THE ATTORNEY GENERAL'S 1994 INTERIM REPORT ON THE INVESTIGATION OF GASOLINE PRICES

The Department of the Attorney General
State of Hawaii

EXECUTIVE SUMMARY

The Attorney General has been investigating gasoline prices in Hawaii since 1989, shortly after the Exxon Valdez oil spill. Although the spill had no significant effect on the supply of crude oil, there were significant price hikes in its wake.

A preliminary report in 1990 concluded that gasoline prices are higher in Hawaii than on the mainland because there is no effective price competition in Hawaii. The report noted that certain practices of the oil companies doing business in the state contribute to this situation, in particular the exchange agreements entered into between Chevron and BHP (formerly PRI) and the three other major local gasoline retailers (collectively the incumbent oil companies).

After further investigation, we have concluded that we will not, at least for the present, proceed against the oil companies to stop them from the practices we expressed concern about in the 1990 Report, especially the use of exchange agreements. (1) Prices are higher in Hawaii because the oil companies use their market power to keep them higher and exchange agreements facilitate them doing so. (2) The oil companies probably have sufficient power to take excessive (supra-competitive) profits out of Hawaii. But they haven't, at least until the end of 1992. Rather, the oil companies kept the prices in Hawaii just high enough so that profits here were about what they were at comparable profit centers on the mainland. (3) However, the failure of the oil companies to let Hawaii wholesale prices fall with the drop in crude prices since 1992 justifies taking a new look at oil company profits in Hawaii. (4) Banning exchange agreements likely would lead the non-refiner incumbents to leave Hawaii. Alternatively, if the prospect of profits were high enough, one of the non-refiner incumbents might bring mainland gasoline to Hawaii to compete with the refiners here. (5) The incumbent refiners may not be able to compete profitably with mainland gasoline. If not, the refinery operations probably would cease in Hawaii.

It is apparent, therefore, that the question of high gasoline prices in Hawaii implicates both antitrust enforcement policies and sound energy policies. Do we want to bring cheaper mainland gasoline to Hawaii and risk losing the local refining capability or is better policy to allow the markets to adjust themselves without government interference, preserve local refining capability, and live with higher gasoline prices?

We recently began an investigation of retail prices in high cost/ high volume areas. We began with Kona. Almost immediately after our investigation began, retail gasoline prices in Kona dropped about 4 cents per gallon. Subsequently they have dropped an additional 6 cents. This obvious sensitivity to the activities of the Attorney General enforces the need to continue the investigation.

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I. OVERVIEW

The Attorney General commenced an investigation of gasoline pricing in Hawaii shortly after the oil spill from the Exxon Valdez in Prince William Sound off the Alaska Coast on March 24, 1989. The spill had no significant effect on the supply of crude oil. Nevertheless, wholesale gasoline prices rose sharply in Hawaii and on the mainland. At the time of the spill, retail gasoline cost about $1.10 in Honolulu. By mid-July, 1989, the price of retail gasoline had climbed to well over $1.30.

The Attorney General undertook the investigation to determine whether the pricing practices of the incumbent oil companies in Hawaii, Chevron, PRI (now BHP), Shell, Texaco, and Unocal, violated the antitrust laws of Hawaii or the United States. These laws prohibit practices that unreasonably restrain trade by persons acting in concert or, in certain cases, by themselves.

In September 1990, the Attorney General published <u>An Investigation of Gasoline Prices in Hawaii: A Preliminary Report</u> (hereinafter, "<u>1990 Report</u>"). That report described the structure of the gasoline industry in Hawaii and the components of the pump price paid by consumers for gasoline. <u>1990 Report</u>, Exhibits 1-12 and accompanying text. Exhibits 1-7 of this report show the changes between then and now. Exhibits 18 through 21 of the 1990 Report showed the history of the prices of crude oil, wholesale gasoline in Los Angeles, the wholesale price of gasoline in Honolulu, and the retail price of gasoline in Hawaii. Exhibit 8 of the present report brings that history forward to the present.

The 1990 Report concluded that gasoline prices in Hawaii are higher than on the mainland because the Hawaii gasoline markets are not driven by price competition. For example, low-priced wholesale gasoline available on the mainland does not come to Hawaii to compete in Hawaii's higher-priced markets. The Report also concluded that certain practices of the oil companies appear not only to make it less likely that competitive gasoline from the mainland would come to Hawaii, but also less likely that the incumbent oil companies would engage in vigorous price competition among themselves. In particular, the Report pointed at the exchange agreements under which the incumbents without refineries in Hawaii exchange gasoline refined in Hawaii for gasoline refined on the mainland.

Based on the Department's ongoing investigation of Hawaii's gasoline markets, the Attorney General concludes that the exchange agreements are not clearly anticompetitive. Further, the Attorney General concludes that the incumbent oil companies did not take excessive (supra-competitive) profits from consumers in Hawaii, at least until the autumn of 1992.

On the other hand, from October 1992, until October 1993, the incumbent oil companies kept wholesale prices at about the same level in spite of declining crude oil costs. The oil companies' practice of keeping wholesale prices high in the face of declining costs appears to be anticompetitive, and we conclude that it justifies the continuation of the investigation.

In the meantime, the Department began investigating price fixing at the retail level on the neighbor islands, especially in high volume markets. Kailua-Kona was the first market studied. Although the Department did not find any price-fixing conspiracy or agreement, retail prices in the Kailua-Kona market declined about four cents per gallon shortly after the investigation began. The Department intends to investigate other neighbor island retail markets.

II. THE ECONOMIC AND LEGAL CONTEXT

The price to consumers is lowest when competition keeps any single seller or group of sellers from controlling the price. In a competitive market, sellers maximize profits and minimize losses by expanding output (sales) until the market price no longer covers the cost of production. Producing more would cause losses. Producing less would forego legitimate profits. When the dominant factor for a buyer is price, the competitor with the lowest price will get the sale. Competitors whose costs are too high to match that price are forced to sell at a loss or leave the market. As a result, the market is kept clear of inefficient producers and consumers get the lowest possible price, the highest quality, and the greatest selection.

On the other hand, when there is no competition, a seller maximizes profits by running up the price to the highest the market will bear. There is nothing to stop the seller, for there is no competitor to offer a lower price. Such a market is called a monopoly. The lack of competition imposes unnecessarily high prices on consumers, reduces output and hence total wealth, and wastes factors of production by allowing inefficiency.

An oligopoly is a market with too few sellers to assure that the product will be priced competitively. In an oligopoly, price competition is very weak. Price competition just does not pay.

For example, in a market with very few sellers, if one company lowers its price, the other companies will follow to avoid loss of market share. As a result, each earns less money because of the lower price. If one company raises its price, the others may follow or they may not. If the other companies do not follow the price upward, the first will cancel its price increase to maintain market share. If the other companies do follow, all will maintain market share and all will make more money.

In a market that is highly concentrated, that is, with, say, five sellers or less, the tendency is for the players to push the price upward above a competitive level to the highest the market will bear. The objective would be to share the excessive (supra-competitive) profit. If new players don't enter the market to compete for the higher profits, the high prices and high profits will persist. The following performance characteristics typify such markets.

1. Prices are higher than in competitive markets.
2. There is no substantial price competition; no price wars. Competition, what there is of it, is based on service and advertising, not price.

3. Market shares of the sellers tend to be stable.

4. There is infrequent entry of new competition and infrequent exit of incumbents.

This is precisely how the gasoline markets in Hawaii perform.

In the 1990 Report, the Attorney General concluded that the exchange agreements of the incumbents might be anticompetitive in the context of Hawaii's oligopoly gasoline markets. 1990 Report at 21. The Attorney General also concluded that the high gasoline prices probably were the result of decisions by the oil companies, or some of them, to increase profits. 1990 Report at 20. These conclusions are the basis for the focus of the Department's investigation since the 1990 Report: (1) whether the lack of price competition in Hawaii is caused by free market forces or by anticompetitive agreements of the incumbent oil companies, particularly their exchange agreements; (2) whether the incumbent oil companies have been receiving excessive profits from their operations in Hawaii; and (3) whether there is any price fixing occurring on the retail level.

III. EXCHANGE AGREEMENTS: DO THEY KEEP LOW-PRICED MAINLAND GASOLINE FROM COMPETING IN HAWAII?

A. Introduction.

Hawaii consumes about 25,000 barrels of gasoline per day. The 1990 Report pointed out that virtually the entire supply of gasoline to the Hawaii markets is manufactured in Hawaii by Chevron and BHP (formerly PRI). Shell, Texaco, and Unocal do not refine gasoline locally. They obtain their gasoline from Chevron or BHP under arrangements called "exchange agreements." These agreements permit the party who does not refine gasoline locally, say Unocal, to obtain its needs from the party that does, say Chevron, in exchange for providing Chevron the gasoline it needs at places where

Chevron does not refine gasoline, but Unocal does. See 1990 Report at 11. The 1990 Report concluded,

> Although exchange agreements may not be price fixing agreements in the classic sense, they may lessen competition in Hawaii. They appear to us to lock-in existing supply arrangements. Moreover, they appear to lock out new competition seeking to introduce aggressively competitive pricing strategies.

1990 Report at 12.

B. Analysis.

1. The Department's concerns.

The Department believes that exchange agreements lessen competition in Hawaii in several ways. The fact is that low-priced wholesale gasoline on the mainland does not compete with the high-priced gasoline made in Hawaii and marketed by the incumbent oil companies. The Department believes that the exchange agreements are a substantial factor. First, these arrangements are formal agreements between competitors. Agreements among competitors have always brought suspicion upon themselves under the antitrust laws because they almost always lessen competition among the competitors entering into them. Second, exchange agreements affect the supply of gasoline. The incumbents do not bring in mainland gasoline. They limit their supplies to gasoline manufactured in Hawaii. Their exchange agreements enable them to do so. Third, the exchange agreements perpetuate the five incumbents' respective shares of the wholesale markets in Hawaii. They do this by dividing the gasoline manufactured in Hawaii among the incumbents according to the incumbents' projected needs. These projections tend to be based on the incumbents' historic market shares. Neither Chevron nor BHP, the two refiners, could be expected to permit their exchange partners to take away any part of their respective market shares. Fourth, by facilitating the limitation of the supply of gasoline in Hawaii to that manufactured in Hawaii, the incumbents' exchange agreements facilitate keeping the market price of gasoline in

Hawaii markets high. Thus, the incumbents' exchange arrangements become the mechanism by which the incumbents keep low-priced wholesale gasoline from the mainland out of Hawaii.

2. The financial context.

The question here is whether it is in the best financial interest of a non-refiner incumbent, acting independently, to exchange its mainland gasoline for gasoline in Hawaii or to bring in its own supplies from the mainland. If a non-refiner brought in its own supplies, the cost would be the cost of production at its mainland refinery plus the cost of transportation to Hawaii. If the non-refiner purchased its supplies on the open market in Hawaii, the cost would be the rack price of wholesale gasoline in Hawaii. By using exchange arrangements, the non-refiner's cost is its mainland cost of production plus a negotiated exchange differential which ordinarily is less than the cost of shipping.

