



**TESTIMONY OF**  
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**TO**

**HOUSE ENERGY AND COMMERCE**  
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**HEARING:**

**“THE AMERICAN ENERGY INITIATIVE: A FOCUS ON RISING GAS PRICES”**

## **INTRODUCTION**

Chairman Whitfield, Ranking Member Rush, members of the Subcommittee, thank you for the opportunity to speak with you today. My name is John Eichberger and I am Vice President of Government Relations for the National Association of Convenience Stores (NACS).

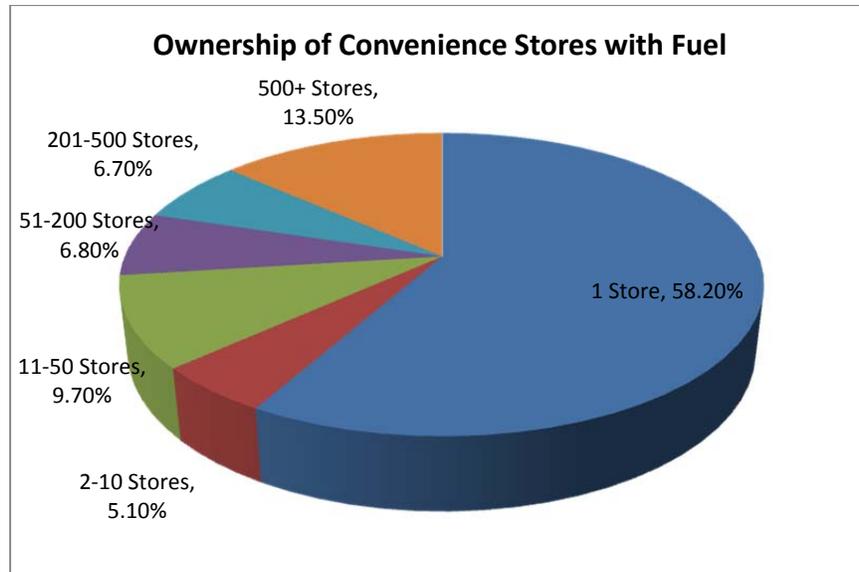
NACS is an international trade association representing the convenience and fuel retailing industry. Our membership consists of nearly 2,200 retail member companies and nearly 1,800 supplier companies. In 2010, the industry operated 148,000 stores in the United States, generated \$575.6 billion in sales (of which \$385.1 billion was in motor fuels), sold 80% of the fuel consumed in the country and employed 1.6 million workers.

I appreciate the opportunity to speak with you about retail gasoline prices. Our members, as the last link in a very long supply chain, have a better understanding of consumer frustration than others in the fuel system. And they often experience similar frustrations as they attempt to provide value to their customers while generating a profit for their business. My testimony today will address how retailers operate in a volatile fuels market and what can be done to stabilize conditions for consumers.

## **COMPOSITION OF THE RETAIL MARKET**

The retail fuels market is diverse and ever-changing. At the end of 2011 there were 120,950 convenience stores that sold motor fuels in the United States. These stores sell approximately 80% of the gasoline consumed in the nation every year. The remaining 20% of the fuel is sold through hypermarket stores like supermarkets, club stores and warehouse stores, traditional service stations, fleet operations and marinas. All totalled, there are approximately 160,000 fuel retailers operating the United States.

Of the convenience stores that sell fuel, 58.2% are owned and operated by companies that have just one store. And although 32% of convenience fuel outlets sell the fuel brand of an integrated oil company, major oil companies own and operate fewer than 1% of the facilities. In fact, ExxonMobil, ConocoPhillips, BP and Shell have either sold or are in the process of selling all of the retail facilities they own. The remaining branded locations are simply reflective of supply contracts in which the independent retailers sell fuel under the brand of their refiner-supplier. In general, the retail fuels market is independent and entrepreneurial.



