THE IMPACT OF GASOLINE STATION DIVESTITURE
ON COMPETITION

December 1978
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INTRODUCTION

In 1974 the State of Maryland enacted legislation prohibiting oil refining companies from directly operating gasoline service stations with company personnel and requiring that all service stations owned and/or supplied by refining companies be operated by independent retail service station dealers.

After a series of court challenges, the constitutionality of the Maryland law was upheld by the U.S. Supreme Court in June, 1978. The law, Chapter 854 of the Laws of Maryland, is therefore now in effect, and by July 1, 1979 all refiners in the State must divest themselves of any existing gasoline service station which they directly operate, and no new ones may be opened.

Similar gasoline retail divestiture legislation has been enacted in several other states but has not been enforced pending the Supreme Court decision in the Maryland case. In still other states, individual legislators have expressed an interest in legislation of this type and can be expected to press for active consideration following the Supreme Court decision. Thus, over a period of time the Maryland decision could have a significant impact on gasoline marketing practices throughout the United States.

The principal advocates and beneficiaries of the Maryland-type divestiture legislation are the franchised retail dealers of brand name gasoline. The principal opponents and negatively affected parties are the refiners, most of whom market some of their gasoline through directly operated retail outlets. Independent distributors
(jobbers) of gasoline seem to favor the divestiture legislation in states such as Maryland, where they are excluded from its provisions, but oppose it in those states where they, too, would be required to cease the operation of gasoline outlets with their salaried personnel.

It is interesting to note that the original draft of the Maryland law included independent wholesale distributors in the provision prohibiting direct retail operations. However, subsequently the legislature excluded this group from the retailing ban.

Overriding the positions of these groups with their special economic interests is the question of the public interest, i.e., that of the gasoline consumer. The Supreme Court decision has pointedly refrained from evaluating this interest. This paper will attempt to address itself to the question of whether and how U.S. consumers will be affected by the elimination of gasoline outlets directly operated by refining companies. It will also inquire into another provision of the Maryland Act, namely the requirement that any supplier of gasoline to retail outlets must extend all discounts off its published wholesale price on a uniform basis throughout the State. This prohibits a supplier from extending discounts selectively within the State in order to meet local competition.

We will begin our inquiry with an analysis of the Maryland law and of similar laws in existence or under consideration in other states. Next, we will examine the competitiveness of the existing gasoline market to determine whether legislative market intervention of the type contained in the Maryland statute is warranted because of
inadequate existing or potential competition. Finally, we will inquire into the impact of the Maryland statute, and similar ones in other states, on future competition in the gasoline market and its effect on consumers.

THE MARYLAND ACT

The Maryland Act was passed in May 1974. Its pertinent provisions are as follows:

"...After July 15, 1975, no producer or refiner of petroleum products shall operate a major brand, secondary brand, or unbranded retail service station in the State of Maryland, with company personnel, a subsidiary company, commissioned agent, or under a contract with any person, firm or corporation managing a service station on a fee arrangement with the producer or refiner. The station must be operated by a retail service station dealer.

"...Every producer, refiner, or wholesaler of petroleum products supplying gasoline and special fuels to retail service station dealers shall extend all voluntary allowances uniformly to all retail service station dealers supplied.

A group of seven oil refining companies (Ashland, Commonwealth Oil, Continental, Exxon, Gulf, Phillips and Shell) brought a joint action against the statute shortly after its enactment. The Act's validity was challenged on various grounds, including that it violated the Commerce and Due Process Clauses of the U.S. Constitution. In addition, it was argued that the provision requiring uniform statewide voluntary allowances conflicted with Section 2(b) of the Robinson-Patman Act, which prohibits price discrimination except in those instances where the seller charges a lower price in good faith to meet an equally low price of a competitor.

(2) Current effective date: July 1, 1979.
The state trial court in Maryland held the Act invalid, primarily on due process grounds. The state Court of Appeals, however, reversed the decision. On final appeal to the U.S. Supreme Court, the law was upheld in a 7 to 1 decision rendered on June 14, 1978.

In its majority opinion, the Supreme Court pointed out that it was upholding Maryland's constitutional right to enact the statute and was not ruling on the law's economic merits:

"Regardless of the ultimate economic efficacy of the statute, we have no hesitancy in concluding that it bears a reasonable relation to the State's legitimate purpose in controlling the gasoline retail market..." (3)

"It may be true that the consuming public will be injured by the loss of the high-volume, low-priced stations operated by the independent refiners, but again that argument relates to the wisdom of the statute..." not its legality. (4)

In deciding in favor of the Act's requirement for uniform state-wide voluntary allowances, the Court ruled that the discrimination proviso in Section 2(b) of the Robinson-Patman Act "created no new federal right." (5) Further, the Court stated that Congress did not intend to "pre-empt the States' power to prohibit any conduct within that exclusion." (6)

In his dissenting opinion, Justice Blackmun asserted that the divestiture provision of the Maryland statute violates the Commerce Clause of the Constitution, which forbids discrimination against interstate commerce.

