

Testimony of

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**To the
Permanent Subcommittee on Investigations
of the United States Senate**

April 30, 2002

Thank you Mr. Chairman and Senators. It is my pleasure to be here today to testify before the Subcommittee. My name is Dave Reeves, and I am President of North America Products, a division of Chevron U.S.A. Inc., which is a wholly owned subsidiary of ChevronTexaco Corporation. In that capacity, I am responsible for all facets of refining, distribution, and marketing for Chevron in the United States (herein after "Chevron").

In the United States, we refine and market gasoline only under the Chevron brand. Although Chevron and Texaco merged last year, no Texaco refineries or retail service stations in the United States were ever intended to be a part of the merger. As a condition of approving the merger, the Federal Trade Commission (FTC) required the disposition of those refining and marketing assets by Texaco. They were sold to Shell in February of this year.

The staff of the Subcommittee has asked that we address certain issues in this written testimony, so let me turn to those issues. I will be pleased to answer any questions Subcommittee members may have on our gasoline operations and activities.

I. Gasoline Production and Delivery

Background – Chevron's Operations

Chevron is the sixth largest refiner in the United States⁽¹⁾. We market gasoline, diesel fuel, jet fuel, aviation fuel, and other petroleum products, on the West Coast, throughout the South, Hawaii, Alaska, and in portions of the Rocky Mountains. In addition, Chevron is a smaller marketer in the Mid-Atlantic region through jobber-served stations. We do not have refining or marketing assets in either the Midwest or Northeast.

Chevron operates six petroleum refineries with a total refining capacity of roughly 900,000 barrels per day. Our largest refineries have crude runs exceeding 200,000 barrels per day. They are located in Pascagoula, Mississippi, and El Segundo and Richmond, California. We have one medium-sized refinery, with a capacity of approximately 90,000 barrels per day, in El Paso, Texas, and two small refineries with a capacity of about 50,000 barrels per day in Honolulu, Hawaii and Salt Lake City, Utah.

Chevron's share of the gasoline market in the United States is roughly 6.6% ⁽²⁾. We sell gasoline in 28 states and the District of Columbia, through 8,200 Chevron-branded retail service stations, of three types – (1) stations owned and operated by Chevron (9% of the total), (2) independent dealers (20% of the total), and (3) stations owned and operated by jobbers or supplied by jobbers (71% of the total). The dealers and jobbers who sell our branded gasoline are independent business people who manage and run their own operations and who establish their own retail gasoline prices.

Changing Fuel Requirements – Federal & State

Over the last three decades, new environmental regulations and fuel requirements have significantly changed the refining and marketing of motor fuels. Nationally, those changes have included the phase-out of leaded gasoline beginning in 1973, vapor pressure (Reid Vapor Pressure or RVP) restrictions on conventional gasoline in 1989, the wintertime oxygenated fuels program beginning in 1992, and the federal reformulated gasoline program (Phase 1 in 1995, and Phase 2 in 2000).

In California, where we are the largest refiner ⁽¹⁾ and a major marketer of gasoline, the state has instituted its own more stringent fuels measures, including California Air Resources Board (CARB) Phase 1 gasoline in 1992 and California Cleaner Burning Gasoline (CBG2) in 1996. These changes have caused refiners to make major modifications to their refineries to make these new fuels. In Chevron's case, we invested over \$1 billion in our El Segundo and Richmond refineries in order to manufacture CBG2 gasoline. Due to the state's unique CBG requirements, the demand for gasoline is supplied almost entirely from West Coast refineries that have the ability to make the state's gasoline. In addition, several other states where we market have also instituted their own localized fuels controls.

New Fuel Requirements

Over the next decade, there will be new national requirements to produce new low sulfur conventional gasoline (average 30 ppm, beginning in 2004) and on-highway diesel fuel (maximum 15 ppm, beginning in 2006). The National Petroleum Council (NPC), a public-private partnership, estimated the domestic investment for these two requirements alone at more than \$12 billion for the industry ⁽³⁾. Additionally, new boutique fuel specifications will be required in several areas where we market, such as Atlanta, Georgia, and Birmingham, Alabama. Finally, many states, including California, are phasing out MTBE, requiring refiners to make further refinery modifications and to look for new fuels formulations.

