TESTIMONY

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BEFORE THE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE

SENATE GOVERNMENTAL AFFAIRS COMMITTEE

MAY 2, 2002

I appreciate the opportunity to speak on the issue of gasoline price volatility.

Gas price volatility is a spreading epidemic, as price spikes become an appalling national norm. The coast to coast consequences are devastating to consumers, the economy and political stability.

Price spikes hit hardest people of low and moderate means, since fuel use is an inelastic necessity that cannot be readily reduced. They inhibit and stunt economic growth and prosperity, in individual states and in our nation as a whole. Alarmingly, price spikes are enabled, even encouraged, by governmental tolerance of anti-competitive practices which undermine the credibility and trust of government itself.

Dangerous, damaging price spikes reflect unprecedented price volatility. In 1996, the difference between the highest monthly average gasoline price and the lowest was 23%. In 2001, the difference was 94%. Within twelve months, gasoline prices in Connecticut have bounced from $1.84 to $1.17 to $1.45. During a two-week period in March, the Lundberg Survey of 8,000 gasoline dealers recorded the sharpest rise in its 50 years of surveying gasoline prices.

The recently released report of this Subcommittee, Gas Prices: How Are They Really Set? (The Subcommittee Report), powerfully documents the key cause -- concentration of market power that enables a handful of companies to manipulate supplies and markets, and reap $10 billion in annual revenue for each 10 cent increase in prices.

Gasoline demand has increased slowly and steadily during the past several years -- in Connecticut around 4% annually. But domestic refining capacity has declined. Hence, the cause of the price spikes can be attributed clearly to an oil industry that has been allowed to relentlessly and purposefully consolidate more market power in fewer companies. With this increased market power, companies reduce inventories, manipulate supply and orchestrate prices at the gas pump, all at a huge cost to consumers.

Today, I reiterate and reinforce with increasing urgency my plea that Congress: (1) stop and abate concentration of market power within the refining, distribution and retail markets; (2) develop better gasoline market information for federal and state energy policy; (3) require minimum levels of inventory; (4) prohibit zone pricing and other tactics that prevent gasoline retailers from obtaining gasoline at competitive prices and (5) diminish our dependency on gasoline through conservation efforts and alternative fuels.

I. Reduce concentration of market power in oil industry

Since 1995, rampant mergers and acquisitions have caused significant concentration of market power. Today, six companies control 55% of the 175,000 gasoline stations in the nation, compared to 30% in 1991. The Subcommittee Report found that refining and supply are highly concentrated in 9 states and moderately concentrated in 28 states. Competition is clearly withering in the face of these mega-mergers.

The Federal Trade Commission has failed to scrutinize adequately or stop the anti-competitive effects of these mergers. In one example affecting Connecticut, the Mobil-Exxon merger, prior to divestiture, resulted in the top four gasoline companies controlling 73% of the retail market in half the metropolitan areas in the Northeast-MidAtlantic region. Divestiture somewhat reduced this number, but I still opposed this merger -- and urged the FTC to do so.

In the retail area, the merger trend has enhanced the ability of industry players to use zone pricing. The FTC describes this practice as 'oligopolisitic'. This term could easily apply to the entire industry.

So too, oil company decisions to close 50 refineries and to merge with competitors have led to significant market concentration in the refinery and production segments of the oil industry. The Wall Street Journal recently reported that the six largest refiners control 59% of the refining market, representing a 50% increase in the concentration level of that market in 12 years. The FTC has approved these refiner mergers with conditions and divestments designed to reduce the impact of the proposed merger. Again, these conditions and divestments have failed to slow, let alone stop, the concentration of market power, undermining competition. When the most recent proposed mergers were submitted to the FTC, that agency had the opportunity to apply measures to correct the errors of previous merger approvals. The FTC again missed the opportunity to impose stringent requirements on the proposed mergers that would open to competition markets that now have become closed to new, independent competitors.

In its review of the California market, the Subcommittee Report found that the federal government allowed the refining market to become an oligopoly with the top 4 refiners owning nearly 80% of the market. Six refiners also own 85% of the retail outlets, selling 90% of the gasoline in the state.

