

DISCUSSION BRIEF

***Regulating the Oil Industry and
Corralling Oil Industry Profits
for the Benefit of
Citizens and Businesses
in Washington State***

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About the Economic Opportunity Institute

The Economic Opportunity Institute is a nonpartisan, nonprofit, public policy institute focused on creating economic security for working Americans. The institute builds a bridge to economic security through research, policy, and public dialogue. The Economic Opportunity Institute is currently developing pragmatic policies in the following areas: retirement security, early childhood education, energy taxation, family leave, and public revenue development.

Table of Contents

Executive Summary	1
1. Oil Company Profits	2
2. Refinery Operations, Market Share and Profits in Washington	5
4. The Windfall Profits Tax	10
5. Regulatory Pricing and a Study Commission	12
6. Conclusion	13

Table of Figures

Oil Company Profits, 2002-2005	2
Profits of Top Three US-Based Oil Companies	2
Profits as a Percent of Average Capital Employed	3
2004 Profits as a Percent of Stockholders' Equity	3
2004 Profits as a Percent of Assets	4
Stock Buybacks Transacted or Announced in 2005 and January 2006	4
Where Does Exxon's Profits Go?	5
Washington's Refineries	6
Crude Oil and Gasoline Prices, 1993-2005	7
Profits of Major Oil Companies and Gasoline	8
Gasoline Prices and Exxon Profits	9
Gasoline Prices in January 2006 – West Coast Average	10
Graduated Windfall Profits Tax Triggered by Price of Gasoline	11
Weekly U.S. Retail Gasoline Prices	12



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**By
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Executive Summary

Washington citizens and businesses are paying historically high prices for gasoline while the major oil companies are reaping windfall profits. As a result, hundreds of millions of dollars are being taken from the budgets of families and businesses and exported out of our state every week.¹ We can reverse this economic injustice by developing a state windfall profits tax, establishing regulatory pricing of gasoline, and creating a study commission of oil company practices and pricing in our state.

The windfall profits tax could generate over \$500 million annually to fund the incubation of renewable energy, reimburse schools for increased heating and transportation costs, provide low-income heating assistance, and/or reduce business and occupation taxes across the board. Regulatory pricing could save consumers and businesses over \$10 million every week. The study commission could lay the groundwork for a rational and publicly debated and endorsed energy policy that recognizes oil as an essential commodity.

Washington state has the authority to create policy to capture some of the windfall profits of oil companies, invest these profits in renewable energy, and regulate gasoline prices. This discussion brief lays out the background and explores policy options for a rational and democratic energy policy in our state.

¹ Northwest Environment Watch, <http://www.northwestwatch.org/scorecard/coutner.asp>, 1/13/2006

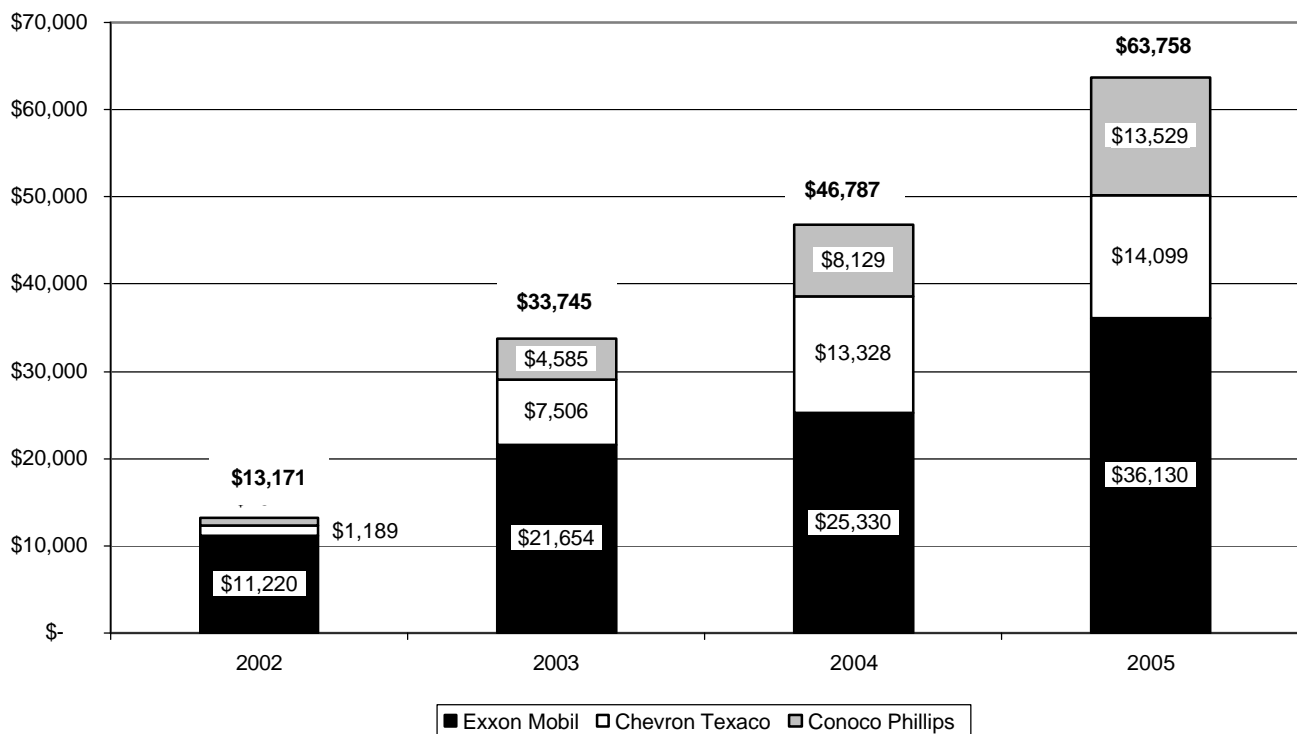
1. Oil Company Profits

Profits for the major oil companies have soared since 2002, particularly in the past year. Profits for vertically integrated oil companies which have released their 2005 annual reports were almost three times 2002 year profits, and 74% greater than 2004 year profits.²

