Problems Of Independent Refiners And Gasoline Retailers

Federal Energy Administration

UNITED STATES
GENERAL ACCOUNTING OFFICE

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ASSISTANT COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-178205

The Honorable Abraham A. Ribicoff, Chairman
Committee on Government Operations
United States Senate

Dear Mr. Chairman:

This report summarizes our review of the Federal Energy Administration's efforts to protect independent refiners and retail gasoline dealers. In our July 23, 1974, report to you on "Problems in the Federal Energy Office's Implementation of Emergency Petroleum Allocation Programs at Regional and State Levels" (B-178205), we pointed out that a number of independent retail gasoline operators had been forced to close and stated that we would examine in more depth the problems of the independent sector of the petroleum industry.

In developing this report, we examined documents and interviewed officials of the Federal Energy Administration, the Department of the Treasury, the Council of Economic Advisors, and the President's Committee on Energy.[1] We also met with retail gasoline dealers, dealer association representatives, and petroleum company officials and obtained data by questionnaire from retail gasoline dealers in California, Connecticut, Illinois, Louisiana, South Carolina, and Washington.

Any discussion of the problems of the independent sector of the petroleum industry should be tempered by the recognition of the complexities and diversities of the industry. There are about

--19,000 producers of crude oil,
--140 refining companies,
--25,000 wholesalers, and
--200,000 retail gasoline stations.

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[1]This Committee was established by the President on June 14, 1974, to coordinate energy policy. It was chaired by the Secretary of the Treasury and consisted of 11 top level executive branch officials. It was abolished on October 11, 1974, when the Energy Resources Council was established by Executive Order No. 11814. The Council is chaired by the Secretary of the Interior and consists of 17 top level executive branch officials.

At the refiner level, 4 large independent refiners and about 120 small refiners compete with the major oil companies. There are large numbers of independent jobbers involved in the wholesale distribution of petroleum products and independent marketers of refined products other than gasoline. At the retail gasoline station level, independent dealers have historically dominated the market. The types of independent dealers involved in the retail gasoline business include those who (1) feature high volume, low costs, and limited service capabilities, (2) provide full service capabilities, and (3) sell gasoline only as a sideline to another type of business, such as a grocery store. Some sell under major brand names; others purchase their products from independent refiners or make spot purchases of surplus fuel. Since each of the types of independents faces unique problems and has sometimes conflicting interests, providing independents adequate protection is a complicated matter.

This report is concerned with the problems of small and large independent refiners of crude oil and of independent gasoline retailers.

In summary, under the Federal Energy Administration's revised crude oil allocation regulations, small refiners, on the average, operated above 1972 levels, but the four large independent refiners, which refine a substantial portion of the crude oil not marketed by the major refiners, operated below 1972 levels. Under the "two tier" pricing system used for crude oil, small refiners and large independent refiners generally paid higher prices for crude oil than the major oil companies. This situation occurred because small and independent refiners did not have access to that part of domestically produced crude oil under price controls. The Administration recognized this problem and adopted new regulations aimed at equalizing crude oil costs of small refiners and large independent refiners with those of the major oil companies.

At the retail level, the Administration was not prompt in developing and reporting data on the market share of independents although required to do so by the Emergency Petroleum Allocation Act. However, studies made by an independent surveying firm, the American Petroleum Institute, and the Administration and responses to a General Accounting Office questionnaire indicate that the number of independent retail dealers appears to have decreased, although the proportion of refiner owned and operated stations has increased. Details of our work follow.

BACKGROUND

Major oil companies[1] are fully integrated in that they are involved in all facets of industry operations--exploration, production, transportation, refining, and marketing. Fifteen major oil companies control the production of 60 to 65 percent of domestic crude oil and refine about 75 percent of the petroleum products sold in the Nation.

For years, crude oil prices remained relatively low and supply was plentiful. In 1972, domestic crude oil sold for about $3.39 a barrel and imported crude oil sold for about $3.32 a barrel. Small and independent companies had access to lower priced imported crude oil and could also purchase crude oil or petroleum products from the major companies who had excess supplies.