As a major marketer in California, we have supported the mandate of Governor Davis to remove MTBE from gasoline. Our customers want it out, and so do we. However, this will require us to modify our refining and marketing operations again, to produce new California CBG Phase 3 (CBG3), and to blend ethanol once MTBE is removed. The extent of ethanol use, and its effect on consumers, will not be fully known until Congress

concludes its consideration of the pending energy bill. The size of a Congressionally-imposed ethanol mandate – whether newly enacted as part of the pending energy bill, or as a de facto result of the existing oxygen mandate when MTBE is removed – will impact fuel formulations, require design of new refinery and marketing facility modifications, and present new logistics, transportation, and distribution challenges.

Supply and Distribution Issues

The NPC recently undertook a study of United States product deliverability and refinery viability, focusing on a 2005 time frame ⁽³⁾. The NPC concluded:

“that the refining and distribution industry will be significantly challenged to meet the increasing domestic light petroleum product demand with the substantial changes in fuel quality specifications recently promulgated and currently being considered. The timing and size of the necessary refinery and distribution investments to reduce sulfur in gasoline and diesel, eliminate MTBE, and make other product specification changes such as reducing toxic emissions from vehicles are unprecedented in the petroleum industry. Large investments will be required at essentially all domestic refineries and many product terminals. It is imperative that the fuel specification changes and resulting required investment be appropriately sequenced with minimum overlap to mitigate the potential for major disruptions in supply and resulting significant price variations. Furthermore, regulatory agencies must streamline the environmental permitting process or significant implementation delays will result. With timely permits, proper sequencing of fuel quality changes with minimum overlap, and sufficient lead time to respond to each major specification change, the NPC believes that the domestic refining industry can be expected to satisfy product demand under the more stringent product specification requirements studied.” (Pg. 2)

The NPC study mirrors our own experience related to supply and distribution of petroleum products, and the increasing complexity we are experiencing. For example, our Pascagoula, MS refinery has already begun work on its new Clean Fuels Project. When completed next year, it will be one of the first refineries in the nation capable of producing both low sulfur gasoline and on-highway diesel fuel outside of California. The project will be completed in advance of national deadlines for these requirements. However, the project must be completed in time to meet local fuel requirements in Birmingham, Alabama, and Atlanta, Georgia - key marketing locations for this refinery. Localized fuels measures for air quality needs, in addition to upcoming national requirements, have made refinery planning more complex. But it has also significantly impacted the pipelining, supply, and distribution of finished products, as refiners move to produce and transport more grades and different formulations.

II. Mergers and Acquisitions in the Petroleum Industry

Similar to other business sectors of the economy, the petroleum industry in the United States has had to become more efficient by seeking ways to lower costs.

Chevron and Texaco completed their merger in October 2001, bringing together two United States-based companies to create a global exploration and production company with enhanced oil and natural gas reserves and production capabilities. The merger has strengthened our ability to compete worldwide with other petroleum companies.

As noted earlier, the merger had no impact on our U.S.-based refining and marketing operations. In 1998, Texaco, Shell and Saudi Refining, Inc. had formed domestic joint ventures for their refining and marketing operations. As part of our merger, Texaco's financial interest in those joint ventures was transferred to Shell and Saudi Refining, Inc. Because the facilities were already being operated by non-Chevron entities, there was no change in the competitive market as a result of the merger and no impact on gasoline supplies.

More generally, our view is that other mergers in the petroleum industry, whether focused on upstream or downstream, or domestic or international operations, have been driven by the same need for greater efficiencies and lower costs. As a result, the mergers have created stronger competitors. We see no connection between mergers and fluctuations in gasoline pricing.

III. Gasoline Pricing and Fluctuations

Pricing Practices

As indicated earlier, virtually all our gasoline is sold-through service stations we own and operate ourselves, through branded dealers, and through jobbers. It is both our philosophy and our practice to price our products competitively at all three levels of distribution – jobber, dealer, and retail. Whether it is the wholesale prices we set to our dealers and jobbers, or the retail price we charge at our own stations, we price our products so we and our independent dealers and jobbers can be competitive with the station down the street. If we price our products too high, our sales volume will drop. Conversely, if we set our prices too low, we may not be able to supply all the gasoline that our customers want to buy.

One issue apparently of interest to the Subcommittee is zone pricing. Zone pricing refers simply to the practice of pricing competitively in localized markets. It means identifying an area where we believe there are competitors to Chevron-branded stations and pricing our gasoline to allow our stations to compete for the business in that area. This permits Chevron to respond to competition in these localized areas and we are confident that it results in lower, not higher, prices for consumers.