Oil Company Profits, 2002-2005

Company	Net income, in millions of dollars				Increase in profits from 2002 to 2005		Increase in profits from 2004 to 2005	
	2002	2003	2004	2005	\$ millions	%	\$ millions	%
Exxon Mobil	\$ 11,220	\$ 21,654	\$ 25,330	\$ 36,130	\$ 24,910	222%	\$ 10,800	43%
Chevron Texaco	\$ 1,189	\$ 7,506	\$ 13,328	\$ 14,099	\$ 12,910	1086%	\$ 771	6%
Conoco Phillips	\$ 762	\$ 4,585	\$ 8,129	\$ 13,529	\$ 12,767	1675%	\$ 5,400	66%
Marathon	\$ 709	\$ 1,314	\$ 1,261	\$ 3,032	\$ 2,323	328%	\$ 1,771	140%
Royal Dutch/Shell	\$ 9,577	\$ 12,606	\$ 18,536	\$ 23,000	\$ 13,423	140%	\$ 4,464	24%
Amerada Hess	\$ (218)	\$ 467	\$ 977	\$ 1,242	\$ 1,460	-0-	\$ 265	27%
Total	\$ 23,239	\$ 48,132	\$ 67,561	\$ 91,032	\$ 67,793	292%	\$ 23,471	35%

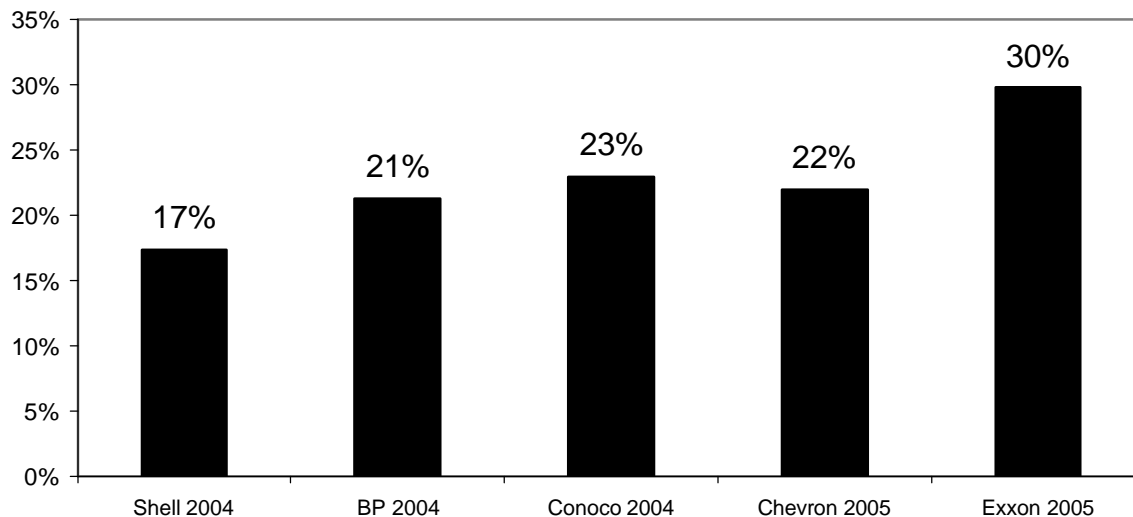
Profits of Top Three US-Based Oil Companies, in millions of dollars



² Robert Pirog, Congressional Research Service, "Oil Industry Profits: Analysis of Recent Performance," August 4, 2005; 4th quarter 2005 income statements from Exxon, Chevron, Conoco Phillips, Marathon, Amerada Hess, and Occidental; Daily Telegraph, January 29, 2006, "Shell sets \$20bn-plus profits record", www.telegraph.co.uk/core/Content/displayPrintable.jhtml;jsessionid+LMNUEEM11...

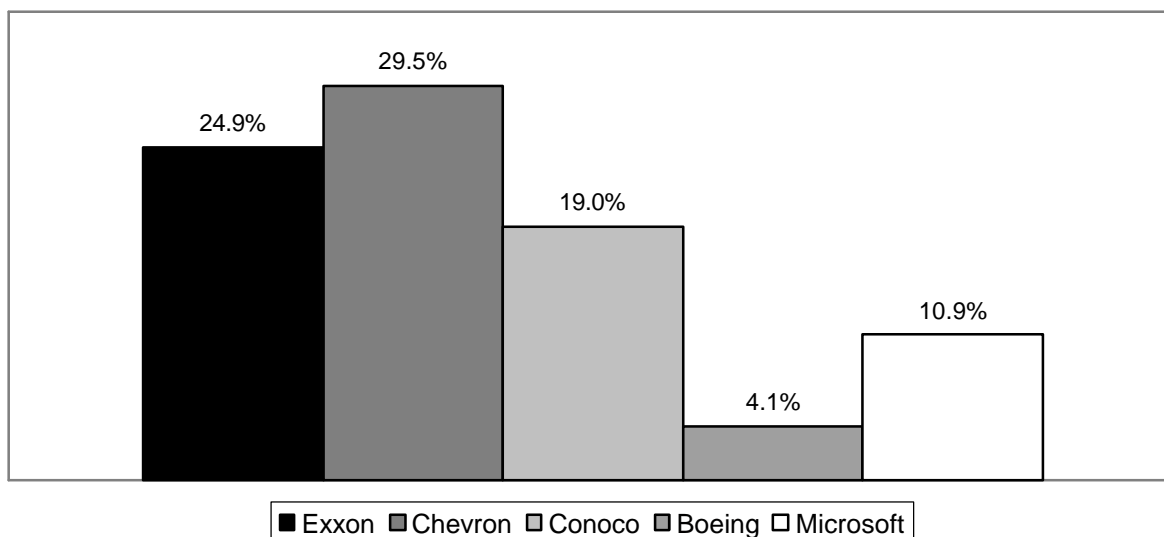
These profits are out of line with average corporate profit rates in our country. Exxon profits as a percent of average capital employed were 30% in 2005, 23.8% in 2004 and 20.95 in 2003.³ Chevron profits in 2004 equaled 22% of capital employed.