Gasoline is the major product of the petroleum industry and accounts for about 40 percent of the petroleum used in the Nation. Both major oil companies and independent refiners operate retail gasoline stations. From 1970 to 1973 the number of retail gasoline stations remained relatively constant at about 220,000 stations. About 6 percent of the retail gasoline stations in the Nation were operated by refining companies. The remaining retail stations were operated by branded and nonbranded independent dealers.[2]

Because of declining domestic crude oil production and an abundant supply of imported crude oil, the oil industry became more dependent on

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[1]According to the Emergency Petroleum Allocation Act of 1973 (87 Stat. 627) an independent refiner is defined as one who produces 30 percent or less of the crude oil it refines and a small refiner (who may also be an independent refiner) is defined as one whose refining capacity does not exceed 175,000 barrels a day. There are four independent refiners who have refining capacity of more than 175,000 barrels a day and who refine a large part of the crude oil not refined by the major companies. Those refiners who do not meet the above definitions of small or independent refiners are the 15 major oil companies.

[2]According to the Emergency Petroleum Allocation Act, a branded independent retailer distributes refined products pursuant to an agreement with a refiner to use the refiner's identifying symbol or name or pursuant to an agreement under which the retailer occupies premises owned, leased, or controlled by the refiner but is not otherwise affiliated with the refiner. A nonbranded independent retailer distributes refined petroleum products but is not affiliated with a refiner other than by means of a supply contract.

imports. In October 1973, when imports accounted for more than 35 percent of domestic consumption, the Arabian nations cut off oil to the United States and other countries.

The Emergency Petroleum Allocation Act was enacted on November 27, 1973. The act was designed to minimize adverse impacts of short-term petroleum shortages. The act directed the preservation of a sound and competitive petroleum industry with emphasis on protecting the competitive viability of the independent sector of the industry while avoiding unnecessary interference in the market place. The act also specified that mandatory allocation regulations provide that small and independent refiners receive at least the same amount of crude oil they received in 1972 or their prorated share if total crude oil supply was less than that available in 1972. The goals were to be achieved through equitable restrictions on supply and price.

The act was originally scheduled to expire on February 28, 1975, but has been extended through August 31, 1975.

On May 7, 1974, the Federal Energy Administration Act of 1974 (15 U.S.C. 761) was enacted and created the Administration to, among other things, deal with energy shortages. Specifically, the Administration was given the tasks of:

--Inventorying energy resources.
--Developing a comprehensive national energy policy.
--Assuring that energy programs are designed and implemented in a fair and efficient manner.

The act stated that the Administration was to:

--Promote stability in energy prices to the consumer.
--Promote free and open competition.
--Prevent unreasonable profits.

To bring about the legislated energy goals, the Administration and its predecessor, the Federal Energy Office, established a series of regulations governing the allocation and price of crude oil and refined petroleum products.

Administration allocation regulations were aimed at insuring an equitable supply of crude oil to all refiners. At the retail level, Administration allocation regulations provided that dealers receive the amount of petroleum products they received in 1972 after certain adjustments for growth in business or their prorated share if supplies were below 1972 levels. The regulations also required that suppliers of retail dealers not impose more stringent credit terms and prohibited suppliers from discriminating among customers within the same class or charging prices higher than allowed by pricing regulations.

Administration price regulations provide three basic price rules for crude oil. First, monthly production up to the level of 1972 is controlled at an average cost of about $5.25 a barrel. Crude oil priced under this provision is termed "old oil." Second, on a lease-by-lease basis, current production in excess of the correspondent month in 1972, termed "new oil" and production from leases yielding an average of 10 barrels or less a day per well, termed "stripper well oil," are not price controlled and can be sold at the existing market price. Third, for each barrel of new oil that is produced in a given month a like amount of old oil production for the month is not subject to price controls. In September 1974 about 67 percent of domestically produced crude oil was price controlled under this so-called two-tier pricing system.

Refiners of petroleum products are subject to the general rule that they may not exceed a base period profit margin. The base period profit margin is determined by averaging the annual profits for any 2 years ending after August 15, 1968. Within that general rule, refiners may generally charge the prices in effect on May 15, 1973, increased dollar for dollar for any additional product costs incurred subsequent to that date. Further, when refiners can substantiate increases in nonproduct costs, such as labor or overhead, they are allowed additional price increases.

