TESTIMONY OF
ATTORNEY GENERAL RICHARD BLUMENTHAL
BEFORE THE SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS
JUNE 29, 2000

I appreciate the opportunity to speak before this committee on a critical economic issue facing many citizens across the nation and especially in my state of Connecticut: the shocking increase in oil and gasoline prices during the past year.

Let me say at the outset, we may be rightly accused of concentrating too narrowly on yesterday's calamities. Looming on the fall and winter horizon is tomorrow's crisis is an imminent shortage of home heating oil that will cause devastating price increases when cold weather comes. That crisis is written in the dry numbers of inventory, production and refining of oil products. Soon it will be visible in the faces and voices of homeowners confronting a reprise of last year's outrageous price spikes. This crisis is the elephant in the room that no one wants to acknowledge today.

We should learn from experience, especially our ongoing bouts with price and supply abuses. In Connecticut, gasoline prices have soared an astounding 90% between March of last year and now. Similar increases have been posted throughout the Northeast-MidAtlantic region, costing consumers in this area more than $2 1 billion on an annual basis, using the Federal Trade Commission figures that each 1% rise in gasoline prices costs consumers $240 million per year.

These numbers have real life consequences. Money spent on food and clothing is now going into the gas tank, families' vacation plans and seniors are paying higher percentages of meager fixed incomes just to reach the grocery store and pharmacy.

Connecticut, like our entire nation, relies primarily on motor vehicles for every day transportation because we do not have a highly concentrated population. Our largest city has only 137,000 people. Quick adaptation to mass transportation alternatives is impracticable even in the time of outrageously high gasoline prices. Rideshare programs, trains and bus transportation are simply not always available.

Connecticut and the rest of the Northeast region now face the whipsaw effect of high gasoline prices after a tough winter of skyrocketing heating oil costs -- wreaking havoc on many unprepared consumers, especially senior citizens who own their own homes. The financial body blow of $2 per gallon for home heating oil has been followed within months by a second hit of $2 per gallon of gasoline -- now soon to be followed by a third this winter.

Indeed, the financial blows are likely to mount, not merely continue. The Energy Information Administration is predicting high heating oil costs again next year because the industry has failed to boost production adequately to replenish low heating oil inventories. The present focus on gasoline inventories may ironically hamper that replenishment of heating oil stocks. Indeed, both gasoline and residential heating oil stocks ended 1999 at their lowest levels in more than 10 years.

The industry has desperately and deceptively sought to shift the blame. It says the gasoline price spike is due to rising crude oil prices but crude oil prices have risen steadily for many months without generating price spikes in gasoline. It also blames the spike on the costs associated with the production of new reformulated gasoline, but the incremental cost of such measures has been estimated at only 4 cents per gallon and the need for producing such gasoline has been known for more than a year, allowing ample opportunity to allocate the costs over time. The industry also cites the increase demand for gasoline and heating oil as unexpectedly reducing inventories. Yet, in Connecticut, for example, we used the same amount of gasoline in 1999 as in 1992. Nationally, demand has been increasing at a steady, but very moderate rate, hardly a jump justifying the recent price spike. Finally, the industry blames taxes on the high cost of gasoline. In Connecticut, we have seen the highest prices for gasoline since the early 1980's, yet we have reduced our gasoline tax by 7 cents since July, 1997 and will reduce our tax again by 7 cents in the next two days.

The industry omits to mention record profits -- the result of increased revenues derived from the very same high cost of gasoline and heating oil.

Last Friday, I joined many national and state officials in calling for the Federal Trade Commission to expand its inquiry into the rapid rise in gasoline prices in the Midwest to study the price increases nationally. Because the petroleum market is a national one, we need the resources and the expertise of the Federal Trade Commission and the Department of Energy. I also urge the FTC to compare the gasoline pricing policies and experience in highly competitive markets with those policies and experience in more concentrated markets. Such information would be useful in understanding the impact of the recent consolidations within the oil industry on the recent gasoline price spike.

