

**TESTIMONY OF MICHIGAN ATTORNEY GENERAL
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**BEFORE THE UNITED STATES SENATE
GOVERNMENTAL AFFAIRS COMMITTEE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS**

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INTRODUCTION.

Good morning. My name is Jennifer Granholm and I am the Attorney General of the State of Michigan. Thank you for extending me the opportunity to testify today on a matter that has generated significant concern for the citizens of Michigan: the volatility of gasoline prices.

For nearly three years, my office has reviewed the market conditions associated with gasoline marketing and pricing both independently and in conjunction with federal officials. In the summer of 2000, we participated with officials from the Federal Trade Commission in an investigation of price spikes that saw the Michigan retail price of gasoline exceed two dollars per gallon in June of that year. Last year, within days of the terrorist attacks on the United States that occurred on September 11, our office issued notices of intended action under the Michigan Consumer Protection Act against 46 separate gasoline retailers who charged anywhere from \$2.50 to \$5.00 per gallon for the economy grade of unleaded gasoline. And in my role as legal counsel for the Michigan Public Service Commission, my office intervened in a Federal Energy Regulatory Commission matter involving Wolverine Pipeline Company that dealt with some gasoline pipeline transportation bottlenecks that had impeded the ability of independent wholesalers and marketers of gasoline to obtain supplies on competitive conditions.

In the course of my performance of these investigations, and in my Office's continuing review of market conditions in the petroleum industry, it has become clear to me that the causes of gasoline pricing volatility are complex and defy easy explanations. And there are some market factors that are clearly beyond the control of federal policymakers. World crude oil price fluctuations, for example, are difficult to control.

I would like to focus my testimony, however, on factors that *are* within federal policymakers spheres of influence. In particular, there are two issues that I would like to address:

- First, several changes in the way the petroleum industry operates have made it more difficult for firms to readily respond with additional supplies in the face of an unanticipated shortage in a specific geographic market; and
- Secondly, increased concentration in the refining and distribution segment of the industry has contributed to the exercise of market power by dominant industry actors to the detriment of consumers.

**INDUSTRY CHANGES MAKE IT MORE DIFFICULT TO RESPOND TO UNANTICIPATED SUPPLY
SHORTFALLS.**

There was a time when the petroleum industry could count on significant inventories and idle refining capacity for purposes of meeting demand and enabling the industry to respond to sudden and unanticipated supply dislocations. If a refinery that supplied the Upper Midwest had a fire and was down for a month, or if a pipeline burst and disrupted the assumed method of transportation, petroleum firms could count on "making up" for the unanticipated shortfall at other refineries or by drawing down inventories at nearby supply locations.

The petroleum industry today is much more limited in its ability to respond to supply disruptions. One of the findings of the Federal Trade Commission in their review of the Summer 2000 gasoline price spikes was that excess refinery capacity and excess inventories no longer provided the "cushion" to address supply dislocations. First, refinery capacity utilization levels have increased significantly over the last decade.^[1] Secondly, the industry has implemented "just-in-time" inventory techniques that reduce the available inventories that could be drawn upon in times of shortages.^[2]

The impact of the trends toward increased capacity utilization and revised inventory planning is that petroleum firms are not as capable of quickly responding to supply shortages as they once were. And when unanticipated shortages occur, bottlenecks in distribution of gasoline supplies can result in significant price spikes.

Typically, when a shortage of gasoline inventories occurs in a particular market, prices increase. And the price increase has the effect of attracting supplies from adjacent markets where supplies are more plentiful. The resulting arbitrage has the effect of reallocating supplies from markets where gas is abundant to markets where it is not. And ultimately, prices in both markets will reach an equilibrium level in response to the supply dislocation. This normal operation of market forces can be counted upon to “self-correct” any supply dislocations in the industry and assure that consumers suffering from abnormally high prices do not experience the high prices for long.

But in the last few years, two factors have inhibited the petroleum market’s ability to respond in the face of abnormally high prices: first, differences in the types of fuel marketed may prevent firms from freely interchanging inventories from one market to another in the face of a shortage. Secondly, if a particular firm has market power to enjoy high prices by holding product off of the market, the firm may elect to do so. Both of these factors were evident during Michigan’s price spikes in the summer of 2000. For example, when gasoline prices in Detroit hit \$2.10 or higher, it would have been logical for adjacent regions to immediately supply additional product to the Detroit market. If adjacent regions sold the same type of gasoline, Detroit gas prices may have declined more quickly as gasoline inventories from Ohio, Indiana and Illinois moved into Michigan. But the differences in gas formulation in these different markets prevented some types of gas from immediately transferring into Detroit from other markets.

Our office became aware of similar tendencies in reviewing arbitrage opportunities between the Chicago spot market and a nearby Michigan marketing distribution point at Niles. Typically, economics would suggest that a price difference of two cents would attract supplies from Chicago to these Michigan markets to meet demand in West Michigan.