The retailer's maximum lawful price is its May 15, 1973, price, increased dollar for dollar for any additional product costs incurred subsequent to that date and, in certain circumstances, may be increased for nonproduct costs.

REFINER OPERATIONS

Crude oil supplies

In January 1974 the Administration established the crude oil allocation program to provide for equitable sharing of crude oil supplies among refiners. Under the program, refiners with crude oil supplies in excess of the national average, as a percent of their refining capacity, were required to sell crude oil to refiners who had less than the national average. However, the program did not result in large independent and small refiners operating at the same percent of refining capacity as the major refiners.

According to an Administration official, the initial program was not successful in equalizing crude oil supplies primarily because of certain

exemptions to the regulations which were applied on a company-by-company basis. Specifically, companies which had more crude supplies in 1974 than in 1973 and companies which imported more crude oil than they estimated to the Administration were not required to allocate the additional quantities of crude oil.

The Administration revised the crude oil allocation program for the quarter June through August 1974 to encourage refinery expansion and crude oil imports and to assist small refiners and large independent refiners in operating at the same percentage of capacity as they did in 1972. Under the revised program, small refiners and large independent refiners were eligible to purchase crude oil from the 15 major oil companies. Generally, the amount which could be purchased by a company was the difference between 25 percent of the crude oil which the company had in 1972 and crude oil which the company had during February through April 1974. Also, this amount was adjusted to show additions to the companies' 1972 refinery capacity. If requested, major oil companies were required to sell crude to eligible purchasers.

The following table compares crude supplies as a percent of refinery capacity of small refiners, the four large independent refiners, and the major oil companies for 1972 which is the base year for allocation regulations, February through April 1974 and June through August 1974.

	Major oil companies	Large independent refiners	Small refiners
1972	87	90	86
February through April 1974	82	78	76
June through August 1974	91	85	89

According to Administration records, if the small refiners and the four large independent refiners had not been allowed to purchase crude oil under the allocation program, they would have had only enough crude oil to operate at an average of 73 and 67 percent of capacity, respectively, during June through August 1974.

Thus, under the revised crude oil allocation program, small refiners, on the average, operated above their 1972 levels; however, the four large independent refiners operated below 1972 levels. According to an Administration official, major refiners operated at a higher percent of refining capacity than did the small and large independent refiners primarily because the major refiners possessed more of the low-price domestic crude oil and the small refiners and large independent

refiners could not afford to pay the higher prices for uncontrolled and foreign oil.

Differences in crude oil costs for major oil companies and small refiners and large independent refiners

Under Administration price regulations, small refiners and large independent refiners on the average have paid more for the crude oil they process than the major oil companies. The following table shows the approximate selling prices of old oil, uncontrolled oil, and imported oil as of June 1974.

