Office of the Attorney General
State of Arizona

TESTIMONY OF ARIZONA ATTORNEY GENERAL TERRY GODDARD

JOINT HEARING OF THE SENATE COMMITTEE ON COMMERCE, SCIENCE AND TRANSPORTATION AND THE SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES

ARIZONA GAS CUSTOMERS: A CAPTIVE AUDIENCE

INTRODUCTION

I respectfully submit this testimony as the Arizona Attorney General on behalf of Arizona's consumers and businesses.

During two recent gasoline market disruptions, one in 2003 and one in 2005, our state has suffered from major gasoline price spikes that left consumers and business struggling to make ends meet.

Arizona consumers and businesses have little legal protection against arbitrary and excessive price hikes, since our state does not have anti-price gouging legislation. My Office has used every investigative tool at its disposal under Arizona's civil antitrust and consumer fraud statutes, but these tools are less than effective against the practices of the oil and gas industry.

Just as I have strongly supported an anti-price gouging law for Arizona, I also support the enactment of a national anti-price gouging statute. A federal law, which would allow state Attorneys General to take action in their own state courts and compliment any existing state anti-price gouging measures, would greatly benefit this Nation's consumers.

I. THE ARIZONA EXPERIENCE

A. The 2003 Pipeline Rupture: A Lifeline Broken

On July 30, 2003, the Kinder Morgan gasoline pipeline running from Tucson to Phoenix ruptured, cutting off approximately one third of Phoenix's fuel supply.[1] Consumer "panic buying" exacerbated supply shortages, causing gasoline stations to run out of fuel and fuel prices to skyrocket. My Office received and verified consumer complaints that some retail stations were charging more than $4 per gallon for gasoline. Although the broken pipeline primarily affected the Phoenix supply of gas, there were significant, if less drastic, price increases in the rest of our State as well (see Attachment A). In the weeks following the pipeline rupture, my Office received more than 1,000 complaints of alleged "price gouging".

The only tools at my disposal to investigate alleged violations of law during pipeline break were Arizona's civil antitrust[2] and consumer protection statutes.[3] Pursuant to Arizona's antitrust act, the Attorney General may investigate alleged anticompetitive behavior and file a civil suit if there is evidence of collusion, such as price fixing, or exploitation of market power by a firm with a dominant market share. Our consumer fraud act prohibits the use of any deception or misrepresentation made by a seller or advertiser of merchandise. While both statutory schemes are crucial consumer protection tools, they have proven ineffective in protecting Arizona consumers against sudden, drastic gasoline price increases inflicted during an abnormal market disruption.

After the pipeline break, my Office issued civil investigative demands to gasoline suppliers under Arizona's antitrust statutes, to determine whether any illegal, anticompetitive, or collusive behavior contributed to the soaring prices consumers were paying at the pump. The investigation revealed no violation of Arizona's antitrust laws but did reveal that profit margins during that period were two to three times higher than profit margins when there was no supply disruption.[4] However, the increased profits earned by the wholesale and retail segments of the industry during and immediately after the supply disruption underscored the need for an anti-price gouging law that would protect consumers from profiteering during a supply emergency.

Our 2003 antitrust investigation following the pipeline break led me to conclude that there is a serious supply problem in Arizona and many Western states, especially during a supply disruption or emergency. The West's gasoline supply is tighter and thus more vulnerable to price spikes and product shortages than other areas of the country because we have very few pipelines to transport refined product[5], rapid population growth in Phoenix, Las Vegas, and Central and Southern California, geographic isolation from alternative suppliers, and

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[1] The Phoenix metropolitan area is Arizona's largest population center.
[2] Arizona Revised Statutes § 44-1401 *et seq*.
[3] Arizona Revised Statutes § 44-1521 *et seq*.
[4] Many other state and federal antitrust investigations failed to establish violations of antitrust law.
[5] Arizona is almost completely dependent upon two rather small Kinder Morgan pipelines to bring fuel into the State. One is from Texas and the other is from California (see Attachment B).

specialized fuel blends, which may deter alternative suppliers from refining gasoline for the Western states.[6]

Moreover, the entire oil industry has moved to a "just-in-time" delivery system, vastly reducing the numbers of refineries nationwide, and minimizing inventories at storage sites ("tank farms"). The effect is a constant and precarious supply/demand balancing act, which is exceedingly beneficial to industry in lowered operating costs, but very harmful to consumers as supply vulnerability sets the stage for price spikes. The slightest interruption with one of the two pipelines or with any of the refineries that produce Arizona's special fuel blend causes shortages and price spikes in our gas market. This unstable supply situation creates an opportunity for oil companies and gasoline retailers to increase prices and profits during any supply disruption, and particularly during emergencies.

