

**STATEMENT OF
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HEARING ON
GAS PRICES: HOW ARE THEY REALLY SET?
April 30, 2002**

Good morning ladies and gentlemen. Today the Permanent Subcommittee on Investigations opens two days of hearings on how gas prices are set in the United States. Gas is the lifeblood of our economy, and through luck, pluck, hard work and ingenuity we've been able to have the gasoline we need in this country.

Most of us take for granted the fact that in most urban areas, we can go a few blocks and find a gas station that has gas and with the five minutes it now takes to fill up our tanks, we can be off and about our business in no time. It's easy to lose sight of the fact that the gas we put in our tanks is the product of an incredibly complicated, worldwide network of countries, companies, and individuals who, using advanced technology and science, take crude oil from under the ground or under the seas, put it in tankers the size of two football fields, ship it across the ocean to ports in New York, California, and the Gulf Coast, pipe it into refineries, heat it under the most dangerous circumstances and produce gas in that process. That gas is then piped or barged across the country to terminals where trucks unload it and deliver it to individual gas stations. It's an amazing process that goes on day after day, hour after hour, 24-7 as they say, to enable America's ready access to the liquid that makes our lives run.

With the central role that gas plays in all of our lives, it is no wonder that the public is highly attuned and sensitive to its price. And when the price of gas jumps dramatically at the pump without any apparent reason, and when all stations regardless of brand appear to raise and lower their prices at the same time and by the same amount, the public gets suspicious. That's what happened over 11 months ago when we started this investigation. The Midwest had just experienced for the second year in a row a price spike leading into the Memorial Day holiday. (Exhibits 1 and 2) Consumers were upset; they didn't trust the answers from the oil companies that the price spikes were just supply and demand at work.

In Michigan, the price of gas seemed to leap up overnight by the same amount across all brands of gas at all stations. If there were real competition in the industry, people asked, why would the prices of different brands go up and down together and just before the holidays?

Since the spikes in spring of 2000 and 2001, the Midwest has also witnessed a Labor Day price spike last year and nationwide, gas prices have increased in the last few months faster than at any time in the past 50 years. Price spikes are becoming a way of life in the United States and not without serious consequences. (Exhibit 3.) At the same time each year not only does the groundhog look for his shadow but for rising gas prices as well. But there are serious consequences to this new pattern. Sudden increases in gasoline prices are costly to the consumer and disrupt our economy, because the cost of transportation, which is based on the cost of fuel, affects the cost of all our goods and services. Last year's increases in the price of gasoline helped push the American economy into a recession, and this year's increases are threatening the current recovery.

Increased gas prices also represent a significant shift in wealth. For every 1 cent/gallon increase in the price of gas, the income to the oil companies goes up \$1 billion a year.

To try to get to the bottom of questions about gas prices, I asked the staff of our Permanent Subcommittee to investigate just how gas prices are set. After interviewing representatives from the oil companies, distributors, service station owners and dealers, trade association representatives, lawyers and economists; after analyzing data from the Energy Information Administration and wholesale and retail price data purchased from the Oil Price Information Service; after reviewing over 250,000 documents subpoenaed from a number of major oil companies and one pipeline company, the Majority Staff of the Subcommittee issued a 400 page report yesterday laying out their findings.

The report includes an analysis of the operations and structure of the oil industry with particular focus on the downstream portion – that is, from the refinery to the pump. Due to staff and time constraints, the staff looked in detail at just

three regions of the country: the West Coast (California in particular); the Midwest (Michigan, Ohio and Illinois, in particular); and the East Coast (Maine and the Washington, D.C. area, in particular).

The Majority Staff's findings are contained in the Executive Summary at the front of the report and provide the basis for these two days of hearings. (For those unable to obtain a hard copy, the report is available on the PSI website.) The Majority Staff found that the mergers in the oil industry over the last few years and the closing of many refineries over the past 20 years have increased the concentration in the refining industry, that is there are fewer refining companies. (Exhibit 4.) Under one test for concentration in at least 9 states the refining and marketing industry is highly concentrated and in at least 28 states it is at least moderately concentrated. Under another test for concentration, 28 states would be considered tight oligopolies. Let me explain.

