TESTIMONY OF

PAUL D. REID

PRESIDENT, REID PETROLEUM CORPORATION

REPRESENTING

THE SOCIETY OF INDEPENDENT GASOLINE MARKETERS OF AMERICA

AND

THE NATIONAL ASSOCIATION OF CONVENIENCE STORES

AT A HEARING OF THE

HOUSE COMMITTEE ON ENERGY AND COMMERCE

ON

"GASOLINE: SUPPLY, PRICE AND SPECIFICATIONS"

MAY 11, 2006

Good morning, Mr. Chairman, Ranking Minority Member Dingell, and members of the Committee. Thank you for holding this important hearing. My name is Paul Reid. I am the President of Reid Petroleum Corporation in Lockport, New York. My company owns 65 motor fuel outlets in Upstate New York and Northwest Pennsylvania and supplies gasoline and diesel fuel to 85 additional retail outlets in that area under long-term supply contracts.

I appear before the Committee representing the Society of Independent Gasoline Marketers of America (SIGMA) and the National Association of Convenience Stores (NACS). I serve as Chairman of SIGMA's Legislative Committee and my company also is an active member of NACS. Together, SIGMA and NACS members sell approximately 80 percent of the gasoline and diesel fuel purchased by motorists in the United States each year.

SIGMA is an association of more than 240 independent motor fuel marketers operating in all 50 states. Last year, SIGMA members sold more than 58 billion gallons of motor fuel, representing more than 30 percent of all motor fuels sold in the United States in 2005. SIGMA members supply more than 35,000 retail outlets across the nation and employ more than 350,000 workers nationwide.

NACS is an international trade association composed of more than 2,200 retail member companies operating more than 100,000 stores. The convenience store industry as a whole sold 143.5 billion gallons of motor fuel in 2005 and employs 1.5 million workers across the nation.

In the United States, there are more than 160,000 retail outlets that sell motor fuel. Of these, less than 5 percent are owned and operated by a major integrated oil company. The overwhelming majority are independent marketers like me. As such, we do not refine gasoline or diesel fuel. Rather, we purchase fuels from producers and importers and sell these fuels to consumers. Because of our dependence on others in the supply chain, SIGMA and NACS members always seek policies that maximize both the overall amount of gasoline and diesel fuel supplies and the number of competing suppliers of these fuels. Independent marketers survive as the most cost-competitive segment of the motor fuels marketing industry because of ample supplies and diverse sources of supply. Without either, we would cease to be a competitive force in the market.

Gasoline supplies across the United States are tight, prices have been high, and the Energy Information Administration named 2006 the "Year of the Fuel Spec." My testimony today will focus on each of these issues in turn and recommend policy solutions. It is very important to note, however, that there are no short-term fixes to any of these issues. The gasoline issues we collectively face are complex, have been building for at least two decades, and will not be resolved overnight. Therefore, we urge Congress and this Committee to focus your attention on options that will benefit consumers in the long-term.

Gasoline Supply

You have heard ample testimony from other witnesses at this hearing on the current state of gasoline supply. Gasoline supplies currently are tight, but adequate to meet consumer demand. There is not, in SIGMA's and NACS' opinion, a significant current shortfall in gasoline supplies. As a result, we have not supported recent calls for EPA to use the fuel specification waiver authority granted to the Agency under the Energy Policy Act of 2005 (EPAct). EPAct authorized such waivers to respond to "extreme and unusual fuel supply circumstances." Such circumstances existed after Hurricanes Katrina and Rita, but they do not exist today.

This year, overall gasoline supplies have been constrained by several factors. First, the final phase-in of EPA's Tier 2 gasoline sulfur standards took effect at the first of the year. It is more difficult for producers to make low sulfur gasoline and the gasoline yield from a barrel of oil is reduced when sulfur is removed. In addition, European refiners do not typically produce gasoline with the U.S. sulfur level, cutting off a possible source of supply relief. Second, in significant part because Congress did not enact MTBE liability protection as part of the Energy Policy Act last year, MTBE is being phased out as a gasoline additive this Spring. The removal of MTBE from the gasoline pool alone reduces overall supplies by approximately two percent. At the same time, many producers are replacing MTBE with ethanol to gain octane. In those areas of the country where reformulated gasoline (RFG) is required, the addition of ethanol to RFG requires a gasoline blendstock with lower volatility, further reducing a producer's gasoline yield from a barrel of crude.