Among the surprises coming out of the post 2003 pipeline break investigation in Arizona was the discovery that the oil industry has so little flexibility. Arizona had almost no ability to obtain petroleum products by alternatives to the pipeline. It was not possible to move gas by tank car since the railroad yards had few storage tanks or facilities to off-load gas. In addition, there was little ability to ship large quantities of gas by truck on short notice. Not only were most of the tanker trucks already spoken for elsewhere, driver hour restrictions prevented overtime to relieve the pressure in Arizona. The Governor requested and received an extension of the overtime limits, which provided some relief. It was not possible to use the National Guard tank trucks since most were on deployment in Iraq and those remaining were incompatible with commercial nozzles. In addition, most military drivers were not licensed to carry petroleum products on the highways.

Additionally, the specialized fuel blends used in Arizona were hard to replace with alternative sources. As a result, the Governor requested, and was granted, a waiver by the Environmental Protection Agency, which allowed the Phoenix area to use conventional fuel for a limited period of time during the disruption. While these measures were intended to alleviate the supply shortages, they had minimal immediate effect since they took time to implement.

Although it seems counterintuitive, any calamity that disrupts the oil and gasoline market seems to benefit the oil industry. Virtually any bad news means higher prices and much higher profits for the industry. Since prices tend to come down much more slowly than they go up, all segments of the industry reap benefits. Given the financial windfalls involved, there is no incentive for industry

[6] Peterson D. and Mahnovski, S. 2003. "New forces at work in refining: Industry views of critical business operations trends", Rand Corporation. Retrieved May 17, 2004 from www.rand.org/publications/MR/MR1707/.

to improve infrastructure or provide supply "cushions," as those measures would only stabilize prices and benefit consumers.

To further complicate matters, the lack of transparency in the oil industry, both with respect to upstream pricing and supply, often leads to uncertainty and confusion among consumers and government agencies alike. When we consider the importance of gasoline to our daily life, our economy, and our security, this lack of transparency is alarming. Not only do consumer fears of stations running out of gas lead to "panic buying," but many state and local government officials are left guessing about the fuel supply situation when a supply emergency occurs.

Recognizing that persistent supply disruptions were not unique to Arizona, I looked for ways to coordinate state and federal dialogue regarding gasoline issues. In 2004, I co-chaired the National Association of Attorneys General's Gasoline Pricing Task Force with then Nevada Attorney General Brian Sandoval. We held face-to-face discussions with the United States Department of Energy, the Environmental Protection Agency, the White House Office of General Counsel, and the Federal Trade Commission about the causes of high gasoline prices especially in Arizona and the Western United States. Every federal agency we spoke to directed us to a different federal agency to discuss our concerns.

I concluded from this effort that no single federal agency is responsible for ensuring a stable, affordable supply of gasoline for the nations' consumers and businesses. The alphabet soup of agencies involved in oil and gas oversight has the inevitable consequence that no agency has responsibility. It is left to the state enforcers, then, to investigate and prosecute illegal, exploitative behavior, especially during a disaster.

B. The Ripple Effect: Katrina and the 2005 Experience

Late this summer, Arizona, like the rest of our Nation, experienced significant fuel price spikes attributed to Hurricane Katrina. In the month prior to Hurricane Katrina, Arizona's fuel prices were at or around the national average prices. Then, although Arizona receives its fuel from California and West Texas—not the Gulf Coast areas afflicted by the hurricane—Arizona prices spiked to approximately 15 cents above the national average in the hurricane's aftermath (see Attachment C).

Consumer reaction was strong. Since the beginning of August 2005, my Office has received hundreds of consumer complaints regarding high gasoline prices. An overwhelming number of these complaints reference price gouging and point to 30 cent price increases at retail gasoline stations that occurred at the time Hurricane Katrina struck the Gulf Coast.