I certainly understand the strain that prices for any important consumer product like gasoline can put on family budgets. In reality, however, the price of gasoline in the United States over the last 20 years (1982-1984=100) has increased less than the average price increase for all goods and services in the Bureau of Labor Statistics Consumer Price Index (CPI-U) "market basket" of those things purchased by the average American family. As of March 2002 ⁽⁴⁾, while the CPI has increased 78.8%, the average price of a

gallon of gasoline has increased by only 7.1%, or about one-tenth of the average for all other items. The attached table compares increases over the last 20 years of various categories of items that make up the CPI.

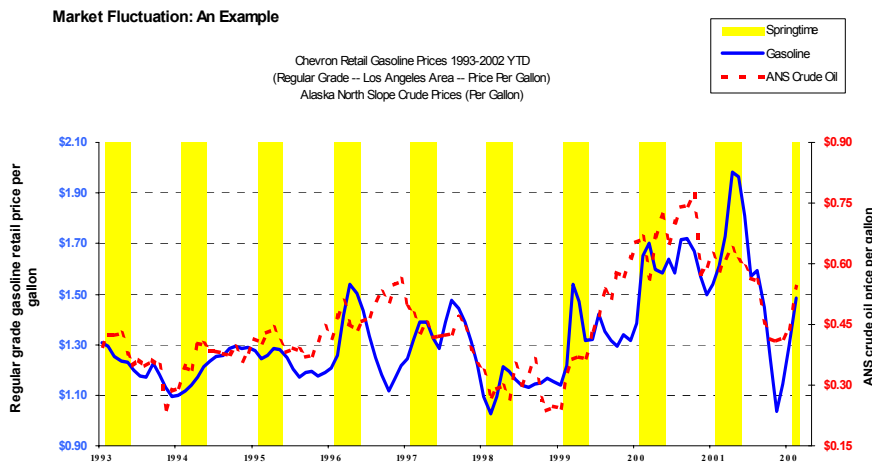
Category	Unadjusted Index %
Medical Care	282.0
Housing	179.1
Food and Beverage	176.6
Transportation (overall)	150.5
Apparel	128.2
Gasoline	107.1
Overall	178.8

Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers (CPI-U): U.S. city average, by expenditure category and commodity and service group

Price Fluctuations

Gasoline prices tend to fluctuate up and down more than many other products, sometimes quite rapidly. It is perhaps understandable that price increases tend to attract considerable attention from the public while price decreases almost go unnoticed.

As the following chart shows, much of the movement in gasoline prices, both up and down, tracks changes in the price of crude oil, which is the raw material for refining gasoline. The chart shows the average regular unleaded price of Chevron gasoline in Los Angeles compared to the average monthly price of Alaska North Slope crude from 1993 to the present time.



Note: Prices in then current dollars not adjusted for inflation. Gasoline prices include 32.1 cpg federal and state excise taxes and 8.25% sales tax in 1993 -36.4 cpg federal and state excise taxes and 8.25% sales tax in 2002.

Typical gasoline yields from a barrel of crude oil range from 40%-65%, depending upon refinery configuration.

It is useful to identify several of the factors affecting petroleum markets that have led in recent years to price fluctuations with which this Subcommittee is concerned:

- Rapidly changing crude oil prices. Crude oil prices have increased by more than \$6/barrel (or ~\$.15/gallon) since November of last year. While not always the case (since prices are also affected by markets for fuels), gasoline prices are influenced by the price of crude, all other things being equal. Uncertainty in the reliability of supply caused by tensions in the Middle East and Venezuela has also contributed to increased crude oil prices.
- Demand for gasoline continues to rise at an annualized rate of 2-3% in recent months. Higher demand puts upward pressure on prices.
- Refinery investments over several years have largely gone for environmental controls and modifications to meet new fuel specifications, rather than to increased capacity. This in turn has resulted in a constraint on any effort to add domestic supply capability.
- Changeover from winter-grade gasoline to summer-grade gasoline tends to result in decreased supply, as inventories in the distribution system are drawn down during this changeover period. As we move into the summer months, demand for gasoline increases, as people tend to drive more. United States refineries run at near capacity most of the year, and this increase in demand, when coupled with the pressure that places on refineries already running near capacity, can put upward pressure on gasoline prices and lead to price fluctuations.

Gasoline prices today, although rebounding from 30 month lows in the 4th quarter of 2001, are still lower than they were a year ago at this time ⁽⁵⁾.