It must be remembered that the refining process produces jet fuel, diesel oil, and distillates as well as gasoline, and that at the end of the process there is a substantial quantity of residual oil which is sold as fuel oil. These products sell at different prices. Generally, residual fuel oil sells for less than gasoline, and sometimes for less than the spot price of certain crude oils. The value of exchanging gasoline rather than importing it or purchasing it locally depends on the value of the various petroleum products covered by the agreement in markets other than Hawaii. This will be discussed in Part IV.

The economic wisdom of bringing mainland gasoline to Hawaii would depend on its earning a higher profit in Hawaii than on the mainland. Currently, the price of wholesale gasoline in Honolulu is about 83 cents. In Los Angeles it is about 58 cents. But Los Angeles is a competitive market, and the market price there is not affected by the output of any single seller in the market. On the other hand, Hawaii is not a competitive market and any appreciable addition to the supply of gasoline in Hawaii would affect the market price. Moreover, the demand for gasoline is relatively inelastic in Hawaii. Consumers in Hawaii buy about the same amount of gasoline per day when the pump price is 70 cents as they do when the price is $1.50. That amount is about 25,000 barrels per day, or about one million gallons.

So if Shell were to supply an additional 4000 barrels a day (the amount it sells in Hawaii) to the Los Angeles market, the additional supply would have no effect on the price of wholesale gasoline in Los Angeles. On the other hand, if Shell, instead of exchanging gasoline with Chevron or BHP, were to import 4000 barrels a day of additional gasoline into the Hawaii market, the additional supply would have a profound effect on the price of wholesale gasoline in Hawaii. Since consumers in Hawaii will purchase only 25,000 barrels a day whatever the price, supplying the market with a total of 29,000 barrels a day would oversupply the market by 4,000 barrels a day and would drive the price sharply down. The risk that the resultant market price of wholesale gasoline would be less than 58 cents plus the cost of transportation is a substantial barrier to bringing low-priced gasoline from the mainland to Hawaii.

There are, of course, other barriers. The Department believes that the cost of doing business in Hawaii is higher than on the mainland. However, the Department has not been able to find a reliable measure of the difference. Moreover, environmental concerns may effectively prohibit the construction of new service stations in many areas. The potential risks of environmental liability make the purchase of existing stations by anyone but major oil companies unlikely. And, the risk of a tanker spill, like that of the Exxon Valdez, and the liability from such a spill, must not be underestimated. These barriers may be insuperable for a non-incumbent. It may well be that the analysis of the potential for new competition must be limited to the oil companies already doing business in Hawaii. In this regard, it must be noted that to bring in mainland gasoline, a non-refiner incumbent would have to abandon its pipeline connections with Chevron and/or BHP, and it would have to write off these assets.

3. The argument that exchange agreements are procompetitive.

In view of the risks and barriers to entry, the claim might be made that without the exchange agreements, the non-refiners would not remain in Hawaii. As a consequence, the Hawaii gasoline markets would be divided between Chevron and BHP. Accordingly, the argument might be made that exchange agreements increase competition in Hawaii rather than lessen it. A market of five sellers is more competitive than two.

4. The argument that exchange agreements are anticompetitive.

The Department, however, does not believe that the analysis should end there. The question is whether the inelasticity of the demand for gasoline in Hawaii keeps the Hawaii markets from being worth competing for. The Department does not believe it does. An oligopolistic market is worth vigorous price competition if a seller can project a profitable outcome from a substantial price reduction. A seller could expect price competition to increase profits if a price decrease would increase sales enough to more than make up for the decrease in price.

A seller's price decrease in an oligopolistic market ordinarily would be matched by other sellers in order to preserve their market shares. But a price decrease would increase sales if other sellers could not match it (because they were less efficient) and if the first seller could supply the entire demand in the market at the lower price.

Shell, Texaco, and Unocal each has enough refinery capacity on the mainland to manufacture gasoline in sufficient quantity to supply the entire demand of the Hawaii markets. Suppose one of them were to reduce its price to the price of wholesale gasoline in Los Angeles plus the cost of transportation to Hawaii. In the face of such a hostile move, it is likely that neither Hawaii refiner would continue to supply gasoline to the hostile seller. The seller would have to bring in its own supplies from the mainland. If it were profitable for the seller to do so, that is, to sell its own mainland gasoline in Hawaii at the Los Angeles wholesale price plus the cost of shipping, you would expect the seller to do it.

Therefore, it is not necessarily the inelasticity of demand for gasoline in Hawaii that keeps Hawaii from being a competitive market. The question is whether it costs less to bring in mainland gasoline than to make it in Hawaii. The Department's information is that it does cost less. Therefore, the Department believes that what keeps Hawaii from being competitive is the use of exchange agreements by the incumbent oil companies in Hawaii. If the incumbents were precluded from using them, the only question would be whether anyone would bring mainland gasoline to Hawaii to sell in competition with the two refiners here. The Department believes that the two refiners may be at great risk of losing the entire market to a mainland competitor.

The Department appreciates the complexity of the problems that must be solved and the risks that must be faced by a seller who undertakes to compete for the Hawaii gasoline markets. The fact is, however, that exchange agreements with the Hawaii refiners are not themselves a subject of competition. Aloha Petroleum, for example, claims that it cannot obtain a competitive exchange arrangement from either Chevron or BHP. And so it remains a fact that the exchange arrangements among the incumbent oil companies (1) are agreements among incumbent competitors (2) that facilitate the limitation of gasoline supplied to Hawaii to that manufactured in Hawaii, (3) that facilitate the allocation of gasoline among the incumbents, (4) that facilitate the incumbents keeping the price of gasoline as high as the Hawaii markets will bear, and (5) that facilitate the incumbents keeping out competitive gasoline from the mainland.

Agreements that keep prices above competitive levels by manipulating the supply of gasoline are per se unlawful under the antitrust laws. United States v. Socony Vacuum Oil Co., 310 U.S. 150, 223 (1940) ("Under the Sherman Act a combination formed for the purpose and with the effect of raising, depressing, fixing, pegging, or stabilizing the price of a commodity in interstate or foreign commerce is illegal per se"). An agreement under which one competitor receives a portion of a market and another competitor receives the remainder is unlawful on its face. Palmer v. BRG of Georgia, Inc., 498 U.S. 46 (1990)("Such agreements are anticompetitive regardless of whether the parties split a market within which they both do business or whether they merely reserve one market for one and another for the other.")

C. Checking the Analysis with the FTC.

The Department asked the Bureau of Competition of the Federal Trade Commission to review the Department's analysis of exchange agreements. The Bureau concluded that on balance, the procompetitive effects outweigh the anticompetitve.

The Bureau did not think that it was clear enough on the face of an exchange agreement that the agreement was made for the purpose and with the effect of maintaining the price of gasoline in Hawaii. At best, maintaining the market price was an incidental effect. Secondly, it was the Bureau's view that exchange agreements on their face do not support the conclusion that the parties use them to divide up the Hawaii markets among them.

The Bureau pointed out that exchange agreements do enable the non-refiner incumbents to save the cost of transportation in doing business in Hawaii. According to the Bureau, this cost saving is enough to save an otherwise naked restraint of trade from illegality as such.

The Bureau also pointed out that it would be difficult if not impossible to prove that exchange agreements have any actual anticompetitive effects in Hawaii. The elimination of the use of exchange agreements would not necessarily lead to lower gasoline prices in Hawaii. True, the non-refiner incumbents could send gasoline to Hawaii to drive out Chevron or BHP. But if they did, the additional gasoline they would supply to Hawaii, because of the inelastic demand for gasoline, would likely reduce the market price to the point of unprofitability, if not total instability, both for them and the refiner incumbents.

If exchange agreements were banned, the non-refiner incumbents would either seek to displace Chevron and BHP, or abandon the Hawaii market altogether, or buy gasoline from Chevron or BHP on the open market. The choice would depend on the comparative profitability of the available options.

It would, of course, be illegal for the non-refiner incumbents to join in an agreement to drive Chevron and BHP from the market. The decision of a single one of the non-refiner incumbents to go after Chevron's and BHP's market share might or might not be opposed by one or more of the incumbents, including Chevron if not BHP. Chevron could import low-priced gasoline from the mainland as easily as any of the non-refiner incumbents. But such a price war would be unlikely. Everyone would lose. If the non-refiner incumbents decided to stay in Hawaii, but not to drive out Chevron and BHP, they would not likely be any more willing to engage in aggressive price competition than they are now.

In any event, the market doubtless would continue to be oligopolistically structured. At worst, it would devolve into a duopoly made up of Chevron and BHP, or a monopoly by the survivor of them. The inelastic demand for gasoline and the higher cost of doing business in Hawaii would continue to discourage the entry of any other new competition.

On the other hand, the Bureau supported the use of state leases of the land under gasoline storage tanks and state easements for pipelines to encourage new competition.

D. Testing the Bureau of Competition's Conclusion that Exchange Agreements are Procompetitive.

The Department does not find the Bureau's analysis entirely satisfying. The Department is convinced that the incumbent oil companies in Hawaii are exploiting the oligopolistic structure of the gasoline markets in Hawaii and the entry barriers that protect them from hostile price competition. In the absence of competition, the incumbent oil companies control gasoline prices in Hawaii. They can keep them as high as they think the market will bear. And they can keep them high without regard to fluctuations in the cost of crude oil. The Department believes that the absence of vigorous price competition in Hawaii implies an "attitude" of cooperation among the incumbent oil companies. The Department believes that the incumbents' exchange agreements play a role in sustaining that attitude in Hawaii.

The Department must acknowledge that exchange agreements, joint production agreements, and inter-company processing agreements have characterized the oil industry throughout the world for many decades. These arrangements have generated an attitude of cooperation among the oil companies. What Hawaii can do to keep Hawaii free from the effects of that attitude of cooperation is problematic at best.

The question is whether prohibiting exchange agreements in Hawaii will lower Hawaii's high gasoline prices. If exchange agreements were not used in Hawaii, the cost of wholesale gasoline refined in Hawaii to the non-refiner incumbents would increase. Under most models of oligopolistic interaction this would lead to an increase in the market price, not a decrease. But such a result depends on (1) the barriers to entering Hawaii markets with mainland gasoline being insurmountable, or (2) the prospect of profits in the Hawaii markets not being attractive enough to justify anyone waging hostile price competition.

The Bureau of Competition's analysis does not allay the concern that the incumbent oil companies are exploiting their market power to take excessive (i.e., supra-competitive) profits from Hawaii consumers. If profits are excessive in Hawaii, they should attract competitive gasoline from the mainland. If that is the case, the Bureau's conclusion that the exchange agreements are procompetitive ought to be rejected.

On the other hand, competitive low-priced gasoline from the mainland will not enter Hawaii markets in the absence of adequate profits, that is, unless the prospect of profits in Hawaii sufficiently exceeds profits from available investment opportunities elsewhere. It will not be brought to Hawaii by new, non-incumbent competition from the mainland or elsewhere. Nor will the non-refiner incumbents be willing to bring their own gasoline to Hawaii rather than buying it from Chevron or BHP. (See paragraph III B 3, above, where the Department acknowledges that environmental concerns, alone, may preclude entry of new competition from non-incumbents.) Therefore, if the incumbent oil companies in Hawaii are not earning excessive profits, the Department would be inclined to accept the conclusion of the Bureau of Competition that exchange agreements are, on balance, procompetitive.