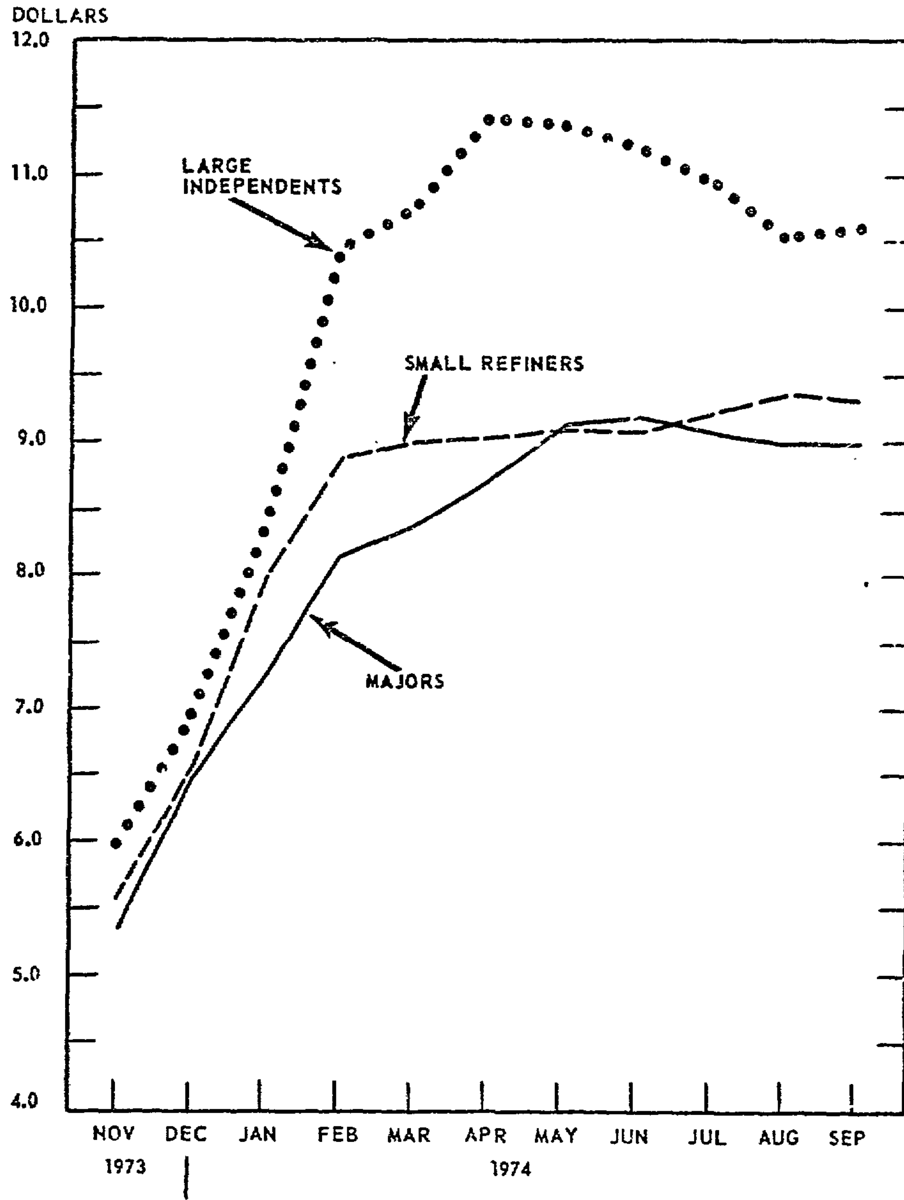
Type of oil	Selling price per barrel
Old	$ 5.25
Uncontrolled	10.00
Imported	13.00

Because of the price structure for crude oil and since major oil companies control most of the production of domestic oil, the average per barrel cost of the crude oil they refine has been lower than the average cost of crude oil purchased by small refiners and large independent refiners.

The graph on the following page compares the average cost of crude oil purchased by major oil companies with the average cost of crude oil purchased by large independent and small refiners for November 1973 through September 1974. Major oil companies' crude oil costs averaged $1.72 less than crude oil costs for the large independent refiners and 30 cents less than crude oil costs for small refiners. According to an Administration official, many small refiners are asphalt or residual fuels producers who pay low crude oil prices because they require a very low grade of crude oil, compared to refiners producing other products (i.e., gasoline) which require a higher grade of crude oil. The Administration did not have data to show the extent to which the lower prices paid by small refiners producing asphalt and residual fuels affected the average crude oil prices for all small refiners.

The Administration recognized the adverse impact of its pricing regulations on the small refiners and large independent refiners as early as July 1974; however, regulations for pricing equalization were not issued until December 1974. Between July and December 1974, officials of the Administration and other Government agencies studied alternatives for equalizing refiners' crude oil prices. Generally, the officials believed that

AVERAGE COST OF CRUDE OIL PURCHASED BY MAJOR OIL COMPANIES, SMALL REFINERS, AND LARGE INDEPENDENT REFINERS FOR THE PERIOD NOVEMBER 1973 THROUGH SEPTEMBER 1974



decontrol of crude oil prices, coupled with an excess profits tax on refiners unless such profits were invested in the exploration for or production of crude oil, was the preferred course of action. According to Administration officials, if crude oil prices were decontrolled, the price of old oil would initially increase to between $10 and $11 a barrel and the increase would be shown in the retail price of all petroleum products and would result in excess profits for major oil companies. Officials of the Administration and other Government agencies estimated that the price of gasoline would increase by various amounts ranging from 2 cents to 9 cents a gallon. They maintained, however, that an excess profits tax which would exempt oil company profits used for exploration or production of crude oil should result in increased domestic crude oil production and consequent reduced demand for importing foreign crude oil. Because the tax would require congressional action and because preliminary discussions with various Members of Congress indicated that many Members of Congress were opposed to decontrol, a decision was made not to propose the preferred alternative of decontrol in 1974.

