The Oil Industry, Gas Supply and Refinery Capacity: More Than Meets the Eye

An investigative report presented
by Senator Ron Wyden
June 14, 2001

"As observed over the last few years and as projected well into the future, the most critical factor facing the refining industry on the West Coast is the surplus refining capacity, and the surplus gasoline production capacity. The same situation exists for the entire U.S. refining industry. Supply significantly exceeds demand year-round. This results in very poor refinery margins, and very poor refinery financial results. Significant events need to occur to assist in reducing supplies and/or increasing the demand for gasoline."

Internal Texaco document, March 7, 1996

"A senior energy analyst at the recent API (American Petroleum Institute) convention warned that if the U.S. petroleum industry doesn't reduce its refining capacity, it will never see any substantial increase in refining margins…However, refining utilization has been rising, sustaining high levels of operations, thereby keeping prices low."

Internal Chevron document, November 30, 1995

America is indeed facing an energy crunch. For much of the year, gas prices have soared and supply has trailed demand.

During the course of my ongoing investigation into potential anti-competitive and anti-consumer practices by the oil industry, I have obtained documents that raise serious questions about the circumstances leading to limited gas supply and high prices.

The oil industry and its allies would have the public believe that insufficient refining capacity, restrictive environmental standards, growing gasoline demand and OPEC production cutbacks are the primary reasons for the current oil and gas supply problem.

However, the record shows – supported by documents I have obtained – that there is more to the story. Specifically, the documents suggest that major oil companies pursued efforts to curtail refinery capacity as a strategy for improving profit margins; that competing oil companies worked together to subvert supply; that refinery closures inhibited supply; and that oil companies are reaping record profits, yet may benefit from a proposed national energy policy that would offer financial incentives to expand refinery capacity.

For the last several months limited domestic refinery capacity has taken center stage as the purported reason for insufficient domestic gasoline supply and higher prices.

In the mid-1990s too much refining capacity, not too little, concerned the nation's major oil companies. At that time, the oil and gas industry faced what they termed "excess refining capacity," a circumstance they viewed as a financial liability that drove down overall profit margins. The industry reduced the total amount of potential supply by closing down more than 50 refineries in the past decade. Since 1995 alone, 24 refinery closings have taken nearly 830,000 barrels of oil per day.

In September 1999, I released a report looking into the anti-competitive practices of zone pricing and redlining by West Coast oil companies. At the time of the 1999 investigation, industry officials explained higher gas prices as the result of refinery fires in California and worldwide production cuts spurred by OPEC. They did not blame inadequate domestic refining capacity as the culprit for restricted supply or high prices.

Today, the nation's major oil companies are experiencing record profits, thanks in no small part to higher prices at the pump. Despite the across-the-board financial gains of the industry, the Bush administration's recently released National Energy Policy seeks to provide incentives, perhaps including relaxed environmental regulations, to quickly boost refining capacity.

Information I have received during my ongoing investigation raises serious concerns that the nation's major oil suppliers have set out in a strategic effort to orchestrate a financial triple play, a coordinated effort that would reduce supply, raise prices at the pump and relax environmental regulations. Unfortunately, in each case, it is the consumer who takes the hit.

While the documents target activity on the West Coast and refinery closings in 11 states, they point to practices with significant national ramifications. The companies involved are national companies that operate in multiple states. In addition, gas and oil is a fungible commodity and the amount of capacity that has been taken offline is significant enough to affect national markets.

The following information reflects what I have found to date during the course of my investigation.

FINDING 1:
Oil Companies Articulated their "Need" to Reduce Oil and Gas Supply to Increase Prices and Grow Profit Margins

Facing what they deemed inadequate profit margins in the mid-1990's, oil companies readily recognized that the surest way to drive up profits was to drive down oil and gasoline supply. By restricting supply, they would be able to demand higher prices and reap higher margins for their product. Oil company documents raise questions as to whether this mindset was the underpinning of a strategic business approach in which the industry willfully engaged to control gas supply.

Internal oil company documents reveal that in 1995 and 1996 competitor companies strategized about opportunities to tighten product supply as a means of increasing profit margins.

