⁵Arizona is almost completely dependent upon two rather small Kinder Morgan pipelines to bring fuel into the State. One is from Texas and the other is from California (see Attachment B).

⁶Peterson D. and Mahnovski, S. 2003. "New forces at work in refining: Industry views of critical business operations trends", Rand Corporation. Retrieved May 17, 2004 from www.rand.org/publications/MR/MR1707/.

To further complicate matters, the lack of transparency in the oil industry, both with respect to upstream pricing and supply, often leads to uncertainty and confusion among consumers and government agencies alike. When we consider the importance of gasoline to our daily life, our economy, and our security, this lack of transparency is alarming. Not only do consumer fears of stations running out of gas lead to “panic buying,” but many state and local government officials are left guessing about the fuel supply situation when a supply emergency occurs.

Recognizing that persistent supply disruptions were not unique to Arizona, I looked for ways to coordinate state and federal dialogue regarding gasoline issues. In 2004, I co-chaired the National Association of Attorneys General’s Gasoline Pricing Task Force with then Nevada Attorney General Brian Sandoval. We held face-to-face discussions with the United States Department of Energy, the Environmental Protection Agency, the White House Office of General Counsel, and the Federal Trade Commission about the causes of high gasoline prices especially in Arizona and the Western United States. Every federal agency we spoke to directed us to a different federal agency to discuss our concerns.

I concluded from this effort that no single federal agency is responsible for ensuring a stable, affordable supply of gasoline for the nations’ consumers and businesses. The alphabet soup of agencies involved in oil and gas oversight has the inevitable consequence that no agency has responsibility. It is left to the state enforcers, then, to investigate and prosecute illegal, exploitative behavior, especially during a disaster.

B. The Ripple Effect: Katrina and the 2005 Experience

Late this summer, Arizona, like the rest of our Nation, experienced significant fuel price spikes attributed to Hurricane Katrina. In the month prior to Hurricane Katrina, Arizona’s fuel prices were at or around the national average prices. Then, although Arizona receives its fuel from California and West Texas—not the Gulf Coast areas afflicted by the hurricane—Arizona prices spiked to approximately 15 cents above the national average in the hurricane’s aftermath (see Attachment C).

Consumer reaction was strong. Since the beginning of August 2005, my Office has received hundreds of consumer complaints regarding high gasoline prices. An overwhelming number of these complaints reference price gouging and point to 30 cent price increases at retail gasoline stations that occurred at the time Hurricane Katrina struck the Gulf Coast.

Although, in the past, Arizona’s fuel prices sometimes exceeded the national average, the price at the pump seldom, if ever, exceeded California’s prices. There is good reason for this. Approximately two-thirds of Arizona’s gas comes from California, so we are subject to the same supply dynamics as California. In addition, California’s gasoline taxes are approximately 10 cents higher than Arizona’s. Yet, for nearly two weeks, in early and mid September 2005, Arizona’s prices exceeded California’s prices by about 8 cents per gallon (an 18 cent difference when adjusted for the tax difference).

Concerned about possible market and supply manipulation and alleged misrepresentations by the oil industry, I issued antitrust and consumer fraud civil investigative demands allowed under Arizona law to Arizona fuel wholesalers and retailers. My Office is currently reviewing the information provided to determine whether any anticompetitive or fraudulent activity occurred during that time period.

C. The “Replacement Cost” Factor

Gasoline retailers and their trade associations claim that gasoline stations must immediately raise their prices in response to a threatened supply disruption because they must raise enough money to pay for their next shipment of potentially higher priced fuel. They call this arbitrary and speculative behavior “replacement cost” pricing. Whatever the reason, gasoline retailers actually seemed to be competing to raise prices during the Katrina episode. I personally observed that as soon as one station posted higher prices, others in the area quickly matched it. To do otherwise, retailers told my Office, would be to risk being overrun by customers and pumped dry.

Unfortunately for consumers, retailers only adhere to “replacement cost” pricing when raising prices. They are very slow to lower their prices as the supply emergency abates and replacement costs decrease. This phenomenon is so widely known that it is commonly referred to as “up like a rocket, down like a feather.” According to AAA Arizona, post Katrina and Rita profit margins for retail gasoline stations in Arizona swelled to three times higher than normal. “As wholesale prices drop, station owners tend to pass along those savings to motorists at a snail’s pace.” Ken Alltucker, *State’s Gasoline Retailers Cash in. Stations Pocketing Year’s Biggest Profits*, Arizona Republic, November 1, 2005.

Documents provided by some retailers and wholesalers in response to my Office's current investigation corroborate AAA's statements about higher-than-normal profits. Preliminary information indicates that some Arizona retailers, whose average per gallon profit margins prior to Hurricane Katrina were 10 cents per gallon, were suddenly making profit margins of 30 cents after Hurricane Katrina struck. At least one Arizona wholesaler's profit margin was 22 cents per gallon post Katrina, when its pre Katrina profit margins were six to nine cents per gallon.

II. Legal Remedies: Price Gouging Legislation

A. What is Price Gouging?

Of the 28 states, the District of Columbia and two territories with protections against price gouging, none has identical legislation. Thus, nationally there is no common definition of "price gouging". However, there are some common elements. Most states require that a state of emergency be declared⁷ for the law to go into effect, and most cover pricing of essential products and services only.⁸ Some states prohibit any price increase during a state of emergency, while others allow a 10 or 20 percent increase.⁹ While some states prohibit only retailers from increasing their prices and profit margins, others have more effective laws that hold the entire production and supply chain accountable.

B. Price Gouging Laws Work

Traditional price gouging laws are not in effect during periods of "business as usual". Rather, they only go into effect when the normal competitive checks and balances of the free market are disrupted by a disaster or other emergency. When a population is trapped and desperate for essential supplies, like food, water, shelter and gasoline, victims do not have the opportunity to shop around or wait to purchase essential products until the prices go down. Demand is steady regardless of the price, so unscrupulous businesses can and sometimes do take advantage of consumers.

Antitrust and consumer fraud laws cover some aspects of rogue business behavior; however, they are not designed to effectively protect consumers from price gouging. Traditional antitrust tools, which require an overt conspiracy, are unlikely to succeed in this highly concentrated industry where the small numbers of participants know exactly what competitors are doing from publicly available data and would have no need to meet or communicate directly to coordinate price activity. The best and perhaps the only way to effectively protect vulnerable consumers in these circumstances is through anti-price gouging laws.

III. Arizona's Predicament

After each of the two major gasoline price spikes in Arizona, there was an outcry from Arizona consumers, pleading for my Office "to do something," to protect them. Most consumers simply assumed that charging exorbitant prices for essential goods, especially gasoline, during a time of crisis would be illegal. They were shocked to find out that in Arizona, as in many states, there are no such protections.¹⁰ I listened to countless consumers angered and frustrated with the situation.¹¹

While I shared my fellow consumers' outrage, it was my unfortunate duty to inform them that our State had no anti-price gouging law. I supported two efforts in

⁷Most legislation requires the President or the Governor to declare the emergency, although some states allow counties and mayors to make the declarations to activate their laws. E.g. California includes the President, Governor, or County or City Executive Officer. Cal. Penal Code § 396.

⁸These products and services often include food, water, shelter, medical supplies, and fuel. ⁹Hawaii (H.R.S. 209-9) and Louisiana (LSA-R.S. 29:732, et seq. and 14:329.6 et seq.) do not allow any increase; California allows a 10 percent increase; Alabama (Ala. Code § 8-31-3) allows a 15 percent increase; New York (NY Gen Bus 396-R) prohibits an unconscionable or excessive increase.

¹⁰A poll by the *Arizona Republic* newspaper in December of 2003 revealed that 85 percent of Arizonans believe price gouging should be illegal.

¹¹One Arizona consumer wrote:

I am sure that you have noticed the continuing rise of gas prices. I understand there is a war going on, and now this hurricane will have some impact, but please take the following to heart. If gas prices don't go down, I may not be able to continue to take my child places, like 4-H meetings, the library, etc. I can't even visit my older child at college, and she is just 2 hours away. We will all have to consider whether or not to continue working, we may not have the means to even get to work. What about all the other bills, if we pay for gas to get to work how will we pay for our utilities and even our house payments. At present my family is spending about \$500 a month just in gas. I don't know how much longer we can do this. Do you recommend we all get gas credit cards and max them out??? I don't know if you can do anything to help us out, if so please do something! There just isn't any reasonable answer for this that I can come up with. The American people need help!

the Arizona Legislature to pass anti-price gouging legislation. Both times, the bills did not even get a vote in committee and never reached the floor of either house.

I initiated investigations in 2003 and 2005 with the legal tools at hand: civil antitrust and consumer fraud law and their attendant remedies. Even if the evidence from my current investigation reveals what would be “price gouging” in any other state, under Arizona law I may not have a legal basis for suing the companies involved. Without evidence of collusion or deceptive conduct, our current antitrust and consumer fraud statutes do not provide consumer relief.

It is important that states have the ability to tailor their own state laws to the needs of their local communities, to cover the essential goods and services applicable to them, to address other local issues. However, it is also important that all Americans have some basic protections against price gouging. For this, a federal law could protect all American consumers against price gouging during national or regional disasters or abnormal market disruptions. I believe that not just gasoline, but all essential commodities and services should be covered in both federal and state legislation. Water, essential foods, vaccines and other medical supplies, shelter and transportation all could be affected during a disaster or abnormal market disruption.

During a state of emergency, the normal supply and demand of the free market may be disrupted. Without legal protections, the suppliers of critical commodities can, and many will, charge what the market will bear. During a state of emergency, consumers have no market choice about where, and at what price, they can purchase essential commodities and services.

It is important to note that the oil industry’s price increases have had a ripple effect throughout Arizona’s economy. For instance, Arizona Public Service Company, one of Arizona’s largest electric companies requested a 20 percent rate increase, citing increased fuel prices as a major factor behind its request. Arizona consumers will, in all likelihood, continue to feel the economic pinch of the post Katrina gasoline price increases for months to come.

CONCLUSION

The oil industry often tells us that high fuel prices are simply the result of supply and demand and that the market is the best arbiter of price. The fact is that the inelastic demand for oil and gas and the concentration of major industry players makes a mockery of competition. The “just in time” delivery system and a lack of alternative supplies means that any supply disruption, however slight, provides an excuse to raise prices. In the Arizona experience, price spikes mean larger profits for the industry, whether they are caused by the change in seasonal fuel blends, pipeline breaks, or major emergencies like Hurricane Katrina. In both major Arizona price spikes investigated by my Office, some Arizona gasoline companies enjoyed profit levels two to three times above pre-supply disruption profit levels.

I am here on behalf of Arizona consumers to tell you that market forces are not working. The industry’s lack of reinvestment in refining capacity, product storage, and delivery infrastructure serves only the industry’s financial interests, while exposing consumers, especially in states like Arizona without anti-price gouging laws, to huge price spikes when the market experiences a supply disruption. It is up to you, our nation’s lawmakers, to stop this noncompetitive, exploitative and economically disruptive situation. I urge you to adopt an anti-price gouging law that will allow the Federal Trade Commission to protect consumers on a national level and state Attorneys General to protect consumers in the state courts.

Chairman STEVENS. Thank you very much.

I am going to yield to Senator Domenici—well, it had been my intention to probably deal with questions. Let me announce this. We have been told there are three votes, two votes that start at 3:20 and two votes that start at 5:30. So maybe we should listen to Ms. Majoras now. Would you please make your statement.

STATEMENT OF HON. DEBORAH PLATT MAJORAS, CHAIRMAN, FEDERAL TRADE COMMISSION

Ms. MAJORAS. Thank you very much, Chairman Stevens, Chairman Domenici, members of the committees. I am Deborah Majoras, the Chairman of the Federal Trade Commission. I appear today to present the Commission’s testimony on the effectiveness of laws in

preventing price gouging. The views expressed in the written testimony represent the views of the Commission. My oral presentation and responses to questions are my own and may, but do not necessarily, represent the views of the entire Commission.

I share the keen interest of both committees on the issue of energy prices. Americans depend heavily on automobile transportation for their day-to-day survival. The cost of transportation is a significant item in their budgets and the price of gasoline, prominently displayed on gas station placards, is a substantial and visible part of that cost. Naturally, sharp increases cause concern for all Americans.

Over the past 20 years, we have become used to relatively low gasoline prices, and our demand rose by 30 percent over that period. The United States now must import more than 60 percent of crude oil from foreign sources, leaving us vulnerable to world market supply and pricing decisions. Even before Hurricane Katrina, increasing crude oil prices have resulted in rising gasoline prices during much of 2005. And now we share our rising demand with rising demand in newly industrialized nations like China and India.

Meanwhile, it is not enough to import the crude or pump it out of the ground. It then must be refined into gasoline. U.S. refiners are operating at high capacity rates, which means that virtually any interruption in their operations will have a significant impact on supply and thus prices.

It was in this already tight market that Hurricanes Katrina and Rita hit, initially disrupting over 95 percent of crude oil production in the Gulf as well as numerous refineries and pipelines. With supplies severely interrupted by the hurricanes, our consumers watched in horror as prices at gasoline stations increased substantially and rapidly, sometimes multiple times in a single day.

Even as we all looked for ways to help our fellow citizens ravaged by these hurricanes, we were concerned that some appeared to be taking advantage of the victims' plight by gouging them with high prices. This has led to the debate over whether the tools law enforcers currently have are sufficient to deal with sharp price increases in times of crisis.

Given the importance of the gasoline industry to consumers, the FTC scrutinizes this industry for illegal conduct like no other. To protect consumers, we carefully review proposed oil industry mergers, challenging them at lower levels of concentration than in any other industry. We scrutinize price movements and business practices and challenge anticompetitive conduct. We review the weekly prices of gasoline and diesel fuel in 360 retail areas and 20 wholesale regions, an exercise we undertake in no other industry. We constantly conduct research to learn more about this critical industry and then share that knowledge with Americans, producing recently a study reviewing industry mergers and a study that explains how gasoline is priced. Currently, as mandated by section 1809 of the Energy Policy Act, we are investigating the industry for price manipulation and any gouging.

It is understandable that many are calling on the FTC to seek out and prosecute those who are perceived to be taking advantage of our citizens at a most vulnerable point. But neither the antitrust

laws nor any other Federal statute makes it illegal to charge prices that are considered to be too high, as long as companies set those prices independently.

The omission of a Federal price-gouging law is not, I believe, inadvertent, nor does it condone the practice. Rather, it reflects a sound policy choice that we should not be quick to reverse. Regardless of how repugnant price gouging is, a law that prohibits it is a form of price control, which might seem attractive and humane in the short run, but is likely to harm consumers more in the long run.

The free movement of prices plays a critical role in protecting consumers from even greater hardship. They signal the producers to increase or decrease their supply, and in a period of shortage, higher prices create incentives for suppliers to send more product into the market that needs it the most, something we just experienced as substantial imports from Europe have helped ease prices even as, as of yesterday, almost 50 percent of Gulf Coast crude oil production is still shut in.

Higher prices also signal the consumers to decrease their demand. During this recent shortage, we in fact saw signs of decreased demand in the United States not witnessed for 20 years.

We should not ignore what we know. In the 1970s, price controls that were established to deal with the energy crunch resulted in massive shortages and endless lines at the pump. Higher prices, as tough as they are to swallow—and they are—help curtail panic buying and topping off practices that cause retailers to run out of gasoline. The choice during times of emergency—high-priced gasoline or no gasoline at all—is not a good one, but unfortunately it is a choice that must be made.

Another problem with outlawing prices that are considered to be excessive is that it is difficult to distinguish fairly between a malevolent gouger and an honest retail gas station owner who is responding responsibly to tough market conditions. Imagine that gas station owner A is a selfish and heartless citizen who has decided to use a national emergency as an opportunity to raise prices by 30 percent above the pre-emergency level, but without regard to costs or availability of supply. He knows that eventually competition will require him to lower the price, but he will make as much as he can during this time when our consumers are confused and panicked. Gas station owner B, on the other hand, is a good citizen. He has no desire to gouge consumers, but not only is the cost of his supply increasing, but the supply he has on hand is dwindling fast. He observes the lines at his station and sees that consumers are coming in consistently to top off the tank because they are worried about what the future might hold. At this rate of demand, he knows that he will run out of gasoline, so he raises the price by 30 percent above the pre-emergency rate.

Now A and B are charging the same price. So how do we distinguish between the one who has gouged and the one who reacted wisely to tough market forces? Further, regardless of motive, both have engaged in pricing behavior that prompts consumers to reduce their gasoline consumption, which in turn reduces the time of shortage—and this is the important point—results in all consumers getting needed supply more quickly.

Beyond the fairness and enforcement issues, a broad Federal statute may chill legitimate and helpful price responses that look the same as gouging. Retailers may be encouraged simply to maintain the current price until they run out of gasoline, and there will be no incentive to speed new supply to the markets affected by the emergency.

If Congress disagrees, however, and believes that enforcement against price gouging is worth the cost, then it should take into account that State officials, given their proximity to local retail outlets, can react more expeditiously to complaints consumers file about local prices. Most of the reports of alleged gouging that the FTC staff have reviewed involved individual retailers that raised prices sharply in response to dramatic increases in demand or expectations of decreased supply right after the hurricanes, but reduced their prices just as quickly when no other stations followed suit or when their suppliers assured them that their storage tanks would soon be refilled. It is more effective and efficient for State and local officials knowledgeable about the local situation to handle such complaints.

I remain convinced that strong enforcement of the antitrust laws is the best way to protect consumers from market failures, and the Commission is committed to strong enforcement. But we need to remember that a market failure is not the same as a market producing a result that is tough and that we do not like. As demonstrated over the past 75 days, if we do not like high prices then we can, for example, use less gasoline and that will help bring the price back down.

There are no quick fixes to the gas price situation, and we should not tell consumers otherwise. Even if Congress were to pass price-gouging legislation, it would not impact the price spikes to which we are vulnerable as long as we depend so heavily on gasoline and particularly on foreign supplies, do not explore alternative sources of energy, do not look seriously at our rising demand, and ignore our tight refining capacity.

Tough decisions lie ahead, and Americans need us to address these decisions with courage, candor, and resolve. The FTC stands ready to work with Congress in any way possible.

Thank you very much, Mr. Chairman.

[The prepared statement of Ms. Majoras follows:]

PREPARED STATEMENT OF HON. DEBORAH PLATT MAJORAS, CHAIRMAN,
FEDERAL TRADE COMMISSION

I. INTRODUCTION

Chairman Stevens, Chairman Domenici, and members of both Committees, I am Deborah Platt Majoras, the Chairman of the Federal Trade Commission. I appear before you to present the Commission's testimony on the impact of recent supply disruptions on petroleum markets; FTC initiatives to protect consumers by safeguarding competitive markets in the production, distribution, and sale of gasoline; and an important recent Commission study on the factors that affect gasoline prices.¹

Recent events underscore the crucial role played by the energy industry in our economy. Not only do changes in energy prices affect consumers directly, but the

¹This written statement presents the views of the Federal Trade Commission. My oral presentation and responses to questions are my own and do not necessarily represent the views of the Commission or any other Commissioner.

price and availability of energy also influence many other economic sectors. No other industry's performance is more deeply felt, and no other industry is so carefully scrutinized by the FTC.

Prior to Hurricane Katrina, increasing crude oil prices had resulted in rising gasoline prices during much of this year. Despite these rising prices, the demand for gasoline during this past summer was strong and exceeded summer demand in 2004. Then, in this already tight market, Hurricanes Katrina and Rita severely disrupted the important Gulf Coast supply of crude oil and gasoline. At one point, over 95 percent of Gulf Coast crude oil production was inoperable, and numerous refineries and pipelines were either damaged or without electricity.² In the period immediately following Hurricanes Katrina and Rita, gasoline prices rose sharply to \$3.00 per gallon or more in many markets. Although a good portion of Gulf Coast petroleum infrastructure has been put back into production, nearly 68 percent of crude oil production remained shut in as of a week ago.³

Substantially in response to the price effects of this massive and continuing supply disruption, demand for gasoline has decreased somewhat. This reduced demand, together with the resumption of a significant fraction of production in the hurricane-damaged region and increased gasoline imports, has brought both wholesale and retail gasoline prices back down to or below pre-hurricane levels. It is important to remember, however, that Katrina and Rita damaged significant parts of the energy infrastructure in the Gulf Coast region, including oil and natural gas production and refining and processing facilities. Some adverse effect on energy prices may persist until the infrastructure recovers fully—a process that could take months.

The Commission is closely scrutinizing prices and examining any activity in the gasoline industry that may decrease competition and thus harm consumers. The Commission and its staff have developed expertise in the industry through years of investigation and research. The agency has carefully examined proposed mergers and has blocked or required revisions of any that have threatened to harm consumers by reducing competition.⁴ Indeed, the Commission has challenged mergers in the oil industry at lower levels of consolidation than in any other industry. In addition, the Commission has conducted investigations of price movements in particular regions of the nation to determine if they result in any part from anti-competitive practices, and investigated and recently settled a complaint against Unocal for monopolization activities that allegedly could have cost consumers billions of dollars in higher gasoline prices. In addition to law enforcement, the Commission places a premium on careful research and industry monitoring to understand current petroleum industry developments and to identify accurately obstacles to competition, whether arising from private behavior or from public policies. The petroleum industry's performance is shaped by the interaction of extraordinarily complex, fast-changing commercial arrangements and an elaborate set of public regulatory commands. A well-informed understanding of these factors is essential if FTC actions are to benefit consumers.

In 2004, the FTC staff published a study reviewing the petroleum industry's mergers and structural changes as well as the antitrust enforcement actions that the agency has taken in the industry over the past 20 years.⁵ Then, in early July of this year, the Commission published a study that explains the competitive dynamics of gasoline pricing and price changes.⁶ This study is based on years of research and experience, as well as information learned at conferences of industry,

² See Minerals Mgmt. Serv., U.S. Dep't of the Interior, Release No. 3328, *Hurricane Katrina Evacuation and Production Shut-in Statistics Report as of Tuesday, August 30, 2005*, at <http://www.mms.gov/ooc/press/2005/press0830.htm>.

³ See Minerals Mgmt. Serv., U.S. Dep't of the Interior, Release No. 3398, *Hurricane Katrina/Hurricane Rita Evacuation and Production Shut-in Statistics Report as of Tuesday, November 1, 2005*, at <http://www.mms.gov/ooc/press/2005/press1101.htm>.

⁴ Since 1981, the FTC has filed complaints against 19 large petroleum mergers. In 13 of these cases, the FTC obtained significant divestitures. In one of these, Exxon/Mobil, the Commission required the largest divestiture ever, including divestiture of over 2000 retail stations and a refinery. Of the six other matters, the parties in four cases abandoned the transactions altogether after agency antitrust challenges; one case resulted in a remedy requiring the acquiring firm to provide the Commission with advance notice of its intent to acquire or merge with another entity; and the Commission sought dismissal of the sixth complaint (Aloha Petroleum) based on changed circumstances that restored allegedly threatened competition.

⁵ Bureau of Economics, Federal Trade Commission, *The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement (2004)* [hereinafter *Petroleum Merger Report*], available at <http://www.ftc.gov/os/2004/08/040813mergersinpetrolberpt.pdf>.

⁶ Federal Trade Commission, *Gasoline Price Changes: The Dynamic of Supply, Demand, and Competition (2005)* [hereinafter *Gasoline Price Changes*], available at <http://www.ftc.gov/reports/gasprices05/050705gaspricesrpt.pdf>.

consumer, academic, and government participants held by the Commission over the past four years, and explains how gasoline prices are set.

The Commission makes its expertise in this industry available to the public in other ways as well. Thousands of consumers have visited the Commission's "Oil and Gas Industry Initiatives" website,⁷ as well as the website recently established by the Commission's Bureau of Consumer Protection to provide advice on identity theft and other important consumer protection matters in the wake of the hurricanes.⁸ As you know, this is the fourth time in recent weeks the Commission has shared its expertise on gasoline markets in testimony before Congressional committees.⁹

Congress has also turned to the Commission to investigate whether businesses have manipulated markets and prices to the detriment of consumers. Section 1809 of the recently enacted Energy Policy Act¹⁰ mandates an FTC investigation "to determine if the price of gasoline is being artificially manipulated by reducing refinery capacity or by any other form of market manipulation or price gouging practices." In response to that legislation and also to the concerns raised by the hurricanes, the Commission has launched an investigation to scrutinize whether unlawful conduct affecting refinery capacity or other forms of illegal behavior have provided a foundation for price manipulation. The FTC staff is looking at pricing decisions and other conduct in the wake of Katrina to understand what has occurred and identify any illegal conduct. The Commission recently issued civil investigative demands to a number of companies in this investigation and anticipates reporting to Congress on the findings of this investigation next spring. Any identification of unlawful conduct will result in aggressive FTC law enforcement activity.

The Commission's testimony today addresses gasoline pricing issues in three parts. It first considers the issue of price gouging. In an economy in which producers are generally free to determine their own prices and buyers are free to adjust their purchases, it is unusual when many parties call for some sort of price caps on gasoline. The testimony considers the problems inherent in a price gouging law and describes the current Commission investigation of petroleum industry conduct in the wake of the hurricanes.

The testimony next reviews the basic tools that the Commission uses to maintain competition in the petroleum industry and thereby ensure competitive prices for consumers: challenging potentially anticompetitive mergers, prosecuting nonmerger antitrust violations, monitoring industry prices and behavior to detect possible anticompetitive conduct, and researching petroleum sector developments. The nation's economy is based on the premise that competition produces the lowest prices and highest quantity and quality of goods and services, and the highest rate of innovation, for the betterment of all consumers. This review of the Commission's petroleum industry agenda highlights the FTC's contributions to promote and maintain competition in the industry.

The final part of this testimony reviews some useful learning the Commission has derived from its conferences and research and its review of recent gasoline price changes. Among other findings, this discussion highlights the paramount role that crude oil prices play in determining both the levels and the volatility of gasoline prices in the United States. It also discusses how demand has increased substantially over the past few years, both in the United States and in the developing economies of China and India. When worldwide supply and demand conditions resulted in crude oil prices in the range of \$70 per barrel after Katrina—a level from which we are doubtless all glad to have seen the price recede by more than \$10 per barrel since the hurricanes—it was not surprising to see higher gasoline prices nationwide.

II. PRICE GOUGING

The Commission is very conscious of the swift and severe price spikes that occurred immediately before and after Katrina and Rita made landfall, and of the pain that these price increases have caused consumers and small businesses. There have been numerous calls in Congress and elsewhere for investigations of "price gouging," particularly at the retail gasoline level, and for legislation making price gouging (or

⁷ See <http://www.ftc.gov/ftc/oilgas/index.html>.

⁸ See <http://www.ftc.gov/bcp/online/events/katrinaindex.html>.

⁹ Previous prepared statements of the Commission are available at <http://www.ftc.gov/os/testimony/050907gaspricetest.pdf> (before the House Committee on Energy and Commerce, Sept. 7, 2005); <http://www.ftc.gov/os/testimony/050921gaspricetest2.pdf> (before the Senate Committee on Commerce, Science and Transportation, Sept. 21, 2005); <http://www.ftc.gov/os/testimony/050922katrinatest.pdf> (before the House Energy and Commerce Subcommittee on Commerce, Trade, and Consumer Protection, Sept. 22, 2005).

¹⁰ Energy Policy Act of 2005, Pub. L. No. 109-58, § 1809, __ Stat. __ (2005).

offenses defined in such alternative terms as “unconscionably excessive prices”) a violation of federal law.

The FTC is keenly aware of the importance to American consumers of free and open markets and intends faithfully to fulfill its obligation to search for and stop illegal conduct, which undermines the market’s consumer benefits. We caution, however, that a full understanding of pricing practices before and since Katrina may not lead to a conclusion that a federal prohibition on “price gouging” is appropriate. Consumers understandably are upset when they face dramatic price increases within very short periods of time, especially during a disaster. But price gouging laws that have the effect of controlling prices likely will do consumers more harm than good. Experience from the 1970s shows that price controls produced longer lines at the pump—and prolonged the gasoline crisis. While no consumer likes price increases, in fact, price increases lower demand and help make the shortage shorter-lived than it otherwise would have been.

Prices play a critical role in our economy: they signal producers to increase or decrease supply, and they also signal consumers to increase or decrease demand. In a period of shortage—particularly with a product, like gasoline, that can be sold in many markets around the world—higher prices create incentives for suppliers to send more product into the market, while also creating incentives for consumers to use less of the product. For instance, sharp increases in the price of gasoline can help curtail the panic buying and “topping off” practices that cause retailers to run out of gasoline. In addition, higher gasoline prices in the United States have resulted in the shipment of substantial additional supplies of European gasoline to the United States.¹¹ If price gouging laws distort these natural market signals, markets may not function well and consumers will be worse off. Thus, under these circumstances, sound economic principles and jurisprudence suggest a seller’s independent decision to increase price is—and should be—outside the purview of the law.

To be sure, there may be situations in which sellers go beyond the necessary market-induced price increase. A seller who does not want to run out of a supply of gasoline to sell might misjudge the market and attempt to charge prices substantially higher than conditions warrant or than its competitors are charging. News stories of gasoline retailers panicking and setting prices of \$6.00 per gallon are evidence of such misjudgments after the hurricanes. But the market—not price gouging laws—is the best cure for this. Temporary prices that are wildly out of line with competitors’ prices do not last when consumers quickly discover that other stations are charging lower prices. A single seller in a competitive market cannot unilaterally raise prices for long above the level justified by supply and demand factors. As long as they are not sustained by collusive activity, departures from competitive prices cannot endure for long in such a market. The few retailers who raised prices to the \$6.00 level reduced them just as quickly when it became apparent that they had misjudged the market.

Even if Congress outlaws price gouging, the law likely would be difficult to enforce fairly. The difficulty for station managers, as well as for enforcers, is knowing when the managers have raised prices “too much,” as opposed to responding to reduced supply conditions. It can be very difficult to determine the extent to which any more moderate price increases are necessary. Examination of the federal gasoline price gouging legislation that has been introduced and of state price gouging statutes indicates that the offense of “price gouging” is difficult to define. For example, some bills define “gouging” as consisting of a 10 or 15 percent increase in average prices, while most leave the decision to the courts by defining gouging in nebulous terms such as “gross disparity” or “unconscionably excessive.” Some, but not all, make allowances for the extra costs that maybe involved in providing product in a disaster area. Few, if any, of the proposed bills or state laws take account of market incentives for sellers to divert supply from their usual customers in order to supply the disaster area, or incentives for consumers to reduce their purchases as much as possible, minimizing the shortage. Ultimately, the inability to agree on when “price gouging” should be prohibited indicates the risks in developing and enforcing a federal statute that would be controversial and could be counterproductive to consumers’ best interest.

We note that at least 28 states have statutes that address short-term price spikes in the aftermath of a disaster, and we understand that a number of these states

¹¹Total gasoline imports into the United States for September and the first three weeks of October were approximately 34 percent higher than imports over the same seven-week period in 2004. See U.S. Dep’t of Energy, Energy Information Admin. (“EIA”), *U.S. Weekly Gasoline Imports* (Oct. 26, 2005), available at http://www.eia.doe.gov/oil_gas/petroleum/info_glance/gasoline.html.

have opened investigations of gasoline “price gouging.” If Congress mandates anti-“gouging” enforcement in spite of the problems discussed above, then state officials—because of their proximity to local retail outlets—can react more expeditiously at the retail level than a federal agency could to the complaints that consumers have filed about local gasoline prices. Most of the reports of alleged gasoline price gouging that the FTC staff has seen involved individual retailers that raised their prices sharply in reaction to dramatic increases in consumer demand or expectations of decreased supply right after the hurricanes—and reduced their prices just as quickly when no other gas stations followed suit, or when their suppliers assured them that their storage tanks would be refilled. It would be far more efficient for state and local officials close to these incidents (and knowledgeable about the local situation) to handle any such complaints.

For all of these reasons, the Commission remains persuaded that federal price gouging legislation would unnecessarily hurt consumers. Enforcement of the anti-trust laws is the better way to protect consumers. The FTC will thoroughly investigate gasoline pricing practices and will aggressively respond to any manipulation of gasoline prices we are able to uncover that violates federal antitrust law. The Commission believes that passage of federal price gouging legislation before completion of the Section 1809 investigation is premature at best. Commission findings regarding possible market manipulation from this study could help inform Congressional committees as they wrestle with the difficult issues presented by rapid price increases in periods of shortage.

III. FTC ACTIVITIES TO MAINTAIN AND PROMOTE COMPETITION IN THE PETROLEUM INDUSTRY

A. *The Price Monitoring Project*

Given the importance of the petroleum industry to the U.S. economy, and to the pocketbook of most consumers, the Commission decided it needed more detailed and more timely knowledge of pricing practices in both wholesale and retail markets. Three years ago, the FTC launched a program unique to the petroleum industry to actively and continuously monitor prices of gasoline and diesel fuel in approximately 360 retail areas and 20 wholesale regions.¹² This initiative to monitor gasoline and diesel prices identifies “unusual” price movements¹³ and then examines whether any such movements might result from anticompetitive conduct that violates Section 5 of the FTC Act. FTC economists developed a statistical model for identifying such movements.

The staff reviews daily data from the Oil Price Information Service, a private data collection agency, and receives information weekly from the public gasoline price hotline maintained by the U.S. Department of Energy (“DOE”). The staff monitoring team uses an econometric model to determine whether current retail and wholesale prices are anomalous in comparison to the historical price relationships among cities. If the FTC staff detects unusual price movements in an area, it researches the possible causes, including, where appropriate, through consultation with the state attorneys general, state energy agencies, and the ETA.

In addition to monitoring DOE’s gasoline price hotline complaints, this project includes scrutiny of gasoline price complaints received by the Commission’s Consumer Response Center and of similar information provided to the FTC by state and local officials. If the staff concludes that an unusual price movement likely results from a business-related cause (i.e., a cause unrelated to anticompetitive conduct), it continues to monitor but—absent indications of potentially anticompetitive conduct—it does not investigate further.¹⁴ The Commission’s experience from its past investigations and from the current monitoring initiative indicates that unusual movements in gasoline prices typically have a business-related cause. The FTC staff further investigates unusual price movements that do not appear to be explained by business-related causes to determine whether anticompetitive conduct may underlie the pricing anomaly. Cooperation with state law enforcement officials is an important element of such investigations.

¹² See FTC, *Oil and Gas Industry Initiatives*, at <http://www.ftc.gov/ftc/oilgas/index.html>.

¹³ An “unusual” price movement in a given area is a price that is significantly out of line with the historical relationship between the price of gasoline in that area and the gasoline prices prevailing in other areas.

¹⁴ Business-related causes include movements in crude oil prices, supply outages (e.g., from refinery fires or pipeline disruptions), or changes in and/or transitions to new fuel requirements imposed by air quality standards.

B. Merger Enforcement in the Petroleum Industry

The Commission has gained much of its antitrust enforcement experience in the petroleum industry by analyzing proposed mergers and challenging transactions that likely would reduce competition, thus resulting in higher prices.¹⁵ In 2004, the Commission released data on all horizontal merger investigations and enforcement actions from 1996 to 2003.¹⁶ These data show that the Commission has brought more merger cases at lower levels of concentration in the petroleum industry than in other industries. Unlike in other industries, the Commission has obtained merger relief in moderately concentrated petroleum markets. Moreover, our vigorous merger enforcement has preserved competition and thereby kept gas prices at a competitive level.

Several recent merger investigations illustrate the FTC's approach to merger analysis in the petroleum industry. An important recently completed case involved Chevron's acquisition of Unocal. When the merger investigation began, the Commission was in the middle of an ongoing monopolization case against Unocal that would have been affected by the merger. The Commission settled both the merger and the monopolization matters with separate consent orders that preserved competition in all relevant merger markets and obtained complete relief on the monopolization claim.¹⁷

Another merger case that resulted in a divestiture order resolved a complaint concerning the acquisition of Kaneb Services and Kaneb Pipe Line Partners, companies that engaged in petroleum transportation and terminaling in a number of markets, by Valero L.P., the largest petroleum terminal operator and second largest operator of liquid petroleum pipelines in the United States. The complaint alleged that the acquisition had the potential to increase prices in bulk gasoline and diesel markets.¹⁸ The FTC's divestiture order succeeds in maintaining import possibilities for wholesale customers in Northern California, Denver, and greater Philadelphia and precludes the merging parties from undertaking an anticompetitive price increase.¹⁹

Most recently, the Commission filed a complaint on July 27, 2005, in federal district court in Hawaii, alleging that Aloha Petroleum's proposed acquisition of Trustreet Properties' half interest in an import-capable terminal and retail gasoline assets on the island of Oahu would have reduced the number of gasoline marketers and could have led to higher gasoline prices for Hawaii consumers.²⁰ To resolve this case, the parties executed a 20-year throughput agreement that will preserve competition allegedly threatened by the acquisition.²¹

In the past few years, the Commission has brought a number of other important merger cases. One of these challenged the merger of Chevron and Texaco,²² which combined assets located throughout the United States. Following an investigation in which 12 states participated, the Commission issued a consent order against the merging parties requiring numerous divestitures to maintain competition in particular relevant markets, primarily in the western and southern United States.²³

Another petroleum industry transaction that the Commission challenged successfully was the \$6 billion merger between Valero Energy Corp. ("Valero") and Ultramar Diamond Shamrock Corp. ("Ultramar").²⁴ Both Valero and Ultramar were

¹⁵Section 7 of the Clayton Act prohibits acquisitions that may have anticompetitive effects "in any line of commerce or in any activity affecting commerce in any section of the country." 15 U.S.C. § 18.

¹⁶Federal Trade Commission Horizontal Merger Investigation Data, Fiscal Years 1996-2003 (Feb. 2, 2004), Table 3.1, et seq.; FTC Horizontal Merger Investigations Post-Merger HHI and Change in HHI for Oil Markets, FY 1996 through FY 2003 (May 27, 2004), available at <http://www.ftc.gov/opa/2004/05/040527petrolactionsHHIdeltachart.pdf>.

¹⁷*Chevron Corp.*, FTC Docket No. C-4144 (July 27, 2005) (consent order), at <http://www.ftc.gov/os/caselist/0510125/050802do0510125.pdf>; *Union Oil Co. of California*, FTC Docket No. 9305 (July 27, 2005) (consent order), at <http://www.ftc.gov/os/adjpro/d9305/050802do.pdf>. The nonmerger case is discussed infra at 16-17.

¹⁸*Valero L.P.*, FTC Docket No. C-4141 (June 14, 2005) (complaint), at <http://www.ftc.gov/os/caselist/0510022/050615com.0510022.pdf>.

¹⁹*Valero L.P.*, FTC Docket No. C-4141 (July 22, 2005) (consent order), at <http://www.ftc.gov/os/caselist/0510022/050726do0510022.pdf>.

²⁰*Aloha Petroleum Ltd.*, FTC File No. 051 0131 (July 27, 2005) (complaint), at <http://www.ftc.gov/os/caselist/1510131/050728comp 1510131.pdf>.

²¹FTC Press Release, *FTC Resolves Aloha Petroleum Litigation* (Sept. 6, 2005), available at <http://www.ftc.gov/opa/2005/09/alohapetrol.htm>.

²²*Chevron Corp.*, FTC Docket No. C-4023 (Jan. 2, 2002) (consent order), at <http://www.ftc.gov/os/2002/01/chevronorder.pdf>.

²³*Id.*
²⁴*Valero Energy Corp.*, FTC Docket No. C-4031 (Feb. 19, 2002) (consent order), at <http://www.ftc.gov/os/2002/02/valerodo.pdf>

leading refiners and marketers of gasoline that met the specifications of the California Air Resources Board (“CARB”), and they were the only significant suppliers to independent stations in California. The Commission’s complaint alleged competitive concerns in both the refining and the bulk supply of CARE gasoline in two separate geographic markets—Northern California and the entire state of California—and the Commission contended that the merger could raise the cost to California consumers by at least \$150 million annually for every one-cent-per-gallon price increase at retail.²⁵ To remedy the alleged violations, the consent order settling the case required Valero to divest: (a) an Ultramar refinery in Avon, California; (b) all bulk gasoline supply contracts associated with that refinery; and (c) 70 Ultramar retail stations in Northern California.²⁶

Another example is the Commission’s 2002 challenge to the merger of Phillips Petroleum Company and Conoco Inc., alleging that the transaction would harm competition in the Midwest and Rocky Mountain regions of the United States. To resolve that challenge, the Commission required the divestiture of: (a) the Phillips refinery in Woods Cross, Utah, and all of the Phillips-related marketing assets served by that refinery; (b) Conoco’s refinery in Commerce City, Colorado (near Denver), and all of the Phillips marketing assets in Eastern Colorado; and (c) the Phillips light petroleum products terminal in Spokane, Washington.²⁷ The Commission’s order ensured that competition would not be lost and that gasoline prices would not increase as a result of the merger.

C. Nonmerger Investigations into Gasoline Pricing

In addition to scrutinizing mergers, the Commission aggressively polices anti-competitive conduct. When it appears that higher prices might result from collusive activity or from anticompetitive unilateral activity by a firm with market power, the agency investigates to determine whether unfair methods of competition have been used. If the facts warrant, the Commission challenges the anticompetitive behavior.

Several petroleum cases of recent years are illustrative. On March 4, 2003, the Commission issued the administrative complaint against Unocal discussed earlier, stating that it had reason to believe that Unocal had violated Section 5 of the FTC Act.²⁸ The Commission alleged that Unocal deceived the California Air Resources Board (“CARB”) in connection with regulatory proceedings to develop the reformulated gasoline (“RFG”) standards that CARB adopted. Unocal allegedly misrepresented that certain technology was non-proprietary and in the public domain, while at the same time it pursued patents that would enable it to charge substantial royalties if CARB mandated the use of Unocal’s technology in the refining of CARB-compliant summertime RFG. The Commission alleged that, as a result of these activities, Unocal illegally acquired monopoly power in the technology market for producing the new CARB-compliant summertime RFG, thus undermining competition and harming consumers in the downstream product market for CARB-compliant summertime RFG in California. The Commission estimated that Unocal’s enforcement of its patents could potentially result in over \$500 million of additional consumer costs each year.

The proposed merger between Chevron and Unocal raised additional concerns. Although Unocal had no horizontal refining or retailing overlaps with Chevron, it had

²⁵ *Valero Energy Corp.*, FTC Docket No. C-4031 (Dec. 18, 2001) (complaint), at <http://www.ftc.gov/os/2001/12/valerocmp.pdf>.

²⁶ *Valero Energy Corp.*, *supra* note 24.

²⁷ *Conoco Inc. and Phillips Petroleum Corp.*, FTC Docket No. C-4058 (Aug. 30, 2002) (Analysis of Proposed Consent Order to Aid Public Comment), at <http://www.ftc.gov/os/2002/08/conocophilipsan.htm>. Not all oil industry merger activity raises competitive concerns. For example, in 2003, the Commission closed its investigation of Sunoco’s acquisition of the Coastal Eagle Point refinery in the Philadelphia area without requiring relief. The Commission noted that the acquisition would have no anticompetitive effects and seemed likely to yield substantial efficiencies that would benefit consumers. *Sunoco Inc./Coastal Eagle Point Oil Co.*, FTC File No. 031 0139 (Dec. 29, 2003) (Statement of the Commission), at <http://www.ftc.gov/os/caselist/0310139/031229stmt0310139.pdf>. The FTC also considered the likely competitive effects of Phillips Petroleum’s proposed acquisition of Tosco. After careful scrutiny, the Commission declined to challenge the acquisition. A statement issued in connection with the closing of the investigation set forth the FTC’s reasoning in detail. *Phillips Petroleum Corp.*, FTC File No. 011 0095 (Sept. 17, 2001) (Statement of the Commission), at <http://www.ftc.gov/os/2001/09/philippstoscstmt.htm>.

Acquisitions of firms operating mainly in oil or natural gas exploration and production are unlikely to raise antitrust concerns, because that segment of the industry is generally unconcentrated. Acquisitions involving firms with de minimis market shares, or with production capacity or operations that do not overlap geographically, are also unlikely to raise antitrust concerns.

²⁸ *Union Oil Co. of California*, FTC Docket No. 9305 (Mar. 4, 2003) (complaint), at <http://www.ftc.gov/os/2003/03/unocalcmp.htm>.

claimed the right to collect patent royalties from companies that had refining and retailing assets (including Chevron). If Chevron had unconditionally inherited these patents by acquisition, it would have been in a position to obtain sensitive information and to claim royalties from its own horizontal downstream competitors. Chevron, the Commission alleged, could have used this information and this power to facilitate coordinated interaction and detect any deviations.

The Commission resolved both the Chevron/Unocal merger investigation and the monopolization case against Unocal with consent orders. The key element in these orders is Chevron's agreement not to enforce the Unocal patents.²⁹ The FTC's settlement of these two matters is a substantial victory for California consumers. The Commission's monopolization case against Unocal was complex and, with possible appeals, could have taken years to resolve, with substantial royalties to Unocal—and higher consumer prices—in the interim. The settlement provides the full relief sought in the monopolization case and also resolves the only competitive issue raised by the merger. With the settlement, consumers are benefitting immediately from the elimination of royalty payments on the Unocal patents, and potential merger efficiencies could result in additional savings at the pump.

The FTC undertook another major nonmerger investigation during 1998-2001, examining the major oil refiners' marketing and distribution practices in Arizona, California, Nevada, Oregon, and Washington (the "Western States" investigation).³⁰ The agency initiated the Western States investigation out of concern that differences in gasoline prices in Los Angeles, San Francisco, and San Diego might be due partly to anticompetitive activities. The Commission's staff examined over 300 boxes of documents, conducted 100 interviews, held over 30 investigational hearings, and analyzed a substantial amount of pricing data. The investigation uncovered no basis to allege an antitrust violation. Specifically, the investigation detected no evidence of a horizontal agreement on price or output or the adoption of any illegal vertical distribution practice at any level of supply. The investigation also found no evidence that any refiner had the unilateral ability to raise prices profitably in any market or reduce output at the wholesale level. Accordingly, the Commission closed the investigation in May 2001.

In addition to the Unocal and Western States pricing investigations, the Commission conducted a nine-month investigation into the causes of gasoline price spikes in local markets in the Midwest in the spring and early summer of 2000.³¹ As explained in a 2001 report, the Commission found that a variety of factors contributed in different degrees to the price spikes, including refinery production problems, pipeline disruptions, and low inventories. The industry responded quickly to the price spike. Within three or four weeks, an increased supply of product had been delivered to the Midwest areas suffering from the supply disruption. By mid-July 2000, prices had receded to pre-spike or even lower levels.

IV. COMMISSION REPORT ON FACTORS THAT AFFECT THE PRICE OF GASOLINE

Identifying the causes of high gasoline prices and gasoline price spikes requires a thorough and accurate analysis of the factors—supply, demand, and competition, as well as federal, state, and local regulations—that drive gasoline prices, so that policymakers can evaluate and choose strategies likely to succeed in addressing high gasoline prices.

The Commission addressed these issues by conducting extensive research concerning gasoline price fluctuations, analyzing specific instances of apparent gasoline

²⁹ *Chevron Corp.*, *supra* note 17.

³⁰ FTC Press Release, *FTC Closes Western States Gasoline Investigation* (May 7, 2001), available at <http://www.ftc.gov/opa/2001/05/westerngas.htm>. In part, this investigation focused on "zone pricing" and "redlining." See *Statement of Commissioners Sheila F. Anthony, Orson Swindle and Thomas B. Leary*, available at <http://www.ftc.gov/os/2001/05/wsgpiswindle.htm>, and *Statement of Commissioner Mozelle W. Thompson*, available at <http://www.ftc.gov/os/2001/05/wsgpithompson.htm>, for a more detailed discussion of these practices and the Commission's findings. See also Cary A. Deck & Bart J. Wilson, *Experimental Gasoline Markets*, Federal Trade Commission, Bureau of Economics Working Paper (Aug. 2003), available at <http://www.ftc.gov/be/workpapers/wp263.pdf>; and David W. Meyer & Jeffrey H. Fischer, *The Economics of Price Zones and Territorial Restrictions in Gasoline Marketing*, Federal Trade Commission, Bureau of Economics Working Paper (Mar. 2004), available at <http://www.ftc.gov/be/workpapers/wp271.pdf>.

³¹ Midwest Gasoline Price Investigation, Final Report of the Federal Trade Commission (Mar. 29, 2001), available at <http://www.ftc.gov/os/2001/03/mugasrpt.htm>; see also Remarks of Jeremy Bulow, Director, Bureau of Economics, Federal Trade Commission, *The Midwest Gasoline Investigation*, available at <http://www.ftc.gov/speeches/other/midwestgas.htm>.

price anomalies, and holding a series of conferences³² on the factors that affect gasoline prices. This work led to the publication of a report³³ that draws on what the Commission has learned about the factors that can influence gasoline prices or cause gasoline price spikes. The report makes numerous significant findings, but three basic lessons emerge from this collective work.

First, in general, the price of gasoline reflects producers' costs and consumers' willingness to pay. Gasoline prices rise if it costs more to produce and supply gasoline, or if people wish to buy more gasoline at the current price—that is, when demand is greater than supply. Second, how consumers respond to price changes will affect how high prices rise and how low they fall. Limited substitutes for gasoline restrict the options available to consumers to respond to price increases in the short run. Because gasoline consumers typically do not reduce their purchases substantially in response to price increases, they are vulnerable to substantial price increases. Third, producers' responses to price changes will affect how high prices rise and how low they fall. In general, when there is not enough gasoline to meet consumers' demands at current prices, higher prices will signal a potential profit opportunity and may bring additional supply into the market.

The vast majority of the Commission's investigations and studies have revealed market factors as the primary drivers of both price increases and price spikes. A complex landscape of market forces determines gasoline prices in the United States.

A. Worldwide Supply, Demand, and Competition for Crude Oil Are the Most Important Factors in the National Average Price of Gasoline in the United States

The world price of crude oil, a commodity that is traded on world markets, is the most important factor in the price of gasoline in the United States and all other markets. Over the years from 1984 through 2003, changes in crude oil prices explained approximately 85 percent of the changes in the price of gasoline. United States refiners compete with refiners all around the world to obtain crude oil. The United States now imports more than 60 percent of its crude from foreign sources, and these costs are passed on to retailers and then consumers. If world crude prices rise, then U.S. refiners must pay higher prices for the crude they buy.

Crude oil prices are not wholly market-determined. Since 1973, decisions by OPEC have been a significant factor in the prices that refiners pay for crude oil. Over time, OPEC has met with varying degrees of success in raising crude oil prices. However, when demand surges unexpectedly, as in 2004, OPEC decisions on whether to increase supply to meet demand can have a significant impact on world crude oil prices.

Overall, the long-run trend is toward significantly increased demand for crude oil. Over the last 20 years, United States consumption of all refined petroleum products increased on average by 1.4 percent per year, leading to a total increase of nearly 30 percent.³⁴

Although they have receded from the record levels they reached immediately after Hurricanes Katrina and Rita, crude oil prices have been increasing rapidly in recent months. Demand has remained high in the United States, and large demand increases from rapidly industrializing nations, particularly China and India, have made supplies much tighter than expected.³⁵

B. Gasoline Supply, Demand, and Competition Produced Relatively Low and Stable Prices From 1984 Until 2004, Despite Substantial Increases in United States Gasoline Consumption

Consumer demand for gasoline in the United States has risen substantially, especially since 1990.³⁶ Although consumption fell sharply from 1978 to 1981, by 1993 consumption rose above 1978 levels, and it has continued to increase at a fairly steady rate since then. In 2004, U.S. gasoline consumption averaged about 9 million barrels per day.

Despite high gasoline prices across the nation, demand generally has not fallen off in 2005. Although there are reports of some diminution in demand in the wake of the hurricanes, it remains to be seen whether this is a long-term reduction. Gasoline demand this summer driving season was above last year's record driving-season demand and well above the average for the previous four years. Higher prices post-

³² FTC Press Release, *FTC to Hold Second Public Conference on the U.S. Oil and Gasoline Industry in May 2002* (Dec. 21, 2001), available at <http://www.ftc.gov/opa/2001/12/gasconf.htm>.

³³ Gasoline Price Changes, *supra* note 6.

³⁴ *Id.* at 19.

³⁵ This phenomenon was not limited to crude oil: other commodities that form the basis for expanded growth in developing economies, such as steel and lumber, also saw unexpectedly rapid growth in demand, along with higher prices. *Id.* at 27.

³⁶ *Id.* at 48.

Katrina finally resulted in some falloff in demand. A preliminary estimate indicates that gasoline demand for September of 2005 was approximately 3.5 percent lower than demand during September 2004.³⁷

Notwithstanding these substantial demand increases in the pre-hurricane time periods, increased supply from U.S. refineries and imports kept gasoline prices relatively steady until 2004. A comparison of “real” average annual retail gasoline prices and average annual retail gasoline consumption in the United States from 1978 through 2004 shows that, in general, gasoline prices remained relatively stable despite significantly increased demand.³⁸ The data show that, from 1986 through 2003, real national average retail prices for gasoline, including taxes, generally were below \$2.00 per gallon (in 2004 dollars). By contrast, between 1919 and 1985, real national average retail gasoline prices were above \$2.00 per gallon (in 2004 dollars) more often than not.³⁹

Average U.S. retail prices have been increasing since 2003, however, from an average of \$1.56 in 2003 to an average of \$2.27 in the first ten months of 2005.⁴⁰ In the last several months, the prices have moved even higher. Setting aside whatever short-term effects may be associated with Hurricanes Katrina and Rita, it is difficult to predict whether these increases represent the beginning of a longer-term trend or are merely normal market fluctuations caused by unexpectedly strong short-term worldwide demand for crude oil, as well as reflecting the effects of instability in such producing areas as the Middle East and Venezuela.

One reason why long-term real prices have been relatively contained is that United States refiners have taken advantage of economies of scale and adopted more efficient technologies and business strategies. Between 1985 and 2005, U.S. refineries increased their total capacity to refine crude oil into various refined petroleum products by 8.9 percent, moving from 15.7 million barrels per day in 1985 to 17.133 million barrels per day as of August 2005 through the expansion of existing refineries and the use of new technologies.⁴¹ This increase—approximately 1.4 million barrels per day—is roughly equivalent to adding approximately 10 to 12 average-sized refineries to industry supply.

Offsetting some of the observed efficiency gains, increased environmental requirements since 1992 have likely raised the retail price of gasoline by a few cents per gallon in some areas. Because gasoline use is a major factor in air pollution in the United States, the U.S. Environmental Protection Agency—under the Clean Air Act⁴²—requires various gasoline blends for particular geographic areas that have not met certain air quality standards. Although available information shows that

³⁷ EIA, DOE/EIA-0208(2005-34), *Weekly Petroleum Status Report*, Oct. 28, 2005, at 17, tbl.11, at http://www.eia.doe.gov/oil_gas/petroleum/data_publications/weekly_petroleum_status_report/upsrr.html.

³⁸ “Real” prices are adjusted for inflation and therefore reflect the different values of a dollar at different times; they provide more accurate comparisons of prices in different time periods. “Nominal” prices are the literal prices shown at the time of purchase.

³⁹ See *Gasoline Price Changes*, *supra* note 6, at 43-47.

⁴⁰ The higher prices in 2005 appear to be the result of market factors that have uniformly affected the entire country. At least for the part of this year that preceded Hurricane Katrina, the FTC’s Gasoline Price Monitoring Project has detected no evidence of significant unusual local or regional gasoline pricing anywhere in the United States during this summer driving season. This contrasts with the past two summers, during which various regional supply shocks, such as the Arizona pipeline shutdown and the Northeast blackouts of August 2003, and the several unanticipated regional refinery outages and late summer hurricanes during the summer of 2004, significantly increased prices in some areas above levels that might be expected based on historical price patterns.

Because of the hurricane-induced shocks to supply, historical price relationships from one area to another no longer held in many instances after Katrina. The pattern of post-Katrina price relationships, however, does appear to be generally consistent with the specifics of Katrina’s and Rita’s impact on the supply infrastructure and with the degree to which particular regions depend on or compete with supplies from the Gulf Coast region. Those few areas in which pricing patterns are not consistent are part of our ongoing investigation pursuant to Section 1809 of the Energy Policy Act of 2005.

⁴¹ Petroleum Merger Report, *supra* note 5, at 196, tbl.7-1; EIA, DOE/EIA-0340(04)/1, 1 Petroleum Supply Annual 2004, at 78, tbl.36 (2005), at http://www.eia.doe.gov/pub/oil_gas/petroleum/data_publications/petroleum_supply_annual/psa_volume1/current/pdf/volume1_all.pdf. EIA, DOE/EIA-0208(2005-33), *Weekly Petroleum Status Report*, August 24, 2005, at http://www.eia.doe.gov/pub/oil_gas/petroleum/data_publications/weekly_petroleum_status_report/historical/2005/2005_08_24/pdf/upsrall.pdf.

⁴² Beginning with the Clean Air Act Amendments of 1970 (Pub. L. No. 91-604, 84 Stat. 1698) and continuing with further amendments in 1990 (Pub. L. No. 101-549, 104 Stat. 2468) and the Energy Policy Act of 1992 (Pub. L. No. 102-486, 106 Stat. 2776), Congress has mandated substantial changes in the quality of gasoline, as well as diesel, that can be sold in the United States.

the air quality in the United States has improved due to the Clean Air Act,⁴³ costs come with the benefits (as they do with any regulatory program). Estimates of the increased costs of environmentally mandated gasoline range from \$0.03 to \$0.11 per gallon.⁴⁴ A recognition that environmental requirements can increase gasoline prices came in the post-Katrina period when the EPA temporarily suspended certain boutique fuel requirements in order to increase the supply of conventional gasoline into affected areas.⁴⁵

FTC studies indicate that higher retail prices are generally not caused by excess oil company profits. Although recent oil company profits may be high in absolute terms, industry profits have varied widely over time, as well as over industry segments and among firms.

EIA's Financial Reporting System ("FRS") tracks the financial performance of the 28 major energy producers currently operating in the United States. Between 1973 and 2003, the annual average return on equity for FRS energy companies was 12.6 percent, while it was 13.1 percent for the Standard & Poor's Industrials.⁴⁶ The rates of return on equity for FRS companies have varied widely over the years, ranging from as low as 1.1 percent to as high as 21.1 percent during the period from 1974 to 2003.⁴⁷ Returns on equity vary across firms as well.

High absolute profits do not contradict numbers showing that oil companies may at times earn less (as a percentage of capital or equity) than other industrial firms. This simply reflects the large amount of capital necessary to find, refine, and distribute petroleum products.

C. Other Factors, Such as Retail Station Density, New Retail Formats, and State and Local Regulations, Also Can Affect Retail Gasoline Prices

The interaction of supply and demand and industry efficiency are not the only factors that impact retail gasoline prices. State and local taxes can be a significant component of the final price of gasoline. In 2004, the average state sales tax was \$0.225 per gallon, with the highest state tax at \$0.334 per gallon (New York).⁴⁸ On average, about 9 percent of a gallon of gasoline is accounted for by state taxes. Some local governments also impose gasoline taxes.⁴⁹

Local regulations may also have an impact on retail gasoline prices. For example, bans on self-service sales or below-cost sales appear to raise gasoline prices. New Jersey and Oregon ban self-service sales, thus requiring consumers to buy gasoline bundled with services that increase costs—that is, having staff available to pump the gasoline.⁵⁰ Some experts have estimated that self-service bans cost consumers between \$0.02 and \$0.05 per gallon.⁵¹ In addition, 11 states have laws banning below-cost sales, so that a gas station is required to charge a minimum amount above its wholesale gasoline price.⁵² These laws harm consumers by depriving them of the lower prices that more efficient (e.g., high-volume) stations can charge.

One of the biggest changes in the retail sale of gasoline in the past three decades has been the development of such new formats as convenience stores and high-vol-

⁴³ Robert Larson, Acting Director of the Transportation and Regional Programs, Environmental Protection Agency, Remarks at the FTC Conference on Factors that Affect Prices of Refined Petroleum Products 79-80 (May 8, 2002).

⁴⁴ See EIA, *1995 Reformulated Gasoline Market Affected Refiners Differently*, in DOE/EIA-0380(1996/01), *Petroleum Marketing Monthly* (1996), and studies cited therein. Environmental mandates are not the same in all areas of the country. The EPA requires particular gasoline blends for certain geographic areas, but it sometimes allows variations on those blends. Differing fuel specifications in different areas can limit the ability of gasoline wholesalers to find adequate substitutes in the event of a supply shortage. Thus, boutique fuels may exacerbate price variability in areas, such as California, that are not interconnected with large refining centers in other areas.

⁴⁵ U.S. Environmental Protection Agency, Fuel Waiver Response to Hurricanes 2005, available at <http://www.epa.gov/compliance/katrina/waiver/index.html>.

⁴⁶ See *Gasoline Price Changes*, supra note 6, at 61.

⁴⁷ *Id.*

⁴⁸ *Id.* at 111 (noting that the other four states with the highest average taxes on gasoline in 2004 were Wisconsin (\$0.33 per gallon), Connecticut (\$0.325 per gallon), Rhode Island (\$0.306 per gallon), and California (\$0.301 per gallon)).

⁴⁹ *Id.* For example, all areas in Florida also have a local tax between \$0.099 and \$0.178 per gallon. Similarly, Honolulu has a local tax of \$0.165 per gallon.

⁵⁰ See, e.g., *Oregon Rev. Stat.*, ch. 480, § 480.315.

⁵¹ See Michael G. Vita, *Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies*, 18 J. Reg. Econ. 217 (2000); see also Ronald N. Johnson & Charles J. Romeo, *The Impact of Self-Service Bans in the Retail Gasoline Market*, 82 *Rev. Econ. & Stat.* 625 (2000); Donald Vandegrift & Joseph A. Bisti, *The Economic Effect of New Jersey's Self-Service Operations Ban on Retail Gasoline Markets*, 24 J. Consumer Pol'y 63 (2001).

⁵² See *Gasoline Price Changes*, supra note 6, at 113.

ume operations. These new formats appear to lower retail gasoline prices. The number of traditional gasoline-pump-and-repair-bay outlets has dwindled for a number of years, as brand-name gasoline retailers have moved toward a convenience store format. Independent gasoline/convenience stores—such as RaceTrac, Sheetz, QuikTrip, and Wawa—typically feature large convenience stores with multiple fuel islands and multi-product dispensers. They are sometimes called “pumpers” because of their large-volume fuel sales. By 1999, the latest year for which comparable data are available, brand-name and independent convenience store and pumper stations accounted for almost 67 percent of the volume of U.S. retail gasoline sales.⁵³

Another change to the retail gasoline market that appears to have helped keep gasoline prices lower is the entry of hypermarkets. Hypermarkets are large retailers of general merchandise and grocery items, such as Wal-Mart and Safeway, that have begun to sell gasoline. Hypermarket sites typically sell even larger volumes of gasoline than pumper stations—sometimes four to eight times larger.⁵⁴ Hypermarkets’ substantial economies of scale generally enable them to sell significantly greater volumes of gasoline at lower prices.

This list of factors that have an impact on retail gasoline prices is not exhaustive, but it shows that prices are set by a complex array of market and regulatory forces working throughout the economy. In the long run, these forces have combined to produce relatively stable real prices in the face of consistently growing demand. Short-run variations, while sometimes painful to consumers, are unavoidable in an industry that depends on the demand and supply decisions of literally billions of people.

V. CONCLUSION

The Federal Trade Commission has an aggressive program to enforce the anti-trust laws in the petroleum industry. The Commission has taken action whenever a merger or nonmerger conduct has violated the law and threatened the welfare of consumers or competition in the industry. The Commission continues to search for appropriate targets of antitrust law enforcement, to monitor retail and wholesale gasoline and diesel prices closely, and to study this industry in detail.

Thank you for this opportunity to present the FTC’s views on this important topic. I would be glad to answer any questions that the Committee may have.

Chairman DOMENICI. Thank you very much, ma’am.

We are going to now proceed with questions and we are going to do it a little differently. Senator Craig, you are going to take my place and go first on our side, followed by Senator Bingaman, and then Senator Stevens will take over on his side.

Senator CRAIG.

Senator CRAIG. Mr. Chairman, thank you very much.

I guess my question is first to the three attorneys general. Under the laws that you have within your States today, have you ever found and have been successful in prosecuting price-gouging?

Mr. HARVEY. We have not, at least during my tenure we have not. Have we ever? I am not sure we can cite any reported cases that show that we have. One of the limitations of our price-gouging statutes in New Jersey is that you must have a declared state of emergency in New Jersey.

Senator CRAIG. Most States are like that.

Mr. HARVEY. Right. And you must have prices that exceed more than 10 percent of the price that was charged prior to the emergency. That has not been sufficiently documented in the past. So I am not aware of any suits being brought.

Senator CRAIG. South Carolina?

Mr. MCMASTER. No, Senator, I am not aware of any in South Carolina. We have had a few suits—

Senator CRAIG. Turn your mike on, would you please.

⁵³ Petroleum Merger Report, *supra* note 5, at 246 tbl.9-5.

⁵⁴ *Id.* at 239.

Mr. MCMASTER. I am sorry.

We have had none in South Carolina that I am aware of under the price-gouging statute, which is a part of the Unfair Trade Practice Act. But we have had a number of cases under the Unfair Trade Practice Act, which is a civil mechanism that prohibits unfair and deceptive acts.

Senator CRAIG. Successful?

Mr. MCMASTER. Yes, sir, they have been successful.

As I mentioned, there are two sides to it. One is the private side, where any individual can bring suit and receive treble damages and attorney's fees. In my State most of the times when anybody sues in any sort of a business type lawsuit, where there is a breach of contract or anything else, the Unfair Trade Practice Act is always included in there as one of the causes of action.

But since I have been Attorney General, since January 2003, we have had one case of the Unfair Trade Practice Act. That was against a power company that had put an assessment, a city assessment for using the telephone poles, in the bills to the customers and some of the customers did not live in the city. So we brought a case against one and the others agreed to—they all agreed to pay some damages back to the people. So that law has worked well.

But we have had no prosecutions or civil actions under price-gouging in my State.

Senator CRAIG. Arizona?

Mr. GODDARD. Senator Craig, we have no price-gouging statute, so I cannot say that we have ever had a successful prosecution.

Senator CRAIG. Do you want one?

Mr. GODDARD. Very definitely, I have been to the legislature at virtually every opportunity to urge passage of such a bill. Some of our colleagues who are not here, specifically Florida, have used their price-gouging statutes successfully against gougers when the hurricanes hit them.

Mr. HARVEY. Senator Craig, could I add something?

Senator CRAIG. Yes.

Mr. HARVEY. Had there been a declared state of emergency in New Jersey, we could have used ours for this Katrina incident. Instead, we used the Motor Fuels Act and the Consumer Fraud Act provisions. There were suppliers, at least retailers, who had increased their prices as many as five times in a single day, which violated our Motor Fuels Act. Some of these prices would have exceeded the 10 percent statutory threshold. But we simply did not have a declared state of emergency in New Jersey.

Mr. MCMASTER. Senator, if I could add to that, we made it very clear in public service announcements that the Unfair Trade Practice Act was available as a remedy and we would bring those investigations and suits vigorously. But that does not have the teeth and the deterrent effect that a criminal action has, and without a declared state of emergency we did not have that available.

Senator CRAIG. Well, the reason I ask that question, I have a survey here that reflects 35 States that have these laws. None of them have been successful in finding gouging. A variety of things have happened—state of emergency declaration. I mean, there are

the mechanics within the law that trigger the action, there is no question about it.

I think the ultimate concern I have, or at least as we walk through this in trying to understand who is on first here or who should not be, is that it is a very complicated process to determine what is or is not fair in the market. So is it fair, because I watch this going on now, for a single retailer to have, let us say, ten locations in a metro market and have four different prices at those ten different locations? It is called zone pricing. Is that gouging or is that marketing?

Does anyone wish to respond to that? And I have seen in the case of my major metro area in Idaho a difference of nearly 10 cents in the same retailer, but in a different location where there is less competition and more traffic. Is that gouging or is that sound pricing?

Chairman STEVENS. That will be your last question, but the gentleman should answer.

Senator CRAIG. Thank you.

Mr. MCMASTER. I would say, depending on how the price is, that would probably be zone marketing. If the price is \$2.40 versus \$2.50, maybe that is marketing. But if it is \$5.20 or as opposed to \$5.30, that might be gouging.

Senator CRAIG. Is that not in the eye of the investigative beholder?

Mr. MCMASTER. It is, and that is the difficulty with the law. In my State we have again a mathematical formula. You take the prior 30 days and compare that to what the current incident is and if it seems to be unconscionable to the prosecutor and in his or her discretion they think it deserves criminal prosecution, then you prosecute, assuming a state of emergency.

Senator CRAIG. Mr. Harvey.

Chairman STEVENS. Senator, we are just going to have to move on.

Senator CRAIG. Oh, I will. Thank you, gentlemen, ladies.

Chairman STEVENS. Senator Salazar.

**STATEMENT OF HON. KEN SALAZAR,
U.S. SENATOR FROM COLORADO**

Senator SALAZAR. Thank you very much, Senator Stevens and Chairman Domenici and Senator Inouye, for holding this hearing.

Thank you for the panelists who are here and my former colleagues from the National Associations of Attorneys General. The question I have for you is on price-gouging and the definition to be adopted. It seems to me that what we have is a tremendous amount of noise going on all over the country about price-gouging and whether or not it has occurred. Part of the problem we have is that we do not have a set definition of what price-gouging is.

I know that our staffs put together a couple of alternatives on how you would define price-gouging, and let me read you two of them and I would like you to comment on how you would define it and whether you think that there is a definition that would make sense nationwide for price-gouging. One of them basically says retailers charging more than a defined percentage above the price charged immediately prior to the proclamation of a state

emergency. A second alternative is retailers charging an unconscionably high price that is not attributable to increased wholesale price.

So as between those two definitions of price-gouging, which one do you think would fit the best if in fact the Congress were to move forward and pass a national price-gouging statute, or do you have some other alternative that would give us a definition of what price-gouging is? Whoever wants to respond.

Mr. HARVEY. As between those two, the first would be more acceptable to me because it has more definition. I still do not think that either is sufficiently specific to give notice and protection to consumers as well as businesses. I would suggest taking a look at the laws we have in New Jersey. For example, we apply a 10 percent rule and we also include increased costs that may be attributable to the retailer. It is true that a business that faces increased costs, for example if a pipeline shuts down in one part of the country and that was the normal area of supply and you have to go to another part of the country, those costs should be built in, and then there maybe should be a 10 percent additional price increase allowed, and the window should be—

Senator SALAZAR. You would do a numerical calculation, right, General Harvey?

Mr. HARVEY. I would.

Senator SALAZAR. How about you, Mr. McMaster?

Mr. MCMASTER. I like the second definition better. It is similar to the one in South Carolina. It uses the words "unconscionable." It is based on a different formula there. But I think that gives your prosecutor, your authorities, more flexibility and still gives plenty of notice to those who would violate the law.

Mr. GODDARD. Senator Salazar, I proposed a provision that really was sort of a blend between the two. We do not use the word "unconscionable" because it is subjective. I tried to use a numerical model—this is a prospective law, not one that was passed by a legislature, but I believe it combines the best of both of your proposals. It also took into account the defense of increased costs and I think that is critical. If a retailer has soaring costs to deal with, that is not gouging. But if, as we found to be the case in Arizona, they simply charged what the market would bear because people were lined up at the pumps and they had no choice as to where to go, I believe that is something that needs to be penalized.

And this is not price control. We are only talking about emergency situations, where the normal supply and demand has broken down and where consumers are truly the victims of unconscionable actions.

Senator SALAZAR. Chairman Majoras, if in fact it was limited to the emergency circumstances that General Goddard was just describing, would it still be your position as Chairman of the Commission to oppose that kind of a price-gouging definition?

Ms. MAJORAS. Senator Salazar, I am actually worried that during a time of crisis it would make it worse, and here is why. Both of these definitions are looking at price only as connected to cost. What they are not taking into account is that price is also used to regulate supply in the marketplace. So if in fact in a place that is experiencing an emergency the gas stations that are going to run

out of supply cannot raise the price, what is going to happen is two things. No. 1, they are going to have a shortage and run out of gas; and No. 2, supplies from elsewhere around the country where refiners and gas stations can get more money because they do not have the price cap placed on them are not going to immediately move supply into the area of emergency, which I submit is the first thing we want to happen when we have an emergency, is to get more gasoline into that area. That is what I am worried about.

Senator SALAZAR. Thank you.

Thank you, Mr. Chairman.

[The prepared statement of Senator Salazar follows:

PREPARED STATEMENT OF HON. KEN SALAZAR, U.S. SENATOR FROM COLORADO

Chairman Stevens, Chairman Domenici, Senator Inouye, Senator Bingaman, I want to thank you all very much for holding this very important hearing.

This morning, the Committee on Agriculture is holding a similar hearing. The Agriculture Committee is receiving testimony regarding the effects of high energy prices on family farms and ranches around the country. As I travel around Colorado, the concern expressed to me most often relates to increasing fuel prices and how those high prices are affecting our farmers, ranchers and rural communities. I expect that is true of my distinguished colleagues on these committees as well.

High fuel prices are hurting Colorado families, farmers and ranchers. I know that during harvest time, no one is hurt by high gas and diesel prices more than farmers and ranchers.

This is what I am hearing from my state.

- During harvest, agricultural producers are some of the largest fuel consumers in the U.S. and producers are facing enormous fuel costs. For example, in Grand Junction, Colorado, diesel prices are still over \$3.00.
- I have heard from a farmer in Brandon, Colorado who has seen a 238 percent increase in diesel costs and a 71 percent increase in gasoline costs since the summer of 2004. This operation will burn 800 to 1,000 gallons of diesel per day during the heavy farming season, and if fuel prices do not moderate, this farmer will realize a doubling of fuel costs for 2006, equating to an additional \$65,000 annually in expenses.
- I have also heard from another farmer in northeastern Colorado who, in order to cover the increasing price of fuel, has applied for additional loans only to be turned down because he is already overextended with existing loans.

These anecdotes are not unique to Colorado. After five years of weather-related disasters such as droughts, hurricanes or fires, these higher input costs are having a severe impact not only on producer's ability to harvest this year, but also in their ability to secure financing to operate next year. This is a crisis that is undermining the stability of farming operations in Colorado and across the country—this is a crisis, an emergency that must be addressed.

In the long-term, we must address energy conservation, new technologies and a balanced development of existing fuel supplies. We must continue to expand opportunities in renewable energy. We must do right by America by investing in ethanol, biodiesel, wind and biomass. Ethanol, for example, is good for our land and water, good for our rural communities, and good for consumers. It not only provides a value-added product for producers, but also paves the way to energy freedom for our country.

At the moment, most of our biofuels are ethanol, and most of that is derived from corn, but we must make these investments and transition into a more diverse set of feedstocks that will help our national security, our national economy and our producers by allowing our farmers from all over the country to grow crops that can be used to make transportation fuels. These diverse feedstocks will include potatoes, tobacco, sugar, wood waste and more. We must make these investments and fully implement and utilize important energy and conservation programs in the farm bill and energy bill to do so.

Such energy efficiency and renewable energy development is something that producers across the country agree on. These investments will allow them to begin to tackle the alarming increases in energy prices and will be a far cheaper form of energy, especially for their individual operations.

At the same time we face this emergency of rising input costs on farms, ranches and rural communities across this country, Congress has cut \$3 billion in agricultural spending. This is \$3 billion cut that will contribute to the decline of the safety-net for these operations—we are not doing everything we can on behalf of those farmers, ranches and agribusinesses.

It seems to me that we are failing rural America. It seems to me that we must address this emergency from two sides. We must address this crisis in the long-term—by developing our renewable technologies, fully implementing the recently passed energy bill and working to expand the conservation and energy titles in the farm bill. But we also are facing a short-term problem. Our producers are seeing increasing input costs, which are not covered by production.

For example, according to statistics from Colorado State University (CSU), for a wheat farmer in Colorado it would take a 40 bushel average yield per acre and an average price of \$4.00 per bushel to cover all costs and break even. However, the average yield in 2005, for example, was 24 bushels per acre and the average price is projected at \$3.34 per bushel.

I hope that the oil company executives who will testify here today realize the real world implications of these high prices—American farms are in real trouble. I also hope they understand why the increases in profits to the tune of billions of dollars that are being reported are perceived by many Americans as a slap in the face to those in danger of losing their family farm or ranch.

Chairman STEVENS. Thank you very much.

I am going to yield my time to Senator Snowe. Senator Inouye yields his time to Senator Pryor. Because you waited so long last time, we are looking at the last first this time. Senator Snowe.

Senator SNOWE. Thank you, Mr. Chairman.

One of the questions I want to address is how do we determine price-gouging.

Ms. MAJORAS. Me?

Senator SNOWE. Yes. I would like to ask, because I gather you do not think we ought to grant the Federal Trade Commission authority to combat price gouging.

Ms. MAJORAS. I worry that it would make things worse for consumers in the long run. Currently, the Federal Trade Commission, which does not have authority to attack price gouging, does not therefore have a definition of it. Nonetheless, in this debate we have struggled about what would define it, and there are some great difficulties in doing that.

Senator SNOWE. This gets back to the original question about gas pricing that occurred this fall. The first panel this morning, chief executive officers of the major oil companies, gave a variety of explanations as to why they were experiencing record profits and record revenues, not only record-breaking for their industry but record-breaking for corporate America.

How do we make the distinction between fair and unfair profits? We do not have a Federal price gouging law, but are there other ways of being able to go after companies who charge unjust prices? Because as I said this morning, oil is not a run of the mill commodity; it is a basic necessity. People are forgoing food, prescription drugs, and making mortgage or rent payments, according to many surveys.

One recent survey, based on a project that was done over the last 3 or 4 years, said one in five households went a day forgoing necessities in order to pay for fuel prices. This is a major issue, as we face the onset of winter. I wonder, how do we go about making the distinction as to what is the normal price increase and as to what is a situation in which oil companies are exploiting vulnerable people, such as the emergency situation we were in in the fall?

Ms. MAJORAS. Well, Senator Snowe, if there is anticompetitive behavior going on between and among these gasoline companies, we will find that and we will prosecute. Currently, the FTC is undertaking an investigation to see whether market manipulation at all is going on in this industry and to see whether there has been some form of gouging. It is a major investigation. We have sent out dozens of subpoenas in the industry and we will expect to report to Congress on it next spring. We can give reports along the way.

But once we conduct that, I hope to have better answers for you, Senator Snowe, in terms of on a going-forward basis what do we need to do, because, as I said in my opening remarks, we are vulnerable to these types of price spikes. As long as we accept the tight refining capacity and the dependence that we have on foreign oil, we are going to be in for a tough road. So we do need to find some solutions.

Senator SNOWE. Even if we did not have a Federal price-gouging law, would the FTC, in its ongoing investigation and study, acknowledge price-gouging if it is found?

Ms. MAJORAS. Well, what we are going to try to do—and again, it is not defined, so we are working on how we would—

Senator SNOWE. You know the essence of it. I do not think it is a secret about how to define price-gouging. Price-gouging is defined in State laws in various ways, but pretty much all definitions are the same.

Ms. MAJORAS. Essentially, yes, although I do not necessarily agree with everyone, how they would define it, because I think they do not take into account some actually very rational price behavior that would be good for consumers. But yes, of course, Senator, we are trying to work with what we know you want us to do. While that does not mean we would prosecute it, when we come back to you and tell you what we have found in the study, we will lay it out for you and we will say, this is what we have found that these companies and these retail stations did when they raised price during this time.

Senator SNOWE. Do you investigate speculation in the commodities market at all?

Ms. MAJORAS. We do not. That falls within the jurisdiction of the CFTC.

Senator SNOWE. Thank you, Mr. Chairman.

Chairman STEVENS. Thank you very much.

Senator Pryor.

Senator PRYOR. Thank you, Mr. Chairman.

I want to welcome these three attorneys general here. Senator Salazar and Senator Bingaman and I used to serve in that office in our home States. We welcome you to the Senate today.

Let me just give you very briefly my philosophy and my approach on this. Consumer protection issues generally, I think, if the law is structured the right way and the attorney general does his job or her job in their home State, can really help to clean up the marketplace and really make that State a very good place for business to occur. Likewise, with regard to antitrust laws—and by the way, Arkansas does have an antitrust law. It also has a separate price-gouging statute, which are different. I think those type laws, if

drafted properly, can be very effective in making sure that the marketplace in your jurisdiction stays free.

We want free markets and we want robust competition, but we need to make sure that the laws of supply and demand are working appropriately. So actually, I think consumer protection laws, price-gouging laws, antitrust laws, can all be very good for business in this country and in your various States.

Also, to Senator Craig's question a few moments ago. After 9/11; when I was the attorney general in my State; we did find price-gouging in our State under our price-gouging law. Our law is not limited just to gasoline. It also has a number of other emergency-type products in there. So again, I think this was very good in settling the market down; and the threat, the deterrent, that the attorney general can offer again can be very good for the State; very good for consumers.

So let me ask our attorneys general just a few very quick questions, especially General Harvey and General McMaster. Have you found it difficult in your States to enforce price-gouging fairly? Has fairness been an issue in your States?

Mr. HARVEY. It has not been an issue for us in New Jersey. We have had very few—we have approached excessive pricing through the Consumer Fraud Act, not really through the price-gouging aspect of the Consumer Fraud Act.

Senator PRYOR. I understand.

Mr. HARVEY. But fairness has not really been an issue.

Senator PRYOR. What about you, General McMaster?

Mr. MCMASTER. Fairness on whose part? On the prosecutor's part or on the—

Senator PRYOR. I think on the prosecutor, on the State's part. Has that been a problem, that the law has not been applied fairly?

Mr. MCMASTER. No, sir. It has not been applied much. There have been a lot, several private actions and a few State actions since I have been in office since 2003, but it has not been used much by the government.

Senator PRYOR. Do you two think that a price-gouging legislation in your States, does your consumers more harm?

Mr. HARVEY. No, I think it does more good than harm, and I think if there is a Federal price-gouging statute you may want to consider giving concurrent jurisdiction to the States, the State attorneys general, to enforce it along with the Federal Government.

Senator PRYOR. I agree with that.

Mr. McMaster?

Mr. MCMASTER. I think ours has done much more good than harm. I do not know that it has done any harm. Our problem is it is not strong enough. We only have the criminal sanctions when there has been a declaration of an emergency.

Senator PRYOR. Right, I understand.

Do you believe that price-gouging statutes are counterproductive to the consumer's best interests and they actually in effect hurt consumers?

Mr. HARVEY. No.

Mr. MCMASTER. Not on the State level. I do not know about on the Federal level because I do not know of a proper definition that would apply fairly and evenly nationwide.

Senator PRYOR. Have you, either of you, experienced long lines at the gas pumps or gas shortages in your States because you have price-gouging statutes?

Mr. HARVEY. No, and even when we brought our three lawsuits against Sunoco, Amerada Hess, and Motiva Shell and certain independent operators, there were no lines. In fact, what we saw is prices began to decrease.

Senator PRYOR. Lastly, Chairwoman Majoras, I want to be clear on something. The opinions you expressed today, are these the unanimous view of the FTC?

Ms. MAJORAS. The written remarks most certainly are, and certainly parts of my oral I took from the written, so yes.

Senator PRYOR. It is unanimous with the FTC?

Ms. MAJORAS. There was one of our Commissioners who was not in town and abstained. But the three of us who remained, yes.

Senator PRYOR. Thank you.

Chairman STEVENS. Thank you very much, Senator.

Now we will turn to the other side here. Senator Bingaman and then Senator Wyden, recognized for 5 minutes.

Senator BINGAMAN. Thank you very much.

Ms. Majoras, let me ask about this section 1809 price-gouging study that was in the energy bill. The way I read that legislation, which the President signed in August, it directs that the FTC conduct an investigation of price-gouging, and report back to Congress within 90 days of enactment. You have said that you are planning to report back next spring. How did you conclude that we did not mean 90 days when we said 90 days?

Ms. MAJORAS. Well, we received a letter from several Senators who had put that provision in, telling us that they meant we could begin it within 90 days. We have had several discussions with members of staff from various members. The fact of the matter is we can give you a report within 90 days. It will not be worth much, I am afraid, Senator, if you really want us to look at whether there has been market manipulation and whether there has been price gouging on a widespread scale. So we have had several discussions with members about this issue.

Senator BINGAMAN. Well, just for the record, I was not one of them, Mr. Chairman. I felt that we meant 90 days when we said 90 days. I think the problem with waiting until next spring is that many of these issues may have subsided and gone off the national agenda to some extent. So I do not know how timely your report will be once we finally see it.

I am somewhat troubled by the testimony that the Commission has provided here. I have always thought the Federal Trade Commission's job was to be the advocate for the consumer at the Federal level and it seems as though the gist of your testimony is that the consumer is better off the higher the price is, that somehow or other that inures to the benefit of the consumer because it increases supply and it has a variety of virtues which, I mean, I guess are arguable.

It does not strike me that enacting price-gouging legislation at the Federal level, if it is properly enforced, could harm the consumer. It is not controlling prices. You imply that this is a way of controlling prices. Did I understand your testimony correctly?

Ms. MAJORAS. Well, sure, partly it is a way. It puts a cap on prices at a particular time.

Senator BINGAMAN. It puts a cap on unconscionable prices, but any price that can be justified by virtue of cost or the increase in the price of the commodity or the market price, that is clearly not covered by price-gouging legislation as I understand it.

Ms. MAJORAS. Senator, let me first make absolutely clear that, yes, without question the FTC is advocating for the consumer, and that is why I am sitting here saying something that is difficult to say. If on a widespread scale we do not allow retailers to price to control for shortages, in other words if we only look at their cost, their historic cost, and we do not allow them to look at the fact that they are about to run out of gasoline, then we will have shortages. We have seen it happen in the past. So that is what I am worried about. The last thing in the world our consumers need during an emergency is to not have access to any gasoline whatsoever.

The problem, sir, is, that if we could be perfect in our enforcement, we could zero in just on the guys who are truly unconscionably taking advantage of our citizens. But the problem is that every statute you pass and enforce, not just a few cases here and there, but seriously enforce, will provide incentives. And if I am an honest retailer who really wants to do the right thing, I am going to be so afraid to raise my price, even when I feel like I need to, to prevent a shortage, because, for heaven's sakes, I might have to go to jail for it. So that is what I am talking about.

Senator BINGAMAN. Well, let me just say, Mr. Chairman, I think the argument that we should not have tough anti-gouging legislation on the books because it might discourage lawful price increases, I just think that is a specious argument. The truth is prosecutors, these attorneys general sitting at the table with you, every day of the week make decisions as to who to prosecute and who not to prosecute based on who they think is out to take advantage of the situation, and that can be done at the Federal level. It has been done at the Federal level in other areas.

The argument that this is difficult to enforce and there are a lot of subjective issues and therefore we do not want to put this kind of a statute on the books just strikes me as unfounded. So we have a basic disagreement about this issue.

Thank you, Mr. Chairman.

Chairman STEVENS. Senator Wyden, you are recognized for 5 minutes.

Senator WYDEN. Mr. Chairman, I think we just have heard from Ms. Majoras an astounding theory of consumer protection. What you have told us, Ms. Majoras, is essentially there are no prices that are ever too high, because somehow if the Government does anything ever under any circumstance that is going to create the shortage and the like.

Ms. MAJORAS. No, that is not what I said, Senator.

Senator WYDEN. Well then, why do you not tell me what you think is an appropriate government role here? That is what all of us are asking. What we know now is 28 States have laws on the books. The gentlemen sitting next to you say that they can do it. So for the life of me I cannot figure out why somebody who is work-

ing constructively cannot work this out in a bipartisan way so that we can have a tool that can be truly useful in the marketplace.

You and I have been at this for almost 2 years now and you always have an excuse for why the Government should not act. We still have not gotten a response to what the Government Accountability Office said on mergers.* Of course there are reasons why gasoline prices are going up—the demand in China and the mischief of OPEC. There are plenty of reasons. But the Government Accountability Office said that the FTC is a significant factor in why people are getting clobbered on the west coast of the United States, and to this day you have not responded to it.

So why do we not just stick to the issue before us today and tell me why it is so difficult for the Federal Trade Commission to work out an arrangement so that the Federal Government can stand up for consumers the way 28 States do, the way these attorneys general do? Why can we not figure out a way to get that done?

Ms. MAJORAS. Well, we can, and I am trying to be constructive, Senator. I am sitting here and I am telling you what we think and what these fine folks behind me who devote their lives to working on these markets think about this issue.

If we pass price-gouging legislation, sir, that only looks at cost as the only element that goes into price during a time of shortage and we enforce that on a wide scale, I submit to you that we will be back here because we will be experiencing shortages that are worse for our consumers. That is what I am trying to tell you. The proposals really only take into account price.

Senator WYDEN. Are there any significant gaps right now in the agency's ability to protect consumers?

Ms. MAJORAS. In this industry?

Senator WYDEN. Yes.

Ms. MAJORAS. No.

Senator WYDEN. Well, that is contrary to even what FTC people have told us. I have sat in hearings where the FTC has said that the agency cannot do anything about a company that gouges unilaterally. I think that is a significant gap, do you not?

Ms. MAJORAS. No, I do not think it is a significant gap. I do not. As we have said, we have States who can take care of this. These are local issues. States are in a much better place to respond very quickly to local market conditions. And the fact of the matter is what we saw in the alleged gouging instances—and we have been watching them and we have been looking at them as closely as we can—is that the price came down almost as quickly as it went up.

Senator WYDEN. You think when a multinational oil company gouges the American consumer and they have stations all over that that is not a national—that is not a matter of national concern? That is just a local concern?

Ms. MAJORAS. First of all, 80 percent of the stations are independently owned and operated. So that is what you are talking about.

Senator WYDEN. Just respond to my question. We have got multinational companies. You have said when they raise prices unilaterally that ought to be a local concern. So you do not think there is

*See appendix I for response.

anything the Federal Government ought to do about unilateral action by an oil company, no matter how much they raise the prices?

Ms. MAJORAS. Well, today there is no—today we allow companies to raise the price as they see fit and allow competition in the marketplace to bring that price back down.

Senator WYDEN. And you have said that that should not change. You have said that there are no significant gaps in the agency's authority. I think that contradicts what folks from the Federal Trade Commission have said.

Let me just ask one last question. This morning the ExxonMobil CEO testified that when the ExxonMobil deal was under review the, quote, "FTC was not interested in ExxonMobil expanding its refinery capacity." Now, that was the largest oil merger in history. Should not the FTC consider the impact on refining capacity, including expansion, of an oil mega-merger?

Ms. MAJORAS. No, no, you misinterpreted what he said. We—

Senator WYDEN. Those were his exact words, Ms. Majoras.

Ms. MAJORAS. Well, he did not like it because we required him to do a divestiture. In order to do the ExxonMobil merger, we said, you cannot own both of these refineries. We need to protect competition for consumers in the refinery market, so you have to sell one. And they sold it to Valero. That is what happened in that merger, Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman.

Chairman STEVENS. Ms. Majoras, two Senators have requested that you provide each of the committees the names of the Senators who agreed that that report should be delayed. Would you do that for us, please?

Ms. MAJORAS. Absolutely.

Chairman STEVENS. Senator Cantwell, I am going to yield to you and then I will be the closing Senator.

Senator CANTWELL. Thank you, Mr. Chairman.

Attorney General Goddard, in your testimony you talked about the importance of the fact that the entire oil industry moved to "just in time" delivery system, which vastly, as you say in your report, quote, "vastly reduces the numbers of refineries, minimizes inventories and storage tanks." Do you want to elaborate on that?

Mr. GODDARD. Senator, I would be happy to. What we found in our research and in our investigations is that "just in time," may reduce industry costs, but makes the consumer hypervulnerable to any supply interruption, any time that there is maintenance on a refinery, because they run refineries at 96 percent or higher of capacity. During a pipeline break such as we suffered in Arizona, there was no extra tank farm storage capacity to pick up the slack in the 2 weeks that the pipeline was down. There were no other alternatives out there in the market.

What I think we are looking at is a structural situation in the industry, which has been able to cut all the items that might provide some redundancy in the market, they have taken them away. Gas is the only industry that I know of where bad news is good news. When they have a reverse of any kind, prices spike. When prices spike, profits in the last two major disruptions, triple.

I would like to respond to something that the chairwoman just said, because it is all well and good to respond to shortages with

increased prices. That is an important factor. But we have seen most of the profits on the downhill side when supplies are adequate. Prices never come down as fast as they go up. In fact, "up like a rocket, down like a feather," is the rule.

Senator CANTWELL. But is not the net result of switching over to "just in time" inventories that we have gone from oil companies having something like 26 or 30 days of oil reserves to "just in time" inventory, only leaving them maybe with a couple of days of inventory?

Mr. GODDARD. Senator, that is the situation in Arizona. I cannot speak for others, but we have essentially a couple of days of inventory, if that.

Senator CANTWELL. So we all know when you only have a little bit of supply, of course the price goes up, right?

Mr. GODDARD. As soon as there is any disruption or potential disruption in the market, a price spike ensues immediately.

Senator CANTWELL. So this morning I asked the oil company executives about exports for that very reason and to provide this committee with information about whether they had exported prior to Katrina supply, whether they had ever diverted, purchased and then diverted supply coming to the United States, and whether they would supply us with information about the paper trading exchange in the off-exchange that they do related to the spot market.

Do you think that information will be helpful in trying to pinpoint this particular issue about potential manipulation of supply?

Mr. GODDARD. Senator, I certainly do. As a consumer in Arizona, if at the time that we were having emergency situations some of our suppliers were diverting their supply overseas, I would feel doubly betrayed.

Senator CANTWELL. Do you think that you had access to this information in your investigations before?

Mr. GODDARD. Senator, we have not had access to any information outside of the geographical limits of our State. One of the problems we have with petroleum industry numbers is the transparency is hazy at best. The reason I was reluctant to answer Senator Domenici's question about profits is that under our civil investigative demands, we must keep the information we get confidential. So it is very difficult to have a clear analysis using just the resources that I have in Arizona of the industry and its practices. We certainly cannot investigate beyond the borders of our State.

Senator CANTWELL. So certainly you would like access to that information, even if it was in your own State, correct?

Mr. GODDARD. Absolutely, Senator.

Senator CANTWELL. Well, hopefully we will have the oil company executives respond, as they said in the committee hearing this morning, and actually provide that information. So maybe we can draw the line between what has happened with exports and potential of supply.

I think this is a critical part of why you need Federal legislation to make sure that supply is not manipulated and that there is transparency in the market. That is exactly what we found out with electricity, that we did not have as much transparency as we thought we had.

If I could make a point about one of the Federal bills that we are looking at S. 1735, which 25 of my colleagues have signed onto, does give the attorneys general additional authority in section 5 and it preserves in section 7 their existing authorities.

So I would love to hear further comments at another time on that legislation.

Thank you, Mr. Chairman.

Chairman STEVENS. Thank you very much.

I am sure you cannot see this from where you are, but this is the Energy Information Administration's gasoline pipelines of the country. As a westerner, I am interested in the fact that Washington State has one; a touch comes up from Utah through Idaho and over into Wyoming; California has two, maybe three, pipes for gasoline. But the Eastern side of the country has enormous capacity for gasoline pipelines. The Western United States has very little.

It does seem to me that the supply concepts of the FTC are reasonable concepts to consider, but I also think that the attorneys general have had something to say. You have an attorneys general association, do you not?

Mr. GODDARD. Yes, sir.

Chairman STEVENS. Have you all discussed this question of the adequacy of State laws in price-gouging circumstances at that association?

Mr. HARVEY. For about 2 years, Senator, we have been looking, in large part raised by Attorney General Charlie Crist in Florida and Attorney General Bill Lockyear in California, among others, of course Attorney General Goddard as well. We have been looking at this issue of price-gouging and gasoline pricing for at least 2 years.

We always seem to face in all of our States price increases that attend certain times of the year, that do not seem to have any supply or market justification. They just appear and then disappear.

Chairman STEVENS. I am an old prosecutor. I do not really like the sound of your law, Mr. Attorney General, that says the Governor has to trigger it. I believe with what Attorney General McMaster said. I believe that a little bit of law enforcement and winning one case and advertising it means a lot in terms of law enforcement.

I would like to suggest that perhaps your association could get together and give us the portion of a bill we might consider. We are going to have to consider these bills some time. I do not think we will get them done before this session is over, but we are going to consider them. It does seem to me that the States ought to take on the role of dealing with local concerns and particularly the independent refiners. 80 percent of these people are independent gas station owners. These that are within one State, the States ought to have a law that takes care of them and provides the adequate needs for publicity that violators will be prosecuted.

I disagree with you to a certain extent, Ms. Majoras. I do believe that we need a Federal statute that has a criminal penalty. We have to look at it in terms of what the standard would be for that penalty.

I do want to ask the attorney generals this. I have said this before before this committee. I come from a background of having

worked in a little gas station back in the 1930s, and that is a long time ago. But still, when the price went up the person I worked for had to raise the price in order to buy the next load of gas. Now, that is the replacement theory that you seem to sort of disapprove. Am I wrong, Mr. Harvey?

Mr. HARVEY. No, no, sir, you are not. Senator, what we found in New Jersey, and one of the reasons that we brought the suits that we brought, is that prices were being charged based upon oil, based upon gas that was already in the ground. It had been bought 2 days before, 3 days before, 4 days before. There was no supply issue. So customers were being charged price increases—

Chairman STEVENS. Well, but that is my point. When they sell that, how are they going to buy the next gas to replace what is in that tank unless they raise the price?

Mr. HARVEY. We would argue that, whatever price-gouging statute that is formulated here, that it reach also beyond the retailers to the suppliers and the refineries. I do not think it should be limited to retailers because I agree with you that—

Chairman STEVENS. But these prices went up primarily because of overseas pricing.

Mr. HARVEY. Not necessarily. We did not experience that in New Jersey. What we saw was not a gasoline shortage. We just saw multiple price increases. And we did not see a supply shortage.

Chairman STEVENS. Well, we have been reading for months about the increasing shortage of crude oil worldwide and that it is going to get worse. As a matter of fact, I have seen charts that indicate we ought to be expecting increases now through the years ahead as China and India and other countries start consuming more and more crude oil, unless we find some additional supply somewhere.

Mr. HARVEY. I have no doubt about that, but we are talking about the narrow period in the days following Hurricane Katrina, when there was sufficient supply in New Jersey. There were in some instances five price increases in a single day, and it went on for multiple days. After we filed suit—

Chairman STEVENS. Were these independent stations?

Mr. HARVEY. Some were. Amerada Hess, however, is a refinery and owner that owns many of its own stations.

Chairman STEVENS. It is still pretty much of an independent in the world scene.

Mr. HARVEY. That is true. But you did have some company-owned stores, which is why we sued both the company and as well as some independents.

Chairman STEVENS. Well, I am belaboring it and I do think we have to get back—this report, when do you think we are going to get it from the FTC, Ms. Majoras?

Ms. MAJORAS. If we do it right, Senator, we will get it done in the spring. As I said, we have sent out dozens of subpoenas to lots of different companies so we can try to do this overall and get it right.

We have offered and we are happy to provide any of our initial findings along the way. But as you can imagine, a 30-day study is not worth as much as a 6-month study in terms of our work. So that is the situation we are facing.

Senator WYDEN. Mr. Chairman.

Chairman STEVENS. Yes. I am trying to listen to three people at one time. Yes, sir, Senator.

Senator WYDEN. I would like to be able to submit some questions for Ms. Majoras in writing. I think she distorted what Mr. Raymond said and what I asked about. He was talking about the refinery they kept, and I would like to submit some questions to her in writing.

Chairman STEVENS. That is fine as long as we are still going to abide by the same concept as this morning. Questions must be submitted by tomorrow noon.

Senator WYDEN. Absolutely.

Chairman STEVENS. And we will submit them through the two committees.

Ms. MAJORAS. If I may, Mr. Chairman, because I have just been accused of distortion. I will obviously respond to it, and if I misunderstood Senator Wyden's question then I will answer it. But I was responding to what I thought he said this morning, and I do not appreciate accusations of distortion.

Thank you, Mr. Chairman.

Chairman STEVENS. We do thank you all. I want to come down and thank you personally for coming. But I think we will just sort of stand at ease for a minute. Senator Domenici said he wished to come back after the vote. As a matter of fact, we are in the middle of four votes that run through. For all intents and purposes, unless you want to wait for 2 hours, this hearing is over. Thank you.

[Whereupon, at 3:31 p.m., the hearing was adjourned.]

