Testimony of Gary Heminger,
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On the Subject of Gasoline Prices
Before the Permanent Subcommittee on Investigations of the
Senate Committee on Governmental Affairs
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Mr. Chairman and members of the Subcommittee, thank you for allowing me the opportunity to meet with you today.

I am Gary Heminger, President of Marathon Ashland Petroleum. We are a Midwest company, headquartered in Findlay, Ohio.

I welcome the opportunity to address this committee on behalf of our nearly 25,000 men and women – employees whose effort and initiative have delivered real supply solutions for our Midwest customers.

Marathon Ashland is an independent refiner. We buy only about five percent of our crude oil needs from a parent company and the remaining 95 percent on the world market – in contrast to companies that refine significant percentages of crude oil they produce.

Unlike many refiners, we regularly supply all segments of the gasoline market: spot, wholesale, brand and retail. Approximately 45 percent of our sales are made to the wholesale market. This segment consists of independent distributors and retailers, and represents our largest single customer base. We are one of the largest suppliers of independent retail marketers.

Your committee is right to focus on issues of gasoline production, delivery and price volatility. These are issues that affect all Americans. They are part of the everyday business context in which Marathon Ashland must operate.

How We Price Gasoline

Our company prices gasoline at the terminal loading rack taking into account our current prices and margins, inventory position, production estimates, delivery schedules, current sales, sales projections, NYMEX price, current competitive prices to the extent they are known, and any other factors that we believe may impact supply or demand. From all of this data, we attempt to synthesize a posting that will enable us to meet our sales projections for a given product and location. If the price we establish is too high in relation to the market, then we sell less volume than we projected. If we do this too often, then we risk running out of storage space as more product is delivered. This can slow down or stop pipeline deliveries, potentially disrupting deliveries over a wider area. If our price is too low in relation to the market, we sell more than we projected. If we do this too often, we risk running out of product before the next delivery. This can leave our customers without needed product and result in a breach of our contract obligations. We typically post rack prices effective from midnight of every business day until midnight of the next business day.

As stated above, Marathon Ashland sells gasoline to every segment of the market. Most of the gasoline we sell is sold to independent companies or businesses that establish their own wholesale or retail prices for the product. We operate approximately 2,000 retail outlets in 14 states through a wholly-owned subsidiary, Speedway SuperAmerica LLC (SSA). SSA prices gasoline taking into account its current prices and margins, current sales, sales projections, resupply cost, competitor prices, and any other factors we believe may impact sales in a given market or at a given location. By far the most important of these factors is competitor prices. If our prices are higher than a retail competitor's by even a penny, we risk losing sales to that competitor. Retail prices change less often than rack prices, which can build a certain amount of compression or expansion into retail prices over time until retail prices adjust. If this happens, it may result in rather abrupt increases or decreases in retail prices. At retail this process is played out before the consumer in 20-inch high numerals on price signs at every retail location.

All of this may seem extraordinarily simple at the level of one store or one terminal, but the process is made complex because we must make price decisions every day at every retail store we operate and every business day at every terminal where we offer product, and back up those decisions with the production, logistics and commercial decisions required to keep everything moving 365 days a year. The complexity is increased by the fact that we face extraordinary competition at every step in the process, from purchasing crude oil, to refining production, to pipeline and barge transportation, to the wholesale and retail marketplaces. By way of example, Exhibit I shows refineries, terminals and wholesale supply competitors in or immediately adjacent to the State of Michigan.

Increased Gasoline Price Volatility

Midwest consumers need more gasoline and other transportation fuels than local refineries are able to produce. Because it lies hundreds of miles inland from additional sources of supply on the Gulf Coast, the Midwest is sensitive to a variety of supply risks. These range from OPEC actions or regulatory decisions, to refinery outages or disruptions anywhere along the 800-mile pipeline and barge link from the Gulf Coast. Each of these factors has the potential to induce price volatility, either alone or in combination with other events or circumstances. To the extent price volatility has increased in the past two or three years, increased demand, large swings in crude oil prices, regulatory requirements and the limitations of the delivery system seem to be the principle contributing factors.

For example, the most recent increase in gasoline prices appears to have been triggered by a rise in crude oil costs. OPEC production cuts, the Iraqi embargo, conflict in the Mid-East and Venezuela, the prospect of new operations in the war against international terrorism – all seem to have played a role in a rise of about 55 percent in crude prices from January 17, 2002 ($17.92) to April 2 ($27.73).