Thus, at a time when the public and many in Congress are calling for policies to increase domestic refining capacity and gasoline production, in reality the nation's existing statutes and regulations are working against supply maximization.

SIGMA and NACS believe that the unfortunate reality is that little can be done in the short-term to increase gasoline supplies. The existing domestic refineries are running at or near full capacity. To significantly increase gasoline supplies, either domestic producers must make more or the nation must import more. Some of the major domestic refiners have, over the past six months, announced close to 2 million barrels per day of capacity expansion at existing refineries. SIGMA and NACS welcome these announcements, but believe that federal regulatory reforms -- such as streamlined refinery permitting and new source review reform, as advanced by Chairman Barton and Senator Inhofe -- will be necessary to assure that this additional capacity comes on line as quickly as possible. Otherwise, we will have no choice but to continue to look overseas for our gasoline to meet increasing demand.

Gasoline Prices

Gasoline prices across the nation have approached or surpassed $3.00 per gallon over the past several weeks. It is important to remember that increased gasoline prices in the Spring of each year are not a new phenomenon. Since 2000, each Spring gasoline prices have risen an average of more than 30 cents per gallon because of the transition to more expensive "Summer" blends with enhanced ozone controls and in anticipation of the higher gasoline demand of the Summer driving season.

In the Spring of 2006, the upward pressure on gasoline prices has been exacerbated by several additional factors. First, crude oil prices have reached and stayed above $70 per barrel for an extended period of time. This time last year, crude oil was trading for about $50 per barrel. Currently, more than 50 percent of the price of a gallon of gasoline flows directly from the price of the crude used to make the gasoline. Second, as noted above, gasoline supplies have been tight because of new sulfur regulations and the phase-out of MTBE, coupled with its replacement by ethanol.

Third, the price of ethanol has more than doubled over the past year. This would be inexplicable but for the fact that Congress itself created this market last year with a mandate requiring its use in ever-increasing quantities, tax credits to encourage its use, and import tariffs to protect domestic producers. Historically, ethanol prices tracked gasoline prices fairly closely. Currently, however, spot ethanol prices are approximately 50 cents per gallon *over* regular gasoline. While ethanol typically comprises 10 percent or less of a gallon of gasoline (more for E85 blends), rising ethanol prices clearly have contributed to rising gasoline prices.

Finally, there is one factor that SIGMA and NACS assert has not been a predominate factor in increasing gasoline prices -- increased retailer margins. As former NACS Chairman Bill Douglass testified before this Committee during your post-Katrina hearings last year, increasing wholesale and retail gasoline prices do not translate into higher margins for gasoline retailers. In fact, the opposite is true. As wholesale gasoline prices rise, as they have for most of the past two months, retailer margins are reduced. In some cases, wholesale prices rise so rapidly that retailers actually have a negative margin on every gallon of gasoline they sell.

My company's experience over the past two months has been consistent with Mr. Douglass' testimony last year. On February 1, 2006, my average wholesale 87 octane regular gasoline cost was $2.40, including taxes, and my average retail price for this same grade was $2.52. As a result, my gross margin -- from which I must pay my employees, my rent, my utilities, my credit card fees, and all other operating costs -- was 12 cents per gallon. Compare that gross margin to April 24, 2006, when my wholesale cost was $2.97 per gallon, including taxes, and my retail price was $3.03 per gallon, giving me a 6 cents per gallon gross profit. Once my expenses are deducted, my company was actually making more money on gasoline sales in February at $2.52 per gallon than we were in late April at $3.03 per gallon. I strongly suspect that my experience over the past two months is reflective of the experiences of nearly every gasoline retailer across the nation.

Again, there are no immediate public policy measures that this Committee and this Congress can take to reduce retail gasoline prices. The only near-term step SIGMA and NACS recommend that Congress undertake to exert downward pressure on retail gasoline prices would be to suspend temporarily the duty on imported ethanol. Ethanol prices have doubled over the past year. The market clearly is signaling high demand and a shortage in supply. Such a tariff suspension will attract additional ethanol supplies to those markets where it is most needed -- the East Coast, the Gulf Coast, and California. Such developments will put downward pressure on ethanol prices.