Although, in the past, Arizona's fuel prices sometimes exceeded the national average, the price at the pump seldom, if ever, exceeded California's prices. There is good reason for this. Approximately two-thirds of Arizona's gas comes from California, so we are subject to the same supply dynamics as California. In addition, California's gasoline taxes are approximately 10 cents higher than Arizona's. Yet, for nearly two weeks, in early and mid September 2005, Arizona's prices exceeded California's prices by about 8 cents per gallon (an 18 cent difference when adjusted for the tax difference).

Concerned about possible market and supply manipulation and alleged misrepresentations by the oil industry, I issued antitrust <u>and</u> consumer fraud civil investigative demands allowed under Arizona law to Arizona fuel wholesalers and retailers. My Office is currently reviewing the information provided to determine whether any anticompetitive or fraudulent activity occurred during that time period.

C. The "Replacement Cost" Factor

Gasoline retailers and their trade associations claim that gasoline stations must immediately raise their prices in response to a threatened supply disruption because they must raise enough money to pay for their next shipment of potentially higher priced fuel. They call this arbitrary and speculative behavior "replacement cost" pricing. Whatever the reason, gasoline retailers actually seemed to be competing to <u>raise</u> prices during the Katrina episode. I personally observed that as soon as one station posted higher prices, others in the area quickly matched it. To do otherwise, retailers told my Office, would be to risk being overrun by customers and pumped dry.

Unfortunately for consumers, retailers only adhere to "replacement cost" pricing when raising prices. They are very slow to lower their prices as the supply emergency abates and replacement costs decrease. This phenomenon is so widely known that it is commonly referred to as "up like a rocket, down like a feather." According to AAA Arizona, post Katrina and Rita profit margins for retail gasoline stations in Arizona swelled to three times higher than normal. "As wholesale prices drop, station owners tend to pass along those savings to motorists at a snail's pace." Ken Alltucker, *State's Gasoline Retailers Cash in. Stations Pocketing Year's Biggest Profits*, Arizona Republic, November 1, 2005.

Documents provided by some retailers and wholesalers in response to my Office's current investigation corroborate AAA's statements about higher-than-normal profits. Preliminary information indicates that some Arizona retailers, whose average per gallon profit margins prior to Hurricane Katrina were 10 cents per gallon, were suddenly making profit margins of 30 cents after Hurricane Katrina struck. At least one Arizona wholesaler's profit margin was 22 cents per gallon post Katrina, when its pre Katrina profit margins were six to nine cents per gallon.

II. LEGAL REMEDIES: PRICE GOUGING LEGISLATION

A. What is Price Gouging?

Of the 28 states, the District of Columbia and two territories with protections against price gouging, none has identical legislation. Thus, nationally there is no common definition of "price gouging". However, there are some common elements. Most states require that a state of emergency be declared[7] for the law to go into effect, and most cover pricing of essential products and services only.[8] Some states prohibit any price increase during a state of emergency, while others allow a 10 or 20 percent increase.[9] While some states prohibit only retailers from increasing their prices and profit margins, others have more effective laws that hold the entire production and supply chain accountable.

B. Price Gouging Laws Work

Traditional price gouging laws are not in effect during periods of "business as usual". Rather, they only go into effect when the normal competitive checks and balances of the free market are disrupted by a disaster or other emergency. When a population is trapped and desperate for essential supplies, like food, water, shelter and gasoline, victims do not have the opportunity to shop around or wait to purchase essential products until the prices go down. Demand is steady regardless of the price, so unscrupulous businesses can and sometimes do take advantage of consumers.

Antitrust and consumer fraud laws cover some aspects of rogue business behavior; however, they are not designed to effectively protect consumers from price gouging. Traditional antitrust tools, which require an overt conspiracy, are unlikely to succeed in this highly concentrated industry where the small numbers of participants know exactly what competitors are doing from publicly available data and would have no need to meet or communicate directly to coordinate price activity. The best and perhaps the only way to effectively protect vulnerable consumers in these circumstances is through anti-price gouging laws.

[7] Most legislation requires the President or the Governor to declare the emergency, although some states allow counties and mayors to make the declarations to activate their laws. E.g. California includes the President, Governor, or County or City Executive Officer. Cal. Penal Code § 396.

[8] These products and services often include food, water, shelter, medical supplies, and fuel.