IV. ARE THE INCUMBENT OIL COMPANIES TAKING EXTRAORDINARY PROFITS FROM HAWAII CONSUMERS?

The Department engaged a professional economist who specializes in petroleum markets to determine whether the incumbent oil companies in Hawaii are earning profits in excess of competitive levels.

A. The Facts Tend to Indicate that Through 1992, the Refineries in Hawaii Have Not Been Earning More than a Competitive Return on Investment.

Our economist began his study by noting that the structure of the gasoline industry on the mainland is quite different from in Hawaii. Southern California is served by many refineries, including both integrated majors (oil companies that own or control oil fields, extract it from the ground, refine it, and market it) and independents. Our economist assumes (and we agree) that the Los Angeles region is a competitive market. A comparison of the pricing and margins at refineries in Hawaii with refineries in the Los Angeles region should identify the impact of the oligopolistic industry structure in Hawaii.

Gasoline, diesel oil, and jet fuel are the main products the oil companies make by refining crude oil. Product prices at wholesale are significantly higher in Hawaii than in Los Angeles. However, even if refinery costs were the same in the two areas, the higher prices in Hawaii do not necessarily imply supra-competitive pricing in Hawaii. The value of the slate of products produced from a barrel of crude oil varies significantly. For example, a gallon of fuel oil is worth less than half a gallon of gasoline. Asphalt and coke are even less valuable. Therefore, in order to determine whether an oil company in Hawaii is exploiting the oligopolistic structure in Hawaii to obtain supra-competitive prices, one must examine the overall value of the product slate in Hawaii.

The yield of gasoline in Hawaii is strikingly lower than in Los Angeles and the yield of fuel oil is higher. Therefore, even though prices are higher in Hawaii, it does not follow that the entire product slate yields a higher average output value in Hawaii. When one compares the average value of the refined outputs in Honolulu and Los Angeles for the years 1984 through 1992, the comparison reveals no significant differences.

Based on the foregoing facts, on additional data produced during our investigation, and on the assumption that refinery costs in Hawaii are not higher than in Los Angeles, our economist concluded that the facts studied do not indicate that oil companies are earning supra-competitive returns in Hawaii from total refinery operations. Wholesale prices in Hawaii are significantly higher for most petroleum products. However, these higher prices do not translate into higher profits. The relatively large production of lower-valued fuel oil effectively offsets the higher prices of the relatively small production of gasoline.

The output mix of a refinery depends on a number of factors. In Southern California, the many players have access to refined product pipelines serving broad markets. An individual refinery can optimize the refinery yield, taking the market prices as given. In Hawaii, however, the main factor determining refinery yield is the relative demand for the products. The data indicates that gasoline, diesel, and fuel oil are produced in amounts that exceed Hawaii consumption. Jet fuel, on the other hand, is significantly underproduced.

Finally our economist calls attention to the dilemma the analysis reveals. As the Department has frequently pointed out, the average refined product cost in Hawaii would be significantly less if products were imported from Los Angeles even taking transportation costs into account. Our economist points out that if gasoline were in fact brought into Hawaii from the mainland, it likely would lead to the closure of the Hawaii refineries because the Hawaii refineries probably could not match the lower price.

B. Price-cost Divergence in 1993 Justifies a Fresh Check.

Exhibit 8 shows that Alaska North Slope (ANS) crude prices have decreased significantly since June, 1992. Wholesale prices in Hawaii, however, have remained steady. The history, in the absence of offsetting increases in refinery and marketing costs, indicates that the incumbent oil companies in Hawaii possessed and exercised the power to maintain Hawaii prices in the face of a substantial decline in costs. There is no indication that the higher prices have caused any loss of sales to the oil companies. The conclusion these facts suggest is that the incumbent oil companies have taken substantially increased profits from their Hawaii operations since June, 1992. The Department's view is that the history of crude oil costs and Hawaii wholesale prices justifies a second look at the question of oil company profits in Hawaii.

Assuming a second look confirms that the oil companies have maintained prices to increase profits, the oil companies doubtless will offer a number of justifications. The one that comes quickly to mind is that the oil companies have maintained prices to recover margins needed to earn a fair return on investment. The implication is that unless they are able to do so, they must reconsider their tenure in Hawaii.

Maintaining prices above cost (including a return sufficient to keep capital invested in the business) for the purpose and with the effect of increasing profits constitutes an anticompetitive use of market power. Any explicit or tacit collusion among the incumbent oil companies toward such an end would very likely violate the antitrust laws.

V. DEALING WITH THE ONGOING HIGH RETAIL GASOLINE PRICES IN HAWAII IN THE FACE OF DECREASING RETAIL GASOLINE PRICES ON THE MAINLAND.

The American Automobile Association (AAA) complains about increasing retail gasoline prices in Hawaii in the face of decreasing prices on the mainland. According to its data, the gap between average prices widened by 22.9 percent in 1993.

The Department's data show a slightly lower average retail price in Hawaii. The Department's data also indicate that retail prices significantly below the average are available throughout each island. But the Department's data do confirm that since October 1992, retail prices in Hawaii have not declined in step with significant declines in the cost of crude oil.

After the 1991 Gulf War, the retail price rose quickly and stabilized at about $1.47. Then the price rose to about $1.50 where it stayed until the federal tax increase took effect in October of 1993 when it rose about 4 cents, which was the amount of the increase in tax. The Department's data reflect an average retail price of about 5 cents less than the AAA data.

The Department regards the retail level of the gasoline markets in Hawaii as relatively competitive. However, competition at the retail level isn't much help to consumers. This is so because the retail margins generally are too narrow to permit price reductions sufficient to overcome consumer preferences for a particular brand, grade, or dealer.

In evaluating competition in Hawaii's gasoline markets, the Department analyzes the wholesale price rather than the retail price. It does this in order to remove the effects of federal, state, and local gasoline taxes, and the effects of retail dealer margins.

After the Gulf War, the Hawaii wholesale price dropped sharply and then rose to about 90 cents in the autumn of 1991. Then the wholesale price rose slowly to 92 cents in June of 1993. Since then it has dropped slightly to just about 83 cents.

In Los Angeles after the gulf war, the price stabilized at about 63 cents. Beginning in March 1992, the price rose to a high of 83 cents in November 1992. Since then the price has fallen to its present level of about 58 cents, about 25 cents below the Hawaii wholesale price.

The major portion of the gap between the retail prices in Honolulu and on the mainland must be attributed to pricing on the wholesale level.

As indicated above, the Department regards the Los Angeles market as competitive. The price of transportation between Los Angeles and Hawaii is 5 to 6 cents per gallon for efficiently-sized shipments. The 25 cent differential between Honolulu and Los Angeles wholesale gasoline, less the cost of transportation, is great enough to require explanation of why low-priced wholesale gasoline from LA doesn't flow into Hawaii to compete with high-priced Hawaii wholesale gasoline. The reason must be either that the business risks don't justify it or that the incumbent oil companies in Hawaii are blocking its entry.

Neither reason refutes our economist's conclusion that the incumbent oil companies, through 1992, were not earning excessive rates of return in Hawaii. So, if the oil companies are blocking the entry of low-priced wholesale gasoline, they have not been doing so to earn monopoly profits. They must be doing so to protect their investments in Hawaii. They would likely suffer substantial, perhaps devastating, losses if the market price were destabilized by the introduction into the Hawaii market of cheap gasoline supplies from the mainland. Such losses could drive all the incumbents from Hawaii.

Thus, the issue becomes one of sound energy policy as well as sound antitrust enforcement. The policy question is whether the public interest is served better by (1) bringing mainland competition to the gasoline markets of Hawaii at the risk of losing Hawaii's local supply of all petroleum products as a result of the closure of Hawaii's two refineries or (2) by permitting the local petroleum markets to work themselves out without government interference in the absence of explicit collusion in fixing prices or explicit agreements among the incumbents to divide the markets or to not compete. This is a question that goes beyond the enforcement of antitrust policy.

VI. RETAIL PRICES IN KONA AND OTHER HIGH VOLUME MARKETS.

Retail prices, on the other hand, appeared to the Department to be excessive in certain high volume markets, chiefly Kailua-Kona, Hawaii, and Kahului, Maui. In early November 1993, the average retail price for self-serve, regular unleaded gasoline in Kailua-Kona was $1.78 per gallon, which was fifteen cents higher than the average price for self-serve, regular unleaded gasoline in Hilo, Hawaii.

The Department began investigating the Kailua-Kona market in early November 1993, to determine why the average retail price for self-serve regular, unleaded gasoline was higher than the average retail price in Hilo. Since the Department initiated its investigation, the average retail price for self-serve, regular unleaded gasoline in Kailua-Kailua-Kona has decreased to $1.68 per gallon as of late February 1994. In comparison, the average retail price for self-serve, regular unleaded gasoline in Hilo is $1.63 per gallon as of late February 1994.

While the Department is pleased to see a reduction in the difference between the average retail prices in Hilo and Kailua-Kona, the Department recognizes that there are some factors that distinguish Kailua-Kona market from the Hilo market and therefore, may explain the remaining price differential between the two communities. For example, the resident population for Kailua-Kona is about 14,950 persons, while Hilo's resident population is about 37,808 persons. This suggests that the demand for gasoline in Kailua-Kona is as much as 250 percent less than the demand for gasoline in Hilo. Furthermore, Kailua-Kona is a resort area whose economic base centers on tourism. In comparison, most of the island's financial and business activity is based in Hilo.

There are other distinctions. Kailua-Kona is served by 10 retailers who sell gasoline, while Hilo is served by 22 retailers. The competition is more intense when there are a higher number of retailers in any community, because each individual retailer strives to attain market share. Second, there is an absence of port storage facilities for gasoline in Kailua-Kona, unlike Hilo which has port storage facilities for the five major oil companies. The lack of port storage facilities in Kailua-Kona, means that gasoline sold in Kailua-Kona is usually transported from Hilo. The transportation cost is around four cents to six cents per gallon of gasoline. Third, the leases for commercial space in Kailua-Kona may be about 200 percent higher than Hilo. Finally, the labor costs may be higher in Kailua-Kona, because the labor pool is smaller and the gasoline retailers must compete with the tourist industry for a smaller labor pool.

The Department has not found any evidence of explicit price collusion or any effort to exclude competition from entering the Kailua-Kona market. But, the ten cents decrease in the average retail price for self-serve, regular unleaded gasoline demonstrates that the Kailua-Kona market is sensitive to Department antitrust scrutiny. The Department's examination of the wholesale level of the Kailua-Kona market remains to be completed.

With respect to the Kahului market, the Department will investigate its retail and wholesale levels shortly.

VII. DIVORCEMENT

Divorcement is the prohibition of oil companies from directly operating retail gasoline service stations. Act 295 of the 1991 Legislature imposed a two year moratorium on oil companies opening and operating retail gasoline stations in order to study the merits of divorcement. Act 295 directed the Attorney General to assess the effect of divorcement on consumer prices. The Department filed its report in January of 1993 under the title of <u>Gasoline Prices In Hawaii The Impact of Oil Company Divorcement On Consumer Prices</u>. Act 329 of the 1993 Legislature extended the moratorium until August 1, 1995.

