General Counsel Corner

By Peter H. Gunst, Esquire

A Modest Proposal

California's gasoline prices are among the highest, if not the highest, in the country. The Select Committee on Gasoline Competition, Marketing, and Pricing of the California State Assembly recently conducted hearings to find out why this is so and what can be done about it.

Two economics professors with distinguished pedigrees -- former Deputy Assistant Attorney General for Antitrust Economics for the U.S. Department of Justice Richard Gilbert and Yale professor Justine Hastings -- presented the Select Committee with some interesting comments and an original proposal calculated to increase competition and reduce pump prices.

In their testimony, professors Gilbert and Hastings identified high California refiner margins as the "main culprit" responsible for high retail prices. They cited the California Energy Commission's finding that the average refiner margin in California in March 2004 was approximately sixty cents per gallon, almost twice the national average of thirty-three cents per gallon. According to professors Gilbert and Hastings, only between five to ten cents of that differential is traceable to California's unique CARB standards.

Professors Gilbert and Hastings attribute California's high refiner margins, and hence its high retail prices, to the fact that the state has a "fairly concentrated oligopoly" of seven firms that dominate the refining of all gasoline sold in California: BPAmoco, ChevronTexaco, ConocoPhillips, ExxonMobil, Shell, Tesoro and UDSValero.

Competition among those refiners is limited because they control a very high percentage of all retail outlets, either through direct ownership or through branded supply contracts. Because they have captive retail markets, they need not compete very much against one another. And apparently they don't.

What can be done about it? Professors Gilbert and Hastings raise an interesting proposal.

As they see it, the simplest way to lower refiner margins is to "force" the major refiners to compete against each other by "unbundling" the sale of gasoline from that of additives, and requiring them to sell "generic" gasoline to *all* potential purchasers, including service station dealers of other brands.

They argue that their proposal is practical and can be readily accomplished. Gasoline, after all, is a generic commodity. This is beyond dispute, as proven by the product exchange agreements into which the refiners routinely enter. There is no reason why gasoline cannot also be sold as a commodity to retailers.

All that differentiates one brand of gasoline from another is the additives that are injected into the transport truck at the distribution rack. There is no reason why a dealer could not buy generic gasoline from one refiner, to which the additives of his or her refiner could then be injected. Through the accretion of the additives, the generic gasoline would become branded gasoline, to be sold as such.

"Unbundling" gasoline and additives could have significant impacts on the marketplace.

First -- and this is of particular interest to professors Gilbert and Hastings -- "unbundling" would make it easier for unbranded operators to obtain a competitive source of supply. This is particularly important to the professors because they see a direct correlation between the drop in unbranded market share in California and increased profit margins for branded refiners.

Second, "unbundling" could significantly impact the pricing structure to branded, direct-supply dealers. If branded dealers were free to purchase gasoline from anyone, subject only to the requirement that additives be obtained from the supplier whose flag is flown at the dealer's station, the dealer should be able to purchase product on a "rack plus" basis, rather than at a wholly artificial "dealer tankwagon" price, which bears no relationship to rack..

The result should be an overall reduction in the price of gasoline to the dealer because it would be very difficult for a refiner to justify selling additives at a wholly unreasonable markup, particularly in the face of increased unbranded competition. Zone pricing might become a thing of the past.

The professors' proposal has the benefit of simplicity. It does not require intensive regulation or administrative monitoring or government intervention. It merely requires that the refiners sell product to third parties on the same basis that they exchange it among themselves.

This modest proposal may have both an upside and downside for branded dealers. New supply alternatives would be opened not only for them but for their unbranded competitors as well. Nevertheless, a proposal that could significantly reduce the differential between rack and dealer tankwagon prices and frustrate zone pricing is worthy of consideration.

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