

TESTIMONY BY

J. LOUIS FRANK, PRESIDENT

MARATHON ASHLAND PETROLEUM LLC

THE COMMITTEE ON GOVERNMENTAL AFFAIRS

UNITED STATES SENATE

HEARING ON

OVERSIGHT OF RISING PRICES AND THE EFFICIENCY AND
EFFECTIVENESS OF

EXECUTIVE BRANCH RESPONSE - PART II

WASHINGTON, DC

JUNE 29, 2000

GOOD AFTERNOON. I'M J. LOUIS FRANK, PRESIDENT OF MARATHON ASHLAND PETROLEUM LLC, A COMPANY THAT MAKES AND MARKETS MOST OF ITS PRODUCTS IN THE MIDWEST.

I WELCOME THIS OPPORTUNITY TO DISCUSS THE GASOLINE MARKET CONDITIONS WE HAVE JUST EXPERIENCED IN OUR PART OF THE COUNTRY AND I LOOK FORWARD TO ANSWERING ANY QUESTIONS YOU OR OTHER MEMBERS OF THE COMMITTEE MIGHT HAVE.

LET ME START BY SAYING THAT A VERY COMPETITIVE GASOLINE MARKET ULTIMATELY DETERMINES THE PRICE OF GASOLINE. WORLDWIDE, CRUDE OIL PRICES HAVE RISEN RAPIDLY AND SUBSTANTIALLY. REFINERS HAVE EXPERIENCED SEVERE INCREASES IN THE COST OF RAW MATERIAL OVER A RELATIVELY SHORT PERIOD OF TIME. WITH THIS BACKDROP OF RISING CRUDE COSTS, A SERIES OF PIPELINE DISRUPTIONS AND OTHER CIRCUMSTANCES CREATED A SUPPLY AND DEMAND IMBALANCE IN THE MIDWEST.

WHEN THERE IS A SUPPLY SHORTAGE IN A COMPETITIVE MARKET, PRICES TEND TO RISE TO WHATEVER LEVEL IS NECESSARY TO BALANCE DEMAND WITH SUPPLY. WHEN SUPPLIES RETURN TO MORE NORMAL LEVELS, PRICES TEND TO RETURN TO LOWER LEVELS. THIS IS A MATTER OF SIMPLE ECONOMICS IN A MARKET ECONOMY. JUST SUCH AN IMBALANCE OF SUPPLY AND DEMAND OCCURRED IN THE MIDWEST OVER THE PAST FEW

WEEKS, AND THAT IS THE REASON THAT PRICES IN THE AREA SURGED.
LET ME EXPLAIN.

REFINERIES IN THE MIDWEST CAN SUPPLY ONLY ABOUT 75% OF THE REGION'S DEMAND. THE BALANCE, ABOUT 1 MILLION BARRELS (OR 42 MILLION GALLONS) PER DAY, MUST BE TRANSPORTED INTO THE REGION. A VERY SMALL AMOUNT IS SHIPPED IN BY TRUCK FROM NEIGHBORING STATES, BUT THE VAST MAJORITY OF THIS PRODUCT COMES IN FROM THE GULF COAST BY BARGE OR BY ONE OF TWO LARGE PIPELINE SYSTEMS. (SEE ATTACHED EXHIBIT TITLED "REGIONAL FUELS PROGRAM.") RECENT EVENTS IN THE MIDWEST ILLUSTRATE THE FRAGILE NATURE OF REFINING AND PRODUCTS DISTRIBUTION IN THE MIDWEST. A SIGNIFICANT PROBLEM AT A REFINERY OR IN THE TRANSPORTATION SYSTEM CAN CREATE A SHORTFALL OF SUPPLY, AND WHEN THIS HAPPENS THE SYSTEM HAS LITTLE OR NO CAPACITY TO PLAY CATCH UP.