[9] Hawaii (H.R.S. 209-9) and Louisiana (LSA-R.S. 29:732, *et seq*. and 14:329.6 *et seq.*) do not allow any increase; California allows a 10% increase; Alabama (Ala. Code § 8-31-3) allows a 15% increase; New York (NY Gen Bus 396-R) prohibits an unconscionable or excessive increase.

III. ARIZONA'S PREDICAMENT

After each of the two major gasoline price spikes in Arizona, there was an outcry from Arizona consumers, pleading for my Office "to do something," to protect them. Most consumers simply *assumed* that charging exorbitant prices for essential goods, especially gasoline, during a time of crisis would be illegal. They were shocked to find out that in Arizona, as in many states, there are no such protections.[10] I listened to countless consumers angered and frustrated with the situation.[11]

While I shared my fellow consumers' outrage, it was my unfortunate duty to inform them that our State had no anti-price gouging law. I supported two efforts in the Arizona Legislature to pass anti-price gouging legislation. Both times, the bills did not even get a vote in committee and never reached the floor of either house.

I initiated investigations in 2003 and 2005 with the legal tools at hand: civil antitrust and consumer fraud law and their attendant remedies. Even if the evidence from my current investigation reveals what would be "price gouging" in any other state, under Arizona law I may not have a legal basis for suing the companies involved. Without evidence of collusion or deceptive conduct, our current antitrust and consumer fraud statutes do not provide consumer relief.

It is important that states have the ability to tailor their own state laws to the needs of their local communities, to cover the essential goods and services applicable to them, to address other local issues. However, it is also important that all Americans have some basic protections against price gouging. For this, a federal law could protect all American consumers against price gouging during national or regional disasters or abnormal market disruptions. I believe that not just gasoline, but all essential commodities and services should be covered in

[10] A poll by the *Arizona Republic* newspaper in December of 2003 revealed that 85% of Arizonans believe price gouging should be illegal.

[11] One Arizona consumer wrote:

> I am sure that you have noticed the continuing rise of gas prices. I understand there is a war going on, and now this hurricane will have some impact, but please take the following to heart. If gas prices don't go down, I may not be able to continue to take my child places, like 4-H meetings, the library, etc. I can't even visit my older child at college, and she is just 2 hours away. We will all have to consider whether or not to continue working, we may not have the means to even get to work. What about all the other bills, if we pay for gas to get to work how will we pay for our utilities and even our house payments. At present my family is spending about $500 a month just in gas. I don't know how much longer we can do this. Do you recommend we all get gas credit cards and max them out??? I don't know if you can do anything to help us out, if so please do something! There just isn't any reasonable answer for this that I can come up with. The American people need help!

both federal and state legislation. Water, essential foods, vaccines and other medical supplies, shelter and transportation all could be affected during a disaster or abnormal market disruption.

During a state of emergency, the normal supply and demand of the free market may be disrupted. Without legal protections, the suppliers of critical commodities can, and many will, charge what the market will bear. During a state of emergency, consumers have no market choice about where, and at what price, they can purchase essential commodities and services.