A "Competitor Intelligence Report" from Chevron dated November 30, 1995 states:

> "A senior energy analyst at the recent API (American Petroleum Institute) convention warned that if the U.S. petroleum industry doesn't reduce its refining capacity, it will never see any substantial increase in refining margins…However, refining utilization has been rising, sustaining high levels of operations, thereby keeping prices low."[1]

This concern over too-ample supply driving down profits was echoed in a Texaco document dated March 7, 1996:

> "As observed over the last few years and as projected well into the future, the most critical factor facing the refining industry on the West Coast is the surplus refining capacity, and the surplus gasoline production capacity. The same situation exists for the entire U.S. refining industry. Supply significantly exceeds demand year-round. This results in very poor refinery margins, and very poor refinery financial results. Significant events need to occur to assist in reducing supplies and/or increasing the demand for gasoline."[2]

Not only did the oil companies view excess refining capacity as a financial liability, they openly suggested that eliminating the excess capacity and tightening supply would help improve their bottom line.

These documents show that oil companies had the intent and motive to hamstring supply and reduce refining capacity. Subsequent events show that they acted.

FINDING 2:
Oil Company Competitors Planned Opportunities to Subvert Oil and Gas Supply

On June 11, 2001, the *Wall Street Journal* reported that Marathon Ashland Petroleum intentionally withheld reformulated gasoline supply in the Midwest in a contrived effort to keep prices, and profits, artificially high.[3] Although Marathon was reported to have operated alone in this instance, documents suggest that over the past five years other leading oil companies have worked together to control the amount of gasoline available on the market.

---

[1] Chevron document – Competitor Intelligence Information, November 30, 1995

[2] Texaco memo - Future Gasoline Specifications, March 7, 1996

[3] Wall Street Journal Article, Marathon Ashland Withheld Gasoline, June 11, 2001

A thankyou note dated April 25, 1994, from Tosco CEO Thomas O=Malley to ARCO Executive Vice President James Middleton raises serious questions about how the two companies worked together to control gasoline supply in a manner financially beneficial to both companies:

> "ARCO represents an important part of Tosco=s business. We want to do everything we can to nurture this important business relationship and make sure it keeps up the tradition of being mutually beneficial." [4]

By highlighting the mutually beneficial "tradition" in which these two competitors engaged, the note points to intentional cooperation to improve their respective bottom lines.

During the mid-1990s California, facing severe air quality problems, transitioned to cleaner-burning, reformulated gasoline referred to as CARB (California Air Resources Board) gas. Because this formulation of gasoline was only required in California, fewer suppliers produced the fuel; those who did could play a significant role in setting the price. Documents obtained by my office indicate that several West Coast refiners and suppliers sought cooperative arrangements through which they could keep the supply of CARB gas tight and demand higher prices as a result.

The President of ARCO Products Company William Rusnack admitted in a deposition taken May 15, 1997, that he met with Tosco CEO Thomas O'Malley to discuss opportunities to work together to control supply of the cleaner burning gasoline, thus propping up the overall price.

> "… explore whether or not there was any mutual benefit, any mutual interest, any profit for both ARCO and Tosco to find a way to have ARCO purchase or Tosco sell CARB [cleaner burning California Air Resources Board] gasoline to ARCO, recognizing that the agreement that was in place at that time did not provide for the supply of CARB gasoline."[5]

Cecil Blackwell, a senior Chevron official, described during a deposition a conversation he had with Jay Kowal, a senior ARCO official, in which they discussed possible agreements affecting supply.

> "And he, as I recall, confirmed their interest …and if we can reach a commercial agreement with them, that he felt, you know, this could change some of their investment decisions or change investment decisions of others on supplying CARB gasoline."[6]

---

[4]Thank you note to ARCO Exec. VP James A. Middleton from Tosco CEO Thomas O'Malley, April 25, 1994

[5]Summary of Deposition of William C. Rusnack, President of ARCO Products Co., taken May 15, 1997

[6] Summary of Deposition of Cecil Blackwell, Senior Chevron Official, taken February 19, 1997

Based on information obtained during this and other depositions related to a court case currently before the California Supreme Court, the plaintiff's attorney compiled an index that documents face to face meetings between top competitors in the West Coast oil industry. These meetings between ARCO and Tosco, ARCO and Exxon, ARCO and Chevron, Chevron and Tosco, etc., expose efforts among the companies to reach agreements to control the supply of oil and gas in the West.

Documents obtained as part of the legal proceeding also verify that major oil and gas companies supplying CARB gas to the California market entered into 44 supply-sharing agreements. These agreements were generated to control the quantity of CARB gas on the market, reduce efforts to expand CARB refining capacity, limit imports of CARB gas and discourage excess CARB gas from being sold on the spot market to independent purchasers. Exxon, ARCO, Chevron, Shell, Texaco, Tosco and Unocal all entered into such supply-sharing agreements with at least one of their competitors.