On December 4, 1974, the Administration adopted regulations aimed at substantially equalizing average crude oil costs at the refinery level through the use of entitlements which permit refiners to share the benefits associated with access to price controlled old crude oil. An entitlement permits a refiner to include one barrel of old oil in its adjusted crude oil receipts for a particular month. Under the regulations, all refiners report to the Administration on a monthly basis their volume of crude oil processed and the volume of old oil included in the refiner's crude oil receipts. The Administration then computes the old oil receipts as a percent of adjusted total volume of crude oil processed for all refiners and issues each refiner enough entitlements to permit it to process the national average ratio of old oil to crude oil processed. Generally, refiners with a higher level of old oil supplies than the national old oil supply ratio must buy entitlements to cover the excess, whereas refiners with a lower ratio must sell entitlements for the amount they are under the national ratio. Therefore, the average costs to refiners with less than the average amount of old oil are reduced and costs to those who process more than the average old oil ratio are increased. The regulations also contain an entitlement adjustment for small refiners to insure their competitive viability.

The sales price of entitlements is fixed by the Administration each month. The price is fixed based on the difference between the weighted average prices for old oil and the weighted average prices of new and released oil, imported crude oil, and crude oil produced from stripper wells. Subject to the general provisions of the Administration's price regulations, funds expended or received for the purchase or sale of

entitlements are passed through as a cost increase or decrease to customers; however, there should be no change in the net costs to ultimate consumers.

Entitlements for the month of November 1974 were issued by the Administration on January 13, 1975, at which time the Administration published a notice specifying the national old oil supply ratio (approximately 41 percent), the name of each refiner to which entitlements have been issued, the number of entitlements issued to each refiner, the number of barrels of old oil included in each refiner's adjusted crude oil receipts, and a $5 sales price for entitlements.

According to Administration officials, two disadvantages of the entitlements program are (1) it involves an additional complex regulatory system and (2) it requires increased enforcement efforts to insure that the various types of oil are, or have been, accurately classified.

RETAIL GASOLINE DEALERS

Monitoring of industry market shares

Although one of the major intents of Federal energy legislation is to preserve the competitive position of the independent sector of the petroleum industry, the Administration has not developed adequate information to assess how its regulations have impacted on the retail segment of th industry. The Emergency Petroleum Allocation Act specifically required that the Administration make a monthly report to the Congress beginning January 1, 1974, on changes in the market shares of the various segments of the industry.

The Administration did not make its first report until August 1974. The report focused on the retailing of motor gasoline and presented data from the American Petroleum Institute; Lumberg Survey, Inc; Independent Gasoline Marketers Council; Society of Independent Gasoline Marketers of America; d Lewin and Associates, Inc. The data from each group showed considerably different proportions and trends in market shares for the classes of gasoline retailers. For example, the data developed by Lumberg Survey, Inc., suggested that nonbranded independent retailers gained in their share of the market, whereas the data based on a sample of Independent Gasoline Marketers Council and the Society of Independent Gasoline Marketers of America members indicated that nonbranded independent retailers lost in their share of the market. The report concluded that questions raised by the data could not be resolved until such time as the Administration developed its own information on market shares.

According to Administration officials, the statutory requirement for market share reports as set forth in the Emergency Petroleum Allocation Act is, in many respects, unworkable. Also, the categories specified in the act (i.e., branded independent marketers, nonbranded independent marketers, small refiners and independent refiners) do not conform to traditional reporting classifications, and the information necessary to prepare historical market share reports for certain fuels has never been compiled by either the Government or industry.

Nonetheless, the Administration has initiated three surveys which it believes will provide a system for monitoring the changes in market shares of gasoline. The system should provide monthly information on refiners, importers, and branded and nonbranded retail outlets. The Administration made its initial report to the Congress on the results of the retail portion of this system on March 4, 1975. The March report was based on a sample of 10,000 retail gasoline stations and compared market share information for company-operated retailers and branded and nonbranded independent retailers for October and November 1974. The report concluded that there were no statistically major changes in market shares during the 2 months.