Congress needs to take action on four fronts to adequately address the current intolerable costs of energy:

- Establish minimum levels of gasoline and heating oil inventory
- Raise the antitrust standard for approving oil industry mergers
- Prohibit the industry practice of zone pricing
- Reduce dependence on gasoline and home heating oil

I. Establish minimum levels of gasoline and heating oil inventory

The Energy Information Administration cites as one of the prime causes of the recent gasoline price spikes the low levels of gasoline stocks in the United States. Lower supply and only slightly increased demand have caused drastic increases in price. In its most recent survey, the EIA found nationwide that gasoline stocks remain at low levels, averaging almost 20 million barrels less than last year, or approximately 10% lower inventory in 2000 than in 1999. In New England, the decline in available gasoline stocks has been even more dramatic: In April, available gasoline stocks were 34% below those existing at the same time in the previous year, while in May, available gasoline stocks were 30% lower. Clearly, the industry purposefully and intentionally reduced product inventory. There are lower gasoline supplies and higher prices but refinery profit margins are nearly three times those in 1999. While the industry profits handsomely from this self-serving reduction of inventories, the consumer is the one who pays and loses.

This phenomenon is hardly novel. In January, heating oil prices doubled to a record level of $2 per gallon, so that a person receiving a 200 gallon delivery faced a $400 bill to heat a home for about 4-6 weeks. Even worse, in some areas of Connecticut, there was simply no heating oil for delivery. East Coast refineries operated at 85% capacity during the winter of 1999, drawing down on inventories instead of adding to them for the approaching winter. Contrary to past years, inventories were not increased during the early winter season.

While the underlying cost of oil has been increasing, the dramatic spikes in gasoline and heating oil have been due to industry decision-making that has reduced available inventory during the winter season. This industry practice may lead to a devastating dearth of gasoline or heating oil especially when unexpected events occur such as sudden drop in temperatures, a pipeline break or a refinery fire.

Just-in-time inventory practices have been used successfully in other industries to reduce costs. But, there is a significant, indeed vital, difference between gasoline or heating oil and other goods such as toys or clothing in applying just-in time management techniques. With many other products, if the manufacturer is wrong, the consumer either does without the product, pays a higher price or switches to a competitor. In gasoline and heating oil, the consumer almost always pays a drastically higher price for the product, with a significant windfall to the highly concentrated industry.

Gasoline and heating oil are the lifeblood of our economy and an essential life-line for many consumers. Inventory decisions cannot be left solely to an industry whose only focus is the bottom line. A recent statement by the head of the American Petroleum Institute boasts that "U.S. refiners and distributors reliably provide Americans with the fuels they need to get where they need to go, helping them earn a living and improving the quality of their lives." This industry recognizes the vital nature of its products but is willing to gamble the fate of consumers on a risky low inventory system.

I applaud the leadership and vision of Senators Joe Lieberman and Chris Dodd in calling for the establishment of a regional strategic petroleum reserve. Clearly, the facts demonstrate the need for the federal government to ensure adequate supplies of heating oil and gasoline.

Since the establishment of a regional strategic petroleum reserve could be expensive and time consuming to implement, Congress should also consider establishing a minimum inventory maintenance requirement. Mandating that oil companies keep a certain amount of product available would ensure that consumers are shielded from destructive price spikes and guard against shortages in supply. Such minimum requirements could be facilitated through tax credits, direct payments or other methods of ensuring or encouraging compliance with the minimum standard.

Currently, states require banks and insurance companies to maintain minimum reserves to pay consumer insurance claims and customer requests for withdrawal of funds from bank accounts. Similarly, minimum inventory requirements for heating oil and gasoline should be considered. If the industry will not guarantee sufficient supplies, then government is justified in doing so. Currently, the industry rewards rather than punishes companies that maintain minimal inventories of heating oil and gasoline.

II. Increase the standard for approving consolidation within the oil industry

Mergers have swept the oil industry -- prompting the Federal Trade Commission, Attorneys General like myself and other antitrust officials, to express strong alarm about the harm to consumers. Recent examples include: Mobil-Exxon, British Petroleum-Amoco; BP/Amoco-ARCO; Motiva (joint venture of Texaco/Shell/Saudi Aramco); Marathon-Ashland refining; Tosco's acquisition of Unocal's refining business; a series of acquisitions by Ultramar/Diamond Shamrock.