Because such agreements benefited the major suppliers and excluded independent operations from the process, significant questions are raised about whether these agreements had the effect of forcing independent refiners to close down – further decreasing overall gasoline supply.

In February 1993, Mobil, Texaco and Chevron (with the financial support of Exxon) filed a lawsuit to overturn the small refiners' exemption to the CARB gas program, reducing the ability of small refiners to compete in the CARB gas market.

An internal Mobil document highlighted the connection between an independent refiner producing CARB gas, the depressed price that would result, and the need to prevent the independent refiner from producing.

> "If Powerine re-starts and gets the small refiner exemption, I believe the CARB market premium will be impacted. Could be as much as 2-3 cpg (cents per gallon)…The re-start of Powerine, which results in 20-25 TBD (thousand barrels per day) of gasoline supply…could…effectively set the CARB premium a couple of cpg lower…Needless to say, we would all like to see Powerine stay down. Full court press is warranted in this case."[7]

The Powerine Oil Company refinery closed in 1995. Despite documented attempts to work in conjunction with major oil companies to restart the Santa Fe Springs, Calif. refinery[8], the major oil companies stood in the way and the refinery remains closed.

---

[7] Internal Mobil Corp. E-mail regarding Powerine refinery, February 6, 1996

[8] Powerine Oil Co. Letter to Mr. M.R. Diaz, General Manager of Supply & Distribution for Texaco Refining & Marketing Inc.

FINDING 3:
Closing Refineries: Oil Companies Act to Inhibit Supply

While oil companies were making agreements to control oil and gas supply, refineries were closing. Since 1995, 24 refineries have closed, including refineries in California, Illinois, Arizona, Oklahoma, Indiana, Kansas, Louisiana, Texas, Mississippi, Michigan and Washington (the Tosco refinery has subsequently reopened), taking nearly 830,000 barrels a day of refining capacity offline. While capacity at some existing refineries expanded during this time, the fact is that more capacity would exist if these refineries were still operating.

According to Energy Information Administration, the following refineries were shut down between 1995 and 2001:

Year	Refinery	Location
1995 [9]	Indian Refining	Lawrenceville, IL
	Cyril Petrochemical Corp.	Cyril, OK
	Powerine Oil Co.	Sante Fe Springs, CA
	Sunland Refining Corp.	Bakersfield, CA
	Caribbean Petroleum Corp.	San Juan, Puerto Rico
1996 [10]	Tosco	Marcus Hook, PA
	Barrett Refg. Corp.	Custer, OK
	Laketon Refg.	Laketon, IN
	Total Petroleum, Inc.	Arkansas City, KS
	Arcadia Refg. & Mktg.	Lisbon, LA
	Barrett Refg. Corp.	Vicksburg, MS
	Intermountain Refg. Co.	Fredonia, AZ
1997 [11]	Gold Line Refg. LTD	Lake Charles, LA
	Canal Refg. Co.	Curch Point, LA
	Pacific Refg. Co.	Hercules, CA
1998 [12]	Gold Line Refining Ltd.	Jennings, LA
	Petrolite Corp.	Kilgore, TX
	Shell Oil Co.	Odessa, TX
	Pride Refg. Inc.	Abilene, TX
	Sound Refg. Inc.	Tacoma, WA

[9] Energy Information Administration/Petroleum Supply Annual 1995, volume 1, p. 80

[10] Energy Information Administration/Petroleum Supply Annual 1996, volume 1, p. 119

[11] Energy Information Administration/Petroleum Supply Annual 1997, volume 1, p. 80

[12] Energy Information Administration/Petroleum Supply Annual 1998, volume 1, p. 119

Year	Refinery	Location
1999[13]	TPI Petro. Inc.	Alma, MI
2000[14]	Pennzoil	Rouseville, PA
	Berry Petroleum	Stephens, Ark.
	Chevron	Richmond Beach, WA
2001[15]	Premcor	Blue Island, IL

These refinery closures took more than 830,000 barrels per day of refinery capacity out of production.

Refinery Capacity Lost Due to Refinery Closures Between 1995 - 2001

< Numbers in Barrels per Calendar Day >

1995	191,750 bbl/cd [16]
1996	268,750 bbl/cd [17]
1997	87,100 bbl/cd [18]
1998	123,650 bbl/cd [19]
1999	51,000 bbl/cd [20]
2000	25,700 bbl/cd [21]
2001*	80,515 bbl/cd [22]
Total Capacity Lost:	**828,465 bbl/cd**

The major oil companies had a financial interest in seeing the closure of independent refineries. By reducing the overall supply of oil and gas and reducing the number of companies involved in producing it, the major oil companies can have tighter reins on the supply and the price.