(3) Majority Opinion of the Supreme Court of the United States. Exxon Corp. et al. v. Governor of Maryland et al., pp. 6-7.
"...to the extent that [Maryland's] interest in competition is nothing more than a desire to protect particular competitors--less efficient local businessmen--from the legal competition of more efficient out-of-state firms, the interest is illegitimate under the Commerce Clause. A national economy would hardly flourish if each State could effectively insist that local nonintegrated dealers handle product retailing to the exclusion of out-of-state integrated firms that would not have sufficient local political clout to challenge the influence of local businessmen with their local government leaders."(7)

The avowed purpose of the Maryland Act is to assure competition in the gasoline market. In the legal memorandum submitted in defense of the Act's constitutionality, the State Attorney General explained that:

"...The Act seeks to maintain competition, not identifiable competitors, by seeking to remove the present and potential effects of the integrated producer or refiner who through the exercise of its large corporate power can artificially distort the composition of, and reactions to, the normal economic forces of the market place."(8)

In evaluating the legislature's concern with improving market competition, it is important to recall the background of events against which the statute was considered and enacted. It was formulated during and immediately after the Arab oil embargo (October 1973-March 1974) which had caused the first peace time gasoline shortage in U.S. history. The shortage was unevenly distributed throughout the country. In some areas, such as Maryland, it affected large numbers of consumers. As with all unexpected shortages, it gave rise to a host of speculations, suspicions and accusations as to its cause and avoidability.

Thus, the deliberations of the Maryland state legislature in the period February-May 1974 on competition in the gasoline market were bound to be overwhelmingly influenced by the exceptional events which were simultaneously occurring in the market place. The State Attorney General in his legal memorandum submitted in defense of the gasoline divestiture legislation specifically referred to these developments at p. 40:

"... The Maryland legislature enacted this legislation in response to conditions which were giving rise to a near crisis situation in the retail gasoline market. The Maryland legislature and the public both recognized that the retail gasoline market was in the midst of an 'energy crisis', and the Legislature felt that it had to do something to bring stability into this market which was so vital to the general economy of the State."

These and other comments indicate that the law might well not have been enacted in the absence of these extraordinary events. It is also obvious that the law could not have prevented the occurrence of these events. The argument has been made in support of the Act that during the shortage some service stations owned and operated by refining companies received preferential gasoline allocations. Yet a recurrence of such an inequity in any future shortage could be prevented by a much smaller degree of legislative intervention in the market than the Act provides, such as stand-by emergency legislation regulating gasoline allocations during a declared shortage. Federal legislation dealing with this problem has already been enacted.

Thus, the extraordinary, extraneous events of early 1974 appear to have been a more important factor in the passage of Chapter 854 of the Laws of Maryland than any evidence of a long term deterioration in competitiveness in the State gasoline market.
GASOLINE RETAIL DIVESTITURE
LEGISLATION IN OTHER STATES

Legislation similar to Maryland's has been passed in other states but has not been enforced, pending the Supreme Court decision on the Maryland Act. Thus, Delaware and Virginia, as well as the District of Columbia, can now be expected to implement their versions of company operated retail gasoline outlet divestiture. There is also a 1974 Florida law limiting the extent to which refiners could directly market gasoline. However, it was struck down by the State's Supreme Court and not appealed.

Additionally, several states now have gasoline retail divestiture bills pending in their legislatures. Eleven other states considered such legislation in 1977/1978, and twelve others in earlier years, but passed no bills. Two of the pending bills (New Jersey and Massachusetts) would include independent jobbers in the definition of suppliers prohibited from operating service stations. A summary of the status of state measures affecting gasoline marketing practices is shown in an Appendix to this report.

COMPETITION IN GASOLINE MARKETING

The U.S. gasoline market has been undergoing a substantial restructuring since the early 1970's which has probably not yet run its full course. Between 1972 and 1977 the number of gasoline service stations declined from 226,000 to about 176,000, with a drop registered each year. At the same time the average monthly gasoline throughput per station has risen from 27,000 to 36,000 gallons.
Different segments of the retail gasoline market have been differently affected by this process. The station decline has been concentrated in units selling brand-name gasoline and offering a full range of automotive services. Most of these stations are operated by independent dealers who lease or own them and are supplied by refiners. Their share of gasoline sales has dropped from 49% to 36% of the market in the last six years. Conversely, the market share of stations operated directly by refining companies has increased from 8% to 13% and that of independent gasoline jobbers from 34% to 45% of the market (see table p. 18).

The question which concerns us here is the impact, if any, of these changes on competition in the gasoline market and, in turn, on the consumer. We begin our analysis with a brief account of the reasons underlying the market restructuring of the past six years.

**Historical Background**

The number of gasoline service stations increased very modestly throughout the post-war period, from about 180,000 in 1948 to a peak of nearly 227,000 in 1972. The growth rate was much lower than that of gasoline consumption or motor vehicle registration during the same period. However, throughout this period small one- and two-pump stations were replaced by stations with a substantially larger number of pumps, so that the number of dispensing units in service grew much more rapidly than the number of stations. In addition, the average efficiency of gasoline pumps also grew significantly as low-speed pumps were replaced by high-speed ones. Thus, the gasoline
retail delivery system expanded at a much more rapid rate than the number of stations. In fact, it was the consensus of the industry that from the mid-1950's to the beginning of 1970's the capacity of the system was growing at an excessive rate relative to the demand for gasoline.

To the extent that this consensus was correct, it reflected largely the integrated structure of the major firms in the oil industry during that period. The profit center of these companies, particularly in terms of the generation of cash flow, has traditionally been the production of crude oil. In part this was due to the inherently high risk in finding commercial oil reserves and the consequent high reward to the successful finder. An important additional factor was U.S. tax legislation, which through an allowable tax deduction for the depletion of a producing field, provided for a lower effective tax rate on the earnings from oil and gas production than on those from the other principal sectors of the industry (transportation, refining, marketing). Consequently, most integrated oil companies perceived their profit strategy in maximizing crude oil production.