Keep in mind that there was no companion rise in profits in the refining and marketing segment of the business during that time period. Retail gasoline margins – price minus acquisition and transportation cost were greatly depressed -- in some cases even negative -- during the first quarter of 2002. Refining and marketing companies and the downstream components of integrated companies are reporting hundreds of millions of dollars in losses for that quarter, despite the dramatic rise in gasoline prices later in the quarter.

We understand that the ups and downs of retail price frustrate gasoline consumers. Price movement occurs as a result of market forces and unforeseen events drive markets. Over time, the real price of gasoline has trended down as a result of these same market dynamics, as shown on Exhibit II. Adjusted for inflation, gasoline now sells at close to an all-time low. This is true for very few other products. But then, few markets are as uniquely competitive as the one that brings America's motorists to approximately 180,000 retail gasoline outlets, a market that is growing even more competitive with the emergence of "hypermarketers," such as Wal-Mart, as gasoline retailers.

Crude oil is the essential raw material for gasoline production and the primary, non-tax cost component of gasoline. I say "non-tax" because taxes represent a significant part of what the consumer pays for gasoline -- as much as 45.7 cents a gallon in Wisconsin or 59.3 cents a gallon in Chicago. As Exhibit II shows, the spot gasoline price in Chicago, which is a key market barometer for gasoline price in the Midwest, tends to track crude oil costs closely, except when events or circumstances lead to a supply demand imbalance. When that happens, gasoline prices may increase well above the historical norms. These are the so-called "price spikes." Some notable events or circumstances, along with the corresponding change in the Chicago spot price, are noted on Exhibit II.

Price spikes are, by definition, short-lived increases due to short-term supply/demand imbalances. Such imbalances can have many causes, and often have multiple causes, as was the case with the price spike that occurred in the spring and early summer of 2000. In all such cases, prices retreat rapidly when the balance of supply and demand is restored.

I am proud of how the people of Marathon Ashland responded during periods of supply/demand imbalance in 2000 and 2001. During those years, we increased our refining throughput - testing the design limits of plants already running at the high-end of historic norms. We sold more product than we produced. In 2000, for example, we sold approximately 2

billion gallons more gasoline than we produced. When a major pipeline failure made product movement difficult, we ran transport trucks 24 hours a day, 7 days a week to supply our customers as best we could. We flew in additional drivers to fill the greatly-expanded route schedules and driving times. We also took the highly unusual step of importing a cargo of Canadian gasoline from Newfoundland through the Great Lakes to supply Michigan and other parts of the Midwest. We acted responsibly and, in fact, took extraordinary steps to keep our customers supplied.

Inadequacy of Domestic Industrial Infrastructure

One reason the supply disruptions of 2000 and 2001 produced such dramatic price effects is that the nation's refining and delivery systems are severely constrained, particularly during periods of peak demand. Understanding this context is important to appreciating why prices may spike when a refinery goes down or a pipeline connection to the Gulf Coast is interrupted.

No new grass-roots refinery has been built in this country since our own Garyville, Louisiana Refinery started up more than 25 years ago. During the same period, the total number of operating refineries has dropped by roughly 100. This puts a huge burden on our ability to move fuel from where it is now made to where it is needed. And yet our delivery system was originally designed for the America of the 1950's.

In the Midwest, fuel demand has increased for a number of reasons, including population growth, economic growth, and our location at the heart of coast-to-coast and border-to-border freight traffic. At the same time, as Exhibit III shows, approximately 25 refineries have closed in the last 20 years in just a seven-state region of the Midwest. It should be no surprise, then, that fuel production in this seven-state region is not adequate to meet demand. It is estimated that Petroleum Allocation for Defense District (PADD) II, which encompasses the Midwest, faces a refined product shortage of approximately 42 million gallons a day.

The shortfall between Midwest demand and Midwest production must be transported to the region, usually from the Gulf Coast, by a marginally adequate delivery system. During periods of peak demand, this system operates at or near capacity. If there is an outage for any reason, then there is very little if any make-up capacity. This can lead to supply/demand imbalances.

MAP's Efforts to Address the Issues

At MAP, we're trying to address these issues. On the production side, we have added a new coker at our Garyville Refinery at a cost of approximately $280 million. This project produces enough additional gasoline for about 60,000 cars per day, with no additional crude oil input. We also have a major capital improvement project underway at our Catlettsburg, Kentucky refinery in addition to numerous smaller projects completed or underway at other refineries. We are constantly looking for cost-effective ways to improve our refineries to increase production, reduce emissions and improve efficiency.