### **RETAIL SALES MIX – FUEL DRIVES CONSUMERS**

In 2010, the convenience and fuel retailing industry generated \$575.6 billion in sales – 1 of every \$24 spent in the United States. Of that \$575.6 billion, motor fuels were responsible for 66.9%. But while fuel sales drive the overall performance of the industry, they do not drive a retailer's ability to make a fair profit. That same year, the industry reported \$6.5 billion in pre-tax profits of which only 26.4% was attributable to fuel sales.

In general, the industry seeks to leverage fuel sales to drive customers inside the store where profit margins are much healthier. This means that the competition for customers has intensified and over the years, especially since 2008, consumer price sensitivity has driven retail profitability lower.

In a 2012 survey of consumers, NACS found that 63% of customers decide where to buy gasoline based upon price. Further, consumers report that they will go out of their way to save pennies per gallon.

NACS found that 40% of consumers would drive 5 minutes out of their way to save as little as 3 cents per gallon. To put that into perspective, assume the customer is driving 45 miles per hour and their vehicle gets 30 miles per gallon. A 10 minute round trip would take the consumer 7.5 miles and consume ¼ gallon of gasoline. At \$3.50 per gallon, this detour would cost the consumer 87 cents. The average fill-up is 10 gallons, which means the total savings at the pump would be 30 cents. The consumer spent 57 cents more in order to make this purchase.

While this behavior does not make rational economic sense, it provides the consumer with a sense of accomplishment to be able to say they saved 3 cents per gallon. Nobody likes to buy fuel, but it is a necessity for most. And when the changing price of this essential commodity is in the customers' face every single day on giant signs at the side of almost every road, it is understandable they would be very concerned about the price they are paying.

### **The Association for Convenience & Fuel Retailing**

Retailers understand this sensitivity and are wary of pricing themselves out of the market. If 3 cents per gallon may cost them 40% of their customers, retailers will be reluctant to set a price at that level.

## **HOW RETAILERS DETERMINE PRICE**

Facing this type of consumer behavior, the retailer is in a very difficult situation – how to set the optimum price to attract as many consumers as possible to lift sales inside the store while turning at least a modest profit at the pump. They also have to understand that 73% of consumers buy fuel and leave without ever entering the store. This contributes to a very delicate decision making process, which can be described in two steps.

### **Step 1: Evaluate the Competition**

To determine the best retail price, a retailer must survey the competition. The retailer wants to set a price that will provide the greatest benefit to his store. Looking at historic data, or perhaps even using a price optimization software program, the retailer will be able to determine what price differential compared to the competition has generated the greatest balance between inside sales, fuel gallons sold and fuel margins. The retailer may determine that being one penny higher than Competitor A, two pennies lower than Competitor B and the same price as Competitor C provides the best mix for his location. Once that optimum price is determined, the retailer must consider if he can afford to sell fuel at that price. Keep in mind that this calculation is being done by multiple players within the same market who are all vying to capture the same price-sensitive consumer.

### **Step 2: Evaluate Costs**

A retailer must set a price that allows him to cover the costs associated with selling his fuel and, hopefully, generate a fair profit.

To better explain this function of the market, NACS evaluated the costs associated with operating a retail fuel business and allocated these costs on a per gallon equivalence. In 2011, the average retail price was \$3.50 and it cost on average approximately 17 cents to sell a single gallon of gasoline. On average, it costs approximately 6 cents per gallon for direct store operating expenses, 3 cents per gallon for facility maintenance and operations, and 2 cents per gallon for additional costs such as inventory shrink, theft and overall business operations. In addition, every fuel transaction paid for with a credit or debit card incurs additional expense. When averaging these transactions over all fuel transactions, including those paid for with cash, the average per gallon card expense is approximately 6 cents.

