The Heritage Foundation Backgrounder

No. 121 The Heritage Foundation 214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202) 546-4400

June 3, 1980

RETAIL PETROLEUM DIVORCEMENT: THE COST TO THE CONSUMER

INTRODUCTION

In the spring of 1974, the Maryland General Assembly became the first state legislature to enact a retail petroleum divorcement law. The Act required integrated oil firms to cease operation of their retail outlets by the summer of the following year. Soon after its enactment, the Maryland statute began to draw the attention of state legislators around the nation. Many of them were struggling with the problem of responding to mounting constituent pressure to do something about the sharp price rises and shortages which accompanied the OPEC oil embargo. Divorcement appeared to present a highly visible approach to the problem. By 1979, some 31 states had either considered or enacted divorcement laws, and by 1980, it was expected that the number would grow to 44. In addition to the activity in state legislatures, retail petroleum divorcement began to attract attention in Washington, as measures were introduced in the Congress to implement it at the federal level.

There is a certain irony in the fact that divorcement legislation has customarily been presented as "consumerist" in its orientation. The evidence on divorcement would indicate that it is actually quite the opposite. A brief overview of some of its effects clearly demonstrates how this can be the case.

Perhaps the most stunning impact of forcing integrated oil firms to cease operation of their retail outlets lies in the amount of money such action adds to the consumer's gasoline bill. The increase at the pump at the affected stations alone would add at least $250 million annually to the price their customers would pay, and overall might add as much as $1.2 billion each year. These figures do not include the additional costs which could result from other stations raising their prices in the face of lessened competition.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

Moreover, the statutes have the effect of protecting the inefficient marketer of petroleum products at the expense of the more efficient one.

One of the reasons for the popularity of divorcement laws at the state level is that they are generally cast as measures aimed at protecting the small businessman from predatory practices on the part of "Big Oil." Sometimes they are introduced as much to punish the oil industry for its perceived role in the rising cost of energy as on the basis of their intrinsic merit. Surprisingly, it is not the major integrated firms such laws hurt. Rather, it is their main source of competition, the independent refiners who will bear the brunt of the burden.

On close examination, it becomes evident that the conflict addressed by divorcement laws consists of two elements. The first is between two groups of small businessmen: retail service station operators and oil jobbers, and the other is between the retail service station operators and the medium-sized independent refiners. The major integrated firms, while opposed to the concept on principle, are not the key factor.

Given the widespread concern over rising energy prices, and the pervasiveness of moves to enact divorcement laws at the state and federal level, it is critical that accurate information be available to key decisionmakers concerned with the issue. All too often, rhetoric and obfuscation have dominated the debate, to the detriment of the public interest. It is therefore useful to take a detached, dispassionate look at retail divorcement.

THE SEEDS OF CONFLICT

During the 1973-74 oil shortage which resulted from the OPEC embargo, officials in Maryland received complaints from retail service station operators that gasoline supplies were being distributed in an inequitable fashion. It was their contention that retail outlets operated directly by producers or refiners were receiving preferential treatment at the expense of the independently operated stations. The State Comptroller, Louis Goldstein, was instructed by the Governor to conduct a market survey to determine the validity of these allegations. The results of the survey indicated that the company-operated retail outlets did appear to have received preferential treatment in receipt of gasoline supplies, and the State Comptroller then proposed legislation which he claimed was aimed at alleviating the problem. There were two key provisions to the law. The first prohibited refiners and producers from opening new company-operated outlets:

> ...After July 1, 1974, no producer or refiner of petroleum products shall open a major brand, secondary brand, or unbranded retail service station in the State of Maryland, and

> operate it with company personnel, a subsidiary company, a commissioned agent, or under a contract with any person, firm, or corporation managing a service station on a fee arrangement with the producer or refiner. The station must be operated by a retail service station dealer.... (Md. Ann. Code Art. 56 Sec. 157E)

The second provision mandated the cessation of the operation of existing company-run outlets by the following summer:

> ...After July 1, 1975, no producer or refiner of petroleum products shall operate a major brand, secondary brand, or unbranded retail service station in the State of Maryland with company personnel, a subsidiary company, commissioned agent, or under a contract with any person, firm, or corporation managing a service station on a fee arrangement with the producer or refiner. The station must be operated by a retail service station dealer. (Md. Ann. Code Art. 56 Sec. 157E)

The impact of these two sections was to effectively bar the opening of retail outlets by any refiner or producer, and require that they either close or sell any stations they were then operating. As might be expected, the law was immediately challenged by the companies operating service stations in Maryland, and although it was initially overturned in trial court, it was subsequently upheld by the Maryland Court of Appeals, and the U.S. Supreme Court.