The Department of Justice and the Federal Trade Commission measure market concentration in two ways. One is the Herfindahl-Hirshman Index or HHI; the other is the 4-firm concentration ratio. The report describes how each of these measures of concentration works. This morning, we have charts showing these measures for all 50 states and the District of Columbia. (Exhibits 5-8.) As you can see from these charts, there's been a dramatic increase in the number of states with moderate to high levels of concentration between 1994 and 2000. The red areas show the levels at which the numbers reflect high concentration. Under Department of Justice Guidelines, an HHI of between 1000 and 1800 is "moderately concentrated," and an HHI over 1800 is considered to be "highly concentrated." A 4 firm concentration ratio of more than 60 percent shows a "tight oligopoly." As you can see from these charts, D.C. is the most concentrated market, followed by Hawaii, Alaska, and a number of states in the Midwest; my home state of Michigan is considered a "tight oligopoly" under the 4 firm ratio and just below "highly concentrated" using the HHI index.

As is true in this industry as in any other, the more competition, the better for the consumer; the less competition, the worse of the consumer. But when an industry is concentrated, individual companies can have a significant effect on the price of a product, like gasoline, by the decisions they make on supply. That's what's happening today, in a number of markets in the United States. The reality is, that a tight balance between demand and supply and low inventories are major contributors to price spikes, because in that tenuous condition, with the demand for gas being inelastic, that is, staying pretty constant despite the price, two things happen: 1) in normal times when the market is concentrated, prices can be spiked before holidays, for instance with less fear of competition driving it back down; 2) in times when there is a market disruption, the market responds wildly to the slightest problem or potential problem. We experienced major price spikes in the Midwest in just two years for those reasons. Let's walk through each of those prices spikes.

Low inventories have helped to create the conditions for price spikes in the Midwest, which have occurred when demand has increased (near driving holidays) and/or the supply of gasoline was disrupted. Not unlike oil companies nationwide, oil companies in the Midwest have adopted just-in-time inventory practices, resulting in crude oil and product stocks that frequently are just above minimum operating levels. And, in the spring of 2000 and 2001, the conversion from the production and supply of winter-grade gasoline to summer-grade gasoline further contributed to low inventories just prior to a seasonal increase in demand. With the stage set by those two factors, the oil companies took actions over these past two years in accordance with their profit maximizing strategies that significantly contributed to the price spikes when disruptions in supply occurred:

– During the spring of 2000, three major refiners determined it wasn't in their economic self interest to produce any more RFG [reformulated gas] than that required to meet the demands of their own customers, and so in that year they produced 23% less RFG than in the prior year, not enough to supply everyone who wanted to purchase it. That contributed to the short supply in the spot market for RFG, contributing to the price spike of spring 2000. While Marathon did have surplus RFG, it withheld some of it from the market so as to not lower prices.

– In the summer of 2001, major refiners deliberately reduced gasoline production, even in the face of unusually high demand at the end of the summer driving season, contributing significantly to the price spike of 2001.

Nationwide, in the winter of 2001 - 2002, demand fell and inventories rose following the tragic events of September 11, 2001. With reduced demand and higher inventories, prices fell. As a result, refining profits fell and refiners cut back on production in order to obtain higher profits. Along with the increase in the price of crude oil and market speculation, these reductions in production and the increase in industry concentration significantly contributed to the run-up in price in the late

winter and continuing into the early spring of this year.

Internal documents from several oil companies confirm that the oil companies view it to be in their economic interest to keep gas inventories low and the supply and demand balance tight.

Several documents from California show that refiners in California sought in the mid-90's to prevent imports into California in order to make the market "tight."

- One internal Exxon memo advises the company to "not do deals that supports other's importing barrels to West Coast."
- Similarly, an internal Mobil memo counsels against importing gasoline, saying it would depress margins.

California refiners also sought to limit the overall refinery capacity in the state.