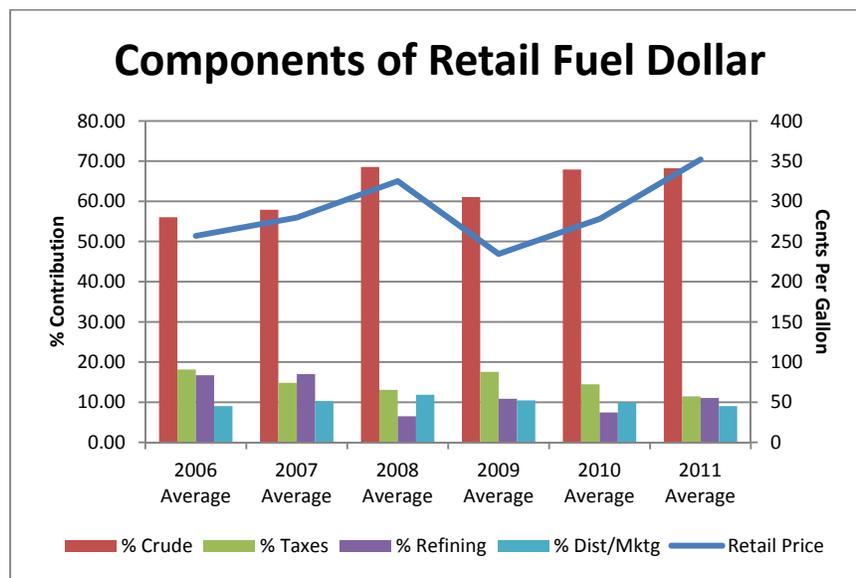
In 2011, because it cost the retailer on average approximately 17 cents to sell a single gallon of fuel, the retailer needs to charge at least 17 cents per gallon more than what he paid for the fuel. (This 17 cents is also called the fuel break-even number. Over the past several years, it has varied between 13 – 17 cents per gallon depending on the price of fuel.) This differential between what he paid for the fuel and what he sold the fuel, not considering other costs, is called the gross margin. What money is left after paying the 17 cents in expenses is known as the net margin or pre-tax profit.

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However, selling fuel at a high enough price to cover costs and generate a profit is not always possible because the wholesale cost of gasoline can change several times in one day and not all retailers incur the same price change at the same time. So, when the optimum price to attract consumers is lower than the price necessary to break-even, the retailer must determine if the anticipated increase in sales inside the store will compensate for the potential loss at the pump.

## COST OF FUEL

The primary factor influencing the cost of gasoline is crude oil. According to the U.S. Energy Information Administration (EIA), crude oil represented on average 68.2% of the retail price of gasoline in 2011. However, in December 2011 and January 2012, crude oil represented 80.0% and 75.5% of the retail price of gasoline, respectively. Over the years, crude oil has consistently been the dominant factor in the price of gasoline.



As crude oil prices move up and down, the wholesale price of gasoline moves with it. This wholesale price determines the cost of goods sold for gasoline retailers. In a perfect world, when wholesale prices change, retailers would adjust their prices to reflect the change. But this is not always possible.

Wholesale fuel prices, which are heavily dependent upon traders on the commodities exchanges, can change several times in one day and retailers are constantly trying to keep pace. The problem is that not all retailers receive deliveries at the same time, nor do they pay the same price at wholesale due to the structure and terms of their contracts. One retailer may incur a 10 cent increase on Monday while another may incur only a 5 cent increase on Tuesday – this changes each retailer’s ability to set the most competitive price. Consequently, competitive pressures often prevent the retailer from immediately covering an increase in the cost of goods sold.

Another challenge facing retailers is ensuring the ability to pay for the next delivery of fuel. A typical fuel delivery is 8,000 gallons. At \$3.00 per gallon, the retailer must be able to pay \$24,000 for that inventory. Since most retailers are small operators, they often do not have the cash reserves to pay for this increase in inventory costs so they attempt to generate enough

revenue from current inventories to pay for the next delivery. In such situations, retailers will often attempt to incorporate into their prices “replacement costs,” increasing retail prices in advance of a delivery in order to generate additional revenues to pay for the replacement gallons.