Profits as a Percent of Average Capital Employed



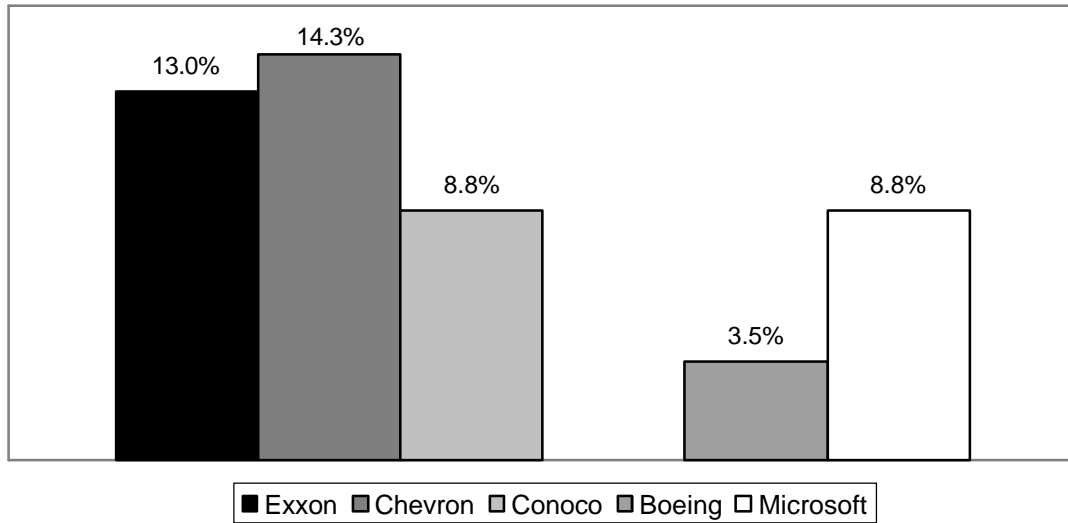
Exxon's profits as a percent of stockholders' equity were 25% in 2004, while Chevron's were almost 30%. In contrast, Microsoft's profits were less than 11% of stockholders' equity and less than 9% of assets, while Boeing's profits were 3.5% of assets and 4% of stockholders' equity.

2004 Profits as a Percent of Stockholders' Equity



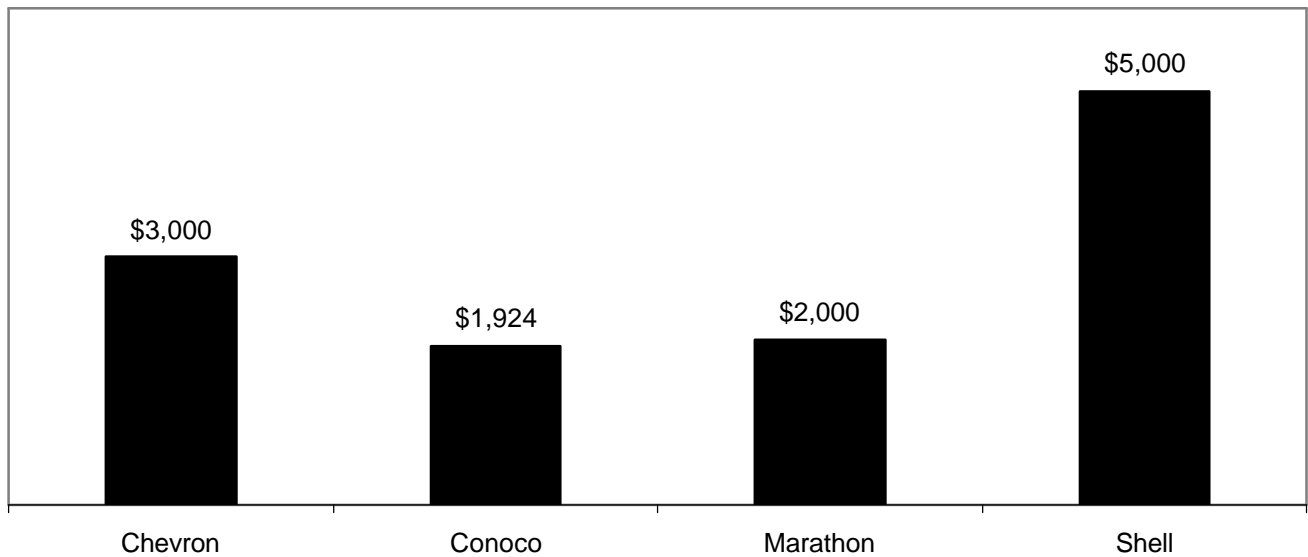
² Exxon Mobil News Release, January 30, 2006; Exxon Mobil 2004 10 K Report, P. 26.