---

[13] Energy Information Administration/Petroleum Supply Annual 1999, volume 1, p. 116

[14] Phone Conversation with Mark Connor, Energy Information Administration Analyst, May 9, 2001

[15] Ibid.

[16] Energy Information Administration/Petroleum Supply Annual 1995, volume 1, p. 80

[17] Energy Information Administration/Petroleum Supply Annual 1996, volume 1, p. 119

[18] Energy Information Administration/Petroleum Supply Annual 1997, volume 1, p. 80

[19] Energy Information Administration/Petroleum Supply Annual 1998, volume 1, p. 119

[20] Energy Information Administration/Petroleum Supply Annual 1999, volume 1, p. 116

[21] Phone Conversation with Mark Connor, Energy Information Administration Analyst, June 12, 2001

[22] Ibid.

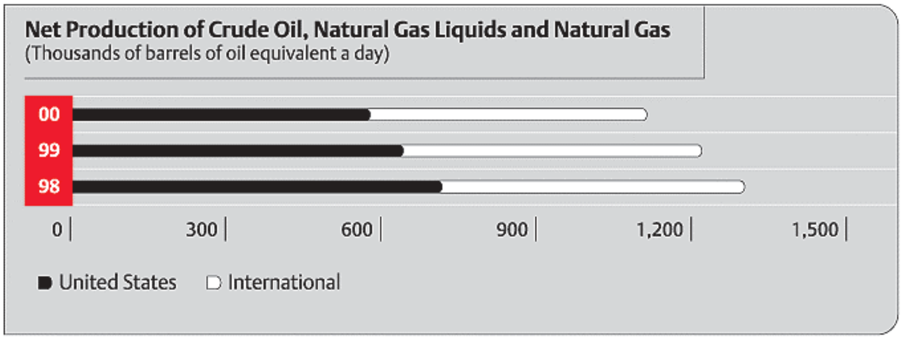
FINDING 4:
Record Profits: Oil Companies Reap Benefit of Higher Prices at Pump

Despite complaints indicting the cost of environmental compliance and manufacturing "boutique" fuels, in the 2000 the oil and gas industry enjoyed record profits that reflect record gas prices.

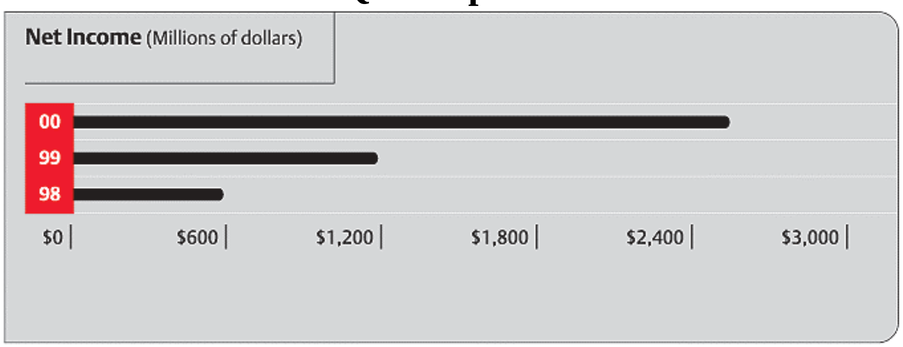
According to Texaco's 2000 Annual Report, the company's production steadily decreased from 1998 to 2000, yet its net income more than quadrupled during the same period – with Texaco posting well above $2.4 billion in net income in 2000.

The following charts show this dramatic relationship and point to the tremendous increase in profits for Texaco.

Texaco Production Steadily Dropped from 1998 – 2000 [23]



Texaco's Net Income Quadrupled from 1998-2000 [24]



Commenting on Texaco's strong first quarter 2001 showing, Chairman and CEO Glenn Tilton said in a news release, "Our outstanding first quarter results follow our record fourth quarter and mark the third consecutive quarter that earnings surpassed $800 million."[25]

[23] Texaco 2000 Financial & Corporate Highlights (www.texaco.com/investor/2000ar/index.html)

[24] Ibid.