The Department concluded that if the legislature believed that the better policy was to protect consumers from high gasoline prices than to protect a relatively small number of retail dealers from vigorous price competition from company stations, the legislature should reject divorcement. As an alternative, the Department recommended that the legislature wait to see what action the Congress takes on proposals similar to the ones made to the legislature by the retail dealers.

VIII. NEED FOR THE ENFORCEMENT OF THE PETROLEUM INDUSTRY INFORMATION REPORTING ACT OF 1991

In 1991, the Legislature enacted the Petroleum Industry Information Reporting Act of 1991 (PIIRA). 1991 Haw. Sess. Laws Act 291 (codified as Haw. Rev. Stat. §§ 486I-1 to -10 (1991)). This statute requires the oil companies doing business in

Hawaii to report regularly data concerning feedstock, petroleum receipts, refinery stocks, inventory, finished product supply and distribution, exchanges, refinery capacity, storage capacity, amounts transported, sales, etc. in such form as prescribed by the public utilities commission.

The statute directs the commission to analyze and interpret the information and report a summary of its findings to the governor and the legislature 20 days prior to the first day of the current legislative session. The statute requires the commission to make the information obtained from the oil companies available to the director of business, economic development, and tourism, the attorney general, and the consumer advocate. The statute authorizes the commission to make all necessary rules.

The statute requires the commission to prescribe by rule when the first report is to be submitted. The commission has not yet done so. We understand that the funds it needs to do so have not yet been appropriated.

The purpose of PIIRA is to provide a central data bank on all levels of the petroleum and petroleum product markets in Hawaii including gasoline. The Department believes that this information is essential to providing an adequate fact basis for appropriate legislative oversight, regulatory action, and antitrust enforcement. Accordingly, the Department believes that it is of utmost importance for the legislature to ensure that the commission has the funds it needs to initiate the process contemplated by PIIRA.

IX. CONCLUSIONS AND RECOMMENDATIONS.

A. Conclusions.

1. Gasoline prices are higher in Hawaii than on the mainland because Hawaii wholesale gasoline does not compete with mainland wholesale gasoline.
2. Through 1992, incumbent oil companies were not earning excessive (supra-competitive) profits in Hawaii.

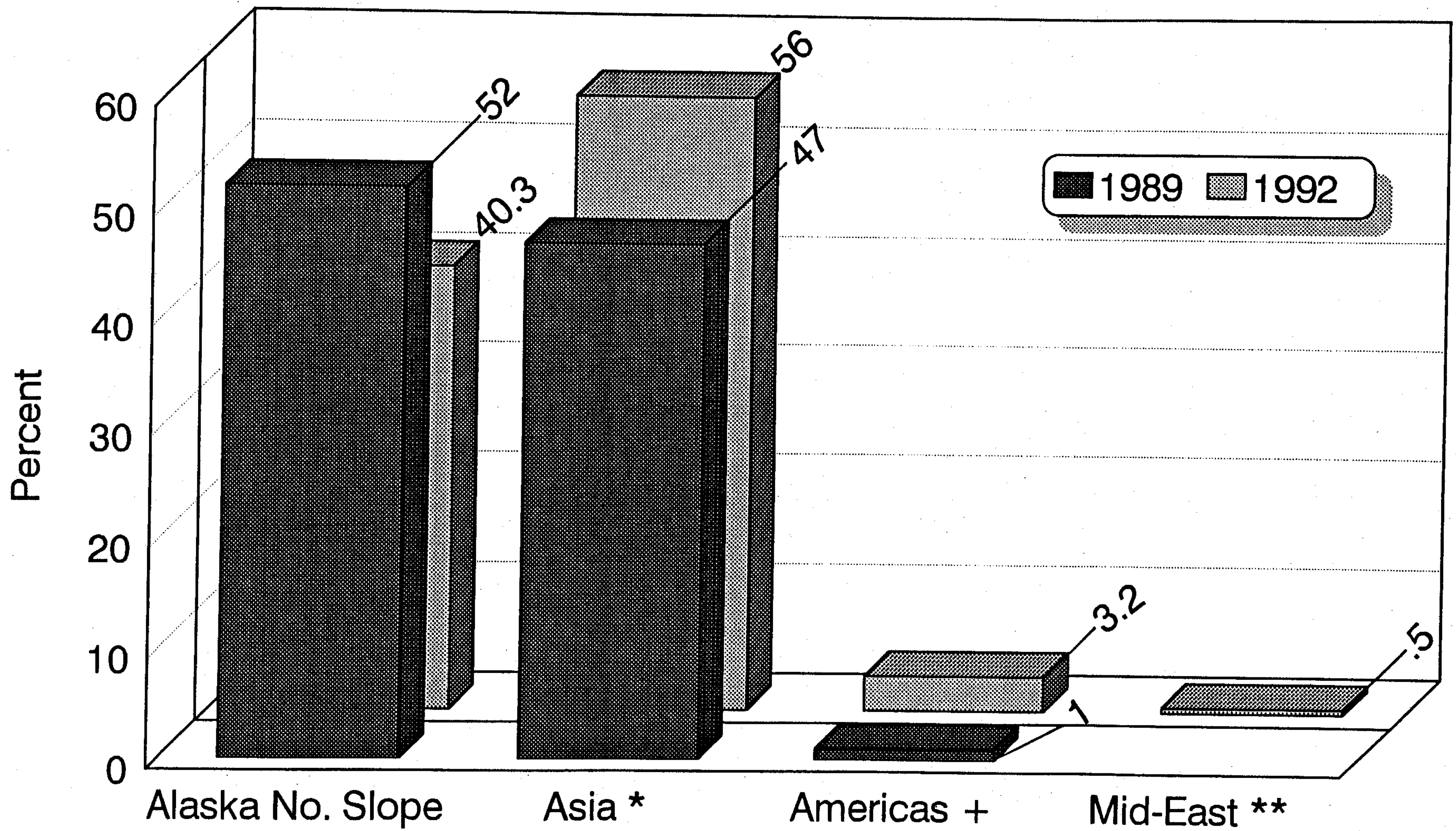
3. However, the failure in 1993 of Honolulu wholesale prices to decrease along with the significant decreases in the price of crude oil requires explanation.
4. The availability of low-cost gasoline on the mainland raises not only serious antitrust questions, but also questions implicating sound energy policy in Hawaii.

B. Recommendations.

1. Help consumers be better shoppers.
2. Permit company stations.
3. Enforce the Petroleum Industry Information Reporting Act, Act 291 of the Session Laws of Hawaii of 1991.
4. Continue the investigation of gasoline pricing in Hawaii; in particular,
    a. The failure of the wholesale price of gasoline to decrease along with the price of crude oil.
    b. Price fixing among retail dealers as well as other sellers of gasoline in Hawaii.

Hawaii's Crude Oil Imports by Source

1989 vs. 1992



* includes oil from Indonesia, People's Republic of China, Malaysia, Australia, New Zealand, Papua New Guinea

\+ includes oil from Ecuador, Argentina, Canada, Venezuela

** only Oman oil

Source: Pacific West Oil Data/EWC/Dbed

Exhibit 1

Distribution of Gasoline in Hawaii

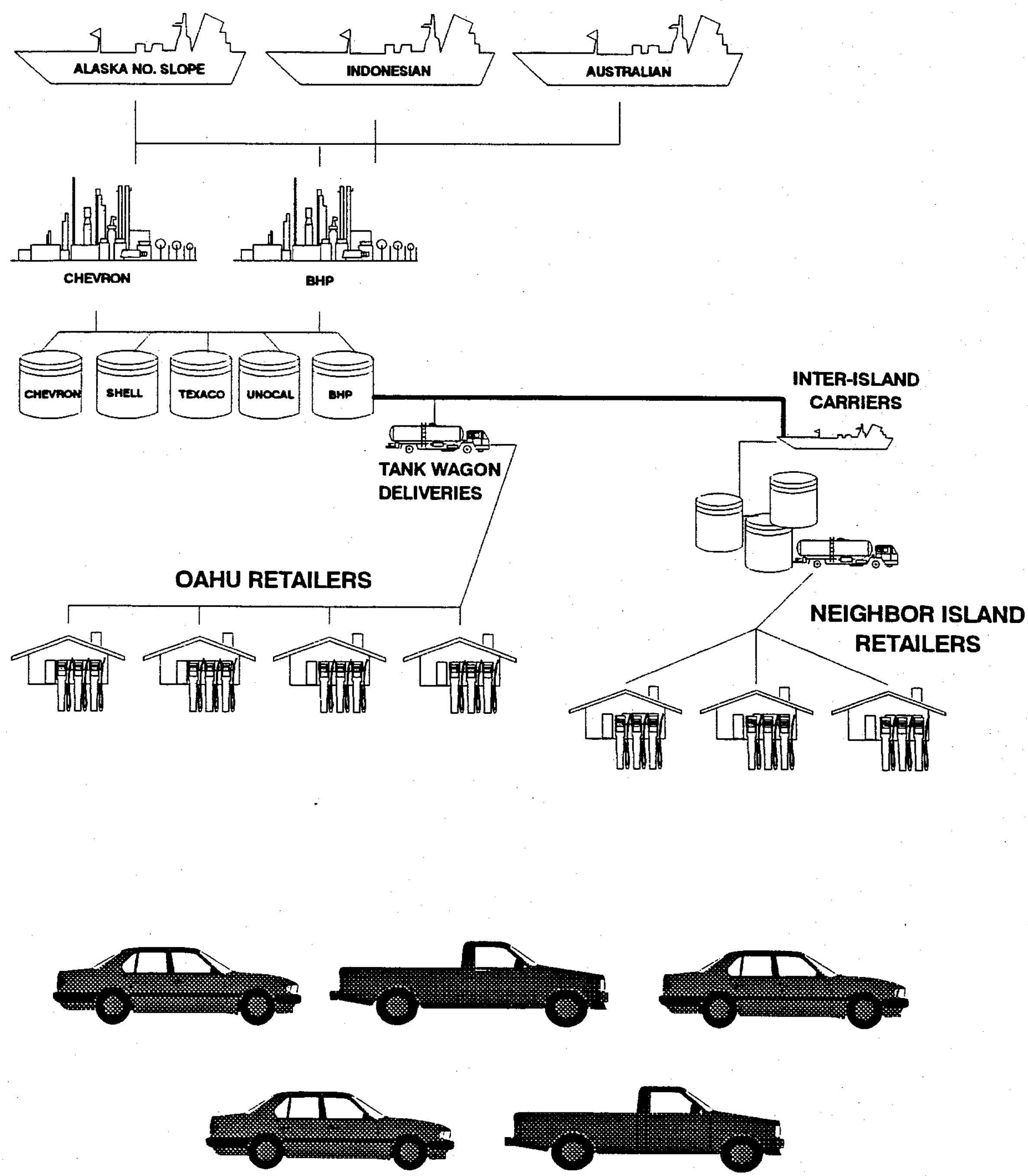
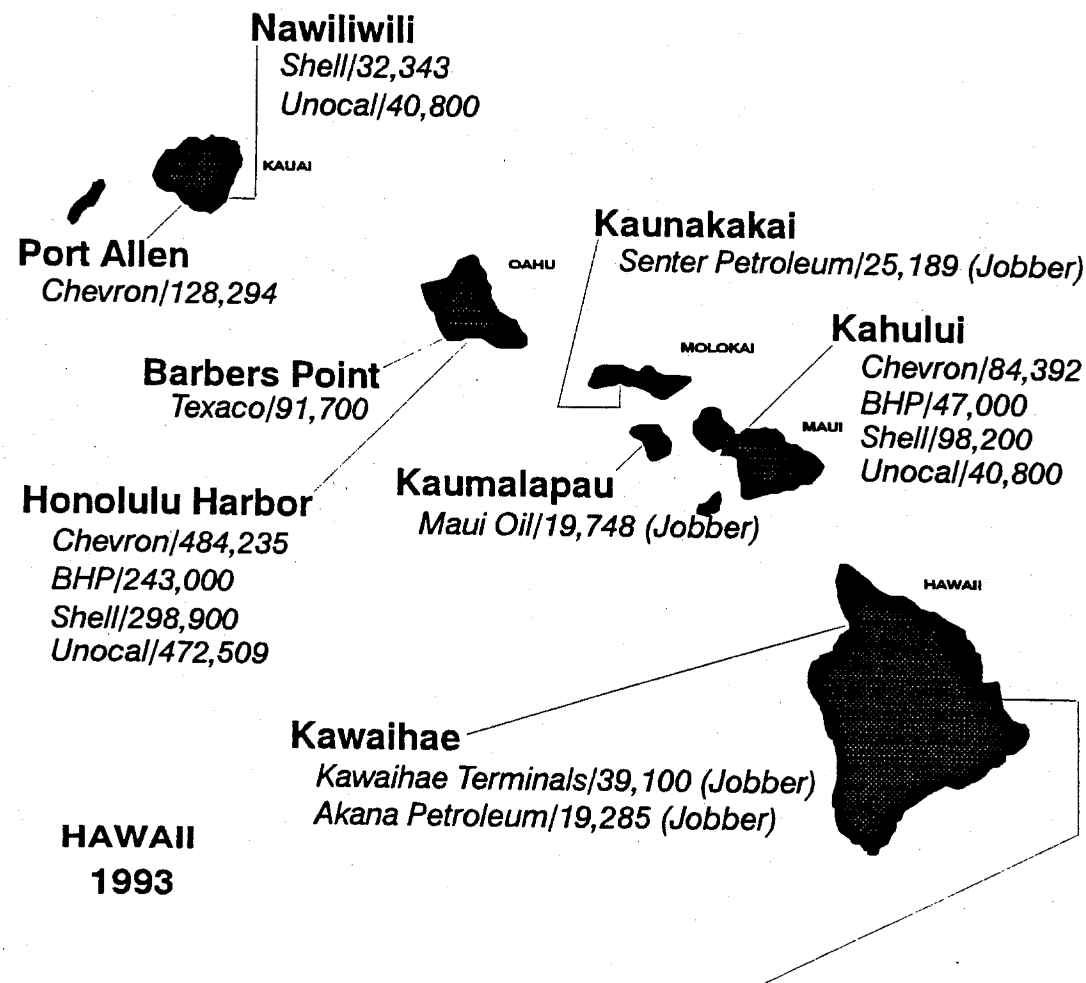