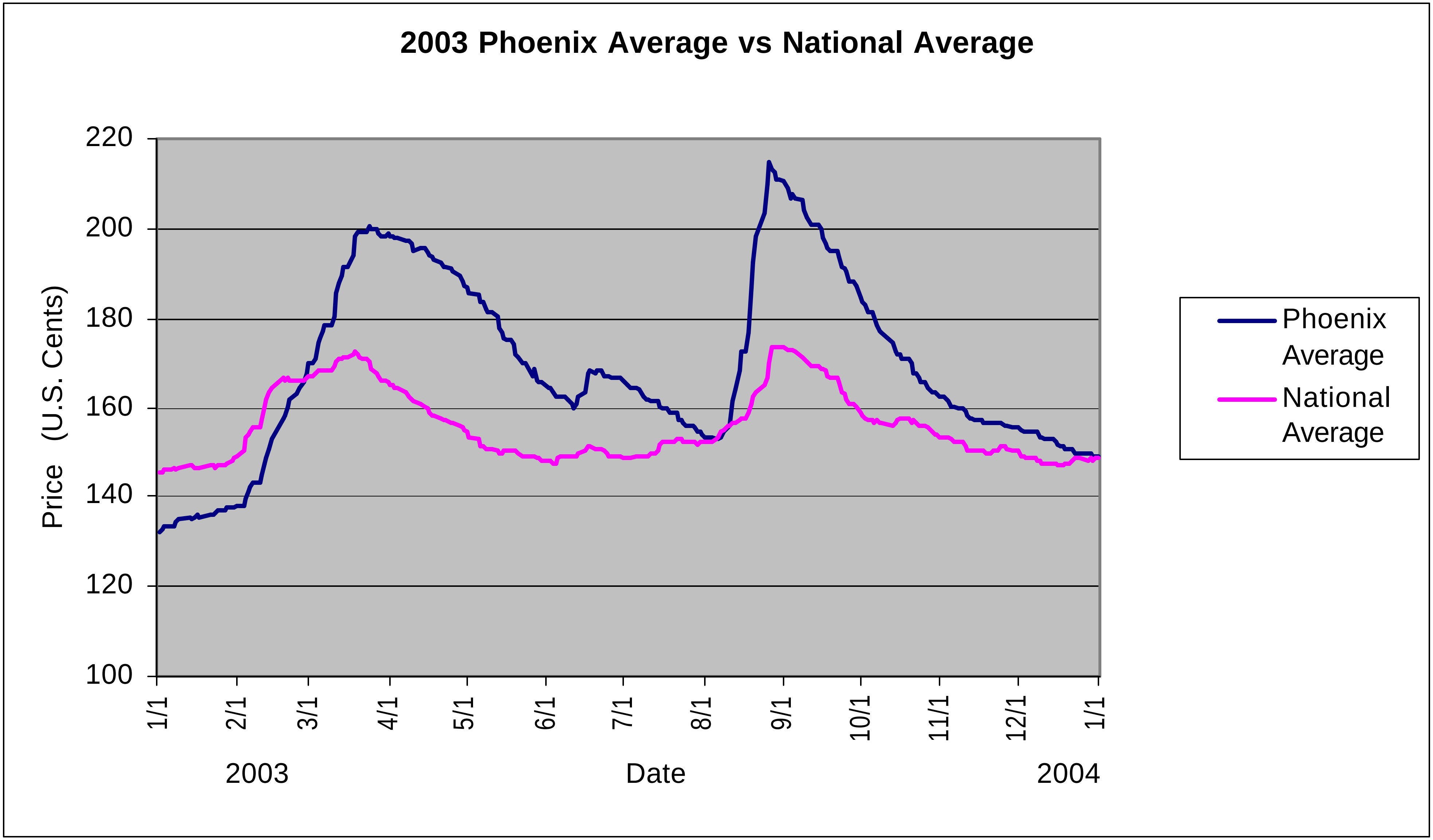
It is important to note that the oil industry's price increases have had a ripple effect throughout Arizona's economy. For instance, Arizona Public Service Company, one of Arizona's largest electric companies requested a 20 percent rate increase, citing increased fuel prices as a major factor behind its request. Arizona consumers will, in all likelihood, continue to feel the economic pinch of the post Katrina gasoline price increases for months to come.

CONCLUSION

The oil industry often tells us that high fuel prices are simply the result of supply and demand and that the market is the best arbiter of price. The fact is that the inelastic demand for oil and gas and the concentration of major industry players makes a mockery of competition. The "just in time" delivery system and a lack of alternative supplies means that any supply disruption, however slight, provides an excuse to raise prices. In the Arizona experience, price spikes mean larger profits for the industry, whether they are caused by the change in seasonal fuel blends, pipeline breaks, or major emergencies like Hurricane Katrina. In both major Arizona price spikes investigated by my Office, some Arizona gasoline companies enjoyed profit levels two to three times above pre-supply disruption profit levels.

I am here on behalf of Arizona consumers to tell you that market forces are not working. The industry's lack of reinvestment in refining capacity, product storage, and delivery infrastructure serves only the industry's financial interests, while exposing consumers, especially in states like Arizona without anti-price gouging laws, to huge price spikes when the market experiences a supply disruption. It is up to you, our nation's lawmakers, to stop this noncompetitive, exploitative and economically disruptive situation. I urge you to adopt an anti-price gouging law that will allow the Federal Trade Commission to protect consumers on a national level and state Attorneys General to protect consumers in the state courts.