The Subcommittee Report also found that 2/3 of the gasoline supplied to Michigan comes from 4 large refiners. Three of those four refiners combine to own 2/3 of the Wolverine Pipeline, one of the key sources for transporting gasoline into the state. The refiners also have substantial interests in terminals. Vertical integration allows a small number of firms to control the refiner sector of the oil industry and to maintain critical market power in the supply and retail segments.

In the refining and production area, the FTC has allowed refiners to merge with other refiners, buy pipeline shares and terminals, and acquire major retailers. This merger trend has resulted in refiners controlling distribution and retail markets, making it impossible for innovative, independent-minded companies to enter the business and buck the industry trend. Thus, refiners and producers can uniformly reduce refining and production levels -- causing widespread supply shortages and higher prices -- confident that no company will enter their market and drive down prices.

The Subcommittee Report found that refiners have sought to maintain a status quo, being as adverse to gaining market share through aggressive pricing as they are to losing market share. The companies' pricing tactics are designed to simply maintain market niche and market share.

The FTC report on the Midwestern price spike of 2000 found that the three refiners of summer-grade reformulated gasoline all decided (not jointly according to the FTC) to limit the upgrade of their refineries to comply with stricter EPA standards so as to only produce enough gasoline to supply their branded gas stations and other existing contractual obligations. Even if such decisions were made independently, each clearly recognized that the others would not be risk-takers and increase their production of summer grade gasoline to raise market share. There is clearly a problem with this market, it is a problem that is replicated throughout the country.

Increased market concentration has caused domestic refining capacity to diminish, even as demand has increased steadily. The predictable result has been extraordinarily tight supplies, barely meeting demand, leading to very volatile prices at the pump. Inadequate inventories, disruption in delivery systems and other factors make the market even more vulnerable.

History shows that oil company profits soar during gasoline shortages. In fact, one company deliberately withheld some of its gasoline inventory from the market during the Midwestern price spike of 2000 in order to keep prices and profits artificially high. Specific internal discussions among oil company executives recounted by the Subcommittee Report plainly relate to potential illegal activity -- action that the companies now say was rejected. The Subcommittee Report is replete with examples of industry efforts to keep gasoline inventory low so that prices would remain artificially high. The report recounts Shell's threat to retaliate, by asking the California legislature to enact a tax on imported gasoline, if Texaco implemented its plan to import California CARB gasoline and relieve a shortfall in refinery output in that state. The story is a stunning example of major oil company efforts to squeeze supplies and raise prices.

It is worth repeating: Every ten cent increase in gasoline prices produces a $10 billion windfall in annual revenue to the oil industry.

In short, when fuel is in short supply, the industry wins, the consumer and our economy lose.

Competition is key. I urge Congress to enact a moratorium of at least one year on any merger or acquisition of any major oil refiner, supplier or retailer, including cross-sector mergers and acquisitions, while Congress, the FTC and the states work together to fashion a longer term remedy that helps restore competitive forces and tempers the market dominance wielded by the few industry giants.

A moratorium is one means to send a message that mergers and acquisitions will face strict scrutiny. The FTC should take a tough approach to both horizontal as well as vertical integration mergers, recognizing that some mergers may tighten market control downstream. Mergers should also be stopped when the merged company poses significant barriers to entry by independent oil companies. The FTC and Congress should promulgate new rules or interpret the current rules to create a presumption that any merger in the oil industry will be rejected unless the oil companies can prove with clear and convincing evidence that consumers will benefit from the merger or acquisition and that tangible, specific steps will be taken to assure that consumers see lower prices and better services. The new rules or new interpretations of these rules should require the FTC to specifically impose divestiture conditions that will spur competition by opening closed markets to new independent entrants.

Finally, the committee should consider legislation to specify that common price patterns or conscious parallelism when combined with a moderately or highly concentrated market should be considered potential evidence of an antitrust violation and the need for specific governmental action to reduce market concentration and encourage new competitors.

II. Develop better gasoline market information for federal and state energy policy

During each price spike, the public clamors for explanations. The causes are hard to determine because specific, detailed market information is lacking. The gasoline markets are complex and opaque. Transparency is vital. A central repository of market information would greatly help the Federal Trade Commission, Congress and the states to take proactive, well-reasoned steps to achieve competitive pricing and adequate inventories.