Exhibit 2

Terminal Facilities (All Islands)



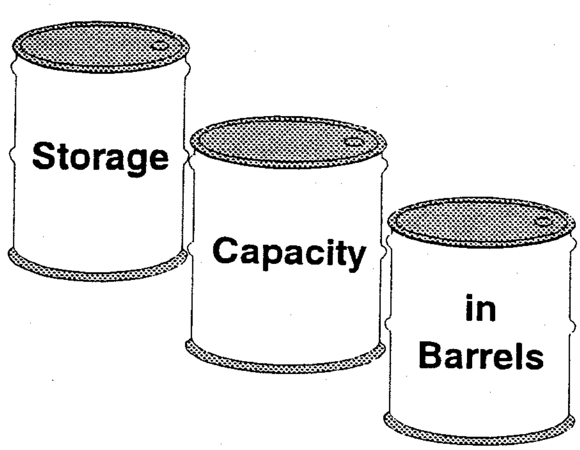
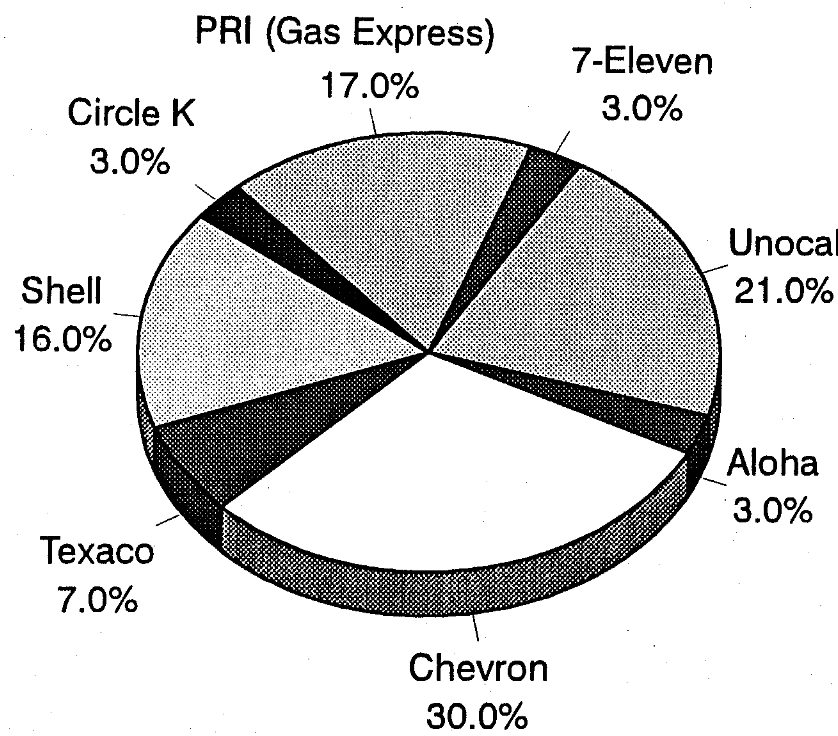
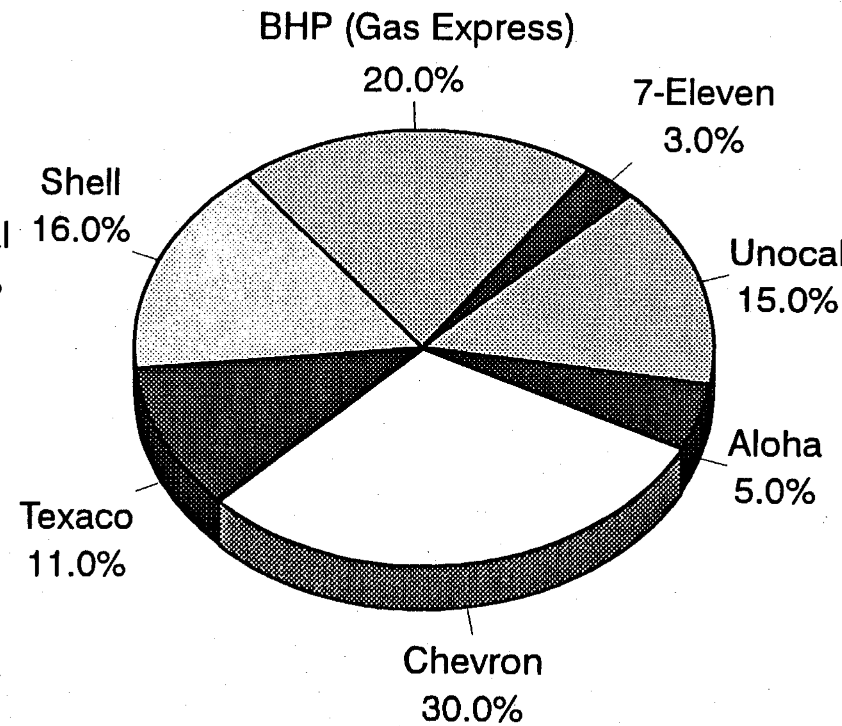