Because of these pressures, when wholesale fuel prices are increasing, it is a challenge for retailers to maintain sufficient markups to cover costs and generate a reasonable profit margin. Typically, during periods of increasing prices retailers operate at lower margins and may in fact lose money on the fuel they sell. However, when prices are declining retailers have an opportunity to recover their lost margins and improve their profitability.

Many observers argue that retailers are quick to increase their prices but slow to decrease their prices. To a degree, this is true. That is because once prices begin to decline retailers try to maintain their elevated street price as long as possible to recover the margins they lost on the way up. However, once one retailer decides he has recovered and wants to attract more customers he will drop his price and every competitor will race to follow him down. These competitive pressures and the volatility of the market make it impossible to evaluate the profitability of a retailer during any one point in time. Rather, it is necessary to observe the market over a period of time.

### **RETAIL PROFITABILITY**

In observing retailer market conditions over the period of a year, it is possible to evaluate the average profitability of fuel retailers. The following table reports the annual average retail prices, the reported retail markup and the percent markup over the past several years. Remember, in 2011 it cost 17 cents to sell a gallon of fuel.

<b>Historic Annual Market Performance (2006-2012)</b>			
<b>Year</b>	<b>Average Retail Price</b>	<b>Average Reported Retail Gross Margin</b>	<b>Gross Margin as % of Retail Price</b>
2012	\$3.46	12.6 cents	3.6%
2011	\$3.51	18.2 cents	5.2%
2010	\$2.77	16.6 cents	6.0%
2009	\$2.33	13.0 cents	5.6%
2008	\$3.24	18.0 cents	5.6%
2007	\$2.79	13.8 cents	4.9%
2006	\$2.57	13.8 cents	5.4%

Although the average retail price has changed considerably over the years, this table demonstrates that the cents per gallon gross margins have remained relatively stable. This has driven the percent margin lower over time, making it much more difficult for retailers to sell fuel for a profit.

The following table displays the average profitability available to retailers over the past year by listing the price, cost to sell fuel, average markup and the resulting retailer profit or loss:

<b>Historic Quarterly Market Performance (2011–2012)</b>						
<b>Period</b>	<b>Avg Retail Price</b>	<b>2011 Est. Fixed Expenses</b>	<b>Avg Card Costs</b>	<b>Avg Fuel Break-Even</b>	<b>Avg Gross Margin</b>	<b>Average Retailer Profit/Loss</b>
1Q2011	\$3.25	\$0.11	\$0.055	\$0.165	\$0.143	(-\$0.022)
2Q2011	\$3.79	\$0.11	\$0.064	\$0.174	\$0.207	\$0.033
3Q2011	\$3.63	\$0.11	\$0.061	\$0.171	\$0.190	\$0.019
4Q2011	\$3.36	\$0.11	\$0.057	\$0.167	\$0.189	\$0.022
J-F 2012	\$3.46	\$0.11	\$0.059	\$0.169	\$0.126	(-\$0.043)

### **RETAILERS STRIVE TO PROVIDE LOW COST OPTIONS TO CONSUMERS**

Fuel retailing is a very competitive business. Retailers make decisions to maximize customer traffic, boost in-store sales and cover their costs at the pump. Competition for the price-sensitive consumer often results in declining or negative margins for retailers, until wholesale prices decline. At that point, competition often allows the retailer to recover the margins lost during the run-up in prices.

To help the consumer deal with fluctuating fuel prices, there is little retailers can do other than compete. The portion of the retail fuel dollar within the control of the retailer is limited, as evidenced by the gross margin presented in the above table. NACS has been working with the National Conference on Weights and Measures to reform regulations to ensure that retailers can continue to offer consumers discounts at the pump. And the 2012 NACS Consumer Fuels Report indicates that such discounts are valuable to consumers.