- One Mobil document talks about how to block the proposed startup of the Powerine refinery. "Needless say," the memo says, "we would all like to see Powerine stay down." It then proposes accomplishing this by buying all its product and marketing it themselves. "Especially," the memo says, "if they start to market below our incremental cost of production." The memo then notes that buying Powerine's product the previous year when it was below Mobil's "incremental cost of production" had worked and it was "a major reason that RFG premium . . . went from 1 cent per gallon to 3-5 cents per gallon."
- A Texaco memo discusses how to use changes in fuel specifications to reduce supplies. The memo says "Significant events need to occur to assist in reducing supplies and/or increasing the demand for gasoline." One example of a significant event, the memo says would be to eliminate the requirement for an oxygenate which the memo says, would make oxygenate usage go down which reduces total volume of gasoline supplies. The memo says, "Much effort is being exerted to see that this happens in the Pacific Northwest."

California refiners also exported gas – that is, shipped gas out of California – to keep the market in that state tight.

- An ARCO internal document discusses the need to export to prevent supply from building up in the state. The memo indicates that ARCO should export in order to intentionally alter the supply/demand balance within California and not just as a passive response to the prevailing economic conditions. In that same presentation one strategy discussed is to "exchange and trade selectively to preserve market discipline."
- Another document in the Subcommittee files indicates that one company would export gasoline out of California to the Gulf Coast, even at a loss, with the rationale that such losses "would be more than offset by incremental improvement in the market price of the much larger volumes of [gas] left behind."
- Another company's plan indicates that exporting gasoline can "improve market conditions," and that company was willing to "take [a] hit on price to firm up market."

An internal BP document from 1999 reflects similar thinking with respect to the Midwest. The document reflects a discussion amongst senior BP executives of possible strategies to increase refining margins, and it mentions "significant opportunities to influence the crude supply/demand balance." It notes that these "opportunities" can increase Midwestern prices by 1 to 3 cents per gallon." The memo discusses strategies to reduce the supply of gasoline in the Midwest. It lists some possible options, including: shutting down refining capacity, convincing cities to require reformulated gas that is not readily available, exporting product to Canada, lobbying for environmental regulations that would slow down the movement of gasoline in pipelines, shipping products other than gasoline on pipelines that can carry gasoline, and providing incentives to others not to provide gasoline in Chicago. BP officials told the Subcommittee staff that these ideas were only part of a "brainstorming" session and that none of the options for reducing supply were adopted. We'll go through this document in some detail later this morning. In another document from the Midwest, an internal Marathon document, Marathon even called Hurricane George a "helping hand" to oil producers because it "caused some major refinery closures, threatened off-shore oil production and imports, and generally lent some bullishness to the oil futures market."

And that is the heart of the problem with respect to gas prices in the United States today – in certain regions of the country – the refining market is so concentrated, that oil companies can act to limit supply and from time to time spike prices to maximize profits, and because there is insufficient competition, there is little-to-no challenge to that action. That’s the major problem as I see it. The ability to control supply allows oil companies to spike prices in a concentrated market without adequate competition to challenge them.

The Majority Staff made some other significant findings. Oil companies do not set wholesale (rack) or retail prices based solely upon the cost to manufacture and sell gasoline; rather wholesale (rack) and retail prices are set on the basis of market conditions, including the prices of competitors. Most oil companies and gasoline stations try to keep their prices at a constant price differential with respect to one or more competitors. For example one company decided that its station in Los Angeles should price the lower of ARCO stations plus 6 cents per gallon, or the average price of major branded stations in the area. Another oil company followed a pricing policy in Baltimore as follows:

We will initiate upward, we will follow Amoco, Shell quickly... we will be slow to come down in a dropping market.

Because many oil companies and gasoline retailers set their retail price on the basis of the prices of their retail competitors, prices in each specific market tend to go up and down together. And oil companies tend to stake out a position in each market vis a vis the competitors and hold that position. Hence, it will often appear that, over time, gasoline prices in that market move together in a “ribbon-like” manner – so that as a brand moves up and down it nonetheless remains at a constant differential with respect to the other brands. Look at this retail pricing chart for Illinois for June 2001, and this one from Maine for January-August 2001. (Exhibits 9 and 10.)