Government Investigations and Decisions

Energy in general, and gasoline in particular, plays a vital role in the United States economy. Because of that, there have been numerous government investigations of gasoline pricing and fluctuations in the last several years, including the work of this Subcommittee. We have participated in those investigations where we have been asked to provide input. Below are outcomes of several of those investigations and decisions in places where we market.

After a gasoline price spike in California in early 1996 followed the introduction of CBG2, the FTC initiated an investigation ⁽⁶⁾ into gasoline pricing in the Western States. We cooperated fully with the FTC in that investigation. In May 2001, after an almost three-year investigation, the FTC concluded its investigation, finding there was no evidence of price-fixing by Chevron or the other refiners, and no evidence of any other federal antitrust violations.

The Government Accounting Office (GAO) also recently looked at gasoline prices in California. In its report, "Motor Fuels California Gasoline Price Behavior" (April 2000) ⁽⁷⁾, the GAO reported:

“Many federal, state and oil industry officials told us that the higher price spikes in California were caused primarily by unplanned refinery outages that disrupted the state’s tight balance between gasoline supply and demand. Because California’s refiners produce at almost full capacity, supply disruptions caused by refinery outages must be made up from other sources, such as out-of-state providers. However, obtaining gasoline from such providers is slow and costly because only a few out-of-state refineries can produce gasoline that meets the state’s stringent emission-reducing standards and the gasoline must be shipped by tanker from far-away locations.” (Pg. 4).

When prices fluctuate in response to changes in supply and demand, it shows that the market is responding in a normal manner. When supplies are tight, rising prices serve to dampen demand and attract additional supplies. That was the conclusion of the GAO ⁽⁷⁾, and the California Energy Commission ⁽⁸⁾ with regard to the price spikes in California in 1996 and 1999.

“On April 1, 1996, an explosion at the Shell refinery in northern California virtually shut down the refinery’s production, which amounted to about 100,000 barrels of gasoline a day. Before the Shell refinery was fully repaired, explosions and mechanical problems disrupted operations at several other refineries. According to the Energy Information Administration (EIA), these disruptions affected about 12 percent of the state’s production for several months. Our analysis showed that California gasoline prices spiked about 39 cents per gallon that spring. The spike was primarily due to the refinery disruptions, according to CARB and oil industry officials. Gasoline was brought into California from as far away as Finland to make up for lost production.” (Pg. 12) ⁽⁷⁾

“The price increases of the spring of 1996 resulted from a combination of factors:

- A rise in crude oil prices globally;
- Seasonal demand increases for gasoline and diesel which are typically accompanied by price increases at the retail level;
- Lower inventories;
- An unusual combination of west coast refinery problems which significantly reduced the region’s production;
- The increased cost to produce California reformulation gasoline (CaRFG); and
- The effect of increased sales tax on a higher retail gasoline price.” (page 4) ⁽⁸⁾

“The rapid price increase experienced during the spring of 1996 evoked a normal response by the motor vehicle fuels market to correct the temporary imbalance. Refiners and other marketers reacted to the unplanned outages in the spring by quickly drawing from available inventories, increasing output of complying fuels and importing additional supplies to California. The market responded to achieve equilibrium, although with a certain amount of initial lag time inherent with a market that uses a unique set of clean fuel specifications.” (Pg. 11) ⁽⁸⁾
(same for 1999 price spike, Pg. 12-13) ⁽⁷⁾

A class action lawsuit alleging antitrust violations, called *Aguilar v. Atlantic Richfield Co. (ARCO)*, 25 Cal.4th 826, 107 Cal.Rptr.2d 841 (2001) ⁽⁹⁾, was also filed as a result of the same 1996 gasoline price spike. In June 2001, the California Supreme Court unanimously rejected the claims in the lawsuit. As the Court described:

“[T]he petroleum companies' evidence showed independence rather than collusion as to their most fundamental strategies with respect to CARB gasoline. For example, at one end of the range, there was Chevron's altogether active plan, which was to "gain an advantage over its competitors by becoming the largest producer of CARB gasoline in the world." At the other end, there was Union Oil's relatively passive stance, which would put it at a disadvantage vis-à-vis its competitors in this regard, and would lead it to exit the market completely." (Pg. 39)

The Court also found no evidence of impropriety with regard to supply contracts. It said the evidence did not:

"even imply collusive, rather than independent, action." (Pg. 41)