Gasoline Specifications

SIGMA and NACS want to thank this Committee, particularly Chairman Barton and Mr. Blunt, for authoring the boutique fuels and fuel waiver amendment that ultimately became Section 1541 of EPAct. For several years, we have appeared before this Committee and others in Congress warning of the negative supply, fungibility, and price impacts of boutique fuels. The enactment of your amendment has slowed the balkanization of the gasoline and diesel fuel markets and, hopefully, has started us on a path toward more harmonized fuel specifications. In addition, we congratulate you for your foresight in pushing for statutory authority for EPA to waive temporarily certain fuel specifications during unforeseeable supply emergencies -- authority that EPA exercised judiciously in response to Hurricanes Katrina and Rita.

As noted, the Energy Information Administration dubbed 2006 "The Year of the Fuel Specification." In addition to the Federal gasoline sulfur program and the phase out of MTBE I mentioned earlier, there are several different new fuel programs that will hit the industry, and consumers, in 2006. First, EPAct's renewable fuel standard takes effect this year and mandates that at least 4 billion gallons of ethanol and biodiesel be used by the nation's refiners and importers. Second, EPA's ultra low sulfur diesel fuel program will begin in June of this year. Finally, EPA has proposed a new mobile source air toxics regulation to reduce the benzene content of gasoline. Together, all of these programs have combined to produce a year in which fuel specifications will change dramatically -- posing challenges for refiners, the motor fuel distribution system, retailers, and consumers. These environmental controls do impose costs on industry -- costs that industry will inevitably seek to add to our selling price if competition permits us to do so.

The EPAct boutique fuel restrictions were a common-sense approach to the proliferation of boutique fuels. These provisions preserve environmental protections by providing states with ample authority to adopt cleaner fuels if a state's air quality concerns warrant these fuels. But EPAct also seeks to impose order on this process by directing states towards existing fuels already in use in their region to restore fungibility, avert supply shortages, and reduce wholesale and retail price spikes. Federal coordination of, and guidance to the states on, gasoline and diesel fuel specifications was long overdue.

SIGMA and NACS do recommend that this Committee consider improvements to Section 1541 of EPAct. First, we urge Congress to adopt an amendment to the EPAct boutique fuels cap to gradually reduce the number of boutique fuels in use across the nation. The current cap does not reduce the number of boutique fuels -- it merely freezes their number at 2004 levels. The adoption of a mechanism to gradually lower this cap over time would complete the work started by Congress in EPAct.

Second, we encourage Congress to address the proliferation of state alternative boutique fuel mandates, such as ethanol and biodiesel mandates. These alternative fuel mandates are not covered by EPAct's boutique fuels cap, but they should be. The same policy goals that led Congress to adopt the EPAct boutique fuels cap -- increased supply, increased fungibility, and decreased price volatility -- are being undermined by a new set of state fuel mandates. The ethanol and biodiesel industries have been granted by Congress a guaranteed demand for their product through EPAct's Renewable Fuels Standard (RFS). SIGMA and NACS urge Congress to expand the EPAct boutique fuel cap to cover these new state mandates.

Third, we urge Congress to consider amending the fuel specification emergency supply waiver authority granted to EPA to include a "hold harmless" provision for states. After Katrina, we learned from several marketers that states were hesitant to waive state fuel specifications out of concern that at some point in the future EPA might force the states to offset the modest emissions increases that might occur during the short emergency waiver periods with further emissions controls on other sources. While the states' concerns may seem unnecessary -- why would EPA grant flexibility in response to a natural disaster with one hand while taking it away with the other? -- such situations are not uncommon. Such a "hold harmless" provision would prevent state hesitation in following EPA's emergency supply waivers and hasten the recovery of adequate fuel supplies after events like Katrina and Rita.

Finally, SIGMA and NACS are concerned about proposals on both sides of Capitol Hill to mandate a quick reduction in the number of fuels in use across the nation. Such so-called "fuel slate" proposals are, in our opinion, premature. EPAct directed DOE and EPA to study whether such a reduction in the number of fuels can be accomplished without reducing gasoline and diesel fuel supplies significantly. A report on this study is due to be delivered to Congress by mid-August 2006. SIGMA and NACS believe that enacting a fuel slate before the conclusions of this report are received is unwise and, perhaps, unnecessary. Everyone's aim is to increase supplies and reduce price volatility. If EPA and DOE conclude that a fuel slate will have the opposite effect in their study, then it clearly is not a step that many in Congress will want to take. As a result, we suggest that Congress consider carefully whether the adoption of a fuel slate is appropriate at the current time. Once the study's recommendations have been received, if the increased supply, environmental benefits, and product fungibility merits of a fuel slate are evident, then Congress can act at a future date.

