TESTIMONY OF

MICHAEL PORTS

PRESIDENT, PORTS PETROLEUM COMPANY, INC.

REPRESENTING

THE SOCIETY OF INDEPENDENT GASOLINE MARKETERS OF AMERICA

AND

THE NATIONAL ASSOCIATION OF CONVENIENCE STORES

AT A HEARING OF

THE HOUSE COMMITTEE ON GOVERNMENT REFORM'S

SUBCOMMITTEE ON

ENERGY POLICY, NATURAL RESOURCES AND REGULATORY AFFAIRS

ON

"VOLATILITY OF U.S. GASOLINE MARKETS"

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I. Introduction

Good morning, Mr. Chairman and members of the Subcommittee. My name is Mike Ports. I am President of Ports Petroleum Company, an independent motor fuels marketer headquartered in Wooster, Ohio. Ports Petroleum owns and operates 60 high volume unbranded retail motor fuels outlets. Our company operates these stores under the "Fuel Mart" name in 11 states from Ohio to Nebraska, south to Mississippi, and east to Georgia.

I appear before the Subcommittee today representing the Society of Independent Gasoline Marketers of America ("SIGMA") and the National Association of Convenience Stores ("NACS").

II. The Associations

SIGMA is an association of more than 250 independent motor fuel marketers operating in all 50 states. Last year, SIGMA members sold more than 58 billion gallons of motor fuel, representing more than 32 percent of all motor fuels sold in the United States in 2003. SIGMA members supply more than 33,000 retail outlets across the nation and employ more than 360,000 workers nationwide.

NACS is an international trade association comprised of more than 1,700 retail member companies operating more than 100,000 stores. The convenience store industry as a whole sold 142.1 billion gallons of motor fuel in 2003 and employs 1.4 million workers across the nation.

III. <u>The Role of Independent Marketers in the Gasoline Distribution Industry</u>

Thank you for inviting me to testify today on the causes of price volatility in the United States gasoline markets, including the price increases we have witnessed in 2004. Collectively, the members of SIGMA and NACS sell approximately 80 percent of the gasoline consumed in the United States every year. However, the vast majority of NACS members and all SIGMA members do not "make" gasoline and diesel fuel. Instead, we are motor fuel marketers, purchasing gasoline and diesel fuel under contract or on the open market. As a result, SIGMA and NACS members are as exposed to fluctuations in the overall supply, and to volatility in the price of crude oil and the impact this volatility has on wholesale and retail motor fuel prices -- just as consumers are.

In fact, independent motor fuel marketers represent the closest proxy for gasoline and diesel fuel consumers that exists in the nation's motor fuel refining and distribution industry today. Shortages in gasoline and diesel fuel supplies, caused by world events, low inventories, refinery or pipeline outages or turnarounds, or simple, enduring stresses in the motor fuel distribution system, impact independent marketers first -- before your offices begin to hear complaints from consumers and businesses about the retail price of gasoline and diesel fuel.

IV. General Comments on the Causes of Price Volatility in U.S. Gasoline Markets

SIGMA's and NACS' message today to this Subcommittee, and to your colleagues in the House and Senate, is very simple. There are two main factors contributing to the high gasoline prices that motorists are paying this Spring and early Summer: (1) high worldwide crude oil prices; and, (2) a very tight balance between gasoline supplies and consumer demand. There is very little that this Subcommittee, or this Congress, can do legislatively in the short-term to address either of these factors. However, SIGMA and NACS urge you and your colleagues to examine longer-term solutions to these problems so that the gasoline and diesel fuel price spikes we witnessed this year do not become the norm.

I am sure that you have heard testimony from government witnesses this morning indicating that the 2004 gasoline price spike is easing. World crude oil prices have started to decline slowly. The same is true of wholesale and retail gasoline and diesel fuel prices across much of the nation.

The challenge we collectively face, however, is to maintain sufficient interest within this Congress to find a solution to the problems affecting the gasoline and diesel fuel markets even as the current price spike eases. If Congress fails to address these problems, simply because the public and media attention to gasoline prices might be subsiding, SIGMA and NACS assert that there is no reason to believe that such price spikes will not occur periodically and perhaps more frequently in the future because the fundamental problems that cause the spikes have not been addressed. We urge the House and the Senate to address the underlying causes of motor fuel price volatility legislatively this year if possible, or in the 109th Congress at the latest.

V. The Specific Causes of the 2004 Gasoline Price Spike

As I have stated, two fundamental factors have contributed to price increases in 2004. World crude oil prices rose precipitously over the first six months of this year. There are myriad reasons for these increases which have been addressed by others and which I will not cover here.