In Michigan and Ohio, we found a clear leader-follower pricing practice. Speedway, owned by Marathon, has a pricing practice that bumps up the price of gasoline on Wednesdays or Thursdays. As the price leader in Michigan, once Speedway goes up, the other brand follows. The typical pattern after that is for Speedway to come down in price pretty quickly, while the other brands follow them down more slowly. You can see this very clearly in these charts from January to August 2001 and April 2001. (Exhibits 11 and 12.)

Oil companies also use a system of what they call “zone pricing” in order to maximize the prices and revenues at each gas station. Since under the antitrust law, they are prohibited from selling wholesale product at a different price to similarly situated retailers, the oil companies have developed a system for differentiating among retailers in the same immediate area. In doing so, they can charge the retailers different wholesale prices for their gasoline. The way they accomplish this is by dividing a state or region into zones. A zone is supposed to represent a particular market, and the stations in that zone are supposed to be in competition with each other. The oil companies use a highly sophisticated combination of factors to identify particular zones. For example, if most people buy their gas on their way home from work instead of on their way to work, a station on one side of a rush hour street may be treated as in one zone and the same brand station on the other side of the street in another zone. The oil company will then charge those two gas stations different prices for their gasoline, because the station on the side of the street with easy access for evening rush hour traffic may be able to get a higher price for its gas than the station on the other side of the street. That’s the kind of thinking that goes into the zone pricing system, and it allows the oil companies to charge the highest possible amount for their gas in a given area.

Another pricing practice the Majority Staff uncovered has to do with how gas station owners set their retail prices. The Majority Staff learned that for those stations that lease from a major oil company (about one-fourth of the 117,000 branded stations) the oil company actually recommends to the station dealer a retail price. Now by law, the oil company is prohibited from telling a lessee dealer what it can charge for gasoline, but that doesn’t keep oil companies from “recommending” a price. And the Majority Staff was told by several dealers that if they don’t charge their retail customers the recommended price, the next delivery of gas from the oil company will reflect any increase instituted by the dealer. These dealers are saying that if they decide to price their gas at \$1.40/gallon when the oil company recommends \$1.35, the next delivery of gasoline to the station (and deliveries are sometimes daily for busy stations) will have a 5 cent/gallon increase in the price to the retailer. If these allegations are true, then the practical effect would be that the recommended price is subtly or not so subtly being enforced.

The Majority Staff report also address several other important issues with respect to gasoline pricing – including the advent of hypermarkets, those are the discount super-stores like Wal-Mart and Cosco that now sell the lowest priced gasoline

in the market; and the impact of boutique fuels, fuels required for specific locations to address particular environmental situations. This morning we will hear from the top marketing executives of five major oil companies: Marathon Ashland, BP, ExxonMobil, Chevron Texaco, and Shell Oil.

On Thursday we will hear from Senator Wyden, who has also been looking into the subject of gas prices; three Attorneys General, from California, Connecticut and Michigan, all of whom have been active in challenging gasoline price increases in their states; and we will hear from a panel of economists and industry experts on the issues raised in the report.

I want to take this opportunity to say a special thanks to the Majority Staff who worked so hard on this report and put together such a thorough product. The Subcommittee's thanks go to Dan Berkovitz, the lead writer of the report; Laura Stuber, counsel to the Subcommittee who oversaw the dozens of interviews with individual gas station owners and operators and ably drafted portions of the report and oversaw its development; Edna Curtin, a detailee from the General Accounting Office who did a substantial portion of the price analysis and chart development; Cliff Tomaszewski, a detailee from the Department of Energy who provided background research on the oil industry and the production and marketing of gasoline; Bob Roach, chief investigator who was responsible for the discussion of the Wolverine Pipeline case; and Mary Robertson, the Subcommittee's Chief Clerk who again, amazed us all with her ability to pull together a complex report for production.

I also want to express my appreciation to Senator Collins and her staff for their support and to Senator Durbin and his staff who assisted in the interviews.

It has been a team effort, and when you think about the complexity of the issues, the size of the industry, and the task of reading through tens of thousands of pages of materials, it is highly impressive that such a small team produced such a well-written report in less than a year.

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