We are right to be alarmed. The Mobil-Exxon merger, had it been approved as proposed, would have enabled the top four gasoline companies to control 73% of the market in half the metropolitan areas in the Northeast-MidAtlantic region. I appreciated the FTC's effort to reduce the anti-competitive impact of the transaction. On balance, as I advocated then, I believe consumers would have been better served by disapproving the deal even as modified.

In the retail area, one result is the power to engage in abuses such as zone pricing,

So too, in the refinery and production segments of the oil industry, the FTC has reviewed mergers that have concentrated market power in the hands of fewer players. There is vastly diminished competition on price and supply.

The merger trend has produced a cartel culture, with innovative companies less likely to buck the industry trend. Refiners and producers can reduce product levels, causing widespread supply shortages and higher prices, with confidence that there is no other company that will raise inventories and reap a significant financial reward.

A prominent business news source indicates that refining margins will reach their highest levels in 3 years, and will likely stay high through this year. The profit results are astounding: Ultramar 1st quarter, 2000, profits more than quadrupled; Chevron 4th quarter, up 63%; Arco 1st quarter, up 238%; Tosco 4th quarter, up 11%; Exxon-Mobil year end, up 34%.

The Federal Trade Commission and Congress should send a message that further consolidations within the oil industry will face a presumption of nonapproval in light of the desperate need for more competition. New rules should 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 better prices and services.

III. Zone pricing should be prohibited

Heightened scrutiny of oil industry mergers will take some time to bring relief to consumers through increased competition. One immediate step could bring some minor reductions in the price of gasoline to consumers: ban the practice of zone pricing.

I have already testified on zone pricing before the House Committee on Judiciary on April 7, 2000 and I have attached that testimony for the Committee's reference. I will not go into great detail on zone pricing before this committee but I would emphasize the importance of prohibiting this pernicious pricing practice.

Zone pricing is a mechanism used in almost every state where the major oil companies artificially create geographic areas for purposes of charging different prices for gasoline to dealers within the zone. Mobil has established 46 zones in a small state like Connecticut.

The power of the major oil companies 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. Hence, consumers in the higher price zones pay a higher retail price -- in Connecticut, up to six cents per gallon.

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.

I urge this committee to consider legislation to specifically ban 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. I have suggested legislative language contained in my testimony before the House Committee on Judiciary.

4. <u>Reduce dependence on gasoline and heatine oil</u>

In addition to the steps suggested in this testimony to make the oil industry more competitive and pro-consumer, Congress should take the historic opportunity to aggressively pursue policies designed to lessen American dependence on OPEC and other foreign sources of oil.

First, mass transportation should be encouraged. Safe, clean and convenient mass transportation would be used by many citizens. I encourage you to discuss solutions with local and state officials. They live with the day to day problems of traffic and pollution. They will know what will work for their communities

Second, cars need to be made more efficient. Increasing the efficiency of cars and light trucks from 27 miles per gallon to 45 miles per gallon would save 237 billion gallons of gasoline over a 5 year period.

Finally, we need to increase our commitment of resources to develop alternative fuels and energy efficient technologies. During these good economic times, we should invest in programs that have long-term benefits.

Thank you for allowing me to address the committee on this most critical topic.

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**TESTIMONY OF
CONNECTICUT ATTORNEY GENERAL RICHARD BLUMENTHAL
BEFORE TEE HOUSE JUDICIARY COMMITTEE
APRIL 7, 2000**

I appreciate the opportunity to speak today on the issue of zone pricing in the gasoline industry

The nation has watched aghast as gasoline prices virtually doubled from under $1 to over $2 gallon in many places within barely a year. Their rapid rise and volatility have been shocking They have siphoned hundreds of dollars out of individual consumer's budgets -- hitting particularly hard the elderly and people on tied incomes.

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The major oil companies have claimed that this differential pricing mechanism is simply meeting the competitive situation in each zone. Yet, one look at their zone system demonstrates that zone pricing is simply designed to increase profits by setting prices based on what the oil companies think the market will bear. The refining companies map out areas and charge dealers different wholesale prices according to secret formulas based on relative wealth, isolation, or other factors. Connecticut, for example, is a geographically small state, but Mobil, one of the largest gasoline distributors in the state, has 46 zones. In one recent example, the wholesale price for gasoline in a town with higher per capita income was six cents higher than the wholesale price for the same gasoline in a nearby town with a significantly lower per capita income.