Exhibit 3

Hawaii Motor Gasoline Market Shares*



1989



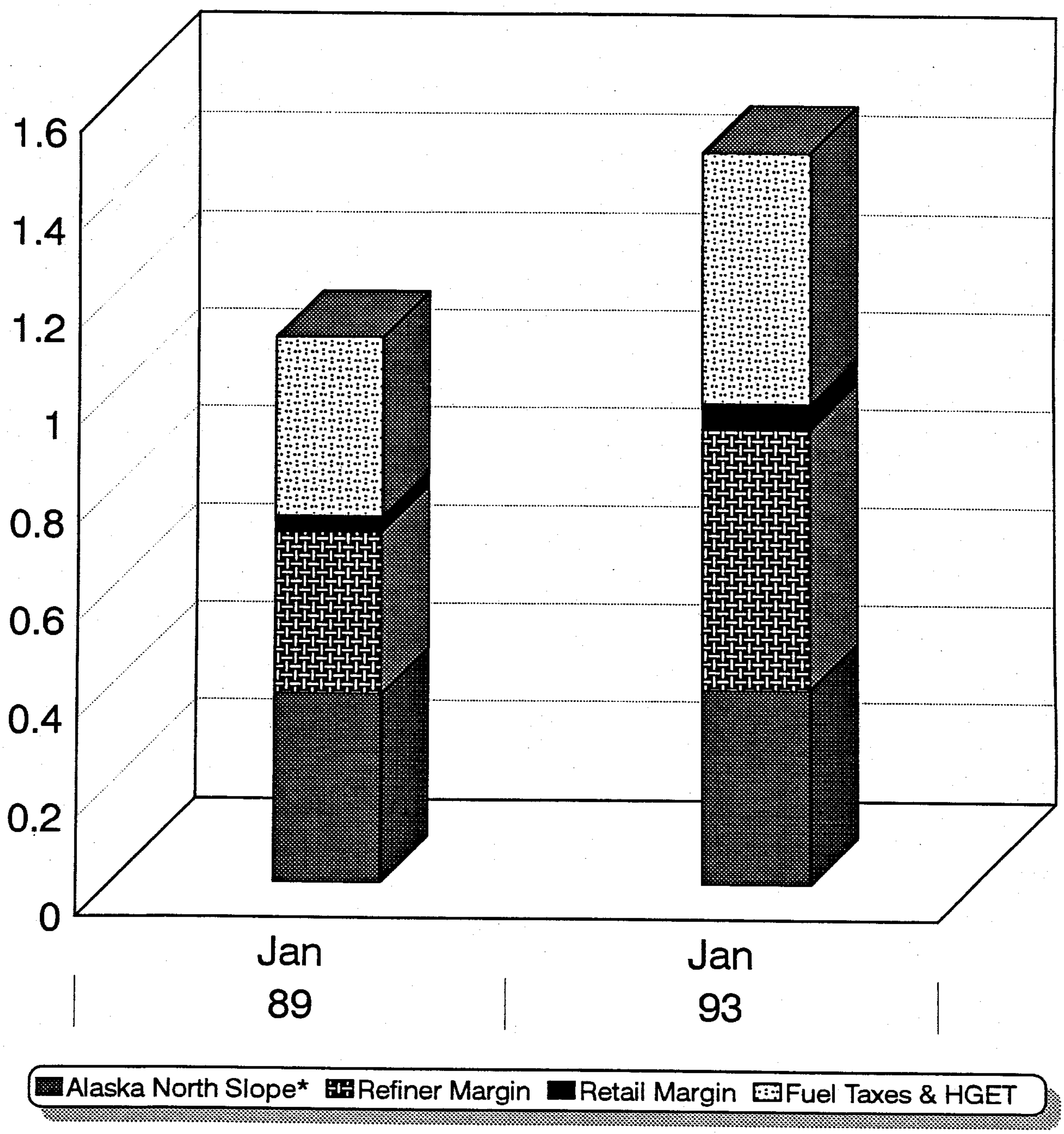
1993

* Estimated

Exhibit 4

Average Component Gas Costs

Honolulu Regular Unleaded
1989 vs. 1993



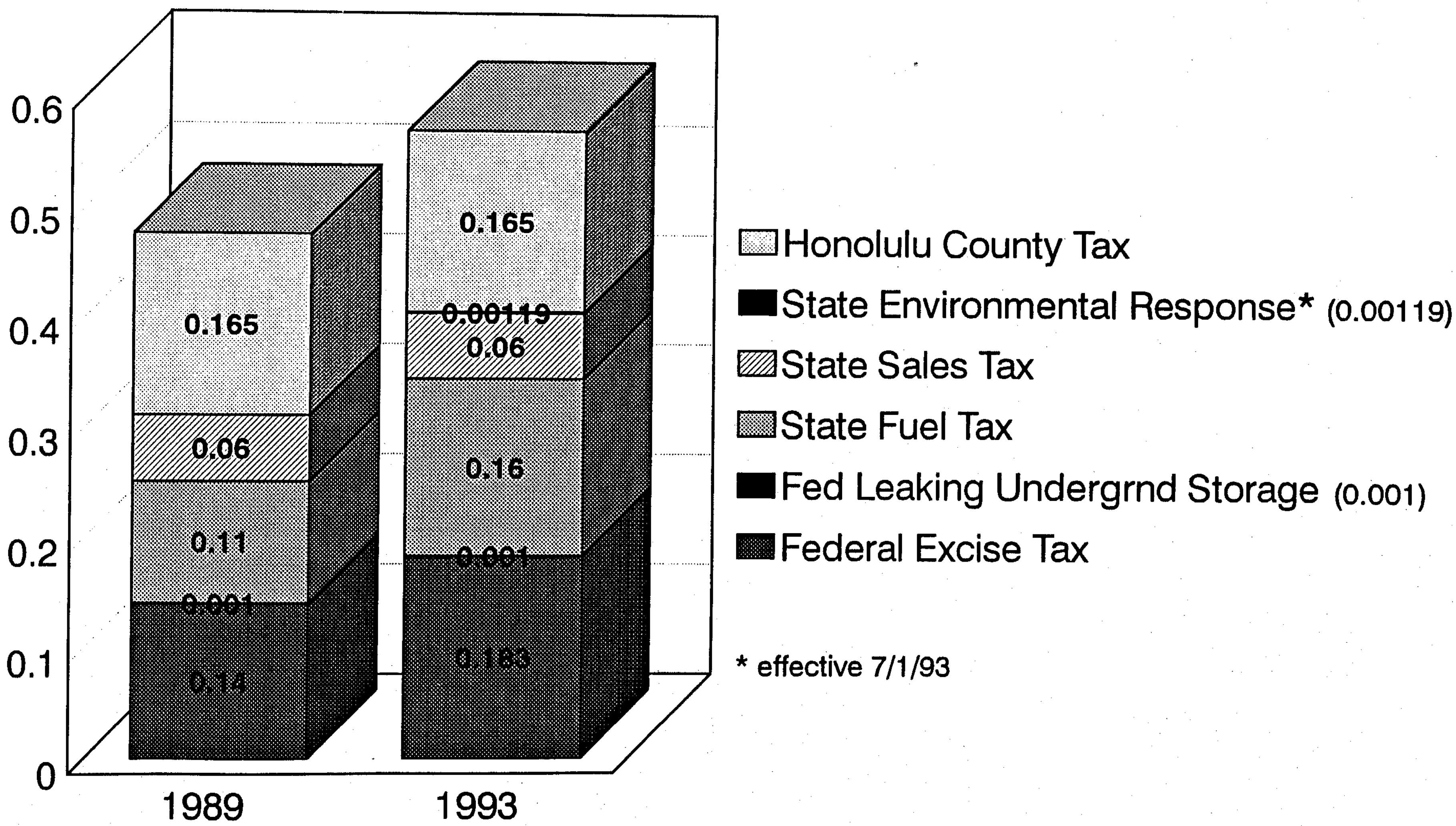
*Crude Cost

Source: Platt's/Lundberg

Exhibit 5

Tax Components of Gas Cost

1989 vs. 1993

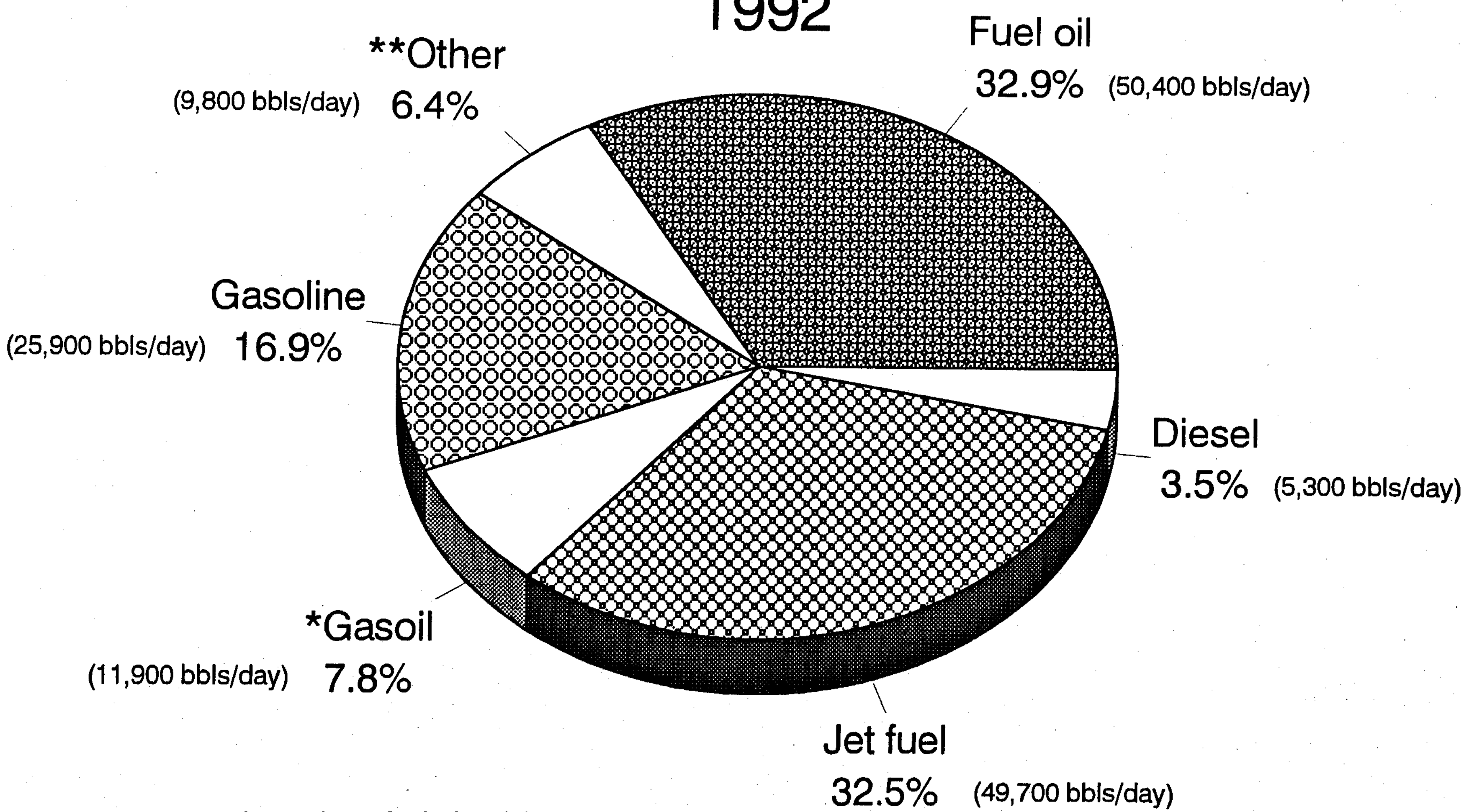


Source: FHA/DOTax/City Budget Dept.