In the aftermath of the Maryland action, Florida and Delaware soon passed divorcement laws of their own, although each differed from the approach taken in Maryland. Florida's statute limited the number of company-operated outlets to 3 percent of the total number of service stations in the state; the Delaware law allowed existing company-operated stores to remain in existence, but barred the addition of more outlets of this type. Both of these laws, however were found to be unconstitutional. In 1979, Virginia, Connecticut, Louisiana, and the District of Columbia all saw divorcement legislation signed into law.

FEDERAL ACTION

One factor which is not well understood by the general public is that the original issue which gave rise to divorcement legislation in the first place has since been resolved at the federal level. As noted, the initial complaint arose from what was felt to be an inequitable allocation of supplies. However, under the provisions of the Emergency Petroleum Allocation Act of 1973 (PL 93-159), gasoline reductions must be made proportionately to all customers of a given refiner.

A secondary complaint of the Maryland station operators who first raised the issue was the arbitrary termination or cancellation of leases (franchises) by the producers. Here again, federal legislation has addressed the problem. In 1978, the Federal Petroleum Marketing Practices Act of 1978 prohibited such actions by requiring the producer to show cause in order to cancel or terminate a lease. The Act provides an appeals process through what is commonly referred to as the "Dealer Day in Court" provisions.

Given the fact that the principal complaints of the service station operators have been addressed at the federal level, the question then becomes whether some valid complaint still remains to warrant additional action. If no such complaint should be found to exist, then the rationale for the current momentum behind divorcement legislation must come into question.

THE CONVERSION QUESTION

One of the primary arguments currently put forward on behalf of divorcement legislation is that the major integrated oil firms are converting lessees to company-operated outlets, or are opening outlets near their leased stations, and underselling them in an effort to dominate the retail market. Were such action taking place, it would be anticipated that two trends would be manifest. The first of these would be a marked decline in the number of dealer-operated outlets, and the second would be a sharp rise in the number of company-operated outlets. The first of these trends is apparent in an analysis of the demographics of retail service stations in the U.S., but the second one is not.

What appears to have happened is, rather than pushing out the dealers, the major firms have been moving away from direct marketing operations in many instances. Taken together, the market share for company-operated service stations among the eight top refiners has decreased by 22.4 percent since 1972. This group includes Exxon, Amoco, Texaco, Shell, Arco, Chevron, Mobil, and Gulf. The latter four companies had increased their company-operated outlets through 1977, but between 1977 and 1979, reduced these operations by more than 25 percent. The number of outlets, however, is not the sole indication of the level of competition in a market: another approach to analysis would be to examine the percent of sales, or market share. Here again, certain trends would be evident if the major integrated firms were pushing the independent dealers out of the market.

In the event a scenario such as the one just described were in fact occuring, certain trends would be expected to be evident. Among them would be a decline in the market share of gasoline sales accounted for by the independent brand dealers, accompanied by a corresponding and equal increase in the share accounted for by company-operated retail outlets of the major refiners. As was the case with the number of service stations, the first trend is

apparent, but not the second. The market shares for gasoline for all refiners rose by roughly 4 percent between 1972 and 1979, while the market share for dealers supplied by refiners declined by 11.3 percent. However, the increase in the refiners' direct sales through their company-operated stores can easily be accounted for by the decrease in direct bulk sales (such as those to taxi firms, or auto dealerships) which came to 4.1 percent. The actual net change in overall direct sales by refiners was a decrease of 0.1 percent between 1972 and 1979. Where then did the difference go? To oil jobbers, wholesalers who take title to petroleum products and then resell them to gasoline stations or through their own outlets, by 12 percent, from 35 percent of sales to 47 percent of sales.

The major refiners' share of direct sales increased at an even smaller rate than did the overall market. Between 1972 and 1979, the major integrated firms increased their share of the market from 4.5 percent to 7.3 percent for a 2.8 percent increase. However, their bulk sales declined from 11.7 percent to 6.9 percent, or a 4.8 percent decrease. This meant that, overall, the major refiners reduced their share of the direct sales of gasoline by roughly 2 percent. In this instance, the increase in their jobbers' share of the market increased by 13.5 percent, again, accounting for the entire difference. Their dealers' share declined by 11.4 percent, from 56 percent of the market to 44.6 percent for the same period.