A P P E N D I X

PREPARED STATEMENT OF HON. DANIEL K. AKAKA, U.S. SENATOR FROM HAWAII

Chairman Domenici and Chairman Stevens, thank you for holding this timely hearing on energy prices and profits. There is nothing closer to the hearts of Americans than gasoline prices, and consumers in Hawaii know a lot about high gasoline prices. Our state has had the highest average gasoline prices in the nation for over 20 years. Today the national average is \$2.36 per gallon for regular; and in Hawaii it is \$2.82. For premium, the national average is \$2.60 per gallon; and in Hawaii, it is \$3.04. To make matters worse, on the islands other than Oahu, the price is even higher.

Hawaii's energy situation is unique for several reasons, not the least of which is the state's almost complete dependence on petroleum for its transportation energy sector but also for its electricity sector. Hawaii depends on imports to meet almost all its energy needs. This dependency, combined with other factors—such as the costs of transporting refined products interisland, high real estate prices and a number of regulations specific to Hawaii—means that gasoline prices in the state are the most expensive in the nation. Although accusations of collusion and market control have remained unproven in the courts, many in the state remain suspicious that the market is “broken,” that there is collusion, and that the high profits of oil companies today are unfair and prove that something is “wrong.”

Hawaii's energy markets are an integrated system. Policies that affect gasoline also affect other products as well, such as syngas or propane, and the refineries that process crude oil into jet fuel, and other residual energy sources. It is for this reason that the policies surrounding oil markets—and gasoline prices in particular—are so important.

I know that many on this panel have questions about the large profits that are being reported and about possible legislation. I look forward to the testimony of the distinguished witnesses today and I have questions that I would like to ask the witnesses at the appropriate time.

PREPARED STATEMENT OF HON. JOHN D. ROCKEFELLER IV, U.S. SENATOR FROM WEST VIRGINIA

I want to thank both Chairman Stevens and Chairman Domenici for arranging this hearing. West Virginians have been asking when Congress was going to do something about the high costs they've been paying at the pump, the devastating cost of natural gas for our manufacturing sector, and the likelihood that a cold winter will mean our seniors and others on fixed incomes will have to choose between food, medicine, and heating their homes.

We know that there are no simple answers. I supported the Energy bill the President signed into law earlier this year, and I have recently joined the Ranking Member of the Energy Committee in asking Interior Secretary Norton to open some portions of the Gulf of Mexico that are closed to drilling. We know that this country has insufficient refining capacity, and that we tend to drive too much and in vehicles that are not as fuel efficient as they could be.

West Virginians understand that the demand for both petroleum products and natural gas is high here, and exploding in Asia. What they may not understand—and what I surely do not understand—is how American oil companies can plead so many problems in carrying out their business and then turn around and make so much money in a few months that even some of my most distinguished, pro-business colleagues are calling on them to contribute to LIHEAP and to otherwise answer for their profits.

My colleagues know, and undoubtedly our audience knows, that my name is Rockefeller, and they know who my great-grandfather was. If you think that makes me side with the oil companies, you haven't followed my career very closely. I am prepared, with no hesitation, to call the profits—profits that these companies are

making off the backs of West Virginians—what they are, obscene. I'm not anti-capitalism, but I will always be anti-gouging.

I look forward to hearing from our witnesses how what they're doing to my constituents isn't gouging, and I again want to thank the two chairmen for providing the nation with this opportunity to probe these companies' actions.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. TED STEVENS TO
HON. DEBORAH PLATT MAJORAS

Question 1. Thank you for your testimony and your work on the gasoline market analysis mandated by Section 1809 of the Energy Policy Act of 2005 (P.L. 109-58). With respect to the latter, and any additional investigations required by Congress (such as the Pryor/Miladski amendment to H.R. 2862), I would appreciate any specific attention you can give to the State of Hawaii and its unique situation with a small market and small number of gasoline providers.

In your 2003 testimony before the Hawaii State Legislature, testifying on the effects of the wholesale gasoline price cap, you suggested that the more consumer friendly way to reduce gasoline prices in Hawaii would be through policies that reduce costs and/or promote competition.

For example, you suggested that you would expect the cost of imported gasoline to influence the price that marketers pay for gasoline in Hawaii. In other words, if we had more importers of refined product, it could help bring down the price of gasoline in Hawaii. So far; we have only one gasoline importer. Are there federal policies or actions that the FTC can identify that could help increase the number of gasoline importers and thus bring down the price of gasoline (both with and without the price cap law)?

Answer. Imports of gasoline into Hawaii—or, more precisely, credible threats to import gasoline—play an important role in limiting the bulk supply price that the two Hawaii refiners (Chevron and Tesoro) can charge. This is so even though those two refineries (situated on Oahu) can produce enough gasoline to supply the entire state—and can do so more cheaply than an importer. (Indeed, there have been few recent gasoline imports into the state.) Nevertheless, a firm that can import a full cargo of gasoline can use that ability to negotiate a bulk supply contract with Chevron or Tesoro at a price no higher than “import parity,” i.e., the cost of importing the cargo. Each firm capable of importing gasoline can achieve an import parity price (although that price may vary from firm to firm depending on each one's cost to import). As a general matter, competition at the wholesale and retail levels in Hawaii benefits from the presence of more bulk suppliers that can credibly threaten to import.

In its recent law enforcement action against Aloha Petroleum's then proposed acquisition of Trustreet's petroleum interests in Hawaii, the FTC took steps to maintain competition at the bulk supply level by ensuring that at least two firms would remain capable of importing gasoline into Hawaii. Although Aloha has been the only regular importer of gasoline into the state in recent years, Trustreet also was able to import by virtue of its 50 percent interest in the Barber's Point terminal, which it shared with Aloha.¹ The Commission's action was resolved when Aloha agreed to lease half the capacity of the Barber's Point terminal for 20 years to Mid Pac, a firm that markets gasoline in Hawaii under the “Union 76” brand name. With this 20-year throughput agreement, Mid Pac replaced the acquired Trustreet as a firm that can credibly threaten to import gasoline into Hawaii and thereby preserved competition allegedly threatened by the acquisition,

To the extent that federal policies help reduce the cost of imports, they could improve the ability of firms to bargain with the Oahu refiners and thus could have some impact on bulk supply prices.² One such policy initiative would be to relax the restrictions imposed by the Jones Act, which increases the costs of shipments to and from United States ports by requiring that they be made on U.S.-built, -owned, and -flagged vessels. In addition, to the extent that federal or state laws or regulations increase the cost of owning and operating a marine storage terminal in Hawaii, relaxing those requirements could have some effect on bulk supply prices. It is impor-

¹Trustreet and Aloha jointly imported a cargo of gasoline in 2002.

²The 2003 testimony before the Hawaii State Legislature to which the question refers was that of Jerry Ellig, then-Deputy Director of the FTC's Office of Policy Planning, entitled “Competition and the Effects of Price Controls in Hawaii's Gasoline Market” (Jan. 28, 2003), available at <http://www.ftc.gov/be/v030005.htm>.

tant to recognize that any benefits that such statutory or regulatory requirements may provide come at a cost to an efficient gasoline market.

Question 2. Some analysts have concluded that Hawaii's gasoline market is competitive, with certain inefficiencies; and that the inefficiencies (high costs and less than vigorous competition), occur between the wholesale and retail level. Can you please expand on how these inefficiencies (between the wholesale and retail level) occur and how they contribute to high gasoline prices in Hawaii? In addition, what recommendations would the FTC have with respect to solving the inefficiencies to create a more competitive market with respect to that sector?

Answer. As a report prepared by Stillwater Associates noted, certain structural characteristics make Hawaii's wholesale gasoline market less efficient than its mainland counterparts.³ These characteristics—such as a limited number of bulk suppliers—are the result of Hawaii's position as a relatively small market that is distant from mainland gasoline markets. The state's size in terms of gasoline demand and its geographic position relative to other gasoline-producing areas lead to certain diseconomies of scale in gasoline production and marine supply that cannot be changed.

Land in Hawaii is more expensive—and land ownership arrangements in the state are more complex—than in most areas of the United States, and this contributes to higher retail costs. Other inefficiencies are the result of laws and regulations that increase costs and distort investment decisions in Hawaii. These include “anti-encroachment” legislation that limits oil companies and jobbers from opening stations near dealer-operated stations; rent caps for lessee-dealer stations; and the state's wholesale price cap.⁴ The removal or reduction of these regulatory impediments to entry or expansion likely would make the wholesale and retail gasoline sectors in Hawaii more competitive. Nonetheless, they would not eliminate the underlying problem associated with a small, isolated market.⁵ In addition, taxes on retail gasoline sales in Hawaii are above the average figure for the United States as a whole.

Question 3. In addition some islands, particularly Maui and West Hawaii, are affected by logistical bottlenecks that further impair competition and cost effectiveness. What are the anti-competitive forces with respect to market entry on those islands, and how could it be solved?

Answer. The Neighbor Islands have a number of disadvantages relative to Oahu. First, those islands incur added transportation costs because they must obtain gasoline supplies from the refiners or marine terminal owners on Oahu. Second, there are fewer terminal owners on the Neighbor Islands than on Oahu, and it is uncertain whether these smaller markets will accommodate entry by additional terminals. Third, the small size of the market on the smaller Neighbor Islands cannot support the number of jobbers and retailers that exist on Oahu or the Big Island. In this vein, the Stillwater Report noted that Aloha does not do business on Maui, while both Aloha and Tesoro are absent from Kauai.⁶ Moreover, according to that report, prices are higher on Maui than on Kauai because Maui lacks unbranded gas stations.⁷ Fourth, the smaller size of the market on these islands also likely results in lower throughput per station, which would raise average costs and therefore increase prices.

There is probably little that can be done to eliminate the costs associated with being situated on small Neighbor Islands distant from the refining center on Oahu, including entry impediments inherent in small markets where scale economies may be important. In addition, there are no indications of restrictions on terminal access that could be challenged under the antitrust laws.

Question 4. Earlier this year I asked the FTC to investigate a price spike in diesel fuel in Oregon. At that time, it was attributed largely to a pipeline outage. However,

³Stillwater Associates LLC, Study of Fuel Prices and Legislative Initiatives for the State of Hawaii (Aug. 5, 2003) (“Stillwater Report”), available at http://www.stillwaterassociates.com/Presentations/Study_of_Fuel_Prices_for_the_State_of_Hawaii.pdf.

⁴Federal Trade Commission, *Gasoline Price Changes: The Dynamic of Supply, Demand, and Competition 110* (2005), available at http://www.ftc.gov/reports/gasprices05/050705_gaspricesrpt.pdf.

⁵The discussion in the text concerning regulatory impediments presents my views and should not be viewed as an official recommendation of the Commission.

⁶Stillwater Report, *supra* note 3, at 61.

⁷*Id.* Aloha supplies gasoline to Costco elsewhere in the state but does not own a terminal on Maui, and thus Costco does not sell gasoline on Maui. Extant terminal owners on Maui may be disinclined to make space available to Aloha so as to prevent low-priced competition from Costco. (It is almost never a violation of the antitrust laws for one firm to refuse to deal with another. So long as a firm makes the decision unilaterally, in its own business interests, it is not obligated to share its facilities with a potential competitor.)

diesel prices remain higher than gasoline prices in my state. I am asking you to initiate a new investigation as to why diesel prices remain so high in Oregon, and to report your findings to me by December.

Answer. In response to requests from Senators Smith and Wyden and Representative Hooley, as well as in response to consumer complaints collected as part of the Commission's Gasoline and Diesel Price Monitoring project, the FTC staff examined diesel pricing in the Pacific Northwest during February and March 2005. As the question notes, a pipeline outage contributed to unusual diesel price increases in the region at that time. The following discussion provides more details regarding the higher-than-predicted diesel prices in the Pacific Northwest during the winter and spring of 2005. As I will subsequently explain, however, current prices for diesel fuel in Oregon—unlike the prices experienced in the Pacific Northwest last winter and spring—are not out of line with diesel pricing throughout the United States and the rest of the world.

The pricing models that the FTC's economists use showed that retail diesel prices in Idaho, Montana, Oregon, Utah, and Washington rose above their predicted ranges in mid-February of 2005. Thus, beyond the increase in diesel prices that has occurred this year across the nation—much of which has stemmed from increases in the worldwide price of crude oil—additional factors affected diesel prices in these western states.

In particular, several disruptions to supply in the Pacific Northwest appear to have exacerbated local prices there. Multiple refineries in Washington—a major source of supply to Oregon—experienced planned and unplanned unit outages during the period, including facilities operated by Shell, Tesoro, and ConocoPhillips. For example, Tesoro reportedly idled most of its Anacortes, Washington, refinery for maintenance and repair purposes for 30 days, during which it discontinued production of diesel fuel. Several of the refinery maintenance operations in the Pacific Northwest were major turnarounds involving hydrotreater upgrades necessary to produce the ultra-low-sulfur diesel mandated for 2006. In addition, because refineries in Montana and Utah ship diesel and other light petroleum products to the Pacific Northwest, diesel pricing in the Pacific Northwest felt the effects of additional supply shortfalls in certain Rocky Mountain states caused by refinery turnarounds and by problems with the acquisition of synthetic crude oil after a January 2005 fire at Suncor's Alberta oil sands facility. Moreover, the Olympic Pipeline, which transports fuel from refineries in Washington to Oregon, was shut down for several days for planned maintenance at the end of February. The rapid rise in Oregon diesel prices was consistent with these supply disruptions.

By contrast, current diesel prices in Oregon—unlike prices last winter and spring—are not high relative to the rest of the country. As the enclosed Figure 1* shows, prices in Portland have been at or below their predicted ranges since the area recovered from the diesel price spike that it experienced earlier this year. Figure 2—which shows statewide average diesel prices for Oregon and Washington relative to the United States average—also demonstrates that diesel prices in Oregon are not abnormally high relative to the rest of the nation.⁸

Nationally, diesel prices have consistently exceeded gasoline prices for most of the past 16 months. Our research has shown that this shift in the relative prices of diesel and gasoline is attributable primarily to worldwide supply and demand factors—particularly the increased dependence of European countries on diesel—and this trend was exacerbated by the timing and magnitude of the Gulf Coast refinery disruptions in the wake of the hurricanes.

No. 2 diesel fuel is used as a transportation fuel in trucks and automobiles. Because New York is a major market for trading in No. 2 diesel, and because the New York spot price is thus a widely recognized benchmark for trading in this product, we enclose a graph that compares New York Harbor spot prices for diesel and gasoline. Figure 3 plots the difference between the New York No. 2 diesel spot price and the New York conventional gasoline spot price since 1997. As that figure shows, until the second half of 2004, diesel prices typically exceeded gasoline prices only for short periods—typically during winter months, when demand for heating oil (another petroleum distillate similar to diesel) was in greatest demand. Since July 2004, however, the New York diesel spot price has exceeded the conventional gasoline spot price in each month except August and September 2005. According to the Energy Information Administration ("EIA"), this diesel-to-gasoline price gap stems largely from a strong shift away from gasoline toward diesel that has posed chal-

* Figures 1-4 have been retained in committee files.

⁸ With the exception of a short period between Hurricanes Katrina and Rita, diesel prices rose steadily across the United States until mid-October.

lenges to global diesel supply and has affected U.S. distillate markets.⁹ Middle distillates' share of total gasoline and distillate consumption in Europe has increased from approximately 60 percent to around 65 percent since 1999, and European daily consumption of diesel fuel is roughly 500,000 barrels per day higher than it was five years ago.¹⁰ All of this may portend a long-term trend toward observed diesel prices that generally exceed gasoline prices.¹¹

In addition to this possible long-term trend, recent events have played a major role. The price gap between diesel and gasoline has widened substantially since late September, and the national average retail price of diesel has exceeded the average retail price of gasoline by over 50 cents per gallon since mid-October.¹² This sudden and dramatic increase in diesel prices relative to gasoline prices is attributable to the supply disruptions associated with Hurricanes Katrina and Rita.

According to the EIA, Rita affected distillate stocks more than gasoline stocks. Distillate stocks fell by 5.6 million barrels for the week that ended September 30 (the week following Rita), while gasoline stocks fell by 4.4 million barrels. Rita had much less impact on gasoline inventories than on distillate inventories because increased imports after the hurricane bolstered gasoline supplies far more than distillate supplies and because refineries shifted some production from distillates to gasoline. A large gap between diesel and gasoline prices likely will persist until distillate inventories recover for the winter heating season. Although the Commission's monitoring program and other detection efforts have not unearthed evidence of anti-competitive conduct in the diesel fuel industry in Oregon or elsewhere in the nation, we will remain vigilant in our search for any such evidence.

Question 5. ExxonMobil's CEO Lee Raymond testified at this hearing that when the Exxon-Mobil merger was under review, the "FTC wasn't interested in ExxonMobil expanding its refinery capacity." I understood Mr. Raymond's comments to refer to expanding capacity at the California refinery that ExxonMobil retained following the merger, rather than the refinery that the company divested as a condition of the merger. I would not think that Mr. Raymond would have any concern about the expansion of a refinery that was no longer owned by his company. My question to you at the hearing was: Shouldn't the FTC consider the impact on refining capacity, including expansion, of the refineries involved in an oil mega-merger like the Exxon-Mobil merger? You answered that the FTC required divestiture of a different refinery than the one I understood Mr. Raymond to be referring to. To be clear, I am asking whether in reviewing oil mergers, the FTC should consider the impact on refining capacity including whether refineries retained following the merger can expand or should be encouraged to expand capacity to increase supply and provide lower prices for consumers?

Answer. In reviewing mergers in the petroleum industry or any other industry, the Commission considers it crucial to evaluate whether the merger is likely to lead to increased productive capacity and a consequent increase in supply, with lower prices for consumers. In this regard, our analysis of a proposed merger looks very carefully at whether the transaction is likely to produce substantial efficiencies that will outweigh probable anti-competitive effects and that could not be achieved absent the transaction. For example, if a merger between two refineries would allow more efficient utilization of intermediate products across refineries that would in turn increase the total production of gasoline at the two refineries, and if this optimization would be unlikely without the merger, then the FTC would recognize this expected output increase as a procompetitive benefit of the acquisition. Our analysis also counts as a procompetitive benefit of a merger any planned or expected increase in capacity at the refineries retained by the merged firm following the acquisition.

In his November 9 testimony, I understand that Mr. Raymond was discussing the FTC challenge to Exxon's plan to merge with Mobil—and thereby to take over Mobil's refinery in Torrance, California, which competed with Exxon's Benicia refinery in the production of CARB gasoline. With respect to this aspect of the Exxon/

⁹J. Hackworth & J. Shore, U.S. Dep't of Energy, EIA, "Distillate in Depth—The Supply, Demand, and Price Picture" (Winter Fuels Conference, Oct. 12, 2005), available at <http://www.eia.doe.gov/pub/oil-gas/petroleum/presentations/2005/distillate2005/distillate2005—files/frame.html>.

¹⁰According to the EIA, despite European refinery investments in hydrotreater and hydrocracker upgrades to facilitate increased diesel production, Europe's refineries have been unable to keep pace with increased diesel demand in the region, and reliance on diesel imports (particularly in the former Soviet Union) has increased.

¹¹The increased demand for diesel in Europe has left some European refineries with excess capacity to produce gasoline, which is why those refineries were able quickly to produce and ship more gasoline to the United States after the hurricanes. These additional imports helped limit the effect of the hurricanes on gasoline prices.

¹²See Figures 3 and 4.

Mobil merger, the Commission determined after a very searching analysis that the transaction would reduce consumer welfare for Californians unless the merged firm divested either the Benicia or the Torrance refinery (and related marketing assets). In order to remedy the anticompetitive effects of this aspect of the merger, the Commission ordered ExxonMobil to divest the Benicia refinery to an FTC-approved third party. The Benicia refinery was in fact divested to Valero Energy Corp.—at that time a new entrant in California—and that refinery remains fully operational today. The FTC did not want Exxon to add to its position in the CARB refining market through an anticompetitive acquisition of a competing refinery.¹³ At no time has the Commission or its staff told Mr. Raymond or any other oil industry executive that the FTC would oppose ExxonMobil's expansion of capacity at the Torrance refinery or the construction of a new refinery in California. It is in the interests of all consumers for ExxonMobil and other refiners to compete vigorously to take additional market share. We would expect such competition to include refinery construction and expansion where warranted.

Your question also raises a broader issue that pertains to all industries. The FTC has no authority to prohibit any firm in any industry from increasing productive capacity through internal expansion. The only legal basis on which a federal antitrust agency can limit corporate expansion is to challenge mergers and acquisitions that are unlawful because they have the potential to create or enhance market power without yielding countervailing benefits such as the creation of new productive capacity. Internal corporate growth through capacity expansion would not raise this concern, and the statutes that we enforce do not give us authority to prohibit internal expansion. Moreover, it would be contrary to the interests of consumers to limit such expansion—even expansion by a firm with a large market share. For consumers to receive the best goods and services at the lowest prices, our economy depends on the efforts of all firms to compete vigorously to grow their market share. Indeed, one of the key factors that the Commission considers in analyzing a proposed merger is the parties' plans to achieve merger-related efficiencies, including expansions of capacity. It would be bad economics and bad policy for an antitrust agency to tell any company that it may not expand capacity.

* * * * *

Finally, in response to your oral request at the hearing, I would like to elaborate on my testimony regarding the timing of the agency's issuance of a report under Section 1809 of the Energy Policy Act of 2005. As I noted at the hearing, the Commission already has begun an investigation under Section 1809 to determine whether the price of gasoline is being artificially manipulated. Our investigation will be thorough. Indeed, the Commission has already issued extensive civil investigative demands to a number of companies in this investigation.

It is essential that our staff be afforded adequate time to collect and analyze the information necessary for this investigation. As the sponsors of Section 1809 themselves recognized, a credible investigation of these issues will take more than 90 days. On September 19, Senators Stabenow, Dorgan, and Boxer, along with six other Senators, clarified in a letter (enclosed) to me that "[t]he Stabenow-Dorgan-Boxer provision, included in the Energy Policy Act of 2005 (Public Law 109-58) [*i.e.*, Section 1809], allows the Commission 90 days to *begin* its investigation" and urged the Commission to submit its report to Congress "as soon as possible" (emphasis added). Similarly, an August 18 press release (enclosed) from Sen. Dorgan stated that section 1809 requires the FTC to "launch" an investigation within the first 90 days. In light of these statements and the needs of the investigation, I anticipate reporting to Congress on the findings of this investigation in spring 2006.

We have informed Members of Congress of the anticipated release date in staff briefings in September 2005, and in a number of letters responding to congressional inquiries about gasoline prices this fall. In the meantime, I anticipate that our staff will be able to brief the appropriate congressional committees on the status of the investigation periodically.

I appreciate your concern about energy pricing and profits, Mr. Chairman, and I thank you for this opportunity to respond to the Committees' questions.

¹³The Commission alleged that the Exxon/Mobil merger would increase the Herfindahl-Hirschman Index in a market defined by the capacity to refine and market CARB gasoline by 171, to a post-merger level of 1,699. See, e.g., Federal Trade Commission, Bureau of Economics, *The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement* 196 (2004), available at <http://www.ftc.gov/os/2004/08/040813mergersinpetrolberpt.pdf>.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. FRANK R. LAUTENBERG TO
HON. DEBORAH PLATT MAJORAS

Question 1. FTC investigations have found that companies withheld supplies from the market in order to keep prices high. For example, the FTC stated in a March 2001 report concluding its Midwest Gasoline Price Investigation:

“An executive of this company [the company was not disclosed] 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 the antitrust laws. In each instance, the firms chose strategies they thought would maximize their profits.”

Does the FTC stand by its 2001 finding that oil companies have withheld oil products from the market in order to prevent prices from falling?

Answer. The Commission did not find in its Midwest Gasoline Price Investigation that firms withheld oil products from the market in order to keep prices high. Rather, the Commission determined that some firms increased their Gulf Coast production of gasoline for shipment into the Midwest only after it was clear that higher prices in the Midwest would make such shipments profitable. The Commission also found that one firm had a higher-than-expected inventory for a short period, accurately anticipated a tight market, and sold this inventory at a rate that maximized its profits at prevailing prices. In the context of localized product shortages caused by refinery production problems and pipeline disruptions, the Commission found no conduct—either collusive or on the part of any individual firm—that violated the antitrust laws. The salient fact found by the investigation was the Commission’s conclusion that “[t]he gasoline price spike in the Midwest was short-lived. Soon after prices spiked, additional gasoline was produced and imported to the region, and prices dropped as quickly and dramatically as they had risen.”¹ Rather than withhold gasoline, most firms moved extra product into the region in order to take advantage of higher prices, and consumers benefitted accordingly.

Several factors that contributed to the price spike in the Midwest in the summer of 2000 were largely beyond the immediate control of the industry participants. These included production problems at refineries,² two important pipeline disruptions,³ and low inventories.⁴

On the other hand, the industry as a whole made errors in supply forecasts and underestimated the potential for supply shortages in the Midwest in the spring and early summer of 2000. For instance, in determining how they would comply with the stricter EPA regulations for summer-grade RFG that took effect that spring, three Midwestern refiners each independently concluded that it would be more profitable to expend capital on refinery upgrades only to the extent necessary to supply their branded gas stations and fulfill their contractual obligations. As a result of

¹ Final Report of the Federal Trade Commission, *Midwest Gasoline Price Investigation* (Mar. 29, 2001), available at <http://www.ftc.gov/os/2001/03/mwgasrpt.htm>.

² Production problems during this period stemmed from several sources. First, there were problems with meeting the new fuel specification requirements for reformulated gasoline, known as “RFG II.” In particular, Midwest refiners’ use of ethanol as an oxygenate in RFG II made it more costly and difficult to achieve the required low vapor pressure for summertime gasolines. Second, some Midwest refineries were shut down longer than expected for maintenance, replacement, or modification of processing units. Third, several refinery disruptions arose unexpectedly from damage to refining equipment caused by fires or thunderstorms.

³ The Explorer Pipeline, which transports gasoline from refineries on the Gulf of Mexico to Chicago, was closed for five days in March 2000 because of a rupture, and its capacity was thereafter reduced to 90 percent until December 2000. In addition, the Wolverine Pipeline, which carries one-third of Michigan’s gasoline supply, was shut down for nine days in June, and subsequently operated at only 80 percent of capacity for a month, causing shortages in Detroit and northern Ohio.

⁴ Gasoline inventories were low in the Midwest in the spring and summer of 2000 because of the high price of crude oil and the expectation (reflected in futures prices) that crude oil prices would fall. Oil companies hoped to rebuild inventories with lower-priced crude oil in the future. In addition, many industries, including the petroleum industry, have moved to just-in-time distribution techniques in recent years in order to reduce ongoing inventory costs. Finally, the Explorer Pipeline break and refinery production problems made it difficult to rebuild inventories in advance of the summer driving season. Further compounding the problem was the need to drain storage tanks of the winter-grade formulation before switching to the summer-grade formulation. As a result of these factors, low inventory levels made it more difficult to respond to unexpected supply problems.

these decisions, these three firms did not have summer-grade RFG available to sell on the spot market, as they had in prior years. When prices unexpectedly rose, these firms realized the significance of the RFG shortfall in the Midwest. Each quickly concluded that it made economic sense to ship extra product into the area, and they juggled their output mixes at Gulf Coast refineries and produced and shipped more RFG by barge into the Midwest. The Commission's investigation did not unearth evidence of an agreement among these firms.

Not every firm made the same misestimation regarding supply shortages, however. One firm made a different decision in 1999 and expended the capital necessary to increase its summer-grade RFG production substantially. This firm, which had more abundant supplies of RFG and had capacity available to produce even more RFG at the time of the price spike, therefore faced very strong demand for its product. Not surprisingly, this company decided to charge what the market would bear and to release its inventory over time consistent with profit-maximization. It was able to sell at higher prices while its competitors scrambled to get more product into the market, and it enjoyed higher profits for a limited period.

I reiterate that the Commission found no evidence that firms in the industry agreed to limit supply into the Midwest in order to take advantage of higher prices. Rather, once the extent of the supply disruption became apparent, the firms moved more product from the Gulf Coast into the Midwest, and prices dropped sharply.

Question 2. If oil companies have enough market power that they can keep the price of oil high by withholding supplies from the market, isn't that by definition an anti-competitive practice?

Answer. This question raises issues with implications beyond the petroleum industry. An answer to this question requires consideration of the reasons why certain business practices are deemed anticompetitive. Congress decreed long ago that the nation's economy would be largely free from government regulation and that the national common market would be governed by the principles of competition. Competitive market forces would best guarantee for consumers the benefits of efficiency and innovation in the production and distribution of goods and services. Nevertheless, because these benefits will not be available if competitive markets are compromised by restrictive business practices, certain practices are deemed anticompetitive if they restrict output or raise prices.

The three primary areas of concern covered by the antitrust laws are anticompetitive mergers, collusion among competitors, and exclusionary or predatory practices by a firm with market power. Mergers may be anticompetitive if they increase the merged firm's potential to wield market power or increase the likelihood of coordinated behavior among the firms remaining in the market. Agreements among competitors to engage in conduct that leads to output restrictions and increased prices also are anticompetitive and, indeed, certain horizontal conduct, including naked price fixing, is considered so pernicious that the law condemns it summarily.

Conduct by a single firm is anticompetitive only if the firm has sufficient market share that its unilateral reduction in output would be a substantial portion of the total market, and only if its decision to restrict output cannot be counteracted relatively quickly by its competitors or by new entrants. The Commission's long history of investigating and studying the petroleum industry has shown that such unilateral power is rare in petroleum markets. It should be noted that anticompetitive unilateral conduct often closely resembles fair but aggressive business behavior, and enforcement policy must distinguish very carefully between them to avoid stifling commercial practices that actually benefit consumers. If law enforcement policy were costless and frictionless and enforcers were omniscient—which they are not—it might be possible to differentiate every instance of anticompetitive conduct from the type of aggressively procompetitive conduct that the law encourages. In recognition of the imperfections in the law enforcement system, antitrust enforcers are at great pains to avoid taking enforcement actions that chill competitive unilateral conduct—in other words, not to reduce incentives for firms, even firms with large market shares, to compete vigorously in their markets.

According to the report on the FTC's Midwest Gasoline Price Investigation, the firm that correctly anticipated the shortages of summertime RFG "found itself with considerable market power in the short term." The firm exercised that power by refusing to release its inventory all at once, which would have reduced the market price. Instead, it chose to release inventory at a rate consistent with a higher and more profitable price that it could temporarily obtain. This higher price, however, could not be sustained for long, as buyers turned to the firm's competitors that were rushing additional product into the Midwest from the Gulf Coast. The antitrust laws do not condemn this conduct as anticompetitive.

First, as I have noted, this temporary market situation stemmed largely from unanticipated factors and was alleviated in only a few weeks. Temporary market

power occurs frequently because of supply problems arising from (among other sources) natural disasters or government-imposed environmental policies, because of sudden increases in demand caused by changes in consumer taste, or because some firms simply respond more quickly than their rivals to opportunities to enter new or emerging markets.

Second, and more important, such an exercise of short-term market power typically benefits rather than harms consumers overall. It is the prospect of profits that provides the incentive for supply, capital, and entrepreneurs to be attracted to markets in the first place. It is unlikely that additional supplies from the Gulf Coast would have been forthcoming so quickly absent the profit opportunity signaled by the high prices in the Midwest. These short-term profit opportunities can also have long-term consequences. The expansion of pipeline capacity to bring refined product from the Gulf Coast into the Midwest was doubtless driven by the potential profit opportunities to supply the Midwest.⁵

As for the firm with the abundant inventory, to have a policy that penalizes firms—particularly firms that ordinarily enjoy modest market shares—if they exercise temporary market power would put at risk the very forces that drive the competitive economy. If the antitrust laws were to condemn the conduct at issue in the Midwest Gasoline situation, it would perversely penalize the firm that more accurately anticipated market conditions by refining more gasoline and building inventory ahead of the market. Restraining firms' ability to reap the rewards of better decision-making may leave even less supply of gasoline products for consumers during future market dislocations. The opportunity to profit by correctly anticipating market shifts—which may also involve the possession of temporary market power—is part of the incentive that drives supply into all markets, to the benefit of all consumers. Even if this temporary market power is the result of unforeseen circumstances, penalizing it may dull future incentives to enter the market and may drive fungible capital into other markets, to the detriment of gasoline consumers.

The Commission deeply appreciates the concern that you and your colleagues have expressed about consumers in petroleum markets, and the agency will steadfastly maintain its extensive efforts to promote competition and protect consumers in those markets. If you or your staff have any questions or comments, please feel free to call me or have your staff call Anna Davis, the Director of our Office of Congressional Relations, at (202) 326-2195.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. RON WYDEN TO
HON. DEBORAH PLATT MAJORAS

Question 1. Please respond to the conclusions reached by the Government Accountability Office (GAO) in its May 2004 report on *Energy Markets: Effects of Mergers and Market Concentration in the U.S. Petroleum Industry* (“GAO Report”) regarding the effects of certain petroleum industry mergers on wholesale gasoline prices.

Answer. First, the GAO's econometric models do not properly control for the numerous factors that cause gasoline prices to increase or decrease. These omissions undermine the GAO Report's estimates of the effects of concentration and mergers on wholesale gasoline prices.

Second, the GAO Report does not measure concentration in any properly defined geographic market. If a merger impacts competition, it does so in the particular geographic region in which the merging firms compete. The GAO Report measures concentration for refinery capacity at the PADD¹ level when analyzing wholesale rack prices in the corresponding PADD. The FTC staff's experience from decades of assessing the competitive effects of mergers in the petroleum industry is that PADDs generally do not correspond to properly defined geographic markets for wholesale gasoline. GAO's failure to delineate a properly defined geographic market calls into question the validity of its conclusions about the effect of concentration and mergers on wholesale gasoline prices.

Third, by focusing exclusively on wholesale prices, the GAO Report fails to address the effects of concentration and mergers on retail gasoline prices. FTC staff's

⁵ See Bureau of Economics, Federal Trade Commission, *The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement* 209 (discussing the Centennial Pipeline's entry into the Midwest and the expansion of the Explorer Pipeline in that region), available at <http://www.ftc.gov/os/2004/08/040813mergersinpetrolberpt.pdf>.

¹ “PADD” stands for “Petroleum Administration for Defense District.” PADD I consists of the East Coast. PADD II consists of the Midwest. PADD III includes the Gulf Coast. PADD IV consists of the Rocky Mountain region. PADD V is made up of the West Coast plus Alaska and Hawaii.

research indicates that wholesale price effects are not necessarily indicative of retail price effects. Indeed, rack wholesale gasoline prices and retail prices do not always move together, in part because rack prices do not necessarily measure actual wholesale transaction prices, which are also affected by discounts, and in part because significant quantities of gasoline reach the pump without going through wholesalers. The GAO's failure to assess the effects of concentration and mergers on retail gasoline prices—that is, the prices that ordinary consumers pay at the pump—further undermines the credibility and importance of its findings.

The Commission, however, has never refused to acknowledge studies that reach conclusions different from those drawn in our staff's own analytical work. Instead, we analyze those studies and attempt to discern the reasons for the differing conclusions. We adopt new approaches and refine our work when we find new methodologies that appear superior. Accordingly, we have spent additional significant resources analyzing the GAO Report, in an effort to determine whether, despite the already-identified significant deficiencies, it presents any useful methodological advances in the analysis of petroleum mergers and joint ventures.

In both our merger analyses and our evaluation of the GAO Report, we look for the best way to use real-world data to gauge whether gasoline prices rose after petroleum industry mergers—including after FTC-required divestitures—from the levels that would have prevailed in the absence of the mergers. It might appear easy to determine the reasons for a gasoline price increase, but it is not. It is a very difficult task, in large part because gasoline prices change continually for numerous reasons. For example, during periods of increased merger activity in the petroleum industry, gasoline prices also were significantly affected by other important changes in gasoline supply and demand conditions unrelated to mergers, such as fluctuations in crude oil prices, variations among regions in access to refineries and to petroleum product pipelines, the proliferation of “boutique fuel” requirements in various states and localities, and differences in state and local gasoline taxes.² In light of the multiple causes of gasoline price changes, economists use a variety of statistical methods to try to isolate the price effects of mergers from the price effects of contemporaneous changes in other factors that affect supply and demand. It is necessary to conduct a considerable amount of testing—typically involving alternative assumptions and statistical methods—before we can have confidence in any particular estimate of a merger's effect on gasoline prices.

In recognition of these complexities, FTC staff has devoted a substantial amount of time to comparing different approaches to estimating the price effects of petroleum mergers, including those used in the GAO Report and in their own studies. On January 14, 2005, the FTC's Bureau of Economics sponsored a public conference featuring five prominent economists who presented their views on the GAO Report and on an FTC staff report about the Marathon-Ashland (“MAP”) joint venture.³ The MAP Study and the GAO Report differed in their econometric methodologies and in their conclusions regarding the price effects of the MAP joint venture.⁴

The five experts invited to serve as panelists at this public conference—all prominent in the fields of industrial organization or applied econometrics—were Professor Jerry Hausman of the Massachusetts Institute of Technology, Professor Dennis Carlton of the University of Chicago, Professor Halbert White of the University of California at San Diego, Professor Kenneth Hendricks of the University of Texas at Austin, and Dr. Scott Thompson of the Antitrust Division of the U.S. Department of Justice.⁵

To assist these expert panelists, the FTC's Bureau of Economics furnished them in advance with copies of the GAO Report, the FTC staff's MAP Study, and a Tech-

² See Federal Trade Commission, *Gasoline Price Changes: The Dynamic of Supply, Demand, and Competition* (2005), available at <http://www.ftc.gov/reports/gasprices05/050705gaspricesrpt.pdf>.

³ Christopher T. Taylor and Daniel S. Hosken, Bureau of Economics, Federal Trade Commission, *The Economic Effects of the Marathon-Ashland Joint Venture: The Importance of Industry Supply Shocks and Vertical Market Structure* (last revised May 7, 2004), available at <http://www.ftc.gov/be/workpapers/wp270.pdf> (“MAP Study”).

⁴ The MAP Study concluded that wholesale prices for conventional gasoline did not increase after formation of the joint venture. Wholesale prices for reformulated gasoline (“RFG”) did increase approximately 18 months after the transaction, but the MAP Study concluded that this increase was more likely attributable to changes in required fuel specifications in the St. Louis, Missouri, area. The MAP Study found no increases in retail prices attributable to the joint venture.

The GAO Report, on the other hand, concluded that the MAP joint venture led to wholesale price increases for both RFG and conventional gasoline. The GAO Report did not analyze the effects of mergers or joint ventures on retail prices.

⁵ Although GAO declined our invitation to participate formally in the conference, GAO's then-chief economist was in the audience.

nical Report prepared by FTC economists that assessed the methodology and findings of the GAO Report.⁶ The Technical Report began with the construction of a “baseline model” that represented FTC staff’s effort to understand the assumptions, methods, and analysis used in the GAO Report. A baseline model enables a researcher systematically to vary initial assumptions and technical procedures employed in a study in order to gauge the effect of such variations on the study’s results and conclusions. To construct the baseline model for the Technical Report, the FTC staff needed to understand the underlying assumptions of the GAO Report. To that end, during the latter part of 2004, our economists had a series of helpful exchanges with GAO economists to clarify technical issues that were not transparent in the GAO Report. GAO economists answered our staffs questions about their data and methodological decisions and provided us with written documentation on certain issues, such as the identity of wholesale terminals that they assumed were either affected or unaffected by particular mergers.

Citing confidentiality restrictions and agency protocols, however, GAO staff stated that they could not provide FTC staff with certain of their data inputs and their statistical programming codes. In light of GAO’s inability to share with FTC staff the proprietary price data that GAO used, our staff purchased the same data, with respect to RFG and CARE gasoline, from the Oil Price Information Service.

FTC staffs Technical Report focused on GAO’s analysis of the effects of mergers on prices for RFG and for gasoline that meets the criteria prescribed by the California Air Resources Board (“GARB gasoline”)—two types of gasoline that GAO concluded were affected by seven of the eight mergers that GAO analyzed. The Technical Report sought to mimic the GAO’s econometric analyses and to assess whether the use of alternative methodologies, modified statistical techniques, or additional real-world data would produce changes in the study’s findings and conclusions.

The introductory portion of the January 14, 2005, conference outlined the major results of the GAO Report and the FTC staff’s MAP Study. A number of in-depth panel sessions followed, addressing topics such as general econometric issues encountered in estimating the price effects of petroleum industry mergers; technical issues encountered in estimating the effects of market concentration on prices; issues involved in the measurement of economic variables; the sensitivity of econometric estimates to changes in underlying assumptions; and the implications for merger policy of current learning regarding consummated petroleum mergers.

The panelists generally agreed on a number of important points.⁷ First, they agreed that the need to control for the many nonmerger developments that affect gasoline prices makes it difficult to estimate reliably the price effects of petroleum mergers. Second, the panelists agreed that there are many conceptual and statistical problems with estimates of the effect of concentration on prices such as those contained in the GAO Report, including the assumptions about relevant markets that underlie GAO’s concentration measurements.

Third, and significantly, the panelists agreed that the GAO Report and the MAP Study, by themselves, did not provide a basis to modify merger enforcement policy. The panelists cautioned against drawing strong conclusions from these studies, in part because the studies came to widely different conclusions about the price effects of particular mergers. Not only did the GAO and FTC studies come to different conclusions about the MAP joint venture, but the GAO Report’s results themselves were mixed. The GAO Report provided 28 statistical estimates of the effects of eight mergers on wholesale prices of branded or unbranded gasoline across three gasoline types or specifications: conventional gasoline, RFG, and CARB gasoline. The GAO Report associated a statistically significant price increase with a merger in 16 cases. In seven cases, however, the report found statistically significant price *decreases* associated with mergers. No statistically significant merger price effect was found in the five other cases.

Finally, the panelists agreed that further exploration of technical issues raised by both the GAO Report and the MAP Study would be beneficial. To this end, they

⁶ FTC Staff Technical Report, *Robustness of the Results in GAO’s 2004 Report Concerning Price Effects of Mergers and Concentration Changes in the Petroleum Industry* (Dec. 21, 2004), available at <http://www.ftc.gov/ftc/workshops/oilmergers/ftcstafftechnicalreport122104.pdf>.

⁷ There were also areas of disagreement among the panelists. For example, they debated the relative advantages and disadvantages of an econometric methodology—the “treatments approach”—that differs significantly from the approaches used by GAO and FTC researchers. In addition, there were differing opinions as to the suitability of market concentration measures in assessing the likely competitive effects of proposed mergers.

urged consideration of new, alternative methodologies and called for additional studies of consummated mergers.⁸

In the months following the January 14, 2005, conference, FTC staff followed up on the panelists' recommendations and conducted further analysis of the statistical and methodological approaches employed in the GAO Report. Using the baseline model developed in their Technical Report, FTC economists found additional indications that GAO researchers' methodological approach and assumptions did not yield reliable estimates of merger effects. In particular, the FTC staff tested whether the use of varying assumptions caused the overall results to change. Indeed, our staff found that when they allowed the effects of variables used by GAO (such as capacity utilization and inventory-to-demand ratios) to assume different values in the pre- and post-merger periods, the estimates of the effects of some mergers analyzed by GAO changed significantly. Another very serious deficiency in GAO's methodology was identified when FTC staff applied the baseline model—i.e., the model that represents GAO's own methodology—and found significant merger-associated price increases at terminal rack locations where (according to GAO's own researchers) only one or neither of the merging parties supplied gasoline before the merger. Clearly, any price increases at such locations in fact stemmed from causes other than the merger, because the merging parties never competed head-to-head there. Yet, GAO's flawed methodology found a merger impact where there could not have been such an impact.

Our staff also has been working with Professor Halbert White (one of the expert panelists at the January 14, 2005, conference) to develop an alternative econometric methodology—the “treatments approach” referred to above—to assess the competitive effects of consummated petroleum mergers. This methodology may provide more accurate estimates of merger effects than the alternatives when data are imperfect and when there are difficulties in specifying all variables that significantly affect gasoline prices. We are continuing to study this issue and to refine our approach, with the goal of making our merger policies even more effective.

The FTC staff has taken a number of additional steps to follow up on the January 14, 2005, conference's findings and recommendations. First, the staff expanded its examination of the MAP joint venture to cover all cities in which both Marathon and Ashland sold RFG prior to the joint venture. The staff also increased the number of control cities (i. e., comparison cities not affected by the formation of the joint venture) to increase confidence in the model's conclusions. These revisions, however, did not change the key finding of the original MAP Study that no price increase was attributable to the formation of the joint venture.

Second, the January 14, 2005, conference served as a springboard for an FTC staff retrospective concerning MAP's 1999 acquisition of the Michigan marketing assets of Ultramar Diamond Shamrock. In July 2005, the FTC released the Bureau of Economics' study of this transaction, finding no evidence that the transaction was associated with an increase in retail gasoline prices.⁹

As I explained in my November 8 letter, the Commission is conducting an investigation to determine whether the price of gasoline is being manipulated, as directed by Section 1809 of the Energy Policy Act of 2005.¹⁰ As part of this investigation, the agency is seeking information from the petroleum industry concerning the possible effects that industry mergers and joint ventures since 1997 may have had on light petroleum product prices. As we examine past mergers and joint ventures as part of our Section 1809 investigation, we will continue to draw upon the learning stemming from last January's conference.

The FTC will steadfastly continue its extensive efforts to maintain competition and protect consumers in petroleum markets.

Question 2. Please explain how “the mergers the agency has allowed” have not harmed consumers and competition.

Answer. We are not aware of any conclusive evidence that recent oil industry mergers have weakened competition or led to higher gasoline prices. As discussed

⁸In the panelists' view, there is likely to be more benefit to public policy development in studying the effects of specific mergers than in conducting more general studies of the relationship between concentration and prices.

⁹John Simpson and Christopher T. Taylor, Bureau of Economics, Federal Trade Commission, *Michigan Gasoline Pricing and the Marathon Ashland and Ultramar Diamond Shamrock Transaction* (last revised July 27, 2005), available at <http://www.ftc.gov/be/workpapers/wp278.pdf>. The GAO Report had concluded that the MAP/UDS merger led to higher wholesale prices for gasoline.

¹⁰The Commission also is conducting an investigation pursuant to Section 632 of the Science, State, Justice, Commerce, and Related Agencies Appropriations Act, 2006, Pub. L. No. 109-108, 119 Stat. 2290 (Nov. 22, 2005), that is focused on gasoline prices in the wake of Hurricane Katrina.

in detail in the enclosed August 2004 FTC staff report entitled *The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement*, most sectors of the petroleum industry at the national, regional, and state levels remain unconcentrated or moderately concentrated, even though the industry has undergone substantial restructuring and consolidation over the past 20 years.¹ Throughout this petroleum industry consolidation, the Commission has remained vigilant to protect against mergers and acquisitions that may harm consumers and competition. In particular, since 1981, the FTC has filed complaints against 19 large petroleum mergers. In 13 of these cases, the FTC obtained significant divestitures in specific markets to protect competition that otherwise may have been diminished by the merger. Of the six other matters, the parties in four cases abandoned the transactions altogether after the FTC's respective antitrust challenges; one case resulted in a remedy requiring the acquiring firm to provide the Commission with advance notice of its intent to acquire or merge with another entity; and the sixth case was resolved with the execution by the parties of a 20-year throughput agreement that will preserve competition allegedly threatened by the acquisition.

Notably, under the especially strict approach that it has taken in reviewing oil mergers, the Commission has obtained relief in markets at lower concentration levels than in other industries. Data released last year on all of the FTC's horizontal merger investigations and enforcement actions from 1996 to 2003 show that the Commission has brought more merger cases at lower levels of concentration in the petroleum industry than in any other industry throughout the economy. Mergers in moderately concentrated markets (with more competitors with lower market shares) have generally led to fewer antitrust challenges than mergers in highly concentrated markets (with fewer competitors and higher market shares).² The Commission has taken a more aggressive enforcement stance in the petroleum industry, however, and has secured relief in a number of oil merger matters involving markets that were only moderately concentrated.³

As an example, in its review of the Exxon/Mobil merger—which was coordinated with the European Commission, 13 states, and the District of Columbia—the Commission identified potential competitive problems in both moderately concentrated markets (gasoline refining and gasoline marketing and retailing) and highly concentrated markets (e.g., jet turbine oil).⁴ The consent order that the FTC issued in settlement of this very intensive investigation required the respondents to sell or assign more than 2,400 Exxon and Mobil gas stations, as well as an Exxon refinery in California, terminals, a pipeline, and other assets. The most significant portions of the consent order resolved problems in moderately concentrated or highly concentrated markets involving gasoline refining and marketing in California, and involving gasoline marketing and retailing in many regions of the Northeast and Mid-Atlantic and in parts of California and Texas. Based on potential increases in concentration and other relevant market factors such as entry conditions, the Commission required sweeping divestitures in all of the many moderately concentrated mar-

¹Recent industry consolidation and restructuring have been accompanied by efficiency-enhancing trends toward greater economies of scale at many levels in the petroleum industry. For example, average refinery size has increased, refineries on average have become more productive per unit of crude oil input, and many very small (and less efficient) refineries have closed. Although the number of refineries has fallen since the late 1990s, total industry capacity to produce refined petroleum products has increased. Moreover, changes such as improvements in supply management technologies have reduced the demand for product terminal space, and have encouraged joint use of underutilized facilities through product exchanges and joint ventures. Brand-name companies and independent wholesalers alike have combined operations to take advantage of scale economies in gasoline marketing. In many cases, mergers and acquisitions (and the exit of some firms) have facilitated the achievement of these greater economies of scale. Other notable changes reflected in the recent restructuring of the industry include increased gasoline sales through non-traditional retail outlets, such as grocery stores and hypermarkets, and the rise to national prominence of a number of substantial independent refiners. All of these trends—from increased refinery efficiency to the proliferation of new gasoline retailing formats—promise benefits to consumers.

²The Commission and the Department of Justice measure market concentration by means of the Herfindahl-Hirschman Index ("HHI"), which is calculated by summing the squares of the market shares of all firms in the market. *FTC and Department of Justice Horizontal Merger Guidelines* ("Merger Guidelines") § 1.5. Under the Merger Guidelines, markets with HHIs between 1000 and 1800 are deemed "moderately concentrated," while markets with HHIs exceeding 1800 are deemed "highly concentrated." *Merger Guidelines* § 1.51.

³FTC Horizontal Merger Investigation Data, Fiscal Years 1996-2003 (Feb—2, 2004), Table 3.1 et seq., available at <http://www.ftc.gov/opa/2004/02/horizmerger.htm>; FTC Horizontal Merger Investigations Post Merger HHI and Change in HHI for Oil Markets, Fiscal Years 1996-2003 (May 27, 2004), available at <http://www.ftc.gov/opa/2004/05/040527petrolactionsHHIdeltachart.pdf>.

⁴*In the Matter of Exxon Corp.*, FTC Docket No. C-3907 (consent order issued Jan. 26, 2001), available at <http://www.ftc.gov/os/2001/01/exxondo.pdf>.

kets involved, as well as in the highly concentrated markets. Specifically, the Commission required the respondents to divest company-owned retail outlets and to reassign franchise and supply contracts, and gave acquirers the right to use the Exxon or Mobil brand name for a limited period of time at the divested retail outlets they acquired.

Similarly, as a consequence of its investigation of the Chevron/Texaco merger, the Commission issued a consent order in early 2002 that went beyond providing relief in highly concentrated markets by requiring divestitures in moderately concentrated gasoline markets.⁵ The complaint that accompanied the FTC's order alleged that competition likely would be harmed in a number of relevant markets, including (1) gasoline marketing in numerous metropolitan areas in the western and southern United States; (2) the refining, bulk supply, and marketing of California Air Resources Board gasoline in California; (3) the refining and bulk supply of gasoline and jet fuel in the Pacific Northwest; and (4) the pipeline transportation of crude oil and natural gas in various geographic markets. To maintain competition, the Commission required comprehensive divestitures and other relief. Twelve states assisted the Commission in conducting the Chevron/Texaco investigation and fashioning the consent order.

As you noted, the GAO issued a report last year on its study of eight petroleum industry mergers, including that agency's finding that six of those transactions led to increased wholesale gasoline prices, averaging about one to two cents per gallon.⁶ There are serious questions, however, about GAO's methodology and the robustness of its conclusions. Although I do not believe that the GAO report represents conclusive evidence that oil mergers have led to higher prices—or, by implication, that the FTC has not done enough to protect the public against anticompetitive oil mergers—we have taken the GAO report's findings very seriously. In January 2005, our Bureau of Economics sponsored a conference featuring five prominent expert economists, who presented their views on the GAO report and on an FTC study of the Marathon-Ashland joint venture, which used a methodology that differed from GAO's and reached different conclusions from those of the GAO report.⁷ As input into the conference, the Bureau of Economics also prepared a technical report that pointedly questioned the GAO's methodology and findings.⁸ The experts at the conference agreed on the difficulties involved in properly identifying the price effects of mergers in an econometric study. They also agreed that it would be premature to change merger enforcement policy based only on these two studies. They recommended that additional merger studies be undertaken and that various technical, statistical issues be explored further.

Since the conference, FTC economists have continued to follow up on the recommendations of the expert panel. They have produced an additional merger retrospective, which found no evidence of a merger-related price increase in the Marathon-Ashland/Ultramar Diamond Shamrock transaction.⁹ In considering the expert panel's technical comments, FTC economists have also found new indications that GAO's econometric methodology may not have properly identified merger effects. Moreover, FTC economists have been working with one of the expert panelists in developing an alternative—and potentially superior—econometric methodology to assess the possible effects of consummated mergers. I would also add that the Commission's ongoing price manipulation investigation under Section 1809 of the Energy Policy Act will include a fresh inquiry into whether past oil mergers have had anticompetitive effects.

As the Commission confirmed most recently in its September 21 testimony before the Senate Committee on Commerce, Science, and Transportation and its September 22 testimony before the House Energy and Commerce Subcommittee on Commerce, Trade, and Consumer Protection, we continue to use all of our available tools to promote competition and protect consumers in the petroleum industry, including careful scrutiny of industry behavior to detect anticompetitive conduct, effective chal-

⁵*In the Matter of Chevron Corp.*, FTC Docket No. C-4023 (consent order issued Jan. 2, 2002), available at <http://www.ftc.gov/os/2002/01/chevronorder.pdf>.

⁶GAO, *Energy Markets: Effects of Mergers and Market Concentration in the U.S. Petroleum Industry* (GAO-04-96), available at <http://www.gao.gov/new.items/d0496.pdf>.

⁷Christopher T. Taylor and Daniel S. Hosken, Bureau of Economics, Federal Trade Commission, *The Economic Effects of the Marathon Ashland Joint Venture: The Importance of Industry Supply Shocks and Vertical Market Structure* (last revised May 7, 2004), available at <http://www.ftc.gov/be/workpapers/wp270.pdf>.

⁸*FTC Staff Technical Report* (Dec. 21, 2004), available at <http://www.ftc.gov/ftc/workshops/oilmergers/ftcstafftechnicalreport122104.pdf>.

⁹John Simpson and Christopher T. Taylor, Bureau of Economics, Federal Trade Commission, *Michigan Gasoline Pricing and the Marathon Ashland and Ultramar Diamond Shamrock Transaction* (last revised July 27, 2005), available at <http://www.ftc.gov/be/workpapers/wp278.pdf>.

lenges to mergers and practices that violate any laws that the Commission enforces, and comprehensive research to understand petroleum sector developments.¹⁰ Thus, for example, in June of this year, the Commission announced settlements of three important petroleum industry cases: its challenge to Chevron Corporation's proposed acquisition of Unocal Corporation; its administrative litigation to address allegations that a Unocal subsidiary violated the antitrust laws by defrauding the California Air Resources Board in connection with reformulated gasoline regulatory proceedings; and its challenge to Valero's proposed acquisition of Kaneb Services LLC and Kaneb Pipe Line Partners. In addition, the FTC filed a federal court complaint in July 2005 challenging a petroleum merger in Hawaii that allegedly would have reduced the number of gasoline marketers and bulk suppliers in the state and would have led to higher gasoline prices for Hawaii consumers.¹¹ I have enclosed copies of the Commission news releases describing these cases for your review.

Pursuant to the Commission's gasoline and diesel price monitoring project, we continuously monitor price movements in 20 wholesale regions and approximately 360 retail areas across the nation to identify corporate conduct in petroleum markets that may violate the antitrust laws. Our economists and attorneys scrutinize every unusual price movement to ascertain whether it arises from conduct in violation of the antitrust laws or instead stems from another cause, such as pipeline disruptions, refinery production problems, low inventories, transitions to new fuel requirements imposed by government air quality standards, or some other supply-related problem. Although these examinations by our staff to date have revealed market-related causes for the unusual price movements detected before Hurricane Katrina, the Commission will take swift and decisive action if our scrutiny of price movements in the aftermath of Katrina or Rita—or at any other time—reveals the use of illegal anticompetitive practices. Of course, a possible link between any identified unlawful activity and recent changes in market structure or any other structural factor would receive close attention.

In addition, in response to Section 1809 of the Energy Policy Act of 2005, the Commission has begun an investigation to determine whether the price of gasoline is being artificially manipulated. This investigation of course will include a review of possibly anticompetitive behavior in the wake of Hurricanes Katrina and Rita. The Commission's Bureau of Competition is conducting the investigation in close consultation and cooperation with the Bureau of Economics, and they will pursue the investigation, and the Commission will report to Congress, as expeditiously as possible. As the FTC staff moves forward with this investigation, it will be able to brief the appropriate committees periodically about its progress. I expect the Commission's report pursuant to Section 1809 to be completed in the spring of 2006.

The Commission investigation also will be informed by our extensive previous investigations and research in the petroleum industry. In particular, the Commission issued a report in early July—*Gasoline Price Changes: The Dynamic of Supply, Demand, and Competition*—that examines in detail numerous factors that produce fluctuations in gasoline prices, including the cost of crude oil, increasing domestic and international demand, and federal, state, and local regulations. The report is based on research and on the expertise that the FTC has acquired in investigating oil-related antitrust matters, holding public hearings, undertaking empirical economic studies, and preparing extensive reports on oil-related issues over the past 30 Years.¹²

The Commission deeply appreciates your concern about consumers in petroleum markets, and the agency will steadfastly maintain its extensive efforts to promote competition and protect consumers in those markets.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. TED STEVENS TO
DAVID J. O'REILLY

Question 1. Do you think given budget deficits and record profits for oil companies that it is appropriate to divert tax benefits (from LIFO accounting method) for large integrated oil companies such as yours to pay for such a measure?

Answer. No. LIFO has been a generally accepted accounting method for tax purposes since 1938 and all taxpayers with inventory have the ability to use LIFO. Changing the rules for one industry on a one-time basis is very poor tax policy. It

¹⁰ I have enclosed copies of those Commission testimonies for your review.

¹¹ The Hawaii lawsuit was resolved with the execution of the 20-year throughput agreement described on page 2 of this letter.

¹² I have enclosed a copy of that report for your information. It is also available at <http://www.ftc.gov/opa/2005/07/gaspricfactor.htm>.

has never been shown that the use of LIFO generates an improper accounting of costs and income for the oil and gas industry, and changing the rules would be contrary to the requirement that taxpayers utilize consistent accounting methods to account for income and expenses from year-to-year. Imposing such a large economic penalty, which would particularly impact the refining and marketing sector, would be counterproductive to fulfilling the national energy policy objectives of increasing investments in additional domestic production and refining capacity.

Question 1a. Does this seem like an equitable approach given that the high cost of oil enable you to not only bank large profits, but also to use accounting methods to substantially reduce taxes? Is it fair to report less taxes when you're profiting the most?

Answer. It is very poor public policy to deny the oil and gas industry the ability to continue to use an accounting method which is available to other industries. LIFO is a well-established accounting practice that is applied for all taxpayers with inventories. Over the long-term, LIFO does not overstate or understate taxes. Over the past 7 decades, the LIFO method of accounting has been demonstrated to show an appropriate matching of revenues and expenses. It is inconsistent with sound tax policy and accounting practice to change the use of these well-established principles at a particular moment for a select industry to secure additional revenues. Further, as this accounting change would impact principally the integrated refining and marketing segment of the industry and is discriminatory, it further distorts the competitive playing field even within the energy industry. It is counterproductive to impose a higher tax burden on an industry, and an industry segment, where shortages are occurring when additional investments by that very industry and industry segment are needed to alleviate the shortages. Using the tax law to impose such a penalty would act as a large economic disincentive for investment to integrated refiners and marketers in an environment when the national policy and focus has been on trying to increase domestic refining capacity and refined product supplies.

Question 2. I realize that you reinvest some of these profits in exploration for more product. In each quarter, have you reinvested the same percentage of the profits to reinvestment? What have your reinvestment percentages been to your total profits? Do they vary from quarter to quarter or year to year?

Answer. Chevron is investing aggressively in energy development including oil and gas exploration, production, transportation, refining, marketing, and development of alternatives. Since 2002 and through the first 9 months of 2005, Chevron has invested more than we earned—\$32 billion in capital expenditures worldwide compared with \$31.6 billion in earnings. During this period, on average, roughly 75 percent of our annual capital program has been invested in the upstream sector (oil and gas production) and roughly 17 percent in the downstream (refining and marketing). The remainder goes to chemicals, technology, power and other.

We do not believe quarter by quarter comparisons, or even single year by single year comparisons, of capital spending versus earnings is particularly meaningful information. But, multi-year data is meaningful, as provided above. Our capital expenditures are planned often years in advance and are based on investment opportunities available. Our major capital projects require sustained spending commitments over multiple years for the new energy capacity to be installed. Thus, we maintain high levels of spending even during periods of depressed earnings.

Question 3. To what non-profit organizations and academic research that address global climate change does your company donate financial support to and how much do you donate each year?

Answer. Chevron contributes to the funding of academic research programs on climate science, engineering, and economics policy research at the Massachusetts Institute of Technology (MIT) Joint Program on the Science and Policy of Global Change, MIT Carbon Sequestration Initiative, and the International Energy Agency's Greenhouse Gas R&D Programme for a total of approximately \$165,000 annually. In addition, Chevron also provides approximately \$25,000 annually to the non-profit organization Resources for the Future which conducts independent research on environmental and energy issues. Climate change is addressed as part of their research portfolio

Question 4. Your industry has taken the position in its SEC filings and at yesterday's hearing that the escalation of its fuel prices is the result of increases in crude oil process. However, if your retail gas prices were raised simply to cover your increased costs in purchasing crude oil, your net profits would remain the same. Everyone knows this is not happening. Can you identify for this committee the reason that the rise in gasoline prices is far out-pacing the rise in crude oil prices?

Answer. Crude oil and gasoline markets are different markets. While increases in gasoline prices have generally followed increases in crude oil prices over time, the

hurricanes impacted the markets differently. Crude prices are driven by overall product demand, the available crude supplies, and the available refining capacity to convert the crude to products. Crude supplies were impacted by the hurricane, but the release from the SPR helped alleviate this constraint.

Gasoline prices are determined by supply, demand, and other competitive factors in the marketplace for products. Following the hurricanes, demand for refined products remained relatively unchanged, but because roughly one fourth of U.S. refining capacity was shut down, there was less available supply of products until those refineries could restart. This temporarily reduced demand for crude oil and lessened price pressures for that commodity. The U.S. gasoline market, however, remained short relative to demand, resulting in temporarily higher prices. Higher prices attracted product imports from around the world. Gasoline prices have now fallen to pre-hurricane levels, as refinery production is being restored and as additional product was imported into the United States.

A significant majority of Chevron's profits come from the exploration and production of crude oil throughout the world. Chevron's profits from its U.S. refining and marketing operations are actually below those for 2004 for the first nine months of the year—partially due the effects of the hurricanes.

Question 4a. Even though crude oil prices have risen this year, your companies aren't actually incurring those costs, are they? Isn't the gasoline and heating oil that your firms are currently selling on the market actually being produced from inventories that your companies purchased when the price of crude oil was much lower?

Answer. Yes, we are incurring these costs. Crude oil and petroleum product inventories turn over very quickly, since refineries typically have only a few weeks of inventory of crude supplies. More significantly, prices for crude oil and refined products are set by the marketplace responding to supply and demand. While increases in gasoline prices have generally followed increases in crude oil prices over time, the hurricanes impacted the markets differently as indicated in the response to the previous question.

Question 4b. If you're producing oil from crude that you bought at \$40 per barrel, but selling it at a price that is purportedly based upon a \$70 per barrel cost to you, wouldn't that account for the 90% increase in profits we've seen?

Answer. Chevron's worldwide profits for the first nine months of 2005 were up about 12% over those for 2004. The vast majority of those profits were from Chevron's worldwide crude oil exploration and production operations. Chevron's profits from its U.S. refining and marketing operations for the first nine months of 2005 were lower than for last year—largely due to the effects of the hurricanes.

Question 5. I have alluded to the vital role petroleum plays in our economy and society, from the price of bread to the price of a plane ticket to the price of heating one's home. While you're obviously in the business for profit, there are other sectors of the economy where we put a limit on selling commodities at unconscionable prices. How much more of a toll do these fuel prices have to take on our society before Congress steps in and places similarly appropriate regulations on your industry?

Answer. The oil and gas industry in the United States is very competitive, and on a comparable basis, oil and company profits, including Chevron's, as a percentage of sales revenue are in line or less than many other industry and business sectors. Further, U.S. retail gasoline and diesel prices are extremely competitive compared to most other developed countries, or when compared to historical U.S. energy prices adjusted for inflation. Additional detailed comparative information can be supplied either by the American Petroleum Institute or the U.S. Department of Energy on these factors.

Price controls or other actions to regulate energy prices would be very poor public policy, and as we have seen from history, are likely exacerbate the current supply and price situation. Chevron is investing aggressively to increase reliable supplies of energy, including investments in oil and gas exploration, production, transportation, refining, marketing, and development of alternatives. Please refer to Chevron's written testimony about what Chevron is doing to help meet America's energy needs. Chevron makes a number of policy recommendations for the Role of the U.S. Government, and in Attachment C: Global Energy Equation and U.S. Energy Policy: A Declaration of Interdependence, to promote investment that would help ensure more reliable and affordable supplies of energy.

Question 5a. Many consumers would say that raising the price of gas by \$2 per gallon over the past 2 years,¹ while reaping over \$25 billion in profits is price gouging. Many lawmakers would agree. What do you say to them?

Answer. The oil and gas industry in the United States is very competitive, and on a comparable basis, oil and company profits, including Chevron's, as a percentage of sales revenue are in line or less than many other industry and business sectors. Gasoline prices are determined by supply and demand, and in times such as those that followed the recent hurricanes, supply is disrupted and that puts upward pressure on prices. Prices have now fallen as refineries damaged in the hurricanes have come back on line and there is more supply in the market. Further, demand has tapered off somewhat, and that puts downward pressure on gasoline prices. Attached below from Chevron's written testimony (Attachment B)² are regular gasoline prices by region, both prior to, and after the hurricanes occurred.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. PETE V. DOMENICI TO
DAVID J. O'REILLY

Question 1. What are you doing to bring oil prices down?

Answer. Crude oil is priced in a global market that has been impacted by a combination of rising oil demand and tightening supply. Increases in the price of oil largely can be attributed to a surge in global demand, particularly in China, developing Asia and the United States, and resulting in less spare production capacity among other factors. The hurricanes in the U.S. Gulf Coast further magnified the tightness in oil markets by shutting in nearly one quarter of domestic refining capacity and roughly one third of domestic oil production.

Price volatility is oftentimes a result of rapid changes in supply, demand, and other competitive and geopolitical factors in the marketplace. Nonetheless; Chevron is investing aggressively to increase reliable supplies of energy, including investments in oil and gas exploration, production, transportation, refining, marketing, and development of alternatives. Since 2002, Chevron has invested \$32 billion in capital expenditures worldwide—more than it earned over this same period. This year alone, Chevron's 2005 capital investment program for the nine month period ending September 30, 2005 totaled \$7.1 billion—a 26 percent increase over spending for the same period last year.

In our written testimony, Chevron makes a number of policy recommendations for the Role of the U.S. Government, and in Attachment C: Global Energy Equation, and U.S. Energy Policy: A Declaration of Interdependence, to promote investment that would help ensure more reliable and affordable supplies of energy.

Question 2. What is the relationship between the price of oil that Americans are paying and the profits you are making?

Answer. Oil is a globally traded commodity and its pricing is a reflection of the interplay between supply and demand, as well as other competitive and geopolitical forces. Current high crude oil prices reflect a changing of the balance between world supply and rising demand, and when that demand/supply relationship is disrupted by events such as a hurricane, which causes lost production, then prices can increase until additional supplies can be brought back in line to meet demand.

The oil and gas industry is one of the world's largest, so its revenues are large. But so are its costs, both for finding and producing crude oil and gas from all over the globe, and refining crude oil into gasoline and other refined products. As the demand for crude oil increases, it is becoming harder and more costly to replace the depleting resource base. The industry is continuing to explore for and produce from more challenging—and more costly—locations in order to satisfy this growing demand. These new potential sources of energy supplies (such as in the deepwater, Arctic or tapping into unconventional resource bases) are more expensive to bring to market. They require higher investments, and the higher revenues the industry is now seeing will enable the investments needed to bring these new energy supplies to market.

That said, the oil and gas industry in the United States is also very competitive. On a comparable basis, oil and gas company profits as a percentage of sales are in line with or less than many other industry and business sectors. Further, U.S. retail gasoline and diesel prices are extremely competitive compared to most other developed countries, or when compared to historical U.S. energy prices adjusted for inflation. Additional detailed comparative information can be supplied either by the American Petroleum Institute or the U.S. Department of Energy on these factors.

¹ Dec. 2003 price per gallon on East Coast was \$1.30; in August 2005 it was \$3.25

² Retained in Committee files.

Question 3. The question I hear most from people is how is the price of oil set? Many Americans think oil companies are rigging prices to reap big profits. How would you respond to that?

Answer. Oil is a globally traded commodity and its pricing is a reflection of the interplay between supply and demand, as well as other competitive and geopolitical forces. As noted above, the oil and gas industry in the United States is very competitive, and on a comparable basis, oil and gas company profits as a percentage of sales are in line with or less than many other industry and business sectors. There are many thousands of participants in the oil markets as buyers and sellers, and therefore the notion that any company could actually “rig” crude prices in an industry this competitive is not plausible. Chevron’s percentage of global oil and gas production is approximately 2%.

Question 4. Americans are being burdened with high oil, natural gas, and gasoline prices while you all are raking in record profits. What do you say to those people that blame you for this and say that it is unfair?

Answer. Chevron understands its important role in providing energy to American consumers. The price of oil is a globally traded commodity and its pricing is a reflection of the interplay between supply and demand, as well as other competitive and geopolitical forces. Current high prices reflect a changing of the balance between world supply and rising demand, and when that demand/supply relationship is disrupted by events such as a hurricane, which causes lost production, then prices can rise until additional supplies can be brought back in line to meet demand.

The oil and gas industry is one of the world’s largest, so its revenues are large. But so are its costs, both for finding and producing crude oil and gas from all over the globe and refining crude oil into gasoline and other refined products. As noted above, higher revenues being generated today in the energy industry will enable the investments needed over coming years to bring new—and more costly—energy supplies to market.

The United States has historically enjoyed some of the lowest energy costs of most developed nations. However domestic supplies have declined, while demand both in the United States and elsewhere around the world continues to increase. In addition, U.S. policy choices have hindered development of additional supplies. In our written testimony, Chevron makes a number of policy recommendations for the Role of the U.S. Government, and in Attachment C: Global Energy Equation, and U.S. Energy Policy: A Declaration of Interdependence, to promote investment that would help ensure more reliable and affordable supplies of energy.

Question 5. Americans want to know if it is not costing so much more to produce a barrel of oil, why are prices rising so high?

Answer. Crude oil is priced in a global market that has been impacted by the combination of rising oil demand and tight supply. As in any other industry or market (real estate, clothing food, electronics, etc.), prices are set by supply, demand and other competitive and geopolitical factors in the marketplace. While the cost of producing oil has increased over the past few years, the rise in oil price has been driven more by a surge in the rate of oil demand growth, particularly in China and developing Asia, and the United States and resulting in less spare production capacity across the oil supply chain and the global refining system. Adding new increments of production capacity is increasingly complex and expensive, and often takes multiple years to achieve. The hurricanes in the U.S. Gulf Coast further magnified the tightness in oil markets by shutting in nearly one quarter of domestic refining capacity and roughly one third of domestic oil production.

Question 6. What is your company’s response to proposals for enactment of a Windfall Profits Tax?

Answer. Chevron opposes a windfall profits tax. Oil and gas industry profits are not excessive compared to other industries. Imposing such a punitive tax would discourage long-term investment in the very sector where tightness of supply currently exists and thereby exacerbate the conditions presently contributing to higher prices. The oil and gas industry operates in a highly cyclical and capital intensive, high risk business, where large investments are needed for continued exploration and production. A windfall profits tax would create a disincentive at the very time America needs more investment in energy production and refining capacity. Moreover, as previously reported by the Congressional Research Service, the 1980 windfall profits tax reduced domestic oil production and increased reliance on annual oil imports, thereby adversely affecting America’s energy security. Such a significant change in U.S. tax law would also send the signal for other governments to change tax regimes in their own countries. This would discourage energy investment globally, and would not lead to additional energy supplies.

Question 7. Do you believe that Americans are dangerously dependent on oil and its refined products?

Answer. Globally, energy markets for oil, natural gas, and refined products are becoming more interdependent, which has ramifications for America's energy policy. Please refer to Chevron's written testimony about what Chevron is doing to help meet America's energy needs, for the Role of the U.S. Government, and Attachment C: Global Energy Equation, and U.S. Energy Policy: A Declaration of Interdependence.

Question 8. The International Energy Agency's recent Global Outlook report expresses concern about world energy supplies and reliance on the Middle East for oil. Do you think the IEA's anxiety is justified?

Answer. The Middle East will continue to be important from an energy perspective, since roughly two thirds of the global oil and gas reserves are located there. As noted in Chevron's written testimony, over the last several years, there has been a significant shift in the relationship between oil and gas supply and demand globally, and markets are becoming more interdependent, which has ramifications for America's energy policy. Per the answer above, please refer to specific sections of Chevron's written testimony.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. LISA MURKOWSKI TO
DAVID J. O'REILLY

Question. First, thank you for being willing in your written testimony to support oil exploration and development in the Arctic coastal plain. If the coastal plain, including the Native-owned lands are opened by Congress this year, how quickly do you believe industry will attempt to explore in the area and what is your view as to how long it might take for the area to produce oil? Does your company have any interest in actually engaging in exploration or oil production operations in Alaska given current events?

Answer. If the ANWR coastal plain is opened by Congress this year, a date would presumably be set for a lease sale which would give industry time to collect seismic data and evaluate the value of acreage. It is likely that seismic data acquisition could begin within 12-18 months; exploration drilling could commence 12-24 months after the first lease sale; and production could begin as early as five years after exploration drilling starts, depending on permits for pipelines. Chevron continues to strongly support opening the ANWR coastal plain for environmentally responsible oil and gas exploration and development, and our long-term interest in ANWR is demonstrated by the maintenance of our 92,000 acre lease position on the coastal plain.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. JAMES M. TALENT TO
DAVID J. O'REILLY

Question 1. The recent hurricanes have highlighted the need for increasing refining capacity, which was already operating at a tight margin of 97 percent. While that is laudable for efficiency purposes, it allows no room for error in case of sudden outages or demand increases. What is the optimal amount of spare refining capacity to ensure a reliable supply of finished petroleum products at stable prices?

Answer. The refined product markets are large, global and flexible, with product imports being an economic component of meeting total U.S. product demand. In fact, the United States has routinely imported petroleum products since the end of World War II. While the recent high crude utilization rates may seem to leave no room for sudden outages, our refineries have been able to meet customer demands by maintaining the appropriate inventories and acquiring product from our system or from other suppliers. As noted in our testimony, Chevron is investing to increase refining capacity in the United States through our existing refining network. Further, Chevron recommended a number of policy changes that the U.S. government can implement to create a better climate for refinery investment, which are highlighted in our written testimony.

Question 2. How has industry consolidation impacted the amount of spare production and refining capacity?

Answer. Domestic refining capacity has continued to grow over time, even as the number of operating refineries has declined. EIA data show that since 1950, while the number of refineries has decreased from over 300 to about 150 today, the U.S. refining capacity has more than doubled, from roughly 7 million barrels per day to almost 17 million barrels per day. We do not believe that industry consolidation has

impacted refining capacity. There are other reasons why some refineries have closed, such as the economics related size and efficiency, and investments needed for environmental and other compliance requirements and fuel reformulations.

With respect to oil and gas production, Chevron does not know how industry consolidation has impacted production capacity, if it has at all. In many cases, consolidation has led to property sales to independent E&P companies, who continue to operate those fields. For Chevron, consolidation has focused on improving efficiencies and reducing operating expenses. These efficiency gains have provided sufficient incentive to move ahead with production enhancement projects which were previously marginal.

Question 3. Describe the degree of competition between refineries for crude oil supplies and sales to retailers. What percentage of crude oil processed in the U.S. is processed by integrated companies (i.e., those produce and refine) versus refined by independent refining companies?

Answer. Chevron faces significant competition from U.S. refining and marketing companies for crude oil supply and sales to retailers. The Federal Trade Commission (FTC) concluded in its 2004 report *The Petroleum Industry: Mergers, Structural Change and Enforcement* that despite substantial industry restructuring and consolidation, "most sectors of the petroleum industry at the national, regional, or state level generally remain unconcentrated or moderately concentrated."

Total U.S. refining capacity is approximately 16.8 million barrels per day. Overall, integrated oil companies provide just over half of the capacity with independent refining companies making up the balance. By comparison, Chevron's share of U.S. refining capacity today is approximately 5.5%, while the largest U.S. refiner is an independent refiner with approximately 13.5% of U.S. refining capacity (Valero).

Question 4. How has the amount of refining capacity tracked changes in demand for gasoline and diesel over the last 30 years?

Answer. Product demand in the United States has grown at a pace of 1-2% per year over this period. As noted in Chevron's written testimony (see Attachment D),* U.S. refining capacity has grown at nearly the same rate through modification and expansion of existing refineries. As noted on that chart, the percentage of refining capacity being operated has generally been increasing over the last two decades. There have been no new refineries constructed in the United States during that time.

Question 5. Explain to me your company's plan to increase refining capacity in the U.S. to meet the need for new refinery capability.

Answer. We are always evaluating opportunities to expand our capacity where demand warrants and it is economic to do so. As noted in Chevron's written testimony, Chevron is making investments to improve reliability and increase production capacity at our refineries in Richmond and El Segundo, CA, and Pascagoula, MS. Chevron has expanded capacity over the past ten years and has plans to continue to do so in the future.

Question 6. EPA 2005 removed the requirement to include oxygenates from gasoline, largely because of concerns over the use of MTBE. What is the impact on the price of removing oxygenates from gasoline?

Answer. There is no way to predict the impact of MTBE reduction on the market as other factors of supply and demand come into play. Unfortunately, the 2005 Energy Bill actually did little to directly address MTBE use. Prior Congressional action effectively required the use of MTBE, yet Congress has not passed new legislation protecting the industry from defective product claims advanced by the plaintiffs' trial bar. Oxygenates are useful in meeting the specifications for reformulated gasoline and for extending volume. When oxygenates are removed from gasoline, other hydrocarbon components can be used to make up part or all of the lost volumes. Nor is there reason to believe that all oxygenates will be dropped from gasoline because of the EPA 2005 changes; ethanol use is likely to rise. And, finally, many other market conditions enter into the supply/demand equation which ultimately determines price. Chevron has already eliminated MTBE use in many places where Chevron refines and markets gasoline.

Question 7. Are there other oxygenates that can be used in place of MTBE, such as using ethanol to make ETBE, and how does the cost of such alternative additives compare to the cost of gasoline?

Answer. Ethanol can be used to replace MTBE to some degree and under some circumstances. However, it should not be viewed as a direct gallon-for-gallon replacement since its physical characteristics differ from those of MTBE in several im-

*The information referred to has been retained in Committee files.

portant respects. Averaged over the long run, ethanol and MTBE have both been more expensive than wholesale gasoline. Ethanol has remained competitive with MTBE only because its cost is subsidized by the Federal Government. Chevron has no plans to make ETBE, which has many of the same physical characteristics as MTBE.

Question 8. Have you studied the use of ETBE, the cost of converting MTBE plants and how long it would take to do so, and whether ETBE avoids the leakage/water contamination problems that were caused by MTBE? How do the costs of retrofitting MTBE plants to produce ETBE and use it to increase the volume of gasoline produced by a barrel of oil compare to the cost of expanding existing or adding new refinery capability?

Answer. Chevron has studied the use of ETBE, including the cost of converting MTBE plants, but has decided against using it in Chevron gasolines. ETBE has many of the same physical characteristics as MTBE.

Question 9. What, if anything, is preventing your company from using ETBE in place of MTBE?

Answer. As noted above, Chevron has decided against using ETBE in the gasolines it manufactures.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. GORDON H. SMITH TO
DAVID J. O'REILLY

Question 1. I have a bill, S. 1743, to give the Federal Trade Commission, additional authority to prevent and punish price gouging in the aftermath of a major disaster. My bill provides effective authority to the Federal Trade Commission to protect consumers from being victimized in the wake of a disaster without hampering the normal functioning of the free market. It even recognizes that there are legitimate reasons why prices may increase. Do you think that this consumer protection authority should be available to the FTC?

Answer. Chevron has indicated its support for the Barton bill which contains price gouging provisions among other important energy policy provisions including fuel waivers during emergencies, boutique fuels, and permit streamlining, among other issues. However, Chevron agrees with the FTC that "price gouging" legislation is likely to do consumers more harm than good. As noted in the prepared statement presented by FTC Chairman Deborah Platt Majoras on November 9, 2005 to the Senate Committees on Energy and Natural Resources and Commerce, Science, and Transportation.

"Experience from the 1970's shows that price controls produced longer lines at the pump—and prolonged the gasoline crisis. While no consumer likes price increases, in fact, price increases lower demand and help make the shortage shorter-lived than it otherwise would have been.

"Prices play a critical role in our economy: they signal producers to increase or decrease supply, and they also signal consumers to increase or decrease demand. In a period of shortage—particularly with a product like gasoline, that can be sold in many markets around the world—higher prices create incentives for suppliers to send more product into the market, while also creating incentives for consumers to use less of the product. For instance, sharp increases in the price of gasoline can help curtail the panic buying and 'topping off' practices that cause retailers to run out of gasoline. In addition, higher gasoline prices in the United States have resulted in the shipment of substantial additional supplies of European gasoline to the United States. If price gouging laws distort these natural market signals, markets may not function well and consumers will be worse off. Thus, under these circumstances, sound economic principles and jurisprudence suggest a seller's independent decision to increase price is—and should be—outside the purview of the law."

Question 1a. Would this serve as a deterrent to price gouging by individual retailers?

Answer. Any beneficial deterrent effect of price gouging legislation would be more than offset by the detrimental effects discussed above.

Question 2. Can you tell me why diesel prices continue to remain significantly higher than gasoline prices in Oregon?

Answer. Transportation fuel prices are determined by supply, demand and other competitive factors in the marketplace. Demand for diesel products has been increasing in both the U.S. and Europe, and is expected to continue increasing as we enter the winter season. The recent impact of hurricanes significantly affected both U.S. gasoline and diesel supplies because of refinery outages. The market works in

a way that supplies move to the highest demand. Because of higher demand for diesel than gasoline, notably in the European Union, the United States ended up attracting less diesel imports which have led to continuing higher prices for diesel in Oregon and the rest of the country.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. JIM BUNNING TO
DAVID J. O'REILLY

Question 1. Some analysts believe that OPEC is approaching its current oil production capacity. Given this, are oil companies looking at alternative sources of energy, such as liquid fuels made from coal, in order to expand their business and maintain energy supplies for the United States? Please include a review of the level of investment your company is making this year and the projected investment over the next three years in coal to liquid fuels initiatives.

Answer. Chevron is established as one of the world's premier producers and refiners of heavy hydrocarbons. Fundamental to our success is a complete suite of advanced research, engineering, and operational capabilities to produce clean transportation fuels and products from the increasing supply of challenged resources such as extra-heavy oil, bitumen, tar, coal, and shale oils. Components of our heavy oil processing technology have been made available to other refiners in the U.S. and around the world through technology licensing agreements.

For several decades, Chevron has sustained investments in the full technology pipeline from basic R&D in catalytic chemistry through the deployment of world-scale processing facilities. For the past few years, we have been significantly expanding our core R&D programs in heavy hydrocarbon conversion technology to meet the challenge of producing advanced fuels from these very large, but technically and economically difficult resource bases. Our R&D expenditures in heavy hydrocarbon conversion technology for 2005 will be an estimated \$50 million. We will continue to invest in R&D expenditures in subsequent years.

Question 2. I have been concerned with the lag time between the wholesale cost of a barrel of oil and the retail price of a gallon of gasoline. As we saw following the hurricane, in an ascending market where wholesale oil prices increase, there is a lag period of a few days before retail gas prices reflect this change. Similarly one would expect a lag in a descending market. My concern is that retail prices are not dropping as quickly as they rose, relative to the change in oil prices. Could you explain why price movements vary during a complete market cycle and whether you believe any part of the energy industry is unfairly profiting from this price lag?

Answer. Crude oil and gasoline markets are different markets. While increases in gasoline prices have generally followed increases in crude oil prices over time, the hurricanes impacted the markets differently. Crude prices are primarily driven by overall product demand, the available crude supplies, and the available refining capacity to convert the crude to products. Crude supplies were impacted by the hurricane, but the release from the Strategic Petroleum Reserve helped alleviate this constraint.

Gasoline prices are determined by supply, demand, and other competitive factors in the marketplace for products. Following the hurricanes, demand for refined products remained relatively unchanged, but because roughly one-fourth of U.S. refining capacity was shut down, there was less available supply of products until those refineries could restart. This temporarily reduced demand for crude oil and lessened price pressures for that commodity. The U.S. gasoline market, however, remained short relative to demand, resulting in temporarily higher prices. Higher prices attracted product imports from around the world. Gasoline prices have now fallen to pre-hurricane levels, as refinery production is being restored and as additional product was imported into the United States.

Question 3. Boosting our domestic energy production is vitally important not only to our economy but also to our national security. Many of the countries we import oil from today are unstable, jeopardizing the reliability of sustained production. Please provide a chart for each of the last five years reflecting the percentage of your exploration and production budget that invested in the United States versus that invested overseas. Please also provide a chart reflecting your current projections of the percentage of your exploration and production budgets that will be allocated to projects in the United States versus overseas for the next five years.

Answer. Since 2002, Chevron has invested \$32 billion in total capital expenditures worldwide. This year alone, Chevron's 2005 capital investment program for the nine month period ending September 30, 2005 totaled \$7.1 billion—a 26 percent increase over spending for the same period last year. Chevron does not disclose capital programs beyond the current year.

Question 4. The disruption caused by the recent hurricanes displayed the United States' vulnerability when it comes to domestic energy supply and production. What suggestions do you have to strengthen our energy supply and production capability?

Answer. Chevron encourages the opening of federal and state lands and waters that are currently off limits to oil and gas exploration and production. These include the eastern Gulf of Mexico, the Atlantic and Pacific coasts, ANWR, and onshore locations across the United States. These areas can be developed with minimal environmental impacts, and the government has significant environmental safeguards currently in place. In addition, streamlined permitting of liquefied natural gas terminals in the U.S. will speed increases in the diversity of the U.S. energy supply.

Question 5. It has been suggested that the United States consider developing a strategic gasoline and natural gas reserve, similar to Strategic Petroleum Reserve we currently have. Some analysts suggest that such reserves may minimize price spikes in these commodities during periods of market supply disruptions. What are your views on whether a strategic natural gas or gasoline reserve would be feasible and whether they might help minimize price increases during periods of market uncertainty?

Answer. Chevron does not believe that establishing gasoline or other refined product reserves would ensure stability of price and supply. There would be costs and logistical challenges for establishing and maintaining such reserves and could result in unintended consequences, such as raising the cost of gasoline or jet fuel. These challenges include determining when and where to store products, dealing with a number of fuel specifications, and the need to rotate storage of products to prevent them becoming stale, among other issues. Chevron believes a comprehensive national energy policy that addresses both supply and demand would have a more significant impact on market stability.

Chevron believes that additional natural gas storage is being developed today and that market forces are the most efficient means for adding new storage. However, Chevron could support studying the establishment of a U.S. natural gas reserve. Such a review would need to assess fundamental technology and market differences, and other issues, associated with natural gas storage as compared to crude oil storage.

Question 6. China is becoming a bigger world oil player. This not only has tightened the world oil market but also has produced national security concerns for us. What concerns or problems do you see have arisen since China became a bigger world energy player?

Answer. China's increased demand for energy has raised important questions for the United States about how to more effectively work with China both to ensure increased energy supplies to meet growing global demand as well as ensure focus on energy efficiency and conservation measures. Such a dialogue between the two largest energy importers in the world is extremely important.

Chinese energy demand, having grown rapidly, has outstripped its domestic sources of energy supply. It is now looking abroad for resources, as are many other countries, including the United States. Globally, demand is increasing, spare production capacity is increasingly constrained, and energy markets have become more interdependent. As noted in Chevron's written testimony, the United States needs to work more actively with other countries to gain access to additional sources of energy and to ensure a level investment playing field across national boundaries.

Question 7. While there have been expansions and efficiency gains at existing refineries, no refinery has been built in the United States in 30 years. Since the oil companies are now making record earnings, are there plans to build new refineries in the United States?

Answer. Chevron currently has no plans to build new refineries in the United States. Instead, we are focusing our efforts on adding capacity at existing refineries because it is typically more cost-effective, and fewer permitting barriers exist. We are always evaluating opportunities to expand our capacity where demand warrants and it is economic to do so. As noted in Chevron's written testimony, Chevron is making investments to improve reliability and increase production capacity at our refineries in Richmond and El Segundo, CA, and Pascagoula, MS. Chevron has expanded capacity over past ten years.

Question 8. The 2005 Energy Bill implemented a controlled phase-out of MTBE. Many companies, however, are planning on completely halting its use. How will a sudden halt of the use of MTBE affect the gasoline market and refineries?

Answer. There is no way to predict the impact of MTBE reduction on the market as other factors of supply and demand come into play. Unfortunately, the 2005 Energy Bill actually did little to directly address MTBE, although there is clearly a disincentive to continued use of MTBE. Prior Congressional action effectively re-

quired the use of MTBE, yet Congress has not passed new legislation protecting the industry from defective product claims advanced by the plaintiff trial bar. Chevron has had a long-standing goal of eliminating MTBE from our gasolines and we continue to work aggressively to fulfill that goal. Years ago we stopped manufacturing MTBE in our own refineries but have not been able to obtain sufficient supply of non-MTBE gasoline from other sources to completely eliminate it from the gasolines we sell. As other companies increase the availability of non-MTBE gasoline to us, we will make greater progress toward meeting our goal. Of note, there was little market/price reaction to the MTBE phase-outs in California, New York and Connecticut which have already occurred.

Question 9. I have noticed very large differences between the price of gasoline in different areas of the country. For example, I recently saw gasoline in northern Virginia that was much more expensive than gasoline in northern Kentucky. Please explain why there can be such a significant difference in gasoline prices in different areas of the country.

Answer. Gasoline prices vary across geographic areas because of differences in supply, demand and competitive forces from region to region. In addition, regional differences in factors such as taxes, supply proximity and disruptions, and special formulated gasoline requirements can affect price levels in different states and regions.

Below are Several Questions on Oil and the Commodities Futures Market

Question 10. When was oil first traded on the world-wide commodities futures market?

Answer. NYMEX launched crude oil futures trading in 1983.

Question 10a. Would the price of oil be affected if oil was taken off the commodities futures market and no longer traded?

Answer. It is our belief that the futures market adds transparency and liquidity, thereby providing a better reflection of the oil's "true" value over time. It has been suggested that futures market speculation distorts the price of oil. However, speculation occurs in physical markets as well (e.g. buying for storage). Ultimately, and over the long term, it is the relative state of the physical supply/demand balance that determines price levels.

Question 10b. Would oil then be bought and sold as a true supply and demand product?

Answer. The answer to this question is covered in the prior answer above.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. JEFF BINGAMAN TO
DAVID J. O'REILLY

Question 1. Section 392 of the Energy Bill, which was negotiated with the involvement of the Chairman and Ranking Member of the Energy and EPW Committees, contains permitting streamlining language. The Energy Policy Act of 2005 permits the EPA Administrator to enter into a refinery permitting cooperative agreement with a state. Under such an agreement, each party identifies steps, including decision timelines, it will take to streamline the consideration of federal and state environmental permits for a new refinery. I want to ask you several questions about that provision, since you have supported streamlining:

A. Have you requested that EPA issue any regulations or take any action to implement these new provisions?

Answer. Section 392 of the Energy Bill requires the Governor to request a permitting cooperative agreement for siting and construction of new refineries. Chevron has not pursued this provision since we have not planned a new refinery since this bill was enacted.

- If yes, when?
- If no, when do you anticipate you will do so?

Answer. Chevron currently has no plans to build new refineries in the United States. Instead, we are focusing our efforts on adding capacity at existing refineries because it is typically more cost-effective, and fewer permitting barriers exist. We are always evaluating opportunities to expand our capacity where demand warrants and it is economic to do so. As noted in Chevron's written testimony (page 9), Chevron is making investments to improve reliability and increase production capacity at our refineries in Richmond and El Segundo, CA, and Pascagoula, MS. Chevron has expanded capacity over past ten years.

Question 1a. Have you worked with any state to encourage them to enter into an agreement with EPA under Section 392 of EPCRA?

Answer. We have not worked with states since we have no current plans to build a new refinery, as noted above.

Question 1b. Do you support the EPCRA streamlining provisions?

Answer. We support provisions to streamline federal, state and local requirements. EPCRA is a good first step, but it does not address the most troublesome permitting challenges a facility must overcome in order to gain approvals from multiple levels of government. The permitting process could be significantly improved without compromising environmental protection by eliminating duplicate requirements, creating single approval authority, providing regulatory certainty and limiting third party ability to protract the project approval process indefinitely.

Question 1c. Do you have any examples of where a state came to EPA and said we want to work closely with you on permitting a new refinery or refinery expansion and EPA refused to provide technical assistance and even financial resources under existing law to that state?

Answer. No. A state would not usually advocate approval of a new refinery or refinery expansion project to EPA. States and local authorities are bound, as is the EPA, by a statutory and regulatory framework for processing permits. It is this cumulative compilation of federal, state and local requirements as well as review and approval timelines that creates investment uncertainty and barriers to capacity expansion projects.

A better example of the state/federal difficulty is the requirement for EPA oversight and/or approval of federally required permits and State Implementation Plans. These federal approvals must be sought even in those situations where the state is granted federal authority to administer the environmental program. When EPA withholds these approvals or disputes the states' implementation interpretations, it creates substantial delays in granting individual permits and amplifies regulatory uncertainty.

Question 2. In answer to several of the questions at today's hearing (Nov. 9) the witnesses have noted that the market for petroleum and petroleum products is a global one and should be viewed in that context. Please list all planned refinery construction that your company plans to undertake globally. Please list them by country and include the projected size of the facility, including the projected capacity for all units and their potential product yields in addition to the project's total investment cost.

Answer. In addition to refining projects in the United States, Chevron currently has clean fuels projects underway at its refineries in Singapore and South Africa. Chevron is evaluating additional refinery investments in a number of locations globally. For competitive reasons, we do not share specific information on projects until they have been publicly announced.

Question 3. The International Energy Agency (IEA) has just released its World Energy Outlook 2005. It contains a piece on the global refining picture. The study notes a lack of investment in upstream and downstream capacity has contributed to the extreme tightness in global oil markets. What are your thoughts in response to this? What is your company doing in response (actions)? What is your company doing (investments/analysis) in the "MENA" regions? Do you agree with the IEA's projections?

Answer. Chevron believes The IEA's assessment of tightness in the global refining picture is a reasonably accurate for near-term conditions. Globally, refinery utilization has increased to the point where complex upgrading capacity to produce more light products (gasoline and diesel fuel, as opposed to fuel oil and other heavy products) is nearly full. However, as the IEA points out, there are complications and risks associated with additional investment in new refineries, including:

1. environmental restrictions and local resistance hamper additional refinery investments
2. increasing light product demand and shrinking fuel oil markets require expensive upgrading units to produce lighter refined products,
3. tightening fuel specifications and trend towards heavier crude oils also require refiners to make refinery investments, and
4. uncertainty in investment economics due to the length of time to build new refining capacity.

Nevertheless, many analysts expect refining capacity to grow by over 1 million barrels per day each year before 2010 as refiners respond to the current tightness. However, we do not necessarily agree with the IEA's demand growth projections and, consequently, their estimated need for refining capacity. Even so, demand

growth appears sufficiently strong near-term to encourage more refining investments globally. Chevron is evaluating additional refinery investments in a number of locations globally. For competitive reasons, we do not share specific information on projects until they have been publicly announced.

Question 4. Voluntary standards—Post hurricanes, what is the industry doing to come up with voluntary standards/best practices for back-up power supply to critical energy infrastructure (refineries, pipelines, etc.) and natural disaster recovery? Will the API undertake such an effort? If not, what is your company doing?

Answer. Chevron has taken several steps to reduce impacts from the hurricanes, including building a dike around our Pascagoula refinery following Hurricane Georges in 1998 to reduce the risk of flooding damage, and more recently placing of generators at marketing terminals and various service station locations to provide emergency power. Chevron is evaluating several projects that would minimize the impact of future hurricanes. These projects could help minimize the wind damage, reduce impact from flooding as well as allow a more rapid startup of the refinery after such an event.

Question 5. A number of witnesses testified that failure of the electricity system resulting from hurricanes Rita and Katrina contributed in great part to the inability to get refineries restarted, or to get natural gas pipelines restarted. What are the arrangements for backup power in case of such emergencies at your critical facilities?

Answer. We can only speak to Chevron's experience. Lack of electrical power to our facility was not the limiting factor in restarting the Pascagoula refinery after Hurricane Katrina. Although we secured temporary electrical generators to restart our fuel terminal, there were many steps and procedures that needed to be executed before the refinery could be safely restarted. Electrical power supply did not limit the full refinery restart. Electrical generators were used at many marketing terminals and service stations to provide emergency power, until normal power service was restored.

Question 6. How many of your plants have on site cogeneration facilities? Which plants have these facilities?

Answer. Four of Chevron's U.S. refineries have cogeneration facilities located on site: they are our facilities at Pascagoula, MS; El Segundo, CA; Richmond, CA; and Kapolei, HI.

Question 7. Are there regulatory barriers at the either the state or federal level that prevent the installation of cogeneration plants at your facilities that do not have them?

Answer. Construction of cogeneration facilities has associated regulatory barriers including permitting difficulties, as well as difficulties/uncertainties whether one can sell excess power to the electrical grid system. Our decisions to install cogeneration facilities are based on the economics of fuel and electricity costs, reliability of the electrical delivery system as well as existing refinery infrastructure and utility balances.

Question 8. Would the presence of cogeneration facilities at your refineries reduce the recovery time during such emergencies?

Answer. Chevron has cogeneration facilities at its Pascagoula refinery, which was impacted by the hurricanes. Although cogen facilities are an alternative source of electrical power, they need a fuel source and utility water to operate. Restoring the natural gas supply and water supply were critical to reestablishing electrical power to the facility.

Question 9. Witnesses at earlier hearings testified that there are a number of modern natural gas generation facilities in the Louisiana/Texas area that are not used to their full capacity. Are there natural gas generation facilities in close proximity to your refinery facilities that could be used for backup generation at the refineries?

Answer. By modern natural gas generation facilities, Chevron is assuming this question is asking whether cogeneration facilities were available to help provide back-up power generation at refineries. As noted in our response to question #6 above, Chevron's Pascagoula refinery, which was our only refinery impacted by the hurricanes, has its own cogeneration capacity.

Question 10. Would use of generators that are in close proximity to refineries to provide backup power during such emergencies mean that recovery times might be shortened, since the restoration time for a nearby facility might be less than the restoration time for the transmission facilities for traditional utilities?

Answer. Chevron used portable generators at its Pascagoula refinery to provide power to its fuel truck loading rack. This loading rack was used to supply motor

gasoline and diesel fuel to emergency services in the initial days following the hurricane. Chevron used the generator to provide electricity until sufficient power was restored by the local utility. Additionally, Chevron used generators at many marketing terminals and service stations, until power was restored.

Environment

Question 11. Please specify exactly which, if any, Federal or State environmental regulations have prevented your company from expanding refinery capacity or siting a new refinery, and documentation on the exact details of the project prevented.

Answer. Several regulations impose economic burdens to existing operations and new projects. However, New Source Review (NSR) presents one of the most significant disincentives to new investment. NSR not only presents a cumbersome, uncertain permitting process, but more importantly, can trigger additional requirements including installing costly emission controls, acquiring emission offset credits from other sources and in some cases initiating re-permitting of entire existing co-located process units. Projects under consideration to increase production capacity must factor all these burdens into the economic justification for investment. In some cases, refinery capacity expansion projects have been constrained or deferred to avoid this uncertain and time consuming process.