Exhibit 6

Hawaii's Consumption of Petroleum Products

1992



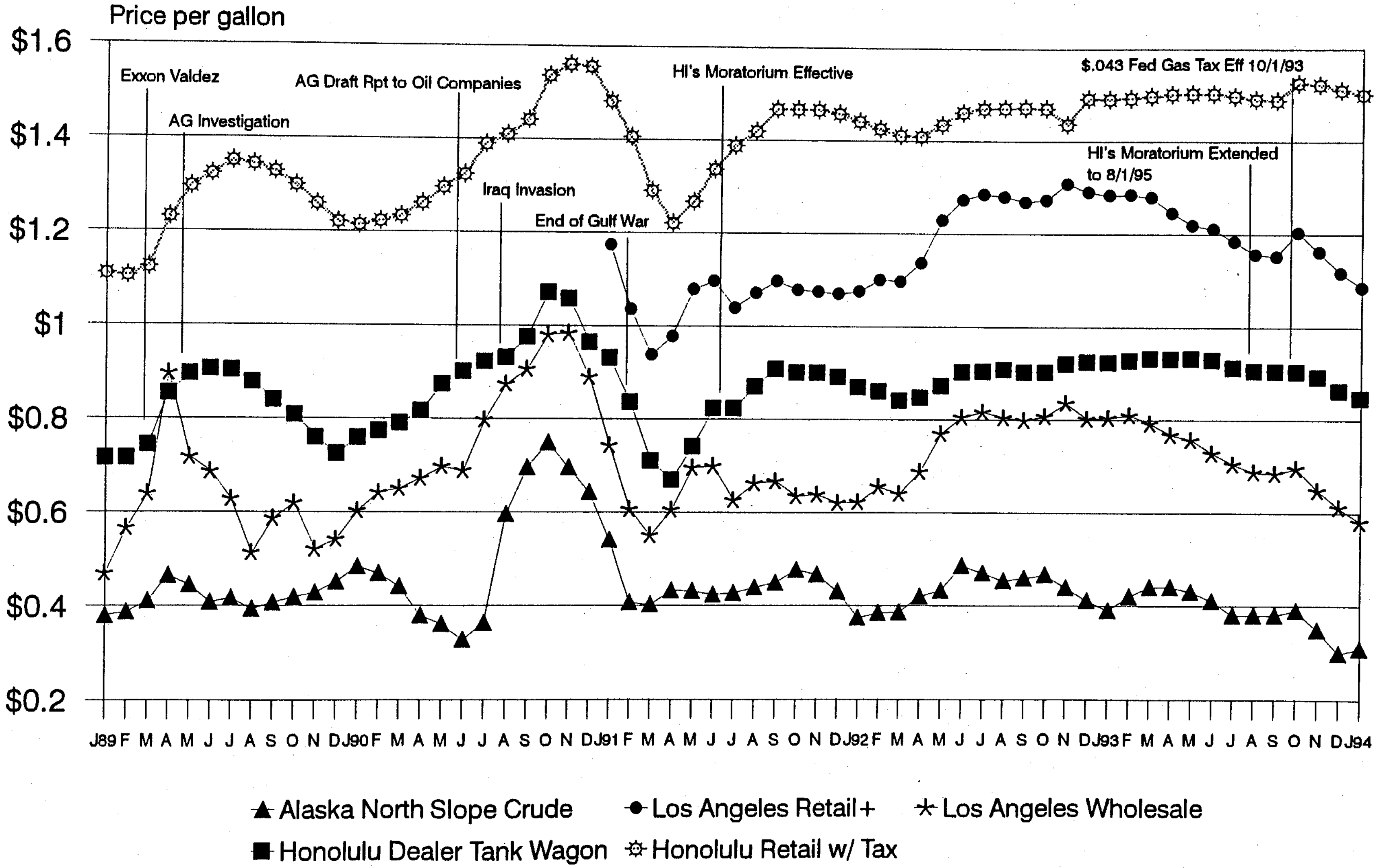
* petroleum for industrial use

** includes kerosene, propane, butane

Source: EWC

Exhibit 7

Price Comparisons of
Crude/Wholesale & Retail Gasoline



*Wholesale average prices combine (1) avg dealer buying prices ex-taxes and (2) avg rack prices

**Hon dealer tank wagon price is the delivered price to retail dealer less taxes

+ Los Angeles retail - beginning January 1991

Source: Platt's/Lundberg

Exhibit 8

Characteristics of an Oligopolistic Market

1) Prices Higher Than in Competitive Markets

2) No Substantial Price Competition; No Price Wars

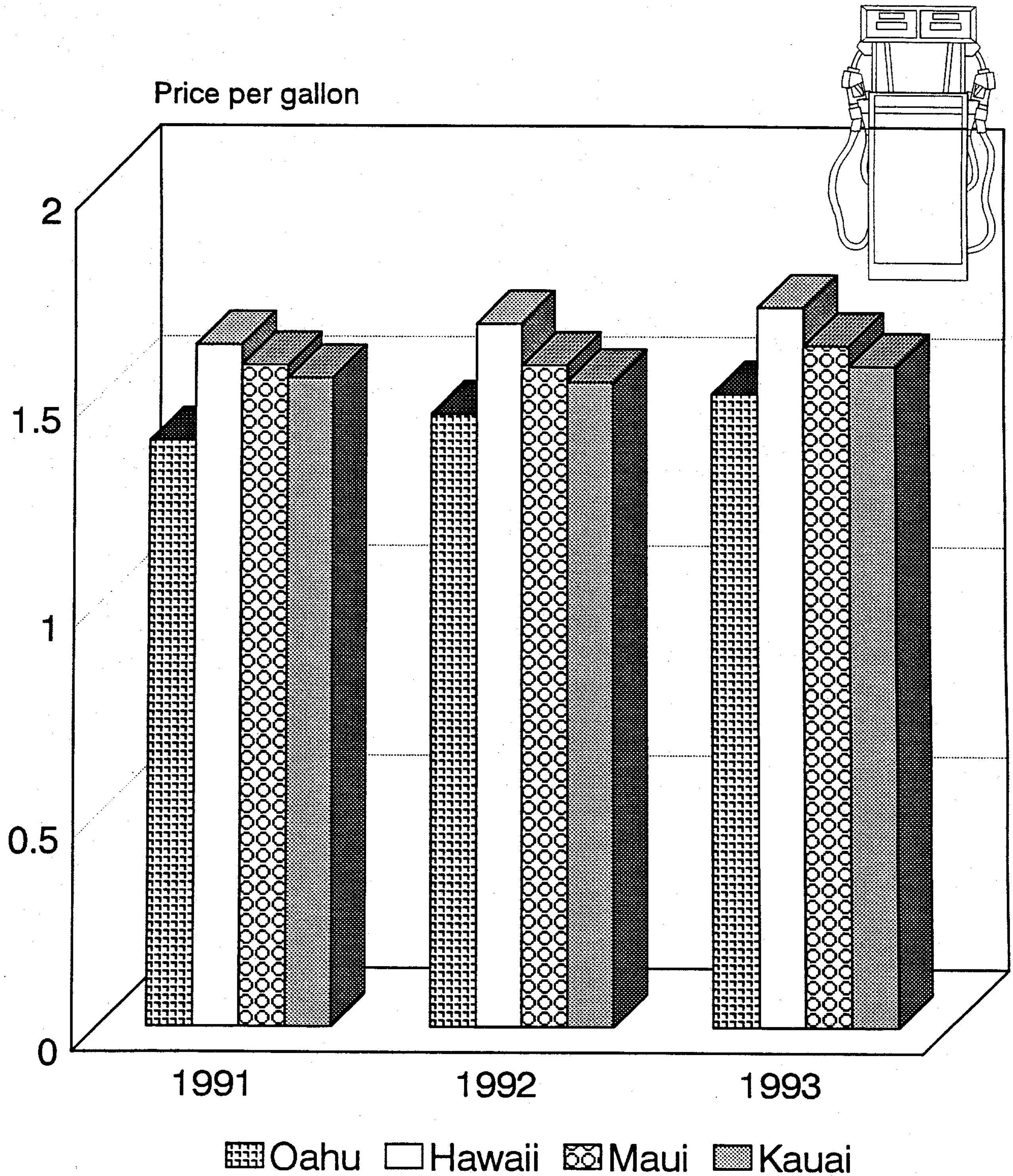
3) Market Shares of Sellers Tend to be Stable