The Court referred to the lower court's 38-page recounting of the evidence showing competition rather than conspiracy. *Aguilar v. Atlantic Richfield Company*, 92 Cal. Rptr. 2d 351 (2000) ⁽¹⁰⁾. As the Court summarized:

“Billions of dollars were invested overall with widely disparate capital expenditures to convert refineries to produce the new gas. . . . The industry experienced profound change. No one disputes that gasoline supply was tight and prices rose dramatically [T]he only logical inference . . . is Defendants' actions were a pro-competitive response to a regulatory requirement which forced members of an oligopoly to restructure their product mix and incur substantial additional capital expenditures.” (Page 46)

IV. What Can Be Done

This Subcommittee has asked us what we can do on the issue of gasoline price fluctuations. One factor that has caused price fluctuations has been supply disruptions from unplanned refinery outages. To address this, Chevron has set a goal to achieve industry-leading performance in “Operational Excellence”, and a lot of our effort today focuses on this goal. Operational excellence means having safe, reliable, efficient, and environmentally sound operations. With an underlying tenet of “Incident Free Operation”, operational excellence has the added benefit of helping us to be reliable suppliers of gasoline, thereby decreasing this potential cause of price fluctuations.

Another important step we take is to be fully ready to meet new government requirements for fuels. We have a formal “management for change” process that involves rigorous planning by multi-functional teams to ensure that when significant changes are made to our operations, they will happen smoothly and without incident. We are implementing “management for change” throughout our refining, marketing, and supply and distribution systems, to meet the many new requirements we see before us. Where we

can, we are making wise and prudent investment decisions to combine refinery and marketing modifications and sequence changes in the most efficient way we can. However, I don't want to underestimate the challenges before us, as companies have to make difficult choices of where and when to invest limited capital for projects.

But government can also take steps to ensure reliable supplies of gasoline and other fuels are available for the American consumer. It is most important that government allow the free market to work as efficiently and effectively as possible. Government can set performance-based standards while taking steps to limit, minimize, and eliminate unneeded mandates and subsidies. Congress is currently considering a very important example of that in its debate of a renewable fuels standard in the Senate energy bill. While we are willing to accept a reasonable – and reasonably phased-in - ethanol mandate as part of a comprehensive solution to address the MTBE issue, we have supported Senator Feinstein's efforts to make sure the size and timing of a new renewables standard in the early years of the program does not adversely impact California, as the state moves forward to phase out MTBE use. Unfortunately, her amendment was not included in the energy bill approved by the Senate last week.

Government should also streamline permitting wherever possible while maintaining environmental protections. With all the new requirements we have before us, it is important that we are able to get the permits we need, make the refinery and marketing facility modifications necessary, and make new fuels on time so that the environmental benefits are achieved and the motoring public is reliably served. Congress should also address the unintended consequences created by the proliferation of boutique fuels that has occurred over the last 10 years. Moving toward regional or more uniform fuel specifications will help reduce constraints on the supply and distribution of petroleum products which has become much more complex in recent years.

Thank you again, Mr. Chairman and Senators, for the opportunity to testify before your Subcommittee today. I would be happy to answer any questions you or other members of the Subcommittee might have.

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V. References

- (1) Energy Information Administration, "Petroleum Supply Annual 2000", Volume 1, pages 105-108. Note: reference (1) updated to reflect refinery dispositions resulting from FTC approved mergers involving Chevron-Texaco, Phillips-Tosco, and Valero-Ultramar Diamond Shamrock to determine that Chevron is the sixth largest refiner in the U.S.
- (2) Lundberg Survey Inc., "Preliminary National Share of Market Report – August, 2001", February 19, 2002.
- (3) National Petroleum Council, "U.S. Petroleum Refining", June 2000.
- (4) United States Department of Labor, Bureau of Labor Statistics, Consumer Price Index: March 2002.
- (5) Lundberg Letter, March 13, 2002.
- (6) Federal Trade Commission 5/7/2001 Press Release, "FTC Closes Western States Gasoline Investigation".
- (7) United States General Accounting Office, "Report to the Honorable Dianne Feinstein, U.S. Senate, Motor Fuels, California Gasoline Price Behavior", April 2000.
- (8) California Energy Commission and California Air Resources Board, "Joint Report to the Legislature, Motor Vehicle Fuel Price Increases", January 1997.
- (9) Aguilar v. Atlantic Richfield, California Supreme Court decision.
- (10) Aguilar v. Atlantic Richfield, Appellate Court decision.

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