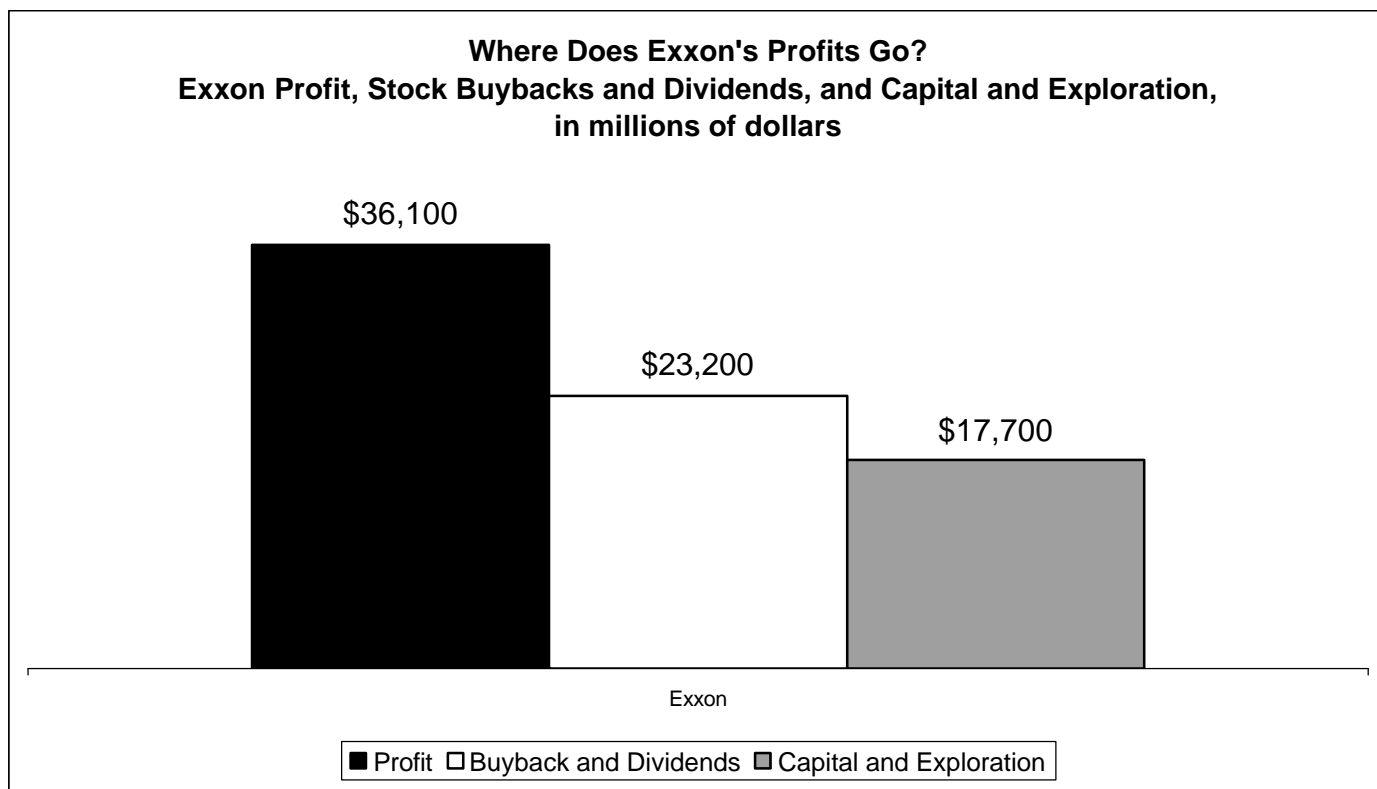
2004 Profits as a Percent of Assets



Where do oil company profits go? Billions go to exploration. But billions more go to the acquisition of other companies, concentrating market power in the oil industry. And billions more goes to stock buybacks, which does nothing for developing energy resources. Last year Conoco bought Burlington Resources for \$35.6 billion. Chevron purchased Unocal for \$17.8 billion. In 2005 Exxon, the world's largest integrated oil company spent \$17.7 billion for capital and exploration and **\$23.2 billion for stock buybacks and dividends.**

Stock Buybacks Transacted or Announced in 2005 and January 2006, in millions of dollars





2. Refinery Operations, Market Share and Profits in Washington

Five oil companies have refineries located in Washington state that produce close to 600,000 barrels of petroleum products a day. BP, Royal Dutch/Shell, and Conoco own and operate three of these refineries, in Cherry Point, Ferndale, and Anacortes. Tesoro owns and operates a refinery in Anacortes. U.S. Oil and Refining, a small privately-held company, owns and operates a small refinery in Tacoma with a capacity of 35,000 barrels a day.

These companies gained record-high profits in 2005. BP's profits for the first nine months of 2005 exceeded profits for the full 2002 year by \$11 billion.⁴ Conoco's 2005 profits were almost 17 times greater than in 2002. Royal Dutch Shell's profits increased over \$4 billion. Tesoro Corporation is one of the largest independent petroleum refiners and marketers in the Western United States. Tesoro's net earnings after taxes increased over \$110 million comparing the first three quarters of 2004 with the first three quarters of 2005. Tesoro realizes \$2 million in net refinery margin per day in refining 192,000 barrels of petroleum product in Alaska and Washington.⁵

The oil industry is becoming increasingly consolidated. In 1993 the top five companies in the U.S. oil refinery industry accounted for 34.5% of total market share, while the top ten accounted for 55.6% of market share. In 2004, the top five accounted for 56.3% of market share, while the top ten accounted

⁴ Pirog, op cit; 3rd quarter 2005 income statements from BP

⁵ Tesoro Corporation Third Quarter Earnings 2005 Press Release and Statements of Consolidated Operations, page 4

for 83.3%. Of these, Conoco held 13% of total market share, Royal Dutch/Shell held 10%, BP held 9% and Tesoro held 3%.⁶ These four companies control 94% of refining capacity in our state.

Washington's Refineries

Company	Vertically Integrated	Refinery Location	% of State Capacity
BP	yes	Ferndale	37%
Shell	yes	Anacortes	24%
Tesoro	no	Anacortes	19%
Conoco	yes	Ferndale	16%
U.S. Oil & Refining	no	Tacoma	6%

Source: Public Citizen: Tyson Slocum's Testimony to Washington State Legislature, October 3, 2005 from www.eia.doe.gov/oil_gas/petroleum/data_publications/refinery_capacity_data/refcapacity.html

Refining and marketing results in 23% of total net income for the major integrated oil companies in the United States. Net income in these operations increased by 96.7% in 2004, compared to 2003, while production increased by only 1.5%.⁷ In fact, there have been no refineries constructed in the United States in 29 years.⁸ This benefits the major oil companies, especially as they have consolidated operations and ownership and developed significant informal price-setting power. They hold unprecedented market power to determine investment in exploration, development, and refining. Any natural disaster or economic or political event around the world can create an excuse for an "unplanned" bottleneck that drives up prices and, over time, results in a price level insulated from and higher than that of a truly competitive market.