The report, however, contained no comparison in market shares in terms of the 1972 base year but stated that the Administration was currently conducting several historical surveys to help monitor such changes. Administration officials told us that they expected to obtain the historical data in the next few months.

ADDITIONAL INFORMATION ON MARKET SHARE TRENDS

Audit and Surveys, Inc., an independent surveying firm, reported a 20,000 drop in the total number of service stations operating nationwide between 1973 and 1974. Also, the Administration's March 1975 report to the Congress on retail gasoline station market shares stated that its November 1974 estimate of the number of stations was about 26,000 or more than 10 percent less than the number [illegible]tions in 1972.

Information furnished to us by the [illegible]ican Petroleum Institute[1], showed a slight increase in the number of co[illegible]-owned stations as of June 30, 1974, compared to December 31, 1973. Since the number of company-owned

[1]This data covered stations operated on a salaried or commission basis by 22 leading oil companies.

stations has increased, the overall decrease in gasoline stations obviously had to come from the ranks of the independent dealers.

Moreover, a limited survey-type investigation of two major oil companies conducted by the Administration's Compliance and Enforcement group in response to complaints of franchise terminations confirmed that the total number of branded service stations for the two companies had significantly declined from January 1972 to July 1974. The investigation also showed that the decline was in the branded independent sector, whereas the number of company-operated stations increased. According to Administration officials, the Administration does not have the legal authority to take effective measures to control lease terminations.

General Accounting Office survey on effect of the 1973-74 gasoline shortage on the position of independent dealers

As previously described in this report, at the time of our review we found little information available at the Administration on the market position of branded and nonbranded independent retail dealers during 1974. Therefore, we developed a questionnaire which we sent to independent retailers in six States who went out of business from January 1973 to June 1974. The six States consume over 20 percent of the gasoline in the Nation and have under registration 22 percent of all motor vehicles. Our questionnaire was sent to over 9,000 former retail operators. Due to the lack of forwarding addresses for some of the former operators and deficiencies in the records of State taxation agencies from whom we obtained listings of former operators, only 6,326 dealers were properly included in the universe of the potential respondents to our questionnaire.

We received 1,682 responses to our questionnaire. The following table shows the number and percent of reasons cited by former dealers for going out of business.

Reason specified[a]	Number of dealers	Percent of dealers
Other business or personal reasons	587	34.9
Inadequate supply of gasoline	448	26.6
Termination of lease	408	24.3
Declining retail sales	167	9.9
Termination of supply agreement	72	4.3
Total	1,682	100.0

[a] These choices were developed during the pretest of our questionnaire in which we interviewed former retail operators to determine the most commonly cited reasons for their going out of business.

We recognize that some of these stations went out of business before the enactment of the Emergency Petroleum Allocation Act. We recognize also that noncompliance with Administration regulations by suppliers may have been a reason for these dealers going out of business, but the information submitted by the dealers was not sufficient in many instances to determine whether noncompliance with, or loopholes in, Administration regulations resulted in station closings.

Almost 35 percent of the respondents cited that other business and personal reasons caused them to go out of business, and this may relate to the traditional high turnover rate of such retail operators. The other four reasons, however, can be related to the gasoline shortage.

Almost 27 percent of the responding dealers cited inadequate supply of gasoline as the principal reason they went out of business. Dealers in this category who offered additional comments often mentioned unilateral cuts by suppliers, reduced supplies under allocation regulations, and general uncertainty over future supplies.

We noted some instances in which oil companies may not have conformed to the allocation regulations by favoring company stations over their branded independent stations. For example, during the early months of 1974, a major petroleum company in its western region showed favoritism in gasoline sales to company-operated service stations, compared with its sales to branded independent stations. The following table shows, based on records obtained from this company, the amount of gasoline supplied to company-operated stations and to branded independent stations as a percentage of the amount of gasoline that these types of stations received in the corresponding months of their 1972 base year.