The problem is national. Zone pricing is used by the major oil companies in virtually every state. In California for example, one major oil company has three price zones within a 14 square mile area, with different prices for gasoline stations only 6 miles apart. Around the nation, zone boundaries change frequently, arbitrarily and secretly.

Oil companies claim that zone pricing is a response to competition, and is needed to help their dealers in more demanding market areas compete and maintain market share. Those claims are untrue and unsupportable. The only real purpose of zone pricing is to allow oil companies to squeeze out extra profits from retailers and consumers wherever they see an opportunity.

In a truly free and open market, every retailer would be free to buy his brand of gasoline from whichever wholesaler offered the best price at that time, and the retailer would pass some of the savings on to the consumer to stay competitive – which is the way a free market should work. Wholesale prices of gasoline by the major oil companies would be based on the supply and demand at the dealer level and the costs of buying and refining gasoline. Under zone pricing, by contrast, they often include an extra secret surcharge based on where the gas station is. Obviously, that isn't a free market. It's a market which has been captured and abused by the major oil companies.

I have worked closely with the Connecticut chapter of the Gasoline and Service Dealers of America (GASDA) to enact state legislation prohibiting zone pricing. The fact that GASDA has fought so hard for this legislation demonstrates the retailers' dissatisfaction and frustration with such arbitrary price gouging schemes. (The strength of industry opposition shows how lucrative it is for big oil companies.) Our local small businesses know our market best. If zone pricing were really necessary to promote competition, as big oil claims, then retailers would advocate it. Instead, they abhor it, because they know it stifles competition -- unfairly to dealers and drivers alike. Robust competition on a level retail playing field, without price manipulation from wholesalers, ultimately benefits consumers.

Zone pricing may seem to be a practice that is illegal under our federal antitrust law. Indeed the Robinson-Patman Act, 15 U.S.C. 13, states in pertinent part:

> It shall be unlawful for any parson engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchases of commodities of like grade and quality . ..and where the effect of such discrimination may be substantially to lessen competition ...

Clearly, zone pricing by its nature is price discrimination. Court interpretations of the Act, however, have required that the discrimination be continuous. Because zones and zone pricing schemes change frequently, at least one court has held that the zone pricing differential is temporary and therefore does not have a significant effect on competition. American Oil Company v. FTC, 325 F.2d 101 (7th Cii. 1963).

In addition, subsection (b) of the Robinson-Patman Act establishes a defense to a price discrimination claim when the "lower price or the furnishing of services or facilities to any purchaser or purchasers was made in good faith to meet an equally low price of a competitor, ..." This "meeting competition" defense has doomed any successful legal action against zone pricing under the Robinson-Patman Act -- not because zone pricing is really pro-competitive, but because the whole system has been designed to be so complex that proof is extraordinarily difficult, and legal challenges can seldom succeed.

Now is the time for Congress to act. I recommend one of three options which would lead to lower prices at the gas pumps.

First, Congress could enact legislation prohibiting zone pricing. I suggest the following language for the committee's consideration: "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."

Second, Congress could enact legislation that establishes a clear prohibition against price discrimination in this context. The committee could consider language such as:

> A person engaged in the business of furnishing gasoline to retail distributors of gasoline shall sell gasoline to all retail distributors of gasoline at the same base price minus any bona fide volume discount and plus any actual transportation cost The invoice for the sale of such gasoline shall indicate the base price and any discounts or transportation costs. Such base price shall not be adjusted more than once in any twenty-four hour period and shall be the rack price as posted in the oil price information service.

Third, Congress could 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, in approving the PMPA, recognized that gasoline dealers are in a weak bargaining position with the major oil companies over terms of the franchise agreement, the PMPA does not provide specific protection against unfairly burdensome franchise provisions foisted upon gasoline dealers by the major oil companies.

The power to impose zone pricing is solely based 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. I suggest that the committee consider the following language: "No franchise, as defined in subdivision (1) of 15

USC 2801, shall liiit 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."

I urge the Judiciary Committee to carefully consider these options in an effort to deliver more competition and lower prices to gasoline stations throughout the United States.