Question 11a. How much have so-called "boutique fuel" requirements added to the average retail price, where applicable, and the average wholesale price per gallon of the gasoline sold by your company?

Answer. Because it is impossible to separate out all the factors that affect supply and demand, Chevron cannot isolate the single impact boutique fuels have on the price of gasoline. However, there is no question that the proliferation of boutique fuels has added to the complexity associated with the regional supply and distribution of fuels. Further, boutique fuels can result in market instability in local markets for short periods of time when supplies of a designated fuel are interrupted and substitutes, while physically available, are not allowed for use.

Question 11b. If the EPA or the Congress were to act to minimize the number of "boutique fuel" formulations required by the states to protect air quality, how many should there be and what should the specifications of each be in order to maintain air quality and improve fungibility?

Answer. Minimizing the number of "boutique fuels" would be helpful. It is equally important to align them with the regional supply and distribution system. Many proposals to reduce the number still leave open the possibility that several could be required in one region. In addition, several proposals still allow state and local jurisdictions to create their own boutiques. Should these shortcomings be rectified, Chevron believes an acceptable list could be forged from S. 1859 (BURR/ALLEN) and H.R. 3893 (BARTON) which generally limit the number of boutique gasolines to five and diesel fuels to two.

Question 12. Streamlining New Source Review (NSR) permitting constraints was mentioned as an incentive that would encourage refiners to supply more product to the U.S. market. How many air quality permit applications for refinery expansions has your company submitted for NSR over the last ten years? How long did it take the EPA, or the applicable State, to approve or deny each permit application, after receipt of a complete permit application? What was the expected percentage increase in product output of the expansion?

Answer. We have submitted approximately 200 permits (from our 5 refineries) that are subject to NSR (federal and local) review for our refineries in the last 10 years. However, this number is not in itself meaningful since some districts require individual permits for sources and others allow multiple sources within a project to be included in a single permit. In general, a major refinery in a non-attainment area will have to seek approximately 2 to 4 major NSR permits a year. These permits are necessary for preventative maintenance projects such as replacing a tank or a pump, and may take 3 to 9 months to obtain. More significant projects such as process debottlenecking and major unit upgrades can take 2 years or longer.

Typical refinery projects subject to NSR permitting include new fuel projects, and other refinery modifications. Due to new technologies and improved efficiency, the new or upgraded equipment will usually have much lower emissions than the previous equipment, but still be subject to NSR even when actual emissions do not increase.

Question 12a. How would you propose to streamline NSR and still maintain local air quality and prevent any increase in total annual emissions from such expansions?

Answer. Codifying many of the reforms in EPA's 2002/2003 NSR reform package would offer significant relief without increasing actual emissions. In particular:

- Plant-wide applicable limits—Allow facilities to make process changes, throughput increases and debottlenecking improvements in any way necessary to accommodate business needs and new technology as long as their total overall plant emissions stay the same.
- Clarify that routine repair and maintenance projects are not defined as new or modified sources. This would encourage facilities to increase reliability and energy efficiency.
- Eliminate unnecessary re-permitting of entire units co-located with a modification when emissions from the existing equipment would stay within permitted limits.
- In addition, we support provisions in the House passed Bill (H.R. 3893) that would streamline permitting process for projects that increase facility efficiency and reliability.

Question 13. How much did the fuel specification waivers that have been granted by EPA to date, due to the supply disruptions caused by the hurricanes, reduce the average retail price of the gasoline or other refined products made by your company?

Answer. It is impossible to determine the how fuel specification waivers granted by EPA to date impacted the retail price of gasoline or other refined products since those are determined by available supply, demand and other competitive factors in the marketplace. However, the EPA waivers were very effective in making both gasoline and diesel supplies more widely available to the public (see copy of Chevron letter previously sent by Mr. Michael Wirth, President of Chevron Global Supply & Trading, to EPA Administrator Johnson, with copies to Chairman Domenici and Senator Bingaman, which provides examples of where Chevron was able to provide additional supplies because of the waivers, dated October 10, 2005). Directionally, the waivers lessened the extent both in terms of volume and time to which certain markets were experiencing very tight supplies.

Question 14. One witness indicated that “getting two 100-year hurricanes in four weeks” caused a great deal of chaos and disruption in the gasoline supply chain. The National Oceanic and Atmospheric Administration has projected that the country and the Gulf of Mexico have entered a cyclical period of 20-30 years during which the Gulf and coastal areas are likely to experience a greater frequency of hurricanes and higher odds of those hurricanes making landfall in the U.S. What preparations has your company made to deal with a greater hurricane frequency to decrease repetition of the supply disruption that occurred this year?

Answer. Following hurricanes and other natural disasters, Chevron evaluates how our onshore and offshore oil and gas production facilities and processes performed. Chevron also participates in similar ongoing industry evaluations. We use the evaluations to guide improvements to our assets and processes, and to help guide design specifications for new facilities which are being constructed. Our primary focus is protecting our employees and contractors, followed closely by protecting the environment. Even in the face of these significant storms, our facilities did very well—we had no injuries to our personnel and we had only minor environmental impact, in spite of significant facility damage.

The installation of a 22-foot dike wall after 1998 Hurricane Georges reduced the risk of damage at our Pascagoula Refinery. Hurricane Katrina-related storm surge damage to the Pascagoula area outside the refinery was far greater than was experienced during Hurricane Georges. Yet in contrast, the flooding inside the refinery was reduced such that we were able to return the refinery to normal operation in 6 weeks after Katrina as opposed to 4 months after Hurricane Georges.

We are evaluating several projects that will minimize the risk of damage from future hurricanes such as Katrina. These projects include efforts to minimize the wind damage, further reduce impact from flooding as well as allow a more rapid startup of the refinery after the event.

Question 15. Over the last 50 years, average annual sea surface temperatures have increased in the Gulf of Mexico and, according to the National Academy of Sciences and other similar scientific expert bodies, are expected to continue increasing as the oceans continue warming due to accelerating global climate change. The Administration’s Climate Action Report (2002) stated “model simulations indicate that, in a warmer climate, hurricanes that do develop are likely to have higher wind speeds and produce more rainfall.” What preparations has your company made to deal with a greater likelihood of greater hurricane intensity so as to decrease repetition of the disruption that occurred this year?

Answer. See the answer to question above.

Question 16. How has your company disclosed to shareholders and investors the risks associated with the potential impacts on your company’s assets in the Gulf of

Mexico or indirect impacts on its assets elsewhere, of either the expected greater frequency of hurricanes making landfall in the U.S. or the probable greater intensity of hurricanes in the region?

Answer. Chevron includes many forward-looking statements in its filings with the Securities and Exchange Commission to assist the investor in making his or her investment decision. The company also makes disclosure of factors of risk and other matters that could materially affect financial results in the future.

Among these various disclosures are the following that were included in the company's 2004 Form 10-K relating to weather conditions and their possible impact on the company's operations and financial results:

Page 2:

“CAUTIONARY STATEMENTS RELEVANT TO FORWARD-LOOKING INFORMATION FOR THE PURPOSE OF ‘SAFE-HARBOR’ PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 . . .”

“This Annual Report on Form 10-K . . . contains forward-looking statements . . . These statements are not guarantees of future performance and are subject to certain risks, uncertainties and other factors, some of which are beyond our control and are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements . . .”

“Among the factors that could cause actual results to differ materially are . . . potential disruption or interruption of the company's production or manufacturing facilities due to . . . severe weather . . . Unpredictable or unknown factors not discussed herein also could have material adverse effects on forward-looking statements.”

Page 4:

“*Risk Factors* . . .”

“. . . some inherent risks could materially impact the company's financial results of operations or financial condition . . .”

“*The company's operations could be disrupted by natural or human factors.*”

“. . . The company's operations and facilities are therefore subject to disruption from either natural or human causes, including hurricanes . . . which could result in suspension of operations, or harm to people or the natural environment.”

Page FS-3:

“*Upstream* Year-to-year changes in exploration and production earnings align most closely with industry price levels for crude oil and natural gas. Crude oil and natural gas prices are subject to external factors over which the company has no control, including . . . weather-related damages and disruptions . . . Moreover, any of these factors could also inhibit the company's production capacity in an affected region.”

Similar disclosures are included in the company's SEC Form 10-Q reports. In the third quarter 2005 SEC Form 10-Q, the following was included in the “Cautionary Statements” on page 2:

“Among the important factors that could cause actual results to differ materially from those in the forward-looking statements are unknown or unexpected problems in the resumption of operations affected by Hurricanes Katrina and Rita and other severe weather in the Gulf of Mexico . . .”

The company makes no reference in its SEC filings to long-range weather forecasts in the company's many areas of operation.

FINANCES, PRODUCTION, IMPORTS, ETC.

Question 17. Please provide for each of last ten years your company's—

- Gross revenue of U.S. operations

Answer. Chevron's United States sales and operating revenues for 1998 through 2004 are summarized below. The data exclude amounts associated with internal transfers between Chevron segments, which are eliminated for preparation of the company's consolidated income statement. As a result of the Chevron merger with Texaco in 2001, an SEC Form 8-K was filed and included combined Chevron and Texaco comparative data for U.S. operations beginning only in 1998. No other pre-merger combined data prior to 1998 for U.S. operations were required under the rules of accounting and SEC disclosure.

\$ billions	2004	2003	2002	2001	2000	1999	1998
U.S. sales and other operating revenues	\$71.0	\$55.9	\$43.5	\$46.7	\$52.1	\$35.2	\$30.2

Source: Chevron Form 10-K (2004 and 2001)—“Operating segments and geographic data” footnote to the consolidated financial statements. Chevron Form 8-K (2001).

- Total capital expenditures in the U.S.

Answer. Chevron’s total capital and exploratory expenditures (C&E) in the United States from 1998 through 2004 are summarized below. The first SEC Form 10-K following the Chevron-Texaco merger included combined Chevron and Texaco comparative data for U.S. capital and exploratory expenditures beginning only in 1999. No other pre-merger combined data prior to 1999 for U.S. capital and exploratory expenditures were required under the rules of accounting and SEC disclosure.

\$ billions	2004	2003	2002	2001	2000	1999	1998
U.S. C&E expenditures	\$3.0	\$2.6	\$3.8	\$6.0	\$4.3	\$3.4	\$4.1

Source: Chevron and Texaco Form 10-Ks; includes Chevron’s and Texaco’s share of affiliate expenditures.

- Net profit of U.S. operations

Answer. Net income from Chevron’s operations in the United States for 2001 through 2004 is summarized below. Data prior to 2001 are not readily available because the split between U.S. and international income for years prior to the Chevron-Texaco merger was not presented for all activities in the pre-merger financial statements because such a disclosure was not required. The information below was obtained from the Chevron SEC Form 10-Ks.

\$ billions	2004	2003	2002	2001
U.S. net income (loss)	\$5.4	\$3.9	\$(1.8)	\$0.4

Source: Chevron Form 10-Ks.

- Total taxes paid to the Federal government

Answer. See answer/chart directly below.

- Total taxes paid to State governments

Answer. As was reported in the annual reports that Chevron filed with the Securities and Exchange Commission, Chevron accrued the following current Federal and State tax amounts for 1998-2004 (see attached table below). As a result of the Chevron merger with Texaco in 2001, an SEC Form 8-K was filed and included combined Chevron and Texaco comparative data for U.S. operations beginning only in 1998. No other pre-merger combined data prior to 1998 for U.S. operations were required under the rules of accounting and SEC disclosure.

CHEVRON CORPORATION—SUMMARY OF U.S. TAXES ACCRUED 1998–2004

[\$ Millions]

	1998	1999	2000	2001	2002	2003	2004
Income taxes							
Federal	(215)	307	1,238	946	(72)	1,147	2,266
State and local	32	(50)	185	276	21	133	368
Total	(183)	257	1,423	1,222	(51)	1,280	2,634
Federal and State non income taxes							
Excise taxes on products and merchandise	3,568	3,767	3,909	3,954	3,990	3,744	4,147
Import duties and other levies, and property and other miscellaneous	397	399	370	418	360	320	364

CHEVRON CORPORATION—SUMMARY OF U.S. TAXES ACCRUED 1998–2004—
Continued

[\$ Millions]

	1998	1999	2000	2001	2002	2003	2004
Payroll taxes	196	165	139	148	141	138	137
Taxes on production	160	158	238	225	179	244	257
Total	4,321	4,489	4,656	4,745	4,670	4,446	4,905
Total income and non in-							
come	4,138	4,746	6,079	5,967	4,619	5,726	7,539

The earliest year of combined financial statement results for Chevron and Texaco in an SEC filing is 1998. All years exclude data for Unocal Corporation, which Chevron acquired in 2005.

- Total donated to charity

Answer. Chevron's charitable contributions over the three year period ended December 31, 2004 were:

Year	(\$ Millions)
2002	\$62.8
2003	\$60.8
2004	\$63.8

Source of Contributions Data: 2002-2004—Chevron Charitable Contributions yearly data files.

Question 18. How much additional petroleum refining capacity do you expect your company to install in the United States over the next 10 years?

Answer. Chevron always evaluates opportunities to expand our capacity where demand exists and it is economic to do so. As noted in Chevron's written testimony, Chevron is making investments to improve reliability and increase production capacity at our refineries in Richmond and El Segundo, CA, and Pascagoula, MS. Many analysts expect world-wide demand for petroleum products to increase by approximately 10 million barrels per day over the next 10 years. Chevron intends to be a global supplier of energy and will want to continue to invest to meet the needs of our customers.

Question 19. What percentage of profits over the last 10 years has your company re-invested in capital, exploration, drilling, and production in the United States? Please provide an annual total for those U.S. expenditures and a clear breakdown.

Answer. The table below shows Chevron's U.S. expenditures related to capital, exploration and production for the periods 1999 through 2004. Drilling expenditures are included in each of the categories. The first SEC Form 10-K following the Chevron-Texaco merger included combined Chevron and Texaco comparative data for U.S. capital and exploratory expenditures beginning only in 1999. No other pre-merger combined data prior to 1999 for U.S. capital and exploratory expenditures were required under the rules of accounting and SEC disclosure.

\$ Billions	2004	2003	2002	2001	2000	1999	1998
U.S. upstream (exploration and production) capital and exploratory expenditures	\$1.8	\$1.6	\$1.9	\$2.4	\$2.4	\$1.8	\$2.7
U.S. production expense	2.0	2.0	2.0	2.1	2.1	2.0	2.2
Total U.S. upstream capital and exploratory expenditures and production expense	3.8	3.6	3.9	4.5	4.5	3.8	4.9
Net income worldwide	13.3	7.2	1.1	3.3	7.7	3.2	1.9
Percentage of total net income reinvested in U.S. upstream capital, exploration, drilling and production	28%	50%	342%	136%	59%	116%	255%

Source: Chevron SEC Form 10-Ks.

Please note the percentage relationships in the table above are not correlated with any percentage-expenditure targets set by the company. That is, capital and exploratory expenditure spending is aimed at economic projects in the United States and

outside the United States that are available investment opportunities, without regard for their geographic location. The production expense shown for the United States represents the level of spending necessary to optimize the production from U.S. producing properties. Currently the greatest number of investment opportunities lies in areas outside the United States. The company possibly would have had higher capital and exploratory spending in the United States during these years if additional economic investment opportunities had been available. However, certain areas in the United States have been placed off-limits for the exploration and production of oil and gas.

Question 20. What percentage of profits over the last 10 years has your company re-invested in non-petroleum energy supply and production in the United States? Please provide a total and the results of such investment.

Answer. Chevron has interpreted the question of “non-petroleum” energy investments in to include all *non-crude oil (i.e., non-liquid hydrocarbons) energy investments*, including investments in natural gas, coal, power, geothermal, pipelines, and shipping, as well as alternative energy and advanced energy technologies, such as gas-to-liquids, renewables, hydrogen, fuel cells and batteries. Detailed information of the total annual investment in these types of activities in the United States is not readily available in the company’s accounting records, however, globally these expenditures over the last 10 years are in the billions of dollars.

Globally, Chevron is making significant investments from the wellhead to the end consumer to bring new natural gas supplies to markets, including the United States. Chevron has major natural gas development projects underway in Australia, Nigeria, and Angola where natural gas will be liquefied for shipment on LNG tankers to markets in the United States and around the world. Chevron has recently contracted for two state-of-the-art LNG tankers to add to its shipping fleet.

Chevron is also partnering with Sasol in a joint venture—Sasol Chevron—aimed at converting natural gas to high quality diesel fuel utilizing its gas-to-liquids (GTL) technology. Sasol-Chevron has announced a memorandum of understanding with Qatar Petroleum for a \$6 billion GTL initiative.

Chevron is investing in major pipeline systems to provide export capability of both liquids and natural gas to world markets. Chevron is a partner in the Caspian Pipeline Consortium (CPC) to bring oil supplies from Kazakstan to ports on the Black Sea, and with the acquisition this year of Unocal, Chevron is also a partner in the Baku-Tbilisi-Ceyhan pipeline (BTC) which will bring oil from the Caspian Sea region to the Mediterranean port at Ceyhan.

In the United States, Pittsburg and Midway Coal Company is a wholly owned Chevron subsidiary, which provides coal to utilities from mines operating in Wyoming, New Mexico, and Alabama.

Chevron Energy Solutions (CES) develops, engineers and constructs holistic energy efficiency, conservation and power system projects for institutions and businesses. CES has developed energy efficiency and renewable projects for large-scale facilities operated by the U.S. Postal Service, the Department of Defense, hospitals and public schools.

Chevron is the world’s largest producer of geothermal energy, having developed more than 1000 MW of capacity. In 2004 Chevron announced a \$128 million plan to expand our Daajat geothermal power plant in Garut, West Java, Indonesia.

Chevron invested in a 22.5 MW wind farm at the Nerefco refinery in the Netherlands, the first large-scale wind project on a brownfield refinery. Chevron has one of the largest solar photovoltaic installations in the U.S., a 5090 kw solar array at our Bakersfield, California production location.

Chevron is a joint venture participant with COBASYS, working to commercialize nickel-metal hydride batteries for such applications as hybrid electric vehicles and stationary power supply devices.

Chevron is also leading a consortium in a five-year demonstration of hydrogen infrastructure and fuel-cell vehicles by building six hydrogen energy service stations with fueling facilities for small fleets of fuel-cell vehicles and capacity to generate high-quality electrical power from stationary fuel cells.

Question 21. On average for the last ten years, please compare your company’s overall capital expenditures in the United States to its expenditures elsewhere.

Answer. The table below shows Chevron’s capital and exploratory expenditures for the periods 1999 through 2004 and the percentage applicable to U.S. expenditures. Some of the exploratory expenditures are capitalized. Other amounts may be expensed under the applicable accounting rules if a project is not successful or if the project does not move into the development phase within a certain time period.

\$ Billions	2004	2003	2002	2001	2000	1999
Capital and exploratory expenditures:						
Total United States	\$3.0	\$2.6	\$3.8	\$6.0	\$4.3	\$3.4
Total Worldwide	8.3	7.4	9.3	12.0	9.5	10.1
Percentage United States	36%	35%	41%	50%	45%	33%

Source: Chevron SEC Form 10-Ks; includes share of affiliate expenditures.

As stated in the response to question 8, the percentage relationships in the table above are not correlated with any percentage-expenditure targets set by the company. That is, capital and exploratory expenditure spending is aimed at economic projects in the United States and outside the United States that are available investment opportunities, without regard for their geographic location. Currently the greatest number of investment opportunities lies in areas outside the United States. The company possibly would have had higher capital and exploratory spending in the United States during these years if additional economic investment opportunities had been available. However, certain areas in the United States have been made off-limits for the exploration and production of oil and gas.

The first SEC Form 10-K following the Chevron-Texaco merger included combined Chevron and Texaco comparative data for U.S. capital and exploratory expenditures beginning only in 1999. No other pre-merger combined data prior to 1999 for U.S. capital and exploratory expenditures were required under the rules of accounting and SEC disclosure.

Question 22. What percentage of your company's gross revenue was collected in the United States in each of the last 10 years?

Answer. Chevron's U.S. sales and operating revenue for 1998 through 2004 are summarized below. The data exclude amounts associated with internal transfers between Chevron segments, which are eliminated for preparation of the company's consolidated income statement. As a result of the Chevron merger with Texaco in 2001, an SEC Form 8-K was filed and included combined Chevron and Texaco comparative data for U.S. operations beginning only in 1998. No other pre-merger combined data prior to 1998 for U.S. operations were required under the rules of accounting and SEC disclosure. The company does not believe the percentage relationships for the 3 years 1995-1997 would differ significantly from the fairly stable relationships shown below for the 7 years 1998-2004.

	2004	2002	2002	2001	2000	1999	1998
U.S. sales and operating revenues as a % of total	47%	47%	44%	45%	44%	42%	42%

Source: Chevron SEC Form 10-Ks and 8-K.

Question 23. How much of your company's revenue collected in the United States was used to pay for purchasing crude oil from OPEC countries?

Answer. Detailed information regarding revenue collected in the United States used to purchase crude oil from OPEC countries is not readily available in the company's accounting records. Revenues in any geographic area are not specifically earmarked for purchasing crude oil from OPEC countries or for any other purpose. The use of cash to fund company operations is independently determined from the source of such cash.

Question 24. Do you support S. 1794 or something like it create gasoline and jet fuel reserves to ensure stability of price and supply? Should it be extended to diesel and other fuels like natural gas?

Answer. Chevron does not believe that establishing gasoline or other refined product reserves would ensure stability of price and supply. There would be costs and logistical challenges for establishing and maintaining such reserves and could result in unintended consequences, such as raising the cost of gasoline or jet fuel. These challenges include determining when and where to store products, dealing with a number of fuel specifications, and the need to rotate storage of products to prevent them becoming stale, among other issues. Chevron believes a comprehensive national energy policy that addresses both supply and demand would have a more significant impact on market stability.

Chevron believes that additional natural gas storage is being developed today and that market forces are the most efficient means for adding new storage. However, Chevron could support studying the establishment of a U.S. natural gas reserve. Such a review would need to assess fundamental technology and market differences,

and other issues associated with natural gas storage as compared to crude oil storage.

Question 25. On average for the last ten years, how much of what is refined by your company in the U.S. stays in the U.S.?

Answer. Through the first 3 quarters of 2005 the percentage of gasoline (including blendstocks), jet and diesel refined at our U.S.-based refineries that was sold in the United States was 98.6%. A small percentage of products sold to other parties at a refinery dock may have been resold outside the United States, but we cannot confirm final sales destinations for such sales. Due to the tight timeframe for developing a response, we were unable to provide an exact percentage for the prior nine years; however, we do not believe there would have been a material difference in this percentage.

Question 25a. What amount of refined product did your company import in 2004 and in 2005?

Answer. Today, Chevron imports more refined products into the United States each year than it exports. We imported a total of 9.8 million barrels of gasoline (including gasoline blendstocks), jet and diesel fuels through the first three quarters of 2005 and 13.1 million barrels in 2004.

Question 25b. What are your assumptions about demand growth in India and China?

Answer. The EIA forecasts that China's oil demand will grow between 3.9% and 5.1% and India's will grow between 3.0% and 4.0% annually between 2002 and 2025. Chevron believes these forecasts are within likely ranges.

Question 25c. How have your investments in the United States increased the energy security of the country?

Answer. Energy markets are increasingly interdependent from a global perspective. Oil is a globally-traded commodity; any investments anywhere in the world that adds supplies benefits all consumers, including those in the United States. And, while natural gas is not yet a globally-traded commodity, natural gas markets are also moving in that direction. Likewise, any investments in global refinery capacity that are generating additional supplies of petroleum products benefit U.S. markets.

Question 26. What market signals will occur in advance of peaking world oil production and what is the appropriate policy or set of policies for the U.S. government to adopt when such signals occur?

Answer. In advance of peaking conventional world oil production, we would expect to see expensive, long-lead projects that generate non-conventional oil from bitumen and shale, as well as diesel and other products from gas, coal and biomass become economic enough for large scale production to proceed. Access to all of these resources, both here and abroad, will be key to an orderly transition from conventional oil. Chevron in its written testimony provides a series of policy recommendations that the U.S. government should consider related to enhancing U.S. Energy Policy.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. DANIEL K. AKAKA TO
DAVID J. O'REILLY

Question 1. I have some questions about the Chevron refinery in Hawaii. As you know, Chevron is one of two refineries that we have in Hawaii, and it is very important to us. It is well-known that no new refineries have been built since 1976. It is also well-known that Hawaii has the highest gasoline prices nationwide over the last twenty years, so I am naturally interested in anything that will help dampen gasoline prices for my constituents.

Do you expect to expand refinery capacity in Honolulu? Right now, Chevron is considered a "small" refinery in terms of its output (less than 75,000 barrels per day throughput). Do you have any plans to expand the capacity of the refinery on Oahu?

Answer. Because of factors including the current investment climate in Hawaii, additional regulatory requirements (wholesale price cap, state ethanol mandate, rent caps, etc), and the sizeable investment that would be needed to increase refining capacity, we have no plans to increase capacity at this time. We are always evaluating opportunities to expand our capacity where demand warrants and it is economic to do so.

Question 2. What factors would make it possible to expand refinery capacity, assuming that Hawaii did not have the wholesale gas price cap law? Would expanding capacity help bring down the price of gasoline?

Answer. Chevron believes that Hawaii currently has sufficient refinery capacity relative to the size of its market. Because it is not supported by local demand, we

believe the sizeable investment required to increase refinery capacity would not be likely to result in a return which would justify the investment.

Hawaii's relatively high gasoline prices are not caused by a shortage of refinery capacity. Factors that make gasoline more expensive in Hawaii than other locations include: (1) higher taxes, (2) more market regulation, and (3) higher costs of doing business. In addition, the wholesale price cap that went into effect in Hawaii effective September 1, 2005 interferes with the normal operation of the marketplace. It is the best interests of consumers if prices are set by supply, demand and competitive forces in the marketplace.

Question 3. I understand from the Stillwater and Associates 2003 report on Act 77 (the Hawaii gas cap law) that refineries in Hawaii have low margins on jet fuel and residual fuel oil for power generation, and that Hawaii refiners compensated with higher gasoline prices. What would be the effect of changing such margins on those fuels on the pump price of gasoline?

Answer. There would probably be little or no effect. The Stillwater and Associates Report in 2003 indicates that margins for each of these products are set by supply and demand for those products in the marketplace. It also points out that the two Hawaii refineries (unlike many more complex refineries on the Mainland) have little ability to vary the slate of products which they produce from a barrel of crude oil.

Question 4. Realistically, what policies at the federal level could help bring gasoline prices down for Hawaii in the short term? What about in the long term?

Answer. As noted in Chevron's written testimony, U.S. policy actions that create more regulatory certainty and create a better investment climate including elimination of boutique fuels, permit streamlining, and access to potentially resource-rich areas will provide more reliable and affordable supplies of energy for the United States. The United States needs more investments in energy supplies, energy infrastructure, and enabling energy imports. Government actions to promote those investments would help secure reliable supplies of energy for American consumers.

Question 5. Would a windfall profits tax affect your profitability in Hawaii, or would it have no effect at all on refineries in general?

Answer. Chevron opposes a windfall profits tax. Oil and gas industry profits are not excessive compared to other industries, and such a tax would reduce available capital and would discourage long-term investment strategies by the oil and gas industry, including potentially Hawaii. Moreover, as previously reported by the Congressional Research Service, the 1980 windfall profits tax reduced domestic oil production and increased reliance on annual oil imports which adversely affected America's energy security. Such a significant change in U.S. tax law would also send the signal for other governments to change tax regimes in their own countries. This would discourage energy investment globally, and would not lead to additional energy supplies.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. RON WYDEN TO
DAVID J. O'REILLY

Question. All over America, the oil industry drives up the price at our gas pumps by redlining and zone pricing. "Redlining" is when your companies draw a phony line around a community to lock out competition and raise prices for the consumers. "Zone pricing" is plain old discrimination and it takes place when one oil company supplies gas to several gas stations located near each other and one station is charged much more than the others for the same type of gas. This drives stations out of business, reducing choice and raising prices for consumers. To help hurting consumers at our gas pumps, will you company commit to stop redlining and zone pricing? Yes or no?

Answer. "Red-lining" is a phrase that historically has been used in the insurance industry, not the oil industry. If you mean distinguishing between direct-served and jobber-served areas, Chevron generally does not allow jobbers to serve stations in areas that are directly served by Chevron. Generally jobbers are set up to serve areas where Chevron has decided it will not make direct deliveries. The Federal Trade Commission has recognized that territorial restrictions may allow a branded refiner to implement a more efficient distribution system. Chevron believes that its approach on this subject is both rational and promotes competition.

A "price zone" is simply another term for a local marketplace. Chevron sets its retailer prices by zones, or local markets, because the competitive environment differs from local market to local market. Each price zone contains stations that Chevron believes are generally subject to the same competitive pressures. The Federal Trade Commission has noted that zone pricing may provide branded refiners the flexibility

to meet localized competition resulting in lower prices than might otherwise occur. Chevron believes that it would be counterproductive and anticompetitive to ignore local market forces in making pricing decisions.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. MARIA CANTWELL TO
DAVID J. O'REILLY

Question 1. I'm aware that the cost of crude oil is driven by the world market and that its cost is currently significantly above historic averages. But I'm not aware of any substantive increases in the cost of producing crude oil, the cost of refining it into various petroleum products such as gasoline and diesel, and the cost of transportation of refined products to markets. Through the end of September 2005, the price of crude had increased 40 percent in 2005 while gasoline prices increased almost 80 percent. If the percent difference in the prices isn't pure profit, please explain to me how you account for the difference in the substantially lower increase in crude oil when compared to gasoline.

Answer. Crude oil and gasoline markets are different markets. While increases in gasoline prices have generally followed increases in crude oil prices over time, the hurricanes impacted the markets differently. Crude prices are primarily driven by overall product demand, the available crude supplies, and the available refining capacity to convert the crude to products. Adding new increments of crude oil production capacity is increasingly complex and expensive, and often takes multiple years to achieve. Crude supplies were impacted by the hurricane, but the release from the Strategic Petroleum Reserve helped alleviate this constraint.

Gasoline prices are determined by supply, demand, and other competitive factors in the marketplace for products. Following the hurricanes, demand for refined products remained relatively unchanged, but because roughly one-fourth of U.S. refining capacity was shut down, there was less available supply of products until those refineries could restart. This temporarily reduced demand for crude oil and lessened price pressures for that commodity. The U.S. gasoline market, however, remained short relative to demand, resulting in temporarily higher prices. Higher prices attracted product imports from around the world. Gasoline prices have now fallen to pre-hurricane levels, as refinery production is being restored and as additional product was imported into the United States.

Question 2. Between 1981 and 2003, U.S. refineries fell from 321 to 149. Further, no new refineries have been built in the U.S. since 1976. In 1981, the 321 refineries had a capacity of 18.6 million barrels a day. Today, the remaining 149 refineries produce 16.8 million barrels a day. I recognize the difficult financial, environmental, and legal considerations associated with the location and construction of new refineries. But I fail to understand the closure of existing refineries even if they required investment to enhance their efficiency and production capability unless, of course, this mechanism is being used to increase the price of gasoline and other refined products. Please help me understand why you would shut down refineries in the face of the supply and demand situation. What conditions would have to exist for you to invest in new refining capacity? I have heard the industry claim that up to \$48 billion has been used on capital expenditures for existing refineries. If those investments were not used for capacity increases, what were they used for?

Answer. Even though the total number of existing refineries in the U.S. has decreased over the past 20 years, total refinery capacity has increased because the average size, sophistication, and capacity of existing refineries have increased (see Chevron's written testimony, included as Attachment D). The rationalization of refining capacity has occurred in part because smaller refineries lacked the financial resources to complete facility upgrades needed to comply with environmental and fuel reformulation requirements. They also lacked the scale needed to economically justify the capital investment necessary and compete efficiently. The Federal Trade Commission noted in a 2004 report on petroleum industry mergers that refinery closures "have overwhelmingly involved small, relatively unsophisticated facilities. Of the 57 refineries closed since 1990, 23 had distillation capacities of 10 MBD or less, only seven had capacities greater than 50 MBD, and only two had capacities greater than 100 MBD." *The Petroleum Industry: Mergers, Structural Change and Enforcement*, p. 185.

Nonetheless, Chevron always evaluates opportunities to expand our capacity where demand warrants and it is economic to do so. As noted in Chevron's written testimony, Chevron is making investments to improve reliability and increase production at our refineries in Richmond and El Segundo, CA, and Pascagoula, MS. Chevron has expanded capacity over the past ten years and has plans to continue to do so in the future.

Question 3. The recent hurricanes resulted in the need to import substantial refined products such as gasoline, diesel fuel and aviation fuel to meet U.S. demand. The question has been raised as to whether the country should develop a strategic reserve of finished petroleum products. What would be your reaction if the Federal government either directly or by way of contract with the private sector sought to create a strategic reserve of finished petroleum products? Since these products have a limited shelf-life, one proposal is to obtain and operate a number of refineries and have the products be used by the Federal government. Appreciate your comments on this proposal.

Answer. Chevron does not believe that establishing gasoline or other refined product reserves would ensure stability of price and supply. There would be costs and logistical challenges for establishing and maintaining such reserves and could result in unintended consequences, such as raising the cost of gasoline or jet fuel. These challenges include determining when and where to store products, dealing with a number of fuel specifications, and the need to rotate storage of products to prevent them becoming stale, among other issues. Chevron believes a comprehensive national energy policy that addresses both supply and demand would have a more significant impact on market stability. Further Chevron believes private enterprise is best suited, rather than the government, to own and operate refineries.

Question 4. Given the recent profitability of the oil industry, I am interested to learn more on the disposition of these profits, particularly to enhance both production and refining capacity. Are any of these profits being used to enhance production and refining capacity for the benefit of other countries? What fraction of your profits is being invested for production and for refining? What percentage of profits have been used for stock buybacks and mergers and acquisitions?

Answer. *Re: Profits being used to enhance production and refining capacity for the benefit of other countries*—Crude oil is a globally-traded commodity. Investments anywhere in the world that add to the supply of crude oil benefit all consumers, including those in the United States. While natural gas is not yet a globally-traded commodity, industry investments are rapidly moving markets in that direction. Likewise, investments in global refinery capacity that generate additional supplies of petroleum products benefit U.S. markets.

Re: Fraction of profits being reinvested for production and refining—Chevron is investing all across the value chain. Since 2002, Chevron has invested \$32 billion in capital expenditures worldwide—more than it earned over this same period.

For the nine-month period ended September 30, 2005, Chevron's capital and exploratory expenditures totaled \$7.1 billion, a 26 percent increase over spending for the same period last year. Approximately three-fourths of total capital spending for the nine-month period ended September 30, 2005, or \$5.5 billion, was invested in upstream (exploration and production) activities. About \$1.3 billion, or 18 percent of total spending, was for global downstream (refining, marketing and transportation).

Our capital expenditures are planned often years in advance and are based on investment opportunities available. Our major capital projects require sustained spending commitments over multiple years for the new energy production capacity to be installed. Thus, we maintain high levels of spending even during periods of depressed earnings.

Re: Percentage of profits used for stock buy-backs and mergers and acquisitions—In 2004, Chevron announced a \$5 billion common stock repurchase program. Purchases under this program totaled \$4.3 billion through September 2005.

In August 2005, Chevron acquired 100 percent of the outstanding common shares of Unocal Corporation. The aggregate purchase price included approximately \$7.5 billion cash as partial consideration of the total purchase price. This was the largest of the company's recent merger and acquisition activity involving cash. From time to time, the company also makes relatively minor property acquisitions in the normal course of business.

Question 5. You've all said profits are cyclical, and that your companies have also suffered from the volatility of the oil markets. Would your stockholders be better served if domestically produced oil was sold at a fixed rate that included a generous profit margin above the production, refining, and distribution costs?

Answer. No, our stockholders are best served when market forces are allowed to act unfettered and when the U.S. government consistently advances a comprehensive energy policy that promotes a stable and encouraging investment climate for the responsible development of energy supplies. This question raises the prospect of establishing comprehensive price controls. History shows price controls and other interference with normal market mechanisms do not accomplish the intended effect. Gasoline price controls in effect in the 1970s and early 1980s were poor public pol-

icy. Prices shot up to their maximum allowed levels, the industry's quality of service dropped, and consumers were forced to wait for hours in long lines to purchase gas during that period. These consequences are not in the best interest of our shareholders or consumers.

Question 6. Do you believe that global warming is occurring? Do you believe that man-made activities have a role in this phenomenon? How will global warming impact your companies in term of added costs for oil and gas development, or allow access to new areas for oil and gas development?

Answer. Chevron recognizes and shares the concerns that governments and the public have about climate change. Although Chevron does not have specific expertise in climate science, Chevron has been implementing a business-driven, four-fold action plan dedicated to reducing our greenhouse gas (GHG) emissions. The action plan is focused on improving energy efficiency, investing in research, pursuing opportunities in innovative energy technologies, and supporting economically sound policies that protect the environment.

We have developed a comprehensive program to manage GHG emissions that is being integrated into our business decisions. We include GHG emissions analysis in the planning of all major capital projects, acquisitions and divestitures.

We also support and assess the work of reputable scientific institutions such as the Massachusetts Institute of Technology (MIT) Joint Program on the Science and Policy of Global Climate Change, MIT Carbon Sequestration Initiative. We also monitor the activities of the Intergovernmental Panel on Climate Change, and the U.S. National Academy of Sciences on all aspects of the climate change issue.

One of the most critical environmental challenges facing the world today is finding ways to provide and use reliable, affordable energy while reducing long-term growth in GHG emissions. Technology offers a variety of potential solutions, including efficiency improvements; CO₂ capture and geologic storage; the use of trees, plants and soils to store carbon; and the development of commercially viable non-fossil-fuel energy systems. Regarding costs and access for oil and gas development, at this time the impact is unclear.

For more information, regarding Chevron climate change activities, our website can be visited at <http://www.chevron.com/social-responsibility/environment/global-climate.asp>

Question 7. Is it accurate that United States LNG terminals in Massachusetts and Maryland are only operating at half capacity? Do you believe if these plants were operated at a higher capacity it would have changes the market dynamics that determine the current price?

Answer. Chevron does not own or operate the referenced LNG terminals in Massachusetts and Maryland and cannot comment on whether they are operating at their rated capacity. We would recommend the Committee get information directly from the terminal owners on this question.

Question 8. Please state for the record your company position on fuel economy standards. Are there other incentives that you support that you feel are better for consumers than the Corporate Average Fuel Economy paradigm?

Answer. Chevron has not taken a position on Corporate Average Fuel Economy standards at this time. Chevron will defer to Congress and other policymakers whether to address changes in fuel economy standards. Chevron has clearly supported efforts to conserve energy, and recognizes that conservation is one of the cheapest forms of "new" energy that we have. Many automakers (including Ford, Toyota, and Honda) are making more fuel-efficient vehicles, which consumers are increasingly purchasing, indicating that market forces are working to help encourage introduction of these new vehicles.

Question 9. I understand that over the past 5 years companies in your industry have downsized significantly. Now there is a shortage in workers and equipment to increase drilling. Please explain that dynamic.

Answer. By its very nature, the economics of oil and gas production runs in long-term cycles. High market prices of oil and gas attract investment, spur drilling and associated industry activity, and increase the demand for workers and equipment. When market prices fall, investment goes elsewhere, workers move to other jobs, and equipment sits idle. We are now in the part of the cycle where prices are high, resulting in demand for workers and equipment. These cycles peak and trough over multi-year periods, which is how long it takes for new investment to bring oil or gas to the market place.

Question 10. As you probably know, Congress is likely to open up the Coastal Plain of the Arctic National Wildlife Refuge to oil and gas exploration. Do you have plan to bid for leases in this area? What does the price of oil have to be to make ANWR exploration and extraction be economically viable?

Answer. Chevron continues to strongly support opening the ANWR coastal plain for environmentally responsible oil and gas exploration and development, and our long-term interest in ANWR is demonstrated by the maintenance of our 92,000 acre lease position on the coastal plain. As a matter of long standing policy, Chevron does not comment on future leasing plans. We will evaluate any future bidding opportunities as they arise.

Question 11. I understand that many of your resources and equipment are working flat out to rebuild infrastructure in the Gulf of Mexico. If there is no capacity to expand oil and gas exploration, what good is opening up sensitive environmental areas to increased drilling going to do for the consumer in the short run?

Answer. Repairing the platforms and pipelines in the Gulf of Mexico is a short-term anomaly to our normal activity, and we expect most repairs to be completed in the near future. Oil and gas exploration and production are longer term activities that include gathering seismic data, exploratory drilling and production of new resources found that collectively take years to complete. If areas were opened today, the capacity for exploration and production would be available when needed.

Question 12. Given the growing demand for oil in Asia, do you believe that oil derived from the Arctic National Wildlife Refuge could be diverted to supply Asian markets? If drilling in the Arctic National Wildlife Refuge is authorized this year, when will it begin to have an impact on gasoline prices? What do you believe that effect will be?

Answer. We believe that most oil produced from ANWR will be directed to lower 48 markets. Gasoline prices are driven by supply, demand, and other market conditions. An ANWR opening could have an immediate impact on market perceptions of long-term supply/demand dynamics, but at this time it is impossible to quantify its impact.

Question 13. Do you support more transparency in the oil and natural gas markets, as would be provided in my bill S. 1735?

Answer. We believe the existing mechanisms and services provide sufficient information on market prices. We also believe the transparency provisions of S. 1735, which require additional data collection and dissemination by the FTC, are not needed and will not measurably improve the quality of price information available to the public, government and market participants.

Question 14. How has the last 3 years of escalating gasoline prices affected demand by American drivers? Have we seen a correlation between a certain level of price increase and less demand by American drivers? What is the actual level of reduced demand today compared to 3 years ago (please respond in the context of a doubling of retail gasoline prices)?

Answer. The extent to which changes in price for gasoline over the past three years affected the demand for gasoline is unclear. Based on EIA data, consumption of gasoline has increased from an average of 8.880 million barrels per day in 2003, to 9.140 million barrels per day in 2005, an increase of almost 3% over the period. Gasoline consumption in 2005 has increased by about 0.8% over 2004.

Question 15. What is the crude oil extraction costs for major oil producing countries, including our own? How does that compare with oil derived from shale or coal?

Answer. Chevron does not have data on crude oil extraction costs for other oil producing countries, as production in many countries is run by national oil companies and this information is not made public. In the United States, operating costs have been rising since the mid-1990s, and have jumped significantly since 2002 due to high demand on purchased goods and services.

Some methods for producing oil from shale indicate that production may be profitable at current crude prices of about \$60 per barrel. Chevron has submitted an application to the U.S. government to build and operate an experimental shale oil pilot facility. If successful, in several years we should have much more information on the costs and technical issues of producing oil from the country's extensive oil shale resource.

Question 16. Regarding foreign exporting, inventory maintenance, and other practices of your company, please provide a response to each of the following questions and information requests:

a. For each and every export shipment to a foreign country of gasoline, distillate fuel oil, propane, or liquefied natural gas occurring from January 1, 2005 to present, please provide the date, product type, volume, domestic port of exit, foreign destination, transportation costs, and the sale price or transfer value upon arrival at the foreign destination.

Answer. Today, Chevron imports more refined products into the United States each year than it exports. The attached table (Attachment 1)* includes the requested data for gasoline and distillate fuel oil exports. There was no export activity involving propane or LNG.

Question 16a. Since January 1, 2001 to present, please identify the number of shipments wherein your company exported gasoline, distillate fuel oil or jet fuel and the sales price or transfer value received at the destination was less than the amount that would have been received had the product been marketed by your firm in the United States.

Answer. Due to contractual commitments, differences in foreign and U.S. fuel specifications, the long lead time between the point of committing to an export and when the actual delivery occurs, constantly changing conditions in foreign and U.S. markets and many other factors, it would be extremely difficult if not impossible to reconstruct the details behind each export that would be necessary in order to answer this question.

Question 16b. Since January 1, 2001 to present, please identify the date, product, volume(s), foreign port of origin, expected U.S. port of entry, and eventual port of final destination in each instance wherein your company basically “turned a ship away” (whether proprietary product or acquired from a third party) by changing the shipments expected arrival in a U.S. port to a foreign port.

Answer. If the premise of the question is that Chevron would direct a cargo destined for a U.S. port to another location in order to reduce supply into the US, Chevron disagrees with that premise. However, Chevron does not maintain a database that would facilitate answering a question about cargoes originally destined to the United States which ended up being shipped to a non-U.S. location. In the normal course of business, changing refinery operations, market conditions or other business reasons can result in cargoes originally destined for one location to be redirected to another location or destination. For example, following hurricanes Katrina and Rita, in response to the temporary shortages of refined product, Chevron contracted for shipments of fuel to supply customers in the United States. Some of those cargoes were originally destined to other markets, including other U.S. ports. As another example, following Hurricane Katrina, cargoes of crude oil which were destined for our Pascagoula refinery had to be redirected because our wharf and terminal were damaged by the storm and could not accept them.

Question 16c. From 1995 until present, please identify by month the inventory levels maintained by your company for gasoline and distillate fuel oil in both barrels and converted to “days of cover” or “days of supply” for your firm’s distribution and sales volumes within each of the Petroleum Allocation Defense Districts (PADDS) in the United States.

Answer. For purposes of this question, Chevron defined the “days of supply” as inventory divided by average daily sales. The attached table (Attachment 2) presents data for the period 1/1/2003 to present. Prior period data is not readily available.

Question 16d. From January 1, 2005 to present, provide the details of each “spot market” (as commonly referred to in the industry for bulk sales, in volumes exceeding 5,000 barrels per transaction) including the date, identity of both the seller and purchaser, location of the product being sold, and the selling price.

Answer. The attached table (Attachment 3) provides the requested transaction details other than purchaser and seller identities. We generally consider purchaser and seller identities to be business confidential. If Committee members have questions about particular Chevron spot transactions, we would be happy to discuss such questions with the staff further.

Question 16e. Describe your company’s use of “in-house trading platforms,” and identify all individuals in your company by name, address, email, and phone number that were authorized during 2005 to either exchange, trade, sell or purchase gasoline or distillate fuel oil on either the “spot market”, NYMEX futures market, or via “forward paper” purchase rights.

Answer. Chevron uses two internal software systems to track trades. One system is used primarily to track non-U.S. waterborne movements of products and the second to track movements of product within the U.S. For privacy reasons, we are not providing the identifying information requested concerning employees. We have numerous employees who are authorized to conduct such activity. If Committee members have questions about Chevron trading activities or the activities of individual

* Attachments 1–3 have been retained in committee files.

Chevron traders, we would be happy to discuss such questions with the staff further.

Question 16f. Please identify all third party reporting services, including but not limited to Oil Price Information Service (OPIS), Lundberg Surveys, Platts, and Oil Intelligence that your company regularly supplies transaction data or marketing information and all individuals of the company by name, address, email, and phone number that were authorized during 2005 to provide the information or data to such third parties.

Answer. For privacy reasons, we are not providing the identifying information requested concerning employees. Chevron has a select number of people within the company who are authorized to conduct such activity. Chevron provides information on crude oil transactions to the following third party reporting services—Platt’s, Bloomberg, Dow Jones (Telerate), Reuters, Argus, RIM (in Asia only) and APPI (Far East only). Chevron provides information on products transactions to Platt’s, Argus or OPIS. Chevron reports natural gas transactions which meet the reporting requirements of the Federal Energy Regulatory Commission’s (FERC) Policy Statement on Natural Gas and Electric Price Indices (Docket No. PL03-3) and participates in both Bidweek and Daily Price Reporting to the following index publications: Platt’s, Bloomberg, Natural Gas Intelligence (NGI), Natural Gas Weekly (NGW), Ioenergy and Argus Media. An independent group within Chevron also communicates with these third party reporting services to obtain feedback on the reporting described in this paragraph, to offer improvements to the transparency of the data used in index development and to discuss any issues with the information supplied by Chevron.

If Committee members have additional questions about Chevron price reporting activities, we would be happy to discuss such questions with the staff further.

Question 16g. Please identify the branded and unbranded “rack prices” that were reported by your company to third party reporting services such as OPIS and the branded and unbranded “rack prices” that were actually charged distributors or jobbers by your company each day, from January 1, 2005 to present, at the truck loading terminal(s) that typically supply gasoline stations in Houston, TX, Atlanta, GA, New York, NY, Chicago, IL, Los Angeles, CA, Portland, OR, and Seattle, WA.

Answer. Chevron does not report its terminal rack prices to price reporting services such as OPIS. Nor during 2005 has Chevron sold unbranded gasoline at the rack to distributors or jobbers at any of the locations identified, or branded gasoline at terminals that supply gasoline stations in New York or Chicago.

Chevron’s branded rack prices for the other terminal locations from January 1, 2005—November 1, 2005 are set forth in the attached table (Attachment 4).^{*} As noted earlier in Chevron’s written testimony (see Attachment B), the hurricanes impacted markets throughout the United States and elsewhere around the world.

Question 16h. Will your company commit that it will take no efforts to retaliate against any firm or individual that is a potential witness before this Committee or cooperates with any investigation into the oil industry by Congress or another governmental authority?

Answer. Chevron does not and will not engage in the type of conduct suggested by the question.

Question 16i. From January 1, 2005 to present, for each instance known to your company wherein a third party (not your company) exported gasoline, distillate fuel oil, propane, or liquefied natural to a foreign country, please provide any of the details known to your company including the identity of the exporter, date, product type, volume, domestic port of exit, foreign destination, transportation costs, and the sale price or transfer value upon arrival at the foreign destination.

Answer. Chevron has only limited anecdotal information regarding third party shipping activity and Chevron does not attempt to validate such information.

Question 16j. Since January 1, 2001 to present please identify the identity, date, product, volume(s), foreign port of origin, expected U.S. port of entry, and eventual port of final destination in each instance wherein your company is aware a third party (not your company) basically “turned a ship away” (whether proprietary product or acquired from a third party) by changing the shipments expected arrival in a U.S. port to a foreign port.

Answer. Chevron does not possess this information. Chevron has anecdotal information about third party shipping activity, but it is not validated and Chevron does not know a third party’s instruction to its vessels.

^{*}The information referred to has been retained in Committee files.

Question 16k. Please provide an itemized list of tax deductions and credits taken under the U.S. tax code for 2004, by your parent company and subsidiaries.

Answer. For 2004, Chevron claimed tax deductions for salaries, wages, compensation, rents, interest, bad debts, taxes and licenses, charitable contributions, depreciation, depletion, advertising, employee benefits and other miscellaneous business expenses. Chevron also claimed foreign tax credits, general business tax credits and non-conventional fuel credits.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. KEN SALAZAR TO
DAVID J. O'REILLY

Question 1. The Agriculture Committee is looking at the impacts these high energy prices are having on agricultural producers around the country. To sum it up: they are hurting. It seems to me that there is tremendous potential for our country to grow fuels such as ethanol and bio-diesel. This approach offers many benefits to rural America as well as to the country as a whole. What type of investments is your company making (and planning to make) in these types of renewable fuels in the United States?

Answer. Chevron has spent more than \$1 billion since 2000 on the next generation of energy by focusing on the pragmatic development of renewables and alternative energy sources, and the creation of more efficient ways of using the energy.

Chevron Energy Solutions (CES) develops, engineers and constructs holistic energy efficiency, conservation and power system projects for institutions and businesses. CES has developed energy efficiency and renewable projects for large-scale facilities operated by the U.S. Postal Service, the Department of Defense, hospitals and public schools.

Chevron is the world's largest producer of geothermal energy having developed more than 1000 MW of capacity. In 2004 Chevron announced a \$128 million plan to expand our Daajat geothermal power plant in Garut, West Java, Indonesia.

Chevron invested in a 22.5 MW wind farm at the Nerefco refinery in the Netherlands, the first large-scale wind project on a brownfield refinery. Chevron has one of the largest solar photovoltaic installations in the U.S., a 5090 kw solar array, at our Bakersfield, California production location.

Chevron is a joint venture participant with COBASYS, working to commercialize nickel-metal hydride batteries for such applications as hybrid electric vehicles and stationary power supply devices.

Chevron is also leading a consortium in a five-year demonstration of hydrogen infrastructure and fuel-cell vehicles by building six hydrogen energy service stations with fueling facilities for small fleets of fuel-cell vehicles and capacity to generate high-quality electrical power from stationary fuel cells.

Question 1a. Rural America is crying out for investment in renewable fuels, and I encourage your companies to look at the potential of renewable fuels. In terms of a percentage of your capital expenditures, how much money did your company spend this year to develop renewable fuel sources in the United States? What will that percentage be going forward?

Answer. Detailed information is not readily available. See answer to question above regarding Chevron investments in renewables, alternative energy sources, and the creation of more efficient ways of using energy.

Question 1b. Will you also provide this committee with some examples of renewable fuel projects that your company is pursuing outside the United States?

Answer. See answer above.

Question 2. As a few of you note in your testimony, diesel prices have remained high while unleaded gasoline prices have come down. It seems as if we are getting lower priced unleaded gas at the expense of diesel. Since diesel is the fuel of choice in agriculture, it is a sort of a double whammy on our producers. What is being done, or what can be done, to get diesel prices back in line with the price of gasoline?

Answer. Transportation fuel prices are determined by supply, demand and other competitive factors in the marketplace. Demand for diesel products has been increasing in both the U.S. and Europe, and is expected to continue increasing as we enter the winter season. The recent impact of hurricanes significantly affected both U.S. gasoline and diesel supplies because of refinery outages. The market works in a way that supplies move to the highest demand. Because of higher demand for diesel than gasoline, notably in the European Union, the United States ended up attracting less diesel imports which have led to continuing higher prices for diesel.

Question 2a. If demand for diesel is so high in Europe and high prices don't attract the supplies necessary to lower prices, isn't that a good indicator that we

should work to produce more diesel in the United States and look to biodiesel as an option?

Answer. As noted in our testimony, Chevron is investing to increase refining capacity in the United States through our existing refining network. Further, there are policy recommendations that the U.S. government can implement to create a better investment climate for refinery investment, which are highlighted in our written testimony. Lastly, biodiesel and diesel made from natural gas (Gas-to-Liquids technology) may create additional and alternative supplies of diesel fuel.

Question 3. For the record, will you tell me what your company has spent on capital expenditures in cash, not including write offs such as amortization or depreciation. Will you also provide the figures spent on cash dividends and stock buyback for the same time period?

Capital expenditures: The table below shows Chevron's capital and exploratory expenditures for the periods 2000 through September 30, 2005. Some of the exploratory expenditures are capitalized. Other amounts may be expensed under the applicable accounting rules if a project is not successful or if the project does not move into the development phase within a certain time period.

\$ Billions	Total for the period 1/1/2000 through 9/30/2005	Nine months ended 9/30/2005	2004	2003	2002	2001	2000
Capital an exploratory expenditures	\$53.6	\$7.1	\$8.3	7.4	\$9.3	\$12.0	\$9.5

Source: Chevron Form 10-Ks.

Cash dividends and stock buy-back: Dividends and share repurchases under repurchase programs for the periods 2000 through September 30, 2005 totaled \$17.4 billion and \$5.9 billion, respectively.

Question 4. On November 1st, Senator Grassley asked your companies to contribute 10% of your record profits to supplement LIHEAP funding for the less fortunate. Will your companies support Senator Grassley's proposal?

Answer. Chevron supports full funding of the LIHEAP program but does not believe funding should be done by the energy industry. Chevron's role is to invest to provide new energy supplies, examples of which are highlighted in our written testimony. Since 2002, Chevron has re-invested the equivalent of our profits to help produce more energy. The government's role is to best determine the priority and the funding of programs such as LIHEAP. Congress's prioritization and funding of LIHEAP should be completely independent of oil industry earnings.

Question 5. I'd like to encourage you to actively work with the Department of Energy and any other relevant federal agency on initiating a public/private education campaign focused on energy education and conservation. In the meantime, will you tell me what your company has done on its own initiative?

Answer. As noted at the hearing, Chevron would be receptive to working with DOE and other on a public/private campaign on energy education and conservation. As a company, Chevron has launched a new thought/advertising campaign called "Will You Join Us" <http://www.willyoujoinus.com/> that highlights energy issues, helps put energy issues into context (particularly around near term, real energy solutions and alternatives) and helps educate the public about steps they can take to conserve energy.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. MEL MARTINEZ TO
DAVID J. O'REILLY

Question. What are each of your companies doing for us to develop that ingenuity and that know-how into independence of fossil fuels as we've known them in the past, utilizing renewables, utilizing ethanol and maybe other technologies as well?

Answer. As noted in Chevron's written testimony to the Committee, in the short term, globally energy markets are becoming more interdependent rather than independent (see written testimony Attachment C: Global Energy Equation, and U.S. Energy Policy: A Declaration of Interdependence). Please refer to Chevron's written testimony about what Chevron is doing to help meet America's energy needs, including research and development expenditures and investments in energy efficiency, and alternatives such hydrogen infrastructure and fuel cell vehicles, advanced bat-

teries, and renewables such as solar photovoltaic installations. Chevron suggests policy recommendations for the U.S. government to consider.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. GEORGE ALLEN TO
DAVID J. O'REILLY

Question. But insofar as fuels, in the next 10 years what can our government do to help or stop hindering the actual use of—whether it's hydrogen, whether it's fuel cells, whether it's clean coal or these renewables, these biofuels, what can we do in 10 years to get our automobiles—rather than looking at just fossil fuels, looking at these renewables and innovative approaches—what can we do, in your view, to actually achieve this greater energy independence?

Answer. As noted above, and in Chevron's written testimony to the Committee, in the short term, globally energy markets are becoming more interdependent rather than independent (see written testimony Attachment C: Global Energy Equation, and U.S. Energy Policy: A Declaration of Interdependence). Please refer to Chevron's written testimony about what Chevron is doing to help meet America's energy needs, including research and development expenditures and investments in energy efficiency, and alternatives such hydrogen infrastructure and fuel cell vehicles, advanced batteries, and renewables such as solar photovoltaic installations. On page 13, Chevron suggests policy recommendations for the U.S. government to consider.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. FRANK R. LAUTENBERG TO
DAVID J. O'REILLY

Question 1. Did the existence of price gouging statutes in Louisiana, Mississippi and Alabama play any role in your decision to freeze prices after Hurricane Katrina?

Answer. No.

Question 2. In the last decade, has your company ever withheld supply of crude oil or refined product from the market in order to prevent prices from falling?

Answer. No.

Question 3. Please describe any business relationship or transaction your company or any of its subsidiaries, wherever located and wherever incorporated, whether wholly owned or not, have had with Iranian nationals (except employment of Iranian expatriates), the Iranian government, individuals or corporations located or incorporated in Iran, or any representative of these people or companies.

Answer. Based upon due inquiry, except for the employment of or possible transactions with Iranian expatriates outside Iran and the other incidental matters mentioned below, we are not aware of any instance in which Chevron Corporation or any of its owned, controlled or operated subsidiaries has, since the combination of Chevron and Texaco occurred in late 2001, entered into any business relationship or performed any transaction with any instrumentality of the Iranian government, with any Iranian national or with any individual or corporation that is located or incorporated in Iran, or with any representative of such persons.

Chevron and its subsidiaries have taken only those actions that the U.S. sanctions permit U.S. companies to take, namely (i) to acquire and analyze preexisting geological and geophysical data and information about Iranian oil and gas fields, (ii) to participate in public conferences concerning Iranian oil and gas properties, and (iii) to meet and become acquainted with the personnel of the Iranian government who manage Iran's oil and gas assets. Chevron has not, of course, entered into any agreements or negotiations for agreements with Iran or made any business proposals to Iran. Neither has Chevron provided any information to Iran concerning our analysis of the geological and geophysical information that we have acquired.

The foregoing actions have involved incidental transactions that are related to attendance at public conferences, to the acquisition of preexisting data and to travel to Iran, all of which are transactions that the U.S. sanctions permit U.S. companies to conduct. Our subsidiaries have also maintained and renewed preexisting trademark registrations in Iran, to protect our valuable trademarks and trade names from being misappropriated by others. Finally, Chevron has made humanitarian donations to U.S. nonprofit relief organizations for their use in connection with natural disasters which have occurred in Iran.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. OLYMPIA J. SNOWE TO
PETER C. HARVEY

Question 1. State of Emergency as Trigger for Price Gouging—Most state price gouging laws are applicable only in situations arising from a declared emergency. My home State of Maine is different in that the law applies in any instance where there is evidence of “unjust and unreasonable profits in the sale, exchange or handling of necessities.” Why did your state legislature choose to limit its law’s impact to declared states of emergency?

Answer. The purpose of New Jersey’s law is to ensure that merchants do not worsen the harm or loss suffered by people who are facing an emergency, or attempting to mitigate the harm or loss incurred as a result of the emergency, by artificially inflating the prices they are charged for essential goods or services. It should be noted that New Jersey’s law applies only when a state of emergency has been declared in New Jersey by the Governor and only in the geographical area of the State where the emergency is declared. It prohibits excessive price increases in the sale of any merchandise “consumed or used as a direct result of an emergency or which is consumed or used to preserve, protect, or sustain the life, health, safety or comfort of persons or their property.” The statute is not a price control provision. Its language makes that clear. Rather, it is a provision aimed at protecting people who are recovering from a disaster or an emergency.

The law seeks to strike a balance between respecting market conditions and protecting consumers. The “Legislative findings” section of the law states, “While the pricing of merchandise is generally best left to the marketplace under ordinary conditions, when a declared state of emergency results in abnormal disruptions of the market, the public interest requires that excessive and unjustified price increases in the sale of certain merchandise be prohibited.”

Question 1a. How frequently do states declare a state of emergency?

Answer. During the past five years, New Jersey has declared weather-related states of emergency 16 times, or roughly 3 times per year.

Question 1b. Has there ever been a situation where there is evidence of an unconscionable increase in price outside of a declared emergency?

Answer. Yes. Generally we allow sellers to charge what the market will bear and rely on competition to keep prices in check. However, there certainly are instances of situational pricing which a reasonable person would consider to be unconscionable, where sellers exploit the immediate needs of consumers and the lack of alternative, less costly sources for essential goods or services. A good example is the tow truck driver who doubles or triples the standard fee ordinarily charged for a tow or repair service for a stranded motorist at 3 a.m. when no other tow truck is available. To determine whether “unconscionable” pricing occurred after Katrina would require a complex analysis of supply and market conditions nationwide after the hurricane.

Question 2. The Department of Energy established a 1-800 phone number as well as Web form for consumers to report possible instances of price gouging. According to the DOE, the information they receive is forwarded to the Department of Justice, the Federal Trade Commission, and the affected State’s Attorney General. Have you been receiving this information?

Answer. Yes.

Question 2a. Is it helpful?

Answer. Yes.

Question 2b. What do your offices do with this information once it is received?

Answer. Follow up, investigate and, where appropriate, take action.

Question 3. As a former Attorney General, I recognize the enormity of the job that you perform with limited resources. In September, I wrote to Attorney General Gonzales and asked the Department of Justice to provide technical and financial support to state attorneys general to investigate price gouging. What, if any, assistance have you received from the DOJ?

Answer. None to date.

Question 3a. What, if any, additional assistance could the Federal Government provide to your offices?

Answer. State attorneys general would welcome federal financial assistance to support investigations and enforcement targeting price gouging and other consumer issues affecting essential commodities such as gasoline, home heating oil, food and non-alcoholic beverages. State attorneys general also have a need for economic and technical expertise from the Federal Government, as well as relevant data, which would be helpful to prove price gouging in many cases. Proving gas price gouging

after Katrina would have demanded analysis of highly technical issues of supply and pricing in the energy industry.

Question 4. Are you aware of price gouging for fuel—or other commodities—in your state following Hurricane Katrina? Are there investigations underway? Do you have adequate state authority?

Answer. As I testified before the Committees on November 9, 2005, I filed four lawsuits on September 26, 2005 on behalf of New Jersey against three oil companies, Hess, Motiva Shell and Sunoco, and a number of independent gas station operators in connection with gas price increases after Hurricane Katrina. In the week after Katrina struck, gas prices in New Jersey soared to an average of \$3.16 a gallon by Labor Day, a dollar higher than the average just one month earlier. We sent inspectors to more than 500 gas stations in response to consumer complaints. Although New Jersey's price gouging law applies only when a state of emergency has been declared in the state, we were able to pursue claims alleging the defendants violated New Jersey's Motor Fuels Act and Consumer Fraud Act, including a provision in the Motor Fuels Act prohibiting a gas retailer from changing gas prices more than once in a 24-hour period.

Since the November 9 hearing, New Jersey has reached a cooperative settlement with Amerada Hess in which the company agreed to pay \$372,391, a portion of which will be used to fund consumer protection initiatives by our Division of Consumer Affairs, including efforts to address the home heating needs of seniors and low-income families in New Jersey. I have attached our press release regarding the settlement to supplement my answer to this question.

We do believe that some retailers engaged in what could be appropriately called price gouging after Katrina by artificially inflating their gas prices based not on what they actually paid, but on what they believed could be charged given the fears raised about gasoline supply. Given the limitations of our price gouging law, our legal efforts were grounded on the Motor Fuels Act, an antiquated statute enacted in 1938 to prevent predatory pricing. The original intent of the Act was to prevent one gas retailer from repeatedly undercutting a competitor's prices to drive the competitor out of business. It provided a tool for us to address the volatility in gas prices in New Jersey following Katrina, but not an ideal tool.

While the New Jersey Legislature could expand the state price gouging statute beyond in-state emergencies, I believe our experience with Katrina points to the need for a federal price gouging statute. A federal price gouging statute should take effect for a limited time span, perhaps for 60 days, in order to help stabilize pricing when a disaster or emergency in one geographic area of the country affects the supply and pricing of an essential, nationally distributed product. As I stated previously, proving gas price gouging after Katrina would have demanded analysis of highly technical issues of supply and pricing in the energy industry. It was a problem that apparently went beyond retailers to the major oil and gas companies, which posted record profits at the same time that consumers were paying record prices. It went beyond state lines. We need a solution that brings federal expertise and resources to bear on the problem and that provides for consistent enforcement nationwide. The enforcement statute should address not only retailers, but also wholesalers, suppliers and manufacturers. A federal price gouging statute should not preempt additional state remedies and, ideally, should provide an enforcement role for State attorneys general.

[NEWS ATTACHMENT]

OFFICE OF THE ATTORNEY GENERAL

ATTORNEY GENERAL HARVEY ANNOUNCES SETTLEMENT WITH AMERADA HESS

NEWARK—Amerada Hess Corporation today voluntarily settled a lawsuit filed in September by the Attorney General's Office, with a portion of the settlement proceeds funding an energy and motoring assistance program for low-income residents, Attorney General Peter C. Harvey and Consumer Affairs Director Kimberly Ricketts announced.

Amerada Hess is the only one of the three oil companies named in the State's lawsuits to reach voluntary settlement of the matter to date.

"This settlement, first and foremost, is about protecting the rights of our consumers," said Acting Governor Richard J. Codey. "It represents a cooperative understanding between the State of New Jersey and Amerada Hess that protects the interests of all of our residents, and also benefits those most in need—low-income families and individuals on fixed incomes who have been hit hard by rising energy prices."

“Our goal is always to make sure that New Jersey consumers get what they pay for,” said Attorney General Harvey. “Gasoline is essential to our lives and it must be priced consistent with the law. Amerada Hess showed good corporate citizenship by reaching this settlement with our Office. We expect other oil companies to follow Hess’s lead.”

The Attorney General filed suit in September against Amerada Hess, Motiva Shell, Sunoco and various independent gas station operators for alleged violations of the State Motor Fuels Act and Consumer Fraud Act.

In settling the lawsuit, Amerada Hess agreed to adhere to state law regarding the pricing of gasoline. Both sides agreed to settle the matter without an admission of any violation having occurred.

Amerada Hess has agreed to pay \$372,391 in settlement. These funds will be used to reimburse state and county investigative and legal costs.

A portion of the funds will also be used to fund future consumer protection initiatives at the Division of Consumer Affairs, including efforts to address the home heating needs of seniors and low-income families in New Jersey.

“At its very core, the mission of the Division of Consumer Affairs is the protection of New Jersey’s consumers and, with this settlement, we have done just that,” said Kimberly Ricketts, Consumer Affairs Director. “This is a good example of how government and private industry can work together in a productive and beneficial manner.”

Deputy Attorney General Brian Brennan represented the State in the settlement with Amerada Hess.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. PETE V. DOMENICI TO
ROSS J. PILLARI

Question 1. What are you doing to bring oil prices down?

Answer. BP is continuing to invest for sustainable production growth. Over the past 5 years, BP has invested \$45 bn in the exploration and production segment. BP’s oil and gas production has grown more than twice as fast as the world’s total production from 2000-2004 (5.4% for BP against 2% for the world.) Due to the investments over the past five years and our plans for the future, this strong contribution to supply is set to continue. BP is directly involved in oil fields which are expected to contribute almost half of non-OPEC production growth over the medium term.

Over the next five years, our plans show the start up of some 35 major projects. This is in addition to the eight projects which have already come on stream in 2004 and 2005 and which are ramping up production. Combined, these projects are expected to develop around 5.5 billion barrels oil equivalent of BP net reserve and underpin our estimates that we will continue to grow production through the end of this decade at a cumulative average growth rate of around 5% p.a. In the longer run, we expect the growth rate to lie in the range of 2% to 5% p.a.

Question 2. What is the relationship between the price of oil that Americans are paying and the profits you are making?

Answer. We don’t report profits on a geographic or segment basis as we do not have an effective means to allocate taxes and interest at these detailed levels. For the first nine months of 2005, BP’s U.S. operating profit (before interest and taxes) was \$8.2 Billion. This represents 35% of BP’s global operating profit for 2005.

Question 3. The question I hear most from people is how is the price of oil set? Many Americans think oil companies are rigging prices to reap big profits. How would you respond to that?

Answer. Oil companies do not set the price of crude. Crude oil is bought and sold on the international marketplace and the price paid reflects the market conditions of the day. Like any commodity market, there is a balance between the world’s supply and demand for crude oil. When there is a disruption in supply, whether perceived or real, prices will normally increase, unless there is a corresponding reduction in demand. Similarly, when there is a surge in demand, as has been happening recently, prices will increase unless there is a corresponding supply response.

The unusually strong global consumption growth of last year, led by China, has had the effect of bringing almost all of the world’s available oil capacity into production. There has always been enough oil in aggregate to meet world demand, but most estimates now place spare production capacity at only around 1-1.5 million b/d, compared to an historic average of around 3 million b/d. This provides little flexibility in the system for supply disruption or strong demand, and markets naturally drive prices up in such a situation. There is general agreement that build up of significant additional excess capacity will take time, even though there is no shortage

of potentially producible oil resources and there have been no reported cases of refineries cutting runs due to a lack of crude supply.

To date, the rise in oil price has had minimal impact on either demand or supply. This is not surprising because in the short run, demand is relatively inelastic. Consumer behaviors take time to change. Lead times to develop additional supplies are long, so despite record levels of industry investment, the production impact is not yet detectable.

Question 4. Americans are being burdened with high oil, natural gas, and gasoline prices while you all are raking in record profits. What do you say to those people that blame you for this and say that it is unfair?

Answer. The high prices experienced by American consumers are a result of natural market forces. Demand is squeezing available supply driving prices up. It is a normal characteristic of free markets that producers receive higher profits when their products are in more demand. Oil companies invest billions of dollars in high-risk, long-term investments for exploration, development and technology. In most years, oil companies do not receive a very large return on those investments. On average, the returns realized by oil companies are significantly below those of biotech, financial firms and computing industries in particular and all industry in general, despite the level of risk undertaken.

Question 5. Americans want to know if it is not costing so much more to produce a barrel of oil, why are prices rising so high?

Answer. Prices are set by the market not by relative production costs. So the high demand for crude is what is driving the price, not its lifting cost. However, the cost of production is rising. BP has experienced oilfield cost increases of between 10-12% in 2005. Additionally, increased demand brings more expensive hydrocarbons into the market such as heavy oil, tar sands and deepwater fields)

Question 6. What is your company's response to proposals for enactment of a Windfall Profits Tax?

Answer. A windfall profits tax would discourage energy investment in the U.S. and decrease domestic energy security and employment. For example, the Congressional Research Services (CSR) found that when the windfall profit tax was imposed during 1980-1988 domestic oil production dropped as much as 6% and oil imports grew as much as 16%. BP has had a consistent investment strategy over the last ten years in the U.S. of about \$6 billion/year independent of oil price and company profits.

Question 7. Do you believe that Americans are dangerously dependent on oil and its refined products?

Answer. American dependence on oil and refined products has both costs and benefits. The amount of oil consumed to produce a dollar of GDP continues to decline, and the amount spent on oil, although it has increased in recent years, remains below previous peaks.

Relying on imported oil & refined products enables the U.S. to tap in to lower-cost supplies. And, given that both crude oil and refined product markets are global, the U.S. would be vulnerable to disruptions (in the production of crude oil or refined products) even if it were self-sufficient. On the other hand, U.S. dependence on foreign production is in itself a function of U.S. oil consumption. Given the current distribution of oil reserves, the larger U.S. consumption, the larger its dependence on foreign oil supplies.

Question 8. The International Energy Agency's recent Global Outlook report expresses concern about world energy supplies and reliance on the Middle East for oil. Do you think the IEA's anxiety is justified?

Answer. The IEA's role is to provide information (on behalf of its consuming-country members) on energy market risks today and in the future. As such, it is appropriate for the IEA to analyze and publicize risks to global energy supplies, including dependence on Middle East oil. The Middle Eastern share of world oil exports has not increased substantially over the last 20 years. It is nonetheless important to keep those risks in perspective by also assessing the benefits accruing to the U.S. and world economies by consuming fossil fuels (including Middle East oil).

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. LISA MURKOWSKI TO
ROSS J. PILLARI

Question 1. In your agreement on an Alaska natural gas pipeline that you are negotiating with the State of Alaska under the state's Stranded Gas Act, do you anticipate making a firm commitment to develop the Alaska gas pipeline project or do you anticipate accepting an agreement that will only involve a series of spending

and work commitments? If the latter is the case, how long will it be before a binding construction commitment deadline is reached?

Answer. Negotiations with the State of Alaska are ongoing and we continue to make progress. A fiscal contract agreement with the State of Alaska that is approved by the Legislature will enable the Alaska Gas Pipeline project to move forward to the next phase of permitting and engineering. We will quickly begin this work after gaining Legislative approval for the fiscal contract in Alaska. This engineering work leading to an Open Season as stipulated in the Federal Legislation will result in the filing of permit applications with the Federal Energy Regulatory Commission, which is responsible for the issuance of a Certificate of Public Convenience and Necessity following application review. Estimated spend by project sponsors prior to final FERC approval is approximately \$1 billion.

A project construction sanction decision would occur following issuance of FERC approvals.

To summarize, once the fiscal contract is approved by the legislature and signed into law, the producers would begin advancing the project. Initial estimates of the project work plan include:

- ~3 years project planning, permitting, engineering, for regulatory applications
- ~2 years regulatory review; final permits.
- ~1 to 2 years preconstruction activity—ROW preparation, ordering steel, compressors, etc.
- ~3 years construction
- First gas flow to North American consumers

Question 2. If there is a concern about tying up your investment capital in a single project, if a pipeline company presented you with a proposal to take all of the risk of construction of the Alaska pipeline project and to ship your gas at a reasonable tariff, would you commit the gas you control to that pipeline within a reasonable time period? If not, why?

Answer. BP has built several basin opening pipelines around the world where the risk profile was such that it required direct BP involvement. We have the capital, the financial capability and the organizational capability needed to undertake an Alaska Gas project provided the potential risks and rewards are balanced.

The resource owners, including the State of Alaska, shoulder the risk in the case of an Alaska Gas pipeline, because it is their firm commitment to use and pay for the pipeline that enables the project to be financed.

No other entity is as motivated to develop a highly efficient, low cost pipeline than the resource owners (producers and state). That is because low costs translate into lower tolls. Lower tolls mean higher netbacks and more revenues. That is good for Alaska, the producers and consumers.

BP has consistently indicated a willingness to work with any party than can reduce risk and add value to a project. If a pipeline company could actually guarantee a cost of service matched to our projected production needs that is more competitive than what we believe we can do ourselves, we would obviously be interested. This has been, and always will be, the case. It's good business. It is the way industry operates.

Indeed, we hope and expect the pipeline industry will develop competitive proposals to move gas out of Alberta to U.S. markets. This would be a much larger challenge for the pipeline industry than for the Alaska to Alberta segment given the costs and risks involved. However, nothing in the agreement we are negotiating with the State of Alaska would preclude this from happening. In fact, an agreement between the producers and the State would be a necessary prerequisite for this to happen.

Question 3. In your companies' view, is it less risky to invest billions of dollars in new LNG facilities to import natural gas from foreign sources, than to invest in the Alaska gas line project? If not, why are you investing in LNG projects before making a firm commitment to the Alaska project?

Answer. We are attempting to do both as soon as possible because the nation needs both sources of natural gas. The fact that we invested in LNG facilities to bring gas to the U.S. before investing in the Alaska gas line project does not indicate a preference for LNG over the Alaska gas line—it merely says that, for a variety of reasons, we were able to bring on LNG investments earlier than the Alaska gas line. The fact that we did so has been to the benefit of the gas consumers of the U.S.

Question 4. All of your companies are global in scope. This nation is concerned about its reliance on foreign sources of crude oil. Does it make sense for the United

States to increase its reliance on foreign LNG while allowing Alaska's natural gas reserves to continue to remain in the ground?

Answer. As mentioned above, the nation needs both sources of natural gas—it is not in an “either/or” situation. So the fact LNG trade into the U.S. increases does not mean that the Alaska gas line is any less likely to proceed. As well as LNG and the Alaska gas line, the nation also needs to increase its conservation of all types of energy so that reliance on all types of energy production is mitigated.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. JAMES M. TALENT TO
ROSS J. PILLARI

Question 1. The recent hurricanes have highlighted the need for increasing refinery capacity, which was already operating at a tight margin of 97 percent. While that is laudable for efficiency purposes, it allows no room for error in case of sudden outages or demand increases. What is the optimal amount of spare refining capacity to ensure a reliable supply of finished petroleum products at stable prices?

Answer. There are a number of factors that impact supply, including global refining capacity. Despite the major supply disruption to the U.S. markets post-Katrina and Rita, the global refining capacity was available to minimize longer market impacts. Historically, a global refining operating utilization of 90% has allowed for enough spare capacity to reduce market impacts to supply disruptions.

Question 2. How has industry consolidation impacted the amount of spare production and refining capacity?

Answer. It has had no impact that we have observed. BP sold 4 refineries in the U.S. during the most recent consolidation activity and each of those refineries continues to operate today under its new owners.

Question 3. Describe the degree of competition between refineries for crude oil supplies and sales to retailers. What percentage of crude oil processed in the U.S. is processed by integrated companies (i.e., those produce and refine) versus refined by independent refining companies?

Answer. Both the market for crude oil and the market for the sale of refined products are extremely competitive. BP, one of the largest crude oil producers in the U.S. has only about 8.7% of U.S. refinery capacity. Per API, the integrated oil companies process approximately 53% of the Refining capacity while the Independents process the remainder.

Question 4. How has the amount of refining capacity tracked changes in demand for gasoline and diesel over the last 30 years?

Answer.

- As shown in the attached API charts,* the gap between U.S. refining capacity and gasoline/diesel demand has decreased over the past 30 years.
- U.S. refining capacity has been steadily increasing over the past 10 years, driven mainly by ‘capacity creep’.
- Refining capacity alone doesn’t give a complete picture. It may not capture other feedstocks (NGL’s, condensates, etc). It also does not reflect changes in the upgrading capability of refineries, i.e. at constant capacity a refinery may have increase gasoline and diesel yields while reducing fuel oil.
- In the case of gasoline, growing U.S. demand has been complementary to an increasing supply surplus from Europe (caused by lower economic growth and the trend towards diesel).

Question 5. Explain to me your company’s plan to increase refining capacity in the U.S. to meet the need for new refinery capability.

Answer. Refinery margins are very volatile and margins over the last 10-15 years have not been high enough on average to justify building a new refinery. BP is planning a \$2 billion project focused on bringing Canadian crude to our existing Northern tier refineries (Whiting, IN; Toledo, OH, Cherry Point, WA). This investment will improve the security of crude supply and give better assurance of keeping refinery runs at maximum. Modest increases in gasoline production are anticipated.

Outside the Canadian crude project, BP is spending approximately \$700 million per year to insure that our U.S. refineries operate safely, in an environmentally appropriate way and achieve a high degree of availability to the American public.

Question 6. EPA 2005 removed the requirement to include oxygenates from gasoline, largely because of concerns over the use of MTBE. What is the impact on the price of removing oxygenates from gasoline?

*The charts has been retained in committee files.

Answer. Assuming that with the elimination of the oxygen requirement for Federal Reformulated Gasoline less MTBE will be blended into refinery gasoline stocks, total domestic gasoline production could decline somewhat. Impact on price is unknown since blending ethanol, imports and other strategies will undoubtedly take up the shortfall.

Question 7. Are there other oxygenates that can be used in place of MTBE, such as using ethanol to make ETBE, and how does the cost of such alternative additives compare to the cost of gasoline?

Answer. The oxygen requirement of RFG has predominantly been met with either MTBE or ethanol. With the elimination of the oxygen requirement, if an oxygenate is to be used it will likely be ethanol. In future years, advances in biofuels production technology may lead to the economic production of other oxygenates and/or blending components. The cost of such alternatives is unknown.

Question 8. Have you studied the use of ETBE, the cost of converting MTBE plants and how long it would take to do so, and whether ETBE avoids the leakage/water contamination problems that were caused by MTBE? How do the costs of retrofitting MTBE plants to produce ETBE and use it to increase the volume of gasoline produced by a barrel of oil compare to the cost of expanding existing or adding new refinery capability?

Answer. Yes, we have studied. ETBE is an ether with properties similar to MTBE and it can impart an odor/taste to water, if not properly contained. BP has no current plans to use ETBE as a gasoline component.

Question 9. What, if anything, is preventing your company from using ETBE in place of MTBE?

Answer. ETBE is an ether with properties similar to MTBE and it can impart an odor/taste to water, if not properly contained.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. GORDON H. SMITH TO
ROSS J. PILLARI

I have a bill, S. 1743, to give the Federal Trade Commission, additional authority to prevent and punish price gouging in the aftermath of a major disaster. My bill provides effective authority to the Federal Trade Commission to protect consumers from being victimized in the wake of a disaster without hampering the normal functioning of the free market. It even recognizes that there are legitimate reasons why prices may increase.

Question 1. Do you think that this consumer protection authority should be available to the FTC?

Answer. We have not reviewed your bill. BP supports market-based pricing that insures an adequate supply from local and global markets at all times. During times of emergency, it is important that supply can be moved to the areas that need it. This should not be inhibited. We also believe that the FTC currently has consumer protection authority sufficient to address improper conduct during emergencies.

Question 2. Would this serve as a deterrent to price gouging by individual retailers?

Answer. We can't predict how individual retailers would respond to increased activity by the FTC.

Question 3. Can you tell me why diesel prices continue to remain significantly higher than gasoline prices in Oregon?

Answer. The primary driver of why diesel fuel prices are higher than gasoline is that available inventory for diesel fuel is much lower than that for gasoline relative to historical levels. Diesel fuel stocks are at the lowest level that they have been since sometime in 2000 on the west coast while Gasoline stocks are the at the highest level they have been since 1995 (See attached charts—based on DOE information).*

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. JIM BUNNING TO
ROSS J. PILLARI

Question 1. Some analysts believe that OPEC is approaching its current oil production capacity. Given this, are oil companies looking at alternative sources of energy, such as liquid fuels made from coal, in order to expand their business and maintain energy supplies for the United States? Please include a review of the level

*The charts have been retained in committee files.

of investment your company is making this year and the projected investment over the next three years in coal to liquid fuels initiatives.

Answer. We do not believe that the world is reaching peak oil production yet. There are still enormous quantities of conventional oil worldwide, close to 1.2 trillion barrels proven as well as additional unproven and yet to find barrels.

However we understand the need to maintain a healthy diversity in the supply of energy and see a number of emerging opportunities to convert a variety of unconventional hydrocarbons including: heavy oils, coal, stranded gas, and biomass, into liquids—in many ways these unconventional liquids represent the next frontier for the oil industry.

Today less than 2.5Mboe/d is produced from unconventional resources. We see three principle challenges to further development of unconventional liquids moving forward: firstly reduction in production costs driven by scale and technology advances (currently unconventional technologies range in costs from ~\$25-80/bbl); secondly, and equally important, will be securing the right policy frameworks to enable development of these higher cost resources in competitive markets and where oil prices can still be influenced by OPEC; lastly, converting most of these unconventional resources, especially coal, is significantly more carbon intensive than conventional oil, and so we will need to find ways of reducing carbon emissions.

BP currently invests in the region of \$35MM per year in conversion technologies (not including heavy oil) and are projecting an increase in spend to over \$55MM by 2010. In addition we invest approximately \$10MM today in technologies to reduce the carbon impact of conversion processes; this will rise to over \$20MM by 2010. We believe this is sufficient to ensure we have a number of technologies ready to commercialize low carbon conversion technologies, including coal to liquids, post 2010 depending on the price and policy environment of particular markets.

Question 2. I have been concerned with the lag time between the wholesale cost of a barrel of oil and the retail price of a gallon of gasoline. As we saw following the hurricane, in an ascending market where wholesale oil prices increase, there is a lag period of a few days before retail gas prices reflect this change. Similarly one would expect a lag in a descending market. My concern is that retail prices are not dropping as quickly as they rose, relative to the change in oil prices. Could you explain why price movements vary during a complete market cycle and whether you believe any part of the energy industry is unfairly profiting from this price lag?

Answer. We believe the profits earned by the industry reflect a fair return on investment over the long term. Describing the pricing environment in our business as having a “complete market cycle,” is not entirely accurate. There is no beginning or end in the market place, but rather periods of rising or falling prices and various levels of volatility. Retail prices do tend to lag wholesale movements up and down over time, however retail prices do not move as a result of wholesale price changes alone. The wholesale price is only one of many factors that are considered when setting prices. Other factors that are considered when setting retail prices include competitor price, year-to-date volume and margin performance, supply, etc.

Question 3. Boosting our domestic energy production is vitally important not only to our economy but also to our national security. Many of the countries we import oil from today are unstable, jeopardizing the reliability of sustained production. Please provide a chart for each of the last five years reflecting the percentage of your exploration and production budget that invested in the United States versus that invested overseas. Please also provide a chart reflecting your current projections of the percentage of your exploration and production budgets that will be allocated to projects in the United States versus overseas for the next five years.

Answer. The table below indicate the absolute spend in the U.S. over the past 5 years for investment in exploration and production. This indicates the amount spent in the U.S. expressed as a percentage of the total exploration and production investment for the year. As you can see, for BP the spend in the U.S. for E&P has remained constant at around \$4 bn since the integration of Arco into the portfolio and the percentage spend has averaged around 45%. This investment is greater than the average percentage profits generated by the U.S. over the period of around 37%. The significant percentage drop in 2003 investment is attributable to the significant investment we made in the Russian TNK-BP joint venture that year.

BP would expect future investment levels in exploration and production to remain at about two-thirds of BP's total global investment. BP would expect the total investment to be around \$15 bn going forward (plus or minus largely dependent on inflationary and foreign exchange effects). As to which geographies will be allocated funding, that would depend on the relative economic regime, including accessibility to resources, fiscal and political stability, and market growth.

EXPLORATION & PRODUCTION CAPITAL EXPENDITURES AND ACQUISITIONS

[\$ millions]

	2000	2001	2002	2003	2004
USA	3,140	4,047	4,116	3,906	3,913
Global	6,344	8,753	9,483	15,192	11,088
USA %	49%	46%	43%	26%	35%

Figures from BP's F&OI 2000-2004

Question 4. The disruption caused by the recent hurricanes displayed the United States' vulnerability when it comes to domestic energy supply and production. What suggestions do you have to strengthen our energy supply and production capability?

Answer. Our recommendation is to simplify the current boutique fuel situation across the U.S. This would increase the industry's ability to provide product to the American public by simplifying delivery logistics across the U.S. Another recommendation is to consolidate and facilitate the permitting process for new projects. Because the scale of oil and gas projects is so large, regulatory certainty is needed before investments can be made and the many avenues available to delay or challenge permits substantially increases the lead time to get new projects on stream. Continuing to promote energy conservation is another important government initiative.

Question 5. It has been suggested that the United States consider developing a strategic gasoline and natural gas reserve, similar to Strategic Petroleum Reserve we currently have. Some analysts suggest that such reserves may minimize price spikes in these commodities during periods of market supply disruptions. What are your views on whether a strategic natural gas or gasoline reserve would be feasible and whether they might help minimize price increases during periods of market uncertainty?

Answer. BP does not support the creation of a product reserve because we believe it would be ineffective. Unlike crude, the storage of product requires regular rotation of stock which is a complex and costly logistical issue. With the multitude of product types across the U.S., it is reasonably likely that the right product would not be available in the right place when needed. It is also likely, especially in events of natural disaster that the infrastructure (people, roads, pipelines, trucks etc.) would not be available to access the reserve. Lastly, when use of the product reserve would be required, it would be sold in to the market at spot prices which would be reflective of the emergency conditions. Thus unless there was a really large reserve, it wouldn't have the desired effect of avoiding price spikes. All these factors indicate that a product reserve would bring costs to consumers without necessarily giving them improved access to product in an emergency situation.

Question 6. China is becoming a bigger world oil player. This not only has tightened the world oil market but also has produced national security concerns for us. What concerns or problems do you see have arisen since China became a bigger world energy player?

Answer. Just as energy demand increases accompanied economic growth in the United States, China's rapidly developing economy now also requires more energy inputs. This is a natural development. As other countries grow, we can expect similar increases in needs for energy. Regular functioning of the international market system plays a large role in ensuring that the world copes with these new demands. Alternate and renewable fuels should be considered where appropriate. Meanwhile major consuming countries should continue seeking ways to improve energy efficiency.

China's share in World oil consumption was 8.2% in 2004. It is likely to rise if high economic growth is maintained, but we do think global oil markets can and will adapt to this, if market forces are allowed to work.

Question 7. While there have been expansions and efficiency gains at existing refineries, no refinery has been built in the United States in 30 years. Since the oil companies are now making record earnings, are there plans to build new refineries in the United States?

Answer. Refinery margins are very volatile and margins over the last 10-15 years have not been high enough on average to justify building a new refinery. BP is planning a \$2 billion project focused on bringing Canadian crude to our existing Northern tier refineries (Whiting, IN; Toledo, OH, Cherry Point, WA). This investment

will improve the security of crude supply and give better assurance of keeping refinery runs at maximum. Modest increases in gasoline production are anticipated.

Outside the Canadian crude project, BP is spending approximately \$700 million per year to insure that our U.S. refineries operate safely, in an environmentally appropriate way and achieve a high degree of availability to the American public.

Question 8. The 2005 Energy Bill implemented a controlled phase-out of MTBE. Many companies, however, are planning on completely halting its use. How will a sudden halt of the use of MTBE affect the gasoline market and refineries?

Answer. A sudden halt in the use of MTBE could result in a reduction in the volume of domestic gasoline production, resulting in an increase in imports.

Question 9. I have noticed very large differences in the price of gasoline in different areas of the country. For example, I recently saw gasoline in northern Virginia that was much more expensive than gasoline in northern Kentucky. Please explain why there can be such a significant difference in gasoline prices in different areas of the country.

Answer. There are a number of factors that can influence price differences between geographies. A major factor is competition between individual retail outlets. Pricing may also be impacted by tax differentials between Virginia and Kentucky. There can also be a significant market differential based on the availability of supply and overall markets in each area.

Question 10. Below are several questions on oil and the commodities futures market:

- When was oil first traded on the world-wide commodities futures market?
- Would the price of oil be affected if oil was taken off the commodities futures market and no longer traded?
- Would oil then be bought and sold as a true supply and demand product?

Answer. The International Petroleum Exchange (IPE) was founded in 1980 and the first contract, for Gas Oil futures, was launched the following year. The IPE Brent Crude futures contract was launched in June 1988. The WTI crude futures contract first traded in March 1983 on the NYMEX. Any statement about the impacts of eliminating commodity trading of crude oil would be pure speculation.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. JEFF BINGAMAN TO
ROSS J. PILLARI

Section 392 of the Energy Bill, which was negotiated with the involvement of the Chairman and Ranking Member of the Energy and EPW Committees, contains permitting streamlining language. The Energy Policy Act of 2005 permits the EPA Administrator to enter into a refinery permitting cooperative agreement with a state. Under such an agreement, each party identifies steps, including decision timelines, it will take to streamline the consideration of federal and state environmental permits for a new refinery. I want to ask you several questions about that provision, since you have supported streamlining:

Question 1. Have you requested that EPA issue any regulations or take any action to implement these new provisions? If yes, when? If no, when do you anticipate you will do so?

Answer. BP has not requested EPA to take steps to implement these provisions and has no current plans to do so in the future.

Question 1a. Have you worked with any state to encourage them to enter into an agreement with EPA under Section 392 of EPAct?

Response: No.

Question 1b. Do you support the EPAct streamlining provisions?

Answer. Yes. We believe the additional authorities assigned to the EPA Administrator may prove to be useful and valuable.

Question 1c. Do you have any examples of where a state came to EPA and said we want to work closely with you on permitting a new refinery or refinery expansion and EPA refused to provide technical assistance and even financial resources under existing law to that state?

Response: No.

Question 2. In answer to several of the questions at today's hearing (Nov 9) the witnesses (you) have noted that the market for petroleum and petroleum products is a global one and should be viewed in that context. Please list all planned refinery construction that your company plans to undertake globally. Please list them by country and include the projected size of the facility, including the projected capac-

ity for all units and their potential product yields in addition to the project's total investment cost.

Answer. This information is commercially sensitive and proprietary. We are willing to meet with you privately to discuss these matters under proper protections of confidentiality.

Question 3. The International Energy Agency (IEA) has just released its World Energy Outlook 2005. It contains a piece on the global refining picture. (Please see the summary below.) The study notes a lack of investment in upstream and downstream capacity has contributed to the extreme tightness in global oil markets. What are your thoughts in response to this? What is your company doing in response (actions)? What is your company doing (investments/analysis) in the "MENA" regions? Do you agree with the IEA's projections?

World Energy Outlook 2005: IEA Projects Growth in Middle East and North Africa Oil and Natural Gas Sectors through 2030 but a Lack of Investment would Push up Prices and Depress GDP Growth

11/7/2005 London—"The importance of the Middle East and North Africa (MENA) to global oil and gas markets cannot be underestimated. These countries have vast resources, but these resources must be further developed. Investment should not be delayed," said Mr. William C. Ramsay, Deputy Executive Director of the Paris-based International Energy Agency, as he presented findings from the World Energy Outlook 2005: Middle East and North Africa Insights (WEO-2005) today in London. Noting that a lack of investment in upstream and downstream capacity has contributed to the extreme tightness in the global oil market in recent months, Mr. Ramsay highlighted the critical role that this region will play in meeting growth in global energy demand.

The WEO-2005 expects global energy markets to remain robust through 2030. If policies remain unchanged, world energy demand is projected to increase by over 50% between now and 2030. World energy resources are adequate to meet this demand, but investment of \$17 trillion will be needed to bring these resources to consumers. Oil and gas imports from the Middle East and North Africa will rise, creating greater dependence for IEA countries and large importers like China and India. Energy-related CO₂ emissions also climb—by 2030, they will be 52% higher than today. "These projected trends have important implications and lead to a future that is not sustainable—from an energy-security or environmental perspective. We must change these outcomes and get the planet onto a sustainable energy path," added Mr. Ramsay.

WEO 2005 focuses on the energy prospects in the Middle East and North Africa to 2030, covering in detail developments in Algeria, Egypt, Iran, Iraq, Kuwait, Libya, Qatar, Saudi Arabia and the United Arab Emirates. Internal demand, resources, policies, investment, production, exports, even energy use for water desalination, all are examined. "To our knowledge, this is the first time that any publication with a focus on the Middle East and North Africa has undertaken such an extensive, country-by-country review of the energy sector of the region. At a time when experts debate whether the world will run out of energy, these results are particularly relevant," Mr. Ramsay said.

In the MENA region, domestic energy demand is driven by surging populations, economic growth and heavy energy subsidies. Primary energy demand more than doubles by 2030. At the same time, MENA oil production will increase by 75% by 2030 and natural gas production will treble, allowing more gas exports. The region's share in global oil production will increase from 35% today to 44% in 2030. However, this means the countries of the Middle East and North Africa would need to invest, on average, \$56 billion per year in energy infrastructure. The level of upstream oil investment required will be more than twice that of the last decade.

But what if adequate investment is not made or consuming countries' policies change? To assess these risks, WEO 2005 develops two other scenarios, each of them far from unlikely: a Deferred Investment Scenario, in which investment in the producing countries is delayed, whether deliberately or inadvertently; and a World Alternative Policy Scenario, in which energy-importing countries take determined action to cut demand and change the pattern of fuel use, driven by high prices, environmental or security goals, or all three.

The two scenarios have significant implications for MENA countries. In the Deferred Investment Scenario, energy prices rise sharply. Global energy-demand growth falls, cutting the region's oil and gas export revenues by more than \$1 trillion from 2004-2030. World GDP growth slows down. Deferred investment could be the result of many factors, but whatever the cause, the results are higher prices, greater uncertainty and market inefficiencies.

The WEO World Alternative Policy Scenario examines the consequences of new policies under consideration in consuming countries. "The G8 Plan of Action, agreed

at the Gleneagles Summit in July 2005, launched detailed initiatives to promote cleaner energy and combat the impact of climate change. The IEA was asked to play an important role. This strong global commitment indicates that governments are already adopting alternative policies—such as those in the World Alternative Policy Scenario—to achieve the G8 goals,” explained Mr. Ramsay. Under this Scenario, global oil and gas demand growth is lower, but the world continues to rely heavily on MENA oil and gas. CO₂ emissions fall 16% below the level of the Reference Scenario—but still increase around 30% by 2030.

Assumptions about international energy prices have been revised significantly upwards in WEO-2005, as a result of changed market expectations after years of underinvestment in oil production and the refinery sector. The average IEA crude oil import price, a proxy for international prices, averaged \$36.33 per barrel in 2004 and peaked at around \$65 (in year-2004 dollars) in September 2005. In the Reference Scenario, the price is assumed to ease to around \$35 in 2010 (in year-2004 dollars) as new crude oil production and refining capacity comes on stream. It is then assumed to rise slowly, to near \$39 in 2030. In the Deferred Investment Scenario the oil price reaches \$52 in 2030.

The World Energy Outlook 2005 contains over 600 pages of detailed statistics and in-depth analysis. The study was produced by the IEA with input from many international experts from producing countries, industry and organizations including OPEC. The IEA’s prestigious annual WEO series has long been recognized as the authoritative source for global long-term energy market analysis and has received honors for analytical excellence including awards from the Russian Academy of Sciences, the U.S. Department of Energy and numerous public and private organizations.

Answer. We do not believe that refining constraints contribute directly to the absolute level of oil price. Oil prices are high because of limited spare capacity and perceptions of increased geo-political risks. Supply interruptions from the recent hurricanes in the Gulf of Mexico have also tightened crude oil availability. The global refining system still has spare distillation capacity that can be used when needed. This has been demonstrated in the wake of hurricanes Katrina and Rita when at one point about 5 mmb/d of U.S. Gulf Coast capacity was shutdown. However, the rapid increase in oil demand growth since 2003 and the need for Saudi Arabia to produce increased marginal volumes of Arab Heavy has considerably tightened refinery upgrading capacity. This has resulted in relative over-supply of fuel oil compared to light and middle distillates. As a result the prices of heavy crudes that contain high fuel yields have deteriorated relative to lighter grades. It is this widening of the so-called “light-heavy” spread that reflects the constraints in the global refining system rather than the absolute oil price.

Industry investment must be based on long-term price expectations (guided by history) due to the long lead-times needed to bring new projects onstream and the long economic lives of those projects. But the industry clearly does respond to changes in prices (and especially to changes in future expectations): A June 2005 survey by Lehman Brothers shows that over 300 leading upstream companies planned to increase Exploration & Development spending in 2005.

The IEA forecast is a ‘business as usual’ scenario that is consistent with the IEA’s role of informing (on behalf of its consuming-country members) of energy market risks today and in the future.

As context, BP has no refining assets in the Middle East or North African region.