But in 2000, there were occasions where the price of gas on the Chicago spot market was up to ten cents lower than the prices for product at these West Michigan locations and supplies did not flow from one market to the other to exploit this price difference at the volume which one would predict. In reviewing this situation, we learned that inadequate supplies were flowing from the Wolverine Pipeline (a joint venture owned in part by Marathon Ashland, Mobil, Equilon, and Citgo) to a distribution point at Niles, Michigan. In order to obtain supplies at Niles, marketers would need to obtain access to tank farms that stored the supplies being taken off the pipeline. But access was not readily given. Ultimately, our office intervened in a Federal Energy Regulatory Commission case which was resolved by the construction of additional tankage at Niles to more freely transport product from Chicago in response to market demand in Michigan.^[3]

It is also possible that, if one firm has a strategic or dominant position in the industry, then it can control the amount of supply that is delivered to a particular market and enjoy higher prices and profits at the expense of consumers. In the Federal Trade Commission’s review of the Summer 2000 price spike, evidence revealed that one firm held reformulated gasoline inventory off of the market to keep prices higher than would have otherwise been the case. Subsequent media reports identified that Marathon Ashland Petroleum was the firm referenced in the FTC’s Report of this incident.^[4]

MERGERS AND INCREASED CONCENTRATION IN THE PETROLEUM INDUSTRY RESULT IN HIGHER PRICES FOR CONSUMERS.

The preceding discussion regarding Marathon Ashland Petroleum and its actions in the Summer of 2000 relates to the second factor which I wanted to discuss as a cause of higher gasoline prices: growing concentration and “merger mania” within the industry. In the last five years, the petroleum industry has witnessed a wave of some of the largest corporate mergers in United States history. Exxon/Mobil, BP/Amoco, Shell/Texaco and other mergers have reduced the number of competitors at the refining level, as well as the downstream transportation, distribution and retail segments of the industry.

Although not as large as the mergers referenced above on a national scale, the most significant transactions in Michigan petroleum markets involved the merger of Marathon and Ashland Petroleum, and then later, Marathon Ashland Petroleum’s acquisition of all Ultramar Diamond Shamrock assets in the State. The latter transaction in Michigan’s petroleum markets really had two components: first, Ultramar Diamond Shamrock (or “UDS”) closed its refinery in Alma,

Michigan --- leaving Marathon as the only company with a refinery presence in the State. Secondly, Marathon purchased all UDS petroleum supply terminals and retail stations in the State.

The impact of the Marathon acquisition has been to further consolidate industry assets that serve Michigan at the refining, supply and retail segments of the industry. After the merger, Marathon owned the only oil refinery in the State, possessed more terminal storage capacity than any other firm in Michigan and held roughly twice the storage capacity of the second largest supply firm in the State.^[5] More significantly, Marathon has emerged as the leading, and in some markets the *only*, supplier of unbranded gasoline to independent jobbers and retailers. By some estimates, Marathon Ashland Petroleum supplies nearly 70% of the unbranded gasoline marketed in the non-metropolitan Detroit portions of the State^[6]. It is typical in many Michigan markets that *all* unbranded independent retailers are supplied by Marathon.

Preserving competition in the supply of gasoline to independent marketers and retailers is essential to maintaining rigorous price competition on a fair and level playing field in the industry. Economist Justine Hastings, who I believe you will be hearing testimony from later this morning has written that “the independent station is the only type of station that can purchase gasoline from any refiner and independently set its retail markup, thus increasing competition at the wholesale and retail levels.”^[7]

But the consolidation in supply sources jeopardizes the ability of independents to compete. It is also foreboding that, in most instances, the independent retailer finds that one of their primary sources of retail competition-Marathon and Speedway retail stations- are owned or affiliated with their supplier. This certainly has implications for retail price competition. I would note to the committee that we receive frequent anecdotal complaints in Michigan that the retail pricing of gasoline is driven in large part by the price movements of Marathon’s affiliated Speedway stations. Michigan consumers frequently observe a weekly price spike pattern where prices of gasoline on the street go down during the early portions of the week only to be driven up through weekly “price restorations” that are initiated on Thursdays. It is possible that the accumulated market power which Marathon possesses in Michigan has led to Speedway becoming the dominant price leader that other firms will follow. And if Speedway leads a fifteen or twenty-cent price increase in retail prices each week, other firms may follow.

Indeed, other firms may have no choice but to follow Speedway’s upward price movements. Over the last two years, we have received an increasing number of complaints from independent retailers who feel “squeezed” by their inability to compete with the street prices charged at Speedway locations. It is occasionally the case where the retail price charged by Marathon-owned Speedway stations is below the wholesale cost of unbranded gasoline paid by independent retailers. This price squeeze renders it virtually impossible for the independent retailer to effectively compete.

We will continue to review the economics of the Michigan gasoline industry to determine whether any of the dynamics that I’ve described are legally actionable. But what I have described primarily involves unilateral pricing practices and the responses of other industry participants.

I think that the primary opportunity to address the types of problems that I’ve described occurs in the context of merger review and determining whether a particular merger will have the potential to reduce the effective competition that is exerted by independent retailers and marketers.