[25] Texaco Press Release: Texaco Reports First Quarter Earning Data – April 26, 2001

Chevron's net income increased from $2.07 billion in 1999 to $5.185 billion in 2000,[26] a 250 percent increase. During the same period, ExxonMobil Corporation's net income jumped from $7.9 billion to $17.7 billion.[27] The trend continued with BP Amoco p.l.c. whose 2000 profits were $11.87 billion, up from $5.008 billion in 1999.[28]

Among these four companies alone, profits for the year 2000 increased by over $22 billion dollars in one year. In light of these substantial profits, oil industry claims that they cannot afford to comply with environmental regulations or expand their refining capacity lack credibility.

FINDING 5:
National Energy Policy Incentivizes Oil Companies to Expand Refinery Capacity

The Bush administration's National Energy Policy, released in May, points to lagging profit margins and costly environmental regulations during the past decade as the reason for lost refinery capacity. The report also states that, "excess capacity may have deterred some new capacity investments in the past," and that "more recently, other factors, such as regulations, have deterred investments." [29]

Oil companies cited excess capacity in the mid-1990s as a cause of inadequate profit margins. It was this excess capacity that the companies sought to eliminate in order to improve their margins. Subsequently, refineries were closed. The industry documents cited earlier indicate that oil companies may have closed those refineries specifically to tighten supply and drive up costs.

This strategy is paying off in multiple ways. In addition to forcing higher gas prices and realizing exploding profits, the industry now stands to benefit from a national energy policy that could reward anti-consumer actions by weakening environmental standards.

The National Energy Policy verifies that America currently faces tight supply and high prices, as well as the fact that oil and gas companies enjoyed higher profit margins in 2000.

> "During the last ten years, overall refining capacity grew by about 1 to 2 percent a year as a result of expansion in the capacity of existing, larger refineries. Although there was a significant, sustained improvement in margins during 2000, those gains arose out of a very tight supply situation

[26] Chevron Press Release: Chevron Reports Net Income of $1.5 Billion in Fourth Quarter And $5.2 Billion for 2000, January 24, 2001

[27] ExxonMobil 2000 Annual Stockholder Report, released January 24, 2001, p. 29

[28] BP Amoco p.l.c. 2000 Annual Stockholder report, released May 8, 2001, p. 34

[29] Report of the National Energy Policy Development Group, released May 17, 2001, p.7-13

and high volatile prices. Industry consolidation has been a key response to this poor profitability" [30]

This is precisely the situation the 1995 and 1996 oil and gas company documents encouraged as a method of improving profit margins.

The National Energy Policy calls for efforts to "streamline" environmental regulations and permitting to provide financial incentives for oil and gas exploration and development and to institute cost benefit analysis when implementing environmental regulations.

Some of the specific recommendations from the Bush administration's National Energy Policy include:

"Recommendations:

- The NEPD Group recommends that the President direct the Administrator of the Environmental Protection Agency and the Secretary of Energy to take steps to ensure America has adequate refining capacity to meet the needs of consumers.
    - Provide more regulatory certainty to refinery owners and streamline the permitting process where possible to ensure that regulatory overlap is limited.
    - Adopt comprehensive regulations (covering more than one pollutant and requirement) and consider the rules' cumulative impacts and benefit.

- The NEPD Group recommends that the President direct the Administrator of the Environmental Protection Agency, in consultation with the Secretary of Energy and other relevant agencies, to review New Source Review regulations, including administrative interpretation and implementation, and report to the President within 90 days on the impact of the regulations on investment in new utility and refinery generation capacity, energy efficiency, and environmental protection."
    - The NEPD Group recommends that the President direct the Attorney General to review existing enforcement actions regarding New Source Review to ensure that the enforcement actions are consistent with the Clean Air Act and its regulations." [31]

---

[30] Report of the National Energy Policy Development Group, released May 17, 2001 p. 7-13

[31] Ibid. p. 7-14

While these recommendations stop just short of calling for weaker environmental standards, the report identifies regulations as one of the causes of the shortage of refinery capacity. The implication is that regulations could be relaxed as an incentive for increasing capacity.

If this approach becomes reality, the U.S. government will reward the same oil companies who perpetuated the gasoline supply crunch, those companies who may have deliberately worked to close refineries and reduce supply. These companies, already enjoying record profits because of their actions, would reap even higher profits by recognizing the cost savings of relaxed environmental standards. As a result, oil and gas profits would continue to rise, the public would be saddled with the costs of dirtier air, and consumers would remain unprotected from high gas prices.