4) Infrequent Entry of New Competition; Infrequent Exit of Incumbents

Exhibit 9

Retail Gas Prices by Island

Regular Unleaded

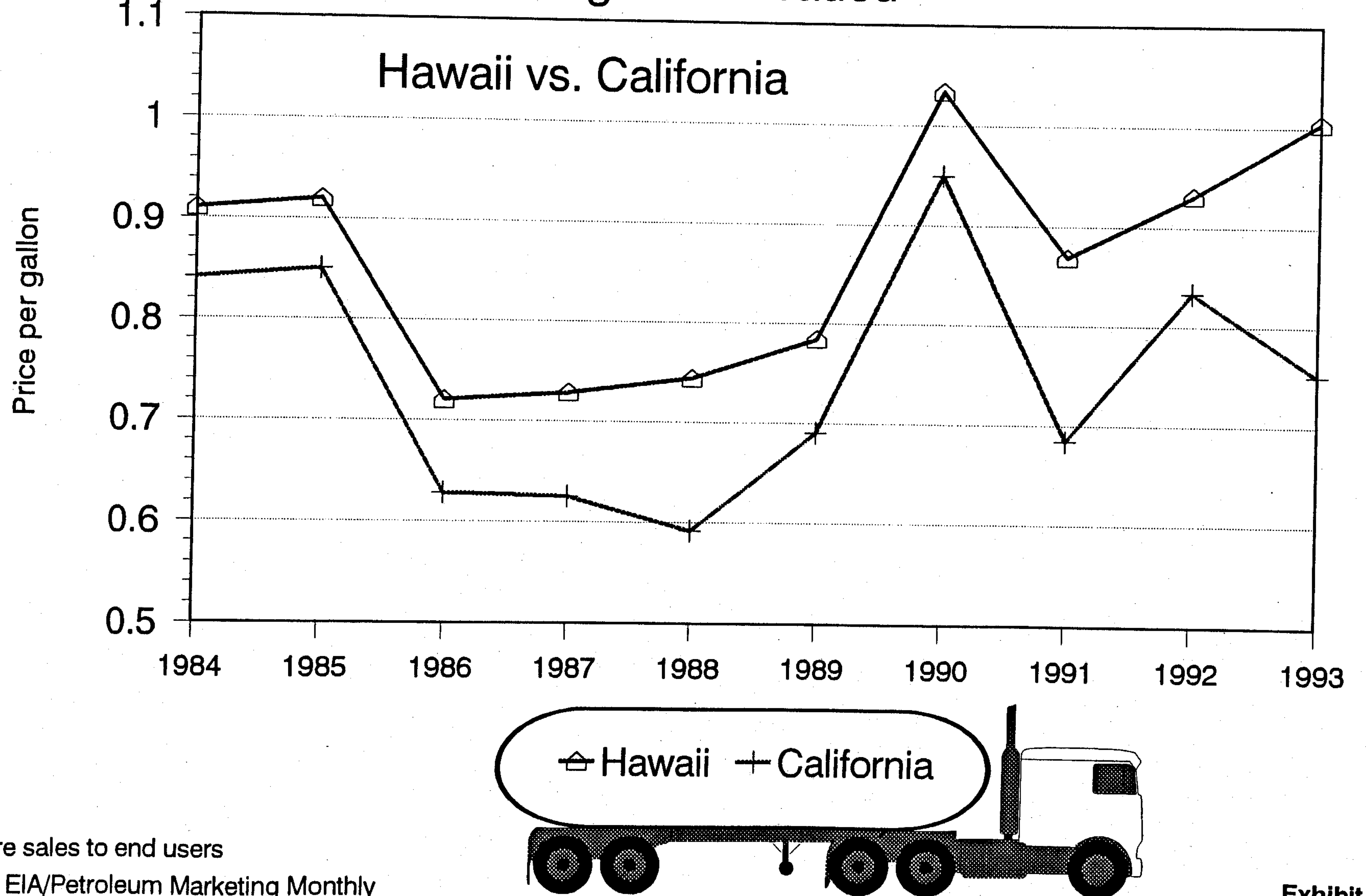


Source: Retailers

Exhibit 10

Wholesale Gasoline Prices

Statewide Averages For Regular Unleaded

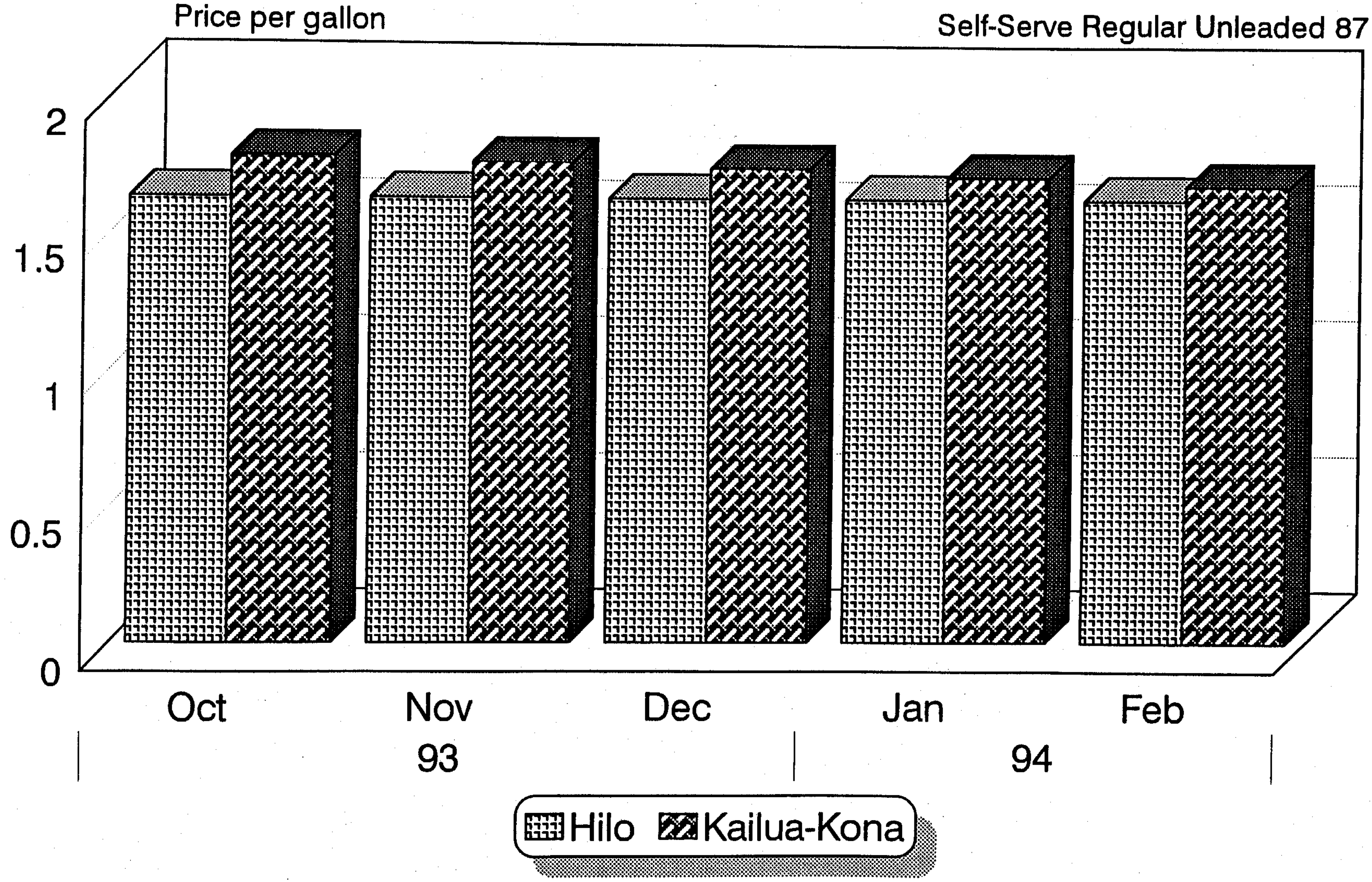


Prices are sales to end users
Source: EIA/Petroleum Marketing Monthly

Exhibit 11

Retail Price Comparisons

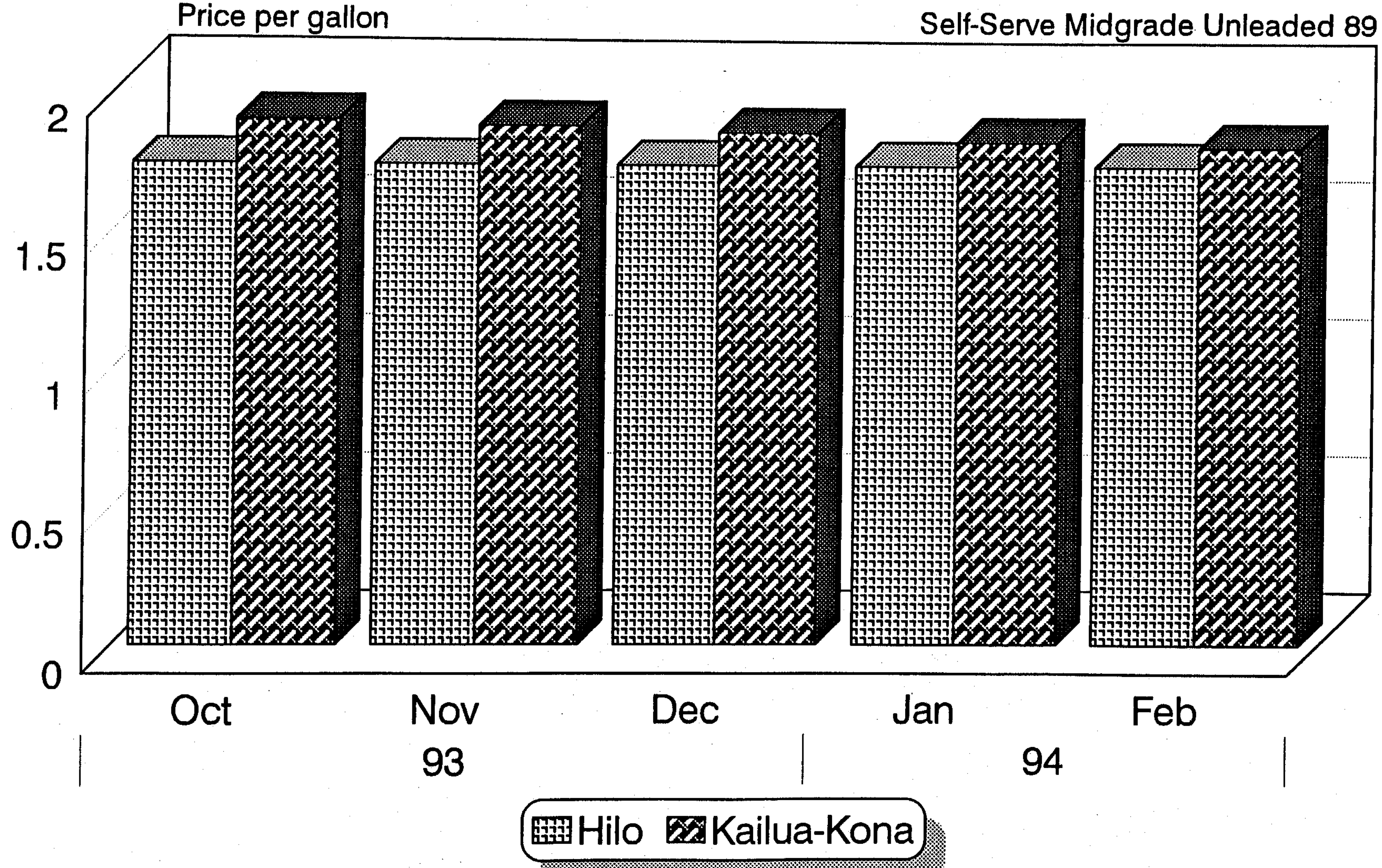
Hilo vs. Kailua-Kona



Source: Lundberg/Retailers

Exhibit 12

Retail Price Comparisons
Hilo vs. Kailua-Kona

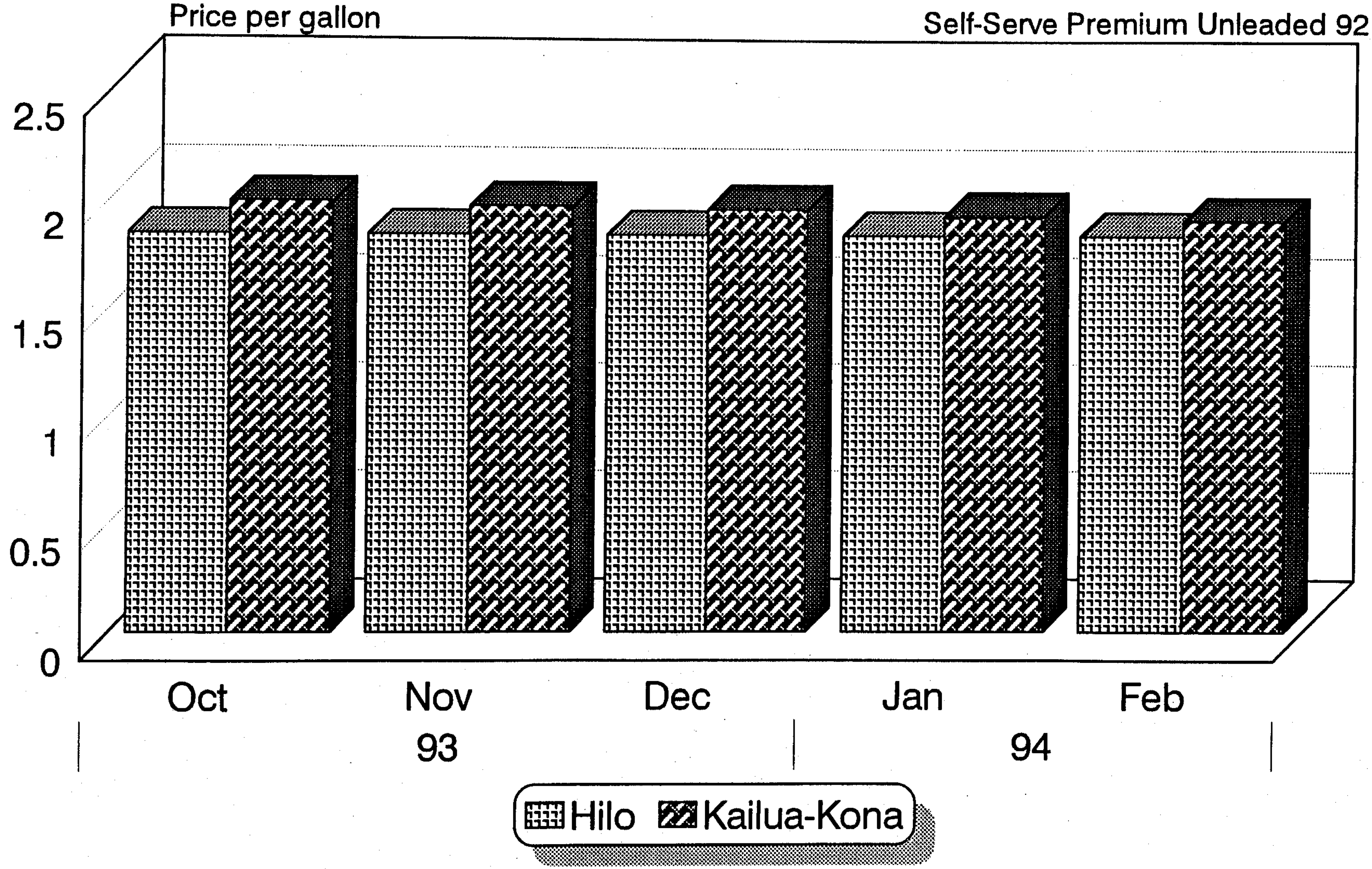


Source: Lundberg/Retailers

Exhibit 13

Retail Price Comparisons

Hilo vs. Kailua-Kona



Source: Lundberg/Retailers

Exhibit 14