But we are also working to address the delivery issue. Earlier this month, a joint venture in which MAP is a one-third owner began operation of Centennial Pipeline, America's newest major refined products pipeline. (See Exhibit IV). Built in part from an existing natural gas line, Centennial connects the product-short Midwest with the nation's major refining center on the Gulf Coast. Such a connection is vital, because one out of every two barrels refined in this country is processed on the Gulf, and it is the only region of the nation with sustainable export capacity.

We also plan to build a common carrier pipeline to link one of the Midwest's fastest growing markets - Columbus, Ohio - with a major avenue of supply, the Ohio River, including our Catlettsburg, Kentucky, refinery. (Also shown on Exhibit IV.) We have secured right-of-way for that line, submitted our permit applications and complied with all known regulatory requirements. These types of projects take not only large amounts of capital, but also an extraordinary amount of time. This project is now in its fourth year, and we are still waiting to learn the disposition of our permit request.

Marathon Ashland - from its inception in 1998 - has invested a total of more than $2.25 billion in Refining, Marketing and Transportation assets to both improve existing assets and add new ones to supply our markets. We are proud of that record, but we are not finished. We plan to continue to invest heavily to meet both the demands of regulation for cleaner fuels and lower emissions and the growing needs of our customers.

Increasing Concentration in the Petroleum Industry

Refining and marketing is a highly competitive business with low average rates of return. It would appear that consolidation in our industry has occurred for the same reasons that it has occurred in other industries: cost efficiency and economies of scale. Three of Marathon Ashland's Midwest refineries (St. Paul Park, Minnesota; Canton, Ohio; and Detroit, Michigan) are small refineries, lacking the inherent efficiencies of larger facilities or the locational advantages of Gulf Coast refineries. Operating these smaller refineries as part of a larger system improves their efficiency. Were it not for the combination efficiencies realized from the creation of Marathon Ashland from the downstream assets of Marathon Oil Company and Ashland Inc., it is questionable whether either company would be able to survive as an independent refining and marketing company. These efficiencies have allowed Marathon Ashland to sustain our presence and invest the capital necessary to remain a viable competitor in the Midwest.

From our viewpoint, consolidation has not lessened the level of competition in our industry. If anything, competition is growing even more intense.

Constructive Steps for the Future

Why have so many refineries closed? Why has no new refinery been built in the United States for more than 20 years? Why has development of needed pipeline systems not occurred? Other industries under pressure are able to re-tool, re-allocate capital, and grow. For example, according to our research, nine auto plants closed in the Midwest between 1979 and 1996. But in the same period, in the same region, 13 new plants were opened. In approximately the same time period, 25 Midwest refineries were idled – and no new plant was built in our market – or, indeed, anywhere in the United States.

Investment payback is hampered by project delays and additional regulatory compliance expense. Marathon Ashland will, for example, spend more than $600 million over the next six years just to comply with new clean-fuels mandates. That huge investment may earn no market return, but it is the table stakes required in refining today. Those stakes are so high that several smaller and less efficient refineries may go out of business.

This is a critical issue that goes beyond recession and recovery to the fundamental return on investment of the industry. Money devoted to refining, delivery and marketing has earned some of the lowest returns in business – an average of about five and a half percent per year over the last 20 years. (See Exhibit V.) With these rates of return and an increasing level of regulation, it is little wonder that so many plants have closed and no new ones have been built, or that investment in our delivery system has not occurred.

Marathon Ashland and its employees are preparing to help meet the Midwest's growing need for transportation fuels. The following government measures would help in this effort: increased regulatory certainty; appropriate rule phase-in; policies that encourage investment in the industry, particularly in the delivery infrastructure of this country; and more expeditious permitting. Much of the "energy policy" debate in this country has focused on our dependency on foreign crude oil. But regardless of where the crude oil comes from, it must still be refined and delivered. For this reason, we need clear, consistent and positive advocacy from our government for the refining and delivery sectors.

The Department of Energy indicates petroleum hydrocarbons are likely to be the predominant transportation fuel in America for at least the next 20 years. Government and industry need to work together to help assure reliability and affordability of supply for America's transportation fuels consumers. I look forward to making that effort productive and long-lasting, and I appreciate the opportunity to appear before this committee.