The University of California Berkeley economists Hayley Chouinard and Jeffrey Perloff have found that anticompetitive mergers could explain up to a 10.3 cents per gallon difference in cross-state gasoline prices and that producer mergers could add another difference of 8.9 cents per gallon.^[8] In Michigan, each one-cent increase in the price of gasoline sustained over a year results in a payment by consumers of approximately \$48.9 million.^[9] It doesn’t take a sophisticated economist to quickly do the math as to the impact that a ten-cent price differential associated with a merger will have on Michigan consumers.

We are evaluating in Michigan whether the Marathon acquisition of UDS assets has had an effect similar to what has been observed in the economics literature in other states where anticompetitive mergers affect prices. And we have made no conclusions on this point. But I think that there are important actions that the federal government could take to assure that gasoline prices remain low for the consumer:

- 1) **ASSURE ADEQUATE RESOURCES FOR MERGER REVIEW.** First, Congress must assure that federal agencies, and in particular the Federal Trade Commission and the Department of Justice Antitrust Division, have the necessary resources to thoroughly review petroleum mergers and stop anticompetitive mergers from being consummated. Not every merger is a bad thing. But I fear that with the resource constraints federal antitrust enforcers face, coupled with the overwhelming number of mergers that have taken place in the last few years, there are

anticompetitive mergers slipping through the cracks. In particular, federal antitrust authorities should review the impact such acquisitions may have upon the ability of independent marketers and retailers to effectively compete on a level playing field. The preservation of vigorous competition in the supply of unbranded gasoline is especially crucial. Antitrust enforcers should focus upon assuring that multiple sources of unbranded gasoline at the wholesale level exist to assure stable, competitively priced supplies for independent retailers, who play an important role in preserving low prices at the pump.

2) **REVIEW WHETHER TRANSPORTATION BOTTLENECKS PRECLUDE NORMAL MARKET FORCES FROM RESPONDING TO HIGH PRICES.**

When sizable enough price differences exist between adjacent markets, *competitive* markets should operate to transfer supplies from one market to the other until the price disparities are reduced. If this is not happening, as we saw in certain instances with the Wolverine Pipeline in the Spring of 2000, it suggests that market actors are impeding supplies from flowing freely---which can artificially maintain prices at higher levels than would otherwise be the case. Federal regulators, and in particular Federal Energy Regulatory Commission staff, should be diligent in reviewing these issues to determine whether pipeline services are being offered at fair, reasonable and nondiscriminatory rates with appropriate access to pipeline customers.

In conclusion, I am concerned about the effect that high gas prices in Michigan have on the consumer, the State's tourism industry and the overall health of the State economy. I believe that the key to protecting consumers in Michigan and nationally is the promotion of healthy, vigorous competition among as many different petroleum refiners, marketers and retailers as possible. Consumers will stand to benefit the most if effective competitors have the capability to keep prices down and have an incentive to respond quickly in the event of supply dislocations. We owe it to them to assure that competition in the petroleum industry remains strong.

[1] The FTC found that "(i)ndustry-wide crude oil refining capacity utilization in the United States in the month of May was 85 percent in 1990, 89 percent in 1992, 93 percent in 1994 and 1996, 94 percent in 1998, and 96 percent in 2000. The average monthly capacity utilization rate in 2000 was 94 percent. This limits further the ability of refiners to increase refinery production significantly in the short run." *Final Report of the Federal Trade Commission Midwest Gasoline Price Investigation*. March 29, 2001. <http://www.ftc.gov/opa/2001/03/midwest.htm> (Hereinafter, the "FTC Report").

[2] See the *FTC Report*, p. 17.

[3] *In Re: Wolverine Pipeline Company*. Federal Energy Regulatory Commission Docket # OR99-15-000.

[4] See *Marathon Ashland Withheld Gasoline*. Wall Street Journal, June 11, 2001, p. 4A.

[5] Five companies now control nearly 80% of the petroleum terminal capacity in Michigan. The companies, and their respective terminal capacity market shares, are:

1) Marathon Ashland Petroleum	28.3%
2) British Petroleum/Amoco	14.4%
3) Exxon/Mobil	14.0%
4) Equilon	13.1%
5) CITGO	9.3%

Market share estimates are based upon capacity figures set forth in the *Petroleum Terminal Encyclopedia (1999)*. The market share estimates are likely underestimated because they do not include the breakout tankage for MAP at the Freedom Junction terminal on the Wolverine Pipeline.

[6] At several Michigan petroleum terminal locations, Oil Price Information Reports or "OPIS" rack price reports do not even list wholesale prices for more than one or two suppliers.

[7] Hastings, Justine. *Vertical Relationships and Competition in Retail Gasoline Markets*. Abstract.

[8] Chouinard, Hayley and Perloff, Jeffrey. *Gasoline Price Differences: Taxes, Pollution Regulations, Mergers, Market Power, and Market Conditions*. Abstract. October 2000.

[9] See Michigan gasoline tax collection summary at <http://www.crcmich.org/TaxOutline/Transportation/gas.html>.