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Gasoline Prices in Utah

A Report to Governor Jon M. Huntsman, Jr

Utah Department of Commerce
October 13, 2006

I. Directive

On September 15, 2006, Governor Jon M. Huntsman directed the Utah Department of Commerce to probe the ongoing remarkably high retail prices of gasoline in Utah. This report is presented in response to that directive.

II. Background for Utah Gasoline Prices

A. Utah Refineries and Retailers

Five refineries are located in Utah. The Energy Information Administration, an arm of the U. S. Department of Energy, has ranked the largest 144 refineries in the United States based on production as measured by barrels processed per calendar day. The Utah refineries and their ranking in production are: Tesoro West Coast is number 93 at 58,000 barrels; Chevron USA Inc. is number 102 at 45,000 barrels; Big West Oil Company (a Flying J Company) is number 111 at 29,400 barrels; Holly Corps Refining & Marketing is number 115 at 24,700 barrels; and Silver Eagle Refining is number 131 at 10,250 barrels.

Refineries regularly report prices of gasoline at the rack rate. The rack rate is defined by Renewable Fuels Association (RFA), a national trade association to the United States ethanol industry, as the “price paid by small independent customers at bulk fuel terminals.” RFA continues “Refineries traditionally offer a discount from the posted rack rate to their branded outlets and the largest customers. The size of the discount will vary according to the volume purchased and the negotiated long-term supply agreements. Although only relatively small amounts of volumes of gasoline are actually sold at the rack price, rack prices are currently the only publicly available wholesale pricing information.”

B. Refinery-Owned Retailers vs. Other Retailers

Retail gasoline stations are owned by various companies and individuals. Refineries may own and operate stations, and historically also have leased sites to independent operators under various operating arrangements that may include sales commissions and/or flat rate rental of property and equipment. Most lessees are required to purchase fuel from the refinery. These types of agreements also require the station to be branded with the oil company name.

The *Oil & Gas Journal* reports that as of October 2001, less than 20% of the gasoline produced in U.S. refineries was sold through a station owned or operated by the refinery. The trend is for refineries to discontinue operation of retail stores. As discussed below based on the responses the Department received to its information requests, the Department was unable to determine the percentage of Utah retailers owned or operated by a refinery.

C. Geographic Isolation and Limitations on Pipeline and Refinery Capacity

There are two petroleum product pipelines, and two crude oil pipelines, in Utah. The Pioneer Pipeline brings product imports from Sinclair, Wyoming, to North Salt Lake. The Chevron Product Pipeline ships product exports from North Salt Lake to markets in Idaho and Washington. The Amoco and Chevron crude oil pipelines both bring crude oil into North Salt Lake from Wyoming, Colorado, and the Uintah Basin. There are also truck shipments into and out of Utah, which are more difficult to track.

While the available supply of petroleum products in the Salt Lake City market is currently adequate, there may be a tightening of the market in the future. The cause of the tightening market can be attributed, in general, to market supply and demand. Namely, growth in demand has, for some time, outpaced growth in supply. The Salt Lake petroleum refineries and the product import pipeline are operating near capacity. For the time period 1990-2005, Utah consumption of gasoline grew an average of 2.9% per year.

Other supply factors also contribute to the tightening of the petroleum product market. The Rocky Mountain States are a fairly remote geographical market, and Salt Lake City is at the end of the supply chain. The two major U.S. petroleum supply areas are Alaska and Texas and neither have direct connections to Utah. Consequently, Utah relies on smaller product sources to meet its growing demand requirements and must compete with other geographical markets for refined products. Additionally, Utah refineries actively market petroleum products for export to Idaho and Washington, which further decreases available supply.

The Pioneer Pipeline runs from Sinclair, Wyoming, to Salt Lake City. Its capacity was 34,000 barrels per day between 1990-1996. It was expanded to 48,000 barrels per day in 1997. Due to the rapidly growing Wasatch Front demand for refined petroleum products, the Pioneer pipeline was expanded again in 2000 to a new capacity of 70,000 barrels per day.