The Energy Information Administration currently compiles a significant amount of statistics on gasoline production, sales and prices, but fails to collect and produce sufficient data on this very complex set of markets. In fact, in each market there are a number of interrelated submarkets. For example, the California gasoline market may require different state-specific policies. And, within the state of California, there are more sub-markets. Even in the geographically small state of Connecticut, Mobil recognizes more than 40 specific retail markets. The Subcommittee report provided an excellent overview of the broader California and Michigan markets. Yet, the Subcommittee had to rely on a number of different sources of information in developing a clear understanding of each market and the power of the oil companies. Public policy makers need better information in order to determine the best policies to create affordable, reliable energy sources.

Connecticut desperately needed more information last week, when Motiva announced that it is closing its 200,000 barrel storage facility in East Hartford. It also indicated that it may mothball the facility rather than sell it. What impact will this closing have on the heating oil and gasoline markets in the Greater Hartford area? Will consumers pay more for their heating oil and gasoline as a result of this closing? Can Connecticut afford to lose another 200,000 barrels in reserve capacity? Should Motiva be required to sell the facility to preserve working reserve capacity? What steps should Connecticut take to ensure adequate supplies of critical heating oil and gasoline?

The Energy Information Administration should be charged with compiling detailed state market and state submarket energy information, and allowing that information to be accessed by state officials and researchers on a secure basis so that officials can quickly respond to a significant step such as Motiva's and to implement proactive policies to ensure adequate supply of gasoline and heating oil.

Finally, such information would also assist the Federal Trade Commission in its analysis of proposed mergers of oil companies.

III. Refiner and distributor control of retail prices such as zone pricing should be prohibited

A merger moratorium and heightened scrutiny of oil industry combinations will take time to benefit consumers through increased competition, but some immediate steps may be available. One such immediate, necessary step is to ban the practice of zone pricing -- and refiner and distributor control of gasoline supplies to retailers.

As the Subcommittee Report documents, zone pricing is applied in almost every state. By artificially creating geographic areas, the companies charge different prices to dealers within different zones based on computer programs and secret calculations as to how much profit can be reaped, not how their competitive market position will be affected. They care only about how much consumers will bear, not how prices will affect market share. Their artificial methodologies and geographic zones are highly guarded secrets. Mobil established 46 zones in a small state like Connecticut so as to keep prices high in selected areas, not reduce them for others.

A March, 2002 survey by the Stamford Advocate found that gasoline prices in a single city ranged from $1.25 per gallon to $1.39 per gallon. The survey also found a 12 cents difference in the same brand of gasoline. In December, 2001, the Stamford Advocate found that gasoline prices averaged 7 cents higher in Stamford than in neighboring Norwalk. A gasoline dealer who owns stations in both cities indicated that zone pricing is the main reason for the price differential, citing his own gasoline purchases that were 5 cents higher for his Stamford stations than his Norwalk stations.

The power of the major oil companies to impose zone pricing and to charge inflated, excessive, arbitrary prices results from gasoline dealer franchise agreements dictating that the gasoline dealers are required to purchase products from a single supplier. As a result of such sole source provisions, gasoline dealers are powerless to seek or shop for a cheaper supply of gasoline.

Zone pricing is invisible and insidious. It distorts the free market. It is possible only because of restrictive contracts that include sole source provisions. It benefits only the oil industry, to the detriment of consumers. Perhaps the industry's own consultant, MPSI, states it best in its promotional brochures quoted in the Subcommittee Report: "To **maximize profits**, you need to establish a large number of price zones.....**You will be able to charge more** in areas that can support higher prices..."

I urge this committee to support legislation specifically prohibiting the practice of zone pricing either as a separate law, an amendment to the antitrust price discrimination statute (Robinson-Patman Act) or an amendment to the Petroleum Marketing Practices Act. The committee should consider the following language:

"No person engaged in the business of furnishing gasoline to retail distributors of gasoline may use a pricing system under which the wholesale price paid for gasoline by any such retail distributor is determined based on the location of the retail distributor in any geographic zone."

Congress should also consider an amendment to the Petroleum Marketing Practices Act (PMPA), 15 U.S.C. 2801, et seq. prohibiting major oil companies from dictating the source of supply of the brand name gasoline.

The PMPA was enacted in 1978 to provide national standards for gasoline franchise agreements regarding the termination and nonrenewal of such franchise agreements. Unfortunately, while Congress recognized the disparity in bargaining strength between dealers and major oil companies, the PMPA does not provide specific protection against unfairly burdensome franchise provisions.