Thus, downstream investment was built by the major integrated oil companies largely as a means to dispose of the crude oil. Such investment was expected to earn a rate of return and usually did. However, the acceptable rate was less than it would have been had the investment not been considered an integral part in the system of producing and disposing of crude oil. (9)

(9) The major integrated refiners also elected to operate their marketing facilities mainly through sales at wholesale to branded independent dealers who own or lease the facility and sell at retail under their supplier's brand.
An indication of the emphasis on crude production profits was the average refiner/distributor margin, i.e., the spread between the refiner's crude cost and the composite sales price of its mix of major products. The following table shows that in the years 1968-70 that margin averaged about $2.00/bbl.

CRUDE OIL PRICES AND REFINER-DISTRIBUTOR MARGINS, 1968-1970
($/bbl)

<table>
<thead>
<tr>
<th></th>
<th>Refiner/Distributor Average Selling Price*</th>
<th>Average Crude Cost</th>
<th>Refiner-Distributor Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>1968</td>
<td>5.13</td>
<td>3.17</td>
<td>1.96</td>
</tr>
<tr>
<td>1969</td>
<td>5.24</td>
<td>3.29</td>
<td>1.95</td>
</tr>
<tr>
<td>1970</td>
<td>5.41</td>
<td>3.40</td>
<td>2.01</td>
</tr>
</tbody>
</table>

*Weighted average of four major products which together accounted for 80% of U.S. refinery output.


Since average U.S. refinery operating cost was estimated at about $1/bbl\(^{(10)}\) and full marketing and distribution costs (excluding gasoline stations) at somewhat less than this amount,\(^{(11)}\) the return on downstream investment was obviously not attractive during those years.

Nevertheless, the industry continued to invest growing amounts of capital into its U.S. refining and marketing sectors. Refinery investment rose steadily from $600 million in 1965 to $1,100 million in 1970 while marketing investment rose from $1 billion to $1.45

\(^{(11)}\) Oil & Gas Journal, May 7, 1973, p. 79, Table 6.
There is little doubt that without the ready availability of incremental crude and the profitability of their crude oil sectors, integrated refiners could not have pursued this strategy as forcefully as they did.

Independent refiners would probably have found it difficult to remain competitive with the integrated refiners under these conditions had it not been for a different gasoline marketing strategy they adopted during this period. Instead of developing brand names and selling them through franchised dealers, as did the integrated majors, the independents sold the bulk of their gasoline, unbranded, through jobber or company-operated outlets. This lowered their overhead expenses relative to the majors since they did not have to promote branded product; it reduced their capital expenditures for distribution and marketing because of their reliance on jobbers; it enabled them to operate their own stations at a lower margin per gallon since they were managed by salaried personnel under direct company control.

Finally, and perhaps most importantly, the non-branded stations operated or supplied by independent refiners were usually more oriented toward high-volume gasoline throughput than to supplying full automotive service to customers. The following percentage figures show the difference in the type of gasoline sales distribution between the various categories of refiners as it existed in 1972. It should

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(13) Independent refiners, as contrasted with integrated refiners, are companies which have little or no access to controlled crude. They accounted for about 15% of the U.S. refining capacity in the 1960's.
(14) "Unbranded" sales are made under such off-brand flags as "Scot," "Fina," "Redhead," etc.
be noted that most firms in the category "Small Refiners" can be classified as independent refiners measured by the criterion of crude oil self-sufficiency.

U.S. GASOLINE DISTRIBUTION, 1972

<table>
<thead>
<tr>
<th></th>
<th>Branded Gasoline</th>
<th>Refiner-Operated</th>
<th>Consumer Bulk Purchases</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large Integrated Refiners</td>
<td>56.0</td>
<td>27.7</td>
<td>4.5</td>
<td>11.7</td>
</tr>
<tr>
<td>Large Independent  Refiners</td>
<td>27.9</td>
<td>47.4</td>
<td>18.4</td>
<td>6.1</td>
</tr>
<tr>
<td>Small Refiners</td>
<td>18.2</td>
<td>61.1</td>
<td>19.6</td>
<td>1.2</td>
</tr>
</tbody>
</table>

Source: Petroleum Market Shares, Federal Energy Administration, April 1976, Tables 34-39. For definitions of the three refiner categories see footnotes to table on p. 19.

The federal government's oil import policy adopted in 1959 and maintained through 1972 also assisted in keeping independent refiners competitive. Under this policy, the share of a refiner's foreign crude oil, which cost $1.25-1.50/bbl less than domestic crude oil during most of that period, was inversely related to the volume of its total company-wide refinery runs. This meant that the larger a company's refinery runs the smaller was its share of low-cost foreign crude. Since the independent refiners are generally substantially smaller than most major integrated companies, the former received relatively more low-cost foreign crude than the latter. This, too, was a primary factor in keeping independent refiners, particularly the smaller ones, competitive during this period.
The independent refiners' emphasis on the profitability of refining and marketing operations, together with their preferential access to low-cost foreign crude, were probably the principal factors enabling them to remain competitive with the majors between the late 1950's and 1972.

**Market Developments Since 1972**

In 1972, the oil marketing situation in the U.S. began to undergo a number of structural changes which brought about the developments in the gasoline market described earlier in this report. Most of these changes are well known and well documented and are, therefore, only sketched out in the following paragraphs.