From these figures, it rapidly becomes evident that the responsibility for the decline in the market share of the branded independent dealer is not the result of predatory tactics on the part of the refiner, but rather, at least in part, from increased competition by independent jobbers. There are numerous reasons for this being a logical circumstance, but the primary reason is that the jobbers are increasingly marketing their gasoline through their own stations, where they offer much lower prices. The reason they can do this is that they do not offer the range of services which branded stations do, such as credit cards, accessories, and full mechanical service. More often than not, their outlets are of the self-service "gas and go" variety. As the Department of Energy noted in an internal memorandum concerning gasoline price control: "...gasoline marketing has experienced a number of changes. Self-serve islands, high-volume outlets, and convenience store/gas station operations have been introduced, but development of these and other new marketing concepts has been impeded by the regulations." Most importantly, the result of various impediments to the free operations of the market ultimately impose unnecessary costs on the consumer.

In the instance of retail petroleum divorcement, such costs are at least in part easily quantified, and significant.

THE COST TO THE CONSUMER

The preponderance of the evidence gathered through polls, market surveys, and other tests of consumer attitudes indicates that the single most important factor governing the purchase of gasoline in times of adequate supply is price. Moreover, it is axiomatic that the most efficient use of a society's resources is in its best interest. It is therefore surprising that retail petroleum divorcement should be presented as benefiting the consumer, as it both raises the price of gasoline at the pump, and encourages inefficiency in the retail petroleum market. Even more surprising, though, is the extent of the economic penalty consumers will bear should divorcement become enforced at the national level. To determine this impact, it is necessary to look at the situation which currently exists.

Gasoline is marketed through several different arrangements. Some service stations are leased to operators, who market under a company's brand name, and use their full range of services, such as credit cards and accessory lines (termed TBA for Tires, Batteries, and Accessories). Others are owned by an operator, who sells under a brand name and uses these services. Other stations are independently owned, and do not use the trademark of a particular company. In some instances, they are operated directly by small and medium-sized refiners. Branded stations leased to independent operators once dominated the market, but their market share has slowly eroded in the post-embargo era.

The reasons for the decline of the full-service, independently operated station are clear when the changes in oil prices are taken into consideration. The margin allowed independent dealers offering a full range of services is considerably higher than that allowed for self-serve operations. Since the ceiling price for such operations is higher, the average price charged by dealers who own or lease stations from the refiners tends to be higher than that at non-branded, or self-serve stations.

A survey by the Lundberg Letter indicated that the spread between company-operated stations and independently operated stations in the city of Baltimore was on the order of 2¢ per gallon. Similar surveys have indicated that in other areas the spread between the two types of stations could be from a low of around 1.9¢ per gallon to as much as 9¢ per gallon. Moreover, due to the different prices allowed various types of operations by the Department of Energy, the possible spread could be even more under some circumstances (such as a dealer having excessive banked margin).

At a minimum, what all of this means is that the company-operated stations turned over to the dealers would no longer afford the price competition they do at present. Therefore, at a minimum, it would be expected that their prices would be increased to at least the level of other leased stations in their area. Were the increase to be as low as that experienced in Baltimore,

the minimum cost to the consumer would be $247,589,500 on the gasoline sold at the retail outlets which were previously owned by the refiners. Should the dealers, in response to the slackened competition, raise their prices to the allowable ceiling, the total cost to the consumer would come to $1,493,998,200. However, this might not be the end of the round of price increases. There is evidence to indicate that many dealers, given a lack of competition, would raise their prices to the maximum allowed by law. Should the stations which were previously company-operated follow this pattern, the total bill to the consumer would be $2,411,163,700 annually.

BUCKING THE TREND

The real question which must be resolved with regard to retail petroleum divorcement legislation is whether it is performing a service to society by fostering further competition in a market threatened with monopolization, as its proponents contend, or whether it is really a measure aimed at protecting a special interest group from the effects of a changing market situation. In order to answer this question, a series of criteria must be examined. The first of these is whether, as proponents of the legislation contend, they are being forced out of business by predatory actions by major integrated refiners. A preliminary analysis of the motor gasoline market conducted by the Energy Information Agency of the Department of Energy examined the marketing practices of the 28 largest refiners (who constitute both the major and the intermediate firms) and concluded: "For example, the major integrated companines, Refiner Groups I and II, are among the leading sellers of gasoline to branded jobbers and unbranded marketers. In fact, they are the only two groups of refiners that have sold more gasoline to their lessee and open-dealers (directly-supplied) in January 1979 than the corresponding month in 1972. This would hardly support the assertion that major integrated oil companies are driving out the small independent businessmen."

Another study of the retail petroleum market conducted by the Petroleum Research Institute Foundation stated: "...at the consumer level, total supplies to independent outlets have continued their upward trend in market share in 1978. The major's decline in the share of retail gasoline market since 1973 and the rise in small and non-integrated companies and jobbers shares during the same period provide further evidence of the heightened competitiveness of the U.S. gasoline market."