In recent years, the Williams Companies proposed building a large product pipeline into Salt Lake City. This pipeline was proposed to connect the Texas Gulf Coast, through Farmington, New Mexico, with Salt Lake City. This proposal was dropped with the Williams Companies bankruptcy.

In addition, the refining industry must deliver gasoline and diesel with significantly lower sulfur content, and the refining industry recognizes the necessity and importance of moving to cleaner, low-sulfur fuels. However, low-sulfur fuels have required large investment by the industry. While low-sulfur fuels, for example, may cost the consumer an extra 2-5 cents per gallon, the capital investment for a petroleum refinery is \$50-\$100 million or more.

D. "Jobber" Costs

Refineries sometimes sell branded gasoline to independent firms known as jobbers who distribute the branded gasoline to retail gasoline stations. These independent firms are numerous and further complicate pinpointing the ultimate profit margins for unleaded gasoline.

E. Gasoline Costs in Rural Utah

In general, retail gasoline prices are higher in rural Utah than in areas with a higher population concentration. Several factors contribute to this circumstance. In some cases, transportation costs to truck the gasoline to retailers in rural areas are higher. Additionally, supply and demand issues are different in rural areas; there generally are fewer retailers to generate price competition. Rural retailers also may be more likely to be subject to increased costs from gasoline provided through jobbers.

F. Current Pricing Disparity

The disparity that has given rise to the current concern is based on gasoline prices for the period beginning about August 22, 2006, when national average gasoline prices began to decrease rapidly. The average price in Utah remained significantly higher than the national average. According to the Energy Information Administration and AAA of Utah, the national average of regular unleaded gasoline was approximately \$2.88 per gallon on August 22, dropping to \$2.25 by October 12. The Utah average for the same period starts at approximately \$2.91, dropping to \$2.57.

Logic dictates that Utah gasoline prices should bear some relationship to the rest of the nation. Although Utah operates in a relatively closed system, crude prices are based on several factors, most of which are global in nature. As a result Rocky Mountain producers of crude price their product similar to those in global markets. Refineries in Utah have not indicated that their product or production costs are higher than other refineries in the United States.

G. Diesel Fuel Costs

In the past, diesel fuel was reliably less expensive than gasoline because gasoline was the premium, higher demand product. Straight distillation of crude oil yields only 20% in gasoline.

Diesel demand has grown recently in the United States, and in the past decade has skyrocketed in Europe. Over half of the automobiles in Europe now run on diesel. Where Europe formerly shipped distillate to the United States, that practice is less frequent now, affecting the prices and price volatility of all distillate products (*e.g.* diesel, heating oil, and jet fuel).

Gasoline and diesel fuel also have distinct demand drivers. The separate demand for diesel gives its price curves a seasonal profile that is completely different from gasoline. While typical “driving seasons” affect both, diesel fuel and other distillate products also are affected significantly by cold weather in the Northeast, harvest season in the Midwest, the airline industry, and major military operations.

H. Pricing Trends in Utah and Surrounding States

Attachments A and B provide comparisons for average retail gasoline prices in Utah and other states. Attachment A contains a chart comparing average Utah prices to national averages and crude prices over the time period from September 11, 2006, until October 10, 2006. The disparity between Utah and national averages has remained reasonably constant during that period.

Attachment B contains six charts for that same time period comparing Utah average prices to Utah’s six surrounding states. Utah prices have remained consistently higher than those in Arizona, Colorado, New Mexico, and Wyoming. The price differentials have been more sporadic with Idaho and Nevada, with Utah’s prices remaining generally higher than those in Idaho, but lower than those in Nevada.

I. Price-Gouging Statute

In 2005 Utah enacted the Price Controls During Emergencies Act. This law prohibits a retailer from taking advantage of an emergency situation by raising prices dramatically over the retailer’s actual costs, and applies only for the duration and geographic area of the emergency.

III. Actions Taken by Surrounding States

At least four surrounding states have taken some recent action in response to high gasoline prices.