The most important change was the peaking and subsequent decline of domestic crude oil production in 1970. This, together with continued oil import restrictions until early 1973, created considerable uncertainties regarding future crude oil supplies. Hence, refining companies more or less stopped increasing their plant capacity, despite a continued rapid growth in oil demand. The predictable result was the virtual disappearance of excess refining capacity by the end of 1972. Another factor was the rise in foreign crude oil prices which surpassed domestic prices for the first time in the post-war period in early 1973. This led directly to the abolition of the oil import control program. Still another factor was the loss of ownership of a large share of foreign crude oil reserves by the international oil companies and the subsequent substantial reduction in the profit margin (currently about 25¢/bbl in the
Middle East) permitted by OPEC. Finally, at the beginning of 1975 Congress abolished the depletion allowance for most integrated oil companies.

The combined consequences of these changes were that by late 1972, the incremental products barrel ceased to be attractive to refiners, since their excess refining capacity had all but disappeared (a condition which still prevails); and the incentive for crude oil disposal ceased to be a determining factor for integrated oil companies in operating downstream facilities (this, too, still prevails).

The logical reaction of the integrated oil companies to these structural changes in their operating environment has been an attempt to improve downstream investment profitability. In the gasoline marketing sector, their approach to this rationalization has been to increase the efficiency of service stations by reducing their numbers and increasing the throughput of those remaining. This is the process which underlies the gasoline marketing trends described earlier.

The change in the treatment of the marketing sector is clearly reflected in the industry's capital expenditures for marketing. Between 1965 and 1970, these expenditures rose. By contrast, from 1971 to 1976 they declined steadily, both in the actual amount, and much more, as a share of total domestic industry expenditures. This is shown in the table on the following page.
Initially, this period of structural change posed a serious threat to independent refiners. In late 1973 and 1974 their crude costs (mostly foreign) rose disproportionately to those of major refiners with access to lower cost domestic oil, since the crude oil allocation system in existence at the time did not include a comprehensive price equalization scheme. Their competitive positions improved commencing in January 1975, when government controls granted independent refiners access to price-controlled low-cost domestic crude (with preferential treatment accorded to smaller refiners) through the "entitlements" system. As a result of these federal controls, and because independent refiners improved the efficiency of their gasoline outlets by the same means as the Majors, namely by increasing throughput volume per station, the Independents were able to cope with the structural changes described earlier.
The strategy adopted by both major and independent refining companies led to the 21% decline in the number of gasoline service stations and the 32% increase in the throughput volume, as shown in the table below.

### NUMBER OF GASOLINE SERVICE STATIONS AND THROUGHPUT PER STATION

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of Stations</th>
<th>Average Monthly Throughput per Station (000 gallons)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>176,450</td>
<td>35.6</td>
</tr>
<tr>
<td>1976</td>
<td>186,400</td>
<td>33.9</td>
</tr>
<tr>
<td>1975</td>
<td>189,480</td>
<td>33.9</td>
</tr>
<tr>
<td>1974</td>
<td>196,130</td>
<td>31.4</td>
</tr>
<tr>
<td>1973</td>
<td>215,880</td>
<td>29.8</td>
</tr>
<tr>
<td>1972</td>
<td>226,459</td>
<td>26.8</td>
</tr>
</tbody>
</table>


The growth in throughput per station was due to the decline in the number of outlets coupled with a 12% increase in motor gasoline demand between 1972 and 1977. It took the form of a massive shift to self-serve and partial self-serve stations, which generate volumes 3 to 5 times that of the traditional full-service station. Self-serve growth has been the most visible change in the retail gasoline market since 1970. In that year, self-service stations or self-service pumps in traditional stations (so-called "split islands") were insignificant. Last year, total self-service sales accounted for about 40% of all gasoline sales. This year, according to trade estimates, it may be as high as 54%\(^{(15)}\), reflecting the public's growing price consciousness following the very sharp price increases in 1973 and 1974. Both major integrated and independent refiners

are engaged in building, or converting to, self-service stations. Currently, these stations account for a larger share of total sales for the independent refiners who started this particular market innovation than for the Majors.

An important aspect of the trend to self-service gasoline marketing has been an accompanying significant increase in the share of total sales by outlets directly operated by refining companies, and a decline in sales by the traditional branded full-service stations operated by independent dealers. There are several reasons why refiners prefer to directly operate self-service stations.

(1) The volume of gasoline sales is much larger than at conventional stations. To maintain these levels, refiners generally conclude that stricter managerial control is required than for conventional stations. Hence, they prefer to operate these stations directly.

(2) A substantial share of the gasoline sold at self-service outlets is unbranded because its principal appeal is the discount price, not the brand name. Unbranded gasoline has traditionally been sold primarily through refiner operated outlets, since independent dealers generally prefer the name recognition advantages of branded gasolines.

(3) Independent refiners, who have been the leaders in the expansion of self-service sales, have traditionally marketed a much larger share of their gasoline output through company-operated outlets than the Majors. In 1972, refiners other than the major integrated
firms sold 19% of their gasoline through company operated outlets, compared to 4.5% for the Majors.

The result of all these factors has been the aforementioned significant increase in the share of sales by refiner operated outlets between 1972 and 1978, as detailed in the table below. The table also shows a substantial increase in the share of refiner sales to independent jobbers. This, too, reflects primarily the increase in non-branded gasoline sales for distribution to self-service or other high volume retail outlets. To a lesser extent, it also reflects the jobber takeover of some branded gasoline distribution in areas from which major companies have withdrawn as part of their market consolidation strategies.