IN MARCH, ONE OF THESE CRITICAL PIPELINE SYSTEMS, THE EXPLORER PIPELINE, EXPERIENCED A LINE FAILURE FOLLOWED BY A SIX-DAY OUTAGE, WHICH RESULTED IN A SHORTFALL OF ABOUT 8 MILLION BARRELS (OR 336 MILLION GALLONS) OF PRODUCTS TO THE MIDWEST. EXPLORER WAS REPAIRED AND RETURNED TO SERVICE, BUT PART OF THE SYSTEM MUST OPERATE AT A REDUCED CAPACITY PENDING COMPLETION OF CERTAIN SAFETY TESTS. AS A RESULT, THE REGION CONTINUES TO SUFFER A SHORTFALL OF UP TO 50 THOUSAND BARRELS (OR 2.1 MILLION GALLONS) PER DAY OF PIPELINE DELIVERIES.

MORE RECENTLY, WOLVERINE PIPELINE, WHICH CARRIES ABOUT 34% OF MICHIGAN'S PETROLEUM NEEDS FROM CHICAGO, ALSO EXPERIENCED A RELEASE THAT RESULTED IN A NINE-DAY INTERRUPTION OF SUPPLY TO THAT AREA. THAT PIPELINE SYSTEM HAS SINCE RETURNED TO SERVICE, BUT IT TOO IS RUNNING AT REDUCED CAPACITY.

ANOTHER FACTOR THAT CONTRIBUTED TO THIS SUPPLY-DEMAND IMBALANCE IN THE MIDWEST WAS THE NEW PHASE II REFORMULATED GASOLINE (RFG) REQUIREMENTS WHICH BECAME EFFECTIVE JUNE 1. PHASE II RFG FOR THE CHICAGO AND MILWAUKEE MARKETS IS ONE OF A NUMBER OF UNIQUE FUELS THAT MARATHON ASHLAND PETROLEUM MUST MAKE FOR DIFFERENT PARTS OF THE COUNTRY. (SEE ATTACHED EXHIBIT TITLED "REGIONAL FUELS PROGRAM.") THIS GASOLINE IS MORE DIFFICULT TO MAKE THAN THE PREVIOUS FORMULATION. UNITED STATES ENVIRONMENTAL PROTECTION AGENCY (EPA) REGULATIONS REQUIRED US TO VIRTUALLY DRAIN OUR TANKS OF WINTER GRADE PRODUCT BEFORE WE COULD ACCEPT DELIVERIES OF THE LOW-VAPOR PRESSURE SUMMER GRADE OF THIS GASOLINE IN MARCH AND APRIL. WE HAD TO BEGIN BUILDING INVENTORIES OF THIS NEW GASOLINE FROM GROUND ZERO AT ALMOST EXACTLY THE TIME AS THE SUPPLY DISRUPTIONS WITH EXPLORER WERE UNFOLDING. IN ADDITION, CONCERNS WITH UNOCAL'S GASOLINE PATENTS MAY HAVE CONSTRAINED PRODUCTION OF PHASE II RFG.

IF THESE SUPPLY ISSUES WERE NOT ENOUGH, EPA'S DECISION TO GRANT THREE WAIVERS FROM THE RFG REQUIREMENTS FOR THE ST. LOUIS

AREA WITHOUT ANY SORT OF PENALTY BECAME THE STRAW THAT BROKE THE CAMEL'S BACK. IN A LETTER DATED MAY 18, 2000, DESCRIBING ONE OF THESE WAIVERS, THE EPA ACKNOWLEDGED THE SHORTAGE OF RFG IN THE ST. LOUIS AREA, CITING THE EXPLORER OUTAGE, AND ENCOURAGED MARKETERS IN THAT AREA TO BUILD UP THEIR INVENTORIES OF RFG WHILE DISTRIBUTING CONVENTIONAL GASOLINE IN THE MARKET. THE RESULT WAS PREDICTABLE.

CONVENTIONAL GASOLINE THAT WAS ORIGINALLY DESTINED FOR THE CHICAGO AND MILWAUKEE AREAS WAS IMMEDIATELY DIVERTED TO ST. LOUIS. THIS CONTRIBUTED TO CONVENTIONAL GASOLINE SHORTAGES THAT IN TURN LED TO SEVERE PRICE INCREASES FOR THOSE PRODUCTS IN THE CHICAGO AND MILWAUKEE MARKETS. THESE SHORTAGES AND PRICE INCREASES EVENTUALLY SPREAD TO OTHER PARTS OF THE MIDWEST. (SEE ATTACHED EXHIBIT TITLED "CHICAGO MARKET WHOLESALE GASOLINE PRICES.")