Question 4. Voluntary standards—Post hurricanes, what is the industry doing to come up with voluntary standards/best practices for back-up power supply to critical energy infrastructure (refineries, pipelines, etc.) and natural disaster recovery? Will the API undertake such an effort? If not, what is your company doing?

Answer. The loss of the power grid was a major cause of delays in restarting refineries, pipelines, and gas processing plants after Hurricanes Katrina and Rita. Even if one component of the fuel supply system has back-up electricity capability, it is of little use when other components are without power. Electricity is critical to the whole supply chain. Oil production can’t be restored unless there is electricity for pipelines to move the oil. For natural gas to flow, the natural gas processing plants must have electric power. Moreover, product pipelines must have power to move product.

The priority restoration of power to the major pipelines was a critical action that prevented potential shortages and panic at a critical time with a holiday increase in demand. Policymakers should consider establishing emergency powers authorities for priority power restoration for all components of the oil and natural gas infrastructure to be used in emergency situations.

The government should do whatever it can to make the electric grid more robust and reliable. Improvements to the reliability of electric power will significantly en-

hance the availability of petroleum products during periods of temporary emergency, such as that which occurred in the Gulf Coast region post-hurricane.

BP is reviewing its own requirements to evaluate whether additional stand-by power capability is necessary to operate critical infrastructure.

Question 5. A number of witnesses testified that failure of the electricity system resulting from hurricanes Rita and Katrina contributed in great part to the inability to get refineries restarted, or to get natural gas pipelines restarted. What are the arrangements for backup power in case of such emergencies at your critical facilities?

Answer. The following examples identify backup power that was arranged in anticipation of Hurricane Rita:

- A small, back-up generator that could operate independently of the power grid was installed at the Texas City refinery to provide on-site power for safety, security and instrument control panels.
- Diesel generators were leased and installed to provide power to major oil pipelines, such as Capline in which BP has an ownership interest.
- BP procured 2 portable generators to supply our product terminals.

BP generally relies upon backup power from the grid or the local utility for operations at its Texas City refinery and works with the local utility or grid operator to enable power restoration at critical energy infrastructure facilities.

BP has on-site cogeneration facilities at its Texas City refinery. These cogeneration facilities are designed to support steady-state industrial operations, not to provide power restoration following a hurricane or similar event. However, BP and Cinergy, its partner in the cogeneration facility, are investigating installation of a backup generator at the Texas City refinery that could startup independently from the grid (black-start capability) and provide power for startup of the cogeneration facilities and power to the refinery. Even though this may be technically possible, on-site management will need to address operational issues.

In light of other emergency situations, such as a cascading effect (or outage) experienced on the power grid that was not in the immediate proximity of the BP facility, these on-site cogeneration facilities would enable the BP facility to isolate itself from the power grid and continue limited operations.

While some of BP's other facilities have on-site generation or cogeneration, BP generally relies upon power via contract from the grid or the local utility for most of its facilities including: processing facilities and pipeline pumping or compressor stations.

Question 6. How many of your plants have on site cogeneration facilities? Which plants have these facilities?

Answer. For BP's largest refineries in the USA:

- There are cogeneration facilities located on-site at the BP refineries in Texas City, Texas and Carson, California.
- There is a cogeneration facility in Whiting, Indiana which provides steam to the BP refinery.
- BP does not currently have an on-site cogeneration facility at its Cherry Point, Washington refinery. However, BP has been actively pursuing a project to add a 500 MW facility at this site.

Additionally, BP has cogeneration facilities at its Green Lake and Chocolate Bayou Chemical Plants in Texas, the Wilmington Coke Calciner in California, at a production facility in Wattenburg, Colorado, and at the Naperville Research Center in Illinois. BP obtains steam from an on-site cogeneration facility at a chemical plant in Decatur, Alabama.

Question 7. Are there regulatory barriers at the either the state or federal level that prevent the installation of cogeneration plants at your facilities that do not have them?

Answer. While state or federal rules may not prevent or prohibit the installation of cogeneration plants at our facilities, there are key aspects that may significantly inhibit the economic viability of this type of investment in the future. BP has worked to overcome these obstacles to arrange for on-site cogeneration at most refineries.

Key aspects that must be addressed when considering installation of on-site cogeneration facilities include:

- Transmission Access including: 1) interconnection studies, wherein the host utility performs a study to determine whether transmission upgrades are necessary prior to interconnecting with a new power plant; and 2) the scope, priority, timing and cost of required transmission upgrades.

- Permitting Issues including: 1) the time period for permits and siting approval which is typically one to three years; and 2) purchase or acquisition of offsets for emissions prior to permitting.
- Negotiating a Utility Interconnection Agreement specifying the terms of interconnection.
- Availability and cost of contracting with the local utility for Backup, Standby and Maintenance power.
- The ability to sell excess power to a local utility under PURPA.

Question 8. Would the presence of cogeneration facilities at your refineries reduce the recovery time during such emergencies?

Answer. Cogeneration facilities coupled with back-up generation that could operate independently of the power grid (black-start capability) may reduce the recovery time in bringing an industrial facility (refinery) back on line.

BP and Cinergy, its partner in the Texas City cogeneration facilities, are investigating installation of a small backup generator that could startup independently of the grid (black-start capability) at the Texas City site which would provide auxiliary power to the cogeneration facilities. Auxiliary power would enable start-up of the cogeneration units and provide power to the refinery for partial operation in the event of a power outage. Depending upon the nature of the power outage on the grid (i.e. damage to transmission lines), on-site cogeneration facilities coupled with backup generation with black-start capability may reduce the recovery time to bring the refinery back on line.

There are certain emergencies and outages where on-site cogeneration facilities are beneficial. One example involves a cascading outage on the utility system or power grid that is not in the immediate proximity of the BP facility. In this case, BP can isolate certain operations from the utility power grid, or, in some instances, may help stabilize the grid while enabling the refinery to continue producing transportation fuels.

Question 9. Witnesses at earlier hearings testified that there are a number of modern natural generation facilities in the Louisiana/Texas area that are not used to their full capacity. Are there natural gas generation facilities in close proximity to your refinery facilities that could be used for backup generation at the refineries?

Answer. BP is not aware of any under-utilized power generation facilities near our refinery in Texas.

Question 10. Would use of generators that are in close proximity to refineries to provide backup power during such emergencies mean that recovery times might be shortened, since the restoration time for a nearby facility might be less than the restoration time for the transmission facilities for traditional utilities?

Answer. A coordinated program with local utilities and/or the grid operator is necessary to energize the grid in a safe and effective manner while providing early power restoration to critical energy infrastructure.

Recent examples of this type of prioritization and communication that enabled early power restoration to critical facilities are:

- Prior to landfall of Hurricane Wilma, BP requested and received priority designation for the Port Everglades Terminal in Hollywood, Florida resulting in power restoration within two to three days to the terminal.
- After Hurricane Wilma made landfall, a utility asked BP to identify critical portions of its retail gasoline network for power restoration so that the public could obtain gasoline and diesel fuel.

Establishing a priority for power restoration to critical energy infrastructure (to the extent practical along with high-priority human needs) would be beneficial.

If there were near-by generators that could startup independently from the grid (with black-start capability) that could follow load and re-synchronize with the grid when the grid was operational, this could be beneficial to provide for limited operations and duration if both the generator and the refinery were disconnected from the grid (isolated).

Environment

Question 11. Please specify exactly which, if any, Federal or State environmental regulations have prevented your company from expanding refinery capacity or siting a new refinery, and documentation on the exact details of the project prevented.

Answer. BP does not believe that any Federal or State environmental regulations have literally "prevented" us from expanding refinery capacity or siting a new refinery. Rather, the complex and overlapping environmental regulations have had the effect of discouraging efforts to expand refining capacity. In particular, New Source

Review (NSR) regulations have created a disincentive to expanding refining capacity.

In general, new refinery construction has been largely uneconomic for most of the past 20 years due to the low level of profitability in the industry. And, although profitability has improved over the past few years, what capital is available for refining has gone mainly for construction of pollution control equipment required by Federal and State regulations, and to construction of processing capability necessary to furnish fuels required by Federal fuels regulations.

Question 11a. How much have so-called “boutique fuel” requirements added to the average retail price, where applicable, and the average wholesale price per gallon of the gasoline sold by your company?

Answer. Typically, the more stringent the standards are for a “boutique fuel”, the greater the cost to produce such a fuel. The production cost of a “boutique fuel” will likely vary from refinery to refinery. Retail and wholesale prices are a function of supply and demand and it is impossible to quantify the impact that cost has on short term prices.

Question 11b. If the EPA or the Congress were to act to minimize the number of “boutique fuel” formulations required by the states to protect air quality, how many should there be and what should the specifications of each be in order to maintain air quality and improve fungibility?

Answer. Reducing the number of “boutique fuel” formulations to five would help to maintain air quality and reduce logistical constraints. The five-fuel slate for the summer season would consist of 9.0, 7.8 and 7.0 psi RVP conventional gasoline, RFG and GARB gasoline with GARB gasoline limited to California and its natural distribution system.

Question 12. Streamlining New Source Review (NSR) permitting constraints was mentioned as an incentive that would encourage refiners to supply more product to the U.S. market. How many air quality permit applications for refinery expansions has your company submitted for NSR over the last ten years? How long did it take the EPA, or the applicable State, to approve or deny each permit application, after receipt of a complete permit application? What was the expected percentage increase in product output of the expansion?

Answer. BP and its predecessor companies submitted two major NSR/PSD permit applications over the last 10 years. Information is not readily available concerning the length of time required for permit processing. Neither of the permitted projects resulted in a net increase of product output from the refinery.

It should be noted that while there were only two projects submitted for formal Federal NSR/PSD permitting, there were other projects for which considerable effort was expended to design the project to “net out” from the NSR/PSD thresholds and thus avoid the formal process. Also, there were many other projects which were inherently below the Federal NSR/PSD thresholds and thus were subject to state-only (or “minor”) NSR permitting.

Question 12b. How would you propose to streamline NSR and still maintain local air quality and prevent any increase in total annual emissions from such expansions?

Answer. BP supports full implementation of the NSR/PSD regulatory reforms which EPA developed over the past 15 years. The three rules were written by EPA after a fully collaborative stakeholder process; we believe they offer the best chance of clarifying and streamlining the NSR process while protecting air quality.

Question 13. How much did the fuel specification waivers that have been granted by EPA to date, due to the supply disruptions caused by the hurricanes, reduce the average retail price of the gasoline or other refined products made by your company?

Answer. The RVP waiver allowed BP to produce additional gasoline at its refineries by blending additional butane into the gasoline pool and significantly increase supply to the affected areas. We cannot say what, if any impact this has had on retail gasoline prices as the retail price is determined by a number of factors.

Additionally, with respect to the distillate market, the sulfur waivers on diesel fuel did not directly increase BP refinery production of diesel fuel, but did allow customers to substitute high sulfur diesel at the terminal which likely reduced the overall level of diesel outages in many locations. Again, cannot determine the impact on retail prices as the retail price is determined by a number of factors.

Question 14. One witness indicated that “getting two 100-year hurricanes in four weeks” caused a great deal of chaos and disruption in the gasoline supply chain. The National Oceanic and Atmospheric Administration has projected that the country and the Gulf of Mexico have entered a cyclical period of 20-30 years during

which the Gulf and coastal areas are likely to experience a greater frequency of hurricanes and higher odds of those hurricanes making landfall in the U.S. What preparations has your company made to deal with a greater hurricane frequency to decrease repetition of the supply disruption that occurred this year?

Question 15. Over the last 50 years, average annual sea surface temperatures have increased in the Gulf of Mexico and, according to the National Academy of Sciences and other similar scientific expert bodies, are expected to continue increasing as the oceans continue warming due to accelerating global climate change. The Administration's Climate Action Report (2002) stated "model simulations indicate that, in a warmer climate, hurricanes that do develop are likely to have higher wind speeds and produce more rainfall." What preparations has your company made to deal with a greater likelihood of greater hurricane intensity so as to decrease repetition of the disruption that occurred this year?

Answer. BP experienced direct impacts to facilities and production in the Gulf of Mexico (GoM) during the 2005 hurricane season. As a result, we have taken a comprehensive approach to mitigate impacts, going forward. For BP, the following are key areas of focus: Deepwater Facility Design & Operating Systems; Shelf Production Facilities; Export Systems & Flow Assurance Program; and Mobile Drilling Unit (MODU) rigs.

Deepwater Facility Design and Operating Systems

Improved communication links with offshore facilities—Each facility now has an independent satellite phone system as back-ups to existing micro-wave and satellite systems. We are moving forward with installation of a subsea fiber optic network project that will improve communication and monitoring of offshore facilities. We are also establishing more reliable metocean monitoring systems to allow remote monitoring of facility movements in storm conditions so we can improve future designs.

Personnel transportation—BP has chartered a fleet of the most modern and capable helicopters that have long-range and wide weather operations windows. These aircraft will enable BP to reduce evacuation and response times, improve safety and enhance our ability to conduct better post-storm assessments.

Future Deepwater Facility Design Criteria—BP has begun evaluating future facilities' design criteria and plans exist to review metocean conditions from the recent past (wind, waves, currents, hurricanes, other storms) to determine what has been the real impact of severe conditions and how BP can and should respond.

Outer Continental Shelf (Shelf) Production Facilities

BP has initiated work on three severely damaged platforms and three damaged caissons to remediate or decommission them prior to the 2006 hurricane season. Evacuation procedures have been strengthened to ensure that lift boats are moved to shore during low sea states before the storm. This will reduce risk of damage to production facilities from these vessels moving around in storms. Our aim is to decrease the impact of future hurricanes by focusing on strengthening the basic structures of our platforms and increasing investment in preventative maintenance.

Export Systems and Flow Assurance Program

BP is working with industry to provide multiple, economically viable, access points to BP's production facilities. Having redundant crude oil and natural gas transportation options will help minimize supply disruptions and expedite the return of any lost production to the market place.

Mobile Drilling Unit Rigs

Industry, MMS and the Coast Guard are working collaboratively to identify short and long term actions which can be taken to make MODU's more robust in times of increased hurricane activity. From this collaboration, interim guidelines will be developed for the 2006 hurricane season. There is concern about moored rigs and their station keeping capability during hurricanes. Key areas of focus include: reducing the probability of station keeping failure, reducing consequences in the event of station keeping failure, and achieving objectives with minimal impacts to exploration and development activity.

Question 16. How has your company disclosed to shareholders and investors the risks associated with the potential impacts on your company's assets in the Gulf of Mexico or indirect impacts on its assets elsewhere, of either the expected greater frequency of hurricanes making landfall in the U.S. or the probable greater intensity of hurricanes in the region?

Answer. In part I, Item 3 of our annual 20-F document, BP discloses external, reputational and operational risks associated with our business. The risk of adverse weather conditions is noted within the Operational Risks section.

FINANCES, PRODUCTION, IMPORTS, ETC.

Please provide for each of last ten years your company's:

- Gross revenue of U.S. operations
- Total capital expenditures in the U.S.
- Net profit of U.S. operations
- Total taxes paid to the Federal government
- Total taxes paid to State governments
- Total donated to charity

Answer. Note: Data is provided since 2000 because that is the year when BP completed the major consolidation of the Arco and Burmah Castro) acquisitions. Using financial and operational data prior to 2000 would not be comparable as BP was a much smaller company than it is today.

GROSS REVENUE OF U.S. OPERATIONS

[\$ millions]

	2000	2001	2002	2003	2004
Sales to third parties					
USA	71,084	84,696	80,381	108,910	130,652

Figures from BP's Annual Report & Accounts.

TOTAL CAPITAL EXPENDITURES, ACQUISITIONS IN THE U.S.

[\$ millions]

	2000	2001	2002	IFRS 2003	IFRS 2004
USA	34,037	6,160	6,095	5,967	6,005

2003-4 data is presented in accordance with International Financial Reporting Standards (IFRS). Prior year data is presented in accordance with UK GAAP, unless otherwise noted. Figures from BP's F&OI 2000-2004.

OPERATING PROFIT OF U.S. OPERATIONS

BP does not report net profit by geography due to the difficulties in allocating tax and interest at a segment and geographic level. As an indicator, however, we provide the following chart, which is the operating profit (pre-tax and pre-interest) by geography. The USA percentage of the total has averaged around 37% over this period.

	2000	2001	2002	IFRS 2003	IFRS 2004
USA	7,627	7,183	2,764	5,935	8,720

2003-4 data is presented in accordance with International Financial Reporting Standards (IFRS). Prior year data is presented in accordance with UK GAAP, unless otherwise noted. Figures from BP's F&OI 2000-2004.

TOTAL TAXES PAID IN THE U.S.

[\$ millions]

	2000	2001	2002	2003	2004
Federal income	2,206	2,039	(240)	1,089	2,072
State Income	353	153	157	392	351
Excise **	6,865	8,501	8,841	9,389	10,121
Production & severance **	793	658	533	770	894

TOTAL TAXES PAID IN THE U.S.—Continued

[\$ millions]

	2000	2001	2002	2003	2004
Real estate personal property	544	430	421	248	277

** Primarily U.S., however, includes expense related to foreign jurisdictions unable to separate in time allotted.

BP SOCIAL INVESTMENT

[\$ millions]

Global investment	2000	2001	2002	2003	2004
UK	15.4	14.9	13.9	12.7	11.7
Rest of Europe	5.3	8	6.2	8.2	6.5
U.S.	46	52.9	46.3	31.5	25.7
Rest of World	14.9	18.9	18.8	22	43.8
Global total	81.6	94.7	85.2	74.4	87.7

* Per BP Sustainability Report.

Question 17. How much additional petroleum refining capacity do you expect your company to install in the United States over the next 10 years?

Answer. Refinery margins are very volatile and margins over the last 10-15 years have not been high enough on average to justify building a new refinery. BP is planning a \$2 billion project focused on bringing Canadian crude to our existing Northern tier refineries (Whiting, IN; Toledo, OH, Cherry Point, WA). This investment will improve the security of crude supply and give better assurance of keeping refinery runs at maximum. Modest increases in gasoline production are anticipated.

Outside the Canadian crude project, BP is spending approximately \$700 million per year to insure that our U.S. refineries operate safely, in an environmentally appropriate way and achieve a high degree of availability to the American public.

Question 18. What percentage of profits over the last 10 years has your company re-invested in capital, exploration, drilling, and production in the United States? Please provide an annual total for those U.S. expenditures and a clear breakdown.

Answer. Note: Data is provided since 2000 because that is the year when BP completed the major consolidation of the Arco and Burmah Castrol acquisitions. Using financial and operational data prior to 2000 would not be comparable as BP was a much smaller company than it is today.

REINVESTMENT OF PROFITS

[\$ millions]

Total BP	2000	2001	2002	2003	2004
Replacement cost profit for the period	9,392	8,456	5,691	12,432	15,432
Capital expenditures and acquisitions	47,549	14,091	19,093	20,012	17,249
Ratio	506%	167%	335%	161%	112%

2003-4 data is presented in accordance with International Financial Reporting Standards (IFRS). Prior year data is presented in accordance with UK GAAP. Figures are shown in brackets because they are outflows. Figures from BP's F&OI 2000-2004.

Question 19. What percentage of profits over the last 10 years has your company re-invested in non-petroleum energy supply and production in the United States? Please provide a total and the results of such investment.

Answer. BP has invested approximately \$600 million in our alternative energy business over the past five years. BP Solar is in the process of more than doubling its annual global manufacturing capacity from 90MW to 200MW to be complete by the end of 2006. The first part of that expansion is seen in a \$25 million investment at our Frederick, Maryland plant—that part of the expansion project is now complete and the company is focusing on finalizing the rest of the expansion plan at facilities in Madrid, Bangalore, and Sydney.

Question 20. On average for the last ten years, please compare your company's overall capital expenditures in the United States to its expenditures elsewhere.

Answer. Note: Data is provided since 2000 because that is the year when BP completed the major consolidation of the Arco and Burmah Castrol acquisitions. Using financial and operational data prior to 2000 would not be comparable as BP was a much smaller company than it is today

CAPITAL EXPENDITURE INCLUDING ACQUISITIONS

[\$ millions]

	2000	2001	2002	IFRS 2003	IFRS 2004
USA	34,037	6,160	6,095	5,967	6,005
% of total	72%	44%	32%	30%	36%

2003-4 data is presented in accordance with International Financial Reporting Standards (IFRS). Prior year data is presented in accordance with UK GAAP, unless otherwise noted. Figures from BP's F&OI 2000-2004.

Question 21. What percentage of your company's gross revenue was collected in the United States in each of the last 10 years?

Answer. Note: Data is provided since 2000 because that is the year when BP completed the major consolidation of the Arco and Burmah Castro) acquisitions. Using financial and operational data prior to 2000 would not be comparable as BP was a much smaller company than it is today.

Gross revenue	2001	2002	2003	2004	2005
USA	71,084	84,696	80,381	108,910	130,652
Global	148,062	174,218	178,721	232,571	285,059
Ratio	48%	49%	45%	47%	46%

Figures from BP's Annual Report & Accounts.

Question 22. How much of your company's revenue collected in the United States was used to pay for purchasing crude oil from OPEC countries?

Answer. There is no reasonable way to determine what amount of U.S. generated revenue was used to purchase OPEC originated crude over the last 10 years.

Question 23. Do you support S. 1794 or something like it create gasoline and jet fuel reserves to ensure stability of price and supply? Should it be extended to diesel and other fuels like natural gas?

Answer. BP does not support the creation of a product reserve because we believe it would be ineffective. Unlike crude, the storage of product requires regular rotation of stock which is a complex and costly logistical issue. With the multitude of product types across the U.S., it is reasonably likely that the right product would not be available in the right place when needed. It is also likely, especially in events of natural disaster that the infrastructure (people, roads, pipelines, trucks etc.) would not be available to access the reserve. Lastly, when use of the product reserve would be required, it would be sold in to the market at spot prices which would be reflective of the emergency conditions. Thus unless there was a really large reserve, it wouldn't have the desired effect of avoiding price spikes. All these factors indicate that a product reserve would bring costs to consumers without necessarily giving them improved access to product in an emergency situation.

Question 24. On average for the last ten years, how much of what is refined by your company in the U.S. stays in the U.S.?

Answer. Initial review shows that more than 90% of finished product (gasoline and distillate) produced by our refineries stays in the U.S. Remaining product is largely sold to customers in Canada, Mexico and the Caribbean.

Question 24a. What amount of refined product did your company import in 2004 and in 2005?

Answer. This information is commercially sensitive and proprietary. We are willing to meet with you privately to discuss these matters under proper protections of confidentiality.

Question 24b. What are your assumptions about demand growth in India; in China?

Answer. We believe that oil demand in China and India will continue to grow with economic activity. In looking at demand we use consensus estimates from a variety of external forecasters including FACTS and Parpinelli-Technon.

Question 24c. How have your investments in the United States increased the energy security of the country?

Answer. Over the last 5 years BP has invested over \$31 billion in the United States to serve our customers and help meet the nation's need for energy.

Our U.S. investments have included continued expenditures in mature operations such as \$700 million per year in Alaskan North Slope fields, a 30% increase in lower-48 natural gas fields over the last two years to \$1.5 billion this year, and over \$650 million per year in refinery investments. Additional investments have also been made to maintain terminal and pipeline capability and to meet new regulations affecting distribution and marketing.

For the future we see continued opportunities to invest in the United States. Projects currently announced include:

- \$2 billion for new development and infill drilling in the Wamsutter natural gas field in Wyoming. This investment is expected to double BP's net production to 250 million standard cubic feet by the end of the decade.
- Two proposed LNG projects, one on the East Coast and one on the Gulf Coast at a cost of \$1.2 billion. These projects will allow us to access our natural gas 32 of 61 position in Trinidad and elsewhere in the world; and if approved, potentially add 2.4 billion cubic feet send out capacity of LNG to supply markets in the USA.
- \$300 million to increase the use of Canadian heavy oil at BP's Midwest refineries in order to secure a North American source of crude oil supply.
- \$2 billion per year sanctioned investment through the rest of the decade as a part of our continuing program to invest over \$15 billion in exploration and production in the Gulf of Mexico.
- BP has publicly announced its intention to participate in the nearly \$20 billion Alaskan Natural Gas Pipeline to bring Alaskan gas to the lower 48. We, together with other interested parties, are nearing completion of a commercial agreement with the State of Alaska.
- Building on the success of BP Solar—which expects to hit revenues of \$1 billion in 2008—BP Alternative Energy will manage an investment program in solar, wind, hydrogen and combined-cycle-gas-turbine (CCGT) power generation, which could amount to \$8 billion over the next ten years.

Question 25. What market signals will occur in advance of peaking world oil production and what is the appropriate policy or set of policies for the U.S. government to adopt when such signals occur?

Answer. Global oil reserves are sufficient to permit oil production to continue rising for many years. In fact, global proved reserves have been rising, not falling over time (which is true even if only looking at non-OPEC countries). Global natural gas and coal reserves are even more abundant.

- While non-OPEC conventional crude oil output may eventually plateau, total non-OPEC supply—including natural gas liquids, heavy oil, gas-to-liquids, coal-to-liquids, and biofuels—could continue rising, especially if prices remain above historical averages.
- The appropriate role for government policy is to ensure access to known resources at a competitive investment regime. Government should ensure that any externalities—environmental, etc.—are reflected in the price of competing energy sources. And policy should seek to encourage outcomes rather than dictate specific paths or options.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. RON WYDEN TO
ROSS J. PILLARI

Question. All over America, the oil industry drives up the price at our gas pumps by redlining and zone pricing. "Redlining" is when your companies draw a phony line around a community to lock out competition and raise prices for the consumers. "Zone pricing" is plain old discrimination and it takes place when one oil company supplies gas to several gas stations located near each other and one station is charged much more than the others for the same type of gas. This drives stations out of business, reducing choice and raising prices for consumers. To help hurting consumers at our gas pumps, will you company commit to stop redlining and zone pricing? Yes or no?

Answer. Zone pricing is a practice we use to recognize different competitive conditions that exist in different geographic areas. Various studies conducted by independent agencies and task forces have consistently found that zone pricing results in reduced consumer prices because it allows for greater competition. See, Md. Task Force on Zone Pricing (2001); and similar reports in Ohio, Penn and Minn. The FTC issued a report in 2001 discussing zone pricing exists, but concluding there was no evidence of collusion among refiners (see press release below). BP will continue to zone price as we believe this is fair to our dealers and ultimately our customers in the form of competitive prices.

For Release: May 7, 2001

FTC Closes Western States Gasoline Investigation

Investigation Finds No Illegal Activity By Oil Refiners

The Federal Trade Commission today announced the completion of its investigation of various marketing and distribution practices employed by the major oil refiners in Arizona, California, Nevada, Oregon, and Washington ("Western States"). After an almost three-year investigation, the Commission found no evidence of conduct by the refiners that violated federal antitrust laws.

According to Commissioners Sheila F. Anthony, Orson Swindle and Thomas B. Leary, the FTC initiated the investigation to explain the differences in the price of gasoline between Los Angeles, San Francisco and San Diego. Regarding the particular question that was investigated—whether there was a violation of antitrust laws—the investigation produced no evidence of illegal conduct by the refiners.

The Commissioners write that "[t]he investigation produced no evidence of horizontal agreement on price or output at any level of supply." While zone pricing—the practice whereby refiners "set uniform wholesale prices and supply branded gasoline directly to their company-operated and leased stations and to some independent open dealer stations within a small but distinct geographic area called a 'price zone.'"—exists in the Western States, the investigation found no evidence of collusion between oil companies in furtherance of this practice.

In addition, the Commissioners state that "the investigation revealed no evidence of conspiracy or coordination" in marketing practices known as "redlining"—the refiners' practice of preventing independent gasoline distributors—"jobbers"—"from competing with them to supply branded gasoline to independent dealers in metropolitan areas."

In the absence of such a conspiracy, redlining "likely would be evaluated under the rule of reason," which "would require the Commission to show actual or prospective consumer harm. " However, the investigation "uncovered no evidence that any refiner had the ability profitably to raise price market-wide or reduce output at the wholesale level, nor did it find a situation in which a refiner adopted redlining in a metropolitan area and increased market-wide prices." As a result of these findings, the Commission voted to close the investigation.

Commissioner Mozelle W. Thompson stated in a concurring statement that despite voting with the majority, he remains "somewhat troubled by the practice of site-specific redlining that some West Coast refiners utilize as part of their distribution strategies." Thompson adds that "[s]uch vertical restraints could be unlawful in those circumstances where—whether in the Western States or other gasoline markets—the practice leads to higher-than-otherwise wholesale prices." He concludes by saying he believes that, "should the Commission find evidence in any future investigation that site-specific redlining results in anticompetitive effects without generating countervailing consumer benefits, it would challenge the practice."

The Commission vote to close the investigation was 4-0, with Chairman Robert Pitofsky recused from participating.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. MARIA CANTWELL TO ROSS J. PILLARI

Question 1. I'm aware that the cost of crude oil is driven by the world market and that its cost is currently significantly above historic averages. But I'm not aware of any substantive increases in the cost of producing crude oil, the cost of refining it into various petroleum products such as gasoline and diesel, and the cost of transportation of refined products to markets. Through the end of September 2005, the price of crude had increased 40 percent in 2005 while gasoline prices increased almost 80 percent. If the percent difference in the prices isn't pure profit,

please explain to me how you account for the difference in the substantially lower increase in crude oil when compared to gasoline.

Answer. In the long-run prices reflect the marginal cost of production. However, in the short-term, prices can move from marginal cost due to disruptions to supply. The scale of the price response to supply disruption is affected in part by the availability of spare productive capacity and inventory levels. Price spikes by definition are short-lived as they sow the seeds of their own destruction by providing a signal to market participants to increase supply from other sources and to limit demand. During the U.S. hurricane season, the price of gasoline increased relatively more than crude as the loss of gasoline supply exceeded that of crude. Moreover, inventories of gasoline were and continue to be at lower levels relative to history than those of crude, increasing the price sensitivity of gasoline to supply disruption relative to that of crude.

In the long-run, refined product supply is tied to the marginal cost of production, with sustained prices above this level encouraging new supplies which in turn brings prices back to this marginal cost. For crude oil, cartel behaviour by OPEC does impact crude price but it should be noted that non-OPEC supply does respond to market principles. Notwithstanding this, the price of both crude oil and refined product is not always tied to the cost of production due to short-term events, as experienced this year.

In the short-run, prices will move above marginal cost on occasions when supply is constrained and/or demand exceeds expectations. In addition, prices are affected by the level of spare productive capacity and inventories.

Additional information is available in the paper below prepared by the American Petroleum Institute.

November 22, 2005

Market Determination of Petroleum Prices

Crude oil and refined petroleum product prices are determined by the forces of supply and demand in the world market. For both crude and products, the growth in spot markets and futures trading has increased substantially the transparency of the price-setting process. American refiners pay the world price for crude oil and distributors pay the world price for imported petroleum products. U.S. oil companies do not set these prices. The world market does. Whether a barrel of crude oil is produced in Texas or Saudi Arabia, it is sold in the highly competitive world marketplace, which is comprised of hundreds of thousands of buyers and sellers of crude oil from around the world.

CRUDE OIL MARKET

In the crude oil market, several "marker crudes" are widely traded in both spot and futures markets.¹ Changes in the prices of these marker crudes are quickly translated into prices for other crudes, with minor differences reflecting quality and transportation differentials. The best known of these markets are the New York Mercantile Exchange (where contracts for future delivery of West Texas Intermediate oil are traded) and the International Petroleum Exchange (where contracts for Brent crude are traded).

These markets have expanded substantially in the last 20 years and have also contributed to a significant increase in the trading of crude oil on so-called "spot markets," which are markets in which crude oil is bought and sold without long-term contracts. Trading of crudes on the spot market has increased significantly over the past two decades and has greatly facilitated refiners' ability to obtain adequate crude supplies. Moreover, as refiners compete for available crude supplies, the price on any given day reflects the independent judgments of the thousands of oil companies, petroleum consumers, investment banks and speculators regarding both the current supply and demand balance and the outlook for how this may change in future months.

Because of the fungibility of the crude oil market, changes in the price for crudes traded on the futures markets are quickly translated into changes in prices for crudes on spot markets, causing world oil prices to move together, as seen on the graph on page 2.* While crude oil prices fluctuate on a minute-by-minute basis, a

¹The term "futures markets" refers to those organized exchanges where standardized contracts for the delivery of crude and petroleum products at various future dates are bought and sold.

*The graph has been retained in committee files.

change in market conditions (for example, concerns about a political disturbance in a producing country) could cause prices to increase for crude that would be delivered months in the future. These higher future prices will, in turn, cause market participants to alter their perceptions of the current balance of supply and demand, possibly building inventories in anticipation of future market tightness, thereby taking crude off the current market and causing current prices to potentially rise.

The price changes for these marker crude oils can, in turn, lead to equivalent changes (with adjustments for quality and transportation differentials) in the prices for all other crudes. In this manner, expected changes in the future supply or demand for crude oil can very quickly be translated into changes in the prices paid for crude being bought and sold today.

REFINED PETROLEUM PRODUCT MARKET

Conceptually, the market for refined petroleum products is very similar to the crude oil market, with widespread trading of products on both the spot and futures markets.

Because it is the major component of petroleum product costs, changes in crude oil prices have a significant effect on petroleum product prices. In fact, the Federal Trade Commission has concluded: "Over the last 20 years, changes in crude oil prices have explained 85% of the changes in the price of gasoline in the U.S." Thus, changes in the future price of crude oil can lead to similar changes in the price of gasoline and other petroleum products. However, changes in the supply or demand of petroleum products arising from factors unrelated to the crude market (such as an expected hurricane that would interfere with refinery operations or colder than normal weather in the Northern Hemisphere) can also cause the price paid for product to be delivered today or months from now to rise or fall independent of crude oil price changes.

Similar to the crude oil market, a change in the price of gasoline or heating oil to be delivered some months in the future can lead to similar changes in the price being paid today on the spot market. These changes will also provide market participants with signals about whether they should be building up or drawing down inventories, thereby either adding to or subtracting from the supply of product currently on the market. A change in this spot price could, in turn, lead to a similar change in the wholesale, or "rack," price paid for unbranded gasoline by retailers and, in turn, in the prices paid by motorists at the pump.

In the wholesale gasoline market, there are generally several different prices quoted, depending on the relationship between the supplier and retailer and on the terms, if any, of their contractual relationship. Thus, the wholesale price paid by different retailers will likely differ slightly depending on such factors as whether there is a long-term supply agreement or whether the retailer has the right to use the supplier's brand. However, through the mechanism described above, a change in the market forces affecting the future supply or demand of petroleum product is quickly translated into a change in the prices being paid for gasoline at the pump today.

Question 2. Between 1981 and 2003, U.S. refineries fell from 321 to 149. Further, no new refineries have been built in the U.S. since 1976. In 1981, the 321 refineries had a capacity of 18.6 million barrels a day. Today, the remaining 149 refineries produce 16.8 million barrels a day. I recognize the difficult financial, environmental, and legal considerations associated with the location and construction of new refineries. But I fail to understand the closure of existing refineries even if they required investment to enhance their efficiency and production capability unless, of course, this mechanism is being used to increase the price of gasoline and other refined products. Please help me understand why you would shut down refineries in the face of the supply and demand situation. What conditions would have to exist for you to invest in new refining capacity? I have heard the industry claim that up to \$48 billion has been used on capital expenditures for existing refineries. If those investments were not used for capacity increases, what were they used for?

Answer.

- Refining is a highly volatile business. Investment decisions are based on long-term trends.
- There are numerous risk factors affecting the profitability of new refining capacity: demand growth, changes in crude quality & availability, refining technology, vehicle technology, regulations, competitor actions, etc.
- In the recent past, investment has been focused on clean fuels, regulatory requirements and extensive expenditures to maintain existing facilities.

- Refinery investment is often directed toward environmental compliance and safety and maintenance issues
- BP evaluates new investment options globally and has invested in existing refineries to maintain supply in global markets. With numerous factors impacting gasoline and diesel markets, the best and most efficient investments in the U.S. continue to be increasing capacity on existing refineries.

Question 3. The recent hurricanes resulted in the need to import substantial refined products such as gasoline, diesel fuel and aviation fuel to meet U.S. demand. The question has been raised as to whether the country should develop a strategic reserve of finished petroleum products. What would be your reaction if the Federal government either directly or by way of contract with the private sector sought to create a strategic reserve of finished petroleum products? Since these products have a limited shelf-life, one proposal is to obtain and operate a number of refineries and have the products be used by the Federal government. Appreciate your comments on this proposal.

Answer. BP does not support the creation of a product reserve because we believe it would be ineffective. Unlike crude, the storage of product requires regular rotation of stock which is a complex and costly logistical issue. With the multitude of product types across the U.S., it is reasonably likely that the right product would not be available in the right place when needed. It is also likely, especially in events of natural disaster that the infrastructure (people, roads, pipelines, trucks etc.) would not be available to access the reserve. Lastly, when use of the product reserve would be required, it would be sold in to the market at spot prices which would be reflective of the emergency conditions. Thus unless there was a really large reserve, it wouldn't have the desired effect of avoiding price spikes. All these factors indicate that a product reserve would bring costs to consumers without necessarily giving them improved access to product in an emergency situation.

Question 4. Given the recent profitability of the oil industry, I am interested to learn more on the disposition of these profits, particularly to enhance both production and refining capacity. Are any of these profits being used to enhance production and refining capacity for the benefit of other countries? What fraction of your profits is being invested for production and for refining? What percentage of profits have been used for stock buybacks and mergers and acquisitions?

Answer. Note: Data is provided since 2000 because that is the year when BP completed the major consolidation of the Arco and Burmah Castro acquisitions. Using financial and operational data prior to 2000 would not be comparable as BP was a much smaller company than it is today.

DISPOSITION OF FUNDS

[\$ millions]

Total BP	2000	2001	2002	2003	2004
Replacement cost profit	9,392	8,456	5,691	12,432	15,432
Share buybacks	2,000	1,300	700	2,000	7,524
Capital expenditures	11,107	13,167	13,303	13,986	14,408
Acquisitions	36,442	924	5,790	6,026	2,841

2003-4 data is presented in accordance with International Financial Reporting Standards (IFRS). Prior year data is presented in accordance with UK GAAP. Figures are shown in brackets because they are outflows. Figures from BP's F&OI 2000-2004.

Question 5. You've all said profits are cyclical, and that your companies have also suffered from the volatility of the oil markets. Would your stockholders be better served if domestically produced oil was sold at a fixed rate that included a generous profit margin above the production, refining, and distribution costs?

Answer. What is being suggested here is creation of a public utility model rather than a free market. We do not agree that shareholders are better served in a price regulated market.

Question 6. Do you believe that global warming is occurring? Do you believe that man-made activities have a role in this phenomenon? How will global warming impact your companies in term of added costs for oil and gas development, or allow access to new areas for oil and gas development?

Answer. While the science of climate change is unproven in absolute terms, BP believes there is sufficient evidence to suggest that human activity could affect the earth's climate in a serious way and that precautionary action should be taken.

BP was one of the first companies to commit to reducing CO emissions from its operations, establishing a goal in 1997 to reduce emissions by 10% from 1990 levels. BP achieved this objective several years early in 2001 and has established new goals to maintain these levels going forward.

On November 29, 2005, BP announced plans to create a new business unit called BP Alternative Energy. This business will be dedicated to developing alternative energy sources (solar, wind, hydrogen, combined-cycle-gas-turbine) for power generation. Investment in this new segment could amount to \$8 billion over the next 10 years.

BP's press release announcing the new business may be found at: <http://www.bp.com/genericarticle.do?categoryId=2012968&contentId=7012352>

Additionally, Lord John Browne's remarks regarding this new business may be found at: <http://www.bp.com/genericarticle.do?categoryId=98&contentId=7012385>

You may find additional detail regarding BP's position on Climate Change on our website: <http://www.bp.com/subsection.do?categoryId=4451&contentId=3072030>

Question 7. Is it accurate that United States LNG terminals in Massachusetts and Maryland are only operating at half capacity? Do you believe if these plants were operated at a higher capacity it would have changes the market dynamics that determine the current price?

Answer. For 2005, including forecasts for December, BP intends to utilize about 90% of its allocated theoretical capacity at Cove Point. BP does not own capacity at the Massachusetts terminal.

Question 8. I understand that Shell and BP have entered into the market and are now operating in the black. If that is accurate, what barriers are you experiencing in expanding this promising market? What federal incentives can Congress provide to help promote the solar energy market? How about advancing the shift to a hydrogen fueled economy?

Answer. BP has been a leader in the solar business for approximately 30 years and the solar business achieved profitability for the first time in 2004.

Enacting simple and uniform net metering and electricity grid interconnection standards and effective electricity time-of-use policies would help level the regulatory playing field currently disadvantaging distributed energy sources such as solar.

Extension of the current tax credits for residential and commercial solar customers for at least five years and incentives for technologies, like solar, that promote grid reliability and help reduce grid congestion could help promote solar market growth.

As to hydrogen, BP has been investing in hydrogen demonstration programs for the last five years. We are a major partner in the world's two largest—Europe's hydrogen bus demonstration project, known as Clean Urban Transport for Europe (CUTE) and the U.S. Department of Energy's fuel cell vehicle and infrastructure validation program. In total we are involved in more than 10 refueling stations around the world, testing a different technology, storage or delivery pathway at each one. These practical demonstrations help companies such as BP learn about what is required to help deliver the hydrogen economy.

In addition to the demonstration programs we are involved in we also participate in a number of committees involved in developing codes and standards for hydrogen transport (for example the DOE tech teams). BP is also an active member of the California Fuel Cell Partnership, the world's premier hydrogen transport organization, bringing together a unique combination of auto manufacturers, energy companies, technology suppliers and legislators. BP supports a variety of work in academia in the area of hydrogen for transport and maintains links with institutions such as the University of Delaware and UC Davis.

Since hydrogen can be made, transported and stored in a variety of ways it is very versatile as a fuel source, but that also creates challenges. As a result commercial availability of hydrogen and fuel cell cars is still several years away since it is not clear which pathways will be most economic. Fuel cell technology also needs to come down dramatically in cost and improve in driving range in order for customers to buy fuel cell vehicles.

Question 9. Please state for the record your company position on fuel economy standards. Are there other incentives that you support that you feel are better for consumers than the Corporate Average Fuel Economy paradigm?

Answer. BP fully supports conservation including increased vehicle efficiency standards. As to specific programs and tools, BP believes it is the role of government to select them and determine their funding.

Question 10. I understand that over the past 5 years companies in your industry have downsized significantly. Now there is a shortage in workers and equipment to increase drilling. Please explain that dynamic.

Answer. Over the past five years this industry has seen relatively low oil prices and industry consolidation. Now it is experiencing high oil prices. This dynamic is not uncommon for cyclical industries.

During the low price environment, the industry saw a curtailment of investment in drilling activity. This forced those who were employed in the drilling sector to find employment elsewhere, thus reducing the size of the workforce.

Now, the industry is in a period of high oil prices and demand for workers skilled in drilling are highly desired because of the surge in spending on drilling activity, new finds and other activities.

Meantime, U.S. universities and colleges are producing fewer graduates with degrees in math, science and engineering. Therefore, there is a smaller pool of potential employees from which to choose. Combine this with the fact that the average age in the oil and gas industry is approximately 50 and you see the real challenge the industry is facing.

In an effort to plan for the future and meet some immediate needs, BP is working with local, state and federal officials and educators to try to build the right educational and training programs to meet the needs of the industry, going forward.

Question 11. As you probably know, Congress is likely to open up the Coastal Plain of the Arctic National Wildlife Refuge to oil and gas exploration. Do you have plan to bid for leases in this area? What does the price of oil have to be to make ANWR exploration and extraction be economically viable?

Answer. BP does not comment publicly on its intentions regarding competitive exploration lease sales. Should the Congress and the President agree that energy development in ANWR is in the best interest of the United States, we will evaluate the opportunity, assess it against the other exploration opportunities in our global portfolio, and then decide, on the basis of many factors including compatibility with a clean environment and healthy wildlife populations—whether the coastal plain is a place BP should explore.

Question 12. I understand that many of your resources and equipment are working flat out to rebuild infrastructure in the Gulf of Mexico. If there is no capacity to expand oil and gas exploration, what good is opening up sensitive environmental areas to increased drilling going to do for the consumer in the short run?

Answer. It is true that the industry is working hard to rebuild infrastructure in the Gulf of Mexico. We are also focused on maintaining and enhancing production in the area. While the industry is presently facing challenges in labor and equipment markets; just as in other sectors, if new opportunities are made available the industry will size itself accordingly. Industry has proven repeatedly that it can meet challenges, if given opportunities.

Question 13. Given the growing demand for oil in Asia, do you believe that oil derived from the Arctic National Wildlife Refuge could be diverted to supply Asian markets? If drilling in the Arctic National Wildlife Refuge is authorized this year, when will it begin to have an impact on gasoline prices? What do you believe that effect will be?

Answer. Crude oil is a global commodity and where it ends up is a function of market conditions at the time it is produced. Historically, the natural market for Alaskan crude is the West Coast of the United States.

Question 14. Do you support more transparency in the oil and natural gas markets, as would be provided in my bill S. 1735?

Answer. BP supports more transparency in the oil and natural gas markets and supports the view taken by the Acting Chairman of the Commodity Futures Trading Commission who stated:

“To deal with the price reporting problems, there have been those who have called for an invasive government presence in the price reporting business. Some have called for the creation of a centralized data hub to which all natural gas, and possibly electricity prices would be reported. Under some proposals this would be a government-sanctioned entity with the power to force companies to report prices. In other scenarios, advocated by some in Congress, the hub would be a government regulator. As one can imagine, such an endeavor would be a huge undertaking as the regulator/data hub sought to ensure the integrity of prices in a widely diverse market. As an alternative I supported, and still do support, an industry initiative such as that proposed by the Committee of Chief Risk Officers, that establishes guidelines for reporting prices. I believe that such industry initiatives can be very

effective in stemming the price reporting problems in a less costly fashion than by interposing a regulator into a job that the market can perform itself.”²

Question 15. How has the last 3 years of escalating gasoline prices affected demand by American drivers? Have we seen a correlation between a certain level of price increase and less demand by American drivers? What is the actual level of reduced demand today compared to 3 years ago (please respond in the context of a doubling of retail gasoline prices)?

Answer. Information on gasoline demand in the DOE web site lags by a little over 2 months so we are just getting insights into demand post the Katrina environment. However, over the past 3 years gasoline demand as increased by 3% annually in an environment that also experienced increasing gasoline prices. While demand growth appears to have slowed in September following Katrina, it is unclear how this may impact full year 2005 growth rates.

Question 16. What is the crude oil extraction cost for major oil producing countries, including our own? How does that compare with oil derived from shale or coal?

Answer. BP does not have independent data on cost of oil extraction for different countries and production costs vary significantly with a given country for different projects. In general, finding and development costs industry-wide have been rising in recent years.

BP does not have investments in oil extraction from shale or coal.

Question 17. Regarding foreign exporting, inventory maintenance, and other practices of your company, please provide a response to each of the following questions and information requests: For each and every export shipment to a foreign country of gasoline, distillate fuel oil, propane, or liquefied natural gas occurring from January 1, 2005 to present, please provide the date, product type, volume, domestic port of exit, foreign destination, transportation costs, and the sale price or transfer value upon arrival at the foreign destination.

Answer. This information is commercially sensitive and proprietary. We are willing to meet with you privately to discuss these matters under proper protections of confidentiality.

Question 17a. Since January 1, 2001 to present, please identify the number of shipments wherein your company exported gasoline, distillate fuel oil or jet fuel and the sales price or transfer value received at the destination was less than the amount that would have been received had the product been marketed by your firm in the United States.

Answer. This information is commercially sensitive and proprietary. We are willing to meet with you privately to discuss these matters under proper protections of confidentiality.

Question 17b. Since January 1, 2001 to present, please identify the date, product, volume(s), foreign port of origin, expected U.S. port of entry, and eventual port of final destination in each instance wherein your company basically “turned a ship away” (whether proprietary product or acquired from a third party) by changing the shipments expected arrival in a U.S. port to a foreign port.

Answer. This information is commercially sensitive and proprietary. We are willing to meet with you privately to discuss these matters under proper protections of confidentiality.

Question 17c. From 1995 until present, please identify by month the inventory levels maintained by your company for gasoline and distillate fuel oil in both barrels and converted to “days of cover” or “days of supply” for your firm’s distribution and sales volumes within each of the Petroleum Allocation Defense Districts (PADDS) in the United States.

Answer. This information is commercially sensitive and proprietary. We are willing to meet with you privately to discuss these matters under proper protections of confidentiality.

Question 17d. From January 1, 2005 to present, provide the details of each “spot market” (as commonly referred to in the industry for bulk sales, in volumes exceeding 5,000 barrels per transaction) including the date, identity of both the seller and purchaser, location of the product being sold, and the selling price.

Answer. This information is commercially sensitive and proprietary. We are willing to meet with you privately to discuss these matters under proper protections of confidentiality.

²Overview of the North American Energy, Commodities and Developing Products Markets Sharon Brown-Hruska, Acting Chairman U.S. Commodity Futures Trading Commission International Swaps and Derivatives Association (ISDA) New York, November 17, 2004.

Question 17e. Describe your company's use of "in-house trading platforms," and identify all individuals in your company by name, address, email, and phone number that were authorized during 2005 to either exchange, trade, sell or purchase gasoline or distillate fuel oil on either the "spot market", NYMEX futures market, or via "forward paper" purchase rights.

Answer. BP does not publicly disclose personal information about its individual employees.

Question 17f. Please identify all third party reporting services, including but not limited to Oil Price Information Service (OPIS), Lundberg Surveys, Platts, and Oil Intelligence that your company regularly supplies transaction data or marketing information and all individuals of the company by name, address, email, and phone number that were authorized during 2005 to provide the information or data to such third parties.

Answer. The third parties that we presently report to are the following: PLATTS, OPIS, CMAI, JJ&A, ICIS and Dewitt's (to the last four entities, we report chemicals (aromatics) only). BP does not publicly disclose personal information about its individual employees.

Question 17g. Please identify the branded and unbranded "rack prices" that were reported by your company to third party reporting services such as OPIS and the branded and unbranded "rack prices" that were actually charged distributors or jobbers by your company each day, from January 1, 2005 to present, at the truck loading terminal(s) that typically supply gasoline stations in Houston, TX, Atlanta, GA, New York, NY, Chicago, IL, Los Angeles, CA, Portland, OR, and Seattle, WA.

Answer. East of Rockies, BP generally does not provide any rack prices to OPIS. BP sends a price notification of our branded and unbranded rack prices directly to our customers each day. OPIS then surveys a panel of customers to collect this information for its daily reporting. If there are any discrepancies between what we send to our customers and what OPIS publishes it is related to what the customer provided to OPIS as a part of its daily survey. On the West Coast, BP does report to OPIS for most finished products.

Regarding information on actual prices charged to distributors and jobbers, this information is commercially sensitive and proprietary. We are willing to meet with you privately to discuss these matters under proper protections of confidentiality.

Question 17h. Will your company commit that it will take no efforts to retaliate against any firm or individual that is a potential witness before this Committee or cooperates with any investigation into the oil industry by Congress or another governmental authority?

Response: Yes.

Question 17i. From January 1, 2005 to present, for each instance known to your company wherein a third party (not your company) exported gasoline, distillate fuel oil, propane, or liquefied natural to a foreign country, please provide any of the details known to your company including the identity of the exporter, date, product type, volume, domestic port of exit, foreign destination, transportation costs, and the sale price or transfer value upon arrival at the foreign destination.

Answer. We do not have information available pertaining to third parties.

Question 17j. Since January 1, 2001 to present please identify the identity, date, product, volume(s), foreign port of origin, expected U.S. port of entry, and eventual port of final destination in each instance wherein your company is aware a third party (not your company) basically "turned a ship away" (whether proprietary product or acquired from a third party) by changing the shipments expected arrival in a U.S. port to a foreign port.

Answer. We do not have information available pertaining to third parties.

Question 17k. Please provide an itemized list of tax deductions and credits taken under the U.S. tax code for 2004, by your parent company and subsidiaries.

Answer. This information is proprietary and confidential under laws and regulations pertaining to tax returns. BP complies fully with the tax filing requirements for companies operating in the United States. If there are particular tax issues you wish to discuss, BP is willing to meet with you to discuss them.

Question 17l. For each and every export shipment to a foreign country of gasoline, distillate fuel oil, or propane from BP's Cherry Point refinery in Washington state occurring from January 1, 2001 to the present, please provide the date, product type, volume, domestic port of exit, foreign destination, transportation costs, and the sale price or transfer value upon arrival at the foreign destination.

Answer. This information is commercially sensitive and proprietary. We are willing to meet with you privately to discuss these matters under proper protections of confidentiality.

Question 17m. For each and every export shipment to a foreign country of gasoline, distillate fuel oil, or propane from BP's Cherry Point refinery in Washington state occurring from January 1, 2001 to the present, please provide the date, product type, volume, domestic port of exit, foreign destination, transportation costs, and the sale price or transfer value upon arrival at the foreign destination.

Answer. This information is commercially sensitive and proprietary. We are willing to meet with you privately to discuss these matters under proper protections of confidentiality.

Question 17n. Since January 1, 2001 to present, please identify the number of shipments from BP's Cherry Point refinery wherein your company exported to a foreign destination gasoline, distillate fuel oil or jet fuel and the sales price or transfer value received at the destination was less than the amount that would have been received had the product been marketed by your firm in the United States.

Answer. Taking into account the entire slate of products produced by the Cherry Point refinery, no exports to a foreign destination yielded a lower overall refinery realization or value than if that product had been marketed in the United States.

Question 17o. Isn't it true that the refining capacity at BP's Cherry Point refinery has over time grown from 96,000 barrels per day to 225,000 barrels per day?

Answer. Yes, since the refinery went into operation in 1971, BP has increased its capacity from about 100,000 barrels per day to today's 225,000 barrels per day. However, current operations and future growth opportunities are being challenged by interpretations of the Magnuson Amendment. The Magnuson Amendment was enacted in 1977 to thwart plans for a crude oil pipeline project from Cherry Point to the upper Midwest. The legislation was not intended to restrict the ability of the Washington refineries to meet the regional demand for petroleum products. However, as a result of a recent federal court decision, BP faces a litigation risk that Cherry Point will not be able to obtain the crude oil needed to meet growing demand for gasoline and other products. Furthermore, lack of access to additional crude supplies acts as a deterrent to possible expansion of the refinery. The West Coast refineries together do not produce enough petroleum products to meet the regional demand. BP supports clarifying legislation to ensure that the Magnuson Amendment does not exacerbate the imbalance between supply and demand in the West Coast states.

Question 17p. Isn't it true that BP has previously stated that the Cherry Point refinery can take crude from the TransMountain Pipeline? Isn't it true that BP has also previously stated that the Cherry Point refinery can transport refined product by rail and via the Olympic pipeline?

Answer. BP gets 100% of its crude supply via water borne shipments. The refinery runs a combination of Alaska and foreign crudes based on availability. There is a pipeline that supplies crude oil from Canada to some of the other Washington based refineries. This pipeline is currently at capacity.

BP ships finished product by truck, vessel and the Olympic pipeline. Rail shipments are only available for butane and propane. The Olympic Pipeline is also operating at capacity and is currently unable to ship additional product from Cherry Point.

Question 17q. Isn't it true that the BP refinery is in a Foreign Trade Zone enabling you to export oil products overseas without tariffs? Since 2001, how much money has BP saved as a result of this tax benefit?

Answer. The BP Cherry Point Refinery is an active Foreign Trade Zone and has operated under zone status since October 2002. While there are benefits from being in a Foreign Trade Zone, they are not derived from the export of oil products.

Question 18. We request that you provide an explanation why your industry trade association would put out information about Senator Feinstein's amendment stating that major oil companies need to expense these exploration costs when each of you as the Chief Executive Officers of the API member companies affected by the Feinstein amendment told two Senate Committees that your companies didn't need these incentives.

Answer. Senator Wyden's question at the Senate hearing specifically referred to his proposed amendment to repeal the tax incentives that were enacted earlier in 2005 in the energy bill. Mr. Pillari's response to this specific question which Senator Wyden asked was "I would agree with what has just been said and say it's a minimal impact on us." With this answer, he agreed with the other witnesses who said that the new incentives in the bill would have a minimal impact on our company.

Senator Feinstein's amendment dealt with the expensing of intangible drilling costs (IDC), which have been the law in the tax code for decades. Expensing of IDC has been allowed on an optional basis from the early days of income taxation. Early

deductibility under the regulations was not mandated by the statute but was a recognition by the tax administrator of the nature of these costs and an appreciation of the risk and “intangible” character of these costs.

When, in 1945, a court found the regulations for current deductibility invalid because of the lack of express statutory authority, Congress expressly confirmed the deductibility of IDC, initially in a House Concurrent Resolution and finally in what is now IRC sec. 263(c).

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. KEN SALAZAR TO
ROSS J. PILLARI

Question 1. The Agriculture Committee is looking at the impacts these high energy prices are having on agricultural producers around the country. To sum it up: they are hurting. It seems to me that there is tremendous potential for our country to grow fuels such as ethanol and bio-diesel. This approach offers many benefits to rural America as well as to the country as a whole. What type of investments is your company making (and planning to make) in these types of renewable fuels in the United States?

Answer. BP is one of the largest blenders of ethanol in the U.S. In 2005 alone, BP will introduce gasoline-ethanol blends to more than twenty new markets in the U.S. This has been achieved through a mix of investment in blending capability at a number of proprietary distribution terminals and contracting for blending services at a number of third party terminals. This has all been done on the basis of economics that were supportive of this investment and product offering.

Question 1a. Rural America is crying out for investment in renewable fuels, and I encourage your companies to look at the potential of renewable fuels. In terms of a percentage of your capital expenditures, how much money did your company spend this year to develop renewable fuel sources in the United States?

Answer. In 2005, BP is investing approximately \$7 million for blending of renewable fuels at proprietary terminals.

Question 1b. What will that percentage be going forward?

Answer. BP is currently conducting research in next generation bio-fuels and evaluating options for expansion of conventional bio-fuels in our operations.

Question 1c. Will you also provide this committee with some examples of renewable fuel projects that your company is pursuing outside the United States?

Answer. Outside of the U.S., BP’s marketing activities are focused in Europe and Australia/New Zealand.

- BP is one of the largest blenders of biodiesel in Europe with most of its efforts focused on Germany.
- The blending of ethanol into gasoline is not common practice in Europe due to a differing distribution infrastructure and the absence of vapor pressure relief for gasoline-ethanol blends.

Question 2. As a few of you note in your testimony, diesel prices have remained high while unleaded gasoline prices have come down. It seems as if we are getting lower priced unleaded gas at the expense of diesel. Since diesel is the fuel of choice in agriculture, it is a sort of a double whammy on our producers. What is being done, or what can be done, to get diesel prices back in line with the price of gasoline?

Answer. As is the case with gasoline, market prices for diesel are set by supply and demand.

- Demand patterns for gasoline and diesel in the U.S. are significantly different. Demand for gasoline is largely driven by individual consumers who appear to have significantly reduced discretionary driving in response to high prices. Diesel demand in the U.S. is largely driven by commercial and agricultural uses with considerably less discretionary demand. This was particularly the case for agricultural demand with supply disruptions coming during harvest season.
- Supply of both fuels was severely impacted by the loss of domestic refinery production caused by Hurricanes Katrina and Rita. In the case of gasoline, high domestic prices attracted gasoline imports from refineries in Europe and the rest of the world to help cover the shortfall while the U.S. refineries ramped back up. Imports were not so readily available for diesel because global refining capacity for diesel is much more tightly balanced. Refineries have limited capability to shift production between gasoline and diesel. Supply conditions for diesel are likely to improve as domestic refining production recovers.

Question 2a. If demand for diesel is so high in Europe and high prices don't attract the supplies necessary to lower prices, isn't that a good indicator that we should work to produce more diesel in the United States and look to biodiesel as an option?

Answer. Refining investments have long economic lifetimes (15+ years) so investment decisions, whether for diesel or other products, need to consider the expected refining business environment over a similar time frame. BP bases its investment decisions on many factors including a forward view of supply and demand and tests those decisions against a range of possible scenarios.

Biodiesel has grown considerably in 2005 with the initiation of the \$1.00/gal federal tax credit, current diesel prices and initiation of the MN biodiesel mandate. However, it still remains well below 1% of the U.S. diesel supply. Significant new biodiesel production capacity has been announced. If current conditions persist, market forces may be expected to attract the output from these new plants into the diesel supply.

Question 3. For the record, will you tell me what your company has spent on capital expenditures in cash, not including write offs such as amortization or depreciation. Will you also provide the figures spent on cash dividends and stock buyback for the same time period?

Answer.

CASH BASIS

	2000	2001	2002	2003	2004
Capital expenditures	(10,037)	(12,181)	(12,098)	(11,885)	(12,286)
Acquisitions, net of cash					
acquired	(6,265)	(1,210)	(4,324)	(211)	(1,503)
Buybacks	(2,103)	(1,133)	(573)	(1,889)	(7,208)
Dividends paid	(4,439)	(4,881)	(5,304)	(5,674)	(6,074)

2003-4 data is presented in accordance with International Financial Reporting Standards (IFRS). Prior year data is presented in accordance with UK GAAP. Figures are shown in brackets because they are outflows. Figures from BP's F&OI 2000-2004.

Question 4. On November 1st, Senator Grassley asked your companies to contribute 10% of your record profits to supplement LIHEAP funding for the less fortunate. Will your companies support Senator Grassley's proposal?

Answer. LIHEAP (Low Income Home Energy Assistance Program) is a government program that provides financial assistance to families who are unable to afford their utility bills. BP agrees with the intent of the program. However, BP believes that it is the role of government to determine the funding levels for specific programs through allocation of its general revenues. BP does not make direct contributions to government programs but pays substantial amounts in federal and state income taxes which are the primary source of government funds.

Question 5. I'd like to encourage you to actively work with the Department of Energy and any other relevant federal agency on initiating a public/private education campaign focused on energy education and conservation. In the meantime, will you tell me what your company has done on its own initiative?

Answer. BP is highly supportive of industry efforts geared to energy efficiency and public education focusing on energy education, efficiency and conservation.

BP has been engaged in a partnership with the National Renewable Energy Lab that has produced a traveling energy education vehicle and interactive program for teachers and students.

BP has created a partnership with the Enterprise Foundation where we donate solar systems to needy families in inner-city Los Angeles.

BP has a long-standing relationship with the National Energy Education Development project that promotes the improvement of energy education capabilities of educators across the country. BP's A+ for Energy program in California (delivered by NEED) provides grants and scholarships to teachers for the delivery of energy and conservation education. The program is being expanded to Texas. NEED also helps deliver the Solar Connection program in Chicago, which offers selected schools solar systems and companion curriculum.

BP has built hydrogen fueling station pilot projects at Los Angeles International Airport, in Florida and Southeast Michigan and will build more in 2006. A number of educational visits have occurred as part of the demonstrations of the technology overall hydrogen fueling initiatives. In addition, BP is in partnership with Ford and Daimler Chrysler to bring fuel technology to the U.S.

BP continues to expand its solar partnerships with companies like Whole Foods and Home Depot where installations of solar systems are actively promoted to the public.

As a member of the American Petroleum Institute (API), BP is supporting an extensive effort led by API to encourage consumers to save energy. This campaign includes television, radio and newspaper ads.

As a member of the Center for LNG, BP has supported educational aspects regarding the need for diversified fuel supply and issues related to LNG.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. OLYMPIA J. SNOWE TO
ROSS J. PILLARI

I have introduced legislation that will offer an up to \$500 tax credit to working low and middle income individuals for the cost of home heating expenses. According to the National Energy Assistance Directors Association, heating costs for the average family using heating oil are projected to hit \$1,666 for the upcoming winter. This represents an increase of \$403 over last winter's prices and \$714 over the winter heating season of 2003-2004. Meanwhile, profits of oil and gas rose 62 percent in the third quarter for companies in the Standard & Poor 500 Index. I am proposing to offset the \$500 tax credit for home heating expenses by curtailing the benefit large oil companies receive by using the LIFO accounting method.

Question 1. Do you think given budget deficits and record profits for oil companies that it is appropriate to divert tax benefits for large integrated oil companies such as yours to pay for such a measure?

Answer. BP pays U.S. federal income tax at a 35% rate as well as a number of other taxes including excise, property, royalties and severance taxes. It is important to note that with the increased profits that BP has seen this year, we have paid a commensurate increase in taxes to the U.S. government. On a group basis, 2005 income taxes are expected to increase by 60% over 2004 payments and increases in the U.S. are of a similar magnitude.

It is appropriate for the Federal Government including the Congress to make decisions about how to use the revenues received from taxpayers from payment of federal income taxes. It is not appropriate for a taxpayer such as BP to determine the proper use of federal tax payments. With respect to use of the LIFO accounting method, the current LIFO accounting rules apply to all industries, and it is inappropriate to change the rules for the oil industry only. In addition, this change would result in a significant financial impact to the refinery side of the business at a time when Congress has expressed an intention to increase refinery capacity.

Question 1a. Does this seem like an equitable approach given that the high cost of oil enables you to not only bank large profits, but also to use accounting methods to substantially reduce taxes? Is it fair to report less taxes when you're profiting the most?

Answer. LIFO (last-in/first-out) is an accounting methodology that tracks and values a taxpayer's inventory for purposes of determining the cost of goods sold, which is deducted by the business from its gross income, and for determining the value of its inventory at year end. This inventory accounting method is based upon the assumption that the last goods brought into inventory are the first goods sold. The use of LIFO inventory accounting is not new and has been an accepted method under the tax code to determine a taxpayer's income since the 1930s. Like taxpayers in other industries, many oil and gas companies properly elected to use LIFO for their downstream inventory. At a time when the industry anticipated continued rising costs, LIFO was acknowledged to be the best method for tracking the true cost of inventory products. Denying access to standard accounting methods to a single industry is unfair.

The revenue raising measure that you are proposing is neither equitable nor is it sound tax policy. Energy prices are only one of a multitude of elements affecting the income tax that BP pays. For every other corporation that is subject to income tax the mix will be different. The common denominator for all of these taxpayers is taxable income to which a rate of 35% is applied. To the extent that BP's taxable income has increased because of energy prices 35% of that income will be paid to the Federal Government. From a policy perspective, a multiplicity of statutory tax rates would undermine the general neutrality of the income tax system in this country. It would also attract capital to industries that are adequately capitalized (and thus selling products at the lowest prices) and be a disincentive to investment in those that need it most.

Question 2. Your third quarter profits have certainly been a lightning rod that has riled consumers as they continue to pay 30 percent more in Maine for their home heating oil for the winter.

I realize that you reinvest some of these profits in exploration for more product. In each quarter, have you reinvested the same percentage of the profits to reinvestment? What have your reinvestment percentages been to your total profits? Do they vary from quarter to quarter or year to year?

Answer. Note: Data is provided since 2000 because that is the year when BP completed the major consolidation of the Arco and Burmah Castro) acquisitions. Using financial and operational data prior to 2000 would not be comparable as BP was a much smaller company than it is today.

GLOBAL CAPITAL EXPENDITURES & ACQUISITIONS

	[\$ millions]				
Total BP	2000	2001	2002	2003	2004
Replacement cost profit	9,392	8,456	5,691	12,432	15,432
Capital expenditures	11,107	13,167	13,303	13,986	14,408
Acquisitions	36,442	924	5,790	6,026	2,841
Ratio	506%	166%	335%	161%	112%

Figures from BP's F&OI 2000-2004.

Question 3. To what non-profit organizations and academic research that address global climate change does your company donate financial support to and how much to you donate each year?

Answer. BP supports a wide range of innovative research through partnerships with many diverse organizations. This research seeks largely to address the challenge of developing secure, reliable and affordable supplies of energy while at the same time reducing the impact of energy production and use on our natural environment. In 2003 our expenditures on all research totaled \$349 million while in 2004 those expenditures increased to \$439 million. Following are several specific examples of climate-related expenditures to non-profit organizations and/or academic research.

- Princeton University, U.S.—With Ford Motor Company, BP sponsors the Carbon Mitigation Initiative, a 10 year, \$20 million project that aims to find safe, effective and affordable strategies to reduce CO₂ emissions and solve the problem of climate change.
- The Carbon Capture Project (CCP)—BP is leading a public-private collaboration made up of industry, governments, NGOs and other stakeholders, funding commercial and academic research into carbon capture and storage. BP funding of this initiative has been approximately \$12 million to date with an expectation to spend several million more over coming years.
- Stanford University, U.S.—BP supports a three-year, \$2 million research program on public aspects of modern energy markets and climate change.
- The Chinese Academy of Sciences and Tsinghua University—BP supports “Clean Energy Facing the Future”—a 10-year, \$10 million program to develop and deploy new clean energy technologies for China and the rest of the world.
- The Tsinghua BP Clean Energy Research and Education Centre—an energy and environmental studies center established through a grant from BP.
- World Resources Institute—a project with leading environmental NGO to study the public policy aspects of a framework to enable a wider scale deployment of carbon capture and storage as a means to address greenhouse gas emissions.
- BP Solar Neighbors—a community program whereby celebrities help bring attention to the benefits of solar power, and help low-income families use solar power to reduce their energy bills. Every time an invited celebrity purchases a BP solar system for their home, BP donates a similar system to be installed on a low-income family's home in South Central Los Angeles. These families also become clean electricity users and learn about energy efficiency and solar energy so they can become environmental role models in their communities.
- A Plus for Education—A BP program that awards \$2 million in annual grants and scholarships to California K-12 teachers to implement creative and innovative educational programs to teach students about energy and energy conservation. The program will also be rolled out in Texas in 2006.

There has been much discussion about the skyrocketing costs of gasoline, heating oil, and other petroleum products over the past year, magnified by the three hurri-

canes which have hit the Gulf Coast region this year. In response to these inquiries into the rising prices and your soaring profits, you have asserted that these increases are tied to market forces, particularly rising prices of crude oil.

I've reviewed your financial filings from the Securities and Exchange Commission, and they paint a very stark picture when compared to the financial misery being experienced by millions of Americans. ExxonMobil, for example, has realized a net income of \$25.42 billion in the first nine months of 2005, an increase of \$8.5 billion over the first nine months of 2004. Exxon's third quarter net income this year was \$9.92 billion, up a full 90%.

Similarly, ConocoPhillips' net income for the third quarter of 2005 was \$3.8 billion, compared with \$2.006 billion during the same time period in 2004. Conoco's filing attributes this jump in profit to "higher crude oil, natural gas and natural liquid gas prices," "improved refining margins," and "equity earnings from our investment in LUKOIL."

In my State of Maine, the median state income is \$17,044 per year. A full 78 percent of Mainers use heating oil to warm their houses in wintertime, and this, combined with gasoline prices of anywhere from \$2.50 to \$3.00 per gallon paints a harsh picture for Maine and New England this winter. Petroleum is not any run-of-the-mill commodity. It is the lifeblood of commerce in this country, with fuel costs being built into the price of every other good bought and sold on the market. And in places like New England where petroleum heats most homes, it's literally a life-and-death commodity.

Question 4. Your industry has taken the position in its SEC filings and at yesterday's hearing that the escalation of its fuel prices is the result of increases in crude oil prices. However, if your retail gas prices were raised simply to cover your increased costs in purchasing crude oil, your net profits would remain the same. Everyone knows this is not happening. Can you identify for this committee the reason that the rise in gasoline prices is far out-pacing the rise in crude oil prices?

Answer. In the long run retail product prices must be sufficient to recover costs of raw materials, manufacture and transportation. In the short run, however, product prices are not cost-driven. The significant increase in crude oil prices over the last two years has caused refiners to look to recovering their increased costs. Refiners are only able to recover these cost increases, however, to the extent that demand is sufficient to absorb product at the increased price. If demand exceeds supply at a given price, the price will increase to the point that supply equals demand. This is the equilibrium price for a free market commodity.

Severe interruptions in the supply chain, such as that caused by the recent hurricanes, drive prices up because overall demand is bidding for scarce supplies. The severe peaking in the wake of the hurricanes was driven primarily by refinery and other supply chain interruptions rather than underlying crude oil prices.

Question 4a. Even though crude oil prices have risen this year, your companies aren't actually incurring those costs, are they? Isn't the gasoline and heating oil that your firms are currently selling on the market actually being produced from inventories that your companies purchased when the price of crude oil was much lower?

Answer. This question relates to LIFO inventory accounting procedures which are standard in many industries. LIFO accounting recognizes that a barrel of crude oil consumed today has to be replaced in inventory by a barrel purchased at today's price, therefore having an economic cost equal to the current crude oil price. In a rising raw material market, the theoretical input costs may appear to be lower than spot market prices for the input materials. In a falling market, the inverse is true, and costs can appear to exceed realizations for the finished goods. Over time, LIFO accounting, which is a generally accepted accounting procedure, fairly portrays manufacturing profit margins.

Question 4b. If you're producing oil from crude that you bought at \$40 per barrel, but selling it at a price that is purportedly based upon a \$70 per barrel cost to you, wouldn't that account for the 90% increase in profits we've seen?

Answer. Product prices are set by the supply/demand balance in the market, not by the price of raw material inputs, although if product prices are not sufficient over the long term to cover input and other costs, the enterprise will fail. BP's profits in 2005 are attributable largely to the production and sale of crude oil, not to the sale of refined products.

Question 5. I've alluded to the vital role petroleum plays in our economy and society, from the price of bread to the price of a plane ticket to the price of heating one's home. While you're obviously in the business for profit, there are other sectors of the economy where we put a limit on selling commodities at unconscionable prices. One example is usury law, where lenders are prohibited from charging unconscionable rates for borrowing money—because we recognize that access to cash

is critical to enterprise. How much more of a toll do these fuel prices have to take on our society before Congress steps in and places similarly appropriate regulations on your industry? Many consumers would say that raising the price of gas by \$2 per gallon over the past 2 years, while reaping over \$25 billion in profits is price gouging. Many lawmakers would agree. What do you say to them?

Answer. Prices for crude oil and refined products represent market driven commodity prices established by supply and demand. Neither the comparison of current prices to historical prices nor the profitability of market participants is sufficient to establish "price gouging." If demand outpaces supply, prices will increase. Historically cheap commodities may, in this way, become expensive over time. High prices and strong profitability attract entry in the free market model, and entry and competition drive prices down if sufficient supplies are available to meet demand. If sufficient supplies are not available, high prices encourage shifting to substitutes for the product in short supply. This leads to innovation and expansion of the economy overall. Free markets have served the United States well. BP believes that regulatory regimes that interfere with natural market forces do not work well and should not be considered in response to if the short run-up in consumer prices attributable largely to the hurricanes.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. FRANK R. LAUTENBERG TO
ROSS J. PILLARI

Question 1. In the last decade, has your company ever withheld supply of crude oil or refined product from the market in order to prevent prices from falling?

Answer. No.

Question 2. Please describe any business relationship or transaction your company or any of its subsidiaries, wherever located and wherever incorporated, whether wholly owned or not, have had with Iranian nationals (except employment of Iranian expatriates), the Iranian government, individuals or corporations located or incorporated in Iran, or any representative of these people or companies.

Answer. The Iran-Libya Act of 1996 (ILSA), renewed in 2001, mandates that the President impose sanctions on persons or entities which make new investments over \$20 million for the development of petroleum resources in Iran. Moreover, the Executive Orders of 1995 and ILSA restrict American company trade and investment with Iran without specific OFAC waiver authority.

Since the enactment of these laws and regulations, BP America, Inc and its subsidiaries have fully complied with all laws and regulations governing American company activity with Iran.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. PETE V. DOMENICI TO
JOHN HOFMEISTER

Question 1. What are you doing to bring oil prices down?

Answer. Shell does not control the price of oil. Oil is a commodity, and prices are set by the marketplace. Crude oil and natural gas prices fluctuate substantially and unpredictably. The industry must manage its business in the face of these severe price fluctuations. The business requires massive investment over long periods of time—even when prices are relatively low—to ensure that there will be energy supplies in the future. The energy consumed today is made possible by investments made years or even decades ago.

Oil and gas industry earnings per dollar of sales are in line with all U.S. industry during the second quarter of 2005. The energy industry overall earned 7.6 cents for every dollar of sales, compared to an average of 7.9 cents for all U.S. industry. The total dollar numbers may be large, but so are the billions of dollars that petroleum companies have invested to supply energy to U.S. consumers—and will need to re-invest—to meet future demand in a safe and environmentally sustainable way.

Shell has a history of making significant investments in the U.S. and is dedicated to growing the North American energy supply. Shell is an industry leader in the Deepwater Gulf of Mexico, beginning with the development of our Auger field over a decade ago. Over the past five years, Shell gross production in the Gulf of Mexico has been nearly one billion barrels of oil equivalent, and over the same period Shell has reinvested almost \$7 billion in new offshore supply capacity.

Shell is aggressively pursuing natural gas prospects in onshore North American basins. We are building new supply positions by developing both conventional and unconventional gas resources. Shell is investing in oil shale in Colorado, where we are testing a process to unlock very large oil shale resources by conversion in the

ground—using electric heaters to gradually heat the rock formation to release light oil and gas. This technology has the potential to recover over 10 times as much as traditional retort technologies, in a more environmentally sensitive way.

Question 2. What is the relationship between the price of oil that Americans are paying and the profits you are making?

Answer. See Answer to Question 1, above.

Question 3. The question I hear most from people is how is the price of oil set? Many Americans think oil companies are rigging prices to keep big profits. How would you respond to that?

Answer. See Answer to Question 1, above.

Question 4. Americans are being burdened with high oil, natural gas and gasoline prices while you all are raking in record profits. What do you say to those people that blame you for this and say that it is unfair?

Answer. See Answer to Question 1, above.

Question 5. Americans want to know if it is not costing so much more to produce a barrel of oil, why are prices rising so high?

Answer. See Answer to Question 1, above.

Question 6. What is your company's response to proposals for enactment of a Windfall Profits Tax?

Answer. History has demonstrated that a windfall profit tax does not work. In the 1980s, the windfall profit tax (WPT) drained \$79 billion in industry revenues that could have been invested into the U.S. economy to fund new production and infrastructure. A WPT discourages investment in domestic production and increases U.S. dependence on imported oil. The Congressional Research Service concluded that between 1980 and 1986 the WPT reduced domestic oil production by as much as 1.6 billion barrels.

Question 7. Do you believe that Americans are dangerously dependent on oil and its refined products?

Answer. Most American consumers and the U.S. economy currently depend on fossil fuels to heat and cool their homes, power their cars and run their businesses. Regardless of the answer to this question, Shell's goal is to invest both in new supplies of oil and gas, as well as in alternative energies and energy technologies of the future, all in an effort to meet U.S. energy needs today and tomorrow.

Question 8. The International Energy Agency's recent Global Outlook report expresses concern about world energy supplies and reliance on the Middle East for oil. Do you think the IEA's anxiety is justified?

Answer. IEA is in the best position to comment on its analysis.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. JIM BUNNING TO
JOHN HOFMEISTER

Question 1. Some analysts believe that OPEC is approaching its current oil production capacity. Given this, are oil companies looking at alternative sources of energy, such as liquid fuels made from coal, in order to expand their business and maintain energy supplies for the United States? Please include a review of the level of investment your company is making this year and the projected investment over the next three years in coal to liquid fuels initiatives.

Answer. Shell believes that coal-to-liquids (CTL) could play a role in addressing the USA's energy needs, particularly given the scale of U.S. coal resources and the strength of its established coal industry. Although CTL technology has been proven, the commercialization of the process remains challenged by high relative capital intensity, which argues for CTL projects of large scale coupled with a high confidence of sustained energy prices sufficient to stimulate private sector investment. Shell's clean coal business unit in the U.S. is focusing on delivering in North America the coal gasification process to a number of projects some of which include processes to convert natural gas to liquids.

Question 2. I have been concerned with the lag time between the wholesale cost of a barrel of oil and the retail price of a gallon of gasoline. As we saw following the hurricanes, in an ascending market where wholesale oil prices increase, there is a lag period of a few days before retail gas prices reflect this change. Similarly one would expect a lag in a descending market. My concern is that retail prices are not dropping as quickly as they rose, relative to the change in oil prices. Could you explain why price movements vary during a complete market cycle and whether you believe any part of the energy industry is unfairly profiting from this price lag?

Answer. Retail gasoline prices tend to move more slowly than the underlying cost of product. This “lag” effect is evident during periods when prices are rising as well as those times when prices are falling. The best way to measure profitability is over a longer period of time, after the market has experienced several rising and falling cycles. This type of longer-term measurement provides a more realistic representation of profitability.

Question 3. Boosting our domestic energy production is vitally important not only to our economy but also to our national security. Many of the countries we import oil from today are unstable, jeopardizing the reliability of sustained production. Please provide a chart for each of the last five years reflecting the percentage of your exploration and production budget that invested in the United States versus that invested overseas. Please also provide a chart reflecting your current projection of the percentage of your exploration and production budgets that will be allocated to projects in the United States versus overseas for the next five years.

CAPITAL EXPENDITURES FOR EXPLORATION AND PRODUCTION

Year	% invested in U.S.
2000	27
2001	26
2002	14
2003	18
2004	13

Our capital expenditure budgets are approved on an annual basis during the month of December, and therefore we cannot provide the data for the next five years.

Question 4. The disruption caused by the recent hurricanes displayed the United States’ vulnerability when it comes to domestic energy supply and production. What suggestions do you have to strengthen our energy supply and production capability?

Answer. To secure energy supply in the United States, industry must re-invest profits to meet both short and long-term needs. Congress should “do no harm” by distorting markets or seeking punitive taxes on an industry working hard to meet the energy demands. Other policy initiatives might include:

Access to Resources. Gaining access to diverse energy resources is a key to securing—energy supply to meet future needs. U.S. oil and gas production must be broadened to other parts of the country in order to ensure reliable and adequate energy supplies. Our current dependence on Gulf production was highlighted when Hurricane Katrina shut in 92 percent of the Gulf’s oil output and 83 percent of its natural gas production. Shell is actively exploring for oil and gas in all the areas in North America that are currently available, but most of the Outer Continental Shelf (OCS) is not available. Yet, there are about 300 trillion cubic feet of natural gas and more than 50 billion barrels of oil yet to be discovered on the OCS surrounding the Lower 48. Alaska OCS has an estimated 122 trillion cubic feet of natural gas and 25 billion barrels of oil. Access to oil and gas resources off our coastlines would be an important step, particularly in light of the fact that the hurricanes highlighted the U.S. dependence on the Gulf Coast for domestic oil and gas supply.

OCS Revenue Sharing. For years, the Gulf of Mexico has shouldered the burden of the U.S. offshore energy production. OCS revenues should be shared with states and communities that have production off their coasts, in order to mitigate the impacts of offshore development.

Conservation. Conservation is important in ensuring future energy supply. Energy efficiency and conservation affect demand and that, in turn, affects the market. Shell has found significant cost savings in our own facilities from energy conservation.

Workforce. Today, nearly 50 percent of all oil and gas industry workers are over the age of 50. The available skilled workforce is aging, and interest in energy-related educational opportunities is shrinking. We need engineers, scientists, inventors, drillers, geologists and skilled trades people to meet our energy needs. Shell has funded a number of workforce initiatives and encourages governments to consider the same.

Question 5. It has been suggested that the United States consider developing a strategic gasoline and natural gas reserve, similar to the Strategic Petroleum Reserve we currently have. Some analysts suggest that such reserves may minimize price spikes in these commodities during periods of market supply disruptions. What are your views on whether a strategic natural gas or gasoline reserve would

be feasible and whether they might help minimize price increases during periods of market uncertainty?

Answer. The creation of strategic reserves for natural gas, gasoline or other products must be carefully considered. The creation of such reserves would involve tremendous costs, logistical challenges and operational complexities. Comprehensive studies should be done to determine whether such reserves are feasible, cost-effective or helpful.

Note, for example, that proposals to create gasoline product reserves have been considered and rejected several times by the California Energy Commission, which found that "a strategic fuel reserve could have several unintended consequences, which could limit its effectiveness as a tool to moderate gasoline price spikes and could reduce the total supply of gasoline to the state." The National Petroleum Council also concluded that strategic product reserves are not appropriate for the U.S.

Question 6. China is becoming a bigger world oil player. This not only has tightened the world oil market but also has produced national security concerns for us. What concerns or problems do you see have arisen since China became a bigger world energy player?

Answer. China's rapid economic growth has resulted in a corresponding growth in energy demand. Because energy markets are global, it is impossible to isolate a single nation or region in evaluating energy supply/demand forecasts. Keeping pace with worldwide growth in energy demand will be a challenge. It will require very large investments in complex, costly and technologically demanding projects.

Question 7. While there have been expansions and efficiency gains at existing refineries, no refinery has been built in the United States in 30 years. Since the oil companies are now making record earnings, are there plans to build new refineries in the United States?

Answer. Neither Shell nor Motiva (a U.S. joint venture between Shell and Saudi Refining, Inc) currently have plans to build a new refinery in the United States. However, from 1994 to 2004 Shell and Motiva refineries in the U.S. increased overall capacity by about 30 percent and invested significant capital expenditures to do so. Shell will continue to consider optimizing its refining assets in all markets to take advantage of existing site infrastructure for expansion and debottlenecking. Motiva recently announced that several options are being considered to increase production of gasoline, diesel and aviation fuels at its Gulf Coast refining network. Capacity expansion projects being considered range from 100,000 barrels per day to 325,000 barrels per day.

Question 8. The 2005 Energy Bill implemented a controlled phase-out of MTBE. Many companies, however, are planning on completely halting its use. How will a sudden halt of the use of MTBE affect the gasoline market and refineries?

Answer. It is unclear if there will be a sudden halt in the use of MTBE. However, a sudden halt could reduce the total gasoline pool depending on what refiners choose to do to replace the lost volume.

Question 9. I have noticed very large differences between the prices of gasoline in different areas of the country. For example, I recently saw gasoline in northern Virginia that was much more expensive than gasoline in northern Kentucky. Please explain why there can be such a significant difference in gasoline prices in different areas of the country.

Answer. Prices in markets will vary as every market is subject to unique conditions. Fuel prices are affected by a number of factors including the cost of crude, formulation requirements, state taxes, supply and distribution logistics, local market conditions, environmental regulations and operating costs. These factors vary in each market.

Question 10. When was oil first traded on the worldwide commodities futures market?

Answer. To the best of our knowledge, the first contract on a regulated futures exchange was in 1978, when a Heating Oil contract was introduced on the New York Mercantile Exchange.

Question 10a. Would the price of oil be affected if oil was taken off the commodities futures market and no longer traded?

Answer. There is no reason to believe prices would be higher or lower on average. Prices would continue to reflect supply/demand fundamentals, as they do now. However, prices might become less reflective of true market conditions at any given moment.

Question 10b. Would oil then be bought and sold as a true supply and demand product?

Answer. Oil currently is priced by supply and demand.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. JAMES M. TALENT TO
JOHN HOFMEISTER

Question 1. The recent hurricanes have highlighted the need for increasing refinery capacity, which was already operating at a tight margin of 97 percent. While that is laudable for efficiency purposes, it allows no room for error in case of sudden outages or demand increases. What is the optimal amount of spare refining capacity to ensure a reliable supply of finished petroleum products at stable prices?

Answer. Shell is not aware of an industry specific optimal amount of spare refining capacity. Competitive forces within a free market system are the best way to determine capacity, supply and prices. A free and competitive market ultimately serves the best interest of the consumer.

Question 2. How has industry consolidation impacted the amount of spare production and refining capacity?

Answer. Shell is not aware of industry consolidation directly impacting spare production and refinery capacity. Since 1990, according to API, refinery capacity has grown from 15.5 to 17 million barrels per day.

Question 3. Describe the degree of competition between refineries for crude oil supplies and sales to retailers. What percentage of crude oil processed in the U.S. is processed by integrated companies (i.e., those produce and refiner) versus refined by independent refining companies?

Answer. There is a tremendous amount of competition between U.S. refineries for crude oil supplies. Several factors come into play when buying crude oil—the quality, sulfur, gravity, country of origin/location, method of shipping, as well as the location of the refinery and financial factors, including term contracts and market conditions. Availability of crude barrels is a significant factor. Weather and unplanned outages of refineries/production facilities affect the global market.

Percentages of crude oil produced by integrated companies versus independent refining companies can be found on the DOE website. The information includes all refiners. www.eia.doe.gov

Question 4. How has the amount of refining capacity tracked changes in demand for gasoline and diesel over the last 30 years?

Answer. According to DOE data acquired by API, the amount of refined product supplied to the U.S. market over the last 30 years has exceeded U.S. refining capacity, except for a period from 1980 to 1984. Demand has been met by a combination of both domestic refined product and the importation of refined products from overseas. Since 1985, there has been stronger growth in demand compared to refining capacity; however, refining capacity has continued to increase since 1994.

Question 5. Explain to me your company's plan to increase refining capacity in the U.S. to meet the need for new refinery capability.

Answer. Shell will continue to consider optimizing its refining assets in all markets to take advantage of existing site infrastructure for expansion and debottlenecking. Motiva recently announced that several options are being considered to increase production of gasoline, diesel and aviation fuels at its Gulf Coast refining network. Capacity expansion projects being considered range from 100,000 barrels per day to 325,000 barrels per day. Note, too, that we have increased capacity as demand has grown. From 1994 to 2004 Shell and Motiva refineries in the U.S. increased overall capacity by about 30 percent while investing significant capital expenditures to do so.

Question 6. EPA 2005 removed the requirement to include oxygenates from gasoline, largely because of concerns over the use of MTBE. What is the impact on the price of removing oxygenates from gasoline?

Answer. The price impact will vary depending on market conditions.

Question 7. Are there other oxygenates that can be used in place of MTBE, such as using ethanol to make ETBE, and how does the cost of such alternative additives compare to the cost of gasoline?

Answer. As of May 2006, it will no longer be necessary under federal law to use oxygenates in gasoline. Refiners may choose to use an oxygenate, such as ethanol, and will likely make such choices based on a variety of factors. The relative costs of alternative additives vary depending on market conditions and may be more or less than the cost of other gasoline components.

Question 8. Have you studied the use of ETBE, the cost of converting MTBE plants and how long it would take to do so, and whether ETBE avoids the leakage/

water contamination problems that were caused by MTBE? How do the costs of retrofitting MTBE plants to produce ETBE and use it to increase the volume of gasoline produced by a barrel of oil compare to the cost of expanding existing or adding new refinery capability?

Answer. Yes, Shell has studied the cost of converting MTBE plants. At this time, however, Shell has no plans to use ETBE as a gasoline additive in the U.S.

Question 9. What, if anything, is preventing your company from using ETBE in place of MTBE?

Answer. While Shell is not prevented from using ETBE in place of MTBE, Shell has no plans at this time to use ETBE as a gasoline additive in the U.S. ETBE has chemical properties similar to MTBE. Therefore, use of ETBE as a replacement for MTBE may not be significantly different from a groundwater perspective.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. GORDON H. SMITH TO
JOHN HOFMEISTER

Question 1. I have a bill, S. 1743, to give the Federal Trade Commission, additional authority to prevent and punish price gouging in the aftermath of a major disaster. My bill provides effective authority to the Federal Trade Commission to protect consumers from being victimized in the wake of a disaster without hampering the normal functioning of the free market. It even recognizes that there are legitimate reasons why prices may increase. Do you think that this consumer protection authority should be available to the FTC?

Answer. The FTC already has effective authority to protect consumers from unlawful pricing practices.

Question 2. Would this serve as a deterrent to price gouging by individual retailers?

Answer. Shell has a strong history of competitive pricing and does not condone price gouging in any form. It is unknown what effect S. 1743 might have on independent retailers.

Question 3. Can you tell me why diesel prices continue to remain significantly higher than gasoline prices in Oregon?

Answer. Nationally, diesel prices have been higher than gasoline for an extended period of time. Diesel and gasoline prices are impacted by similar market fundamentals, but they can and do operate independently if the underlying supply and demand is impacted for one product more than the other. In the case of diesel, growing economies tend to expand demand as industry uses fuel to power factories, utilities use diesel fuels to generate electricity, and transportation demand increases as goods are moved from one part of the country to the other. At the same time, diesel supply is impacted as refineries experience planned or unplanned maintenance and begin the necessary modifications to reduce the amount of sulfur contained in diesel fuels. All of these elements impact the ultimate price a consumer pays for diesel fuel.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. JEFF BINGAMAN TO
JOHN HOFMEISTER

Question 1. Section 392 of the Energy Bill, which was negotiated with the involvement of the Chairman and Ranking member of the Energy and EPW Committees, contains permitting streamlining language. The Energy Policy Act of 2005 permits the EPA Administrator to enter into a refinery permitting cooperative agreement with a state. Under such an agreement, each party identifies steps, including decisions timelines, it will take to streamline the consideration of federal and state environmental permits for a new refinery. I want to ask you several questions about that provision, since you have supported streamlining: Have you requested that EPA issue any regulations or take any action to implement these new provisions? If yes, when? If no, when do you anticipate that you will do so?

Answer. Neither Shell nor Motiva has formally requested this step. However, on the refinery expansion project that Motiva is considering along the Gulf Coast, if Motiva submits a permit application to either Texas or Louisiana the company would meet with EPA Region 6 officials as well as EPA HQ to brief them on the project and to set out the desired timeline for permitting.

Question 1a. Have you worked with any state to encourage them to enter into an agreement with EPA under Section 392 of EPA Act?

Answer. Neither Shell nor Motiva has formally used this process.

Question 1b. Do you support EPAct streamlining provisions?

Answer. Yes, we do support the streamlining provisions.

Question 1c. Do you have any examples of where a state came to EPA and said we want to work closely with you on permitting a new refinery or refinery expansion and EPA refused to provide technical assistance and even financial resources under existing law to that state?

Answer. Shell is not in a position to know about interactions between individual states and the EPA.

Question 2. In answer to several of the questions at today's hearing (Nov. 9) the witnesses (you) have noted that the market for petroleum and petroleum products is a global one and should be viewed in that context. Please list all planned refinery construction that your company plans to undertake globally. Please list them by country and include the projected size of the facility, including the projected capacity for all units and their potential product yields in addition to the project's total investment cost.

Answer. Shell Oil Company is the domestic operating company of Royal Dutch Shell and as such SOC has no investments planned outside of the U.S. Previously in this questionnaire, we mentioned Motiva expansion plans are being considered in the U.S. In Singapore, affiliates of Royal Dutch Shell recently announced the awarding of contracts for basic design and engineering for a potential world-scale ethylene cracker facility at the Pulau Bukom manufacturing complex. Potential product yields and investment costs have not been disclosed.

Question 3. The International Energy Agency (IEA) has just released its World Energy Outlook 2005. It contains a piece on the global refining picture. The study notes a lack of investment in upstream and downstream capacity has contributed to the extreme tightness in global oil markets. What are your thoughts in response to this? What is your company doing in response (actions)? What is your company doing (investments/analysis) in the "MENA" regions? Do you agree with IEA's projections?

Answer. The IEA report summary provides a plausible explanation for tight global oil markets. Actions taken by Shell include the following:

Globally, this year Royal Dutch Shell plc has expended a total of \$15 billion in capital investments: \$10 billion in exploration and production, \$2 billion in gas and power and \$3 billion in downstream. In the U.S., Shell Oil Company has invested over the last five years virtually 100 percent of U.S. after-tax earnings in U.S. projects to meet future energy needs.

Returning production and refining capacities to pre-hurricane levels is a priority. The U.S. Congressional Budget Office estimates the energy sector sustained capital losses from hurricanes Katrina and Rita between \$18 billion to \$31 billion.

Shell has major upstream investments in the Gulf of Mexico, where we have reinvested almost \$7 billion in the last five years. We are pursuing natural gas in the Gulf as well as onshore. We have a major oil shale investment in Colorado, testing a process to unlock very large oil shale resources.

Motiva Enterprises LLC, a joint venture between Shell Oil Company and Saudi Refining Inc, announced in September that it is studying options for major capacity expansion at its refineries in the U.S. Gulf Coast—a project that, once decided, will take years to complete.

Shell is investing in LNG and hydrogen as well as renewable energy sources such as solar and wind. Although renewable energy technologies are a small part of the total global energy mix, their annual growth rate outperforms traditional fuels. Shell has major developing new technologies such as coal gasification, oil shale, gas-to-liquids and biofuels we will be able to put more supply into the marketplace.

Question 4. Voluntary standards—Post hurricanes, what is the industry doing to come up with voluntary standards/best practices for back-up power supply to critical energy infrastructure (refineries, pipelines, etc.) and natural disaster recovery? Will the API undertake such an effort? If not, what is your company doing?

Answer. It our understanding that API is evaluating this important issue. Shell continuously strengthens its preparation and response activities, and to ensure that consumers have an adequate supply of fuel at all times—especially during emergencies. For example, shortly after Hurricane Katrina, the Shell Pipeline Company procured thirteen 1-megawatt generators. These units are capable of powering even our largest electric pump drivers and were later needed to make critical movements from our Port Arthur Products Station in the absence of commercial power. We are reviewing needs at other critical facilities and intend to make similar back-up power procurements where practicable.

Question 5. A number of witnesses testified that failure of the electricity system resulting from hurricanes Rita and Katrina contributed in great part to the inability

to get refineries restarted, or to get natural gas pipelines restarted. What are the arrangements for backup power in case of such emergencies at your critical facilities?

Answer. See Answer to Question 4, above.

Question 6. How many of your plants have on site cogeneration facilities? Which plants have these facilities?

Answer. Five of our plants in the U.S. have on-site cogeneration: Shell Deer Park Refinery and Chemical (Texas); Motiva Port Arthur Refinery (Texas); Shell Geismar Chemical (Louisiana); Shell Los Angeles Refinery (California); Shell Martinez Refinery (California).

In addition to the above facilities, Shell is a minority owner of the March Point Cogeneration Company, a cogeneration facility located on the Puget Sound Refinery property.

Question 7. Are there regulatory barriers at either the state or federal level that prevent the installation of cogeneration plants at your facilities that do not have them?

Answer. Four of our plants do not have cogeneration facilities: Motiva Convent Refinery (Louisiana); Motiva Norco Refinery and Shell Norco Chemical; (Louisiana); Mobile (Alabama); Puget Sound (Washington) (reference March point Cogeneration note above).

Decisions to build cogeneration facilities are based on environmental regulations, local electricity costs, plant requirements and internal economics. Cogeneration projects have been considered at the above plants and did not meet internal economics or could not compete with local utility electricity costs.

Question 8. Would the presence of cogeneration facilities at your refineries reduce the recovery time during such emergencies?

Answer. Recovery time for our plants is dependent upon many factors including parts of facility impacted by severe weather, natural gas supplies (that may feed a cogeneration facility), electricity and availability of feedstocks. Recovery time could be reduced if cogeneration facilities were on site and functional when traditional utility facilities are out.

Question 9. Witnesses at earlier hearings testified that there are a number of modern natural generation facilities in Louisiana/Texas area that are not used to their full capacity. Are there natural gas generation facilities in close proximity to your refinery facilities that could be used for backup generation at the refineries?

Answer. There are no generation facilities in close proximity that could be used for back-up generation.

Question 10. Would the use of generators that are in close proximity to refineries to provide backup power during such emergencies mean that recovery times might be shortened, since the restoration time for a nearby facility might be less than the restoration time for the transmission facilities for traditional utilities?

Answer. Generally, yes, when electricity is a critical path item.

ENVIRONMENT

Question 11. Please specify exactly which, if any, Federal or State environmental regulations have prevented your company from expanding refinery capacity or siting a new refinery, and documentation on the exact details of the project prevented.

Answer. We are not aware of any environmental regulations that have prevented us from expanding refinery capacity or siting a new refinery.

Question 11a. How much have so-called "boutique fuel" requirements added to the average retail price, where applicable, and the average wholesale price per gallon of the gasoline sold by your company?

Answer. Boutique fuels generally cost more to produce because they require special production and handling, which can cause inefficiencies in the distribution system. In the event that supply or transportation is disrupted, boutique fuels create the potential for significant price volatility because supplies cannot be readily shifted between areas.

Question 11b. If the EPA or the Congress were to act to minimize the number of "boutique fuel" formulations required by the states to protect air quality, how many should there be and what should the specifications of each be in order to maintain air quality and improve fungibility?

Answer. Refiners now produce numerous, different fuels to satisfy state and federal requirements. There are several factors to consider when evaluating whether or not to reduce the number of boutique fuels such as ensuring air quality needs, the impact on supply, cost issues and distribution compatibility. After weighing those factors, we recommend reducing the number of gasoline formulations to ap-

proximately 5 in order to streamline and simplify this complex system. There is a proposal by API to consolidate fuel requirements to five standardized fuels, which Shell supports. The proposal would provide states with fuel options that ensure continued progress toward attaining air quality standards. The fuel options available to states would depend on air quality need, cost-effectiveness, the availability of other, more cost-effective emissions controls, and compatibility with the nation's gasoline manufacturing and distribution system.