Finally, a study by Lawrence M. Lamont and Charles F. Phillips, Jr. of Washington and Lee University in Lexington, Virginia stated: "The gasoline dealer's problem is a competitive one generated by an evolution in the retail gasoline market that has seen the price of gasoline nearly double, and become a major factor in the consumer's buying decision. As a result, 48 percent of Virginia consumers now express a preference for self-service

gasoline with its attendent price advantages. To meet this level of demand, major and independent refiners, jobbers, independent marketers and other newer market entrants have developed self-service gasoline outlets. Thus, the decline in the number of traditional service stations has occurred because this larger segment of consumers have chosen to shift to self-service outlets."

A second criterion which could help to ascertain the validity of the assertion that divorcement addresses the cause of the decline of independently operated service stations would be the determination if any other explanation for the phenomenon exists. Here again, we find evidence that does not support the position favoring divorcement. Rather than being pushed out of the market by the major integrated refiners, it appears that the main source of competition for the independent dealer is the petroleum jobber. As the DOE study states, "The notion that dealers (at least in part) are being driven out of business by other small businessmen such as jobbers or independent marketers could not be rejected...."

The effect on the independent marketer/refiner was noted in a speech before the College of Industrial Management at the Georgia Institute of Technology by Dr. Fred C. Allvine. He stated: "There are other less obvious aspects of marketing divorcement which you should consider. One of these is what the long-run impact of marketing divorcement on suppliers. There is no question in my mind that marketing divorcement would be particularly detrimental to the independent/refiner marketer segment of the petroleum industry. One of the primary ways that independent refiners have been able to offset the crude oil disadvantage they face has been by efficiently integrating refining and marketing. To deny the independent refiner/marketer an opportunity to continue to market a portion of his products directly would severely cripple this segment of the industry. In many areas of the country the independent refiner is a major source of supply to the private brand marketer. Thus, marketing divorcement will lead to a futher contraction in sources of supply for the private brand market."

A final criterion for assessing the relative merits of the notion of retail petroleum divorcement is whether it is deemed to be in the public interest in even a general sense. Here again, the preponderance appears to indicate the opposite. Dr. Allvine stated in his speech that "Marketing divorcement legislation is clearly not in the public interest. The DOE study indicated that in New York, the effect of retail divorcement would be to increase...the New York consumers' gasoline bill more than $1.5 million for the <u>single</u> month of July 1979." The Lamont and Phillips study states: "...divorcement legislation establishes an undesirable precedent that could lead to the inclusion of other competitors that market gasoline through company-operated stations for the extension of the legislation to other industries."

It appears that the evidence does not support the contention that retail petroleum divorcement would, as its advocates allege,

enhance competition in the retail petroleum market. Rather, it would appear that the primary thrust of the legislation is to provide protection from the normal forces of the market to a special class of businessmen. Dr. Allvine has stated: "The spread of marketing divorcement legislation would inhibit badly needed adjustments from occurring in the marketplace, be anticompetitive, contribute to greater inflation, and be contrary to the public interest."

CONCLUSION

As with so many issues, the debate over retail petroleum divorcement presents a sharp dichotomy over what exactly constitutes the public interest. Its proponents would portray themselves as hapless victims of rapacious corporations, struggling to survive in the face of unfair and predatory practices. Their characterization most certainly strikes a responsive chord among a significant segment of the general public and the media. In spite of the popular appeal of the dealers' allegations, though, they do not bear up under close scrutiny. As Dr. Allvine noted, "What is marketing divorcement legislation in the Maryland variety really all about? To a very large extent, it is class legislation designed to protect brand dealers from changes occurring in the market place. We all know that there are far too many major brand stations to efficiently serve the needs of the public. Dealer organizations are attempting to slow the badly needed attrition of major brand service stations. Furthermore, marketing divorcement will reduce the growth of gasoline-convenience store operations which is winning increasing public acceptance."

Clearly, marketing divorcement is not what it is portrayed. Nor are its effects ones that the general public would wish on itself, were it aware of their true nature. At a minimum, the implementation of such legislation at the federal level would cost the consumer around $250 million each year, and the total cost could run as high as $2.4 billion annually. It would also encourage the continued operation of inefficient outlets, and reduce competition. Most importantly, perhaps, is that it will not do for the independent dealers what they believe it will do. As Lamont and Phillips point out: "Divorcement legislation will not alter the competitive pressure on gasoline dealers from other price marketers nor will it stop consumers from expressing preference for low priced gasoline."

Milton R. Copulos
Policy Analyst