WHAT DID MY COMPANY DO IN RESPONSE TO THE GASOLINE SUPPLY AND DEMAND IMBALANCES IN THE MIDWEST?

WE CONTINUED TO MANAGE OUR EXISTING GASOLINE SUPPLIES AS PRUDENTLY AS WE KNEW HOW, AND WE TOOK IMMEDIATE AND EXTRAORDINARY STEPS TO BRING ADDITIONAL SUPPLIES INTO THE MIDWEST. IN FACT, WE HAVE SUPPLIED ABOUT 10% MORE GASOLINE TO THE MIDWEST THIS YEAR THAN LAST YEAR. TO DO THIS WE RAN OUR REFINERIES AT FULL CAPACITY, AND, BECAUSE PIPELINES WERE NOT AVAILABLE, WE UTILIZED

HIGHER COST TRUCKING AND BARGES TO BRING PRODUCT IN FROM OTHER AREAS. WE CONTRACTED TO SHIP GASOLINE IN FROM AS FAR AWAY AS NEWFOUNDLAND, CANADA.

WHAT COULD BE DONE TO IMPROVE THE MIDWEST SUPPLY SITUATION IN THE SHORT RUN?

WHILE MIDWEST INVENTORIES ARE SLOWLY BUILDING AND PRICES APPEAR TO BE DROPPING, THE SUPPLY SITUATION IS STILL QUITE TENUOUS. ANY FURTHER PIPELINE OR REFINERY PROBLEMS COULD CAUSE THE SUPPLY SHORTAGE TO RECUR. AT THEIR REQUEST, MARATHON ASHLAND PETROLEUM SUBMITTED TO THE EPA AND UNITED STATES DEPARTMENT OF ENERGY (DOE) A LIST OF MEASURES THAT GOVERNMENT COULD TAKE TO PROVIDE SOME SHORT-TERM RELIEF TO THE MIDWEST.

AT THE TOP OF THIS LIST IS THE RECOMMENDATION THAT THE UNITED STATES DEPARTMENT OF TRANSPORTATION (DOT) TAKE WHATEVER STEPS ARE NECESSARY TO GET EXPLORER AND WOLVERINE SAFELY RUNNING AT FULL CAPACITY AS SOON AS POSSIBLE. WE ALSO RECOMMEND THAT DOT GRANT RELIEF ON DRIVER HOUR RESTRICTIONS FOR TRANSPORT DRIVERS IN THE MIDWEST AND THAT THE LARGER TRUCKS USED IN MICHIGAN BE ALLOWED IN OTHER MIDWEST STATES. TEMPORARY REMOVAL OF TERMINAL VAPOR RECOVERY UNITS LIMITS AND TANK OPERATING RESTRICTIONS WILL BE OF HELP IN CERTAIN LOCATIONS. A COMPLETE LIST CAN BE FOUND IN THE ATTACHED COPY OF MARATHON ASHLAND PETROLEUM'S LETTER TO EPA AND DOE.

MY COMPANY IS CURRENTLY WORKING ON SEVERAL LONGER-TERM INFRASTRUCTURE PROJECTS THAT COULD HELP EASE SITUATIONS LIKE THE ONE WE JUST EXPERIENCED. WE'RE SEEKING RIGHTS OF WAY AND PERMITS TO CONSTRUCT A NEW REFINED PETROLEUM PRODUCTS PIPELINE TO SERVE THE GROWING CENTRAL OHIO MARKET, BUT OUR PROGRESS HAS BEEN HAMPERED DUE TO RIGHT-OF-WAY LITIGATION. WE'VE ALSO JOINED TWO OTHER COMPANIES TO CONVERT A NATURAL GAS PIPELINE INTO A NEW PRODUCTS PIPELINE FROM THE GULF COAST TO THE MIDWEST, INCLUDING THE CHICAGO AREA. FEDERAL AND STATE GOVERNMENTS COULD HELP BY EXPEDITING THE PERMITTING PROCESS FOR THESE SIGNIFICANT PROJECTS AS WELL AS OTHERS OUR COMPANY HAS PLANNED, AND BY RETHINKING THE DEMANDS ON PETROLEUM REFINING AND MARKETING POSED BY NEW FUELS REGULATIONS.