3. The connection between crude oil prices, gasoline prices, and profits

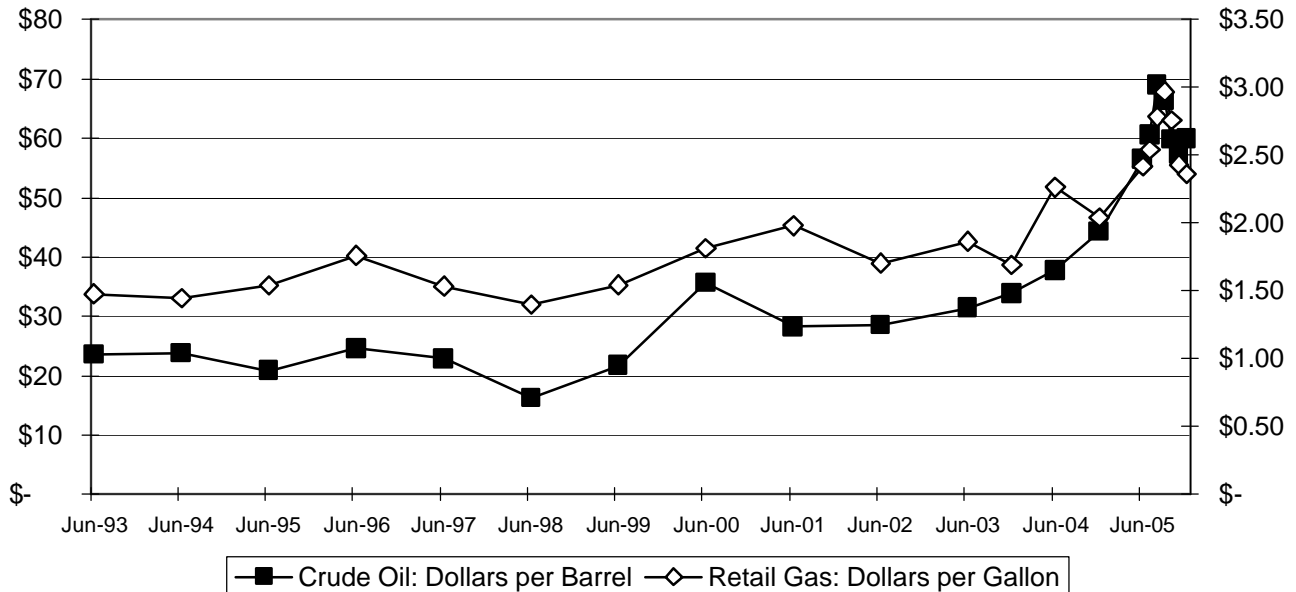
What is the link between windfall profits and gasoline prices? Gasoline prices track crude oil costs. As crude oil costs increase, gasoline prices follow. Crude oil in 1993 sold for \$24 a barrel in constant 2005 dollars. Retail gasoline prices were \$1.48 in constant 2005 dollars. In 2000, crude oil cost \$36 a barrel, and retail gasoline sold for \$1.82. By the end of 2004, crude was up to \$44 a barrel, and retail gasoline was at \$2.04. In September crude hit \$66 a barrel, and retail gasoline cost \$2.97.

⁶ Public Citizen, *Mergers, Manipulation and Mirages: How Oil Companies Keep Gasoline Prices High, and Why the Energy Bill Doesn't Help*, March 2004, Table 1, compiled by *Public Citizen's Energy Program* <www.citizen.org/cmep> from corporate annual reports and U.S. Energy Information Administration data; Table 1 of Tyson Slocum, Public Citizen, Testimony before the U.S. Senate Committee on the Judiciary, February 1, 2006, "Consolidation in the Energy Industry: Raising Prices at the Pump?"

⁷ Pirog, p. CRS-8-9, op cit

⁸ Western States Petroleum Association, "What's Going on in the Gasoline Market", presentation to Washington State Legislature, October 3, 2005

Crude Oil and Gasoline Prices, 1993-2005



But what does this have to do with integrated oil company profits? Everything, because, as Lord Browne of Madingley, the Group Chief Executive for BP, explains in the BP 2004 Annual Report,

“We execute our strategy against the context of the time. We make plans to achieve three targets:

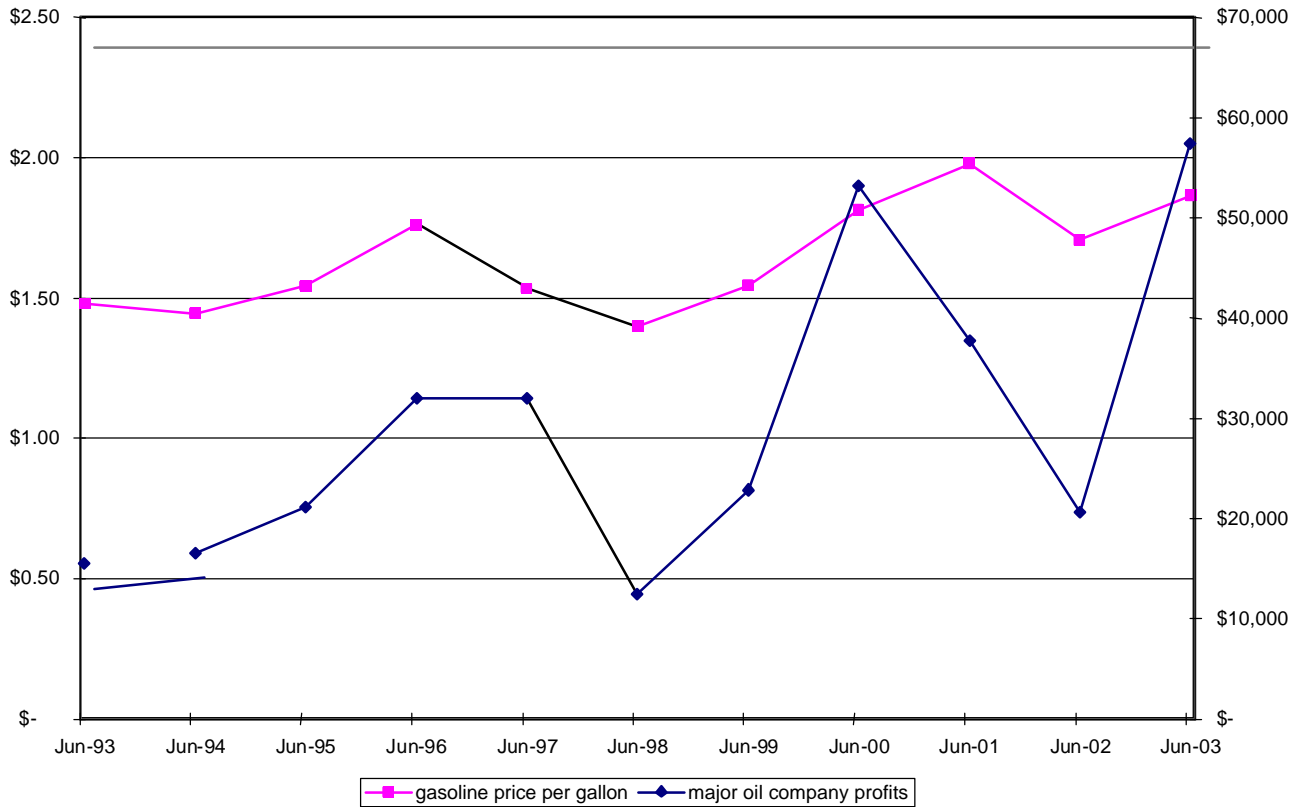
- To underpin growth by a focus on performance, particularly on cash returns, investing at a rate appropriate for long-term growth.
- To increase dividends.
- To return to shareholders, by way of share buybacks, 100% of free cash flow generated above what is needed for investment and dividends: this generally occurs, all other things being appropriate, when the price of oil exceeds \$20 a barrel.”⁹

Lord Madingley’s words are borne out comparing gasoline prices to oil company profits. When gasoline cost \$1.48 in 1993, the largest integrated oil companies gained over \$15 billion in profits. When gasoline cost \$1.82 in 2000, this group of companies made over \$53 billion. In 2003, when gas cost \$1.87, profits exceeded \$57 billion.¹⁰

⁹ BP 2004 Annual Report, p. 6, emphasis added.

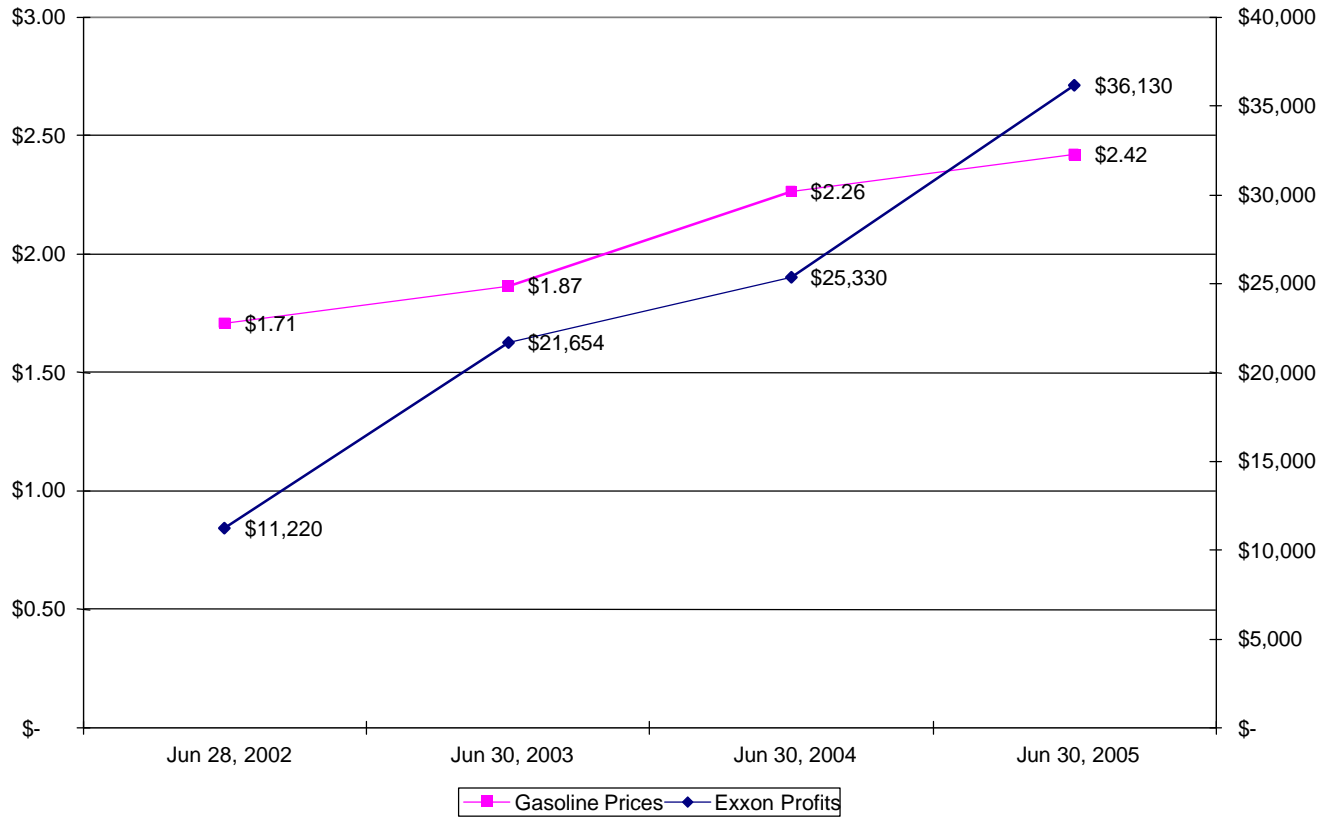
¹⁰ Energy Information Administration, 2003 Performance Profiles of Major Energy Companies, www.eia.doe.gov/emeu/perfpro/summary.htm. For 2003, this grouping included the top 28 major U.S. energy companies reporting to the Energy Information Administration’s Financial Reporting System.