The point I will make is that even if crude prices do fall significantly in the coming months, the second factor leading to the 2004 price spikes -- tight gasoline supplies -- will continue to exert significant upward pressure on gasoline prices in the future. If Congress wants to prevent future gasoline price spikes, SIGMA and NACS suggest that it focus its legislative attention on three issues: the expansion of overall gasoline supplies, the restoration of gasoline fungibility, and the increase in domestic motor fuel refining capacity.

As an initial matter, I would note that none of the public policy initiatives SIGMA and NACS are discussing in our testimony today would benefit motor fuel marketers directly. Rather, they are aimed at restoring fungibility to the motor fuels market to improve overall supplies, at easing the movement of gasoline and diesel fuel into markets when shortages occur, and at increasing domestic refining capacity. If these initiatives increase the overall supply of domestically-produced gasoline and diesel fuel in this country by a mere five percent, SIGMA and NACS believe Congress will have taken significant and positive steps towards easing the upward pressure on gasoline and diesel fuel prices, increasing competition in the market, and reducing the frequency and magnitude of periodic price spikes.

The current statistics on the state of our nation's domestic refining industry and on levels of available gasoline supplies are well known to most policymakers. More than half the domestic refineries operating in 1981 are out of business today. A new refinery has not been built in this country in almost 30 years. The remaining refineries are operating at maximum capacity on a daily basis in an effort to keep pace with demand. Consequently, the nation is becoming increasingly dependent on imports of gasoline and diesel fuel because the capacity of our nation's refineries is not expanding quickly enough to meet continually increasing consumer demand.

In order to understand fully the challenges we are facing, we must add to these bleak domestic refining capacity statistics the affect of the balkanization of the motor fuels markets into islands of "boutique" fuels over the past two decades. Twenty years ago, there were two blends of gasoline, offered in three octane levels, and essentially one blend of diesel fuel. Today, there are more than 18 unique blends of gasoline mandated across the nation -- again offered in three octane grades -- and at least three different blends of diesel fuel. And in most instances, gasoline or diesel fuel that is sold in one city can not be sold lawfully in another city -- even if that city is just across a state or county line several miles away.

Simply stated, the ability of our nation's motor fuel refining and distribution industries to increase gasoline production -- or transfer product from market to market -- in times of tight supplies and increasing wholesale and retail prices no longer exists. The environmental compliance burdens placed on the nation's refining industry over the past twenty years have effectively destroyed the world's most efficient commodity manufacturing and distribution system. To enhance the quality of our air, an objective of which SIGMA and NACS are completely supportive, the government has imposed on domestic refiners tens of billions of dollars in costs and has fragmented the motor fuels distribution system into islands of boutique fuels. But as for all other good things, there is a price for this cleaner air that ultimately must be paid by consumers of gasoline and diesel fuel.

As long as the motor fuels refining and distribution system works perfectly, supplies are adequate and retail prices remain relatively stable. However, if there are any new stresses placed on the system, such as a pipeline disruption or an increase in world oil prices, the industry no longer has the flexibility to react and counterbalance these forces.

If we collectively want to prevent future national and regional gasoline and diesel fuel price spikes, the current situation must be addressed and changed.

VI. Policy Recommendations

There are no short-term fixes to the inter-related issues of increasing overall gasoline and diesel fuel supplies and preventing future price spikes. Therefore, SIGMA and NACS urge Congress to examine a broad slate of legislative initiatives to address these issues in the medium- and long-term. These issues can be summarized as follows:

- Address boutique fuels -- repeal the reformulated gasoline oxygenate mandate; adopt a moratorium on new boutique gasoline and diesel fuels; and, conduct a detailed study to determine if the number of boutique fuels across the country can be reduced without sacrificing environmental protections or significantly reducing gasoline supplies;
- Encourage expansion of existing domestic refining capacity -- adopt regulatory reforms that clarify New Source Review applicability to refinery expansions and streamlines the federal and state permitting process for expanding existing refineries and building new refineries; and,
- Incentivize investment in new refining capacity -- adopt federal tax incentives that encourage, rather than discourage, domestic refiners to expand capacity at existing facilities and build new facilities.

I will discuss each of these initiatives in turn.