The power to impose zone pricing is based squarely on the power of the major oil companies to control purchases by the gasoline dealers. If the wholesale supply of gasoline were truly competitive, and a Mobil gasoline dealer could purchase Mobil gasoline from any Mobil gasoline wholesaler, the major oil companies could not dictate the price of wholesale gasoline based on location. The dealer could simply choose another vendor of the same brand of gasoline at a more competitive price.

Thus, the PMPA could be amended to prohibit the anti-competitive provisions in gasoline dealer franchise agreements that dictate the wholesale source of gasoline. Hence, the committee should consider a provision stating: "No franchise, as defined in subdivision (1) of 15 USC 2801, shall limit the source of acquisition of gasoline by a retail distributor except that the franchisor may require that such gasoline is the same brand as the franchisor."

IV. Inventory reductions/expand refinery capacity

Recent dramatic spikes in gasoline and heating oil have been due in large part to lower supplies and decision-making that has reduced available inventory. OPEC is not solely or even predominantly to blame. The industry must be held accountable. Tight supplies are aggravated by unanticipated events such as sudden drops in temperatures or refinery fires.

The Energy Information Administration has recognized the clear connection between price volatility and refiner inventory practices, finding that wholesale gasoline prices are bid up by more than underlying cost increases when inventories are low. The Subcommittee Report also provides powerfully persuasive examples of how the industry profits from tight supplies and inventories.

Present inventory practices increase profits while subjecting consumers to wide swings in gasoline prices and preventing quick industry adjustments to unexpected supply shortages or increased demand.

In the 1980's, refiner capacity averaged 77.6%, which allowed for easy increases in production to address shortages. In the 1990's, as the industry closed refineries and adopted just-in-time inventory practices, refinery capacity rose to 91.4%, leaving little room for expansion to cover supply shortfalls.

While consumers suffered, refiner profits soared during the 1990's. During the 1980's, refiner margins averaged approximately 19 cents per gallon. In the 1990's the average refiner margin rose 23% to 23.4 cents per gallon. Hence, mergers, refinery shut-downs and inventory practices resulted in increased bottom lines for oil companies, and price volatility and uncertain supplies for consumers.

I urge Congress to carefully review these inventory practices and refinery closings and take steps that will encourage or mandate increased inventory and refinery capacity. Although returning competition to these markets would result in additional inventory and less price volatility, the current market requires some form of proactive governmental oversight. Congress should consider incentives encouraging competitors to expand into the refinery and distribution markets, lowering barriers to entry.

V. Conservation

In addition to making the oil industry more competitive and pro-consumer, Congress should aggressively pursue policies designed to lessen American consumer susceptibility to decisions made by members of OPEC and other foreign sources of oil as well as domestic industry concentrations..

We are becoming more, not less, dependent on oil. Many solutions to this dependence will also give us cleaner air, so we should pursue these goals with more vigor than ever.

First, mass transportation should be encouraged. Safe, clean and convenient mass transportation would be used by many citizens.

Second, cars need to be more fuel-efficient. Congress needs to continue to pressure automobile manufacturers to increase the average miles per gallon for their fleet of cars. Back in the 1970's, automobile manufacturers complained that they couldn't make their 12 miles per gallon vehicles more efficient. Today, cars average 27 miles per gallon. Increasing that average to 45 miles per gallon would save 237 billion gallons of gasoline over a 5 year period.

Finally, we must increase our commitment of resources to development of alternative fuels and energy efficient technologies such as fuel cells.

VI. Conclusion

The Subcommittee report shows very disturbing internal discussions among oil company executives of potentially illegal action -- including intentional action to create shortages of product or price increases. The companies say now that such "options were presented and rejected". Further investigation may say more about what they did, and whether it was legal.

But one certain truth should drive fundamental, necessary reform. Too much market power concentrated in too few hands, causing prices too high for the good of consumers and our economy. Parallel pricing in concentrated markets ought to trigger a meaningful antitrust investigation and be made evidence of anti-competitive practices. Steps should be taken to stop further concentration -- mergers and acquisitions that contribute to refinery closings and supply shortages. Federal oversight must assure adequate inventories. More and better information should be made available, and conservation should be supported.

The Subcommittee has made a compelling case for real and effective action now.

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