Alternative Fuels

In recent months, both the President and Congress have increased their focus on the alternative fuels market as a way to reduce our dependence on petroleum products. Currently, discussions have centered on the product E85, comprised of 85 percent ethanol and 15 percent gasoline. Members of SIGMA and NACS follow closely the development of new fuels because we operate a major portion of the refueling infrastructure for the American motorist. However, we are very concerned about proposals that would establish an alternative fuels mandate and caution Congress against such action.

In general, it would be premature for Congress to consider yet another alternative fuels mandate when the regulations to implement the renewable fuels standard of EPAct have not yet been written. We urge Congress to give the industry and the market the necessary time to adjust to new regulatory requirements and to take time to assess the market effects of such requirements before moving forward with additional mandates. Taking action without fully understanding the potential market effects of those actions would be irresponsible.

With regard to E85 specifically, there are many facts that must be understood about the market viability of this product. First, E85 is truly an alternative fuel that can only be used in specially designed, flexible-fuel vehicles and less than five percent of the current motor vehicle fleet is comprised of these vehicles. While this percentage may rise in the future based on long-term plans of motor vehicle manufacturers and motorists' behavior, there is no guarantee that consumer demand for these vehicles will remain constant or increase in the future. If demand does increase, the number of retailers offering E85 will likewise increase, consistent with market demand and without a government mandate.

Second, the costs of infrastructure development for widespread marketing of E85 will be significant. Because of E85's corrosive properties, retailers selling E85 must dedicate a separate underground storage tank (UST) and dispenser system to the product. The most cost-effective option is to install a new UST and dispenser system, which can cost between $50,000 and $200,000 per location, depending upon the market in question. Since the majority (approximately 70 percent) of motor fuels retailers are small businesses with 10 or fewer stores, such costs cannot be easily absorbed. Furthermore, many facilities do not have the physical space/real estate to install an additional UST system. Since many facilities have only two gasoline USTs, one for regular unleaded and one for premium (mid-grade is provided by blending the two), a retailer would have to replace an existing UST system to accommodate E85, thereby greatly reducing the availability of gasoline. Such conversions will make economic sense to retailers once demand reaches a critical level, but forced conversions will serve only to penalize retailers who netted only 1-2 cents per gallon in pretax net profit in 2005.

Third, while the domestic ethanol industry is increasing its production to satisfy both the renewable fuels standard (RFS) established in the EPAct and to replace the fuel additive MTBE, it is uncertain if this increase will be sufficient to meet current or future demand. In fact, the industry is already diverting supplies traditionally used in conventional gasoline markets to satisfy the demand in reformulated gasoline markets, an indication that supplies are not sufficiently plentiful to completely satisfy national demand. These distribution efforts are further complicated by the state renewable fuel mandates mentioned above, which lock supplies within geographic borders. In addition, EPA has not yet finalized rules to implement the RFS and the market effects of this program will not be known for years to come. Therefore, given the supply and distribution difficulties currently being experienced, as well as the uncertainty surrounding the newly enacted RFS, it would be irresponsible to enact yet another requirement for the use of ethanol, especially for a fuel that is not in strong demand, such as E85.

Fourth, according to the Renewable Fuels Association, E85 contains approximately 75 percent of the energy provided by regular unleaded gasoline. As a result, E85 offers motorists lower fuel economy and fewer "miles per dollar." For marketers to offer E85 at a price competitive with regular gasoline, E85 must be priced at a level that reflects this decreased energy content. Given that recent wholesale ethanol prices have matched or exceeded those for gasoline, it has not been practical for E85 retailers in most markets to price their E85 below regular unleaded without losing substantial money on every gallon sold. Consequently, marketers of E85 have reported 70-80 percent reductions in sales volumes when E85 is priced equal to or above regular unleaded.

Consequently, rather than pushing E85 to market via federal mandate, SIGMA and NACS would encourage Congress to consider alternative policy directions that would increase the production of E85 fuel and flexible fuel vehicles, reduce infrastructure enhancement costs to accommodate the product, improve consumer awareness and acceptance of E85, and increase consumer demand. This would be a much more market-oriented and consumer-friendly approach towards an alternative fuels market.

*　　*　　*

SIGMA and NACS appreciate the opportunity to present this testimony. I am pleased to answer any questions you may have.