Question 12. Streamlining New Source Review (NSR) permitting constraints was mentioned as an incentive that would encourage refiners to supply more products to the U.S. market. How many air quality permit applications for refinery expansions has your company submitted for NSR over the last ten years? How long did it take the EPA, or the applicable State, to approve or deny each permit application, after receipt of a complete permit application? What was the expected percentage increase in product output of the expansion?

Answer. In the last ten years, neither Shell nor Motiva has submitted applications for air quality permits for significant refinery expansions under NSR.

Question 12b. How would you propose to streamline NSR and still maintain local air quality and prevent any increase in total annual emissions from such expansions?

Answer. Shell supports the streamlining of the NSR process. In addition, we strive to minimize emissions in the planning and design of manufacturing facilities. We expect careful government review of these plans, and work closely with all permitting agencies to achieve the best result both in terms of the environment and the supply of energy to consumers.

Question 13. How much did the fuel specification waivers that have been granted by EPA to date, due to the supply disruptions caused by the hurricanes, reduce the average retail price of the gasoline or other refined products made by your company?

Answer. Typically, fuel prices increase when interruptions to the supply or transportation systems occur. The speed and willingness of the EPA to grant fuel waivers was incredibly helpful in quickly and efficiently improving the fuel supply in areas directly or indirectly impacted by hurricanes.

Question 14. One witness indicated that "getting two 100-year hurricanes in four weeks" caused a great deal of chaos and disruption in the gasoline supply chain. The National Oceanic and Atmospheric Administration has projected that the country and the Gulf of Mexico have entered a cyclical period of 20-30 years during which the Gulf and coastal areas are likely to experience a greater frequency of hurricanes and higher odds of those hurricanes making landfall in the U.S. What preparations has your company made to deal with a great hurricane frequency to decrease repetition of the supply disruption that occurred this year?

Answer. See Answer to Question 15, below.

Question 15. Over the last 50 years, average annual sea surface temperatures have increased in the Gulf of Mexico and, according to the National Academy of Sciences and other similar scientific expert bodies, are expected to continue increasing as the oceans continue warming due to accelerating global climate change. The Administration's Climate Action Report (2002) states "model simulations indicated that, in a warmer climate, hurricanes that do develop are likely to have higher wind speeds and produce more rainfall." What preparations has your company made to deal with a greater likelihood of greater hurricanes intensity so as to decrease repetition of the disruption that occurred this year?

Answer. We prepare for and monitor tropical storm developments every year and incorporate learning's from previous years. We have safely evacuated and redeployed people over the last two seasons, just as we have done for decades. We are currently undertaking an assessment of our offshore operations to determine what future actions and modifications may be required to prevent future disruptions. Shell supports the expansion of oil and gas production to new areas both onshore and offshore, subject to appropriate environmental and land use regulations.

Question 16. How has your company disclosed to shareholders and investors the risks associated with the potential impacts on your company's assets in the Gulf of Mexico or indirect impacts on its assets elsewhere, of either the expected greater frequency of hurricanes making landfall in the U.S. or the probably greater intensity of hurricanes in the regions?

FINANCES, PRODUCTION, IMPORTS, ETC.

Please provide for each of the last ten years your company's—
Gross revenue of U.S. operations

Total capital expenditures in the U.S.
 Net profit of U.S. operations
 Total taxes paid to the Federal government
 Total taxes paid to State governments
 Total donated to charity.

Year	Gross revenue	Capital expenditures	U.S. earnings
1995	24.3	2.9	1.4
1996	28.8	3.2	1.7
1997	28.5	3.5	1.7
1998	16.6	4.0	-2.4
1999	17.3	1.5	1.7
2000	26.1	1.5	3.1
2001	21.1	2.3	1.9
2002	54.7	6.6	2.0
2003	75.1	2.5	2.7
2004	102.9	1.6	4.7

All amounts are in billion dollars.

Total taxes paid to the Federal government
 Total taxes paid to State governments

SHELL OIL COMPANY AND ITS CONSOLIDATED SUBSIDIARIES

Year	Federal	State
1995	667	35
1996	295	51
1997	648	40
1998	192	39
1999	811	39
2000	1,343	51
2001	908	75
2002	229	27
2003	1,330	45
2004	2,115	133
Total	8,538	535

All tax amounts in millions of dollars.

Total donated to charity.

Year	Donations (Millions \$)
1995	16.2
1996	19.2
1997	23.2
1998	26.3
1999	26.2
2000	32.1
2001	36.7
2002	35.8
2003	36.3
2004	32.4

YTD 2005 (through Third Quarter) \$24.8 million. The above amounts reflect U.S. donations only.

Question 17. How much additional petroleum refining capacity do you expect your company to install in the United States over the next 10 years?

Answer. Shell will continue to consider optimizing its refining assets in all markets to take advantage of existing site infrastructure for expansion and debottlenecking. Motiva recently announced that several options are being considered to increase production of gasoline, diesel and aviation fuels at its Gulf Coast refining network. Capacity expansion projects being considered range from 100,000

barrels per day to 325,000 barrels per day. Note, too, that we have increased capacity as demand has grown. From 1994 to 2004 Shell and Motiva refineries in the U.S. increased overall capacity by about 30 percent while investing significant capital expenditures to do so.

Question 18. What percentage of profits over the last 10 years has your company re-invested in capital, exploration, drilling and production in the United States? Please provide an annual total for those U.S. expenditures and a clear breakdown.

Year	U.S. earnings	Capital exploration (CapEx)	Exploration expense (Expl Exp)	CapEx + Expl Exp	% of U.S. earnings
1995	1.4	2.9	0.2	3.1	221%
1996	1.7	3.2	0.3	3.5	206%
1997	1.7	3.5	0.3	3.8	224%
1998	-2.4	4.0	0.4	4.4	N/A
1999	1.7	1.5	0.2	1.7	100%
2000	3.1	1.5	0.2	1.7	55%
2001	1.9	2.3	0.3	2.6	137%
2002	2.0	6.6	0.2	6.8	340%
2003	2.7	2.5	0.3	2.8	104%
2004	4.7	1.6	0.4	2.0	43%

All amounts are in billions of dollars.

Question 19. What percentage of profits over the last 10 years has your company re-invested in non-petroleum energy supply and production in the United States? Please provide a total and the results of such investment.

Answer. Shell has invested in hydrogen, solar and wind energy in the U.S. over the last 10 years. The capital and earnings from these businesses are in addition to the amounts reported in the response to question 18. We do not typically report U.S. numbers for these businesses.

Question 20. On average for the last ten years, please compare your company's overall capital expenditures in the United States to its expenditures elsewhere.

Year	U.S. capital expenditures	Total world-wide capital expenditures	% U.S. capital expenditures
1995	2.9	11.0	26%
1996	3.2	11.0	29%
1997	3.5	12.3	28%
1998	4.0	12.9	31%
1999	1.5	7.4	20%
2000	1.5	6.1	25%
2001	2.3	9.6	24%
2002	6.6	22.4	29%
2003	2.5	12.3	20%
2004	1.6	12.7	13%
Average:	3.0	11.8	25%

Question 21. What percentage of your company's gross revenue was collected in the United States in each of the last 10 years?

Year	% net proceeds collected in U.S.
1995	22%
1996	22%
1997	22%
1998	18%
1999	16%
2000	19%
2001	17%
2002	33%
2003	38%

Year	% net proceeds collected in U.S.
2004	39%

Shell only reports net proceeds by region, not gross revenue. Difference between the two is mainly taxes collected by Shell on behalf of various taxing authorities.

Question 22. How much of your company's revenue collected in the United States was used to pay for purchasing crude oil from OPEC countries?

Answer. Shell does not keep records in this format.

Question 23. Do you support S. 1794 or something like it to create gasoline and jet fuel reserves to ensure stability of price and supply? Should it be extended to diesel and other fuels like natural gas?

Answer. See answer to Question 5. from Senator Bunning's questions.

Question 24. On average for the last ten years, how much of what is refined by your company in the U.S. stays in the U.S.?

Answer. Shell's U.S. retail supply requirements generally exceed Shell's U.S. gasoline refining capacity.

Question 24a. What amount of refined product did your company import in 2004 and 2005?

Answer. Much of the data that is requested by this Question is the subject of a supplemental subpoena issued by the Federal Trade Commission on November 23, 2005 with a return date of January 4, 2006. This response requires the compilation of a large amount of export and import data over a five-year period of time, and historical tax expenditure data. Shell is willing, upon request, to provide non-proprietary information to the Committee as soon as the response to the FTC subpoena is completed.

Question 24b. What are your assumptions about demand growth in India in [sic] China?

Answer. In its World Energy Outlook 2004, the International Energy Agency states that global primary energy demand is set to rise by 59% from now until 2030. Two-thirds of the new demand will come from the developing world, especially China and India.

Question 24c. How have your investments in the United States increased the energy security of the country?

Answer. Shell has invested virtually 100% of its U.S. profits in the U.S. over the last five years to meet the energy needs of the U.S.

Question 25. What market signals will occur in advance of peaking world oil production and what is the appropriate policy or set of policies for the U.S. government to adopt when such signals occur?

Answer. History has shown that estimates of recoverable resources have continuously increased over time, despite the effects of cumulative production, as we better understand the nature of the fields we drill and as we discover new fields. Predictions of peaking oil production typically focus on conventional crude oil produced from reservoirs in much the same way as the industry has operated in the past. New technology is enabling more development of conventional resources, and development in deep and ultra-deep water that were previously deemed inaccessible.

Technology will also add significant new "unconventional" resources to the hydrocarbon supply mix in the form of extra-heavy oil, tar sands, gas-to-liquids, coal-to-liquids and biofuels.

The growth of oil production could be constrained for other reasons, such as onerous policies related to access, licensing and leasing, and fiscal terms and conditions. Such onerous factors could give the appearance of peaking oil production. Government policies that create a favorable investment climate, put oil production back on a growth path. Specifically, policymakers in the U.S. should consider:

- Lifting the current drilling/leasing moratoria in certain areas on the Outer Continental Shelf (OCS), in a manner that ensures industry's impact is minimized, and environmental resources are protected;
- Developing an equitable and fair system to share OCS revenues with coastal states and nearby communities and to share federal onshore oil and gas revenues with local communities.
- Developing policies that foster development of unconventional domestic resources, such as oil shale and tar sands, and innovative technologies, such as coal gasification processes.

- Providing extended and/or flexible lease terms for production in frontier areas in the offshore and offering an opportunity for development of consortia to test new technology in clearly defined, high-risk areas; and
- Providing additional funds, including direct funding from federal oil and gas royalties, bonus bids and rental fees, to BLM and MMS and state wildlife management agencies to perform their environmental and regulatory responsibilities in a timely fashion.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. RON WYDEN TO
JOHN HOFMEISTER

Question. All over America, the oil industry drives up the price at our gas pumps by redlining and zone pricing. “Redlining” is when your companies draw a phone line around a community to lock out competition and raise prices for the consumers. “Zone pricing” is plain oil discrimination and it takes place when one oil company supplies gas to several gas stations located near each other and one station is charged much more than the others for the same type of gas. This drives stations out of business, reducing choice and raising prices for consumers. To help hurting consumers at our gas pumps, will your company commit to stop redlining and zone pricing? Yes or no?

Answer. We will continue to utilize appropriate and legal measures to address competitive factors in the marketplace, and will need sufficient flexibility to deal with the circumstances affecting each of the classes of trade in their respective market areas. We disagree that zone pricing is illegally discriminatory. We take care to operate within federal and state pricing regulations. Legally implemented, zone pricing has been an effective method of addressing the impact of extremely competitive conditions within a local market area. Responding to such competition is beneficial to both the impacted retailers and to consumers.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. MARIA CANTWELL TO
JOHN HOFMEISTER

Question 1. I’m aware that the cost of crude oil is driven by the world market and that its cost is currently significantly above historic averages. But I’m not aware of any substantive increases in the cost of producing crude oil, the cost of refining it into various petroleum products such as gasoline and diesel, and the cost of transportation of refined products to markets. Through the end of September 2005, the price of crude had increased 40 percent in 2005 while gasoline prices increased almost 80 percent. If the percent difference in the prices isn’t pure profit, please explain to me how you account for the difference in the substantially lower increase in crude oil when compared to gasoline.

Answer. Retail gasoline prices tend to move more slowly than the underlying cost of product. This “lag” effect is evident during periods when prices are rising as well as those times when prices are falling. The best way to measure profitability is over a longer period of time, after the market has experienced several rising and falling cycles. This type of longer-term measurement provides a more realistic representation of profitability.

Question 2. Between 1981 and 2003, U.S. refineries fell from 321 to 149. Further, no new refineries have been built in the U.S. since 1976. In 1981, the 321 refineries had a capacity of 18.6 million barrels a day. Today, the remaining 149 refineries produce 16.8 million barrels per day. I recognize the difficult financial, environmental, and legal considerations associated with the location and construction of new refineries. But I fail to understand the closure of existing refineries even if they required investment to enhance their efficiency and production capability unless, of course, this mechanism is being used to increase the price of gasoline and other refined products. Please help me understand why you would shut down refineries in the face of the supply and demand situation. What conditions would have to exist for you to invest in new refining capacity? I have heard the industry claim that up to \$48 million has been used on capital expenditures for existing refineries. If those investments were not used for capacity increases, what were they used for?

Answer. According to information compiled by API, the number of U.S. refineries peaked in 1981, when there were 315 operating refineries. We believe that some owed their existence largely to government subsidies to small refiners that ended in 1981 and that many closed because they were small and inefficient. As the industry faced increasing requirements for cleaner fuels and improved environmental performance, the number of refineries continued to shrink—from 194 in 1990 to 144 at

the end of 2004. However, growth in capacity at existing refineries has largely offset the effect of refinery closures-particularly in the later part of the last decade, with the result that total refinery capacity in the U.S. has grown from 15.5 to 17 million barrels per day since 1990.

Shell has invested in new refining capacity in order to help satisfy demand. From 1994 to 2004 Shell refineries in the U.S. increased overall capacity by about 30 percent and invested significant capital expenditures to do so. Shell will continue to consider optimizing its refining assets in all markets to take advantage of existing site infrastructure for expansion and debottlenecking. Motiva recently announced that several options are being considered to increase production of gasoline, diesel and aviation fuels at its Gulf Coast refining network. Capacity expansion projects being considered range from 100,000 barrels per day to 325,000 barrels per day.

Capital expenditures not used for adding capacity include costs of modifications to comply with clean air and boutique fuel requirements, as well as maintenance and improvements to sustain and improve asset integrity. In addition to product demand, key factors for any proposed refinery expansion would include the overall cost to design, engineer, build and operate new processing units; favorable indicators of future crude supply and related costs; and expected return on investment.

Question 3. The recent hurricanes resulted in the need to import substantial refined products such as gasoline, diesel fuel and aviation fuels to meet U.S. demand. The question has been raised as to whether the country should development a strategic reserve for finished petroleum products. What would be your reaction if the Federal government either directly or by way of contract with the private sector sought to create a strategic reserve of finished petroleum products? Since these products have a limited shelf-life, one proposal is to obtain and operate a number of refineries and has the products be used by the Federal government. Appreciate your comments on this proposal.

Answer. See the Answer to Question #5 from Senator Bunning's questions.

Question 4. Given the recent profitability of the oil industry, I am interested to learn more on the disposition of these profits, particularly to enhance both production and refining capacity. Are any of these profits being used to enhance production and refining capacity for the benefit of other countries? What fraction of your profits is being invested for production and for refining? What percentage of profits have [sic] been used for stock buybacks and mergers and acquisitions?"

Answer. From 2000 through 2004, Shell bought back approximately \$7.0 billion in its own stock on a global basis. During that same time period, Shell spent nearly \$14.0 billion in U.S. capital expenditures, which represents 134% of U.S. Business Segment Earnings for that period.

Question 5. You've all said profits are cyclical, and that your companies have also suffered from the volatility of the oil markets. Would your stockholders be better served if domestically produced oil was sold at a fixed rate that included a generous profit margin above the production, refining and distribution costs?

Answer. Competitive and open markets are the most effective way of operating commodity businesses.

Question 6. Do you believe that global warming is occurring? Do you believe that man-made activities have a role in this phenomenon? How will global warming impact your companies in terms of added costs for oil and gas development, or allow access to new areas for oil and gas development?

Answer. We share the concern that the emission of greenhouse gases (GHG) from human activities could lead to changes in the global climate and might impact development and access. We are engaged with the World Business Council for Sustainable Development, which advocates change in infrastructure and lifestyle over the coming decades to address the issue of climate change. No single solution or single industry can deliver this change.

Question 7. Is it accurate that United States LNG terminals in Massachusetts and Maryland are only operating at half capacity? Do you believe if these plants were operated at a higher capacity it would have changed the market dynamics that determine the current price?

Answer. The Maryland facility (Dominion Cove Point LNG regas) operated at approximately 80-90 percent for Shell's capacity in 2005. Shell holds one-third of the capacity at this terminal. We do not utilize the Massachusetts terminal. Market dynamics for LNG are at the global level and occasional spot cargos would not likely have an impact.

Question 8. I understand that Shell and BP have entered into the market and are now operating in the black. If that is accurate, what barriers are you experiencing in expanding this promising market? What federal incentives can Congress provide

to help promote the solar energy market? How about advancing the shift to a hydrogen-fueled economy?

Answer. The renewables and hydrogen industries are still in the investment stage. Shell has invested nearly \$1 billion in new energies between 2002-2005, with over \$300 million invested in the U.S. alone over the last five years. Shell Wind is the No. 2 wind company in the U.S. and the vast majority of its 740MW Wind portfolio operates in the USA where we have seven large wind farm projects. Shell Solar is the No. 2 solar company in the U.S.

Policymakers should be aware that these emerging industries require a stable and predictable investment climate if they are to grow. In addition, we support extending the 30 percent federal solar tax credit for ten years; lifting the \$2000 credit cap on residential systems; and a stable and consistent production tax credit for wind energy projects.

Shell Hydrogen has hydrogen projects in the United States, Iceland, The Netherlands, Japan and Luxembourg. In the U.S., Shell is pleased to be working with federal and state policymakers on a number of important efforts. The goal of introducing hydrogen as a fuel on a significant scale requires an unprecedented joint undertaking by government, the automotive industry, and energy companies. Strong government support and structures are required to shape a coordinated and geographically concentrated introduction of vehicles and deployment of fueling infrastructure.

Question 9. Please state for the record your company position on fuel economy standards. Are there other incentives that you support that you feel are better for consumers than the Corporate Average Fuel Economy paradigm?

Answer. Shell does not have a position on the U.S. CAFE policy debate. However, Shell does support conservation measures and recognizes that energy efficiency improvements — whether in vehicles, in residences, or in businesses—can make a difference in energy demand.

Question 10. I understand that over the past 5 years companies in your industry have downsized significantly. How there is a shortage in workers and equipment to increase drilling. Please explain that dynamic.

Answer. Workers in the industry who are in highest demand in the current market are those with the specialized technical education, training, and experience required to find and produce oil and gas, typically individuals with university degrees in specific engineering and science disciplines. This pool of talent has been shrinking over the past 15-20 years due to two important factors. First, technology continues to advance making many processes and activities less labor intensive. Second, and most significantly, U.S. domestic oil industry growth has been constrained by both legislation and low price/low return on investment environment. This lack of stability has had its impact. Portrayed and viewed as a sunset, 'old energy' for the past 15-20 years, the oil business has failed to attract in sufficient numbers those with the aptitude to learn the specialized technical skills needed to be successful in our industry who have opted for industries they viewed as offering greater long-term opportunity. It is too soon to know if this trend can be reversed but if the industry is to be successful in attracting new talent, it will take a number of years of what would be considered higher than normal growth opportunities in the U.S. Growth is needed to change the dynamic for the industry to be considered sustainable enough for students on college campuses today to begin specializing for jobs in our industry in greater numbers. Throughout this timeframe, despite these challenges we have remained active on university campuses to encourage continued interest in our industry and continue to do so.

With respect to the availability of drilling rigs and other equipment required to find and produce oil, this too has been driven by supply and demand. As noted, the overall trend in the U.S. is one of a shrinking oil industry, over a period of nearly 20 years. During the last 20 years, oil prices have fallen to \$10 twice (1986 and 1998) and lingered at the \$20 level most of the time. Owners of needed rigs and equipment require significant levels of investment and lead time, and many companies who provided such equipment and related oil field services in the past have gone out of business. Remaining companies who survived over the past 15-20 years are understandably cautious that the current price environment will not be sustained, exposing them to great risk in any investment they make. In addition, both rig companies and service companies face the same challenges as majors and independents in attracting people and retaining them.

Question 11. As you probably know, Congress is likely to open up the Coastal Plain of the Arctic National Wildlife Refuge to oil and gas exploration. Do you have plans to bid for leases in this area? What does the price of oil have to be to make ANWR exploration and extraction be economically viable?

Answer. Although Shell has no current exploration and production plans for the Arctic National Wildlife Refuge (ANWR), Shell supports exploration and development on public lands, including lands such as ANWR, subject to appropriate environmental and land use regulations to ensure that industry's footprint is minimized and that biological resources and the environment are protected. Any future Shell decision with regard to ANWR will be guided by our evaluation of any acreage that may eventually be made available for lease and a positive assessment at that time that leasing and development activity can be done without significant adverse impact on the environment.

We look forward to continuing our policy of engaging with stakeholders as Shell considers business opportunities in Alaska and on other public lands made available for leasing, where Shell can best use our technological expertise to responsibly develop vital oil and natural gas resources.

For competitive reasons, Shell cannot reveal our economic criteria or any internal economic assessment of areas that could potentially be offered for leasing in the future. From a geographical perspective, ANWR is no more remote than the National Petroleum Reserve—Alaska (NPR). Recent lease sales in NPR have attracted aggressive bids from many companies. These bids were made in 2004, prior to the increases in oil and gas commodity prices seen in 2005.

Question 12. I understand that many of your resources and equipment are working flat out to rebuild infrastructure in the Gulf of Mexico. If there is no capacity to expand oil and gas exploration, what good is opening up sensitive environmental areas to increased drilling going to do for the consumer in the short run?

Answer. Oil and gas production is an investment cycle business where 5 to 10 years is necessary to develop new production. Actions taken in the short run to improve the industry's ability to drill in any prospective new areas will benefit consumers over the long run.

Question 13. Given the growing demand for oil in Asia, do you believe that oil derived from the Arctic National Wildlife Refuge could be diverted to supply Asian markets? If drilling in the Arctic National Wildlife Refuge is authorized this year, when will it begin to have an impact on gasoline prices? What do you believe that effect will be?

Answer. Any material new oil that is brought onto the market should have a downward effect on oil prices. The actual impact on global prices cannot be known without knowing the global supply and demand balance at the time that that production occurs. The world oil market is a fungible market in which crude oil and products move to markets where they obtain the highest value and/or incur the lowest cost of transportation. All else being equal, oil from ANWR and other material new oil should be good for U.S. consumers, regardless of where actual crude volumes are ultimately delivered.

Question 14. Do you support more transparency in the oil and natural gas markets, as would be provided in my bill S. 1735?

Answer. Current laws and regulations provide transparency and we are not aware that they need to be modified. Concerns about or proposals to improve current laws and regulations should be fully understood and carefully studied to ensure no unintended consequences.

Question 15. How has the last 3 years of escalating gasoline prices affected demand by American drivers? Have we seen a correlation between a certain level of price increase and less demand by American drivers? What is the actual level of reduced demand today compared to 3 years ago (please respond in the context of a doubling or retail gasoline prices)?

Answer. Gasoline demand has increased over the last three years despite considerable volatility in prices. The Energy Information Administration (EIA) collects, reports and analyzes data regarding supply and demand within the energy sector and might be better situated to provide the analysis requested.

Question 16. What is the crude oil extraction costs for major oil producing countries, including our own? How does that compare with oil derived from shale or coal?

Answer. The costs of exploration, development and production of crude oil can vary significantly between countries and between types of resources, even within the same country. On the technical side, costs vary with reservoir depth, reservoir size, the characteristics of the oil in the reservoir, the needs for supporting infrastructure and whether the oil is in an onshore or offshore location. In the latter case, water depth is also an important variable. On the institutional side costs are heavily influenced by the fiscal regime, local content requirements, local partnership requirements and access to material opportunities.

A recent report from the International Energy Agency (IEA) "Resources to Reserves: Oil & Gas Technologies for the Energy Markets of the Future" (September

2005) included an estimate of the distribution of costs for different resource types and different resource regions. The report can be accessed through the IEA website at <http://www.iea.org/>

IEA's report sites a varying ranges of costs for crude extraction from between \$5-\$15 for Middle East OPEC suppliers at the low end, up to a wide range of \$25 to \$70 for some oil shale developments at the high end. Shell does not necessarily endorse this range as an accurate assessment for the potential cost of oil shale production. Because there has never been commercial oil shale development in the United States, neither Shell nor the oil industry has any history of actual unit production costs. However, assuming that Shell's research continues to advance, we hope to make a commercial decision by the end of this decade that could lead to first generation commercial production in the next decade.

Question 17. Regarding foreign exporting, inventory maintenance, and other practices of your company, please provide a response to each of the following questions and information requests: For each and every export shipment to a foreign country of gasoline, distillate fuel oil, propane, or liquefied natural gas occurring from January 1, 2005 to present, please provide the date, product type, volume, domestic port of exit, foreign destination, transportation costs, and the sale price or transfer value upon arrival at the foreign destination.

Answer. Much of the data that is requested by this question is the subject of a supplemental subpoena issued by the Federal Trade Commission on November 23, 2005 with a return date of January 4, 2006. This response requires the compilation of a large amount of export and import data over a five-year period of time, and historical tax expenditure data. Shell is willing to provide, upon request, non-proprietary information to the Committee to this question as soon as the response to the FTC subpoena is completed

Question 17a. Since January 1, 2001 to present, please identify the number of shipments wherein your company exported gasoline, distillate fuel oil, or jet fuel and the sales price or transfer value received at the destination was less than the amount that would have been received had the product been marketed by your firm in the United States.

Answer. See Response to Question 17, above.

Question 17b. Since January 1, 2001 to present, please identify the date, product, volume(s), foreign port of origin, expected U.S. port of entry, and eventual port of final destination in each instance wherein your company basically "turned a ship away" (whether proprietary product or acquired from a third party) by changing the shipments expected arrival in a U.S. port to a foreign port.

Answer. See Response to Question 17, above.

Question 17c. From 1995 until present, please identify by month the inventory levels maintained by your company for gasoline and distillate fuel oil in both barrels and converted to "cays of cover" of "day of supply" for your firm's distribution and sales volumes within each of the Petroleum Allocation Defense Districts (PADDS) in the United States.

Answer. See Response to Question 17, above.

Question 17d. From January 1, 2005 to present, provide the details of each "spot market" (as commonly referred to in the industry for bulk sales, in volumes exceeding 5,000 barrels per transaction) including the date, identify of both the seller and purchasers, location of the product being sold, and the selling price.

Answer. See Response to Question 17, above.

Question 17e. Describe your company's use of "in-house trading platforms" and identify all individuals in your company by name, address, email, and phone number that were authorized during 2005 to either exchange, trade, sell or purchase gasoline or distillate fuel oil on either the "spot market", NYMEX futures market, or via "forward paper" purchase rights.

Answer. See Response to Question 17, above.

Question 17f. Please identify all third party reporting services, including but not limited to Oil Price Information Service (OPIS), Lundberg surveys, Platts, and Oil Intelligence that your company regularly supplies transaction data or marketing information.

Answer. See Response to Question 17a, above.

Question 17g. Please identify the branded and unbranded "rack prices" that were reported by your company to third party reporting services such as OPIS and the branded and unbranded "rack prices" that were actually charged distributors or jobbers by your company each day, from January 1, 2005 to present, at the truck loading terminal(s) that typically supply gasoline stations in Houston, TX, Atlanta, GA, New York, NY, Chicago, IL, Los Angeles, CA, Portland, OR and Seattle, WA.

Answer. See Response to Question 17, above.

Question 17h. Will your company commit that it will take no efforts to retaliate against any firm or individual that is a potential witness before this Committee or cooperates with any investigation into the oil industry by Congress or another governmental authority?

Answer. The question appears to ask whether Shell will comply with existing provisions of the civil and criminal laws concerning interference with witnesses. Shell has complied, and will continue to comply, with all such laws.

Question 17i. From January 1, 2005 to present, for each instance known to your company wherein a third party (not your company) exported gasoline, distillate fuel oil, propane, or liquefied natural to a foreign country, please provide any of the details known to your company including the identify of the exporter, date, product type, volume, domestic port of exit, foreign destination, transportation costs, and the sale price or transfer value upon arrival at the foreign destination.

Answer. See Response to Question 17, above.

Question 17j. Since January 2, 2001 to present please identify the identity, date, product, volume(s), foreign port of origin, expected U.S. port of entry, and eventual port of final destination in each instance wherein your company is aware a third party (not your company) basically "turned a ship away" (whether proprietary product or acquired from a third party) by changing the shipments expected arrival in a U.S. port to a foreign port.

Answer. See Response to Question 17, above.

Question 17k. Please provide an itemized list of tax deductions and credits taken under the U.S. tax code for 2004, by your parent company and subsidiaries.

Answer. See Response to Question 17, above.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. KEN SALAZAR TO
JOHN HOFMEISTER

Question 1. The Agriculture Committee is looking at the impacts these high-energy prices are having on agricultural producers around the country. To sum it up: they are hurting. It seems to me that there is tremendous potential for our country to grow fuels such as ethanol and bio-diesel. This approach offers many benefits to rural American as well as to the country as a whole. What type of investments is your company making (and planning to make) in these types of renewable fuels in the United States?

Rural American is crying out for investment in renewable fuels, and I encourage your companies to look at the potential of renewable fuels. In terms of a percentage of your capital expenditures, how much money did your company spend this year to develop renewable fuel sources in the United States? What will that percentage be going forward?

Answer. Shell currently blends ethanol into gasoline in many states. Investments include investments in terminal ethanol blending equipment. With the enactment of the Renewable Fuels Standard in the recently passed energy bill, which requires the use of 4.0 billion gallons of renewable fuel in 2006 up to 7.5 billion gallons of renewable fuels in 2012, use of ethanol and other renewable fuels will increase.

Shell purchased an equity stake in Iogen Energy Corporation, a world-leading bio-ethanol technology company, in May 2002. The U.S. \$29 million investment will enable the Canadian based company to develop more rapidly the world's first commercial-scale biomass to ethanol plant. Traditionally manufactured ethanol costs significantly more than gasoline. The type of feedstock used accounts for well over half of the final ethanol cost. By developing the commercial scale ability to produce ethanol from biomass, Shell and Iogen hope to reduce the cost of producing ethanol thus making it more competitive. However, the specification of the gasoline into which ethanol (produced via whatever process) is blended has to be changed in order to meet the final fuel specifications. This together with the changes required in the logistical infrastructure in order to make the blended product available at service stations makes it unlikely that traditionally manufactured ethanol will ever be able to compete directly with mo-gas on a cost basis.

Question 1a. Will you also provide this committee with some examples of renewable fuel projects that your company is pursuing outside the United States?

Answer. Shell is, we believe, the largest marketer of biofuels by volume in the world, selling 2.4 billion litres of biofuel in 2004, mostly in the USA and Brazil where government policies favor ethanol. Shell markets bio-esters in Europe, and has technology development programs in advanced biofuels such as cellulose ethanol (Iogen, discussed above) and biomass-to-liquids (Choren investment).

Use of biofuels as a vehicle fuel might be favored for purposes of (1) reducing carbon-dioxide emissions, (2) increasing domestic energy security and/or and (3) supporting agricultural production. Biofuels do cost more to produce than conventional fuels, and this cost must be covered. To create consumer demand for biofuels the cost must be reduced, and the performance of the fuel must assured. Further, biofuel technologies are relatively inefficient, typically delivering only 20-30% more energy than is consumed in their production. Advanced processes are being developed and need to be refined.

For information on Shell Wind, Solar and Hydrogen, please see response to Senator Cantwell Question 8, above.

Question 2. As a few of you note in your testimony, diesel prices have remained high while unleaded gasoline prices have come down. It seems as if we are getting lower priced unleaded gas at the expense of diesel. Since diesel is the fuel of choice in agriculture, it is a sort of a double whammy on our producers. What is being done, or what can be done, to get diesel prices back in line with the price of gasoline?

If demand for diesel is so high in Europe and high prices don't attract the supplies necessary to lower prices, isn't that a good indicator that we should work to produce more diesel in the United States and look to biodiesel as an option?

Answer. Nationally, diesel prices have been higher than gasoline for an extended period of time. Diesel and gasoline prices are impacted by similar market fundamentals, but they can and do operate independently if the underlying supply and demand is impacted for one product more than the other. In the case of diesel, growing economies tend to expand demand as industry uses fuel to power factories, utilities use diesel fuels to generate electricity, and transportation demand increases as goods are moved from one part of the country to the other. At the same time, diesel supply is impacted as refineries experience planned or unplanned maintenance and begin the necessary modifications to reduce the amount of sulfur contained in diesel fuels. All of these elements impact the ultimate price a consumer pays for diesel fuel.

Question 3. For the record, will you tell me what your company has spent on capital expenditures in case, not including write offs such as amortization or depreciation. Will you also provide the figures spent on cash dividends and stock buyback for the same time period?

Year	Dividends	Stock buyback	Capital expenditures
2000	5.4	0.0	6.1
2001	5.2	4.0	9.6
2002	5.5	1.3	22.4
2003	6.5	0.0	12.3
2004	7.6	1.7	12.7

All amounts are for Shell worldwide and are in billions of dollars.

Question 4. On November 1, Senator Grassley asked your companies to contribute 10% of your record profits to supplement LIHEAP funding for the less fortunate. Will your companies support Senator Grassley's proposal?

Answer. Shell believes such public service funding decisions are more properly suited for the role of government than for private industry. Shell will direct its efforts to finding more energy so that Americans can not only heat and cool their homes, but also fuel their vehicles and power their businesses.

Question 5. I'd like to encourage you to actively work with the Department of Energy and any other relevant federal agency on initiating a public/private education campaign focused on energy education and conservation. In the meantime, will you tell me what your company has done on its own initiative?

Answer. Shell has a long-term commitment to educating consumers about vehicle maintenance and driving safety, starting with the Shell Answer Man campaign, which provided useful information to consumers for approximately 40 years. While the Answer Man campaign was ended in the 1990's, we continue to educate reporters and consumers about issues relevant to today's drivers, including fuel technology, alternative fuels and fuel economy. Over the last few years we have conducted one-on-one meetings with reporters to discuss conventional fuels, emerging fuels and future fuels, and have issued press releases and tips books designed to educate consumers on better caring for their vehicles and driving for improved fuel economy.

Question 6. In your testimony you mention workforce-training efforts Shell has in Louisiana and Wyoming. Will you provide my office with more information about these programs? Colorado's returning veterans will be excited to learn about these opportunities.

Answer. Shell is involved in numerous workforce-training efforts in Louisiana, Wyoming and other parts of the U.S. Workforce training is a priority issue for the future viability of oil and gas development in the U.S.

In Louisiana, we are in the process of creating the Center for Petroleum Workforce Development in conjunction with LSU, the State of Louisiana and the City of New Orleans to offer an education and training curriculum tailored to maintain a top level producing operations, drilling and support workforce to meet the growing needs of the oil and gas industry in the Gulf of Mexico, onshore United States and globally. Shell is also leading the effort to form the first PTEC (Process Technology) Advisory Council for the Greater New Orleans area, and we are in the process of identifying the Technical/Community Colleges where we would implement this curriculum. We expect to resume our efforts to make this opportunity available to inner city youth in 2006.

Workforce efforts are also underway in Wyoming and the Rockies in general. Shell is actively involved with Rock Springs (Wyoming) Community College and has worked along with the school and others in our industry to implement a PTEC program there. Through an industry group called Center for the Advancement of Process Technology, Shell sponsors scholarship opportunities for students entering or currently enrolled in Process Technology programs at over 40 technical/community colleges located in Alabama, Alaska, California, Canada, Colorado, Delaware, Illinois, Indiana, Louisiana, Mississippi, Montana, New Jersey, New Mexico, North Dakota, Oklahoma, Texas, Virgin Islands, Washington, and Wyoming.

Shell also sponsors a technical scholarship to support students pursuing four-year engineering and geosciences degrees at accredited universities. Scholarships are renewable and students have an opportunity to participate in internships at a Shell facilities. Shell offers student internship job opportunities in offshore Gulf of Mexico, at a Louisiana chemical plant, in the Rockies and Alaska.

Shell is also partnering with the President's National Hire Veterans Committee to explore how Shell can proactively tap exiting military personnel for operator and craft jobs across Shell locations, including Louisiana and the Rocky Mountain Region.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. OLYMPIA J. SNOWE TO
JOHN HOFMEISTER

Question 1. I have introduced legislation that will offer an up to \$500 tax credit to working low and middle income individuals for the cost of home heating expenses. According to the National Energy Assistance Directors Association, heating costs for the average family using heating oil are projected to hit \$1,666 for the upcoming winter. This represents an increase of \$403 over last winter's prices and \$714 over the winter heating season of 2003-2004. Meanwhile, profits of oil and gas rose 62 percent in the third quarter for companies in the Standard & Poor 500 index. I am proposing to offset the \$500 tax credit for home heating expenses by curtailing the benefit large oil companies receive by using the LIFO accounting method. Do you think given budget deficits and record profits for oil companies that it is appropriate to divert tax benefits for large integrated oil companies such as yours to pay for such a measure?

Answer. We do not believe that it is appropriate to tax selected oil companies under the LIFO proposal for a number of reasons.

Oil is a commodity, and prices are set by the marketplace. Crude oil and natural gas prices fluctuate substantially and unpredictably. The industry must manage its business in the face of these severe price fluctuations. The business requires massive investment over long periods of time—even when prices are relatively low—to ensure that there will be energy supplies in the future. Oil and gas industry earnings per dollar of sales are in line with all U.S. industry during the second quarter of 2005. The energy industry overall earned 7.6 cents for every dollar of sales, compared to an average of 7.9 cents for all U.S. industry. The total dollar numbers may be large, but so are the billions of dollars that petroleum companies have invested to supply energy to U.S. consumers—and will need to reinvest—to meet future demand. Developing these energy resources will require a tremendous capital investment by our company, year in and year out, in periods of high and low prices.

In addition, the LIFO methodology is a long-standing and well-accepted methodology that is available to taxpayers. This methodology is based upon the assumption

that the last goods brought into inventory are the first goods sold. In a time of rising prices, LIFO is acknowledged to be the best method for tracking the true cost of products in inventory and cost of goods sold. This one-time accounting method change has been universally opposed as inappropriate tax and accounting policy. In our view, the proposal is inequitable and punitive, as it arbitrarily subjects a select group of oil companies to taxation without policy justification. Furthermore, the proposal would result in disincentives to the domestic oil and gas industry at a time when the country needs more domestic oil and gas. Shell supports and relies upon stable regulatory and fiscal policies that enable companies to develop energy projects and secure energy supplies. We respectfully request that Congress “do no harm” by distorting markets or seeking punitive taxes on an industry working hard to respond to high prices and supply shortfalls.

Question 1a. Does this seem like an equitable approach given that the high cost of oil enables you to not only bank large profits, but also to use accounting methods to substantially reduce taxes? Is it fair to report less taxes when you're profiting the most?

Answer. See Response to Question 1, above.

Question 2. Your third quarter profits have certainly been a lightning rod that has riled consumers as they continue to pay 30 percent more in Maine for their home heating oil for the winter.

I realize that you reinvest some of these profits in exploration for more product. In each quarter, have you reinvested the same percentage of the profits to reinvestment? What have your reinvestment percentages been to your total profits? Do they vary from quarter to quarter or year to year?

Answer. Shell has reinvested roughly 100% of its U.S. earnings back into U.S. businesses over the last 5 years. The percentage invested varies from year to year and from quarter to quarter.

Question 3. To what non-profit organizations and academic research that address global climate change does your company donate financial support to and how much do you donate each year?

Answer. The majority of Shell's research and development investment on future energy technologies is focused in house through Shell Renewables and Shell Global Solutions. In addition we are partners in a number of industry consortia, which are engaged in the development of technologies such as hydrogen fuel cells and carbon sequestration. Shell makes an annual donation of \$100,000 to the MIT Joint Program on the Science and Policy of Global Change. We are closely involved with a number of non-profit organizations that address climate change (e.g. Pew Center).

The Shell Group established The Shell Foundation, a UK registered charitable organization with a goal to promote sustainable development, which includes projects related to energy and climate change. In December 2000 Shell announced an endowment to the Shell Foundation of \$250 million.

Shell has other climate change related investment programs throughout the world. For example, in the UK we recently launched Shell Springboard—a program to encourage small businesses with big ideas on climate change. Springboard offers a financial boost of up to £40,000 for a small number of UK businesses who submit the most compelling plans for a product or service, which helps combat climate change.

Question 4. There has been much discussion about the skyrocketing costs of gasoline, heating oil, and other petroleum products over the past year magnified by the three hurricanes, which have hit the Gulf Coast region this year. In response to these inquiries into the rising prices and your soaring profits, you have asserted that these increases are tied to market forces, particularly the rising prices of crude oil.

I've reviewed your financial filings from the Securities and Exchange Commission and they paint a very stark picture when compared to the financial misery being experienced by millions of Americans. ExxonMobil, for example, has realized a net income of \$25.42 billion in the first nine months of 2005, an increase of \$8.5 billion over the first nine months of 2004. Exxon's third quarter net income this year was \$9.92 billion, up a full 90%.

Similarly, ConocoPhillips' net income for the third quarter of 2005 was \$3.8 billion, compared with \$2.006 billion during the same time period in 2004. Conoco's filing attributes this jump in profit to “higher crude oil, natural gas and natural liquid gas prices,” “improved refining margins,” and “equity earnings from our investment in LUKOIL.”

In my State of Maine, the median state income is \$17,044 per year. A full 78 percent of Mainers use heating oil to warm their houses in wintertime, and this, combined with gasoline prices of anywhere from \$2.50 to \$3.00 per gallon paints a harsh

picture for Maine and New England this winter. Petroleum is not any run-of-the-mill commodity. It is the lifeblood of commerce in this country, with fuel costs being built into the price of every other good bought and sold on the market. And in places like New England where petroleum heats most homes, it's literally a life-and-death commodity.

Your industry has taken the position in its SEC filings and at yesterday's hearing that the escalation of its fuel prices is the result of increases in crude oil prices. However, if your retail gas prices were raised simply to cover your increased costs in purchasing crude oil, your net profits would remain the same. Everyone knows this is not happening. Can you identify for this committee the reason that the rise in gasoline prices is far out-pacing the rise in crude oil prices?

Answer. Fuel prices are affected by a number of factors including the cost of crude, formulation requirements, state taxes, supply and distribution logistics, local market conditions, environmental regulations and operating costs.

Question 4a. Even though crude oil prices have risen this year, your companies aren't actually incurring those costs, are they? Isn't the gasoline and heating oil that your firms are currently selling on the market actually being produced from inventories that your companies purchased when the price of crude oil was much lower?

Answer. Our refineries typically only hold enough crude to make sure they don't slow down due to supply disruptions. There is generally only a 10 to 20 day supply of crude oil feedstock at the refinery or in the process of being delivered. Crude oil used at Shell refineries is bought from a variety of sources both domestically and internationally. The price paid is set by the marketplace on the day it is purchased. Occasionally, crude oil feedstock is purchased from distant suppliers, such as those in the Far East. In such cases, the price is set by the marketplace at the time of purchase, which might be six to eight weeks before it is processed by the refinery.

Question 4b. If you're producing oil from crude that you bought at \$40 per barrel, but selling it at a price that is purportedly based upon a \$70 per barrel cost to you, wouldn't that account for the 90% increase in profits we've seen?

Answer. See Response to Question 4a, above.

Question 5. I've alluded to the vital role petroleum plays in our economy and society, from the price of bread to the price of a plane ticket to the price of heating one's home. While you're obviously in the business for profit there are other sectors of the economy where we put a limit on selling commodities at unconscionable prices. One example is usury law, where lenders are prohibited from charging unconscionable rates for borrowing money—because we recognize that access to cash is critical to enterprise. How much more of a toll do these fuel prices have to take on our society before Congress steps in and places similarly appropriate regulations on your industry?

Answer. It remains to be seen what steps Congress will take to address the nation's energy policy issues. A number of policy proposals that Congress might want to consider are identified in my written and oral testimony.

Question 5a. Many consumers would say that raising the price of gas by \$2 per gallon over the past 2 years, while reaping over \$25 billion in profits is price gouging. Many lawmakers would agree. What do you say to them?

Answer. The attention focused on the oil industry during periods of higher profits vastly outweighs the focus when profits are down due to the same cyclical factors that have moved markets for years, and have caused this industry to be a "feast or famine" business. We kept exploring, producing, refining, transporting and satisfying consumer demand for products when oil prices dropped below \$10 per barrel. We must take the long-term view of the business, and hope that our ability to recover costs and make a profit returns when the pricing environment changes.

Now we are in one of those periods where the pricing environment has been more favorable to the oil industry, and we are generating the cash needed to keep investing in the future of energy and to pay much more in taxes as well. No one knows how long this period will last, and conditions will inevitably change. Recently, gasoline prices have declined by nearly \$1 per gallon as conditions have returned to a more typical environment. Neither the rise in price nor the fall back down should influence energy policy or company strategies in a significant way.

Consumers should consider that they pay much more per gallon for many other types of consumer products that don't require the same degree of sophisticated business activity to place in commerce—foods, cleaning supplies and other household products, for example. The oil industry is among the most efficient in the world in delivering highly refined products to consumers, and must comply with an impressive array of environmental laws and regulations in the process, as well as other forms of business regulation, many of which vary considerably across state lines. We

must make a wide variety of different fuels to satisfy local regulatory specifications, adding more cost to the process.

In conclusion, we disagree that the volatility in pricing, and the varying impact of such volatility on profits, means that the industry has engaged in price gouging.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. FRANK R. LAUTENBERG TO
JOHN HOFMEISTER

Question 1. In the last decade, has your company ever withheld supply of crude oil or refined product from the market in order to prevent prices from falling?

Answer. Shell has not withheld crude oil or refined product from the market in order to prevent prices from falling.

Question 2. Please describe any business relationship or transaction your company or any of its subsidiaries, wherever located and wherever incorporated, whether wholly owned or not, have had with Iranian nationals (except employment of Iranian expatriates), the Iranian government, individuals or corporations located or incorporated in Iran, or any representative of these people or companies.

Answer. I am president of Shell Oil Company, which is a wholly owned subsidiary of Royal Dutch Shell plc (RDS). Shell Oil Company is not involved in activities in Iran. It is well-known, however, that certain RDS subsidiaries have a history in Iran that spans nearly 50 years.

For the record, I am a U.S. citizen. Therefore, consistent with U.S. law and with our corporate policy, I do not advise or otherwise participate in any RDS activities relating to potential or actual transactions in or for Iran.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. OLYMPIA J. SNOWE TO
JAMES J. MULVA

Question 1. I have introduced legislation that will offer an up to \$500 tax credit to working low and middle income individuals for the cost of home heating expenses. According to the National Energy Assistance Directors Association, heating costs for the average family using heating oil are projected to hit \$1,666 for the upcoming winter. This represents an increase of \$403 over last winter's prices and \$714 over the winter heating season of 2003-2004. Meanwhile, profits of oil and gas rose 62 percent in the third quarter for companies in the Standard & Poor's 500 index. I am proposing to offset the \$500 tax credit for home heating expenses by curtailing the benefit large oil companies receive by using the LIFO accounting method.

A) Do you think given budget deficits and record profits for oil companies that it is appropriate to divert tax benefits for large integrated oil companies such as yours to pay for such a measure?

B) Does this seem like an equitable approach given that the high cost of oil enables you to not only bank large profits, but also to use accounting methods to substantially reduce taxes? Is it fair to report less taxes when you're profiting the most?

Answer. LIFO has been a generally accepted accounting method under the Internal Revenue Code since 1938 and therefore is considered to generate a clear reflection of a taxpayer's income. All taxpayers with inventory have the ability to elect to use LIFO. It is not a loophole established for the petroleum industry.

Revaluing LIFO inventories for select oil and gas companies is bad tax policy because it would be contrary to the requirement that taxpayers utilize consistent accounting methods to account for income and expenses from year to year, and it would create a bad precedent that could be used to penalize other industries as a means of raising revenues.

A one-time increase in the LIFO inventory valuation would generate a substantial negative tax impact in the year of the change, as many oil and gas companies have inventories reflecting years of historical costs. Such a penalty is equivalent to a windfall profits tax and would provide a huge economic disincentive to invest in new oil and gas supplies and refining capacity. It would also hurt U.S. companies' ability to compete with foreign companies for oil and natural gas resources around the world.

We also don't see a windfall. Even with the highest price environment our industry has seen in 22 years, adjusted for inflation, our profit margin of 7.7 cents per dollar of sales is near or below the average of all industries.

Question 2. Your third quarter profits have certainly been a lightning rod that has riled consumers as they continue to pay 30 percent more in Maine for their home heating oil for the winter. I realize that you reinvest some of these profits in exploration for more product. In each quarter, have you reinvested the same percentage

of the profits to reinvestment? What have your reinvestment percentages been to your total profits? Do they vary from quarter to quarter or year to year?

Answer. Our reinvestment percentages are reflected in the table below. Since 1995, we have invested, on average, the equivalent of 189% of our earnings into our business. Annual reinvestment percentages have ranged from 87% to 865%.

There is no distinct relationship between quarterly profitability and the amount we invest in expanding our business in a given quarter, therefore quarterly reinvestment percentages can vary significantly. Because of the magnitude and complexity of the projects that we undertake and the long-term commitment they represent, investment plans are contemplated well in advance of actual expenditures, based on a set of long-term economic assumptions e.g. estimated commodity prices, estimated costs, estimated tax expenses etc. As long as there is no major shift in those long-term assumptions, investment activity continues despite the fact that investment may exceed earnings in a given quarter or a given year. Given the long term investment horizon associated with our asset base, a temporary increase or decrease in earnings will not normally immediately result in a significantly higher or lower investment in a given quarter or year.

CONOCOPHILLIPS REPORTED (PHILLIPS PETROLEUM COMPANY PRIOR TO SEPTEMBER 2002)

\$MM	Net income ¹	Capital expenditures & investments ²	Reinvestment as % of net income	U.S. net income ³	U.S. capital expenditures & investments ⁴	Reinvestment as % of net income
1995	469	(1,456)	310%	335	(923)	276%
1996	1,303	(1,544)	118%	1,130	(841)	74%
1997	959	(2,043)	213%	710	(1,059)	149%
1998	237	(2,052)	865%	263	(936)	357%
1999	609	(1,690)	278%	376	(919)	244%
2000 *	1,862	(8,460)	454%	1,250	(7,707)	617%
2001 *	1,661	(10,054)	605%	1,305	(8,887)	681%
2002 **	(295)	(4,388)	.....	(910)	(2,043)	.....
2003	4,735	(6,169)	130%	2,513	(2,493)	99%
2004	8,129	(9,496)	117%	4,659	(2,520)	54%
2005	9,850	(8,573)	87%	5,626	(3,140)	56%
10 Year Avg.	2,683	(5,084)	189%	1,569	(2,861)	182%

* 2000 Includes Alaska acquisition—(\$6.443MM), 2001 Includes Tosco Acquisition—(\$7.038MM).

** The merger of Conoco and Phillips in August, 2002 is not considered an acquisition in this table. Sources:

¹ Net Income. 2005 YTD through September (ConocoPhillips 3Q, 10Q); 2004-2000 ConocoPhillips 2004 Annual Report, page 108; 1999-1995 (Phillips 2001 Annual Report, page 95).

² Capital Expenditures & Investments. 2005 YTD through September (ConocoPhillips 3Q, 10Q); 2004-2000 (ConocoPhillips 2004 Annual Report, page 108); 1999-1995 (Phillips 2001 Annual Report, page 95).

³ U.S. Net Income. A domestic and international breakdown is provided externally for the major company segments (I.e. E&P and R&M). Midstream and Emerging businesses are internally reported as domestic and international and this breakdown is included in the above total. The Chemical and Corporate Segments have been included in the U.S. total.

⁴ U.S. Capital Expenditures & Investments. 2005 YTD through September (ConocoPhillips 3Q, 10Q); 2004-2002 (ConocoPhillips 2004 Annual Report, page 45); 2001 (ConocoPhillips 2003 Annual Report, page 49); 2000 (ConocoPhillips 2002 Annual Report, page 49); 1999 (Phillips 2001 Annual Report, page 47 adj. to exclude discontinued ops.); 1998 (Phillips 2000 Annual Report, page 47 adj. to exclude discontinued ops.); 1997 (Phillips 1999 Annual Report, page 44); 1996 (Phillips 1998 Annual Report, page 42); 1995 (Phillips 1997 Annual Report, page 40).

Question 3. To what non-profit organizations and academic research that address global climate change does your company donate financial support to and how much do you donate each year?

Answer. ConocoPhillips has numerous projects focused on or related to global climate change. Some are part of an overall corporate initiative while other projects are being researched and implemented locally with lessons learned and best practices to be shared across the company.

As stated in our 2003 Climate Change Position Statement, ConocoPhillips recognizes that human activity, including the burning of fossil fuels, is contributing to increased concentrations of greenhouse gases (GHG) in the atmosphere, which can lead to adverse changes in global climate. While the debate continues over the extent of human contributions and the timing and magnitude of future impacts, the company is committed to taking action now to begin addressing the issue.

In 2004, ConocoPhillips took several actions toward implementing our climate change position. The company's E&P and R&M business segments began assessing data to develop objectives to reduce GHG emissions. Guidance for integrating climate change considerations into ConocoPhillips' project planning and approval processes is being developed in conjunction with efforts to integrate sustainable development. The company actively engages in discussions on climate change and supports third-party studies and research through memberships in the American Petroleum Institute (API) and the International Petroleum Industry Environmental Conservation Association, the World Business Council for Sustainable Development, and the International Emissions Trading Association among others.

In 2004, ConocoPhillips created a Global Gas unit within its E&P business to focus the company's efforts in the development and management of lower-carbon natural gas. The company is performing internal research and participating in a number of joint industry projects that are focused on increasing its understanding of carbon dioxide (CO₂) sequestration, and reducing capture and storage costs through development and application of new technology. These projects include WESTCARB (the U.S. Department of Energy's West Coast Regional Sequestration Partnership), the SINTEF Group study of CO₂ for enhanced oil recovery and disposition in aquifers in Norway, and the Alberta Research Council's Enhanced Coalbed Methane Consortium. ConocoPhillips also is a member of CO₂Net, the European network of CO₂ researchers, developers and users of CO₂ mitigation technology. In addition, ConocoPhillips has joined the CO₂ Capture Project.

We participate in a number of joint industry/government initiatives that address the capture and sequestration of Carbon Dioxide. These organizations are non-profit and most of them also involve the academic community. This includes almost one million dollars annually to support two research efforts on CO₂ capture and long term geological storage as a viable green house gas mitigation technique. Additionally, ConocoPhillips sponsors a \$700,000 per year research effort at the University of Bergen in Norway to evaluate the sequestration of CO₂ and production of methane from methane hydrates.

ConocoPhillips sponsors numerous academic fellowships on many different subjects related to the oil and gas industry. Though not climate change specific, some are associated with climate change such as a \$70,000 fellowship at the University of Oklahoma to improve the efficiency of diesel fuel which will consequently reduce carbon dioxide and other emissions.

Our individual operations research and implement many local efforts that are climate change-related. Our operations in Norway are spending more than three million dollars on climate change initiatives including studies of climate for the arctic environment, using waste CO₂ in reservoir management and wind-powered generation for offshore platforms. Our extensive refinery efficiency improvement effort makes us a lower cost refiner and reduces greenhouse gas emissions. Likewise, our efforts to reduce gas flaring in production directly relates to climate change because flaring produces greenhouse gases. Finally, our clean fuels program will help all consumers reduce their individual greenhouse gas emissions from driving.

Question 4. There has been much discussion about the skyrocketing costs of gasoline, heating oil, and other petroleum products over the past year, magnified by the three hurricanes which have hit the Gulf Coast region this year. In response to these inquiries into the rising prices and your soaring profits, you have asserted that these increases are tied to market forces, particularly the rising prices of crude oil.

I've reviewed your financial filings from the Securities and Exchange Commission, and they paint a very stark picture when compared to the financial misery being experienced by millions of Americans. ExxonMobil, for example, has realized a net income of \$25.42 billion in the first nine months of 2005, an increase of \$8.5 billion

over the first nine months of 2004. Exxon's third quarter net income this year was \$9.92 billion, up a full 90%.

Similarly, ConocoPhillips' net income for the third quarter of 2005 was \$3.8 billion, compared with \$2.006 billion during the same time period in 2004. Conoco's filing attributes this jump in profit to "higher crude oil, natural gas and natural liquid gas prices," "improved refining margins," and "equity earnings from our investment in LUKOIL."

In my State of Maine, the median state income is \$17,044 per year. A full 78 percent of Mainers use heating oil to warm their houses in wintertime, and this, combined with gasoline prices of anywhere from \$2.50 to \$3.00 per gallon paints a harsh picture for Maine and New England this winter. Petroleum is not any run-of-the-mill commodity. It is the lifeblood of commerce in this country, with fuel costs being built into the price of every other good bought and sold on the market. And in places like New England where petroleum heats most homes, it's literally a life-and-death commodity.

Question 4a. Your industry has taken the position in its SEC filings and at yesterday's hearing that the escalation of its fuel prices is the result of increases in crude oil prices. However, if your retail gas prices were raised simply to cover your increased costs in purchasing crude oil, your net profits would remain the same. Everyone knows this is not happening. Can you identify for this committee the reason that the rise in gasoline prices is far out-pacing the rise in crude oil prices?

Answer. During the recent hurricanes in the third quarter, refined product supply was impacted more than crude supply. The United States lost five million barrels per day or nearly 30% of its total refining capacity at the peak, and this substantially reduced the industry's ability to supply the market with gasoline and diesel fuel. The market price of gasoline increased rapidly due to the real and very significant shortage of supply caused by Gulf Coast refining and distribution shutdowns.

The hurricanes shut down 1.5 million barrels per day of Gulf of Mexico crude production at the peak. This event normally would create a significant shortage of U.S. crude oil supply and a large, rapid associate increase in crude oil price. However, with about two million barrels per day of U.S. refining capacity down for an extended period and a release of crude from the U.S. Strategic Petroleum Reserve, a severe crude shortage did not develop and the crude price increase was tempered.

According to DOE data, in the third quarter of 2005 versus the third quarter of 2004, the WTI crude price rose by 44%. During that same period, a simplified Gulf Coast refinery margin called a light oil price spread (two-thirds regular gasoline plus one-third heating oil minus WTI crude) more than doubled due to the hurricanes. The retail gasoline price reflects both the crude price increase as well as the increase in refining margins resulting from the hurricane-induced shutdown of U.S. refining capacity.

Product prices increased as a result of the imbalance, which moderated demand and attracted new supplies from overseas, which to a large degree restored the supply/demand balance. Gasoline prices have now fallen to below pre-hurricane levels.

The U.S. Federal Trade Commission's assessment that 85% of the changes in retail gasoline prices are caused by crude price changes has historically been true. However, there were unique circumstances in the third quarter caused by the hurricanes and their impact on such a large portion of the nation's refining capacity.

It is also important to note that the marketplace sets prices in accordance with the laws of supply & demand. These prices do not necessarily reflect production costs at any given moment. Sometimes supply/demand conditions set prices above and sometimes below costs and an acceptable return. Historically, over the last 20 years, both crude prices and refining margins have been set at levels that gave the petroleum industry sub-par returns when compared with other industries. Between 1990 and 2002, the average return on equity for the petroleum industry was 11.3%, lower on average than the 12.6% return for the S&P industrials. The refining & marketing sector has an even lower historical return on capital than the total petroleum sector. Between 1990 and 2002, the refining and marketing sector had a return on capital employed of 5.0% versus 7.1% for the total petroleum industry.

While the petroleum industry has been criticized for having a large concentration of energy infrastructure in the Gulf Coast, we are there because of the energy resources and because that is where we have been able to get energy infrastructure sited. Much of New England, including Maine, suffers from a lack of energy infrastructure due to community opposition to expansions. For example, ConocoPhillips made an attempt to provide Maine consumers with competitive options to home heating oil by bringing LNG into the state. We worked closely with the citizens and city council of Harpswell, Maine where we hoped to site an LNG regasification facility. There was support of the State, Labor, some of the commercial fishermen and

most of the citizens who grew up in the area, but the project failed on a close vote. That project could have been a real energy supply success story for Maine.

Question 4b. Even though crude oil prices have risen this year, your companies aren't actually incurring those costs, are they? Isn't the gasoline and heating oil that your firms are currently selling on the market actually being produced from inventories that your companies purchased when the price of crude oil was much lower?

Answer. First it is important to note that the marketplace sets prices in accordance with the laws of supply and demand. These prices do not necessarily reflect production costs at any given moment. Sometimes supply/demand conditions set prices above and sometimes below costs and an acceptable level of return. Over the long-run, prices on average equate to cost and an acceptable level of return or there will be too much or too little supply, which will push prices back towards a cost-based equilibrium level. In the short-term, there can be a series of imbalances that lead to prices being above and below a long-term cost-based equilibrium.

During a supply disruption, like we saw after the hurricanes, prices rise for all available supplies, including those in storage. There is about a three-week time lag between when crude is purchased and put in storage and when refined products are produced. Since the market was in a period of rising prices after the hurricanes, by the time the crude was turned into products, it was worth more. During periods of price decline, crude would be worth less by the time it was refined into products.

Question 4c. If you're producing oil from crude that you bought at \$40 per barrel, but selling it at a price that is purportedly based upon a \$70 per barrel cost to you, wouldn't that account for the 90% increase in profits we've seen?

Answer. ConocoPhillips reported third-quarter 2005 net income of \$3.8 billion, up 89% from this quarter last year. Of this increase, 48% came from our worldwide oil and gas exploration and production operations, 38% of this increase came from our worldwide refining and marketing operations and 15% came from our strategic alliance with LUKOIL, which we entered into during the fourth quarter of 2004.

According to U.S. Department of Energy data on spot prices for West Texas Intermediate crude, the increase in the third quarter of 2005 over the third quarter of 2004 was 44%. Our exploration and production earnings were up by closer to 60% during this period because they were also helped by higher natural gas prices and higher crude oil sales.

Earnings from our U.S. refining and marketing operations were about \$1.1 billion in the third quarter of 2005, compared with \$505 million a year ago. U.S. Department of Energy data for a simplified refining margin in the Gulf Coast, called a crack spread (2/3 regular gasoline, 1/3 heating oil minus WTI) more than doubled in the third quarter of 2005, versus the third quarter of 2004 as a result of the hurricanes and shutting in of nearly 30% of the nation's refinery capacity at the peak. The doubling of our U.S. refining & marketing earnings was consistent with the doubling of the Gulf Coast light oil spread or simplified refining margin. Thus, our earnings are reflective of the change in commodity prices.

It is important to remember that crude and gasoline prices are set in the marketplace by a large number of buyers, sellers, traders and financial players based on global and regional supply and demand conditions and may be higher or lower than costs and a profit on any given day, depending upon market conditions. In the third quarter of 2002, for example, this simplified refinery margin (Gulf Coast crack spread) was 60% below where this spread was in the third quarter of 2004. 2002 was a particularly weak year for refining margins due to weak demand resulting from September 11, 2001 and the economic slowdown in the United States. Over the long run average, refinery margins equate to costs plus a modest return but at any given moment, margins will vary based on market conditions. The U.S. refining business has historically had sub-par returns, given the large capital investments required to stay in business, and the large investments required to reduce emissions and make clean fuels. While the environmental investments are very important, they usually do not provide a return. Between 1990 and 2002, the average return on equity for the petroleum industry was 11.3%, lower on average than the 12.6% return for the S&P industrials. The refining & marketing sector had an even lower historical return on capital than the total petroleum sector. Between 1990 and 2002, the refining and marketing sector had a return on capital employed of 5.0% versus 7.1% for the total petroleum industry.

Question 5. I've alluded to the vital role petroleum plays in our economy and society, from the price of bread to the price of a plane ticket to the price of heating one's home. While you're obviously in the business for profit, there are other sectors of the economy where we put a limit on selling commodities at unconscionable prices. One example is usury law, where lenders are prohibited from charging un-

conscionable rates for borrowing money—because we recognize that access to cash is critical to enterprise.

How much more of a toll do these fuel prices have to take on our society before Congress steps in and places similarly appropriate regulations on your industry?

Answer. Imposing a regulatory scheme on the petroleum industry as a result of price increases that arose from world-wide events and weather related incidents is bad economic policy and could discourage capital investments aimed at increasing refining capacity. This would result in less supply being available in the marketplace and will do nothing to ensure lower prices for consumers.

Question 5a. Many consumers would say that raising the price of gas by \$2 per gallon over the past 2 years (Dec. 2003 price per gallon on East Coast was \$1.30; in August 2005 it was \$3.25) while reaping over \$25 billion in profits is price gouging. Many lawmakers would agree. What do you say to them?

Answer. Calling the increase in gasoline prices between the two times cited in the question “price gouging” disregards the fact that: (a) during the same time frames world wide crude oil prices more than doubled (b) the costs of refining and marketing gasoline increased, and (c) the August 2005 gasoline price was driven by the devastation wreaked on oil producing platforms in the Gulf of Mexico, shut ins of the refining complex in the Gulf Coast region (which produces 44% of America’s gasoline), and the shutdown of the Colonial Pipeline which delivers most of the gasoline to the East Coast of the United States from the Gulf Coast region, all of which were occasioned by Hurricane Katrina. The East Coast gasoline price has now dropped to \$2.21 per gallon (November 21, 2005—DOE) as refinery production has been restored and gasoline imports have been brought in from Europe to replace lost domestic supplies.

We are also in a commodity business and our prices and profits swing up and down with prices set in global and regional highly transparent markets. On average, the petroleum business has had sub-par returns historically. ConocoPhillips’ third-quarter revenues of about \$50 billion generated about \$3.8 billion of income. This represents a profit margin of 7.7 cents per dollar of sales, near or below the average of all industries. With this level of profit in the highest price environment our industry has experienced in 22 years, adjusted for inflation, we don’t see how our profits can be construed as gouging.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. JEFF BINGAMAN TO
JAMES J. MULVA

Question 1. Section 392 of the Energy Bill, which was negotiated with the involvement of the Chairman and Ranking Member of the Energy and EPW Committees, contains permitting streamlining language. The Energy Policy Act of 2005 permits the EPA Administrator to enter into a refinery permitting cooperative agreement with a state. Under such an agreement, each party identifies steps, including decision timelines, it will take to streamline the consideration of federal and state environmental permits for a new refinery. I want to ask you several questions about that provision, since you have supported streamlining: Have you requested that EPA issue any regulations or take any action to implement these new provisions? If no, when do you anticipate you will do so?

Answer. No, we have not as they relate only to new refineries.

The Section as written is specific only for the construction of a new refinery. We have no current plans to build a new refinery in the United States. ConocoPhillips plans to invest \$4-5 billion, on top of our other refinery investments of \$1-2 billion per year. This multi-year investment program is aimed at growing our U.S. refining capacity by about 11 percent and improving our capability of handling lower quality oils in order to make 15 percent more clean fuels such as gasoline, diesel and heating oil by the year 2011. These expansions will add enough clean fuels product to be the equivalent of adding one world-scale refinery to our domestic refining system.

Question 1a. Have you worked with any state to encourage them to enter into an agreement with EPA under Section 392 of EPAct?

Answer. No, we have not.

Question 1b. Do you support the EPAct streamlining provisions?

Answer. The provision, if utilized as intended by all parties, may be helpful in the project timeline of a new refinery in the United States. However, the provision as we interpret it is applicable solely to the construction of a new refinery. As such, the provision has little if any value to ConocoPhillips. ConocoPhillips currently owns and operates twelve refineries in the United States. We have an aggressive growth plan for these refineries that not only adds domestic capacity to the United States

but will increase the facilities' robustness in their flexibility to handle more difficult-to-refine crudes including heavy oils and will expand our conversion capabilities to clean fuels.

This investment program is a large downstream expansion but is dependent upon the securing of permits to proceed. We are disappointed that the provisions in EPCRA 2005 addressed only new refineries and provided limited or no additional permit streamlining for other capacity and/or crude and product flexibility projects.

Question 1c. Do you have any examples of where a state came to EPA and said we want to work closely with you on permitting a new refinery or refinery expansion and EPA refused to provide technical assistance and even financial resources under existing law to that state?

Answer. No. However, this does not mean that the permitting processes in existence today are efficient or certain in their timing and application. A federal facilitator coordinating the permitting process for qualifying projects could provide all parties with improved understanding and commitments to time and content of applications and eliminate the overlap between federal agencies and/or federal and state agency efforts.

Question 2. In answer to several of the questions at today's hearing (Nov. 9) the witnesses have noted that the market for petroleum and petroleum products is a global one and should be viewed in that context. Please list all planned refinery construction that your company plans to undertake globally. Please list them by country and include the projected size of the facility, including the projected capacity for all units and their potential product yields in addition to the project's total investment cost.

Answer. ConocoPhillips plans to invest \$4-5 billion, on top of our other refinery investments of \$1-2 billion per year. This multi-year investment program is aimed at growing our U.S. refining capacity by about 11 percent and improving our capability of handling lower quality oils in order to make 15 percent more clean fuels such as gasoline, diesel and heating oil by the year 2011. These expansions will add enough clean fuels product to be the equivalent of adding one world-scale refinery to our domestic refining system.

The following table provides some of our preliminary estimates for these U.S. refinery projects. Note that most of these projects are in the early design phase. As such, individual unit capacities and specific product yields are not yet defined. We have provided a rough estimate of our intended crude capacity increases, clean product volumes (a total of gasoline, jet fuel and diesel) expected, the types of units that will be added or modified, and an early estimate of the capital investment costs. Note that we have not done final engineering or applied for the permits, which could change our plans. Thus, these are very rough estimates and are subject to change.

ConocoPhillips is also considering opportunities to build grass roots refining capacity, and acquire existing refining capacity. On November 25, we announced that we would acquire Louis Dreyfus' 275MBPD refinery near Wilhelmshaven, Germany, subject to regulatory approvals. Should we be successful in acquiring the Wilhelmshaven refinery, we will consider upgrading investments to increase diesel and gasoline output.

PROPOSED MAJOR CONOCOPHILLIPS U.S. REFINERY CAPACITY RELATED CONSTRUCTION

Refinery	Country	Ownership interest	Current facility crude capacity (MBPD) ¹	Projected crude capacity (MBPD) ²	Estimated clean product increase (MBPD) ³	Total investment cost (\$MM)	Major units being added or modified
Los Angeles	USA	100%	139	179	34	495	Crude Unit Hydrocracker Coker FCC
San Francisco	USA	100%	115	122	6	235	Hydrocracker
Ferndale	USA	100%	93	105	10	455	Crude Unit Coker FCC
Wood River	USA	100%	306	331	21	1230	Crude Unit Hydrocracker Coker FCC
Borger	USA	100%	146	146	40	230	Coker FCC
Billings	USA	100%	58	83	21	395	Crude Unit FCC
Alliance	USA	100%	247	287	34	270	Crude Unit Coker FCC
Sweeny	USA	100%	229	259	26	705	Crude Unit Coker FCC
Bayway	USA	100%	238	238	40	300	Crude Unit FCC
U.S. total			1571	1750	152	4315	

¹ Utilizes corporate stated crude capacities. Sweeny and San Francisco capacities were updated as of 2005, respectively.

² Calculated growth added to stated corporate capacity.

³ Clean product increase estimated as crude increase multiplied by average system clean product yield of .85.

⁴ Major emphasis of project is to process heavier, higher sulfur crudes.

Question 3. The International Energy Agency (IEA) has just released its World Energy Outlook 2005. It contains a piece on the global refining picture. (Please see the summary below.) The study notes a lack of investment in upstream and downstream capacity has contributed to the extreme tightness in global oil markets. What are your thoughts in response to this? What is your company doing in response (actions)? What is your company doing (investments/analysis) in the “MENA” regions? Do you agree with the IEA’s projections?

World Energy Outlook 2005: IEA Projects Growth in Middle East and North Africa Oil and Natural Gas Sectors through 2030 but a Lack of Investment would Push up Prices and Depress GDP Growth

11/7/2005 London—“The importance of the Middle East and North Africa (MENA) to global oil and gas markets cannot be underestimated. These countries have vast resources, but these resources must be further developed. Investment should not be delayed,” said Mr. William C. Ramsay, Deputy Executive Director of the Paris-based International Energy Agency, as he presented findings from the World Energy Outlook 2005: Middle East and North Africa Insights (WEO-2005) today in London. Noting that a lack of investment in upstream and downstream capacity has contributed to the extreme tightness in the global oil market in recent months, Mr. Ramsay highlighted the critical role that this region will play in meeting growth in global energy demand.

The WEO-2005 expects global energy markets to remain robust through 2030. If policies remain unchanged, world energy demand is projected to increase by over 50% between now and 2030. World energy resources are adequate to meet this demand, but investment of \$17 trillion will be needed to bring these resources to consumers. Oil and gas imports from the Middle East and North Africa will rise, creating greater dependence for IEA countries and large importers like China and India. Energy-related CO₂ emissions also climb—by 2030, they will be 52% higher than today. “These projected trends have important implications and lead to a future that is not sustainable—from an energy-security or environmental perspective. We must change these outcomes and get the planet onto a sustainable energy path,” added Mr. Ramsay.

WEO 2005 focuses on the energy prospects in the Middle East and North Africa to 2030, covering in detail developments in Algeria, Egypt, Iran, Iraq, Kuwait, Libya, Qatar, Saudi Arabia and the United Arab Emirates. Internal demand, resources, policies, investment, production, exports, even energy use for water desalination, all are examined. “To our knowledge, this is the first time that any publication with a focus on the Middle East and North Africa has undertaken such an extensive, country-by-country review of the energy sector of the region. At a time when experts debate whether the world will run out of energy, these results are particularly relevant,” Mr. Ramsay said.

In the MENA region, domestic energy demand is driven by surging populations, economic growth and heavy energy subsidies. Primary energy demand more than doubles by 2030. At the same time, MENA oil production will increase by 75% by 2030 and natural gas production will treble, allowing more gas exports. The region’s share in global oil production will increase from 35% today to 44% in 2030. However, this means the countries of the Middle East and North Africa would need to invest, on average, \$56 billion per year in energy infrastructure. The level of upstream oil investment required will be more than twice that of the last decade.

But what if adequate investment is not made or consuming countries’ policies change? To assess these risks, WEO 2005 develops two other scenarios, each of them far from unlikely: a Deferred Investment Scenario, in which investment in the producing countries is delayed, whether deliberately or inadvertently; and a World Alternative Policy Scenario, in which energy-importing countries take determined action to cut demand and change the pattern of fuel use, driven by high prices, environmental or security goals, or all three.

The two scenarios have significant implications for MENA countries. In the Deferred Investment Scenario, energy prices rise sharply. Global energy-demand growth falls, cutting the region’s oil and gas export revenues by more than \$1 trillion from 2004-2030. World GDP growth slows down. Deferred investment could be the result of many factors, but whatever the cause, the results are higher prices, greater uncertainty and market inefficiencies.

The WEO World Alternative Policy Scenario examines the consequences of new policies under consideration in consuming countries. “The G8 Plan of Action, agreed at the Gleneagles Summit in July 2005, launched detailed initiatives to promote cleaner energy and combat the impact of climate change. The IEA was asked to play an important role. This strong global commitment indicates that governments are already adopting alternative policies—such as those in the World Alternative Policy Scenario—to achieve the G8 goals,” explained Mr. Ramsay. Under this Scenario, global oil and gas demand growth is lower, but the world continues to rely heavily on MENA oil and gas. CO₂ emissions fall 16% below the level of the Reference Scenario—but still increase around 30% by 2030.

Assumptions about international energy prices have been revised significantly upwards in WEO-2005, as a result of changed market expectations after years of underinvestment in oil production and the refinery sector. The average IEA crude oil import price, a proxy for international prices, averaged \$36.33 per barrel in 2004 and peaked at around \$65 (in year-2004 dollars) in September 2005. In the Reference Scenario, the price is assumed to ease to around \$35 in 2010 (in year-2004 dollars) as new crude oil production and refining capacity comes on stream. It is then assumed to rise slowly, to near \$39 in 2030. In the Deferred Investment Scenario the oil price reaches \$52 in 2030.

The World Energy Outlook 2005 contains over 600 pages of detailed statistics and in-depth analysis. The study was produced by the IEA with input from many international experts from producing countries, industry and organizations including OPEC. The IEA’s prestigious annual WEO series has long been recognized as the authoritative source for global long-term energy market analysis and has received honors for analytical excellence including awards from the Russian Academy of Sciences, the U.S. Department of Energy and numerous public and private organizations.

Answer.

Comments on Investment

The main drivers for present elevated prices are the exceptionally strong global economic recovery and resulting demand growth and supply disruptions, including the recent hurricanes in the Gulf of Mexico. While sustained strong prices help encourage investment, for many years the industry has recorded poor historical returns, which have limited capital available for investment. Between 1990 and 2002, the average return on equity for the petroleum industry was 11.3 percent, lower on average than the 12.6 percent average return for the S&P industrials. The refining & marketing sector has an even lower historical return on capital than the total petroleum sector. Between 1990 and 2002, the refining and marketing sector had an average return on capital employed of 5.0 percent versus an average of 7.1 percent for the total petroleum industry. Given the degree of price, technical, capital and political risk in our projects, the price levels and returns in the 1980s and 1990s did not allow the industry to attract sufficient capital. The IEA report acknowledged that average financial returns over the past three decades have usually been very low and that uncertainty about future investment returns discourages investment.¹

Until recently, accelerated levels of investment were not encouraged because growing global demand could be met largely from spare oil production capacity in Russia and in OPEC countries, and by taking advantage of spare global refining capacity and spare capacity in oilfield services and supplies. As a result, the market did not provide the economic incentives for new grassroots investment. Within the past two years, the free market metrics have encouraged the industry to recalibrate the investment dial to higher, more aggressive levels of spending.

In the exploration, development and production business, investment by private oil companies has also been constrained by a lack of access to low-cost reserves, including in the United States. The opportunities available tend to be more remote, complex, or involve lower quality crude oil that requires higher prices to be economically produced.

Expansion in the refining business has also been constrained by the need to dedicate investments to a “stay in business” program for emissions reductions and clean fuels projects. These projects, while useful for ensuring a cleaner environment, do not expand and sometimes reduce supplies. Difficulties in permitting have also constrained refinery investment in the United States.

¹International Energy Agency, World Energy Outlook 2005, November 2005, page 98.

Now that the market is identifying that new supplies are needed and peak clean fuel investments are nearing completion, the private sector will likely make these investments without need of any new government incentives. However, the industry does need governments at all levels to be thorough—but at the same time—to streamline permitting and environmental review processes so we can make these investments and add energy supplies.

ConocoPhillips has been aggressively investing in refining, and in developing new natural gas supplies for the United States. The projects described below are all very large and will require significant capital expenditures in the future.

Over the past five years, ConocoPhillips has spent \$4.0 billion worldwide, of which \$3.2 billion was spent domestically, to expand and modernize our refineries and upgrade marketing operations.

Going forward, we are planning an expanded incremental investment program, whereby we expect to invest \$4-5 billion, on top of our ongoing refinery investments of \$1-2 billion per year. This investment program is aimed at growing our U.S. refining capacity by about 11 percent and improving our capability of handling lower quality oils in order to make 15 percent more clean fuels such as gasoline, diesel and heating oil by the year 2011. These expansions will add enough clean fuels product to be the equivalent of adding one world scale refinery to our domestic refining system.

ConocoPhillips is making major investments in North American Arctic natural gas through the Mackenzie Delta and Alaskan North Slope pipelines. Initial development of Mackenzie Delta will access about 6 trillion cubic feet of gas, which is expected to come on stream in the year 2011 at approximately 1 billion cubic feet per day. As other fields are added, the pipeline will have the capacity to be expanded to 1.8 billion cubic feet per day. The total cost of this pipeline is estimated to be at least \$6 billion.

The Alaskan North Slope presently has an estimated 35 trillion cubic feet of natural gas, which would increase total U.S. gas reserves by approximately 20 percent. When the pipeline connecting this gas with the lower 48 market is completed, about 4.0-4.5 billion cubic feet per day will be added to natural gas supplies. This equates to about 8 percent of present U.S. natural gas production. This project exemplifies what we have been saying about capital-intensive projects that require many years before we see a return on the investment. The Alaska pipeline alone is expected to cost about \$20 billion and take ten years before the first cubic foot of gas is sold on the market. In October 2005, ConocoPhillips joined Governor Murkowski of Alaska in announcing that we have reached an agreement in principle on terms and conditions that would move the Alaskan natural gas pipeline closer to reality. Once the agreement is completed by all gas owners, the Alaska legislature will, hopefully, act on that agreement, passing it quickly. While it is not a short-term solution, gas from Alaska will eventually make a sizable contribution in addressing the market problems we are anticipating for natural gas.

ConocoPhillips is also investing aggressively in bringing liquefied natural gas (LNG) to the U.S. market. We are progressing LNG projects in Qatar and Nigeria and aggressively pursuing projects in Russia, Venezuela and Australia. These are all multi-billion dollar projects. We expect to bring our first cargo of Qatari gas to the United States in 2009. We are also developing an LNG supertanker to bring gas to the United States. We are participating in the construction of an LNG regasification facility at Freeport, Texas. We are pursuing a second LNG regasification terminal in Compass Port, offshore Alabama, although it is currently bogged down in the permitting process. We are committed to making the investments in these two facilities, which total over \$1.5 billion. We are also pursuing permitting of regasification facilities on the East and West Coasts, as well as an additional Gulf Coast terminal.

To bolster U.S. and global oil supplies, ConocoPhillips is expanding conventional crude production in Venezuela, Russia and the Far East. There is likely to be a bridge of unconventional heavy-oil and natural gas before the world transitions to alternative fuels in a major way. ConocoPhillips has invested and continues to invest heavily in unconventional heavy oil production in Venezuela and Canada. Our company recently announced that we will be partnering with a Canadian company to develop the \$2.1 billion Keystone pipeline to bring over 400 thousand barrels per day of much-needed Canadian heavy oil production to our U.S. mid-continent refineries.

There is an estimated 7 trillion barrels of unconventional oil in place globally versus conventional estimates of 3 trillion barrels. Technology improvement will be important in raising the present low recovery rates of unconventional oil. We are building additional upgrading capacity in our refineries to process unconventional heavy crude, while exploring opportunities to apply our proprietary technology for

turning natural gas into a slate of clean refined oil products, which will enhance clean diesel supplies.

ConocoPhillips' Investments in MENA Region

ConocoPhillips' Middle East and North Africa regional office is in Doha, Qatar. Regional activities comprise pursuit of new business opportunities throughout the region in addition to a number of existing and emerging businesses.

Through its subsidiary, Dubai Petroleum Company, ConocoPhillips produced first oil in 1969 and continues to operate four offshore oil fields.

In Syria, we have a service contract with the Syrian Petroleum Company that expires on December 31, 2005. Our current plan is to honor that contract to its termination date. We expect our presence in Syria to end in 2006, once the formalities of closing out the service contract are accomplished. We have no plans to seek additional business in Syria.

In 2003, ConocoPhillips and Qatar Petroleum signed a heads of agreement for the development of Qatar Gas 3 a large scale (7.8 MMTPA) LNG project located in Qatar with the U.S. Gulf Coast targeted as the primary gas sales market. Development activities continue with a final investment decision expected soon. If the project is approved, first gas is expected in late 2009. Also in 2003, ConocoPhillips signed a Statement of Intent with Qatar Petroleum for the development of a large scale gas to liquids (GTL) plant located in Qatar. Currently this project is on hold by Qatar Petroleum, owing to the unprecedented level of industrial development activities in Qatar.

In 2004, ConocoPhillips and LUKOIL announced their intent to seek the right to develop the West Qurna field in Iraq. Subject to confirmation of LUKOIL rights under its PSA (production sharing agreement) related to the field, as well as governmental authorities and parties to the contract, ConocoPhillips expects to enter into further agreements regarding the assignment of a 17.5 percent interest in the PSA by LUKOIL.

Since spring 2004, following U.S. government approval, ConocoPhillips together with partners Amerada Hess and Marathon have been negotiating with the Libyan Government and the Libyan National Oil Company to re-enter the Oasis concession (Waha Oil Company) the companies departed in 1986. These negotiations are continuing.

Views on IEA's Projections

We generally agree with the IEA's reference case and its view of how challenging it will be to get \$17 trillion (2004 dollars) of investment between 2004 and 2030. We believe that governments around the world can help by maintaining an attractive investment climate and removing barriers to investment, such as allowing greater resource access, streamlined—but thorough—permitting processes and stable fiscal terms. We would like to put in perspective one comment made in the report that the level of annual Upstream investment in MENA countries will have to double to meet the IEA's production forecast. The level of investment in MENA countries over the last 15 years was constrained by the enormous amount of excess capacity these countries held in the mid-1980s as they continued to lose market share to non-OPEC production and an extended period of relatively weak prices and returns on investment. The market is now providing the price incentive for investment. Earlier this year, Saudi Arabia announced an investment program to expand their oil production capacity by 1.5 million barrels per day (from 11-12.5 million barrels per day) or by 14 percent by early 2009.

Question 4. Voluntary standards—Post hurricanes, what is the industry doing to come up with voluntary standards/best practices for back-up power supply to critical energy infrastructure (refineries, pipelines, etc.) and natural disaster recovery? Will the API undertake such an effort? If not, what is your company doing?

Answer. First, it is worth noting that our industry has established voluntary pre-hurricane shutdown procedures to protect people, the environment and equipment. Shutting down the complex refinery processes that may be in the path of hurricanes is a proactive step to reduce the chances for more extensive damage. The severity of the recent hurricanes and local infrastructure devastation has been unprecedented. Our company has faced different challenges from hurricanes Katrina and Rita, and there is no single common solution or best practice for post-hurricane disaster recovery. We have extensive existing best practices to repair and restart our refineries. The first step of any recovery effort is a critical assessment of the condition of all equipment and infrastructure. We will continue to work hard to develop future best practices to minimize downtime at our refineries and other critical infrastructure facilities.

Our industry has shown great resilience in working within the storm-devastated areas to set priorities for both the good of the community and the energy industry. The API should be consulted directly for positions on potential standards of disaster recovery. We are active members of the API and will participate in any activities undertaken.

Question 5. A number of witnesses testified that failure of the electricity system resulting from hurricanes Rita and Katrina contributed in great part to the inability to get refineries restarted, or to get natural gas pipelines restarted. What are the arrangements for backup power in case of such emergencies at your critical facilities?

Answer. One-half of our U.S. refineries have owned cogeneration plants or local area third-party cogeneration plants with contracts to supply electricity to the refineries. Each major storm event we witnessed this year brought with it widespread devastation. An on-site or local area cogeneration plant is much like a refinery in terms of storm exposure to wind and flood damage.

Storm damage to on-site cogeneration plants can occur to the same degree as the damage to the refinery. Additionally, cogeneration plants normally require connectivity to a regional electrical grid system in order to start up. Thus, damage to adjacent regional power distribution grids will have a significant impact on the ability to restart either the cogeneration plant or the refinery.

As an example, following Hurricane Rita, both our Lake Charles refinery and the local area third-party NISCO cogeneration plant, of which we own 36 percent, experienced hurricane damage. The same hurricane also produced widespread devastation in the region. The startup timing of both plants was dependent on the completion of repairs to the portions of the damaged regional power distribution system.

In cases where storm devastation is this widespread, there are often many additional concerns for refinery restarts such as availability of refinery workers and contractors who have been displaced, critical local services like police and firefighting, fresh water supplies, etc. In cases of such severe devastation, the civil/community needs may be given first priority for manpower or critical backup equipment such as portable generators, etc.

Question 6. How many of your plants have on site cogeneration facilities? Which plants have these facilities?

Answer. Roughly one half of our U.S. refineries have owned cogeneration plants or local area third party cogeneration plants with contracts to supply electricity to the refineries.

Los Angeles, CA—Owned cogeneration that provides a portion of the total electricity requirement for the plant.

San Francisco, CA—Owned cogeneration that provides a portion of the total electricity requirement for the plant.

Lake Charles, LA—We own 36 percent of a local area cogeneration plant, this percentage ownership supplies a majority of the electricity needs for our plant.

Bayway, NJ—Third-Party local area Cogeneration supplies power to our plant on contract.

Sweeny, TX—Third-Party local area Cogeneration supplies power to our plant on contract.

Borger, TX—Third-Party local area Cogeneration supplies power to our plant on contract.

Ponca, OK—Third-Party local area Cogeneration that supplies power to our plant on contract—note, this cogeneration will shut down in 2006.

Question 7. Are there regulatory barriers at either the state or federal level that prevent the installation of cogeneration plants at your facilities that do not have them?

Answer. No.

Question 8. Would the presence of cogeneration facilities at your refineries reduce the recovery time during such emergencies?

One-half of our U.S. refineries have owned cogeneration plants or local area third-party cogeneration plants with contracts to supply electricity to the refineries. Each major storm event we witnessed this year brought with it widespread devastation. An on-site or local area cogeneration plant is much like a refinery in terms of storm exposure to wind and flood damage.

Storm damage to on-site cogeneration plants can occur to the same degree as the damage to the refinery. Additionally, cogeneration plants normally require connectivity to a regional electrical grid system in order to start up. Thus, damage to adjacent regional power distribution grids will have a significant impact on the ability to restart either the cogeneration plant or the refinery.

As an example, following hurricane Rita, both our Lake Charles refinery and the local area third-party NISCO cogeneration plant, of which we own 36 percent, experienced hurricane damage. The same hurricane also produced widespread devastation in the region. The startup timing of both plants was dependent on the completion of repairs to the portions of the damaged regional power distribution system.

In cases where storm devastation is this widespread, there are often many additional concerns for refinery restarts such as availability of refinery workers and contractors who have been displaced, critical local services like police and firefighting, fresh water supplies, etc. In cases of such severe devastation, the civil/community needs may be given first priority for manpower or critical backup equipment such as portable generators, etc.

Question 9. Witnesses at earlier hearings testified that there are a number of modern natural gas generation facilities in the Louisiana/Texas area that are not used to their full capacity. Are there natural gas generation facilities in close proximity to your refinery facilities that could be used for backup generation at the refineries?

Answer. Natural gas production and distribution was disrupted during the hurricanes so natural gas-fired power generation plants would not have helped. Unless the facilities are immediately adjacent, power lines would connect them to the refinery, and power lines were severely impacted during the hurricanes.

Question 10. Would use of generators that are in close proximity to refineries to provide backup power during such emergencies mean that recovery times might be shortened, since the restoration time for a nearby facility might be less than the restoration time for the transmission facilities for traditional utilities?

Answer. One-half of our U.S. refineries have owned cogeneration plants or local area third-party cogeneration plants with contracts to supply electricity to the refineries. Each major storm event we witnessed this year brought with it widespread devastation. An on-site or local area cogeneration plant is much like a refinery in terms of storm exposure to wind and flood damage. Storm damage to on-site cogeneration plants can occur to the same degree as the damage to the refinery. Additionally, cogeneration plants normally require connectivity to a regional electrical grid system in order to start up. Thus, damage to adjacent regional power distribution grids will have a significant impact on the ability to restart either the cogeneration plant or the refinery.

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In cases where storm devastation is this widespread, there are often many additional concerns for refinery restarts such as availability of refinery workers and contractors who have been displaced, critical local services like police and firefighting, fresh water supplies, etc. In cases of such severe devastation, the civil/community needs may be given first priority for manpower or critical backup equipment such as portable generators, etc.

ENVIRONMENTAL QUESTIONS

Question 11. Please specify exactly which, if any, Federal or State environmental regulations have prevented your company from expanding refinery capacity or siting a new refinery, and documentation on the exact details of the project prevented.

Answer. At this time we are not aware of any projects that have been directly prevented as a result of any specific Federal or State regulation. However, the Clean Air Act, Resource Conservation and Recovery Act, Clean Water Act, Toxic Substance Control Act, Comprehensive Environmental Response Compensation and Liability Act, Oil Pollution Act, Solid Waste Disposal Act, Hazardous and Solid Waste Amendments, etc. give rise to many regulatory programs. Each of the resulting regulatory programs gives rise to numerous design, operation, maintenance, monitoring and reporting obligations for refineries. Specifically, these obligations arise from (but are not limited to) New Source Review and Prevention of Significant Deterioration, Refinery Maximum Achievable Control Technology (MACT) I, Refinery MACT II, Heater and Boiler MACT, New Source Performance Standards (NSPS) Subpart J, NSPS Subpart K, NSPS Subpart GGG, NSPS Subpart VVV, NSPS Subpart QQQ, National Emissions Standards for Hazardous Air Pollutants (NESHAP) for Benzene Waste Operations, National Pollution Discharge Elimination System, Spill Prevention Control and Countermeasures, Stormwater Pollution Prevention, Hazardous Waste Regulations, etc. In addition, many of the environmental programs have extensive permitting processes which can require years of negotiation. Cumulatively,

the programs add significant cost and time to refinery construction or expansion. Ultimately, the cost and time of the environmental requirements must be included in a refinery construction or expansion project, increasing costs and reducing the return on investment. All of these factors must be considered as part of the investment decision during the project planning process and make refinery construction and expansion efforts less attractive in the absence of significant improvement of the long-term refining margin outlook.

Question 11a. How much have so-called "boutique fuel" requirements added to the average retail price, where applicable, and the average wholesale price per gallon of the gasoline sold by your company?

Answer. Boutique fuels generally represent barriers to market entry for refiners who do not have the flexibility to make these more difficult-to-produce specialty fuels. Additionally, not all transportation systems can accommodate the addition of a specialty grade without giving up some shipping flexibility. Boutique fuels also limit the amount of storage that can be held for any given fuel since these fuels must be held in separate tanks. These factors make meeting boutique fuels demand more difficult, particularly when operating problems occur and when these fuels are first introduced. In general, these factors increase the price to produce these specialty fuels but the magnitude depends on market conditions.

In addition, the transition periods when products with new specifications are introduced tend to have greater price volatility since the supply system needs to go through an adjustment period to accommodate the new product. Similarly, when there are different seasonal specifications (e.g., summer and winter gasoline), inventories must be drawn down at the end of one season to enable switching to a different seasonal specification. The switching points will have low inventories and leave the market more vulnerable to supply disruption.

Question 11b. If the EPA or the Congress were to act to minimize the number of "boutique fuel" formulations required by the states to protect air quality, how many should there be and what should the specifications of each be in order to maintain air quality and improve fungibility?

Answer. EPA Act 2005 has initiated the process of reducing the proliferation of boutique fuels. In addition, Congress directed the U.S. EPA to merge southern and northern grades of RFG, beginning the process of reducing the number of "boutiques". Congress also directed the Agency, in concert with the Department of Energy, to study the boutique fuels in this country to identify and make recommendations to Congress for a more efficient federal fuel system.

In reviewing the various boutique gasolines in this country, five (5) primary summer gasoline types evolve as reasonable candidates for a future slate. These are California gasoline, Conventional Gasoline at 9.0 psi Reid Vapor Pressure (RVP), Conventional Gasoline at 7.8 psi RVP, Conventional Gasoline at 7.0 psi RVP, and RFG. However, states have adopted various versions of these fuels (sulfur controls, ethanol mandates, additives and other unique specifications or controls) that have complicated the delivery infrastructure and their interchangeability should shortages occur in one area when supplies are ample in another. This has become even more apparent with the impact of the hurricanes that severely tested the supply and distribution for motor fuels in this country.

We support Congress in its efforts to look for means of rationalizing the number of boutique fuels. We believe this effort must include a review of the air quality benefits, fungibility, costs and supply impact to assure unintended consequences of taking action does not occur. Any such reduction of fuels on a federal basis must preempt state and local controls in order to assure no overlapping controls exist that defeat the intended purpose of the rationalization.

The U.S. EPA has taken action to bring diesel fuels used on the highway and in non-road application to a common specification. However, we have recently begun to experience the bifurcation of the diesel markets by independent state action to adopt unique "boutique" diesel fuels beyond the federally directed specifications. Most recently the state of Texas has adopted a unique diesel fuel that is manufactured solely for the eastern half of Texas. Likewise, Minnesota this year has imposed a formulation mandate for diesel fuel sold in the state. California has had its unique diesel fuel for several years. These actions do not bode well for the future of a single nationwide diesel fuel with federally imposed ultra-low sulfur content to enable the next generation of low emission vehicles. We encourage Congress to include diesel fuel harmonization as further actions are considered relative to the proliferation of "boutique" fuels.

Question 12. Streamlining New Source Review (NSR) permitting constraints was mentioned as an incentive that would encourage refiners to supply more product to the U.S. market. How many air quality permit applications for refinery expansions

has your company submitted for NSR over the last ten years? How long did it take the EPA, or the applicable State, to approve or deny each permit application, after receipt of a complete permit application? What was the expected percentage increase in product output of the expansion?

Answer. At least 20 major PSD (prevention of significant deterioration) permits have been applied for in the last 10 years. Permit approvals range from 9 to 24 months, with typical permit approval occurring in the 12- to 15-month window. In addition to major PSD permitting, numerous (well over 100) minor permitting activities have occurred at the same time. Permit approvals for minor permits range from 3 to 12 months with approvals generally occurring in about 6 to 9 months. In addition to the permit approval process, some consideration should be given to the time required to prepare permit applications, which can take as much as 6 to 12 months (for bigger projects) before a permit is ready for submission to the agency.

The permitting experiences relied on for the previous examples have resulted in relatively modest increases of either crude capacity or product conversion. Many past permits have resulted in no capacity increase but have focused on improved product quality, increased reliability, increased refinery efficiency, or have been required for regulatory compliance (e.g. to meet clean fuels requirements).

Due to the evolution of implementation, the various permitting programs (federal, state and local) have had the effect of becoming a disincentive to some small, cost-effective projects which in the past were an important way a refinery met growing demand in a traditionally low margin environment. With larger projects having much longer implementation cycles (e.g. multiple years), overall flexibility to meet market fluctuations has diminished.

Question 12a. How would you propose to streamline NSR and still maintain local air quality and prevent any increase in total annual emissions from such expansions?

Answer. The following is a list of some specific potential options to consider for improving the permitting process:

- To mandate the use of the NSR Reform rules (not all states have implemented to date)
- Codify that NSR programs cannot be altered by states
- Codify a 10-year refinery PAL (plantwide applicability limit) which is applicable in all states, incorporate (and reduce emissions) as new federal regulations are implemented, but wait for the 10-year term of the PAL to end before applying any State Implementation Plan-required emissions reductions due to NAAQS (National Ambient Air Quality Standard) attainment
- For post-Katrina reconstruction, allow for expedited permitting provided that objective is to rebuild
- Reasonable permit review—a deadline-based approach designed to coordinate and eliminate overlap among numerous permitting processes
- Energy projects get priority review due to national security significance
- Time limits on government reviews (90 days)
- Grant DOE authority as facilitator, if requested, for ensuring timely review of all permits to build new refineries or add new capacity
- Initiate federal, state, and local review process simultaneously
- Public participation addressed via 45-day comment period
- To allow project construction to begin concurrent with a complete permit application to the state, rather than final permit approval (e.g. expand allowable work to include actual construction such as making tie-ins, building supports and foundations, perhaps even building and setting new equipment such as furnaces, vessels, exchangers, pumps, etc.)
- Encourage more flexible permit terms and conditions. For example, allow physical changes and modifications to refineries to be permitted “prospectively” (e.g. if a project is anticipated to increase production, set allowable increases in the permit for the anticipated pollutant increases even though specific project information is unknown, thus allowing for future modifications so long as the capped emission limits for pollutants are not exceeded)
- Extend to refineries the recently proposed rule for electric generating units which clarifies that Federal NSRIPSD permitting is triggered only if there is an increase in the maximum hourly emissions rate of a source which then yields a significant increase in the annual mass emissions of the pollutant in question. This proposal, dated Oct. 20, 2005 at FR 61081-61103 utilizes the New Source Performance Standard (NSPS) as the initial emissions test for determining emissions increase
- Calculate emission increases using past-actual to future-actual analysis instead of past actual to future potential

Question 13. How much did the fuel specification waivers that have been granted by EPA to date, due to the supply disruptions caused by the hurricanes, reduce the average retail price of the gasoline or other refined products made by your company?