Profits of Major Oil Companies (in millions) and Gasoline



A look at the largest integrated oil company reinforces the causal link between profits and gasoline prices. With gas at \$1.71 in 2002, Exxon made \$11 billion in profits. When gas averaged \$2.26 in 2004, Exxon made \$25 billion. Last year, with gas at \$2.42 a gallon, Exxon made \$36 billion in profits, a historic record for corporate income.

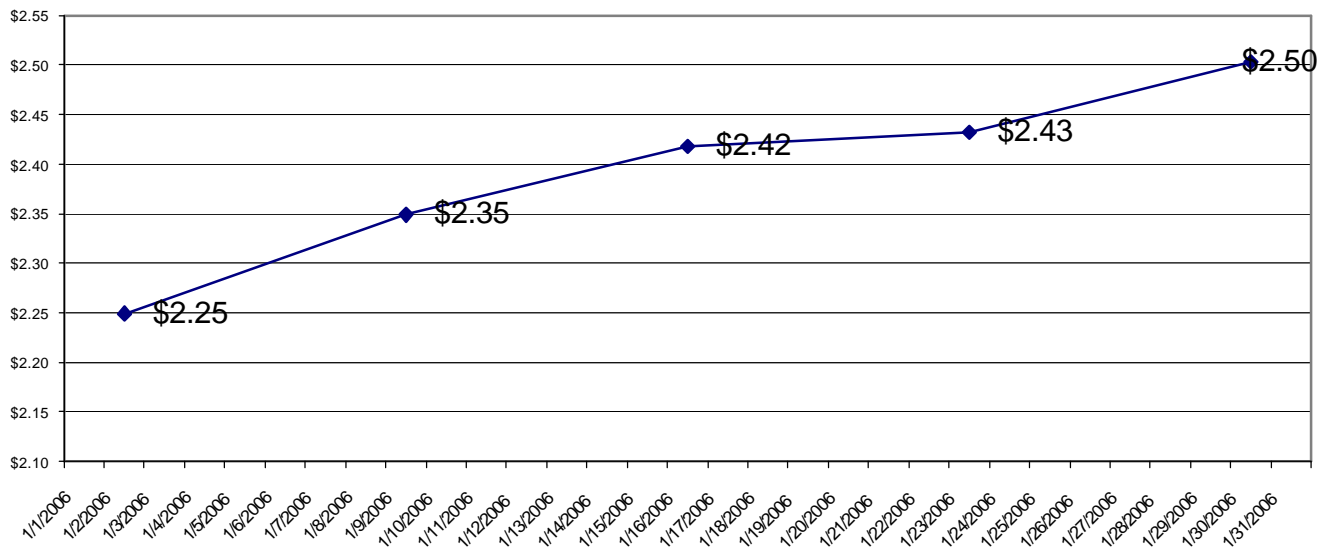
Gasoline Prices and Exxon Profits



Since January 1st, gasoline prices have steadily increased, continuing the increase in profits for integrated oil companies for 2006.¹¹

¹¹ http://tonto.eia.doe.gov/dnav/pet/hist/mg_tt_p5w.htm

Gasoline Prices in January 2006 - West Coast Average



4. The Windfall Profits Tax

The State of Washington clearly has *an interest* in preventing excess profiteering by oil companies. Gasoline is a critical commodity, necessary to every aspect of the state economy and the health and safety of the people of the state. The state legislature can take immediate emergency action to protect the people and vital interests of the state, as well as develop the research and fact-finding necessary for a longer-term solution to the problem of near-monopoly control of a vital resource.

Washington has the power to regulate prices and profits of the integrated oil industry. Previous legislative actions have set both the precedent and the policy pathway to do this. The state currently enforces a petroleum products tax. The tax is imposed on the wholesale value of products derived from refining crude oil. At a tax rate of .5%, the tax generated \$26.5 million in 2004. The state also enforces an oil spill tax on crude oil transported in the navigable waters of the state and off-loaded at an in-state marine terminal. The tax is 4 cents per barrel. It resulted in \$5.8 million in revenue in 2004.

State Representative Bob Hasegawa is proposing legislation, HB 2977, to impose a tax on oil company profits when retail gasoline prices exceed \$1.75 a gallon. The tax would be graduated, starting at 10% of profits apportioned to Washington state through the three-factor formula of payroll, property, and sales. For every 10 cents the price rises, the tax rate increases by 2%, topping at prices at \$2.75 or greater with a tax rate of 30%.

Graduated Windfall Profits Tax Triggered by Price of Gasoline

Gasoline price equal to or greater than	But less than	Tax rate
	\$1.75	zero
\$1.75	\$ 1.85	10%
\$1.85	\$1.95	12%
\$1.95	\$2.05	14%
\$2.05	\$2.15	16%
\$2.15	\$ 2.25	18%
\$2.25	\$ 2.35	20%
\$2.35	\$2.45	22%
\$2.45	\$2.55	24%
\$2.55	\$2.65	26%
\$2.65	\$ 2.75	28%
\$2.75		30%

The structure of this tax creates a disincentive to raising gasoline prices and an incentive to keeping prices at an appropriate and reasonable level. It punishes passing on such a tax to the consumer.