IT IS OFTEN MENTIONED THAT THE UNITED STATES DOES NOT HAVE A COHESIVE NATIONAL ENERGY POLICY -- ONE THAT WOULD RECOGNIZE THE IMPORTANCE OF AMPLE, AFFORDABLE AND CLEAN ENERGY FOR THE NATION. SUCH A PLAN WOULD ENCOURAGE A VIABLE AND VITAL DOMESTIC PETROLEUM INDUSTRY--BOTH UPSTREAM AND DOWNSTREAM. IT WOULD ALSO EMPHASIZE THE NEED TO INCREASE THE ENERGY INDEPENDENCE OF THE UNITED STATES. IDEALLY IT WOULD THEN PROVIDE OUR CITIZENS SUFFICIENT ENERGY AT A COST THAT WILL SUSTAIN OUR ECONOMIC GROWTH IN AN ENVIRONMENTALLY RESPONSIBLE MANNER.

SIGNIFICANT COMPONENTS OF A COMPREHENSIVE NATIONAL ENERGY POLICY WOULD INCLUDE THE FOLLOWING FEATURES:

ENCOURAGE INCREASED CRUDE OIL PRODUCTION FROM MARGINAL WELLS—THOSE THAT PRODUCE LESS THAN 10 BARRELS PER DAY.

OPEN FEDERAL LANDS FOR ENVIRONMENTALLY RESPONSIBLE EXPLORATORY DRILLING FOR CRUDE OIL.

OPEN OFFSHORE AREAS FOR DRILLING IN DEEP WATERS.

RECOGNIZE THE NEED FOR STRENGTHENING THE DOWNSTREAM INFRASTRUCTURE OF THE DOMESTIC PETROLEUM INDUSTRY—THE SECTOR THAT INCLUDES REFINING, PIPELINING, TERMINALING AND MARKETING.

IN CLOSING, LET ME SAY THAT I AM VERY PROUD OF THE WAY MARATHON ASHLAND PETROLEUM RESPONDED TO THIS SITUATION AND, ON BEHALF OF THE 28,000 EMPLOYEES OF MY COMPANY, I AM SINCERELY AND PROFOUNDLY OFFENDED BY ANY ALLEGATION OR INSINUATION THAT WE HAVE ENGAGED IN EITHER PRICE GOUGING OR COLLUSION WITH OUR COMPETITORS.

AND I AM EQUALLY OFFENDED BY ASSERTIONS THAT PRICES HAVE COME DOWN IN RESPONSE TO CALLS FOR AN FTC INVESTIGATION. AS I SAID IN MY OPENING REMARKS, THE GASOLINE MARKET IS HIGHLY COMPETITIVE AND THE MARKET ULTIMATELY DETERMINES THE PRICE OF GASOLINE. PRICES IN THE MIDWEST WENT UP IN RESPONSE TO A SUPPLY/DEMAND IMBALANCE AND THEY HAVE RESPONDED AS ADDITIONAL SUPPLIES BECAME AVAILABLE IN THE MARKET. IT IS A MATTER OF

SIMPLE ECONOMICS. HOWEVER, THE SYSTEM IS FRAGILE AND ANY SIGNIFICANT DISRUPTION IN A REFINERY OR IN THE DISTRIBUTION SYSTEM COULD RESULT IN ANOTHER SUPPLY-DEMAND IMBALANCE IN THE MIDWEST.

AGAIN, I APPRECIATE THIS OPPORTUNITY TO APPEAR BEFORE THIS COMMITTEE, AND I LOOK FORWARD TO ANSWERING ANY QUESTIONS YOU OR OTHER MEMBERS OF THE COMMITTEE MAY HAVE.