A. Arizona

In 2005 the Arizona Attorney General began an investigation into the causes of high gasoline prices after Hurricane Katrina, and has supported legislation prohibiting price gouging during national or local emergencies. Arizona has not yet enacted a price-gouging statute. The

Attorney General maintains an Internet website showing the retail prices in Arizona compared to national averages, and provides consumer recommendations on cutting gasoline consumption.

B. Idaho

On September 14, 2006, the Idaho Attorney General sent letters to Flying J Inc., Shell Oil Products US, Sinclair Oil Corporation, Tesoro Corp., and Chevron USA Inc. The letters asked for an explanation regarding the pricing disparity between Idaho and the national average, and how the situation could be addressed.

The Attorney General received responses from Flying J. Inc., Shell Oil Company, Tesoro Corp., and Chevron USA Inc. All four responses explained the disparity as a result of supply and demand market forces, indicating that Idaho's prices are not out of line with other locations. The Attorney General's office responded to those companies on October 3, 2006, indicating that the office was troubled with the explanations of the responses and urged the companies to consider its pricing practices in anticipation of action by Idaho's policy makers.

C. New Mexico

In 2005 the New Mexico Legislature and Governor provided a gasoline relief tax rebate. The rebate was based on family size and income, and was provided to every person who filed a 2004 or 2005 state income tax return. This rebate was coupled with a Low Income Home Energy Assistance Program, and individual rebate amounts ranged from \$64 to \$289.

D. Wyoming

On September 20, 2006, Wyoming Governor Dave Freudenthal sent letters to three refineries in the region asking for an explanation of the high gasoline prices. His letter encouraged the refineries to take steps to lower wholesale prices where possible and reminded the refineries that the situation might lead to additional investigations, legislation, or regulation. As of the date of this report, the Governor had received one response from Frontier Oil noting that the company did not control retail prices, and that wholesale prices had been dropping.

IV. Utah Department of Commerce Information Requests

On September 19, 2006, the Utah Department of Commerce (Department) hosted a discussion with representatives of the Utah Petroleum Association (UPA) and the Utah Petroleum Marketers & Retailers Association (UPMRA). Lee Peacock, representing the UPA, presented a graph comparing gasoline rack prices in Utah with other selected locations, and indicating that rack prices in Utah began declining in mid-August. John Hill, representing the

UPMRA, indicated that one factor in the retail gasoline prices is the need for retailers to sell product in their systems that had been purchased at a previous, higher rack price.

As a follow up to this meeting, the Department sent information request letters to the UPA, the UPMRA, and 24 randomly selected gasoline retailers throughout Utah. From the UPMRA and the gasoline retailers, the Department requested bills of lading and daily retail pump prices for August and September 2006. From the refineries, the Department requested the following:

- the most recent financial statement;
- the daily rack prices for regular unleaded gasoline for the prior year;
- the percentages for the past year for crude oil purchased from the following sources: domestic crude, Canadian crude, and non-Canadian international crude;
- for each day for the past year, the daily price per barrel paid for crude oil from each of these sources;
- for the past year, the percentage of profits from the sale to retailers of all grades of unleaded gasoline that has been used by the refineries to subsidize the transition to ultra-low-sulfur diesel fuel; and
- identification of each gasoline retailer in Utah in which a refinery has an ownership or affiliate relationship.

With respect to each of these requests, the Department committed not to publicly release any proprietary information, and encouraged the companies to make any confidentiality claim they felt was appropriate under the Government Records Access and Management Act.

V. Responses to Information Requests

The information requested by the Department included material that may be available to the public through published financial statements and annual reports if the company is publicly traded. Financial statements and company reports are not readily available for privately held companies. The Department received financial reports for the publicly traded companies, but this material is consolidated by region or nationally.

Four of the five refineries responded to the Department's request. Generally the responses referred the Department to the refinery's Internet website or other public sources, gave a general explanation of the issue, or refused to provide certain information. In particular, no refinery was willing to inform the Department of the prices paid for crude oil.

Chevron indicated to the Department that it sells gasoline to jobbers who supply the product to approximately 240 Chevron or Texaco branded retail stations that are not owned or operated by Chevron. Tesoro directed the Department to their Internet website that lists all retailers who sell their branded gasoline, but did not provide any indication of ownership.