A. Address Boutique Fuels

First, the balkanization of our nation's fuels markets into distinct islands of boutique fuels must be stopped and, possibly, reversed. The first step toward achieving this goal is to repeal the federal reformulated gasoline program oxygenate mandate. This mandate is not necessary to improve air quality and has led many states to adopt boutique gasolines over the past decade in order to avoid being forced to bring MTBE or ethanol into their markets. A repeal of the RFG oxygenate mandate is contained in the conference report on H.R. 6, the national energy policy legislation. SIGMA and NACS strongly support H.R. 6 and urge its adoption before Congress adjourns for the year.

The second step towards stopping further balkanization is to prevent additional boutique fuels from being mandated in the future. Over the next several years, many states will submit plans to implement the new ozone clean air standard. Many of these state implementation plans likely will contain additional proposals to further balkanize the gasoline and diesel fuel markets through the adoption of new fuel blends developed to address local and regional air quality concerns. SIGMA and NACS posit that there already is an ample slate of fuel blends from which these states can choose to achieve their air quality needs. H.R. 4545, a boutique fuels moratorium bill introduced by Congressmen Blunt and Ryan last month and supported by SIGMA and NACS, would put a stop of the balkanization of these markets. Although this bill failed to receive the two-thirds majority required under suspension of the rules, it did receive a clear majority of support when considered on the House floor last month. We urge the House to revisit H.R. 4545 in the near future.

Both H.R. 6 and H.R. 4545 contain provisions that require federal agencies to study ways to reduce the number of boutique fuels that already exist in the market. We strongly support these studies, but caution again that there is no short-term fix to this problem. Any proposal to reduce the number of fuels in this nation must be studied carefully with respect to the impact such reductions would have on overall gasoline supplies. Simply dictating arbitrarily that there should be one, five, or ten blends of gasoline in the country may be irresponsible and may lead to supply shortages that could make the 2004 price spike look mild in comparison.

B. Regulatory Reform

Currently, a disincentive exists for domestic refiners to add new capacity to their existing facilities. If they expand capacity, they expose themselves to the potential application of EPA's New Source Review ("NSR") regulations, which could impose tens of millions of dollars in additional environmental protection costs. SIGMA and NACS urge Congress and EPA to move forward with NSR reform that will continue to protect the environment while enabling facilities to expand capacity and satisfy consumer demand.

Second, it is virtually impossible to obtain the necessary federal and state permits to expand an existing refinery or build a new one. SIGMA and NACS urge Congress to streamline this process, without sacrificing environmental protections, to encourage, rather than discourage, the expansion of domestic refining capacity. Last month, the House passed H.R. 4517, a refinery revitalization bill sponsored by Congressman Barton which takes important steps toward streamlining the permitting process in certain circumstances. We supported that bill and urge Congress to expand its provisions to further incentivize the additional expansion of domestic refining capacity.

C. Incentivizing Expansion of Refining Capacity

Congress has a choice to make with respect to motor fuel refining policy. It can continue down the path followed for the past two decades. This path, as we have witnessed, results in static or reduced domestic refining capacity, balkanization of the motor fuel markets, increased imports, increased volatility in wholesale and retail prices, and rising costs for consumers. Over the past ten years, there has been disincentive for refiners to increase capacity due to the costs involved and the lack of opportunity to achieve a reasonable return on that investment.

Alternatively, we can embark on a different path. One that continues to encourage clean fuels. One that encourages, rather than discourages, expansion of domestic refining capacity. One that changes the fundamental economic calculus that a refiner makes when it decides whether to spend the huge sums necessary to make the upgrades required to produce clean fuels or to close the refinery.

SIGMA and NACS posit that Congress must adopt federal tax code changes to incentivize domestic refiners to expand refining capacity. Such changes could include faster depreciation periods for refining assets, the ability to expense environmental upgrades investments when capacity also is expanded, or an investment tax credit aimed at encouraging the construction of new, state-of-the-art, clean fuels refineries. Whatever course Congress chooses to follow, it is clear that the status quo does nothing to encourage expansion of domestic refining capacity. If we want capacity to increase, then we must change the fundamental economics of such expansions.

VII. <u>The "Costs" of Environmental Protection</u>

SIGMA and NACS are supportive of reasonable and scientifically-supported clean fuels programs and do not support any effort to "roll back" existing environmental protection programs.

However, it is disingenuous to state categorically that environmental protection programs have not contributed to increased retail gasoline price volatility. Environmental protection programs impact retail gasoline prices, directly and indirectly, in at least three ways -- each of which leads to upward pressure on retail prices.