	Percent of 1972 base year allocation supplied in		
Class of station	February 1974	March 1974	April 1974
Branded independent	58	58	64
Company-operated	113	92	100

Over 24 percent of the former dealers cited lease termination as the principal reason they went out of business. Although leases may be terminated by either the lessee or the lessor, our analysis of these responses indicated that most of the lease terminations were by actions of the lessor. The Administration believes that it cannot control leases between third parties and suppliers or dealers per se because of limited statutory authority.

Although many of the lease terminations appeared to accord with normal business practices, others appeared to involve actions by oil companies which may have departed from normal practices and which, in combination with altered market conditions brought on by the 1973-74 gasoline shortage, adversely affected independent dealers. For instance, in Louisiana, a dealer who had been in business on the same corner for 12 years reported to us that he was told that the company was not going to renew his lease. The company's sales representatives advised the dealer that, if he would sign a mutual lease cancellation, the company would buy back his inventory, otherwise the company would cancel and not buy back anything. The dealer signed the mutual cancellation, and the company opened a new company-owned self-service station just one quarter mile from the former dealer's closed station.

About 10 percent of the former dealers indicated declining retail sales as the principal reason they went out of business. Although some of the cases were attributable to business circumstances that might have occurred at any time, many cases were related to the gasoline shortage. Additional comments by dealers who selected this reason were often related to less gas at higher prices which increased the price at the pump, reduced sales, and deteriorated the competitive position of the station.

Of the 4-plus percent of dealers citing termination of supply as their reason for going out of business, two major explanations provided were that the supplier abandoned the geographical market or the supplier quit supplying other than its own stations.

Of the 1,682 independent retailers who responded to our questionnaire, 1,047 indicated that their stations had been reopened by other dealers. Of these, 119, or 11.4 percent, said their stations were now operated as company-owned stations.

AGENCY COMMENTS

In commenting on the matters discussed in our report, Administration officials told us that in December 1974 small refiners had lower crude costs on the average than the major oil companies. They stated that in December 1974 the average crude oil costs for the large independent refiners, the major oil companies, and the small refiners were $10.35, $9.27 and $9.02, respectively. They said that from the outset the intent of the entitlements program was to prepare the market for a return to competitive practices and pointed out that several weeks after the entitlements program initiation, the President proposed decontrol of oil prices effective April 1, 1975.

Administration officials said that independent retailers were having problems well before the Arab embargo. In particular, the nonbranded independent retailers in 1972 were heavily dependent on surplus fuel that the major oil companies found cheaper to sell on the spot market than to hold in inventory. In 1973 the demand for fuel rose and in the consequent tight supply situation, no surplus supply was available. Prices rose dramatically, and marginal operations which had been built on low margin, high volume, and price underselling became uncompetitive.

Administration officials said also that, subsequent to January 1974, the Administration had attempted to adjust regulations to cope with many of the problems of the independent retailers.

We recognize that the Administration has made good faith efforts to deal with problems affecting the independent retail dealers. However, we believe that the Administration cannot validly assess the effectiveness of its efforts to protect the independent sector of the retail market until it develops adequate market share data. As previously stated in this report, the Administration has not developed historical market share data on the retail sector, and several recent studies indicate that the number of independent retail dealers has decreased since 1972, whereas the proportion of refiner owned and operated stations has increased.

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Although the Administration has stated that it does not have sufficient legal authority to control lease terminations, the Congressional Conference Report on the Emergency Petroleum Allocation Act states that the Administration should watch closely for possible efforts by major oil companies to force independent dealers out of the retail market and convert station operators to salary employees. The Conference Report further states that:

> "Should it be shown to be progressing in a manner which can not be dealt with under the allocation authority contained in this bill, it may be in order for the Congress to consider remedies such as proposed in the Senate bill or as may be appropriate in the formulation of tax, import and antitrust policy."

We believe our review and the Administration's limited study point to deterioration in the market position of independent retail operators and clearly indicate the need for the Administration to expedite its efforts to obtain more thorough and sophisticated data on changes in market shares.

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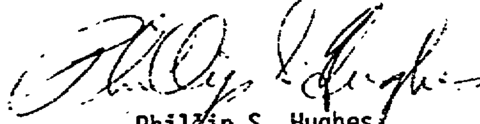
We hope that the foregoing information will be helpful to you.

Sincerely yours,



Phillip S. Hughes
Assistant Comptroller General

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