SHARES OF REFINER MOTOR GASOLINE SALES TO MARKETING CATEGORIES

<table>
<thead>
<tr>
<th></th>
<th>1978 (Jan.-Aug., prelim.)</th>
<th>1972</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Major</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Integrated Refiners</td>
<td>11.7</td>
</tr>
<tr>
<td></td>
<td>Other Refiners</td>
<td>2.8</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>9.5</td>
</tr>
<tr>
<td></td>
<td>Direct Sales to Bulk Purchasers</td>
<td>6.8</td>
</tr>
<tr>
<td></td>
<td>Refiner-Operated Retail Outlets</td>
<td>7.4</td>
</tr>
<tr>
<td></td>
<td>Branded Open and Lessee Dealers</td>
<td>45.4</td>
</tr>
<tr>
<td></td>
<td>Independent Jobbers</td>
<td>40.5</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Note: For definitions of refiner classifications see table on page 19.
Source: Federal Energy Administration/Energy Information Administration.

Since, as pointed out, independent refiners have spearheaded the drive toward the high volume marketing strategy now spreading throughout the industry, it is not surprising that their share of total gasoline sales has increased steadily from 1973 through 1977,
while that of the major integrated refiners has declined correspondingly, as the table below shows.

**GASOLINE DISTRIBUTED BY OIL REFINERS: 1972-1978**

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Volume (Billion Gallons)</td>
<td>101</td>
<td>105</td>
<td>103</td>
<td>106</td>
<td>110</td>
<td>113</td>
<td>78</td>
</tr>
<tr>
<td>Percent Shares by:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Major Integrated Refiners*</td>
<td>73.6</td>
<td>74.1</td>
<td>73.3</td>
<td>72.1</td>
<td>71.5</td>
<td>70.7</td>
<td>71.3</td>
</tr>
<tr>
<td>Other Refiners**</td>
<td>26.4</td>
<td>25.9</td>
<td>26.7</td>
<td>27.9</td>
<td>28.5</td>
<td>29.3</td>
<td>28.7</td>
</tr>
</tbody>
</table>

*Refiners with greater than 175,000 barrels per day of capacity and access to more than 30% company-controlled crude. These refiners are: Amoco, Arco, Citgo, Conoco, Exxon, Getty, Gulf, Marathon, Mobil, Phillips, Shell, Socal, Sun, Texaco, and Union.

**Includes Large Independent Refiners, i.e., those with greater than 175,000 barrels per day capacity and access to less than 30% controlled crude (Ashland, Hess, Petrofina, and Sohio); and Small Refiners, i.e. those with less than 175,000 barrels per day of refining capacity, regardless of access to controlled crude oil (100+companies).

Source: DOE Energy Information Administration, Petroleum Market Shares.

The slight reversal of this trend in the first eight months of 1978 reflects primarily the fact that the Majors increased their sales to independent jobbers at a faster rate than the non-Majors. For both types of refiners, the increase in sales to independent jobbers more than offset the decline in sales to independent dealers during this latest period. Thus, at the consumer level, total supplies to independent outlets have continued their upward trend in market share in 1978. The Majors' decline in the share of the retail

\[(16)\] 14% for the Majors vs. 3.4% for the non-Majors in the first eight months of 1978 over the comparable period of 1977.
gasoline market since 1973 and the rise in small and non-integrated companies' and jobbers' shares during the same period provide further evidence of the heightened competitiveness of the U.S. gasoline market.\(^{(17)}\)

Consumers have benefitted from the trend described above, since unbranded, self-service and other high volume gasoline outlets generally have lower prices than full-service stations. As can be seen in the table on page 21, gasoline at self-service stations is priced 2 to 5 cents per gallon below the price at full service stations, while non-Major brand gasoline is priced 2 1/2 to 6 cents per gallon below Major brand levels. (See table for definitions of brand categories.)

Self-service outlets allow the marketer to reduce margins and, consequently, to lower prices through savings generated by reduced labor costs and increased volume. Stations carrying non-Major branded gasoline are also able to undersell Major branded full-service stations because they offer fewer services, such as credit cards, and have therefore lower overhead costs than the Majors' conventional stations. The majority of these non-branded stations is supplied by independent refiners either directly or through jobbers. Most of the directly supplied non-branded stations are refiner owned and operated.

\(^{(17)}\) These findings are directly at variance with the assertion in the opening sentence of the State of Maryland's Legal Memorandum in support of Chapter 854 which claims justification for the legislation is provided by "the present and even greater potential economic evil of complete forward vertical integration by some of the largest corporations in our nation into the direct retail spectrum of petroleum products."
U.S. RETAIL GASOLINE DEALER AVERAGE
SELLING PRICE
(cents per gallon)

<table>
<thead>
<tr>
<th></th>
<th>Full Service</th>
<th>Self Service</th>
<th>Self vs. Full</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1977-Year Average</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Lead Regular</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Major Brand</td>
<td>63.5</td>
<td>59.1</td>
<td>-4.4</td>
</tr>
<tr>
<td>Non-Major Brand</td>
<td>57.9</td>
<td>56.1</td>
<td>-1.8</td>
</tr>
<tr>
<td>Non-Major vs. Major</td>
<td>-5.6</td>
<td>-3.0</td>
<td></td>
</tr>
<tr>
<td><strong>Unlead Regular</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Major Brand</td>
<td>68.0</td>
<td>64.8</td>
<td>-3.2</td>
</tr>
<tr>
<td>Non-Major Brand</td>
<td>62.0</td>
<td>59.9</td>
<td>-2.1</td>
</tr>
<tr>
<td>Non-Major vs. Major</td>
<td>-6.0</td>
<td>-4.9</td>
<td></td>
</tr>
</tbody>
</table>