Answer. ConocoPhillips' U.S. refining system was able to supply approximately 340 thousand barrels of extra gasoline due to the RVP waivers. This helped increase the supply of gasoline which would likely directionally reduce the price of gasoline. However, it is difficult to isolate the price impact since there are many other suppliers and operating factors that impact the overall supply and demand balance and marketplace. The diesel waivers proved to be burdensome and difficult to implement, resulting in minimal ConocoPhillips supply increases.

Question 14. One witness indicated that "getting two 100-year hurricanes in four weeks" caused a great deal of chaos and disruption in the gasoline supply chain. The National Oceanic and Atmospheric Administration has projected that the country and the Gulf of Mexico have entered a cyclical period of 20-30 years during which the Gulf and coastal areas are likely to experience a greater frequency of hurricanes and higher odds of those hurricanes making landfall in the U.S. What preparations has your company made to deal with a greater hurricane frequency to decrease repetition of the supply disruption that occurred this year?

Answer. First, it is worth noting that our industry has established voluntary pre-hurricane shutdown procedures to protect people, the environment and equipment. Shutting down the complex refinery processes that may be in the path of hurricanes is a proactive step to reduce the chances for more extensive damage. The severity of the recent hurricanes and local infrastructure devastation has been unprecedented. Our company has faced different challenges from hurricanes Katrina and Rita, and there is no single common solution or best practice for post-hurricane disaster recovery. We have extensive existing best practices to repair and restart our refineries. The first step of any recovery effort is a critical assessment of the condition of all equipment and infrastructure. We will continue to work hard to develop future best practices to minimize downtime at our refineries and other critical infrastructure facilities.

Our industry has shown great resilience in working within the storm-devastated areas to set priorities for both the good of the community and the energy industry. The API should be consulted directly for positions on potential standards or disaster recovery. We are active members of the API and will participate in any activities undertaken.

Question 15. Over the last 50 years, average annual sea surface temperatures have increased in the Gulf of Mexico and, according to the National Academy of Sciences and other similar scientific expert bodies, are expected to continue increasing as the oceans continue warming due to accelerating global climate change. The Administration's Climate Action Report (2002) stated "model simulations indicate that, in a warmer climate, hurricanes that do develop are likely to have higher wind speeds and produce more rainfall." What preparations has your company made to deal with a greater likelihood of greater hurricane intensity so as to decrease repetition of the disruption that occurred this year?

First, it is worth noting that our industry has established voluntary pre-hurricane shutdown procedures to protect people, the environment and equipment. Shutting down the complex refinery processes that may be in the path of hurricanes is a proactive step to reduce the chances for more extensive damage. The severity of the recent hurricanes and local infrastructure devastation has been unprecedented. Our company has faced different challenges from hurricanes Katrina and Rita, and there is no single common solution or best practice for post-hurricane disaster recovery. We have extensive existing best practices to repair and restart our refineries. The first step of any recovery effort is a critical assessment of the condition of all equipment and infrastructure. We will continue to work hard to develop future best practices to minimize downtime at our refineries and other critical infrastructure facilities.

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Question 16. How has your company disclosed to shareholders and investors the risks associated with the potential impacts on your company's assets in the Gulf of Mexico or indirect impacts on its assets elsewhere, of either the expected greater frequency of hurricanes making landfall in the U.S. or the probable greater intensity of hurricanes in the region?

Answer. All of ConocoPhillips worldwide operations, like all activities conducted by industry, governments, non-government organizations and private individuals, have a degree of external risk involved. This external risk might be as a result of acts of God such as extreme weather or earthquakes or man-made actions such as political change, terrorism or war. ConocoPhillips assesses and takes steps to manage these risks when warranted. ConocoPhillips seeks to be transparent about the location of all our operations through our Annual Report to Stockholders, Fact Book, our Forms 10-K and 10-Q and many other documents, allowing shareholders and investors to make their own evaluations of the degree of risk involved. We do include a safe harbor statement in our various documents describing the risks involved in any forward-looking statement. The Forms 10-K, 10-Q and Annual Report to Stockholders specifically state (among many other possible factors) that differences from forward-looking statements could result from potential disruption or interruption of our operations due to accidents, extraordinary weather events, civil unrest, political events or terrorism.

FINANCIAL, PRODUCTION AND IMPORT QUESTIONS

Question 17. Please provide for each of last ten years your company's: Gross revenue of U.S. operations; Total capital expenditures in the U.S.; Net profit of U.S. operations.

Answer. Please see chart below.

CONOCOPHILLIPS REPORTED (PHILLIPS PETROLEUM COMPANY PRIOR TO SEPTEMBER 2002)

\$MM	Net income ¹	Capital expenditures & investments ²	Reinvestment as % of net income	U.S. net income ³	U.S. capital expenditures & investments ⁴	Reinvestment as % of U.S. net income
1995	469	(1,456)	310%	335	(923)	276%
1996	1,303	(1,544)	118%	1,130	(841)	74%
1997	959	(2,043)	213%	710	(1,059)	149%
1998	237	(2,052)	865%	263	(936)	357%
1999	609	(1,690)	278%	376	(919)	244%
2000 *	1,862	(8,460)	454%	1,250	(7,707)	617%
2001 *	1,661	(10,054)	605%	1,305	(8,887)	681%
2002 **	(295)	(4,388)	.....	(910)	(2,043)	.....
2003	4,735	(6,169)	130%	2,513	(2,493)	99%
2004	8,129	(9,496)	117%	4,659	(2,520)	54%
2005	9,850	(8,573)	87%	5,626	(3,140)	56%
Average	2,683	(5,084)	189%	1,569	(2,861)	182%

*2000 Includes Alaska acquisition—(\$6,443MM), 2001 Includes Tosco Acquisition—(\$7,038MM).

**The merger of Conoco and Phillips in August, 2002 is not considered an acquisition in this table. Sources:

¹Net Income. 2005 YTD through September (ConocoPhillips 3Q, 10Q); 2004-2000 (ConocoPhillips 2004 Annual Report, page 108); 1999-1995 (Phillips 2001 Annual Report, page 95).

²Capital Expenditures & Investments. 2005 YTD through September (ConocoPhillips 3Q, 10Q); 2004-2000 (ConocoPhillips 2004 Annual Report, page 108); 1999-1995 (Phillips 2001 Annual Report, page 95).

³U.S. Net Income. A domestic and international breakdown is provided externally for the major company segments (I.e. E&P and R&M). Midstream and Emerging businesses are internally reported as domestic and international and this breakdown is included in the above total. The Chemical and Corporate Segments have been included in the U.S. total.

⁴U.S. Capital Expenditures & Investments. 2005 YTD through September (ConocoPhillips 3Q, 10Q); 2004-2002 (ConocoPhillips 2004 Annual Report, page 45); 2001 (ConocoPhillips 2003 Annual Report, page 49); 2000 (ConocoPhillips 2002 Annual Report, page 49); 1999 (Phillips 2001 Annual Report, page 47 adj. to exclude discontinued ops.); 1998 (Phillips 2000 Annual Report, page 47 adj. to exclude discontinued ops.); 1997 (Phillips 1999 Annual Report, page 44); 1996 (Phillips 1998 Annual Report, page 42); 1995 (Phillips 1997 Annual Report, page 40).

CONOCOPHILLIPS REPORTED (PHILLIPS PETROLEUM COMPANY PRIOR TO
SEPTEMBER 2002)

\$MM	Sales & operating revenue ¹	U.S. sales & operating revenue ¹	U.S. % sales & operating revenue
1995	13,368	11,310	85%
1996	15,731	13,211	84%
1997	15,210	12,633	83%
1998	11,545	9,535	83%
1999	15,396	13,019	85%
2000	22,155	18,700	84%
2001	24,892	22,466	90%
2002	56,748	46,674	82%
2003	104,246	74,768	72%
2004	135,076	96,449	71%
2005	128,184	95,461	74%
Average	49,323	37,657	76%

¹Sales & Operating Revenue, U.S. Sales & Operating Revenue. 2005 YTD through September (ConocoPhillips 3Q, 10Q); 2004-2002 (ConocoPhillips 2004 Annual Report, page 97); 2001 (ConocoPhillips 2003 Annual Report, page 97); 2000 (ConocoPhillips 2002 Annual Report, page 92); 1999 (Phillips 2001 Annual Report, page 83); 1998-1996 (Phillips 1998 Annual Report, page 67); 1995 (Phillips 1997 Annual Report, page 63).

Question 17a. Total taxes paid to the Federal Government

Answer. Total U.S. and International tax provisions for the years 2003, 2004 and 2005 (YTD September) were \$3,744 million, \$6,262 million and \$7,068 million, as reflected in our financial statements. Of these amounts, federal and state tax provisions were \$1,346 million, \$2,604 million and \$3,159 million for the same time periods.

CONOCOPHILLIPS REPORTED—TAX PROVISION

\$MM	Federal tax provision	State tax provision	Total U.S.	International	Total company
2003	1,173	173	1,346	2,398	3,744
2004	2,335	269	2,604	3,658	6,262
2005 ¹	2,715	444	3,159	3,909	7,068

¹Total Company tax provision. 2005 YTD through September (ConocoPhillips 3Q, 10Q); 2004-2003 (ConocoPhillips 2004 Annual Report).

Question 17b. Total taxes paid to State governments

Answer. State tax provisions for the years 2003, 2004, and year-to-date 2005 were \$173 million, \$269 million and \$444 million respectively.

Question 17c. Total donated to charity

Answer. Over the past three years, ConocoPhillips' charitable donations were \$36 million in 2003, \$39 million in 2004 including \$2 million pledged for tsunami victims, and \$44 million to date in 2005 including \$7 million pledged for Gulf Coast disaster relief.

Question 18. How much additional petroleum refining capacity do you expect your company to install in the United States over the next 10 years?

Answer. Our current, formal forward planning for expanding our refining business generally goes out six years. ConocoPhillips plans to invest \$4-5 billion, on top of our other refinery investments of \$1-2 billion per year. This multi-year investment program is aimed at growing our U.S. refining capacity by about 11 percent and improving our capability of handling lower quality oils in order to make 15 percent more clean fuels such as gasoline, diesel and heating oil by the year 2011. These expansions will add enough clean fuels product to be the equivalent of adding one world-scale refinery to our domestic refining system.

Question 19. What percentage of profits over the last 10 years has your company re-invested in capital, exploration, drilling, and production in the United States? Please provide an annual total for those U.S. expenditures and a clear breakdown.

Answer. We have invested a total of \$34.4 billion in capital expenditures and investments in the Exploration and Production (E&P) part of our business since 1995. This represents the equivalent of 147 percent of our earnings for this period. For the same time frame, U.S. E&P capital expenditures and investments totaled \$15.5 billion, or 116 percent of U.S. E&P net income of \$13.4 billion.

EXPLORATION AND PRODUCTION CAPITAL EXPENDITURES AND INVESTMENTS RELATIVE TO NET INCOME

[Millions of dollars]
[Phillips Petroleum Company Prior to September 2002]

Year	U.S. E&P capital expenditures and investments	U.S. E&P net income	U.S. E&P capital expenditures and investments as a % of U.S. E&P net income	Total E&P capital expenditures and investments	Total E&P net income	Capital expenditures and investments as a % of U.S. E&P net income
1995	(329)	239	138%	(856)	373	229%
1996	(294)	320	92%	(981)	493	199%
1997	(381)	360	106%	(1,346)	609	221%
1998	(311)	(32)	n/a	(1,406)	(67)	
1999	(320)	379	84%	(1,079)	570	189%
2000 ¹	(7,394)	1,388	533%	(8,120)	1,945	417%
2001	(1,354)	1,342	101%	(2,516)	1,699	148%
2002 ²	(1,205)	1,156	104%	(3,276)	1,749	187%
2003	(1,418)	2,374	60%	(4,508)	4,302	105%
2004	(1,314)	2,942	45%	(5,249)	5,702	92%
2005 ³	(1,221)	2,965	41%	(5,018)	6,004	84%
Total ..	(15,541)	13,433	116%	(34,355)	23,379	147%

¹2000 Includes Alaska acquisition—(\$6,443MM).

²The merger of Conoco and Phillips in August, 2002 is not considered an acquisition in this table.

³Through September 30, 2005.

Question 20. What percentage of profits over the last 10 years has your company reinvested in non-petroleum energy supply and production in the United States? Please provide a total and the results of such investment.

Answer. Over the last 10 years, including both Conoco and Phillips activities prior to the merger, we have invested about \$435 million in alternative energy supply technologies. Chief among these is our investment in gas-to-liquids technologies, which target the ability to economically develop and produce stranded natural gas reserves. Stranded natural gas reserves are those located in areas which cannot currently be economically transported to market. In addition, we have invested in coal-to-liquids technologies, and are stepping-up our investment in coal/petroleum coke gasification technologies.

Question 21. On average for the last ten years, please compare your company's overall capital expenditures in the United States to its expenditures elsewhere.

Answer. Increased spending outside the U.S. is occurring because North America only has about 12 percent of the world's undiscovered oil and gas reserves (IEA estimate), and because of limited resource access to the most highly prospective areas in the United States. In addition, some of our spending outside the U.S. (e.g., Qatar LNG, Venezuela, Canada) will be to increase energy supplies to the U.S. in the form of LNG or unconventional heavy oil.

CONOCOPHILLIPS REPORTED (PHILLIPS PETROLEUM COMPANY PRIOR TO SEPTEMBER 2002)—CAPITAL EXPENDITURES AND INVESTMENTS

\$MM	Capital expenditures & investments ¹	U.S. capital expenditures & investments ²	U.S. % capital expenditures & investments
1995	(1,456)	(923)	63%
1996	(1,544)	(841)	54%

CONOCOPHILLIPS REPORTED (PHILLIPS PETROLEUM COMPANY PRIOR TO
SEPTEMBER 2002)—CAPITAL EXPENDITURES AND INVESTMENTS—Con-
tinued

\$MM	Capital expenditures & investments ¹	U.S. capital expenditures & investments ²	U.S. % capital expenditures & investments
1997	(2,043)	(1,059)	52%
1998	(2,052)	(936)	46%
1999	(1,690)	(919)	54%
2000*	(8,460)	(7,707)	91%
2001*	(10,054)	(8,887)	88%
2002**	(4,388)	(2,043)	47%
2003	(6,169)	(2,493)	40%
2004	(9,496)	(2,520)	27%
2005	(8,573)	(3,140)	37%
Average	(5,084)	(2,861)	56%

*2000 Includes Alaska acquisition—(\$6,443MM), 2001 Includes Tosco Acquisition—(\$7,038MM).

**The merger of Conoco and Phillips in August, 2002 is not considered an acquisition in this table.

Sources:

¹Capital Expenditures & Investments. 2005 YTD through September (ConocoPhillips 3Q, 10Q); 2004-2000 (ConocoPhillips 2004 Annual Report, page 108); 1999-1995 (Phillips 2001 Annual Report, page 95).

²U.S. Capital Expenditures & Investments. 2005 YTD through September (ConocoPhillips 3Q, 10Q); 2004-2002 (ConocoPhillips 2004 Annual Report, page 45); 2001 (ConocoPhillips 2003 Annual Report, page 49); 2000 (ConocoPhillips 2002 Annual Report, page 49); 1999 (Phillips 2001 Annual Report, page 47 adj. to exclude discontinued ops.); 1998 (Phillips 2000 Annual Report, page 47 adj. to exclude discontinued ops.); 1997 (Phillips 1999 Annual Report, page 44); 1996 (Phillips 1998 Annual Report, page 42); 1995 (Phillips 1997 Annual Report, page 40).

Question 22. What percentage of your company's gross revenue was collected in the United States in each of the last 10 years?

Answer.

CONOCOPHILLIPS REPORTED (PHILLIPS PETROLEUM COMPANY PRIOR TO
SEPTEMBER 2002)—SALES & OPERATING REVENUE

\$MM	Sales & operating revenue ¹	U.S. sales & operating revenue ¹	U.S. % sales & operating revenue
1995	13,368	11,310	85%
1996	15,731	13,211	84%
1997	15,210	12,633	83%
1998	11,545	9,535	83%
1999	15,396	13,019	85%
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2002	56,748	46,674	82%
2003	104,246	74,768	72%
2004	135,076	96,449	71%
2005	128,184	95,461	74%
Average	49,323	37,657	76%

Sources:

¹Sales & Operating Revenue, U.S. Sales & Operating Revenue. 2005 YTD through September (ConocoPhillips 3Q, 10Q); 2004-2002 (ConocoPhillips 2004 Annual Report, page 97); 2001 (ConocoPhillips 2003 Annual Report, page 97); 2000 (ConocoPhillips 2002 Annual Report, page 92); 1999 (Phillips 2001 Annual Report, page 83); 1998-1996 (Phillips 1998 Annual Report, page 67); 1995 (Phillips 1997 Annual Report, page 63).

Question 23. How much of your company's revenue collected in the United States was used to pay for purchasing crude oil from OPEC countries?

Answer.

CONOCOPHILLIPS U.S.—ANNUAL CRUDE OIL PURCHASES FROM
OPEC COUNTRIES

[\$ millions]

Year	Direct purchases from OPEC	Purchases from OPEC countries via third parties	Total crude oil purchases from OPEC countries	U.S. sales and operating revenue	OPEC purchases as a percent of U.S. sales and operating revenues
2003	\$2,099	\$2,723	\$4,822	\$74,768	6.4%
2004	\$2,558	\$4,790	\$7,348	\$96,449	7.6%
2005	\$3,626	\$5,666	\$9,292	\$95,461	9.7%

Question 24. Do you support S. 1794 or something like it to create gasoline and jet fuel reserves to ensure stability of price and supply? Should it be extended to diesel and other fuels like natural gas?

Answer. The holding and management of a strategic gasoline reserve is complex and challenging, but deserves further study. Unlike the SPR crude oil reserve that only needs to get crude to 140 refineries, half of whose capacity are in three states, a strategic gasoline reserve or reserves will have to supply more than 1,500 terminals across all states. Also, unlike crude oil, it is difficult to store gasoline for long periods of time as the inventory must be turned over seasonally to match required products specifications and to avoid product (aging) degradation. Location is very important, as it must be away from areas that are likely to experience frequent supply logistics disruptions such as power outages and hurricanes to avoid the potential loss of power and disruptions to the distribution systems. The reserve must be distributed across the country since it is impossible to predict when and where there will be outages. Additionally, the numerous regional and local fuels specification requirements severely complicate design of strategic reserves due to the very large number of different grades required in different locations around the United States. In addition, the cost of storage is high so it is important to do a cost-benefit analysis to determine whether the costs of holding this inventory are worth the benefits of avoided disruption costs.

It is also important that this reserve not be used for price management purposes but rather be saved for use when there is a physical disruption to supplies. It would not ultimately be beneficial to consumers to have the government remove the price signals when there is a supply disruption. Price rises during a disruption play an important role in the marketplace to moderate demand to avoid physical shortages and attract additional supplies from around the world.

Question 25. On average for the last ten years, how much of what is refined by your company in the U.S. stays in the U.S.?

Answer. In August, 2002, ConocoPhillips was formed from the merger of Conoco, Inc. and Phillips Petroleum Company. This merger and acquisition resulted in multiple accounting and computer systems, making it impossible to provide 10 years worth of data in the short time period provided. However, we were able to gather data from January 2004. Using data from January 2004, over 98 percent of the clean products produced by our refineries stayed in the United States. Those products are finished gasoline, gasoline blending components, diesel, heating oil, kerosene and jet fuel.

Question 25a. What amount of refined product did your company import in 2004 and in 2005?

Imports in Bbls	2004	2005
Alkylate	306,313	411,110
Butane	0	236,357
Reformate	339,545	405,341
Naphtha	2,696,303	3,405,293
Isomerate	93,146	0
Gasoline blendstocks	3,435,307	4,458,101
Diesel	264,622	419,751
Light cycle oil	0	126,369
Diesel	264,622	546,120

Imports in Bbls	2004	2005
RBOB	1,831,202	2,523,945
Conv gasoline	2,182,254	3,578,795
Finished gasoline	4,013,456	6,102,740
Total	7,713,385	11,106,961

Question 25b. What are your assumptions about demand growth in India and China?

Answer. As China and India continue to grow and modernize their economies they will have relatively rapid energy demand growth. China and India today consume approximately 9 million barrels per day, or about 11 percent of world oil demand. We would agree with the U.S. Department of Energy's forecast that between 2002 and 2015 oil demand in these 2 countries will more than double. In 2015, China's share of world demand will be about 14 percent. However, we have already seen a substantial amount of this growth in the last two years, and the growth rate is expected to moderate. A significant amount of demand growth in the last year was due to the use of off-grid diesel generators resulting from power shortages. As China adds more coal-fired and other electric generation capacity, diesel demand use for purposes of power generation will likely be reduced.

Natural gas presents a similar picture as oil for China and India but demand is less advanced than oil use due to the lack of infrastructure for distributing gas. According to the U.S. Department of Energy, these two countries consumed a little over 2 trillion cubic feet of natural gas in 2002, or 2.3 percent of worldwide demand of 92 trillion cubic feet. DOE projects that by 2015, these two countries will be consuming over 5 trillion cubic feet, and by 2025, they will be consuming over 9 trillion cubic feet or about 6 percent of the world's natural gas consumption.

DOE projects natural gas to overtake coal as the second largest source of energy by 2025. Growth in coal demand will be concentrated primarily in China and India, both of which possess sizable coal reserves. China and India today account for over 40 percent of global coal demand, and this will grow to about 48 percent of total world coal demand by 2025.

Question 25c. How have your investments in the United States increased the energy security of the country?

Answer. ConocoPhillips has been aggressively investing in refining and in developing new natural gas and crude supplies for the United States. By increasing supplies, these projects are increasing energy security in the United States.

The projects described below are all very large and will require significant capital expenditures in the future.

- Over the past five years, ConocoPhillips has spent \$4.0 billion worldwide, of which \$3.2 billion was spent domestically, to expand and modernize our refineries and upgrade marketing operations.
- Going forward, we are planning an expanded incremental investment program, whereby we expect to invest \$4-5 billion, on top of our other refinery investments of \$1-2 billion per year. This investment program is aimed at growing our U.S. refining capacity by about 11 percent and improving our capability of handling lower quality oils in order to make 15 percent more clean fuels such as gasoline, diesel and heating oil by the year 2011. These expansions will add enough clean fuels product to be the equivalent of adding one world-scale refinery to our domestic refining system.
- ConocoPhillips is making major investments in North American Arctic natural gas through the Mackenzie Delta and Alaskan North Slope pipelines. The initial development of Mackenzie Delta will access about 6 trillion cubic feet of gas, which is expected to come on stream in the year 2011 at approximately 1 billion cubic feet per day. As other fields are added, the pipeline will have the capacity to be expanded to 1.8 billion cubic feet per day. The total cost of this pipeline is estimated to be at least \$6 billion.
- The Alaskan North Slope presently has an estimated 35 trillion cubic feet of natural gas, which would increase total U.S. gas reserves by approximately 20 percent. When the pipeline connecting this gas with the lower 48 market is completed, about 4.0-4.5 billion cubic feet per day will be added to natural gas supplies. This equates to about 8 percent of present U.S. natural gas production. This project exemplifies what we have been saying about capital-intensive projects that require many years before we see a return on the investment. The Alaska pipeline alone is expected to cost about \$20 billion and take ten years before the first cubic foot of gas is sold on the market. In October 2005,

ConocoPhillips joined Governor Murkowski of Alaska in announcing that we have reached an agreement in principle on terms and conditions that would move the Alaskan natural gas pipeline closer to reality. Once the agreement is completed by all gas owners, the Alaska legislature will hopefully act on that agreement, passing it quickly. While it is not a short-term solution, gas from Alaska will, eventually, make a sizable contribution in addressing the market problems we are anticipating for natural gas.

- ConocoPhillips is also investing aggressively in bringing liquefied natural gas (LNG) to the U.S. market. We are progressing LNG projects in Qatar and Nigeria and aggressively pursuing projects in Russia, Venezuela and Australia. These are all multi-billion dollar projects. We expect to bring our first cargo of Qatari gas to the United States in 2009. We are also developing an LNG supertanker to bring gas to the United States. We are participating in the construction of an LNG regasification facility at Freeport, Texas. We are pursuing a second LNG regasification terminal in Compass Port, offshore Alabama, although it is currently bogged down in the permitting process. Investments in these two facilities are expected to total over \$1.5 billion. We are also pursuing permitting of regasification facilities on the East and West Coasts as well as an additional Gulf Coast terminal.
- To bolster U.S. crude supplies and improve energy security through diversification of supply sources, ConocoPhillips is expanding conventional crude production in Venezuela, and continues to invest heavily in unconventional heavy oil production in Venezuela and Canada. This crude supply will likely come to the United States. Our company recently announced that we will be partnering with a Canadian company to develop the \$2.1 billion Keystone pipeline, which will bring over 400 thousand barrels per day of much needed Canadian heavy oil production to our U.S. mid-continent refineries. We are also building additional upgrading capacity in our refineries to process unconventional heavy crude.
- While we are aggressively investing in the United States, we could do much more if not deterred by U.S. policies. Increased resource access and permit streamlining changes could open new opportunities for furthering our nation's energy security.

Question 26. What market signals will occur in advance of peaking world oil production and what is the appropriate policy or set of policies for the U.S. government to adopt when such signals occur?

Answer. Many of the "signals" commonly quoted as signs of production peaking have alternative explanations and thus may be false signals. For example, the reduction in reserve-to-production ratios can be a sign of efficiency improvement, and doesn't necessarily mean that production is peaking. Similarly, lower reserve additions after the 1980s reflect the fact that privatizations around the world opened up known reserves for development so that the industry could bring reserves to market without exploring as much with the associated risk. Returns and investment in this industry are highly cyclical so it is easy to mistake the downside of the investment cycle for a peak.

In addition, peak forecasts often assume static technology and ignore the important role of technology in expanding the resource base that can be economically produced. Peak predictions also often ignore the role of unconventional oil and natural gas. For example, there are estimated to be 7 trillion barrels of unconventional oil in place (versus 3 trillion barrels of conventional) and two-thirds of that is in North America. Recovery rates are relatively low today but technological improvement will change that over time. Finally, peak forecasts often fail to take into account that host government tax rates may be reduced over time to offset rising costs in mature areas. This will extend the economic life of fields.

To believe that the peak of global oil production was approaching, we would want to see an acceleration of decline rates in existing production and multiple years of high investment and drilling activity without much of an increase in overall production. Trends in lower 48 natural gas production illustrate what happens when production approaches peak. In the early 2000s, there was a 50 percent increase in drilling rates and little appreciable production increase. Recovery rates per well are dropping steeply and existing production is declining at a rate of 30 percent per year, up from a rate of 15 percent per year in the early 1990s. This trend will continue if new areas remain off limits for development.

It would be prudent to prepare for the day global production peaks long before the signals occur. Governments around the world should be supportive of the development of alternative energy sources and fuel efficiency improvement today. When

the signals do occur, we should see sustained higher oil prices, which will help commercialize the new technologies that have been developed.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. JAMES M. TALENT TO
JAMES J. MULVA

Question 1. The recent hurricanes have highlighted the need for increasing refinery capacity, which was already operating at a tight margin of 97 percent. While that is laudable for efficiency purposes, it allows no room for error in case of sudden outages or demand increases. What is the optimal amount of spare refining capacity to ensure a reliable supply of finished petroleum products at stable prices?

Answer. The U.S. refining industry operates at a very high level of utilization and efficiency. In order to provide refined products at the most economic prices to the consumer, the markets take advantage of excess capacity outside of the U.S., allowing for relatively low-priced product imports. (The U.S. has imported petroleum products routinely for decades to meet consumer demand. In 2004, net gasoline imports were about 800 thousand barrels per day (mbd) or 9 percent of market needs.)

Recently the U.S. experienced severe supply disruptions following Hurricanes Rita and Katrina. These interruptions, while severe, were also short-term in nature as demonstrated by gasoline markets self-correcting to below pre-hurricane levels within a little over one month. During the recent hurricane impact periods, U.S. gasoline imports increased substantially, which helped restore the supply and demand balance.

Furthermore, pricing impacts and inventory draws reflected these same short-term supply disruptions, with impacts mitigated by the proactive steps taken by the major oil companies to constrain wholesale prices and dramatically increase supplies.

While the “optimum” will vary by location and how easy it is to obtain alternative supplies, we believe, and prices reflect, that global refining capacity has become too tight so we have plans in place to add refining capacity. Going forward, we are planning an expanded incremental investment program, whereby we expect to invest \$4-5 billion, on top of our other refinery investments of \$1-2 billion per year. This investment program is aimed at growing our U.S. refining capacity by about 11 percent and improving our capability of handling lower quality oils in order to make 15 percent more clean fuels such as gasoline, diesel and heating oil by the year 2011. These expansions will add enough clean fuels product to be the equivalent of adding one world-scale refinery to our domestic refining system.

We do not need any new government incentives to make these investments. However, we do need thorough—but expedited—permitting and regulatory environmental reviews so we can quickly make the investments, thereby adding capacity and refined product supply.

Question 2. How has industry consolidation impacted the amount of spare production and refining capacity?

The U.S. Federal Trade Commission in a study published in 2004 stated that “mergers of private oil companies have not significantly affected worldwide concentration in crude oil. This fact is important because crude oil prices are the chief determinant of gasoline prices.”² In the same report, the FTC concluded that despite some increases over time, concentration for most levels of the petroleum industry has remained low to moderate. This report also observed that industry developments have lessened the incentive to be vertically integrated throughout all or most levels of production, distribution and marketing. Several significant refiners have no crude oil production, and integrated petroleum companies today tend to depend less on their own crude oil production. Thus, there has been a trend of majors selling capacity to independent refiners. The FTC report concluded that mergers have contributed to the restructuring of the petroleum industry in the last two decades but have had only a limited impact on industry concentration.³

There has been a reduction in the number of refineries being operated but it is not related to mergers. Between 1973 and 1981, government control on the pricing and allocation of crude oil favored small refineries and provided incentives for companies to own and operate small, inefficient refineries. The elimination of these government controls in 1981 spurred the eventual exit of many inefficient refineries. The number of domestic operable refineries declined from 319 in 1980 to 149 in

²U.S. Federal Trade Commission, Bureau of Economics, “The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement”, August 2004, page 12.

³U.S. Federal Trade Commission, Bureau of Economics, “The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement”, August 2004, page 16.

2004. According to the FTC, refinery closures overwhelmingly have involved small, relatively unsophisticated facilities.⁴ The oil industry has done a commendable job of expanding and increasing the utilization of existing refineries. Despite the fact that the closure of inefficient refineries reduced the total number of refineries by more than half since 1980, U.S. refining capacity fell by only 6 percent, and this impact was more than offset by efficiency improvements that allowed the industry to increase refinery runs by 14 percent. Additionally, there has been substantial excess capacity outside of the United States until recently, allowing for relatively low-priced product imports.

Other issues constraining capacity that don't relate to consolidation are the historical weak returns in the refining industry and the need to invest a great deal of capital for reducing refinery emissions and making clean fuels. As a result of the strong economic recovery in 2004 and spending focused on clean fuels rather than expansion, demand growth during the recent economic recovery has outpaced supply growth.

The two hurricanes exacerbated this tightness by disabling 5 million barrels per day (mmbd) or nearly 30 percent of the nation's refining capacity at the peak (September 25, 2005, 4 mmbd shutdown for Rita, 879 mbd shutdown from Katrina).

Question 3. Describe the degree of competition between refineries for crude oil supplies and sales to retailers. What percentage of crude oil processed in the U.S. is processed by integrated companies (i.e., those produce and refine) versus refined by independent refining companies?

Integrated companies make up roughly 55 percent of total U.S. refining capacity.⁵ The balance of U.S. refining is made up of very large (e.g., Valero, the largest U.S. refiner) to much smaller independent companies. ConocoPhillips utilizes only 10 percent of its equity production in U.S. refineries. Like all other integrated companies, ConocoPhillips must compete for the balance of crude supplies from the same domestic and import markets as the independent refining companies.

Integrated company 'brands' make up roughly 60 percent⁶ of the total U.S. retail gasoline markets. Much of this market share is made up of branded jobbers (i.e., independent businesses that establish their own pump prices). The balance of the U.S. retail market is made up of independent and unbranded companies.

Question 4. How has the amount of refining capacity tracked changes in demand for gasoline and diesel over the last 30 years?

Note: A graph accompanying this question has been retained in committee files.

Answer. The refining industry has historically not attracted sufficient investment because of unattractive returns. Between 1990 and 2002, it had a ROCE of 5.2 percent versus 7.1 percent for the total petroleum industry. Refining is highly capital intensive and the industry spends a great deal on mandated emissions reduction and clean fuels production, which generally do not have a return on investment. Additionally, there has been substantial excess capacity outside the U.S. until recently, allowing for relatively low-priced product imports.

As a result of this low return, coupled with difficulties in permitting, no grassroots refineries have been built in the U.S. since the mid-1970s. For many of the same reasons, inefficient refineries that were not economic in a free market (built during small refinery entitlement program) were closed. However, the oil industry has worked diligently to expand and increase the utilization of existing refineries. Despite the fact that the closure of inefficient refineries reduced the total number of refineries by more than half since 1980, U.S. refining capacity fell by only 6 percent, and this impact was more than offset by efficiency improvements that allowed us to increase refinery runs by 14 percent.

While the U.S. refining industry has the potential for making substantial amount of investment going forward in response to recent increases in refining margins and provisions of the National Energy Policy Act, substantial barriers remain for building grassroots refineries. The biggest barrier is that future refinery margins are not expected to be high enough to justify the high cost of grassroots building. The cost of expanding existing capacity is about half that of adding grassroots capacity so it is a more viable option. Additionally, there is still a strong need to streamline the permitting process and to provide more certainty to the future regulatory environment.

⁴U.S. Federal Trade Commission, Bureau of Economics, "The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement", August 2004, page 7.

⁵U.S. Department of Energy, EIA Website *eia.doe.gov*, Report of Capacity of Operable Petroleum Refineries by State as of 1/1/05.

⁶Lundberg Survey Incorporated, Share of Market Data, June 2004 (subscriber confidential).

Question 5. Explain to me your company's plan to increase refining capacity in the U.S. to meet the need for new refinery capability.

Answer. We have announced a multi-year capital investment plan to increase capacity and improve utilization at nine of our twelve U.S. refineries. Going forward, we are planning an expanded incremental investment program, whereby we expect to invest \$4-5 billion, on top of our other refinery investments of \$1-2 billion per year. Measured in terms of improved output, the investments in the aggregate are anticipated to yield the equivalent of adding a world-scale refinery to the company's U.S. refining system.

Question 6. EPAAct 2005 removed the requirement to include oxygenates from gasoline, largely because of concerns over the use of MTBE. What is the impact on the price of removing oxygenates from gasoline?

Answer. While EPAAct 2005 removed the statutory requirement for oxygen in the federal formula for Reformulated Gasoline (RFG), immediately in California and after 270 days for the balance of the country upon enactment by the President of the United States, EPAAct 2005 did not affect the U.S. Environmental Protection Agency's regulatory requirement for oxygen in RFG. We understand from public statements by the EPA that the requirement continues to exist unless and until the Agency acts to remove it through regulatory process.

In any case, we have not attempted nor do we believe it possible to estimate the impact, if any, on the price of removing oxygenates from gasoline. This is dependent in a major way upon the availability of other components, demand, imports, and other environmental constraints imposed on non-oxygenated gasoline. We note that the EPA's Tier 2 gasoline sulfur standards are stepping down from a 300 parts per million cap limit to an 80 parts per million cap limit beginning January 1, 2006 and that the federally imposed renewable fuel standard also becomes mandatory beginning in the same time frame. The regulatory provisions defining the renewable program remain to be proposed. These two additional constraints may very well overwhelm any impact of removing the oxygen mandate from RFG when ultimately allowed by the EPA.

Question 7. Are there other oxygenates that can be used in place of MTBE, such as using ethanol to make ETBE, and how does the cost of such alternative additives compare to the cost of gasoline?

Answer. There may be other suitable oxygenates that can be used in gasoline in the United States. However, state government limitations, e.g. California and New York, suggests that ETBE and other ethers or heavy alcohols may not be considered acceptable substitutes in the United States. The only oxygenate of sizable market availability that we are aware of is ethanol. The cost of ethanol varies substantially but has historically been above the cost of that to produce and supply non-ethanol containing gasoline. Delivered cost of ethanol is dependent in a major way upon availability, subsidies, demand, imports, raw material costs and other features known best by the ethanol producers.

Question 8. Have you studied the use of ETBE, the cost of converting MTBE plants and how long it would take to do so, and whether ETBE avoids the leakage/water contamination problems that were caused by MTBE? How do the costs of retrofitting MTBE plants to produce ETBE and use it to increase the volume of gasoline produced by a barrel of oil compare to the cost of expanding existing or adding new refinery capability?

Answer. In the past, we have considered the blending characteristic of ETBE in gasoline and its impact on octane and other specification values for gasoline. However, we have not recently considered the cost of converting any MTBE plant to ETBE production because state government limitations, e.g. California and New York, suggest that ETBE and other ethers or heavy alcohols may not be considered acceptable substitutes in the United States. Additionally, we are not aware of any current ETBE blending in gasoline in the United States.

Question 9. What, if anything, is preventing your company from using ETBE in place of MTBE?

Answer. State government limitations, e.g. California and New York, suggest that ETBE and other ethers or heavy alcohols may not be considered acceptable substitutes in the United States.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. GORDON H. SMITH TO
JAMES J. MULVA

Question 1. I have a bill, S. 1743, to give the Federal Trade Commission, additional authority to prevent and punish price gouging in the aftermath of a major

disaster. My bill provides effective authority to the Federal Trade Commission to protect consumers from being victimized in the wake of a disaster without hampering the normal functioning of the free market. It even recognizes that there are legitimate reasons why prices may increase. Do you think that this consumer protection authority should be available to the FTC?

Answer. We concur with the statements of FTC Chairman Majoras, who testified before these Committees on November 8, 2005. Chairman Majoras noted that the large price-spikes reported in a few instances after the hurricanes quickly corrected themselves through normal market operations and that price-gouging legislation can actually harm consumers if it dampens natural market prices, which serve as an important market signal. Chairman Majoras concluded that federal price-gouging legislation “would unnecessarily hurt consumers” and that “[e]nforcement of the antitrust laws is the better way to protect consumers.”

Question 1a. Would this serve as a deterrent to price gouging by individual retailers?

Answer. We believe the FTC Act already empowers the FTC to prohibit unfair trade practices that are detrimental to consumers.

Question 2. Can you tell me why diesel prices continue to remain significantly higher than gasoline prices in Oregon?

Answer. U.S. diesel prices are higher than gasoline prices due to a tighter global diesel supply-demand balance, which stems from the strong trend in Europe toward dieselizing the passenger car fleet and robust diesel demand in Asia. Global and U.S. diesel demand have been and will likely continue to grow at a faster rate than gasoline demand. Thus, the trend of global diesel prices moving above gasoline prices is not likely to be reversed even when immediate supply losses from the hurricanes are restored.

The long-term strengthening diesel prices was exacerbated by the hurricanes, which temporarily shut down nearly 30 percent of U.S. refining capacity at the peak. While the U.S. made up lost gasoline supplies through imports and specification waivers, diesel fuel did not have the same options. Diesel demand and price strength in Europe made it difficult for the U.S. to attract as much diesel as gasoline supplies. European refineries have excess gasoline production capacity due to dieselization so they were able to provide additional gasoline supplies. In addition, diesel prices gain strength in the winter as diesel is blended and/or re-graded into the heating oil market.

Oregon must compete in the global and regional markets for diesel supplies and it often doesn't have as attractive logistics for obtaining products as other regional ports. Since Oregon does not have refineries, the state must import all of its fuels from states such as Washington, California or from foreign countries. Most fuel supplies are imported from Washington via pipeline (up to its maximum capacity) and marine shipments from California or foreign locations into Portland. While Oregon has logistical disadvantages that raise its supply cost, Oregon is mostly experiencing the same supply and demand and pricing trends that are being experienced by U.S. and global markets.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. JIM BUNNING TO
JAMES J. MULVA

Question 1. Some analysts believe that OPEC is approaching its current oil production capacity. Given this, are oil companies looking at alternative sources of energy, such as liquid fuels made from coal, in order to expand their business and maintain energy supplies for the United States? Please include a review of the level of investment your company is making this year and the projected investment over the next three years in coal to liquid fuels initiatives.

Answer. We have not seen evidence that OPEC is approaching its peak capacity. Nevertheless, we believe it is important to develop new technologies to supplement existing supplies and ease the transition once peak oil production is reached. The points below highlight some of our activities in this area. The information reflects activities of both Conoco and Phillips prior to our merger in 2002 and the merged company since then. We have omitted forward-looking spending because it is confidential, competitively sensitive, and could mislead shareholders because there are a number of factors and approvals that need to occur before this spending can occur.

Coal-to-Liquids Activity (CTL)

Includes:

- Specific Coal-to-products activities

- E-Gas gasification technology activities
- Related Gas-to-Liquids (GTL) activities

CTL and Related Technology Development

- Offered support to University of Kentucky/Purdue/Southern Illinois University to utilize Wabash River gasification facility for the FT Development Center activities outlined in the Energy Policy Act of 2005
- Various proprietary analysis and lab work

Project Support

Examples included below. This excludes proprietary studies and those that we are contractually committed to not disclose.

- Completed feasibility study for gasification project in Illinois to refuel ammonia plant and provide syngas to coal-to-liquids demonstration plant (Rentech Development project with Royster-Clark in East Dubuque, 5,000 barrels per day Fischer-Tropsch liquids)
- Considering proposals for feasibility studies to 6 prospective coal-to-liquids facilities.
- Presented at Gasification Technologies Conference that ConocoPhillips was developing an E-Gas CTL template and reference plant.

E-Gas Technology Development Program Expenditures

- Spent \$16 MM from 2003-2005.

Potential E-Gas/CTL Projects

Program Description

1. Technology Development—Coal to Gasoline
2. Technology Development—Coal to Clean Diesel
3. Technology Development—CTL Joint effort with DOE
 - a) Support initial studies with universities
 - b) Demonstration unit at Wabash (50% cost share)
4. Project Development efforts—CTL Td Party licensing
 - a) Development of E-Gas coal-to-liquids template
 - b) Proposal preparation for commercial CTL requests
5. Potential Project Development

ConocoPhillips Fischer-Tropsch (F-T) Technology Development Program—Related to GTL Program

Highlights:

- Developed proprietary reactor system for conversion of synthesis gas to diesel via Fisher-Tropsch technology
- Developed proprietary upgrading scheme to maximize production of distillates from F-T derived materials
- Participated in DOE program to better understand and improve performance of F-T derived fuels
- Developed significant intellectual property portfolio for F-T technology
- Operated 400 barrel per day demonstration plant in Ponca City, Oklahoma for more than one year
- Continuing technology development and optimization at lab and pilot plant scale, including catalyst development

Actual Program Expenditures since Program Inception

- Note that spending for programs in individual years is confidential, proprietary information that cannot be disclosed for competitive reasons or due to confidentiality agreements

1997	Catalyst screening and laboratory set-up
1998	Catalyst development at laboratory scale; Preliminary flowsheet development
1999	Continued lab scale development and initial pilot plant work
2000	Technology development at lab and pilot plant scale
2001	Continued technology development at lab and pilot plant scale; Ultraclean fuels program work with DOE using FT diesel

2002 .....	.....	Continued technology development at lab and pilot plant scale; Continuation of DOE fuels program;
2003 .....	.....	Construction of Demonstration Plant for scale-up of technology Continued technology development at lab and pilot plant scale; Continuation of DOE fuels program
2004 .....	.....	Complete Demo Plant construction and begin operations of it Continued technology development at lab and pilot plant scale;
2005 .....	.....	Full operations of Demonstration Plant Continued technology development at lab and pilot plant scale; Operated Demonstration Plant
Total	\$184 MM	Optimization of technology Total portion of actual GTL expenditures that apply to CTL

Question 2. I have been concerned with the lag time between the wholesale cost of a barrel of oil and the retail price of a gallon of gasoline. As we saw following the hurricane, in an ascending market where wholesale oil prices increase, there is a lag period of a few days before retail gas prices reflect this change. Similarly one would expect a lag in a descending market. My concern is that retail prices are not dropping as quickly as they rose, relative to the change in oil prices. Could you explain why price movements vary during a complete market cycle and whether you believe any part of the energy industry is unfairly profiting from this price lag?

Answer. The price of crude oil impacts the price of gasoline. However, additional factors such as regional spot markets affect retail street prices as well. Crude oil is sold on the world market. It is priced based on its own buyers and sellers. Directionally, retail pump prices are impacted by crude oil prices; however the impact may be delayed because of regional gasoline spot markets or may be overshadowed by regional spot market events. Crude oil represents roughly 50 percent of the cost per gallon of gasoline, so ultimately an effect is seen albeit, delayed.

During the recent hurricanes, refined product supply was impacted more than crude supply. The United States lost nearly 30 percent of its total refining capacity at the peak and this substantially reduced the industry's ability to supply the market with gasoline and diesel. Refined product prices rose as a result of this imbalance to moderate demand, attract new supplies from overseas and restore the supply/demand balance. The hurricanes also shut down one million barrels per day of Gulf of Mexico crude production. This event normally would create a significant shortage of U.S. crude oil supply and a large, rapid associated increase in crude oil price. However, with about two millions barrels per day of U.S. refining down for much of the same period and a release of crude from the U.S. Strategic Petroleum Reserve, a severe crude shortage did not develop and the crude price increase was tempered.

The branded pump price changes lag spot product price changes. This minimizes dramatic upward changes in cost for independent marketers and consumers. The result is that during a rising market, branded customers are insulated from steeply rising costs. Except for 356 retail locations (including fee-operated stores), ConocoPhillips does not sell at the retail level. This accounts for approximately 4.3 percent of total gallons sold through our U.S. marketing operations. Pump prices are set in the marketplace with independent marketers posting prices based on their business economics and supply and demand fundamentals. In a rising market, pump prices, set by independent marketers, lag spot product prices. This ultimately lessens the impact on the driving public. The result for suppliers during a rising market is negatively impacted marketing margins.

The appearance of retail prices rising more than they later fall (price asymmetry) can be misleading. Because of time lags in the gasoline distribution system, retail prices may continue to rise even after wholesale prices have begun falling, giving the appearance of pattern price asymmetry. However, when allowance is made for the lagged adjustment times, the perceived pattern asymmetry may disappear. The GAO studied gasoline price asymmetry and concluded that during a market price shock, retail gas prices would rise and fall in price symmetrically, with over half the price adjustment occurring in the first month, but with complete price adjustment to shocks taking as long as 17 weeks.⁷

Question 3. Boosting our domestic energy production is vitally important not only to our economy but also to our national security. Many of the countries we import oil from today are unstable, jeopardizing the reliability of sustained production. Please provide a chart for each of the last five years reflecting the percentage of your exploration and production budget that is invested in the United States versus

⁷U.S. General Accounting Office, Energy Security and Policy: Analysis of the Pricing of Crude Oil and Petroleum Products, Report GAO/RCED-93-17, U.S. Government Printing Office (Washington, DC, March 1993).

that invested overseas. Please also provide a chart reflecting your current projections of the percentage of your exploration and production budgets that will be allocated to projects in the United States versus overseas for the next five years.

Answer. The chart below provides historical information for U.S. and international exploration and production capital expenditures. While not yet approved, it is anticipated that the company's Board of Directors will approve various capital expenditures during the next five years with the result that between 18-27 percent of new capital expenditures will be located in the United States.

While expenditures tend to shift with opportunities outside the United States, note that a significant portion of the capital expenditures outside of the United States will be directed towards increasing supplies that will go to the United States (e.g., LNG projects, Canadian oil sands).

E&P CAPITAL EXPENDITURES

[\$Millions]

Year	U.S. E&P capital expenditures and investments	International E&P capital expenditures and investments	Total E&P capital expenditures and investments	U.S. E&P capital as % of total E&P capital
2000 ¹	(7,394)	(726)	(8,120)	91%
2001 ¹	(1,354)	(1,162)	(2,516)	54%
2002 ²	(1,205)	(2,071)	(3,276)	37%
2003	(1,418)	(3,090)	(4,508)	31%
2004	(1,314)	(3,935)	(5,249)	25%
2005 ³	(1,221)	(3,797)	(5,018)	24%

¹Phillips heritage only prior to merger as reported.

²COP after August 30, 2002. Phillips prior to that.

³Through September 30, 2005.

Note: Year 2000 includes Alaska acquisition. The merger of Conoco and Phillips in August 2002 is not considered an acquisition in this table.

Question 4. The disruption caused by the recent hurricanes displayed the United States' vulnerability when it comes to domestic energy supply and production. What suggestions do you have to strengthen our energy supply and production capability?

Answer. This country needs additional refining capacity, pipelines, and other critical energy infrastructure to be added in the United States or in markets that can serve the United States. The private sector will likely make these investments without need of any new government incentives now that the market is providing signals that this capacity is needed. However, the industry does need governments at all levels to be thorough—but at the same time—to streamline permitting and environmental review processes so we can make these investments and add energy supplies.

We think serious consideration should be given to the issue of access to resources. ConocoPhillips is not pursuing the opening of national parks, the Everglades and other such sensitive areas to energy development. But with the entire East and West Coasts, the Eastern Gulf of Mexico and key areas in Alaska all closed to entry, it is understandable why supply/demand is tight. The industry's only access to new offshore development remains the Central and Western Gulf of Mexico.

The Eastern Gulf of Mexico probably has more natural gas potential for consumers than about any place in the lower 48 states. When outer continental shelf lease sale 181 was withdrawn from development, another key prospect for finding badly needed natural gas reserves was removed from consideration. We would encourage the Senate to consider reinstating that sale and revisiting access in other areas. Our industry has the technological know-how and the track record necessary to protect Florida's treasures and, at the same time, explore and produce in the Eastern Gulf in a safe and environmentally responsible manner.

The Rocky Mountain region of the country is another area where new natural gas production can make a difference. But the leasing and permitting process has hampered development in areas such as the San Juan basin of New Mexico and the Powder River basin to the north. Funding and staffing appear to be improving but continue to be key challenges in these areas. Local BLM personnel are doing a commendable job with the resources they have but more funding for permitting and related staffing must be directed to those areas.

Our company is particularly concerned about permitting and siting issues associated with building new LNG receiving terminals. LNG offers one of the most prom-

ising options for meeting the growing natural gas needs of American consumers in the near term. The permitting and approval of new regasification terminals are occurring significantly slower than we expected, and many terminals are being delayed or may be cancelled altogether due to local opposition. We are concerned that all of the new terminals will be sited in the U.S. Gulf Coast because of difficulties in permitting terminals closer to other consuming regions. Recent hurricanes demonstrated the need to diversify the location of key energy infrastructure.

The siting of LNG terminals was addressed in earlier energy policy legislation. However, the Federal Government, the states and the individual localities where these facilities are planned need to have continued dialogue and cooperation on siting issues. There also needs to be better cooperation among the various federal agencies charged with evaluating and permitting these facilities.

Our energy supply and production capability can only be strengthened by the development of all energy sources—coal, including coal gasification, nuclear, alternative energy with appropriate environmental safeguards—as well as conservation and efficiency standards. We will need to include all of these to diversify supply sources and put some needed slack back in our system.

Question 5. It has been suggested that the United States consider developing a strategic gasoline and natural gas reserve, similar to Strategic Petroleum Reserve we currently have. Some analysts suggest that such reserves may minimize price spikes in these commodities during periods of market supply disruptions. What are your views on whether a strategic natural gas or gasoline reserve would be feasible and whether they might help minimize price increases during periods of market uncertainty?

Answer. The holding and management of a strategic gasoline reserve is complex and challenging, but deserves further study. Unlike the SPR crude oil reserve that only needs to get crude to 140 refineries, half of whose capacity is in three states, a strategic gasoline reserve or reserves will have to supply more than 1,500 terminals across all U.S. states. Also, unlike crude oil, it is difficult to store gasoline for long periods of time as the inventory must be turned over seasonally to match required products specifications and to avoid product (aging) degradation. Location is very important as it must be away from areas that are likely to experience frequent supply logistics disruptions such as power outages and hurricanes to avoid the potential loss of power and disruptions to the distribution systems. The reserve must be distributed across the country since it is impossible to predict when and where there will be outages. Additionally, the numerous regional and local fuels specification requirements severely complicate design of strategic reserves due to the very large number of different grades required in different locations around the United States. In addition, the cost of storage is high so it is important to do a cost-benefit analysis to determine whether the costs of holding this inventory are worth the benefits of avoided disruption costs.

It is also important that this reserve not be used for price management purposes but rather be saved for use when there is a physical disruption to supplies. It would not ultimately be beneficial to consumers to have the government remove the price signals when there is a supply disruption. Price rises during a disruption play an important role in the market place to moderate demand to avoid physical shortages and attract additional supplies from around the world.

A strategic natural gas reserve is feasible, although a sophisticated analysis would be advisable to determine the potential effectiveness. Working gas storage capacity in the United States exceeds 3.3 trillion cubic feet. Storage capacity could be expanded to facilitate a strategic reserve. Cost for such an expansion would be influenced by various factors including the type of storage facilities required, injection/withdrawal capacities, pipeline interconnections and the cost to acquire the gas to be placed in storage. Gas storage facilities include depleted reservoirs, aquifers, salt caverns and LNG storage tanks. Each type of facility has different technical and economic characteristics. Key factors that would determine if strategic gas reserves could influence price volatility in the manner desired include: (1) location of stored gas relative to load centers, (2) the rate at which stored gas could be delivered to the pipeline system, and (3) the ability of the downstream pipeline infrastructure to move gas to market without constraint.

Question 6. China is becoming a bigger world oil player. This not only has tightened the world oil market but also has produced national security concerns for us. What concerns or problems do you see have arisen since China became a bigger world energy player?

Answer. China is reaching a phase of its economic development that is commodity-intensive, and per-capita income in some regions has reached a level that allows Chinese consumers to purchase cars and appliances, resulting in sharply rising

energy consumption. But there are still many consumers in China who do not have access to adequate energy resources. For example, according to the International Energy Agency, there are over 700 million people in China who rely on traditional biomass for cooking and heating today. The World Health Organization estimates that, each year, 1.6 million women and children in developing countries are killed by the fumes from indoor biomass stoves. Over half are in China and India. As incomes rise in developing countries, households typically switch to modern energy services for cooking, heating, lighting and electrical appliances and transport fuels for personal mobility. An important means to reducing global poverty is to increase developing country access to energy. However, rapid growth in demand in China and other developing countries is tightening the global energy supply/demand balance. The United States can do its part in allowing affordable energy to citizens of the U.S. and the world by promoting conservation and the more efficient use of energy. The United States can also play a role in transferring more efficient energy technologies to China and other developing countries.

Question 7. While there have been expansions and efficiency gains at existing refineries, no refinery has been built in the United States in 30 years. Since the oil companies are now making record earnings, are there plans to build new refineries in the United States?

Answer. We don't have knowledge of other companies' expansion plans but ConocoPhillips is planning an expanded incremental investment program, whereby we expect to invest \$4-5 billion, on top of our other refinery investments of \$1-2 billion per year. This investment program is aimed at growing our U.S. refining capacity by about 11 percent and improving our capability of handling lower quality crude oils in order to make 15 percent more clean fuels such as gasoline, diesel and heating oil by the year 2011. These expansions will add enough clean fuels capacity to be the equivalent of adding one world-scale refinery to our domestic refining system.

While the U.S. refining industry has the potential for making a substantial amount of investment going forward in response to recent increases in refining margins, substantial barriers remain for building grassroots refineries. The biggest barrier is uncertainty about future investment returns. Financial returns over the past three decades have usually been very low. While returns in the last two years have greatly improved, it takes about five years to build a refinery, increasing the risk that future margins many not cover investment costs. The cost of expanding existing capacity is a more viable option because expansions cost about half that of adding grassroots capacity and they can be done much more quickly.⁸ Additionally, there is still a strong need to streamline the permitting process and to provide more certainty in the future regulatory environment. The International Energy Agency concluded in its latest World Energy Outlook that in OECD North America it is "virtually impossible to build a grassroots refinery," citing "environmental restrictions and local resistance."⁹

Question 8. The 2005 Energy Bill implemented a controlled phase-out of MTBE. Many companies, however, are planning on completely halting its use. How will a sudden halt of the use of MTBE affect the gasoline market and refineries?

Answer. A refinery using MTBE today to produce RFG and discontinuing its use will be impacted by the reduction of a high octane/low RVP blendstock used for gasoline production. Should the U.S. EPA remove the oxygen mandate in RFG, a refinery would have various options in addressing this loss of blendstock, including the blending of other hydrocarbon products and/or possibly the addition of ethanol, reducing delivered pool octane by shifting product slates and/or grades. How the market reacts to these changes remains indeterminate and highly dependent upon other regulatory and/or market constraints on the system as well as demand for the product types.

Question 9. I have noticed very large differences between the price of gasoline in different areas of the country. For example, I recently saw gasoline in northern Virginia that was much more expensive than gasoline in northern Kentucky. Please explain why there can be such a significant difference in gasoline prices in different areas of the country.

Answer. Although price levels vary over time, U.S. Department of Energy EIA data indicate that average retail gasoline prices tend to typically be higher in certain states or regions than in others. DOE attributes these differences to the following factors:

⁸Bear Steams, Not in My Backyard Report—The Prospects and Pitfalls of a Grassroots Refinery, October 4, 2005.

⁹International Energy Agency, World Energy Outlook 2005, November 2005, page 97.

Proximity of supply—Areas farthest from the Gulf Coast (the source of nearly half of the gasoline produced in the U.S. and, thus, a major supplier to the rest of the country), tend to have higher prices. The proximity of refineries to crude oil supplies can even be a factor, as well as shipping costs (pipeline or waterborne) from refinery to market.

Supply disruptions—Any event which slows or stops production of gasoline for a short time, such as planned or unplanned refinery maintenance can prompt bidding for available supplies. If the transportation system cannot support the flow of surplus supplies from one region to another, prices will remain comparatively high.

Competition in the local market—Competitive differences can be substantial between a locality with only one or a few gasoline suppliers versus one with a large number of competitors in close proximity. Consumers in remote locations may face a trade-off between higher local prices and the inconvenience of driving some distance to a lower-priced alternative.

Environmental programs—Some areas of the country are required to use special gasolines. Environmental programs, aimed at reducing carbon monoxide, smog, and air toxics, include the federal and/or state-required oxygenated, reformulated, and low-volatility (evaporates more slowly) gasolines. Other environmental programs put restrictions on transportation and storage. The reformulated gasolines required in some urban areas and in California cost more to produce than conventional gasoline served elsewhere, increasing the price paid at the pump.

State and local taxes—There are also substantial differences in tax rates between states. For example, Rhode Island has a gasoline tax of 30 cents per gallon, while the state of Georgia has a gasoline tax of 7.5 cents per gallon.

The price differences between markets are normally a result of differences in the balance of supply-demand and the cost of supply. An area with restricted supply or higher cost supply will generally have higher prices than an area with balanced supply-demand and/or lower cost of supply.

The comparison between prices in northern Virginia and northern Kentucky can be explained by the first two factors—proximity of supply and supply disruptions. After the recent hurricanes, U.S. Gulf of Mexico refining was significantly impacted and a very large percentage of area refining capacity (close to 30 percent of U.S. capacity at peak) shut down. In addition, major distribution and pipeline systems, like the Colonial product pipeline, were also shut down as a result of flooding and loss of power from the hurricanes. This situation restricted gasoline production and supply from the Gulf Coast refining center to the East Coast and parts of the Mid-continent. In the example referenced of northern Virginia and northern Kentucky, the impact of Gulf Coast refining and Colonial pipeline shutdowns created a significant shift or difference of supply-demand balances between these two areas. Northern Virginia, which derives its supply from the Colonial pipeline, is at the end of the pipeline. Thus, this area lost a significant volume of gasoline supplies due to the refinery and pipeline outages caused by the hurricanes. This loss of supply, and the fact the demand was not impacted by the hurricanes, created a shortage of supply for the area, resulting in higher gasoline prices. In contrast, northern Kentucky is supplied by local/regional refineries and pipelines not directly impacted by the hurricanes. Thus, this area did not experience the same degree of supply disruption. The net result was greater spot and pump price increases in Virginia, due to more direct impacts from the hurricanes and loss of normal supply.

Question 10. Below are several questions on oil and the commodities futures market: When was oil first traded on the world-wide commodities futures market?

Answer. The two major world-wide futures markets for trading crude oil are the New York Mercantile Exchange (U.S.) and the InterContinental Exchange (ICE—formerly known as the International Petroleum Exchange in London). The International Petroleum Exchange was founded in 1980 and the first futures contract on gas oil (heating oil) was introduced the following year. The International Petroleum Exchange launched Brent futures in June 1988.

The New York Mercantile Exchange (NYMEX) pioneered the development of energy futures and options contracts. The heating oil contract started trading in 1978, light sweet crude oil in 1983 and unleaded gasoline in 1984.

Question 10a. Would the price of oil be affected if oil was taken off the commodities futures market and no longer traded?

Answer. The futures market is helpful in having an efficient, low-cost market. First, the futures market provides market liquidity and price (discovery) transparency. Second, the futures market provides a means to 'hedge' physical market risk. And third, the futures market provides a valuable means to manage 'credit' risk. If the futures market did not exist, all three of these benefits would be lost and the price of oil could increase. Without the ability to hedge, the risk of future

physical price increases must be built into the current (prompt) prices as insurance against these potential price increases. Without the ability to manage counterparty (contract performance) 'credit risk,' the cost of this risk will likely be built into the current physical prices as insurance against non-performance (bad debt). And further, the lack of price discovery would make the market inefficient—as it was in the past. The only available prices prior to the futures market were company/producer postings. These postings were set by a very few entities (i.e. lacked liquidity and price discovery) and actual sales/purchases physical prices were commonly discounts or premiums to published postings. (These transactions were often company confidential and not transparent to the general market). This made it extremely difficult for buyers and sellers to know what 'fair market value' was at any point in time or at different locations. Also, this gave considerable leverage (market knowledge) to a relatively few companies who executed a sufficient number of transactions to understand the market.

Question 10b. Would oil then be bought and sold as a true supply and demand product?

Answer. The oil market today is highly liquid and efficient, with prices normally set by supply and demand conditions, including seasonal specification changes. The price is also impacted by factors that can affect future supply and demand and cost (e.g., transportation, storage, risk, etc.) Eliminating the connection to the futures market will make the current markets less efficient and directionally increase prices from today. First, the futures market provides market liquidity and price (discovery) transparency.

Second, the futures market provides a means to 'hedge' physical market risk. And, third the futures market provides a valuable means to manage 'credit' risk. If the futures market did not exist, all three of these benefits would be lost and the price of oil could increase. Without the ability to hedge, the risk of future physical price increases must be built into the current (prompt) prices as insurance against these potential price increases. Without the ability to manage counter party (contract performance) 'credit risk', the cost of this risk will likely be built into the current physical prices as insurance against non-performance (bad debt).

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. PETE V. DOMENICI TO
JAMES J. MULVA

Question 1. What are you doing to bring oil prices down?

Answer. Oil prices have already been reduced significantly since Hurricanes Katrina and Rita made landfall as the temporary period of higher prices attracted new supplies and brought the market back in balance. According to U.S. Department of Energy data, the spot price of WTI crude peaked at nearly \$70 per barrel on August 30, 2005, after Hurricane Katrina, but has since fallen below levels immediately preceding the hurricane to \$58 per barrel on November 22. Similarly, U.S. average gasoline prices reached their peak at over \$3.00 per gallon during the week of September 5 following Hurricane Katrina. Subsequently, the average gasoline price fell to \$2.15 per gallon during the week of November 28. This price was last observed in June 2005, well before the hurricanes.

The following are actions ConocoPhillips has or is taking to bring additional supplies to the market, which should contribute to the reduction of prices:

- Increased West Coast, Gulf Coast and Mid-continent gasoline and distillate (jet & diesel) products supplies by deferring refinery turnarounds and re-directing supplies to impacted areas
- Increased gasoline and distillate imports where feasible to re-supply short markets from what is normally brought in during the September time period
- Worked with the Federal Government on temporary waivers of required product specifications to increase available supplies.
- Diligently worked to quickly restore all ConocoPhillips shut in natural gas and crude oil Gulf of Mexico production and refining capacity immediately after the hurricanes
- Affected ConocoPhillips plants worked diligently to restore temporary power and operations that allowed rapid blending and shipping of all available products stranded in storage just prior to the hurricanes.
- Held gasoline rack prices constant for a few days immediately after the hurricanes and then lagged spot prices by 50 percent in the state of emergency areas.
- Although constrained by anti-trust laws from giving them specific direction on re-sale pricing, we encouraged customers (independent marketers, dealers and resellers) to exhibit restraint following the hurricanes.

Longer term we are:

- Pursuing a very aggressive capital program to expand domestic refining capacity and increase U.S. gasoline and distillate domestic supply. This investment program is aimed at growing our U.S. refining capacity by about 11 percent and improving our capability of handling lower quality oils in order to make 15 percent more clean fuels such as gasoline, diesel and heating oil by the year 2011. Planned expansion is the equivalent of adding the capacity of one world-class refinery to the U.S.
- Bolstering U.S. and global oil supplies by expanding conventional crude production in Venezuela, Russia and the Far East.
- Producing unconventional heavy oil in Venezuela and Canada and continuing to invest in unconventional heavy-oil production in Canada. This crude is intended to come to our refineries in the United States. Our company recently announced that we will be partnering with a Canadian company to develop the \$2.1 billion Keystone pipeline to bring over 400 thousand barrels per day of much-needed Canadian heavy oil production to our U.S. mid-continent refineries. We are also building additional upgrading capacity in our refineries to process unconventional heavy crude.
- Developing technology for turning natural gas into a slate of clean refined oil products, which will enhance clean diesel supplies.
- Conducting research and development on alternative energy sources. We recently had a successful experiment with renewable diesel, and we are conducting other tests to evaluate technologies to produce gasoline and other liquid fuels from non-petroleum feedstock.
- Expanding the business of gasoline and blending stock imports to the United States, which will increase gasoline supplies, particularly in the Northeast region of the United States.

Question 2. What is the relationship between the price of oil that Americans are paying and the profits you are making?

Answer. As discussed in our testimony, there is a strong relationship between the price of crude oil and gasoline prices. Our industry is a commodity industry with associated high price volatility driven by supply and demand. That also means that our earnings are highly volatile. However, it is important to note that even though the third quarter of 2005 was the highest price environment our industry has experienced in 22 years, adjusted for inflation, our profit margin of 7.7 cents per dollar of sales was near or below the average of all industries. The petroleum industry for the last 20 years has had returns on equity on average below the S&P industrials.

Question 3. The question I hear most from people is how is the price of oil set? Many Americans think oil companies are rigging prices to reap big profits. How would you respond to that?

Answer. Crude oil prices are set in the global market place where thousands of buyers, sellers, traders and financial players come together in both physical (spot) and futures markets to buy and sell crude oil. Several crude oils with large traded volumes have become the established regional markers for pricing all other crude. The major marker crude oil in the United States is West Texas Intermediate (WTI) in Cushing, Oklahoma, sold on a spot basis and on the New York Mercantile Exchange. In Europe, the major marker crude oil is North Sea Brent crude, which is sold in Sullom Voe, Scotland on a physical and forward basis and on the Intercontinental Exchange (ICE) in London. In the Middle East and Asia, the major marker crude oils are Dubai and Oman. All other crude oils are priced in relation to these markers, adjusting for quality and location differentials. Quality differentials are determined by the refining value of that crude (e.g., priced below WTI if it has higher sulfur content or if it produces less high value clean products and more low-value heavy products). Location differentials are determined by the shipping costs of the specific crude to the major market for that crude oil.

Because of these highly transparent marker prices, it is highly unlikely that crude oil will be traded at prices that vary significantly from these markers, adjusting for quality and location differences, because either the buyer or seller would not be willing to pay or receive something above or below the "marker" price. If the seller asks for too high a price, the buyer will purchase the crude elsewhere. If the buyer offers too low a price, the seller will sell elsewhere.

Collectively the international oil majors¹⁰ have only a 14.5 percent market share of global oil production. In addition, trade of marker crude oils is many times great-

¹⁰Total crude and NLG production, including syncrude, in 2004 for ConocoPhillips, Royal Dutch Shell, British Petroleum, ExxonMobil, Chevron and Total.

er than the physical volume produced. For example, the 2005 year-to-date paper trade for WTI has averaged 241 million barrels per day, which is substantially higher than the approximately 450 thousand barrels per day of physical WTI production. This large volume of trade provides a highly liquid and very competitive market. Given this liquidity and transparency, oil companies cannot exert significant influence on the price of crude oil.

Spot¹¹ prices for crude oil are determined by current short-term and anticipated supply/demand conditions. In the last few years, prices rose as a result of the global economic recovery and exceptionally strong oil demand growth. This strong demand growth occurred at a time when OPEC had little spare oil production capacity. The tight supply/demand balance has been exacerbated by market concerns about increased geopolitical risk in a number of oil-producing countries and hurricanes shutting in U.S. crude production.

Spot product (e.g., gasoline and diesel) prices tend to follow crude oil prices since the cost of crude oil is a large part of the cost of these products, and both crude oil and products prices are driven by the same global market fundamentals. A recent report by the U.S. Federal Trade Commission¹² indicated that changes in crude oil prices have accounted for approximately 85 percent of the increases and decreases in motor gasoline prices over the last 20 years. Product markets are becoming increasingly global because of increased trade to rectify product supply/demand imbalances that may occur in any region. As a result, supply and demand in one region can have an impact on prices in another region. For example, as a result of the hurricanes in the United States, gasoline prices went up in Europe and Singapore.

There are a number of factors that may result in periodic dislocations between crude oil and product prices, such as seasonal demand, a tight product supply/demand balance, and product specification changes. The recent hurricanes strengthened product prices relative to crude because it was easier to replace lost crude oil than refined products. This was particularly true for diesel fuel due to strong European demand limiting their ability to export additional diesel to the United States. The United States was able to get substantial additional gasoline imports from Europe, and that is why gasoline prices dropped swiftly to pre-hurricane levels.

Retail product prices lag spot prices in part because some product goes through a succession of resales by any combination of traders, jobbers, lessee dealers, or independent marketers. A U.S. Department of Energy study¹³ on gasoline price pass-through from the spot to retail level last year determined that significant changes in spot prices appear to show up in retail prices with some time delay, and somewhat dampened.

Question 4. Americans are being burdened with high oil, natural gas, and gasoline prices while you all are raking in record profits. What do you say to those people that blame you for this and say that it is unfair?

Answer. Our profits did increase as a result of higher energy prices, but energy products are commodities with prices set in international and regional markets by thousands of players based on supply/demand conditions. Prices rose in response to the reduction in supplies resulting from the hurricanes but these price increases attracted gasoline supplies from all over the world, which swiftly moved gasoline prices below pre-hurricane levels. The increase in earnings has also led to increased investment in new supplies, which should ultimately lower prices for the long-term.

ConocoPhillips has been reinvesting our earnings in developing new supplies. We have had earnings of about \$10 billion through the first nine months of 2005—about \$1 billion a month, but our capital investments were also close to \$1 billion a month. In fact, over a three-year timeframe, using 2003-2004 reported results and 2005 annualized year-to-date third-quarter actual results, ConocoPhillips' earnings are about \$26 billion but investments are just over \$26 billion. Mistaking the size of our earnings for a windfall fails to realize the enormous levels of investment and risk required to achieve those earnings and bring new energy supplies to the market.

¹¹ Spot prices are wholesale prices for physical delivery of the crude or product set at a number of industry transfer points, such as a location on a pipeline or at a harbor.

¹² Gasoline Price Changes: The Dynamic of Supply, Demand, and Competition: A Federal Trade Commission Report (2005).

¹³ U.S. Department of Energy, Energy Information Administration, Michael Burdette and John Zyren, "Gasoline Price Pass-through," January 2003.

Most people don't realize how volatile profits and returns are in this industry due to significant swings in crude prices. A recent study by PIRINC¹⁴ showed that returns on investment in domestic oil and gas production averaged just under 8 percent between 1985 and 2003, with individual years ranging from lows of near zero in 1986 and 1998 to 18 percent in 2000 due to energy price swings.

Today we have the highest price environment our industry has experienced in 22 years, adjusted for inflation. Yet despite being at what some consider as the top of the cycle, ConocoPhillips' profit margin of 7.7 cents per dollar of sales in the third quarter of 2005 is near or below the average of all industries. On average, over the course of the investment cycle, the petroleum industry has had sub-par returns. Between 1990 and 2002, the average return on equity for the petroleum industry was 11.3 percent, lower on average than the 12.6 percent return for the S&P industrial companies.¹⁵

Question 5. Americans want to know if it is not costing so much more to produce a barrel of oil, why are prices rising so high?

Answer. Increases in the cost of finding, developing and producing a barrel of oil are a large factor in the price increases we have seen in recent years. Steel prices doubled between the end of 2002 and end of 2004, and they are a large cost component for our industry. In the last three years, onshore drilling costs in the U.S. rose 52 percent and the cost of tubular goods rose by 125 percent. These components represent about half the cost of onshore wells. Costs have been rising in part because the oil services industry has not been able to keep pace with the spending increases by the petroleum industry. However, there is also a longer term trend of costs increasing because our industry doesn't have access to the lowest cost reserves, including reserves in the United States. Thus, our industry is going after more remote, deeper water, more complex and lower quality reserves that inherently cost more than what we were developing a decade ago. Both Goldman Sachs and Sanford Bernstein recently estimated that oil replacement costs are presently around \$50 per barrel, when they were closer to \$20 per barrel in the 1990s.¹⁶ We believe that some of this replacement cost is related to the high market price environment and will come down as prices come down.

Question 6. What is your company's response to proposals for enactment of a Windfall Profits Tax?

Answer. ConocoPhillips does not see a windfall. Our earnings, as well as earnings from the rest of the petroleum industry, even in the 3rd quarter of 2005, were in line with other industries. In cents per dollar of sales, ConocoPhillips made 7.7 cents similar to Caterpillar (7.4 cents) and IBM (7.0 cents), and well below GE (11.2 cents), McDonalds (13.8 cents), American Express (17.0 cents) Coca-Cola (21.2 cents), Eli Lilly (22.1 cents), Google (24.2 cents), Merck (26.2 cents) and Citigroup (33.2 cents) in the third quarter of 2005.

In the case of ConocoPhillips, we have been reinvesting an amount equal to all of our earnings, and any additional tax, would reduce our ability to invest. Reducing industry investment would sow the seeds for the next supply crunch. This tax would also reduce the competitiveness of the U.S. oil and gas industry vis-a-vis foreign competitors.

Commodity prices are highly volatile, and the petroleum industry won't be able to attract capital if governments shave off the top but don't help on the bottom. As an example of this volatility, just seven years ago, the price of WTI was \$11/bbl.

Rather than impose a punitive tax that would discourage domestic production, it makes more sense to encourage domestic investment by opening up highly prospective areas for exploration and development, such as the Eastern Gulf of Mexico, for natural gas drilling.

Question 7. Do you believe that Americans are dangerously dependent on oil and its refined products?

Answer. The United States consumes 25 percent of the world's oil, almost equal to consumption in all of Europe and Eurasia combined. In the developing countries of the world, oil consumption is rising as their per capita income rises and they can afford a better lifestyle. The large demand in the United States, combined with rapid growth in some developing countries, is tightening the supply/demand balance

¹⁴Petroleum Industry Research Foundation, "Lessons From the Hurricanes", November 2005, page 7.

¹⁵U.S. Department of Energy, Energy Information Administration, Financial Reporting System.

¹⁶Bernstein Research Call, November 4, 2005, page 2; Goldman Sachs, Jeff Currie, "The sustainability of higher energy prices, April 2005, page 21.

and putting upwards pressure on prices. It is important that the United States conserve oil and use it more efficiently to relieve some of the supply/demand pressure.

The United States is part of a global energy market and should continue to foster improving the development and transparency of energy markets.

Question 8. The International Energy Agency's recent Global Outlook report expresses concern about world energy supplies and reliance on the Middle East for oil. Do you think the IEA's anxiety is justified?

Answer. This recently published study by the International Energy Agency concluded that, "the world's energy resources are adequate to meet the projected growth in energy demand in the Reference Scenario." The study goes on to say that cumulative energy-sector investment needs are estimated at about \$17 trillion (2004 dollars) over 2004-2030, about half in developing countries. The IEA stated that financing the required investments in non-OECD countries is one of the biggest challenges posed. Our perspective is that these investments can be made, if 1) private industry is allowed access to resources and 2) governments who own these resources and set the rules by which infrastructure can be developed, maintain an attractive investment climate (e.g., stability of fiscal regimes and terms, rules of law, streamlined regulatory processes).

While it is not IEA's base or reference case, the agency's study has a deferred investment scenario for Middle East and North African producing nations, which results in lower supplies and higher prices. However, IEA's analysis also indicates that these producing countries would lose out financially were investment to be deferred because the price increase would fail to compensate for lower export volumes resulting from reduced demand.

In our view, the major reason that production capacity hasn't been expanding faster in these countries is because the production wasn't needed up until very recently. Few countries can afford to develop capacity and have it sit idle. Looking forward, we are concerned that there is a potential for misunderstanding between producing and consuming nations. Producing countries become very concerned when they hear consuming nations talk about drastically reducing the demand for their product, and they will then likely hesitate to expand supplies rapidly. They want to know that the demand will be there before they make multi-billion dollar investments. Thus, we would underline the importance of the IEA's recommendation to deepen the consumer-producer dialogue to "reconcile their interests and achieve mutually beneficial outcomes."¹⁷

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. LISA MURKOWSKI TO
JAMES J. MULVA

Question 1. In your agreement on an Alaska natural gas pipeline that you are negotiating with the State of Alaska under the state's Stranded Gas Act, do you anticipate making a firm commitment to develop the Alaska gas pipeline project or do you anticipate accepting an agreement that will only involve a series of spending and work commitments? If the latter is the case, how long will it be before a binding construction commitment deadline is reached?

Answer. ConocoPhillips has been diligently pursuing the Alaska Gas Pipeline Project for a number of years and is committed to continuing this effort. We have reached an agreement in principle with the State of Alaska on the base fiscal terms for the project, and this agreement includes significant spending and work commitments. After the fiscal contract is complete, we will initiate steps to secure the state and federal permits necessary to begin construction. The actual date a commitment to construct is made depends in large measure upon the date these permits are issued, and whether there are any legal challenges to these permits.

Question 2. If there is a concern about tying up your investment capital in a single project, if a pipeline company presented you with a proposal to take all of the risk of construction of the Alaska pipeline project and to ship your gas at a reasonable tariff, would you commit the gas you control to that pipeline within a reasonable time period? If not, why?

Answer. ConocoPhillips is investing in many projects to bring additional supplies of natural gas, LNG and refined products to United States consumers. We are prepared to invest in the Alaska Natural Gas Pipeline project. We are not limiting investment capital to any single project.

Question 3. In your companies' view, is it less risky to invest billions of dollars in new LNG facilities to import natural gas from foreign sources, than to invest in

¹⁷International Energy Agency, World Energy Outlook 2005, November 2005, page 51.

the Alaska gas line project. If not, why are you investing in LNG projects before making a firm commitment to the Alaska project?

Answer. ConocoPhillips believes that many new sources of natural gas will be necessary to meet future natural gas demand in the United States. Consequently, in addition to the Alaska Natural Gas Pipeline project, we are investing in the MacKenzie Delta gas pipeline and other gas exploration and development projects in the United States and Canada, as well as LNG opportunities around the world. None of these investments are being made at the expense of the Alaska project.

Question 4. While all of your companies are global in scope, this nation is concerned about its reliance on foreign sources of crude oil. Does it make sense for the United States to increase its reliance on foreign LNG while allowing Alaska's natural gas reserves to continue to remain in the ground?

Answer. The United States needs to develop both a significant number of LNG import projects and Alaskan natural gas reserves if U.S. natural gas energy needs are to be met. Even successful development of Alaskan natural gas will in no way eliminate the need for a significant increase in LNG imports.

The United States currently consumes around 22 trillion cubic feet (Tcf) of natural gas annually. The National Petroleum Council estimates that, by 2025, U.S. natural gas consumption will have risen to about 28 Tcf. The U.S. Department of Energy's corresponding prediction is that U.S. natural gas consumption will exceed 30 Tcf by 2025.

Where will the gas supply necessary to meet this demand come from? Based on assumptions of sustained high natural gas prices, which would continue to stimulate U.S. domestic drilling activity, the NPC and DOE both estimate that, by 2025, U.S. domestic natural gas production will still be maintained at around today's level of 19 Tcf. However, many independent consultants estimate that domestic production is likely to be considerably lower than this figure, especially if natural gas prices fall and domestic drilling becomes less economic. Some industry analysts believe that U.S. production may well fall below 16 Tcf by 2025.

Whichever predictions turn out to be correct, current forecasts indicate that required imports (the gap between U.S. demand and U.S. domestic production) are likely to be at least 9 Tcf annually by 2025.

If Alaska North Slope (ANS) gas reserves are developed, the massive ANS pipeline will provide around 1.8 Tcf of additional gas annually. It is hoped that the MacKenzie Delta pipeline proposed from northern Canada will provide a further 0.6 Tcf annually. However, even if these reserves are developed and current Canadian imports of around 3 Tcf are maintained, the United States will still be facing an import deficit of about 3.6 Tcf annually. Thus, even if all available sources of pipeline gas are developed, including Alaskan reserves, a significant volume of LNG imports will be required to ensure that U.S. consumer demand is met.

In summary, it is not a question of 'choosing' either Alaskan gas or LNG. Both are required if U.S. consumer demand is to be met.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. RON WYDEN TO
JAMES J. MULVA

Question. All over America, the oil industry drives up the price at our gas pumps by redlining and zone pricing. "Redlining" is when your companies draw a phony line around a community to lock out competition and raise prices for the consumers. "Zone pricing" is plain old discrimination and it takes place when one oil company supplies gas to several gas stations located near each other and one station is charged much more than the others for the same type of gas. This drives stations out of business, reducing choice and raising prices for consumers. To help hurting consumers at our gas pumps, will your company commit to stop redlining and zone pricing? Yes or no?

Answer.

Redlining.—ConocoPhillips has not and does not engage in any practice whereby its marketers are precluded from branding or reselling ConocoPhillips motor fuels to retail outlets in any discreet geographic area or region of the country. ConocoPhillips' marketers have non-exclusive territories and can compete for the resale of motor fuels to branded retail outlets anywhere marketers believe in their own business judgment they can economically resell motor fuels.

Zone Pricing.—Zone pricing is a methodology whereby competitive discounts and allowances are given to individual service station dealers in response to lower retail prices of competitors with whom the service station dealer competes. This practice has repeatedly been found to be consistent with relevant laws governing marketplace competition. State and Federal Court opinions, and studies of zone pricing

practices by the Federal Trade Commission, have concluded that appropriate use of zone pricing is pro-competitive, and that such practices comport with the principles of the Robinson-Patman Act which permits pricing differences that reflect a good faith effort to meet competition. ConocoPhillips' use of zone pricing has comported, and will comport, with applicable law.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. MARIA CANTWELL TO
JAMES J. MULVA

Question 1. I'm aware that the cost of crude oil is driven by the world market and that its cost is currently significantly above historic averages. But I'm not aware of any substantive increases in the cost of producing crude oil, the cost of refining it into various petroleum products such as gasoline and diesel, and the cost of transportation of refined products to markets. Through the end of September 2005, the price of crude had increased 40 percent in 2005 while gasoline prices increased almost 80 percent. If the percent difference in the prices isn't pure profit, please explain to me how you account for the difference in the substantially lower increase in crude oil when compared to gasoline.

Answer. Increases in the cost of finding, developing and producing a barrel of oil are a large factor in the price increases we have seen in recent years. Steel prices doubled between the end of 2002 and end of 2004, and they are a large cost component for our industry. In the last three years, onshore drilling costs in the U.S. rose 52 percent and the cost of tubular goods rose by 125 percent. These components represent about half the cost of onshore wells. Costs have been rising in part because the oil services industry has not been able to keep pace with the rapid spending increases by our industry. Shipping rates for large crude carriers (VLCCs) also tripled between 2002 and 2004, raising the cost of imported crude. However, there is also a longer term trend of costs increasing because our industry doesn't have access to the lowest cost reserves, including in the United States. Thus, our industry is going after more remote, deeper water, more complex and lower quality reserves that inherently cost more than what we were developing a decade ago. Both Goldman Sachs and Sanford Bernstein recently estimated that oil replacement costs are presently around \$50 per barrel, when they were closer to \$35 per barrel in the early 2000s and \$20 per barrel in the 1990s.¹⁸ We believe that some of this replacement cost is related to the high market price environment and will come down as market prices come down. Costs have also been rising for refining. According to the Nelson-Farrar Composite Refinery Operating Index and Construction Cost Index, between 2001 and 2004, operating costs have increased 14 percent and construction costs increased 16 percent.

Using data published by the U.S. Department of Energy, the spot price of WTI crude rose by 41 percent from January-September 2004 to January-September 2005 (from \$39.25 to \$55.52/barrel). During this same time period, the U.S. Gulf Coast spot price for regular gasoline went up by 38 percent (from \$1.16 to \$1.59 per gallon). The retail gasoline price increase in the Gulf Coast went up by only 24 percent during the same time period (\$1.72 to \$2.13 per gallon). It is also important to remember that the hurricanes shut in nearly 30 percent of total U.S. refining capacity at the peak, and that 10 percent of Gulf refining capacity is still shut in (as of November 28). Despite this reduced supply capability in the Gulf Coast, retail gasoline prices in the Gulf fell by 18 percent since the end of September and are presently significantly below pre-hurricane levels.

Question 2. Between 1981 and 2003, U.S. refineries fell from 321 to 149. Further, no new refineries have been built in the U.S. since 1976. In 1981, the 321 refineries had a capacity of 18.6 million barrels a day. Today, the remaining 149 refineries produce 16.8 million barrels a day. I recognize the difficult financial, environmental, and legal considerations associated with the location and construction of new refineries. But I fail to understand the closure of existing refineries even if they required investment to enhance their efficiency and production capability unless, of course, this mechanism is being used to increase the price of gasoline and other refined products. Please help me understand why you would shut down refineries in the face of the supply and demand situation. What conditions would have to exist for you to invest in new refining capacity? I have heard the industry claim that up to \$48 billion has been used on capital expenditures for existing refineries. If those investments were not used for capacity increases, what were they used for?

Answer. According to the Federal Trade Commission, between 1973 and 1981, government controls on the pricing and allocation of crude oil favored small refin-

¹⁸ Bernstein Research Call, November 4, 2005, page 2; Goldman Sachs, Jeff Currie, "The sustainability of higher energy prices, April 2005, page 21.

eries and provided incentives to companies to own and operate small, inefficient refineries. The elimination of these government controls in 1981 spurred the eventual exit of many inefficient refineries, which also faced high investment needs in order to meet increasingly stringent emission and clean fuel requirements. According to the FTC, refinery closures overwhelmingly have involved small, relatively unsophisticated facilities.¹⁹ These refineries probably could not compete in U.S. and global products market under free market conditions.

To consider investing in a grassroots refinery in the United States, there would have to be substantial improvements in the permitting process and we would have to be convinced that refinery margins and returns would be significantly higher than they were historically on a sustained basis.

Our company today is one of the largest refining companies in the United States. Over the last ten years, we have made significant investment in our refineries. Our capital programs have focused on the business objectives stated below:

- Improve mechanical integrity and utilization
- Meet environmental and fuels standards while maintaining capacity
- Infrastructure improvements to ensure the long-term viability of our assets
- Modernization programs for instrumentation and controls
- Updating technology of individual processes
- Adding conversion capacity for lower quality crude processing
- Adding incremental throughput capacity.

The average annual capital spend for our U.S. refining system has increased by roughly 50 percent when comparing the period of 1997-2001 versus 2002 through projected 2006.

1997-2001 (1) = \$640MM/Year
2002-2006 Projected (2) = \$965 MM/Year

Notes: (1) Approximate Capital Spend for Conoco, Phillips and Tosco refineries. (2) ConocoPhillips Capital Spend excluding the planned Strategic Investment Program to invest \$4-5 billion from 2006-2011 on top of other refinery investments of \$1-2 billion per year.

In the period of 2002-projected 2006, the capital spend includes an average of roughly \$400 MM/Year for the \$2 Billion Clean Fuels program. This program builds extensive facilities to meet the EPA regulatory requirements for Low Sulfur Gasoline (LSG) and On-Road Ultra Low Sulfur Diesel (ULSD). Our program for Clean Fuels has focused on meeting the new fuel regulatory requirements while maintaining our capacity of clean product production.

Going forward, our company has announced a multi-billion dollar program to be implemented over the next five years. While this Strategic Investment Program is underway, our ongoing capital spending will continue for infrastructure improvements, environmental and fuels compliance, and modernization of our plants.

Question 3. The recent hurricanes resulted in the need to import substantial refined products such as gasoline, diesel fuel and aviation fuel to meet U.S. demand. The question has been raised as to whether the country should develop a strategic reserve of finished petroleum products. What would be your reaction if the Federal government either directly or by way of contract with the private sector sought to create a strategic reserve of finished petroleum products? Since these products have a limited shelf-life, one proposal is to obtain and operate a number of refineries and have the products be used by the Federal government. Appreciate your comments on this proposal.

Answer. The holding and management of a strategic gasoline reserve is complex and challenging, but deserves further study. Unlike the SPR crude oil reserve that only needs to get crude to 140 refineries, half of whose capacity are in three states, a strategic gasoline reserve or reserves will have to supply more than 1,500 terminals across all states. Also, unlike crude oil, it is difficult to store gasoline for long periods of time as the inventory must be turned over seasonally to match required products specifications and to avoid product (aging) degradation. Location is very important as it must be away from areas that are likely to experience frequent supply logistics disruptions such as power outages and hurricanes to avoid the potential loss of power and disruptions to the distribution systems. The reserve must be distributed across the country since it is impossible to predict when and where there will be outages. Additionally, the numerous regional and local fuels specification requirements severely complicate design of strategic reserves due to the very large number of different grades required in different locations around the United States.

¹⁹U.S. Federal Trade Commission, Bureau of Economics, "The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement", August 2004, page 7.

In addition, the cost of storage is high so it is important to do a cost-benefit analysis to determine whether the costs of holding this inventory are worth the benefits of avoided disruption costs.

It is also important that this reserve not be used for price management purposes but rather be saved for use when there is a physical disruption to supplies. It would not ultimately be beneficial to consumers to have the government remove the price signals when there is a supply disruption.

While the concept of adding refinery capacity to improve the U.S. balance of domestic supply relative to total demand appears to be sound public policy, getting the Federal government into the refining business may not be the most efficient (cost effective) alternative. Federal government products demand is fairly evenly distributed across the U.S. To supply Federal government demand will require solving the logistics and distribution issues inherent in this proposal. The U.S. industry accomplishes this by 'exchanging' products between refinery supply locations and pipeline/terminal demand locations across the country. Similar arrangements are possible between Federal government and private enterprises. However, the most efficient (lower cost) option remains the removing of current barriers to expansion (permitting) and encouraging the continued growth of the existing private U.S. refining industry.

The private sector expanded refining capacity modestly in recent years because it wasn't needed given surplus global capacity and the ready availability of low-cost product imports. With two years of strong demand growth, particularly in Asia, the global refining balance is now tight and new capacity is needed. The market is now providing the appropriate signals for private investment to build more capacity. As a consequence, there is no need for the government to own capacity.

Question 4. Given the recent profitability of the oil industry, I am interested to learn more on the disposition of these profits, particularly to enhance both production and refining capacity. Are any of these profits being used to enhance production and refining capacity for the benefit of other countries? What fraction of your profits is being invested for production and for refining? What percentage of profits has been used for stock buybacks and mergers and acquisitions?

Although ConocoPhillips' absolute dollar earnings for the first nine months of 2005 appear large because of the size and scope of the company's operations, the company's net income as a percentage of total revenues earned was only 7.5 percent. (Over the last three years, the company's net income as a percentage of total revenues averaged only 4.2 percent.)

With respect to how the company has reinvested its earnings, the table below shows that we reinvested at a rate of 120 percent of earnings in 2003, into our Exploration and Production (E&P) and Refining and Marketing (R&M) segments. In 2004, we began investing in LUKOIL, an international integrated oil and gas company headquartered in Russia. Combining that investment with the investments in our R&M and E&P segments, our reinvestment percentage was 114 percent of earnings in 2004 and 77 percent of earnings through September 30, 2005.

We started a modest share repurchase program in early 2005 that has resulted in stock repurchases of \$1,165 million, equivalent to about 12 percent of earnings, through September 30, 2005.

CAPITAL EXPENDITURES AND INVESTMENTS IN E&P AND R&M AND LUKOIL STOCK PURCHASES AS A PERCENTAGE OF NET INCOME 2003 THROUGH YTD 2005

[Millions of Dollars]

Year	Net income	Capital expenditures & investment in E&P and R&M	Capital expenditures & investment in E&P and R&M as a percent of net income	Purchases of shares in LUKOIL	Purchases of LUKOIL shares as a % of net income	% of net income used for E&P/R&M capital expenditures & investment and LUKOIL share purchases
2003	\$4,735	\$(5,687)	120%	.....	.....	120%
2004	\$8,129	\$(6,593)	81%	\$(2,649)	33%	114%
2005	\$9,850	\$(6,093)	62%	\$(1,523)	15%	77%

Question 5. You've all said profits are cyclical, and that your companies have also suffered from the volatility of the oil markets. Would your stockholders be better served if domestically produced oil was sold at a fixed rate that included a generous profit margin above the production, refining, and distribution costs?

Answer. While reduced price volatility would make it a lot easier to run a business, shareholders have invested in our stock because they want to be exposed to energy price risk. Some of them may own our stock and other commodity stocks in order to hedge stock and bond portfolios, given that there has historically been a negative correlation between stocks and bonds and commodity prices.

We would be uncomfortable making investments based on promises of "guaranteed" returns because our projects often have lives of 20 years or more, and we would not be certain that those fiscal terms would be upheld in a different political climate.

Finally, this approach would not lower the average price of energy for consumers unless additional lower-cost reserves were made available.

The best, and most transparent, way to ensure that supply matches demand is to let the market work.

Question 6. Do you believe that global warming is occurring? Do you believe that man-made activities have a role in this phenomenon? How will global warming impact your companies in term of added costs for oil and gas development, or allow access to new areas for oil and gas development?

Answer. ConocoPhillips recognizes that human activity, including the burning of fossil fuels, is contributing to increased concentrations of greenhouse gases (GHG) in the atmosphere, which can lead to adverse changes in global climate. While the debate continues over the extent of human contributions and the timing and magnitude of future impacts, we are committed to taking action now to begin addressing the issue.

In 1997, an international conference on global warming concluded an agreement, known as the Kyoto Protocol, which called for reductions of certain emissions that contribute to increases in atmospheric greenhouse gas concentrations. The United States has not ratified the treaty codifying the Kyoto Protocol but may in the future ratify, support or sponsor either it or other climate change related emissions reduction programs. Other countries where we have interests, or may have interests in the future, have made commitments to the Kyoto Protocol and are in various stages of formulating applicable regulations. Because considerable uncertainty exists with respect to the regulations that would ultimately govern implementation of the Kyoto Protocol, it currently is not possible to accurately estimate our future compliance costs under the Kyoto Protocol, but they could be substantial.

ConocoPhillips' U.K. and Canadian businesses are actively preparing for GHG regulations in those countries, beginning in 2005 and 2008, respectively. Since the start of 2005, ConocoPhillips' facilities across Europe have been subject to the European Union's emissions trading program. Our commercial organization is preparing to trade CO₂ allowances in order to optimize ConocoPhillips' net emissions position for businesses in Europe. The trading group will focus on minimizing the cost of procuring any additional allowances required to meet compliance and maximizing the value of any excess allowances.

In addition to regulation, other potential long-term risks associated with climate change include the impact of climate itself and climate policy on energy demand and commodity prices, increased operating expense due to rising fuel prices and a changing physical operating environment. There are also potential reputation and informal societal license-to-operate issues that could arise for businesses and industries whose products or processes are associated with high levels of greenhouse gas emissions.

ConocoPhillips is pursuing several innovative business opportunities that could result in GHG emission reductions within the company, industry or for our customers. These include CO₂ sequestration, co-generation, coal/petroleum coke gasification, bio-diesel manufacture and energy efficiency improvements.

Question 7. Is it accurate that United States LNG terminals in Massachusetts and Maryland are only operating at half capacity? Do you believe if these plants were operated at a higher capacity it would change the market dynamics that determine the current price?

Answer. ConocoPhillips does not own or operate any existing regasification terminals in the United States. However, it would not surprise us if existing regasification terminals are operating at low utilization rates. The reason lies in a combination of two factors.

First, global LNG supply is currently constrained, so there is insufficient LNG supply available to meet potential worldwide demand. Natural gas demand has

risen rapidly during 2005 in countries such as Spain, Italy, France, Korea and India. At the same time, LNG supplies have not grown as quickly as expected. In particular, operational problems at LNG supply projects in countries such as Nigeria, Egypt, Trinidad and Australia have resulted in supply shortfalls.

Second, and more importantly, there is a world market for LNG supplies, so of the limited volumes available worldwide, those volumes that are not dedicated to a certain market under long term contract will flow to the market that results in the highest netback pricing. So far this year, we have seen a willingness of buyers in other countries (Japan and Spain) to pay LNG prices that exceed equivalent U.S. netback prices. As a consequence, owners and capacity holders of U.S. regasification terminals have not been able to secure sufficient LNG volumes to achieve high utilization. There are a number of projects presently underway to bring dedicated LNG supplies to the U.S. market. However, these projects will not be completed before the 2008-2009 time period.

Question 8. Please state for the record your company position on fuel economy standards. Are there other incentives that you support that you feel are better for consumers than the Corporate Average Fuel Economy paradigm?

Answer. When addressing what can be done to promote conservation and efficiency, there are few solutions that would have as much impact as higher fuel efficiency standards. This is an issue that should be kept on the table to determine if it makes sense. We would suggest prudence, and caution against overreaching, in view of the impact on the automobile industry and possible adverse economic consequences.

Question 9. I understand that over the past 5 years companies in your industry have downsized significantly. Now there is a shortage in workers and equipment to increase drilling. Please explain that dynamic.

Answer. The oil and gas industry has experienced significant price volatility over the past decades, which has led to shrinkage of the industry workforce. While the industry workforce today is smaller than in the early '80s, much of this reduction in human resource and equipment capacity has been offset with advances in technology. Continued advancements in seismic technology, reservoir simulation and drilling applications have not only made it possible to be more efficient with exploration and development resources (human resources and capital resources) but it has also enabled the opening of new areas where production previously was not technically or economically possible. Examples include deep water exploration and production, unconventional reservoirs that are being tapped through multi-lateral drilling and "minimal footprint" developments that have opened up arctic exploration and production.

Increases in industry activity can, in the short term, strain the supply of fully trained workers and equipment availability. But the oil industry has previously demonstrated its ability to adapt to market forces, mobilize workforces, and increase investment in technology to access new oil and gas supplies. Opening up new resource-rich areas for exploration and production in which new technology can be applied is certainly an efficient action to help address U.S. supply concerns. Additionally, altering some of the restrictive visa requirements in the U.S. would help multinational companies mobilize trained human resources to the United States to assist in the increasing exploration and production activity.

Question 10. As you probably know, Congress is likely to open up the Coastal Plain of the Arctic National Wildlife Refuge to oil and gas exploration. Do you have plans to bid for leases in this area? What does the price of oil have to be to make ANWR exploration and extraction economically viable?

Answer. At any given time, ConocoPhillips is evaluating a number of prospective projects around the world. If Congress were to make such a decision, it would have to compete with other global opportunities that we are evaluating at the time and would involve comparisons of risk, potential reserve size, and development and operating costs. A decision on whether to drill there could only occur after those determinations are made.

Question 11. I understand that many of your resources and equipment are working flat out to rebuild infrastructure in the Gulf of Mexico. If there is no capacity to expand oil and gas exploration, what good is opening up sensitive environmental areas to increased drilling going to do for the consumer in the short run?

Answer. Opening up new areas for drilling will help the consumers over the longer term (3+ years). It typically takes several years for a new area in the Gulf of Mexico to be explored and, if commercial hydrocarbon deposits found, developed. There are ample industry resources (people and equipment) to pursue these opportunities now if these areas were made available. New production reduces U.S. de-

pendence on imports, increases supply, and may moderate consumer prices, particularly for natural gas.