This legislation would effect fewer than 70 U.S. based oil companies that have refining operations. How much revenue might this tax raise for the state of Washington to fund our efforts to offset increased heating and transportation costs and incubate renewable energy? A rough calculation can be made by considering solely the publicly-owned companies that have refineries in Washington, that is, Conoco, Tesoro, Shell, and BP. If we use the refining capacity of these companies as a proxy for the apportionment of profits to Washington state, at today's gasoline prices, the windfall profits tax would generate over \$500 million annually from these companies. This of course does not include those companies, such as Exxon, that import gasoline into our state via pipelines. The tax includes such companies, and therefore would generate significantly greater revenues.¹²

What would be the appropriate use of this revenue? We need to offset the rising cost of energy for businesses and citizens in our state, and we need to develop our own renewable energy resources within our state. The windfall profits tax could be distributed

- As an across-the-board reduction in the B&O tax, in recognition of increased fuel costs borne by business
- To school districts to offset increased transportation and heating costs
- To citizens for additional home heating assistance
- For the incubation of our renewable energy industry, from crop development through refining and distribution
- To finance mass transit projects.

¹² Calculated on the basis of 2005 stated and estimated profits and Washington state refinery share of global refinery share.

5. Regulatory Pricing and a Study Commission

The windfall profits tax would be a catalyst for incubation of public and private strategies for energy independence and conservation. But in and of itself, it will not result in lower and flattened and predictable fuel prices. There is a policy mechanism that will dampen unregulated price increases. Hawaii has already put into place a ceiling on the wholesale price of gasoline and diesel. Hawaii recognizes that gasoline and diesel are essential commodities, indeed necessary utilities for private and public enterprise. Rather than allow the price of these commodities to be decided by concentrated market forces, Hawaii determines a weekly price ceiling.

The Gas Cap Law is a legal limit on wholesale gasoline prices, or the maximum amount that may be charged for producing gasoline and delivering it to a service station. Under the new law, the gas cap is set weekly by the Hawaii Public Utilities Commission (PUC) based on average spot prices for regular unleaded gasoline in three U.S. markets, New York Harbor, the Gulf Coast, and Los Angeles. The PUC has an open docket, and issues the price ceiling every Wednesday for the following Monday through Sunday.

In Washington, the Utilities and Transportation Commission could take on this task. We would not want to determine the wholesale price by the same spot markets that are used in the Hawaii formula. Those are not the lowest prices possible, one reason being that Hawaii is penalized (and accepts a penalizing formula) for being out in the middle of the ocean. Washington state could determine a price ceiling based on the average of the three states, regions, or cities with the lowest retail prices.

While wholesale prices cannot be perfectly translated to retail prices, and vice versa, it is instructive to estimate the cost savings for our state if this system was in effect. For example, for the week of December 5, 2005, the average retail price per gallon for regular gasoline was \$2.08 in Minnesota, \$2.05 in Texas, and \$2.05 in Massachusetts.¹³ These prices average out to \$2.06. Our state's price for the same week was \$2.39. With our suggested formula, the state's businesses and citizens would have saved 33 cents per gallon. **Washington motorists consume 7.3 million gallons of gasoline daily, so this price drop would save almost \$17 million a week.**¹⁴

Weekly U.S. Retail Gasoline Prices, Regular Grade Dollars per gallon, including all taxes

States	11/21/05	11/28/05	12/5/05
California	2.453	2.412	2.335
Colorado	2.277	2.209	2.142
Florida	2.300	2.236	2.187
Massachusetts	2.110	2.049	2.055
Minnesota	2.041	2.021	2.081
New York	2.408	2.350	2.314
Ohio	2.029	1.999	2.159
Texas	2.101	2.056	2.047
Washington	2.391	2.341	2.271

¹³ Department of Energy, U.S. Retail Gasoline Prices

¹⁴ As of December 2004, Massachusetts included an excise tax of 21 cents a gallon on gasoline, while Texas and Minnesota charged a 20-cent excise tax, and Washington state a 28-cent excise tax (which has subsequently been raised to 31 cents). Excluding these taxes would result in savings per gallon (through the proposed regulatory pricing) dropping to about 22 cents, resulting in a net weekly savings for the citizens and businesses of Washington of \$11.4 million.

Both the windfall profits tax and regulatory pricing are immediate policies that the legislature could enact. However, there is a dearth of underlying information on prices, profits, vertical integration and allocation of costs and profits, refinery margins, actual cost of crude oil, and industry attempts to realize further consolidation and the monopoly pricing power which that would enhance.

HB 3044, sponsored by Representative Steve Conway, addresses the need for public data on the oil industry and begins regulatory oversight of pricing. It acknowledges that citizens, businesses, and public entities are in the dark about oil company operations and market manipulations. Therefore, it empowers the utilities and transportation commission to gain and make publicly accessible gasoline pricing and availability. It also requires each oil company to file with the commission the price to be charged for petroleum products. It prohibits changes in these prices without prior filing, while specifically prohibiting the UTC from setting prices.

HB 3044 also requires each oil company to file

- Intrastate and export shipments of petroleum, and
- Refinery profit margins

HB 3044 is the first step to enabling the public to gain an understanding of the market power and monopoly pricing structure of the oil industry.

6. Conclusion

Gasoline is an essential commodity, necessary to our state's economy and the health and safety of the citizens of Washington. The quasi-monopoly market power of the major integrated oil companies enables them to disproportionately benefit from high fuel prices. Their incentives are to keep fuel supplies tight and to not expand the production of refined fuels. This enables their profits to be artificially enhanced, at the expense of businesses, citizens, governments, and, indeed, democracy, in our state.

If we continue to hold markets sacrosanct, no matter how they distort economic activity and inequitably reinforce privilege and power, we are surrendering democratic governance. On the other hand, through governance and lawmaking, we have the power to enforce parameters of fairness and equity for the market economy. We can appraise the health of our democracy by testing our willingness to act or not act to protect the economic security of businesses and citizens in the face of the run-up of oil prices. The enactment of a windfall profits tax, regulatory pricing, and a commission for inquiry, research and policy recommendations will enable our state to rationalize energy policy to the benefit of our citizens and businesses, the promotion of energy independence, and the vitality of Washington's entire economy.