First, as has been noted in numerous statements from the Environmental Protection Agency ("EPA") in its rulemakings covering both emissions from petroleum refineries and clean fuel programs, there are direct costs to these environmental protection programs. Simply stated, the nation's domestic refiners must expend billions of dollars to upgrade refining processes to reduce emissions and to produce cleaner fuels for the nation's consumers to use in their cars and trucks. EPA has variously estimated these costs as adding between 1 and 8 cents per gallon for each of the environmental protection programs covering the refining industry over the past decade, including the refinery MACT standards, the reformulated gasoline program, and the gasoline and diesel fuel sulfur reduction programs. In addition, EPA has predicted in each of these rulemaking proceedings that some refineries will not be able to make the investments necessary to achieve the new regulatory standards and will close. When the "cost" of environmental upgrades is added to the reduction in gasoline and diesel fuel supplies, the direct cost of environmental programs covering the domestic refining industry is easy to calculate.

Second, apart from direct costs of environment protection programs, there are substantial indirect costs that flow directly from the programs. As stated above, EPA repeatedly has estimated the "cost," on a cents per gallon basis, of numerous environmental protection programs. What these estimates ignore is that the direct "cost" of environmental upgrades constitutes only a small portion of the upward "price" pressure that these upgrades exert on gasoline and diesel fuel prices.

This disconnect between cost and price is a common economic principle. Diamonds have a high price not because the cost of production is high, but because diamonds are rare, demand for diamonds is high, and supplies of diamonds are limited.

The same analysis applies to gasoline and diesel fuel prices. While the cost of producing a gallon of gasoline or diesel fuel is relevant in terms of determining these products' wholesale and retail prices, it is the economic axiom of supply and demand that dictates the price consumers pay for gasoline and diesel fuel. Thus, while the direct cost increases associated with environmental protection programs may be measured in a few cents per gallon for each program, the analysis of the impact of these programs on the price of a gallon of gasoline or diesel fuel cannot cease once direct costs are considered.

Such an analysis also must consider indirect costs imposed by the combined impact of these environmental programs -- in terms of reducing the number of refineries producing these products, decreased outputs from operating refineries to produce these clean fuels, and the destruction of the fungibility of the domestic gasoline and diesel fuel markets -- to determine the true "cost" of these environmental programs. This complete analysis of "costs," direct and indirect, leads to the conclusion that the direct "costs" of environmental protection programs have little or no relationship to the "price" that these programs exact from consumers. In recent months, policy makers have come to understand that the indirect costs of these programs may in fact be substantially higher than the direct costs.

Third, as noted above, environmental protection programs -- most notably the reformulated gasoline oxygenate mandate -- have been responsible for the severe balkanization of the nation's gasoline (and, to a lesser extent to date, diesel fuel) markets into islands of unique "boutique" fuels. This reduction in gasoline fungibility, and the prohibition against moving an alternative blend of gasoline from an area with ample supplies to an area experiencing supply shortages, is directly responsible for the majority of the retail gasoline price spikes the nation has experienced over the past decade.

Again, the law of supply and demand operates effectively in the gasoline markets. If gasoline supplies in a region are low because of a natural disaster, a refinery or pipeline outage, or other distribution system problems, it generally is not lawful to supply that area with gasoline blends from surrounding areas because of environmental program restrictions. These artificial supply barriers impose a direct price penalty on consumers each time a supply shortage occurs.

To date, EPA has addressed severe supply shortages in various markets by granting temporary "enforcement discretion" letters for specific geographic areas. These temporary "waivers" permit non-compliant fuel to be sold in these areas for the duration of the supply crisis. SIGMA and NACS generally do not support such "waivers" of fuel specifications because they disadvantage stakeholders that have secured adequate supplies of compliant product in the covered market. More importantly, however, waivers are a short-term, ad-hoc solution to a longer term problem -- the gasoline and diesel fuel markets have been balkanized and supply crises will continue to occur periodically unless some rationality and fungibility is returned to the nation's motor fuel distribution system.

In sum, the assertion that no evidence exists that environmental protection programs have caused, in whole or in part, directly or indirectly, increased gasoline price volatility is simply wrong. Ample evidence exists of such a causal relationship to anyone who understands the fundamental rules of supply and demand or who drives a car or truck.

VIII. <u>Conclusion</u>

SIGMA and NACS believe that we as a nation are at a crossroads with respect to motor fuels. If we continue along our present path, balkanization will proliferate, domestic refining capacity will continue to stagnate or decrease, and increased motor fuel prices and periodic price spikes could become the norm, rather than the exception. We can either chart a different course or continue with the status quo. For independent motor fuels marketers and for your constituents, SIGMA and NACS hope that Congress leads the way to the new course.

Thank you again for inviting me to testify today. I would be pleased to answer any questions my testimony may have raised.