Question 12. Given the growing demand for oil in Asia, do you believe that oil derived from the Arctic National Wildlife Refuge could be diverted to supply Asian markets? If drilling in the Arctic National Wildlife Refuge is authorized this year, when will it begin to have an impact on gasoline prices? What do you believe that effect will be?

Answer. The primary market for Alaskan crude is likely to be the U.S. West Coast to replace declining supplies of Alaskan crude these refineries are presently using.

Production from ANWR would likely come too late to relieve near-term supply problems. Should leasing be permitted and subsequent commercial discoveries made, it will be an estimated 7-8 years or more before oil production from ANWR could reach the market. During this timeframe, the world will become increasingly reliant on fewer and fewer producing countries and having a secure domestic supply would improve U.S. and global energy security.

We have not assessed in detail the impact of opening ANWR on the price of crude oil or gasoline. Adding new crude supply sources would directionally lower the world oil price. Directionally, it also makes sense that by replacing declining supplies to U.S. West Coast refineries, ANWR production would lower refiners' crude costs since their alternative is to replace this crude with higher-cost shipments from the Middle East and Asia. Likewise, reduced West Coast crude costs would likely lower West Coast gasoline costs.

Question 13. Do you support more transparency in the oil and natural gas markets, as would be provided in my bill S. 1735?

Answer. ConocoPhillips supports the concepts of transparency to the extent it is compatible with freely functioning competitive markets. We participate in providing data to generate natural gas price indices in the United States and are active in the Committee of Chief Risk Officers (a voluntary industry organization) working to develop industry best practices in risk management, part of which addresses market transparency.

Section 8 of S. 1735 purportedly seeks to enhance transparency of crude, gasoline and petroleum distillates wholesale markets through enforcement efforts focused on monitoring "companies with total United States wholesale or retail sales of crude oil, gasoline, and petroleum distillates in excess of \$500,000,000 per year." We do not believe that there is cause to single out larger wholesale and retail operations. They are already publicly traded, thus making their earnings or losses a matter of public record vis-a-vis regular SEC filings, plus they have the greatest downside risk were they to engage in anti-competitive practices.

A second cause for reservation is that compliance with Section 8 could expose companies to increased antitrust risk and impede the natural functioning of market operations. Although Section 8 allows the FTC to refrain from publishing information that it thinks might harm competition, we are skeptical of any effort to collect and publicize transaction-level information that is currently confidential. Moreover, such an effort would leave those companies subject to antitrust laws in an awkward position not only with respect to compliance with potentially conflicting rules, but also with respect to the conduct of their competitive business operations. Finally, (aside from information that is already publicly available and information that the FTC will have to omit in order to avoid harm to competition), it is not clear exactly what benefit the public would derive from having access to the thousands of individual transactions done at the wholesale and retail levels for crude oil, gasoline, and petroleum distillates.

Question 14. How have the last 3 years of escalating gasoline prices affected demand by American drivers? Have we seen a correlation between a certain level of price increase and less demand by American drivers? What is the actual level of reduced demand today compared to 3 years ago (please respond in the context of a doubling of retail gasoline prices)?

Answer. Year-to-date through August 2005, U.S. gasoline demand was 9.2 million barrels per day versus 8.9 million barrels per day in 2003, representing a 2.9 percent increase. However, the adverse price effects on demand were probably masked by rising employment during this period, which increased driving. The consulting firm, PIRA Energy Group, recently estimated that between 2003 and 2004, with a 17 percent real increase of retail gasoline prices and an assumed marginal elasticity of about -10 , gasoline demand would have been reduced by about 150 thousand barrels per day if it hadn't been for the growth in employment.²⁰ PIRA used a high-

²⁰PIRA Energy Group, U.S. Gasoline Demand Elasticities are Higher at the Margin, July 2005.

er elasticity than historical to reflect that in a high crude price environment, gasoline's share of the consumer basket increases such that consumers are more likely to reduce consumption than when it was a smaller share of the basket. Applying this higher elasticity to a doubling of real prices, it would theoretically shave 900 thousand barrels per day off demand if there wasn't offsetting employment growth. It is important to keep in mind that U.S. average retail gasoline prices year-to-date through October 2005 (\$2.32 per gallon) were 44 percent higher (not 100 percent or doubling) than the same period in 2003 (\$1.61 per gallon). Thus, the impact would have been 400 thousand barrels per day of reduced demand if all else were equal. While the average retail gasoline price peaked at over \$3.00 per gallon in September 2005, the November 28, 2005 price fell to \$2.15 per gallon, well below pre-hurricane levels. This should have restored nearly 250 thousand barrels per day of demand based on PIRA's assumption about the price elasticity of demand. We believe driving behavior and the elasticity or responsiveness to price is also contingent on whether consumers perceive tighter market conditions are temporary or are more permanent. All prices and demand numbers quoted are from the U.S. Department of Energy.

Question 15. What are the crude oil extraction costs for major oil producing countries, including our own? How does that compare with oil derived from shale or coal?

Answer. The cost to find, develop and produce oil varies greatly both within and outside of the United States. Costs depend on the scale, depth and complexity of underground reservoirs; the nature of the oil in place; whether the oil fields are onshore or in shallow or deep coastal shelf areas; royalties, taxes and other forms of government take, among other factors.

Published estimates of exploration, development and extraction costs show the cheapest oil is found in countries like Saudi Arabia, Iran, Kuwait and Iraq, with costs of approx \$7-\$8/bbl. U.S. onshore oil, Russia, U.S. deep water, Western Europe offshore and Canada conventional oil are increasingly more expensive, on average. However, companies make investment decisions based not on geographic averages, but on the individual circumstances of each opportunity, knowing that the actual price they will receive for the oil they extract will depend on market conditions many years in the future.

Oil replacements costs are also deemed to be particularly high today. Goldman Sachs and Sanford Bernstein believe they are about \$50 per barrel per day, including host government take, which is a large percentage of the cost. This is the price that is needed to justify new investment today. We believe that some of that elevated cost is due to high prices and spending levels outpacing the service industry's capacity to supply rigs and services. Thus, costs will come down as prices come down.

ConocoPhillips does not currently extract oil from shale or coal, so we have no operating knowledge of the related costs. A 2005 report (Oil Shale Development in the U.S.) by the Rand Corporation estimated that commercial development of shale oil using the mining/retort process will require prices of ~\$70-90/barrel.

Question 16. Regarding foreign exporting, inventory maintenance, and other practices of your company, please provide a response to each of the following questions and information requests: For each and every export shipment to a foreign country of gasoline, distillate fuel oil, propane, or liquefied natural gas occurring from January 1, 2005 to present, please provide the date, product type, volume, domestic port of exit, foreign destination, transportation costs, and the sale price or transfer value upon arrival at the foreign destination.

Answer. The United States is a net importer of clean products. For example, in 2004, the United States exported 976 thousand barrels per day of finished petroleum products and blending components (excluding LPGs), but imported almost three times that amount or 2.8 million barrels per day of finished petroleum products and blending components. Thus, the U.S. is a net importer by 1.8 million barrels per day. The North American market is also highly interconnected. There is a significant volume of cross-border energy trade between the United States, Mexico and Canada. Nearly 20 percent of U.S. finished products and blending component imports are from these countries, and 32 percent of U.S. product exports are to these countries. Canada and Latin American sources also comprise half of U.S. crude imports, which highlights the importance of continued trade.

Imports and exports play a very important role in balancing U.S. and global supply and demand. If there is a disruption in one place, prices rise and attract imports from other places. Similarly, exports allow companies to move product when logistically or economically it can't be moved to another domestic location, or if the product doesn't meet domestic specifications. Logistical reasons for exports include an inability to find Jones Act tankers and pipeline bottlenecks, which force the prod-

uct to be put on the water. In some cases, exports are key to relieve containment issues and maintain refinery production rates.

A recent example of a ConocoPhillips export due to a containment issue is the sale of 280,000 barrels of No. 2 heating oil from our Alliance, La. refinery. We originally contracted to sell this cargo FOB to Projector (Ecuador) on August 16, 2005 with a loading date of August 27-29. Because of Hurricane Katrina, the ship couldn't load at Alliance. To meet our commitment, we agreed on August 30 to load the cargo at our Lake Charles, Louisiana refinery. If we didn't load this cargo at Lake Charles, we would have shutdown the refinery due to distillate containment since the main pipeline to move product to the East Coast (Colonial) didn't start up for at least three days after Hurricane Katrina.

Given pipeline bottlenecks and costs, it is also sometimes cheaper (and more profitable) to export product. For example, on September 19, 2005 with pipeline capacity utilization at its maximum, we sold 50,000 barrels of diesel from our Ferndale, Washington refinery to Petro-Canada that was exported to Vancouver. The profit on this sale exceeded the profit that could have been obtained in the U.S. market.

ConocoPhillips wishes to provide the Committee with all information that the Committee considers important to its current inquiry. The nature and extent of the information requested regarding the sale price of the exports, however, is highly confidential and competitively sensitive. Disclosure of this data would reveal confidential marketing and sales strategies which, in the hands of marketplace rivals, would be harmful to the interests of both ConocoPhillips and consumers. In addition, revelation of such confidential transactional information, especially of relatively recent vintage, could be deemed anticompetitive and invite antitrust scrutiny by state or federal enforcement agencies and potential private plaintiffs.

APPENDIX A* summarizes information provided by ConocoPhillips to the United States Census Bureau identifying certain product exports.

In addition to this information, ConocoPhillips believes that there may be additional transactions with respect to which ConocoPhillips sold product to a buyer in the United States and the buyer then exported the product. In the time available to ConocoPhillips to prepare this response, it has not been possible to identify such transactions. However, the Federal Trade Commission has requested similar information, and ConocoPhillips expects to be able to review available electronic records prior to its response to the Federal Trade Commission and to identify additional transactions, if any, with respect to which it is reasonable to believe product was exported from the United States.

Question 16a. Since January 1, 2001 to present, please identify the number of shipments wherein your company exported gasoline, distillate fuel oil or jet fuel and the sales price or transfer value received at the destination was less than the amount that would have been received had the product been marketed by your firm in the United States.

Answer. ConocoPhillips' policy is to sell its refined products to realize the best netback in the marketplace. Because exports are often contracted in advance of loading, the product sold is often subject to logistical constraints or the product is not marketable in the relevant regional market, comparing the profitability of hypothetical alternative transactions is not possible.

Question 16b. Since January 1, 2001 to present, please identify the date, product, volume(s), foreign port of origin, expected U.S. port of entry, and eventual port of final destination in each instance wherein your company basically "turned a ship away" (whether proprietary product or acquired from a third party) by changing the shipments expected arrival in a U.S. port to a foreign port.

Answer. It is common industry practice to charter ships with a destination indicating "Any Safe U.S. or European port", "Any Safe European or Mediterranean port" or "Any Safe European or Asian port", etc. Ships are loaded at origin without a final decision being made as to the destination of the cargo. As the ship embarks, the only decision made is the general direction the cargo will travel, with the final destination designated only when a purchaser commits to the cargo or when the greatest netback for that cargo has been identified. As a result, the final destination is often one of many destinations which may or may not have been previously designated for the cargo.

Answering this question requires the examination of thousands of chartering agreements and Bills of Lading and making an attempt to draw conclusions from the original entry in relation to the final port of discharge. We were unable to conduct this examination in the short time period set for response. However, the same

*Appendixes A-C have been retained in committee files.

information has been requested by the FTC and we will be examining the relevant documents over the next several weeks and providing the FTC with our analysis.

We were able to identify a transaction that, while not a diversion of a cargo, represented the export of imported product. In August 2005 (prior to Hurricane Katrina), we had imported 100,000 barrels of gasoline from Korea to the West Coast of the United States. The gasoline was intended for the Arizona market, and did not meet California's specifications. ConocoPhillips demand for gasoline in Arizona was lower than anticipated. Had we imported the entire cargo of 300,000 barrels we would have tied up 500,000 barrels of storage that we use to bring Carb Gasoline from San Francisco to L.A. potentially jeopardizing the operating rates at our San Francisco refinery. Consequently we sold 200,000 of that cargo to the Mexican national oil company before it arrived in L.A., along with 100,000 barrels of premium (would not meet California specifications) from our Northern California refinery, which was the condition they placed on the deal. On net, there was no impact on the market. We imported 100,000 barrels of gasoline that met Arizona specifications and we exported 100,000 barrels of gasoline that did not meet U.S. specifications.

Question 16c. From 1995 until present, please identify by month the inventory levels maintained by your company for gasoline and distillate fuel oil in both barrels and converted to "days of cover" or "days of supply" for your firm's distribution and sales volumes within each of the Petroleum Allocation Defense Districts (PADDS) in the United States.

Answer. ConocoPhillips reports its inventory levels on a weekly and monthly basis to the Department of Energy. APPENDIX B represents the data we had readily available from these reports. The same data have been requested by the Federal Trade Commission and ConocoPhillips has waived its confidentiality claim with the Department of Energy to provide the FTC with the inventory data it is requesting.

APPENDIX B contains data from the period July 4, 2003 through April 9, 2004 (first tab) and data from April 16, 2004 through November 18, 2005 (second tab). The DOE changed its reporting format in April 2004, so we started a new report at that time incorporating the new format.

Question 16d. From January 1, 2005 to present, provide the details of each "spot market" (as commonly referred to in the industry for bulk sales, in volumes exceeding 5,000 barrels per transaction) including the date, identity of both the seller and purchaser, location of the product being sold, and the selling price.

Answer. ConocoPhillips wishes to provide the Committee with all information that the Committee considers important to its current inquiry. The nature and extent of the information requested regarding "spot market" transactions, however, is highly confidential and competitively sensitive. As drafted, this question would reach tens of thousands of individual transactions and would require the identification of detailed information respecting pricing, participants, locations, and volumes. As such, it would reveal confidential marketing and sales strategies which, in the hands of marketplace rivals, would be harmful to the interests of both ConocoPhillips and consumers in vigorous spot market competition. In addition, revelation of such confidential transactional information, especially of relatively recent vintage, could be deemed anticompetitive and invite antitrust scrutiny by state or federal enforcement agencies and potential private plaintiffs. Consequently, we would hope to work with the Committee to explore an appropriate mechanism and format by which this information may be provided in order to accommodate the Committee's interest in obtaining the necessary information for its purposes without unnecessarily compromising ConocoPhillips' interest, or that of the consuming public, in preserving the confidentiality of this strategically sensitive competitive data. To that end, particularly in light of the Federal Trade Commission's role in advising the Congress during the current inquiry and the agency's familiarity with the underlying marketplace issues respecting disclosure of sensitive competitive information, ConocoPhillips would welcome the involvement of the Federal Trade Commission in consultations directed at identifying an appropriate mechanism and procedure by which the Committee may receive the information it deems necessary.

Question 16e. Describe your company's use of "in-house trading platforms," and identify all individuals in your company by name, address, email, and phone number that were authorized during 2005 to either exchange, trade, sell or purchase gasoline or distillate fuel oil on either the "spot market", NYMEX futures market, or via "forward paper" purchase rights.

Answer. ConocoPhillips does not use in-house trading platforms. However we do own a small interest in the Houston Street Exchange, Inc. trading platform. ConocoPhillips does a small volume of its trading via Houston Street.

ConocoPhillips' Commercial group trades through the larger publicly available platforms normally used by open market traders. These include the NYMEX, Ac-

Lox Shingleton
Lynn Argianas

Andy Sostek
Tucker Horne

Sam Handsborough
Paul Smith

Heavy Products

Viens, Andy
Knut Torvik
Monsalve, Romulo
McIntyre, Kyle
Omar Suby

Grimaldo, Carlos
Patrick Hayes
Heskamp, Doug
Post, Denise
Stillings, Owen

Usatschew, Walter
Love, Turkessa
Davis, Paul

Natural Gas Liquids

United States
M.J. Morrison
J.C. Jewett
J.J. McLiverty
P.W. Burger
Kathy Watson
Cassidy Simmons
Adam Ellis
S. Weed
Cody Womack

J.S. Wilborn
R.E. Sommerstedt
M.W. Schwartz
S.R. Walton
R. Hahn
S. Stewart
H.J. Gump
D.G. Lipford
E.M. Lindsey
S.M. Merveldt

L.A. Bradshaw
E. Brandt
B. Oakes
Kent Nettlingham
Amanda Seaberg
Calgary
C. Gleave
K. Robertson

Natural gas and power prices were provided by only one individual:

James Allison—Regional Risk Manager, Gas & Power—North America

Question 16g. Please identify the branded and unbranded “rack prices” that were reported by your company to third party reporting services such as OPIS and the branded and unbranded “rack prices” that were actually charged distributors or jobbers by your company each day, from January 1, 2005 to present, at the truck loading terminal(s) that typically supply gasoline stations in Houston, TX, Atlanta, GA, New York, NY, Chicago, IL, Los Angeles, CA, Portland, OR, and Seattle, WA.

Answer. We do not send branded and unbranded rack price information to any third party service provider such as OPIS. OPIS gets ConocoPhillips’ rack price from our independent marketers (customers).

Attached hereto as APPENDIX C is the requested rack pricing data for regular unleaded gasoline.

Question 16h. Will your company commit that it will take no efforts to retaliate against any firm or individual that is a potential witness before this Committee or cooperates with any investigation into the oil industry by Congress or another governmental authority?

Answer. Yes.

Question 16i. From January 1, 2005 to present, for each instance known to your company wherein a third party (not your company) exported gasoline, distillate fuel oil, propane, or liquefied natural to a foreign country, please provide any of the details known to your company including the identity of the exporter, date, product type, volume, domestic port of exit, foreign destination, transportation costs, and the sale price or transfer value upon arrival at the foreign destination.

Answer. ConocoPhillips generally does not have knowledge about third-party activities except where we sold them the cargo and we were exporter of record as noted in response to question 16A (Cantwell).

Question 16j. Since January 1, 2001 to present please identify the identity, date, product, volume(s), foreign port of origin, expected U.S. port of entry, and eventual port of final destination in each instance wherein your company is aware a third party (not your company) basically “turned a ship away” (whether proprietary product or acquired from a third party) by changing the shipments expected arrival in a U.S. port to a foreign port.

Answer. ConocoPhillips generally does not have knowledge about third party activities except where we sold them the cargo and we were exporter of record as noted in response to question 16A (Cantwell).

Question 16k. Please provide an itemized list of tax deductions and credits taken under the U.S. tax code for 2004, by your parent company and subsidiaries.

	U.S. tax code section
Deductions:	
Bad Debts	166
Property Taxes	164
State and Local Income Taxes	164
Franchise Tax Expense	164
Sales and Use Taxes	164
Payroll Taxes	164
Production Taxes	164
Environmental Taxes	164
Other Taxes	164
Excise Taxes	164
Interest	163
Charitable Contributions	170
Depreciation	167
Depletion	611
Expired and Surrendered Leases	165
General and Administrative Expense	Various
Selling Expense	162
Financing Expense	163
Geological and Geophysical Expense	165
Dry Hole Expense	165
IDC Expense	263
Retirement of Assets	165
Amortization	Various
Cost of Retirements	165
Exploration G&A Expense	162
Partnership Losses	Various
Miscellaneous	Various
Lease Carrying Expense	162
ETI Exclusion	114
Net Operating Loss Deduction	172
Dividends Received Deduction	241
Credits:	
Foreign Tax Credit	27
General Business Credit	38
Credit for Prior Year Minimum Tax	53

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. KEN SALAZAR TO
JAMES J. MULVA

Question 1. The Agriculture Committee is looking at the impacts these high energy prices are having on agricultural producers around the country. To sum it up: they are hurting. It seems to me that there is tremendous potential for our country to grow fuels such as ethanol and bio-diesel. This approach offers many benefits to rural America as well as to the country as a whole. What type of investments is your company making (and planning to make) in these types of renewable fuels in the United States?

Answer. We are currently investing in terminal tanks and equipment to allow blending of biodiesel where mandated by state law. Additionally we are conducting research in novel ways of using agricultural feed stocks to manufacture gasoline and diesel directly, as well as evaluating the methods of improving the economics of ethanol and biodiesel manufacture and distribution.

ConocoPhillips was supportive of efforts to include a provision in the Energy Bill that encourages the use of animal fats and waste as a renewable feedstock to run our refineries. Our refining operations believe these feedstocks have potential and are looking at how to implement their use.

We do not believe that additional Congressional efforts to enact mandates for biodiesel or other renewables are appropriate at this time, given the negative effect that such costly mandates would have on consumers who are already dealing with high energy costs.

Question 1a. Rural America is crying out for investment in renewable fuels, and I encourage your companies to look at the potential of renewable fuels. In terms of a percentage of your capital expenditures, how much money did your company

spend this year to develop renewable fuel sources in the United States? What will that percentage be going forward?

Answer. Our company will spend approximately 1-2 percent of our research expenditures on renewable fuels this year, with approximately half of that spent in the United States. Our planned expenditures are similar until we identify an attractive technology, in which case we will increase our spending as needed to commercialize the technology.

Question 1b. Will you also provide this committee with some examples of renewable fuel projects that your company is pursuing outside the United States?

Answer. We recently completed a commercial scale test demonstrating a new technology for converting renewable feed into high quality diesel fuel at our Whitegate Refinery in Ireland. We are in the process of evaluating the data from this test, and modeling its applicability across our worldwide refining network.

Question 2. As a few of you note in your testimony, diesel prices have remained high while unleaded gasoline prices have come down. It seems as if we are getting lower priced unleaded gas at the expense of diesel. Since diesel is the fuel of choice in agriculture, it is a sort of a double whammy on our producers. What is being done, or what can be done, to get diesel prices back in line with the price of gasoline?

Answer. U.S. diesel prices are presently higher than gasoline prices due to a tighter global diesel supply-demand balance, which stems from the strong trend in Europe toward dieseling the passenger car fleet and robust diesel demand in Asia. Global and U.S. diesel demand have been and will likely continue to grow at a faster rate than gasoline demand. Thus, the trend of global diesel prices moving above gasoline prices is not likely to be reversed even when immediate supply losses from the hurricanes are restored.

The longer-term trend of strengthening diesel prices was exacerbated by the hurricanes, which temporarily shut down nearly 30 percent of U.S. refining capacity at the peak. While the United States made up lost gasoline supplies through imports and specification waivers, diesel fuel did not have the same options. Diesel demand and price strength in Europe made it difficult for the United States to attract as much diesel as gasoline supplies. European refineries have excess gasoline production capacity due to dieselization since gasoline demand is declining there. Thus, they were able to provide additional gasoline supplies to the United States. Another factor buoying present diesel prices is that they gain strength in the winter as diesel is blended and/or re-graded into the heating oil market.

- When the price of diesel for a given market location is above cost of alternative sources of added supply, supplies will flow into that market. This was the case immediately after the hurricane, when the United States did attract additional distillate imports. The diesel-gasoline price difference also provided an economic incentive for refiners to change product mixes towards maximum diesel production, although this switch would likely have occurred anyway, since the fall season is the normal period when refiners switch from maximum gasoline (summer season) to maximum heating oil (winter season, including diesel). However, there is only a limited ability for refiners to switch between maximizing diesel vs. gasoline production (~10 percent). On average, refineries in the U.S. have 46 percent gasoline yields (on total refined products production) and 21 percent distillate yields (diesel and heating oil).
- ConocoPhillips increased diesel supply by maximizing diesel production over gasoline when economic, moving/drawing inventory, deferring refinery turnarounds (increased production), maximizing imports where feasible, and working diligently to re-start its Gulf of Mexico refining capacity shut down by the hurricanes. All these actions, combined with the rest of the industry efforts, have very effectively restored diesel supply and brought the price down dramatically since the hurricanes made landfall.
- The temperature this winter will likely determine the degree to which the spread between diesel and gasoline prices narrows. In the short-term, if the cold winter forecast is incorrect, this will tend to bring down all distillate prices, including diesel. In the long-term, the solution is to encourage increased domestic production of diesel through refinery expansions. Looking ahead, the pending requirement to produce ultra low sulfur diesel may adversely impact diesel supply reliability next year. This could cause the diesel-gasoline price inversion to widen for some period of time. The EPA should adopt reasonable transition provisions and enforcement protocols that enable the industry flexibility necessary to get through U.S.-wide system conversion from low sulfur to ultra low sulfur diesel without supply disruptions.

Question 2a. If demand for diesel is so high in Europe and high prices don't attract the supplies necessary to lower prices, isn't that a good indicator that we should work to produce more diesel in the United States and look to biodiesel as an option?

Answer. The high price of diesel in Europe is due to the tax on the fuel, which, depending on the country, varies from \$1.50 to \$3.50 a gallon higher than the U.S. tax of 34 cents per gallon. The taxes on gasoline in Europe are generally higher than those on diesel. Therefore, the high European tax structure gives the illusion of high diesel prices at \$3.70 to \$5.70 per gallon but makes diesel less expensive than gasoline for the consumer. The wholesale price of diesel fuel in Europe is similar to the U.S., which limits the ability for Europe to export to the United States.

U.S. demand has historically been higher for gasoline; therefore U.S. refineries are geared toward making more gasoline. Diesel engines do offer some fuel efficiency benefits, but also have emissions and consumer acceptance barriers to overcome. A large scale "dieselization" of the U.S. fleet would take broader consumer acceptance of diesel engines and solutions to emissions concerns. Refinery configurations would need to be altered in response to this change in fuel demand, and the overall effect on consumers of such a change is difficult to predict.

We do anticipate growth in U.S. diesel demand and expect renewable diesel (biodiesel or other non-hydrocarbon diesel) to fulfill part of that demand growth.

Question 3. For the record, will you tell me what your company has spent on capital expenditures in cash, not including write offs such as amortization or depreciation. Will you also provide the figures spent on cash dividends and stock buyback for the same time period?

Answer. Since 2003, the company has spent about \$24 billion in capital expenditures and investments, has paid \$3.5 billion in dividends to shareholders and repurchased \$1.2 billion in company stock. At the same time, the company decreased its debt balance by \$6.3 billion.

Year	Capital expenditures and investment	Net increase/ (decrease) in debt	Dividends paid on company stock	Repurchases of company stock
2003	(6,169)	(1,986)	(1,107)	
2004	(9,496)	(2,778)	(1,232)	
2005*	(8,573)	(1,505)	(1,210)	(1,164)
Total	(24,238)	(6,269)	(3,549)	(1,164)

* 2005 Information is through September 30.

Question 4. On November 1st, Senator Grassley asked your companies to contribute 10 percent of your record profits to supplement LIHEAP funding for the less fortunate. Will your companies support Senator Grassley's proposal?

Answer. ConocoPhillips is concerned about the impact of energy prices on consumers, particularly our customers who can't afford higher energy prices. LIHEAP has been in place since 1982 to help needy families pay their home energy bills and the Federal Government has traditionally had the primary responsibility of helping families in need. This long-standing role of the government is appropriate and should continue.

ConocoPhillips is concerned that any additional taxes, whether mandated or requested, on the oil and gas industry will reduce investment, and therefore reduce the expansion of supplies. This will tend to extend the period of elevated prices.

Question 5. I'd like to encourage you to actively work with the Department of Energy and any other relevant federal agency on initiating a public/private education campaign focused on energy education and conservation. In the meantime, will you tell me what your company has done on its own initiative?

Answer. ConocoPhillips was a leader in helping API develop a \$24 million outreach program, which is currently ongoing, to address the pricing environment as well as provide education to lawmakers and the public on our industry. That program, along with the Alliance to Save Energy education effort (a broad energy industry effort) and individual company efforts, devote significant attention to public education and outreach. ConocoPhillips is very interested in discussing with DOE and the Federal Government the development of a public/private education campaign focusing on several areas, including conservation.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. FRANK R. LAUTENBERG TO
JAMES J. MULVA

Question 1. Did the existence of price gouging statutes in Louisiana, Mississippi and Alabama play any role in your decision to freeze prices after Hurricane Katrina?

Answer. The existence of state price gouging laws had no substantial influence on our pricing decisions after the hurricanes. Our guiding concern in our decision to freeze prices in impacted areas after the hurricanes was concern for our reputation and our belief that any increases would be temporary.

Question 2. In the last decade, has your company ever withheld supply of crude oil or refined product from the market in order to prevent prices from falling?

Answer. ConocoPhillips has no information that the company ever withheld crude oil or refined products from the market in order to prevent prices from falling. In the United States ConocoPhillips is a significant net purchaser of crude oil for its refineries and has no economic incentive to prevent crude prices from falling. Regarding refined products, the company, like other U.S. refiners, has limited storage for refined products, and requires contemporaneous marketing of these products to maintain refinery operations. Thus, supplies must enter the market quickly and cannot be withheld for any reason.

Question 3. Please describe any business relationship or transaction your company or any of its subsidiaries, wherever located and wherever incorporated, whether wholly owned or not, have had with Iranian nationals (except employment of Iranian expatriates), the Iranian government, individuals or corporations located or incorporated in Iran, or any representative of these people or companies.

Answer. ConocoPhillips does not have any operations or investments in Iran, either directly or indirectly through foreign subsidiaries, nor is ConocoPhillips currently negotiating for business opportunities in Iran.

In 1995, the National Iranian Oil Company ("NIOC") awarded our foreign subsidiary, Conoco Iran N.V., a service contract to develop the Sirri Fields located offshore Iran adjacent to ConocoPhillips operations in Dubai, but the subsequent imposition of U.S. sanctions precluded our involvement in that project and we withdrew from that project after consultation with the U.S. Government. The Sirri Fields project was then awarded by NIOC to Total.

In a separate matter, ConocoPhillips received on April 8, 2004, a pre-penalty notice from the Office of Foreign Assets Control ("OFAC") stating that OFAC had reasonable cause to believe that two U.S. entities, Conoco Inc. and Conoco Middle East Ltd., had from March 1999 until September 2000 engaged in prohibited facilitation of trade with Iran by Conoco (U.K.) Limited ("CUKL", our primary U.K. operating subsidiary). OFAC indicated that it believed that the two U.S. entities had committed prohibited facilitation by: (1) providing CUKL with an opportunity to obtain and analyze (without charge) data from the Azadegan oil field in Iran and to share its interpretation of those data with NIOC in what the company views as a typical pre-contractual petroleum industry format for the purpose of furthering the possibility of participating in the future development of that field; and (2) providing CUKL with support and assistance in the performance of the technical analysis.

In response to the pre-penalty notice, we informed OFAC that we believed that these activities did not constitute prohibited facilitation under the Iranian Transactions Regulations. First, we submitted that the referral to CUKL of the opportunity to analyze Azadegan data did not constitute or involve acts of "facilitation" within the meaning of the Iranian sanctions either as they existed at the relevant time or as they were subsequently amended on April 26, 1999. Second, we argued that none of the activities performed by CUKL would have been prohibited if performed by a U.S. person. While the Iranian sanctions prohibit transactions by U.S. persons relating to Iranian-origin goods and services as well as exports of technology, goods and services to Iran by U.S. persons, unlike other OFAC regulatory regimes such as the Sudanese Sanctions Regulations, U.S. persons are not required to refrain from all "transactions" and "dealings" in Iranian Government "property." Third, we noted that OFAC has consistently stated that it cannot and does not regulate speech and informational discussions, which were the essence of what CUKL conveyed to NIOC in sharing its opinion of the NIOC data provided to CUKL. Finally, we pointed out that ConocoPhillips had voluntarily advised the U.S. Government as early as July 1999 of its interest in the Azadegan field and its intention to seek an OFAC license to negotiate an executory contract to develop the Azadegan field and had voluntarily supplied OFAC in September 2000 the facts concerning the NIOC discussions as soon as any public suggestion was made that there was an economic sanctions issue. We also noted that, ultimately, given OFAC's decision not to grant ConocoPhillips license request and ConocoPhillips' inability to pursue negotia-

tions, NIOC awarded Azadegan field (which is potentially as large as the entire Alaskan North Slope) contracts to Japanese and European companies.

Nevertheless, we determined that a settlement of the allegations in the pre-penalty notice was appropriate in order to avoid the cost of a protracted enforcement proceeding and potential litigation.

In March 1999, the Office of Foreign Assets Control ("OFAC") issued License No. IA-3706 (the "License") to ConocoPhillips (formerly Conoco Inc.), authorizing the company to participate in a joint venture with Petroleum Nasional Berhad ("Petronas") to construct and operate an oil refinery in Melaka, Malaysia (the "Refinery") pursuant to the joint venture contracts that were signed prior to the promulgation of the U.S. economic sanctions against Iran. While it was known that Petronas would process Iranian crude oil at the Refinery, it was a condition of the License that the company would not be involved in any way in the purchase, processing or refining of Iranian crude oil. ConocoPhillips has successfully participated in the operation of the Refinery within the scope of the License and has never purchased Iranian crude oil or been involved in any of Petronas' decision regarding its use.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. OLYMPIA J. SNOWE TO
LEE R. RAYMOND

Question 1. I have introduced legislation that will offer an up to \$500 tax credit to working low and middle income individuals for the cost of home heating expenses. According to the National Energy Assistance Directors Association, heating costs for the average family using heating oil are projected to hit \$1,666 for the upcoming winter. This represents an increase of \$403 over last winter's prices and \$714 over the winter heating season of 2003-2004. Meanwhile, profits of oil and gas rose 62 percent in the third quarter for companies in the Standard & Poor 500 index. I am proposing to offset the \$500 tax credit for home heating expenses by curtailing the benefit large oil companies receive by using the LIFO accounting method. Do you think given budget deficits and record profits for oil companies that it is appropriate to divert tax benefits for large integrated oil companies such as yours to pay for such a measure?

Answer. No. LIFO tax accounting is not a tax benefit. It is a standard accounting method that has been in use and allowable to a broad range of American businesses since the 1930s. It is poor tax policy and shortsighted to impose a tax or deny an otherwise allowable deduction or credit to one segment of industry simply because that sector is large and profitable at the moment. While oil industry profits are strong right now, when compared to sales, they are in line with the average of other industries. In addition, a change in LIFO would set a dangerous precedent by discouraging needed investment and negatively impacting investor confidence in the U.S. economy.

Question 1a. Does this seem like an equitable approach given that the high cost of oil enables you to not only bank large profits, but also to use accounting methods to substantially reduce taxes? Is it fair to report less taxes when you're profiting the most?

Answer. It would be inequitable to prohibit one segment of the oil industry from using the existing LIFO inventory accounting method. The LIFO method and rules are longstanding, well-accepted, SEC-sanctioned and properly match current costs with current revenues, consistent with generally accepted accounting principles. The LIFO method is available to and used by many industries, and is certainly not unique to the oil industry. It would be highly discriminatory to retroactively curtail a segment of the oil industry, alone, from using the existing LIFO accounting rules.

Question 2. Your third quarter profits have certainly been a lightning rod that has riled consumers as they continue to pay 30 percent more in Maine for their home heating oil for the winter.

A. I realize that you reinvest some of these profits in exploration for more product. In each quarter, have you reinvested the same percentage of the profits to reinvest? What have your reinvestment percentages been to your total profits? Do they vary from quarter to quarter or year to year?

Answer. Over the last ten years, ExxonMobil's cumulative capital and exploration expenditures have exceeded our-cumulative annual earnings. Our average annual capital expenditures have been approximately \$14.0 billion, while our average annual net income has been approximately \$13.8 billion. *See*, Attachment A,*

*Attachments A-K have been retained in committee files.

ExxonMobil Long Term Earnings and Investment History. Please refer to the table below of quarterly data. On average, for the seven quarters from 1Q2004 to 3Q2005, ExxonMobil reinvested 66% of Upstream net income in Upstream capital and exploration expenditures and 44% of total consolidated net income. Comparing quarterly earnings to capex is not appropriate, since our capital investments take years to plan and execute, while quarterly earnings vary dramatically with current market conditions. If we varied our capital spending with our earnings, our capital investment implementation would be far less effective and would yield fewer production benefits for consumers.

REINVESTMENT %'s TO TOTAL PROFITS

	1Q 2004 \$M	2Q 2004 \$M	3Q 2004 \$M	4Q 2004 \$M	1Q 2005 \$M	2Q 2005 \$M	3Q 2005 \$M	Avg. 1Q04- 3Q05 %
Upstream capital & exploration expenditure (capex)	2,704	2,840	2,877	3,294	2,812	3,678	3,586	
Upstream net income after tax ...	4,013	3,846	3,929	4,887	5,054	4,908	7,349	
Total consolidated net income after tax	5,440	5,790	5,680	8,420	7,860	7,640	9,920	
Upstream capex as a % of upstream net income	67%	74%	73%	67%	56%	75%	49%	66%
Upstream capex as a % of total consolidated net income	50%	49%	51%	39%	36%	48%	36%	44%

Data Source & Notes: Quarterly ExxonMobil Press Releases and associated 8-K.

Question 3. To what non-profit organizations and academic research that address global climate change does your company donate financial support to and how much do you donate each year?

Answer. ExxonMobil has committed to provide up to \$100 million over a 10 year period to Stanford University's Global Climate and Energy Project (GCEP), which is the largest-ever investment in independent climate and energy research. GCEP is a major long-term research program designed to accelerate the development of commercially viable technologies that can meet global energy demand while dramatically lowering GHG emissions.

GCEP is investigating a full spectrum of energy resources, environmental technology, and end uses that can be adopted globally for:

- Advanced transportation options;
- Improved electric power generation and transmission;
- Expanded use of hydrogen and biomass fuels;
- Next-generation coal, nuclear power, and renewable energy; and
- Carbon dioxide capture and storage.

GCEP projects initiated in 2003 and further developed in 2004 include an integrated assessment of technology options, studies of hydrogen production and use, advanced combustion-system research, and studies of geologic sequestration of carbon dioxide. More recently, GCEP launched new research projects targeting fundamental breakthroughs in technologies, including renewable biomass, fuel cells, and solar cells.

More information on the GCEP is provided at <http://gcep.stanford.edu/>.

Details of other individual ExxonMobil contributions are provided in our annual Worldwide Giving Report that is posted on ExxonMobil's website: <http://www.exxonmobil.com/Corporate/Citizenship/gcr-contributionsworldwide-report.asp>.

In 2004, contributions that were identified as being targeted to climate change research and education in the Giving Report totaled \$2,245,000.

Question 4. There has been much discussion about the skyrocketing costs of gasoline, heating oil, and other petroleum products over the past year, magnified by the

three hurricanes which have hit the Gulf Coast region this year. In response to these inquiries into the rising prices and your soaring profits, you have asserted that these increases are tied to market forces, particularly the rising prices of crude oil.

I've reviewed your financial filings from the Securities and Exchange Commission, and they paint a very stark picture when compared to the financial misery being experienced by millions of Americans. ExxonMobil, for example, has realized a net income of \$25.42 billion in the first nine months of 2005, an increase of \$8.5 billion over the first nine months of 2004. Exxon's third quarter net income this year was \$9.92 billion, up a full 90%.

Similarly, ConocoPhillips' net income for the third quarter of 2005 was \$3.8 billion, compared with \$2.006 billion during the same time period in 2004. Conoco's filing attributes this jump in profit to "higher crude oil, natural gas and natural liquid gas prices," "improved refining margins," and "equity earnings from our investment in LUKOIL."

In my State of Maine, the median state income is \$17,044 per year. A full 78 percent of Mainers use heating oil to warm their houses in wintertime, and this, combined with gasoline prices of anywhere from \$2.50 to \$3.00 per gallon paints a harsh picture for Maine and New England this winter. Petroleum is not any run-of-the-mill commodity. It is the lifeblood of commerce in this country, with fuel costs being built into the price of every other good bought and sold on the market. And in places like New England where petroleum heats most homes, it's literally a life-and-death commodity. Your industry has taken the position in its SEC filings and at yesterday's hearing that the escalation of its fuel prices is the result of increases in crude oil prices. However, if your retail gas prices were raised simply to cover your increased costs in purchasing crude oil, your net profits would remain the same. Everyone knows this is not happening. Can you identify for this committee the reason that the rise in gasoline prices is far out-pacing the rise in crude oil prices?

Answer. Generally, changes in the price of crude oil directly effect the price of gasoline. See, Attachment B, *Price Per Gallon*. Hurricanes Katrina and Rita created a highly unusual situation, however, in which the gasoline markets were reacting not so much to crude oil prices as to the hurricanes' unprecedented impact on gasoline supply and distribution logistics. Prior to Katrina, U.S. refineries were operating at 97.1% of capacity; just after Rita, U.S. refineries operated at 69.8% of capacity due primarily to damage done to refineries by the hurricanes, but also due to logistical problems (crude supply to refineries and product movements out). Almost 29 percent of U.S. refining capacity was offline as a result of these natural disasters. In addition, both the Colonial and Plantation pipelines were non-operational for three days. In other words, although demand remained unchanged, supply was dramatically reduced. In fact, with decreased supply, the demand for gasoline actually increased significantly following Hurricane Katrina, perhaps reflecting consumers' fears that they would not be able to obtain gasoline at all, given the supply disruptions. In response, gasoline prices rose. This price increase had the affect of attracting sufficient additional supplies from other sources, such as imports from Europe and Asia, to meet demand.

Although U.S. refineries currently are still operating well below historical levels—utilization is now about 86% of capacity—the industry is supplying almost as much gasoline as it was prior to the hurricanes. Capacity has been shifted from making other products to supply gasoline demand, and imports from Europe have increased substantially. As a result, gasoline prices are now below levels that existed prior to Hurricane Katrina in nearly all parts of the U.S. Gasoline prices have fallen further than have crude oil prices over the past few weeks.

Question 4a. Even though crude oil prices have risen this year, your companies aren't actually incurring those costs, are they? Isn't the gasoline and heating oil that your firms are currently selling on the market actually being produced from inventories that your companies purchased when the price of crude oil was much lower?

Answer. ExxonMobil is a net buyer of crude oil—we refine nearly three times as much crude as we produce. In 2004, we spent \$139 billion buying crude oil for our operations. We pay the prevailing market price for crude to meet our refining needs. Our domestic crude inventories represent only about two weeks supply for our refineries, and some of this is used to fill equipment. We also purchase product at current market prices to meet our customers' needs. ExxonMobil does not engage in speculative activities.

Question 4b. If you're producing oil from crude that you bought at \$40 per barrel, but selling it at a price that is purportedly based upon a \$70 per barrel cost to you, wouldn't that account for the 90% increase in profits we've seen?

Answer. No. See previous answer. ExxonMobil is a substantial net buyer of crude oil and we pay the market price to meet our refining needs. We also purchase product at current market prices to meet our customers' needs.

Question 5. I've alluded to the vital role petroleum plays in our economy and society, from the price of bread to the price of a plane ticket to the price of heating one's home. While you're obviously in the business for profit, there are other sectors of the economy where we put a limit on selling commodities at unconscionable prices. One example is usury law, where lenders are prohibited from charging unconscionable rates for borrowing money—because we recognize that access to cash is critical to enterprise. How much more of a toll do these fuel prices have to take on our society before Congress steps in and places similarly appropriate regulations on your industry?

Answer. We don't accept the premise of your question. While Congress alone evaluates the factors impacting public policy options and legislates according to its judgment, we urge you to recognize the vital role petroleum plays in sustaining and expanding modern living standards and economic prosperity. Any decisions made about near-term action should properly consider the long term consequences on the economy of those decisions.

Crude oil prices are established by a robust global market and those prices largely influence the price of petroleum products sold throughout the world. Historic market interventions by governments, through price controls or otherwise, have proven to be self-defeating and ineffective on many levels.

Question 5a. Many consumers would say that raising the price of gas by \$2 per gallon over the past 2 years, while reaping over \$25 billion in profits is price gouging. Many lawmakers would agree. What do you say to them?

Answer. ExxonMobil condemns price gouging. In the immediate aftermath of the storms, we acted responsibly in pricing at our company operated service stations and we also encouraged our independent retailers and distributors to do the same.

Competition for retail sales is broad. For example, only about 7% of retail stores branded Exxon or Mobil are actually operated by ExxonMobil—the remainder are dealers and distributors, or in some cases resulting from FTC divestment requirements, other oil companies. Many distributors operate under multiple brands and there is significant competition to supply them. Retailers with no refining capacity, such as Racetrac, QuickTrip, WaWa, Sheetz, 7-11, and Stop-n-Go sell a significant percentage of domestic gasoline.

Gasoline prices in the U.S. are determined by supply and demand of crude oil and refined products. Oil company earnings per dollar of revenue from sales of these products are in line with other major industries. The scale of our industry is so huge, however, that the large total volume of sales results in a large total profit. Moreover, the recent historic highs need to be put into the context of the cyclical nature of the oil business. For example, in 1998, crude prices were as low as \$10 a barrel, and our full year earnings were correspondingly lower, at about \$8 billion.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. PETE V. DOMENICI TO
LEE R. RAYMOND

Question 1. What are you doing to bring oil prices down?

Answer. Oil is a globally traded commodity. See, Attachment C, *Why is Global Oil Demand Increasing?* and Attachment D, *How Much Spare Oil Capacity Is There?* Prices are established across a broad market, with many participants. Although ExxonMobil is the second-largest non-government oil producer (slightly behind BP), we produce only 3% of the world's oil. In fact, we are a huge net purchaser of crude oil, refining nearly three times as much crude as we produce. In recent years, ExxonMobil is investing on average \$15 billion per year to find and produce new oil supplies and expand refining and distribution capability. We are working to expand crude oil and gasoline refining capacity in a cost effective manner and we always focus on extremely efficient logistics. See e.g., Attachment E, *ExxonMobil—What Percentage of the World Energy Market?*

Question 2. What is the relationship between the price of oil that Americans are paying and the profits you are making?

Answer. In fact, the vast majority (approximately 70 percent) of ExxonMobil sales and profits are made outside of the United States. Because oil is a globally traded commodity, the absolute level of crude oil price, established on a global basis, is a key factor impacting American consumer costs and energy industry earnings. On a dollar-for-dollar basis, our industry's profits are generally in line with the average of all U.S. industry. For the second quarter of this year, the oil and gas industry

earned 7.7 cents for every dollar of sales compared to an average of 7.9 cents for all U.S. industry. *See*, Attachment F, *How Do Oil Industry Earnings Compare to Other Industries?*

Question 3. The question I hear most from people is how is the price of oil set? Many Americans think oil companies are rigging prices to reap big profits. How would you respond to that?

Answer. That perception is grossly incorrect and contradicted by numerous government studies. For example, *See*, Federal Trade Commission Report on The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement (August 2004) ("Private oil companies have small shares of world crude oil production and reserves, limiting any influence on world oil price"). <http://www.ftc.gov/opa/2004/08/oilmergersrpt.htm>

Oil is a globally traded commodity. Prices are established across a broad market with many participants, so the ability of a single company to substantively impact prices is minimal. ExxonMobil produces less than 2 percent of the world's daily energy and only 3 percent of the world's oil.

Question 4. Americans are being burdened with high oil, natural gas, and gasoline prices while you all are raking in record profits. What do you say to those people that blame you for this and say that it is unfair?

Answer. We recognize that the increases in energy prices following Hurricanes Katrina and Rita put a strain on Americans' household budgets. In recent weeks, gasoline prices have come down to below pre-Katrina prices as shut-in energy supplies have returned and refinery operations have been restored.

ExxonMobil engages in cyclical, global, commodities-based businesses. Those cycles transcend the oil industry and are experienced by all commodity-based businesses, from orange juice to corn, coffee to gold. The high points of such market cycles are generally marked both by high prices and profits. However, the oil industry has experienced sustained periods of low prices and investment returns, throughout much of the 1980s and 1990s, for example. As recently as 1998, global oil prices hit \$10 per barrel and gasoline sold in the United States for under a dollar per gallon. ExxonMobil nevertheless invested more than \$15 billion in new capital expenditures and research in that year, nearly twice our earnings.

Global crude oil markets largely determine petroleum product prices, although events such as the recent hurricanes, which caused outages at nearly one-third of our nation's refining capacity at one point, can also significantly influence product markets and prices. Our company is but a small part of the enormous global energy market, producing only 3 percent of the world's daily crude oil needs. Every day, our 85,000 employees work extremely hard to stay ahead of our global competition and provide energy supplies to consumers at competitive prices.

Question 5. Americans want to know if it is not costing so much more to produce a barrel of oil, why are prices rising so high?

Answer. While crude oil costs are a critical component of gasoline prices, other factors also affect the price of gasoline. *See*, Attachment G, *What Affects Gasoline Prices?* Both crude oil and gasoline are commodities that are traded globally in open and transparent markets. *See*, Attachment H, *U.S. Sources of Crude Oil*.

Prices in these global markets reflect not only the cost of supply, but speculation by global commodities traders regarding future prices and competition among purchasers. For example, recent concerns about relatively low levels of global spare crude oil production capacity seem to be affecting the crude oil futures trading. ExxonMobil does not engage in speculative commodity trading activities in energy commodities.

Generally, changes in the price of crude oil directly affect the price of gasoline. With regard to the post-hurricane increase in U.S. gasoline prices, Hurricanes Katrina and Rita created a highly unusual situation, however, in which the gasoline markets were reacting not so much to crude oil prices as to the hurricanes' unprecedented impact on gasoline supply and distribution logistics. Prior to Katrina, U.S. refineries were operating at 97.1% of capacity; just after Rita, U.S. refineries operated at 69.8% of capacity due primarily to damage done to refineries by the hurricanes, but also due to logistical problems (crude supply to refineries and product movements out). Almost 29 percent of U.S. refining capacity was offline as a result of these natural disasters. In addition, both the Colonial and Plantation pipelines were non-operational for three days. In other words, although demand remained unchanged, supply was dramatically reduced. In fact, with decreased supply, the demand for gasoline actually increased significantly following Hurricane Katrina, perhaps reflecting consumers' fears that they would not be able to obtain gasoline at all, given the supply disruptions. In response, gasoline prices rose. This price in-

crease had the affect of attracting sufficient additional supplies from other sources, such as imports from Europe and Asia, to meet demand.

Question 6. What is your company's response to proposals for enactment of a Windfall Profits Tax?

Answer. We strongly oppose it. The non-partisan Congressional Research Service (CRS) concluded that the "windfall profits" tax of the 1980s was harmful to the U.S. economy. According to the (CRS), the tax drained \$79 billion in industry revenues during the 1980s that could have been used to invest in new oil production—leading to 1.6 billion fewer barrels of oil being produced in the United States from 1980-1988. The tax reduced domestic oil production as much as 6 percent, and increased oil imports as much as 16 percent.

It would be similarly counterproductive to impose such a tax today. Increasing the costs of oil and gas production in this country would undermine the urgent policy goal of expanding energy supplies to the American economy and people. Such a tax would not be imposed on oil production outside of the United States, significantly advantaging the foreign national oil companies with which we must compete. In a global marketplace, it would send capital investment for energy development, and jobs, overseas. It would undermine the American companies within the industry, making them less competitive, when political leaders and the American people are looking to them to expand supplies, which would tend to reduce long-term energy prices.

Our investment decisions to fund projects are made five to ten years before they are realized, based upon assumptions about investment returns in our cyclical commodities businesses. We go through peaks and valleys, and our business plans assume that there will be peaks and valleys, so that, over the cycle, our shareholders see an adequate return on their investment. To lop off the peaks would undermine investor confidence and capital formation. The industry would then have more difficulty attracting and investing the amount of capital needed to continue to supply the energy needs of societies around the globe.

Question 7. Do you believe that Americans are dangerously dependent on oil and its refined products?

Answer. No. The emergence of abundant, affordable energy over a century ago provided a key foundation for the tremendous gains in living standards and quality of life achieved in the United States and throughout the world. In addition, the more recent emergence of the world's developing country economies has been based on vastly increased energy use, and particularly the use of oil and its refined products.

Question 8. The International Energy Agency's recent Global Outlook report expresses concern about world energy supplies and reliance on the Middle East for oil. Do you think the IEA's anxiety is justified?

Answer. The IEA's overall numerical projections are very similar to ExxonMobil's annual Energy Outlook. Much of the anticipated increases in crude oil production is expected to come from the Middle East where much of the global resource base is located. While the share of production from the Middle East will grow, other regions will still provide the majority of production. We do not view the projections for increases in production from the Middle East as a significant concern. ExxonMobil is working around the world to increase global hydrocarbon production, including in Africa, Russia, Canada, and South America.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. LISA MURKOWSKI TO
LEE R. RAYMOND

Question 1. In your agreement on an Alaska natural gas pipeline that you are negotiating with the State of Alaska under the state's Stranded Gas Act, do you anticipate making a firm commitment to develop the Alaska gas pipeline project or do you anticipate accepting an agreement that will only involve a series of spending and work commitments? If the latter is the case, how long will it be before a binding construction commitment deadline is reached?

Answer. The details of the contract are still being negotiated with the State of Alaska. Discussions are well advanced. While significant progress has been made, additional work remains (such as completing fiscal negotiations, additional engineering, permitting, and other activities) before a final construction decision can be made.

Question 2. If there is a concern about tying up your investment capital in a single project, if a pipeline company presented you with a proposal to take all of the risk of construction of the Alaska pipeline project and to ship your gas at a reason-

able tariff, would you commit the gas you control to that pipeline within a reasonable time period? If not, why?

Answer. ExxonMobil is involved in many capital intensive projects in the U.S. and around the world, and is capable of handling them at the same time. A pipeline, particularly of this scale, cannot be financed without the underpinning of credit-worthy shippers. Consequently, a pipeline company would not be in a position to take all of the risk of construction.

Question 3. In your companies' view, is it less risky to invest billions of dollars in new LNG facilities to import natural gas from foreign sources, than to invest in the Alaska gas line project? If not, why are you investing in LNG projects before making a firm commitment to the Alaska project?

Answer. There is risk in every project that ExxonMobil develops and operates. ExxonMobil is very interested in and capable of developing viable projects that will provide additional energy to meet U.S. demand. Work remains to be done on an Alaska gas line (such as completing fiscal negotiations, additional engineering, permitting) before a final construction decision on that project can be made. The fiscal negotiations are well advanced. We are investing in a broad range of projects, including LNG, simultaneously and are capable of handling them at the same time.

Question 4. While all of your companies are global in scope, this nation is concerned about its reliance on foreign sources of crude oil. Does it make sense for the United States to increase its reliance on foreign LNG while allowing Alaska's natural gas reserves to continue to remain in the ground?

Answer. To meet its energy demand, the U.S. needs natural gas supplies from both domestic and international sources. It makes sense to progress projects that can economically provide energy to the U.S., such as LNG and Arctic gas, in order to provide reliable and competitive energy supplies to American consumers.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. JAMES M. TALENT TO
LEE R. RAYMOND

Question 1. The recent hurricanes have highlighted the need for increasing refinery capacity, which was already operating at a tight margin of 97 percent. While that is laudible for efficiency purposes, it allows no room for error in case of sudden outages or demand increases. What is the optimal amount of spare refining capacity to ensure a reliable supply of finished petroleum products at stable prices?

Answer. Although hurricane and flooding damage, transportation logistics, employee safety, and personnel dislocations contributed to the supply shortage following Hurricanes Katrina and Rita, the most critical contributing factor was the loss of electric power to run pipelines and refineries. A more reliable power system would help ensure that the product distribution infrastructure is sufficient to deliver fuels to the market place.

Refinery capacity utilization reflects optimization of many factors—for example, maintenance schedules, raw material availability and cost, and product demand. Refining is a global business, and the U.S. has routinely imported petroleum products for decades to balance supply and demand. As a global integrated company, ExxonMobil uses its worldwide resources to re-supply areas that experience shortages due to local or regional supply problems. In response to the recent hurricanes, the markets worked even under the most extraordinary circumstances.

Question 2. How has industry consolidation impacted the amount of spare production and refining capacity?

Answer. We believe that recent consolidations in the U.S. refining sector have improved the efficiency and capacity of U.S. refining, thus benefiting consumers. In our own merger, we have seen improvements from sharing the best practices of each of the parent companies with the refineries of the other. Several refineries have been sold to independent/smaller refiners as part of FTC conditions for allowing mergers to proceed. For example, independent refiner Valero is now the largest U.S. refiner.

Question 3. Describe the degree of competition between refineries for crude oil supplies and sales to retailers. What percentage of crude oil processed in the U.S. is processed by integrated companies (i.e., those produce and refine) versus refined by independent refining companies?

Answer. Domestic refineries must compete on the world market for the majority of crude that they process—in 2004, per the EIA, U.S. refiners processed 2 barrels

of imported oil for every barrel of domestically-produced oil.¹ As of year-end 2004 per the Annual Refining Survey in the *Oil and Gas Journal*, major international integrated refiners operated 56% of the U.S. refining capacity, and smaller integrated refiners operated an additional 13%. The remaining 31% is operated by independent refiners.

Competition for retail sales is much broader than it might appear. For example, only about 7% of retail stores branded Exxon or Mobil are actually operated by ExxonMobil—the remainder are dealers and distributors, or in some cases resulting from FTC divestment requirements, other oil companies. Many distributors operate under multiple brands and there is significant competition to supply them. Retailers with no refining capacity, such as Racetrac, QuickTrip, WaWa, Sheetz, 7-11, and Stop-n-Go sell a significant percentage of domestic gasoline. About 15% of ExxonMobil's U.S. gasoline sales are through the unbranded wholesale market, generally to such retailers.

Question 4. How has the amount of refining capacity tracked changes in demand for gasoline and diesel over the last 30 years?

Answer. Domestic production has supplied the vast majority of gasoline and diesel demand growth over the last 30 years. U.S. refining output has increased by 30 percent over the past 30 years.

Question 5. Explain to me your company's plan to increase refining capacity in the U.S. to meet the need for new refinery capability.

Answer. ExxonMobil is studying expansions at some of its U.S. refineries and we would like to continue to invest in the U.S. if there are attractive economic opportunities to do so. Over the last decade ExxonMobil has increased its U.S. refining capacity by the equivalent of three average-sized refineries through expansions and efficiency gains at existing U.S. refineries. Decisions on refinery investments are based on long-term economics.

Question 6. EPA 2005 removed the requirement to include oxygenates from gasoline, largely because of concerns over the use of MTBE. What is the impact on the price of removing oxygenates from gasoline?

Answer. Ultimately, prices will be determined by the conditions in the marketplace.

ExxonMobil used significant quantities of MTBE as the only practical solution to the Federal Government's 2% oxygenate mandate. Assuming EPA completes its rulemaking to remove the oxygenate requirement, this mandate will be repealed effective May 2006.

ExxonMobil will be able to maintain current gasoline production capability without the use of MTBE, but we cannot speak for others in the industry. Since Congress eliminated the oxygenate mandate but refused to provide limited liability protection from defective product suits, there is a possibility that MTBE use might be reduced even at the expense of gasoline production.

Question 7. Are there other oxygenates that can be used in place of MTBE, such as using ethanol to make ETBE, and how does the cost of such alternative additives compare to the cost of gasoline?

Answer. Many U.S. states have banned the use of MTBE, with some states banning other ethers such as ETBE. ETBE has similar properties to MTBE in terms of taste and smell thresholds. To replace MTBE with ETBE would therefore not address the concerns that are associated with MTBE.

Question 8. Have you studied the use of ETBE, the cost of converting MTBE plants and how long it would take to do so, and whether ETBE avoids the leakage/water contamination problems that were caused by MTBE? How do the costs of retrofitting MTBE plants to produce ETBE and use it to increase the volume of gasoline produced by a barrel of oil compare to the cost of expanding existing or adding new refinery capability?

Answer. ExxonMobil has no plans to use ETBE in the U.S. See previous answer.

Question 9. What, if anything, is preventing your company from using ETBE in place of MTBE?

Answer. See previous answer.

¹ Per EIA, 15.4 MBD of total crude processed, 5.4 MBD of domestic crude production, and 0.02 MBD of crude exports.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. GORDON H. SMITH TO
LEE R. RAYMOND

Question 1. I have a bill, S. 1743, to give the Federal Trade Commission, additional authority to prevent and punish price gouging in the aftermath of a major disaster. My bill provides effective authority to the Federal Trade Commission to protect consumers from being victimized in the wake of a disaster without hampering the normal functioning of the free market. It even recognizes that there are legitimate reasons why prices may increase.

Do you think that this consumer protection authority should be available to the FTC?

Answer. Although the intentions of this legislation are understandable, we believe that, if implemented, this type of legislation could harm consumers. As FTC Chairman Majoras testified:

“Regardless of how repugnant price gouging is, a law that prohibits it is a form of price control, which might seem attractive . . . in the short run, but is likely to harm consumers more in the long run. . . . We should not ignore what we know. In the 1970’s price controls that were established to deal with the energy crunch resulted in massive shortages and endless lines at the pump. . . . The choice during times of emergency—high price gasoline or no gasoline at all—is not a good one, but unfortunately, it’s a choice that must be made.” [Energy Pricing and Profits, Joint Hearing of the Senate Commerce, Science, and Transportation Committee and the Senate Energy and Natural Resources Committee, 109th Cong., 9 (Nov. 9, 2005) (Statement of Deborah Platt Majoras, Chairman, Federal Trade Commission).]

We agree with Chairman Majoras.

Would this serve as a deterrent to price gouging by individual retailers?

Answer. As noted in the question above.

Question 2. Can you tell me why diesel prices continue to remain significantly higher than gasoline prices in Oregon?

Answer. Our market share in Oregon is very small and, therefore, we cannot comment specifically on diesel versus gasoline prices in Oregon.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. JIM BUNNING TO
LEE R. RAYMOND

Question 1. Some analysts believe that OPEC is approaching its current oil production capacity. Given this, are oil companies looking at alternative sources of energy, such as liquid fuels made from coal, in order to expand their business and maintain energy supplies for the United States? Please include a review of the level of investment your company is making this year and the projected investment over the next three years in coal to liquid fuels initiatives.

Answer. ExxonMobil’s long term Energy Outlook, which includes a detailed assessment of global production through 2030, anticipates increasing OPEC (and global) production over the next 25 years. While alternative sources will grow, we believe they will continue to be a small percentage of the world’s total energy. See, www.exxonmobil.com/corporate/Citizenship/Corp—citizenship—energy—outlook.asp, See also: Attachment I, *Will Energy Demand Continue to Increase?*

ExxonMobil has a proprietary technology applicable to the conversion of coal to liquids, and we continue significant research expenditures to further advance this technology. Specifically, this technology provides for the conversion of “syngas” to hydrocarbon liquids, such as diesel. We envision employing this technology to produce liquids from natural gas in Qatar around the end of this decade.

Technology is commercially available today to convert coal to “syngas.” In fact, ExxonMobil operates a commercial unit today in Texas producing syngas for chemical feedstocks from carbon sources. The combination of coal-to-syngas technology with syngas-to-liquids technology would allow the production of liquids from coal. However, we do not foresee that coal to liquids will be cost-competitive with conventional petroleum for many years to come.

Question 2. I have been concerned with the lag time between the wholesale cost of a barrel of oil and the retail price of a gallon of gasoline. As we saw following the hurricane, in an ascending market where wholesale oil prices increase, there is a lag period of a few days before retail gas prices reflect this change. Similarly one would expect a lag in a descending market. My concern is that retail prices are not dropping as quickly as they rose, relative to the change in oil prices. Could you ex-

plain why price movements vary during a complete market cycle and whether you believe any part of the energy industry is unfairly profiting from this price lag?

Answer. We believe the gasoline markets following Hurricanes Katrina and Rita were reacting not so much to crude oil prices as to the hurricanes' unprecedented impact on gasoline supply and distribution logistics. Prior to Katrina, U.S. refineries were operating at 97.1% of capacity; just after Rita, U.S. refineries operated at 69.8% of capacity due primarily to damage done to refineries by the hurricanes, but also due to logistical problems (crude supply to refineries and product movements out). Moreover, there was an unprecedented reduction in our ability to transport gasoline from the Gulf Coast to other parts of the country. For example, both the Colonial and Plantation pipelines, which supply the East Coast and Midwest, were non-operational for three days. In conjunction with decreased supply, the demand for gasoline increased dramatically following Katrina, perhaps reflecting consumers' fears that they would be unable to obtain gasoline, given the supply disruptions. These events occurred in a very short time, and prices thus rose very quickly.

Because it has taken much more time for supply to increase than it took for supply to decrease, prices fell more slowly than they rose. Although U.S. refineries currently are still operating well below historical levels—utilization is now about 86%—the industry is supplying almost as much gasoline as it was prior to the hurricanes. Almost 29 percent of U.S. refining capacity was offline as a result of these natural disasters. Capacity has been shifted from other products to supply gasoline demand, and imports from Europe have increased substantially. As a result, gasoline prices are now at or below the levels that existed prior to Hurricane Katrina.

Question 3. Boosting our domestic energy production is vitally important not only to our economy but also to our national security. Many of the countries we import oil from today are unstable, jeopardizing the reliability of sustained production. Please provide a chart for each of the last five years reflecting the percentage of your exploration and production budget that invested in the United States versus that invested overseas. Please also provide a chart reflecting your current projections of the percentage of your exploration and production budgets that will be allocated to projects in the United States versus overseas for the next five years.

Answer. Please refer to the table below. Capital & Exploration expenditures depend on the availability of opportunities and the timing of many individual projects. We expect global Upstream expenditures to average \$14-15 billion per year in the coming years. The proportion spent in the U.S. will depend on the availability of attractive options in this country. Unlike almost all other countries in the world, the U.S. puts much of its most promising hydrocarbon-bearing areas currently out of bounds for development, as a matter of policy.

PERCENTAGE OF U.S. UPSTREAM CAPITAL & EXPLORATION
EXPENDITURES

	2000 \$M	2001 \$M	2002 \$M	2003 \$M	2004 \$M
Upstream Capital & Exploration Expenditures					
U.S.	1,865	2,423	2,357	2,125	1,922
Non-U.S.	5,068	6,393	8,037	9,863	9,793
Upstream Capital & Exploration Expenditures	6,933	8,816	10,394	11,988	11,715
U.S. Capital & Expl. Exp. As a % of Total Upstream	27%	27%	23%	18%	16%

Data Sources & Notes: Exxon Mobil Corporation Annual Report—Form 10-K and Financial & Operating Review.

Question 4. The disruption caused by the recent hurricanes displayed the United States' vulnerability when it comes to domestic energy supply and production. What suggestions do you have to strengthen our energy supply and production capability?

Answer. The hurricanes also displayed the resilience of our domestic petroleum industry and the power of markets to respond efficiently and effectively to major supply disruptions.

Part of meeting the challenge of our future energy needs should be new policies authorizing exploration and production of abundant domestic oil and gas resources that are now closed to development. This is particularly true with respect to oil and gas deposits in the Outer Continental Shelf, the Rocky Mountain region, and in

Alaska. Another part should be a streamlined process to permit and expedite the construction of facilities to import liquefied natural gas (and not exclusively on the Gulf Coast) that can be used to heat homes, generate electricity and provide the essential feedstock for many American manufacturing sectors, such as chemicals and fertilizer.

In addition, achieving recent production gains at our U.S. refineries generally has not been facilitated by federal policies. Specifically, federal laws and regulations could more efficiently sustain the gains in environmental quality that we have achieved historically than is now possible under several Clean Air Act programs. ExxonMobil, and many others in industry, support reforms in the area of permitting for more efficient refinery expansions and reductions in the number of “boutique fuels” that hamper supply flexibility. Regulatory constraints on supply flexibility can lead to greater market volatility in emergency situations, and we therefore also support efforts to strengthen the Federal Government’s waiver authorities in such cases.

Question 5. It has been suggested that the United States consider developing a strategic gasoline and natural gas reserve, similar to Strategic Petroleum Reserve we currently have. Some analysts suggest that such reserves may minimize price spikes in these commodities during periods of market supply disruptions. What are your views on whether a strategic natural gas or gasoline reserve would be feasible and whether they might help minimize price increases during periods of market uncertainty?

Answer. ExxonMobil agrees with both the California Energy Commission and the National Petroleum Council (which advises the Secretary of Energy), which have concluded in recent times that such fuel reserves are not appropriate for the U.S. Product reserves are costly and complex due to, among other factors, product degradation from extended storage, many current fuel specifications, and logistical challenges of maintaining storage in multiple locations. The fastest and most efficient response to temporary supply imbalances is to let markets function. Refiners have rapidly responded to temporary supply challenges without the need for government intervention. Although hurricane and flooding damage, transportation logistics, employee safety, and personnel dislocations contributed to the supply shortage following Hurricanes Katrina and Rita, the most critical contributing factor was the loss of electric power to run pipelines and refineries.

Creating a strategic natural gas reserve could be counterproductive, potentially interfering with and discouraging the market’s creation of important seasonal inventories. The U.S. currently has the most robust system of natural gas inventories of any industrialized nation. The system works to provide prompt supplies of natural gas during the peak winter heating season and facilitates maximum production of natural gas during the low demand months. The purchasers of gas held in inventory take market risk on the interval between purchases made during the spring and summer months (April thru October) and the gas sold during the winter season (November thru March). The normal build of inventory may be disrupted if it is perceived that there is too much price risk due to the uncertainty of how strategic inventories may be released.

Building strategic product or gas reserves when markets are tight will put further upward price pressure on the market and remove necessary operational supply from the market.

Question 6. China is becoming a bigger world oil player. This not only has tightened the world oil market but also has produced national security concerns for us. What concerns or problems do you see have arisen since China became a bigger world energy player?

Answer. World energy demand has grown because of economic growth. Demand has grown in the U.S., as well as China, India and the rest of the developing world. This economic growth is necessary to improve the standard of living in these areas. The oil market is global and transparent. Supporting the efficient use of energy, not only in the U.S. and other mature economies, but in growing economies as well will allow for continued development while minimizing the demand on energy sources.

Question 7. While there have been expansions and efficiency gains at existing refineries, no refinery has been built in the United States in 30 years. Since the oil companies are now making record earnings, are there plans to build new refineries in the United States?

Answer. ExxonMobil is studying expansions at some of its U.S. refineries and we would like to continue to invest in the U.S. if there are attractive economic opportunities to do so. Over the last decade ExxonMobil has increased its U.S. refining capacity by the equivalent of three average-sized refineries through expansions and efficiency gains at existing U.S. refineries. Decisions on refinery investments are

based on long-term economics. See, Attachment J, *How Do Fewer Refineries Affect Supply?*

Question 8. The 2005 Energy Bill implemented a controlled phase-out of MTBE. Many companies, however, are planning on completely halting its use. How will a sudden halt of the use of MTBE affect the gasoline market and refineries?

Answer. ExxonMobil used significant quantities of MTBE as the only practical solution to the Federal Government's 2% oxygenate mandate. Assuming EPA completes its rulemaking to remove the oxygenate requirement, this mandate will be repealed effective May 2006.

ExxonMobil will be able to maintain current gasoline production capability without the use of MTBE, but we cannot speak for others in the industry. Since Congress eliminated the oxygenate mandate but refused to provide limited liability protection from defective product suits, there is a possibility that MTBE use might be reduced even at the expense of gasoline production.

Question 9. I have noticed very large differences between the price of gasoline in different areas of the country. For example, I recently saw gasoline in northern Virginia that was much more expensive than gasoline in northern Kentucky. Please explain why there can be such a significant difference in gasoline prices in different areas of the country.

Answer. ExxonMobil does not market directly in Kentucky and, therefore, cannot comment specifically on the variances in retail prices between Kentucky and Northern Virginia. However, generally speaking, the disparity between prices of fuel in different parts of the country is due to the differences in required gasoline formulations, transportation costs, local competitive conditions, and state taxes.

Question 10. Below are several questions on oil and the commodities futures market:

- When was oil first traded on the world-wide commodities futures market?
- Would the price of oil be affected if oil was taken off the commodities futures market and no longer traded?
- Would oil then be bought and sold as a true supply and demand product?

Answer. The NYMEX website reports that their crude futures trading began in 1983.

We do not participate in the petroleum futures market to any significant extent. Conceptually, we would expect that futures trading would increase the liquidity and therefore the efficiency of the market for oil just as it does for many other commodities, including most American agricultural production. Eliminating the futures markets for petroleum would likely reduce the transparency of pricing. Thus, as with the agricultural futures markets, the petroleum futures markets should be beneficial overall to buyers and sellers.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. JEFF BINGAMAN TO
LEE R. RAYMOND

Question 1. Section 392 of the Energy Bill, which was negotiated with the involvement of the Chairman and Ranking Member of the Energy and EPW Committees, contains permitting streamlining language. The Energy Policy Act of 2005 permits the EPA Administrator to enter into a refinery permitting cooperative agreement with a state. Under such an agreement, each party identifies steps, including decision timelines, it will take to streamline the consideration of federal and state environmental permits for a new refinery. I want to ask you several questions about that provision, since you have supported streamlining: Have you requested that EPA issue any regulations or take any action to implement these new provisions?

Answer. No.

- If yes, when?
- If no, when do you anticipate you will do so?

Answer. ExxonMobil is evaluating this provision and whether it can be beneficial to our plans.

Question 1a. Have you worked with any state to encourage them to enter into an agreement with EPA under Section 392 of EPAct?

Answer. No. ExxonMobil is evaluating this provision and whether it can be beneficial to our plans.

Question 1b. Do you support the EPAct streamlining provisions?

Answer. Yes. There are, however, more effective steps that could be taken to facilitate domestic fuel production. These include extending the NAAQS ozone attain-

ment deadlines for refining areas such as Houston and Philadelphia; codifying comprehensive New Source Review reform; reducing the number of state specific “boutique” fuels; and expanding federal EPA fuel preemption authority to state fuel requirements.

All of these steps were emphasized in reports in 2000 and 2004 from the National Petroleum Council to the Department of Energy.

Question 1c. Do you have any examples of where a state came to EPA and said we want to work closely with you on permitting a new refinery or refinery expansion and EPA refused to provide technical assistance and even financial resources under existing law to that state?

Answer. No.

Question 2. In answer to several of the questions at today’s hearing (Nov. 9) the witnesses have noted that the market for petroleum and petroleum products is a global one and should be viewed in that context. Please list all planned refinery construction that your company plans to undertake globally. Please list them by country and include the projected size of the facility, including the projected capacity for all units and their potential product yields in addition to the project’s total investment cost.

Answer. Refining is a global business, and the U.S. has routinely imported petroleum products for decades to balance supply and demand. ExxonMobil is studying expansions at some of its U.S. refineries. Decisions on refinery investments are based on long-term economics. ExxonMobil is currently participating in a joint venture to construct a multi-billion dollar refining/chemical operation at Fujian, China to meet anticipated demand for petroleum products in the region. When completed, it will process 240 KBD of crude oil. Other expansion projects are also under consideration but are confidential at this point.

Question 3. The International Energy Agency (IEA) has just released its World Energy Outlook 2005. It contains a piece on the global refining picture. (Please see the summary below.) The study notes a lack of investment in upstream and downstream capacity has contributed to the extreme tightness in global oil markets. What are your thoughts in response to this? What is your company doing in response (actions)? What is your company doing (investments/analysis) in the “MENA” regions? Do you agree with the IEA’s projections?

Answer. The IEA’s global demand projections are similar to those found in ExxonMobil’s long term Energy Outlook. The Outlook envisions growing demand for oil through 2030. The growth in supply will require significant investment on a global basis.

ExxonMobil is pursuing opportunities where available globally. We have brought on significant new crude oil production in Africa and we have major LNG investments underway in the Middle East. However, private (non-government owned) oil company investment opportunities in crude oil production are limited in many areas of the world.

Question 4. World Energy Outlook 2005: IEA Projects Growth in Middle East and North Africa Oil and Natural Gas Sectors through 2030 but a Lack of Investment would Push up Prices and Depress GDP Growth 11/7/2005 London—“The importance of the Middle East and North Africa (MENA) to global oil and gas markets cannot be underestimated. These countries have vast resources, but these resources must be further developed. Investment should not be delayed,” said Mr. William C. Ramsay, Deputy Executive Director of the Paris-based International Energy Agency, as he presented findings from the World Energy Outlook 2005: Middle East and North Africa Insights (WEO-2005) today in London. Noting that a lack of investment in upstream and downstream capacity has contributed to the extreme tightness in the global oil market in recent months, Mr. Ramsay highlighted the critical role that this region will play in meeting growth in global energy demand.

The WEO-2005 expects global energy markets to remain robust through 2030. If policies remain unchanged, world energy demand is projected to increase by over 50% between now and 2030. World energy resources are adequate to meet this demand, but investment of \$17 trillion will be needed to bring these resources to consumers. Oil and gas imports from the Middle East and North Africa will rise, creating greater dependence for IEA countries and large importers like China and India. Energy-related CO₂ emissions also climb—by 2030, they will be 52% higher than today. “These projected trends have important implications and lead to a future that is not sustainable—from an energy-security or environmental perspective. We must change these outcomes and get the planet onto a sustainable energy path,” added Mr. Ramsay.

WEO 2005 focuses on the energy prospects in the Middle East and North Africa to 2030, covering in detail developments in Algeria, Egypt, Iran, Iraq, Kuwait,

Libya, Qatar, Saudi Arabia and the United Arab Emirates. Internal demand, resources, policies, investment, production, exports, even energy use for water desalination, all are examined. "To our knowledge, this is the first time that any publication with a focus on the Middle East and North Africa has undertaken such an extensive, country-by-country review of the energy sector of the region. At a time when experts debate whether the world will run out of energy, these results are particularly relevant," Mr. Ramsay said.

In the MENA region, domestic energy demand is driven by surging populations, economic growth and heavy energy subsidies. Primary energy demand more than doubles by 2030. At the same time, MENA oil production will increase by 75% by 2030 and natural gas production will treble, allowing more gas exports. The region's share in global oil production will increase from 35% today to 44% in 2030. However, this means the countries of the Middle East and North Africa would need to invest, on average, \$56 billion per year in energy infrastructure. The level of upstream oil investment required will be more than twice that of the last decade.

But what if adequate investment is not made or consuming countries' policies change? To assess these risks, WEO 2005 develops two other scenarios, each of them far from unlikely: a Deferred Investment Scenario, in which investment in the producing countries is delayed, whether deliberately or inadvertently; and a World Alternative Policy Scenario, in which energy-importing countries take determined action to cut demand and change the pattern of fuel use, driven by high prices, environmental or security goals, or all three.

The two scenarios have significant implications for MENA countries. In the Deferred Investment Scenario, energy prices rise sharply. Global energy-demand growth falls, cutting the region's oil and gas export revenues by more than \$1 trillion from 2004-2030. World GDP growth slows down. Deferred investment could be the result of many factors, but whatever the cause, the results are higher prices, greater uncertainty and market inefficiencies.

The WEO World Alternative Policy Scenario examines the consequences of new policies under consideration in consuming countries. "The G8 Plan of Action, agreed at the Gleneagles Summit in July 2005, launched detailed initiatives to promote cleaner energy and combat the impact of climate change. The IEA was asked to play an important role. This strong global commitment indicates that governments are already adopting alternative policies—such as those in the World Alternative Policy Scenario—to achieve the G8 goals," explained Mr. Ramsay. Under this Scenario, global oil and gas demand growth is lower, but the world continues to rely heavily on MENA oil and gas. CO₂ emissions fall 16% below the level of the Reference Scenario—but still increase around 30% by 2030.

Assumptions about international energy prices have been revised significantly upwards in WEO-2005, as a result of changed market expectations after years of underinvestment in oil production and the refinery sector. The average IEA crude oil import price, a proxy for international prices, averaged \$36.33 per barrel in 2004 and peaked at around \$65 (in year-2004 dollars) in September 2005. In the Reference Scenario, the price is assumed to ease to around \$35 in 2010 (in year-2004 dollars) as new crude oil production and refining capacity comes on stream. It is then assumed to rise slowly, to near \$39 in 2030. In the Deferred Investment Scenario the oil price reaches \$52 in 2030.

The World Energy Outlook 2005 contains over 600 pages of detailed statistics and in-depth analysis. The study was produced by the IEA with input from many international experts from producing countries, industry and organizations including OPEC. The IEA's prestigious annual WEO series has long been recognized as the authoritative source for global long-term energy market analysis and has received honors for analytical excellence including awards from the Russian Academy of Sciences, the U.S. Department of Energy and numerous public and private organizations.

Voluntary standards—Post hurricanes, what is the industry doing to come up with voluntary standards/best practices for back-up power supply to critical energy infrastructure (refineries, pipelines, etc.) and natural disaster recovery? Will the API undertake such an effort? If not, what is your company doing?

Answer. Commercial power availability is essential to pipeline operation. The ability of emergency response officials at the federal, state and local levels to facilitate, coordinate and prioritize the response of the electric power utilities during outages is critical. A more reliable power system would help ensure that the product distribution infrastructure is sufficient to deliver fuels to the marketplace. ExxonMobil is working closely with industry and government to assess the impact of the hurricanes, as well as to identify improvements for the future. Additionally, ExxonMobil is conducting a review of learnings from Hurricanes Katrina and Rita events and

will be incorporating findings into future pre-hurricane season checklists and business continuity plans.

Question 5. A number of witnesses testified that failure of the electricity system resulting from hurricanes Rita and Katrina contributed in great part to the inability to get refineries restarted, or to get natural gas pipelines restarted. What are the arrangements for backup power in case of such emergencies at your critical facilities?

Answer. All ExxonMobil pipeline operations where power was interrupted worked closely with electric power providers to restore power as quickly as possible. Where a rapid restoration of power supply by the provider was not possible, portable rental power generation equipment was obtained with up to 2MW capacity being typical. This easily-transportable power generation equipment is more flexible and practical than permanent facilities for the size of the pump stations in our pipeline system. A more reliable power system would help ensure that the product distribution infrastructure is sufficient to deliver fuels to the market place.

ExxonMobil self-generates approximately 50% of our total electricity demand. This self-generation is located at our *refineries, chemical plants and production facilities* around the world. Back-up power is a commercial arrangement negotiated between ExxonMobil and a third-party supplier. When required, back-up power is delivered over the transmission grid. This commercial arrangement is meant to 'back-up' our self-generation capabilities in the event this generation is unavailable. Because, at most of our facilities, cogeneration supplies only part of a site's total demand, these facilities cannot operate at or near full capacity without an operating transmission grid. A dedicated power generation plant to supply emergency power to a specific refinery in the event of an emergency is not practical since it would require a dedicated transmission interconnection system.

Question 6. How many of your plants have on site cogeneration facilities? Which plants have these facilities?

Answer. ExxonMobil has interests in 85 cogeneration facilities at more than 30 locations around the world representing a capacity of approximately 3,700 MW. Within the U.S., cogeneration facilities exist at six U.S. locations including the Baytown Texas refinery and petrochemical complex, Baton Rouge Louisiana refinery and petrochemical complex, Beaumont Texas refinery and petrochemical complex, Billings Montana refinery, Torrance California refinery and the Joliet Illinois refinery. In addition we have cogeneration at three upstream production facilities in Alabama and California.

Question 7. Are there regulatory barriers at either the state or federal level that prevent the installation of cogeneration plants at your facilities that do not have them?

Answer. There are a number of regulatory barriers impacting cogeneration development, including multiple and overlapping permit programs—federal and state New Source review, Title V (federal Clean Air Act) operating permits, and stormwater pollution prevention and discharge elimination permits. Permit applications may also require Endangered Species Act reviews. Potentially, acid rain permits may be needed also, depending on output to the grid. Governments wanting to promote cogeneration investments, that benefit both industry and the public alike, must also develop markets and market rules with several characteristics, namely: 1) dispatch priority as electricity and steam cannot be made independently and steam is integral to site operations; 2) non-discriminatory access to the transmission grid allowing cogeneration investors access to markets and customers; 3) use-based transmission / ancillary / back-up power charges—charges based on actual use to support net internal load. Even in the United States, not all markets possess these characteristics.

Question 8. Would the presence of cogeneration facilities at your refineries reduce the recovery time during such emergencies?

Answer. The presence of cogeneration capability at our refineries reduced some startup times in the aftermath of the hurricanes.

Cogeneration facilities provide for high efficiency electricity supply that is controlled by the individual sites. Whether they facilitate a reduced recovery time during these stated emergencies depends upon the damage sustained at our own facility and whether that damage could be evaluated / repaired sooner than the damage sustained within the utility / grid operator's system or facility. Secondly, fuel (i.e. from a natural gas pipeline system) would have to be available in order to operate the cogeneration facility. Lastly, the cogeneration facility must have been designed such that it can operate isolated from the public transmission grid. Advanced turbine technology, when combined with advanced NO_x emissions control technology as required in numerous locations, could prohibit operation in a "stand alone" mode.

Startup of these cogeneration facilities may require electric power from the grid or generators.

Question 9. Witnesses at earlier hearings testified that there are a number of modern natural gas generation facilities in the Louisiana/Texas area that are not used to their full capacity. Are there natural gas generation facilities in close proximity to your refinery facilities that could be used for backup generation at the refineries?

Answer. Not to our knowledge, but this idea is likely not practical. Many generators do not have "black start" capability and thus require a functioning transmission grid in order to start their generation facilities. Even if the generator has the ability to operate isolated from the grid, extensive interconnection investments would be required to connect the generation facility directly (and only) to an individual refinery.

Question 10. Would use of generators that are in close proximity to refineries to provide backup power during such emergencies mean that recovery times might be shortened, since the restoration time for a nearby facility might be less than the restoration time for the transmission facilities for traditional utilities?

Answer. No, for the reasons outlined in the previous question. This approach would require a dedicated transmission interconnection between a specific generator(s) and a specific refinery (or other facility). This would be neither practical nor cost effective. Generally, generators are not sufficiently sized to supply the total power needed to operate a refinery.

ENVIRONMENT

Question 11. Please specify exactly which, if any, Federal or State environmental regulations have prevented your company from expanding refinery capacity or siting a new refinery, and documentation on the exact details of the project prevented.

Answer. There are a number of federal, state and even local regulations that impact or even restrict refinery expansion. A major component of these is EPA's New Source Review (NSR). EPA's NSR program, especially prior to the recent NSR reforms, created significant impediments to expanding refinery capacity. As originally conceived, facilities seeking to construct a new major source or make major modifications were subject to this program. However, EPA significantly expanded this program as it applies to small changes to existing sources. For example, under EPA's "past actual to future potential emissions increase test", many projects which did not increase actual emissions still became subject to NSR. Given the costs associated with NSR emission controls, unless the project had a very large return, the project was often not progressed.

For example, recently one of our refineries had spare crude unit capacity. A minor physical modification (a new section of piping) could have been installed that would have allowed importation of an additional 5,000 barrels per day of crude to help fill some of the spare capacity. However, the refinery did not implement this project because, under EPA's "past actual to future potential test", this project would have required Prevention of Significant Deterioration/NSR permitting. Permitting costs alone were estimated at twice the expansion project cost and NSR permitting would likely cause a 1-2 year delay and trigger emissions controls investment requirements on the crude unit. Consequently the refinery was unable to capture this opportunity to refine approximately 1.8 million barrels (~75 million gallons) of crude oil during the year into gasoline and other products.

How much have so-called "boutique fuel" requirements added to the average retail price, where applicable, and the average wholesale price per gallon of the gasoline sold by your company?

Answer. It is very difficult to quantify an exact impact of boutique fuels on the average price per gallon of gasoline. States have promulgated unique fuel specifications ("boutique fuels") to meet federal air quality standards, and the resulting proliferation of differing fuel specifications increases costs. Further, these differing fuel specifications complicate supplying fuel to the affected areas. This tightened supply situation amplifies even minimal supply disruptions. Ultimately, prices are determined by the market.

If the EPA or the Congress were to act to minimize the number of "boutique fuel" formulations required by the states to protect air quality, how many should there be and what should the specifications of each be in order to maintain air quality and improve fungibility?

Answer.

1. Existing gasoline boutique fuel designations should be rationalized to five formulations: a. California RFG for California only; b. Federal RFG; c. 7.8 RVP (Reid Vapor Pressure) volatility-control gasoline for modest non-attainment areas; d. 7.0

RVP volatility-control gasoline for areas with a more significant non-attainment problem; and e. conventional gasoline.

2. Diesel fuel should be limited to two formulations: a. CARB diesel for California only; and b. EPA diesel for the rest of the country.

3. Home heating oil formulations should be limited to the grades that are currently in the market place.

Question 12. Streamlining New Source Review (NSR) permitting constraints was mentioned as an incentive that would encourage refiners to supply more product to the U.S. market. How many air quality permit applications for refinery expansions has your company submitted for NSR over the last ten years? How long did it take the EPA, or the applicable State, to approve or deny each permit application, after receipt of a complete permit application? What was the expected percentage increase in product output of the expansion?

Answer. All capital projects, including capacity expansions, are evaluated for permitting requirements. The number of NSR air quality permit applications is not readily available. However, the permit applications have tended to be associated with relatively large capacity increase projects on average every few years. They require, on average, a year longer to obtain versus other permits. Although it is possible under the NSR regulations to offset the increase in emissions resulting from new construction, cost-effective emission offsets at many sites are no longer available. Consequently, the restrictive interpretation of NSR requirements has the potential to subject even small debottlenecks to NSR permitting. Without the NSR reforms, refineries will be limited in their ability to improve efficiency, reliability, and production capability.

Question 12a. How would you propose to streamline NSR and still maintain local air quality and prevent any increase in total annual emissions from such expansions?

Answer.

1. Include the NSR reforms finalized in 2002 and 2003 (relating to emission calculation methodology, changes that would not trigger NSR, etc.) in legislation to provide certainty and flexibility for U.S. manufacturing operations. NSR reforms were originally envisioned by the Clinton Administration; implementation of reforms by the current Administration has been held up by litigation.

2. Each state should incorporate federal NSR reforms into state regulations. Such action would provide for a more rapid and certain permitting of refinery expansions.

3. Establish an annual facility-wide or partial-facility allowable emission limitation based on current permit limits. This would allow facilities to make any changes necessary without going through permitting, as long as the "cap" is not exceeded, thereby maintaining local air quality and preventing any increases in total allowable emissions.

4. Adopt an hourly rate of emissions increase as the first step in determining whether or not NSR is triggered; include a significance test.

Question 13. How much did the fuel specification waivers that have been granted by EPA to date, due to the supply disruptions caused by the hurricanes, reduce the average retail price of the gasoline or other refined products made by your company?

Answer. Prices are determined by the market. The EPA waivers of certain federal fuel requirements allowed prompt increases in fuel supplies to areas that otherwise would have experienced product shortages or run-outs.

Question 14. One witness indicated that "getting two 100-year hurricanes in four weeks" caused a great deal of chaos and disruption in the gasoline supply chain. The National Oceanic and Atmospheric Administration has projected that the country and the Gulf of Mexico have entered a cyclical period of 20-30 years during which the Gulf and coastal areas are likely to experience a greater frequency of hurricanes and higher odds of those hurricanes making landfall in the U.S. What preparations has your company made to deal with a greater hurricane frequency to decrease repetition of the supply disruption that occurred this year?

Answer. Whether there will be a greater hurricane intensity or frequency in the future remains unclear, with views differing among experts. In any event, evaluating the future frequency and impact of weather events is an imprecise and uncertain area of science.

ExxonMobil places a premium on safety and reliability, and has comprehensive emergency-response and business-continuity plans in place at all our facilities. Safety factors are incorporated over and above the base platform design that results in structures designed for events more severe than a 100 year event.

We are working closely with industry and government to assess the impacts of the hurricanes, as well as to identify improvements for the future.

Question 15. Over the last 50 years, average annual sea surface temperatures have increased in the Gulf of Mexico and, according to the National Academy of Sciences and other similar scientific expert bodies, are expected to continue increasing as the oceans continue warming due to accelerating global climate change. The Administration's Climate Action Report (2002) stated "model simulations indicate that, in a warmer climate, hurricanes that do develop are likely to have higher wind speeds and produce more rainfall." What preparations has your company made to deal with a greater likelihood of greater hurricane intensity so as to decrease repetition of the disruption that occurred this year?

Answer. See previous answer.

Question 16. How has your company disclosed to shareholders and investors the risks associated with the potential impacts on your company's assets in the Gulf of Mexico or indirect impacts on its assets elsewhere, of either the expected greater frequency of hurricanes making landfall in the U.S. or the probable greater intensity of hurricanes in the region?

Answer. While ExxonMobil may not agree with the premise of your question, we do acknowledge that weather can impact our results. ExxonMobil's disclosure of "Factors Affecting Future Results" notes that the operations and earnings of the Corporation and its affiliates throughout the world are affected by local, regional and global events or conditions that affect supply and demand. These events or conditions include weather, including severe weather events, that can disrupt operations. We provide the information on "Factors Affecting Future Results" to shareholders and investors both in our annual report on Form 10-K and on our website.

FINANCES, PRODUCTION, IMPORTS, ETC.

Please provide for each of last ten years your company's—

- Gross revenue of U.S. operations
- Total capital expenditures in the U.S.
- Net profit of U.S. operations
- Total taxes paid to the Federal government
- Total taxes paid to State governments

Answer. Please refer to the table below.

TEN YEAR U.S. SELECTED FINANCIAL DATA SUMMARY

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
	\$M	$M	$M	$M	$M	$M	$M	$M	$M	$M
Gross Revenue—U.S.	51,013	55,103	55,665	45,783	53,214	70,036	63,603	59,675	70,128	88,382
Total capital & exploration expenditure—U.S.	3,618	3,716	3,889	4,195	3,402	3,338	3,942	3,957	3,766	3,025
Net income after tax—U.S.	3,134	3,951	4,523	2,841	3,157	6,750	6,255	3,601	5,634	8,154
Income, excise and other taxes										
Total income taxes to Federal Government—U.S.	1,294	1,729	1,840	1,040	608	3,132	2,532	1,048	2,589	3,353
Total income taxes to State governments—U.S.	232	205	207	141	148	309	229	121	346	406
Excise taxes—U.S.	6,328	6,701	7,063	7,459	7,795	6,997	7,030	7,174	6,323	6,833
All other taxes and duties—U.S.	1,297	1,238	1,163	967	1,021	1,253	1,177	1,120	1,209	1,223
Total income, excise and other taxes	9,151	9,873	10,273	9,607	9,572	11,691	10,968	9,463	10,467	11,815

Data Sources:

Exxon Corporation Annual Report—Form 10-K and Financial & Operating Review
 Mobil Corporation Annual Report—Form 10-K and Fact Book
 Exxon Mobil Corporation Annual Report—Form 10-K and Financial & Operating Review.

Question. Total donated to charity:
Answer.

EXXON MOBIL CORPORATION—CONTRIBUTIONS AND COMMUNITY
 DEVELOPMENT EXPENDITURES—1995-2005

Year	\$ millions
1995	\$79.5
1996	85.9
1997	90.3
1998	104.0
1999	97.6
2000	97.1
2001	125.9
2002	98.5
2003	103.0
2004	106.5
2005 (estimate)	138.7
Total 1995-2005	\$1,130.0

Question 17. How much additional petroleum refining capacity do you expect your company to install in the United States over the next 10 years?

Answer. Refining is a global business, and the U.S. has routinely imported petroleum products for decades to balance supply and demand.

Over the last decade ExxonMobil has increased its U.S. refining capacity by the equivalent of three average-sized refineries through expansions and efficiency gains at existing U.S. refineries. ExxonMobil is studying expansions at some of its U.S. and international refineries. Decisions on refinery investments are based on long-term economics. It should be noted that U.S. refining output has increased by 30 percent over the past 30 years.

Question 18. What percentage of profits over the last 10 years has your company re-invested in capital, exploration, drilling, and production in the United States? Please provide an annual total for those U.S. expenditures and a clear breakdown.

Answer. Please refer to table 1 below which provides details of our Upstream capital & exploration expenditure and Upstream net income. We would emphasize that capital expenditures depend on the availability of attractive opportunities, both in the United States and throughout the world. Also, the amounts for capital investment among business lines within the industry depend upon the relative opportunities they present.

Question 19. What percentage of profits over the last 10 years has your company re-invested in non-petroleum energy supply and production in the United States? Please provide a total and the results of such investment.

Answer. A negligible amount of ExxonMobil's company profits has been re-invested in non-petroleum (non crude oil and natural gas) energy supply and production.

Question 20. On average for the last ten years, please compare your company's overall capital expenditures in the United States to its expenditures elsewhere.

Answer. Please refer to the table 2 below.

Question 21. What percentage of your company's gross revenue was collected in the United States in each of the last 10 years?

Answer. Please refer to the table 3 below.

Table 1.—% OF PROFITS REINVESTED IN U.S. UPSTREAM ACTIVITIES

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	10-yr. total
Upstream—U.S. Only											
Capital & exploration expenditure (capex)—\$M	1,685	1,625	2,008	2,174	1,729	1,865	2,423	2,357	2,125	1,922	19,913
Total upstream—U.S. only											
Net income after tax—\$M	954	2,518	2,331	850	1,842	4,542	3,933	2,524	3,905	4,948	28,347
Upstream Capex											
As % of Upstream U.S. Net Income After Tax	177%	65%	86%	256%	94%	41%	62%	93%	54%	39%	70%

Data Sources & Notes:

E Exxon Corporation Annual Report—Form 10-K and Financial & Operating Review
 Exxon Corporation Annual Report—Form 10-K and Fact Book

M Mobil Corporation Annual Report—Form 10-K and Financial & Operating Review

Table 2.—CAPITAL & EXPLORATION EXPENDITURE—LAST 10 YEARS

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	10-yr. total	%
Total capital & exploration expenditure												
U.S.	3,618	3,716	3,889	4,195	3,402	3,338	3,942	3,957	3,766	3,025	3,685	26%
Non-U.S.	9,953	12,306	10,228	11,340	9,905	7,830	8,369	9,998	11,759	11,860	10,355	74%
Total capital & exploration expenditure	13,571	16,022	14,117	15,535	13,307	11,168	12,311	13,955	15,525	14,885	14,040	100%
U.S. Capital & Expl. Exp. as a % of total	27%	23%	28%	27%	26%	30%	32%	28%	24%	20%		

Data sources:

E Exxon Corporation Annual Report—Form 10-K and Financial & Operating Review

M Mobil Corporation Annual Report—Form 10-K and Fact Book

X Exxon Mobil Corporation Annual Report—Form 10-K and Financial & Operating Review

Table 3.—TOTAL GROSS REVENUE—LAST 10 YEARS

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	10-yr. ave.\$M	%
	\$M											
Total gross rev- enue												
U.S.	51,013	55,103	55,665	45,783	53,214	70,036	63,603	59,675	70,128	88,382	61,260	29%
Non-U.S.	146,161	157,943	142,070	119,844	129,315	158,403	145,814	141,274	166,926	202,870	151,062	71%
Total gross rev- enue	197,174	213,046	197,735	165,627	182,529	228,439	209,417	200,949	237,054	291,252	212,322	100%
U.S.% of total gross revenue	26%	26%	28%	28%	29%	31%	30%	30%	30%	30%	30%	

Data Sources
 Exxon Corporation Annual Report—Form 10-K and Financial & Operating Review.
 Mobil Corporation Annual Report—Form 10-K and Fact Book.
 Exxon Mobil Corporation Annual Report—Form 10-K and Financial & Operating Review.

Question 22. How much of your company's revenue collected in the United States was used to pay for purchasing crude oil from OPEC countries?

Answer. ExxonMobil's 2004 purchases of crude oil from OPEC countries into the U.S. were \$8.8 billion.

Question 23. Do you support S. 1794 or something like it create gasoline and jet fuel reserves to ensure stability of price and supply? Should it be extended to diesel and other fuels like natural gas?

Answer. Product reserves are costly and complex due to, among other factors, product degradation from extended storage, many current fuel specifications, and logistical challenges of maintaining storage in multiple locations. Both the California Energy Commission and the National Petroleum Council (which advises the Secretary of Energy) have concluded in recent times that such fuel reserves are not appropriate for the U.S. The fastest and most efficient response to temporary supply imbalances is to let markets function. Refiners have rapidly responded to temporary supply challenges without the need for government intervention. Although hurricane and flooding damage, transportation logistics, employee safety, and personnel dislocations contributed to the supply shortage following Hurricanes Katrina and Rita, the most critical contributing factor was the loss of electric power to run pipelines and refineries.

Creating a strategic natural gas reserve could be counterproductive, potentially interfering with and discouraging the market's creation of seasonal inventories. The U.S. currently has the most robust system of natural gas inventories of any industrialized nation. The system works to provide prompt supplies of natural gas during the peak winter heating season and facilitates maximum production of natural gas during the low demand months. The purchasers of gas held in inventory take market risk on the interval between purchases made during the spring and summer months (April thru October) and the gas sold during the winter season (November thru March). The normal build of inventory may be disrupted if it is perceived that there is too much price risk due to the uncertainty of how strategic inventories may be released.

Building strategic product or gas reserves when markets are tight will put further upward price pressure on the market and remove necessary operational supply from the market.

Question 24. On average for the last ten years, how much of what is refined by your company in the U.S. stays in the U.S.?