*September through December 1977 only.

|                     |              |              |               |
| **1978 - January through August** |              |              |               |
| **Lead Regular**    |              |              |               |
| Major Brand         | 64.2         | 59.3         | -4.9          |
| Non-Major Brand     | 59.9         | 56.8         | -3.1          |
| Non-Major vs. Major | -4.3         | -2.5         |               |
| **Unlead Regular**  |              |              |               |
| Major Brand         | 68.0         | 64.4         | -3.6          |
| Non-Major Brand     | 63.5         | 60.5         | -3.0          |
| Non-Major vs. Major | -4.5         | -3.9         |               |

Note: The Major Brand category includes those stations using the primary brand of a major refiner. The Non-Major Brand category includes all the other stations in the survey. Stations using secondary brands of major refiners are included in the non-major brand category as these stations typically price their gasoline to compete with independent refiner and marketer brand stations.

Thus, the movement of the last several years from dealer operated to jobber and refiner operated gasoline stations has been accompanied by a movement from higher priced to lower priced gasoline. The impact of this on the average U.S. gasoline price can be seen in the following table. It demonstrates that the weighted average U.S. retail price for all grades of gasoline has risen at a significantly slower rate than the Consumer Price Index since 1974, even though the crude oil acquisition cost to U.S. refiners (which accounts for nearly 50% of the retail gasoline price, including excise tax) rose faster than the CPI during this period.\(^{18}\)

<table>
<thead>
<tr>
<th>Year</th>
<th>CPI</th>
<th>Gasoline*</th>
<th>Refiner Crude Oil Acquisition Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1974</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>1975</td>
<td>109.1</td>
<td>106.3</td>
<td>114.4</td>
</tr>
<tr>
<td>1976</td>
<td>115.4</td>
<td>111.3</td>
<td>120.1</td>
</tr>
<tr>
<td>1977</td>
<td>122.9</td>
<td>117.7</td>
<td>131.9</td>
</tr>
<tr>
<td>10 Months 78 Average</td>
<td>131.3</td>
<td>121.7</td>
<td>136.2 (1st 9 months)</td>
</tr>
<tr>
<td>October 1978</td>
<td>136.0</td>
<td>126.3</td>
<td>138.9 (September)</td>
</tr>
</tbody>
</table>

*Weighted average all grades.


It must of course be recognized that throughout the period gasoline has been (and continues to be) under federal price control. However, it is unlikely that the price would have been significantly higher in the absence of this control. Evidence of this is seen in the accumulation of rising amounts of unrecouped or "banked" costs by the refining industry on their gasoline sales. These banked costs

\(^{18}\) During this period two qualitative changes in the demand for gasoline occurred with approximately offsetting impacts on the weighted average price: (1) a shift from leaded to unleaded gasoline; and (2) a shift from premium to regular gasoline.
are generated whenever a refiner sells products at a price which does not include all costs allowed under DOE price regulations. These unrecouped costs are considered "banked" in the month in which they occur, because under existing regulations they can be incorporated as a cost item into prices in future months, competition permitting. The fact that the industry has continued to accumulate banked costs on gasoline sales from 1974 through the first six months of 1978 shows that competition, rather than regulation, has set the price ceiling on these sales.

ACCUMULATED UNRECOUPED (BANKED) COSTS ON GASOLINE SALES FOR 30 LARGEST U.S. REFINERS

(Millions of Dollars)

<table>
<thead>
<tr>
<th>Year</th>
<th>Monthly Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>1974</td>
<td>295</td>
</tr>
<tr>
<td>1975</td>
<td>338</td>
</tr>
<tr>
<td>1976</td>
<td>557</td>
</tr>
<tr>
<td>1977</td>
<td>906</td>
</tr>
<tr>
<td>6 months 1978</td>
<td>993</td>
</tr>
</tbody>
</table>


On the basis of the above evidence, it may therefore be concluded that the innovations in the gasoline retail market of the last several years have benefitted the consumer by increasing gasoline purchasing options from outlets other than the traditional branded full-service station. Since the newer types of outlets generally sell at relatively low prices, reflecting the fact that they offer fewer services or lesser known brands than the traditional stations, the result has been a reduction in the weighted average price of gasoline from what
it would have been in the absence of these market innovations.
The changes have also reduced market concentration in the gasoline retail market, since independent and small refiners and independent jobbers have captured a larger share of the retail market for self-serve and unbranded gasoline than the integrated majors. The share of the latter in total gasoline retail sales has therefore declined. Altogether, then, the market innovations described in this section appear to have enhanced competition in the retail gasoline business.

THE IMPACT OF RETAIL DIVESTITURE ON MARKET COMPETITION

The Maryland Act requires all refiners to divest directly operated service stations in that State by July 1, 1979. Since nearly all such stations in Maryland, as well as elsewhere, are owned by the operating refiner,(19) the company has the option of selling the station to an independent dealer or jobber whom it may or may not supply with gasoline, depending on the arrangement worked out between buyer and seller. Alternately, the refiner may lease the station to an independent dealer and become its supplier. Failure to sell the station at an acceptable price or to lease it on acceptable terms, would lead to its closure and dismantling of the equipment.