Sinclair indicated that it owns and operates 18 retail outlets, but reported that the majority of its fuel sales in Utah are to jobbers. With the exception of the information from Sinclair, the responses were insufficient to determine the extent to which retail stations are owned by or affiliated with refineries.

Of the 24 retailers to which the Department submitted requests, four rural retailers provided information. This information included invoices paid for wholesale gasoline and retail prices charged. However, none of this information included volume discounts or other rebates that would be necessary to determine absolute profit margins. The small number of responses, and their limited scope, makes firm conclusions impossible.

VI. Conclusions

Retail gasoline prices are affected by numerous economic factors. Most telling from this investigation, though, is the type of information the refineries and retailers were not willing to provide to the Department.

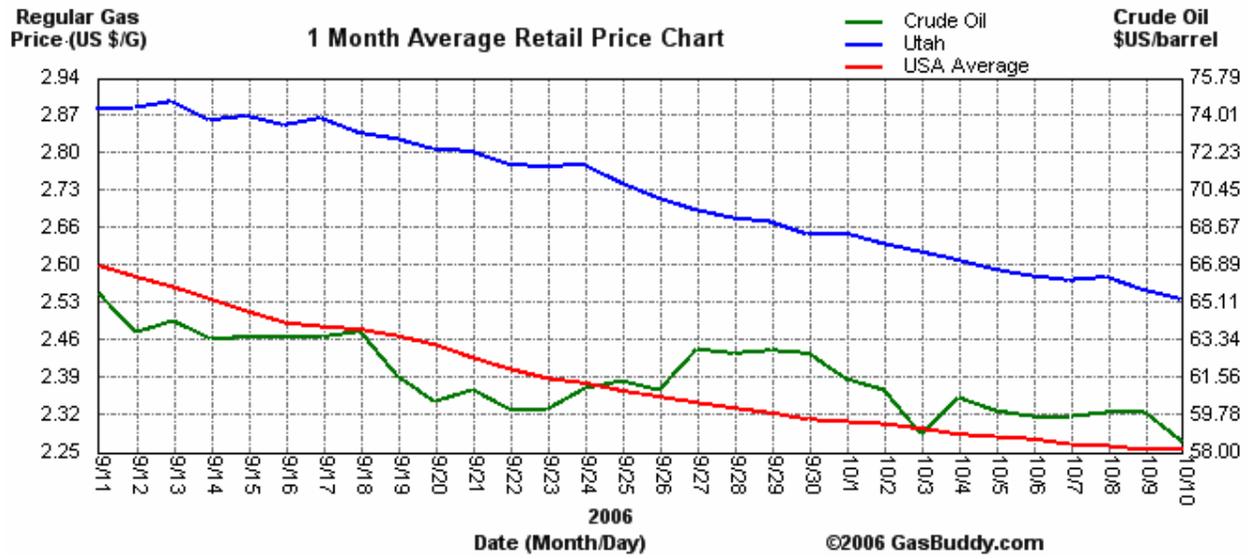
From the information that was provided, it appears that some retailers took an opportunity to increase profit margins as wholesale prices began to decrease. Gasoline profits often are not the most significant profit source for a retail station, and throughout most of the year the profit margin for gasoline is small, often only a few cents per gallon. It appears, however, that during recent weeks some retailers have been making a profit margin several times greater than average.

Because of the failure of the refineries to provide crude oil prices, it is impossible to determine whether recent profit margins for the refineries were an aberration similar to the retail margins.

VII. Potential Further Actions

Governmental action to lower retail gasoline prices could follow one of three potential outlines: increasing supply, reducing demand, or direct regulation and monitoring of the industry. As was noted previously, Utah has not experienced any significant pipeline development in recent years. Additionally, numerous potential incentives exist to encourage a reduction in gasoline usage in Utah. Regulatory options could mandate increased transparency in profit margins or “level the playing field” between various refineries and retailers.

ATTACHMENT A



ATTACHMENT B