Answer. ExxonMobil is typically a net seller of gasoline and distillates since its refinery production exceeds its U.S. marketing demand. Typically exports are less than 3% of total production and volumes are about balanced with imports, but can vary for a variety of market and supply/demand factors. ExxonMobil has imported products to the U.S. and has exported products to longstanding customers in Mexico, South/Central America and the Caribbean. This approach balances refinery production in an efficient manner.

We do not have 10 years worth of data readily available. However, ExxonMobil has exported YTD 2005 (mostly to Mexico) about 9 million barrels of gasoline ~3 million barrels distillates and ~0.5 million barrels of jet kerosene. We sold 97.8% of our domestic production within the U.S. In 2004 97.6% of ExxonMobil's domestic production was also sold in the U.S.

Question 24a. What amount of refined product did your company import in 2004 and in 2005?

Answer. ExxonMobil has imported about 12.5 MB of gasoline and blending components, ~1.5MB of distillates and ~0.5MB of jet kerosene so far in 2005. Corresponding imports in 2004 were 1.5MB of gasoline, and ~0.1MB of jet kerosene. There were no imports of distillate in 2004.

Question 24b. What are your assumptions about demand growth in India and China?

Answer. In ExxonMobil's Energy Outlook, Asia-Pacific total energy demand is anticipated to grow in excess of 2% annually between today and 2030.

Question 24c. How have your investments in the United States increased the energy security of the country?

Answer. ExxonMobil's global investments, averaging \$15 billion annually in recent years, continue to increase the diversity and reliability of supply. This diversity increases the energy security of all importing nations, including the U.S. Recent projects have added production not only in the U.S., but in Europe, Africa, Russia and the Caspian region.

Question 25. What market signals will occur in advance of peaking world oil production and what is the appropriate policy or set of policies for the U.S. government to adopt when such signals occur?

Answer. ExxonMobil's detailed assessment of global energy supply and demand through 2030 anticipates increasing global oil production over the next 25 years. Advancements in technology, both anticipated and unanticipated, would indicate that consideration of policy options in response to peak oil is premature.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. RON WYDEN TO
LEE R. RAYMOND

Question. All over America, the oil industry drives up the price at our gas pumps by redlining and zone pricing. "Redlining" is when your companies draw a phony line around a community to lock out competition and raise prices for the consumers. "Zone pricing" is plain old discrimination and it takes place when one oil company supplies gas to several gas stations located near each other and one station is charged much more than the others for the same type of gas. This drives stations out of business, reducing choice and raising prices for consumers. To help hurting consumers at our gas pumps, will you company commit to stop redlining and zone pricing? Yes or no?

Answer. No. For a more detailed discussion of the pro-competitive effects of territorial restraints, see "The Economics of Price Zones and Territorial Restraints in Gasoline Marketing," (Federal Trade Commission, March 2004), at pp. 31-35.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. MARIA CANTWELL TO
LEE R. RAYMOND

Question 1. I'm aware that the cost of crude oil is driven by the world market and that its cost is currently significantly above historic averages. But I'm not aware of any substantive increases in the cost of producing crude oil, the cost of refining it into various petroleum products such as gasoline and diesel, and the cost of transportation of refined products to markets. Through the end of September 2005, the price of crude had increased 40 percent in 2005 while gasoline prices increased almost 80 percent. If the percent difference in the prices isn't pure profit, please explain to me how you account for the difference in the substantially lower increase in crude oil when compared to gasoline.

Answer. Crude oil and gasoline prices are determined by the actions of willing buyers and willing sellers in the global, transparent market place based on their outlook of various market factors. See, e.g., *Attachment K, International Comparison of Gasoline Price*. Compared to the previous year, in 2005, crude prices are up, transportation costs are up, refinery costs are up and various mandated product specification changes continue to increase costs.

Question 2. Between 1981 and 2003, U.S. refineries fell from 321 to 149. Further, no new refineries have been built in the U.S. since 1976. In 1981, the 321 refineries had a capacity of 18.6 million barrels a day. Today, the remaining 149 refineries produce 16.8 million barrels a day. I recognize the difficult financial, environmental, and legal considerations associated with the location and construction of new refineries. But I fail to understand the closure of existing refineries even if they required investment to enhance their efficiency and production capability unless, of course, this mechanism is being used to increase the price of gasoline and other refined products. Please help me understand why you would shut down refineries in the face of the supply and demand situation. What conditions would have to exist for you to invest in new refining capacity? I have heard the industry claim that up to \$48 billion has been used on capital expenditures for existing refineries. If those investments were not used for capacity increases, what were they used for?

Answer. U.S. refining output has increased by 30 per cent over the past 30 years. The number of refineries in the U.S. has fallen as smaller or less efficient plants were closed. Over the last decade ExxonMobil has increased its U.S. refining capacity by the equivalent of three average-sized refineries through expansions and efficiency gains at existing U.S. refineries.

ExxonMobil has invested \$3.3 billion over the last five years in its U.S. refining and supply system. A substantial portion of this investment has been directed towards environmental improvement projects.

Refining is a global business, and the U.S. has routinely imported petroleum products for decades to balance supply and demand. ExxonMobil is currently participating in a joint venture that is developing plans to construct a multi-billion dollar

refining/chemical operation at Fujian, China to meet anticipated demand for petroleum products in the region, and ExxonMobil is studying expansions at some of its U.S. refineries. Decisions on refinery investments are based on long-term economics.

Question 3. The recent hurricanes resulted in the need to import substantial refined products such as gasoline, diesel fuel and aviation fuel to meet U.S. demand. The question has been raised as to whether the country should develop a strategic reserve of finished petroleum products. What would be your reaction if the Federal government either directly or by way of contract with the private sector sought to create a strategic reserve of finished petroleum products? Since these products have a limited shelf-life, one proposal is to obtain and operate a number of refineries and have the products be used by the Federal government. Appreciate your comments on this proposal.

Answer. The fastest and most efficient response to temporary supply imbalances is to let markets function. Although hurricane and flooding damage, transportation logistics, employee safety, and personnel dislocations contributed to the supply shortage following Hurricanes Katrina and Rita, the most critical contributing factor was the loss of electric power to run pipelines and refineries. Both the California Energy Commission and the National Petroleum Council (which advises the Secretary of Energy) have concluded in recent times that such fuel reserves are not appropriate for the U.S. ExxonMobil does not believe that the entry of the government into the U.S. refining business would be a sound strategy.

Question 4. Given the recent profitability of the oil industry, I am interested to learn more on the disposition of these profits, particularly to enhance both production and refining capacity. Are any of these profits being used to enhance production and refining capacity for the benefit of other countries? What fraction of your profits is being invested for production and for refining? What percentage of profits have been used for stock buybacks and mergers and acquisitions?

Answer. Yes, but the benefits of capital investment in one country are not limited to that country, when you are dealing with global commodities such as petroleum products. Approximately 70 percent of our profits come from outside the U.S.

Please refer to the table below. Over the last ten years, ExxonMobil's cumulative capital and exploration expenditures have exceeded our cumulative annual earnings. Our average annual capital expenditures have been approximately \$14.0 billion, while our average annual net income has been approximately \$13.8 billion. See Attachment A, *ExxonMobil Long Term Earnings and Investment History*.

PROFITS INVESTED FOR PRODUCTION & REFINING

	2004 \$M	2003 \$M
Capital & Exploration Expenditure		
Production		
U.S.	1,669	1,842
Non-U.S.	8,629	8,758
	10,298	10,600
Refining		
U.S.	550	998
Non-U.S.	774	768
	1,324	1,766
Capital & exploration expenditure—production & refining	11,622	12,366
Total consolidated net income after tax	25,330	21,510
% net income invested in production & refining	46%	57%

Data Sources:

Exxon Mobil Corporation 2004 Financial & Operating Review.

Answer. Please refer to the table below.

PROFITS USED FOR STOCK BUYBACKS, MERGERS & ACQUISITIONS

	2004 \$M	2003 \$M
Common stock acquired	9,951	5,881
Mergers		

PROFITS USED FOR STOCK BUYBACKS, MERGERS & ACQUISITIONS—
Continued

	2004 \$M	2003 \$M
Acquisitions		
Total consolidated net income after tax	9,951	5,881
% net income used for stock buybacks, mergers & acquisitions	25,330	21,510
	39%	27%

Data Sources:
Exxon Mobil Corporation 2004 Form 10K—Consolidated Cashflow Statement & Consolidated Statement of Income.

Question 5. You've all said profits are cyclical, and that your companies have also suffered from the volatility of the oil markets. Would your stockholders be better served if domestically produced oil was sold at a fixed rate that included a generous profit margin above the production, refining, and distribution costs?

Answer. No. The oil market is global in nature. Price controls introduce distortions and inefficiencies in the market. Stockholders, like all energy consumers, are best served by a free and efficient market. The U.S.'s previous experience with price controls resulted in reduced domestic production and increased dependence on imports.²

Question 6. Do you believe that global warming is occurring? Do you believe that man-made activities have a role in this phenomenon? How will global warming impact your companies in term of added costs for oil and gas development, or allow access to new areas for oil and gas development?

Answer. Attached as Appendix A is ExxonMobil's recent "Report on Energy Trends, Greenhouse Gas Emissions and Alternative Energy,"* which addresses our approach to the complex topic of global climate change.

Question 7. Is it accurate that United States LNG terminals in Massachusetts and Maryland are only operating at half capacity? Do you believe if these plants were operated at a higher capacity it would have changes the market dynamics that determine the current price?

Answer. ExxonMobil does not have a financial or operating interest in either terminal so we cannot comment on operational matters there. If the facilities were at 100% of capacity there would likely be a nominal market impact if any since the natural gas markets served by these two facilities are very large relative to the capacity of both.

Question 8. Please state for the record your company position on fuel economy standards. Are there other incentives that you support that you feel are better for consumers than the Corporate Average Fuel Economy paradigm?

Answer. Our position has been and continues to be in favor of efficient use of our products, both internally and by our customers. We have made substantial improvements in the energy efficiency of our operations in the past and expect to continue to do so.

We have been and continue to be involved in joint research with selected automakers on efficiency and emissions improvement. We expect that the automakers will continue to seek efficiency improvements in response to market forces. High fuel efficiency vehicles are available to consumers today.

Question 9. I understand that over the past 5 years companies in your industry have downsized significantly. Now there is a shortage in workers and equipment to increase drilling. Please explain that dynamic.

Answer. Demand for drilling equipment and crews fluctuates based on the amount of drilling activity. There are continual improvements in technology and other efficiencies that enhance the ability of industry to effectively explore for, develop, and produce energy supplies.

Question 10. As you probably know, Congress is likely to open up the Coastal Plain of the Arctic National Wildlife Refuge to oil and gas exploration. Do you have plan to bid for leases in this area? What does the price of oil have to be to make ANWR exploration and extraction be economically viable?

²Congressional Research Service Report 90-442 E, The Library of Congress, *The Windfall Profit tax on Crude Oil: Overview of the Issues*, September 12, 1990.

*Appendix A-C have been retained in Committee files.

Answer. If ANWR is ultimately opened for leasing, ExxonMobil would look at potential opportunities there in the same manner we would look at opportunities in the U.S. and elsewhere around the globe. We do not have sufficient information or data needed to properly answer the second question. In addition, given the scale and long-term nature of the energy industry, there are no quick fixes or short-term solutions. We have ongoing investment programs to develop future supply and to advance energy-producing and energy-saving technologies. If we are to continue to serve our customers and your constituents, corporate and government leaders alike cannot afford to simply follow the ups and downs of energy prices. We must take a longer-term view.

Question 11. I understand that many of your resources and equipment are working flat out to rebuild infrastructure in the Gulf of Mexico. If there is no capacity to expand oil and gas exploration, what good is opening up sensitive environmental areas to increased drilling going to do for the consumer in the short run?

Answer. The size, scale, and timeframe of the energy industry are immense. It is not appropriate to compare the activities associated with repairing Gulf of Mexico infrastructure with those required to study, explore, develop, and produce oil and gas from a new geologic basin. The time horizons are much different, and many of the contracting companies involved are different as well. Access to new energy supplies is needed to help meet projected U.S. energy demand. It requires significant time, risk, and resources to develop energy resources. Industry experience and proven technologies demonstrate that these resources can be developed in an environmentally responsible manner.

Question 12. Given the growing demand for oil in Asia, do you believe that oil derived from the Arctic National Wildlife Refuge could be diverted to supply Asian markets? If drilling in the Arctic National Wildlife Refuge is authorized this year, when will it begin to have an impact on gasoline prices? What do you believe that effect will be?

Answer. Oil is a globally traded commodity. It is our understanding that proposed ANWR legislation would require that its oil production be used in U.S. markets. Energy resources obtained from ANWR would increase diversity of U.S. energy supplies, and would add to the supplies needed to meet projected world energy demand. New supplies assist in helping meet energy demand, and have a positive effect on prices for the U.S. consumer. Given the scale and long-term nature of the energy industry, there are no quick fixes or short-term solutions.

Question 13. Do you support more transparency in the oil and natural gas markets, as would be provided in my bill S. 1735?

Answer. ExxonMobil supports open and liquid markets that are free from government intervention. We are continuing to assess S. 1735 in order to establish a company position.

Question 14. How has the last 3 years of escalating gasoline prices affected demand by American drivers? Have we seen a correlation between a certain level of price increase and less demand by American drivers? What is the actual level of reduced demand today compared to 3 years ago (please respond in the context of a doubling of retail gasoline prices)?

Answer. The price effect on demand ("price elasticity") is notoriously difficult to assess reliably over short time periods, and we are not able to respond quantitatively to the specific three year time frame posed. We note that historically, elasticity is very low in the short term—the ability of individuals to adjust their consumption day-to-day is limited. Certainly, one can adjust the thermostat and avoid unnecessary car trips, and this can have a real but limited effect. Over a period of years, the effects of choices in new car purchases, where to live versus work, and other lifestyle decisions can have a larger effect on total energy demand.

Question 15. What is the crude oil extraction costs for major oil producing countries, including our own? How does that compare with oil derived from shale or coal?

Answer. The cost of extracting oil varies widely depending upon the particular field in question and in some cases, the cost of energy itself which can be a major component of production cost. Even with this wide variation, we expect that the cost of producing oil from shale or coal would be substantially higher still. ExxonMobil had a shale oil venture in the 1980s that was determined to be non-economic at the time when oil prices dropped significantly from prior levels.

Question 16. Regarding foreign exporting, inventory maintenance, and other practices of your company, please provide a response to each of the following questions and information requests: For each and every export shipment to a foreign country of gasoline, distillate fuel oil, propane, or liquefied natural gas occurring from January 1, 2005 to present, please provide the date, product type, volume, domestic port

of exit, foreign destination, transportation costs, and the sale price or transfer value upon arrival at the foreign destination.

Answer. ExxonMobil has exported YTD 2005 (mostly to Mexico) about 9MB of gasoline, approximately 3MB distillates and 0.5MB of jet kerosene. We sold 97.8% of our domestic production within the United States. We do not export LNG or propane.

All exports were essentially at market prices at the time of delivery and were sold to achieve the highest value for the product. Export sales prices exceed domestic prices, at the time of the deal adjusted for quality and location difference. Cargo-specific pricing and other data are proprietary.

Question 16a. Since January 1, 2001 to present, please identify the number of shipments wherein your company exported gasoline, distillate fuel oil or jet fuel and the sales price or transfer value received at the destination was less than the amount that would have been received had the product been marketed by your firm in the United States.

Answer. None at the time of the deal.

Question 16b. Since January 1, 2001 to present, please identify the date, product, volume(s), foreign port of origin, expected U.S. port of entry, and eventual port of final destination in each instance wherein your company basically “turned a ship away” (whether proprietary product or acquired from a third party) by changing the shipments expected arrival in a U.S. port to a foreign port.

Answer. None.

Question 16c. From 1995 until present, please identify by month the inventory levels maintained by your company for gasoline and distillate fuel oil in both barrels and converted to “days of cover” or “days of supply” for your firm’s distribution and sales volumes within each of the Petroleum Allocation Defense Districts (PADDS) in the United States.

Answer. The ExxonMobil supply chain and inventories are managed on a global, efficient basis to ensure reliable supplies for our customers. Consistent data are readily available from 2003 on a U.S. basis (we do not typically segregate by PADD) and is listed below for each year. The annual average reflects operations and avoids the volatility in monthly data caused by operating events such as turnarounds, pipeline delivery timing and sales fluctuations.

	2003	2004	2005 (YTD)
Inventory, MB*	63.0	62.1	60.7
Days of sales**	29	28	27

* Includes finished plus intermediates.

** Sales based on finished.

Question 16d. From January 1, 2005 to present, provide the details of each “spot market” (as commonly referred to in the industry for bulk sales, in volumes exceeding 5,000 barrels per transaction) including the date, identity of both the seller and purchaser, location of the product being sold, and the selling price.

Answer. Details of spot market transactions are proprietary information.

Question 16e. Describe your company’s use of “in-house trading platforms,” and identify all individuals in your company by name, address, email, and phone number that were authorized during 2005 to either exchange, trade, sell or purchase gasoline or distillate fuel oil on either the “spot market”, NYMEX futures market, or via “forward paper” purchase rights.

Answer. ExxonMobil does not use “an in-house trading platform” as we understand the term. ExxonMobil does not engage in speculative trading in the futures market. ExxonMobil uses derivatives for transactions in the U.S. market to match the market price with the timing of physical delivery. The use of derivatives represents less than 2.5% of our total trading activity.

Question 16f. Please identify all third party reporting services, including but not limited to Oil Price Information Service (OPIS), Lundberg Surveys, Platts, and Oil Intelligence that your company regularly supplies transaction data or marketing information and all individuals of the company by name, address, email, and phone number that were authorized during 2005 to provide the information or data to such third parties.

Answer. ExxonMobil did not communicate transaction data, marketing information, or any other related information to OPIS, Lundberg, Platts or other third-party reporting services for U.S. gasoline, distillates or jet kerosene in 2005.

Question 16g. Please identify the branded and unbranded “rack prices” that were reported by your company to third party reporting services such as OPIS and the branded and unbranded “rack prices” that were actually charged distributors or jobbers by your company each day, from January 1, 2005 to present, at the truck loading terminal(s) that typically supply gasoline stations in Houston, TX, Atlanta, GA, New York, NY, Chicago, IL, Los Angeles, CA, Portland, OR, and Seattle, WA.

Answer. ExxonMobil does not report prices to OPIS.

Question 16h. Will your company commit that it will take no efforts to retaliate against any firm or individual that is a potential witness before this Committee or cooperates with any investigation into the oil industry by Congress or another governmental authority?

Answer. Yes. Exxon Mobil does not make business decisions based upon anyone’s testimony before Congress or cooperation with Congressional or government agency investigations. That being said, the Company cannot guarantee that no one who testifies or cooperates in an investigation will be unhappy about a business decision the Company makes and allege that the Company is retaliating against them.

Question 16i. From January 1, 2005 to present, for each instance known to your company wherein a third party (not your company) exported gasoline, distillate fuel oil, propane, or liquefied natural to a foreign country, please provide any of the details known to your company including the identity of the exporter, date, product type, volume, domestic port of exit, foreign destination, transportation costs, and the sale price or transfer value upon arrival at the foreign destination.

Answer. ExxonMobil sold 0.5MB in 2005 to Defense Energy Support Center which we understand was exported. We have no direct knowledge of exports by third-parties.

Question 16j. Since January 1, 2001 to present please identify the identity, date, product, volume(s), foreign port of origin, expected U.S. port of entry, and eventual port of final destination in each instance wherein your company is aware a third party (not your company) basically “turned a ship away” (whether proprietary product or acquired from a third party) by changing the shipments expected arrival in a U.S. port to a foreign port.

Answer. We do not have knowledge about any third-party actions regarding “turning any ships away.”

Question 16k. Please provide an itemized list of tax deductions and credits taken under the U.S. tax code for 2004, by your parent company and subsidiaries.

Answer. Similar to all other industries, our parent company and subsidiaries took the deductions and credits appropriate to our business as provided for in the Internal Revenue Code. Information on tax returns is confidential and we will not comment on the specifics of our return. However, the following is a general listing of the deductions and credits that we took on our 2004 U.S. Federal Income Tax Return.

A. Deductions claimed on 2004 Federal income tax return:

1. Cost of Goods Sold
2. Salaries and Wages
3. Repairs and Maintenance
4. Bad Debts
5. Rents
6. Taxes and Licenses
7. Interest
8. Charitable Contributions
9. Depreciation
10. Cost Depletion
11. Advertising
12. Pensions, Profit-sharing, etc., plans
13. Employee Benefit Programs
14. Other allowable deductions including, but not limited to:
 - Amortization expenses
 - Freight and delivery expenses
 - Insurance expenses
 - Office supplies expenses
 - Relocation expenses
 - Research and development expenses
 - Utilities

B. Credits Claimed on the 2004 Federal Income Tax Return:

- Foreign Tax Credit
- General Business Credit
- Credit for Federal Tax on Fuels

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. KEN SALAZAR TO
LEE R. RAYMOND

Question 1. The Agriculture Committee is looking at the impacts these high energy prices are having on agricultural producers around the country. To sum it up: they are hurting. It seems to me that there is tremendous potential for our country to grow fuels such as ethanol and bio-diesel. This approach offers many benefits to rural America as well as to the country as a whole. What type of investments is your company making (and planning to make) in these types of renewable fuels in the United States?

Answer. ExxonMobil's primary focus with regard to renewable fuels is on research to identify options that are commercially viable, as for example through the Global Climate and Energy Project (GCEP) and other such initiatives, to which ExxonMobil plans to contribute over \$100 million. ExxonMobil has an ambitious research program and we examine renewable fuels as part of this effort. At present, ExxonMobil blends almost a million gallons of ethanol into our gasoline products every day in the U.S. This has required investment throughout our supply system. Renewable fuels manufactured by today's technologies are generally more costly than petroleum-derived fuels and require government subsidies to be competitive.

Question 1a. Rural America is crying out for investment in renewable fuels, and I encourage your companies to look at the potential of renewable fuels. In terms of a percentage of your capital expenditures, how much money did your company spend this year to develop renewable fuel sources in the United States? What will that percentage be going forward?

Answer. As a percentage of total investment, the amount currently being invested is inconsequential at less than 0.1 percent of our total capital spending. However, through our funding and participation in the research partnership with Stanford University—the \$100 million Global Climate and Energy Project—we are supporting research into breakthrough renewable energy sources.

We are investing in facilities to blend ethanol at selected terminals in the U.S. in 2005, but the amount of this capital is very small in relation to our total spending. We expect to continue to invest in additional ethanol blending facilities in the coming years to meet the expanded renewables requirements imposed by this year's energy bill.

Question 1b. Will you also provide this committee with some examples of renewable fuel projects that your company is pursuing outside the United States?

Answer. Similar to our U.S. activity, we are making investments to support blending of renewable fuels in other countries where renewable fuel use is required.

Question 2. As a few of you note in your testimony, diesel prices have remained high while unleaded gasoline prices have come down. It seems as if we are getting lower priced unleaded gas at the expense of diesel. Since diesel is the fuel of choice in agriculture, it is a sort of a double whammy on our producers. What is being done, or what can be done, to get diesel prices back in line with the price of gasoline?

Answer. Prices are determined by the market. From time to time diesel prices have been higher than gasoline prices, depending on market factors of supply and demand. New grades of diesel are being required in the U.S. such as the introduction of low-emission diesel in Texas in 2005 and the planned initial introduction of ultra-low sulfur diesel nationwide in 2006. These changes affect the amount of motor fuels that can be produced in the U.S. and potentially the availability of refined product imports, adding further challenges to the supply chain.

Question 2a. If demand for diesel is so high in Europe and high prices don't attract the supplies necessary to lower prices, isn't that a good indicator that we should work to produce more diesel in the United States and look to biodiesel as an option?

Answer. Prices are determined by the market. Directionally higher prices will attract increased supplies which may then moderate prices compared to what the prices would have been without those increased supplies. Biodiesel, however, is generally more costly to produce than petroleum-derived diesel and requires subsidies to be competitive.

Question 3. For the record, will you tell me what your company has spent on capital expenditures *in cash*, not including write offs such as amortization or depreciation. Will you also provide the figures spent on cash dividends and stock buyback for the same time period?

Answer. Please refer to the table below.

CAPITAL EXPENDITURES, CASH DIVIDENDS, STOCK BUYBACKS

	2004 \$M	2003 \$M
Total capital & exploration expenditures	14,885	15,525
Cash dividends to ExxonMobil shareholders	6,896	6,515
Common stock acquired	9,951	5,881

Data sources:

Exxon Mobil Corporation 2004 Form 10-K.

Question 4. On November 1st, Senator Grassley asked your companies to contribute 10% of your record profits to supplement LIHEAP funding for the less fortunate. Will your companies support Senator Grassley's proposal?

Answer. No. On November 7, 2005, the American Petroleum Institute (API) responded formally to Senator Grassley's inquiry. API stated its strong support for Congress to provide full funding for this important program, which it established in 1982. API observed that higher oil and natural gas prices have resulted in significantly increased royalty payments and income taxes to the Federal Government.

Question 5. I'd like to encourage you to actively work with the Department of Energy and any other relevant federal agency on initiating a public/private education campaign focused on energy education and conservation. In the meantime, will you tell me what your company has done on its own initiative?

Answer. Through its membership in the American Petroleum Institute, ExxonMobil has supported a major advertising campaign this Fall emphasizing energy education and conservation as a major theme. This continuing campaign has been implemented nationally in the print, radio and television media. Enclosed as Appendix B are API's print media advertisements.

Additionally, ExxonMobil has its own external communications program, a substantial part of which is designed to communicate some of the tough energy challenges facing the U.S and the rest of the world and describing some of the company's actions to address those challenges. We have used and continue to use a broad range of communications channels (television, newspapers, magazines, online) to reach people and energy efficiency has taken a high profile in the content of these programs. For example, we run 26 opinion editorials annually in the *New York Times*, *Washington Post* and other publications and energy efficiency is widely covered in these, including several specifically on the subject. In addition, a large portion of our U.S. advertising in 2005 featured energy efficiency content. [Examples are included in Appendix C.] Information on our website, www.exxonmobil.com, provides more detail supporting the advertising.

Following Hurricanes Katrina and Rita, the company placed print advertisements in newspapers across the country, describing ExxonMobil's actions to maintain fuel supplies and asking Americans to help by using fuel wisely; we also provided some energy saving tips.

We have a range of communications initiatives designed to help people understand energy issues. For example, we prepare annually—and have done so for decades—a detailed, long-range outlook of global energy supply and demand trends. See, www.exxonmobil.com/corporate/Citizenship/Corp—citizenship—energy—outlook.asp. These are communicated widely through publications and presentations to audiences, as well as posted on our website.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. FRANK R. LAUTENBERG TO
LEE R. RAYMOND

Question 1. In the last decade, has your company ever withheld supply of crude oil or refined product from the market in order to prevent prices from falling?

Answer. No.

Question 2. Please describe any business relationship or transaction your company or any of its subsidiaries, wherever located and wherever incorporated, whether wholly owned or not, have had with Iranian nationals (except employment of Iranian expatriates), the Iranian government, individuals or corporations located or incorporated in Iran, or any representative of these people or companies.

Answer. ExxonMobil believes it is in compliance with the laws and executive order dealing with contacts with Iran and has in place procedures to help ensure future compliance.

In addition to a copy of ExxonMobil's 'Special Review Procedures for Transactions Involving Sensitive Countries,' we have attached a copy of a letter the company received this year from the Office of Foreign Assets Control ("OFAC") which we believe demonstrates the care the company is taking to ensure compliance with the law.

[Attachment.]

DEPARTMENT OF THE TREASURY,
Washington, DC, February 2, 2005.

Case No. IA-7041

PETER D. TROBOFF, Esquire,
Covington & Burling, 1201 Pennsylvania Avenue, N.W., Washington, DC. 20004-2401

DEAR MR. TROBOFF: This responds to your letters of December 21, 2004, and January 10, 2005, on behalf of Exxon Mobil Kazakhstan Inc. and its affiliates (collectively, "ExxonMobil"), requesting confirmation that certain transactions by ExxonMobil in connection with its participation in current and proposed activities relating to the North Caspian Production Sharing Agreement are not prohibited by the Iranian Transactions Regulations, 31 C.F.R. Part 560 (the "ITR"). You explain that in November 1997, the Government of Kazakhstan entered into a Production Sharing Agreement ("PSA") with a consortium of international petroleum companies (the "Consortium"), which entitles Consortium members to explore for oil, develop discovered reserves, and produce oil from several blocks in the northern Caspian Sea. Agip KCO, a subsidiary of ENI, a company based in Italy, is the Consortium operator. ExxonMobil holds a 16.67 percent ownership interest in the Consortium. The Government of Iran is not a shareholder or participant in the Consortium. You further explain that pursuant to the PSA, each member of the Consortium will take its equity share of oil production in kind at the field's delivery point.

BACKGROUND

The ITR prohibit the exportation, reexportation, sale or supply, directly or indirectly, from the United States or by a U.S. person, wherever located, of any goods, technology or services to Iran or the Government of Iran. This prohibition also applies to the exportation, reexportation, sale or supply of goods, technology or services to a person in a third country undertaken with knowledge or reason to know that the goods are intended specifically for supply, transshipment or reexportation, directly or indirectly, to Iran or the Government of Iran, ITR, § 560.204. ITR § 560.410(a) makes clear that the § 560.204 prohibition on the exportation of services to Iran applies to services performed by U.S. persons outside the United States on behalf of the Government of Iran, or where the benefit of such services is otherwise received in Iran.

As noted in your letter, the prohibition in ITR § 560.204 on exports to Iran or the Government of Iran does not apply to the exportation to any country of information and informational materials, ITR, § 560.210(c). The term *information and informational materials* is defined in ITR § 560.315 to include publications, films, posters, phonograph records, photographs, microfilm, microfiche, tapes, compact disks, CD ROMs, artworks, and news wire feeds.

In addition, § 560.210(c)(2) of the ITR provides that the informational materials exemption does not apply to transactions related to information and informational materials not fully created and in existence at the date of the transactions, or to the substantive or artistic alteration or enhancement of informational materials, or to the provision of marketing and business consulting services.

The ITR also prohibit U.S. persons, wherever located, from engaging in any unauthorized transactions or dealings in or related to (1) goods or services of Iranian origin or owned or controlled by the Government of Iran; or (2) goods, technology or services for exportation, reexportation, sale or supply, directly or indirectly, to Iran or the Government of Iran. ITR, § 560.206. The term "transaction or dealing" includes, without limitation, purchasing, selling, transporting, swapping, brokering, approving, financing, facilitating, or guaranteeing. ITR, § 560.206(b). The prohibition against facilitation in the ITR bars, without a license, a U.S. person, wherever located, from approving, financing, facilitating, or guaranteeing any transaction by a foreign person where the transaction by that foreign person would be prohibited by the ITR if performed by a U.S. person or within the United States. Additionally, a U.S. corporation may not modify its policies or procedures or those of a foreign affiliate or subsidiary to enable that entity to enter into a transaction that would be prohibited if performed by a U.S. person or within the United States. ITR, §§ 560.208 and 560.417.

ISSUES

The first issue raised in your letter relates to ExxonMobil's participation in studies and possible construction of a pipeline from Atyrau, Kazakhstan, to the Aktau region of Kazakhstan in order to transport the crude oil produced in the Kashagan field to market. We understand that in January of 2003, ExxonMobil notified the non-U.S. members of the Consortium that ExxonMobil would neither fund nor participate in planning any study or portion of a study that analyzes issues regarding the subsequent transportation of Kashagan crude oil to or across Iran. You assert that the ITR do not prohibit ExxonMobil's participation in studies of the proposed Atyrau-Aktau pipeline and terminal or in the construction, partial ownership and operation of such a new pipeline and terminal, as such activities would take place in Kazakhstan and all of the pipeline and terminal construction activities would be located and operated in Kazakhstan. Additionally, you advise that ExxonMobil would not be involved in any shipments of oil to or through Iran by non-U.S. Consortium members, although non-U.S. Consortium members may independently decide to ship their portion of the oil through Iran.

Based on the facts you have presented regarding the ownership structure of the Consortium and the proposed activities to be engaged in by ExxonMobil, and independent of the issues discussed below, we do not regard ExxonMobil's participation in the Atyrau-Aktau pipeline study and its participation in the ownership, construction and operation of the pipeline and related facilities to be prohibited by ITR §§ 560.206 and 560.208 *per se*. However, this conclusion does not relieve ExxonMobil from the responsibility of ensuring that it does not engage in related activities that are prohibited by the ITR. In particular, before engaging in transactions involving the PSA and the Consortium, ExxonMobil must ascertain whether such transactions would provide goods or services to the Government of Iran or a person in Iran, or involve a dealing in or related to goods or services of Iranian origin or owned or controlled by the Government of Iran. For example, ExxonMobil would be prohibited from providing any consulting or other services to the Consortium in connection with transportation activities involving Iran. In addition, any activity by ExxonMobil involving the Atyrau-Aktau pipeline, including among other activities the development, construction and/or operation of the pipeline, that would directly or indirectly benefit Iran or the Government of Iran or promote the trading or dealing in Iranian-origin goods or services would be prohibited by ITR § 560.204 or § 560.206.

Secondly, you raise the issue of ExxonMobil's proposed receipt of Iranian transportation studies prepared for and funded by the non-U.S. Consortium members for ExxonMobil's internal purposes. The studies are described as pre-existing materials created by third parties that are not publicly available. You explain that it is common practice in the oil industry for members of a consortium to share with other consortium members relevant studies they prepare, even though some consortium members have not contributed to funding the studies or otherwise participated in their preparation. In your letter of January 10, you describe the accounting arrangement that was created to ensure that the U.S. members of the Consortium are not funding or otherwise involved in the Iran transportation studies. This arrangement provides that a portion of Agip KCO's overhead will be allocated to such studies and charged exclusively to the non-U.S. Consortium members.

You confirm that the U.S. Consortium members are not indirectly funding such costs by disproportionately funding other work in return for not paying for the Iran export option costs. You explain that although ExxonMobil has not yet received any studies or reports from the non-U.S. Consortium members concerning any specific study that may have been undertaken regarding an Iranian export option, ExxonMobil expects eventually to see high-level summaries of that data and information included in the joint transportation studies and reports. You further explain that ExxonMobil will not comment on or discuss the studies with Agip KCO, or other non-U.S. Consortium members that funded the studies. In addition, ExxonMobil will not enhance the quality or usefulness of these studies for the non-U.S. Consortium members. Rather, you expect that the studies may enable ExxonMobil to permit better planning and support for the non-Iranian transportation option.

With regard to the receipt by ExxonMobil of pre-existing transportation studies created and funded by the non-U.S. Consortium members that are not publicly available, it appears from the information you have provided that such materials would constitute informational materials that are exempt under ITR § 560.210(c). Accordingly, ExxonMobil's receipt of such transportation studies would not be prohibited by the ITR, provided that ExxonMobil does not directly or indirectly provide any goods or services, including marketing or consulting services, to the non-U.S.

Consortium members in connection with the creation or such studies and provided further that such transactions do not involve either the development, production, design, or marketing of technology specifically controlled by the International Traffic in Arms Regulations, 22 C.F.R. parts 120 through 130, the Export Administration Regulations, 15 C.F.R. parts 730 through 774, or the Department of Energy Regulations set forth at 10 C.F.R. part 810, or exchanges of information that are subject to regulation by other government agencies. We note that ExxonMobil's receipt of such information will assist it in making further determinations as to whether its participation in the development, construction, ownership and/or operation of the Atyrau-Aktau pipeline may be prohibited by the ITR unless authorized by OFAC.

Sincerely,

ROBERT W. WERNER,
Director, Office of Foreign Assets Control.

June 24, 2004

EXXON MOBIL CORPORATION

SPECIAL REVIEW PROCEDURES FOR TRANSACTIONS INVOLVING SENSITIVE COUNTRIES

Introduction. Exxon Mobil Corporation generally seeks to pursue promising business opportunities, regardless of location, as long as all applicable legal requirements are met. Even when lawful, however, a transaction may have public affairs sensitivities that warrant prior review by the Public Affairs Department and, in some cases, endorsement by the appropriate Corporate Contact Executive. These Special Review Procedures cover selected transactions that require such reviews and endorsements. These Special Review Procedures do not cover all proposed transactions that should receive special review because of unusual public affairs sensitivities. If a business unit is considering a transaction that does not fall literally within the transactions described below but that could involve similar sensitivities, the business unit should obtain appropriate advice, reviews, and endorsements.

Legal Compliance. In many countries, but particularly in the U.S., significant legal restrictions exist on transnational commercial transactions. For example, currently more than seventy countries are subject to some kind of U.S. economic sanctions. This statement of Special Review Procedures is not intended to be a summary of applicable legal requirements and prohibitions or a guide to determining whether a proposed transaction is lawful. The Law Department is available to make those determinations in all cases, including cases where the applicable laws of different countries may conflict with respect to a proposed transaction.

Definition of "Transactions Involving a Country". These Special Review Procedures cover selected transactions with Category A or B countries listed below. As used in this statement of Special Review Procedures, "transactions involving a country" are defined broadly to include any business dealing with the government or nationals of the country; with any company or other entity in the country; or with any entity anywhere directly or indirectly owned or controlled by, or acting for, such government, nationals, company or other entity. Transactions include activities such as exporting and delivering goods to a country or its government, nationals, or other entities referred to above; importing and procuring goods from them; providing services to or accepting services from them; contracting with them; investing in them; and transmitting funds to or receiving funds from them.

Implementation. The responsible business unit should carefully consider all transactions that might involve a Category A or B country and should follow these Special Review Procedures for all such transactions. Questions regarding the interpretation or implementation of these Special Review Procedures should be referred to the Public Affairs Department.

Future Revisions. Revisions to the Special Review Procedures must be endorsed by the Contact Executive for the Public Affairs Department following review by the Vice President—Public Affairs and by the Vice President and General Counsel.

CATEGORY A TRANSACTIONS

Transactions involving a Category A country would typically involve a high degree of public affairs sensitivity. Trade between the United States and these countries typically is subject to significant legal and political restraints.

Procedure. Subject only to the following two exceptions, no transaction involving a Category A country should be initiated, committed to, or entered into until the responsible business unit has obtained endorsement from its Corporate Contact Executive. Prior to any review by a Corporate Contact Executive, Corporate Public Af-

fairs, the Law Department and the business unit's leadership should review the proposed transaction.

The exceptions are the two types of transactions described below.

1. Lawful transactions involving informational materials, patents, trademarks or copyrights, *provided such transactions are licensed, authorized, or exempt under U.S. law.*
2. Lawful transactions for bunkering of Cuban non-military vessels and fueling of Cuban non-military aircraft by non-U.S. affiliates, *provided such activities do not involve any individual who is located in the U.S., or is a national or permanent resident of the U.S.*

The excepted transactions described above do not require Corporate Contact Executive endorsement. The Law Department is available to provide advice on whether a particular transaction that appears to meet the conditions described above is lawful.

For all other transactions involving a Category A country, review by the Corporate Public Affairs Department, the Law Department, and the business unit's leadership, and endorsement by Corporate Contact Executive are required. In some instances, that review and endorsement may make the proposed transaction unlawful with the result that the transaction should not be entered into. The Law Department can advise on when such circumstances apply, and such proposed transactions should be declined by the business unit without additional review.

CATEGORY B TRANSACTIONS

Transactions involving a Category B country would typically involve heightened public affairs sensitivities, although the sensitivities normally are not as great as those involving a Category A country. Trade between the United States and these countries typically is subject to legal restrictions, but certain types of commercial activity are permitted. Alternatively, they are countries for which there are special political sensitivities.

Procedure. Transactions involving a Category B country which entail:

1. Commitments extending more than one year; or
2. A significant loan or unusual credit terms; or
3. Significant capital investment

should not be initiated, committed to, or entered into before the responsible business unit has obtained endorsement from its Corporate Contact Executive. Prior to any review by a Corporate Contact Executive, the Corporate Public Affairs Department, the Law Department, and the business unit's leadership should review the proposed transaction. As with Category A transactions, in some instances that review and endorsement may make a proposed transaction unlawful with the result that the transaction should not be entered into. The Law Department can advise on when such circumstances apply, and such proposed transactions should be declined by the business unit without additional review.

EXXON MOBIL CORPORATION

ATTACHMENT TO STATEMENT OF SPECIAL REVIEW PROCEDURES APPLICABLE TO TRANSACTIONS INVOLVING PUBLIC AFFAIRS SENSITIVITIES

Category A

Cuba	Syria
Iran	North Korea
Iraq	Sudan

Category B

Burma (Myanmar)	Libya
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RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. OLYMPIA J. SNOWE TO TERRY GODDARD

Question 1. The Department of Energy established a 1-800 phone number as well as web form for consumers to report possible instances of price gouging. According to the DOE, the information they receive is forwarded to the Department of Justice, the Federal Trade Commission, and the affected States' Attorney General. Have you

been receiving this information? Is it helpful? What do your offices do with this information once it is received?

Answer. The Department of Energy periodically sends my Office e-mails containing summary information about complaints it receives from Arizona consumers regarding high gasoline prices charged by gasoline stations within the state. The information is helpful to the extent that it provides price information for specific gasoline stations. However, since the identity of the complainant is not disclosed and the information arrives well after prices have changed, it is difficult for us to corroborate the complaints. Additionally, because Arizona does not have a price gouging statute, we cannot take legal action regarding the reported high prices. Nonetheless, we monitor the Department of Energy's summaries for evidence of severe price spikes, which may indicate abnormal supply or demand issues and necessitate an antitrust or consumer fraud investigation.

Question 2. As a former Attorney General, I recognize the enormity of the job that you perform with limited resources. In September, I wrote to Attorney General Gonzales and asked the Department of Justice to provide technical and financial support to state Attorneys General to investigate price gouging. What, if any, assistance have you received from the DOJ? What, if any, additional assistance could the Federal Government provide to your offices?

Answer. In May 2004, many other state Attorneys General and I asked the President and several federal agencies to investigate the causes of high gasoline prices. On June 2, 2004, R. Hewitt Pate of the Department of Justice's Antitrust Division wrote us a letter stating that the Department of Justice investigates and prosecutes criminal antitrust activity. He made it clear that the Department of Justice does not investigate "price gouging". Mr. Pate also clarified the Federal Trade Commission's ("Commission") role in investigating and prosecuting civil antitrust activity in relation to gasoline pricing issues, but not price gouging *per se*. Since receiving Mr. Pate's correspondence, my Office has not attempted to contact the Department of Justice regarding price gouging or gasoline issues, because we did not have evidence of criminal antitrust activity.

It would be helpful for states to receive assistance from the Federal Government in analyzing the economic conditions that affect prices in local markets.

For example, in 2003, when Arizona experienced severe price spikes resulting from a gasoline pipeline break between Tucson and Phoenix, my Office contacted the Commission regarding gasoline pricing issues. The Commission responded by providing my Office with helpful information about gasoline industry market structure. In September 2004, my staff and I also discussed Arizona gasoline pricing issues with Chairman Majoras and Commissioner Jones Harbour. Chairman Majoras agreed to investigate the reasons for Arizona price spikes that had been attributed to the pipeline break. The Commission reported its findings in its June 2005 report: *Gasoline Price Changes: The Dynamic of Supply, Demand and Competition*.

On several occasions, my Office has provided the Commission with information for its Gasoline Price Monitoring project.

Other than these contacts, my Office has not received any direct support or involvement with federal agencies.

Question 3. Are you aware of price gouging for fuel or other commodities in your state following Hurricane Katrina? Are there any investigations underway? Do you have adequate state authority?

Answer. Although Arizona's gasoline supply is not directly connected with the Gulf areas affected, in the days and weeks following Hurricane Katrina, hundreds of Arizona consumers complained to my Office about the significant price increases at Arizona gasoline stations in advance of and following Hurricane Katrina. Simultaneously, representatives of my Office found, through the course of our regular gasoline price monitoring, that the average price of gasoline in Arizona had actually climbed about 8 cents higher than California during this period. This is an extremely unusual phenomenon. Though Arizona receives much of its gasoline supply from California, our prices are usually at least 10 cents less than California's, due to California's higher gasoline taxes.

As a result of consumer complaints, the California price disparity, and other credible information my Office received regarding the Arizona gasoline market, I launched antitrust and consumer fraud investigations to look for potential market manipulation and/or deceptive practices. While the investigations are not complete, we have learned that some Arizona gasoline retailers' and wholesalers' post-Katrina profit margins were two to three times higher than they were before the hurricane hit.

In Arizona, we do not have the authority to prosecute price gouging, because Arizona does not have a price gouging law. If the current investigations do not turn

up illegal anticompetitive or deceptive activity, my Office has no authority to take action against the companies that increased their profits so greatly at consumers' expense during the Hurricane Katrina disaster.

Question 4. State of Emergency as Trigger for Price Gouging—Most state price gouging laws are applicable only in situations arising from a declared emergency. My home state of Maine is different in that the law applies in any instance where there is evidence of “unjust and unreasonable profits in the sale, exchange or handling or necessities.” Why did your state legislature choose to limit its law’s impact to declared states of emergency?

Answer. The Arizona Legislature has not passed an anti-price gouging law, even though bills, which I supported, were introduced in the 2004 and 2005 sessions.

However, I recommend to our Legislature that the trigger for a price gouging law not be limited to declared states of emergency within the state. At times, there may be a major supply disruption of an essential good or service absent a disaster or emergency. I support price gouging legislation that also includes, as triggers, declarations of “Abnormal Market Disruption” or “Supply Emergency.” I believe these additional triggers would have provided important consumer protection against price gouging in states like Arizona that were indirectly affected by Hurricane Katrina. If states are affected by regional disasters, it is my opinion that the most effective anti-price gouging laws would include the additional triggers.

Question 4a. How frequently do states declare a state of emergency?

Answer. According to Arizona’s Department of Emergency and Military Affairs, there have been 167 Gubernatorial Declarations of Emergency in Arizona in the 40 years since 1966. A table listing the declared emergencies is attached for your reference.

Question 4b. Has there ever been a situation where there is evidence of unconscionable increase in price outside of a declared emergency?

Answer. Since Arizona has no law defining “unconscionable price increase,” it is difficult to answer this question. In the period after Katrina, Arizonans saw profits of some suppliers and retailers triple. The Governor did not declare an emergency in connection with Hurricane Katrina.

Question 5. Have you ever uncovered any evidence that oil companies deliberately kept their oil products off the market in order to raise prices?

Answer. We received allegations of withholding gas in 2003, after the Kinder Morgan pipeline from Texas to Arizona ruptured, and in September 2005, after Hurricane Katrina. In both cases, my Office issued Civil Investigative Demands to investigate the validity of these allegations.

In 2003, my investigation shed light on the complexity of the private and opaque gasoline supply and distribution system in Arizona, particularly in the Phoenix metropolitan area. However, that investigation was inconclusive due to uncontrolled variables, such as the scarcity of tanker trucks, long lines at the racks, and elaborate supply contracts. These variables made it impossible to determine whether gasoline suppliers were deliberately withholding product. It is possible that suppliers were unable to distribute product due to blockages at the racks, or unavailability of tanker trucks. It is also possible that suppliers were rationing supply in an uncertain market in order to comply with their supply contracts. My Office simply did not have enough information, nor the resources or jurisdiction to gather all of the necessary information to make a final determination as to causes of the shortages.

In 2005, my Office received allegations that a local retail chain was withholding gasoline from the market for the purpose of driving up prices. Because the investigation is ongoing, I cannot definitively answer the question at this time.

RESPONSE TO WRITTEN QUESTIONS SUBMITTED BY HON. TED STEVENS TO
HENRY MCMASTER

Question 1. State of Emergency as Trigger for Price Gouging—South Carolina’s price gouging statute is triggered by a declaration of a state of emergency by the Governor of South Carolina or the President of the United States. After a declaration, it is unlawful to sell most commodities for or to raise rental rates to an unconscionable price. An unconscionable price is a price that (1) represents a gross disparity over the average price received in the usual course of business for the previous thirty days or (2) grossly exceeds the average price in the trade area for the preceding thirty days.

Legislation has been proposed in South Carolina to make the price gouging statute apply when the President or the governor of any other state of the United States declares a state of emergency and the basis for that declaration is causing an abnor-

mal disruption of the market in South Carolina. Why did your state legislatures choose to limit its law's impact to declared states of emergency?

Answer. The market needs to be free to set prices and allocate scarce resources as it does in the usual course of business in the United States without merchants being afraid to make necessary pricing decisions.

Question 1a. How frequently do states declare a state of emergency?

Answer. The Governor of South Carolina declared hurricane related states of emergency for Hurricanes Hugo (1989), Fran (1996), Bonnie (1998), Floyd (1999), and Charley (2004). A state of emergency was declared for a winter storm in 2002.

Question 1b. Has there ever been a situation where there is evidence of unconscionable increase in price outside of a declared emergency?

Answer. South Carolina investigators interviewed employees in 100 plus gasoline retailers post-Hurricane Katrina. Follow-up investigations are being conducted of four of these retailers. Though final conclusions have not been reached, it appears that some of these stations may have been susceptible to prosecution for price gouging if South Carolina's price gouging statute had been activated by a declared state of emergency.

Question 2. The Department of Energy established a 1-800 phone number as well as a web form for consumers to report possible instances of price gouging. According to the DOE, the information they receive is forwarded to the Department of Justice, the Federal Trade Commission, and the affected State's Attorney General. Have you been receiving this information? Is it helpful?

Answer. Yes.

Question 2a. What do your offices do with this information once it is received?

Answer. The information is used to identify potential problem retailers for investigation.

Question 3. As a former Attorney General, I recognize the enormity of the job that you perform with limited resources. In September, I wrote to Attorney General Gonzales and asked the Department of Justice to provide technical and financial support to state Attorneys General to investigate price gouging. What, if any assistance have you received from the DOJ?

Answer. South Carolina did not request assistance from DOJ.

Question 3a. What, if any additional assistance could the Federal Government provide to your offices?

Answer. South Carolina's resources were sufficient to investigate these issues at the retail level. We believe the appropriate federal role is to investigate the producers and refiners for anti-trust and unfair trade practices.

Question 3b. Are you aware of price gouging for fuel or other commodities in your state following Hurricane Katrina?

Answer. Though final conclusions have not been reached, it appears that a small number of gasoline retailers (four or less) may have been susceptible to prosecution for price gouging if South Carolina's price gouging statute had been activated by a declared state of emergency.

Question 4. Are there any investigations underway?

Answer. South Carolina investigators interviewed employees in 100 plus gasoline retailers post-Hurricane Katrina. Follow-up investigations are being conducted of four of these retailers.

Question 4a. Do you have adequate state authority?

Answer. Legislation has been proposed in South Carolina to make the price gouging statute apply when the President or the governor of any other state of the United States declares a state of emergency and the basis for that declaration is causing an abnormal disruption of the market in South Carolina. If this legislation is adopted, we will have adequate authority.

PREPARED STATEMENT OF HON. BILL RICHARDSON, GOVERNOR, STATE OF NEW MEXICO

Chairman Domenici, Chairman Stevens, Ranking Member Bingaman, Ranking Member Inouye, and members of the committees, I appreciate the opportunity to submit this written testimony on the subject of today's joint committee hearing: energy pricing and corporate profits.

As you may know, several Democratic Governors sent the President and Congressional leaders a letter on September 20, 2005 requesting an investigation into possible price-gouging by oil companies. I commend you for responding favorably to this

request, as well as that of the growing number of Americans who want answers to their questions about record corporate profits at a time of exorbitant energy prices.

We stated in our letter, “If gas prices remain at artificially and unexplainably high levels, American families will see the effects not only at the pump, but in their grocery bills and prescription drug costs.”¹ Unfortunately, our concerns have been borne out. The recent spike in gas prices has placed an extraordinary financial burden on families, and there is no relief in sight. Although we have seen a slight decrease recently in gasoline prices, home heating costs are projected to increase dramatically this winter. According to an Energy Information Administration (EIA) Short Term Energy Outlook report released yesterday, American families who heat their homes with natural gas are expected to spend 41% more for fuel this winter than they did last winter.² This is an increase of \$306—a large burden for working families.³ The EIA further projects that the utility bills for families using heating oil will grow this winter by 27% (\$325) and that propane users will pay on average 21% (\$230) more this winter than last.⁴ If the weather is colder than expected, these costs will rise even further.⁵

As a Governor of a state with a diverse population, I have seen the toll that high energy costs takes on working families. Americans don’t spend money on energy and fuel because they want to; they spend it because they have to. Even worse, while high energy costs affect all Americans, they disproportionately affect the neediest Americans, who are often forced to choose among basic needs.

What’s most troubling is that as our citizens are forced to bear this financial burden, our nation’s oil companies are turning out record profits. Exxon Mobil recently posted a \$9.9 billion quarterly profit—the largest in U.S. corporate history.⁶ To put this number in perspective, this one company’s quarterly profit could pay for all Social Security benefits for a three-month period, an Ivy League education for 60,000 kids, or more than 160 Boeing 737s.⁷ Likewise, Royal Dutch Shell reported third quarter profits of \$9 billion and ConocoPhillips earned \$3.8 billion, roughly double its profits from a year earlier.⁸ Overall, the industry is expected to post a record \$96 billion in corporate profits for 2005.⁹

Corporate profitability should be encouraged—unless it is obtained by illegal price gouging on the backs of working families. In our September 20th letter, we cited a study published by Dr. Don Nichols, economist and director of the Robert M. La Follette School of Public Affairs at the University of Wisconsin Madison, showing that gas prices outstripped crude oil prices.¹⁰ Dr. Nichols explained that gasoline prices of \$3.00 per gallon—which much of our country saw for months—would only be expected if crude oil were costing \$95.00 per barrel.¹¹ At their peak, however, crude oil prices were in the range of \$70.00 per barrel. Thus, the question for your committee is: where did the additional money go? Many Americans suspect that it went right into corporate pockets.

And if companies did price-gouge and profiteer illegally, then commensurate fines and surrender of those ill-gotten gains should be considered and those monies redirected to helping families with energy costs.

I applaud you for following up on this matter. However, I encourage you to consider this the beginning of a long process of finding ways to help alleviate the burden of rising energy costs. As you investigate the relationship between corporate profits and high energy prices, I also encourage you to draw on Governors’ first-hand knowledge and experience. Across the country, Governors have shown leadership in investigating price gouging and promoting energy efficiency. In addition to launching our own investigations and lawsuits, we have spearheaded multi-state co-

¹ Letter from Democratic Governors to President Bush, Majority Leader Frist, and Speaker Hastert (Sept. 20, 2005).

² Energy Information Administration Short-Term Energy Outlook (Nov. 8, 2005), at <http://www.eia.doe.gov/emeulsteo/pub/contents.html>.

³ *Ibid.*

⁴ *Ibid.*

⁵ *Ibid.*

⁶ Terence O’Hara, *Oil Industry Seeks to Cast Huge Profits as No Big Deal*, WASH. POST, Oct. 28, 2005, at D1.

⁷ *Ibid.*

⁸ H. Josef Hebert, *Oil Execs to Be Asked to Justify Profits*, WASH. POST, Nov. 2, 2005, at <http://www.washingtonpost.com/wp-dyn/content/article/2005/11/01/AR2005110101432.html>.

⁹ *Ibid.*

¹⁰ Donald A. Nichols, Professor of Economics and Public Affairs; Director, The La Follette School of Public Affairs; Co-Director, the Center for World Affairs and the Global Economy, The University of Wisconsin-Madison, *ECONOMIC OUTLOOK FOR LATE 2005 AND 2006: STRONG GROWTH WITH A BIT OF INFLATION FED BY THE KATRINA BOOM* (Sept. 16, 2005), <http://www.lafollette.wisc.edu/calendar-news/2005/outlooksepo5.pdf>, at 5-7.

¹¹ *Ibid.*

operative efforts to reduce energy costs, proposed utility sales tax holidays, initiated campaigns to weatherize homes, and distributed tax rebate checks. New Mexico families are receiving rebate checks ranging from \$64 to \$298 to help cover rising energy costs. We have also expressed our strong support for additional emergency LIHEAP funding, and we'll continue to fight for these critical funds. Through these experiences, we have gained valuable insight into how to best assist Americans in this time of need.

Again, on behalf of our nation's Democratic Governors, I urge you to remain vigilant on this critical matter. The American people will not tolerate being held hostage to corporate profit. They deserve answers and they deserve economic relief. Democratic Governors stand ready to assist in any effort aimed at protecting Americans from rising energy costs. Thank you.

U.S. SENATE,
Washington, DC, November 8, 2005.

Hon. TED STEVENS,
Chairman, Committee on Commerce, Science and Transportation, U.S. Senate, Hart Building, Washington, DC.

Hon. PETE DOMENICI,
Chairman, Committee on Energy and Natural Resources, U.S. Senate, Dirksen Building, Washington, DC.

DEAR CHAIRMEN STEVENS AND DOMENICI: Thank you for convening tomorrow's joint hearing on energy prices and supply. As members of the Senate Energy and Commerce Committees, we write to request that the witnesses at tomorrow's hearing—specifically, the CEOs of the five major oil companies expected to attend be sworn in, to offer testimony under oath.

We are aware that Majority Leader Frist called for this hearing as part of the effort "to investigate high energy prices." Many of us have previously called for similar investigations and believe such an effort is long over due, given factors such as the oil companies' record profits, complaints from across the nation about potential price gouging in the wake of Hurricanes Katrina and Rita, and other long-standing controversies about the pricing policies and business practices of these corporations.

In order for the Senate to play its proper oversight role, we believe it would be most appropriate for these witnesses to be administered the oath. Not only will this give us and our constituents the utmost confidence in the testimony that is offered, it will also provide us a reasonable opportunity to request additional information to aid in this investigation.

If the American people are to find this inquiry credible, it is essential that the oil executives testify under oath. Anything less would undermine the integrity of this Congress and these committees. Thank you for your attention to this request.

Sincerely,

Maria Cantwell, Bill Nelson, Jay Rockefeller, Frank R. Lautenberg, Ron Wyden, Barbara Boxer, Byron L. Dorgan, Tim Johnson, Mark L. Pryor

PREPARED STATEMENT OF RED CAVANEY, PRESIDENT AND CEO, AMERICAN
PETROLEUM INSTITUTE

API is a national trade association representing more than 400 companies involved in all aspects of the oil and natural gas industry, including exploration and production, refining, marketing and transportation, as well as the service companies that support our industry. Its mission is to advocate public policy in support of a strong, viable U.S. oil and natural gas industry essential to meet the energy needs of consumers in an efficient and environmentally responsible manner. API advocacy efforts on positions are based on the consensus of its members.

INTRODUCTION

The oil and natural gas industry recognizes the concerns across the country over the higher energy costs American consumers and businesses have been facing this year. Until recently, the focus has been on gasoline and other motor fuels. As the colder weather approaches, however, attention is shifting to the cost of heating fuels, particularly natural gas and heating oil. This statement is intended to address these concerns. The industry is also cognizant of the criticism leveled at it for what may appear to others as unreasonable or unjustified prices and high earnings. This

statement will attempt to address those concerns and to offer the proper context in which to view both prices and earnings.

FACTORS IN THE COST OF GASOLINE

Hurricanes: The catastrophic impact of Hurricanes Katrina and Rita on our industry cannot be overstated. Because the Gulf Coast is the heartland of our industry—particularly the area between New Orleans and Houston—the two storms challenged our industry as it has not been challenged in decades. The men and women of the oil and natural gas industry not only responded to Katrina and Rita, they lived it. Thousands of our employees and their families and friends are also suffering the hardships of living in New Orleans, Lake Charles, Beaumont, Port Arthur and Pascagoula, and throughout this devastated region they call home. Many were left homeless. In concert with fire and police officials, neighbors, suppliers, and government authorities, our companies worked to restore oil and natural gas production, bringing the refineries back online, and restarting the pipelines—while at the same time grieving over the loss of homes, neighborhoods, and even loved ones.

The Gulf Coast region includes some 4,000 offshore platforms in federal waters, dozens of refineries and natural gas processing plants, and hundreds of transportation and marketing facilities. These federal waters account for nearly 30 percent of the nation's crude oil production and approximately 20 percent of the natural gas production.

Over the last two months, our companies have made much progress in recovering from the hurricanes, but much remains to be done. Almost 67 percent of oil production in the Gulf of Mexico is shut down and 50 percent of natural gas production in the Gulf is shut down. While many refineries, pipelines, and other facilities are back in operation, or are about to be, some facilities remain damaged and out of service. Fuels are flowing to consumers nationwide, but at reduced levels, posing a more difficult challenge for our companies to keep up with demand for gasoline and other products.

Imports of gasoline have helped ease the tightness of gasoline supply, as has consumer response to calls for wiser use of energy. Nevertheless, we continue to face tight supplies.

Wiser and more efficient use of energy in this time of tight supply is crucial—as important as our efforts to bolster supply. Companies are working night and day to get fuels to where they are needed in the quantities they are needed. And they are supplementing domestic production with increased imports of gasoline to help alleviate tight supplies.

While we will attempt to provide you with the latest information we have, we would caution you that the situation can change markedly from day to day, from the standpoint of what we know and what actual progress has been made.

We know that the effects of Hurricanes Katrina and Rita on our industry are having a nationwide impact. We understand how Americans throughout the country have faced increased prices for gasoline and other fuels. However, we believe the market is working, as prices have moderated in recent weeks and are now well under the post-Katrina highs. What follows is background on two key components of the price of gasoline: crude oil price and taxes.

Crude oil costs: Crude oil is the single largest component of the price of a gallon of gasoline. Before Hurricanes Katrina and Rita struck, the price of gasoline was rising primarily because U.S. refiners have been paying more for crude oil. In fact, the Federal Trade Commission noted this exact point in a report this July:

To understand U.S. gasoline prices over the past three decades, including why gasoline prices rose so high and sharply in 2004 and 2005, we must begin with crude oil. The world price of crude oil is the most important factor in the price of gasoline. Over the last 20 years, changes in crude oil prices have explained 85 percent of the changes in the price of gasoline in the U.S.

It is important to remember that oil companies do not set the price of crude oil. Crude oil is bought and sold in international markets and the price paid for a barrel of crude oil reflects the market conditions of the day. There is a fragile balance between the world's supply and demand for crude oil. Because of this tight market, any disruption of oil supply—or even the threat of disruption—can push prices upward as buyers and sellers in the worldwide marketplace look to secure supplies for their customers. Obviously, the disruptions caused by the hurricanes were significant, as were the effects of these disruptions on fuel prices.

While more than half the cost of gasoline is for crude oil, every time a motorist pulls up at the pump, he or she pays an average of 46 cents in federal and state

taxes per gallon of gasoline. State taxes range from 26 cents to 63 cents per gallon. The remainder is the cost to refine, distribute and sell the gasoline, and profits.

Returning to normal operations: Our industry has never experienced back-to-back events like Hurricanes Katrina and Rita and their brutal aftermath. The hurricanes hit an industry that was already stretched to its limit by an extraordinarily tight global supply and demand balance. As EIA notes in its October Short-Term Energy Outlook, "The impact of the hurricanes on oil and natural gas production, oil refining, natural gas processing, and pipeline systems has further strained already-tight natural gas and petroleum product markets on the eve of the 2005-2006 winter heating season." EIA anticipates crude oil prices to average about \$64.50 per barrel through the end of 2006. And, EIA estimates that natural gas heating costs will be about 50 percent higher this winter, assuming the winter is not colder than normal. The damage wrought by Katrina and Rita has clearly exacerbated the very market conditions that have led to today's higher prices.

Oil and gasoline prices jumped immediately after Katrina due to the widespread damage to energy infrastructure, but have moderated slightly as the industry restores operations. Oil prices rose to nearly \$70 per barrel, but have moderated to around \$60 per barrel. Similarly, the average price for gasoline nationwide jumped 46 cents per gallon in the week after Katrina hit, rising from \$2.65 to \$3.11 per gallon. However, as companies restarted some affected refineries and pipelines and the damage from Rita appeared less severe than expected, gasoline prices moderated. As of November 7, nationwide gasoline prices (for all grades) averaged \$2.38 per gallon. Natural gas prices have declined, closing at \$11.4125 per million Btu (MMBtu) on November 4. That is about a 20 percent decrease from the record of \$14.338 per MMBtu set on October 25. However, \$11.4125 per MMBtu is 43.5 percent higher than last year. And, it was only 4-5 years ago that natural gas prices averaged in the \$2-3 MMBtu range.

EIA now forecasts that typical per-household expenditures for home heating oil will be significantly higher this winter when compared with last year: \$350 (48 percent) more for natural gas users; \$378 (32 percent) more for heating oil users; and \$325 (30 percent) more for propane users. To help the most economically vulnerable cope with higher bills during this time of crisis, we urge Congress to fully fund the Low-Income Home Energy Assistance Program (LIHEAP).

ZERO TOLERANCE FOR PRICE GOUGING

In the aftermath of Hurricanes Katrina and Rita and their effects on gasoline prices, we have seen repeated accusations that the oil and natural gas industry is engaging price gouging. Nothing could be further from the truth. In fact, API and its member companies condemn price gouging. We have said so repeatedly, including in nationwide advertising. There is zero tolerance for those who break the law.

History provides an important guide here. Our industry has been repeatedly investigated over many decades by the Federal Trade Commission, other federal agencies, and state attorneys general. Of the more than 30 investigations, none has ever found evidence that our companies have engaged in any anti-competitive behavior to drive up fuel prices.

Marketing complexity: The gasoline marketing system has the complexity and flexibility required to meet the varying needs of both companies and consumers. Companies have three basic types of outlet options and may employ any and all in their marketing strategies to maximize efficiencies, compete in the marketplace and serve consumers. First, they can own and operate the retail outlets themselves (company owned and operated outlets). The second option is to franchise the outlet to an independent dealer and directly supply it with gasoline. This option may have three different forms of property ownership: The operator can lease from the refiner, lease from a third party, or own the outlet outright. The third option is to utilize a "jobber," who gains the right to franchise the brand in a particular area. Jobbers can choose to operate some of their outlets with their own employees and franchise other outlets to dealers. The mix of distribution methods varies widely across firms. Different refiners, depending on which type is perceived as most efficient, use different types of outlets.

Retailers are typically categorized as branded and unbranded sellers of fuel. Those who are retailers of unbranded gasoline generally pay lower wholesale prices for gasoline and they attract customers with generally lower retail prices. These retailers price gasoline at retail based on an unbranded "rack" price. They typically shop around in the marketplace, without any binding long-term contracts, in order to obtain the best price. Understanding up-front that there is a certain degree of supply and price risk associated with this method of petroleum retailing, gasoline purchased by an unbranded retailer and priced off an unbranded rack price thus

entails no long-term relationship or security of supply between buyer and seller. Most importantly, unbranded purchases do not typically allow the purchaser the use of the supplier's brand name.

In contrast, a branded retailer is obligated by a contract to buy branded gasoline and pay a "dealer tank wagon" (DTW) price, which is generally higher than the rack price. Branded product is typically priced somewhat higher because it offers the dealer greater security of supply and the right to use the supplier's brand name. This makes sense when one considers the investment in the brand name and the importance to both the supplier and retailer of assuring reliable and uninterrupted supply to customers.

In periods of market tightness, however, when a supplier may not have enough product to supply all branded dealers plus the unaffiliated, unbranded buyers, the unbranded retailers, without supply contracts, may pay higher wholesale prices than name-brand retailers. This typically occurs when there is a supply disruption caused by a pipeline or refinery breakdown—such as was caused by the two recent hurricanes.

GASOLINE PRICES AND THE WORLD OIL MARKET

As noted above, prices are rising because of the forces of supply and demand in the global crude oil market. Supply and demand is in a razor-thin balance in the global market. Small changes in this market have a big impact.

World oil demand reached unprecedented levels in 2004 and continues to grow. Strong economic growth, particularly in China and the United States, has fueled a surge in oil demand. The U.S. Energy Information Administration (EIA) reports that global oil demand in 2004 grew by 3.2 percent—the strongest growth since 1978—and projects growth to average 1.8 percent this year and next. By comparison, world demand between 1993 and 2003 grew at an average rate of 1.6 percent.

At the same time, world oil spare production capacity—crude that can be brought online quickly during a supply emergency or during surges in demand—is at its lowest level in 30 years. Current spare capacity is equal to only about 1 percent of world demand. Thus, the world's oil production has lagged, forcing suppliers to struggle to keep up with the strong growth in demand.

The delicate supply/demand balance in the global crude oil market makes this market extremely sensitive to political and economic uncertainty, unusual weather conditions, and other factors. Over the past several years, we have seen how the market has reacted to such diverse developments as dollar depreciation, cold winters, the post-war insurgency in Iraq, hurricanes in the Gulf of Mexico, the Venezuelan oil workers' strike in 2002-2003, uncertainty in the Russian oil patch, ongoing ethnic and civil strife in Nigeria's key oil producing region, and decisions by OPEC.

While consumer concern about high gasoline prices is very understandable, we must recognize that gasoline prices mirror crude oil prices. Crude oil costs make up more than 50 percent of the cost of gasoline. Retail gasoline prices and crude oil prices have historically tracked, rising and falling together. When supply is abundant and demand is low, we see the opposite of today's situation: in late 1998, crude oil was selling under \$11 per barrel—and gasoline was selling for less than \$1 a gallon.

We currently import more than 60 percent of the crude oil and petroleum products we consume. American refiners pay the world price for crude and distributors pay the world price for imported petroleum products. U.S. oil companies don't set crude oil prices. The world market does. Whether a barrel is produced in Texas or Saudi Arabia, it is sold on the world market, which is comprised of hundreds of thousands of buyers and sellers of crude oil from around the world.

NATURAL GAS

Natural gas fuels our economy—not only heating and cooling homes and businesses but also generating electricity. It is used by a wide array of industries—fertilizer and agriculture; food packaging; pulp and paper; rubber; cement; glass; aluminum, iron and steel; and chemicals and plastics. And, natural gas is an essential feedstock for many of the products used in our daily lives—clothing, carpets, sports equipment, pharmaceuticals and medical equipment, computers, and auto parts. Only 4 to 5 years ago, natural gas prices were in the \$2 to 3 per million Btu (MMBtu) range. Recently, prices have settled in the \$12-14 per MMBtu range, setting record levels in October. Higher natural gas prices have taken their toll—more than 2.8 million U.S. manufacturing jobs have been lost since 2000, and chemical companies closed 70 facilities in the year 2004 alone and have tagged at least 40 more for shutdown.

Unlike oil, natural gas imports in the form of liquefied natural gas (LNG) are limited by the lack of import terminals. There are only five operating in the United States. A number of additional terminals have been proposed but many have run into not-in-my-backyard opponents and complex permitting requirements. While natural gas imports from Canada have been important, Canada's own needs are growing. Expanding our ability to tap into global natural gas supplies is essential.

The National Petroleum Council (NPC) study, "Balancing Natural Gas Policy: Fueling the Demands of A Growing Economy" (2003) highlighted the significant costs associated with current policies—such as access restrictions on the OCS and process impediments to development in the West—that do not support the development of America's abundant natural gas resources. The NPC estimated that continuing on our current policy path could result in \$300 billion more in consumer costs over 20 years.

More than 60 million homes are heated by natural gas. A cold winter will make already high costs even higher for consumers.

EARNINGS

There is considerable misunderstanding about the oil and natural gas industry's earnings and how they compare with other industries. The oil and natural gas industry is among the world's largest industries. Its revenues are large, but so are its costs of providing consumers with the energy they need. Included are the costs of finding and producing oil and natural gas and the costs of refining, distributing and marketing it.

It should not be forgotten that the energy Americans consume today is brought to us by investments made years or even decades ago. Today's oil and natural gas industry earnings are invested in new technology, new production, and environmental and product quality improvements to meet tomorrow's energy needs. Oil & Gas Journal estimates that the industry's total U.S. reinvestment this year will be \$85.7 billion, compared with \$80.7 billion in 2004 and \$75.5 billion in 2003. It also estimates that exploration and production spending in the U.S. will grow 6 percent this year and that total upstream oil and gas spending will reach nearly \$66 billion. A single deepwater production platform can cost in excess of \$1 billion.

The industry's earnings are very much in line with other industries—and often they are lower. This fact is not well understood, in part, because the reports typically focus on only half the story—the total earnings reported. Earnings reflect the size of an industry, but they're not necessarily a good reflection of financial performance. Earnings per dollar of sales (measured as net income divided by sales) provide a more relevant and accurate measure of a company's or an industry's health, and also provide a useful way of comparing financial performance between industries, large and small.

For the second quarter of 2005, the oil and natural gas industry earned 7.7 cents for every dollar of sales compared to an average of 7.9 cents for all U.S. industry.¹ Many industries earned better returns in the second quarter than the oil and natural gas industry. For example, banks realized earnings of 19.6 cents on the dollar. Pharmaceuticals reached 18.6 cents, software and services averaged 17 cents, consumer services earned 10.9 cents and insurance saw 10.7 cents for every dollar of sales. (For the third quarter, the oil and natural gas industry earned 7.4 cents for every dollar of sales. The average figure for all U.S. industry is not yet available.) Last year, the oil and natural gas industry realized earnings of 7 percent, compared to an average of 7.2 percent for all U.S. industry. Over the last five years, the oil and natural gas industry's earnings averaged 5.7 cents compared to an average for all U.S. industry of 5.5 cents for every dollar of sales.

WINDFALL PROFITS TAX

Along with the charges of unjustified high fuel prices we are also hearing calls for reinstatement of a windfall profits tax (WPT) as a response to the nation's energy challenges. Such demands ignore one very basic fact: by any reasonable standard, our industry's earnings cannot be categorized as "windfall," as can be seen by the figures above. To single out one industry for earnings that are in line with other industries—or lower—would send a dangerous message to America's business community and to the hundreds of thousands of individual and institutional investors—including pension funds—who trust our industry with a significant portion of their financial future.

¹Earnings equal profits divided by sales calculated from "Corporate Scorecard," *Business Week*, August 22/29, 2005; and from company financial reports for oil and natural gas figures.

Strong earnings enable our industry to remain competitive globally, where they must compete with government-owned national oil companies, and benefit millions of shareholders. These earnings enable the industry to invest in innovative technologies that improve our environment and increase energy production to provide for America's future energy needs. Levying new taxes would likely end up harming consumers. As *The Wall Street Journal* editorialized, ("China Does Carternomics," August 19), "A windfall profits tax only discourages increases in supply by disincentivizing further production."

Again, we should let history be our guide. The WPT was enacted in 1980 to raise revenue and to ensure that oil companies did not benefit unduly as domestic price controls were removed in a period of relatively high crude oil prices. While it failed to raise the revenues predicted due to declining oil prices in the 1980s, the WPT did drain \$79 billion in industry revenues that could have been used to invest in new oil and gas production, according to the Congressional Research Service (CRS). In fact, as many as 1.6 billion fewer barrels of oil were produced domestically due to the WPT, according to CRS. This lesson is particularly important to remember as the nation continues to experience very tight energy markets, combined with ever-rising demand for petroleum products.

Clearly, a WPT was a bad idea in the 1980s, and it is an even worse idea today in light of the tremendous capital investment that will be needed in the nation's oil and natural gas sector to meet the accelerating growth in U.S. energy demand.

The Windfall Profit Tax remains a bad idea for several reasons:

- As stated above, the oil and natural gas industry is not earning "windfall profits." The reality is that the industry's earnings have been very much in line with other industries, and often they are lower. According to *Business Week* and *Oil Daily*, the oil and natural gas industry earned 5.7 cents for every dollar of sales compared to an average of 5.5 cents for all U.S. industry over the past five years.
- The oil industry uses its earnings to invest in new technology, new production, refining and product distribution infrastructure, and environmental and product quality improvements. According to the Congressional Research Service (CRS), before the WPT was repealed in 1988, it generated about \$79 billion in gross revenues—money that could have been used by the oil industry to invest in new energy production and infrastructure.
- The National Petroleum Council projects that producers will have to invest almost \$1.2 trillion through 2025 to fund U.S. and Canadian natural gas exploration and production activities and \$200 million for infrastructure. Investments of this magnitude require long-term fiscal stability, while a WPT would establish a precedent that could discourage investment in domestic energy production.
- Crude oil prices, which are set on the world market, and natural gas prices fluctuate substantially and unpredictably. The industry must manage its business in the face of these severe price fluctuations, riding out the low prices in anticipation of recovering during higher prices. In fact, as recently as 1999, the petroleum industry was weathering depressed oil prices of around \$10 per barrel.
- A WPT taxes away the benefits of better times and offers no help to oil and gas companies during bad times. This discourages investment in domestic production and increases U.S. dependence on imported oil. The CRS concluded that between 1980 and 1986 the WPT reduced American oil production by as much as 1.6 billion barrels.
- The WPT is an overly complex tax. Administering the WPT cost oil companies an estimated \$100 million per year and the government an additional \$15 million per year. These costs continued to be incurred even after the tax had ceased to produce any meaningful revenues.

Proposals for energy industry funding of LIHEAP: In recent weeks, we have heard numerous proposals that the oil and natural gas companies be forced to turn over some of their earnings to fund low-income heating assistance programs. The oil and natural gas industry recognizes the hardship on families of high energy costs and has consistently supported full funding of the Low Income Home Energy Assistance Program (LIHEAP) program each year. Congress should continue to provide full funding for the program.

LIHEAP is funded by Congress each year and those funds are then provided as block grants to the states, U.S. territories, the District of Columbia and recognized American Indian tribes and tribal organizations for their use in assisting families. The Federal Government traditionally has had the primary responsibility of helping families needing energy assistance. In addition, LIHEAP provides assistance for all

types of home energy bills including electricity (whether produced from natural gas, nuclear, coal, hydro, or renewable fuels).

LIHEAP is a vital program that is designed to respond to problems that result from a variety of market forces, including tight supplies. Congress needs to address the supply problem directly by providing access to the oil and natural gas reserves that are off limits in non-park lands in the West and under the waters off our coasts. These recoverable reserves would provide enough natural gas to heat 125 million homes for 120 years, and 131 billion barrels of recoverable oil, enough to produce gasoline for 73 million cars and fuel oil for 30 million homes for 60 years.

As noted earlier, the hurricanes devastated the Gulf Coast states, their communities, their farms and their businesses. The region's oil and gas production and refining facilities were particularly hard hit, cutting deeply into normal supplies of energy. The Congressional Budget Office estimates the damage to the energy industry along the Gulf coast to have been \$18-\$31 billion. API member companies continue to be heavily engaged in efforts to get fuels flowing to consumers across the country. The companies will continue to increase supply as they spend billions of dollars to restore production and refining capacity in the region. These companies have donated tens of millions of dollars to charitable organizations working in the Gulf Coast recovery and restoration effort, while joining hand-in-hand with those non-profit organizations and government agencies to rebuild lives and communities.

For government to insist that one industry give extra funds to an appropriately government sponsored program—above and beyond what it has already contributed through its taxes, and through its private charitable contributions—would set a dangerous precedent, allowing government to shift its responsibilities to various segments of the private sector, depending on the political winds of the day.

ENERGY PRICES: WHAT CAN BE DONE?

The solution to high prices is more supply of crude oil and gasoline and natural gas, but there is no simple strategy to make that happen. The United States is at a critical turning point in shaping its future energy policy. The Energy Policy Act of 2005, signed by the President in August, signals a first step in a much-needed effort to enhance energy security and ensure the reliable delivery of affordable energy to consumers. But much remains to be done.

The problems we face are very real: growing world demand for energy; a lack of national commitment to develop our abundant domestic energy resources and critical infrastructure; and scant attention to energy efficiency. These factors have resulted in a tight supply/demand balance for U.S. consumers, causing recurring price spikes, greater market volatility, and overall strain on the nation's energy production and delivery systems.

Energy demand continues to grow. The Energy Information Administration (EIA) forecast that by 2025, U.S. energy consumption will increase by 35 percent, with petroleum demand up by 39 percent and natural gas up by 34 percent. These demand increases occur despite expected energy efficiency improvements of 33 percent and renewable energy supply increases of 41 percent.

Additional EIA forecasts point out our basic problem: Domestic energy supplies are not keeping up with increased demand; and we are relying more and more heavily on imports to meet our energy needs. EIA projects that U.S. crude oil production will fall by 17 percent by 2025 (assuming no production from ANWR), while crude oil imports will increase by 67 percent, and net petroleum product imports increase by 90 percent. Given these trends, it comes as no surprise that EIA forecasts that our nation's dependency on foreign sources of petroleum will rise from 59 percent today to 68 percent in 2025.

This increase, to the extent that it reflects import costs lower than domestic supply costs, would represent a gain from trade which should be encouraged. However, when we have resources that can be developed at prices competitive to imports, and we choose not to do so, we place a wasteful and unnecessary burden on our own consumers.

In fact, we do have an abundance of competitive domestic oil and gas resources in the United States. According to the latest published estimates, there are more than 131 billion barrels of oil and more than 1000 TCF of natural gas remaining to be discovered in the U.S.

However, 78 percent of this oil and 62 percent of this gas are expected to be found beneath federal lands and coastal waters.

Federal restrictions on leasing put significant volumes of these resources off limits, while post-lease restrictions on operations effectively preclude development of both federal and non-federal resources. The most comprehensive study of the effects of such constraints was the 2003 National Petroleum Council study of natural gas,

which included an analysis of federal constraints on U.S. gas supply in two key areas—the Outer Continental Shelf (OCS) and the Rockies. The study found that in key areas of greatest supply potential, federal policy precludes or seriously constrains development. For instance, of the 209 TCF of estimated undiscovered gas in the Rockies, 69 TCF is completely off limits, while another 56 TCF is seriously constrained by federal policy. That is 125 Tcf that is restricted—enough to heat 60 million homes for 30 years. On the OCS, the Atlantic, Pacific and Alaskan offshore, and most of the Eastern Gulf of Mexico are off limits to development.

The OCS resources off the lower 48 states alone are enough to provide gasoline for 1116 million cars and heating oil for 47 million homes for 47 years, plus enough natural gas to maintain current production levels for almost 70 years. Furthermore, the study found that sustaining these constraints over the next 20 years would cost U.S. consumers more than \$300 billion in increased energy costs.

We are aware that opponents of oil and natural gas development still raise environmental concerns. However, history provides overwhelming evidence that our industry can find and develop oil and natural gas resources safely and with full protection of the environment, both on land and offshore. For example, according to the U.S. Coast Guard, from 1980 to 1999, 7.4 billion barrels of oil were produced in federal offshore waters, with less than 0.001 percent spilled, less than the volumes of natural seeps that occur on the sea floor. The industry's leak prevention performance in offshore production during three major hurricanes (Ivan, Katrina and Rita)—two of them back-to-back—within 12 months, featuring 170 miles-per-hour winds and seas of up to 100 feet, continues this remarkable environmental record.

Using advanced technology and sound operational practices, our industry has steadily reduced the environmental impact of oil and gas development, both onshore and offshore. The surface presence for exploration and development wells has shrunk significantly. For example, a drilling pad the size of the Capitol is all that would be needed to access any oil reserves that might exist in the entire 68.2 square mile District of Columbia. Horizontal and directional drilling now enables our industry to drill multiple underground wells from a single pad, sometimes reaching sites as far away as 10 miles from the drilling pad.

Additionally, the U.S. oil and natural gas industry is among the most heavily regulated industries in our country. Every lease contains a standard stipulation to protect air, water, wildlife and historic and cultural resources, but leases may also include up to nearly 1,000 additional stipulations to further protect resources.

The recently enacted Energy Policy Act of 2005 takes a positive step by requiring an inventory of OCS oil and natural gas resources. It will not, by itself, result in new energy supplies.

We need to build on the energy legislation by opening offshore areas, ANWR and resource-rich lands in the West to encourage the flow of more American natural gas and oil to the marketplace. And, while we must focus on producing more energy here at home, we do not have the luxury of ignoring the global energy situation. In the world of energy, the U.S. operates in a global marketplace. What others do in that market matters greatly.

For the United States to secure energy for our economy, government policies must create a level playing field for U.S. companies to ensure international supply competitiveness. With the net effect of current U.S. policy serving to decrease U.S. oil and gas production and to increase our reliance on imports, this international competitiveness point is vital. In fact, it is a matter of national security.

We can no longer wait 12 years, as we just did, to address our nation's energy policy. The energy legislation is a foundation, but it must be built upon. More needs to be done and more quickly, particularly increasing access to offshore resources. We have the ingenuity, the technology, and environmental protections. If enactment of the energy legislation means we have a commitment to continued action, then it will truly be a turning point in reshaping U.S. energy policy.

REFINERIES

We cannot understand or deal with high gasoline prices if we do not consider the state of refineries in the United States. During the 1980s-90s, the oil industry earned relatively poor rates of return on their investments. This was especially true in the refining sector, which was hard hit with the need for new investment in technology and equipment to meet various environmental requirements and to produce cleaner burning fuels.

Attracting capital for new refinery capacity has been difficult with refining rates of return historically averaging well below the average for S&P Industrials. Over the 10-year 1994-2003 period, the return on investment for the refining and marketing sector was 6.2 percent or less than half as much as the 13.4 percent for S&P

Industrials. In only one year between 1977 and 2003 did the average return of refiners exceed the average for the S&P Industrials.

Reflecting unprecedented infrastructure damage incurred by Hurricane Katrina, refiner margins² peaked on August 31st at levels nearly 3 times higher than pre-hurricane margins. These margins peaked again with the arrival of Hurricane Rita, this time at a lower level, and then returned to pre-hurricane levels within a week or two.

From 1994 to 2003, the industry spent \$47.4 billion to bring refineries into compliance with environmental regulations. That included \$15.9 billion in capital costs and \$31.4 billion in operations and maintenance costs to comply with regulations covering air, water and waste rules. Moreover, by 2010, the U.S. refining industry will have invested upwards of \$20 billion to comply with new clean fuel regulations. This is in addition to the cost of compliance with many dozens of other environmental, health, safety and security regulations. All this investment severely reduces the funds available for discretionary capacity expansion projects.

Technological advancements have helped refineries produce more from existing facilities than they did in the past. Refineries are doing a better job of bringing product to market for less—and the consumer has benefited. Even though a new refinery has not been built from scratch in 30 years, existing refineries are continually being upgraded and reworked to improve efficiency. Inefficient process units are replaced and new units are built to provide more fuel processing flexibility. U.S. refining capacity has expanded from 14.7 million barrels per day in 1994 to 17.1 million barrels a day today, or 2.4 million barrels a day. This expansion is the equivalent of about 12 new 200,000 a day capacity refineries. Based on publicly available data on announced refinery capacity expansion plans, at least 1 million barrels/day of additional refinery capacity projects are either planned or under strong consideration for the years 2005-2009.

We can see this in the decline in the refiner/marketer margin (measured as the difference between the retail price of gasoline minus taxes and minus the refiner's composite crude oil price). Back in 1980, the cost to refine and market and distribute gasoline averaged about 95 cents per gallon (in inflation-adjusted terms). By 1990, it averaged more than 61 cents per gallon, and, by 2000, it was 52 cents per gallon, which is about where it has averaged over the last five years. Multiplying these reductions by the 330 billion gallons of petroleum products consumed translates into billions of dollars of savings for consumers. All Americans benefit every day from these improvements and efficiency gains.

Removing refinery capacity constraints: The record-high gasoline prices, while primarily caused by increased crude oil prices and exacerbated by Hurricanes Katrina and Rita, have underscored the fact that U.S. demand for petroleum products has been growing faster than—and even exceeds—domestic refining capacity. While refiners have increased the efficiency, utilization and capacity of existing refineries, these efforts have not enabled the U.S. refining industry to keep up with growing demand.

The U.S. refining industry has been expanding a little more than 1 percent per year over the past decade—the equivalent of a mid-size refinery being built each year. In order to create the opportunity for increasing the growth of U.S. refinery capacity, government policies are needed to create a climate conducive to investments to expand domestic refining capacity.

In addition, many of the steps the Federal Government could take to help the refinery capacity situation are covered in the December 2004 National Petroleum Council (NPC) study, *Observations on Petroleum Product Supply—A Supplement to the NPC Reports "U. S. Petroleum Product Supply—Inventory Dynamics, 1998" and "U.S. Petroleum Refining—Assuring the Adequacy and Affordability of Cleaner Fuels, 2000."*

The NPC study suggested that the Federal Government should take steps to streamline the permitting process to ensure the timely review of federal, state and local permits to expand capacity at existing refineries.

For example, new-source review (NSR) requirements of the Clean Air Act need to be reformed to clarify what triggers these reviews. Some refineries may be able to increase capacity with relatively minor adjustments, but are unsure if the entire facility's permit review would be triggered—a burdensome and time-consuming process.

In addition to the administrative issues deterring new refining capacity investments, there are financial constraints as well. Attracting capital for new refinery capacity has been difficult with refining rates of return historically averaging well

² Refiner margins measured by the difference between the wholesale price of gasoline and the price of light sweet crude oil traded on the NYMEX.

below the average for S&P Industrials. Over the 10-year 1994-2003 period, the return on investment for the refining and marketing sector was 6.2 percent or less than half as much as the 13.5 percent for S&P Industrials. In only one year between 1977 and 2003 did the average return of refiners exceed the average for the S&P Industrials.

While taking these factors into account, it is important to remember that the oil and natural gas industry operates in a global marketplace. Many oil and gas companies are global companies, whose U.S. investment decisions compete not only with decisions as to how to allocate capital investments in the U.S. among various sectors of the industry, but also with competing demands and investment needs overseas. In a global marketplace, companies will make the best economic investment decisions in order to bring affordable petroleum products to consumers. Imports may be the more economical option than new U.S. refineries, but that is a decision to be left to the global marketplace. Government policies must encourage, not interfere with, the global marketplace.

REFINERY AND PIPELINE INFRASTRUCTURE RECOMMENDATIONS

Assessing hurricane impacts: The Department of Energy, with assistance from the National Petroleum Council, should conduct a comprehensive study of the impact of the recent hurricanes and the market response to determine whether there are measures that could be put in place to lessen the impact of such events.

Streamline permitting process: Streamline the permitting process for refineries, storage facilities, and pipelines so that new or expanded capacity and repairs are not held up by regulatory bottlenecks. A lead agency should be established for permit reviews—DOE for refining and DOT for pipeline. Congress should consider actions to facilitate expansion of oil pipeline capacity.

Lifting barriers to capacity expansion: Barriers need to be lifted from existing refineries so that the outlook for domestic capacity expansions and crude/product flexibility projects can improve where the infrastructure is already in place.

- It is important to reconsider NAAQS PM2.5 and ozone attainment deadlines in major refining areas (Houston/Philadelphia) which will act as a constraint to the growth of such capacity.
- Given that the current standards are being implemented now, and the significant health science uncertainties, Congress should defer the current standard review process until the next statutory review cycle (2010-2012). The current ozone and PM2.5 quality standards should remain in effect for now.
- New Source Review reforms should be codified to add certainty around when the permit reviews are triggered.

Allow federal preemption in emergencies: The Federal Government should be given absolute federal fuel preemption authority to waive both federal and state environmental and product quality fuel requirements. The period of waivers should be extended from 90 to 120 days.

Reduce number of state “boutique fuels” requirements: There are many local fuel specifications that require special production and handling, causing inefficiencies in the distribution system and increased volatility when refining or supply interruptions occur. Congress could improve this situation by reducing the number of “boutique fuels.”

Establish emergency powers authorities: This would facilitate an effective response to future emergencies. Give federal agencies authority to grant short-term relaxation of federal and state requirements in the event of emergencies to expedite bringing pipelines and distribution facilities back on-line. Policymakers should consider establishing emergency powers authorities for priority power restoration for all components of the oil and natural gas infrastructure to be used in emergency situations.

Improve electric system reliability: Improvements that enhance the reliability of electric power supply will significantly enhance the availability of petroleum products during periods of temporary emergency, such as that which occurred in the Gulf Coast region post-hurricane.

Reasonable pipeline operations: Support legislative and administrative action by FERC that would facilitate emergency response to disasters by pipeline operators and that would encourage expansion of existing infrastructure and new service.

Reduce likelihood of imports bottlenecks: The Coast Guard and the Minerals Management Service should assess the marine infrastructure and identify current and potential future bottlenecks to imports, particularly in emergency situations when above-normal import levels may be desirable.

NATURAL GAS RECOMMENDATIONS

Given the importance of natural gas throughout the economy and the approach of the winter heating season, attention has begun to focus not only on ways to use natural gas more wisely, but also on how to enhance future supplies. America's oil and natural gas industry supports the following actions:

Low-Income energy assistance: Congress should fully fund the Low Income Home Energy Assistance Program (LIHEAP), and it should release LIHEAP funds early. Providing early funds to those in need can help prevent defaults on home heating bills and service curtailments.

Offshore Development: The OCS inventory required by the Energy Policy Act of 2005 should be promptly conducted to allow states and the nation as a whole to fully appreciate the sizable resources off our coasts that have been placed "off limits" to development. While current estimates indicate substantial resources, these are based on older data and are likely to be conservative. Using advanced computers and programs to review the resource base will enable policymakers and their constituents to more fully understand the true costs of OCS moratoria.

Lifting moratoria. Restrictions on federal lands off the Atlantic and Pacific coasts, Alaska and most of the Eastern Gulf of Mexico have put 77 billion barrels of oil and 420 trillion cubic feet (Tcf) of natural gas off limits. That is enough natural gas to heat more than 100 million homes for over 60 years. And, it is three times the natural gas resources of Canada and Mexico combined.

Giving states greater authority: States deserve the right to opt out of moratoria by choosing to develop resources off their coasts. This could help supply additional, critically needed natural gas and oil supplies to American consumers. Natural gas resources off the lower 48 states alone are estimated to be enough to maintain current natural gas production for almost 70 years and could supply current industrial and commercial needs for 29 years.

Adopting expansive 5-year lease sale program: The Minerals Management Service (MMS) is in the process of preparing its next 5 year plan. The first step in this process, its recent call for information, drew record support for OCS development. To maximize future supplies of natural gas, MMS should include all areas (not under moratoria) in their leasing program; expand OCS acreage offered for sale in Alaska, including the Beaufort and Chukchi seas and Bristol Bay; and schedule an early sale for the remaining Sale 181 acreage. The Sale 181 area is particularly important as it has substantial resource potential and access to existing infrastructure that could speed delivery of its resources to energy users. And, an early sale would send a powerful signal to energy markets.

Streamlining Coastal Zone Management process: Uncertainties that can impede/deter resource development can be reduced if: a deadline of 120 days (from filing of an appeal) is set for review and decisions on state appeals of consistency findings; initial action is taken to reach federal and state agreement on information needed for the decision-making process; and a single consistency finding is allowed. The CZM process has proved to be a major impediment, allowing states to challenge oil and gas projects more than a hundred miles off their shores and leaving some projects in limbo as approval decisions can take years.

DEVELOPING ONSHORE RESOURCES RECOMMENDATIONS

Onshore lands in the Mountain West and Alaska hold great potential for additional domestic supplies if access is allowed and permitting and regulatory process impediments removed. Alaska has significant resource potential—estimates of 69 Tcf of natural gas and 18 billion barrels of oil. For example, the mean estimate of oil in the Arctic National Wildlife Refuge (ANWR) is 10 billion barrels (EIA), enough to replace current levels of imports from Saudi Arabia for 20 years. Actions needed include:

Expanding access to Alaskan resource-rich areas: Congress should open ANWR. In an area the size of South Carolina (19 million acres) exploration and production activity would likely only affect an area comparable to Dulles airport (2,000 acres). We should also expand leasing in the National Petroleum Reserve-Alaska, and we should provide support for the building of the necessary infrastructure to bring Alaska natural gas supplies to consumers in the lower 48 states.

While Alaska's onshore resources will be critical to sustaining a healthy energy future, it will take a while to develop them. In the shorter term (2-5 years) the abundant natural gas resources in the Mountain West can provide much needed domestic supplies. However, vast areas of multiple-use federal lands have been withdrawn from development directly or indirectly through restrictions and constraints on operations. In assessing these non-park, non-wilderness federal lands, the NPC concluded that 125 TCF of natural gas was effectively off limits to development and/

or significantly affected by access-related regulatory requirements such as no surface occupancy and prohibitions on drilling at certain times of the year. The regulatory process is complicated and duplicative and constitutes an impediment to production of the nation's energy resources. And, legal challenges by antidevelopment groups are growing. In 1999, about 4.5 percent of the leases offered were protested. By 2005, that had grown to 50 percent. For example, in 2004 every lease sold in Utah was protested resulting in delays of up to 18 months.

Improving regulatory process: Measures should be taken to protect the environment, wildlife and historical and cultural properties, but the regulatory process can be improved by removing process impediments. We should allow joint filing of right-of-way and drilling permits for federal lands to expedite the permitting process. We should expand the use of categorical exclusions or sundry notices for minimal disturbance activities, including categorical exclusions for wells and rights of way with minimal surface disturbance in existing fields and sundry notices instead of Applications for Permit to Drill (APDs) for successive wells on multi-well drill pads. Categorical exclusions do not remove the required environmental protections but rather apply to those minimal surface operations where an impact is negligible.

We should also implement Bureau of Land Management's (BLM's) 2003 Process Improvement Memoranda. We should conduct an independent review of agency practices and interpretation of criteria for determining site significance, including establishment of standards for cultural resource reports and eliminating duplicate survey requirements. And we should monitor BLM lease stipulations and conditions of approval to determine their effectiveness and removing them as appropriate.

Providing adequate agency funding: We should have updated resource management plans (RMPs). All activity on BLM lands is managed through RMPs. New lease sales cannot be held without updated RMPs. Further, activities not anticipated in an earlier RMP cannot occur until the plan is updated or amended. Reasonably foreseeable development scenarios should be used as planning tools, not to establish caps on the number of wells or other limits on surface activities. We should improve data sharing by federal and state land management agencies, encourage the use of joint APD/Right-of-Way applications for wells and ensure regulatory compliance through vigorous inspection and enforcement programs. In addition, we should administer the National Environmental Protection Act (NEPA) process effectively; and provide timely resolution of appeals and protests.

Additional measures: If implemented, the above policy suggestions can help result in additional future oil and natural gas supplies essential to our energy security and economic growth. However, with significant amounts of oil and gas production still shut down in the Gulf of Mexico in the aftermath of the recent hurricanes, there are additional measures that could be taken by BLM to expedite onshore production now, including:

- Exercising existing authority to allow year-round drilling and completions to proceed;
- Issuing permits immediately for all applications in areas where existing NEPA requirements have been met;
- Proposing new fast track, emergency response rules when there is a national energy emergency in order to significantly reduce permit review and approval times.

Additionally, the Endangered Species Act (ESA) and National Environmental Policy Act (NEPA) impose an array of regulatory requirements and have provided opportunities for antidevelopment groups to litigate with the intention of delaying or preventing energy projects.

Updating Endangered Species Act: Recent legislation reported out by the House Resources Committee contains a number of process improvements. Industry supports an ESA process that is based on sound science using peer-reviewed data, includes an evaluation of the economic and social impacts of threatened or endangered species designation, encourages the use of voluntary agreements, and recognizes that different levels of protection can be appropriate for different species.

Reforming National Environmental Protection Act (NEPA): Duplicative environmental documentation in the NEPA process should be eliminated, the Environmental Assessment process should be strengthened to help reduce the need for Environmental Impact Statements, and interagency consultation and cooperation should be improved. The NEPA process should be made more objective and timely through the use of best available scientific evidence and clear definitions of information needed for decision-making. In addition, agency monitoring and enforcement should be enhanced.

Tapping global supplies through Liquefied Natural Gas: Despite the growth of alternative fuels, oil and natural gas are expected to provide nearly two-thirds of the

energy America consumes in 2025. And, natural gas demand is forecast to grow 34 percent by 2025, according to Energy Information Administration. While additional domestic supplies can and should be developed, the United States also needs to tap into global supplies of natural gas through liquefied natural gas (LNG) shipments. There are only five LNG receiving terminals currently in operation. To support growth in LNG supplies, LNG project permit applications should be processed within one year. This will require coordinating and streamlining permitting—LNG project sponsors face multiple, often-competing state and local reviews, as well as federal reviews, which result in permit delays. It will also call for setting clear review deadlines and conducting concurrent reviews also can streamline the process. Adequate regulatory agency funding should be provided. Additional funding and staff will be needed to promptly process increased applications for LNG terminals and to administer regulatory programs for these terminals once they are operational. Finally, public education programs on the safety and security of LNG operations should be conducted.

CONCLUSION

The U.S. oil and natural gas industry recognizes the catastrophic impact that Hurricanes Katrina and Rita have had on millions of Americans and our industry is working with government and others in the private sector to do all we can to alleviate their suffering. The industry also recognizes the frustration and hardship felt by consumers as a result of higher prices and a basic misunderstanding of industry earnings.

If we all do our part—industry providing supplies and repairs as expeditiously as possible, government facilitating needed approvals, and consumers adjusting their energy-use habits to consume less fuel—Americans can overcome this challenge as we have others in our nation's history.