In fact, 57% of consumers said they would consider taking advantage of a discount offered if they paid with cash. Other discounts consumers would consider include a discount for paying with a debit card (41%), using a loyalty card (44%) and using a discount associated with a purchase from another store like a supermarket (49%).

And retailers have responded, with 48% of consumers reporting that a fuel discount is available at a store convenient to them. Of these customers, 84% have taken advantage of one of these discounts, with 33% having saved money by paying with cash, 7% paying with a debit card, 33% using a loyalty card, and 29% leveraging a discount from another store.

### **CONGRESS AND ADMINISTRATION CAN INFLUENCE RETAIL PRICES**

Retailers are doing what they can to provide consumers the best value at the pump, but again their influence over the ultimate price is limited. The largest contributing factors to the retail price of gasoline are beyond the control of retailers. But there some things Congress and the Administration can do to influence these other factors:

**Crude Oil:** Because crude oil contributes more to the retail price of fuel than any other component, this is the area in which the greatest benefit can be derived. The United States has a variety of crude oil resources that are not yet contributing to the world market, including shale oil reserves, off-shore and Arctic Circle resources. In addition, improving access to Canadian crude oil products would help supplement overall supplies.

While it is not reasonable to believe that the United States can independently dominate the international crude oil supply situation, supplant the world's largest suppliers or offset increasing demand in the developing world, it is reasonable to believe that expanded domestic production can help calm the markets. There is a substantial amount of speculative investment contributing to the futures market for crude oil. These investments are based upon anticipated future supply and demand conditions. The announcement of a long-term commitment by the United States to increase its contributions to the international crude oil market could help calm some of the inflationary influences in the futures market and could provide long-term, meaningful benefit to consumers.

**Regulation:** Any regulation that imposes costs on the system will be reflected in elevated prices in the wholesale gasoline market, and as demonstrated above these costs will be transferred at some point to the consumer. This is true regardless of the intent of the regulation and Congress and the Administration must recognize this fact.

For example, the anticipated Tier 3 regulations affecting the sulfur content in gasoline will increase the cost of refining operations and could result in some smaller, less-profitable refineries shutting down. This will affect the overall cost structure of the market. Some may believe that the proposed benefits of such a rule justify the costs, but NACS urges both Congress and the Administration not to underestimate the effect additional costs regulations such as this will have on the retail price of fuel.

Further, it is critical that the cumulative effect of various regulations be understood and that these objectives be coordinated to avoid conflict. For example, the proposed greenhouse gas emissions reductions for 2017 – 2025 model year vehicles will result in a corporate average fuel economy equivalent to 54.5 miles per gallon. This proposed rule will make it virtually impossible for the nation to comply with the mandated volumes contained within the Renewable Fuels Standard. Given the projections of these two rules, by 2022 in order to satisfy the RFS every gallon of gasoline in the nation will have to contain 37.5% renewable fuels. This will require the complete replacement of the nation's entire retail equipment infrastructure at an estimated cost of at least \$21.7 billion. Further, there will be insufficient vehicles equipped to operate on these fuels. According to EIA's 2011 Annual Energy Outlook, by 2025 only 15.5% of vehicles will be flexible fuel and able to run on the fuel formulations mandated by these two regulations. This is the type of unintended consequences that Congress and the Administration must strive to avoid.

## CONCLUSION

The retail fuels market is a complex system that is influenced by a wide number of factors. The best strategy for providing long-term relief and stability to consumers is to enact a comprehensive transportation energy policy. NACS does not believe that improved efficiency, enhanced sustainability, national energy security and economic growth are mutually exclusive objectives. But if they are not pursued in a strategic, coordinated effort they can lead to unintended consequences that can derail progress towards all of the objectives and, in the end, consumers will endure the brunt through higher prices at the pump. Enhancing supplies of traditional energy resources while conducting an orderly transition to alternatives is the best way to benefit consumers.