In Maryland, about 230 stations(20) must be divested. Some of these will undoubtedly be sold or leased to independent operators who may continue to market the gasoline under the same terms as the previous

(19) This applies invariably to the equipment and buildings, but the land may sometimes be leased.
(20) Equal to 6% of all service stations in Maryland.
operator. However, a number of the stations under divestiture order are unlikely to find new operators and will therefore have to be closed. The principal reason is the high share of unbranded outlets among refiner operated service stations. Since non-major refiners sell a substantially larger share of their gasoline output through these types of outlets than do the Majors, the impact of divestiture legislation falls primarily on the non-majors. These refiners have built owner-operated stations in order to have assured outlets for their largely unbranded gasoline products. Franchised dealers, however, are generally more interested in selling branded products, where they have the supplier's promotional support, than in unbranded products where they must make all the sales efforts themselves and thus carry a higher risk of failure.

Since divestiture legislation forces refiners to put a significant number of stations up for lease or sale over a short period, potential lessees and buyers are in a favorable position to select among the offers. The stations not favored by lessee dealers under these circumstances are likely to be unbranded full-service stations because of the aforementioned preference of dealers for the support of brand recognition, and unbranded self-serve stations which require relatively low gross margins and long operating hours to generate a sustained high rate of operating utilization.

Another important factor to dealers is future supply assurance for the divested stations. If a refiner is forced to give up profitable direct retail operations, it may well decide to withdraw from
the entire area, which rules out leasing. In that case it might be difficult for a potential buyer to obtain an assured source of supply, particularly under the current conditions of very little excess refining capacity and a tight supply of unleaded gasoline, both of which can be expected to last for several more years.

For all these reasons, it is likely that some refiner-operated stations may be closed permanently and some refiners, particularly Independents, may leave the State following implementation of divestiture legislation. Directionally, the result would be a lessening in competition. Generally speaking, competition tends to be reduced whenever the number of competitors in a given market declines. This is particularly so when the eliminated competitors offer the lowest price to the consumer.

Thus, the Maryland Act and similar types of legislation could reasonably be expected to increase the volume of gasoline sold through stations operated by independent branded dealers at the higher prices dictated by their higher operating cost, and would restrain a competing marketing strategy which currently tends to limit the increase in those prices. While it would be difficult to estimate the potential cost of this legislation to the consumers, it is reasonable to assume that if retail divestiture laws had been in existence on a wide scale at the beginning of the 1970's, the trend to low-price, high-volume gasoline outlets would have moved at a considerably slower pace than it did.
Retail Divestiture and the Jobber

One group of independent marketers which could be expected to bid for a number of the stations subject to divestiture would be the gasoline jobbers, of which there are about 12,000 in the U.S. In recent years available statistics indicate that jobbers have registered the fastest growth in retail gasoline sales among the four principal market segments. Between February 1972 and February 1978 their sales volume increased by 134% while total U.S. gasoline sales rose by only 12%.

However, further expansion as a result of refiner retail divestiture could create competitive problems, in the view of some dealers as well as legislators. The reason is that many jobbers are dual distributors. They operate some of their stations directly while leasing others to independent dealers whom they supply with gasoline. Usually both types are located in the same general marketing territory. This is of course precisely the practice which the Maryland Act has outlawed for refiners. Unless one assumes that refiners are currently subsidizing their direct retail operations out of upstream profits, for which there is no present evidence, the system of dual distribution is no more or less anticompetitive if practiced by jobbers than by refiners.

Dual distribution jobbers are in a position to give preferential treatment to their directly operated stations through price discounts or services rendered. The Maryland legislature, as pointed out earlier, was sufficiently concerned with this prospect to include jobbers in

(21) Major refiners, non-major refiners, independent dealers and jobbers.
the initial version of their divestiture legislation. Jobbers were excluded from the final version, but a law was passed in May, 1978 (Chapter 993, Laws of Maryland) requiring distributors to provide non-controlled outlets with gasoline products at a wholesale price of at least 4¢/gallon under the lowest retail price posted for each grade of gasoline at any directly operated outlet. However, independent jobbers were again exempted from this provision.

In assessing the future role of the jobber under these circumstances, it must be considered that U.S. gasoline sales are likely to start declining from about 1980 on because of mandated progressive increases in automotive fuel efficiency. In consequence, refiners can be expected to withdraw from marketing areas which cease to be economically attractive as a result of the decline in volume. In fact, to some extent they are already engaged in such retrenchment strategies. Part of their market share and some of their stations will probably be taken over by local jobbers. If these jobbers would gain additional market share as a result of refiner divestiture legislation, their local market dominance could become such that state legislatures may well feel compelled to put restrictions on their dual distribution operations. Some legislators, supported by independent dealers, have in fact proposed this in their divestiture bills. It would therefore seem that divestiture legislation aimed at the retail operations of refiners may in the long run have a spill-over effect on regulating the marketing activities of jobbers.
Impact on Backward Integration

A final point to be considered in evaluating the impact of retail divestiture legislation on competition is the disincentive it would create for backward integration by gasoline marketers. Historically, a number of independent marketers, upon reaching a certain size, have integrated backward into refining by building their own plant or buying into an existing one whose continued viability may have required greater security of products disposal. The prohibition of refiner operated retail outlets would act as a major deterrent to such a move, since most retail marketers large enough to consider it are likely to operate at least some of their stations, probably their most profitable ones, directly. Thus, retail divestiture legislation could have the unintended side effect of discouraging entry into the refinery business.