ATTACHMENT A



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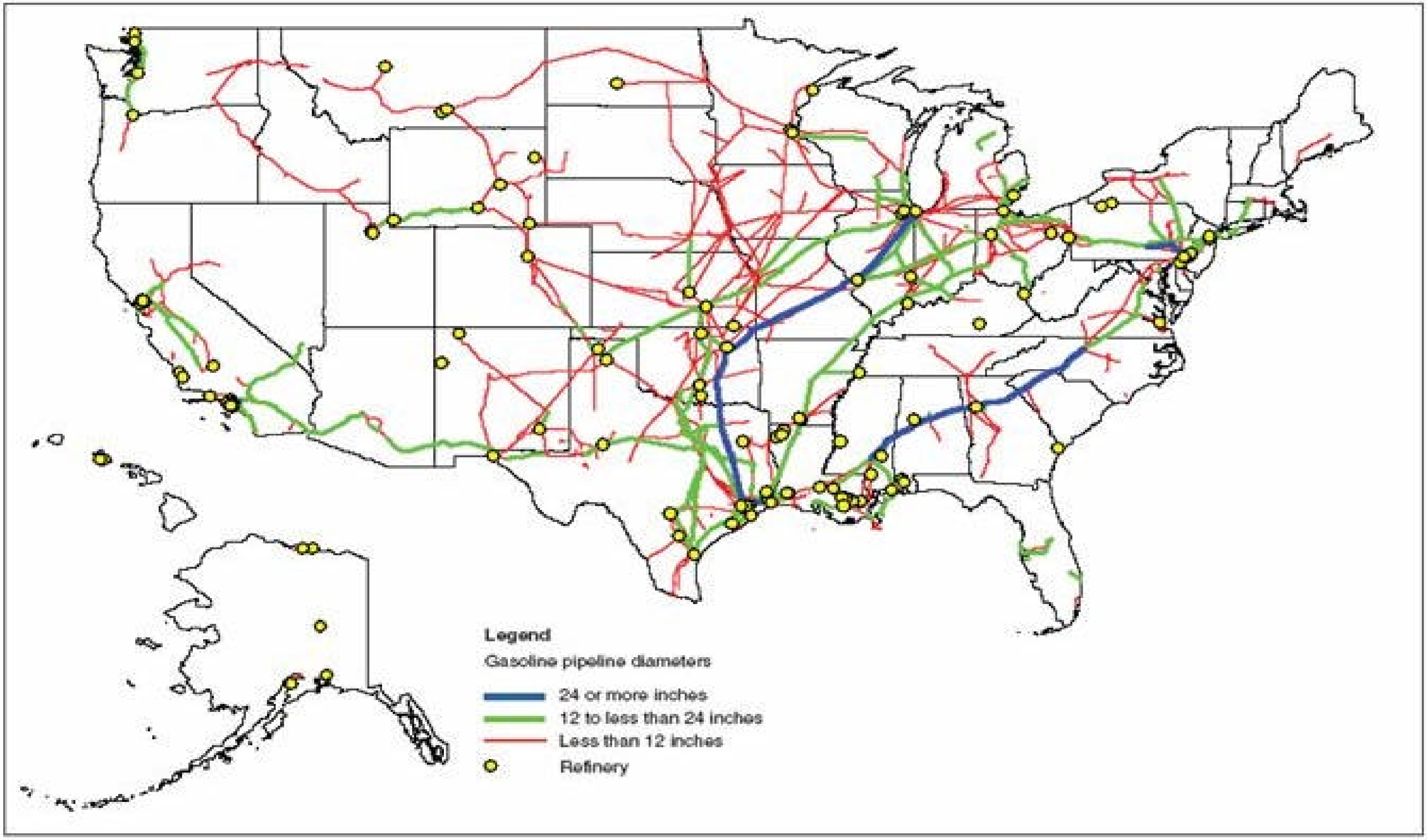
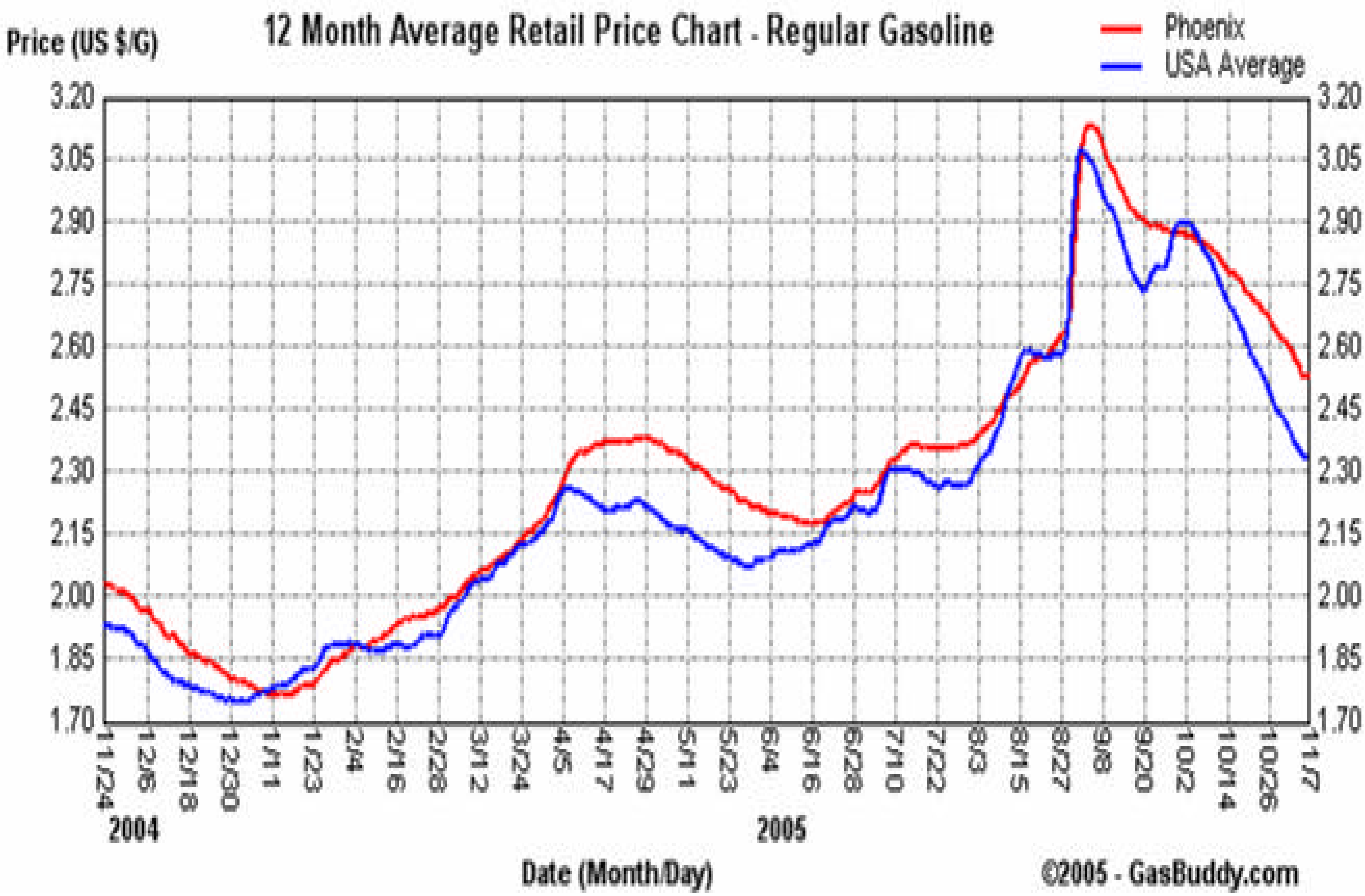
[12] Please note the price spike in mid-March of 2003 corresponded with the start of the war in Iraq. The later spike in September occurred after the Tucson-Phoenix gasoline pipeline ruptured.

ATTACHMENT B



Sources: GAO analysis of Department of Transportation and the Energy Information Administration data.

ATTACHMENT C



Price (US $/G)
12 Month Average Retail Price Chart - Regular Gasoline
Phoenix
USA Average
3.20
3.05
2.90
2.75
2.60
2.45
2.30
2.15
2.00
1.85
1.70
11/24
12/6
12/18
12/30
1/11
1/23
2/4
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10/14
10/26
11/7
2004
2005
Date (Month/Day)
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