The Moratorium Alternative

A variant of retail station divestiture legislation has been the proposal to freeze the number or share of refiner operated retail stations. This has sometimes been suggested as a compromise between refiner and dealer interests in that it would permit refiners to retain their existing directly operated outlets while preventing them from acquiring new ones. Such a moratorium, for example, has been enacted for a one-year period in the State of Virginia.

While a freeze would obviously have a less drastic effect on retail market operations than the forced divestiture of all outlets,
it would create some problems of its own. Maintenance of current or historical direct retail positions for all refiners in a given state would arbitrarily favor some and hurt others, depending on their relative market share and their plans at the time of the freeze. Independent refiners would probably be more adversely affected than the Majors, since the refinery and market expansion plans of the Independents are tied much more closely to direct retail operations than are those of the Majors. Further, a moratorium on direct retail operations could induce some refiners to leave a state and would certainly reduce the incentive for others to enter it.

THE IMPACT OF STATE-WIDE UNIFORM PRICE ALLOWANCE REQUIREMENTS ON COMPETITION

The Maryland law requires that refiners and other wholesale suppliers of gasoline extend voluntary price allowances uniformly to all retail dealers which they supply within the State. The State argues that the selective price allowances which existed prior to passage of the law permitted price reduction in one area at the expense of consumers in another region. Furthermore, according to the State, selective price allowances lead to price wars which tend to disrupt the market place and force some dealers out of business, thus fostering an unhealthy competitive environment.

These arguments, however, have little support. Furthermore, they ignore certain potential negative effects of this provision of the Maryland law on gasoline dealers. A supplier who grants a price
allowance to dealers in one part of the state cannot expect to recoup the reduction by raising the price to dealers in another part. The price reduction in the first market area may have been necessary to meet competition. But competition would also prevent an arbitrary price increase in the second area. Thus, selective price allowances benefit consumers with access to the outlets receiving the discount but do not harm consumers without access to these outlets.

Regarding the supplier, selective discounting may lower total earnings from what they would otherwise be, or it could maintain or increase them, depending on the effect of the discounting on sales volumes. At any rate, in a competitive environment, a seller cannot expect to regain in one market area what has been lost in another.

Thus, while uniform state-wide price discounting will likely increase price stability in gasoline marketing, this is by no means synonymous with increased competition. On the contrary, because of its built-in rigidities, the regulation would be more likely to stifle competition than to foster it.

Uniform price allowance requirements also discriminate between suppliers of a larger number of stations and those supplying only a few outlets, as well as between suppliers whose dealers are located throughout the State and those whose dealers are concentrated in just one part of it. For instance, supplier A with only a few dealers in a given state may decide to lower wholesale prices in order to increase its market share. If a competitor, supplier B, has many
more dealers in the same state, some of which are outside the immediate marketing area of supplier A, supplier B may find it economically unattractive to meet the competitor's price reduction since it would have to be extended to all dealers throughout the State. The result would be that those of supplier B's dealers located in the marketing area of supplier A would not receive a price allowance and therefore be placed at a competitive disadvantage. This would obviously be contrary to the intent of the Maryland law, which aspires to protect dealers from unfair competition.

Finally, uniform state-wide price allowance requirements could create marketing problems for companies and dealers in state border areas, since market territories are usually not delineated by state border lines. If the uniform pricing requirements in one state create a significant differential in gasoline prices between it and neighboring states, consumers living in or travelling through state border areas could be expected to maximize their purchases in the state with the lower price. In fact, suppliers in the state with no allowance restrictions are likely to lower their price selectively to dealers in the border area in order to attract business from the neighboring state.
APPENDIX

STATE DIVESTITURE LEGISLATION

Bills Enacted

Delaware: prohibits new company operated service stations, law not in effect.

District of Columbia: prohibits refiners from opening new directly operated outlets as of April, 1977. All directly operated stations must be divested by January 1, 1981. Voluntary allowances by refiners and wholesalers must be uniform district-wide.

Maryland: prohibits refiners from opening new directly operated outlets as of July 1, 1978 and requires divestiture of all directly operated outlets by July 1, 1979. Also provides for uniform statewide voluntary allowances by refiners and wholesalers.

Virginia: establishes a moratorium on the opening of new company operated stations by refiners, effective May 1, 1978 through March 1, 1979. H. 458, carried forward for consideration in the next legislative session, calls for divestiture of company operated stations and uniform voluntary allowances.

Bills Pending

Illinois: divestiture bill closely resembling the Maryland statute. H. 3415 calls for divestment of refiner operated service stations and uniform voluntary allowances.

Mass.: at least 18 bills relating to various gasoline marketing practices are pending before the legislature. The most important of these, HR. 3253, would prohibit any "supplier" from "directly or indirectly" operating a service station.

N.J.: Assembly Bill 1517 would prohibit refiners, producers and wholesalers from directly operating stations by July 1, 1980. Also provides for uniform statewide allowances.

N.Y.: Assembly Bill 1373 closely resembles the Maryland statute. Would prohibit refinery operated stations by July 1, 1979 and require uniform statewide allowances.

Ohio: House Bill 795 would prohibit refiners from owning or operating retail stations.
APPENDIX (cont'd)

States which Considered Bills in 1977/1978 but Enacted No Legislation

Connecticut
Hawaii
Maine
Minnesota
New Hampshire
Oregon
Rhode Island
Tennessee
Utah
West Virginia
Wisconsin

States which Considered Bills Prior to 1977

Alabama
Arkansas
California
Colorado
Florida
Georgia
Indiana
Iowa
Kansas
Louisiana
Missouri
Pennsylvania